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OUTLOOKS

April 2018

ECONOMIC OUTLOOK

Summary

The Federal Reserve raised the Fed Funds Rate last month by 0.25%, taking its targeted range to 1.50% to 1.75%. This was the sixth rate increase and the Fed indicated that two more hikes are likely this year, if the economy evolves as they expect. The cumulative impact of these higher short term interest rates and larger budget deficits are beginning to effect commercial paper borrowing rates for large corporations. The incremental borrowing costs for these firms has increased about 0.25% this year, over and above the 0.25% rate hike recently implemented by the Federal Reserve.

Higher relative credit costs were a little worrisome in Q1 2018 but haven't had a material impact on the economy so far. The final revision of Q4 2017 was raised to 2.9% from 2.7% and preliminary estimates for Q1 2018 have been steady at around 2.5%. This is significant because the last four years have witnessed about a 1.0% average Q1 run rate on GDP. So, no seasonal Q1 weakness this year, combined with a full employment economy and rising real incomes translates into a solid handoff for Q2 growth prospects.

One surprising statistic this year has been the increase in the savings rate despite higher disposable income from the recently passed tax cut legislation. Consumers spent and borrowed a lot money in the fourth quarter and it seems as if we may be experiencing a little payback for that boost in economic activity.

On the surface it may look like the consumer "saved the tax cut" but history suggests (2003) that after a temporary rise in the savings rate, consumer spending picks back up once their liquidity improves and some modest debt reduction takes place.

Positives

Initial jobless claims are the lowest in over 40 years

Industrial production increased 1.1% month-over-month, 0.4% expected

Capacity utilization increased to 78.1%, the highest since 2014

Negatives

Housing starts drop 7.0% month-over-month to 1.236 million units (annualized)

Consumer confidence drops to 127.7, 131 expected

Real personal spending is flat for the month and the prior month is revised to -0.2%

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EQUITY OUTLOOK

Summary

The S&P 500 fell 2.5% in March, finishing in negative territory for the second straight month. Although, because of the strong start in January (+5.7%), the index sits just 0.8% below the 2017 close. Trade war rhetoric continued to escalate last month as President Trump announced tariffs on steel and aluminum which was met by a retaliatory response from China. The President also continued to make changes in his cabinet, replacing moderate voices with hardline members more likely to support his agenda.

There were several instances of negative, company-specific news targeting some of the technology leaders which have helped fuel the market's momentum over the last several quarters. Partly as a result of those headlines, the Russell 1000 Growth Index fell 2.7% underperforming the Russell 1000 Value which lost 1.8%. It's possible the disruptive innovations from the likes of Amazon, Facebook, Google, Netflix and Tesla will continue to play an increasing role in day-to-day life. Yet, it's still a bit early to know whether new leadership will emerge from the current stock market pullback or if these same bellwethers will continue to carry the torch.

The possible trade war, cabinet changes and tech selloff was enough to create uncertainty in the minds of market participants. Volatility, which spiked in early February, remained elevated throughout the month of March. We expect volatility to continue near term, although headline risks that caused the dislocation in technology stocks will eventually subside. Trade talks are still in the early innings and the potential impact may not have been fully digested by markets. In spite of the headline risks, fundamentals look very solid heading into earnings season. During the first quarter, analysts revised S&P 500 earnings higher by 5.4%. Historically, earnings are much more likely to be revised lower throughout the reporting quarter. In fact, S&P 500 earnings have been revised lower during the quarter by an average of 3.9% over the last five years and 5.5% over the last 10 years. The catalyst for the upward earnings revisions this quarter has primarily been the reduction in the corporate tax rate. If earnings come through as or better than expected in the coming weeks, it's quite likely equity markets will stabilize and possibly resume the long-term upward trend. However, disappointing results could be met with selling pressure.

Positives

- Synchronized global expansion
- Corporate earnings momentum
- Positive consumer and business sentiment

Negatives

- Trade war threat
- Elevated volatility

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FIXED INCOME OUTLOOK

Summary

The investment-grade bond market delivered positive returns across all sectors for the month of March after experiencing declining values in January and February. The momentum for higher yields seen during those two months stalled out in the later days of February and reversed course in the final few days of March. In between, the bond market experienced an unusually low level of volatility with the 10-year Treasury note closing each day in a 2.80-2.90% trading range for 22 consecutive trading sessions.

The move lower in rates happened even after the Fed's Open Market Committee (FOMC) raised the benchmark overnight rate by 25 bps and had its inaugural meeting under the leadership of new Chair Jerome Powell. While the tone and tenor of the post-meeting press conference was much the same as the former Chair Yellen's emphasis on gradual increases that are data-dependent, the accompanying data signaled the potential for a more hawkish FOMC. The Fed's "dot plots", an indication of each member's belief on the most probable path of the overnight rate, continued to indicate that the consensus expectation is for two additional rate hikes in 2018. New to their outlook was the central expectation for three increases in 2019 and two more in 2020. Previously they had been expecting only two rate hikes in 2019.

Given all of the geopolitical and policy uncertainties confronting the economy, it is difficult to have much clarity for the remainder of this year, let alone 2019 and 2020. Even so, it is hard for us to imagine the need for an overnight rate that is so significantly above the Fed's own target rate of inflation. Given the demographic headwinds confronting most of the world's larger developed economies and the abundance of production capabilities in nearly every industry, we do not believe inflationary pressures are likely to force the FOMC to be that draconian. We still believe rates could move higher with the 10-year piercing 3%, but there is little reason to call for anything resembling a bond rout.

Positives

Global rates have declined making U.S. yields even more attractive

Many believe that an overly aggressive Fed will lead to a recession and lower rates

Credit spreads are attractive given solid credit fundamentals, tax reform and cash repatriation

Negatives

Treasury borrowings are to increase just as the Fed reduces their balance sheet

Import prices might increase more as the U.S. dollar stays weaker for longer

Inflationary pressures could reemerge if trade wars flare

Unknowns

China's trade policy and retaliation to tariffs

China could begin to sell holdings of U.S. Treasury debt

Negotiations with Iran and North Korea could elevate geopolitical concerns

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