

STRATEGAS Insight

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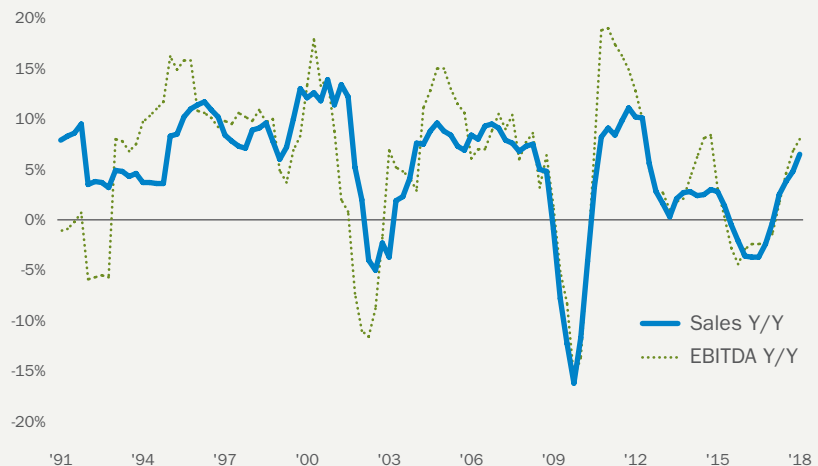
Assessing the Four Horsemen of the Economy

Policy makers are vested with control of four distinct policy levers to guide the economy: fiscal, monetary, regulatory, and trade. When a new administration begins, particularly one which tips the balance of power to the erstwhile minority, the market must recalibrate the range of potential outcomes for each of these levers. Putting personal politics aside, business leaders and investors have generally welcomed the fiscal and regulatory initiatives undertaken by the new Administration and its Congressional partners. The impact of lower taxes—a fiscal policy lever—has been immediate. Lower corporate tax rates have demonstrably increased US corporate profits. As measured for the S&P 500, profits are forecast to have grown 20% in Q22018, roughly in line with the first quarter's 23% increase. More important, in our view, are the supply side effects, specifically related to business and consumer spending,

which have only just begun accruing to the economy and likely will take more time to manifest fully. In this regard, investors should keep an eye on sales and earnings before interest, taxes, depreciation, and amortization (EBITDA) growth, which have grown 6.5% and 8.0% year over year, respectively. Although visually

lower than the earnings per share (EPS) growth rate (as they effectively back out the purely accounting-related impacts of last year's tax reform), the upward trend in these two series highlights the strengthening undercurrent of real business activity and the improvement in operating leverage.

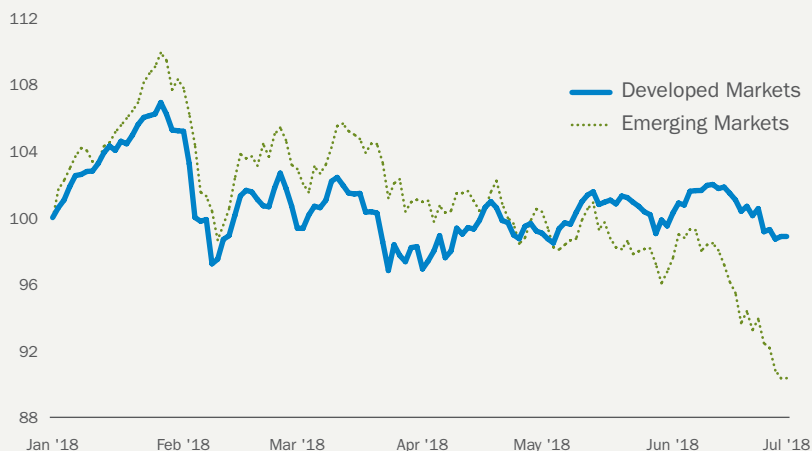
S&P Sales and EBITDA year over year



Source: Factset Market Aggregates. Chart represents S&P 500 last 12 months sales year over year vs. EBITDA last 12 months year over year from March 29, 1991 to March 29, 2018. Last twelve months (LTM), also commonly designated as trailing twelve months (TTM), indicates the time frame of the immediately preceding 12 months in reference to a financial metric used to evaluate a company's performance. Year over year (Y/Y) is a method of evaluating two or more measured events to compare the results at one time period with those of a comparable time period on an annualized basis. EBITDA stands for earnings before interest, taxes, depreciation and amortization and is one indicator of a company's financial performance. The S&P 500 is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

Though last year's fight over the GOP's ultimately failed effort to "repeal and replace" the Affordable Care Act was recounted, nearly blow by blow, above the fold, much of the regulatory reform enacted in the last 18 months has been removed from the headlines. Among a battery of reforms across multiple sectors—from Energy and Transportation to Materials and Manufacturing—few industries have seen as much regulatory rollback as Financial Services. Perhaps most notable was the largely bipartisan initiative to raise the Treasury's required asset threshold to apply the SIFI designation (systemically important financial institution) to regional and community banks—the increase should be a boon for lending. All in, business conditions inside the US are easing. That's a positive for investors for the time being. But protectionist tensions continue to ratchet upward as the White House engages our global trading partners—a group that has grown to include G7 members—in a near-weekly barrage of threatening missives over import tariffs. Most economists agree that tariffs are detrimental to commercial enterprise, and the resulting tit-for-tat and unpredictable retaliatory nature of trade skirmishes foster a decidedly uncertain environment for business that investors historically have put to the market. Better to get out of the way and buy another day. Additionally, investors may take a more defensive view of trade rhetoric, which would be typical, given the leaky and volatile nature of policy communications from the Trump White House. (Last week alone, for example, a story emerged suggesting the President wanted to withdraw from the World Trade

**Emerging Markets vs. Developed Markets
(MSCI Emerging Markets Index vs. MSCI World Index)**



Source: Bloomberg. Chart represents index data from Jan 1, 2018 to June 29, 2018 and is indexed to 100. The MSCI World Index captures large and mid cap representation across 23 Developed Markets (DM) countries. With 1,644 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The MSCI Emerging Markets Index captures large and mid cap representation across 24 Emerging Markets (EM) countries. With 845 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

Organization.) We would assign much of the blame for the second quarter's broader equity market consolidation to escalating trade (and geo-political) uncertainty. Said simply, a trade war is bad for business.

What would cause the Administration to change its approach to trade? Few assurances can be given as to where the prevailing balance of intellectual or political power in the Administration rests at any given time. But there is some merit to the notion that, for the time being, it rests more firmly with the more globalist free trade wing, led by Treasury Secretary, Steve Mnuchin, and National Economic Council Director, Larry Kudlow, than with the more protectionist faction, led by National Trade Council Director, Peter Navarro, and US Trade Representative, Amb. Robert Lighthizer. Secretary Mnuchin is largely credited with influencing the

President's decision to use the CFIUS (Committee on Foreign Investment in the United State) process for reviewing China's and other countries' investment deals with the US. This is regarded as "less hawkish" than the Sino-specific restrictions advocated by the National Trade Council. But there is another, more directed, instrument for squaring the perception of disequilibrium among the four policy levers than reviewing the seating chart on Air Force One or scoring the win-loss record of presidential tweets: the capital markets.

Since former Federal Reserve (Fed) Chairman Paul Volker used the Fed's management of the money supply—a monetary policy lever—as a means to break the back of inflation in the early 1980s, the bond market, through a period of generally high and variable interest rates, played a unique role in shaping the country's

fiscal and monetary policy. As our colleague and chief strategist, Jason DeSena Trennert, has said, “The cost of money would, and did, impose some rough justice on the profligacy of policymakers who always and everywhere sought to spend other people’s money.” At issue today, of course, is the muting of the bond market’s ability, following nearly a decade of monetary policy aimed at saving financial actors from themselves, to overreach. Thus, the odds of an equity market correction in the near term should be viewed as rising. Although the strength of the US economy and the anticipated supply side impacts of recently enacted fiscal policy warrant the Fed’s move to “normalize” interest rate policy, the term premium of the yield curve should never be negative, nor should the term structure of inflation

Advisor Takeaway:

Given the improving trajectory of the domestic economy, the two most worrisome headwinds are heightened trade tensions and the increased probability of a Fed policy mistake. As our colleague and chief economist, Don Rissmiller, has framed it so memorably, “Fed tightening until something breaks. Tariffs until the market shakes.” Of these, the former worries us more in the longer term. We continue to believe a combination of fiscal stimulus and regulatory easing should pave the way for real gross domestic product (GDP) to eclipse 3% in 2018, for inflation to continue to rise gradually, and for a capital spending cycle to emerge and intensify. In a way, the real economy is likely to “outperform” the stock market. Investors should expect returns in line with corporate profit growth (focus on EBITDA) plus the dividend yield.

expectations be flat. Both of these warning signs are extant today. If the Federal Open Market Committee (FOMC) tightens another 150 basis points, as it has suggested, raising the fed funds rate to 3.50%, then that rate is likely to end up at least 50 basis points too tight. If the Fed maintains its apparent proclivity to move toward that end game, then

the Treasury curve will likely invert along the way—perhaps as early as Q12019, increasing the odds that a leveraged player gets into trouble. (We have been watching emerging markets credit—both sovereigns and corporates. Spreads are widening, and recent US dollar strength suggests the market has been watching too.)

About Strategas

Strategas is a global institutional brokerage and advisory firm. The Firm provides macro research, capital market and corporate advisory services, and investment management solutions to institutional investors and corporate executives in more than twenty countries around the world.

Founded in 2006 by Jason DeSena Trennert, Nicholas Bohnsack, and Don Rissmiller, the Firm was acquired by Baird Financial Group in 2018. Strategas operates independently as a wholly-owned subsidiary of Baird and offers institutional securities services through Strategas Securities, LLC, a broker-dealer, and investment management solutions, including this commentary, through Strategas Asset Management, LLC, a registered investment advisor.

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Index Overview & Key Definitions

Fed, The Fed or FED refers to the Federal Reserve System, the central bank of the United States. **Fed Funds Rate**, the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **Gross Domestic Product** (GDP) rate is a measurement of the output of goods and services produced by labor and property located in the United States.

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