INVESTMENT STRATEGY OUTLOOK

REGIONS ASSET MANAGEMENT

THE ECONOMY

August 2018

"Strong" Is The (FOMC's) Word For The U.S. Economy

As expected, the FOMC left the Fed funds rate target range unchanged at their meeting which concluded on August 1. In their post-meeting statement, however, the Committee teed up a September rate hike with the use of the word "strong" (or a derivative thereof) six times to characterize the labor market and the broader economy. We'd find it hard to argue with that characterization, even if the headlines on some of the latest data releases suggest otherwise.

There can be little debate that "strong" is the proper description of Q2 real GDP growth. The Bureau of Economic Analysis' (BEA) initial estimate puts Q2 real GDP growth at an annualized rate of 4.1 percent, with consumer spending and net exports the main drivers of growth. The initial Q2 release incorporates the BEA's comprehensive revisions to the historical GDP data and also introduces methodological changes aimed at better measurement of certain components of GDP. On the whole, while there were changes in quarterly growth patterns, the revised GDP data do not change the broader view of the U.S. economy – average quarterly GDP growth over the Q3 2009-Q1 2018 period remains at 2.2 percent.

One notable element of the revisions to the GDP data is that the personal saving rate is now shown to be considerably higher than had previously been reported. For instance, prior to the revisions, the personal saving rate for Q1 2018 was reported to be 3.3 percent, but the revised data put the saving rate at 7.2 percent. A slight downward revision to growth in consumer spending played a modest role, but the upward revision in the saving rate is almost entirely accounted for by upward revisions to two components of personal income – nonfarm proprietors' income and dividend income. As such, the higher reported saving rate says little, if anything, about the financial wherewithal of the vast majority of households.

With the initial Q2 release, the BEA also introduced a new series on not seasonally adjusted GDP. One benefit of this is that the raw data will help us better assess the extent to which residual seasonality remains an issue in the GDP data. Of more significance, however, is that the not seasonally adjusted data offer a much cleaner view of the economy's underlying trend rate of growth, best seen in the year-on-year percentage change rather than in the annualized rates of change from quarter to quarter. As illustrated in the accompanying chart, year-on-year growth has clearly accelerated, with Q2 nominal GDP growth the fastest of the current expansion and Q1 and Q2 real GDP growth (3.3 percent) bettered only by growth in Q2 2015.

While we don't look for Q2's growth rate to be sustained, we do look for real GDP growth of around 3.0 percent over the second half of 2018. Some of the recently released higher frequency data, however, may inspire some doubts. For instance, total nonfarm employment rose by 157,000 jobs in July, well below expectations. The "miss" on July job growth, however, must be put in the context of sharp upward revisions to job growth over the previous two months. Prior estimates of job growth in May and June were revised higher by a net 59,000 jobs over the two-month period.

On the whole, the July employment report is more noise than signal. For instance, local government payrolls are reported to have fallen by 20,000 jobs in July, with 13,900 of these job losses coming in education. This is nothing more than noise reflecting the difficulty of seasonally adjusting the data for this segment given that the timing of the school year changes from year to year. Additionally, the closing of remaining Toys R Us stores took 31,800 jobs out of retail trade in July, which says more about the changing nature of retail trade than about the underlying health of the U.S. economy. The bottom line is that even with the "miss" in July, monthly job growth has averaged 201,000 jobs over the past 12 months, roughly double the number needed to absorb growth in the labor force.

Both the ISM Manufacturing Index and the ISM Non-Manufacturing Index fell in July, the latter hitting an 11-month low. In each case, however, the underlying details are more robust than implied by the headline index. Firms in both broad sectors continue to point to solid growth in demand, but report increasing transportation bottlenecks and difficulty in finding skilled labor. Still, even having fallen in July, the ISM indexes remain firmly in expansionary territory, where we expect them to stay over coming quarters.

Our view, which is supported by the ISM survey data, is that the demand side of the economy remains solid, which is to be expected given robust job growth and the high degree of fiscal stimulus coursing through the economy. The concerns, however, are on the supply side of the economy. Certain industry groups, mainly construction and transportation & warehousing, are facing pressing labor supply constraints. Firms in both the manufacturing and non-manufacturing sectors are contending with backlogs of unfilled orders that continue to grow, even if at a slightly slower pace of late. Tariffs are contributing to higher input costs and causing firms to rethink production schedules. The danger from these supply side constraints is that they will result in stepped-up inflation pressures, which in turn would impact the pace at which the FOMC raises the Fed funds rate.

Still, though fully cognizant of the downside risks, we expect real GDP growth of around 3.0 percent over the back half of 2018. Our view is that the economy's underlying momentum combined with the high degree of fiscal stimulus will more than offset any potential disruptions from trade policy over the remainder of this year. Our worries are more concentrated on the supply side of the economy, which we see as more of an issue for 2019 than for 2018. ▲

Source: BEA, BLS, ISM

No Matter How You Measure It, Growth Has Accelerated

Source: Bureau of Economic Analysis; Regions Economic Division

STOCKS

Overcrowding and Opportunity

Through the end of July, nearly 65% of S&P 500 companies have reported quarterly results with 75% topping the consensus estimate for sales and 78% besting the consensus earnings per share (EPS) estimate. While results overall have been encouraging, Mr. Market, however, has presented us with updated versions of a few classic, albeit painful cautionary tales - "Sometimes good just isn't good enough", and "Crowded trades rarely, if ever, end well." Entering this earnings season, the consensus estimate called for the information technology (IT) sector to generate 20.8% EPS growth over the same period last year; with 64% of the IT sector having reported at month-end, EPS growth has surprised to the upside, rising 25.6%. But that hasn't prevented the IT sector from undergoing a bout of weakness, falling 5% from its year-to-date high over the last four trading days of July amid high profile missteps out of a couple of FAANG names, specifically the "F" and the "N" - Facebook and Netflix.

FAANG sell-offs on earnings have been a rarity, and short-lived when they have occurred, as investors have often written them off as transitory, while continuing to buy focusing on the big picture and long-term potential. With great expectations comes the potential for spectacular failure when those expectations aren't achieved, and some notable technology names appear to have entered earnings season priced for perfection. With technology carrying around a 26% weight in the S&P 500, history tells us we're likely due for some sector rotation and for traditional value names to potentially play catch-up. The herd moved headlong into information technology but now appears quite eager to leave tech for "greener" pastures. Be careful to avoid throwing the baby out with the bathwater as opportunities within IT will undoubtedly present themselves to those with a discerning eye and dry powder.

Information technology's outperformance over the past few years has been driven by innovation and a willingness on the part of investors to pay-up for secular growth - a company's ability to grow sales and earnings independent of the economic backdrop. With 2nd quarter preliminary U.S. GDP coming in at 4.1%, and the consensus 3rd quarter GDP estimate topping 3% and trending upward, this may be the early innings of a long-awaited shift toward cyclical value sectors such as financial services, energy, and industrials, among others. It's still too early to tell if tech outflows will continue, but we're more inclined to skate to where the puck will be (cyclical sectors) than where it has been (information technology). We're not turning our back on technology, and we aren't tilting our portfolios to either growth or value, for now, but we are cognizant of a number of value-oriented sectors poised to potentially play catch-up should the trajectory of U.S. economic growth be maintained for a few more quarters.

Shifting gears, emerging market stocks came into 2018 as one of the trendiest ideas out there, but is a decidedly less crowded asset class currently than it was seven months ago. The emerging markets playbook says sell developing-markets stocks and bonds on rising interest rates and U.S. dollar (USD) appreciation, and that's exactly what investors have done, with the MSCI EM Index falling 6.1% year-to-date through July after rising 8.3% in January alone. U.S. dollar strength makes it more problematic for emerging countries to pay down dollar-denominated debt and make required interest payments. Many emerging economies have ample foreign exchange reserves this time around and are more capable of weathering additional U.S. dollar strength than in past instances. U.S. dollar strength is a counter-trend rally in our view, driven by capital inflows from abroad on global growth fears. A weakening dollar would be great for EM, but even a stable dollar would go a long way toward stemming the tide of capital outflows from emerging economies.▲

Source: Bloomberg

BONDS

Living on the Edge - Technically

The last week of July proved to be anything but calm across global interest rates, which took their cue from the Bank of Japan (BoJ) amid speculation that the body was poised to alter its monetary policy stance. The BoJ decided to introduce forward guidance and announced the yield on 10-year Japanese Government Bonds (JGBs) would be "allowed" to trade within a wider range, raising the cap to 0.20% from 0.10%. Immediately following the BoJ's announcement, the yield on 10-year JGBs fell to around 0.04% before making a parabolic move up to 0.13% the following day - the largest move since mid-2016. Markets appeared quite eager to test the BoJ's tolerance for allowing the yield to climb before it intervenes. News that the BoJ might alter its policy stance sent shockwaves throughout the global financial system. The yield on the 10-year U.S. Treasury bond spiked 7.5 basis points in one day to a 2-month high at 2.98%. The 10-year spent the entirety of June and all but the last four trading days of July mired between 2.75% and 2.95%. The U.S. 10-year yield closed out July at 2.96% but climbed to north of 3% for the first time since May amid a rise in global yields on the heels of the Bank of Japan's meeting.

The 3% threshold for the U.S. 10-year yield has been a psychologically important level, but appears less significant from a technical perspective, while 2.95% has been an important technical level and the top end of the 10-year yield range since mid-June. A sustained move above the 2.95% level on the 10-year yield could signal a new, higher range for the 10-year yield, while bringing the year-to-date high of 3.10% into play as the next "ceiling" to watch. Strong performance out of bank stocks over the last few weeks of July might prove to be the canary in the coal mine, potentially pointing toward a 10-year yield poised to make another run at 3.1%, and perhaps even 3.25% after a multi-month period of consolidation. While perfectly imperfect, as is most any methodology proclaiming to be a silver bullet when attempting to determine the short-term direction and magnitude of interest rate movements, technical levels can be a valuable process component and should be monitored. Breaks in key support and resistance levels can open the flood gates for bigger moves and validate or refute the current trend.

We continue to focus on diversification within fixed income portfolios, a common theme this year for us. Given our expectation that recent strength in the U.S. dollar is overdone, we would advocate for exposure to emerging market debt as weakness provides an attractive entry point into the space. Additionally, we continue to implement exposure to structured products across portfolios, although pockets of this area have become expensive since we initiated a position in the first quarter. "Value" in corporate credit remains difficult to find making active management crucial in our view when allocating to investment-grade corporates and high yield. Simply holding fixed income credit exposure via index-linked vehicles isn't advisable at this point. This is when a good active manager earns his or her fee.▲

Source: Bloomberg