Beacon Trust Quarterly

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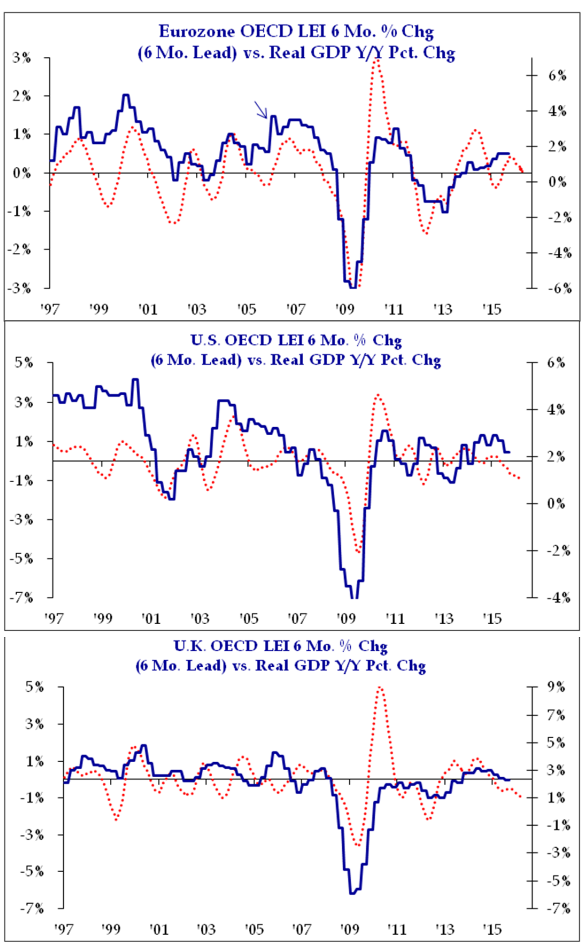
Health of the Global Economy

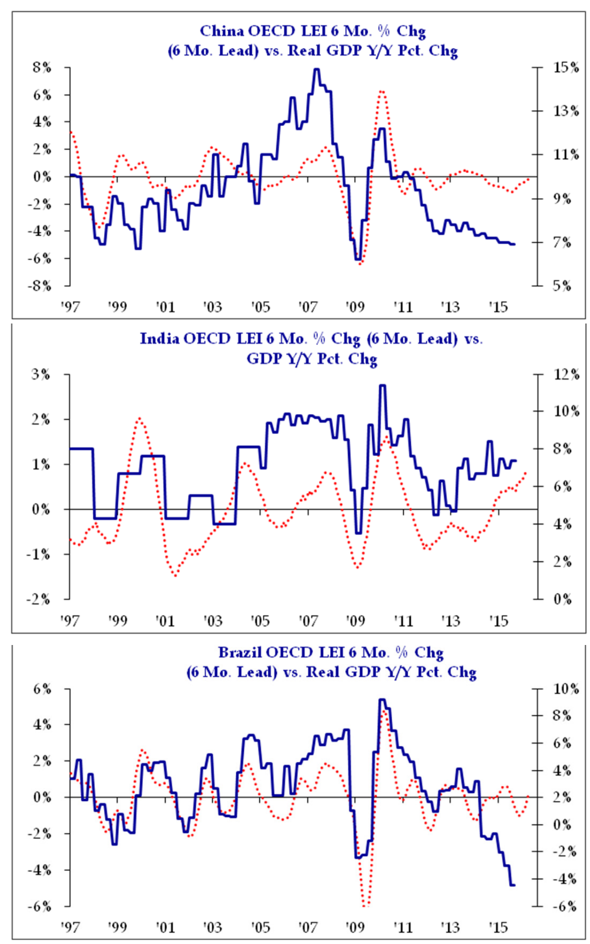
The “R” word, as in recession, has been muttered increasingly of late, and international think tanks, such as the International Monetary Fund (IMF), continue to mark down global growth prospects. Our base case continues to envision modest real growth globally and about 2% in the US this year. Regarding the US, there are a few key indicators that point to a modest growth path. First, the Institute of Supply Management (ISM) Non-Manufacturing Index, which accounts for 90% of economic activity, points to moderate gains for current dollar GDP. Personal Income growth continues slightly in excess of 4%, and the household savings rate has jumped to 5% in recent quarters. Lastly, the Change in Labor Market Conditions Index, which predicted the start and end of the last recession to the month, is also signaling 2% real growth. Unfortunately, the economy and its outlook are not that simplistic. If we dig deeper into the weeds, we find incipient signs of a soft patch in economic activity. Personal Consumption Expenditures (PCE) are the main driver of economic growth and represent nearly 70% of total GDP. While income gains should continue to be supportive of PCE gains, we should ask the question, “how do households feel?” One gauge of consumer confidence, the Bloomberg Consumer Comfort Index, is showing signs of concern. Households might be

Developed Market Leading Economic Indicators are Slowing



Source: Strategas Research Partners

EM LEIs Still Weak, But There is Some Improvement



Source: Strategas Research Partners

responding to economic and financial developments such as market volatility, lower commodity prices, and weaker international growth. The Consumer Comfort Index slipped 1% in December and January to date. The higher savings rate may also reflect a more cautious attitude on the part of households. Nonresidential fixed (or business) investment is another important component of GDP, accounting for 13% of the total. Business investment has been lackluster for several quarters but might take a significant leg down based on two indicators: 1) the Policy Uncertainty Index; and 2) Nondefense Capital Goods Orders excluding Aircraft. Finally, we would highlight the trend in Leading Economic Indicators (LEIs). These may be observed in the accompanying charts for both Developed Markets and Emerging Markets. LEIs are slowing in Developed Markets such as the US, eurozone and U.K. and are already weak in Emerging Markets. Policy responses may be required to prevent negative growth outcomes. In the case of the eurozone, additional Quantitative Easing (QE) is likely in March. China's economic transition will depend, to a large extent, on its ability to bolster household incomes through wage gains and transfer payments. In summary, there should be global growth but less of it.

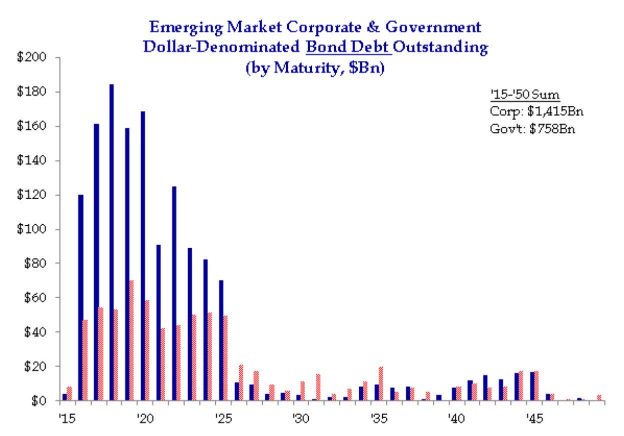
US Market Expectations

The US stock market had a disappointing return in 2015 relative to our expectation. The S&P 500 produced a total return of 1.4% reflecting wider credit spreads, deteriorating corporate earnings, weakening Emerging Market currencies, lower commodity prices, and proliferating geopolitical risk. Several of these market headwinds are prevalent in 2016. Corporate credit spreads have spiked to new highs, in large measure due to financial conditions in the Energy and Materials sectors. Recently, however, financial stress has spread to other sectors such as Financials and Consumer Discretionary. The S&P 500 dividend return is contracting along with corporate earnings. Market volatility, one of our key themes last year, retuned with a vengeance last August. The market will likely remain choppy given divergent central bank monetary policies, swings in currencies and commodities prices, and proliferating geopolitical risk which would include government elections. Our projected S&P price range is currently 1,950–1,700. Total return from the fixed-income market was about flat last year. Bond yields were well-behaved, and we expect the same this year. The 10-year Treasury note yield could average a touch lower than 2015 at 2.0%. Our range forecast is 2.50% - 1.50%. A major factor in the tame yield outlook is a significant decline in Treasury coupon supply. This reflects a combination of lower financing needs and greater reliance on T-bill issuance. Core inflation should be relatively stable based on the trend in the Output Gap. Given risks to growth cited above and benign inflation expectations, we believe the Fed might raise the funds rate only once or twice.

Currencies and Commodities

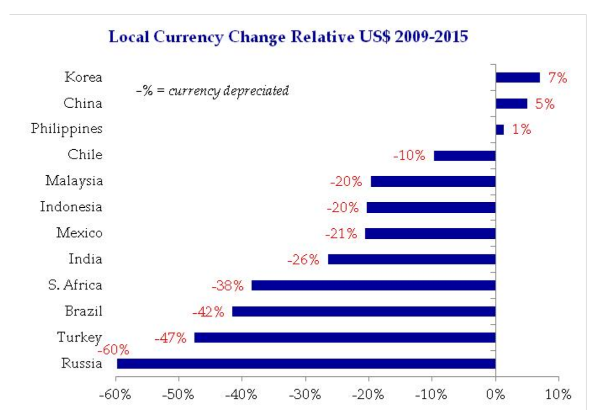
The strong link between oil prices and the dollar is one that we expected to "keep the price of oil depressed", as we wrote in last year's Outlook. The degree of depression has been surprising, however, given stable performance and outlook for the Dollar Index, which is measured against major foreign currencies. The fly in the ointment, however, has been the supply situation, which is exacerbated by Iran's early return to the market and its market share battle with Saudi Arabia. As non-OPEC production is removed later this year, a more favorable supply/demand balance should

EM Dollar Crisis Watch



Source: Strategas Research Partners

Emerging Market Currencies Are Already Under Pressure



Source: Strategas Research Partners

ensue. Assuming $28/bbl is the low in WTI Crude this year, a rebound to $50-$60 seems plausible. While the dollar has been stable against major currencies, it has been strong against a broader basket of currencies which includes Emerging Markets (EM) trading partners. The quadrupling of corporate EM debt denominated in dollars to $18 trillion since 2004 comes at an increased cost with a strong dollar. Those countries that increased debt rapidly would appear to be most exposed to a debt crisis. However, most of the debt of these countries has been issued in local rather than foreign (dollar) currencies. Even if, as we suspect, a crisis is avoided, EM currency markets are likely to remain skittish, and growth prospects will likely be muted. The accompanying charts show the EM dollar denominated maturity schedule and EM currencies relative to the dollar since 2009.

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