

Eagle Eye

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Market & Economic Outlook

Barilotti Wealth Strategies is pleased to present economic and market insights from the Portfolio Managers in the MainStay Investments Strategic Asset Allocation and Solutions Division.

“Your best work involves timing. If someone wrote the best hip hop song of all time in the Middle Ages, he had bad timing.”

— Scott Adams

The end is near—Eventually. Currently accepted wisdom is that we are in the later stages of a protracted economic expansion. We’re fully onboard with that view ourselves. The trick now will be in identifying just when exactly it is that we will roll over from expansion to contraction. Being too early is being wrong.

For the time being, the turning point is nowhere in sight. In fact, just the opposite—the U.S. economy and that of many other nations around the globe have been accelerating. We see that, of course, in recent Gross Domestic Product (GDP) prints, but more timely readings on components of GDP suggest that the upward trajectory of growth will persist for some time yet. Well supported by low interest rates and easy credit conditions, business capital expenditures and household spending are marching higher. Confidence readings and survey evidence suggests that will still be true well into 2018. Tax cuts are likely to throw a little more gasoline

onto the fire, as would an infrastructure bill if Trump and the Republicans can successfully shuttle one through Congress.

But even as the economy and stock prices hurtle higher, there are signs of fatigue. A wide array of labor market metrics, ranging from the very low headline unemployment rate itself to the considerable number of unfilled job openings and the high percentage of businesses reporting difficulty finding qualified applicants, make it clear the pool of available workers has been well and truly tapped.

Concerns about potential inflation spawned by rising wages has led to the Federal Reserve to engage in a series of rate hikes and to announce balance sheet runoff at an accelerating pace through 2018. At the same time, the European Central Bank is curtailing by half their quantitative easing program, and the U.S. Treasury is poised to dump significantly newer issuance on the market as the deficit grows. Lastly, non-bank corporations have been steadily adding debt over the past several years such that leverage is now approaching levels equal to historical peaks by some measures. The combination of a scarcity of qualified workers, rising rates and bond yields, and excessive leverage is a potentially toxic mix.

On the radar screen

1. With tax reform now approved, Congressional Republicans and the Trump Administration will redirect their attention to fulfilling other campaign promises. Welfare reform is a possibility, but an infrastructure bill seems more likely. While a necessary investment in our future, such fiscal expansion risks exacerbating existing strains on labor markets and can further add to the deficit.
2. Rich asset valuations have been sustained, in part, by lofty investor and consumer confidence readings. Strong economic activity, rising wages, and recently passed tax cuts could further inflate optimism and drive price multiples higher still in the short term.
3. Trade protectionism also featured prominently in the Trump campaign. This has not been a hallmark of the Administration to date, but emboldened by tax legislation success, Trump may become more aggressive in pursuing trade policy going forward.
4. The steady expansion of China’s economy over the past year belies structural imbalances that need to be repaired. Policy makers are gradually reining in credit growth and beginning the process of eliminating excess capacity. Neither are easy. A policy misstep could have global ramifications.

Through our lens, the next recession appears well more than a year away, but we must acknowledge that strain is building and asset valuations are very demanding. Investors are simply not being well rewarded for putting their capital in harm's way. Yet, we believe it would be premature to back away from the market just yet. We maintain an overweight sensitivity to equities in aggregate, albeit one much smaller than was the case at earlier points in the cycle, but with a keen preference for international stocks over those of U.S. companies. Positioning within our fixed income book is more cautious as spreads are tight and absolute yields quite low. For now, we tilt toward quality (investment-grade over high yield) and away from duration (shorter maturity instruments over longer maturities), although we anticipate extending our duration at some point in late '18 or '19 as we approach recession. We will want to be in long dated Treasuries before the "safe harbor" trade kicks in.

"Debts and lies are generally mixed together."

– **François Rabelais**. After a vexing period of inaction stretching across much of the year, the Republican administration pulled off a stunning volte-face on tax cuts this fall, hammering out a complex piece of legislation in just a few short weeks. Passing through the Senate on a strictly party-line vote, the new tax law is controversial for how the benefits are regressively distributed across the income spectrum: those who are already wealthy generally stand to gain the most. But, while the egalitarianism of the law is fairly a matter of debate, there is no such dispute regarding its likely impact on economic growth in the year ahead. The fiscal thrust that will come from individual and corporate tax cuts, repatriation, and the immediate expensing of business investment will provide a significant boost to activity in 2018. You might assume that we, being investment managers, would be unequivocally supportive of such a policy, and yet we are ambivalent at best. Two issues are of concern.

The U.S. economy is chugging along at a very healthy pace already; additional government-sponsored stimulus is not necessary at this point in the game. In fact, it can be counterproductive by pushing the economic tachometer into the red. Added strain on a system operating at capacity is likely to yield inflationary pressures, forcing the Fed to tighten monetary policy as an offset and thereby pulling forward the next recession. Tax cuts today are feeding a boom-bust cycle. We'd prefer to see a more moderate pace of growth that can endure for a longer period.

The other issue we have is that this legislation is more about tax cuts than tax reform, meaning that it will add materially to an already ballooning federal deficit. While the additional Treasury bond issuance needed to finance these cuts is likely to push bond yields higher in the near term, it's the more distant implications that worry us. In the inimitable words of Charlie Schultze, "the problem with the deficit isn't that the wolves are at the door; it's that the termites are in the foundation." By further exacerbating the public debt problem, tax cuts reduce the fiscal space available to future governments to respond to the next recession and compound an already massive entitlement spending bomb that will detonate some number of years into the future. A revenue neutral tax reform bill would have been vastly preferable to the tax cut candy we've been given today, Republican promises of cuts that will pay for themselves notwithstanding.

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