Market and economic update

October 30, 2017

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Current economic events
U.S. growth remains on a positive trend. The economy gained an annualized 3 percent in the third quarter, despite a drag from hurricanes Harvey and Irma. Consumer spending was somewhat softer than prior quarters, but business spending strengthened, consistent with trends we have seen in corporate earnings growth. Strong fundamentals mean markets are able to ignore current progress on tax cuts and the next Federal Reserve (Fed) chair. Tax cuts could accelerate economic growth but it appears we are still a long way from policy clarity or implementation. The October jobs report, scheduled to be released this week, should see a rebound from weather-related softness in the September report.

Foreign markets continue to hold up on solid economic growth indicators, but politics garner the headlines. The win for Prime Minister Abe and his party in Japan’s snap election solidifies his leadership and indicates pro-growth policies are likely to remain at the heart of government initiatives. Stimulative policy, improving economic growth and solid corporate earnings trends likely mean solid returns for Japanese stocks. In the wake of the 19th National Congress of the Communist Party in China, leadership is quite clear, with President Xi Jinping solidifying his power and leadership. Policy trends are somewhat less clear but in our view, the slowing trend of growth in China is likely to continue as they work out their credit overhang and encourage further growth in consumer spending.

Equity markets
U.S. equities ended last week fractionally higher due to strong third quarter results, particularly from information technology companies. Midway through the third quarter reporting period, we continue to believe that increasing earnings, restrained inflation and low interest rates provide valuation support and the basis for stocks to still trend higher.

Third quarter results are surprising to the upside, with sales and earnings growing roughly 6 percent and 8 percent year over year, respectively, according to Bloomberg.

- A common theme from third quarter company releases is that economic growth around the world has been strong, consistent with our synchronized pro-global growth outlook. Additionally, on balance and somewhat surprising, minimal reference is being made to the impact of recent hurricane activity, tax reform, foreign currency concerns and geopolitics.

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[1] Important disclosures provided on page 3.
• Investors do seem keenly focused on improved prospects for tax reform and the positive near-term implications that tax reform could have on company earnings. At present, consensus expectations are for year-over-year earnings growth of approximately 10 percent for both 2017 and 2018, according to FactSet Research Systems and S&P Global. Any fiscal stimulus would likely be additive to the growth rate in 2018.

Valuations remain elevated. Many valuation metrics appear extended when compared to historical averages, suggesting caution or a risk-off bias. Conversely, the macroeconomic backdrop of constrained inflation and low interest rates provide valuation support and reasons for stocks to trend still higher.

• Valuations can be poor timing tools, with stocks remaining overvalued or undervalued for prolonged periods, often depending on the pace of inflation and speed at which the Fed raises interest rates. Valuations based on earnings can also be misguided in an environment of improving global conditions where earnings are being reset higher, in addition to potential fiscal stimulus.

• There are also few signs that a recession is imminent, evidenced by an upward sloping yield curve. Looming recessions are often signaled by an inverted yield curve, which at present is not the case.

• Given valuation levels, it does seem reasonable to expect the pace of equity gains to slow in coming days, with third quarter earnings season coming to a close, investors shifting attention to uncertainties associated with tax reform, a likely new Fed administration and ongoing geopolitical concerns. However, as long as inflation remains muted, the Fed stays generally accommodative and earnings increase, stocks seem poised to inch still higher.

**Fixed income markets**

Bond yields ended the week only slightly higher but rose as high as 2.48 percent midweek, breaking through the key 2.4 percent technical level for several days. Various economic releases over the week exceeded expectations and continued to indicate a stable economic recovery. Central banks continue to gradually remove policy accommodation, which, in turn, should remove a degree of downward pressure on yields experienced post-crisis. With rates expected to gradually rise within the context of a strong economic backdrop, we continue to see high quality credit exposure rather than duration as the preferred method of picking up incremental yield.

President Trump is expected to announce his nomination for Fed chair this week, which could have broad implications for domestic monetary policy. Jerome Powell is viewed as the strong favorite and would be seen as a status quo nomination given his past board experience and close policy alignment with current Chair Janet Yellen. John Taylor or Kevin Warsh, who have seen their odds drop in recent days, would represent a more hawkish pivot at the Fed, potentially pushing bond yields higher on the expectation they may favor more rapid rate increases and asset sales from the Fed’s balance sheet.

The European Central Bank (ECB) took another gradual step towards the removal of accommodation, announcing they would extend asset purchases at least until September 2018, reducing monthly purchases from 60 billion euros to 30 billion euros. While the statement was interpreted as slightly dovish, since there was no firm end date for asset purchases, the ability to extend the program much beyond year-end 2018 is limited due to the lack of supply of eligible bonds. The Bank of England (BOE) is expected to lift the target rate this week for the first time since 2007, and the Fed is expected to increase rates again in December (and is already reducing the balance sheet). With additional clarity around the ECB’s expected conclusion of the asset purchase program, monetary stimulus is gradually being ratcheted back across the globe.
Real estate markets
Publicly traded Real Estate Investment Trusts (REITs) lagged the S&P 500 over the past week and now trail the broader market by 14 percent for the year. The increase in interest rates did not help the space last week. Additionally, third quarter earnings have been slightly weaker than expected, which has added to the selling pressure. Investor outflows from the sector continue. We believe we are closer to the end of the real estate cycle than the beginning, but do not see a current catalyst which could spur revaluation.

Commodities markets
The big news in the oil market last week occurred on Friday as the CEO’s of major oil companies called on OPEC to extend its production cuts by another nine months. There were reports confirming that OPEC is forming a consensus around extending production cuts to the end of 2018. West Texas Intermediate (WTI) jumped 2.5 percent on the news, testing the highest levels of the year. Despite the recent price strength, we remain cautious on commodity futures price investments, believing the market remains well supplied.

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