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INVESTMENT COMMENTARY

Receding Fiscal Stimulus and Modest Underlying Growth Will Thwart the Fed's Rate Hiking Plans

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The U.S. economy continues to ride the tailwinds of last year's tax cut and the increased federal spending bill passed earlier this year. As well, the tax bill has helped stoke equity prices, as an outsize share of the increased after-tax income of corporations has been devoted to massive share buybacks and enlarged dividend payments. But the fiscal engine driving growth and lifting stock prices is poised to downshift in coming months, and reverse next year and beyond. Together with the Fed's normalizing campaign, the two main policy levers will morph into headwinds, joining other forces that will return the economy to its much-slower longer-term trend.

More immediately, the escalation of trade tensions with China threatens to wreak havoc on the financial markets and take a bigger toll on the economy next year than is currently built into most economic models. Remarkably, investors have largely remained unperturbed by the threat of an all-out trade war. Either investors are getting a case of battle fatigue with the ongoing trade saga between the world's two largest economies, or they believe that the punitive measures, both taken so far and threatened, will not derail the U.S. growth engine. Alternatively, the markets may be forging ahead on the assumption that both parties will dial down the rhetoric before things reach cataclysmic proportions.

That would be a mistake. The two headstrong leaders show no signs of backing down. From our lens, if the trade war escalates to the full extent of the tariffs threatened – 25 percent on the more than $500 billion of imports from China, and China retaliates by imposing tariffs and other trade barriers on U.S. exports – the toll on the U.S. economy would be significant, slicing as much as 1 percent from growth next year. As it is, the U.S. economy is in the late stages of an expansion, with the second quarter marking the peak in growth. The slowdown could be orderly or disruptive, depending on how monetary policy navigates unfolding events and whether external shocks, such as the burgeoning trade war with China and a potential emerging market debt crisis, continues to escalate and sends the economy into a downturn sooner rather than later.

Small Bang for the Buck

The Trump administration is understandably patting itself on the back for the economy's robust performance in the second quarter, noting that the tax cuts on households and businesses enacted last year contributed mightily to the outcome. No doubt, the tax bill had a meaningful impact on consumer spending and business investment; putting more money in the hands of households and extra cash in corporate coffers is a time-honored incentive to make purchases that would otherwise not have been made. What's more, the positive impulse will continue, albeit with gradually diminishing force, reinforced by the spending bill passed earlier this year.

But how much bang for the buck the government is getting for its efforts is open to question. It's doubtful that tax cuts will fix the underlying causes of the economy's diminished long-term growth potential, namely the slowing labor force and productivity growth. True, if the steep reduction in corporate taxes leads to a big pick up in investment spending, that would help improve productivity growth. But so far, the primary result of the cut from 35 percent to 21 percent in the corporate tax rate is a huge reduction in government revenues and a deficit destined to run more than $1 trillion a year over the next decade.

Indeed, the results so far are astonishing. Corporate tax revenues plunged by 45 percent in the first half of the year from a year earlier, a downturn exceeded only during the Great Recession, even as corporations continue to rack up strong profits. Not only was the corporate tax bill slashed by a an annual rate of $135 billion in the first half, the government also lowered the tax on earnings repatriated from overseas affiliates, opening the floodgates for another $465 billion brought home during the period. Together, the tax savings and the foreign earnings provided nonfinancial corporations with a windfall of $700 billion more cash than was needed to finance capital spending. That's the largest surplus or negative financing gap ever recorded for a six-month period.

Modest Investment Rebound

Not surprisingly, those powerful incentives have spurred an increase in business investment spending. But the vast majority of the increased cash infusion that corporations received during the period was channeled into other uses, most notably into dividends, share buybacks, mergers and acquisitions, and balance sheet repair. What's more, following the solid 11.5 percent increase in the first quarter, outlays on plant and equipment slowed to an 8.5 percent pace in the second quarter, according to the latest GDP report. While that's still a healthy increase, much of it derived from energy-related investment spending, reflecting the rebound in oil prices over the past year.

Indeed, energy investment grew by a formidable 30 percent in the second quarter and, barring another collapse in oil prices, should provide support for overall investment spending going forward. But even if oil prices remain elevated, spending on oil and gas structures and equipment will not provide as much of a boost to investment outlays as in the past. The reason: The energy sector has become much more efficient in producing oil. To put this in perspective, U.S. oil field production since the start of the year has averaged 10.4 million barrels a day with just over 1000 rigs in operation. But just four years ago, it required 1800 rigs to produce 8.3 million barrels a day.

Meanwhile, another catalyst behind investment spending is starting to fade. Recall that there was much excitement last year over the synchronized upswing in global growth that included most emerging markets as well as developed nations. That, in turn, gave U.S. exports a sizeable boost, energizing manufacturers to step up investment spending. But this year the global outlook has turned weaker. European momentum slowed in the first half of 2018 along with Chinese growth, and emerging markets are facing headwinds from a stronger dollar, elevated oil prices and higher interest rates. Japan is still struggling with a core inflation rate that remains well below 1 percent, and the U.K. is facing a messy Brexit process that is threatening to bring down the government.

Trade Little Trickle Down Effect

Despite the headlines garnered by some high-profile companies claiming that they were rewarding employees with higher pay because of the tax cuts, wages overall have only increased modestly. Yes, the 2.9 percent increase in average hourly earnings over the past year is a notch better than the 2.-2.5 percent growth over the first seven years of the recovery. But over the past two years, there has been virtually no improvement — the 2.9 percent annual increase in August is only 0.3 percent higher than it was in October 2016.

Meanwhile, the cost of living has steadily increased thanks, in good part, to rising energy prices. In October 2016, the consumer price index increased 1.6 percent from a year earlier. This August, the CPI was up 2.7 percent. Simply put, the purchasing power of households has been virtually unchanged in recent years. Indeed, real average hourly earnings for non-management workers decreased 0.1 percent in August, so these workers are actually worse off than they were a year ago. Nor will household budgets be getting any relief from climbing oil prices. The toughened U.S. sanctions on Iran will slash 1 million barrels a day in oil supplies from that nation and OPEC is refusing to increase production to offset that shortfall, pointing to still higher oil prices in coming months.

As expected, with inflation hitting the Federal Reserve's 2.0 percent target and the economy still registering above-trend growth, the stage was set for another quarter-point rate increase at the September 25-26 policy meeting. So far, the Fed has raised its short-term policy rate eight times since moving away from its zero-rating policy in December 2015, lifting it to the current 2.00-2.25 percent range. One more increase is planned for December, according to the Fed's dot plots, and three more in 2019, assuming the economy performs as the central bank expects. So far, the Fed's rate-hiking campaign has not made a meaningful dent in economic activity, as evidenced by the robust second-quarter growth in GDP.

That said, the Fed's gradual nudging up of short-term rates is another headwind that will restrain growth going forward. The question is how far is it willing to go if the jobless rate continues to fall, a distinct possibility given the surge in workers that are dropping out of the labor force due to retirements and other reasons. Two camps are developing within the FOMC. The more hawkish camp sees the tightening in resource utilization and the ongoing boost to economic activity from the large fiscal stimulus as increasing the risk for acceleration in inflation or financial market imbalances. The other more dovish camp is skeptical that traditional trade-offs between resource utilization and inflation (aka the Phillips Curve) still hold. They are also worried about the signals from the flattening Treasury yield curve and would be in favor of pausing interest rates once the estimated long-run neutral rate is reached.

Heightened Risk of a Policy Mistake

From our lens, the Fed is on the cusp of a policy overreaction that will reinforce the growth slowdown that is poised to unfold later this year and in 2019.

The Phillips Curve should have been dismissed as a guide to policy some time ago. For one, the official unemployment rate greatly exaggerates the tightness in the labor market. Despite monthly payroll gains averaging 206 thousand since May – well above population growth – the unemployment rate has remained at 3.9 percent, indicating that companies are dipping into the vast pool of shadow workers outside of the labor force to fill positions. The labor force participation rate for the prime 25-54 age group is still more than a full percentage point below its prerecession level, which translates into more than a million eligible unemployed workers that can still be lured back to the workforce.

And while stronger wage growth may be necessary to bring back these workers, the link between labor costs and inflation is considerably weaker than in the past. Business pricing power has been eviscerated by an array of structural forces that are not going away, including globalization which continues to exert deflationary pressure on tradable goods, and the ever-expanding tentacles of e-commerce, which transfers pricing power from companies to consumers. According to the latest survey of small businesses by the NFIB, a record share of firms plans to increase worker compensation in coming months, dwarfing a much smaller share that plans to increase prices.

Hence, the prospective increase in labor costs will squeeze profit margins more than it will boost inflation, something that Wall Street is beginning to recognize. More than 75 percent of companies reported negative earnings guidance for the third quarter, up from 57 percent in the second quarter and under 50 percent in the first. Trump's protectionist trade policies will intensify the profit squeeze. One key reason companies have enjoyed record profits amidst a slow-growth recovery has been their ability to hold down labor costs, not only by successfully resisting wage demands but also by outsourcing output overseas where labor costs are lower. With China being a major source of operations for many American firms, that channel is rapidly closing. Since the U.S. production apparatus is not geared towards producing most goods imported from China, import substitution would not be a readily available solution.

Nonetheless, according to the late-September policy meeting the hawks still have the upper hand, convinced that it is only a matter of time before the sturdy pace of job creation stokes an outbreak of wage and price inflation.

As long as they maintain a forecast that exceeds the economy's growth potential, as was the case in the SEP projections at the September 25-26 meeting, (which pegs a GDP growth rate of 2.5 percent in 2019), the Fed will stay on the rate-hiking path. That prospect heightens the risk of sending the economy into a recession sooner rather than later, reminiscent of past overreactions to incoming data that miscalculated the growth-retarding impact of policy tightening six to twelve months down the road.

Fed Will Slow Rate Hikes

Our sense is that the Fed will slow the path of rate hikes planned for next year as it responds to incoming data that will track weaker growth than is envisioned in the latest SEP. While the rate hikes so far have not had a significant impact on the economy, their cumulative effects are starting to weigh on certain sectors and will spread more broadly next year. Housing is often viewed as the canary in the coal mine, rolling over before the air is sucked out of the rest of the economy leading up to a recession. We are still a ways from that point, but housing activity has leveled off this year following eight years of recovery from an unprecedented bust. Builders are coping with higher material costs, partly due to higher tariffs on steel, worker shortages and a scarcity of lots to build on. Meanwhile a broadening swath of potential homebuyers are finding homes unaffordable, owing to higher prices and rising mortgage rates.

It is noteworthy that the yield curve flattened following the latest policy meeting, with the 10-year/2-year spread reaching the narrowest point in more than a decade. At the current 10-year yield of 3.05 percent, the next quarter-point rate hike would bring about the dreaded inversion. Some, including several Fed officials, believe that the yield curve is not as meaningful a recession indicator as in the past due to special factors that have been holding down long-term rates. They may turn out to be correct. But an inverted yield curve has been an infallible precursor of all postwar recessions, so it should not be a trivial event dismissed out of hand.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Barclays TSY Bellwethers)	9/30/2017	6/30/2018	9/30/2018	Last Quarter (1)	Last Year (2)
6-Mo. Bill	1.19	2.08	2.37	0.47	1.60
2-Yr. Note	1.48	2.53	2.82	0.14	-0.21
5-Yr. Note	1.94	2.73	2.95	-0.28	-2.05
10-Yr. Note	2.33	2.85	3.06	-1.09	-3.97
30-Yr. Note	2.86	2.98	3.20	-3.27	-3.75

Municipal Bonds	Yields (%)			Total Return (%)	
	9/30/2017	6/30/2018	9/30/2018	Last Quarter (1)	Last Year (2)
ML Rev 22+ Index	2.95	3.23	3.48	-0.62	0.93
ML G.O. 22+ Index	2.80	3.14	3.38	-0.87	0.27

Equities	Levels			US $ Terms (%)	
	9/30/2017	6/30/2018	9/30/2018	Last Quarter (1)	Last Year (2)
S&P 500	2519.36	2718.37	2913.98	7.71	17.90
DJIA	22405.09	24271.41	26458.31	9.63	20.76
NIKKEI (Tokyo)	20356.28	22304.51	24120.04	6.20	19.67

Commodities	US $			Percent Change (%)	
	9/30/2017	6/30/2018	9/30/2018	Last Quarter (1)	Last Year (2)
COMEX Gold Active Monthly	1280.15	1254.50	1191.50	-5.02	-6.92
CRB Future Com. Pr. Index*	183.0882	200.3852	195.1592	-2.61	6.59
West Texas Intermediate Crude ($ per bbl.)	51.67	74.15	73.25	-1.21	41.77

Currencies	Levels			Percent Change (%)	
	9/30/2017	6/30/2018	9/30/2018	Last Quarter (1)	Last Year (2)
Yen	112.51	110.76	113.70	-2.65	-1.06
Sterling	1.3398	1.3207	1.3031	-1.33	-2.74
Euro	1.1814	1.1684	1.1604	-0.68	-1.78

Foreign Bond Markets	Levels			US $ Total Return (%)	
	9/30/2017	6/30/2018	9/30/2018	Last Quarter (1)	Last Year (2)
3-Mo. LIBOR DEM Fixing (3)	-0.39	-0.38	N/A	N/A	N/A
ML German 10-Yr.+ Bond Index	0.92	0.74	0.85	-1.01	3.45
3-Mo. LIBOR Yen Fixing (3)	-0.05	-0.05	N/A	N/A	N/A
ML Japanese 10-Yr.+ Bond Index	0.45	0.39	0.53	-2.24	0.00

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