The Quarterly Perspective

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ABOUT
Harman Wealth Management

At Harman Wealth Management, we provide private, advanced, independent planning and investment management to individuals, families, and institutional clients.

We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to insightful, objective solutions, and always working solely for the best interest of our clients.

Three Big Ways the Tax Cut and Jobs Act has Impacted 2018 So Far.

First half of 2018 clearly showing fiscal boost.

Even with unemployment low and the economy running at full capacity, Congress moved to pass the Tax Cuts and Jobs Act last December. The initial objective was to improve corporate competitiveness by updating the tax structure and lowering the rate, but Congress also passed along a number of individual tax cuts. Collectively, the TCJA was the largest tax overhaul since 1986.

The White House took a long-term view of the tax package, emphasizing the benefits to long-term economic growth. While a number of economists disagreed with the timing and approach, the consensus agreed that the economy would see a near-term boost. So how do things look six months into 2018? Here are three key areas showing the effects of tax cuts so far:

1. STRETCHED MANUFACTURING MOMENTUM
The surprise of 2017 was global "synchronized" growth as other major nations joined the U.S.'s positive growth trend. On a global scale, it was the best trend seen since 2010. So far, 2018 has turned out differently and the U.S. stands out. While developed market peers are showing signs of slowing, the U.S. has maintained strong growth momentum through the first half of 2018.

2. INCREASED RETAIL ACTIVITY
In February, most wage-earning Americans saw reduced withholding in their paychecks due to lower tax rates. In reality, they essentially received a pay raise. As a result, spending has gone up as well. General retail sales are up 7.1% since last year, the highest level since 2011.

3. CORPORATE EARNINGS
Based on growth alone, S&P 500 companies were already expected to show double digit increases in earnings for 2018. But with the TCJA reducing headline corporate rates from 35% to 21%, the earnings outlook got even juicier. When the numbers came in, first quarter earnings grew 24.8% from the same point a year ago.

FAST FACTS:
Growth rates compared to one year ago.

MANUFACTURING[1]
+7.6%
Value of Shipments for All Manufacturing Industries (May 2018)

RETAIL[1]
+7.1%
Retail Sales: Excluding Motor Vehicles and Parts Dealers, (June 2018)

S&P 500 EARNINGS[2]
+24.8%
Retail Sales: Excluding Motor Vehicles and Parts Dealers, (June 2018)

Sources: [1]Federal Reserve of St. Louis, [2]FactSet

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A Trade Tutorial for 2018

New trade deals could provide stimulus to U.S. growth but also inflation.

Much of the market's focus in 2018 has pivoted toward policy issues with trade taking center stage. Since the president's March 1st announcement for tariffs on steel and aluminum, trade tensions have dominated the headlines.

For the most part, trade issues are way oversimplified. Too often the media unjustifiably relies on the assumption that efforts to improve trade relationships will ultimately lead to an economically debilitating "trade war." The issues with trade can be very complex and multi-layered, but it is still worthwhile to revisit what the real issues are about.

With production cost becoming so paramount, U.S. trade policy has focused on increasing U.S. competitiveness.

Keys to Understanding the Trade Issues:

COMPETITION FOR TRADE IS REALLY ABOUT PRODUCTION.

For centuries trade was about natural resources. Nations rich in natural resources would export raw materials or the goods made from them to the betterment of national growth and prosperity. But, with global integration, the rules changed to favor low cost production.

A great example comes from the U.S. textile industry. In 1990, the U.S. had nearly 1.7 million workers in the textile and apparel industry. In 2018, there are only 340,000 jobs on record.[1] The consequences to trade have been steep. Not only has the U.S. seen over a million jobs move overseas, but a once profitable export switched to become an import.

With production costs becoming so paramount, U.S. trade policy has focused on increasing U.S. competitiveness. The first move was to reform the corporate tax code, not only by decreasing the tax rate, but also incentivizing more investment in the U.S.

ITS ABOUT UPDATING EXISTING AGREEMENTS

Among the blustery headlines about trade wars, the media is overlooking the obvious: the U.S. is seeking to update existing agreements. Nearly one-third of all U.S. exports go to Canada and Mexico, and "yes" the rules could use some updating since NAFTA was established in 1994.

At stake are important issues that affect the "fairness" of the competition for American workers. Does the Mexican government prevent labor representation for workers and, thus, suppress wages? Are companies abiding by the same environmental standards? Are states and provinces subsidizing exports, allowing for the dumping of low cost goods?

The reality is that China has a lot to gain from their non-compliance and trading partners often lack the political capital to take a tougher stance.

CHINA HAS BEEN A KNOWN PROBLEM, AND ITS MORE THAN JUST THE DEFICIT

The issues with China go well beyond the trade deficit and instead center on a myriad of transgressions from intellectual property theft, to obstructionism, to state supported companies. In short, China entered the World Trade Organization (WTO) in 2001 under the commitment they would embrace an open, market-oriented trade regime. Fast forward to 2018 and there is clear acknowledgement that China is far from abiding by everyone else's rules.

As evidence, the Obama administration alone filed 16 formal complaints against China at the WTO and won them all. The reality is that China has a lot to gain from their non-compliance and trading partners often lack the political capital to take a tougher stance. Therefore, the Chinese won't voluntarily give up trade gains until met with greater consequences for non-compliance. Few have been willing to tackle this challenge.

Making Sense of the Positive Outlook on Jobs

Jobs numbers are the best in decades.

With the economy in its ninth year of expansion, the employment picture has been characterized as the best in decades. As recent as May, the unemployment rate stood at 3.8%, the lowest figure since 1970. Moreover, the percent of labor force participants receiving unemployment insurance is at the absolute lowest levels since starting records in the 1960s.

While the headline data tells a very good story, we also know other factors are at work and the full story shows there may be more than meets the eye.

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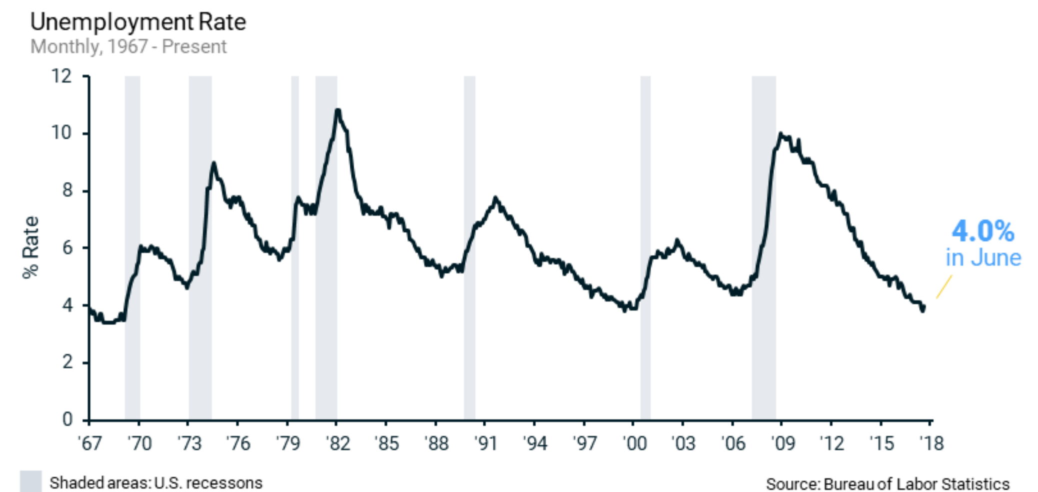
CYCLICALITY AT WORK

An important notion to understanding employment data is seeing its ties to the overall economy and cyclical forces that reoccur across decades. While a low unemployment rate sounds like a success of present policy, it is also a natural by-product of economic growth that follows a longer-term cyclical process.

Chart 1 below shows the present unemployment rate of 4.0% along with the context of the last five decades. While in comparison the 4.0% is clearly very favorable, what we can also see is that economic growth has not been sustained for very long at or below this level.

Part of the explanation is revealed in the employer survey data. Employers report the need for pay increases to keep good workers along with the struggle to get newer, qualified workers through the door. Unfortunately, tight labor markets lead to wage inflation which eventually contributes to consumer price inflation.

Chart 1



WHAT'S IT MEAN FOR INVESTORS?

A hallmark of typical investor behavior is to become overly confident at the just the wrong time. After all, it is defensible to transfer optimism to the markets when surrounded by "best in decades" economic news. But a broad view of history reveals a different interpretation. Yes, low unemployment rates are a good thing for real people in need of good jobs, but low rates also reveal growing risks that economic forces are maturing. While the end of the expansion is not yet in sight (and could go much longer), investors are cautioned against assuming favorable headlines accurately represent market risks.

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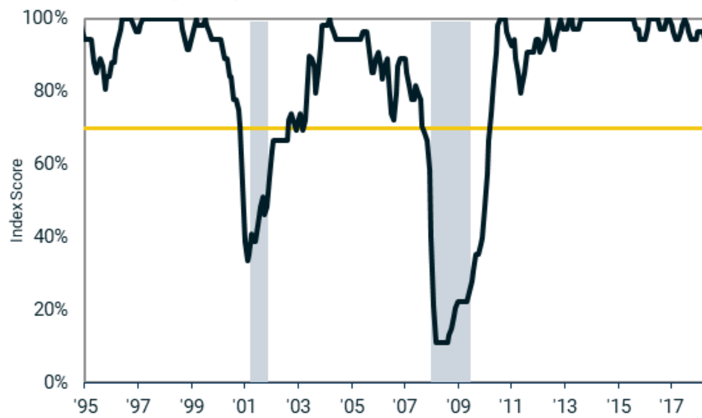
Business Cycle Risk Profile

- The Economic Systemic Risk Index continues to score highly consistent with further economic growth.
- Since early 2016, several favorable growth trends have taken hold across important economic factors such as industrial production, manufacturing, and retail sales. As of mid-2018, the economy appears bolstered by federal stimulus from the Tax Cut and Jobs Act.
- The economy remains at “full employment” with the unemployment rate at 4.0%. Job growth has actually strengthened since the fall of 2017.
- The economy reflects late-cycle characteristics across many fronts. Loan demand is showing mixed signals. Labor is tight with signs of wage inflation emerging. Markets have reached very high valuation levels. Inflation is on a rising trend but has not reached distressed levels for consumers.
- At its current level, the index value reflects no historical precedence for a recession.



Interpreting the Index Score:

- The index score measures nine economic factors that have demonstrated co-movement with the deteriorating conditions of the past seven recessions dating back to 1970.
- When the index score is at 100, it means all nine of the factors are measuring at levels consistent with past economic expansion.
- When the index score is below 100, it means that one or more of the weighted factors has moved to a level consistent with past economic contractions.
- In aggregate a score of 70 or higher is interpreted as a composite profile consistent with past economic expansion. A score lower than 70 is interpreted as a composite profile consistent with past economic contraction.
- Markets can, and sometimes do, demonstrate volatility even though the economic factors are measuring consistent with expansion.

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Interested in Adaptive Business Cycle Investing?

Today's markets, economies, and policies are more complex than ever, challenging investors on what to watch and when to take action.

At Harman Wealth Management, we understand sound investments are uniquely supported by the conditions that favor them. And, when conditions change, so do the investments that benefit.

That's why we conduct rigorous and disciplined tracking of the U.S. business cycle. We also track the cyclical factors that shape our investing environment, like currencies, commodities, and rates. We embrace a world where investing dynamics are constantly evolving and believe it's imperative to have an investment strategy that adapts with it.

With Adaptive Business Cycle Investing we invest consistent with business cycle forces, aligning investments with the conditions driving returns in the present, rather than chasing what worked in the past.

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We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to integrative advanced planning by aligning investment objectives with business cycle opportunities and risks.

At Harman Wealth Management, our aim is to help clients realize their goals within a disciplined, insightful, and rewarding relationship.

For more information about Harman Wealth Management or investing with the business cycle, contact us at 281-719-8601.

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Investing involves risk including the potential loss of principal. No investment strategy can guarantee a profit or protect against loss in periods of declining values. Past performance is no guarantee of future results. There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio in any given market environment.

Please note that individual situations can vary. Therefore, the information presented here should only be relied upon when coordinated with individual professional advice.

The Standard and Poor's 500 is an unmanaged index generally representative of the U.S. stock market and cannot be invested in directly.

In general, the bond market is volatile as prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. Bonds are also subject to other types of risks such as call, credit, liquidity, interest rate, and general market risks.

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