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2018 Outlook: Lightning Strikes

2018 has begun with increasing volatility in the financial markets. We anticipate a continuation of this throughout the year. Global economic output expectations for 2018 have increased to 3.9% according to the International Monetary Fund. This is the time to address fiscal sustainability and broaden economic growth participation. The risks of not implementing policies around economic stability include an increasing gap between the wealthy and the poor, aging populations with decreasing safety nets and encumbered sovereign balance sheets. With this in mind, global diversification in both equity and fixed income investments could help ballast portfolios through what may be more volatile times, as well as enhance risk-adjusted returns.

Equity Markets: Low interest rates and slow, stable growth culminated in a banner year for equity returns in 2017. 2018 transitions to higher expected global growth on the one hand and greater risks on the other hand. Government deficit spending has led to high public debt levels, and massive monetary stimulus has led to artificially low interest rates. Working through these consequences will be challenging. With equity valuations currently at elevated levels, we see continued volatility for stock prices.

Financial flexibility and investments in productivity enhancing activities have been attractive corporate characteristics, particularly since the 2008 stock market downturn. We believe these characteristics will continue to influence corporate values. The ability to withstand economic volatility, as well as to opportunistically gain market share, are valuable competitive advantages.

Fixed Income Markets: Strengthening global growth and increasing U.S. federal deficits are impacting not only treasury yields, but also the U.S. dollar. The U.S. dollar and treasury bond prices have been falling over the last year. 2018 began with a jolt of both the 10-year and the 30-year Treasury yields surprising to the upside. Rising interest rates are consistent with Federal Reserve policy in regard to targets on economic growth, unemployment and inflation. However, the macroeconomic backdrop leaves plenty of room for upside and downside surprises in interest rates in 2018. For example, the latest CPI for January rose to 2.1%. This was greater than expected overall and noteworthy in such categories as apparel and auto insurance. The growing federal debt burden leaves open the possibility of higher refinancing costs which may also dampen economic growth prospects.

As investors sought greater income over the last few years in riskier bonds, the differential between low- and high-quality bond yields narrowed. This period of slow economic growth with declining interest rates benefited a broad spectrum of quality. We now expect yield spreads to widen as investors reassess the "risk" premium in a more volatile interest rate environment.