Global Economic Review

Eagle Eye

MARKET & ECONOMIC OUTLOOK

4Q 2018

ON THE RADAR SCREEN

1. Corporate profits are always of greatest interest. Pre-announcement guidance was a little disconcerting heading into the 3Q reporting season, but actual results have thus far been consistent with expectations for another very strong set of numbers.

2. Capital expenditures will be a critical element to extending the current economic expansion. The trend has been encouraging, but August data was disappointing. We look for a rebound in the September data.

3. Accelerating inflation would be a clear and present risk to the expansion and markets. We look to wage gains for evidence that inflationary pressures are building.

4. Roll-off of the Fed's balance sheet assets increases to $50B/month on October 1st. Combined with a change in pension funding tax rules effective September 15th, demand for Treasuries may be falling at the margin. Expect yields at the long end of the curve to continue rising.

5. The dollar rally has levelled off in recent weeks, restoring calm in non-U.S. markets. If that condition holds, we will see a material impact on financial conditions as we move through year end.

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

"Certainty is just the inability to imagine the alternative."
– Ludwig Wittgenstein

Firing on most cylinders. This time last year, we were vocal champions of the notion that today's long economic expansion – nearing record territory, and the record bull market for stocks were in the latter stage of the business cycle. At that time, we had plenty of company. In fact, the phrase "we're in the late innings" became a tediously common refrain in the commentariat.

A year later, the expansion looks no closer to its end. Questioning our certainty of place in the business cycle seems not only appropriate, but necessary. Might we still be underestimating the durability of growth?

In some respects, operating conditions appear strained: unemployment is low, wages are rising, and many prospective employer's report difficulty in finding qualified labor; the Fed is tightening monetary policy; delays in supplier deliveries are becoming more frequent; and use of debt capital is at an extreme. From that vantage, one could reasonably deduce that we are approaching the end. However, there are an equal number of factors suggesting economic growth may have runway. Credit to both businesses and households remains inexpensive and readily available; confidence is near record highs; labor force participation appears to have bottomed (and may rebound); and tax reform and industry deregulation have introduced helpful supply side effects that could linger for years. The jury is still out.

We find growing credibility that businesses could prolong this expansion still. It is a virtuous circle in which businesses: 1) invest more heavily in plant and equipment; said investment 2) leads to rising worker productivity (defined as more output per hour worked); and more productive workers allows employers to 3) raise wages without increasing prices or sacrificing profit margins. If this scenario plays out, it would be very friendly to stock prices and supportive of growth.

In the interim, conditions look generally benign. Fiscal support from tax cuts and spending bills remains powerful, business capital expenditures are up, household consumption remains robust on the back of strong job gains and rising wages, and hostilities over trade policy are still mostly contained. As such, we continue to lean fairly aggressively into equities. That's not the stance we would have envisioned being in today if you were to have asked us a year ago. But then, we were never certain.

Insights from the Strategic Asset Allocation and Solutions Division

Continued from previous page

"When the Fed puts on the brakes, someone goes through the windshield." - unattributed. The Federal Reserve Open Market Committee (FOMC) recently hiked the Fed Funds target rate for the eighth time in three years. The move up in rates occurs parallel to balance sheet runoff – where the Federal Reserve (Fed) reduces its assets at an accelerating rate. Adjusting for inflation, the real rate is roughly zero – anything but restrictive. Nevertheless, policy is becoming "less loose" and the effects are gradually becoming evident. Some of the structurally most vulnerable economies around the world such as Argentina and Turkey are in turmoil at least partly in response to declining dollar liquidity. While no major economies face jeopardy at present, there are other hot spots likely to develop in the coming quarters (South Africa and Malaysia being two possible contenders for that honor).

It's not just emerging market currencies and equities feeling stress from tighter monetary policy. Treasury bond yields are moving higher too as fears of disinflation diminish, demand from central banks wanes, and investors bake higher future short rates into their calculations. Our expectation is that this process has some distance yet to go, and so we continue to hold the duration in our portfolios a little short for the time being.

"I can calculate the movement of stars, but not the madness of men." - Sir Isaac Newton. There are times when market prices seem to become disconnected from underlying fundamentals. Two examples in today's market jump right to mind. The first are homebuilders, many of which find themselves in bear market territory. It's true that recent housing market data has been a little soft and increasing costs for labor, land, and materials threaten to pressure margins some, but volumes are still up year-over-year, prices on homes are rising, inventories are thin, and homebuilder confidence is elevated. It's odd to see such negative sentiment amongst investors when conditions at the construction site don't seem to warrant it.

A similar situation exists in the energy patch. The price of West Texas Intermediate crude oil has climbed more than 60% over the past 15 months, U.S. production has soared by 2.5 million barrels a day over that period, and extraction costs have fallen. So, to repeat: the price received for the product has risen, while costs of obtaining that product have fallen and the amount of product sold has risen by about 30%. Nirvana, right? And yet stocks in the energy sector have struggled to keep pace with the broader market, and energy infrastructure assets have fallen way behind despite their services being in enormous demand. Investors, still showing scars from the last energy rout, are amazingly reluctant to re-embrace the story even as it unfolds all around us.

Such scenarios test our patience, but we stay the course knowing that eventually prices and fundamentals will fall back into alignment. Our bet on energy has been a multi-year pain trade, yet it is one we have no intention of abandoning.

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 a strategy 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.

Barilotti Wealth Strategies, LLC
The Sterling Building
1819 JFK Blvd, Suite 301
Philadelphia, PA 19103
barilottiws.com

Eagle Strategies LLC

PROTECTION. RETIREMENT. INVESTMENT. ESTATE.

PROFESSIONAL GUIDANCE
PERSONAL ATTENTION

SMRU #1792240 Exp. 6/30/2020