KEEP CALM AND CARRY ON

August 15, 2017

Markets experienced their third “mini-surge” in volatility this year as tensions ratcheted up between the United States and North Korea. Our standard playbook for geopolitical risk analysis leans on market history. As shown in the exhibit below, geopolitical events tend to have a short-lived impact on the financial markets. Whether you consider Iraq’s invasion of Iran in 1980, the Bay of Pigs crisis in 1961 or even the Asian currency crisis of 1997, bull markets tend to recover from crises relatively quickly. So how could the playbook be wrong this time? Because the severity of the risk (North Korea acquiring a nuclear missile) is substantial and the diplomatic path is unclear. Our current view is that it will take a relatively extreme outcome (such as a trade war with China or actual military engagement) to justify a change in tactical asset allocation policy. However, we will continue to recalibrate this view as developments take shape. We don’t expect the current level of ambiguity to last more than 12 months.

Back in the real economy, our Global Growth Foundation tactical theme continues to evidence itself. The divergence between growth and inflation continues most strongly in the United States, where strong job gains in July occurred while core inflation was slowing. Global leading indicators are at a multi-quarter high, and surveys measuring the outlook of companies doing business in China have reached a six-year high. Global earnings in the second quarter finished strongly, and upward revisions in earnings expectations reached a level last seen in 2011. Equity market advances have broadly matched earnings growth this year – taking some pressure off valuations, which were a driver in recent years. Along with the current economic momentum, politicians globally are also supporting the growth outlook – and the foundation for risk taking.

The outlook for central bank policy remains at the forefront of many investors’ minds, but we don’t expect any major upsets. We think central bankers’ desire to “normalize” interest rates will be capped by the current lack of inflationary momentum. Current estimates of the Federal Reserve’s favorite inflation measure show it trending at just 1.4%, quite a distance from the 2% goal. With political scrutiny of monetary policy on the rise, central bankers will do their best to avoid the spotlight. The end result will likely be a very measured approach to adjusting quantitative easing programs and increasing interest rates. Combined with steady growth, we think this will remain a favorable environment for risk taking.

BULL MARKET SPEED BUMPS
Crises during bull markets tend to only have a short-term negative effect on financial markets.

<table>
<thead>
<tr>
<th>Event</th>
<th>Year</th>
<th>Decline lasted</th>
<th>Decline</th>
<th>Time to fully recover</th>
</tr>
</thead>
<tbody>
<tr>
<td>Iraq invades Iran - war</td>
<td>1980</td>
<td>7 days</td>
<td>5.4%</td>
<td>52 days</td>
</tr>
<tr>
<td>Bay of Pigs</td>
<td>1961</td>
<td>7 days</td>
<td>3.5%</td>
<td>29 days</td>
</tr>
<tr>
<td>Iraq attacks USS STARK</td>
<td>1987</td>
<td>5 days</td>
<td>2.5%</td>
<td>11 days</td>
</tr>
<tr>
<td>Asian currency crisis</td>
<td>1997</td>
<td>6 days</td>
<td>11.2%</td>
<td>45 days</td>
</tr>
<tr>
<td>Japan earthquake and tsunami</td>
<td>2011</td>
<td>5 days</td>
<td>3.6%</td>
<td>12 days</td>
</tr>
<tr>
<td><strong>Average (of 21 post 1940 crises)</strong></td>
<td><strong>8 days</strong></td>
<td><strong>4.3%</strong></td>
<td><strong>37 days</strong></td>
<td><strong>37 days</strong></td>
</tr>
</tbody>
</table>

Source: Northern Trust, Crandall, Pierce & Company. Data based on Dow Jones Industrial Average. Select crises during ongoing bull markets.
INTEREST RATES
LIBOR-Overnight Index Swap (OIS) spreads have significantly narrowed since last fall, indicating improved market liquidity and banking system stability. We believe most of the U.S. money market reform’s dislocation has settled and we are entering a new normalized market environment for short-term assets. Investors have begun to slowly move back into prime strategies as they gain more comfort with the lack of volatility in variable net asset values (NAVs). Spreads between prime funds and government money market funds have stabilized around 25 basis points. We believe a prime fund may offer investors an attractive opportunity to pick up incremental yield, if they don’t need immediate access to the cash.

Markets have shifted focus to Asia as the summer lull hits Europe and the United States. The Chinese yield curve has steepened as a result of better than expected economic data and continued low inflation. There is a risk that this could continue as global central banks appear less dovish. However, China faces downside risks as it weans itself away from reliance on global exports, which should temper the outlook for domestic bond yields. Any dollar strengthening could ignite concerns for the emerging markets more broadly. The duration outlook remains neutral, but we remain watchful of China’s regulatory reform agenda and global political tensions.

CREDIT MARKETS
High yield continues to be both a notable overweight in our recommended portfolio and a source of continued conversation within our investment meetings. As interest rates have fallen and credit spreads have tightened this year, our expected one-year return forecast has fallen to 4.2%. However, we retained our high yield overweight given the attractive risk-adjusted nature of that prospective return. High yield offers one of the lower risk profiles of our risk asset options – and in the current environment, we have high confidence that the return expectation is reasonable.

The confidence in our return expectation is driven by continued healthy fundamentals in high yield markets. Global growth and low interest rates have teamed up to keep credit defaults contained since the financial crisis (see chart) and we think this will continue. A low default rate results from a variety of factors, with low interest rates supporting many of them. First, low interest rates reduce funding costs, lower cash interest burden and increase access to capital. Second, low interest rate periods support economic activity, with improving corporate earnings driving a lower default rate. Finally, low interest rate periods typically follow a period of higher default rates (in this case the post-financial crisis period). In response, many companies restructured their balance sheets and are much healthier today. All of these factors support the asset class and our ongoing overweight.
PERSPECTIVE

EQUITIES

With second quarter earnings season nearing the end, global earnings have been coming in well ahead of expectations, representing double-digit growth across major markets. This comes in welcome contrast to investors’ continued worries over geopolitical developments. Coordinated global growth combined with favorable monetary conditions has led to improved guidance from companies, as well as positive earnings estimate revisions. As seen in the nearby chart, the three-month global earnings revision ratio has reached levels not seen since 2011. U.S. earnings have beaten by 5% so far, topping the typical trend of 3% to 4% upside. Earnings estimates typically decline into the quarter, making earnings beats less notable. We did not see this in the second quarter.

Outside the United States, earnings beats have been even more impressive, driving positive revisions in most markets, excluding Europe. In Europe, the continued strengthening of the euro is suppressing forward estimates due to translation, though core growth remains strong. In the United States, if the dollar remains low, second half earnings could be boosted by as much as 3%. With elevated P/E multiples, we continue to expect most of the returns in equities to come from earnings growth, and the current global backdrop is proving conducive to that growth.

REAL ASSETS

Inflation in many parts of the world remains missing in action. Despite a 4.3% unemployment rate in the United States, wages – a necessary ingredient for persistent inflation – are growing at a meager 2.5%. In Europe, wage pressures are even lower, with unemployment sitting at 9.1%. Japan has been flirting with deflation for the past 20-plus years. Global demand continues, but only modestly, and energy costs remain muted. As such, none of the central banks in the three largest developed economies seem to be able to convince investors that pricier times are ahead (see chart).

Despite the current environment, we remain strategically weighted to all four “real assets” – inflation-linked bonds, natural resources, global real estate and global listed infrastructure – given a mix of current expectations and unique asset class dynamics. Stuckflation expectations keep us from overweighting inflation-linked bonds, but the fact that the markets agree with our inflation assessment has lowered asset class valuations. The commodity glut is a major driver of Stuckflation, but demand remains steady and natural resource companies are learning to operate in this new environment. Global real estate and listed infrastructure have unique relationships with inflation. Both can adjust pricing to keep pace with inflation (making them attractive bond alternatives during inflationary periods); but both also benefit from low interest rates, which follow inflation. Higher real rates pose a bigger problem for real estate and infrastructure than higher nominal rates; we think central banks want the latter more.
CONCLUSION

After a busy first seven months of the year, our investment strategy discussions this month yielded no changes to our recommended tactical asset allocation positioning. Asset markets have generated strong performance so far this year, but the fundamentals have supported it. Earnings growth has fully driven gains in the equity markets, with gains outside the United States outpacing the growth in U.S. earnings. This improving corporate performance has improved the outlook for corporate defaults, tightening credit spreads. Investment grade bonds have also generated a positive return, although overshadowed by risk markets, due to the rally in interest rates and credit spreads. The only real losers have been oil and the U.S. dollar, which have broken their normal inverse correlation. The decline in the price of oil is being judged as beneficial to growth (which it is), while the dollar’s decline has been tied to improving relative growth outside the United States and shifting investor preferences. All in all, it has paid to filter out the noise of the political world and focus on the improving momentum in the global economy in 2017.

Each month we debate the outlook for growth, inflation, monetary policy, fiscal repair, regulatory reform and political leadership – along with other topical issues. Our outlook for growth remains positive globally, while we continue to see the risk of inflation as “later.” The topic of regulatory reform has become increasingly important as political leaders globally search for levers to improve growth in a “post-monetary policy” world. Currently, the United States is the one major region we have a positive regulatory outlook toward – but Europe is on the list for a potential upgrade. Key to this upgrade will be progress by French President Emmanuel Macron in his effort to deregulate areas such as the labor market. Not only would this be a positive economic event, but it would likely strengthen the hands of France and Germany in their efforts to further European Union unification.

The potential for reform in Europe captures the upside scenario in our Political Leadership Openings risk case, while the troubles with North Korea demonstrate the downside risk. Our other key risk case, Monetary Misstep, highlights the dependence of financial markets on the easy monetary policy in place globally. But it also highlights a new risk surrounding the potential for a more disruptive Fed chairperson when Janet Yellen’s term ends in February 2018. As always, we are monitoring these risk cases and currently view them as manageable enough that they aren’t affecting our asset allocation recommendations. While markets have had a nice run so far this year, we still think fundamentals support an overweight to risk over the next 12 months.

-Jim McDonald  Chief Investment Strategist