ECONOMIC OUTLOOK

bounty management

unique investment insight

Bounty Management Corporation
The Rice Building
10 High Street, 5th Floor
Boston, Massachusetts 02110
t 617.357.8285 *f* 617.451.9064

October 2018

As Bull Market Ages
Fiscal Stimulus Fuels Growth "Effectively Indefinitely"

The U.S. economy is on pace for a second consecutive quarter of 4% GDP growth in the three months through September. Near-term expectations for the U.S. economy have been moving higher due to the additional stimulus of increased government spending, tax law changes, deregulation, and less upward pressure on the dollar. The economy seems to be firing on all cylinders with accelerating GDP growth, rising consumer and small business confidence, and rising employment and wage growth. In early October, Federal Reserve Chairman Jerome Powell enthusiastically suggested there is little risk the current expansion will be knocked off course stating, "There's no reason to think this cycle can't continue for quite some time, effectively indefinitely." Historically, Federal Reserve leaders are terrible market forecasters, and, true to form, in the following week, markets around the world started to fall on concerns of rising interest rates, slowing global growth, and trade tensions with China.

There are two reasons for the improvement in the U.S. First, a number of headwinds for the U.S. economy became tailwinds in 2017 and 2018, including a reversal of energy price declines and investment in the oil patch, less upward pressure on the dollar, and improved economic activity abroad. Second, the fiscal stimulus and tax law changes of the size enacted in late 2017 may still be underappreciated, especially when paired with only gradual recent moves in interest rates. Along with the federal spending agreement in February 2018, changes could reasonably add ½ of a percentage point to growth rates in the second half of 2018 and persist into 2019. Growth and spending come at a cost. The Joint Committee on Taxation and CBO estimate that tax revenues will fall by twice as much in 2019 ($280 billion) as in 2018 ($136 billion) resulting in larger deficits – last year's deficit rose 17% to $779 billion and this year will be near $1 trillion.

The sugar fix of financial easing (tax cuts and government spending) will eventually wear off and comes with a long-term cost of adding almost $2 trillion to the Federal debt. As spending fades in 2019, there will be a slowdown in growth paired with meaningfully higher interest rates according to former Fed Chair Bernanke. Officials believe a current 2.00-2.25% range for the federal funds rate is short of the target "neutral" rate of 3%, but on the current path that level will be reached late next year. A recent survey by the National Association of Business Economists showed that two-thirds of economists expect a downturn before 2021, citing a combination of higher rates and fading stimulus. The good times may last for a while longer, but may sow the seeds for excessive optimism - already at the highest levels since early 2000 - and an aggressive Fed, two key signs for recession risks.

U.S. Economy

The Conference Board's index of leading indicators is one of the more reliable indicators on recession risk. Constructed from a number of readily available economic time series, components are broken down by real economic activity (jobless claims, workweek length, consumer sentiment, and factory orders among others) and market-derived components (S&P 500, yield curve, and credit trends). Readings show the shorter-term 6 month average remains deep in "no recession" territory, buoyed by both real activity and market factors. The U.S. economy posted strong mid-year GDP growth of 4.2% annualized in the second quarter. Business capital spending strengthened 8.7% annualized in Q2, balanced across investment in structures, equipment, and intellectual property products. Near-term expectations for the U.S. economy have been moving higher. A year ago in September, the Federal Reserve forecasted a 2.1% y/y gain for 2018, and a trend-like 2% projection for 2019. Currently, it sees 2018 growth at 3.1%, 2019 at 2.5%, and 2% in 2020.

Employment and Wages

According to August and September data from the Conference Board, the relative balance of households expecting higher incomes in six months versus lower incomes stood at its highest level since 2001. The proportion reporting jobs as "plentiful" versus "hard to get" also pushed further toward a late-1990s high. Wage growth in the aggregate remains pinned just below 3% y/y, still representing gradual improvement over time. Competition for workers via pay raises may be heating up - see Amazon's recent wage hike to $15/hr for warehouse workers. Small business confidence was exceedingly strong in September, and anecdotes about labor shortages are widespread. Hiring remains impressive, though there was a slowdown through August in manufacturing, a drop of 3,000 capping a four-month deceleration. The slower pace may be the first sign that tariffs are having an adverse impact.

Real Estate

There are a number of factors responsible for the slowdown in housing and the bad news may not be over. Nationwide, the number of previously owned house sales fell 4.1% y/y in September, the seventh straight month of declines. Residential permits were down 5.5% over last year. Single family housing starts rose a modest 1.9% in July, below the levels in the spring. Other measures such as existing home sales have also been slowing. The reasons are clear: mortgage rates are near seven year highs and rising prices have reduced affordability. A tight labor market and sharply rising materials prices are raising builders' costs. The new tax law limits deductions for mortgage interest which makes home ownership less enticing in some states with high state and local taxes. There is little relief in sight with the Fed raising rates and unemployment low. Even spending on home improvements is trending down.

Consumer and Manufacturing

Consumer sentiment hit an 18 year high in September, a positive indicator of spending going into the holiday season as continued strength in jobs and the economy bolstered expectations. Subject to country reviews and votes, the US-Mexico-Canada-Agreement (USMCA) will be the new framework starting in 2020. In some ways just a rose by another name, last minute negotiations saw the U.S. extract some concessions from the Canadian dairy industry, along with modest adjustments to auto production guidelines between the three countries. Stronger labor provisions will aid passage regardless of the upcoming midterm elections. Factory activity slowed in September and some analysts think the industrial sector may have peaked.

World Economy

Europe

Rapid and broad Eurozone expansion has moderated in 2018, but on balance broad survey data remains in expansion territory. Activity in the broader Eurozone has downshifted in 2018, to 2.1% y/y in the second quarter after a peak near 3% y/y in Q3 and Q4 of 2017. The Eurozone reading is not as strong as last year, but far from worrying. German growth for the second quarter was better than expected rising 0.5% or 1.8% annually. Actions by the new populist government in Italy continued to roil local bond and equity markets last quarter, putting more color to plans that boost spending, lower taxes, and lower the pension age, all against an already poor debt backdrop. There has also been talk of a separate Italian currency that would help "resolve" debt problems. Deficit projections always embed high economic assumptions and it's those that are straining credibility. They rely on strong growth of around 2% y/y, a pace the Italian economy has not achieved for more than a few quarters over the last 20 years (Q2 1.1% y/y).

Japan

The Bank of Japan remains on autopilot, with some rumblings that it will allow a modest increase in long-term rates to aid bank profitability. Regardless, the BOJ will be the last of the big three central banks to curtail asset purchases after the ECB ends its buying in December. Protectionism is a risk, though the country hasn't been specifically targeted yet by Washington, as is a scheduled consumption tax increase in the second half of 2019. A past iteration caused a significant slowdown in growth back in 2014. The Q3 Tankan Large Manufacturing index missed estimates, falling 2 points to 19, still higher than readings on average in recent years, but showing a similar pattern to Europe in receding from highs.

China and Emerging Markets

With Canada and Mexico out of the way and an agreement signed with South Korea, the U.S. Administration stepped up the pressure on China. September saw the announcement that tariffs on the next $200B of Chinese imports would increase from 10% to 25% in January 2019, with an additional $267B of goods potentially targeted depending on retaliation. PMI figures in China have been mixed, with smaller firms less able to access credit than their larger and/or state-backed counterparts. Auto sales plummeted 11.6% in September, the steepest drop since 2011. Q2 GDP in Turkey decelerated to 5.2% y/y from 7.4%, and a further deceleration into the 2-3% y/y range is becoming a consensus view in the wake of recent market upheaval. The International Monetary Fund in October lowered its world growth forecast to 3.7% from 3.9% in April citing suppressed activity due to the effects of trade measures, a weaker outlook for some developing economies as well as geopolitical tensions and higher oil prices.

Oil/Commodities

Supply and demand figures in the oil market are forecasting a reduction of exports from Iran ahead of sanctions set to go into force in November. According to Bloomberg tanker tracking data, Iranian exports have fallen well below two million barrels a day, down from nearer three million per day in the second quarter. For reference, the largest oil tankers can carry roughly two million barrels, and total global oil demand is roughly 100 million barrels a day. While just a small portion of the market, the supply impact has helped crude prices set fresh multi-year highs in early October above $75 on the West Texas benchmark and above $85 for European Brent. Gold prices have been weak mainly due to the strength of the U.S. dollar. Lower prices and questions on U.S.-China trade along with Brexit contributed to a boost in global central bank purchases and provided some support for prices.

Investment Perspective

As we reflect on the last ten years of a slow rise in the market after the financial crisis - with a few bumps in the road along the way - we turn our attention to what happens next. As the adage goes, bull markets do not die of old age, but something happens to change investors' expectations about the future. There are plenty of possible reasons for a downdraft including midterm elections, a falling housing market, Italy, China, and generally over-valued stocks. These concerns are already influencing investors and are not yet enough to hobble the bull market. September and October brought continued strong figures with job growth, wages rising the fastest since the last recession, manufacturing surveys the best since 2004, low/contained producer prices/inflation, and consumer confidence the highest since 2000. What is not to like?

Two top concerns for investors are rising interest rates and U.S. trade policy. The Fed is raising interest rates to keep the economy from overheating and give it the ability to lower rates in the next downturn. Inflation is also a concern, but is still a modest 2.3% to 2.9% over the past year. The fear is rising rates make credit more expensive and increase costs for business loans and mortgages as debt payments increase. The Fed has to be careful in raising rates slowly and not cause a recession. Part of the purpose of monetary easing (e.g., low interest rates and government bond purchases) during the past ten years was to raise asset prices. The result was a positive wealth effect and investors fear the opposite may occur as central banks raise interest rates.

International trade friction and tariffs continue to be a concern with investors increasingly worried about the impact on the global economy. Although the tariffs have had limited impact so far, particular industries such as auto makers, agriculture, and industrials have been feeling the pain. Outside the U.S., markets have not been as resilient and returns have diverged from the U.S. with markets in Europe and Asia negative for the year (e.g., China -24%, Germany -11%). Manufacturers such as Caterpillar have missed out on the broader rally as trade tensions have raised costs, dampened profit outlooks, and forced projects to be scrapped. According to the U.S. Department of Agriculture (USDA), farm income is expected to drop 13% or $10 billion this year. The USDA has pledged $5 billion for farmers (only $35 million has been paid out so far) but there are longer term effects of losing export markets and relationships that take years to cultivate.

Historically, a late cycle bull market features more limited upside in equity performance though stocks still typically outperform bonds. For fixed income, we favor shorter-term high quality government bonds as rates continue to rise. Inflation resistant assets such as commodities, energy stocks, and Treasury Inflation Protected Securities (TIPS) have performed relatively well. Equities are still the broad asset class of choice although we expect more volatility. We still see opportunities in health care, energy, materials, technology, and some financials. Buybacks continue at a record pace of $200 billion a quarter – a boost to earnings and stock prices, but not long-term investment. The added growth from the tax cuts and increased government spending will boost earnings and the market for the next few quarters. What bears watching is whether or not the fiscal stimulus can overcome the tightening of monetary policy and higher interest rates. As these trends unfold, we will continue to build portfolios by investing in companies with solid financials, strong management, and growth prospects at reasonable valuations. As always, we remain vigilant and patient.

September 30, 2018
DJIA: 26,458.31
S&P 500: 2,913.98

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.

This report, prepared by Bounty Management Corporation, is provided for informational purposes only. The report does not contain investment recommendations and was issued without regard to the financial situation or particular needs of any specific recipient. Bounty Management does not accept any liability for any direct, indirect or consequential damages or losses arising from any use of this report or its contents. The information in this report was obtained from sources believed to be accurate, but we do not guarantee that it is accurate or complete. The opinions expressed herein are strictly those of Bounty Management, are made as of the date of this material, and are subject to change without notice. There is no guarantee that the views and opinions expressed in this communication will come to pass. Please consult with your personal tax advisor before making tax-related investment decisions. **Past performance is no guarantee of future results.**