TREASURY | PARTNERS

2018 Mid-Year Review

Bumpier Ride: Same Destination

July 11, 2018

Executive Summary

- Continued equity strength due to strong economic fundamentals and rising earnings
- Benefits from tax reform will extend the economic cycle
- Interest rates will continue to grind higher
- Employment/wage pressures keep building
- Prolonged trade wars could have harmful impact on sentiment and fundamentals

Richard Saperstein
Managing Director/Principal
+1 917-286-2777
rsaperstein@treasurypartners.com

Steven Feit
Managing Director
+1 917-286-2793
sfeit@treasurypartners.com

David D'Amico
Managing Director
+1 917-286-2780
ddamico@treasurypartners.com

Brendan Jones
Executive Director
+1 917-286-2772
bjones@treasurypartners.com

Daniel Beniak, CFA
Director
+1 917-286-2783
dbeniak@treasurypartners.com

TreasuryPartners.com

2018 Market Recap

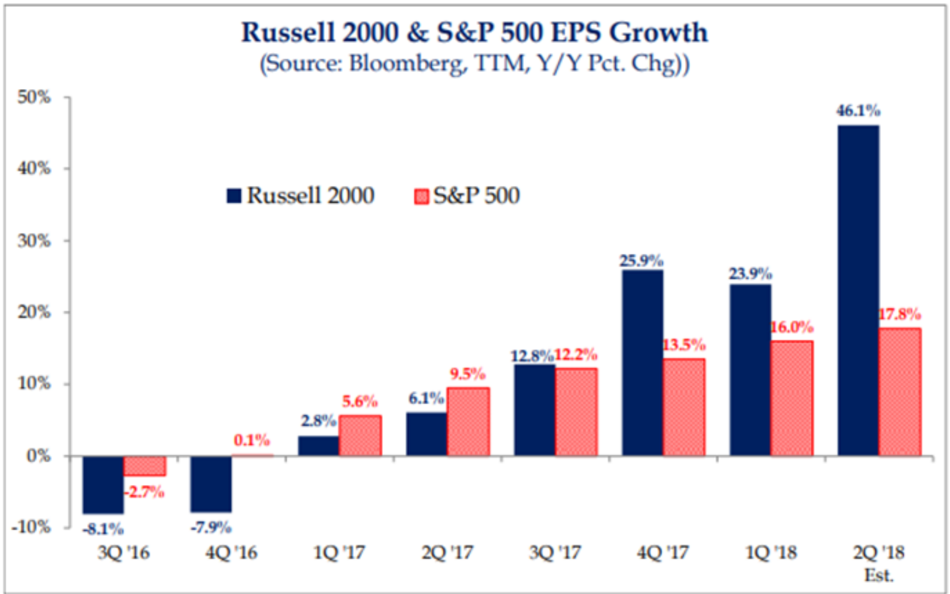
Last year the S&P 500 rose 19.4% with little volatility. At the halfway mark, 2018 looks to be quite different with the S&P 500 increasing only 1.7% through June 30.

S&P 500 Year to Date Price Changes

Source: Bloomberg

Investor sentiment has shifted frequently with changes in geopolitical news. Headlines about Italian politics and Chinese trade policy have repeatedly served as "tape bombs" driving down multiples and, therefore, stock prices.

At the same time, the US economy continues to grow. S&P 500 Q1 corporate earnings per share were up over 17% year-over-year. This growth stemmed from both federal tax cuts and impressive underlying growth in revenues (8+% YoY, as estimated by Cornerstone Macro). Small cap stocks (as represented by the Russell 2000) have benefitted even more: EPS has increased almost 50% year-over-year.



Source: Strategas

Manufacturing and service sector surveys forecast continued near-term expansion. Rising wage growth, low unemployment and benign inflation readings bode well for the financial health of American consumers. The underlying fundamentals remain strong.

Interest rates have generally moved higher in 2018 across the curve. The recent political upheaval in Italy, however, caused a significant flight-to-quality bid that took yields off their highs (for more background, please see our June 8, 2018 blog post, ***Mamma Mia! Italy's Bad Week = A Lesson for Investors***, on TreasuryPartners.com). The inset table and chart shows these moves.

Treasury Yields Over Time

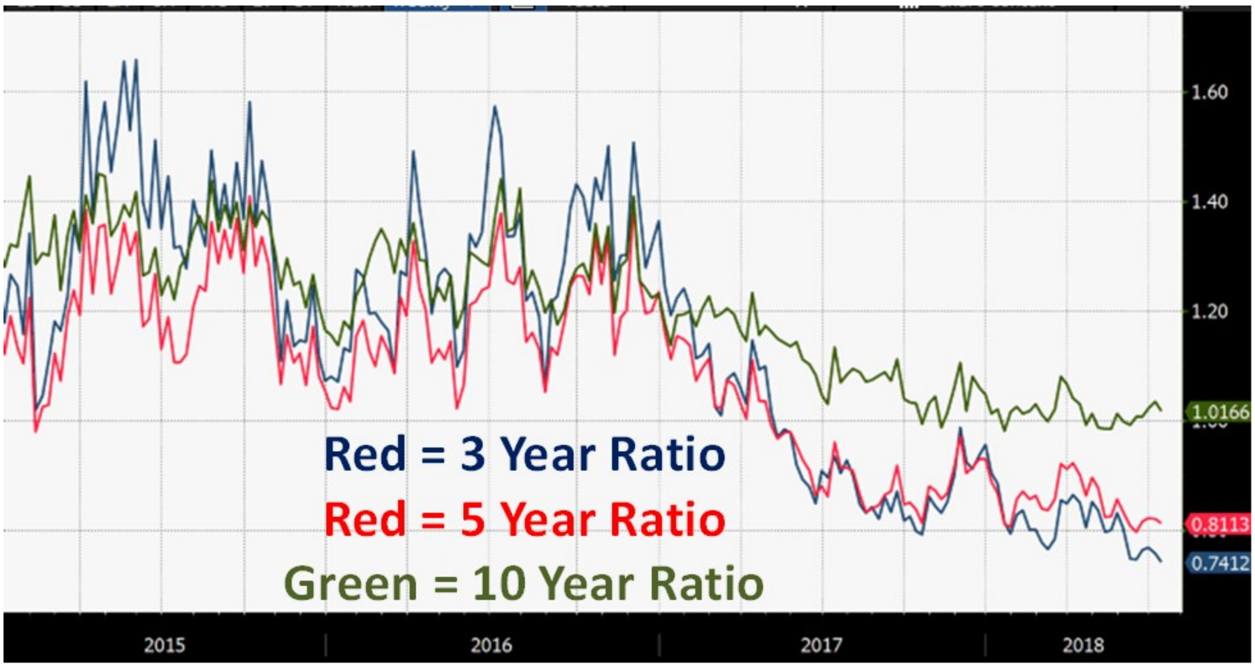
Maturity	Current Treasury Yields	2018 YTD Increase	Increase Since 6/30/2017
1 Year	2.34%	+0.59%	+1.11% (was 1.23%)
2 Year	2.56%	+0.65%	+1.19% (was 1.37%)
3 Year	2.66%	+0.66%	+1.13% (was 1.53%)
5 Year	2.75%	+0.56%	+0.90% (was 1.85%)
10 Year	2.86%	+0.43%	+0.59% (was 2.27%)
30 Year	2.97%	+0.21%	+0.16% (was 2.81%)

Source: Strategas

New Fed Chair Jerome Powell has reiterated the Fed's slow-but-steady pace of rate hikes. They plan 4 in total in 2018 (2 remaining in the second half). The combined hikes since late 2015's "liftoff" are adding up (7 separate 0.25% hikes up to 2.00%), increasing short-term rates and contributing to the yield curve's flattening.

Municipal bonds are trading at overvalued levels compared to taxables, particularly for maturities within 5 years. Muni/Treasury yield ratios, which reflect the relative value of municipals to Treasuries, remain low relative to averages. Tax reform and low supply have caused short term tax-free yields to decline, especially in high tax states.

A-Rated Municipal/Treasury Ratios



Source: Bloomberg (Bloomberg BVAL Municipal Curves)

Outlook

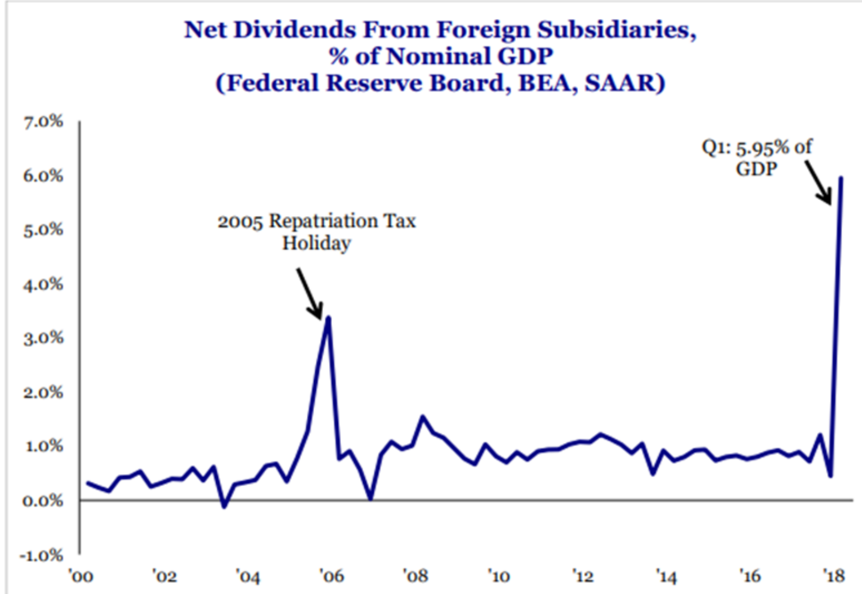
Economy

In our 2018 Outlook (***2017 Review and 2018 Outlook: Looking Forward to Tax Reform's Impacts*, January 18, 2018**), we forecast greater volatility, a sunny economic backdrop, further rate hikes by the Fed, and poor rewards in reaching for yield. Very little of our thinking has changed. Higher equity markets and rates remain our base case.

Admittedly, the global synchronized growth trend has faded. The European and Chinese expansions are slowing, and headline-grabbing currency meltdowns have occurred in Brazil, Argentina and Turkey. However, US economic data continues to suggest strong and resilient growth. This is likely to be a driving force for domestic markets. Three factors are still poised to have outsized impacts:

- **Tax Reform's Unfolding Impact:** 2017's tax reform was an economic game-changer. It has already made a mark powering large increases in corporate earnings and spurring the repatriation of hundreds of billions of overseas corporate profits. The "slow-burn" effects may be even more consequential going forward.

Businesses now have 5-years in which they can expense 100% of capital expenditures against their taxes. While this is a powerful encouragement to invest in their productive capabilities, it's not fast-acting. Companies require several quarters to plan and implement major capex programs. Over time, this should lead to significant new spending on durable goods. With luck, this will foster a "virtuous cycle" as the increased spending boosts corporate revenue growth, which in turn encourages even more reinvestment.

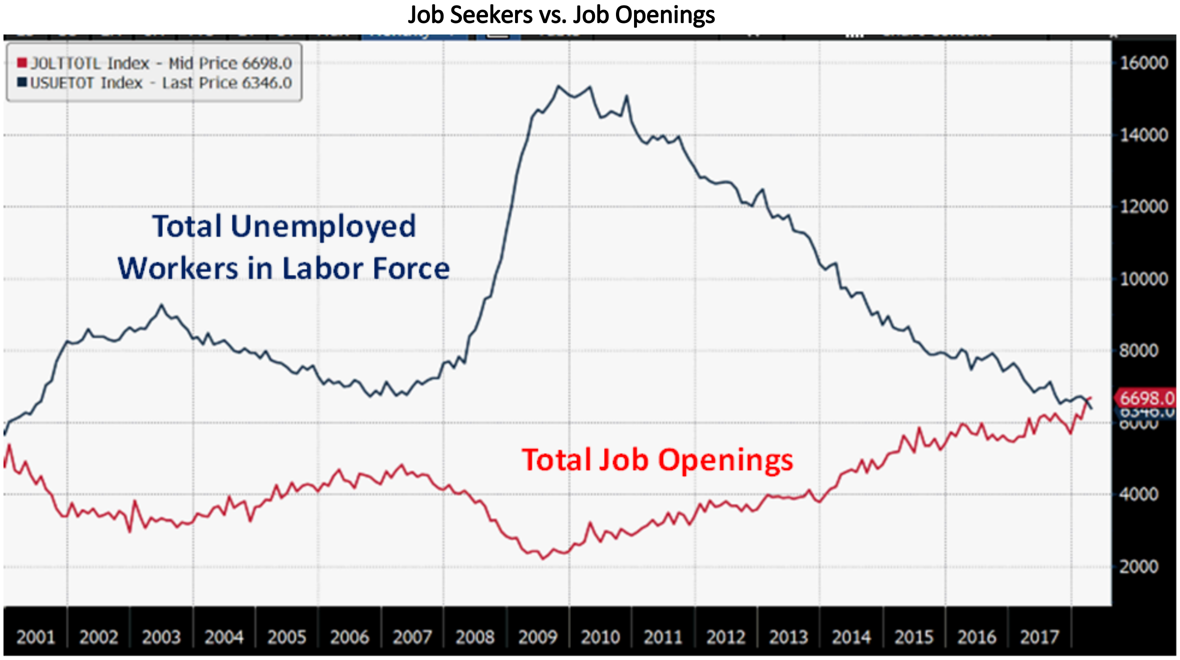


Source: Strategas

In addition, businesses responded to the change in taxation of foreign earnings by repatriating significant cash which is being used for capex, boosting dividends, repaying debt and stock buybacks (which are noticeably surging). Whichever way it goes, a lot of money is being pumped back into the domestic economy. Even more is likely on the way.

- **Employment/Wages/Inflation Feedback Loop:** The US jobs picture keeps improving. At 3.8%, headline unemployment is at a level that has only been achieved one other time since the early 1970s. New jobless claims are at their lowest-ever levels when adjusted for the size of the American population. And, for the first time since 2001, the number of job openings exceeds the number of job seekers.

Job Seekers vs. Job Openings



Source: Bloomberg

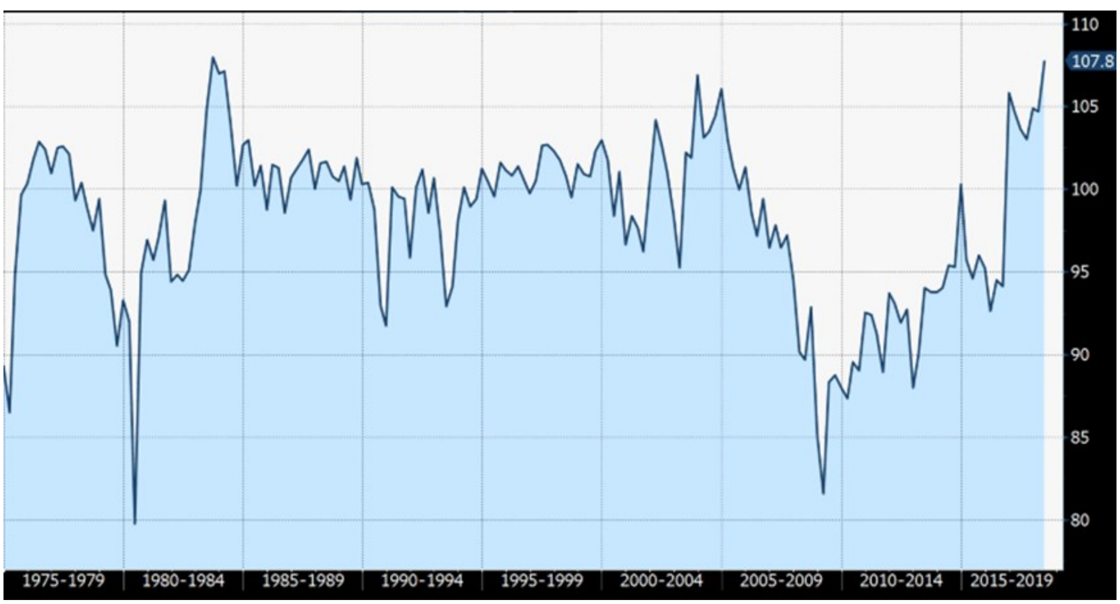
Historically, when employment conditions were this tight, it put upward pressure on wages, which in turn boosted inflation. This higher: employment/wages/inflation "feedback loop" was a consistent feature of past economic cycles.

However, the relationship has not held in this cycle – employment is strong but wage and inflation growth are still modest in comparison. Several theories have been proposed as to why "this time is different": automation, technological disruption, greater employer leverage across industries due to corporate consolidation, etc. We think these factors only serve to delay the inevitable.

Regardless, tepid wage growth has contributed to the flattening of the yield curve, as low inflation expectations have anchored long-term yields while the Fed pushes up short-term yields. We think the traditional relationship will reassert itself and have shortened durations across client portfolios

- **Exceptionally High Business Optimism:** Business executives and owners have good reason to be excited about their firm's prospects. In addition to the strong economic backdrop and the cut in tax rates, industry surveys regularly cite satisfaction with the federal government's efforts to reduce regulatory burdens. The combined effect has resulted in a surge in business confidence: in fact, the National Federation of Independent Business' index of small business optimism is at its highest ever level.

NFIB Small Business Optimism Index
(Higher = Greater Optimism)



Source: Bloomberg

Although this is subjective "soft" data, it's noteworthy when the "animal spirits" of the real economy's decision-makers are this strong. Firms need confidence before committing to major risks such as expansions, employee hiring, and new ventures, which are the lifeblood of economic growth. American businesses aren't lacking in optimism, which bodes well for expectations of future corporate investment.

Trade Wars

One issue that seems more “noise” than “signal” – at least for now - is the rhetoric and speculation about potential “trade wars.”

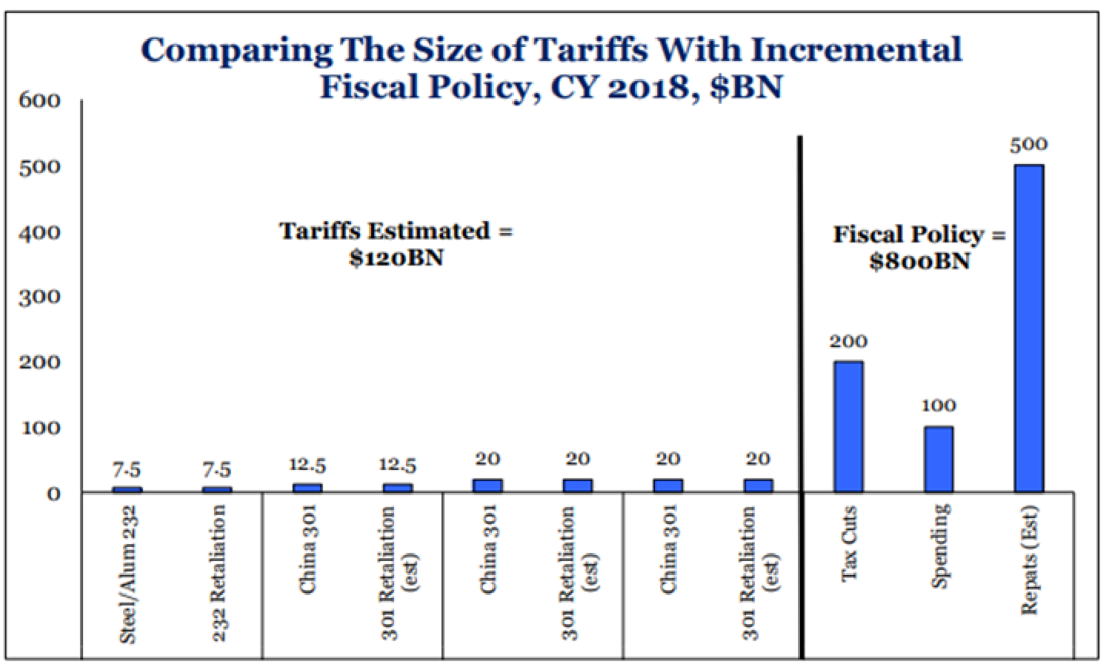
The prospect of multinational trade spats has dominated headlines and impacted sentiment. Thus far, we’ve seen:

- Deteriorating ties within NAFTA, as both Canada and Mexico have responded to initial US tariffs with retaliatory tariffs of their own. Additionally, long running NAFTA renegotiations have not been successfully concluded, and the Trump Administration continues pledging to withdraw from the agreement unless it receives “fair” trade terms.
- The situation with the Eurozone is similar, as the European Union has responded to potential US tariffs on European automobiles with their own threatened tariffs on American cars.
- Finally, the China-US trade relationship is increasingly strained as both sides have imposed tit-for-tat tariffs on over $30 billion worth of goods, and continue threatening to tack on far more.

At this point, though, the magnitude of the actually-enacted tariffs is not enough to derail economic growth. When viewed in the context of the fiscal stimulus of tax reform, there is no comparison - the positive impact of tax reform is an order of magnitude larger than the tariffs.

If the matter escalates further, however, it could begin to negatively affect economic growth and sentiment. After all, the US is an advanced economy with industries that maintain intricate global supply chains. Disruptions to these supply chains through increased tariffs would threaten profitability (over 1/3rd of the earnings of S&P 500 companies are linked to foreign trade and overseas business). This, in turn, could spur the Fed to tighten more slowly, damping the rise in short term rates. We are closely monitoring developments in this area.

FISCAL POLICY FAR EXCEEDS TARIFF ESTIMATES



Source: Strategas

Equities

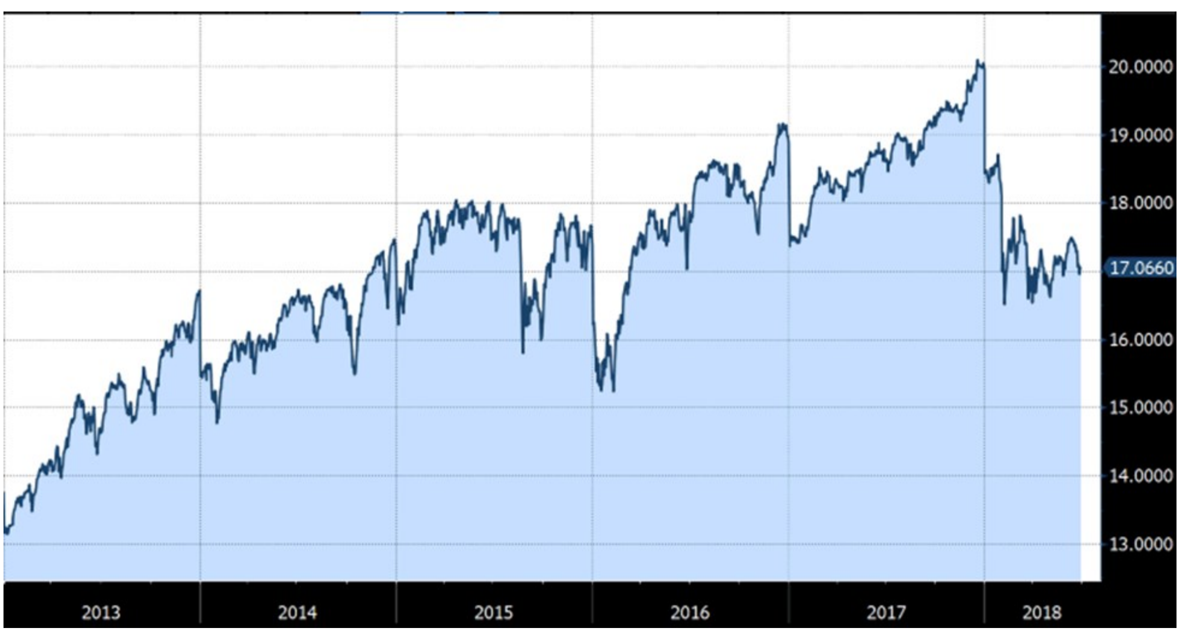
The spike in corporate earnings is impressive and has important implications. Looking at the S&P 500, we experienced 3 years of earnings per share stagnation (2014-2016) before enjoying a satisfying 11% YoY increase in 2017. Now, 2018's YoY growth is set to dwarf 2017, *as the most recent estimates top 20%.*

S&P 500 Adjusted Earnings Per Share

Source: Bloomberg (Bloomberg Estimates Adjusted Annualized EPS)

At 17x, the current P/E ratio is about where it was at the beginning of 2017 - despite higher earnings and stimulus from tax reform. Note that a 17x P/E multiple is not low compared to historical averages. It undoubtedly already reflects the good economic projections we presented above.

S&P 500 Price-Earnings Ratio



Source: Bloomberg (Bloomberg Estimates Adjusted Annualized EPS)

In terms of positioning, we're overweight small and mid-cap ("SMID") stocks. Large-caps are more likely to be multi-nationals, and as such are more exposed to the strong US Dollar and deteriorating growth trends overseas. In addition, the larger the proportion of foreign sales, the more exposed a company is to retaliatory tariffs.

SMIDs, in contrast, tend to be more US-centric and benefit from both strong American growth and lower corporate taxes. Moreover, their domestic focus in sales and operations provides greater insulation from trade war shocks. Small-caps in particular (as represented by the S&P 600 index) have already outpaced the large-cap S&P 500, posting a robust 8.7% YTD price return. We expect this trend to continue.

S&P 500 (Large Cap) vs. S&P 600 (Small Cap) YTD Price Performance

Source: Bloomberg

Fixed Income

We're maintaining below average maturities in client portfolios.

Over the past year, we saw a significant rise in rates. Although absolute levels can't be described as "exciting", yields are more palatable than they've been in some time. Indeed, the 1 year Treasury yield now exceeds the S&P 500's dividend yield for the first time since the Great Financial Crisis.

1 Year Treasury Yield – S&P 500 Trailing 12 Month Dividend Yield

Source: Bloomberg

However, there are factors which suggest now isn't the time to reach for yield:

- **More Fed Hikes Inbound:** The Fed continues to normalize monetary policy, with additional increases anticipated in 2018 and beyond. Breakeven calculations show the market continues to underprice the Fed's rate forecasts (particularly for 2-3 year maturities).

  In addition, the Fed is further tightening monetary policy by allowing its post-crisis balance sheet to roll off. This increases the supply of available bonds, shifting market leverage to buyers who are likely to demand higher yields as a result.

- **Curve is Increasingly Flat:** Short-term rates are rising faster than long-term rates. The relative incentive for staying short is therefore compelling. Investors don't miss out by choosing the shorter maturity, and simultaneously benefit from less price risk if rates move higher (recall that bond yields and prices have an inverse relationship).

Yield Differential Between 2 Year and 10 Year Treasuries

Source: Bloomberg

Technical factors will likely further bias rates upward:

- To finance expanding federal deficits, Washington expects to issue a whopping $1.8 trillion in net new Treasuries through 2019 ($650 billion more in 2018, $1.2 trillion in 2019).

- At the same time, the European Central Bank projects ending its own Quantitative Easing program in December 2018, tightening monetary policy in a major overseas market.

Taking this into account, we're maintaining our current short-maturity focus for new purchases in client bond portfolios. Our expectation is that the market is not respecting the potential for inflation to return and cause rates to move higher.

Risks to Our Outlook

The major risks to our outlook remain the same as in January:

- A spike in inflation causes the Fed to hike rates faster. Given that the curve is already relatively flat, this could cause it to "invert" – an unusual situation in which short-term rates are higher than long-term rates.
- As mentioned earlier, if the talk of "trade wars" begins to morph into reality, it will likely pressure economic growth and may accelerate inflation.
- As the Fed and European Central Bank draw down their post-crisis stockpiles of bonds, some emerging markets may run into trouble. We have seen examples of this in movements in the Brazilian and Turkish currencies, for instance.
- Geopolitical shocks, whether in Italy, Iran or elsewhere.

As always, we remain alert, and are prepared to change strategies and positioning as new information is received.

Our best wishes to all our clients and friends for a relaxing and refreshing summer.