INVESTMENT STRATEGY OUTLOOK

REGIONS
ASSET MANAGEMENT

THE ECONOMY

March 2018

There's Good News and There's Bad News

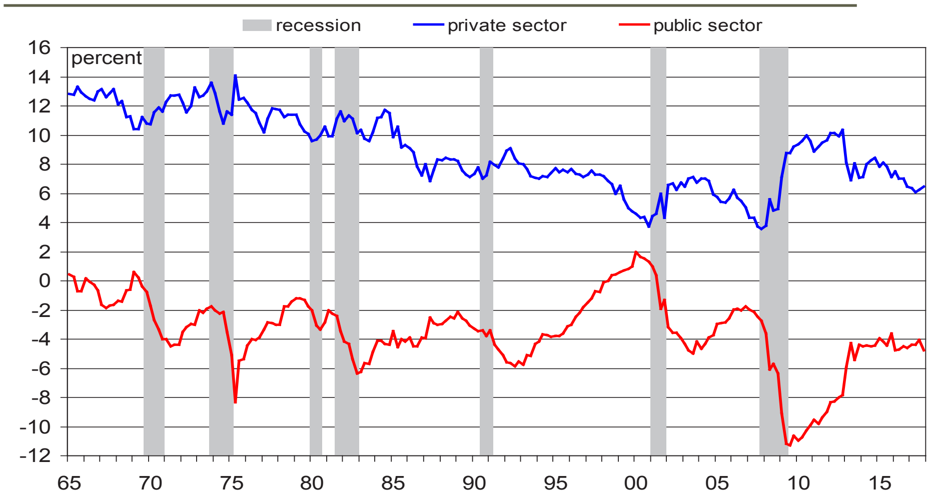
When faced with a good news/bad news scenario and given the choice, our preference is always to take the bad news first and save the good news for last. After all, it's hard to enjoy good news knowing there is bad news to follow, so better to deal with the bad then enjoy the good. Being the bearer of the news in this instance, we're going to proceed in the opposite order, though anyone who does want the bad news first is welcome to skip ahead then circle back.

In any event, between the tax bill enacted in late-2017 and the federal government spending bill enacted last month, the U.S. economy will see a significant degree of fiscal stimulus this year and next. Our baseline forecast anticipates that, on net, fiscal stimulus will add around six-tenths of a point to top-line real GDP growth in both 2018 and 2019. So, the good news is that the U.S. economy now has the fiscal policy it should have had a decade ago. There are some who question whether this is appropriate given the current economic expansion is now in its ninth year and the economy is closing in on full employment. Be that as it may, the reality is that fiscal stimulus is poised to spark a significant late-cycle acceleration in the economy's growth rate.

The bad news is that when the kick to growth fades, which will begin in 2020 if not late-2019, the costs will be with us for some time to come. Think of it as going on a holiday season shopping binge financed with credit cards, only on a ginormous scale. In other words, the magnitude of the fiscal stimulus to be delivered this year and next means already large federal government budget deficits figure to get larger over coming years. To be sure, to the extent the tax bill adds to the economy's sustainable growth rate, that would mitigate the impact on the deficit but, even in the most optimistic case, i.e., the tax cuts pay for themselves, the added government spending this year and next (if not longer) will add to the size of the deficits.

If so, dissaving in the government sector will be an increasing drag on private sector saving, i.e., combined household and business saving. While considerable attention is given to the saving rate in the household sector, this is only one part of the bigger picture, and the total level of saving in any economy is what matters because, in any economy, the aggregate level of investment must equal the aggregate level of saving. In a closed economy, dissaving in one or more sectors must be offset by saving in the remaining sector(s) to maintain a given level of investment, while in an open economy foreign saving can compensate for insufficient domestic saving.

Domestic Saving, % Of GDP



Source: Bureau of Economic Analysis; Federal Reserve

This matters because investment is the key fuel of any economy's growth over time. In the U.S., the domestic saving rate, or, total domestic saving as a percentage of GDP, stood at just 1.74 percent as of Q4 2017, well below historical norms. This reflects a household saving rate of 1.97 percent, a corporate (net) saving rate of 4.52 percent, and a government (combined local, state, and federal) saving rate of negative 4.75 percent. Note that the government sector saving rate does not yet reflect the tax cuts and increased spending, and even if the household saving rate rises as we think it will, the domestic saving rate could easily fall further over coming quarters. If so, this will leave the U.S. with two options.

One option is to embark on a path of steadily lower levels of investment spending, which implies a lower "speed limit" (our term for the economy's sustainable rate of noninflationary growth). The other option is to attract even higher levels of foreign saving. The U.S. has relied heavily on foreign saving over recent decades to compensate for declining domestic saving. It is often neglected in discussions on trade, but the reality is that the flip side to a trade deficit is a surplus in the capital account. One key reason the U.S. has been such a magnet for foreign capital is that the U.S. dollar is effectively the world's reserve currency, so that dollars accumulated by foreigners in the trade of goods and services have basically been "recycled" into demand for U.S. dollar denominated assets.

To the extent federal government budget deficits do become larger over coming years, in the absence of a corresponding increase in domestic saving the U.S. will need to attract even greater levels of foreign savings in order to finance a given level of investment. Doing so, however, will become more costly, i.e., it will take higher U.S. interest rates to attract higher levels of foreign savings. Though no such move is now in the offing, one downside risk is that there could come a time when there is a viable alternative to the U.S. dollar as the world's main reserve currency, which would make attracting foreign saving into the U.S. more difficult, i.e., more costly. Instead of an alarmist rant, this is hopefully taken as a reminder that the U.S. has been, and remains, highly dependent on foreign capital to finance both current consumption and future growth. That of course can go on until it can't, a time that can come abruptly and without advance notice.

We'll close by noting that the FOMC is widely expected to approve a 25-basis point hike in the Fed funds rate at their March 20-21 meeting. The main uncertainty surrounding this month's meeting is whether the updated "dot plot" will imply three or four such hikes for 2018 – the December 2017 dot plot implied three 25-basis point hikes. We do not see that changing in March, but it will at some point this year if wage growth and inflation accelerate faster than the FOMC anticipates.▲

STOCKS

Buybacks Buoy Stocks

February was quite a month for equity investors as the first bout of significant volatility since mid-2016 arrived, sending market neophytes and half-hearted bulls jockeying to see who could find the exit first. The S&P 500 opened February trading at 2,823, before moving in a straight line lower to 2,532 on February 9 – all told a 10.3% decline over just 7 trading days. Ultimately, the S&P 500 closed down 3.7% on a total return basis for the month, ending an incredible winning streak in which the S&P 500 generated a positive total return in 15 consecutive calendar months. After broad-based strength throughout 2017, sector and stock leadership have narrowed over the past month, but with secular growth and economically sensitive names continuing to lead the pack, it's difficult to get too bearish at this juncture. As we've grown accustomed to over the past year, information technology was the standout performer during the month, falling just 0.1% in price. After doubling the total return of the S&P 500 since the start of 2017, the information technology sector now accounts for over 25% of the Index, the largest weight it has carried since 2000. Along with information technology, consumer discretionary and financial services were the only other S&P 500 sectors to outperform during February. Notably, the energy sector was the biggest loser, falling 11.3% during the month, despite crude oil prices holding above $60 per barrel, backing-off just 4.7% from the end of January through month-end.

There were some $41.1B in withdrawals from domestic equity funds - ETF's and mutual funds – in February according to TrimTabs data, with the majority of outflows occurring over the first week of the month. Global equity funds were beneficiaries of U.S. outflows, taking in $17.9B. Corporations took advantage of the equity correction by stepping in to repurchase their own stock to the tune of $151.1B, an all-time monthly record based on data from TrimTabs. How much of the total was already set to be deployed through February versus repurchase programs that were accelerated due to the pullback in stocks is unknown. The prospect of corporate buyback activity stepping up on market dips, with potentially much, much more on the horizon as tax reform benefits boost corporate confidence, could weigh heavily in the decision-making process of those looking to either trim positions or outright short stocks. The additional cash windfall from the passage of corporate tax reform in December has led Goldman Sachs to surmise that share buyback activity could surpass the $650B mark for the full-year 2018 – a buyback wave we have little desire to dog paddle against.

Corporate coffers have been flush for some time as hard-learned and not easily forgotten lessons from the financial crisis led management teams to hoard cash, while playing more defense than offense. But times have changed, and as the economic expansion rolls on, investors expect C-suites to chart a path for growth as well as return excess capital to shareholders – it's no longer an either/or decision. Buyback activity and dividend hikes may have garnered the lion's share of capital allocation plans over the past decade, but 2018 could finally be the year we see the baton passed to capital expenditures and M&A activity to lead the next leg higher in this protracted equity bull market. Corporations have to state their intentions to be both opportunistic and disciplined with regard to share buybacks and M&A, but it's very possible that a free-for-all materializes in select pockets of the market as prized targets operating in fast-growing sectors/industries are bought, forcing companies to pay-up, or risk becoming acquisition targets themselves. We remain bullish on equities given ample liquidity and burgeoning corporate confidence.▲

Source: Bloomberg, Factset, TrimTabs, Goldman Sachs

BONDS

A Herculean Task

It's been a rough start to the year for bond investors as yields on sovereign bonds have jumped higher on the heels of a reset of sorts for inflation expectations and the potential for global economic growth to persist or accelerate. Year-to-date through February, the Bloomberg Barclays U.S. Treasury Index declined 2.1%, while the broader Bloomberg Barclays Aggregate Bond Index didn't fare much better, falling 2.0% over the same time period. The Bloomberg Barclays U.S. Corporate Index, an index of investment-grade corporate bonds, fell 2.5% through February, while its below-investment-grade counterpart, the Bloomberg Barclays U.S. Corporate High Yield Index, declined only 0.26%. Credit spreads throughout early February's sell-off in global equity markets remained largely in-check, displaying few signs of system-wide stress as the prototypical flight-to-safety trade that often manifests itself as investors flock into Treasury bonds during spikes in equity market volatility failed to materialize.

While it's been no easy task to find anything across the fixed income landscape that has posted a positive absolute return year-to-date, there have been a couple of pockets that have weathered the storm better than most. Foreign unhedged bonds, i.e. exposed to foreign currency fluctuations, have held up quite well, as evidenced by the Bloomberg Barclays Global Aggregate (Global Agg) Bond Index's 0.29% year-to-date total return through February. U.S. bonds account for 37% of the Global Agg, while Japan, France, Britain, Germany and Italy combined total just over 38%. Currency exposures have played no small part in the relative outperformance of the Global Agg as the Index has posted a total return of 7.7%, while the Bloomberg Barclays Aggregate Bond Index – 91% U.S. bonds - has returned just 1.4% since the start of 2017. The Bloomberg U.S. Dollar Spot Index is down 10.4% over this time.

Floating rate notes have performed relatively well year-to-date. These are loans priced off of LIBOR (London Interbank Offered Rate). LIBOR is loosely tied to the fed funds rate as select banks in the U.S. – and abroad as well - supply a rate each morning at which they would lend to other banks. Floating rate notes often carry a yield tied to 90-day LIBOR plus 2%-3%, and the rate typically resets quarterly. Many of these loans are callable at par value as of a pre-specified date. While floating rate notes can play a complementary role in fixed income portfolios, at this point they come with risks that shouldn't be ignored. The asset class has experienced sizable inflows, and rising demand has driven prices in many cases above par value, setting up an adverse scenario for investors should companies elect to call these loans back at par. Floating rate can have its place in a diversified portfolio, but right-sizing exposure and selecting an active manager capable of navigating the space is crucial to achieving a desirable outcome.

Our base case remains that global interest rates will rise throughout 2018, and that the U.S. dollar will remain range-bound around current levels, but with a downward bias as growth abroad outpaces that of the U.S. Recent portfolio shifts have focused on increasing allocations to managers with expertise investing in niche areas, specifically structured products, i.e. asset-backed securities such as mortgages or credit card receivables, and emerging market debt. It will be a challenge to eke out a positive total return from fixed income this year given central bank policy normalization and a low starting point for interest rates, but there are still pockets of relative value out there for those looking. ▲

Source: Bloomberg, Factset