Voya Global Perspectives

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Executive Summary

- The "growth and reflation" trade continues intact due to the positive trajectory of the global economy and the hawkish inflection point in global central bank policy
- Corporate earnings on track to reach all-time high in 2017, while 2Q17 earnings season kicks off in July with strong expectations
- Consumers remain the game changer, benefiting from record high personal wealth, rising wages and employment gains
- 2017 markets have been "two steps forward and one step back," a path that rewards those fully invested or those who opportunistically "buy the dips."

Figure 1. Voya Global Perspectives Forecast Update

2017 Forecast	Original	Midyear Update
S&P 500 Price	2400	**2475**
S&P 500 Earnings per Share	133	133
Crude Oil (NYM)	58	**50**
Euro/U.S. Dollar	1.05	1.05
Gold (NYM)	999	999
U.S. Ten-Year Treasury Yield	3.00%	**2.60%**
U.S. Unemployment Rate	4.50%	**4.00%**
U.S. GDP Growth	2.50%	2.50%
Eurozone GDP Growth	1.75%	1.75%
Japan GDP Growth	1.00%	1.00%
Global GDP Growth	3.50%	3.50%

Source: Voya Investment Management

2017 Midyear Update: The Growth and Reflation Trade

It has been quite a year in the global financial markets and the political landscape:

The Bad News

- Divergence became convergence as central banks around the world (ECB, BOE) signaled intentions for Federal Reserve-like monetary policy tightening
- Reflation — a signal of economic growth — stalled as inflation measures waned, delaying expectations for resurgent global growth
- Commodities initially surged and then fell, and oil in particular donned the mantle of a bear market
- The political backdrop in the United States turned negative with obsessive fears of Russia election tampering and failure to enact healthcare legislation or tax cuts

The Good News

- Corporate earnings growth soared double digits in the first quarter. We believe earnings will surpass expectations and achieve an all-time record high in 2017
- Both U.S. "hard" and "soft" economic data continue to march forward, including manufacturing, housing, consumer and business confidence
- Consumers remain the game changer, benefiting from record high personal wealth, rising wages and employment gains
- Slowing inflation expectations bolster asset and market prices

Fundamentals Are Driving Markets

Corporate earnings growth — a leading fundamental indicator — continues to impress, providing the clearest signal that the global economy is on the rise, albeit at a measured pace. Amid the global march forward, Europe and Britain are currently the most interesting exemplars of sustained global growth.

- Europe is truly on a roll — the recent May composite PMI report showed economic activity rose to the best level in six years, and Markit's eurozone manufacturing measure hit a 73-month high
- Germany's 2016 growth rate was its fastest in five years, reaching record high levels in the first quarter of 2017. Ifo, the country's most prominent business conditions index, hit an all-time record high in June and its industrial production surged in May
- France's economic growth smashed expectations in the first quarter: consumer spending was the best since 2004; business investment the best in five years, and manufacturing the best in more than a decade. Meanwhile, French President Emmanuel Macron's pro-growth economic proposals included lowering the corporate income tax to 25% from 33%
- Despite lingering Brexit uncertainty, Britain powered forward, overtaking France as the second largest economy in Europe, trailing only the Germans, on strong GDP, manufacturing and consumer spending

Figure 2. The UK Has Surpassed France as the Second Largest European Economy

Countries		GDP		Trade (% of GDP)	Demographics		
Developed Markets	USD (billions)	Per Capita	1-Yr Change	Exports	Population (millions)	Unemployment	Median Age
U.S.	19027	14.7	2.0%	7.6%	327	4.3%	37
Germany	3384	10.7	1.8%	39.5%	82	3.9%	45
Canada	1596	10.8	2.0%	24.5%	36	6.6%	41
U.K.	2464	9.8	1.9%	16.5%	63	4.9%	40
Eurozone	11589	9.0	1.8%	19.5%	339	9.3%	
Japan	4732	9.6	1.6%	13.6%	127	3.1%	45
Ireland	302	16.4	6.6%	42.9%	5	6.4%	35
France	2406	9.3	1.2%	20.8%	65	9.8%	40
Emerging Markets							
Brazil	2029	2.4	-2.5%	9.1%	204	12.0%	29
Russia	1370	2.7	42.3%	20.9%	146	5.2%	39
India	2480	0.5	7.0%	10.7%	1311	5.0%	26
China	11201	2.1	6.8%	19.1%	1375	4.1%	36
Mexico	1025	2.2	2.3%	36.5%	127	3.5%	27

Source: FactSet. Data are most recent available

Outlook for Growth and Reflation Trade Still Positive

There has been much ado about the “growth and reflation” trade, aka “Trump Rally” being over. In our view this is nonsense; rosy expectations have instead been replaced by clear-eyed pragmatism. The current rally continues intact due to a positive change in the trajectory of the global economy.

Meanwhile, markets have been correctly discounting or pricing in that increasing regulation and raising taxes are a thing of the past. It is not a matter of “if” but “when” tax cuts are instituted. This not only will be positive for corporations but for small business and consumers as well. It also will be positive for markets as discussed in the market review below.

There are more positives. The U.S. dollar would have surprised investors if it remained stable, but even better, it actually weakened despite multiple U.S. Federal Reserve rate increases. This certainly bolsters expectations on exports but also has contributed to blockbuster ISM manufacturing and services readings in June, which were both above a robust 57 level.

Q2 and First Half Market Review

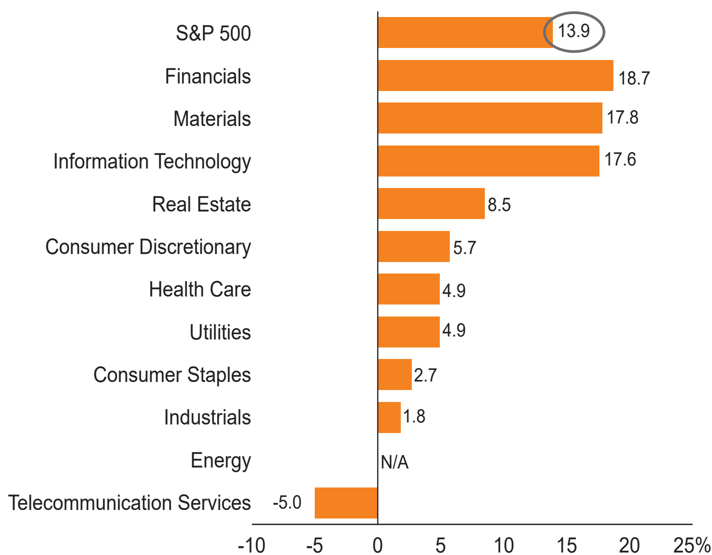
U.S. markets were “Yankee Doodle Dandy” but it was the markets overseas that delivered the fireworks in the quarter and the first half of the year. Emerging markets piled on 6.4% in Q2 bringing the first half returns to 18.6% along with, not far behind, EAFE stocks, also up 6.4% for the quarter and 14.2% in the first half.

Interest sensitive global REITS came from behind and rivaled domestic equities, returning 3.0% in the second quarter as interest rates continued to defy expectations by ticking downward. Despite the action overseas, U.S. large cap stocks were up a downright patriotic 3.1% in Q2 to bring the first half returns to 9.3%. Small caps and midcaps also were positive but investors are keeping their distance, not firing until they see the whites of the eyes of those anticipated Trump pro-growth policies needed to justify the initial steep run-up in these asset classes.

Global equity markets have had a star spangled year, with average returns of 3.8% in Q2 and 9.4% in the first half (Figure 4).

Drilling down into the U.S. sectors, the S&P 500 index’s information technology sector continues to dominate U.S. equities, bringing its first half gains above 16%. The reason for this gain is simply that technology earnings have grown faster than other sectors. The healthcare sector’s returns are not far behind. A positive earnings outlook and muted proposed cost modifications in the proposed Obamacare replacement are helping to drive these stocks higher. Financials lagged despite strong double-digit earnings growth, but began to pick up toward quarter-end as the outlook for rates moved higher with central bankers’ more hawkish tone. Expected strong earnings growth and an ultimately upward path in yields bodes well for financials’ continued advance. Unlike tech-heavy U.S. indexes, European indexes are heavily weighted toward financials, so expect continued outperformance in EAFE.

Figure 3. First Quarter 2017 Earnings Growth for S&P 500 Companies is the Highest Since 2011



Data as of June 30, 2017, all S&P 500 companies reported.
Source: FactSet, Voya Investment Management

The bounty of gains extended to fixed income too. Sluggish first quarter GDP of 1.4%, an absence of inflation and lack of a definitive policy change calendar are making bond investors skeptical. Even the Fed's June hike of short term rates has not been able to convince long rate investors that the economy is in danger of running too hot. As a result of lower rates, long U.S. Treasurys were of course the biggest beneficiary, up 4.2% in Q2, but investment grade corporate, high yield and yes, even global bonds were all "in the green." Global bond markets are up more than 4.5% for the year. Will rates likely go higher? Yes, but the low growth U.S. GDP scenario needs to be liberated with a revolution of fiscal policy change. Monetary policy has run its course. What's more, this broad based swath of good performance reinforces the case for global diversification as a means of building wealth while mitigating risk.

Demystifying Diversification

The "safe" trade is not always the "smart" trade. Many investors seek safety in "herd" behavior, what we call the "consensus." But markets can often confound the consensus, making the maximum number of investors look silly at the same time. In our view, the trade that has confounded the most investors since 2008 has been "rates are rising, don't buy long bonds." This year was no exception as long bonds continued their bull run in the first half. Meanwhile cash, the seemingly safe place to hide from all risk, continues to post negative real returns.

When will investors learn? When markets are in trouble, long bonds are a lot more like Indianapolis race cars than Model-T Fords. Really? Yes, really. If you want a reliable defense when equities are getting hammered, you are often better served by 20-year plus U.S. Treasurys than expensive and opaque hedge funds (Figure 4). They may not be exciting and at times may even post negative returns but their negative correlation to equities means they tend to go up when equities go down. Allocation to long bonds is vital if you fear the next equity market correction — we had one last January and we will certainly have another.

Figure 4. Demystifying Diversification: U.S. Treasury 20+ the Indianapolis Race Car Hedge for a Portfolio

Index	Q2 2017	YTD 2017	2016	2015	2014	2013	2012	2011	2010	2009	2008
Equity											
S&P 500	3.1	9.3	12.0	1.4	14.9	32.4	16.0	2.1	15.1	26.5	-37.0
S&P Midcap	2.0	6.0	20.7	-2.2	10.3	33.5	17.9	-1.7	26.6	37.4	-36.2
S&P Smallcap	1.7	2.8	26.6	-2.0	5.5	41.3	16.3	1.0	26.3	25.6	-31.1
Global REITs	3.0	5.4	5.0	0.1	16.5	4.4	28.7	-5.8	20.4	38.3	-47.7
EAFE	6.4	14.2	1.5	-0.4	-4.0	23.3	17.9	-11.7	8.2	32.5	-43.1
Emerging Mkts	6.4	18.6	11.6	-14.6	-2.4	-2.3	18.6	-18.2	19.2	79.0	-53.2
Average	3.8	9.4	12.9	-3.0	6.8	22.1	19.2	-5.7	19.3	39.9	-41.4
Fixed Income											
Corporate	2.5	3.8	6.1	-0.7	6.7	-1.5	9.8	8.1	9.0	18.7	-4.9
U.S. Treasury 20+	4.2	5.7	1.4	-1.6	25.1	-13.9	3.4	33.8	9.4	-21.4	33.7
Global Aggregate	2.6	4.4	2.1	-3.2	0.2	-2.6	4.3	5.6	5.5	6.9	4.8
High Yield	2.2	4.9	17.1	-4.5	2.3	7.4	15.8	5.0	15.1	58.2	-26.2
Average	2.9	4.7	6.7	-2.5	8.6	-2.6	8.3	13.2	9.8	15.6	1.9
Overall Average	3.4	7.5	10.4	-2.8	7.5	12.2	14.9	1.8	15.5	30.2	-24.1

Source: FactSet, FTSE NAREIT, Voya Investment Management, The overall average model allocation includes 10 asset classes, equally weighted: 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. Returns are annualized for periods longer than one year. Past performance is no guarantee of future results.

Global Market Outlook and Forecast Update

We are making the following changes to our 2017 forecast to reflect the developments in the first half:

- Increasing S&P 500 price to $2475 to reflect strength in earnings
- Maintaining our above-consensus S&P 500 earnings of $133
- Decreasing 10 Year U.S. Treasury yield to 2.60%
- Decreasing crude oil to $50 per barrel
- Decreasing unemployment to 4.0%

These changes reflect our constructive view that the economy and markets will continue to march forward, albeit in a fitful way with "two steps forward and one step back." Of course, hesitant investors will continue to focus on the one step back instead of the resilience of the two steps forward. As the market continues to advance in this manner, investors will be well served not only to get invested but also to "buy the dips."

Diversification does not guarantee a profit or ensure against loss

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