

Economic & Investment Outlook

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U.S. Government Policy Outlook

Current Policies	Short Term(6-12 Months)	Intermediate Term(1-3 Years)
1. Fiscal Policy		
<i>Tax</i>	Tax Cut +	Positive
<i>Spending</i>	Spending on the rise -	Negative
2. Regulatory Policy	Regulations Decreasing +	Positive
3. Trade Policy	Tariffs Increasing -	Tariffs Increasing -
4. Monetary Policy	Accommodative +	Neutral
Policy Summary	Mostly Favorable	Neutral

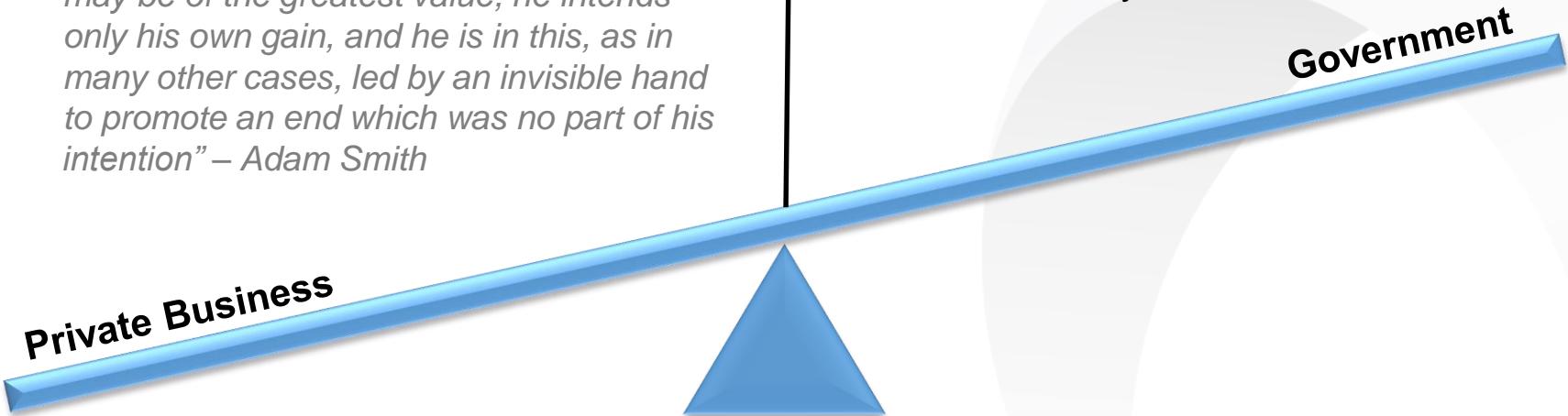
Government Policy is a Balancing Act

Private Business is the lifeblood of the Economy. Private Business helps the economy grow by unleashing the entrepreneurial spirit through pursuit of self interest.

“Every individual... neither intends to promote the public interest, nor knows how much he is promoting it... he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention” – Adam Smith

Government serves important functions in the economy, some of these functions are:

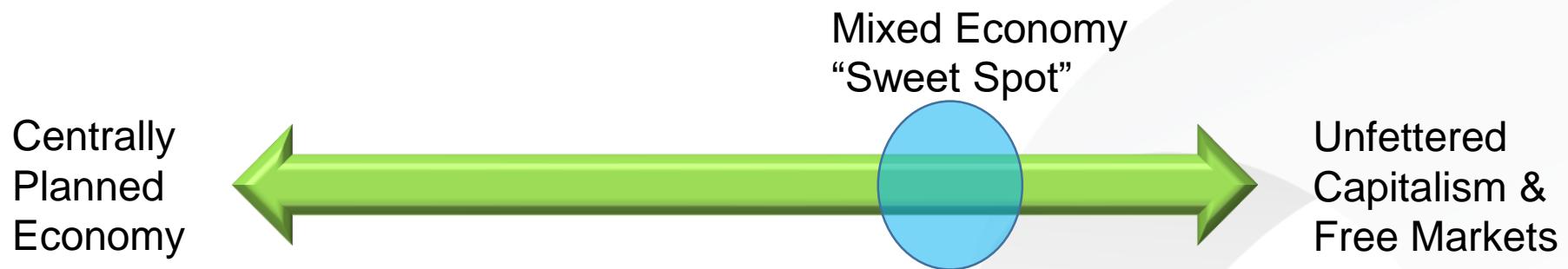
- Enforcing the Rule of Law
 - Protecting Property Rights
 - Enforcing Contracts
- Fixing Externalities
 - Child Labor Laws
 - Pollution Laws
- Social Safety Nets



Quote Source: Adam Smith, *The Theory of Moral Sentiments*, Part IV, Chapter I, pp.184-5, para. 10

A Mixed Economy

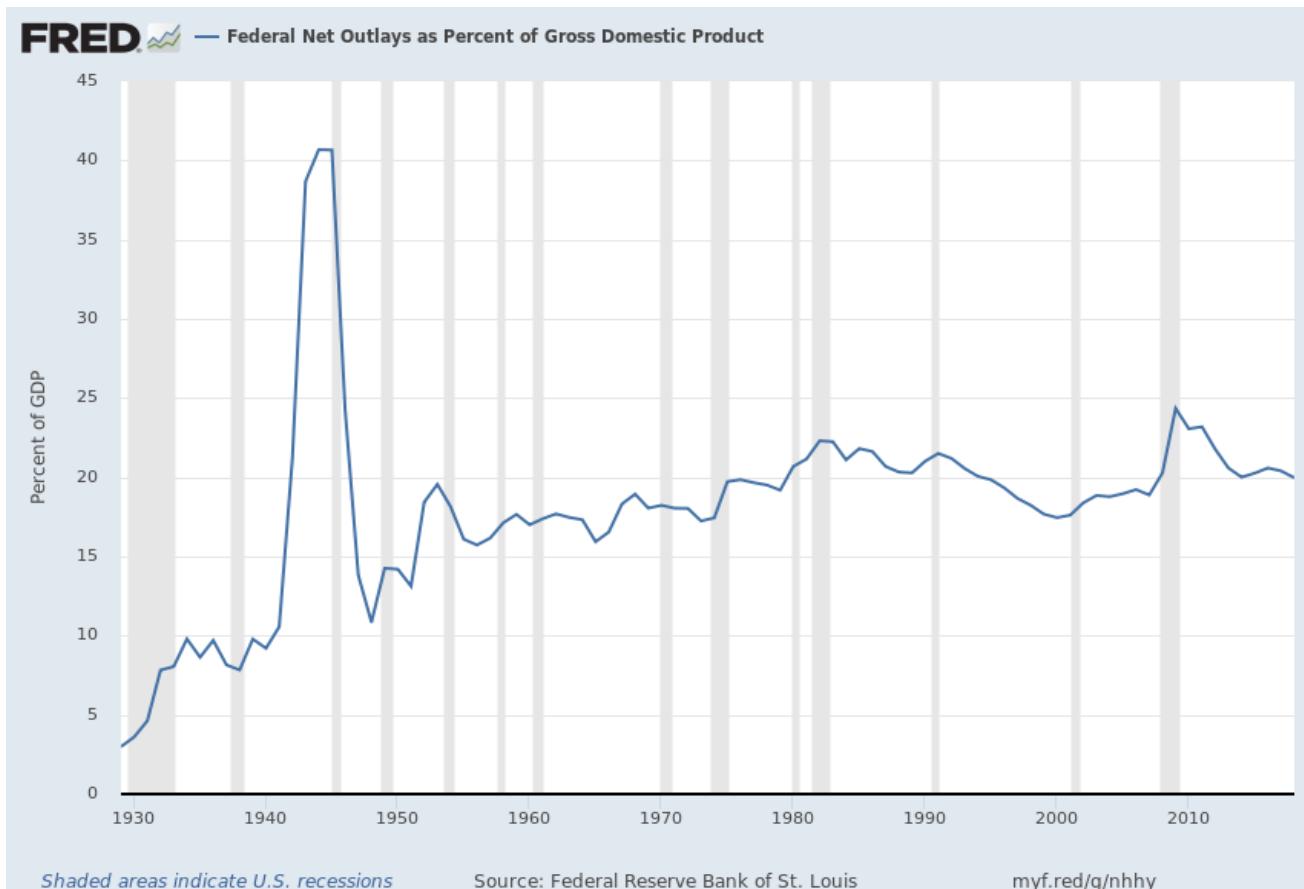
Because benefits to economies are found in both Private Business and Government, the end result is often the creation of a mixed economy.



1. Fiscal Policy

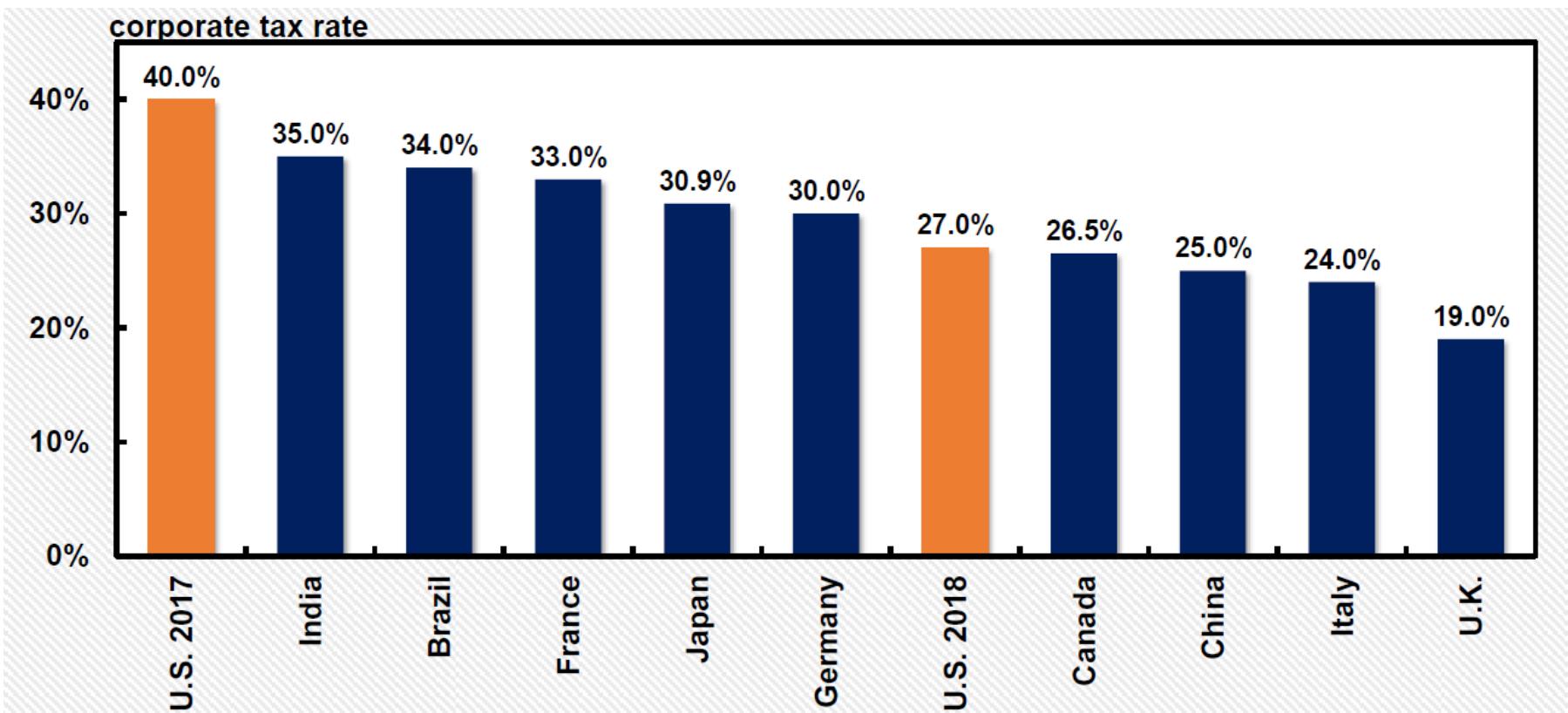
Government Spending

Government spending sits around 20% of GDP. Typically a level 17-18% is better. Government spending has the potential to crowd out private sector activity.

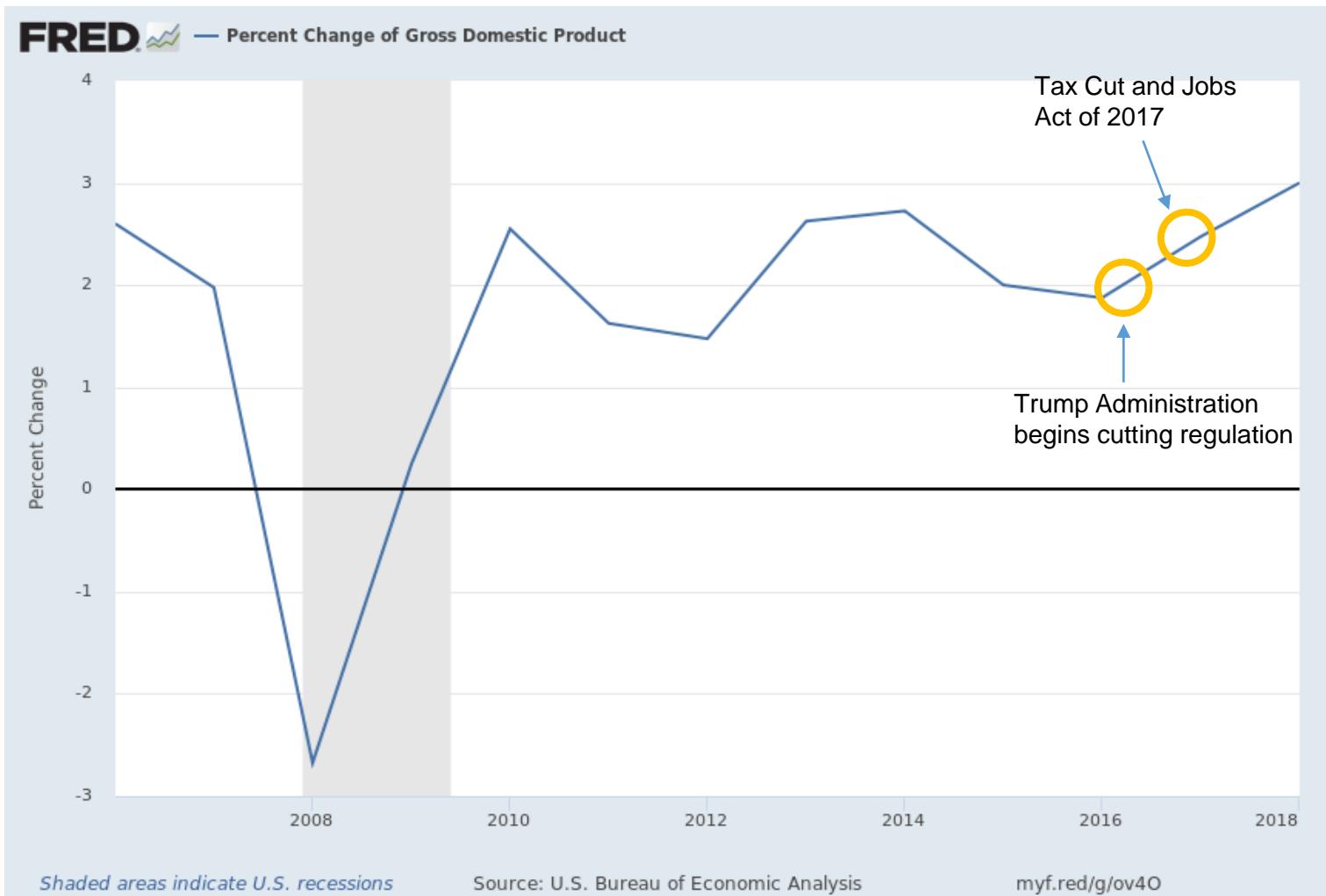


Tax Cut

The tax cut was, and continues to be a favorable factor to the American economy. Specifically, the corporate tax cut makes the U.S. more competitive with other countries.

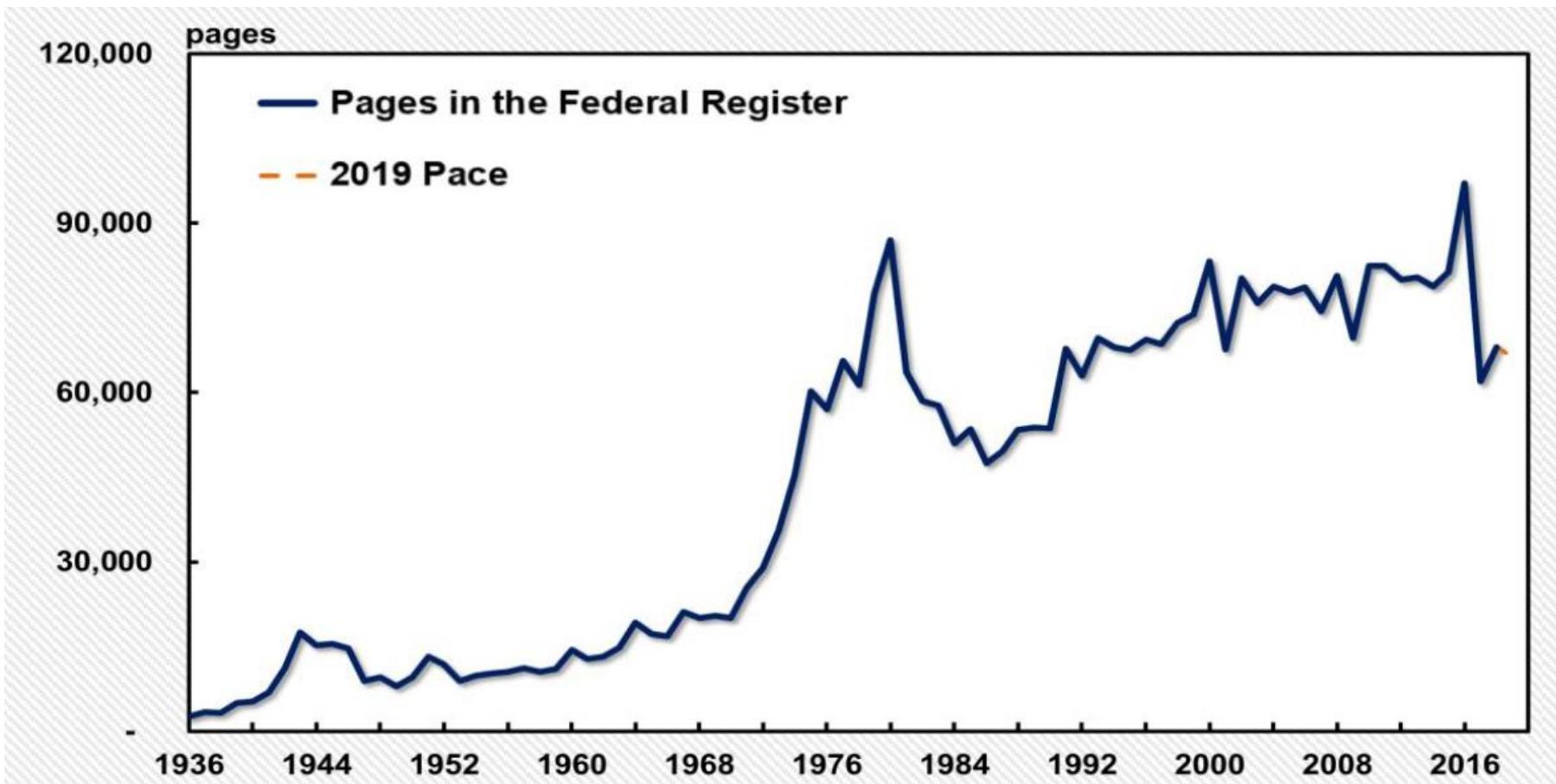


GDP Growth Rate



2. Regulatory Policy

Pages in the Federal Register



3. Trade Policy

Trade Uncertainty At Historic Highs

Uncertainty surges after 20 years of stability. In the past year, the World Trade Uncertainty index jumped 10-fold from previously recorded highs as the US-China trade war escalated.



Source: International Monetary Fund. World Uncertainty Index. Ahir,Bloom, Furceri (2018). The source for the data on key dates in the US-China trade negotiations comes from Brown and Kolb (2019). Note: The font in blue indicates the tariff measure taken, and the font in black indicates the narrative of the World Trade Uncertainty index. A higher number means higher trade uncertainty.

Trade Situation with Top Partners

Country	Total Trade (Billions)	% of Total Trade	Status	Comment
China	\$659.8	15.7%	Dispute Ongoing	
Canada	\$617.2	14.7%	USMCA	Pending Ratification
Mexico	\$611.5	14.5%	USMCA	Pending Ratification
Japan	\$217.6	5.2%	Initial Agreement	Details Uncertain

4. Monetary Policy

History of the Fed

1913: President Woodrow Wilson signs Federal Reserve Act into law



1935: Banking Act of 1935 creates Federal Open Market Committee (FOMC)



Goals of the Fed

1. Pursue full employment and stabilize prices
2. Supervise and regulate banks
3. Stabilize financial system as lender of last resort

FOMC Toolbox

1. Open Market Operations
2. Set Reserve Requirement
3. Set Discount Rate

FOMC Expansionary Policy

To create a growth environment the Fed will use its tools in the following ways:

Open Market Operations

- Fed buys bonds



Reserve Requirement

- Fed lowers requirement



Discount Rate

- Fed lowers rate



Results



*Potentially Inflationary

FOMC Contractionary Policy

To avoid an overheated economy the Fed will use its tools in the following ways:

Open Market Operations

- Fed sells bonds



Reserve Requirement

- Fed raises requirement



Discount Rate

- Fed raises rate



Results



*Potentially Deflationary

Government Policy Changes the Game

In response to the 2008 financial crisis, central banks around the world implemented unprecedented and prolonged actions to try and “fix” the economy.

1. Quantitative Easing (QE)
2. Zero and Negative Interest Rate Policy (ZIRP and NIRP)



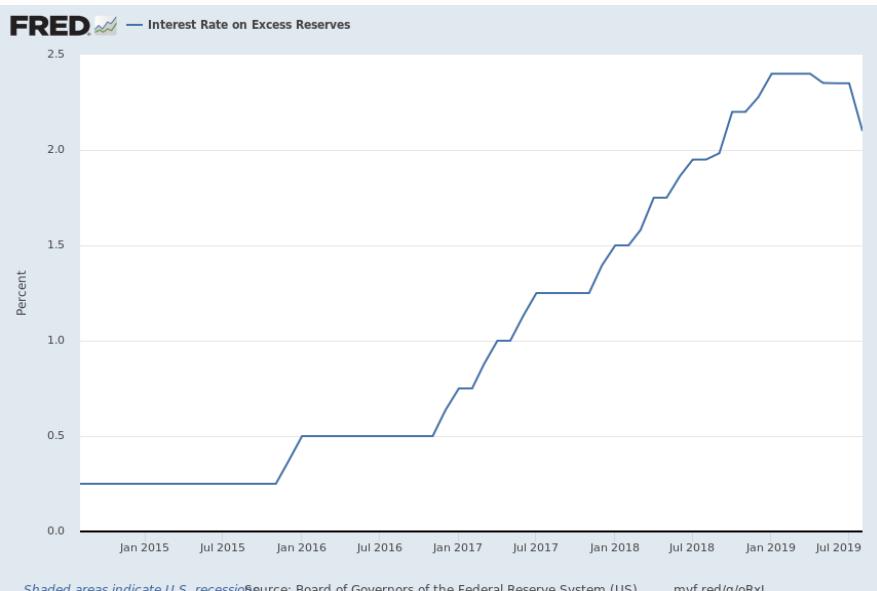
Then and Now: Changes in Monetary Policy

Policy	Pre-2008	Current
Interest on Reserves	No Interest	Interest on Reserves
FOMC/Open Market Operations	Short-Term Maturity Emphasis	All Maturities Emphasis

Source: fred.stlouisfed.org

Quantitative Easing

Similar to open market operations, the Fed buys bonds and other securities from banks. This increases banks' reserve accounts at the Fed. In recent years, the Fed began paying interest on excess reserves. Interest on excess reserves and heightened financial regulation disincentivizes lending.



Results



Reserves

Fed Pays Interest On Reserves



Financial Regulation



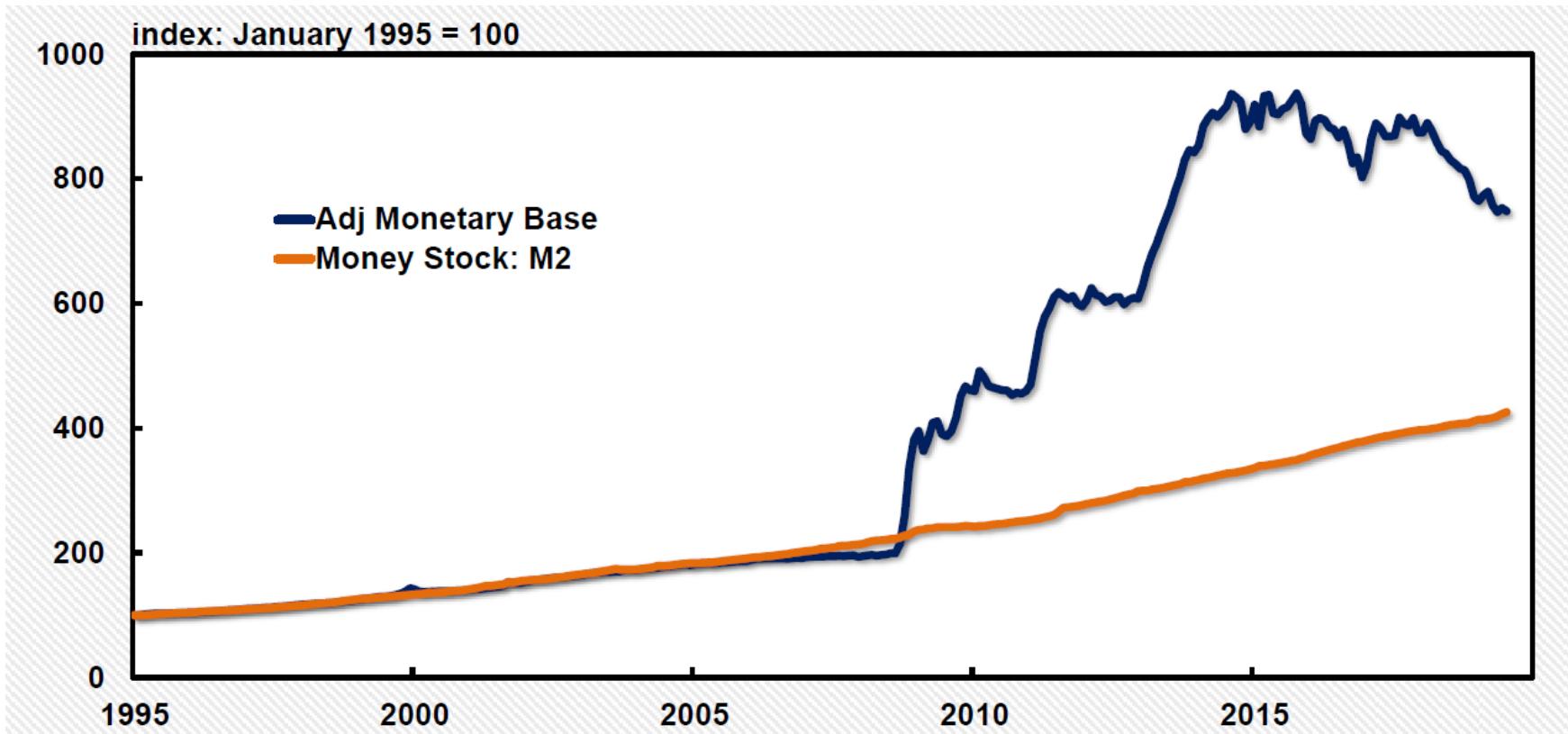
Reluctance to Lend



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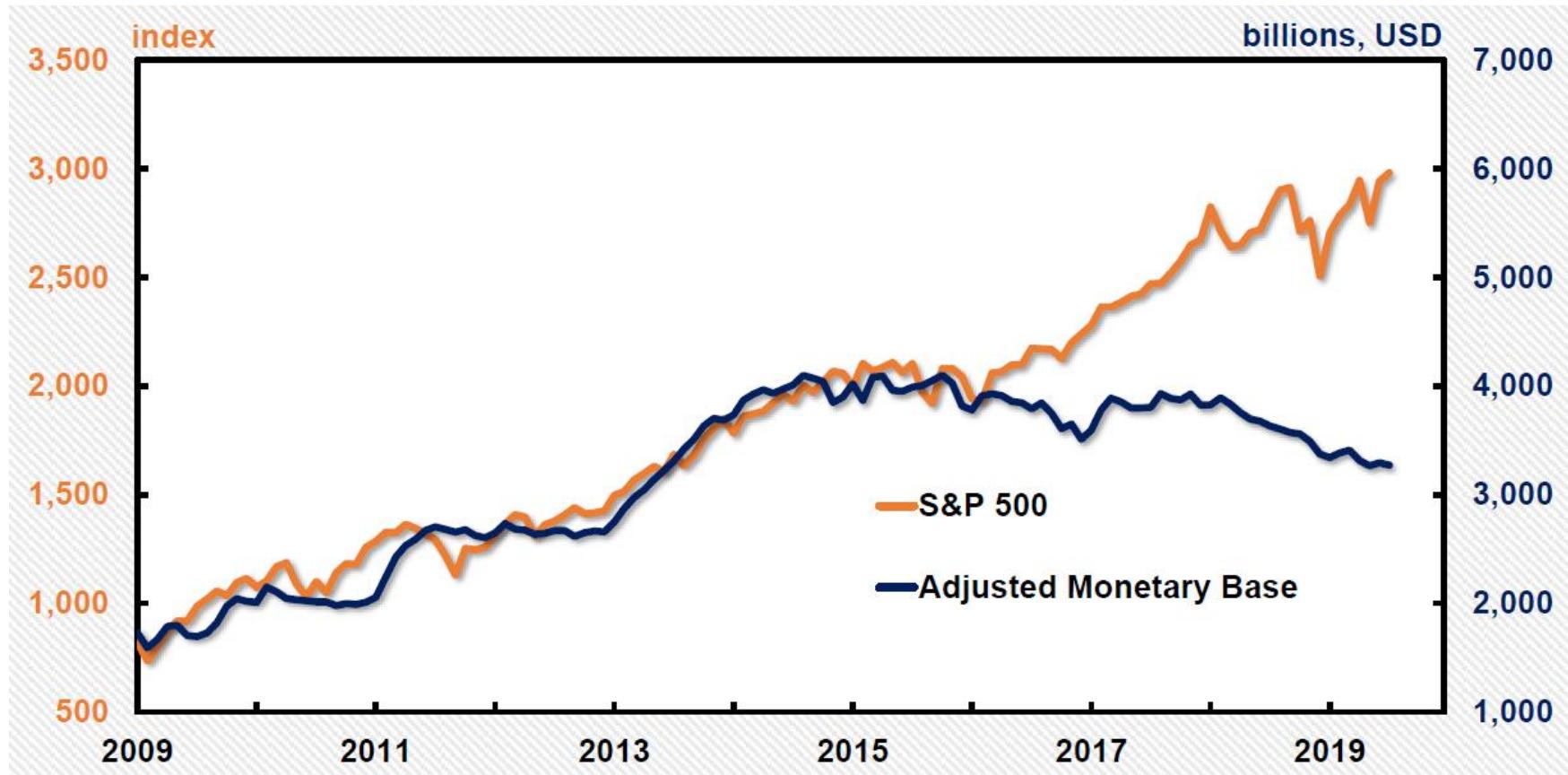
Banks' Reluctance to Lend

Banks' reluctance to lend, due to regulatory constraints and interest earned on reserves, causes a disconnect between reserve growth and money supply growth.



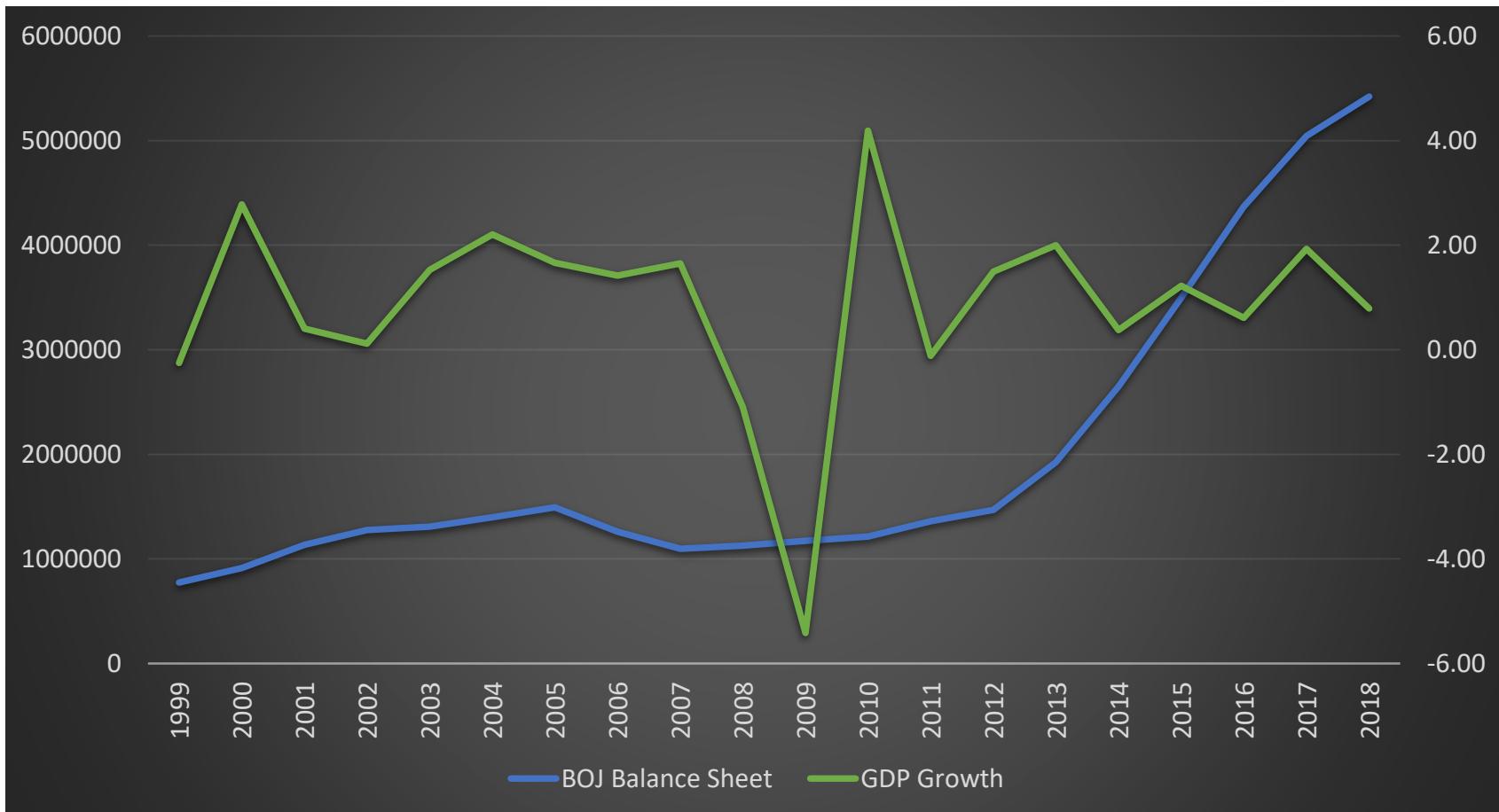
Market Still Grows without QE

The stock market has increased in value primarily due to growth of corporate earnings, modifications to mark-to-market accounting and entrepreneurial activities, not because of QE.



Japan and QE

Japan has employed massive QE since 2012. This stimulus failed to deliver significant GDP growth.

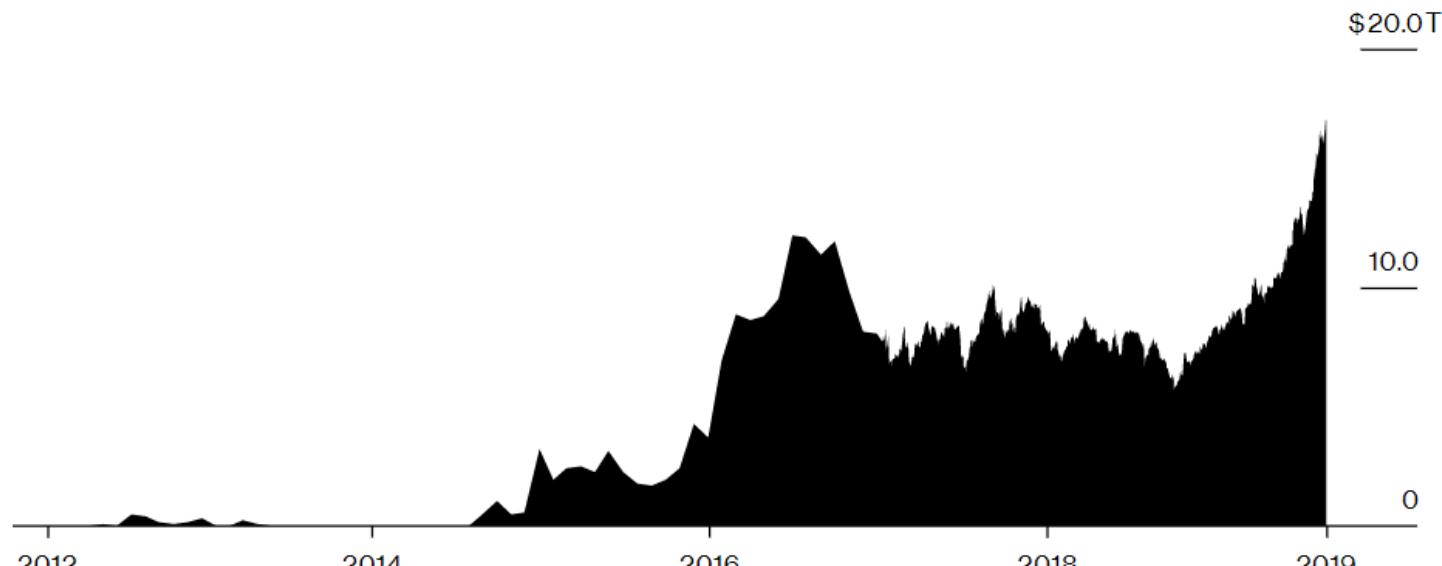


Source: alfred.stlouisfed.org. Japanese GDP Growth on right axis. BOJ balance sheet in Hundreds of Millions Yen and left axis.

Negative Rates

Negative rates are an attempt by central banks to encourage commercial banks to lend. Negative rates appear to not stimulate growth and may actually hinder growth.

Market Value of Negative-Yielding Bonds in the Bloomberg Barclays Global-Aggregate Index



Data: Compiled by Bloomberg



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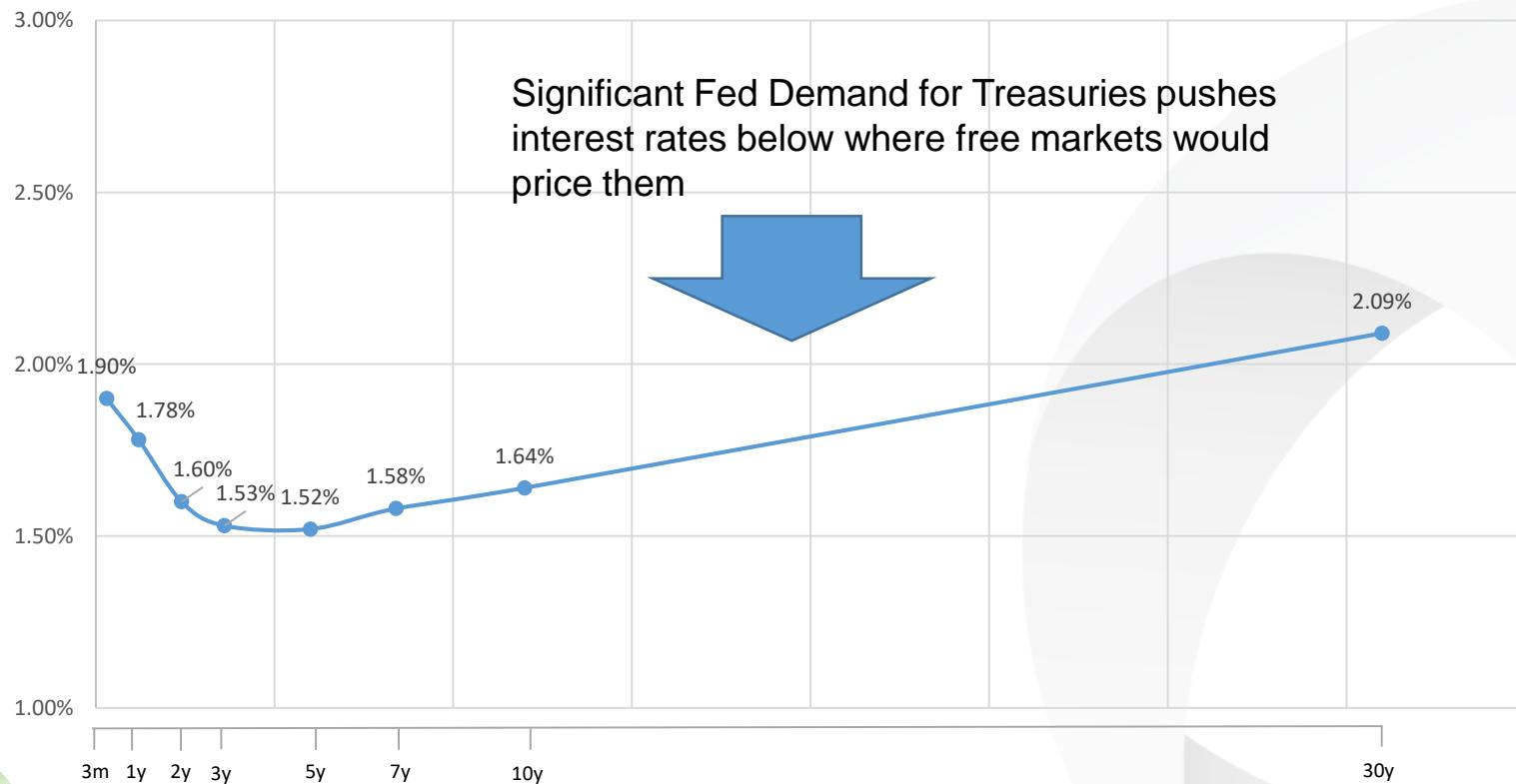
Trust Your Gut, Negative Rates Don't Make Sense

While negative rates may work in central bank projections and theories, they don't work in a lot of other ways.

- Standard investment valuation models aren't built for negative rates
- Pensions use a discount rate to see if they are properly funded. Negative rates on fixed-income securities means pension funds would be underfunded.
- Psychologically, negative rates create a “hunker down” mentality.

Yield Curve: What's the Message?

Central Banks' new and intensive actions have complicated the current interpretation of the yield curve. In today's environment, monetary policy pushes rates down and this distorts the market's ability to communicate information on the state of the economy through rates.



Source: treasury.gov. Data as of September 25, 2019

Why we think the Fed shouldn't cut rates

- Historically Low Unemployment of 3.7%
- Housing starts sit at 1.364 million, a new post-recession high
- ISM Non-Manufacturing Index at 56.4 (Growing)
- Personal Income is up 4.6% in the last year
- Retail sales up 3.4% in the last year
- Household debt service payments as a % of disposable income is historically low at 9.9%
- Wage growth of 3.7% over the last year
- Consumer confidence high at 135.1

Economic Outlook

- U.S. economy continues to grow with GDP in the 2.0% to 2.5% range
- Odds of a U.S. recession in the next twelve months are low, but increasing modestly
- CPI inflation continues to be tame, but could move above 2% in the next 12 months
- U.S. corporate profits continue to be robust, but profit growth for 2019 will be in the low single digits
- Another quarter point increase in the federal funds rate is possible between now and year-end
- Equities look attractive relative to bonds given abnormally low interest rate environment

Investment Outlook

- After multiple years of favoring stocks over bonds, moving to more neutral weights
- Small cap value looks attractive relative to other equity asset classes
- Prefer U.S. fixed income to developed international fixed income due to negative interest rates
- Increasing weights in U.S. equities with corresponding decrease in international equity
- Still see emerging market equities as an attractive long-term investment opportunity

Key Terms

Money Supply (M2): entire stock of currency and other liquid instruments in a country's economy (cash+checking deposits+savings deposits+time deposits+money market funds)

Discount Rate: the amount the Fed charges member banks to borrow in order to maintain their reserve

Reserve Requirement: the minimum amount of reserves (deposits) that must be held by a commercial bank at the Federal Reserve

Open Market Operations: the Federal Reserve buying and selling government securities on the open market to expand or contract the amount of reserves (money) in the banking system

Inflation: increase in prices and fall in dollar's purchasing power

Lender of Last Resort: typically a central bank, provides loans to banks that are experiencing difficulty