# Q2 2017 Outlook & Review

QMA's ASSET ALLOCATION GROUP

KEY POINTS

## Economic Outlook

The global economy has started 2017 on a solid note as the various regions have strengthened in synchronized fashion for the first time since 2010 based on business purchasing manager surveys.

While China shows new signs of slowing, growth appears to be picking up in Latin America and Eastern Europe. The risk of a full euroskeptic revolt on the continent is subsiding, and the UK has essentially shrugged off the economic policy uncertainty related to Brexit.

In the US, however, a disconnect has emerged between the surging survey data and the hard economic data, with early reports indicating US GDP growth of near 1% for Q1.

While it's possible the lackluster US Q1 economic reports are simply lagging the survey data, the surveys might also reflect optimism about policy stimulus that may never actually materialize now that the failure of House Republicans to pass the American Health Care Act has cast doubt on the likelihood that the president's ambitious pro-growth agenda will be enacted.

Ironically, given the risks associated with an overheating economy, the heightened chance of continued gridlock in Washington and more modest growth might extend rather than short-circuit an economic expansion now entering its eighth year.

## Investment Outlook

Despite strong fundamentals, we think there is a reasonably high risk of a shorter-term pullback in the equity markets. As such, we have trimmed the size of the above-average exposure to stocks in our portfolios.

The rally in risk assets continued in Q1, but within markets a rotation was seen, as US equity sector, style and market cap performance turned more defensive and interest rates once again were range-bound after their big run-up in Q4.

Corporate earnings have been a bright spot. S&P 500 earnings, which were up 8% YoY in Q4, look ready to grow by 10% in Q1. EuroStoxx 600 profits in Q4 were up 12%.

The biggest risks loom on the US policy front. While corporate tax reform and fiscal stimulus are the key issues for markets (not health care), the failure of the GOP to deliver on health care complicates the odds for corporate tax cuts and a large infrastructure spending bill.

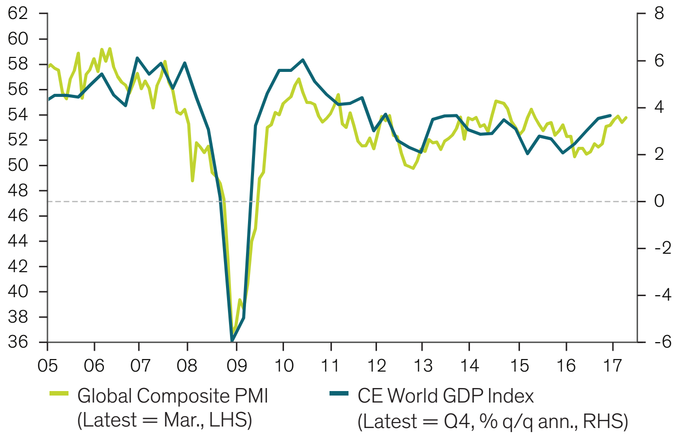
None of this fundamentally changes our investment outlook for the year. We still believe stocks will finish 2017 higher than where they finished Q1, and still maintain a modest overweight in equities and other risky assets. Because we expect to be buying into any downdraft, we were also holding more cash as dry powder as we moved into quarter end.

# Waiting for GoDOT?

## ECONOMIC OUTLOOK

The global economy has started the year on a solid note as regional economies have strengthened in a synchronized fashion for the first time since 2010, at least based on purchasing manager index (PMIs) surveys. Figure 1 illustrates the correlation of PMI readings with GDP growth and shows the global composite PMI index at a three-year high, consistent with world GDP growth of about 3.5%.

1/ GLOBAL MANUFACTURING PMI & GDP

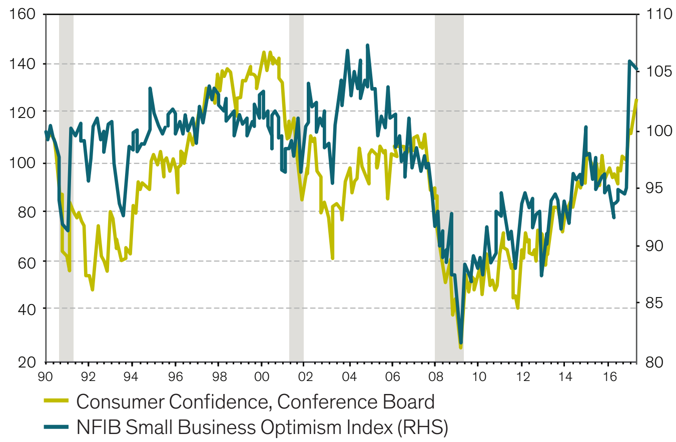



As of 3/31/2017.
Source: Global Economics Chart Book, Capital Economics, 4/5/2017.

So, what caused the pickup and what can we expect looking forward? Turbulence in China this time last year led policymakers there to take actions that juiced credit growth and lifted economic activity above its sustainable rate. As worries about China and deflation risk receded, financial markets and commodity prices sharply recovered. Rising producer price inflation supported a recovery in corporate profits that caused capital spending to firm, and a virtuous circle unfolded.

In November, Donald Trump's victory in the US presidential election, combined with the GOP's continued control of both houses of Congress, raised expectations for an end to Washington gridlock and the prospect of fiscal stimulus and pro-growth economic policies. This seemed to boost "animal spirits" and evidently also played a role in the more optimistic survey data (Figure 2).

2/ POST-ELECTION SURGE IN CORPORATE AND CONSUMER CONFIDENCE




As of 3/31/2017.
Source: Thomson Reuters Datastream, QMA.

While we don't foresee many major potential shocks to global growth near term, we do expect the growth impulse to soften and economic expansion to again become less synchronized as the rest of the year unfolds. Recent moves to tighten monetary and fiscal policy and increase property controls suggest growth will inevitably slow in China. Indeed, a GDP tracker model employing higher-frequency data suggests that may already be the case[1] even as activity in Latin America and Eastern Europe is picking up.

In the Eurozone, economic conditions have benefited from a steady recovery in manufacturing and an undervalued euro. While political developments still pose a threat, they appear less ominous. In the Dutch election a few weeks ago, the euro skeptic party performed worse than expected. A victory by anti-euro candidate Marine Le Pen in France now looks less likely, and Angela Merkel appears on more solid footing for re-election in Germany.

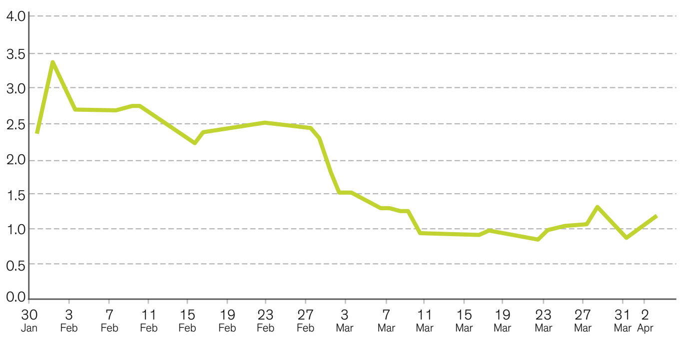
The UK economy has largely shrugged off the uncertainty related to Brexit, and the triggering of Article 50 is unlikely to have a significant immediate economic impact. Depending on how trade negotiations go, Brexit could still emerge as a negative catalyst, but uncertainty could also diminish as negotiations progress and that the British and Eurozone economies continue to expand at a moderate pace.

However, in some countries, including Germany, Japan and, especially, the United States, a disconnect has emerged between the surging survey data and lagging hard economic data on such items as retail sales and industrial production. This raises the question of whether the surveys are painting too rosy a picture. The Atlanta Fed's GDP NowCast forecasts US GDP growth of just 1% for Q1 (Figure 3, on next page) after big downgrades in March from disappointing construction, vehicle sales and wholesale trade reports. One possible explanation is that the surveys are leading the hard data and the hard data is about to pick up. Alternatively, Q1 economic

[1] Emerging Markets Activity Monitor, Capital Economics, 3/30/2017.

data may be understating economic growth due to the typical problems with seasonal adjustments. Or, the survey data may be signaling an anticipation of policy stimulus that, like the elusive title character in Samuel Becket's famous play *Waiting for Godot*, never materializes and impacts actual conditions.

### 3/ PERCENT CHANGE IN ATLANTA FED Q1 REAL GDP FORECAST




As of 3/31/2017.
Source: Federal Reserve Bank of Atlanta, Blue chip Economic Indicators, Blue Chip Financial Forecasts. Forecasts are not guaranteed and are show for illustrative purposes only.

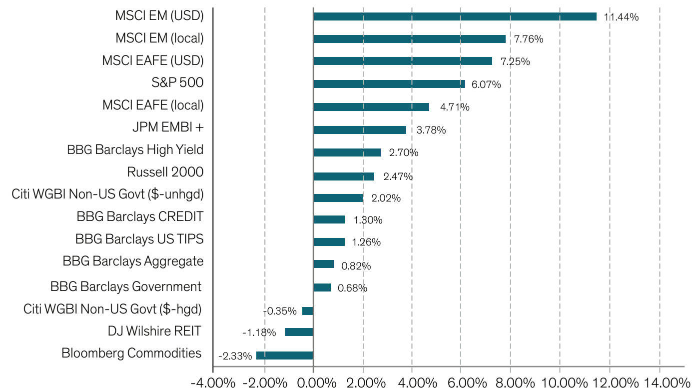
The failure of House Republicans to pass the American Health Care Act (AHCA) in March sows doubts about the ability of President Trump and the GOP to deliver on their ambitious agenda. This causes us to reduce the odds in our base case that meaningful fiscal stimulus is enacted, or, if it is, that it arrives as soon or is as large as initially expected.

Not that any of this would be so terrible from an economic perspective. Given the economy does not appear to be at imminent risk of serious slowdown and has edged close to full employment, the continuation of gridlock and modestly paced growth ironically may extend the life of the now-eight-year economic expansion more than a dramatic final flourish would.

## INVESTMENT OUTLOOK

The rally in stocks and other risky assets continued in Q1, as stocks once again outperformed bonds by a wide margin and high-yield bonds beat the broader fixed income market (Figure 4). But there was some rotation within markets and the risk-on sentiment was not as uniformly strong as it had been in the prior quarter. US equity sector, style and market cap performance took on a more defensive tone and interest rates were range-bound after their big run-up in Q4.

### 4/ Q1 2017 TOTAL RETURNS

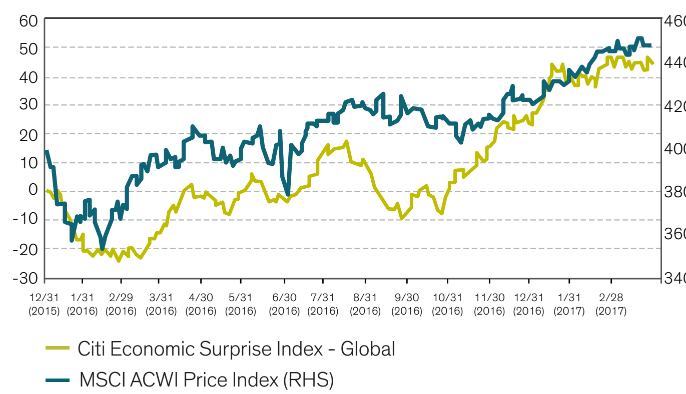



As of 3/31/2017.
Source: Bloomberg. Past performance is not a guarantee or reliable indicator of future results.

US stocks have delivered a nearly 12% total return since the election. It's difficult to pinpoint how much of this has been driven by an improvement in economic and earnings conditions that would have transpired regardless of the election outcome and how much can be attributed to improving business sentiment on expectations of fiscal stimulus and business-friendly regulations.

Figure 5 shows the stock market rally has coincided with a long string of better-than-expected economic data. At the same time, the five-quarter earnings recession that ended last June has given way to an impressive earnings recovery. Q4 S&P 500 profits were up nearly 8% YoY and look set to expand by 10% in Q1. EuroStoxx 600 profits in Q4 were up 12%.

### 5/GLOBAL STOCKS LOOSELY TRACK ECONOMIC SURPRISE INDEX



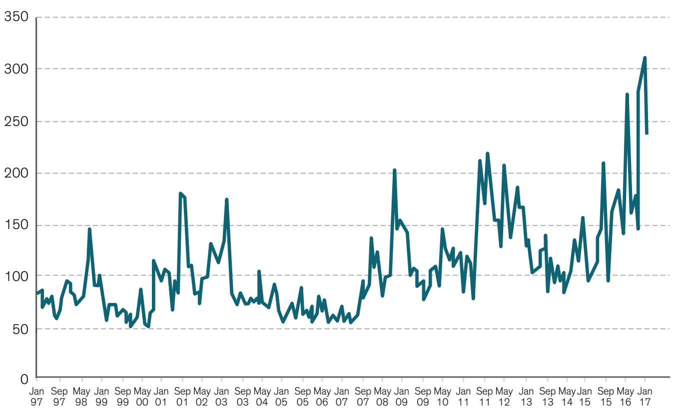

As of 3/31/2017.
Source: Bloomberg, Factset, QMA.
Past performance is not a guarantee or reliable indicator of future results

***Still, despite the strong fundamentals, we think there is a reasonably high risk of a shorter-term equities pullback.*** We have trimmed the size of our above-average exposure to stocks and were holding more cash as dry powder as we moved into quarter end.

Even under the most benign circumstances it would be difficult for the economic data to continue to surprise to the upside, since the strong performance would likely raise expectations higher going forward. Rich valuations (S&P 500 forward price-to-earnings at 18.2) coupled with the recent high policy expectations and a rise in policy uncertainty (as measured by an index of newspaper citations, Figure 6) all add to the potential for disappointment.

Corporate tax reform and fiscal stimulus are the key issues for markets in the macro sense, not health care. But the failure of the AHCA (the passage of which would have reduced the budget deficit by approximately $300 billion) complicates a major overhaul of the tax code involving significant tax cuts, and diminishes the odds of a large infrastructure package that unleashes spending on a long wish list of projects, including Department of Transportation (DOT) initiatives, new veterans hospitals and improved broadband networks.

### 6/GLOBAL ECONOMIC POLICY UNCERTAINTY HAS SURGED




As of 3/31/2017.
Source: Economic Policy Uncertainty, QMA.
http://www.policyuncertainty.com/

We still maintain a modest overweight in equities and other risky assets and expect to be buying into any downdraft, as we believe the general trend for equity markets between now and year end still points upward. While we may be in the latter stages of the economic expansion, we do not believe a recession or the end of the bull market is upon us. During the elongated economic expansions of the 1980s and 1990s, the late-cycle environment (from when the economy first reached full employment to the subsequent recession) lasted an average of almost four years and proved to be a rewarding environment for equity market investors. The current expansion took much longer than those cycles to reach this point, of course. Even so, we do not believe the rising potential for disappointments in the US policy arena will be enough to shake the petals from this late bloomer just yet.

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**For more information**

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**About QMA**

Since 1975, QMA has served investors by combining experienced judgment with detailed investment research in an attempt to capture repeatable long-term outperformance. We manage approximately $116 billion* in assets globally for institutions, sub-advisory clients and individual investors through a broad mix of asset allocation, core equity, value equity and indexing solutions.

QMA is a business of Prudential Financial, Inc.

*As of 12/31/2016.

**Sources**
Capital Economics, Thomson Reuters Datastream, Federal Reserve Bank of Atlanta, Bloomberg, Factset, policyuncertainty.com.

**Notes to Disclosure**



QMA- 20170404-82