# Q2 2018 ECONOMIC OUTLOOK

By the LNWM Investment Strategy & Research Group

With the tax season so recently behind us, and as we all adjust to a new tax regime, US interest rates are beginning to reflect the upcoming decline in federal tax revenue. Economist Milton Friedman advocated "cut taxes under any circumstances" but he also recognized the importance of controlled spending.

Personally, I think our government has lowered taxes without any spending restraint, and financial markets are beginning to price in some of the consequences. Low interest rates have helped keep asset prices elevated and aided in the recovery from the 2008 financial crisis. I think the current market is particularly susceptible to a dramatic interest rate increase, which is why it is an area of focus throughout this Economic Outlook.

> "Elections should be held on April 16th – the day after we pay our income taxes. This is one of the few things that might discourage politicians from being big spenders."
>
> – Thomas Sowell

Any institution or individual that knowingly cuts revenue and borrows to finance the shortfall must hope for much stronger growth to wipe out the imbalance, or accept higher inflation and thereby devalue the debt. For the US, which is already growing at a strong pace, the imbalance is likely to become more expensive as interest rates increase, ultimately hindering growth. This is a recipe for short-term success but long-term difficulty, in our view.

- **Gino Perrina**, LNWM Chief Investment Officer.

## SUMMARY

- **As we expected, the new US tax law is providing a boost to economic growth and 1st quarter corporate earnings**. In our Q1 2018 Outlook, we mentioned that the US economy was potentially getting unnecessary stimulus given very robust economic data. In the short run, the extra stimulus should continue to be a good thing for asset values. However, what we thought were longer-term concerns, i.e. higher deficits and higher interest rates, have begun to materialize more quickly than we expected.
- **Another of our concerns has been the rising risk of trade wars.** This was a key driver of equity market volatility in recent weeks as tensions, particularly between the US and China, have increased. Should this continue, we expect equities and other risk assets to vacilate until disputes are resolved.
- **We expect US inflation to exceed the Fed's target of 2% by the end of 2018**, which will lead to further increases in the Fed Funds discount rate. However, outside the US — particularly in Europe and Japan — inflation is yet to meet central bank targets, indicating that monetary stimulus will continue in major foreign economies.
- **Episodic bouts of volatility should continue** given the geopolitical environment and tightening monetary policy. We don't think increased volatility will translate into outsized equity market returns, which we expect to remain relatively muted.

## HAS EVERYTHING BEEN COUNTED?

> "Not everything that can be counted counts, and not everything that counts can be counted"
>
> – Albert Einstein

A typical balanced portfolio – 60% equities/40% bonds – had delivered positive returns for nine consecutive quarters up until the first quarter of 2018. In fact, in January it seemed a forgone conclusion that Q1 2018 would be no different. However, the potential for trade wars and the uncertain long-term impact of 2017 tax cuts started to take a toll on the markets. By February, it seemed there was no place to hide other than cash. Even managed futures, which historically move in the opposite direction of falling equity markets, had a negative return for the month.

### UPDATE ON KEY ECONOMIC DRIVERS

Inflation – US inflation continues to move up toward the Fed's stated target of 2%. In 2017, the market-implied path of interest rates was lower than the Fed's own forecast. However, that changed in Q1 2018, which was a key driver for the rise in interest rates.

Geopolitical Disruption – The focus of geopolitical risk has shifted from North Korea to the Middle East as the Trump administration has made clear its intent regarding Syria. If and how this situation escalates is now a major concern, as signaled by the spike in oil prices, which recently hit a two-year-high.

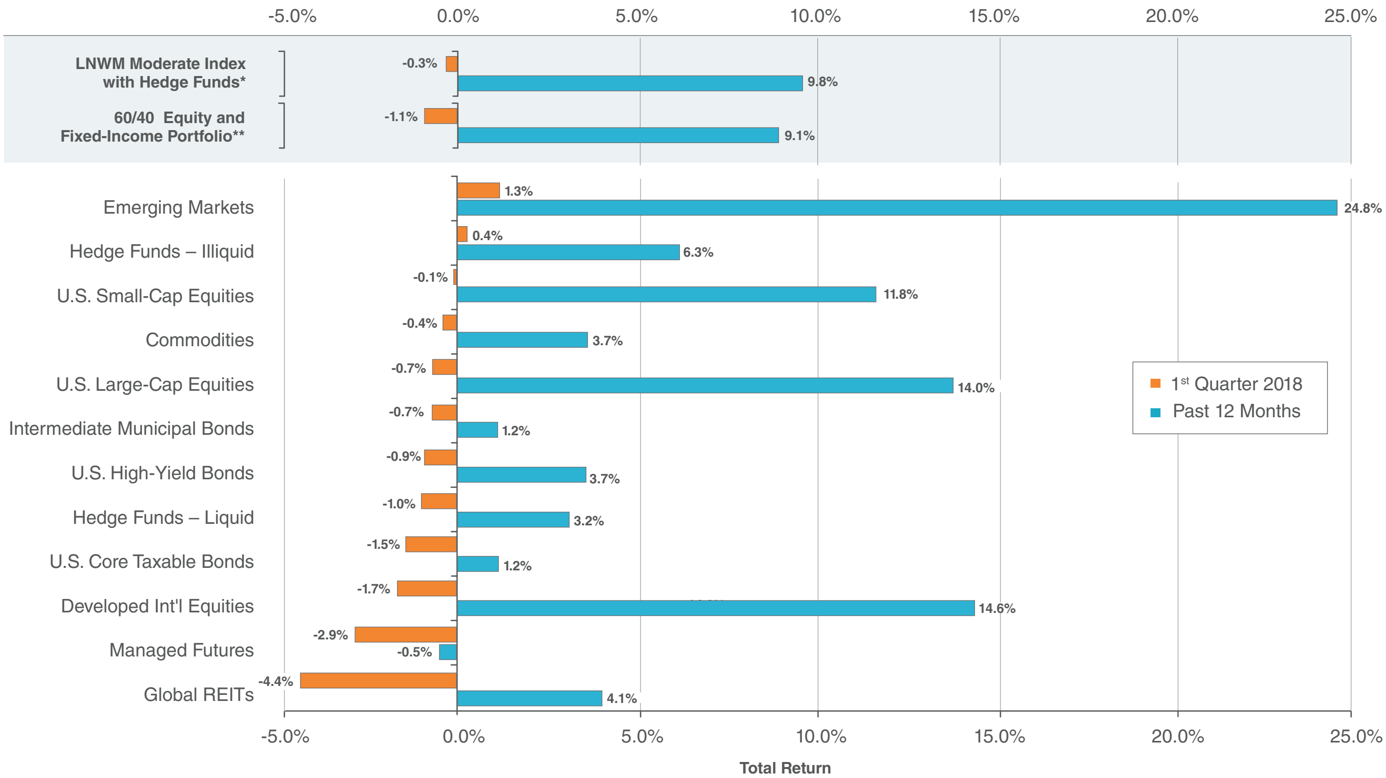
Corporate Earnings – Q1 2018 earnings for the S&P 500 are expected to be up 18.6% (from Q1 2017), according to Thomson Reuters. And earnings reports so far have been very strong, particularly in the financial sector. However, we've seen equities sell off after posting strong earnings, indicating that "perfection" may already be priced in, thereby limiting the upside of equities. We think this is especially true in the US and a motive for maintaining our non-US allocations.

Shift in Monetary Policy – The Federal Reserve has made clear its intent to increase the Fed funds target rate. Only recently has this translated into higher interest rates across the maturity spectrum. We will remain positioned for rising rates as we see this as a continuing theme going forward.

Longer-term Benefits and Costs of Tax Policy Changes – The US budget deficit will surpass $1 trillion annually by 2020, according to the Congressional Budget Office. This is two years sooner than previously estimated. In our Q1 2018 Outlook, we expressed concern that the new tax plan would increase the deficit. This is coming to fruition much faster than anticipated, and we think it will continue to put upward pressure on bond yields.

The volatility in the first quarter of 2018 could be a warning of what's to come. Since late 2017, we've been positioning LNWM portfolios for rising volatility (and higher interest rates) as well as staying globally diversified, in terms of region and asset class. The first quarter of the 2018 proved the value of these strategies.

**Performance of Asset Classes**
1st Quarter 2018 and Past 12 Months (As of March 31, 2018)




*Net of manager fees, gross of LNWM fees | **Assumes no manager fees

SOURCE OF DATA: Morningstar, Bloomberg, Hedge Fund Research. Please see the disclosure and definitions.

## Looking Forward

We believe the US economy is now in the later stages of a decade-long economic expansion. The Federal Reserve recently increased its estimate for 2018 US economic growth to 3.3%, up nearly 1 percentage point from previous estimates. As a result, the Fed is likely to proceed with raising its target interest rate at least two more times in 2018, after a mid-March increase of 25 basis points.

In the near term, we remain optimistic regarding US economic fundamentals and corporate earnings. A key factor is the US labor market, which continues to be the biggest source of strength, as demonstrated by February's significant increase in the labor participation rate (the percentage of work-eligible Americans who are working or job-seeking). As expected, the participation rate was accompanied by an increase in wages, since this is what attracts more people back into the workforce. A strong labor market and rising wages make consumers more confident and willing to spend, further supporting corporate profits. As we've highlighted in the past, consumer spending largely drives US economic growth, accounting for about 70% of US GDP.

**2018 Tailwinds**

- Synchronized global growth
- US fiscal stimulus
- Corporate health
  - Strong forecast earnings
  - Stable balance sheets
- Consumer optimism
- Global infrastructure cycle

**2018 Headwinds**

- Rising inflation
- Fed monetary policy
- Federal deficit
- Trade war with China
- Geopolitical disruption
  - Iran, Syria, North Korea
- US mid-term elections in 2018

Additional support for equities is provided by the 2017 corporate tax cuts, which are causing analysts to revise upward their estimates for corporate earnings. Another positive: weakness in the US dollar, which boosts the sales of US companies doing business abroad and makes US products more price competitive.

In developed economies – mainly the Eurozone and Japan – years of stimulus have started to produce results – higher growth and some inflation. The European Central Bank's plan to reduce bond purchases, along with increased inflation expectations, have driven European bond yields higher, which has resulted in less demand for US dollar-denominated bonds even as bond yields in the US have moved higher. Our expectation for higher yields across the globe is the reason we have positioned our fixed-income portfolios to be less sensitive to interest rate increases, mainly through shorter bond durations.

## Performance and Portfolio Changes

We've had numerous discussions with clients during the first quarter, particularly during the February selloff. While we're never content with flat or slightly negative performance, we are pleased to report that our diversified portfolios handily outperformed a passive benchmark of 60% stocks/40% bonds. Many of the portfolio changes we made late 2017 and early 2018 have been additive.

First, we've been limiting our interest-rate exposure since we continue to expect rates to rise further, albeit slowly. In the first quarter, the yields on 2-year Treasuries and 10-year Treasuries increased by 39 and 34 basis points, respectively, pushing the yield curve higher. The rise in bond yields as riskier assets (i.e. equities) were selling off demonstrates the diverging relationship between the stock and bond markets.

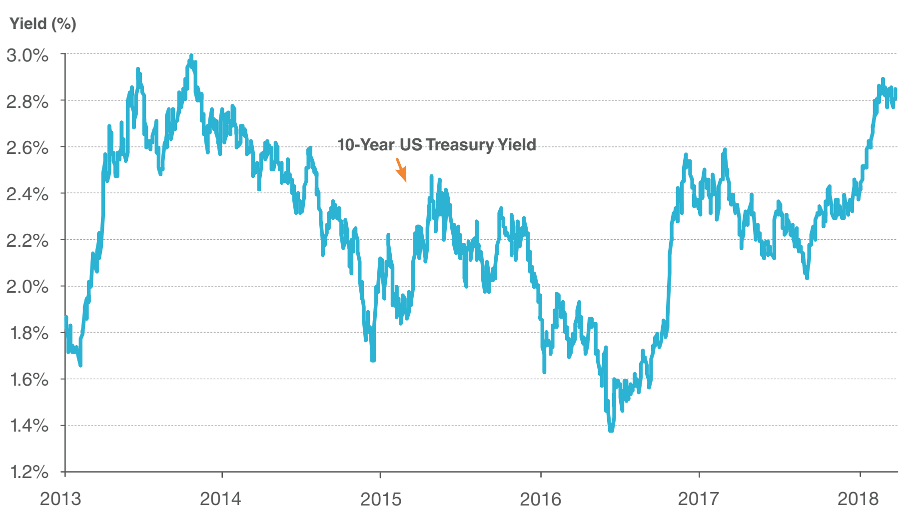
Performance for our multi-strategy fixed-income allocation was positive in the first quarter, while most fixed-income strategies were down. Our equity allocations suffered, although our allocation to non-US equities was mixed, as emerging market equities were up with a weakened dollar and developed market equities underperformed given escalating trade tensions. Our allocation to alternative assets performed as we'd hoped by dampening volatility and offsetting losses in other parts of the portfolio. We have a few underperforming managers, particularly in equities and alternatives, that we are currently evaluating.

Our focus on rising inflation expectations should come as no surprise. We've addressed this most explicitly through our recent allocation to an infrastructure fund, which as we discussed in our Q1 2018 Economic Outlook, should benefit from rising inflation. As equities sold off and interest rates increased in the first quarter, the infrastructure fund performed very well (+3%); most importantly, performance was as we expected given the environment. We do not try to time markets and did not anticipate such strong performance so quickly. For all our allocations, we focus on risk and the drivers of performance, and while we are certainly pleased with the returns, we are most satisfied that this allocation responded as expected given the environment. Looking forward, we will maintain our allocation to infrastructure and are considering the addition of another fund in this space as our thesis of increasing inflation (and interest rates) going forward hasn't changed.

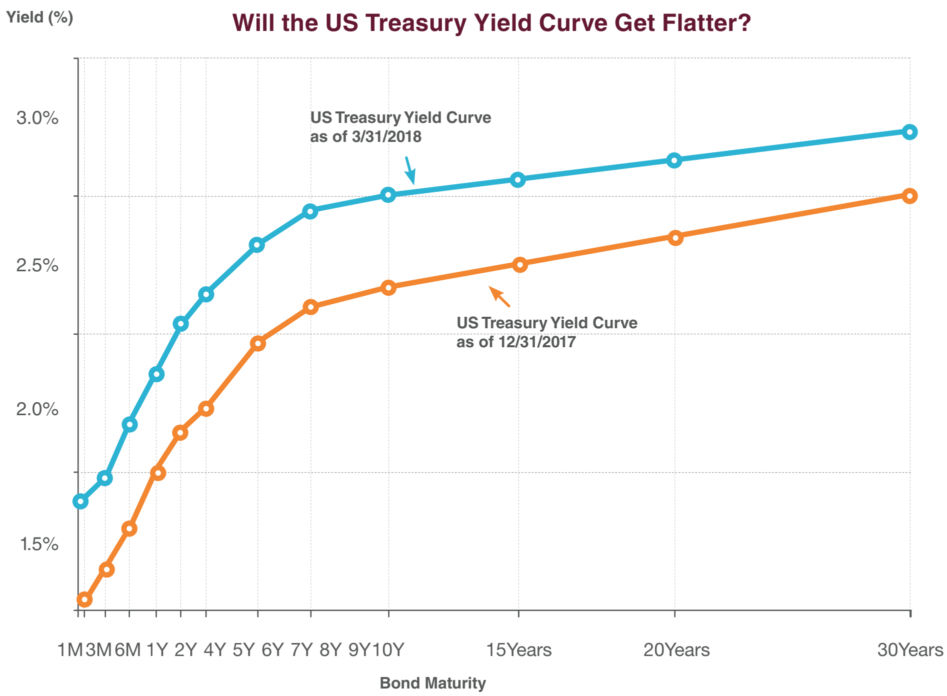
As always, we appreciate your trust and look forward to discussing any questions you may have.

## A CLOSER LOOK

### US FIXED INCOME

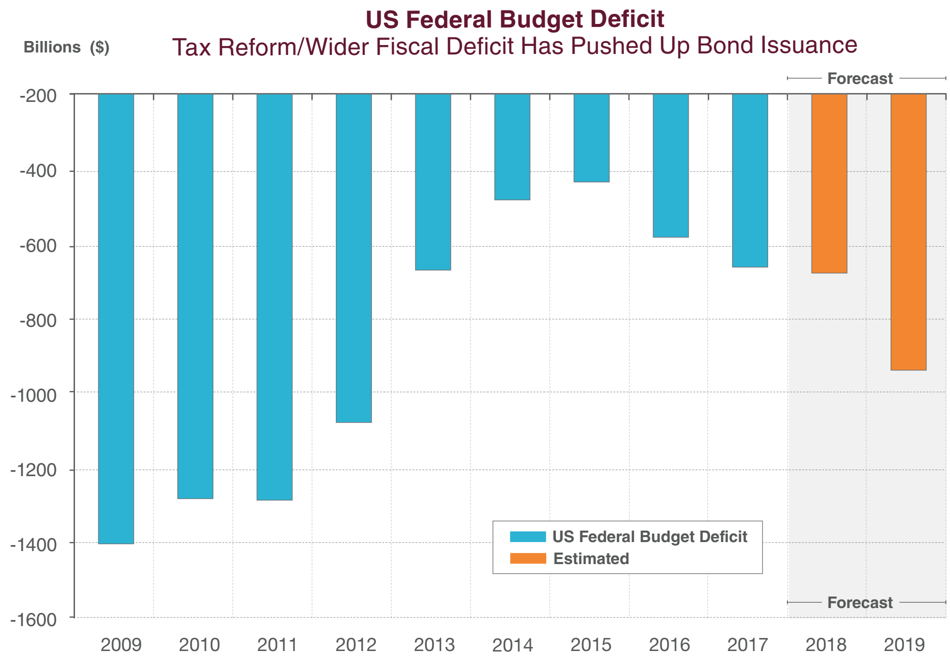



US Treasury bond yields have risen dramatically since last June and sit well above the 2016 post-crisis lows. Yields could rise more this year due to anticipated rate increases by the Federal Reserve, rising inflation expectations, and larger-than-anticipated US deficits due to tax reform.



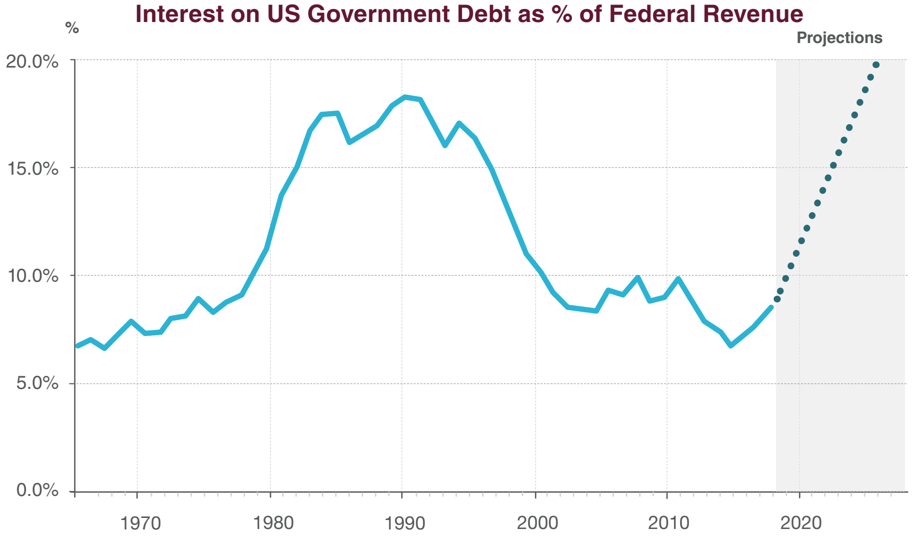

SOURCE OF DATA: Bloomberg.

The yield curve shows the yields on US Treasury bonds across the maturity spectrum. In the first quarter of 2018, the yield curve flattened slightly as short-term interest rates have risen more than longer-term rates. We think the flattening could continue as the US government issues shorter-term debt to fund the federal deficit.

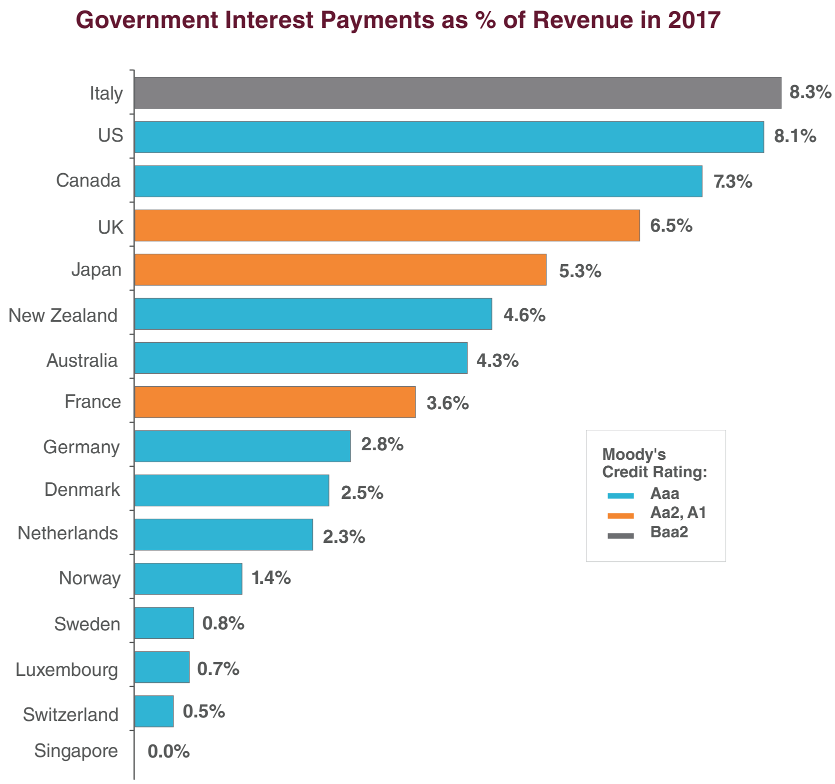



SOURCE OF DATA: Haver Analytics, Federal Reserve as of April 2018. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

US tax reform, while benefiting US corporations and individuals, will come at the expense of a rising US budget deficit as tax revenue decreases. Consequently, we expect the level of Treasury bond issuance to rise as the government borrows more to meet its obligations, leading to additional upward pressure on interest rates.

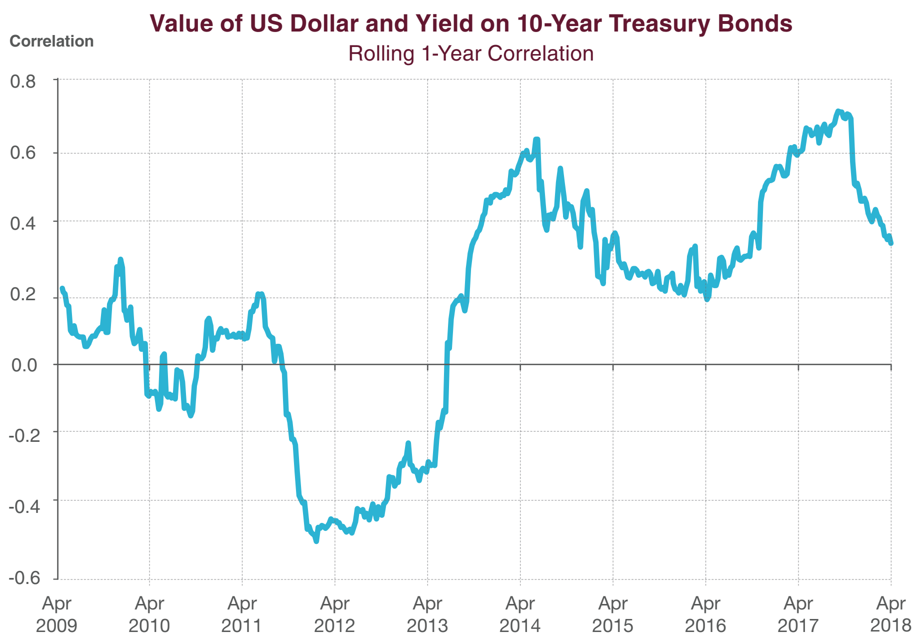



SOURCE OF DATA: Wall Street Journal.




SOURCE OF DATA: Moody's Investors Service.

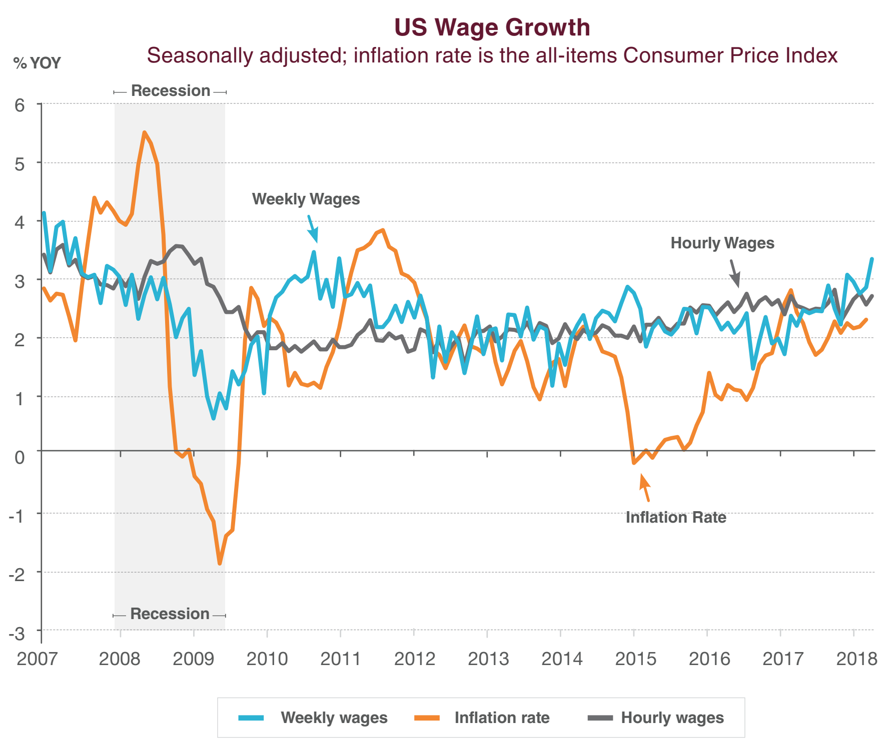
The percentage of tax revenue the US government will need for making interest payments -- already near the highest among developed nations -- will increase. As US interest rates rise, it will become more expensive for the US government to borrow, and this will be offset by even more borrowing and/or cuts in spending. Both options are likely to hamper future economic growth.




SOURCE OF DATA: Bloomberg.

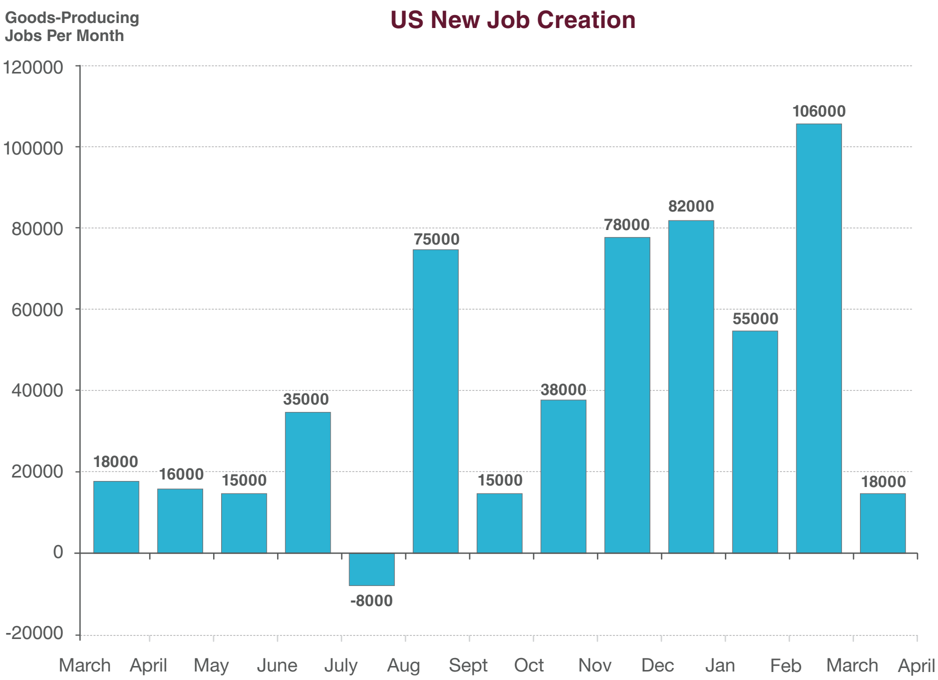
Historically, higher US interest rates have meant increased demand for US bonds. In the last few months, this has not materialized, which suggests US interest rates will need to push higher still. Behind this phenomenon are rising rates on foreign bonds, which have begun to rise in tandem with Treasuries, and are competing to satisfy global demand.

## US & GLOBAL ECONOMIES



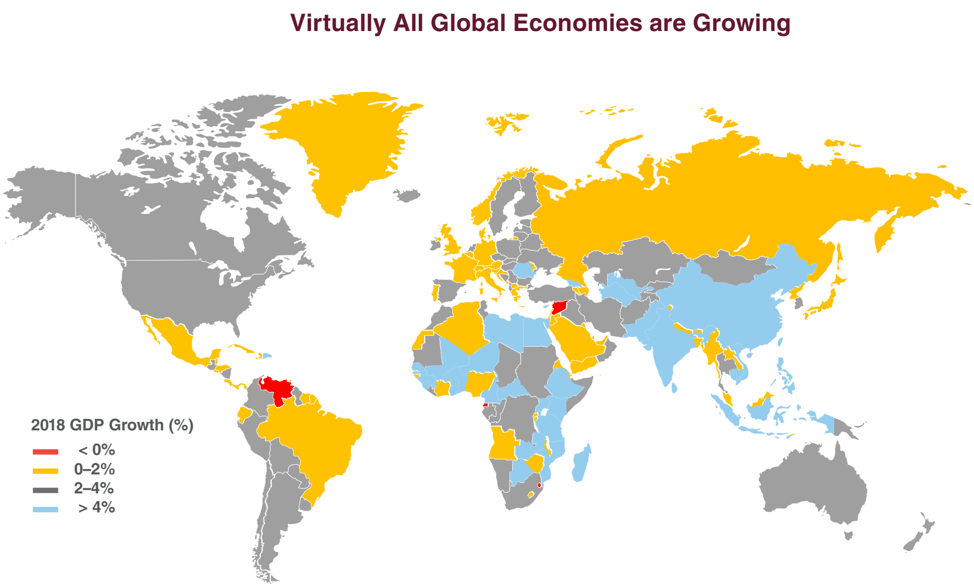

SOURCE OF DATA: BLS.

As the US economy has continued to expand, we've seen steady growth in inflation over the last three years. With the US labor market appearing to be at full employment by many definitions, we believe wages and inflation are likely to accelerate further from here.




SOURCE OF DATA: Bureau of Labor Statistics

In recent years, first-quarter economic data has been significantly impacted by weather, and 2018 was no exception. Job growth was likely affected by bad weather in March 2018. However, trade war rhetoric may have also been a factor and should the "saber rattling" continue, it would be a headwind as businesses may curtail expansion plans.

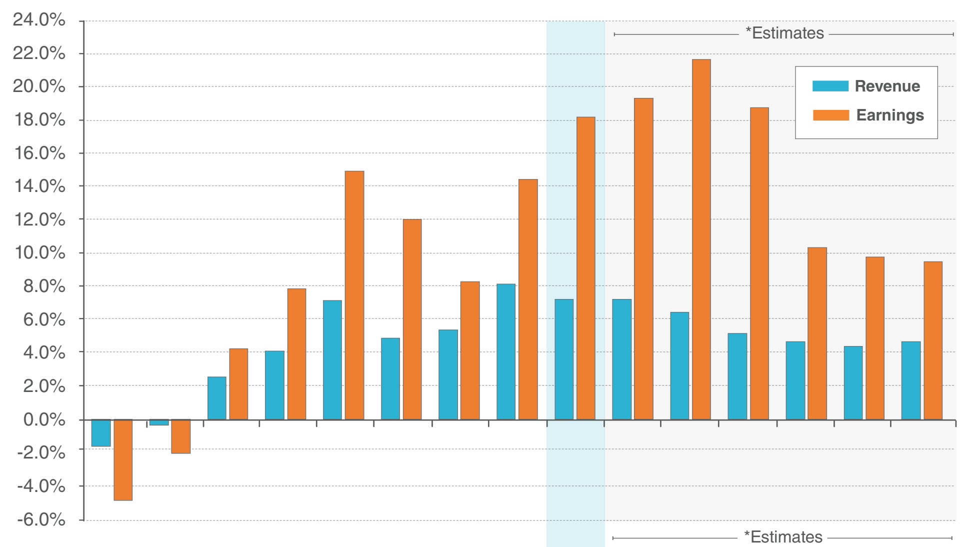



SOURCE OF DATA: Citigroup.

Synchronized global growth is a powerful tailwind for the financial markets, but it has been an uncommon occurrence, certainly in recent history: only twice since 1984. As the chart shows, major world economies are now nearly all in expansion mode.

## US EQUITIES

**S&P 500 Revenue and Earnings Growth***

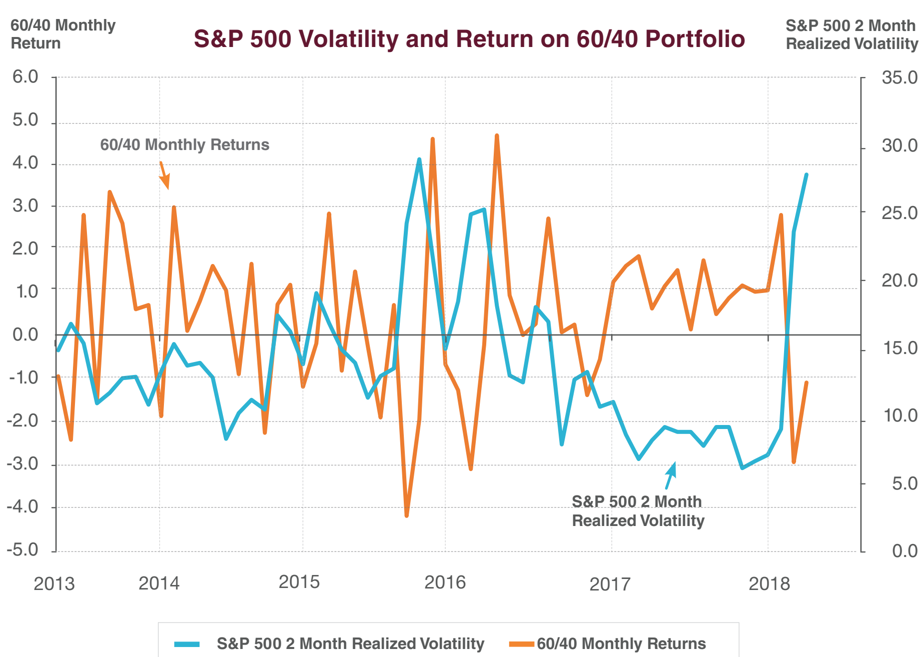



| | Q1-16 | Q2 | Q3 | Q4 | Q1-17 | Q2 | Q3 | Q4 | Q1-18 | Q2 | Q3 | Q4 | Q1-19 | Q2 | Q3 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Revenue | -1.7% | -0.4% | 2.6% | 4.2% | 7.3% | 5.0% | 5.5% | 8.3% | 7.4% | 7.4% | 6.6% | 5.3% | 4.8% | 4.5% | 4.8% |
| Earnings | -5.0% | -2.1% | 4.3% | 8.0% | 15.3% | 12.3% | 8.5% | 14.8% | 18.6% | 19.8% | 22.2% | 19.2% | 10.6% | 10.0% | 9.7% |

SOURCE OF DATA: Thomson Reuters I/B/E/S, Thomson Reuters Proprietary Research.

For Q1 2018, S&P 500 companies are expected to post an 18.6% increase in earnings vs. a year ago. If this happens, it will be the highest quarterly earnings growth since Q1 2011 (+19.5%). Cyclical sectors, such as energy and materials, are expected to show the greatest growth in earnings year-over-year at 70.4% and 27.1%, respectively. As shown in the chart, earnings are expected to accelerate through Q3 2018 (22.2% higher than Q3 2017) and then taper off as tax implications become fully incorporated into comparisons. If these earnings increases do materialize, we would expect sentiment on US equities to improve throughout the year, barring a negative geopolitical event (i.e. trade war, North Korea escalation, etc.).

**S&P 500 Volatility and Return on 60/40 Portfolio**




SOURCE OF DATA: Morningstar, LNWM.

For a hypothetical portfolio of 60% stocks/40% bonds, risk-adjusted returns, as measured by the Sharpe ratio, rose steadily from mid-2015 and peaked at the end of 2017 as financial market volatility fell to near historical lows. February 2018 brought a spike in volatility, which we view as a return to more normal levels of volatility. We have positioned our portfolios for this and have seen some benefits so far in 2018.

## ABOUT THE AUTHOR

**Gino Perrina**, Ph.D., CFA is the Chief Investment Officer at Laird Norton Wealth Management and has more than 15 years of experience in investment analysis, strategy and risk management. Prior to joining LNWM in November 2015, Gino was a Managing Director at BlackRock Inc. in New York City, responsible for managing risk in the firm's alternative asset portfolios (+$100 billion in total investment). He was also Managing Director of Research and Risk Management at BlackRock Alternative Advisors (2006 to 2010), Head of Fixed Income Research at Russell Investments (2010 to 2012) and a fixed income analyst and portfolio manager at Microsoft and IAC/InterActive Corp.

## ABOUT LAIRD NORTON WEALTH MANAGEMENT

With nearly $5 billion in assets under advisement, Laird Norton Wealth Management is the Northwest's premier wealth management company. Founded in 1967 to serve the financial management needs of the Laird and Norton families, the firm now provides integrated wealth management solutions to more than 600 individuals, families, business leaders, private foundations and nonprofit organizations.

## LNWM ASSET CLASS RETURNS CHART INDEX DEFINITIONS

**Intermediate Municipal Bonds**: Barclays Municipal Bond 1-10 Year Blend Index that measures the performance of municipal bonds with maturities between one and 10 years. An investment cannot be made directly in an index.

**U.S. High-Yield Bonds**: ICE BofAML US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

**U.S. Core Taxable Bonds:** The Barclays Capital U.S. Aggregate Bond Index covers the USD denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS, ABS, and CMBS sectors.

**U.S. Large-Cap Equities**: The Russell 1000 Index is an index of approximately 1,000 of the largest companies in the U.S. equity market.

**U.S. Small-Cap Equities:** Russell 2000 Index, a measure of the performance of the 2,000 smallest companies in the Russell 3000 Index, representative of the U.S. small capitalization securities market.

**Developed International Equities:** MSCI EAFE Index, a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada. As of June 2014, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

**Emerging Markets:** MSCI Emerging Markets Index, a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of June 2014, MSCI Emerging Markets Index consisted of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

**Commodities:** The Bloomberg Commodity Index is made up of 22 exchange-traded futures on physical commodities. The commodities are weighted to account for economic significance and market liquidity and weighting restrictions on individual commodities and commodity groups promote diversification.

**Global REITs**: FTSE EPRA/NAREIT Global Equity REIT Index, a measure that tracks the performance of listed real estate companies and REITs worldwide.

**Managed Futures**: The SG CTA Index provides the market with a reliable daily performance benchmark of major commodity trading advisors (CTAs). The SG CTA Index calculates the daily rate of return for a pool of CTAs selected from the larger managers that are open to new investment.

**Hedge Funds – Liquid:** HFRX Global Hedge Fund Index – A daily-valued index designed to be representative of the overall liquid hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry. For

**Hedge Funds – Illiquid:** HFRI Fund Weighted Composite Index – A global, monthly-valued, equal-weighted index of over 2,000 single-manager funds that is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies. Constituent funds report monthly net of all fees performance in U.S. dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

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The LNWM Moderate Index with Hedge Funds ("Index") is comprised of a hypothetical combination of actual investment returns generated by investment managers and funds recommended by LNWM during the time period indicated. Past performance is no guarantee of future results. Historically, the Index asset class allocations range from 20%-33% fixed income, 36%-67% equity, 10%-33% hedge funds and 0-5% cash. The actual allocations at any given time are available upon request. Within equities there is a mix of active and passive strategies, value and growth, various capitalizations and international stocks. The Index reflects all changes in LNWM's recommended managers during the period. The investment results include the reinvestment of dividends and other earnings. The Index is net of mutual fund fees; however, the index does not include the imposition of LNWM management fees. Fees charged by Laird Norton Wealth Management will reduce the net performance of your investment portfolio. The Laird Norton Tyee Asset Strategies, LLC standard schedule of fees is set forth in our Form ADV Part 2A and is available upon request. Fees for accounts managed by Laird Norton Trust Company are based on the trust company's standard fee schedule and may include fiduciary fees and related expenses in addition to investment management fees.

The 60/40 Equity & Fixed-Income Blend Portfolio: Annually rebalanced blend of the Barclays Capital U.S. Aggregate Bond Index and the MSCI All-Country World Index (ACWI). The blend is intended to reflect a typical moderate asset allocation without active management or manager fees for comparison.

The Moderate Index is not an actual portfolio and it is not possible to invest in the Index directly. Neither is it possible to invest directly in any index used to demonstrate the performance of any individual asset class shown. The Index performance does not represent the actual performance experienced by any client or group of client accounts. Actual performance results in client accounts will have varied substantially from the performance shown as a result of the inception of the investment, the timing and expenses of trades in the portfolio, the addition or withdrawal of cash, funds or securities, the imposition of taxes, expenses of custody and other variables not accounted for in the Index.

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