



July 2018 Market Commentary: An Abundance of Macro Variables

By Paul Hoffmeister, Chief Economist

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- Overall, we believe the macroeconomic trajectory was slightly negative in June.
- In our view, more tax cuts in the US are possible this fall; the EU Summit seemingly concluded without an eruption of new concerns; tit-for-tat tariff threats abound; and the Treasury curve may invert by year-end.
- We believe the dollar is becoming more costly and less plentiful; a new threat for risk assets.

In last month's client letter, we suggested that rising interest rates, trade tensions, and concerns about the cohesiveness of the European Union and the integrity of the euro were restraining risk asset prices. We also looked at the Camelot Recession Matrix to assess the possibility of a slowdown in US growth or even a recession. Based on the Matrix's seven variables, we believe that despite the strong job and manufacturing environments today, economic growth in the United States will likely peak during the next two quarters and a recession is possible by 2020; due in part to the trajectory of Fed policy, the flattening yield curve, fears at the Fed about low unemployment causing inflation, and growing risk aversion in corporate credit markets.¹

To be clear, we believe the US economy is performing very well today, thanks in some degree to last December's tax cuts and the deregulation since early 2017. We're concerned, however, with how some of the major macro variables are evolving in recent months -- notably a Fed policy geared toward limiting or potentially restricting economic growth, the tough and public trade negotiations and their potential impact on risk-taking, and the implications of subpar growth and strict budget requirements in the EU that threaten the Union's very existence.

It is hard to recall another period during the last 30 years when so many important macro variables seemed to be impacting financial markets at the same time. During

¹ June 2018 Market Commentary: Thinking about a Slowdown, New Risks in Europe",

President Reagan's first term, financial markets had to deal with the prospect of extreme Fed policy to fight historic inflation, major tax cuts, a wave of deregulation, volatile currency and commodity markets, protectionist policies against Japanese imports, and of course Reagan's new approach to the Cold War. Most would likely agree that our economic environment today is not as severe as those years. But, in the same vein, we seem to be similarly forced to assess major changes in a spectrum of macro variables, including monetary, fiscal, regulatory, and trade policy.

Notable Macro Developments in June

In June, the Federal Reserve raised the federal funds rate to a target range of 1.75-2.00% and signaled two more quarter-point increases by year-end.² For the month, the Treasury curve flattened. For example, between the ends of May and June, the 2-year/10-year Treasury spread narrowed approximately 10 basis points to nearly 33 basis points.³ If the Fed raises overnight rates by another 50 basis points as it is currently telegraphing, we believe it's likely that segments of the Treasury curve will invert by year-end.

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As a result, we expect investors in the coming months will need to seriously contemplate the potential implications of an inverted yield curve, which in the past has signaled a looming recession.⁴

In a March 2018 study titled "Economic Forecasts with the Yield Curve", Michael Bauer and Thomas Mertens, economic researchers at the San Francisco Federal Reserve Bank, concluded the following about the economic forecasting power of the slope of the curve:

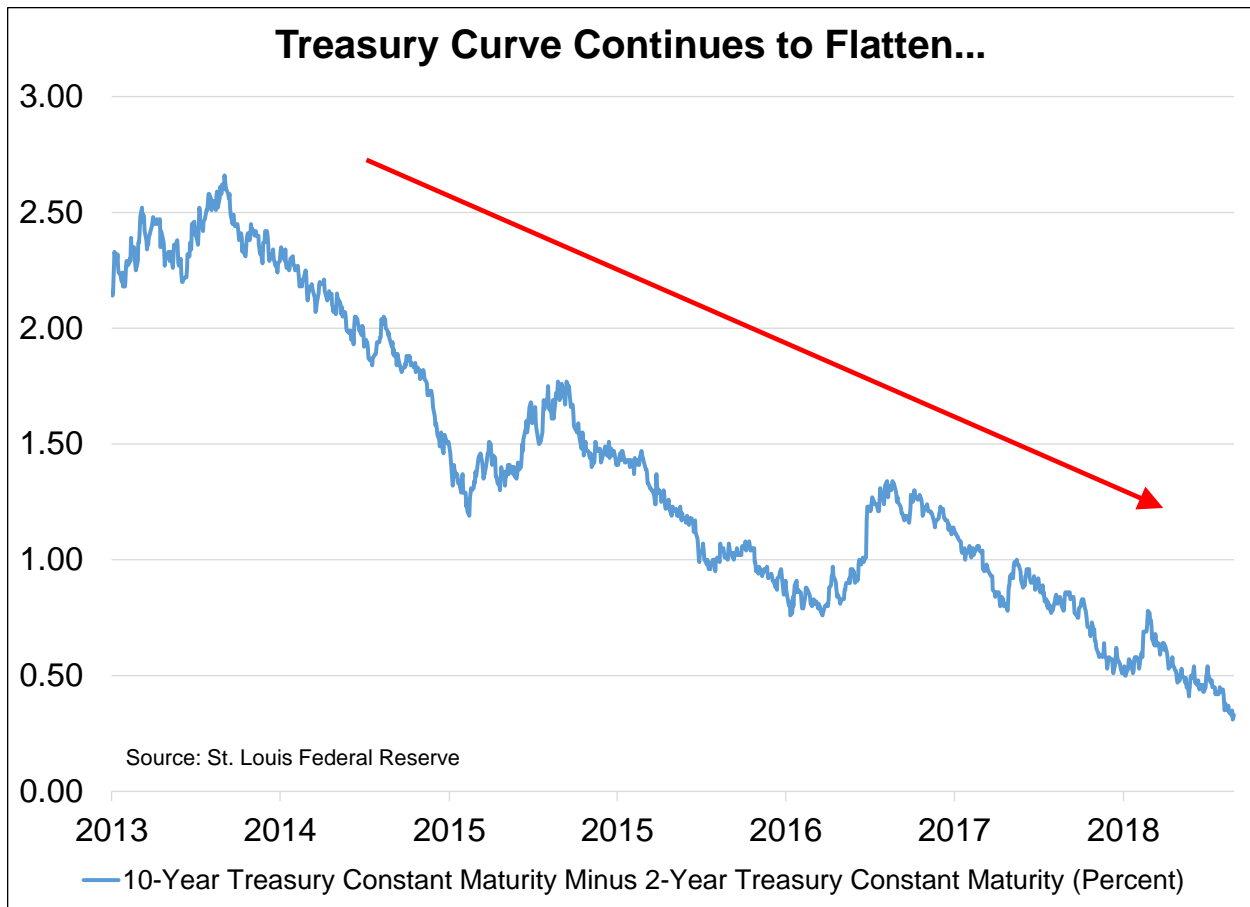
The term spread—the difference between long-term and short-term interest rates—is a strikingly accurate predictor of future economic activity. Every U.S. recession in the past 60 years was preceded by a negative term spread, that is, an inverted yield curve. Furthermore, a negative term spread was always followed by an economic slowdown and, except for one time, by a recession. While the current environment is somewhat special—with low interest rates and risk premiums—the power of the term spread to predict economic slowdowns appears intact.⁵

² "Fed Raises Interest Rates and Signals 2 More Increases Are Coming," by Jim Tankersley and Neil Irwin, June 13, 2018, New York Times.

³ Source: St. Louis Federal Reserve.

⁴ "FRBSF Economic Letter", Michael Bauer and Thomas Mertens, March 5, 2018, San Francisco Federal Reserve Bank.

⁵ Ibid.



The trade outlook also seemingly worsened during the last month. On June 15, President Trump threatened to impose 25% tariffs on \$50 billion of Chinese imports, and the Chinese government quickly responded that it would erect trade barriers of the “same scale and the same strength.”⁶ ⁷ Shortly thereafter on June 18, U.S. Trade Representative Robert Lighthizer threatened an additional 10% tariff on up to \$200 billion in Chinese imports.⁸ China’s Commerce Ministry replied quickly again: “If the United States loses its senses and comes up with a new list, China will be forced to strike back hard, and launch comprehensive measures that match the US move in quantity and quality.”⁹ Based on the public rhetoric, it appears that the US is at the brink of a tit-for-tat tariff battle with China; and even with other major trading partners.

For its part, the EU threatened to impose 25% tariffs on \$3 billion of US goods in retaliation to the tariffs on steel and aluminum that the Trump administration put into

⁶ “With Trade War, Trump Starts Unravelling a Quarter Century of US-China Economic Ties,” by David Lynch and Emily Rauhala, June 15, 2018, Washington Post.

⁷ “China: The U.S. Has Launched a Trade War,” by Mark Thompson, June 15, 2018, CNN.

⁸ “Trump Threatens China with New Tariffs on Another \$200 Billion of Goods,” by Julia Horowitz and Jethro Mullen, June 19, 2018, CNN.

⁹ Ibid.

effect at the beginning of June.¹⁰ In response, President Trump is now considering 20% tariffs on automobiles imported from the EU.¹¹

In an interview with Fox's Maria Bartiromo, Trump said, "The European Union is possibly as bad as China just smaller, OK. It's terrible what they did to us. European Union—take a look at the car situation. They send a Mercedes in; we can't send our cars in."¹²

Adding to the stiff resistance against the White House from China and the EU, Canada began on July 1 to impose tariffs on more than \$12 billion in American imports in retaliation to the US steel and aluminum tariffs.¹³

With the Trump Administration negotiating with so many major trading partners at once, and in a pattern of tit-for-tat maneuverings and retaliations, markets may be discounting a long road ahead before any of today's major trade disagreements are resolved.

It's possible that the United States has lost leverage in renegotiating existing trade agreements by having to deal with so many major trading partners at once. Not only do we think further headline risks are likely, but the probability may grow that uncertainties in international trade arrangements will begin to weigh on economic activity and production.

On the positive side of things, there were arguably a number of bright spots in the macro outlook during the last month. On June 26, House Ways and Means Chairman Kevin Brady revealed that he sees a second round of tax cuts on the horizon; the focus of which will be to permanently extend the individual income tax cuts that are scheduled to expire in 2025 and to enhance incentives for retirement savings and education.¹⁴

According to The Hill, Brady expects a legislative outline to be released in August and votes to be held in the fall. Given their potential impact on US equity markets, we'll be especially focused on whether "Tax Reform 2.0" will include tax reductions on capital gains or dividends. Our best guess is, Brady will be looking to do something on this front.

Just a few days after Brady's remarks, National Economic Council Director Larry Kudlow made the case for more tax cuts, telling Maria Bartiromo on Fox Business News, "Let's make the tax system more efficient, let's make it simpler, let's make it more powerfully growth oriented."¹⁵

¹⁰ "EU Threatens \$300 Billion Tariffs Against U.S. After Fresh Trade Salvo From Trump: Report," by Barbara Kollmeyer, July 2, 2018, MarketWatch.

¹¹ "Trump Cites Car-Tariff Threat as Biggest Trade Leverage," by Jacob Schlesinger, July 2, 2018, Wall Street Journal.

¹² Ibid.

¹³ "Canada Hits Back at U.S. on Tariffs, Says It Will Not Back Down", by David Ljunggren, June 29, 2018, Reuters.

¹⁴ GOP Chairman Envisions Tax Reform 2.0 as a Package of Bills," by Naomi Jagoda, June 26, 2018, The Hill.

¹⁵ "Maria Bartiromo's Wall Street", June 29, 2018, Fox Business News.

But perhaps even more importantly, when asked by Bartiromo whether the Fed will “blow it and raise rates too much”, Kudlow responded:

My hope is, that the Fed under its new management, understands that more people working and faster economic growth do not cause inflation. Do not cause inflation. What our program is, we’re expanding the economy’s potential to grow. That’s the new equipment. That’s the new structures. That’s the new technology that we’re doing. And therefore, therefore, that cannot be inflationary. Don’t tell somebody up in the rustbelt, don’t tell somebody in the middle of the country that working and growing is a bad idea. That is impossible. That violates common sense. My hope is, and I speak to Jay Powell periodically and he’s a good man, my hope is they understand that, and they move very slowly.¹⁶

In our view, Kudlow is doing two significant things here. First, as the country’s top economic adviser, he is pushing back against current Phillips Curve thinking that sub-4% unemployment will spark inflation, which is a key argument for raising interest rates aggressively.¹⁷ Secondly, Kudlow seems to be making the case directly to Fed officials, both publicly and privately, that they proceed with extreme caution in their interest-rate hiking program.

It’s possible that if the US economy faces more serious risks and headwinds, the White House will push strongly on the Fed to back off its tightening campaign. Perhaps there’s a “Trump put” when it comes to excessively aggressive Fed policy?

As for risks out of the EU, we believe late June’s EU Summit was slightly positive, for seemingly not causing an eruption of new concerns. After reportedly “tortuous” negotiations, according to Reuters, an agreement was reached on the increasingly tense issue of EU migration policies.¹⁸ But an agreement on the EU budget and finances, and clarity surrounding whether Italy will be able to implement the fiscal reforms (15% flat tax and increased social spending) that its new, populist government successfully campaigned on, was not reached.¹⁹

We remain concerned that if EU leaders attempt to prevent Italy’s new government from implementing the economic mandate from its recent elections, that the European Union will experience greater stresses in terms of unity, raising fears about the currency union

¹⁶ Ibid.

¹⁷ “Does Low Unemployment Signal a Meaningful Rise in Inflation?” By James Bullard, Q3 2017, Federal Reserve Bank of St. Louis.

¹⁸ “EU Cuts Migration Deal After Marathon Talks, But Differences Remain”, by Gabriela Baczyńska, Noah Barkin, and Richard Lough, June 27, 2018, Reuters.

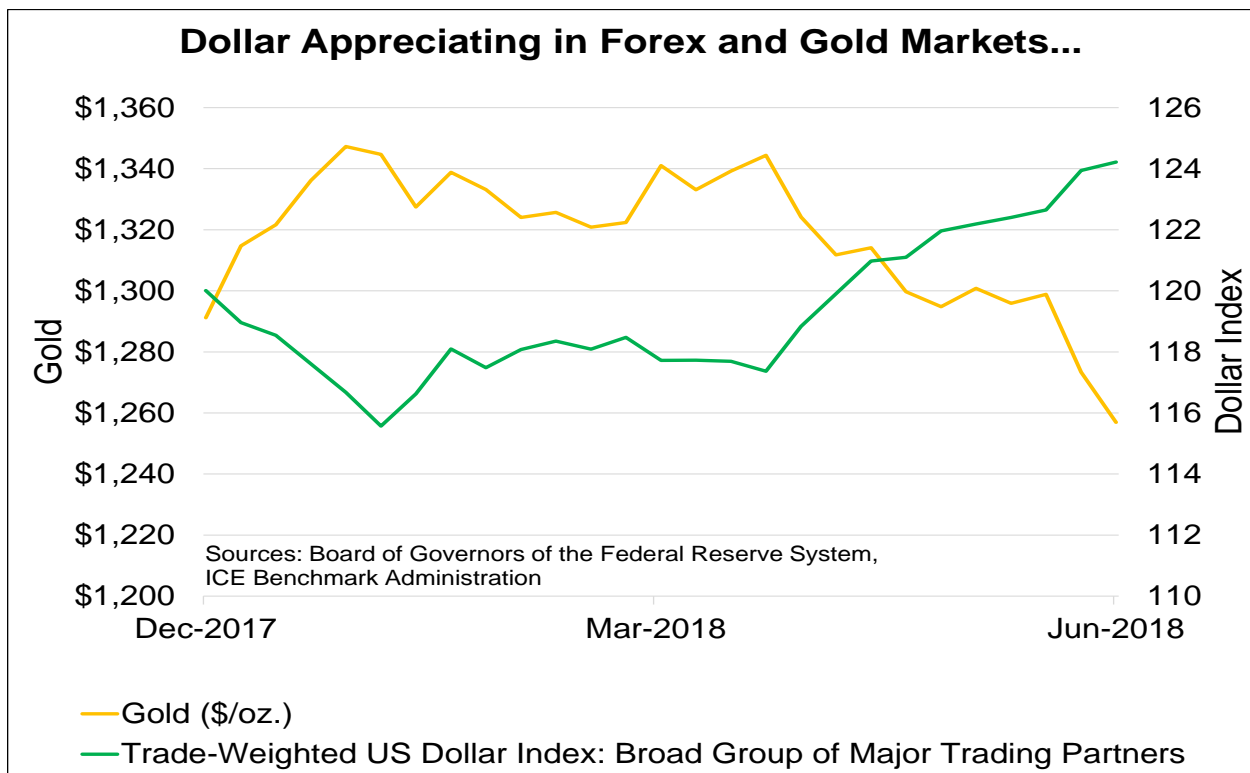
¹⁹ “Italy’s Populist Playbook: How to Shake Up the EU Establishment”, Nikos Chrysoloras, June 29, 2018, Bloomberg.

itself. The next EU Summit is scheduled for September, at which time Italy's 2019 budget will likely be a bigger focus.²⁰

In sum, there were a number of positive and negative developments in June; but overall, we believe the macroeconomic trajectory was slightly negative. As we see it, there will be a concerted effort inside Congress to pass another round of tax cuts before the midterm elections and there is strong advocacy from the White House against the Fed raising interest rates too aggressively; on the other hand, the current trajectory of Fed policy that was reaffirmed in mid-June continues to threaten to slow the economy and the US has lost some leverage in trade negotiations.

New Concern: Is the Dollar Too Strong?

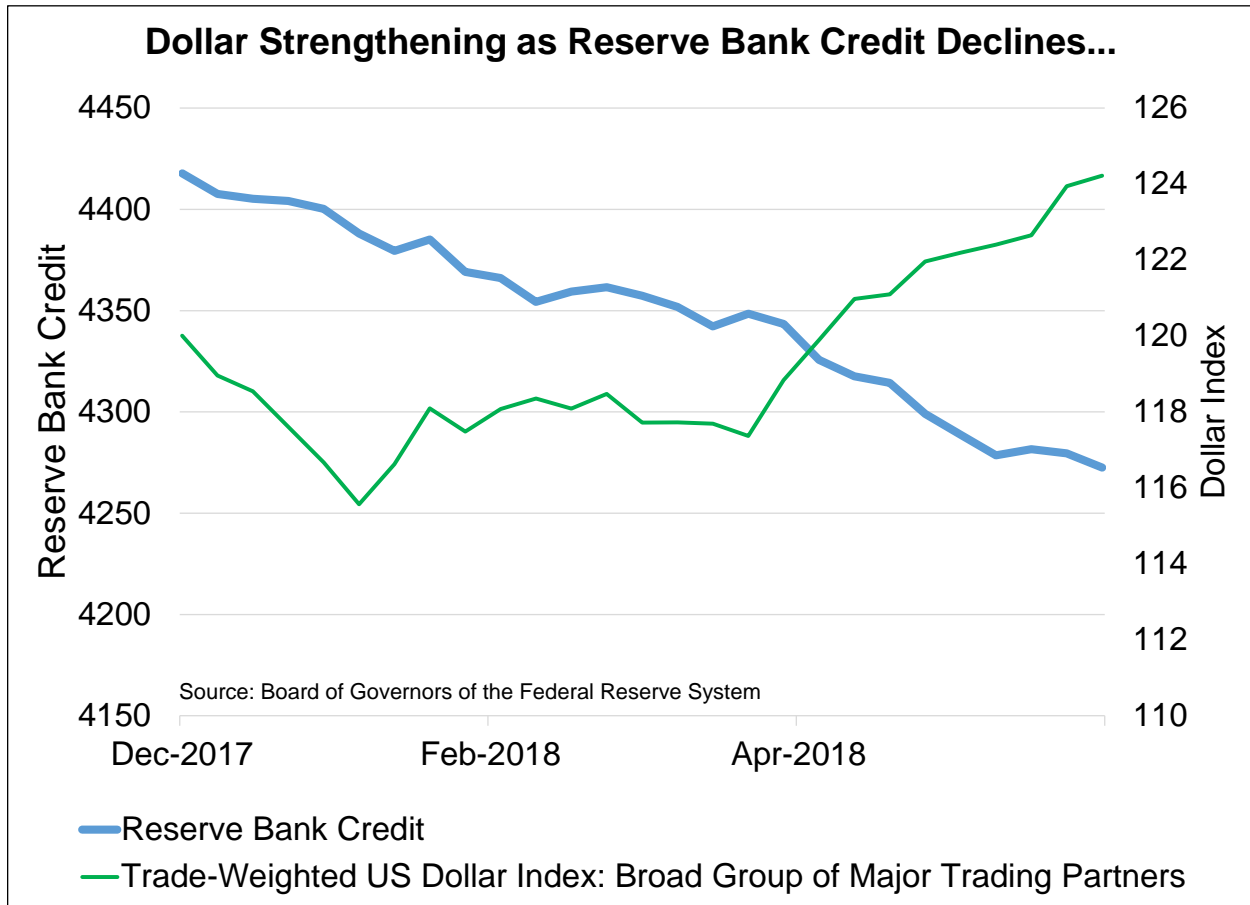
In the classical economic model, money should be stable in order to maximize its function as a means of exchange, unit of account, and store of value.²¹ And when the value of money deviates substantially and produces either inflation or deflation, great economic harm can ensue. As John Maynard Keynes wrote in *The Economic Consequences of Peace* in 1919, "The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."



²⁰ Ibid.

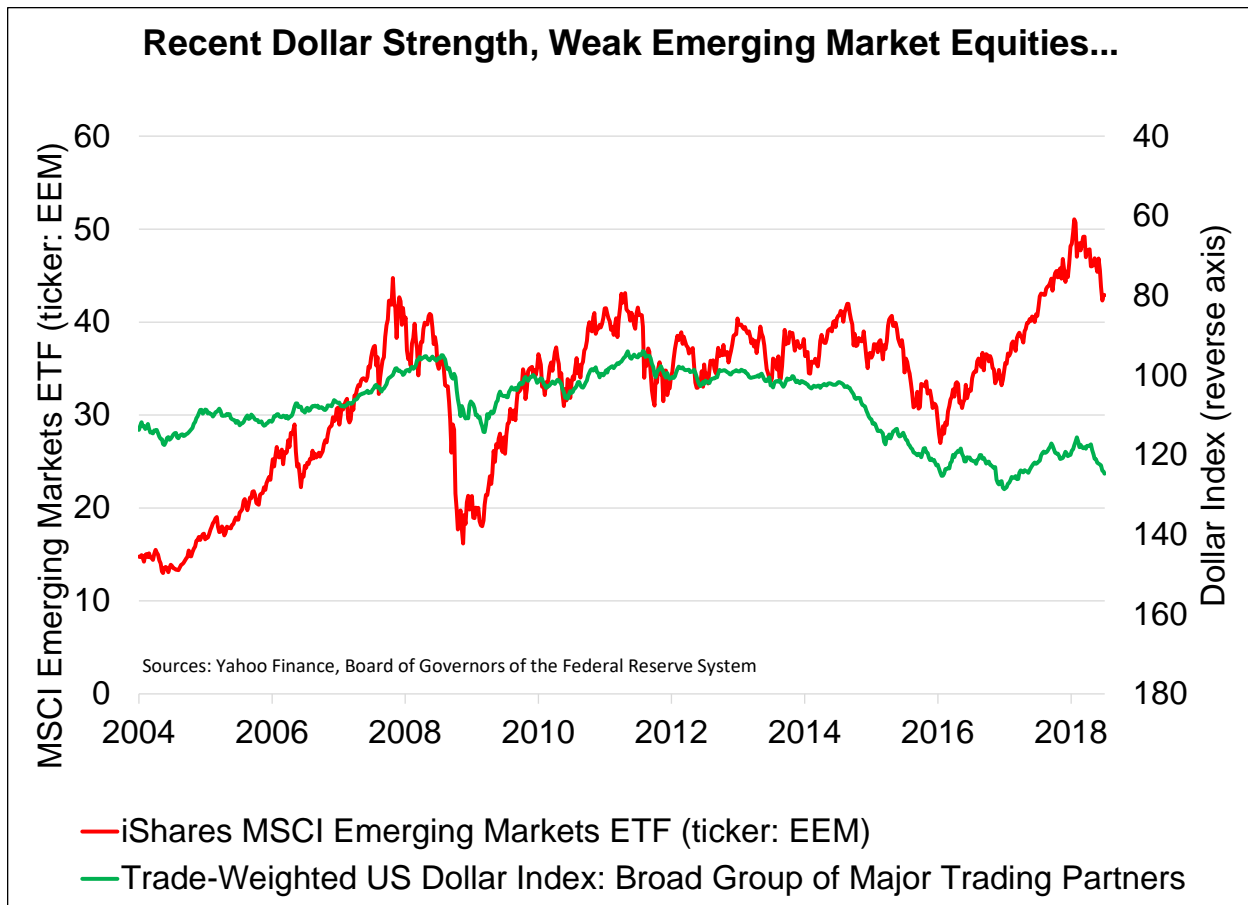
²¹ "What All Classical Economic Thinkers Can Agree About", by Nathan Lewis, May 23, 2013, Forbes.com.

In recent months, the dollar has lost the stability it had since the beginning of the year, and we're worried about a possible decline in dollar liquidity. Since April, the dollar index has appreciated by nearly 6%, while the dollar-denominated gold price has fallen almost 9%.



We believe the primary culprit for the dollar appreciation is the shrinking in the Federal Reserve's balance sheet, which is arguably reducing the supply of high-powered base money in the dollar economy. While most attention today appears to be paid on the Fed's interest rate-hiking campaign which is raising the cost of dollar-denominated credit, the Fed is also in the early stages of shrinking its balance sheet which is reducing the supply of dollars in the economy.

As we see it, the global economy is in the throes of not only a higher cost of dollar capital, but also a decline in dollar liquidity; in other words, the dollar is becoming more costly and less plentiful. We believe this is potentially a major headwind for risk assets and could create serious tail risks if interest rates rise further and the Fed balance sheet shrinks substantially more.



Looking at the financial landscape today, further strengthening of the dollar would make us especially concerned about emerging markets, foreign governments that require US dollar reserves, commodity producers, and US exporters – not to mention financial institutions highly exposed to these market segments.

Conclusion

Larry Kudlow indicated last month that the OECD estimates that the United States is the fastest growing industrialized country today.²² We believe recent tax cuts and deregulation are important catalysts for the robust economic growth, which has also contributed to strength in many risk asset prices. But we're concerned about the "margin". That is, we're concerned with where things are headed.

On the one hand, more tax cuts might be passed later this year, which could support risk assets. On the other hand, concerns persist about trade and the EU, and we are now especially worried about the strong dollar, in combination with the higher cost of dollar capital and the decline in dollar liquidity.

We expect attractive growth data to continue to be released in the coming weeks and months. But this kind of economic data is more lagging than forward-looking. In order to

²² "Press Briefing by NEC Director Larry Kudlow on the G7 Summit", June 6, 2018, White House.gov.

determine whether the economic trajectory begins to improve, at least in our view, we'll be especially monitoring the slope of the yield curve, value of the dollar, and direction of corporate credit spreads.

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