Title: Advocacy Investing® Portfolio Strategies, Issue 101
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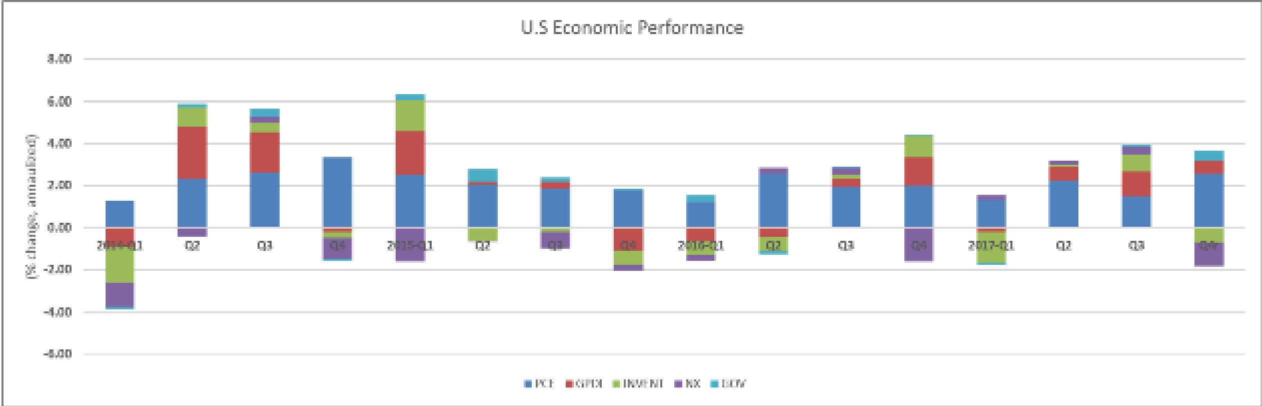
Advocacy Investing®

I AM SHOCKED, SHOCKED…

- **U.S. economic growth in the fourth quarter of 2017 was revised slightly downward to 2.5% (annualized)**
- **Oil prices have fallen from their 28 month highs, stabilizing in the low $60 range**
- **The economy generated 313,000 jobs in February, a 28 month record**
- **Jerome Powell takes over as new Fed Chairman. In his first testimony to Congress, Powell presented a remarkably bullish view of the economy, paving the way for three to four rate increases this year**
- **The global economy continues on its upswing, but momentum is fading somewhat**
- **Congress averted a government shutdown with a two year spending deal. Deficits of $1 trillion-plus expected over the next two years**
- **Risks of a trade war and the prospects of record fiscal deficits spook nervous financial markets as the main indices bounce around multi-week lows**

.Economic growth in fourth quarter of 2017 (4Q17) (second estimate) was revised marginally downward from 2.6% to 2.5% annualized. Private Consumption Expenditures, Government Spending and Fixed Investment all showed positive contributions to GDP growth, while negative contributions from Inventory Changes and Net Exports dragged growth down. The revision reflected a slight slowdown in Nonresidential Fixed Investment (offset by stronger Residential Fixed Investment).

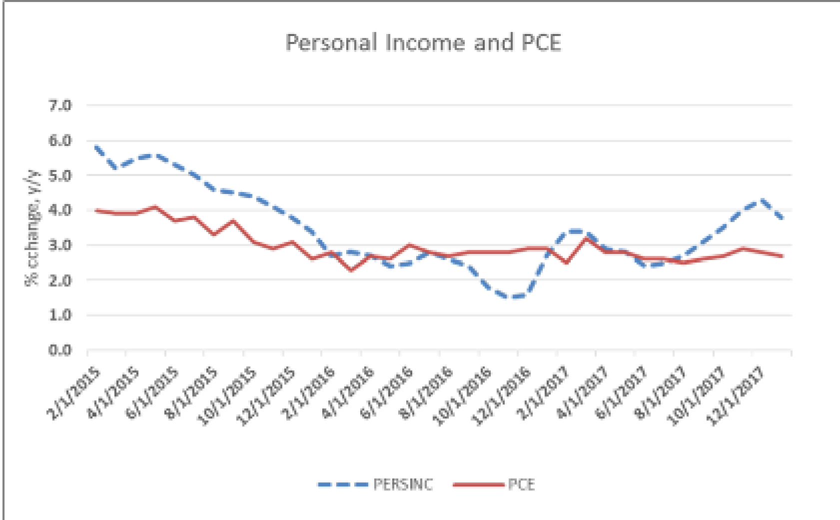
Figure 1: Contributions to Growth



Data releases remain relatively bullish. Industrial Production fell by 0.1% month-on-month (m/m) in January, while Manufacturing remained flat. Durable goods fell by 3.7% m/m in January—Durable Goods ex-Transportation and Core Capital Goods fell by 0.3% m/m each. Factory Orders were down by 1.4% m/m. Surveys were mixed, but remained positive. As far as early-February surveys were concerned, the Empire State Index fell to 12.5 from 17.7 the previous month, while the Philadelphia measure rose to 25.8 from 22.2 over the same period. The late-month surveys also underscored the strength of the sector: the ISM-Manufacturing rose to 60.8 at the end of February from 59.1 the previous month, and the Markit PMI-Manufacturing fell slightly from 55.5 to 55.3 over the same period. The broader Chicago PMI fell from 65.9 at the end of January to 61.8 at month-end—still a strong performance.

Households remain optimistic. The Conference Board Consumer Confidence Index reached an all-time high of 130.8 at the end of February, while the University of Michigan-Reuters measure was stable at 99.7. Personal Income and Personal Consumption Expenditures rose by respectively 0.4% and 0.2% m/m in January, while retail sales fell 0.3% m/m.

Figure 2: Optimistic, but Cautious

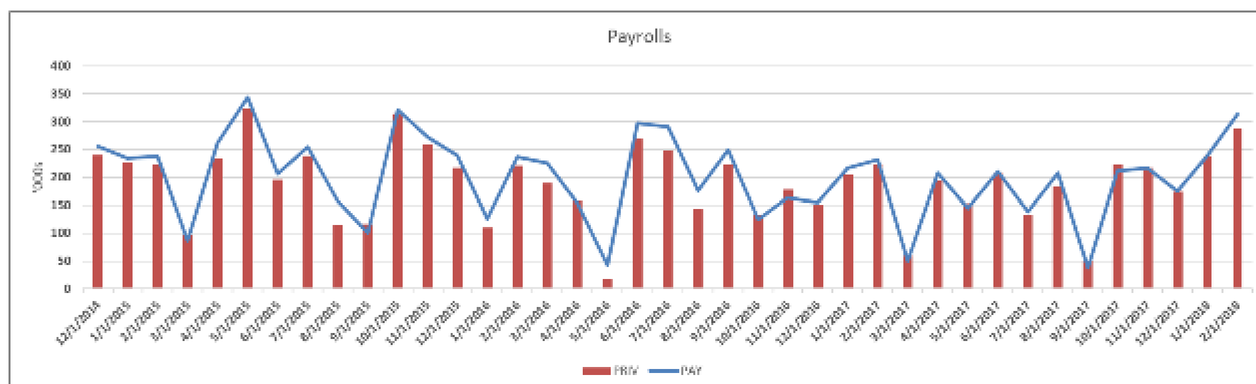


The services sector continued to show buoyancy. The ISM-NonManufacturing index fell slightly to 59.5 at the end of February from 59.9 the previous month, while the Markit PMI-Services rose from 53.3 to 55.9 over the same period. Exports fell by 1.3% (m/m) in January, and imports were flat. As a result, the trade deficit rose to $56.6 billion, from $53.9 billion in December. The dollar index (DXY) gained 1.7% in February, but is still 11% lower than its level one year ago.

The housing market was mixed. Housing Starts rose in January, while New Home and Existing Home Sales both fell slightly. The Case-Shiller 20-City price index gained 6.3% year-on-year (y/y) in December. Construction spending was flat in January after gaining 0.8% m/m the previous month.

The oil markets were not spared the February volatility. Oil prices (West Texas Intermediate, WTI) fell to $61.64/barrel (bbl) at the end of February, down 7.2% from their 2018 high of $66.40/bbl on January 26th. Oil prices continued to inch down towards $60/bb since. However, oil market fundamentals have not changed: abundant U.S. crude oil (conventional and shale); continued commitment by OPEC and Russia to cap oil production to end-2018; and, a normalization of inventory levels. With these factors in mind, oil prices should remain in the $60-65/bbl range over the medium term.

Figure 3: **Payrolls at a 28-month High**

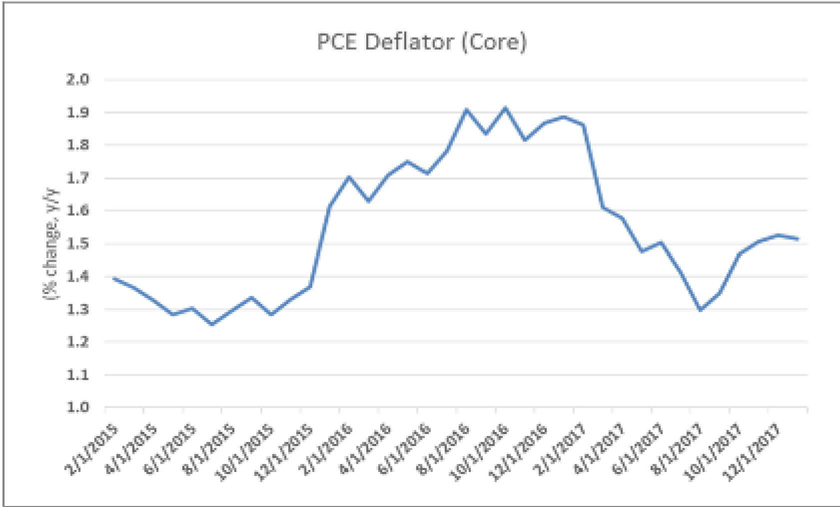


Strong Payrolls: The February Establishment Survey showed that employment grew by a robust 313,000 in February (+287,000 for the private sector), the highest number since mid-2016. In addition, the previous two months were revised upward by an aggregate of 54,000. The improvement was broad-based, with the Labor Diffusion Index (which measures the breadth of the sectoral jobs increase) rising to 68.6 from 58.9 the previous month. The strong February number brought the three-month moving average to 242,000 from 200,000 in 4Q17. The goods-producing sector added 100,000 positions (Construction, +61,000; Manufacturing, +31,000; and Mining, +8,000). Manufacturing in particular has added 116,000 positions in the past four months. Private business services added 187,000 jobs and government payrolls rose by 26,000. Average weekly hours worked increased from 34.4 to 34.5, and average hourly earnings increased by 0.1% m/m (2.6% y/y), which led to an (annualized) 5.5% increase in the labor income proxy. The separate Household Survey shows that labor force increased by 785,000, and the labor participation rate increased to 63% from 62.7% the previous month. The unemployment rate (U3) and the unemployment/underemployment rate (U6) remained flat at 4.1% and 8.2%. High-frequency data also supports the improvement in the labor markets, with Initial Weekly Jobless Claims at 231,000 in the last week of February. Overall, labor markets continue to tighten, but the puzzle of lagging earnings remains. It is possible that higher labor participation rates provide additional slack to the labor markets.

Headwinds Turn to Tailwinds: The release of the Minutes of the January 30th-31st meeting of the Federal Open Market Committee (FOMC) and the Congressional testimony of the new Federal Reserve chair, Jerome Powell, both underscore a remarkably bullish view of the economy. According to the FOMC Minutes, "…Participants generally saw incoming information on economic activity and the labor market as consistent with continued above-trend economic growth and a further strengthening in labor market conditions, with the recent solid gains in household and business spending indicating substantial underlying economic momentum."

Powell, in his first appearance in front of Congress as Fed Chair, reiterated the optimistic view of the economic trends, stressing the fact that "…headwinds of the recent past have turned into tailwinds," citing in particular the fiscal stimulus and strong global demand. Powell also discounted the impact of the recent market turmoil on real economic activity. While not departing from his predecessor's policy, he also downplayed the risks of sharply higher inflation. In fact, inflation remains under-performing, with the Core PCE Deflator, the Fed's preferred measure, gaining only 1.5% y/y in January. Nevertheless, Powell signaled that he would maintain the policy of gradual tightening, potentially accelerating the pace, as well as balance sheet normalization. The February payroll number is not likely to change the Fed perspective, and we expect the first rate increase of 2018 at the next FOMC meeting on March 20th-21st.

Figure 4: Inflation Underperforms

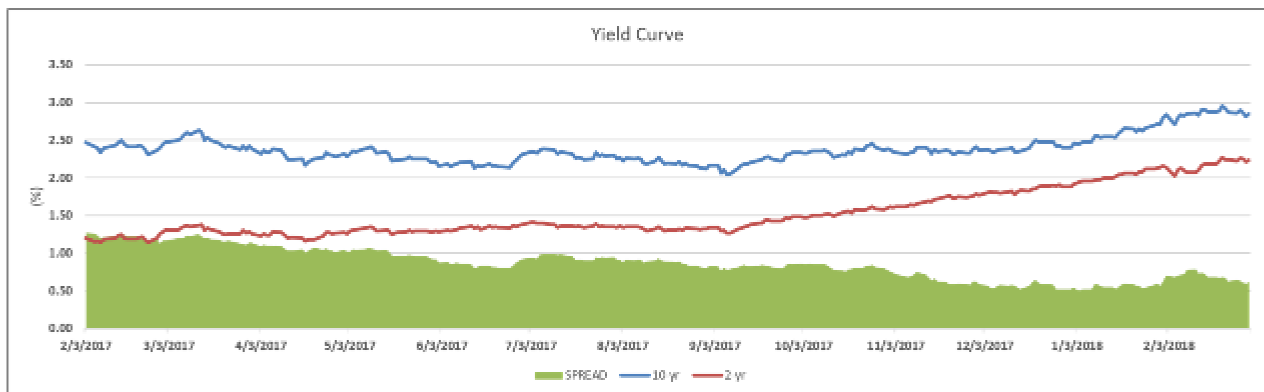


Bond markets have shown concern over the direction of the economy (rising fiscal deficits and potential for overheating) and the 10-year yields have increased sharply, rising by 0.50% (50 bp) since the end of the year to 2.80-2.90%, the highest levels since mid-2011. The yield curve has steepened slightly since the beginning of the year, but has flattened by 0.64% points in the past 12 months to 0.61% at the end of February.

The global economy continues to exhibit dynamism, but the momentum of global growth is fading somewhat after 18 months of above-trend growth. Global manufacturing growth is slowing from an above-trend 5.5% (annualized) growth pace in 4Q17 to a more sustainable 3-4% in 1Q18, as companies trim inventories. The Eurozone PMI-Manufacturing eased somewhat

in February, but the PMI-Composite rose. In any case, these indicators are still at record levels. China's economic output has been growing at 6% (annualized) in the past few quarters. India's growth pace, at 7.2% (annualized), actually exceeded the Chinese one for the first time in 4Q17.

Figure 5: A Flattening Yield Curve



The major central banks' stance remained unsynchronized. The Federal Reserve is well ahead in its monetary tightening and balance sheet normalization, while The Bank of Japan is still in ultra-easing mode. The European Central Bank (ECB) is not expected to begin the process until later this year, but Draghi, the president of the ECB, announced a shift of ECB policy. According to Draghi, the ECB will remove the "easing bias" (i.e. the explicit commitment to increase bond purchases if needed), reflecting increased confidence in the sustainability of the Eurozone economic recovery.

I Am Shocked, Shocked…: With the two latest legislative initiatives (the December 2017 Tax Cuts and Jobs Act, and the February 2018 bi-partisan two-year spending agreement), the Republican party has essentially jettisoned its long-standing balanced budget/fiscal austerity message. It is estimated that between these two measures, the fiscal gap will widen from $660 billion (3% of GDP) in FY 2017 to about $1 trillion (5.3% of GDP) in each of FY 2018 and 2019. Furthermore, Federal debt could balloon from 77% of GDP at the end of FY2017 to 100% by 2027. The bond markets have reacted negatively to the prospects of the projected mountain of debt. After a period of relative stability in 3Q17, the 10-year T-bond yield surged by 50 basis points (50 bp) from mid-December to early March to its highest level since mid-2011. At the same time, we have seen net sales of U.S. sovereign debt by foreigners, which has contributed to both the rising interest rates and the weakening dollar.

.***The U.S. economy is expected to continue to expand at a steady pace,*** driven by both PCE, strong capital expenditures and sharply higher government spending. However, the concomitant widening in the external deficits is expected to act as a drag on growth. The impact of the massive fiscal stimulus is not expected to kick in until 2H18 at the earliest. All other things equal, it could give a short-term boost to the economy, but that boost could dissipate somewhat into higher inflation. However, the Fed reaction to higher inflation, as well as the negative impact to continuing turmoil in financial markets could also act as a drag on growth. Overall, we project growth of 2.5% in 1H18. While growth could reach 3.0% in 2H18 when the fiscal stimulus starts kicking in, the key to faster growth in the medium and long term is to increase both labor force participation and productivity. In either case, there are structural forces at play that could make such an outcome more problematic.

Key Risk Factors:

Trade Wars: the key risk that has emerged in recent days is the specter of a trade war. President Trump's announcement of tariffs on steel and aluminum imports has sparked strong reactions from America's main trading partners. Retaliatory tariffs could lead to an escalation of trade conflicts, damaging key sectors of the U.S. economy and spooking nervous financial markets even further. These concerns have been amplified by the departure of Gary Cohn, the former Goldman Sachs chairman who ran the National Economic Council, from the White House. Cohn was considered a key conduit to Wall Street, as well as the "adult in the room" in a White House with a weak economic policy bench.

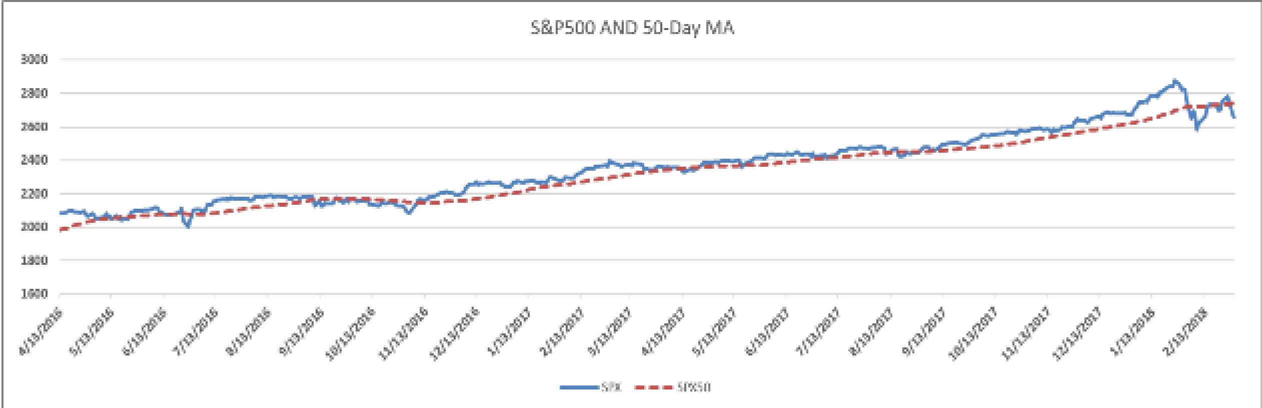
Policy Chaos: the departure of key White House personnel, the thin bench in key policy positions across the various government departments, and the chaotic nature of White House decision-making has resulted in a confusing and often unhinged economic policy.

North Korea: President Trump stunned the world by accepting to meet with the North Korean leader Kim Jong Un in the next few weeks. The prospect on a renewal of negotiations, which started with the post-Olympic rapprochement between North and South Korea, has eased the risk of a military confrontation with the United States.

Europe: The rise of conservative and extreme-right parties in the recent Italian elections is yet another challenge facing the European Union.

The Mueller Investigation: The Special Prosecutor has opened new avenues of investigation, which poses new threats to the Trump presidency.

Figure 6: Market Correction

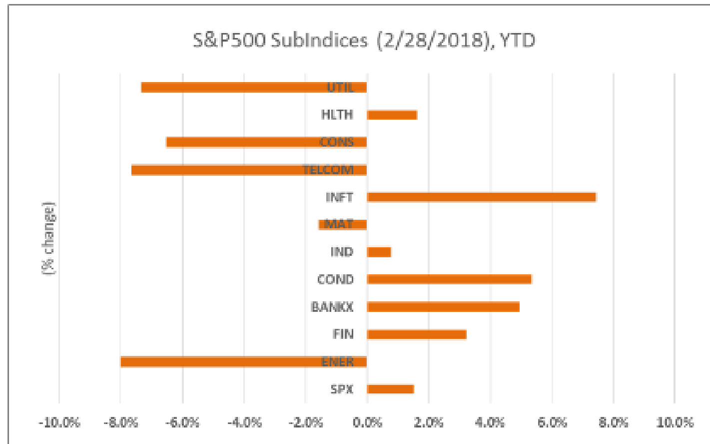


Toil and Trouble: Financial markets continued to suffer from turmoil and volatility in February and early March. The S&P500 fell by 3.9% in February, its first monthly decline since March 2017 and its worst monthly drop in two years. The index peaked on January 26th, reaching a record 2,892, then dropping to 2,591 on February 8th, its lowest point in three months.

Furthermore, volatility returned with a vengeance after a long period of calm, with sharp intraday daily swings for the major indices. Moreover, the VIX volatility index tripled in early February to a high of almost 38 before settling into the low 20s since that peak.

Since U.S. corporations had already found creative ways to raise cash for buybacks and dividends prior to the recent tax overhaul, analysts do not expect significant increases in those activities. For the same reasons, capital expenditures are not expected to surge either. A recap of corporate announcements since the approval of the tax cut legislation showed that 40% of the additional cash flow is expected to be allocated to stock buybacks and dividend payments, another 25% to capital expenditures, and 15% to employees. Surveys of CEOs also show that very little of this cash will be used for deleveraging.

Figure 7: Market SubIndices



Record buyback/dividend payments levels ($218 billion announced in February) could provide some support for equity markets. However, the markets face two key risks: tightening monetary policy and chaotic policymaking. The latter has been exemplified by arbitrary action by the White House on tariffs on steel and aluminum, an action that has already led to the resignation of Gary Cohn, a key economic advisor to the president.

Up to now, Wall Street and the major business actors have found little to criticize in the Trump administration's economic policies: tax cuts and deregulation were particularly welcome. However, the rise of the economic nationalists at the expense of the Wall Street globalists has proven unsettling. In particular, casual mention of trade wars and tirades against "decades" of exploitation of America's good will by foreign powers does not sit well with Wall Street.

Late bull markets are characterized by a continued rise in the markets in the midst of rising credit spreads and higher volatility. We saw that in the 1980s, 1990s and 2000s, and we are seeing it again now. Markets also remain highly sensitive to Fed liquidity, but the Fed cannot suppress volatility, while at the same time tightening monetary policy, so we could see more market "tantrums."

The Goldilocks February employment report (strong jobs growth, but an easing of wage inflation), as well as the prospects for an easing of tensions on the Korean Peninsula, offered some relief to beleaguered markets, with the S&P500 gaining 3% for the week ending March 9th. On balance however, even with steady earnings increase, higher after-tax earnings and cash flows, and shares buyback, the markets face a relatively high risk of a correction in the next few months. Nevertheless, as long as the economy remains on a solid footing, we should see a rebound from the lows, albeit within high volatility.

February Data Releases

Economic Data Releases-February 2018	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP(4Q17 % Annualized, Second Estimate)	3.2%	2.5%	2.5%	2.3%	2.6%
PCE Deflator(%, y/y) (Jan)	1.7%	1.7%	1.7%	1.6%	1.9%
Core PCE Deflator (% ,y/y)	1.5%	1.5%	1.5%	1.4%	1.7%
CPI (%. y/y) (Jan)	2.1%	0.2%	2.1%	1.9%	2.1%
Core CPI (%, y/y)	1.8%	1.7%	1.8%	1.7%	2.0%
Employment					
First Time Claims ('000) (last week Feb)	210	220	231	215	225
Non-Farm Payrolls ('000), Feb	239	205	313	152	230
o/w Private Sector	238	195	287	150	216
Unemployment (U3, %) Jan	4.1%		4.1%		
Underemployment (U6, %) Jan	8.2%		8.2%		
Labor Force Participation (%), Jan	62.7%		63.0%		
Balance of Payments					
Trade Deficit $ billion) (Jan)	$53.9	$55.1	$56.6	$52.8	$56.1
Exports (% m/m)	1.8%		-1.3%		
Imports (% m/m)	1.2%		0.0%		
Current Account Deficit ($ billion, ,3Q17)	$100.6		$124.4		
Dollar Index-eom (Nov)	89.17		90.61		
Oil Prices-eom (WTI, $/bbl) (Feb)	$65.80		$61.64		
Housing Market					
Housing Starts ('000) (Jan)	1209	1232	1326	1210	1305
New Home Sale ('000) (Jan)	643	640	593	610	675
Existing Home Sales (MM) (Jan)	5.56	5.65	5.38	5.48	5.70
Construction Spending (%, m/m) (Jan)	0.8%	0.3%	0.0%	-0.8%	1.2%
Case Shiller-20 (%, m/m) (Dec)	0.7%	0.6%	0.6%	0.5%	0.7%
Case Shiller-20 (%, y/y)	6.4%	6.3%	3.0%	6.2%	6.6%
Industrial & Manufacturing					
Corporate Profits (y/y) 3Q17	10.0%		9.9%		
Bus Inventories (m/m Jan)	0.4%	0.3%	0.4%	0.3%	0.4%
Empire State (Feb)	17.7	12.5	13.1	13.0	19.0
Philadelphia (Feb)	22.2	21.0	25.8	19.0	24.7
Chicago PMI (Feb)	65.7	65.0	61.9	62.0	66.8
Markit PMI Mfg (Feb)	55.5	55.5	55.3	55.4	55.9
ISM Mfg (Feb)	59.1	58.6	60.8	57.7	59.5
Industrial Production (% m/m, (Jan)	0.4%	0.2%	-0.1%	-0.3%	0.5%
Manufacturing (% m/m) (Jan)	0.0%	0.2%	0.0%	-0.1%	0.3%
Durable Goods (m/m) (Jan)	2.6%	-2.0%	-3.7%	-4.5%	0.3%
Durable Goods, ex transp (m/m)	0.7%	0.3%	-0.3%	0.0%	0.8%
Durable Goods, Core Capital (m/m)	-0.6%	0.5%	-0.2%	0.1%	1.0%
Factory Orders (m/m) m/m (Jan)	1.8%	-1.3%	-1.4%	-4.3%	0.4%
Services					
Markit PMI Services (Feb)	53.3	55.9	55.9	53.5	55.0
ISM Non-MFG (Feb)	59.9	58.8	59.7	58.0	60.0
Consumer Spending					
Retail Sales (% m/m) (Jan)	0.0%	0.3%	-0.3%	0.0%	0.5%
UMich Consumer Sentiment (end-Feb)	99.9	99.5	99.7	98.0	100.3
ConfBd Consumer Confidence (end-Feb)	124.3	126.4	130.8	126.1	129.5
Personal Income (%, m/m) (Jan)	0.4%	0.3%	0.4%	0.1%	0.5%
Personal Consumption Expenditures (%, m/m) (Jan)	0.4%	0.2%	0.2%	0.1%	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.

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