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Outlook as of July 2018

WORLD ECONOMY

- Worsening trade tensions and the actual implementation of tariffs are threatening to slow global growth in the second half of the year, although US economic momentum should allow global economic growth to improve somewhat year-over-year.
- While capital spending is forecast to be the primary driver of US economic growth this year, US consumer spending has been surprisingly resilient, aided by rising after-tax income from strong job growth and lower taxes.
- For both the UK and the Eurozone, weaker growth in Q1 has extended into Q2. The recent currency declines will provide crucial support to exporters, with the exception of Germany, which is targeted for higher US tariffs.
- The Japanese economy likely achieved slightly positive second quarter growth following the first quarter contraction, but domestic spending continues to disappoint. As in Europe, the weaker yen will help second half growth, but a pending sales tax increase will heighten consumer angst.
- The Chinese economy has yet to be seriously affected by the exchange of trade barbs with the US administration. However, the rollout of higher tariffs this month will put pressure on the government as it attempts to maneuver a controlled growth slowdown.

MONETARY POLICY & CURRENCIES

- The Federal Reserve is signaling two further interest rate hikes in 2018. Given the near-absence of inflationary pressures and continued flattening of the yield curve, we suspect the Fed may be nearing the end of this tightening cycle.
- The Bank of England very much wants to begin the tightening process and has cited improving consumer sentiment for its belief that the slowdown earlier this year was temporary. The lack of improvement in actual consumer spending, and uncertain economic impact on business spending of the pending exit from the Eurozone, should keep the central bank at bay for the balance of this year.
- The ECB finally announced the plan to taper, and then end by December, the massive quantitative easing program induced by the financial crisis. Lower growth forecasts across the region and lack of a tangible inflation threat will postpone any actual rate hikes until well into 2019.
- The Bank of Japan's governors have admitted they are unlikely to reach the 2% inflation target any time soon. Coupled with the prospect of a 2019 sales tax increase to fight the growing fiscal deficit, we expect the current level of monetary easing to stay in place for the foreseeable future.
- Positive US economic momentum, higher interest rates relative to other countries, and the Fed's commitment to policy normalization, all favor a continued advance of the dollar against most currencies in the coming months; although we expect that substantially higher US budget deficits due to the 2017 tax cuts will eventually serve to halt the appreciation.

BOND MARKETS

- Lack of a sustained move above 3% in the 10-year US Treasury yield may be a sign that inflation remains contained, despite the economy being at full employment. Recent data readings also indicate that uncertainty around further trade protectionism is causing US corporations to refrain from major capital expenditures for the time being.
- Further contraction in high yield rate spreads against like-maturity US Treasurys in recent months is another indication of the continued health of the US economy. However, it also renders these issues fairly valued, if not overvalued, at current levels.
- Municipal bond outperformance over Treasurys has been impressive this year, as much of the prospective 2018 issuance was advanced into Q4 of 2017 due to changes in the advance prefunding rules under the tax reform legislation. A more normal issuance calendar through year-end should leave tax-exempt bonds with returns similar to their taxable brethren.
- Emerging markets countries with higher levels of externally-financed debt are feeling the pressure on their currencies from continued Fed tightening. The resulting selloff in the entire asset class has rendered attractive the debt of countries with lower fiscal deficits that have been able to finance with longer maturities and in local currency.

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EQUITY MARKETS

- Despite trading in a rather narrow trading range since the first quarter correction, US equities are expected to break out to the upside on the back of still-strong second half sales and earnings growth. US small and mid cap equities are more fully valued, but continue to be greater beneficiaries of tax reform and less exposed to protectionist trade policies.
- Unless the trade situation deteriorates markedly over the summer months, weaker currencies should help drive better sales and earnings growth for European equities. Lower relative valuations versus other markets are an added attraction for prospective buyers.
- Among developed markets, Japanese equities are perhaps the most exposed to the ongoing trade battle between the US and China. Japan's trading proximity to China and the yen's safe haven currency status could combine to pressure their very important export industries if large inflows cause the yen to strengthen.
- Monetary easing by the People's Bank of China should help the renminbi to weaken and form a bottom for Chinese equities and the entire emerging markets equities sector. Any subsequent gains will be reliant on continued US growth stoking demand for Chinese goods, and, of course, a moderation in the current trade rhetoric.

ALTERNATIVES & COMMODITIES

- The loss of a large portion of Iranian and Venezuelan oil production to international sanctions should be filled by higher output from Saudi Arabia, Russia, and the US shale sector. WTI crude should remain in a $65-$75 trading range over the coming months.
- Continued Fed tightening and the near-absence of inflationary pressures have been major headwinds for gold this year, and will likely keep prices from rising appreciably for the balance of 2018.
- Tariff-induced price increases for industrial metals have led to lower demand, especially in the very important Chinese economy. We expect price pressures to continue over the summer, until more clarity develops over the ultimate economic impact of the simmering trade battles.
- Persistently low market volatility and high market correlations have been a challenge for hedge funds over the last decade. The pickup in market volatility and asset class dispersion in recent months should help managers pursuing differentiated strategies, and also allow investors to hedge portfolio risks more effectively.
- Rising asset values have made it harder for private equity managers to acquire good companies at reasonable prices. We aim to overcome these challenges by maintaining our focus on seasoned, disciplined managers and by seeking value in niche 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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