Market & Economic Update

WEEK OF: AUGUST 14, 2017

Current economic events

Escalating tensions with North Korea last week contributed to a spike in volatility, falling stocks and a rise in safe-haven assets, such as U.S. Treasuries and precious metals. Markets bounced back after senior U.S. officials made statements to alleviate concern. While global growth remains on an upturn, if the string of disappointing inflation releases persists, the Federal Reserve (Fed) and European Central Bank (ECB) may need to alter the scope of their plans to reduce monetary policy accommodation.

Inflation data in the United States has come in below expectations five months in a row, with Friday's Consumer Price Index (CPI) release showing an increase of only 1.7 percent year over year. Earlier in the week, the Producer Price Index (PPI) release also disappointed to the downside. The Fed has indicated they prefer to see inflation rising around 2 percent and ongoing misses could prompt a refrain from plans to continue increasing interest rates in coming quarters. However, with a tight labor market, and indications that firms are experiencing difficulty finding qualified workers, we expect wage data to trend higher, which along with other economic data, indicates prices should also move higher.

Global growth remains strong and expectations are ticking higher. Over the weekend, Japanese gross domestic product (GDP) data indicated annual growth of 4 percent, substantially better than market expectations for 2.5 percent. In Europe, GDP growth is expected to come in at 2.1 percent, in line with the prior quarter, which was the highest year-over-year increase since 2011. In the United States, growth remains steady and has trended modestly higher since 2015. The continuation of stable-to-higher global economic growth supports our willingness to take some risk in the current environment, despite asset prices remaining above historical averages.

Contributed by: William J. Merz, CFA – Portfolio Strategist

Equity markets

The "wall of worry" for equities is back under construction following escalating rhetoric between the United States and North Korea. Increased geopolitical tensions and the increased probability of an unexpected outcome are among items likely to weigh on equity prices over the coming days and weeks following superb and broad based year-to-date returns.

- As of Friday's close, the Dow Jones Industrial Average, S&P 500, and international-oriented MSCI EAFE and MSCI EM indices are up between 9 percent and 22.6 percent year to date. The small cap-oriented Russell 2000 is up a more modest 1.3 percent, presumably due to factors such as political uncertainty and a falling dollar.

On balance, there remains much to like about the global macro-economic backdrop for equities. Earnings are increasing, global economic growth appears synchronized, inflation is moderate and the Fed remains accommodative. Equities typically trend higher during periods of rising earnings, restrained inflation and low interest rates.

 Important disclosures provided on page 3.

- The second quarter earnings season is nearing an end, with overall results exceeding expectations.

Near term, the risks to equity prices seem balanced, with downside bias due to rising concerns over geopolitics, valuations and falling interest rates.

- Rising geopolitical tensions may pressure consumer confidence, negatively impacting already soft consumer spending levels.
- Valuations remain full. The S&P 500 trades at roughly 21 times and 18.7 times trailing 12-month and 2017 earnings estimates, respectively, according to Bloomberg, which is above the approximate 50-year historical average of 14.5 times.
- And, importantly, the disconnect between rising stock prices and falling yields is among reasons to maintain a cautious bias until this conflicting trend is reconciled.

Technically, momentum appears to be stalling heading into the dog days of summer.

- The S&P 500 closed on Friday, August 11 fractionally below its 50-day moving average of roughly 2,450 and nearly 4.5 percent above the 200-day moving average of 2,340. Should geopolitical tensions linger or indications of economic growth wane, it seems plausible for the popular index to trend down toward the 200-day moving average level while remaining in a secular uptrend.

Contributed by: Terry D. Sandven – Chief Equity Strategist

Fixed income markets

Bond yields declined approximately three basis points to six basis points last week amidst further declines in inflation expectations and rising geopolitical uncertainty. Inflation expectations fell after July core CPI and PPI both came in below expectations. Market-based inflation measures declined slightly last week and remain approximately 30 basis points to 40 basis points below peaks observed earlier this year, further fueling concerns about the sustainability of inflation growth and the future of Fed monetary policy in 2018 and beyond. However, we believe that with a tight labor market, wage data should move higher and contribute to modestly higher inflation and yields by late 2017.

Three Fed members spoke in favor of near-term balance sheet reductions last week, further bolstering the view that the Fed will soon announce a starting date. While balance sheet reductions should weigh on bond prices, the impact is likely to be modest in the near term, considering plans have been well communicated and other major central banks remain net buyers.

We continue to recommend modestly shortening maturities in bond portfolios in order to limit exposure to rising yields, and favor a tilt to credit exposure. We believe longer-term municipal bonds are more attractive than corporate bonds for taxable investors, though short-term municipals appear expensive.

For investors seeking higher yields, there are limited choices, and higher volatility and risk should be expected. Private debt remains the most attractive source of yield for qualified investors, though it comes at the expense of liquidity. High yield U.S. corporate bonds and emerging market bonds remain expensive, though fundamentals are reasonably good. In the emerging market debt space, investor flows are robust, currency volatility remains low and current account balances are improving. Economic strength and credit quality of index constituents appear somewhat better for local currency-denominated debt, although if the U.S. dollar reverses course and rallies, it would act as a headwind to local currency emerging market bond prices. A rise in volatility would harm both high yield and emerging market debt. We urge investors in these sectors to utilize active managers that can navigate complex credit analysis and would avoid passive exchange-traded funds (ETFs) or mutual funds that attempt to track an index.

Contributed by: Gregory L. Powell, CFA – Senior Fixed Income Analyst

This information represents the opinion of U.S. Bank. The views are subject to change at any time based on market or other conditions and are current as of the date indicated on the materials. This is not intended to be a forecast of future events or guarantee of future results. It is not intended to provide specific advice or to be construed as an offering of securities or recommendation to invest. Not for use as a primary basis of investment decisions. Not to be construed to meet the needs of any particular investor. Not a representation or solicitation or an offer to sell/buy any security. Investors should consult with their investment professional for advice concerning their particular situation. The factual information provided has been obtained from sources believed to be reliable, but is not guaranteed as to accuracy or completeness. U.S. Bank is not affiliated or associated with any organizations mentioned.

Based on our strategic approach to creating diversified portfolios, guidelines are in place concerning the construction of portfolios and how investments should be allocated to specific asset classes based on client goals, objectives and tolerance for risk. Not all recommended asset classes will be suitable for every portfolio. Diversification and asset allocation do not guarantee returns or protect against losses.

Past performance is no guarantee of future results. All performance data, while obtained from sources deemed to be reliable, are not guaranteed for accuracy. Indexes shown are unmanaged and are not available for direct investment. The **S&P 500 Index** consists of 500 widely traded stocks that are considered to represent the performance of the U.S. stock market in general. The **Dow Jones Industrial Average (DJIA)** is a price-weighted average of 30 actively traded blue chip stocks and is the most widely used indicator of the overall condition of the U.S. stock market. The **MSCI EAFE Index** includes approximately 1,000 companies representing the stock markets of 21 countries in Europe, Australasia and the Far East (EAFE). The **MSCI Emerging Markets Index** is designed to measure equity market performance in global emerging markets. The **Russell 2000 Index** measures the performance of the 2,000 smallest companies in the Russell 3000 Index and is representative of the U.S. small capitalization securities market.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. **International investing** involves special risks, including foreign taxation, currency risks, risks associated with possible differences in financial standards and other risks associated with future political and economic developments. Investing in **emerging markets** may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investing in **fixed income securities** are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. Investment in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. The **municipal bond market** is volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issues of municipal securities. Interest rate increases can cause the price of a bond to decrease. Income on municipal bonds is free from federal taxes, but may be subject to the federal alternative minimum tax (AMT), state and local taxes. **Alternative investments** very often use speculative investment and trading strategies. There is no guarantee that the investment program will be successful. Alternative investments are designed only for investors who are able to tolerate the full loss of an investment. These products are not suitable for every investor even if the investor does meet the financial requirements. It is important to consult with your investment professional to determine how these investments might fit your asset allocation, risk profile and tax situation. **Private debt investments** may be either direct or indirect and are subject to significant risks, including the possibility of default, limited liquidity and the infrequent availability of independent credit ratings for private companies. **Qualified Purchaser**: For individuals, the criteria is met by a net worth of more than $5 million in investments. For other entities, such as corporations, partnerships, trusts and employee benefit plans, the criteria is met with at least $25 million in investments. Governed by Regulation D of the Securities Act of 1933. **Exchange-traded funds (ETFs)** are baskets of securities that are traded on an exchange like individual stocks at negotiated prices and are not individually redeemable. ETFs are designed to generally track a market index and shares may trade at a premium or a discount to the net asset value of the underlying securities. **Mutual fund investing** involves risk and principal loss is possible. Investing in certain funds involves special risks, such as those related to investments in small- and mid-capitalization stocks, foreign, debt and high-yield securities and funds that focus their investments in a particular industry. Please refer to the fund prospectus for additional details pertaining to these risks. Investments in **real estate securities** can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates and risks related to renting properties (such as rental defaults). There are special risks associated with an investment in **commodities**, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors.