


Douglas Coté, CFA
Chief Market Strategist

Karyn Cavanaugh, CFA
Senior Market Strategist

Executive Summary

- The economy is quietly enjoying a "stealth" economic boom driven by pro-business tax cuts
- Small business optimism on a "stratospheric trajectory" resulting in robust expansion plans
- Trade tariff retaliation, rising inflation and a rising U.S. dollar spike global market volatility
- Strength amidst uncertainty argues for broad global diversification

2018 Mid-Year Outlook: Confident Economy, Cautious Markets

Strong economic news punctuated the first half of the year, yet markets remained mired in struggle. Main Street has been celebrating as the economy has quietly amassed record highs in U.S. wealth, employment and spending. On the other hand, Wall Street is shuddering from the fireworks of rising rates, retaliatory trade tariffs and surging oil prices, which are intensifying volatility. In our midyear outlook, we address this tug of war between the economy and markets.

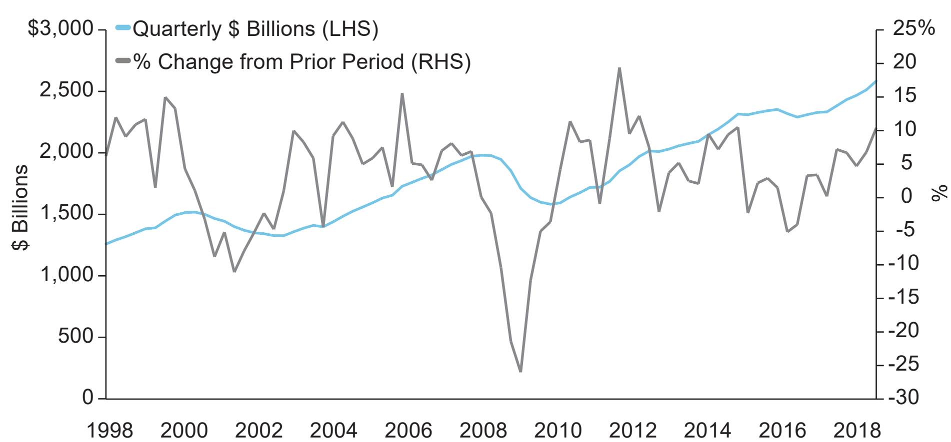
Stealth Economic Boom

In politics, there is an adage that says, "It's the economy stupid." It's summer, business is good, the Fourth of July fireworks are lighting up the sky and Main Street is enjoying a "stealth" economic boom. How can this be with so many domestic and international threats? Yet as the word "stealth" implies, this boom eludes us — why? Is it because the constant flurry of statistics is not demonstrative of a boom? No, not at all. The data are in plain sight, setting new all-time highs. The GDP forecast by the Atlanta Federal Reserve estimates that second quarter 2018 will register 4.5% growth. Our own view concurs with this. Who knew? Most likely, the positive economic deluge has been too fast and furious, while investors have been focusing their attention on the daily deluge of market volatility and negative headlines.

Certainly, consumers are strong and have been for a while. But it is now clear that businesses are spending at a rate not seen in a decade on good old fashioned capital expenditures (capex). Following four quarters of robust growth, the first quarter of 2018 was a hearty endorsement of this trend when non-residential investment or capex rose to 10%. Record levels of corporate profits have prompted dividends and buybacks but have done little to combat aging capital stock and the resulting below-trend productivity gains. Workers need tools to increase their efficiency and output. A surge in capex is not surprising given the pro-business tax cuts and deregulation.

Figure 1. Capex Expenditures Have Begun to Accelerate

U.S. Gross Private Fixed Nonresidential Investment, SAAR



Source: FactSet, BEA. Data as of 03/30/18

Is the resurgence of capex a cyclical or secular trend? Cyclical would mean a relatively short-term boost that would peter out, whereas secular would mean self-sustaining long-term propulsion. Here are the reasons why we see this cyclical capex change turning into a secular trend:

- Corporate tax rate slashed to 21% or by 40%
- Cash repatriation of $2 trillion in cash held overseas, bringing back $217 billion in Q1 alone
- Capex retooling expected to boost productivity in Q2 to nearly 2%

Juanita Duggan, president and CEO of the National Federation of Independent Businesses (NFIB), recently said, "Main Street optimism is on a stratospheric trajectory thanks to recent tax cuts and regulatory changes. For years, owners have continuously signaled that when taxes and regulations ease, earnings and employee compensation increase." [1] In May, the NFIB's Small Business Optimism Index set several records:

- Expansion plans are the most robust in survey history
- Positive earnings trends reached a survey high at a net 3%
- Positive sales trends are at the highest level since 1995

One cannot overemphasize the importance of small businesses: companies employing fewer than 50 workers account for 41% of all private nonfarm payroll jobs in the United States (source: BLS). This surge of business spending leads to a robust manufacturing sector, which accounts for more than one-third of capital expenditures. Manufacturing also has the highest economic growth multiplier effect of any sector — each dollar of sales in manufacturing supports $1.33 of output in other sectors. (Source: BEA).

- The June U.S. ISM Manufacturing index posted its second highest reading in 14 years at 60.2
- A blowout June Dallas Fed Manufacturing report was near a 12-year high at 36.5
- The U.S factory sector recovered in 2017, driven by a mining sector rebound

[1] Source: "Small Business Optimism Index Soars, Continuing Historic Run, Hitting Several Records in May," NFIB press release, June 12, 2018.

Tariff Retaliation and Rising Crude Oil Prices

Global trade is a requirement of economic growth. Period. Therefore, it is indeed concerning to see continued trade tensions and tariff threats. Uncertainty slows the economy as businesses put plans for investment and expansion on hold. In light of this, heightened market volatility is par for the course. Despite all of the trade war rhetoric, however, world volumes of imports and exports rose in April, the U.S. trade deficit shrank in May and bilateral trade between China and the U.S. is up on a year-over-year basis. A bright spot for exports is in liquefied natural gas (LNG). U.S. LNG exports could account for 45% of the global growth in energy supply by 2019, boosting economic growth, lowering the trade deficit and inducing additional energy capex.

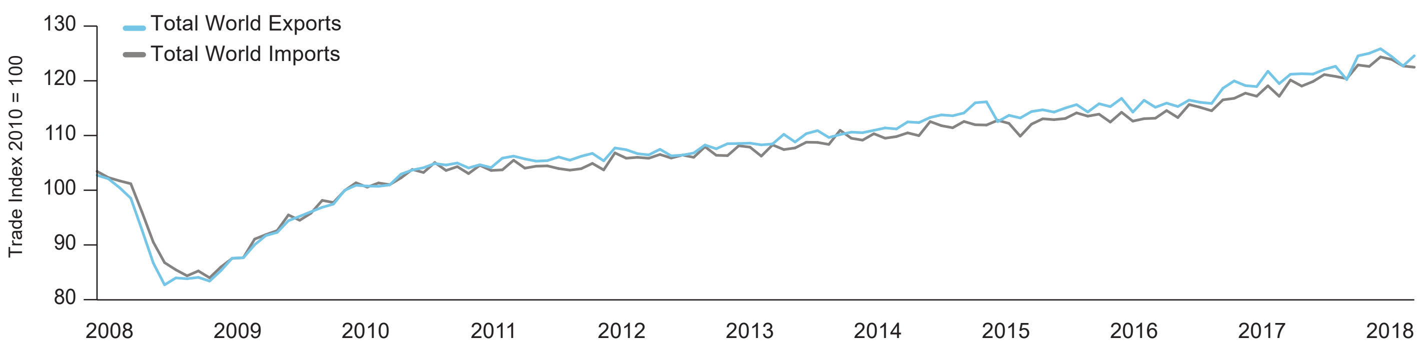
- The U.S. is projected to be the third largest LNG exporter after Australia and Qatar by 2020 (source: EIA)
- Louisiana's Sabine Pass LNG export terminal has enabled exports to quadruple in 2017 to 25 countries with four additional export terminals scheduled over the next few years
- The Interstate Natural Gas Association of America (INGAA) expects new oil and gas capex to total $791 billion from 2018 through 2035

Higher crude oil prices are actually good for the economy because they lead to higher capex and thus economic growth. Recall in early 2016 when oil prices collapsed to $26 per barrel. Today at $74 per barrel, the price of oil not only is leading to enormous capex growth, it is also a sign of increasing global demand. Certainly, supply disruptions from Iran and Venezuela, along with OPEC and non-OPEC cartel-induced restrictions, have an impact on price, but crude oil looks cheap compared to $140 per barrel in 2008.

The Fed and Rising Rates

A paramount concern among investors is the Federal Reserve (Fed) raising interest rates. In June the Fed raised the Fed funds rate to 2%, a level deemed unlikely not too long ago. Isn't this bad news? Absolutely not: rising rates are a sign of economic growth, something at which the Fed achieved only limited success with its unorthodox stimulus measures (QE1, QE2, QE3). Only when the

Figure 2. Global Trade Volumes Continue to Rise



Source: FactSet. Data as of 03/30/18. **Past performance is no guarantee of future results.**

Figure 3. S&P 500 Earnings Growth

Sector	Earnings Growth Percent
Energy	96.5
Materials	44.1
Information Technology	33.9
Financials	26.8
Industrials	23.0
Telecommunication Services	18.7
Utilities	17.9
Consumer Discretionary	15.5
Health Care	14.4
Consumer Staples	10.7
Real Estate	8.1
S&P 500	**24.8**

Source: FactSet. Note: Earnings growth is the percentage change in earnings per share compared to one year ago. Earnings surprise percent is the share-weighted average of the ratio of actual company earnings vs. the consensus estimates. **Past performance is no guarantee of future results.** Indices are unmanaged and not available for direct investment.

government enacted significant fiscal stimulus — through tax cuts and deregulation — did businesses have incentives to invest in a massive way.

Inflation moved up at it fastest pace in six months in May and core PCE, the Fed's preferred measure of inflation, has finally hit its target of 2%. After many years of falling short of this target, the Fed has said it is comfortable letting inflation run hot for a while. Stronger inflation has done little to move long-term rates higher. Higher inflation could favor Fed action and accelerated rate hikes on the short end of the yield curve, though this is unlikely. Inflation for now is still not a pressing issue.

On the other hand, the European Central Bank (ECB) is still firmly accommodative, as is the Bank of Japan. The ECB in particular has seemingly failed to recognize the cues from U.S. policy: it takes pro-business fiscal and regulatory policy to grow the economy on a sustainable course. Monetary stimulus is only a temporary sugar high. If Europe does not aggressively enact labor and business reform, it will lose its hard won gains.

Q2 Market Review

The second quarter was marked by lower geopolitical tension, better than expected economic data, first quarter reported earnings growth of 25%, revenue growth of 8.4% and improved expectations for continued +20% profit growth for the remainder of the year. Countering these undeniably solid market fundamentals were concerns about trade, and to a lesser extent, the stronger U.S. dollar and a flatter yield curve. Nevertheless, the fundamentals prevailed and the S&P 500 was up 3.4% in Q2.

Q2 Winners:

- Small cap stocks, better insulated from trade concerns and riding a wave of optimism from tax cuts and deregulation, were up 8.8%
- Global real estate investment trusts (REITs) up 5.5% on interest rates that defied consensus and actually went down rather than up when trade tensions mounted
- High yield bonds gained 1% on low defaults, lower issuance and global demand for yield

Q2 Losers

- Emerging markets (EM) plummeted -7.9% as a rising U.S. dollar and higher U.S. rates induced outflows from emerging economies. Still, EM fundamentals remain strong on rising commodity prices and global growth
- Global bonds were down 2.8% on a stronger U.S. dollar, which rose 5% in the quarter

Figure 4. Strategic Diversification

Index	Weight	June 2018	QTD	YTD	3 years	5 years	10 years	15 years	20 years
Equity									
S&P 500	10%	0.6	3.4	2.6	11.9	13.4	10.2	9.3	6.5
S&P Midcap	10%	0.4	4.3	3.5	10.9	12.7	10.8	11.4	10.3
S&P Smallcap	10%	1.1	8.8	9.4	13.8	14.6	12.2	12.0	9.9
Global REITs	10%	1.6	5.5	0.9	6.7	6.9	5.7	9.6	8.8
EAFE	10%	-1.2	-1.0	-2.4	5.4	6.9	3.3	7.7	5.8
Emerging Mkts	10%	-4.1	-7.9	-6.5	6.0	5.4	2.6	11.1	8.2
Average		-0.3	2.2	1.3	9.1	10.0	7.5	10.2	8.2
Fixed Income									
Corporate	10%	-0.6	-1.0	-3.3	3.1	3.5	5.4	4.6	5.4
U.S. Treasury 20+	10%	0.2	0.4	-3.0	3.6	4.8	6.2	5.7	6.5
Global Aggregate	10%	-0.4	-2.8	-1.5	2.6	1.5	2.6	3.7	4.3
High Yield	10%	0.4	1.0	0.2	5.5	5.5	8.2	7.8	6.5
Average		-0.1	-0.6	-1.9	3.7	3.8	5.6	5.5	5.7
Overall Average		-0.2	1.1	0.0	7.0	7.5	6.7	8.3	7.2

Source: FactSet, FTSE NAREIT, Voya Investment Management. Market indexes represent the ten asset classes: S&P 500, S&P 400 Midcap, S&P 600 Smallcap, MSCI U.S. REIT Index/FTSE EPRA REIT Index, MSCI EAFE Index, MSCI BRIC Index, Bloomberg Barclays U.S. Corporate Bonds, Bloomberg Barclays U.S. Treasury Bonds, Bloomberg Barclays Global Aggregate Bonds and Bloomberg Barclays U.S. High Yield Bonds. **Past performance is no guarantee of future results.** One cannot invest in an index.

The Economy and Markets

The economy and markets do harmonize over time but they certainly are not now, and the current disharmony probably explains why it feels like a "stealth economic boom." A potential trade war seems disruptive but is far better than real warfare, which seems distant at this time. One could see rising rates and surging crude oil prices as dampening growth, but they also are indicators of economic strength. The most important thing to keep in mind is that fundamentals drive markets. From this perspective we have the makings of one of the best economic backdrops in 30 years. Investors should pay close attention to the good economic news and would do well to "stick to the plan" of broad global diversification.

Figure 5. Forecast Update

Forecast Data	Update	Midyear Reasoning
S&P 500 Price	Affirmed at $2900	Earnings up, valuation down on rising rates
S&P 500 Earnings	Raised to $160	Valuation gets more compelling on stronger earnings
WTI Crude Oil	Raised to $70	Global demand increase on economic growth and supply disruptions
World GDP	Affirmed at 4%	Still driven by the Big Three: Europe, China, U.S.
U.S. GDP	Affirmed at 3%	Upside prospects on surging capex
FX Euro/U.S. Dollar	Affirmed at 1.12	U.S. economic strength and rising Fed funds rates continue
10 Year U.S. Treasury Yield	Raised to 3%	Persistently high U.S. economic growth
Gold	Affirmed at $999	Overused as a hedge with no yield and high carry costs

Source: Voya Investment Management

Diversification does not guarantee a profit or ensure against loss

This commentary has been prepared by Voya Investment Management for informational purposes. Nothing contained herein should be construed as (i) an offer to sell or solicitation of an offer to buy any security or (ii) a recommendation as to the advisability of investing in, purchasing or selling any security. Any opinions expressed herein reflect our judgment and are subject to change. Certain of the statements contained herein are statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Actual results, performance or events may differ materially from those in such statements due to, without limitation, (1) general economic conditions, (2) performance of financial markets, (3) interest rate levels, (4) increasing levels of loan defaults (5) changes in laws and regulations and (6) changes in the policies of governments and/or regulatory authorities.

The opinions, views and information expressed in this commentary regarding holdings are subject to change without notice. The information provided regarding holdings is not a recommendation to buy or sell any security. Fund holdings are fluid and are subject to daily change based on market conditions and other factors.

Past performance is no guarantee of future results.

BBGP-COMMENTARY_2Q18 • 070918 • IM0702-43255-0719 • **163081**