Market Outlook | 4Q17

Voya Global Perspectives

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Executive Summary

- These "Teflon" markets have been perpetually repelling bad news of all stripes
- Market resilience is further bolstered by strong fundamentals worldwide
- Pro-business tax cuts are the elixir that may shift this market into high gear
- Central banks may be unintentionally blocking progress on reflation
- Prudent diversification protects against upside and downside risk

The Teflon Markets, Growth and Reflation

Nothing — nothing bad, that is — has been able to stick to these Teflon markets, which have demonstrated an astounding, maybe even confounding, resilience. In the face of North Korean missiles flying over Japan, a U.S. administration under investigation and unable to pass any legislation, the third largest eurozone economy grappling poorly with its exit plans and the Federal Reserve determined to raise interest rates with or without evidence of inflation; global markets shrugged it all off, enthusiastically reaching all-time highs. On balance, third quarter performance was simply awesome:

- The Dow Jones Industrial Average had its eighth consecutive positive quarter, the first time in 20 years
- The S&P 500 and Russell 2000 indexes both hit record highs
- The MSCI Emerging Markets and MSCI EAFE indexes are enjoying their best year out of the last seven

How have investors reacted? With fear and trepidation worthy of Friday the 13th horror flicks, a date that coincidently is upon us in October. Markets are going up, yet retail investors are bailing out, which is baffling. The bears betting against the market declare "markets are expensive" and "overbought." It certainly seems counterintuitive to declare this market "overbought" while net equity flows remain negative and inflows into defensive bonds persist. Instead, we believe the bull market everyone seems to hate is unlikely to expire anytime soon.

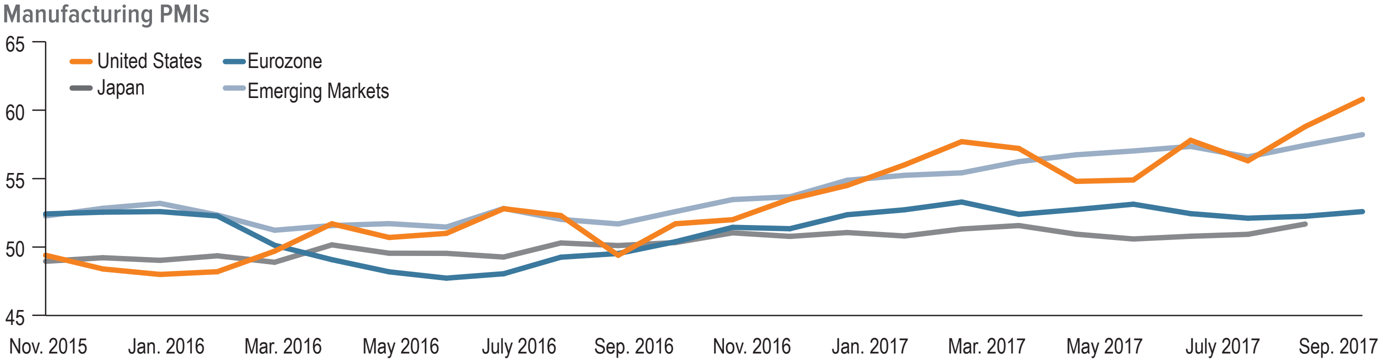
Resilience Driven by Fundamentals

Does it get any better than this? Growth is marching forward — not only in the United States but around the world — and the outlook for reflation, if not the actual data, has been sparked. Growth and reflation moving together is not only a positive economic condition, it is a requirement. Judging by the strong reaction of U.S. Treasury yields, the impetus for growth was the mere mention of tax cuts. In our view, tax cuts are the most meaningful pro-growth policy that unequivocally spurs economic growth and reflation. Here are the indications that growth is being propelled forward and that reflation may be right around the corner:

- All 45 of the OECD developed economies have positive second quarter growth
- Japan's Q2 annualized growth was the fastest growing economy in the G7 at 4.0%
- Eurozone GDP recorded its strongest YoY growth since 2011 in Q2 at 2.2%
- U.S. manufacturing PMI surged to 60.8, the second strongest reading in 30 years
- U.S. Q2 GDP growth was revised up to 3.1% annualized
- U.S. Treasury yields bounced off a declining trend for the global reserve currency

A little more insight from the spectacular rebound of U.S. factory orders potentially implies a 5.5% annual increase in GDP. There are risks of course, and corrections do occur on a regular basis, but the breadth and magnitude of this synchronous global economic expansion are extraordinary.

Figure 1. U.S. Manufacturing has Rebounded; Global Reports also Indicate Expansion.



Source: Institute of Supply Management, FactSet. Data as of 09/29/17.

Central Banks Gracefully Bowing Out

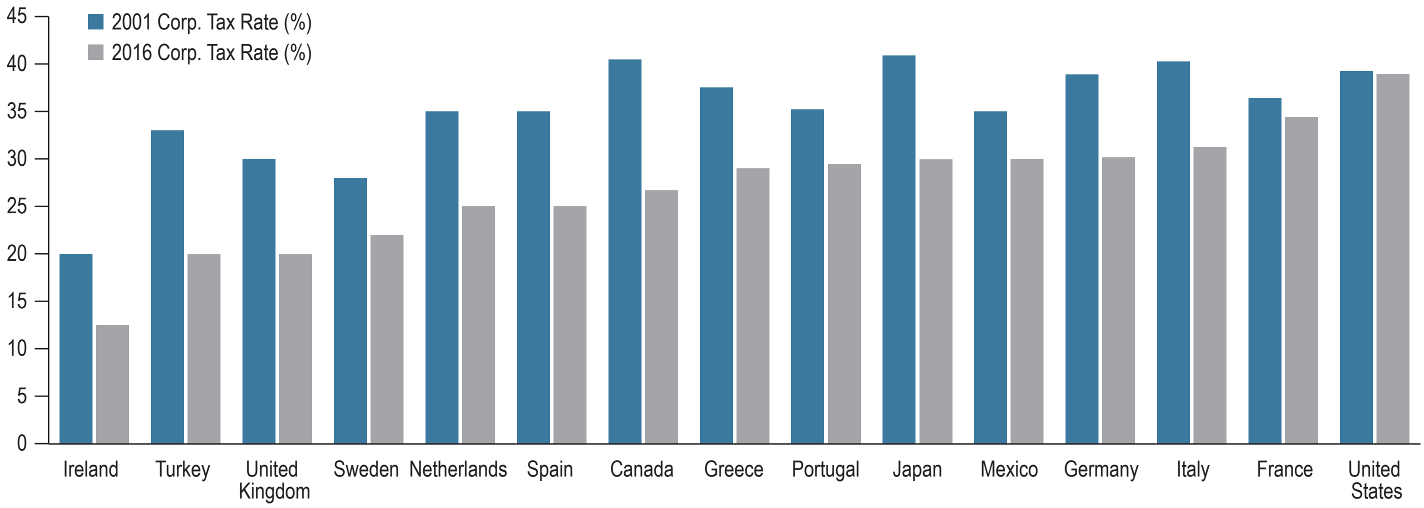
Reflation, aka good inflation, is a trickier issue. Are the central banks the answer to reflation or are they the problem? It seems clear that Fed Chair Janet Yellen believes the latter with her determination to begin shrinking the Fed's $4 trillion balance sheet and to raise rates without the backup of hard data. Other world central banks see the same writing on the wall and will slowly and carefully remove their unconventional and extraordinary monetary stimulus. There is no conundrum: reflation is staying artificially low because the central banks are enablers of these "emergency" measures and are crowding out the growth policies they purport to endorse. Once they get out of the way free market capitalism will flourish, bringing interest rates and economic growth back to "normal" after a decade's hiatus.

That is why tax cuts and other pro-growth economic policies are so important to implement. Tax cuts have a dual impact: first on the supply side, where they benefit business with lower costs; second on the demand side, where they benefit consumers with more discretionary money to spend. It is the only way economic growth and reflation will normalize to higher, historical levels. Our view is that tax cuts are likely to happen before the end of 2017. It may be hard to fathom in this partisan environment, but sending less money to the government is – "surprise, surprise" – extremely popular with voters. The positive potential impact of a massive tax cut, on this market that is already regularly hitting new highs, is impossible to gauge. It's what statisticians call "upside risk," what we consider the risk to investors of missing all the fun of a bull market.

Q317 Market Review

A broad swath of global markets set new record highs or rebounded sharply. In the U.S., third quarter performance was spurred by a spectacular turnaround in the energy sector. Although the beleaguered energy sector is still negative for the year, energy was up double digits in the last month and 6.0% for the quarter. Technology was the overall leader, up 8.3% in a broader market that returned 4.5%. As we approach the Q3 earnings season, look for the same one-two punch. In addition, financials are the most likely upside surprise as yields embrace reflation.

Figure 2. The U.S. Corporate Tax Rate Remains the Highest among Developed Nations



Source: OECD.stat. Graph shows combined central and sub-central government tax rates.

- U.S. equities are being driven by two consecutive quarters of double-digit earnings growth that is expected to continue
- U.S. small caps surged 6.0% in Q3 and look even more attractive now that tax reform is back on the table
- Overseas markets continued their power march with emerging markets adding an 8% return in Q3 while international (EAFE) added 5.5% in the quarter, putting both above 20% year-to-date
- Bonds, including corporates, Treasurys, high yield and global, were also positive across the board despite a more hawkish but slow moving Federal Reserve
- The U.S. dollar's decline in Q3 further bolstered an important contribution from foreign currency to globally diversified, unhedged investors
- Industrial metals such as copper, aluminum and steel rose during the quarter — all indicators of global growth

It is rare indeed that by the end of September all equity and fixed income asset classes show positive returns for both the quarter and the year. Bearish investors sitting this one out are missing significant opportunities.

Conclusion

Many investors who were burned badly by the bear market a decade ago are anchored to the fear that it could happen again. It certainly could for a host of reasons. In our view, current risks are decidedly to the upside, which we believe this Teflon market will continue to demonstrate. The probability is greater than zero that the U.S. gets a comprehensive tax cut sometime in the near future. For hesitant investors, we think the way to capitalize on this is to engage in broad global diversification, across continents, stocks and bonds. The pro-business economic backdrop further enforces the resilience of these markets.

Figure 3. Reported Second Quarter Earnings Growth for S&P 500 Companies is 10.3%.

Sector	Earnings Growth Percent
Energy	329.9%
Information Technology	15.2%
Utilities	10.8%
Financials	10.3%
Materials	8.0%
Real Estate	7.5%
Health Care	6.7%
Industrials	6.4%
Telecommunication Services	4.8%
Consumer Staples	3.9%
Consumer Discretionary	0.0%
S&P 500	**10.3%**

Source: FactSet. Earnings growth is the percentage change in the cumulative share-weighted EPS earnings from that of a year ago.

Figure 4. 2017 Returns Positive across Bonds, Stocks and Foreign Currencies

Index	Sept 2017	3Q17	YTD 2017
Equity			
S&P 500	2.1	4.5	14.2
S&P Midcap	3.9	3.2	9.4
S&P Smallcap	7.7	6.0	8.9
Global REITs	-0.2	1.8	7.3
EAFE	2.5	5.5	20.5
Emerging Mkts	-0.4	8.0	28.1
Average	2.6	4.8	14.7
Fixed Income			
Corporate	-0.2	1.3	5.2
U.S. Treasury 20+	-2.2	0.6	6.3
Global Aggregate	-0.9	1.8	6.3
High Yield	0.9	2.0	7.0
Average	-0.6	1.4	6.2
Overall Average	**1.3**	**3.5**	**11.3**

Source: FactSet, FTSE NAREIT, Voya Investment Management. Asset classes represented by 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, Bloomberg Barclays U.S. High Yield Bonds. **Past performance is no guarantee of future results.**

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