CREEKSIDE INVESTMENT MANAGEMENT, INC

The Trump Trade Is Back On

The Trump trade is back on. Two days before the end of last week and the third quarter, the Administration released its framework for tax reform. Everything else paled to investors, hurricane damage in Texas, Florida and Puerto Rico, Rocket Man, separatist elections in Turkey and Spain and least of all Fed monetary policies seemed to matter. The market took off.

Prior to the tax plan release, short sale activity stood at the highest level since before the election. The most recent weekly survey from the American Association of Individual Investors showed some 33% of respondents were bullish, below the 38% average, symptomatic of this long bull market that many have averred. Not only have the markets priced in a higher chance of tax reform, it suggests that there is plenty further to go if the tax cuts come through. The bears guessed wrong again. Since markets are a reflection of public opinion, Congress will do well to heed to the message markets are sending.

Putting the possibility of a corporate tax cut aside for the moment, third quarter earnings reports begin mid-October and should prove to be another strong profits season. Consensus is presently calling for a 6% rise in corporate profits following the low double digit sums in the first two quarters. With the first half delivering a sustained sharp rise in private sector confidence and an easing in global financial conditions may be signals that a more extended breakthrough in GDP growth above current expectations of 2.5-3.0 GDP growth.

Almost daily we are confronted with the notion of a market meltdown. While there is always the possibility of a black swan event, bear markets are usually caused by recessions. Viewing global growth in the 3% range hardly builds a case for an end to the bull market for the time being. Bull markets seldom end with a sharp sell-off but usually end by a gradual insidious rollover that is difficult to define and recognition comes late.

Global Watch: Recent reports confirm that China and Japan are slowing slightly in the current quarter. There seems to be slowing in global retail spending that includes these two countries as well as the U.S. Households face a purchasing power squeeze from rising inflation accompanied by only modest wage gains. However, trade in capital goods is accelerating. Europe and emerging economies are growing sufficiently enough that only a modest decline from the second quarter's “boomy” 3.8% growth is expected in the third quarter. U.S. second quarter GDP was revised upward to 3.1% buoyed mainly by inventories being replaced and strong manufacturing exports.

U.S. Economic Outlook: Recent data indicates the economy is in good shape. The Chicago Purchasing Managers Index, ISM Manufacturing and Service Index, Personal Consumption Expenditures and real incomes all point to growth. Businesses’ spending has finally gotten off of the floor. All point to domestic growth.

Monetary Policy: In the third week of September the FOMC voted to hold steady its target rate range for the federal funds rate of 1.00-1.25%, which was pretty well expected. Beginning in October the Fed plans to start reducing its $4.4 trillion portfolio of mortgage backed securities and government bonds with subsequent action in the December meeting to raise the funds rate. Chair Yellen seems adamant in carrying out these actions, yet inflation remains well below the Feds own 2% threshold (Three governors of the Fed's governing board have suggested that it might be better to wait for 2% inflation). Underlying inflation in the form of rents commodity prices and higher import prices as the dollar recovers would seem to be putting pressure on the consumer and perhaps this is what Yellen is counting on. Yet, raising rates while inflation has persistently remained under the Fed's target rate seem to be a total disconnect with reality.

Many fear what is being called "The Great Unwind" of the Federal Reserve's holdings of Treasuries and mortgage backed securities. Officially, it amounts to $4.5 trillion and much has been written and said how the day of reckoning will happen. Just to add a bit of perspective, 4.5 trillion is a lot of paper to think about. However, acquiescing what follows is totally unrelated to the issue at hand is that the assets under management at Blackrock is even a larger sum, $5.4 trillion, bigger than the Fed's balance sheet by a mere trillion.

Rather than selling securities, the plan is to shrink the balance sheet by not reinvesting securities that mature making the process gradual and predictable. Treasuries will be capped at $6 billion and mortgages $4 billion per month. Right now the thinking is that the ultimate goal would be to shrink the portfolio by about one half of its current size. This should make things better, not worse, as it will remove the overhang on the markets, hopefully steepen the curve and make bond investing profitable again.

What will this do to interest rates? Once again, the Feds goal has gone down from 3.0% to 2.75% for the overnight Fed funds rate. The long end of the curve is problematic depending on demand for the 10-30 year Treasury which may be influenced by non-U.S. demand.

Equity Strategies: With the exception of an almost complete bail out of energy in the first quarter, we really haven't changed our leading strategies from the beginning of the year. Aerospace and defense, technology, industrials, financials and materials are favored. Consumer stocks are under weighted to the benchmark. Health care is equally weighted as policy clarity has/is lacking.

Technology: We continue to see multiple, broad based demand drivers that will continue into next year and beyond such as data center and networking, artificial intelligence, deep machine learning and autonomous driving applications will drive increased memory content in tech ecosystems. In addition, a not so insignificant tailwind in a weaker dollar aiding large scale exports in the tech space.

Financials: Banks will likely benefit from rising rates and upcoming initiation of capital releases that will be passed on to shareholders in the form of dividends and buybacks. While expectations are low for third quarter earnings, strong fundamentals for banks are solid in addition to $59 billion in excess capital has been released for possible buybacks and dividends. Alternative fund managers have been successful attracting huge new assets to manage that have, so far, been underappreciated in share prices.

Industrials: Industrials and tech should both be direct beneficiaries of increased business spending on capital goods as more clarity on tax leading to earnings growth.

Materials: We elected to overweight this sector by reinvesting in domestic steel. Chinese imports have been curtailed as the price of their steel has escalated to a level of being non-competitive in the U.S. Monsanto, headed to a $128 share buyout by Bayer, the large German conglomerate that is expected to close by year end.

Energy: Underweighted as the long term dynamics of hydrocarbons render oil an un-investable asset class in our opinion.

Overall, equity portfolio performance for the third quarter was good as portfolio returns exceeded benchmarks by about 100 or so basis points.

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Few see, read or even know about the Wall Street Journal's weekend issue. Pity, as it crams a lot that is worth knowing into a single edition - September 23-24th for example. Dan Neil who reports in everything automotive that Chinese industry ministers confirmed the world's largest vehicle market (24.4 million in 2016) would phase out fossil-fuel vehicle sales in favor of— guess?… electric vehicles. Because of climate change? Partly. But more to relieve smog in their congested cities and mostly to kick the dependence on imported oil. When will this edict go into play? Initially, 2016 until the German Chancellor intervened (protecting imports of Mercedes Benz and BMW) resetting the date certain to 2019. Because the Chinese auto market is so huge it will hasten the development and production of electric powered 🚗 at a faster pace than previously thought.

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