Global Market Snapshot

Key Market/Economic Observations

United States

Trade War Risks Resurface; Recovery Turns Nine

- Trade war risks escalated in June, when President Donald Trump proposed an additional 10% tariff on $200 billion of imports should China refuse to "change its practices." These tariffs are targeted toward patent- and technology-sensitive industries. This announcement came in response to China's retaliation against the announcement by the United States earlier in the spring of a 25% tariff on $50 billion of imports from China.
- The first wave of tariffs, to be imposed on $34 billion of Chinese goods, is scheduled to take effect on July 6. The situation continues to seem quite fluid, however.
- As second-quarter earnings season begins, U.S. companies are likely to address any trade concerns on their earnings conference calls. It remains to be seen if and how their outlooks will shift. To date, we have not seen a material impact on earnings expectations.
- In terms of quantifying the impact, even including the potential for an additional 10% tariff on $200 billion worth of Chinese goods, the effect on U.S. GDP would be manageable — estimated by economists to be about 0.2%. Therefore, we believe the market will be most concerned with signs of any further deterioration in trade negotiations, as well as certain indirect effects related to business confidence, a stronger dollar, and supply chain disruptions that could negatively affect U.S. exporters that use imported parts.[1]
- Despite the headlines, the fundamental backdrop remains sound, in our view. Second-quarter economic growth is poised to rebound from the seasonally slow first quarter. The Federal Reserve Bank of Atlanta GDPNow forecasts 4.7% second-quarter growth. PNC forecasts the expansion to continue, estimating economic growth of 3.0% for all of 2018, up from 2.3% last year.
- Third-quarter earnings season commences in July, with analysts currently forecasting 19.0% growth for the S&P 500® versus the comparable quarter a year earlier. If realized, this will be the second highest quarterly growth rate since 2011. The strongest quarter for that time frame was in first-quarter 2018, when earnings grew 24.7%. Energy is expected to have the fastest growth by sector, followed by Materials, Information Technology, and Financials. Revenues are estimated to grow by 9.5%. The short-term earnings boost from tax reform will likely ease in coming quarters. However, analysts are still projecting double-digit earnings growth for the third and fourth quarters. Currently the Street is estimating just under 20% growth for 2018.
- It is nearly impossible to determine the precise impact issues like trade have on the market. However, we think it is safe to say that such variables have governed 2018 performance, and the uncertainty they generate is unlikely to subside by year end. This backdrop, coupled with the presumption of rising inflation and tighter monetary policy, is not typically associated with expanding market multiples. Therefore, we think earnings growth is likely to be the most critical driver of equity market returns.

[1] "Tariff Wars — The Phantom Menace" (Cornerstone Macro Research, June 21, 2018).

Europe

As European Central Bank (ECB) Moves to Normalize Policy, Politics and Economics Continue to Cloud the Outlook

- The European economy, broadly, continues to expand, but conditions remain less than impressive. Leading indicators continue to confirm that growth on the continent is stable, but slowing: The IHS Markit Eurozone Manufacturing PMI® dropped to 55.0 in June. This is still above historical averages, but it's significantly down from the 60.6 reading at the end of last year.
- U.S. tariffs on European metal exports went into effect at the beginning of June. Though there was no major market fallout, as most analysts continue to assume a trade war will be avoided, the European Union affirmed it would retaliate with its own set of tariffs. The roughly $3 billion worth of U.S. goods (about half the amount of the U.S. tariffs on the European Union) mostly target American agricultural goods. The European Union also filed a suit with the World Trade Organization.
- After avoiding a bit of a crisis (see the June 2018 *Global Market Snapshot*), Italian lawmakers affirmed the country's commitment to the euro and the Eurozone, which further supported markets. But, European markets have not yet fully recovered from the fallout. The 10-year yield on Italian bonds has come down from its highs, but remains 107 basis points above its recent lows (as of June 28, it was 2.79%). Yields on other Eurozone countries' debt are similarly down from their highs, but remain above their pre-crisis lows.
- Italy is not the only country facing political instability: After Prime Minister (PM) Mariano Rajoy lost a vote of no confidence, the Spanish parliament replaced him with Socialist Pedro Sanchez. Perhaps to avoid the same volatility experienced by Italy, the new PM immediately took steps voicing his support for the Eurozone.
- The ECB announced at its June meeting that it intends to end its quantitative easing program by the end of the year; however, bond reinvesting will continue. Surprising investors, the central bank stated that it intends to maintain current rates through the summer of 2019, at least. This dovish surprise led to a weakening of the euro/dollars, with interest rate differentials between the two regions continuing to widen.

Japan

Abenomics Leading to Divergent Monetary Policy and Equity Valuations

- Ongoing trade tensions between China and the United States have given investors reason to question the global economic growth outlook. Export-heavy economies, like Japan, often serve as indicators of how consumers and companies are reacting to the uncertainty. Thus far Japanese export growth has been resistant to the trade war rhetoric, rising 8.1% year over year in May (latest data available), outpacing the expectation of 7.5%.
- The direction of monetary policy from the Bank of Japan (BOJ) continues to diverge from its U.S. and Eurozone counterparts. At its June meeting, the BOJ maintained its short-term policy rate of -0.1%; the 10-year government bond yield target of 0%; and Japanese Government Bond, exchange-traded fund, and real estate investment trust asset purchasing programs.
- In June the BOJ also downgraded its assessment of inflation to a range of 0.5% to 1%, marginally lower than first-quarter inflation and well off Governor Haruhiko Kuroda's target of 2.0%. With few, if any, monetary policy actions left to employ, we expect the highly accommodative monetary policy to remain in place through 2019 and possibly longer.
- Irrespective of negative interest rates and hyperaccommodative monetary policy, the yen has marginally appreciated versus the dollar

year to date, likely benefiting from safe-haven inflows in response to rising geopolitical risks. We would expect the yen to weaken relative to major currency pairs (the dollar and the euro) due to widening interest rate differentials and a narrowing current account.

- Despite less-than-favorable economic conditions and demographic challenges such as an aging population, valuations of Japanese equities remain favorable relative to other major developed markets. As of June 25, 32% of the companies in the Nikkei 225 were trading at price-to-book ratios less than one; however, only 14% and 4% of companies in the STOXX® Europe 600 and S&P 500, respectively, were trading at discounts to book value.

Emerging Markets

Encouraging Survey Data Trumped by Geopolitics

- Emerging market (EM) equities had another difficult month in June. As of June 28, EM equities have given back almost all of their relative performance advantage versus U.S. equities after returning over 37% in 2017. Since the end of 2016, EM equities are up 25.8%; during the same time period, U.S. equities are up 25.3% and developed international equities are up 23.2%.
- While the narrative surrounding tariffs is primarily focused on Asian countries, Latin American equities have struggled from both trade headwinds and geopolitical risks. Argentina, for example, was recently loaned $50 billion by the International Monetary Fund, its largest loan in history, as the Argentine peso is at its weakest level relative to the dollar on record.
- Although China is somewhat limited in terms of its ability to retaliate with additional tariffs given the amount they import from the United States, other possible responses include making it more difficult for U.S. companies to do business in China and weakening the yuan/dollar to support Chinese exporters. Yuan weakness is an immediate threat to other EM currencies, and further EM currency weakness would be an immediate negative for both stocks and bonds in that asset class.
- If the dollar continues to appreciate versus EM currencies, EM debt stress will likely mount — it is harder to service debt denominated in dollars when your local currency is depreciating. Over the last 20-plus years, EM companies have dramatically increased their issuance of foreign-currency-denominated debt.
- We should temper this short-term concern with a longer-term perspective. Over the past decade, U.S. equities have dramatically outperformed EMs. For context, the S&P 500 has a cumulative total return over the past 10 years of 164%, while dollar-denominated EM has returned 29%. We believe this performance divergence will ultimately reverse, making EM an attractive long-term allocation.

Energy

Energy Outperformance Continues on Improved Earnings Outlook, Higher Crude Prices

- Energy stocks took a breath this month, fearing OPEC would agree to materially increase output at its June meeting. To date, the Energy sector continues to outpace the S&P 500 by about 3.5%.
- OPEC reached an agreement in principle to boost oil production, in a move aimed at offsetting production declines in Iran and Venezuela. The preliminary agreement calls for an additional 600,000 barrels per day in production, which equates to approximately 0.5% of global supply.
- The agreed-upon production increase was smaller than the market feared, and additional comments from President Trump discouraging our allies from purchasing Iranian oil led to an increase in West Texas Intermediate crude from below $65 per barrel to over $70. Energy stocks gained more than 3% after the OPEC meeting.

- We believe that if oil prices remain at or near current levels, Energy stocks will continue to benefit without a material drag on U.S. economic growth.
- Permian oil production now exceeds takeaway capacity from midstream pipelines. As a result, geographic pricing differentials have widened substantially, with no additional pipeline capacity expected to come online until second-half 2018. Higher differentials are likely to spur production in other basins as the cost of transportation in the Permian increases, both of which are a positive for midstream pipelines.

Chart 1

Stocks Have Advanced Amid Rising U.S. Debt

(As of 12/31/16)

Source: Pensionpartners.com

Strategy Views

Do Current U.S. Debt Levels Pose a Risk to the Economic/Market Expansion?

Rising debt levels seem to be a permanent fixture on the list of things to worry about. In 1972, a TIME magazine cover was titled "Is the U.S. Going Broke?" Throughout recent history, one can find countless examples of similarly worded, debt-fueled anxieties. With little exception, lower levels of leverage provide for a more stable system, but are we currently on the brink of a debt-driven crisis? We don't believe so.

Government

The Congressional Budget Office believes the U.S. budget deficit will reach $1 trillion, or 4.6% of GDP, by 2020. Overall debt levels continue to rise, and currently sit at over 100% of GDP. With tax cuts and additional fiscal spending serving as the newest and most visible strain on U.S. government finances, it is only natural for investors to consider how this may affect financial markets, and in turn, their portfolios.

Let us first keep in mind that we have been here before. The United States hasn't run a budget surplus since 2001, and from 2009 to 2012 the deficit exceeded the current 2020 forecast. While not a reason to celebrate, it does underline the point that perhaps we are not sailing into completely uncharted waters. This also enables us to use history as a guide in terms of analyzing market behavior in similar environments.

Since 1966, the U.S. national debt has risen in every calendar year. Through every administration, Democrat and Republican alike, the one constant has been more debt — from $320 billion in 1966 to nearly $20 trillion today. With a current budget deficit north of $600 billion, the national debt continues to mount. Just 10 years ago, national debt as a percentage of GDP was 62%. As mentioned above, today this ratio is over 100%. How have markets historically reacted to periods of rising debt? In reality, it is hard to identify any discernable pattern. As the U.S. national debt increased 8.4% annually since the mid-1960s, the stock market rose 9.7% each year, on average (Chart 1).

What about rising debt-to-GDP ratios? Surely this measure is a better indication of how markets react to increasing fiscal stress? Again, history would prove otherwise. From 1982 to 2016, this ratio moved from 32% to 105%. Over the same time period, the S&P 500 gained 11.7% per year.[2]

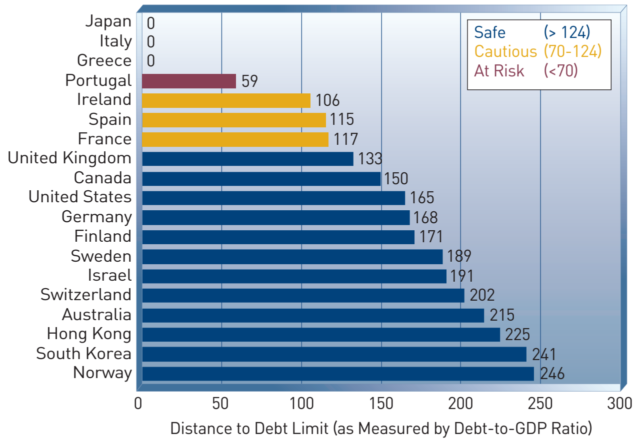
There will likely be a breaking point, but it is hard to know precisely when. According to a study conducted by Moody's in 2015, the United States remains in the fiscal "safe zone" (Chart 2, page 5).

[2] Bilello, Charlie. "Should Investors Fear Rising National Debt?" July 12, 2017, pensionpartners.com/should-investors-fear-rising-national-debt/.

Chart 2

U.S. Likely Still Safe

As of 12/31/15



Source: Moody's Investors Service, Inc.

There is no question that rising national debt is a valid concern, and if left completely unchecked it will probably have a negative impact on the economy. However, it is hard to find a clear relationship between rising debt and market performance, and timing the exact moment when the national debt "matters" is likely a fool's errand. There are countless risks in every market environment, and to protect our portfolios from the volatility associated with those risks (rising debt levels included), the best medicine is likely good old-fashioned diversification.

What about other areas of the economy? Could they be the bigger risk from a debt perspective?

Household

Debt in the household sector has actually fallen since the financial crisis, which is unusual during an economic expansion. Interest coverage ratios are similar to levels seen in the early 1980s and 1990s, and household assets are about seven times larger than total liabilities. Loan delinquency rates in the household sector remain at multi-decade lows and household debt relative to net worth has returned to levels last seen in 1985. Even student loan default rates (a highly publicized issue) are falling. It is hard to argue that the current cycle is at risk from household sector debt.[3]

Corporate

The corporate debt backdrop paints a similar picture. First, debt-to-GDP ratios for corporations fail to accurately measure a company's ability to cover debt expenses, leaving out things like foreign sales, structurally higher profit margins, and significantly higher corporate cash levels. S&P 500 companies can cover interest costs by seven times given the current level of earnings. This is a more comfortable margin than any time during the 1990s or 2000s. Also, delinquency rates, at 1.1%, are currently at the lowest level of the past three economic expansions. Again, in the near term, there are no signs that companies are going to have issues meeting their debt obligations.[4]

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[3] "Time to Not Freak Out About Debt Again," *The Fat Pitch* (blog), June 11, 2018, http://fat-pitch.blogspot.com/2018/06/time-to-not-freak-out-about-debt-again.html.

[4] Ibid.

Hawthorn Asset Allocation Playbook
As of: 6/1/2018

Asset Class	Sub Asset Class	Favorability							Points of View
		-			Neutral			+	
Equities					●				
U.S.	Large Cap					●			Relative valuation causes us to narrowly favor large over small. Small Caps have outperformed year to date as investor concerns related to trade and, more recently, a stronger dollar have driven them to seek protection from less exposed small cap stocks. Smaller companies may also benefit from positive tax reform-related forward guidance, however, valuations remain quite expensive at 22.5 times on a forward earnings basis. 30% of small cap indexes like the Russell 2000® still have no earnings, so be selective when investing in the asset class.
	Mid Cap				●				
	Small Cap				●				
Non-U.S.	Intl. Large/Mid Cap				●				Valuations appear relatively more attractive versus domestic equities, potentially creating attractive long-term opportunities in many international markets. Still largely accommodative monetary policy by global central banks and solid earnings momentum should also provide additional support. However, political risk is again elevated and economic momentum has weakened versus what we are seeing in the United States.
	Intl. Small Cap				●				
	Emerging Markets		●						Although we like emerging market (EM) for the long term given current valuations, we believe the rally to be overextended. The shorter-term bear case for EM equities rests mainly on tightening in China, as well as the newfound strength in the dollar. Year-to-date, EM has underperformed both developed international and U.S. markets.
Fixed Income				●					
U.S.	Short Muni Fixed Income			●					Although interest rates may drift higher given solid economic momentum, we believe we may have already seen the bulk of the move higher in rates for this business cycle. Therefore, we favor positioning fixed income portfolios in the intermediate part of the curve.
	Core Muni Fixed Income					●			
	U.S. High Yield			●					The credit cycle is aging, and valuations should become an increasing headwind for below-investment-grade bonds. Leveraged loans, although more senior in the capital structure, have seen issuance balloon in recent years while covenants have weakened. Given our view on interest rates, credit risk may be starting to outweigh the protection from higher rates.
	U.S. Leveraged Loans			●					
	U.S. TIPS			●					Less value in TIPS with breakeven inflation rates now around 2.20%. We prefer to hedge inflation over the long-term via our equity exposure.
Non-U.S.	Global Bond			●					Although we are not overly negative on credit given the strength of the economy, we do believe slowly shifting to higher-quality areas of fixed income is sensible given the level of spreads. Unconstrained funds have reached for yield in lower-rated credits.
	Unconstrained Bond				●				
	Emerging Market Bond			●					
Alternatives						●			
Private	Private Real Estate				●				Key drivers include a still relatively constrained supply backdrop, modest leverage levels, and the fact that capital flows into the asset class are becoming increasingly global (that is, investor demand is quite robust).
	Private Debt				●				Middle-market lending in the corporate sector is still quite constrained, continuing to create opportunities for private debt investors. Some banking deregulation may open this space up to more traditional bank lending, however.
	Private Equity				●				Opportunity in new/less efficient markets, and a more diverse investable opportunity set; for example via secondaries and "co-investment" options. That said, as with public markets, valuations are exteneded.
Hedge Funds	Equity Long/Short					●			A transition from a primarily macro-driven market environment to a more fundamentally driven one will be positive for these alpha-generating strategies. Central banks now appear more committed to a steady normalization of interest rates than they have been in years past. We believe differentiated return streams can add value in today's market versus a tradtional equity/bond portfolio.
	Event Driven					●			
	Relative Value					●			
	Directional					●			
Cash					●				

Tactical Allocations						●			
	Master Limited Partnerships					●			Performance has suffered after a strong start to the year. Markets penalized the sector after a potentially unfavorable tax ruling, however we believe the overall impact will be small. Stronger fundamentals and rising energy prices could spur investor interest given currently depressed valuations and underweight energy positioning among equity portfolio managers.
	Infrastructure					●			Defensive qualities and income potential that we like in this market.
	Currency Hedged Europe					●			Stable economic conditions, improving earnings growth, and relatively attractive valuations put European equities in a good position despite recent political volatility. The currency hedge has been additive to 2018 performance.
Tactical	**Currency Hedged Japan**					●			Valuations are attractive, earnings growth is strong, and consumer confidence is high. We still like the currency hedge as the BOJ remains easy relative to the Fed and yen positioning (now net long) is no longer supportive of a move higher.
	Energy						●		With higher and more stable oil prices, better capital discipline, and attractive relative valuations, we believe Energy sector equities can outperform the broad market on a tactical basis.
	U.S. Banks						●		We think valuations, the regulatory backdrop, and the continuation of this business cycle are compelling reasons to tilt toward U.S. banks within value allocations. Banks are historically correlated with increases in cap ex which we believe will continue this year.
	Structured Note (Drawdown)				●				Ability to earn a coupon while waiting for a more attractive entry point into equities can be an attractive strategy. However, cash has become more palatable given the rise in short-term interest rates.