SMITH AFFILIATED CAPITAL

FOURTH QUARTER 2017 INVESTMENT COMMENTARY

FED UNWINDS DESPITE INFLATION "MYSTERY"

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Mother Nature upended the economic landscape during the late summer months, as Hurricanes Harvey, Jose, and Irma wreaked havoc domestically. The cost to the economy in terms of lost sales, output and worker hours will not be known for some time. Private and government statisticians will probably not have a full reckoning until next year. From our lens, the storms took a meaningful bite out of the economy's growth rate in the third quarter, perhaps lowering it from a pre-hurricane consensus forecast of 2.7 percent to about 2.0 percent, with all of the damage inflicted in August and September.

No doubt, some of the lost activity will never be recovered. A haircut not taken in late August is unlikely to be replaced by two visits to the barber in September. Likewise, a restaurant customer is not likely to replace a lost meal with two trips to a favorite eating place. But the vast majority of lost sales and output will be made up in coming months. The rebuilding efforts, in turn, will add muscle to the economy's growth rate in the fourth quarter, boosting the demand for construction materials and workers as well as for goods and services from an array of related industries supporting the rebuilding process. Even the auto industry, which has seen sales languish this year, will get a boost as owners replace the estimated half-million vehicles wiped out by the hurricanes.

But at best, the rebuilding efforts will restore ground lost and not propel the economy beyond the lackluster 2.0 percent growth trajectory seen since the Great Recession. It remains to be seen if the rebound from the weather-related setback will be strong enough for the Federal Reserve to pull the rate-trigger in December, fulfilling its planned three hikes this year. Assuming that growth does accelerate, the Fed will still need evidence that inflation is moving higher to justify an increase. Despite the recent inflation lift from a temporary storm-induced spike in gasoline prices, that prospect remains more of a hope than reality. Wage growth remains stagnant, goods are still in a deflationary spiral, inflationary expectations are declining and consumer spending is weakening. Official data may reveal a historically low unemployment rate, but inflation models based on the Phillips Curve have broken down and are losing credibility even among some Fed officials.

3 Percent Growth Not Sustainable

As expected, the economy rebounded from the tepid 1.2 percent first-quarter growth rate to a respectable 3.1 percent in the second quarter. The Trump administration immediately took heart from the rebound as it confirmed its promise to lift growth from the historically low 2 percent trend throughout the recovery to 3 percent or more. But, as noted, that promise has already been diluted by current events, as the hurricanes slashed third-quarter growth back down to the 2 percent pace. True, the growth-dampening shock effects will wear off and be replaced by faster growth in the fourth quarter. We doubt, however, that the revival will restore all of the lost ground during the fourth quarter, as the rebuilding benefits will spill over into 2018.

More important, the fundamentals that were evident before the storms hit indicate that the economy does not have enough horsepower to drive the growth engine up to 3 percent on a sustainable basis. Recall that consumer spending, the main growth driver came in much weaker than expected in July and the results for May and June were revised significantly lower. Hence, not only was there less momentum heading into the third quarter than thought, the period itself started on a limp note. Then came the August figures and things got even worse. Retail sales were again softer than expected during the month and, as was the case in July, the results for the prior two months were revised down again. True, Hurricane Harvey struck late in the month and appears to have made a dent in sales. But the hurricane damage came too late to have a meaningful impact, instead wreaking the most havoc on industrial production, where both utility and energy-related output was slashed. Housing activity was also impacted to a significant extent, particularly in Houston, which is the largest market for single-family construction.

By al By all accounts, the storm-ravaged South put an even deeper crimp in sales third quarter significantly, with the former pegging the rate at slightly over 1 percent. Simply put, even with a robust revival in, production and housing during September. As a result, the tracking models of the Federal Reserve Banks of Atlanta and New York lowered their growth estimates for the fourth quarter, growth for the entire year will look very much like 2016 and the six earlier years of the recovery. The new normal of 2 percent growth has yet to be upended and there is little prospect that the economy will move on to a stronger trajectory in 2018. The flattening yield curve and the weakening dollar echo that prospect; indeed, even the Fed's latest survey of economic projections assume that growth will slow in 2018 relative to this year.

Growing Income-Spending Disconnect

With businesses reluctant to expand capital spending and the government having unwound its crisis-induced fiscal stimulus, consumers have done most of the heavy lifting to keep the recovery going over the past several years. Overall, households maintained a steady spending pace of around 2.5 percent through the first seven months of the year, almost spot-on with the average since the end of the Great Recession. But while households have largely lived within their means throughout the first six years of the recovery, a disturbing pattern has emerged since the end of 2015. In 2016, growth in incomes and spending diverged sharply, with real disposable incomes slowing dramatically even as spending held at the 2.5 percent pace. That divergence has continued this year. Over the past 1-1/2 years, incomes have increased at a 1.2 percent average annual rate, more than a full percentage point less than spending growth.

That is to say, households have been financing spending by dipping into savings. The personal savings rate, at 3.5 percent in July, is down 2.5 percentage points since the end of 2015 and well off the 5.5 percent average over the past twenty-five years. Significantly, virtually the entire decline occurred before the election, as the savings rate hit 3.7 percent in November. That, in turn, rules out the notion that the confidence boost following the election somehow made households more willing to live with a smaller savings cushion. The so-called "Trump Bump" did contribute to post-election euphoria on Wall Street and Main Street, but the change in consumer spending and savings habits took place well before the election.

Clearly, consumers cannot outspend their income gains for long. True, the simultaneous increase in household wealth, with net worth hitting an all-time high of $96.2 trillion in the second quarter, probably encouraged households to live with a lower savings rate, much as was the case during the dot-com boom in the late 1990s and the housing bubble in the 2003-2006 period. But in both 1999 and 2006, the previous periods of peak net worth and low savings rates, events did not end well. In those episodes, asset values were crushed by the dot-com bust in 2000 and housing collapse in 2007-2009. Households responded quickly to those events, reining in spending and pushing the savings rate back up. Not surprisingly, that behavior ushered in recessions, a mild one in 2001 and the Great Recession later on as household finances were further battered by the huge mortgage debts that fueled the housing boom.

No Wealth Boost This Time

Understandably, there are some who view the current upbeat measures of balance sheet health as a negative omen of things to come. After all, the higher asset values are, the more vulnerable they are to a collapse that could once again bring the economy to its knees. Many analysts believe the stock market is overvalued, ripe for a correction, and that home prices have increased too high too fast, pricing many buyers out of the market. Time will tell if those judgements are correct. A more worrisome development, from our lens, is the downshifting of income growth since 2015. Our concern is two-fold.

First, the slowdown in real incomes has occurred despite low inflation – the core inflation rate, which excludes volatile food and energy prices, is running at a 19-month low of 1.4 percent. Hence, consumer purchasing power has not benefited from lower inflation. Indeed, the longer inflation remains low, the greater is the incentive for consumers to hold back purchases in anticipation of lower prices. Second, the savings drawdown is not sustainable. The current savings rate is already near a historic low, so households would need to rely on other sources to sustain spending at the current pace. These include credit or assets. But households are reluctant to ramp up borrowing for a variety of reasons, including the still-raw scars from the financial crisis as well as the tougher standards they face from lenders. While appreciated asset values do instill more confidence and, hence, willingness to spend, most of the wealth gains from stocks accrued to upper-income individuals who are not likely to change spending patterns. Rising property values do benefit a broader segment of the population, but homeowners are more inclined to rebuild housing equity than use it as cash-dispensing machines as they did during the housing boom of the early 2000s.

Looking ahead, consumers should finance spending the old-fashioned way – by aligning purchases with income growth. But the slowdown in the latter over the past 1-1/2 years is not an encouraging omen. Most startling is that it has occurred despite the persistent fall in the unemployment rate, which the Fed and many others believe is already below its natural long-run rate. Yet despite the shrinking slack in the labor market, wage growth has been stuck at 2.5 percent over the past five months, well below the 4 percent increases seen in the advanced stage of the past three recessions. Fed Chair Yellen and the majority of Fed officials still cling to the premise that a tightening labor market will stoke wage inflation and bring the core inflation rate up to their elusive 2 percent target. But workers face formidable headwinds that are constricting their bargaining power.

Forget for the moment the unsettled question of whether the potential huge supply of labor that remains outside of the labor market is inhibiting wage growth of existing workers. No doubt, some of these sidelined workers would be lured back in if wages were higher; but the increased competition from these new entrants would weaken the bargaining power of jobholders, limiting their ability to demand higher wages. In addition to the wage-dampening effect of an increase in the labor force participation rate, the marked slowdown in trend productivity is also keeping worker pay in check, even as it reduces the economy's growth potential. In other words, the time-honored tradeoff between unemployment and wage growth – the so-called Phillips Curve – has weakened considerably. We suspect that unemployment can fall to well below 4 percent before stoking wage pressures, supporting the notion that the economy still has room to run.

After December, Fed Will Pause

Despite this backdrop, the Federal Reserve appears determined to normalize monetary policy. It has already announced plans to reduce its balance sheet starting in October and intends to hike short-term rates once more this year, followed by three more in 2018. The markets were prepared for the balance sheet shrinkage as it was telegraphed well in advance, but remained highly skeptical that another rate hike would be forthcoming this year, given the persistence of low inflation, until recently. However, since the September policy meeting, Chair Yellen, Governor Dudley and several other Fed officials have made hawkish comments, which heightened market expectations of a rate hike in December.

Barring the onset of very disappointing data, particularly on the jobs front, for October and November, we suspect that the Fed will likely pull the rate trigger in December. Yellen and the majority of the FOMC members appear convinced that the long-delayed upward pressure on wage inflation will still take place in the medium term as the unemployment rate continues to decline. Other Fed members, such as Lael Brainard and Charles Evans are less convinced, arguing that lowered inflation expectations and other fundamental factors have caused the inflation trend to downshift permanently. They would like to see the Fed maintain its current stimulus to raise inflation expectations or wait for more visible signs of an inflation pick-up. Although the more hawkish view seems to have the upper hand for the time being, even Yellen admits that she is somewhat mystified by the inflation slowdown this year and acknowledges that more permanent forces may be at work that could alter policy decisions going forward.

We suspect that a December rate increase would not deal a fatal blow to the economy, but doubt that a recovery that is mired in a lackluster 2 percent growth trend can withstand three more increases next year. The Fed is more worried about moving too gradually and falling behind the inflation curve than it is about moving prematurely and stifling growth. That thinking is a mistake. Recall that the December 2015 rate increase was based on the same premise and included a forecast of three more increases in 2016. But growth almost stalled out over the first half of 2016, and the Fed quickly put additional increases on hold until the last month of that year. More than likely, it will face the same prospect in 2018.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Bloomberg Barclays TSY Bellwethers)	09/30/2016	6/30/2017	9/30/2017	Last Quarter (1)	Last Year (2)
6 Mo. Bill	0.43	1.13	1.19	0.31	0.82
2 Yr. Note	0.76	1.38	1.48	0.20	0.02
5 Yr. Note	1.15	1.89	1.94	0.26	-2.00
10 Yr. Note	1.59	2.30	2.33	0.28	-4.58
30 Yr. Note	2.32	2.84	2.86	0.33	-8.61

Municipal Bonds	Yields (%)			Total Return (%)	
	09/30/2016	6/30/2017	9/30/2017	Last Quarter (1)	Last Year (2)
ML Rev 22+ Index	2.35	3.01	2.95	1.38	0.802
ML G.O. 22+ Index	2.33	2.89	2.80	1.59	-0.031

Equities	Levels			US $ Terms (%)	
	09/30/2016	6/30/2017	9/30/2017	Last Quarter (1)	Last Year (2)
S&P 500	2,168.27	2423.41	2519.36	4.48	18.60
DJIA	18308.15	21349.63	22405.09	5.58	25.45
NIKKEI (Tokyo)	16449.84	20033.43	20356.28	2.00	13.39

Commodities	US $			Percent Change (%)	
	09/30/2016	6/30/2017	9/30/2017	Last Quarter (1)	Last Year (2)
COMEX Gold Active Monthly	1315.75	1241.55	1280.15	3.11	-2.71
CRB Future Com. Pr. Index*	186.32	174.78	183.09	4.76	-1.73
West Texas Intermediate Crude ($ per bbl.)	48.24	46.04	51.67	12.23	7.11

Currencies	Levels			Percent Change (%)	
	09/30/2016	6/30/2017	9/30/2017	Last Quarter (1)	Last Year (2)
Yen	101.35	112.39	112.51	-0.11	-11.01
Sterling	1.30	1.30	1.34	2.86	3.28
Euro	1.12	1.14	1.18	3.4	5.15

Foreign Bond Markets	Levels			US $ Total Return (%)	
	09/30/2016	6/30/2017	9/30/2017	Last Quarter (1)	Last Year (2)
3-Mo. LIBOR DEM Fixing (3)	-0.35	-0.39	-0.39	N/A	N/A
ML German 10-Yr.+ Bond Index	0.18	0.92	0.92	4.34	-4.79
3-Mo. LIBOR Yen Fixing (3)	-0.03	0.01	-0.05	N/A	N/A
ML Japanese 10-Yr.+ Bond Index	0.22	0.46	0.45	0.18	-13.23

Source: Bloomberg Financial Data
Notes: 1) 12/31/2016 thru 3/31/2017 2) 3/31/2016 thru 3/31/2017
*Thomson Reuters/Jefferies CRB Commodity Excess Return Index

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