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Q4 Economic & Market Outlook: *The fundamental things (still) apply*

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I don't like disturbances in my place. Either lay off the politics or get out.

– Rick Blaine, from *Casablanca*

ASSET CLASS PREFERENCES

- Most preferred
- Neutral
- Least preferred

EQUITIES (Most preferred)	FIXED INCOME (Least preferred)
United States (Neutral)	United States Government Debt (Least preferred)
Large Cap (Neutral)	TIPS (Least preferred)
Mid Cap (Neutral)	Non-U.S. Developed Markets Government Debt (Least preferred)
Small Cap (Neutral)	Municipals (Neutral)
Growth (Neutral)	Corporate – Investment Grade (Neutral)
Value (Neutral)	Corporate – High Yield (Neutral)
Non-U.S. Developed Markets (Most preferred)	Emerging Markets – Hard Currency (Most preferred)
Emerging Markets (Most preferred)	Emerging Markets – Local Currency (Most preferred)

TIPS=Treasury Inflation-Protected Securities

Allocations based on an unhedged, U.S. dollar-denominated portfolio. Please note the forecasts above concern asset classes only and do not reflect the experience of any product or service offered by TIAA. These forecasts are for informational purposes only and should not be considered investment advice or constitute a recommendation to purchase or sell securities. Market forecasts are subject to uncertainty and may change based on varying market conditions, as well as political and economic developments. Past performance is not an indicator of future results.

EXECUTIVE SUMMARY

- While the U.S. economy is walking, it won't be running anytime soon.
- Leadership changes at the Federal Reserve (Fed) place unusually high uncertainty on near-term monetary policy.
- Hopes for fiscal stimulus from Washington, D.C., are down to a flicker.
- December could be a bumpy month for markets, with political showdowns galore.
- Global stocks continue to rally, supported by improving corporate profits.
- Low U.S. interest rates reflect too dire a scenario for growth and inflation.
- The U.S. dollar has fallen further and faster than we expected.
- Our tactical investment posture is unchanged: we favor international stocks and emerging-markets bonds.

There are just three months left in what's been either an unprecedented or unremarkable year for investors, depending on one's perspective. Global financial markets have delivered uniformly positive returns in relatively straight lines. Economic forecasts continue to call for solid — but not spectacular — growth. Day-to-day market volatility has stayed remarkably muted even as newspapers routinely blast alarming headlines. As time goes by, the list of risks appears to be increasing while the number of attractive investment opportunities shrinks. Yet the fundamental things still apply: the growth outlook remains reasonably good for the world's largest economies and the financial assets tied to their fate.

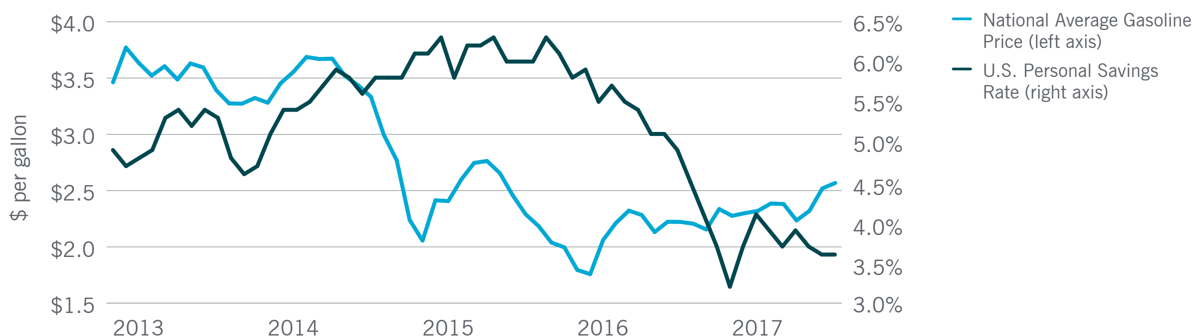
THE ECONOMY: "WE MUSTN'T UNDERESTIMATE AMERICAN BLUNDERING."

While 2017 has been a disappointing year for the U.S. economy, it's been far from poor. Expectations for Gross Domestic Product (GDP) growth have fallen throughout the year as it has become clear that no contribution from federal government spending is forthcoming. Nevertheless, consumer spending has improved after a slow start to the year. Business investment is picking up even without corporate tax reform. Lastly, the U.S. dollar's sharp fall — arguably 2017's most significant economic and market development — has helped exports add meaningfully to U.S. GDP for the first time in many years.

The U.S. economy appeared to be expanding at a brisk 2.5% clip until Hurricanes Harvey and Irma made landfall late in the third quarter. Natural disasters obviously have an immediate negative economic impact, but the recovery and rebuilding processes normally help the afflicted areas bounce back quickly. The sharp rise in gasoline prices nationwide following Harvey is of particular concern, as a large number of oil refineries in the Gulf region were shut down or damaged. Higher gas prices act as a tax on consumers and — given already low household savings rates — could lead to reduced spending on other items (Figure 1). Personal spending should pull back from its strong second-quarter pace, with overall weather-related effects shaving up to 1.0% from the economy's third-quarter growth rate. The timing and magnitude of any bounce will become clearer once the full extent of the damage is known and the rebuilding effort begins. Our forecast for U.S. GDP growth in 2018 remains 2.5%, up from an expected 2.2% pace this year. (Hurricane Maria has left tens of billions of dollars in damage that will wreak havoc on Puerto Rico's economy, according to initial estimates. However, neither the storm's immediate effects nor the island's eventual recovery will be taken into account when determining U.S. GDP. That is because data from Puerto Rico, a U.S. territory, is excluded from U.S. economic statistics.)

Meanwhile, the game of catch-up continues for other developed economies, particularly the eurozone[1], which has consistently beaten expectations throughout the year. The dual rise

Figure 1 – Higher gasoline prices threaten already-stretched consumers



Source: Bloomberg.

in business sentiment and consumer spending has put the continent on its firmest footing in over a decade. China, another large piece of the global economic pie, has managed to keep growth stable amid attempts to contain the financial risks associated with its rising debt levels. In addition, the International Monetary Fund's most recent global growth forecast left the top levels unchanged: 3.5% in 2017 and 3.6% in 2018.

Beneath those numbers, though, growth in the U.S. edged down, while that in the eurozone, China and Japan all rose. China is part of a wider emerging-markets (EM) comeback, with Eastern Europe and Latin America also on the uptrend. The gap between EM and developed-markets growth rates, which fell to 1% in 2015, now appears primed to average 3% or more per year over the next several years.

THE POLICYMAKERS "NEVER MAKE PLANS THAT FAR AHEAD."

The central banks

The gentle acceleration in the pace of global expansion has thus far arrived without a significant rise in inflation. This presents global central banks with a mild dilemma: in the absence of any urgency in the data, they need to determine how quickly to tighten monetary policy as growth improves in anticipation of higher near-term inflation. December will be an interesting test case for how central banks respond to good-but-not-great economic conditions. Markets are divided about whether the Federal Reserve will raise its policy rate in December for the third time this year. Adding to this uncertainty are the next moves by the European Central Bank (ECB), which has hinted that it may scale back its monthly bond-buying program — something the Fed did back in 2013 — by the end of 2017, as well.

We think the Fed will ultimately elect to hike rates in December, and the ECB will announce a tapering of its open-market purchases sometime during the fourth quarter. Investors should not regard either of these moves as a sign that global tightening — or much higher interest rates — are on the way. Financial markets often react in knee-jerk fashion to changes in monetary policy, but both central banks have moved gradually and been careful to telegraph their intentions well in advance. In our view, only the arrival of stronger inflation will prompt them to become less patient.

There is no economic consensus about why prices in the U.S. have not increased faster given the cooperation of two usual suspects: low interest rates and an expanding (2%+) economy. As Figure 2 shows, however, inflation has failed to pick up even as the unemployment rate has fallen to a decade low. Job openings are at an

Figure 2 – Inflation is decelerating despite the low and falling unemployment rate

Source: Bloomberg.

all-time high, but employers are not aggressively raising wages to fill them. Without rising average take-home pay for workers, inflation is missing one of its key ingredients.

The politicians

If inflation is the dog that hasn't barked this year, the lack of economic stimulus coming from Washington, D.C., may have helped serve as a muzzle. The shocking — shocking! — failure of Congress and the White House to enact any major facets of their agenda through the first three quarters of the year may have helped forestall higher inflation and interest rates. A much-discussed $1 trillion infrastructure package, for example, had the potential to significantly lift near-term economic growth. Such stimulus would draw not just on unutilized resources — both labor and equipment — but, given the scarcity of idle hands these days, also on the skills of many workers already employed elsewhere. Boosting demand in a market with limited supply typically causes prices — or, in this case, wages — to rise.

It remains too soon to say whether fiscal policy will affect the economy or markets this year. December is shaping up to be a month of showdowns on the budget, tax reform and immigration, among other hotly debated topics. Keep in mind that market risks around government brinksmanship have been more fizzle than sizzle in recent years when a U.S. Treasury default is not on the table, as it won't be until next year. While we don't expect the fourth-quarter legislative calendar to derail the U.S. equity rally, we also do not share the optimism of those who expect a robust tax bill, including both cuts and reforms, by year-end. Recent experience has told us to expect nothing from Washington as a base case, and it seems prudent to adhere to this rule until it is contradicted.

Of course, Congress will have one more unavoidable task in the coming months: a hearing and vote to confirm the next Chair of the Federal Reserve. Because President Trump's views on monetary policy are not well known, his range of possible replacements for Janet Yellen, assuming she is not renominated, is unusually wide. It's possible the next Fed chair will have less experience in economics and central banking than his or her predecessors, creating more uncertainty about the path of policy in 2018. Questions about future leadership could also limit the credibility of Fed communications this quarter.

THE MARKETS: "YOUR WINNINGS, SIR."

Stocks

If equity investors have been bothered by political and central bank uncertainty, they certainly haven't been showing it. U.S. stock indexes have risen in every month this year. In fact, the S&P 500 Index has not experienced a pullback of 5% or more since July 2016 (Figure 3), its longest such stretch since 1994. A combination of solid corporate earnings growth and a lack of obvious investment alternatives has fueled this smooth rise. S&P 500 company earnings are on track to increase by around 10% in 2017, close to the index's year-to-date return.

The late summer months brought brief bouts of volatility, with headlines about North Korea, natural disasters and the ongoing investigations in Washington all causing investors to gently tap the brakes. As of now, the temptation for investors to cash in their gains from the past several years has not been strong enough to cause even a modest drop in stock prices. While investor confidence may persist through the balance of this year, the current level of equity market valuations is a high place from which to fall, if and when risk aversion takes hold. Given their progress through September, we do not expect U.S. large-cap stocks to rise appreciably further over the balance of this year. However, their outlook for the next few years remains positive, supported by broad-based global growth and improving earnings.

Figure 3 – The S&P 500 Index has enjoyed a mostly steady ride

Source: Bloomberg.

While neither political nor geopolitical turmoil has conspired to create an equity market correction, they may be partly responsible for the U.S. dollar's sharp third-quarter drop. Currencies tend to move in anticipation of changing interest rates. As global growth has become more broad-based, the gap between U.S. and global interest rates has begun to shrink, resulting in a weaker U.S. dollar. But growth convergence alone cannot explain the 7% decline in the trade-weighted dollar since December. Lack of progress on key political initiatives and few details on promised changes to trade agreements have also contributed to dollar weakness, particularly relative to EM currencies.

The greenback's decline has been a boon to U.S. investors in foreign assets. It's no longer poor salesmanship to bring up Paris: French stocks have returned 23% this year in U.S. dollars. Figure 4 shows that while gains in non-U.S. equities — both developed and emerging — have matched those of U.S. stocks this year, the dollar's weakening has amplified those overseas rallies by a further 7.5%. Having already fallen so far and so fast, the U.S. dollar, in our view, has only limited further downside in the fourth quarter. Still, international markets remain more attractive given their combination of lower valuations and accelerating growth.

Figure 4 – U.S. dollar weakness is responsible for non-U.S. equity outperformance

Source: MSCI, Bloomberg.

Bonds

Interest rates dipped during the quarter but finished the period slightly higher on net. The 10-year U.S. Treasury yield fell from 2.30% at the end of June to as low as 2.04% in early September before rebounding later in the month. Longer-term yields have barely budged as the Fed has raised rates on the short end, and the resulting flatter yield curve is often regarded as a sign of economic pessimism. Disappointing U.S. growth has undoubtedly been positive for longer-maturity bond prices, as has the recent saber rattling by North Korea and Washington.

Even so, small pivots from both the Fed and the ECB toward tighter monetary policy should help push rates higher before the year is out. While our former 2.75% year-end target for the 10-year U.S. Treasury yield now looks too aggressive, rates should at least be able to climb back to their 2.45% starting point for the year. For the 10-year note, that would be a modest 12 basis point (0.12%) rise from September 30's level.

Fixed-income markets are, of course, not immune to political risks. The U.S. Treasury bill market became the subject of some unlikely intrigue in the third quarter. Normally, prices on these short-term securities exhibit relatively little volatility and move according to near-term interest-rate expectations. In the past few months, though, credit risk actually became an issue for some T-bills as the so-called "debt ceiling" approached. Had Congress failed to raise this borrowing limit by early October, the U.S. Treasury could have technically defaulted, reminiscent of similar events in 2011. To compensate for this risk, bills maturing in October traded at a discount to those maturing in September or November. Fortunately, Congress and the White House agreed on an extension to push the next debt-ceiling deadline well into 2018, allowing October T-bill yields to fall back in line (Figure 5).

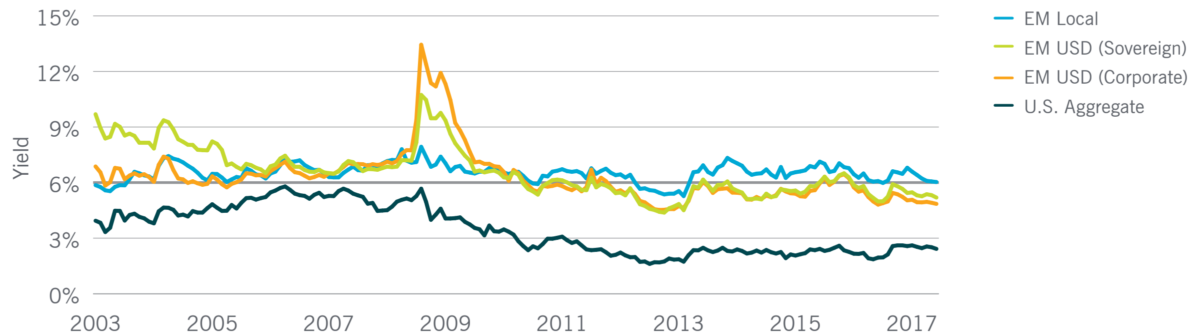
Turning to Europe, even if the ECB elects to pull back on its asset purchases this year, interest rates there will likely remain depressed for the foreseeable future. Investors looking outside the U.S. for additional sources of yield and total return may want to consider EM debt (EMD) instead. Denominated in both the U.S. dollar and EM currencies, EMD offers yields that far exceed those on comparably rated U.S. securities (Figure 6). For more details on this asset class, please read our recent white paper, *Emerging-markets debt: a new world in fixed income.*

Figure 5 – Political risk affected the Treasury bill market this summer

Yield on T-bill maturing October 5

Source: Bloomberg

Figure 6 – EMD still offers a significant pickup in yield over U.S. fixed income



Source: JPMorgan, Bloomberg

Conclusion:

The beginning of a beautiful friendship

Casablanca, the movie responsible for the quotes and phrases scattered throughout this piece, is widely — and rightly — recognized as one of the greatest ever made. First screened in New York City in November 1942 — nearly seventy-five years ago — the film has come to be seen as an allegory for America's late but ultimately decisive entry into World War II, years after most other major powers were already engulfed in it.

Fast forward from the greatest military challenge of the 20th century to the greatest economic challenge of the 21st, and it's the rest of the world that has arrived late to the party. But now that Europe is finally growing again, joining the U.S. and most of the emerging markets, the global expansion is more stable, and financial markets are more resilient, contributing to greater consumer and investor confidence. While risks to the durability of this positive outlook remain in the months ahead, diversified portfolios can still build on the year's already-strong returns — maybe not today, maybe not tomorrow, but soon.

1 A monetary union of 19 out of 28 European Union (EU) member countries that have adopted the euro as their currency.

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