Eagle Eye

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Market & Economic Outlook

Eagle Strategies is pleased to present economic and market insights from the Portfolio Managers in the MainStay Investments Strategic Asset Allocation and Solutions Division.

"As long as the music is playing, you have to dance. We're still dancing." — former Citi CEO Chuck Prince

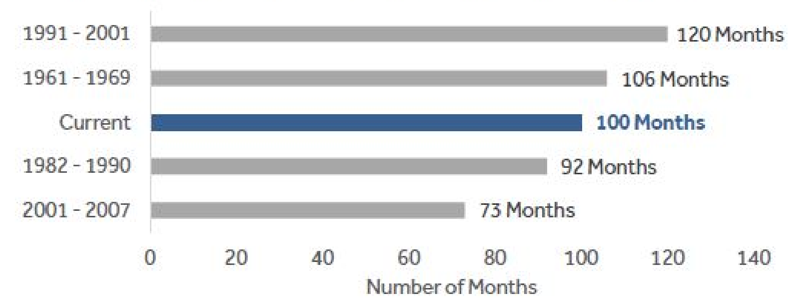
The long climb endures. The U.S. economic expansion is now into its ninth year making it the third longest in U.S. history. Expansions aren't limited by time, but the sheer longevity of the current cycle does demand that we be mindful of an eventual turning point. More disconcerting are some indications that a turning point may be approaching:

1) Unemployment readings have fallen to very low levels with many business owners reporting difficulty filling open positions.

2) The Federal Reserve Bank continues a series of rate hikes that look increasingly well entrenched, even as they begin to mop up excess liquidity in the financial system via balance sheet runoff.

3) There are some signs of excess in the credit markets: underwriting standards are relatively lax, use of leverage is heavy outside of the financial sector, and delinquencies are rising in some areas, such as credit card debt and auto loans.

Current Economic Expansion is Third Longest in U.S. History



Sources: Strategic Asset Allocation and Solutions Group (SAS), NBER, 9/30/2017.

On the radar screen

1. We are keeping a close eye on wage gains as an indicator that we have moved beyond full employment; that core inflation may be percolating; and that tighter monetary policy lies on the horizon.

2. Rising wages ultimately threaten corporate profitability. As we move through the upcoming earnings season, we will be monitoring profit margins for the possible compression from their current elevated levels.

3. We hear anecdotal reports of lax underwriting standards—or "covenant-lite" issues—and mounting use of leverage [leveraged buyout (LBO) debt exceeded earnings before interest, taxes, depreciation, and amortization (EBITDA) by seven times, which is above regulatory guidelines.] Deteriorating credit conditions are not yet a source of immediate concern, but the trend is worrisome.

4. With monetary policy shifting into reverse, a boost from fiscal policy would be welcome. Tax reform could do much to engender faster economic growth, but we are skeptical that a meaningful piece of legislation can be passed in the current political environment. Negotiations through the fall will be telling.

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Without ignoring these cautionary omens, a broader reading of incoming data suggests growth of economic output is likely to continue for a while longer. Even though the Fed is in the process of gradually removing monetary accommodation, current conditions are nevertheless extremely benign. Rates remain low in both absolute and real terms, credit spreads are tight, lending standards are not stringent, and equity pricing is generous. Elevated confidence readings and ready access to inexpensive debt have combined to drive both household spending and business capital expenditures.

Demographic changes, technological developments, and globalization help to constrain inflation—allowing the Fed to move slowly in normalizing policy and thereby extending the life expectancy of the current cycle.

Anticipating that the expansion still has room to run, we are not yet defensive in our portfolio positioning, nor are we aggressive in our risk posture. Our reluctance to lean into risk assets is our belief that valuations are rich across most assets in the U.S. We also harbor some concern that wage inflation, oddly absent thus far, will begin to rise soon—eating into corporate profitability as it does. All this being so, we've set our overall equity exposure close to benchmark weight, reallocated holdings within the fixed income portion of our portfolios to favor higher quality and shorter duration instruments, on average, and redeployed equity assets away from the U.S. toward stocks in developed and developing foreign markets where we believe growth opportunities are more attractive.

" A tax loophole is something that benefits the other guy. If it benefits you, it is tax reform." – Russell B. Long.

In punting the debt ceiling and government funding issues to December, President Trump was trying to clear space on the calendar for Congressional Republicans to tackle tax reform. While certain to garner headlines throughout the fall, we are doubtful that a substantive piece of legislation can be passed. We wish we could say otherwise, for a more efficient tax system promises significant long term structural benefits at no cost, but we simply can't see meaningful reform in the current political environment. At its core, tax reform requires lots of compromise and will bring with it winners and losers. Given the extreme partisanship that exists today and rampant internal warfare within Republican ranks, it strikes us as improbable that such compromise can be secured. A more likely outcome is that a modest tax cut with little actual reform is passed offering only a small fiscal boost to the economy and adding to the nation's ever-mounting debt burden.

The GOP Tax Bill Looks to Significantly Reform the Tax Code

	Corporate
Corporate Tax Rate	20%
Expensing	Businesses will be able to expense equipment for five years
Repatriation	Two rates—cash vs. hard assets
Business Tax Credits	R&D and low-income housing credit preserved, most others eliminated
	Personal
Individual Tax Rates	Three individual rates: 12%, 25%, 35%
Itemized Deductions	Charitable giving and mortgage interest deductions preserved, most others eliminated
Standard Deduction	Nearly doubled: $24,000 for a couple and $12,000 for single filers
Personal Exemption	Repealed
Estate Tax	Repealed
Alternative Minimum Tax (AMT)	Repealed

Source: Cornerstone Macro Research, "Unified Framework for Fixing our Broken Tax Code," Trump congressional tax plan outline, 9/27/17.

"You cannot surprise an individual more than twice with the same marvel." - Mark Twain. Two months ago, North Korea set markets on edge with the launch of an intercontinental ballistic missile that was met with "fire and fury" hyperbole from our own President. Several missiles and one underground nuclear detonation later, and such antics barely merit comment from market pundits. The novelty has worn off.

Given the catastrophic implications of actual military conflict, the likelihood of such has struck us as being extremely remote from the outset. Nevertheless, the crisis can be a clear and present threat to capital markets. Allowing the Kim regime to obtain the expertise needed to deliver a nuclear warhead to the continental U.S. is simply not a state of affairs the Trump administration is willing to accept. Pressure is being brought to bear on other nations believed to have influence over North Korea, most specifically China. Our worry is that this pressure has the potential to spill over into a very damaging trade war. "Rocket man" could inflict great harm on Western economies simply in pursuing the bomb, regardless as to whether he is successful in obtaining it. It's our relationships with our trading partners that are vulnerable, not Guam.

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