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In our previous edition of *Viewpoints* we declared that the global economy had reached an inflection point after nearly a decade of speculation fueled by "free" money from the central banks of the world. Market activity in recent months has reinforced this view, and we believe that the highs achieved by the stock market in January will ultimately represent the peak of this upcycle. We continue to increase our bias towards defensive securities with reliable income streams, a category we expect will take over market leadership from the select growth-oriented securities that have disproportionately driven major indices higher in recent years.

With the mixed bag of data pouring out of markets and economies worldwide, we must acknowledge that today a superficial case can be made for almost any investment outlook. In this issue we'll investigate some of the common arguments from the bull camp and attempt to highlight our more cautious views.

One of the more popular talking points from today's market optimists is the sub-4% unemployment figure in the US, its lowest rate in 50 years, and the fact that for the first time in history there are more job openings than there are unemployed people. Looking at this headline figure alone, it is perfectly rational for one to expect a tighter labor market will lead to higher wages, and in turn stimulate growth in personal consumption, the driving force of the economy which represents 70% of GDP. The headline figure, however, obscures several factors that paint a less rosy picture of the health of the labor force: 1) there remains a sizeable and widening skills gap, principally due to a

faltering education system; 2) the labor force participation rate (people aged 16-64 who are either working or looking for a job) has steadily declined from a peak of 67.3% in 2000 to 62.7% today; and 3) the newly created jobs driving the unemployment rate lower have been predominantly low-paying, low-skilled service work. We do expect a modest uptick in wages going forward, but to whatever extent this does occur, it could impede corporate profit margins, and consequently challenge lofty stock valuations.

The stimulus provided by the Trump tax cuts is another phenomenon that has supported expectations for prolonged economic growth. Conventional wisdom argues that in response to a tax break, corporations will direct a greater share of their after-tax profits towards capital expenditures, which in turn will boost productivity. This, along with a stronger labor market should in theory accelerate economic growth and support current stock market valuations. Although we've seen a modest boost to capex and research & development budgets in the six months since the tax cuts were enacted, the emphasis in corporate treasury offices continues to be returning capital to shareholders via share repurchases and dividends. At the current pace it is possible that buybacks will total an unprecedented $1 trillion in 2018. Notably, Apple Inc. announced in May its plans to repurchase $100 billion of its own shares. This rampant buyback activity reflects the widespread determination in executive suites that using profits to buy back shares is a more attractive proposition than reinvesting in the business. With respect to the tax cuts, we tend to agree with former Fed chair Ben Bernanke, who stated at a recent conference: "what we're

getting is stimulus at the very wrong moment," implying that fiscal stimulus should be used to combat recessions, not at the peak of the business cycle.

From our perspective, the positive effects of the tax cut have already been realized in security prices. The S&P 500 rallied 20% and the 10-year Treasury yield increased 45 basis points (a massive move by today's standards) between September 2017, when tax reform began to look possible, and December 2017, when the bill was signed. Earnings forecasts also made meaningful moves higher: consensus estimates currently reflect 21%, 23% and 20% S&P 500 year-over-year earnings growth in the second, third and fourth quarters of 2018, respectively. The relevant question for investors is whether these growth rates are sustainable. Historically, earnings growth is the mother's milk of stock prices, and returns suffer once it becomes clear that growth rates have reached a peak. We don't think this cycle will be any different.

As we consider the investment landscape that lies ahead, we inevitably return to our mantra: "do not fight the Fed." Following a decade of accommodative monetary policy, which according to more conservative estimates pumped $4 trillion of liquidity into the US financial system, we've entered into a new period where liquidity is receding and financial conditions are tightening. According to McKinsey Global Institute, the debt held by nonfinancial corporations grew by $29 trillion globally in the past decade. In the US, 22% of nonfinancial corporate debt is considered "junk," and another 40% is rated BBB, just one grade above junk. In other words, since the Great Recession the quantity of debt has surged while the quality of debt has plummeted. In due time, monetary tightening will surely reveal which companies and households have

been swimming naked, and we expect a more pronounced rotation into defensive sectors will follow.

Outside the US we've seen a number of warnings so far this year that global growth is slowing. Among the markets that have been hit particularly hard are emerging market currencies and debt, China's stock market (down 15% year-to-date), cryptocurrencies, and European bank stocks. Despite what the financial media suggests, we believe weakening economic data will ultimately prove more disruptive to markets than the threat of a Trump trade war. That said, with the copious amount of cash still sloshing throughout the system, it

is indeed possible that speculators could once again take hold of the market and push the averages to new highs in the near-term. While many will attempt to wring out the last drops of returns from this upcycle, from our standpoint there isn't enough runway left for appreciation to justify risk-on trades, and we remain comfortable with our early rotation to defense, characterized by dividend-paying stocks, high-quality bonds, and larger cash reserves. In difficult markets, we have found this strategy to be prudent and profitable.

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