Market Perspectives

Sentinel Trust Company, LBA
Investment Committee
Bruce L. Swanson, PhD
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January Recap

Prospects for a further acceleration in economic growth, combined with capital expenditures and corporate earnings supercharged by tax reform, drove outsized market gains in January, as equity investors extrapolated inflation-free above-trend growth into the future.

Fixed income investors had a different perspective on inflation, with the increase in yields and fall in price wiping out a full year's return for many owners of treasuries. Higher yielding bonds significantly outperformed their investment grade peers. A continued fall in the dollar bifurcated the world bond market and supported commodity prices.

Global equities returned 5.6% in January, with emerging markets once again in the forefront, but US stocks kept pace with a 5.3% gain. In the US, growth stocks outperformed value stocks by more than 3%, with smaller capitalization value stocks returning only 1%. Technology and consumer discretionary (Amazon up 24%!) sectors gained 8-9%, while the interest rate sensitive utility sector fell 3% on higher rates and a likely regulatory offset to lower taxes. What may have been lost to equity investors is that the VIX volatility index actually increased 22% over the month despite the rally in stocks, suggesting that the gains might represent more of a near-term top rather than simply the extension of the bullish trend.

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International Markets

Overseas, developed markets managed to post a 1.2% local market advance on top of 3-5% currency gains for a 5% total return. Eurozone shares gained 6.4% as the economy grew at 2.5%, nearly twice trend levels. European Central Bank ("ECB") President Draghi remained dovish in refusing to specify a time limit for the expiration of the bond purchase program. Similarly, Japan was up modestly in local terms and gained 4.6%. Emerging market equities returned 8% on the month, led by 12%+ gains in China, Brazil (+17%), and Russia. Russia benefited from higher oil prices, the first positive economic growth in over three years and a bond rating upgrade.

From a growth perspective, the economic backdrop continued to be highly supportive. The International Monetary Fund raised global growth forecasts to 3.9% for 2018 and 2019. The U.S. created 200,000 net jobs and manufacturing in advanced economies approached three-year highs, with the Eurozone at the highest level since 2006. The news was more nuanced on the cost and inflation front, as inflation fell back to 1.3% in the Eurozone, but picked up in the US. While headline inflation increased a modest 0.1% in December, the 3% fall in gasoline prices obscured a broad-based 0.23% increase in core prices. In addition, the US employment cost index rose 2.6% in the fourth quarter, its highest rate since 2008. This is a comprehensive measure of effective

wage costs, as it includes benefits and is calculated net of productivity gains.

Bonds

Treasuries collapsed in January, with higher yields across all maturities leading to a 1.4% loss for the Treasury index. At today's low interest rates, bonds are quite sensitive to interest rate moves. The month's 30-basis-point increase in yields resulted in an outsized 3.3% loss for 20+year treasuries. Dollar weakness over the month made international bonds a useful diversifier, with the non-dollar bond index up 3%. The credit market reflected the divergence between stock and bond returns, with "bond-like" investment grade corporate bonds losing 1.9%. More equity sensitive high-yield bonds gained 0.6% as tighter spreads offset the drag from higher benchmark rates, especially in the more speculative CCC-rated bonds (which returned 2%). Local currency emerging market debt gained 4.5%, boosted by dollar weakness. Other interest-sensitive assets also moved in different directions, with US real estate investment trusts down 3% and energy master limited partnerships up nearly 6%.

Strong US economic news and the big move up in interest rates failed to stabilize the dollar. The trade-weighted dollar plunged more than 3%, bringing the cumulative decline since the start of 2017 to 13%. Particular strength against the dollar was seen in the British Pound (+5%), Swiss Franc (+4.6%), Euro (+3.4%), and Yen (+3.2%), with the Chinese Yuan gaining the most in 40 years. The Korean Won was the outlier, falling 1% on political tensions.

The weaker dollar benefited the commodity complex as the Goldman Sachs index gained 3.4%. Crude oil gained 7% to approach a three-year high, as Saudi Arabian output reductions and exports from the US led to continued inventory normalization. US supplies declined to less than five days, down from 12 days in March 2017.

February Commentary

As of mid-month, global equity markets have declined nearly 5% in February, but have recovered 3% from earlier lows. The catalyst for the decline was a wage-gain surprise in the February 2nd employment report that spooked bond investors, with longer-dated Treasuries (20+ year maturities) losing more than 4% for the month and 7% in 2018. Our concern that the unwinding of short volatility strategies would be destabilizing was realized as the VIX volatility index rose 4X more than what had been indicated by the magnitude of the equity decline. The VIX index is subsequently down 50% from its peak.

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Our long-held view has been that interest rate normalization would be the most likely catalyst for an overvalued equity market to correct and that inflation risks are to the upside. To provide some context for the sea-change in consensus thinking, back in the summer of 2016, the market thought the federal funds rate would peak at 0.6%! In contrast, our issue was never whether the Federal Reserve Board ("Fed") was erring in tightening too aggressively, but why it had waited so long. This month's employment report increased the risk that the Fed has fallen behind the inflation curve, with all of the associated challenges for policymakers and markets. While perhaps not yet a likelihood, no longer can anyone view it as simply a tail-risk scenario.

The monthly wage gains in the employment report were inflated by weather (biased jobs mix in favor of high-paid workers), but this was not an outlier: the quarterly annualized gain hit an 8-year high, the employment-cost index had its strongest reading since 2008 and the percentage of small businesses expecting to boost compensation hit a 30-year high.

Petri-Dish Conditions

It would be hard to imagine better petri-dish conditions for growing inflation, at least in the US. The "mad scientists" at the Yellen Fed have dealt incoming Chairman Powell an impossible hand, with current Fed policy being so out of sync with both the stage of the economic cycle and the level of financial asset pricing. Unbelievably, overall financial conditions (as measured by a Goldman Sachs index) are the most accommodative since the 2000 dot-com bubble at a time of:

- full employment,
- US growth above trend and accelerating,
- international growth also above trend,
- rising wage gains,
- a doubling in Treasury borrowings in 2017, and
- a large structural fiscal deficit.

As if that were not enough fuel for inflation, the Administration's tax reform is perfectly good policy, but from a timing perspective it will increase the deficit beyond the 5% level when the economy is already near a cyclic peak.

Assuming little near-term appetite for fiscal tightening (entitlement reform and/or tax increases), the burden for the normalization of financial conditions falls on the Fed. Chairman Powell will

employ some combination of higher-than-expected interest-rate increases, a stronger dollar, more volatile markets and more restrained equity gains to achieve his goal. In a sense, investors need to appreciate that what was a "Fed put" to support asset prices has become a "Fed call" to cap equity appreciation as part of the policy normalization process. While the Fed put still exists, that protection kicks in only after a significant and sudden (20%) decline and exists to support the real economy, not asset prices on a standalone basis.

Federal Reserve Board Policy

In terms of Fed policy, the Fed is likely to stick to a gradualist approach and simply extend the duration of the tightening cycle as needed, depending on inflation developments. I am pencilling in seven(!) rate hikes by the end of 2019; the market is pricing in four hikes over the next three years (up from 3.6 in January). The Fed would tolerate if not welcome an overshoot of its 2% inflation target and likely maintain its gradualist approach. While the non-consensus forecast for interest-rate curve steepening has "worked" this year (2/10 spread up 15 basis points in 2018), ultimately the curve will flatten, but at much higher levels in 2019. While not a formal call at this point, given that the Fed's gradualist approach implies a major overshoot below full employment, a recession would seem inevitable, probably in 2020.

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Since a number of macro developments have fallen into place, our risk of confirmation bias has increased and it is worth examining counterarguments. Empirically, core inflation has ranged between 1.1% and 2.5% for the past 15 years, so a breakout might appear unlikely, especially with US inflation (excluding shelter) running below 1%. In addition, there is no guarantee that the increase in wage gains will translate into increases in inflation, as it is plausible that productivity has either been undermeasured or will pick up. Alternatively, the corporate tax cuts could allow for both wage increases and higher net profits without the need to raise prices. A better argument is that inflation is best analyzed on a global basis and there is as yet little sign of a global pick-up in inflation despite a negative output gap. While conceding all this to be valid, it is worth noting that an inflation boost is "baked in" this spring when some transient factors roll off. In addition, inflationary expectations have already picked up, with 10-year inflation-indexed Treasuries revealing an expected inflation of 2.1%, up from 1.5% in 2015-2016. In the end, I am focused on US inflation because that is what drives the Fed. The ECB and other central banks cannot normalize their monetary policy until the Fed takes the lead.