SMITH AFFILIATED CAPITAL

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INVESTMENT COMMENTARY

The Fed, Tariffs, and Curve Flattening Curtail Expansion

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As expected, the U.S. central bank hiked short-term interest rates by another quarter-point at its June 12-13 policy meeting, lifting the bellwether federal-funds rate up to a range of 1.75-2.00 percent. It was the second increase so far this year, and the seventh since the Fed moved away from its lengthy zero-rate policy in December 2015. While rates are still historically low and less than what Fed officials deem to be a neutral rate – i.e. a level that neither stimulates nor restrains economic activity – that won't be for long if the Fed follows through with its current plan. At the June meeting, most policy makers expected to pull the rate trigger two more times this year, followed by three increases in 2019.

Hence, sometime in 2019, the Fed will have returned rates to a neutral level, currently estimated at just under 3.0 percent, assuming its upgraded growth and inflation forecast comes to pass. Of course, that's the rub: on the surface, the economy was doing fine when policy makers convened in mid-June; unemployment had fallen to an 18-year low of 3.8 percent, growth was tracking a 4.0 percent pace or better for the second quarter and the deflation threat had been defused, at least for now. Understandably, the Fed believed that the economy no longer needed as much of a monetary crutch to keep forging ahead, and is gently stepping on the brakes to keep the growth engine from overheating.

But the second quarter is probably as good as it gets. The economy received a burst of energy this spring, fueled by massive tax cuts enacted last year and increased deficit spending Congress passed earlier this year. These catalysts still pack a punch, but they will start to fade as time goes on. Hence, the economy will need to rely more on organic sources to sustain growth, and we doubt they will live up to the Fed's expectations. No doubt, the fundamental underpinnings appear to be solid, highlighted by a robust job market. But Fed rate hikes, high debt burdens, low savings and rising fuel prices against a backdrop of lagging wage growth are squeezing household purchasing power. Importantly, business leaders and investors are becoming increasingly concerned over heightened trade tensions and the potentially disruptive effects a trade war would have on the economy and financial markets. Even Fed Chairman Powell, who dismissed the threat of a trade war at the post-FOMC press conference, is taking notice. At a recent ECB forum in Sintra, Portugal, his message was that business leaders would be rethinking investment and hiring decisions if trade tensions continue to escalate. Bond investors are not waiting for that prospect to materialize and are already cushioning their portfolios against a growth-killing trade shock with Treasury securities.

Consumers Can't Keep It Up

When the Federal Reserve increased interest rates in March for the first time this year, it did so more on the basis of hope than reality. Recall that the economy was just finishing a lackluster period of growth in the first quarter, as GDP slowed to a 2.0 percent pace from 3.0 percent or more in each of the previous three quarters. Consumers, the economy's main growth driver, were the biggest drag, as consumption expenditures slumped to a 1.1 percent rate from a robust 4.0 percent in the previous quarter. The Fed correctly believed that the slowdown from a post-hurricane influenced surge would be temporary, and that spending would pick up again in the spring.

Following an eye-opening spike in retail sales during May, and upward revisions over the previous two months, consumption expenditures are tracking the strongest growth rate in nearly four years in the second quarter. Thanks to that rebound, the forecasting community upped their near-term growth outlook; It now looks like real GDP could well advance close to a 4.0 percent annual rate in the second quarter, and some believe it may move into the white-hot zone of 5.0 percent – a rare occurrence seen in only three other quarters this century. The Atlanta Federal Reserve's GDP tracking model pegged it at 3.8 percent on June 29th.

But before uncorking the champagne to celebrate an economy off to the races, the likelihood is that this will be as good as it gets as June has already started to recede. There are several reasons why the second-quarter's growth spurt should not be viewed as a template for the rest of the year.

Most important is that household fundamentals do not justify the outsized boost from consumption that took place during the period. While personal incomes continue to grow along with expanding payrolls, the increase is not keeping up with the spending pace. As a result, households have financed some of their purchases by drawing on savings, reducing the personal savings rate to precariously low levels. The overall rate dipped to 2.8 percent in April, one of only a small handful of times it fell below 3.0 percent during the recovery. And it is the budget-strapped households on the lower end of the income ladder that are mostly forced to dip into rainy-day funds. These individuals are being squeezed by the rising costs of fuel and shelter and are prime candidates to cut back spending to replenish depleted savings.

Perhaps more worrisome is that this segment of the population relies heavily on credit to support purchases and, hence, are more vulnerable to the rise in interest rates being engineered by the Federal Reserve. The strain may already be affecting their behavior, as consumers have sharply cut back their credit card borrowing this year. Through April, revolving credit – mainly credit card debt – has increased by an average of $1.5 billion a month, down from a $5 billion monthly average increase in 2017. The slowdown is highly understandable. Debt servicing charges on consumer credit increased considerably faster than incomes over the last three years; by the end of 2017, they accounted for 5.86 percent of disposable incomes, only a tad under the 6.0 percent that prevailed at the onset of the Great Recession.

Importantly, the interest rates charged on credit cards respond directly to changes in the Federal Reserve's short-term policy rate, usually with a lag of less than 60 days. Hence, the debt-servicing ratio at the end of last year – which is the latest period available – does not reflect the three quarter-point rate hikes implemented in December, March and June of this year. With total revolving credit outstanding topping $1 trillion, a quarter-percentage point rate increase translates into roughly a $2.5 billion increase in monthly interest payments. Multiply that by three rate increases, and you would need to see a meaningful acceleration in income growth to compensate for the increased debt servicing charges that is now unfolding. True, the tax reduction that took hold in the first quarter boosted disposable incomes significantly. We suspect, however, that a big chunk of the tax savings was used to pay down credit card debt, which contributed to the sharp consumer spending slowdown during that period.

Flattening Yield Curve Portends Heightened Recession Risk

Slower growth is already built into the Fed's second-half outlook, of course, but it will probably not short-circuit its rate-hiking strategy unless some unforeseen shock amplifies the slowdown. However, a tightening policy into a slowing economy always carries risk, given the economy's lagged response to higher interest rates. One wild card is how the financial markets react. The yield curve has flattened considerably this year, with the 2 year – 10 year Treasury yield spread narrowing to the lowest point since August of 2007, just four months prior to the onset of the Great Recession. At 33 basis points, the current slim spread would close entirely at the end of the year, should the Fed follow through with its planned two quarter-point increases in short-term rates and the 10-year yield holds at under 3.00 percent. Every one of the last 11 recessions has followed an inverted yield curve.

It will be interesting to see if the Fed backs off if the spread continues to narrow in coming months. The futures market has already priced in lower odds of a December rate increase. No doubt, the escalating war of words on the trade front is playing a big role in this development. Not only does the threat of a global trade war dampen growth prospects, but it also encourages a capital flight into safe assets, both of which put downward pressure on Treasury bond yields. Keep in mind too that a stock market meltdown is highly possible if an all-out trade war erupts. Just look at how wildly stock prices react as the trade rhetoric shifts from bellicose to compromise. A confidence-shattering plunge in stock prices would likely have more of a negative impact on the economy than would the direct effects from a trade war.

As it is, the stock market appears to be running more on hyped-up fumes than earnings. While corporate tax cuts have given after-tax earnings a sizeable boost in the first quarter, they have done little to strengthen pre-tax earnings, which have declined for two consecutive quarters. Profit margins are being squeezed by rising fuel and unit labor costs even as companies have limited pricing power. What's more, with stock market leverage the highest in more than two decades, traders are exceptionally vulnerable to a market correction that could easily trigger an adverse chain reaction as positions are forced to unwind.

Trade Tensions Will Amplify Looming Growth Slowdown

Despite the disruptive effects on the financial markets, President Trump shows no signs of backing down from his trade rhetoric. Trump's China threat, if implemented, would pose much more of a downside risk to the economy than the recently implemented steel and aluminum tariffs. We calculate that if the U.S. imposes 25% tariffs on $50 billion of imports, which is set to begin on July 6, and 10% tariffs on $200 billion from China, and China retaliate kind, the direct hit to each economy would reach 0.3 -0.4 percent. We also believe the tariffs would have pronounced indirect effects for two main reasons. First the tariffs on $200 billion of imports would affect a wide array of business sectors, including some with significant supply chain multipliers. Second the potential financial market and confidence impact would be substantial.

Keven Hassett, Chairman of the Council of Economic Advisors, recently made the point that a strong U.S. economy would provide a solid buffer against retaliatory tariffs on U.S. goods. While that's true, it is also short-sighted as the economy is on the verge of losing momentum and, hence, will become increasingly vulnerable to the negative shock from a trade war near term. As noted earlier, heightened trade tensions have already put a damper on business sentiment, which could translate into weaker hiring and investment spending.

Keep in mind too that more than half the revenue of multinational corporations are generated overseas; not only are these companies vulnerable to weaker global growth, they are now also operating in a more hostile government environment towards the Trump administration.

Simply put, the economy is poised for a gradual slowdown over the second half of the year, but trade tensions may amplify the process. The latest report on durable goods suggest that growing uncertainty is already prompting business leaders to pull back on investment decisions, as capital goods orders declined in May for the second time in three months. In this environment of heightened uncertainty, the financial markets face a much bumpier road ahead, one that is fraught with myriad risks, both at home and abroad where emerging markets are suffering a liquidity squeeze underpinned by the stronger dollar, and Europe, buffeted by political divisions and a potential banking crisis, is straining to keep the single currency bloc intact. When global dysfunction abounds – whether sparked by U.S. actions or not, the dollar becomes king and U.S. treasury securities remain the safest and most desirable place to keep funds.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Barclays TSY Bellwethers)	6/30/2017	3/31/2018	6/30/2018	Last Quarter (1)	Last Year (2)
6-Mo. Bill	1.13	1.92	2.08	0.50	1.44
2-Yr. Note	1.38	2.27	2.53	0.15	-0.15
5-Yr. Note	1.89	2.57	2.73	-0.06	-1.51
10-Yr. Note	2.30	2.74	2.85	-0.28	-2.64
30-Yr. Note	2.84	2.97	2.98	0.52	-0.17

Municipal Bonds	Yields (%)			Total Return (%)	
	6/30/2017	3/31/2018	6/30/2018	Last Quarter (1)	Last Year (2)
ML Rev 22+ Index	3.01	3.24	3.23	1.02	2.95
ML G.O. 22+ Index	2.89	3.17	3.14	1.10	2.76

Equities	Levels			US $ Terms (%)	
	6/30/2017	3/31/2018	6/30/2018	Last Quarter (1)	Last Year (2)
S&P 500	2362.72	2640.87	2718.37	7.67	12.77
DJIA	20663.22	24103.11	24271.41	1.26	16.31
NIKKEI (Tokyo)	18909.26	21454.30	22304.51	4.08	13.46

Commodities	US $			Percent Change (%)	
	6/30/2017	3/31/2018	6/30/2018	Last Quarter (1)	Last Year (2)
COMEX Gold Active Monthly	1242.30	1322.80	1254.50	-5.16	0.98
CRB Future Com. Pr. Index*	174.77	195.36	200.39	2.57	14.65
West Texas Intermediate Crude ($ per bbl.)	46.04	64.94	74.15	14.18	61.06

Currencies	Levels			Percent Change (%)	
	6/30/2017	3/31/2018	6/30/2018	Last Quarter (1)	Last Year (2)
Yen	112.39	106.28	110.76	-4.22	1.45
Sterling	1.30	1.40	1.32	-5.77	1.40
Euro	1.14	1.23	1.17	-5.19	2.26

Foreign Bond Markets	Levels			US $ Total Return (%)	
	6/30/2017	3/31/2018	6/30/2018	Last Quarter (1)	Last Year (2)
3-Mo. LIBOR DEM Fixing (3)	-0.39	-0.39	-0.38	N/A	N/A
ML German 10-Yr.+ Bond Index	0.92	0.90	0.74	2.70	5.20
3-Mo. LIBOR Yen Fixing (3)	0.01	-0.03	-0.05	N/A	N/A
ML Japanese 10-Yr.+ Bond Index	0.46	0.40	0.39	0.49	2.66

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