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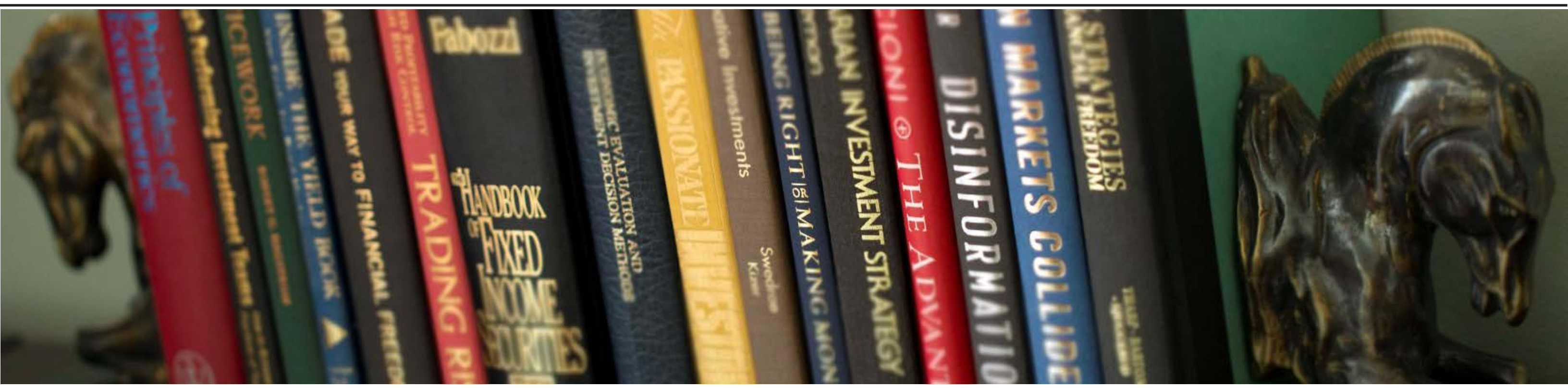
# AVALON PERSPECTIVES

Quarterly Note

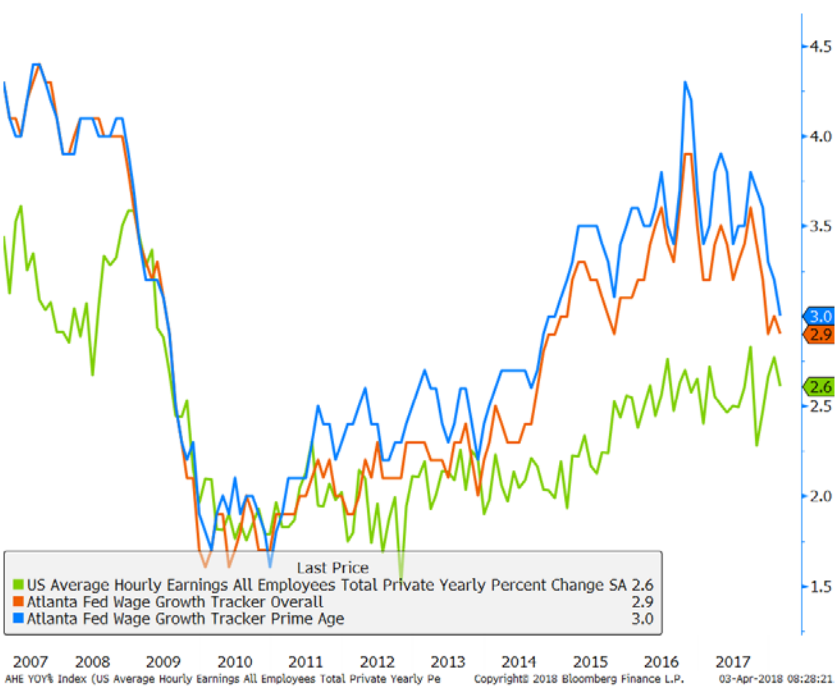
Q1 2018




The first quarter was certainly a ride for better and worse. January started like 2017 finished, February witnessed the return of volatility and an inflation scare, and tariffs and the threat of tariffs dominated March. Through the first three months of 2018, many of the risks to equity and bond markets have been realized (the February inflation scare for bonds) or have begun to take shape (the tariffs for equities). Markets have certainly become far more volatile, and below we explore the reasons.

## Wages, Inflation, and February

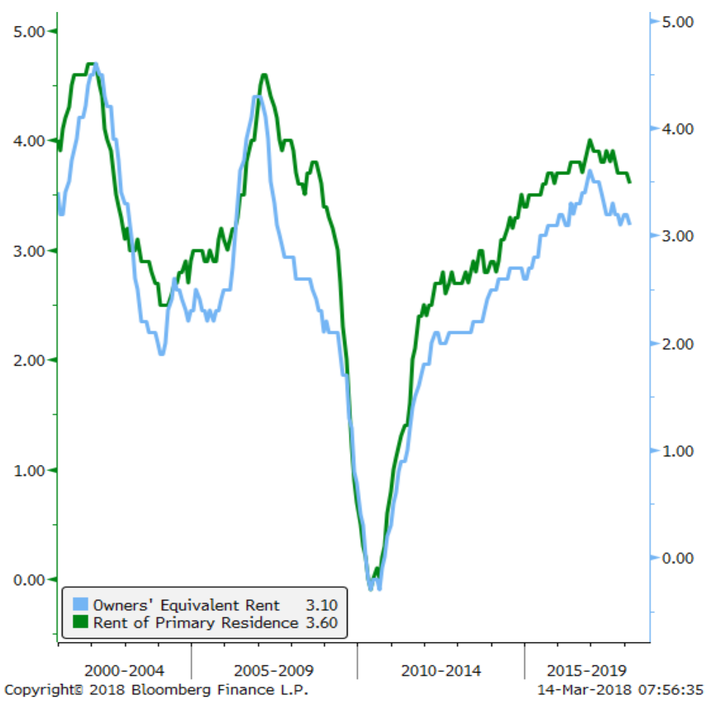
In February, the market was upset by a 2.9% surge in hourly wages. A quicker, sustained pace of wage growth is a phenomenon the U.S. economy has been waiting for since the conclusion of the Great Recession. The reason for the market's negative reaction? A 2.9% wage growth would lead to inflation pressures, a stronger economy, and therefore further and faster rate hikes by the Federal Reserve. Not to mention, the only thing the Fed cares about at this point in the economic cycle is wages.




Source: Bloomberg

There are numerous issues with this general assessment, starting with the wage figure itself. The Atlanta Fed Wage Growth Tracker does a good job of stripping out some of the distortions in the wage growth series, and it peaked in mid-2016. Since then, it has been in a steady decline. The data from the Friday jobs report is "average hourly earnings" which has been moving sideways for the better part of three years. Higher wages are always positive, but this data was simply not the inflationary data the markets are looking for yet.

Speaking of inflation, inflation expectations were higher through early February (and peaked most recently) stoking fears of a potential inflation scare. But this was by no means a surge. The real "surge" in inflation expectations happened in late 2017 following the tax package. By the middle of February, inflation expectations only made it back to normal levels, not concerning ones.



Source: Bloomberg

When there is talk about a surge in inflation, it is speculation that shelter (rent) pressures will remain at current levels or accelerate. Since shelter is about 50% of the current inflation readings, any deceleration will have a real effect on realized inflation. If shelter does decelerate, it will take an across the board acceleration in prices, or even hold flat, realized inflation. There is one major problem with that assumption though. Both the major “owners’ equivalent rent” and “rent of primary residence”, the two housing lines in the consumer inflation figures, have both begun to slowly decline.

Certainly, there remain questions about why wage inflation has not accelerated at this stage of the economic cycle with the current level of labor market tightness. Boomer retirement may be disproportionately depressing the average hourly earnings measure (the methodology behind the Wage Tracker should remove this tendency).

But it may be an issue of looking at better data—not a breakdown in the economic relationships.

**<u>And Then Came Tariffs</u>**

There is still a considerable lack of detail surrounding the potential, or rather expected, China tariffs. The Trump Administration is using “Section 301” powers to implement the China tariffs. Importantly, the steel and aluminum tariffs are not all that critical to the U.S. or the global economy given the wide-ranging exemptions that have been handed out by the Administration. The critical aspect of a Section 301 investigation is that the available remedies are wide-ranging. After all, the language reads, "the President... may impose duties or other import restrictions on the products of such foreign country or instrumentality, and may impose fees or restrictions on the services of such foreign country or instrumentality, for such time as he deems appropriate." There is no need for the President to consult Congress, but there is the requirement that the President allow for some offenders.

In the end, there is certainly a more protectionist lean to the Administration than in the past. At the moment, however, a trade war is not (necessarily) imminent, and the details of any action will not be available for some time. Markets appear to be handling the potential action in stride, and there has not been an overreaction.

The primary takeaway is that paying attention to trade developments over the next few months will be paramount. As long as any incremental tariffs are indeed "surgical", the global economy should be able to cope.

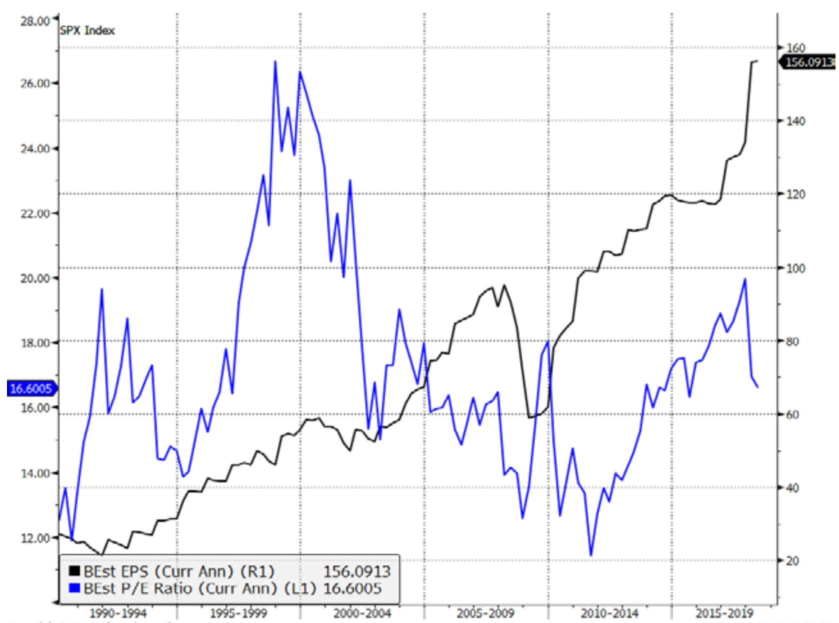
There are issues that the U.S. and China can find common ground on trade including steel and other areas. For instance, last summer following a meeting between President Xi and President Trump, China offered to be more open to U.S. beef exports. There remains the possibility this is the starting point for a "threaten-to-negotiate" style of trade tariff, similar to the recent steel and aluminum tariffs that appear to be targeted to gaining an upper hand in NAFTA negotiations. But these are on a much larger scale, and China will retaliate.

What did we learn on March 22nd? Relatively little. There were few details, and the process of getting from announcement to implementation is arduous. It will be 15 days before there is enough detail to make a projection about the potential consequences. Then there will be haggling and lobbying for 30 days, and those efforts are certain to change at least some of the outcomes. In the end, it is certain the U.S. will place tariffs on Chinese goods, and there will be retaliation. That is all that is known at this point.

**<u>Where Does This Leave Us?</u>**

For starters, the U.S. economy is probably not going to accelerate much further from here. No (significant) deceleration appears imminent, but harsh tariffs and retaliatory actions could alter this landscape. Waiting for details on the timing and targets is crucial because there is a likelihood the tariff rhetoric is a “threaten-to-negotiate” tactic.

With all of the headlines, the fundamentals of the equity market have held up well. Markets are well off their January 2018 highs, but S&P 500 earnings expectations for 2018 remain at their peak $156 levels. This indicates that valuations have declined without a deterioration in company fundamentals. In fact, the valuation on the S&P 500 is at a level last seen in mid-2016. The S&P 500 Value Index is trading at similar multiples to 2014.




Source: Bloomberg

Certainly, there are reasons to worry about the economy and markets. If one materializes, trade wars are not a positive for the U.S. or global economy. Inflation scares, regardless of whether there is credence to them, can also cause nauseating volatility.

There is no escaping that volatility is back, and the 2017 calm is behind us. With multiples moving lower as earnings remain elevated, equities are becoming cheaper, and not because of a decline in equity earnings. This one appears to have been driven predominately by an inflation scare (that waned quickly) and geopolitical headlines. Market pullbacks do happen, and it is difficult to blame this one on the economy.

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