Economic and Capital Market Review

Second Quarter 2017

Economic Review

At the beginning of each year, it's common to see optimistic economic outlooks, as forecasters turn their attention to the months ahead with all its fresh possibilities and potential. Many forecasters look forward expectantly, especially those in the financial services industry. Who wants to invest capital amid a dour economic outlook?

The beginning of 2017 was no different, especially with the surprise election of President Trump. While the decibel level of political discord ratcheted up, with passions running deep on both sides of the aisle, the markets, by contrast, quickly concluded the incoming administration and Congress would be good for business. Stock prices jumped, bond yields rose, the dollar strengthened, and inflation expectations increased, as the market focused on possible tax reform, tax cuts, less regulation, bold infrastructure initiatives, and more deficit spending. Many forecasters got caught up in the exuberance and raised their expectations for GDP growth. We looked forward to growth of around 2.5% in 2017, much better than 2016's tepid 1.6%.

However, the first six months of 2017 have been more difficult than expected, both from a political and an economic perspective. Politically, the pro-growth policies espoused by the administration have faced slow implementation and/or an inability to gain traction. Most notably, the efforts to repeal and replace the Affordable Care Act (ACA) appear to have stalled. If lawmakers are able to achieve bipartisan health-care reform, we believe it could provide much-needed positive momentum in Washington. Moreover, a resolution – one way or another – would decrease the uncertainty that is hindering planning by consumers, providers, insurers, businesses, and others in the health-care system.

Aside from the ACA, tax reform and potential tax cuts may not gain real traction until 2018. Tax reform is complicated and subject to intense lobbying. We may not have better clarity until late in the year or even into 2018. Infrastructure initiatives and spending seem to be delayed well into 2018 or beyond. Thus, in our view, any boost to this year's economic growth depends on the "animal spirits" of confident consumers and business leaders.

From an economic perspective, the first half has been slower than expected, especially in the first quarter, which grew at a 1.4% annual rate. While second-quarter growth appears faster, the balance of the year would need to be consistently stronger to meet the initial 2.5% forecast. Given consumer spending has been modest, growing at only a 2.1% annual rate for the six months ended in May, and businesses have only grown fixed investment at a 3% rate year over year, we now expect full-year GDP growth in the 2% to 2.25% range, down from our more optimistic outlook at the start of the year.

Sources: US Bureau of Economic Analysis, Eurostat, Japanese Cabinet Office

In contrast to what's been happening domestically, better-than-expected growth abroad has been a welcome economic surprise. Economies in continental Europe seem to be accelerating, as political uncertainty has waned in the wake of populist electoral defeats in France, the Netherlands, and Austria. In fact, continental Europe expanded at a faster rate than the U.S. during the first quarter and is expected to continue expanding into the second half of 2017.

Japan has also been a bright spot, with decent growth, low inflation, and low unemployment. Japan's quarterly Tankan survey of large businesses rose for the third straight period and is at its highest level in three years. However, given continued low inflation rates, we expect the Bank of Japan will be slow to reverse its hyper-accommodative monetary policy.

China's economy officially continues to chug along, posting growth rates in the mid 6% range. However, recent reports indicate growth may be modestly decelerating, as monetary authorities rein in credit expansion associated with the overheated housing sector in major cities and non-bank lenders. The actions are taking a toll on banks' profitability, as net interest margins are shrinking and credit growth is slowing. Additionally, the Chinese renminbi has been appreciating against the U.S. dollar since monetary authorities announced a plan in May intended to dampen currency volatility.

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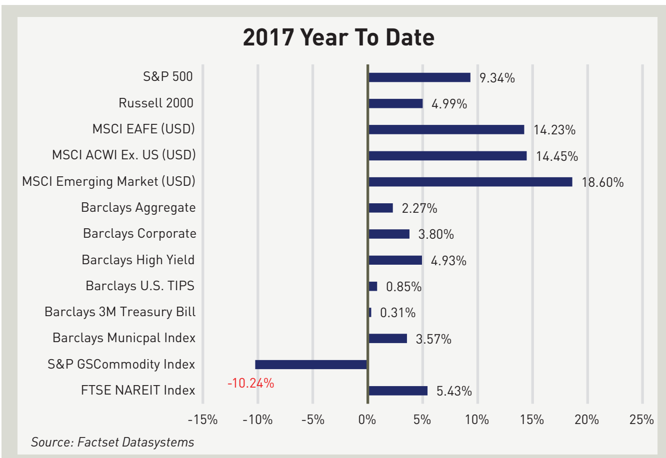
Overall, riskier assets performed well during the second quarter and calendar year to date. Domestic large-cap stocks, as measured by the S&P 500, rose more than 3% during the quarter and more than 9% since the start of the year. Health Care and Industrials led the way, with returns of 7.1%, and 4.7%, respectively, for the quarter. The Health Care sector improved on the prospect that much of the ACA will remain in place, as well as anticipated regulatory relief in the pharmaceutical industry. Industrials, particularly airlines, benefitted from declining oil prices during the quarter.



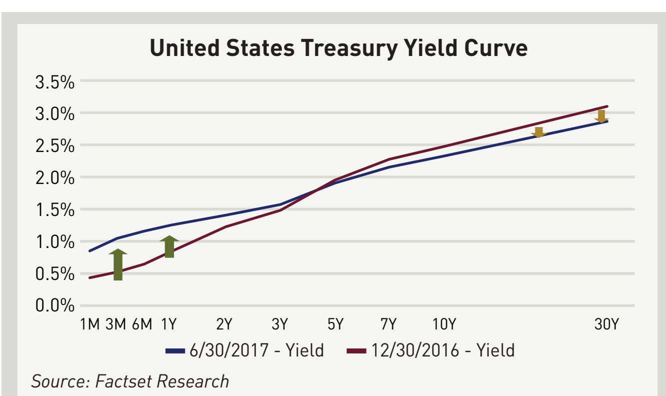
Conversely, the Telecommunications and Energy sectors languished, returning -7.1% and -6.4%, respectively. Wireless providers are in a price war, which is pushing down forecasted revenues, while the oil price slide during the quarter hurt Energy stocks.

After languishing for much of the period, Financials had a late-quarter surge, gaining more than 6% in June. Investors seemed pleased with the results of the Federal Reserve's stress testing and acceptance of the banks' intended capital plans. Indeed, many banks plan to substantially increase their dividend payouts and share repurchases, essentially returning close to 100% of earnings over the next 12 months to shareholders. However, during the calendar year to date, Financials still trail the S&P 500, as the much-discussed post-election regulatory relief has not yet materialized.

From a style perspective, growth stocks outperformed value stocks by more than 3%, led by the strong performance of momentum factors. Year to date, growth has outperformed value by more than 9%, led by the so-called FAANG stocks: Facebook, Apple, Amazon, Netflix, and Google (Alphabet). Representing approximately 10% of the S&P 500's market capitalization, these stocks alone have contributed to about 24% of the benchmark's return this year. However, this group of stocks, as well as the broader Technology sector, pulled back from their rapid rise toward the end of the quarter, with the S&P 500 Information Technology sector falling about 2.7% in June.

Small-cap stocks, as measured by the Russell 2000, continued to underperform large-cap stocks during the quarter and have returned about 5% for the first six months of the year versus large cap's return of 9.3%. Small caps would have lagged by an even greater amount if not for a 3.5% jump in June. Just as in the large-cap space, growth stocks far outperformed value in both the quarter and calendar year-to-date periods.

International stocks bettered their domestic counterparts once again. Foreign developed-market stocks, as measured by the MSCI EAFE Index, returned 6.3% during the quarter and pushed their calendar year-to-date performance to 14.2%. Emerging markets continued their strong performance, also returning 6.3% for the quarter and an even stronger 18.6% year to date as measured by the MSCI Emerging Markets Index. For U.S.-based investors, developed and emerging-markets performance has benefitted from a depreciating U.S. dollar this year.



The bond market, as measured by the 10-year Treasury note yield, was relatively calm through much of the quarter. Yields had been dropping irregularly since mid-March to a near-term low in late June of 2.13%. However, yields started moving higher at the end of the quarter, as the market began to anticipate an end to hyper-accommodative monetary policies.

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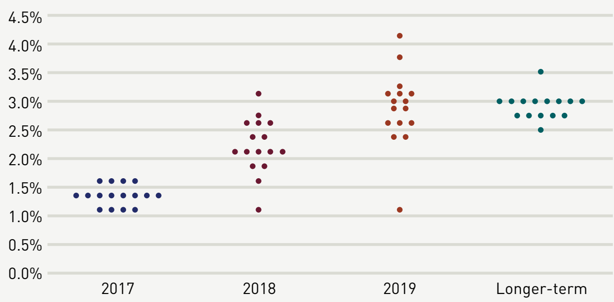
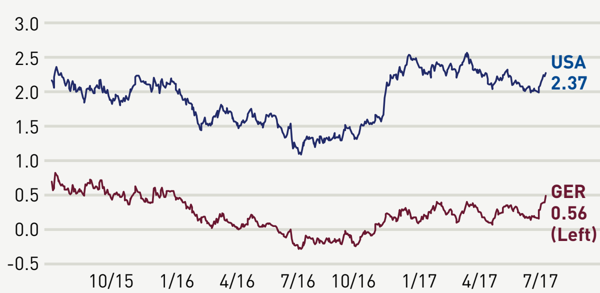
On balance, the yield curve flattened, with the 2-year note moving 13 basis points (bps) higher, while the 30-year Treasury yield fell 17 bps. In our view, this is a rational reaction given the current market environment in which the Fed has raised short-term rates three times since December 2016 and inflation has cooled.

Projected Appropriate Policy Path: Fed Funds Rate



Source: Board of Governors of the Federal Reserve System

Global 10-Year Yield



Source: Factset Research

In addition to interest-rate policy changes, the Fed indicated it will begin scaling back its holding of Treasuries and mortgage-backed securities (MBS) by letting some maturities pay down and not reinvesting the proceeds. Initially, the amounts are small – $6 billion of Treasuries and $4 billion of Agencies and MBS per quarter, gradually rising to $30 billion and $20 billion, respectively. This unwind could begin as early as September. If it does, we expect the Federal Open Market Committee (FOMC) to hold off on a simultaneous fed funds rate hike in order to avoid hitting the market with too much monetary restraint at once. Instead, we believe the Fed could move again in December, completing four 25 bps increases over a 12-month time period, ending the year with a fed funds rate in the 1.25% to 1.5% target range. Current forecasts by the FOMC suggest three additional rate hikes in 2018.

In contrast, the European Central Bank (ECB) continues to expand its balance sheet by 60 billion euros per month as part of its asset purchase program and short-term interest rates remain negative. The program is set to continue through the balance of 2017. However, Mario Draghi, the president of the ECB, recently indicated that the recovery in European economies may be on a firmer footing, therefore the ECB's current policy may need to be adjusted. He indicated that even though observed inflation may be low, he views it as temporary, stating: "Deflationary forces have been replaced by reflationary ones."

Additionally, Mark Carney, governor of the Bank of England (BOE), indicated in late June that "Some removal of monetary stimulus is likely to become necessary." When combined with the recent four-year high in British inflation and statements from the BOE's chief economist on how a tighter policy may be prudent in the second half of the year, markets have begun to interpret these remarks as preparation for a turn in BOE policy. British bond (gilt) yields rose, while the pound appreciated against the dollar.

Outlook

In our view, domestic equities are fully valued at the current 17.5x price-to-forward earnings ratio for the S&P 500, and 24.5x for the Russell 2000 small-cap index. While markets can certainly go higher from these levels, such increases would need to be based on better earnings forecasts than we see now. This melt-up scenario could occur should the administration and Congress work to enact more pro-growth policies, especially tax reform at the corporate level. Because real political progress could take longer than expected, we believe equity markets may hover at current levels until political visibility improves or economic growth breaks out of the current trend.

Similarly, we expect fixed-income markets to continue in their current range until the economy breaks out of its 2% growth rate. The yield curve may even flatten further, as the Fed likely continues on its tightening course later this year. Should growth accelerate more quickly, we could see 10-year Treasuries move back to the high end of their range over the past two years – even higher should inflation start to perk up again. For the time being, we believe corporate spreads should remain stable at these relatively tight levels. In addition, positive earnings should support credit spreads, absent too many share repurchase programs funded by debt. Selectivity will be the key, as certain areas, including traditional retailers, certain real estate sectors, and Energy may remain under secular pressure.

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Currently, futures markets are not pricing in the same degree of tightening that the FOMC indicated in its assessment of the future path of interest rates. In the recent past, the market has discounted the Fed's aggressiveness and has been generally correct – the Fed has indeed raised rates more slowly and cautiously than its forecasts would imply. However, the FOMC seems to be operating in a more confident space, with both domestic and international growth on firmer footing, and other central banks looking to reduce their hyper-accommodative monetary policies as well.

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