SEVEN SUMMITS CAPITAL

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TENUOUS IS THE WORD

It took over almost two weeks to settle several high profile Senatorial and House of Representative races following the much anticipated mid-term election. What now know is that the Democratic Party flipped more seats in the House than they have during any Congressional election since Watergate in 1974. Republicans pick-up two additional seats in Senate, thereby retaining their narrow majority.

Equity markets posted losses in October between 10% and 12%, which was the largest single month loss since 2011. The S&P 500, Dow Jones Industrial Average and Nasdaq indices bounced back approximately 5% in early November ahead of Election Day. The day after Election Day, equities markets rallied over two percent. However, since that initial post-Election Day rally, the broad equity markets have given up all of November's gains and the broad indices are again sitting relatively flat for 2018.

There is a great debate occurring among market watchers why the markets have recently given up all of 2018's gains. The S&P 500 price index, at its peak this year, was up almost 10% as of the beginning of October. Some opinions of market watchers point to higher long-term interest rates and expectations of even higher levels over the next year. Others, point to a slow-down in global economic growth and point to the U.S.'s aggressive tariff antagonism as contributing to that slowdown. Lastly, some pundits with more of a political bias point to market worry over a Democratic takeover of the House of Representatives and what that will mean for a continuation of deregulation and further fiscal stimulus over the remainder of President Trump's term in office.

I believe that the weakness that we are seeing in sentiment and the broad equities markets over the last month and a half is due to elevated risks challenging the validity of the factors that drove last year's exuberance. Those factors, in my opinion, were:

- Hope and realization of major fiscal stimulus (tax cuts)
- Aggressive deregulation of industrial, financial, and energy-related industries.
- Synchronized global growth (Global GDP accelerated from a growth rate of 2.51% in 2016 to 3.52% in 2017)
- Optimism that U.S. economic growth was shifting into a higher gear going forward enabling potential GDP growth of at least 3% going forward.
- Rising interest rates in the U.S. would be held in check by rising business productivity rates and relatively low inflation rates in spite of higher economic growth.

Each one of the above drivers of optimism during 2017 appeared to be based upon simple, but flawed assumptions. In my opinion, the factors that the market ignored in 2017 and early 2018 were:

- Fiscal stimulus can be effective with minimal unintended consequences if enacted during a period of time when there is significant slack in the economy and above normal unemployment. However, unintended consequences of fiscal stimulus increase when such stimulus is injected into the economy late in an economic cycle when unemployment is nearing full-employment levels and economic slack measures such as capacity utilization and producer prices are well off the cycle bottom.

- European economic growth and emerging markets growth measures rose strongly in 2017, while U.S. economic growth shot up to 2.47% from just 1.88% in 2016. This growth was the fastest economic growth in the U.S. since 2014 & 2015 when it grew 2.70% and 2.61%, respectively. What appeared to be synchronized global growth in 2017 was more likely a combination European growth finally benefiting from zero interest rates and quantitative easing from the European Central Bank (ECB) and the positive impact of a weaker U.S. dollar on emerging market countries. Growth was accelerating around the world, but it was not synchronized, it was simple coincident.

- Virtually all estimates of U.S. economy long-term potential growth puts that potential in the 1.5% to 2.0% range based upon projected productivity growth rates and growth in the workforce. Both monetary and fiscal policy actions can temporarily move economic growth above or below the long-term potential measure. The latest calculated ten year potential GDP growth rate published by the Congressional Budget Office in August 2018 was 1.90%.

- The U.S. Federal Reserve has two mandates which dictate monetary policy decisions. Those equal mandates are price stability and full employment. Higher inflation dictates interest rate hikes in order to forestall a wage inflation spiral. Unemployment falling below full employment levels will also dictate Fed tightening of monetary policy to slow the economy and provide relief to an unsustainably tight job market. The Federal Reserve has been raising short-term interest rates very modestly since December 2015. After the most recent 0.25% hike in September, the Fed Funds rate stands at 2.25%. It is widely expected that the Federal Reserve will announce another 0.25% hike in December. The concern is now being expressed by some in the financial media and the current occupant of the Oval Office, that the Federal Reserve needs to stop raising interest rates before those higher rates retard economic growth. What is not being widely discussed is that last year's tax cut (Fiscal Stimulus) and the financial distortions being caused by the mounting trade wars is increasing the need for the Federal Reserve to be more restrictive than they might otherwise have had to be at this point in the economic cycle.

What I believe that we are seeing play out in the equity markets since September is the beginning of a rethinking of 2017's illusion (hope). This illusionary hope was based upon an optimistic unproven supply-side economic theory. That theory contends that cutting corporate taxes and reducing regulation will automatically increase the potential growth rate of the economy and drive productivity generating investment that enables higher economic growth and a low inflationary environment. This theory also contends that corporate tax cuts will result in wage growth that would not otherwise materialize.

As market participants look at what has unfolded during the first ten months of 2018 and begin to make their 2019 forecasts, GDP growth is expected to peak at around 3% for the year in 2018 and decelerate to 2.5% in 2019. Inflation is expected to continue to creep up from the current rate of 2.50% on the CPI, which is above the Federal Reserve's targeted 2% CPI inflation, and the Federal Reserve is expected to raise interest rates one more time in 2018 and at least three times in 2019. This forecast throws significant doubt on the promise of the supply-side theory that drove regulatory and fiscal policy in 2017. Furthermore, so far there has been no material increase in wage growth above the established long-term trends that were in place prior to last year's tax cut.

Further dampening enthusiasm is that 2017's 3.0% GDP growth likely will deserve asterisks as the second and third quarter growth rates of 4.20% and 3.50% look like they will be bookended by the 2.20% for the first quarter of 2018 and an expected sub-3.0% growth rate for the fourth quarter of 2018. Looking at the internal data from the strong second and third quarter reports indicates that the above trend growth seen in those two quarters had more to do with higher government spending and the private sector attempting to get orders in from China before tariff deadlines. Pulling forward orders from China is not widely discussed. However, it is evidenced when one looks at the growth in Chinese exports through the end of the third quarter, in spite of imposed and threatened tariffs. BCA Daily Insights Research is quoted in the November 12th Barrons "Up & Down Wall Street column. Barron's quoted BCA as stating that Chinese exports increased at a 15.6% annual growth rate in 2018 as of October. BCA stated, "Chinese exports are being driven by purchases of Chinese goods from global businesses trying to beat the imposition of higher tariffs." BCA points out that this growth portends a payback later when exports decelerate.

I believe that stock investors are figuring out that much of the hype surrounding the tax cut that drove strong stock market gains last year was overly optimistic. If this is the case, it only makes sense that the broad stock market would pause in 2018 without adding to last year's gains until further evidence materializes confirming or denying whether or not we are indeed in a new economic environment or simply going through a short-term sugar high following the promise of the end of 2018 tax cut legislation. The next several quarters will be informative regarding what economic trajectory that we are on.

Overhanging all of this rethinking of the economic backdrop and the future level of interest rates is the far less quantitative global geopolitical landscape. Ray Dalio, founder and CEO of Bridgewater Associates, the largest hedge fund in the world, said in a November 11th podcast that "politics is more important than at any time in my lifetime (60 years)." Dalio worries about populism breaking out here and around the world. He said that today reminds him of 1937. Dalio talks about how populism rises up from a strong individual being brought to power by a subset of the population who feel economically and culturally disenfranchised. Dalio reminds listeners that populism breeds nationalism, protectionism, and militarism. Dalio worries about a repeat of history when the economy again turns down while populism is rising. History shows that social and political divisions and conflicts that fuel populism widen and become more inflamed when the economy turns down.

Given all of the upheavals (Brexit, the cancellation of the Iran Nuclear Agreement, tariff brinkmanship, an emboldened and aggressive Saudi Arabia, Nationalist governments in Italy, Austria, Poland, Czech Republic, Hungary, and another possible impeachment of a U.S. President), it is implausible to me that this worrisome geopolitical backdrop does not hang over the global equity markets.

At the present time, my base case remains in line with my strategy of becoming increasingly cautious by reducing high beta and cyclical exposure within portfolios through May 2019. At present the outlook for sustained above-trend economic growth, agreements which defuse rising trade tensions, a Fed engineered soft-landing, and relative order on various contentious geopolitical fronts are tenuous. By May 2019, I believe that the trajectory of the economy will become evident, the U.S. political land-mines will either have exploded or will have been disarmed, and the impact of an aggressive tariff strategy on international relations and corporate supply chains will be known. Until then, the situation is tenuous.

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