Market Outlook
Third Quarter 2018

Third-Quarter Outlook
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Global synchronized economic recovery vs. U.S. trade tantrums – who wins?

Writing in the early days of July, more than halfway through 2018, it is time to take stock of how markets have behaved in the first half and what we expect to transpire in the second half. From an investment-return perspective, the first six months of 2018 have unfolded pretty much as forecast, despite the arrival of a number of unpredictable twists and turns. The expected full-year asset class returns I referenced as we entered 2018 were 8-10% from equities, 5-6% from high-yield credit, 2-4% from investment grade and slight losses on government bonds. In my 2018 outlook piece I wrote:

> *"The broad conclusion for 2018 is the global economy looks just fine – better, in fact, than we have seen in over a decade. The coming year should therefore be constructive for equities, neutral for credit and "meh" for rates. The main risks to stability are not expected to originate from the economy, but rather again from the political sphere. This is an area we at Signature continue to devote significant resources to following and understanding, a luxury that our unique integration of both dedicated bottom-up securities and top-down macro teams affords versus most of our more generalist competitors. But I remind you that investing through a political lens is a recipe for DISASTER. We look to determine how and when politics might impact the underlying economic and investment fundamentals which are the ultimate driver of investment returns. As a rough guide, I would estimate that 80% of politics do not matter for investors (including any late-night tweets from the White House), 10% matter but will have the opposite impact from what most would anticipate, and 10% matter as expected. The key is determining which is which!"*

The expectation that markets would dance between strong underlying economic fundamentals and heightened political volatility remains sublimely accurate. The only difference between my perspective today and what I generally hear from clients is the relative importance of the two. The public, and particularly the hyper-active media world, remains incessantly fixated on the unfolding political drama, tending to ignore the rather boring yet robust underlying economic fundamentals. This is a mistake.

One must keep in perspective that every inane tweet will not beget inane policy that will, in turn, damage the economy and hurt investors. It is possible, but often not probable. As mentioned, more

than 80% of politics do not have an impact on investment returns. The difficulty is in determining what matters and what does not, something Signature spends a lot of effort trying to understand. In fairness, I used to argue that 90% of politics did not matter, so I have doubled the significance and importance of understanding how politics will impact investment returns, given the current geopolitical backdrop.

We expect that markets will start the third quarter with a focus on the exceptionally strong second-quarter U.S. company earnings (+20%), and then gradually succumb to the escalating beat of protectionist trade rhetoric as President Trump ramps into campaign mode in advance of the November elections. In the background, the U.S. Federal Reserve and other central banks will continue along the path of policy normalization and are edging closer to the point where this tips into tightening. The strong economy, volatile politics and tightening monetary policy are the trifecta that will dictate market returns for the rest of the year.

The strong U.S. economy remains more prone to overheating in the coming 12 months than tipping over from trade concerns. In politics, understanding what missives might become actual longer-term policy, rather than serve as part of the shorter-term negotiating tactics, and what the likely near-term impacts of those might be, will remain a fluid process. This analysis combines many real long-term structural issues related to the ongoing multi-decade rise of China as an economic, geopolitical and military super power. It also includes Trump's many pure fantasy claims, outright lies and gross lack of any real understanding of the global economy. To the extent that all of this is part of his negotiating tactic, he really doesn't care. But there will be significant twists to the plot along the way.

The third element of the trifecta is the state of play in monetary policy. While central banks remain extremely transparent and continue to have the luxury of gradualism given a reasonably benign inflation backdrop, it must be emphasized that, in the U.S. at least, we are entering the zone where policy normalization begins to tip into policy tightening. This is particularly the case when one also considers the ongoing reduction in the Fed's balance sheet. How this quantitative tightening will play out with respect to monetary conditions and market liquidity remains anyone's guess, as it has never been done before. But my sense is that we are approaching a time in the coming six to 12 months in which markets will begin to fret about its potential impacts. While not front and centre in the public debate, it is an area where Signature's macro, rates and risk teams are beginning to focus more attention.

With that as our broad strokes outlook, it is worth looking at how we are positioning our portfolios. We have remained tilted towards risk assets ever since our Regime Change call in the summer of 2016. What was then a forecast has unfolded as a global synchronized economic recovery over the past two years. Today we still expect that the strong underlying economic fundamentals will drive reasonable returns for risk assets in the coming year, but are mindful of the escalated political and trade tensions.

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While our base case remains constructive, we also perceive elevated tail risks of adverse outcomes. With strong market returns over the past two years, rising policy rates and increased political tensions, we are not as bullishly optimistic as we were two years ago. We have tactically raised some cash, reduced our equity exposure toward neutral while retaining a cyclical tilt, and reduced our significant underweighting in bonds. This is not a time to panic, as economic and earnings fundamentals, the ultimate drivers of equity markets, remain robust. But it is a time to also manage assets prudently, respecting the unprecedented nature of the current political economy.

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