Tri-Star Trust Bank
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OUTLOOKS

February 2018

ECONOMIC OUTLOOK

Summary

Last month we raised the prospect for 2018 to be the year for Main Street and possibly not Wall Street. This is not a bearish statement intended to imply a significant market correction is coming, it's meant to convey a message that Main Street may get a bigger slice of the economic pie this year, compared to Wall Street. We saw a glimpse of this phenomena embedded within the Non-Farm Payroll data last week. Payroll growth exceeded expectations for January (200,000 vs 180,000 expected) and the prior month was revised higher by 12,000 jobs. More importantly, average hourly wages increased .10% higher than expected for the last two months, bringing the year-over-year average to +2.90%, a cycle high.

Wages are growing at the fastest level in over nine years and some of the employee wage increases and special bonus awards have not made their way into the aggregate income data just yet. So, Main Street is experiencing a full employment economy, with cycle high wage growth and reasons to expect more good news to follow on the labor front. Wall Street on the other hand, has to face the prospect of higher than expected inflationary pressures, a potentially more aggressive Federal Reserve and higher risk-free rates by which to discount future cash flows.

Markets have been reacting to some of these developments recently and there may be more to follow. But, does that mark the end of the bull market for riskier assets? Probably not, because tax reform is boosting corporate earnings and balance sheets, while the secular forces of disinflation (Amazon Effect, globalization/robotization and excess capacity) are firmly entrenched in our economic system. Oh, and before we get too worked up about higher commodity prices, the Bloomberg Commodity Index is at the same level that existed in 1992. In summary, a historically expensive stock market with exceptionally bullish sentiment is ripe for a pullback. But Main Street's relative gains can coincide with Wall Street valuations that improve as earnings increase. This hopefully leaves the Fed with real time data that indicates no need for a "bad cop" that is forced to hike rates beyond a necessary level.

Positives

Factory orders gain 1.70% vs 1.50% expected

ISM non-manufacturing index jumps to 59.9 vs 56.7 expected

Personal consumption came in at 3.80% vs 3.70% expected

Negatives

Unit labor costs increase 2.0% vs .09% expected

Average hourly earnings increase to 2.90% vs 2.60% expected

Auto and truck sales disappoint at 17.07 million units (annualized) vs 17.2 million expected

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EQUITY OUTLOOK

Summary

The broad based global equity rally continued into January as markets digest increasingly strong economic data and corporate earnings momentum. The S&P 500 advanced 5.7%, but volatility started to creep back into the markets towards the end of the month. The CBOE Volatility Index spent much of January trading around 10 yet ended closer to 15. While that is still a historically low level of volatility, the rate of change is meaningful and does indicate some level of stress or uncertainty could be on the horizon.

Growth outpaced value stocks in January following two consecutive months in which value carried the flag. Classic growth sectors such as consumer discretionary +9.3% and technology +7.6% were the leading performers for the month. The value-oriented and interest rate sensitive real estate and utilities sectors, impacted by a 30 basis point rise in the 10-year Treasury, declined 2.0% and 3.1% respectively. We believe the long run of growth's outperformance over value is likely nearing an end. While gradually rising interest rates may temporarily put pressure on higher yielding value stocks, we believe value stocks resume the leadership position this year.

International equity markets continued to perform well in the first month of 2018. MSCI EAFE Index, which tracks developed international stocks, rose 5.0% and the MSCI Emerging Markets Index climbed 8.3%. We continue to believe the strong relative performance of international stocks is in the early innings because their economies are earlier than the U.S. in their expansion cycle and many foreign central banks are still engaged in quantitative easing. International equities also continue to gain from a weak U.S. dollar and this trade has yet to show any sign of slowing.

Stagnant wage growth and sluggish inflation have been particularly troubling for the Federal Reserve policy makers. The strength of recent data points, with wages and inflation in particular, brings into consideration the economy may begin to overheat. This enhances the possibility the Fed may be more aggressive and raise rates more quickly than the markets currently anticipate. This could spell the end of the Goldilocks economics situation we've enjoyed for the last several quarters.

In recent trading sessions, market volatility has accelerated and equity markets have traded lower. The CBOE Volatility Index spiked more than 400% to over 40, at the time of this writing. Volatility is one measure of investor sentiment and is certainly a signal of some dislocation in the marketplace. Improving economic fundamentals and corporate earning guidance should continue to drive stocks higher in the long run, that said, we still view any near-term pullback as a buying opportunity.

Positives

- Synchronized global expansion
- Corporate earnings growth

Negatives

- Rising volatility
- Accelerated Fed rate hikes

FIXED INCOME OUTLOOK

Summary

Bonds delivered negative returns for January as interest rates increased sharply across the yield curve. While bond strategists and investors work to assess the impact of the tax reform bill on the government's budget deficit and the Treasury's funding needs, companies are busy announcing bonuses and wage increases. Bigger deficits will lead to a greater supply of bonds just as the Fed is reducing its rate of open market purchases for its balance sheet. The declining U.S. dollar is increasing import prices just as oil prices have climbed to the highest level in three years. Higher wage costs ignited by the tax cuts could combine with these pressures and lead to inflation that is finally at, or even above, the Fed's 2% target rate. With one legislative victory, the Trump administration is now working on an infrastructure program which would likely cause even greater deficits and inflationary pressures.

As measured by the Fed funds futures market, investors were expecting two rate hikes by the Fed for all of 2018. That market now shows three hikes being the most likely outcome and many forecasters are looking for four. Anxiety has set into the bond market with this more aggressive outlook for the Fed. With the 2-year yield up by 26 basis points (bps) and the 10-year higher by 30 bps, we think we are much closer to fair value than we were just a few months ago. Ultimately, we still think the 10-year will breach 3% and could rise as high as 3.25% during the first half of the year, but we are not overly concerned that rates will move beyond that. At some point, higher rates could begin to weigh on the stock market and if volatility returns there, yields will react by declining again. Shorter rates should continue to rise along with increases in the Fed funds rate until the expectation of further hikes diminishes.

Corporate credit spreads narrowed as they remained the favored sector of the bond market. Lower taxes and the repatriation of overseas capital is positive for credit fundamentals and could lead to lower issuance of bonds for the next few years. We still favor corporate obligations over Treasury issues, but acknowledge there is not as much opportunity going forward as there has been in the past few years.

Positives

U.S. rates across the yield curve are higher than all other developed high quality governments

Investors are likely to continue rebalancing into bonds as stock prices increase

The Federal Reserve's Open Market Committee (FOMC) is likely to remain on a steady path under Chairman Powell

Negatives

Increasing deficits will require additional Treasury debt issuance

The Fed is increasing its portfolio "run-off" rate by reducing open market purchases

Wage pressures and import prices could lead to higher overall inflation

Unknowns

An infrastructure bill could also increase the budget deficit

Global tensions: North Korea, Russia, China, Syria, Iran....