ATLANTA CAPITAL
INVESTMENT MANAGERS

October 10, 2017

Bill Hackney, CFA
(404) 876-9411
www.atlcap.com

Have you noticed? Clowns—evil clowns—are creeping into our popular culture. A few weeks ago the movie "It" premiered, featuring the evil clown Pennywise. An adaption of a Steven King novel by the same name, this horror film was a big box office hit.

Then there's the launch of the sixth season of "American Horror Story" on the FX channel. Episode one opens with last November's surprising election results, which quickly sends the lead character into an emotional tailspin. Watch the series and you will find evil clowns haunting or killing someone in almost every episode.

Given the chaotic state of the world and the rancor in American politics, it's no wonder that evil clowns have found their way into our culture. There's "Rocket Man" Kim Jong-Un in North Korea. There are acts of terror and political protests. There are devastating natural disasters. And, of course, there's you-know-who in Washington . . . actually, there's a bipartisan list of characters you could plug in here.

When I think of clowns, I don't immediately think of evil clowns, but of a song by Stephen Sondheim. Recorded by Judy Collins, Frank Sinatra, Barbra Streisand and other great vocalists, "Send in the Clowns" is a melancholy melody with some seemingly bizarre lyrics. Why the reference to clowns? Sondheim once explained: "It's a theatrical reference meaning if the show isn't going well, let's send in the clowns, in others words, let's do the jokes."

Something good is going on

In analyzing the key events of recent months, it occurred to me that the American media—from network news to individual tweets and Facebook posts—is too focused on the bad news in our culture. This has created an impression among many investors that things aren't going well. Yet, the US stock market hit record highs during the third quarter. In terms of both duration and amplitude, the bull market that began in March 2009 is one of the best on record. Surely something good is going on?

It's time to send in the clowns. Here is some good news that you might have missed during the past few months. It might not make you laugh, but it should make you smile.

American consumers are in the best financial shape ever. Two goverment reports in September caught my eye. The Federal Reserve reported that the total net worth of US households (assets like stocks and houses, less debts like mortgages and credit cards) pushed further into record territory during the second quarter with a $1.7 trillion advance. Household net worth has now increased for seven consecutive quarters.

Since the net worth data is biased toward the wealthy, the trend in household incomes is a better indicator of the financial health of the typical American. So, the second report that caught my eye was the US Census Bureau's annual report, "Income and Poverty in the United States: 2016," which publishes data on real median household income. (A *median* measures the midpoint of a distribution of data, so it's unaffected by extremely high or low values. And *real* indicates that the data have been adjusted for inflation.)

Remember hearing during last year's political campaign about "middle class incomes stagnating" and "the average worker hasn't had a raise in 15 years." This is the report that provided the basis for these assertions, because since 2000 real median household income has generally drifted lower. But this isn't the case anymore. According to the Census Bureau's recent report, real median household income has posted a healthy gain in both 2015 and 2016. And last year's gain of 3.2% was sufficient to push household income to a new record of $59,039. The previous record high was set in 1999.

The United States is the second most competitive economy in the world in 2017, trailing only Switzerland, according to a closely watched index from the World Economic Forum. The US climbed one spot since last year's rankings, reaching its highest place in eight years, possibly reflecting executives' early optimism that a new administration would enact business-friendly policies. . .

~Wall Street Journal
September 27, 2017

Today, real consumer incomes are growing again much like they did during the halcyon days of the late 1980s and 1990s. What's more, in 2016 consumer income growth was best among females and households of ethnic minorities. In fact, the bureau notes that this was the first time that the female-to-male earnings ratio has recorded an annual increase since 2007. That should be cause for celebration.

Healthy manufacturing

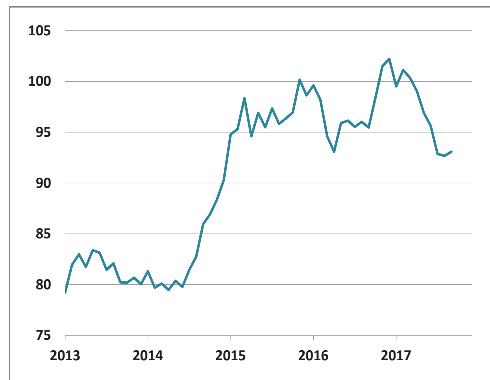
Not to be outdone by consumers, **our much-maligned American manufacturing sector is experiencing its best growth in over a decade**. One of the best ways to track manufacturing is The Institute of Supply Management's index of US manufacturing activity, called the Purchasing Managers Index. The PMI climbed to 60.8 in September, its highest reading since 2004. Of the 17 industries tracked, all but one (furniture and related products) recorded an improvement last month. Importantly, the new orders component of the index jumped 4.3% to 64.6. Strong order growth is a harbinger of further improvement in manufacturing in the months ahead.

When gauging the health of manufacturing, it's important not to confuse growth in production with growth in jobs. In order to remain competitive in world markets, US manufacturers have scored huge gains in productivity (output per hour worked) over the years. As a result, factory workers have steadily shrunk as a percentage of the labor force. Today they represent about 9% of total jobs, down from 18% in the mid-1980s. During the 2002-2007 economic expansion, factory jobs declined by two million, despite strong growth in factory output. In the current expansion, factory jobs have actually increased by one million from their low in 2010.

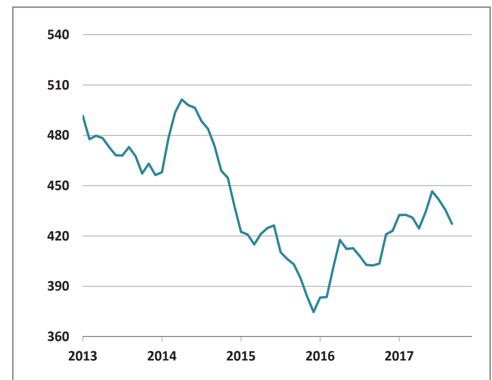
Despite being a small part of our labor force, manufacturing accounts for about 13% of our GDP and about 42% of the market capitalization of the S&P 500® index. It is more important to the stock market than to the economy or labor market.

The strengthening US dollar in 2014-2016 and falling industrial commodity prices in 2014-2015 hurt US manufacturing and energy related industries during these years (see charts). That's the primary reason that corporate earnings, measured by the S&P 500 index, flatlined between mid-2014 to mid-2016.

US Dollar Index (DXY)



Commodity Prices (CRB)



Sources: Bloomberg as of September 30, 2017. Data provided is for informational use only.

Prices for many industrial metals have tumbled to their lowest levels in weeks, as investors react to signs that central banks around the world are gearing up to unwind stimulus programs. Copper prices have fallen 7.5% from their September high and are hovering near their lowest levels since early August. Nickel is off roughly 14% from its recent peak, while iron ore is down 17%.

~ Wall Street Journal
September 26, 2017

Here in 2017, S&P 500® earnings are growing again thanks to a weaker dollar, higher commodity prices and the emergence of a synchronized global economic expansion. For the first time in the last 10 years, all major parts of the global economy—developed countries and emerging markets, Europe, Asia, Brazil, Russia and the US—are experiencing growth. S&P 500® earnings should hit $130 in 2017 for a 9% gain over the prior year. If the synchronized global expansion remains on track, S&P 500® earnings should hit $140 in 2018.

Continued healthy earnings growth will be crucial to further stock market gains. With the S&P 500® up about 15% since the beginning of the year, the market's price/earnings ratio has stayed around 20 times trailing four quarter earnings. That's relatively high by historic standards and is unlikely to rise further if interest rates and inflation drift up in the months ahead.

Two key threats

What could go wrong with this picture? I see two key interrelated threats to the global economy and the stock market. Both will impact the credit markets first, so equity investors need to keep a sharp eye on the debt markets.

Private equity transactions have hit a post-financial crisis high this year as cheap debt and record sums of ready cash lifted the value of deals to $212bn. . . Fueling the boom are more relaxed debt terms while the easier access to loans is also firing deal activity.

~ Financial Times,
September 29, 2017

The first of these is what some have called the "Great Unwinding." Over the past nine years, the Federal Reserve, followed by the European central banks, engaged in an unconventional monetary policy called quantitative easing or QE. This involved the central banks purchasing massive amounts of government and mortgage debt in an effort to push down long-term interest rates and force investors into more risky assets in the hope that all this would eventually spur economic growth. Little economic growth was created, but the prices of risky assets like stocks, real estate, private equity, junk bonds and emerging market debt surged.

Beginning this month, the Fed will begin unwinding its $4.5 trillion hoard of treasury and mortgage debt that's been accumulated during QE. It will do so by letting these bonds mature. The Fed's massive balance sheet runoff will be slow at first, but should ramp up to $50 billion per month by early 2018 and continue through 2020. Just as QE tended to force interest rates down, it stands to reason that the Great Unwinding could put upward pressure on rates over the next few years.

The second threat is the pace of the current synchronized global economic expansion. Too rapid economic growth coupled with the Great Unwinding could

Atlanta Capital Management Co., LLC
1075 Peachtree Street NE
Suite 2100
Atlanta, GA 30309

More than 50m Americans live in districts that are mired in a "deep ongoing recession", with falling employment and a shrinking business base, according to a report that highlights the fractured nature of the US recovery. . . . Southern states, including Alabama, Arkansas and Louisiana, account for more than half the population in distressed communities, the report says . . . The research highlights profound economic divisions, even at a time when the country is in its third-longest recovery on record and when median incomes have just seen the strongest two-year surge in modern times.

~Financial Times
September 26, 2017

cause longer-term interest rates to spike up, putting downward pressure on riskier assets like stocks and real estate.

One reason that the current economic recovery and bull market have lasted as long as they have is that heretofore, the global economy was not synchronized. Just as the US recovery got underway in 2010-2011, much of Europe slipped back into recession. Then, as Europe recovered in 2013 and 2014, commodity prices weakened and China experienced a crisis in its property sector. The emerging market economies—once the engine of global growth—sputtered through 2015 and much of 2016. This unsynchronized, substandard, crisis-prone recovery (2009-2016) prevented economic excesses from developing, created deflation and allowed central banks to pursue an extraordinarily easy monetary policy.

Early stages of synchronized expansion

Now the economic news is getting better fast. A synchronized global expansion began to unfold in late 2016 and is gathering steam. In reaction, central banks are attempting to normalize monetary policy. So far at least, this synchronized expansion is in its early stages and we haven't yet seen an acceleration in inflation which portends a tightening in monetary policy and significantly higher interest rates. Indeed, consumer price inflation in the US is lower now (1.9%) than at the beginning of the year (2.5%).

My belief is that stock prices can continue to work their way higher as long as bond yields and inflation remain well behaved. The global economic expansion seems capable of producing annual corporate earnings growth of 6% to 9% through 2018. That's sufficient enough to push the broad stock market averages higher, even though they currently trade at around 20 times earnings. The economic environment should favor cyclical sectors like Technology, Financials, Industrials, Energy and Materials over defensive, dividend-oriented sectors like Consumer Staples, Real Estate, Utilities and Telecomm Services.

When will interest rates and inflation begin to interfere with equity valuations? In my view, it's when 10-year Treasury yields (now 2.3%) move north of 3.5% and/or consumer price inflation (CPI) moves north of 3.0%. In the meantime, investors should maintain a heavy commitment to the equity market and anticipate that scary headlines are more likely to emanate from the political realm than the global economy. ☘

This material is presented for informational and illustrative purposes only and should not be construed as investment advice, a recommendation to purchase or sell specific securities, or to adopt any particular investment strategy. The opinions expressed herein are those of the author and do not necessarily reflect the views of other employees at Atlanta Capital Management. Any current investment views and opinions/analyses expressed constitute judgments as of the date of this material and are subject to change at any time without notice. Index and commodity changes are based on price-only percentage change. This material has been prepared on the basis of publicly available information, internally developed data, and other third party sources believed to be reliable. However, no assurances are provided regarding the reliability of such information and Atlanta Capital has not sought to independently verify information taken from public and third party sources. This material may contain statements that are not historical facts, referred to as forward-looking statements. Future results may differ significantly from those stated in forward-looking statements, depending on factors such as changes in securities or financial markets or general economic conditions. **Investing entails risks and there can be no assurance that any forecasts or opinions expressed in this material will be realized. It is not possible to directly invest in an index. Past performance does not predict future results.**