MARKET COMMENTARY

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Which Asset Class Will Justify Investors' First-Half Love?

Few forecasters predicted that the first six months of 2017 would witness sharply rising United States and global equity markets alongside falling U.S. long-term interest rates. But, in retrospect, the results are understandable.

Corporate profits have been strong; employment, along with business and consumer confidence, has been high; and inflation has remained restrained. However, while both bonds and stocks advanced in the first half of 2017, a repeat performance in the second half is unlikely, and market watchers are eagerly waiting to see which asset class will ultimately justify investors' love over the coming six months – and beyond. Interestingly, a large part of the answer may be determined by what happens outside the U.S.

"Kiss You in Paris … Hold Your Hand in Rome"

While the current political narrative is tilted toward anti-globalization and protectionism, the current reality remains a global economy and markets that are very much interconnected. During the second quarter, that economic backdrop continued improving; and much as we have opined, both International Developed and Emerging Markets provided patient investors with compelling outperformance compared to their U.S. counterparts.

Indeed, the risk-ridden eurozone equity market advanced a robust 8.1% in the second quarter, and the economic outlook remains decidedly positive. The German IFO Institute Business Climate Index, for instance, recently hit its highest level since data collection began back in 1991. More importantly, it's no longer just Germany doing the heavy lifting, as the recovery has broadened to the economic block's second and third largest economies, France and Italy. During the second quarter, Italian business confidence as represented by the Economic Sentiment Index, hit an 11-year high, and France's Business Confidence Composite Overall Indicator remains perched near a six-year peak. With the recent election of the euro-friendly President Emmanuel Macron in France, political risk in the eurozone has subsided significantly.

With eurozone growth gaining momentum, Mario Draghi, the president of the European Central Bank (ECB), may, at the moment, be the world's most important central banker. While the U.S. Federal Reserve ceased increasing the size of its Treasury holdings when "Round Three" of its quantitative easing ended in late 2014, the ECB more than picked up the slack in the beginning of 2015 by pushing the eurozone's short-term policy rate into negative territory and purchasing trillions of euros' worth of eurozone government bonds to lower longer-term interest rates.

These actions conspired to push most of the German government bond market into negative territory as well. Indeed, during 2016, the German 10-year bonds fell to a record low, -0.18% yield. While the 10-year note has since made its way back into positive territory, the German 7-year bond spent the entire first half of 2017 in negative territory – that is, until the last day of the second quarter.

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The cause of this late rebound was not just stronger growth prospects, but, importantly, the market's reaction to Draghi's June 27 comment that low inflation in the eurozone was transitory and "deflationary forces are being replaced by reflationary ones." Put simply, the market perceived this to be the ECB readying the market for an announcement that it would soon begin to slow its buying of eurozone bonds.

It wasn't just German and eurozone bonds that jumped late in the first half, but also U.S. Treasuries. Why? Because, with a mere click of a mouse, capital can move around the globe, and all bond markets therefore compete for investor attention. Over the past few years, not only has lackluster foreign growth been a headwind to the U.S. economy, but low eurozone bond yields have kept U.S. Treasury yields from pushing higher. With German and eurozone bonds at such low levels, yield-seeking investors have flocked to the U.S. Treasury market and kept rates low. Now, with eurozone bond yields rising, U.S. yields are free to follow suit.

Rising "Animal Spirits" in the U.S.

While foreign bond markets impact U.S. Treasury yields, economic fundamentals obviously matter as well. And while U.S. inflation has recently moderated, we expect the coming months will see it rising again. During the second quarter, both U.S. consumer and business confidence remained elevated. With the unemployment rate falling to 4.4% in June and companies having difficulty filling a record number of job openings, we believe wages will continue rising as corporations look to poach workers from other firms or lure them off the job market sidelines. These rising wages will eventually lead to rising prices as companies look to protect their profits – thus the feedback loop into inflation. As the Fed's Chairwoman Janet Yellen recently stated, "The fundamentals for rising inflation are in place."

Ultimately, we agree with her textbook assessment and also believe that traditional economic and market relationships will prevail. That means that this economic cycle will eventually end, as all cycles do, with higher wages and rising inflation and the Fed then stepping in to hike rates to slow an economy without slack. The return to this norm is simply taking longer than usual because of the deep scars of the Great Recession, which have led to business owners and consumers behaving in a restrained manner. However, as with many things in life, people forget and move on; and we continue to believe that the high confidence levels of consumers and businesses portend the eventual return of "animal spirits." Their reappearance will likely bring faster economic growth in the short to intermediate term as consumers and businesses spend and invest at a quicker, confidence-emboldened pace. Longer term, it will lead to an overheating economy with excesses that need to be recessed. The good news is we believe that condition remains sometime in the future.

Lastly, we continue to advise that investors discount the current U.S. political noise. We believe that the current administration's potentially pro-business agenda is not the difference between economic growth and recession, nor positive or negative market returns, but simply a short-term accelerant. And we continue to place any such legislative actions into the following broad context: Since the Great Recession, all policy actions have had one goal, which is to avoid another financial crisis. Not only did consumers eschew debt and save more, but government regulations forced banks to rebuild their balance sheets and lend less. Taxes were raised to narrow government deficits.

We believe these actions have served to help rebuild the foundation of the American economy, as both the U.S. consumer and banking system appear to be very healthy. However, one could argue that while these steps helped rebuild the economy, they also conspired to slow growth. Now it appears that the current administration's recipe is an attempt to speed up growth by rolling back some of the safety steps of the past with a combination of tax reform, regulatory relief and government spending.

The Bottom Line

In the coming months, we expect that there will be rising global economic growth against a backdrop of central banks attempting to extricate themselves from exerting artificial upward pressure on asset prices. Our biggest concern remains the asset class that was the primary target for their balance sheet expansion and low interest rate policy: government bonds. After the Fed, the ECB and the Bank of Japan have spent the past few years buying trillions of dollars worth of government bonds and pushing yields lower in the process, they're now looking to gradually bring an end to their purchases. Currently, there appears to be ample private demand to meet the resulting rising bond supply, but what price will real-return-seeking investors pay? Will they continue accepting yields less than likely future inflation and, in some cases, outright negative nominal yields? If so, investment textbooks need to be rewritten.

Any potential bond repricing will likely also negatively impact equity markets in the short term. After all, those markets felt the love when central bankers pushed interest rates down. Still, we advise investors to look through any short-term correction in the equity market. Why? Simply because we believe the U.S. and global economies still have room left to expand. And over the intermediate term, if the American and the global economies strengthen, there's a strong probability that global equity markets will also advance – albeit at a moderate pace given the current valuation levels. Furthermore, we continue to recommend tilting toward foreign equity markets because they've been given less love by investors over the past few years and therefore, have less to justify.

To recap, we believe the second half of 2017 will likely result in rising bond yields and equity markets that advance at a more moderate pace. And this, in our view, means that those investors who have loved equity markets will find their actions justified in the intermediate term.

Standard and Poor's 500 Index® (S&P 500®) is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The International Developed Markets asset class is measured by the Morgan Stanley Capital International Europe, Australasia, and Far East (MSCI EAFE) Index, which is composed of all the publicly traded stocks in developed non-U.S. markets. The MSCI EAFE Index consists of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

The International Emerging Markets asset class is measured by the MSCI Emerging Markets Index, which is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of May 27, 2010 the MSCI Emerging Markets Index consisted of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey.

The eurozone, officially called the euro area, is a monetary union of 19 of the 28 EU member states which have adopted the euro as their common currency and sole legal tender. The other nine members of the EU continue to use their own national currencies.

The IFO Business Climate Index is a closely followed leading indicator for economic activity in Germany prepared by the Ifo Institute for Economic Research in Munich, Germany.

The Italy Economic Sentiment Index is based on a survey of 4,000 companies in manufacturing, construction, retail trade and services.

The National Institute of Statistics and Economic Studies manages the Business Confidence Composite Overall Indicator, which is calculated on the balances of total orders, inventories and production outlook. It takes into account many of the individual Business Confidence components.

The European Central Bank is the central bank responsible for the monetary system of the European Union (EU) and the euro currency.

The Bank of Japan (BOJ) is the central bank of Japan.