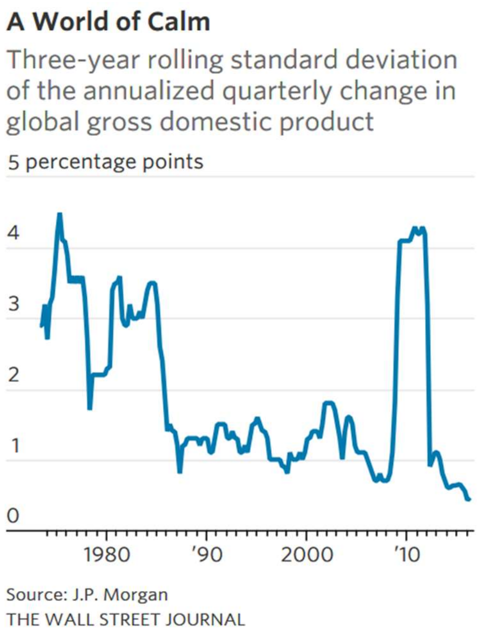
Third Quarter 2017 Outlook
July 2017
Lynne Amerson

Global Economic Thoughts and Reflections

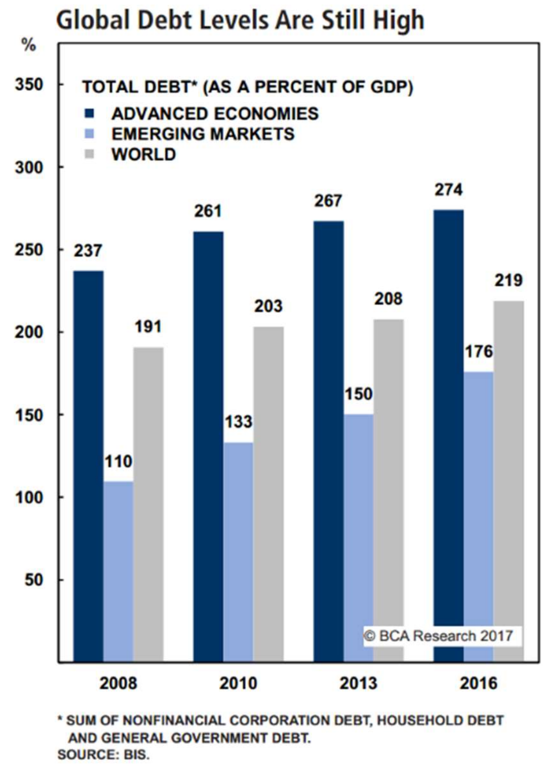
If you think watching paint dry is boring, then try tracking the global economy as of late. Investors are experiencing an extremely quiet period not just in terms of the common VIX statistic, that measures stock movements, but even more broadly in terms of economic volatility from quarter to quarter. Over the past three years, the swing in the annualized US GDP is just 1.5% (Chart: A World of Calm). This trend can also be seen in other economies around the world. Investors are being lulled into a state of calm instead of a state of awareness. Before the tech bubble burst in 2000 and the great recession of 2008 a similar environment existed. This time is not different and things can change quickly; hopefully that part investors do remember.



We are seeing more studies trying to predict investors' behavior. They are looking for clues beyond the typical market drivers. We think looking at an expanded set of factors makes sense since the global economy has undergone structural changes over the past decade. As we move from manufacturing based economies to more service oriented ones, we should expect to consider different factors for signals. This does not mean abandoning our work on valuations, interest rates and employment, but rather casting a wider net and perspective. We review the state of these factors in our quarterly report.

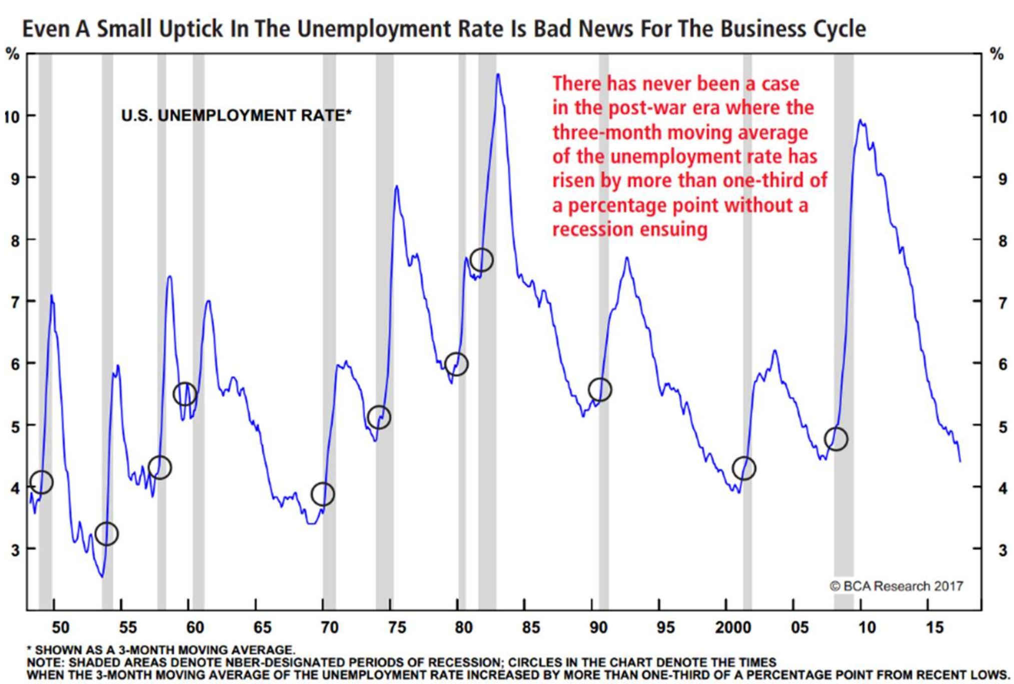
In our previous reports, we have been wary of market valuations. The current PE of the S&P 500 is 30 (Schiller CAPE Ratio). With a historic median of 16, this looks overvalued to us. However, we've also noted that the market can stay overvalued for a long time which is why valuations should only be part of a market analysis. We find the underlying economics and profit fundamentals to be constructive allowing us to push out any expectation of a recession until late 2018.

Which brings us to interest rates. Federal banks around the world are acting like overly protective parents. The Fed's action path will be problematic at best. Monetary policy changes have a lag effect of 12-18 months and engineering a soft landing is extremely difficult. Additional constraints exist around the world when it comes to accommodative policy. The zero lower-bound nominal interest rate and the proportionately high level of debt to GDP levels in many countries will make it more difficult to maneuver an economy out of a recession. (Chart: Global Debt Levels Are Still High) This could cause the next recession to be deeper and longer than one would expect given the other underlying financial conditions. The stage may be set for quite some time before the show starts.



It may not be intuitive, but full employment raises the odds for recession. In the US, the unemployment rate currently stands at 4.3%. For reference, the 2000 low was 3.8%. We've discussed before how, especially in the last recovery, the unemployment rate looked healthier than reality. This was a function of the participation rate and workers accepting jobs that were below their skillset, just to re-enter the market. However, data now suggests that these two factors have diminished and we're now seeing signs of entering the last leg of the cycle with wages rising.

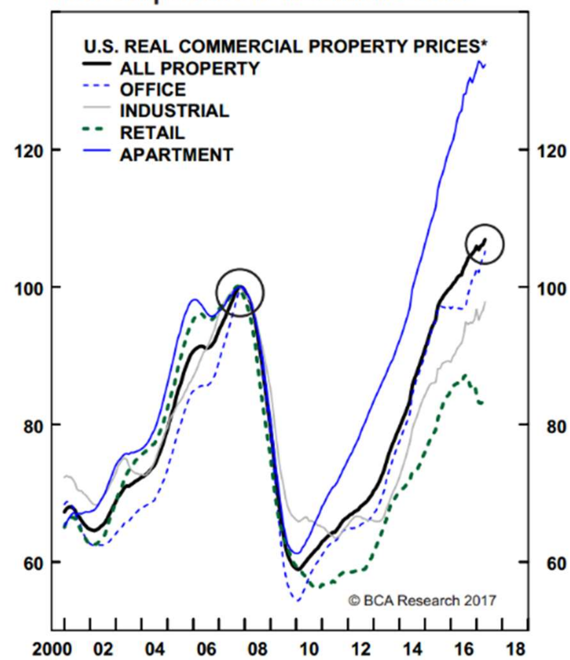
The unemployment rate is usually rising or falling and once it starts rising, it keeps rising. The data suggests that whenever the three-month average unemployment rate rises by more than one third of a percent a recession follows. (Chart: Even A Small Uptick) One of the largest risks to monetary policy is allowing the unemployment rate to fall so far that there is nowhere to go but up.



Another factor we've reviewed is commercial real estate. The length of the real estate cycle is unique to each time period, but the process is similar: demand is high and prices rise, capacity is created but inevitably too much capacity is brought online, demand slows, vacancy rates increase, prices fall.

Commercial real estate prices have risen by 82% since October 2010. (Chart: Commercial Real Estate Prices) While loans, as a percent of GDP, are back to pre-recession levels and nearly half of the loans are held by banks (to the sum of $2 trillion). With the increase of projects in the pipeline, vacancy rates in the office sector are expected to rise just as demand growth for more space is likely to slow. As vacancy rates rise and prices inevitably fall, the value of the underlying real estate declines. This in turn effects the collateral on the banks' books. That would slow lending which could cause prices to fall further. If the timing of this cycle corresponds to the slower global growth we expect in the second half of next year, that will quicken the arrival of a recession.

Commercial Real Estate Prices Have Surpassed Pre-Recession Levels



* SOURCE: REAL CAPITAL ANALYTICS, BEA SERIES DEFLATED BY GDP DEFLATOR; REBASED TO PREVIOUS PEAK = 100.

One last sector to review for signals is the oil market. An extended correction in the oil market could pressure equity markets. Currently for example, investors are worried about the US shale production being at odds with OPEC's intention to decrease inventories. However, for oil prices there is a distinction between the rate of change and the level. Rapidly falling oil prices can be a negative for growth as this leads to a decline in capital spending by the energy sector, but a lower price level benefits household spending and industries who use oil as an input. Energy capex in the US dropped by 70% in a two year period between 2014-16. The fallout was even more severe in emerging markets crushing industrial production and global trade. Now that we've settled into lower oil prices we can see that supporting growth both at a household level, as a lower proportion of their income goes to gasoline, and a rebound in industrial production.

Global recession like falling dominoes

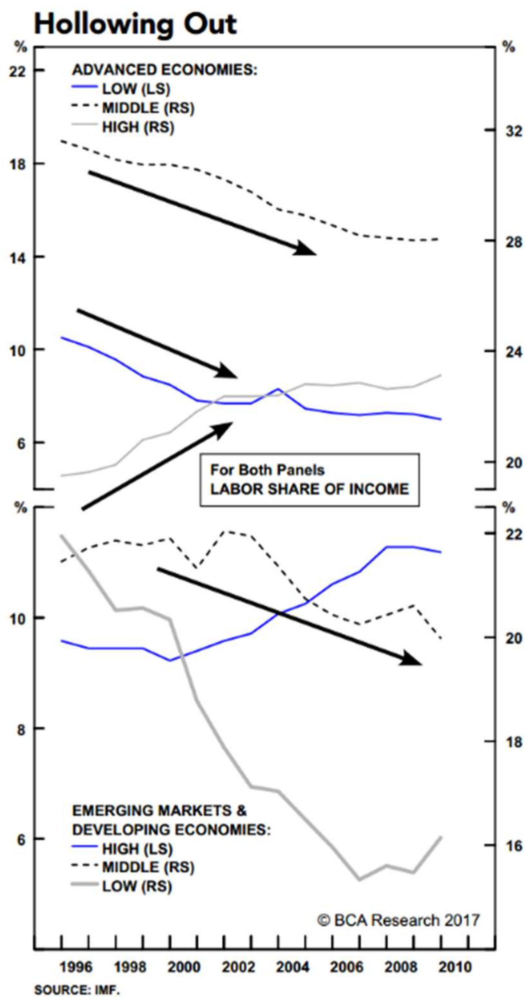
Recessionary conditions in the US will affect the global economy in different ways than one might expect. The US accounts for only 5% of the global ex-US GDP which means even if the US cuts spending it won't really detract from global growth. What we think matters is the effect a negative turn in the US economy could have on sentiment. Global markets have a higher correlation when risk sentiment deteriorates. Investors can look back to 2008 and 2001 for evidence of this. The stretched valuations in many markets could increase this effect this time. Here again we see the cycle that starts with deteriorating sentiment, a decline in asset prices which leads to deteriorating balance sheets for both households and corporations.

There are various drivers of sentiment and the geopolitical climate is one of them. Currently the pace of adverse geopolitical news is unpredictable and investors have repositioned to risk taking. Recent tensions between the US and North Korea and the desire to use our relationship with China to force

North Korea to the negotiation table is an ongoing concern. Since our last writing, France elected Emmanuel Macron with center-right support while in the UK, Theresa May failed in a vote for majority. Stateside we see a widening between parties and a diminishing ability to enact new legislation. If this persists, outcomes that may have come to be expected, may not be implemented and this may cause investors to refocus and lose the rose-colored glasses from election day.

Policy Extremism

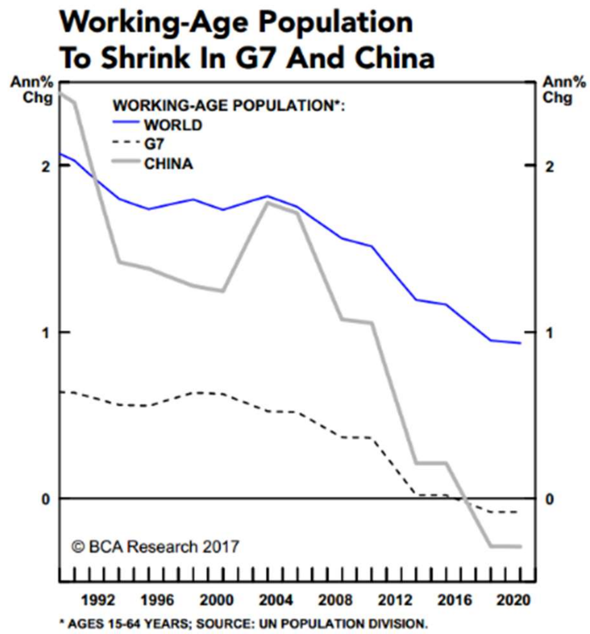
Potential for policy extremism is a result of global inequalities and numerous secular drivers that have reached a tipping point. Several drivers pre-date the financial crisis and have been building for decades. While it's too early to declare globalization dead, the world is in transition and policymakers are in the crosshairs.



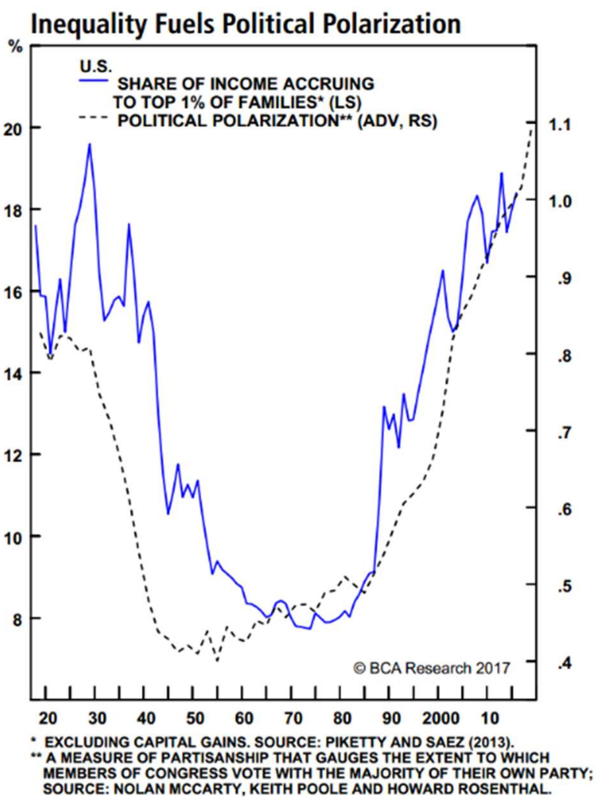
Technological advances have contributed to rising inequality and a hollowing out of the employment pool. Theoretically, while improvements in technology may hurt low income workers at first, eventually it becomes a benefit as total national income rises. Most recently however, technology has led to a shrinking middle class. Otherwise known as "hollowing out". (BCA Research) While low and high skilled job levels have increased, low and middle skill job incomes have not. (Chart: Hollowing Out) This could be a result of technology not just replacing physical work, but cognitive too. A recent IMF study concluded that technology alone explains about half of the drop in the labor share of income since 1980. ("Understanding the Downward Trend in Labor Income Shares," *IMF World Economic Outlook* (April 2017)).

The labor supply shock from China and Eastern Europe is over. Management used the threat of labor outsourcing to gain the upper hand in wage negotiations resulting in rising share of the income benefiting the high income earners. The world working population has peaked according to UN estimates (Chart: Working-Age Population) and as the world becomes less labor-abundant, workers will be able to negotiation a larger share of the income pie.

This comes with a shift to an aging global population. One that moves from contributing to the savings rate to one that will drain the savings pool. As we've discussed before, there is a strong link between aging and savings rate. This was made more significant by near-retirees experiencing the financial crisis and thus saving more in the years leading to retirement. On a global basis, savings must equal investment with real interest rates moving to keep it in check. High savings levels pressured interest rates to remain low given the demand for bonds. However, as savings start to deplete globally, that pool will decrease and rates will rise. We do see global growth as a counterbalance to this trend in the near-term, but are watchful for a bear market in bonds.



Specifically, in the US there are significant cost pressures with the aging population that are effecting fiscal spending. There is simply not enough non-defense discretionary spending available to fund increases in defense spending, security and maintain entitlements. This puzzle is one of the main drivers behind the political polarization that could lead to policy extremism.



The current level of political polarization in the US hasn't been seen since pre-war times. (Chart: Inequality Fuels Political Polarization) The correlation is based on the divergent views of the two parties and their desire or opposition to redistribute of the wealth. With this being an underlying principle, it is difficult to see how this hurdle will be overcome with policy decisions.

In conclusion, we continue to monitor the global economy and keep a particularly watchful eye on an expanded set of market factors. While the underlying economic fundamentals remain supportive, we are wary of the market quietness and the resulting investor complacency.

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Investment Conclusions
July 2017
Harold Pine

Conclusions and Portfolio Concepts

While the global economy continues to do well and markets propel forward, it doesn't escape us that valuations have continued to climb. We began to make portfolio changes two years ago, with a more conservative stance at the beginning of 2017. In the short run, this has left some return from stocks on the table. Volatility, sometimes known as the fear index, has reached all-time lows over the last month. Our tactical changes are designed with a 1-3 year stance. We are two years into reducing risk in the portfolios with the most aggressive changes coming in the first part of the year. It is not likely we will make any further reductions in our risk policy because we are at the lower limits of our equity exposure. We do prefer Europe and Japan over the U.S. and have for some time. This has provided positive attribution in the first half of 2017.

What does all this mean? From a portfolio standpoint, it means that we are at or slightly above our strategic benchmarks for the two years we have been monitoring performance. Over the last twelve months, we have left on the table about 200 basis points or 2% of total return. We will say that on a risk-adjusted basis, we have been extremely productive as measured by the Sharpe Ratio. Risk is about surviving the short term and returns are about surviving the long term. If you get it wrong big, it can take decades to recover.

The NASDAQ just crossed 5000 from its 2000 peak recently. Seventeen years is a long time to break even. Most don't have the capacity to stomach 80% drawdowns and have the subsequent confidence that you somehow get it back – 17 years later! One must decide on the utility of piling on risk and reaching for returns when valuations are high. This is an individual investor preference and Chasefield takes this into account when positioning portfolios. Of course, everyone prefers more return to less. This is always the case especially when volatility is a distance memory.

We will be delivering a comprehensive look at markets and benchmarks in a subsequent report in the coming week. Please feel free to contact us at any time.