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Q1 2018 | Capital Markets Outlook

Investors weigh the effects of tax cuts and remaining QE

Solid global growth offers support for the bull market to continue in 2018.

U.S. tax reform may help to lift stocks by encouraging business investment spending.

The major risk we see is central bank tightening that could become too aggressive.

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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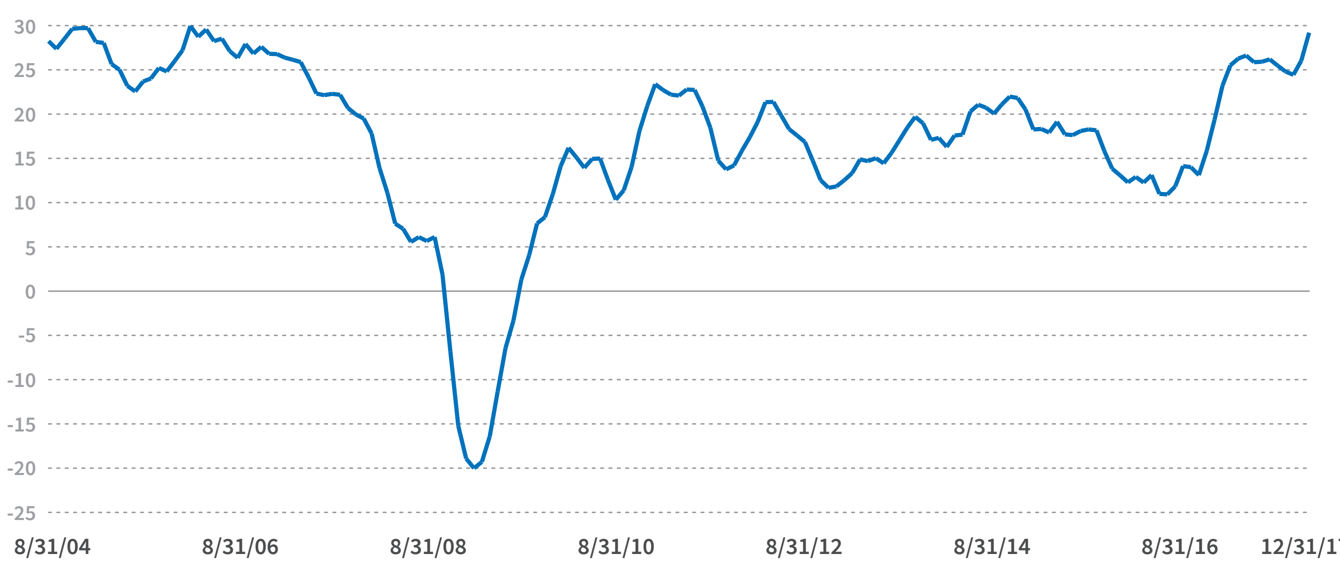
Can market calm continue in 2018?

As we noted in our previous quarterly update, some of the impressive 2017 statistics *(see page 4)* were driven purely by a solid fundamental environment — a synchronous uptick in global macroeconomic growth and corporate earnings. In addition, it was certainly helpful that some of the more ominous risks that had emerged on the horizon several quarters earlier failed to materialize. Heading into 2017, we had identified populist political movements and the new U.S. administration's campaign platform of protectionist trade policies as risks. In actuality, we saw populist pressures ease in election outcomes and the U.S. administration show restraint, at least temporarily. It is certainly too early to call the all-clear on these issues: Germany's Chancellor Merkel is seeking to form a coalition government that is expected to be much weaker than its predecessor; an imperiled U.K. Prime Minister, Theresa May, is struggling through Brexit negotiations; and the NAFTA renegotiation talks among the United States, Canada, and Mexico are now into their sixth month with no major breakthrough. However, there is evidence that markets are taking them in stride.

At the outset of 2018, two key issues — the effects of changing U.S. fiscal policy and global monetary policies — need to be assessed to determine whether markets can keep rolling.

Tax cuts target lukewarm capital investment

Morgan Stanley Capex Plans Index, 2004–2017



Source: Morgan Stanley Capex Plans Index, a 3-month moving average of a population-weighted composite compiled from various monthly Federal Reserve Bank surveys of manufacturers measuring 6-month capex plans.

Will tax cuts stimulate more business investment?

Real global growth rates have finally risen to the pace experienced in the mid-2000s. With Purchasing Managers Index (PMI) readings around the world — an indicator of business activity — looking "toppy," and market valuations on the expensive side of fair value, what will it take to boost these real growth rates?

Capital expenditures would seem to be the obvious candidate, and the new U.S. tax policy changes could promote capex. The late December passage of the Tax Cuts and Jobs Act of 2017 allows a five-year period for U.S. corporations to fully expense capital investments in the year in which the outlay is made. Another provision allows a holiday period in which corporations can repatriate cash held abroad from foreign affiliates at deeply discounted tax rates that are even lower than the reduced statutory rate. Supporters argue that the combination of an almost 1% boost to real GDP from immediate fiscal stimulus and a multi-year runway for expensing of capital investment will provide strong incentives for the corporate sector and "unlock" pent-up investment spending.

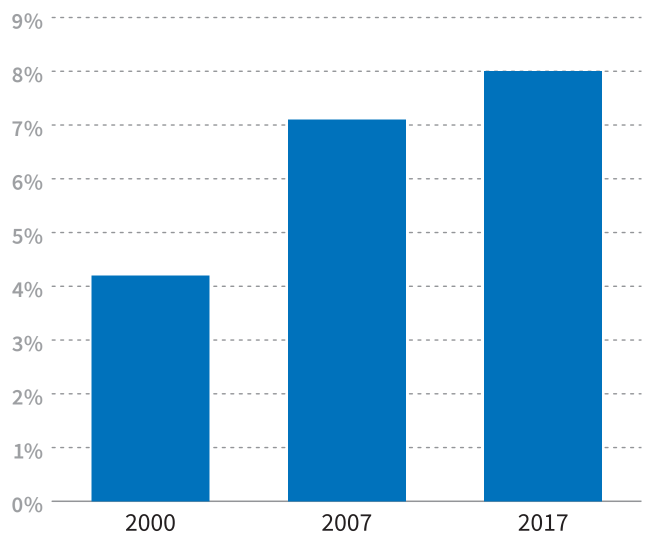
Analyzing the tax package

The only relevant recent analogue we have as a basis for comparison with the new tax package is the 2003 Bush tax cuts, which allowed for 50% expensing of capital investment, and then phased out quickly. This example is murky because the U.S. economy at that time was still in the process of emerging from the recession following the bursting of the tech bubble in 2000. Also, the resultant spending by the corporate sector was likely pulled forward by the sun-setting nature of the expensing benefit, having the effect of depressing growth in the further-out years.

While this comparison suggests capital investment will increase, another perspective that focuses on the distinctive characteristics of this cycle is more pessimistic. In this view, global disinflation has kept a lid on the prices of capital goods, so that investment spending is depressed in nominal terms only. When viewed in real (price-adjusted) terms, the recent trajectory of capital expenditures actually looks quite normal. In other words, there is little pent-up investment spending waiting to be released. Adding to this view, in a recent op-ed Michael Bloomberg argued that corporations are already so flush with cash that enticements to invest via these new tax code changes won't matter at all.

Will tax incentives encourage companies to part with cash they have compiled?

Median cash levels of Russell 3000 Index companies



Source: Putnam.

We believe that the truth is somewhere in between. We do not dismiss the importance of a large immediate burst of fiscal stimulus to financial markets. And financial incentives are powerful motivators, so CEOs and CFOs will be enticed to maximize the benefits afforded to them by this change in the tax code. However, while risk assets have some incremental upside as a direct result of the landmark GOP accomplishment of 2017, this enthusiasm is tempered somewhat by the knowledge that there remains quite a bit of excess capacity already in the system in the traded goods sector.

What will be the effect of tighter monetary policy?

When assessing monetary policy, we must first consider what measure of quantitative easing (QE) matters most for financial markets — the stock or the flow.

The stock refers to the overall size of central bank balance sheets, whereas the flow is the amount of periodic asset purchases. The stock is still large, but the flow is fading, with the Fed now fully engaged in reducing its balance sheet and the European Central Bank (ECB) likely to announce a specific tapering plan in 2018. With the monthly supply of liquidity that markets have become accustomed to now declining, those who believe QE flow matters more anticipate that markets might struggle. This contrasts with a view expressed by many policy makers that the overall size of a central bank's balance sheet is more important.

On this matter, we tend to side with the latter point of view. Earlier in 2017, we had some concern that the Fed's switch from actively buying Treasuries and mortgage-backed securities to shrinking its balance sheet might cause an uptick in volatility. This turned out not to be the case, which leads us to believe that the size of the global central bank balance sheet — the combined size of the Fed, Bank of England, ECB, and Bank of Japan (BoJ) — is more important in supporting monetary conditions. Our current view is supported by empirical research, including a paper published by Federal Reserve staff that suggests that the "stock" effect on yields might be as much as eight times as large as the flow effect (D'Amico and King, "Flow and Stock Effects of Large-Scale Treasury Purchases," April 2011).

Since the pace of the decline in the size of the Fed's balance sheet is being offset by continued purchases by the ECB and BoJ, we believe there is still time before global monetary conditions become restrictive.

The market rally is poised to continue

With our answers to these two critical questions, we look rather optimistically toward the beginning of 2018. While risk asset valuations continue to indicate a cap on upside potential, valuation has limited utility in anticipating market corrections. We continue to give the rally in almost everything the benefit of the doubt, but we will be looking for signs of inflation that could cause central banks to tap the brakes a bit more forcefully.

Market milestones of 2017

In 2017, market volatility sank to lows last seen over 50 years ago

- Annual realized market volatility of 6.74% — lowest since 1964 (5.25%)
- Two-month realized volatility for September/October below 4% — first time since 1964
- Tightest two-week trading range (as of August 1) of the past 50 years (0.32%)

The VIX (S&P volatility index) made history

- The VIX saw its lowest close ever on November 3 (9.14)
- More than 50 of the VIX's 60 sub-10 closes happened in one year
- The intraday high was 17.3, the lowest since 1995 (17.0)

The S&P 500 had a year for the record books

- 60 record-high closes
- The index gained more than 1% and lost more than 1% on only four days each
- The index outperformed the energy sector by 26 percentage points — the largest relative outperformance since the S&P beat the technology sector during the dotcom collapse in 2000 (30 percentage points)
- There have been 295 trading days since a peak-to-trough 3% decline (on the Friday before the 2016 U.S. election)
- 383 days since a 5% correction (after the U.K.'s Brexit referendum)
- 2,222 days since a 20% correction (at the end of the Great Recession)
- Every month had a positive total return (first time ever, since tracking of daily data began in 1929)

Source: Data compiled by Putnam.

Equity insights

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Equity market trends

Index name (returns in US$)	Q4 17	12 months ended 12/31/17
Dow Jones Industrial Average	10.96%	28.11%
MSCI EAFE (ND)	4.23	25.03
MSCI Emerging Markets (ND)	7.44	37.28
MSCI Europe (ND)	2.21	25.51
MSCI World (ND)	5.51	22.40
Nasdaq	7.26	32.99
Russell 1000	6.59	21.69
Russell 2000	3.34	14.65
Russell 3000 Growth	7.61	29.59
Russell 3000 Value	5.08	13.19
S&P 500	6.64	21.83
Tokyo Topix	8.61	26.55

U.S. tax reform can lift industrials

In the United States, tax reform is expected to provide a boost to business profitability and provide many more ancillary benefits. The Tax Cuts and Jobs Act should serve as a catalyst to further accelerate capital and operational spending by businesses, particularly for many industrial companies that have been woefully underinvested in capital equipment. In addition, the extended period of outperformance of growth over value suggests we may see more plentiful valuation opportunities in 2018, notably in undervalued sectors such as retail and energy.

Emerging markets may remain on upswing

For emerging markets, despite their strong run in 2017, we believe interesting opportunities remain. When compared with other equity markets, particularly the United States, EM stocks are relatively inexpensive on some measures. In addition, the bulk of EM outperformance in 2017 was concentrated in a handful of Asian technology stocks, leaving attractive choices across a variety of other sectors and capitalization sizes. For China specifically, President Xi Jinping's second term in office may herald an era of faster reforms, with a focus on quality of growth rather than growth at any cost. Technology and environmental protection appear to be attractive growth themes for Chinese stocks in the coming years.

Governance improving in Japan

Another area of note is Japan, where we are seeing improving corporate governance and profitability for many Japanese businesses. For several years, the government under Prime Minister Shinzo Abe has been exerting pressure on company boards to increase their return on equity for shareholders. Prior to this, companies had been running conservative, cash-heavy balance sheets and relied on conglomerate-style business models to insulate themselves from cyclical weakness in any one industry. While the changes have been slow to take hold, we are seeing increasing signs that companies are improving both their profitability and the efficiency of their balance sheets.

Fixed income and currency insights

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Fixed income market trends

Index name (returns in US$)	Q4 17	12 months ended 12/31/17
BB Government Bond*	0.05%	2.30%
BB MBS*	0.15	2.47
BB U.S. Aggregate Bond*	0.39	3.54
ICE BofAML U.S. 3-month T-bill	0.28	0.86
CG World Government Bond ex-U.S.	1.57	10.33
JPMorgan Developed High Yield	0.75	7.80
JPMorgan Emerging Markets Global Diversified	1.16	10.26
JPMorgan Global High Yield	0.87	8.28
S&P LSTA Loan	1.10	4.11

* BB is an abbreviation for Bloomberg Barclays.

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The acceleration in global growth witnessed in 2017 will continue well into 2018, we believe, but with significant changes in its components. The U.S. economy appears poised to do better than its recent solid pace. Europe and Japan may improve relative to the United States as 2018 unfolds. Meanwhile, the United Kingdom may be headed toward a softer version of Brexit as a consequence of recent developments in the country's efforts to separate from the European Union. Overall, we expect reasonably solid global growth, continued policy tightening by the Fed, relatively benign inflation, and a generally supportive environment for risk-driven assets. We also think bond yields may continue to drift higher over the course of 2018 as rate normalization continues.

The Fed will be a key focus of investor attention as a new chairman takes office and new governors join the Federal Open Market Committee. While we don't anticipate significant policy changes under the new Fed chairman, we do see the potential for communication snafus as the market adjusts to the tone and language of a new leader.

U.S. growth may accelerate with help from tax cuts

There are no obvious downside risks to the U.S. growth pattern, but there are some upside risks, including the labor market, corporate investment, and the effects of the tax reform completed in December. At the margin, corporate tax reforms could buoy the equity markets by raising after-tax earnings, and investment projects that are currently not viable could become more possible with a lower tax rate. The household tax cuts will likely have little impact on consumption because they are, in net terms, very small and geared toward high-income households. But the rally in equity markets creates a wealth effect, and this will boost consumption growth in 2018. The labor market is key to household income and spending, and it continues to improve, albeit at a slower pace.

China turns to restructuring

China avoided a sharp downturn in 2017, but in 2018 the pace of domestic reform may accelerate, with greater emphasis placed on forcing the restructuring of state-owned enterprises (SOEs). The outcome of this restructuring effort depends on whether Xi Jinping, who has consolidated political power, can overcome the strong links between the SOEs, the ruling party, the People's Liberation Army, and a handful of leading Chinese families. Restructuring could slow the economy, and anything that destabilizes internal debt markets creates the risk of a more significant downturn.

The biggest risk is the Fed moving too aggressively

With the real economy likely to do a bit better in 2018, the Fed has legitimate concerns about the possibility that inflation will tick higher. But the longer-term trends in the economy suggest that higher rates are risky. The impact of demographics, the persistent effects on consumer behavior as a result of the financial crisis, the disinflationary impulse from the pattern of global competition and technological innovation, as well as high levels of corporate debt — for all of these reasons, we think the capacity of the economy to deal with much higher interest rates is limited.

The dollar may rally a bit longer

The U.S. dollar outlook continues to be most heavily influenced by the Fed and Congress' surprising ability to deliver a tax reform package. At its December meeting, the Fed hiked rates by 25 bps, as largely expected by the markets. The market is pricing another 50–60 bps in hikes in 2018, a level still a little below the Fed's economic projections, or "dots" outlook, but this gap has closed quite a bit over the past several months. With Jerome Powell approved by the Senate Banking Committee to be the next Fed Chair, it suggests policy continuity over the medium term. Over the coming months, the tactical U.S. dollar rally may continue, though it has already started to wane as the dollar is quite rich.

The euro appears stable

The outlook for the euro remains dominated by relative monetary policy, better-than-expected growth, and a diminished euro political risk premium. The ECB continues to balance the doves, who point to tame core inflation rate, with the hawks, who call for tapering and then ceasing asset purchases. The euro has already moved considerably, so much of the near-term direction will be based on whether the ECB is dovish or hawkish relative to the Fed.

Brexit negotiations to influence the pound

In the United Kingdom, the discussions over Brexit remain fluid and quite noisy, contributing significant volatility to the British pound. Unless there is a breakthrough in negotiations, this volatility is likely to persist. The statements from the Bank of England have been surprising. The BOE has hiked rates for the first time in ten years (by 25 bps) and backpedaled on expectations suggesting that only a couple of hikes would be necessary over the coming three years, putting the fate of the pound firmly back onto Brexit negotiations.

Yen to remain soft as capital leaves Japan

With Prime Minister Abe's landslide victory in the October election, the tail risk of the end of "Abenomics" has been dramatically reduced. 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, adding that there was no need to raise rates just because foreign rates rise. The dollar-yen rate will remain a function of Fed policy and the long end of the U.S. Treasury yield curve. With financial market volatility low, the yen should continue to soften as capital leaves Japan to be invested in higher-yielding assets abroad.

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