HIGHMARK® CAPITAL MANAGEMENT

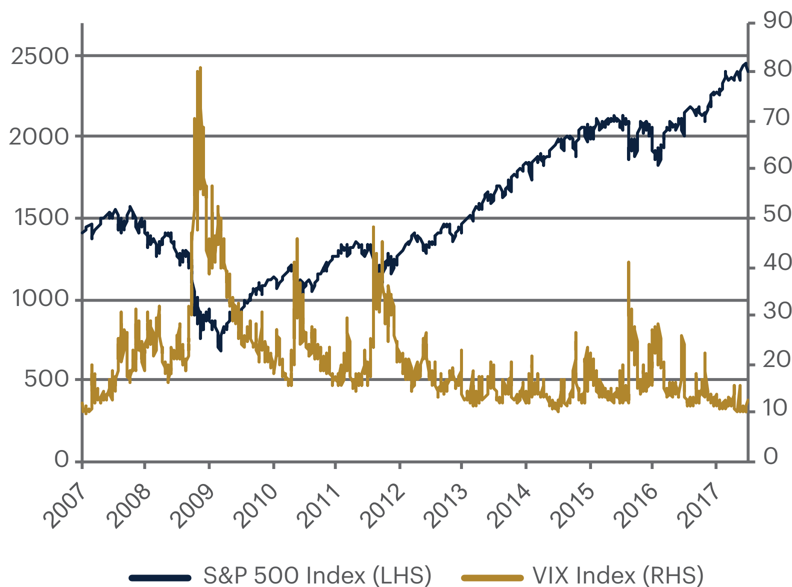
Economic and Market Perspectives

3Q 2017

Introduction

The relative calm of domestic equity and bond markets indicated that investors tuned out of most of the political drama that dominated headlines once again in the second quarter. Rather, corporate fundamentals and economic data releases remained in focus. Yet interestingly, the respective lenses through which bond and stock market investors interpreted these signals have led to divergent opinions as to what lies ahead.

As we noted in last quarter's Perspectives, the so-called 'hard' economic data did not follow the more optimistic 'soft' data driven by expectations of a pro-growth agenda out of Washington. While this disparity remained largely unreconciled in the second quarter, it did not stop investors in the two major asset classes from speculating on which direction the convergence might play out. Stock investors found themselves riding the wave of consumer and small business enthusiasm, while bond investors took a 'show me' posture as interest rates fell amid weak inflation and real growth data.



Source: Bloomberg.

Aside from the healthy returns global stock markets enjoyed in the first half of 2017, the other glaring sign that equity investors are anticipating positive economic developments is the level of realized and expected market risk or volatility. The domestic measure of future stock market (S&P 500 Index) volatility is an index called VIX—short for "volatility index."

The VIX often has an inverse relationship to stock prices, so a low level of the index is commonly coincident with rising stock prices. Conversely, stock prices tend to fall when VIX is high or rising. Because of this relationship, the index is also called the market's 'fear gauge.' After setting historic lows and breaking into single-digit territory during the second quarter, stock investors are decidedly more fearless than fearful. Even episodic bouts of worry have generally evaporated rapidly as a 'buy the dip' mentality prevails.

Meanwhile, bond investors, in the face of a more hawkish Fed, are not buying into the optimism driven by the prospect of a pro-growth fiscal agenda. True to its traditional skeptical nature, bond market behavior reflects a future that resembles the recent past–one of low growth and subdued inflation. Driven by soft economic data and a lack of meaningful progress on fiscal policy reform, longer-term bond yields fell as the yield curve flattened during the quarter.

A flattening yield curve is one of the most ominous signals the bond market can send investors. It can also be one of the most prescient signs of future economic conditions. However, distortions created by both domestic and foreign central bank activity currently make the yield curve's forecasting ability somewhat questionable. What remains clear is that the bond market stands by its belief that the 'proof is in the pudding.'

Second Quarter Economic and Market Highlights

U.S. Growth: The U.S. economy grew by 1.4%[1] in the first quarter. This tepid growth rate was in line with first quarter readings of past years, but is expected to rebound in the second quarter based on early estimates.

Inflation: May CPI rose at a 1.9% annualized rate falling from a near 5-year peak of 2.7% in February. Excluding food and energy, prices rose by a modest 1.7%, giving the Fed some consternation as it seeks to normalize its monetary policy.[2]

Employment: The U.S. labor market remained healthy as unemployment fell in May by 0.1% to 4.3%—a 16-year low. Job growth has remained steady as the domestic economy added an average of 180,000 new jobs per month in the first half of the year. Despite low levels of unemployment, wage growth remained relatively subdued at 2.5% year-over-year.[3]

Energy: Oil entered bear market territory in June as U.S. production and inventories rose. After reaching a 12-month high of $54.45 in Q1, West Texas Intermediate Crude Oil traded below $43 per barrel, its lowest level since August 2016.[4]

Corporate Earnings: S&P 500 earnings growth beat expectations, growing by 13.9% compared to last year according to Factset. 75% of firms beat analyst consensus expectations.

Consumer: The University of Michigan Index of Consumer Sentiment fell off its recent highs in June but remains at an above-average level. A lack of progress in Washington may have contributed to a decline in the future expectations segment of the survey.

Market performance

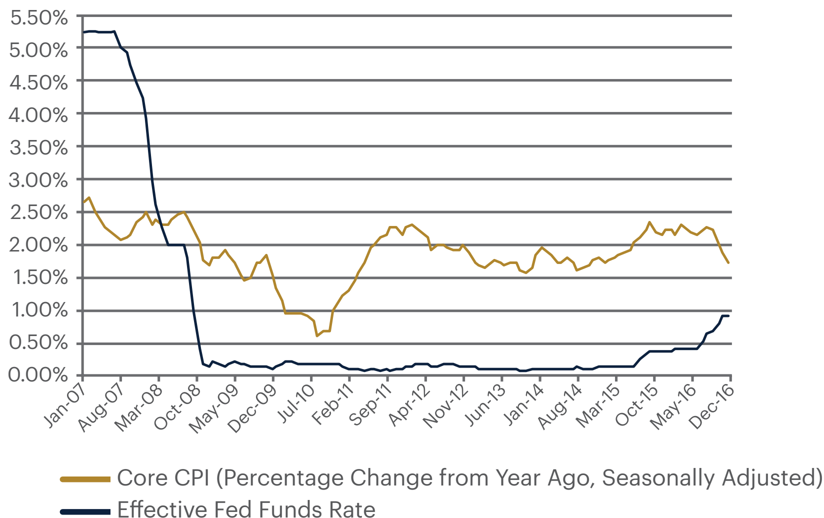
	% Total Return					
As of 6/30/2017	Q2 2017	YTD 2017	1-Year	3-Year	5-Year	10-Year
S&P 500 Index	3.1	9.3	17.9	9.6	14.6	7.2
MSCI EAFE Index (Net)	6.1	13.8	20.3	1.2	8.7	1.0
MSCI Emerging Markets Index (Net)	6.3	18.4	23.8	1.1	4.0	1.9
Barclays US Aggregate Bond Index	1.5	2.3	-0.3	2.5	2.2	4.5
BofAML US Treasury Bills	0.2	0.3	0.5	0.3	0.2	0.7
Bloomberg Commodity Index	-3.0	-5.3	-6.5	-14.8	-9.3	-6.5

Source: Morningstar Direct
Periods greater than one year are annualized

[1] U.S. Bureau of Economic Analysis
[2] Bloomberg: Y-o-Y Urban Consumers NSA
[3] U.S. Bureau of Labor Statistics
[4] Bloomberg

No easy task

Despite core inflation dipping below its stated 2% target, the Federal Open Market Committee (the Committee) raised short-term interest rates by 0.25% for the second time in 2017 at its June meeting, raising from 0.75% –1% to 1% –1.25%. This move marked just the fourth time the Fed has hiked rates since initially moving off the zero-bound range in December 2015. The Committee is expected to move rates higher once more this year to target a Fed Funds rate of 3% by 2020. In a press conference following the announcement of the policy change, Fed Chairwoman Janet Yellen suggested one-off declines in wireless phone service plans and prescription drugs may have contributed to what the Committee felt was temporary weakness in core inflation.



Source: Federal Reserve Bank of St. Louis

At her press conference following the Committee meeting, Chairwoman Yellen announced details on how it will begin to slowly unwind its $4.5 trillion balance sheet by reducing bond holdings built up under the quantitative easing programs used to stimulate financial markets following the Global Financial Crisis. At an undetermined date this year, the Fed expects to allow $10 billion per month of U.S. Treasuries and agency mortgage securities to mature without reinvestment. The run-off will increase by $10 billion every three months until it maxes out at $50 billion per month.

Concerns about elevated prices for financial assets have also motivated monetary policy makers to turn hawkish.

As desperately as the Fed wants to return to an equilibrium state of monetary policy in order to restock the ammunition required to fight future cyclical downturns, prevailing inflation trends have not cooperated. Concerns about elevated prices for financial assets have also motivated monetary policy makers to turn hawkish. So, when prices for goods and services began to accelerate late last year, the Fed felt that its opportunity to commence a sustained campaign to normalize interest rate policy had finally arrived. After years of unfulfilled projections of getting out of the stimulus game, the Fed hopes three consecutive quarters of hikes and a plan to shrink its balance sheet marks the beginning of a gradual exit strategy from an unprecedented level of monetary stimulus.

Looking forward, two major questions will stay top of mind for FOMC members. Is the weakness in inflation in fact temporary, as the Chairwoman suggests, and what is the neutral rate of interest (a rate that is neither restrictive nor stimulative for the economy)? The answers to these questions will determine if the Fed can continue to hike and where rates will settle.

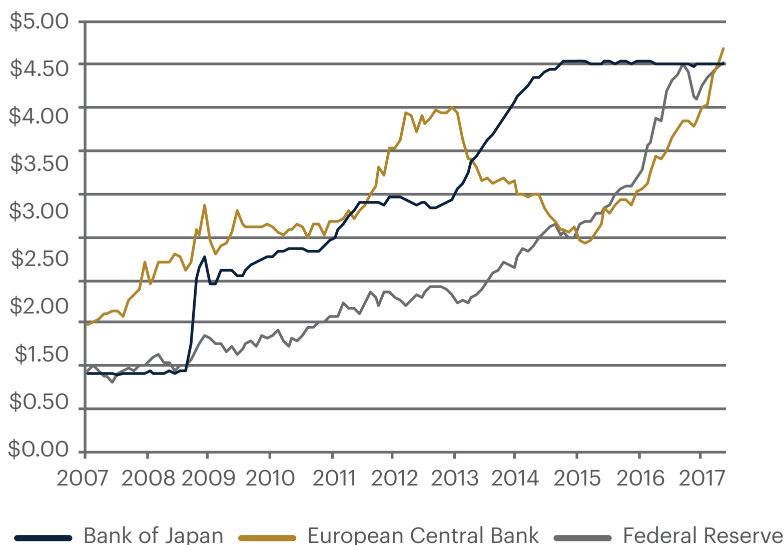
Normally, as the economy reaches full employment, the central bank would look to tap the brakes to avoid a spike in core inflation driven by higher wages. However, the traditional relationship between labor market tightness and labor costs suggested by an economic model called the Phillips curve is not holding up. Many theories have been floated as to why wage inflation remains so elusive in an environment of such low unemployment. A new paradigm of disinflationary wage pressure from rapidly advancing technology has been suggested by one Fed Governor. Our aging population may also be keeping a lid on prices. If the Fed determines structural forces are in play, they are likely to allow themselves more leeway around their stated 2% inflation target.

Assuming the inflation dynamic improves, allowing stimulus to be weaned, the question then shifts to where to stop. As of the last meeting, the Fed's dot plot suggests that 3% is the current consensus expectation of FOMC members. But the neutral rate is an unobservable and evolving figure subject to many economic variables. Materially missing the mark in either direction could have significantly negative implications for both the domestic and global economies. Such a challenge is why central banking is often characterized as walking a tightrope with a blindfold. We expect the Fed to tread carefully from here and to err on the 'undershoot' side given current inflation trends and high levels of public and private debt.

Coming of age

The duration of the current U.S. economic expansion and a flattening yield curve has some market participants worried that a recession and preemptive equity market sell-off may be imminent. This concern appears premature, as duration is not a contributing factor to the end of an expansion cycle's life and the yield curve remains upward sloping. While economic expansions in the U.S. have run about five years on average, the current cycle will enter its ninth year this quarter. Only expansions in the 60s and 90s have exceeded its duration. In addition to being atypically old, this cycle has been characterized by some other important distinctions that make comparisons by duration unreliable.

Total Assets of Major Central Banks (in trillions of dollars)



Source: Bloomberg

Perhaps the most obvious distinction is the extraordinary length to which global central banks went to rescue financial markets in response to the Global Financial Crisis. As illustrated in the chart above, major central bank balance sheets have expanded dramatically since 2007. Although the Fed is now pulling back, it remains accommodative. Most importantly, the Fed remains aware it has the ability to prematurely splash cold water on an economy that has not been close to running hot in either observed inflation or real growth terms. The same goes for other major central banks. Given the interconnectedness of the global economy, importing an economic weakness is a practical source of concern. The European Central Bank and the Bank of Japan are keenly aware that their respective economies are still fragile and continue to require monetary stimulus support.

While all central banks try to stay ahead of the curve when it comes to inflation, a new structural paradigm is sinking in for policy makers. That is, demographically challenged developed markets are likely to require more liquidity than in the past to fight the dual headwinds of low labor force and productivity growth—the main drivers of economic growth. Add in the disinflationary power of technology and globalization and central bankers will be worrying much more about the impact of deflation than inflation.

The flattening Treasury yield curve, a reliable economic barometer, is responding in part to the continued stalling of pro-growth legislation in conjunction with disappointments in recent readings on inflation. Measured by the difference between the interest rate on long and short maturity Treasuries, the yield curve is now below pre-election levels. Following last November's Presidential election, the yield curve steepened on the anticipation of an economic 'reflation' (a term used to indicate conditions of higher growth and inflation) generated by stimulative fiscal policy—namely tax cuts and deregulation.

As we noted last quarter, the Trump administration and congressional Republicans stumbled out of the gate, as major legislation on health care and tax reform failed to make progress. The second quarter was equally unproductive. Ultimately, however, we believe the Republicans will find a path forward for tax cuts in some form, but the timing of implementation and the impact on the economy remains uncertain.

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U.S. Treasury Yield Curve vs. U.S. Recessions

Source: Federal Reserve Bank of St. Louis, National Bureau of Economic Research

Looking back to the cycle peak steepness of the yield curve in early 2011, one could argue the recent decline is nothing more than a continuation of the market's gradual acceptance of some of the structural realities mentioned above. In that regard, investors are simply adjusting to the 'new normal' economic landscape of lower future growth and inflation and are not predicting an impending recession. Should the curve invert (turn negative), as it has ahead of every recession since 1980, worry would be justified in our eyes. Until then, we will take comfort in the expectation that central bankers will tread carefully in these uncharted waters.

Caveat emptor—"Let the buyer beware"

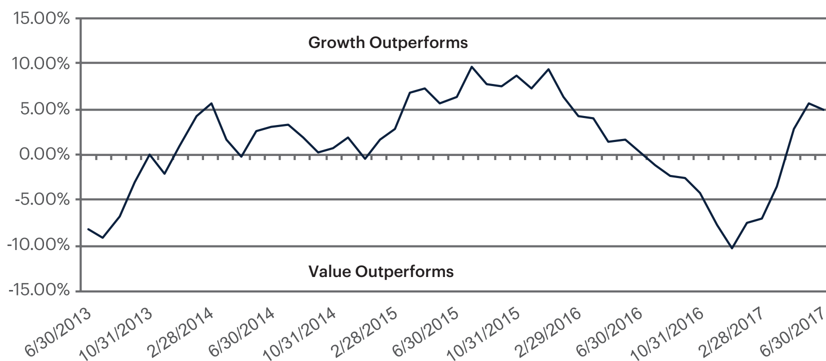
Originally coined by CNBC host Jim Cramer in 2010, the acronym "FANG" represents four high-growth companies: Facebook, Amazon, Netflix and Google (now Alphabet). Since then, the acronym has been modified by others looking to quickly group a select basket of the most popular, high quality growth stocks. Add Apple, replace Netflix with Microsoft, as Goldman Sachs did, and you have "FAAMG."

Perhaps market analysts have gotten a little carried away with their love of acronyms, but the general theme remains the same: technology focused stocks with high earnings growth rates are the darlings of the U.S. stock market this year. With inflation and real growth looking more elusive, investors have gravitated to companies that can grow independent of the economic cycle. Such a phenomenon is consistent with previous periods of growth stock outperformance.

While companies that can grow earnings faster than the market nearly always enjoy a premium valuation, they are certainly not without risk. Yet the market seems to be ignoring this reality as it piles in. Thus far in 2017, realized price volatility of the FAAMG stocks has been below that of utility stocks according to Goldman Sachs. Simply looking at the 7.4% first half of 2017 outperformance by the technology-heavy NASDAQ 100 index compared to the more broadly diversified S&P 500 index is a clear sign that investors favor the perceived safe harbor of growth even if it is not part of the acronym de jour.

Such favoritism is a notable shift from the market's initial direction post-election. The pro-growth agenda of a newly-elected, business-friendly President and politically aligned Republican Congress was expected to reinvigorate sub-par activity levels of the current economic expansion cycle. A rotation away from growth companies and toward more cyclically sensitive value stocks ensued. But missteps and delays in Washington challenged that outlook and investors came back to growth stocks under the evolving narrative that odds of an economic second wind were fading.

Russell 1000 Growth Minus Russell 1000 Value Rolling 12-Month Returns



Source: Morningstar Direct

Without hope of fiscal stimulus, investors have shifted their attention to signs the economy may be slowing down. Surveys of manufacturers' outlooks and measures of production are peaking, while industrial commodity prices (copper, aluminum, zinc, etc.) have steadily declined since January. In response, longer-term interest rates have ground down from their post-election peak even as the Fed raises short-term rates.

The ongoing narrowing of market leadership is a common characteristic as expectations for a moderating economic environment emerge. Since the Great Recession, the U.S. economy has experienced multiple 'mini-cycles', or signs of moderating growth, that eventually rebound without ever lapsing into a recession. The corresponding rotation of market leadership highlights just how much sensitivity the stock prices of seemingly cyclically immune businesses have to the evolving macroeconomic outlook.

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To be clear, this is no Dot Com Bubble. Most of today's market-leading technology companies generate substantial cash flow from well-established markets, have little or no debt and plenty of cash. In this sense, they are considered 'high quality' companies. But elevated valuations, and perhaps more notably low realized levels of volatility, appear to ignore the inherent business risk of technology companies and their counter-cyclical stock price behavior. In other words, should the President's fiscal policy agenda regain its footing and inflation expectations accelerate, expect growth stocks to be reintroduced to the concept of volatility.

Conclusion

A mixed interpretation of divergent economic signals is a logical outcome, especially in light of uncertainty on the fiscal policy front. The market's current low volatility profile may not be accurately reflecting both known and unknown future threats to financial asset prices. The stakes for fiscal policy action are only increasing as the Fed wants to gradually reduce its influence on the economy and markets. Lack of clarity on this front will continue to negatively impact business and personal spending decisions until Washington confirms the status of promised pro-growth reforms. Market and economic indicators will likely suffer from distortion under such a regime. Ultimately, we expect some progress to be made, but exactly how much will remain an open question until legislation is signed into law.

Over the near-term, prospects for the equity market will be brighter if meaningful tax cuts and deregulation come to fruition; though a rotation of sector leadership should also be expected under such a scenario. Bond returns are likely to face headwinds, but the persistent demand for yield should keep rates in check.

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