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# Outlook as of May 2018

## WORLD ECONOMY

- Global GDP is still expected to grow at a slightly higher rate compared to last year, with improving US economic growth compensating for the somewhat unexpected slowdowns in Europe and Asia. Increasing trade tensions are the biggest risk to this generally positive scenario.
- Despite the typical first quarter slowdown experienced throughout this recovery/expansion, full year US GDP growth should return to the 3.0% annual growth trajectory on which it ended 2017. Fiscal policy initiatives on spending and tax reform will be reflected in greater business spending on fixed investments. Improved labor force productivity will be essential in extending the length of this expansion into 2020.
- The more pronounced first quarter slowdown in continental Europe likely stemmed from the sharp appreciation of the various currencies last year, although weather and labor strife had some impact. Concerns about the nature of the eventual UK exit from the European Union continue to weigh on the British economy, even as Prime Minister May struggles with conflicting agendas within her own Conservative Party.
- Japan is showing signs of a pickup in manufacturing and overall business spending, but consumption continues to be constrained by slow wage growth within an aging population. The impending sales tax increase to battle protracted budget deficits is an important headwind to sustainably improved economic growth.
- Unless the trade skirmishes with the US turn particularly vicious over the coming months, the more important near term challenge to the Chinese economy is how to reduce manufacturing overcapacity and chronic pollution without provoking an unintended spike in unemployment.

## MONETARY POLICY & CURRENCIES

- Improved economic growth from the fiscal policy expansion should keep the Fed on its telegraphed schedule of 25 basis point rate increases in each of June, September, and December 2018. The terminal rate at which the Fed ends this tightening cycle should be roughly 3.0%, which should occur by mid-2019.
- Growing dissent around the ultimate structure of Brexit may cause further delay in tightening moves by the Bank of England, in which case, the pound should decline against the dollar based on the divergence in central bank policy.
- The ECB is anticipated to announce an end to its bond buying program at the June meeting, although the actual interest rate hikes will be delayed into 2019 given the recent economic weakness.
- The specter of tighter fiscal policy in the form of a sales tax increase should preclude the Bank of Japan from simultaneously engaging in monetary tightening, particularly as recorded inflation remains substantially below the Bank's 2% target.
- The bearish case for the dollar revolves around rising deficits and the heightened potential for protectionist trade policies. The bullish case of better economic growth rates, higher interest rates, and a tighter Fed may win out in the near term, keeping the dollar strong.

## BOND MARKETS

- The flattening of the Treasury yield curve is often seen as an important warning indicator of impending economic weakness. We believe the entire curve will experience a largely parallel shift upwards as better growth and burgeoning wage inflation drives yields higher across the maturity spectrum.
- Improved economic growth dynamics have allowed corporate bonds to maintain their narrow yield advantage against like-maturity Treasurys. Continued low default rates should lead high yield bonds to outperform their investment grade counterparts as well as Treasurys in a rising rate environment.
- While we are not yet concerned about imminent tightening at their respective central banks, developed market international bonds carry such low yields that any upside economic surprises can exert meaningful downward pressure on bond prices in those markets.
- Higher interest rates and the stronger dollar are pressuring emerging market debt, especially the debt priced in local currencies. Nonetheless, emerging market central banks have the ability to cut rates if economic conditions worsen, giving them a significant advantage over their developed market counterparts, who have far less flexibility to cut rates that are already near historical lows.

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## EQUITY MARKETS

- Earnings will continue to be the primary driver of any further advance in US equity markets, as valuation multiples have likely peaked due to monetary tightening and an increase in rates across the yield curve. With the impact of the corporate tax cut already factored into equity prices, revenue growth and continued cost discipline will be necessary to sustain high single digit earnings growth into 2019.
- Relatively cheap valuation levels and the recent alleviation of some of the currency pressure should allow European equities to advance over the coming months despite the protectionist headlines, which will likely continue. It appears the trade skirmishes are primarily between the US and China, but watch for an extension to Germany due to the large trade surplus with the US.
- Japanese equities are even more reliant on yen weakness to boost earnings and stock prices within their important export and manufacturing sectors. Proximity to China and reliance on exports could be significant headwinds for Japanese equities, especially if trade tensions escalate or the Chinese economy experiences a further slowdown in growth.
- Chinese equity weakness and the impact of dollar strength on many of the currencies have combined to pressure emerging markets equities over recent weeks. However, the larger concern remains the impact of announced and proposed tariffs on many of the commodity producing countries.

## ALTERNATIVES & COMMODITIES

- Oil prices continue to be driven by supply restrictions, as opposed to any meaningful uptick in global demand. With the OPEC+Russia production agreement nearing an end, prices may be in the process of peaking. US shale production should rise at the current price levels, but transportation bottlenecks may be delaying the process. Any break above $70 per barrel in WTI should spur both the Russians and Americans to ramp up production.
- Gold is basically treading water at current levels and will have difficulty breaking higher until the Fed ends its tightening cycle or we see an unexpected surge in inflation.
- Some industrial metals have gotten caught up in the recent tariff announcements, but most prices will remain challenged given the Chinese industrial slowdown and apparent lack of a US infrastructure package this year.
- Persistently low market volatility and high market correlations have been a challenge for hedge funds over the last decade. Steps toward policy normalization by the global central banks should create more favorable conditions going forward, which should benefit managers pursuing differentiated strategies and allow investors to hedge portfolio risks more effectively.
- 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 niche markets, or those experiencing disruption from technological or regulatory change.

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