TEMPO
Financial Advisors, LLC

550 Cochituate Road, Suite 25 ■ Framingham, MA 01701
Tel 508.655.7827 ■ Fax 508.655.7829
www.TempoAdvisors.com

THE TEMPO VANTAGE

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Economics 101 For Presidents

The upward trending, low volatility stock market that had been in place for nearly two years continued as we began 2018. Through January 26th the S&P 500 was up 7.5%. Then the trend abruptly changed.

Over the next nine trading days the market dropped just over 10%, marking the first correction (defined as a drop of over 10% but less than 20%) since late 2015.

What changed? Rising interest rates and the fear of further increases, both of which harm the stock and bond markets. More on this below.

After the initial decline the market has remained volatile but hasn't gained or lost much.

For the quarter as a whole the S&P 500 was down 0.76% and international stocks were down 1.5%. Most other categories were plus or minus break even.

Despite the increase in volatility the sectors that had been in and out of favor have remained the same. The outliers on the positive side continue to be technology and defense stocks, both of which were up 5%. On the negative side were stocks more vulnerable to rising interest rates such as utilities and real estate, which were down 3% and 7%, respectively.

Bonds did poorly in the first quarter as interest rates were generally rising. Most U.S. bond categories were down 1% for the quarter. To find anything that made money in bonds you either have to look internationally or in nontraditional areas of the bond market such as global bonds (+1%), bank loan bonds (+1%), and convertible bonds (+1.8%).

With each day we get a new tweet from our President. As far as the market is concerned the most important information coming out of the White House has to do with policy changes that could have an impact on inflation. Unfortunately most of that information shows a complete misunderstanding of basic economic principles.

Any economist worth their salt knows what NAIRU is. NAIRU stands for the Non-Accelerating Inflation Rate of Unemployment.

The basic idea is that there is a natural rate of unemployment. Think of this like supply and demand for employers vis-à-vis employees. If unemployment is higher than the natural rate there is an excess of potential employees and employers can hire workers at lower wages.

Lower wages, lower inflation. Conversely if unemployment is lower than the natural rate employers will compete for qualified workers and salaries will rise. Higher wages, higher inflation.

According to this theory the government shouldn't try to reduce unemployment once it is below the natural rate to avoid igniting inflation.

The Fed considers the natural rate of unemployment to be somewhere between 4.5% and 5%. The unemployment rate in the United States has been below 4.5% since April of 2017 and currently stands at 4.1%.

Clearly Trump has never heard of NAIRU as most of his rhetoric is about making America great again and bringing jobs back. I have news for him: The jobs are back!

One saving grace is that the calculation for unemployment may have a bit more slack than usual. Unemployment measures the number of people who report to be looking for work as a percent of our population. During the Great Recession (2008-9) many people simply stopped looking for work. People not seeking employment don't count toward the statistic.

With unemployment at 4.1% it is quite possible that people who had previously given up and no longer reported looking for work are being enticed to rejoin the job market. This could help unemployment stay at current levels even as jobs are created.

The second economic concept that Trump has clearly not read the memo on is Trade Wars. Economists know that you can't win a trade war. No one wins in a trade war.

Trump thinks that imposing tariffs on foreign goods will reduce our trade deficit. What he doesn't understand is that while trade policies can change the balance of trade with a specific country (i.e. China) they won't change our overall trade deficit.

Trade of goods and services and monetary flows are symbiotically linked. Import tariffs strengthen the U.S. dollar which makes U.S. goods less attractive to foreign buyers, makes foreign goods more attractive to U.S. buyers, and shifts the trade deficit elsewhere.

Moreover, trade wars are inflationary. New tariffs would reduce the volume of both imports and exports, leaving Americans poorer by depriving them of additional gains from the specialization that accompanies expanding international trade. According to the Council of Economic Advisers "Imports of goods have kept inflation low, while imports of capital (i.e. foreign investors buying our financial products) have kept interest rates low, helping to sustain growth."

It is difficult to say how hard this President will push for more tariffs.

I think he is more bluster than anything. It is the only way he knows how to negotiate. But retaliatory taxes by other countries will hurt Trump's base more than anyone and nothing gets to Trump like declining support among his base. Eventually he will ease his trade rhetoric. At least I hope so.

There is still hope on the inflation front. If the unemployment rate levels off (or even ticks up a bit), if trade tensions ease, and if the Fed raises rates with just the right amount of finesse we might be able to keep the economy in good shape.

Tempo Financial Advisors' 1st Quarter Investment Performance

All three of Tempo's investment strategies beat their benchmarks in the first quarter, something we always like to see. As it happens only one of the three also managed a gain.

Tempo Dynamic Growth made 0.9% in the first quarter, which was nearly 2% better than its benchmark. This is the ultimate success for any investment strategy - to make money when the benchmark loses. Our allocations to technology (+5%), international small growth (+3.7%), and emerging market equities (+1.8%) more than offset modest losses in our other holdings.

Dynamic Growth accounts have been rebalanced for the second quarter with portfolios becoming a bit more conservatively positioned than they have been for a while.

Tempo Dynamic Income lost 0.4% in the first quarter. As you know we never like losing money. Still our negative return was between 0.5% and 1% better than most bond benchmarks. The bright spot was our allocation to convertible bonds (+3.5%). But losses in other holdings dragged us into negative territory.

Dynamic Income accounts have also been rebalanced for the second quarter and they too are now more conservatively positioned. For the first time in quite a while we own no alternatives (lower risk investments that don't correlate highly to stocks or bonds). Only bonds. The bonds we own are not your main street sort of bond. We own bank loan bonds, emerging market bonds, global bonds and convertible bonds.

From a slightly longer term perspective I am pleased to report that **Dynamic Income** and **Dynamic Growth** are both 4.5% ahead of their respective benchmarks for the one year ending 3/31/18.

Tempo Lifestyle accounts, regardless of risk level, were all just about break even for the quarter. This was about 1% better than benchmarks.

Our overweight positions in technology and defense stocks continue to boost performance on the equity side. So do our somewhat unconventional bond positions: inverse bonds (+4%), bank loan bonds (+1%), global bonds (+1%).

For the one year ending 3/31/18 **Lifestyle** accounts are in line with benchmarks.

Reminder

Please contact us if there has been a change in your financial circumstances that would warrant a fresh perspective on your portfolio.

Daniel J. Traub