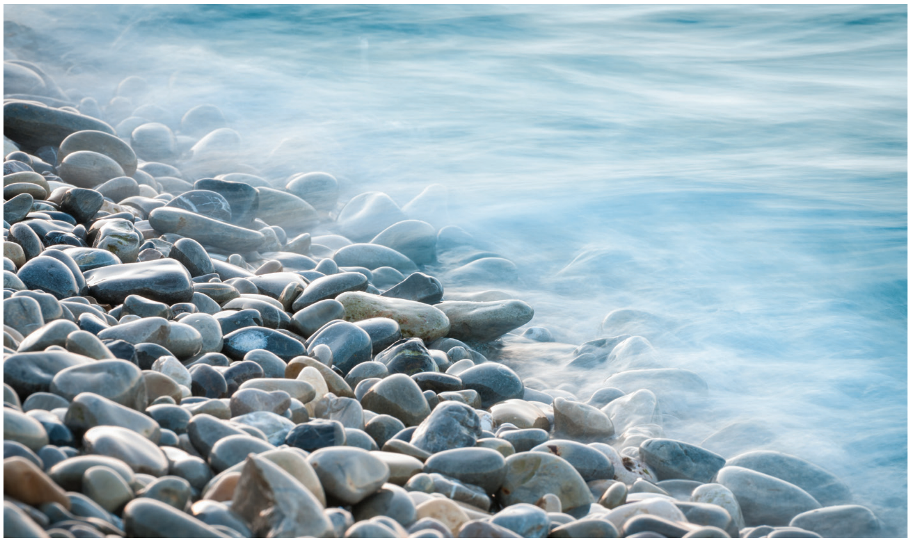
Perspectives

Keeping you informed and engaged about macroeconomic trends and market events



Trade War & Peace

"History teaches us that men and nations behave wisely once they have exhausted all other alternatives." —Abba Eban

THE IMPOSITION OF TRADE BARRIERS served as the defining global economic development of the second quarter. President Donald Trump's administration applied tariffs against China, a major trading partner and geopolitical rival, as well as traditional U.S. allies in Europe and Canada—inviting comparable tariffs in response. These retaliations prompted follow-on threats of tit-for-tat escalations from President Trump, whose now famous tweet that "trade wars are good and easy to win" shook the psyche of investors who are not so sure. Trump also took the world by surprise with confrontational interactions with Canadian Prime Minister Justin Trudeau and British Prime Minister Theresa May, in contrast to seeming love fests with North Korean dictator Kim Jong Un and Russian President Vladimir Putin. Putting aside risks of trade wars and uneasy global relationships, immigration issues were also a key point of contention in the U.S. and Europe during the quarter. The Trump administration enacted a zero-tolerance policy that targeted illegal immigration at the southern border; this attracted condemnation from across the political spectrum for its practice of separating and detaining families, including children. The governing coalitions in Italy and Germany likewise pointed a spotlight on the immigration issue, forcing action at a European Council meeting in late June with a deal that seeks to establish an EU-wide (rather than country-by-country)

IN THIS ISSUE

1. We remain optimistic about the global economy, but risks to our outlook have risen due to populism and political uncertainty as well as to U.S. trade policy. Even so, with solid earnings growth and average equity valuations, stocks should be able to rally into 2019.

2. U.S. economic growth is firing on all cylinders in 2018, fueled by strong business investment, tax cuts, and an ever-tightening labor market boosting consumer spending and leading to record-high consumer and business confidence.

3. Economic growth in Europe remains firm, even after the recent moderation in some headline figures. While Japan may be vulnerable to a tariff-based disruption, the country has so far avoided this ongoing trade war.

4. Above-trend expansion in the developed world, economic reforms, improving corporate fundamentals, and reasonable valuations support emerging market equities. Risks include a sharp rise in the U.S. dollar, trade tensions, and elections.

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approach centered on financial-burden sharing and more restrictive borders.

Escalating trade tensions and the polarization of electorates over issues like immigration and fiscal sovereignty dominated headlines and caused a substantial increase in market volatility. And yet, these risks not withstanding, there is still much to applaud about our global economy, including solid growth, strong momentum in corporate profits, and equity valuations that appear reasonable against a backdrop of still low, albeit rising, interest rates. For these reasons, we perceive this old bull market still has some life left in it, though we acknowledge that risks to the equity market are rising thanks to trade wars and populist behavior more generally, and the outlook is no longer skewed to the bullish side.

So what impact, if any, will trade wars have upon the future direction of economic growth? And are trade wars, as President Trump tweeted, in fact "good and easy to win"?

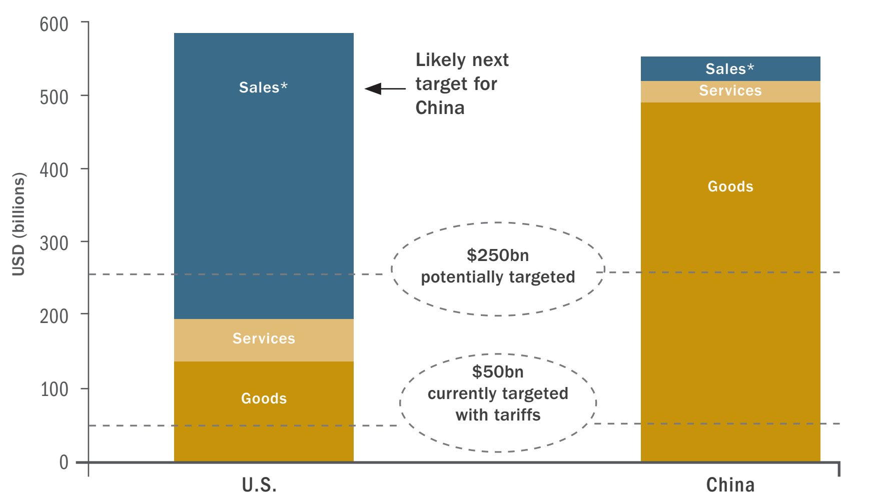
To recap, in 2017, President Trump took steps to make good on his campaign promises to rebalance global trade in America's favor by withdrawing from the Trans-Pacific Partnership trade pact (TPP) and signaling he would be renegotiating the terms of the North American Free Trade Agreement (NAFTA) with Canada and Mexico. In January, the U.S. slapped controversial tariffs on imported washing machines and solar panels, which most heavily affected Chinese and South Korea manufacturers. Then on June 1, the U.S. imposed a 25% tax on steel and 10% tax on aluminum imports from the EU, Mexico, and Canada on the basis of national security. The EU retaliated with taxes on American exports like blue jeans, motorcycles, and bourbon whiskey, and Canada and Mexico likewise enacted countermeasures by imposing taxes on U.S. steel products and varied food items including yogurt, whiskeys, coffee, pork, and cheese. Then, after more than one year of multilateral discussions related to restructuring the terms of NAFTA, the President signaled he wanted to end the three-party talks and deal separately with Canada and Mexico, though it is not immediately clear how such an arrangement would work as the U.S., Mexico and Canada all have to agree to changes in terms. Trump also threatened 20% tariffs on EU autos, and the trade bloc responded that it would place $294 billion in fresh tariffs against American made cars and auto parts if he does. In recent days, European Commission President Jean-Claude Junker and Trump agreed to halt plans to impose new tariffs, and work together to eliminate tariffs on all non-auto industrial goods, increase cooperation on energy purchases, and work together to reform the World Trade Organization. The EU made a commitment to buy more American soybeans and liquefied natural gas as part of the negotiations.

As intense as interactions with Europe, Mexico, and Canada have been, all eyes are on the escalating threats of trade wars between the U.S. and China, which has moved from saber-rattling into actual skirmishing with the risk of an all-out war on the horizon. At stake is not only the rising trade deficit but the forced transfer of proprietary technology by U.S. firms seeking to do business in China. The removal of this provision was a key point in the announcement of $50 billion in U.S. tariffs on Chinese goods and limitations placed on Chinese investment in the U.S. Duties were applied to an initial $34 billion of goods on July 6, and tariffs on another $16 billion of electronics and components are scheduled. The Trump administration has threatened to target another $250 billion of Chinese products with 10% tariffs, a move that would raise prices for Americans and hurt China's economy, and if China retaliates, another $200 billion.

While China has so far met U.S. tariffs with equal retaliatory tariffs, with only $130 billion in U.S. goods exported to China, it is not possible for President Xi Jinping to match tariffs on a half-trillion dollars of products. There are certainly other ways he could retaliate, including targeting our services surplus by withholding licenses or launching tax, anti-monopoly or other investigations. They could, of course, also decide to pitch some of their vast holdings of U.S. Treasuries.

No doubt, a trade war of this magnitude would have impacts on global growth, but the biggest loser may be the U.S. consumer as multinational companies will arguably feel the biggest brunt of these tariffs. According to the Peterson Institute for International Economics, multinational companies account for half of the value embedded in all Chinese exports. Three-fifths of those exports have been going to the U.S.; of those, 70% represent capital and consumer goods. For now, the share of computer and electronic products subject to the initial round of Section 301 duties is relatively small at 8.3%. That is because the Trump administration wants to limit the direct impact of the tariffs on consumer goods such as cell phones and laptops. However, if President Trump goes through

While China relies on exports, the U.S. draws more revenue from sales abroad that are not immune from retaliation



with his promise to slap tariffs on an additional $200 billion in response to China's tit-for-tat retaliation on the first round of Section 301 duties, we expect households will start to see the impact more clearly on their everyday lives—in the form of higher prices and, perhaps, shortages of desired products.

To be blunt, the strategy of waging a trade war with China could prove to be the equivalent of cutting off one's nose to spite one's face. The global economy has experienced tremendous growth—supported by expansion in trade. This system has evolved over decades, leading to either bilateral or multi-nation trade agreements. These may be free trade agreements, in which goods and services are exchanged mostly without tariffs—or negotiated trade agreements in which tariffs are set for individual goods. Admittedly, while the original goal of these trade agreements was an improvement in trade for all parties, these gains have proved to be asymmetric over time. Some countries have developed into trade surplus nations (the country exports more than it imports), while others have sustained persistent trade deficits. The U.S. falls into the trade deficit category. While the U.S. runs trade surpluses with certain countries, its overall annual trade deficit has widened during this economic expansion and stood at a staggering $568.4 billion in 2017.

Narrowing our trade deficit is a noble goal, but this trade renegotiation process seems destined to lead to higher prices for consumers and hurt the bottom lines of companies that sell imported goods and those that depend on global supply chains in the production process. The result may be a net loss for society. A small group of producers will probably benefit substantially from the trade impediments—while most consuming industries and households suffer a decline in purchasing power that may be small at the individual level but could add up to a big loss across the economy. Ultimately, it would be much cheaper and more efficient to write a check directly to the losers from global trade than to impose a small tax on everyone else. Which is what the Trump administration made a move to do at the end of July with an announcement of $12 billion in emergency aid to farmers reeling from commodity price declines in corn, soybeans, dairy, wheat, sorghum and cotton thanks to all of these trade moves. Of course, providing subsidies is politically unpalatable and perceived as unfair to taxpayers and workers who do not qualify for such relief. The outrage over this move, and to tariffs in the first place, has the country reeling over the risks of an all-out trade war, and has dissipated the euphoria over year-end tax cuts as consumers begin to feel the impact of rising prices on commodities and consumer products.

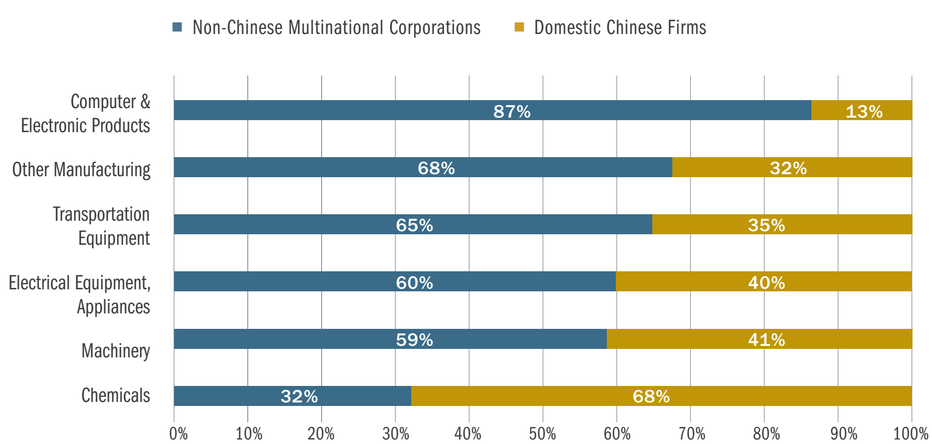
How big a risk are trade wars to the U.S. and global economic picture? To be sure, there has been a dramatic secular decline in tariffs, both as a percentage of dutiable U.S. imports and of total U.S. imports, such that the current level of imposed tariffs is measured, but not meaningful. However, the scope of proposed tariffs is another story. However, we do not believe the world is going back to the bad old days of the 1930s, when average tariff rates reached almost 60% on dutiable imports under the Smoot-Hawley J.P. Tariff Act. We believe that the U.S. is simply using tariffs to establish a stronger negotiation position as it attempts to rebalance the global trading system. A more connected world implies a higher incidence of trade disputes and a broadening of international economic tensions to include matters of national security and intellectual property (IP). However, the same forces broadening the scope of trade disputes will restrain international economic diplomacy from arriving at a "mutually assured destruction" scenario in the medium-term. The globalization genie is out of the bottle; President Donald Trump, or any world leader for that matter, does not have the power to put it back in.

As such, moderate, negotiated solutions are still our base-case outcomes for EU, NAFTA, and China trade disputes, driven by the political economy of trade's distributional effects, supply-chain issues, and credible retaliation threats. Looking back at U.S. trade disputes with Japan and Germany in the mid-1980s—the Plaza Accord to intervene in currency markets to weaken the U.S. dollar; mild trade restrictions on Japanese imports; and a push for increased market access to U.S. exports—all of them led to more or less amicable denouements, though negotiations were acrimonious at times. We believe the same pattern will hold true with current negotiations. There will be blood, as they say, if that is not the case and the U.S. engages in tit-for-tat trade wars with the world or pulls out of NAFTA or the World Trade Organization (WTO).

In this period of elevated trade policy uncertainty, proper portfolio diversification may minimize adverse effects when they occur, though it is difficult to position portfolios for spontaneous or fluid geopolitical events. While we expect the sound fundamental backdrop to outweigh these trade tensions longer-term, volatility and investor anxiety are likely to remain elevated in the near term.

Multinational companies have the most to lose in a trade war

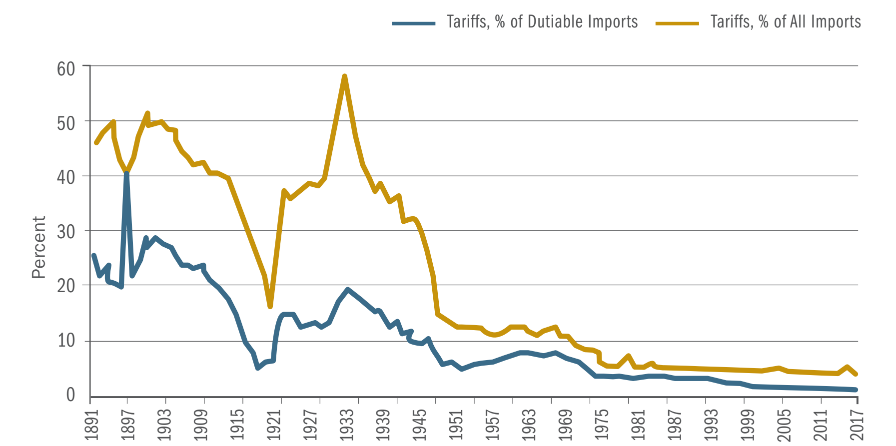
Revised Tariffs Against China Hit Non-Chinese Supply Chain Even Harder



We also believe that the U.S.'s shift from promoting free trade and global commerce to potentially disrupting it is seismic, and could have significant effects across industries and companies over time. So far, it is difficult to forecast future announcements given the somewhat erratic nature of the social media–based negotiations. However, we do believe that companies will ultimately have to reconsider and in some cases reconfigure their supply chains in response to the philosophical change in U.S. trade policy. Long-term, this could create a drag on cost inputs and have a slowing effect on earnings.

Finally, impediments to trade could also lead to a higher inflation rate as domestic companies use the tariffs umbrella to raise their selling prices. The Fed may feel compelled to lean against this threat to price stability, thereby aggravating any economic shock arising from the disruption of global supply chains—which is how a bear market could develop. While this is not our expectation, we are mindful of the risks to stock and bond holdings alike in this scenario, and will remain keenly focused on a trade-related escalation of inflation which could be the worst fallout from these current tensions.

There has been a dramatic secular decline in tariffs, both as a percentage of dutiable U.S. imports and of total U.S. imports

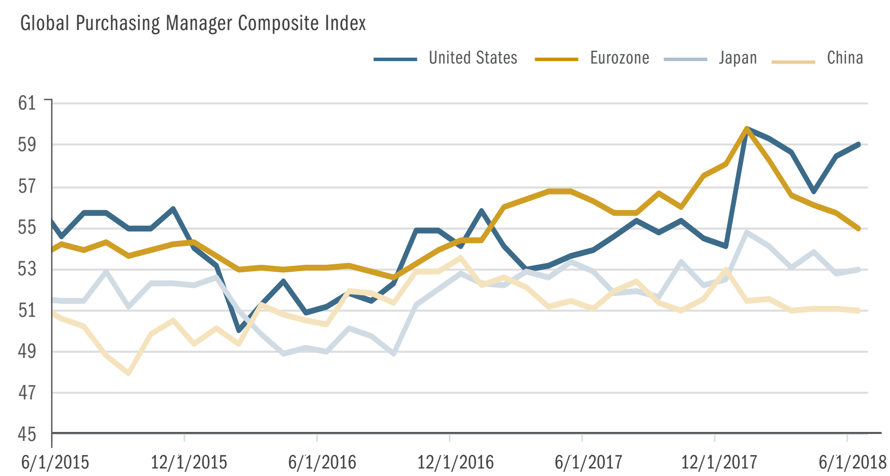


GLOBAL ECONOMIC OVERVIEW: Ready to Resynchronize

THE SYNCHRONIZED GLOBAL ECONOMIC EXPANSION that powered earnings growth in 2017 appeared to have plenty of steam coming into 2018, though year-to-date the economic data has fallen somewhat short. The U.S. economy has been the most robust, as confidence remains high and last year's tax cut package has put disposable income in the pockets of consumers and corporations alike. While the outlook for the European economies has also been broadly positive, there has been softness in the Purchasing Managers Indices (PMIs) and some sentiment indicators. Political instability in Italy and higher bond yields in the peripheral countries was clearly one factor slowing euro zone growth. Also, the UK is beginning to slip as Brexit uncertainties are weighing on business confidence and capital spending. Although corporate governance reforms are improving Japan's longer-term economic prospects, in the short run Japanese growth is heavily dependent on the country's exports and thus the strength of global growth. Finally, while China has been largely successful in sustaining economic growth despite Beijing's efforts to restrain credit expansion and restructure older industries, momentum could slow thanks to trade wars. For now, Chinese growth is helping sustain expansion in other emerging markets, though currency weakness could create financial risks for countries with large fiscal and/or current account deficits.

Provided trade tensions do not escalate much further, we expect the second half of this year should be better than the first. The weakening in global goods demand that led to disappointing growth metrics in the first quarter seems to have worked its way through the system, with U.S. consumption growing by nearly 4% from a year prior in the second quarter, and retail sales in Europe showing signs of stabilization. While the hard data will need to provide confirmation of this trend, the clouds which have been hanging over the international economy for the past few months could be breaking.

Global PMIs retreated off their highs in the first half of 2018 but are starting to stabilize and bounce back



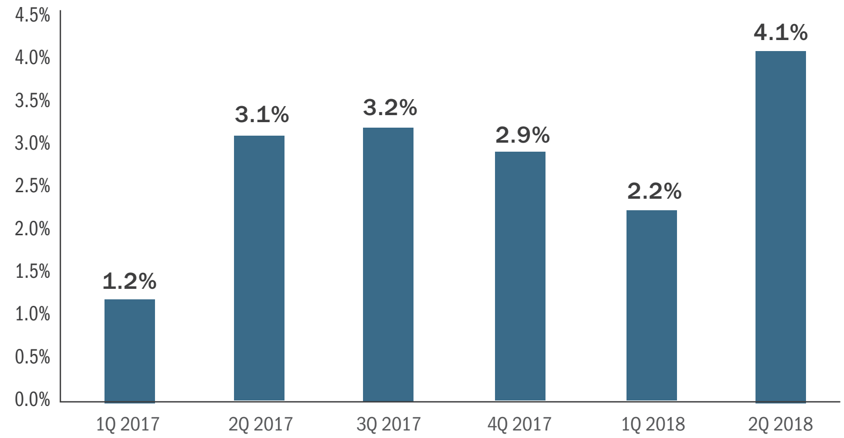
U.S. ECONOMY: It's A Wonderful Life

THE U.S. ECONOMY IS FIRING FROM ALL CYLINDERS, and posted real GDP growth of 4.1% in the second quarter of 2018. Indeed, for the first time since 2007, the U.S. economy now has a positive output gap, i.e. actual output higher than potential output as measured by the Congressional Budget Office. And the outlook for consumption spending, which accounts for nearly 70% of U.S. GDP, is arguably the best in years. According to the Federal Reserve's latest Financial Accounts, the net worth of American households climbed to a record US$100.8 trillion, and the household debt to net worth ratio plunged to a 31-year low in the first quarter. The best household balance sheet in decades, coupled with federal personal income tax cuts, still-low interest rates, and easy access to credit explain why consumer confidence remains high.

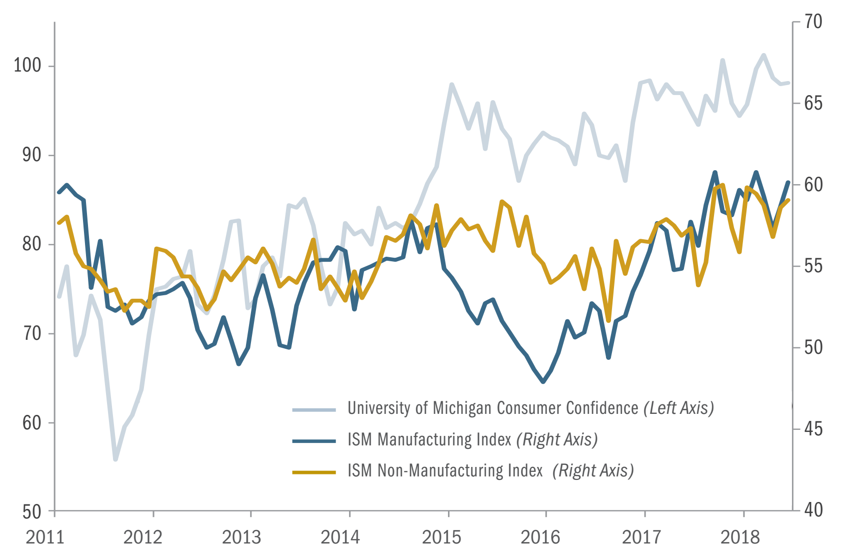
A buoyant labor market is also positive for consumption spending; in May, the unemployment rate hit a new low of 3.8% (it ticked up slightly in June to 4% due to an increase in the labor force), According to the establishment survey, nonfarm payrolls grew by about 1.2 million over the January-June period, the best start of the year since 2015. The household survey also paints a positive picture of the U.S. labor market with the lowest unemployment ever recorded as a share of the working age population. Also encouraging is the fact that the jobs created have tilted towards full-time positions, the latter rising this year at the fastest pace since 2010, and pushing up its share of total employment to a decade-high of 82.7%.

Sky-high business optimism also suggests the expansion has legs and hence could extend through next year. Solid corporate profits bode well for investment outlays at large firms. But even small businesses, which account for the bulk of employment creation in the U.S., plan to expand and invest. The latest National Federation of Independent Businesses (NFIB) small business survey showed that more than a third of respondents feel now is a good time to expand. Gauges of manufacturing and service sector activity remained elevated, if down a bit from multiyear peaks reached early in the year.

Second quarter U.S. GDP jumps to a four-year high



Confidence and activity levels remain off the charts



Even interest-rate sensitive sectors like housing are proving more resilient to rising mortgage rates than one might otherwise expect. Home prices and existing home sales continue to increase at a healthy clip, though home construction has lagged as builders have focused on the higher end of the market. We expect demand for housing to at least hold its own against the backdrop of moderately rising rates. Millennials are starting families in greater numbers—a life change that usually necessitates moving from central-city districts to more-spacious, affordable housing in the suburbs. If anything, it is the lack of inventory of homes for sale that is standing in the way of a more robust housing recovery. And the absolute level of mortgage rates remains relatively low within the context of the past 10 years.

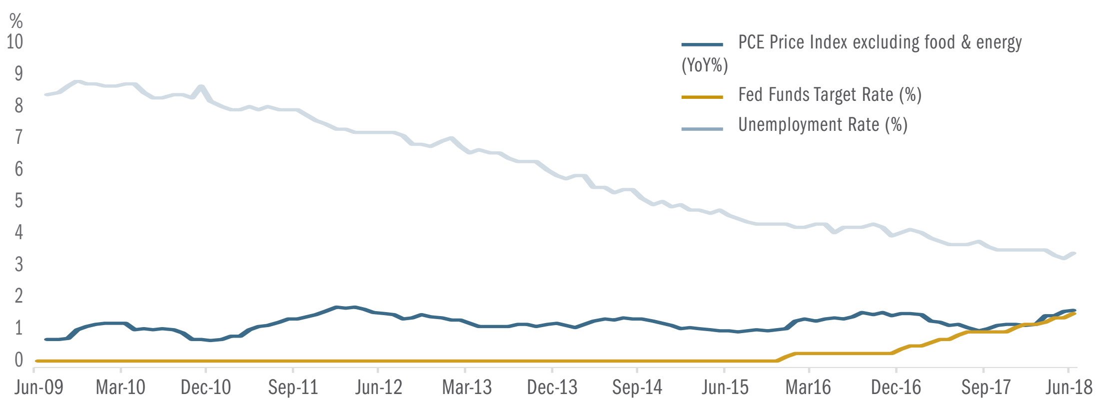
All in all, the U.S. economic outlook is largely positive, with 2018 real GDP growth expected to come in above 3%. Momentum from this year could spill over to 2019, which is why we expect a healthy performance for next year as well, although a moderation in growth may be in the cards after this year's red hot pace.

But there are risks that could bring the current expansion to an earlier end, most especially the tariffs imposed by the U.S. government on imports which not only raise prices and hence lower real disposable incomes for consumers, but also put in jeopardy the livelihood of American workers. Millions of jobs that directly depend on imports are now threatened after U.S. tariffs were imposed on a range of goods. Ditto for the nearly 11 million jobs that are supported by exports and which are now vulnerable to a drop in foreign demand for American-made goods courtesy of retaliatory tariffs from trade partners. Corporate profits could also take a hit from protectionism. For the past few years, U.S. profit growth has been driven by the "rest-of-the-world" component. The latter has increased its share of overall U.S. corporate profits to reach a four-year high of 20.3% in the first quarter of this year. So, growing protectionism from Washington has potential to hurt the bottom line of corporate America and hence offset some of the benefits obtained through tax cuts.

With inflation trending close to the Fed's 2% target, the Fed continues to gradually tighten monetary policy and is likely to do so for some quarters to come. Against this backdrop, short-term interest rates have risen faster than long-term rates – flattening the U.S. yield curve – which is an increasing cause of concern as we near inversion, as curve inversions often precede recessions. The Fed's hawkish monetary policy relative to other developed market central banks has boosted the U.S. dollar, which is creating potential earnings headwinds for U.S. multinational companies.

It is an open question whether the Federal Reserve will carry on with policy normalization amidst downside risks related to trade. At its June meeting, the Fed shrugged off those risks and not only raised the Fed Funds target rate to 2.00% but hinted at two more rate hikes (of 25 basis points each) before year-end and three more in 2019 amidst rising inflation pressures. Revisions to the Fed's forecasts showed a narrower band than before for GDP projections, highlighting growing confidence within the FOMC about the economic outlook. In his press conference on June 13, Fed Chairman Jerome (Jay) Powell was notably positive on the U.S. economic outlook. Although the Fed expects to raise rates in a steady and predictable fashion, the chairman was adamant that the U.S. economy would be able to handle the shift from extraordinary monetary expansiveness to a more neutral setting and, eventually, to a somewhat restrictive one. He also said the Fed is willing to tolerate an inflation rate that runs slightly above its 2% target for the Commerce Department's price index for personal consumption expenditures (PCE) price index, as long as that rate is perceived as temporary. Whether the central bank continues on its rate-rising course as it projects (turning policy from neutral to restrictive) ultimately depends upon two factors: how the economy responds to the actions it takes until that point, and if inflation is indeed showing signs of persistent acceleration beyond target. The Fed may also be watching how uncertainty surrounding U.S. trade policy plays out, though other geopolitical risks have subsided somewhat as provocative rhetoric has cooled substantially in the wake of the U.S.-North Korea summit. Global relationships remain in flux, however, and other risks like a government shutdown over a border wall also loom.

With unemployment down and inflation up, the Fed Funds rate is marching higher



DEVELOPED INTERNATIONAL ECONOMIES: Mind the Gap

THE ECONOMIC DATA COMING OUT OF EUROPE has been disappointing this year. Instead of building upon the improved business activity seen in 2016 and 2017, there has been a widespread deceleration. However, the weakness during the first quarter reflected a variety of one-offs, including poor weather as well as unusually high absenteeism due to the influenza epidemic and industrial strikes (especially in France, where President Emmanuel Macron is pushing hard for economic reforms). While PMIs are still in positive territory, they have rolled over from exceptionally high readings at the end of last year. The euro zone unemployment rate continues to move lower too, yet remains elevated compared to that of the U.S. and the UK. Still, the number of officially unemployed persons in the euro area has impressively declined from a high of almost 3.7 million in 2012 to

2.4 million as of April this year. We are also seeing a continued modest acceleration in lending to households and corporations. Although lending-activity growth within major financial institutions remains in the low single-digit territory, it reached its best level in seven years in May.

However, as European Central Bank (ECB) President Mario Draghi put it at his June 14 press conference, “There has been an undeniable increase in uncertainty,” caused by geopolitical events. Yet, the central bank still terms underlying growth as solid despite the soft patch through which the euro zone economy appears to be traversing. Since deflation risks have moderated significantly in the view of Draghi and the other ECB governors, the decision was made to end net asset purchases by the end of this year. Taking a page out of the Fed’s playbook, Draghi emphasized several times at his press conference that monetary-policy accommodation is ample, and will continue to remain so. In addition to keeping the central bank’s balance sheet steady by reinvesting maturing debt indefinitely, the ECB president stated that policy rates will remain unchanged at least through the summer of 2019 (or later, if needed). In other words: the ECB wants to keep its options open, much as the Fed did in 2015. The pace of interest-rate normalization will depend on the data. Draghi’s comments were viewed as dovish by the markets, helping to push the euro down sharply against the U.S. dollar. Still, ECB-watchers are concerned that the central bank is on the cusp of repeating its 2011 policy mistake of raising rates two separate times just as the periphery debt crisis was about to hit in full fury.

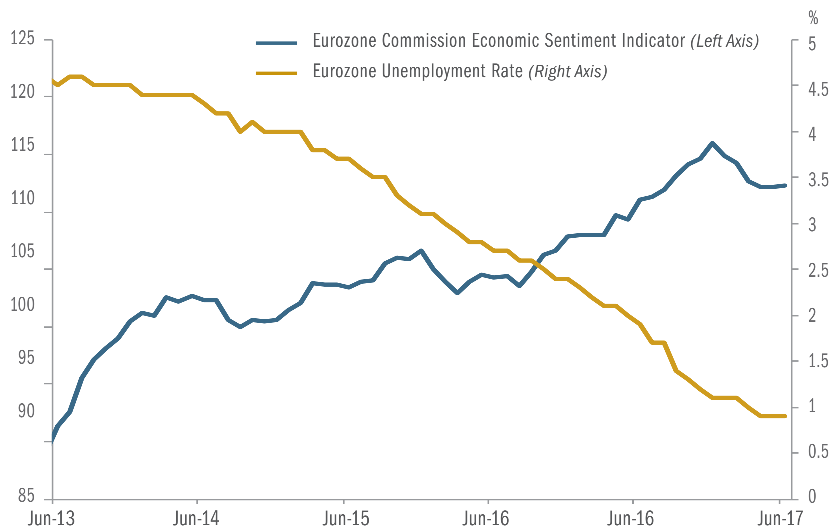
Speaking of European periphery sovereign debt, yields have increased in recent weeks, with a particularly sharp spike in yield for Italian paper. The precipitating event was the formation in Italy of a government coalition composed of the Five Star Movement and Lega (formerly known as the Northern League), led by technocrat Giuseppe Conte. Both are populist parties with anti-immigrant, anti-euro, and anti-Brussels biases. Investors are worried that fiscal restraint will be jettisoned as the new government seeks ways to jumpstart the country’s growth. Conte has laid out a plan to institute a universal basic income scheme, undo previous pension reforms that raised the retirement age, and replace the current income tax brackets that go up to 43% with two flat rates of 15% and 20%. These are all expensive propositions that would blow a hole in Italy’s budget. Even more disastrous would be an attempt to ditch the euro and opt out of the euro zone; although the new government has been backtracking on its more extreme anti-euro rhetoric since it became clear that bond vigilantes are alive and well and ready to punish the country for any attempt to escape the euro currency straitjacket.

In Spain, the Socialists, the country’s biggest opposition party, ushered in a new government after a no-confidence vote led to the ouster of Prime Minister Mariano Rajoy, who was replaced by Pedro Sanchez in early June. For now, key risks have been slightly mitigated by the new government’s commitment to maintain the Conservative party’s 2018 budget. Add in the mix tough talk on tariffs from President Trump and German Chancellor Angela Merkel’s clash with the Christian Social Union (CSU) party over immigration policy, and European investor fortitude was understandably in flux during the quarter.

Even more on edge is sentiment around the UK economy, though it looks more like the U.S. in terms of its economic performance than its European neighbors. Since exiting recession in mid-2009, the country has endured only two small declines in quarterly GDP, both during 2012. The cumulative rise in inflation-adjusted GDP since the start of the expansion amounts to 18%—close to the 21% advance posted in the U.S., and well above the cumulative 12% posted by the euro zone. However, GDP growth did slow to a 1.2% pace in the first quarter of 2018; like other countries in Europe, the recent data suggest that the UK is wending its way through a soft patch. Underlying growth appears solid, however, with household spending and capital formation posting steady, albeit modest, gains, with the trade sector the only real trouble spot. As in the U.S., UK unemployment sharply declined; the headline rate fell to nearly 4.2% in the first quarter of 2018 from 4.6% one year earlier. Average weekly earnings, however, continued to rise by about 2.5% year over year. Since consumer-price inflation gained 2.4% over the one-year period ending March 31, 2018, inflation-adjusted wage growth remains minimal. All this suggests a stable U.K. economy. Yet, even with near-full employment, the Bank of England probably won’t be in a hurry to raise its policy rate anytime soon thanks to Brexit.

The biggest source of uncertainty facing

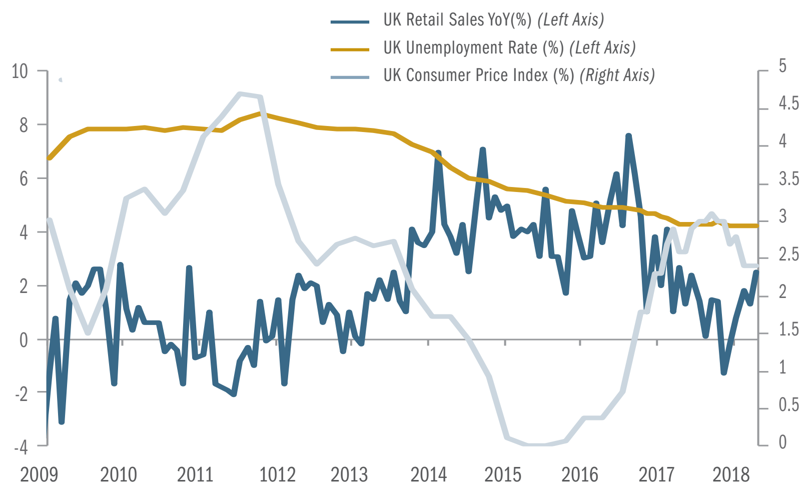
European economic indicators have cooled since the end of 2017, even though unemployment continues to decline



the UK is its looming withdrawal from the EU. The Conservative Party's internal fight over the country's future relationship with the EU has stalled progress toward a clear post-Brexit status. Although there will be some sort of transition process after the UK officially exits the EU on March 31, 2019, the outline of the resulting relationship remains as murky as a thick London fog. There is little consensus, for example, over how to handle the customs border with Ireland. Some want as seamless a border as possible, which means that the UK will need to follow all the rules and regulations of the EU without the benefit of having a vote in the creation of those rules and regulations. Politicians lobbying for a hard Brexit, meanwhile, threaten to topple Prime Minister Theresa May's government if a more complete sundering of the relationship fails to be negotiated. It is hard to believe that the referendum to exit the EU occurred two years ago as precious little seems to have been definitively decided since. And notably the pound sterling is trading almost exactly where it was versus the U.S. dollar the day after the Brexit vote. Investors are worried about the rising odds of a hard Brexit and a more thorough disruption of the country's trade with the EU. Not helping matters was President Trump's recent official state visit to the country, where he succeeded in undermining Theresa May's authority with lavish praise for rival and hard Brexit proponent Boris Johnson, and also suggesting he would have sued the EU as an exit negotiation tactic.

Turning to developed Asia, Japan continues to offer one piece of positive data for every piece of negative data. On the positive side, we have seen very strong earnings growth, the first signs of decent wage growth, a strong labor market, and robust business confidence. On the other hand, weak consumer confidence has translated into poor retail spending and household consumption, and a negative GDP print for the first time in two years. Rising in oil prices have also not been great for a country that imports nearly all its oil. We expect consumer confidence to rebound as higher wages flow through to household balance sheets, but further increases in the oil prices will be a drag and overall upside

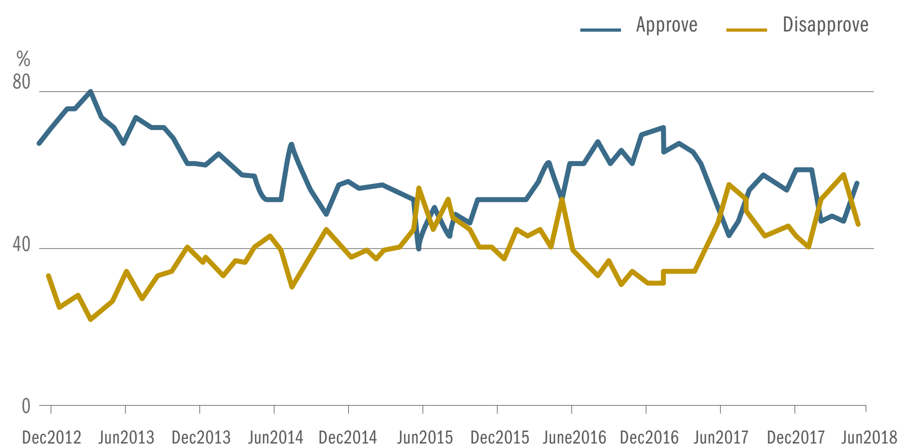
UK hangs in for now but Brexit timetable is set to squeeze



for the economy is limited from here, especially with the planned increase in the VAT (value added tax) looming next year. At least the support from the Bank of Japan should remain for some time, as we do not expect any change in policy for this year, at the very least.

In terms of politics, it is fairly astonishing that Japan has escaped any tariffs thus far given their significant presence in the automobile market. We believe it is a testimony to Prime Minister Shinzo Abe's resilience in managing to get seven meetings with President Trump since the election. The lack of tariffs or threat of tariffs is a significant achievement for a country that was once considered a major trade violator. Of course, the Japanese economy has come a long way since, as Japan now ranks among the lowest in the Organization for Economic Cooperation and Development (OECD) in terms of net trade contribution to GDP. For his part, Prime Minister Abe continues to push forward with the objectives of Abenomics, even as his potential involvement in the Morimoto and Kaken school scandals threatened to unseat his standing as a long-serving Prime Minister. However, potential opponents have been unable to gain traction without a comprehensive plan to compete with Abenomics. As such, Abe's approval rating remains above 40%, which makes it all but certain he will retain his current position through the 2020 Olympics.

Abe's approval rating remains high despite recent scandals



CHINA & EMERGING ECONOMIES: Pressure Cooker

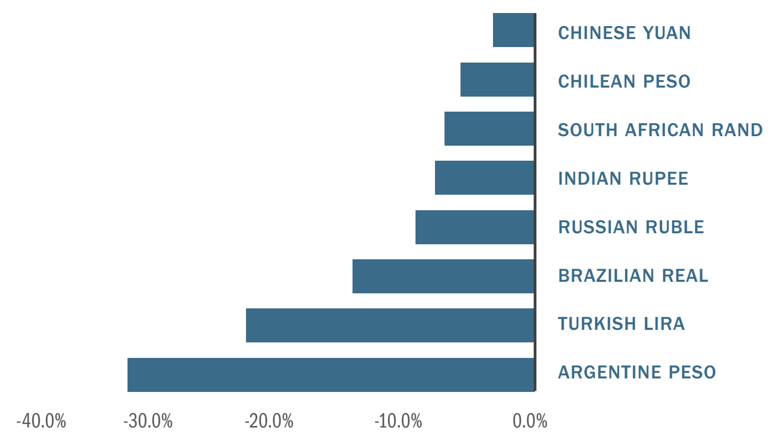
ON THE EMERGING MARKETS ECONOMIC FRONT, there has likewise been some loss of momentum lately. While on average, EM PMIs are still in expansion territory and China grew faster than expected in the first quarter of this year, recent months (March, April and May) saw consecutive declines in activity indicators for emerging markets. Making matters worse, EM currencies were under siege as rising U.S. interest rates and tariff talks converged to sink exchange rates and pressure economic and market outlooks.

Chinese GDP fell from 6.8% to 6.7%, reflecting aggressive financial deleveraging and authorities' efforts to crack down on shadow banking. Tighter credit conditions for local government financing prompted infrastructure investment to record a poor quarter. But on the flipside, manufacturing investment accelerated in the quarter, likely reflecting solid company profits and a shift towards higher value-added sectors related to the "Made in China 2025" initiative. Indicators signal that household spending was buoyant in the second quarter despite a slowdown in retail sales growth, with consumer confidence hovering at historically high levels in the period. The external sector appears to have detracted from overall growth on the back of slowing export growth and a still-solid expansion in imports. While shipments accelerated in June, the uptick is expected to be short-lived as it mostly reflected front-loaded exports ahead of upcoming tariff increases.

China's elevated debt prompted Chinese authorities to unveil a series of measures, including tighter regulation and higher borrowing costs. Moreover, the housing market is slowly cooling following the government's attempt to tame booming prices, especially in tier-one cities. We expect the People's Bank of China to keep benchmark interest rates on hold and to use other monetary policy tools to manage liquidity in a more flexible and targeted manner. Just recently, the central bank announced its decision to reduce required bank reserves by $100 billion to provide cushion against a potential trade war.

As for other Asian economies, India experienced a normalization in cash conditions following its demonetization scheme of late 2016 and the fading of disruptions from last year's launch of the Goods and Services Tax which should facilitate a recovery in GDP growth this year. In June, the Reserve Bank of India raised its key rate for the first time since 2014 and maintained its 7.4% annual economic growth forecast. They were following in the footsteps of other central banks in the Philippines and Indonesia who raised rates to stabilize their currencies even as growth wobbled slightly.

Strong U.S. dollar has EM currencies under siege



Turning to Brazil, economic data has taken a turn for the worse following a nationwide truckers' strike in May and early June that crippled economic activity. Industrial production recorded the largest contraction in almost 10 years in May, and the manufacturing PMI plunged into contractionary territory in June. In addition, both business and consumer sentiment dropped, weighed on by the industrial action. On the political front, October's elections are coming into focus, and the lack of a strong centrist and reform-minded contender is casting a shadow on the country's future and reverberating through financial markets. Early polls place far-right candidate Jair Bolsonero in the lead but show that former President Lula da Silva would be on top if he can contend.

Mexicans headed to the polls on July 1, electing Andres Manuel Lopez Obrador (AMLO) as its next president by a wide margin. Victory for AMLO, a left-leaning populist and outspoken critic of the Trump administration, signals a decisive turn away from the establishment parties that have dominated Mexican politics for decades. In Colombia, young populist Ivan Duque won the country's presidential election in June, and vows to bring pro-business policies back to the country by cutting taxes and modifying parts of the FARC peace deal made with Marxist guerrillas.

In Russia, turnarounds in the manufacturing and mining sectors boosted activity amid firmer commodity prices and solid demand. The unemployment rate inched down to a multi-year low in May, and in June, Russia and OPEC members agreed to raise oil production, a move that should bode well for Russia's oil revenues going forward. Russia also announced an upcoming increase in the VAT and a gradual raise in the retirement age, to keep government finances on a sustainable path. And while in April the U.S. imposed sanctions on Russian oligarchs and companies with ties to President Vladimir Putin in retaliation for the country's actions in Syria, by July President Trump met Putin in Helsinki for a summit that had Trump openly praising the leader.

Turkish President Recep Tayyip Erdogan's reelection did not ease concerns over the overheated economy there and concerns are growing over the direction of economic and monetary policy under the president's newly expanded powers. Meanwhile, new South African President Cyril Ramaphosa had to grapple with the news that South Africa's economy shrank an annualized -2.2% in the first quarter from the previous quarter, the biggest growth decline in nine years.

Notably during the quarter, Pakatan Harapan, a coalition party formed in 2015, toppled Barisan Nasional (BN) in the Malaysian general election, ending 61 years of BN rule. The shock defeat puts Mahathir Mohamed, a 92-year old former prime minister (1981–2003) back at the country's helm, this time as the leader of a reform-minded political party. The country has been roiled by the misappropriation of $4.5 billion of state funds, $700 million of which was traced to former prime minister Najib Razak's personal accounts. Public discontent has mounted over rising food, housing, and transportation costs and eroding trust in national institutions. However, there is concern that Mahathir will reverse some economic policies viewed as pro-growth. For example, the new administration removed the goods and services tax at the beginning of June, which previously stood at 6%. The sales and services tax will be reinstated at a rate that is yet to be announced.

Finally, the relationship between the U.S. and North Korea appeared to warm after a June summit in Singapore between President Trump and Supreme Korean Leader Kim Jong Un. While no firm commitments of denuclearization were made, the talks appeared to have gone well and rhetoric between the leaders has markedly softened, much to the relief of the world.

Relief was not long-lived, however, after President Trump announced a withdrawal from the 2015 Iran nuclear deal, prompting Iran to warn they will return to enriching uranium more than before.

GLOBAL MARKET OUTLOOK: Withering Heights

GLOBAL EQUITIES CONTINUED THEIR FIRST QUARTER MALAISE, as trade concerns escalated and risks to economic growth and valuations increased. U.S. equities outperformed the rest of the world by posting modest gains, even as international and emerging market stocks slumped with all the uncertainty. Growth outperformed value, as did domestic-oriented small caps which are more insulated from international trade and tariff concerns. Energy stocks led markets higher, gaining 13% amid concerns about oil supply shortages around the world. The information technology sector also rallied on solid earnings reports from tech giants. Meanwhile, stocks in the industrials, financials, and telecommunication services sectors lost ground.

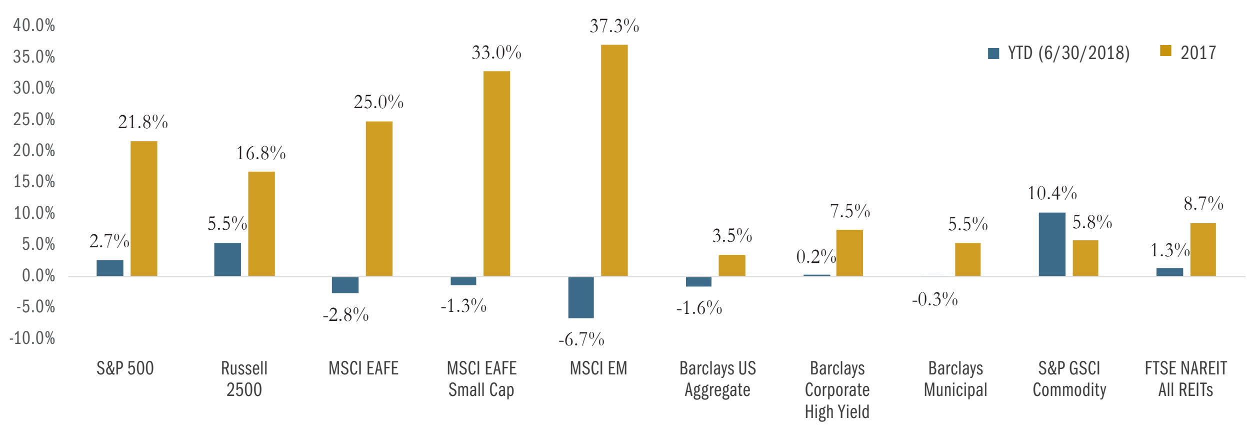
Investment-grade bonds declined, hurt by rising U.S. interest rates and signs of higher inflation. In April and May, the yield on the benchmark 10-year U.S. Treasury note rose above the psychologically important 3% threshold before settling at 2.85% to end the quarter. Municipal securities outperformed taxable bonds, helped by limited issuance and strong demand. High yield bonds, which have less interest rate sensitivity than high-quality issues, outperformed, helped by light issuance and strength in some energy bonds as oil prices rose.

The U.S. dollar rallied versus most currencies, as strong U.S. economic data releases reinforced expectations that policy rates are likely to continue to move higher. Commodities rallied over the quarter, led by continued strength in the energy sector, though agriculture & livestock and precious metals declined during the period.

U.S. equities in a tug of war between positive earnings and negative politics

Generally, the second quarter seemed characterized by a tug of war between positive corporate fundamentals and a negative political backdrop. April and May brought evidence that corporate earnings had accelerated even more than expected following the December 2017 tax cut and further stimulus provided by federal spending increases in March. Earnings for the S&P 500 as a whole rose by 24.6% in the first

Global equities have a hangover after last year's lofty gains



quarter relative to a year earlier, marking the best increase since profits rebounded following the Great Recession nearly a decade ago. Steep cuts in the corporate tax rate deserved part of the credit, but top-line revenue growth also surprised on the upside. Indeed, more than three-quarters of firms reported higher-than-expected increases in both earnings and revenues.

Stocks recorded decent gains in the second quarter, although the performance of the major benchmarks varied considerably. The technology-focused Nasdaq Composite Index outpaced the large-cap benchmarks and reached new highs, helped by the continued strong performance of many "mega-cap" technology firms. The smaller-cap indexes also outperformed and set new records late in the quarter. The narrowly focused Dow Jones Industrial Average lagged as escalating trade tensions weighed especially on several of its export-focused components. Growth shares continued to outpace their value counterparts, except in the small-cap space. Volatility, as measured by the CBOE Volatility Index, subsided a bit from the multiyear peaks reached early in the previous quarter, but the market continued to see larger price swings relative to 2017's remarkably steady climb upward. Within the S&P 500 Index, energy shares performed best as oil prices climbed to four-year highs, while industrials and business services, financials, and consumer staples shares endured losses.

Trade tensions clearly deserved much of the blame for stock prices being unable to follow profits higher. Market indexes recorded sharp intraday declines on several occasions in the quarter following the announcement of new tariff threats from the Trump administration, as well as vows of reprisals from U.S. trading partners.

Whether the mounting threats were merely negotiating tactics on all sides remained unclear, but markets appeared to waver late the in the quarter as evidence emerged that the prospect of tariffs was already impacting corporate strategy and profit outlooks. Stocks slumped in particular on June 21, after German automaker Daimler lowered its profit outlook due to prospective higher tariffs on SUVs it manufactures in the U.S. and sells in China. A few days later, Harley-Davidson revealed in an SEC filing that it was planning to move some of its motorcycle production overseas to avoid retaliatory tariffs recently announced by the EU. Shares of Boeing, Caterpillar, and other U.S. industrial firms also fell sharply late in the quarter as concerns grew about their export markets. Signs of slowing growth in Europe and China, even in advance of an all-out trade war, also weighed on sentiment toward exporters.

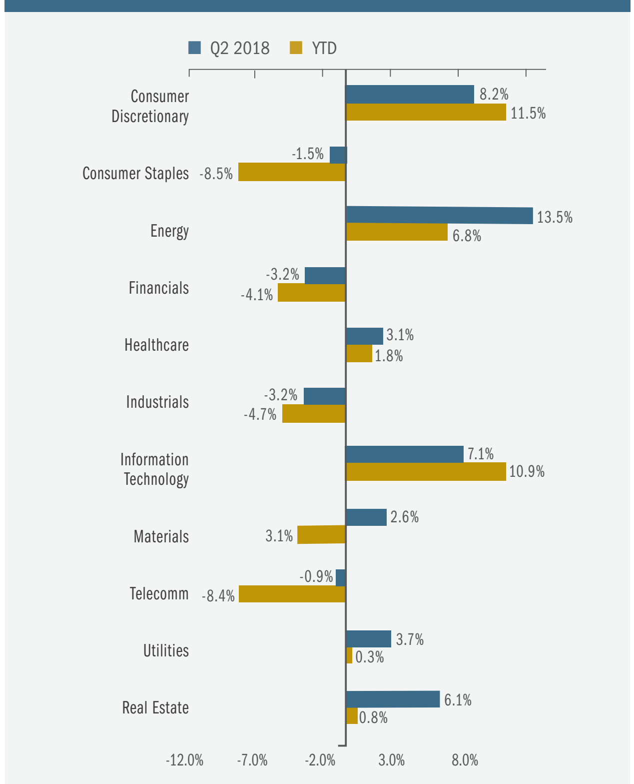
Investors seem to have priced in the fact that S&P 500 earnings growth will be solid this year, suggesting their focus will begin to shift to what lies ahead. It will be important to look for any signs that earnings may begin to come under pressure from higher rates, higher wages, higher input costs, or a combination of the three. Furthermore, the current earnings season will bring with it new information about how companies plan to spend their repatriated funds. Companies brought back about $200 billion in the first quarter, spending most of it on buybacks and dividends; with trade uncertainty looming large, however, it seems unlikely that companies will use these funds to ramp up investment spending until there is a bit more clarity around the path ahead.

Developed international equities slide into negative territory

International stock markets posted losses in the second quarter, as President Donald Trump's tariffs on steel and aluminum imports rattled international markets, and retaliatory tariffs against U.S. products sparked worries about a global trade war amid slowing growth in some key markets.

Within the MSCI EAFE Index, which tracks developed markets in Europe, Australasia, and the Far East, the energy, health care, materials, utilities, and consumer staples sectors posted gains. Financials, telecommunication services, consumer discretionary, and industrials shares underperformed the EAFE benchmark. Growth once again handily outperformed value stocks.

Energy, consumer discretionary, and tech lead the charge in 2018



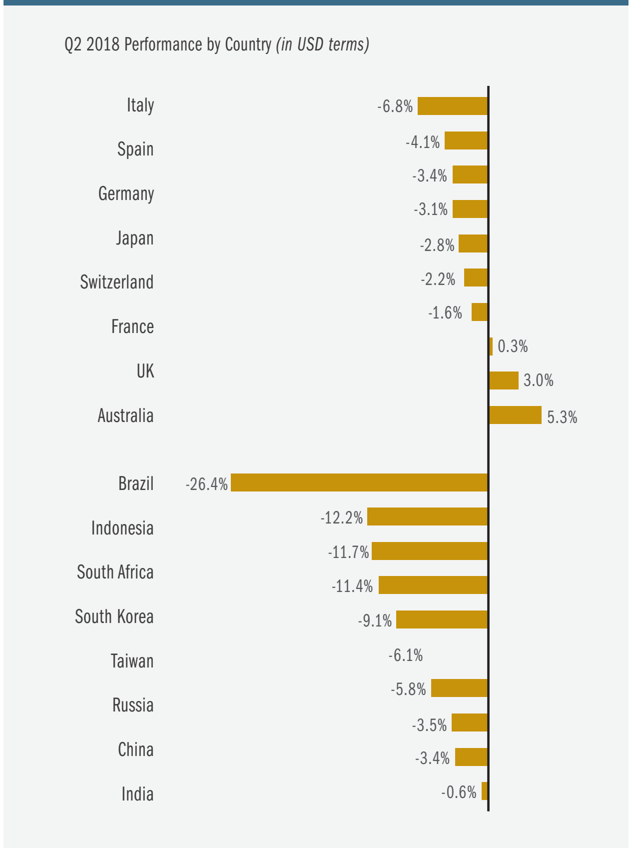
In terms of regional performance, European equities began the quarter in positive territory, buoyed by favorable economic news and relatively strong corporate earnings reports. In May, key indices in France, Germany, and the UK reached their highest levels this year before losing ground as political and trade concerns came to the fore. Markets were most rattled when Italy formed a coalition government of the populist Five Star Movement and far-right League party as the two parties vowed to increase fiscal spending and proposed anti-EU establishment policies that could threaten Italy's membership in the EU. Bank stocks were notably weak amid concerns about Italy's vast public debt and high level of nonperforming loans, recovering some of their losses only after the two political parties strongly endorsed the EU at quarter-end.

Japanese equities weakened for U.S. dollar investors as the yen fell versus the dollar and underperformed the broad EAFE bench-mark. Markets posted particularly sharp declines as investors worried Trump might levy additional tariffs on Japanese imports. Weakness in business spending, residential investment, and private consumption combined to push the country's GDP into contraction territory, ending eight consecutive quarters of economic expansion. The Bank of Japan maintained its negative short-term interest rate target and kept its yield curve control policy in place. The June meeting statement indicated that while the economy is expanding modestly, inflation remains in the range of 0.5% to 1%, well below target. BoJ Governor Haruhiko Kuroda warned about "significant consequences" for the Japanese economy due to the brewing trade battle between the U.S. and China.

Emerging markets slump as stronger dollar and rising U.S. rates curb risk appetite

Emerging markets stocks slumped in the second quarter of 2018 as a stronger dollar and policy tightening in the U.S. diminished the appeal of these riskier assets. The dollar surged against nearly all global currencies, raising the cost of paying off U.S. dollar-denominated debt in the developing world. In June, the Federal Reserve increased its benchmark rate for the second time this year and forecast a total of four increases in 2018, up from a prior forecast of three increases. The more aggressive pace of U.S. rate hikes reduced the attractiveness of foreign assets and increased worries about further currency depreciation. During the quarter, central banks in Indonesia, Turkey, and the Philippines repeatedly raised interest rates to stabilize their currencies. A brewing trade dispute between the U.S. and China also dampened risk sentiment as investors fretted that an escalating conflict would hurt the synchronized growth that drove last year's global economic expansion. The MSCI Emerging Markets Index recorded its worst quarterly performance since September 2015. All 11 sectors in the index fell, led by financials stocks. Energy stocks declined the least as oil prices surged to multiyear highs.

International and emerging markets stocks sustain serious losses in the second quarter



Chinese stocks fell, with yuan-denominated A shares dropping nearly 17% in the quarter. China's benchmark Shanghai Composite Index entered bear market territory and the yuan fell to its lowest level since November near quarter-end as weaker economic signals and rising trade tensions with the U.S. worried investors. Southeast Asian stocks fell, led by Thailand's nearly 15% drop. The Philippine central bank raised its benchmark rate twice during the quarter to curb inflation and shore up the peso. Bank Indonesia hiked its key rate three times within six weeks to stabilize the rupiah, which has shed more than 5% in 2018 and ranks among the worst-performing currencies in Asia. However, Thailand's central bank left its key rate unchanged near a record low and raised its economic growth forecasts for 2018 and 2019. Indian stocks declined when India's rupee currency slid to a record low near quarter-end as surging crude oil prices revived inflation concerns and caused the country's fiscal and current account deficits to widen.

Mexican stocks shed 3.5% in the quarter amid uncertainty regarding the fate of ongoing trade talks with the U.S. and the outcome of the country's presidential election in July. In June, Mexico's central bank increased its benchmark rate for the second time this year to support the peso. It also warned that the balance of inflation risks has worsened and that Mexico's growth outlook remained tilted to the downside.

Brazilian stocks sank about 26% as the real weakened, at one point touching its lowest level in more than two years in early June. Brazil's economy grew more than expected in the first quarter, but a crippling nationwide truckers' strike in May, uncertainty ahead of the presidential election in October, and rising interest rates worldwide undermined confidence in the country's outlook.

Andean markets were mixed: Stocks advanced in Colombia after Ivan Duque, an investor-friendly candidate, won the country's presidential election. Stocks in Chile and Peru retreated. Central banks in both countries left their respective interest rates on hold over the quarter. However, in June, Chile's central bank revised its 2018 growth target upward and hiked its inflation forecast amid surging prices for copper, the country's top export.

Russian stocks shed nearly 6% in the quarter, weighed by large declines in April after the U.S. imposed sanctions on Russian oligarchs and companies with ties to President Vladimir Putin in retaliation for the country's actions in Syria and other aggressions worldwide. In June, Russia's central bank kept its benchmark interest rate unchanged but lifted its inflation forecast, a surprisingly hawkish move that arose from a proposed hike in the nation's value-added tax.

Turkish stocks plunged almost 26% as the lira hit a record low in April, and the central bank hiked interest rates each month during the quarter to stop the currency's slide. A rally in Turkish assets following President Recep Tayyip Erdogan's election fizzled out within a day as investors resumed worrying about the overheated economy and the President's heavy-handed discussions of monetary and economic policy.

Finally, South African stocks ended down almost 12% for the quarter as investor optimism depleted in the face of wretched economic statistics. New President Cyril Ramaphosa will have his work cut out for him getting the economy back on track, but made a bold move in July by refusing to sign a deal with Russian state firm Rosatom to increase South Africa's nuclear-power-generating capacity over concerns it would cost too much.

High yield and municipals outperform as rates continue to rise

Global bond markets suffered from bouts of volatility in the second quarter due to a confluence of factors. These included a greater dispersion between accelerating U.S. growth and a softening of economic activity elsewhere, escalating trade tensions between the U.S. and China and the formation of a populist coalition government in Italy.

U.S. 10-year Treasury yields rose from 2.74% to 2.86%. They rose significantly in April, touching a seven-year high in mid-May, as growth and inflation expectations continued to build, before risk aversion and "safe haven" buying led to a significant retracement. Bund 10-year yields fell from 0.50% to 0.30% on safe haven demand and as European data saw further softening. In contrast, Italian 10-year yields increased from 1.79% to 2.68% and two-year yields from -0.33% to 0.72%, as the formation of a populist coalition government in May raised concerns over Italy's future relationship with Europe. Spain suffered some contagion effect with 10-year yields rising from 1.16% to 1.32%.

The U.S. yield curve flattened with two-year yields increasing from 2.27% to 2.53%. The spread between two and 10-year yields reached its lowest point since 2007. The Fed raised rates and kept to its hawkish tone at its June meeting.

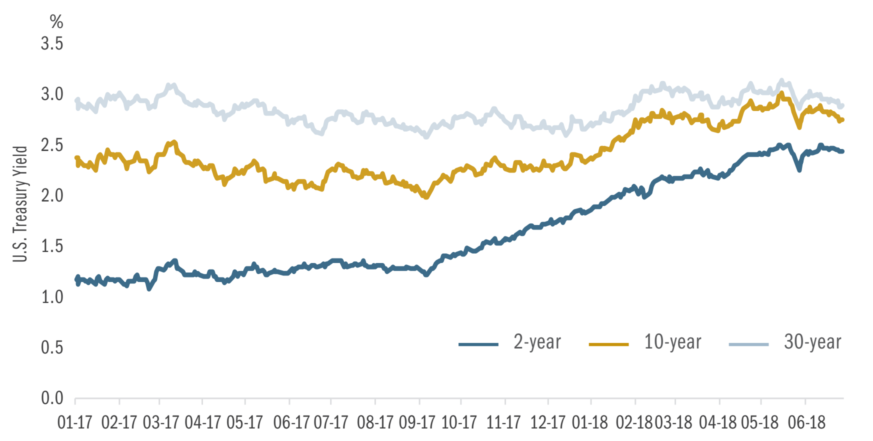
In the investment-grade corporate bond universe, prices declined amid heavy supply driven by merger activity. Mortgage- and asset-backed securities prices edged higher as investors sought quality safe havens and the yield curve flattened. High yield bonds benefited from stock market gains, generally positive earnings reports, and low default levels. The sector generally is less sensitive to interest rate fluctuations than other fixed income segments. Light issuance and inflows also provided support, and below investment-grade energy issuers received a boost from rising oil prices. Bank loans likewise recorded gains.

Municipal bonds benefited from a favorable technical environment as issuance for the first half of the year was down about 20% from the same period in 2017 amid a sharp drop in refunding deals. Lower-rated munis such as tobacco bonds outperformed as investors sought out higher yields. Although market fundamentals remained solid overall, S&P Global Ratings lowered its credit ratings on Connecticut and Kentucky amid concerns about the states' unfunded pension liabilities.

Emerging markets debt produced negative returns, hampered by faltering investor sentiment, a stronger dollar, and some country-specific issues. Argentina's central bank hiked rates 12.75% over an eight-day period starting on April 27, lifting the country's benchmark lending rate to 40% as the bank sought to halt a precipitous drop in the peso. Several other emerging markets' central banks, including India and Turkey, also raised rates to try to strengthen their currencies. In Russia, bonds were pressured after the U.S. imposed sanctions in April on Russian business leaders, government officials, and companies with ties to President Vladimir Putin in retaliation for alleged meddling in the 2016 U.S. elections.

Convertible bonds showed their protective qualities in the second quarter against volatile equity markets. The primary market was very active and the new supply has resulted in a slight cheapening in valuations in a segment that has historically performed well in periods of rising rates and equity market volatility.

Dramatic yield curving flattening raises fears of inversion



Commodities are a mixed bag as precious metals and agricultural commodities drop on trade wars while the energy complex surges

The Bloomberg Commodities index posted a slightly positive return in Q2. Crude oil prices continued to rally, with President Trump's decision to withdraw the U.S. from the Iran nuclear accord contributing to higher prices, despite OPEC announcing plans to boost supply. The industrial metals index registered a small gain. Nickel (+11.9%) and aluminum (+8.4%) were firmly up while zinc (-11.5%) and iron ore (-1.7%) lost value. The agricultural component registered a sizeable decline with grains prices losing value on global trade concerns.

Soybeans in particular were weak as China typically purchases one-quarter of this annual oilseed crop from the U.S. Without exports to China, the chances of a glut in the bean market increase dramatically, especially if the 2018 crop is at the same level or higher than it was over the past half-decade. Despite increasing risk aversion in the markets, gold and silver fell -5.4% and -1.6% respectively.

Looking ahead

Make no mistake about it: the headwinds blowing in the face of risk assets have picked up. Growth in business activity has slowed a bit, especially in Europe. Monetary policy in the U.S. is getting tighter, and is set to become less expansionary in Europe as well. Inflation has ticked higher, driven by synchronized global growth and a tightening of labor markets and industrial capacity in the U.S., Germany, the UK, China, and elsewhere in Asia. A jump in oil prices is also pushing headline consumer-price index readings to their highest levels in several years; OPEC and Russia have shown a fair degree of discipline in constraining the supply of crude oil at a time when demand is strong and inventory levels have fallen. Some developing countries have been forced to raise their policy rates dramatically to defend their currencies. Most important, the stoking of trade-war tensions by the U.S. threatens to undermine the very foundation of the system that has supported the global economy since the end of World War II. Although the actual trade actions to date have been modest, the impact on global supply chains bears close watching.

Economic conditions and earnings trends remain favorable, but markets may have continued heightened volatility due to high valuations, rising interest rates, and potential geopolitical events. The U.S. corporate tax cut has been positive for equities, but potential inflation and trade tensions represent sources of risk. That said, high valuations are concentrated in a relatively narrow subset of the market; there are many reasonably priced securities from which our managers can select. And the raging bull market optimism that characterized investors at the start of the year has faded dramatically as the news flow has turned less favorable. As far as we're concerned, that is more than okay—because the potential for a meaningful advance in equities is greater when investors are pessimistic and bad news is already largely discounted in the price of riskier assets.

Our recommended tactical tilts in portfolio allocation reflect the political risk premium that exists in markets around the world

	Negative	Neutral	Positive
EQUITIES		•	
U.S. Large Cap			•
Non-U.S. Large Cap	•		
U.S. Small Cap		•	
Non-U.S. Small Cap			•
Emerging Markets		•	
BONDS	•		
Investment Grade	•		
High Yield		•	
ALTERNATIVES			•
Hedged Startegies			•
Real Estate	•		
Hybrid / Opportunistic			•
Commodities	•		

We will be watching closely how this drama plays out in the months ahead. With any luck, the Trump administration will shy away from further ratcheting tensions. But we must admit that does not seem to be in the cards in the near-term.

However, if one believes, as we do, that the global economy is sound and that the political uncertainties currently roiling markets will be contained, then the proper course (in our view) should be to remain exposed to equities and other risk assets and ride out the short-term ups and downs.

With earnings growth looking solid, equity valuations in-line with or below their long-term averages around the world, and interest rates still historically low, stocks should be able to rally into 2019. However, the torrid pace of returns experienced in 2017 has clearly come to an end. Even with the downside of rising interest rates, fixed income remains an important ballast in portfolio construction. Though bonds will likely continue to offer low returns, they offer security in what at times seems an unsecure world. Alternative investments, which behave in different ways from traditional stocks and bonds, can provide differentiated returns and risk that are compelling in these uncertain times. As always, diversification should remain the central tenet of all investment plans given the political risk premium which continues to exist in markets around the world.

SOURCE FOR ALL GRAPHS: Bloomberg.