Title: Advocacy Investing® Portfolio Strategies, Issue 104
By: Karim Pakravan, Ph.D.
Copyright: Marc J. Lane Investment Management, Inc.
Date: June 15, 2018

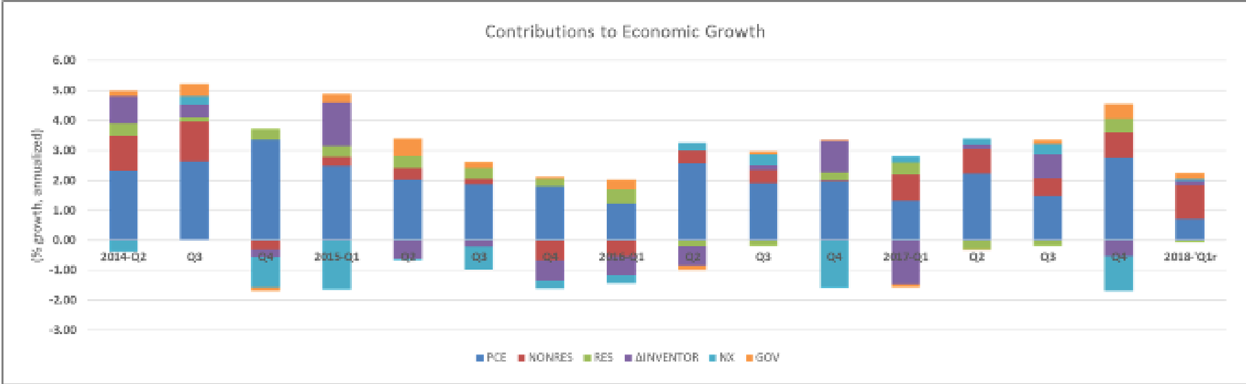
Advocacy Investing®

ANIMAL SPIRITS

- **The economy is expected to accelerate after a slow start to the year**
- **Oil prices soften after surge in response to OPEC/Russia output pledges**
- **Strong payrolls number: 223,000 jobs created in May**
- **Inflation remains below the Fed target**
- **The Fed is expected to increase interest rates at the June FOMC meeting**
- **Global growth loses some of its shine, but remains on track**
- **Italy's political crisis shook markets already on edge**
- **Financial markets whiplash as markets react to lengthening catalog of risk**

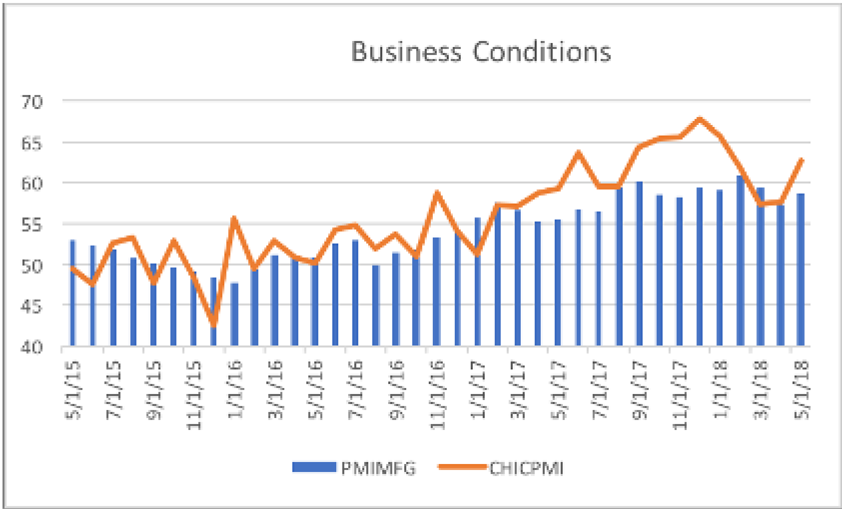
Economic growth in first quarter 2018 (1Q18) was revised modestly downward (from 2.3% to 2.2%, annualized), down from 2.9% in 4Q17. Final Sales to Domestic Purchasers (which excludes exports and inventory changes) rose by only 1.9%, down from 4.5% the previous quarter. Most sectors (Private Consumption Expenditures, PCE, Non-Residential Investment, Net Exports, Inventory Investment, Net Exports and Government) were up, with only Residential Investment in the negative column. Most of the deceleration in growth was due to a sharp slowdown in PCE, with Non-Residential Investment actually accelerating.

Figure 1: Contributions to Growth



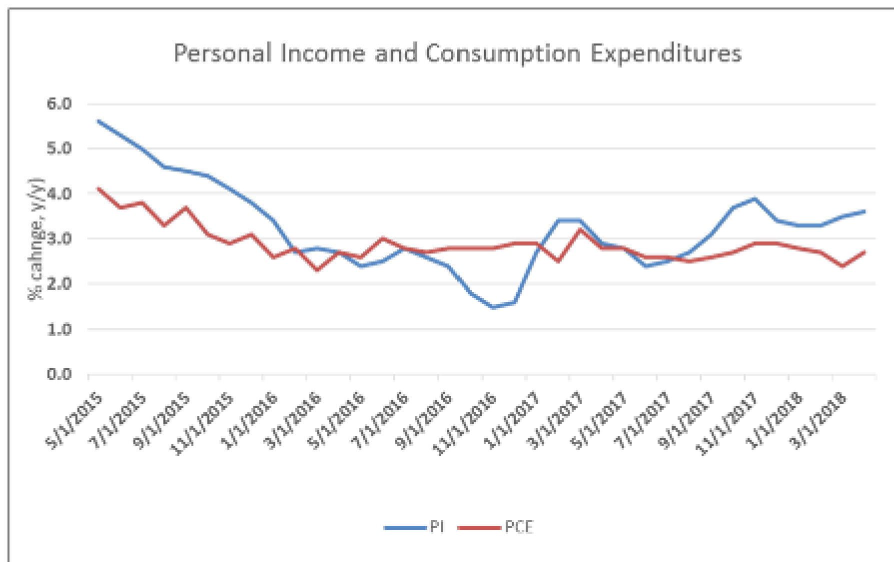
The goods sector showed some strength in April. Industrial Production and Manufacturing were up by respectively 0.7% and 0.5% month-on-month (m/m) in April. Durable Goods fell by 1.7% m/m in April—but Durable Goods ex-transportation and Core Capital Goods increased by respectively 0.9% and 1.0%. Factory Orders fell by 0.3% m/m in April. Early-month surveys were also positive: The Empire State Index of manufacturing activity rose to 20.1 in May from 15.8 the previous month, and the Philadelphia measure increased from 23.1 to 34.4 over the same period. Late month surveys were equally strong: the broad-based Chicago PMI rose to 62.7 at the end of May from 57.6 a month earlier, the ISM-Manufacturing rose from 57.3 to 58.7 over the same period, and the Markit PMI Manufacturing was flat at 56.4.

Figure 2: Business Conditions



The University of Michigan-Reuters Consumer Confidence Index fell slightly to 98.0 at the end of May from 98.8 the previous month, but the Conference Board measure strengthened slightly from 125.6 to 128 over the same period. Retail sales increased by 0.3% m/m in April—and were up by 0.3% excluding food and gasoline. Personal Income and Personal Consumption Expenditures increased by respectively 0.3% and 0.6% m/m in April.

Figure 3: Households Perk Up



The services sector remained buoyant: the ISM-NonManufacturing rose to 58.6 at the end of May from 56.8 the previous month, and the Markit ISM-Services increased from 54.6 to 56.8 over the same period.

The trade deficit narrowed in April to $46.2 billion from $49.0 billion the previous month. Both exports and imports fell by 0.5% m/m. The dollar gained 2% in May, up 5.9% from its 2018 low on January 31st.

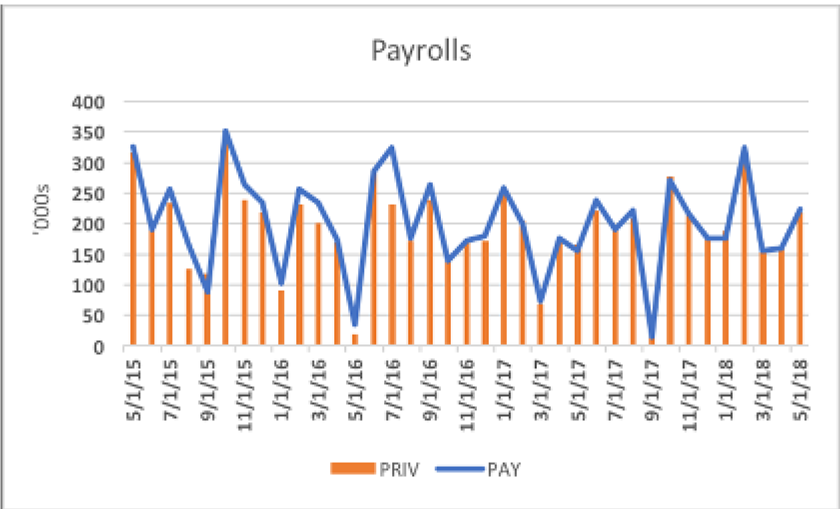
The housing market softened somewhat, with Housing Starts, New and Existing Home Sales all slightly down in April. Housing prices continue to rise, with the Case-Shiller 20-City Index up by 0.5% m/m (6.8% year-on-year, y/y) in March.

Seesawing Oil Prices: Oil prices initially surged in May in response to continued rise in demand, OPEC/Russia tight discipline and the rise in geopolitical risks (Iran and Venezuela). Brent oil

briefly hit $80/barrel (bbl), and West Texas Intermediate (WTI) peaked at $72.24 on 5/21, a 42-month high. However, under pressure from the United States and other major consuming countries, OPEC and Russia announced that they could ramp up production—a range of 300-800 thousand barrels per day (tbd) by year-end—is under discussion. Oil prices immediately reacted, with WTI dropping by 10% from its May peak to a low under $65/bbl by early June. Since 2016, OPEC has cut production by 1.8 million barrels per day (mbd). However, almost half of the cut has come from the sharp decline in Venezuelan production (minus 713 tbd, partly compensated by a 308 tbd increase in Iranian production. Over the same period, North American oil crude oil production rose by 1.9 mbd—1.3 mbd from U.S. shale oil, and 600 tbd from Canadian conventional crude.

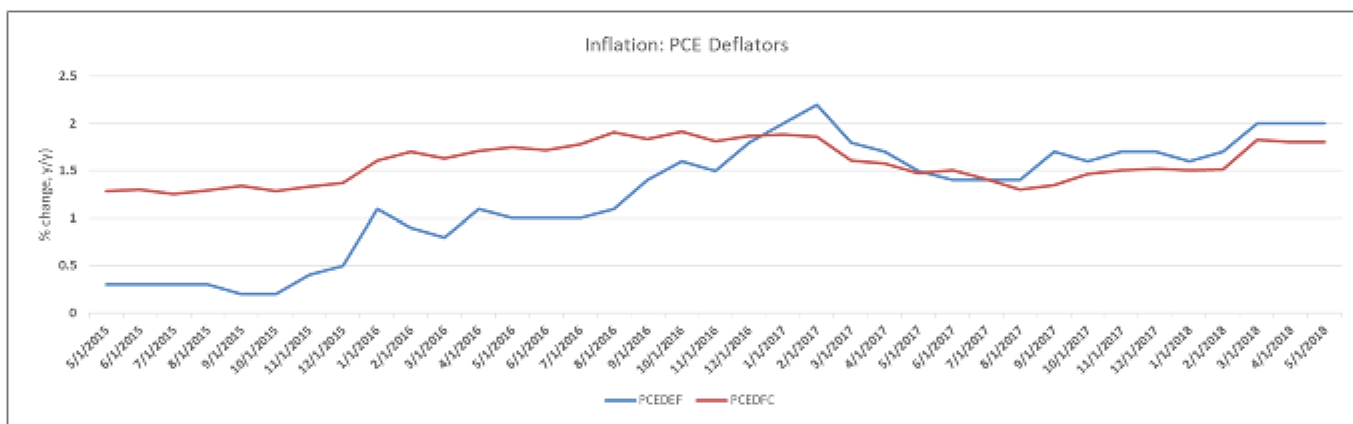
Oil markets are on the cusp of a possible bear market. OPEC and Russia are meeting on June 22nd, at which time we will get a clearer picture of the producer countries intentions. Furthermore, the commitment by OPEC/Russia to provide additional supplies comes at a time when U.S. non-conventional crude production is at record levels. Recently, U.S. shale oil production increases have been constrained by transportation bottlenecks. However, these should be resolved soon. Additionally, there are considerable uncertainties regarding the oil markets supply/demand balance in the next few months, including the size/timing of any OPEC/Russia production increase; the surge in U.S. shale production; Venezuela output decline; and the impact of sanctions on Iranian production. All in all, we expect more volatility in oil markets, with oil prices in the mid-60s in the short-term.

Figure 4: Payrolls Rebound



Strong Payrolls: The May payrolls number came at an above-expectation 223,000 new jobs (218,000 for the private sector). The previous two months were revised upward by an aggregate of 15,000, bringing the three-month average to 179,000—down from the 208,000 average since the beginning of the year. The improvements were broad-based: the goods-producing sector added 47,000 positions (mining, +4,000; manufacturing, +18,000 construction, +25,000), the private services sector added 171,000 and government, 5,000. The Labor Market Diffusion Index, which measures the breadth of the job market changes, rose to 67.6 from 64.0 the previous month. Average weekly hours were unchanged at 34.5, and average weekly earnings increased by 0.3% m/m—2.7% y/y—which translated into a 5% increase in the labor income proxy. The separate Households' Survey showed a further decline in the unemployment rate (U3) in May, from 3.9% to 3.8%, and a fall in the unemployment and underemployment rate (U6), from 7.8% to 7.6%. However, while the demand side for labor remained strong, the supply side continued to show weakness, with the Labor Participation rate falling to 62.7% at the end of May from 62.8% the previous month. High-frequency data also showed a tight labor market, with Initial Weekly Jobless Claims at 221,000 in the last week of the month.

Figure 5: <u>Inflation Below Target</u>



Inflation Slips Again: The latest inflation readings show Headline Inflation up to 2.5% y/y in April (Core inflation registered 2.1% y/y). The PCE Deflator was flat at 2% y/y, while the Fed's preferred measure, the PCE Deflator Core, remained at 1.8% y/y.

The Fed at Ease: The Minutes of the May 1st-2nd Federal Open Market Committee (FOMC) shows that the FOMC members maintained a dovish stance, with no reason to change their assessment of the economic situation, characterized by above-trend growth fueled by strong

labor markets, robust business and household confidence, fiscal stimulus and strong global growth. The FOMC also maintained a benign view of inflation, with the Fed's preferred measure (the Core PCE Deflator) close to 2% and expected to remain around 2% in the medium term. The Minutes also mentioned a "symmetrical "approach to inflation, intimating that the Fed could allow inflation to overshoot 2% without jumping into action. The latest payroll numbers are not expected to change the Fed's trajectory. Consequently, we continue to expect another three rate increases in the balance of the year, with the first one probably coming in June. Bond markets reversed themselves, and the pressure on yields eased up. The 10-year bond's yield surged to almost 3.11% on May 16th before falling back to 2.93% at the end of May. The yield curve remained very flat, with the 10-year/2-year spread at only 0.5% (50 bp). However, the Italian crisis resulted in sharp swings, with a flight to safety on May 29th pushing the 10-year yield down by 25 bp in one day on May 29th, to 2.78%, with a subsequent recovery to 2.88% at the end of May, and 2.98% at the end of the second week of June.

Global growth lost some of its shine in 1Q18, with a slowdown in both the United States and the Eurozone. The slowdown was particularly marked in the Eurozone, where 1Q18 economic growth fell to 1.6% (annualized) from 2.8% in 4Q17. Slow growth could extend in 2Q18, as indicated by the Eurozone Markit PMI –Manufacturing falling to 55.5 at the end of May, a 15 month low. The UK economy continues to suffer from the impact of Brexit, with GDP up by only 0.1% quarter-on-quarter (q/q) in 1Q18. The Japanese economy shrank by 0.6% (q/q) in 1Q18. The Chinese economic growth in 1Q18 slowed slightly, to 6.8%, but the Indian economy continued on its strong growth path. However, global fundamentals remain strong, and the slowdown is expected to be temporary. Trade tensions and surging oil prices could result in headwinds for the global economy. IMF President Lagarde recently warned about protectionism and the threats posed to the global economic and trade architecture by efforts to "rock the system"—a clear reference to President Trump's one-sided flurry of trade actions. In any case, there is cause for concern, as global trade fell in March for the second consecutive month.

Global inflation remains muted. While it is approaching 2% in the United States, Europe is actually suffering from disinflation, with the main inflation gauge at about 1.2%. Japanese inflation is also minimal. As a result, the main central banks remain asynchronous: The Fed is well on its way to tightening monetary policy; the European Central Bank remains cautious and is unlikely to move to undo quantitative easing until 2019; and the Bank of Japan is also likely to wait.

The April data releases and May surveys seem to indicate that the economy is picking up after a slow 1Q18. Both PCE and investment are moving at a faster pace, and the impact of the tax cuts could be kicking in. However, the economy is also facing headwinds: higher oil prices, which will negate some of the benefits of tax cuts, higher interest rates, trade tensions and

financial market jitters. While some analysts have upped their growth forecast to as high as 4% for 2Q18, I would expect the economy to expand by 2.75-3.0% for the next two quarters. We should also note that while the risks are balanced, significant tail risks remain.

Box: The Italian Job

The most immediate threat to the eurozone comes from the Italian political crisis, which has upended the European financial markets. Italian bond yields initially jumped to over 3%, with the spread to German bonds widening to 2.88%. The right wing/populist Five Star/League coalition finally was able to form a government. This is the first major Western European country with an openly populist, Eurosceptic and anti-immigrant government. Moreover, the new Italian government will face the same fundamental issues and seems ill-equipped technically, politically and ideologically, to handle them. Political risks have not faded, just been postponed. An immediate Italian political crisis has been averted. Nevertheless, the Italian situation is by no means resolved. In fact, it can be characterized as a “slow burn.” Policy gridlock between the coalition partners and rising tensions with the country’s European partners could lead to new elections and revive fears of an “Italexit.” Given Italy’s massive debt problem—Italian sovereign debt totals €2.3 trillion (about 120% of GDP), a third of which is held by foreigners, we could see another European financial crisis looming in the not-too-distant future.

Other Global Risks:

We are entering a period of unexpectedly high global risks, with new risks being added to the already long list of existing ones. Global political and economic risks abound. First and foremost, we are seeing a worsening of the geopolitical risks, in large part the result of chaotic and contradictory U.S. policies. Second, Italy is furnishing another cause for concern. Finally, U.S. monetary policy and the strength of the dollar are raising risks in emerging markets. However, we should note that most of these issues pose risks in the medium term. A review of these risks follows:

Iran Nuclear deal: Tensions have been heightened further by Pompeo’s recent speech outlining a 12-point list of demands on Iran, accompanied by the threat of unprecedented sanctions in the case of non-compliance by Iran. Iran is unlikely to comply with the list’s drastic demands. Furthermore, the United States is increasingly isolated on the issue. The Europeans, China and Russia have stated that they remain in the agreement, ignore U.S. sanctions and work on salvaging the deal and countering the U.S. sanctions.

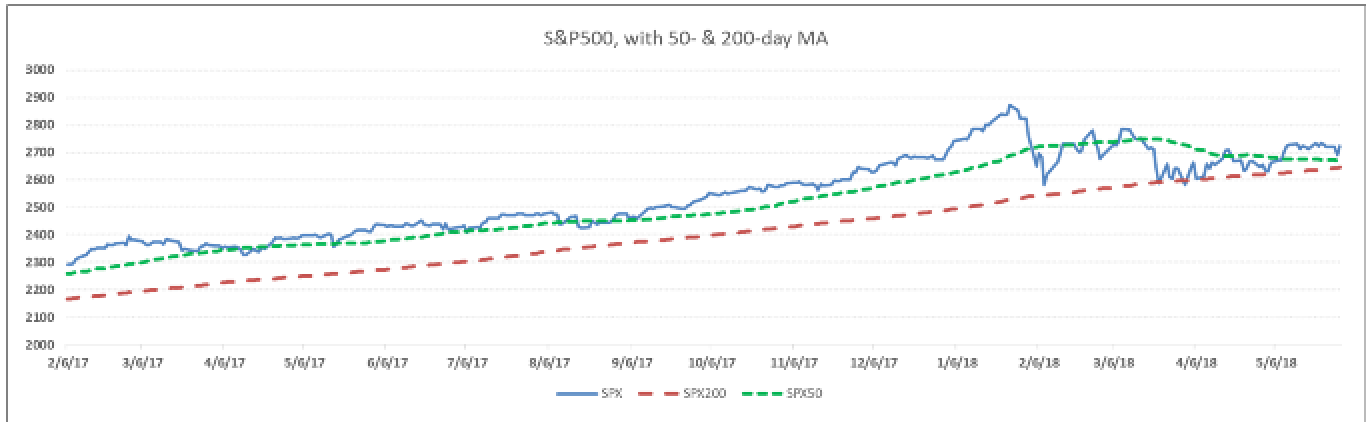
North Korea: The Trump-Kim Summit is back on. However, President Trump has weakened his negotiating position by seeming to agree to a long-drawn denuclearization process, Furthermore, his go-it-alone approach has alienated China and weakened the China-U.S.-Japan-South Korea united front would be seriously weakened. In any case, we will not return to the status quo ante, no matter what the summit outcome.

Trade Wars: The erratic and contradictory trade policies followed by the Trump administration have contributed to the rise of tensions with major trading partners. Most recently, the administration announced broad limits on Chinese investments in technology, as well as 25% tariffs on $50 billion of imports from China. This comes a few days after an announcement of a tentative and vague trade deal achieved in two days of negotiations last week with China, and another reversal by the Trump administration on the China technology company ZTE. Across the pond, the U.S. and Europe are also slouching towards a trade war as the U.S. refused to extend the reprieve on tariffs on steel and aluminum. Canada and Mexico suffered the same fate, which brought a pledge by all affected by retaliatory action. Finally, NAFTA negotiations, which were supposed to end a few weeks ago, are still stalled.

Emerging Markets (EM): concerns about emerging markets have resurfaced after a long period of relative calm. Two factors have revived these concerns: the strengthening dollar and the rising U.S. interest rates. In combination with a sharp increase in EM foreign currency debt (both sovereign and corporate, estimated at $8.3 trillion, 75% of which is denominated in dollars), this has resulted in a run on major EM currencies, especially those of countries with large current account deficits and/or heavy external debt burdens. While we don't foresee another EM financial crisis, the time for complacency in EMs is over.

Each of these crises has the potential to be destabilizing for the financial markets and the global economy. Taken together, they present a particularly difficult challenge at a time of uncertain leadership in the United States, deep divisions between the United States and its traditional allies, and the weakening of global financial governance.

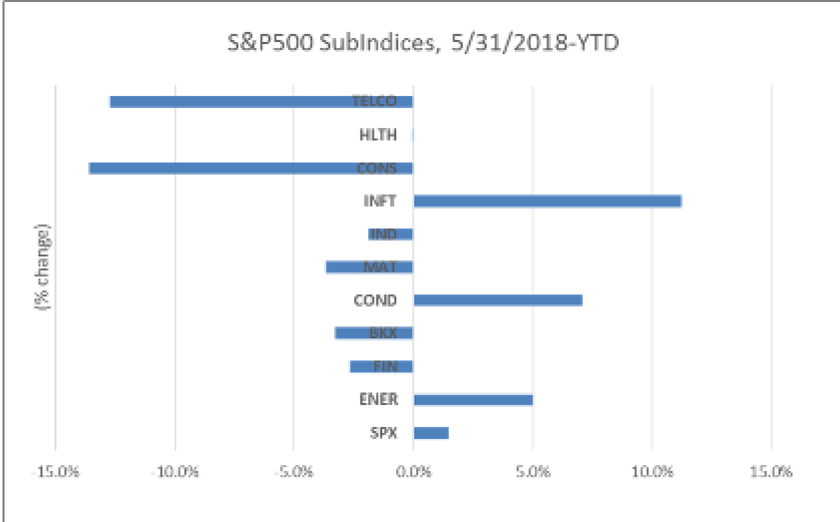
Figure 6: S&P500 at Neutral



Animal Spirits: The equity markets continue to be on a roller-coaster. The brief respite enjoyed by global financial markets in the first three weeks of May ended as the catalog of risks, both geopolitical and financial, lengthened—existing issues worsened and new sources of concern emerged. Equities were hammered in the last week of May and first week of June. The S&P500 peaked at 2,733 on May 23rd, a 3% gain over end-April and its highest level since mid-March. However, the markets reversed themselves in the last week of May, first slowly losing ground and then crashing on the day after Memorial Day on negative Italian news. Then, the strong payrolls report and the short-term resolution of the Italian political crisis brought back some measure of calm, with the S&P500 returning to a 12-week high by early June.

In less unsettled times, the markets should be buoyed by robust economic growth and record profits in 1Q18. However, investors seem to have overreacted to market risks, as they face a plateful of disquieting issues and confusing signals: the U.S. withdrawal from the Iran nuclear deal, the U.S. North Korea summit, the Italian political/financial crisis and the renewal of trade tensions with both China and the European Union. S&P500 profits in 1Q18 were buoyed by the corporate tax cut, rising by about 23% y/y. However, almost half of the profit boost was due to the tax savings. Furthermore, stock buybacks, fueled by repatriated profits and the corporate tax cut bonanza, are at record levels. Equity markets remain expensive, with the 12-month forward price-earnings ratio at about 21.

Figure 7: ***S&P500 Subindices***



The question remains: do investors look at fundamentals or at risks? While the positive prospects of the U.S. economy have quieted the markets, we are still seeing manic behavior by investors, set to flee the markets with every shock and return at any positive signal. Moreover, we are in an environment of significant medium-term risks and tightening monetary policy—at least in the United States. So, while the S&P500 hit a 12-week high in the second week of June, and could break through 2,800 in the short term, that level would be difficult to maintain.

May Data Releases

Economic Data Releases-May 2018	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP(1Q18 % Annualized, Second estimate)	2.9%	2.2%	2.2%	2.1%	2.6%
PCE Deflator(%, y/y) (Apr)	2.0%	2.0%	2.0%	2.0%	2.2%
Core PCE Deflator (%, y/y)	1.8%	1.8%	1.8%	1.8%	2.1%
CPI (%, y/y) (Apr)	2.4%	2.5%	2.5%	2.4%	2.8%
Core CPI (%, y/y)	2.1%	2.2%	2.1%	2.0%	2.3%
Employment					
First Time Claims ('000) (last week May)	234	224	221	215	230
Non-Farm Payrolls ('000), May	159	190	223	155	220
o/w Private Sector	162	184	218	150	217
Unemployment (U3, %) Apr	3.9%		3.8%		
Underemployment (U6, %)	7.8%		7.6%		
Labor Force Participation (%)	62.8%		62.7%		
Balance of Payments					
Trade Deficit $ billion) (Apr)	$47.2	$49.0	$46.2	$47.6	$52.5
Exports (% m/m)	2.0%		-0.5%		
Imports (% m/m)	-1.8%		-0.5%		
Current Account Deficit ($ billion, 4Q17)	$101.5	$126.8	$128.2	$120.3	$133.0
Dollar Index-eom (May)	92.48		94.07		
Oil Prices-eom (WTI, $/bbl) (May)	$68.57		$66.97		
Housing Market					
Housing Starts ('000) (Apr)	1,336	1,324	1,287	1,260	1,350
New Home Sale ('000) (Apr)	672	677	662	650	690
Existing Home Sales (MM) (Apr)	5.600	5.600	5.46	5.480	5.640
Construction Spending (%, m/m) (Mar)	-1.7%				
Case Shiller-20 City (%, m/m) (Mar)	0.8%	0.7%	0.5%	0.6%	0.8%
Case Shiller-20 City (%, y/y)	6.8%	6.4%	6.8%	6.3%	7.0%
Industrial & Manufacturing					
Corporate Profits (y/y) 1Q18	-6.6%		0.1%		
Bus Inventories (m/m) (May)	0.6%		0.0%		
Empire State (May)	15.8	15.5	20.1	14.0	19.0
Philadelphia (May)	23.2	21.0	34.4	18.5	26.0
Chicago PMI (May)	57.6				
Markit PMI Mfg (Apr)	57.6	58.4	62.7	56.6	59.4
ISM Mfg (Mar)	57.6				
Industrial Production (% m/m) (Apr)	0.7%	0.6%	0.7%	0.2%	0.9%
Manufacturing (% m/m) (Apr)	0.0%	0.3%	0.5%	0.1%	1.0%
Durable Goods (m/m) (Apr)	2.7%	-1.2%	-1.7%	-2.5%	1.1%
Durable Goods, ex transp (m/m)	0.4%	0.6%	0.9%	-0.2%	1.2%
Durable Goods, Core Capital (m/m)	-0.9%	0.7%	1.0%	1.0%	1.4%
Factory Orders (m/m) (m/m Apr)	1.7%	-0.4%	-0.3%	-1.0%	0.3%
Services					
Markit PMI Services (May)	54.6	55.7	56.8	54.8	55.7
ISM Non-MFG (May)	56.8	58.0	58.6	56.8	59.0
Consumer Spending					
Retail Sales (% m/m) (Apr)	0.8%	0.3%	0.3%	0.1%	0.5%
UMich Consumer Sentiment (end-May)	98.8	99.0	98.5	98.5	99.3
ConfBd Consumer Confidence (end-May)	125.6	128.0	128	125.5	130.0
Personal Income (%, m/m) (Apr)	0.2%	0.3%	0.3%	0.2%	0.5%

Dr. Pakravan has been a senior economic strategist in global financial markets for over 25 years. Dr. Pakravan is a recognized specialist in leading-edge applied macroeconomic and financial research on currencies and emerging markets, country risk assessment and modeling in an enterprise-wide risk management context, as well as international financial architecture. Dr. Pakravan has a Ph.D. in Economics, University of Chicago, a M.Sc. in Econometrics and Mathematical Economies, London School of Economics, and a B.A. in Mathematical Economics, University of Geneva. He is the author of numerous publications and is an Associate Professor of Finance at the Kellstadt Graduate School of Management at DePaul University.

The Advocacy Investing® Portfolio Strategies newsletter is a publication of Marc J. Lane Investment Management, Inc. We attempt to highlight and discuss areas of general interest that may be useful for anyone interested in the dynamics of our economy and our markets. Nothing contained in Advocacy Investing® Portfolio Strategies should be construed as investment advice or a market recommendation. Consultation with a financial professional is recommended before implementing any of the ideas discussed herein. Copyright © 2018 Marc J. Lane Investment Management, Inc.