

ECONOMIC OUTLOOK

Summary

The labor market continues to show signs of sustained strength as first time claims for unemployment insurance fell to a 48 year low last month. In addition, the Employment Cost Index (ECI) increased 0.8% quarter-over-quarter in Q1 and is accelerating. One area in the compensation mix that is showing a more muted recent response is ECI Benefits, which are fairly flat over the last five years at just below 3.0%. That being said, a low 4.0% unemployment rate and solid growth in the economy is driving labor costs higher. Not only that, but transportation/diesel costs are rising, while a wide range of raw input costs are putting the squeeze on businesses, crimping their operating margins.

Economists generally call this kind of price pressure “cost-push” as opposed to “demand-pull”. The former is very consistent with today’s environment as the cost of labor, materials and services are increasing. Some of the price pressures are self-induced, with the threat of tariffs and supply disruptions causing purchasing managers to scramble in order to secure needed inputs before prices move higher. Demand-pull inflation is different and entails an overwhelming desire to purchase a good or service beyond a natural level of supply, which allows the vendor to raise the retail price.

Beyond a handful of specialized products where pricing is firm, the U.S. economy is experiencing a typical late cycle response of cost-push inflation. That’s one half of the equation. But what about prices received for the goods or services? Here we have a totally different story, most finished goods and many services, are oversupplied, creating negative pricing power for the vendor.

Think autos and trucks, most electronics, media, restaurants and clothing, for example. Higher input costs and minimal pricing power equates to a modest margin squeeze and that is what corporate America is telling us right now. It’s not a disaster and tax reform has helped immensely, but we view today’s pricing pressures as more cyclical than secular and think the excess supply of goods and services will act as a restraint on prices over the medium to long-term.

Positives

Unemployment rate drops to a cycle low of 3.9%

Industrial production increased 0.5%, bringing capacity utilization to 78.0%

New home sales increased to 694,000 (annualized), second best in this cycle

Negatives

Average hourly earnings increase 0.1% for the month and 2.6% for the trailing twelve months

Durable goods excluding transportation were flat, 0.5% expected

Auto and truck sales came in around 16.5 million units (annualized)

EQUITY OUTLOOK

Summary

U.S. equity markets were little changed in the month of April as investors took time to digest corporate earnings and other geopolitical developments. The S&P 500 ended the month higher by 0.4% and remains essentially flat year-to-date (-0.4%). While the market's reaction has been muted, earnings results so far have generally been very upbeat. With over three quarters of companies reporting Q1 results, 69.7% have exceeded what were already lofty earnings expectations. Much of the earnings success can be attributed to the reduction in the corporate tax rate. However, what's potentially more impressive is that 72.3% of companies have actually exceeded revenue expectations.

Neither growth nor value stocks offered much of an advantage over one another for the month with both the Russell 1000 Growth and Russell 1000 Value Indexes advancing 0.3%. The energy and consumer discretionary sectors were the top performers returning 9.4% and 2.4% respectively. Energy stocks have stronger earnings growth than any other sector, which was priced in by the markets. The energy outperformance in April was more likely a result of the rally in crude oil prices, which advanced on geopolitical concerns and supply/demand factors. Consumer staples (-4.3%) and industrials (-2.8%) were the two laggards last month.

Investing in international stocks in April offered a different experience depending on where you placed your bets geographically. Emerging markets are one of the top performing asset classes over the last 12 months, advancing

22.1%, but the rally stalled last month dipping 0.4%. On the other hand, developed international climbed 2.4% in April. We continue to believe international equities broadly offer a more attractive risk/reward profile relative to domestic equities. In addition, the current U.S. expansion has gotten long in the tooth, yet many foreign economies are much earlier in the cycle. We remain overweight to the asset class and particularly prefer active management in this space as there will likely be a greater divergence between the geographic winners and losers in the intermediate term.

Earnings season hasn't exactly resulted in a substantial market rally, but we have seen a relative reduction in volatility in recent weeks. The solid earnings results and impressive guidance have also brought market valuations in line with historic norms. We believe equities continue to be one of the most attractive asset classes and overweight in long term portfolios.

Positives

Upbeat corporate revenue, earnings and outlook

Consumer and business confidence

Negatives

Unsettled trade negotiations

Rising wages and input costs

FIXED INCOME OUTLOOK

Summary

After consolidating the upward move of the first two months of the year, interest rates made another push higher in April with the 10-year finally piercing the magical 3.00% level. Alarm bells rang out on all of the major financial news networks as they promoted each upcoming segment with headlines warning bond investors of the upcoming peril. Just about the same time their expert guests were leaving the news set, yields began to stabilize and move a bit lower. Apocalyptic headlines are good for ratings, but they do little to help investors navigate the reality of today's bond market.

Many bond investors are rightly concerned about the increasing issuance of debt by the Treasury to finance our widening budget deficit at the same time the Fed systematically reduces purchases for their balance sheet. A large amount of these new bonds will need to be absorbed by some other investors and one of the biggest ones, the Chinese, might withhold their enthusiasm for our bonds and use it as ransom during trade negotiations. But none of this is new news. That's the reason why rates have risen to the yield they are now. It would be unwise to use those same reasons to say that they will affect the yield structure over and over again.

We still believe that the Fed will increase the Funds rate two more times this year and possibly a few more times next year as well. This too is not new information and the yield of the 2-year Treasury note adequately reflects this with a yield of about 2.50%. As the increases actually occur, the yield will gravitate upward until they eventually reflect the terminal yield of the cycle. We believe this will be below 3.00%. If the 10-year note increases a bit more to a level of 3.25% or so over the course of the next few quarters, the curve should avoid inverting and sending the next wave of alarmists to the news sets. If we are wrong, and the curve does invert, these talking heads will likely warn of the impending economic collapse in another bid for ratings.

Fear not and turn the channel on your televisions. We believe that the bulk of the move higher in longer rates is now in the rearview mirror. There will be some negative return months like April, but going forward, average monthly returns should improve. Unless there is a company-specific negative credit event, bonds pay their legally contracted coupon rates and will return all of the principal value at 100 cents on the dollar upon maturity dates.

Positives

Global synchronized growth story is eroding with European weakness

The spread between U.S. rates and the rest of the high quality world has grown

Call for an overly aggressive Fed actually supports lower 10-year yields

Repatriation of overseas cash is positive for the corporate spreads to remain firm

Negatives

Treasury borrowings are to increase just as the Fed reduces their balance sheet

Unrest with China could lead to a reduction in their purchases of our debt

Inflationary pressures could reemerge if trade wars flare

Unknowns

Geopolitical concerns with Iran and North Korea over nuclear agreements
