Market & Economic Commentary

Fall 2017

Jim Scheinberg CIMA®, AIFA®
Managing Partner

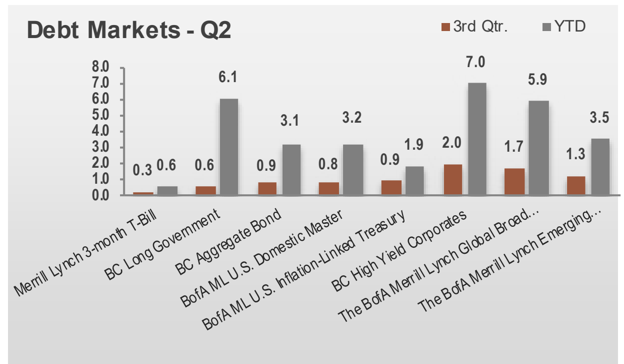
w 800 403 7065 x272
e Jim.Scheinberg@npier.com
www.npier.com

The New Roaring Twenties?

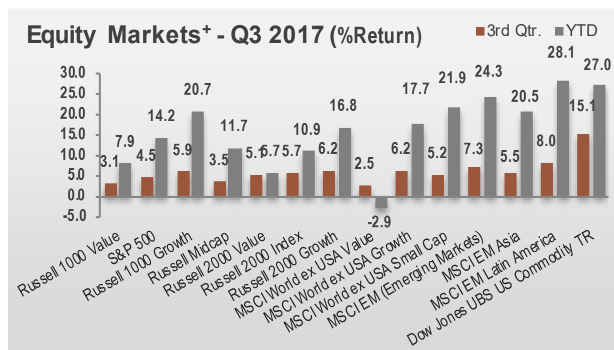
For the sake of my theory, please afford me some poetic, or perhaps better said, chronologic-license and forgive the fact that we are a still a few years away from the 2020s. Though this period will likely never be known as the second coming of the prolific period of global growth that occurred nearly 100 years ago, to ignore the similarities may prove to be costly to those who doubt the strength of the era we are presently enjoying… and the potential aftermath that may follow.

How the Markets Fared

The bond markets have been mostly quiet on the high-quality end of the credit spectrum, returning a bit better than their coupons. More risk exposed markets like high yield and emerging market debt have fared much better. Part of the international story is related to the decline of the U.S. dollar since the beginning of the year (after a big rally post-Trump's election).



Globally, most developed market equity indexes returned another 4%-6%, bringing year-to-date gains into the 10%-20% range. There was no clear leader in Q3, with most indexes advancing similarly. For 2017 as a whole, however, international stocks have outpaced domestic indices by more than 4% and growth oriented industries have trounced more cyclically oriented value names by better than 10%. Small cap stocks have lagged a bit over large caps here in the U.S., the same is not true overseas, where they have outpaced their more multinational-focused larger peers. Emerging markets equities continue to dominate those in the developed markets, posting returns nearly double the U.S. indices



Hindsight is 1920

Warren G. Harding was considered by many historians to be one of the most ineffective Presidents of modern era. He was elected in 1920 based on a nationalist "A return to normalcy" campaign which included a pledge to reject membership in the League of Nations (now the UN). Protectionism would grow steadily for the next nine years culminating in the catastrophic Smoot–Hawley Tariffs passed in 1930, which many argue deepened the crash of '29 into the Great Depression. Harding only received the nomination because the Republican field was greatly divided (with over 12 candidates vying for the nomination). In fact, Harding garnered less than 10% of the vote on the first six ballots!

The Roaring Twenties were stoked by a period of deregulation and protectionism that was a reaction to the Progressive-era that proceeded it. The first two decades of the 1900s were marked by social reform that championed protection for workers and the rise of women's rights (including the passage of the 19th amendment in 1919 granting women the right to vote). The progressive era also fostered an era of "government knows best" including the advent of the Federal Reserve in response to the credit crisis of 1907 and the moralistic enactment of prohibition. By 1920, many Americans had had enough, resulting in a populist-led election of Harding, the last businessman elected President before Donald Trump.

Today we find ourselves with an ineffective President who similarly was nominated due to a deeply divided and contested Republican primary. Trump's slogan of "Make America Great Again" parallels the essence of Harding's campaign perfectly. Threats of withdrawing from NATO, building a wall, and border taxes are modern era incarnations of the same nationalistic swell of 1920. As was true a century ago with woman's suffrage, debate over the legalization of same sex marriage intensified a divide across the United States. A swelling environment of political correctness was pierced by Trump's brash campaign and continues to be confronted head on by the likes of the Alt-Right extremes and Fox News.

As was true prior to Harding's election, taxes had recently expanded under President Obama along with burdensome regulations prior to the Trump election. As both Trump and Harding came into office, American businesses were primed as regulations eased and the tide of taxes appeared to be heading out after 8 years of rising.

It is these last similarities that are most important. The post crisis period of 2009-2016 was one of the most economically anemic in history, with GDP growth creeping along well below a two percent per year pace. Business leaders across America stockpiled cash and hesitated to invest in labor and resources for growth due to increased banking regulations under Dodd Frank and impeded by the costs of implementing ACA (Obamacare). Further, increased regulations from the Federal government as well as states like California muted recovery in the housing, healthcare and manufacturing sectors. The Democratic platform that appeared to be heading into the White House in 2017 projected even higher taxes, more government entitlements and still stricter regulations on business and Wall Street. By the time Trump rolled into office, the mere relief that business conditions were not going to get even more challenging gave American businesses a sense of liberation. Then the numerous rollbacks of environmental and financial regulations gave CEOs and other business leaders confidence to stretch their legs. Likewise the dismantling of an overbearing administrative state was an important factor in hastening the expansion of the 1920s. Many who doubt the potential for further gains in the stock market and U.S. economy should take note of these important similarities. The Roaring Twenties were some of the most profitable for American and subsequently international corporations and led to massive gains in the U.S. and global stock markets. The present economic recovery may not be growing long-in-the-tooth… in fact, it may have just begun.

Business is Varooming!

The engine of U.S. business is suddenly firing on all cylinders. The Institute of Supply Management (ISM) Report on Business (ROB) for September for the manufacturing sector climbed to 60.8 (anything over 50 indicates expansion) and the service-industries side of the survey jumped to 59.8, both post-financial-crisis highs. The ROB exhibited all of the key reasons for optimism regarding U.S. business conditions in the subcomponents of the survey data. New orders continued to soar, with readings of 64.6 and 63 respectively. Backlogs of unfulfilled orders also similarly swelled and inventories declined to 52.5 and 51.5 respectively, suggesting that more new orders are likely on the way. If these conditions hold, we can expect these indicators to sustain their current lofty levels or even extend their momentum in the coming months. That's good news, as these metrics indicate that the manufacturing side of the economy will grow at 5.5% over the next year and that the services side will advance at 4.2%. Most expectations for Real GDP growth for 2018 are in the mid-two-percent range. So if the ISM is even close to being right, there is substantial room for upside surprise.

Work-Work-Work

The ISM reports also showed strength in their employment data, shockingly even more upbeat on the manufacturing side of the survey than for services. This data is supported by the recent lows set in the unemployment rate of just 4.2%, the lowest since the dot-com era. The recent string of hurricanes disrupted the normalcy of the weekly employ¬ment statistics over the last two months, but short-term losses are expected to be followed by increased construction and related spending in the effect areas which should prove to be additive to future job gains. 4.2% unemployment is approaching "over-employment," a condition where skilled workers are harder to find and cost dearly when acquired. This near-imbalance in the supply demand curve for labor is excellent news for the American worker, as they can now demand greater and greater wages. As evidence, September hourly wages grew 0.5% for a year-over-year gain of 2.9%, adjusted for inflation. Wages, which remained largely stagnant for almost a decade, have grown in excess of 2% for nearly five years in a row and appear to be heading even higher.

Home, Home In the Range

The pace of domestic real estate growth has been remarkably steady for nearly four years, now. After a bounce off the lows from 2013 through early-2014, home prices have appreciated in a narrow range of 4%-6% annually ever since (according to the Case Shiller 20 City Average). This advance has been maintained by low inventories and demand fuelled by affordability due to low interest rates. The July report showed home-prices advancing at a 5.8% annual pace.

The National Association of Realtors reported that the median price for existing home sales was up 4.2% year-over-year, decelerating from the 5%-6% pace of prior months. This was influenced by price reductions in the Florida and Gulf Coast markets in the wake of this year's tragic hurricane season. Supply remained tight at just 4.2 months. Supply (inventory divided by monthly sales) usually averages about six months but has been hovering near 4 since 2012. As long as supply stays below norm, the average homeowner should see further gains of 4-6%.

Consumed with Optimism

As we have always said at North Pier, when jobs are plentiful for Americans and they see their home prices and wages climbing, they feel confident as consumers. The latest University of Michigan Consumer Sentiment Index (October-prelim) set a 13 year high of 101.1, climbing from 95.1 during the prior month. In fact, the last time consumers felt this confident about their present economic situation was when Bill Clinton was in office. Though upbeat, views about the future are tamed a bit by expectations of more modest wage growth. After a decade of wage stagnation, who could blame workers for being a little skeptical of recent increases in earnings. This optimism has been confirmed by the last few Consumer Sentiment surveys from the Conference Board.

Re-flation

For the last several years, we had witnessed the beginning hints of inflation, only to see price increases subsequently ease. Recently, the Producer Price Index (PPI) showed an increase of 0.4% month over month for September for a year-over-year increase of 2.6% (2/2% excluding food and energy costs). Prices to consumers have also risen of late with the CPI rising 0.5% in September and 2.2% year-over-year. North Pier believes that present conditions almost certainly will lead to sustained inflation above the Fed's targeted 2% level this time around. As reported above, wages are on the rise, growing at their largest rate in over a decade. Industrial commodities, like copper and aluminum are up nearly 25% this year. With material and energy prices firm and labor costs going up, it appears that at least moderate inflation is really here. The question remains, will moderate inflation, which is desired by policy makers, gain momen¬tum, leading to meaningful cost increases to consumers and higher interest rates from the Fed? Both could put pres¬sure on the economy in the future or if they get too far out of hand.

Fed-up

Federal Reserve Chairwoman, Janet Yellen's, term is up on February 1st. Although Donald Trump may renew her position for another term, he is also closely considering two candidates to replace her who have been harsh critics of the low interest rates maintained by the Fed in recent years. John Taylor, a Stanford professor in economics, and Kevin Warsh, a former Fed governor, are both being considered for the job and will most certainly lobby for more normalized levels for interest rates in light of the strength in the economy. The Fed Chairperson does not, however, single hand¬edly dictate the direction of monetary policy, as the Fed operates under The Federal Open Markets Committee (The FOMC). The FOMC must reach majority consensus to enact its policy. Nonetheless, if either Taylor or Warsh are ap¬pointed Chair, a more hawkish era will certainly be born at the Fed and the historical low rates we've enjoyed recently will eventually fade into the annals of history. Higher rates will test the staying power of economic growth, but so would high inflation, so striking the right balance will be a challenge for the Fed and its Chairperson, whether it be Yellen or someone new.

PIER*ing* Ahead

There is nothing new about this quarter's report on the economy. We have been painting a rosy picture of business and consumer activity for nearly two years now. What is new is the lofty valuation of the U.S. stock markets. At nearly 18 times earnings, the S&P 500 is valued at 20% more than historical norms. However, if we are beginning an era similar to the 1920's these valuations are com¬pletely justifiable and may prove to be quite a good buying opportunity. After all, if the market simply maintains its current valuations, once the S&P 500 adds another 15% to earnings (which is presently predicted for the coming year), stocks could advance proportionately. If the global economy is just starting to heat up, we could have several more years of enhanced growth, thus leading to mean¬ingfully higher levels in equities. As a reminder, stock prices better than tripled before the 1929 crash. Much of that appreciation was due to corporate earnings better than doubling during the decade of the twenties.