MARKET VIEW

Midyear Outlook: Our Experts Give Their Macro Views

July 9, 2018

Lord Abbett investment leaders offer their insights on the macroeconomic and policy factors that could influence markets in the second half of 2018.

In Brief

- We convened five Lord Abbett investment leaders to discuss the macro factors that may affect economies and markets in the year's second half.
- Policy matters dominated the conversation. The experts discussed *monetary policy*, with a focus on potential moves by the U.S. Federal Reserve.
- The panel also weighed the economic impact of U.S. *fiscal policy*, especially in light of recent changes to the U.S. tax code.
- In addition, participants examined the implications of *trade policy* amid rising tensions among the United States and its key trading partners.
- Our experts identified other macro factors to watch in coming months, such as the U.S. debt-ceiling debate, geopolitical developments, and the shape of the U.S. Treasury yield curve.

While a number of trends that have supported global economic growth and financial asset prices in the first half of 2018 look set to continue, other factors have emerged that could affect the investment climate in the year's second half. In particular, developments in trade policy could weigh on global growth, and geopolitical events could produce a "September to remember," in the words of one Lord Abbett investment expert.

With that in mind, what should investors be watching in the final six months of the year? We recently gathered five Lord Abbett investment leaders for a wide-ranging discussion of the current market and economic environment and their views on key investment themes for the second half of 2018. In this, the first of a special three-part *Market View*, our panel examines second-half macroeconomic conditions. Part two will focus on the market environment, especially in terms of the direction of bond yields and key measures of investment risk. In the concluding segment, our experts will discuss how the factors outlined in parts one and two inform the outlook for key asset classes.

Our panel featured Lord Abbett partners **Robert Lee**, chief investment officer; **Giulio Martini**, director of global asset allocation; **Thomas O'Halloran**, portfolio manager for micro-, small-, and large-cap growth strategies; **Daniel Solender**, director of tax-free fixed income; and **Kewjin Yuoh**, portfolio manager for taxable fixed income. (Coming soon: Visitors to lordabbett.com will be able to access video and audio highlights of the panel discussion.)

Lee outlined a logical framework for the macro discussion. The three key issues that investors should focus on in the second half of the year, he says, “all surround different forms of policy: monetary policy, fiscal policy, and trade policy.”

Economic Backdrop

But first, a view of the current environment is in order. The panel acknowledged favorable global economic conditions. “We've had an excellent economic environment, with synchronized global growth [see Chart 1] that's led to a situation where company earnings have grown very rapidly and have exceeded investors' expectations,” notes Martini. “The question is, for how long can this be sustained?”

Table 1. Sync and Swim: Global Economies Continue to Grow in Unison, for Now

Forecasted gross domestic product (GDP) rates, as of July 2, 2018

	Forecasted GDP Growth (%)		
	Q2 2018	Q3 2018	Annualized (Q2)
United States	0.8	0.9	3.3
Euro Area	0.2	0.2	1.0
Germany	0.4	0.4	1.4
France	0.4	0.4	1.6
Italy	0.3	0.3	1.0
Spain	0.9	0.9	3.5
United Kingdom	0.3	0.4	1.2
Japan	0.7	0.1	2.8
China (Y-O-Y)	7.0	7.3	—

Forecasts for U.S. growth continue to outpace those for most developed nations.

Source: Now-Casting Economics. Y-O-Y=year-over-year. Note: Calculations for annualized GDP based on originally reported figures before rounding.

In assessing the likelihood of whether the current period of growth is coming to an end, Martini points out that “expansions normally end because an excess develops—either in the real economy or in the financial system—that can only be resolved with a future period of slow or negative economic growth.” He notes that one of those cautionary signals is excess demand, which manifests itself in rising inflation. “That's something we decidedly don't have right now,” he says.

Inflation is “one of the most important questions for investors,” adds Lee, with the shape of the yield curve, U.S. Federal Reserve (Fed) rate moves, and fiscal and trade policy all tied into the inflation outlook. “So far we've had very contained, stable inflation and inflation expectations within a pretty reasonable range."

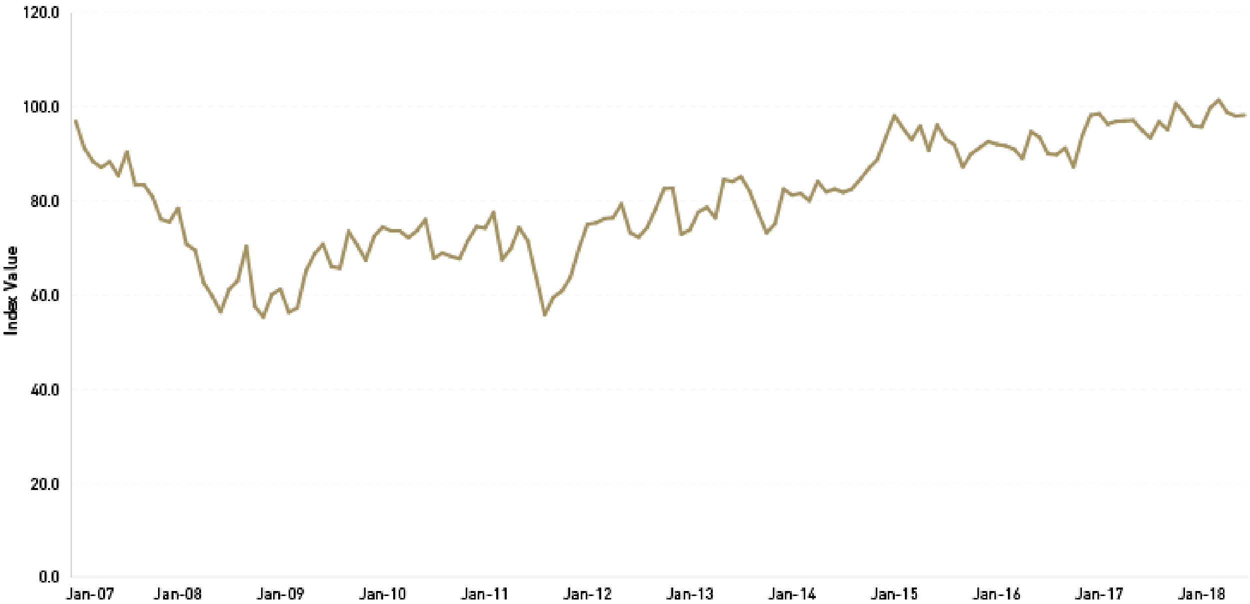
But, cautions Lee, "investors shouldn't get complacent." He called the Fed's efforts to shrink its balance sheet "an experiment that hasn't really been tested in the United States." Further, inflation potentially could be fueled by trade-policy moves on the part of the United States and its trading partners (a topic that our experts discuss in greater detail later on).

The panel examined other aspects of the current U.S. economic scene. For the municipal bond sector, the continued economic strength represents a tailwind. "You have to look at the impact on the economy doing so well and a lot of the business that's coming from that," says Solender. Regarding general obligation bonds, revenues in most U.S. states are "way ahead" of budgets, he says, which may come as a surprise to many investors. As for revenue bonds, Solender singled out toll roads and airports as examples of sectors that are benefiting from the stronger economy. This strength has carried over to make overall municipal bond credit quality "very strong," he says.

O'Halloran focused on the robust U.S. consumer sector. "That's where 70% of the spending is," he notes. Longer-term trends in technology have made the consumer experience "vastly better," he says, lending support to current and future spending.

Yuoh agreed. "If you look at consumer sentiment, we're at higher levels than we were before the Great Recession." (See Chart 2.) He says this indicates a "bifurcation" that investment professionals have to consider. "In the United States, with this very strong environment with the consumer, all leading indicators are continuing to trend upward."

Chart 1. Robust Consumer Sentiment Appears to Support U.S. Growth Prospects
University of Michigan Consumer Sentiment Index, January 2007–June 2018



Source: University of Michigan, University of Michigan: Consumer Sentiment [UMCSENT], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/UMCSENT, July 4, 2018.

But that's where the prospects for the United States and other nations may diverge, according to Yuoh. For example, investors are contending with the implications of signs of weakness in emerging-market economies, as well as uncertainties of how trade tensions will affect growth in China.

Martini had one further observation on China: “One of the things that's going on right now … is a clampdown [by the Chinese government] on the growth of shadow banking in an attempt to reduce financial risk.” He believes it may be difficult to fully gauge the potential spillover effect upon the rest of the world from this “attempt to put the Chinese economy on a sounder financial footing.”

Monetary Policy

The direction of U.S. monetary policy emerged as a particular focus for the panel. Lee recapped recent developments, noting that the Fed began tapering asset purchases in 2013, before finally ending them in 2014; in December 2015, the central bank implemented the first of seven rate hikes. And while the Fed has stepped up the pace of hikes in 2018, from a historical perspective the pace “isn't extremely fast.” For Lee, the key questions are: Is the Fed ahead of, or behind, the curve on inflation? In reducing monetary accommodation, is it “taking the punch bowl away” too quickly?

“If you look at credit spreads in various fixed-income sectors, and if you look at the stock market overall, I would say risk markets tend to be more comfortable with the pace of Fed tightening,” Lee says.

Martini notes that in addition to the Fed’s tightening moves since December 2015, the central bank has allowed the securities that it added to its balance sheet from the asset-purchase program to roll off as they mature. “What we're seeing is a situation where previously the Fed had been keeping its balance sheet constant,” he says, but the Fed allowed it to expand, from $1 trillion to $4.5 trillion, at the height of quantitative easing (QE). The balance sheet represents risk that the Fed has taken out of the markets and chosen to hold itself, he says. As the balance sheet shrinks, Martini explains, the Fed is transferring risk back into the market that it previously had held on its own books.

“The change in Fed policy is one of those factors that you have to add in on top of earnings, low inflation, and all the other things that matter in the environment,” Martini says. “And it's difficult to assess that, because we've never been through anything like this before.”

Fiscal Policy

The passage of the U.S. Tax Cuts and Jobs Act in December 2017 was intended to spur economic growth in the United States, at a time when the economy was already expanding at a steady clip. While the legislation had a notable impact on economic data and asset prices in 2018, the longer-term effects remain to be seen. Yuoh observes that the U.S. economy had just come from “an incredible monetary policy experiment” with the Fed’s asset purchase program. In the QE era, the United States had experienced an unusually long, nine-year expansion marked by steady, if unspectacular, growth. Now, with the addition of fiscal stimulus, Yuoh asks, “what if we return to a normal business cycle?”

In the past, notes Lee, fiscal stimulus measures would happen during a recession or periods of economic weakness. “This time it's been pro-cyclical,” he says. Labor markets had already been tightening, and the economy was advancing at a steady pace, “and yet we got a pretty substantial fiscal stimulus package.” Much like the Fed’s balance-sheet unwinding, there is little historical precedent for pro-cyclical stimulus, Lee says. “It's an open question as to whether that will lead to inflation, and whether the effects will be short term and/or longer term.”

In the muni market, the tax bill has had “a tremendous impact,” notes Solender. He says that provisions of the legislation that removed the ability of municipalities and issuers to refinance bonds in advance of their call dates had reduced municipal new-issue supply by around 20%, year to date (through June 28). Meanwhile, a considerable amount of muni issuance that would have occurred in 2018 was pushed into December 2017 based on concerns about other provisions of the tax bill. As a result, Solender says, the supply of new issues in the muni market is very low, “slowly picking up, but still behind the pace of previous years.” At the same time, limits on tax exemptions, such as the deductibility of state and local taxes and mortgage interest, have spurred demand for muni securities, especially in high-tax states such as New York and California.

Trade Policy

The first half of the year offered an avalanche of headlines on trade—everything from the sometimes contentious re-do of the North American Free Trade Agreement (NAFTA), to the trade negotiations between the European Union and a Brexit-bound United Kingdom, and worsening trade relations between the United States and China amid a volley of tariff threats. Martini believes trade policy is “something to worry about” because there historically have been very few trade wars, and thus little guidance as to how the current situation may play out.

If trade conflicts escalated to the point that reciprocal tariffs were implemented between the United States and China, the United States and the European Union, and among the three NAFTA signatories and other trading partners, the impact on global economic growth likely would be negative, says Martini. Extensive trade conflicts could slow global economic growth by “two or three tenths of a percent ... from what looks to be a pretty strong year right now,” he says. The direct impact of the trade war wouldn't be devastating, but what might hurt global economies are the effects on uncertainty for businesses that might change their investment decisions, or delay investments in the United States or in other countries. “It would really create some uncertainty about the broader policy environment,” he adds.

Yuoh says financial markets have been reacting to the uncertainty that Martini referenced. He thinks there could be a “healthy” debate about what the endgame is for the U.S. administration with regard to trade policy and protectionism. But “without knowing what that endgame is or how we get there,” investors in global asset markets will demand risk premiums for that uncertainty.

“I think the base case is that pragmatism will prevail,” says Lee. But he adds that “one needs to take a step back as well and look at the broader, longer-term issues.” He cited the rise of populism and economic nationalism, not just in the United States but also in other developed nations. “These are complicated, longer-term issues which one needs to really think about.”

What Else to Watch

What other macro factors, beyond the economic and policy considerations already discussed, could influence markets in the second half? For one thing, a crowded geopolitical calendar. “When you look at it, this could really be a ‘September to remember,’“ says Martini. He cited the following developments expected for September and early October:

1. U.S. congressional negotiations around the debt ceiling;
2. A potential U.S. government shutdown should those negotiations fail;
3. A possible conclusion to the investigation by U.S. special counsel Robert Mueller into Russian interference in the 2016 U.S. presidential election;
4. The scheduled wrap-up of Brexit negotiations by U.K. legislators;
5. Related U.K.-EU negotiations; and
6. Continued friction between Italy and the rest of the European Union over budgetary rules.

“All of those things could definitely … increase uncertainty around a range of outcomes,” Martini says.

Lee addressed other, longer-term geopolitical risks: the progress of denuclearization negotiations with North Korea, the withdrawal of the United States from the Iran nuclear deal, ongoing tensions with Russia, and continued instability in the Middle East, especially as it relates to oil supplies. “I don't think the picture is particularly dire” for any of those situations, “but I think some of the risks have increased,” he says.

In munis, Solender expects that recently enacted **amendments to two rules related to municipal-bond pricing** from the Municipal Securities Rulemaking Board designed to provide greater transparency on pricing and trade data could affect investors' approach to purchasing municipal securities.

Yuoh suggested that market watchers monitor developments in the U.S. yield curve, especially as investors react to Fed policy moves in the months to come.

Finally, O'Halloran noted many of the concerns expressed in the course of the discussion, especially as they relate to equities. "I take those very seriously," he says. But he believes investors should continue to focus on developments in technology and the positive impact they have on consumers and businesses. O'Halloran thinks "the innovation boom that we're in the midst of right now" could help drive equity prices higher in the current year, and over the next several years.

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Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. One such comparison involves the two-year and 10-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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LORD ABBETT

MARKET VIEW

Midyear Outlook: What Is the Yield Curve Telling Us?

July 16, 2018

If the economic outlook is so great, why is the yield curve flattening? Second of three parts.

In Brief

- Because the yield curve has inverted before nearly every recession going back to the 1960s, the shape of the curve is eyed carefully by investors for its predictive value.
- Our panelists weigh the possibility that the shape of the yield curve today may be a less reliable guide to the timing of the next recession than it has been in the past.
- Since the U.S. Federal Reserve has managed interest-rate expectations skillfully, the flattening yield curve today may reflect largely the influence of a zero or negative term premium.

We recently gathered five Lord Abbett investment leaders for a wide-ranging discussion of the current market and economic environment and their views on key investment themes for the second half of 2018. In the first of a special three-part *Market View,* published on July 9, our panel examined **second-half macroeconomic conditions**. In this, the second segment, we focus on the market environment, especially in terms of the direction of bond yields and key measures of investment risk. (In the concluding portion, our experts will discuss how the factors outlined in parts one and two inform the outlook for key asset classes.)

Our panel featured Lord Abbett partners **Robert Lee**, chief investment officer; **Giulio Martini**, director of strategic asset allocation; **Thomas O'Halloran**, portfolio manager for micro-, small-, and large-cap growth strategies; **Daniel Solender**, director of tax-free fixed income; and **Kewjin Yuoh**, portfolio manager for taxable fixed income. (Coming soon: Visitors to lordabbett.com will be able to access video and audio highlights of the panel discussion.)

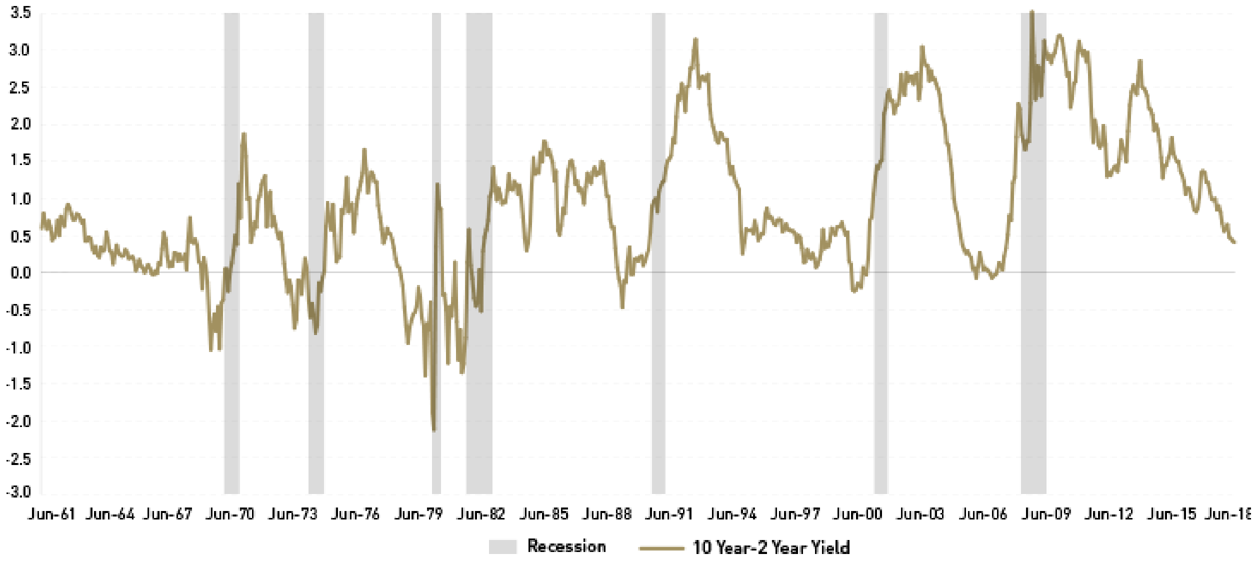
One of the major topics at our panel's midyear outlook discussion revolved around the flattening yield curve and what that may portend for the U.S. economy.

A yield curve is said to flatten when the difference between short- and long-term interest rates diminishes. Historically, a flattened yield curve can be the first step toward a full inversion, in which short-term rates ultimately exceed long-term rates and investors are no longer paid for taking on risk.

Because the yield curve has inverted before every recession going back to the 1960s (although less convincingly so in the last two cases) and with a time lag of about six to 24 months before a recession begins, the shape of the yield curve is eyed carefully by investors for its predictive value.

Chart 1. Inverted Yield Curve and Recessions: Will History Repeat?

Yield curve differential of the 10-year Treasury bond and the two-year Treasury note, June 30, 1961 – June 30, 2018



Source: U.S. Federal Reserve Bank of New York and Bloomberg. Yield curve represents the differential in two- and 10-year U.S. Treasury yields. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Past performance is not a reliable indicator or guarantee of future results.

But something has changed, according to our panelists, who weighed the possibility that the shape of the yield curve today may be a less reliable guide to the timing of the onset of the next recession than it has been in the past.

Lee was the first to address the issue after he was asked if he thought that the U.S. Federal Reserve (Fed) was behind or ahead of the curve in terms of the pace of rate hikes. “From a historical perspective,” Lee says, “I would say the pace has been reasonably gradual. But the evidence from the markets is mixed. On the one hand, the yield curve has been flattening—an event that has some predictive value, although not perfect, of a weakening economy. When the Fed hikes too quickly, that tends to impede economic activity.”

“But on the other hand,” he continues, “if you look at risk markets—at credit spreads in various fixed-income sectors, and look at the stock market overall—they tend to be more comfortable with the pace of Fed tightening. Credit spreads have widened some, but they’re reasonably close to their recent tights, and the equity market is off its highs of late January, but not by a huge amount.”

So, the yield curve may be sending a bit of a warning signal, but, for now, investors are more or less nonchalant.

Martini opines that investors have reason to be happy. “Investors appreciate that we’ve had an excellent economic environment for a couple of years now, with corporate earnings exceeding expectations and low inflation.”

O’Halloran agrees, and says that he expects healthy earnings growth to continue for the foreseeable future, given lower corporate taxes, less regulation, and “a technology revolution that is in full bloom."

But the question on everybody's mind, Martini says, is: "How long can this be sustained?"

Yuoh responds: "That is the key question. Can the U.S. economic expansion continue? Is the flattening yield curve indicating a coming recession?... People have been saying, for four or five years now, that we're in the sixth, seventh, or eighth inning of this business cycle. Nevertheless, this domestic expansion continues. Leading indicators are still on an upward trend. We've got a housing recovery and fiscal stimulus. And risk valuations are reflecting the current environment…. But what if—after this incredible monetary policy experiment of quantitative easing—we are returning to a normal business cycle?... It's not so clear cut now what the yield curve is telling us."

It's the Term Premium

Today's flattening yield curve can be ascribed to the stickiness of the 10-year Treasury yield. While two-year yields have climbed almost 70 basis points (bps) in 2018 (as of July 10), those on the 10-year maturity are up less than 50 bps. The gap between the maturities dwindled to around 27 bps in July, the smallest since 2007, according to Bloomberg. And it is the resilience of longer maturities that is helping drive the yield curve toward inversion.

But is that something to worry about? Is the yield curve telling us that the current economic expansion is getting long in the tooth?

It helps, Martini says, if you consider the fact that "the yield curve is really made up of two components. One is investors' expectations about future short-term interest rates and the other is a risk premium or term premium."

The first component has not been a driving factor in the shape of today's yield curve because the Fed has skillfully managed investors' expectations about short-term interest rates—both in terms of their pace and direction.

The second component, the term premium, is the excess yield that investors require to commit to holding a long-term bond instead of a short-term bond. Historically, the term premium has been positive and fairly constant; investors expect to be paid for taking risk. So, episodes of flat or inverted yield curves in the past largely have reflected changes in short-term interest-rate expectations—the term premium being more or less constant.

"The problem now is that most models of the yield curve are indicating that the term premium is either zero or negative," Martini says. This is due in part to the fact that investors are not anticipating any fundamental changes in the low inflation status quo. If they were, the term premium would be higher.

"Expansions normally end," Martini says, "because an excess develops either in the real economy or in the financial system that can only be resolved with a future period of slow or negative economic growth. Excess demand is one of those excesses that manifests itself in rising inflation, and that's something we decidedly don't have right now."

In this "Goldilocks" economy—that is, one of rapid economic growth and little inflation, with stable interest-rate expectations and investors seemingly willing to accept less compensation for risk-taking—a flattening yield curve may have lost its predictive value for a coming recession—at least at this point in time.

A Caution Against Complacency

However, Lee's warning in **our first installment of the midyear market outlook** —that investors should not be too complacent—needs to be heeded.

As Yuoh points out, "the Fed has been so transparent since the financial crisis of 2008–09, that they've literally taken volatility out of the market. But with a new Fed chairman, Jerome Powell, you may run the risk in the second half of the year that the reaction function changes." (The reaction function is a mathematical function that gives the value of a particular monetary policy the Fed chooses in response to some indicator of economic conditions.)

“And to the extent that the reaction function changes and the markets make interpretations as to what the new reaction function means, I think that we could have some term premium return to the marketplace,” Yuoh says.

Martini agrees. “One of the things that investors are questioning is how is the behavior of the Fed changing, and is it changing in an important enough way so that you have to factor that into your outlook? “

The Fed has raised interest rates seven times since 2015, Martini notes, “but what it’s also done more recently is allow the securities that it took on its balance sheet in very large quantities to roll off as they mature. The Fed’s balance sheet represents risk that the Fed had taken out of the markets and chosen to hold on its own balance sheet. And as the balance sheet shrinks, it’s transferring risk back into the market. One of the things that investors are concerned about is, ‘How is the market going to absorb that?’”

“Does it inevitably involve some volatility,” he continues, “or some changes in risk appetite that make it difficult to absorb that would then reverberate back into asset prices?”

Referring back to Yuoh’s description of Fed policy over the past decade as an “incredible monetary policy experiment,” Martini concludes that “the change in Fed policy is one of those factors that you have to add in on top of earnings, low inflation, and all the other things that matter in this environment. And it’s difficult to assess that, because we’ve never been through anything like this before.”

On the Municipal Side

Interestingly enough, the tax-free income side of the fixed-income market is not experiencing a flattening of the yield curve, at least at the short end, according to Solender. “For the part of the muni bond yield curve that comprises one-year to 10-year maturities, the curve is actually steepening, meaning that shorter rates are not rising as much as longer rates. Beyond 10 years, the curve is slightly flattening. But the shorter maturities are reacting different from the taxable markets.”

“And the main reason for that,” he continues, “is that we’re a retail-dominated market. If you look at Fed data, about two-thirds of muni bonds are owned by individual investors, either through managed products or in brokers’ accounts. And retail investors are very risk averse right now in the muni market.”

Despite the fact that rates have been rising for more than two years, retail investors are suddenly concerned about the pace of rising rates, according to Solender. “They’re going short in the muni market in a big way, and what that’s doing is pushing down on short-term rates. There’s excess demand, so our yield curve is actually steepening, which is a different dynamic from what we’re seeing in other markets.”

On the Equity Side

For investors in the equity market, the shape of yield curve is, so far, having little effect on their portfolio decisions. “We aren’t seeing that flight to safety on the equity side today that we saw between 2008 and 2016,” O’Halloran says, “when we had a massive bubble in low-volatility stocks. I see very broad leadership in the equity markets, and it’s spreading to small caps now. And technology is creating tremendous growth opportunities in many different areas.”

Summing Up

As Peter R. Fisher of the Tuck School of Business, Dartmouth College, wrote recently in the *Financial Times,* “The scale of intervention in the rates market in the past decade has been unprecedented….The U.S. and other governments have intervened to change the price of money.

It would hardly be surprising, then, if the information that price conveys has changed too."[1]

Has the Fed's massive experiment in quantitative easing, and the consequent withdrawal of volatility from the marketplace, rendered the yield curve less useful as an indicator of market expectations? It may well have done so—at least for now. But as the central bank's presence in the marketplace recedes and the markets return to normal, it's probably a good bet that the shape of the yield curve will once again take its place among the leading indicators of the health of the U.S. economy. Our investment experts will keep you informed.

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[1]"The Signal and the Noise in the Flat Yield Curve," *Financial Times*, April 20, 2018.

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LORD ABBETT

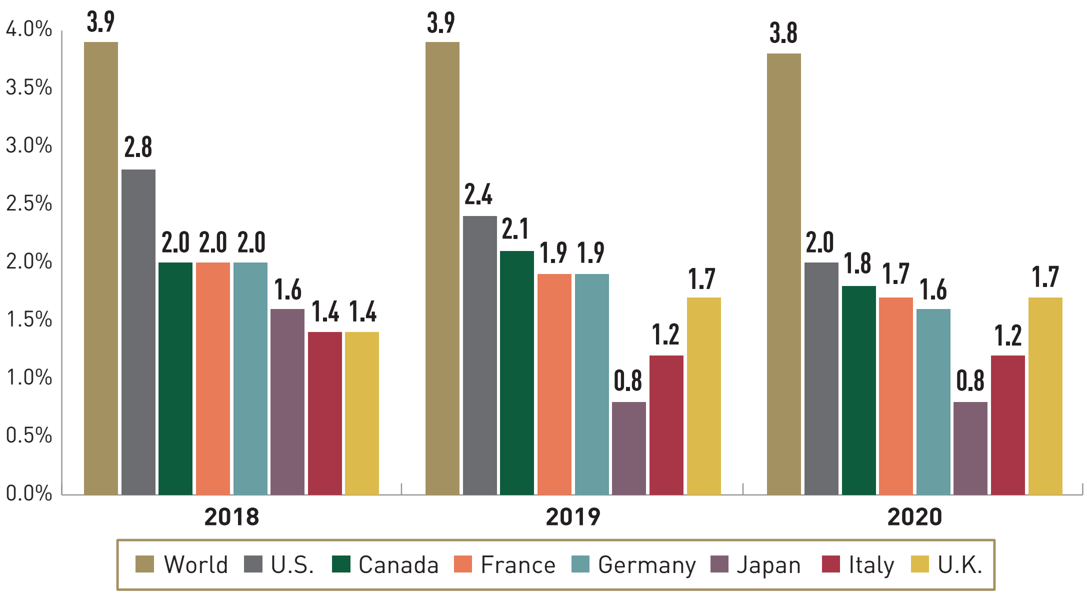
MARKET VIEW

MIDYEAR OUTLOOK: POSITIONING PORTFOLIOS

Lord Abbett investment professionals scope out the potential opportunities and risks in the second half of 2018. (Third in a series.)

CHART 1. DESPITE ECONOMIC TENSIONS, NO RECESSION IN SIGHT FOR A WHILE

U.S. GROSS DOMESTIC PRODUCT (GDP) GROWTH ESTIMATES, IN PERCENT



Source: International Monetary Fund, Federal Reserve, Bank of Canada, European Central Bank, European Central Bank, Bank of Japan, and the Bank of England. Data as of July 10, 2018.

IN BRIEF

- At a recent roundtable to discuss their midyear investment outlook, Lord Abbett panelists remained constructive on the global economy, despite widening geopolitical tensions.
- Panelists observed that risk markets tend to be more comfortable with the pace of U.S. Federal Reserve tightening, especially considering how much pro-cyclical fiscal policy has stimulated economic growth.
- They also believe that while volatility from rising interest rates has led to a flight to safety in U.S. fixed-income markets, there has been broad leadership in the U.S. equity markets, which is now spreading to small caps.

How should investors position their portfolios when considering serious questions about monetary, fiscal, and trade policy? Will risk assets, for example, lose some of their appeal as economic fundamentals for the United States and the world diverge?

These and many other questions figured prominently in a recent roundtable discussion with five Lord Abbett investment leaders. The panel featured Lord Abbett partners Robert Lee, chief investment officer; Giulio Martini, director of strategic asset allocation; Thomas O'Halloran, portfolio manager for micro-, small-, and large-cap growth strategies; Daniel Solender, director of tax-free fixed income; and Kewjin Yuoh, portfolio manager for taxable fixed income. (Coming soon: Visitors to lordabbett.com will be able to access video and audio highlights of the panel discussion.)

Likeminded with the world's major central banks (see Chart 1), Lee and the rest of the panelists remained constructive on the global economy, despite widening geopolitical tensions and a flattening yield curve. One reason for their outlook is that fiscal policy and tax cuts appear to be outweighing the effects of tariffs first imposed by the United States on its trading partners (and the "tit-for-tat" reactions they prompted). Another reason is the absence of excess (domestic) demand, which typically causes an economy to overheat, resulting in rising inflation. While commenting on relatively low inflation to date, Martini cited the pervasive "Amazonification" of the economy—an allusion to the powerful information platform that allows consumers to survey prices for items so easily and cheaply that businesses feel enormous pressure to hold down their costs and prices.

FEATURED INVESTMENT LEADERS

Robert Lee
Chief Investment Officer

Giulio Martini
Director of Strategic Asset Allocation

Thomas O'Halloran
Portfolio Manager for Micro-, Small-, and Large-Cap Growth Strategies

Daniel Solender
Director of Tax-Free Fixed Income

Kewjin Yuoh
Portfolio Manager for Taxable Fixed Income

EQUITIES: HEALTHY EARNINGS GROWTH SHOULD CONTINUE

As a long-time growth equity investor, O'Halloran naturally would be concerned about a jump in inflation and protracted trade wars, but he exuded an overarching optimism about global capitalism, transformative innovation, and seemingly insatiable consumerism—all of which have driven a phenomenon that Austrian economist Joseph Schumpeter once called "creative destruction."

"Company earnings have been fantastic [see Chart 2], and I see healthy earnings growth continuing [see Chart 3]," said O'Halloran, who was featured in a recent Wall Street Journal report on top-performing actively managed funds. "Interest rates are very low. The world is awash in money. The U.S. government is deregulating and lowering taxes, which is a good thing."

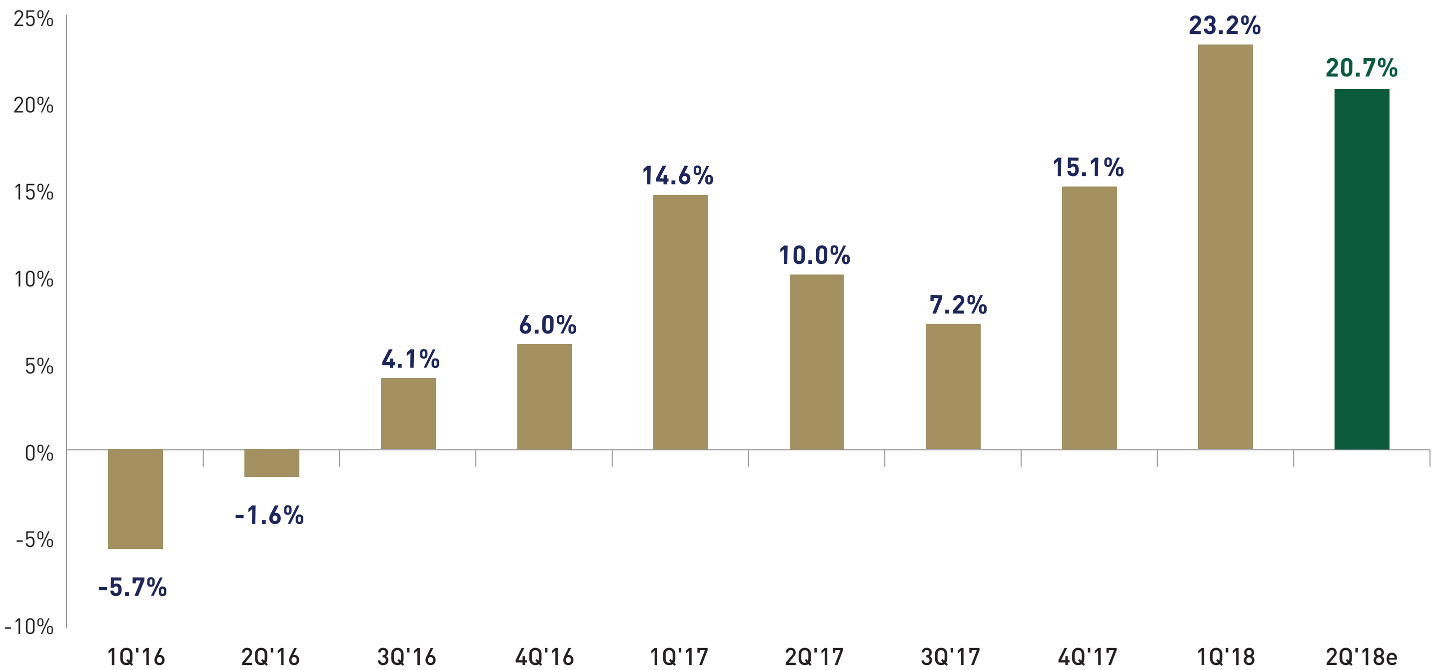
As a result, O'Halloran remains very bullish on equities, because the technology revolution is in full bloom, and is creating tremendous growth opportunities for companies across many different industries that potentially could last for years.

While volatility from rising interest rates has led to a flight to safety in the fixed-income markets, O'Halloran hasn't seen similar moves in the U.S. equity market. In fact, he has seen broad leadership in the U.S. equity markets (particularly in growth stocks), which is now spreading to small caps.

"Several market strategists have recently commented upon improving breadth in the equity market," O'Halloran said in a follow-up comment. "These include Tony Dwyer of Canaccord, who said that every internal measure is positive, suggesting broad strength.

CHART 2. ANALYSTS EXPECT ANOTHER 20%-PLUS EPS GROWTH QUARTER

S&P 500® INDEX QUARTERLY YEAR-OVER-YEAR EARNINGS GROWTH



Source: Thomson Reuters.

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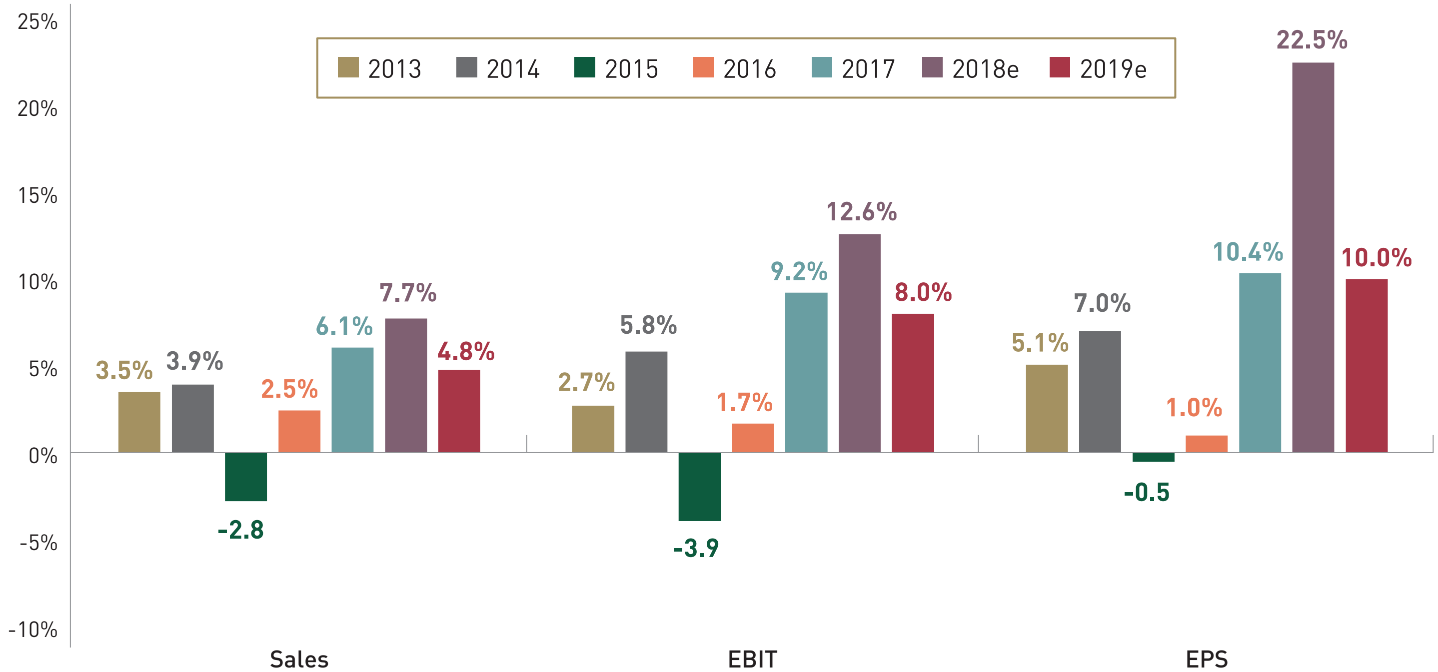
CHART 3. PROSPECTS FOR 2018–19 EPS, SALES, AND OPERATING INCOME ALL LOOK STRONG

S&P 500® INDEX ANNUAL GROWTH RATES



Source: FactSet.

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Dennis DeBusschere of Evercore/ISI and Chris Verrone of Strategas have commented about the performance equivalence of the S&P 500 of equal and market cap-weighted indexes. Jeff deGraaf of Renaissance Macro stated that breadth is good enough and that the market remains in an uptrend."

Other measures are supportive of improving breadth such as the NYSE advance-decline line hitting an all-time high, O'Halloran added, noting that small-cap stocks are outperforming large-cap stocks, year to date, by 500 basis points.

WHERE CONTINUED GROWTH MAY COME FROM NEXT

Expanding on his long-term bullishness about the technology revolution, O'Halloran cited the secular growth opportunities created by artificial intelligence (A.I.), cloud computing, and modern medicine.

- Massive investments in A.I.-related technology have the potential to increase productivity, streamline operations, transform multiple industries, and boost the global economy in what might be a multi-decade evolution, as global tech giants, and China, vie for hegemony in various markets while building new ones.
- "The cloud"—a blanket term for the networks of data centers that have expanded the digital universe by delivering services over the Internet—has transformed small-, mid-, and large-cap companies. Leading-edge tech companies "born" in the cloud have disrupted their respective markets. Others are providing the platform for innovative start-ups to expand rapidly. Among the many benefits are cost savings for providers and customers, resource flexibility, ease of use, and speed of deployment.
- In the fast-moving field of genetics and genomics, for example, thanks to the plummeting cost of sequencing the human genome, significant progress in identifying genetic defects has led to breakthrough diagnostics and preventive medicines, as well as targeted drug therapies, some of which deliver corrective genes into a patient's own diseased cells. The pace of this advance is breathtaking, compared to another example of exponential growth, Moore's Law, which enabled the computer revolution; genetic sequencing now has sharply outpaced that phenomenon.

"But let's not forget the consumer—that's where 70% of the spending [comes from]," said O'Halloran. "The consumer experience is just getting vastly better, as exemplified by a giant company that gets everything to us cheaper and more conveniently, hot meal delivery services at your fingertips, and innovative pet care and food companies–to name just a few beneficiaries. Technology will continue to improve the consumer experience, while better enabling companies to acquire customers, segment demand, and become more efficient."

When he was asked about greater regulatory pressure over privacy concerns, O'Halloran predicted that the tech giants most affected eventually will resolve such issues and maintain their secular growth trajectory.

"I think their stock prices will go up a lot more for a number of years, but at some point, the government will probably step in and end their ascent [through regulation and/or legal action]," O'Halloran added. "And when that happens, we will see the effect of it in their stock prices, and we will move on. But for now, I don't think there will be enough government pressure to cause these stocks to stop their upward trends and turn down."

TAXABLE FIXED INCOME: AVOIDING COMPLACENCY

While consumer confidence may be at all-time highs, Yuoh pointed to the bifurcation that investors have to manage for when it comes to growth. On the one hand, leading economic indicators in the United States are continuing to trend upward. On the other, there are the conundrums facing trade policymakers and the potential impact on global growth amid emerging market weakness and uncertainty about China going forward.

"If you look at current valuations, it's already reflected some of the [recent concerns]," said Yuoh. "High-yield debt is doing well. Investment-grade corporates have weakened over the last few months, and that shift has been pretty dramatic. If you look at commercial mortgage-backed securities and asset-backed securities, commercial mortgage-backed securities focused on domestic real estate, asset-backed securities focused on the consumer, you see they've done very well this year."

Will trade policy and protectionism dampen performance? Between sometimes confusing pronouncements and conflicting interpretations, there could be healthy debate about what the endgame might be for the Trump administration with regard to sustained trade wars. "So, without knowing what that endgame is, without knowing how we get there, you have to have a risk premium for that uncertainty," Yuoh said.

"As investors, we have to make our best scenario estimates of how this trade war might play out, but also focus on the underlying fundamentals," he added. "The potential impact to U.S. GDP is probably 0.1%—give or take 0.05%."

Lee's base case points to an enduring pragmatism. "Cooler heads will prevail, with lots of noise and volatility and, thus, opportunity," he said. "But one certainly needs to take a step back as well and look at broader, longer-term issues, like populism, economic nationalism, and the change in sponsorship of multinational bodies such as the World Trade Organization and the Trans-Pacific Partnership."

In any case, another risk in the second half of 2018 is a more hawkish policy by the U.S. Federal Reserve (Fed). "To the extent that the Fed's 'reaction function' changes and the markets make interpretations as to what the new reaction function means, I think that we could have some term premium return to the marketplace," Yuoh said.

TAX-FREE FIXED INCOME: LIMITED SUPPLY/EXCESS DEMAND

Unlike his taxable fixed-income brethren, Solender said he has seen a steepening of the yield curve on rates out to 10 years, although it is flattening a bit beyond those maturities. Solender said the municipal bond market is dominated by individual investors who are currently very risk averse and that the composition of investors in the market has been the cause for the differences between the taxable and tax-exempt yield curves.

"Individual investors keep asking questions about whether we think interest rates are going to rise, and what we're going to do with their portfolios in response to interest rates possibly rising—not realizing that [rates have] been rising for two years now, and [that] we've been in a bear market for a while," said Solender. "As a result, [investors are] going short in the U.S. municipal bond market in a big way, and that's helping to push down short-term rates. We don't have a lot of supply on the short end. There's excess demand."

Of course, U.S. tax policy, specifically the limit on state and local tax deductions and property-tax itemizations, has had a tremendous impact on the U.S. municipal bond market this year. According to Solender, new-issue supply (whereby bonds for new projects come into the market) is down about 20% year to date, in large part because issuers can no longer refinance bonds in advance of their call dates.

Demand, on the other hand, remains robust, especially in high-tax states like California and New York, since the new U.S. tax bill continued to exempt interest on municipal bonds from federal taxation, Solender said. But with the corporate tax rate dropping, from 35% to 21%, the tax exemption is not as beneficial anymore for major municipal-bond investors such as banks or insurance companies. Still, with the new-issue supply low, the demand from individuals is more than enough to offset the lower corporate demand, so the U.S. municipal bond market has been performing well relative to other fixed-income markets.

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