May 2018

Global Economy Remains Strong Despite Bouts of Volatility and Adjustment

Overview

In April, U.S. and foreign stock indices had mixed performance, but major indices such as the S&P 500 (domestic equities) and the MSCI ACWI ex-USA (foreign equities) posted gains. U.S. core bonds declined during the month when the yield of the 10-year U.S. Treasury Note rose and briefly touched 3.0%. The Federal Reserve left its key benchmark rate unchanged, as expected, at its meeting on May 2, and its statement reflected an assessment of overall strength in the U.S. economy. In this installment of *Insights*, we take a step back from some of the granular, topical discussions of recent months and provide an assessment of economic growth in the three key global regions: the U.S., Europe, and emerging markets. Overall, we anticipate continued global expansion that is consistent with a relatively low risk of recession in the U.S. In our view, risks such as trade policy disputes and monetary policy tightening (in the U.S.) and normalization (in the Eurozone) are real, but they will likely not derail further global economic expansion.

Performance

Core U.S. bond yields rose and their prices fell in April, but large U.S. stocks rose to reverse a two-month string of declines. Year-to-date through April, the Bloomberg Barclays U.S. Aggregate Bond Index has declined 2.19% because of rising yields. Despite its high volatility, the S&P 500 Index has declined only 0.38%.

	April	2018 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	-0.36	-1.46	2.44	4.25	US Muni Bonds
BarCap US Agg Bond TR USD	-0.74	-2.19	1.47	3.57	US Taxable Bonds
BoAML US High Yield Master II TR USD	0.67	-0.25	4.76	7.75	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-1.45	-3.17	3.78	6.78	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-2.96	1.36	-1.92	3.33	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-0.55	0.61	2.89	-0.26	Hybrid/Hedged Equity
DJ Industrial Average TR USD	0.34	-1.63	12.96	9.39	US Equity -- Large
S&P 500 TR	0.38	-0.38	12.96	9.02	US Equity -- Large
NASDAQ Composite TR USD	0.08	2.67	17.64	12.59	US Equity -- Large
Russell 1000 TR USD	0.34	-0.35	12.84	9.10	US Equity -- Large
Russell Mid Cap TR USD	-0.15	-0.61	11.77	9.48	US Equity -- Mid-sized
Russell 2000 TR USD	0.86	0.78	11.74	9.49	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	1.60	0.40	5.46	2.26	Int'l Equity -- Comprehensive
MSCI EM NR USD	-0.44	0.97	4.74	2.17	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	2.58	2.17	-7.32	-7.80	Commodities
HFRX Global Hedge Fund USD	0.09	-0.92	1.18	-0.34	Multi-Asset Alternative Invm't

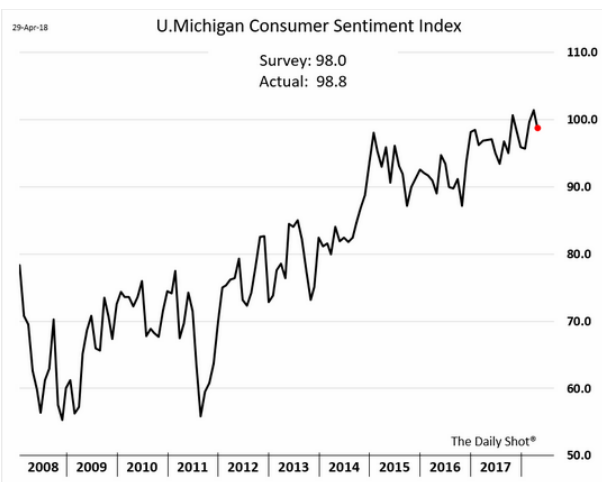
Source: Morningstar Direct. Data through 04/30/2018

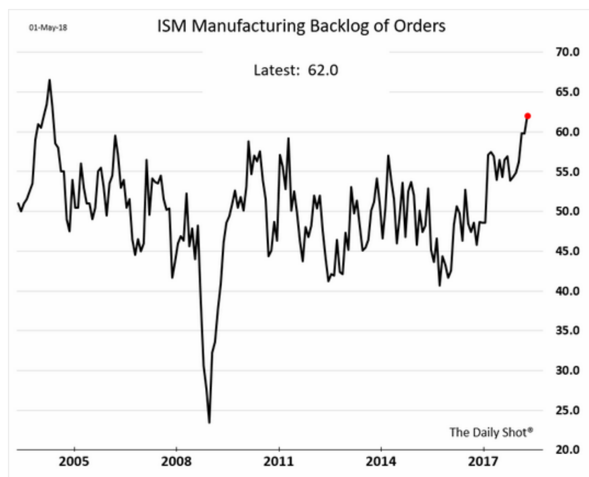
In April, the U.S. dollar reversed course and strengthened. As a result, local currency emerging market bonds also reversed course and fell nearly 3%, but they remain up approximately 1.4% for the year, according to the JPMorgan GBI Emerging Market Diversified Index. Emerging market equities dropped 0.44% in April, but they remain up approximately 1% for the year, as measured by the MSCI Emerging Market Index.

Outlook

Our base case outlook for further global economic expansion remains intact. We continue to anticipate a moderate rate of inflation in the U.S., a largely measured and telegraphed U.S. Federal Reserve policy, and supportive economic growth in Europe and emerging markets. This seems the most likely scenario, in our view, even if doubts remain about (a) the pace of growth in Europe (i.e., it slows from its rate last year), (b) trade policy (i.e., protectionism stokes market worries), and (c) central bank policy (i.e., measures contribute to currency volatility).

First, economic conditions in the U.S. remain solid, and there are many signs of health. Consumer sentiment, as you can see in the graphic below on the left, has edged down a bit from its recent high, but it is still very strong and near its cyclical peak. Manufacturing orders have risen to the highest level in more than five years, as you can see in the chart below on the right. GDP growth in the first quarter came in at 2.3%, which was above the consensus expectation of 2.0%. It was also the highest first-quarter GDP reading in several years. Prices have

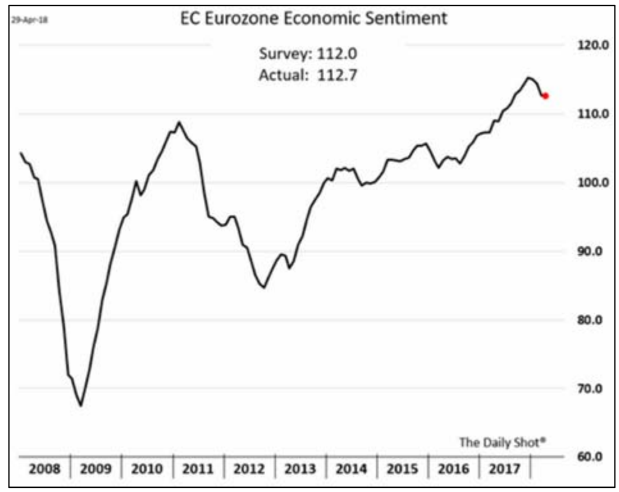




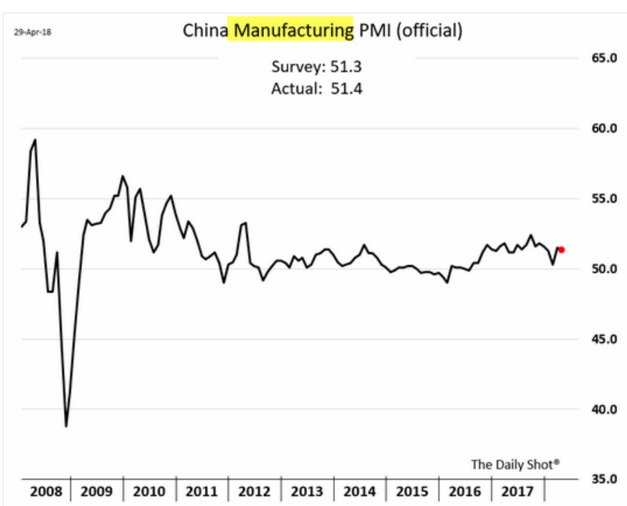
continued to move gradually toward the Fed's target levels. In its most recent statement, the Federal Open Market Committee recognized that headline and core inflation have "moved close to 2 percent," which is the Committee's target. Policy doves on the committee (i.e., those who tend to favor more accommodative interest rate policy) seem to have shifted toward more neutral positions. We remain of the opinion that the Fed will increase its policy rate three more times in 2018, which would take the target range from the current 1.50% - 1.75% to 2.25% - 2.50%. As we see it, the next increase will likely be in June.

As U.S. economic strength has persisted and price pressures have risen to within target ranges, bond yields have also increased. In late April the 10-year Treasury Note briefly touched the psychological level of 3.0%, which it has not done since January 2014. The U.S. dollar, which had weakened notably against many foreign currencies this year, strengthened in April due largely to the economic strength at home and rising bond yields, as described above, and some softening economic data elsewhere globally. We tend to think that this U.S. dollar strengthening will prove temporary, and the dollar will weaken point-to-point over the next 12-18 months, which should provide a tailwind to some foreign stock and bond investments.

We can, then, turn to Europe, where the economic data is mixed. The eurozone's economy grew at a 1.7% annualized rate in the first quarter. It is not entirely clear why GDP growth was less than its full-year 2017 2.5% rate. Possible explanations include weather, labor strikes, euro currency strengthening, among other factors. Nevertheless, factory growth indicators in April were largely in-line. The European Commission's Eurozone Economic Sentiment index has declined slightly from its recent high (as shown nearby), but it remains at a very elevated, positive level. Overall, however, weaker economic data suggests that the European Central Bank (ECB) will be increasingly data-dependent as it considers when and how to end its quantitative easing policy and embark further upon monetary policy normalization. Current tapering of QE by the ECB has been targeted to end in October of this year, but the ECB may extend its bond purchases through 2018 if it judges that economic conditions continue to require policy accommodation.

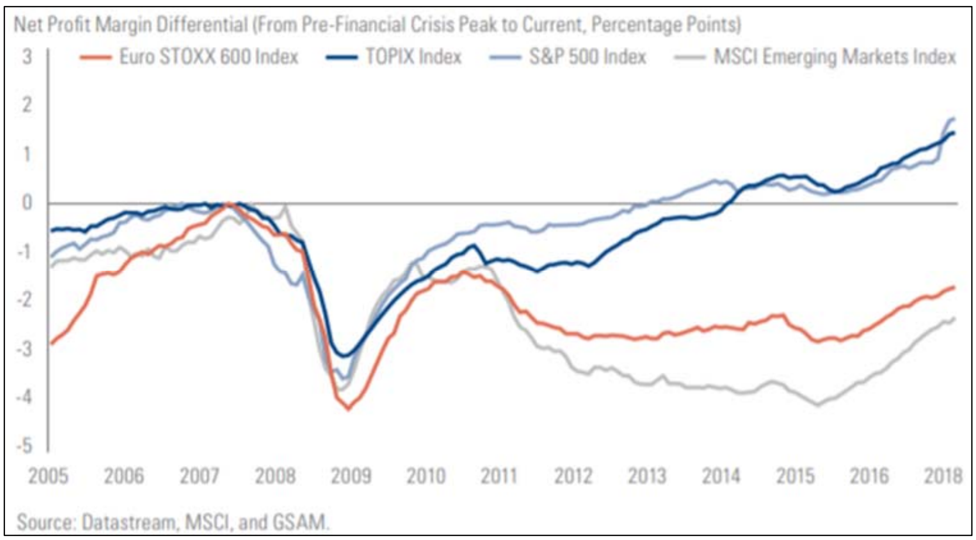


Although recent economic GDP data out of the eurozone was a bit weak, the story is different in emerging markets. China reported that its economy grew at a 6.8% annualized rate in the first quarter of 2018, which beat expectations. Although manufacturing activity has ticked down since mid-2017 (as you can see in the chart below on the left), the service sector activity (i.e., non-manufacturing) has been trending up after having bottomed in early 2016 (as you can see in the chart below on the right). China has been looking to shift to a service-based economy, similar to the U.S., which makes the Non-Manufacturing PMI particularly important. Both measures are above 50, which means that they are in expansion territory.



In many ways, as goes China, so go emerging markets generally. Emerging market economies are, broadly, in an earlier stage of economic expansion than the U.S. In view of this and an expanding and largely stable Europe, we believe that foreign markets offer solid potential for earnings growth, which in turn could result in the increase in their stock prices. One reason for this is that when global growth has been above-trend, it has historically has supported earnings growth outside the U.S. because foreign markets tend to be more levered to that economic growth through their greater operational debt, broader economic composition, and financial sector tilt.

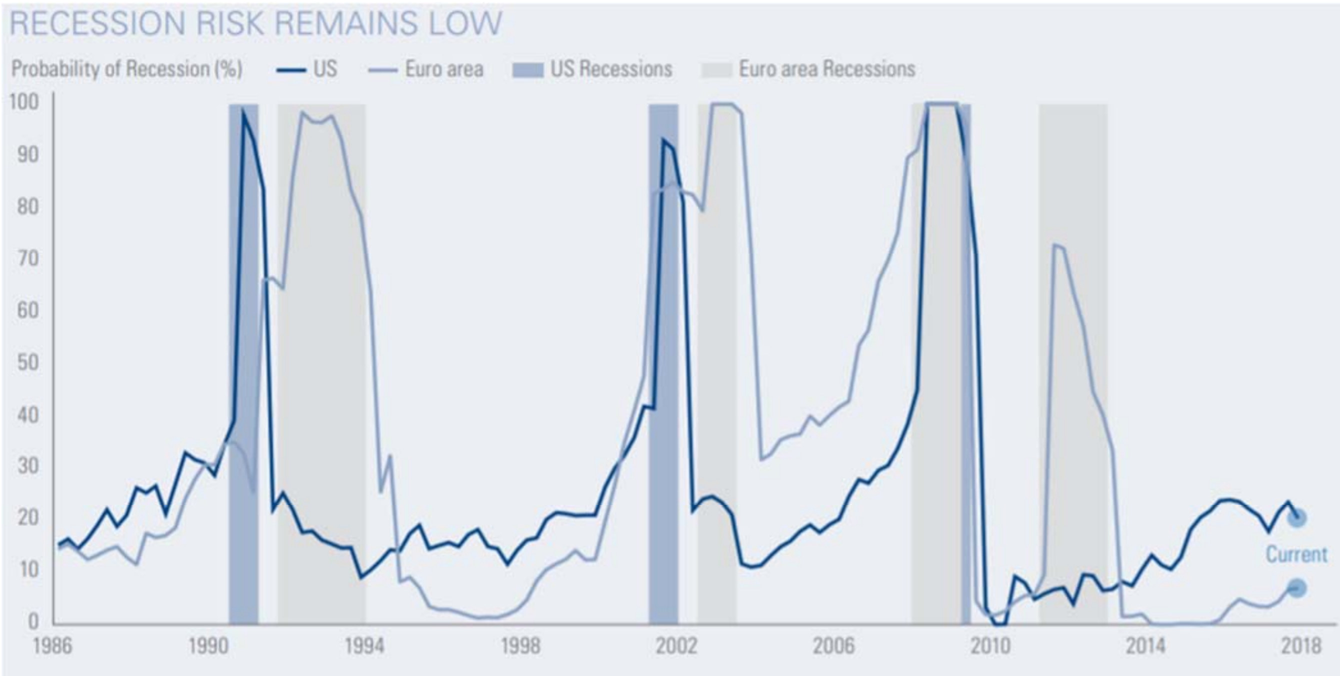
The graphic below shows the net profit margin differential for stocks representing different regions (Europe, Japan, the U.S., and emerging markets). It shows that currently U.S. and Japanese stocks on average has posted vastly greater net profit margins than companies in Europe (the orange line) and emerging markets (the gray line). Strong growth rates in EM and broad economic stability in Europe currently suggest that, if the profit margin trends revert to their longer-term mean, companies in the EM world and in Europe could notch earnings and profit growth that could help to attract investor flows and boost their stock prices.



Looking at the U.S., European, and emerging market landscapes, we continue to think that the operating environment is favorable to broad earnings growth, especially outside the U.S. Earnings growth deceleration is more of a risk as a late-cycle factor in the U.S. than in, say, emerging markets and Europe, which are at earlier stages of their respective expansions. Core bond prices remain vulnerable to rising rates in the U.S. High yield U.S. bonds and loans are attractive debt options relative to U.S. government bonds because of their lower interest-rate sensitivity and correlation to economic strength. The risks posed by U.S. central bank monetary policy (i.e., rising rates by the Fed) and uncertainty surrounding global trade pacts and policies due to protectionist rhetoric and retaliation are real and should not be discounted; however, in our view these may add to periodic bouts of volatility for various asset classes but not derail global economic expansion.

In fact, although it is impossible to predict the exact outcome of ongoing trade negotiations, particularly those between the U.S. and China, on the one hand, and the three NAFTA countries, on the other hand, we currently think that the upshot of these talks will be largely, if not entirely, benign to the global economy. Our present view remains, in other words, that recent trade actions and retaliatory responses by nations such as China are unlikely to escalate into a full-scale trade war per se.

One implication of this view is that we currently believe that the odds of an economic recession are low for both the U.S. and Eurozone, as depicted by the graphic below on the following page.



Source: Goldman Sachs Global Investment Research, National Bureau of Economic Research, and GSAM. As of March 2018. The chart shows quarterly data from January 1984 to March 2018, the latest available data, of the unconditional probability of a US and Euro area recession over the next 8 quarters. The economic and market forecasts presented herein are for informational purposes as of the date of this document. There can be no assurance that the forecasts will be achieved. Please see additional disclosures at the end of this document.

Economically, we believe that growth will continue, and, after a period of settling, investors will recognize that and return to stocks. Geopolitical risks, monetary policy risks, and trade rhetoric do increase the likelihood that 2018 will continue to see pockets of volatility that were largely absent in 2017 but that have so far characterized this year. However, market volatility was atypically low in 2017, and investors would be wise to expect bouts a more normal market environment characterized by volatility and adjustment. But we believe they would also do well to be encouraged by the underlying economic strength globally, especially in the U.S. and emerging markets.

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