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Global economic summary & outlook

August 2016

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International

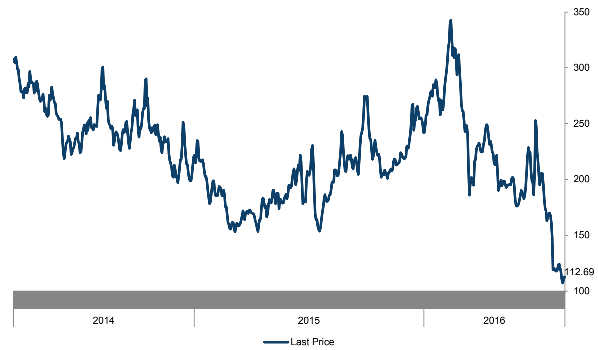
The world is refocusing on various ways to stimulate growth as the Brexit dust settles. Globally, multiple central banks have continued to cut interest rates as inflation remains benign and growth elusive. As governments increasingly shun austerity, signs of impending fiscal stimulus have appeared in recognition of the fact that monetary policy alone is not sufficient to revive growth. For example, Japan recently announced a ¥28 trillion "lend and spend" package in an effort to trigger economic growth and inflation.

For the time being, we believe the fixed income environment remains friendly, as U.S. yields remain attractive relative to overseas markets. However, we anticipate that fiscal programs will increase, and that eventually this will stimulate real economic growth. We remain vigilant with regard to identifying a long-term inflection point in interest rates.

Europe — summary

- In the U.K., investors remain focused on the aftermath of the Brexit vote. In August, the Bank of England (BOE) cut its base rate to 0.25% from 0.50% and introduced a stimulus package valued at £170 billion (approximately $225 billion), which included a government and corporate bond purchasing program. The BOE reduced its U.K. GDP forecast for 2017 and 2018 to 0.8% and 1.8%, respectively. The FTSE stock index rallied on the news.
- Eurozone growth remains sluggish. Economic spillover from Brexit is limited, but data for the period preceding the referendum already showed signs of slowing. May 2016 industrial production declined 1.2% from April 2016, as measured by Eurostat's Index of Industrial Production. Eurozone Purchasing Managers Index (PMI) data is relatively unchanged for the second quarter of 2016, but published results appear stronger than expected. It is still unclear if the new European Central Bank (ECB) stimulus is having the desired effect but, if growth does not accelerate soon, sovereign nations will be forced to confront European Union (EU) austerity policies.
- Potentially, as a preemptive move to the eventuality of austerity policies, the EU warned Spain and Portugal against further excessive deficits. Although fines were not actually imposed, Brussels demanded specific plans regarding these countries' efforts to reduce 2016 and 2017 deficits, including "structural measures." The implication is bearish for European growth, as the EU's solution for Europe's economic problems appears to be more Brussels, not less.
- Despite lackluster data, European corporate spreads continue to tighten. Although European high yield corporate bonds are not part of the ECB's bond buying program, yield spreads on the asset class have reached record lows as evidenced by pricing on the Markit iTraxx Europe Crossover Index (i.e., European high yield credit default swaps (CDS), see chart). It appears that high yield bond prices are being indirectly supported by the "crowding in" effect of ECB purchases in other markets.
- Italy's Prime Minister Matteo Renzi has actively pushed the EU to devise a "bail-out" plan for the country's distressed banks. However, the EU prefers a "bail-in" solution whereby depositors and bondholders incur losses in order to recapitalize the financial institutions. Renzi has come under pressure due to Italy's lackluster economic performance. Industrial output in Italy fell by -0.4% in June, the second consecutive month of decline.

Markit iTraxx Europe Crossover Index



Source: Bloomberg

Note: The Markit iTraxx Europe Crossover Index comprises 60 equally weighted CDS on the most liquid sub-investment grade European corporate entities.

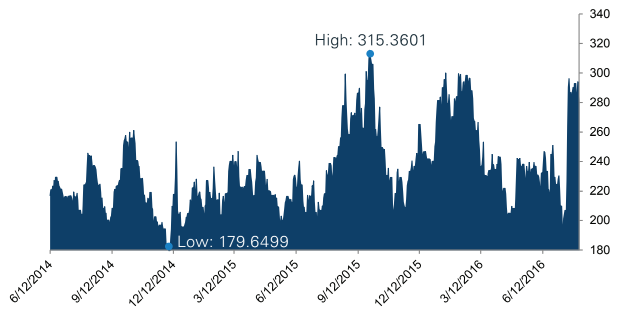
Europe — outlook

- The BOE's recent action of cutting its base rate to 0.25% will put considerable pressure on the ECB to follow suit given the post-Brexit rise in anti-European sentiment.
- We expect European rates to remain low for an extended period.

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

- Japan introduced a long-awaited stimulus package. However, whereas investors expected the Bank of Japan to increase its stimulus program, the government instead introduced a ¥28 trillion (approximately $275 billion) "spend and lend" package targeting infrastructure and other programs.
- India, the world's seventh-largest economy, introduced sweeping tax reforms which streamlined corporate tax rules. The effect is net cost savings for many companies, and therefore stimulative. The move represents the most significant tax reform legislation since Indian independence.
- Reacting to slack inflation data as well as an uncertain economic outlook, the Reserve Bank of Australia cut interest rates by 0.25%. Retail sales increased a modest 0.1% in June.
- We continue to like emerging market debt as central banks cut rates. Although yields are attractive compared to developed markets, there are fundamental risks. The Central Bank of Brazil stated that "inflation leaves no room for a rate cut." Brazilian bonds, in local currency, are among the best performing so far in 2016. Industrial production in Brazil rose 1.1% in June, the fourth consecutive monthly increase.
- Turkish sovereign spreads widened after the recent coup and following S&P's hasty downgrade into non-investment grade territory. The market now awaits reviews by Moody's and Fitch sometime in August. A downgrade by all three ratings agencies would likely push Turkey's USD-denominated sovereign spreads wider.

Turkey/U.S. 10-year Treasury bond spreads



Source: Bloomberg

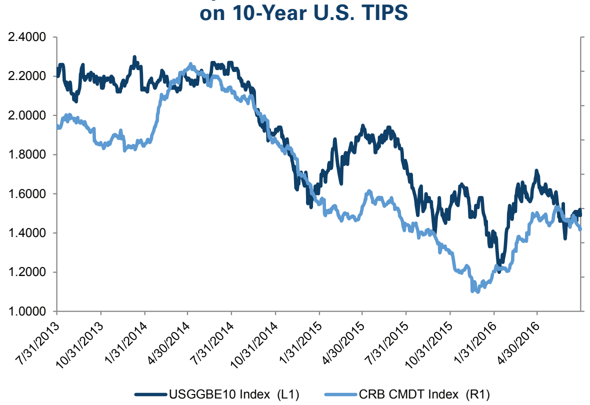
Rest of the world (ex-Europe and U.S.) — outlook

- We anticipate that Chinese economic growth will accelerate slightly in the third quarter of 2016, as a result of significant lending stimulus injected by the People's Bank of China in the first quarter of 2016. Although retail sales grew at a +10% rate year-to-date, Chinese imports continue to decline and have not yet increased in response to a lower yuan.
- We expect the Reserve Bank of New Zealand to follow the Reserve Bank of Australia's lead and lower rates, too.

Currencies and commodities

- We continue to believe commodity prices (ex-Energy) will remain on a gradual recovery, as global growth stabilizes and recovers toward the end of 2016. Under that scenario, and against a backdrop of a benign Fed, the USD should continue to weaken against commodity related currencies.
- Iron ore prices continue to rebound from the recent low point reached on May 31, 2016.
- The CRB Commodity Index and the 10-year breakeven rate on Treasury Inflation Protected Securities (TIPS) exhibit a correlation of over 80% over the past two years (see chart). A continued recovery in commodities prices would suggest that inflation expectations will eventually increase.

The CRB BLS Spot Index and the breakeven rate on 10-Year U.S. TIPS



Source: Bloomberg
Notes: The CRB BLS Spot Index tracks the price of 22 commodities. The breakeven rate is calculated by subtracting the real yield of the inflation linked maturity curve from the yield of the closest nominal Treasury maturity. The result is the implied inflation rated for the term of the stated maturity.

Domestic

United States — summary

- On July 29, 2016, the U.S. Department of Commerce's Bureau of Economic Analysis (BEA) released its advance (i.e., initial) estimate regarding the national income and product accounts. According to the release, real gross domestic product (GDP) grew at an annualized rate of only 1.2% in the second quarter of 2016, versus an expected rate of 2.5% as measured by a survey of 77 economists. On August 26, 2016, the BEA will release its second estimate based on more complete source data.
- The shortfall in the BEA's estimate of second quarter 2016 real GDP growth relates primarily to 1) weak private (i.e., business) inventories; and 2) lower private fixed investment (i.e., capital expenditures).
- A decline in private inventories reduced the second quarter 2016 real GDP growth estimate by 1.2%. Moreover, inventories as a percent of sales remain somewhat elevated (see chart), suggesting that continued destocking could weigh on future GDP estimates. Regardless, inventories remain one of the most volatile and difficult to estimate contributors to GDP.

Manufacturing and trade inventory to sales ratio

Source: U.S. Census Bureau

- Private fixed investment contracted sequentially at an annualized rate of 3.2%, the third consecutive quarter of decline, and had the effect of reducing the real GDP estimate by 0.5%.
- Consumer strength continued to contribute positively to real GDP growth. Personal consumption expenditures (i.e., consumer spending) grew at a 4.2% annualized rate in the second quarter of 2016, improving from a 1.6% growth rate in the first quarter of 2016.
- Aside from the weak GDP report, most economic data released in July reflected stronger than anticipated trends as evidenced by the increase in the Citi Economic Surprise Index, which advanced from -19.8 to a high of +43.1 during the month.
- On July 8, 2016, the U.S. Bureau of Labor Statistics released nonfarm payroll data pertaining to the month of June showing the economy added 287,000 jobs in the period, up from a revised increase of only 24,000 in May. The favorable nonfarm payroll data represents a significant positive indicator of economic conditions, given the economy's reliance on the consumer. The payroll data was somewhat tempered, however, by disappointing wage growth.

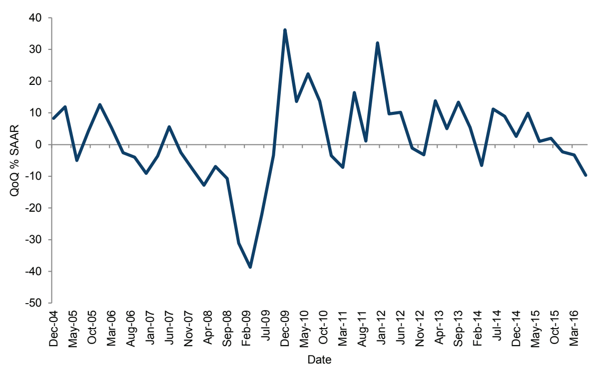
- Oil prices fell throughout the month of July, and ended the period down approximately 20%. Further softness in oil and other commodities prices may raise concerns regarding the U.S. Fed's ability to meet its 2% inflation target rate.

United States — outlook

- While we currently expect that the economy could accelerate during the second half of 2016, we nevertheless anticipate that GDP will continue to grow at a relatively subdued rate. Given real GDP annualized growth of 0.8% and 1.2% in the first quarter of 2016 and second quarter 2016, respectively, we remain comfortable with our 1% to 2% GDP growth rate outlook for the calendar year.

- In a somewhat worrisome trend, strong consumer spending is being offset by weak capital and inventory investment. U.S. Gross Private Domestic Investment (i.e., a measure of capital and inventory investment) declined 9.7% in the second quarter of 2016 (see chart). We believe these contradicting indicators require close monitoring, as any sign of weakening consumer spending could signal an economic slowdown. Alternatively, any indications of an increase in manufacturing and/or business investment could precede a stronger recovery.

U.S. gross private domestic investment



Source: U.S. Bureau of Economic Analysis

- Recent Fed statements note that events overseas, including the U.K. referendum on membership in the EU, may impact the U.S. economy. Consequently, we expect Fed interest rate policy to remain cautious.

- A low rate of inflation, which continues to reside well below the Fed's 2% target rate, may also restrain its resolve to raise the fed funds target rate.

- We continue to believe that a single Fed rate hike in the second half of 2016 is possible.

Disclaimers