June 2018

While the Tech. heavy Nasdaq and the Russell 2000 (Small Caps) indexes notched new all time highs in June, the Dow 30 and definitive S&P 500 indexes remained mired in Correction. From Bloomberg:

Traders Are Still Haunted by the VIX Five Months Later

By *Lu Wang* and *Elena Popina*

June 29, 2018

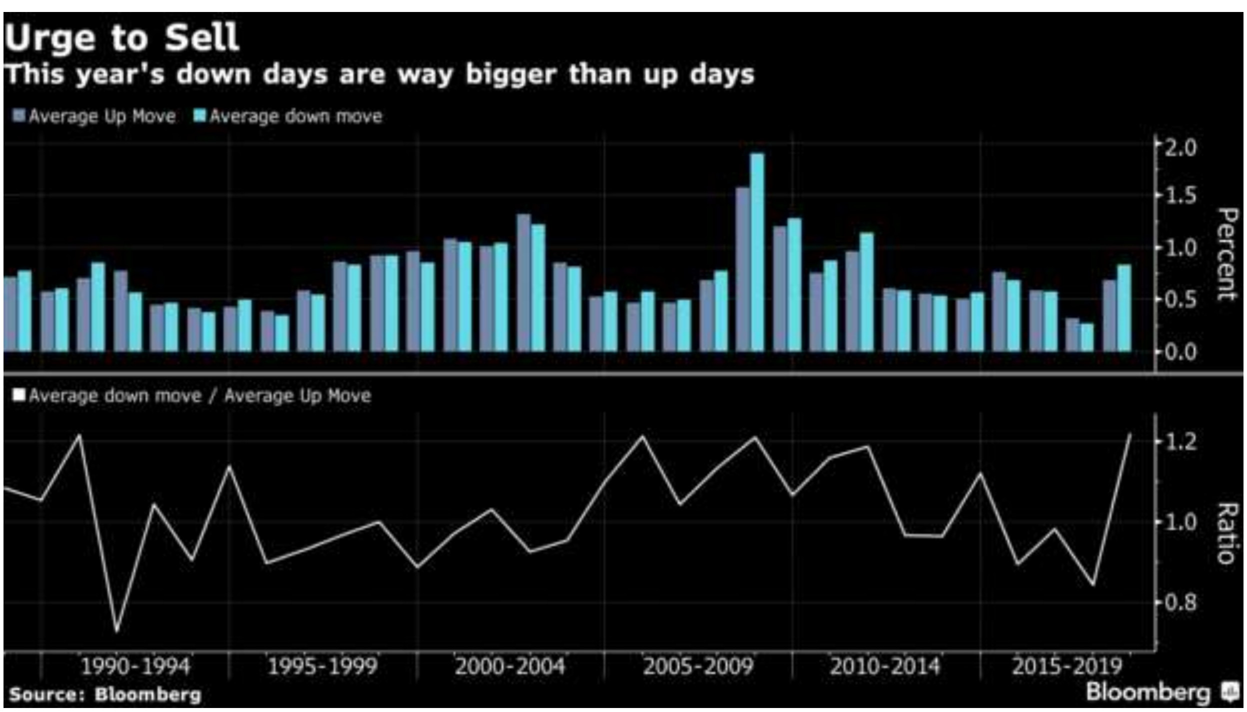
It's summer. But in the Florida offices of Raymond James & Associates and at brokerages around the U.S., February is still in the air.

Repercussions from that month's rout won't go away -- not in chats with clients, not in the market itself. Gone are the days when you could buy an exchange-traded fund tracking the S&P 500 and turn off the ringer. Look away for five minutes, and some customer is on the phone demanding to know what the latest swerve did to his portfolio.

"It's not an investor's market anymore. It's a trader's market," said Andrew Adams, 32, an equity strategist for Raymond James in St. Petersburg. "There's definitely much more hand-holding. I do a lot more talking than before."

Things may be placid on the surface. But look closer and you see an equity landscape that has been altered by February's surge in volatility, by some measures the worst since the financial crisis.

A procession of awful days is battering investor nerves. While most of 2018's sessions have been up ones, when the market falls, it falls hard. Single-day drops are 20 percent bigger than gains, on average, the widest gap in seven decades.

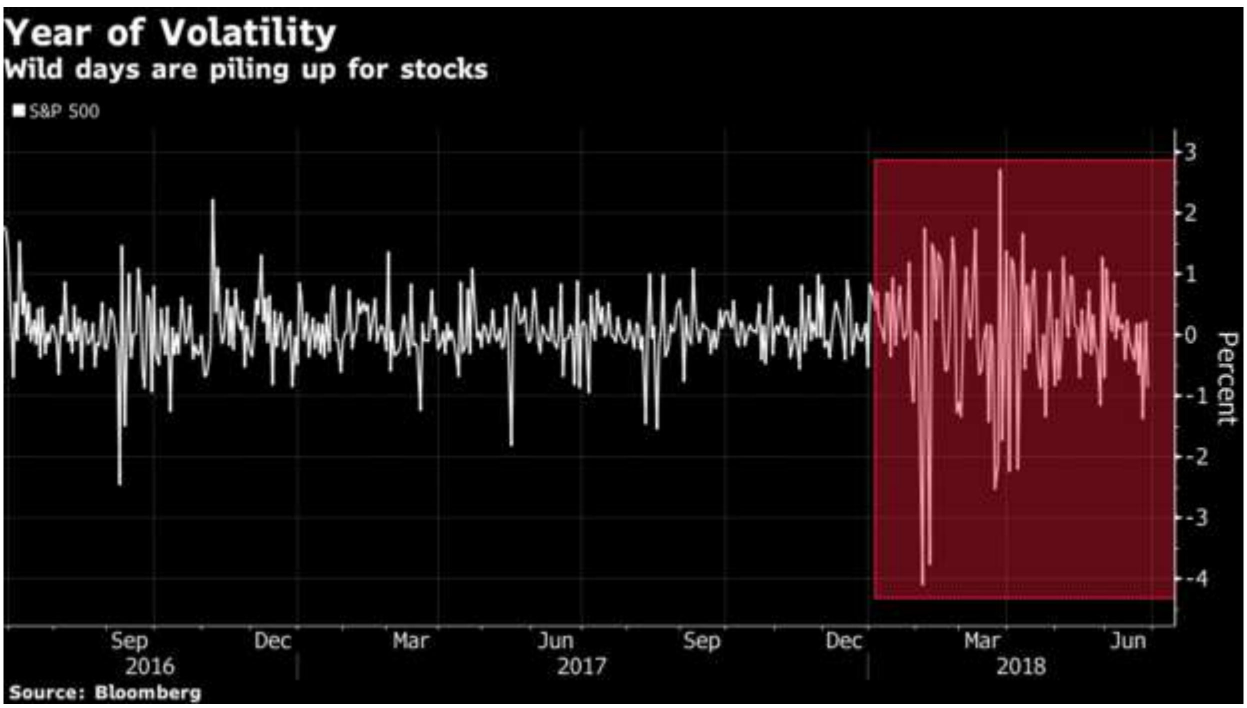


“Each big selloff becomes more dangerous,” said Jerry Braakman, chief investment officer of First American Trust in Santa Ana, California. “Ultimately something is going to fail and take us to a bear market.”

A decline of that size -- 20 percent, by Wall Street conventions -- is a long way off, held back by the strongest earnings estimates in a decade. The problem for peace-loving investors is that while profit forecasts rarely announce themselves, alarms about threats such as Donald Trump’s trade crusades blare out by the minute.

Investors are like boxers who can’t get their legs. The worst blow landed in February, when the S&P 500 lost 10 percent in nine sessions, the fastest peak-to-trough correction since 1950 (the crash of 1987 began well below that year’s high). Halfway into the year, the S&P 500 has posted 36 one-day swings days of at least 1 percent, four times the total in all of 2017.

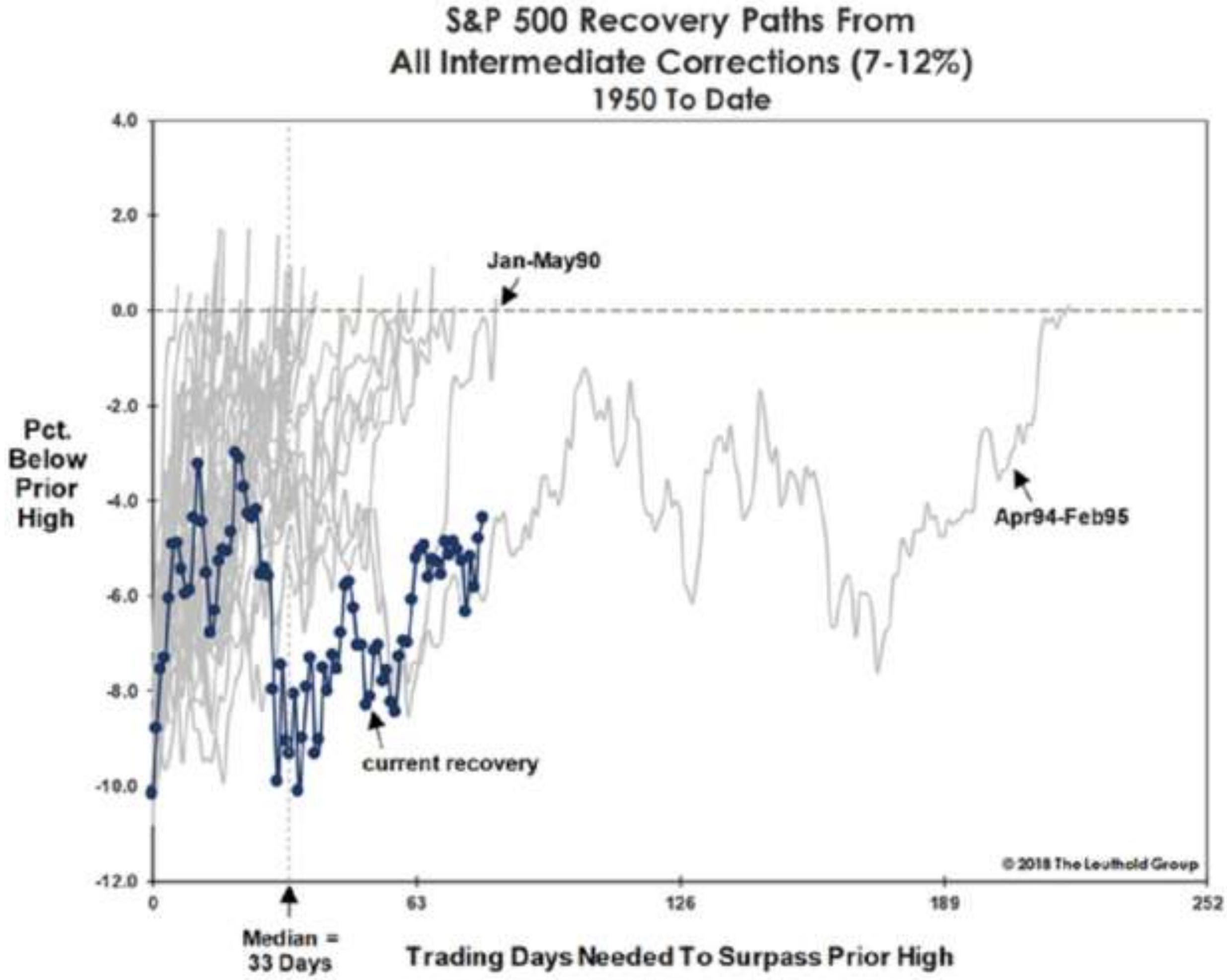
The average move in the S&P 500 is 0.7 percent this year, up from 0.3 percent in 2017. It’s a pace that if maintained would be the biggest increase on record. ...



Forces that had fortified bulls are turning traitor. President Trump, whose plans to cut taxes and ease regulations spurred a buying frenzy in December and January, is now waging a global trade war. The Federal Reserve has upped the pace of tightening, ending its role as the market’s biggest ally.

Over at Leuthold Group (which has a reputation for excellent analysis) in Minneapolis, they rank equity downdrafts by degrees of pain. An “intermediate correction” is what everyone hoped February’s was -- a plunge that never gets worse than about 12 percent. The odds of it being one of those are shrinking. Of 33 such episodes over the last seven decades, only one has taken longer to erase.

The exception was in 1994, a selloff that also began in February and lasted two years. Like now, the second year of Bill Clinton’s presidency featured a tightening Fed and losses in Treasuries.



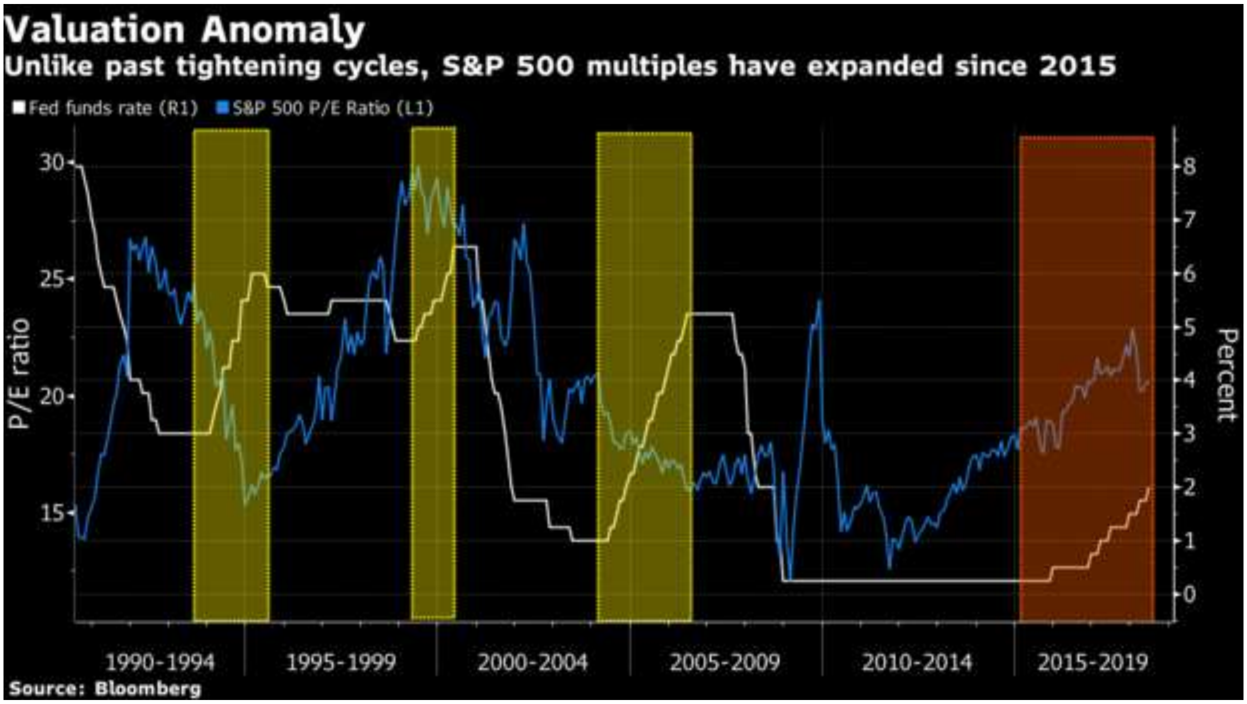
“Bulls could argue that this year’s market difficulties represent a similar adjustment to sharply higher rates across the curve, and that higher prices are in store when those rates have been fully absorbed,” said Doug Ramsey, chief investment officer of Leuthold. “Our view is less optimistic.

... More than one fifth of S&P 500 members are in bear market-like declines of 20 percent or more. Nine of the 11 major industries have, at one point or another, suffered bigger losses than the broader gauge.

“Is it possible that we’re experiencing a rolling bear market? We think the answer is yes,” said Mike Wilson, chief U.S. equity strategist at Morgan Stanley. “This year has been so difficult to navigate with the exception of technology’s unabated leadership.”

It’s testing the patience of investors who are already reluctant to pay up for earnings. Sure, analysts forecast profits will increase by more than 10 percent in each of the next two years. But the question is, what’s the fair multiple for earnings now that the safety net from the Fed seems to be gone?

“Our fear is the Fed is going too far and more pain lies ahead,” said Jim Bianco, founder of Bianco Research LLC. “If this was a ‘standard’ bull market correction, the market should have recovered to a new high by now. The longer it goes without recovering, the more it starts looking like the first leg down in a larger correction.”



Trump's accelerating trade war threats have hit foreign stocks even harder, especially Emerging Markets. We have previously shared our concerns about most Emerging Markets in a rising interest rate environment, and the geopolitical risk investors face in many of these countries. From Bloomberg:

Turkey to China, Bear Markets Spread Across Emerging World

By *Srinivasan Sivabalan*
June 26, 2018

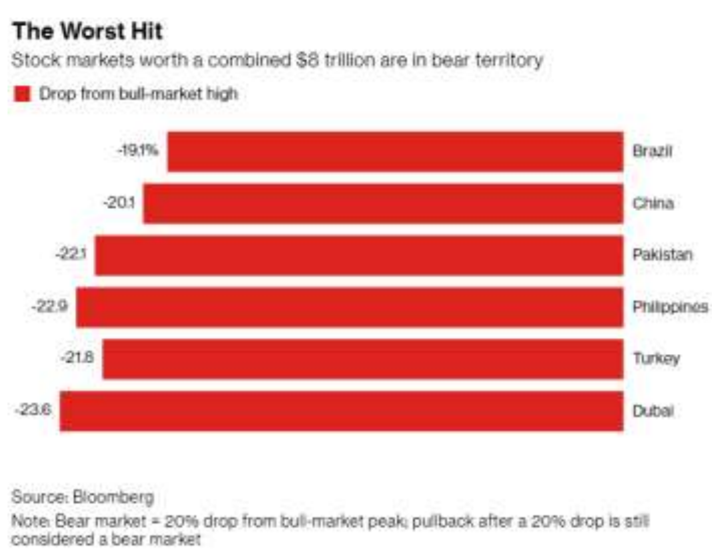
The decline in emerging-market stocks isn't a misstep anymore. It's now a full-blown plunge.

With China, the world's second-biggest stock market, extending its losses from a bull-rally peak to 20 percent, as many as six equity exchanges worth a combined $8 trillion are in a bear market. The benchmark index for the asset class is a whisker away from the threshold.

Two eastern European nations are also heading for a bear market, while 10 other markets have crossed the half-way mark, a correction of 10 percent from their highs.

Bear markets are a key signal for trend reversals as investors use them to verify whether the previous bull market has ended or the sell-off is just a correction in a rally. In the latter case, the 20 percent loss threshold acts as a bounce-back point.

Here's the state of play in emerging markets:



Bear Markets

When the slump began in late January, after a two-year, $8-trillion rally, some investors expected deeper losses in markets with the highest valuations. But in the past five months, the biggest declines have come from markets with price-earnings ratios that are below the emerging-market average.

In the chart above, only the Philippines has a greater P/E multiple than the MSCI Emerging Markets Index's 11.2, with a valuation of 15.1. The other nations have multiples ranging from 6.3 to 10.6.

Corrections

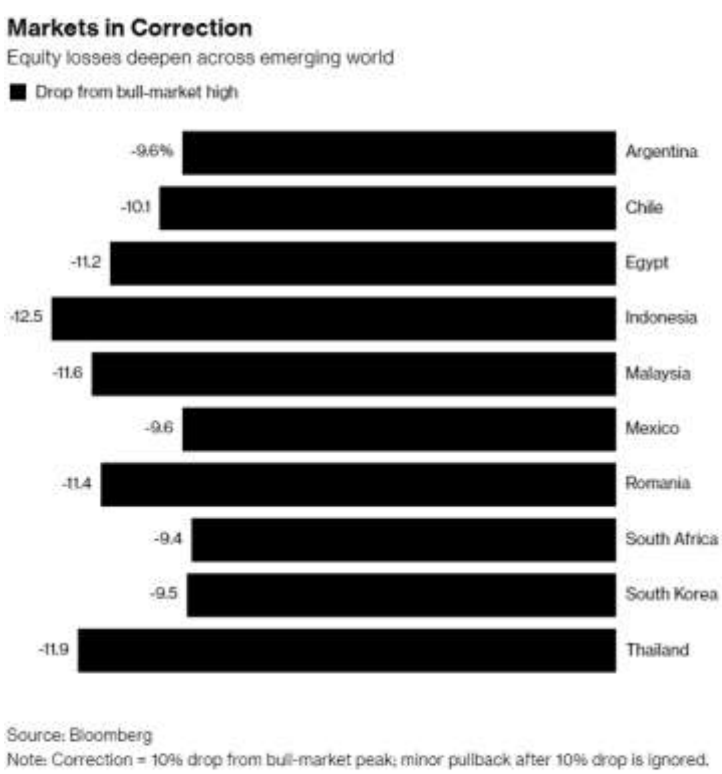
The idea that some markets are more vulnerable than others is being challenged as stock losses spread across developing nations. Four of the 10 countries in correction are in Asia, showing that even stronger economies are victims of poor sentiment.

Nearing Bear Markets

With losses exceeding 15 percent, Hungary and Poland are the closest to the bear-market threshold among developing nations.

Adamant Bulls

But the nine that are still in a bull market are limiting losses for the emerging-market gauge. No common theme connects them ...



Unlike our negative view on most Emerging Markets, we have consistently recommended the Size Factor when combined with the Value or Quality Factor. From Invesco:

Can small-cap outperformance continue?

Several drivers suggest that small caps may be able to continue their recent dominance over large caps

Posted by Nick Kalivas, Senior Equity Product Strategist on Jun 8, 2018, in Exchange-Traded Funds

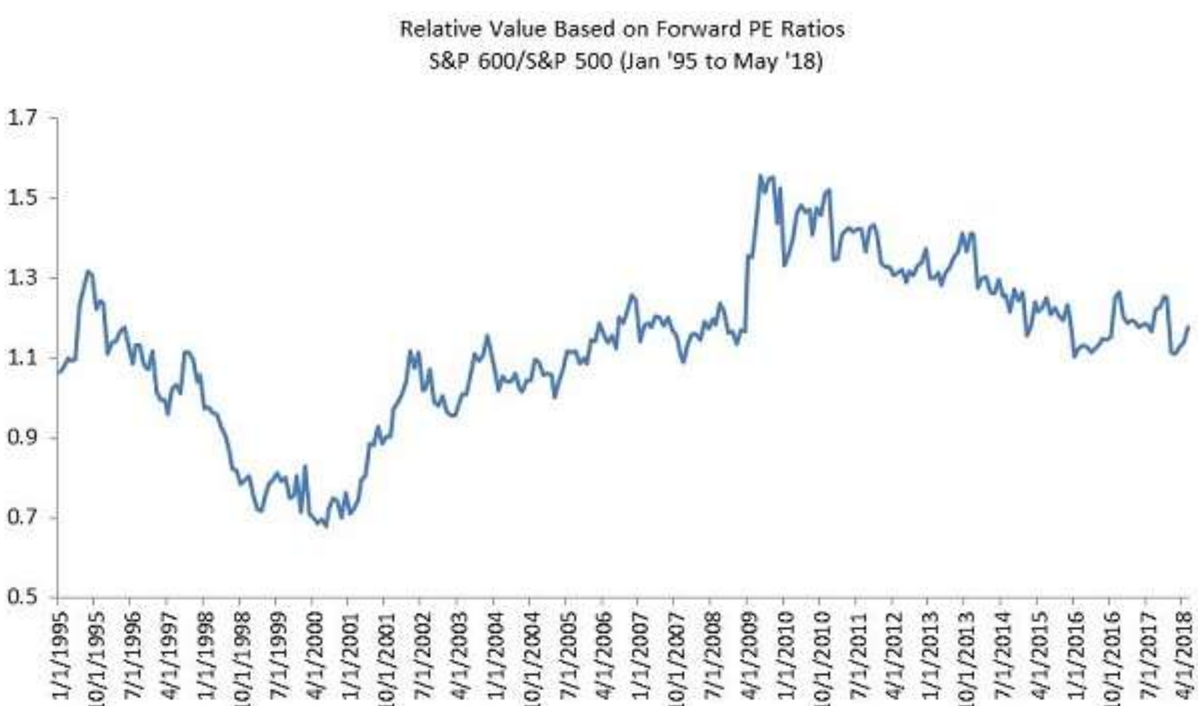
Small caps have materially outperformed large caps in 2018, with the S&P SmallCap 600 Index outpacing the S&P 500 Index 7.80% to 2.58% between Dec. 29, 2017, and May 25, 2018. Below, I highlight the drivers of small-cap returns this year, and why I believe the trend could continue.

Tax cuts have benefited small caps. In the three years ending December 2017, the companies in the S&P SmallCap 600 Index had an average effective tax rate 4.3% higher than the S&P 500 Index. Investors looking for stocks that may experience improved profitability due to US tax reform have turned to the small-cap sector.

Trade tensions may favor small caps. 2018 has been a year of trade tensions, but smaller companies have less overseas exposure than larger companies. S&P SmallCap 600 Index companies generated 78.8% of their revenues from the US compared to 70.9% for the S&P 500 Index. The difference was even more dramatic in the growth style box, where S&P SmallCap 600 Growth Index companies produced 80.6% of their revenue from the US compared to 65.1% for S&P 500 Growth companies. The recent political tensions in Italy and Spain and the potential threats to economic growth in the eurozone may prompt investors to reduce their overseas exposure and benefit small caps relative to large caps.

The trend in earnings estimate revisions favors small stocks over large. Earnings estimate revisions have been strongest in the small-cap sector. Forward earnings estimates for the S&P SmallCap 600 Index have risen by more than 28% compared to 18.7% for the S&P 500 Index over the past six months.

The US economy has shown relative strength. More recently, the US economy has continued to display strong growth, while economies in Europe and Asia have softened. The IHS Markit Eurozone Manufacturing



PMI has declined from a peak of 60.6 in December 2017 to a recent low of 55.5 in May 2018, while the Nikkei Japan Manufacturing PMI has eased from a January 2018 high of 54.8 to a recent low of 52.8 in May.[4]In contrast, the IHS Markit US Manufacturing PMI was just below its cycle high at 56.4 in May.

Investors may be choosing small caps over emerging markets for their risk sleeve. Investors have become uneasy over emerging markets due to geopolitical tensions (the Turkish lira crisis, instability in Venezuela, and Russian sanctions, for example), a rising 10-year Treasury yield, and a firmer dollar that has rallied from its February low. The risk sleeves of portfolios may have tilted toward small caps.

Small-cap valuation has become more attractive. Some see better value in small caps as the price-to-earnings (P/E) ratio has compressed on the S&P SmallCap 600 Index, suggesting that small caps have cheapened in recent years. On a forward earnings basis, the S&P SmallCap 600 Index is currently trading at 20.1 compared to 17.0 for the S&P 500 Index. The ratio of 1.18 is down from a peak of over 1.33 in July 2009.

For those of you tempted to wade through Friday's edited Global Investment Strategy's Third Quarter 2018 forecast, ominously titled "The Beginning Of The End", we repeat Peter Lynch's admonition: **"If you spend more than 13 minutes analyzing economic and market forecasts, you've wasted 10 minutes."**

I. Macro Outlook

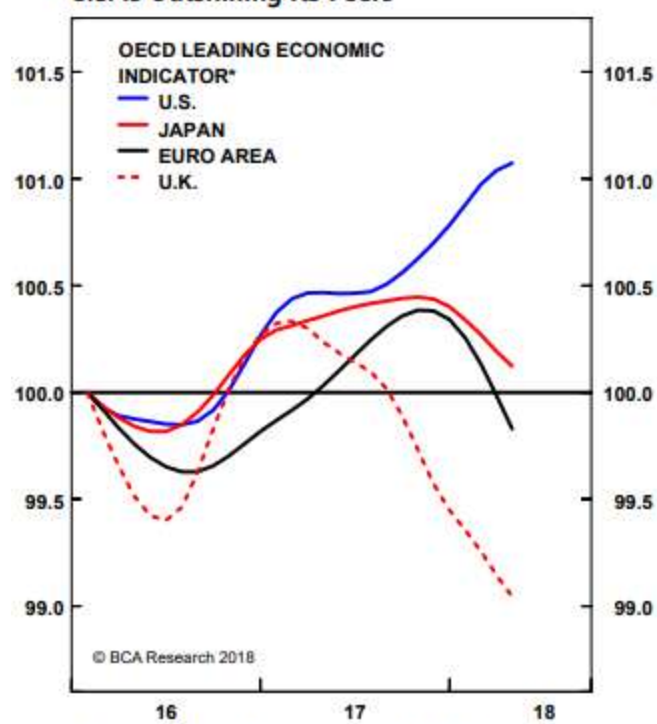
Back To The USA

The global economy experienced a synchronized expansion in 2017. Global real GDP growth accelerated to 3.8% from 3.2% in 2016. The euro area, Japan, and most emerging markets moved from laggards to leaders in the global growth horse race.

The opposite pattern has prevailed in 2018. Global growth has slowed, a trend that is likely to continue over the next few quarters judging by a variety of leading economic indicators (LEIs).

CHART 2

U.S. Is Outshining Its Peers



* AMPLITUDE ADJUSTED, REBASED TO JAN. 2016 = 100. SOURCE: OECD.

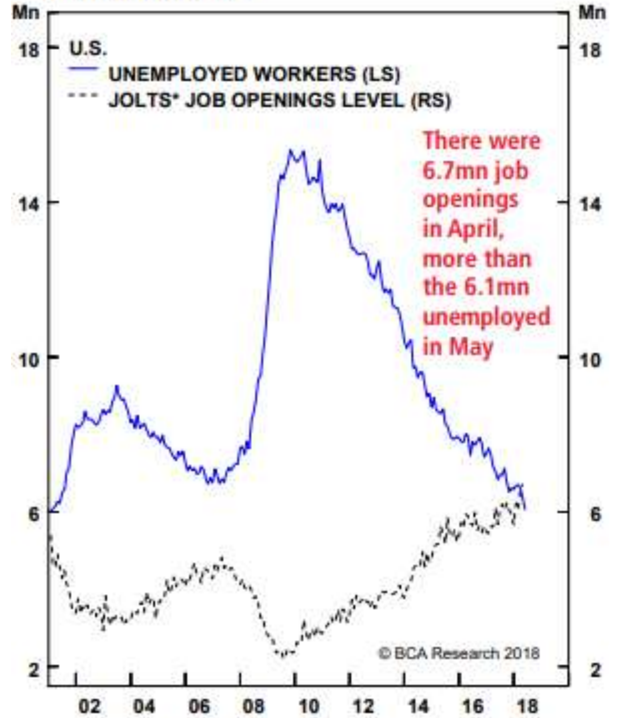
The U.S. has once again jumped ahead of its peers: It is the only major economy where the LEI is still rising (**Chart 2**). The latest tracking data suggest that U.S. real GDP growth could reach 4% in the second quarter, more than double most estimates of trend growth.

Such a lofty pace of growth cannot be sustained. For the first time in over a decade, the U.S. economy has reached full employment. The unemployment rate stands at a 48-year low of 3.75%. The number of people outside the labor force who want a job, as a percentage of the total working-age population, is back to prerecession lows. For the first time in the history of the Bureau of Labor Statistics' Job Openings and Labor Turnover Survey (JOLTS), there are more job vacancies than unemployed workers (**Chart 4**).

Mainstream economic theory states that governments should tighten fiscal policy as the economy begins to overheat in order to accumulate a war chest for the next inevitable downturn. The Trump administration is doing the exact opposite. The budget deficit is set to widen to 4.6% of GDP next year on the back of massive tax cuts and big increases in government spending.

CHART 4

There Are Now More Vacancies Than Jobseekers



* JOB OPENINGS AND LABOR TURNOVER SURVEY.
SOURCE: BUREAU OF LABOR STATISTICS.

The Fed In Tightening Mode

As the labor market overheats, wages will accelerate further. Average hourly earnings surprised to the upside in May. The Employment Cost Index for private-sector workers – one of the cleanest and most reliable measures of wage growth – rose at a 4% annualized pace in the first quarter. ...

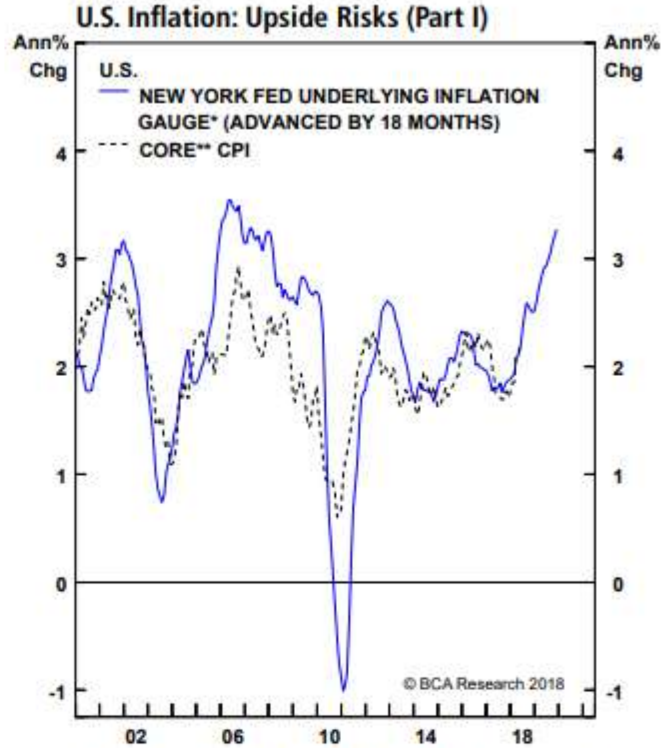
Rising wages will put more income into workers' pockets who will then spend it. As aggregate demand increases beyond the economy's productive capacity, inflation will rise. The New York Fed's Underlying Inflation Gauge, which leads core CPI inflation by 18 months, has already leaped to over 3% (**Chart 7**). The prices paid components of the ISM and regional Fed purchasing manager surveys have also surged.

The Fed has a symmetric inflation target. Hence, a temporary increase in core PCE inflation to around 2.2%-to-2.3% would not worry the FOMC very much. However, a sustained move above 2.5% would likely prompt an aggressive response.

The fact that the unemployment rate has fallen 0.7 percentage points below the Fed's estimate of full employment may seem like a cause for celebration, but this development has a dark side. There has never been a case in the post-war era where the unemployment rate has risen by more than one-third of a percentage point without this coinciding with a recession (**Chart 9**). The Fed wants to avoid a situation where the unemployment rate has fallen so much that it has nowhere to go but up.

CHART 7

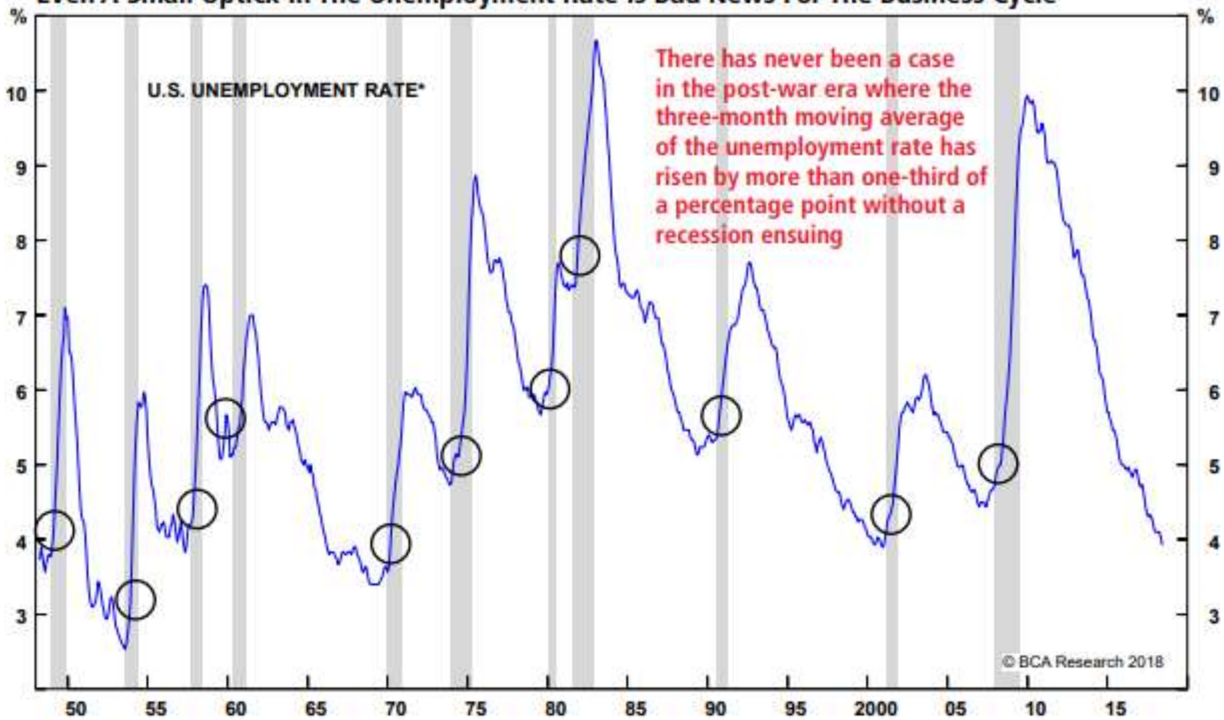
U.S. Inflation: Upside Risks (Part I)



* TREND INFLATION MEASURE BASED ON BROAD PRICE VARIABLES, MACROECONOMIC VARIABLES, AND FINANCIAL VARIABLES.
SOURCE: FEDERAL RESERVE BANK OF NEW YORK.
** EXCLUDING FOOD AND ENERGY.

As such, we think that the bar for the Fed to abandon its once-per-quarter pace of rate hikes is quite high. If anything, the risk is that the Fed expedites monetary tightening in order to keep real rates on an upward trajectory. Jay Powell's announcement that he will hold a press conference at the conclusion of every FOMC meeting opens the door for the Fed to move back to its historic pattern of hiking rates once every six weeks.

CHART 9
Even A Small Uptick In The Unemployment Rate Is Bad News For The Business Cycle



* SHOWN AS A 3-MONTH MOVING AVERAGE.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS; CIRCLES IN THE CHART DENOTE THE TIMES WHEN THE 3-MONTH MOVING AVERAGE OF THE UNEMPLOYMENT RATE INCREASED BY MORE THAN ONE-THIRD OF A PERCENTAGE POINT FROM RECENT LOWS.

Housing ...

As Ed Leamer pointed out in his 2007 Jackson Hole symposium paper succinctly entitled, “Housing Is The Business Cycle,” housing has historically been the main conduit through which changes in monetary policy affect the real economy.

A house will last a long time, and the land on which it sits – which in many cases is worth more than the house itself – will last forever. Thus, changes in real interest rates tend to have a large impact on the capitalized value of one’s home.

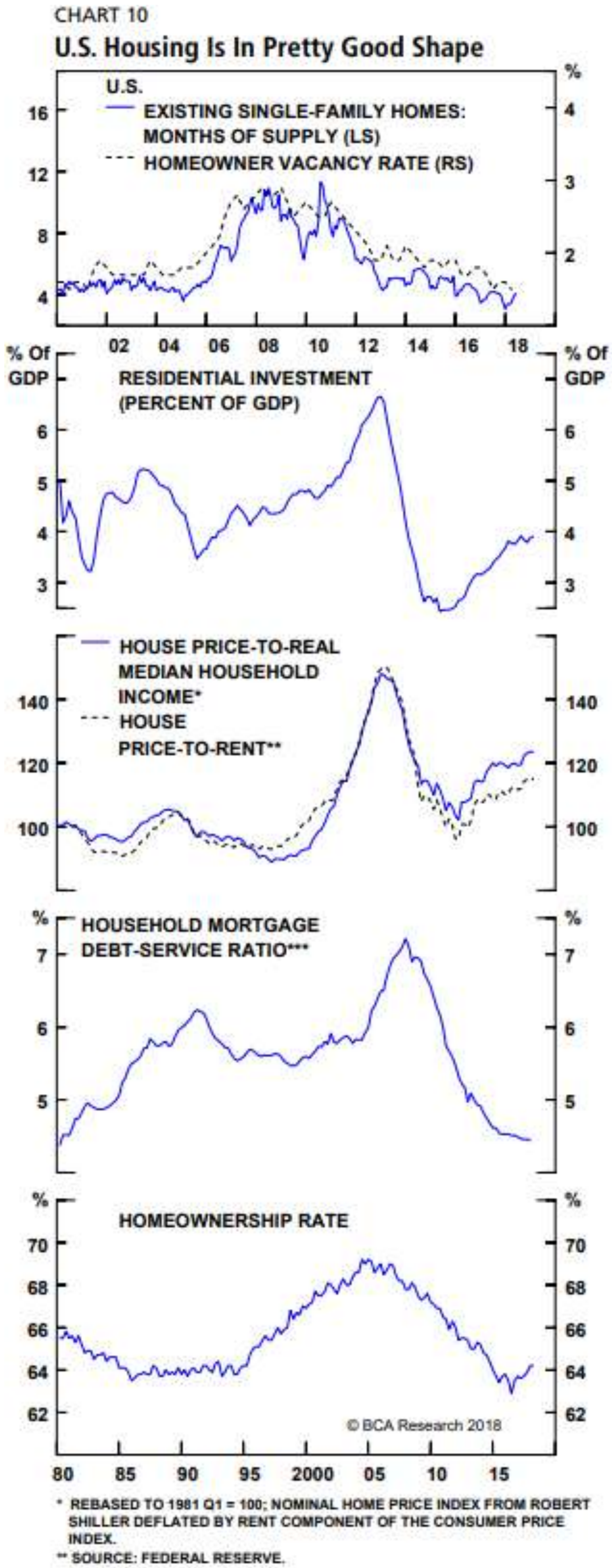
Today, the U.S. housing market is in pretty good shape (**Chart 10**). Construction activity was slow to increase in the aftermath of the Great Recession. As a result, the vacancy rate stands at ultra-low levels.

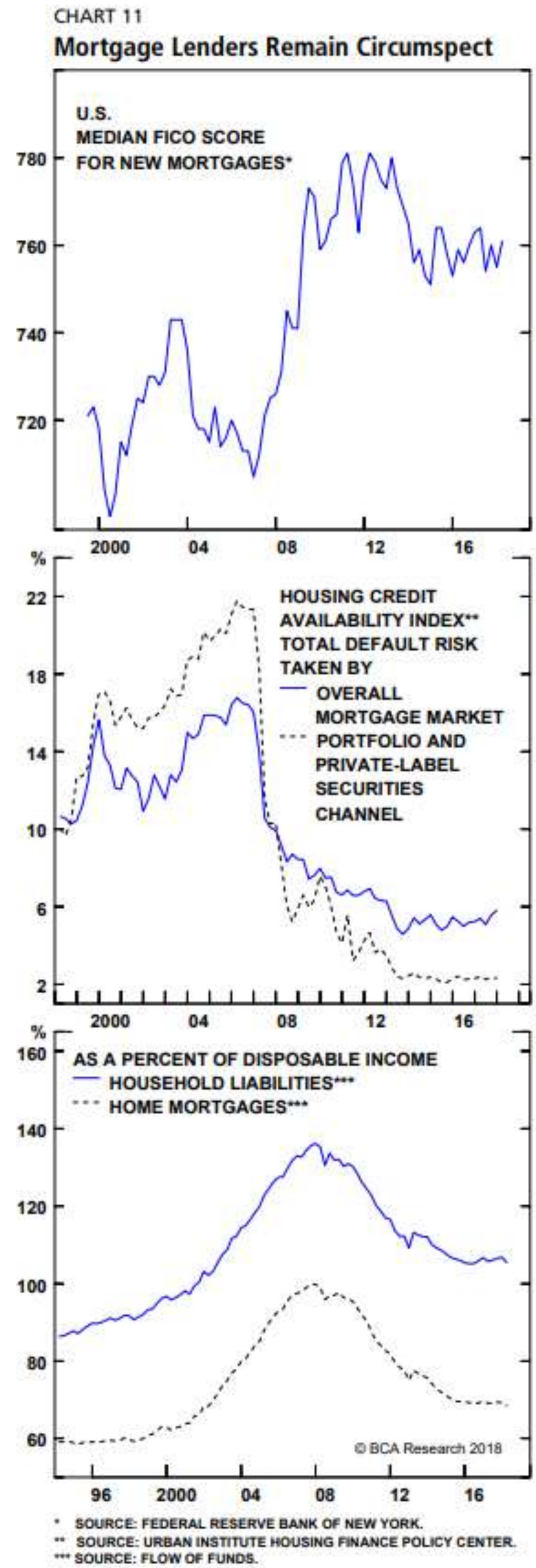
Home prices have been rising briskly, but are still 13% below their 2005 peak once adjusted for inflation. On both a price-to-rent and price-to-income basis, home prices do not appear overly stretched.

Mortgage-servicing costs, expressed as a share of disposable income, are near all-time lows. The homeownership rate has also been trending higher, thanks to faster household formation and an improving labor market.

Lenders remain circumspect (**Chart 11**). The ratio of mortgage debt-to-disposable income has barely increased during the recovery, and is still 31 percentage points below 2007 levels. The average FICO score for new mortgages stands at a healthy 761, well above pre-recession standards.

The Urban Institute Housing Credit Availability Index, which measures the percentage of home purchase loans that are likely to default over the next 90 days, is nowhere close to dangerous levels. This is particularly the case





for private label mortgages, whose default risk has hovered at just over 2% during the past few years, down from a peak of 22% in 2006.

If Not Housing, Then What?

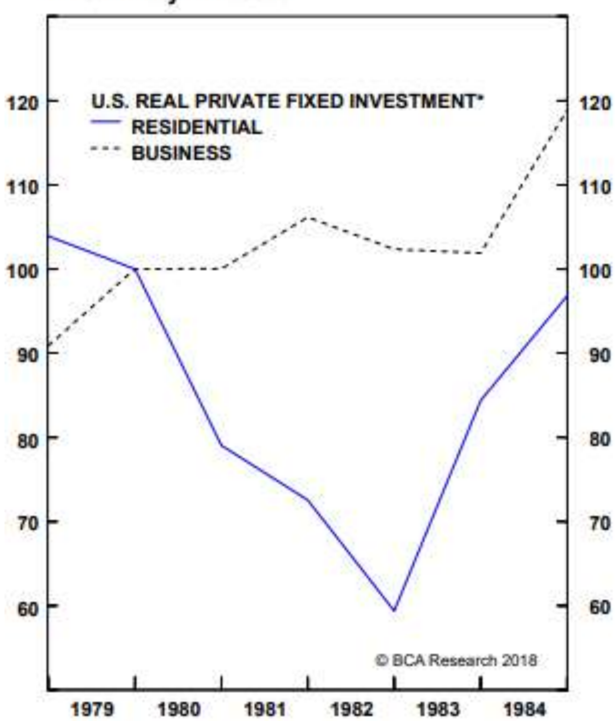
Since the U.S. housing sector is in reasonably good shape, the Fed may need to slow the economy through other means. Here's the rub though: Other sectors of the economy are not particularly sensitive to changes in interest rates.

Decades of empirical data have clearly shown that business investment is only weakly correlated with the cost of capital. Unlike a house, most business investment is fairly short-lived. A computer might be ready for the recycling heap in just a few years. The Bureau of Economic Analysis estimates that the depreciation rate for nonresidential assets is nearly four times higher than for residential property. During the early 1980s, when the effective fed funds rate reached 19%, residential investment collapsed but business investment was barely affected (**Chart 13**).

Rising rates could make it difficult for corporate borrowers to pay back loans, which could indirectly lead to lower business investment. That said, a fairly pronounced increase in rates may be necessary to generate significant distress in the corporate sector, given that interest payments are close to record-lows as a share of cash flows (**Chart 14**). In addition, corporate bonds now represent 60% of total corporate liabilities. Bonds tend to have much longer maturities than bank loans, which provides a buffer against default risk.

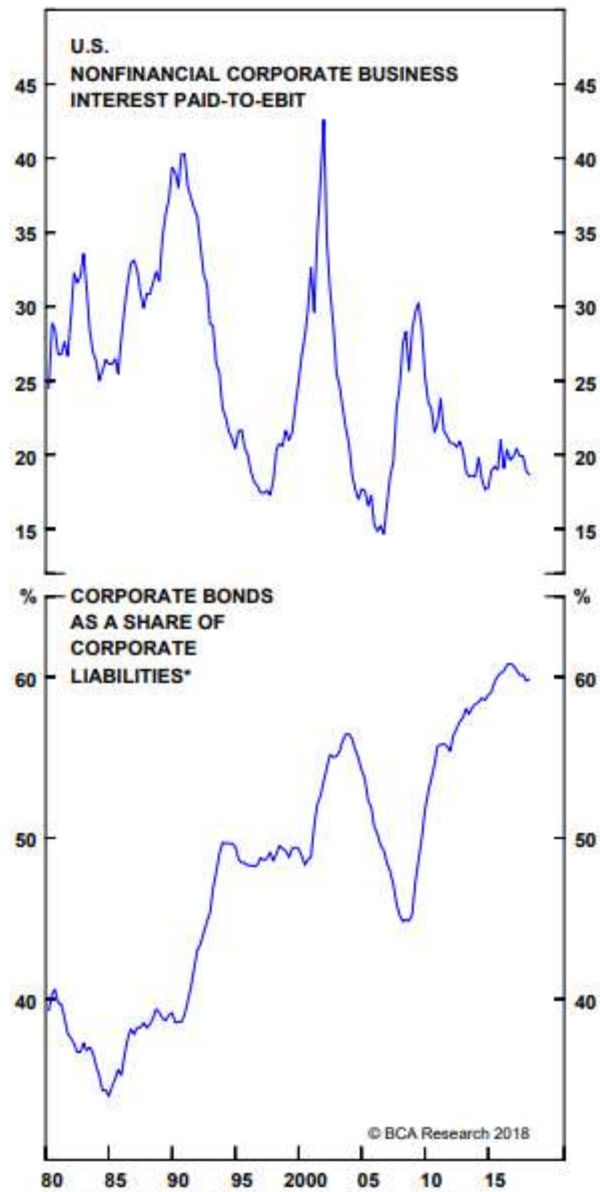
A stronger dollar would cool the economy by diverting some

CHART 13
Residential Investment Collapsed In Response To Higher Interest Rates In The Early 80s… While Business Investment Was Barely Affected



* SHOWN REBASED TO JAN. 1979 = 100. SOURCE: BUREAU OF ECONOMIC ANALYSIS.

CHART 14
U.S. Corporate Sector Interest Payments At Near Record-Low Levels As A Share Of Cash Flows



* CORPORATE LIABILITIES DEFINED AS THE SUM OF DEBT SECURITIES AND LOANS.
SOURCE: U.S. FLOW OF FUNDS AND BUREAU OF ECONOMIC ANALYSIS.

spending towards imports. However, imports account for only 16% of GDP. Thus, even large swings in the dollar's value tend to have only modest effects on the economy. Likewise, higher interest rates could hurt equity prices, but the wealthiest ten percent of households own 93% of all stocks. Hence, it would take a sizable drop in the stock market to significantly slow GDP growth.

The conventional wisdom is that the Fed will need to hit the pause button at some point next year. The market is pricing in only 85 basis points in rate hikes between now and the end of 2020. That assumption may be faulty, considering that housing is in good shape and other sectors of the economy are not especially sensitive to changes in interest rates. Rates may need to go quite a bit higher before the U.S. economy slows materially.

Global Contagion

Investors and policymakers talk a lot about the neutral rate of interest. Unfortunately, the discussion is usually very parochial in nature, inasmuch as it focuses on the interest rate that is consistent with full employment and stable inflation in the United States. But the U.S. is not an island unto itself. Even if a bit outdated, the old adage that says that when the U.S. sneezes the rest of the world catches a cold still rings true. What if there is a lower "shadow" neutral rate which, if breached, causes pain outside the U.S. before it causes pain within the U.S. itself?

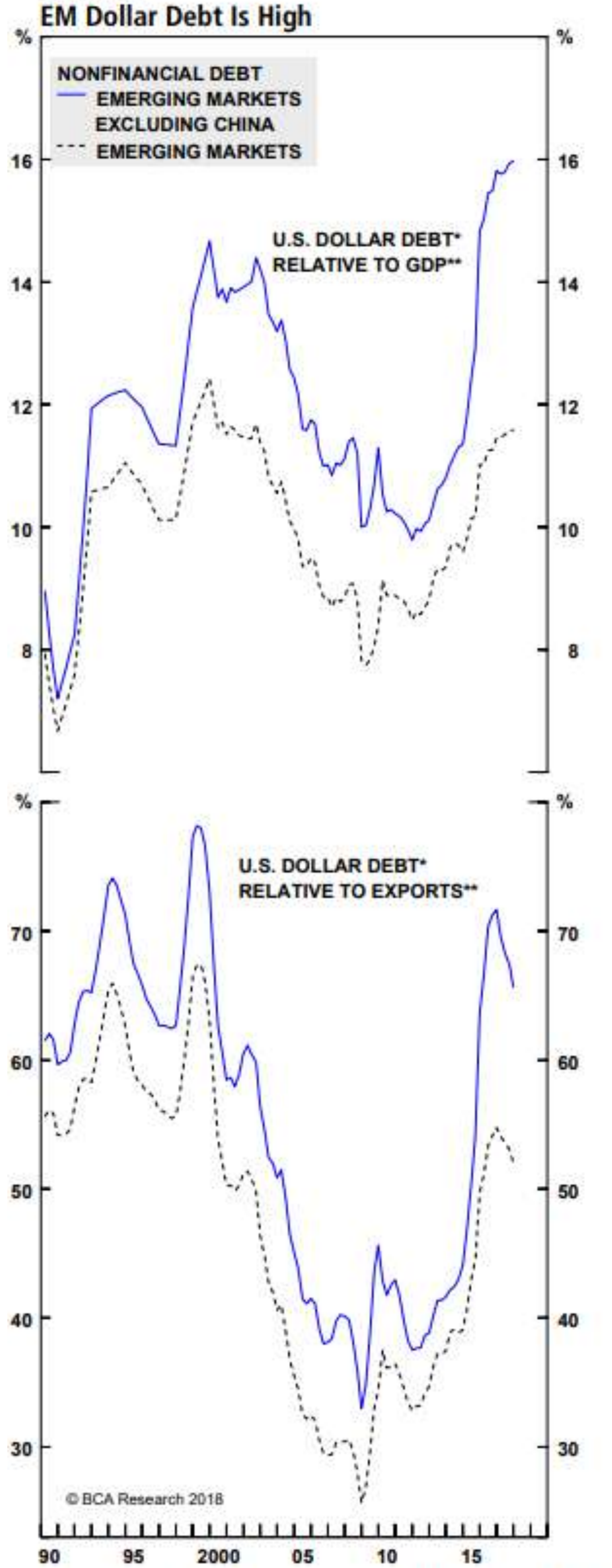
Eighty per cent of EM foreign-currency debt is denominated in U.S. dollars. Outside of China, EM dollar debt is now back to late-1990s levels both as a share of GDP and exports (**Chart 16**). Just like in that era, a vicious cycle could erupt where a stronger dollar makes it difficult for EM borrowers to pay back their loans, leading to capital outflows from emerging markets, and an even stronger dollar.

The wave of EM local-currency debt issued in recent years only complicates matters (**Chart 17**). If EM central banks raise rates, this could help prevent their currencies from plunging. However, higher domestic rates will make it difficult for local-currency borrowers to pay back their loans. Damned if you do, damned if you don't.

China To The Rescue?

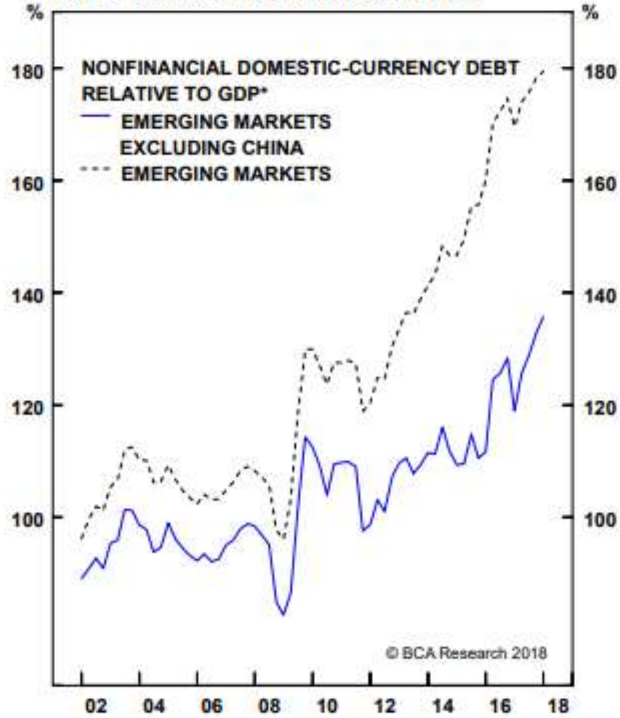
Don't Count On It When emerging markets last succumbed to pressure in 2015, China saved the day by stepping in with massive new stimulus. Fiscal spending and credit growth

CHART 16
EM Dollar Debt Is High



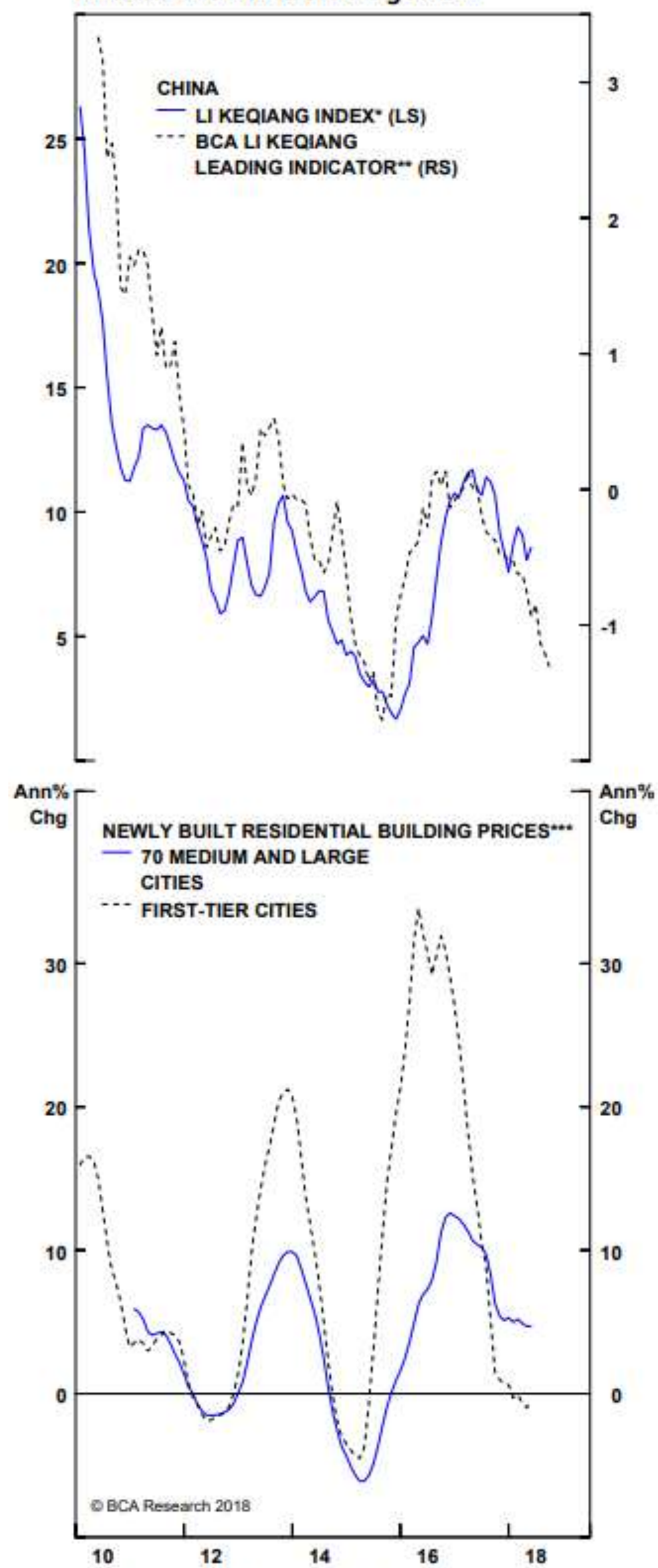
* SOURCE: BANK FOR INTERNATIONAL SETTLEMENTS (BIS) AND WORLD BANK. BIS DATA FROM 2000. BACK ESTIMATES FOR THE 1990-2000 PERIOD ARE BCA CALCULATED BASED ON EXTERNAL DEBT DATA FROM THE WORLD BANK'S INTERNATIONAL DEBT STATISTICS.
** SOURCE: IMF.

CHART 17
EM Borrowers Like Local Credit Too



* CALCULATED AS EM NONFINANCIAL DEBT MINUS EM NONFINANCIAL DEBT DENOMINATED IN FOREIGN CURRENCIES.
SOURCE: BANK FOR INTERNATIONAL SETTLEMENTS AND IMF.

CHART 18
Chinese Growth Is Slowing Anew



* SHOWN SMOOTHED. SOURCE: BLOOMBERG FINANCE L.P.
** BASED ON 6 MEASURES OF MONEY AND CREDIT.
*** SOURCE: NATIONAL BUREAU OF STATISTICS.

accelerated to over 15% year-over-year. The government’s actions boosted demand for all sorts of industrial commodities.

Today, Chinese growth is slowing again. May data on industrial production, retail sales, and fixed asset investment all disappointed. Our leading indicator for the Li Keqiang index, a widely followed measure of economic activity, is in a clear downtrend (**Chart 18**). Property prices in tier one cities are down year-over-year. Construction tends to follow prices.

So far, the policy response has been muted. Reserve requirements have been cut and some administrative controls loosened, but the combined credit and fiscal impulse has plunged. Onshore and offshore corporate bond yields have increased to multiyear highs. Bank lending rates are rising, while loan approval rates are dropping.

There is no doubt that China will stimulate again if the economy appears to be heading for a deep slowdown. However, the bar for a fresh round of stimulus is higher today than it was in the past. Elevated debt levels, excess capacity in some parts of the industrial sector, and worries about pollution all limit the extent to which the authorities will be willing to respond with the usual barrage of infrastructure spending and increased bank lending. The economy needs to feel more pain before policymakers come to its aid.

Rising Risk Of Another RMB Devaluation

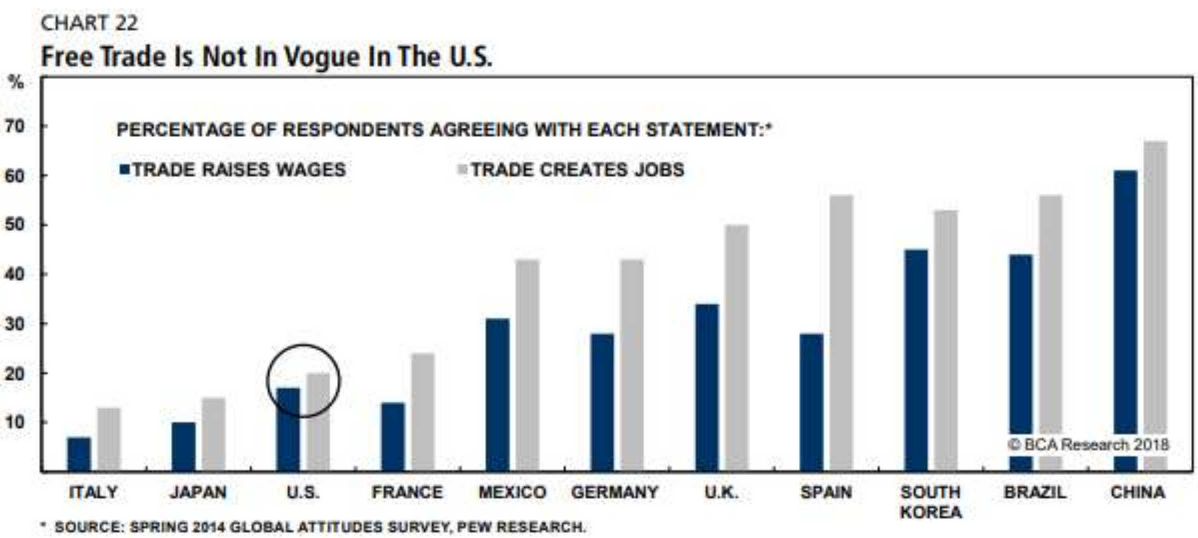
Even if China does stimulate the economy, it may try to do so by weakening the currency rather than loosening fiscal and credit policies. ... the yuan has fallen much more over the past week than one would have expected based on the broad dollar's trend. The timing of the CNY's recent descent coincides with President Trump's announcement of additional tariffs on $200 billion of Chinese goods.

Global financial markets went into a tizzy the last time China devalued the yuan in August 2015. The devaluation triggered significant capital outflows, arguably only compounding China's problems. This has led commentators to conclude that the authorities would not make the same mistake again. But what if the real mistake was not that China devalued its currency, but that it did not devalue it by enough? Standard economic theory says that a country should always devalue its currency by a sufficient amount to flush out expectations of a further decline. China was too timid, and paid the price.

Capital controls are tighter in China today than they were in 2015. This gives the authorities more room for maneuver. China is also waging a geopolitical war with the United States. The U.S. exported only $188 billion of goods and services to China, a small fraction of the $524 billion in goods and services that China exported to the United States. China simply cannot win a tit-for-tat trade war with the United States. In contrast, a currency war from China's perspective may be, to quote Donald Trump, "good and easy to win." The Chinese simply need to step up their purchases of U.S. Treasurys, which would drive up the value of the dollar.

Trump And Trade

Needless to say, any effort by the Chinese to devalue their currency would invite a backlash from the Trump administration. However, since China is already on the receiving end of punitive U.S. trade actions, it is not clear that the marginal cost to China would outweigh the benefits of having a more competitive currency. The truth is that there may be little that China can do to fend off a trade war. Protectionism is popular among American voters, especially among Trump's base (**Chart 22**). Donald Trump ran on a protectionist platform, and he is now trying to deliver on his promise of a smaller trade deficit.



Whether he succeeds is another story. Trump's macroeconomic policies are completely at odds with his trade agenda. Fiscal stimulus will boost aggregate demand, which will suck in more imports. An overheated economy will prompt the Fed to raise rates more aggressively than it otherwise would, leading to a stronger dollar. All of this will result in a wider trade deficit. What will Trump tell voters two years from now when he is campaigning in Michigan and Ohio about why the trade deficit has widened under his watch? Will he blame himself or America's trading partners? No trophy for getting that answer right.

Trump seems to equate countries with companies: Exports are revenues and imports are costs. If a country is exporting less than it is importing, it must be losing money. This is deeply flawed reasoning. I run a current account deficit with the place where I eat lunch and they run a capital account deficit with me – they give me food and I give them cash – but I don't go around complaining that they are ripping me off.

A trade war would be much more damaging to Wall Street than Main Street. While trade is a fairly small part of the U.S. economy, it represents a large share of the activities of the multinational companies that comprise the S&P 500.

Trade these days is dominated by intermediate goods. The exchange of goods and services takes place within the context of a massive global supply chain, where such phrases as "outsourcing," "vertical integration" and "just-in-time inventory management" have entered the popular vernacular.

This arrangement has many advantages, but it also harbors numerous fragilities. A small fire at a factory in Japan that manufactured 60 per cent of the epoxy resin used in chip casings led to a major spike in RAM prices in 1993. Flooding in Thailand in 2011 wreaked havoc on the global auto industry. The global supply chain is highly vulnerable to even small shocks. Now scale that up by a factor of 100. That is what a global trade war would look like.

The Euro Area: Back In The Slow Lane

Euro area growth peaked late last year. Real final demand grew by 0.8% in Q4 of 2017 but only 0.2% in Q1 of 2018. The weakening trend was partly a function of slower growth in China and other emerging markets – net exports contributed 0.41 percentage points to euro area growth in Q4 but subtracted 0.14 points in Q1. ...

It is too early to expect euro area growth to reaccelerate. German exports contracted in April. Export expectations in the Ifo survey sank in June to the lowest level since January 2017, while the export component of the PMI swooned to a two-year low.

We also have yet to see the full effect of the Italian imbroglio on euro area growth. Italian bond yields have come down since spiking in April, but the 10-year yield is still more than 100 basis points higher than before the selloff. This amounts to a fairly substantial tightening in financial conditions in the euro area's third largest economy. And this does not even take into account the deleterious effect on Italian business confidence.

If You Are Gonna Do The Time, You Might As Well Do The Crime

At this point, investors are basically punishing Italy for a crime – defaulting and possibly jettisoning the euro – that it has not committed. If you are going to get reprimanded for something you have not done, you are more likely to do it.

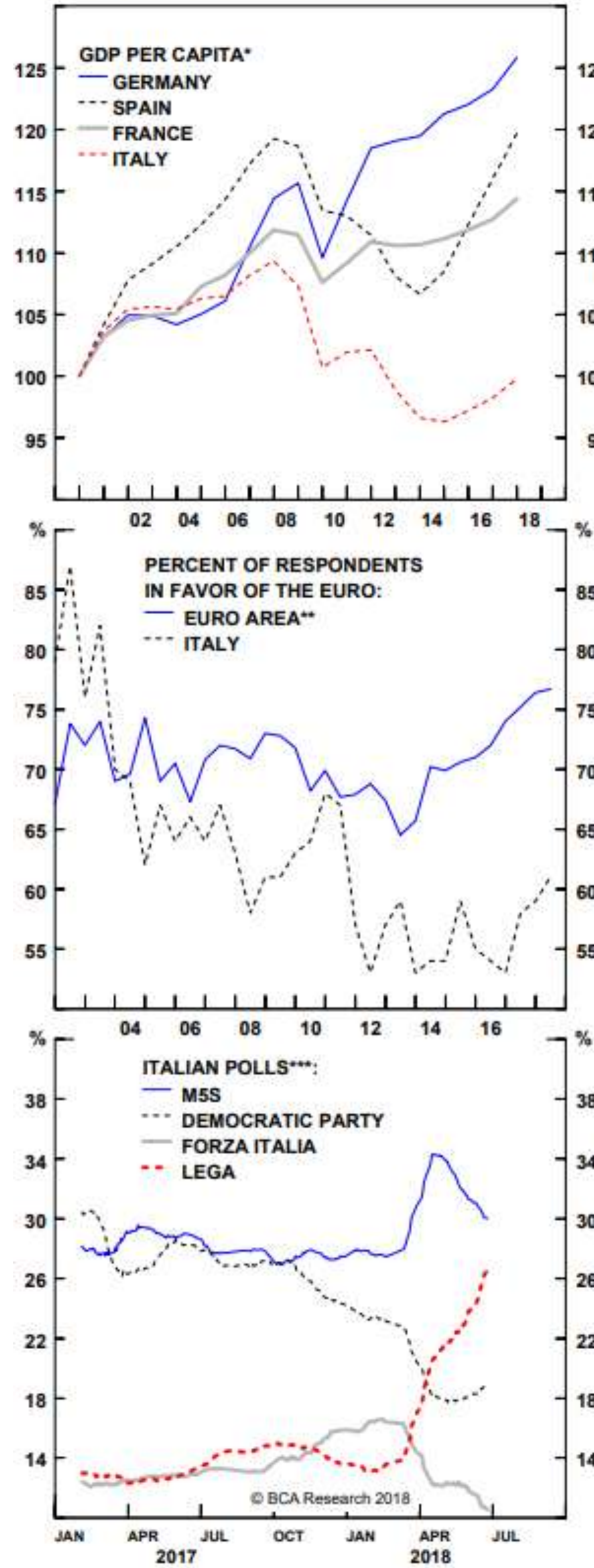
Such a predicament can easily create a vicious circle where rising yields make default more likely, leading to falling demand for Italian debt and even higher yields. The fact that Italian real GDP per capita is no higher now than when the country adopted the euro in 1999, and Italian public support for euro area membership is lower than elsewhere, has only added fuel to investor concerns (**Chart 27**).

The ECB could short-circuit this vicious circle by promising to backstop Italian debt no matter what. But it can't make such unconditional promises. Recall that prior to delivering his "whatever it takes" speech in 2012, Mario Draghi and his predecessor Jean-Claude Trichet penned a letter to Silvio Berlusconi outlining a series of reforms they wanted to see enacted as a condition of ongoing ECB support. The contents of the letter were so explosive that they precipitated Berlusconi's resignation after they were leaked to the public.

One of the reforms that Draghi and Trichet demanded – and the subsequent government led by Mario Monti ultimately undertook – was the extension of the retirement age. Italy's current leaders promised to reverse that decision during the election campaign. While they have softened their stance since then, they will still try to deliver on much of their populist agenda over the coming months, much to the consternation of the ECB and the European Commission.

It was one thing for Mario Draghi to promise to do "whatever it takes" to protect Italy when the country was the victim of contagion from the Greek crisis. But now that Italy is the source of the disease, the rationale for intervention has weakened.

CHART 27
Italy: Neither Divine Nor A Comedy



* SHOWN REBASED 1999 = 100.
** EQUALLY-WEIGHTED AVERAGE OF GREECE, GERMANY, SPAIN, FRANCE, PORTUGAL, BELGIUM, THE NETHERLANDS, AUSTRIA, FINLAND, AND IRELAND.
SOURCE: EUROBAROMETER.
*** SOURCE: VARIOUS POLLING AGENCIES.

Italy's Macro Constraints

Much has been written about what Italy should be doing, but the fact is that there are no simple solutions. Italy suffers from an aging population that is trying to save more for retirement. Italian companies do not want to invest in new capacity because the working age population is shrinking, which limits future domestic demand growth. Thus, the private sector is a chronic net saver, constantly wanting to spend less than it earns.

Italy is not unique in facing an excess of private-sector savings. However, Italy is unique in that the solutions available to most other countries to deal with this predicament are not available to it.

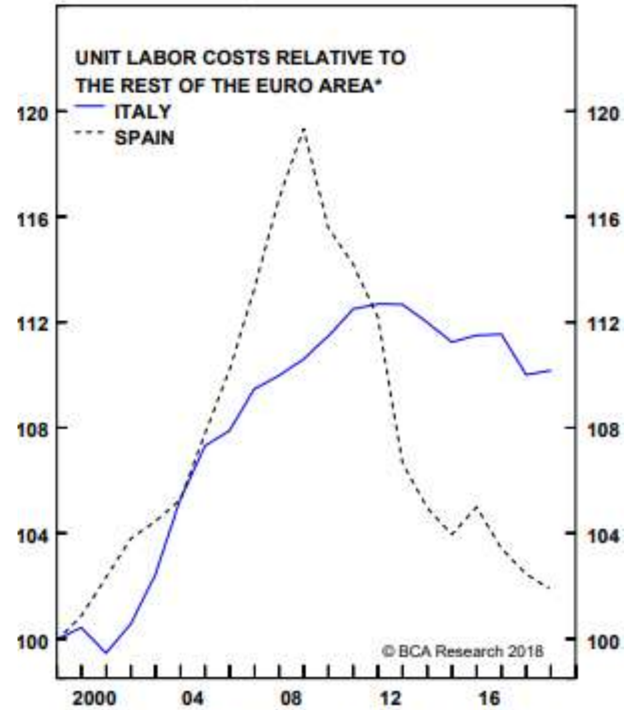
Broadly speaking, there are two ways you can deal with excess private-sector savings. Call it the Japanese solution and the German solution.

The Japanese solution is to have the government absorb excess private-sector savings with its own dissavings. This is tantamount to running large, sustained fiscal deficits. Italy's populist coalition Five Star-Lega government tried to pursue this strategy, only to have the bond vigilantes shoot it down.

The German solution is to ship excess savings out of the country through a large current account surplus (in Germany's case, 8% of GDP). However, for Italy to avail itself of this solution, it would need to have a hypercompetitive economy, which it does not. Unlike Spain, Italy's unit labor costs have barely declined over the past six years relative to the rest of the euro area, leaving it with an export base that is struggling to compete abroad (**Chart 29**).

Since there is little that can be done in the near term that would improve Italy's competitiveness vis-à-vis the rest of the euro area, the only thing the ECB can do is try to improve Italy's competitiveness vis-à-vis the rest of the world. This means keeping monetary policy very loose and hoping that this translates into a weak euro.

CHART 29
Italy: More Work Needs To Be Done On The Labor Competitiveness Front



* SHOWN REBASED TO JAN. 1999 = 100. INCLUDES ESTIMATE FOR 2018.
SOURCE: EUROPEAN COMMISSION.

II. Financial Markets

Downgrade Global Risk Assets From Overweight To Neutral

Investors are accustomed to thinking that ... the Fed will stop raising rates if growth slows and equity prices fall. This was a sensible assumption a few years ago: The Fed hiked rates in December 2015 and then stood pat for 12 months as the global economic backdrop darkened. These days, however, the Fed wants slower growth. And if weaker asset prices are the ticket to slower growth, so be it. ...

Likewise, worries about growing financial and economic imbalances will limit the ... tendency for the Chinese government to ease fiscal and credit policy at the first hint of slower growth. ... The ECB is hoping, perhaps unrealistically so, to wind down its asset purchase program later this year. This means that a key buyer of Italian debt is stepping back just when it may be needed the most.

The loss of these three policies ... along with additional risks such as rising protectionism, means that the outlook for global risk assets is likely to be more challenging over the coming months. With that in mind, we downgraded our 12-month recommendation on global risk assets from overweight to neutral last week.

Fixed-Income: Stay Underweight

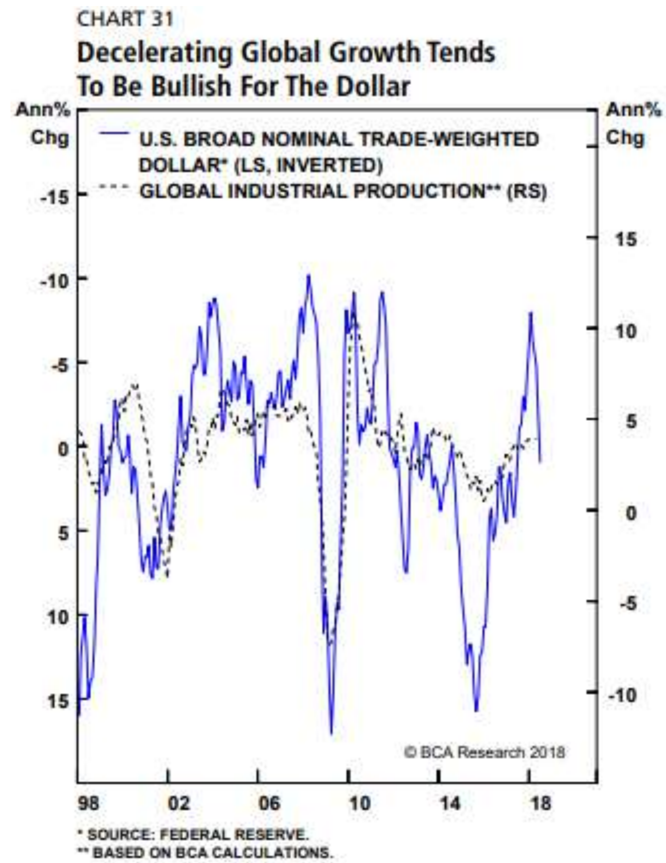
A less constructive stance towards equities would normally imply a more constructive stance towards bonds. Global bond yields could certainly fall in the near term, as EM stress triggers capital flows into safe-haven government bond markets. However, if we are really in an environment where an overheated U.S. economy and rising inflation force the Fed to raise rates more than the market expects, long-term bond yields are likely to rise over a 12-month horizon. ...

Bond yields are strongly correlated across the world. Thus, an increase in U.S. Treasury yields over the next 12 months would likely put upward pressure on bond yields abroad, even if inflation remains contained outside the United States. ...

Our increasing caution towards equities extends to the corporate bond space. BCA's U.S. Corporate Health Monitor (CHM) remains in deteriorating territory. With profits still high and bank lending standards continuing to ease, a recession-inducing corporate credit crunch is unlikely over the next 12 months. Nevertheless, our models suggest that both corporate and investment credit are overvalued. ...

Currencies: King Dollar Is Back

The U.S. dollar is a counter-cyclical currency, meaning that it tends to do well when the global economy is decelerating (**Chart 31**). If the Chinese economy continues to weaken, global growth will remain under pressure. Emerging market currencies will suffer in this environment especially if, as discussed above, the Chinese authorities engineer a devaluation of the yuan.



Momentum is moving back in the dollar's favor. ... a simple trading rule – which goes long the dollar whenever it is above its moving average and shorts it when it is below – has performed very well over time. The dollar is now trading above most key trend lines.

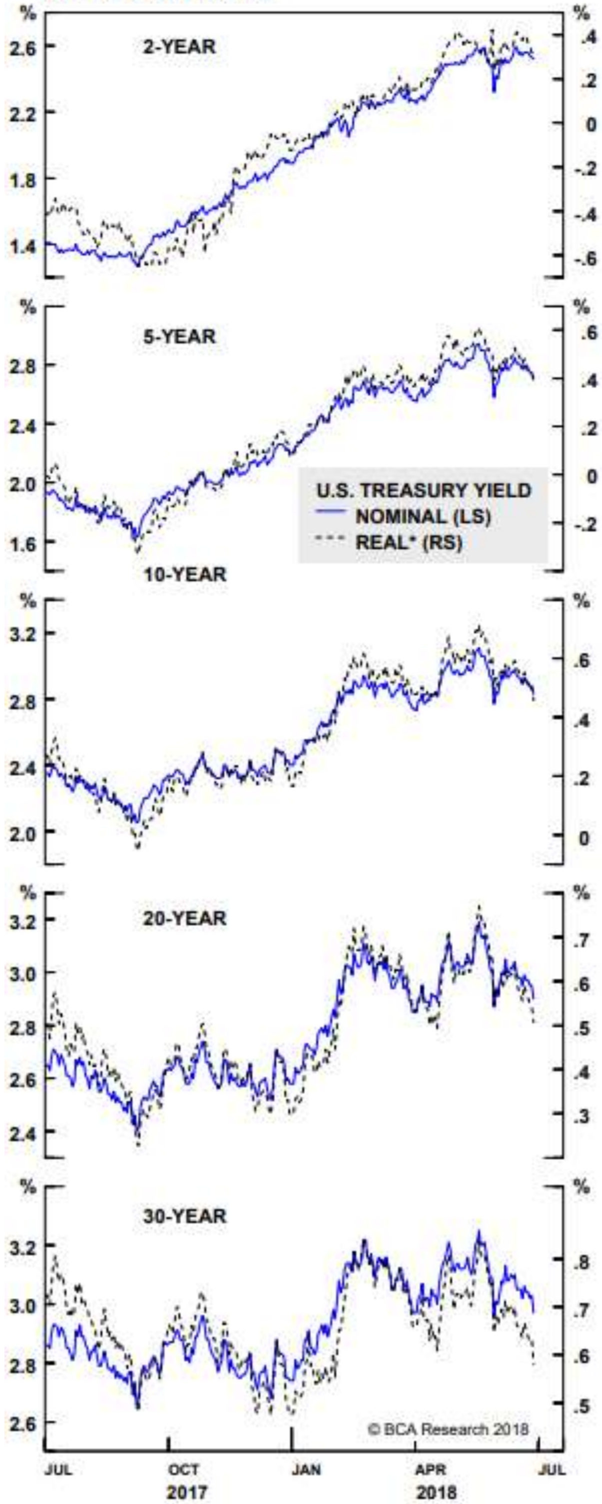
Some commentators have argued that a larger U.S. budget deficit will put downward pressure on the dollar. However, this would only happen if the Fed let inflation expectations rise more quickly than nominal rates, an outcome which would produce lower real rates. So far, that has not happened: U.S. real rates have risen across the entire yield curve since Treasury yields bottomed last September (**Chart 33**). As a result, real rate differentials between the U.S. and its peers have increased.

Historically, the dollar has moved in line with changes in real rate differentials. The past few months have been no exception. If the Fed finds itself in a position where it can raise rates more than the market anticipates, the greenback should continue to strengthen.

True, the dollar is no longer a cheap currency. However, if long-term interest rate differentials stay anywhere close to where they are today, the greenback can appreciate quite a bit from current levels. For example, consider the dollar's value versus the euro. Thirty-year U.S. Treasurys currently yield 2.98% while 30-year German bunds yield 1.04%, a difference of 194 basis points. Even if one allows for the fact that investors expect euro area inflation to be lower than in the U.S. over the next 30 years, EUR/USD would need to trade at a measly 84 cents today in order to compensate German bund holders for the inferior yield they will receive.3 We do not expect EUR/USD to get down to that level, but a descent into the $1.10-to-$1.15 range over the next few months certainly seems achievable.

CHART 33

U.S. Real Rates Have Risen Across The Entire Yield Curve



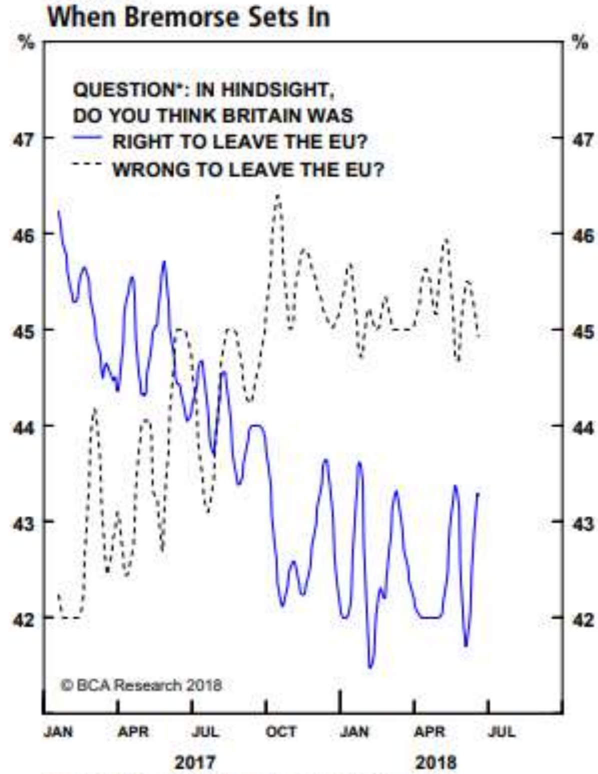
* DEFLATED BY CPI SWAP.

Brexit worries will continue to weigh on the British pound. ... The currency is extremely cheap. Inflation has come down from a 5-year high of 3.1% in November, but still clocked in at 2.4% in April. Real wages are picking up, consumer confidence has strengthened, and the CBI retail survey has improved. In a surprise decision, Andy Haldane, the Bank of England's Chief Economist, joined two other Monetary Policy Committee members in voting for an immediate 25 basis-point increase in the Bank Rate in June.

Perhaps most importantly, Brexit remains far from a sure thing. Most polls suggest that if a referendum were held again, the "Bremain" side would prevail (**Chart 37**). Rules are made to be broken. It is the will of the people, rather than legal mumbo-jumbo, that ultimately matters. In the end, the U.K. will stay in the EU.

CHART 37

When Bremorse Sets In



* BOTH SERIES SHOWN AS 15-DAY MOVING AVERAGES.
SOURCE: WHAT UK THINKS.

The yen is likely to weaken somewhat against the dollar over the next 12 months as interest rate differentials continue to move in the dollar's favor. That said, as with the pound, we think the downside for the yen is limited. The yen real exchange rate remains at multi-year lows. Japan's current account surplus has grown to nearly 4% of GDP and its net international investment position – the difference between its foreign assets and liabilities – stands at an impressive 60% of GDP. If financial market volatility rises, as we expect, some of those overseas assets will be repatriated back home, potentially boosting the value of the yen in the process.

Commodities: Better Outlook For Oil Than Metals

The combination of slower global growth and a resurgent dollar is likely to hurt commodity prices. Industrial metals are more vulnerable than oil. China consumes around half of all the copper, nickel, aluminum, zinc, and iron ore produced around the world. In contrast, China represents less than 15% of global oil demand.

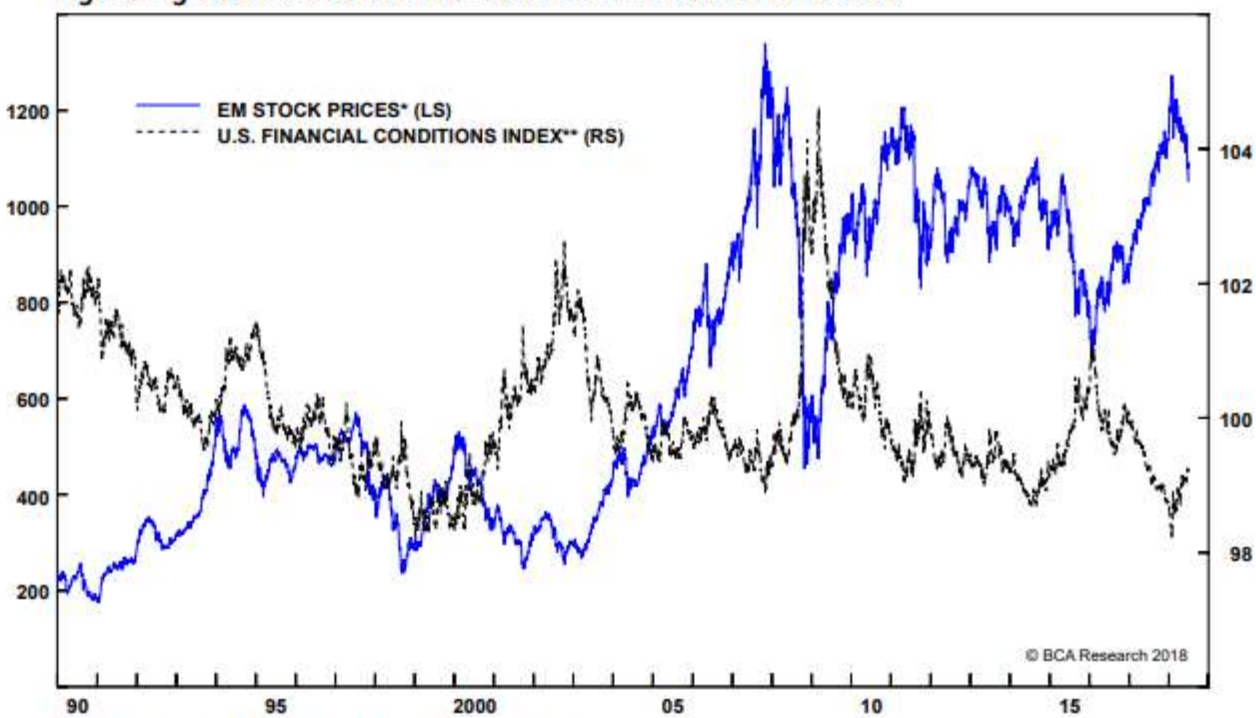
The supply backdrop for oil is also more favorable than for metals. While Saudi Arabia is likely to increase production over the remainder of the year, this may not be enough to fully offset lower crude output from Venezuela, Iran, Libya, and Nigeria, as well as potential constraints to U.S. production growth due to pipeline bottlenecks. Additionally, a recent power outage has knocked about 350,000 b/d of Syncrude's Canadian oil sands production offline at least through July. ...

The prospect of higher inflation down the road is good news for gold. However, with real rates still rising and the dollar strengthening, it is too early to pile into bullion and other precious metals. Wait until early 2020, by which time the Fed is likely to stop raising rates.

Equities: Prefer DM Over EM

One can believe that emerging market stocks will go up; one can also believe that the Fed will do its job and tighten financial conditions in order to prevent the U.S. economy from overheating. But one cannot believe that both of these things will happen at the same time. As **Chart 41** clearly shows, EM equities almost always fall when U.S. financial conditions are tightening.

CHART 41
Tightening U.S. Financial Conditions Do Not Bode Well For EM Stocks



* IN U.S. DOLLARS. SOURCE: MSCI INC. (SEE COPYRIGHT DECLARATION).
** SOURCE: GOLDMAN SACHS (VIA BLOOMBERG L.P.)

Our overriding view is that U.S. financial conditions will tighten over the coming months. As discussed above, the adverse effects of rising U.S. rates and a strengthening dollar are likely to be felt first and foremost in emerging markets. Our EM strategists believe that Turkey, Brazil, Argentina, South Africa, Malaysia, and Indonesia are most vulnerable.

We no longer have a strong 12-month view on regional equity allocation within the G3 economies, at least not in local-currency terms. The sector composition of the euro area and Japanese bourses is more heavily tilted towards deep cyclicals than the United States. However, a weaker euro, and to a lesser extent, a weaker yen will cushion the blow from a softening global economy. In dollar terms, the U.S. stock market should outperform its peers.

Getting Ready For The Next Equity Bear Market

A neutral stance does not imply that we expect markets to move sideways. On the contrary, volatility is likely to increase again over the balance of the year. We predicted last week that the next "big move" in stocks will be to the downside.

We would consider moving our 12-month recommendation temporarily back to overweight if global equities were to sell off by more than 15% during the next few months or if the policy environment becomes more market-friendly. Similar to what happened in 1998, when the S&P 500 fell by 22% between the late summer and early fall, a significant correction today could set the scene for a blow-off rally. In such a rally, EM stocks would probably rebound and cyclicals would outperform defensives.

CHART 44
Value Stocks: An Attractive Proposition

* SOURCE: MSCI INC. (SEE COPYRIGHT DECLARATION).
** BASED ON RELATIVE PRICE/SALES, PRICE/BOOK, PRICE/EARNINGS, AND DIVIDEND YIELDS.

However, absent such fireworks, we will probably downgrade global equities in early 2019 in anticipation of a global recession in 2020.

The U.S. fiscal impulse is set to fall sharply in 2020, as the full effects of the tax cuts and spending hikes make their way through the system. Real GDP will probably be growing at a trend-like pace of 1.7%-to-1.8% by the end of next year because the U.S. will have run out of surplus labor at that point. A falling fiscal impulse could take GDP growth down to 1% in 2020, a level often associated with "stall speed." Investors should further reduce exposure to stocks before this happens.

The next recession will not be especially severe in purely economic terms. However, as was the case in 2001, even a mild recession could lead to a very painful equity bear market if the starting point for valuations is high enough.

Valuations today are not as extreme as they were back then, but they are still near the upper end of their historic range. A composite valuation measure incorporating both the trailing and forward PE ratio, price-to-book, price-to-cash flow, price-to-sales, market cap-to-GDP, dividend yield, and Tobin's Q points to real average annual total returns of 1.8% for U.S. stocks over the next decade. Global equities will fare slightly better, but returns will still be below their historic norm. Long-term equity investors looking for more upside should consider steering their portfolios towards value stocks, which have massively underperformed growth stocks over the past 11 years (**Chart 44**).

From Verdad's Dan Rasmussen on Jun. 11th:

Taking a Long-Term Perspective

It doesn’t take much study to learn that financial markets are full of risks. Today we see a long bull market stretching valuations in the US, Italian political troubles, a North Korean nuclear threat, rising interest rates, escalating tensions over global trade, and then, of course, the unknown unknowns of black swan events.

In light of these risks, many investors are taking what they think is the prudent course: holding cash, waiting for the next big pullback, sitting out a few innings.

But are there hidden costs to this seemingly prudent strategy? The math of compounding means that most of the dollar gains to investing come after many years of staying fully invested in a consistent strategy.

Investor and author Morgan Housel notes that this is an underappreciated element of Warren Buffett’s success. “There are over 2,000 books picking apart how Warren Buffett built his fortune,” noted Housel. “But none are called This Guy Has Been Investing Consistently for Three-Quarters of a Century.”

To illustrate this mathematically, consider three hypothetical investments, one yielding 5% per year, one yielding 10% per year, and one yielding 15% per year. Let’s look at what $1M invested in each investment would be worth after 5, 10, 15, 20, 25, and 30 years.

Figure 1: Compounding Math on Three Hypothetical Investments

	5 yrs	10 yrs	15 yrs	20 yrs	25 yrs	30 yrs
$1M @ 5% return	$1.3	$1.6	$2.1	$2.7	$3.4	$4.3
$1M @ 10% return	$1.6	$2.6	$4.2	$6.7	$10.8	$17.4
$1M @ 15% return	$2.0	$4.0	$8.1	$16.4	$32.9	$66.2

Over long horizons, compounding has the power to dramatically increase your wealth. Now let’s think of the costs of waiting just one year to invest.

Figure 2: Compounding Math on Three Hypothetical Investments Less One Year

	4 yrs	9 yrs	14 yrs	19 yrs	24 yrs	29 yrs
$1M @ 5% return	$1.2	$1.6	$2.0	$2.5	$3.2	$4.1
$1M @ 10% return	$1.5	$2.4	$3.8	$6.1	$9.8	$15.9
$1M @ 15% return	$1.7	$3.5	$7.1	$14.2	$28.6	$57.6

These numbers, as you can see, are significantly lower than the first table. The final table shows the foregone gains from missing a year of compounding as a percent of the original $1M investment.

Figure 3: Foregone Gains (% of Original Investment)

	5 yrs	10 yrs	15 yrs	20 yrs	25 yrs	30 yrs
$1M @ 5% return	6%	8%	10%	13%	16%	21%
$1M @ 10% return	15%	24%	38%	61%	98%	159%
$1M @ 15% return	26%	53%	106%	213%	429%	864%

If you're looking out 30 years, waiting one year to decide whether to invest in a 5% yielding asset would cost you 21% of your original investment. In a 10% yielding asset it would cost you 159%, and in a 15% yielding asset it would cost you 864% of your original investment. A little prudence could cost a lot in terms of lost future gains. Or, as one of the old investment proverbs puts it, **"It's time in the market that builds returns, not market timing."** (emphasis added)

The problem with taking a long-term perspective is that it requires accepting risk today. ...

From June 25th's WSJ:

Private Placements Draw Troubled Brokers

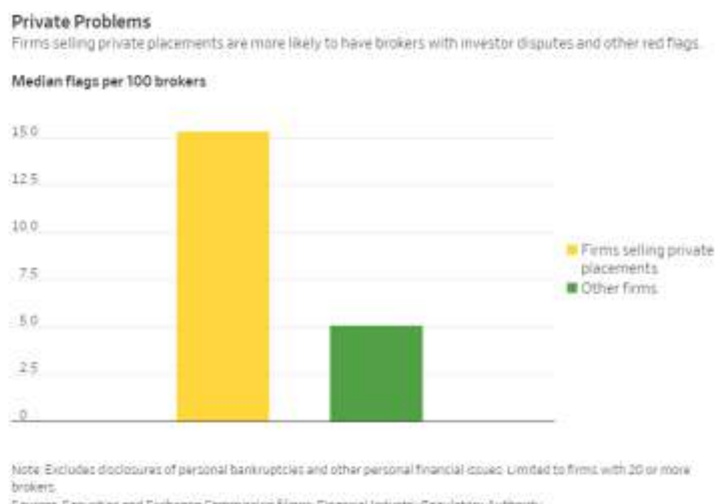
By *Jean Eaglesham* and *Coulter Jones*

Securities firms with an unusually high number of troubled brokers are selling tens of billions of dollars a year of private stakes in companies, often targeting seniors, an analysis by The Wall Street Journal found.

The emerging trend could mean that unsuspecting investors will be exposed to losses or fraud in a market that has grown sharply in recent years.

In a review of more than a million regulatory records, the Journal identified over a hundred firms where 10% to 60% of the in-house brokers had three or more investor complaints, regulatory actions, criminal charges or other red flags on their records—significant outliers in the investment community. These brokerages helped sell to investors more than $60 billion of stakes in private companies, known as private placements. (HCM doesn't sell Private Placements.)

Sales of private placements are surging, as part of a broader rise in private capital markets, fueling concerns among investor representatives about how the products are sold. More than 1,200 firms sold around $710 billion of private placements last year, and sales for the first five months of this year are on track to top that record-setting tally, the Journal found.



Private placements, which could be stakes in anything from an apartment complex or oil well to a biotech company, can offer investors higher returns than publicly traded stocks and bonds. But there's typically less information available about the companies, increasing the risks for investors.

The clustering of higher-risk brokers underscores regulator worries about the largely unpoliced market.

"Sales of private placements are so lucrative to the brokerage firms that they are a perennial concern for regulators," said Brad Bennett, a former enforcement chief at brokerage watchdog the Financial Industry Regulatory Authority. Issues on the regulators' radar, he said, include whether the private placement offers a stake in a legitimate business, what selling perks or markups the brokers get, and how it is sold to investors. ...

Most private placements are restricted to sophisticated investors, such as hedge funds and insurers, seeking alternatives to public stocks and bonds. In some cases, relatively wealthy individuals can get in.

Regulators lean heavily on the hundreds of brokerages to monitor deals, but rich commissions create strong motivations to sell, sometimes without consideration for the investor.

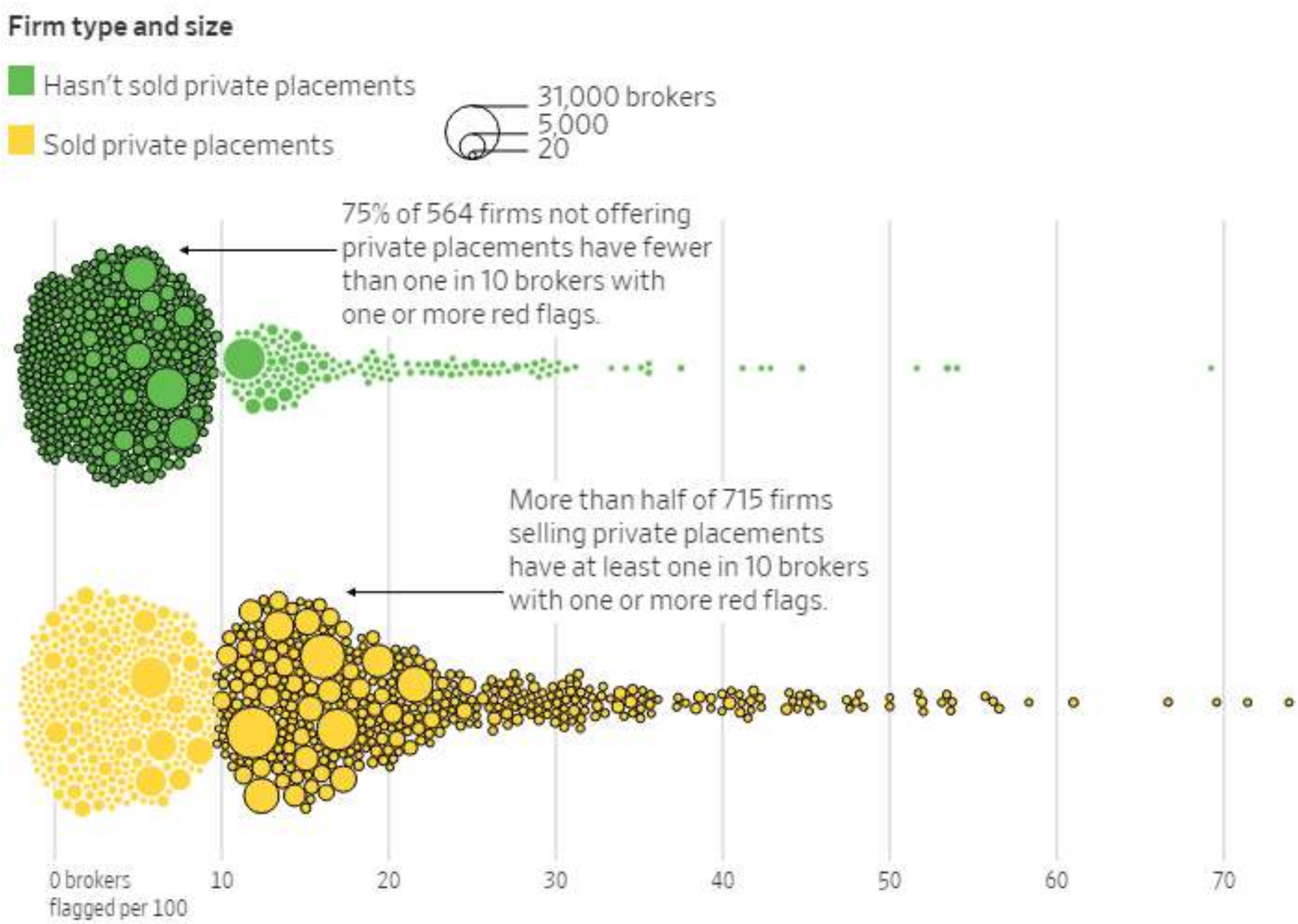
"Firms that permit brokers to peddle these products tend to put fee generation above what is good for their clients," said Andrew Stoltmann, a Chicago-based lawyer who represents investors in claims against brokers. "And brokers who want to generate fees at their clients' expense tend to flock to these firms."

Finra has warned in the past about "fraud and sales practice abuses" by firms and brokers in the market.

Lawyers representing investors say the red-flag firms identified by the Journal tend to hire troubled brokers for

Where Red Flags Roam

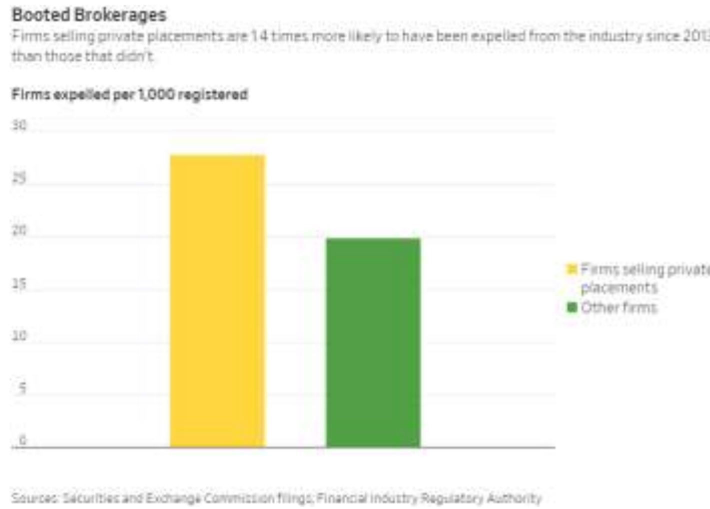
Firms offering private placements tend to have more brokers with red flags than those that don't.



Note: Excludes disclosures of personal bankruptcies and other personal financial issues. Firms with at least 20 registered brokers featured.

Sources: Securities and Exchange Commission filings; Financial Industry Regulatory Authority their track record in aggressively selling high-commission deals, sometimes using questionable tactics. Firms say their vetting of brokers goes much deeper than the number of red flags.

Most of these firms are small to midsize brokerages, with fewer than 500 brokers, and are spread throughout the country. The big Wall Street firms in general have proportionally fewer brokers dealing direct with investors, and also with multiple red flags. ...



Even though only around 4 out of 10 brokerages sell private placements, these brokerages account for more than half of the 94 firms that Finra expelled since 2013, the analysis found. ...

From the NYT:

Obama-Era Investor Protection Rule Is Dead

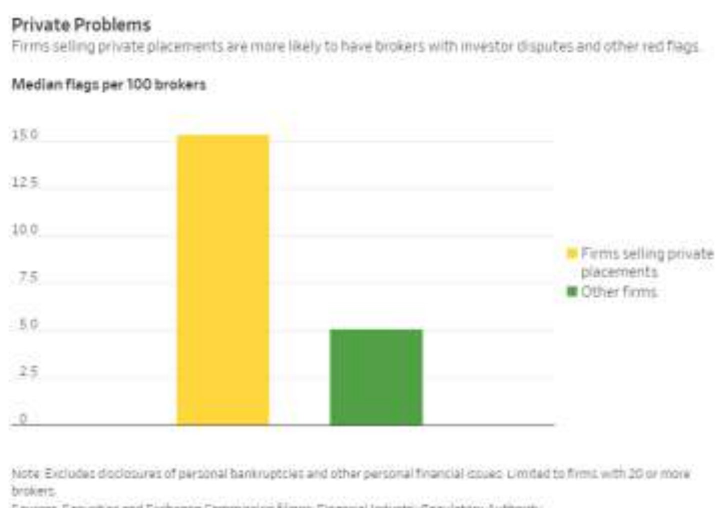
By **Tara Siegel Bernard**

June 22, 2018

Retirement investors, you're back on your own.

Just a year after it took partial effect, the so-called fiduciary rule — a requirement that financial professionals put their customers' interests ahead of their own with retirement accounts — has effectively died. (Once again, Registered Investment Advisors, like Hughes Capital Management, owe a fiduciary duty to their clients, although, as we have shared, not all of them live up to this legal standard.)

On Thursday, a federal appeals court dealt a final blow to the rule, legal experts said. The court made effective its decision in March voiding the Obama era rule. That decision said the Department of Labor, which oversees retirement accounts, overstepped its authority. The department did not try to defend the rule after the appeals court's initial decision, experts said, and it let a deadline pass to petition the Supreme Court to hear the case.



"This is a terrible day for retirement savers," said Micah Hauptman, financial services counsel to the Consumer Federation of America.

The rule, drafted over six years by the Labor Department, was strongly challenged by the financial services and insurance industries even as it was being written. The industries argued that the rule would make it too costly to work with smaller investors. The rule's future was initially called into question shortly after President Trump took office. Then, last November, the Labor Department pushed back the full application of the rule by 18 months, to July 2019.

The Department of Labor declined to comment on Friday. Nor did it provide any guidance on what rules now apply to retirement accounts.

"It seems that even the D.O.L., through its silence, is taking the position that the rule is dead," said Arthur Laby, a professor at Rutgers Law School and expert in fiduciary law.

Generally speaking, brokers must make recommendations that are deemed "suitable," which is a less stringent requirement than a fiduciary standard. The Labor Department rule would have required all financial professionals, including brokers and insurance agents, to adhere to the higher standard when providing advice related to their tax-advantaged retirement accounts, like individual retirement accounts.

What remains unclear is whether the fiduciary rule will leave any imprint. Financial services firms had begun to make changes in the way they did business in anticipation of the rule. Raymond James, for example, had said it would alter the way it paid some brokers to lessen conflicts of interest. But the firm declined to comment on Friday on whether it would follow through with those plans.

Mutual fund companies, including Capital Group's American Funds, had created a new class of shares — known as clean or unbundled shares — that removed layers of fees that would have been paid to the broker.

"There is definitely not the momentum there would have been with the fiduciary rule looming," said Aron Szapiro, director of policy research for Morningstar, "but they are far from dead."

The spotlight will shift to the Securities and Exchange Commission, which in April proposed its own "best interest" standard, a rule that one agency commissioner described as an enhancement of the status quo (as we previously shared). Consumer advocates have long said that the financial services industry wanted the S.E.C. to write any new rule because it was expected to be more industry-friendly. That process is still in its early days.

Regardless of what happens, consumers may want to heed the words of Phyllis Borzi, an assistant secretary of labor during the Obama administration who helped lead the effort to draft the original fiduciary rule.

"When somebody is trying to give you advice, what you do is ask them if they are legally obligated to act in your best interest and as a fiduciary," Ms. Borzi said. "If they say yes, or any euphemism that can be construed as a yes, then ask them to put it in writing."

Positions

FSP - On 4/9 this Office REIT dropped 7.8% on 2.5x average volume when it cut its dividend from .19 to.09. One analyst subsequently lowered his recommendation to Hold from Buy, resulting in 3 Holds and 2 Sells with an average Target Price of 8.5, 10% higher than the 7.7 on the day of our analysis. We waited our usual 15 trading days after the negative event for the bounce, but when FSP closed at 7.78 we decided to continue waiting. On 6/1 it bounced on high volume, and we sold for the 2 clients holding a position at 8.19.

FSP 8.4300
12.0000
11.0000
10.0000
9.0000
8.4300
8.0000
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Jul
Aug
Sep
Oct
Nov
Dec
2018
Feb
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