Economic Outlook

First Quarter 2018

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A New Phase for Equities

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SEI recently released its first-quarter Economic Outlook. A summary of the conclusions is provided below:

- We suspect the bull market in U.S. equities is somewhere around the beginning of the end, while it may be closer to the end of the beginning in other countries. To be clear, we are not saying that the bull market in any part of the world is ending, any time soon. Instead, we are noting that the fundamental, technical and psychological factors driving equity market performance appear consistent with the latter stages of an up cycle.

- Although equity markets experienced their first real correction in some 20 months during this past February and March, the pullback does not look to us like the start of a more serious decline. We see the upward shift in investors' interest-rate expectations as the global economy kicks into a higher gear, along with the Trump Administration's recent actions on the trade front, as fundamental drivers behind the return to more volatile equity price action.

- There are cyclical pressures pushing yields up from their historic lows. The long bull market in equities and other risk-oriented assets has been sustained by the extraordinarily expansive monetary policies of the world's most important central banks. The subsequent decline in yields across the maturity spectrum has reached levels never seen before.

- The Treasury yield curve remains upward sloping and, in our opinion, can narrow further without causing too many problems. Interest-rate spreads for investment-grade, high-yield and emerging-market debt also remain near cycle lows. High-yield bonds, in particular, should be considered the canary in the coal mine.

- As we have pointed out on several occasions in the past, the U.S. equity market historically has withstood the depressive impact of rising interest rates until the 10-year bond reaches a level of 4%-to-5%. Owing to the structural decline in bond yields and the elevated equity valuations that have resulted, we now think it prudent to assume that the stock market will begin to struggle if the 10-year Treasury bond rate were to approach 4%.

- While we maintain a favorable view of equities and other risk assets, we must admit that our optimism is being tested as the Trump Administration uses protectionism as a bargaining tool against friend and foe alike. Impediments to trade—tariffs, quotas and non-tariff barriers—raise prices and reduce demand, leading to a dead-weight loss for society.

- We are in watchful waiting mode when it comes to trade, but we think it is premature to expect a catastrophe. SEI prefers to see what trade sanctions are levied, and how target countries respond, instead of assuming the worst from the get-go. Until there is more clarity on the extent of the protectionist measures being put into place, we think it is best to focus on the healthy fundamental backdrop.

- In the U.S., Congressional elections will be taking place in November, potentially putting Republican control of the House of Representatives in jeopardy. Legislating in the U.S. has been tough enough under a "unified" government; it will become next to impossible under split governance. Of course, we can also expect a Democratic House to engage in a variety of investigations of the President and his staff and Cabinet.

- Although the ride has turned bumpier, SEI believes that economic fundamentals justify further gains in U.S. and global equity prices. The synchronized global expansion is still alive and well. Earnings continue to climb briskly around the world. U.S. companies' cash flows and earnings, meanwhile, are benefiting mightily from tax reform. There are few signs that a recession will rear its ugly head anytime in the next 12-to-18 months.

A full-length paper is available if you wish to learn more about this timely topic.

Definitions

Cyclical: Cyclical sectors, industries or stocks are those whose performance is closely tied to the economic environment and business cycle. Cyclical sectors tend to benefit when the economy is expanding.

Spread: Spread is the additional yield, usually expressed in basis points (one basis point is 0.01%), that an index or security offers relative to a comparable duration index or security (the latter is often a risk-free credit, such as sovereign government debt). Spread sector generally includes non-government sectors where investors demand additional yield above government bonds for assumed increased risk.