Global Economic Review

Eagle Eye

MARKET & ECONOMIC OUTLOOK

2Q 2018

BARILOTTI WEALTH STRATEGIES IS PLEASED TO PRESENT ECONOMIC AND MARKET INSIGHTS FROM THE PORTFOLIO MANAGERS IN THE STRATEGIC ASSET ALLOCATION AND SOLUTIONS DIVISION.

"When the people of Iceland are forced to grow their own pineapples, we know we have a problem."

– Dan Roberts, MacKay Shields

The four horsemen plus one. The long bull market in equities ran into stiff resistance on several fronts as we pushed through the first quarter of the new year. We list the following among the most consequential challenges to market pricing today:

Inflation. Trouble began in late January with the release of estimated average hourly earnings, which showed unexpectedly large growth year over year. Conventional wisdom has long held that wages will rise in response to a tightening labor market as employers are forced to bid more aggressively in their efforts to attract talent. That relationship had thus far failed to materialize in the current cycle with compensation growth remaining subdued even as unemployment fell toward 4%. Evidence that the traditional relationship might finally be reappearing sent shockwaves through the market. Higher wages can chew into corporate profit margins, drive upwards the cost of debt capital, and erode the present value of future earnings (and hence put downward pressure on equity price multiples).

Forced unwind of esoteric trading strategies. The initial sell-off spawned by inflation fears created a pop in both real and implied volatility. That in turn led to algorithm-driven sell orders from risk parity, managed volatility, and short VIX strategies, extending the price drop into correction territory. This chain of events was in some ways reminiscent of the implosion of "portfolio insurance" strategies on Black Monday way back in the fall of '87. Wall Street's financial engineers have struck again…

Tightening monetary policy. The change in leadership at the Federal Reserve from Janet Yellen to Jerome Powell brought no discernable policy modification. The Fed continues on its path of gradual hikes to target overnight lending rates and incrementally stepping up the pace at which it allows its balance sheet to roll off.

ON THE RADAR SCREEN

1. Corporate earnings are always top of mind. The first quarter reporting season is underway, and we expect to see very solid growth at both the top and bottom line.
2. Ongoing developments in trade policy represent headline risks. Negotiations with Canada and Mexico over NAFTA and with Korea over a bilateral agreement seem to have improved, but it is China that is at center stage. We can envision developments on that front breaking in either direction.
3. Inflation fears spooked the market once already this year. It is not our expectation that price indices will rise rapidly, but aberrant data could again disrupt markets.
4. The spring home buying season is in full swing. Despite higher mortgage rates and reduced tax benefits associated with home ownership, we anticipate significant transaction volume and view that as a yardstick by which to measure the health of the consumer.
5. Damage associated with data privacy issues have mostly been contained to Facebook thus far. Contagion to other big tech names would undercut a pillar of market support helping to sustain the rally these past couple of years.

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Additionally, members of the committee as a group expressed expectations of modestly higher rates down the road than were previously estimated.

Actual financial conditions tightened further as spreads on private lending (commercial paper, LIBOR) have widened significantly in recent months. This appears to be driven by technical supply/demand considerations rather than concern over credit quality, but regardless the reason, debt capital is being rationed to a degree we haven't seen in many years.

Big tech regulatory risk. Abuse of Facebook user data during the Presidential election again raises the specter of more aggressive regulatory oversight. For years, technology companies have led the market higher while operating in an environment of benign neglect. That may now be coming to an end, as both privacy issues and monopolistic practices draw scrutiny. Litigation and compliance costs are likely to rise, gnawing away at investor sentiment toward the sector.

Trade protectionism. The Trump administration has repeatedly attacked the liberal economic order, upping the ferocity with each additional move. It began with tariffs on imports of solar panels and washing machines. Next up were duties imposed on steel and aluminum. Trump's economic advisor, Gary Cohn, found this sufficiently reprehensible to tender his resignation over the matter (to be replaced by a protectionist, Peter Navarro). And then in late March came a set of heavy tariffs on roughly $50B in Chinese goods along with the promise that this is to be "the first of many" such policy maneuvers. While these actions unto themselves are still relatively immaterial to aggregate economic activity, there has been a clear tone change out of Washington. The steady march toward more open trade that has guided policy for the past several decades is under assault. Financial markets are responding by discounting the possibility these policy actions may be only the initial skirmishes in the ugly trade war to come.

"The real key to making money in stocks is not to get scared out of them." – Peter Lynch. Having laid out a lengthy list of concerns, you might understandably assume we've become bearish in our outlook for equities. Not so. As a discounting mechanism, the stock market response to recent events strikes us as being largely rational, although overdone. Inflation and tight monetary policy will ultimately constrain economic growth, complex trading instruments and strategies are an ever-present risk to capital markets, regulatory oversight will diminish profitability for some tech companies, and tariffs are an inefficient and unproductive tax on economic activity. But these factors combined are still dwarfed by the massive fiscal stimulus emanating from the recent tax cut legislation and the just-passed federal budget. Corporate profitability is absolutely soaring, and while stock prices can be whipped around in the short run by headlines and policy developments, they eventually tie back to company earnings.

As the market fell in early February in response to inflation fears we felt premature, we added considerable risk to the portfolios we manage. That move was initially validated as subsequent price data revealed that any rise in inflation is still quite muted, but that victory was short lived. Trade rhetoric and policy action in late March sparked a retest of the February lows. Remaining aggressively overweight equities has been our pain trade these past few weeks, but for now we stand our ground.

Economic fundamentals remain highly encouraging. If trade tensions do not escalate gravely and sentiment does not deteriorate dramatically, we expect equity prices to rise smartly through the balance of the year (the proverbial "wall of worry" stocks are poised to climb has become quite imposing!). And so, we maintain our current bias heavily favoring stocks over bonds, particularly those outside the US. Likewise, we hold our duration a little short and continue to shy away from lower quality credit instruments.

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"In most things success depends on knowing how long it takes to succeed." - Charles de Montesquieu.

Over the past year and a half, we have been favorably disposed toward the energy sector. During that same period, the price of WTI crude oil has climbed by roughly 35% while US domestic output is estimated to have risen almost 25%. Under normal circumstances, one would expect an industry that is enjoying rapid sales growth, higher sales prices, and lower costs of goods sold (crude oil extraction costs continue to fall with technological advancement) to perform quite well. These apparently are not normal circumstances. Midstream Master Limited Partnerships (MLPs) are down some 20% over that period while the broader energy sector is flat, comparing poorly indeed to the 25% gain enjoyed by stocks overall. This is a reminder that market prices and underlying fundamentals can diverge for extended periods of time on occasion. As investors in energy assets, we have found this a trying experience, but we have elected to hold our ground. Flat or falling pricing in the face of significantly improved profitability implies valuations that are that much more attractive now than before. Couple that with stable to expanding profit margins on further production gains going forward, and we have ample reason to be encouraged. We stand confident as ever that sentiment toward the sector will eventually shift and prices will rise. Success in this trade has taken longer to arrive than we expected, but success we believe we will see.

Past performance is no guarantee of future results.

About Risk: All investments are subject to market risk, including possible loss of principal. Stocks and bonds can decline due to adverse issuer, market, regulatory, or economic developments. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner, or that negative perception of the issuer's ability to make such payments may cause the price of that bond to decline. A bond's prices are inversely affected by interest rates. The price will go up when interest rates fall and go down as interest rates rise.

MLPs and other natural resources sector companies are subject to certain risks, including, but not limited to fluctuations in the prices of commodities; the highly cyclical nature of the natural resources sector may adversely affect the earnings or operating cash flows of the issuers in which the Fund will invest; a significant decrease in the production of energy commodities would reduce the revenue, operating income, and operating cash flows of MLPs and other natural resources sector companies and, therefore, their ability to make distributions or pay dividends.

LIBOR is a benchmark rate, which some of the world's leading banks charge each other for short-term loans. It stands for Intercontinental Exchange London Interbank Offered Rate and serves as the first step to calculating interest rates on various loans throughout the world.

VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking, is calculated from both calls and puts, and is a widely used measure of market risk, often referred to as the "investor fear gauge."

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