

Market & Economic Commentary: Green with Envy

Fall 2018

Josh Mackenzie
Research Analyst
josh.mackenzie@npier.com

Jim Scheinberg CIMA® AIFA®
Managing Partner
jim.scheinberg@npier.com

(800) 403-7065
www.npier.com
www.northpiersearch.com



The information and statistical data contained are from sources which North Pier Fiduciary Management, LLC believes to be reliable but in no way warranted by us to accuracy or completeness. North Pier does not undertake to advise you as to any change in figures of North Pier's views. This is not a solicitation of any order to buy or sell. North Pier, our affiliates, and any Officer, Director or Stockholders, or any member of their families, may have a position in and may from time to time purchase or sell any of them herein mentioned securities.

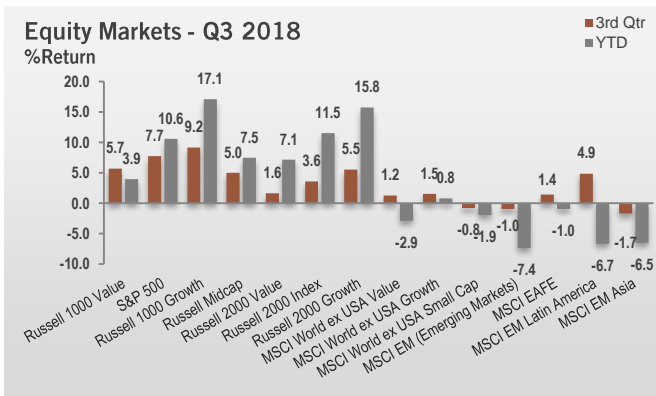
Page intentionally left blank

Market & Economic PIERspective

Green with Envy

The entire world is green with envy. By all measures, the U.S. economy is performing exceptionally well. While growth has slowed marginally in Europe, China, and other emerging markets, the U.S. continues to surge. 4.2% real growth in the second quarter was followed by what portends to be a stellar third quarter (initially estimated at 3.5%). There is a distinct possibility that the United States may average 3% growth for the entirety of 2018, something that quite amazingly has not happened since prior to the great recession! Strong outperformance of U.S. assets was a recurring theme for 2018 and that trend continued in the third quarter. However, fear over rising interest rates and building tensions with China broke the upward momentum here in the U.S. since the third quarter closed. Though corporate earnings and the housing market continue to steam ahead, U.S equity markets have since fallen into correction territory to start off Q4, shaking off what otherwise has been a strong economic and earnings calendar. Will this break in our domestic tranquility prove to be a bump in the night, or the first shots of an all-out global trade war? That remains to be seen... or should we say, "heard?"

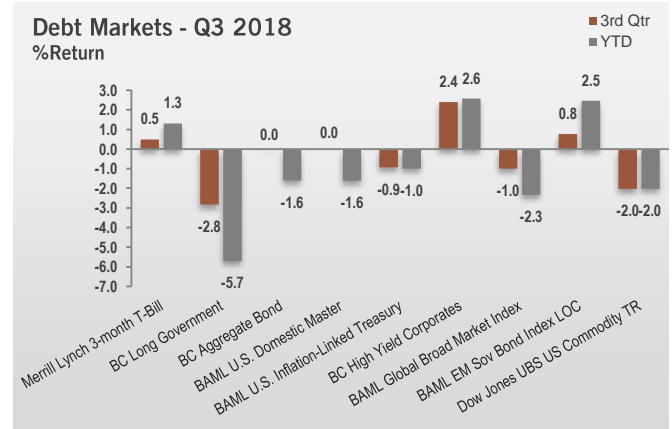
How the Markets Fared



Third quarter equity performance in the U.S. reflected the superb strength of economic growth. The S&P 500 clocked in at 7.7% gain, the best quarterly performance for the index since 2013! Growth stocks again outpaced value, and larger domestic companies caught up with their smaller counterparts, as concerns over international trade subsided... for the time being. Propelling domestic equity performance was a strong Q2 earnings season, where companies exceeded expectations on both the top and bottom lines, further highlighting the sustained increase in economic activity. Developed international markets performed adequately from a U.S. investor's perspective,

returning a modest 1.4%. Emerging markets, which saw large losses in the second quarter, found support in Q3, bolstered by rebounds in Latin America, which was up 4.9%. A stronger dollar and rising U.S. interest rates put pressure on indebted foreign countries, with a crack appearing in the weakest of the emerging markets. Countries like Argentina and Turkey have seen the value of their currencies obliterated; their resultant inflation increasing the difficulty of servicing their debt. So far, these two markets have been isolated instances, but it remains important to monitor some of the larger emerging market economies going forward: India, Brazil, and China to see if similar conditions materialize.

In late September the Federal Reserve raised rates for the third time this year, additionally they enthusiastically telegraphed their intention to continue raising interest rates, once more in 2018 and further next year. The yield on the 2-year Treasury now stands at an attractive 2.8% While rates have been on the rise there have been no apparent signs of stress appearing in the credit markets. The "risk-on" attitude stemming from the fast pace of economic growth here in the U.S. helped the riskier corners of the bond market (namely high yield and emerging market debt) perform well, returning 2.4% and 0.75% respectively. Credit spreads, which were already extraordinarily tight, narrowed even further and default rates remained



Market & Economic PIERspective

historically low. Investment grade corporate debt was flat and developed market international debt was down 1% on the quarter (in part due to a continued rise in the dollar). Declines in the price of intermediate and long government bonds erased the coupons for BarCap Aggregate and led to losses of nearly 3% for long dated U.S. government bonds. (For a discussion on why rates are on the rise, see *Piering Ahead...* ahead.)

Strong Planks

Strong Planks	Weak Planks
Business-to-business activity (ISM 59.8 reading in September)	Rising interest rates
Strong services growth (Non-Manufacturing ISM 61.6 reading in September)	Uncertainty about the future path of inflation
Generational lows in unemployment (3.7% as of latest data release)	Concerns about the China-U.S. relationship
Continued consumer confidence (25-year highs)	Mid-term election uncertainty
Retail sales (6.6% YOY in August)	

PIERING Ahead

Economic growth powered U.S. equity gains in the third quarter. Corporate profits provided a further boost. Of the nearly half of S&P 500 companies that have reported Q3 earnings (as of October 26), 77% have beaten bottom-line forecasts and 59% have topped estimates for revenue growth. That support looks unlikely to abate until perhaps later next year. Valuation metrics such as forward P/E suggest (currently 15.5 times) the U.S. equity market is not overtly expensive, compared to historical averages (5-year average of 16.4 times).

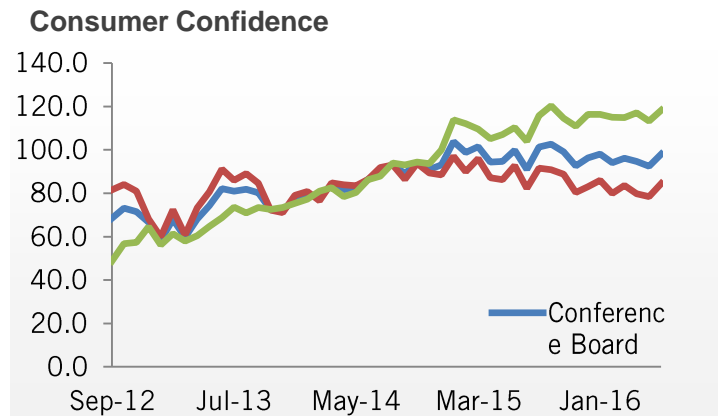
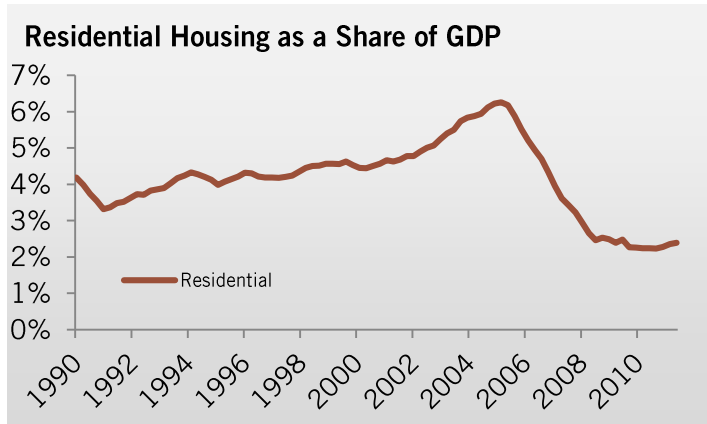
Stepping back and contemplating global markets there are several important things to note. The “America First” agenda is powering the U.S. economy. Growth in the United States has been exceptional, as has equity market performance. Though moderating a bit, the rest of the world has also expanded at a solid clip in 2018. However, financial markets have not commensurately rewarded that growth, concerned with potential slowing ahead due to what-if scenarios conjectured based on uncertain trade environments. Further driving this divergence is a stronger U.S. dollar. The dollar has been buoyed by normalization of monetary policy from the Federal Reserve and fiscal stimulus from the Trump administration (e.g. lowered corporate tax rates). As interest rates rise, capital begins to flow back to the United States, putting upward pressure on our currency.

Monetary tightening is widely expected to continue well into 2019, both in the form of further interest rate hikes from the Fed and the systematic unwind of the Federal Reserve’s balance sheet. This tightening is occurring simultaneously with the expansion of the budget deficit to finance fiscal stimulus in the form of tax cuts and increases in federal spending. An additional headwind to the bond markets is a tax arbitrage phenomenon that incentivized sponsors of defined benefits plans to pull their 2018/2019 contributions into the 2017 tax year that ended on Sept 15, 2018. This artificially drove up bond prices in the summer (suppressing yields), and subsequently, will result in a lull in routine buying in the coming quarters. More supply combined with dwindling Federal Reserve demand... If one was looking for higher interest rates, this is the formula. Higher interest rates could likely lead to further dollar strengthening, which in theory would continue to put pressure on non-dollar-denominated assets.

Further complicating the picture are international trade tensions. Curiously the dollar has reacted positively to tariff escalation between the United States and China. The administration imposed 10% tariffs on \$200 billion of Chinese goods beginning September 24th. The Trump administration further proclaimed that if no concessions were obtained from the Chinese, the 10% rate would increase to 25% on January 1st, with the potential to apply that rate to a further ~\$250 billion in trade. China responded in kind with tariff imposition on the United States. Tariffs are taxes

Market & Economic PIERspective

on consumers and businesses, as they increase the cost of goods and services coming into the country. Some of those costs will manifest in reduced corporate margins (as many companies, like Caterpillar have recently reported), other costs will be passed through to the end consumer. As a result, you will likely end up paying a bit more for your next car. To the extent that these additional pressures stoke inflation even further, we may see a more aggressive Fed in response. Talks between the two nations are tentatively scheduled for the G20 Summit in Argentina in a few weeks. If some significant progress is made, it will be a real positive for investor sentiment and should provide a boost for markets heading into the end of the year.



It appears all roads are leading to higher rates. The reason this is so important, and is the focus of this writing, is because interest rates act like financial gravity. Stocks, bonds, housing, you name it, all markets are impacted by the cost of money. Rising interest rates are equivalent to turning up the gravity - so to speak - implicitly weighing everything else down in the process. To gauge what impact an increase in financing costs are having on the economy, the housing and auto sectors are a good barometer. Big expensive purchases that require lots of borrowing are highly sensitive to the cost of credit. For the last two years, U.S. equities and the housing market and consumer spending have had little issue handling the steady increase in the cost of capital; after all, we are still historically in a low interest rate environment. The question is, at what level does the cost of capital begin to meaningfully impact behavior at the household level, and profitability for the business sector? Piercing ahead, strong growth looks set to continue, but keep an eye on housing, auto sales and how the consumer acts over Christmas. If there is a change in the weather, you'll likely see a shift in the direction of these economic winds first.