Investor Intelligence

Newsletter©

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From the Executive Desk

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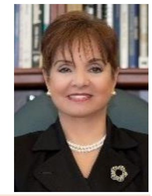
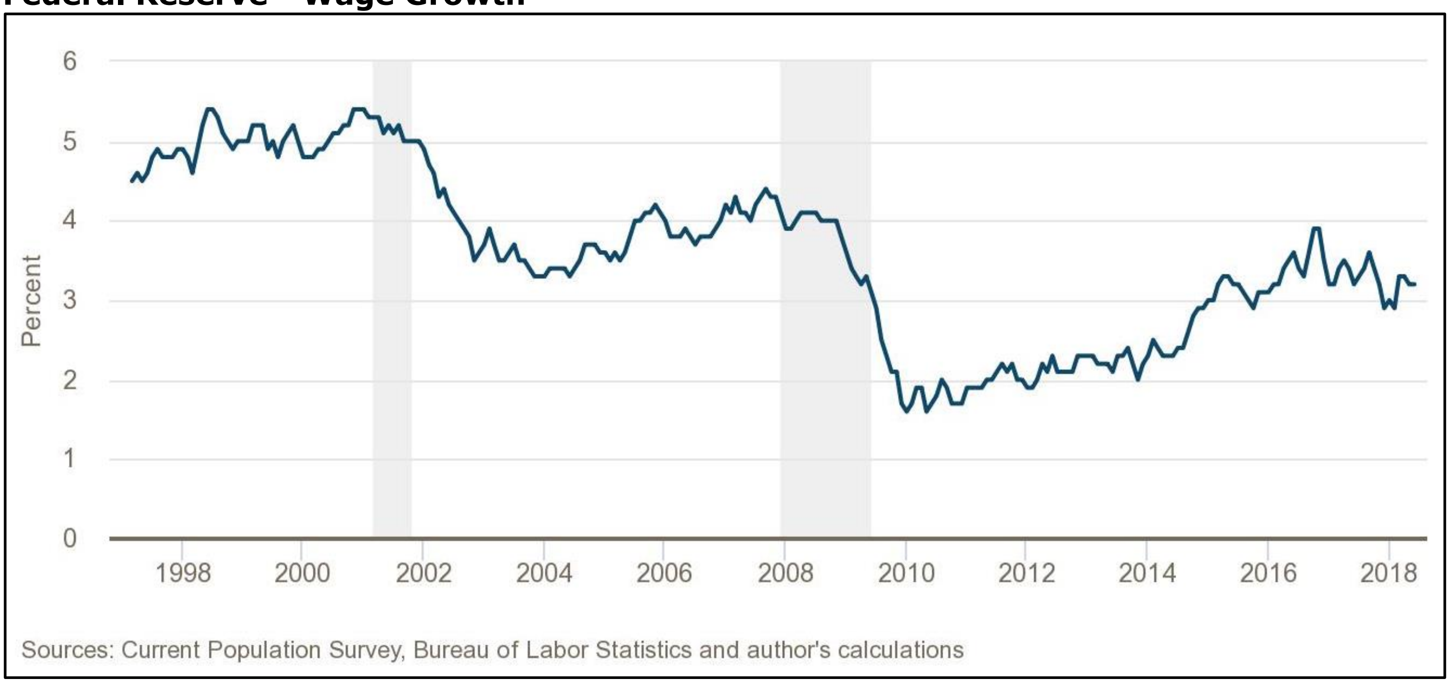
Founder & Chief Executive Officer



As I read recently in the New York Times, corporations have been reaping the benefits of the economic upswing the U.S. has experienced over the last 3 years, while employee paychecks are still lagging far behind from historical trends (see the graph below). There are several explanations for this; hourly earnings move forward at a slower pace than profits; the use of independent contractors and the weakening of labor unions has put workers at a disadvantage; threats to move operations overseas, where labor is cheaper, continue to loom; and super-efficient tech companies have changed the labor/production equation through the use of information and communications technology. Nevertheless, since the economic crisis ended in 2009 corporate profits have grown at an annualized rate of 6.5%. In comparison, yearly wage growth has yet to reach 3%. In 2000, when the unemployment rate fell below 4%, as it has this year, corporations received 8.3% of the nation's total income in the form of profits. Now corporate profits are at 13.2%. In these same periods workers' compensation across the entire workforce has fallen from 66% to 62% of national income. Maybe at this point in the recovery of the U.S. economy, shifting some of those corporate profits to workers can have significant social benefit without affecting inflation. Better wages can lead to better benefits such as paid vacation, paid sick leave, health insurance and life insurance, among others factor that contribute to a better quality of life. But, this recovery seems to be more about providing "quantity" over "quality" of jobs and, after keeping rates near zero during the recession and timidly raising interest rates as the economy recovered, the Federal Reserve now has to deal with tariffs that will push prices higher. With a mandate of keeping inflation under control and maximizing employment, the Fed will most likely seek to dampen spending and investing by continuing to raise interest rates. They would rather curb economic activity before the economy runs "too hot" and head towards a "downturn". Wage increases traditionally signal the Fed that the heat in the economy is on. However, the conventional wisdom that higher wages inevitably lead to higher prices, is not supported by empirical evidence. A study by the Federal Reserve Bank of Cleveland, for example, concluded that "the connections among wages, prices, and economic activity are more akin to a tangled web than a straight line," and that "the ability of wages to help predict future inflation is limited." The recent tax overhaul has propped corporate earnings further, but this is yet to translate into higher wages. Economic inequality in the U.S. continues to be very high in comparison to other developed economies, and the disparities seem to have no end in sight.

Federal Reserve - Wage Growth



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Economic Perspectives

Edmundo J. Garza
President

According to the International Monetary Fund's World Economic Outlook (WEO) update for July 2018, global growth is projected to reach 3.9% in 2018 and 2019, in line with the most recent forecasts. However, the expansion has become less even, and risks are mounting. The rate of expansion appears to have peaked in some countries and growth has lost last year's wonderful synchronicity. Growth in the United States remains in line with the April WEO forecast, while projections have been revised down for the euro area, Japan, and the United Kingdom. Among emerging market and developing economies, growth prospects are also becoming more uneven, amid rising oil prices, escalating trade tensions, and market pressures on the currencies of some economies with weaker fundamentals. Growth projections have been revised down for Argentina, Brazil, and India, while the outlook for some oil exporters has strengthened. The balance of risks has shifted further to the downside. The recently announced and anticipated tariff increases by the United States and retaliatory measures by trading partners have increased the likelihood of escalating and sustained trade actions. These could derail the recovery and depress medium-term growth prospects, both through their direct impact on resource allocation and productivity and by raising uncertainty and taking a toll on investment. For the IMF, avoiding protectionist measures and finding a cooperative solution that promote continued growth in goods and services trade are essential to continued growth. Policies and reforms should aim at sustaining activity, raising medium-term growth, and enhancing its inclusiveness.

Indicators (As of July 10, 2018)

United States:
CPI: 2.8% Chg. from yr. ago
Unemployment Rate: 4.0%
GDP: 2.0% Comp. Annual rate of Chg. on 2018:Q1
Ind.Prod.Index: +0.6% change from previous month
Source: *St. Louis Fed. Res.*

Eurozone:
CPI: 1.9% Chg. from yr. ago
Unemployment Rate: 8.4%
GDP: 0.4%, Comp. Annual rate of Chg. on 2018:Q1
Ind.Prod.Index: 1.3% change from previous month
Source: *Moody's Analytics*

Japan:
CPI: 0.7% Chg. from yr. ago
Unemployment Rate: 2.2%
GDP: -0.2%, Comp. Annual rate of Chg. on 2018:Q1
Ind.Prod.Index: -0.2% change from previous month
Source: *Moody's Analytics*

Puerto Rico:
CPI: 0.0% Chg. from yr. ago
Unemployment Rate: 9.3%
Payroll Employment: -4.0% Chg. from yr. ago
GDB Econ. Act. Index: -7.9% Chg. from yr. ago
Source: *Economic Development Bank of Puerto Rico*

Market Recap

Evangeline Dávila, CIMA®
Chief Research & Investment Officer

Stocks: The global economy has enough momentum and financial conditions are still accommodative, but it seems we are in the late stage of the market cycle where increased volatility is to be expected. Optimism for US equity investors has been tempered by a number of factors: Rising bond yields continue to weigh on valuation multiples; a tougher environment appears ahead for corporate earnings with rising borrowing costs; and trade frictions remain a risk. However, an underweight to emerging markets seems recommendable as they face headwinds from a firmer US dollar, global bond yields trending higher and moderating Chinese growth.

Bonds: As we reach the middle of the year, fixed income investors face a sideways market as slowly rising (normalizing) yields grind against the time required for higher coupons to make a positive contribution. Active management to navigate the yield curve and pick-up additional yield through credit instruments could provide the opportunity for small, single digit positive gross returns.

Alternatives: The nascent recoveries emerging in Brazil and Russia, some of the world's top commodities producers, are now threatened by political developments. In the case of Brazil, there is concern about upcoming elections and a lack of progress with the reform agenda. In the case of Russia, sanctions risk is offsetting optimism from rising commodities prices. India is probably one of the better commodity producer stories as it does not face any of the political clouds that hang over China, Brazil and Russia.

The Advisor’s Corner

Eileen Rivera
Due Diligence Officer & Investment Adviser

T. Rowe price recently published an article in the Financial Analysts Journal, which explains one of the most vexing problems in investing; that the expected effects of portfolio diversification seem to disappear when facing down markets. Of course, the statement that “all correlations go to 1 in a crisis” is both an oversimplification and an exaggeration, but it has been well documented that correlations tend to increase in down markets and the effect seems to be pervasive for a large variety of financial assets. Historically, when market sentiment turns negative all of a sudden and fear grips the market, government bonds almost always rally because of the flight-to-safety effect. This is why the expected stock–bond correlation is one of the most important inputs to the asset allocation decision. However, it may be difficult to estimate, and can change drastically with macroeconomic conditions. In fact, inflation and interest rates have been known to drive market volatility *more than* business cycles and risk appetites at some times in the past. Investors should emphasize the stock–bond correlation and consider whether it will continue to be negative in the future, as shocks to interest rates or inflation can turn this correlation positive. In such situations, strategies that use leverage to increase the contribution to the risk of bonds may experience unexpected drawdowns. Sample correlations can be misleading. Prudent investors and managers should not use them in risk models without adding other tools, such as downside risk measures and scenario analyses. To enhance risk management beyond naive diversification, investors could optimize portfolios with a focus on downside risk, and depending on aversion to losses, evaluate the value of downside protection as an alternative to asset class diversification.

What to Do?

With the first half of 2018 closed, the environment and general mood in the market remains cautious. The broader, macro-oriented stories to watch include continuing tensions between the U.S. and its key global trade partners (Eurozone and China chief among them); the pace of rises in both domestic and global interest rates and inflation; the return of equity volatility; changes in currency trends; and further policy normalization by global central banks. ***Amid an uncertain scenario we continue to recommend prudent asset allocation and risk assessment, based on future capital needs, for plan sponsors, institutions and individual investors. Due diligence reviews and an adherence to a well-developed investment policy remain the most prudent course for long-term investors. Continued fiduciary education is paramount.***