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Economic and Market Outlook

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Inflection Point?

It is easier to perceive error than to find truth,
for the former lies on the surface
and is easily seen, while the latter lies in the depth,
where few are willing to search for it.
—Johann Wolfgang Von Goethe

Section I. Finding Relevance

Part A. On a Roll

The U.S. economy's improving growth looks unstoppable. But is it?

On the surface, there was much to boast about in April and May. Early indications suggest June's results simply added to what you see below:

- May's unemployment rate fell to 3.8%, the lowest in 18 years.
- The closely watched Index on Wages rose 2.7% year-over-year, better than the average rate of the last several years.
- Construction Spending surprised with a jump of 1.8% in April—the biggest monthly gain in more than two years.
- The Institute for Supply Management (ISM) Index for manufacturing climbed to 58.7 compared to the prior month's 57.3 and represents an expansion of 21 straight months above 50.
- A record of 6.7 million jobs were available in April.
- Consumer Spending accelerated in April and May, which strongly supports the higher end of GDP forecasts for the second quarter.
- Economists now forecast that the second quarter's Gross Domestic Product (GDP) will come in between 3.6% and 4.8%.

In other words, the fundamentals of growth look solid right now.

The economy clearly has Job growth and Wage gains, which support Consumer Spending. Both Business Confidence and Consumer Confidence remain strong—see [Chart-1](#) (Business Tendency Surveys for Manufacturing) and [Chart-2](#) (University of Michigan Consumer Sentiment).

The most bullish forecast of GDP comes from the Atlanta Fed's GDP Now Tracker, which sees the second quarter rising by 4.8%.

"It all sounds so good," says Bernard Baumohl, Chief Global Economist for The Economic Outlook Group, June 1, 2018. We continue to quote him at length because of the relevance of his thoughts:

Now take a deep breath because there's one other sobering fact to consider. All these great stats on the economy tend to obscure the fact that behind much of this stimulus is a raging river of fiscal red ink. The \$1.5 trillion tax cuts and the \$1.3 trillion burst in government spending essentially locks the US to a path of trillion dollar budget deficits a year for the next ten years.

The key point is you can make almost anyone and anything initially look good on the surface by relying excessively on debt—and that is precisely what is so disconcerting about this economy. Case in point: Despite all the strong economic numbers, the government still had to borrow a record \$488 billion in the first quarter. And that's just the beginning.

Is this pattern unusual, even dangerous? You bet it is and here's why.

This business expansion is now the second longest ever. We've now completed nine straight years of growth. The only other time the US achieved a ninth year of economic expansion was in 2000. Back then, like now, the unemployment rate also hovered between 3.8% and 4%. But the fundamental difference is that the strong economy and low unemployment in 2000 generated a budget surplus of \$236 billion! In fact, the government enjoyed several years of significant surpluses during that expansion. Those surpluses provided an opportunity to reduce the national debt and build a war chest to prepare for the next downturn.

In stark contrast, the ninth year of the current expansion—again with identical unemployment levels as 2000—is expected to produce a mammoth \$804 billion deficit this year, followed by trillion dollar annual deficits as far as the eye can see, according to the CBO. So you can marvel all you want about the lovely stats on jobs, construction activity and manufacturing, but the underlying truth is that a healthy economy should not be generating a sea of red ink, especially at this late stage in the business cycle.

Baumohl concludes:

Sure, the macroeconomic data have been looking good and many analysts will myopically focus on that trend. But the argument we're making is that these solid numbers look increasingly illusory! The combination of unsustainably high levels of US debt, rising short and long term rates, the prospect of a full scale trade war, and the growing disenchantment among foreign investors with President Trump's politics and trade policies—all suggest this aging expansion is approaching a turning point.

The first quarter GDP is expected to be the lowest quarter of growth for the year, at 2.2%. The quarter ending this month (June), when reported in late July, should be very strong (i.e., up to 4.8%), but should also prove to be the peak quarter for 2018.

Additionally, Corporate Earnings' growth is likely to have already seen its best quarter for the year, at a 26% year-over-year rate for the first quarter.

John Lynch, Chief Investment Strategist for LPL Financial, recapped just how excellent the first quarter's earning season was. He noted the following highlights:

- S&P 500 earnings have now increased at a double-digit clip four out of the past five quarters.
- The streak of consecutive quarters with earnings exceeding expectations is now 36, based on Thomson Reuters' data.
- The percentage of companies beating earnings estimates at just over 78% is the highest since FactSet began tracking the data in 2008.
- The magnitude of the upside surprise, at 7.5%, was the biggest since 2010.
- Revenue grew more than 8% year over year, fastest since 2011 (and in line with the fourth quarter of 2017).
- Estimates for the next four quarters rose during reporting season, a relatively rare positive development.

Despite the economic environment being the perfect scenario for stocks (i.e., excellent growth), and the second-quarter expectations remaining solidly positive, the stock market was mired in a correction (decline of 11.6% at its low). The correction can be seen in Chart-3 (S&P 500 Monthly Close Since 1995 with 120 Month Simple Moving Average).

The average correction involves a decline of 13.3%, with a range between a decline of 10.1% in 1967 and 19.9% in 1990. The average, as well as most frequent, duration of a correction has been four months, with a range of two to seventeen months.

We believe the decline that took place during the first and second quarters was a correction and not the beginning of a Bear Market because 88% of the 16 Bear Markets seen in Table I were directly related to recessions (14 of 16), and there is no recession underway or even close at hand (supported by our seven leading economic indicators

and the two Nowcasting Indexes—discussed below in Section II). Note the average Bear Market involves a decline of 38.3% versus the 13.3% for corrections.

Part B. What Could Go Wrong?

A tightening supply chain, longer lead times, shortage of parts, shortage of labor—these are all leading to a bidding war for the marginal capacity. The lack of prior investments in capacity has collided with a rapid rise in demand.

Result—Price Pressures.

Factors:

1. Backlogs hit their highest level since April 2004: ISM Backlog of Orders Non-Manufacturing 60.5—Manufacturing 63.5.
2. Inventories still falling, but less so each month: ISM Manufacturing Inventories—Feb. 56.7; March 55.5; April 52.9; May 50.2.
3. An indication of high-demand pressures can be seen by looking at Customer Inventory levels: Manufacturing—Feb. 43.7; Mar. 42.0; April 44.3; May 39.6; Non-Manufacturing—NA (not surveyed).
4. Prices showing consistent upward pressure: Non-Manufacturing—Feb. 61.0; Mar.61.5; Apr. 61.8; May 64.3; Manufacturing—Feb. 74.2; Mar. 78.1; Apr. 79.3; May 79.5.

What is becoming clear is that supply chains are increasingly interlinked globally, which makes them vulnerable to an all-out trade war. Just the fear of supply-chain disruptions and/or higher prices can easily both slow production and increase costs (i.e., inflation)—and inflation could prompt more aggressive action by the Fed in the form of higher interest rates.

Chart-4 (Current Prices Received; Diffusion Index for FRB – Philadelphia District) reflects the manufacturers' average prices. Note the sharp rise, particularly since the beginning of 2018. The latest level is the highest reading since March of 1989—nearly 30 years ago. The prior time before 1989 that the Index reached a level of 40 involved Fed Chair Volcker's decision to induce a recession to kill spiking inflation (note: the 1981-82 recession was the worst downturn to that time since the Great Depression, with nearly 11% unemployment). See Chart-5 (Consumer Price Index) as the evidence of inflation influencing recessions.

As an example of rising demand encountering inventory shortages, we look to housing, where U.S. Home Prices increased 8.7% between April of 2017 and April of this year. The year-over-year increase was the fastest increase in twelve years, according to data released from the Federal Housing Finance Agency (FNFA).

Chart-6 (Underlying Inflation Gauge and Prices [UIG] with CPI, Core CPI) is a new indicator of inflation created by economists at the NY Federal Reserve Bank.

The UIG uses a dynamic factor model for large data sets that signal changes in trend inflation. Note the UIG is well above the Federal Reserve's desired inflation level of 2.0 to 2.5%. At 3.2%, the UIG supports what we see from ISM data of Manufacturing and Non-Manufacturing industries.

Part C. Inflation and Rising Interest Rates Have Arrived

Question: Are we near the peak, or will the upward direction continue?

Political risks loom large in Corporate thinking about both prices and production.

The following excerpt, which we quote at some length, from ISM's May report (issued June 5, 2018) outlines the concerns (with our underlining emphasis):

Companies surveyed by the Institute for Supply Management have been reporting rising prices for the past two months, including sharp spikes in steel and aluminum.

And many executives in corporate earnings reports also reported seeing rising costs, and were planning to increase prices to consumers.

In its semi-annual economic forecast released Monday [June 4], ISM said 74 percent of manufacturing companies and 50 percent of services firms believed the tariffs would "raise the price of the goods that you produce and deliver to your customers."

Manufacturers expect an average price hike of 5.4 percent, while the services firms put the figure at just over seven percent, the survey showed.

Meanwhile, close to 60 percent of firms in both sectors expect "delays and disruption" in their supply chain due to the tariffs.

This too could lead to price increases and companies have already been complaining about logjams in deliveries, in part because of the lack of truck drivers.

Companies around the country have reported difficulties finding workers to fill open positions and this survey showed 78 percent of manufacturing companies and 64 percent of services firms have struggled to hire in the past six months.

ISM reported that about half of the manufacturers had raised wages, compared to just a third of services firms.

The survey showed firms in both sectors were generally upbeat about their prospects for continued growth this year.

"However, finding and onboarding qualified labor and being able to pass on raw material price increases will ultimately define manufacturing revenues and profitability," said Timothy R. Fiore, chair of the ISM Manufacturing Business Survey Committee.

However, there was a sharp decline in the share of firms expecting to increase capital expenditures this year, compared to the December survey. That could be a reflection of the uncertainty over the trade disputes, which businesses have warned could hurt growth this year.

Prices Paid a Warning Sign for Profits—and Trade

The prices index has been above 70 all year, rising to 79.5 in May, which is the highest print in seven years. The rise in the index follows the path of core finished goods PPI (bottom graph) [our Chart-7 {ISM Prices Index & Core Finished Goods PPI}]. In April, 61.2 percent of respondents reported paying higher prices. Of the industries, seventeen reported paying higher prices, including apparel, textile mills, furniture, fabricated metals and electrical equipment.

To corroborate the price pressures, supplier deliveries remained above 60 for the third consecutive month, indicating slower deliveries to meet orders. Sixteen industries reported slower deliveries, including apparel, machinery, fabricated metals and textiles. Commentary from survey respondents highlighted the issue of labor shortages, transportation delays and tariff uncertainties.

This report reinforces our outlook for continued increases in the PCE deflator and the employment cost index for 2018. While output has improved, the bigger story from the ISM release is the rise in uncertainty on supply chain availability and rising prices paid for inputs. Higher input prices could weigh on profit margins, causing upward pressure on inflation. Similarly, a higher level of uncertainty will impact economic actions going forward and, in our view, lead to higher inflation and thereby continued Fed rate increases this year.

Like Charts-1 and -2, Chart-8 (NFIB Small Business Optimism Index) remains relatively strong, which indicates Business Confidence, similar to Consumer Confidence, continues to support an expanding GDP.

However, inflation, supply-chain, and interest-rate pressures continue to intensify.

The lengthy quote from the May 2018 ISM report shows our concerns to be justified—Cost-Push Inflation is afoot!

To date, neither the Fed's balance sheet reduction (i.e., sales of Treasury and Mortgage debt) nor the refinancing needs of corporations have greatly added to upward pressures on interest rates, which is one of the elements of Cost-Push Inflation (i.e., the cost of capital).

Reductions to the Fed's balance sheet will take place over years, not months, and is thus unlikely to have a dramatic impact on interest rates.

However, repairing the corporate balance sheet is a large problem because corporate America is staring down a \$4 trillion wall of refinancing.

After years of borrowing for stock buybacks, company buyouts, and increased shareholder dividends—all at extremely cheap interest rates, the amount of debt to be refinanced will put added pressure on interest rates.

Chart-9 (CORPORATE BALANCE SHEETS ARE NOT IN GOOD SHAPE!) shows that corporate debt has returned to the peak levels before the last three recessions. The amount of corporate debt is measured as a percentage of GDP.

The debt problem on balance sheets is, in fact, a global problem because central banks all pushed rates lower. According to S&P Global Ratings, corporations with high debt-to-earnings ratios (i.e., at five times or greater) hit 37% at the beginning of 2018 versus 32% before the recession in 2007.

For the U.S., our concern is that companies will need to refinance \$4 trillion in bonds over the next five years, with the need starting at the \$700 billion level this year, and another \$750 billion in 2019. See Chart-10 (Maturing Debt).

Debt due to be refinanced in the next five years represents two-thirds of all outstanding debt according to Well Fargo Securities. If more of one's cash flow is spent into servicing one's debt, and not growing one's company, that could, over time, lead to slowing corporate growth and possible economic contraction.

Increasingly, investors are likely to fear that, as companies are forced to refinance at higher rates, credit conditions will erode.

Unfortunately, not only does the Fed desire to sell debt issues into the market, and corporations must refinance (sell issues into the market), but, thanks to the tax cut and deficit-spending increase passed in 2017, \$1.12 trillion in new debt will hit the market in the current fiscal-budget year—up from \$665 billion in 2017 and \$584 billion in 2016.

Clearly, bond traders are about to grasp the size of the bond deluge (Monetary, Fiscal, and Corporate).

It is quite possible that the market, and not the Fed, will force interest rates higher in the second half of 2018 and in 2019.

The following is from a Bloomberg interview, April 7, 2018:

Rick Rieder at BlackRock Inc. is among investors saying mounting deficits are likely to be a driving force for the Treasury market in 2018. In his view, the prospect of ballooning issuance, combined with quicker inflation and shifting central-bank policies, "truly changes the supply/demand paradigm."

Also taken from the same Bloomberg interview is the following:

"The CBO report will certainly restart the conversation on how high deficits are going to be in the coming years," said Gennadiy Goldberg, senior U.S. rates strategist at TD Securities. "The market still hasn't caught on to the fact that deficits in the 2019 fiscal year are going to be immensely higher than this year."

One added point—unless the majority of the new debt requirements are issued at the 10-year-and-longer-term time frame, the shape of the yield curve may fully flatten and then invert. Investors would take an inversion (i.e., 2-year Treasury greater than 10-year) as a sign of a developing recession and Bear Market.

The Yield Curve is one of our seven leading economic and market indicators. It is currently positive (see below in Section II).

Part D. “Flat-Earth Economics”

In May of this year, 1,140 economists, including 14 Nobel Prize winners, sent a letter to President Trump warning that his tough rhetoric and protectionist policies threatened a “repeat of the mistakes the U.S. made in the 1930s, mistakes that plunged the world into the Great Depression [quotation taken from *The Guardian*, May 3, 2018].”

In 1930, a similar letter of warning was signed by 1,028 economists. President Hoover ignored the letter.

Dominic Rushe, writing for *The Guardian*, quotes from the warning letter to President Trump:

Today, Americans face a host of new protectionist activity, including threats to withdraw from trade agreements, misguided calls for new tariffs in response to trade imbalances, and the imposition of tariffs on washing machines, solar components, and even steel and aluminum used by US manufacturers.

Congress did not take economists’ advice in 1930, and Americans across the country paid the price. The undersigned economists and teachers of economics strongly urge you not to repeat that mistake. Much has changed since 1930—for example, trade is now significantly more important to our economy—but the fundamental economic principles as explained at the time have not.

Rushe also quotes Bryan Riley, Director of the National Taxpayers Union, which coordinated the letter. (Note: The National Taxpayers Union is a conservative taxpayers advocacy organization.) Riley said:

Many of the arguments against free trade were like “flat-earth economics.” People look at the changes that have gone on in the country and blame free trade for, say, the decline in manufacturing, when in fact the changes have more to do with automation.

Riley went on to say:

In comparison with the 1930s, international trade is now more important to the global economy than ever. If Trump’s rhetoric translates into a full trade war, the consequences could be dire. We rely more on international trade than at any point in world history.

In our March 2018 report entitled, “The Mistaken Gamble of Fiscal Policy,” we quoted Douglas Irwin, Professor at Dartmouth College, and recognized expert in trade, who said, “In June of 1930, Henry Ford reportedly told President Hoover that the Smoot-Hawley tariff bill was ‘an economic stupidity!’ Few listened!”

In a parallel to Henry Ford (Foremost Industrialist in the 1930s), Gary Cohn (Prominent Investment Banker, formerly with Goldman Sachs, and briefly President Trump’s Director of the National Economic Council, until he resigned) said that the use of “tariffs and trade disputes could wipe out all of the gains of the tax cuts.” He warned that the hit to the economy could exceed the \$2 trillion benefit of the tax cut.

We can only hope that President Trump does not make Hoover’s mistake.

In *The New York Times* article entitled, “Just the Fear of a Trade War Is Straining the Global Economy” (June 16, 2018), the writers, Peter S. Goodman, Ian Austen, and Elizabeth Malkin, say:

Fears are deepening that the current outbreak of antagonism could drag down the rest of the world.

Just talking about protectionism is causing trouble. It’s an existential risk to the world economy.

They continue:

The Trump Administration has embroiled the United States in increasingly acrimonious conflicts with huge trading partners. If you seriously disrupt any of these, you’re going to feel the effects.

Two days earlier (June 14, 2018), the Editorial Board of *The New York Times* issued their own warning:

Trade deals can be renegotiated—sure, let’s get a better deal with China—as countries and their economies evolve and the needs of their citizens change. The American economy was once dependent on manufacturing; today, service exports carry much more of the load. It doesn’t mean we don’t build jets or cars or chips, but it does mean that the software and computing algorithms that operate in those things may have as much value as the hardware and may provide better jobs.

Mr. Trump doesn’t see it that way. He lives in a world where Pittsburgh is still Steel City. But it’s not the 1960s anymore—Pittsburgh makes sophisticated robots, not steel.

Threatening an all-out trade war, insulting our next-door neighbor and ally, will not change the nature of our economy, only damage it. In Wisconsin and Iowa, Nebraska and Kansas, farmers who need to maintain access to foreign markets are hoping that Mr. Trump’s bluster is just that, a negotiating tactic, and that cooler heads will eventually prevail.

Don’t bet the farm on it.

The dynamic of a trade war between the United States and friend as well as foe grew dramatically during this past quarter.

Jim Cramer, former Hedge Fund Manager and current CNBC commentator, said on June 18, 2018:

Such trading blows are likely to raise costs—and hurt profit margins—for many very large companies and their supply chains. Trade war fears are now trade war truths [our emphasis].

Buckle up.

His statement describes an inflection point in thought. We have yet to see what the consequences will be to such a turning.

Section II. State of the Economy

In what follows, we update the state of the economy and the stock market.

The current state of the economy is one of expansion. That conclusion is based on the current status of the seven economic indicators that have served us well.

Our conclusion is further supported by the Nowcasting Indexes of the Federal Reserve Banks of Chicago and Philadelphia.

The status of each indicator appears in the Summary Table below.

Summary Table of Charts 11-17

<u>Indicator No.</u>	<u>Chart</u>	<u>Indicator Name</u>	<u>Status</u>
(1)	<u>Chart-11</u>	<u>Civilian Unemployment Rate</u> (Current vs. 12 Months Moving Average)	Positive
(2)	<u>Chart-12</u>	<u>Real Retail and Food Service Sales</u> (Percentage Change from Year Ago)	Positive
(3)	<u>Chart-13</u>	<u>Industrial Production</u> (Percentage Change from Year Ago)	Positive
(4)	<u>Chart-14</u>	<u>Real Personal Income Excluding Transfer Receipts</u> (Percentage Change from Year Ago)	Positive
(5)	<u>Chart-15</u>	<u>All Employees: Total Nonfarm Payments/Civilian Labor Force</u> (Percentage Change from Year Ago)	Positive
(6)	<u>Chart-16</u>	<u>10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity</u>	Positive
(7)	<u>Chart-17</u>	<u>Smoothed U.S. Recession Probabilities</u> (Percent)	Positive (low prob.)

Concerning the indicators listed in the Table above (see Charts 11-17), it is important that any decision to reduce the allocation to stocks due to an expected Recession depends on sell signals from a majority of the seven indicators.

In effect, four of the seven must be negative and, at the same time, the market direction must be negative (i.e., the 40-Week Moving Average of the S&P 500 Index must be greater than the current week).

It is clear from the Table above, we are nowhere near meeting the required forecast for a Recession and, by derivation—a Bear Market.

Chart-18 (Chicago Fed National Activity Index) is clearly above the -.70 line that declares a recession exists.

Chart-19 (Aruoba-Diebold-Scotti Business Conditions Index) is also well above the -.80 line that declares a recession exists.

Section III. Political Risk

Political risk refers to one of the types of investment risk—specifically, it is defined as:

Any political change that alters the expected outcome and value of a given economic action by changing the probability of achieving business objectives (fiscal, monetary, trade, investment, industrial, income, labor, developmental) or events related to political instability (terrorism riots, coups, civil war, and insurrection).

Sources—“Integrating Political Risk in Enterprise Risk Management,”
PricewaterhouseCoopers (2006)

—“Political Risk Management: A Portfolio Model,”
Business Horizons (1988)

As we said earlier, the second quarter GDP will most likely be the best for 2018.

There is a clear and present danger that the second quarter results will prove to be the peak quarter for the economic expansion now nine years old (June 2009 to June 2018).

Why do we believe that the quarter just ended may prove to be the peak quarter of growth? The underlying cause is the cancer-like growth of protectionism.

The uncertainty over trade is nothing short of dramatic.

A recent survey (June 5, 2018) conducted by the Business Roundtable showed, “A whopping 89% of CEOs described lower US economic growth as a moderate to serious risk.”

The overall CEO Economic Outlook Index fell from 118.6 in the first quarter to 111.1 in the second quarter.

The Business Roundtable is chaired by CEO Jamie Dimon, of JPMorgan Chase, who was quoted as saying, “Rather than planning future corporate hiring sprees, as Trump might have us believe, CEO fears of future trade wars actually seem to be curtailing job-expansion plans.”

Federal Reserve Chairman Jerome Powell said, on June 20, 2018, “For the first time we are hearing (from business leaders) about decisions to postpone investment, postpone hiring, postpone decisions [our emphasis].”

Sadly, political risk has become the primary concern for the economy and, in turn, the financial markets.

Nevertheless, unless a trade war bumbles into being, we anticipate further solid earnings reports in the third quarter with above-average gains in the fourth quarter to be the governing dynamic for the stock market.

Thus, until the concerns discussed in Section I, and above concerning political risk, actually result in our primary economic and market indicators to turn negative on balance, the significance of our report speaks for the continuing need for heightened awareness and the exercise of caution.

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