U.S. Economy on Target

bbtperspectives.com/u-s-economy-target/

June 21, 2018

June 2018

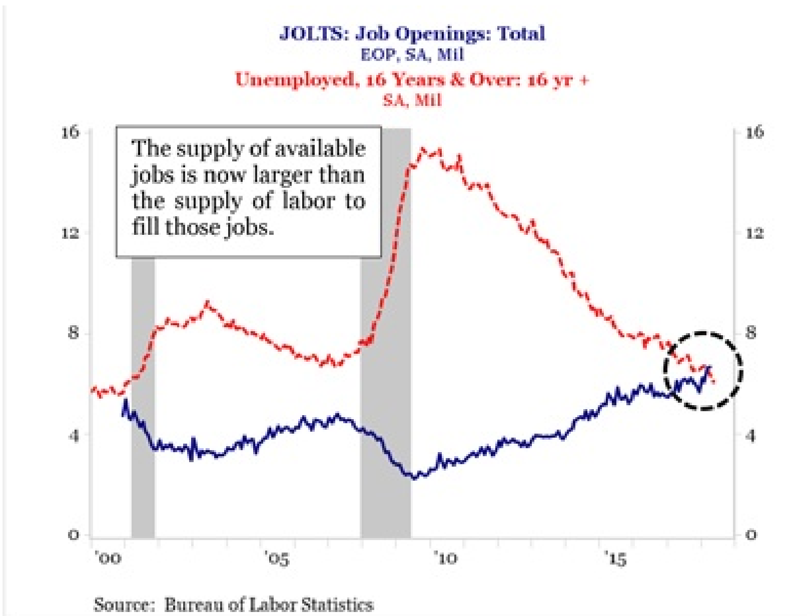
> The best thing the Federal Reserve can do, not just for the United States but for the global economy at large, is to keep our house in order through the continued pursuit of the dual mandate.
>
> *Jerome Powell, Chair of Federal Reserve*

As we approach the halfway point of 2018, investors have encountered many twists and turns. Globally synchronized economic growth has faded into U.S. dominated economic growth. Corporate tax reform has accelerated both economic and earnings growth. The Fed continues with its slow but steady path to normalization. Economic sanctions against North Korea have crippled their economy forcing them to commit to peaceful denuclearization. In this edition of *Market Monthly* we discuss these issues and more with an outlook that remains cautiously optimistic through 2018 and becomes increasingly guarded in 2019.

U.S. Economy Leading the Way:

The global economy has shifted from being globally "in sync" to being U.S. led. Many of the anticipated economic benefits from the Tax Cuts and Jobs Act are coming to fruition at an accelerating rate with U.S. gross domestic product (GDP) expected to accelerate from its 2.2% Q1 pace to 3.8% in Q2. Corporations are hiring as evidenced by the lowest unemployment rates since 1969. Corporations are investing their tax savings as evidenced by a 21% jump in capital expenditures during Q1, elevated share buybacks, increased dividends, high volume merger activity, $300 billion in repatriated profits and rising employee compensation. Consumer and small business sentiment remains elevated.

The employment picture is highly encouraging, as the chart below shows, with more job openings at 6.7 million than there are available workers to fill those jobs at 6.1 million. A robust jobs picture, rising incomes and lower taxes have all contributed to a rise in consumer spending in Q2 that was absent in Q1.



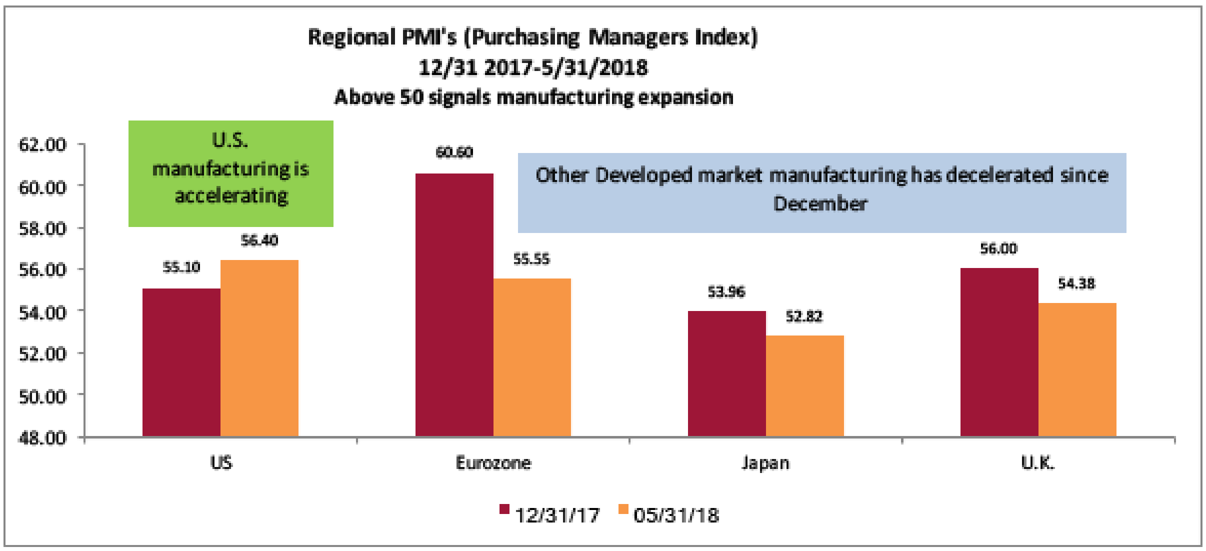
A 3.75% unemployment rate in the U.S. is the lowest in 50 years and almost a full 1% below the Fed's target rate for full employment. Wage inflation is expected to accelerate later in 2018 but poses no economic threat until or unless it sneaks toward a 4% rate.

Global Economy De-synchronizing:

The Organization for Economic Co-Operation and Development (OECD) with its 35 member countries tracks the pulse of the world economy. Earlier this year we pointed to a globally synchronized economy that was led by European members of the OECD. Today this has shifted to a world economy that is clearly U.S. led.

The share of OECD countries in "expansion" territory has declined from 97% to 83% since 2017. The share of OECD countries whose PMI Index is higher than it was a year ago has shrunk from 83% at year-end to 43% today. We don't view this as an alarm bell, since the world remains in expansion territory, but rather as a warning indicator that economic growth outside the U.S. is slowing.

The chart below illustrates this changing of the economic tide since the end of 2017 by illustrating changes in the Manufacturing Purchasing Managers Index (PMI), which surveys corporate decision makers about their investment and hiring attitudes. A PMI survey above 50 indicates economic expansion but below 50 reflects economic contraction. We focus on the manufacturing sector as it is a better early indicator of recession risks and highly correlated with future stock market returns. For now, recession risks remain quite low and manufacturing activity continues to support stock prices.



The red bars above illustrate PMI surveys at the end of 2017. The orange bars illustrate PMI surveys at the end of May. The U.S. has accelerated while the rest of the world has slowed, but most remain in expansion mode.

There are three primary reasons for these trends.

1. U.S. tax reform has generated differential growth vs. the rest of the world.
2. U.S. dollar appreciation has been a headwind for European economies and markets.
3. Italian political populism, German immigration issues and lingering Brexit concerns have temporarily distracted Europe’s previous economic momentum.

Differential growth for the U.S. and a strong dollar could continue to serve as headwinds for European economies and markets whose companies generate over 1/3 of their sales in U.S. dollars. This is likely to persist until early 2019. The fledgling coalition government in Italy seeks lower taxes and increased government spending (with a Sept. 20th budget announcement) despite having the world’s fourth largest debt load. Risks of an Italian Euro exit are highly overstated in that investors prefer to have their debts repaid in Euro’s, not Lira.

The Fed:

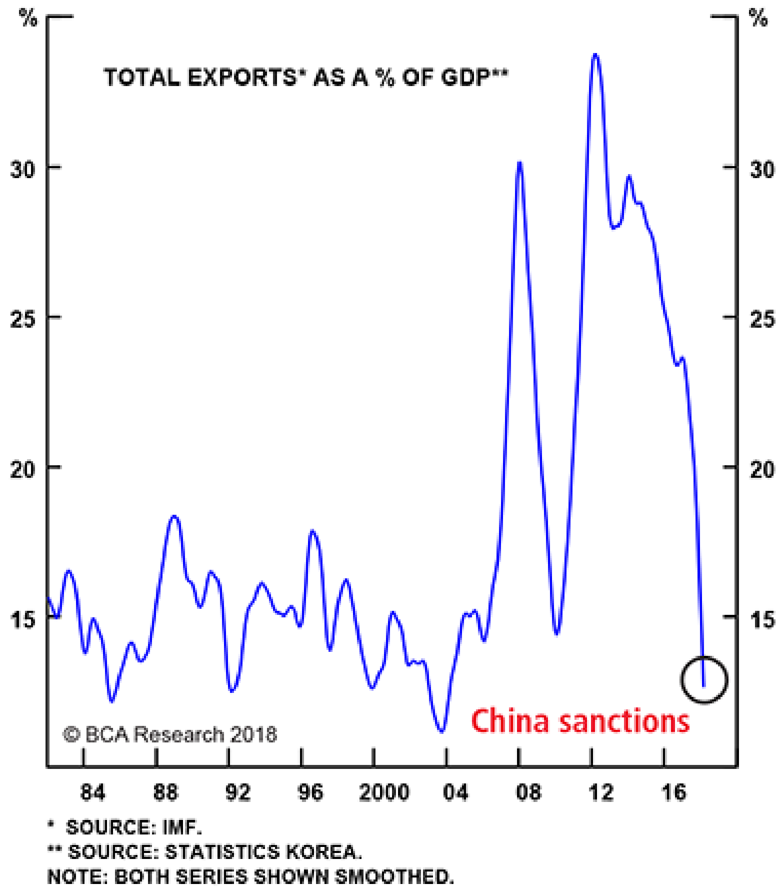
The Fed's unanimous rate hike decision on June 13th was a significant step toward an exit strategy from 10 years of emergency monetary policy with a decidedly hawkish tilt. Several things happened that shifted the dialogue.

- Low unemployment, now at 3.75%, overshoots the Fed's long-run rate of 4.5%
- GDP growth, Inflation and household spending all were upgraded for 2018
- Rate hike projections for 2018 shifted from three to four thus shifting their forward rate path
- The pace of anticipated balance sheet reduction was accelerated
- Beginning January 2019, post FOMC meeting press conferences will shift from every other meeting to every meeting, leaving the door open for increased transparency
- No references were made to international risks from Europe or elsewhere
- Chairman Powell indicated risks associated with trade and tariffs must appear in the economic data to warrant consideration beyond the headlines

The Fed continues to write this unprecedented chapter of their playbook and will continue walking a fine line shifting policy from "normalizing" to "tightening." The Fed now sees unemployment and inflation data as meeting their dual mandate targets but has stopped short of calling the "all clear" sign. Policy remains accommodative at the current Fed funds rate of 1.75%-2% but is inching its way toward a normalization range of 3.25%-3.5% by the end of 2020. For now, the positive impact of fiscal stimulus exceeds any negative impact of monetary tightening. On balance, this recent more hawkish tone from the Fed signals a shift from being extraordinarily accommodative to modestly accommodative. The coordination between tighter monetary policy (higher rates) and easier fiscal policy (tax reform) remains a primary focus but will eventually reach an inflection point.

North Korea:

The June 12th Singapore summit meeting between President Trump and Kim Jung Un was a geopolitical positive with limited direct economic implications. In our issue from August 2017, we wrote "…likely that negotiations are on the brink of breaking out behind the scenes." North Korea remains a risk but now that negotiations are underway, the North Korean issue is less of a threat to economic or market optimism than it was before. The chart below shows total exports as a percentage of North Korean GDP and reflects the effectiveness of last summer's sanctions as exports have plummeted almost 30%. Sanctions are crippling the North Korean economy.



These negotiations should be viewed as a good beginning to a complicated process given past failures with North Korean nuclear disarmament. A mutually acceptable definition of "denuclearization" with a corresponding implementation process will be the primary focus over weeks to come as officials from the U.S., Korea and China craft the details. Risks arising from the Korean peninsula have not disappeared, but they have abated for now as evidenced by the suspension of joint military exercises between the U.S. and South Korea. Trade relations between the U.S. and China remain a larger risk than a break down in relations with North Korea.

Trade Tensions:

Trade tension concerns remain a primary market risk in 2018. Continued economic expansion fueled by tax cuts have supported stock prices but not advanced them. The window for trade deals remains open only because sustained economic strength has bought us time. The lack of a trade truce is causing enough uncertainty that markets fear business decision makers could delay capital expenditures and hiring decisions thereby slowing economic growth. This building dynamic poses a larger threat to the economy than the tariffs themselves. Soft economic indicators of business sentiment remain bullish with support from tax savings windfalls; however, markets continue to reflect a wall of worry for reluctant investors.

Market Review:

Stocks: Stocks have been supported by the best earnings growth in years but constrained by concerns about trade, geopolitics, Fed policy and possibly mid-term elections. We believe that whether these concerns are evaluated individually or as a whole, they are surpassed by the positive economic momentum created by tax reform, which is still in its early stages. Trade tensions, approaching mid-term elections and share buyback blackouts will likely keep the U.S. market range bound in the weeks to come, setting up the kind of advance typical during mid-term election years. Rising volatility would not be a surprise.

Primary catalysts for further market advances are an accelerating U.S. economy, double-digit earnings growth, low interest rates, positive consumer and business sentiment and lower taxes.

The two primary challenges to the U.S. market are:

1. Potential for negative earnings revisions if dollar strength and trade tensions impact pro-growth decision-making.
2. Accelerated rate hikes begin to bite stock prices

Differential performance trends so far this year have been driven by two primary forces:

1. Tax reform: Companies that are the largest beneficiaries of corporate tax reform have led the U.S. market so far this year. The best illustration of this is small cap companies who saw their tax rate fall more than many of their larger counterparts. Additionally, tax windfalls have resulted in robust merger activity which exponentially impacts smaller firms.
2. Dollar Strength: Dollar strength so far in 2018 has created headwinds for U.S. investors. The table below provides returns for both international markets without respect to currencies (unhedged) and international markets for those who wish to hedge against a strong dollar (hedged). To best illustrate, we will focus on the MSCI Europe Ex UK index below. In 2017, U.S. investors gained an additional 2.31% in returns due to dollar weakness. However, due to dollar strength in 2018, their returns have impacted them by -3.25%. The dollar has been supported by higher interest rates and strong economic growth. The Euro has been weakened by continued low rates but also concerns about the Eurozone by populist movements such as Italy. Over time, currency fluctuations tend to iron out but in the short-term currencies can have an impact.

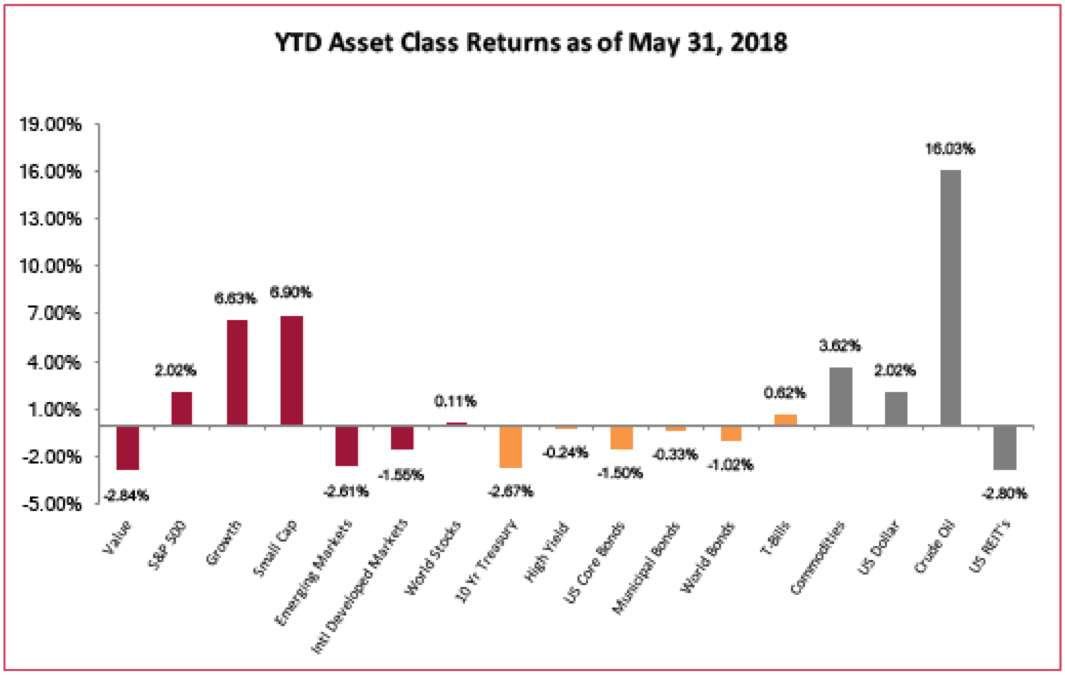
Market Monthly Hedged and Unhedged International Indices Year to Date Returns through June 18, 2018		
Name	**YTD**	**12 Month**
MSCI Emerging Market (unhedged)	-0.25	15.20
MSCI Emerging Market (hedged)	-3.74	12.78
Value Added/Lost in USD vs Local Market Returns	**-3.49**	**-2.42**
MSCI EAFE (unhedged)	0.23	6.06
MSCI EAFE (hedged)	-1.57	7.66
Value Added/Lost in USD vs Local Market Returns	**-1.80**	**1.60**
MSCI Europe Ex UK (unhedged)	0.42	1.96
MSCI Europe Ex UK (hedged)	-2.83	4.27
Value Added/Lost in USD vs Local Market Returns	-3.25	2.31

Bonds: Returns for 2018 have largely been negative due to rising interest rates and consistent with our "keep your coupon" return expectations. The best performing areas for bond investors have been high yield, municipal bonds and T-Bills. High-yield bonds continue to be supported by robust corporate earnings, a strong economy and shrinking supply. Municipal bonds have been supported by the continued demand for high bracket investors and a shrinking supply due to the loss of tax-exempt status for newly issued prerefunded bonds. T-Bill's have done well because their rates have climbed by more than their values have depreciated since they are a short duration asset.

The grid below illustrates the interest rate trends for U.S. Treasury notes for the one year ended June 15, 2018. The bottom table points out that while 2-Year T-Notes have climbed 1.2% in yield over the last year, 30-Year notes have climbed by only .27%. This explains the flatter yield curve with short rates rising by more than long rates.

Treasury Yields (%)				
From	**2-Year**	**5-Year**	**10-Year**	**30-Year**
2018-06-15	2.55	2.81	2.93	3.05
1 Month Ago	2.58	2.94	3.09	3.21
3 Months Ago	2.31	2.65	2.85	3.08
6 Months Ago	1.79	2.12	2.36	2.74
12 Months Ago	1.35	1.76	2.16	2.78
Treasury Yield Changes (bps)				
From	**2-Year**	**5-Year**	**10-Year**	**30-Year**
1 Month Ago	-3	-13	-16	-16
3 Months Ago	24	16	8	-3
6 Months Ago	76	69	57	31
12 Months Ago	120	105	77	27

Asset class returns are shown below for stock, bond and nonfinancial assets with commodities (led by oil) generating some of the best returns so far in 2018. This is consistent with our reflation theme we discussed earlier this year.



Final Thoughts:

The U.S. economy has pulled away from the pack and leads global GDP growth this year. Yet, stock prices remain relatively flat over concerns such as a flat yield curve, trade tensions, mid-term elections, rising rates and rising inflation. Evidence supports a continuance of the U.S. expansion. It has been the one of the longest in history but also one of the lowest and therefore has more runway. We think the economy and markets continue to support stock prices later in 2018 and into 2019. It will not be a straight line, but it continues to make sense to stay invested.

Sources: Strategas Research Partners, Evercore ISI, FactSet, Goldman Sachs Global Investment Research, Morningstar, BCA Research, Standard & Poors

This piece is produced by BB&T's Wealth Portfolio Management Team.