HAVERFORD

# 2017 FALL OUTLOOK

## Hurricanes and North Korea

Our thoughts and prayers go out to our clients, their families and all those affected by the devastation inflicted by Hurricanes Harvey and Irma. While estimates vary, most experts agree that Harvey will be one of the costliest hurricanes in U.S. history. Combined with Irma, damages will run into the hundreds of billions of dollars. Initially devastating to the regional economy, most natural disasters in the U.S. have had a minimal impact on overall Gross Domestic Product (GDP). That speaks to the economy's size and diversity. Third-quarter GDP estimates have come down modestly, but subsequent quarters should see an uptick due to rebuilding. Beyond the human and emotional toll, the biggest impact from natural disasters is on wealth, with the costs typically borne by the government (i.e., taxpayers), corporations (mainly the insurance industry), and private philanthropy.

We give President Trump and the Democrats credit for removing the debt ceiling and government shutdown risk (albeit for just three months) in order to quickly get monies to the affected areas. Fortunately, the insurance industry appears well capitalized to shoulder the many claims from the two hurricanes. It is a wonderful sight to see Americans come together and volunteer to help those in need and distress. The enormity of private philanthropy from individuals across the economic spectrum is uniquely American and worthy of celebration.

The markets have remained relatively calm amidst North Korea's aggressive rhetoric and more frequent missile testing. Even increased fears of a nuclear-capable North Korea are not causing the market much angst. A North Korean preemptive strike against the U.S. or its allies remains a low probability event, but no one can rule out the possibility of a mistake (i.e., errant missile) which could escalate into military action. Such aggression would almost ensure the annihilation of the Kim Jong-un dynasty. Nevertheless, as we have seen throughout this eight-plus-year bull market, geopolitical events, including military excursions, have had little effect on the equity markets. The economy and earnings are most important to markets.

We have said for several years that the key to a successful normalization of monetary policy is better pro-growth fiscal policy. The economic benefits from tax cuts and regulatory relief could serve as an offset to tighter monetary policy. The Trump election, combined with Republican control of Congress, created enthusiasm for such an outcome. Alas, ten months later that enthusiasm has ebbed somewhat. Both the inability of Congress to pass healthcare reform and a seemingly dysfunctional executive branch have reduced the odds of tax reform/tax cuts.

One big positive on the fiscal policy front has been regulatory relief and equally important, the curtailing of new government regulations. In this regard, President Trump has demonstrated his pro-business bona fides. This helps explain why numerous surveys of business leaders remain optimistic.

The White House is intent on Congress passing tax reform by the end of this year. We agree with the consensus view that it is a nearly impossible task. Tax reform is complicated (vs. tax cuts alone). It took President Reagan more than two years to effect the last tax reform back in 1986. Furthermore, Republicans in Congress cannot seem to come together on any issue. Perhaps the odds of tax relief will improve in 2018 as the fall elections loom closer, creating some urgency for an achievement.

Without the growth benefits of tax cuts, we believe investors can expect more of the same: 2% GDP growth, low interest rates, Fed normalization occurring at a glacial pace, and low inflation. The good news is the stock market has proven for the past eight years it can do well in this environment.

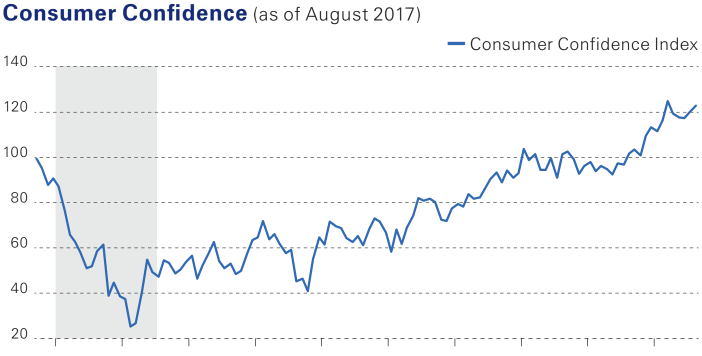
# The Economy

Despite the worrying headlines, consumers have rarely been more confident. The Consumer Confidence Index rose to a near cycle high of 122.9 in August, according to the Conference Board Index. One of the key drivers of this continued optimism is the state of the job market. The economy added 156,000 jobs in August, a modest drop from the year-to-date average of 180,000, but still a healthy pace. Since 2010, the U.S. has created nearly 18 million jobs; as the economy approaches full employment a slowdown in the monthly figures was inevitable. The unemployment rate now stands at 4.4%, and many companies are reporting difficulty finding qualified workers. The long-term unemployed have been returning to the labor force but these workers do not have the skills to fill many of today's vacancies. The latest data shows a record high 6 million unfilled job openings and it is taking longer for companies to fill open positions (31 days versus 23 days ten years ago).

When workers feel confident about their job prospects they are likely to spend more. This is evident in the recent retail sales data, which rose 0.6% month-over-month in July. Non-store sales (primarily e-commerce) rose 1.3%, as online shopping continues to take a larger share of the total market. Overall, retail sales have been growing at an annualized pace of close to 4%. Similarly, people with jobs are more likely to commit to buying a house. The housing market remains strong with prices rising more than 5% over the past year, supported by growing demand and low interest rates.

Normally, wage inflation is a consequence of tightening labor markets. At this point in the economic cycle one would expect employers to be raising wages in order to attract and retain workers. However, average hourly earnings rose a modest 2.5% year-over-year in August and have been relatively stable around this level for more than two years. In the past three business cycles, similar levels of unemployment pushed wage growth above 4%, which in turn triggered the Fed to raise rates aggressively. The subdued pace of wage growth, and inflation in general, continues to puzzle economists as the path of this business cycle diverges from historical patterns.

**Consumer Confidence** (as of August 2017)



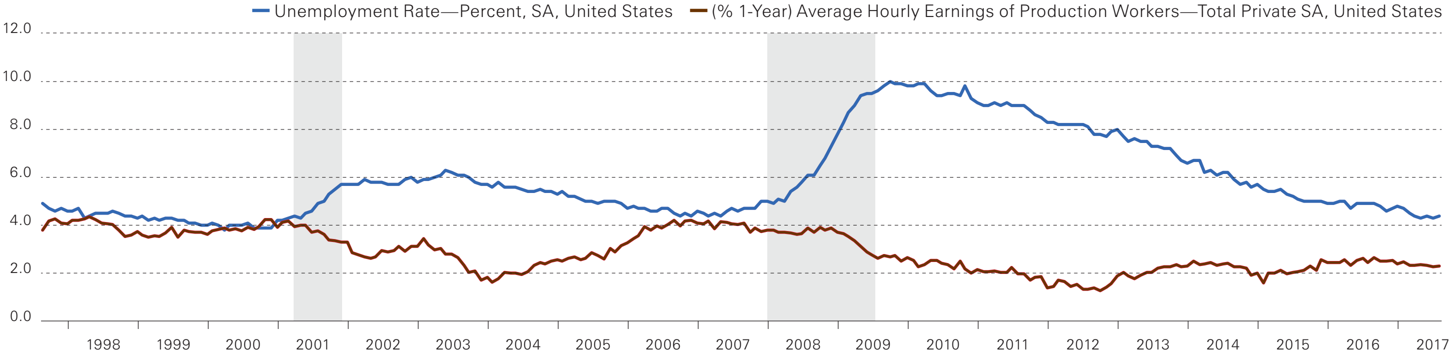

Sources: The Conference Board, FactSet Research Systems

In the 32 quarters since this economic expansion began following the financial crisis of 2008-2009, U.S. GDP growth has averaged just 2.1% annually. Consumers have been doing their part with strong personal consumption driving two-thirds of the U.S. economy. To achieve higher levels of growth the economy needs a boost from business spending, which in turn would boost productivity. For whatever reasons, businesses have been reluctant to invest, with fixed investment averaging only 1.1% since 2009, versus the 50-year historical average of 4.4%. Sentiment may finally be turning, however. Spending on business equipment rose more than 8% in the second quarter, the highest level in more than two years, helping to boost overall second-quarter GDP growth to 3%. Following the election, business surveys have surged to new highs in anticipation of tax reforms. The Business Roundtable CEO Economic Outlook Survey rose to a three-year high, while the latest Purchasing Managers Index (PMI) reading of the manufacturing sector hit 58.9, the highest level since 2011. Arguably, the best way to encourage investment spending is via corporate tax reform. Tax cuts will be the key to driving GDP growth out of this lackluster range.

## Markets are reacting to a global rebound in corporate earnings

Earnings growth—not politics or easy money—is the driver behind the market's recent gains. Since June of last year, global markets (as defined by the MSCI All Country World Index or ACWI) are up 15% in response to healthy profit growth. Trailing twelve-month S&P 500 earnings per share are up approximately 10%, while the earnings of corporations in the developed markets of Europe and Japan have increased over 20%, on average. These increases stand out in stark comparison to the earnings picture only a year ago, when U.S. corporate profits were in slight decline with global profits down double-digits.

**Wage Inflation** (as of August 2017)




Sources: Bureau of Labor Statistics and FactSet Research Systems

Over the course of the past year, several impediments to profit growth have abated. Currency headwinds, energy prices, and sales growth have all turned more positive. Since hitting its highest levels since 2003, the trade-weighted-dollar index has declined almost 10% this year. A softer dollar boosts the purchasing power of overseas consumers and increases the value of profits earned abroad. This is particularly meaningful to multinational companies in the S&P 500. Approximately 45% of their revenue is derived from sources abroad. According to Bloomberg, twice as many large stocks, which tend to have a global presence, have positively surprised on sales and earnings versus small stocks. Not surprisingly, the price performance of large-cap stocks has significantly outpaced small-cap stocks in 2017.

While a weaker dollar benefits U.S. corporations and dollar-denominated investors, the inverse is true for the rest of the world, particularly companies in the eurozone where a weakening dollar could potentially become a headwind. We believe we are far from those levels. Improved economic growth prospects for the global economy have been the primary driver of U.S. dollar weakness. For foreign companies, the positive effects of robust economic activity will likely trump any concerns over a moderately stronger currency. Evidence that international economies are growing on par with the U.S. is a very welcome development!

The past two quarters marked the first time since 2011 that S&P 500 companies have posted back-to-back double-digit earnings growth. This pace of profit growth is clearly not sustainable over the long run, but in the short term domestic companies should continue enjoying earnings momentum as long as the positive effects of weaker currency and global growth remain.

**U.S. Dollar Index (DXY)** (as of September 8, 2017)


Source: FactSet Research Systems

The outlook for global earnings growth is encouraging as well. Economic acceleration, improved profit margins, and more stable commodity prices all bode well. The Japanese economy, as an example, has grown for six straight quarters, a feat not seen since 2006. GDP growth in the second quarter hit 2.5% on an annual basis, exceeding economists' expectations.

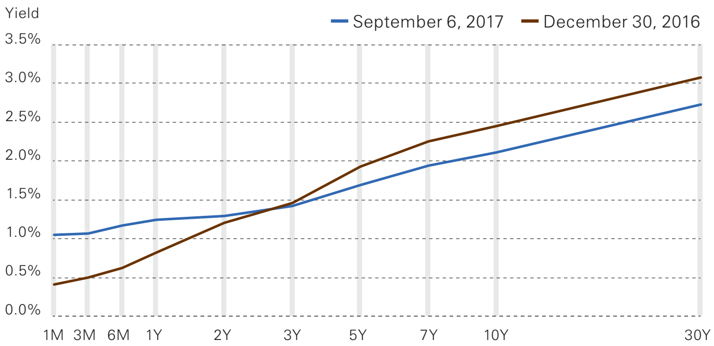
Given a backdrop of improving profitability, market valuations appear reasonable. Although P/E multiples and other valuation metrics might seem elevated based on current earnings, those metrics do not look as rich when viewed in the context of higher earnings in the future. In addition to economic factors, the greatest driver of corporate profitability in coming years could come from tax reform. If tax reform passes as expected, multinationals stand to benefit from lower tax rates and from the repatriation of trillions of dollars stranded overseas. Smaller companies will benefit greatly as well, as they tend to have higher overall tax rates relative to their larger, more international, peers.

# Fixed Income

Interest rates remain stubbornly low, despite three moves by the Federal Reserve since December 2016. The 7, 10, and 30-year U.S. Treasury yields are approximately 30 basis points lower than year-end 2016. Commentators commonly cite two major issues that may move rates higher: the pressure from continued deficit financing that will likely increase with tax reform, and the start of the process to shrink the Fed's balance sheet.

Fears of rates rising due to government spending stem from two valid concerns: the increased supply of bonds necessary to fund the higher spending, and fears that monetizing debt

**United States Treasury Yield Curve** (as of September 6, 2017)




Source: FactSet Research Systems

is inflationary. In the current market, any inflationary impact will likely be muted in the near term. U.S. inflation is well below historical levels, and there are few signs of an increase in inflation in any of the developed economies. Historically, it is rare for major rises in long-term interest rates to occur without the specter of rising inflation.

As for increased supply, the markets react differently depending upon the nature of government deficit spending. Historically, global fixed income markets have not negatively reacted to reasonable counter-cyclical spending and funding recovery efforts from natural disasters. Conversely, they have reacted far more harshly to spending, usually referred to as "pork" but better characterized as macroeconomic foolishness.

Expectations that the Federal Reserve will soon begin to reduce its balance sheet magnify these concerns, but we believe these fears are likely overstated. First, the rate of asset liquidation will be exceptionally gradual. Even the most aggressive estimates expect a four-year time horizon. Depending upon market conditions, it could be as long as six years. In the initial stages, the Fed will stop reinvesting the proceeds of maturing bonds; actual selling of bonds will come later. The Federal Reserve took several years to accumulate these assets and we think it is reasonable that the liquidation will take years as well.

Second, the global demand for fixed income assets still greatly exceeds available supply. Central banks will purchase $1.4 trillion in debt this year versus $1.9 trillion of net new supply. Blackrock estimates total aggregate demand will be close to $8 trillion. We believe that a market that is out of balance can easily absorb an annual reduction in Federal Reserve assets of roughly $300-400 billion. The demand for tax-exempt municipal bonds also outstrips supply, as the total funds available for investment from maturing bonds, redemptions and coupon payments have exceeded new supply for the past several months.

We continue to believe that the path toward normalization of interest rates will be long and gradual and that fears to the contrary are overblown. Longer-term U.S. Treasury rates are close to their lowest levels since the U.S. election last November. The absolute level of interest rates permits some degree of spending and asset reduction without undue impact.

All data as of September 8, 2017, unless otherwise noted.





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