2ND QUARTER OUTLOOK

The 2nd quarter comes on the heels of the quietest market since Lyndon Johnson was President. The S&P 500, a broader measure of U.S. equities, posted an average daily swing of just 0.3% in the first three months of 2017, making the quarter the quietest since 1967. The calm allowed us to kick up our own heels and contemplate both the current state of capital markets and what the future likely holds for investor longer term.

Our view is that the market will deliver further gains in 2017 on solid economic and corporate earnings growth, and the reversal of overstated geopolitical risk sentiment. Longer term, investors will need to adeptly traverse the cycle of reflation, recession, and stagflation.
EXECUTIVE SUMMARY

ECONOMIC OUTLOOK:
The global economy is in a synchronized reflationary window that should stay open for several more quarters. Growth will then likely slow, culminating in a recession in 2019. While the recession is likely to be mild, the policy response will surely be dramatic. This will set the stage for a period of stagflation beginning in the early 2020s.

OVERALL STRATEGY:
While a near-term pullback is possible, investors should overweight equities and high-yield credit during the next 12 months, while underweighting safe-haven government bonds and cash.

FIXED INCOME:
Stay underweight U.S. Treasuries and international global bonds. Bonds look set to rally in the second half of 2018 as growth begins to slow, but that should continue a protracted bear market.

EQUITIES:
Favor equities of all types, with emphasis on developed market small caps to complement large cap in the US and EAFE markets. Emerging markets will benefit from better relative valuations and reflationary tailwinds, but structural problems could drag down returns next year.

CURRENCIES:
The broad trade-weighted dollar will appreciate by 10% before peaking in mid-2018. The yen still has considerable downside against the dollar. The euro will grind lower, as will the Chinese yuan. The pound is close to a bottom.

COMMODITIES:
Favor energy over metals. Gold will move higher once the dollar peaks in the middle of next year.
The 1st quarter of 2017 was dominated by political headlines and improving global economic data, confirming that the “reflation trade” remains in place. This led stocks to outperform bonds over the course of the quarter, despite a rally in fixed income during these last few weeks.

- Emerging market (EM) equities significantly outperformed other asset classes, up 13% for the quarter, on expectations that better global economic momentum will lead to better trade prospects.

- International equities and the domestic S&P 500 returned 7.8% and 6.0%, respectively, signaling that political risks in both regions seem to have taken a back seat to encouraging economic data.

- Small cap equities and REITs returned 1.4% and 4.2% respectively, as domestic data, and particularly housing data, continued to improve.

- Despite the Fed’s decision to hike rates in March, fixed income generated positive returns for the quarter; yields remained relatively range bound, leading the Barclays US Aggregate to return 0.8% and global high yield to return 3.0%.

- Commodities were the only asset class to see a negative return for the quarter, led mostly by faltering oil prices as concerns over inventory levels in the U.S. weighed on sentiment toward future supply/demand dynamics.
GLOBAL RISK-MARKETS SUCH AS EQUITIES AND HIGH YIELD BONDS SHOULD CONTINUE TO MAKE GAINS THROUGH 2017 ON THE TWIN TAIL-WINDS OF IMPROVING GLOBAL EARNINGS AND RECEDING POLITICAL RISKS.

REAL GLOBAL GROWTH

The global economic and earnings backdrop is positive, with the market maintaining recent gains on the prospects of continued growth, despite a flurry of geopolitical concerns. This is because the economic improvements are real with global PMI indexes reaching their highest levels in over 5 years. This has global earnings growing for the first time in years. As can be seen in this BCA chart both trailing and forward earnings are set to grow globally, and revisions to earnings presage continued growth expectations.

OVERSTATED POLITICAL RISKS

The failure to repeal and replace Obamacare has cast a pall over market expectations for the far more important issue of tax cuts and reform. Companies that are highly taxed or related to infrastructure (ie “Trump Trade”) underperformed recently, falling from year end highs. These fears are overstated.

Republican civil war leading to obstructionism is not as likely as feared. As shown on the attached chart from political consultant Pool, Rosenthal – The average level of polarization within the GOP is well within the range of the past century (as shown on chart on next page). In fact, the GOP remains considerably less polarized than the Democrats were for most of the post- Second World War era. The data therefore suggests that while the GOP is indeed becoming more conservative, it is doing so uniformly.
Despite a slump in national opinion polls, Trump retains support among Republican voters. This means that he can campaign against Freedom Caucus representatives in the 2018 mid-term elections, as he recently threatened in an ominous tweet. Data suggest that voters would indeed follow Trump and dump the Freedom Caucus.

**BREXIT: Market Has Moved On**

The market has adjusted to Brexit. It did not quake at the invocation of Article 50 by London on March 29, nor the publication of the EU’s negotiation “guidelines” on March 31. It seems that political tensions between the EU and the U.K. likely peaked before January 16. This was the day when the market fully priced in the rumors that the U.K. would seek to withdraw from the EU Common Market. Prime Minister Theresa May confirmed the rumors on January 17 with a key speech.

Why no fireworks since then? First, the EU guidelines on the Brexit negotiations do not appear to be aggressive. The EU has offered the U.K. a “transition period,” for an indefinite time between the U.K.’s technical withdrawal and the new cross-channel status quo. Second, the EU has implied that it will at least begin talks on an FTA with the U.K. while the negotiations on withdrawal are still ongoing. Third, a leaked copy of an EU parliamentary resolution on Brexit also suggests that a “transition period,” in this case limited to three years, is in the offing. It also hints that the EU would treat the U.K.’s notice of withdrawal as revocable, i.e. reversible.

**LA PEN: Fading**

Here in early April, Le Pen is trailing Emmanuel Macron by 26% with a month to go to their likely second-round matchup. She did worse than expected in a recent debate. At this point in the U.S. election, candidate Trump trailed Secretary Hillary Clinton by only 5%. Even Francois Fillon appears to be rallying against Le Pen. Despite ongoing corruption allegations against him, Fillon is leading Le Pen in a hypothetical second-round matchup by 16%. She will likely not win, and the polls are likely correct.
PORTFOLIO POSITIONING:

With real global growth and fading political risks, the Trump Trade is likely to reignite.

- Favor equities over bonds and cash.
- Overweight small cap stocks across all markets.
- Have strategic weightings to developed market equities, with currency hedging.
- Have strategic weightings to emerging market stocks and bonds, on a short leash.

EMERGING MARKETS OUTLOOK

- Maintain exposure to high yield bonds, complemented with distressed mandates.
- Favor private lending over indexed REITs in real estate, for active management, higher return, and risk control benefits.
- Build strategic weightings in natural resources and infrastructure asset classes.
- Complement municipal bonds with corporates, MBS, TIPS, and MLP’s, along with more aggressive active mandates and closed-end funds.
- Maintain hedged equity and managed futures exposure for accredited investors.
What does the longer-term future hold for investors? Our friends at PIMCO, JPMorgan, and BCA have helped us with some longer-term thinking. Here’s a plausible scenario:

**STAGE ONE: CONTINUED REFLATION**

Wall Street always uses so much jargon. What is reflation?

“A fiscal or monetary policy, designed to expand a country’s output and curb the effects of deflation. Reflation policies can include reducing taxes, changing the money supply and lowering interest rates. The term “reflation” is also used to describe the first phase of economic recovery after a period of contraction.”

*Investopedia*

You knew that, because we’ve all become monetary experts the last few years. With 24/7 financial news, few are unaware that significant fiscal and monetary policies have been employed across the globe in the wake of the 2008 financial crisis to aid economic and financial markets. Not always to the intended affect. While financial markets have rallied hugely, global economic markets have grown only rather tepidly. That is why reflation is still in affect.

From this Citi Group Global Markets chart we see the results of reflation. The chart shows the sum of the Citibank global economic and inflation surprise indices. The combined series currently stands at the highest level in the 14-year history of the survey.
The oil plunge reversed. U.S. energy sector capex tumbled by 70% between 2014 and 2016, knocking almost 1% off U.S. real GDP. And the damage to commodity exporting countries like Russia and Brazil were ever more pronounced. But the declines reversed, and the growth comparisons have gone from negative to positive.

Inventories began to be rebuilt. The global economy emerged from a protracted inventory destocking cycle. In the U.S., inventories made a negative contribution to growth for five straight quarters starting in Q2 of 2015, the longest streak since the 1950s. The U.K., Germany, and Japan also saw notable inventory corrections. Now economies are adding to inventories.

China fears abated. The market feared a hard economic landing in China and a disorderly devaluation of the RMB. These fears faded as the Chinese government ramped up fiscal stimulus, and maintained and orderly RMB.

Stimulus continued. Financial conditions continued to ease in most economies, delivering an impulse to growth that is still being felt. In the U.S., for example, junk bond yields dropped from a peak of 10.2% in February 2016 to 6.3% at present.

Animal spirits ignited. The improved global economics, plus the election of Donald Trump and a Congressional Republican majority led to hopes for tax reform and deregulations. This in turn, led to a surging stock market and rising home prices that have helped buoy consumer and business sentiment.

Looking forward, global growth should stay reasonably strong over the next 12 months. Goldman Sach’s global leading indicator measure remains in a solid uptrend. And ignited animal spirits are powering a recovery in business spending, as evidenced by the jump in factory orders and capex intentions. Further, the lagged effects from the easing in financial conditions over the past 12 months should help support activity. Financial conditions measurements usually lead the business cycle by 6-to-9 months. So, the current message from the index is that U.S. growth will remain sturdy for the remainder of 2017.

But storm clouds are forming. Many of the economic measures seeing momentum are stretched. Home prices cannot rise faster than rents or incomes indefinitely; nor can equity prices rise faster than earnings. Corporate spreads also cannot keep falling. As the equity and housing markets cool, and borrowing costs start climbing on the back of higher government bond yields, the tailwind from easier financial conditions will dissipate.
When that happens – most likely, sometime next year – GDP growth will slow. Living in a world of slow trend growth could prove to be challenging. The U.S. corporate sector has been feasting on credit for the past four years.

Yes, household balance sheets are still in reasonably good shape, but even here, there are areas of concern. Student debt is going through the roof and auto loans are nearly back to pre-recession levels as a share of disposable income. Together, these two categories account for over two-thirds of non-housing related consumer liabilities. The risk is that defaults will rise if GDP growth falls below 2%, a pace that has often been described as “stall speed.” This could set in motion a vicious cycle where slower growth causes firms to pare back debt, leading to even slower growth and greater pressure on corporate balance sheets – in other words, a recipe for recession.

**STAGE TWO: RECESSION**

Expansions and recessions are part of economic life. This particular expansion is kind of like a monk who lives a long life. Lots of time, but not much fun. There it is in light blue, from JP Morgan’s latest Guide to the Markets.

![Graph showing U.S. Corporate Sector Has Been Feasting On Credit](image1)

![Graph showing Strength of economic expansions](image2)

Of course expansions don’t die of old age or no fun, instead they are often killed off by rising interest rates, ie “the Fed.” Higher rates are expected, as shown in the graph below from Business Insider, depicting the survey of Fed Governors opinion of where forward rates should be over the next few years.

![Fed Dot Plot](source: Business Insider)

Now, rates rising to 2.5% to 3% by 2019 may not appear significant, but in today’s economy the level of rates that supports full employment and stable inflation may not be anywhere near as high as its been in the past, or much higher than they are now. It pretty much seems like those two criteria (employment and inflation) are set be just about right real soon. After all, in an intellectual capital intensive economy, low rates are more attractive to companies than higher rates. And rising economic inequality has also reduced aggregate demand, because the wealthy that have benefitting from rising asset prices like stocks, are savers on the margin, not spenders. So the Fed has to keep rates somewhat low just to prop up spending.
Therefore, the “neutral interest rate” is surely lower than it has historically been. A variety of forces have pushed down the neutral rate over time. For example, the amount of investment that firms need to undertake in a slow-growing economy has fallen by nearly 2% of GDP since the late-1990s. And getting firms to take on even this meager amount of investment may require a lower interest rate since modern production techniques rely more on human capital than physical capital.

If the Fed were to raise 3-4 more times, that will probably be sufficient to overshoot and bring about a recession, as the Trump agenda is unlikely to spark long term growth.
THE TRUMP TRADE ISN’T OVER - YET

The failure to replace the Affordable Care Act has cast doubt in the eyes of many observers about the ability of Congress to pass other parts of Trump’s agenda. As a consequence, the “Trump Trade” has gone into reverse over the past few weeks, pushing down the dollar and Treasury yields in the process. We agree that the “Trump Trade” will eventually fizzle out. However, this is likely to be more of a story for 2018 than this year.

If anything, the repeal and replace fiasco may turn out to be a blessing in disguise for the Republicans. Opinion polls suggest that the GOP would have gone down in flames if the American Health Care Act had been signed into law.

The GOP’s proposed legislation would have reduced federal government spending on health care by $1.2 trillion over ten years. 64-olds with incomes of $26,500 would have seen their annual premiums soar from $1,700 to $14,600. Even if one includes the tax cuts in the proposed bill, the net effect would have been a major tightening in fiscal policy. That would have warranted lower bond yields and a weaker dollar.

The failure to pass an Obamacare replacement serves as a reminder that comprehensive tax reform will be more difficult to achieve than many had hoped. However, even if Republicans are unable to overhaul the tax code, this will not prevent them from simply cutting corporate and personal taxes. Worries that tax cuts will lead to larger budget deficits will be brushed aside on the grounds that they will “pay for themselves” through faster growth (dynamic scoring!). Throw some infrastructure spending into the mix, and it will not take much for the “Trump Trade” to return with a vengeance. Hence our pro-risk bias.
TRUMP’S FISCAL DREAMLAND

Where the disappointment will appear is not during the legislative process, but afterwards. The highly profitable companies that will benefit the most from corporate tax cuts are the ones who least need them. In many cases, these companies have plenty of cash and easy access to external financing.

As a consequence, much of the corporate tax cuts may simply be hoarded or used to finance equity buybacks or dividend payments. A large share of personal tax cuts will also be saved, given that they will mostly accrue to higher income earners.

The amount of infrastructure spending that actually takes place will likely be a tiny fraction of the headline amount. This is not just because of the dearth of “shovel ready” projects. It is also because the public-private partnership structure the GOP is touting will severely limit the universe of projects that can be considered.

Most of America’s infrastructure needs consist of basic maintenance, rather than the sort of marquee projects that the private sector would be keen to invest in. Indeed, the bill could turn out to be little more than a boondoggle for privatizing existing public infrastructure projects, rather than investing in new ones.

Meanwhile, the Trump administration is proposing large cuts to nondefense discretionary expenditures that go above and beyond the draconian ones that are already enshrined into current law.

As such, the risk to the economy beyond the next 12 months is that markets push up the dollar and long-term interest rates in anticipation of continued strong growth and lavish fiscal stimulus only to get neither.

THE POINT: A Fed that is raising rates could coincide with continued subpar economic growth. At high debt levels, we have the kindling for the next recession several years from now. A downturn would likely be short-lived due to massive government stimulus response, leading to more tepid growth accompanied by inflation.
Again, with the Wall Street jargon! Stagflation means inflation without strong economic growth. If our crystal ball is correct and high debt and slow growth combine with government stimulus that causes inflation but no long term economic growth jump than stagflation will return. Does anyone remember the 1970’s?

By historical standards, any coming recession will be a mild one for most countries, especially in the developed world. This is simply because the excesses that preceded the subprime crisis in 2007 and, to a lesser extent the tech bust in 2000, are likely to be less severe going into the next global downturn than they were back then.

The policy response may turn out to be anything but mild, however. Memories of the Great Recession are still very much vivid in most peoples’ minds. No one wants to live through that again. But in contrast, memories of the inflationary 1970s are on too many people’s minds.

A recent NBER paper documented that age plays a big role in determining whether central bankers turn out to be dovish or hawkish. Those who experienced stagflation in the 1970s as adults are much more likely to express a hawkish bias than those who were still in short pants back then.

The implication is the future generation of central bankers is likely to see the world through more dovish eyes than their predecessors. Even if one takes the generational mix out of the equation, there are good reasons to aim for higher inflation in today’s environment.

For one thing, debt is high. The simplest way to reduce real debt burdens is by letting inflation accelerate. Whoosh, its gone. In addition, the zero bound is less likely to be a problem if inflation were higher. After all, if inflation were running at 1% going into a recession, real rates would not be able to fall much below -1%. But if inflation were running at 3%, real rates could fall to as low as -3%.

Political developments will also facilitate the transition to higher inflation. In the U.S., the presidential election campaign will start coming into focus in 2019. If the economy enters a recession then, Donald Trump will go ballistic. The infrastructure program that Republicans in Congress are downplaying now will be greatly expanded. Gold-plated hotels and casinos will be built across the country. Of course, several years could pass between when an infrastructure bill is passed and when most new projects break ground. By that time, the economy will already be recovering. This will help fuel inflation.

As the economy turns down in a few years, the Fed will also be forced to play ball. The market’s current obsession over whether President Trump wants a “dove” or a “hawk” as Fed chair misses the point. He wants neither. He wants someone who will do what they are told. This means that the next Fed chair will likely be a “really smart” business executive with little-to-no-experience in central banking and even less interest in maintaining the Federal Reserve’s institutional independence. The empirical evidence strongly suggests that inflation tends to be higher in countries that lack independent central banks. This may be the fate of the U.S.
WRAPPING UP

Risk assets have enjoyed a strong rally since late last year, and a modest correction is long overdue. Still, as long as the global economy continues to grow at a robust pace, the cyclical outlook for risk assets will remain bullish. As such, investors with a 12-month horizon should stay overweight global equities and high-yield credit at the expense of government bonds and cash, per our advice above.

CRYSTAL BALL GAZING

It’s been a quiet 1st quarter, giving pause for longer term thinking. What might the longer-term future hold?

Global growth is likely to slow in the second half of next year, with the deceleration intensifying into 2019, possibly culminating in a recession in a number of countries. To what extent markets “sniff out” an economic slowdown before it happens is a matter of debate. U.S. equities did not peak until October 2007, only slightly before the Great Recession began. Commodity prices did not top out until the summer of 2008. Thus, the market’s track record for predicting recessions is far from an enviable one. Nevertheless, investors should err on the side of safety and start scaling back risk exposure next spring.
The 2019 recession will last 6-to-12 months, followed by a gradual recovery that sees the restoration of full employment in most countries by 2021. At that point, inflation will take off, rising to over 4% by the middle of the decade. The 2020s will likely be remembered as a decade of intense pain for bond investors. In relative terms, equities will fare better than bonds, but in absolute terms they will struggle to generate a positive real return. As in the 1970s, gold will be the standout winner.

Have a great spring!