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Global economic summary & outlook

September 2016

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International

The global growth outlook remains mixed with Europe (ex-U.K.) now beginning to feel the negative effects of Brexit. Analysts have trimmed their expectations regarding European economic growth, as inflation rates continue to fall and business confidence declines. Sluggish economic trends put the European Central Bank (ECB) in a difficult position, given its recent increase in monetary stimulus and desire to see both growth and inflation move higher across Europe. Since the ECB is unlikely to remove stimulus while economic growth remains subpar, low and possibly negative European interest rates may persist for the foreseeable future.

Elsewhere in the world, other major central banks have implemented further rate cuts. Consequently, the U.S. seems an outlier, as members of its Board of Governors of the Federal Reserve System comment publicly regarding the potential for a rate increase. In Asia, Chinese data implies a tentative pickup in economic activity, although the country's competitive advantage vis-à-vis the U.S. has all but disappeared when one considers transportation costs and higher wages. Going forward, and given its declining competitive advantages, China's ability to grow via its export markets could be limited. We continue to expect a benign interest rate environment for the rest of the world, and thus a favorable bond environment for the foreseeable future outside of the U.S.

Europe — summary

- Despite sluggish economic growth, only six of the 28 European Union (EU) member countries presently have budget deficits that exceed 3% of Gross Domestic Product. This represents a significant improvement and is down from 23 in 2009. The 3% limit is a requirement of the EU under the Stability and Growth Pact. This improvement has increased speculation that governments will increase fiscal stimulus as politicians recognize the limits of monetary policy. However, the deadlock on any specific fiscal programs highlights the political stagnation between the EU and its member countries.
- Wolfgang Shäuble, Germany's Federal Minister of Finance, warned that if Brexit was not handled correctly, it could lead to the end of the EU. Scotland revealed a 15% budget deficit, confirming that it is highly unlikely that the country will ever secede from the U.K. and join the Eurozone.
- Recent post-Brexit U.K. economic data appears surprisingly resilient, and a stimulus package by the Bank of England will help the economy going forward. U.K. unemployment is at a very low 4.5%, consumer credit rose recently at the fastest pace in 10 years, and retail sales have benefitted from an increase in retail tourism as overseas buyers take advantage of a weak pound. Jewelry and watch sales increased 16.5% in July. It appears that Article 50 of the Lisbon Treaty will be triggered sooner rather than later and, contrary to speculation, will not require a Parliamentary vote.
- Recently released data suggests a weaker German economy as a result of a slowdown in exports. Business sentiment in Germany fell sharply following the Brexit vote. As the powerhouse of the European economy, a German slowdown puts downward pressure on European risk assets, despite the ECB's continuing quantitative easing activities.

U.K. consumer credit rose at the fastest pace in 10 years

- Portuguese yields rose, as speculation mounted regarding a possible further downgrade to the country's last remaining investment grade rating. The yield increase is noteworthy, as it indicates that European bond markets are still subject to market forces and not completely controlled by the ECB.
- As expected, former French President Nicolas Sarkozy announced his intention to seek nomination as the French Republicans' presidential candidate. This could dilute Marine Le Pen's odds of becoming the next French President, although she leads Sarkozy by six points in recent polls.

Europe — outlook

- We believe European yields will remain low. The structural imbalances of the Eurozone (e.g., chronic regional unemployment) aren't necessarily conducive to economic growth. The region's structural imbalances can only be resolved by political change, and debate regarding that issue and the future of the EU. itself could lead to market volatility. With little sign that ECB policies are producing the desired results, political pressure within the EU. is mounting to affect real change. Absent any progress, anti-EU politics will eventually gain traction and other countries may threaten to exit membership.

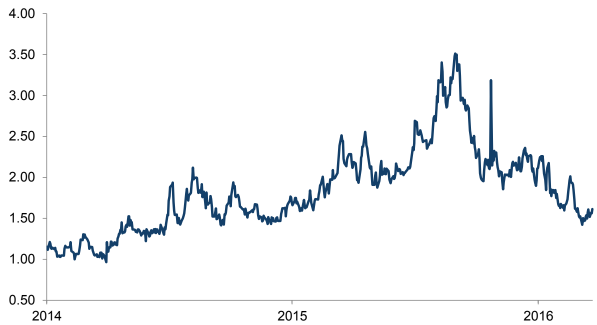
Political pressure within the EU is mounting to affect real change

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

- Chinese economic data continues to be, on balance, positive. Retail sales enjoyed their seventh consecutive month of growth in excess of 10% and analysts expect +6.7% second quarter 2016 Chinese GDP growth. There is growing global sentiment against Chinese overseas M&A activity which cites as issues the country's managed currency exchange rate and the national interest represented by certain target companies. In August 2016, Australian authorities blocked a Chinese investor group's bid for Ausgrid, a state-owned electric utility. This sentiment is likely to spread to other regions.
- Japan's unemployment rate fell from 3.1% to 3.0%, the lowest level in 20 years. The consumer price index (CPI) (excluding fresh food), fell to -0.5%, the third consecutive monthly decline. The country faces major demographic headwinds as its population continues to age. The result is full employment (among the employable), but lackluster growth and deflation. These seem an inevitable consequence of a declining population. There could be parallels with other developed countries such as Germany and Italy, which face similar demographic trends.
- Brazil is one of the few countries in the world where inflation is a problem. Against a backdrop of political uncertainty, the country appears to be experiencing a classic case of stagflation (i.e., high inflation and slow economic growth). That said, the country has the best-performing equity and bond markets this year.

- The Revolutionary Armed Forces of Columbia (FARC), a guerilla movement, ended its 50-year war with the Columbian government. U.S. dollar-denominated Columbian spreads tightened on the news relative to the U.S. curve. As of August 30, 2016, the 10-year Colombian-U.S. dollar denominated bond yielded 3.2%.

Colombia-U.S. dollar denominated bond 8-year spread to U.S. treasuries



As of 8/31/2016. Source: Bloomberg

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

- Outside the U.S., we anticipate further central bank easing in the form of interest rate cuts. However, foreign central bank rate cuts could be hindered by any short-term strength in the U.S. dollar. Combined with stimulative fiscal actions, emerging markets and some developed countries may begin to see a growth recovery later in 2016 and into 2017. We increasingly expect that fiscal stimulus could occur somewhere within the EU, given the region's growing sentiment against austerity, and a general improvement in the fiscal condition of most member countries.

Emerging markets and some developed countries may begin to see a growth recovery later in 2016 and into 2017

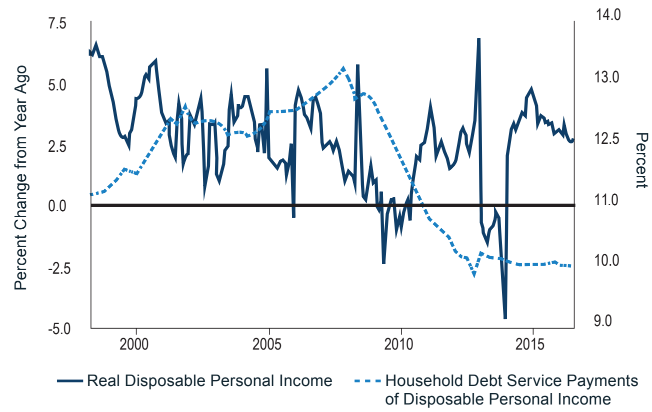
Domestic

Growth in the U.S. continues to track at a sub-par pace. Nevertheless, the U.S. Federal Reserve (Fed) appears to continue to look for an opportunity to raise its benchmark interest rate, despite the fact that recent economic data trends don't support such a move (i.e., the Fed is said to be "data dependent"). The timing of the next action by the U.S. Fed is the subject of intense investor debate and speculation. As of August 31, 2016, futures markets estimated the odds of a Fed rate hike at 36% and 60% for the September 20-21 and December 13-14 meetings, respectively. We believe the strongest possibility exists for a benchmark interest rate increase at the December meeting. However, without a reasonable improvement in the trend of economic data, the rationale for a rate hike seems weak.

United States — summary

- Economic data released in August did little to alter the expectation that the domestic economy will experience a modest bounce in the third quarter of 2016 after posting very disappointing performance in the second quarter of 2016.
- Many of the same economic themes that prevailed during the first half of 2016 remain in place, including consumer spending as the main engine of growth. Currently, the Federal Reserve Bank of Atlanta's GDPNow forecast anticipates that personal consumption expenditures will advance at a 3.5% annualized rate in the third quarter of 2016, and contribute approximately 2.4% to overall GDP growth.
- Although employee wage growth has somewhat trailed expectations, the recent trend of real disposable personal income and household debt service payments suggests that consumer financial health remains very strong (see chart).

Real disposable personal income to household debt service payments ratio trend

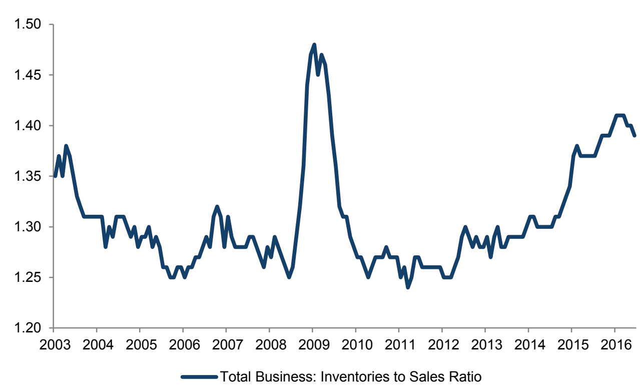


As of: 7/1/16 for real disposable personal income and 1/1/16 for household debt service payments of disposable personal income. Source: St. Louis Federal Reserve Bank

- Weak business inventory investment detracted from U.S. GDP growth over the past three quarters, but many economists now believe that inventory spending will rebound and add to overall GDP growth. We believe expectations regarding a resurgence in inventory investment should be tempered as the inventory to sales ratio (see chart) remains elevated.

Consumer financial health remains very strong.

Historical total business inventories to sales ratio



As of: 6/1/2016. Source: U.S. Bureau of the Census

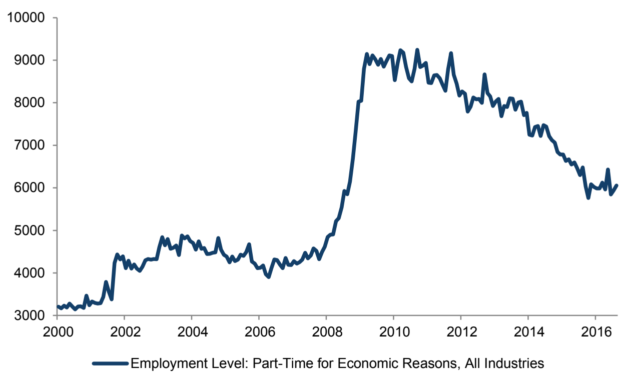
United States — outlook

- The Federal Reserve Open Market Committee (FOMC) will meet on September 20 and 21. In addition to the usual agenda, FOMC meetings in March, June, September and December involve the submission by Federal Reserve Board members and Federal Reserve Bank presidents of economic projections and fed funds rate target levels (the "Summary of Economic Projections" (SEP)). Previously, in June 2016, nine FOMC members projected two rate hikes for 2016, while six members anticipated only a single rate hike. September's SEP submission will be closely watched by investors. We continue to believe that the most likely FOMC action will be a single rate hike in December.

- Employment, as measured by the seasonally adjusted growth in non-farm payrolls, remains supportive of the economy. With data updated through August 2016, the trailing twelve month average increase in non-farm payrolls totaled 203,917.[1] However, there still appears to be slack in the labor force, as average hourly earnings have advanced only 2.5% on a year-over-year basis.[1]

- One possible reason for excess slack in the labor force could be the large number of people who are working part-time but would prefer to be working full-time. While the number of people working part-time jobs for economic reasons has declined since 2008-2009, the level remains elevated to the pre-recession period of 2002-2007 (see chart). The Bureau of Labor Statistics reports that 6.053 million people continue to work part-time jobs for economic reasons.

Historical U.S. part-time employment level



As of 8/31/2016. Source: U.S. Bureau of Labor Statistics

- We continue to anticipate that the U.S. economy will expand at a moderate pace of between 1% and 2% during 2016, which implies a recovery to GDP growth of approximately 3% in the second half of the year. We expect that GDP growth in the second half of 2016 will be led by sustained consumer spending along with diminishing headwinds from areas that detracted from growth in recent periods, such as business inventory spending and net exports.

Disclaimers

[1]Source: United States Department of Labor, Bureau of Labor Statistics