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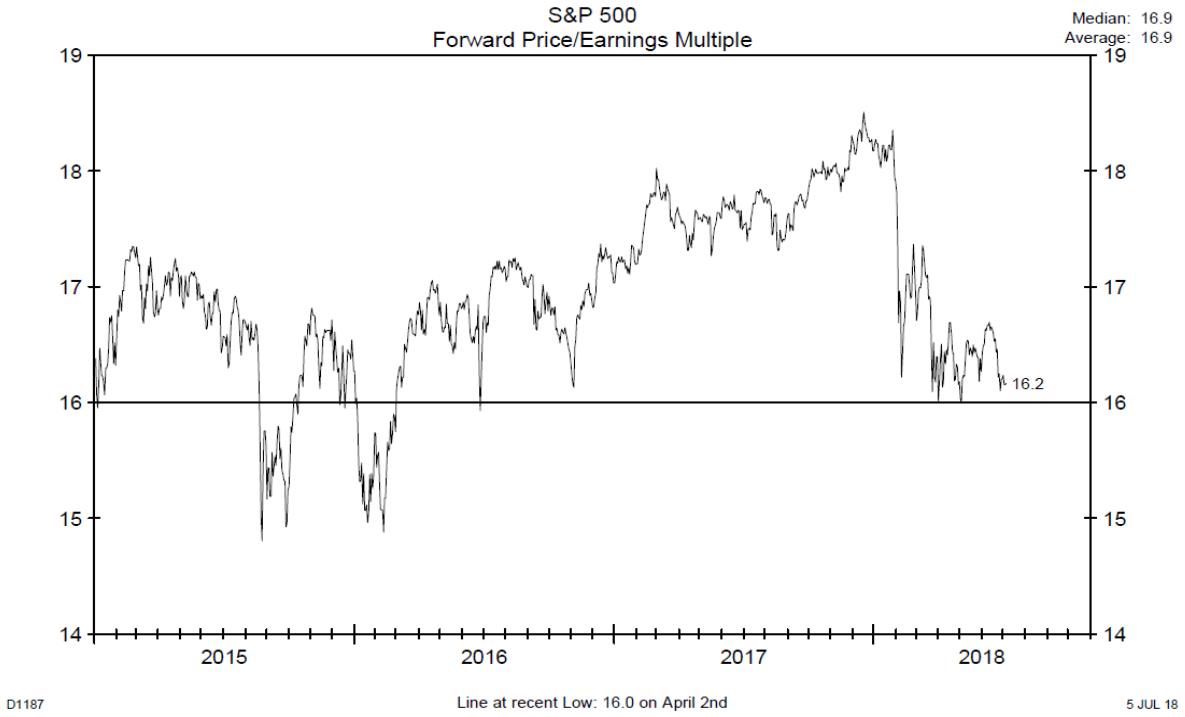
Private Wealth

HANDICAPPING THE FUTURE

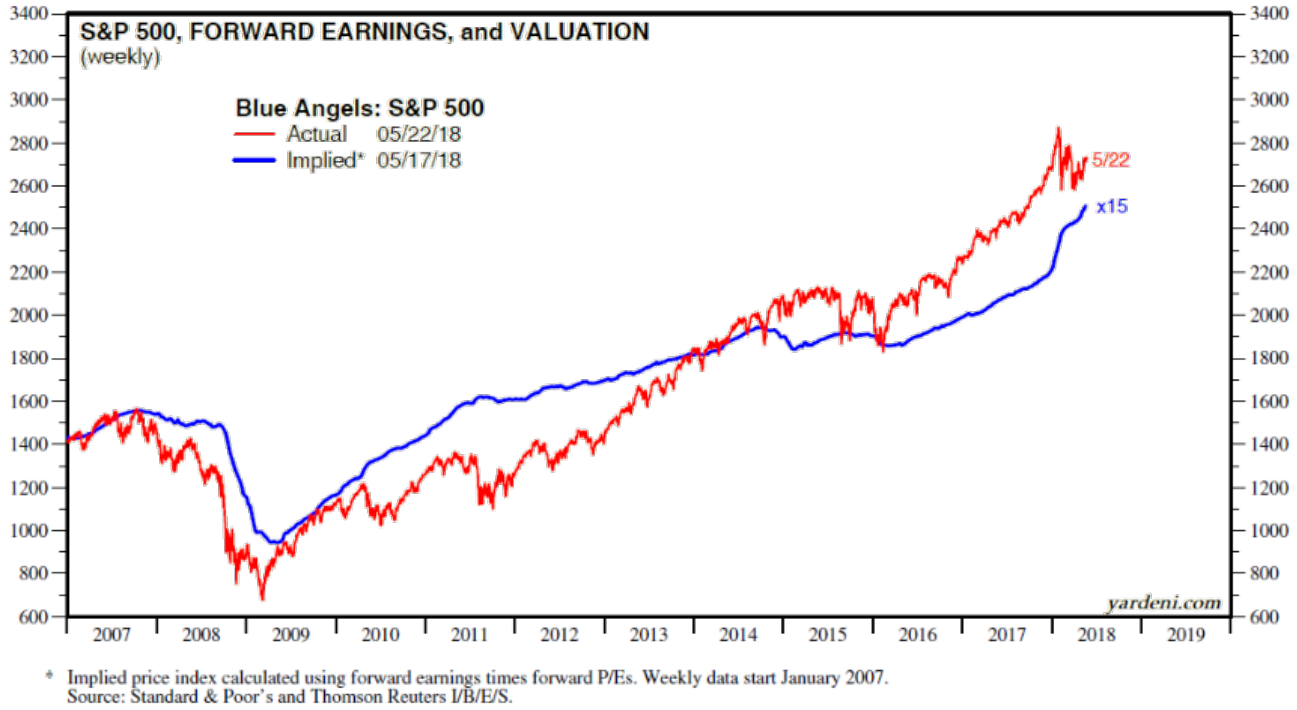
Since the January high and subsequent 10% correction, the market has been in a relatively narrow trading range for roughly five months. However, earnings estimates continue to improve and the economy is reasonably strong. So, why the hesitation? In my opinion, it has to do with having a clear view of the future and what is fogging our lenses is the Federal Reserve policy and foreign trade negotiations. Markets don't like uncertainty and until we get some resolution to these issues, especially the trade impasse, the market isn't likely to make much headway.

So, let's examine some of these issues. Simplistically, the market is two dimensional. It's earnings times a price earnings ratio. The earnings variable has been performing very well. Analysts now forecast earnings for the S&P 500 to reach $161.33 this year and $176.61 for 2019. For the next twelve months the average of these two forecasts is $168.97 which puts the S&P 500 at just over 16x earnings.



Source:

If we use 15x earnings as historic fair value, we're a little on the expensive side. But we almost get back to the average as the year progresses and 2019 earnings come into focus.



Source: Yardeni

So, valuation doesn't seem to be a threat to this market. However, the extent to which investors handicap these earnings estimates will determine the future direction of the market and as I said, Federal Reserve policy and trade negotiations seem to be the two most critical issues.

Federal Reserve Policy

So far, the Federal Reserve has raised interest rates seven times to a range of 1.75 to 2.00%. Expectations now call for two more hikes this year, which would take us to 2.25% to 2.50% by year-end, with a further two hikes anticipated in 2019.

Historically, higher interest rates aren't good for the market. Initially, they limit or lower the markets' valuation or price earnings ratio because they foretell a slowdown in the economy. Today, economists aren't sure how much tightening the economy can take because of the extraordinary amount of debt outstanding. One indication could be the net interest on government debt service, which is now up 14.7% year over year at the end of May. That's a big increase for interest rates at 1.5%. So, the worry is that the Fed could overshoot and take rates too high.

Nonetheless, Federal Reserve Chairman Powell seems intent on further rate increases as he references the "Neutral Rate" as his target. This is a level of interest rate where monetary policy neither boosts nor slows the economy but keeps it moving forward on an even keel. Powell said that he believes the neutral rate is in the range of 2.25% to 3.5%. This suggests that there is at least another two or more rate increases in store. Today the ten year treasury rate yields 2.85%. If the spread to the Fed Funds rate is maintained, it would push its yield to 3.60% by sometime next year. However, Powell has also said that he is prepared to be tempered with his rate increases should inflation pickup. And, currently, there are some signs that this may happen. The producer price index for May rose 3.1% year over year and tariffs could make this worse. The risk is that with more inflation, the ten year yield starts to normalize. Since 1962, the real or inflation adjusted yield has averaged 2.3%. With the CPI at 2.8%, it would mean that Treasuries could yield 5.1%, a lot higher than the market expects.

Trade Policy

Probably the biggest issue facing the market is trade policy uncertainty and whether Trump is negotiating to change attitudes and for fairness or whether he, in fact, wants to reverse the trade deficit. If it is the latter, it won't be good for either interest rates, inflation or the economy. In fact, given the consequences of this issue, it is remarkable that the market is performing as well as it has. Certainly, other global markets, especially in Asia, seem to be taking this issue more seriously and have had sizable corrections.

Because a trade war is so difficult to quantify, it is possible that analysts are waiting for some kind of corporate guidance. Similarly, when tax reform was passed at the end of last year, analysts refrained from raising estimates until they got guidance, especially during the year-end conference calls which resulted in the market peak run-up at the end of January. Although trade policy is only now unfolding, there will likely be a number of negative comments during the upcoming second quarter earnings reports. Even if earnings estimates are not changed, although they very well could, it wouldn't be a surprise to see the handicapping of those future earnings move down a notch or two.

The problem is that this isn't just about tariffs. In fact, in the recent "2018 National Trade Estimate Report on Foreign Trade Barriers", tariffs aren't even one of the main categories. They are included with Import Policies. So, when Trump talks about fairness, one has to assume it is in the context of this report which classifies trade barriers into ten different categories.

2018 National Trade Estimate Report on Foreign Trade Barriers

1. **Import policy**

   - Tariffs and import charges, quantitative restrictions, import licenses, customs barriers, and other market access barriers

2. **Sanitary and phytosanitary measures to trade**

   - Standard related measures include testing, labeling and certification requirements

3. **Government procurement** (e.g. buy national policies and closed bidding)

4. **Export subsidies** (e.g. export financing on preferential terms and agricultural export subsidiaries that displace U.S. exports in third country markets)

5. **Lack of intellectual property protection** (e.g. inadequate patent, copyright, and trademark regimes and enforcement of intellectual property rights)

6. **Service barriers** (e.g. limits on the range of financial services offered by foreign financial institutions, restrictions on the use of foreign data processing and barriers to the provision of services by foreign professionals)

7. **Investment barriers** (e.g. limits on foreign equity participation and access to foreign government – funded research and development programs, local content requirements, technology transfer requirements and export performance requirements and restrictions on repatriation of earnings, capital fees and royalties)

8. **Governments** – tolerated anticompetitive conduct of state-owned or private firms that restricts the sale or purchase of U.S. goods or services in the foreign country's markets

9. **Digital trade barriers** (e.g. restrictions and other discriminating practices, affecting cross-border data flow, digital products, internet-enabled services and other restrictive technology requirements)

10. **Other barriers** that encompass more than one category (e.g. bribery and corruption that affect a single sector)

Generally, the report focuses on the growing trend by trading partners to impose localization barriers that are designed to protect, favor, or stimulate domestic industries, services, providers or intellectual property at the expense of imported goods, services or foreign-owned or developed intellectual property. Many unreasonably differentiate between domestic and foreign products and services.

The problem is that non-tariff barriers are very difficult to quantify.

So far, Trump's approach to the trade negotiations has been disjointed and piecemeal. But it is starting to gain some clarity, in that he is taking a different tact than previous presidents who chose to take their disputes to the World Trade Organization (WTO) where it can take three to five years to fully resolve an issue. Instead Trump is using Section 232 of the Trade Expansion Act of 1962, which allows the president to adjust imports without a vote by Congress should the Department of Commerce find evidence of a national security threat. The law doesn't define "national security risk" but he recently declared that the steel and aluminum industries were strategically important.

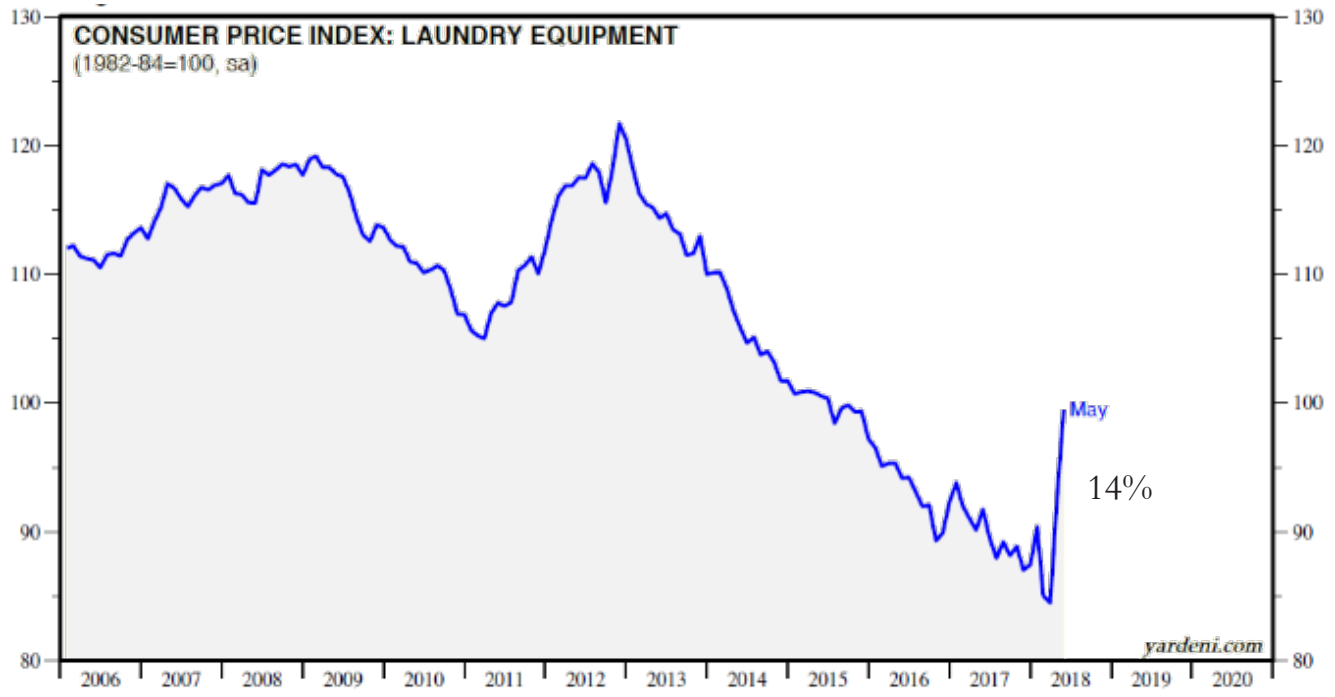
There is also section 301 of the Trade Act of 1974 which allows a U.S. trade representative who is part of the executive office of the president to designate and retaliate for unfair trade practices by other nations. As a result, this started Robert Lighthizer's probe into whether China was infringing on American Intellectual Property Rights, innovation or technology development.

These actions go well beyond the use of tariffs and suggest that the trade issue unrest could be with us for a while and again, the handicapping of future earnings could suffer.

China has already implemented regulatory actions which include more onerous customs procedures and border inspections.

Furthermore, tariffs seem to hurt the importing country as much as the targeted country.

As an example, the Consumer Price Index (CPI) for laundry equipment had been falling since 2012 until tariffs on washing machines were imposed in January of this year as shown below.



Source: Bureau of Labour Statistics, Yardeni

It then jumped by 14% from December through May.

The Purchase Price Index (PPI) for steel mill products has also jumped by 10% between February and May.

From my experience, I have rarely seen protectionist measures used to re-capture market share. In most every case, they have been used as cover to raise prices. More tariffs will equal higher inflation.

So far, the tariff negotiations only amount to posturing. The only serious consequences seem to be for the American farmer where soybean prices have collapsed. But the threat of tariffs on autos takes this strategy to another level. The U.S. is the world's largest auto importer at $296.12 billion of goods. A threatened 25% tariff would cost Americans $45 billion or roughly $5800 per vehicle.

Further escalation of the trade war or not, business confidence and threatened supply chain disruptions are causing businesses to postpone spending. This is not good for the economy.

Consequently, trade tensions suggest higher inflation, potentially higher interest rates and slower GDP growth.

Market

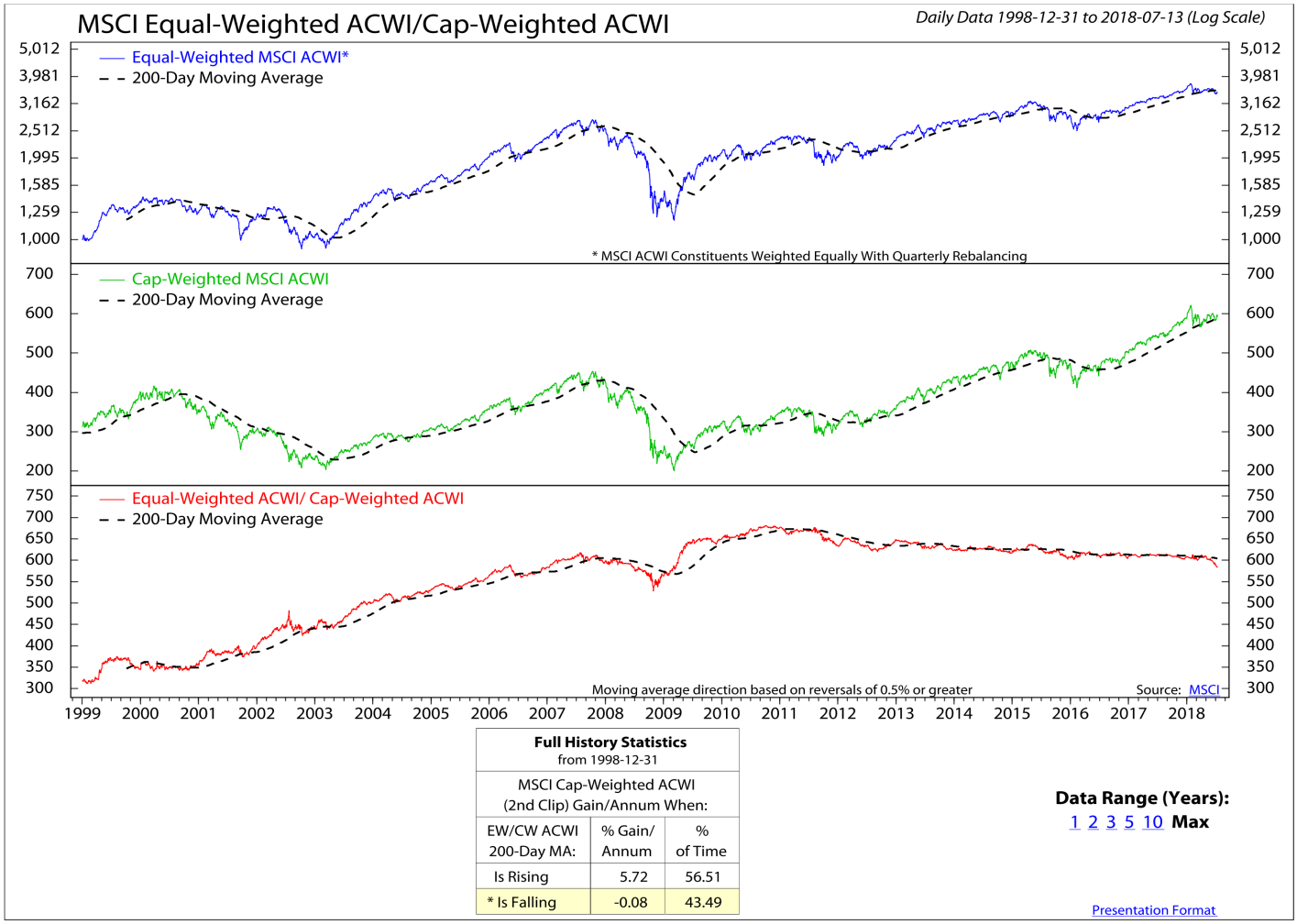
We've consistently said that we don't see an end to this bull market until there is either a threat of recession or we get a much tighter monetary policy.

Right now, we seem to be past the peak in global economic growth, but U.S. indications still point to a reasonably robust expansion. In fact, this small deceleration in economic growth is probably a positive because it takes the pressure off the Federal Reserve to press with further interest rate hikes and will ultimately extend the economic cycle.

Nonetheless, trade war escalation threatens this constructive outlook and investors are increasingly questioning what they should pay for the tax induced jump in this year's earnings.

Furthermore, the market's internal indicators are not as constructive as we would like to see. Breadth is getting narrow which is a condition that we have seen as precedent to many previous market tops. Of the eleven market sectors, only three remain above the 200-day moving average.

A good way to monitor this is by comparing the capitalized (cap) weighted market averages against the equally weighted average.



Source:Ned Davis Research

While the cap weighted average has continued to hold up, the equally weighted average is underperforming. The bottom clip in the above chart compares the two averages and indicates the differential between the two has reached a nine-year low.

This narrowing in contribution is even more apparent when reviewing the performance of the FAANG stocks (Facebook, Amazon, Apple, Netflix and Google). The S&P 500 is up approximately 78 points year-to-date and of this advance, the FAANG stocks have contributed as follows:

Amazon	24 points
Apple	15 points
Netflix	9 points
Facebook	5 points
	53 points
Microsoft	15 points
	68 points

Combined, Amazon and Microsoft account for 50% of this year's gain in the market. This lack of breadth is generally not a good sign and we would much prefer to see broader market participation.

Looking a little further into the future suggests some caution. Interest rates are projected to rise further and will likely start to bite. The Federal Reserve's reduction in its balance sheet will reduce liquidity. The European Central Bank will likely move from accommodate to at least a neutral policy. Fiscal stimulus for the economy from the U.S. budget deficit will start to fade next year and the impact from tax reform will have worked its way through the system by the end of this year.

Furthermore, earnings comparisons will become increasingly more difficult starting in 2019.

Right now, the fundamentals of the economy and earnings projections gives us some comfort.

However, handicapping the future is getting tougher. Markets like to have a clear and positive view of the future and we need the trade clouds to lift to give us some visibility.

GRC/amh
July 4, 2018

CREDITS: Ned Davis
TD Securities
Yardeni Research