Key Private Bank's Mid-Year Market Outlook

July 2018

Investment Overview

George Mateyo, Chief Investment Officer, Key Private Bank

The first half in review

This time last year, we adopted the phrase: "Investing at the End of an Era," intending to draw readers' attention to the fact that the ultra-accommodative monetary policies that were initiated in 2009–10 were becoming less accommodative. Headwinds, we thought, were not surfacing quickly, but important tailwinds were losing their momentum.

Six months later, in our 2018 Outlook, while observing that the U.S. economic cycle had entered the latter innings, "thanks to tax reform" we wrote, "we may be able to enjoy some extra innings." How true that was.

As Bruce McCain notes in his Economic Recap and Outlook, after starting the year a bit sluggishly, the U.S. economy is currently displaying signs of accelerating growth, both relative to its recent trend and also against its international peers. Significantly higher interest rates and protectionist policies, if fully enacted, will likely have deleterious effects. However, Bruce thinks there is still time before rising interest rates pose a threat, and the economic impact from trade disputes will be modest.

That said, Bruce's view that tariffs "take money out of the economy by either increasing the prices buyers pay or reducing the profits sellers earn" is an important message. It signals that while the economy may be able to withstand the pressures from a trade war, corporate profits, and in turn stock prices, may face larger challenges. Moreover, while a trade war ultimately benefits no one, in the short run, there will be winners and losers that emerge.

To that point, the U.S. equity market, as measured by the Russell 3000 Index, rose 3.2% during the first half of 2018. This marks the fifth straight 6-month period of positive returns. The market roared out of the gate in January with a 5.3% gain, easily one of the best starts of the year in almost three decades. The advance proved short-lived, however, and stocks retraced their gains in subsequent months amid concerns about stretched valuations, rising interest rates, a tumultuous geopolitical environment and, more recently, trade disputes. Nonetheless, our recommendation that clients with growth-oriented portfolios should maintain an equity bias was rewarded.

Markets outside the U.S. bore the brunt of the escalating trade war rhetoric. Developed international markets, as defined by the FTSE Russell Developed ex-U.S. Equity Index, fell 2.2%, primarily due to currency-related weakness associated with a rising U.S. dollar. Emerging markets fared worse, losing nearly 7%, although many countries saw their equity markets fall significantly further; rising U.S. interest rates, tightening financial conditions, increasing prospects of a trade war, and the strengthening U.S. dollar all contributed to the sell-off. Accordingly, our endorsement for international equities at the beginning of 2018 was not beneficial.

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That said, in the second quarter, we recommended that clients scale back on international developed equities and incrementally boost exposure to domestic stocks. Reasons we cited included a stalling of the economic growth outlook within the European Union (EU), weaker than expected earnings prospects for many European markets stemming from sectoral differences and suppressed interest rates, which constrain European financial institutions; currency headwinds; and the re-emergence of political fragmentation in various regions throughout the continent.

We also tempered our enthusiasm for stocks as a whole earlier this year and recommended that clients give strong consideration to alternative investment streams. This includes volatility premiums, which have historically persisted with above-average consistency, given the historical observation that investors typically overpay for protection just as homeowners usually overpay for insurance.

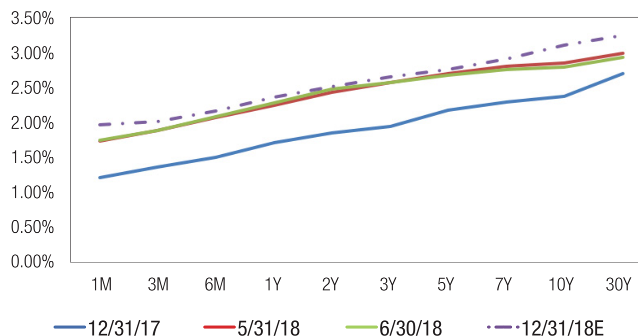
We also reiterated our view that cash, for the first time in ten years, had again become a legitimate investment option, with short-term instruments actually generating yield. As a result, we suggested that clients who possess known liabilities and cash needs maintain six-to-twelve months of cash to ensure such funding requirements can be met.

We thought bonds, on the other hand, should be de-emphasized as we heeded Kevin Gale's assessment that 2018 "would be a difficult one for fixed income investors." This proved prescient as fixed income returns, broadly speaking, declined in the first half of 2018 as evidenced by a return of -1.6% recorded by the Bloomberg Barclays Aggregate Index.

The performance of fixed income assets was muted by the fact that the Federal Reserve ("the Fed") raised its stated policy interest rate by 25 basis points in June, the second rate hike this year, and signaled two additional rate hikes for the remainder of the year. In response, the 2-year treasury yield rose to 2.52% at the end of June, the highest level in 10 years, while the 10-year treasury yield declined by 2 basis points. As a result, the treasury yield curve (the difference between 2- and 10-year treasuries) flattened to 33 basis points, marking the lowest level since July 2007.

A flattening yield curve in itself is not worrisome; it is the potential for an inversion (an event marked by short-term bonds yielding more than long-term bonds) that poses

Fig. 1 U.S. Treasury Curve



risk as market historians will note that nearly all of the last several recessions have been preceded by an inverted yield curve.

Looking ahead to the second half

The term "cautiously optimistic" is an oft-used phrase by many investment prognosticators, but it is short on precision and clarity. A cautiously optimistic forecast could also seemingly almost never be viewed as wrong; the forecast can either be deemed as being cautious or optimistic after the fact.

As we look ahead to the balance of the year and beyond, our view might best be summarized as more cautious than optimistic. To be clear, full-blown pessimists we are not, but risks are rising in our view, and as such, investors should be preparing for lower returns, higher volatility, and continued uncertainty relative to the recent past.

Of the attendant risks, the state of the U.S. economy is not one of them. Again previewing Bruce McCain's outlook in the following pages, consumer and capital spending are both growing nicely, employment trends have remained strong, and inflation, thus far, has not yet accelerated to a point where the Fed needs to aggressively lift interest rates and attempt to slow the economy down.

Nevertheless, liquidity is gradually being withdrawn and as Steve Hoedt cautions, "the Fed will likely keep tightening until something breaks." Such a risk is especially relevant when one examines the vast amount of liquidity that was injected into the economy following the Great Financial Crisis 10 years ago. U.S. and European debt, for instance, approximated $16 trillion in 2008; today governmental debt exceeds $33 trillion,

more than doubling, while the underlying economic growth created in the last decade to service that debt has expanded by a mere 25%.

Similarly, non-financial corporate debt outstanding in the U.S. has swelled by over $2 trillion in the last seven years; the growth in cash flow available to pay for that debt has grown too, but only by $1 trillion over the same period. The repatriation of corporate earnings held overseas will help close some of that gap but ultimately these bills will come due. This could be especially nettlesome for fixed income investors and other creditors, and thus we continue to advise de-emphasizing fixed income relative to one's long-term strategic asset allocation targets.

Stocks, on the other hand, are supported by rising economic growth and surging corporate profits. Thus, we continue to suggest a modest overweight to equities is warranted. Valuations, particularly within the U.S., remain elevated, which will likely limit upside, however.

Overseas, valuations are comparatively more attractive, but we prefer to maintain the neutral stance to developed markets that we adopted earlier this year. Emerging markets, meanwhile, continue to enjoy compelling long-term prospects such as superior economic growth and favorable demographics. Yet, given rising trade tensions and the incumbent increase in the U.S. dollar, investors with a shorter time horizon should adopt a neutral stance to emerging markets as well for now, in our view.

In summary, as one of my mentors astutely stated, 2017 will be remembered as a year that belonged to Wall Street, but 2018 belongs to Main Street. In response, we recommend a modest equity-bias with neutral stance across geographies and an underweight to bonds.

We also encourage investors to expand their definition of diversification and explore uncorrelated return streams to the extent they are able to do so. Cash, we continue to believe, offers a compelling return for short-term liquidity needs. And above all else, we believe in remaining disciplined and focusing on one's long-term objectives. These are things we can and should control, and these are the determinants of long-term investment success.

Economic Recap and Outlook

Bruce McCain, Ph.D, CFA,® Chief Investment Strategist, Key Private Bank

The first half in review

We thought 2018 would be a good year for the U.S. economy, and it seems set to fulfill that expectation. As usual, however, the pattern of growth has provided a few surprises. The year started out slower than many hoped, in part because of a severe slowing of consumer spending over the first two months. But the spending reacceleration since then suggests consumers will contribute solidly to the year as a whole, especially if income growth improves.

Offsetting the temporary consumer weakness, capital spending has been very strong, contributing 1.3% to Q1 GDP. Some have suggested, in fact, that we are in the initial stages of a capital investment renaissance. Most of the investment has been focused heavily on information processing equipment and software rather than on the equipment and structures. Overseas economic growth has been disappointing on a relative basis, as the strong international momentum of 2017 has moderated in 2018. Projected overseas growth remains solid this year, but domestic growth will likely be stronger than expected.

Despite an early scare this year, inflation remained reasonably subdued thus far. Wage rates, in particular, even in the face of growing labor shortages, have not risen sharply. The restrained level of inflation has allowed the Federal Reserve to maintain a slow approach to lifting interest rate hikes, which has kept rates lower for longer relative to past cycles.

Perhaps the biggest surprise so far in 2018, however, has been the harsh trade rhetoric and tariffs that have been imposed. While extreme posturing is often a part of the early phases of difficult negotiations, not only has the conflict gone farther than expected, it has targeted a much wider range of trading partners than most anyone expected.

Looking ahead to the second half

Economists talk about the growth rate at which the economy achieves its potential without stimulus or drag from monetary policy. Below that rate, like pushing on a gas pedal, the economy tends to accelerate. Above that point, rate hikes exert a braking effect. To this point, the Fed has eased off the accelerator, which will cause the economy to decelerate, but should not trigger a recession until the brakes are fully applied. At the current pace, the Fed's tightening would most likely not cross into the braking range until 2019.

Inflation will be key to a decision to brake more forcefully. Inflationary pressures have accelerated in recent reports, and while we have not yet heard calls for significantly higher rates, we should and will remain watchful.

We need to remember, too, that after interest rates rise to the level where they apply serious braking force, it normally takes 9 to 12 months for the economy to slow significantly. That would mean that there is little risk of significant recession this year and most likely not until well into next year or beyond.

The potential for trade wars poses a unique concern. Economists warn us that trade barriers made the Great Depression far more severe than it would otherwise have been, but our practical experience with broad trade wars is limited. Theoretically, tariffs should act like other tax increases. They take money out of the economy by either increasing the prices buyers pay or reducing the profits sellers earn. That should reduce economic output over time, but their effect should spread through the economy gradually rather than causing an immediate calamitous reaction.

What should we watch for the remainder of the year?

At a rate of 200,000+ new hires a month, the labor force has been expanding at roughly twice the rate that population growth and productivity improvement can sustain longer term. As we run short of people to employ, the number of new hires should fall and wage rates should rise more rapidly. Higher wage rates would not automatically translate into higher inflation as long as companies face intense competition, but higher wage rates combined with spreading product price increases would indicate the economic expansion may be reaching its final stages.

The pattern of rate hikes may also shape this cycle in a unique way. So far, the Fed has raised rates slowly and steadily. That provides opportunity to see how earlier hikes affect the economy before rates rise again, which could allow the Fed to avoid the overshoot that typically causes overtightening and recession.

Admittedly, the potential for trade war poses a major uncertainty, but the tariffs imposed so far have been built on a politically vulnerable foundation. It will be hard to defend the idea that the tariffs implemented were essential for national security. At some point, therefore, the World Trade Organization (WTO) or U.S. Congress could reverse much of what has been imposed.

Perhaps, therefore, the President may have decided that his best strategy was to strike fast and hard over a broad front and then negotiate for peace. In this case, he could then seek a negotiated settlement ahead of the mid-term elections. If that does not work and his tariffs are reversed, the President can blame whoever reversed his strategy for the failure and keep his base energized. All said, although we will obviously need to monitor the economy for signs of any major damage, political considerations suggest an extended trade war may not be very likely.

What should we expect from overseas economies?

Off the bottom early this year, the dollar has risen about 6%. The currency tends to be strong when U.S. economic growth outpaces overseas growth. Domestic growth was strong coming into 2018, and the stimulus provided by tax and spending legislation should add even more strength. At the same time, overseas growth has moderated, giving the U.S. an even wider edge. Faster relative growth and higher relative interest rates argue that the dollar will remain strong through the balance of 2018.

Overseas growth improved in the second quarter, suggesting the international outlook may be somewhat better than the first quarter results indicated. Most overseas economies continue to have a solid outlook, and their stimulative monetary and fiscal policies still provide potential for upside. A strong dollar would also help the competitiveness of their exports, which should spur somewhat faster growth. While the U.S. prospects look better for 2018, overseas economies should be more competitive in 2019 and beyond.

Equity Market Recap and Outlook

Steve Hoedt, Head of Equity Research, Key Private Bank
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The first half in review—U.S. equities

Coming into 2018 we believed that the "Goldilocks" situation for the stock market would continue. We saw earnings for the S&P 500 Index growing to $150+, and with both low recession risk and Baa yields of 4.2%, thought that a 19 Price Earnings (P/E) multiple for a target price of 2850 was justified. We tempered our enthusiasm with an expectation for an increase in volatility and thought a correction along the way was likely.

In January, volatility returned with a thunderclap, and the market has churned in choppy fashion ever since experiencing its first correction since November 2015. Performance has now developed into a tug-of-war, as rising real rates—which typically compresses P/E multiples—have largely offset strong earnings growth.

We do not discount growing risks which count downward earnings revisions caused by dollar strength, trade issues, and market adjustment to tighter monetary conditions among their number. Presently, with U.S. GDP at its potential (no "output gap") and large fiscal programs enacted, historically the dollar has risen in both real and nominal terms. U.S. GDP also appears to be stronger than growth abroad providing a further lift to the greenback which weighs on earnings. It has also become clear that the Trump Administration does not view trade issues as mere political gamesmanship; it views balancing trade as existential for the United States and her people.

Looking ahead to the second half—U.S. equities

Heading into the second half, we see continued solid earnings and robust economic growth, with only gradual tightening of monetary policy, which should prove just enough to prevent more than a correction from occurring. Nonetheless, tightening conditions reinforces our view that we are in the late stages of a mature economic cycle, and we are believers in the market axiom that the Fed will keep tightening until something breaks.

The question, as always, is the timing. Of course, the policy controlling rate that causes the market to unwind speculation will only be known in hindsight, but it is likely to be crossed long before the Fed's "dual mandate" goals are achieved. Throughout this cycle, each intermediate-term correction has felt like both the fundamental and technical backdrop is at risk, only for market participants to ultimately realize that the positive influences that drive our modestly bullish thesis are still intact. These include: solid global growth; positive domestic economic activity driving earnings; capital spending improvement; real household median incomes

Fig. 2 Stocks and the economy are diverging, with the economy outperforming stocks

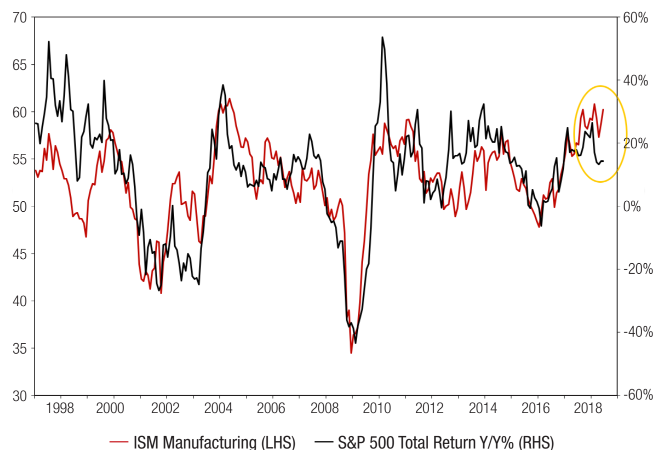
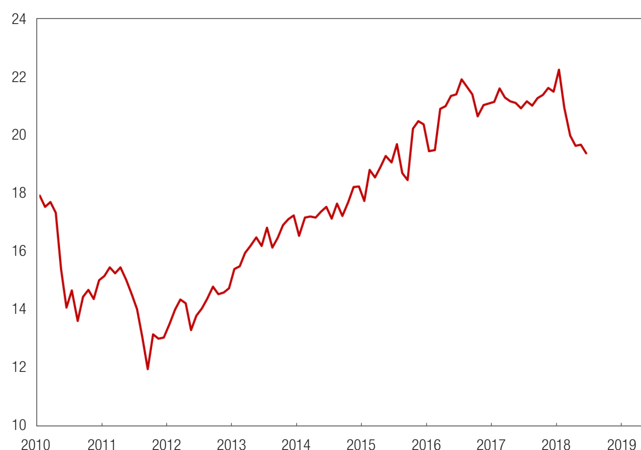


Fig. 3 S&P 500 Trailing Operating P/E: 2018 has been a year of multiple compression



jumping with strong employment; and the demographic-driven push to higher home ownership. Given this, we would avoid adopting a more defensive tone until actual changes in the fundamental backdrop begin to manifest themselves.

The first half in review—non-U.S. equities

Entering 2018, non-U.S. markets looked poised for continued outperformance, with attractive valuations relative to history and strong expected earnings growth. Both Developed and Emerging countries were earlier in the economic market cycle than the United States, and foreign central banks were pursuing more accommodative policies. Actual results so far this year have been more volatile than expected.

Estimated future earnings peaked early in 2018 and were subsequently reined in due to a strengthening U.S. dollar propelled, in part, by broad-based tax reform in the U.S. In addition, political and trade uncertainty hindered sentiment, and the rate of economic expansion (i.e., the second derivative) moderated. As a result, returns in U.S. dollar terms lagged. In developed non-U.S. markets, financial companies bore the brunt of underperformance due to interest rate differentials, while confusion about the growth and earnings outlooks stemming from trade uncertainties and election results weighed on emerging market shares.

Looking ahead to the second half—non-U.S. equities

In Europe, political uncertainty remains, though Brexit appears to be "softening" as the breakaway date nears, and Italian populists appear wedded to the EU. Amid political discourse, economic growth in absolute terms remains strong; Eurozone countries have had positive economic expansion for 20 consecutive quarters. Unemployment is at a decade-long low (8.5%), and wage growth remains steady. Tempered expectations, low interest rates, and strong labor markets bode well for the long term, though for the second half of 2018, investors should expect volatility tied to currency shifts and trade rhetoric.

Japan has weathered 2018 volatility well on low expectations entering this year. Economic expansion continues, though at a more moderate pace, while the Japanese technology sector is somewhat insulated from trade uncertainty as the industry provides vital parts to end producers in both China and the United States. Economic conditions remain accommodative, and earnings growth remains strong.

Emerging market returns were hindered by a strengthening U.S. dollar during the first half of 2018. Investor sentiment deteriorated due to confusion over earnings growth and company profit potential in a more volatile world, masking strong long-term fundamentals such as favorable demographics and other secular tailwinds. Earnings growth expectations remain high, valuation is attractive, countries have a lower external financing burden than in the past (an often overlooked fact), and free cash flow yields remain higher than in developed markets. Tariffs will likely spell continued Asian volatility and election uncertainty rules South American valuation in the near term, though these will likely be viewed as transitory in nature over time.

In all, short-term sentiment, trade war escalation, and political rhetoric subsume earnings growth stories and fundamental growth in the current market environment. While there is a real possibility of further price consolidation during the second half of 2018, longer-term prospects remain attractive.

Fixed Income Market Recap and Outlook

Kevin Gale, Head of Taxable Fixed-Income, Key Private Bank
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The first half in review—fixed income

As indicated in our 2018 Outlook, we thought the year would be a difficult one for fixed income investors. For the full year, we anticipated that the Federal Reserve Open Market Committee ("FOMC") would raise interest rates three times, pushing the 10-year Treasury yield to a range of 2.75%–3.00%. Mid-way through the year, we are on pace for both of these outcomes. We have seen two interest rate hikes by the FOMC through the end of June and we believe two more rate hikes will occur in the second half of the year. The 10-year Treasury note yield ended the first half of the year at 2.84%, in the middle of our year-end target range.

U.S. Treasury yields were higher across the board during the first half of the year, with the 2-year note yield rising 66 basis points to 2.52% and the 10-year yield rising 39 basis points to 2.84%. For the remainder of 2018, we expect volatility in the Treasury market to remain elevated as trade war tensions rise. In addition, with an abundance of treasury supply expected to continue to fund federal budget deficits, at some point, investors may become "full" of U.S. Treasuries and demand higher yields to hold the debt.

Returns across the fixed income asset class were muted in the first half of the year. The Bloomberg Barclays Aggregate Index closed the first half with a return of -1.6%, paced by Corporate bonds, which fell 3.3%, and Treasuries declining 1.1%. High Yield bond indexes closed up 0.2%, while Bank Loans were the star performer, rising 2.1% during the first six months of the year.

Fig. 4 FOMC Probability of one rate hike

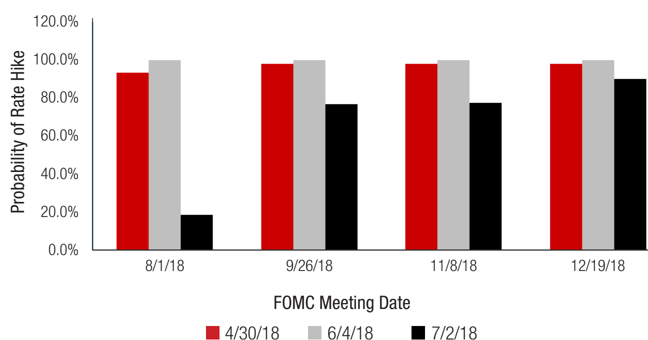
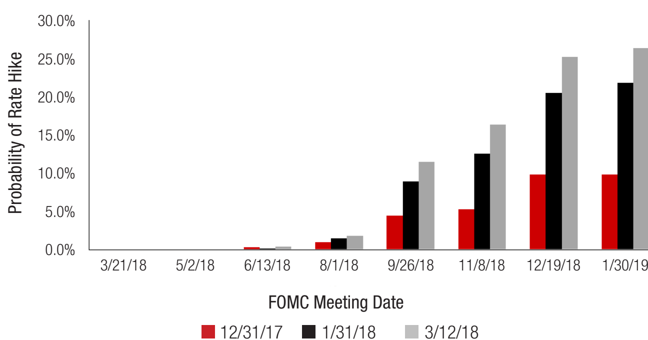


Fig. 5 Probability of 4 rate hikes in 2018



Looking ahead to the second half—fixed income

For the remainder of 2018, we expect one additional interest rate increase by the FOMC and for interest rates to continue to gradually rise, with the 10-year Treasury yield remaining within a range of 2.75% – 3.00%. We expect volatility to remain elevated across the bond market as political risks and fears of inflation weigh on the markets. We believe returns across the fixed income asset class will remain muted for the second half of 2018. As such, we maintain a modest underweight to duration for fixed income portfolios and continue to remain overweight short-term Investment Grade corporate credit. Within corporate credit, we believe the front-end of the curve (maturities of three years or less) are attractive versus longer maturities. We remain cautious on High Yield.

Investment grade fixed income

Performance in Investment Grade credit lagged the broader market during the second quarter of 2018. U.S. Corporate credit lost 1% during the second quarter, lagging the 0.1% total return for the Barclays Aggregate Index and 0.1% return for U.S. Treasuries. The negative returns were driven by wider credit spreads.

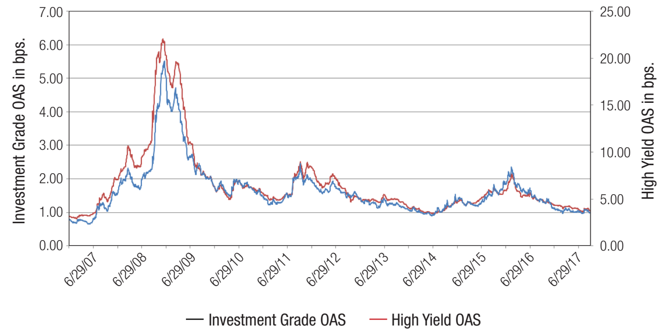
Credit spreads were 13 basis points wider during the quarter, closing at 123 basis points. Spread widening was driven by underperformance from lower quality issuers with 'BBB' rated credit spreads widening 17 basis points during the quarter to 153 basis points. Higher-rated credit performed much better, with 'AA' rated credit widening a modest 4 basis points during the quarter to 70 basis points.

Investment Grade credit was also impacted by the Treasury yield curve. Historically, as rates rise, credit spreads tighten. We saw this during 2Q18 as the yield curve continued to flatten with short rates rising faster than long rates. Short-dated credit (1–3 year maturity) outperformed with credit spreads tightening 3 basis points during the quarter to 65 basis points, while longer dated credit spreads (10+ year maturity) saw credit spreads widen to 175 basis points.

Corporate credit spreads reached their widest levels since early 2017 during 2Q18 as sentiment turned negative on fears of a trade war with China and possible increased mergers and acquisitions (M&A) activity that could push leverage up across the asset class. U.S. political and trade issues are the main forces that drove credit spreads wider during the quarter.

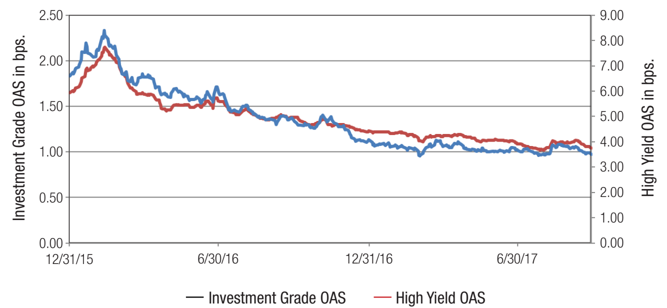
We believe that solid fundamentals and more attractive all-in yields will lead to better performance over the coming months for Investment Grade credit. The front-end of the credit curve (maturities of three years or less) offers the most attractive value without having to take too much interest rate risk due to the flatter Treasury yield curve. We remain overweight the front-end of the corporate credit curve (three years and less) and neutral on the long-end of the credit curve.

Fig. 6 Investment Grade and High Yield OAS



Source: Bloomberg

Fig. 7 Investment Grade and High Yield OAS



Source: Bloomberg

For more information about how this market information might impact your portfolio, contact your Key Private Bank Advisor.

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