PRISM
NEWSLETTER

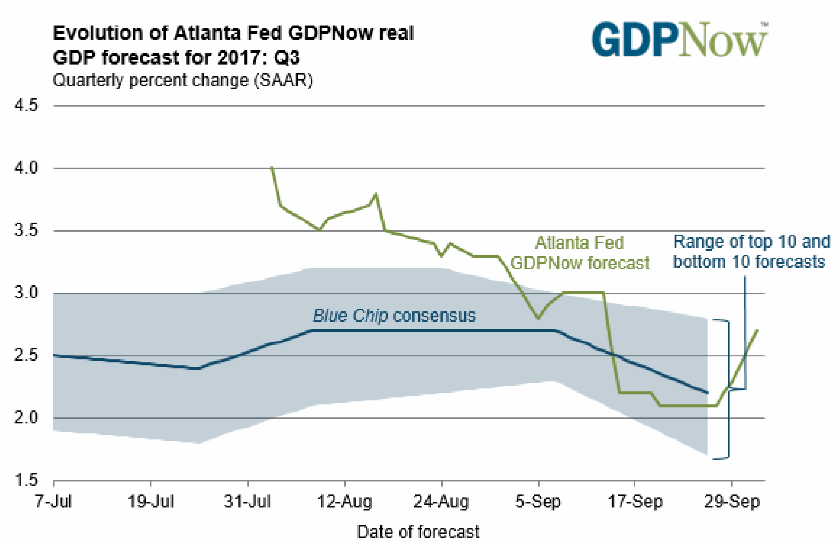
VALUE ARCHITECTS
ASSET MANAGEMENT

Economics

Synchronized Global Growth – Not a time for Complacency

The US economy is in its eighth year of expansion, making this one of the longest growth cycles going back to the 1850s. Finally, other world economies are picking up steam, shaping up for the first synchronous acceleration in both developed and emerging markets since 2010. This has occurred only twice in the last twenty years. With the headwinds from emerging markets subsiding, and non-US developed economies advancing, some reflation is beginning to appear, at long last.

Updating our economic viewpoint, so far in 2017, economic growth trends have trended stronger. The most recent forecast from the Atlanta Fed's GDPNow model suggests third quarter growth to come in at 2.7%, reaching the high end of the consensus range for economists. That's somewhat unusual as the consensus economic forecasts have generally been too high versus GDPNow forecasts or actual results over the last few years.



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*

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PRISM | October 2017

The Newsletter of Value Architects

Prisms have always been a source of wonder and fascination as they bend light into its components, revealing its infinite spectrum. Investments can be like a prism. What you see depends on how you turn the glass. What others see as white is actually a rainbow of colors packed into a small space. That's why we have decided to call our newsletter 'Prism'.

Mission

Our mission is to preserve and grow wealth by design. We base our decisions on our own rigorous, in-depth research and thorough knowledge of every investment position. The strategies that we apply to our clients' funds are no different than the ones we use to manage our own.

Philosophy

We seek the highest compounded returns by committing capital to businesses we believe will provide exceptional long-term appreciation. We do not concern ourselves with the day-to-day fluctuations of the market, but rather with the long-term building of value. As our strategies place the highest priority on preserving capital, our disciplined investment processes seek to mitigate portfolio risk.

Value Architects Asset Management

50 Harrison Street, Suite 109,
Hoboken, NJ 07030
201.222.9930
info@valuearchitects.com
www.valuearchitects.com

This forecast tool had reached a low of 2.1% in mid-September but has strengthened to current levels based on much stronger personal income and manufacturing indicators.

The final update of second-quarter GDP ticked up to 3.1%, the fastest rate since the first quarter of 2015 largely driven by personal consumption growth at a 3.3% rate. We expect a slight downshift in growth, probably around 0.5% versus the Q2 pace due to the impact of hurricanes Irma that lambasted the Florida Keys and ultimately the Gulf side of Florida, and Harvey which stalled over southern Texas dropping torrential and unprecedented amounts of rain.

The US expansion is more advanced than Japan and Europe, prompting the Fed to move to less accommodative policy sooner than other central banks. The Fed has hiked four times since December 2015, with another hike expected in December 2017. Market watchers are now turning their attention to the Fed's balance sheet taper, an effort to shrink the central bank's $4.5 trillion balance sheet, set to begin in October. The tapering process allows maturing securities to roll off at a monthly pace of $6 billion for Treasuries and $4 billion for agency MBS (mortgage-backed securities). We expect the monthly pace to grow by $6 billion and $4 billion for Treasuries and agency MBS, respectively, per quarter until reaching monthly limits of $30 billion for Treasuries and $20 billion for agency MBS. The Fed is taking a conservative approach in our view, and we believe it will most likely become a blueprint for other developed market central banks when they eventually begin decreasing their balance sheets.

Shifting beyond US borders, the global economy churned out healthy growth in the second quarter, with advanced economies benefiting from lenient monetary conditions and tightening labor markets while emerging economies made the most of a recovery in commodity prices and resilient dynamics in China. The global economy grew 3.2% annually in the second quarter, marking the best result in two years and coming in marginally above the 3.1% expansion recorded in the first quarter.

Upbeat momentum, which is reflective of broadening and strengthening expansions across advanced and emerging economies, seems to have carried over into the third quarter. In the Euro area, survey-based data continues to point to solid growth in the third quarter following a robust second-quarter expansion, with survey-based data reaching a new cyclical peak in August. Strong economic growth is prompting the European Central Bank (ECB) to shift to a more hawkish tone on interest rates, and analysts now expect the Bank to announce a tapering in Q4. However, ECB officials remain wary of inflation remaining below its 2.0% target, while the recent strengthening of the euro prompted the Bank to lower its inflation forecasts for 2018 and 2019. As such, analysts expect the ECB to lay out a plan in October although the unwinding of the balance sheet will not likely start until next year.

In Japan, economic recovery is progressing more slowly than in the US and Europe, particularly on the inflation front. Nevertheless, Q2 GDP growth marks the fastest expansion since Q1 2015. Annual real GDP growth has trended around 1.0% for the past few years, but inflation has been disappointing, failing to break above 1.0% for any meaningful period of time. Japan's struggle to prop up inflation should keep the Bank of Japan in accommodative mode for the foreseeable future.

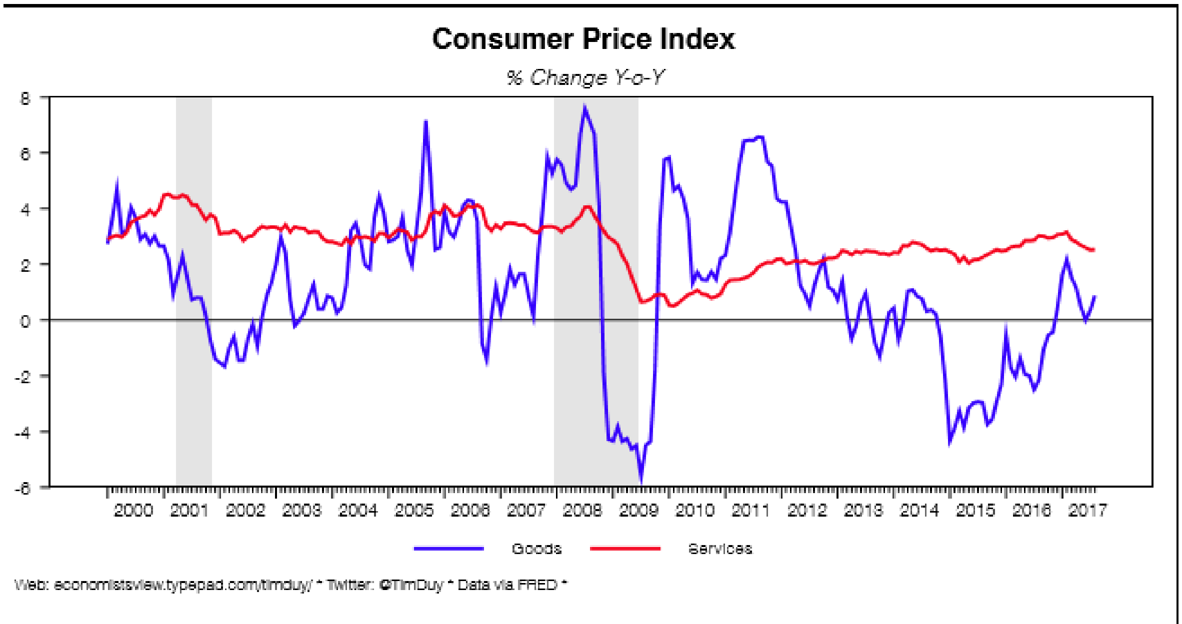
In terms of US monetary policy, the battle over that final rate hike of 2017 continues as some policymakers find it increasingly difficult to ignore weak inflation numbers in recent months. Such concerns, however, do not appear likely to take center stage in December. Indeed, the Fed looks fairly committed to a rate hike at that meeting. But the consensus on that meeting and beyond is being held together by forecasts of a rebound of inflation next year. It will be hard to maintain that consensus if inflation numbers don't soon give more hope to those forecasts.

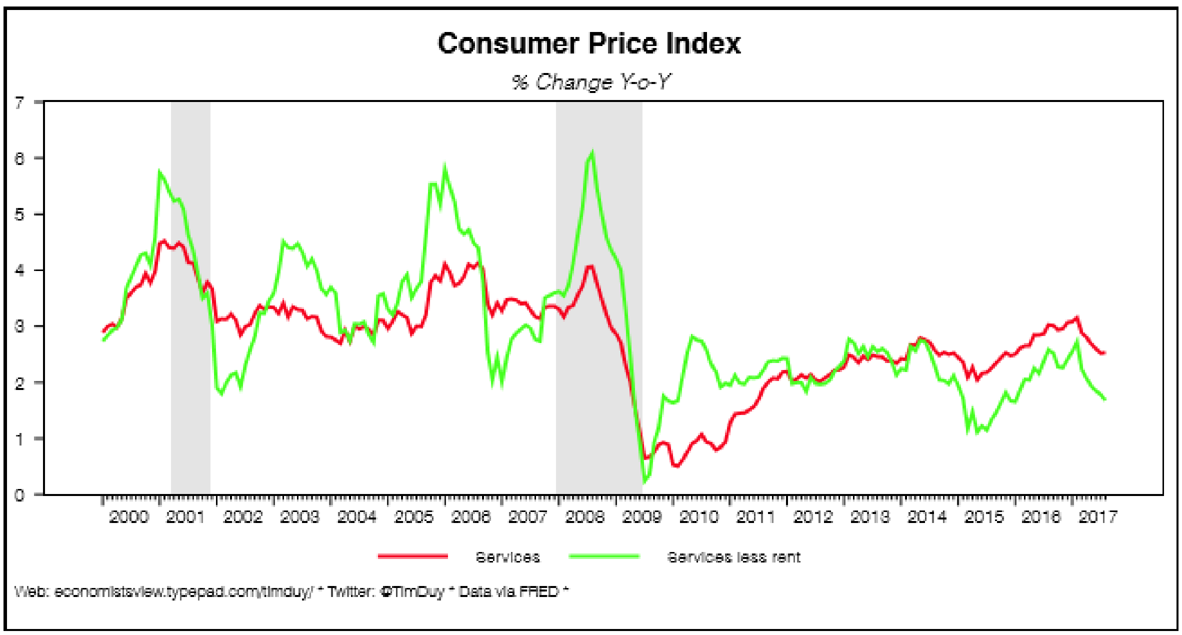
New York Federal Reserve President William Dudley touched on the US economy in a recent speech, reiterating his view that transitory factors account for recent inflation weakness. Dudley represents the consensus view at the Fed. There is fairly strong resistance to the idea that the inflation shortfall is more persistent than transitory. The view that policy needs to remain preemptive to maintain a gradual pace of rate hikes dominates the policy discussion.

That said, important cracks in that consensus view emerged in recent weeks. In a speech Monday, Chicago Federal Reserve President Charles Evans followed in the footsteps of Federal Reserve Governor Lael Brainard by raising concerns about inflation expectations:

"Expectations of future inflation play an important role in the inflation process...In effect; actual inflation can take on a bit of a self-fulfilling nature, as expectations of future inflation become embedded in current wage and price decisions. I am concerned that inflation expectations are too low today, making it harder to achieve our 2 percent target."

To date, policymakers have been generally dismissive of low inflation, with most sticking with Dudley's story regarding the importance of transitory factors. Services inflation, which offsets the persistently disinflationary force of goods, has been notably weak in recent months, and held up largely due to rising rental costs. This feels more persistent than transitory. Moreover, it is not unreasonable to expect that upward force from rents will soon wane in the wake of the multifamily building boom across major metro areas in recent years.



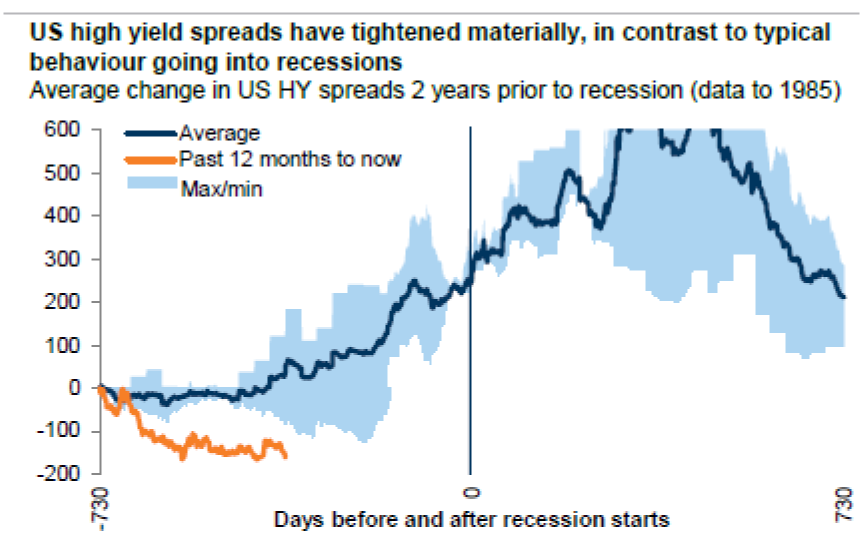


The Fed's rate projections are held together by the view that weak inflation is only transitory, but if this bet is wrong, the Fed risks a policy mistake that threatens the expansion and further entrenches inflation expectations below target. This is particularly risky given that the Fed believes that in a low interest rate world, policymakers are more likely than not to face the effective lower bound on policy rates in the future. Policy making would only be more difficult if that happened in an environment of already soft inflation expectations. It appears that the Fed is waking up to the risk only very slowly.

After eight years of economic growth and with a Fed becoming more hawkish, are there any signs of slowdown? There is conflicting evidence from capital markets. Let's focus on bonds first. If you look at the difference in yield between 2 and 10-year treasuries known as the "spread", the numbers over this past year are the lowest since 2008, when the US economy was in a recession:

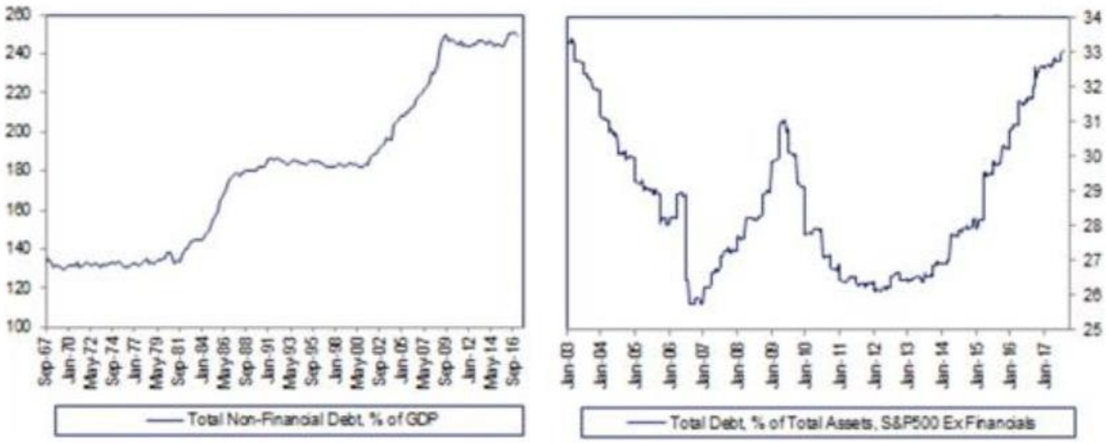
Flat yield curves are dangerous because they signal an economy that is not robust enough to keep the central bank in tightening mode for the foreseeable future. What the flatness indicates is that the central bank will have to move from its current neutral to hawkish stance to an accommodative to neutral stance in order to prevent the economy from worsening.

The Trump rally in yields which began in November has petered out as reflation seems to be beckoning. As a result, the yield curve has resumed flattening. The spread which hit 134 basis points in December got as low as 77 bps in September, a full 57 bps move. Interest rate hikes by the Fed threaten to flatten the curve even more. We are still a long way from an inverted yield curve – what is considered a generally reliable indicator of imminent recession. But the yield curve is telling the Fed that it only has room for a limited number of hikes in the next two years to prevent itself from creating the next recession. But conflicting evidence comes from high yield spreads, the difference between high yield bonds and US Treasuries.



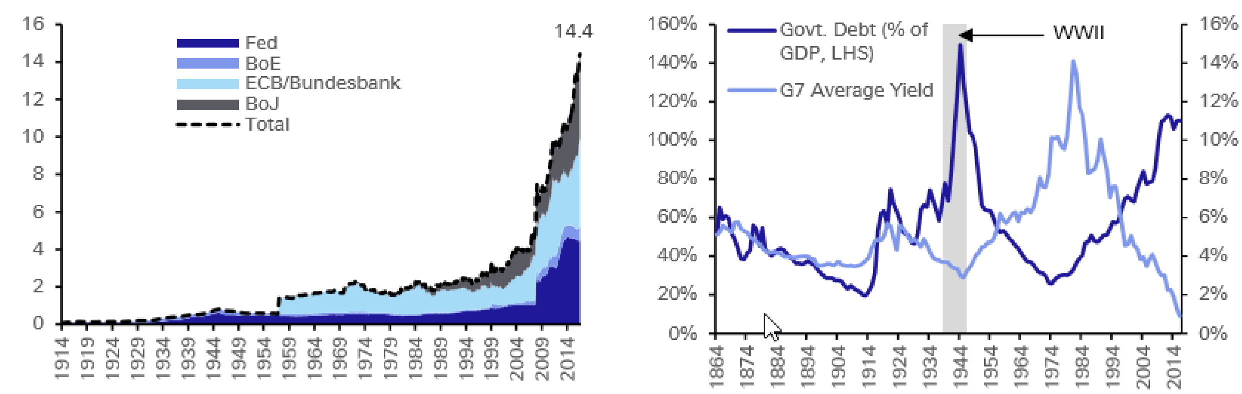
As you can see, typically high yield (junk) markets tend to anticipate oncoming recessions early. Rather than widening, junk spreads are tightening.

US corporations have loaded up on debt, almost as if 2008 never happened. At these yields, one can understand the motive. But, as you can see, debt to GDP (for non-financial companies) is higher than it has been at any point in the past half century:



Governments around the world have responded to the 2008 crisis by fueling liquidity through their central banks' aggressive monetary policy of quantitative easing (buying bonds to force bond yields down) and also through fiscal stimulus by heavy borrowing. The following charts from Deutsche Bank are harrowing:

Figure 5: Central Banks Assets inflation adjusted to June 2017 price levels (left) and G7 Government Debt (% of GDP) with Average G7 10Y Government Bond Yield (right)



Source: Deutsche Bank, Global Financial Data, Haver, official websites of Central banks

With global economies gaining traction and central banks' policy shifting toward a tighter policy stance, we would anticipate upward pressure on bond yields at a time when neither government nor many corporate balance sheets are prepared.

It's easy to be lulled into complacency as global growth gains momentum. But the adjustment to monetary policy accompanied by reversing quantitative easing will put pressure on interest rates, hopefully over a long and protracted horizon. Much as QE was uncharted, reversing QE is equally uncharted. Although the Fed ended QE in October 2014, it continued to reinvest all principal payments from its holdings back into the Treasury and MBS markets. This activity has provided continued support for the bond market—support that if ended abruptly potentially could drive interest rates sharply higher and derail economic growth.

Rick Konrad

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Managing Partner