Hawthorn Global Market Snapshot

Key Market/Economic Observations

United States

Tax Plan Unveiled; Yield Curve Continues to Flatten

- Republicans finalized tax legislation details, landing on a 21% corporate tax rate that will become effective in 2018 rather than in 2019, as previously proposed. This is perhaps the most critical development as it relates to the Tax Cuts and Jobs Act of 2017's ability to provide meaningful fiscal stimulus next year. Assuming final passage, additional areas of interest include:
  - 100% expensing for capital equipment purchases, which should help encourage capital expenditures;
  - reduced tax rate on repatriated foreign profits;
  - corporate net interest deduction capped at 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA) for the first five years and 30% of earnings before interest and taxes thereafter[1]; and
  - no "first in, first out" provision, which would likely have caused investors to realize larger capital gains when selling a position. It would have mandated shares purchased first (usually with a lower cost basis and a higher capital gain) be sold first.
- There is some speculation the net result of the bill could be a fiscal stimulus of up to 1% of GDP in 2018.[2] We also believe the short-term impact of the bill will be a net stimulus for the economy in the coming year. This, combined with an economy already on solid footing, has the potential to extend the current business cycle, in our view. The long-term impact will be largely driven by the amount companies choose to invest as a result of the bill.
- We believe the primary risk is that adding this degree of fiscal stimulus to an economy already at full employment could lead to an "overheating." We will keep a close eye on inflation to help detect a scenario that might compel the Federal Reserve (Fed) to tighten monetary policy more quickly than currently forecast.
- The debate continues as to whether tax cuts are being reflected in current market prices. Although this is difficult to know with any certainty, we believe it is possible we are entering a paradigm shift in which the economy starts to outpace the market (we have seen the opposite for many years). For now, even given historically elevated valuations, earnings should be supportive of U.S. stocks in 2018, although multiples may have trouble expanding.
- The flattening of the yield curve continues to garner significant attention. The standard interpretation is that a flattening curve means the bond market is pessimistic about future growth while the Fed is concerned about inflation. We feel the shape of the curve certainly deserves watching, but on its own a flatter curve is not necessarily

[1] EBITDA is a more friendly deduction versus EBIT because it is 30% of a higher number. This is particularly important for more highly indebted companies.

[2] Estimate via Strategas Research Partners, "Shock and Awe Tax Cuts Are Coming: New Changes Lift Tax Cuts to 1 Percent of GDP," December 14, 2017.

a threat. Under similar circumstances over the past four decades, the S&P 500® has continued to rise and a recession has been more than a year away. We are still more than 50 basis points (bps) away from an inversion, which means the risk of a recession remains relatively low.

- A decomposition of the 10-year Treasury yield into its component parts (inflation expectations, growth expectations, and the term premium) shows that although the 10-year yield remains low and the curve is flattening, the growth expectations component remains in an uptrend. We typically do not see recessionary conditions until these growth expectations start to deteriorate.
- Finally, we believe a flatter yield curve could be a headwind to our preference for U.S. banks within our value allocations. After some analysis, however, we determined that banks perform well when the 120-day moving average spread between 2-year and 10-year Treasuries is above 45 bps. Currently, the moving average is 104, indicating banks should still have time before coming under significant pressure via the spread between long and short maturity interest rates.

Europe

ECB Maintains Status Quo; Increases Growth Estimate for 2018 Despite Lingering Political Risk

- In its final meeting of 2017, the European Central Bank (ECB) maintained its prior policy guidance to taper asset purchases beginning in 2018 while keeping interest rates at accommodative levels. We viewed the overall message as cautiously optimistic.
- For 2018, the GDP growth estimate was increased from 1.8% to 2.3%. ECB President Mario Draghi noted that while inflation metrics have improved, readings remain persistently below the ECB's 2% target level, also likely indicating that patience and accommodation are still required to bring inflation back to target.
- The month of December illustrated continued strength in the Eurozone's industrial economy, despite the headwind of a stronger euro. Eurozone manufacturing PMI reached a record 60.6 reading; the services PMI indicator rose to its highest level since 2011.
- While the strength of most indicators will make comparisons more difficult, we think it's important to note that equities, as measured by the STOXX® Europe 600 index, typically perform well in periods when PMIs are above the 50 level.
- The outlier in terms of economic data for November was a weaker-than-expected retail sales report, only rising 40 bps year over year, underwhelming expectations by 1.2%. However, a tightening labor market could help spur more robust consumption.
- Politics remain front and center heading into 2018, with the German government yet to form a ruling coalition, Britain's exit from the European Union drawing nearer, and populist uprisings in Catalonia highlighting continued tension within the bloc. Despite the lingering political risks, the economy and business confidence continue to grow, which we expect will result in earnings growth in the mid- to upper-single digits for 2018.

China

Leverage Levels Remain at the Forefront for the PBOC

- Starting with the November 2017 Caixin China General Manufacturing PMI reading of 50.8 compared to expectations of 50.9, economic data were mixed over the past month. Consumer Price Index (CPI) data for November came in lower than expected; however, foreign reserves and imports grew faster than expected, with Singles Day shopping festival spending up nearly 40% on a year-over-year basis, according to Alibaba estimates.
- After reaching an all-time high on November 22, the Hang Seng Index (Hong Kong) has subsequently sold off nearly 4%. Leading on the downside is the index's largest security, Tencent, which has declined

nearly 9% since November 22. Meanwhile, the Shanghai Composite Index is down nearly 5% in the same period. We believe the volatility in recent weeks is primarily driven by technicals, as Chinese equities have become fairly expensive given their strong performance this year.

- The day after the Fed rate hike on December 13, the People's Bank of China (PBOC) raised its policy rate by 5 bps, after last raising the interest rate by 10 bps in March. While the move was small in size, we believe it was viewed by investors as a sign that the bank is serious in its approach to promoting deleveraging the Chinese economy. The PBOC's report for new loan growth in November exceeded all 34 analyst estimates, growing more than 40% on a year-over-year basis.
- The Politburo is expected to host its annual Central Economic Work Conference on December 18–20. While it is a closed session, the event should receive higher-than-normal scrutiny since it is the first meeting after President Xi's power consolidation move after the Communist Party Congress in December. Given debt and leverage ratios continue to increase, consensus expects much of the conference will be focused on improving lending standards and on mortgage lending reforms.
- Consensus expects Chinese GDP for 2018 to grow 6.4%, a relatively steep decline from the 2017 estimate of 6.8%. In addition, 6.4% GDP growth would be the lowest annual growth rate in China since 1990. China's market share of global exports peaked in 2015, and we believe it may decline further in 2018 should protectionist policies in the United States gain traction.

Japan

Continued Economic Improvement; Escaping Fears of Deflation?

- The economy continues to grow, with the output gap reaching 0.5% in third-quarter 2017 versus 0.4% in the previous quarter and -0.2% in third-quarter 2016. Due to the output gap's historically high correlation with inflation, this trend may provide some evidence that inflation could begin to move toward the targeted 2% level.
- Japan's wholesale prices, which often precede changes in the overall CPI, continue to increase moderately, with the domestic Corporate Goods Price Index reaching 99.8 in November versus 99.4 in October. The nationwide November core CPI met consensus estimates, up 0.8% year over year versus 0.7% in the prior month.
- Additionally, positive corporate dynamics show further signs of overcoming deflation, with the third-quarter 2017 profit-to-sales ratio near cycle highs at 6% and an October unemployment rate at 2.8% (a 23-year low). The tight Japanese labor market may put pressure on corporations to push wages higher, a common tailwind for inflation.
- Japan has now had seven consecutive quarters of positive economic growth, with third-quarter GDP reporting quarter-over-quarter annualized growth of 2.5% versus consensus of 1.5% and a revised 2.6% (previously 2.5%) in the prior quarter. This better-than-expected number can be attributed to a significant upgrade in capital expenditures.
- The yen overall was weaker despite stronger-than-expected growth figures from Japan, with the dollar remaining in demand on news of U.S. tax reform progress. Also, as expected, the Bank of Japan will continue with its current policy framework to achieve its 2% inflation target.
- Aside from the banking industry, strong earnings have resulted in a higher pile of cash reserves. Surveys have found that firms are upgrading their capital expenditure plans for fiscal 2017 as a result.
- To incentivize an increase in wages, the Japanese government is attempting to reduce the effective corporate tax rate to 25% for companies that will increase wages by 3% or more.

Energy

Cracks and Fracks Drive Prices Higher

- On Monday, December 11, the price of Brent crude jumped above $65 per barrel for the first time in more than two years, primarily driven by headlines that a crack formed on the Forties pipeline in the North Sea, one of the world's largest pipelines. Consensus estimates give a best-case scenario that the pipeline is offline for at least two weeks for repairs; anything longer could provide a tailwind for further Brent crude price appreciation.
- The OPEC meeting on November 30 went as we and consensus expected; production cuts were extended to the end of 2018. Unlike previous meetings, the message from OPEC showed a united front among members and nonmembers, including Russia, to extend cuts.
- The decision to extend production cuts for all of 2018 suggests to us a low probability for relative oil price volatility in the coming months, barring unforeseen geopolitical events. Since the OPEC announcement, the implied volatility of crude oil futures has dropped to the lowest level since 2014.
- With West Texas Intermediate (WTI) and Brent crude prices near year-to-date highs ($59 and $65 per barrel, respectively), net long futures contracts also remain near year-to-date highs, rebounding sharply from the near-term low in late October.
- After peaking in late July, U.S. oil and gas rig counts have climbed for five consecutive weeks, with expectations that exploration and production firms are ramping up production in tandem with rising oil prices. With the considerable impact from outages at the Forties pipeline and the resumed production in the United States, the spread between WTI and Brent crude prices remains near its widest level over the past two years, continuing to put a ceiling on oil price appreciation in the United States.

Hawthorn Strategy Views

A Change in 2018: Is Higher Volatility Something to Fear?

We just experienced a year in which many financial market records were broken due to the peculiar absence of volatility. As an example, the largest S&P 500 drawdown in 2017 was just -3%, the second lowest reading in the last 70 years, trailing only the -2.5% intra-year decline in 1995.[3] In our view, no matter what direction the market trends during 2018, it will be hard to get much "better" than 2017—rising markets with little volatility can be nirvana for investors, but such a backdrop is often short lived. A key question for investors is determining whether we are now in a new market paradigm, or whether we are witnessing financial market extremes that are unsustainable. We believe the latter is more likely, but timing is always a challenge.

We continue to believe it is too soon to call for an imminent recession or bear market, but history tells us markets are likely to fluctuate more than they did during the past 12 months. There is certainly no rule that dictates 2018 will be more volatile than 2017, but we believe an increase in volatility is probable. It is important not to confuse low volatility with durable stability.

If we assume volatility increases in 2018, what does that tell us about the direction of asset prices? Interestingly, not very much at all. In other words, a call for more volatile markets does not by rule have to be a call for poor market performance. History would indicate that, on average, forward returns are positive and only slightly below the mean when starting in the lowest volatility decile, which is where we are today (Table 1, page 5).

It is clear that volatility is mean reverting and, therefore, given present conditions, is likely to be higher during the next 12 months (Table 2, page 5).

The conclusion of this analysis is that we should be mentally prepared for higher volatility in 2018. To control any inclination to panic in times of market stress, we believe it is important to understand that a return to a more "normal" volatility environment

[3] Strategas Research Partners, "Low Vol Years Often Followed By Wider Return Outcomes," November 28, 2017.

Table 1

Volatility Index (VIX) versus S&P 500 Returns (1990–2016)

Volatility Index		Median Forward S&P 500 Total Return				
VIX Decile	VIX Range	1-Month	3-Month	6-Month	9-Month	12-Month
Bottom 10%	<12 25	1.2%	3.1%	5.7%	8.4%	10.5%
10-20%	12.25 to 13.43	1.1%	3.2%	6.3%	9.2%	12.5%
20-30%	13.44 to 14.85	1.0%	2.8%	6.6%	9.2%	12.8%
30-40%	14.86 to 16.32	1.1%	2.5%	6.8%	9.8%	12.9%
40-50%	16.33 to 17.93	1.5%	2.8%	4.9%	9.0%	12.7%
50-60%	17.94 to 19.89	1.6%	2.9%	5.5%	9.8%	13.1%
60-70%	19.90 to 21.97	1.4%	2.8%	3.9%	8.4%	11.9%
70-80%	21.98 to 24.52	0.9%	2.8%	2.9%	3.5%	8.2%
80-90%	24.53 to 29.02	1.8%	3.9%	7.2%	8.0%	10.7%
Top 10%	>29.02	3.3%	7.5%	14.7%	19.1%	24.0%
All Periods		1.3%	3.2%	6.1%	9.4%	12.8%

Data compiled from Pension Partners

Source: Hawthorn

Table 2

Volatility Index (VIX) and Mean Reversion (1990-November 14, 2017)

		Average Forward Returns (1990 - 2017)				
Starting Decile (Low to High)	VIX Levels	1-Month	3-Month	6-Month	9-Month	12-Month
0-10%	9.31 - 12.20	12.8%	18.2%	22.5%	29.1%	38.3%
10-20%	12.21 - 13.36	7.2%	9.2%	13.0%	16.9%	15.7%
80-90%	24.41 - 28.91	-5.6%	-8.6%	-13.0%	-2.8%	-4.5%
90-100%	28.92 - 80.86	-9.7%	-22.7%	-32.4%	-35.6%	-38.1%

Data compiled from Pension Partners

Source: Hawthorn

may actually feel worse due to our genetically coded cognitive biases. The Party Effect, otherwise known as recency bias, can be powerful as investors evaluate their investments based on recent behavior and performance. Humans tend to extrapolate recent experiences (unusually low volatility in this case) and use them as indications of what to expect in the future. We think investors will likely benefit from the awareness of such biases, particularly the understanding that the current volatility backdrop should not be extrapolated too far into the future. An increase is price fluctuation would be normal, should be expected, and is *not* necessarily associated with poor returns. Although we still believe the market will ultimately be challenged by historically elevated valuations, our view is that the current business cycle has not yet run its course; therefore, stocks can still rise in the midst of higher volatility as we begin 2018.

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Appendix

Table A1

Equity Market Snapshot (total returns in U.S. dollars; through December 18, 2017)

	Total Returns		
	Month to Date	Quarter to Date	Year to Date
S&P 500®	1.14%	6.67%	21.86%
Small Cap (Russell 2000)	-0.82%	2.91%	14.17%
S&P 500 Value	1.12%	5.75%	14.73%
S&P 500 Growth	1.15%	7.41%	28.17%
S&P 500 / Industrials -SEC	0.56%	4.66%	19.45%
S&P 500 / Consumer Discretionary -SEC	1.80%	9.21%	22.25%
S&P 500 / Consumer Staples -SEC	2.20%	6.47%	13.47%
S&P 500 / Health Care -SEC	0.70%	2.85%	23.73%
S&P 500 / Financials -SEC	1.64%	8.29%	21.80%
S&P 500 / Real Estate - SEC	0.28%	4.03%	11.72%
S&P 500 / Information Technology -SEC	1.28%	10.39%	40.59%
S&P 500 / Telecommunication Services -SEC	4.72%	2.58%	-2.23%
S&P 500 / Utilities -SEC	-1.89%	4.75%	17.19%
S&P 500 / Energy -SEC	0.13%	1.22%	-5.49%
S&P 500 / Materials -SEC	-0.42%	4.45%	20.97%
MSCI EM (Emerging Markets)	-0.18%	3.54%	32.68%
MSCI FM Frontier Markets	1.14%	3.58%	29.76%
MSCI Europe	-0.77%	-0.06%	23.38%
MSCI China	-1.21%	4.31%	49.60%
MSCI Japan	-0.70%	6.99%	22.64%

Source: FactSet Research Systems Inc., Hawthorn

Table A2

Fixed Income Market Snapshot (total returns in U.S. dollars; through December 18, 2017)

	Total Returns		
	Month to Date	Quarter to Date	Year to Date
Bloomberg Barclays US Aggregate	-0.04%	0.02%	3.16%
Bloomberg Barclays US Aggregate	0.55%	0.48%	3.64%
Bloomberg Barclays Global US Treasury (1-3 Y)	-0.01%	-0.30%	0.40%
Bloomberg Barclays US Aggregate Government - Treasury (1-5 Y)	-0.01%	-0.40%	0.69%
Bloomberg Barclays US Aggregate Government - Treasury (5-10 Y)	0.34%	-0.19%	2.41%
Bloomberg Barclays US Aggregate Government - Treasury - Inter.	0.10%	-0.34%	1.21%
Bloomberg Barclays US Aggregate Government - Treasury - Long	2.53%	3.18%	9.40%
Bloomberg Barclays US Treasury Inflation Protected Notes (TIPS)	0.56%	0.91%	2.65%
Bloomberg Barclays US Aggregate Credit - Corp. - Investment Gr.	0.96%	1.22%	6.47%
Bloomberg Barclays US High Yield - Corporate	0.09%	0.25%	7.27%
Bloomberg Barclays US Floating Rate Notes Corporates	0.07%	0.50%	2.38%
S&P Municipal Bond Investment Grade	0.86%	0.53%	4.83%
S&P Municipal Bond High Yield	0.71%	0.73%	5.02%
GS Commodity Index	-1.01%	4.19%	0.28%
Alerian MLP	3.71%	-1.93%	-7.44%

Source: FactSet Research Systems Inc., Hawthorn

Table A3
F/X Market Snapshot (through December 18, 2017)

Major Currencies	Current	1 Month Earlier	3 Months Earlier
Euro/U.S. Dollar	1.18	1.18	1.20
Australian Dollar/U.S. Dollar	0.77	0.76	0.80
Pound/U.S. Dollar	1.33	1.32	1.36
U.S. Dollar/Yen	112.66	113.08	111.05

Source: FactSet Research Systems Inc., Hawthorn