Review & Outlook

SECOND QUARTER 2018

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Review and Outlook

In a twist on an old saying, the second quarter of 2018 came in like a lamb and went out like a lion. In April, investors realized that the volatility they experienced in February and March was really just a return to normal. Economic data was largely positive and small swings in the market no longer made headlines. But pundits and prognosticators like to worry, so despite solid economic data, by May we started hearing about worries on the horizon. A UN briefing for April (published in May) stated, "Stronger global economic growth, but risks are building."[2] The risks, they noted, were concerns about income inequality and the potential for weaker growth in 2019, not risks related to economic or stock market performance in 2018.

Index Performance Data: Total Return as of 6/30/2018

Indices[1]	Q2 2018	Trailing 12 Months
CRSP US Total Stock Market Index (Total Return)	3.91%	14.83%
MSCI Global ex-US Total Stock Market Index	-3.55%	5.12%
Bloomberg Barclays 1-5 Year US Investment Grade Bond Index	0.25%	0.12%

By late May, the underlying data remained positive, but concerns had solidified. The possibility of new tariffs and 'tit-for-tat' rhetoric around trade made headlines leading up to the G7 meetings in Quebec in early June. Then President Trump's trip to Singapore to meet with Kim Jong Un, the first ever meeting between leaders from the U.S. and North Korea, dominated the news. Yet despite all the tension and excitement, investors remained unfazed.

Looking ahead, we see more of the same. Corporate earnings have been strong in the wake of the tax cuts, the labor market remains strong, and interest rates are low. In June, NABE economists increased their outlook for GDP growth in 2018 to 2.9%, a slight upward revision from their March forecast.[3] Three-quarters of those surveyed said that the recent trade policies will hurt the economy in the long run, but tax cuts approved in early 2018 will add to GDP growth this year and for much of 2019. A majority of those participating in the survey said they expected a recession by 2020, with 18% predicting a recession by late 2019.

The tax cuts have lowered government revenues while expenditures have continued to increase. However, it is not clear that increasing the deficit right now will be beneficial in the long-term. The year 2000 was the last time we had these levels of unemployment and corporate earnings; but we also saw a federal budget surplus at that time. There are no surpluses now, and the Congressional Budget Office expects the deficit to exceed $1 trillion per year by 2020[4], which is two years sooner than previously forecast.

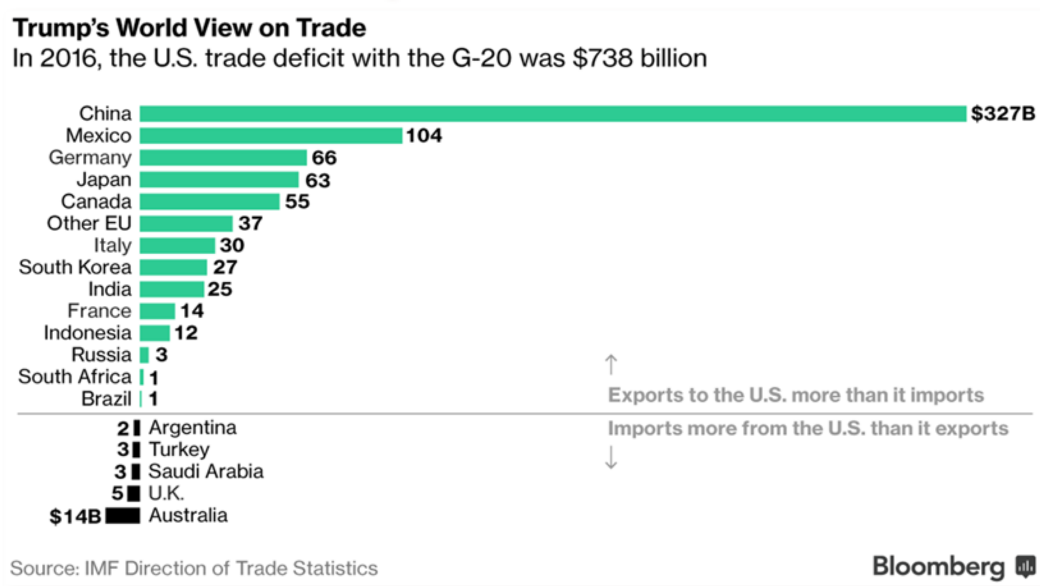
It is this clash of economic trends – implementing policies that promote near term growth without addressing the resulting consequences for the longer-term – that has our attention. It will take time for more protectionist trade policies to be reflected in the data on inflation and employment, perhaps around the time that we start to feel a squeeze from the growing deficit. Our view is that a healthy economy should not generate historic deficits. While we like what the data implies for the next 2-3 quarters, we think that a recession is very likely by 2020, possibly even before the end of 2019, as the markets cannot escape the policy collision that we see brewing on the horizon.

In Focus

In this quarter's In Focus, we explain how we are thinking about the issues surrounding trade policy and discuss whether we should adjust our investment strategy in response. While we do consider how tariffs might make certain asset classes more or less attractive (or in the case of individual stocks, how tariffs can make specific companies more or less attractive), we also have to distinguish between what makes for good headlines and what suggests real change. We do not try to buy and sell securities based on how a fund or stock might behave in a given week or month. Instead, we try to understand larger trends and policies that might lead to longer term changes in valuations.

For example, President Trump has expressed concern about our trade deficit with certain countries and suggested that they need to buy more from us in order to reduce the deficit. These statements are not particularly concerning to us, and do not make us think that trade patterns will change soon and that significant new investment opportunities will emerge. We know that the trade deficit is a matter of rather simple math: People in the U.S. finance a high rate of consumption, not through savings, but by borrowing, mostly from foreigners. We buy their goods, and they buy U.S. bonds or other securities as part of their savings. Those purchases balance out, but the accounting shows an imbalance in the flow of goods between the two countries. That imbalance is the trade deficit. Tariffs can alter trade balances slightly, but not if other countries retaliate by adding their own tariffs and we continue to consume as we do. When we hear about tariffs designed to reduce trade deficits, we understand that those deficits aren't going to disappear overnight, so we know not to adjust our investment strategy in anticipation of smaller trade deficits. We do pay attention to how tariffs might alter the attractiveness of certain companies or asset classes (such as what happens if steel and aluminum become more expensive in general), but since we know that trade deficits aren't going away any time soon, we aren't in a hurry to our long-term strategy.

Figure 1: US Trade Deficit[5]



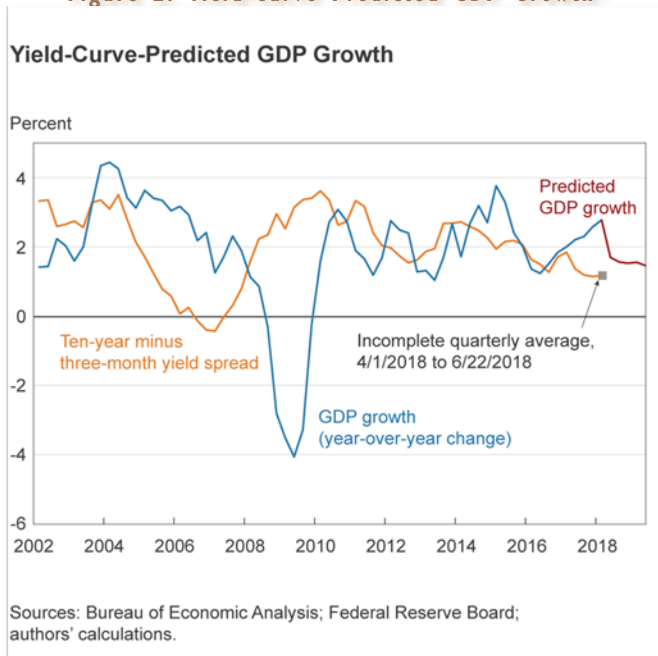
Interest rates also factor into concerns about trade. As mentioned, other countries buy U.S. Treasuries while we buy goods that they produce. So, at least indirectly, trade discussions or disputes can affect interest rates. Some of the bluster about tariffs will be short-lived and should be ignored. We try to focus on what we think are more dependable influences on rates, such as demographics. As the U.S. population ages, the demand for bonds is likely to increase (think baby boomers who want their IRAs to be less susceptible to market downturns). The higher demand for bonds would put upward pressure on the price of bonds and downward pressure on the return or yield from those bonds. If the U.S. economy continues to be seen as a safe haven, global demand for U.S. bonds would also help put downward pressure on yields. Of course, that outlook suggests that medium and longer-term rates will stay low for some time, meaning that we do not expect the yield on 10-year Treasuries to go back to the 6% range that we saw in the 1990s.

The view that rates are likely to increase slowly (instead of returning quickly to what many of us still think of as normal) has led us to invest in bonds in a particular way. We do not favor typical bond mutual funds right now, as the managers of those funds have to buy and sell bonds in this rising rate environment, often suffering capital losses. Instead, we buy individual bonds or funds with bonds that all mature at the same time, both of which we can hold to maturity. The result is a small positive return and added stability.

Naturally, there's always a "what if" to consider. In this case, it is short-term interest rates. On June 13^{th}, the Federal Reserve raised short-term interest rates, and hinted at doing so twice more later this year, in order to keep the economy from 'overheating' (a possibility with tax cuts and deficit spending when unemployment is already low).

Rising short-term rates and slow moving longer-term rates can cause an 'inverted yield curve', where short-term bonds offer higher yields than long-term bonds. Longer-term bonds require that you tie up your money for longer and should, as a result, give you more reward. But an inverted yield curve means something isn't quite right in the economy. An inverted yield curve has preceded all nine recessions since 1955, and the worry is that short-term interest rates could run up faster than long-term rates. The Fed has a large number of bonds in its portfolio, which it purchased during the recovery from the last recession. As it "unwinds its balance sheet", it is letting those bonds mature without replacing them, which means a lower demand for bonds. We think the increase in demand for bonds by aging baby boomers and investors from other countries (where bond yields are not as attractive as in the U.S.) will more than offset the drop in demand from the Fed. If demand for bonds falls, we'll see rates increase faster than expected, and that could lead to a drop in the stock market as money flows from stocks to bonds and investing slows in general. We think stocks and longer-term bond yields will both rise very slowly (not steadily, but slowly) for much of 2018, but a drop in the stock market due to sharp changes in interest rates is possible.

Figure 2: Yield-Curve Predicted GDP Growth[6]



Recently, a CNBC news article stated, "Russia cuts Treasury holdings in half as foreigners start losing appetite for U.S. debt."[7] We are not anticipating a significant spike in interest rates as a result, but that headline illustrates a risk. If China, in particular, were to sell some of their Treasury holdings, interest rates in the U.S. could increase rapidly. We do not think that is likely because China would be devaluing something they own in large amounts. Instead, we think that they will respond to the new tariffs in other ways.

Fortunately, our bond holdings are "laddered", meaning that when a portion matures each year, we buy new bonds to replace them. Buying new bonds at higher rates works well, so we are in a good position if bond yields increase only slightly, or if they go up relatively quickly.

1. CRSP US Total Stock Market Index: http://www.crsp.com/products/investment-products/crsp-us-total-market-index#performance-report. MSCI ACWI ex-US IMI Index: https://www.msci.com/acwi. Bloomberg Barclays Indices: https://www.bbhub.io/indices/sites/2/2017/03/Index-Methodology-2017-03-17-FINAL-FINAL.pdf
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3. National Association for Business Economics. "NABE Outlook Survey - June 2018." June 2018 Outlook Survey Summary_v2, www.nabe.com/NABE/Surveys/Outlook_Surveys/June_2018_Outlook_Survey_Summary_v2.aspx.
4. Wasson, Erik, and Sarah McGregor. "U.S. Deficit to Surpass $1 Trillion Two Years Ahead of Estimates, CBO Says." Bloomberg.com, Bloomberg, 9 Apr. 2018, www.bloomberg.com/news/articles/2018-04-09/u-s-budget-deficit-to-balloon-to-1-trillion-by-2020-cbo-says.
5. "China, Germany Step Up as U.S. Retires From World Leadership." Bloomberg.com, Bloomberg, 3 July 2017, www.bloomberg.com/news/articles/2017-07-03/as-u-s-retires-from-world-leadership-china-and-germany-step-up.
6. "Yield Curve and Predicted GDP Growth, May 2018." ClevelandFed.org, Federal Reserve Bank of Cleveland, 28 June 2018, www.clevelandfed.org/our-research/indicators-and-data/yield-curve-and-gdp-growth.aspx.
7. Cox, Jeff. "Russia Cuts Treasury Holdings in Half as Foreigners Start Losing Appetite for US Debt." CNBC, CNBC, 18 June 2018, www.cnbc.com/2018/06/18/russia-cuts-treasury-holdings-in-half-as-foreigners-start-losing-appetite-for-us-debt.html.

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