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Wenning Investments, LLC

Wenning Advice

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Stock and bond markets as a whole typically reflect what's happening in the economy, but that hasn't been the case in recent years.

With the Federal Reserve Board managing the economy, we've had eight years of subpar growth, even as the stock market consistently broke records. The economy was expanding, but the expansion was modest, averaging about 2%, compared with the 3.3% average growth we've enjoyed post-World War II.

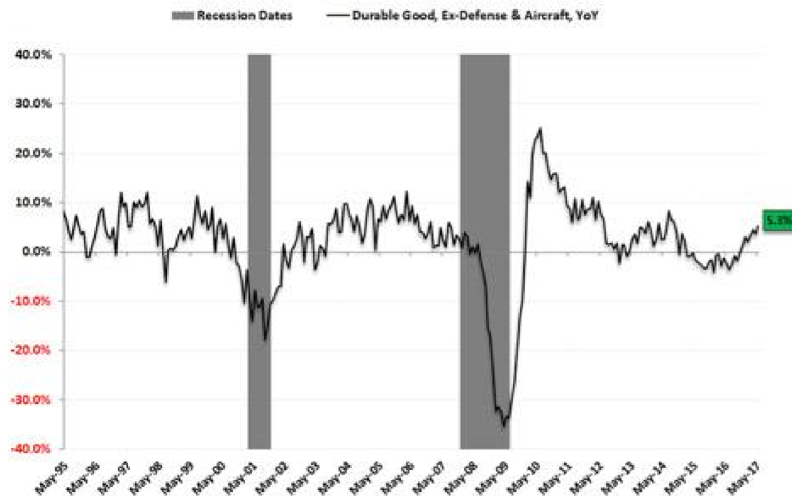
Now the economy is gaining strength ... and the Fed is tightening, raising interest rates. What impact will these factors have on the markets? What other factors are likely to have an impact?

Positive Economic Factors

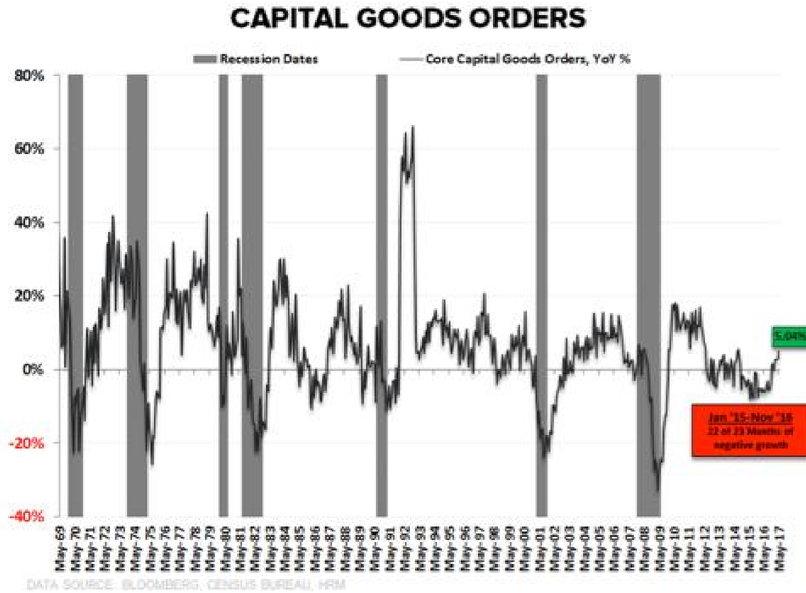
The economy is cyclical and, although interrupted by the financial crisis of 2007-2008 and the Fed's zero interest rate policy (ZIRP), there are signs now that the economic cycle is back on track.

Consider the following, as noted by Hedgeye:

Durable goods. Durable goods accelerated from +0.7% year-over-year in April to +2.7% in May. Subtract aircraft and it accelerated from +3.7% year-over-year in April to +5.3% in May, which is a 33-month high. Subtracting aircraft provides an indicator for U.S. household spending, which accounts for 70% of U.S. gross domestic product (GDP).



Capital expenditures. Capital expenditures accelerated from +3.1% year-over-year growth in April to +5.0% in May. That's also a 33-month high. Capital expenditures bottomed out along with the stock market in January-February 2016; they were down -6.2% year-over-year and remained in recession until November 2016 before rebounding.



Corporate Profits. After five consecutive quarters of year-over-year declines in corporate profits, profits surged +9.3% for the most recent quarter.

While technically the economy has been experiencing one of the longest recoveries on record, the recovery has been barely noticeable. Hedgeye notes that U.S. bond yields were at all-time lows at this time last year, as the U.S. experienced an industrial, cyclical and profit recession.

Overdue for an Adjustment

Given the low growth the economy has experienced in recent years, we may be due for higher growth, especially if tax reform and deregulation policies are approved (see below).

However, it can also be argued that we're overdue for a recession. Of course, no one knows when the next recession will take place or how severe it will be, but in its latest Secular Outlook, "Pivot Points," PIMCO estimates that the probability of a recession sometime in the next five years is around 70%.

Of course, five years is a long time, so PIMCO isn't making a risky prediction, especially when taking into account the "rising populist pressures

and diminishing returns from unconventional monetary policy and fiscal austerity" cited in its report.

The report also notes that, "Markets have shrugged off and indeed rallied after the Brexit vote and the U.S. presidential election, and risk appetite has been robust, resulting in lofty equity valuations, tight credit spreads and low realized volatility."

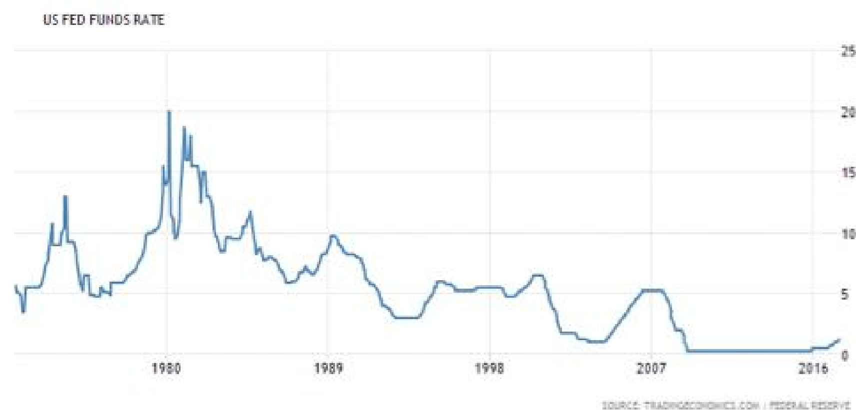
In other words, the economy may finally be growing at a reasonable rate or we may be experiencing another episode of irrational exuberance.

Driving Without a Spare Tire

Regardless of which direction the economy goes in, it's best to be prepared for the worst.

One reason to be prepared, according to PIMCO, is that if a recession were to take place in the not-too-distant future, the Federal Reserve Board and other central banks would not have nearly as much influence as they did during the financial crisis.

To help overcome the financial crisis, the Fed was able to lower interest rates to about zero and they remained there for seven years. But in June, the Fed raised its benchmark interest rate for the third consecutive quarter, to a range from 1 percent to 1.25 percent.



While the Fed has increased its benchmark rate by a percentage point since 2015, rates remain close to zero and are likely to stay low for the foreseeable future. After all, this is what PIMCO calls The New Neutral world, which it defines as the "world in which average policy rates are set well below the levels that prevailed before the crisis."

After its meeting on June 14, the Federal Open Market Committee announced that "the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run."

Because interest rates remain pretty close to zero, "central banks in The New Neutral world will likely have limited scope to cut rates. Also, with sovereign debt levels already high, fiscal space outside the U.S., China and Germany - which won't be inclined to use it - will be constrained."

As PIMCO says, it's like driving without a spare tire.

On the other hand, we may not need a spare tire. Few would dispute that Fed actions boosted both the stock market and the bond market during the Fed's quantitative easing (QE) bond-buying spree. And yet, as interest rates increase, the stock market continues to set new records.

"The fact that the central bank and Wall Street are moving in opposite directions suggests limits to the Fed's influence over the economy," according to *The Wall Street Journal*.

Policy Points

In addition to the above, PIMCO identifies five "pivot points" that are worth considering. They might instead be referred to policy points, as they revolve around monetary, fiscal, trade, geopolitical and exchange rate policies.

Monetary Policy: The Great Unwinding

While it's clear that interest rates are going up, no one knows for sure how high they will go, except that they are likely to remain relatively low for the foreseeable future.

Fed actions could also be influenced by potential changes in the board. Chair Janet Yellen's term will be over at the end of 2017 and there are three additional vacant seats. The general counsel also has stepped down.

The Fed's greatest challenge, though, is the unwinding of its $4.5 trillion portfolio. It announced its process for doing so during its meeting on June 14, but it is not yet clear when the "normalization" process will begin and how much of its portfolio the Fed will sell off.

The Fed has said it expects normalization to begin this year "provided that the economy evolves broadly as anticipated." To date, the Fed has been reinvesting payments from its current holdings. It will unwind gradually, by reinvesting a shrinking portion of its payments.

PIMCO anticipates a portfolio reduction of only about $1 trillion, spread out over "a number of years," but that would leave the portfolio at about $3.5 trillion, which is nearly four times as large as it was before the Fed began QE.

Regardless, if the Fed's unprecedented bond-buying lowered interest rates, the unwinding "likely will put upward pressure on term premia and thus long-term bond yields and mortgage rates," PIMCO concludes.

Will Economic Trends Continue?

Economic performance, like the stock market, has largely been driven by business and consumer expectations that the Trump Administration's deregulation efforts and tax reform will succeed.

That expectation was dealt a significant blow when the House of Representatives recently failed to approve the American Health Care Act, which was supposed to be the first step in repealing and replacing the Affordable Care Act.

As a result, the Affordable Care Act, which is viewed by many to be expensive and burdensome, is likely to remain in place. Failure to approve the AHCA also jeopardizes other deregulation and tax reform efforts, as savings created by replacing the Affordable Care Act were expected to balance the cost of tax reform.

Fiscal Policy: Deregulation and Tax Reform

During the Obama administration, the emphasis was on monetary policy and stimulus spending to boost the economy. Taxes increased and new regulations were added at a record rate.

This Keynesian approach resulted in growth averaging about 2% throughout the recovery, which is well below the 3.3% annual average that prevailed from the end of World War II until the financial crisis.

Some believe factors such as globalization and the retirement of baby boomers have made 3% growth unattainable, but President Trump believes the economy can grow at that rate again using a supply side approach that combines deregulation and tax reform.

He has already made some progress on deregulation using executive orders, much as President Obama used executive orders to create many new regulations. While President Trump has not succeeded in repealing and replacing the Affordable Care Act (ACA), the U.S. Senate has been working on an alternative version and the House of Representatives approved the American Health Care Act.

Efforts are also underway to repeal and replace the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Republican replacement, the Financial Choice Act, passed in the House, but is not expected to be considered by the Senate anytime soon.

The ACA and Dodd-Frank were by far the two most significant regulations approved during the past eight years. Democrats are united in opposition to repeal or reform efforts, while Republicans remain somewhat divided about what to replace them with.

President Trump also created an executive order that requires two regulations of comparable cost to be eliminated for every new regulation that's created. And Federal Communications Commission Chairman Ajit Pai is seeking to repeal net neutrality rules.

Tax reform proposed at the end of April would lower rates, simplify brackets and eliminate the the estate tax, the alternative minimum tax, itemized deductions and corporate loopholes. The U.S. has the largest corporate tax rate in the developed world; loopholes create advantages for some businesses at the expense of others, so the proposed reform would potentially help U.S. businesses be more competitive while boosting small business growth.

However, tax reform may be even more contentious than healthcare reform; it will be difficult to gain a consensus. PIMCO says, "We expect that any U.S. fiscal package that passes will be tilted to tax cuts, but light on reform; we see limited fiscal space in Europe."

Trade Policy: Protectionism or Reform?

President Trump's "America First" doctrine has been on full display, as he has pressured some companies to expand in the U.S., pulled out of the Trans-Pacific Partnership and threatened to pull out of the North American Free Trade Agreement (NAFTA), which he is seeking to renegotiate.

If more beneficial terms can be negotiated, America could benefit. If, instead, America begins imposing trade tariffs, as President Trump has proposed on imported steel, prices will increase and other countries will retaliate with their own tariffs.

In our Wenning Advice blog, we quoted *The Wall Street Journal* as reporting that instead of making America great again, protectionist policies would "Make Depressions Great Again." We also noted that The Smoot Hawley Tariff Act played a major role in the Great Depression.

PIMCO, though, says, "We believe the odds of a protectionist pileup or a global trade war have diminished over our 12-month cyclical horizon, but over the next three to five years the risks remain material, though in our baseline case a global trade war is averted."

PIMCO expects the U.S. to focus on bilateral trade deals, including renegotiating NAFTA and negotiating trade with China, and on aggressive use of existing authority within the World Trade Organization (WTO).

Exchange Rate and Geopolitical Policies

What happens in the rest of the world affects the U.S. and its economy more than ever. While the U.S. has begun playing a greater role in world affairs, what happens in China, North Korea, Russia and other countries is largely unpredictable and outside of U.S. influence.

PIMCO presents both optimistic and pessimistic scenarios about China.

"In an optimistic scenario," it says, "some colleagues believe that President Xi pulls off a clean sweep at the 19th Party Congress and uses his enhanced stature to end policy paralysis and embark on a major reform agenda that improves the economy's efficiency: better balanced, less reliant on leverage, and an attractive destination for capital inflows. In this upside scenario, China's growth remains above the current pace of 6.5%, disruptive devaluation is avoided, and the glide path to a floating exchange rate is a smooth one. President Trump and President Xi strike a grand bargain on trade, currency and geopolitical spheres of influence, perhaps including an acceptable freeze or wind-down of North Korea's missile program."

In the pessimistic scenario, "The U.S. levies across-the-board tariffs against Chinese imports, triggering a bilateral trade war. China follows with a globally disruptive CNY devaluation, which accelerates capital flight and leads to a huge drain on foreign currency reserves. The People's Bank of China is forced to tighten in a vain effort to maintain some control over the exchange rate. However, with property and equity markets in free-fall, the central bank gives up on the peg, the CNY floats, and capital outflow intensifies, causing a risk-off jolt to global markets and confidence."

Reality is likely to land somewhere in between.

The outlook for Europe, meanwhile, seems somewhat more predictable, but potentially bleaker, with growth expected to average just 1.25% over the next five years.

Emmanuel Macron's victory in the French presidential election over National Front candidate Marine Le Pen is seen as a positive by PIMCO, but "investors over the next three to five years will have to respect and factor into their asset allocations the broad-based wave of anti-globalization sentiment and political polarization that is evident in the Brexit vote, the U.S. election and the rise of populist political parties in France, the Netherlands and Italy."

For Japan, PIMCO sees continuing challenges, including an unrealistic inflation target, an aging population, and a lack of coordination between

"massive fiscal and monetary policy."

And while emerging markets are well-positioned for healthy growth and returns, assuming there are no significant global shocks, PIMCO concludes that, "Assets today are also not priced even close for the risk of a North Korea left-tail outcome."

YTD

Here's how securities performed during the most recent quarter.

Index	Ticker	6/30/2017
S&P 500	$INX	8.24%
Dow Jones Industrial Average	$INDU	8.03%
Russell 2000	$RUT	4.27%
International ETFs		
Emerging Markets	EEM	18.28%
MSCI EAFE	EFA	12.92%
Europe	IEV	14.20%
Japan	EWJ	9.80%
Latin America	ILF	9.79%
Bond ETFs		
1-3 year U.S. Treasury	SHY	0.04%
3-7 Year U.S. Treasury	IEI	0.87%
7-10 Year U.S. Treasury	IEF	1.71%
20+ U.S. Treasury	TLT	5.04%
US Agg Bond	AGG	1.34%
Investment Grade Bonds	LQD	2.84%
High Yield Bonds	HYG	2.09%
Yield Reaching		
US High Dividend Equity	DVY	4.11%
Lev Loans	BKLN	-0.94%
Utilities	XLU	6.98%
High Dividend Global	SDIV	4.18%
MLPs	AMLP	-5.08%
Alternatives		
Gold	GLD	7.66%

Where to Invest

Growth should continue to accelerate during the second half of the year as earnings and GDP comparisons on a year-over-year basis become easier to beat. Stock investors will continue to make shorter-term and longer-term investments.

Bond investors have seen short-term bond yields rise over the past year, which is a welcome relief for those who are living off of the income generated by their bonds. The recent GDP revision moved the 10-year Treasury yield back to the upper end of its trading range. With recent bonds maturing and money market balances higher, this will be a good time to put those proceeds to work.

Keep in Touch

Have an idea for a future issue of *Wenning Advice*? Are you interested in active investing or would you like to refer a friend who may be interested?

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