Growth Moderating And Inflation Marks Time

Executive Summary

It seems implausible when looking backward. Growth, after all, has exceeded 3% in the last four quarters. But one must understand the underlying “environmental” conditions behind that.

In 2018 we saw several such temporary forces at work, most prominently the fiscal boost — read: tax cuts and other related incentives such as expensing of business spending — in the large, $1.5 trillion borrow-and-spend package of a year ago.

So what’s hard to believe? We’re now experiencing moderating growth.

Our research suggests, for instance, that the steep slowdown we’ve already observed in manufacturing has, in the past, been associated with growth nearer 1.5%. But if those purchasing managers get any more blue, then growth could be short of that.

Inflation, after reaching or even exceeding 2% this past fall, slowed to the 1% zip code, only to quickly return to around 1.75% now. That’s still a dash below the Fed’s target, but some measures are already at 2%.

This late in the business cycle, the economy’s performance is terrific and marks one of the most successful runs ever in terms of sustained economic growth. And our subdued inflation is the envy of past decision-makers and the person on the street. This should be driving us to do victory laps, like the yet-again-world-champion women’s national “futbol” team.

The last official growth number we read about was over 3%, above the average of the last decade. Can you update us, please.

Glad to.

You may be thinking of the growth rate of the last year or so, and are certainly talking about growth in the first quarter of the year: the latest estimates for both place growth near 3.1%, driven in the first three months of 2019 by temporary boosts in net exports and inventories. Alas, the former has already eased since the latest estimate of GDP. And the latter, additions to inventories, is a bit of a poisoned chalice. Though it adds to growth while it occurs, if it’s the result of weak sales, inventories can lead to bulging warehouses and weaker demand down the road. Since business sales are near flat or even negative after taking out the effect of prices, we do feel that some of the inventory build was involuntary, due partly to buy-ahead-of-tariff-driven price increases.

The Interviewees

The content in this issue of Capital Markets Review was taken from interviews with Hamilton Capital Chairman & CEO Matt Hamilton, CIO Tony Caxide and Managing Director, Portfolio Management, Srinath Sampath shortly after the end of the second quarter of 2019.
Equity Portfolios

STOCKS LIKE FED’S NEW PURSUIT OF INFLATION

Executive Summary

The second quarter extended the robust gains of the first quarter, if not to the same degree. Public equities again led the leagues, and U.S. stocks beat non-U.S. stocks. This is a story we’ve told many times in this cycle, which has shown strong staying power, leading to rising investor wealth.

Though we are gradually moving past several temporary positive factors, investors’ enthusiasm was fueled by low bond yields (which help the value of future cash flows from stocks) and the hope that the Federal Reserve would cut rates, perhaps aggressively. So we often saw days where weak economic releases led to gains in stock prices. The market… it’s a strange beast.

The Fed has indeed shifted to a more supportive posture. Data certainly has given it reason, with benign inflation and some signs of economic moderation. But the Fed may also have changed its philosophical stripes. Given that short-term rates in this cycle may peak in the 2.5% range, the Fed won’t have room to cut rates in the next recession as much as it usually does — in the vicinity of 4%. This is leading to talk of an “insurance” rate cut and a potentially itchy trigger finger.

We can’t get a reasonably priced seat on a plane, and it’s often a middle seat at that! This must mean everyone is making money in the market, right?

The stock market has indeed delivered further gains in the second quarter, though not as exuberant as in the first. And most financial assets did well, though U.S. stocks led the leagues. Again, the U.S. economy has often been the envy of the world in terms of its ability to create jobs, and the U.S. stock market is delivering a similar performance in terms of minting wealth.

We also observed that small-cap stocks trailed. This sector often outperforms during risk-seeking periods, so its subdued performance fits in with the still-good-but-less-good character of recent months.

We like the end result, but we’re also curious as to what’s driving this.

The short answer: hopes for lower interest rates, including easier Fed policy.

It helps to go back to last year to understand. During 2018, everything was terrific for the first nine months or so, and then it wasn’t. A number of factors led to faster inflation and a central bank that was determined to move to neutral, from easy. That meant higher interest rates and, as a result, stocks in the fourth quarter more than reversed gains in the first three quarters, leading to market losses and placing cash among the highest-performing asset classes.

What happened then? The Chinese tried to slow things down to reduce leverage in their economy. Commodity prices fell and inflation slowed, and so have earnings. Add a couple of surprisingly low new-jobs releases, and concerns of a slowing economy emerged. Which also drove many interest rates, like mortgages’, down meaningfully.

Make sense so far?

Yes, we follow. And then what?

This seems to have been the final straw for the Fed, and may have changed its calculations.

In the past it’s leaned towards erring on the side of holding down inflation. This has served our economy and our markets very well for decades. But in this cycle it has failed to bring inflation up to its targeted rate. Much discussion has focused on the role of temporary factors. But recent comments suggest that the Fed is losing patience and thus may have tilted somewhat toward rather greater tolerance of, even determination for, bringing about higher prices.

This is a remarkable event — we don’t remember the Fed actually encouraging inflation. Like, ever. Though we don’t expect irresponsible actions, it certainly creates a greater probability of cuts in short-term rates, a so-called “insurance” easing in policy.

Sounds like a historic shift, but perhaps one founded on reasonable factors?

It is not unreasonable. As we noted earlier, there have been many signs of a slowdown, and inflation has been persistently lower than it “should be” in the eyes of the Fed governors. So they are adapting and changing their tactics. And the equity market likes it for the time being.

We could be spoilsports and talk about the risk that inflation is temporarily distorted on the downside by a change in methodology and because the key factors of disinflation in the past 15 years are being downgraded from hurricane force to tropical storm, or perhaps even mere rain (i.e., China’s entry into the global trade network, the internet, shale, and perhaps even artificial intelligence).

Or we could note that earnings have actually fallen (yes, that’s negative growth) for the last two reported quarters. Or share our scenario analysis in the event the trade dispute ends (the U.S. is showing signs of wanting this a little more than the Chinese) and trade re-accelerates, and whether that might lead the Fed to once again raise rates. Yes, we do get paid to worry and we take that duty very seriously.

But let’s put that aside and, even if briefly, enjoy the double-digit returns earned so far.

Tomorrow is another day and we’ll certainly keep watch for scary things under the bed.

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:

August 28
Lunch, Scioto Country Club

October 16
Lunch, Scioto Country Club

Space is limited, so please contact Mileah Hamulak at mhb@hamiltoncapital.com or (614) 643-5136 to RSVP.
Fixed Income Portfolios

THE FED QUANDARY: ONE CUT, TWO CUTS, NO CUTS, FEW CUTS

Executive Summary

Risk assets continue to flourish in an era of low rates and the possibility of additional easing by central banks. Fixed income has also benefited from the outlook of a global slowdown and the possibility of a prolonged trade war. The Fed continues to reign with a steady hand. As we continue to juggle the desire for gains while minimizing late-cycle losses, we continue to favor short-duration, high-quality assets in fixed income as we believe that treasury bonds remain expensive.

How did the treasury markets fare in the second quarter?

Bond prices appreciated across the curve. While the Fed Funds rate remained unchanged during the quarter, the 2-year treasury increased in price, causing its yield to drop from 2.26% to 1.75%. Similarly, the 10-year treasury saw its yield drop from 2.41% to 2% over the quarter. So the second quarter saw a continuation of the bond rally that we witnessed during the first quarter. There were many reasons for this dash to safety: growth is moderating worldwide, with the IMF reducing its 2019 forecast from 3.7% to 3.5%; the trade dispute is still with us and looks to be even more protracted than previously anticipated; and the ECB and the Fed have changed their postures to an increasingly dovish stance since last year.

While on this topic, the 10-year treasury yield has not been this low since late 2016, so it’s worth checking whether you would benefit from refinancing your mortgage.

What else is on the Fed’s mind these days, and how is it responding to this information?

The Fed is doubtless pleased with today’s low unemployment rate of 3.7%. However, with core and headline inflation running below the preferred 2%, at 1.5% and 1.75% respectively, the Fed likely believes that it overestimated U.S. economic strength and correspondingly over tightened in 2018 through its rate increases and balance-sheet runoff, particularly in light of the continuing trade war and the slowdown in global growth.

Despite the twin pressures of Twitterverse eruptions and bond markets forecasts (the latter is predicting at least two 0.25% rate cuts this year), the Fed continues to remain data-driven, provide regular forward guidance, and govern dispassionately. Unflappable Fed Chairman Jay Powell seemingly intends to see his 4-year term through and do everything in his powers to deliver a stable economy by mitigating the possibility of a recession. One potential Fed trajectory, therefore, is that it lets inflation ‘run hot’ at above 2% for a period of time to overcome the sub-2% core inflation spell we’ve experienced since 2012. This would argue for an ‘insurance cut’ of the Fed Funds rate to prop up inflation.

Given this backdrop, tell us how Hamilton Capital’s fixed income portfolio is positioned today.

With bonds being so expensive, our mandate to achieve attractive yields in fixed income while simultaneously safeguarding client assets remains our primary focus and helps us navigate these turbulent waters. The portfolio maintains a lower duration than the benchmark in order to mitigate duration risk, where an increase in interest rates would hurt longer bond portfolios to a greater degree than shorter bond portfolios. Additionally, we’re wary of the excessive amount of leverage in the system and have chosen to stay predominantly in bonds bearing high-quality credit. This mantra of being fearful when others are greedy should stand us in good stead in the coming years.
Economic Outlook (Continued)

So what if you adjust for those factors?

Growth would be closer to 1.5% — still not bad, in the grand scheme of things.

Really? You feel that’s OK?

Everything is relative.

For instance, consumer spending, the largest component of GDP, has been growing at about 2%, perhaps a bit faster. Though this has been supported by tax cuts and robust hiring, which is now slowing, it’s still quite respectable.

And another thing is…timing.

If we were coming out of a deep recession, the Fed had driven interest rates to the floor (or below it, as it might have to in the future, à la Europe) and the government was loosening the purse strings with higher spending on unemployment, infrastructure and such, then 2% growth might be disappointing. But this late in the economic cycle, a recovery of record-breaking persistence still delivering 2% growth with no inflation to speak of? That’s great.

Ah, inflation, yes, we’ll come back to that. Still on growth, where is the data pointing?

A number of factors are pointing to more moderate numbers ahead.

For instance, surveys of purchasing managers in the manufacturing sector gained strength in late 2017, through the first nine months of 2018. But they have slowed steeply since then. Their recent level still points to growth, but at a rather slower pace of, say, 1.5% or so. And any additional decline in said surveys would further weaken the overall growth environment.

It’s no accident, then, that the underlying, sustainable growth pace in the first quarter was closer to 1.5% than the advertised (and properly measured) official data point. And current estimates from the Federal Reserve Bank of Atlanta for second-quarter growth, as we discuss this in mid-July, are just above 1.5%. Official data will emerge later this month.

What else matters to growth?

Well, there is the elephant in the room that we haven’t yet gotten to — trade disputes.

These have had both a positive impact (by accelerating demand before the dreaded tariffs hit and increase prices and decrease supply) and a negative impact (by raising uncertainty and taming businesses’ animal spirits, reducing their willingness to take risk and invest).

This is a devilish thing to forecast — nay, it is an impossible thing to forecast since there is no past pattern of behavior through many cycles to study and assess — and neither Washington nor Beijing (nor Berlin nor Paris nor Tokyo nor other capitals involved) knows where it will end. Based on President Trump’s negotiated agreements since taking office, chances are that Washington will, in the end, reach modest changes from the past, declare victory as the election approaches and life will go on. But anything can happen.

Because of the impact to date, however, we do not feel that a resolution of the conflict will necessarily result in a large notch up in growth. But the direction could be positive, and growth might be higher than otherwise. If it happens. All else being equal. Whether that’s a good pace remains to be seen.

And finally, tell us more about inflation.

In a simpler world we would be doing flips. Actually, we are pleased as American consumers and investors, but many observers don’t seem to be.

Inflation tends to accelerate as unemployment falls and factories and offices get closer and closer to using their machines and desks and computers and people on a full-time basis, and it gets hard to find new people to make more widgets or run spreadsheets or answer phone calls from clients.

But not this time. Though inflation reached, even exceeded, the Fed’s target of 2% as recently as last fall, it then slowed meaningfully to run-rates under 1% as commodity prices fell sharply. It has since bounced back, but the current pace near 1.75% (a little lower if we exclude the volatile food and energy sectors, which can obscure underlying trends) is really phenomenal, particularly this late in a recovery lasting a decade. So there is much to be thankful for.

Now, some very credible measures are already at 2%. Nevertheless, the Fed seems to have shifted its stance to one of actually targeting higher inflation. Well, we don’t remember that happening…ever. Which probably means that their analytical equation is likely to place greater weight on reasons to ease rates. Which is already in bond prices, which offer thin rewards over inflation for the risk incurred.