Title: Advocacy Investing® Portfolio Strategies, Issue 107
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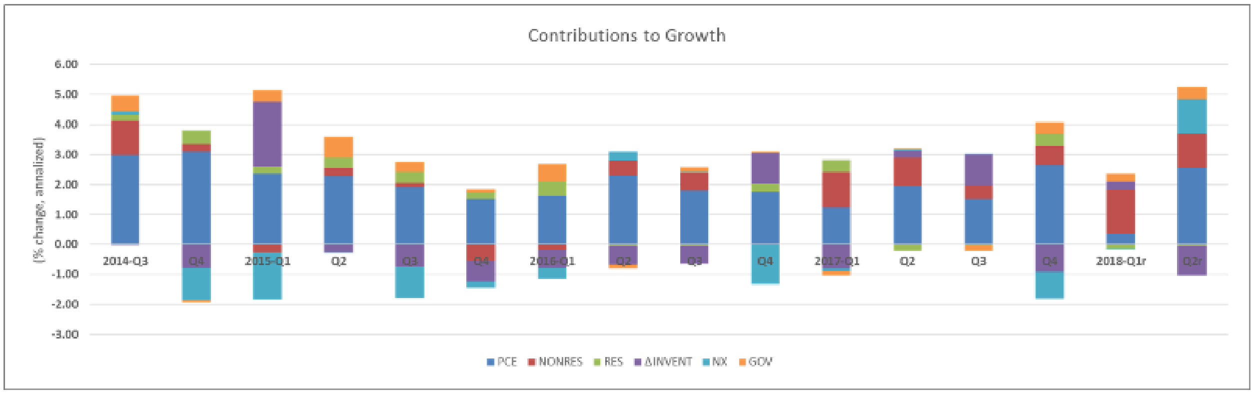
Advocacy Investing®

DISTANT THUNDER

- **Second quarter economic growth revised slightly upward to 4.2% (annualized)**
- **Data releases underscore continued economic strength**
- **Trade deficit widens sharply in July**
- **Oil markets tighten in anticipation of U.S. sanctions on Iranian oil exports**
- **Robust employment growth in August, with 201,000 new positions**
- **Inflation picks up**
- **Fed Chair Powell compares monetary policy to "navigating by the stars, with the stars moving," but reiterates path on gradual monetary tightening**
- **Global economy on track, but downside risks increase**
- **U.S. economy on track to grow above trend in short-term, but faces headwinds**
- **The S&P500 tests the 2,900 level in a resurgent bull market, but faces a volatile September**

Economic growth in the second quarter (2Q18) was revised slightly upwards, from 4.1% (annualized) to 4.2%. This change, the first of two, reflected upward revisions in Government Expenditures, Non-Residential Fixed Investment and Inventories investment, as well as downward revisions in Personal Consumption Expenditures (PCE) and Residential Fixed Investment. Final Sales to Domestic Purchasers (which exclude inventory changes and exports) growth remained unchanged at 3.9% (annualized).

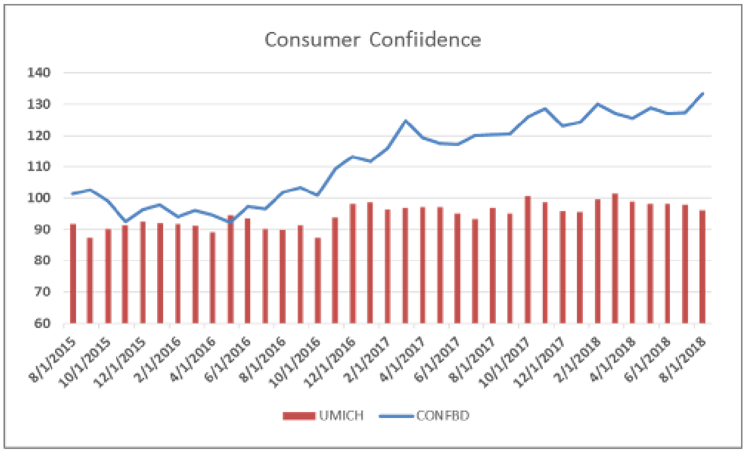
Figure 1: <u>Composition of Growth</u>



Data releases reflect a robust economy, with some loss of momentum. Industrial Production and Manufacturing were up by respectively 0.1% and 0.3% month-on-month (m/m) in July. Durable Goods fell by 1.7% m/m—and the less volatile Durable Goods ex-Transportation rose by 0.2% m/m and Core Capital Goods increased by 1.4% m/m. Factory orders fell by 0.7% m/m in July. August early-month surveys were mixed. The Empire State Index of manufacturing rose to 25.6 from 22.6 the previous month, while the Philadelphia measure fell from 25.7 to 11.9 over the same period. The broad-based Chicago PMI fell slightly to 63.6 at the end of August from 65.5 the previous month, while the ISM-Manufacturing rose from 58.1 to 61.3 over the same period—a 14-year high. The Markit PMI-Manufacturing fell slightly to 54.7 at the end of August from 55.3 the previous month. Services remained strong, with the ISM-NonManufacturing rising to 58.5 at the end of August from 55.7 a month earlier, and the PMI-Services declining from 56.0 to 54.8 over the same period.

Households remained optimistic. The University of Michigan-Reuters consumer confidence index rose to 96.2 at the end of August from 95.3 the previous month, and the Conference Board measure jumped from 127.9 to 133.4 over the same period, its highest level in 18 years. Retail Sales increased by 0.5% m/m in July—ex-food and gasoline, they rose by 0.6%. Personal Income and Personal Consumption Expenditures (PCE) increased by respectively 0.3% and 0.4% m/m in July.

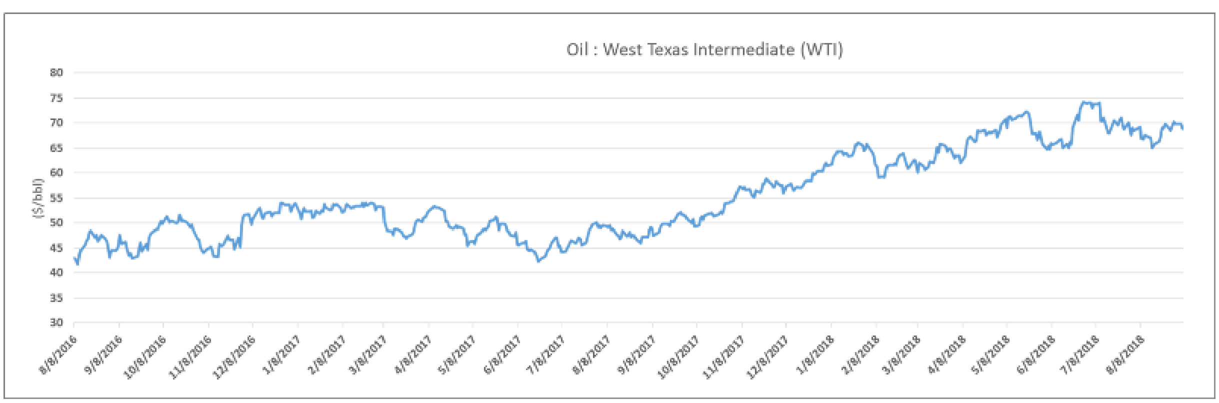
Figure 2: Household Optimism



The trade deficit jumped in July to $50.1 billion, from an average of $45.6 billion in 2Q18, the widest since February 2018. The trade deficits with China and the European Union both soared to record levels—reaching an aggregate $54.4 billion, from $45.2 in June. Exports fell by 1.0% as global demand for U.S. aircraft and soybeans fell, while imports jumped by 0.9%. The dollar continued to strengthen, with the Dollar Index (DXY) gaining 0.6% over August—and 7.3% from its year-to-date (ytd) low on February 15th.

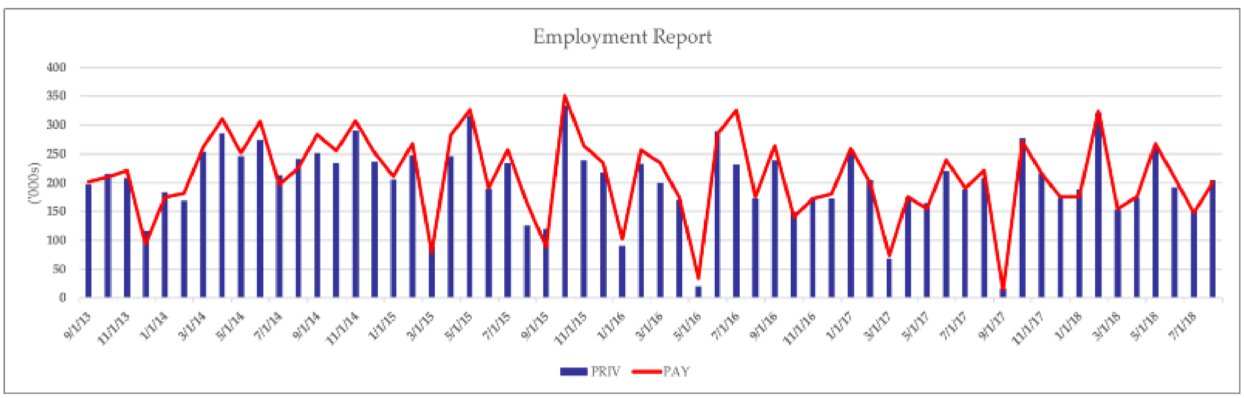
The housing market remained soft. New Home Sales and Existing Home Sales were basically unchanged in July, while Housing Starts inched up. House prices, as measured by the Case-Shiller 20-City Price Index, rose at a slower pace of 0.1% m/m in June (6.3% year-on-year). Construction spending rose by 0.1% in July after declining by 0.8% the previous month.

Figure 3: Oil Prices



Sanctions on Iranian Exports Loom: Oil supplies continue to tighten, as OPEC (and main non-OPEC producers such as Russia) maintain production discipline and Iran sanctions start to bite in the face of strong demand. The prospect of U.S. sanctions on Iranian oil exports, scheduled to start on November 4th, has already cut loadings as insurance companies have removed coverage of tankers carrying Iranian oil—which has forced Iran to use its own tankers for oil exports. As a result, Iranian exports have dropped by a third in August to 1.5 million barrels per day (mbd), from 2.5 mbd in the previous month, and could fall to 0.7 mbd by November. Oil prices (West Texas Intermediate, WTI) fell to an 18-week low of $65.01/barrel (bbl) on August 15th, a 7.3% drop from month-end July—and an 11.3% fall from their 2018 high on July 10th, only to rebound to close to $70/bbl by the end of August. U.S. crude production rose by 230 thousand barrels per day (tbd) in June, and is on track to surpass 11 mbd. U.S. sanctions on Iranian oil exports will continue to loom over markets in the next few weeks, keeping oil prices at around $70/bbl. The key test will come after November 4th, when U.S. sanctions on Iranian oil are set to start.

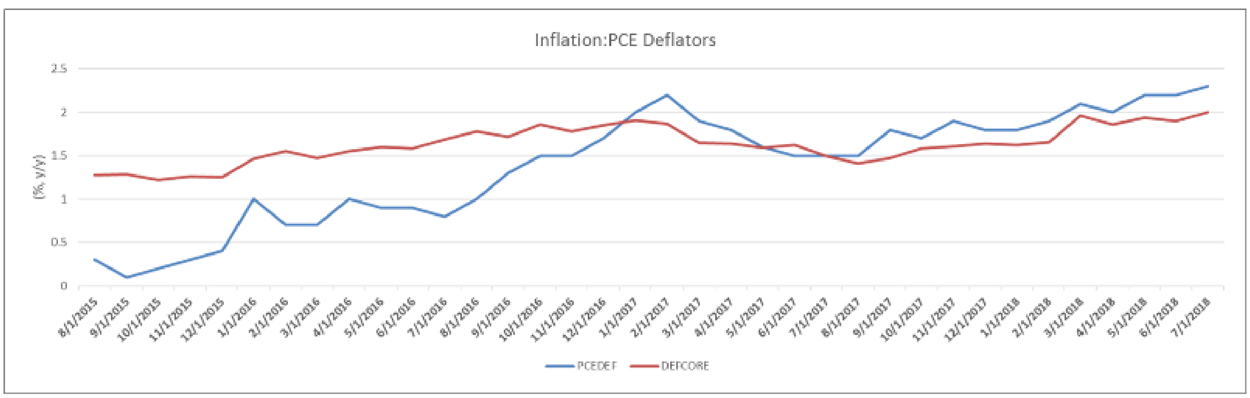
Figure 4: <u>Labor Markets</u>



Labor Markets Supply Side Constraints: The August employment report indicated that the economy created 201,000 jobs in August (204,000 for the private sector). At the same time, the numbers for the previous two months were revised downward by an aggregate 40,000, which brought the three-month moving average to 185,000—from 213,000 in 2Q18 and 195,000 in the previous 12 months. Job creation was broadly distributed. The Goods sector generated 26,000 jobs, (Mining, +6,000; Construction, +23,000; and Manufacturing, minus 3,000). Private Services added 178,000 positions and Government fell by 3,000. Weekly hours worked were stable at 34.5, and Average Hourly Earnings accelerated, rising by 0.4% m/m (2.9% y/y), the fastest pace since 2009. In combination, the Labor Income Proxy rose by 4.6% (annualized). The separate Household Survey showed unemployment (U3) stable at 3.9%, and the broad measure of unemployment and underemployment (U6) down to 7.4% from 7.5% the previous month. Labor force participation remained at 62.9%. High frequency data also underscored a tightening labor market, with Initial Weekly Jobless Claims down to almost 203,000, their lowest level since 1973. Overall, both the Establishment Report and Household Survey indicate that while we are seeing solid employment growth, we are also seeing signs of supply side constrains developing in labor markets: a participation rate plateauing at around 63% and higher wage inflation. We should note that the trend has been for a rise in the participation rate for women offsetting the fall of men's participation.

Inflation has picked up in recent months. Headline inflation (CPI) jumped to 2.9% y/y in July (2.4% for Core inflation, which excludes the volatile food and gasoline items). The PCE Deflator rose by 2.3% y/y—and the Core PCE Deflator, the Fed's preferred indicator, increased by 2.0% y/y. Overall the PCE Deflator Core is up by 0.6% compared to the same time last year.

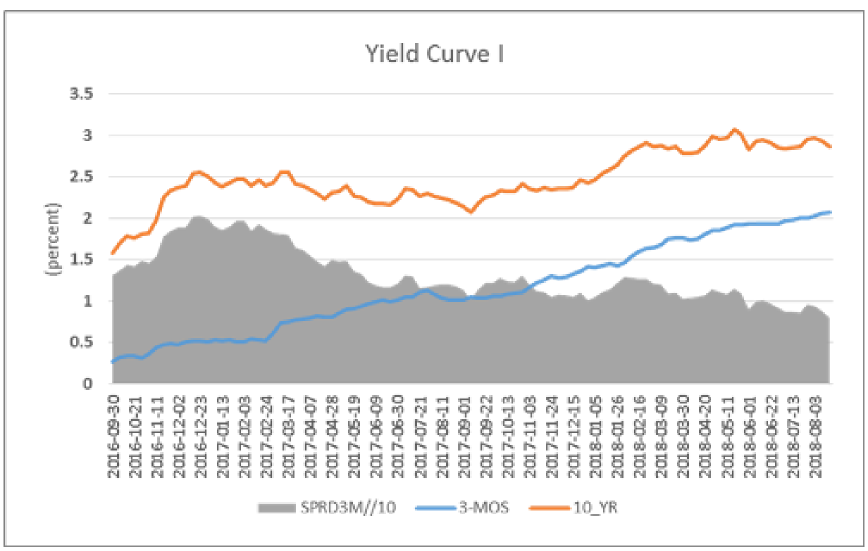
Figure 5: Inflation Pickup



In the Shadow of the Grand Tetons: The annual Kansas City Fed's Monetary Policy Symposium is a gathering of the major central banks, academics, policy makers and market participants. The meetings, held under the lofty Grand Teton peaks in Jackson Hole, Wyoming, are keenly watched by the markets, not only for clues about monetary policy but also for the intellectual underpinnings of central banks' thinking. This year's symposium, entitled "Changing Market Structure and Implications for Monetary Policy" was held on August 23rd-25th. The event was particularly important as it was the maiden speech of the new Fed Chair Jay Powell at this forum. Powell compared the conduct of monetary policy as "navigating by the stars," while the location of the stars has moved significantly. Powell's presentation was in two parts. The first addressed the issue of conducting monetary policy in an era of structural changes in macroeconomics, particularly with regard to the puzzle of continued low inflation and lagging wage growth despite robust economic growth. This dilemma is at the core of the choice of the path of monetary policy. In this regard, Powell reiterated the view that the U.S. macroeconomic conditions remain healthy and inflation expectations are well anchored at close to 2.0%. Moreover, the Fed has to navigate between two risks: too-fast or too-slow monetary tightening. The second part of his comments addressed current monetary policy. With these conditions in mind, monetary policy continues to attempt to balance gradual tightening and raising the benchmark rate towards its "neutral" level over the balance of 2018 and 2019, with an eye to the data. In practice, this should mean two more rate increases this year (September and December) and three to four next year, with the Fed Funds rate at 3.5% at the end of 2019. However, these increases are not set in stone, and Powell was cognizant of risks to the outlook, including a worsening of global financial conditions, stronger inflation and rising trade tensions. Nevertheless, the latest employment report will only bolster the case for sustaining the path of monetary tightening.

The 10-year Treasury bond yields have stabilized in the past few weeks at close to 2.90%, but the yield curve continues to flatten: the 10 year/2 year Treasury note spread (or difference between the two) has fallen to 0.22% (22 bp) from 53 bp at the end of 2017, and the 10 yr/3-month Treasury note spread has fallen from 101 bp to 75 bp over the same period.

Figure 6: <u>Yield Curve</u>



The global economy continues to be on track for an above trend 3%-plus growth, but faces heightened downside risks from cross-currents in emerging markets, particularly Turkey and

Argentina. The Chinese authorities have introduced some modest stimulus measures to offset the impact of trade tensions, with the United States, but both the Caixin PMI Manufacturing and Composite indices have continued to fall. Overall, Chinese economic growth is expected to slow to around 6.0% over the next few quarters. The eurozone seems to be improving though, as reflected in stronger PMI readings, with growth expected to remain above-trend at around 0.4% quarter-on-quarter (q/q) in 2Q18. Nevertheless, there are sources of concern. Global trade volumes are shrinking after a very strong 2017; credit conditions are tightening in emerging markets and the JPMorgan Global Output PMI dropped at the end of August.

Early indications from data releases are that economic growth should remain above trend in 3Q18. Personal Consumption Expenditures and Fixed Investment are expected to continue apace, as should government spending. The main headwinds will come from the strong dollar and trade tensions, which should lead to a widening of the trade deficit—a negative in terms of economic growth—as well as higher interest rates. However, higher inflation, as well as a potentially significant jump in oil prices in 4Q18 should erode purchasing power, affecting PCE. Furthermore, the fiscal stimulus will run out of steam in 4Q18 and 1Q19. Moreover, widening fiscal deficits, expected to reach $1 trillion in FY2019, could lead to budgetary tightening in 2019. The New York Fed's "Nowcast" projects 3Q18 growth at 2.0% (annualized), which might be too pessimistic—2.5-3.5% could be more realistic.

Global Risks:

Trade Tensions: Trade tensions had seemed to ease somewhat as the United States and Mexico have announced a new "NAFTA Plus" trade agreement. This came at the heels of the prospects for a resumption of trade negotiations between the United States and the EU. However, the process of integrating Canada in the new agreement is once again sinking the process into chaos as a result of President Trump's verbal attacks on our northern neighbor—which is also the United States main trading partner. At the same time, the Trump administration is on the verge of imposing tariffs on $200 billion of Chinese goods, a move that will likely lead to Chinese retaliation. The U.S.-China trade dispute is expected to worsen over the near future, disrupting global supply changes and U.S. exports.

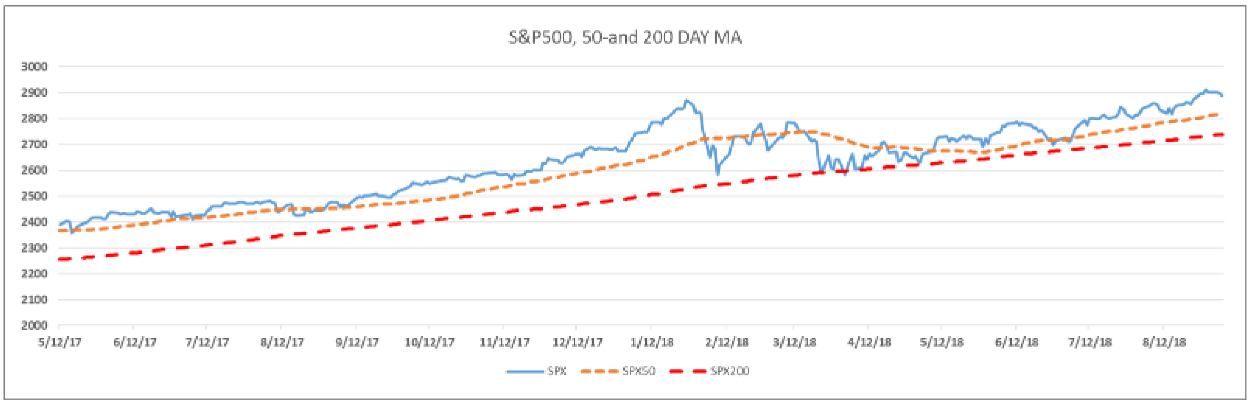
North Korea: Tensions are on the rise once again between the United States and North Korea, as both sides accuse the other of bad faith. Any further negotiations are on hold as North Korea ups the ante and threatens to resume nuclear and ballistic testing.

Emerging Markets: emerging markets have been hammered by financial crises in Turkey and Argentina, as well as by both rising U.S. interest rates and the strong dollar. While these markets are in a better position to absorb shocks than in the previous crises of the 1980s and

1990s, the attendant turmoil could slow global economic growth and contribute to greater volatility in global financial markets.

Political Risks: Continued chaos in the Trump administration, the Mueller investigation, recent indictments of President Trump's former associates and the renewed prospect of Democratic control in possibly one of the Congressional chambers are pushing the country not just toward "known unknowns" (in former Secretary of Defense Rumsfeld's words), but also "unknown unknowns."

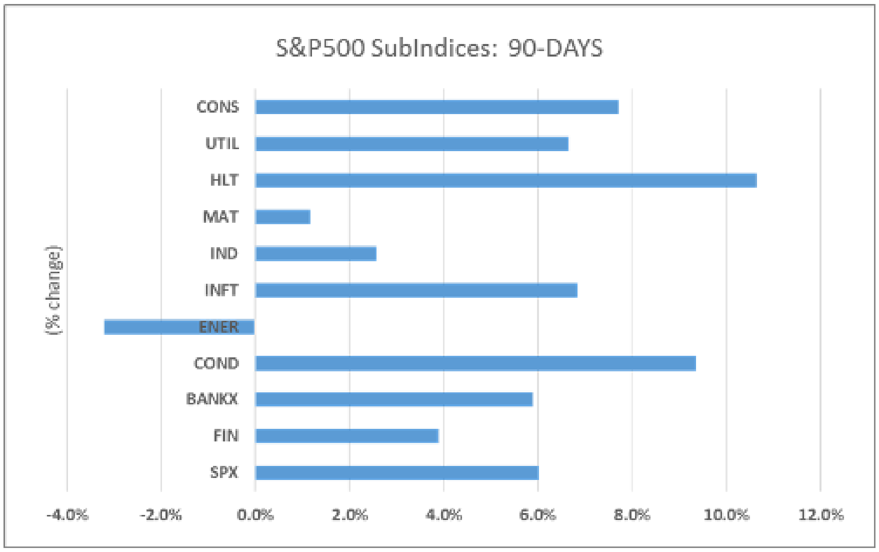
Figure 7: <u>S&P500 Bulls</u>



Testing 2,900: The S&P500 broke through 2,900 on August 29th and ended the month at 2,904, a 3.6% monthly gain—the index has risen by 18.1% y/y and 15% from its 2018 low of 2,545 on April 2nd.

In the past nine years, the U.S. equity markets have been on a bull run that broke all the longevity records, logging 3,453 days on August 22nd and increasing by almost a factor of five over this period. However, this year has proven to be one of the rockiest ones of the bull market, with the S&P500 dropping sharply and not regaining its 2018 high of 2,872 on January 26th until seven months later, on August 24th. Overall, the bulls have been dominant since early July, with the S&P500 surpassing both its 50-day and 200-day moving averages. Nevertheless, rising risks have made the market index wobbly as it tests the resistance level of 2,900. Tech stocks have led the sell-off and the VIX volatility index has reached 15, its highest level since July. Global equity markets have also been hit, with the European Stoxx index dropping to its lowest level in five months at the end of the first week of September.

Figure 8: S&P500 SubIndices



On the positive side, S&P500 profits have risen by 25.5% y/y in 2Q18, with about one third of the gain coming from the 2017 corporate tax cut. Earnings per share (EPS) have risen to almost $140, a 12% quarter-on-quarter increase. Macroeconomic conditions remain favorable, but the markets have been affected by a noisy early September: trade tensions with China and Canada, emerging markets volatility and tech companies under political pressure. These factors are expected to continue in the next few weeks, with the mid-term elections looming.

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August Data Releases

Economic Data Releases-August 2018	*Prior*	*Consensus*	*Actual*	*Min*	*Max*
Macroeconomy					
GDP(2Q18 % Annualized, Second estimate)	2.2%	4.1%	4.2%	3.8%	4.2%
PCE Deflator (%, y/y) (July)	2.2%	2.3%	2.3%	2.3%	2.4%
Core PCE Deflator (% ,y/y)	1.9%	2.0%	2.0%	1.9%	2.1%
CPI (% y/y) (July)	2.8%	2.9%	2.9%	2.9%	3.0%
Core CPI (%, y/y)	2.3%	2.4%	2.4%	2.2%	2.5%
Employment					
First Time Claims ('000) (last week August)	213	213	203	205	217
Non-Farm Payrolls ('000), August	147	195	201	150	237
o/w Private Sector	153	190	204	160	237
Unemployment (U3, %) (July)	3.9%		3.9%		
Underemployment (U6, %)	7.5%		7.4%		
Labor Force Participation (%)	62.9%		62.9%		
Balance of Payments					
Trade Deficit ($ billion) (July)	$45.70	$50.20	$50.10	$44.80	$51.20
Exports (% m/m)	1.9%		-1.0%		
Imports (% m/m)	0.5%		0.9%		
Current Account Deficit ($ billion,1Q18)	$116.2	$129.3	$124.1	$123.0	$138.0
Dollar Index-eom (August)	94.55		95.14		
Oil Prices-eom (WTI, $/bbl) (August)	$68.74		$69.80		
Housing Market					
Housing Starts ('000) (July)	1,158	1,271	1,158	1,200	1,300
New Home Sales ('000) (July)	638	649	627	630	660
Existing Home Sales (MM) (July)	5.38	5.42	5.34	5.35	5.51
Construction Spending (%, m/m) (July)	-0.8%	0.4%	0.1%	0.1%	2.3%
Case Shiller-20 City (%, m/m) (June)	0.2%	0.1%	0.1%	0.1%	0.7%
Case Shiller-20 City (%, y/y)	6.5%	6.5%	6.3%	6.4%	6.7%
Industrial & Manufacturing					
Corporate Profits (y/y) 2Q18	2.7%		6.7%		
Bus Inventories (m/m) (June)	0.3%	0.4%	0.4%	0.3%	0.4%
Empire State (August)	22.6	24.0	25.6	19.0	22.0
Philadelphia (August)	25.7	22.5	11.9	20.0	23.8
Chicago PMI (August)	65.5	63.8	63.6	61.0	65.0
Markit PMI Mfg (August)	55.3	54.5	54.7	54.3	54.7
ISM Mfg (August)	58.1	57.7	61.3%	56.5	58.1
Industrial Production (% m/m) (July)	1.0%	0.3%	0.1%	0.1%	0.7%
Manufacturing (% m/m) (July)	0.8%	0.3%	0.3%	0.1%	0.7%
Durable Goods (m/m) (July)	0.7%	-0.8%	-1.7%	-2.0%	4.0%
Durable Goods, ex transp (m/m)	0.1%	0.5%	0.2%	-0.3%	1.0%
Durable Goods, Core Capital (m/m)	0.6%	0.5%	1.4%	0.4%	1.2%
Factory Orders (m/m) m/m (July)	0.6%	-0.7%	-0.8%	-1.2%	0.4%
Services					
Markit PMI Services (August)	56	55.2	54.8	55.2	55.7
ISM Non-MFG (August)	55.7	56.8	58.5	55.7	57.5
Consumer Spending					
Retail Sales (% m/m) (July)	0.2%	0.1%	0.5%	0.0%	0.3%
Retail Sales, ex Gasoline, Food (% m/m	0.2%	0.4%	0.6%	0.2%	0.4%
UMich Consumer Sentiment (end-August)	95.3	95.5	96.2	94.0	96.0
ConfBd Consumer Confidence (end-August)	127.9	126.8	133.4	124.0	128.0
Personal Income (%, m/m) (July)	0.4%	0.3%	0.3%	0.3%	0.4%
Personal Consumption Expenditures (%, m/m) (July)	0.4%	0.4%	0.4%	0.1%	0.5%

Dr. Pakravan has been a senior economic strategist in global financial markets for over 25 years. Dr. Pakravan is a recognized specialist in leading-edge applied macroeconomic and financial research on currencies and emerging markets, country risk assessment and modeling in an enterprise-wide risk management context, as well as international financial architecture. Dr. Pakravan has a Ph.D. in Economics, University of Chicago, a M.Sc. in Econometrics and Mathematical Economies, London School of Economics, and a B.A. in Mathematical Economics, University of Geneva. He is the author of numerous publications and is an Associate Professor of Finance at the Kellstadt Graduate School of Management at DePaul University.