# Economic and Capital Market Review

First Quarter 2018

## Economic Review

### Strong global growth contrasted by uncertainty around inflation, Fed actions, and trade tariffs

While the overall global economic backdrop remained strong during the first quarter, seeds of doubt began to emerge, a contrast to the untamed exuberance that carried through the end of 2017. In the U.S., real GDP increased 2.3% in 2017, up from 1.5% in 2016, and we continued to edge closer to one of the longest expansion periods in history.[1] Globally, synchronized growth has continued across both developed and emerging economies. However, a confluence of monetary policy, fiscal policy, market factors, and various exogenous events has created a unique market environment that seems primed to react (most likely to the downside) should any one element get too far off-kilter.

The Tax Cuts and Jobs Act (TCJA) remained in the spotlight during the quarter, as everyone — businesses, investors, governments, etc. — continued to assess the expected near- and longer-term effects of the tax policy changes. From a broad economic standpoint, the TCJA is expected to add an estimated 0.2% to 0.4% to GDP growth over the next two years. Additionally, the International Monetary Fund cited the U.S. tax changes as a primary influence in its decision to revise upwards its 2018-2019 global growth expectations.[2] However, as we discussed last quarter, this fiscal policy push comes late in our country's economic cycle, adding fuel to an already strong fire.

The primary question for the economy, as it relates to fiscal policy, was — and still is — whether the TCJA would tip the scales on inflation and subsequently interest rates. So far, U.S. inflation measures remain muted. The Fed has consistently blamed "transitory factors" for causing inflation to fall below its 2% target. In a recent speech, Fed Governor Lael Brainerd acknowledged that "persistent" factors could be at play in the low level of core inflation, but monetary policy should still ensure inflation is "firmly re-anchored" at 2%, while also sustaining full employment.

Indeed, the labor market appears to be firing on all cylinders. The economy arguably remains at full employment, with unemployment measuring 4.1% for the fifth straight month in February. Non-farm payrolls increased by 313,000 in February, which is the highest reading since July 2016. However, wage growth during the quarter was only modest, perhaps limited by a small increase in the labor-force participation rate. In fact, the U.S. employment-to-population ratio remains well below pre-crisis levels.

**U.S. Employment-to-Population Ratio**


*Source: FactSet*

So the Fed remains in a difficult position. At the end of 2017, market expectations for the number of Fed rate hikes for 2018 stood at three with zero probability of a fourth hike. As of the end of this quarter, the probability of a fourth hike had risen to nearly 25%. The Fed, now led by Chairman Jerome Powell, initiated the first of these hikes in March based on revised expectations of faster economic growth, higher inflation, and lower unemployment over the next several years.

International investors continue to witness broad-based economic growth. Both global manufacturing and non-manufacturing purchasing managers' indexes (PMIs) remain in expansionary territory (above 50) and near multi-year highs.

However, the rate of economic growth appears to be slowing, as global central banks begin withdrawing liquidity and decreasing their balance sheets. The European Central Bank reduced its level of quantitative easing and the euro strengthened. The Bank of Japan remains focused on jump-

[1] U.S. Business Cycle Expansions and Contractions, National Bureau of Economic Research. http://www.nber.org/cycles.html

[2] World Economic Outlook Update, January 2018, International Monetary Fund. https://www.imf.org/en/Publications/WEO/Issues/2018/01/11/world-economic-outlook-update-january-2018

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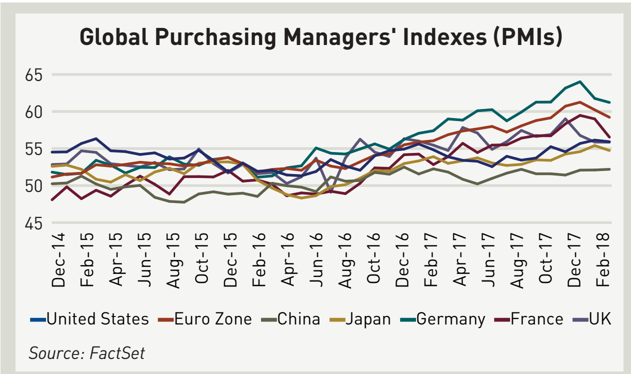
starting inflation. U.S. tax policy changes will likely boost global growth at least temporarily.



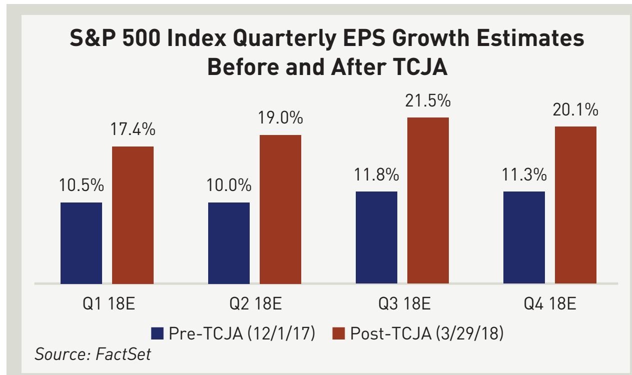

One threat to global growth that emerged during the quarter was increasing trade protectionism. While this issue has been simmering in the background for some time, it kicked into high gear when the Trump administration initiated a series of trade tariffs, first on steel and aluminum, and then with provisions specifically targeting China. Not only do these actions raise the risk of retaliatory measures by foreign governments, they also introduce uncertainty for businesses and consumers around the world, as trade tariffs will likely affect costs, prices, and demand.

### Equity Market Review

### Tax reform driving analyst estimates higher, while long-overdue volatility returns

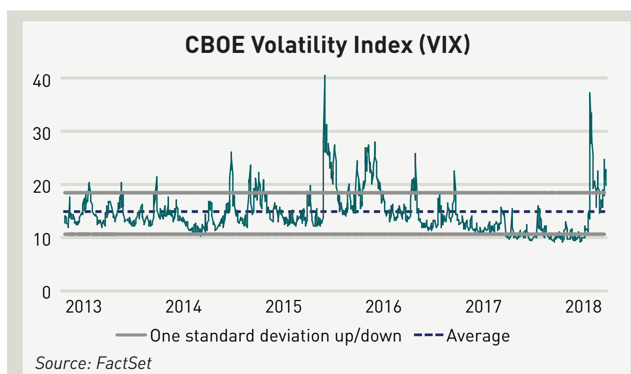
Equity markets kicked off the year with excitement as investors continued to price in the positive impacts from the TCJA. While there are puts and takes to the new legislation, the collective response to the new tax measures was positive. Many companies revised their earnings expectations higher as a result of a reduction in the corporate federal tax rate (from 35% to 21%). Less clear, though positive, are second-order effects of an increase in earnings, as well as the repatriation of profits held offshore. The increase in profits and/or funds from repatriation could be redeployed in a number of shareholder-friendly ways, such as reinvesting in the business (new equipment, higher wages, etc.) or returning capital through buybacks and dividends.

As companies announced their fourth-quarter earnings results and expectations for the coming quarters and year, analysts' earnings estimates began to move higher. The estimated S&P 500 year-over-year earnings growth rate for the first quarter now stands at about 17%, up from almost 11% at the end of 2017 and is the highest earnings growth since the first quarter of 2011.




Additionally, estimated S&P 500 sales growth for the coming quarter of 7.3% is at its highest level in eight years. Interestingly, for companies that generate more than 50% of their sales in the U.S., the earnings growth rate is expected to be 16.1%, compared to 11.4% for companies that generate less than 50% of their sales in the U.S.

The spoiler to this upbeat outlook came toward the end of January when investors received a jolt from a sharp uptick in market volatility. Importantly, volatility (both realized and expected) had been expected to normalize higher from its exceptionally low levels in 2017.




What catalyzed the uptick in volatility remains debatable. However, the January non-farm payrolls report showed an unexpected increase in wages, which may have sparked fears that inflation was set to spike and that the economy was on

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course to overheat. And like other "flash" corrections, the market response is usually to sell first and ask questions later. From January 29 through February 8, the S&P 500 pulled back just over 10%. Interest rates also made marked moves higher in January, with 2-year and 10-year Treasury yields increasing 38 basis points (bps) and 33 bps, respectively, by the end of month. Potentially exacerbating the correction was activity among several market products designed to bet against volatility, in which investors had to scramble to cover their exposure once volatility set in. The market experienced an additional draw-down during March on trade-war fears. Between March 9 and March 23, the S&P 500 declined about 7%.

It's important to keep in mind that 2017 was an anomalous year for volatility, which remained well below the five-year average for much of the year, as measured by the CBOE Volatility Index. Most (including the best) years can experience market pullbacks from 3% to 15%, spanning a few days to a few months. In fact we're still considered to be in a bull market, which celebrated its ninth anniversary in March. We continue to expect a normalization of volatility; however, we believe the domestic markets still have a favorable fundamental backdrop for 2018.

The increase in volatility created technical pressure on what was otherwise a positive fundamental environment. However, fundamental worries began to creep in toward the end of the quarter, particularly with the increased rhetoric around trade tariffs. Additionally, the Technology sector sold off sharply toward the end of the quarter, triggered by concerns around data privacy at Facebook. Recall that performance of the FAANG group of stocks — Facebook, Apple, Amazon, Netflix, and Google (Alphabet) — has largely driven the strong performance of many large-cap indices over the past year. Over the past 12 months, on a market-capitalization weighted basis, the FAANG group returned about 41%.

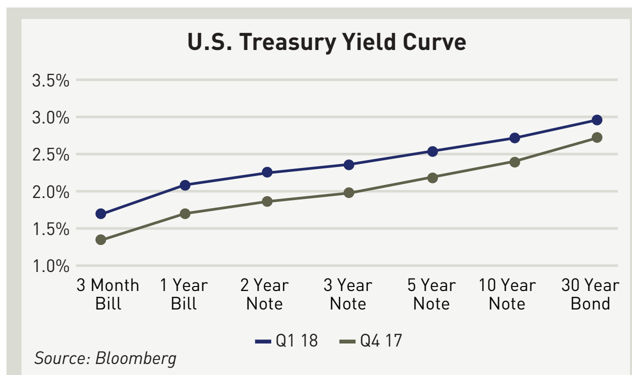
One silver lining to the pullback in equity prices was its effect on valuations. We've been in an elevated valuation environment for some time, so the combination of rising analyst estimates and lower stock prices led to valuation compression during the quarter. Although stocks aren't necessarily "cheap," they're marginally more attractive heading into the second quarter.

### Fixed Income Market Review

### Continued focus on the Fed and inflation, with a growing influence from the impact of tax reform

In a continuation of themes that dominated 2017, fixed income markets remained focused on the Fed and inflation. Additionally, markets continue to deal with the implications of tax reform, as fiscal policy, monetary policy, and economic forces combine in a perplexing environment characterized by low interest rates, low inflation, low unemployment, and solid growth.

Fiscal policy stimulus combined with less accommodative monetary policy pressured Treasury rates higher during the quarter, with the U.S. Treasury curve steepening through mid-February, but ultimately flattening relative to the end of 2017.




While fixed income volatility also surged in sympathy with equity markets this quarter, it did not result in a flight to quality in U.S. Treasury securities. Additionally, there was little carryover into the credit markets, as investment-grade spreads, while moving wider, did so in an orderly fashion. Investment-grade spreads widened by 13 bps during the quarter, but remain near multi-year tight levels.

Although the fiscal policy boost from tax reform was well received across the board, the timing of the legislation could potentially put the Fed, U.S. Treasury, and fixed

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*Source: FactSet*

income investors in an awkward position. Specifically, the Congressional Budget Office estimates that the TCJA will increase the federal deficit by more than $1.4 trillion over the next 10 years due to lower expected tax revenue, a funding shortfall that will likely be bridged with additional Treasury issuance. At the same time, the Fed continues to conduct its balance sheet unwind, reinvesting approximately $50 billion less per month of securities by the end of 2018 than it was at the end of 2017.

Corporate issuance was benign during the first quarter aside from some merger and acquisition-related deals. Here too is where the effect of tax reform may be creeping in. Not only did the TCJA lower the federal corporate tax rate, but it also included provisions making it favorable for companies to repatriate cash from overseas operations. Companies could potentially use this cash to pay down existing debt, or fund transactions or other expenditures that would have otherwise required new debt financing.

Likewise, near-term municipal issuance has been impacted by the TCJA, as an estimated $40 billion in planned issuance was pulled forward from the first quarter 2018 to the fourth quarter of 2017. It remains to be seen what the ultimate impact of the TCJA is on municipal markets, but several key provisions are expected to have a net negative effect for both issuers and investors. For example, the overall reduction in personal and corporate income tax rates may reduce demand for municipal bonds, as the lower tax burdens could lead to less need for tax-exempt income. Other provisions, including the limitation to state and local tax deductions and changes to the rules governing advanced refunding strategies could also negatively affect issuers and investors. Also potentially impacting the municipal market is the expected increase in the federal budget deficit as a result of the TCJA, which could lead to higher borrowing costs for issuers.

### Looking Forward

### Increased volatility does not signal the end of good times, but vigilance is warranted

In the coming months, we continue to anticipate the normalization of market volatility and central bank policy. A resurgence of volatility should lead to an increase in the average level of volatility in equity markets in the coming quarters. However, this recent uptick in volatility does not necessarily signal the end of this market cycle, as the underlying fundamentals of the U.S. economy remain strong. Economic and earnings growth are improving, labor markets are tight, and the Federal Reserve minutes point to anticipated increases in wage growth and inflation. We expect fixed income markets to be determined by inflation expectations. Additionally, we expect major central banks will likely continue to gradually tighten monetary policy. Ultimately, it is important to keep in perspective how remarkably calm the past few years have been for stocks and bonds, and to view upticks in volatility as a return to normal rather than a slide into turmoil.

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### Indexes

The **Chicago Board Options Exchange (CBOE) Volatility Index® (VIX®)** reflects a market estimate of future volatility. VIX is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward-looking and is calculated from both calls and puts.

The **Purchasing Managers' Index (PMI)** is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The purpose of the PMI is to provide information about current business conditions to company decision makers, analysts and purchasing managers.

The **S&P 500 Index** is an unmanaged cap-weighted index of 500 publicly traded stocks generally representative of the large-cap U.S. stock market performance and includes a representative sample of leading companies in leading industries. An investor cannot invest in the S&P 500 Index.

The **Merrill Lynch Option Volatility Estimate Index** is derived from over-the-counter options on Treasuries maturing in two to 30 years. Gauges the level of fear or complacency in fixed income markets.

Indexes are unmanaged and not available for direct investment.

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