SMITH AFFILIATED CAPITAL

THIRD QUARTER 2017 INVESTMENT COMMENTARY

PROBLEMS AHEAD FOR FINANCIAL ASSETS TIED TO US GROWTH PROSPECTS

In this Issue:

- **Inflation Defying the Fed**
- **Don't Blame One-Off Depressants**
- **Housing Costs Easing**
- **Misguided Belief in Phillips Curve**
- **Easy Money Dependency Heightens Financial Instability**

As the second half of the year gets underway, the economy is entering the ninth year of recovery from the Great Recession. But don't uncork the champagne, as this anniversary has as many critics as celebrants. True, the upturn has been durable, lasting longer than eight of the eleven postwar expansions. But it is also the weakest, in terms of growth, than any of the previous eleven. What's more, there is no sign that the economy is poised to break out of that listless pattern, despite the unprecedented, albeit futile, help from a misguided monetary policy.

Indeed, with the June 14 rate hike under its belt, the Fed expects to increase rates one more time this year and three more in 2018. But the best-laid plans often go awry, and there are reasons to suspect that things will not fall into place as neatly as the Fed expects. Keep in mind that the central bank has a dual mandate: to achieve maximum employment in a stable price environment, which, since 2012, has been officially defined as a 2 percent inflation rate. While some success has been achieved on the employment side of the mandate, the inflation effort has been an abysmal failure. Since April 2012, the Fed's preferred inflation gauge has been running below that 2 percent threshold every month. In this persistent low inflation environment, the financial markets are betting – correctly in our view – that the Fed will reconsider its rate-hiking plans. However, Fed officials focus more on future than current inflation; their view is that the ever-tightening labor market will spark higher wages and bring inflation up to the 2 percent target over the medium term. They had a similar view in 2015 and 2016, but their aggressive strategy for rate hikes in those years was thwarted by missed inflation calls, an underperforming economy and other unforeseen factors. The way things look now, their ambitious plans for this year and next will have to be scaled back as well.

Inflation Defying the Fed

The June 14 quarter-point rate hike by the Fed was the second this year and the fourth since it started the process of bringing interest rates up to normal levels. The process began with the first quarter-point increase in December 2015, seven years after the Fed drove its policy rate down to near zero as part of its effort to combat the financial crisis and lift the economy out of the Great Recession. The central bank stuck to its zero rate policy through the first seven years of recovery for a variety of reasons, including the fact that the recovery itself was the weakest on record, making it vulnerable to a series of shocks, both homegrown and from overseas, that threatened to derail it.

But the threat of deflation also haunted the Fed throughout the period, particularly since the global economy remained mired in recession well after the U.S. started to recover. Only when Europe and other developed economies regained their footing and the U.S. job market tightened up, did the Fed feel confident that the deflationary pull had eased. Indeed, the Fed's preferred inflation gauge, the core personal consumption deflator, which hovered precariously around 1 percent during the first two recovery years, finally started to climb in 2011 and briefly hit the 2 percent mark in early 2012. At that point, the Fed needed to wait for the job market – where unemployment was still sky-high at 8.5 percent – to catch up before feeling confident its dual mandate had been met.

In the years that followed, the job-creating engine revved up and the unemployment rate plunged. But inflation did not follow the time-honored pattern of moving higher as the job market tightened. Instead, that brief climb to 2 percent in the core-inflation rate, which excludes volatile food and energy items, was just that – brief, lasting four months. Since early 2012, the Fed's inflation measure has never hit that target again. Worse, the trend is moving in the opposite direction, slipping to 1.5 percent in April. Other price measures, such as the consumer price index, have mirrored that downtrend; from January through May, the core consumer price index has slowed by 0.6 percentage points.

Don't Blame One-Off Depressants

To be sure, the Fed was aware of the deceleration in inflation before hiking rates on June 14 and promised to "monitor inflation developments closely" as it pursues its policy goals. Still, the central bank does not appear to be overly concerned, claiming that certain "one-off" factors are mainly responsible for the recent inflation setback. Two in particular caught the Fed's eye: an astonishing free-fall in prices of cell phone plans and the slowing in prescription drug prices. The Fed believes that once these one-off factors fizzle out, the inflation rate will move up to its 2 percent target over the medium term.

But two-thirds of the decline in the inflation rate this year has been due to more fundamental factors, and the prospect that they will undergo an abrupt reversal is slim. For one, core goods remain in deflationary territory, as their prices have continued to decline every month this year and are down nearly 1 percent from a year ago. This persistent decline reflects a global oversupply of goods that will not dissipate soon as there is still a vast amount of spare capacity in the global product markets. Even in the U.S. where the recovery is the longest, industrial capacity is fully 3.3 percent below its long-term average.

The only reason inflation is positive is because prices of services – which account for more than 60 percent of all output in the U.S. – continue to rise. But even here, the inflation pace is slowing, and the slowdown reaches well beyond cell phone plans. The biggest thrust behind the rise in service prices in recent years has been housing costs, particularly the ever-spiraling cost of renting a home or apartment. However, after doubling between 2011 and 2015, the annual increases in rents leveled off last year and actually declined this year, dragging down the inflation rate. The downward pull is set to continue.

Housing Costs Easing

Indeed, since rents and other housing costs comprise more than 50 percent of total service prices, they have an important bearing on the direction inflation will take. Not surprisingly, the upward climb in rents in recent years, which far exceeded the increase in incomes, sowed the seeds for the eventual easing now unfolding. For one, developers lured by the profits in the rental market embarked on an apartment building boom that, in time-honored fashion, has resulted in an oversupply of rental units. For another, more millennials are turning away from rentals, perhaps priced out of many markets, and becoming first-time homebuyers.

With mortgage rates hovering near historic lows, the shift from renting to home buying is likely to continue, extending the time it takes for the oversupply of rental properties to unwind and reinforcing the downward pull on rents. The easing of rental price increases along with the moderation in medical services, recreation and transportation prices, combined with the sharp decline in wireless service plans, strongly suggest that inflation will remain stubbornly below the Fed's 2 percent target, both this year and next.

But what about the wage inflation that a tightening job market is supposed to ignite, prompting businesses to pass on higher labor costs to consumer? Clearly, that classic wage-price inflation dynamic is far from happening. For a variety of debatable reasons, the steep fall in the unemployment rate has not spurred an acceleration of wage growth; if anything, the average 2.5 percent increase in worker pay in effect over the past several years combined with 1 percent productivity growth is consistent with a 1.5 percent inflation rate, which is about where we are now.

Misguided Belief in Phillips Curve

That said, the Federal Reserve is clinging to the belief that tightening labor market conditions will underpin a pick-up in inflation over the medium term, particularly once the aforementioned "one-off" price declines run their course. From our lens, that's wishful thinking unless the Fed unexpectedly lowers the target for unemployment to well under 4 percent, something not seen since December 2000. Even then, the Fed would most likely find out that its long-standing belief in the Phillips Curve has been misguided.

In Japan and Germany, for example, wage increases are negligible despite the fact that unemployment rates in those nations are the lowest in decades. Indeed, low inflation is an even thornier issue abroad than it is in the U.S. Not coincidentally, both Germany and Japan share the same problems as the U.S.: low productivity and an aging workforce. These are critical forces restraining wages and inflation that will remain intact over the foreseeable future. Still, central banks continue to believe that they can attack the problem with ultra-loose monetary policies that have failed time and again to soak up excess capacity and the oversupply of goods, which is a byproduct of elastic global supply chains. The Bank of Japan is the poster child of misguided decisions, having embarked on a series of unconventional policy moves long before the Federal Reserve to lift the economy out of its quarter-century deflationary quicksand.

Yet, core inflation in Japan remains at zero and the sustained ultra-loose monetary policy has only increased the nation's dependency on its continuation. In the U.S., the Fed has finally acknowledged the risk of this dependency. Instead of promoting growth and restoring

price stability, the seven years of ZIRP and QE has promoted excessive leverage, asset bubbles, unwise risk-taking and the transfer of wealth from lenders to borrowers and shareholders. Pension funds are deeply underfunded and struggling to meet the burgeoning liabilities owed to an ever-growing army of retirees. Meanwhile, savers continue to be penalized by low rates, which are driving them into riskier investments that are totally inappropriate for an aging population.

As a result, the threat of financial instability that will end in another crisis has risen exponentially. The stock market is clearly vulnerable to a sharp correction, as P/E ratios are historically high even as unsustainable forces have been propping up earnings per share. These include the massive stock buybacks and M&A activity – financed with leverage -- that have inflated per share earnings by removing shares from the equation. As the yield curve flattens and squeezes bank capital, the lending spigot to finance leveraged buyouts will narrow. What's more, a key plank of the Republican tax reform plan is the elimination of the deduction for net interest expense, which would greatly increase the cost of borrowing and vanquish the incentive of businesses to engage in stock-friendly debt-financed activities, such as outsize dividend payments as well as share repurchases.

Easy Money Dependency Heightens Financial Instability

The recent turmoil in the bond and stock markets illustrates how difficult it is for economies, including the U.S., to loosen their dependency on easy monetary policies. Just the hint that the ECB and Bank of England is poised to become somewhat less accommodative sent investors running for the hills in late June, driving bond yields up and stock prices down. As a result, the Fed and other central banks are facing an unhappy conundrum. A key reason they are now starting to turn away from nearly a decade of ultra-loose monetary policy is to prevent financial instability. Yet that is precisely what their actions are bringing about, as the rug under overvalued assets is being pulled out.

Without the safety net provided by the proverbial central bank put, investors can no longer count on a bail-out when adverse developments hit the fan. From our lens, plenty of them are coming down the pike. The growth and reflation trade underpinned by expected fiscal stimulus has all but evaporated, given the ongoing chaos in Washington punctuated by the deep division within the Republican Party over health care legislation.

As it is, Congress has a lot on the table to mull over beyond repealing and replacing the ACA. The Senate, for example, now has four additional priorities to address: passing a budget by September 30 to avoid a government shutdown, raising the debt ceiling by early October, drafting a tax reform and infrastructure bill and addressing the Russian interference issue. Needless to say, that is a lot to bite off and only a diehard optimist could think that things will go smoothly. More than likely, expect some potentially confidence-shattering headlines to roil the markets, reinforcing the uncertain prospects of Federal Reserve policy.

Sooner or later, the dysfunction in Washington will spread beyond the beltway into the real economy. We suspect that is already happening. Business and consumer confidence has come off their highs. The University of Michigan Sentiment Index fell to its lowest level since November in June, led by a downturn in growth expectations. The hard data continue soften, coming in consistently under expectations and prompting downward adjustments to second-quarter growth estimates. The early-spring consensus that the economy would rebound vigorously from the tepid 1.2 percent pace in the first quarter is no longer baked in the cake. Instead a modest improvement to about 2.5 percent is generally expected, and the tracking model of the Federal Reserve Bank of New York pegs it at 1.9 percent.

Against this backdrop of lackluster growth, sustained low inflation, overvalued equity and real estate assets combined with a chaotic political environment, the demand for safety and liquidity is likely to remain strong, if not increase. The Fed would be ill-advised to ignore the data and continue with its rate-hiking strategy, hoping to build up a cushion to use against the next downturn. At the current 10-year Treasury yield, four more rate increase by the end of 2018 – the Fed's current plan – would bring about an inverted yield curve, a reliable precursor to recessions.

RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISONS

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Bloomberg Barclays TSY Bellwethers)	06/30/2016	3/31/2017	6/30/2017	Last Quarter [1]	Last Year [2]
6 Mo. Bill	0.35	0.90	1.13	0.21	0.65
2 Yr. Note	0.58	1.26	1.38	0.12	-0.30
5 Yr. Note	1.00	1.93	1.89	0.66	-2.63
10 Yr. Note	1.47	2.39	2.30	1.31	-5.56
30 Yr. Note	2.29	3.02	2.84	4.26	-8.79

Municipal Bonds	Yields (%)			Total Return (%)	
	06/30/2016	3/31/2016	6/30/2017	Last Quarter [1]	Last Year [2]
ML Rev 22+ Index	2.10	3.24	3.01	2.65	-1.17
ML G.O. 22+ Index	2.08	3.18	2.89	3.07	-2.71

Equities	Levels			US $ Terms (%)	
	06/30/2016	3/31/2016	6/30/2017	Last Quarter [1]	Last Year [2]
S&P 500	2,098.86	2,362.72	2,362.72	3.09	17.87
DJIA	17,929.99	20663.22	20,663.22	3.95	22.09
NIKKEI (Tokyo)	15575.92	18909.26	18,909.26	6.06	31.05

Commodities	US $			Percent Change (%)	
	06/30/2016	3/31/2016	6/30/2017	Last Quarter [1]	Last Year [2]
COMEX Gold Active Monthly	1,322.20	1249.35	1,242.30	-0.56	- 6.04
CRB Future Com. Pr. Index*	193.43	185.88	174.78	-5.98	- 9.64
West Texas Intermediate Crude ($ per bbl.)	48.33	50.60	46.04	-9.01	-4.74

Currencies	Levels			Percent Change (%)	
	06/30/2016	3/31/2016	6/30/2017	Last Quarter [1]	Last Year [2]
Yen	103.20	111.39	112.39	-0.90	-8.91
Sterling	1.33	1.26	1.30	3.78	-2.15
Euro	1.11	1.07	1.14	7.27	2.88

Foreign Bond Markets	Levels			US $ Total Return (%)	
	06/30/2016	3/31/2016	6/30/2017	Last Quarter [1]	Last Year [2]
3-Mo. LIBOR DEM Fixing [3]	-0.32	-0.37	-0.39	N/A	N/A
ML German 10-Yr.+ Bond Index	0.14	0.76	0.92	-2.00	-10.69
3-Mo. LIBOR Yen Fixing [3]	-0.02	0.03	0.01	N/A	N/A
ML Japanese 10-Yr.+ Bond Index	0.00	0.47	0.46	0.42	-8.12

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

Disclaimer: This publication contains the current opinions of the manager and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Such opinions are subject to change without notice. This publication is distributed for education purposes only. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Forecasts are based on proprietary research and should not be interpreted as an offer or solicitation, nor the purchase or sale of any financial instrument. No part of this publication may be reproduced in any form, or referred to in any publication, without the express written permission of Smith Affiliated Capital Corp.