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2018 SPRING OUTLOOK

Finally! GDP Growth Could Exceed 3%

In 1978, *New York Times* sportswriter Leonard Koppett first introduced the Super Bowl indicator. His "research" concluded that a Super Bowl win for a team from the American Football Conference (AFC) foretells a decline in the stock market for the coming year. A win for a team from the National Football Conference (NFC) means the stock market will be up for the year. For Philadelphians, it is one more reason to vigorously celebrate the Eagles' Super Bowl victory. While it may be fun to rely on superstition to provide our market outlook, Haverford's positive view of the economy and global equities market is supported by several strong fundamental factors.

Fiscal policy has become decidedly more pro-business in the past twelve months. Monetary policy remains accommodative. Consumer confidence is strong and bolstered by higher after-tax wages. Corporate earnings will most likely grow in excess of 12% in 2018. Economies around the world are also accelerating—even Brazil is exiting their deep recession. Policy makers from France to Japan are attempting to enact pro-growth reforms.

We expect U.S. Gross Domestic Product (GDP) growth to accelerate and likely surpass current consensus estimates. The Congressional Budget Office (CBO) currently predicts Gross Domestic Product will increase 2.2% in 2018, about the same as in 2017. A historical analogy points to a different outcome. Following the tax cuts of 2003, GDP growth accelerated significantly and outperformed CBO expectations by over one full percentage point in both 2003 and 2004. We believe growth will come in above 3% for the next 12 to 18 months and the 2017 Tax Cuts and Jobs Act will be extremely positive in the long-term.

Beyond the fact that ninety percent of employees saw an increase in their take-home pay in February, U.S. corporations have been unshackled from the previously archaic international tax scheme. These consumer and corporate benefits alone would have been enough to drive growth in the coming year, but additional stimulus measures both within and outside the tax code are also present. Tax reform forces the repatriation of most international earnings and allows for the immediate depreciation of capital expenditures. This will encourage industry to immediately put capital to work.

Cisco Systems recently announced plans to bring back to the United States $67 billion that it holds overseas, paying over $11 billion in additional taxes in the process. Apple also plans to bring back the vast majority of its $252 billion in overseas

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cash after paying a tax of $38 billion. We acknowledge most of these earnings won't be spent, but the gross figures of just these two companies are larger than the entire 2018 corporate, individual, and small business tax-cuts combined.

Regulatory reform will also stimulate growth in 2018. In April, we expect the Senate to vote in favor of weakening certain provisions of the Dodd-Frank Act in an effort to reduce capital burdens on banks with less than $250 billion in assets. We believe this measure, along with others proposed by the Federal Reserve, will go a long way to alleviate overly burdensome rules for small and regional banks that were treated unfairly under the 2010 financial reform law. Increased government spending will also add to the economy in the coming year.

These pro-growth initiatives do not come without a price. Signs of inflation have begun to creep into the data. The Labor Department reported January year-over-year wage growth of 2.9% (which was later revised down to 2.8% and February came in at 2.6%), while U.S. import prices rose 3.6% and Producer prices rose 0.2% month-over-month. In February, the Consumer Price Index (CPI) was up 2.2%. This is not a "hot" inflation number, but it does augur for additional interest rate hikes in the near-term. For most of the economy and the stock market, a little inflation is not a bad thing. There is a reason central banks define price stability as 2% inflation rather than zero inflation. But there is also a good reason why the great economist Milton Friedman once quipped, "Inflation is a lot like drinking—the good stuff comes first, but the hangover can be a doozy."

A little inflation can actually boost consumer and business confidence as wages and profits rise. It is not until wage growth hits 4% that we would become significantly more cautious in our outlook. An overheating economy may cause policy mistakes that could end this nine-year expansion and bull market. Others may include draconian trade measures, which appear more likely following President Trump's impromptu steel and aluminum tariff announcement, or even too much fiscal stimulus in the form of additional defense, non-defense, and infrastructure spending. At some point the Fed Funds rate will rise to a point that it begins to choke economic activity, but as of now the Fed Funds rate is still negative in real terms (Fed Funds rate minus CPI) and the runway for expansion remains long.

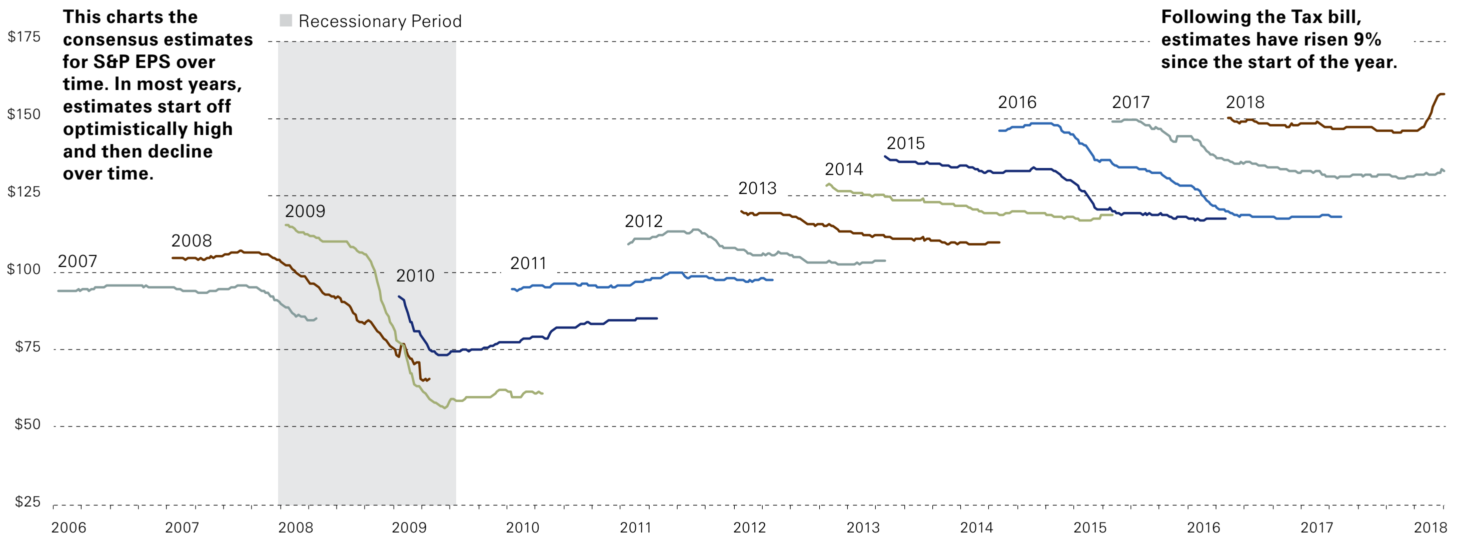
Equity market conditions turned negative in early February when a quick 10% correction occurred in a matter of days. The pullback coincided with sharply higher market volatility. After a highly unusual period when the market went more than 300 trading days without a major decline, something had clearly changed. Investors were turning their focus from improving corporate profits and GDP growth toward the possibility of higher inflation and interest rates. The yield on the 10-year Treasury note increased more than 45 basis points in less than a week, scaring bond and equity investors alike. But simply put, there is a significant difference between rising rates caused by expectations for real economic growth and higher rates due to inflationary expectations. Professor Friedman would probably say we haven't even enjoyed our first drink yet. We believe we have a long way to go before becoming truly concerned by inflation. The 30-year bond, currently at 3.12%, would be yielding much more if inflation were a real concern.

The market bounced back quickly from its February lows, as bond yields stabilized and the earnings outlook improved sharply. The S&P 500 is now cheaper than it appeared just a few months ago, at 17x consensus 2018 earnings per share (EPS). Earnings expectations have risen 9% since the start of the year. Many companies reported strong and improving fundamentals in 4Q17, and expect large windfalls from tax reform. Expectations differ greatly by sector however. Retailers, for example, are expecting improving sales trends, as confident consumers spend their income tax savings at the mall. Earnings expectations for the Consumer

Unemployment Rate versus Wage inflation

Source: FactSet Research Systems

S&P 500 Annual Earnings Estimates (Consensus; Weekly)



Source: Strategas Research Partners

Discretionary sector increased to 14% year-over-year for 2018 as retailers increased guidance for the coming year. We increased our exposure to this area in November with purchases of Gap and Tapestry in our Quality Dividend Yield Strategy.*

The Industrial sector is also set to benefit from tax reform. We expect many companies will take advantage of 100% expensing of capital expenditures, leading to a surge in new capital projects. Business investment has been a drag on GDP growth throughout this nine-year economic cycle, and one of the key reasons for the economy's poor productivity growth. Recent additions to Industrial names in our portfolios, Honeywell and Johnson Controls, have already seen a pickup in capital spending for 2018.*

Rising bond yields are a positive driver for the Financial sector. Higher interest rates expand banks' net interest margins, boosting profitability. Margins have been rising for six straight quarters. Looser banking regulations proposed by the Trump administration will further help the sector.

Interestingly, we also noted the first warnings of escalating costs in companies' fourth quarter results. As the U.S. economy ramped up, railways and trucking fleets have not kept up with demand. Mondelez, for example, halted operations last month at one of its plants because of a shortage of rail cars. Procter & Gamble and General Mills have warned of a shortage of truck drivers. With the U.S. economy running at close to full employment, shortages are particularly acute for lower-skilled workers. Many companies are experiencing higher transportation costs, which are now rising at double the pace of inflation. We took advantage of the recent volatility to reduce our exposure to consumer goods companies and added to transportation. UPS and FedEx are two portfolio holdings that should benefit. Both companies have increased prices in recent months and will implement peak period surcharges. While increased costs could push inflation expectations higher, many companies are actually lowering prices. Companies such as Walmart and Costco have said they will reinvest their tax savings in prices, in order to remain competitive. The deflationary impact of the tax reform bill will likely offset some of these higher wage and input costs.

Investors will eventually adjust to this new paradigm of accelerating growth juxtaposed with higher inflation and interest rates. We believe that with hindsight, market pull-backs will prove to be buyable events. This bull market can continue, but it will be more choppy. Hopefully, we will be able to take advantage of increased stock volatility to make positive changes to our portfolios. In response to our evolving economic outlook, we have increased holdings in industrial and financial companies while reducing exposure to consumer packaged goods companies. In portfolios with a global mandate we have increased international exposure. Markets outside the U.S. trade at a discount to the U.S. We expect this spread to narrow in the coming years as dispersion between GDP growth rates also narrow.

The rapid change in yields has created opportunities in the bond market. Floating rate notes that reprice quarterly based upon 3-month LIBOR have been particularly attractive. For those clients seeking the highest quality and principal

* Based upon individual investment objectives and/or mandates, not every portfolio for which Haverford acts as investment manager participated in the stated securities transactions.

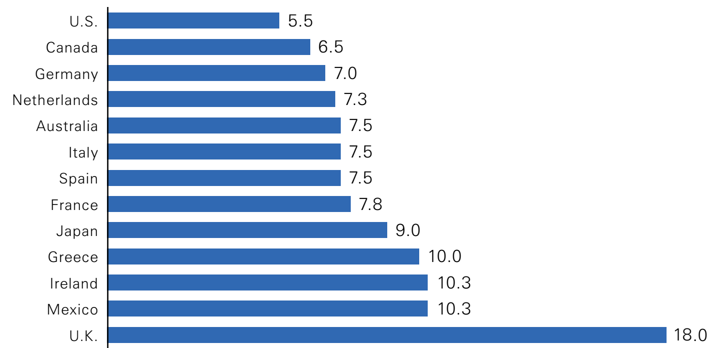
preservation, they can obtain a 2% yield on a Treasury issue with a maturity as soon as December 2018. That is a marked change from a very long period of exceptionally low rates on cash equivalents.

The structure of U.S. Treasury debt is one reason why shorter-maturity yields have risen more rapidly than longer rates in response to anticipated Federal Open Market Committee action. The U.S. has a much shorter average debt maturity than other countries. Treasury Secretary Mnuchin has indicated the maturity structure will not be lengthened and increased deficit spending will add even more pressure to short-term rates. This is very noticeable in the Treasury bill market. Bills now yield even more than insured CDs and high quality commercial paper. We are taking advantage of this exceptionally rare occurrence.

In contrast to all of the anomalies and dislocations in other sectors, the municipal bond market has been relatively tranquil during the first few months of 2018. Increased issues in advance of the tax bill in late 2017 has muted supply;

Average Maturity of Debt Outstanding (in Years)

U.S. average debt maturity is less than other countries



Source: OECD, Deutsche Bank, Bloomberg

February had the lightest new issue supply in eighteen years. As expected, investors in high tax states have favored bonds exempt from state and local taxes that they can no longer fully deduct. We anticipate that demand to continue. We continue to favor tax-exempt municipal bonds for those investors in appropriate tax brackets.

We are certain that in the future unexpected news, economic data, and market turbulence will test investors' resolve. It is one guarantee we can make. In this era of heightened political rhetoric, sensationalized 24-hour news, and instant access to near infinite data points, it may be easy to lose the long-term perspective. Haverford is here to help you maintain perspective and remain focused on meeting your goals.

All data as of March 9, 2018, unless otherwise noted.

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