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ECONOMIC AND INVESTMENT OUTLOOK

The Past Is Prologue: A New Chapter in the History of Financial Markets

Notable changes in the global economy are rising to the surface and influencing the financial landscape in ways that are both profound and likely to persist—they could have implications for investors for many years to come.

As we enter a new chapter in the history of financial markets, we appear to be transitioning away from the meager economic growth and emergency monetary policy that has dominated markets since the global financial crisis (GFC). The destination is uncertain, but one thing is clear: The environment we encounter will bear little resemblance to the one we have seen for the better part of the past decade.

To understand where we're going, it's important to understand where we've been.

Goldilocks Arrives

By the time the GFC reached its peak, US policymakers had already taken the first steps toward an intervention program that would eventually flood the market with liquidity. In an attempt to jump-start a flailing economy, the Federal Reserve started aggressively buying US Treasury bonds and mortgage-backed securities on the open market, and cut the policy rate to 0% for the first time in history. However, these policies were more effective at lifting financial markets than stimulating economic growth.

Ultimately, the Fed's extraordinarily accommodative policy, combined with muted economic growth and low inflation, created the ideal environment for equity and fixed income markets. In the US, over time, investors became willing to pay a premium for corporate earnings growth, and valuations ascended to levels that exceeded long-term averages. In a development that is uncharacteristic but not unprecedented, stock and bond markets moved higher in tandem, while volatility in both markets dissipated—creating a Goldilocks environment for the markets.

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Goldilocks Departs

It appears to us that this Goldilocks environment is shifting due to two key developments that have emerged over the past 18 months: Global growth has resynchronized and broadened out, meaning the US is no longer the sole driver of economic growth. And the US has embarked on an aggressive agenda of fiscal policy, marking a distinct shift from the prior decade of emergency monetary policy.

For much of the post-GFC era, the US led the global economy with tepid, but steady, GDP growth. That leadership role started to fade in mid-2016 as international developed and emerging economies gained some long-awaited traction. Despite headwinds, they expanded at a pace that eventually equaled or exceeded the US's muddle-through growth rate of 2%, ushering in synchronized global economic expansion (CHART 1). In addition to relinquishing its role as the sole driver of global growth, the US has benefited from this development, enjoying the strongest economic growth since 2015.

Simultaneously, as the Fed moves toward reducing its massive balance sheet and normalizing its target policy rate, legislators have been busy cutting corporate taxes, offering incentives for capital expenditures and approving a new federal budget, including $300 billion in new spending and an additional $200 billion in proposed infrastructure projects.

This distinct shift in government policy from monetary to fiscal stimulus will likely have sustained implications for the economy. As a result of this new direction, the benign inflation backdrop that has been entrenched for nearly a decade may finally be coming to an end.

Heading in the Direction of 'Normal'

So far, this discussion has focused primarily on changes that are concrete and demonstrable—things we already know are happening. There are also several changing dynamics worth exploring that could strongly influence the economy and markets. They are all inextricably linked.

Inflation May Finally Be on the Horizon

After nearly a decade of ultra-easy monetary policy, the Fed has achieved near-full employment. However, it has been less successful at promoting price stability. Its preferred gauge of inflation, Core Personal Consumption Expenditures, has consistently fallen short of the Fed's 2% objective (CHART 2).

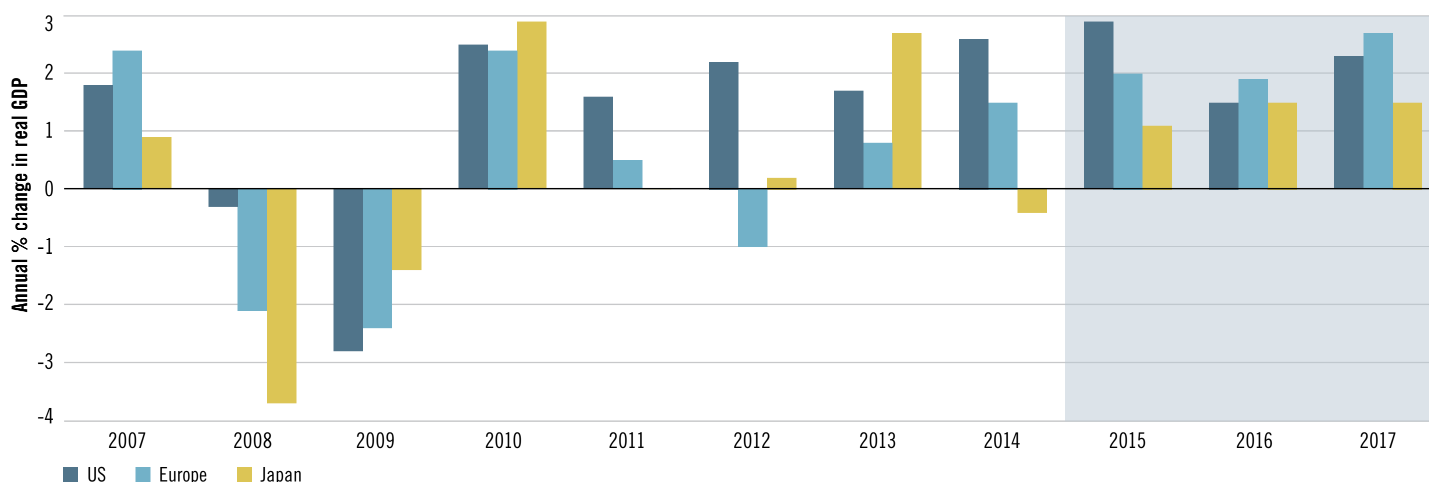
This inflation dynamic extends beyond just goods and services and beyond the US. Average hourly earnings, a widely used measure of employee wages, typically reaches a growth rate of 4% per year by the end of an economic growth cycle. But the last time wage growth exceeded 3% was 2009. Since the passage of tax reform in December, anecdotal evidence suggests that a number of large companies are raising wages, and government reports on wages and job "quit" statistics suggest competition for workers is heating up.

Of course, inflation is influenced by other factors beyond monetary policy. Huge secular headwinds from globalization to technological innovation have helped keep a lid on inflation. But with the emergence

CHART 1:

Economies Outside the US Are Finally Growing in a Harmonized Fashion

Annual percentage change in real GDP



Source: Bloomberg.

of fiscal policy, cyclical forces could meaningfully lift prices for the first time in a decade. Still, we believe inflation is unlikely to spike sharply or escalate in the near term to levels seen in previous market cycles.

While emergency monetary policy may have fallen short of achieving price stability and robust economic growth, a combination of these forces has created a backdrop for bond investors that can only be described as nirvana. As we depart from the era of emergency monetary policy and migrate into a world where economic growth and inflation are bolstered by fiscal stimulus, this backdrop will likely fade.

Deficit Spending Complicates the Picture for Bonds

The US government is spending more at a time when tax reform could mean less income. This dynamic has significant ramifications for the federal deficit and, ultimately, fixed income markets.

On the supply side, tax reform has created a considerable near-term budget deficit that the US government will need to address by issuing more Treasury bonds. As a result, Treasury bond issuance in 2018 and 2019 could reach twice the level seen in 2017.

On the demand side, we see three main challenges: Investor appetite for risk-free assets, which was insatiable during the Goldilocks environment, may moderate. Demand for Treasuries could be further weakened as the Fed tries to reduce the size of its balance sheet from a peak of $4.5 trillion down to something in the neighborhood of $2.5 trillion (CHART 3). And as central banks in other developed markets inch closer to unwinding their own ultra-accommodative monetary policies, their own sovereign debt might look more appealing.

This regime change has meaningful long-term implications for the Federal Reserve and direction of monetary policy in the US. If fiscal stimulus adds even a temporary additional thrust to economic growth, concerns about an "overheating economy" may begin to rise. This is a concern that investors and policymakers have not encountered for more than a decade, and it could put the Fed in a position where missteps are more easily made. If its inflation and growth targets are achieved or even exceeded, the Fed may have to consider adjusting its policy course.

This scenario—in stark contrast to the last decade, which was characterized by 2% real GDP growth, benign inflation, extremely accommodative monetary policy, and less extreme deficit spending—would be far less idyllic for fixed income investors.

Equity Market Valuations and Volatility

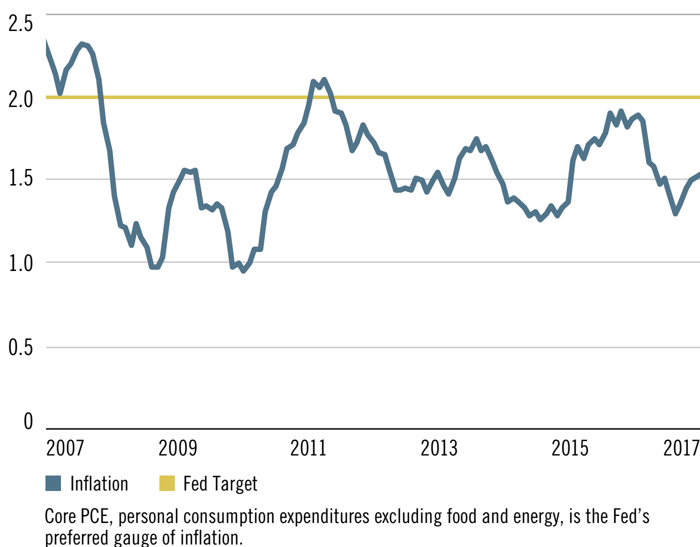
Low rates and inflation have not only been extremely favorable for bonds, they have also been good for stocks. So, a shift in this backdrop could have implications for stock valuations. Any hint of stronger-than-expected inflation can constrain stock valuations, placing the burden for growth squarely on the shoulders of corporate earnings.

It has also been suggested that the stock market may face headwinds if US 10-year Treasury yields rise to a certain "magic level." While we agree that absolute bond yields influence stock market valuations, to a point, we are convinced that two other factors are more meaningful:

CHART 2:

Inflation Has Yet to Reach the Fed's 2% Target

Annual percentage change in Core PCE and the Fed's target policy rate



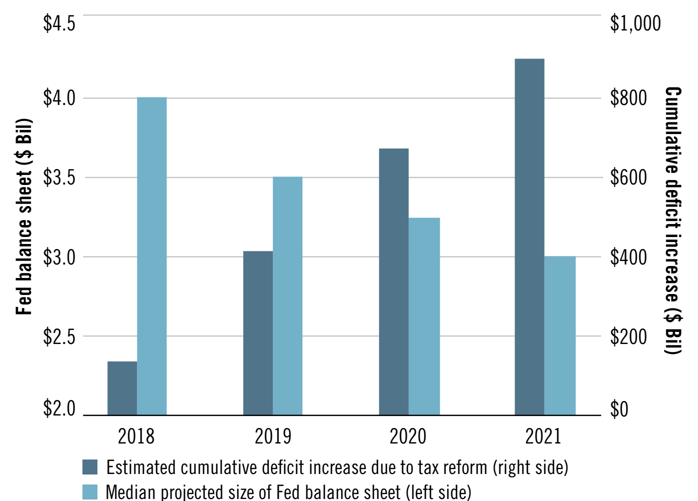
Core PCE, personal consumption expenditures excluding food and energy, is the Fed's preferred gauge of inflation.

Source: Bloomberg.

CHART 3:

The Fed Trims Its Balance Sheet, while the US Budget Deficit Is Set to Widen

Projections for the Fed's balance sheet and increase in the US budget deficit due to tax reform



Source: Federal Reserve Bank of New York and Congressional Budget Office.

CHART 4:

Several Years of Goldilocks Led to Elevated Returns and Low Volatility, Punctuated in 2017

Annual total return and realized volatility for the S&P 500 Index

	Return	Volatility
2017	**21.8**	**6.8**
5-year average (2013–2017)	16.2	11.7
Historical average (1929–2017)	11.0	16.5

Source: Bloomberg.

the forces behind rising yields and the pace at which they are increasing. If an expanding economy and consumer demand drive inflation, rising yields should not be terribly concerning. But if inflation rises without a commensurate increase in consumer demand, valuations could be affected.

February's market pullback and the turbulence that followed gave us the first signal that we have reached the end of the extraordinarily calm market environment that has been in place since the presidential elections in November of 2016.

While this unprecedented atmosphere of lofty returns and absent volatility may be behind us, we do not think that means the end of the road for equities (CHART 4). In fact, strong prospects that corporations can continue to grow profits and the global economy can continue to strengthen, favor equities over fixed income.

The distinction between the last few years and the next is that the near-perfect financial conditions that pushed equity and bond market volatility to an all-time low are unlikely to persist.

The Bottom Line: Financial Conditions Are Changing

Last year, nearly all of the forces that contribute to financial conditions were favorable for markets. Interest rates in the US barely moved, tighter credit spreads mirrored confidence in the economy, stock prices soared and the dollar weakened. To the contrary, this year we have already seen rates rise, credit spreads widen modestly and stock market returns moderate. In fact, the lone variable helping financial conditions in 2018 is a further weakening of the dollar.

The US economy and financial markets are drifting away from the extremely unusual conditions we have experienced for the past decade and moving in the direction of an environment that more closely resembles a pre-crisis "normal." Their ultimate destination is unknown. But we have reached a turning point: The global economy is no longer in an apparent state of malaise and the Fed is no longer fueling ideal financial conditions with extremely accommodative monetary policy.

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Chief Investment Officer
March 1, 2018

Kyle Hutchinson, Assistant Vice President, contributed to this report.

KEY TAKEAWAYS

Investors may need to prepare for a shift in trends that have been in place for much of this cycle:

- **Stock and Bond Correlations**
In a normal market cycle, stocks and bonds may move in opposite directions and there is a wider degree of dispersion between winners and losers. As the era of financial repression fades and fiscal policy takes the reins, this traditional relationship could return.

- **Volatility Returns to the Market**
Stock market volatility and performance could return to levels that more closely resemble historic norms. While market turbulence may seem unfamiliar to investors after the unusual tranquility of 2017, it is not uncommon over the course of a traditional market cycle.

- **Growth Versus Value**
Growth stocks have outperformed value stocks by nearly 100% since 2008, but in this new environment the gap between growth and value returns could moderate.

- **Active Versus Passive Investing**
The lines distinguishing winners from losers in the stock market will become clearer. So, "owning the market" in a passively managed index fund could be less effective.

- **Alternative Asset Classes**
As interest rates rise and stock market volatility picks up, hedge funds and other alternatives could see new opportunities to generate alpha and reduce portfolio volatility.

ASSET ALLOCATION UPDATE

Economic Momentum Continues

A Supportive Environment for Risk Assets

We remain positive about global economic growth and corporate fundamentals, but the easy financial conditions that dampened volatility in 2017 seem to be ebbing. In this environment, we believe risk assets will continue to offer the best total return opportunities, although investors should expect volatility to revert toward historical norms.

Equities: Opportunities at Home and Abroad

We maintain our overweight exposure to equities despite the February spike in volatility. We still see the most promising opportunities in international developed markets such as Europe and Japan.

In the United States, we have a neutral recommended weight to equities. Within US equities, we prefer small-caps over large-caps because they tend to be more sensitive to economic growth. The distinct shift from monetary policy to fiscal policy that was punctuated with the passage of tax reform last December bodes well for the US economy and should benefit smaller companies. Within US large-caps, sectors like financials should benefit from stronger economic growth, lower taxes, deregulation and higher rates as the Fed continues to normalize policy.

In emerging markets, we continue to recommend a neutral weight. But after another year of improvement in the economic and corporate backdrop, we continue to look for opportunities to raise our outlook on the asset class.

Fixed Income: Headwinds Mount, Selectivity Is Key

As the Fed continues to gradually normalize monetary policy, bonds appear to offer limited total return opportunities, and we have therefore maintained an underweight position to the asset class. Expectations of a pickup in inflation have caused a further backup in interest rates to start the year. Moreover, the significant level of deficit spending expected in the US could boost the supply of Treasury bonds at a time when the Fed is taking its foot off the gas pedal as a buyer.

Within fixed income, we still prefer US investment-grade credit to government bonds. And to guard against interest rate risk, we are maintaining our short duration bias relative to the benchmark. For investors in high tax brackets, the municipal bond market continues to offer tax-advantaged income, although selectivity remains key.

Alternatives: A Hedge against Volatility

Low market volatility and interest rates have weighed on hedge fund performance in recent years, but rising rates could present hedge funds with new opportunities. As we look for market volatility to pick up from the record low levels of 2017, alternatives could offer investors valuable downside protection and further diversification in multi-asset-class portfolios.

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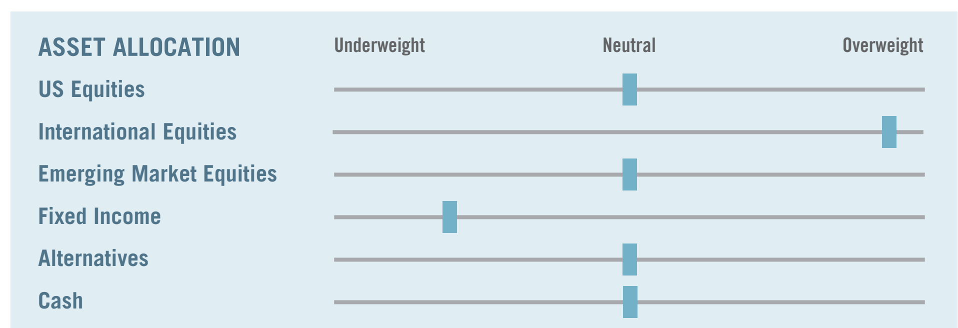

FIDUCIARY TRUST FORUM

Give It Away Now? Tax Reform Raises the Ceiling on Lifetime Gifts

While 2017 was a banner year for the markets, it was also a remarkable year for taxpayers. Amid the slew of changes introduced by the Tax Cuts and Jobs Act, one could ultimately have the most significant impact on family wealth: the amount that is exempt from federal estate, gift and generation-skipping transfer tax has doubled. In 2018, individuals can transfer up to $11.18 million and married couples can transfer up to $22.36 million tax free.

Q. Are the new estate tax laws a game-changer for my estate plan?

BRYAN: With the exemptions now doubled, the amount you can transfer tax free to your beneficiaries is dramatically higher. This applies to transfers at death, and also offers an opportunity to make lifetime gifts that previously would have been subject to gift tax at a rate of 40%.

However, these opportunities are limited because a sunset provision in the new tax law means the higher exemptions expire at the end of 2025 and revert back to their previous levels. If the value of your estate falls below the new thresholds, it might seem logical to assume you no longer need to think about estate taxes. But that would be a false assumption, because these new thresholds are not permanent.

So, this really is a game-changer for many families because it requires that they take a new, close look at their estate plans.

Q. Is it better to gift assets during my lifetime or as part of my estate?

GERRY: The answer to that question depends on a number of variables and your specific situation. But it really is important to consider the question carefully: Some assets might be better to give during your lifetime and others might be better to leave as part of your estate. The goal is to maximize the after-tax value of the assets you pass along to your beneficiaries.

With respect to gifting, an asset's growth potential is the first factor we look at. In general, the more an asset is expected to appreciate in the future, the greater its gifting "value" from a tax perspective. For example, gifting an ownership stake in your company while it's young and in the early development phase will ultimately pass on much greater value to your beneficiaries than gifting ownership in a business that has already matured. Any appreciation after it is gifted will belong to your beneficiaries and not be subject to future gift and estate taxes.

BRYAN: The other important factor we look at is income tax cost basis, because assets gifted during your lifetime are taxed at their original cost basis. That means if you give away an asset that has appreciated significantly, such as real estate or stocks you have held for a long time, your beneficiaries could be subject to capital gains and other taxes potentially totaling 30% when they decide to sell.

However, the cost basis on property that is inherited after death is adjusted, or "stepped up," to its current market value. For example, if you leave the family home to your children in your will or revocable trust, they will receive the property at its fair market value and can sell it immediately without any capital gains taxes. The only amount they would pay taxes on is any appreciation between the time they inherit the property and the time they sell it. So, if you own assets with a low cost basis, it can be better to leave those to your heirs via your estate versus gifting them during your lifetime.

Q: What is the best way to gift assets?

GERRY: How you give can be just as important as what you give. Often, making outright gifts isn't practical because beneficiaries are too young or are not ready to receive large amounts of wealth. We often recommend using trusts to control the timing, size and conditions attached to those distributions.

BRYAN: In addition to providing more control over how and when your assets are distributed, trusts can be designed to help mitigate certain tax liabilities. Trust structures you may not have considered in the past—such as a dynasty trust, grantor trust or directed trust—might be especially useful with the higher exemptions now in place.

GERRY: If you are considering gifting to grandchildren or subsequent generations, a Delaware dynasty trust can help ensure that distributions are not subject to generation-skipping transfer taxes. In other trust structures, such as grantor trusts, you (the grantor) are responsible for paying taxes on any income earned by the trust, allowing trust assets to effectively grow income tax free. Lastly, if illiquid assets such as real estate or ownership stakes in a family business are being gifted, using a directed trust allows you to retain control over how those assets are invested.

Q. What should I do now?

GERRY: Re-examine your balance sheet and overall estate plan, particularly your current will and trusts, within the context of these higher exemptions. If you plan to make a particularly large gift, you may need to reevaluate your future cash needs and adjust your financial plan accordingly. But professional guidance is strongly advised. You don't want capital gains or state-level taxes to inadvertently reduce the value of your gift.

If you decide that gifting is an appropriate strategy, keep in mind that you don't have to use the full exemption amount right away. But starting early could have advantages.

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For more information about lifetime gifting, estate planning and the new tax rules, please contact your Fiduciary Trust relationship manager or call us at (877) 384-1111.

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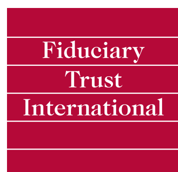

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