TRI-STAR TRUST BANK

Tri-Star Trust Bank
www.tristartrust.com

OUTLOOKS

July 2017

ECONOMIC OUTLOOK

Summary

The Fed raised short-term interest rates by 0.25% on June 14, marking the fourth hike in this tightening cycle. They expect to raise rates a further four times (1.0%) over the next 12 months or so. Whether they do or don't will in large part be determined by their evolving view of the "natural rate of interest" or r* (r-star), in Federal Reserve parlance. In essence, how much compensation should short-term (1 month to 3 month) risk free investors get paid over the present inflation rate. The Fed has long believed that a 2% inflation premium on its short-term rate was static and optimal. If inflation was 2% then r* would equal 4% (2% real rate plus 2% inflation).

However, what if the optimal short-term rate is not a real spread of 2% above inflation but was 0.0% to 1.0% above inflation? That puts the final short interest rate guided by the Fed in the 2% to 3% range. We are at 1.25% currently. A risky asset is generally discounted by the risk-free rate and the lower the risk-free rate, the higher the valuation garnered from the risk asset, all else equal. Therefore, the reevaluation by current Fed members that their estimated, optimal short-term rate is not static and could be much lower is significant. It suggests a much lower trajectory in further rate hikes which supports a fuller valuation in assets such as stocks.

Our best guess is that r* is somewhere between 0.0% and 1.0% over the next few years. There are many reasons for this and we have discussed these causal factors in prior writings. Debt, demographics and disinflation are the Big 3. History shows that the more debt incurred in an economy, the lower the potential growth rate. In addition, under-saved Baby Boomers are working longer and saving, not spending, as they prepare for retirement. Finally, the digital economy (Amazon/Facebook/Google, etc.) is creating major disruption for traditional business models, putting pressure on profit margins and wages. So, the evolution of the Fed's thinking on the r* issue will be the difference between getting monetary policy about right and needlessly creating a policy error.

Positives

ISM Manufacturing Index hits 57.8 this month vs 55.3 expected

ISM Employment Index hits 63.5 vs 59.5 last month

Trade balance for the month was less negative than expected, boosting GDP estimates

Negatives

Housing starts were light at 1.092 million vs 1.156 million last month

Building permits were soft at 1.168 million vs 1.228 million last month

Univ. of Michigan Consumer Sentiment Index 94.5 in June vs 97.1 last month

EQUITY OUTLOOK

Summary

We're halfway through 2017 and it's time for a mid-year review. Year-to-date, equity markets worldwide have enjoyed positive returns. Number one in broad index returns was the MSCI Emerging markets index, which jumped 18.4%. U.S. market performance was relatively tame by comparison but still solidly in positive territory; the S&P 500 tacked on 9.4% in the first half.

Drilling deeper into our domestic markets, growth stocks (think technology and health care) led the charge in a dramatic manner. Thanks to market heavy-weights, such as Facebook and Amazon, the S&P 500 Growth Index rose 13.3%. On the other side of the ledger, the S&P 500 Value Index, which tilts heavily toward energy and telecom stocks, gained just 4.8%.

One explanation for such a wide divergence in returns between investment styles this year has been the rapidity with which market participants have faded the impact of regulatory reform. Immediately following the election, U.S. markets enjoyed a surge, the "Trump Bump" if you will, which discounted the change in power in Washington.

Yet the much anticipated economic benefits which were to accrue from a Republican pro-business agenda appear to be disappearing as tax and reform proposals have yet to be floated, much less deliberated, in Congress. If the current state of the health care reform process is any measure, regulatory or tax reform may be a distant illusion in terms of any meaningful impact on economic growth.

The result of this reset in expectations has been the severe underperformance of cyclical industries, i.e., energy, materials and industrials, as hopes of reform fade.

With the expansion more than eight years old, an extremely low unemployment rate, re-leveraged corporate balance sheets and rising short-term rates, there is a point to be made we are in the late innings of the game.

The other side points to continued consumer confidence: slow wage gains, historically low real rates, accelerating corporate earnings and a market only modestly overvalued.

While acknowledging the onset of the summer doldrums, we maintain our outlook for positive equity market returns in 2017.

Positives

Estimates for 2017 corporate earnings growth relatively stable

Imbalances not apparent

Negatives

Regulatory reform appears fleeting

Complacency abounds

Housing price increases pressuring market

Unknown

North Korea

FIXED INCOME OUTLOOK

Summary

Following a spate of weaker than expected economic reports and declining core inflation statistics, longer term interest rates declined during the first half of June with the 10-year Treasury reaching its lowest level of the year at 2.10% on June 14, the day of the Federal Reserve's Open Market Committee (FOMC) meeting. The post-meeting yield was a full 50 basis points lower than the yearly high reached almost exactly three months earlier.

Late in the month, rates rose across the curve as the European markets experienced a lite-version of a central bank induced taper-tantrum. This happened when ECB President Mario Draghi made an impromptu comment suggesting that the conditions might be right for them to begin a reduction in their asset purchase program. Although he backtracked on his comment the next day, the damage was done and rates began rising across Europe. The reaction in the markets was eerily similar to those of the U.S. bond market when then-Fed Chair Bernanke suggested the same back in May of 2013. Back then, the U.S. 10-year increased from below 2% to 3% in the subsequent few months. In the last few days of June, the 10-year German Bund yield doubled from 0.24% to 0.48%, and yields have continued to rise in July. The European moves higher allowed U.S. yields to do the same without the U.S. dollar increasing relative to the Euro. The U.S. 10-year Treasury ended the month at 2.30% and has also continued upward in July. While long rates plunged and then rose, shorter maturity yields continued a steady trek higher, correlating closely with the projected path of overnight rates.

The Fed remains committed to gradually normalizing interest rates and has reinforced its expectations of another rate hike this year followed by up to three more per year for the next couple of years. While appearing quite dramatic after seven years of a zero interest rate policy, this would be gradual relative to the 2004-2006 cycle where they increased the overnight rate 17 meetings in a row from 1.00% to 5.25%. We still believe the Fed is overestimating the target or long-term level of the overnight rate, particularly with the core rate of inflation falling and wage growth barely above 2%.

Our terminal target for Fed Funds is closer to 2% which should be achieved in 2018. If borrowing costs move much higher, the economy will likely slow and recession fears emerge. The Fed also knows from history that recessions usually follow when the yield curve becomes inverted. Longer rates should continue to trend modestly higher but will be capped around the highs seen earlier this year at 2.60%. Next year, if the global economy cooperates and geopolitical events do not upend the current business optimism, the 10-year could make a push back up to 3%.

Positives

Inability to enact pro-growth policies of the Trump Administration

Declining core inflation and little wage growth even with low unemployment

Negatives

The Fed is committed to further rate increases and to begin to reduce the balance sheet

European yields finally beginning to rise, U.S. dollar weakening

Unknowns

Potential terror attacks create safe haven bid for Treasuries

Russia; North Korea; Iran; Syria