ECONOMIC OUTLOOK

bounty management
unique investment insight

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Global Trade Tension
More Offshore Moves and Automation Ahead?

> "Free trade, one of the greatest blessings which a government can confer on a people, is in almost every country unpopular." -- *Thomas Macaulay, Essay on Mitford's History of Greece, 1824*

If anything encapsulates our complex, uncertain, uncooperative world in 2017, it's trade. For decades seen as a powerful force for good – enhancing growth, competitiveness and living standards – trade made greater integration within the global economy seem more or less inevitable. The theoretical and real benefits of free trade - the one concept on which a room full of economists could nearly all agree - always came with qualifiers in practice, namely the transition costs for displaced workers and their families as well as the concentrated effect on communities and certain regions. Global trade has not benefited all participants equally - while hundreds of millions of people have been lifted out of poverty by global economic growth, trade has laid waste to entire industries, stripping away livelihoods and hopes and helping give rise to an upsurge of protectionism which then only exacerbates weakness in living standards over time.

Manufacturing gets the brunt of attention given how tangible both the production and final products are, but offshoring of higher-skilled service sector jobs is increasingly possible due to technology. This stealth "offshoring" due to automation - blue collar, white collar, and in the service sector - may loom larger in years ahead. Safeguarding the clear gains of trade and technology will depend on recognizing that displaced workers face real challenges, and will require a different set of priorities across education, health care, and social safety nets. Technology is already transforming health care and financial services; it is not clear that even traditionally high-skilled workers will be safe. Despite significant benefits from technology and automation over time, even technology firms risk the same backlash that faced banks and globalization in the wake of the last recession.

At the same time that trade and increasing automation are displacing workers, the Bureau of Labor Statistics (BLS) reports that the U.S. currently has a record six million unfilled job openings and the official unemployment rate is 4.3%. Why are there both displaced workers and so many unfilled jobs? Many theories have been offered to explain the disparity, including a lack of mobility, low wages, and undesirable jobs. One often cited reason is that workers lack the skills required for available jobs. In practice, retraining for high-skilled information, technology, education, or health services jobs takes time. Finding ways to retain the positive aspects of trade and investment will now be a key priority for global leaders.

U.S. Economy

The tension between strong sentiment and more moderate activity continued through the first half of 2017, as GDP growth is setting up to post an average of 2% - no better or worse than the post-recession average. The consumer remains solid, along with residential investment, while trade and business investment have been mixed. Washington policy remains in flux, with the original timeline for tax reform by the August recess still hostage to health care reform efforts. It isn't clear that a win on the latter will help the Administration or the Republican Congress ahead of the 2018 midterms. The Fed continues to see slow growth at 2.2% for 2017 and 1.8% economic growth in the longer run.

Employment and Wages

Private payroll employment gains are gradually decelerating as the unemployment rate hit 4.3% in May, averaging 159,000 in the six months through May. That's a step-down from 170,000 on average in 2016, and 200,000 plus in 2014 and 2015. However, Fed officials and many economists suggest that only 50,000 to 100,000 additional jobs per month are sufficient to keep the jobless rate stable. Unfortunately, the big puzzle in 2017 is why wage growth hasn't accelerated more clearly if the labor market is so tight. Average hourly earnings growth edged down to 2.5% y/y in May, from 2.9% at year-end 2016. One interpretation is that there is greater slack than the conventional jobless rate suggests, with about 2.5 million prime-aged workers still missing from employment rolls, relative to the pre-recession peak. There are compositional effects too, as low-wage service sector jobs have formed the bulk of job gains, while older, higher-paid workers are beginning to hit retirement.

Real Estate

The S&P/Case-Shiller Index of home prices rose 5.7% y/y in April, continuing a pattern of solid price gains in an environment of tight supply. At 4.2 months of supply in May, inventory is lower than during the mid-2000s boom, when price gains across the U.S. averaged over 10%. The June NAHB Housing Market index indicated a slight paring back of builder optimism, as the top-line fell 2 points to 67. Buyer traffic, present sales, and future sales expectations edged lower, but all are still up from pre-election levels, and all were well above 50 except buyer traffic at 49 (a reading above 50 indicates a favorable outlook on home sales). While traditional new building has been climbing slowly and steadily, the value of home improvements put in place has been surging as buyers choose to add or improve current housing amid high prices and limited supply.

Consumer

Strong e-commerce and building materials sales could not offset the slowdown in auto sales and electronics. Auto sales averaged below 17 million annualized in the three months through May, after 17.2 million in the first quarter, and 18 million in the fourth quarter of 2016 (a post-recession high). Vehicle production slipped 2%, no surprise given weaker sales numbers in 2017. Consumer sentiment and consumer expectations both fell in June. The S&P/Experian Bankcard default index (a balance-weighted measure of credit accounts in default each month) ticked to a four-year high at 3.53%, but broader measures that include mortgages and autos, despite some problems in the subprime auto market, are still quite low. Helping sentiment once again is a drop in gasoline prices amid seasonally-strong inventories. Instead of rising into the summer driving season, average national gasoline prices have been flat to lower since March, also weighing on consumer prices.

World Economy

Europe

Emmanuel Macron's victory in the second round of the French Presidential election proved a "buy-the-rumor, sell-the-news" moment for European equities, marking a near-term peak in the Euro Stoxx 600 Index versus large-cap U.S. stocks. Macron's newly-founded political party garnered a majority in the June parliamentary election, marking a different sort of anti-establishment sentiment as traditional parties were left on the outside looking in. The core of the Eurozone looks stronger as German Chancellor Merkel sought to play up German and French ties in the lead-up to the July G-20 meeting, warning against a tide of protectionist sentiment emerging across the Atlantic.

In the U.K., Prime Minister May called a snap election with the hope of securing a better negotiating stance in Brexit talks, a choice she surely regrets. May's Conservative party lost its narrow majority in the U.K. parliament and has formed a fragile minority government with the Northern Irish DUP party. With Brexit looming, London real estate looks less appealing. U.K. nationwide house price growth decelerated to 2.1% y/y in May, from 2.6%, having averaged 4-6% appreciation in 2016. The m/m decline is the third in a row, first since 2009. For Brexit, the EU's top priority is an orderly exit. The U.K.'s priority is an exit plus the benefits of access to trade with EU economies. Issues in the negotiations are likely, so monetary policy will remain accommodative from the Bank of England despite inflation's rise and the plunge in the pound.

China and Developing World

Mainland Chinese shares will get a modest allocation in MSCI Emerging Market Index in 2018 after years of speculation about inclusion. Capital controls remain a problem for foreign investors, but the road to liberalization aims to be gradual. A stronger yuan in 2017 stands in contrast to a weakening trend in recent years as growth slows, and may in part reflect not just domestic monetary tightening, but a desire to assuage a trade and currency conscious U.S. administration. The currency rose 2.5% against the dollar in the first half, after falling 4.5% annualized in the three years through year-end 2016. India's growth slowed to 6.1% down from 7% in the previous quarter. The weaker GDP numbers suggest Prime Minister Modi's decision to scrap 86% of India's paper currency - an attempt to crack down on tax evaders – temporarily stopped India's economic boom. The International Monetary Fund (IMF) nudged up its forecast for world growth this year to 3.5%, the fastest rate in five years.

Commodities

Global crude oil benchmarks ended June below levels prior to OPEC's late-November 2016 announcement of production cuts. U.S. and non-OPEC supply has remained surprisingly resilient, boosting inventories, and markets fear OPEC's incentives to cooperate will break down as more pumping, not less, will be required to meet already-stretched government budgets. A shakeup in the Saudi royal line of succession in June put the young reform-minded son of current King Salman ahead of his older cousin. The move may help longer-term efforts to diversify the economy away from oil. Gold rallied and finished the first half of the year +7.85%.

Investment Perspective

The U.S. economy is now in its third longest expansion on record. The index of Leading Economic Indicators (LEI) continued to show improvement throughout the first half of the year and suggests that the economy is likely to remain on its long-term trend of about 2% growth. In the first half of the year, stocks also had one of their quietest periods with the average daily swing in the S&P 500 of 0.3%, the lowest in fifty years. Trillions in global government support since the recession has helped suppress market volatility. Along with low volatility, economic growth was slow: first quarter U.S. GDP growth registered 1.4% and the IMF recently lowered its U.S. growth forecast for 2017 to 2.1%. In the bond market, after an initial bump in interest rates and inflation expectations after the election, the Federal Reserve raised short-term rates, but longer-term bond yields tumbled to their lowest level so far this year in June in a sign that investors are beginning to question whether or not there will be any policy changes that might increase growth.

The Federal Reserve continues to move toward less-easy money, but is receiving conflicting signals on its mandates. A jobless rate of 4.3% is uncomfortably low for some officials worried about rising wage pressures and inflation, but prices continue to undershoot the targeted 2% inflation rate and wage growth since the recovery has been low. As long as equity markets and the labor market hold up, the Fed will likely stick to the plan, gradually lifting short-term interest rates, and will begin letting the $4.5 trillion in treasury and mortgage securities run off the balance sheet. The global central bank liquidity spigot is being dialed down, providing less support for asset prices. In June, the European Central Bank suggested it could be nearing the end of its bond buying and the Bank of England hinted at a rate hike. Tighter monetary policy (or less loose policy) will act as a brake on the economy.

Investors have benefited enormously from global central bank support since the financial crisis. Even with low growth, asset prices in both the bond and stock markets have appreciated. Companies have responded to low, stable growth by borrowing heavily to buy back stock or pay dividends and corporate debt as a percentage of GDP is now back at levels last seen before the recession. As the Fed raises rates and reduces its balance sheet, there is a risk of overtightening. Given the size of the stimulus since 2008, it seems reasonable to expect some bumps in the road as central banks try to unwind monetary support. Shorter duration bonds still play a role for stability in balanced portfolios, but offer little purchasing power protection or real return after inflation. In the equity market, valuations remain above historical levels and many stocks have moved far above their moving averages. For stocks, we favor areas such as industrials, healthcare, energy, some technology, and materials. Financials are benefiting from the increase in short-term rates, but continue to see deterioration in credit particularly for consumer loans (e.g., auto loans and credit cards). Dividends remain an important part of investment returns. Any move toward protectionism should raise red flags as most large U.S. corporations are interconnected with the global economy. With the Fed increasing rates and talk of more restrictive monetary policy around the world, investors need to pay attention. As these trends unfold, we remain steadfast in our long-term focus on finding well run, high quality companies at good valuations in areas that offer growth opportunities. As always, we remain vigilant and patient.

June 30, 2017
DJIA: 21,349.63
S&P 500: 2,423.41

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.

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