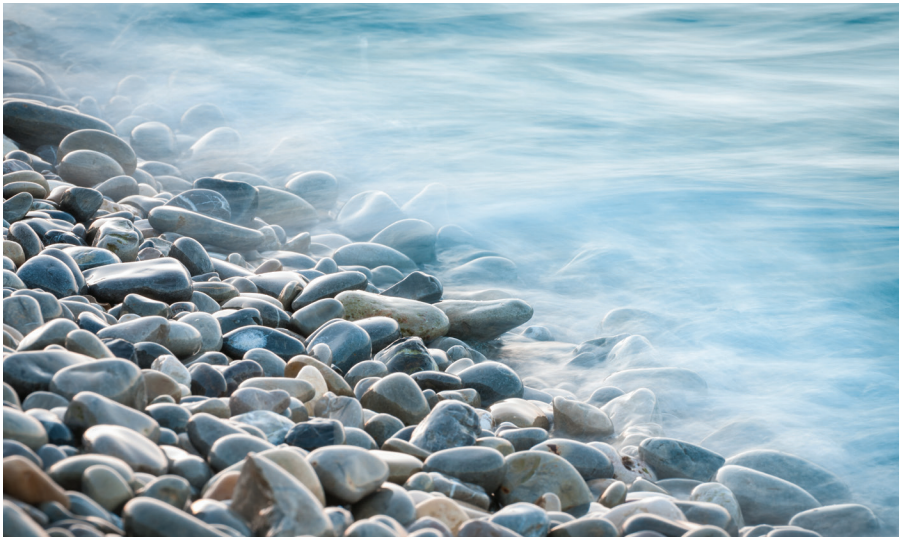


# Perspectives

*Keeping you informed and engaged about macroeconomic trends and market events*



*“There has never been a time of greater promise, or greater peril.”*

—Professor Klaus Schwab  
*Founder & Executive Chairman of the World Economic Forum*

## A Stormy Quarter: Treasury Turmoil, Tariff Tantrums & Tech Wrecks

2018 BEGAN MUCH AS 2017 ENDED, with steadily rising equity markets, low interest rates, and burgeoning market optimism. Strong economic growth against a backdrop of moderate inflation had just gotten a boost from the successful passage of the Trump administration’s tax cuts, not to mention continued monetary accommodation from global central banks. But then, a couple of strong economic data reports perversely caused investors to question whether the economy was beginning to overheat and inflation was beginning to rise. Quickly, the narrative shifted to a fear of rising inflation, increased central bank tightening and, most importantly, rising bond yields. This change caused previously (over)emboldened inves-

tors to quickly reposition for a shifting environment. As bond investors pushed yields higher, stock investors pushed equities lower.

After a few weeks of rumbling and investor repositioning, this selling eventually subsided only to see the market be hit once again, this time when President Trump announced tariffs on imported aluminum and steel and on other Chinese products (largely geared at challenging intellectual property theft). This followed action in January when Trump imposed tariffs on solar panels and large-scale washing machines. In themselves, these measures may have a limited impact on the U.S. economy (though some point to the possibility of more meaningful downstream effects).

### IN THIS ISSUE

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There is great optimism for the global economy based on fundamentals, but policy risk is increasing due to growing fiscal deficits, the potential for more hawkish monetary policy, and protectionist tensions.

2

U.S. corporate profitability and economic data such as employment and rising household income continue to improve. Fiscal stimulus from tax cuts should add to growth, but at the expense of much higher deficits and higher interest rates down the road.

3

Some European leading economic indicators have declined from historically elevated levels, but overall remain supportive. Improving domestic and overseas demand suggests that Japanese GDP could continue to trend higher in 2018.

4

Emerging market company fundamentals continue to improve across most countries and sectors; the prospect of rising inflation, rate hikes, a stronger U.S. dollar, and a trade war remain risks for the asset class.

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**FANG volatility raises worries in first quarter market action**



What worries many commentators is the possibility that these are only initial steps, both in terms of where the U.S. may end up (American economists still hark back to the devastating effects of the Smoot-Hawley tariffs in the 1930s), and in terms of possible reprisals from other countries. Indeed, China immediately announced its own countermeasures as a result.

This situation is changing daily, but will need to be watched closely. As it stands now, Trump has temporarily excluded six countries, including Argentina, Australia, Brazil, South Korea, Canada, Mexico and the European Union, the U.S.’s biggest trading partner, from higher U.S. import duties on steel and aluminum as discussions continue.

As an aside, South Korea was excluded because of its important security relationship with the U.S., including a shared commitment to eliminating the North Korean nuclear threat. At press time, South Korean President Moon Jae-in is pushing for a three-way leaders’ summit with North Korea and the U.S. aimed at ending the nuclear threat on the Korean peninsula.

Another big story of the quarter was the large swings in so-called ‘FANG’ (Facebook, Amazon, Netflix, Google) stocks in the U.S. These stocks represent some of the largest companies in the U.S. stock market, and their price moves can have significant effects, both directly on the overall U.S. index, and indirectly on markets around the world.

For its part, Facebook’s role in the 2016 U.S. election grew more complicated when bombshell reports in *The New York Times* and *The Guardian* revealed the extent to which London-based data mining and analytics firm Cambridge Analytica misused data from as many as 50 million Facebook users. The data was obtained by Cambridge psychology professor Aleksandr Kogan and given to the affiliated behavior research firm Strategic Communication Laboratories in a violation of Facebook’s terms of service. The actions of the firm, which denies any wrongdoing, has kicked up a massive debate over Facebook’s failures to police its platform and its responsibility to both user privacy and the institution of democracy itself. That said, CEO Mark Zuckerberg’s recent testimony to Congress was well-received by the markets, in that he sincerely apologized to lawmakers for failing to protect user privacy, while not relenting in his defense of his company’s platform, strategy, and monetization plans. And there can be little doubt of the power of this business model, as despite the controversy, Facebook reported stellar first quarter results, with a double-digit increase in daily active users and a surge in mobile advertising revenue.

Elsewhere in the tech sector, Nvidia and Tesla sagged over concerns over driverless car safety, while Amazon was in the crosshairs after suggestions that Donald Trump would increase regulation on the internet giant. Many speculate Trump is clapping

back at Jeff Bezos, owner of *The Washington Post*, for unflattering news coverage, especially as it relates to special prosecutor Mueller’s investigation of Russian collusion and the more recent FBI investigation into Trump’s personal lawyer, Michael Cohen, including his involvement in an alleged payoff made to pornographic actress Stormy Daniels during the campaign.

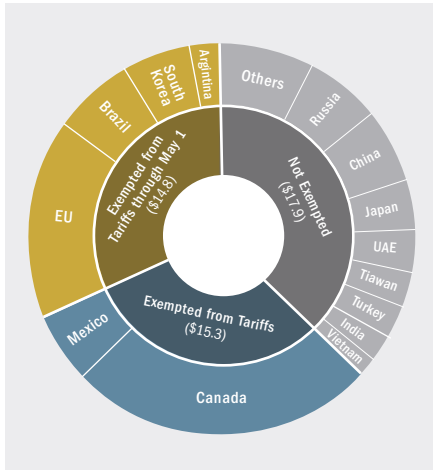
Putting aside the risks and implications of the Mueller investigation and Michael Cohen’s legal problems, which continue to evolve and will be a focus item especially as we move closer to the mid-term elections, it seems worthwhile to reflect on the potential for a tariff tantrum and tech wreck to increase market volatility in the months ahead. And in this regard, we urge investors to remain not only calm, but look actively for buying opportunities when the markets become overwhelmed by news headlines and lose focus on the fundamentals.

To state the obvious about a man who is the subject of a book titled “The Art of the Deal,” President Trump views himself as a negotiator. We believe that in any negotiation, the conversation starts with an opening bid or anchor from which to negotiate. Investors continue to react – and, in some cases, overreact—to the President’s tweets which we have come to see as “opening bids.” Indeed, the aluminum and steel tariffs were initially broad based in their application, but over the past few weeks they have been winnowed down. After initially being subject to the tariffs, Australia, Canada, Mexico, the European Union, Argentina, Brazil and South Korea are now exempt, as they are allowed to negotiate a different path forward. And while China is not on the above exempt list and has since been subject to more potential tariffs, we continue to believe that the U.S. and China will eventually find common ground.

While many focus on the risks to the U.S. economy in a trade war scenario, Chinese trade practices do create long-term strategic threats to the U.S. economy. U.S. corporations are frustrated with China’s policy requiring foreign companies to turn over source code and other proprietary technology in exchange for access to the Chinese market. If China’s current strategy continues, high-tech Chinese companies will be

## Two-thirds of U.S. steel and aluminum imports exempted

US Imports of Steel and Aluminum, by Trading Partner and Tariff/Exemption Status (Billions)



able to gain the best western technology and become much more competitive globally. This has major long-term implications for many U.S. companies and industries that currently maintain global leadership.

It is for this reason that comments from Chinese Premier Li Keqiang at the end of the quarter helped allay trade war anxiety and boosted markets. The premier stated that China would not force foreign firms to transfer technology to Chinese partners and that China would look to strengthen its intellectual property rights—addressing two important areas of concern for the U.S. Also, as part of ongoing negotiations, China offered to import more semiconductor chips from the U.S., which will reduce its purchases of South Korean and Taiwanese chips. Although the situation remains fluid, productive dialogue is happening, suggesting what we may ultimately be experiencing is more of a trade skirmish than a war.

And clearly China does not want a full scale trade war. China accounts for the largest share of the U.S. trade deficit at about 50%, almost the same as the total share of the next five economies (Canada, Mexico, Japan, Germany, and Saudi Arabia). Also, the Chinese government is focused on its own economic stability, which means economic growth and job creation—and a trade war is clearly not conducive for this. In fact, the U.S. is arguably in much better position to handle the fallout of a trade war; we have a relatively

closed economy by comparison, as exports constitute approximately only 8% of U.S. GDP compared to 16% of GDP in China.

Of course, China has already shown it can respond to U.S. trade relationship changes with retaliatory tariffs or by reducing imports and delaying business deals signed with the U.S. They could also subsidize exports in areas affected by tariffs. U.S. industries with significant exports to China that would be most at risk include semiconductors, tech hardware, aircraft, vehicles, agriculture, nuclear reactors, and electric machinery. And though the threat always exists, we do not think China will sell U.S. Treasuries at this stage, as this would weaken the dollar, which would help U.S. trade.

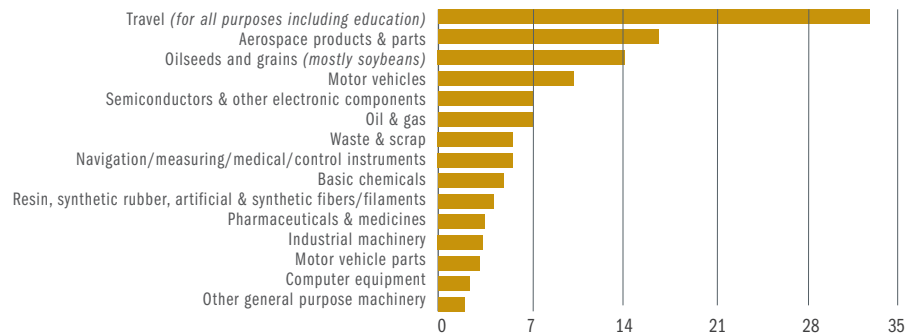
Chinese Premier Li Keqiang’s recent comments that China is prepared to ease market access for U.S. companies and stop forcing foreign companies to transfer technology is the kind of win we believe Trump is after. Indeed, if Trump gets those kinds of concessions in writing, he would be able to say he did more for America against China than Obama, Bush, or Clinton, of key importance to him before mid-term

elections. Yet those changes would do little to alter the record U.S. trade deficit with China or to deter China from plans to go head-to-head with the U.S. in many high-tech sectors soon. If Trump wants those major concessions, he has to be ready to go much harder against the Chinese. And so far, Chinese President Xi appears to be betting that Trump will cave to political pressure before that happens, or has a much more targeted set of trade concessions as his aim anyway. And ultimately, those scenarios may be what are for the best for our global economy.

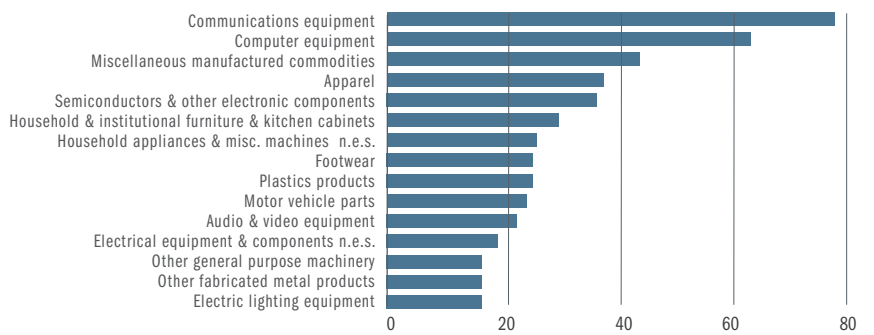
Indeed, globalization has played an important role in the returns of all assets in recent decades, whether it has been in driving lower inflation outcomes and bond yields, or in the ability of global corporations to deliver stronger earnings than they have in the past. Protectionism could serve to reverse these trends, though we would argue the ability to ‘put the genie’ back in the bottle given our increasingly interconnected world. Likewise, the true willingness of politicians to close their economies remains to be seen.

## Top 15 U.S. Exports to China and Chinese Exports to the U.S. in 2017

### 2017 Top U.S. Exports to China



### 2017 Top Chinese Exports to U.S.



As such, we continue to advise that investors not overreact to any political actions because the overall global economic machine is a bigger force. However, we concede that presidents and their administrations can target/impact individual stocks and certain economic sectors. Indeed, after being heavily regulated in the Obama administration, it appears as if the banking industry is set to get some relief, and it is obvious that the Trump administration wants to see a vibrant domestic manufacturing sector. And on the other side of the equation, it appears as if the technology

sector could find itself in political crosshairs in the coming quarters as we debate its use of the massive amount of data it collects. Notably, one sweeping new EU regulation, called the General Data Protection Regulation (GDPR), is set to roll out in May and will require that EU citizens receive more information about what data tech companies collect and why. Companies will face fines of up to 4% of their global annual revenue for non-compliance and breaches. Regulation is proving to be complicated, however, as big American tech companies say Europe's tightened regulations and

higher taxes, while meant to protect European citizens and their businesses, could isolate the EU and stifle innovation.

Ultimately, these complex issues and their associated political narratives must be monitored as they evolve. Achieving ideal results will require renewed dedication to productive, bilateral consultation and negotiation. However, underlying economic fundamentals continue to point to a global economy that is still very much moving forward, and U.S. Treasury market turmoil, tariff tantrums, and tech stock volatility are unlikely to shift that trajectory, at least not yet.

## GLOBAL ECONOMIC OVERVIEW: Marching Along

**AFTER HITTING ITS STRIDE IN 2017**, the world economy is on track for another year of robust growth. The expected upswing from 3.8% to 3.9% GDP reflects a synchronized acceleration among advanced and emerging market economies with a notable rebound in global trade which is now expanding three times as quickly as in 2016.

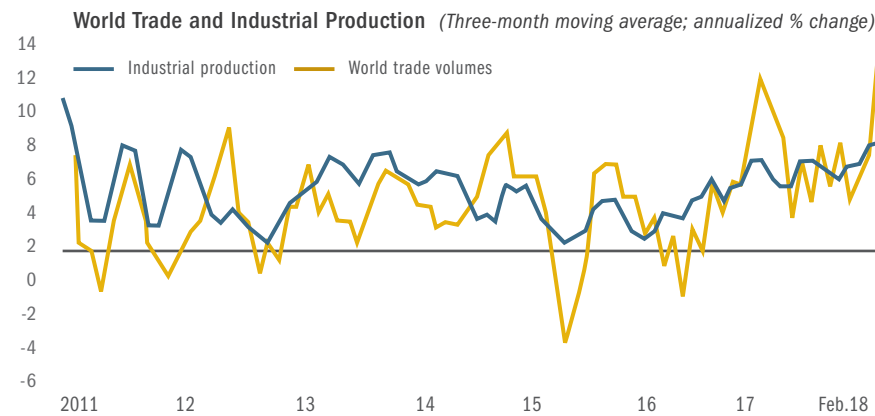
pace of growth over the last decade. Growth in overall GDP as well as in the manufacturing and services sectors remains solid but has cooled off slightly this year. For its part, the UK continues to lag other European economies in terms of GDP growth thanks to Brexit uncertainty, though a weak pound sterling and strong demand from trading

domestic demand. President Xi Jinping has locked in his political power, put in place a team of experienced and reform-minded officials to guide economic policy, and hinted at major economic and financial reforms. The key challenge for China is the execution of proposed reforms not just to the financial system but also to other parts of the economy, especially the state-owned enterprises.

That said, risks in the environment increased during the quarter, as concerns about protectionism are elevated again. As discussed, China and the U.S. announced new tariffs against one another; the initial volleys were strategically designed, but modestly scaled. Also, we are now less than a year from Brexit. Both sides would like to show strength while preserving productive commerce. Even if negotiations with the European Union can be successfully completed, the UK still faces the challenge of negotiating a large number of trade pacts with other parts of the world. Time is short, and the degree of difficulty is high. And NAFTA (North American Free Trade Agreement) is being renegotiated amid heightened rhetoric and the approach of Mexican and American elections.

Renewed volatility in financial markets reflects these rising risks. However, worst case outcomes are by no means assured: policy makers still have opportunities to keep the global expansion on track. We suspect the pressure to maintain current economic momentum will help keep these key risks at bay for now.

### Global growth strengthens thanks to rising industrial production and trade



Financial conditions globally remain accommodative and supportive of the recovery. Central bank monetary policy moves have been well telegraphed and absorbed smoothly by markets. Withdrawal of monetary support in the U.S. continued, with an increase in short-term interest rates in March, though the effects are being offset by fiscal stimulus with the passage of the Tax Cuts and Jobs Act at year-end.

In 2017, the euro zone turned in its fastest

partners has helped boost net exports. The Japanese economy, which is in the midst of a long and mostly steady expansion, continues to perform well but is facing a slowdown in domestic demand as wage growth eases.

Emerging markets contributed to the broad-based and synchronized global upturn last year and many are on track to turn in an even better growth performance in 2018. China's growth remains robust and well balanced across sectors and across categories of

## U.S. ECONOMY: Still Got It

**U.S. ECONOMIC DATA** releases since the beginning of the year have been somewhat mixed. After slipping in the first two months of the year as consumers pulled back after heavy spending during the winter holidays, retail sales rose 0.6% in March, while auto sales jumped 2%, the most in six months. Readings from the Institute for Supply Management’s (ISM) purchasing managers’ indexes across manufacturing and services did ease a little in March, but they remained

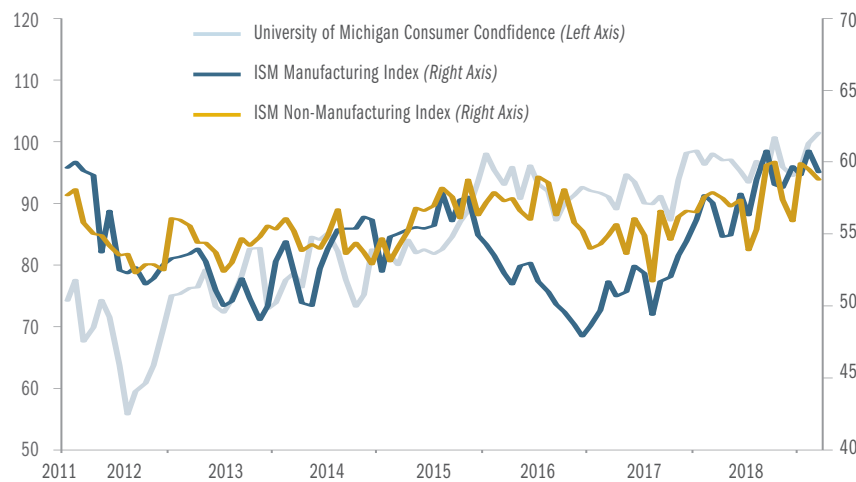
at elevated levels and suggested continued solid expansion. While first quarter U.S. GDP growth slowed to 2.3% from the fourth quarter’s 2.9% pace, the slowdown was due to seasonal factors and the pace of expansion actually better than expected. Economists expect growth will accelerate in the second quarter as households start to feel the impact of the Trump administration’s \$1.5 trillion income tax package on their paychecks.

Recently appointed Fed Chair Jay Powell presided over a meeting of the Federal Open Market Committee (FOMC) for the first time in March, and at the subsequent press conference he largely stuck to the same script as his predecessor Janet Yellen. Though the Fed’s post-meeting statement added a section highlighting that the economic outlook had strengthened in recent months, he reiterated the aim of gradually normalizing monetary policy, while also pointing out the absence of signs of any imminent acceleration in inflation. The latest set of forecasts from the Fed stirred a little more comment among market participants, particularly the projections for core inflation that were slightly above the central bank’s 2% target in 2019 and 2020, which hinted policymakers might be willing to tolerate such an overshoot if they believed longer-term inflationary pressures were limited.

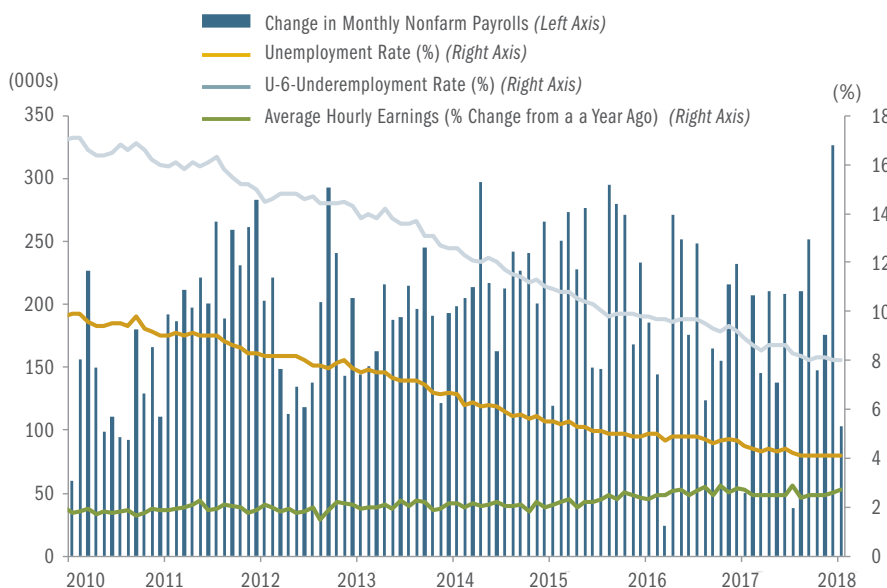
After heightened concerns about inflation early in the year, March’s core personal consumption expenditures (PCE) price index and the equivalent reading for the Consumer Price Index (CPI) indicated a steady but still subdued pace, considering the strength of other economic indicators. The annual rate of 1.8% in the core PCE index was its quickest since April 2017—with higher health care prices among the drivers for the second consecutive month, a reversal of the trend seen in recent years. Meanwhile, core CPI remained at the high end of its recent range at 2.1% according to the most recent March report.

Hiring came in well below consensus expectations in March’s labor market report at 103,000, and revisions subtracted around 50,000 positions from data for the first two months of the year. But after the previous month’s outsized gains, there was speculation weather may have affected recent numbers, particularly in construction, as warmer temperatures in February preceded March’s poor weather in the Northeast. Wage growth increased, albeit in line with forecasts, as a monthly rise of 0.3% pushed the annual rate up 0.1% to 2.7%. The unemployment rate remained

### Activity levels remain robust and confidence hits new highs



### Employment situation continues its progress; wage growth finally picks up in 2018

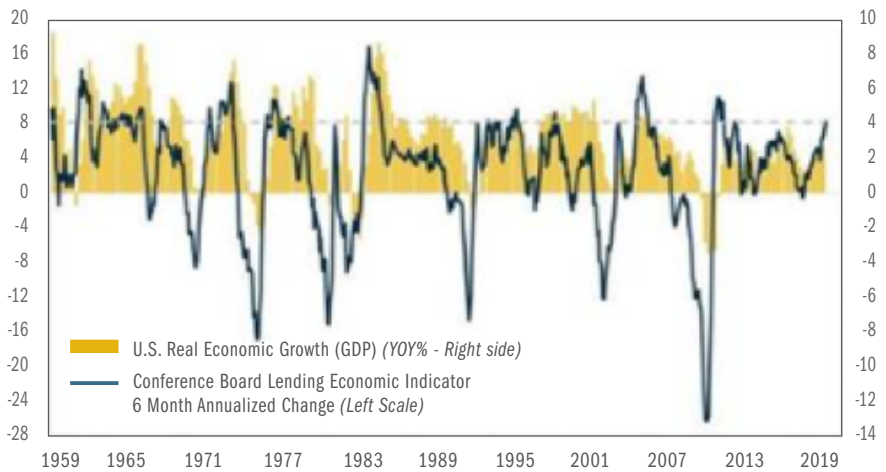


at 4.1% for the sixth consecutive month, although the pace of payroll gains over recent months looked likely to prompt a renewed decline in coming months. The Fed's latest set of projections also anticipated further labor market tightening, predicting the jobless rate could fall to 3.6% by the fourth quarter of 2019.

One year ago, weak first quarter economic growth caused many investors to question whether strong consumer and business survey data would eventually show up in overall U.S. economic growth. We are having a bit of déjà vu as the world seems to be pondering this question once again. Although some indicators of economic growth in the U.S. are showing a slight pullback, we must remember that in the recent past, the trend for first quarter economic growth has been abnormally weak while the rest of the year is strong. We agree with the Fed's assessment about a recent pickup in economic activity and believe the domestic environment is supportive of continued momentum over the rest of the year. To that point, a broad leading indicator of future economic growth, the Conference Board's Leading Economic Index, continued to rise in the quarter, gaining 8.2% in March, one of its highest readings in the last five years.

**Leading indicators lift future expectations**

Accelerating Leading Economic Indicators

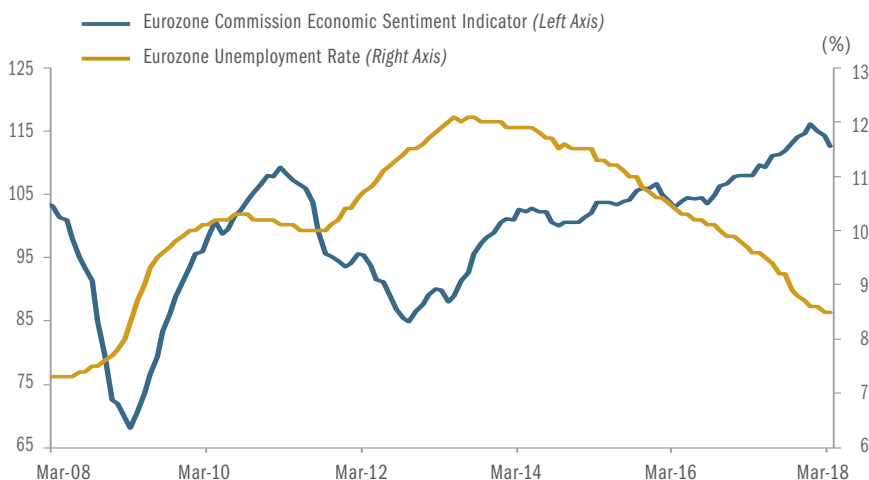


While there may be headwinds from the uncertainty over trade and related equity market volatility, we continue to believe that the economy is set to move forward. At this stage we do not anticipate any impact on the Fed's path of gradually normalizing monetary policy, and it remains difficult to judge whether the rhetoric on tariffs will be translated into substantive action that could meaningfully affect economic activity. That said, several more moderate voices left the White House in the first quarter—Gary

Cohn, Rex Tillerson, and H.R. McMaster—while hawkish ones in Peter Navarro, Mike Pompeo, and John Bolton were elevated, nominated, or appointed. Given these changes, the chances of a more confrontational approach to foreign policy have risen considerably. Developments on trade will likely complicate diplomacy, and a more strident tone on other issues could further isolate allies and increase already heightened geopolitical risk relating to North Korea, China, Russia, and Iran and the Middle East, among others.

**DEVELOPED INTERNATIONAL ECONOMIES: Growing Pains**

**Euro zone employment and confidence still healthy even as growth moderates slightly**



THE ECONOMIC BACKDROP IN THE EURO ZONE remained encouraging over the last three months. GDP growth for the fourth quarter was confirmed at 0.6%, and 2.5% for the year. However, forward looking surveys painted a picture of slightly slower future growth. The composite purchasing managers' index hit a 14-month low in March, albeit the reading of 55.3 still implies solid growth. The region's recovery, however, is underpinned by strong domestic demand, and confidence among consumers and businesses is still healthy, which should limit the negative impact of the stronger euro on exports. Inflation remained weak, with the core measure unchanged in March at 1.0% year-on-year, despite a rise of 0.3% in the equivalent headline

reading to 1.4%, which appeared mainly due to the effect of Easter on food prices.

The ECB's reduction of its bond purchases from €60 billion to €30 billion each month at the start of 2018 may have been an additional factor in some of the data's deceleration. For this reason, toward the end of March, ECB President Draghi reiterated a pledge not to raise interest rates until well after the central bank had ended its quantitative easing program, and then only at a predictable and measured pace. Benchmark German Bund yields ended the month at their lowest point since early January.

On the political front, the key event of the quarter was Italy's election, which yielded no overall winner. The anti-establishment Five Star Movement emerged as the largest single party; President Sergio Mattarella will now mediate talks to form a new government. Germany formed a new government after its inconclusive elections in September 2017. Angela Merkel remains as chancellor after her center-right Christian democratic political alliance (CDU/CSU) agreed to another grand coalition with the center-left Social Democratic Party (SPD).

In France, a critical test of President Emmanuel Macron's reform agenda loomed, as unions representing a wide range of public sector workers organized protests against his proposals. France's railways appeared to be the key symbolic battleground, since its unions had been at the forefront of mobilizing wider public support to defeat attempts by previous French administrations to reform welfare and pensions. In response to President Macron's planned overhaul of the state-owned rail operator that would end its employees' longstanding special privileges, unions launched a series of strikes on the network scheduled to last several months. The French president's approval ratings have fallen back from their peak following his election last year, and though he commands a sizable majority in the French parliament that allows him to push through legislation virtually unchecked, the confrontation looked likely to provide an important test of public opinion on his attempts to improve the competitiveness of the French economy.

Turning to the UK, Brexit-related uncertainty continues, though the UK and the EU signed a preliminary agreement on the

terms of a transition period for the UK's departure from the EU in the first quarter. The agreement appeared to boost the possibility of an orderly withdrawal process, but many of the most difficult political issues—including the nature of the UK's trading relationship with the EU and of the border arrangements between the Irish Republic and Northern Ireland—remained yet to be decided. We suspect a "soft" Brexit deal (similar to the relationship between Norway and the EU) will be achieved that preserves substantial commerce, with the current framework of cooperation maintained in the areas of national security, defense, and foreign relations. However, even in this optimistic scenario, the long-term gains will be dwarfed by costs for the UK.

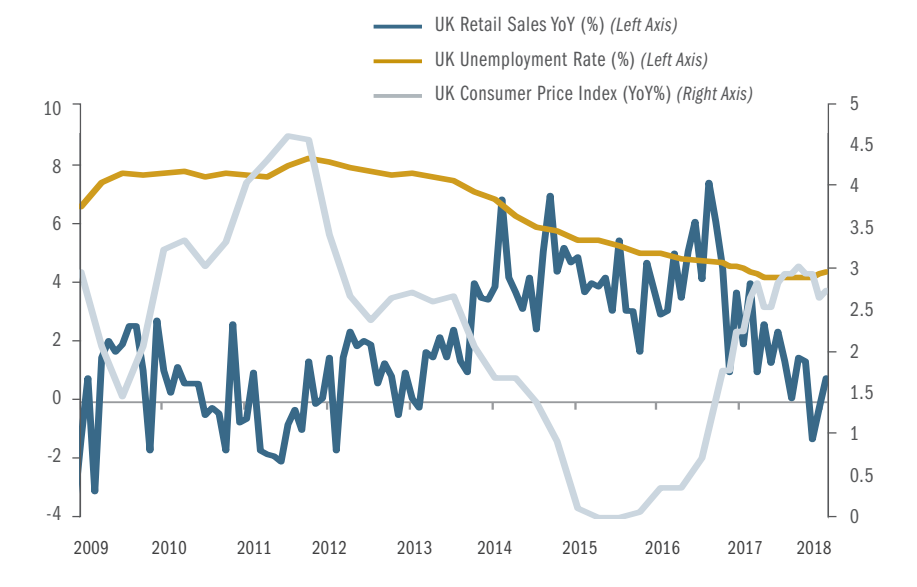
Growth has continued to be underpinned by household spending, though consumers have been squeezed due to past sterling depreciation that reduced real incomes. The boost from trade owing to the weaker sterling should fade, though Brexit-related uncertainty will continue to weigh on business investments, until more clarity emerges on the future relationship. Overall, the real economy is likely to grow by 1.8% in both 2018 and 2019. Labor markets remain tight, and inflation continues to decline as the impact of the post-EU referendum fall in the value of sterling washes out of the system. On the monetary policy front, the

Bank of England is expected to hike overnight interest rates by 25 basis points in May and November, pushing the policy rate to 1.00% this year. They are also projecting one hike of 25 basis points after the official Brexit date in 2019 to contain inflationary pressures.

The Japanese economy experienced a soft patch of economic growth in the first quarter with many indicators of production and consumption slipping slightly. However, Japanese GDP grew at 1.7% in 2017, the country's eight consecutive quarter of growth, and the longest streak since the late 1980s, showing the Abenomics platform of economic improvement remains intact. That said, investment is likely to slide as the boost from construction in the run up to the Tokyo Olympics wanes. Also, the planned consumption tax hike (delayed to October 2019) will further weigh on household spending as we move toward 2019.

Japanese inflation is expected to accelerate to 1.0% in 2018 and 1.5% in 2019, with the near-term profile supported by elevated food prices. Even so, the Bank of Japan (BoJ) is expected to maintain its benchmark policy rate at -0.1% and its yield control target of "around 0%" on 10-year government bond yields. Domestically, new twists in the controversy surrounding the Moritomo Gakuen land sale have seriously dented Prime Minister Abe's

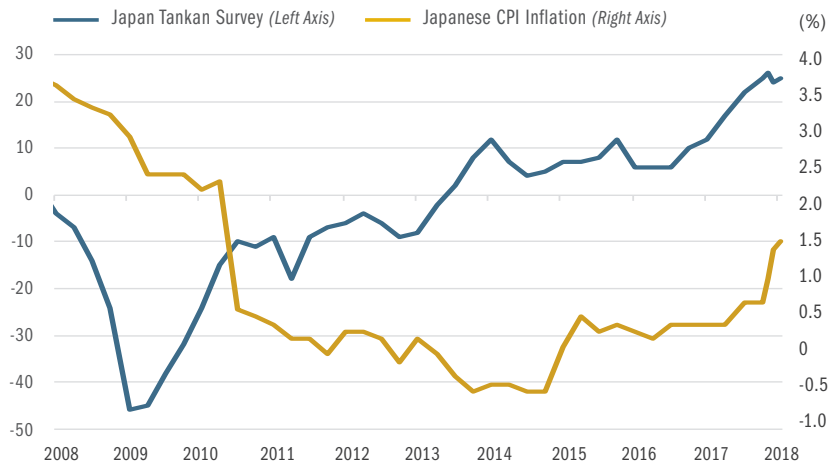
### UK economy hangs in even as Brexit uncertainty rises



approval rating. Nevertheless, Prime Minister Abe has persisted in his dogged efforts to revive the TPP, and in the quarter 11 countries from Japan to Australia, Malaysia and Singapore signed the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). Abe also continues to court Trump in an effort to reopen discussions about U.S. involvement in a trade partnership.

Finally, the decision by the ruling Liberal Democratic Party to recommend the reappointment of current BoJ Governor Haruhiko Kuroda for a second term has eliminated one area of potential uncertainty and should ensure a stable monetary policy environment.

**Japanese economy is firing on all cylinders**



**CHINA & EMERGING ECONOMIES: Forever Xi**

**AFTER HAVING RECORDED A ROBUST PERFORMANCE LAST YEAR**, the Chinese economy seems to have gained further momentum in early 2018, led by export growth and real estate activity. Against this backdrop, Xi Jinping was reappointed as China's president with no limit on the number of terms he can serve, in effect making him the most powerful Chinese leader since Mao Zedong. In his address to the National People's Congress, Xi made it clear he will continue to focus on balancing growth with reform and deleveraging. While he did not name a specific GDP target, economists expect real GDP growth to cool from 6.9% in 2017 to 6.4% in 2018 and 6.1% in 2019. For now, favorable trade momentum should remain supportive of the country's exports; however, an escalation of trade friction with the U.S. could derail export performance and weigh significantly on Chinese growth.

Consumer price inflation, which remained benign in 2017, should accelerate on the back of higher energy prices and robust wage growth but is likely to remain below the People's Bank of China's (PBoC) 3% target. The PBoC is therefore likely to have rates remain on hold, though U.S. rate hikes could lead to higher interbank interest rates and additional volatility in the Chinese currency. As with the Fed, the

PBoC is also in transition, as U.S.-educated economist Yi Gang was named the next governor of China's central bank.

Other developments in East Asia saw North Korean leader Kim Jong Un make his first visit to China, which provides most of the support for his regime, ahead of a planned meeting with President Trump in May. Kim's trip was followed by the first summit between North and South Korea in more than a decade at the end of April. The leaders of the two Koreas discussed the denuclearization of the peninsula, and some of the frames of a potential deal that will satisfy the North Korean leader's desire to secure the position of his regime as well as the geopolitical and security interests of China, the U.S., and its allies.

For its part, India regained its spot as the fastest growing major economy in the fourth quarter of 2017, accelerating by 7.2%. These latest GDP numbers point to a clear strengthening of India's recovery from a sharp slump in the first of 2017, when growth fell from 7% to a three-year low of 5.7% after Prime Minister Modi implemented a demonetization scheme and new GST tax. Some expect Indian GDP growth may surge over 10% in the coming years, as Modi's reforms establish the basis for a new India.

In Latin America, Brazil's central bank cut interest rates to a record low level of 6.5% to stimulate the country's economy, with a recovery from a deep recession that ended last year still struggling to gain momentum. Historically, Brazil has had some of the highest real interest rates in the world, but benchmark rates have declined by 7.75% since October 2016. Inflation undershot the central bank's target for the first time ever in 2017 and has remained relatively weak. Policymakers signaled another rate cut was likely in the coming months, possibly in an effort to combat any effect from political uncertainty, ahead of the country's presidential elections later this year. In early April, one of the leading candidates, the former President Lula da Silva, lost his appeal to Brazil's supreme court against a sentence for corruption, which seemed almost certain to rule him out of the contest. With Lula polling twice the support of his nearest rival prior to the ruling, the court's decision left the outcome of the elections even more unpredictable.

Positive sentiment in South Africa built further on the momentum gained when Cyril Ramaphosa succeeded Jacob Zuma as president in February. Growth for 2017 came in ahead of government forecasts at 1.3%, with data showing the economy picking up pace during the year. In March,

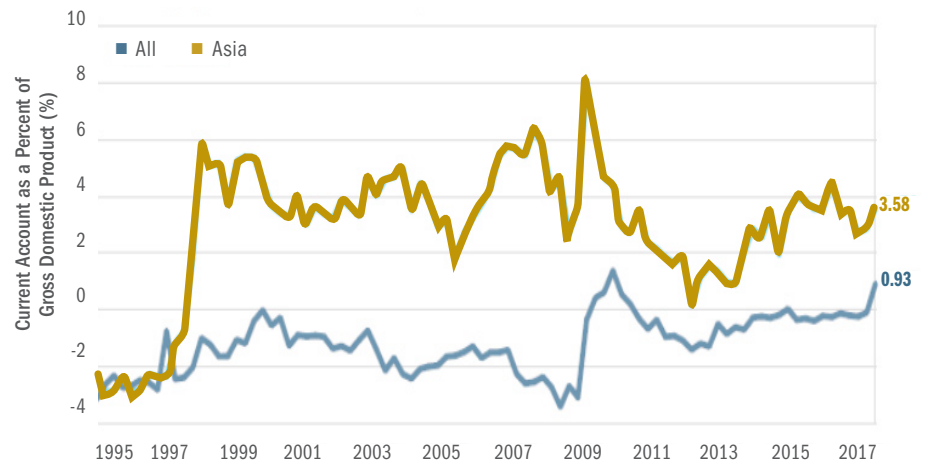


the South African central bank cut interest rates to their lowest point in two years and predicted inflation would stay in its target band of 3%–6% until at least the end of 2020. The country’s bonds and currency received another boost when credit-rating agency Moody’s said it would keep South Africa at investment grade, thus avoiding a relegation to junk status that would have forced some international investors to relinquish their holdings of South African debt. Moody’s cited the significant growth potential of the South African economy, if President Ramaphosa is able to build on his early steps to strengthen the country’s institutions.

Hungary’s election produced a widely expected victory for Prime Minister Viktor Orban’s Fidesz party, its third consecutive success at the polls. The country’s strong economy, as well as Prime Minister Orban’s tough stance on immigration, appeared to be the main factors that drew support from voters. The government retained its two-thirds parliamentary majority that has allowed it to make changes to the country’s constitution, many of which have been criticized by the

### Emerging market current account balances have improved

Surpluses in emerging Asian countries have helped broad EM current accounts. As of June 30, 2017



EU for undermining democratic checks and balances. The policies used by Prime Minister Orban have been mirrored by Poland’s governing Law and Justice party, underlining the difficulties facing the EU in attempting to ensure all member states abide by its rules,

without adding further to populist support.

Finally, this quarter saw the announcement of sweeping new sanctions against Russia for meddling in the 2016 U.S. presidential elections and other malign cyber activity.

### GLOBAL MARKET OUTLOOK: Moody Markets

**GLOBAL STOCKS DECLINED AMID INVESTOR WORRIES** about rising interest rates, mounting inflation pressures, and escalating trade tensions between the U.S. and China. Talk of a potential trade war sent developed market stocks reeling at various times throughout the quarter, while emerging markets stocks largely powered through the turmoil. U.S. equities began the year strongly, boosted by tax reforms, but ended the quarter lower amid concerns over inflation and slumping technology company shares. Eurozone equities posted negative returns as worries over U.S. rates and trade affected other markets. UK equities were negatively impacted by sterling strength amid expectations that the BoE may lift rates sooner and faster than the market had previously anticipated. Japanese equities also declined, especially as heightened uncertainty resulted in a generally stronger yen against major currencies.

Emerging market equities outperformed, as growth accelerated in many constituent countries and commodities rallied. In particular, Brazil gained amid expectations that former President Lula da Silva would be prohibited from participating in October’s presidential elections. Global bond markets reflected higher inflation, with most major government bond yields climbing. Corporate bonds faced some headwinds from elevated supply and waning demand from outside the U.S. Mortgage- and asset-backed securities held up better than the broad market index. Municipal bonds outperformed taxable bonds in a mixed technical environment. New issuance was muted, but there was reduced demand from some banks and insurance companies. High yield bonds declined, but losses were limited by strong investor demand and by the bonds’ lower interest rate sensitivity.

### First quarter volatility surges but at final count markets record only modest losses

Returns of Key Market indices		
MARKET INDEX	Q1 2018	1-year (3/31/17-3/31/18)
S & P 500	-0.8%	14.0%
Russell 2500	-0.2%	12.3%
MSCI EAFE	-1.5%	14.8%
MSCI EAFE Small Cap	0.2%	23.5%
MSCI EM	1.4%	24.9%
Barclays US Aggregate	-1.5%	1.2%
Barclays US Corp High Yield	-0.9%	3.8%
Barclays US Municipal	-1.1%	2.7%
S & P GSCI Commodity	2.2%	13.8%
FTSE NAREIT All REITs	-6.7%	-1.0%

Commodities finally found their footing, given increased global demand numbers, rising inflation, and a flight-to-quality bid for segments like precious metals.

**U.S. equities have a sizzling January, correct in February, and post losses in March**

U.S. equities began 2018 strongly, buoyed by ongoing strength in economic data, robust earnings, and the confirmation of a major tax reform package. However, the latter part of the quarter saw a marked increase in volatility. Investors first digested the destabilizing potential of an elevated U.S. inflation reading and the possibility that Fed may need to become more proactive in raising interest rates in order to keep upward price pressures under control. The Fed did indeed raise rates by 25 basis points in March, to a range of 1.5% to 1.75%. It did not, however, alter its overall rate projection of three hikes for 2018. The announcement quelled some concerns, but escalating U.S.-China trade sanctions precipitated a renewed bout of turbulence in March. Finally, allegations that a data analysis firm improperly acquired information about millions of Facebook users weighed on the tech sector and raised concerns about data privacy and security among Internet and social media companies and the potential for new regulations.

Overall, the S&P 500 Index declined -1.2% in the quarter and posted its first quarterly loss since 2015. The small-cap Russell 2000 Index fared better than the larger-cap benchmarks, while the technology-heavy Nasdaq Composite was the sole major index to record a gain in the quarter. From January 26 through February 8, the S&P 500 Index experienced a “correction,” or a drop of at least 10%. This was the broad market’s first correction since falling about 14% from May 2015 to February 2016. During the quarter, there were 23

days of market moves of more than 1%, compared to a total of 8 days in all of 2017.

S&P 500 sector performance was mixed. Despite losses in March, information technology shares performed the best, thanks to a vigorous rally in January. Consumer discretionary stocks also outperformed the broad index, in part due to strong early performance from Internet-related media and retailing stocks. All other sectors declined, especially the telecommunication services and consumer staples sectors. Telecoms were hurt as rising interest rates weighed on shares of some companies that pay relatively high dividends. Consumer staples stocks struggled due to weakness in sector heavyweight Wal-Mart, whose shares tumbled in February due to lower-than-expected earnings.

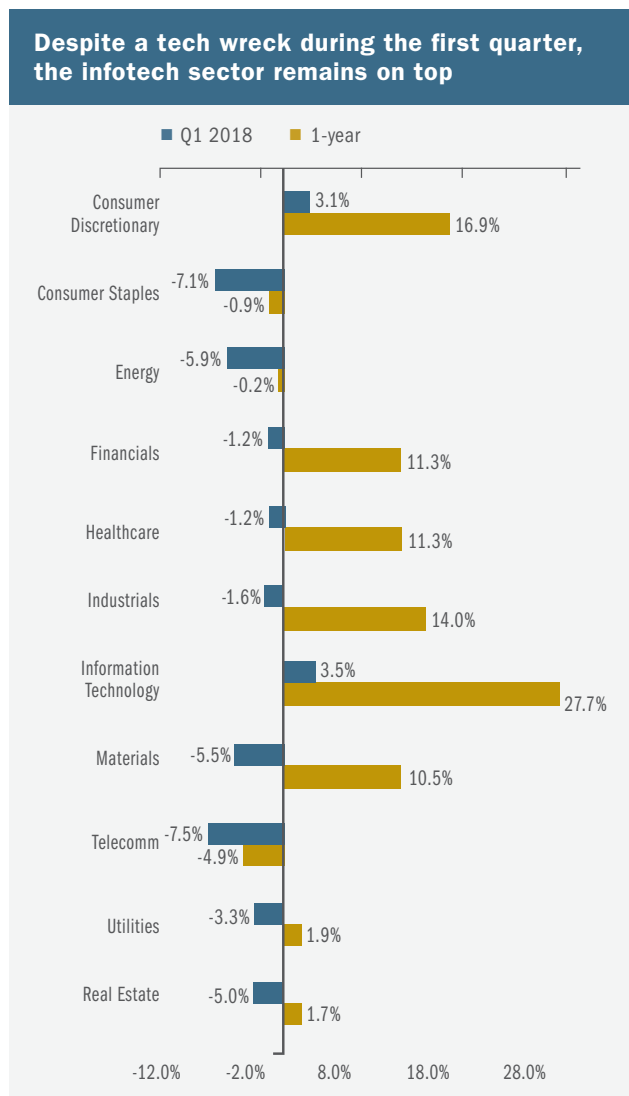
**Developed international equities trade off over worries of trade wars and tech regulation**

Stocks in developed non-U.S. equity markets fared modestly worse than U.S. shares, even though a weaker U.S. dollar versus major currencies reduced losses in dollar terms. The MSCI EAFE Index, which measures the performance of stocks in Europe, Australasia, and the Far East, returned -1.4%. As for sectors, utilities, information technology, and consumer discretionary posted gains, while healthcare, industrials, and real estate sectors recorded losses. As in the U.S., growth stocks outperformed value stocks.

Euro zone equities delivered negative returns in the first quarter, with the bulk of the declines coming in March. The region’s stock markets began the year on a firmer footing but worries about the path of U.S.

interest rates and the outlook for global trade led to declines for the period overall. The worst performers in terms of sectors for the euro zone were healthcare and telecommunication services. These sectors are typically thought of as “bond proxies” offering stable returns and are much sought after when bond yields are low. However, amid expectations of rising U.S. rates, and therefore rising bond yields, such sectors fell out of favor in the quarter. Energy was the only sector posting a positive return while information technology and consumer discretionary saw only modest declines. In terms of countries, Italian stocks rose more than 5%, even though early-March elections resulted in a hung parliament and no coalition government has yet been formed.

The UK’s FTSE Index fell -6.9% over the quarter, performing poorly as gilt yields rose in line with a broad-based sell-off in global bonds. Sentiment towards UK equities struck new lows in the period as overseas buyers continued to shun the market amid ongoing political



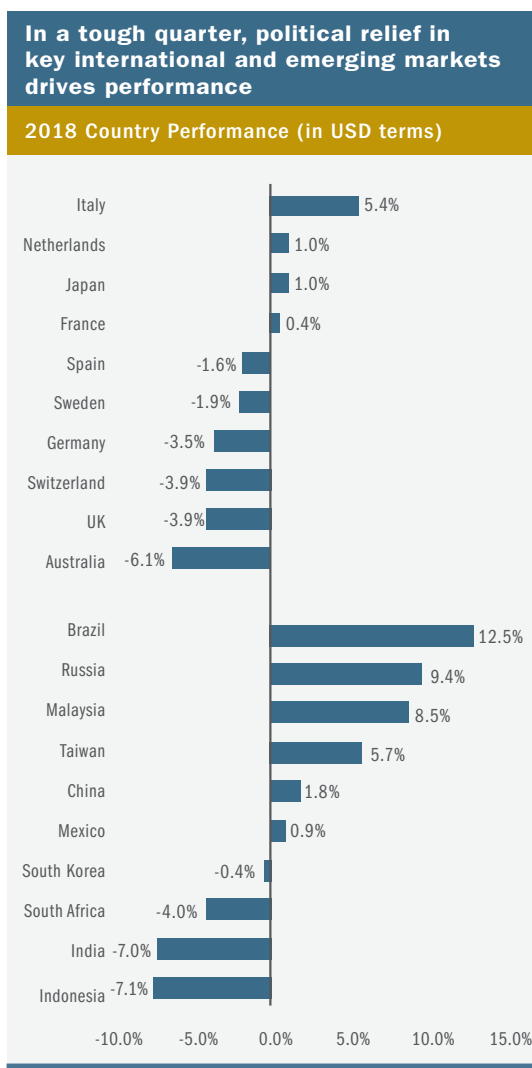
uncertainty and a weak outlook for economic growth. Despite this, the trend for inbound merger and acquisition activity remained on track with a number of UK companies becoming the subject of bids from overseas trade buyers.

Japanese equities fell sharply as volatility returned to global markets amid heightened geopolitical tensions. After a strong start to the quarter, global trade restrictions rattled markets in the last two months. U.S.-based investors fared better as the yen surged 6% against the dollar. In terms of company performance, Nippon Steel & Sumitomo Metal shares retreated -18% following the announcement of tariffs on U.S. steel imports. Nintendo extended its strong rally, adding another 15% to its market value in the first quarter. Shares of several pharmaceutical companies also climbed higher, including Ono, Astellas, and Daiichi Sankyo. However, Takeda Pharmaceutical sank -18% on rumors that the company was considering acquiring its larger rival, Ireland-based Shire.

**Emerging markets eek out a gain amid rising volatility**

Emerging markets equities registered a positive return in the first quarter, despite a rise in market volatility stemming from tensions over global trade. The MSCI Emerging Markets Index recorded a 1.5% gain and outperformed the MSCI World Index.

Brazil generated the strongest return as former President Lula da Silva saw his criminal conviction upheld, which will prohibit the left-wing candidate from participating in October’s presidential elections. Despite falling back later in the quarter over rising tensions with the U.S. over Syria, Russia recorded a strong gain as the central bank cut interest rates and the country’s debt was upgraded to investment grade by ratings agency S&P. Peruvian stocks were another strong performer amid improved sentiment following the resignation of President Pedro Pablo Kuczynski amid accusations of bribery. Mexican stocks edged higher despite concerns about the continuation of the NAFTA. Although Chinese equities were volatile towards the end of the quarter,



given rising trade tensions with the U.S., the market recorded a positive return and outperformed. Macroeconomic data remained broadly stable, albeit there were ongoing signs of a gradual slowing in momentum, with official PMI easing to 50.3. Thailand was among the best-performing markets, supported by strong performance from energy and utilities stocks. Taiwan, where technology stocks led the market higher, and Malaysia also recorded strong returns.

In contrast, Indian equities lost value, in part due to concern over a reported fraud at a state-owned bank. Weak performance from the ruling Bharatiya Janata Party in two state by-elections in March also weighed on sentiment. Emerging European markets were also weaker, notably Poland where state-controlled enterprises led the market lower. Headwinds from higher oil prices and global interest rate

tightening further complicated matters. In the Philippines, currency weakness was a headwind amid rising inflation and as the current account moved into deficit. In Indonesia, signs of deterioration in policy and ongoing subdued growth weighed on sentiment. Turkish stocks shed more than 4% as the lira weakened. Turkey reported in March that its economy grew a stronger-than-expected 7.3% and 7.4% in the final quarter and full year of 2017, respectively, driven by government and household spending. Rapid growth has raised concern that Turkey’s current account gap, already among the biggest in the developing world, could further widen. Finally, South African stocks retreated as investors pocketed previous months’ gains spurred by rising optimism about a change in the country’s leadership. South African assets rallied ahead of the removal of President Jacob Zuma, who resigned in February after many scandals and was replaced by his deputy, Cyril Ramaphosa.

Emerging markets continue to be an area of keen interest for investors, despite rising geopolitical risks. After languishing for years, flows into the asset class have been heavy in the last twelve months, and for good reason. Most developing countries have smaller current account deficits, larger foreign exchange reserves, and more flexible currencies than they did in previous decades, reducing the risk of a financial crisis. Compared with developed markets, most emerging markets have more attractive demographics and a stronger tailwind from rising consumption. Most importantly, emerging markets stocks remain attractively valued relative to developed markets stocks.

Near-term risks include a rise in U.S. protectionism and a faster-than-expected pace of rate hikes by the Fed. However, we believe that emerging markets will be able to withstand a gradual tightening of

monetary policy given that their financial positions have broadly improved in recent years. Economic growth in emerging markets has stabilized, and corporate earnings have begun to recover after years of disappointing performance. That said, careful stock selection is crucial for producing good long-term returns as emerging markets continue to show wide dispersion in the performance of individual countries and companies.

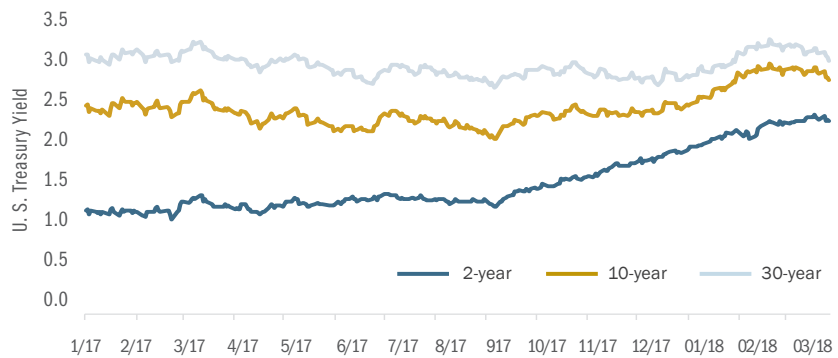
**High yield and U.S.-denominated emerging market debt are the only segments to salvage gains as bond yields rise sharply**

Treasury yields reached multi-year highs during the first quarter as the prospect of an increasing supply of Treasury securities and rising inflation expectations worried investors. The two-year Treasury note's yield reached its highest level since January 2008, the benchmark 10-year Treasury yield hit a four-year high, and the 30-year yield climbed to a two-and-a-half-year high. Longer-term Treasury yields peaked for the quarter on February 21 before receding somewhat in March. The yield curve flattened dramatically, as the spread between the 2-year yield and the 10-year yield fell to just 48 basis points—the tightest levels since 2007.

Other factors may have also weighed on Treasuries during the three-month period: the Federal Reserve continued to slowly shrink its holdings of Treasuries and mortgage-backed securities, a process it began in October, and also appeared more committed to a gradual tightening of monetary policy. In addition, there were concerns about other central banks starting to reduce their stimulus programs, and a weakening dollar reduced the appeal of Treasuries for non-U.S. investors.

The interest rate hike at the Fed's March policy meeting, which was widely expected, moved the federal funds rate to a range of 1.50% to 1.75%. It was the first meeting under the leadership of Jerome Powell, who succeeded Janet Yellen as Fed chief in early February. The Fed's median projection is currently for two more hikes this year. Another measure of short-term interest rates, the three-month London interbank

**In 2018, yield curve flattening continued, sparking recession fears**



offered rate (Libor), also increased. Libor, the interest rate that banks charge each other for U.S. dollar loans, rose to 2.31% by the end of March from 1.69% at the end of 2017. Many analysts believe an increased supply of Treasury bills and commercial paper (short-term corporate debt) contributed to the bump in Libor.

Mortgage-backed securities (MBS) performed in line with Treasuries and held up better than the broader investment-grade bond market. The Fed's continued slow reduction of its MBS holdings was a headwind for the sector; however, rising interest rates helped reduce mortgage prepayment risk, and investor demand for high-quality securities provided support.

Investment-grade corporate bonds faced headwinds from elevated supply and waning demand outside the U.S. The issuance of \$40 billion of new bonds in March by pharmacy chain CVS to fund its purchase of health insurer Aetna was the third-largest investment-grade corporate bond deal on record and was generally well received by the market. High yield bonds lost ground but held up better than the broad U.S. investment-grade market. The sector was supported by solid corporate earnings reports and a low default rate. Generally higher oil prices during the quarter were also beneficial for energy issuers, which make up a large portion of the high yield indexes. Below investment-grade credit spreads—the yield premium offered by riskier bonds compared with similar-maturity Treasuries—reached the tightest levels since 2007 in January, but spreads widened later in the period as equity weakness weighed on the sector.

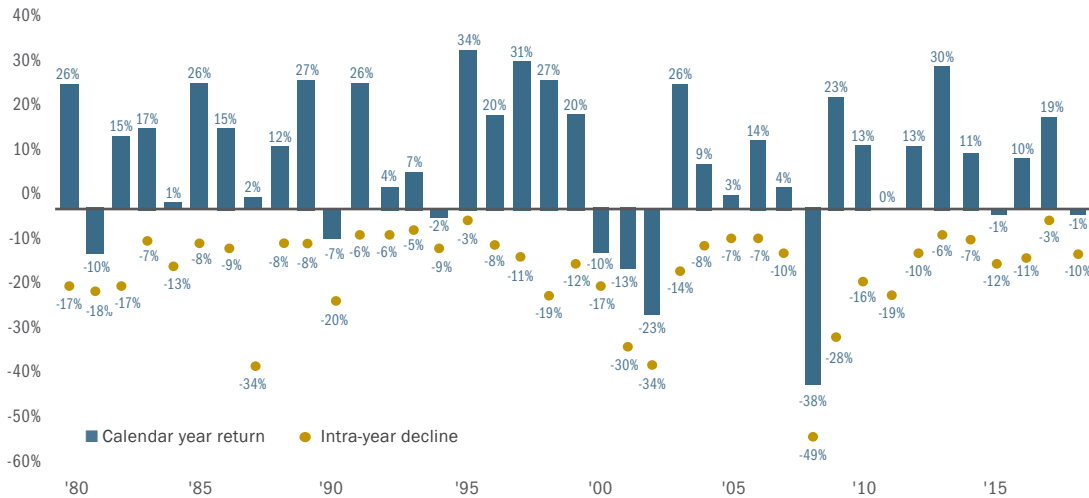
Municipal bonds recorded negative results for the quarter but narrowly outperformed Treasuries. The *Wall Street Journal* noted that this year's first-quarter return was the weakest start to the year for the sector in 15 years. Tax-exempt bonds faced a mixed technical environment as a result of tax reform. New issuance was muted, but with lower corporate tax rates, some banks and insurance companies had less need for munis in their portfolios.

Emerging markets bonds performed well in the quarter thanks to their higher yield spreads and lack of interest rate sensitivity, especially those denominated in USD. That said, the segment struggled later in the period as equity market volatility and concerns about the potential for trade wars weighed on demand for riskier assets. Credit news was mixed in the sector. In a widely expected decision, S&P cut Brazil's credit rating to BB- from BB, noting that the country had failed to pass meaningful fiscal reform needed to support continued economic growth. In South Africa, yields on bonds fell to their lowest level in three years after Moody's announced they will maintain an investment grade credit rating.

**Commodities are a mixed bag as industrial metals drop on trade wars while the energy complex surges**

The S&P Goldman Sachs Commodity Index (GSCI) was up in the quarter thanks to rising energy prices on strong global demand and a flight-to-quality bid for gold. The segment's performance was materially dampened, however, by weakness from industrial metals amid rising global trade tensions and

Despite average intra-year drops of -13.8%, annual stock market returns have still been positive in 29 of 38 years



concern that further escalation could impact demand. Copper was particularly weak, down -8.3%. In agriculture, corn (10.6%) and soy bean (9.8%) prices were notably strong. In the energy segment, Brent crude (5.1%) rallied into quarter-end amid rising confidence that OPEC would maintain its production cuts through the full year 2018. In precious metals, gold (1%) posted a positive return but silver (-5.1%) lost value.

**Looking ahead**

If 2017 was defined by extreme calm, 2018 will likely be marked by heightened volatility. Not only do we have shifting political sands and a U.S. administration intent on renegotiating various trade deals, we also have an economy that is inching closer to the end of the economic cycle. While we believe that the Fed does not want to cut off this expansion by tightening rates too quickly, it will continue tightening rates over the coming years. This is important because, historically, a tightening Fed leads to higher bond and stock market volatility.

The length of this expansion has meant that for years now, pundits have come up with various reasons why the cycle was about to end, and the latest reasons seem to surround inflation, higher Fed Funds rates and the yield curve. Of course, the cycle is highly relevant, because not surprisingly, recessions are bad for stocks--looking back to 1980, median S&P performance was -8% in the six months after

a recession began, and roughly flat in the six months prior to a recession. The size of the budget deficit and the relatively low level of Fed Funds rates (giving the Fed less ability to take rates down) are among the reasons many believe the market decline could be even more pronounced around the next recession.

But while a wall of worry remains, the balance of indicators suggest there is still a lot that can improve in this cycle. While the duration of this recovery has been long, at 34 quarters and counting, there are two other expansions since 1980 which lasted 30 quarters or more, and this is the lowest level of average GDP growth that we have seen in a recovery. GDP growth has averaged 2.2% since the Great Recession ended, versus average recovery growth rates of 3.5%, and the relatively slow growth is one of the reasons that there are still a number of things that can improve. Of course, regulatory change, especially around housing and lending, has helped keep speculative excess, and growth, at bay.

We continue to believe that the economy is set to move forward and that it will eventually push the market higher in the intermediate term, albeit at a moderated pace and with heightened volatility. Indeed, we surmise that market volatility over the past few weeks could be due to short-term buyers of the “Trump trade” becoming short-term sellers of the “Trump trade” as the narrative shifted from positive (tax reform) to negative (tariffs).

Tweets, monthly employment numbers, FBI raids, all of these can impact how markets trade in the short and medium term, but investors would do well to remember that economic fundamentals are strong and corporate profits are rising. Though most believe we are closer to the next recession than the last, whether it is in the future or six months away matters tremendously. The balance of indicators at this time suggests no cause for alarm and that much can still improve.

Diversification continues to be an important strategy to manage volatility, but also valuations, which, despite the pullback, remain broadly at elevated levels. It is also a time when consideration of more active management, as opposed to beta-focused index investing, can have its merits, as fundamental stock-pickers may add value by offering downside protection alongside strong rising market participation. Active portfolio management, in terms of disciplined rebalancing and active tax-loss harvesting, are other ways to manage and even make the best of volatile markets. Though a repeat of last year’s meteoric market rise is unlikely, we urge caution to those investors running for the hills, as market volatility has in no way guaranteed negative returns by the turn of the calendar. Likewise, we see no compelling reason to be overextended in equity asset classes, and believe a well diversified portfolio balanced to your individual risk profile and growth and income needs remains the best option for the year ahead.

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