Quarterly Market Outlook

August 2018

Favorable U.S. Economic Conditions Driving U.S. Asset Class Outperformance

Generally speaking, U.S. economic growth has been strong, inflation modest and unemployment low. The current 9-year boom is one of the longest economic expansions on record and comes on the heels of unprecedented levels of monetary and fiscal stimulus. During the second quarter, strong corporate earnings, protectionist policy, and rising interest rates drove the U.S. Dollar index (DXY) up 5%[1], resulting in relative outperformance of U.S. assets versus non-U.S. assets. We believe this outperformance may be temporary as U.S. assets reach valuations that imply very little compensation for the risk taken (see "Flattening Risk Curve" below).

Traditional Assets Facing Headwinds

While U.S. equities have outperformed on a relative basis, all markets have been facing headwinds associated with tightening dollar liquidity and the threat of trade wars. Since the end of January 2018 (when volatility spiked) through June, most asset classes are down. Global developed equities (MSCI World) have lost 4.6% while emerging markets (MSCI EM), which are particularly sensitive to the trade concerns, have declined 13.8%. Core U.S. bonds (Bloomberg Barclays Aggregate) have lost 0.5% and commodities (Bloomberg Commodity) are down 1.9%.[2]

Escalating Trade Tensions

The trade tensions between the U.S. and China continue to intensify. The U.S. formally enacted 25% tariffs on $50 billion of Chinese imports, which elicited a reciprocal response from China. President Trump responded by proposing tariffs on an additional $200 billion of Chinese imports. China does not have enough U.S. imports to respond in kind, so they are evaluating alternative measures, which include blocking U.S. merger activity and increasing costs for U.S. companies doing business in China. The uncertainty around the size and scope of a potential trade war has contributed to market volatility. Despite specific winners who may directly benefit from less competition, the long-term impact is likely to be inflationary (as goods prices increase) and negative for global economic growth.

Populism

The backlash against free trade and immigration is characteristic of populism, a movement that has influenced political outcomes in the U.S., Latin America, and several European countries. The underlying driver of this phenomenon is growing wealth inequality which has reached extremes last seen in the 1930s. This movement is likely to pick up momentum in the next recession, contributing to an increase in political uncertainty.

Italy is a Growing Risk

The newly formed Italian government, consisting of a coalition between Italy's two populist parties – the Northern League and the Five Star Movement – is on a collision course with the EU over its planned fiscal expansion (6%-7% of GDP). Germany is likely to reject Italy's proposal as it violates EU budgetary rules. The challenge of finding a solution that both sides can agree on has the potential to reignite fears around the sustainability of the European Union.

[1] Source: Bloomberg. US Dollar Currency (DXY). 3/31/18 – 6/30/18.

[2] Source: Bloomberg. MSCI World Index Net (NDDUWI). MSCI Emerging Markets Index (NDUEEGF). Bloomberg Barclays Aggregate Bond Index (LBUSTRUU). Bloomberg Commodity Index (BCOMTR). All periods: 1/31/18 – 6/30/18.

End of QE

On June 14th, Mario Draghi announced the European Central Bank's (ECB) intention to end quantitative easing (QE) at year-end. The Bank of England (BOE) halted its purchases in 2017, while the Federal Reserve is now reducing its balance sheet by allowing bonds to mature without reinvestment. Additionally, both the Fed and the BOE have been raising short-term interest rates. All of these actions represent a significant reduction in global liquidity, which may eventually lead to a slowdown in economic activity. Barring a major market or economic disruption we expect the reduction of liquidity to continue over the coming year.

Flattening Risk Curve

Years of money printing and low market volatility have driven investors into increasingly riskier investments in the hope of earning higher returns. This has resulted in a flattening "risk curve." The risk curve refers to the level of return one should expect for a particular level of risk. In nearly all periods the risk curve is upward sloping indicating that higher returns can be expected for taking greater risk. In today's unique environment, the U.S. risk curve is approaching a flat position. That is, the expected return of cash (1-year T-Bill yield of 2.3%[3]) is only slightly below the expected return of U.S. bonds (Barclays Aggregate Bond Index yield of 3.3%[4]) or U.S. stocks (price-to-earnings multiples approaching multi-decade historical highs[5]). This means that investors may receive little compensation over the next 5-10 years for taking risk in U.S. assets.

Recession on the Horizon

The current economic environment remains healthy, but there is mounting risk of a material slowdown sometime in 2019 or 2020. The recent U.S. tax cuts have been highly supportive of growth, but the effects are likely to fade over the next 12-18 months. Concurrently, monetary tightening (rising short-term interest rates and the end of QE) is likely to increase borrowing costs, leaving the economy exposed as the benefits of the fiscal expansion recede.

Relative Attractiveness of Uncorrelated Investments

As traditional asset classes offer muted expected returns and economic/market risks appear to be rising, the case for uncorrelated assets becomes more compelling. Such strategies may help diversify portfolios to limit losses during the next recession. They may also improve total portfolio returns over the next market cycle due to less dependence on a favorable economic environment

[3] Source: Bloomberg. USD United States Treasury Bill Yield Curve 1 Year (BV010087). 6/30/18.
[4] Source: Bloomberg. Barclays US Aggregate Bond Index (LBUSTRUU). 6/30/18.
[5] Source: Based on the Shiller P/E as reported by Robert Shiller. http://www.multpl.com. 6/30/18.

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