August 2017

The comments and events of the past several weeks did bring into sharp focus geopolitical risks and the effect on financial markets during a period of low volatility and complacency. North Korea is just one of a number of flashpoints: South China Sea, Iran, Syria, Ukraine and now, Venezuela. The populist surge, reflected with Brexit, appears to have receded in Europe after the French elections and German elections are scheduled for October, expectations for Angela Merkel to retain her position. Each has contributed in its own way to investor skittishness.

D.C. is in the middle of the August recess but a full fall calendar provides plenty of opportunities to move markets. After Labor Day, Congress returns to working on a budget for the fiscal year beginning in October and a debt ceiling debate. Estimates are for the debt ceiling to be reached at the end of September or into early October. The White House has called for a clean rise of the debt ceiling, no conditions or riders. This could expose another fracture point in the Congressional majority party. Leadership has also stated they would be moving on to tax reform, another possibly contentious debate. Of importance to financial markets is filling the seat of Chair of the Federal Reserve. Janet Yellen's, the current chair, term ends at the end of February. She may be reappointed or someone else may be nominated. This raises important questions regarding the direction of the nation’s monetary policy.

Despite the storm and thunder, the stock market has moved higher, inflation remains subdued and interest rates have been range bound. The corporate earnings recovery, begun in the first quarter, continues, albeit at a slower pace. Second quarter earnings continue to advance, up approximately 9% for S&P 500 companies, as of recent data, with 70% of reporting companies beating analyst’s estimates. This is a somewhat slower pace than the previous quarter, but still positive. Yes, it has been a year since this index has experienced a 5% or more correction. With a low inflation environment, low interest rates, strong labor market, and synchronized global growth, a slow growth in the global economy could continue for some time. There is no pre-determined time frame for a period of economic expansion. The current U.S. expansion is 8 years old, the third longest since 1950. There have been only 10 economic cycles since 1950, too small a sampling to create an average. Each cycle is unique with the current cycle possibly the most unique.

Typically there is an inverse relationship between unemployment rates and inflation rates. Proving to be a conundrum for members of the Federal Reserve, the unemployment rate recently declined to 4.3% yet its preferred measure of inflation was flat to the prior month or slightly lower than earlier this year. Structural forces, more powerful than prior cycles, come into play due to retirement of baby boomers and competition from a global workforce, automation, and disruptive technologies.

Economic expansions do not end due to old age. Often they end when the Federal Reserve raises interest rates above the neutral rate. Such a move results in a cutback in short term borrowing and long term investment. This cycle, the Fed began raising rates from zero, which is without precedent. The Fed has also indicated it will soon begin to shrink its balance sheet, but very slowly, from its current $4.5 trillion level. The balance sheet level at which it considers being neutral is

undefined. Some Fed members have opined $2.5 trillion, while, prior to the financial crisis, the balance sheet was in the $1 trillion range. The normalization of interest rates and its balance sheet places the Fed in unchartered territory, bringing into sharp focus the significance of any change in leadership of the Federal Reserve.

Finally, the scars to the constituent's psychology are still visible. The financial crisis had its beginnings about 10 years ago, but individuals and corporations continue to be somewhat risk adverse. Employment security may be more important than wage growth. Monetary authorities retain a dovish bias to avoid sending the economy into a decline. Politicians and regulators concentrate on taming past abuses. With the passage of time, these scars may diminish and charge the forward psychology of all the constituents of the nation's economy.