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Outlook as of September 2017

WORLD ECONOMY

- The global economy continues to experience an unusual period of synchronized, non-inflationary growth. The austerity programs implemented by a number of countries earlier in the decade appear to be bearing fruit in improved economic growth, and can serve as a model for other countries with seemingly intractable fiscal deficits.
- Better growth rates for both consumer and capital spending are offsetting slight drags from lower government spending and residential investment. As a result, we expect the US economy to break out of the first-quarter doldrums and move towards a path of 2+% GDP growth for the remainder of the year. Improvement, or maintenance, of this growth rate in 2018 is likely dependent on the passage of meaningful fiscal initiatives in Congress.
- The notable economic recoveries in the economies of a number of the peripheral euro-area countries (Spain, Ireland and Portugal), coupled with a welcome uptick in German domestic consumption, have allowed Eurozone growth to exceed beginning-of-the-year forecasts, although the strong euro may slow economic momentum in the second half of the year. If the new Macron government is successful in implementing labor market reforms, expect France to solidify the overall economic improvement experienced over the last few years.
- The strong yen is affecting the most recent Japanese capital spending and production results. Slowdowns in these categories will detract from better consumer spending and serve to slow second-half GDP growth.
- Markedly improved economic growth in Mexico and Brazil should help offset a modest deterioration in Chinese growth and allow continued momentum in emerging market growth for the second half, although the Indian economy may experience a pronounced slowdown in the coming quarters.

MONETARY POLICY & CURRENCIES

- Despite persistently low inflation, the Federal Reserve is expected to continue on its path to rate normalization and announce the timing of its balance sheet reduction program after the September FOMC meeting. We still expect another rate increase in December; however, the current trajectory of the tightening cycle is likely to leave US interest rates lower than initially contemplated.
- Reinforcement of the Fed's tightening resolve, together with better US economic growth, should allow the dollar to recover some its summer losses. Any progress in Congress around tax reform and fiscal spending could further assist the recovery.
- The 10+% appreciation in the euro and its disinflationary impact will be a topic of discussion at this month's ECB meeting. The de facto monetary tightening caused by the higher currency could delay the ECB's planned announcement of a reduction in its intermediate maturity bond purchases.
- Persistently low inflation will keep the Bank of Japan on its current path of asset purchases, not only of fixed income securities, but also equities and REITs.
- Action by the People's Bank of China has succeeded in stemming the outflow of capital from the country and stabilizing the currency. Although the renminbi-dollar peg is looser than in the past, the central bank is expected to continue tracking US interest rate policy, to prevent a resumption of the currency depreciation.

BOND MARKETS

- Lower US bond yields, reflecting receding inflationary pressures, are testing the tightening resolve of the Fed. The improving second half growth outlook should exert some upward influence on rates, based on higher demand for credit and fewer government bond purchases of intermediate term maturities.
- Weak oil prices in August have caused some pressure in the high yield debt markets. With energy prices temporarily impacted by the hurricane season, high yield debt should not experience much further spread widening to Treasuries, given the stable credit quality existing in most other sectors of the market.
- Aggressive monetary easing by developed market central banks is likely to continue for the time being. With yields so low, the asset class remains unattractive for investors.
- Emerging market debt has produced strong returns so far this year, but some sideways movement is to be expected over the coming months. Many EM central banks still have the flexibility to cut rates, offering investors capital appreciation potential absent in the developed international bond markets, due to the near-zero DM yields.

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EQUITY MARKETS

- US equities have been driven higher by strong first-half earnings growth of over 10%. The growth rate will slow in the second half, as year-over-year comparisons become more difficult, but it will remain comfortably positive into next year and should allow for continued market appreciation in an environment where interest rates rise only gradually. Any market pullbacks due to geopolitical or domestic political issues (e.g. upcoming debt ceiling debates) should be used as buying opportunities.
- Currency translation effects will make earnings comparisons for European equities more challenging in the coming months, although they are not expected to decline. Relatively cheap valuations, and an expected reduction in currency pressures, will continue to attract global investors to the asset class.
- Japanese equities have lagged many other global equity markets this year, likely due to the ongoing demographic challenges facing the economy and the impact of the strong yen on important export industries. While caution is advised in the allocation to this asset class, any weakness in the yen should allow equities to advance over the balance of the year.
- Emerging equity markets have produced the best global returns this year. Investors have largely discounted the protectionist threats prevalent at the beginning of the year, while the strong advance in non-energy commodity prices has benefitted many of these resource-rich economies. Although the EM valuation advantage has narrowed, economic growth continues to outpace the developed economies, and earnings growth should remain strong over the next few quarters.

ALTERNATIVES & COMMODITIES

- The early start to the hurricane season has caused the temporary closure of roughly 25% of US refining capacity, which has had a negative impact on oil prices. Nonetheless, supply/demand dynamics should keep oil prices range-bound over the coming months and not break above $55 per barrel.
- Gold, the classic hedge against geopolitical and domestic political risk, saw prices jump amid concerns about North Korean aggression and continued controversy over White House statements that could jeopardize anticipated fiscal policy relief. With few signs of inflationary pressures, and the Fed resolved to normalizing rates, gold should back off from the recent highs in the coming months.
- The continuing improvement in global economic growth has been beneficial to industrial metals prices in 2017, buoyed also by hopes of a substantial infrastructure program in the US. If we don’t see legislation passed by Congress before year-end, expect a consolidation, but not a sharp falloff, as supply and demand for many metals remains roughly in balance.
- 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 investors seeking to mitigate risks arising from unstable markets or policy/geopolitical uncertainty.
- High asset valuations make it difficult for private equity managers 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 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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