ECONOMIC OUTLOOK

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unique investment insight

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Brighter Outlook For The Global Expansion
Nothing But Blue Skies Ahead?

Since the summer 2016, there has been consistent improvement in economic data in both the manufacturing and service sectors not only in the U.S., but overseas as well. Key regions including the Eurozone, Japan, and China have all seen consumer and business sentiment move higher, and overseas markets have outperformed the U.S. to start the year. Global growth is projected to pick up modestly to around 3½% by 2018 from just under 3% in 2016. While the increase is welcome, this leaves global GDP growth below the historical average of 4% in the decades prior to the financial crisis. Confidence has improved, but consumption, investment, trade and productivity are far from strong. Asset prices are still supported by global central banks' asset purchases and low interest rates. A key question for 2017 is whether economic activity ends up following sentiment higher in a renewed growth phase, or sags as the same old uncertainties restrain spending and investment. Excessive optimism without follow-through in underlying growth momentum is a recipe for disappointment in riskier assets, while improvement in fundamentals would help resolve stretched market valuations as the U.S. expansion closes out its eighth year.

Better economic data in Europe has also helped to curb rising populist trends, but hurdles remain, starting this month with the French election and later this year in Germany. The Dutch election in March saw the far-right Freedom party undershoot anticipated gains, dulling populist momentum after Brexit and President Trump's election in 2016. In Japan, large manufacturers have recovered just as consumer confidence readings have pushed to 3-4 year highs in the past few months. In China, significant credit expansion remains a risk, but emerging markets in general are recovering from earlier commodity price declines and the pressure of a stronger U.S. dollar.

Although we are late into the slow expansion in the U.S., there is a possibility for further growth to take hold given lingering economic slack in Europe and Japan, and latent potential in key emerging economies. That would be a welcome shift after several years of soft activity, inflation, and corporate profits. Historically, expansions do not die of old age, instead faltering on tighter monetary policy - sometimes in a boom-bust pattern - or some external shock. Either source usually then reveals an internal imbalance (e.g., unsustainable debt) with negative implications for employment, investment, profits, and market valuations. Monetary policy in the U.S. is tightening as the Federal Reserve lifted interest rates twice since December and discussed shrinking its $4.5 trillion balance sheet. Plenty of geopolitical risks remain on the radar screen, so we are left with the uneasy feeling that despite early momentum toward better economic data, a sustained pickup needs to follow in order to stave off worries this is a false spring.

U.S. Economy

Top-line GDP growth slowed to 2.1% in the fourth quarter and first quarter GDP is headed for another pothole as estimates have moved below trend toward 1%. Winter weather was no worse than normal this year and a moderate consumer spending trend may just be a bump in the road after strong gains averaging 2.7% in 2016. Business investment remains moderate. Firms are optimistic about prospects for tax reform, but there will be winners and losers if import taxes are part of the final legislation. The Federal Reserve lifted its policy rate to 1% in March and the median member is looking for two more hikes in 2017. With so much unresolved on fiscal policy, members are hesitant to think much has really changed. Still, unemployment is below 5% and inflation hit 2% y/y in February, effectively "mission accomplished." The task ahead will be to keep those goals near target while mindful of financial stability concerns. The Fed's growth projections at 2.1% for 2017 were raised slightly, but the long-term projection of 1.8% for economic growth has not changed.

Employment and Wages

Payrolls gained in the private sector with January +216,000 and February +219,000, but slipped to +98,000 in March. More moderate consumer spending in the first quarter was negative adjusted for inflation due to slippage in average weekly earnings growth. A steady 2.25% trend rate of nominal earnings growth is lower than top-line CPI inflation of 2.7% y/y in February. The unemployment rate continued to push lower to 4.5% in March. Even the broader U-6 measure, which includes involuntary part-time and marginally attached workers in the ranks of the unemployed, hit a post-recession low of 9.2% in the latest data. There is still room for improvement in the U-6 rate as that measure hit 7-8% in the decades before the financial crisis.

Consumer

Hard and soft indicators around the U.S. consumer diverged significantly in the first quarter. Consumer sentiment surged to the highest in over a decade albeit with confidence sharply divided on partisan lines. The U Michigan Survey revealed Democrat identifying consumers see recession-like conditions ahead while Republican respondents are overwhelmingly optimistic about the economy's prospects. There was some weakness in retail activity as vehicle sales lurched lower in the quarter. March sales at 16.5 million annualized were the lowest since February 2015, though delayed tax refund activity and severe mid-month weather probably played a role. The New York Fed noted continued rising delinquency rates on auto loans, particularly subprime. Credit card debt is now over $1 trillion, up 6.2% over last year. This is all happening in an environment where the job market and wages are improving, so what happens when the tide goes out?

Manufacturing

There are early indications of resurgence in manufacturing data in January and February, as the Federal Reserve's release revealed increases of 0.6% and 0.5%, respectively, the firmest gains since 2014. The level of real output in February exceeded the prior post-recession high, following on a clear rise in the ISM Manufacturing Survey since the summer of 2016 (1Q2017 average of 57.0, after Q4 at 53.3 and Q3 at 51.1). Increases reflect dynamics already in place prior to the U.S. election, including an end to the energy sector recession and reduction in upward pressure on the dollar in 2017. The dollar has been among the headwinds facing U.S. manufacturing firms and the big question ahead is how much tariffs and trade frictions offset reshoring of manufacturing production as a result of the new administration's "America First" policies. Infrastructure spending plans are likely to be shelved until 2018 to boost Republicans prospects in a mid-term election year.

World Economy

Europe

U.K. Prime Minister Theresa May officially triggered Article 50 of the Lisbon Treaty on March 29, starting the clock on a two year deadline to agree on terms of exit from the EU. The EU's top priority is an orderly exit; the U.K's priority is securing an exit plus the benefits of access to trade with EU economies. Bumps in the negotiating road are likely, so monetary policy will remain accommodative from the Bank of England despite inflation's rise driven by energy prices and the plunge in the pound.

Economic growth in the Eurozone moved up a notch to 0.5% in 4Q16 from 0.4% in 3Q16, according to a recently released GDP flash estimate. The pickup comes on the heels of similar readings by other indicators, including the OECD Composite Leading Indicators in January and the IHS Markit PMI for manufacturing. Despite a heavy overcast of political uncertainly, including the French elections and the Brexit divorce now underway, business confidence has continued high during 1Q2017. The strengthened optimism was reflected in the March jump in the Markit Eurozone PMI Composite Output Index to 56.7 up from 56.0 in February to the highest reading since April 2011. The primary driver was a strong rise in exports on the back of the weakened euro. Germany and France had the strongest showing, but PMIs in the Eurozone periphery countries are also starting to tick higher. The central bank continues to guide expectations that asset purchases will remain through year-end 2017, but officials may look to lift negative real interest rates sooner.

Japan

After lackluster performance in 2016, consumer confidence jumped sharply in the first quarter, aided by a significant jump in stock prices. After years of no wage growth, households are still looking for sustained real income gains. The Q1 Tankan Survey of manufacturers came in at 12, short of expectations, but still the strongest since 2015. Underlying components hinted at firming capex and inflation expectations ahead. The Bank of Japan gave no indication it was cutting back on the massive purchases of government bonds it is using to support the world's No. 3 economy by injecting hundreds of billions of dollars into the economy every year.

China and Developing World

In China, a surge in February imports supports the notion that domestic activity is reviving with the caveat that the figures are impacted by the New Year holiday. Imports surged nearly 40% y/y, while exports slipped 1.3%. The earlier timing of the Lunar New Year meant that the year-ago comparison base for imports was far weaker, driving the headline import gain. Behind the scenes, with the government setting a lower 6.5% target for growth, "official" growth rates should continue to decline in years ahead.

Significant fourth quarter emerging market currency headwinds reversed in the first quarter as evidenced by the Mexican peso up 10.7%, the Russian ruble up 8.9%, and the Korean won up 8%. Nearly a mirror image of post-election results, save for the Turkish lira which continued to move lower on domestic turmoil and surging inflation (11.3% y/y in March, after 7.8% on average in 2016). S&P removed South Africa's investment-grade rating after President Zuma fired his finance minister, calling into question the continuation of positive fiscal and growth trends in favor of domestic vested interests. The rand fell 9% against the dollar in the span of a week from late March, into April. The International Monetary Fund (IMF) nudged up its forecast for world growth this year to 3.5%, the fastest rate in five years.

Investment Perspective

In financial markets, there are apparent disconnects between the positive assessment of the economy as reflected in stock values and forecasts for low economic growth for the foreseeable future. After the collapse of health care reform in March, the markets realized that even under optimal circumstances, the fiscal stimulus portion of the Trump agenda – tax cuts and infrastructure spending – will require a long slog through Congress. Equity markets have marched higher on positive data and hoped for reforms in the past six months, despite the Federal Reserve raising interest rates and unchanged forecasts of low 2% GDP growth. The improvement in market sentiment also contrasts with longer-term trends of low consumption growth and investment, aging demographics, and low productivity growth.

Investors are equally conflicted. A recent sentiment survey from the Yale School of Management shows a collective fear of missing out on the stock market rally. Asked if markets will be higher in a year, both individual and institutional investors responded positively. When asked about valuations, both believed the market was over-valued. Investors, starved for yield, have been investing in stocks, ignoring the riskiness and over-valuation based on fundamental measures such as revenue/sales and price/earnings. S&P 500 earnings have stagnated since 2013, but this does not stop analysts from forecasting double digit earnings growth at the beginning of the year before they reduce estimates to near zero as the year progresses. Leverage and high debt levels are still an issue across the board for individuals, governments, and businesses. For corporations, low rates since the financial crisis encouraged companies to replace equity with debt to buy back shares rather than invest in their business and expand profits – a zero sum transfer that can't be repeated indefinitely. U.S. investors are hoping consumers will spend enough to keep the economy rolling along without an accident.

With relatively good economic data and low interest rates, there is still an argument for stocks. Globally, interest rates remain suppressed and equity markets are supported by $13 trillion in asset purchases by the Federal Reserve, the Bank of England, the Bank of Japan, and the European Central Bank. Valuations are stretched and proposed federal changes may be priced into stocks – changes that may never materialize. If interest rates rise, there will be more competition from bonds for investors' money. We favor industrials, healthcare, energy, and some technology. Financials will benefit from an increase in short-term rates, but loan volumes are declining and credit quality is deteriorating. Bonds and cash act as ballast for stability in balanced accounts. Oil remains in the $45 - $55 range with U.S. supplies and demand both rising. OPEC's production cuts are slowly working to curb global supply. Gold prices rose +9.4% in 2016 and have gained another 10% in 2017. Gold remains a safe-haven asset and a hedge against macroeconomic uncertainty and fiat based paper currencies. As always, valuation matters and buying at a reasonable level will result in better performance over time. While we are certainly attuned to the day-to-day geo-political news, we are guided by our discipline in finding well-run companies in attractive industries at relatively good prices. Although we have become more cautious, stocks over the long-term have provided real growth and protected purchasing power with returns above inflation. We will as always stay vigilant.

March 31, 2017
DJIA: 20,663.22
S&P 500: 2,362.72

About Bounty Management
Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.