October 2017

Hawthorn Global Market Snapshot

Key Market/Economic Observations

United States

Late Cycle Continues to Show Signs of Durability

- Our business cycle tools lead us to believe the current economic expansion can persist well into 2018. For example, our recession probability indicator remains below the 50% level that, on average, gives eight quarters of lead-time prior to a recession. The current reading is 48.8%.
- While we do not see a recession as a near-term risk, there are late cycle signals. For example, when looking at one-day relative performance during earnings announcements, companies are seeing no reward for beating analyst expectations. Prior to the most recent quarter, the lowest reward for an earnings beat was during third-quarter 2007, and prior to that was around the Technology Bubble in 2000.[1]
- Even as the Federal Reserve (Fed) has tightened monetary policy, financial conditions have actually eased via rising stock prices, narrowing credit spreads, and a weakening dollar. Financial conditions tend to lead GDP growth by about six to nine months, so it would be reasonable to expect continued economic growth next year.
- Persistent growth will likely pressure the unemployment rate lower, in our view, ultimately leading to an uptick in inflation (more on this in the Strategy Views section on page 4). This may be the catalyst for the next recession, with the Fed forced to raise interest rates in order to bring the unemployment rate back to its so-called "natural rate," which neither suppresses nor encourages inflation. According to data from the Federal Reserve Bank of St. Louis, the current natural rate of unemployment is around 4.75%.[2]
- The unemployment rate moved below the estimated natural rate in November 2016. If one defines the "final phase" of the business cycle as the period in which the unemployment rate remains below its natural rate, the economy spends an average of 33 months in a late cycle mode (often including the start of a recession). We are now about one-third of the way to that average, with 10 months having passed since the unemployment rate fell below 4.75%.[3] Once the unemployment rate starts to rise, a recession almost always follows.
- As this late cycle phase develops, equities historically perform quite well. Even as risks mount and valuations push higher, it is often extremely painful for investors to miss the final year of a bull market. Since the 1930s, the average return during the final 12 months of a bull market for the S&P 500® is 25%, accounting for approximately 19% of the entire return during the cycle. Balancing the difficulty in predicting market peaks with the fear of missing a late cycle run is an ever-present challenge with no perfect solution.
- Given the economic backdrop, we believe equity markets can move higher in the coming quarters, primarily driven by the earnings growth rate. That said, we do

[1] Bank of America Merrill Lynch, *U.S. Strategy in Pictures*, October 15, 2017.
[2] https://fred.stlouisfed.org/series/NROU.
[3] BCA Research, *U.S. Investment Strategy Weekly Report*, October 16, 2017.

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not expect volatility to remain at historical lows, and elevated valuations make equity markets vulnerable to shocks. In the longer term, valuation is almost all that matters, so we continue to expect forward returns to be meaningfully below historical averages.

- In the near term, we see fund manager positioning somewhat more aggressive, and cash levels have decreased from 5.7% to 4.8% during the last 12 months.[4]
- S&P 500 stock correlations continue to push to new multiyear lows, recently dipping below 0.30. Correlations peaked at about 0.80 in fall 2015 and have since slowly declined. Against a backdrop of slow but presumably steady monetary policy normalization, this should be a better environment for active managers, in our view.

Europe

European Central Bank Asset Purchases in Focus

- The European Central Bank (ECB) is meeting October 26 and is widely expected to provide additional details regarding plans to taper its asset purchase program.
- To date, the ECB has been less transparent than the Fed regarding precise plans for balance sheet reduction, but the consensus is for a reduction to 40 billion euros for six months (current purchases are about 60 billion per month), ending its purchases completely after that point.
- Many investors have argued for a slower glide path, meaning purchasing less per month but for a longer period of time. This would likely have several benefits, including pushing back rate hike expectations to 2019, reducing potential euro strength by preserving interest rate differentials between the United States and Europe, and addressing certain concerns about bond scarcity related to available debt for purchase each month.
- It is difficult to predict the precise path of tapering, but we believe this transition in ECB policy will be a test for the global bond markets. We think the reaction is likely to be somewhat muted, but the risk to European rates, and by extension U.S. rates, is probably to the upside as asset purchase plans crystalize.

China

Reading the Tea Leaves from the Chinese Communist Party Congress

- After a robust start to 2017, it appears that growth in China will slow somewhat in second-half 2017. Softer data are likely the result of less accommodative monetary policy and increased restrictions on property speculation.
- Record slow money supply growth also reflects this less accommodative monetary policy and the trend decline in Chinese inflation and real GDP growth. A so-called "hard landing" will be avoided, in our view, but a modest growth deceleration is likely.
- We think the message from the Chinese Communist Party Congress will, in part, highlight the need to focus on domestic policy reforms in 2018–19. The degree to which these reforms are pursued is an open question, in our view, but on balance government policy may be in the process of shifting from a growth tailwind to a headwind.
- Chinese president Xi Jinping, during a speech at the annual Davos Forum, highlighted China's continued integration into the global economy, acknowledging the benefits reaped by the country.
- As China's economic and market reforms have been less than promised thus far, productivity growth has declined. Foreign direct investment in China has also retraced to its lowest level since the global financial crisis. Therefore, we think the Chinese

[4] According to Bank of America Merrill Lynch's Global Fund Manager Survey, the 10-year average cash level is 4.5%. Therefore, there is additional room for cash to find its way into the market, but less so than 12 months ago. Also according to the survey, the ratio of cyclical (Consumer Discretionary, Energy, Industrials, and Materials) versus defensive (Health Care and Consumer Staples) has moved from 1.11 to 1.16 over the past 12 months.

government will be compelled to make some effort to reinvigorate certain reforms.

- We continue to believe emerging market equities may feel a negative impact from recent and forthcoming policy developments in China. However, relative valuations still make emerging markets a compelling region for long-term positions.
- Interestingly, while the one-year forward price-to-earnings (PE) of the MSCI Emerging Markets Index is only slightly above the historical average, the one-year forward PE of MSCI China Index is at its highest point since first-quarter 2010.

Japan

Cyclical Tailwinds Trump Secular Headwinds

- Most investors are aware of the long-term difficulties associated with the Japanese economy, including high debt levels (government debt to GDP is over 250%) and challenging population demographics.
- However, we see signs of a cyclical acceleration that has the potential to boost economic growth and equity prices. Since the last week of August, local currency equity markets in Japan as measured by the MSCI Japan index are up close to 10.0%.
- Economic positives:
  - There have been six quarters of positive economic growth.
  - The underlying growth trend of approximately 1.5%, which is above potential GDP of 0.7%, should help support inflation.
  - The Abenomics-related 10% corporate tax cut is helping support earnings, business spending, and business confidence, which has reached a 25-year high.
- Equity market positives:
  - Local currency equity markets appear to be on the verge of a structural breakout from a long series of lower highs that started in the early 1990s. In dollar terms, this breakout has already occurred.
  - Our sense is that investor interest in Japan is somewhat low—the three largest Japanese exchange-traded funds continue to see outflows, and positioning in the futures market is not as aggressive as prior periods of strong equity performance.[5]
  - Small caps and general market breadth indicate broad-based participation in the move higher in prices.
- We believe the yen is also important to the performance of Japanese equities, given that yen/dollar strength has had a 0.96 negative correlation with Japanese stocks over the past five years. Our view is that the Bank of Japan (BOJ) is far more likely to continue its current monetary policy regime compared to the Fed. The Fed has already begun tightening policy, whereas the BOJ has yet to show any real commitment to a shift in policy direction. This should help support a wide interest rate differential between Japan and the United States, likely promoting a relatively weaker yen.

Energy

Middle East Tensions Take the Baton from Hurricane Disruptions

- In a month that started with natural disasters affecting refinery operations along the Gulf coast, the West Texas Intermediate (WTI) oil price continued to grind higher, with the 50-day moving average (DMA) crossing above the 100 DMA for the first time since October 2016 and edging closer to the 200 DMA by mid-October.
- Following the vote for Kurdish independence on September 25, tensions between the Iraqi central government and the Kurdistan Regional Government have turned to outright hostilities in the oil-rich region of Kirkuk, Iraq. There is only one oil pipeline in northern Iraq, running through Kurdish-controlled regions to

[5] Strategas, Technical Analysis Research, October 12, 2017.

- a Mediterranean port in Turkey. The Turkish government has already stated it does not acknowledge the Kurdish referendum.
- The combination of both events, and ongoing production cuts from OPEC members, led to the United States exporting a record 1.9 million barrels a day in early October, an all-time high.
- WTI prices remain at a steep discount to Brent crude, further encouraging the feedback loop of increased U.S. production and exports keeping a lid on oil prices from ramping significantly higher.
- OPEC's Monthly Oil Market Report for October indicated a further increase in oil demand estimates for 2018 and perhaps a swift near-term market rebalance.

Hawthorn Strategy Views

Economic Expansions and How They Die

When will the current business cycle end? This question has become ubiquitous among many investors as the current expansion moves into its 100th month. For perspective, since World War II the average economic expansion has lasted about 58 months, with the longest on record being 106 months in the 1960s and 120 months in the 1990s. Although we do not see anything on the horizon that is likely to derail the current cycle, economic expansions do not last forever. Expansions do not die of old age, but they do eventually die. Therefore, the million dollar question is: What will be the catalyst for the next recession? Six of the last seven recessions have coincided with a bear market in the United States, so the motivation for investors to predict the next economic downturn is clear.

What will cause the next recession?

It is difficult to know for sure, but we believe a logical narrative would be as follows:

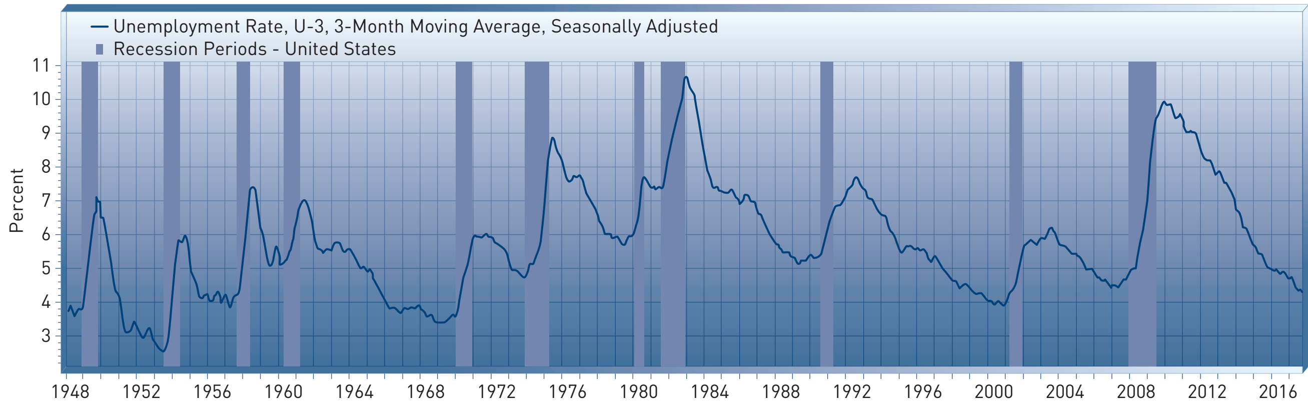
- In 2017, all 46 OECD economies will have positive growth for the first time in more than 10 years. Inflation remains relatively low, and central banks are tightening policy, but slowly. Financial conditions have eased, other leading economic indicators remain expansionary, and none of our business cycle tools are predicting a recession. Global growth continues as we move through 2018.
- Continued growth helps push the unemployment rate further below the so-called "natural rate," leading to an uptick in wage growth and inflation. The Fed will likely further increase interest rates to bring the unemployment rate back to a level that does not encourage upward price pressure in the economy.
- It is extremely difficult for central banks to raise the unemployment rate "just a little," and the economy has never avoided a recession when the three-month moving average of the unemployment rates has increased by more than one-third of a percent (Chart 1, page 5).
- Therefore, as the Fed leans against an uptick in inflation, the unemployment rate will likely start to rise and the next recession will be upon us.

We often hear that the Phillips Curve, or the relationship between unemployment and inflation, is no longer a useful tool for predicting price increases in the economy. We believe it is true that the Phillips Curve has become flatter over the past few decades, but it is also true that the curve has a "kink" and becomes steeper once the unemployment rate pushes below 5.0%. Therefore, wage pressure should increase as growth continues to push unemployment lower, and that should translate into higher prices. Our forecast is for the unemployment rate to dip below 4.0% in 2018.

Evolution within the retail sector (that is, e-commerce) is often cited as an important reason why the Phillips Curve seems to be less useful than it once was. When examining the data, this conclusion is questionable, in our view. According to BCA Research, the majority of the decline in inflation since 2007 has been in areas such as energy, food, and rent—not really affected by this technological trend (Table 1, page 5).[6]

[6] BCA Research. "Is the Phillips Curve Dead?" September 22, 2017.

Chart 1
Unemployment Rate versus Recession Periods
Though September 2017

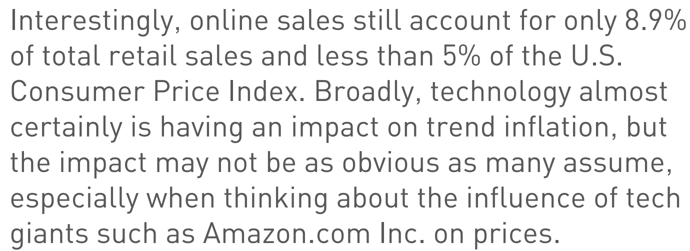


Circles represent periods in which the 3-month moving average unemployment rate has risen by more than one-third of a percent.
Source: Federal Reserve

Table 1
Decline in Inflation Since 2007

Expenditure Category	Average 2000-07	Average 2007-16	Difference
Headline CPI (%)	2.86	1.81	-1.05
Major Contribution to Disinflation (Percentage Points of Contribution):			
Energy	0.69	0.06	-0.63
Owner's Equivalent Rent of Residences	0.78	0.53	-0.25
Food	0.41	0.32	-0.09
Total	1.88	0.91	-0.97
Sectors Potentially Affected by E-Commerce (Percentage Points of Contribution):			
Personal Care Services	0.02	0.01	-0.01
Wireless Telephone Services	-0.02	-0.03	-0.01
Airline Fares	0.01	0.01	0.00
Intracity Transportation	0.01	0.01	0.00
Personal Care Products	0.00	0.00	0.00
Recreational Reading Materials	0.01	0.00	0.00
Sporting Goods	0.00	0.00	0.00
Appliances	0.00	0.00	0.00
Furniture and Bedding	-0.01	-0.01	0.00
Tools, Hardware, Outdoor Equipment and Supplies	0.00	0.00	0.00
Audio Equipment	0.00	0.00	0.00
Video Discs and Other Media, Including Rental of Video	0.00	0.00	0.00
Personal Computers & Peripheral Equipment	-0.03	-0.02	0.01
Information Technology Commodities	-0.04	-0.03	0.01
Internet Services and Electronic Information Providers	-0.02	0.00	0.01
Apparel	-0.05	0.02	0.07
Total	-0.13	-0.06	0.07

Source: Bureau of Labor Statistics, BCA Research



Interestingly, online sales still account for only 8.9% of total retail sales and less than 5% of the U.S. Consumer Price Index. Broadly, technology almost certainly is having an impact on trend inflation, but the impact may not be as obvious as many assume, especially when thinking about the influence of tech giants such as Amazon.com Inc. on prices.

Another common assumption regarding inflation is that baby boomers leaving the workforce will be a massive headwind for inflation. According to a recent study by the International Monetary Fund, population aging has in fact been a major headwind to inflation over the past few decades, but it will actually be inflationary in the coming years. The notion that as incomes drop for baby boomers so does spending may not be accurate. Initially it may be true, but later in life spending actually increases due to health care costs.[7]

Conclusion

We do not believe the economy will enter a recession in 2018, but financial markets are focused on when this unusually long cycle might end. We believe it is reasonable to assume that as growth pushes unemployment lower, inflation with rise. As this happens, the Fed will likely tighten policy and eventually cause the next economic downturn, in our view. For those who question the ability of inflation to meaningfully rise, we present two examples for why certain forces may not be the death knell for inflation that many assume.

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[7] BCA Research, *Global Investment Strategy*, October 4, 2017.

Appendix

Table A1
Equity Market Snapshot
(total returns in U.S. dollars; through October 17, 2017)

	Total Returns		
	Month to Date	Quarter to Date	Year to Date
S&P 500®	1.67%	1.67%	16.14%
Small Cap (Russell 2000)	0.48%	0.48%	11.47%
S&P 500 Value	0.95%	0.95%	9.52%
S&P 500 Growth	2.24%	2.24%	22.00%
S&P 500/Industrials-EC	1.18%	1.18%	15.47%
S&P 500/Consumer Discretionary-SEC	1.44%	1.44%	13.55%
S&P 500/Consumer Staples-SEC	0.91%	0.91%	7.54%
S&P 500/Health Care-SEC	1.72%	1.72%	22.38%
S&P 500/Financials-SEC	1.21%	1.21%	13.84%
S&P 500/Real Estate-SEC	1.90%	1.90%	9.43%
S&P 500/Information Technology-SEC	3.24%	3.24%	31.49%
S&P 500/Telecommunication Services-SEC	-3.66%	-3.66%	-8.18%
S&P 500/Utilities-SEC	2.47%	2.47%	14.63%
S&P 500/Energy-SEC	-0.10%	-0.10%	-6.73%
S&P 500/Materials-SEC	2.36%	2.36%	18.56%
MSCI EM (Emerging Markets)	4.10%	4.10%	33.39%
MSCI FM Frontier Markets	1.33%	1.33%	26.94%
MSCI Europe	0.09%	0.09%	23.56%
MSCI China	4.83%	4.83%	50.34%
MSCI Japan	3.32%	3.32%	18.43%

Source: FactSet Research Systems Inc., Hawthorn

Table A2

Fixed Income Market Snapshot

(total returns in U.S. dollars; through October 17, 2017)

	Total Returns		
	Month to Date	Quarter to Date	Year to Date
Bloomberg Barclays US Aggregate	0.25%	0.25%	3.40%
Bloomberg Barclays Global US Treasury (1-3 Y)	-0.07%	-0.07%	0.63%
Bloomberg Barclays US Aggregate Government-Treasury (1-5 Y)	-0.08%	-0.08%	1.01%
Bloomberg Barclays US Aggregate Government-Treasury (5-10 Y)	0.15%	0.15%	2.75%
Bloomberg Barclays US Aggregate Gov-Treasury-Intermediate	-0.01%	-0.01%	1.55%
Bloomberg Barclays US Aggregate Government - Treasury - Long	1.11%	1.11%	7.20%
Bloomberg Barclays US Treasury Inflation Protected Notes (TIPS)	0.15%	0.15%	1.87%
Bloomberg Barclays US Aggregate Credit-Corp-Investment Grade	0.53%	0.53%	5.74%
Bloomberg Barclays US High Yield-Corporate	0.33%	0.33%	7.36%
Bloomberg Barclays US Floating Rate Notes Corporates	0.16%	0.16%	2.04%
S&P Municipal Bond Investment Grade	0.60%	0.60%	4.90%
S&P Municipal Bond High Yield	0.13%	0.13%	4.39%
GS Commodity Index	0.80%	0.80%	-2.99%
Alerian MLP	-1.61%	-1.61%	-7.14%

Source: FactSet Research Systems Inc., Hawthorn

Table A3

F/X Market Snapshot

(through October 17, 2017)

Major Currencies	Current	1 Month Earlier	3 Months Earlier
Euro/U.S. Dollar	1.18	1.20	1.15
Australian Dollar/U.S. Dollar	0.78	0.80	0.78
Pound/U.S. Dollar	1.32	1.36	1.31
U.S. Dollar/Yen	112.34	111.05	112.81

Source: FactSet Research Systems Inc., Hawthorn

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