GLOBAL ECONOMIC OUTLOOK
APRIL 2018

The U.S. stock market started out in an upward trajectory in January, building on gains from 2017. However, after reaching an all-time high on January 26th, equity markets quickly experienced their first 10% correction in more than a year. After rising for an impressive 9 straight quarters, the S & P 500 closed modestly lower last quarter. Around the world, a majority of global stock markets also posted minor losses to start the year.

While volatility has clearly picked up in recent weeks, we believe that economic fundamentals remain mostly positive. Recent tax cuts should help provide a boost for capital equipment spending this year, corporate profits are currently forecast to rise about 19% in 2018 (followed by an increase of around 10% in 2019) and the U.S. consumer appears to be in a pretty healthy position as a result of continued job growth, gradually rising wages along with increases in both the housing and equity markets over the past several quarters.

However, unlike last year, it looks like equity markets may be in for a somewhat bumpier ride in 2018. The biggest headwinds that we see this year include talk of trade wars (mostly between the United States and China), rising interest rates and the gradual removal of central bank stimulus, uncertainty out of Washington and the Trump administration, and geo-political concerns from overseas. Valuation levels (depending on the measure) mostly remain above trend but for now appear supported by historically low interest rates, rising corporate profits and positive economic growth. Lastly, rising government budget deficits are starting to become a growing concern. At least for now, we believe this is an issue for down the road.

Over the past month or two, emotional investor selling, computer driven trading, along with T.V. news headlines like “markets in turmoil” have all contributed to a pickup in market volatility in early 2018. We think it’s important to take a step back at times and focus on the various

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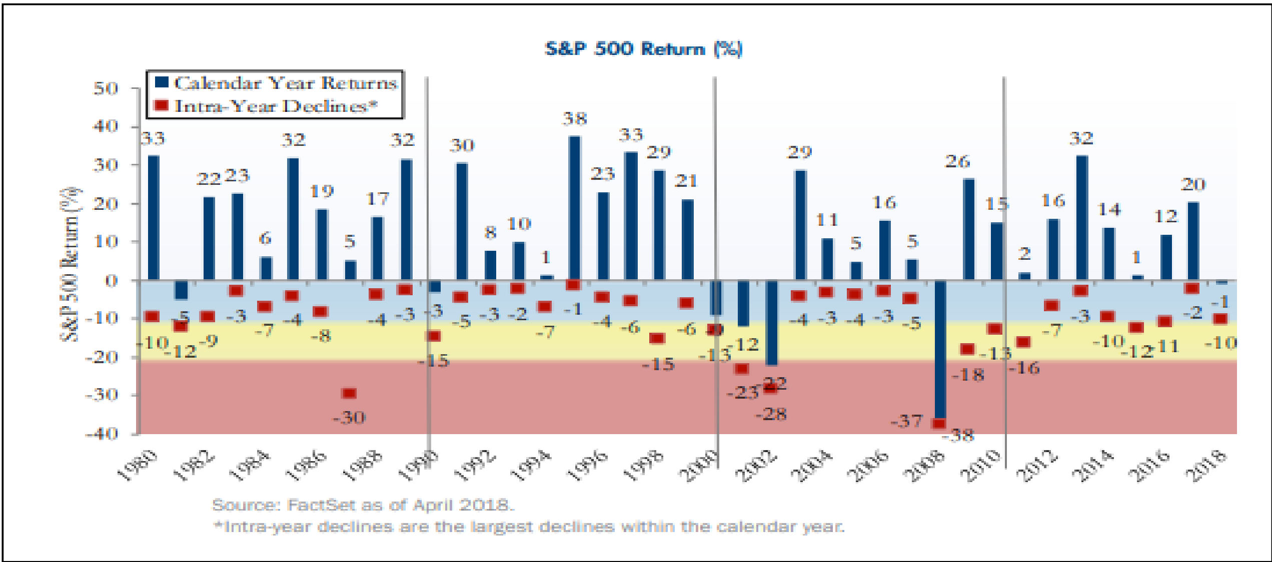
issues at play in the markets. After a period of very low volatility over the past few quarters, investors can be forgiven for over reacting to the recent spike in volatility. Investors are starting to wonder when the end of the current cycle may arrive. Yes, this is one of the longest economic cycles in the post WWII period and the Federal Reserve Bank is raising short term interest rates (from very low levels). However, there are other positive forces still at work. For example, the Conference Board's monthly Leading Economic Index (LEI) continues to rise, consumer and business confidence levels remain positive and the New York Stock Exchange advance / decline line just posted an all-time high this past week. So while uncertainty had increased somewhat in early 2018, we believe it is too early to say that this is the start of a lasting slowdown.

Importantly, market pullbacks are a part of the investing process. For example, the S & P 500 has experienced an intra-year decline of 10% or more in almost half of the calendar years since 1980 (see chart below – Source: Factset, City National Bank Q1, 2018 Quarterly Update). However, in all but six of these years, the market ended the year in positive territory. For reference, the blue squares represent full year market returns while the red squares indicate intra-year market declines.

THE U.S. ECONOMY

A majority of economic data continues to indicate that the economy and U.S. consumer remain on solid footing. While the latest employment report (for April) came in softer than forecast, the average monthly employment gain so far this year has been 202,000 jobs per month. This compares favorably with an average monthly increase of 182,000 jobs per month for all of 2017. In addition, weekly jobless claims, which



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represent a timely measure regarding the health of the labor markets, recently touched the lowest level since 1973.

Right now, the unemployment rate currently stands at 4.1%, where it has been for the past six months. If the economy continues to grow over the next several months (as expected), the unemployment rate should continue to move lower from here. On the wage front, average hourly earnings (while not rising as strongly as we would like) continue to grind higher over time. If labor markets continue to strengthen, we believe it is likely just a matter of time before wage growth rises above the current 2.7% towards a reading of 3% (or more). Consumer confidence levels also appear healthy and remain close to the highest level in more than a decade.

Retail sales data has been somewhat weak over the past few months which doesn't seem to make too much sense given the fact that consumers appear to be in a pretty healthy position these days. However, retail sales rebounded 0.6% month over month in March representing the first increase in four months. On a year over year basis, retail sales are currently up 4.1%. Looking at the housing market, a majority of data (for example existing home sales, new homes sales, and the Wells Fargo / NAHB Home Builders Index) point to continued slow but uneven improvement from month to month. Housing starts rose 1.3% month over month in March and currently stand 4.5% above prior year levels.

On the business side, recent tax legislation should provide a boost for business equipment spending and corporate profits over the next several quarters. We look at a host of different business spending related indicators including the Institute for Supply Management's ISM Manufacturing Index, the Federal Reserve Bank's monthly report on industrial production and the Commerce Department's monthly report on Capital Goods Orders. While the ISM Manufacturing Index has pulled back slightly, the index continues to point to healthy levels of business spending (see chart on page 4 – source: Factset). For reference, when the index is above the 50 level, that indicates expansion and when the index is below 50, it indicates contraction.

Overseas

Overseas, the world economy appears to be growing at a healthy rate. According to a recent update, the IMF projects that global growth is set to reach 3.9% this year which would represent the strongest growth rate since 2011. According to Fidelity Investments, about 90% of the world's Purchasing Manager Indices are currently above the key 50 level indicating

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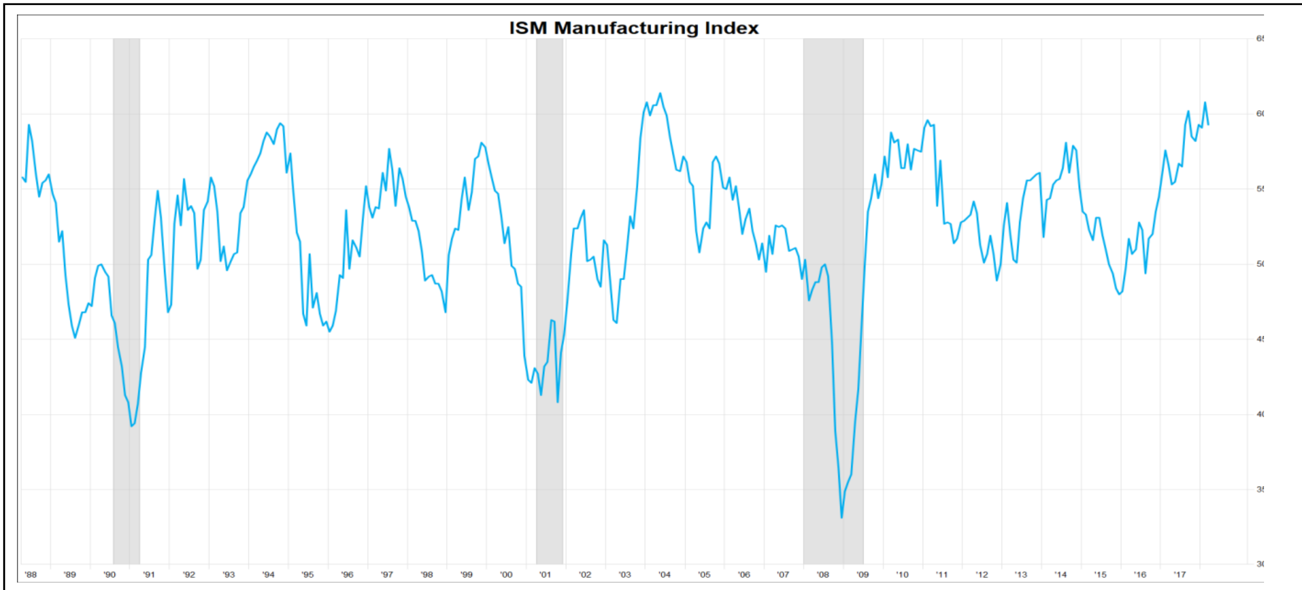

expansion. This indicates that at least for now, growth around the world remains fairly broad based.

While we remain mostly positive in terms of our outlook for global growth, there are a few areas of concern. Debt levels in China remain high and will have to be addressed over time. Economic data has started off the year on the soft side throughout much of Europe. For example, the widely watched ZEW Business Survey in Germany moved into negative territory this past month (likely due to worries over global trade wars). Given the fact that the German economy generates over 40% of economic growth from exports, a rise in global protectionism could have an outsized impact on Germany if it were to develop (which is not our base case). Looking ahead, positives include the fact that the unemployment rate in Europe continues to come down, European Central Bank (ECB) asset purchase programs remain in place (although at a reduced rate from previous years) and nationalistic policies seem to have temporarily died down for now. In Japan, news has generally been positive. The country has recently enjoyed its longest period of uninterrupted growth since the late 1980's (which may have ended this past quarter) and the unemployment rate is currently at a 25-year low. Despite the fact that the Bank of Japan has still not met its 2% inflation target, tax hikes are on the table for next year to deal with the country's rising deficit. This could lead to increased economic uncertainty in 2019.

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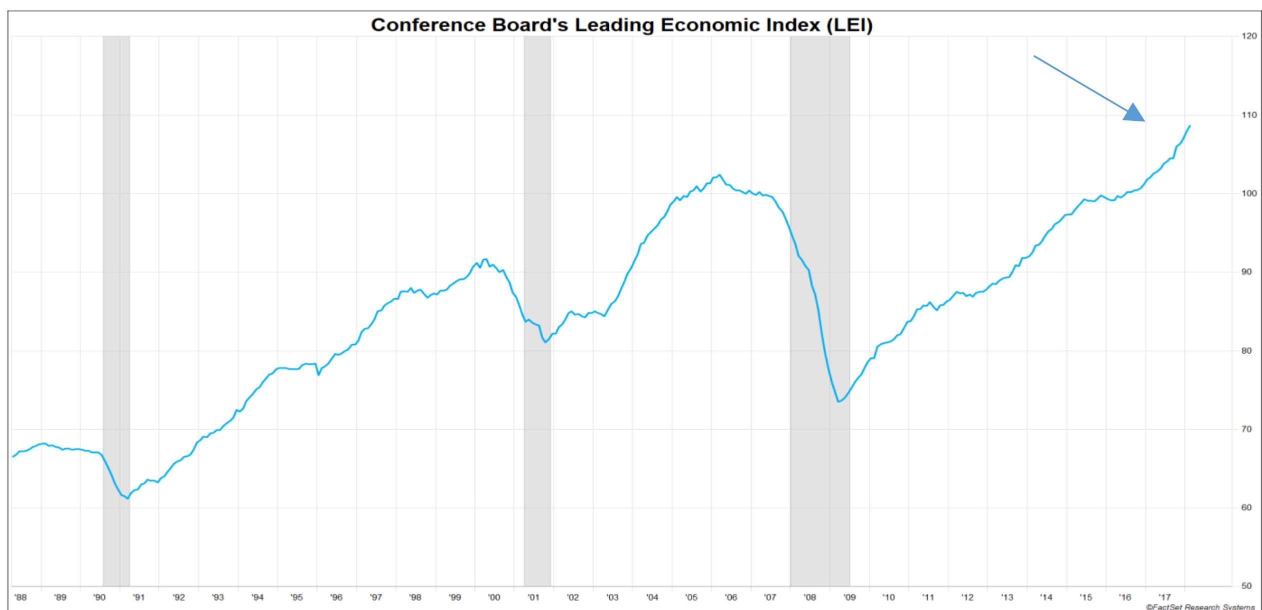
Leading Economic Indicators

We monitor several leading economic indicators here in the U.S. to try and gauge the outlook for the economy and the markets. One indicator that has had a fairly accurate track record of forecasting the direction of the economy is the Conference Board's Monthly Leading Economic Indicator (LEI). For reference, over the past 3 decades, the index has turned down several months ahead of each of the past few recessions (note: the gray regions on the chart below refer to the last three U.S. recessions - source: Factset). The fact that the LEI Index remains in an uptrend indicates that the outlook for the economy over the next 2-3 quarters appears to be positive. We will continue to update you on this and other economic indicators in future market updates.

Corporate Profits and Balance Sheets

Over time, stock prices tend to follow the direction of corporate profits. Thus, it is important to track the growth rate of corporate profits over time. Looking ahead, S & P 500 earnings per share (EPS) are currently forecast to increase 19% in 2018 followed by an increase of 10.5% in 2019. This year all 11 sectors of the market are currently forecast to generate positive year over year EPS growth with nine sectors forecast to generate double digit EPS growth. Next year all 11 sectors are once again currently expected to generate positive EPS growth with five sectors forecast to generate double digit growth. On the revenues side, S & P 500 companies are currently forecast to generate 6.4% growth this year followed by an increase of 4.7% next year. This represents a



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positive backdrop for equity markets over the next several quarters (date source – Factset).

Looking ahead, two questions that we have are: 1) Will company profits actually meet Wall Street's rosy profit forecast? 2) How long will companies be able to generate double digit profit growth? Ultimately it's only reasonable to expect that profit growth will slow down from current levels. Over longer periods of time, corporate profits tend to track the level of nominal GDP (i.e. real GDP plus inflation). However, if corporate profits can continue to rise (although at a reduced rate over the next 2-3 three years), we believe that should provide a positive backdrop for equity markets. Lots of things can change over the next 2-3 years. At least for now, the near-term outlook for corporate profits remains positive.

POTENTIAL HEADWINDS

We are happy to report that the current expansion recently celebrated its 9th birthday this past March. Looking at past cycles, this makes the current expansion one of the longest in the post WWII period. When all is said and done, this could very well be the longest economic expansion on record. Looking ahead, there are a few factors that could lead to trouble down the road:

- During his election campaign, the president accused China of unfair trading. Now that he is president, Donald Trump has threatened to raise tariffs on a number of Chinese goods. Nothing has been finalized yet and what has taken place so far seems more like tough negotiating to us. Looking at the value of U.S. exports to China versus Chinese exports to the United States, it appears that China has much more to lose from a trade war than the United States. There have been some signs of de-escalation in recent days. However, should the U.S., China and other nations engage in major trade wars, this could have a very negative impact on economic growth and financial markets.

- Another potential issue for the markets could result if the Federal Reserve Bank raises short term rates more aggressively than investors anticipate. Historically, economic cycles tend to come to an end when the central bank steps on the break too much and chokes off economic growth. So far, this time, the central bank has been raising rates at a gradual rate. We see another two (or possibly three) rate hikes in 2018 followed by some additional rate hikes in 2019. The central bank has signaled that the neutral i.e. peak rate this time around is likely to be lower than in previous cycles. We hope that's the case but will keep an eye on the central bank in the quarters ahead.

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- Third, there are a number of hot spots around the world that could flare up and destabilize global financial markets. For example, recent events in Syria, Russia and the United States, Iran versus Israel and the situation in North Korea all bear watching.

- Lastly, the economy is starting to experience a modest increase in inflationary pressures. Some of the sources for this include rising oil prices, tightening labor markets, along with a weaker dollar. Recently, the core and headline Consumer Price Index (CPI) both moved above the widely watched 2% level. On the other hand, the central bank's preferred inflation gauge, the Personal Consumption Expenditures Inflation Index (PCE Index) remains a bit below 2%. Our feeling is that while inflation appears likely to trend somewhat higher over the next few months, the central bank is unlikely to panic as the level of inflation experienced during the 1970's does not look likely to return any time soon.

- Lastly, the U.S. is starting to face rising budget deficits over the next several years. Recent tax cuts and the latest U.S. budget are likely to exacerbate things over the next several years. According to recent research from the Congressional Budget Office (CBO), the yearly budget deficit will top $1 trillion dollars fairly soon and remain there for a number of years. We are not sure when investors and the markets will start to be concerned about this but it is on our radar.

FIXED INCOME

On the fixed income side, both short and long-term rates have been rising over the past several months. Yields on the short end of the Treasury curve have been rising as the central bank gradually raises (i.e. normalizes) interest rate policy, and longer-term rates (i.e. U.S. 10 Year Treasury Yields) are rising to reflect positive underlying economic growth and a modest rise in inflationary pressures. Due to factors including globalization, the spread of technology and the Internet, demographic trends, and rising debt levels, we don't anticipate that interest rates are likely to rise dramatically from current levels.

However, for a number of other reasons, we believe that yields are likely to continue trending higher over the next several quarters. First, the world economy is growing, second central banks are starting to pull back and reduce asset purchase programs that have been in place over the past several years, third the unemployment rate in a number of countries continues to move lower and fourth, we are starting to see somewhat higher signs of

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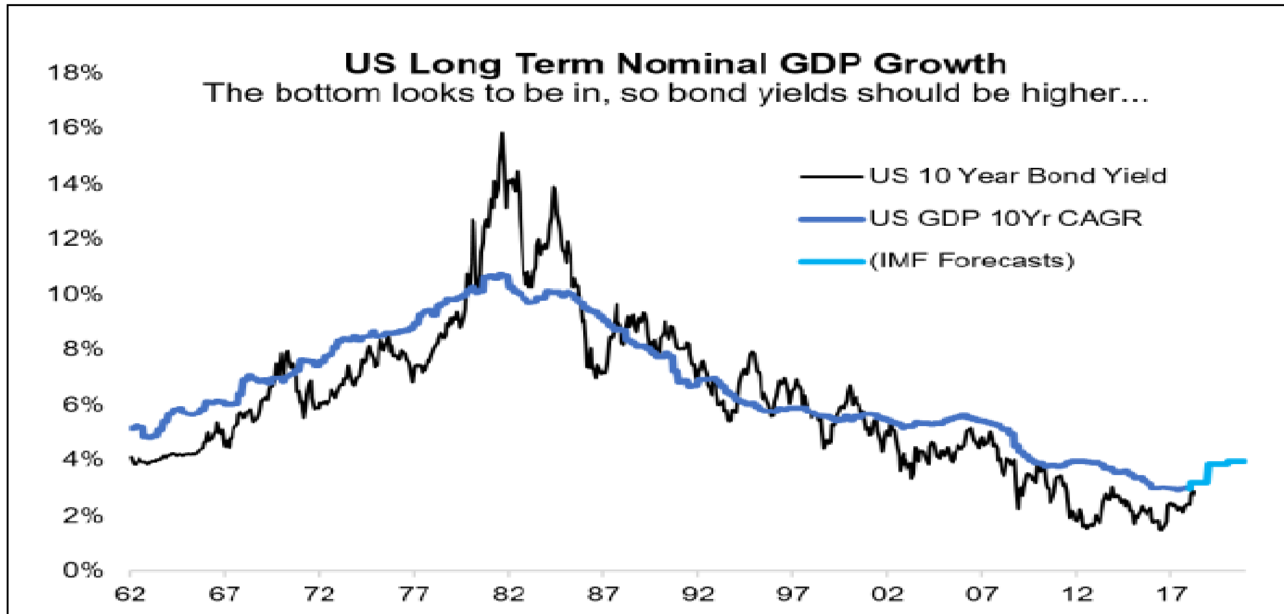
inflation around the world. Over long periods of time, 10-year U.S. Treasury yields tend to track the level of nominal gross domestic product - GDP (see chart below - source: Reuters, IMF).



Thus, we would not be surprised to see somewhat higher yields in the U.S. and around the world over the next few quarters. At RDM we are positioned for somewhat higher interest rates, as we have highlighted in the past. First with a majority of our fixed income assets, we have laddered individual corporate and muni bonds (with a maturity range of approximately 3 to 8 years in most cases). Thus, instead of trying to time movements in interest rates (which is very hard to do on a regular basis), we have created bond ladders which create predictable cash flow for our clients. Second, with the remainder of our fixed income investments, we own a strategic mix of low duration bond funds. Over the past several quarters, this mix of funds has performed quite well compared to the widely followed U.S. Barclays Aggregate Bond Index as interest rates have started to climb higher.

On a separate note, credit spreads (i.e. the difference between U.S. Treasury Bond yields) and either 1) investment grade corporate bonds yields or 2) high yield bonds, have remained fairly steady in recent weeks (despite the pickup in equity market volatility). Spreads moved somewhat higher during the first quarter of the year but have started to come down once again. At least historically, credit spreads have weakened for a period of time before the economy and financial markets have run into trouble. This is something that will be on our radar in the quarters ahead.

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In summary, thanks to a boost from recent tax cuts and fiscal stimulus, the U.S. economy appears on track to generate positive growth once again in 2018. We are not sure if real (i.e. inflation adjusted) GDP growth will reach 3% for the entire year but we feel reasonably positive that growth in 2018 should be somewhat stronger than what we have experienced over the past several years. Business and consumer confidence levels appear healthy, corporate profits are rising, manufacturing activity is showing signs of improvement and interest rates are rising at a gradual rate. Offsetting some of these positives are the potential for trade wars, more aggressive Fed rate tightening, rising inflation, and geopolitical concerns. Rising budget deficits are a growing concern but are likely to have an impact over the next several years as opposed to the next few quarters.

From our perspective, we are probably in the mid to late innings of the current economic expansion. A maturing business cycle suggests that we should be more alert but does not necessarily mean the end of the expansion is just around the corner. We would not be surprised to see some economic data cool down a bit in coming months (after all, a number of economic indicators recently established multi-decade highs and can't be expected to rise much higher). Combined with some of the headwinds that we highlighted above, we would not be surprised to see some additional bumps in the road as we head through the year and get closer to mid-term elections this Fall.

On a more positive note, global earnings growth remains positive and should continue to provide a positive backdrop for equity markets this year. Although a majority of valuation levels for the market remain above historical trends, we believe that continued economic growth combined with a further increase in corporate profits should continue to provide a positive tailwind for equity markets over the next few quarters.

As always please give us a call if you have any questions.

Respectfully,

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S & P 500 - The S&P 500 is a widely followed index that tracks the performance of 500 U.S. large-cap equities. MACD - Moving average convergence divergence (MACD) is a trend-following momentum indicator that shows the relationship between two moving averages of prices. The MACD is calculated by subtracting the 26-day exponential moving average (EMA) from the 12-day EMA.

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