"FOMO versus FOC(O):

Fear of Missing Out versus Fundamentals Outweigh Complacency (Over Time)"

Prepared by Lake Partners, Inc.

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Summary

Summary

<u>*Overview*</u>

While there were plenty of things to worry about during the third quarter, three particular concerns stood out:

- the Fed's intentions to normalize interest rates and reduce its balance sheet;
- the lack of progress in reforming the US tax code; and
- North Korea's nuclear tests and missile launches (and the rapid escalation of rhetorical threats between Trump and Kim).

All of these were outweighed, though, by a much greater fear: FOMO, the Fear of Missing Out. The upward momentum of markets, at least for risk assets, was too alluring to resist for most investors. Yes, valuations generally for equity and credit markets might be rich, but look! They were rising higher, and with little if any interruption! Continued signs of improving economic growth coupled with tame inflation, not only in the US but globally, provided ample justification for investors' optimistic view that the trend must be inexorable.

However, the three concerns listed above have not gone away. If anything, they have continued to intensify, albeit slowly. The first highlights the fundamental sea change occurring in monetary policy, which threatens to remove the excess liquidity that has been vital to the rise in asset prices since the global financial crisis of 2008. The second presents a challenge to investors' expectations for fiscal policy, threatening the assumptions underlying the so-called "Trump Trade." And the third poses an existential threat that few investors want to contemplate. The risk for markets is that at some point, the Fear of Missing Out is replaced by the realization that Fundamentals Outweigh Complacency Over Time.

Summary

Outlook

Looking forward, we continue to expect the investment landscape to be characterized by:

- a significant degree of dispersion among major equity and fixed income markets around the world (magnified by currency moves);
- a significant degree of dispersion and rotation within equity and credit markets; and
- renewed volatility across markets, due to the political and policy uncertainties associated with the Trump administration in the US, as well as "Brexit" and ECB policy in Europe. The markets have largely shrugged off potential geopolitical flashpoints (such as North Korea), but these could flare up at any time.

Our view is that the global investment environment is undergoing a significant transition:

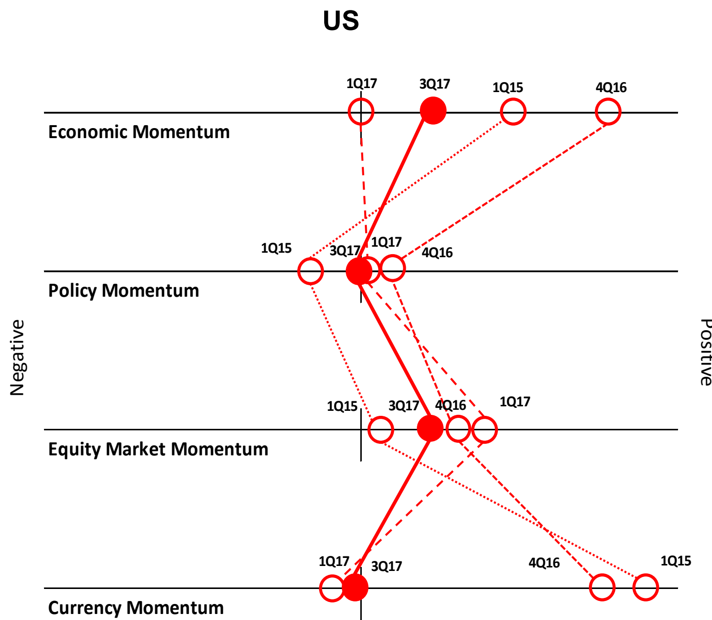
- In the US, the Federal Reserve has embarked on an effort to normalize interest rates and reduce its balance sheet. While monetary policy may remain cautious, excess liquidity will be less of a factor in driving markets, while fundamentals will be increasingly important. On the one hand, equity markets have been excited by the prospect of fiscal stimulus, tax reform, and deregulation with Trump as president. However, there has been little evidence of significant legislative traction in these areas, without which investor sentiment is likely to turn sour. Furthermore, the markets face risks associated with reflation, rising interest rates, the ongoing need to raise the debt ceiling, the pending reduction of the Fed balance sheet, and potential trade wars. Consequently, volatility and sector rotation will increase, as investors try to sort out the "winners" and "losers" from policy changes.
- In Europe, there is a disconnect: investors' have grown increasingly enthusiastic about the improving economy, but they have largely discounted the implication that this will lead to less monetary stimulus, as well as a stronger euro (which would dampen exports). Furthermore, needed structural changes are impeded by the continent's political patchwork, while the consequences of "Brexit" negotiations remain a wild card. The rise of populist politics across the region poses another uncertainty for investors.
- In Japan, there is a conundrum: any improvement in growth continues to be disproportionately small relative to the size of quantitative and qualitative easing.
- In China, there is a contradiction: efforts to stimulate and restructure the economy conflict with the need to reduce excessive leverage throughout the financial system.

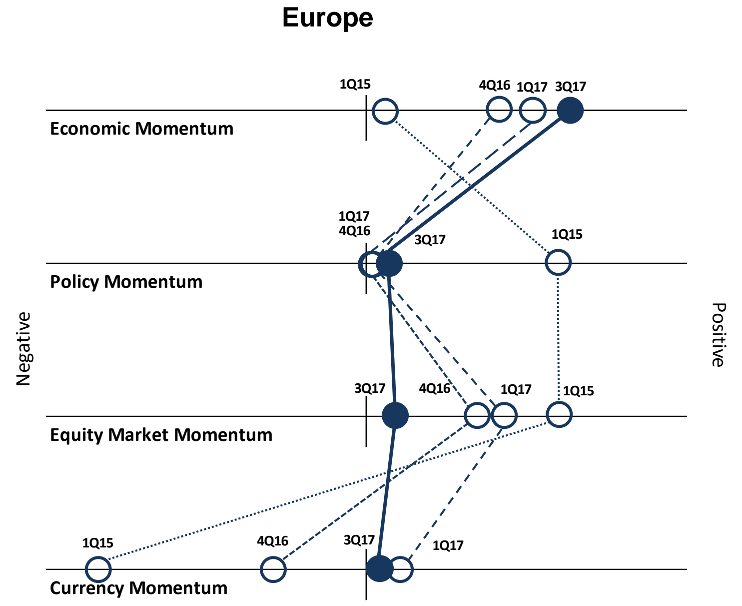
Summary

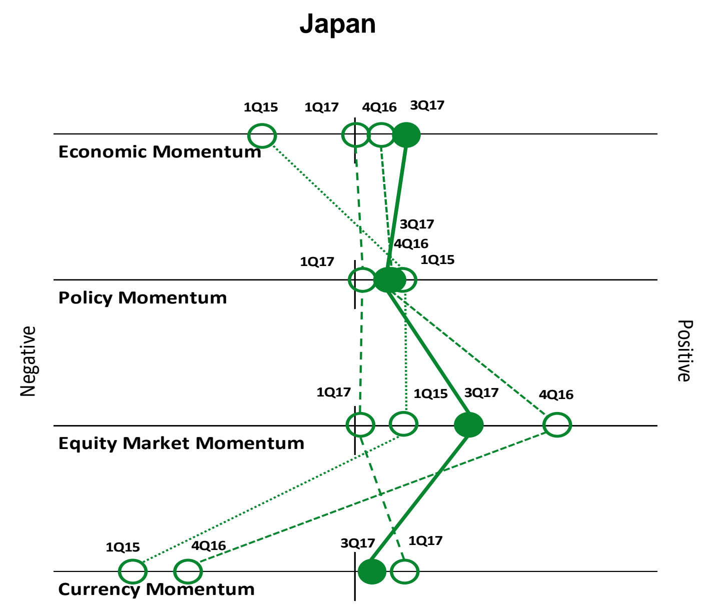
Although markets have been eerily calm, as indicated by the low levels of the VIX, we believe that this is unsustainable. We expect the crosscurrents stemming from the macro divergences and dissonances to engender turbulence across markets.

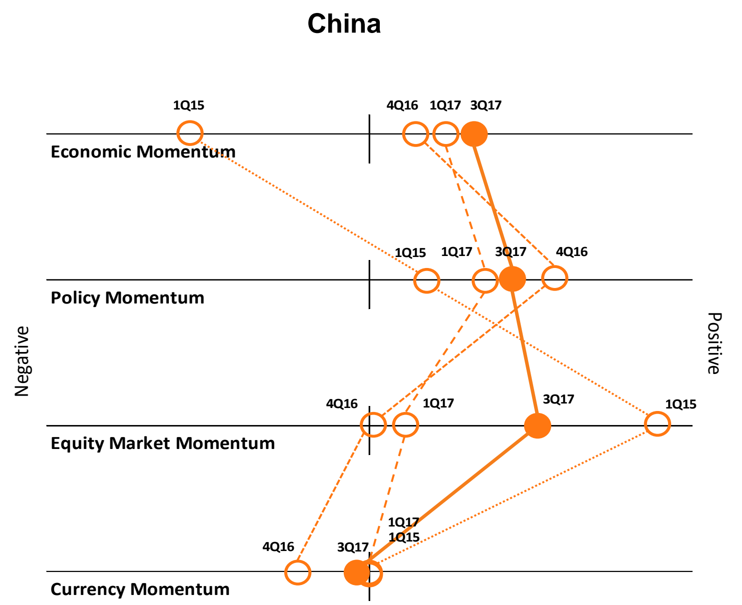
The divergences among the major blocs of the global economy are illustrated on the next page along four dimensions: economic momentum, policy momentum, equity market momentum, and currency momentum. While the illustration is largely conceptual, rather than quantitatively precise, we think it is a useful and thought-provoking way to think about trends, as well as how changes in economic and policy momentum can impact the path of equity markets and currencies.

Summary – Divergent Trajectories Across Major Regions









Market Developments – Third Quarter 2017

During the third quarter, the S&P 500 Index gained 4.5% and volatility in the aggregate remained limited (aside from a few brief spikes). However, under the seemingly placid surface there were significant divergences and rotation among sectors:

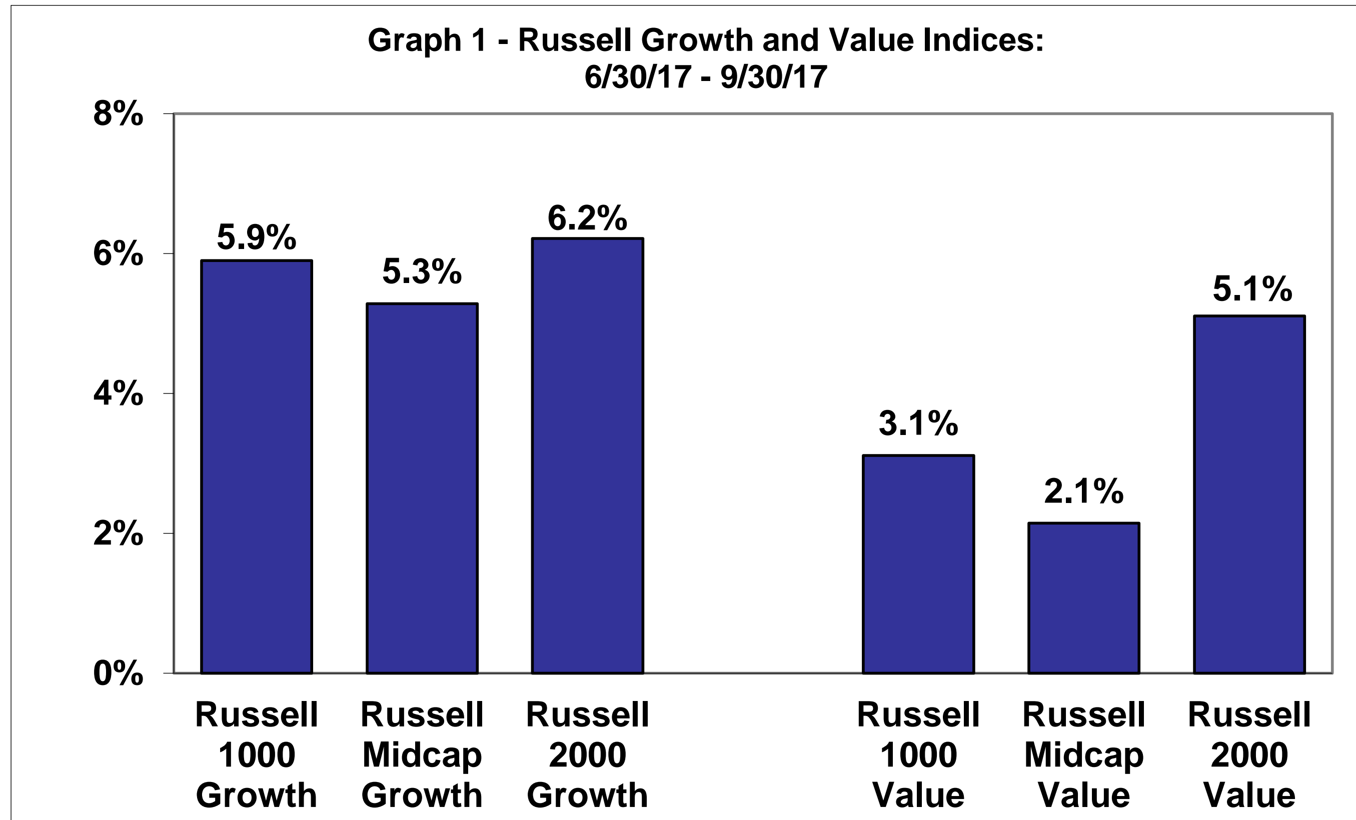
- Most notably, growth stocks continued to outperform value stocks, as shown in Graph 1 (which also was true of the first and second quarters). This applied across capitalization segments:
  - Among large-cap stocks, the Russell 1000 Growth Index gained 5.9%, while the Russell 1000 Value Index was up 3.1%.
  - Similarly, among small caps the Russell 2000 Growth Index rose 6.2%, while the Russell 2000 Value Index was up 5.1%. It should be noted, though, that small caps did jump significantly in September in reaction to the Trump administration's proposed tax "principles."
- Much of the performance spread between growth and value was attributable to sector performance (please see Graph 2):
  - In particular, Information technology led with a gain of 8.6%, although the sector did flatten out in September.
  - Interestingly, energy was up 6.8%. However, the sector had been down for most of the quarter, until rebounding more than 9% in September when oil prices recovered.
  - In contrast, real estate and consumer discretionary lagged with minor gains of 0.9% and 0.8%, respectively, while staples were down -1.3% on lackluster growth prospects.

Non-US equity markets also were productive (please see Graph 3):

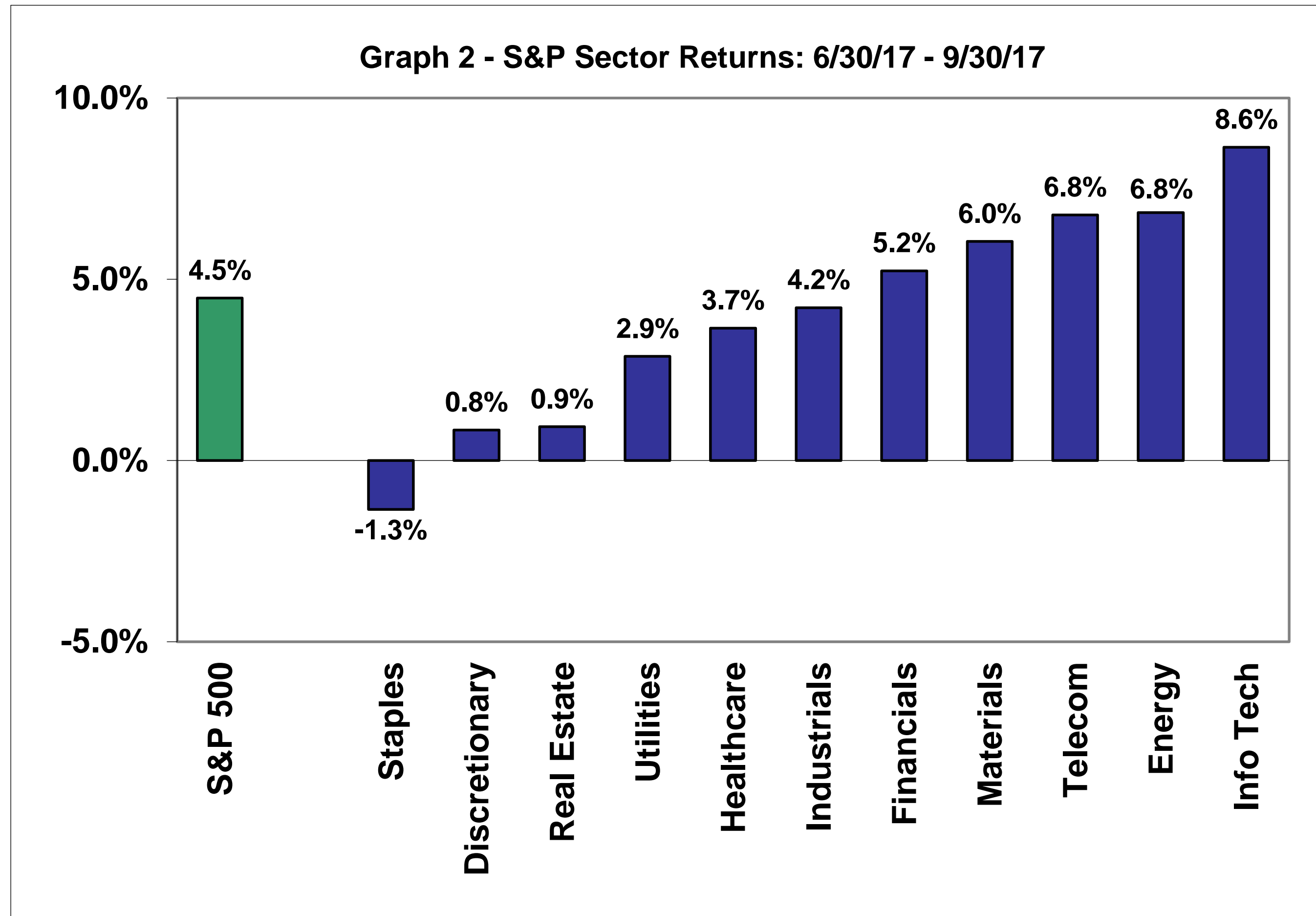
- European equities continued to benefit from signs of stronger economic fundamentals, credit demand, and expectations for improving corporate profits, although there was a certain degree of volatility due to uncertainties about ECB policy. The MSCI Europe Index finished the quarter with a gain of 3.5% in local currency terms and 6.5% in US dollars, in part due to the strength of the euro and the British pound.
- The MSCI Japan Index had a gain of 4.2% in local currency terms and 4.0% in US dollar terms as the economy showed signs of picking up, at least at the margin.
- Emerging markets stood out during the quarter, as the MSCI Emerging Markets Index gained 7.9%. In particular, China rose 14.7% on renewed optimism about the economy, while Russia and Brazil gained 17.6% and 23.0%, respectively. [Note: emerging market figures based on MSCI indices in US dollar terms].

In fixed income markets, the Bloomberg Barclays US Aggregate Bond Index rose 0.9% (please see Graph 4). Yields on 10-year Treasuries fluctuated in a relatively narrow range, while high yield tended to perform in sympathy with equities and investors' appetite for risk. In Europe, interest rates and bond yields mostly edged lower, while they were range-bound in Japan. Emerging market bonds as an asset class continued to post solid gains.

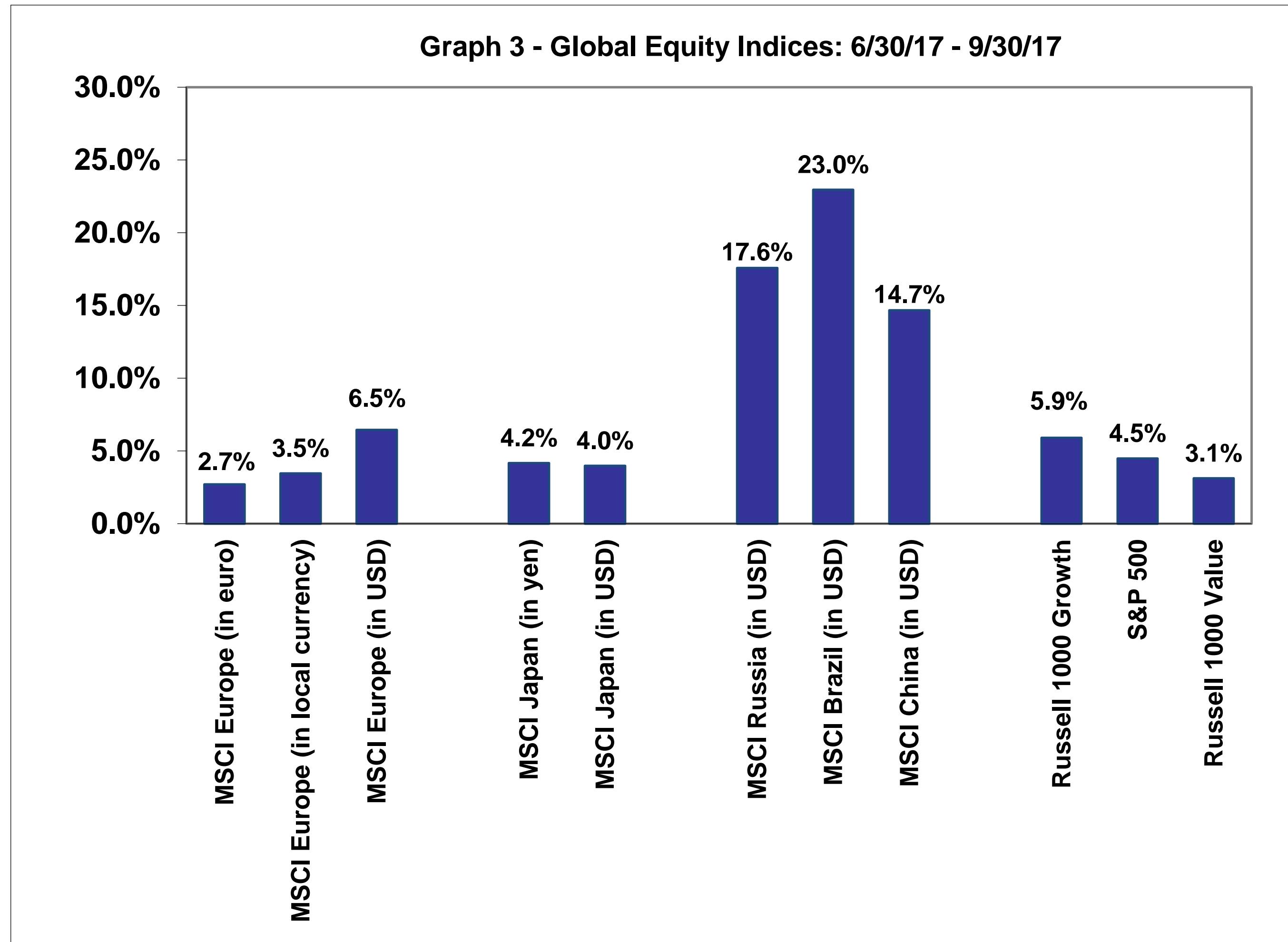
Market Developments – Third Quarter 2017



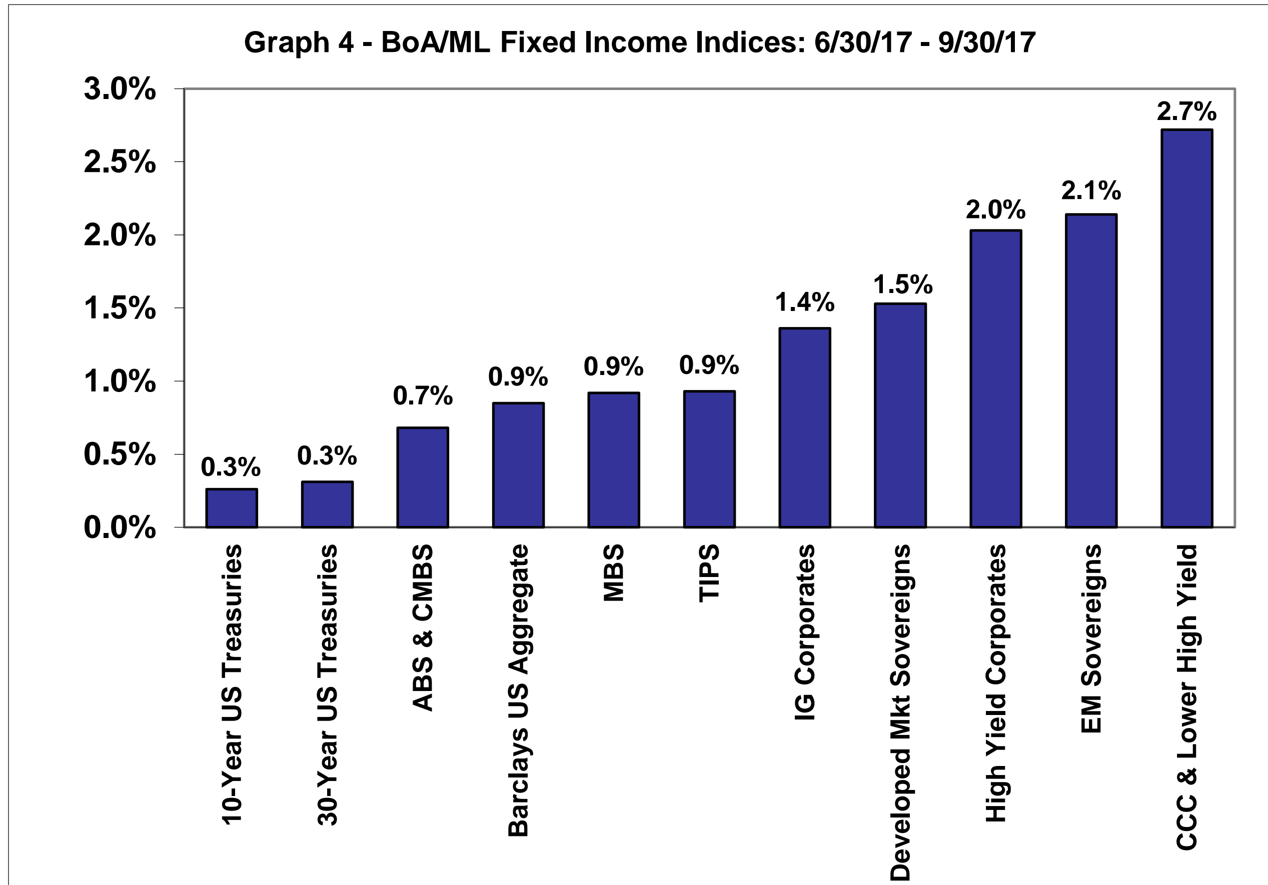
Market Developments – Third Quarter 2017



Market Developments – Third Quarter 2017



Market Developments – Third Quarter 2017



Market Scenarios

Market Scenarios

As shown on page 16, there are a number of possible scenarios, to which we have applied different probabilities:

- *Slow-Growth Recovery* continues to be our core scenario with a probability of 80%.
- *Economic Revitalization* and *Unexpected Inflation* are still "right tail" scenarios. Because actual policy measures under the Trump administration are uncertain, the range of possible outcomes under these scenarios is 5% to 20% for Economic Revitalization, and 5% to 15% for Unexpected Inflation.
- The "left tail" scenario, *Policy-Driven Decline*, has a wide range of possible outcomes—5% to 15%—again because actual policy measures under the Trump administration are uncertain.

Our overall view is that global economic growth, albeit modest, can be maintained, primarily due to the relative strength of the US economy and acceleration in Europe and continued strength in China. The US is still in a mid-cycle phase of slow but sustainable growth, rather than a late-stage phase in imminent danger of rolling over into recession. Europe and Japan have exhibited signs of cyclical improvement and better momentum, although further improvement remains uncertain. Trend-line growth in China is still much faster than in the major developed economies, despite a steady loss of momentum over the past several years. Longer term, though, the country's financial system is vulnerable due to ever increasing overleverage even as it struggles to restructure, transitioning from a focus on production to an emphasis on consumption and services. Given the government's commitment to stimulate, the risk of an imminent dislocation in China remains low, but it is an increasingly worrisome possibility.

- The *Slow-Growth Recovery* scenario implies upside potential for equities, but downward pressure on fixed income.
  - In the US, the Federal Reserve's policy has shifted decisively from providing excess liquidity to normalizing interest rates and reducing its balance sheet. The prospect of lower taxes, reduced regulation, and fiscal stimulus in the form of infrastructure spending has the potential to stimulate economic growth, which would also reinforce the trend towards higher interest rates. However, the range of possible outcomes is unusually wide given the lack of specificity of the proposals from the Trump administration, and the uncertainties about the ability of Congress to pass major legislation. While "pro-growth policies" are expected to be positive for corporate profitability, the impact could be very positive for some businesses and highly negative for others. Similarly, the effects of potential changes in trade policy will vary widely for different sectors and companies. Investors therefore will need to actively examine earnings potential industry by industry and company by company, rather than simply investing passively by allocating to "the market."
  - In Europe, equity markets have responded positively to signs of an improving economy, but they have largely discounted the implication that this will lead to less monetary stimulus, as well as a stronger euro (which would dampen exports). Although the immediate economic impact of Brexit is limited, given that it will entail a long, drawn out process of adjustment, it is likely to weigh on Europe longer term and impose a greater risk of inflation in the UK.

Market Scenarios

  - In Japan, equities have been driven by improved earnings, as well as more investor-friendly moves by company managements, but economic growth remains modest despite some signs of improvement.
  - Outcomes in emerging markets will vary widely depending on a country's sensitivity to trade with the US, reliance on external financing, and domestic economic development. Regarding China specifically, the economy is expected to maintain its current trajectory of stable growth and slow restructuring, although risks are continuing to build in the financial system.

- *Economic Revitalization* would involve a robust cycle of investment (capital expenditures, hiring, mergers and acquisitions) by the private sector. This would usher in a speculative "blow off" phase for equity markets in the US, given their lofty levels of valuation, especially if accelerating growth is short lived due to a reliance on unsustainable tax cuts or debt financing.

- A similar market environment would ensue in the *Unexpected Inflation* scenario, at least initially (barring a commodity price shock). However, the outlook for both equities and bonds would be less attractive depending on the pace of inflation and how central banks respond. Yield curves in the US, Europe, and Japan would steepen to the extent economic growth and/or ballooning central bank balance sheets lead to a pickup in inflation expectations.

- In the *Policy-Driven Decline* scenario, the two most significant risks involve the US and China:
  - China is a significant source of potential downside volatility both for equities, and not just in China and other emerging markets, but globally. In particular, China's financial system has been in the process of building potentially unsustainable levels of debt, while the economy has been steadily slowing, diminishing the ability to support debt levels. The risk of a serious dislocation would have extensive repercussions. The direct impact on global economic activity might turn out to be limited, but the effect on market psychology could be far greater, creating a negative wealth effect.
  - The other source of risk stems from potential policy steps by the Trump administration. In particular, it remains to be seen what form tax proposals take, whether they can be enacted, and whether they result in significantly larger federal deficits. The risk of a trade war is another uncertainty.

Market Scenarios

Global Scenario:	Policy-Driven Decline	Slow-Growth Recovery	Economic Revitalization	Unexpected Inflation
Current Probability:	10%-20%	80%	5%-20%	5%-15%
Previous Probability:	10%-20%	80%	5%-20%	5%-15%
Trends:	US: trade war triggers inflation and economic stagnation; deficits trigger funding crisis; bond yields rise, pressuring credit markets. Europe: ECB reversal of easing dampens economy, exacerbated by weakness in the banking system, "Brexit," a breakup of the EU and the refugee crisis. Japan: unsustainable government debt and structural demographic issues lead to recession. Emerging Markets: China experiences a hard landing or debt crisis, and is unable to adequately ameliorate the effects due to diminished reserves.	US: self-sustaining but modest recovery supported by corporate capex and hiring; relatively stable dollar; limited inflation; modest tax reform and fiscal stimulus. Europe: cyclical recovery maintains momentum; monetary policy stable; relatively stable euro; however, uncertainty due to "Brexit" and nationalistic politics creates drag. Japan: structural and demographic challenges dampen economic growth. Emerging Markets: China makes (slow) progress transitioning to a more consumption-driven economy; "Belt and Road Initiative" bolsters trade; modest levels of inflation; stable monetary policy; growth slower but positive. Countries such as India and Brazil remain on path of economic reform.	US: cyclical recovery gains momentum; less dependency on imported energy; corporate capex and hiring expand in response to tax reform and fiscal stimulus. Europe: continued QE and piecemeal fiscal/labor market reform lead to an acceleration of business activity. Japan: modest structural reforms occur; weak yen, monetary stimulus, and fiscal drag create economic crosscurrents. Emerging Markets: financial and structural reforms, and the rise of the consumer sector, especially in China, lead to improved pattern of growth.	US: aggressive fiscal policies give the economy a "sugar rush;" Fed policy becomes significantly tighter. Europe: effective fiscal unification and structural reforms spur the regional economy; the euro becomes more important as a reserve currency, attracting capital inflows. Japan: structural reforms occur; a weaker yen drives up the cost of imports, especially energy; QQE relieves the "Liquidity Trap" by stimulating consumption. Emerging Markets: China devalues the yuan to stimulate exports, causing import costs and wages to inflate; efforts to avoid a "hard landing" lead to excess stimulus and over-investment; environmental crises divert resources from manufacturing.
Primary Asset Allocation Implications:	*Govt. Bonds*: mixed *Major Equities*: unattractive *Emerging Markets*: unattractive	*Govt. Bonds*: negative *Major Equities*: attractive *Emerging Markets*: mixed	*Govt. Bonds*: negative *Major Equities*: attractive *Emerging Markets*: attractive	*Govt. Bonds*: unattractive *Major Equities*: neutral *Emerging Markets*: negative
Niche Opportunities:	Hedged Strategies Real Assets	Long/Short Equities	Commodities Venture Capital	Commodities Gold
Overall Return Expectations:	Very Low to Negative	Low to Moderate	"Normal" to High	Limited
Key Assumptions:	Absence of major geopolitical conflict, major climate change, widespread natural disaster or pandemic; continued globalization and encouragement of international trade.			
Significant Risks:	US change in policy triggers a trade war; aggressive tax reform leads to ballooning deficits; an economic correction or policy error, as well as political instability in China; protracted uncertainty from "Brexit"; refugee crisis in Europe; disintegration of the EU; a disorderly decline in the yuan, with an outbreak of "currency wars;" a geopolitical crisis involving Iran, Saudi Arabia, North Korea, Syria, or Russia; a spike in commodity prices or dislocation in the supply of industrial or agricultural commodities; rise of militarism in China and Japan, resulting in a confrontation over territorial disputes or access to sea lanes; major act of terrorism or cyberattacks.			

Tail Risks

A variety of potential geopolitical flash points continue to simmer:

Tail Risks – Regional

- North Korea
  - North Korea's continued effort to develop nuclear arms is an unpredictable and potentially destabilizing factor in Asia. Furthermore, an increasingly confrontational approach by the US towards Korea compounds the unpredictability of the situation.
- Middle East
  - Syria, Iraq, and ISIS remain a highly complex source of potential instability for the Middle East. The ongoing conflict in Yemen, pitting Saudi Arabia and Iran against each other, continues to be another indication of the growing instability of the region, as does the current political confrontation with Qatar. Turkey has become less cooperative with Europe and the US, further complicating the situation. There is a growing risk of armed conflict involving any number of the players in the region, but especially between the US and Iran.
- Russia
  - Ukraine has been the tip of a potential iceberg, namely a new "cold war" between Russia and the West. The shifting policy of the US towards Russia, as well as towards NATO, has added another layer of uncertainty to the situation.
- Europe
  - In Europe, the rise of nationalist/populist parties in Germany, Austria, France, and Italy could further undermine the cohesion of the European Union, as could separatist movements, especially in Spain.
- UK
  - In the UK, "Brexit" could lead to protracted negotiations and dislocations, which would dampen economic growth.
- Asia
  - With the rise of militarism in China and a potentially more confrontational policy in the US towards China's claims over the South China Sea, seemingly minor territorial disputes could escalate rapidly into armed conflict.
- US
  - Potential conflicts of interest and/or scandals involving President Trump, his family, advisors, and cabinet members could lead to a political or even constitutional crisis in the US.
  - Potential budget crisis and risk of default.

Tail Risks

Tail Risks – Global

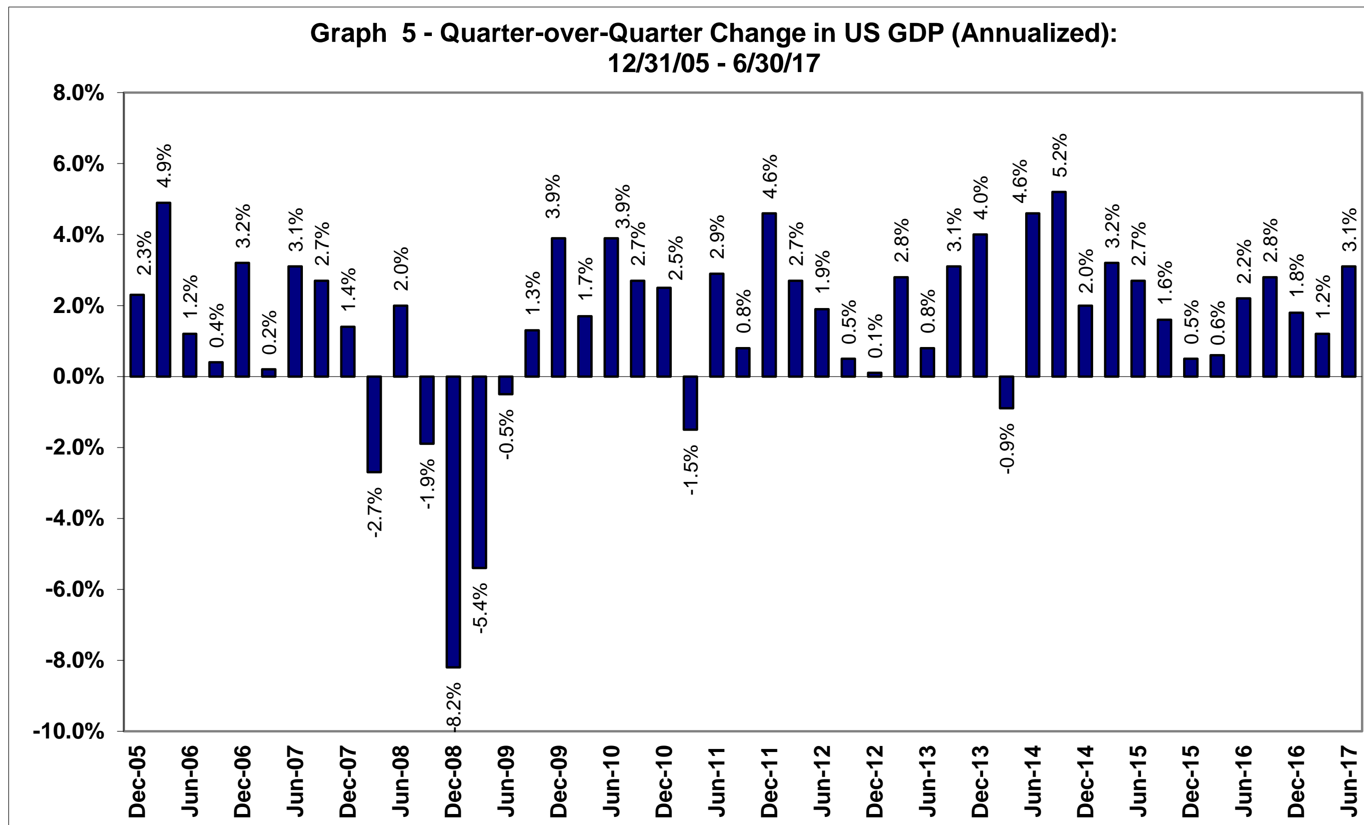
- Energy
  - Oil prices would face potentially wide swings, either as the result of supply disruptions stemming from political conflicts, or renewed overproduction, either by OPEC members unwilling to adhere to quotas or US producers seeking to increase market share.
- Cybersecurity
  - Increasingly worrisome is the potential for a crippling cybersecurity breach affecting a major financial institution, defense system, infrastructure network, or the internet.
- Terrorism
  - Major acts of terrorism could depress market sentiment and economic activity.
- Disease
  - Although Ebola has receded from the headlines, an outbreak of another potential pandemic, or fear of an outbreak (either of Ebola, Zika, or another disease), could have negative impacts on international travel and trade, not to mention a downward spiral for globally integrated economies.

Key Economic and Policy Trends

Key Economic and Policy Trends - US

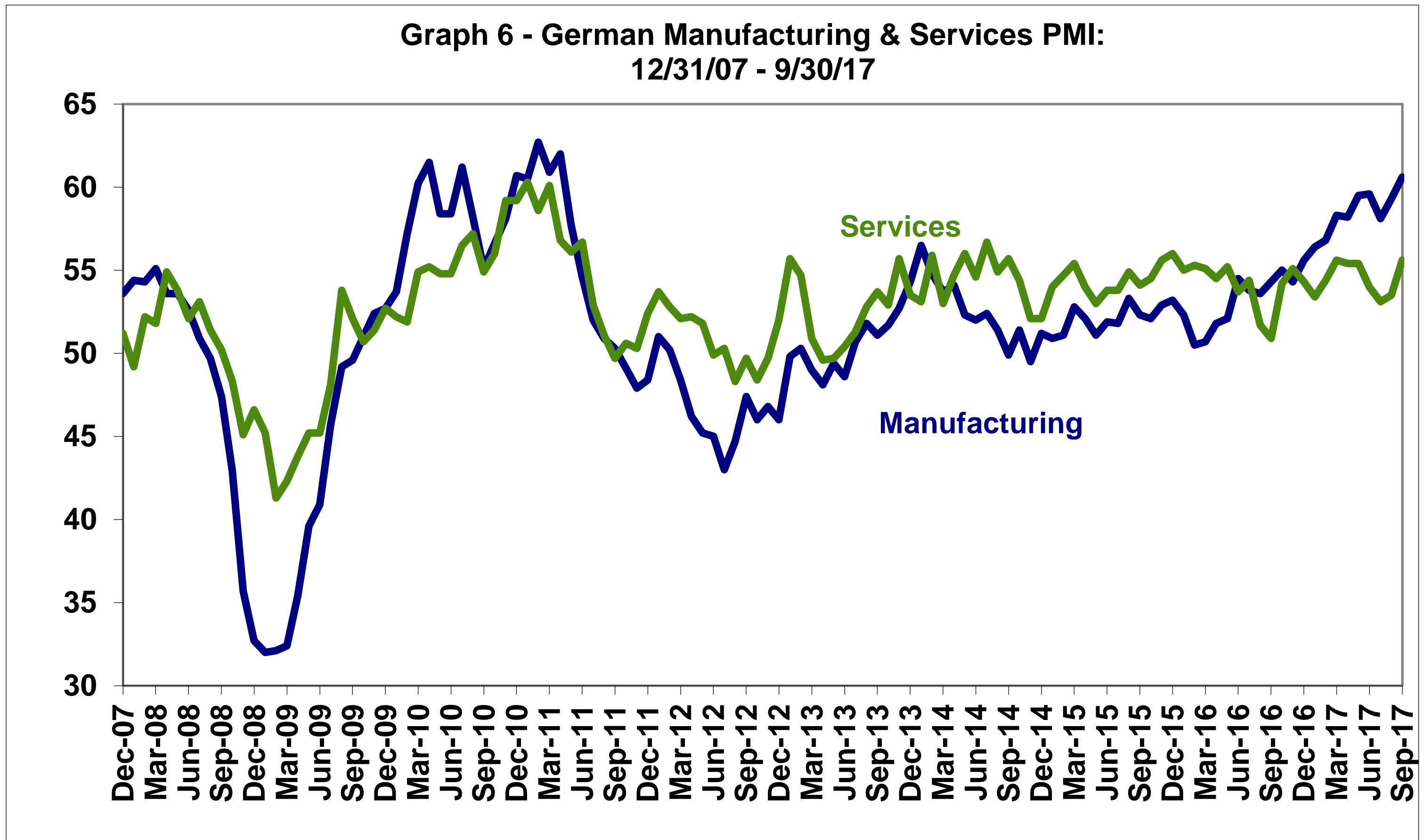
As shown in Graph 5, the pace of growth in US gross domestic product accelerated during the second quarter. The consumer accounted for the bulk of this figure.

The inflation picture remains somewhat uncertain and has become more so given that the effects of Hurricanes Harvey, Irma, and Maria will result in discontinuities in the economic data, even if only for a short time. As the Fed noted in its September 20 FOMC Statement, "…the Committee continues to expect that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, and labor market conditions will strengthen somewhat further. Higher prices for gasoline and some other items in the aftermath of the hurricanes will likely boost inflation temporarily; apart from that effect, inflation on a 12-month basis is expected to remain somewhat below 2 percent in the near term but to stabilize around the Committee's 2 percent objective over the medium term. Near-term risks to the economic outlook appear roughly balanced, but the Committee is monitoring inflation developments closely."



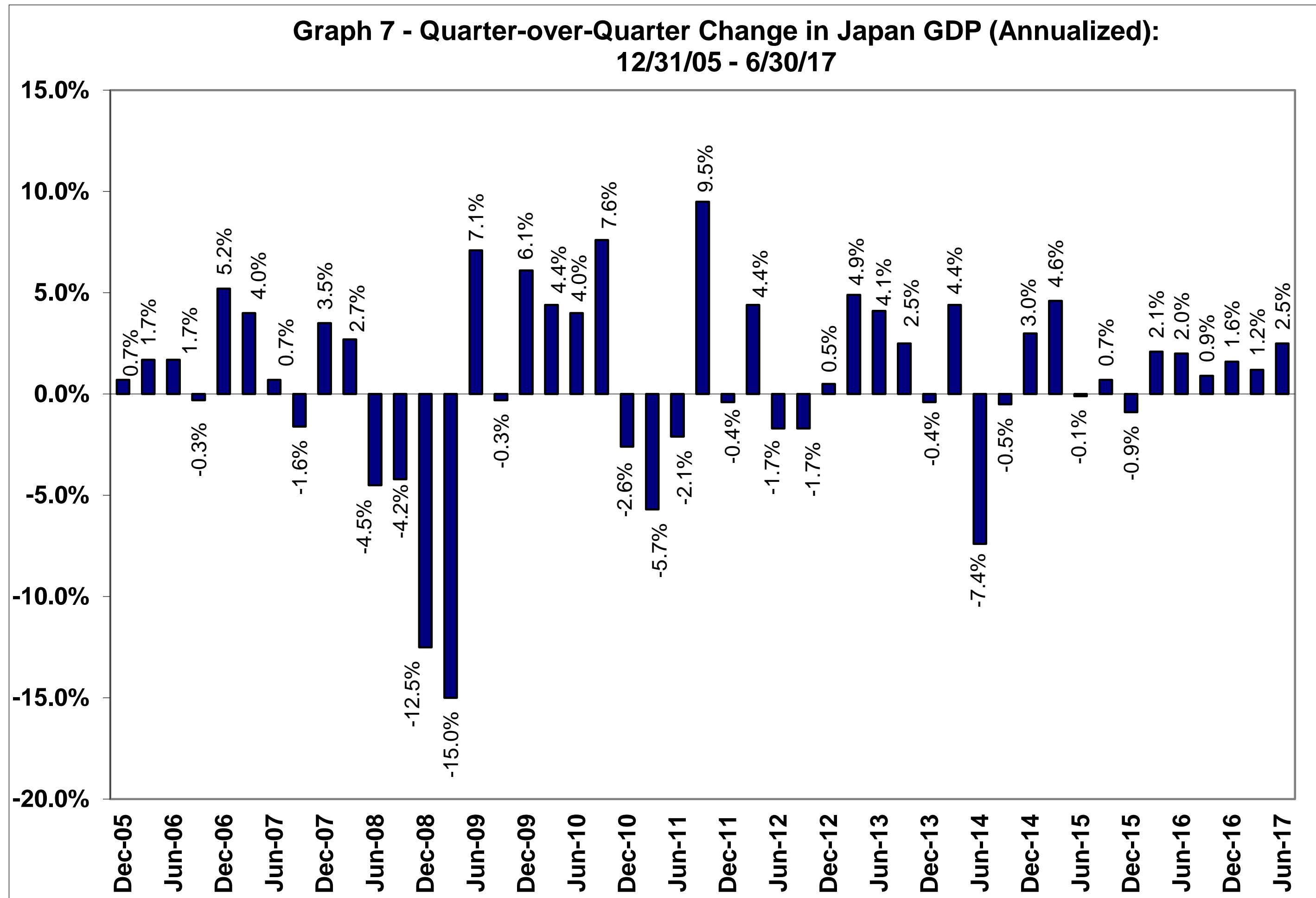
Key Economic and Policy Trends - Europe

In Europe, the economic recovery continues to exhibit not only positive but accelerating momentum. The closely watched Purchasing Managers Indexes for manufacturing and for services in Germany have trended higher since mid-2012 despite some interruptions (see Graph 6), reflecting the pickup in business sentiment. Inflation has trended higher, an encouraging sign from the perspective of the ECB. As the IMF noted in its World Economic Outlook (July 2017), "growth projections for 2017 have been revised up for many euro area countries, including France, Germany, Italy, and Spain, where growth for the first quarter of 2017 was generally above expectations. This, together with positive growth revisions for the last quarter of 2016 and high-frequency indicators for the second quarter of 2017, indicate stronger momentum in domestic demand than previously anticipated." The effects of Brexit and a potentially stronger euro are still uncertainties to be factored in.



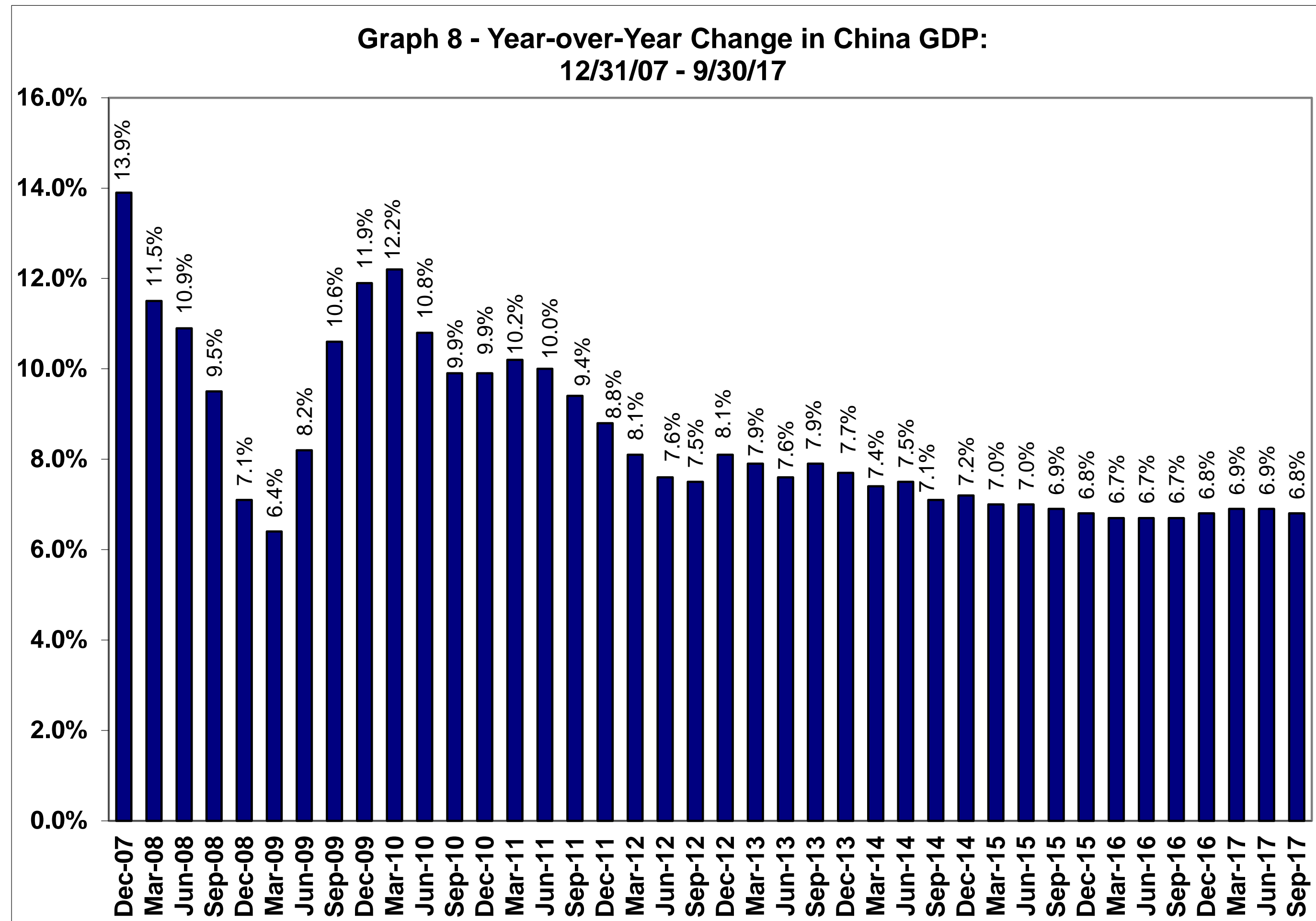
Key Economic and Policy Trends - Japan

In Japan, the economic picture has brightened, but the improvement in annualized growth rates for GDP over the last two years has been markedly uneven (see Graph 7). Notably, inflation increased to 0.7% in August (year over year), from 0.4% in each of the previous four months. Also, exports rose 18.1% in August (year over year). As noted by Trading Economics, " … [this] was the ninth straight month of increase in exports and fastest since November 2013 …"



Key Economic and Policy Trends - China

Although annualized growth rates in China have trended slowly lower since 2010, they have picked up a bit in recent quarters (see Graph 8). While the steadiness of the deceleration may have more to do with official management of the statistics rather than actual data, the direction of change has been clear. While it is clear that Xi Jinping has successfully consolidated his power over the Communist Party and the military, it remains to be seen what specific policy steps will be taken to more fully implement his sweeping vision for the country's future. Overall debt levels remain alarmingly high.



Investment Implications

Investment Implications - US Markets

US Equities – Neutral to Moderately Positive

Tailwinds	Headwinds
• General economic improvement, becoming more sustainable • Potential “pro-growth” policy changes and tax cuts/reform could bolster corporate profitability and capex • Corporate balance sheets relatively healthy, although debt levels are creeping higher • Expected rise in interest rates is measured enough not to threaten multiples • Continued M&A activity • Business and consumer confidence up • Wage growth and reflation contribute to pricing power • A recovery in oil prices would relieve some of the pressure on the energy industry • Investors more receptive to differentiating among stocks on the basis of fundamentals rather than momentum; favorable for value-oriented and long/short strategies	• Relatively “full employment” points towards wage inflation, which would be negative for corporate profitability, though positive for consumption • Rising interest rates increase cost of capital, erode corporate margins, dampen housing sector • Multiple expansion unlikely to serve as a driver for stock prices; unexpected inflation and accelerating rate increases would undermine multiples • Valuations are stretched relative to historical norms • Impact of tax, regulatory and fiscal policy highly uncertain • Bull market is getting old • A strengthening dollar (in reaction to higher rates) would be a positive for inflation, but a negative for corporations repatriating foreign earnings • Increasing concerns about the role of high-frequency trading and risk parity programs in potentially exacerbating downside market volatility • Impact of tax, regulatory and fiscal policy highly uncertain • Impact of trade policy highly uncertain

Investment Implications for US Markets (continued)

US Government Fixed Income – Neutral to Negative

Tailwinds	Headwinds
• Yields on longer-term issues are supported by demand for duration • Dollar strength would be supportive	• Interest rates face upward pressure from Fed tightening and balance sheet reduction • Treasury yield curve likely to flatten • Unexpected inflation and accelerating rate increase would undermine pricing • Reduction of Treasury holdings by central banks, particularly China • Growing concerns about the liquidity of the Treasury market; lack of dealer capacity to support volumes • Impact of tax, regulatory and fiscal policy highly uncertain

US Credit Markets – Neutral to Negative

Tailwinds	Headwinds
• Relatively higher yields for corporates (high yield and investment grade) remain supportive • Defaults generally still low	• Spread tightening less likely given the stage of the economic cycle and potential for higher rates • Refinancing for weaker credits becomes more difficult as cost of capital increases • Prevalence of “covenant lite” issuance • Lingering concerns about the liquidity of the high yield market • Unexpected inflation and accelerating rate increase would undermine pricing

Investment Implications for European Markets

European Equities – Neutral

Tailwinds	Headwinds
• Excess liquidity via accommodative monetary policy • Relatively benign inflation outlook • Valuations generally reasonable relative to historical averages • Negative interest rates support risk assets • European companies tend to have high operating leverage; would benefit from continued acceleration in the regional economy • Greek debt crisis has receded	• Pace of economic recovery improving but still slow • Uncertainty over “Brexit” • Political uncertainty • Immigration/refugee crisis may cause persistent fiscal, economic, political, and social strains, directly and indirectly • Valuations not cheap • Exporters exposed to stronger euro • Uncertainty over changes in US trade policy

European Sovereign Fixed Income – Neutral

Tailwinds	Headwinds
• Continued quantitative easing would be supportive • Relatively benign inflation outlook	• Historically low yields • Potential for ECB to scale back policy • Weaker euro would be inflationary • Immigration/refugee crisis may cause persistent fiscal, economic, political, and social strains, directly and indirectly • Greek debt crisis has receded from the headlines but could re-emerge

Investment Implications for Japanese Markets

Japanese Equities – Neutral

Tailwinds	Headwinds
• Excess liquidity via accommodative monetary policy • Benign inflation outlook • Valuations generally reasonable relative to historical averages • Renewed yen weakness would help support export sector • Slowly strengthening trend of greater attentiveness by corporate managements to the needs of shareholders (includes increased dividends, share buybacks, restructuring, etc.) • Asset allocation shift by major institutions from fixed income to equities	• Slow pace of economic recovery • Slow pace of "third arrow" economic reforms • Fiscal and monetary measures less effective than expected • Uncertainty over changes in US trade policy

Japanese Government Bonds – Neutral to Modestly Negative

Tailwinds	Headwinds
• Increased quantitative easing would be supportive • Benign inflation outlook	• Historically low yields • Weaker yen would be inflationary • Long-term structural challenges (high debt burden; aging population)

Investment Implications for Emerging Markets

Chinese Equities – Neutral

Tailwinds	Headwinds
• Monetary policy biased towards accommodation • Ample policy tools and central bank reserves to address economic issues • Government taking steps to restructure local government debt, rein in excesses in credit markets • Continued growth in consumer-related and service sectors	• Pace of economic growth in doubt • Challenge of shifting from an investment-intensive economy to a more consumption-oriented economy • Currency reserves have declined due to PBoC's previous efforts to defend the currency • Continued increase in leverage throughout the financial system • Concern over rising levels of non-performing loans in the banking sector • Health of residential and commercial real estate sectors unclear • Long-term challenge of dealing with environmental degradation

Other Major Emerging Markets – Highly Mixed

Tailwinds	Headwinds
• India: benefiting from economic reform • Russia: would benefit from rising oil prices	• Mexico: benefits from linkages with the US would be undermined by hostile US trade policy • Russia: exposure to oil sector, and sanctions over Ukraine • In general, a number of emerging markets face pressures associated with reliance on exports • Stronger US dollar would have negative impact on ability to service debt • Risk of "currency war" in reaction to yuan devaluation • Uncertainty over changes in US trade policy