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Outlook as of February 2018

WORLD ECONOMY

- The global synchronized growth momentum from 2017 has carried into this year with many economies around the world expanding at an accelerated rate.
- The US has experienced a slight slowdown in 1Q momentum the last few years most likely due to weak business spending. This year, greater business confidence, which began to surface in the middle of last year, should be further boosted by tax reform and allow capital spending growth to offset the expected slight slowdown in consumption growth.
- European economies have begun to experience an uptick in domestic consumption, the continuation of which would be a notable structural development that could compensate for any export headwinds resulting from the sharp currency appreciation during the past 12 months.
- Japanese economic growth continues to be overly dependent on external trade as very low unemployment rates have yet to exert meaningfully upward pressure on wages and domestic spending. Capital spending will benefit from corporate tax reform and allow the economy to move further away from the deflationary concerns which existed through most of this decade.
- Effective management by authorities of the Chinese economic slowdown will be important to monitor for its impact on the global economy, but particularly emerging market economies that rely on Chinese demand for an increasing portion of their economic growth. The government has already shown a propensity to dial back some of the austerity initiatives should growth slow too rapidly.

MONETARY POLICY & CURRENCIES

- The immediate economic benefits deriving from the recently introduced tax reform should allow the Fed to remain on its steady, gradual tightening path with three 25 basis point increases this year. The tightening policy should end late next year or early 2020 at roughly a 3.00% Fed Funds rate.
- Recent sterling appreciation should reduce inflationary pressure and allow the Bank of England to more closely monitor the economic impact of the Brexit process before embarking on a rate normalization path.
- Although inflation rates have yet to approach their 2% target, the European Central Bank is experiencing an internal struggle as the hawkish members are pushing harder for a firm end to quantitative easing and the immediate commencement of rate increases. Fear of even more currency appreciation will be Chairman Draghi's defense as he would prefer to tighten very gradually.
- Concern over higher fiscal deficits resulting from tax reform and some surprising jawboning coming directly from the Treasury Secretary is putting additional pressure on the dollar. A higher economic growth trajectory, incrementally tighter monetary policy, and higher levels of interest rates relative to other developed market economies should allow the dollar to settle into a trading range around these levels for the remainder of the year.

BOND MARKETS

- The increase in bond yields at the beginning of the year has been largely driven by inflationary concerns caused by the weaker dollar and higher energy prices. As these inflationary pressures are likely temporary, more issuance of Treasuries due to higher deficits combined with less buying by the Fed should be the primary catalysts causing bond yields to drift higher across the yield curve.
- High yield bonds are fully valued at the current rate spreads to Treasuries. With no recession forecast over the near term, default rates should remain low into next year. Caution should be exercised in the lower rated sectors as easy access to cheap financing has masked the fundamental weakness in many issuers that will be exposed in the next downturn.
- It is very difficult to find value in developed market international bonds as the yield levels remain low and the anticipation of reduced bond buying by central banks over the near term heightens the risk of upward interest rate spikes.
- Emerging market debt enjoys the benefit of higher absolute levels of interest rates which gives the central banks in this asset class the ability to conduct traditional monetary easing programs to combat any economic slowdowns. A weaker dollar has also been helpful, but exposure to Chinese economic growth is a potential pressure point.

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EQUITY MARKETS

- A strong fourth quarter earnings season and upward earnings revisions by analysts due to the tax cuts have helped drive equities even higher to start the year. With rates moving higher, it will be difficult to achieve much more multiple expansion with earnings growth becoming the primary driver of further price appreciation. After the impact of the tax cut, we expect earnings growth to settle into the mid single digits.
- European equities are generally cheaper than those in the US as they are skewed to more cyclical industries which tend to trade at lower multiples. An end to currency appreciation would likely be welcomed by company managements and investors in these markets.
- Equities of the large Japanese multinational companies have been the primary beneficiaries of the strong global growth environment and the appreciating currencies of many of their trading partners. Weak consumption spending and its impact on the domestically driven sectors continues to be the main risk of investing in Japan.
- Attractive valuations and better near term earnings growth rates relative to domestic markets have been drivers of continued outperformance of emerging markets equities into 2018. An upward spike in developed market bond yields and concern around the magnitude of the Chinese growth slowdown could temper this relative outperformance.

ALTERNATIVES & COMMODITIES

- The excess inventories which have plagued the energy industry for the last three years have been largely worked off. At these higher prices of crude oil, watch for the US shale producers to notably increase their production levels thus capping further appreciation over the coming months.
- The expectation that other developed market central banks will join the Fed in tightening monetary policy should limit meaningful appreciation in the price of gold above current levels.
- Political delays in the passing of a US infrastructure bill and the Chinese initiative to try to curb pollution with a mandated reduction in industrial production will likely halt the advance in industrial metals through the first half of the year.
- Persistently low market volatility and high market correlations have challenged hedge fund managers following the global financial crisis. Moves towards policy normalization by central banks should create more favorable conditions for differentiated managers and allow investors to mitigate risks from unstable markets or policy and geopolitical uncertainty.
- High asset valuations have made it difficult for private equity managers to acquire companies at reasonable prices. We maintain our focus on seasoned, disciplined managers and continue to seek value in dislocated markets, or those experiencing disruption from technological or regulatory 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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