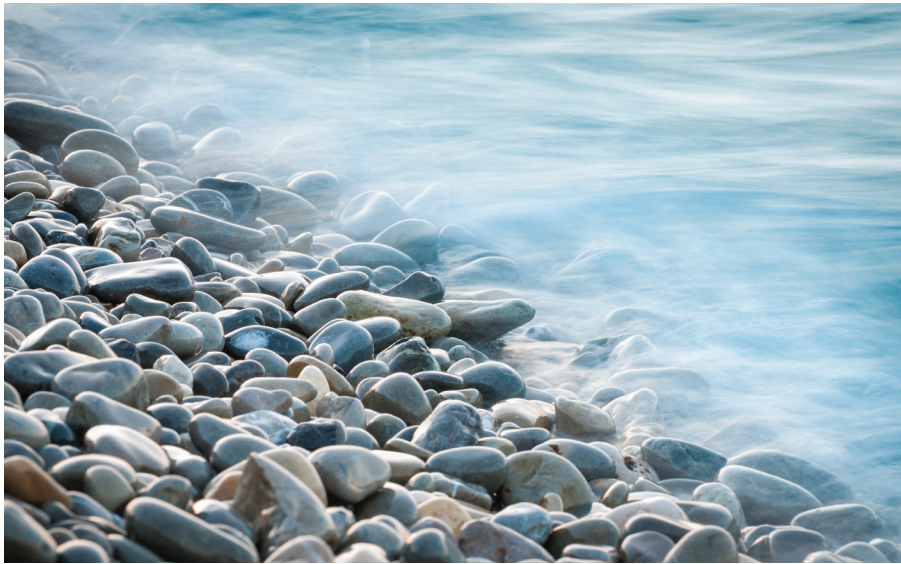


# Perspectives

*Keeping you informed and engaged about macroeconomic trends and market events*



## A Great Balancing Act

*“So be sure when you step. Step with care and great tact and remember that Life’s a Great Balancing Act. Just never forget to be dexterous and deft. And never mix up your right foot with your left.”*

—Dr. Seuss, from “Oh, the Places You’ll Go!”

**WHEN THE YEAR BEGAN**, there was a wide divergence of views on what a Trump presidency would mean for the markets. Immediately following the election, there was an enormous boost in consumer and business confidence as investors hoped we might be entering a more pro-growth regime from what we had experienced under the Obama administration. Specifically, there was an excitement about the potential for less regulation, lower taxes, and fiscal spending on infrastructure, all of which Trump promoted on the campaign trail. Yet there were worries about other things he talked about: trade barriers, more restrictive rules on immigration, and

Trump’s mercurial behavior, all of which could undermine global trade and raise uncertainty. Add in the mix expectations of contentious elections in France, Germany, and Italy, a U.K. government initiating Brexit negotiations, as well as ongoing recalibrations within key emerging market countries including China, India, and Brazil, and the investment landscape could have best been described as complicated.

As we take stock of market action in 2017, the prolific gains investors have experienced belie little of these complications. Many developed market indices are trading at record levels and volatility measures like the CBOE Volatility Index (which mea-

### IN THIS ISSUE

1

We see evidence of a synchronized global economic recovery and believe it will provide a constructive backdrop for investors in the half year ahead. Protectionism, geopolitical strife, and monetary or political policy mistakes present downside risks to our otherwise optimistic outlook.

2

U.S. economic momentum stalled some in early 2017, but has regained its footing. Valuations may be high but all-in yields remain compelling, and if tax cuts come back on the agenda it will provide a further boost to U.S. earnings.

3

The Japanese and European recovery has gained strength, with the ECB and BoJ maintaining their accommodative stance. The pro-EU results of the French elections helped boost investor sentiment while results of the British election raised uncertainty, especially regarding Brexit negotiations.

4

Emerging market company fundamentals and corporate profits are improving and valuations continue to look reasonable. Further gains are possible and share prices are still about 30% lower than their 2007 peak in USD price terms.

### Ropes Wealth Advisors

Ropes Wealth provides customized and unbiased investment management and financial planning advice that is seamlessly integrated with your wealth management strategies.

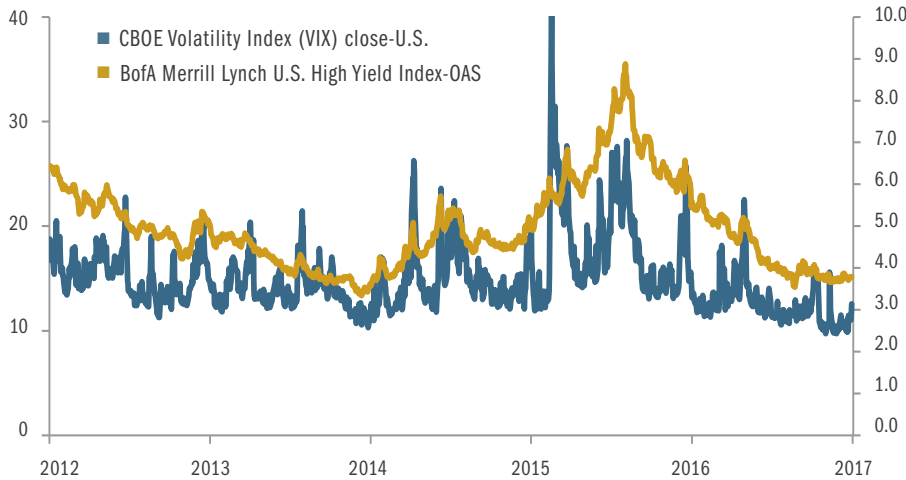
P 1-617-235-4260

F 1-617-235-4261

[ropeswealthadvisors.com](http://ropeswealthadvisors.com)

SOURCE FOR ALL GRAPHS: Bloomberg.

**The VIX is low and credit spreads have declined**



sure the market expectations of near-term volatility as conveyed by S&P 500 stock index option prices) and high yield credit spreads are exceptionally low. Some market pundits believe these are worrying signs of complacency, and we could be in the calm before the storm. This calmness is especially striking in the context of the political turmoil that has dogged the Trump administration; the tensions over North Korea; the escalation of brutality in Syria; and the horrific terrorist attacks all over Europe and the U.K.

Even more nerve-wracking is that an outsized portion of the market's returns have been generated by just a few stocks, both at home and abroad. In the U.S., a few mega-technology companies have, in fact, been driving returns on and off for the past three years: the FANG stocks (Facebook, Amazon, Netflix and Google) which have recently been modified with a new acronym, the FAAMG stocks (Facebook, Amazon, Apple, Microsoft and Google). Depending on which acronym you use, between 33% to 40% of U.S. market returns over the last three years are attributable to those stocks alone (and more than 50% of Nasdaq's returns year-to-date), even though they represent barely 10% of total market capitalization. Likewise, the 18.4% surge in the MSCI Emerging Markets Index this year has been led by just a few big technology names, with Samsung, Tencent, Alibaba, Taiwan Semiconductor, and Naspers Ltd. accounting for almost a third

of the emerging market gauge's advance this year.

Naturally, there are concerns that there is too much concentration, too much weight, too little diversification, and too many investors piling in to a few names just because. Comparisons to the 2000 tech bubble abound, though arguably fundamentals for FAAMG stocks today are much stronger and valuations much lower. This concentration of gains also raises legitimate concerns about the lessons of the late 1960s and 1970s, a peak time for the so-called

Nifty Fifty, the "it" stocks of their day. The Nifty Fifty were seen as solid investments in the companies leading America's economy, names such as Kodak, IBM, and McDonald's. They soared in the 1960s, and by 1972, they commanded a valuation of more than twice the S&P 500. Then they crashed and brought the market down with them. Many of the same arguments made about those stocks then are made about these dominant tech companies today.

Past patterns are useful and important, but as they say, past performance is no guarantee of future results. Comparisons to the tech bubble of 2000 seem a little stretched given today's technology leaders are mature companies that justify their valuations with actual financial performance. And the collapse of the Nifty Fifty in the 1970s was part of a larger economic malaise of double-digit inflation and low growth, along with political turmoil and a crisis of national confidence. Some of those elements may be in play today, of course, but the ongoing digital revolution appears to be still in its middle rather than late stages. In addition, unlike the 1970s Nifty Fifty, today's tech giants can thrive even as significant parts of the overall economy suffer. They are not proxies for "the economy;" they are the change agents disrupting the

**FAAMG stock fundamentals and valuations much different than 2000 tech bubble leaders**

		SIZE	VALUATION	CASH BALANCES	
Tech Bubble (as of Q1 2000)		SPX WEIGHT	P / E	CASH + ST INVESTMENTS	CASH/ENTERPRISE VALUE
MICROSOFT	MSFT	4.5%	55.1	21,205	4%
CISCO SYSTEMS	CSCO	4.2%	116.8	4,653	1%
INTEL	INTC	3.6%	39.3	11,216	2%
ORACLE	ORCL	1.9%	103.6	2,768	1%
LUCENT	LU	1.6%	35.9	1,709	1%
FAAMG (as of Q1 2017)		SPX WEIGHT	P / E	CASH + ST INVESTMENTS	CASH/ENTERPRISE VALUE
APPLE	AAPL	3.9%	14.9	67,101	9%
ALPHABET	GOOGL	2.8%	25.0	92,439	18%
MICROSOFT	MSFT	2.7%	21.8	126,018	27%
AMAZON	AMZN	1.9%	89.0	22,392	5%
FACEBOOK	FB	1.7%	25.2	32,306	8%

old economy and reaping disproportionate rewards from the new.

That said, it is hard to argue that markets are not vulnerable to a period of consolidation after this year's meteoric rise. For now, though, we anticipate these episodes to continue to be short-lived because the fundamental underpinnings of the economy and corporate earnings are there to provide a floor. Indeed, though "hard" data such as GDP growth has been less convincing, purchasing manager activity indices and consumer and business sentiment surveys worldwide paint a rosy picture. Central bank policy globally remains mostly accommodative, and the Fed's path to normalizing monetary policy has been well-communicated. Most importantly, earnings growth is the strongest in years, and finally, synchronized, with all major regions posting gains. Indeed, the S&P 500 experienced 13.9% growth in earnings per share in the first quarter. European earnings rose 21%. Emerging market earnings growth had been negative until October 2016, but grew 4% in Q1 and is projected to rise to 10% in Q2. And it is not just the bottom line: these strong earnings results

reflect revenue gains that have been better than expected, a trend also consistent with a pick-up in growth.

It is probably also true that investors are at least familiar, if not comfortable, with many of the known risks to the outlook: the pace of the Fed's tightening cycle, China's renminbi policy, and the direction of energy prices. This is not to say these risks will not cause fallout to the markets; however, we have already experienced their impacts and survived. The current low level of volatility today also owes something to the favorable political outcomes in Europe where there has been no swing toward populism. While we still have to negotiate the German and Italian elections, so far voters on the continent have chosen not to join the UK in leaving the European Union (EU).

As for political volatility in the U.S. goes, investors seem to have adopted the attitude of "expect the worst and you won't be disappointed." Between FBI Director Comey's firing, the Russia investigation, and President Trump's never-ending stream of ill-conceived tweets, there seems no bounds and no pause to the

negative news flow coming out of Washington. And yet, markets have not reacted with fear and loathing as one might have thought, and in fact seem impervious to the risks and strangely above the fray. We suspect this is because even if Trump's proposed pro-growth agenda is not enacted at all as envisioned, his mere election guarantees that individuals and businesses are no longer at risk of further regulation and higher taxes, which is why confidence measures spiked in the first place and why they remain elevated.

Finally, it is worth noting that while investment flows by retail investors have been improving, there are not yet the signs of a care-free stampede into the stock markets that historically has often accompanied the very latter stages of previous bull markets (and most often those poised to crash). For all of these reasons, we believe it is reasonable to remain positive about the markets, though primed for episodes of volatility, and use diversification as a key tool to balance the risks presented by current valuations and potentially stressful geopolitical and macroeconomic circumstances.

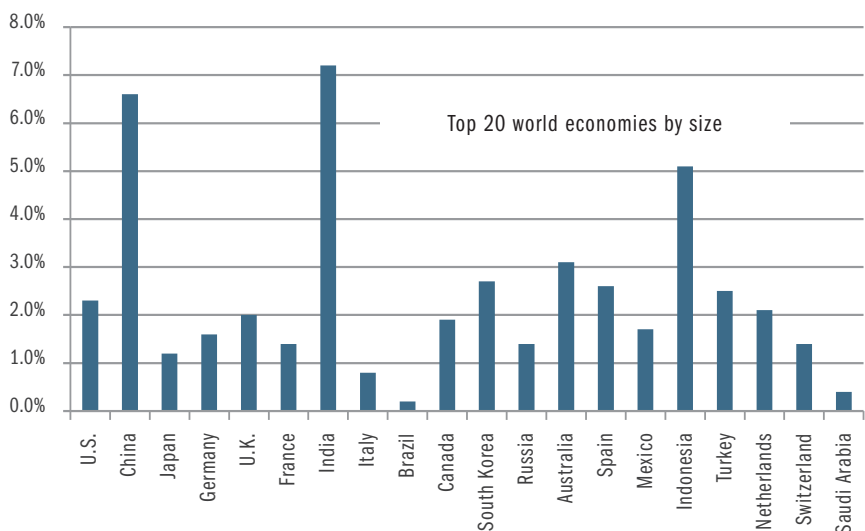
## GLOBAL ECONOMIC OVERVIEW: In Sync

THE GLOBAL ECONOMY is having one of its best years in more than half a decade. All of the world's top 20 economies are growing so far this year, a broadening of growth we haven't seen since 2010. While we do not want to overstate the importance of synchronized global growth, it is notable that for the first time in years no major economy appears particularly susceptible to tipping into recession.

Indeed, global GDP remains on track to exceed 2016's 3.1% pace as risks with the potential to jeopardize the economic recovery have thus far failed to materialize. Trump's much-dreaded protectionist agenda has not yet come to fruition and global trade is in good health. Following the French and Dutch election, the EU is enjoying political stability not seen in years and the economy is in smooth sailing. Although growth in China has decelerated, it is

### All of the world's top 20 economies on track to grow in 2017

IMF 2017 GDP forecast



expected to remain robust throughout this year, while authorities will continue with the implementation of economic reforms and initiatives to deleverage the financial sector. Moreover, monetary policies remain largely accommodative, with the exception of the U.S.

The balance of the year promises to be intriguing, however. On a negative note, uncertainty is high on Trump's fiscal mea-

sures, and the U.S. Congress will be debating healthcare and tax policy with a debt ceiling deadline looming. The combination of a snap election and imminent negotiations over the UK's withdrawal from the European Union has the British economy on tenterhooks. China will be holding a key party meeting in the early fall that will set an important tone for economic policy. Oil prices are in retreat, challenging the finances

of many producers. And rising political uncertainty in Brazil and the Persian Gulf highlights the fragility of the emerging markets. Nevertheless, we are optimistic that global growth trends can strengthen in spite of the ever-present risks of geopolitical strife and monetary or political policy mistakes. Broadening growth should feed higher levels of confidence that in turn creates a positive feedback loop of higher investment.

## U.S. ECONOMY: Growing Up Isn't Easy

**SINCE THE START OF THE SECOND QUARTER**, U.S. economic data has been mixed. On one hand, the unemployment rate has fallen to 4.3% and consumer confidence remains at elevated levels. On the other hand, the demand side of the economy (i.e. data on light vehicle sales, housing starts, net exports, and inventory growth, etc.) has disappointed in recent months, coming in below expectations and prior readings. However, there are nuances, as will be described.

First-quarter real GDP growth was a weak 1.4%, with business spending and investment the only real bright spot. Weather and delayed tax refunds may have contributed to the slowdown in personal consumption that characterized the quarter. Even so, consumers' spending was 2.7% higher in the first four months of this year than in the same period of 2016, though it was slower

than the 3.2% year-over-year growth at the end of 2016. And although retail sales surprised on the downside in May despite buoyant consumer sentiment and a robust labor market, upward revisions to previous months took the edge off of May's miss. Consumer sentiment measures are still off the charts, and while there is not a perfect correlation, confidence is often a leading indicator of spending to come, especially in the second half of a calendar year.

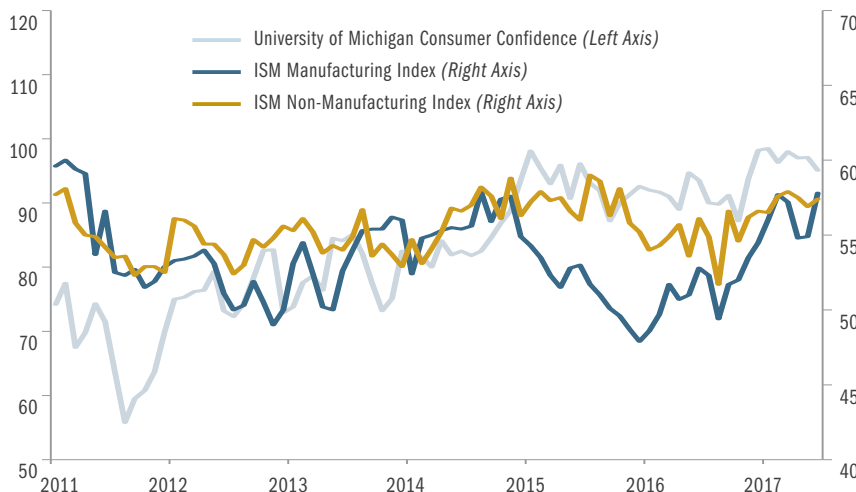
And though home sales and construction have also been sluggish of late, the U.S. housing market nevertheless recently reached two milestones: national house prices surpassed their pre-crisis peak in December and aggregate housing wealth topped its pre-crisis peak in the first quarter. Housing supply has tightened and there appears to be pent-up demand. To highlight one indicator, less new housing has

been built in the past 10 years than in any other 10-year period in the last 40-years.

The Institute of Supply Management (ISM) manufacturing index surged in June to a 57.8 reading (50 is the dividing line between expansion and contraction for this index), thanks to a faster pace of job creation and resilient output growth. The ISM Non-Manufacturing index of service sector activity was likewise strong, measured at 57.4. June's monthly payroll growth was 222,000, bringing the 2017 average of monthly payroll gains to 180,000. While the unemployment rate inched up slightly from 4.3% in May to 4.4% in June, it was for the good reason that the labor force expanded. However, average hourly earnings continue to trend at a mediocre 2.5% year-over-year growth rate. Sustained economic growth should result in wage pressures in the quarters ahead, further shoring up households' disposable income at a time of tightening financial conditions.

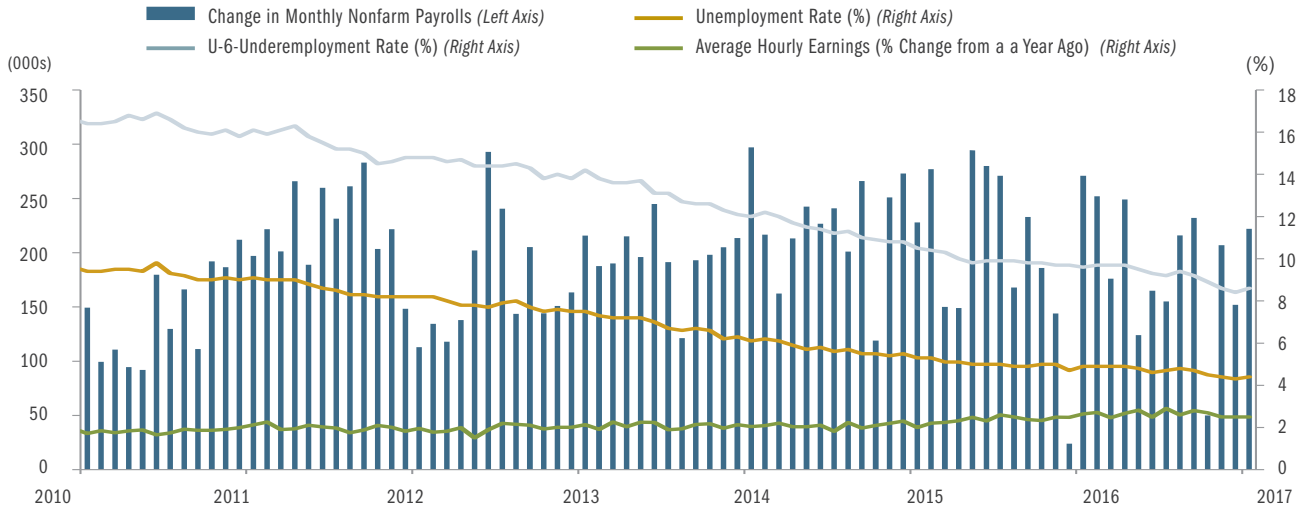
Indeed, as was widely expected, the Federal Open Market Committee (FOMC) hiked the fed funds rate to a target range of 1.00% to 1.25% at its June meeting. The FOMC also announced the framework it will use to gradually shrink the size of its balance sheet. By all appearances, it has laid the groundwork to begin reducing its holdings of Treasury and agency securities and to hike rates once more by year-end. Inflation remains below the Federal Reserve's target, largely due to declines in prices of medical care, commodities, and telephone services. Even so, slightly higher inflation readings are likely in the quarters ahead, given the projected forward business momentum.

### ISM activity gauges rebound in June; consumer confidence maintains its high





**Strong labor market a bright spot in the U.S. economy's uneven start to 2017**



As for politics, prospects for imminent progress on tax reform and an infrastructure package, the policy areas with the most potential upside for markets, continue to fade as Congress grapples with the difficulties of delivering on campaign pledges to replace the Affordable Care Act. Coupled with controversy surrounding the White House, it seems increasingly likely that very little of the congressional GOP legislative agenda moves forward before campaigning for 2018 midterm elections begins. In the short term, the Congressional Budget Office (CBO) projects that the Treasury can sustain operations without an increase in the debt

ceiling through early to mid-October. A vote to increase the debt ceiling is likely to be contentious, and it could become a risk event for markets as in years past. A separate concern is that protectionist policies could resurface. Commerce Secretary Wilbur Ross will soon reveal results from the Section 232 investigation of the impact of imports of steel and aluminum on U.S. national security. While steel and aluminum are a small part of overall global trade, this investigation could mark a return of protectionism to the policy agenda after such fears subsided earlier in the year.

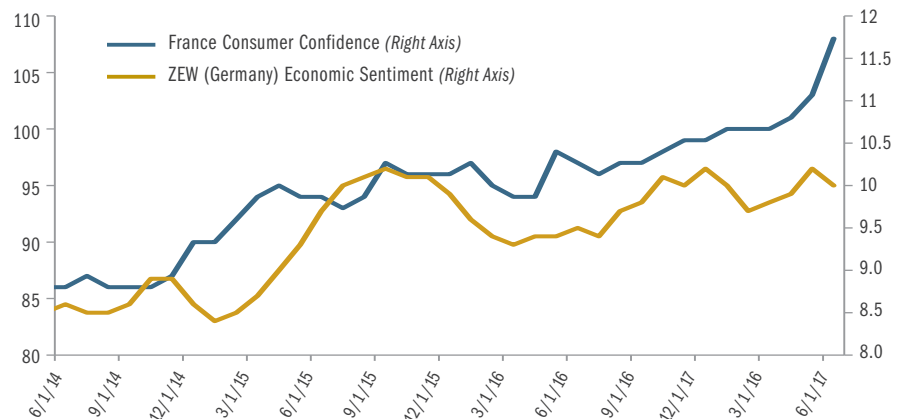
All in all, the outlook for the U.S. this year is one of continued modest growth,

on account of a solid job market, a relatively healthy housing market, and a notable turnaround in business investment growth. However, with exports, inventories, and government spending all weak in the first half, the economy is primed for a bounce back in the second half. Nonetheless, persistent political wrangling in Washington continues to foment doubts about the administration's ability to roll out growth-inducing policies later this year. By all accounts, though, inflation will stay low, and risks of recession are minimal. Therefore, we expect the economy to grow just 2.2% this year, and see it picking up only slightly to 2.4% in 2018.

**DEVELOPED INTERNATIONAL ECONOMIES: Vive la France!**

**EUROPE'S SLOW-BUT-STEADY RECOVERY** continued in the second quarter, with a number of economic indicators showing strong improvement. The German Ifo monthly survey of business sentiment in June returned to an all-time high, and Germany's projected GDP growth was raised to 1.8% in 2017 and 2.0% in 2018. Across the euro zone, unemployment continued to decline, hitting a post-global financial crisis low of 9.3% in April and May. Manufacturing and services in Germany and France, measured by PMI figures, remained well in expansion territory, and are in fact at a six-year high. Meanwhile, separate reports showed Italy and Spain, the third

**Consumer and business sentiment have rallied further with Macron's victory and the threat of populism abated**



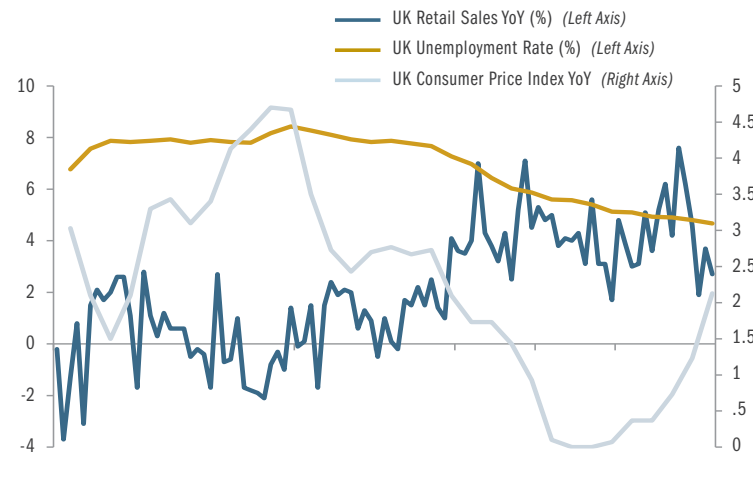
and fourth biggest euro zone economies, continued to show strong momentum in May. Business activity and order books remained strong in Italy, while Spain saw further increases in employment for the month. Euro zone business sentiment hit a post-financial-crisis peak in May.

The victory of pro-European centrist Emmanuel Macron in France’s presidential election has helped deliver a further boost to already high consumer confidence in the Euro zone, as well as the recent setbacks to the Italian populist Five Star Movement. In fact, confidence reached its highest level since July 2007,

more than a year before the onset of the global financial crisis. Against this backdrop, eurozone GDP is expected to grow at 1.9% in 2017 and unemployment to fall to 9.1% by the end of this year, with risks are tilted to the upside. Though inflation has exceeded expectations since late 2016, it has been largely an oil story and therefore transitory. The recent stability in oil prices and strength of the euro, along with ample spare capacity — both material and labor — should keep a lid on price pressures and eurozone headline inflation is likely to average a benign 1.6% for the full year. For its part, the European Central Bank (ECB) will be faced with a tough communication challenge over the next year. Improving growth has weakened the case for continuation of extraordinary monetary policy measures, but inflation is expected to remain below 2% for the next few years. We suspect the ECB will announce tapering of its asset purchases in the fourth quarter of 2017, before the current quantitative easing program expires in December. We expect that to be followed by a small hike in the deposit rate sometime in the middle of 2018 as a concession to hawks within the ECB. Mario Draghi’s recent speech in Sintra, one of the most market-moving events of the quarter, foreshadowed this action. Draghi emphasized that the ECB believes the forces currently weighing on eurozone

inflation are temporary. He implied that weak core inflation data is understating the underlying inflationary pressures gradually building in the eurozone. Importantly, he said that “as the economy continues to recover, a constant policy stance will become more accommodative”. Bond and equity markets globally reacted badly to the idea that the ECB thinks it will need to reduce its degree of stimulus just to keep the policy stance unchanged. This reduction in monetary stimulus could continue to put pressure on government bond markets over the next 12 months.

**U.K. retail sales are constrained by lack of wage growth and rising inflation even as unemployment has fallen to a cycle low**



However, it should be remembered that the reason the ECB may soon look to reduce its QE purchases is that the euro zone economy is in a much better condition than it was a few years ago. Against this healthy economic backdrop, the outlook for European corporates earnings should remain positive, unless the removal of central bank stimulus leads to a very large and sharp upward adjustment in corporate borrowing costs and the euro. Hopefully the adjustment in borrowing costs will be gradual enough for European equity markets to continue to make positive progress, helped by the boost to margins and earnings from stronger sales growth.

Turning to the UK, the economic and political outlook remains highly uncertain. Prime Minister Theresa May had called for a snap election in the hope it would bring the country stability and strong leadership

as it entered negotiations to leave the EU. May and the Conservative party, however, suffered an unexpected and serious setback, losing the party’s majority in Parliament and any claim May had to a popular mandate. May’s ability to negotiate with the EU was weakened, making its outcome much more uncertain and offering opportunities for others to propose differing views over the next 18 months. Brexit negotiations formally started on June 19th, with monthly meetings scheduled through March 2019. That leaves about 20 meetings to resolve the enormous political, economic, market, and logistical challenges of Brexit.

If May had prevailed with a strong majority in the election, then the agenda surrounding those meetings would have been clearer. Now, however, the eventual outcome for Brexit will be extremely uncertain and likely come close to—or at—the deadline. Worse, the UK government could change again before March 2019. It is notable, however, that this uncertainty appears to have had little lasting impact on the markets.

The deep recession after the global financial crisis brought investment down and raised unemployment, but the recovery has momentum. We also note that the UK election did resolve some other uncertainties, though in our view this did not receive enough attention. UK populism, as measured by UKIP’s share of the vote, appears to be receding. More importantly, the Scottish National Party, which was expected to campaign for a second referendum to secede from the United Kingdom, suffered heavy losses. With a UK break-up less likely, the pound’s value has been supported.

As in the U.S., while employment data presents a picture of a robust UK labor market, wage growth is nonexistent. Real income is further constrained by inflation caused by the pound’s post-referendum depreciation. This has resulted in falling

consumer spending, which accounts for nearly two-thirds of British economy. Some expected the weaker pound would support the export sector, but that tailwind has not materialized. The outlook for investment is not particularly cheery either, with significant legal, policy and regulatory uncertainty likely to deter businesses from making long-term bets on the British economy. As such, the British economy is expected to underperform its peers and grow at just 1.3% this year, with risks tilted to the downside.

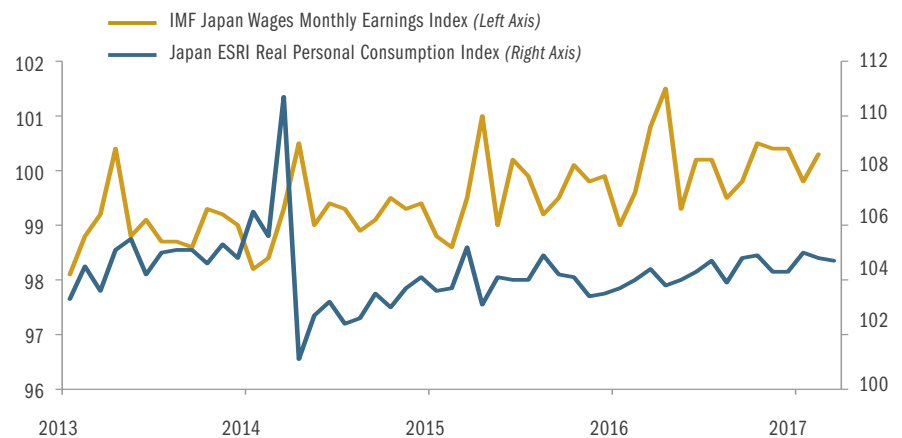
For this reason, the Bank of England (BoE) has given mixed signals while repeating its intention to remain accommodative, despite growing inflationary pressures. Governor Mark Carney publicly stated that “now is not yet the time” to raise rates, citing mixed economic indicators and uncertainty over Brexit. The BoE’s chief economist Andy Haldane, on the other hand, has sounded a more hawkish note. This reflects the uncertainties surrounding Brexit, and illustrates the difficulties of managing consistent policies faced with unique challenges.

Finally, the Japanese economy should continue to grow at a steady, if uninspiring, pace of just above 1% in 2017 and 2018. Growth has been supported by buoyant investment, a pick-up in export revenues on the back of the yen’s weakness, and additional fiscal spending. At the same time, tepid household income growth continues to be a drag. While wage growth has continued

to rise swiftly over the past couple of years, follow-through consumption has failed to materialize. However, this appears to be changing, albeit slowly. Retail demand at major department stores rose in May and auto sales were very strong in April. Auto production helped provide a major boost to industrial production, driven in part by the strong sales in Japan and also in China. Monetary policy stance should remain accommodative, with the Bank of Japan (BoJ) holding its benchmark policy rate at -0.1% and its “around 0%” yield target for 10-year Japanese government bonds, though this could prove challenging in the face of rising global yields. Fiscal policy is expected to continue at its current pace, though the slow pace of structural reforms and a favoritism scandal has caused

slumping support for Japanese Prime Minister Shinzo Abe, who is facing one of the biggest challenges of his political career after his ruling party suffered a humiliating defeat in Tokyo’s local elections. Abe is facing growing public opposition to one of his most cherished political goals of revising the U.S. post war pacifist constitution as well as widespread criticism of a sweeping new anti-conspiracy bill. Shortages of childcare places and persistent challenges for women in the workplace are other issues fuelling the growing lack of public confidence in Abe’s tenure. On the plus side, though, Abe’s push for reforms around corporate governance and stewardship have resulted in meaningful improvements in shareholder friendly activity and disclosure.

**Rising Japanese wages have not be accompanied by a commensurate increase in consumption, constraining growth**



**CHINA & EMERGING ECONOMIES: Going the Distance**

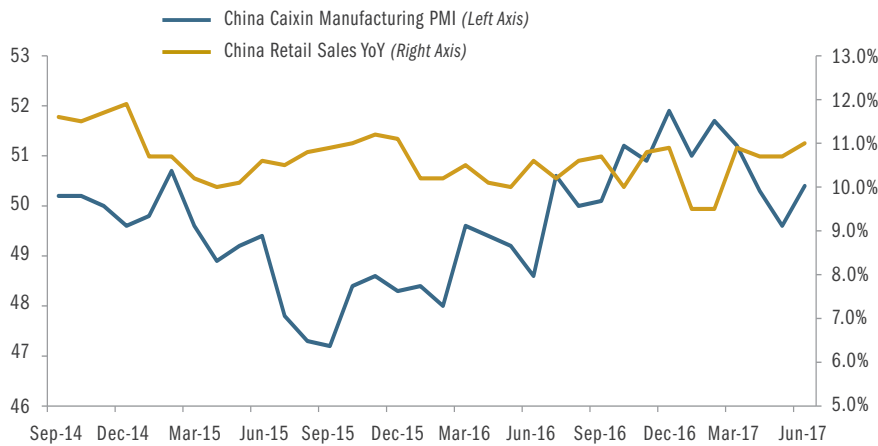
**CHINA REMAINS A MAJOR LONG TERM CONCERN** for global financial markets, but economic momentum appears to be holding for the time being. Moderating factory activity is being offset by a buoyant services sector, with the latter’s PMI rising to the highest in four months. According to Markit, new orders in the services sector expanded in May at the fastest pace this year amidst stronger underlying client demand. China’s services sector is finding support from an improving domestic economy. Consumption spending is in good shape as

evidenced by nominal retail spending which grew almost 11% on a year-on-year basis in May, while real estate activity is bouncing back after treading water in the last few years. While still weak, growth in private sector investment seems to be picking up. All in all, China remains on track to grow about 6.5% this year.

Solid economic growth in the run up to the party congress this autumn should allow room for policymakers to make some difficult choices given the still significant challenges facing China’s policymakers. A

highly levered economy has a risk of disorderly deleveraging, which explains Moody’s recent downgrade of China’s credit rating. New bank loans averaged a record 1.1 trillion yuan/month in the 12 months to May. And it now takes twice as much credit (compared to pre-2009) to generate an additional unit of GDP in China—in economist parlance “credit intensity” has doubled since 2009. Credit to the private sector in China has grown to a record 92% of GDP, well above that of other emerging economies which are closer to 50% of GDP. So, the threat of

**Chinese growth rebounds, driven by the consumer**



defaults and hence a financial crisis in the world's second largest economy should not be underestimated, and we are likely to see some tightening in monetary conditions to deal with the acceleration in household debt and the real estate market. That said, China's aggregate debt (both private and public) remains manageable at around 250% of GDP, and the government balance sheet is strong enough to deal with nonperforming assets and recapitalization of banks.

With the risks of protectionist U.S. policies and a pronounced slowdown in China failing to materialize, growth in other Asia economies gathered steam, thanks to resilient domestic demand, which is benefiting from public spending initiatives, higher commodities prices, and accommodative monetary policies. Indonesia has been the real standout, thanks to the government's ambitious spending plan to upgrade infrastructure in the wake of improved tax collection following the government's tax amnesty and higher earnings from natural resources. Malaysia, Philippines, and Thailand also posted positive growth, while Singapore has been a laggard constrained by unfavorable demographics and a soft labor market. Though India's growth slowed to 6.1%, compared to 7.1% in the prior quarter due to the impacts of demonetization, the World Bank and IMF project India will expand by 7.2% in this financial year as the country reaps the benefits of reforms such as the Goods and Services Tax scheduled to be rolled out in July.

For its part, the Gulf nosedived into the worst political crisis in years after several countries, led by Saudi Arabia, decided to sever diplomatic ties with Qatar abruptly in early June. One of the world's largest producers of liquefied natural gas, Qatar has long used its significant energy-derived wealth to pursue an independent political path, particularly in terms of its support for various Islamist groups across the Middle East that have been widely viewed as threats by the rulers of many other Arab countries. Qatar's recent opening up of ties with Saudi Arabia's main rival Iran may have been one of the triggers for the

**India's new tax structure finalized; majority of items in 12% and 18% tax slabs**

Tax Rate	Indicative Items
0%	50% of the consumer price basket, including foodgrains
5%	Mass consumption items like spices and mustard oil
12%	Processed foods
18%	Soaps, oil, toothpaste, refrigerator, smartphones
28%	White goods, cars
28% plus cess	Luxury cars, pan masala, tobacco, aerated drinks

rupture in relations between the fellow members of the regional Gulf Cooperation Council. Saudi Arabia and its allies closed all borders with the country and imposed

trade and travel bans, and have issued 13 demands for Qatar to end the political and trade blockade, including the shutdown of broadcaster Al-Jazeera and a scale down in its ties with Iran.

Elsewhere, South Africa's economy unexpectedly moved into recession, after a contraction in the final quarter of 2016 was followed by a decline of -0.7% quarter-on-quarter over the first three months of 2017. The subsequent period has seen further problems, with an upsurge of political concerns due to the sacking of the country's respected finance minister by President Jacob Zuma, which led Standard & Poor's to cut South Africa's credit rating to one level below investment grade. However, rival rating agency Moody's decided against such a move, arguing that South Africa's strengths such as low levels of foreign-currency debt, deep domestic markets and a well-capitalized banking sector went some way toward offsetting its political and economic problems.

By contrast, Brazil exited its deepest-ever recession in the first quarter, with growth of 1% compared to the previous three months marking an end to eight consecutive quarters of contraction. The turnaround was mainly due to an outsized soybean harvest, but similarly to South Africa, did not capture the impact on the economy of the country's most recent political crisis, a bribery scandal which initially appeared to threaten the position of President Michel Temer. The current president only came to power in 2016, after the previous incumbent was impeached for budgetary irregularities. Although President Temer survived a ruling by Brazil's electoral court, which potentially could have removed him from office, questions remained over his ability to see through a program of labor and pension reforms, which is widely viewed as essential to bridge the country's budget deficit of over 9% of GDP.

Rounding out the emerging markets, higher oil prices are providing some relief to the Russian economy, where the decline in GDP this year is now projected to be milder. Prospects of a strong recovery are subdued given long-standing structural bottlenecks and the impact of sanctions on productivity and investment.



## GLOBAL MARKET OUTLOOK: Up, Up, and Away

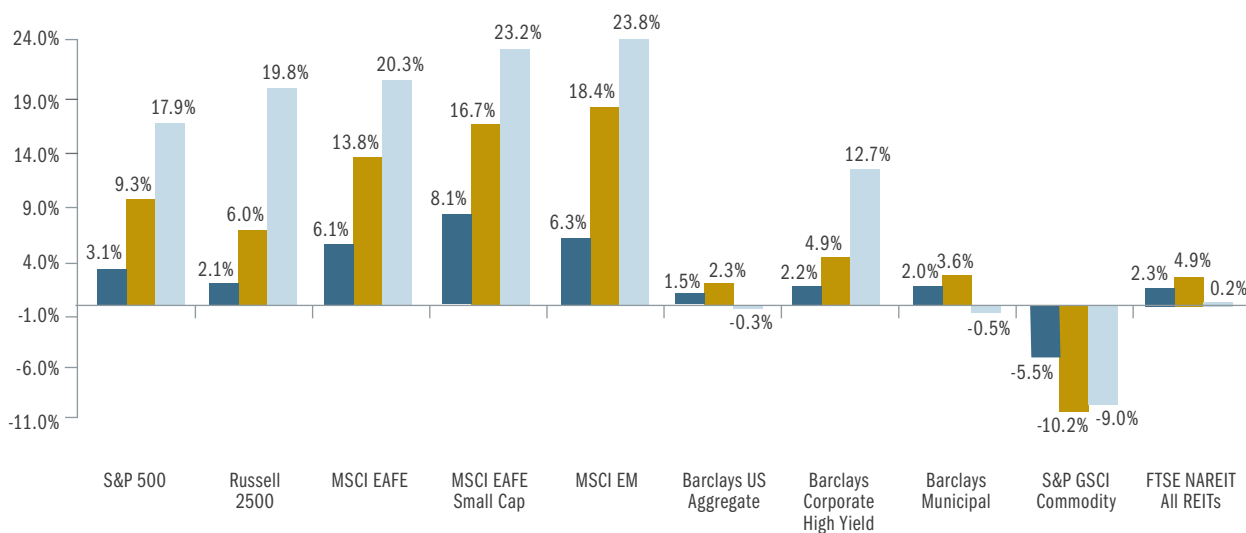
**RISK ASSETS CONTINUED TO RALLY** through the second quarter, with international equity markets taking the lead relative to the U.S. Emerging market equities returned 6.3% in the second quarter, bringing year-to-date returns to 18.4%, driven mostly by outsized returns in emerging Asia. Similarly, developed international markets returned 6.1% over the quarter and 13.8% year-to-date. Improving economic and earnings data in international markets are helping drive equity markets upward, and attractive valuations relative to the U.S. add to the prospect of better future returns abroad. In the U.S., investors started to question the

path of Fed rate hikes given weaker than expected inflation data, leading 10-year rates to fall to 2.15% and the Barclays Aggregate Bond Index to return 1.5% over the second quarter. High yield also rallied as rates fell, returning 2.6% for the quarter. U.S. large cap equities continued their upward trajectory, rising 3.1% in Q2 and 9.3% year-to-date, driven largely by the technology sector. Small cap equities underperformed as the strength of the domestic recovery was called into question after a weak 1Q GDP print, returning 2.5% for the quarter and 5.0% year-to-date. REITs returned 2.3%, cushioned by flows into higher yielding sectors of the

equity market as rates fell. Commodities were the sole negative return as oil prices fell steeply amidst concerns over a supply glut stemming from persistent U.S. production. Importantly, cash has returned just 0.2% this year, meaning that investors sitting on the sidelines would have missed out on healthy returns across a wide array of asset classes thus far in 2017.

Going forward, it is notable that neither equities nor bonds reacted well to recent speeches that suggested the ECB could soon begin reducing its quantitative easing purchases and the BoE might raise interest rates this year. One of the key questions for the rest of the year will be the extent to which

### Markets globally surge higher in defiance of valuation concerns



bond and equity markets can withstand a gradual reduction in monetary stimulus, which has helped to support markets in recent years. As well as being a busy quarter for central bank watchers, this was also a period filled with key political developments. At the start of the quarter, the markets were not expecting an election in the UK and were worried about elections in France. By the end of the quarter, Marine Le Pen's anti-euro campaign in France had been rejected, with pro-euro and pro-reform candidate Emmanuel Macron elected as president,

with a majority in parliament. In contrast, in the UK, Theresa May's decision to call an election has weakened both the strength and stability of her government at a crucial time for the country, as it embarks on Brexit negotiations. With seemingly nothing predictable in politics anymore, global markets will next have to contend with elections in Germany and Italy, developments with Trump and the Republican Congress, as well as increased speculation about whether Fed Chairwoman Janet Yellen will continue in her role when her term expires in February 2018.

### U.S. equities rise again, sparking fears of complacency

The S&P 500 recorded a total return of 3.1% over the quarter. Large cap equities outperformed small and mid caps over the period, with the Russell 2500 and Russell 2000 recording respective total returns of 2.1% and 2.5%. Growth-oriented sectors, including technology, once again dominated market returns, though tech stocks pulled back a bit in June, such that healthcare and industrials ultimately came out on top for the quarter. The energy sector, a value

**U.S. valuations are not cheap, but are not unattractive**

Forward P/E	S & P 500	MSCI Europe	MSCI Japan	MSCI Emerging Markets
Current	18.6x	15.6x	14.5x	12.9x
10-year Median	15.2x	13.0x	14.8x	11.9x
Premium / Discount	3.4x	2.7x	-0.4x	1.0x
10-year Government Bond Yields	U.S.	Germany	Japan	China
Current (%)	2.35	0.48	0.08	3.61
10-year Median	250	1.7	0.86	3.55
Premium/Discount (bps)	-15	-132	-78	6
Forward ROE	S & P 500	MSCI Europe	MSCI Japan	MSCI Emerging Markets
Current (%)	15.4	11.5	8.8	12.2

haven and market darling in 2016, changed course in 2017 as oil prices slid during the quarter. Commodity-related stocks, such as precious metals and natural resources, also were losers in this short span. Financials stocks, which had a big tailwind in late 2016 on optimism about the potential for less regulation under the Trump administration, started to rebound as interest rates moved higher.

It is worth noting that one of the biggest stories of the quarter is the continued pressure on the retail industry, which can only be described as under siege. There have been nine retail bankruptcies announced thus far —as many as all of 2016. J.C. Penney, RadioShack, Macy’s, and Sears have each announced more than 100 store closures. Sports Authority has liquidated, and Payless has filed for bankruptcy. Several apparel companies’ stocks hit new multi-year lows, including Lululemon, Urban Outfitters, and American Eagle, and Ralph Lauren announced that it is closing its flagship Polo store on Fifth Avenue, one of several brands to abandon that iconic thoroughfare. E-commerce generally and Amazon specifically are being tagged with most of the blame, though clearly the explanation is a bit more nuanced and also connected to the legacy of the Great Recession. Coincidentally, the quarter ended with the announcement of Amazon’s blockbuster purchase of the upscale grocery chain Whole Foods for \$13.4 billion, so stay

tuned for more fallout to come in the grocery retail space.

Separately, political uncertainty remained an important feature in the U.S. market as President Trump’s actions raised doubts over the ability of the administration to push its fiscally expansive policies and also weighed on the dollar. The dollar was further negatively impacted amid rising expectations that central banks in other major developed economies are also preparing to tighten monetary policy. Currency therefore played a major role in driving the returns of overseas markets in the quarter, which may continue in the quarters to come especially if conversations around raising the U.S. debt ceiling cause further dollar depreciation.

**Developed international equities surge with relief over Macron win**

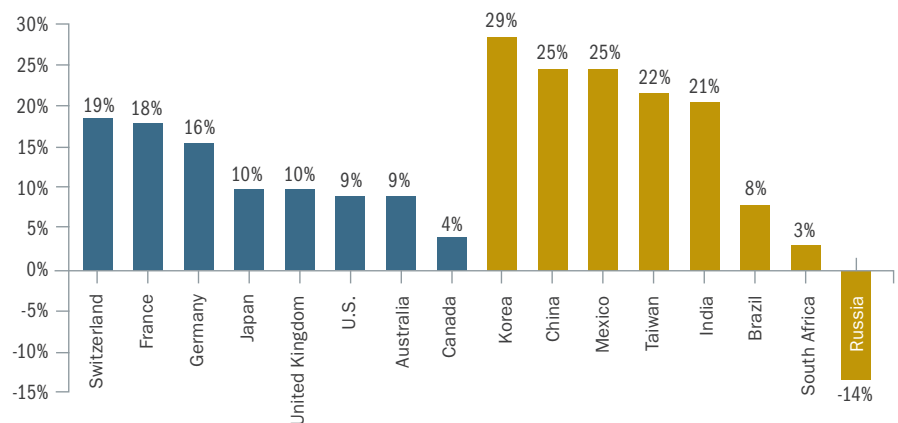
The first quarter corporate earnings season was positive with many companies reporting both sales and profit growth. Despite the generally brighter backdrop, the top sector performers were largely in defensive areas of the market. Real estate and utilities were the top gainers, with utilities were boosted by merger & acquisition speculation. The energy sector registered a negative return for the quarter.

The MSCI EAFE Index gained 6.1% in the quarter, and 13.8% for the year, while the MSCI EAFE Small Cap Index advanced by 8.1% in the quarter and 16.7% for the year. Growth stocks handily outgained value stocks overseas during the period--as was the case in the U.S.

In terms of geographic performance, eurozone equities came out on top, as reduced political risk, positive economic data, and improved corporate earnings all supported shares. Denmark, France, and Italy were the strongest country performers. However, gains were capped at the end of the quarter by worries the central bank could start to tighten policy. The UK equity market was volatile over the quarter amid uncertainty over the economic outlook, the political backdrop, and the future path of monetary policy. The FTSE All-Share generated a total return of 1.4% (generally supported by robust corporate results). After weakening in the early part of April, the Japanese

**European and Asian countries are leading the year’s returns by double-digits**

YTD (as of 6/30/2017) Performance by Country



market trended upwards for most of the quarter to end 6.8% higher. The Japanese currency was volatile throughout the period, reflecting global uncertainty, but ended on a softer note against most major currencies. Real estate stocks and leasing companies performed well as they rebounded from the relative lows seen at the end of March, while insurance stocks underperformed. Cyclical sectors also showed a mixed performance with paper stocks and chemicals rising by more than the market, while steels, autos and shipping stocks lagged. The strongest sector by far was consumer discretionary, driven by the continued rise in Nintendo's share price.

**Strong Asia performance drives emerging markets run-up**

Emerging market equities were beneficiaries of a supportive global backdrop in the second quarter, in particular U.S. dollar weakness. The MSCI Emerging Markets index registered a strong gain of 6.3% for the quarter, and has advanced 18.4% year-to-date.

Asia ex Japan equities continued on their strong run in 2017 to record another period of solid gains in the second quarter. These came on the back of improving data for the Chinese economy and a broader risk-on approach from global investors. Chinese stocks saw robust gains over the period as better economic data and a landmark decision in mid-June, by index provider MSCI, to include Chinese A-shares in a

range of its benchmark indices supported sentiment. The Chinese yuan also finished up strongly as the currency rebounded over the period to finish up 1.6% against the U.S. dollar. These gains were especially impressive given the ratings agency Moody's cut China's credit rating for the first time since 1989, citing concerns about rising debt and slowing economic growth. In nearby Hong Kong, stocks tracked Chinese markets higher on investor optimism following a solid earnings results season for its blue-chip heavyweights. Over the strait in Taiwan stocks advanced led by the island's technology sector. Korean stocks were among the region's best performers after an election victory for new President Moon Jae-In – who is looking to reinvigorate the economy and implement meaningful corporate governance reforms. In Southeast Asia, all markets finished up with Indonesia and the Philippines the strongest performers while Thailand underperformed the region. Meanwhile in India, stocks gained but were by comparison cautious over the possible short-term impact of the implementation of a much-awaited national goods and services tax at the start of July.

Elsewhere, Turkish equities rebounded strongly with U.S. dollar weakness, domestic stimulus, and a firmer outlook for exports to Europe all boosting sentiment. Poland continued its meteoric rise thanks to strong GDP growth. Greece was the strongest index market as the country reached agreement with eurogroup

creditors for the release of an €8.5 billion loan tranche. This covers upcoming debt repayments in July.

Russian stocks slid more than 6% as data showed lackluster economic growth and oil prices fell on disappointment that OPEC extended, but did not deepen, its production cuts until March 2018. Brazilian equities also lost value as political risk increased following corruption allegations against President Temer. Brazil's central bank reduced its benchmark rate by 1% at month-end, citing increased uncertainty, and signaled a moderate pace of rate cuts in the future, which disappointed investors who expected more aggressive easing.

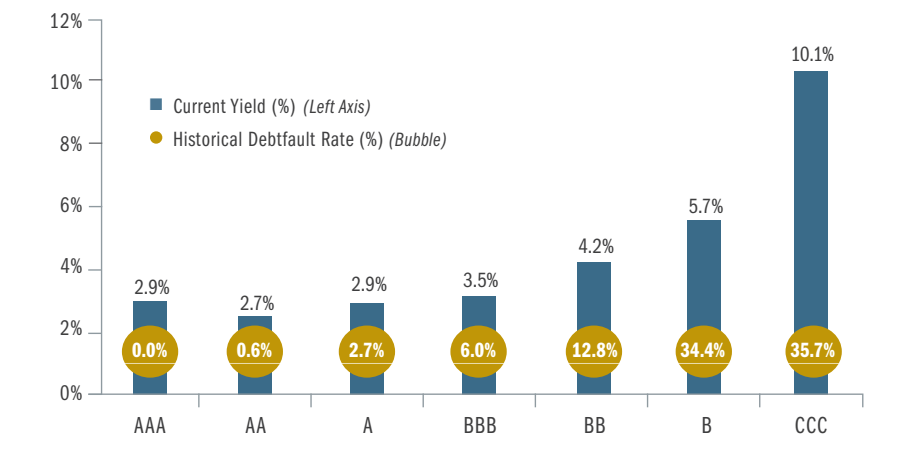
Qatar was the weakest market, negatively impacted by the imposition of an economic and diplomatic blockade by neighboring countries, notably Saudi Arabia.

**Munis and emerging market debt steal the show, though all bonds perform well in the quarter**

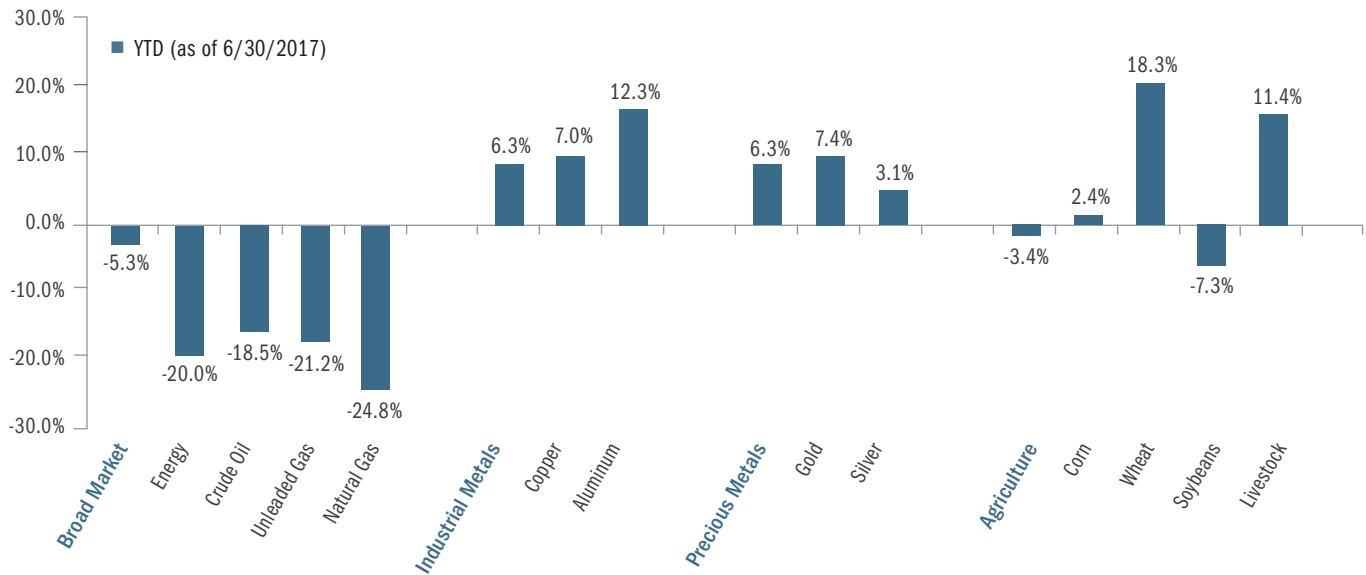
Fixed-income indices performed well during the second quarter of 2017. Long-term fixed-income indices easily outperformed short-term, as long-term yields have declined while short-term rates have risen, resulting in a flattening yield curve. A laggard this quarter were TIPS, which rose only 0.3% as inflation expectations have moderated along with the price of oil.

Corporate bond indices benefited as credit spreads continued to tighten over the quarter as asset volatility declined near-historic lows. A combination of factors has supported corporate credit markets: generally improving credit metrics, fewer debt-funded M&A or shareholder enhancement programs, and the market's expectation of possible Trump administration revisions to tax and regulatory policies reinvigorating economic growth and earnings. In the high-yield market, the Bank of America Merrill Lynch High Yield Master Index rose 1.8%, as declining long-term interest rates did not have as much of an impact on the high-yield market because of its shorter duration. Structured credit delivered more muted results as rising interest rates at the end of the quarter in the wake of a Fed

**Corporate bond yields decline to low levels though historical default rates remain subdued**



**No real bright spots in YTD commodity price action**



interest rate hike extended the durations on various segments of the asset- and mortgage-backed securities markets.

At current levels, both the investment-grade and high-yield corporate bond indices are trading much tighter than their long-term historical averages. Since the end of 1998, the average spread of the investment grade index is +167 (currently +109), and since the end of 1996, the average spread of the high-yield index has averaged +607 (currently +364).

**Hedged strategies hang in**

Returns for hedged strategies were broadly positive for a sixth month in a row, led by equity strategies including special situation, long/short, and event driven. Merger arbitrage strategies also generated positive performance, while distressed strategies were down slightly. Special situations equity gained as managers benefited from a supportive equity backdrop and positive sector and security selection. Positions in the consumer sector were particular contributors to returns. Merger arbitrage was positive as spreads tightened materially for widely held mergers NXP/Qualcomm, Level 3 Communications/CenturyLink, and Actelion/Johnson & Johnson. Additionally, the Valspar/Sherwin-Williams merger closed at the end of May, contributing to return. Managed futures funds

were among the losers, as well as commodity strategies.

**Commodities get crushed in the second quarter**

Energy was the weakest commodity as Brent crude fell -9.3% in the quarter. Year-to-date losses now stand over -20%. OPEC members and other producer nations extended production cuts but these were not as deep as the market had anticipated. The weakness was also exacerbated by rising U.S. production. Industrial metals were also down, with iron ore falling heavily on concern of weaker demand from China and elevated stockpiles in the country. Agricultural commodities were down slightly with declines in sugar and coffee the key headwinds. In precious metals, silver was particularly weak, falling -9.3%, but gold was more resilient. However, as the Federal Reserve continues to pursue rate increases, gold prices look primed to fall. Additional rate hikes by the Fed may further discourage investor flows into gold.

**Looking ahead**

In terms of the breadth of global growth, the first half of 2017 is shaping up to be the best start to a year since 2011. On the surface, anyway, the environment is as Goldilocks as it gets— reasonable growth, low inflation, and accommodative central

banks are all supportive of risk assets. A surge in economic momentum in Europe and Japan, and solid corporate earnings globally, amply offset some wobbles in the hard data and a below-expectations print for U.S. first quarter growth. Equities, unsurprisingly, posted handsome gains as a result; but even so, investor sentiment appeared more cautious than price action might imply. At least, the decline in bond yields suggests so. Although bond yields and equity prices have diverged previously in this expansion, the deviation is now raising questions about the reflation trade and, in turn, Fed policy. Whether the level of bond yields is a warning of slowing economic momentum, or merely the result of a savage short squeeze and the third year running of negative sovereign supply, remains a critical consideration in positioning for the remainder of 2017.

While we are elated about this year's returns thus far, we believe the next 12 to 18 months could be challenging for investors as the central banks reverse their policies and their aggregate balance sheet goes from expansion to contraction. Further, central banks will be "normalizing" their balance sheets at a time when growth and inflationary pressures should still be muted. A further complication is the reality that there may or may not be policy stimulus coming out of Washington and





there may or may not be a hard Brexit. Ultimately, we are poised to find out how much quantitative easing and zero interest rate policy depressed volatility and inflated asset prices, if at all.

Navigating this kind of environment is challenging, as too much caution can choke off returns while complacency in the face of rising risks will hurt when markets reverse. For now, we still believe the probability of a recession in the next 12 months remains low, but do see a growing potential for episodes of volatility and consolidation within the equity markets. An announcement of quantitative tightening from the Fed, combined with the announcement of a reduction in QE from the ECB, and a slowdown in Chinese growth in response to tightening there could well be the cause of a pull-back. Also on our radar is the risk that the Treasury runs out of borrowing room under the debt ceiling, and the fractiousness in Washington could result in an interruption of government (and potentially a ratings downgrade). Nevertheless, at this point we expect episodes of volatility to be short-lived, and stick with our conviction that a still-healthy global economy will continue to drive sales and earnings higher, which should be supportive for equity markets over the next 12 months. Given that the next moves from

central banks are likely to involve tightening rather than easing in monetary policy, it just seems too early for investors to go underweight equities and seek refuge in an overweight to government bonds and duration.

Therefore, in our asset allocation, we remain modestly overweight equities and underweight bonds. Within equities, the low level of inter-regional equity index correlation, together with the broad-based global upswing in growth, point to the benefits of a diversified equity exposure across regions. We acknowledge the full valuations of U.S. stocks, but prefer to keep an exposure, as all-in yields remain compelling, and should we see tax cuts back on the agenda it would likely give a boost to U.S. earnings. International and emerging market equities are important components of most of our recommended investment plans, and we are pleased to see the benefits of diversification demonstrated in this year’s market returns. With bonds, we believe that current yields will prove to be the low end of the 2017 range as recent softness in inflation clears and global economic momentum persists.

The remainder of 2017 promises to be eventful, but perhaps not for the reasons we expected. We doubt there will be major changes to U.S. tax and fiscal policy this

year. Euro-skeptics appear to be on the downslide, such that German elections this autumn have now turned into a virtual non-event, with Angela Merkel expected to ride home comfortably with a win. Even if we do have an upset in Germany, it is unlikely to disturb the apple cart since Merkel’s rival Martin Schulz, of the Social Democratic Party, is perhaps the strongest supporter of EU integration in frontline European politics. He could also help correct some structural imbalances in the Germany economy, such as low wages and tight fiscal policy. And on the other side of the Alps, Italy seems to be witnessing the return of more familiar political forces as the center-right parties have gained ground in recent local elections. This text was missing at the end:

With an awareness of both the unpredictable nature of global events and our all-too-fallible ability to accurately predict financial markets, we build diversified portfolios on your behalf as we seek to optimize our chances of achieving your long-term investment success. While great wealth is often created through investment concentration, great wealth is preserved through diversification, and now more than ever we anticipate the benefits of our approach will shine through as market risk becomes more heightened in the wake of this year’s welcome, but heady, returns.

DISCLOSURE: The information set forth in these materials is presented by Ropes Wealth Advisors LLC (“Ropes Wealth”) a wholly owned subsidiary of Ropes & Gray LLP. Ropes Wealth cautions the reader that past results are not indicative of future performance. The historical return of markets generally and of individual assets classes or individual securities may not be an accurate predictor of future returns of those markets, asset classes or individual securities. The economic commentary contained in this newsletter is for informational and educational purposes only and is not intended as investment advice.

SOURCE FOR ALL GRAPHS: Bloomberg.