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Outlook as of February 2017

WORLD ECONOMY

- Global growth momentum evident at the end of 2016 has generally carried over into 2017, although business and consumer confidence surveys reflect the expectation that promised policy initiatives will be needed to achieve full year growth forecasts.
- After a frustratingly slow recovery, capital spending is becoming a meaningful contributor to US growth. Productivity gains derived from investment in capital equipment can help offset rising wages and allow the economic expansion to continue beyond 2017.
- Currency weakness against the dollar, coupled with rising demand from the strengthening US economy, are providing the expected boost to UK and Eurozone exports. Continued political uncertainties, and concerns that the current global populist wave turns into outright protectionist policies, inhibit us from taking a more positive view of economic prospects for Europe.
- The weaker yen has indeed boosted Japanese export growth since last summer, but higher import prices have created domestic inflationary pressure, which serves as an effective tax increase in a demographically challenged economy with anemic wage growth. The recent yen strength is an unwelcome development with respect to exports.
- China continues to seek a controlled slowdown of economic growth while working through the overhang of excessive investment spending of the past decade. Strains on the currency and capital account make the ultimate success of their aspirations for a “soft landing” more tenuous.

MONETARY POLICY & CURRENCIES

- Consumer price inflation remains below the Fed’s 2.0% target at the core level, despite a slight pick-up from higher energy prices. This should give the Fed the flexibility to tighten gradually and deliver a “normalized” 3% Fed Funds rate by 2019.
- With German inflation rising in recent months, the ECB is now facing pressures to consider tapering its bond purchase program. Chairman Draghi will have to be careful not to disrupt the burgeoning improvement of the peripheral countries with any premature tightening moves.
- The Bank of Japan’s changed emphasis from negative interest rates to yield curve control and a 0% target for 10 year government bonds has taken some pressure off monetary policymakers. However, with no support from fiscal policy expected this year, the current level of monetary easing will need to stay in place throughout the year in order to sustain economic growth.
- Recent stabilization in the renminbi has relieved some of the pressure on the People’s Bank of China to introduce additional capital controls and discourage continued capital flight out of the country. Given the implied peg to the dollar, maintaining currency stability will likely entail some tightening by the PBOC in tandem with any moves by the Fed.
- The dollar bull market is rather mature, but policy divergence and relative growth differentials between the US and other countries suggest continued appreciation against most currencies.

BOND MARKETS

- The outlook for gradual monetary tightening in a steadily improving US economy should allow a shift upwards in the entire yield curve, with intermediate rates paralleling the Fed-induced rises at the short end of the curve.
- Rate increases driven largely by better economic growth prospects should allow credit spreads for both investment grade and sub-investment grade bonds to narrow over the coming months.
- It appears unlikely that any cut in individual tax rates will be made retroactive to the beginning of this year. Demand for municipal bonds should therefore remain fairly steady and allow the market to absorb increased issuance without causing municipal yields to spike more than we expect for the broader bond market.
- Developed market international bonds should maintain their current yields through the year. Given the possibility that global growth may improve during the year and cause rates to rise, the low absolute levels suggest caution.
- If the Fed tightening framework is gradual and well-communicated, we see an opportunity for higher coupon emerging market debt to outperform other bond categories as EM central banks have more flexibility to reduce rates down the line.

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EQUITY MARKETS

- Given the strong post-election surge in US equities that carried through into January, a consolidation or pullback in prices would not be surprising. With no recession in our forecast, positive earnings growth expected for all of this year, and only a gradual tightening expected from the Fed, any pullbacks should be used as opportunities to deploy cash into US equities.
- We are somewhat optimistic on the outlook for continental European and UK equities, based on the recent currency depreciation and resulting improvement in export growth. However, uncertainties around the upcoming EU elections and the ultimate ramifications of Brexit call for a continued underweighting of European equities.
- Japanese equities have had a stronger start to the year than most other developed equity markets. The recent rise in the yen could harm the export sector and drag down growth equity markets if it should persist.
- Valuations for emerging markets equities remain compelling and the 2016 run-up in commodity prices has alleviated near-term revenue concerns. However, questions around the magnitude of the slowdown in Chinese economic and earnings growth, plus the possibility of growing trade conflicts with the US, call for continued caution in our allocation to this asset class.

ALTERNATIVES & COMMODITIES

- A trading range for oil prices in the $45 to $60 range appears to have been established. The OPEC production cut agreement provides a floor, while continuing production efficiencies by the US shale extractors should allow them to keep pumping at lower break-even levels, thereby keeping a lid on prices.
- Although not currently expected, gold could break out above current levels if the market perceives an unexpectedly large rise in wage and goods inflation and concludes that the Fed is tightening too slowly. Gold prices could also jump on news of a global trade conflict and expectations of higher inflation. Any such rally would be short-lived, however, as such an environment would quickly become deflationary.
- A controlled slowdown in Chinese growth and the promise of greater infrastructure and defense spending in the US has pushed industrial metals prices higher. In the absence of an excess supply overhang apparent in the energy sector, industrial metals prices would benefit from the forecasts for higher US and global growth in 2017.
- Hedge funds positioned for rising interest rates and macroeconomic uncertainty should benefit from the current environment as investors seek ways to mitigate exposure to unstable, volatile markets.
- Sustained high asset valuations make it challenging for private equity managers to acquire assets at reasonable prices. We maintain our focus on seasoned, disciplined private equity managers and continue to seek opportunities in dislocated markets, and those facing disruption from regulatory or technological change.

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Ben Pace is the Chief Investment Officer and a member of the Investment Committee. Prior to joining Cerity Partners, Benjamin Pace was Chief Investment Officer and Head of Global Investment Solutions for Deutsche Bank Private Wealth Management in the U.S. Ben has more than 25 years of experience in investment management. Prior to joining Deutsche Bank in 1994, he managed equity income funds for two investment organizations.

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