Quarterly Economic Report

Inside views on economic and market factors affecting global markets and business health

Q2 2018

Economic Report: Q2 2018

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Thoughts From The Desk

Market volatility returned in full force in the first quarter and brought about investor anxiety across all markets from equities to fixed income to derivatives. Led by stronger-than-expected economic data and renewed concerns of an overheating economy and inflation perhaps around the corner, bond yields rose amid speculations of more aggressive central bank tightening. For corporate cash investors, the return of volatility was a blessing as reinvestments of short duration assets benefited from higher yields. However, should corporate Treasurers be concerned with the three-deviation movement in volatility we witnessed in the first quarter in the bond markets?

In the short run, no. The global synchronized economic growth story continues to show positive momentum across all regions with inflation largely below central bank targets. In the United States, economic growth in the short run appears to be broad-based, and despite signs of a tightening labor market, inflation remains below the Fed's preferred two percent target. Furthermore, the Fed's prescribed message of a gradual path toward rate tightening and a long and slow easing of asset purchases should afford investors time to make necessary portfolio adjustments. Specifically for corporate cash mandates, the spike in short-term LIBOR during the quarter was not an early sign of credit stress; rather it appeared to be technical in nature. The excess issuances of Treasury bills and the shortening of maturity demand from repatriated cash further lifted the front-end benchmark borrowing rates thus benefiting investors with reinvestment power.

In the medium to long run, we will monitor the flattening of the yield curve, the removal of monetary accommodations, the repricing of asset classes as a result of new benchmark Treasury rates, and volatility gauges while taking into consideration possible new fiscal and geopolitical policies. We anticipate the yield curve to flatten further from its quarter-end spread of 47 basis points as the Fed marches toward three rate hikes in 2018. As mentioned in prior writings, we will be mindful of tail risks while positioning portfolios to help mitigate market gyration by remaining defensive on duration and selective on credits.

While we exit a period of excess calm marked by prior years and usher in a new market environment that will likely see volatility test new highs, discerning the cause behind the volatility will be key for investment performance.

We hope you continue to find this report helpful as you position your business to respond to the economic landscape.

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Overview

Domestic economy

The U.S. economy continues to expand at a steady pace. The $1.5 trillion tax bill should, at a minimum, serve as a short-term stimulus.

The consumer continues to drive the economy. Q4 consumption was the highest in three years.

The labor market is on firm footing, averaging over 200,000 jobs in Q1 and maintaining a 17-year low unemployment rate.

Home prices continue to climb due to supply constraints and despite increases in mortgage rates.

Inflation is subdued. However, there could be an acceleration over the course of the year given the tight labor market and steady growth.

Global economy

Broad-based global growth is supported by recovery in investment, manufacturing and trade with solid pickup in commodity-exporting economies.

Inflation is still largely below target, allowing central banks to maintain gradual policy normalization to retain accommodative financial conditions.

China's growth is forecast to soften with the new policy direction emphasizing reduction of credit expansion and ongoing structural reforms.

Heightened risk of trade protectionism, rising oil prices and bouts of volatility could lessen the positive cyclical global growth forces.

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Overview

Central banks

Hawkish sentiment continues to build across the global monetary policy landscape. Recent projections from the Federal Reserve imply two additional rate hikes of 25 basis points in 2018 with three more penciled in for 2019. Front-end Treasury yields continue to rise as a result.

A synchronized global recovery and improving growth outlooks have continued to increase market participants' speculation as to the timing of a reduction in global monetary policy support from the ECB, BOJ and BOE. As expected at the March meeting, the ECB kept its monetary policy unchanged but decided unanimously to remove the explicit pledge to step up the Asset Purchase Program if needed. The removal of accommodation through a reduction in asset purchases or an increase in policy rates will continue to be a well-debated theme throughout 2018.

Uncertainties still remain, such as the ultimate response of corporations and individuals to the recent tax reform, uses of repatriated corporate cash, further policy changes such as healthcare reform and infrastructure spending and how the Fed progresses on its path of policy tightening. The Fed is well underway on its tightening cycle and its unprecedented balance sheet reduction is smoothly progressing.

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Overview

Markets and performance

The broad U.S. bond market performance, measured by the Bloomberg Barclays U.S. Aggregate Index, showed negative total returns in Q1, as bond yields rose to multiyear highs.

Bond market underperformance was due to wider risk premiums resulting from concerns on trade policy, decreased investor demand and increased cost of funding. However, yields in the short end provide value for income-seeking investors as intermediate to long duration remains range bound given the flat term structure.

With wider spreads, it was evident that investment grade corporates bore the brunt of the underperformance in Q1. However, short duration assets soften the negative price movements as they provided investors the flexibility to improve portfolio income in a rising rate environment.

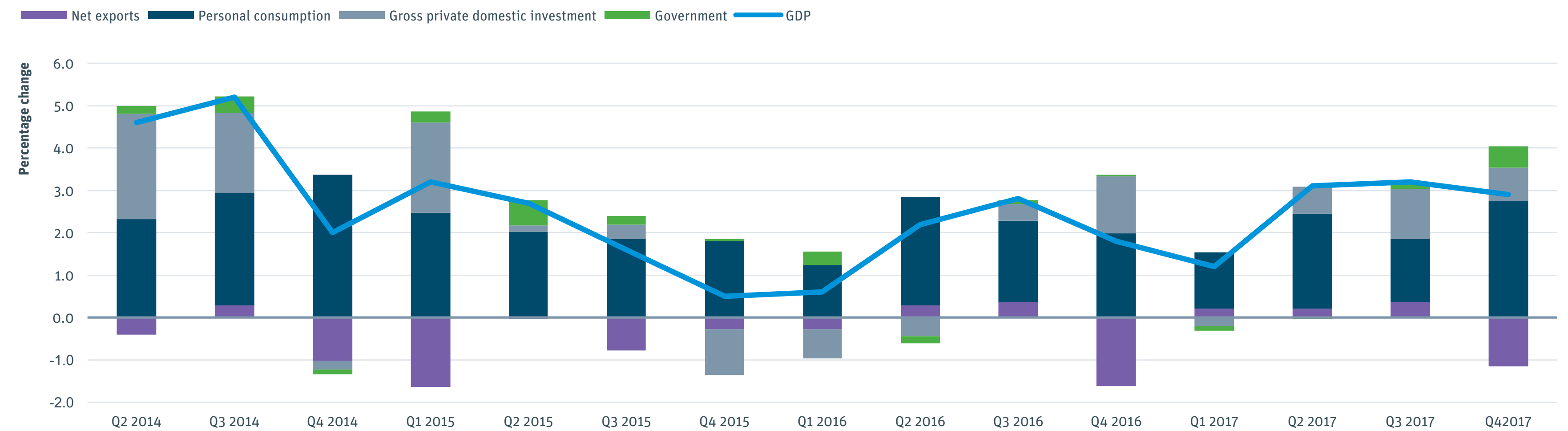
Meanwhile, corporate revenue growth continued to accelerate, benefitting from a robust economic backdrop, and now is outpacing growth in corporate borrowing.

Domestic Economy

GDP: Steady growth

The U.S. economy grew by 2.9 percent in Q4 2017. Recent tax reform and government spending should boost growth in 2018 and support the Federal Reserve's plan to raise interest rates a total of three times in 2018.

GDP and Components



Source: Bureau of Economic Analysis (BEA), Congressional Budget Office (CBO) and SVB Asset Management. Data as of 3/28/2018. GDP values shown in legend are % change vs. prior quarter, on an annualized basis.

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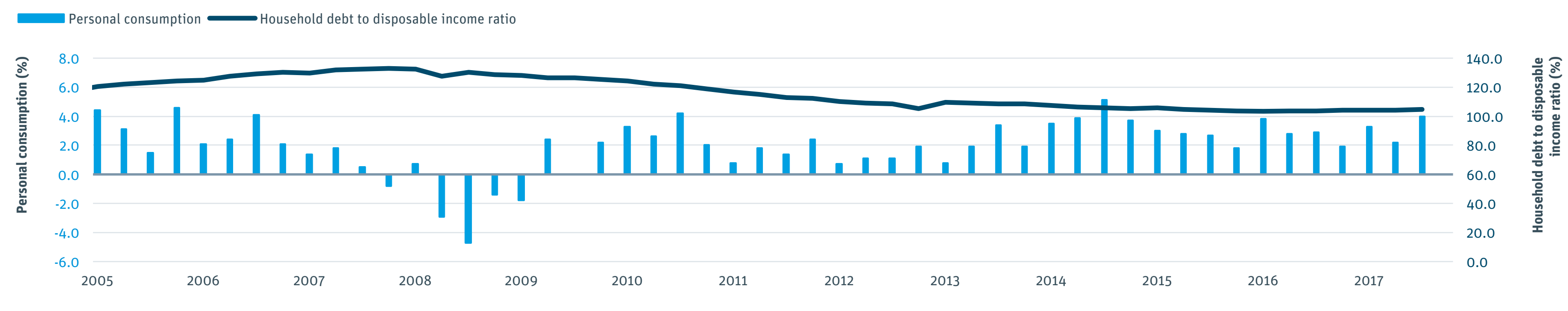
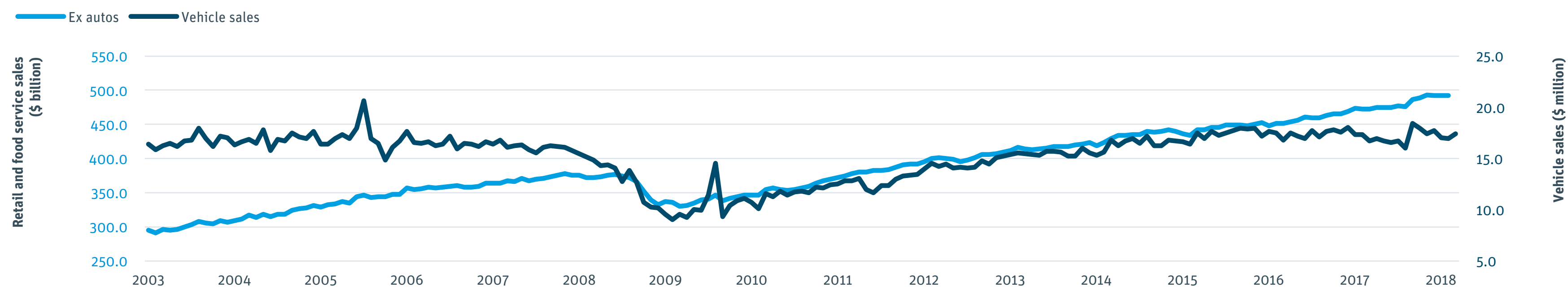
Consumption: Going strong

Consumption in Q4 2017 was the strongest in three years and drove growth for the quarter. However, retail sales for the start of 2018 show a slowdown following the holiday season. Sales of vehicles fell following a spike caused by people replacing their cars in the aftermath of the hurricanes.

Consumption Overview



Retail and Food Service Sales



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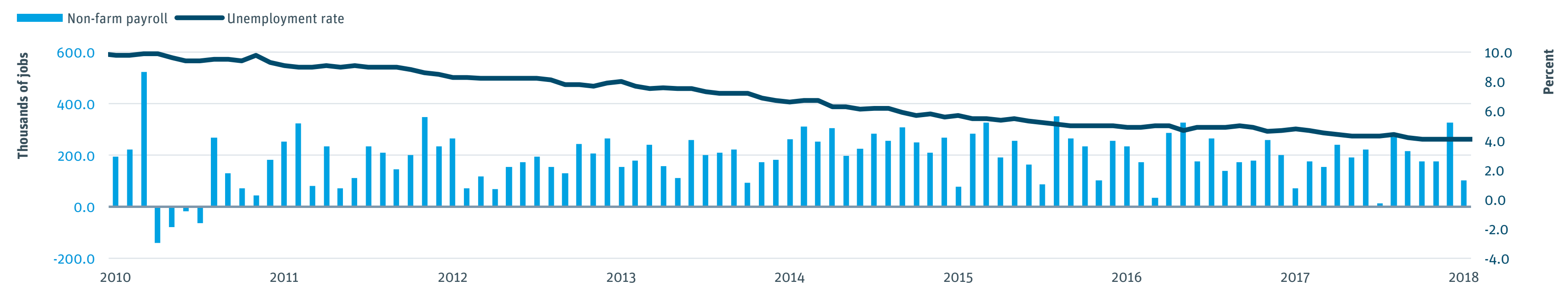
Source: Bloomberg and SVB Asset Management. Data as of 3/29/2018.

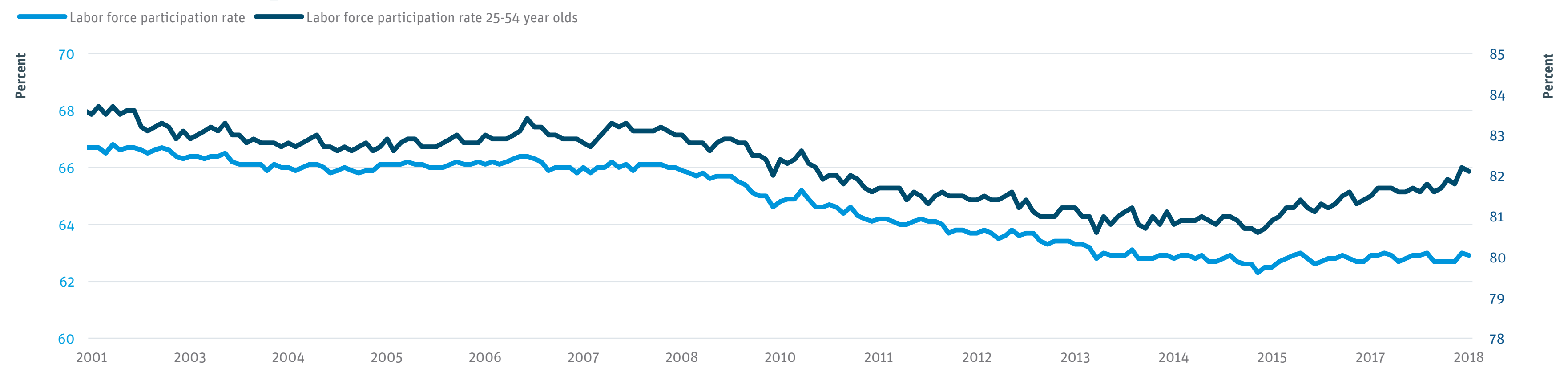
Employment: Healthy balance

The United States continues to add jobs with an average of over 200,000 jobs added in Q1 2018. Meanwhile, the unemployment rate is at a 17-year low and the labor force participation rate for 25 to 54-year-olds shows a healthy pace of growth the last few years.

Employment Landscape



Labor Force Participation



Source: U.S. Bureau of Labor and Statistics (BLS), Bloomberg and SVB Asset Management. Data as of 4/6/2018. The U3 unemployment rate, defined as persons marginally attached to the labor force, counts those who currently are neither working nor looking for work but indicate they want and are available for a job and have looked for work in the past 12 months.

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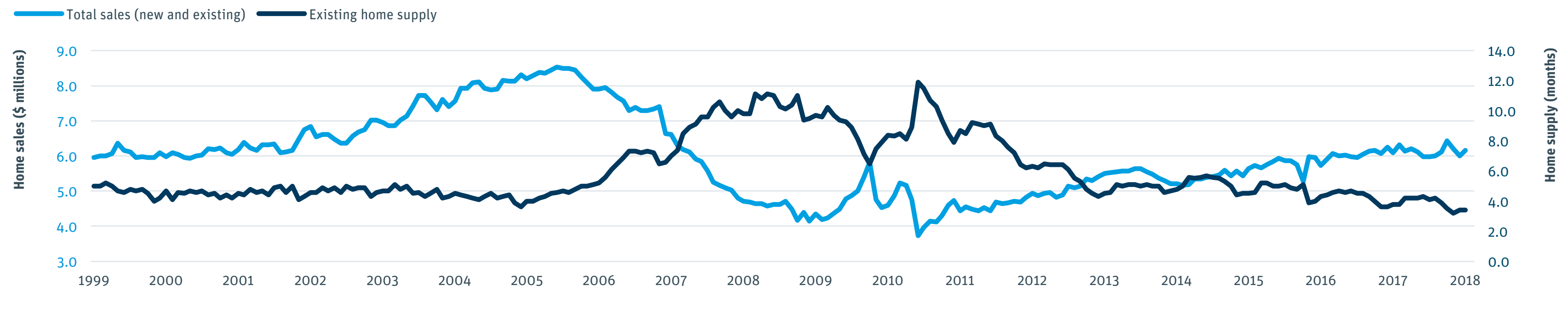
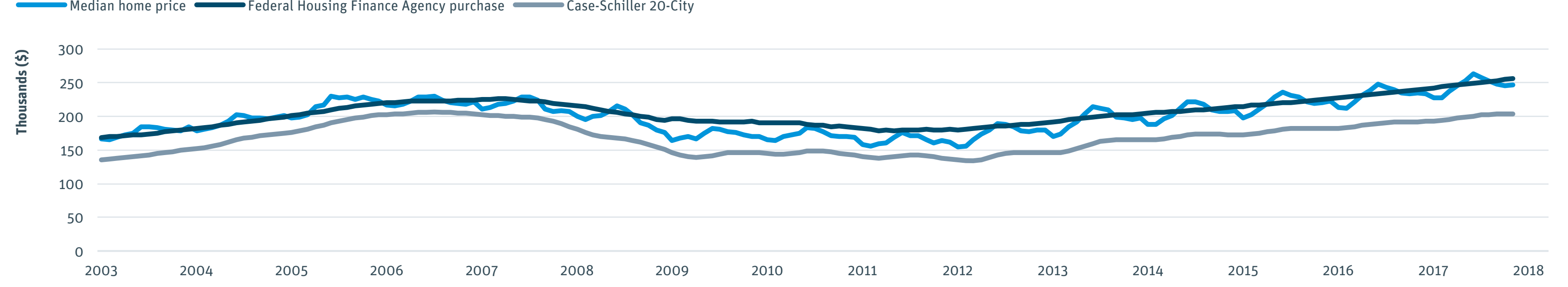
U.S. Housing: Stable footing

The U.S. housing market continues on stable footing; however, limited inventory could dampen sales in the long run. Despite the Fed's course to raise rates through 2018, mortgages continue to be at relatively low levels and home prices continue to climb.

Home Sales and Supply



Home Prices — Indexed to 100



Source: Bloomberg and SVB Asset Management. Data as of 2/28/2018.

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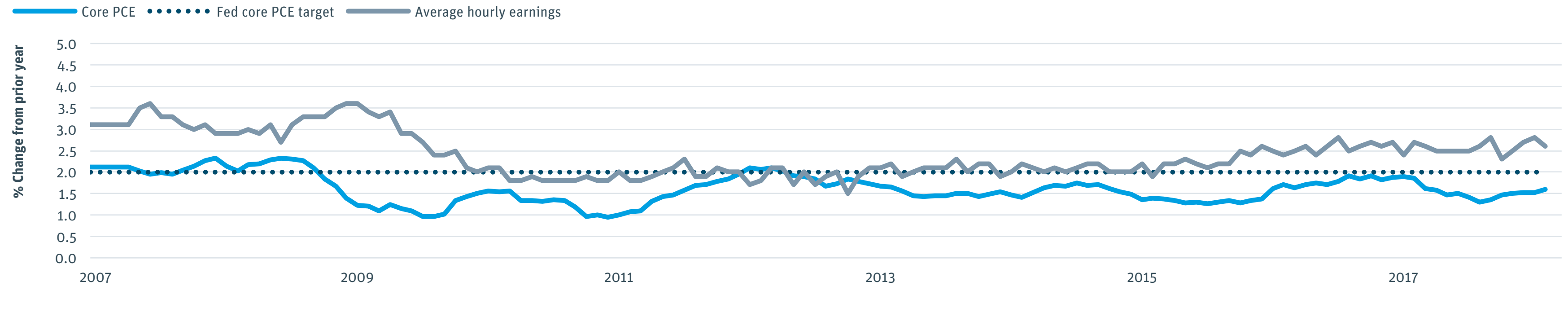
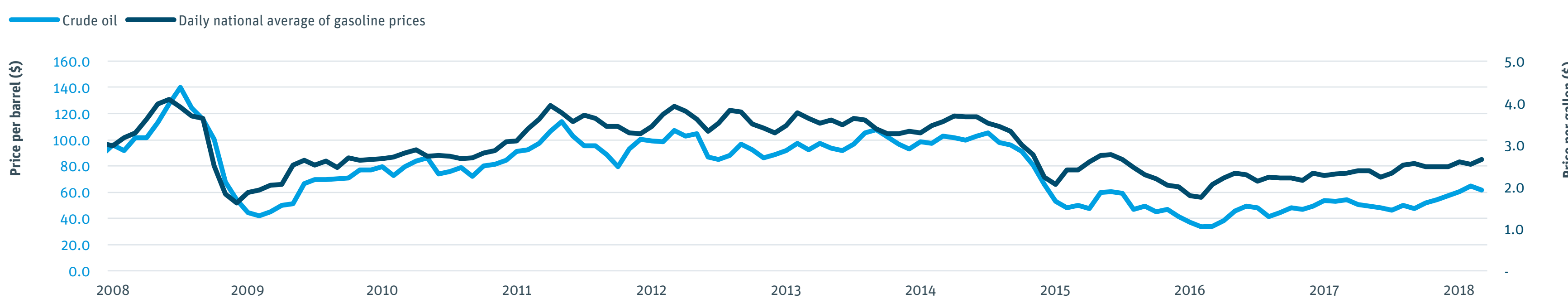
Inflation: Room to rise

Core personal consumption expenditures (PCE) continue to be below the Fed's two percent target, and the market is on inflation watch waiting for the tight labor market to spur wage growth and boost inflation. The Federal Reserve plans to raise rates two more times in 2018. However if inflation accelerates the Fed may consider a fourth rate increase.

Core PCE below the Fed's target while wage pressure could pick up



Oil Prices



Source: Bloomberg and SVB Asset Management. Data as of 3/31/2018.

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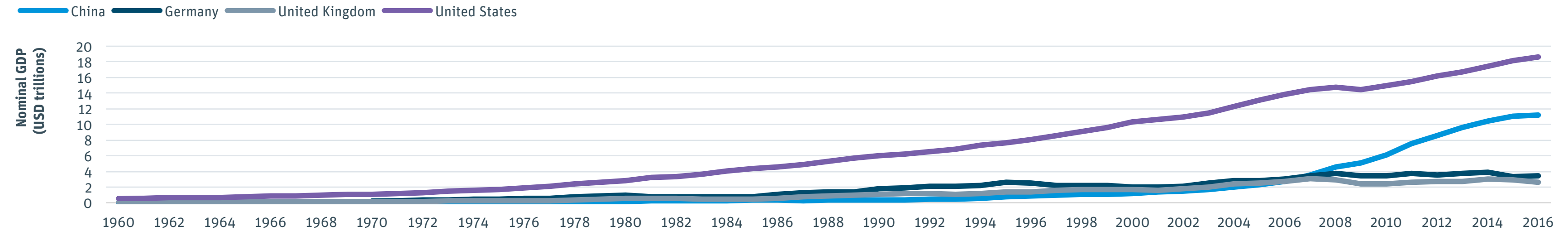
Global Economy

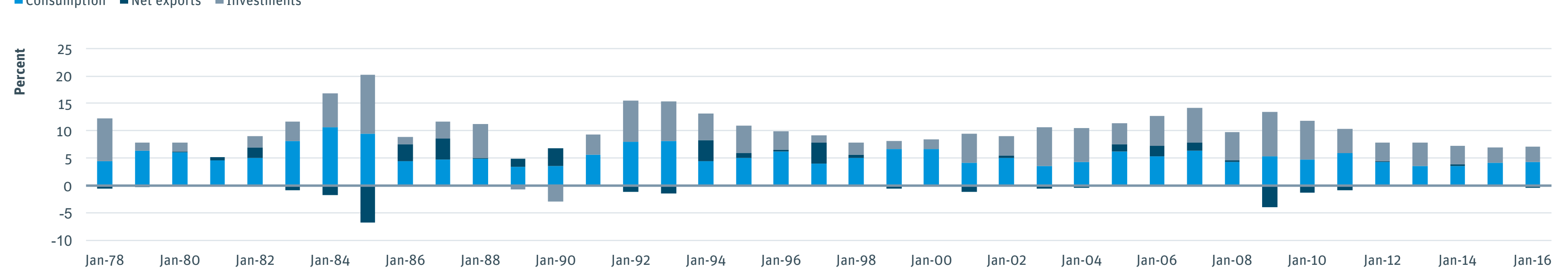
Global Economic Development: China's race to the top

China's rapid economic growth and its emergence as a global economic power to have played a key role in world economic development. In 1979, China implemented reform policies and opened up its economy to the outside world. Since then, it has seen robust growth with an average annual growth rate reaching about 10 percent in the last 33 years. As China's economic rebalance continues to advance, domestic consumption's role in GDP growth is becoming increasingly more important, lessening the potential economic impact of trade disruption.

China has been the largest contributing country in the world GDP growth rate



China's GDP growth is less dependent on net exports



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Source: Word Bank, Bloomberg and SVB Asset Management. Data as of 4/2/2018.

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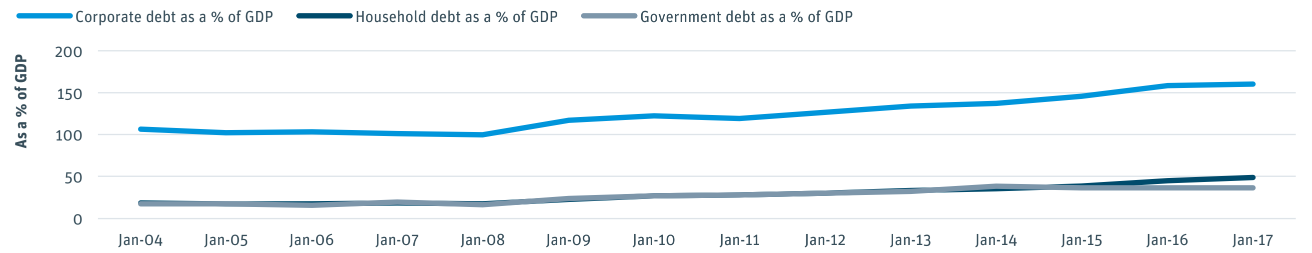
Global Focus: Where will China finish?

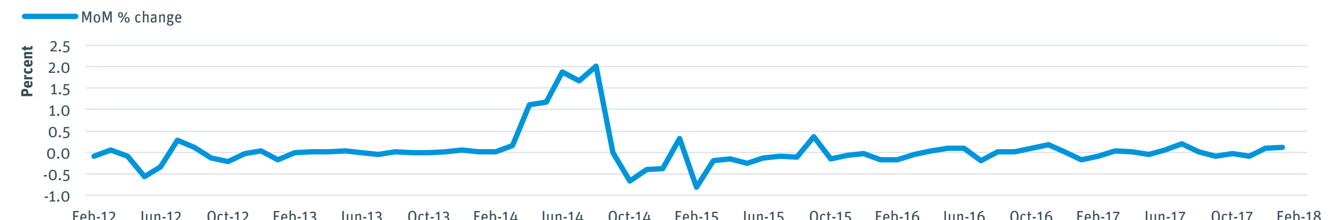
For the first time since 2010, China's GDP growth in 2017 accelerated to 6.9 percent from 6.7 percent driven by consumption and global synchronized growth. China's growth is forecast to soften in 2018 and 2019 as export decelerates and new policy direction emphasizes growth quality over quantity. Key structural reform includes corporate deleveraging, tightening of policies in the property sector and financial regulation enhancement. The monetary and fiscal policy stance is expected to be neutral with a tightening bias.

Corporate debt is high and household debt is rising



Corporate debt has stabilized relative to GDP, but household debt is rising, albeit from a low base.

House price inflation has moderated



House price increases have moderated, but prices remain high in several large cities.

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Source: Bloomberg, SVB Asset Management. Data as of 4/2/2018.

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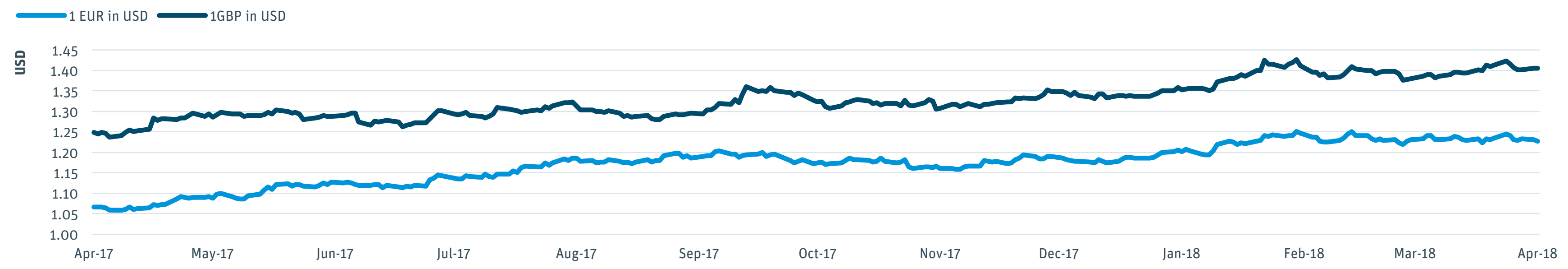
United States: Defying convention

The U.S. Dollar Index has retreated in Q1 2018 despite the Fed hiking rates for the sixth time since the financial crisis. Weakness in the U.S. dollar can be attributed to concerns over looming twin deficit and global trade disruption. Additionally, geopolitical risk and uncertainty over NAFTA negotiations may continue to weigh on U.S. dollar bearish sentiment. Other economies such as Europe and the United Kingdom have also recovered faster and inflation has ticked higher. With the agreement of a transition deal for Brexit in place, some of the near-term uncertainties have been removed, resulted in both the euro and British pound strengthening against the greenback year to date.

U.S. Dollar Index (DXY)

U.S. Dollar per one Euro (EUR), per one British Pound (GBP)



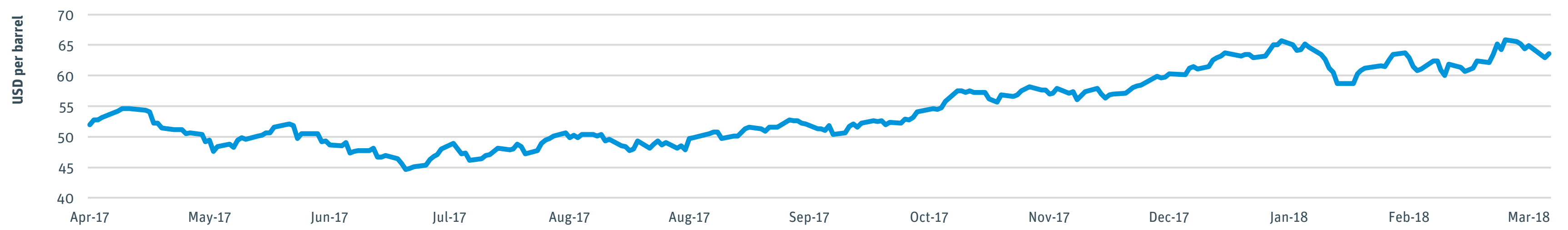
Source: Bloomberg, Silicon Valley Bank and SVB Asset Management. Data as of 4/3/2018.

Emerging Markets: Tempered exuberance

Emerging market currencies have been mixed with JP Morgan Emerging Market Currency Index (EMCI) rallying from mid-December to February before retreating toward the end of March. The catalysts for local currencies' strength are synchronized global economic recovery, U.S. dollar weakness and increased equities flowing into emerging markets. However, with the heightened risk of trade protectionism and rising oil prices, economic outlook near term has dampened. While China's response to U.S. tariff proposals appeared to be balanced and the two sides left the door open for a negotiated solution, the investors remain guarded that the situation could escalate and lead to diminished global growth.

JPM Emerging Market Currency Index (EMCI)

Crude Oil — West Texas Intermediate (WTI)



Source: Bloomberg, Silicon Valley Bank and SVB Asset Management. Data as of 4/3/2018.

Central Banks

Historical Interest Rates

Fed policy normalization and the resultant policy rate hikes have elevated yields in the front end of the U.S. fixed income market.

2-year Treasury Note | 1-year Treasury Note | Fed funds midpoint | Fed rate hike

Percent (interest rate)

2.5
2.3
2.1
1.9
1.7
1.5
1.3
1.1
0.9
0.7
0.5

Mar-17 Apr-17 May-17 Jun-17 Jul-17 Aug-17 Sep-17 Oct-17 Nov-17 Dec-17 Jan-18 Feb-18 Mar-18

2Q17: Treasury yields hit highs in March after the FOMC decision to raise the federal funds target rate. The Treasury curve movement was much more muted after the June decision to raise rates though, as Treasury yields remain in a tight range quarter over quarter.

3Q17: Treasuries broke out of their recent trading range as hawkish comments reverberated across central banks. Projections from the Federal Reserve implied one additional rate hike of 25 basis points in 2017 with three more to follow in 2018.

4Q17: Treasury yields continued their ascent as the FOMC raised rates at their December roundtable and again communicated median committee projections for three hikes in 2018.

1Q18: Treasury yields continued their ascent as the FOMC raised rates at their March meeting and communicated their belief that growth will accelerate in the U.S. economy. Median committee projections still show three total rate hikes in 2018, with some committee members calling for four total.

Source: Bloomberg and SVB Asset Management. Data as of 3/30/2018.

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Central Bank Economic Projections

Global growth and employment remain strong and synchronous while inflation remains relatively subdued.

Economic projections	2017	2018	2019
United States			
Change in real GDP	2.3%	2.7%	2.4%
Unemployment rate	4.4%	3.8%	3.6%
Core PCE inflation	1.5%	1.9%	2.1%
Eurozone			
Change in real GDP	2.3%	2.4%	1.9%
CPI inflation	1.5%	1.4%	1.4%
Unemployment rate	9.1%	8.3%	7.7%
China			
Change in real GDP	6.9%	6.5%	
CPI inflation	1.6%	3.0%	
Unemployment rate	3.9%	4.5%	
Japan			
Change in real GDP	1.7%	1.4%	0.7%
Core CPI inflation	0.8%	1.4%	2.3%

Source: Federal Reserve, European Central Bank, National People's Congress of China and Bank of Japan. Data as of 3/30/2018. Forecasts are not available for all periods.

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Federal Reserve Rate Projections

Committee members' projections for the path of the federal funds rate.

The FOMC Dot Plot

Current and historical Fed projections for the federal funds rate (median rate)

Recent FOMC meetings have indicated a steeper path of interest rate hikes with current projections implying three to four rate hikes this year and another three in 2019.

Source: Bloomberg and Federal Reserve. Data as of 3/21/2018.
Median rate references forecasted rate at the end of each period.

Central Banks: A leisurely stroll to higher ground

Solid employment gains, positive economic growth and mild inflation allow central banks to maintain a gradual approach to normalization. The measured pace of change provides for accommodative financial conditions to absorb road bumps, including those caused by fluctuations in the geopolitical arena and trade policies.

Benchmark interest rate | Consumer spending (MoM change) | Growth rate (QoQ change) | Inflation (YoY change) | Unemployment rate

Percent

8.00
7.00
6.00
5.00
4.00
3.00
2.00
1.00
0.00

-0.10 0.10 0.40 1.40 2.40

0.00 0.20 0.60 1.10 7.30

4.35 1.20 1.60 2.90 3.90

0.50 0.40 0.40 2.70 4.30

1.50 0.20 0.60 2.20 4.10

Analysis

JAPAN: Inflation inching up but well below target, even as unemployment is at a 25-year low. No change to easing policy.

EU: Economic growth paced by good business activity. No change to rates, but ECB poised to end asset purchase program by year-end.

CHINA: Stability reigns, with growth expected to hit the 6.5 percent target. Policy tightening occurring via structural reforms.

UK: Domestic demand is firm, helped by a strong labor market. With inflation at target, a rate hike is expected in May.

US: Political headlines are masking a robust economy driven by job creation. Tame inflation sanctions moderate pace of rate hikes.

Source: Federal Reserve, European Central Bank, Bank of England, The People's Bank of China, Bank of Japan, Bloomberg and SVB Asset Management.

Markets and Performance

Broad Market Performance

Asset class returns

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018 YTD
Crude Oil 78.00%	Gold 29.67%	Gold 10.23%	REIT 16.47%	Wilshire 33.06%	REIT 28.24%	S&P 500 1.40%	Crude Oil 44.80%	S&P 500 21.80%	Crude Oil 7.30%
U.S. High Yield 58.21%	REIT 26.97%	Crude Oil 8.15%	Wilshire 16.05%	S&P 500 32.39%	S&P 500 13.69%	REIT 1.30%	U.S. High Yield 17.13%	Wilshire 21.00%	Gold 1.40%
Wilshire 28.29%	Wilshire 17.18%	U.S. Aggregate 7.84%	S&P 500 16.00%	U.S. High Yield 7.44%	Wilshire 12.70%	Wilshire 0.70%	Wilshire 13.40%	Gold 13.70%	S&P 500 -0.80%
S&P 500 26.46%	U.S. High Yield 15.12%	REIT 7.48%	U.S. High Yield 15.81%	Crude Oil 7.32%	U.S. Aggregate 5.97%	U.S. Aggregate 0.55%	S&P 500 12.00%	Crude Oil 12.50%	Wilshire -0.80%
REIT 26.27%	Crude Oil 15.10%	U.S. High Yield 4.98%	Gold 6.96%	REIT 1.26%	U.S. High Yield 2.45%	U.S. High Yield -4.47%	Gold 8.60%	U.S. High Yield 7.50%	U.S. High Yield -0.86%
Gold 23.96%	S&P 500 15.06%	S&P 500 2.11%	U.S. Aggregate 4.21%	U.S. Aggregate -2.02%	Gold -1.51%	Gold -10.50%	REIT 7.10%	REIT 3.70%	U.S. Aggregate -1.46%
U.S. Aggregate 5.93%	U.S. Aggregate 6.54%	Wilshire 0.98%	Crude Oil -7.08%	Gold -28.26%	Crude Oil -45.76%	Crude Oil -30.50%	U.S. Aggregate 2.65%	U.S. Aggregate 3.54%	REIT -8.40%

All returns above are on a total return basis. 2018 YTD returns are on an aggregate basis up to 3/31/2018. U.S. Aggregate refers to Bloomberg Barclays Aggregate Bond Index; U.S. High Yield refers to Bloomberg Barclays U.S. High Yield Index; Gold refers to S&P GSCI Gold Spot; Crude Oil refers to Spot West Texas Intermediate Crude Oil; Wilshire refers to Wilshire 5000 Total Market Index; REIT refers to MSCI US REIT Index; S&P 500 refers to S&P 500 Index.

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Source: Thomson Reuters and Bloomberg Barclays indices.
Past index performance is no guarantee of future results.

Fixed Income Returns: Volatility returns

Increased volatility, wider risk premiums and increased cost of funding have all contributed to the underperformance in risk assets. However, yields in the short end have provided value for investors as intermediate to long duration remains range bound given the flat term structure.

		Current duration	Current yield	Periodic total return %						
				Q1 18	Q4 17	Q3 17	Q2 17	Q1 17	Q4 16	Q3 16
U.S. Aggregate Index	U.S. Treasuries	6.13	2.55	-1.18	0.05	0.38	1.19	0.67	-3.84	-0.28
	U.S. Agencies	3.89	2.56	-0.53	0.06	0.82	0.93	1.13	-2.10	0.25
	Corporates	7.50	3.77	-2.32	1.17	1.34	2.54	1.22	-2.83	1.41
	U.S. MBS	5.05	3.30	-1.19	0.15	0.96	0.87	0.47	-1.97	0.60
	U.S. ABS	2.10	2.80	-0.39	-0.01	0.42	0.60	0.54	-0.70	0.20
	U.S. CMBS	5.38	3.29	-1.32	0.35	0.79	1.31	0.86	-3.03	0.59
U.S. Short Duration	1-3 yr U.S. Treasuries	1.94	2.29	-0.16	-0.28	0.24	0.19	0.27	-0.46	-0.11
	1-3 yr U.S. Agencies	1.77	2.34	-0.04	-0.21	0.27	0.28	0.35	-0.39	0.00
	1-3 yr corporates	1.96	3.00	-0.38	-0.04	0.59	0.59	0.69	-0.18	0.32
	AAA Credit Card ABS	2.27	2.76	-0.48	-0.08	0.41	0.67	0.56	-1.04	0.15
	AAA Auto ABS	1.80	2.74	-0.25	-0.02	0.37	0.46	0.41	-0.31	0.15

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Source: Bloomberg Barclays Indices. Heatmap colors based on periodic total return percentage for time period shown. Past performance is not a guarantee of future results.

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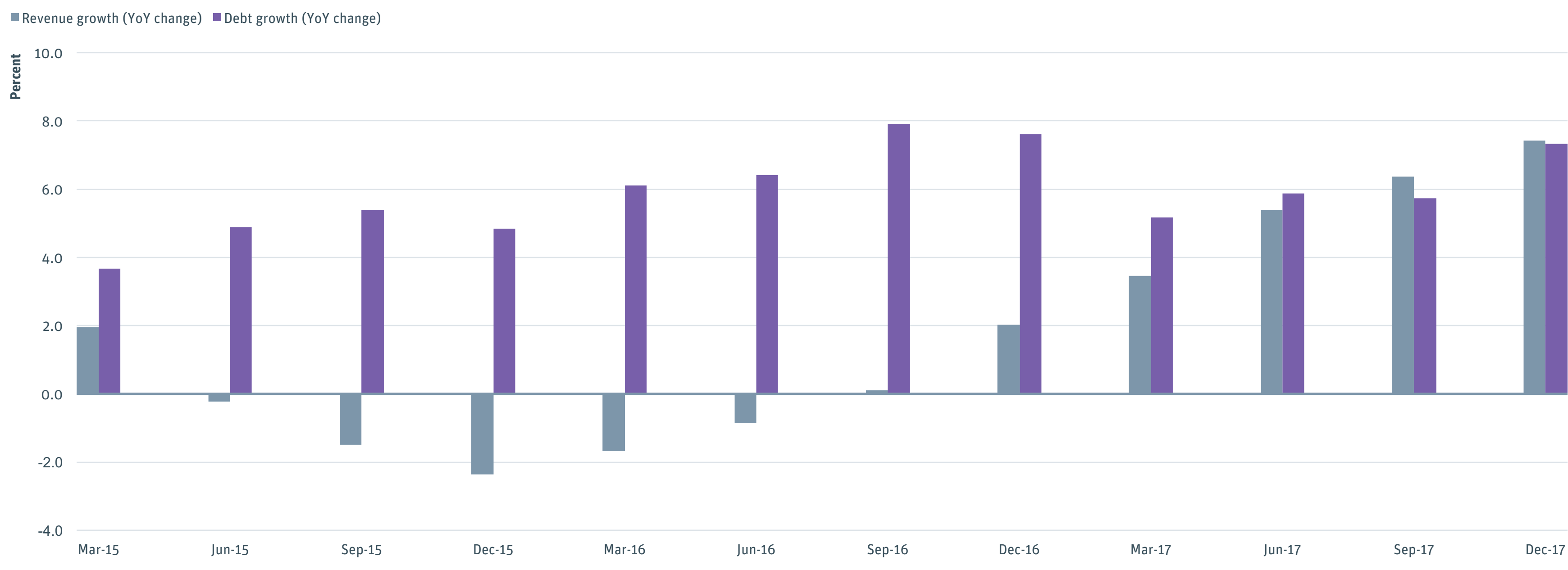
Corporate Sector

Revenue growth now outpaces debt growth

- Pace of debt growth has moderated
- Revenue growth turned positive in second half of 2016 and accelerated throughout 2017
- Rate of revenue growth overtook the rate of debt growth in Q4 2017

S&P 500



Source: Bloomberg. Data as of 3/27/2018.

Flat Yield Curve

The 2s10s curve closed below 50 in the first quarter of 2018, which is the flattest in over a decade. Comparing the current rate-hiking cycle to the one from 2004 to 2006, the curve has room to flatten further. Contributing to the continued flatness is larger front-end Treasury issuance relative to the long end along with repatriation from the 2017 tax reform.

2s10s Treasury Curve

Yield spread of the 10-year and 2-year Treasury notes

Yield spread (bps)

350
300
250
200
150
100
50
0
-50

2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

From 2004 to 2006, the FOMC raised the federal funds rate 17 straight times.

During the financial crisis, the FOMC cut rates to a low range of 0 to 0.25 percent starting in 2009.

In 2015, the FOMC signaled they would be increasing the federal funds rate. The first increase occurred at the December FOMC meeting with a new range of 0.25 to 0.50 percent

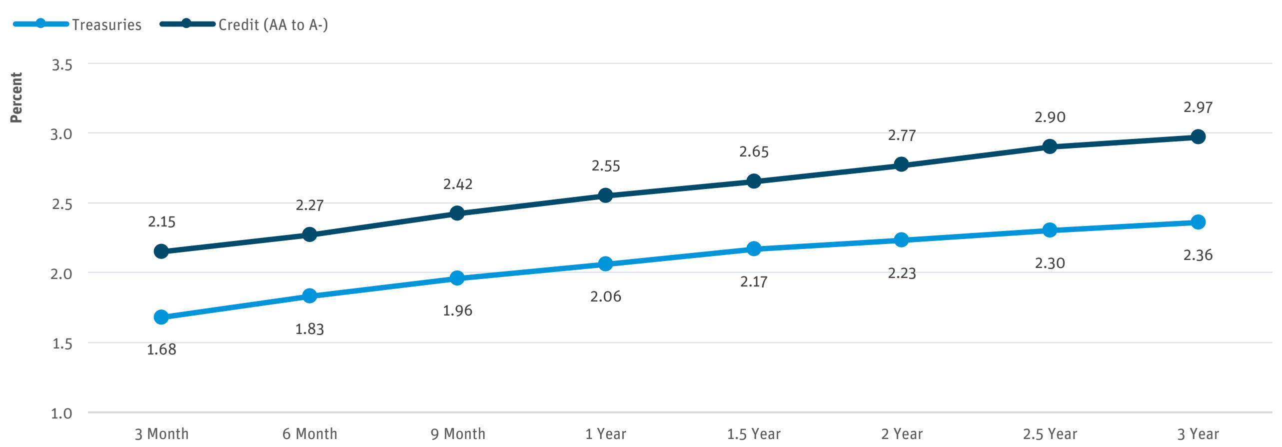
The FOMC raised the federal funds rate three times in 2017 and so far once in 2018. At the March FOMC meeting, the Fed still forecasted a total of three hikes in 2018.

Source: SVB Asset Management and Bloomberg. Data as of 3/29/2018. Past performance is not a guarantee of future results. The above is not to be construed as a recommendation for your particular portfolio.

Relative Value: Attractive credit yields

Credit can offer a yield pickup of approximately 50 basis points over comparable Treasuries at the end of Q1 2018. In a rising rate environment, spread products help mitigate the impact from negative bond prices due to higher income.

Front-end Yields



2017 ended with credit offering a yield pickup of around 25 basis points over comparable Treasuries.

The increased volatility witnessed in the first quarter along with increased supply and less credit buying due to repatriation caused this spread to widen.

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