

Turning the Page

Q1 2018 COMMENTARY

That the market did so well in 2017 doesn't guarantee that 2018 will be a repeat ... investors must maintain realistic expectations and remain vigilant for developments that may impact the markets in the months and quarters ahead.

Highlights

- While there are concerns that the bitcoin market could become a material source of volatility, bitcoin billionaires argue it is a distinctly non-correlated asset class that provides "alpha."
- The first quarter of 2018 should enjoy stronger growth as capital spending by companies continues to expand, and as global growth supports U.S. exports.
- The prospects for tax reform and scaled-back regulations have spurred U.S. corporate and consumer confidence. As a result, mergers and acquisitions should gain pace in 2018.
- Although projections for rate hikes include three moves in 2018 and two in 2019, much depends on the effects of tax reform and possible increase of infrastructure spending.
- Chinese growth, while still solid, could slow as the authorities restrain government spending and place tighter controls on bank and online lending.

Q4 LOOKBACK

The last quarter of 2017 was filled with the now-familiar headlines warning of impending doom for markets. The "Hindenburg Omen" was back, along with an equally foreboding "Titanic Syndrome," both sell signals suggesting that the market's underpinnings were resembling 1999 and 2007, just before major sell-offs. Geopolitical worries, too, continued to hover over markets.

Still, global markets climbed higher toward the end of 2017 thanks in large part to stronger earnings, strong credit markets, economic growth gaining strength, positive leading indicators, accommodative central banks and the potential for a U.S. tax reform package that should substantially lower corporate taxes. In other words, the sort of backdrop that provides the catalysts for markets to power ahead and demonstrate resilience.

However, even the most optimistic analysts question whether markets are priced for perfection and poised for the kind of pullback that burns off enough froth to provide for more rational valuations. Pullbacks have been nearly non-existent, save for a couple of days in which the technology sector worried itself over the negative implications of a possible tax provision.

That the market did so well in 2017 doesn't guarantee that 2018 will be a repeat of the conditions that afforded such strong performance. Circumstances change and events intervene. Therefore, as we turn the page to 2018, investors must maintain realistic expectations and remain vigilant for developments that may impact the markets in the months and quarters ahead.



THE FUTURE(S) OF BITCOIN

And then there was Bitcoin—a cryptocurrency, “mined” by prospectors using high-powered computers to solve increasingly complex mathematical equations. Those who dared to criticize the legitimacy of bitcoin, or cryptocurrencies in general, were deemed latter-day Luddites, who weren’t smart enough to embrace not just the trend, but the future itself.

Bitcoin futures have begun trading as we enter the new year, and a number of exchanges are planning to provide trading platforms. Traders will be able to leverage their bets, adding to concerns that the bitcoin market could become a material source of volatility.

The Futures Industry Association, a global organization of commodities brokers, has publicly questioned whether there’s been enough consideration regarding the volatility associated with the cryptocurrency market. In addition, there are concerns regarding overall risk, stress testing and limits on trading the currencies. According to a spokeswoman for the organization, “The industry doesn’t feel that it necessarily had the opportunity to discuss the potential impact and that the proper safeguards have been put in place before the launch of the instruments. We’re agnostic about the product. It really is the process we’re focused on here.”

As with bitcoin or any other asset that moves dramatically higher, investors worry about the inevitable fall. With the ability now for traders to short bitcoin, coupled with the leverage that can be incorporated in trading, any volatility can be magnified. As with any potential volatility, market participants always fear collateral damage caused by a pullback.

Meanwhile, bitcoin millionaires—indeed billionaires—scoff at any concerns. They view bitcoin from a more fundamental perspective, explaining that it, along with the burgeoning asset class of cryptocurrencies, is a distinctly non-correlated asset class that provides the “alpha” that’s needed for portfolios. To invoke a term emblematic of the dot-com era, this is to bitcoin adherents the “new paradigm.”

THE U.S. ECONOMIC BACKDROP

One of the most important changes during 2017 was the series of positive economic surprises, both in the U.S. and internationally. The Citigroup U.S. Economic Surprise Index, a barometer of how economic data releases have missed or beat consensus estimates, is almost at its highest level since the beginning of 2014.

The U.S. economy saw growth climb into the 3 percent range during the second and third quarters, and expectations are that the fourth quarter of 2017 will also have a gross domestic product above 3 percent. The first quarter of 2018 should also enjoy stronger growth as capital spending by companies continues to expand, and as global growth, coupled with a still competitive U.S. dollar, supports U.S. exports.

Manufacturing gained strength across the country. According

to the U.S. Bureau of Labor Statistics, 12.4 million Americans are working in manufacturing, an increase of 25,000 jobs from 2016, and nearly 1 million from 2010. Compared with 1980, however, nearly 6 million jobs have been lost. Many jobs in manufacturing are being created because positions are being “reshored,” coming back to the U.S. primarily from China, where wages have been rising steadily. In addition, automotive jobs have been “reshored” from Germany, Japan and Mexico over the last six years. The place of robots in the manufacturing equation has garnered attention as the price for robots has declined and more companies become automated. Still, projections are that for 2018, manufacturing and manufacturing hiring continue to gain momentum.

The prospects for tax reform, along with a scaling back of regulations, have helped spur corporate and consumer confidence. As a result, mergers and acquisitions should continue to gain pace in 2018.

Employment continues to expand, with the unemployment rate ticking down to 4.1 percent, suggesting a tightening labor market. The previous lowest unemployment rate was 3.9 percent at the end of 2000. The hiring index for The National Federation of Independent Business reached an all-time high at the end of 2017. Among college graduates, the jobless rate is 2.1 percent, while the jobless rate for those adults who haven’t graduated from high school is moving lower from 6.5 percent in September to 5.2 percent in November 2017.

Wage gains, while modest in 2017, and up 2.5 percent in November compared with a year earlier, are poised to move higher as competition for workers heats up and the economy continues to expand. According to the Business Roundtable, an industry group composed of the largest U.S. corporations, wages in the fourth quarter of 2017 were their largest costs.

Stronger growth internationally, and still highly accommodative central bank policies, have helped foster a synchronized global recovery. The prospects for tax reform, along with a scaling back of regulations, have helped spur corporate and consumer confidence. As a result, mergers and acquisitions should continue to gain pace in 2018, as nearly every sector appears ripe for a deal. And the deals are getting larger in each sector, ranging from the \$69 billion CVS deal with Aetna, to the deal announcement between Disney and most of Fox. Then there’s Broadcom’s \$105 billion bid for Qualcomm, a takeover attempt which will continue into 2018.

President Donald Trump has declared that plans for infrastructure spending will be announced in January as he continues to build out the growth agenda touted during the presidential campaign. Industrials, materials, industrial commodities and the subsectors associated with infrastructure spending should be the primary beneficiaries of any infrastructure program introduced in 2018.

THE FEDERAL RESERVE'S PATH TOWARDS NORMALIZATION AND BEYOND

With fiscal stimulus being introduced, concerns are mounting that the economy could expand at a significantly more rapid pace, pushing long dormant inflationary pressures higher. For the Federal Reserve, it could mean more rate hikes in 2018 than is currently being discounted by the market.

In her last press conference in mid-December, outgoing Fed Chair Janet Yellen, following the fifth rate hike since the financial crisis, said, "At the moment the U.S. economy is performing well. The growth that we're seeing, it's not based on ... unsustainable buildup of debt." She added that "the global economy is doing well. We're in a synchronized expansion. This is the first time in many years we've seen this."

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The Wall Street Journal

Although updated projections for rate hikes by the Federal Open Market Committee (FOMC) include three moves in 2018 and two in 2019, in reality much depends on the economic and inflationary effects of tax reform and possible increase of infrastructure spending over the next few years. Also, the composition of the FOMC may prove to be more hawkish than the dovish tilt of the current board.

As *The Wall Street Journal* editorial page observed recently, "The challenge for [new Fed Chair Jerome Powell] and the Fed will come if their forecasts are wrong and they are underestimating the growth effects of tax reform, deregulation and the rest of the Trump-Congress policy mix."

Interestingly, the same editorial warned that if unwinding the "unprecedented buildup" of the Fed's balance sheet contributed to "artificially inflated asset prices, then the unwinding could be bumpy."

THE INTERNATIONAL BACKDROP

Just as data in the U.S. began marching higher during the second half of 2017, the global landscape similarly began to see clear signs of optimism. Corporate spending on capital equipment ("capex") and infrastructure projects indicated that confidence in the viability of the recovery was taking hold. Moreover, capex spending benefits from the gains of a virtuous circle. As growth prospects and confidence improves, stock prices climb higher, which reinforces confidence, followed by a pickup in investment.

In 2017, economic growth expectations began to gain traction abroad, including the eurozone, Japan and emerging markets,

particularly in Asia. In early 2018, markets should benefit from stronger trade dynamics as the capex cycle continues to underpin growth. Eurozone economic forecasts are steadily being revised higher as German and French data indicate stronger growth. The region is seeing improving industrial production along with rising business confidence.

European Central Bank (ECB) President Mario Draghi raised estimates for eurozone GDP to 2.3 percent in 2018, in addition to revising language on economic slack in the region. At the ECB press conference in mid-December Draghi said that the ECB expects a "significant reduction of economic slack" in 2018.

In Japan, GDP is being revised up to 2 percent as domestic demand grows along with exports. Consumer confidence continues to improve as the effects of "Abenomics" are felt across the economy. Prime Minister Shinz Abe is focused on the kind of difficult structural reform that modernizes the Japanese economy particularly in terms of the labor market. Wages are beginning to show signs of creeping higher, something that has been missing for decades as Japan has tried again and again to induce inflation into the country's collective psyche.

Projections for China's growth varies as the Chinese leadership continues to focus on the transition from a heavy manufacturing framework to a more consumer-driven economic base. At the 2017 National Congress of the Communist Party, China's President Xi Jinping stressed during his three-hour speech that the direction of the country's expansion must focus on structural reforms that mitigate financial risks, reduce pollution and provide an economic environment that minimizes the income gap. Missing from his comments were the stark pledges and targets set in the 2012 speech of his predecessor, President Hu Jintao, who called for China to "double its 2010 gross domestic product and per capita income for both urban and rural residents." Rather, Xi called for a "new socialism with Chinese characteristics."

Transitioning the economy could allow the Chinese leadership to focus on an older theme of "quality over quantity," while at the same time giving Beijing the time to sort out the structural and economic imbalances, risks and speculation so closely associated with the years of rapid growth. While market forces are being integrated into their financial infrastructure, authorities want enough regulation to avoid the kind of leverage that brought about the 2008 global financial collapse.

A particularly interesting and curious warning about asset bubbles came from the head of the People's Bank of China, Zhou Xiaochuan, when he referred to the danger of a "Minsky moment." That's the moment asset prices collapse following a period that had encouraged excessive risk-taking. China's high debt burden unequivocally needs reform and is often mentioned as a potential risk for global markets, and not just within China. While no one expects that President Xi has read

the seminal works on financial instability by the late economist Hyman Minsky—who counts Bill Gross and Paul McCulley, who coined the term “Minsky moment,” as devotees—Minsky’s main thesis is inextricably associated with financial collapse, and certainly Xi understands the implications for China. No doubt, curbing risk will be a key component of China’s five-year plan.

China will continue to focus on moving up the value-added chain as it supports its own companies gaining global stature and brand recognition. Global technology names, for example, more frequently are part of the Chinese push towards building status and prowess. Electric vehicle manufacturing is an area in which China seeks to dominate with regard to the technology involved, as well as exports.

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Chinese growth, however, while still solid, could slow as the authorities restrain government spending and place tighter controls on bank and online lending. During the National Congress, President Xi made a point of addressing the excesses and rampant speculation in housing when he said, “Houses are built to be inhabited, not for speculation.” An automobile sales tax is expected to increase. The global commodities markets, and emerging markets with close trading ties to China, are especially sensitive to any changes that may actually be implemented to slow growth.

At the end of 2017, Chinese economic data are in fact surprising to the upside. As the world’s second largest economy, investors globally are watching to see how far Chinese leaders are prepared to allow their economy to soften, if at all. It is still said that when the U.S. catches a cold, the rest of the world sneezes. A slow-growing China, at the very least, will certainly give the world a headache.

References include the following: *Barron’s*, *Bloomberg*, *Cornerstone Macro*, *CNBC*, *The Economist*, *The Federal Reserve*, *Financial Times*, *Goldman Sachs*, *ISI Evercore Research*, *MarketWatch*, *Morgan Stanley*, *The New York Times*, *Recode*, *Renaissance Macro Research* and *The Wall Street Journal*

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Q1 2018 LOOK AHEAD – WILL IT BE A REPEAT OR A RHYME OF 2017?

As the first quarter begins, the same catalysts that underpinned the market at the end of 2017 are still in play: an acceleration of synchronized global recovery, strong business confidence and equally strong consumer confidence, mergers and acquisitions. However, volatility can rear its head at any moment with geopolitical risks still hovering over the market and political dysfunction in Washington gripping the headlines. There may even be fear of a too-strong global economy, as analysts get nervous that central banks will continue tightening and raise interest rates globally.

Daniel Franklin, the editor of *The Economist’s* “The World in 2018,” said, “It will be a critical year on many fronts, including North Korea’s nuclear challenge, the Brexit negotiations, China’s economic reforms and America’s mid-term elections as well as the presidential polls in Brazil and Mexico. We will see intriguing battles for influence, ideas and leadership.” In fact, we could add to this list just as we can create a lengthy list for the proverbial “Wall of Worry” that greets the market each and every trading session.

Resilient and healthy markets look for growth and earnings in a wide spectrum of sectors. Resilient and healthy markets look for opportunities. And resilient and healthy markets are able to look past headlines, both real and fake.

Above all, resilient and healthy markets provide investors with multiple entry points after they sell off 2 percent, 10 percent or 12 percent. Investors have forgotten that markets, in many different ways, “self-regulate” by rotating from sector to sector (as they did during the last quarter) or they sell off in a “sell first, ask questions later” mode.

Either way, the markets invite investors and traders back in based on the fundamentals that matter the most—the bottom line and the top line, that is, earnings. We turn the page from one quarter from another to one year to another—but that doesn’t mean the theme has changed.