Market Outlook
Second Quarter 2018

Second-Quarter Outlook
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Fade the trade war, buy the earnings growth

Normalization continues to be the key lens through which we view recent economic and market activity. Signature has been making the case that the global economy has been normalizing following the near decade-long recovery and rolling global credit crisis that was kicked off by the 2008 U.S. credit debacle. Given the improving economic backdrop, central banks, led by the U.S. Federal Reserve, have begun to normalize monetary policy. However, what remained abnormal for equity markets in 2017 was the near absence of any volatility. Well, we can now tick that box! The first quarter of 2018 saw volatility return with a vengeance starting in the first week of February and continuing through to the end of the quarter.

According to the talking heads on TV, the causes of turbulence in the first quarter have ranged from inflation surprises, tariffs and trade wars, to threats of real war, Trump twitter tirades, and a slowdown in growth, among others. On any given day, the press and short-term trading funds can hype some story and, in the latter's case, hope to make a profitable trade by pushing the market around. Most of the narratives are plain wrong – or flimsy at best –but can be a tradable idea. For longer-term real investors (as opposed to short-term traders, i.e. those with a time horizon longer than the next hour, week or month) there has been little to no change in the underlying economic and investment fundamentals, which remain robust and supportive of risk assets.

Most of us seem to have forgotten that a "normal" market should have periods of varying volatility and should see a couple of 5-10% drawdowns over the course of any given year. This is a sign of a healthy market! To paraphrase a key idea of economist Hyman Minsky: Stability breeds instability, and short-term instability (volatility) can breed longer-term stability.. In other words, in a period of very low volatility when the market keeps rising, as it did in 2017, people will come to view markets as a one-way bet and, over time, keep pushing the market up -- this is the classic way to build a bubble that must ultimately topple over.

In a more balanced/volatile market, where investors are more cautious of the potential downside, you tend to see a more "two steps forward, one step back" behaviour that keeps valuations in line with underlying fundamentals. It is my belief that markets have seen a significant decline in "bubble" risk and are transitioning toward a more normal two-way market. This is HEALTHY!

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While markets started the year heading straight up, and were up over 7% in the first three weeks, the subsequent correction through February/March now has markets roughly flat year-to-date. My expectation that 2018 will see a roughly 10% return from global equities on the back of solid earnings growth of 12-15% remains intact. While markets have become more volatile in 2018, from a fundamental perspective our outlook for the year has not changed. And the following quote from my 2018 outlook remains the base case:

> *"The broad conclusion for 2018 is the global economy looks just fine – better, in fact, than we have seen in over a decade. The coming year should therefore be constructive for equities, neutral for credit and 'meh' for rates. The main risks to stability are not expected to originate from the economy, but rather from the political sphere."*

The first quarter has seen further confirmation of the underlying strength and breadth of the synchronized global recovery, and I expect first-quarter earnings announcements over the coming month to further confirm the underlying strength of the global earnings cycle. But there has also been no shortage of political noise to sidetrack markets in the short term.

We will take a quick look at some of the more explicit political drama unfolding, but I first want to remind investors that while the political noise may bounce markets around in the very short term, over any longer time horizon (3-6 months or more), markets will be driven by the underlying economic and investment fundamentals – NOT politics. While the past month has seen markets buffeted by fears of a politically driven trade war (which is not happening!), the political blustering has occurred in a relative vacuum of fundamental data as it has happened between earnings periods. As first-quarter earnings season gets rolling, I expect markets will take their cues from the underlying earnings strength that we are expecting.

This will be the first quarter in which the U.S. tax cuts will be reflected in the numbers and in corporate guidance as management teams have had some time to begin to assess the likely impact on earnings, both over the short and longer term. While much of the increase in U.S. earnings expectations, currently just shy of 20% for 2018, already reflect a significant boost from the tax cuts, the fact that the market has declined to its pre-tax bill level would suggest the disappointment versus expectation would need to be significant to push the market lower. Providing earnings come in close to or better than expectations (as we expect they will), then markets should reconnect with the robust underlying fundamental backdrop.

The strong underlying fundamentals, along with the broad stability in rates, credit and foreign exchange markets, give us the confidence to take advantage of the recent pullback in valuations to increase our overweight call on global equities in the context of our overall global asset allocation position.

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Tariffs, tiffs and trade wars

One of the biggest headline generators over the past month, and source of angst for many investors, has been the fear that a global trade war will be kicked off by the U.S. government. Given the change of economic advisors at the White House, with more adults departing and some questionable fringe players gaining prominence, it is not a zero probability, and the risks of a policy mistake are clearly higher than they were before. But we are still nowhere even remotely close to a true trade war. Both sides are, so far, more engaged in a snowball fight than any sort of serious conflict. Measures on the table for discussion will have a minimal macro-economic impact and the reality is that the U.S. and Chinese economies and financial markets are incredibly intertwined.

There is no possible way that either side can "win" a trade war, yet there is also tremendous scope to improve both the bilateral and multilateral trade relationships with China, particularly in areas such as intellectual property (IP) protection, reciprocity and market access on both sides. None of the real issues behind the U.S.-China trade relationship are being discussed in the public twitter discourse, but they are well understood by both sides, if not by the White House. In fact, the core of the Trans-Pacific Partnership agreement, which President Trump promptly withdrew from upon being elected, was to address these very issues on a multilateral basis. So while the White House may appear to have a limited grasp of the realities, those within the U.S. State and Trade departments have done a lot of work in the area.

The history of China's economic success over the past three decades has stemmed from embracing market-oriented economic reforms and increasingly opening the economy to global competition and best practices. The current leadership under Xi Jinping came to power furious about the stalling of reform under the previous leadership, and has spent its first five-year term consolidating power and pushing an aggressive supply side and structural reform agenda aimed at sustaining China's economic growth potential and avoiding the middle-income trap that often stalls emerging economies on their trajectory to higher-income status.

Success in this area requires sustained structural reforms and breaking down vested interests. It involves a focus on improving quality over quantity, on curbing excess supply, and broadening and deepening financial-sector reforms through curbing excess indebtedness and opening and integrating China's financial economy to global financial markets. It is not about political reform, but about engaging with the rest of the world to help improve the efficiency of the Chinese economy and establishing globally competitive players in emerging industries such as electric vehicles, renewable energy, mobile e-commerce and payments, artificial intelligence etc. But at its core, it is about constantly pushing reforms and opening and integrating China's economy with the global economy. It is quite the opposite of erecting trade barriers. It also looks to the future, not the past. The U.S. claims that China has not played fair in trade certainly have some merit, particularly in the

realms of IP protection, and cyber theft and reciprocity. China is well aware of and open to discussions on these issues. But many of the U.S. claims, and certainly anything related to the trade deficit are not valid, nor is comparing the China of 20 years ago with the China of today given the extraordinary pace of growth and development seen over that time. China's economy today is a radically different one versus its economy when it entered the World Trade Organization.

One can revisit the 2012 report, China 2030, a joint initiative by Beijing and The World Bank, for a glimpse of the current leadership's reform-focused agenda. I was told by the head of the World Bank at the time that the report originated from the current Chinese leadership, even before they were handed the reins of power. The recent history of China's reform path would suggest to me that while the details matter a lot, President Xi is committed to continuing the broad economic reform and economic opening path of the past 30 years, and is committed to ensuring a broadly open global trading environment. There will always be differences in opinion as to what is fair, and there will be many sticking points along the way, but trade and investment negotiations with China are equally likely to end up in a win-win outcome as in a lose-lose outcome. This is why the international diplomacy "dance" has so far remained very measured on the Chinese side, with Beijing merely matching the U.S. and not upping the ante. The objective of the Chinese government, to our understanding, is to engage in negotiations. It will not shrink from the U.S.'s attempts to bully, but rather will go toe-to-toe with the U.S. until the U.S. is ready to sit down and talk.

In this battle, the U.S. has met its match. China has as many, if not more cards, in its hand than the U.S. Most of the White House's claims have little basis in fact let alone economic theory, but are calibrated to play to Trump's political base, many of whom would ironically be the most adversely impacted by his proposed trade actions. This is also not a short-term issue, and Signature will continue to monitor developments beyond the short-term political noise. How the world and China adapt to the ongoing rise and integration of China into the global economic, financial and political worlds is, and will remain, the single most important factor for investors to understand – much as it has been for the past 20 years.

For 2018, Signature's forecast is for ongoing trade spats, but nothing even close to a trade war. Fears that China could devalue its currency or sell its U.S. Treasuries are premature. Yes, those are cards it holds and it's well aware of the potential options, but it is also aware of the longer-term strategic impact of those actions, and both are closer to the nuclear option of mutual destruction than constructive dialogue.

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