# CenterState Wealth Management

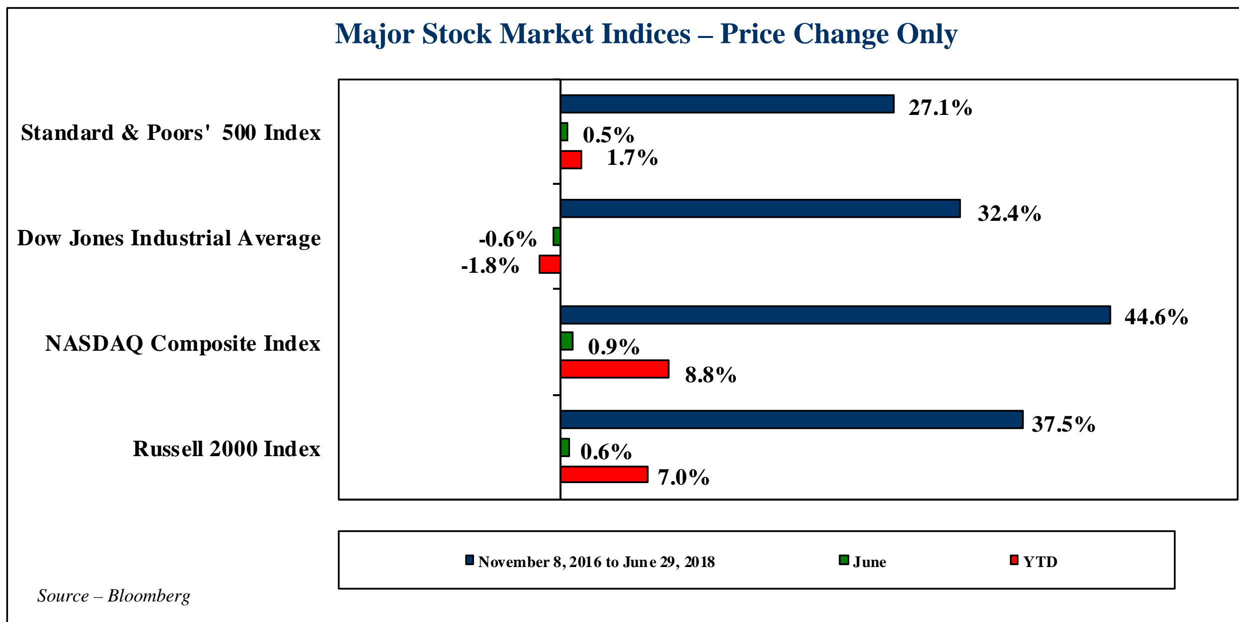
## INVESTMENT STRATEGY STATEMENT

**July 2, 2018**

## I. Equity Markets

### A. Escalation of Trade Tensions Takes a Toll on Common Stocks.

- Hardly a day went by last month without a significant and meaningful headline coming our way. With Donald Trump unable to win trade concessions from his Canadian, Mexican, and European Union counterparts ahead of an early June deadline, the President announced his decision to impose tariffs on steel and aluminum imports from the closest U.S. neighbors and allies. This action was followed by President Trump reviving a plan it had previously suspended to place tariffs of 25% on $50 billion of industrial imports from China. While China responded by calling for tariffs on U.S. products from Farm Belt states, it also offered to purchase nearly $70 billion of U.S. farm, manufacturing, and energy products from the U.S. if the Trump Administration abandoned the threatened tariffs.




- The trade spat with our Western Allies spilled over to the Group of Seven summit in Canada with President Trump withdrawing his support for a joint statement stressing the importance of a rules-based international trading system. Mr. Trump refused to sign the statement after he left the summit, citing comments made by Canada's Prime Minister Justin Trudeau at a post-summit press conference. At that event, Mr. Trudeau said Canada found it "insulting" that Mr. Trump justified the new tariffs on Canadian metals on national security grounds. The President and several of his senior advisors responded with highly personal attacks on Mr. Trudeau.

- During the summit, President Trump said major U.S trading partners had treated the U.S. "like the piggy bank that everyone is robbing." Adding to the tension was Mr. Trump's call for Russia to rejoin the G-7 meeting, a suggestion most of the U.S.'s traditional allies rejected. President Trump departed the G-7 meeting for a summit in Singapore with Kim Jong Un -- the first face-to-face meeting between a sitting U.S. president and a North Korean leader -- aimed at ultimately reaching a denuclearization agreement on the Korean Peninsula.

- Mid-month the Federal Reserve raised interest rates for the second time this year, but more importantly, suggested that rates could be increased four times this year rather than three. The following day, the European Central Bank laid out plans to wind down its massive bond buying program by the end of the year. ECB President Mario Draghi justified the decision to end the bond buying program by stating that "progress toward a sustained adjustment in inflation has been substantial so far."

- As June came to a close, China's State Council responded to President Trump's intention to place tariffs on $50 billion of China imports by announcing it would levy penalties of the same rate on U.S. exports to China of the same value. Not to be outdone, Mr. Trump asked the U.S. trade representative to target $200 billion worth of Chinese products for a fresh round of tariffs and raised the possibility of slapping a 20% charge on European cars if the European Union did not remove duties on U.S.-built cars.

- Escalating trade tensions are rattling global stock markets as the back and forth trade retaliation announcements raise investors' concerns about everything from the future of U.S.-China relations to the fate of the North American Free Trade Agreement and the future of U.S. relations with our closest allies.

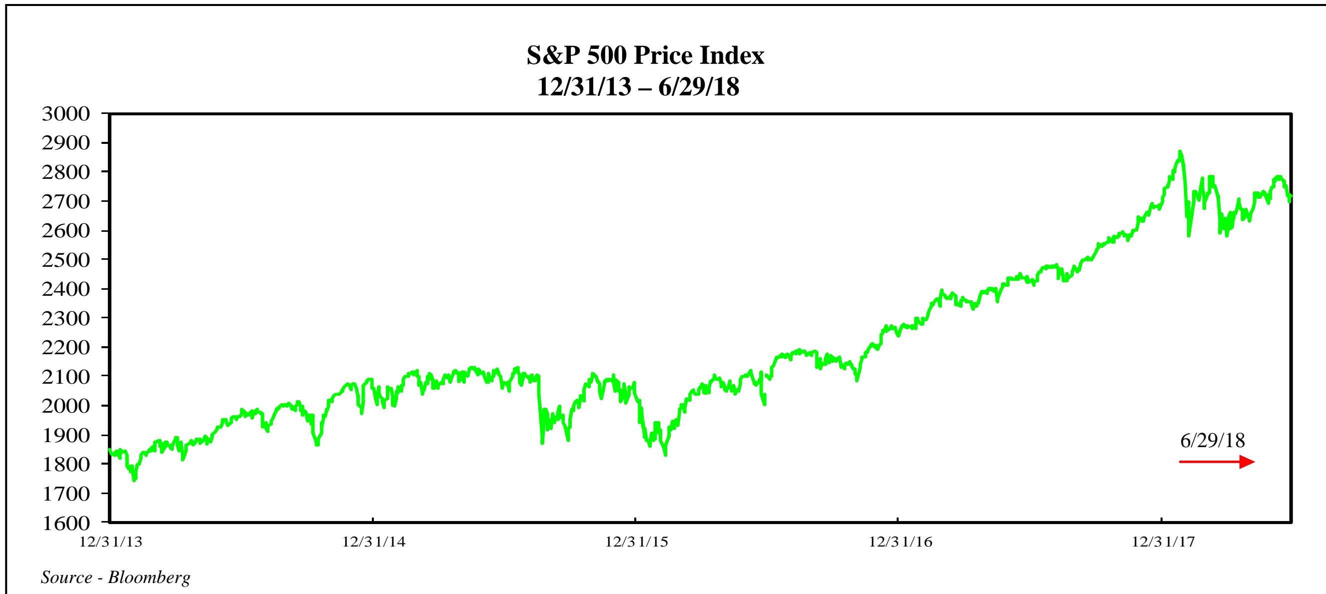
- Despite a strong start to June, stocks weakened into month end against the mounting trade tensions. For the full month of June the DJIA declined -0.6%, while the other major stock market measures were barely positive at 0.5% to 0.9%. For the first six months of the year, the S&P 500 and the DJIA are higher by 1.7% and lower by -1.8%, respectively, while the NASDAQ Composite and the Russell 2000 are higher by 8.8% and 7.0%, respectively.

## B. Rising Trade Tensions vs. Strong Fundamentals.

- The heated trade rhetoric between the U.S. and our major trading partners, particularly China, escalated to the point that it drowned out almost all other economic issues as June drew to a close. The Trump administration is intent on seeking reciprocal or equal access trade agreements which eliminate the inherent disadvantage the U.S. encounters in most trade arrangements currently in place. As the U.S. begins the process of renegotiating trade agreements across the whole spectrum of product categories and trading partners, Mr. Trump believes it is necessary to stake out positions from which the Administration can begin the negotiations.

- This process can be unsettling to investors as the U.S. threatens to place tariffs on imported goods if our trading partners do not lower their tariffs on U.S. exports. The concern is that the current parrying, particularly between the U.S. and China, leads to perpetual rounds of threats and retaliation that hurt consumer and business confidence, causes supply chain disruptions, and produces a cost shock which could lead the Federal Reserve to tighten monetary policy to lean against any inflationary pressures which could arise.

- When we initially reviewed President Trump's first foray into resetting the trade agreements the U.S. has with our major trading partners in the April *ISS*, we laid out three overriding principles which needed to be kept in mind when thinking about how these trade negotiations could play out. First, no country has ever won a trade war, it is the rare confrontation where a victor has never been declared. Secondly, the U.S. market is the prize which all foreign countries wish to sell into. These realities should force negotiations to an outcome which leads to trade that is more even handed and continues to grow.



*Source - Bloomberg*

- Lastly, at some point China cannot match the U.S. with retaliatory responses because the U.S. imported more than four times the amount of goods and services from China than China imported from the U.S. last year. To the extent that tariffs do get implemented on U.S. imports from China, currently the total proposed tariffs are only a small portion -- at most 0.1% -- of total nominal GDP. That figure could rise, however, if the scope of the tariffs increases.

- We encourage our readers not to overreact to the back and forth trade retaliation announcements between the U.S. and China. It is all part of a negotiating process. The U.S. and China will likely avoid a serious trade conflict because both countries will eventually do what is in their best economic interest.

- It is difficult to argue that fair and reciprocal trade across the globe is not in every countries' best interests. The Administration is likely asking itself, what better time to take on the unfavorable trade agreements with our global trading partners than when the domestic economy is benefitting from tax cuts, the repatriation of earnings from overseas, and the $300 billion federal spending plan passed in February. Do not be surprised if the world economy is benefitting from lower trade barriers across the board in the years to come.

- While we acknowledge that the markets are being forced to digest a marked rise in trade tensions as the Trump administration attempts to reset the inherent disadvantage the U.S encounters in most trade agreements currently in place, the bottom line is that earnings have been, and should continue to be, unambiguously positive for stock prices since the earnings recovery began in 3Q 2016.

- Operating earnings have now advanced for seven consecutive quarters and the analysts at Standard & Poor's have revised sharply higher their earnings estimates for 2018 in light of the economy's forward momentum and the reduction in the corporate tax rate. Current estimates are that operating earnings will grow more than 26% over the four quarters of 2018.

- With the 17.2% growth in operating earnings over the four quarters of 2017, the 26.6% year-over-year gain in operating earnings in 1Q 2018, and the modest rise in stock prices so far in 2018, the trailing four quarter price-to-operating earnings ratio on the S&P 500 has fallen from 22.6x at year end to 20.6x at the end of June, slightly below the 21.1x on the day of the presidential election.

- As always, there is no shortage of things for investors to worry about. Investors are watching to see the extent to which inflationary pressures build, assessing the risk of the Federal Reserve making a policy mistake, monitoring the nation's political mood ahead of the mid-term elections, and looking for the extent to which rising trade tensions create a negative feedback loop on the pace of economic growth, particularly on business capital spending initiatives following the immediate expensing provision contained in the tax bill.

- The economy's forward momentum remains solid and the outlook for earnings is very strong, both benefitting from the fiscal stimulus put in place earlier this year. We continue to suggest that the best way to navigate the choppy waters of rising trade tensions is to invest in high quality, dividend paying U.S. companies. By keeping the proper long term perspective and upgrading the quality of your portfolio, investors will be better able to navigate the unchartered waters we have entered.

## C. Federal Reserve Raises Rates for Seventh Time.

- After the Federal Reserve raised the range for the federal funds rate by 25 basis points to 1.75% to 2% at the June 12-13 FOMC meeting, Chairman Jerome Powell said "The decision you see today is another sign that the U.S. economy is in great shape." Mr. Powell went on to state, "Growth is strong. Labor markets are strong. Inflation is close to target." In our view, an assessment of the economy by the Chairman of the central bank does not get much better than that.

- The rate hike last month was the seventh increase since the Federal Reserve began raising interest rates in December 2015 and it followed a rate hike in March. In its policy statement, the Committee noted that inflation has "moved close to 2 percent," the central bank's target. The gradual rise in inflation is coinciding with a moderate acceleration in the economy's growth rate, largely as a result of the fiscal stimulus Congress injected into the economy with the tax cut in December and the $300 billion two year spending bill passed in February.

- In an acknowledgement of the economy's forward momentum and the rise in inflation toward the central bank's 2% target, the Federal Reserve removed language from the policy statement indicating that "the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run." Looking forward, the FOMC Committee stated that it expected further gradual increases in the target range for the federal funds rate.

- The quarterly update to the Committee's economic projections was largely unchanged, but did point to a slight increase in the economy's expected growth rate for 2018 to 2.8% from 2.7%, but not for 2019 (2.4%) and 2020 (2.0%). The forecast for the unemployment rate was revised down to 3.6% for this year compared to the previous forecast of 3.8%. The Federal Reserve maintained its forecast of the range for the federal funds rate peaking at 3.25% to 3.5% in 2020, but did adjust its forecast for 2018 to four rate hikes rather than three. The media focused on this change in the rate forecast and concluded that the central bank had taken on a more "hawkish" outlook for the path of monetary policy.

## D. A More "Hawkish" Federal Reserve?

- We tend to disagree with this assessment of a more "hawkish" Federal Reserve following the June 12-13 FOMC meeting, for the following reasons. First, the median forecast of four rate hikes this year rather than three resulted from 8 of the 15 Federal Reserve officials now looking for at least four rate increases this year, up from 7 at the March FOMC meeting. We are hard pressed to view that outcome as all that incrementally "hawkish" when you consider it was just one official changing their interest rate forecast.

- Secondly, the Federal Reserve's interest rate forecast to the end of 2020 did not rise by one additional rate hike. Instead, one rate hike was pulled forward from 2020 into 2018. Given the "front-end loaded" nature of the large fiscal stimulus that Congress passed into law earlier this year and during the last week of 2017, it does not surprise us that the Federal Reserve would look to lean against the fiscal stimulus sooner rather than later to guard against inflationary pressures building.

## E. Getting Close to Neutral Policy Stance.

- The minutes of the May FOMC meeting and Chairman Powell's comments in the press conference following the June FOMC meeting make it perfectly clear the Federal Reserve is actively discussing how much further the Federal Reserve will need to raise interest rates over the next two years. With inflation low and appearing to be under control, the central bank does not want to run the risk of unnecessarily bringing about the next recession because it raised interest rates clearly to the side of restraint without inflation pressures building in a material manner beyond the Federal Reserve's 2% target.

- Likewise, the central bank does not want to leave monetary policy too accommodative for too long a period of time such that a substantive inflationary cycle builds which requires the Federal Reserve to aggressively raise interest rates and send the economy into a severe recession. As a guide for future rate increases, the discussion at the FOMC Committee is focused on two key questions. First, the Federal Reserve needs to approximate the level of the real, or inflation-adjusted, neutral rate at which monetary policy is neither stimulating nor restraining the economy's growth rate.

- Following that, the committee members need to determine how high to push interest rates above the real neutral rate to slow the economy and prevent an unwanted build in inflationary pressures. We have discussed the notion of the real neutral rate since last summer when both Chair Janet Yellen and Govenor Lael Brainard asserted that the real neutral rate was close to zero. With the most recent reading on the core personal consumption deflator at 2% year-on-year for May and the current 1.75%-2.0% target range for the federal funds rate, the real federal funds rate, using the midpoint of 1.88%, is slightly negative at -0.12%.

- The real neutral rate cannot be observed directly in real time. It can only be inferred after the fact in terms of how the economy subsequently performed in response to the level of interest rates the Federal Reserve put in place. Then there is the issue of how much above neutral the Federal Reserve needs to raise the federal funds rate to keep the economy from overheating.

- As we have described in previous *ISS's,* trying to ascertain the current level of the real neutral rate can be fairly arcane, somewhat arbitrary, and a bit of a moving target. That is why we have focused our readers on the yield spread between two-year and ten-year Treasury notes since the summer of 2015 to monitor the Treasury market's assessment of how tight or easy monetary policy currently is.

- As a reminder, we have monitored the yield spread between the two-year and ten-year Treasury notes as an indicator of whether investors viewed the pace of rate hikes by the Federal Reserve as too slow or deliberate -- which could lead to a build in inflationary pressures and cause a widening of the yield spread -- or too aggressive -- which could lead to a slowdown in the economy and cause a narrowing of the yield spread.

- The yield spread dropped to 53 basis points at the end of 2017 after the Federal Reserve hiked rates three times last year from 122 basis points and 125 basis points at the end of 2015 and 2016, respectively. Following the rate hike in March, the yield spread fell to 46 basis points. Now with the Federal Reserve raising rates last month for the seventh time in the current rate hiking cycle, the yield spread has narrowed further to only 33 basis points. We continue to believe the Treasury market is growing increasingly fearful that the Federal Reserve could commit a policy mistake.

**Treasury Market Talks To Federal Reserve**

| | Ten-Year Treasury Yield | (minus) | Two-Year Treasury Yield | (equals) | Yield Spread |
|---|---|---|---|---|---|
| 12/31/15 | 2.27% | | 1.05% | | 122bp |
| 12/30/16 | 2.44% | | 1.19% | | 125bp |
| 12/29/17 | 2.41% | | 1.88% | | 53bp |
| 3/30/18 | 2.95% | | 2.49% | | 46bp |
| 6/29/18 | 2.86% | | 2.53% | | 33bp |

*Source - Bloomberg*

- In the context of a real neutral rate, we take the narrowing of the yield spread as a signal that the Federal Reserve is approaching that level of the federal funds rate where monetary policy could flip from being neutral to the side of restraining the economy's forward momentum. We, and the market it appears, feel the real neutral rate is still fairly close to zero, and further rate hikes will push monetary policy clearly to the side of being restrictive.

- It is important to note that the narrowing of the yield spread is not occurring solely from the Federal Reserve raising rates and in the process pushing the yield on the two-year Treasury note higher. It is also happening because the yield on the ten-year Treasury has declined from its recent peak of 3.11% back on May 17. We believe that the yield on the ten-year Treasury note settling in at a level just below 3% is recent weeks is an acknowledgement by investors that the rise in interest rates is beginning to take a toll on households as borrowing costs rise on auto loans, credit cards, home equity lines of credit, and home mortgages.

- The question is whether the new leadership at the Federal Reserve can balance its intention to raise interest rates so that the central bank has the ability to lower interest rates during the next recession with the risk of unnecessarily bringing about the next recession because it raised the real neutral rate clearly to the side of restraint without inflation pressures building in a material manner beyond the Federal Reserve's 2% target.

- As we have stated many times since the Federal Reserve started raising interest rates in December 2015, rate hike decisions over the next couple years will be a dynamic process requiring a great deal of judgement by the Federal Reserve as to what level of short-term interest rates the economic expansion can tolerate and whether policy needs to shift from becoming less accommodative and/or a neutral position to an outright tightening posture. The economy's inflation rate will determine how high the federal funds rate can rise without stalling the economy

- We will watch the two-year to ten-year Treasury yield spread for the market's assessment of whether monetary policy has moved into the restrictive zone. We doubt the Federal Reserve will deliberately raise interest rates in such a manner that it pushes the yield on the two-year Treasury note above the yield on the ten-year Treasury note if inflationary pressures remain low. This is the primary reason we believe the proposed policy moves of two more rate hikes this year and four more in 2019-20 by the Federal Reserve are too aggressive.

- The pace of rate hikes for the rest of the year could end up reflecting a tug of war between a sturdy economy and the looming risks to future growth, including those from rising trade tensions between the U.S. and such key trading partners as China, the European Union, Canada, and Mexico. All of those countries have vowed to retaliate against any U.S. tariffs with their own penalties against U.S. goods, with some incremental tariffs from Canada going into effect yesterday.

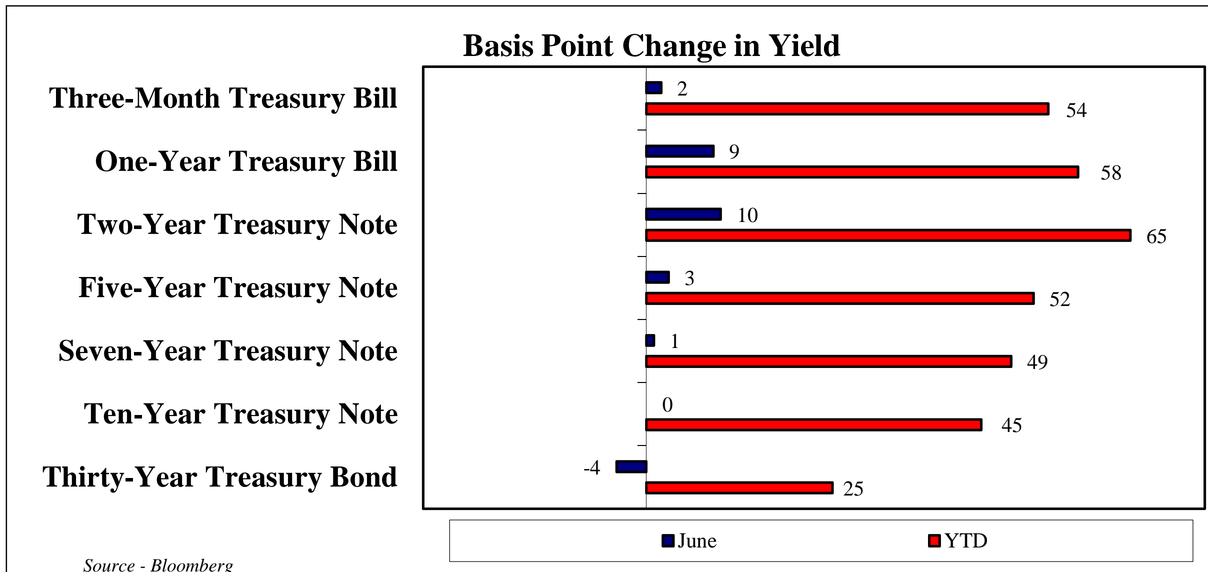
- Our view remains that the Federal Reserve raises interest rates one, maybe two additional times this year to push against the fiscal stimulus, and then becomes data dependent in 2019 with respect to any further rate increases. The most important data to follow will be the wage and inflation data. It would not surprise us if the dialogue shifts over the next 6 to 12 months from "Is the Federal Reserve behind the curve?" to "Is the Federal Reserve moving too far?" As always, stay tuned!

## II. Treasury Market

### A. Treasury Yield Curve Continues to Flatten.

- Despite all of the significant events which took place during June, which we reviewed earlier in this *ISS*, the action in the Treasury market was fairly quiet last month. Concerns about the political climate in Italy, which drove a fairly strong flight-to-safety into Treasury securities during May, eased as a new populist government was formed, ending months of political turmoil. The key for the Treasury market was the new governing coalition in Italy providing assurances that leaving the euro was not under consideration.

- The only noteworthy development in the Treasury market during June was a further, modest flattening of the yield curve. Driven by the Federal Reserve raising the target for the federal funds rate by 25 basis points to 1.75% to 2.0% on June 13, yields on one-year and two-year Treasury notes rose by 9 and 10 basis points, respectively.




- With rising trade tensions last month, the longer end of the yield curve was little changed. As common stock prices rose to a mid-month peak on June 12, the yield on the ten-year Treasury note rose modestly to 2.98% compared to 2.86% at the end of May. As trade tensions escalated over the past couple weeks, yields on longer dated Treasury securities moderated, with the ten-year Treasury yield ending June back at 2.86%, unchanged on the month.

- As we have mentioned in previous *ISS's*, as the yield on the ten-year Treasury note rose from the recent low recorded last year on September 5, both the real, or TIP, yield and the implied inflation expectation embodied in the nominal ten-year Treasury have risen, as shown in the table below. However, since the recent high ten-year Treasury note yield on May 17, the 25 basis point decline in the ten-year Treasury yield has been driven by a 20 basis point drop in the TIP yield -- reflective of a softening in the market's outlook for economic growth -- along with a modest 5 basis point decline in market's inflation outlook.

**Market Inflation Expectations**

| Date | Nominal Ten-Year Treasury Yield | (minus) | Inflation-Index Ten-Year Treasury Yield (TIP) | (equals) | Implied Inflation Expectation |
|---|---|---|---|---|---|
| 12/31/2015 | 2.27% | | 0.71% | | 1.56% |
| 11/8/2016 | 1.86% | | 0.12% | | 1.74% |
| 12/30/2016 | 2.44% | | 0.48% | | 1.96% |
| 9/5/2017 | 2.06% | | 0.28% | | 1.78% |
| 12/29/2017 | 2.41% | | 0.43% | | 1.98% |
| 5/17/2018 | 3.11% | | 0.94% | | 2.17% |
| 6/29/2018 | 2.86% | | 0.74% | | 2.12% |

*Source - Bloomberg*

- The fundamental factors which have pushed yields on longer dated Treasury securities higher on the year -- a moderate acceleration in the economy's growth rate, a firming in the nation's core inflation rate to the Federal Reserve's 2% target in May, larger federal budget deficits, and the Federal Reserve shrinking its holding of government bonds -- will continue to place a floor on ten-year Treasury yields.

- Keeping a lid on ten-year Treasury yields is the Federal Reserve's effort to raise short-term interest rates which is increasing borrowing costs and the Trump administration's aim to seek reciprocal or equal access trade agreements with our major trading partners -- of which rising trade tensions is a natural result of the process. In fact, if our assessment that the Federal Reserve is fairly close to pushing monetary policy to the side of becoming restrictive, the peak in ten-year Treasury note yields may not be much higher than the 3.11% recorded on May 17. We have slightly lowered the lower bound of the expected trading range for the ten-year Treasury note to 2.8%, while maintaining the upper bound of 3.1%.

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