FSA INVESTMENT GROUP

FSA INVESTMENT GROUP

Quarterly Market Commentary
August 2018

Separating the Notable from the Noise

While U.S. economic indicators such as unemployment, production, and consumption are supporting solid growth, the threat of tariffs injects a bit of unknown into the outlook. President Trump continues to push China by expanding the types of goods subject to 25% tariffs. China threatens retaliation. Trade talks in Europe ended without any immediate tariffs, and there still is no resolution on NAFTA. Uncertainty is looming all around. Does the status of trade talks fundamentally change the outlook for our risk-on stance, or is it just noise? What are the fundamentals of the market really telling us?

Trade Game

A simple search on Google for "U.S. Trade News" results in more than 1.4 billion results, with 531 million of those being news stories. Of those stories, you will find headlines that point to how the U.S. will be hurt, will benefit, everyone will lose, China will win, the world is doomed, trade war is imminent, trade war has been avoided, etc. The issue is that there are so many scenarios that it can be difficult to cut through the noise. In their global outlook, Allianz stated that they believe there are three different scenarios: Trade Game, Trade Feud, and Trade War.

- *The Trade Game scenario is characterized as a minor event to the global economy. Tariffs being instituted on a small portion (less than 4%) of global trade volume. No real impact on inflation in the U.S. No real effect on Europe's recovery, and China stays on the soft-landing trajectory.*

- *Investment Services*
- *Reporting Services*
- *Consulting Services*

ABOUT OUR FIRM

We are dedicated to providing investment management and strategic wealth planning to Indian tribes and high net worth individuals. Simply put, we strive to be our client's trusted advisor. As a financial advisory firm, our primary focus is to provide unbiased opinions that are designed to achieve long term investment results. FSA Investment Group does this with the highest levels of trust, integrity and respect while always collaborating using a team approach. We are dedicated to professionally supporting, educat-ing, and providing informed direction to each and every client.

FSA INVESTMENT GROUP
308 SOUTH ALCANIZ STREET
PENSACOLA, FLORIDA 32502

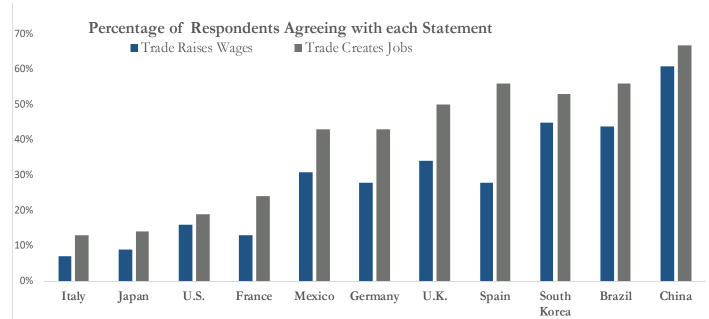
Telephone: 850.696.1550
Fax: 251.459.6918
Email: info@fsa-ig.com

- *A* ***Trade Feud*** *starts to become an issue to global growth. Tariffs on more than $250 billion of products from China as well as other countries. In the U.S., growth starts to become affected, inflation begins to rise, and the deficit begins to grow larger. Outside of the U.S., Europe's recovery is slowed, and China begins to depreciate their currency like in 2015 (around 10%).*

- *The* ***Trade War*** *scenario becomes a threat to the global economy. Tariffs on more than $700 billion products from China and worldwide retaliation on U.S. exports. Global trade contracts significantly. The U.S. experiences a significant reduction in growth, with inflation accelerating. Europe's recovery is stalled, and recession hits most emerging markets.*

Knowing these possible scenarios, why would President Trump continue to push the trade agenda? The simple answer is that the administration and others do not see the expansion of global trade as a good thing. BCA Research published a recent survey on how each country views the benefit of global trade (**see Figure 1**). The results vary across the board. The U.S. scored very low on the survey, with less than 20% of respondents indicating that they believe global trade increases their wages. Also, just over 20% in the U.S. believe that global trade creates jobs. On the opposite side, China had over 60% who believe global trade benefits them. With a large portion of the U.S. expressing negative views on trade, it is no surprise that President Trump has made this his number one initiative. It also means that this concern is not likely to go away anytime soon.

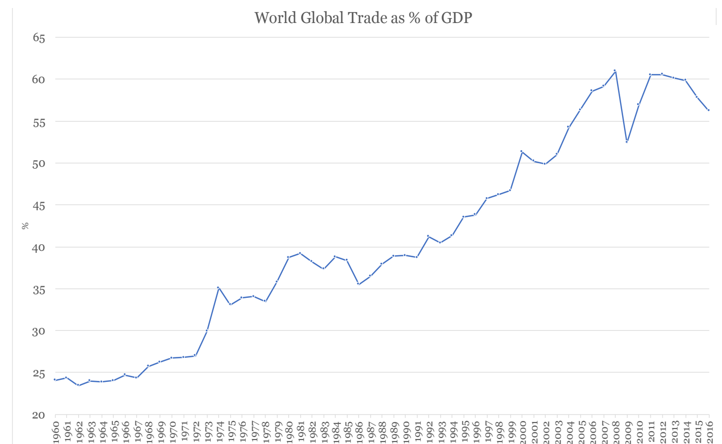
Figure 1



Source: Spring 2014 Global Attitudes Survey; Pew Research; BCA Research; Highland Associates

In light of the negative U.S. opinion on trade, changes are likely but less drastic than the headlines might indicate. Global trade has been on a long uptrend since the early 1970s (**see Figure 2**). With global trade close to high water marks, it seems there is room for some reversal. President Trump is challenging this by shifting away from multi-country agreements and toward more individual-country agreements. NAFTA is a good example of this tactic. Breaking apart multi-country agreements and renegotiating individual trade agreements is a slow and arduous process, as evidenced by the current state of affairs.

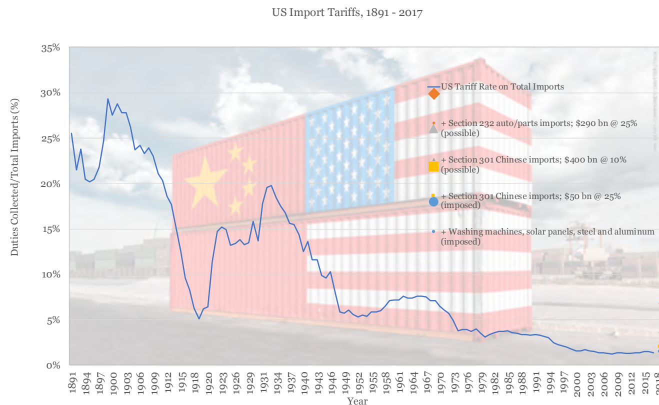
Figure 2



Source: World Bank

Looking more closely at the U.S., the level of tariffs has been steadily declining since World War II (**see Figure 3**). While the newly imposed tariffs are higher, the likely result looks more like the early 2000s and less like the Depression era. The biggest risk is a tariff on auto imports, but this seems less likely after Trump's recent meetings in Europe.

Figure 3



Source: International Trade Commission; JP Morgan; Highland Associates

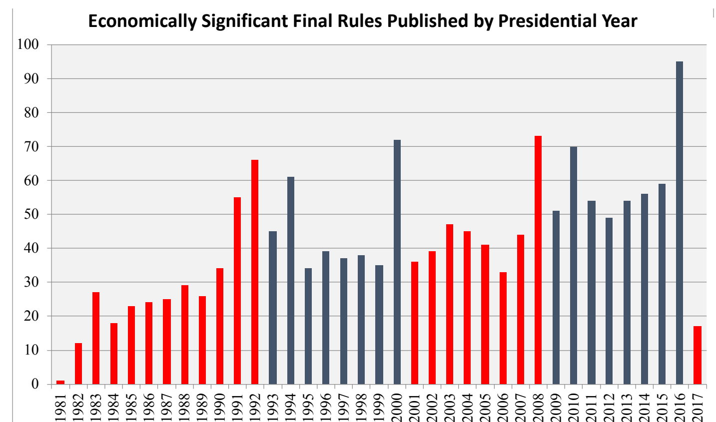
At the end of the day, China's tactics with the U.S. are based on a long game versus a short game. China's Presi-dent Xi Jinping had his term limits removed in March, and President Trump has 2–6 years left, depending on the next election in 2020. This means China can wait it out when it comes to trade. Exporting to the U.S. is very important, and any retaliation will most likely look different. They will talk tough in the media, but their actions will focus on mak-ing it more difficult for U.S. companies to do business in China through increased regulations, more examinations, and holding up shipments. This response is much different from tariffs and can take much more time. All of these is-sues point to a longer road to a solution rather than a swift action. Based on this outlook, we do not view the current trade chatter as an immediate threat to the econo-my. However, we are mindful as the discussions continue.

Business Sentiment

Although trade has been dominating the headlines, there have been some developments inside the U.S. that could prove to be very important going forward. In 2016, the NFIB conducted a survey assessing the top concerns for business owners. The top three issues were (1) cost of healthcare, (2) unreasonable government regulations, and (3) federal taxes on business income. Regarding healthcare costs: President Trump tried to outright repeal the Affordable Care Act but had to settle on repealing the tax penalty for failure to hold qualified healthcare plans. While a total healthcare overhaul isn't in the near future, significant progress has been made in addressing regulatory and tax burdens on businesses.

The regulatory environment under the Trump administration has been one of the most favorable toward business, especially when compared to the previous administration. According to George Washington University's Regulatory Studies Center, the number of economically significant regulations published has plummeted to the lowest level since 1982 (**see Figure 4**).

Figure 4



Source: George Washington University Regulatory Studies Center; Highland Associates

In addition to falling regulations, President Trump has put into place one of the largest tax reform bills in the past half century. With the new tax changes, not only are companies paying lower tax rates, but they are also being incentivized to expand their operations through the expensing of capital projects. The benefits from the tax changes have just now started to trickle through the economy and are expected to provide a tailwind going into the second half of the year.

With the administration addressing two major concerns for business, it is no surprise that business confidence has been on the rise. In fact, business confidence reached its highest level since July 2004, as measured by the Business Confidence

Index published by the OECD. This confidence has also translated into a growing U.S. economy, with second quar-ter gross domestic product (GDP) hitting 4.1%, which is a tailwind for company earnings and capital markets. This bodes well for our risk-on posture.

Diffusion Index

Sifting through the noise to find the noteworthy is a difficult task. That is why we spend a great deal of time focusing on the underlying data to discern the direction of shifts in the investment landscape. This idea was the genesis of the Diffusion Index, which exam-ines fundamental and market data to gain a perspective on whether we are in a risk-on or risk-off environment. We believe that there is not one single factor that can diagnose the environment; therefore, we look at a multitude of inputs divided over six main categories: (1) unemployment, (2) leading economic indicators, (3) monetary policy, (4) interest rates, (5) credit spreads, and (6) equity market momentum.

When we combine the Diffusion Index com-ponents with current events, the picture becomes much clearer. Take our two examples of trade and confidence. In the trade news, there has been a great deal of speculation, but not much action. This would point to the trade talks being noise, not a catalyst for change up to this point. On the other hand, the confidence news seems to be showing up in the data through in-creasing leading economic indicators, falling unem-ployment, and tightening credit spreads. This would seem to confirm that business sentiment has been a noteworthy market catalyst.

How has this method worked in the past? Looking back to 2007, online global economics magazine The Globalist summarized the top headlines for the year. The first half of the year headlines were focused on China's President Hu Jintao, U.S. government outsourcing jobs, the growing income inequality in the U.S., Nicolas Sarkozy being elected in France, etc. With the depths of the financial crisis just around the corner, there was very little mention of it in the headlines.

Looking at the Diffusion Index by each cat-egory, we started to see a much different story. Unemployment seemed to be moving off its lows and began to move higher. The Leading Economic Indicator Index had been in decline for 12 straight months. The U.S. yield curve had been inverted for 11 of the last 13 months. The Fed had paused raising the Fed Funds rate in 2006. High yield spreads widened by more than 100 basis points from June to July. Equity markets were continuing to experience positive momentum even though they had two consecutive months of losses. Not all the data points were pointing to a risk-off position in July, but most were indicating that risk needed to be reduced in portfolios.

Fast forward to the end of the financial crisis, late June 2009. Warren Buffet claims U.S. economy in shambles, "no signs of recovery yet." However, one month later, Highland's Diffusion Index flipped from risk-off to neutral and turned to risk-on in January 2010. In July 2009, credit spreads, yields, and equity market momentum were turning positive. By January 2010, all areas we were monitoring were extremely positive.

Today, we are seeing positives in all areas except for interest rates (**see Figure 5**). Unemployment is at the lowest level since January 2001. Leading Economic Indicators continue to imply sustainable strength led by an increase in new orders on the back of higher business spending. Monetary policy remains on a tightening path but has yet to become restrictive. The yield curve is flattening but isn't close to inverting. Credit spreads remain tight and equity market momentum remains positive.

Although economic growth remains solid in the U.S., it has slowed in emerging markets. We are watching to see if this could spread through tightening financial conditions and a widening in credit spreads, but so far, this has not transpired. The flatness of the yield curve, which is at levels last experienced in 2007, is another indicator we are watching closely. While the spread between long and short rates has declined substantially the last year, it is still sloping upward. Furthermore, it is important to note that it is an inverted yield curve that has been associated with recessions, not a flat yield curve. This is an indicator that we and the Fed are closely monitoring. If this were to invert, this could warrant a change in positioning.

Figure 5

Source: Highland Associates

Conclusion

That brings us back to the question: What is noise and what is notable? Today, we are seeing confirmation in expanding business sentiment fueled by the late-cycle fiscal stimulus. This has led us to maintain our risk-on stance by overweighting public equities and diversified alternative strategies and underweighting fixed-income strategies. We are also favoring U.S. equities over international equities, with a tilt toward mid/small cap over large due to the following reasons:

- *Small and midcap equities have much higher exposure to the U.S. economy in driving revenues and earnings.*
- *These companies benefit more from lower corporate taxes.*
- *They are less likely to be impacted in a global trade war.*
- *Small and midcap benefit from less regulations due to their higher fixed cost base.*

While the trade game continues to change daily, we do not view this as an immediate threat to our current risk-on stance. As the situation changes and we can confirm the impact, we will change our positioning accordingly. When the only constant is change, being dynamic is the order of the day.

IMPORTANT DISCLOSURES: Highland Associates, Inc. ("Highland") and FSA Investment Group, LLC ("FSA-IG") have entered into an agreement whereby Highland will support FSA-IG in the areas of asset allocation, capital market research and manager research. Highland and FSA-IG will collaborate in the construction of model portfolios for FSA-IG's clients. FSA-IG is solely responsible for the consulting services and discretionary management of their client portfolios as set forth in the Investment Advisory Agreement by and between FSA Investment Group, LLC and Highland Associates, Inc.

The information contained herein is provided as of the date first set forth and are the views and opinions of Highland Associates, Inc. While Highland has tried to provide accurate and timely information, there may be inadvertent technical or factual inaccuracies or typographical errors. Highland assumes no duty to update any such information for subsequent changes of any kind. This information is confidential and may not be disseminated without prior written consent from Highland Associates, Inc.

Receipt of this report is intended for FSA Investment Group's investors and/or their representatives; it is for informational purposes only, and should not be construed as investment advice or a recommendation by FSA Investment Group, LLC or Highland Associates, Inc. to purchase or sell any securities or any other financial instrument. Investing involves a high degree of risk, and all investors should carefully consider their investment objective and the suitability of any investment program. Forward looking statements are based upon assumptions which may differ materially from actual events. This information should not be relied upon in making an investment decision.

This portfolio commentary is provided for informational purposes only and may contain forward-looking statements that may not come to pass. All information is subject to change without notice and should not be relied upon for any investment decision. This writing is provided for the sole use of its intended recipient and may not be distributed to any unauthorized third parties without the prior written approval of FSA Investment Group. Investing involves the risk of loss, including the potential loss of principal, and past performance may not be indicative of future results. There can be no assurance that any investment strategy will provide profitable or that any asset class will achieve the return expectations set forth above. Please contact FSA Investment Group if you have questions about this commentary and refer to the account statements generated by your custodian for official account data.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

Authors:

R. Scott Graham, CFA, Chief Investment Oficer, Highland Associates

J. Andrew Webb, CFA, CPA Director, Highland Associates

FSA INVESTMENT GROUP
308 SOUTH ALCANIZ STREET
PENSACOLA, FLORIDA 32502

Telephone: 850.696.1550
Fax: 251.459.6918
Email: info@fsa-ig.com