MANAGED ASSET PORTFOLIOS

MAP VIEWS
Third Quarter 2017

Much like the first quarter, investors shrugged off a host of potential problems and pushed stock prices higher during the second quarter. The Fed raised interest rates in June on the heels of hikes in March and in December 2016. Washington has yet to deliver progress on healthcare reform, tax reform or even infrastructure. While we have expressed our opinion on growth in the past, at the risk of sounding like a broken record, economic expansion remains muted. First quarter GDP came in at a revised annual clip of just 1.4%, down from average growth in the past four quarters of 2.10% and a paltry 2.14% since the recovery began in late 2009. Such anemic growth, combined with recently softening auto sales, declining oil prices, and weakening economic data from the likes of China hardly portray a picture of strength. Yet, the Fed remains determined to follow through on their agenda to push rates higher.

Despite their determination, it appears as though the bond market is questioning the Fed's read on the economy. Despite three rate hikes during the past six months, bond investors seem unconvinced that these short term increases will translate to higher long term bond yields. Yields on the U.S. ten year have declined from 2.62% on March 13th to 2.30% today. Perhaps more telling is the flattening of the yield curve. The spread between 2-year and 10-year Treasury bonds stands at just under 90 basis points. While a trend is not a guarantee, in the past, when this spread has fallen below zero, a recession has almost always followed[1]. Furthermore, traditionally, the flattening, or inversion of the yield curve, can be an indicator of a slowing economy.

Interestingly, a study by University of Notre Dame economist Bill McDonald showed that during last month's Fed meeting, members used the word "inflation" 97 times, the most since the minutes of the January 2016 meeting. Recall, at that time, energy prices were tumbling, putting stress on emerging markets and high yield bonds. Furthermore, during the most recent meeting, members used fewer upbeat words such as "optimistic," or "progress." Again, use of such words fell to their lowest levels since January of 2016. As such, we would not be surprised to see the Fed curtail their hikes for now, letting the economy digest their recent hikes before raising again. The market seems to agree with our assessment as it is currently pricing in less than a 10% chance of a hike in September[2].

Switching gears, we believe the inability of Congress and the President to easily pass a reformed health-care bill has raised doubts about their ability to execute on other campaign promises such as simplifying and lowering taxes, reducing government regulation, and increasing infrastructure spending. While we are the first to agree that lower taxes and deregulation are positives for the stock market, we are concerned the market is expecting that of all these pro-growth reforms will quickly become law. Stock market valuations have expanded on the expectation that these new laws will boost corporate earnings. Any sort of delay in passing (let alone enacting) these highly anticipated reforms could easily result in a stock market correction (or as the financial press will undoubtedly report as 'a compression of Trump valuations').

One of the primary economic challenges facing the U.S. and many other developed countries, is the structural shift toward lower paying jobs. We believe this shift is at least partly responsible for the declining US Labor Force Participation Rate, which has retraced to levels not seen since the late 1970s. Additionally, we believe this retracement has resulted in the constraint of many consumers' discretionary income. Further pressure has been put on consumers through the rampant adoption of technology. While technology has been widely understood to improve efficiency, it also has significantly negatively affected total employment. For example, of the manufacturing job losses experienced in recent years, it is estimated that only 15% have gone offshore. The remaining 85% was attributable to technological advancement and automation. We anticipate the rate of adoption in the workplace will only accelerate into the future. This is evident in the following news headlines: Wendy's to install 1,000 self-ordering kiosks; Domino's Pizza using robots to deliver pizzas in Australia and Europe; Driverless truck made its first delivery. Even Adidas, the German sports apparel company, is moving a shoe factory from China to a robotic plant in Germany, because robots offer the most cost effective option. As a result, we believe this shift toward automation will continue to carry many challenges, both economic as well as social.

2017 is shaping up to be a year where what you do not own will be more important than what you do own. Over recent years, many investors have embraced passive investing. We believe the move toward indexing will come back to haunt many investors during the next market correction. Clearly there are good companies and bad companies, cheap stocks and expensive ones. With indexing, all stocks are comingled. Unlike purposeful active investing, indexing does not discriminate between good and bad stocks. As much as this strategy seemingly works in rising markets, many indexers, who have become complacent in the bull market of the last 10 years, will be disappointed during the next market correction. With the rise in the equity markets, valuations have become stretched and finding investable value stocks has become a less obvious task than it was a few years ago.

With that being said, we believe value can still be found in specific geographies and in select names. In particular, we continue to find opportunities in Europe. Recent economic data suggest that the European economic landscape is improving and we believe this factor will lead to better corporate earnings. Our macroeconomic views have not changed since our last update. Accordingly, we remain overweight those sectors of the stock market that are not directly tied to a strong economy (e.g. Consumer Staples). We remain underweight financials. Despite experiencing robust performance in the back half of 2016, financials have lagged the broader market in 2017. Despite favorable Stress Test outcomes and the resulting significant dividend increases and share buyback announcements, the Financial Select Sector SPDR ETF, or XLF, is up 6.89% YTD through June 30th as compared to 9.34% for the S&P 500. Without subsequent rate rises and anticipated regulatory changes, we believe it will be difficult for the sector to have significant further advances. In the end, after more than seven years of one of the feeblest recoveries in history, we believe now is not the time to get excited about strong economic growth and we have positioned our portfolios accordingly.

Thank you for allowing us to service your investment needs. It is a responsibility we do not take lightly. We work diligently every day to deliver the best risk-adjusted returns for our clients. Enjoy the summer!

July 24, 2017
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The information contained herein represents our views as of the date above and does not represent a recommendation by us to buy or sell any security or securities mentioned. Past performance is no guarantee of future results.

[1] *Wall Street Journal 06/16/2017* [2] *CME Group 07/24/2017*