Q3 Market Outlook: What's in Store for Markets in the Second Half?

July 12, 2018
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Five trends to watch for during the remainder of 2018.

We are coming to the mid-year point for 2018, and the past six months have felt like six years. Markets have experienced a significant uptick in volatility, yet equity investors may not have much to show for all their troubles. Year-to-date performance as of June 22 shows many major indices in the red: the MSCI All Country World ex USA Index lost 3.53%, the MSCI EAFE Index is down 3.43%, and the MSCI Emerging Markets Index lost 6.08%. One of the few exceptions is the S&P 500 Index, which is up a modest 3.04% for the same period.[1] What happened? And what are markets telling us about the global economy?

Four key forces have been pressuring stocks

1. **Lower growth.** While first-quarter earnings were generally strong, markets are viewing those

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results in the rearview mirror. The bigger focus is what's ahead — what economic conditions could mean for earnings in the second quarter and beyond. Unfortunately, many major economies — including the US, the eurozone and Japan — experienced a deceleration in growth in the first quarter. While this was largely seasonal, and for some economies could be attributed to poor weather conditions, the first-quarter slowdown appears to have bled into at least the start of the second quarter for most of these economies — except the US — based on recent economic data.

2. **Higher costs.** Not only do we need to worry about lower growth, we also need to worry about input costs, which cause a narrowing of profit margins. In the April release of the US Federal Reserve's Beige Book, business owners and managers indicated significant concern about aluminum and steel tariffs driving up input costs. And then there's the rise in oil prices which, although it has eased recently, could also impact input costs. For example, oil prices helped to push up input cost inflation in the eurozone, which is at its second-highest level in seven years.[2] And I fully expect upcoming US employment situation reports to show that wage growth is rising. Rising costs cause a narrowing of profit margins, all else being equal, which in turn reduces earnings.
3. **Monetary policy concerns.** And then there's concern that very accommodative monetary policy might soon end. I believe it's no coincidence that the February market sell-off began the same week that former Federal Reserve (Fed) Chair Janet Yellen handed over the reins to Jerome Powell, which brought uncertainty over whether the Fed would remain so accommodative. In recent weeks, those concerns seem to be coming to fruition: The Fed's policy-making arm (the Federal Open Market Committee) increased its median policy prescription for the federal funds rate, and the European Central Bank (ECB) announced it would end tapering by December. We also saw jitters earlier this year when markets began to fear that the Bank of Japan (BOJ) would begin normalization sooner than expected — although the BOJ quickly refuted that concern.
4. **Geopolitical uncertainty.** We have seen a lot of geopolitical uncertainty in recent months. The difficulty Germany had in forming a coalition government, the strained relationship between the different political parties in that coalition, the difficulty the UK has had in orchestrating its Brexit from the European Union, and the fluctuation of tensions between the US and North Korea are just a few of the geopolitical risks adding to the volatility we have experienced this year. The most recent example is the potential for Italy's coalition government to disrupt not only Italy, but the European Union.

Outlook for the second half of the year

Below are five trends that I expect to see during the remainder of 2018:

1. **The global economy should accelerate modestly from here.** The US is already showing signs of re-acceleration, and I expect other major economies to follow suit, albeit more modestly. Although this is not a synchronized global growth environment, most economies should improve in the back half of this year. In other words, the lower growth we are currently experiencing is likely only temporary, in my view.

Take the eurozone — I believe there are still positive drivers of this region's economic growth in 2018.

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- The European Commission's Economic Sentiment Indicator fell slightly for the first quarter, but remains consistent with strong gross domestic product growth.[3]
- Unemployment continues to fall in the eurozone, although there are significant differences by country.

Globally, growth seems solid. In fact, the International Monetary Fund (IMF) expects the global economy to grow at 3.9% for both 2018 and 2019.[4] And, while I believe input costs are on the rise, I don't expect them to significantly impact profit margins in the near term — unless tariffs proliferate quickly.

2. **Globally, the upward bias for stocks remains — but it is diminishing.** Given that global growth is likely to accelerate and monetary policy is still generally accommodative, there should still be an upward bias for stocks globally, in my view. I believe that growth and supportive monetary policy are powerful forces that are likely to help stocks end in positive territory for the year. However, that bias is diminishing as monetary policy tightens – and the threat of protectionism grows.
3. **I expect to see more disruption and greater volatility.** As monetary policy normalizes, I believe capital markets will normalize as well due to an erosion of the support that the Fed's policy has given to stocks. In this environment, I expect a continued reduction in correlations among stocks as fundamentals matter more. In addition, I expect a continued increase in volatility as monetary policy accommodation is reduced, and geopolitical disruption would further exacerbate that volatility.

   While this is not my base case, I think it's worth noting that the Fed may add to monetary policy disruption as balance sheet normalization progresses, given how powerful a tool it is. The pre-set course calls for an increasingly larger amount of assets to be rolled off the Fed's balance sheet each quarter. I suspect this could have the opposite effect that quantitative easing had on stocks, putting downward pressure on them and creating more volatility. Complicating this scenario further is that the Fed seems to be preoccupied with the yield curve and concerned about what could happen if it inverted. There is the possibility that, in order to avoid an inverted yield curve, the Fed may accelerate balance sheet normalization. That could be very disruptive for capital markets, particularly equities.

4. **Debt pressures are expected to grow.** The world is becoming increasingly indebted. As borrowing costs rise, debt is becoming a bigger issue for consumers, businesses and the government. In its most recent Global Financial Stability Report, the IMF warned about the growing debt overhang occurring in different economies.[5] This problem is widespread and may have negative effects in any economy that is raising rates. For example, Canadian homeowners are showing signs of coming under pressure given that many have adjustable-rate mortgages. And the headwinds that many emerging markets economies have faced can be at least partly attributed to higher borrowing costs. As monetary policy normalization continues and accelerates in coming years, this pressure is likely to increase. In addition to the short-term effects of debt pressure, there is a long-term effect as well: More money spent on servicing debt means less money available for investment purposes, and that will impact longer-term economic growth.
5. **Protectionism continues to cast a shadow.** I can't say it enough: Tariffs are like bacteria in a petri dish — they multiply quickly. I expect current protectionist threats and actions will not

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dissipate, but will in fact escalate. At times, protectionist threats and actions have sent stocks downward, but investors have been all too willing to believe the threat has passed at the first sign of an abatement in trade drama. For example, Chinese President Xi Jinping's conciliatory speech at the Boao Forum in March was all investors needed to hear to send stocks upward. But we all know how that ended — with a flare up in trade tensions and clear signs that Xi has no interest in making serious concessions.

Investors should not ignore this very real threat. Protectionism can raise input costs significantly, which can create demand destruction. For example, in 1984, US consumers paid an estimated $53 billion in higher prices because of import restrictions levied that year.[6] The day before US President Donald Trump's tariff announcement, the US Chamber of Commerce issued a statement that US steel prices are already nearly 50% higher than steel prices in Europe and China.[7]

In addition, the current tariff rhetoric and actions are increasing economic policy uncertainty, which has historically coincided with a slowdown in business investment. In a recent ECB meeting, ECB President Mario Draghi explained that protectionism as well as threats of protectionist actions can "have a profound and rapid effect on business, on exporters' confidence … and confidence can in turn affect growth." I strongly believe that business sentiment and, more importantly, business spending are already showing signs of being hurt by the recent wave of protectionism, and it could get worse from here. We can't forget that in trade wars, retaliation is not limited to tariffs — it can take different forms, such as devaluing a currency or reducing US Treasury purchases or selling existing holdings of US Treasuries.

I can't stress enough that a significant rise in trade wars could eliminate the upward bias for stocks that currently exists, so we will need to follow the situation closely.

What does this mean for investors?

In this environment, I believe exposure to risk assets is important for meeting long-term goals — especially given my view that an upward bias for stocks continues to exist (albeit in a weaker form). However, mitigating downside risk will be critical, in my view, and that includes being well-diversified within equities and fixed income. And, perhaps most important during this period of uncertainty, I believe that exposure to alternative investments can help with diversification and risk mitigation. That may include strategies such as market neutral portfolios and other lower-correlating asset classes, including those with income-producing potential. One alternative investment to consider is real estate investment trusts (REITs), including non-traditional REITs.

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1 Source: Bloomberg, L.P., as of June 22, 2018

2 Source: IHS Markit Eurozone Manufacturing PMI, June 2018

3 Source: European Commission

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4 Source: IMF, as of April 2018

5 Source: IMF Global Financial Stability Report, October 2017

6 Source: Gary Hufbauer and Howard Rosen, “Trade Policy for Troubled Industries,” Washington DC Institute for International Economics, 1986

7 Source: US Chamber of Commerce, May 30, 2018

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Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

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The Summary of Commentary on Current Economic Conditions by Federal Reserve District (the Beige Book) is published eight times per year. Each Federal Reserve Bank gathers anecdotal information on current economic conditions in its district, and the Beige Book summarizes this information by district and sector.

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Quantitative easing (QE) is a monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective.

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The MSCI All Country World ex-US Index is an unmanaged index considered representative of large- and mid-cap stocks across developed and emerging markets, excluding the US.

The MSCI EAFE Index is an unmanaged index considered representative of stocks of Europe, Australasia and the Far East.

The MSCI Emerging Markets Index is an unmanaged index considered representative of stocks of developing countries.

The S&P 500® Index is an unmanaged index considered representative of the US stock market.

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