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Global economic summary & outlook

July 2016

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International

Europe — summary

- As the market digests Brexit, the focus should be towards broader Europe, which economically has consistently underperformed the U.K. for the past five years.
- This notion is supported by relative equity market performance year to date (see below).

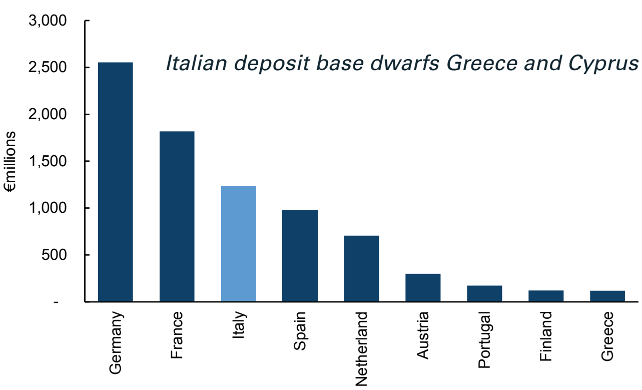
Equity market performance year-to-date as of July 21, 2016

FTSE (U.K.)	+7.44%
DAX (Germany)	-5.34%
IBEX 35 (Spain)	-9.96%
CAC 40 (France)	-5.50%
FTSE MIB (Italy)	-21.44%

Source: Bloomberg

- Additionally, distressed Italian banks presently remain one of the flashpoints for the European Central Bank (ECB) and the Italian government. Non-performing loans (NPLs) at Italian banks are estimated to be as high as 17% of total loans.
- The Italian government has threatened to override European Union (EU) rules and use taxpayer money to restructure distressed banks. This directly contradicts the 'bail in' mechanism instituted by the European Commission, which requires depositors and investors to absorb losses.
- Problems with the Italian banking system represent a potentially major systemic risk to Europe as deposits there greatly exceed those of Greece and Cyprus. However, until it is resolved, it represents the clash of national sovereignty versus the power of the EU.

Monetary financial institution deposit liabilities - May 2016



Source: ECB Statistical Data Warehouse

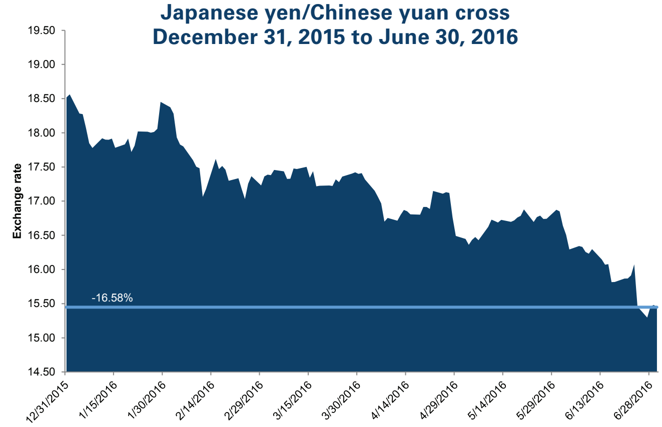
Europe — outlook

- With Brexit now a reality, global stimulus will increase. The uncertainty caused by the event is having predictable consequences as investors flee to quality.
- We anticipate a resulting temporary slowdown in Europe and the U.K., although all trade agreements between the U.K. and Europe will remain in place for at least two years from the triggering of article 50 of the Lisbon Treaty.
- Away from Europe, the Chinese have continued to devalue the renminbi. This could have the effect of exporting deflation and driving global prices lower.
- Given this, we continue to expect lower bond yields and higher financial asset prices as quantitative easing (QE) induced liquidity causes investors to search the world for return.
- We anticipate Eurozone growth will be close to flat for the remainder of 2016 following signs that a slowdown was already underway during the second quarter.
- We also expect that the litany of elections and referenda ahead for the EU, along with Greek and Italian economic malaise, will cause future uncertainty. For example, the Italian constitutional referendum, the Hungarian immigration referendum, and the Austrian general election rerun could all further a populist swing towards anti-EU sentiment.
- As a result, we anticipate more stimulus from the ECB including expansion of qualified assets for ECB purchases and possibly some easing of the stability pact limits to allow for more fiscal stimulus. The U.K.'s Finance Minister stated that corporate taxes could be cut from 25% to below 15% to attract businesses to the U.K., which may potentially force European governments to follow suit with other fiscal stimuli.

Rest of the world (ex-Europe and U.S.) — summary

- Japan's Abe government gained enough seats in the upper house to allow it to change the Japanese constitution. Given the lack of economic success so far, more Japanese QE is likely.
- China continues to devalue its currency, which is down by 16.7% against the Japanese yen so far in the first six months of 2016 (see below). The renminbi devaluation supports deflation around the globe and is generally supportive of lower yields. China has no current domestic inflation problems.

Japanese yen/Chinese yuan cross December 31, 2015 to June 30, 2016



Source: Bloomberg

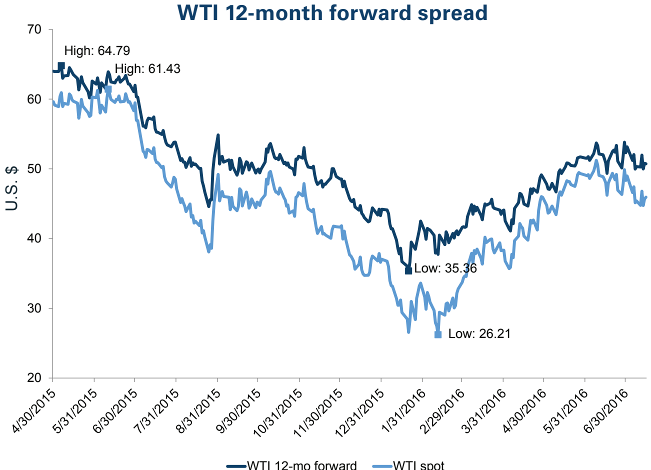
- Despite political uncertainty, the Brazilian economy continues to show tentative signs of improvement with moderate inflation and slightly less negative growth expectations. The gradual recovery in commodity prices has helped. Local currency Brazilian bonds are among the best performers year-to-date.

- Over the last three months, an estimated 19 central banks have cut interest rates around the world in an effort to stimulate economic growth.
- The Australian general election ended up in a hung Parliament without any party having a clear majority. A Liberal/Conservative coalition will now govern. Of note however was the rise in the vote for non-establishment parties which increased to 28%, a significant jump from previous elections.

Rest of the world (ex-Europe and U.S.) — outlook

- Concerted global easing by central banks, a combination of QE and interest rate cuts, are all supportive of financial asset prices broadly. Although it is too early to quantify, we anticipate a pickup in growth around the world later in 2016.
- Central banks outside of the big four (the U.S. Federal Reserve (Fed), ECB, Bank of Japan (BOJ), People's Bank of China (PBOC)) should continue to cut interest rates. Cuts will be dependent on a continuing weaker U.S. dollar.
- Chinese authorities will likely continue to take action to support economic growth, including devaluing the yuan and increasing loans. We expect this to continue to the extent that authorities achieve the desired growth target of 6%-7%. The lower yuan will have the effect for now of easing any global inflationary pressure.
- The gradually higher trend in commodity prices should continue, excluding energy, helping commodity-based countries. The West Texas Intermediate (WTI) 12-month forward contango is rising again implying that global oil and petroleum stocks are growing again, increasing storage costs.

WTI 12-month forward spread



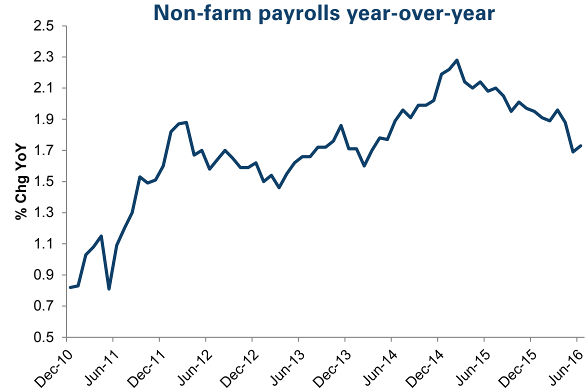
Source: Bloomberg

Domestic

United States — summary

- After moving past a very disappointing May non-farm payroll number of +38,000 that was released the first week of June, economic data were largely as expected and consistent with a mid-2% GDP growth rate for the second quarter.
- The most impactful economic release during the month of June was the non-farm payroll report. Expectations were for an increase of 160,000 jobs (including a 35,000 drop due to a Verizon strike.) Instead, the Department of Labor reported a meager gain of 38,000 jobs. This report confirmed a multi-month slowdown in the labor market (see following chart) bringing into question the health of what had been the bright spot of the economy to date.

Non-farm payrolls year-over-year



Source: Bloomberg

- Consumer spending continues to be the engine of growth behind the economy, although a decelerating employment growth picture could threaten this and warrants close attention.
- Although the direct effects of Brexit on the U.S. economy are likely to be minimal, the disruption to U.K and European growth could be significant.
- Rates rallied globally as economic uncertainty in the U.K. and Europe increased. As a result, there is now an increased expectation for easier monetary policies abroad. These policies are likely to influence the Fed towards an easier for longer policy stance.
- Inflation expectations in the U.S. remain well below the Fed's target of 2%. This continues to be a concern for the Fed and we believe this will delay any interest rate increases in the near future.
- Markets quickly re-priced the probability of Fed rate hikes downward after the employment report, as it was expected that the Fed would be forced to pause. The 10-year note rallied approximately 10 basis points.

United States — outlook

- Market expectations for rate hikes from the Fed remain very low despite hawkish comments made by a couple of non-voting Fed bank presidents. We continue to believe that it is likely we will see just one rate hike in 2016. We anticipate employment growth to continue to be positive, although at a somewhat reduced rate due to the economy's current high level of employment.
- The manufacturing sector appears to be stabilizing as many of the regional manufacturing indices have turned up recently. We would still like to see industrial production turn upward (see chart below). We continue to forecast GDP growth for the year in the 1% to 2% range.

Industrial production year-over-year

Source: Bloomberg

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