capital markets review

HAMILTON CAPITAL MANAGEMENT
Future In Sight™

Spring 2017

Economic Outlook

Speaks Softly, But Keeps Growing

Executive Summary

The recent economic story has been one of solid performance beating glum expectations. Fourth-quarter growth of 2.1% was near the central tendency of several years. And while the third quarter was a bit stronger, quarters before that weren't, and a slowdown is broadly forecast for the first quarter of 2017 just ended. And round 'n' round it goes.

Over the last year or so, the housing and consumer sectors remained robust, growing at 5+% and near 3%, respectively. Although housing is a small part of GDP, consumers are the elephant in the room, weighing in at 70% of U.S. economic output. Their recent strength has been partially mitigated by a few spoilers, including capital investment, government spending and net exports. Inflation, meanwhile, has gradually increased.

This "speak softly" economy is not ostentatious but carries the stick of long-life, and has managed to sharply reduce unemployment from the highs of the Great Recession, no matter which measure you use. And we use several.

What does the latest data tell us about growth?

At this point we only have published information for the fourth quarter, and economic growth of 2.1% for that three-month period was moderate. Of course, just one quarter does not a story tell. But if we assess several quarters of detail, it appears the fourth quarter result is representative of several years' performance.

With regards to the first quarter just ended, we do have some hints, and they point to slowing growth, perhaps a little over 1%. This pace would certainly be within normal volatility for this series.

Post-election, the mood seems to have improved, and this slow-and-steady outcome in the statistics seems consistent with what we feel. Is that fair?

Indeed, many sentiment surveys have improved, some of them markedly. Of course, moods come and go and typically peak just before the wheels come off. Hence, they're not a reliable predictor of markets or even GDP. So far we haven't seen strong confidence translate into significantly stronger spending, which is not exactly a surprise. Most economies tend to shift direction step-wise, and the story of the U.S. economy post-Great Recession has been particularly gradual.

How about where the growth is coming from? Any major shifts to highlight?

Although the numbers bounce around quite a bit, the make-up of growth has been broadly stable for some time.

Continued inside

The Interviewees

Matt Hamilton, CFP®
Chairman
& CEO

Tony Caxide, CFA®
Chief Investment
Officer

Jeff Liu, CFA®
Managing Director
Portfolio Management

The content in this issue of *Capital Markets Review* was taken from an interview with Hamilton Capital Management Chairman & CEO Matt Hamilton, CIO Tony Caxide and Managing Director, Portfolio Management, Jeff Liu shortly after the end of the first quarter of 2017.

Economic Outlook

(Continued)

We would underline a couple of major positives – housing and the consumer. The former is tiny, representing only about 3% of GDP. However, it can swing up and down a great deal, and thus it punches above its weight. Growth seems to be in the middle-to-high single digits, and may be slowing very gradually.

The consumer, on the other hand, is the heavyweight, making up the largest portion (near 70%) of the economy. This sector shows less volatility but is, of course, crucial. It has shown growth near 3% of late, though that may be easing a bit, back to nearer 2% - 2.5%.

And if those are growing above 2%, then other sectors must be pulling the average down?

That's exactly right.

Capital investment, for instance has been rather weak. And, with capacity utilization still very low, businesses seem to have plenty of unused capacity – at least in the industrial sector. Until that's used up, we may not see a large acceleration in investment.

Government spending remains tepid, growing at effectively zero. And inventory growth has been mediocre, though it boosted the overall GDP data meaningfully in the fourth quarter.

Finally, we've seen net exports acting as a moderate brake on growth. Though this seems to be the result of strong consumer demand pulling in imports, statistically it appears as a net drag.

So we've had unremarkable-but-steady growth for some time. Has this impacted our ability to grow in the future?

Persistent past growth, per se, does not necessarily spell gloom for future growth. But, in this instance, two broad factors have emerged that may hinder economic gains down the road.

The first is available labor. Though you'd never know it from reading the papers or social media, we've seen huge progress in unemployment from the dark days of the last deep recession. From a 10% peak, the most commonly used official measure of unemployment has dropped to 4.5%, which is awfully close to full employment. Even if you discount that a little, and we do, we feel that "true" unemployment is falling toward 5%. This is good…and potentially bad. Employers are having a tough time finding new hands to fill their large number of open jobs. And economic growth comes from an expanding labor force and gains in productivity. The former is increasingly a challenge, and the latter has been frail for some time. This does not augur well for our future growth.

The second is monetary policy. Our central bank, the Federal Reserve, has for several years maintained ultra-loose monetary conditions to facilitate growth. As it sees broad economic conditions return to normal, it's increasingly leaning toward "normalizing" policy by raising interest rates (and adjusting other monetary tools) so it doesn't find itself catching up with an over-heated economy and/or one in which inflation has taken the bit between its teeth.

There are a few other signals that we are monitoring, such as slowing bank lending and falling auto sales, that could dent growth. Pent-up demand may also have been sated to a greater degree than many perceive. But we don't feel this warrants panic right now, particularly in light of our fairly conservative portfolio design.

Can you drill down a little more on the inflation status?

Well, inflation has already accelerated, after the 2015 collapse linked to the sharp drop in commodity prices.

The "headline" measure is already running measurably above the Federal Reserve's 2% target. But this increase has been driven by commodities, like food and energy, which can be very volatile and distort the "true" or underlying direction for price changes. If we consider the "core" measure – excluding food and energy – the conclusion is gentler but similar. Core prices are rising at near 1.8%, close to the Fed's 2% target and seemingly also inconsistent with aggressive monetary stimulus. Finally, the very low unemployment rate triggers some apprehension that one of corporate America's key cost inputs – wage rates – accelerates further.

We're not painting a picture of a runaway train. Though rising, inflation is still fairly moderate. And the headline number could ease shortly. But even a more moderate pick-up has implications for the conduct of monetary policy and could hurt profit margins and the value in bonds.

So, moderate and steady growth, and gradual increases in inflation. Not exactly a Liberace performance!

No, flamboyant it isn't. But it does have other virtues. This growth cycle has been durable – one of the longest since the Civil War. Inflation has been well contained, and we avoided debilitating deflation. Unemployment is sharply down. People are confident and households' net worth sharply exceeds previous peaks. And we could go on. Of course, some have not participated as much as others, so we are not running short of things to do better. Nor of things to worry about. It's what we do.

One last key ingredient of note in this particular batch of economic soup: Chinese growth. We feel that we are in the middle of a temporary stimulus from Beijing, as Chinese leadership wants economic stability leading up to a major political transition later this year. But once that's behind us, it could mean that 2018 growth could disappoint, and markets do anticipate.

In Other Words

"It's always important to remember that corporate fundamentals and not Washington, DC ultimately dictate the direction of the stock market."

— Richard Bernstein,
Richard Bernstein Advisors

Want To Learn More?

If you'd like to take a deeper dive into Hamilton Capital's proprietary research or better understand our top-down, forward-looking investment process, join our Investment Team for one of our upcoming market briefings:

May 17
Lunch, Scioto Country Club

May 18
Lunch, Scioto Country Club

June 8
Lunch, The Refectory

July 12
Lunch, Scioto Country Club

Space is limited, so contact Laura Hamilton at lah@hamiltoncapital.com or (614) 545-4013 to RSVP.

Equity Portfolios

Continued Optimism, But Beware Of Mood Shifts

Executive Summary

The post-election exuberance in the broad equity market continued in early 2017, though small-cap stocks came up, well, short.

Surveys and market sentiment remain strong on hope for an improved regulatory environment, additional government stimulus (from infrastructure and/or tax cuts) leading to more jobs and higher wages, and, for some, a focus on "America First" that translates into reduced immigration, improved trade outcomes, more manufacturing and coal jobs, and other expected gains.

But sentiment is a fickle friend. Actual investment, lending and spending are not yet measuring up to the level of enthusiasm in surveys.

Ironically, some of the hoped-for outcomes have already been taking place long before new ideas become law and actual new dollars flow into the economy.

First things first: How did the stock market start the year?

The year started out well. Broad measures of the U.S. stock market returned in the range of 5%. Not bad for three months. Naturally, not everything rose equally. Small-cap stocks lagged, with a modest return of near 1%. As you may recall, we've long argued that small caps are expensive (in terms of price/earning multiples, for example), so that's not a surprise.

Markets outside the U.S. also did well. Emerging markets led, but Europe, and to a lesser extent the UK and Japan (measured in U.S. dollars), also were solid.

So the market must be sniffing good things from the new government?

The market certainly has been looking forward to the potential actions to be taken by a "new" Washington, though, as we've noted before, this is a common frame of mind for several months after elections. But in the wake of an eight-year Democratic administration that was perceived by some to have emphasized regulation, higher taxes, government deficits and distributive policies, many hopes now ride on the new Republican-controlled executive and legislative branches.

The key word is "hope." We feel that, based on tangible achievements to date, it's hard to know with conviction how big and when positive steps will actually occur. Thus, though sentiment has risen, actual spending, or plans for spending, have not shifted materially from where they were previously.

It sounds like you have somewhat more moderate expectations.

Well said. It's not that we are deeply negative, though we are proudly guilty of being skeptical by nature. We are analysts by trade and by internal wiring. We're as eager as the next guy to build castles in the air, but, in a world where the future can never be known for certain, we sleep best when our castles rest on a strong foundation of fundamental factors and solid reasoning.

As fiduciaries of our clients' savings, we need conviction for a particular path or another. In this environment of relatively expensive stocks (and selected other risk assets, for that matter), we're having trouble putting the Legos together resulting in 3% to 4% economic growth. Or strengthening job growth. Or higher productivity growth. Or sustainable earnings growth of much above a few percent per year. And that's before we see higher interest rates from the Fed, or higher costs from rising wages, or credit/demand problems in China – all of which have ample probability.

Why not strong growth?

We touched on this, from a macro-economic perspective, when we talked about our Economic Outlook and the hurdles we see from weak growth in the labor force and productivity. Beyond that, even if we're optimistic about government policy, we may have to wait until 2018 for any material fiscal boost. And even then, the realities of already-high government debt levels are probably going to constrain how large said budget largesse could become.

That's if things work out well and aren't offset by any negatives. Of course, should trade disputes erupt, the positives could be diluted.

So you see no benefit from new policies?

We wouldn't go that far. We hope that some modest and sensible regulatory relief will take place. We also feel that a fiscal boost is likely. But the reality is that the budget deficit has already been widening for a little while, giving the economy some lift. And this deficit will eventually come under additional pressure, from Medicare, Medicaid and Social Security, before any new policies from Washington.

So we would describe it as a constrained environment – one that, glass-half-full, is already gunning the economy a bit but, glass-half-empty, offers little room for new stimulus to be brought to bear.

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For Your Information

Hours & Holidays: Hamilton Capital Management is open Monday through Friday, 8:00 a.m. to 5:00 p.m., except New York Stock Exchange (NYSE) holidays. Upcoming holidays include: Memorial Day, May 29; day before Independence Day, July 3 (1:00 p.m. close); and Independence Day, July 4.

Change In Your Financial Circumstances: If you face changes that could affect your financial circumstances, please call us so that we can discuss any appropriate adjustments to your portfolio.

Form ADV: If you would like to receive a copy of our current Form ADV, Part 2A and 2B, please contact us.

Fixed Income Portfolios

Monetary Policy Normalization In Abnormal Times

Executive Summary

U.S. inflation is approaching the Fed's target rate of 2%. The American economy is viewed as "…at or near maximum employment." In anticipation of incoming wage pressure and inflation risk, the central bank has begun a monetary "normalization" process by gradually raising the so-called Fed Funds rate and began discussions on how to shrink its balance sheet, now engorged with treasury and mortgage-backed bonds.

The Fed raised rates back in December, and now it just increased them again. Were there any new messages out of the latest decision?

Yes and no. The Fed boosted its target range by another quarter percentage point – to 0.75% to 1% — only a short while after an identical December hike. The central bank's statement indicated a more upbeat outlook for the economy. Fed governors noted that the labor market has continued to strengthen and that economic activity has expanded at a moderate pace. They also observed that inflation has increased and was moving close to the Fed's 2% target level.

These statements and the hint that there may be two more hikes this year have been consistent with the Fed's "dependent-on-data" and "forward-guidance" methodology.

However, a couple of new and noteworthy details emerged. Fed officials agreed that they would likely begin reducing the Fed's balance sheet, which includes assets purchased during and after the 2008-09 financial crisis, perhaps later this year. The other is that some members expressed concern that some financial assets may be overpriced, describing them as "quite high relative to standard valuation measures."

What are the factors behind the Federal Reserve's moves?

Inflation and the labor market are the main triggers.

Driven by rising commodities prices, consumer inflation is running above 2%. "Core" inflation, which excludes the volatile food and energy components and which the Fed (and we) favor, is also approaching 2%.

Meanwhile, the official U.S. unemployment rate is currently at 4.5% (close to the level before the financial crisis) and new claims for jobless benefits are at their lowest since the mid-1970s! Not exactly a sick economy. Hence the Fed's assertion that we're "at or near maximum employment."

Would the Trump administration's ambitious fiscal plan light a fire under inflation?

The short answer is…maybe. Inflation is primarily a function of monetary policy. The Trump administration's fiscal program contains personal and corporate tax cuts, and higher defense and infrastructure expenditures. An increase in this spending could become inflationary if it's also accompanied by a surge in monetary growth. By normal standards, U.S. monetary policy is still too loose and, hence, "normalization" seems reasonable.

What's the implication of this "normalization" to the fixed-income market?

The relationship between interest rates and bond prices is similar to a seesaw – the higher the interest rate, the lower the price for bonds. Any change would be larger at longer maturities. In addition, should interest rates rise, it's harder for less-profitable companies to repay debt and raise new money. In academic terms, duration risk and credit risk could worsen as interest rates rise.

At HCM, we've maintained a cautious posture in our fixed-income portfolios in anticipation of the direction for inflation. Toward the end of last year, we shifted our EM sovereign bond allocation to neutral. We've also taken steps to reduce our high-yield bond holdings to neutral to address the issue of credit quality. We believe our fixed-income portfolios are well positioned to weather a higher-rate and inflation environment.

THE HCM ADVANTAGE

The largest investors often have the benefit of sophisticated internal investment departments led by a qualified Chief Investment Officer to design and manage their investment portfolios.

Unfortunately, most investors can't maintain an internal team of that caliber. But if having an external investment team of that sophistication is something you could gain from, then we're here to serve.

We function in a fiduciary capacity as an external Chief Investment Officer for our clients. Our structure is similar to the investment departments of large, sophisticated institutional investors, and our team has extensive global investment experience. In fact, several of our team members have received national recognition for their abilities and accomplishments.

Each day, we diligently apply our disciplined investment process to the design and continuous, forward-looking supervision of your portfolio. Our goal: To build a complete investment solution for you.

HAMILTON
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