Global Economic and Market Commentary

Summary

- Whereas the US large and small-cap equity and high yield indices finished the first half with positive returns, non-US equities, especially EMs and investment grade credit, suffered the most from the rise in trade tensions, Eurozone political risks and volatility shocks.
- Within equities, tech and energy remain the best performing global sectors. Brent crude rallied 23.5% and the trade-weighted dollar appreciated by 4.3%. Financials performed poorly as US and global yield curves flattened or inverted.
- Our base case outlook calls for a 1.9% return on the S&P 500 in 2018 as compared with 4.4% in our previous outlook mainly due to multiple compression as a result of increased policy uncertainty.
- We are reducing our overweight in tech and growth stocks where global forward price earnings ratios are at least one standard deviation above the mean. We are also reducing our non-US overweight because of the increased risk of a Chinese currency crisis and a deterioration in European growth prospects both as a result of increased trade tensions.
- We are taking a more defensive stance in global equities since the probability of a global growth slowdown in 2019 has increased.

"Nowadays people know the price of everything and the value of nothing." –*The Picture of Dorian Gray by Oscar Wilde.*

Domestic equities led global markets in the first half of the year reflecting the strength in US growth relative to other global economies, elevated earnings from the new tax bill and moderate domestic inflation expectations. The S&P returned 3.43% in the quarter and 2.65% year-to-date through June 30th. The attractiveness of US Treasury yields and a global flight to quality amidst trade policy uncertainty fueled US dollar strength and helped domestic fixed income to tread water in the second quarter despite a more hawkish statement from the Federal Reserve in June. The Bloomberg Barclays US Aggregate Index declined 0.16% while high yield and municipal bonds returned 1.03% and 0.87% in the quarter, respectively.[1]

> Domestic equities outperformed and the US dollar strengthened

International equities fared worse with emerging markets (EMs) and specifically, Latin America leading non-US markets lower. While resilient initially, EMs ultimately succumbed to unpredictable trade policy late in the quarter. EMs were down 7.96% in the second quarter and now stand at down 6.66% year to date. The US dollar hit an 11-month high in June and we best characterize the current environment as similar to the period immediately following the election in 2016.

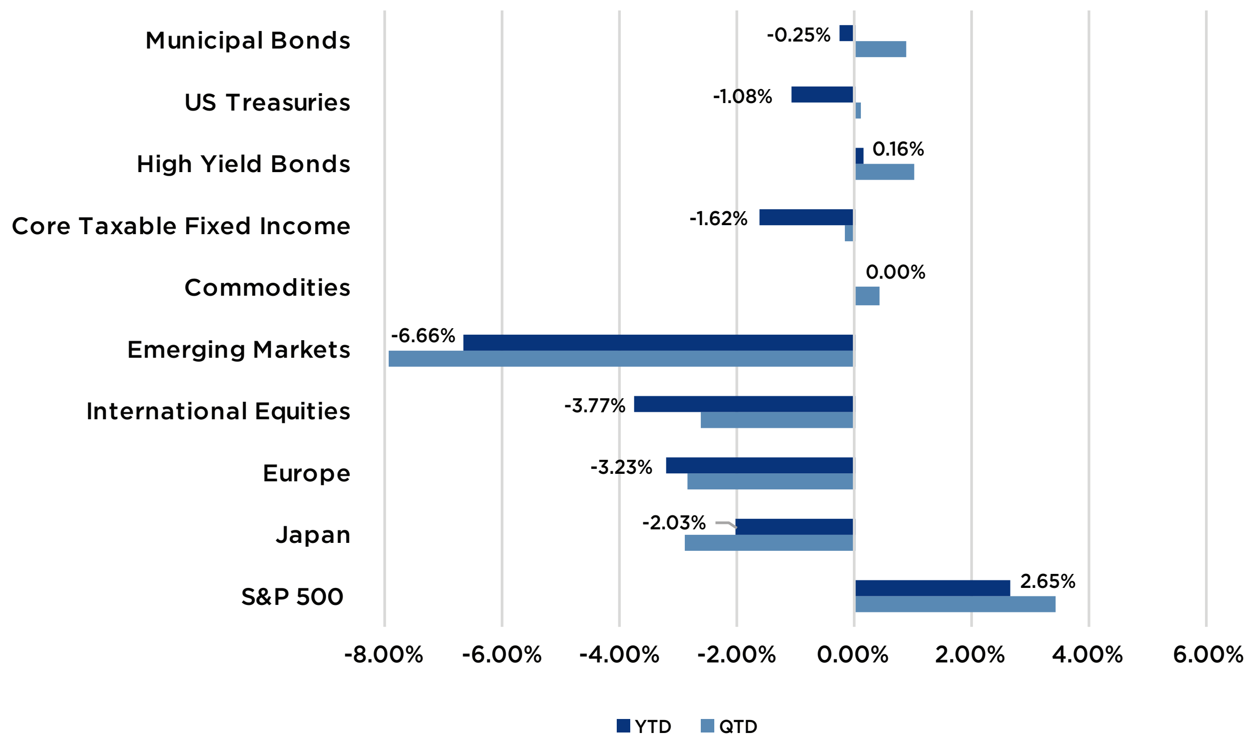
Developed international markets performed better than EMs with the MSCI EAFE Index down 1.24% for the quarter and down 2.75% year-to-date. A surprise slowdown in Europe and Japan,

[1] The Bloomberg Barclays US Corporate High Yield Index returned 1.03% and the Bloomberg Barclays Municipal Index returned 0.87%.

Italian politics and Brexit weighed on equity returns, though the recent currency depreciation should boost growth in the second half of 2018 as the European and Japanese economies remain on stable footing.

We view the risks of contagion as low. The periphery of Europe has been repairing its economies since 2012 and the ECB now has a better playbook to address these countries if they begin to struggle again. Also, EM capital accounts are significantly more in balance than they were in the late 1990s and more debt has been issued in local currencies. That being said, we have downgraded our expectations for global growth relative to the end of 2017 as non-US economies have stumbled year to date. Until the data improves or the "tit for tat" tariff talk (and Tweets) evaporate, we remain cautious in our approach to risk assets and require a greater margin of safety. Most valuation benchmarks are near post-1989 averages, so we remain invested in equities but favor higher quality, more defensive companies. Also, we no longer prefer non-US equities to domestic equities despite the valuation discount. In fixed income, we are reducing our exposure to credit, specifically high yield bonds, as spreads are near historically tight levels and allocating the proceeds to short duration investment grade bonds.

EXHIBIT 1: GLOBAL CAPITAL MARKET RETURNS YTD THROUGH JUNE 30, 2018



Source: Bloomberg

Likely Tariff Changes

Trade and Tariffs

The trade war initiated by President Trump is the biggest threat to US as well as global growth. Until the latter part of June, "the trade war" had been mainly a war of words, with actual tariffs imposed on washing machines, solar panels, steel and aluminum, being relatively insignificant. Recent developments suggest that the amount of tariffs actually implemented will rise substantially. On June 15, the White House confirmed that a 25% tariff on up to $50 billion of Chinese imports would soon go into effect. Three days later, after China promised to retaliate on a similar scale, the President further widened the potential tariffs to cover an additional $200 billion in imports at a 10% rate with an additional $200 billion ready if needed. Trump also mentioned possible US tariffs on auto and auto parts imports. A breakdown of these potential tariffs is shown in Exhibit 2.[2]

EXHIBIT 2: PRESIDENT TRUMP'S MAIN TRADE THREATS AND ECONOMIC IMPACTS

	Quantity of US annual imports, $ billion	Likely tariff rate, per cent	% of US total imports of goods, 2017	% of US nominal GDP, 2017
US tariffs already announced on China	**50**	**25**	**2.1**	**.2**
Extra tariffs on China if China retaliates	**200**	**10**	**8.4**	**1.0**
Back stop in case of further China retaliation	**200**	**10 (?)**	**8.4**	**1.0**
Tariffs on all auto imports into the US, incl. parts	**360**	**25**	**15.1**	**1.9**
Overall Total	**810**	**17**	**34.0**	**4.1**

Source: Fulcrum Asset Management

If all these tariffs were imposed, it would represent the largest tariff increase since the 1930s. However, this will not occur until China fully retaliates and until the US selects products and receives industry comments, a process that could take months. The European Union, along with Canada and Mexico, have imposed retaliatory tariffs in response to America's actions against steel and aluminum and further retaliation is likely if Trump imposes tariffs on European automobiles, as he has threatened to do.

[2] See Gavyn Davies, Financial Times, June 24, 2018.

President Trump believes he has a stronger bargaining position and the US will come out with a better final deal in an escalating trade war, especially one involving China, as America buys from China almost four times as much as it sells. This limits China's ability to match tariffs. President Trump hopes that China's small value of imports from the US in relation to its exports will force it to yield to his demands, some of which (including curtailing the theft of US intellectual property) are more reasonable than others, such as shrinking the US bilateral trade deficit. However, Trump overestimates the extent to which he has a stronger hand. If China runs out of American goods to tax, it could raise existing tariffs higher, take measures to impede US service exports to China, or it could harass American firms operating in China. A large portion of Chinese exports to the US involves intermediate grade imports from other countries. Thus, US tariffs on these goods will be damaging those countries nearly as much as China. The US imports a great many parts and components from China upon which US manufacturers rely to be globally competitive.[3]

The US trade deficit with China is much smaller on a net basis than it is on a gross basis

In general, the trade war would act as a tax increase on the US economy combined with a partial boycott on its exports. Thus far the value of US annual imports exposed to a scheduled or explicitly threatened tariffs is $810 billion or 4.1% of US GDP. Gavyn Davies estimates that the first round effects of these tariffs would directly increase the Consumer Price Index (CPI) by over 1% which would be partly offset by a decline in the selling prices of the taxed goods and overall dollar appreciation.[4] This by itself is manageable but other countries would almost certainly increase their retaliation, further reducing US output and employment. The ultimate result is hard to predict. The consequences of steady escalation could add up to a 10% tariff on all US and China trade in both directions, which is an extreme but not impossible occurrence. This would reduce US GDP by more than 1.3% next year according to Mark Zandi.[5] Such a calculation assumes only one front. The effects of two directional tariffs with other trading partners would limit growth even further. Barclays estimates that a 10% two-directional tariff on all US imports and exports would reduce corporate profits by 11%.[6]

Not included in Barclays' or Zandi's analysis is the impact of all this uncertainty, which in itself extracts a heavy economic toll. The US Fed has already collected data showing that US businesses are putting off investment commitments as a result of trade uncertainty. The likely confidence effects on asset prices would also undermine consumer demand.

There will be substantial delay before tariffs are fully implemented and this will provide some opportunity to reach a preemptive settlement. Trump is willing to grant exclusions from tariffs but only if a trading partner reduces tariffs on US goods in return. For example, the Canadian, Mexican and EU exclusions from the initial tariffs on steel and aluminum were contingent upon their taking a softer stance on trade with the US which they refused to do. Exemptions were granted to other countries that were willing to limit their own steel and aluminum exports to the US.

We expect the political costs of tariffs to increase as the amount of imports subject to new tariffs grows. The share of consumer focused goods would rise and the ability to substitute imports from other countries would fall. This,

[3] The Economist, June 23, 2018.
[4] Gavyn Davies, Op Cit.
[5] Barron's, June 25, 2018.
[6] Barclays US Equity Strategy, June 11, 2018.

combined with the ability of trading partners to target goods produced in "red states" in imposing retaliatory tariffs, will reduce the effectiveness of the proposed tariffs as a negotiating strategy. If China chooses to take measures adversely affecting the operations of US companies in China, opposition to tariffs among politically influential groups will be increased.

It is difficult to see how the US trading partners will be convinced that Trump will follow through unless global financial markets including the US equity market selloff substantially. A trade war will hurt the economies of US trading partners more than the US economy but it is unlikely to be good for US equity prices and US voters are averse to a falling stock market. The question arises as to whether Trump is willing to suffer the fallout from a major selloff before a midterm election. Trump treats the Dow as his own personal approval rating. Despite this, he might be willing to accept a significant correction if there is enough time for markets to recover before the mid-terms. For this reason, it is possible that the US and its trading parties around the world will deescalate and move toward a negotiated settlement by the end of the summer. Such a settlement might move the US and its trading partners closer to the reciprocity line through at least some convergence of tariff rates. For example, the EU taxes US auto exports 10% whereas the US taxes European auto exports at 2.5%. The German government has said that it is open to cutting the EU tariff rate on US autos to zero. Some countries may lower their relatively high tariffs if the US does not increase tariffs above the current levels or keeps them below currently threatened levels. Though the average global tariff rate might not rise significantly, supply chains would still be disrupted and companies would take some time to adjust. Still, the economic damage done would not be serious enough to prevent a relief rally. In our opinion, the US Administration is posturing for a settlement involving some tariffs rate convergence but reduced trade. If it occurs, the apparently favorable resolution to the current tense situation would likely push equity prices higher into the election season.

> A full blown trade war will hurt the economies of US trading partners more than the US

The US Growth Outlook

Following a short lived slowdown, US growth is re-accelerating. This implies that the economy is growing over 2 percentage points above the 1.75% estimate of the long-term trend, supported by continued, albeit declining, positive impulses from financial conditions and the start of a fiscal boost. For 2018 as a whole, we anticipate that real GDP will increase to a 2.8% rate before the gain slows to 2% in 2019.

> Our Q2 GDP growth estimate stands at 4% annualized

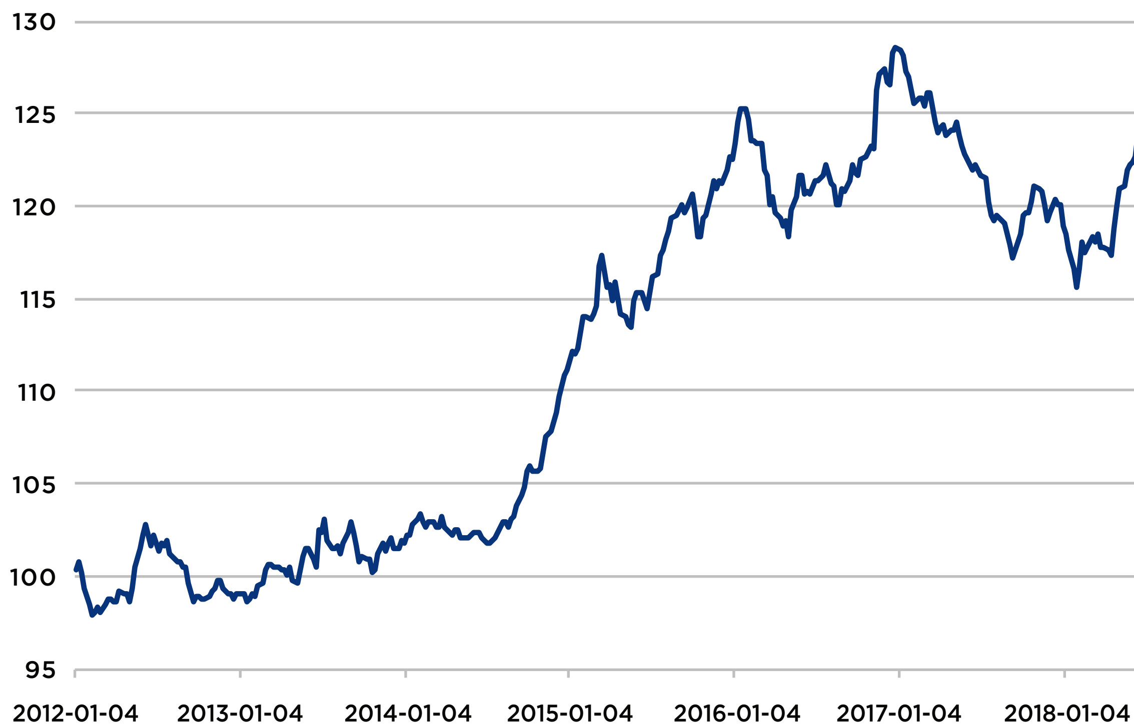
In our base case forecast, the Trump Administration places some restrictions on US imports, raising costs and disrupting supply chains. This will be accompanied by some retaliatory tariffs on US exports. The two-way tariffs will lead to only a small improvement in the trade balance and a resulting decline in net import leakage. At the same time, businesses will hold back on investment to restructure their supply chains because of price changes and uncertainty about the future. Although business tax cuts will be mainly used or financed by repurchase of shares, there will be some tax induced increase in investment which will dissipate by 2019.

Consumer spending, which represents the lion's share of final demand, should continue to grow in 2018 assuming rising house prices and persistent job growth. However, by 2019 we expect consumption to slow partly as a result of lower than expected real wage gains associated with a tariff induced increase in inflation. In addition, we anticipate that the household savings rate, which declined from an average of 6.1% in 2015 to just 2.6% at the end of 2017,[7] to start to rise significantly as baby boomers approach retirement age and as many workers remain insecure even as unemployment remains low. Greater volatility in financial markets should also increase precautionary demand for savings.

The US labor market continued to tighten in the first half of 2018. In our base case outlook, we expect further declines in the unemployment rate toward 3.5%, even as the growth rate of the economy starts to slow in the second half of the year. Despite wage increases being substantially below their full employment trend, core inflation has surprised on the upside this year. Next year we expect to see a substantial overshoot of the Fed's 2% inflation target, partly as a result of higher import and energy price inflation.

In our base case outlook, we anticipate a total of four Fed rate hikes this year but only two next year due to a pronounced slowing of real GDP growth. We expect the US dollar to remain firm on a trade-weighted basis for the remainder of the year, but start to weaken thereafter.

EXHIBIT 3: TRADE-WEIGHTED US DOLLAR 2012-2018



Source: Federal Reserve Bank of St. Louis

[7] D. Bachman et al, "United States Economic Forecast," Deloitte, June 13, 2018.

Valuation Issues

Without taking into account the imposition of new tariffs, analysts have revised their estimates of 2018 S&P earnings upward. The consensus of these estimates is substantially higher than that shown in our last quarterly report. Our new estimates for 2018 and 2019 S&P earnings (without the proposed tariffs) are $159 and $170, respectively, compared with $155 and $162 in our last quarterly commentary. The recent upward revisions are mainly the result of a stronger than anticipated increase in earnings in Q1, higher oil prices and greater than expected benefit from the tax bill. However, the moderate increase in tariffs assumed in our base case outlook, about 50% of those shown in Exhibit 2, should decrease corporate earnings by about 2% in 2018 and 5% in 2019. This means that the market is currently trading at about 17 times tariff-adjusted forward earnings. By the end of the year, we would expect this multiple to compress to about 16.5 times (the trailing 20-year average)[8] as the equity risk premium increases due to uncertainty about trade policy and a temporary increase in the inflation rate. This assumes that the Fed will impose only two 25 basis point rate hikes in 2019 believing the tariff-induced increase in the price level to be one-off.

At 16.5, the expected end of 2018 forward earnings multiple is slightly elevated (.12 standard deviations overvalued) based on the 16.1 average of the past 28 years, but in line with that of the past 20 years. This, along with other valuation metrics, would suggest that the market may remain slightly, to significantly, overvalued on an absolute basis, although it is likely to become less stretched as 2019 progresses. Other metrics, in addition to the forward price/earnings ratio, bear this out. For example, the estimated end of year cyclically–adjusted price/earnings, price-to-cash flow and price-to-sales ratios are all above their 28-year means, but less than one standard deviation overvalued with the exception of the price-to-sales ratio which is slightly less than 1.76 standard deviations overvalued. On the other hand, the estimated end of year spread between the earnings yield and the Treasury yield still suggests substantial undervaluation in relation to bonds.[9]

Outlook for the US Stock Market

Bullish Case

- The threatened tariff increases are withdrawn and other tariff increases imposed since April 1, 2018 are rescinded.
- Technological advances and manufacturers begin to lower corporate costs as deregulation improves business confidence and the economy grows by 3% in 2019 as well as 2018.
- Higher-than-expected corporate earnings growth in both years results in the S&P 500 reaching 3000 by the end of the year.

Bearish Case

- The threatened tariffs are imposed and there is proportionate retaliation.
- This, together with other dubious policy and financial market decisions in the United States, Europe and China, triggers a global financial crisis.
- The S&P 500 falls to below 2160 by the end of 2018 in our bear case.

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[8] See Morgan Stanley: Cross Asset Strategy Valuation, July 2, 2018.

[9] Morgan Stanley, Op. Cit., JP Morgan Asset Management: "Guide to Markets, 3Q," page 5. 28-year price-to-sales ratio data obtained from Bloomberg.

Base Case

In our base case, upward revisions in analysts' estimates of earnings since the first quarter report are offset by the negative effect of tariff increases. As a consequence, the US earnings growth rate remains virtually the same. However, we have adjusted downward our estimate of the forward multiple for the end of 2018 to reflect higher policy uncertainty. As a consequence, the price index for the S&P 500 decreases slightly from 2674 at the end of 2017 to 2673 at the end of 2018. The estimated total return on the S&P 500 for 2018 is entirely due to dividends. It is 1.9%, which is substantially lower than the 4.4% return projected in our prior quarterly report.

We expect modest but positive returns for domestic equities in 2018

We assign a 20% probability to the bullish and bearish cases. The weighted average of the expected total returns is .4% positive for the year assuming the S&P 500 is only slightly less than 2160 in the bearish case.

Europe and the UK

During the second quarter, the MSCI Europe ex-UK Index declined 2.86% and the MSCI UK Index gained 2.95%. Year to date, the returns have been -4.07% and -1.05%, respectively. In addition to negative trade policy feedback, the unexpected slowdown in growth within the Eurozone, continued political uncertainty, Brexit issues and increased volatility have weighed on European equity markets.

We continue to monitor the Brexit negotiations of the UK and EU. On June 20, the British Parliament approved a measure that gave Prime Minister Theresa May room to negotiate the split with the EU but will provide Parliament with a say in the process. While the outcome of the vote was anticlimactic, it reduced the uncertainty surrounding negotiations and provided May with some much needed legitimacy.

We expect the negotiations between the EU and the UK to be contentious up to the deadline in March of next year. From an economic perspective, we continue to believe that the UK will be worse off outside of the EU regardless of what is negotiated. According to Barclays, the average long-term effect on UK GDP ranges between -3.5% and -6.5%, depending on the ultimate trade agreement or lack thereof.[10]

In addition to Brexit, political uncertainty continues to have significant effects on both equity and fixed income markets in Europe. In Italy, the far-left Five Star Movement and far-right League have formed a coalition to govern the country. Both parties are skeptical of the EU, and believe that the relationship with Brussels should be renegotiated. In late May, the spread of Italian 10-year bonds over German 10-year Bunds rose to over 300 basis points and reached its highest level since 2013 owing to the high-handed and controversial rejection of an economic minister by President Sergio Matarella.[11] The fact that the minister was euro-skeptic created an atmosphere of confrontation rather than compromise and it was felt that Italy's membership in the Eurozone was more at risk. Although a solution was found and the spread has declined from the recent peak, it remains elevated compared to recent history. To date, the new government has not set forth a plan to address elevated fiscal deficits within the country.

[10] Montagne, Frances, Kochugovindan; "There's No Market Like the Single Market;" Barclays; June 13, 2018.

[11] Ranasinghe, Dhara & Ramnarayan, Abhinav; "Italian Bonds Suffer Worst Day in 25 Years;" May 29, 2018; Reuters.com accessed 6/20/18.

Although the ECB's bond buying program will provide a backstop to the yield on Italian debt, we expect yields to remain elevated.

EXHIBIT 4: ITALIAN 10-YEAR GOVERNMENT BOND YIELD 2013-2018

Source: Bloomberg

In Germany, Angela Merkel continues to suffer from a lack of confidence due to her perceived mismanagement of the refugee crisis within the country. Merkel is in a politically precarious position as she must balance the need of the EU to provide joint support to refugees and the countries where they first land and combat the rise of populist sentiment that is a direct consequence of increased immigration. After years of favorable support within Germany, Ms. Merkel's recent troubles could have the ability to increase volatility within German and European equity markets.

The European Central Bank provided an update to its quantitative easing program during the third week of June and provided a dovish message by indicating negative interest rates will continue for longer than previously expected. During the meeting, the Bank signaled that the government bond purchase program would be reduced to 15 billion euros in October and halted at the end of the year. This is in line with expectations we expressed in previous commentaries. During the same meeting, the Bank stated that it will hold interest rates at the current -0.4% level at least through the summer of 2019 and possibly longer.[12] This action is expected to put continued pressure on the euro relative to the dollar as the rates set by the central banks continue to deviate. Given the continued divergence in monetary policy, the euro/US dollar exchange rate declined to 1.17 on June 30 from a high of 1.25 in mid-February. This should be positive for export growth since it improves the competitiveness of Eurozone exports.

[12] Barley, Richard; "Goodbye ECB Bond-Buying, Hello Forward Guidance;" The Wall Street Journal; June 14, 2018; www.wsj.com

The pace of GDP growth in the eurozone slowed during the first quarter to 0.4% (quarter on quarter) from 0.7% during the prior three quarters.[13] Although the slowdown was expected (see our previous commentary), it remains to be seen how much of the slowdown was caused by temporary factors, such as weather, and how much can be attributed to more fundamental problems. Nowcast data from June indicate that the Eurozone will continue to expand at an above-trend 1.8% pace, but below the 2.3% pace in 2017.[14] Additionally, Eurozone PMI declined to 54.1 in May, which was the lowest level in 18-months. While both the Nowcast and PMI indicate that growth will be slower in 2018 than in 2017, we still expect expansion in Europe to continue and believe a recession remains unlikely in the near term provided US tariffs on European automobiles and auto parts do not materialize.

Poitical volatility will remain in Europe but risk of contagion is low

The forward P/E ratios of Europe and the UK remain similar to the end of the first quarter, at 13.5x and 13.2x, respectively, and remain at a discount to US Equities.[15] The valuation discounts are less attractive now given the sensitivity of European markets to EM economies and additional political stress. It is our base case outlook that substantial tariffs are not imposed; however, we have reduced our bias to be overweight developed international equities, particularly Europe, factoring in the higher probability of a sustained slowdown in growth. We continue to believe that attractive investments can be found in Europe and the economic uncertainty and higher volatility levels will provide our active managers a better environment to outperform their benchmarks in the final half of the year.

Japan

During the second quarter of 2018, Japanese equities, as measured by the MSCI Japan (net) index, declined 2.84% and underperformed the MSCI EAFE Index. Year to date, the MSCI Japan Index has outperformed the MSCI EAFE Index by 72bps.

Data released in June indicated that Japanese GDP contracted at a 0.6% annualized rate in the first quarter of 2018.[16] Similar to Europe, the contraction appears to be a combination of poor transient conditions, such as weather, and a generalized slowdown. We believe the Japanese economy will avoid a recession this year but 2018 full year GDP may lag behind estimated trend growth. Nowcast data show a slowdown in the annualized growth rate from 1.7% in 2017 to 1.0% in June and Barclays expect full year growth to average 1.5%.[17, 18] During the quarter, the Yen depreciated to 110.76 from 104.73, reversing the strength in the first quarter. We felt the strength in the Yen was overdone in March and looking forward, we expect more weakness than strength due to divergence in monetary policy.

The BOJ is now an outlier to the Fed and ECB with no formal timetable for removing accommodative monetary policy. We continue to watch the effects of Abenomics play out, but it appears the economy has taken a small breather during

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[13] Bartunek, Robert-Jan, "Euro Zone Economy Slows as Expected in First Quarter," Reuters May 2, 2018; reuters.com

[14] Fulcrum Monthly Report Card June 2018.

[15] Yardeni, Ed, Abbott, Joe, Quintan, Mali; "Global Index Briefing: MSCI Forward P/Es;" www.yardeni.com June 27, 2018.

[16] White, Stanley & Kihara, Leika, "Abenomics May be Losing Steam Just as Trade Friction Escalates;" www.reuters.com June 7, 2018; www.reuters.com

[17] Fulcrum Monthly Report Card June 2018.

[18] Barclays Global Outlook.

the process. Keeping everything in context, Japan has been plagued by low growth and minimal inflation for over two decades, and we do not expect these issues to be solved in only a few quarters. Also, Abe seeks reelection in September and an unsuccessful campaign could alter the stance of policy in the future.

We have previously identified factors that make the country's equities attractive, including structural reforms, improved governance, easy monetary policy and a stable political environment. However, challenges remain, including labor shortages due to an aging population and an unemployment rate of 2.2%, low productivity growth, and (for the first time in nearly a generation) rising costs.[19] These headwinds make identifying successful investments in Japan challenging, but attractive valuations create a larger margin of safety for our active managers.

The forward P/E of the MSCI Japan Index was 13.0X at the end of the quarter, which is a slight increase from the 12.9X at the end of 1Q2018, but still below the year-end 2017 level of 14.6x.[20] We believe that Japanese equities remain attractively valued compared to both historical levels and to other developed nations, including the United States. We continue to see evidence of improved corporate governance and shareholder friendliness contributing to improvements in the equity markets. Additionally, the recent depreciation of the Yen should help to improve exports and provide a boost to the economy. While we maintain our overweight to the country, we reduced our exposure marginally during the early part of the second quarter.

Emerging Markets

Pressure on EM assets has continued to build, with EM FX, credits and equities correcting substantially in the last two months. As a result of a stronger dollar and the sudden increase in protectionist threats from the Trump Administration, financial market outflows from EMs have been of similar magnitude to those during the crisis of January 2016. There have been near record withdrawals from EM equity funds at the same time as capital outflows from China resumed. Emerging market currencies have fallen by about 5.50% against the dollar since April. In an attempt to offset these currency declines, other components of the financial conditions indices have had to tighten significantly. Policy rates have risen, credits spreads have widened and equities have declined sharply.

> The Renminbi is now down more against the US dollar than in August 2015

Initially, interest rate increases were only in those countries with substantial current account deficits such as Turkey, Argentina, India and Indonesia. However, monetary policy tightening is now more widespread and taking place in economies, such as Mexico, previously believed to have much stronger economic fundamentals.

We anticipate EM earnings and GDP growth rates to slow somewhat, although there is no sign of substantial weakness in real economies yet. What is surprising is that the Nowcast estimates show Chinese growth actually increasing to about 8%. This is in direct contrast to the view of most economists who were estimating that Chinese growth would dip to about 6.5% in Q2 from 6.8% in Q1 as a result of the recent slowdown in retail sales and fixed investment.

[19] Ministry of Internal Affairs and Communications; "Monthly Results April 2018;" Statistics Japan; http://www.stat.go.jp/english/data/roudou/results/month/index.html

[20] Yardeni, Ed, Abbott, Joe, Quintan, Mali; "Global Index Briefing: MSCI Forward P/Es;" www.yardeni.com June 27, 2018.

Oxford Economics estimates that overall consumer demand for both staples and durable goods slowed in the second quarter, "with monetary policy less easy and wage growth seemingly softening." [21] As signs of a slowdown spread, Beijing is likely to take expansionary measures, especially in the face of US/China tensions.

China is likely to use a combination of fiscal and monetary stimulus, such as lower household tax rates and lower reserve requirements. This will put downward pressure on the Renminbi unless the Central Bank uses enough of its dollar reserves (estimated at $3.1 trillion in May) to purchase local currency in the open market and the government relies mainly on fiscal stimulus. Capital controls must also be tightened. Supporting the currency will be difficult if, as we expect, the divergence between US and Chinese interest rates widens and Chinese assets command a higher risk premium in relation to US assets. For this reason, a substantial further devaluation of the Renminbi against its currency basket is more likely but not yet part of our base case outlook. We still believe that Governor Yi Gang's pledge to keep the Renminbi "generally stable" will be honored. Going back on that pledge would touch off a cycle of competitive devaluations in the Asian region over which Beijing is increasingly asserting leadership.

China is fundamentally different from most EMs in terms of political dynamics, monetary policy, trade balances and external funding risks. For example, in contrast to other EMs, we expect China to lower interest rates slightly while the US is hiking. We do not anticipate that US tariff increases will substantially reduce the earnings growth rate of Chinese companies which should exceed 20% in Hong Kong dollars. The US represents only 1.3% of fiscal year revenue for listed Chinese companies, according to Goldman Sachs.[22]

However, "Given that China is the largest most liquid market in the EM complex," 33% of the MSCI Emerging Markets Index, benchmark-based risk reduction "could pressure Chinese stocks via portfolio flows, notably through passive mandates." [23]

We are keeping a neutral weighting in EM equities and believe that the recent substantial selloff has involved some overreaction. Absent a further significant devaluation of the Renminbi, extreme tightening measures by other EM central banks will be avoided. Although earnings and GDP growth rates should be less than anticipated in our earlier report, they should still be solid given that fundamentals are stronger than in previous risk off episodes. We would remain cautious about increasing any EM exposure this year even if the US partially settles its trade disputes with the rest of the world, including China. There are other strategic tensions between the US and China outside the trade domain, which in Martin Wolf's words have, "uncertain ends" and "lack definite outcomes." These tensions involving technology, internet protocol and national security will not be resolved quickly. EMs did not recover from the earlier US Sino crisis from August 2015 to January 2016 until a year later even though there were no trade disputes. The 2017 growth resurgence was led by a sharp increase in material export growth due to the Chinese housing boom. This is unlikely to be repeated.

There are other strategic tensions between the US and China outside the trade domain

[21] L. King, as cited by J. Kynge, FT, July 3, 2018.
[22] Goldman Sachs, "China Musings," June 27, 2018.
[23] Ibid.

Fixed Income

The US 10-year Treasury exhibited a see-saw pattern during the quarter, rising from 2.74% at the beginning of the quarter, reaching a peak of 3.11% in mid-May and ending the quarter at 2.86%. Breaking down the rise in nominal rates between inflation expectations and real interest rate components, the majority of the nominal rate increase came from a rise in inflation expectations which rose 7bps from 2.06% to 2.13%, while real rates rose 5 basis points to 0.74%. With the FOMC's medium-term inflation expectations tethered to 2%, the rise in real rates reflected a strong domestic economy and expectations for future rate increases.[24] As we have discussed, forecasted domestic growth for 2018 should exceed trend growth and the unemployment rate will trend downward necessitating further increases in the overnight rate. Unpredictable trade policy spurred a flight to quality in the second half of the quarter pushing longer maturity Treasury yields lower. A progression to a "trade war" should result in lower long-term yields; however, we would anticipate more demand in shorter maturities due to the flat yield curve. The longer term effects of tighter trade policy in the Treasury market are difficult to predict, but "high yielding" dollar-denominated assets would likely see increased demand resulting in stable or lower yields. Also, under this scenario, growth forecasts would be cut and expectations for Fed hikes would be tempered.

The Fed Chairman, Jerome Powell, announced another 25 basis point increase in the Fed Funds target rate in June, bringing the overnight target to 1.75-2.00%. Additionally, in his comments, he highlighted an increased pace of interest rate hikes, four total in 2018 and three in 2019. These forecasts exceeded market expectations and would raise the overnight rate to 2.50% and 3.25% at the end of 2018 and 2019, respectively. Due to the forecasted decline in US GDP growth in 2019 and 2020, coupled with tighter Fed policy, the US yield curve continued its flattening trend, with the spread of the two- to 10-year Treasury decreasing from 0.47% at the beginning of the quarter to 0.32% by the end of June. We believe this will continue through the end of the year. A flat or inverted yield curve suppresses bank profitability and generally results in a slowdown in lending, making a recession more likely. The Fed is cognizant of this market dynamic but also is loyal to its goal of raising rates to a level near the neutral rate of interest.[25]

Given our expectation for a flattening yield curve, we will adjust the fixed income allocation in client portfolios to minimize exposure to the intermediate part of the curve (5-10 year maturities). Further, we will incorporate a "barbell" exposure by allocating to short maturities with attractive relative yields, low risk and high liquidity and also overweighting the longer end of the curve which protects portfolios in a risk off scenario. Overall, we are underweight interest rate risk and we will be underweight credit exposure as well.

Municipal Bonds

Contrary to the movement of US Treasuries, yields of municipal bonds fell across all tenors. Prices were buoyed by reduced supply following record setting issuance in the fourth quarter. Additionally, the muni curve steepened slightly as more buyers favored the shorter part of the muni bond curve. These market dynamics reflected on the strong returns for municipal bonds; The Bloomberg Barclays Municipal Bond Index returned 0.87% for the quarter compared to -0.16% for taxable bonds as measured by the Bloomberg Barclays U.S. Aggregate Index. The 10-year municipal to Treasury ratio decreased to 86% in the quarter. Similar to taxable fixed income, we favor shorter maturities and better quality credits.

[24] FOMC meeting June 13 – https://www.federalreserve.gov/monetarypolicy/fomcpresconf20180613.htm

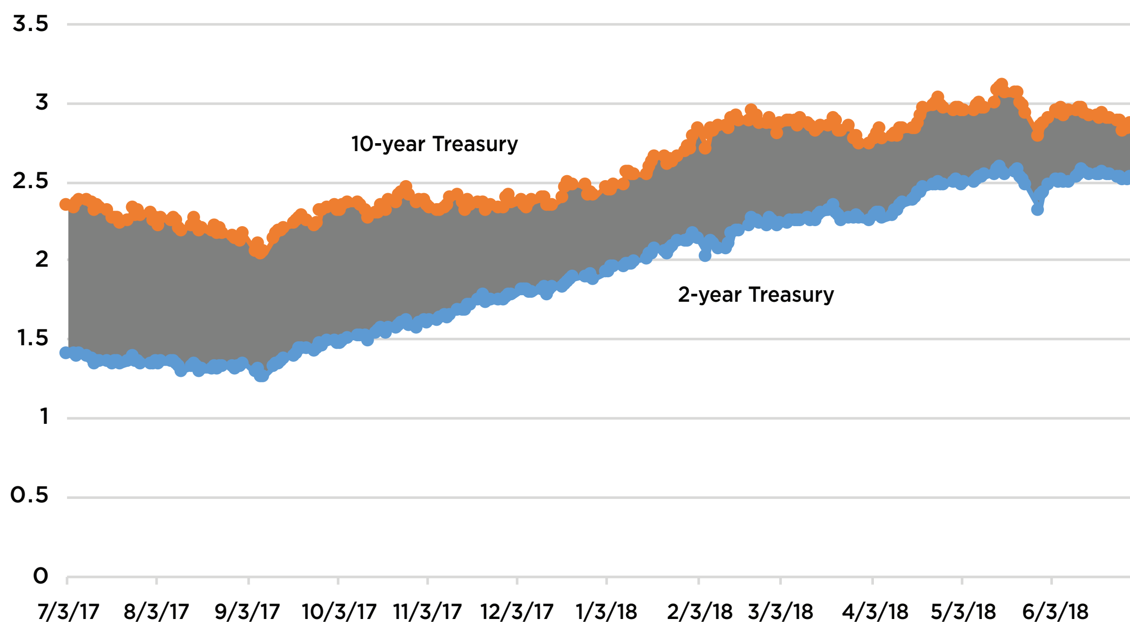
[25] The neutral rate of interest or r* is the rate of interest in an economy that is seen as neither encouraging nor discouraging economic decisions, and is consistent with both stable inflation and strong employment.

Spread Product

US Investment Grade bond spreads widened 14 basis points during the quarter while High Yield (HY) bond spreads widened only nine basis points from the beginning of the quarter. For the 20 years ending March 31, 2018, movements of HY Corporate bond spreads have typically changed by a factor of 5+ times more than the corresponding move in US Investment Grade (IG) bond spreads.[26] A widening of IG credit spreads often precedes a recession; however, the recent movement is likely more technical in nature. Increased M&A and buybacks in the IG Corporate space has raised debt/equity ratios and increased supply. Additionally, the supply/demand dynamics from the ECB's Asset Purchase Program and US Zero Interest Rate Policy (ZIRP) has begun to reverse and the attractiveness of US IG corporate bonds compared to local country corporates and US Treasuries should continue to fade. High yield on the other hand has experienced a robust fundamental backdrop and issuance has been skewed to better quality credits. Due to the absolute tight spreads of HY bonds (363 bps), we are reducing our exposure to sub investment grade credit as well as investment grade credit and shortening the maturity exposure in corporate bonds. It is unlikely that credit spreads will tighten much further in the near term and the relative yield and risk in risk free bonds is more appealing that is has been since the global financial crisis (GFC). Additionally, we have maintained our allocation to non-agency MBS.

EM currency weakness has impacted the monetary policy of numerous EM central banks by halting easing cycles and drawing focus to supporting their currency. The JP Morgan EMBI Global Index was down 3.51% in the quarter. Based on our outlook on the unpredictable nature of trade policy, we do not view current weakness as an opportunity to add to the asset class.

EXHIBIT 5: THE SHRINKING GAP BETWEEN THE 2-YEAR AND 10-YEAR US TREASURY



Source: Bloomberg

[26] Bloomberg and Drexel Morgan Capital Advisers calculations.

Conclusion

We anticipate that global and US economic growth, at 3.6% and 2.6%, respectively, will be lower by 10 and 0 basis points than those forecast in our previous commentary. In other words, while global growth should be less than last year's 3.7% rate, the growth rate in the US should still increase by 20 basis points. The real issue is the pace of economic activity in the US and globally in 2019 and 2020. Flattening or inverted yield curves, combined with frontloaded fiscal stimulus in the US, would suggest pronounced deceleration if not recession in these years. A decline back to or below trend growth is already evident in the non-US Developed Markets (DMs).[27]

The US and global bond markets are telling us something but it is not clear what. The US yield curve is flattening (i.e., the gap between the 2-year and 10-year US Treasury yield is shrinking) and the global yield curve has already inverted. Global short-term yields are higher than global long-term yields for technical reasons. Notably, the US makes up about 50% of the one- to three-year segment of the JP Morgan GBI Index, but only 25% of the seven- to ten-year segment.

The flattening of the US yield curve is harder to explain. The rise in the two-year yield is attributable to Fed Chairman Jerome Powell sending strong signals that the Fed will continue to raise rates at a 25 basis point per quarter rate through 2019. The opposite movement in long-term rates is much harder to explain, particularly in light of the Fed Chairman's commitment not to let market volatility or EM weakness influence monetary policy. One explanation is that long-term yields are being temporarily held down by continued quantitative easing in Europe and Japan. The large amount of money still being invested in long-dated paper may be keeping US long-term yields down. The ten-year German Bund yield is at .5% and the 10-year Japanese bond yield is 0%. The foreign exchange hedge yield for a US investor is 3.1% for the ten-year Bund and 2.6% for the ten-year Japanese bond which may be creating an upper bound on US long-term yields. Thus, once quantitative easing ceases in Europe, we should expect an increase in US long-term yields, which has been temporarily delayed.

> We are monitoring global yield curves, recession risk and changes in monetary policy

The alternative explanation is that Fed policymakers have overestimated how much they should tighten and that a weakening US expansion will eventually cause them to ease. The most obvious cause of declining growth is Fed overtightening about which the President of the St. Louis Fed has expressed some concern. Nine years of low rates and easy credit have led companies to over lever. For example, according to Raghuram Rajan, US covenant-lite loans are well above their pre-crisis levels. The greatest concern may not be so much higher interest rates, which will increase the costs of floating-rate and new debt, but rather a tightening of liquidity which will make it harder for borrowers to refinance their maturing debt. McKinsey estimates that $1 trillion of corporate debt will be refinanced in the next four years.[28] Concern that incipient corporate debt difficulties will choke off growth and result in a flight to default free bonds may partly account for the present downturn in long-term Treasury yields.

The possibility of a full-blown trade war might be another reason that US and global investors fear a recession sooner rather than later. We have already discussed the adverse hit that a full-blown trade war would have on both US and global growth rates.

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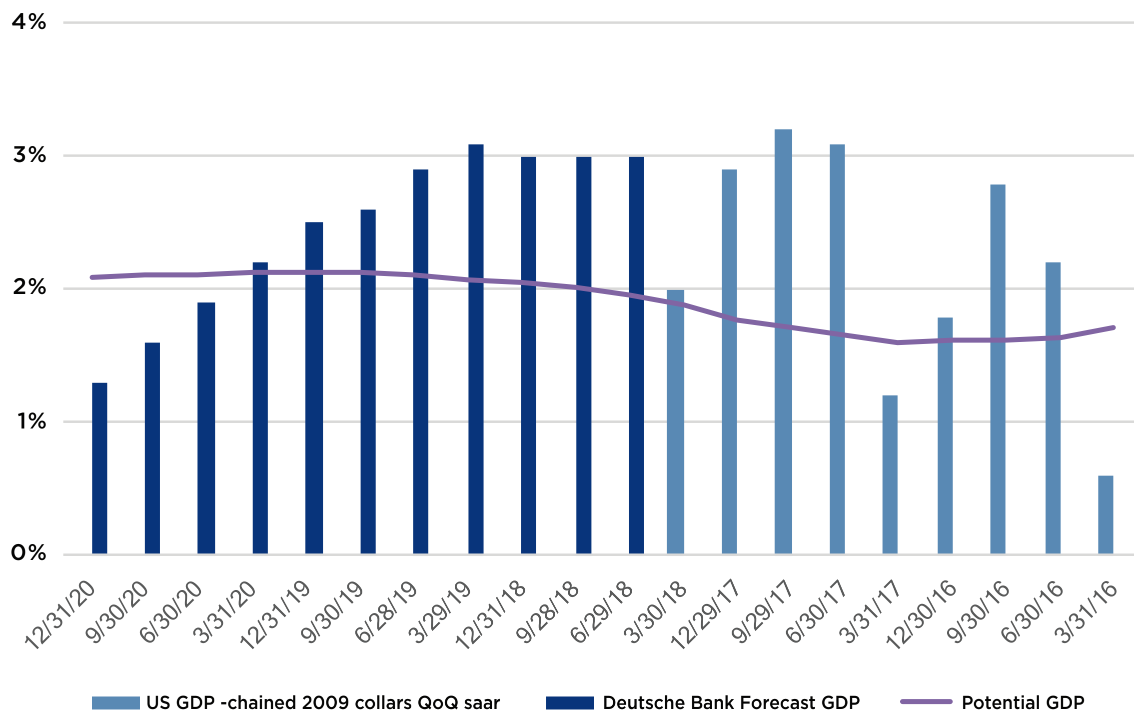
[27] Gavyn Davies. Financial Times, July 1, 2018.

[28] Raghuram Rajan, "Bond Markets Send Signals of Looming Recession," Financial Times, June 30, 2018.

Investors may also be concerned that the confluence of a decline in fiscal stimulus and a peaking of monetary tightening could well lead to a US recession by 2020. The US economy has been juiced by the tax cuts and fiscal spending package that Congress passed at the end of 2017. This stimulus, which is front-end loaded, should last another year or so, but just as its effects are fading the Fed will be pushing rates higher and trimming its $4 trillion balance sheet. Put together, you have a drag big enough to push the US economy into a recession in 2020 and the global economy as well if the ECB starts to tighten at the end of 2019. At a minimum, the use of front-end loaded fiscal stimulus late in the business cycle is putting an arch in a previously consistent annualized growth pattern. Deutsche Bank estimates that GDP growth will equal or exceed 3% for four consecutive quarters starting with 2Q2018 which was not achieved during any consecutive four-quarter period in the past nine years.[29] However, they also estimate that GDP will average about 1.5% for the four quarters starting in 1Q2020 which is nearly equivalent to the lowest trailing 4 quarter growth rate in the period after the Great Recession (see Exhibit 6).

EXHIBIT 6: PAST AND PRESENT GDP GROWTH



Source: Congressional Budget Office, FRED Database, Deutsche Bank.

There may be a growth or outright recession in the second half of 2019 or early 2020, but a lot could happen that could extend the cycle or end it sooner. If trade tensions are allowed to escalate beyond the US midterm elections, global and US recessions in 2019 would be likely. On the other hand, the Fed may become less aggressive and a negotiated settlement of the trade disputes could well occur before the midterms. Thus, US and non-US equities could be under pressure during the remainder of the year and in 2019 or if monetary policy is less aggressive than we expect

[29] Deutsche Bank: As cited in Barron's, June 25, 2018.

and tariff increases do not go beyond two rounds, global equities should enjoy a melt up starting in the Fall before experiencing a greater than 20% fall sometime in 2019. Non-US equities could recover and US equities could hold up through 2019 and even beyond if the US and global economies continue to expand despite mounting headwinds.

We need to be prepared for all of these scenarios. We prefer equity managers with downside capture less than 100% and with greater upside than downside capture. At this point, the near-term risk in non-US equities is greater than that in US equities and we are paring back the former. We are emphasizing managers that prefer companies with strong balance sheets that can weather supply chain disruptions and economic downturns easily. We believe the equal weighted benchmark will have a higher risk-adjusted return than the cap-weighted benchmarks and are reducing our overweighting to FAANG [30] stocks which have dominated the S&P 500 Index and account for more than 100% of its increase year to date. The outsized gains of these stocks, which represent a large percentage of the Index, should make them more at risk in a market pullback. Since escalation of the trade war may increase dollar strength, we are reducing our exposure to US multinationals and increasing our exposure to companies less affected by currency translation.

> We have a greater tilt toward defensive equities

Since 2009, growth stocks have outperformed value stocks in the US market. As shown in Exhibit 7, the annualized 10-year total return for growth stocks is 3.6 percentage points above that of value stocks. The current outperformance is almost 2 standard deviations above the mean and nearly equal to that which occurred at the end of 1999. Eventually, there will be a reversion to the mean and we are inclined to eliminate our growth stock overweight.

EXHIBIT 7: ANNUALIZED TRAILING 10-YEAR RELATIVE TOTAL RETURN (GROWTH VS VALUE)

Source: Zephyr Style Advisor

We believe that risky bonds are overpriced and credit spreads are excessively tight. We are shifting from high-yield fixed income securities to governments but still keeping duration below that of the bond indices.

[30] Facebook, Amazon, Apple, Netflix and Google.

Tail Risks

While we remain cautiously optimistic for continued global growth, we are always monitoring risks that could derail financial markets but are not priced in. The following is a list of left tail risks that we believe could have a significant effect on financial markets should such events occur.

- A full blown trade war and the rise of worldwide tariffs – Trump's trade brinkmanship invites retaliation from many countries that should be allies against Chinese trade practices. His tactics and policy could lead to political isolation and the burden of tariffs on a wide basket of goods. The result will be a slowing of growth in the US and rest of world, a decline in corporate profits and recession.
- European Contagion – Italian sovereign debt would be the catalyst as the ECB tapers its purchases of European sovereign debt in 2018. The asset purchase program (APP) has been the backstop of peripheral bond issuance and large percentage of Italian sovereign debt is held by Italian banks which are already on weak financial footing. Forced selling to maintain capital ratios will exacerbate any move downward in price leading to additional intervention which is negative for European growth and corporations.
- Chinese hard landing – Policy missteps related to curbing the growth of credit, maintaining currency stability and an aggressive push for "Made in China 2025" create imbalances in the Chinese economy, impair growth and dissuade foreign investment. The ripple effects of a slowdown severely impact neighboring countries and emerging markets and the global economy slows.
- A large devaluation of the Renminbi similar to that which occurred in the late 1990s leads to another Asian currency crisis, which becomes contagious, affecting countries outside the region as it did in 1998.
- Rapidly accelerating wage increases due to labor shortage cause profit margins to decline sharply in the US from historically high levels and the Fed to tighten more aggressively than expected. This makes US equities vulnerable to earnings multiple compression due to higher inflationary expectations and even greater compression in the cyclically high price-to-sales ratio.
- "Unknown Unknowns" – The greatest risk to our portfolios is an event which we and others are unable to predict. These so-called black swans can emerge out of nowhere and leave devastation in their wake. By necessity, our approach and diligence remain the best defense against events which are impossible to predict.

IMPORTANT INFORMATION

All information contained herein is based on past performance and is not intended to be indicative of future results. The indices used are unmanaged and return figures reflect the reinvestment of dividends and earnings. There is no guarantee that historical risk and rate of return will persist in the future.

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