CERITY PARTNERS

Outlook as of March 2018

WORLD ECONOMY

- Global GDP growth remains robust, although business and consumer surveys, as well as harder data, are showing signs of a slight slowdown in the rate of growth.
- The disappointing business and consumer spending reported early this year is not consistent with the still-ebullient consumer and business surveys. As the benefits of tax reform become more tangible, we expect business spending to regain the momentum evident in the second half of 2017.
- In contrast with the US, Eurozone survey numbers have begun to weaken, even as the more backward-looking actual spending data remained rather strong. Consumer spending is improving in Germany, but the sharp appreciation in the euro and pound sterling over the last 12 months is beginning to negatively impact export growth and industrial spending.
- The stronger yen and weak domestic consumption are slowing Japanese economic momentum, although corporate tax reform should lead to increased business spending on capital projects.
- The Chinese growth slowdown continues to be managed effectively by an even more powerful central government. The impact of this slowdown on their Asian trading partners and the Latin American commodity producers appears mild at this time, but will begin to be felt over the coming months.

MONETARY POLICY & CURRENCIES

- As US economic momentum continues into 2018 and the expansionary fiscal impact of the 2017 tax reforms is experienced, this raises the probability the Federal Reserve will increase the fed funds rate four times this year.
- Uncertainty around the ultimate outcome of the Brexit process and the disinflationary impact of the recent strengthening of Sterling should keep the Bank of England on the sidelines, with no rate increases expected this year.
- Eurozone inflation is at the lowest level in over a year, which should provide cover for the ECB to continue its gradual approach to ending bond purchases and eventually increasing rates. The recent euro appreciation is also keeping the more hawkish committee members at bay.
- The reappointment of Chairman Kuroda confirms the Bank of Japan will continue with its attempts to stoke domestic inflation by maintaining a highly accommodative monetary policy for some time to come.
- The expectation of higher US economic growth relative to other developed market economies should offset fears of higher US deficit spending and allow the dollar to maintain a rather narrow trading range in 2018.

BOND MARKETS

- Heightened inflationary concerns that grabbed the headlines help explain the sharp rise in bond yields in 2018. The so-called crowding out effect, from increased Treasury bond issuance to fund higher deficits, may be a longer term reason for what is likely the beginning of a bear market for bonds.
- Continued narrow spreads between rates of high yield debt and comparable maturity Treasurys suggest that high yield investors remain unconcerned about an imminent rise in default rates, although valuations appear full at these price levels.
- The current low yield levels of developed market international bonds are likely warranted by continued low inflation and the relative reticence of the monetary authorities in tightening policy. However, any surprise spike in rates will leave this asset class particularly vulnerable to negative total returns.
- The Federal Reserve’s resolve to move forward with policy normalization, and any resultant strengthening of the dollar, puts some pressure on emerging market debt. While global growth remains robust, EM central banks still have the flexibility to cut rates if conditions deteriorate, which would allow EM debt to offer attractive total returns.

Outlook as of March 2018

EQUITY MARKETS

- After hitting historic lows last year, volatility returned to US equity markets with a vengeance in February. Earnings will be the primary driver of mid to high single digit returns over the remainder of the year. Further expansion of valuation multiples is unlikely, given the upward bias for interest rates.
- The currency induced inflation brought on by the Brexit vote appears to be dissipating, which will reduce pressure on British consumers and the Bank of England. UK equities should be able to recover their year-to-date relative underperformance over the coming months.
- Eurozone equities remain cheap compared to their US counterparts. Continued monetary easing by the ECB should offset any pressure on economic and earnings growth from a rising euro and allow comparable price appreciation to the US.
- Robust global growth is vital to the growth of the export-dominated Japanese economy. The appreciating yen may be helping boost the returns of dollar based investors in Japanese equities, but continued currency strength will be a significant headwind to key export sectors.
- Lower relative valuations allowed emerging markets equities to hold up well in the recent global volatility. The expected increase in US economic growth as we progress through the year bodes well for revenues and earnings in many of these markets.

ALTERNATIVES & COMMODITIES

- Since West Texas Intermediate broke above $60 per barrel, oil markets are closely watching the response of the US shale producers to determine if this was a temporary blip, or reflective of a more permanent work down of excess inventories. Any slowdown in demand growth from China and other EM economies could cause further downward pressure on oil prices.
- With inflation still benign and the Fed continuing on its tightening path, gold prices are likely to decline as we progress throughout the year.
- The probability of Congress passing a meaningful infrastructure bill has declined as we move closer to the US mid term elections. Adding to this, the engineered slowdown of Chinese industrial production should cause prices of most industrial metals to decline in the coming months.
- Persistently low market volatility and high market correlations have been a challenge for hedge fund managers since the global financial crisis. Policy normalization moves by global central banks should create more favorable conditions for differentiated managers, and allow investors to offset portfolio risks more effectively going forward.
- 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.

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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