POST OAK PRIVATE WEALTH ADVISORS

ADVISORY, CONSULTING & INVESTMENT MANAGEMENT

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Quarterly Market & Economic Update

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We all know President Trump has a fondness for words that express grandeur and bigness: for example, “huge”, “great”, “tremendous”, and of course, “bigly”.

We should expect to hear more “big” words from Trump in the next few months. That’s because the signature piece of legislation from his term so far—the tax reform bill—appears to be having a significant impact on the U.S. economy. I’ll hold off on calling it huge or tremendous or “bigly”, but I do want examine the different ways tax reform, especially the provisions that lowered corporate tax rates, are helping to energize the U.S. economy.

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Let’s start with the pace of economic growth. It wasn’t long ago that many economists were talking about a 2% annual rate of GDP growth as the “new normal.” But corporate tax relief and deficit spending seem to have disrupted the narrative of secular stagnation. Consensus forecasts for Gross Domestic Product (GDP) growth for Q2 are now tracking an annual rate of 3% or higher. And those are the conservative estimates—the GDPNow forecast published by the Federal Reserve Bank of Atlanta sees Q2 economic growth heading just shy of 4%. One research firm, Macroeconomic Advisers, recently boosted their Q2 growth estimate above 5%. To be clear, this level of growth, if actually achieved, would represent a 50% jump in the U.S. economy, which is quite remarkable by almost any standard.

Next, consider corporate earnings. With momentum building in the economy and the tax burden eased somewhat, you would expect earnings to respond favorably. Earnings growth has been robust during recent quarters, topping 24% on a year-over-year basis in Q1 according to FactSet. Energy, materials, technology and financial firms have been the biggest contributors to earnings growth, with each of these sectors outpacing the overall earnings growth rate for S&P 500 firms. Look for earnings growth to be strong for the rest of 2018, but perhaps not as strong as Q1. FactSet sees Q2 earnings growth to come in at a year-over-year rate of 19.0%, then continuing those double-digit gains for the remainder of the calendar year.

The tax reform package is not only helping U.S. businesses bolster their bottom lines, it’s also driving a wave of capital market activity, from share buybacks to mergers and acquisitions (M&A). Repatriated earnings from overseas are fueling most of this activity; stock buybacks reached a record $178 billion in Q1 this year, with 24 companies with the biggest overseas cash hordes responsible for two-thirds of the buybacks. Total stock buybacks for all of 2018 are expected to surpass $800 billion, according to a J.P. Morgan Chase analysis. Moreover, M&A deals are happening at a pace not seen since 2007, with $1.7 trillion in deals occurring in the first four months of 2018 alone. Not all of these deals are being done with repatriated earnings, but merger activity could increase as U.S. firms bring back these foreign profits to fuel domestic deals.

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What about employment? The jobs picture for U.S. workers is as good as its been in nearly a generation. The unemployment rate for May dropped to 3.8%, the lowest it has been since April 2000. There will always be unemployment or underemployment in some corners of the economy, but in general anyone who wants a job can find one at this point in the cycle. Many employers are actually facing a shortage of skilled workers, which represents a different problem for the U.S. economy. The unemployment rate for college-educated workers is lower than the overall unemployment rate, at 2% in May according to the Bureau of Labor Statistics. And manufacturers see the lack of skilled employees as the biggest challenge they face in the year ahead, as reported in the ASQ Manufacturing Outlook Survey.

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With the labor market as tight as it is right now, you would expect wage growth to accelerate. While there have been some gains in recent months, wage growth overall has been quite moderate. Hourly wages for private sector workers in May climbed 2.7% over the same month last year, a slight increase from the 2.6% average year-over-year wage growth over the past 12 months

Not only have wage gains been modest, they now are getting compressed by inflation. The Consumer Price Index (CPI) for May rose 2.8% on a year-over-year basis, the biggest jump in over six years. Most of this rise was attributed to higher gas prices. The core CPI, which excludes energy and food prices, saw a smaller increase of 2.2% year-over-year in May, but still was the largest rise in over a year. The average worker may not want to see higher prices deflate what wage growth they are able to achieve, but the return of inflationary pressures is cold comfort to economists, who have been expecting prices to rise after so much monetary and now fiscal economic stimulus.

The Federal Reserve responded to the positive signs of U.S. economic health by raising rates in June. The Fed funds target rate is now back to where it was just before the worst of the financial crisis in the fall of 2008. And in reading the Fed's statement following the last Open Market Committee meeting, the trajectory for rates is only going to get higher. The Fed's quarter-point hike in June was largely expected by investors, but the one piece of news that came out of that meeting was the increase in rate guidance, penciling in two additional rate hikes for the rest of 2018, for a total of four hikes this calendar year. Prior to the June FOMC meeting, the Fed was projecting just three hikes in 2018.

The concern among investors is that the Fed takes a bolder stance in cooling the economy, just as growth appears to be hitting its stride. Adding an additional quarter-point hike for the next six months doesn't strike us as a particularly bold move, especially as many market analysts were out in front of the Fed in anticipating more rate increases. Still, the potential remains for the Fed to throw cold water on an overheating economy, especially as all of the pieces of an accelerating expansion fall into place with fiscal stimulus, strong employment and rising inflation.

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Tighter monetary policy and higher interest rates aren't the only potential speed bumps facing the U.S. economy. Tariffs announced in May and June by the Trump administration pose a threat to the current trend of growth—or they should if you subscribe to the teachings of free-market economists. An escalating trade war with our major trading partners—Canada, Mexico, the European Union, Japan and China among others—could derail the ongoing expansion. At least that's how the theory goes, or if you look for guidance from history, specifically U.S. trade policies of the 1920s and 30s that precipitated and exacerbated the Great Depression. These concerns

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are presently hanging over the financial markets like a dark cloud, and are the primary reason why many investment portfolios were flat over the previous quarter, even in the midst of an exceptional period of economic growth.

Much of the fretting about tariffs and possible trade wars with allies might be overdone in my view. First, we have to account for how much of these announcements from Trump and his trade representatives is mere bluster or posturing for future negotiations. After more than 500 days of Trump in the White House and on the front page, people here and around the world are getting more familiar with his style of deal making.

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Second, we should consider the actual impact tariffs may have on the U.S. economy as a whole. Despite our large trade deficit, imports do not contribute much to the U.S. economic engine—they're just 15% of our Gross Domestic Product according to the World Bank. The average for all other countries is closer to 30%. Also remember that trade is a complex beast—there are over 17,000 individual items listed in the U.S. Harmonized Tariff Schedule and companies can petition the Commerce Department for exemptions and reclassifications to avoid hefty tariff charges. Reportedly, the White House has received more than 20,000 requests from U.S.-based companies looking for ways to get their imported goods around the higher tariff rates.

Finally, it's helpful to look at U.S. tariffs relative to other countries or regions. The U.S. has a weighted mean tariff rate of 1.6% on all imported products, according to World Bank data. That's close to the average for the European Union (1.6%) and Japan (1.35%). Other trading partners have much higher average tariff rates, including China (3.5% weighted mean), Mexico (4.3%) and South Korea (7.7%). Even if the announced tariffs are enacted as Trump has proposed, they would only have a small impact of overall U.S. tariff rates. One analysis from French bank Societe Generale showed the latest tariff increases would only raise the U.S. effective tariff rate to 2.0%.

The Treasury Department expects the budget deficit to hit $1.0 trillion in 2020, due primarily to tax cuts and higher government spending.

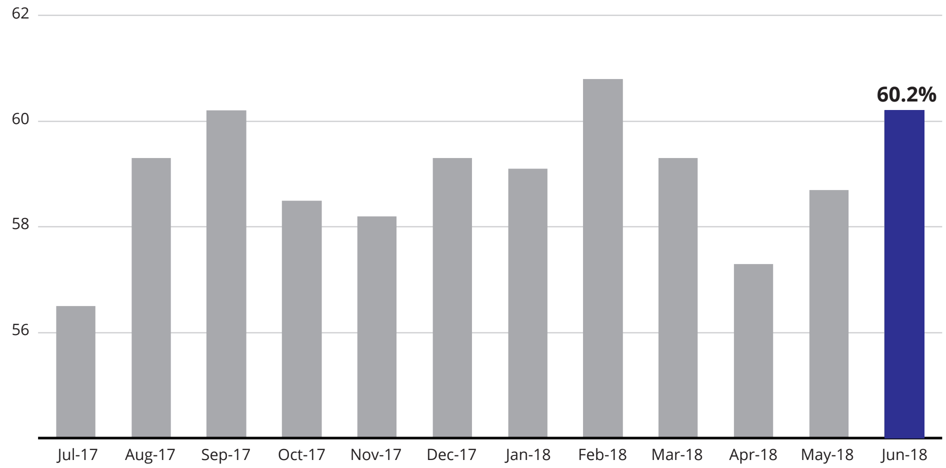
My biggest concern, and one that bears watching going forward, is the expanding U.S. budget deficit. So far through the U.S. government's current fiscal year (eight months), the deficit has grown to $532 billion. That's almost 25% higher than the $432 billion deficit from the previous fiscal year and the widest chasm between federal receipts and expenditures since May 2009. Perhaps more ominously, the Treasury Department expects the budget deficit to hit $1.0 trillion in 2020, due primarily to tax cuts and higher government spending.

President Trump and his team believe the U.S. economy can grow its way to fiscal balance. The early signs from the stimulus packages are hopeful, and we may soon get a surge in economic growth that will push the U.S. economy further along. But there's also the risk that we are just pushing an insurmountable problem down the road, for other generations of workers and investors to deal with. Right now, it's full steam ahead on the open seas. But as prudent investors, our job is to watch for signs of trouble on the horizon.

Economy

Behind the strong numbers on economic growth and employment, other indicators also showed improvement that point to an overall healthy U.S. economy. Confident consumers went shopping in May and pushed retail sales to their highest monthly gain since November last year. The robust job market and wage gains has also kept consumer confidence above its long-term average through the 2nd Quarter. There were also bright spots in manufacturing; the Institute for Supply Management (ISM) reported growth across all industry sectors in June as its Manufacturing Index beat analyst expectations. (See Chart 1 below.) The ISM report also noted increasing concerns among manufacturers about the potential impacts from tariffs. Additionally, shortages of skilled labor and truck drivers extended supplier delivery times.

Chart 1: Institute for Supply Management Purchasing Managers Index (PMI)



Source for chart data: Institute for Supply Management

In oil markets, the per-barrel crude oil price (WTI) climbed above $70 in Q2, while Brent crude briefly rose above $80 per barrel during the quarter. An OPEC agreement to limit production contributed to some of this price increase, but a U.S. supply squeeze, geopolitical tensions with Iran, and strength in the U.S. economy also played a role in boosting energy prices.

Equities

U.S. stocks rebounded in Q2 after a rocky start to the year. The S&P 500 Index gained 3.4% for the quarter and is now up 2.6% for the year-to-date through June 30, 2018. The narrower Dow Jones Industrial Average, composed of just 30 bell weather U.S. stocks, eked out a smaller quarterly gain of 1.2% and remains down for the year (if just at a -0.7% return.)

Fears of tariffs and trade wars hampered the progress of these large-cap indices; bigger firms are at greater risk from potential trade disputes, as a greater share of their revenues come from international markets than smaller firms. These concerns showed up in the Q2 sector returns: industrials, financials and consumer staples underperformed the broad market, while technology and consumer discretionary stocks soared. Energy companies enjoyed the best quarterly performance, riding the wave of rising oil prices. (See Chart 2 on the following page.)

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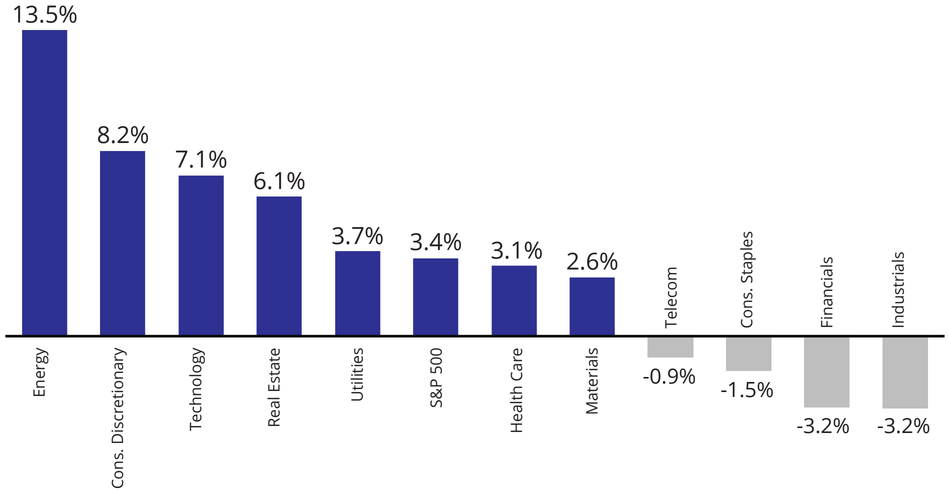
Chart 2: 2nd Quarter 2018 returns for S&P 500 sectors



Source for chart data: S&P Dow Iones Indices

Bonds

While the Federal Reserve raised its target rate in June and pushed short-term yields higher, yields on the long end of the bond spectrum stayed relatively flat during the 2nd Quarter. The benchmark 10-year U.S. Treasury yield ended the period at 2.86%, just slightly above where it began the quarter. Long-term bond yields did rise through April and into May, even breaking above the theoretical 3.0% barrier. But perhaps more critically, the yield curve continued to flatten as the difference between 10-year and 2-year Treasury rates narrowed. The spread between 2-year and 10-year yields is now at its lowest point since before the Great Recession and the start of monetary policy easing. (See Chart 3 below.) The shape of the yield curve is important for investors to watch, because an inverted curve has preceded all U.S. recessions since World War II. However, just because the yield curve gets flatter doesn't mean it will invert. It does bear watching, especially if the pace of interest rate increases ramps up.

Chart 3: Difference (spread) between 10-year and 2-year U.S. Treasury yields

Source for chart data: Federal Reserve Bank of St. Louis, FRED data

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In the corporate market, yields on investment-grade bonds rose and values fell for the second quarter in a row—the first time that has happened since the global financial crisis. The rise in interest rates deserves some of the blame, but the knock-on effects of repatriation may also be at work; some of the companies with the biggest overseas cash hordes had kept their foreign profits in U.S. corporate debt. Now that this money can return to the U.S. at a preferred tax rate, demand for corporate issues from these once reliable buyers is bound to decrease.

Outlook

Now that expectations for faster economic growth have been elevated, it will be up to the economy to deliver. We would expect to see some lift in GDP growth from the ongoing effects of fiscal stimulus—lower corporate tax rates and the repatriation of overseas profits. Perhaps some tempering of these expectations would be wise. The outcome of the tariff and trade disputes is up in the air, and lately this uncertainty has constrained investor optimism. The strength of fiscal stimulus may ultimately outweigh whatever adverse effects tariffs will have on the broader U.S. economy, and that will help sustain corporate earnings growth and the ongoing bull market for equities. Also, it seems we are closer than we have been in a while to seeing inflation hit the Fed's target level. Therefore, we're also more likely to see higher interest rates moving forward. Both higher energy costs and higher borrowing costs are bound to impact consumers and businesses. Will the U.S. economy be strong enough to withstand these pressures? That will remain to be seen in the next few quarters.