SMITH AFFILIATED CAPITAL

FIRST QUARTER 2018 INVESTMENT COMMENTARY

No Time for Complacency with a MOTS Outlook for 2018

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The U.S. economy is ending the year on a positive note, with growth likely to approach 3.0 percent, only a tad slower than the 3.2 average rates of the previous two quarters, which has led to a more of the same (MOTS) consensus call for 2018. In line with above-trend growth, the unemployment rate has been driven down to a 17-year low of 4.1 percent in November and may well dip further in the coming year. Understandably, the Trump administration is basking in the glow of these ebullient metrics, even though its signature legislative accomplishment, the $1.5 trillion tax cut, was only just finalized. From our lens, the three-quarter-growth spurt is a belated response to the avalanche of global monetary stimulus, led by the Federal Reserve, the scope of which has never before been encountered. And while the Fed has started to take its foot off of the gas pedal, the ECB and Bank of Japan are still going full bore.

But the ramped-up growth trend is not sustainable. While the stock market is priced for an endless expansion, the bond market is sending out the opposite signal. Notwithstanding a modest pick-up in December, long-term yields have hardly budged from the levels prevailing at the start of the year. Meanwhile, three Fed-induced rate hikes in 2017 lifted short-term rates, resulting in an ever-narrowing yield curve that has historically foreshadowed slower growth. This time will be no different. True, the front-loaded fiscal stimulus will give a temporary boost early in the year, but the impetus should be brief and its long-term economic effects may turn out to be more negative than positive, as the $1 trillion addition to the national debt will become an albatross that weighs on the economy for years to come.

The Fed's plan to raise rates three more times in 2018 would be a misguided response to a nonexistent inflation threat that will reinforce the secular influences contributing to the prospective slowdown. With labor force and productivity trends supportive of 2.0 percent growth at most, the economy can exceed that speed limit only as long as there is spare capacity in the labor and product markets. After that, supply restraints will kick in and nudge the growth engine into a slower gear. We suspect that tipping point lies not far beyond the first quarter of the year. The Fed's challenge will be to let those organic forces unfold instead of overreacting to a temporary growth spurt that would risk sending the economy into a recession. That risk will become more compelling in 2018 because the annual rotation of regional bank Presidents on the FOMC will result in a more hawkish bias on the policy-making committee. Every past recession has followed an inversion of the yield curve, and three more rate hikes would bring the nation closer to that historic precursor later in the year.

Another Year of Missed Calls

Yogi Berra famously said that making a prediction is difficult, especially about the future. To their credit, economists collectively got the 2017 growth story reasonably correct. Modest growth was expected, and that's what we got, with GDP advancing by another ho-hum pace of slightly over 2.0 percent. But the headline call masked some dramatic misses in the underlying details. While unemployment fell more than expected the big miss was on inflation, which the majority of economists (and policy makers) thought would be ramping up over the course of the year.

Indeed, at the start of year, the big bet on Wall Street was on the so-called "reflation trade". With the economy nearing full employment at the end of 2016 and the expansion moving into a mature stage, the widespread perception was that the time-honored sequence of rising wages, inflation and bond yields would naturally follow. Of course, nothing of the sort occurred. While the job market tightened, wages failed to respond. At the end of 2016, average hourly earnings of all workers in the private sector had increased by 2.9 percent over the previous twelve months. By November of 2017, the annual rate of increase had fallen to 2.5 percent. With labor costs – a major source of price pressure – held in check, so too was inflation. The core inflation rate actually fell by 0.5 percentage point, from 2.2 percent to 1.7 percent between the end of 2016 and November 2017. And with inflation dormant, bond yields hardly budged over the course of 2017; the 10-year Treasury yield ended the year at 2.41 percent, virtually spot on with the level at the start of the of the year.

The Fed was just as culpable as private economists in missing the inflation call and, by implication, the market response, as it doesn't explicitly forecast market-determined yields and stock prices. Like most private economists, the majority of Fed officials thought wages and inflation would respond to the ever-tightening job market, a relationship that is captured by the so-called Phillips curve. But while the unemployment rate fell more steeply than the Fed envisioned, the inflation rate slipped further below its long-standing 2 percent target. Despite that recalcitrant behavior, the Fed stuck to its rate-hiking strategy, believing that transitory forces, such as plunging prices on cell phone plans, were suppressing inflation; the Fed was convinced that once these transitory forces ebbed, the Phillips curve would belatedly kick in and spur higher inflation.

As unemployment fell further, that conviction hardened and served to justify the three quarter-point rate increases put into effect during the year, including the last hike at the December policy meeting. But by late in the year, even the Fed admitted that it was befuddled by the persistence of low inflation and wondered if something more fundamental than transitory forces was responsible. A vocal minority among Fed officials wanted to proceed more cautiously in lifting rates, preferring to wait for actual evidence that inflation is increasing before stepping on the monetary brakes. Despite that resistance, the central bank reaffirmed its commitment to lift rates at its December meeting, expecting to hike three more times in 2018. The decision to move ahead was influenced by the ongoing strength in the labor market and the upgraded growth outlook for the upcoming year. The new Summary of Economic Projections now pegs growth at 2.5 percent in 2018, revised up from the 2.1 percent estimate made three months earlier, in part reflecting the fiscal stimulus from the just-enacted $1.5 trillion tax cut.

While we doubt that acceleration will come to pass, it's likely that the Fed will stay the course if only because the FOMC will undergo a significant changing of the guard in 2018. Thanks to the annual rotation of four voting members on the Federal Open Market Committee, the four new members will have a more hawkish inflation bias than the ones they replace. This new mix may well be more trigger-happy in lifting rates if the economy and job market continue to outperform expectations, even if inflation remains dormant. As a result, the odds that monetary policy will tighten too aggressively in the year ahead have increased, reminiscent of overreactions that short-circuited previous expansions. The threat looms larger because last-minute changes in the tax bill front-loads about $200 billion of additional fiscal stimulus into early 2018. That could impart a bigger near-term boost to growth, probably more than the Fed is willing to tolerate, and quicken the pace of rate increases. That, in turn, raises the odds of an earlier recession than otherwise.

Consumers are a Weak Link

One reason to worry is that consumers – the economy's main growth driver – would be most immediately affected by higher short-term interest rates. And it is the consumer that is the weakest link in the outlook. True, personal spending appears to have accelerated in the fourth quarter, following a slowdown in the third. However, a big contribution came from a temporary bulge in purchases related to hurricane replacement demand. This is particularly the case for auto sales, reflecting the need to replace up to 1 million vehicles that were destroyed by the storms, according to Cox Automotive. Likewise for housing-related purchases, such as for building materials and home furnishings, as homeowners were forced to repair damaged properties and replace belongings that were swept away by the hurricanes.

However, the-end-of-year spending binge extends an ominous pattern that has been in place for most of 2017. Simply put, consumers continue to spend beyond their income means and, as a result, are dipping deeply into savings to help finance purchases. In November, the personal savings rate fell to 2.9 percent, which is the lowest since November 2007. Clearly, this is not a sustainable way to finance spending. No doubt, rising wealth stemming from appreciating stock and property values is contributing to this overspending. Households tend to spend a bigger fraction of their paycheck when they feel more financially secure.

But home equity is relatively illiquid and most stocks are held by upper-income households who tend to sit on capital gains rather than increase spending. Nor will households further down the income scale use their home equity as cash dispensing machines, as they did when the housing bubble spurred extensive use of home equity loans from 2003 through 2006. The painful memory of the consequences of the housing collapse is still raw in the minds of millions of households. What's more, the new tax bill removes an important incentive to borrow against equity, as it eliminates the interest deduction associated with home equity loans.

That said, households increasingly relied on borrowing to finance purchases in 2017, including installment debt, even as they drew down savings. These borrowers, in turn, are immediately affected by higher Fed-induced interest rates. Delinquency rates on installment debt are already on the rise and higher interest payments on credit cards, which Fed rate hikes quickly bring about, would further stretch household budgets and restrain spending. An even more dire situation is unfolding with auto loans, which have been extended aggressively to less creditworthy borrowers; not surprisingly, these subprime loans are falling behind in payments at a rapidly rising pace and undermining a growing class of securities that is backed by these dubious obligations. From our lens, consumers will be earmarking more of their paychecks this year to rebuild depleted savings and service outstanding debt. The tax cuts will sustain a higher level of spending than otherwise. But we suspect that most of the tax savings has already been spent and very little of it will find its way into the spending stream in 2018.

Bogus Stimulus

The Trump administration is unabashedly claiming that the package of corporate and individual tax cuts will pay for itself through the incremental growth it will produce. This claim flies in the face of virtually every respectable private forecast, not to mention those provided by government agencies (except, of course, Secretary Mnuchin's Treasury Department). We expect the tax cuts will impart a very modest 0.3 percent growth boost this year, and that assumes no offsetting drags from harmful protectionist measures the administration is considering. These include steep tariffs on Chinese imports and renegotiating the terms of NAFTA that could well spur retaliatory action from trading partners.

We are equally skeptical that the lowered tax on repatriated funds will be channeled into higher wages and more jobs as the administration asserts. Astonishingly, there were absolutely no strings attached to this tax giveaway that would coerce companies to divert some of the repatriated funds for these purposes. At least the tax holiday granted by the Bush administration in 2004 gave lip service to this precondition, which companies flagrantly ignored. Instead, virtually the entire $400 billion in repatriated dollars went into share buybacks and increased dividends. What's more, the sudden inflow of funds pushed the dollar up by 10 percent, which restrained exports and offset whatever stimulus the tax holiday was designed to accomplish.

Critics of the tax cut assert that with the economy near or at full employment, fiscal stimulus is not only inappropriate, but will stoke higher wage and price inflation that will force the Fed into a more aggressive tightening stance. We agr`ee that the fiscal action is ill-timed and may well provoke quicker rate hikes than otherwise. Hopefully, the Fed, even with its rotating cast members, may also realize that in an era of globalization, low productivity, an aging population and ubiquitous price transparency associated with Internet shopping, inflation is far less sensitive to unemployment trends than in the past. Indeed, the jobless rate in Japan just hit a 24-year low of 2.7 percent, yet core inflation remains quiescent at 0.3 percent and the Bank of Japan shows no sign of tightening.

As was the case at the start of 2017, the consensus forecast is for modestly stronger growth, higher inflation and rising bond yields in the year ahead. Changing dynamics in the domestic economy undermined the inflation and interest rate projections last year. This time, the outlook may be further challenged by a myriad of external threats that most models are blissfully ignoring. Topping the list are global security concerns, including the North Korea threat and sectarian strife in the Middle East that stand to rattle nerves among risk-takers, portending a flight from the stock to the bond market. Domestically, the Russian probe will continue to reverberate on Capitol Hill, feeding the rumor mill and perhaps uncovering surprising revelations that generate heightened market volatility. More immediately, Congress faces a January 19 deadline to devise a funding bill that prevents a government shutdown. This will require some bipartisan cooperation in Congress, something that will be hard to come by as legislator's eye the looming mid-term elections. Against this backdrop, investors should shrug off their embedded complacency and reduce their appetite for risky assets, which now comprise an outsized share of portfolios. With stocks overvalued by many conventional measures and tracking the second longest bull market on record, the time for rebalancing as a hedge against disruptive shocks is clearly at hand.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Barclays TSY Bellwethers)	12/31/2016	9/30/2017	12/31/2017	Last Quarter (1)	Last Year (2)
6-Mo. Bill	0.61	1.19	1.53	0.28	0.98
2-Yr. Note	1.19	1.48	1.89	-0.33	0.25
5-Yr. Note	1.93	1.94	2.19	-0.71	0.67
10-Yr. Note	2.44	2.33	2.41	-0.25	2.14
30-Yr. Note	3.07	2.86	2.74	3.00	9.14

Municipal Bonds	Yields (%)			Total Return (%)	
	12/31/2016	9/30/2017	12/31/2017	Last Quarter (1)	Last Year (2)
ML Rev 22+ Index	3.36	2.95	2.83	2.17	7.86
ML G.O. 22+ Index	3.32	2.80	2.75	2.13	8.60

Equities	Levels			US $ Terms (%)	
	12/31/2016	9/30/2017	12/31/2017	Last Quarter (1)	Last Year (2)
S&P 500	2,238.83	2,519.36	2,673.61	6.93	21.80
DJIA	19,762.60	22,405.09	24,713.22	10.95	28.07
NIKKEI (Tokyo)	19,114.37	20,356.28	22,764.94	12.01	25.68

Commodities	US $			Percent Change (%)	
	12/31/2016	9/30/2017	12/31/2017	Last Quarter (1)	Last Year (2)
COMEX Gold Active Monthly	1,147.50	1,280.15	1,309.30	2.28	14.10
CRB Future Com. Pr. Index*	192.51	183.09	193.87	5.89	0.70
West Texas Intermediate Crude ($ per bbl)	53.72	51.67	60.42	16.93	12.47

Currencies	Levels			Percent Change (%)	
	12/31/2016	9/30/2017	12/31/2017	Last Quarter (1)	Last Year (2)
Yen	116.96	112.51	112.69	-0.16	3.65
Sterling	1.23	1.34	1.35	0.86	9.51
Euro	1.05	1.18	1.20	1.62	14.15

Foreign Bond Markets	Levels			US $ Total Return (%)	
	12/31/2016	9/30/2017	12/31/2017	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	0.63	0.92	0.90	0.59	-2.61
3-Mo. LIBOR Yen Fixing (3)	-0.05	-0.05	-0.02	N/A	N/A
ML Japanese 10-Yr.+ Bond Index	0.40	0.45	0.43	0.80	0.41

Source: Bloomberg Financial Data
Notes: 1) 9/30/2015 thru 12/31/2016 2) 12/31/2015 thru 12/31/2016

*Thomson Reuters/Jefferies CRB Commodity Excess Return Index