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Outlook as of October 2017

WORLD ECONOMY

- With a few exceptions, most of the world is reporting positive economic growth this year. The trend is expected to last well into 2018, amid expectations that the largely below-trend growth of the current expansion can extend the cycle for an above-average length of time.
- Led by strong capital investment and steady consumer spending, US economic growth is finally approaching the 3% level that economists expect from an economy growing at its full potential. If the Trump administration's proposed tax plan is passed, the resulting cuts in corporate tax rates could help shift 2018 GDP growth above full potential.
- The strong rise in the euro, Swiss franc, and pound sterling this year is beginning to impact economic growth across the region. Within the Eurozone, new fiscal stimulus initiatives proposed by France and Germany should help offset any currency-related growth shortfalls.
- The strong yen, persistently low inflation and consumers' hesitance to spend, all suggest that the Japanese economy will struggle to grow. Capital spending and exports can help drive growth higher going into 2018, but both sectors likely need a boost from a weaker yen.
- Stable energy prices and the controlled slowdown in China are allowing emerging market economies to participate in the synchronized global growth rally. A cautious approach to monetary tightening by the developed market central banks is crucial to these export-dependent markets until domestic consumer spending plays a bigger role in their economies.

MONETARY POLICY & CURRENCIES

- The Federal Reserve appears resolute about monetary policy normalization, but has made it clear the process will be gradual and changes will be communicated in advance. The Fed has also lowered its end-target rate levels, reflecting the difficulty of raising rates in the current disinflationary environment.
- Although we may be at the end of a long term bull market in the dollar, optimism over tax reform and economic deregulation, coupled with incremental tightening by the Fed, can help the dollar to recover some of its recent losses in the coming months.
- Higher UK GDP growth and inflation readings are pressuring the Bank of England to consider raising rates, even if only to roll back the easing move made immediately after the Brexit vote.
- The European Central Bank will announce plans for scaling back its bond buying program in the coming weeks. Taking their cues from the Fed, we expect Chairman Draghi will be careful to manage both the message of gradualism during the implementation process, as well as the messengers delivering that message.
- With inflation in Japan stubbornly low, the Bank of Japan is likely one to two years away from starting to unwind the assets added to its balance sheet through monetary easing. As this expansion in the balance sheet was relatively massive, it will be informative for the other central banks to monitor the distortions quantitative easing may cause to their fixed income and equity markets.

BOND MARKETS

- The improving outlook for US economic growth, plus the growing probability that Congress will pass some pro-growth tax legislation, should maintain upward pressure on bond yields as we approach year-end.
- Municipal yields should generally move lock-step with changes in Treasury yields, although we may see some variations from states disproportionately affected by proposed changes such as the elimination of state and local deductions for income and property taxes.
- The stable near-term outlook for energy prices will allow high yield investors to focus less on distress in the energy patch and more on the favorable economic outlook, healthy balance sheets and historically low default rates across the rest of the high yield market.
- As many developed market central banks finally begin to unwind the aggressive monetary easing implemented in the financial crisis, bonds in these markets remain unattractive, given their minimal yields and the prospect of higher interest rates to come.
- Emerging market debt has provided strong returns this year. Although investors should monitor the potential impact of Fed tightening and slower growth in China on the sector, the high yields on EMD should help buffer any impact of these two factors.

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EQUITY MARKETS

- The combination of strong earnings growth and still-low interest rates has driven US equities to above-average valuation levels. Any meaningful advance above current levels will likely require some progress on corporate tax reform, which could propel earnings growth higher than current estimates.
- Valuation levels are more reasonable in European equities, although earnings growth in these markets is being challenged by the recent currency appreciation. In anticipation of a weakening euro abating some of the pressure on sales and earnings as we approach year-end, we recommend ample exposure to European equities.
- The demographically challenged Japanese economy continues to struggle with low GDP growth. The equity market will likely underperform other markets, unless supported by meaningful currency depreciation to boost exports.
- Emerging equity markets may need to digest the very strong year-to-date gains, but economic and earnings fundamentals warrant continued exposure to this more reasonably valued area of the global equity markets.

ALTERNATIVES & COMMODITIES

- The severe start to the hurricane season has heightened volatility in the energy markets, although it appears that the OPEC production limits are generally holding. Absent further production cuts by non-US producers, continuing US shale production will limit significant price appreciation from the current levels.
- While gold remains a viable hedge against inflation and geopolitical risk, confirmation of the Fed's resolve to normalize rates should keep inflation contained and prices below $1,300 per ounce, unless we see a serious escalation in global tensions.
- Industrial metals prices have been major beneficiaries of the synchronized global growth environment, but we will need to see meaningful progress on the proposed US infrastructure spending program for prices to continue climbing above current levels.
- Persistently low market volatility has stymied many hedge fund managers since the financial crisis. Moves toward policy normalization by central banks should create a more favorable environment for managers following differentiated strategies, as well as for investors seeking to mitigate risks from unstable markets or policy/geopolitical uncertainty.
- High asset valuations make it difficult for private equity managers to acquire assets 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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