MILLRIVER
WEALTH MANAGEMENT

OUTLOOKS

May 2017

ECONOMIC OUTLOOK

Summary

The first look at Q1 GDP growth came in at 0.7%, with consumption up just 0.3%, the least since the third quarter of 2009. Consumer and business surveys are buoyant but it is just not translating into spending. One area of concern highlighted by Larry Fink, the CEO of BlackRock, is the persistent downtrend in “real” (inflation adjusted) personal income since Q1 2014. You can’t spend what you don’t have, unless you borrow money or deplete savings. This is probably not an issue with the top 25% of income earners, but for the other 75% of wage earners, higher medical deductibles and meager salary increases constrains potential spending.

In addition to very soft real personal income statistics, another more insidious variable may be the prolonged deflation that exists in the broader commodity space. The Bloomberg Commodity Index at around 82.3 is virtually the same value that existed in 1993! The index reached a high in July 2008 at 237.9 and now sits about 65% below the peak level. So, let’s recap, we’re eight years into the slowest economic recovery since the Great Recession and the Fed is hiking rates into a deflationary headwind, while we are likely at full employment. Something has to give.

Our best judgement is that the Fed may go on hold after December this year, allowing the economy to pick up steam and foreign central banks to come off their zero or negative interest rate policy before hiking interest rates further. The economy has an overabundance of goods and services at today’s prices and can produce much more. If you eliminate the housing market from the inflation equation, the digital economy, price transparency and capital light business models are wreaking havoc on the top line of many corporate enterprises. Labor may be tight and some well-deserved salary increases may materialize, but revenue growth is hard to come by, so other expense line items will have to be addressed to maintain profitability. These situations in total do not indicate a brewing inflation problem and suggest a prolonged, very easy monetary backdrop for investors.

Positives

Industrial Production rises 0.5% month-over-month

New Home sales increase 5.8% month-over-month

ISM Non-Manufacturing Index increases from 55.2 to 57.5

Negatives

ISM Manufacturing Index falls to 54.8 from 57.2 last month

Personal Spending unchanged year-over-year for the last two months.

Car and Truck Sales in April come in at 16.81 million units annualized vs 17.1 million expected

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EQUITY OUTLOOK

Summary

Equity markets ground out more advances in April, driven by improvement in the trifecta of sales, margin and earnings, rather than hoped for progress on regulatory reform.

The S&P 500 rose 1.03%, bringing year-to-date gains to 7.2%. International markets in aggregate fared better as the recovery from 2016's slump has gone global. Emerging markets took the spotlight as the MSCI EEM Index jumped 1.0%; developed markets gained as well, up 2.5% as measured by MSCI EAFE.

Style reversal persisted as growth continued to outpace value for the fourth consecutive month, bringing the year-to-date differential to 7.4%. Not surprisingly, the top performing sectors in both periods include the usual growth sectors of tech, consumer discretionary and healthcare.

The market's initial response to proposals for regulatory reform proved more euphoric than reality has warranted. While traders may have discounted any such economic impact, reports from the frontlines of corporate America, by means of first quarter business updates, bring the focus back to the here and now.

Despite an abysmal first quarter GDP print of 0.7% growth in the first quarter, two thirds of S&P 500 companies have reported results much better than expected. We noticed that the improvement went beyond earnings per share, which are subject to financial management, but also included better top line growth and an improving outlook for the year in general.

Many headlines point to general weakness in the economy. These include GDP less than expected, a slowing in commercial bank lending, new car sales declining and the Amazon-izing of retail shopping. There are countervailing factors as well; the oil sector is improving, housing is solid, inventory levels are down and delinquency rates are improving.

We stick to our view that what matters most to equity markets is the direction of corporate earnings. So far in 2017, the direction as measured by first quarter results and an increase in estimates for the remainder of the year, is higher.

Positives

Corporate earnings headed higher

Fed policy clearly telegraphed and gradual

Negatives

Some uncertainty arising from ambiguous policy direction

Unknown

Geo-political nervousness

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FIXED INCOME OUTLOOK

Summary

Interest rates dropped sharply during the first half of April, continuing the trend that began in mid-March. The failure of the Republican Party to advance Trump's pro-growth initiatives, a series of soft economic releases and the uncertainty over the first round of the French elections conspired to push yields lower. After starting the month at a yield of 2.39%, the 10-year Treasury note dropped to a low of 2.17% on April 18, a few days before the French election. From the high closing level in mid-March, this decline was nearly 46 basis points (bps). This move was quite astonishing considering that the Fed had just reconfirmed its intent to increase the Fed Funds rate two more times this year and possibly three additional times in both 2018 and 2019.

After a win in the preliminary French elections by the centrist, pro-business, pro-Euro candidate Emmanual Macron, yields began to move back up. Not normally a significant driver for U.S. bond yields, the French elections have become a concern as the rise in populism and localism around the world could have led to the country voting to leave the European Union, just as the U.K. has done. The implications of France leaving are much more dire to the survival of the EU since France also uses the Euro as its currency, whereas the U.K. did not. If France were to leave, it is unlikely that the Euro would survive as the common currency for 19 of the 28 European Union members.

By the end of April, yields had climbed most of the way back up to where they started the month. The 2-year actually increased 1 bp to end at 1.26% and the 10-year ended about 11 bps lower at 2.28%. With the slight decline, treasury returns were a solid 0.62% for intermediate maturities. Corporate credit spreads widened out about 5 bps as yields fell, then narrowed back and rose to about the same spread level. Overall Intermediate corporate bonds delivered a superior return of 0.83% for the month.

At the early May meeting of the FOMC, the Fed labeled the Q1 GDP weakness as transitory and they, as well as most private economists, expect a sharp snapback in Q2. They remain committed to continuing their path to normalizing monetary policy through rate increases and an orderly reduction in their balance sheet.

We still believe that rates should rise modestly over the course of the year, but we have lowered our end of year target for the 10-year Treasury note to 2.60-2.75%. If tensions escalate to some kind of intervention in North Korea, all bets are off.

Positives

Difficulties of the new administration to pass healthcare and tax reforms

Increasing global tension: Russia, North Korea, Iran, Syria

Negatives

The Fed is committed to further rate increases and balance sheet reductions

Possibility of a significant increase in the Federal budget deficit and additional Treasury borrowings

Unknowns

French elections and the demise of the European Union with a "Frexit"

Kim Jong-un

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