University of Dayton
Hanley Sustainability Fund

2H 2017 Econ Outlook

U.S. Outlook

The S&P 500 has continued its gains from 2016 up roughly 11% YTD. While much of 2016's gains were supported by excitement about President Trump in office, 2017 has seen strong equity performance from a supportive economic backdrop; including strong growth, healthy labor markets and consumers, and earnings growth. A strong economic backdrop comes with risk such as valuation premiums, the Federal Reserve and plans of unwinding a $4.5 trillion balance sheet, and currency risks.

Q2 GDP was recently revised to 3% annualized growth from its original 2.7% observation, the highest since Q2 2015. This strong economic growth was fueled by consumer spending (motor vehicles, cellphones, housing and utilities) and strong business investment. Along with consumer spending, we have observed robust manufacturing data, with Manufacturing PMI remaining in expansion territory at 52.8 for August. Third quarter estimates have been released at rates as high as a 3.4% increase and we also expect manufacturing data to remain supportive of a strong labor market. We believe that a strong consumer base and a weakening dollar will continue to boost or economic climate.

While inflation remains low in the U.S. we are confident that we will see a pick-up in domestic prices given growth and healthy labor markets. With unemployment currently at 4.4% (below the Fed's normal rate), we believe this will eventually begin to pressure wage growth, which grew 2.95% annualized for May (down from February's 4.25%). Although wage growth has been relatively flat, we remain confident in consumer spending given University of Michigan's Consumer Sentiment for August at 96.8 and U.S. Retail sales at 4.2% for July. We ultimately remain confident in U.S. consumers and believe they will be a key economic driver for 2H 2017 and into 2018.

For Q2 2017, 73% of the S&P 500 companies have reported positive EPS and 70% have reported positive sales (with 99.6% of the companies in the S&P 500 reporting actual results for Q2, 2017). Blended earnings growth rate is 12.1% with the energy sector leading the way at 533% growth. Such high earnings in the sector are a result of oil being at its lowest in November 2016 ($44.46), which led to unusually low earnings in the year-ago quarter. On a dollar-level basis, the Energy sector reported $8.2 billion in the 2017 Q2, compared to $1.9 billion in Q2 of 2016. If this sector was excluded from the earnings report, the blended earnings growth rate would fall nearly 2.5%. Blended revenue growth rate for Q2 was 5.1%. Technology and Financials also both outperformed earnings season, with YoY earnings growth of 16.7% and 12.1%, respectively.

Another U.S. equity catalyst we see is a potential tax cut. Identical to his campaign run, Trump has called for a complete tax overhaul to boost economic growth on September 5th. How the team of tax negotiators plan to accomplish this goal remains unclear. Trump has begun his tax sales pitch in Missouri, targeting certain Congress leaders as reelection season comes closer. Trump plans to slash corporate taxes to a proposed 15%, which could potentially cost $2 trillion over 10 years unless he can pass legislation that would offset these cuts. Other than eliminating state and local deductions, the tax negotiating team has provided very little detail as to how they would offset corporate tax cuts. If legislation passes, tax experts have noted that high-income individuals will undoubtedly benefit, while impact on the middle class remains less clear. Supporters of the Trump Administration expect additional details aside from the dozen released by the White House in April. We believe this could drastically benefit U.S. domestic stocks by improving margin expansion and EPS growth; as well as large global companies, especially the technology and Healthcare sectors, who will benefit from repatriation tax cuts and will be able to consolidate cash on to a common balance sheet.

Things we remain watchful about are President Trump's proposed Healthcare bill, The Federal Reserve's $4.5 trillion balance sheet, and the relative state of the Dollar. A coalition of Democratic Organizations has formed to criticize Trump and Republicans for trying to repeal one of Obama's most controversial legislations, the Affordable Care Act. This formation was in response to Republican's failure to repeal Obama Care in July, a pledge Republican's have made since 2010. One group within the coalition aims to spend $1 million in digital ads aimed to criticize Trump's "sabotage" of the Act. Trump has taken shots at GOP leaders, such as Senate Majority Leader Mitch McConnell, blaming him for Republican's inability to pass any healthcare legislation, only making matters worse as he received backlash for pointing fingers instead of shouldering some of the responsibility. As of now, any legislation that potentially passes, will have little effect on healthcare's future; regardless, we have little expectations in the healthcare bill passing soon.

The Federal Reserve remains in a dynamic stage with potential to increase rate hikes in December and unwinding their balance sheet which we believe could end our bull market if handled incorrectly. The Federal Reserve's upcoming decisions could also have huge impacts on the U.S. Dollar. The Dollar, which appreciated greatly following Trump's election, has begun to fall in recent weeks. Amid criticism on Trump and Republican Party's ability to pass legislation the euro went above $1.20 last week, the first time since 2015 and marks a 15% EUR/USD appreciation YTD. Depending on the Fed's upcoming meeting on September 8th, the dollar could remain weak if they turn more dovish about the prospect of another rate hike. Although this drastic and quick Euro appreciation against the Dollar, we believe it was mostly justified given the Euro's 2016 2H fall given Brexit's negative effect on the Euro and the Dollar's appreciation on the back of Trump's proposals and a hawkish Fed. Ultimately, we believe the Dollar still has room to fall against the Euro regardless of its recent activity (will be touched on more in EMEA's outlook) and will continue to benefit U.S. equity's bottom-line.

While the S&P 500 is trading at roughly 22 times earnings, above the 20-year average of ~18x, we remain optimistic and overweight U.S. equities. We believe that these valuations are justified given U.S. macro tailwinds of GDP growth, healthy labor markets, corporate earnings, and a potential tax reform and outweigh the threats of the Federal Reserve's upcoming decision regarding their balance-sheet and monetary policy, a healthcare reform, currency fluctuations.

EMEA Outlook

Euro equities have outperformed the MSCI All Country World Index YTD with the Stoxx 50 up roughly 20%. Most of these gains were seen Q1 of 2017 where equities benefitted from a weak Euro and a strong macro backdrop of healthy labor markets, strong manufacturing data, a supportive central bank, and fading political uncertainty. While we still see a supportive backdrop much like Q1, the corrected Euro, which is up 15% against the Dollar YTD to 1.20 (a two year high), has been a headwind for companies bottom-line, ultimately keeping the Stoxx 50 flat since May.

Euro Area growth has been a tailwind for Euro stocks in H1 2017 with Q1 and Q2 GDP of 2.2% and 2.3% annualized, respectively. We expect this growth to continue given Macron's win in France and his fiscal reformation within the country, Germany's contribution of healthy labor markets, and strong manufacturing data across the EU with manufacturing PMI well above the expansion level at 57.4.

Euro area unemployment has reached all-time lows since the recession with July's unemployment rate at 9.1%, down from 11.6% in three years. Jobless rate has been falling in developed countries, such as Germany whose rate is only 3.7%. While we have seen healthy unemployment rates, we have yet to see the economy's full employment put pressure on wage growth with only 1.4% for August. Although wage growth has remained unimpressive, we believe that we will see growth in the back half of 2017 given declining jobless rates, GDP growth, and strong manufacturing sector.

Although Euro equities have recently faced headwinds with rapid Euro appreciation vs the Dollar, Euro stocks have seen extensive earnings growth for Q2 so far with estimates at roughly 12%. Although earnings have been positive for H1, we remain tentative in the back half of the year as we expect the Euro to keep appreciating vs the Dollar. Although we are cautious on Euro stocks, we believe that certain sectors, such as financials and utilities will outperform the Stoxx 50 given the strong currency.

The Euro is up roughly 15% YTD against the Dollar and has been a headwind for equities and their relatively strong economic backdrop in Q2. The Euro struggled in 2016 given mass amounts of political uncertainty with Brexit and the French election along with excitement around U.S. policy reform. When uncertainty faded in Europe and President Trump's reform drama was muted, the Euro was left in a position to correct. Although it's strong performance and the EUR/USD recent breach of 1.20, we believe it still has upside potential given the ECB's potential QE taper at the end of 2017, a strengthening economy, fading political risk, and the U.S. Congress' inability to pass meaningful legislation.

Although we see a relatively strong backdrop, we are cautious on the outcome of the German Election and the ECB's decision to taper its current monetary policy. The German election is only a couple of weeks away with Chancellor Angela Merkel defending her position against Martin Schulz. Polls currently show Merkel's party, the Christian Democratic Union (CDU), along with its sister party, the Christian Social Union (CSU), will end up being the largest party in the Bundestag election of Sept 24, but still falling short of a majority. This sort of thing is common in Germany, so attention goes to the smaller parties and possible coalitions. There is so much speculation as to who will join with who, but for now the CSU and SPD are the two largest. Here is a list of what they stand for:

- Christian Democrats (CDU): The leading party in Germany, headed by Angela Merkel. The centre-right group - made up of the Christian Democratic Party (CDU) and the

Bavarian Christian Social Union (CSU) - they have employment, tax cuts and ongoing public investment at the forefront of their manifesto.

- Social Democrats (SPD): Led by Martin Schulz, the centre-left are vying to make another Grand Coalition to remain in government. The party polled well following the election of their new leader, but then suffered once again in regional polls. The SPD is a traditionally working class party, pledging investment in education and infrastructure, funded by higher taxes for the rich.
- Left (Linke): Led by Sahra Wagenknecht and loosely descended from the East German communists. This small party, often used as a protest vote, is campaigning for a rise in national minimum wage, a rejection of military missions abroad and the dissolution of NATO.
- Green (Grüne): Led by co-chairs Katrin Göring-Eckardt and Cem Özdemir, this party could be the coalition kingmakers. They rely on educated, urban citizens, focusing on the environment, taxes and social policies.
- Free Democratic Party (FDP): Led by Christian Lindner, the party was Merkel's junior coalition party in her second term. It failed to reach five per cent of the vote to allow another coalition in 2013. The party campaigns for tax cuts and to remain in financial markets - particularly within the EU.
- Alternative for Germany (AfD): A right-wing populist party lead by Alice Weidel and Alexander Gauland. The party's hardline anti-EU, anti-immigration views have attracted voters from almost all of the other parties, especially among lower income households.

The eurozone economy is getting stronger, the deflation threat has disappeared along with political risk, corporate earnings are growing and optimism has taken hold in households and among businesses. There is a problem; the euro EURUSD is +0.0252% and it's almost 15% rally this year to a more than two-year high against the dollar. "The stronger euro has made the ECB's taper tiptoeing even more complicated. While a clear hint on tapering at this week's meeting could send the euro even higher, potentially undermining the recovery, room to postpone tapering is limited due to bond scarcity," Carsten Brzeski, chief economist at ING, said in a note. Since ECB President Mario Draghi said in July that policy makers would discuss QE's future "in the autumn," analysts have speculated an announcement would come at the September policy meeting because it coincides with the new ECB staff forecasts. The current program of buying €60 billion euros worth of bonds a month is slated to run until the end of the year, but the ECB has kept the door open for an extension. Few people expect the central bank to end the bond buying program altogether at the end of the year, but the question is how long it'll be extended for and when the tapering will begin. Looking at the state of the economy, not a single member state produced negative economic growth last quarter, and traditional laggards such as Italy, France and Greece appear to be on a more stable recovery path. Additionally, while inflation is not as high as the ECB would like it to be, consumer prices are rising significantly faster than in recent years. The ECB's annual inflation target stands near but just below 2%. A 10% appreciation by the euro versus the dollar could take 30bps off the inflation rate over the next six quarters, according to Société

Générale. Given the current economic climate of the Euro Area, we believe that the ECB will announce its taper by the end of 2017, and will be finished with its monthly asset purchase within a year.

The Eurozone is fundamentally in the right place with a strong macro backdrop and equities at fair valuations, but we remain underweight Euro equities given the state of the ECB and our view on the EUR/USD. We believe that the ECB tapering is much more prominent and offers more downside potential than the Fed and the EUR will continue to appreciate given a strong economy. Although we do see potential growth in the Euro, we believe the threats are too much for the strengths and opportunities in Euro equities.

APAC Outlook

Asia Pacific remains a dynamic region with China's growing consumer base and its dependent commodity market as well as Japan's lagging economic data (but recent GDP breakout) and monetary footing. Although each nation has specific offering, we remain wary on Asian equities.

China reported their GDP numbers of 6.9% in both June and July in 2017. Regardless of long term slowdown, China is still on track to meeting the estimate of 6.5% growth rate for 2017. Part of the slowdown in growth can be attributed to the exports and imports which can be seen in the June and July data. Imports grew from 1.8% to 13.3% YoY while exports have steadily grown from -3.8% to 5.5% YoY. This data of declining exports and increasing imports shows, for what we believe, a new era in China of growing domestic demand and slowing production and exports.

In concurrence to this trend of decreasing trade of manufactured goods, Industrial production fell below estimates at 6.7%. Industrial production has typically been strong suit of the Chinese economy but these signs are indicative of shift in the Chinese economy becoming a service based economy (chart below shows PMI for both over time). Inflation was below the estimates of the Central bank giving the consumers and producers more purchasing power as the economy makes a shift into more service based industries. This is one of the reasons why early service companies like Alibaba have seen success in China as consumers have more to spend on services they typically wouldn't have sought out.

China has been dealing with overcapacity issues, especially in heavy metals and coal for a while now, and are claiming to be reducing capacity through supply-side reform. Yet, we have continued to see that their capacity isn't being reduced. Aluminum supply is up 15% since the end of 2015, and crude steel output increased by 11% in June and July from the same period in 2015. There are many reports discussing the closure of factories and plants, but these plants are just being replaced with new ones, or increased output from existing firms: thus, the overcapacity issue continues.

What has made this whole situation confusing is the fact that prices of many commodities have been rising rapidly. The reason for this uptick is that financial firms have increased the allocation of commodities in their WMP's. This not only increases prices but also makes inefficient firms boost their production. Additionally, the financial firm's actions have encouraged even more speculation.

Over the summer, China saw a massive increase in speculative buying of commodities. Rebar futures reached a four-year high and iron ore is up 30% from a June low. Since December 2015, futures-traded prices of iron ore are up 97%, and steel rebar are up 149%. Yet, economic growth has been slowing this year, and in the real estate market sales have been on a small decline. People in the industry expect home price growth in China to stay on a mild slowing trend for the next year. Currently, this trend is most noticeable in major population centers. From June to July, prices in Beijing fell 0.4%, the first fall since February 2015, while Shanghai prices fell by 0.2%.

While the real estate market slows, we expect to see increased infrastructure spending from the government to drive growth .While this offers potential growth for the real estate market, excessive spending in this area could point back to their overcapacity issues and add to China's credit situation and large amounts of domestic debt. Also, rising prices don't indicate tighter supply; they're the result of huge financial inflows into commodity trading. China needs to reduce capacity, eliminate debt and try to increase their efficiency, but only seem to be shutting down old plants while new ones boost production. Looking forward, its likely prices are near their peak, but it's important to remember how volatile Chinese commodities are simply because of the large number of daily trades taking place. These price changes have a growing impact on global commodity prices.

Consumer Confidence and PMI have been strengthening in the last months in Japan with higher production volume and employment in the manufacturing sector. Consumer confidence has come in at 43.8 in August improving on 43.3 in July while Q2 GDP was reported at 4% annualized, the highest among its G7 peers. Along with this domestic and international demand has been up in the past months. Manufacturing in Japan has seemed to turn around in the last few months but it will take longer to see if it will affect their monetary policy in the next few months.

Tensions are rising between the rest of the world and North Korea due to continued ICBM testing by the state. A recent Hydrogen bomb was tested underground in the province and showed the capability of the North Korean program. Any kind of conflict escalation in this area will cause mass selling off of currency if and might see further threats to Japan economically and militarily. The Yen has also been trending up despite the fact due to the manufacturing weakness and talks of bringing back government bond purchasing programs, trading higher against currencies such as the USD and the Pound. Along with this, in the last month Japan has padded its foreign exchange reserves by about 8 billion for the second month in a row showing it may be hedging against fluctuation.

We remain cautious on APAC equities as they face near-term headwinds such a commodity glut, high debt burden, and increasing imports for China as well as relatively flat data and geopolitical tensions for Japan.