PCM
PEAK CAPITAL MANAGEMENT

Trade War or Spat… Does it Matter?

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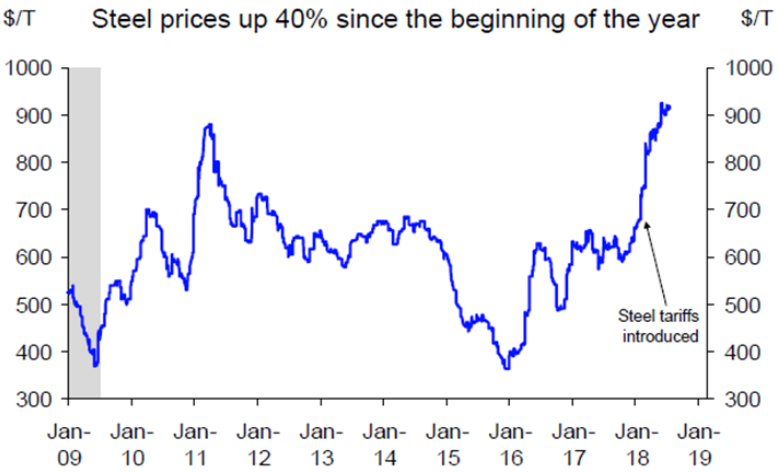
Are we headed for a full-fledged trade war or simply a spat among friends while President Trump tries to negotiate better trading terms for U.S. companies? Given the latest economic data, some are even questioning if it even matters if a trade wars occurs in terms of knocking the U.S. economy off the rails.

Trying to forecast where the economy is headed today is as difficult as forecasting weather in the mountains of Colorado. You do not have to live here long before you realize it that can rain or hail at the same time it is sunny outside. That is an accurate picture for the U.S. economy right now. You have the impact of the largest corporate tax cut in history just beginning to be felt as companies increase capital spending and hire more workers while other sectors of the economy are retrenching because of uncertainty surrounding new tariffs.

Trade War Concerns

- **Inflation**
- **Retaliation**
- **Sentiment**

The issue is of great importance for investors especially when you consider that according to S&P Global, Inc. data 43% of the sales in aggregate of the S&P 500 come from outside of the U.S. The number of firms reporting higher revenues right now is higher than it has been in four years. The companies most at risk are goods producing since they depend most on exports. What remains unknown, however, is how elastic demand will prove to be with cars, washing machines, soybeans, and solar panels.



Source: NYMEX, Bloomberg Finance LP, DB Global Research

There are 3 primary concerns if a trade war develops. First is **Inflation** that rises to a point where the Fed has to become more aggressive in their role of price stability. New tariffs on imports will drive prices higher and likely drive raw material costs higher. Second is **Retaliation** from our trading partners as they increase tariffs on U.S. exports hurting the growth of U.S. companies who sell their products and services overseas. Third, the negative media coverage of a trade war is very likely to hurt **Sentiment** and become a drag on even domestic growth.

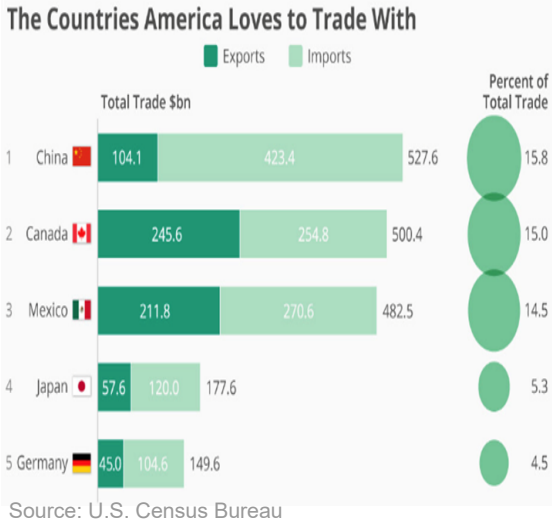
On paper, the potential impact on actual GDP remains small at this point. As mentioned, tariffs impact goods producing companies the most and services have become more than two-thirds of the U.S. economy. How much a trade war ultimately impacts the economy will be determined by where we are in the economic cycle. The greatest risk is a trade war in a late cycle economy that many believe represents where we are given the length of the expansion, very little labor market slack, and corporate margins. There are, however, other data points that look more like mid-cycle economy including wage growth, housing, corporate leverage and delinquencies.

Rising commodity prices will ignite talks of overheating with the U.S. economy as the debate rages on whether a trade will prove to be inflationary or deflationary. Manufacturing employment in the U.S. is at the highest level since 1998 according to the Bureau of Labor Statistics (BLS) with 2 million created since the end of the last recession.

The typical investment strategy when trade disputes have occurred in the past is a shift to smaller companies that are less dependent on exporting products. That strategy seemed to work when the first tariffs were announced with small caps outperforming large caps by 600 basis points since the first of April. The greatest risks remain with companies deriving revenues by exporting agricultural products, technology, energy, aircraft, and vehicles and auto parts. We are also wary of the impact a trade war will have on already devastated emerging markets.

To determine whether or not a trade war will force investors to the sidelines you have to try and figure out what the endgame will ultimately be. Just the threat of the U.S. imposing tariffs on European vehicle imports has created movement that can lead to more free and fair global trade. Volvo CEO Martin Lundstedt came out publicly and has advocated for all countries to eliminate all tariffs on vehicles crossing borders. This makes even more sense today since you have Japanese or European companies building cards in the U.S. and the U.S. is building cars in Canada, Europe and Asia. While the process or methods utilized by Trump and the Administration may leave much to be desired, if the ultimate outcome is true free trade consumers will be the biggest winners as the rising tide would lift all economic ships.

Seething Red

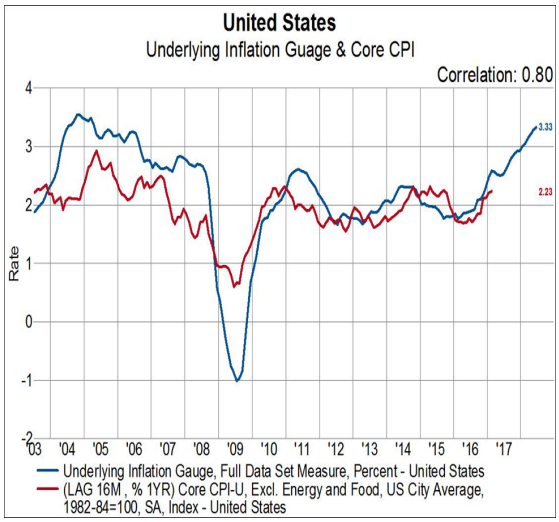


Source: U.S. Census Bureau

The U.S. global trade deficit last year was in the red to the tune of $566 billion that has President Trump seeing red. While that number is the highest in the last few years it is still lower than the record $762 billion the deficit reached in 2006. Trump has vowed to reduce the trade deficit claiming it is hurting American workers and is the result of unfair trade deals signed by previous Republican and Democrat administrations. Virtually all of the trade deficit is contained within consumer products and automobiles. Last year the U.S. imported around $600 billion in consumer items and exported just below $200 billion. Cars added another $201 billion to the deficit explaining why they are so often part of the discussion.

- The U.S. is a net exporter of services exporting $778 billion in 2017 while only importing $534 in services last year led by royalties on intellectual property of $75 billion.
- American imports of energy were the lowest in decades at $183 billion and exports, which used to be illegal, were $71 billion. The U.S. should be a net energy exporter by 2020.
- China remains the largest trading partner today with total trade of $636 billion in 2017. The deficit with China was $375 billion or two-thirds of the total deficit last year.

Introduction to Inflation Symmetry

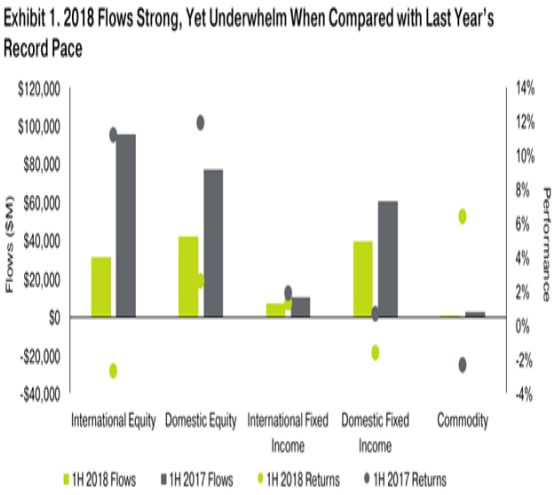


Source: Knowledge Leaders Capital

In July, Fed Chairman Powell communicated that the Fed felt comfortable with economic growth and stability, leading the Fed to stay the course on two more rate hikes through the second half of 2018. Readers of the PCM Report know the importance of inflation on the Fed's plans. The Fed has spoken of inflation symmetry, meaning that if inflation has been below the 2% target, it may be acceptable for inflation to run over the 2% target for a period of time. The chart below shows a New York Fed Underlying Inflation Gauge (blue line) vs Core CPI (red line). The significant uptick in the Underlying Inflation Gauge coupled with the Fed's adoption of inflation symmetry may suggest that the Fed will continue a tightening policy despite a possible uptick in inflation above the 2% target.

- The Underlying Inflation Gauge leads Core CPI by approximately 16 months (Knowledge Leaders Capital).
- The Underlying Inflation Gauge includes measures of prices, and market variables to demonstrate economic pricing pressure.
- The chart below shows that the Underlying Inflation Gauge serves as a leading indicator of Core CPI with a correlation of .80.
- The Underlying Inflation Gauge in to 2018 measures at 3.33, with a strong upward trend.

ETF Fund Flows Abate



Source: Morningstar, Bloomberg, as of 6/30/18.

It's helpful to analyze the flow of assets into and out of Exchange Traded Funds (ETFs) to get a pulse on the market. At over $1 trillion in assets, the size of the ETF universe is substantial, and evaluating ETF flows can be a good barometer of market sentiment. Net inflows could suggest bullish sentiment while net outflows could suggest bearish sentiment. Based on industry data from Morningstar and Bloomberg, inflows into ETFs so far this year (through the end of June) have cooled somewhat compared to the same period in 2017. While still positive, the slowdown in ETF flows might suggest that investors are more uncertain about future returns, particularly through the remainder of the year.

- Through the first half of 2018, net flows into ETFs totaled $120 billion. Although a sizable number, it is well behind the $250 billion in net flows through the first half of 2017. By asset class, the biggest difference in flows occurred in international equities, which delivered stellar returns in 2017 but have struggled this year in the face of a stronger U.S. dollar and increased trade tensions.
- Last year was an anomaly in many ways, with market volatility well below historical averages. Investors were generally more willing to invest in equities. But with increased volatility this year, and higher yields on bank deposits, investors seem to be more willing to sit on the sidelines.

Macro View – A Study of Cycles

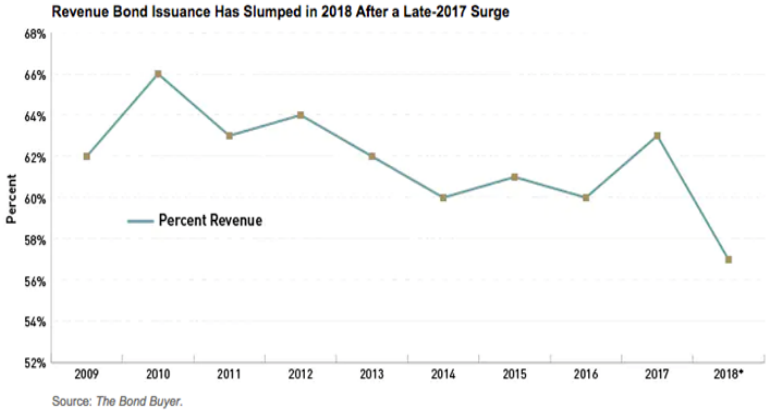
The table to the left from Deutsche Bank Securities does a thorough job reviewing various indicators, what they tell us about economic and market cycles, and where the current market and economic cycle currently stands. It is worth noting that 3 of 8 indicators demonstrate that the economy is approaching a recession: duration, slack, and profits. The flashing red lights do not necessarily suggest that a recession will occur in the coming months. Torsten Slok, PhD, Deutsche Bank Securities Chief International Economist, states, "In the last 3 cycles, the late cycle phase lasted 2-4 years which in the current context would put the next recession potentially as far out as 2021." Factors that may stretch the cycle out include an appreciating dollar, continued increases in productivity, and further increase in labor force participation. As analysts evaluate a pending recession and subsequent bear market, the focus is shifting to managing risk over seeking returns.

Where are we in the cycle?			
Duration		**Slack**	
Length of cycle	Late	Labor market slack Output market slack	Late Late
Cost Pressures		**Cyclical Demand**	
Wage growth Unit labor cost growth	Mid Mid	Resi investment/GDP Housing starts Consumer durables/GDP Capital spending	Early Mid Early Mid
Confidence		**Leverage**	
Cyclically adj. confidence	Mid	Household leverage Most levered companies	Early Mid
Credit		**Profits**	
Bond default rates Loan delinquencies Bank Lending Standards	Mid Mid Mid	S&P 500 margins Earnings rel. to normalized	Late Mid

Source: Deutsche Bank Securities

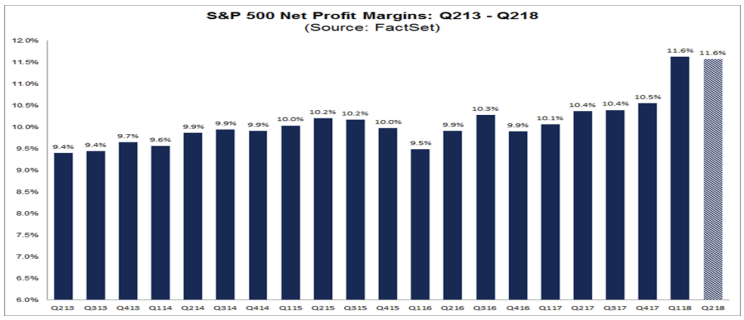
Fixed Income - Muni's Surprise on Upside

Many fixed income commentators wrote off tax-free municipal bonds in light of the tax cut package last year believing demand for tax-free bonds would fall with tax rates. This resulted in fewer muni bonds being issued and a sharp drop off in the refunding market that has fallen 19% from the level this time last year. High yield muni's generated among the highest returns of any fixed income category in the first six months of 2018 but most remain cautious about Puerto Rico and Tobacco bonds, the two most prevalent high yield muni's. Of particular interest is the dramatic drop in the percentage of muni's issued as revenue bonds compared to GO bonds (general obligation). After steady declines during the last 8 years, revenue bonds rose in 2017 before plummeting so far this year. Muni's continue to have attractive risk/reward characteristics.



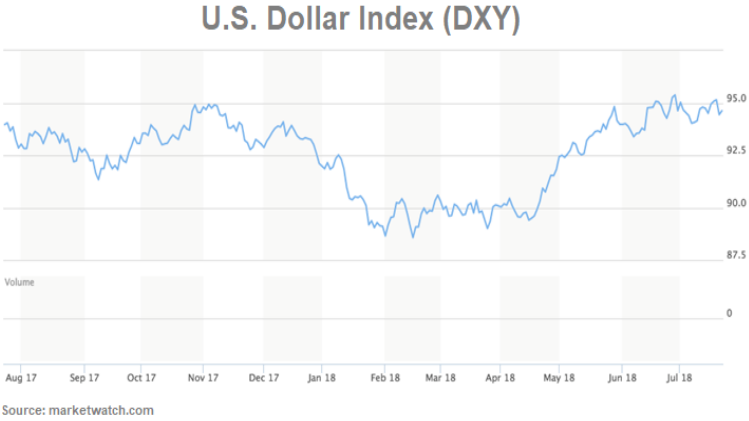
Taking Stock – Earnings, Costs, and Profit Margins

Factset reports that as of July 20th, the blended earnings growth rate for the S&P 500 for Q2 2018 is 20.8%. A blended earnings growth rate combines actual results reported with estimates of companies that have not yet reported. The blended revenue growth rate for the S&P 500 is 9.0%. A recurring theme on earnings calls has been rising costs to companies, yet profit margins remain elevated with a blended net profit margin for the S&P 500 for Q2 2018 at 11.6%, demonstrated in the chart below, representing the highest since Factset began measuring S&P 500 net profit margins in 2008. The 5 year average for S&P 500 net profit margins is 10.0%. Elevated net profit margins may be the result of reduced corporate taxes. Analysts are predicting earnings, revenue and net profit margins to continue to tick up through the remainder of 2018 (Factset). Real estate, IT, and financials are leading the charge in net profit margins for Q2 2018 with energy and consumer staples among the lowest results for the quarter.



Technical - Bucking the Trend

Ask most traders how a trade war will impact the U.S. dollar and probably 95% would say protectionist policies would exacerbate the decline the in greenback and push the dollar to fresh lows. Interesting that since President Trump first introduced a 25% tariff on imported steel and 10% on aluminum the dollar has risen almost 9% since February. There are many schools of thought on why this is happening. The most credible is this is Trump's tactics from his "Art of the Deal" mentality and will result in concessions from Asia and the Eurozone that negatively impacts their economies in the short-term. The benefit of a stronger dollar is inflation is muted reducing the impact of retaliatory tariffs. If the dollar remains strong, however, it will begin to compound the headwinds experienced by companies who generate significant profits from exporting their goods and services.



Understanding the Yield Curve

Clint Pekrul, CFA

Much has been made recently about the possibility of an inverted yield curve, and what an inversion would mean for financial markets. We thought it would be helpful to explain what an inverted yield curve means, and how it might impact the prices of financial assets.

For starters, the yield curve basically describes the interest rates on U.S. government debt for a range of various maturities. For example, the U.S. Treasury issues debt that matures in a fairly short period of time and debt that matures several years down the road. The Treasury issues this debt to finance the U.S. government. Treasury bills mature generally in less than one year, while Treasury bonds can mature 10 to 30 years in the future.

Generally, Treasury bonds will carry a higher rate of interest than Treasury bills for the simple reason that holding a bond carries more risk. The further you go out into the future, the more uncertain your rate of return becomes. In order to entice investors to buy its debt, the Treasury will generally have to compensate investors with a higher rate of interest. This is why Treasury bonds normally carry a higher rate of interest, or coupon payment, than Treasury bills.

If you were to plot the interest rates across all the various maturities, it would form a curve (hence the term "yield curve"). The result is generally a curve that is upward sloping (i.e. lower interest rates for Treasury bills and higher rates for Treasury bonds). An upward sloping curve has many ramifications for the financial markets. The interest charged on debt is directly pegged to the Treasury yield curve. For example, the interest rate you pay on your mortgage or auto loan is to some degree tied directly the interest rate on Treasury securities. The reason is that Treasuries are considered risk-free from a credit standpoint. That is, there is little to no likelihood that the U.S. government will fail to repay the principal on the debt it issues. Therefore, Treasury yields represent the "base-line" rate.

Yields on other debt (e.g. mortgages, corporate bonds, etc) will carry a higher rate than Treasuries because of credit risk. That is, a consumer or corporation does not have the same creditworthiness as the U.S. government. The point is that interest rates across the global debt market are inextricably linked to the Treasury yield curve, which emphasizes the importance of the shape of the yield curve.

In order for banks to be profitable, they must charge a higher rate on the loans they make than the rate they must pay on deposits. This differential, or the spread between the interest collected on loans and the interest paid on short -term deposits, largely determines a bank's profitability. Under normal conditions, an upward sloping yield curve will encourage banks to lend, which in turn drives economic activity. However, there are circumstances where the yield curve becomes flat or inverted.

A flat yield curve implies that short-term interest rates are identical to long-term interest rates. When this happens, banks can become less profitable. The interest banks pay out on deposits isn't much different than the interest they collect on loans. Lending activity can diminish under these circumstances. What's worse for banks is when the yield curve inverts. This implies that the interest banks pay on deposits exceeds the interest they collect on loans. As a consequence, the bank's profit margins can come under pressure. Lending activity can dry up consider ably and the economy can slip into a recession.

The fear of a recession is prevalent today. The Federal Reserve, which sets short-term interest rates, has been increasing its target rate. However, the longer end of the yield curve, which the Federal Reserve does not control, has not moved much. As a result, the yield curve has flattened recently. The concern is that the yield curve might actually invert, which historically been a precursor to a recession.

If we indeed go into a recession, it would mark the end of an incredibly long expansion coming off the financial crisis of 2008-2009. Despite evidence that the economy, particularly in the U.S., is on firm ground (unemployment is low and GDP is expanding at an acceptable pace), global forces might hold down long-term rates while the Federal Reserve bumps up the short end of the yield curve. Critics would likely blame such a recession as a monetary policy error. In the meantime, we'll have to wait and see how things play out.

Q: Are the markets concerned about the Mid-Term elections?

Yes, because the markets worry about everything!

First, the second year of the Presidential Cycle is historically the weakest with the markets retreating 20% on average since 1913 from the typical gains experienced in the first year of a new Administration according to CNBC data. Since this always falls on the mid-term elections professional investors expect more volatility. A couple of months ago the odds were overwhelmingly in favor of the Democrats taking control of the House of Representatives. If this occurs it will likely put a halt on Trump's agenda of reducing regulation and lowering taxes to stimulate economic growth. The latest polls show the "Blue Wave" that Democrats were hoping for has all but evaporated and it now looks like a coin toss in terms of which party will control the House. If Democrats do take control it is virtually assured the topic of impeachment will achieve feverish levels and likely slash consumer confidence.

There is very little chance of the Senate changing control even though the margins are much smaller. The Democrats are required to try and hold onto many more seats that Republicans and many of those Democratic Senate seats are in states won by Trump by wide margins.

Regardless of who wins, I have this one prediction that will almost certainly be right: political vitriol is going nowhere.

I don't think the market is overly concerned about the mid-term elections, mostly because there's no early indication that there will be a blue wave of Democrats overtaking the House or the Senate. If we maintain the status quo in Washington, then there's greater certainty that major legislation will pass (e.g. additional tax reform, deregulation, etc.), which the market will view favorably. However, as we saw in 2016, election results don't always play out as anticipated. If there is indeed a blue wave in November, be prepared for increased market volatility, as Democrats will most certainly oppose Trump on every major legislative initiative. For now, I think the markets are more focused on the future path of interest rates and the potential for an all-out trade war.

Q: What is the future of Tesla and electric cars?

The jury is still out in terms of Tesla in my opinion. They are the 800 pound gorilla in the US EV market and have created some incredible technology that allows cars to travel farther and faster on batteries and updating cars software as they drive down the highway. However, Tesla still has not shown a profit and the most recent reports of Tesla management trying to recoup advances paid to vendors to show a profit are suspect at best. They are in a difficult spot because they are facing pressure to become profitable but the very way they may go about achieving that could jeopardize the future of the company.

It has been very disappointing to see how they have struggled to ramp up production on the entry-level Model 3 sedans. Considering that their employees are among the smartest engineers on the planet they have failed to solve some relatively rudimentary production issues. The EV market comprises only 1.4% of all cars sold in the U.S. compared to 3% in China according to public data.

The new leadership at the EPA is also an issue causing uncertainty in the EV market. Gas mileage standards that companies were poised to have to meet in the future are being replaced with much broader guidelines that are easy to achieve. With the new massive shale oil fields discovered, it is almost assured that petroleum prices will remain relatively low for the foreseeable future.

Investors seem to have a love-hate relationship with Tesla. On the one hand, some investors like Tesla for their focus on socially responsible investing (e.g. electric cars with no carbon emissions, solar panel manufacturing, etc.), while others criticize the company for not being profitable. In a recent headline, Tesla was found to have gone back to suppliers to seek partial refunds to meet their cash needs. Analysts, who have long pressured Elon Musk to make the company profitable, generally did not like this news, and the stock traded lower. Regardless of your thoughts on Tesla, I do think the technology behind electric cars, and clean energy in general, is here to stay and will only improve in the years ahead.

All weights as of July 24, 2018

Income	
Mortgage Backed Bond	32.11%
Investment Grade Credit	9.20%
High Yield Bonds	16.84%
Preferred Stock	22.07%
US Dividend Equities	6.29%
US REITs	8.48%
Short (Inverse) Treasury Bond	5.00%

Balanced Income	
US Dividend Equities	16.28%
International Dividend Equities	16.69%
US REITs	13.37%
High Yield Bonds	35.67%
Long Term Treasuries	12.98%
Short (Inverse) US Equity	5.00%

US Growth	
Low Volatility Factor	18.12%
High Quality Factor	13.41%
Small Cap Factor	13.56%
Value Factor	15.33%
Momentum Factor	10.55%
Long Term Treasuries	29.03%

Global Growth	
Low Volatility Factor	9.76%
High Quality Factor	6.55%
Small Cap Factor	7.11%
Value Factor	7.48%
Momentum Factor	5.32%
Developed Market Equity	18.83%
Emerging Market Equity	13.61%
Long Term Treasuries	31.34%

Weights are approximations only and subject to change.

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