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MIDYEAR UPDATE: GLOBAL EQUITY MARKETS AT AN INFLECTION POINT

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HIGHLIGHTS

- Following a strong start in January, global equity markets have retraced some of their gains while volatility has increased from record lows. The U.S. stock market continues to be supported by an improving economy and stellar corporate profits. However, valuations have eased amid prospects for higher interest rates and uncertainty about potential trade conflicts.
- In the euro-zone the combination of slower growth and increased political uncertainty in Italy has left investors wondering whether the region could be headed for another crisis. Meanwhile, China's stock market and currency are under pressure and several emerging economies including Argentina, Brazil and Turkey also confront pressures.
- These developments suggest the global economy is less synchronized than at the start of this year. If so, the dollar could strengthen further, which together with an expanded U.S. budget deficit, could cause the overall trade deficit to expand and increase the potential for trade conflict over the next year or two. This is the wildcard in the outlook for the global economy and markets.
- Amid these developments, we have not altered our investment strategy. We expect U.S. growth to remain solid in spite of rising global uncertainties. Markets are likely to remain volatile, but we believe strong fundamentals will outweigh these concerns for now.

THE RALLY IN GLOBAL EQUITIES AND SYNCHRONIZED GROWTH

Following Donald Trump's surprise victory in the U.S. presidential election in November 2016, U.S. and world equity markets staged a remarkable rally that lasted through January of this year: U.S. and international equity markets posted returns of 35% in U.S. dollar terms during that span, while emerging markets generated even higher returns of 45%. The rally ended a period of sideways market moves that began in 2015, when a slump in oil prices and slowdown in world growth caused corporate profits to soften.

Some observers have attributed the rally to "animal spirits" that were unleashed following Trump's election. His stated goal was to "Make America Great Again" by reviving economic growth through a combination of changes in corporate and personal tax rates and steps to lessen regulatory burdens that businesses faced. Confidence readings for businesses and households surged in response to the pro-growth message, and the U.S, economy grew at a 3% rate in the second half of 2017, while the unemployment rate fell toward 4%. Following passage of the tax legislation at the end of 2017, the U.S. stock market surged in January.

This is only part of the story, however. The other part is that developments in the U.S. coincided with a revival of economic growth and corporate profits in other regions of the world including Europe, Japan, China, and emerging economies in Asia. In the case of Europe, economic growth in 2017 reached a 10-year high of 2.4%, well in excess of the region's potential rate of about 1.5%. Japan's growth rate also accelerated to its highest pace in many years at 1.7%. China's economy expanded at 6.8%, which was comfortably above the targeted rate of 6.0% and well above expectations at the start of 2017.

The synchronized expansion, in turn, contributed to a revival in growth of the volume of world trade to 4.3%, which was the strongest showing since the beginning of this decade. As commodity prices firmed, many emerging economies recovered from a slump in 2015 and the first half of 2016. In sum, a rising tide lifted all major economies and markets simultaneously.

LESS SYNCHRONIZED GROWTH IN 2018

More recently, growth has been less synchronized, and the U.S. stock market has moved sideways while China and other emerging markets have sold off (see Figure 1). This has raised the specter that the rally in global equities may be over.

Figure 1: Investment Returns for Asset Classes (%)

	11/8/16–1/31/18	2017 (Jan 1–Dec 31)	2018 (Jan 1–June 30)
Stock Market			
U.S. (S&P 500)	35.2	21.8	2.6
Russell 2000	33.9	14.6	7.7
International (EAFE $)	34.9	25.7	-2.4
Emerging Markets (MSCI $)	43.2	37.8	-6.6
U.S. Bond Market			
Treasuries	-1.7	2.3	-1.1
IG Credit	3.1	6.2	-3.0
High Yield	10.0	7.5	0.2

Source: Bloomberg. For informational purposes only. You cannot invest directly in an index.

Although U.S. real GDP growth moderated to 2.3% in the first quarter, the economy rebounded in the second quarter, and it is maintaining a 3% trajectory. Meanwhile, jobs growth has been solid, with the unemployment rate falling to 3.8%, the lowest level since the 1960s. With inflation now approaching the Fed's target of 2%, it is expected to continue raising interest rates in the balance of this year.

In Asia, China's economy has been expanding at a pace comfortably above the government's target of 6%, but the Chinese stock market has sold off markedly as trade tensions with the U.S. have escalated. The renminbi has also come under pressure due to increased capital outflows. Meanwhile, Japan's economy posted slightly negative growth of 0.2% in the first quarter, ending a period of eight consecutive quarters of positive growth. Accordingly, monetary policies in the region are on hold.

By comparison, Europe's economy has decelerated, growing by just 0.4% in the first quarter. Some observers believe it is a temporary development that is linked to bad weather and the threat of trade wars. However, the slowdown has continued into the current quarter, and several confidence indicators including purchasing managers' indices and the German IFO index have softened back to levels of one year ago.

Meanwhile, political developments in Italy have cast a cloud over the euro-zone. Following national elections in March, two opposition parties, the Five Star Movement on the left and the Northern League on the center-right formed a coalition government. Italian government bond yields subsequently surged amid worries that the two parties would increase government spending and cut taxes, expanding the country's outsized budget deficit, which at 140% of GDP is among the largest in the world. The selling pressures intensified when the President of Italy over-ruled the choice of a Prime Minister on grounds that he was opposed to Italy staying in the euro-zone. More recently, the coalition has been restored but with a different leader.

Finally, tensions have also increased in several prominent emerging economies – notably, Argentina, Brazil and Turkey – whose currencies have come under pressure, as they need to attract capital flows to finance large current account imbalances. These developments have caused market participants to question the potential for contagion to spread to other emerging economies with large external deficits, especially if the Federal Reserve continues to raise interest rates.

IMPACT ON FINANCIAL MARKETS AND THE DOLLAR

Thus far, the worries about Italy and the euro-zone and potential problems in emerging markets have added to volatility for both stocks and bonds. But it is premature to conclude the global rally in equities is over. The U.S. stock market, in particular, is being bolstered by strong earnings growth, which could surpass 20% this year, partly due to corporate tax rate cuts.

Our view is that equity markets are at an inflection point. The global rally could resume if worries about the euro-zone and trade conflict subside. However, if these risks intensify markets could capitulate at some point.

Depending on which scenario plays out, we believe either will have important sway on the direction of the U.S. dollar. It has strengthened against the euro and other currencies recently, amid expectations the Fed will continue to raise interest rates on a quarterly basis while the European Central Bank (ECB) is expected to stay on hold. Should developments in Italy continue to deteriorate, we would expect the euro to weaken further against the dollar, as the ECB would likely respond by flooding the banking system with liquidity and by delaying any attempt to shrink the size of its balance sheet.

If so, a stronger dollar would undermine the efforts of the Trump administration to rein in the U.S. trade deficit via imposition of tariffs. In our view, the U.S. current account deficit is set to widen considerably in the next few years as the budget deficit surges in response to tax cuts and spending increases. This could set the stage for a replay of the mid-1980s, in which the dollar became over-valued and then weakened considerably once the U.S. economy softened. While this is unlikely to happen anytime soon, risk premiums for holding dollars could rise once the U.S. economy shows signs of faltering in 2019 or 2020. We consider such an outcome to be the wild card in the outlook for the global economy and markets.

POSITIONING INVESTMENT PORTFOLIOS

Amid these uncertainties, we have not significantly altered our equity strategy, which continues to emphasize high-quality names with franchise value. We expect earnings growth to remain strong, supported by solid economic fundamentals. Volatility will likely remain elevated, as the market will focus on increasingly divergent global growth, the U.S. interest rate outlook and the impact of rising trade tensions.

In our bond portfolios, we remain comfortable with a modest overweight to credit risk. Credit spreads have adjusted wider along with the recent market volatility and rising uncertainty, yet we expect fundamentals to remain solid and support valuations. In terms of interest rate risk, we are positioning portfolios similar to market benchmarks. Expectations for further Fed tightening are fair given our economic outlook. Inflation data has firmed recently near the Fed's 2% target and is generally reflected in future inflation expectations.

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