INVESTMENT STRATEGY OUTLOOK

REGIONS ASSET MANAGEMENT

THE ECONOMY

July 2018

The U.S. Economy Keeps Humming Along

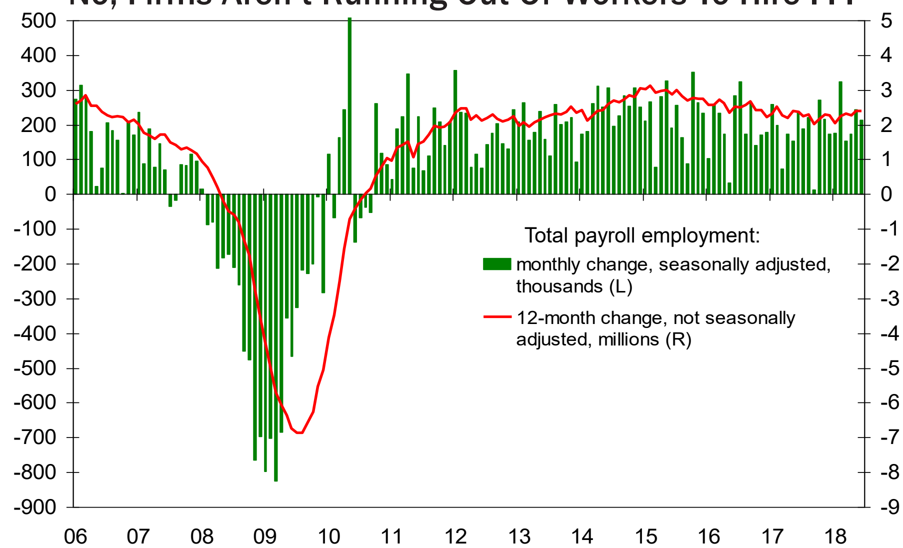
The BEA recently released their third estimate of Q1 GDP, which showed real GDP grew at an annualized rate of 2.0 percent in the opening quarter of 2018. Sure, we know what you're thinking – if that's an example of the economy humming along, it seriously needs to change its tune. Which is precisely what happened in Q2. Though the BEA won't release its initial estimate of Q2 GDP until July 27th, our tracking estimate puts real GDP growth above 4.0 percent for the quarter, and our forecast would see Q2 2018 real GDP growth go down as the fourth fastest quarterly growth rate in the life of the current expansion, now more than nine years old. Now that's what we call humming along.

The reality, however, is that neither Q1 or expected Q2 real GDP growth truly reflects the underlying health of the economy. We often caution that taking quarterly changes and annualizing them, as is done with the GDP data, tends to imply sharper swings than generally occur in a $20 trillion economy. Moreover, measured real GDP growth in Q1 of any given year is biased lower by the residual seasonality issue, which was again the case this year. To us, the year-on-year percentage change in real GDP is the best gauge of the economy's underlying growth rate, and through this lens we see that real GDP grew by 2.8 percent in Q1 and our forecast would put Q2 year-on-year growth at 3.1 percent – both considerably faster than the average rate of 1.9 percent seen from the start of the expansion through Q4 2017.

Total nonfarm employment rose by 213,000 jobs in June, marking the 93rd consecutive month of job growth, far and away the longest such streak on record. As has been the case over the life of the current expansion, job growth remained notably broad based in June. The hiring diffusion index, a measure of the breadth of hiring across private sector industry groups and our favorite beneath the headlines metric in the monthly employment reports, came in at 65.5 percent in June. True, the breadth of hiring doesn't tell us anything about the intensity of hiring, but over the past 12 months private sector payrolls have increased by an average of 196,000 jobs per month. That hiring remains this broad based and this robust this deep into an expansion should quash the notion that job growth is on the verge of running out of steam because firms "can't find any workers to hire," which we've always thought a ridiculous notion, yet one we hear repeated frequently.

The unemployment rate rose from 3.8 percent in May to 4.0 percent in June, reflecting a reported 601,000 person increase in the labor force that pushed the participation rate up to 62.9 percent. As a general rule, we don't put much stock in the month-to-month changes in the labor force, as this tends to be a highly volatile number, and June is no exception. We pay far more attention to the underlying data on labor force flows, which get far less attention than they deserve. Over 4.5 million people went from not in the labor force in May to being employed in June, a notably high number but in line with what we've seen over the past 15 months, and over 1.9 million people entered the labor force as unemployed in June, higher than the recent run rate but which in part reflects a sizeable inflow of summer job seekers entering the labor force in June. The broader point is that the data on labor force flows have for some time shown sizeable inflows into the labor force each month, which we've argued has acted as a brake on wage growth and will continue to do so.

No, Firms Aren't Running Out Of Workers To Hire . . .



Source: Bureau of Labor Statistics; Regions Economics Division

The manufacturing sector remains on quite a roll. Manufacturers added 36,000 jobs in June, meaning that manufacturers have added 285,000 jobs over the past 12 months, the highest such total since the 12 months ending with April 1998. The ISM Manufacturing Index rose to 60.2 percent in June; while this lofty reading is to some extent inflated by significantly slower supplier delivery times in June, allowing for this distortion shows continued strength in new orders and current production and further growth in backlogs of unfilled orders. Still, survey respondents indicated a considerable degree of concern over the impact of tariffs – those imposed by the U.S. and the retaliatory tariffs imposed by our trading partners – and there are already visible impacts in terms of higher input costs and shifts in production to foreign plants in order to avoid foreign tariffs imposed on goods produced in the U.S.

Several FOMC members have expressed concern over the potential impact of tariffs though, somewhat oddly, those concerns have focused on the growth aspect rather than the inflation aspect. Still, it seems highly unlikely that such concerns will alter the path of monetary policy. At least this year – the trade spats intensifying and running into 2019 and beyond would raise the likelihood of the FOMC acting on their concerns. For now, though, the "dot plot" released in conjunction with the June FOMC meeting implies a total of four 25-basis point hikes in the Fed funds rate in 2018 and three more like-sized hikes in 2019. Concerns over trade notwithstanding, in an economy growing at a well above-trend pace, thanks mainly to fiscal stimulus, the FOMC's main focus remains on inflation.

Recent months have seen considerable angst over trade wars, geopolitical tensions, diminishing monetary accommodation, and other factors that pose risks to the economic expansion. At this point, however, this has all been little more than background noise to a U.S. economy that keeps humming along. This could change, of course, but our view is that it will take much more than this to trigger a significant slowdown in an economy amped up on fiscal stimulus. ▲

Source: BEA; BLS, ISM

STOCKS

Riding The Storm Out

After displaying amazing resiliency through most of June, domestic equities sold-off late in the month amid ongoing trade rancor, another rate hike out of the Federal Open Market Committee (FOMC), and quarter-end portfolio rebalancing. The S&P 500 eked out a 0.48 percent return for the month, while the small-cap Russell 2000 did a bit better, posting a 0.58 percent return. Abroad, the MSCI All Country World (ACWI) ex US Index fell 1.88 percent and the MSCI Emerging Markets Index really took it on the chin, declining 4.57 percent. It's notable that the U.S. Dollar Index (DXY) rose around half of one percent during the month, so steep declines in foreign equity markets have likely been derived predominately from capital flows into U.S. assets, specifically Treasury bonds and money markets, amid this ongoing geopolitical uncertainty.

For the first time since the 2007-2009 Financial Crisis, cash appears to be a palatable alternative for investors looking to get away from the fray. Prior to the past few months, investor preference would likely have been to move into high yield bonds or even longer-dated Treasury bonds, but with the Fed funds rate climbing higher and the spread between the yield on 2-year and 10-year U.S. Treasury bonds compressing down to a cycle-low of 33 basis points, and with inflation showing nascent signs of life, investors aren't being properly incentivized to take on interest rate risk at the present time. The trailing 12-month yield on the S&P 500 is 1.93 percent; the current 2-year U.S. Treasury bond yield is 2.52 percent, and the 10-year U.S. Treasury yield sits at 2.85 percent. Not much of a competition between short-term bonds and stocks - if income and preserving purchasing power is your aim anyway.

Investors seeking to deploy capital into assets positively correlated to what looks and feels like a robust U.S. economic backdrop, i.e. stocks, are facing a dilemma unlike any other over the past decade. The revenue hit that multinational U.S. companies could potentially take should a protracted trade war materialize could be substantial and should not be underestimated, but it's also difficult to handicap negotiations as an about-face could easily turn the tide in a less detrimental direction. It's also difficult to ignore the relative attractiveness of clipping a 2.5 percent coupon from a 2-year U.S. Treasury bond while waiting for the trade dust to settle.

With the FOMC poised to pull short-term interest rates higher still over the coming quarters, expected returns on short-term Treasuries will rise, bolstering their appeal and providing greater competition for higher yielding equities. When looking to add exposure to risk assets, investors have shifted capital into domestically-focused small-cap stocks, providing desired exposure to the U.S. economy while leaving them potentially less susceptible to the international brouhaha. Small-caps will likely continue to garner investor capital over the coming months as rising short-term rates amid robust U.S. economic growth should lead to continued U.S. dollar strength, a positive backdrop, relatively speaking anyway, for domestically-focused companies.

2nd quarter earnings season begins in earnest over the coming weeks, with the consensus estimate projecting 20 percent year-over-year earnings per share (EPS) growth. With EPS expectations lofty, forward guidance and C-suite confidence, or the lack thereof, will tell the tale. A crisis of confidence from those with "Chief" in their title on earnings calls would weigh on capital expenditure plans and on expectations for share buybacks and dividend hikes. It will be worth monitoring those companies choosing to take the easy way out by lowering earnings guidance citing trade-related concerns as it's far too early to place the blame for a future earnings shortfall squarely on the shoulders of trade. Investors will respond with their capital, penalizing those unjustifiably lowering guidance. ▲

Source: Bloomberg

BONDS

Remaining Range-Bound

As noted previously, the FOMC dot plot released in the wake of the Committee's June 12-13 meeting highlighted an expectation among FOMC participants that a Fed funds rate target range midpoint of 2.375 percent at year-end would be "appropriate monetary policy." Interestingly, the median expectation among dot plot participants was that the Fed funds rate by year-end 2019 will need to be above the FOMC's own longer run median estimate for the neutral Fed funds rate. The FOMC dot plot effectively pulled forward one rate hike previously included in the Committee's 2020 projection, raising the expectation for 2018 by one hike and leaving expectations for 2019 alone. By pulling forward one rate hike, the Committee was perceived to be more "hawkish", dragging yields on long-dated Treasury bonds lower. The yield on 10-year U.S. Treasury bonds dropped from 2.98 percent on June 13 to 2.85 percent at month-end, and the yield on 30-year Treasury paper fell from 3.10 percent to 2.98 percent.

The yield curve has continued to flatten out, with the 2/10 spread compressing down to just 33 basis points at the end of June. Investor concerns over a yield curve inversion may come into play sooner than we had previously anticipated. Trade war fears and what is perceived to be a more hawkish FOMC are acting as powerful gravitational forces for the long end of the curve, and together should keep long-term interest rates under wraps, barring a thawing of icy trade relations near-term. The European Central Bank (ECB) appears poised to remain accommodative well into 2019. Market participants initially expected policy normalization via rate hikes to commence in the back half of 2018. An incrementally more dovish ECB, an incrementally more hawkish FOMC, continued repatriation of foreign profits by U.S. multinationals, political angst abroad, and stubbornly low wage growth, make U.S. Treasuries attractive, for domestic and foreign investors alike.

The 10-year yield has been trading in a wide range between 2.7 and 3.1 percent since the start of February, finding a "comfort zone" between 2.8 and 2.95 percent. It's likely in our view that 3 percent will act as significant near-term resistance on the upside, while 2.75 percent should provide meaningful support. With short-term yields rising and long-term yields falling, the best opportunity for investors appears to be on the short end and in the belly of the yield curve. Credit, while still expensive, is less so than had been the case earlier in the year. The yield-to-worst on the Bloomberg Barclays U.S. Corporate High Yield Index sat at 6.49 percent at month-end, a year-to-date high, and the highest level since the end of November 2016. High-yield defaults remain subdued, and the rally in energy prices lends support to approximately 15 percent of the Index, but we're late in the game, and we're likely closer to the exits in high yield than we are to playing extra innings. While Treasuries may be garnering capital at present, we would use the recent rally in Treasuries to re-position on the shorter end of the yield curve, while diversifying via structured products and dollar-denominated emerging market debt. ▲

Source: Bloomberg