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Outlook as of May 2017

WORLD ECONOMY

- The surprising surge in populist/nationalistic sentiment which characterized the geopolitical environment last year is beginning to wane this year. Centrist candidates are consolidating power in Europe and the new US administration is moderating its more extreme protectionist rhetoric. This shift will allow the continuation of the worldwide growth momentum, which has been fueled mainly by central banks' highly accommodative monetary policies.
- US GDP growth has gotten off to a slow start in 1Q for the last five years. While statisticians may be struggling with the seasonal adjustments amid inconsistent winter weather, consumers clearly continue to be cautious in their spending patterns. The recent advance in business spending is encouraging and we expect continued job and wage growth to shake consumers out of their winter doldrums.
- European economies have reaped tangible benefits from currency depreciation amid relatively easier monetary policies. Political developments in Holland and France have allayed fears of an impending breakup of the European Union, although these have not totally disappeared. Positive results from the structural reforms adopted by Spain and Ireland should encourage Italy, France, and potentially Greece to initiate similar policies.
- Japan needs the yen to stop appreciating so it can take advantage of improving economic conditions in its primary export destinations in Asia and elsewhere around the world.
- Signs of a controlled slowdown in China and stabilization within the commodities markets bode well for improving economic growth among the emerging economies.

MONETARY POLICY & CURRENCIES

- Slower US economic growth in Q1 and continued moderation in energy price inflation should forestall any further interest rate rises until the fall. We expect the Fed to announce two rate hikes for the balance of the year, as well as a preliminary program to reduce its balance sheet. This likely would entail letting maturing bonds run off without replacement, as well as principal paydowns of mortgage backed securities.
- The European Central Bank acknowledges the improved economic environment, but is being careful in adopting and communicating a strategy to moderate quantitative easing and eventually raise rates. Lower inflation due to stable energy prices will delay the need for tightening until 2018.
- Year to date yen appreciation will keep the Bank of Japan on its current path of monetary ease with little possibility of tapering bond purchases or increasing rates over at least the next twelve months.
- Capital outflows from China are stabilizing. The People's Bank of China is expected to raise rates in line with US Fed moves, to keep the currency steady and help prevent outflows.
- As a byproduct of slower US economic growth in Q1, the dollar has weakened against most global currencies. Delays in approving promised fiscal policy measures have also contributed to the dollar's decline. With better economic growth and more clarity around spending and tax policies expected in the coming months, the dollar should resume its nearly decade-long appreciation path.

BOND MARKETS

- We are early in the US tightening cycle. With no economic recession on the horizon, we expect the yield curve to remain stable over the coming year, with intermediate and long-term rates rising in tandem with changes in the Fed funds rate at the short end.
- Strong credit conditions in most economic sectors have allowed interest rate spreads against Treasuries to narrow in both the Investment grade and high yield bond sectors. We don't expect high yield rate spreads to narrow further, but the higher absolute yield will maintain the attractiveness of the category in an environment of gradual rate increases.
- Following the late 2016 sell-off, municipal bonds should perform in line with the taxable market. Default rates remain low overall, although investors need to be aware of regional and security- specific opportunities/risks within the asset class.
- Although the outlook for reduced bond purchases by developed market foreign central banks remains well into next year, the risk of any perceived shortening of the time frame is too large for investors in developed international bonds given the very low current yield levels.
- Emerging market debt has benefitted from better-than-forecast GDP growth in EM countries, coupled with a moderation in protectionist rhetoric from the US administration. The asset class now appears fairly valued, as US monetary tightening has historically been a challenge to performance.

Outlook as of May 2017

EQUITY MARKETS

- First quarter earnings results validated the year-to-date rally in US equities. Earnings growth should moderate as year-over-year comparisons become more difficult for the coming quarters. Further expansion of earnings multiples is likely dependent on the outcome of corporate tax cuts in the administration's tax proposals.
- With many of the political uncertainties in Europe being resolved in a market-friendly direction, investors may begin to focus more on the relative valuation advantage of the region's equity markets compared to stretched US valuations.
- With the Japanese economy heavily dependent on exports, the safe haven attribute of the yen in a volatile geopolitical environment has been a major challenge for Japanese equities this year. Expected depreciation of the currency should allow Japanese equities to close some of the performance differential against other global equity markets over the coming months.
- The strong outperformance of emerging markets equities has narrowed the valuation gap with US equities, which widened considerably after the surprise Trump election victory in November. Since economic growth in many of these countries is linked to commodity prices, some caution is warranted, given the uncertain outlook for oil prices.

ALTERNATIVES & COMMODITIES

- Continued strong US production and the apparent hesitancy of OPEC to meaningfully extend production cutbacks will pressure oil prices down towards the bottom of the $40-$60 range which has been established over the last year.
- Weaker than expected US GDP growth in Q1, together with the prospect of delayed tightening by the Fed, caused a temporary spike in gold prices. Given the Fed's resolute tightening bias, and with economic growth expected to improve in the coming quarters, we expect gold prices to trade in a rather tight range of $1,200-$1,300 per ounce over the period.
- Now that the slowdown in China has reduced demand for copper, steel and other industrial metals, any further price advances will be heavily influenced by passage of the proposed $1tn US infrastructure program.
- Persistent low market volatility has stymied many hedge fund managers since the financial crisis. The progress toward policy normalization by central banks suggests a more favorable environment for investors to mitigate risks arising from unstable markets or policy/geopolitical uncertainty.
- High asset valuations make it difficult for private equity mangers to buy assets at reasonable prices. We maintain our focus on seasoned, disciplined managers and continue to seek value in dislocated markets and those experiencing 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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