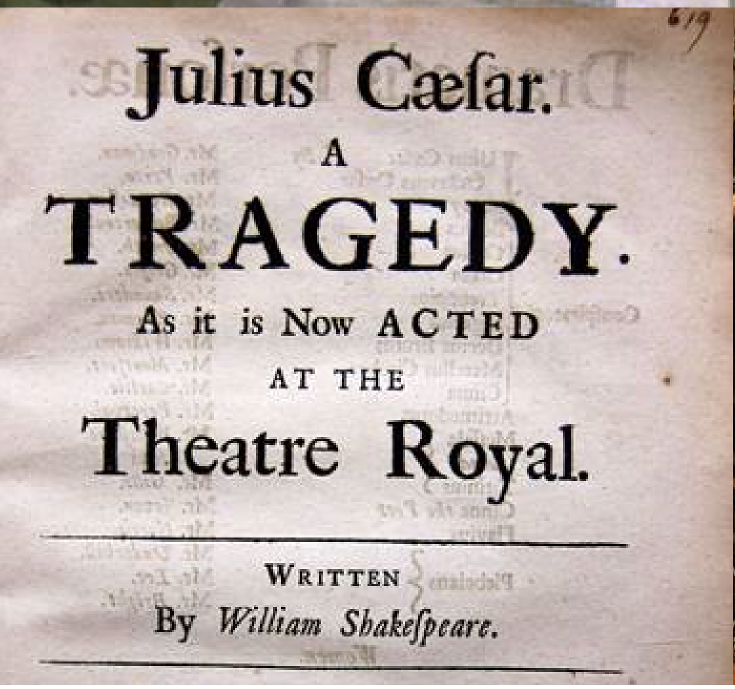
Towerpoint Wealth
Monthly Market Commentary

Author: Joseph Eschleman, CIMA®, President

Et Tu, Italy?
May 2018



Julius Cæsar.
A
TRAGEDY.
As it is Now ACTED
AT THE
Theatre Royal.

WRITTEN
By *William Shakespeare.*

info@towerpointwealth.com
Twitter: @twrpointwealth

TOWERPOINT WEALTH
500 Capitol Mall, Suite 1060
Sacramento, California, 95814

1.916.405.9140

"An Investment in Knowledge Pays the Best Interest"
(Ben Franklin)

Et Tu, Italy?

CAESAR	*Et tu, Brute! Then fall, Caesar!* *[Dies]*
CINNA	*Liberty! Freedom! Tyranny is dead!* *Run hence, proclaim, cry it about the streets.*
CASSIUS	*Some to the common pulpits, and cry out* *'Liberty, freedom, and enfranchisement!'*
BRUTUS	*People and senators, be not affrighted;* *Fly not; stand stiff: ambition's debt is paid.*
	("Julius Caesar" by William Shakespeare, Act III, Scene I)

Things just got interesting – maybe. It is hard to write anything definitive given how quickly events are unfolding. Investors were taking turns being spooked by possible trade wars, cancelled (but now rescheduled) Korean denuclearization summits, and elevating unrest in the Middle East. The US market continues its volatile tug-of-war between heavy fiscal stimulus and tightening monetary policy. Interest rates and the US dollar finally started to act the way we've been expecting them to (rising and strengthening, respectively), causing a "risk off" run in many EM assets.

And then along came Italy. The populist and left-leaning 5 Star party attempted to form a government with the nationalist, anti-establishment, and right-leaning League party (with both parties being anti-Eurozone), only to see the Italian President Sergio Mattarella block that formation and reject the coalition's choice for Economic Minister (Paolo Savona, who was viewed as being far too much of a Eurosceptic). Those two parties will now try to re-form a workable coalition, or Italy will need to have new elections, and the concern is that populist and/or anti-Eurozone activists will gain power. As Europe's third largest economy (behind Germany and France), the thought of Italy leaving the Eurozone is simply intolerable to the markets, and they reacted violently.

Italian short-term bond yields and spreads to German Bunds skyrocketed, investors rushed into save haven investments like the yen and US Treasuries, and European banks and financial firms took it on the chin. After grinding higher through most of April and May, US Treasury yields collapsed to levels not seen in months as investors rushed to "de-risk" their portfolios. The corresponding boost to the dollar exacerbated the sell-off in Emerging Markets. We witnessed an overall level of market panic that we have not seen since the Greek financial crisis that began in 2010, amplified by the comparative size and importance of the Italian economy relative to Greece.

At the root of the problem is Italy's declining economic, fiscal, and banking health, driven by the effects of massive immigration, a *de facto* voluntary tax system, a bloated entitlement state, and widening gaps in wealth and prosperity between the relatively wealthy North and the poor South. The fear was that the new coalition government would seriously consider leaving the Eurozone in order to get out from under the economic guidelines and constraints that Zone members must adhere to (e.g. acceptable budget deficits).

But let's slow down a little. It is interesting to note that while *short-term* Italian bond yields spiked, the increase was not nearly as dramatic in *longer* (i.e., 10-year) yields, suggesting that investors put a low probability on Italy actually exiting the Eurozone. Further, even as we write this, the markets have rebounded, seemingly believing this to be a short-term phenomenon but perhaps not a long-term problem. A majority of Italians in a recent poll favored remaining in the Eurozone and, with the exception of "Brexit", the nationalist/populist movement in Europe has lost traction in most countries. Finally, the awkward 5 Star – League coalition seems to be making progress toward actually forming an acceptable government; if successful then no new election will need to be held.

Italy is notorious for its inability to maintain stable governments (averaging one change in government per year since the end of World War II), so the 5 Star – League government is unlikely to be able to implement such a massive change as leaving the Eurozone before the already tenuous coalition falls apart (assuming it forms). Germany, France, the ECB, and the IMF will exert *massive* pressure on Italy to remain in the Eurozone, undoubtedly taking a similar "stick and carrot" approach as when dealing with Greece a few years ago.

Finally, since the initial Greek/Southern Europe crisis, the Eurozone is economically more healthy and the ECB has implemented several policy tools (e.g., the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM)), that would provide at least a partial "firewall" should the Italian situation spin out of control.

We simply don't view this as a long-term risk, at least based on what we know now. Things can always change for the worst, but we believe cooler heads will prevail (we feel the same way about the zigzagging US trade negotiations, though those currently seemed headed in the wrong direction as well). Short-term volatility may make investors uncomfortable but we believe the ultimate outcomes will be tolerable.

A more nuanced question revolves around the effect on central bank policy. The ECB President Mario Draghi wants to begin tapering the ECBs quantitative easing program, and the belief was that, with the Eurozone economy fairly stable and the euro finally weakening versus the US dollar, he would perhaps begin to do so in September. He now likely will be forced to wait, at least until the political outcome in Italy is more clear (perhaps as early as late July, but more likely to be September or October).

The Fed has a different problem. It has signaled strongly that it wants/plans to raise rates again in June, and then perhaps again in September, and the disciplined unwinding of the Fed's balance sheet continues as planned. But the US yield curve is very flat (with only ~50 bps difference between the 2-year and 10-year Treasury rates), and as the Fed raises the short-end of the curve while "flight to quality" investment flows drive down the long-end, it may find itself in the unwanted situation of generating an inverted yield curve. The market would probably not react well to that, as inverted yield curves are sometimes a harbinger of impending economic recession (with a 12-18 month time lag).

We don't see this as a meaningful risk, as the underlying reasons for an inversion, should it occur, will have more to do with investment flows versus signaling a weakening economy, and investors should be able to understand that. But even though we view the current market volatility and uncertainty as, frankly, a healthy return to more "normal" market conditions, there is no question that navigating the markets has become more difficult for investors and central bankers alike.

With that as a backdrop, here is what we see in the current economic and investment landscapes.

The Current Economic Landscape

Despite significant recent market volatility, the global economy remains reasonably positive right now:

- Q1 GDP growth in the US came in at 2.2% (down slightly from earlier estimates). GDP growth is expected to accelerate through Q2 (3.2%) and Q3 (3.1%) before slowing in Q4 (2.9%), bringing the consensus estimate for all of 2018 to 2.8% (source: *The Wall Street Journal*);
- There is uncertainty regarding this forecast, however, as the ultimate impact of the tax law changes and the outcome of ongoing trade negotiations could dramatically change the economic outlook for the US over the remainder of the year. Specifically, current trade negotiations seem to be taking a protectionist-leaning turn for the worst, as the Trump administration seems increasingly resolved to impose tariffs on both Europe and China –actions that would almost certainly result in retaliation policies that would affect both inflation and global growth;
- Both the US manufacturing and services sectors remain well in expansionary mode (56.6 in May and 56.8 in April, respectively; any reading above 50 is considered expansionary), though both have stabilized or experienced month-over-month declines in the past 3-4 months (source: *ISM*);
- Inflation (as measured by CPI) rose 2.5% year-over-year in April, in line with market expectations and tracking slightly above the Fed target of 2.0% (source: *TradingEconomics*).
- We believe inflation will continue to tick up but that it does not yet constitute a primary risk to economic growth. Further, we believe the Fed will allow inflation to run slightly "hot" before stepping in more aggressively;
- The consensus estimates are that the Fed will raise rates at least two more times in 2018, in June and then again September. This may change depending on what unfolds with the situation in Italy and with the outcome of current trade negotiations – negative turns of events in either area may slow down the planned steady tightening initiatives;
- Interest rates were "grinding higher" through April and May, with the 10-year Treasury rate breaking through the mental barrier level of 3.0%. There was then a significant reversal in late May back to yield levels not seen in several months because of the Italy-induced "flight to quality". We continue to believe rates generally will inch steadily higher, with periodic reversals during market disruptions;
- The yield curve remains flat as the Fed raises rates on the short-end but the long end remains "tamped down" by high demand. We do not anticipate (or fear) an inverted yield curve – should one occur, we believe it will be because of investment flows and Fed actions, not necessarily because of an imminent recession;
- The US dollar, after weakening through the first quarter; strengthened through April and May, accelerating as the Italian situation unfolded. We believe the dollar will continue to strengthen through 2018, as the US economy, interest rates, investment flows, and inflation all pick up steam (source: *TradingEconomics*);

- With almost all US S&P 500 companies having reported, first quarter earnings were up a whopping 24.2% year-over-year, on an 8.5% increase in revenues. While this is very positive, expectations are for stabilizing or slightly decelerating earnings as we move through the remainder of 2018 (source: *Zachs Earnings Report*);
- Manufacturing all across the Eurozone remains solidly expansionary, with the Markit Manufacturing index falling slightly from 56.0 in April to 55.5 in May. Likewise, the Services index fell slightly from 54.7 in April to 53.9 in May (source: *TradingEconomics*);
- Eurozone unemployment fell slightly to 8.5% in April, down from 8.6% in March – the lowest level since 2008, and annualized inflation is expected to come in at 1.9% in May, up from 1.2% in April, with most of the increase coming from rising oil prices. Expected inflation for all of 2018 remains under 2.0%, another reason we simply do not see a major inflation spike in 2018 (despite market fears) (source: *TradingEconomics*);
- ECB President Mario Draghi wants to taper his quantitative easing program, but remains frustrated by low inflation rates and now the situation in Italy. Assuming an acceptable outcome in Italy, expectations are that he will begin some level of tapering perhaps as soon as September of this year;
- Japan's GDP contracted 0.6% (annualized) in Q1, after expanding 1.6% in 2017, its first contraction after eight consecutive quarters of growth. The consensus estimate for 2018 GDP growth is 2.2% (source: *TradingEconomics*);
- China's (official) GDP growth in Q1 was 6.8% (annualized), after growing at 6.9% in 2017, and (official) estimates for 2018 suggest a slight slowing to 6.5% -- 6.6% (source: *TradingEconomics*).

The Towerpoint Wealth & Market Outlook:

- ***The global economy continues to expand, though there are distinct signs of slowing. Further economic slow-down (though not a recession) is expected in the second half of 2018. The consensus expectation is that the US will not see a recession until later in 2019 or perhaps even 2020 (barring exogenous events);***
- ***Over the past several months, we saw (a) stabilization or slow declines in both the manufacturing and service sectors (though both remain solidly in expansionary territory); and (b) a continued downward trend in the Citigroup Economic Surprise Indicators, both in the US and in the G-10 countries (with the G-10 index actually falling into negative territory in recent weeks). A downward trend in this index means that actual economic data are coming in at worse levels than estimated;***
- ***Somewhat to our surprise, the US dollar remained weak through the first quarter, before strengthening through most of April and May, with an acceleration in late May following the Italian situation. We believe going forward that an expanding US economy, rising inflation rates, continued tightening of Fed policy, and strong investment flows will further strengthen the dollar;***
- ***Inflation is a question mark, and definitely is trending higher, but we don't share the market's overall level of concern. Inflation will continue to rise over the course of 2018, but (we believe) not to levels that should impact economic expansion. The primary impact will be on Federal Reserve policy – should inflation rise more quickly than we expect, the Fed may be more aggressive in its rate hike response, though we believe it is inclined to let inflation "run hot" before stepping in;***

- ***We remain in somewhat "uncharted waters" from an economic policy perspective, as heavy fiscal stimulus in the US battles against tightening monetary policy. So far, fiscal stimulus appears to be winning the tug-of-war, but the longer term impact on deficits and inflation remain unknown. We believe this is at least a contributing factor to ongoing market uncertainty and volatility;***
- ***Despite market turbulence and investor uncertainty, solid GDP growth and solid earnings and revenue growth make for a generally positive market environment, and we still think stocks can end the year higher than where they began. However, decelerating earnings growth and rising interest rates may combine to push valuations down and volatility up;***
- ***Market volatility will also be affected by ongoing geopolitical uncertainties regarding trade negotiations, Italy, the Middle East, the Korean peninsula, and now Spain, which recently ousted market-friendly Prime Minister Mariano Rajoy on corruption charges, and replaced him with Socialist Pedro Sanchez;***
- ***EM and EAFE markets continue to have better valuations than the US, but the strengthening US dollar and a "risk off" mentality has hit EM hard recently via significant investment outflow. We still like EM and EAFE as longer-term positions, but investors may be headed into increased volatility;***
- ***The US yield curve remains flat (there is currently ~50 bps difference between the 2-year and 10-year yields), as lower longer-term expected growth rates and technical investment flows compete with higher inflation expectations on the long-end of the curve, but we believe the risk of inversion is low. We do expect rates to "grind higher" over the course of 2018, barring further market corrections and a corresponding "flight to quality" response from investors;***
- ***At these rates and credit spreads, the public credit markets still look very expensive to us. We are further concerned about high yield liquidity and refinancing risk and the growing level of "covenant lite" bank loans. We are nearing the end of the current credit cycle and risks are increasing;***
- ***As was true in 2017, we believe 2018 should continue to be constructive for alternative investments, especially if interest rates continue to rise and market volatility remains elevated – these are the conditions when alternative investments historically performed best and/or played an important diversification role in client portfolios.***
- ***We remain constructive on real assets and the commodity complex, as both inflation and demand increases, though we believe oil prices may soon begin to stabilize after their recent rally;***
- ***While we generally are constructive on the global economy and overall market performance, the public markets are not cheap. While we see little reason why the market cannot move higher over the next 6 months (though with the key difference of a return of more "normal" market volatility), we also believe that clients need to have their expectations managed as to what a globally diversified portfolio can deliver over a full market cycle.***

"Sell in May and go away" has always been one of our least favorite market clichés – it strikes us as lazy-minded. The fact that is has "worked" in the past seems to us to be the poster child for the expression *post hoc, ergo propter hoc* (i.e., just because B followed A does not mean that A caused B).

But as we head into the summer of 2018, that advice sure looks tempting, as market conditions look to be challenging for the next couple of months, to say the least. **Ultimately, however, we believe the more prudent approach is to remain calm, stay diversified, keep your investment time horizon aligned with your long-term financial objectives, and pay attention.**

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Towerpoint Wealth
500 Capitol Mall, Suite 2350
Sacramento, CA 95814
Phone: 1.916.405.9140
Email: info@towerpointwealth.com
Twitter: @twrpointwealth