ON THE RADAR SCREEN

1. A war of words over trade is rapidly escalating into a war of deeds as a growing list of tariffs come into force. The levies themselves are insignificant relative to total economic activity, but ancillary effects such as diminished business confidence and supply chain disruptions could prove far more deleterious.

2. Accelerating capital expenditures, driven by both tight labor markets and provisions of the tax reform legislation, are lifting business activity and will hopefully lead to improvements in worker productivity. Look for this to persist.

3. Wage gains remain modest despite numerous indications of a very tight labor market. Should that change, the Fed would likely feel pressured to maintain or even accelerate the pace of monetary tightening.

4. The burden of hostile rhetoric around trade has fallen squarely on the shoulders of emerging economies. Stress evident in Turkey and Argentina has spread to Brazil, Mexico, South Africa and other locales. A full-blown EM currency crisis does not yet look to be in the offing, but the odds of such are rising.

5. Spreads on Italian debt have widened versus core Eurozone sovereigns as a populist coalition took power and granted key positions to a number of Eurosceptics. Another chapter in the ongoing European debt crisis may lie ahead. Support helping to sustain the rally these past couple of years.

MARKET & ECONOMIC OUTLOOK

EAGLE STRATEGIES IS PLEASED TO PRESENT ECONOMIC AND MARKET INSIGHTS FROM THE PORTFOLIO MANAGERS IN THE STRATEGIC ASSET ALLOCATION AND SOLUTIONS DIVISION.

“Let China sleep; when she wakes, she will shake the world.”

– Napoleon, 1817

Shooting the US expansion in the foot. Looking at the incoming data, the situation on the ground couldn’t appear to be much better. The second quarter gross domestic product (GDP) print is likely to be the strongest observed in several years. Growth is well supported by the consumer, the firm, and the government. Household spending is popping as strong payroll gains, rising wages, and low debt service costs leave families with plenty of disposable income. Corporations – flush with cash from repatriated earnings and spurred on by changes in the tax law – are reinvesting aggressively in their businesses. A generous government budget provides a further boost to final demand that surpasses the impact of rising rates – for now.

This booming economic activity is translating into soaring profits. Earnings were up more than 20% year over year in the first quarter, and the second quarter numbers look similarly promising. If the story were to end there, we would undoubtedly run amongst the rampaging bulls. But, of course, the story doesn’t end there.

We see two primary sources of risk that could bring about the premature demise of the current expansion, both of which fall into the category of self-inflicted wounds. The first is the growing potential for a monetary policy error. Fed members and their new chairman, Jay Powell, are determined to normalize rates and choke off inflation before it materializes in pernicious form. That’s a noble goal, but its pursuit doesn’t justify euthanizing otherwise healthy economic growth, which is exactly what the yield curve suggests is possible. There is a great deal of information embedded in the term structure of rates. Yields at the long end of the curve remain depressed (somewhat to our surprise) as bond buyers collectively continue to view inflation and the neutral policy rate as being quite low over time. The Fed’s rate hike actions are causing the shape of the curve to flatten markedly.
Insights from the Strategic Asset Allocation and Solutions Division

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Should they ignore the message the bond market is sending and persist in their every-other-quarter hike campaign, the curve is likely to be inverted early in 2019, precipitating the next recession a year or so later. Our hope is that they will moderate the pace of tightening, allowing the economy to run a little hot for a while, and in so doing, give the long end of the curve a chance to normalize. The other worry on our minds – one we seem to share with most everybody – is around trade policy. For decades, the US has been in the vanguard of the charge toward free trade and increased globalization. That policy direction has turned on a tweet in 2018 as the Trump administration has picked tariff fights with all our major trading partners. The levy’s themselves are not of a size that they threaten to materially enervate global growth, but knock-on effects very well may. Repercussions of the growing barrage of tariffs are likely to include supply chain disruptions, a strengthening dollar, faltering business confidence, and mounting stress in financial markets of emerging economies. We remain of the opinion that the president’s trade advisors are employing tariffs as a negotiating tactic to secure terms of trade more advantageous to the US. These barriers are not likely to be as imposing or long enduring as feared, but they nevertheless will usher in some vexing days for investors. If tariff threats are to be effective tools at the negotiating table, they must be believed – not only by our trade partners, but by financial markets also.

In most things we strive to be pragmatic, not dogmatic, but our faith in fundamental data can only be labeled dogmatic. As such, given the strength of readings on the state of the US economy, we continue to lean heavily into equities. We do so, though, we significantly more reluctance than was the case for three months ago. We’ve altered the mix within our equity portfolio a bit to lessen exposure to global trade at the margins. Our bias favoring non-US assets has been curbed while our focus on small cap and value stocks remains fully intact.

“One thing that is immutable is that as each generation comes into Wall Street, they think they know better how to do it, and they eventually do the same dumb loans in pursuit of profits and bonuses. It has never been different.” - Steve Wasserman. Almost a decade into the current expansion, credit markets for non-financial corporations are looking rather frothy. A glut of global savings and financial repression amongst the world’s leading central banks has pushed lenders into accepting risks they might otherwise not. Underwriting standards have deteriorated; leverage ratios have ballooned; and security types that perhaps should have been relegated to history’s dust bin are drawing renewed interest (interest only loans and payment-in-kind bonds being on that list). Deregulation is a factor, too, as some investor protections are stripped away including a requirement that issuers of Collateralized Loan Obligations retain some equity risk from the deal on their own books. Since February, CLO issuers have no longer been required to keep any of their own skin in the game. The growth of non-bank loan originators (private debt and equity firms) are likely also contributing to the generalized deterioration in lending standards. All the while, spreads remain not far off pre-recession lows. There is no imminent crisis, but with the upside exhausted and the downside growing more daunting by the day, we’ve been gradually rotating away from lesser quality corporate debt. In part, that’s taken the form of a “quality tilt” in which we shift into government, agency, and mortgage backed debt instruments. It’s also involved moving into other types of debt securities. Our holdings of municipal bonds, for example, are growing rapidly. Munis tend to experience lower default rates and higher recovery rates than do comparably rated corporate issues. Further, they represent a useful source of diversification as their default cycle tends not to be closely correlated to that of corporate borrowers.
About Risk

All investments are subject to market risk, including possible loss of principal. Stocks and bonds can decline due to adverse issuer, market, regulatory, or economic developments. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner, or that negative perception of the issuer’s ability to make such payments may cause the price of that bond to decline. A bond’s prices are inversely affected by interest rates. The price will go up when interest rates fall and go down as interest rates rise.

MLPs and other natural resources sector companies are subject to certain risks, including, but not limited to fluctuations in the prices of commodities; the highly cyclical nature of the natural resources sector may adversely affect the earnings or operating cash flows of the issuers in which the Fund will invest; a significant decrease in the production of energy commodities would reduce the revenue, operating income, and operating cash flows of MLPs and other natural resources sector companies and, therefore, their ability to make distributions or pay dividends.

Past performance is no guarantee of future results.

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