Q3 2017 | Capital Markets Outlook

The Fed may be ahead of the curve

As short-term rates rise, inflation slips away

The inflation expected by critics of quantitative easing and advocates of Phillips curve theory has failed to materialize.

We believe that structural forces, including demographics in the labor force, continue to exert disinflationary pressure in the United States.

The combination of weak inflation and a lower normal rate of growth means that the Fed may be past the midpoint of rate increases for this cycle.

Asset allocations

Shading in the table indicates the change from the previous quarter

	Underweight	Neutral	Overweight
EQUITY		●	
U.S. large cap		●	
U.S. small cap		●	
U.S. value		●	
U.S. growth		●	
Europe		●	
Japan			●
Emerging markets			●
FIXED INCOME	●		
U.S. government	●		
U.S. investment-grade corporates		●	
U.S. mortgage-backed			●
U.S. floating-rate bank loans		●	
U.S. high yield			●
Non-U.S. developed country		●	
Emerging markets		●	
COMMODITIES	●	◌	
CASH			●

Currency strategy

U.S. dollar versus	Favor other	Neutral	Favor dollar
€ Euro	●		
£ Pound		●	
¥ Yen		●	

Global allocation insights

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Stimulus effects are a fading concern

As major central banks around the world responded to the 2008 financial crisis by massively increasing the size of their balance sheets in an effort to flood the financial system with liquidity, one popular critical refrain from the sceptics of this policy was that, down the road, developed market economies would be at risk of hyperinflation. This liquidity, skeptics claimed, would eventually find its way into the real economy, and a positive feedback loop of accelerating velocity in the money supply would cause prices of everything to spiral out of control.

Yet here we sit, a full eight years into the third-longest economic expansion in the post-War era, and the Federal Reserve's (Fed) preferred inflation metric — core personal consumption expenditures, or PCE — has met or exceeded the Fed's 2% target in a grand total of only four months, all of them in early 2012. It is thus no surprise that the hyperinflation alarmists have gone into hiding.

A tight labor market should lift wages

With fears of policy-induced inflation put to rest, attention shifted to more traditional wage-driven inflation sparked by a tighter labor market. By most accounts, the U.S. labor market is certainly tight. Given the steady descent of the unemployment rate and the steady ascent of job openings, on the surface it seems like the right question is whether the Fed is behind the curve in setting the federal funds rate in the 1.00%–1.25% range. This level would seem to be too low for today's unemployment rate of 4.3% if the Fed truly believes in its models, which are built in part on faith in

Inflation only briefly reached the Fed's 2% goal in this economic recovery

Percent change (year over year) in core personal consumption expenditures (PCE) price index, 12/31/08–5/31/17

Source: U.S. Bureau of Economic Analysis.

the Phillips curve. The Federal Open Market Committee (FOMC) made it clear in its June meeting statement that it believes a return to inflation levels above 2% is just around the corner. What's more, many pundits have been quick to point out that a Taylor rule model (which calls for rates to rise faster than inflation) with traditional default inputs would put the current federal funds target rate at 3% or higher.

Demographics provide the most revealing clues

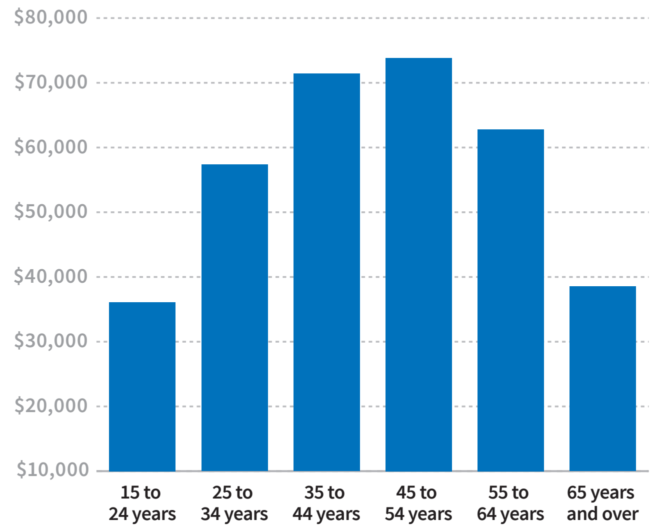
In our view, it makes more sense to be asking if the Fed is now *ahead* of the curve. Let's review what we know for certain, beginning with a discussion of the "neutral rate," or the policy rate that is neither expansionary nor contractionary for the real economy. Through their speeches and research, Fed members have told us that this rate has declined over time and has likely been close to zero recently. If that is indeed the case, then the current upper bound of the target policy rate, since it is above zero, is, by definition, contractionary.

We also know that the United States and most developed markets have aging populations, which has profound impacts on wages and, therefore, on inflation generally. According to the U.S. Census Bureau, between 2000 and 2010 the U.S. age cohort of workers 18–44 years old grew just 0.6%, while the population older than 65 increased by 15.1%. These trends have continued in the seven years since the last census.

For some time after the recession, it was expected that older workers would return to the labor market. As a St. Louis Fed staff paper observed in late 2013, *"If a large portion of the workers who are currently out of the labor force is out because of cyclical influences, then the unemployment rate might not be fully capturing the slack in the labor market."* However, in her press conference following the June FOMC meeting, Chair Janet Yellen noted the recent stability in the labor force participation rate, indicating that people have already re-entered the workforce in the face of those demographic headwinds, and so there is likely even less slack now. Households headed by people between the ages of 50 and 65 are the highest paid. As these people retire, their income falls, and in the workforce they are being replaced by younger people, who are paid less. This trend helps to hold down inflation.

Younger workers joining the labor force earn much less than older workers, easing wage pressures

U.S. median income levels by age bracket



Source: U.S. Census Bureau, 2010 (most recent data available).

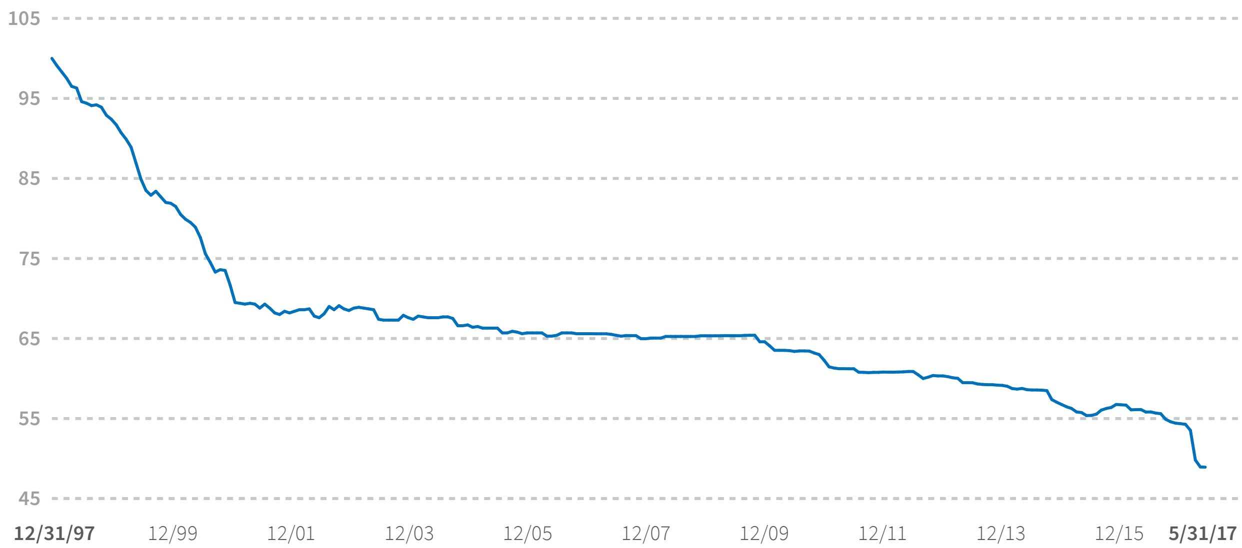
Innovation is a deflationary force

Another interesting tidbit in Chair Yellen's press conference was her mention of the impact of wireless telephone services on overall inflation, which she described as "appear[ing] to be one-off." We would not describe the impact of this component of inflation as one-off, for obvious reasons.

However, nitpicking aside, this specific item highlights a bigger problem for the inflation bulls, namely, that prices in the traded goods segment have flatlined. Prices in the technology sector have almost always been in deflation, and because we use more technology and services than ever before, their weights in PCE have increased over time. It is the hedonic quality control adjustments to these prices that drive their deflation. Put another way, consider how much wireless data you "consume" via your smartphone now versus 10 years ago. If the price of your wireless plan goes unchanged from one contract to the next, but your new plan includes more data than your old plan, this "quality" change must be accounted for in the inflation statistics. More data for the same price equals deflation. Real estate offers a parallel: From 2005 to 2014,

The price of wireless has declined for 20 years

BLS Price Index for Wireless Telephone Services, 12/31/97–5/31/17 (not seasonally adjusted)



Source: Bureau of Labor Statistics.

the Case-Shiller U.S. National Home Price Index was unchanged, yet the size of the median home increased from just over 2,100 square feet to more than 2,600 square feet. Deflation is all but built in to some key items in the inflation statistics by virtue of the way they are calculated.

The Fed may be just a few hikes from the cycle peak

With so much changing in consumer behavior, demographics, and labor market dynamics, it is hardly surprising that the Fed and the central banks of other developed markets are focusing on hard questions about the future path of inflation. In fact, if we tweak the aforementioned Taylor rule to include a lower NAIRU (non-accelerating inflation rate of unemployment) to account for the substitution of cheaper, younger workers for more expensive older workers, Fed policy begins to look too tight.

The implication for financial markets, we believe, is that it will prove difficult in the short term for companies to gain pricing power, which could dampen earnings growth. The policy framework is also likely to constrain the rise of long-term bond yields around the world. At the same time, inflation is unlikely to rise dramatically or slip back into outright deflation, so we can expect that inflation-sensitive assets will move sideways. As of the end of June, the slope of the U.S. yield curve measured by the difference between the 10-year Treasury yield and T-bills sits just above 110 basis points. That level coincides with where it stood at approximately the midpoint of the Fed's last tightening cycle in 2005. From that point in the 2005 cycle, the Fed made five more hikes. Today, inflationary pressure and the neutral rate are lower, and so it seems likely that there will be fewer than five hikes ahead before short-term rates peak.

Market trends

Index name (returns in US$)	2Q 17	12 months ended 6/30/17
EQUITY INDEXES		
Dow Jones Industrial Average	3.95%	22.12%
MSCI EAFE (ND)	6.12	20.27
MSCI Emerging Markets (ND)	6.27	23.75
MSCI Europe (ND)	7.37	21.11
MSCI World (ND)	4.03	18.20
Nasdaq	4.19	29.39
Russell 1000	3.06	18.03
Russell 2000	2.46	24.60
Russell 3000 Growth	4.65	20.72
Russell 3000 Value	1.29	16.21
S&P 500	3.09	17.90
Tokyo Topix	5.88	20.73
FIXED INCOME INDEXES		
BB Government Bond*	1.17%	-2.18%
BB MBS*	0.87	-0.06
BB U.S. Aggregate Bond*	1.45	-0.31
BofA Merrill Lynch 91-day T-bill	0.20	0.49
CG World Government Bond ex-U.S.	3.81	-5.01
JPMorgan Developed High Yield	2.21	13.36
JPMorgan Emerging Markets Global Diversified	2.24	6.04
JPMorgan Global High Yield	2.07	13.42
S&P LSTA Loan	0.76	7.42
COMMODITY INDEX		
S&P GSCI	-5.46%	-9.01%

* BB is an abbreviation for Bloomberg Barclays.

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Equity insights

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U.S. equities: The market benefits from moderate economic improvement

For U.S. equity investors, the second quarter offered a number of familiar themes: relatively low market volatility, new record highs for major indexes, and a modest advance for stocks. Along with these positive trends, however, came a decidedly lower level of optimism about progress from Washington in implementing pro-growth, business-friendly policies. Mounting concerns and increased media focus on political controversies stalled initiatives in Congress and contributed to two brief, broad-based market declines.

Heightened uncertainty in Washington remains a key risk for equities. In our view, however, a number of favorable trends remain in place and are likely to keep politics from derailing market momentum. Corporate earnings strength may be the most potent positive force. Investors have shown an impressive ability to look beyond headline distractions and focus on healthy fundamentals and stronger-than-expected financial results from many U.S. businesses. And, despite a backdrop of political drama, many areas of the economy have been quite uneventful — a scenario that we believe could continue to fuel the market. Along with a slow and steady advance for equities, we have seen moderate improvements in wage growth, employment, consumer confidence, and consumer spending. While moderate changes may not generate headlines, they tend to bode well for stock market performance and investor sentiment.

A deliberate, communicative, and fairly predictable Fed has also helped maintain calm in the market. However, we see potential risks for equities in the context of Fed policy. While the three interest-rate hikes since

December were widely expected, much less certain is the effect on markets when the Fed begins the process of shrinking its balance sheet. Investors have become quite accustomed to the Fed's accommodation, but we are in unprecedented territory as the Fed works to reduce a balance sheet of more than $4 trillion.

Non-U.S. equities: European political risk falls and non-commodity emerging markets strengthen

Looking ahead to the second half of 2017, we think the disappointments of U.S. policy change will become increasingly less relevant to the markets. Against a backdrop of stalled legislation, we expect international markets will remain attractive for investors, both for their distance from U.S.-based uncertainties and for what we consider their compelling fundamentals and valuation profiles.

In the second quarter, all eyes were on the unfolding political situation in France, where the general election promised to deliver either a stunning blow to EU institutions or a resounding victory for foundational EU principles. With far-right French presidential candidate Marine Le Pen vanquished by political centrist Emmanuel Macron, European markets have risen on the improved prospects for a more unified European Union and the promise of economic reforms in France.

As France and much of Europe benefit from the macroeconomic bounce, including stronger industrial production and employment indicators, we see relatively fertile ground for adding to select equity positions. This situation is quite unlike the United States, where we see more classic signs of late-cycle economic conditions: Consumer credit is slowing while delinquencies are rising, auto sales are depressed, the labor market is near full employment, and policymakers are tightening interest rates. In Europe, therefore, where we prefer to focus on stock-specific stories that exhibit promising catalysts for change, we think the lagging nature of Europe's cyclical recovery relative to the United States enhances the potential of European equities to perform well.

We anticipate that the strength in non-commodity-exposed emerging markets — such as India, South Korea, Taiwan, and Argentina — may continue, if certain conditions remain in place. Generally speaking, the U.S. dollar's relative stasis can give some breathing room to emerging-market stocks, as can relatively low developed-market interest rates. Despite higher risks, we believe yield-seeking investors will continue to pour money into both the equity and debt markets of the world's emerging economies if the currency, interest-rate, and policy backdrop remains supportive.

Economic stability in China is the consensus expectation, at least until its next political transition during the 19th National Congress of the Communist Party of China this fall. The expectation of stability is based on policymaker's willingness to supply continued stimulus to the Chinese economy. But we expect volatility to be a rising risk in China and in countries and markets that are tied to China's economic fortunes.

Fixed income and currency insights

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Fixed income: Despite late-cycle signs, mortgages and high yield offer potential

In the United States, we see an increasing amount of evidence pointing toward late-cycle economic conditions. In our view, the key problem the U.S. economy faces is that the tightening labor market is constraining corporate profits. Firms attempted to regain healthier margins in the first quarter of 2017 by raising prices, but households rebelled, and consumption growth eased. This is most clear in the auto market, but it has happened in other areas, including residential real estate. That said, we continue to find value in various areas of the real estate markets, and we continue to prefer various forms of credit and liquidity risk to interest-rate risk across fixed income.

For example, within the securitized debt sector, we continue to find attractive opportunities within interest-only collateralized mortgage obligations (CMOs), although we have been more cautious in our allocation relative to mortgage credit. The underlying fundamentals for commercial real estate continue to be stable overall, as employment growth, low interest rates, and a positive GDP trajectory provide a tailwind for the CMBS sector. Nonetheless, we believe the growth in property prices experienced over the past few years will be difficult to maintain going forward.

Turning to high-yield credit, we acknowledge that the market has had a good run year to date — and a strong 18-month record — but our outlook is for continued strength and further yield compression. While this asset class outlook is positive, we are slightly more cautious on the fundamentals due to the complexity of comprehensive policy implementation in the current political environment. With respect to high-yield valuations and “technicals,” or the balance of supply and demand, our view is neutral.

For the emerging markets, we maintain a bias toward dollar-denominated sovereign debt and have a greater sense of caution with respect to emerging-market local debt and foreign currency exchange risk. U.S. rates have largely fallen in 2017, and we do not see inflation rising to a level that would prompt more aggressive Fed action. That is good news for emerging-market sovereigns with dollar-based debt obligations.

Overall, we believe a variety of forces are aligned that may enhance the attractiveness of emerging-market debt (EMD) for many investors. Across the developed markets, we think political risk has declined. The recent elections in Europe support this view, and we think these election results suggest the region will maintain its commitment — in the near term, at least — to accommodative monetary policy. Europe typically lags the global cycle, so if normal global dynamics hold, it would not be surprising to see Europe staying strong when the rest of the world slows.

Currency: Major currencies may be more stable, with the euro showing relative strength

The U.S. dollar outlook continues to be most heavily influenced by the Fed, as expectations for fiscal policy have been pushed beyond the investment horizon. The Fed’s recent stance is relatively hawkish compared with market pricing and our own beliefs. With no urgency to hike rates aggressively, it is likely that the Fed will start to pare back its balance sheet gradually, but economic data and financial conditions will play a larger role in determining the pace, leaving the expensive dollar as more of the laggard than the leader.

The outlook for the euro is dominated by relative monetary policy and political risk. The ECB continues to balance the doves, who point to tame core inflation rate, with the hawks, who call for removal of emergency level accommodation and tapering of asset purchases. This balance is likely to persist until September or October, when the ECB will communicate to the market what it will do at year-end when the purchase program expires. Over the medium term, the euro should continue to appreciate.

In the United Kingdom, the results of the snap election have left the Conservative government in a much weaker position as they are forced to form a minority coalition with Northern Ireland’s DUP (Democratic Unionist Party). The market has taken this to mean that the Conservatives will be forced to take a softer stance and remain in the single market and customs union, but in actuality, the likelihood of a hard Brexit has increased. In this context, the Bank of England kept rates unchanged, but three dissents in the vote suggest that its tolerance of inflation is limited. Since currency weakness caused much of the recent U.K. inflation spike, it is likely that the currency will not be allowed to fall much further. Given the risks associated with Brexit, the pound should be weak, but not excessively.

Bank of Japan (BoJ) Governor Kuroda continues to underscore that the inflation outlook remains subdued and, as such, the market should not expect any change in BoJ policy for the foreseeable future. This will keep the dollar-yen rate a function of Fed policy and the pace of policy relative to market pricing. Over the medium term, however, the return distribution is asymmetric because the yen is fundamentally cheap. A more dovish Fed stance could cause the yen to appreciate more swiftly.

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