Foresters Financial Midyear outlook

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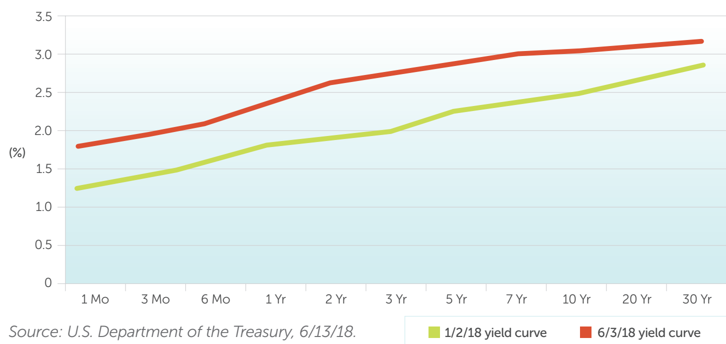
Shifting sands

The current backdrop

As the markets move into the second half of the year, the investment landscape has changed notably. The "Goldilocks" environment, which propelled the stock market in 2017 and the beginning of 2018, has been replaced with more volatile, although more typical, conditions. In addition, interest rates have moved higher (see *Exhibit 1*), particularly on shorter-term maturities as the Federal Reserve (Fed) is on course to raise rates 1% this year. Higher short-term rates have, for the first time in a decade, created a meaningful, relatively low-risk investment alternative to the stock market and long-term bonds. Finally, a stronger dollar and trade tensions have diminished the appeal of emerging markets, a sector that was a favorite of strategists at the beginning of the year.

Exhibit 1: Shift in U.S. Treasury yield curve since January 2018



Source: U.S. Department of the Treasury, 6/13/18.

Despite rising rates, select opportunities remain in fixed income

Corporates: Sustained economic growth continues to be a factor in this sector, evidenced by solid earnings and a decades-low unemployment rate. However, compared to U.S. Treasurys, corporate bonds traded tightly compared to U.S. Treasurys earlier this year. Going forward, we anticipate that spreads will widen somewhat by year-end. The coming months may see certain cyclical sectors, such as Energy and Financials, outperform. Concerns surrounding M&A activity or geopolitical risks could impact bond spreads in the second half of the year, leading to a potential "decoupling" in which bond spreads move on a sector-by-sector basis, rather than on the more typical movements with spreads moving together. Floating rate bonds offer investors a degree of insulation from increasing interest rates, so demand for these securities is also likely to pick up. Finally, we believe that shorter maturities, specifically one- to three-year securities, should outperform in this environment.

Municipals: The supply-demand dynamic in municipal bonds has typically been a key factor in gauging this sector and that is likely to be the case in the second half of this year. To date, supply has been fairly muted which has acted as a support for this asset class. We think a solid level of demand will remain, even though interest from banks, a traditional municipal market participant, has declined.

U.S. Treasurys: With rates already rising, U.S. Treasurys look unattractive across the yield curve. The only sector we find appealing is the one- to three-year maturities, which could offer a compelling risk/reward scenario.

Agency mortgage-backed securities (MBS): MBS could see some downward pressure due to the Fed's efforts to continue to unwind its balance sheet. With that policy change, the MBS market will lose its largest buyer, lowering the demand for these instruments. The Fed's unwinding has been happening at a tempered pace, so some other institutional investors, such as banks, have been able to absorb a portion of MBS supply, but the question now is, as the Fed starts to move at a faster pace, will MBS remain attractive? Given the uncertainty around this, we are cautious on this sector.

High yield: Default rates for issuers remain low in the high yield market. Spreads are relatively tight but supported by economic growth and good corporate fundamentals. High yield bonds have also benefited from less interest rate sensitivity than investment grade corporate bonds. As well, rising oil prices have buoyed the Energy sector, the largest segment of the high yield market. Overall, we believe high yield is poised to deliver positive returns.

Tax windfall filled the sails of U.S. stocks

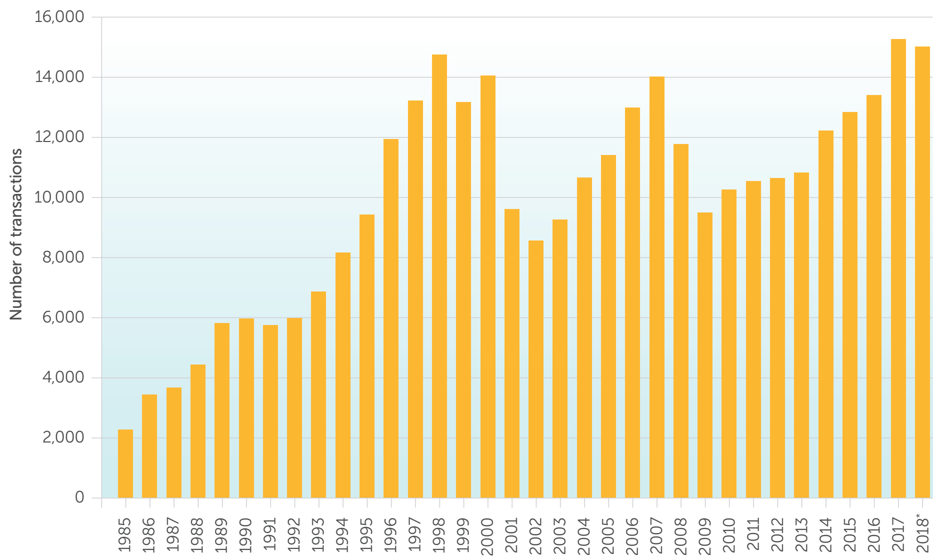
Lower taxes have been a big windfall for companies and a driving factor in the market since President Trump's election. While this has acted as a terrific tailwind to help drive valuations, today's market participants have started to consider if there are any remaining drivers to spur on this last phase of the current U.S. economic cycle. Company earnings have historically driven equity markets higher and our hope is that, with the reinvestment of tax savings back into businesses and share buybacks, earnings can continue to move higher in the second half of the year.

Energy and Financials likely to lead U.S. equities

Large-cap stocks: Growth has been positive across most sectors, with strong market expectations surrounding earnings. Tax reform has not functioned as the sole driver, as companies have been able to expand their profit margins. Company outlooks have largely been upbeat, although the stock market reaction has been muted to an extent. Business investment, also referred to as capital expenditures or capex, has been strong[1] and there are certain sectors that we expect to outperform. Energy has had the strongest earnings performance, obviously due to higher oil prices, which we feel could edge higher in the near term. We expect Information Technology to continue to be a positive performer owing to the ongoing digitalization of the U.S. economy. Financials, with increasing interest rates and potential M&A activity involving regional banks, offer attractive opportunities. Finally, we think Materials should continue to perform well because of limited supply additions and industry consolidation.

Small- and mid-cap stocks: Many of the large-cap factors discussed above also apply to the small- and mid-cap universe. One interesting feature of small- and mid-caps is that they provide investors with a window into domestic performance, while larger caps tend to have more of a multinational component to them. Also, the level of M&A activity is a significant factor in the small- and mid-cap world. For instance, in the Banking and Consumer Staples sectors, merger activity may pick up a bit because these companies could choose to combat rising costs by merging with other firms and creating entities with more economies of scale. Industry estimates suggest that M&A volume for 2018 will be similar to last year's total (see *Exhibit 2*), possibly driven to some extent by the threat of rising rates and the accompanying desire to avoid the higher interest levels that are looming next year.

Exhibit 2: M&A activity projected to remain high in 2018



Source: IMAA, 3/31/18. *Forecast

What are we watching?

Heading into the second half of the year, there are four main economic indicators that we are monitoring:

Rising dollar: The U.S. currency has been strengthening (see *Exhibit 3*). With interest rates moving upwards, led by a hawkish Fed, and growth outside the U.S. slowing, the greenback may continue to rally in the months ahead. A surging dollar and rising rates could present specific challenges for emerging markets. First, a rising dollar may curb risk appetite and cause foreign investors to pull back from emerging markets, reducing access to funding and diminishing growth prospects. We would point out that emerging markets, corporations and banks have taken advantage of low-cost dollar borrowings to shore up their finances. Second, higher interest rates could make it more expensive for overseas borrowers to service their debt commitments.

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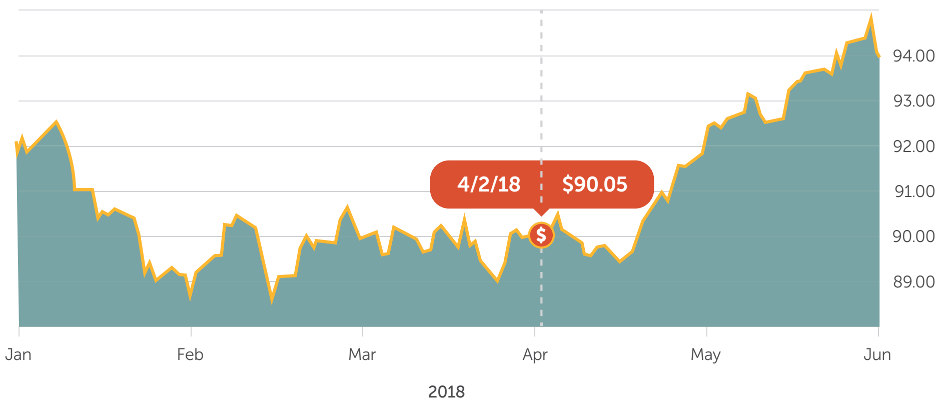
[1] Bloomberg.com, "Trump Tax Windfall Going to Capex Way Faster Than Stock Buybacks", Wang, Lu; 4/26/18.

Exhibit 3: The return of the mighty greenback?



Source: Bloomberg, 5/31/18.

Oil: Rising oil prices have negatively impacted global consumption as gasoline hit $3 per gallon for the first time since late 2014.[2] Such a rise in prices at the pump could actually act as an offset to the extra cash provided by last year's Tax Cuts and Jobs Act, and serve as a brake on consumer spending, especially for those in lower income brackets.

Geopolitical: The recent elections in Italy were rife with talk of the country leaving the euro and re-adopting the Italian lira. The rise of populism seems to be ongoing and widening in scope. Trade tensions and U.S.-North Korean negotiations also create some uncertainty that could adversely impact markets.

Central Banks: While the Fed is on course for four rate hikes this year, other major central banks now appear hesitant to tighten monetary policy, or even move away from the very easy monetary policy that has been in place since the Great Recession. Consequently, the difference between U.S. and foreign interest rates is unusually wide. As for the Fed, it appears to be on course to raise rates into 2020 in order to prevent inflation from moving too far above its 2% target. At some point, higher interest rates will slow the economy.

What does it all mean?

The fundamental U.S. economic backdrop continues to exhibit solid growth. Rates are going up, but relative to historical levels, are still at attractive levels. For example, *Exhibit 4* shows that the rates for 30-year mortgages continue to be at the historical low end. Inflation remains relatively contained, even though it is on the rise. Fed monetary policy is currently supportive of economic growth. We believe that the reason that volatility has returned to markets is, in large part, due to the emergence of geopolitical "wildcards" which can be difficult to anticipate. Historically, oil has been a challenge to industry pundits, given its tendency to surprise investors. Will its recent spike be an issue in the short term? Lastly, with the growing realization that the Fed has embarked upon its typical tightening cycle, the economy has shifted out of its so-called "goldilocks" phase into a more normal environment. We would point out that this shift does not mean that the economy is about to make a sudden, dramatic turn towards recession but rather that the seemingly perfect world of low interest rates, upward trending equity markets and barely visible inflation is starting to end.

Exhibit 4: 30-year mortgage rates are still near historic lows

Source: Freddie Mac, FRED, 6/7/18.

[2] Source: U.S. Energy Information Administration, 6/11/18.

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June 2018 Midyear Outlook: Where we see opportunities

	U.S. equities	Municipal bonds	Corporate bonds	High yield
Headwinds	• Potential last phase of economic cycle • Increasing volatility	• Decreased buying from some traditional market participants	• Late in economic cycle; Fed tightening monetary policy	• Higher interest rates could hurt overly leveraged firms
Tailwinds	• Large caps: Trump tax cuts, corporate earnings, capital expenditures • Small and mid caps: Increased M&A activity	• Less new issue supply due to tax reform	• Economy is strong	• Low default rates; strong economy
Key takeaways	• Earnings expectations still strong • Company profits and capex positive	• Tax advantages of asset class attractive • Supply-demand dynamic stable	• Energy and Financials appear to offer solid opportunities	• Energy sector looks attractive

These views represent the opinions of the Chief Investment Officer, Co-Directors of Equities and Director of Fixed Income and are not intended as investment advice or to predict or depict the performance of any investment. These views are as of the close of business on June 19, 2018, based on the information available at the time and are subject to change at any time based on market or other conditions. We disclaim any responsibility to update such views.

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