# ECONOMIC & INVESTMENT ENVIRONMENT REVIEW

*An analysis of current market trends from Private Client & Institutional Services*

APRIL 2017

## OOPS, SHE DID IT AGAIN!

We are not talking about Britney Spears. Instead, this is a reference to Federal Reserve Chair, Janet Yellen. She and her team of Federal Open Market Committee members have been busy. They did it again — they raised the Federal Funds target rate a second time in just three months. This is the third hike since the Fed began its normalization policy back in December 2015.

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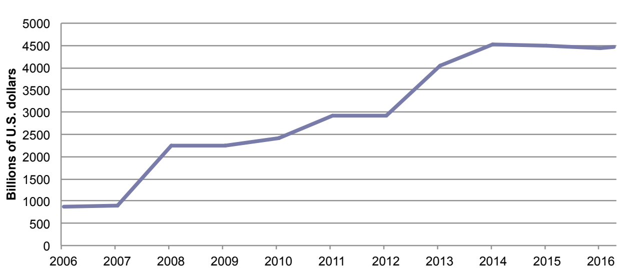
In mid to late-February, market trading reflected a mere 30% expectation of a March rate hike. Just two weeks later, after numerous meetings and presentations, expectations of a rate increase jumped to over 90%. Given the exceptional broadcast of the plan, domestic and foreign stock market investors then took the increase in stride.

Taking it in stride is an understatement. The S&P 500® stock market index just posted its sixth quarter in a row of positive returns with a gain of +6.1%. Sixteen of the last 17 quarters have shown a gain. Given this optimistic backdrop, Janet Yellen has now become emboldened to begin talk of the Federal Reserve tackling its balance sheet.

1. FEDERAL RESERVE BALANCE SHEET




Source: Federal Reserve

### RESTOCKING THE MONETARY TOOLBOX

Before 2008, the Federal Reserve maintained a balance sheet of about $800 billion in mostly U.S. Treasury securities. During the Great Recession, in an effort to boost the economy by pushing long interest rates down, the Fed initiated its Quantitative Easing strategy. Its balance sheet ballooned to over $4 trillion, where it sits today.

There is no script for how to reduce this monster. Just like the 2017 Oscars, it would be very easy for Janet Yellen to draw the wrong envelope when making her choice. Her hands might be shaking given the "taper tantrum" of 2013 when Ben Bernanke dropped hints of simply reducing the level of Quantitative Easing activity. The yield on the 10-year U.S. Treasury Note shot up by 140 basis points over the next three months. The S&P 500 plunged over 10% in the same time frame. Mortgage applications fell 60%.

Perhaps, the U.S. economic and investment environment has matured from tantrum-like responses to the classic teenage shrug of the shoulder. While the stock market had a winning quarter, the current yield on the 10-year U.S.

Treasury Note fell to about 2.35%. This was about 25 basis points (0.25%) below where it traded after the March 2017 hike, and it even was below the yield at the time of the first Fed hike in December 2015. Furthermore, the VIX index® of stock market volatility (also known as the fear index) fell back to 11.8, which is not too far from its record low of 9.97.

Three Fed rate hikes; talk of the reversal of Quantitative Easing; stock market strength; political uncertainty; and the 10-year U.S. Treasury Note yield is notching lower. What is going on? We believe this activity reflects continued less-than-robust economic growth as well as limited inflationary pressures.

Isn't the Fed raising its target interest rate because it sees inflation coming down the pike? We do not believe that to be the case. Instead, the Fed is raising its target rate to get back to a more normal interest rate structure. Janet Yellen is looking to the future, and she wants the Federal Reserve to have as many tools as possible to fight off the next recession. Leaving the target rate at its low of zero to 25 basis points would be similar to continuing to do CPR on a breathing patient — harmful.

## INFLATION NOT HEATING UP

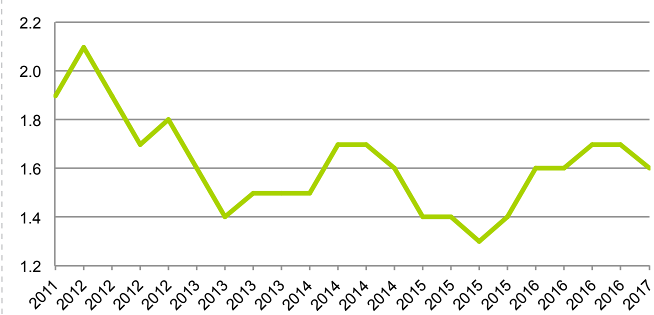
Pockets of inflation do exist and we are finally seeing signs of wage growth. The overall inflationary environment that many market-commentators expected earlier in the year, however, is just not coming to fruition. Your author's investment career began when inflation was in the double-digits with no end in sight. Early-career experiences tend to color one's opinions tremendously, so this rebuke of a return to inflation is not taken lightly.

One development that contributes to our resolve is the advancement of technology. Oil fields, for example, may be shuttered and re-started with amazing dispatch in tandem with movement in the price of a barrel of oil. Amazon® and Walmart® are in the fight of their lives to be the low-price leader, and they are squeezing costs at every turn. Delivery by drone as well as via the trunk of an Uber® driver's car is becoming de rigueur. UPS® is developing software that enables it to collect and deliver packages by neighborhood in an effort to reduce costs and remain competitive.

Another example of technology contributing to cost reduction and price restraint involves the investment industry. BlackRock®, Inc. is the world's largest asset manager with $5.1 trillion in assets under management. The company just announced a major overhaul of its business that will include job losses and an increased reliance on computer models to manage money. Very close to home…

Moving on, recent consumer confidence reports from The Conference Board® and the University of Michigan® show expectations of inflation remaining near record lows. Additionally, businesses continue to report difficulty in raising prices even as some input costs go up. Industrial capacity utilization remains low at 75%, which is not exactly inflationary. Furthermore, the core Personal Consumption Expenditure index®, which is the Fed's favored measure of inflation, remains below its 2% target at 1.6% on a year-over-year basis.

2. CORE PERSONAL CONSUMPTION EXPENDITURE INDEX, PERCENT CHANGE




Source: Federal Reserve Bank of St. Louis

On another note, with a nod to Nobel Prize-winning economist Milton Friedman, recent monetary statistics provide the dagger to the inflationary outlook. Money supply growth has been flat to downward sloping for the past seven years. The velocity of money, which is tantamount to financial recycling, is also in decline.

## MORE OF THE SAME

If inflation is not expected in the near future, is recession? Our answer continues to be no. That "LTR" (less than robust) assessment we have stuck with all these years continues, although it has been made more difficult lately given the strength in survey-based or "soft" data such as consumer confidence and small business confidence. These measures are also referred to as "animal spirits."

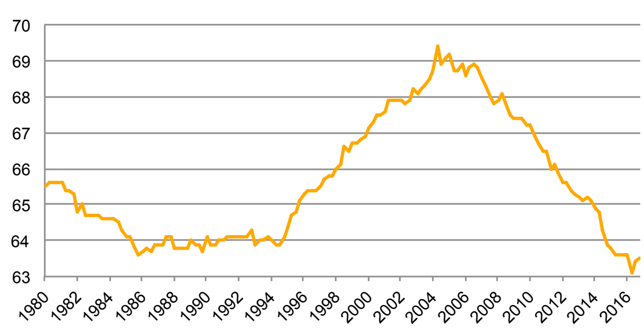
Meanwhile, "hard" economic data such as hiring activity, wage growth, business investment and residential investment have been mixed. According to Moody's Economy.com®, models of U.S. Gross Domestic Product (GDP) growth based on soft data would point to annualized first-quarter 2017 GDP growth between 3.3% and 4.8%. Using "hard" data, most forecasts (including that of the Federal Reserve) arrive at annualized GDP growth of about 0.9%. Not all that inspiring yet not in recession territory.

After nine years of recovery, this sluggish growth may indeed be indicative of a late-stage recovery. Here is our lightning bolt, however: late cycle does not equal end of cycle. Abundant naysayers point to the fickle nature of animal spirits, income inequality, high levels of debt, a lack of business investment and millennial malaise all as reasons to expect an end to this recovery. No argument here — those are all good reasons to lose sleep at night.

## CAUSES OF OPTIMISM

Move past the current sleeplessness, however, and we see reasons to be optimistic. Those reasons are born between the years 1981 and 1997. There are about 75.4 million of them. They now make up the biggest slice of the U.S. population. We're talking about the millennials. The oldest millennial is now 35 years old. Even they cannot stop the hands of time!

3. HOMEOWNERSHIP RATE FOR THE U.S., PERCENT




Source: Federal Reserve Bank of St. Louis

At the same time, U.S. home ownership levels are at 50-year lows. This pendulum will swing, and in our opinion, it will be driven by aging millennials who finally decide to buy a home and start a family. It may not be the McMansion home of boomers, but neither is it going to be a parent's basement nor a micro-apartment. When this shift happens, it will provide a boost to the U.S. economy. Housing is a significant contributor to economic growth. Ask any new homeowner just how many trips he/she has made to the hardware store. The National Association of Home Builders® estimates that each new single-family housing unit creates three new jobs.

Speaking of jobs, the U.S. saw an excellent pace of net new job creation in the first quarter of 2017. The improvement was broadly based and the participation rate also increased. Plans to hire were supported by the Institute for Supply Management® survey of manufacturers, which showed an increase in the employment sub-index from 54.2 to 58.9 in March. The most recent Job Openings and Labor Turnover report noted a near-record number of job openings as well as a voluntary quit rate at its cyclical high.

The employment situation is showing signs of improvement globally as well. It has been a long time since those words were written. Euro-area unemployment posted a decline to an eight-year low of 9.5%, which compares favorably to the 2013 peak of 12%. The Tankan survey of Japanese business sentiment reflected employment gains as well as signs of long-awaited wage growth.

As noted earlier, the U.S. economy is in the midst of a sluggish recovery that we expect to continue. There is a lot of uncertainty in the economic and investment environment, and that is a headwind to economic growth. Employment and housing provide powerful tailwinds to economic growth, however, and periodic reports of strength will bring about some temporary inflationary fits in the bond market. When those happen, bond prices drop, which presents a buying opportunity for our fixed income portfolios. Our approach involves filling out a bond maturity ladder by scanning the yield curve for mispriced opportunities. In other words, our bond buying reflects a patient "buy the dip" strategy.

## DEALING WITH HIGH STOCK VALUATIONS

U.S. stocks are not cheap, and there have been few dips to buy. In fact, the S&P 500 had its first 1% down day in over 100 trading days just last month. One reason for this relates to the behavior of crowds. If everyone wants to buy on a dip, there will be no dip. Any whiff of weakness typically brings on the buyers and poof, the opportunity is gone.

Another reason is the basic nature of common stock investments. They are a lens through which investors' expectations of the future can be viewed. We argue investors, as a whole, see evidence of future economic and earnings growth in a continued relatively low inflation, low interest rate environment. This vision contributed to a net flow of almost $40 billion into global stock funds during the quarter, which was the highest level in two years.

The price-to-earnings (P/E) ratio of the S&P 500 index is over 18 times forward 12-month earnings. This means investors are paying $18 for $1 of potential future earnings, and it compares to the average forward P/E ratio of about 14. Furthermore, investors are paying 2.1 times sales or about $2.10 for each $1 dollar of sales. According to Barron's®, this ratio hit its all-time high of 2.3 during the tech bubble. The "lens" described above has a bit of a rose tint to it!

So, how do we structure an equity portfolio when we are reasonably positive about the economic outlook but aware of the market's expensive valuation? We do not suggest one try to time the market. That is a loser's game. We do look for pockets of opportunity as a way to enhance a core equity portfolio.

One pocket includes the foreign arena. Even though foreign stock mutual funds were one of the strongest performing investment categories in the first quarter of 2017, they continue to merit consideration. They do have some ground to make up! The largest foreign stock mutual fund provided investors with a 10-year average annualized return of less than 1% for the decade ending in 2016. We see value in more reasonable price-to-earnings ratios as well as higher earnings growth rates than those in the U.S.

A word of caution: after one quarter of strong performance, numerous articles extolling the virtues of international investing will magically appear. Several of those articles will cite the fact that the U.S. stock market capitalization only represents 40% of the global market capitalization. This fact will then be extrapolated to suggest a U.S. investor should have 60% exposure to foreign stocks. We are not singing that tune. Exposure to U.S.-based companies brings investors exposure to foreign markets whether they want it or not. Adding a slight international flavor to an investment portfolio through a well-managed mutual fund will simply allow an investor to take advantage of more reasonable valuations than U.S. stocks currently provide.

Whew! These are fascinating times. With each conclusion written, it is easy to look back and see how much was not covered. We try to recognize you may not be pining for floods of economic information. That said, you might have noticed a dearth of coverage of the political environment. You are welcome. This was not out of a lack of respect for the power of fiscal policy. It reflects an admiration for the strong steady undercurrent in the U.S. economy, which is what should be shouted from rooftops!

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