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INVESTMENT COMMENTARY

A Strengthened Appeal of Safe-Haven Assets

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Slowing economic activity, low inflation, chaos in the oval office and heightened geopolitical risks strengthen the appeal of safe-haven assets. Spring, the season of hope, made an auspicious entrance in late March, bringing another nor'easter that was as welcome to the victims in its path as a trade war is to the financial markets. Speaking of a trade war, recent events raised the odds that one may well be on the way. Coming hard on the heels of announced tariffs on steel and aluminum, President Trump ordered tariffs of up to $60 billion on Chinese imports, adding more heft to the administration's protectionist leanings. The announcement, like the nor'easter, had the predictable effect, stoking an astonishing increase in market volatility and angst amongst our trading partners. And, as advertised, the move is not going unheeded in China, as that nation immediately announced it is imposing retaliatory tariffs on American goods.

Just as the administration's tax cuts last year cheered the business community and pumped more energy into stock prices, Trump's imposition of new and higher tariffs is having the opposite effect, drawing criticism from business leaders and wreaking havoc in the financial markets. Stocks posted their first quarterly loss in more than two years in the first quarter. Trump softened the tariff's bite on steel and aluminum by excluding Canada and Mexico as well as a host of other allies, but that has not quelled fears his policies will veer towards a more protectionist stance. Nor has it damped down the chaos that is engulfing the Oval Office. Indeed, by reshuffling his inner circle to include advisors with more hawkish views on trade and foreign relations (including replacing the national security advisor H.R. McMaster with the more hawkish John Bolton) the president is further escalating geopolitical tensions. There are many flaws in current trade arrangements that need to be addressed. But erecting barriers to trade and ramping up geopolitical tensions poses a big threat to the growth outlook.

As it is, the economy turned in an underwhelming performance in the first quarter, dragged down by softer consumer spending. .Since personal consumption is the economy's main growth driver; there is reason to be concerned that the nation's second longest recovery is running out of steam. Yet, the Federal Reserve is putting more headwinds in the consumer's path; at the March 20-21 meeting, it lifted the benchmark short-term interest rate for the sixth time in this rate-hiking cycle and set a course of steeper increases over the next two years than predicted at the December policy meeting. The Fed's new chairman, Jerome Powell, may be flexing inflation-fighting muscles to maintain credibility with the bond vigilantes. But the Fed's premise that sharper rate hikes are needed to prevent overheating two years down the road is doomed to backfire as the current level of rates are already generating signs of distress, not only among households, but also in the business community. For example, the 3-month London interbank offered rate (Libor) has increased twice as fast as the federal funds rate over the past six months. More than $1.2 trillion of residential mortgages are linked to Libor, which will reset immediately. What's more, commercial construction will come under additional pressure as REIT's that invest in commercial mortgages borrow heavily in the floating rate markets to finance operations. Hence, the Fed's so-called gradual path towards policy normalization is having amplified effects on vulnerable sectors of the economy. Rather than fear overheating, the Fed may be extinguishing the fuse that is keeping the economy's growth engine humming at a simmering pace.

Consumers Dangerous Debt Levels

Households spent a good part of the recovery working off the excessive debt burden acquired prior to the Great Recession. Much of the pay downs were involuntary, reflecting a tidal wave of defaults, foreclosures and short sales stemming from massive layoffs during the downturn and the housing bust that forced millions of people to lose their homes or sell them at a deep discount. As well, lenders closed the credit spigot for several years to restore battered balance sheets and to comply with tougher regulations mandated by Congress following the financial crisis. On the other side of the ledger, the demand for loans shriveled as consumers, fearful of job security and whose nest eggs were decimated by the plunge in stock prices and housing values, refrained from taking on new debt for some time.

Deprived of the fuel that borrowing provides, consumer spending recovered much more slowly from the Great Recession than normally occurs during cyclical upturns. But the deleveraging process ended in 2014. Since then, consumers have steadily increased their debt loads. By late 2016, outstanding household debt finally exceeded the previous peak set in 2008 and continued to set new records through the end of last year. Indeed, in the final quarter of 2017, roughly 27 percent of total consumer purchases (excluding home purchases) were financed by credit – the largest share of credit-financed spending since the financial crisis. Not surprisingly, the 4 percent growth rate in personal consumption expenditures during that period was the strongest in three years.

But the aggressive dive back into the borrowing pool will restrain consumer behavior going forward. It appears that the torrid rise in asset values has encouraged households to take on new debt, reminiscent of the wealth effect associated with asset bubbles that preceded the last two recessions. Then, as now, households spent beyond their income means, allowing savings to drop to unsustainable levels. The personal savings rate, at just over 3.0 percent, is about half the level of two years ago. This leaves households with little in the way of reserves should the job market sputter, crimping incomes, and/or an adverse shock batters their balance sheets. The last time the rate was this low were the years leading up to the financial crisis. In fact, signs of distress are already appearing. The delinquency rate is rising on new credit card borrowing and the share of delinquent auto loans is higher now than before the financial crisis.

Fiscal Bump Fading

Indeed, consumers may already be cutting back. Installment borrowing slowed considerably in December and January, and retail sales fell for three consecutive months through February. On March 29 the Commerce Department reported that real personal consumption expenditures were unchanged in February following a 0.2 percent decline in January. Even allowing for a modest rebound in March, growth in real PCE is likely to downshift to about a 1.0 percent annual rate in the first quarter, which would be the weakest in nearly five years. That, in turn, will surely drag down first-quarter GDP, currently tracking a weak 1.7 percent pace.

To be sure, the slowdown comes on the heels of a buoyant second-half performance, including an upwardly revised growth rate of 2.9 percent in the fourth quarter. But that buoyancy in top-line growth masks weaker underpinnings that continued into this year. For example, the income-equivalent GDP measure, real Gross Domestic Income (GDI) increased by only a 0.9 percent annual rate in the fourth quarter. It's doubtful if the income side of the ledger is getting much of a boost so far this year. Recall that the much-ballyhooed acceleration in worker pay in January was almost entirely reversed in February, when the year-over-year increase in average hourly earnings slipped back to 2.6 percent from 2.8 percent. This is a volatile series that is hard to predict on a monthly basis. But there is no question that it received a temporary lift from minimum wage hikes in a multitude of states at the start of the year as well as from one-time bonus payments corporations granted workers as a token of thanks to the administration for last year's corporate tax cuts.

We suspect that just as the fourth quarter growth rate, which was boosted by post-hurricane rebuilding activity, overstated the economy's strength; the first quarter downshift overstates the economy's weakness. Thanks mainly to the fiscal stimulus provided by the Tax Cut and Jobs Act and the recent $1.3 trillion spending bill; growth should rebound this quarter and next. However, the "sugar high" from the fiscal stimulus will wane towards the end of the year. Hence, after a modest pick-up in 2018, growth should subside again next year, returning to the lackluster pace seen since the end of the recession. Neither the labor force nor productivity growth is showing any sign of accelerating from their entrenched trends, which underpin a 1.8 percent potential growth rate for the U.S. economy.

Labor Market Slack

With the economy expected to exceed its growth potential both this year and next, the Fed believes continued rate increases are needed to prevent it from overheating and spurring an inflation outbreak. But that rationale assumes the economy has used up all of its slack and hence above-trend growth could only translate into higher prices. Nothing could be further from the truth. While the official unemployment rate hovered just over 4 percent over the first two months of the year, that gauge has long been discredited as a measure of labor slack, as it fails to count millions of workers involuntarily in part-time jobs or those too discouraged to search for a job. If those workers are counted, the unemployment rate jumps to 8.2 percent. And that doesn't include the 2.4 million workers not in the labor force who would take a job if one were available.

While the growing wave of retirements is depressing the labor force participation rate, there remains a large pool of prospective workers on the sidelines that can be lured back to the labor force. That was amply demonstrated in February when the 313 thousand increase in nonfarm payrolls – far greater than the increase in the working age population – did not lower the unemployment rate.

Instead, 133 thousand more people who were not in the labor force the previous month took a job in February as job opportunities became more plentiful. As a result, the labor force participation rate rose 0.3 percent, the largest monthly increase in 20 years. But at 63.0 percent, the participation rate still hovers near 30-year lows and includes many more sidelined workers that can be tapped into to accommodate above-trend payroll increases.

This potential supply of labor is a key factor holding back wages. With productivity growth mired at less than 1 percent, there is little incentive for companies to grant larger pay increases without sacrificing some profits. If they try to fully pass on higher wages to consumers, sales would suffer. True, the weaker dollar provides some cover, as import prices are rising and allowing companies to match higher prices on foreign made goods. What's more, there likely will be stealth acceleration in inflation over the spring and summer due to favorable base effects. Recall that cell phone plan prices were plummeting last spring and early summer, dragging down the price indexes. Hence, year-over-year comparisons will be measured off of those lowered prices, giving a temporary lift to inflation this spring and summer. But like the temporary "sugar high" provided by fiscal policy, these base effects will fade by the fall and slow the annual inflation rate.

Increased Recession Odds

The risk is that the Fed will overreact to the temporary pick-up, thinking inflation is gaining traction, particularly if the job market continues to deliver above-trend payroll growth. But steeper rate hikes would further flatten the yield curve, enhancing the signal that the recovery is moving into a mature, fragile state. Since the last rate hike, bond yields have actually declined along with market-based inflation expectations. The 10-year breakeven rate is down about 10 basis points and the 5-year, 5-year forward inflation rate is down about 20 basis points from their February peaks. Inflation expectations remain well anchored on Main Street as well, as the Conference Board's March consumer confidence survey revealed a 0.1 percent decline in 12-month inflation expectations, despite an increase in gasoline prices during the month.

From our lens, a number of headwinds are restraining the rise in high-quality bond yields and will continue to do so over the foreseeable future. Quite possibly the aforementioned stealth increase in inflation due to base effects may cause a temporary spike in long-term interest rates. But the forces underpinning a longer -term downward pull should reassert themselves later this year. For one, the risk-on trade that spurred investors to channel funds into the stock market is poised to reverse, as the incentive behind this trade has all but evaporated. The 10-year Treasury yield currently exceeds the dividend yield on the S&P stock index by about 100 basis points. The last two times the spread was this wide – in mid-2011 and late 2013 – bond yields fell sharply.

What's more, reckless lending reminiscent of the period leading up to the financial crisis has returned in spades. According to the Institute of International Finance leveraged lending soared to a new high of $1.5 trillion last year and about half of U.S. leveraged loans are "covenant-lite". These are mostly loans extended to weak companies, which were able to service debt payments when short-term rates were near zero. But after six rate hikes by the Fed, meeting those payments as loans are reset will become ever-more difficult, setting the stage for a wave of defaults that will further turn investors away from risky assets. The St. Louis Federal Reserve's Financial Stress Index has been climbing rapidly and is currently at the highest level in nearly two years.

Whether the first-quarter drop in stock prices, the first in two years, amid heightened volatility is the first chapter in a new era of risk averse investor behavior remains to be seen. But the backdrop supporting an increased bias towards safe-haven buying is becoming firmly entrenched. The administration continues to be a seed bed of chaos, with ongoing cabinet reshuffling short-circuiting a coherent message on domestic policy and foreign affairs, a president consumed with the Mueller investigation and coping with a barrage of scandalous accusations, and a geopolitical landscape that is taking on a cold war veneer with each Russian transgression. Add to that mix the nontrivial prospect of a trade war, and a strong case can be made for parking funds in a safe asset that offers an attractive risk-adjusted real return.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market (Barclays TSY Bellwethers)	Yields (%) 3/31/2017	Yields (%) 12/31/2017	Yields (%) 3/31/2018	Total Return (%) Last Quarter [1]	Total Return (%) Last Year [2]
6-Mo. Bill	0.90	1.53	1.92	0.34	1.18
2-Yr. Note	1.26	1.89	2.27	-0.17	-0.17
5-Yr. Note	1.93	2.19	2.57	-1.02	-0.81
10-Yr. Note	2.39	2.41	2.74	-2.39	-1.09
30-Yr. Note	3.02	2.74	2.97	-3.89	3.54

Municipal Bonds	Yields (%) 3/31/2017	Yields (%) 12/31/2017	Yields (%) 3/31/2018	Total Return (%) Last Quarter [1]	Total Return (%) Last Year [2]
ML Rev 22+ Index	3.24	2.83	3.24	-1.6	4.62
ML G.O. 22+ Index	3.18	2.75	3.17	-2.04	4.75

Equities	Levels 3/31/2017	Levels 12/31/2017	Levels 3/31/2018	US $ Terms (%) Last Quarter [1]	US $ Terms (%) Last Year [2]
S&P 500	2362.72	2673.61	2640.87	-0.76	14.02
DJIA	20663.22	24713.22	24103.11	-1.96	19.45
NIKKEI (Tokyo)	18909.26	22764.94	21454.30	-5.06	15.55

Commodities	US $ 3/31/2017	US $ 12/31/2017	US $ 3/31/2018	Percent Change (%) Last Quarter [1]	Percent Change (%) Last Year [2]
COMEX Gold Active Monthly	1249.35	1309.30	1322.80	1.03	5.88
CRB Future Com. Pr. Index*	185.88	193.87	195.36	0.77	5.10
West Texas Intermediate Crude ($ per bbl.)	50.60	60.42	64.94	7.48	28.34

Currencies	Levels 3/31/2017	Levels 12/31/2017	Levels 3/31/2018	Percent Change (%) Last Quarter [1]	Percent Change (%) Last Year [2]
Yen	111.39	112.69	106.28	5.69	4.59
Sterling	1.26	1.35	1.40	3.71	11.67
Euro	1.07	1.20	1.23	2.66	15.70

Foreign Bond Markets	Levels 3/31/2017	Levels 12/31/2017	Levels 3/31/2018	US $ Total Return (%) Last Quarter [1]	US $ Total Return (%) Last Year [2]
3-Mo. LIBOR DEM Fixing [3]	-0.37	-0.39	-0.39	N/A	N/A
ML German 10-Yr.+ Bond Index	0.76	0.90	0.90	3.61	15.44
3-Mo. LIBOR Yen Fixing [3]	0.03	-0.02	-0.03	N/A	N/A
ML Japanese 10-Yr.+ Bond Index	0.47	0.43	0.40	6.96	7.48

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

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