Entering the fourth quarter, our medium-term outlook for the US economy has grown more conflicted. We continue to believe that US economic and market fundamentals are strong, but we also note that political and policy risks have grown considerably. In particular, we see risks in the possibility that the Federal Open Market Committee (FOMC) hikes rates too far as it leans against fiscal stimulus and that protectionist trade policies could derail both markets and economic growth.

These risks will likely come to a head in the next 12–18 months, in our view, when the impact of fiscal stimulus from tax cuts and February’s budget will begin to fade and interest rates will probably be much higher. The median FOMC participant now expects to be targeting a Fed funds rate of 3.1% by the end of 2019, above their estimate of the longer-run neutral rate of 3.0%.

Similarly, as we have cautioned since the US presidential election, we believe the administration’s protectionist trade threats reflect a firmly held world view rather than a negotiating tactic. As a result, continued escalation is more likely than not. Regardless, the reality of broadening categories of trade subject to tariffs and the uncertainty about the trajectory of trade policy should begin to weigh more on market and corporate sentiment, reversing the lift to both from tax cuts and fiscal stimulus at the beginning of the year.

At the same time, the global economy could become less supportive. In the euro zone, growth has moderated and political risk remains high, especially with a Brexit deadline of 30 March 2019. In China, authorities are walking a tightrope in their effort to rein in leverage and financial risk while maintaining relatively rapid growth. Protectionism pressures both economies even more.

This potential confluence of risks has become the subject of increased discussion in recent months but clearly is not fully reflected in US markets. Consensus projections for 2019 real GDP growth have barely budged, and US equity markets had a particularly strong third quarter, despite significant escalation in the US-China trade conflict. While we continue to believe that current equity market valuations are justified, we also recognize that they are high relative to history, exposing markets to a rapid shift in sentiment.

Nonetheless, US fundamentals remain good. While growth is likely to moderate somewhat through the end of the year, it is relatively high and should be supported by robust labor markets and stimulus from the tax cuts and February budget. Corporate earnings have also been strong and boosted by tax cuts. Finally, the United States may be better positioned for a downturn than other major economies: with the Federal Reserve hiking rates and rolling off its asset purchases, we believe it will have more flexibility than the European Central Bank (ECB) or Bank of Japan (BoJ) to add stimulus if necessary.

Markets

US market performance in the third quarter reflected this optimistic economic outlook. US equity markets outperformed other regions, bringing S&P 500 Index year-to-date returns to 10.6%. Similarly, the yield on the 10-year Treasury rose to 3.05%. Volatility as measured by the CBOE Volatility Index (VIX) and by daily high/low spreads for the S&P 500 Index declined from earlier in the year but remained above 2017 levels. Sector and factor indices experienced some rotation, but their returns reflected tech and growth outperformance on a year-to-date basis.
Analysis of sector dynamics has been complicated by the GICS reclassification that took place on 24 September. The new communications services sector will include companies from the old telecommunications services sector, as well as media, home entertainment, and internet services companies from the consumer discretionary and information technology sectors (Exhibit 1). Due to these changes, fundamental characteristics of the impacted sectors are significantly different, including valuation metrics and style exposure. For example, the new communications services sector now includes Facebook, Netflix, and Alphabet. Its mid-September next 12-month price/earnings ratio was 17.8x versus 10.5x for the former telecommunications services sector.¹

Looking ahead, our expectations are shaped by our mixed outlook. We believe current equity market valuations are justified, but we do not expect them to rise absent a change in the risks we have outlined. Rather we continue to expect equity market returns to be lower than in 2017 and to be driven primarily by earnings growth, which has been particularly strong in the United States due in part to the economic outlook and in part to tax cuts. Given heightened risks, we also expect higher volatility and greater uncertainty than in 2017. We believe that security selection and risk management will be important, particularly when it comes to the difficult task of assessing exposure to changes in trade policy and international economic relations.

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¹ As of 30 September 2018. Nominal, broad definition, Jan-1997=100. Source: Federal Reserve, Haver Analytics
What We’re Watching

1. **US labor markets.** Our continued optimism about US economic fundamentals rests in large part on improving middle class prospects. Real median household income lagged in the early stage of the recovery but more recently has begun to rise, finally approaching pre-crisis levels in 2017. This trend has been driven by strong labor markets. Even with the unemployment rate reaching multi-decade lows, we are looking for relatively fast jobs growth to continue and, more importantly, for wage growth to gradually grind higher to pre-crisis levels.

2. **US mid-term elections.** Based on recent polling and the dynamics of state-level races, our base case expectation is that the Democrats will win control of the House of Representatives. Our view on the Senate is non-consensus—we see it as a toss-up, with the Democrats benefiting from a late campaign season surge in enthusiasm. In a scenario in which Democrats control either or both houses of Congress, we would anticipate gridlock on material policies and amplified political battles over House-led budget resolutions, investigations of the White House, and Senate-led court appointments. We also see potential risks that, faced with a less-friendly Congress, the White House could become even more aggressive in its approach to trade and foreign relations. If Republicans hold both the House and the Senate, we would expect the policy outlook to remain much the same.

3. **Protectionism.** In our recent Insights, we discuss US protectionism from a corporate perspective. We believe protectionism is an even more serious risk to markets than the economy and that this risk continues to be widely underappreciated. To date, roughly 30%–35% of US imports have been threatened with tariffs (Exhibit 2). The administration has already followed through on roughly a third of these threats, and many US trade partners have retaliated proportionally. However, tariffs on the bulk of covered trade only went into effect on 24 September, so the effects are just beginning to be felt.

Furthermore, understanding these effects is complicated due to changes in the global economy. Unlike during the trade conflicts of the 1980s, companies no longer base most of their production in their home countries. Rather, many have extensive and often specialized global supply chains that would be difficult, disruptive, and costly to reorient. Similarly, many are global businesses with significant and growing overseas revenues and operations. Finally, strategic decision making is made difficult by uncertainty over the trade environment and the stability of international relations and rules.

4. **US interest rates.** In recent years, we have felt that the Fed has had the tendency to “talk hawkish and act dovish.” From our standpoint, it made the most sense to watch the data. In particular, low inflation sent the message that cyclical pressures were weaker than many believed. Now core PCE inflation is finally touching 2.0%, and even if it moderates somewhat in coming months, we believe the Fed may be talking more dovish than it will act. Markets may be understimating the Fed’s commitment to following through on the five additional rate hikes the median FOMC participant currently projects (Exhibit 3). We believe a significant surprise could see yields move up substantially—perhaps to levels exceeding 3.5% for the 10-year Treasury. One wildcard is whether escalating trade conflict might lead the FOMC to “pause” and assess impacts—for the time being, we think not.

5. **European politics.** In the quarter ahead, two key European political events will again present risks to markets and the economy. First, Italy’s populist governing coalition must submit its draft 2019 budget to the European Commission (EC) by 15 October. On 27 September, the coalition agreed to a budget deficit of 2.4% for the next three years, reversing plans by the previous government to achieve a balanced budget in 2020. While the details have yet to be released, on the surface the plan seems likely to lead to confrontation with the EC, new concerns about Italy’s medium-term debt

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Exhibit 2

**~30%–35% of US Imports Have Been Threatened with Tariffs**

<table>
<thead>
<tr>
<th>US Imports Covered by Tariffs</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>(Dollar amounts are based on 2017 import values.)</em></td>
</tr>
<tr>
<td>Autos &amp; Parts Imported from Mexico and Canada</td>
</tr>
<tr>
<td>Imposed</td>
</tr>
<tr>
<td>As of 1 October 2018</td>
</tr>
</tbody>
</table>

Source: Goldman Sachs, US ITC Dataweb

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Exhibit 3

**The Fed Is Leaning against Stimulus**

<table>
<thead>
<tr>
<th>Projected Fed Funds Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>As of 26 September 2018</td>
</tr>
</tbody>
</table>

Median FOMC Projection

Source: Bloomberg, Federal Reserve
sustainability, and possibly credit rating downgrades. Second, the United Kingdom likely needs to conclude a withdrawal agreement with the European Union (EU) before the end of the year to leave enough time for approval. The risk of a “hard Brexit” or even a Brexit with no agreement by 30 March 2019 is rising, with significant consequences for markets and the UK economy.

6. China’s rebalancing. China has maintained rapid growth since the global financial crisis in part through rising leverage, particularly in the corporate sector, where debt is now 164% of GDP. Reducing debt and financial system risk has become a priority in Xi Jinping’s second term. However, several economic indicators have recently suggested that slowing credit growth has reduced economic activity. In response, Chinese policymakers have begun to ease credit access and prices (Exhibit 4). We are watching for further monetary easing and fiscal stimulus, as authorities seek to calibrate policy to both rebalance the economy and maintain rapid growth, a challenge made even more difficult by trade conflict with the United States.

US Household Income Growth

In mid-September, the US Census Bureau released its annual estimates of US household income. While backward-looking, we consider the data release an important check on our long-held view that the recovery from the crisis only began in earnest for many middle and lower income households around 2014—and that improving prospects for these households would be good for consumption and drive a “third leg” of the US expansion.

September’s release brought confirmation that this trend has indeed continued, but also that it has slowed. The annual change in real median household income declined from 2015’s record pace of 5.1% to 1.8% in 2017. Nonetheless, the three-year compound annual growth of 3.3% is the highest since the data series began in 1967 (Exhibit 5). Ten years after the crisis, this record growth has finally restored median household income roughly to its pre-crisis peak, and a shade below its 1999 absolute peak (Exhibit 6).
The details of the release told a similar story. Most household types continued to experience real median income growth in 2017 but at a slower pace than in the prior two years and with some notable exceptions (Exhibit 7). Looking ahead, we believe the most critical factor for sustaining broad income growth will be stronger real wage growth, particularly in middle- and low-wage occupations.

Household income can be thought of as a function of the number of people in the household that are employed; the quality of their jobs, including whether they work full or part-time; and how much they get paid per hour. In recent years, the employment variables in this equation have been particularly positive. Robust jobs growth has led to a falling unemployment rate and pulled more working-age adults back into the labor force. Tighter labor markets also contributed to a decline in the part-time share of total employment.

However, as we discussed in our last Outlook, with the unemployment rate already at multi-decade lows and with labor force participation facing downward pressure from population aging, these trends will almost certainly decelerate (although perhaps not as much as some think). Regardless, we believe that as it becomes increasingly difficult to fill open jobs, employers will “pay up” and real wage growth per hour worked will grind higher toward pre-crisis levels, contributing to continued household income growth. That was not the case in 2017 and early 2018, when stagnant nominal wage growth combined with rising inflation to produce low and falling real wage growth. In more recent data, there have been signs that nominal wage growth has begun to slowly rise again (Exhibit 8), which in our view would be a welcome development if sustained.

Conclusion

Overall, we remain optimistic about US economic fundamentals. The broadening of household income growth to middle and low income households that began around 2014 has continued. Robust labor markets signal that it should be sustained, as do signs that wage growth is beginning to grind higher after stalling in 2017. Fiscal stimulus from February budget and tax cuts are adding to momentum, with the latter also boosting corporate earnings.

However, we are increasingly concerned that Fed tightening against a backdrop of slowing stimulus and increasing US protectionism could derail economic growth and sentiment over the medium term. The impact of protectionism in particular could be more meaningful for markets than for the economy, are likely underappreciated, and are difficult to assess at an individual company level. This mixed outlook makes careful risk assessment and security selection particularly important in our view.
US Fixed Income Outlook

The preceding Outlook reflects the views and analysis of Lazard’s US Equity teams. The views of Lazard’s US Fixed Income teams have diverged over the last few quarters and the teams now have different expectations, in particular relating to the Fed funds rate, as detailed here.

US fixed income markets have been remarkably calm over the past several months, despite increasing uncertainty in the rest of the world. US trade relations have deteriorated with China, a populist government has taken power in Italy, and several emerging markets have descended into crisis. However, increased demand for the traditional safe haven, US Treasuries, has not materialized, suggesting that these disruptive events remain idiosyncratic. Focusing solely on US conditions, we believe there are several reasons for the stability in the US fixed income market, including economic growth, benign inflationary pressures, low volatility, and a Fed leadership that incorporates market data into its decisions.

Many market participants have expressed concern about the flattening of the US yield curve because an inversion of the yield curve during Fed tightening episodes has historically been a reliable market precursor to a US recession. However, we do not share this concern. Currently we have no expectation for a US recession as the underlying economy has yet to show signs consistent with the end of a growth cycle. In our view, the yield curve is no longer a reliable market indicator of economic expectations. Long-term rates for sovereign bonds have been globalized after the numerous and extraordinary emergency interventions taken by central banks since the global financial crisis in 2008. Before then, US Treasury markets were dominated by US institutional investors, and the Fed’s focus was a normal business cycle. An inverted yield curve was a reliable indicator of recession because it reflected the capitulation to strong Fed tightening by bond market vigilantes. This paradigm, however, does not currently exist.

This view reflects our conclusions that:

• We are not in a normal business cycle. The United States is still recovering from depression-like symptoms and the impact of strong government intervention.

• Fed policy remains accommodative. The Fed is not in a tightening mode. It is focused on economic stability and returning policy back to the normal accommodative stance that existed before the global financial crisis. We define the “pre-crisis normal” accommodative stance as a real Fed funds rate of 0.0%–0.5%. According to this measure, the current rate is just about crossing zero.

• Long US Treasury rates continue to reflect global rather than domestic conditions. Currently, the long US Treasury market remains the only reliable hedge against risk assets as it is: 1) the only deep, developed sovereign market with sufficient yield to permit a strong upward move in prices; and 2) it is the only deep, developed sovereign market not being manipulated by its central bank. As a result, long US Treasuries continue to trade like global insurance instruments. They do not and likely will not reach levels consistent with US economic factors until either Germany or Japan allow their long rates to rise to more sustainable levels.

Historically, the impetus for a US yield curve inversion and US recession has been aggressive Fed tightening, resulting in positive real Fed funds rates (Exhibit 9). In our view, we are very far away from such an aggressive policy under the Fed’s current regime.

We see it as healthy and reassuring that the Fed is normalizing its policy. Absent a dramatic and unexpected acceleration in US growth, in our view, US rates will not rise materially higher than current levels. As we discussed previously, we believe the 10-year Treasury yield is trading lower than normal due to global factors. As a result, we believe the key indicator for the 10-year Treasury yield is the 10-year German bund (10-year bunds yielded about 0.50% at quarter end).

We note that US Treasury supply has increased, which could potentially push up rates and steepen the yield curve. The market, however, typically discounts information, and the uptick in US Treasury issuance is well known by investors and has been taken in stride. At the same time, inflation has remained muted, the Fed continues to provide forward guidance on monetary policy, and low developed markets global yields, such as the German bund (Exhibit 10), remain low and have held US longer-term yields in check.

We also see several sources of demand that could likely absorb supply, such as that from banks in search of high-quality liquid assets, or investor rotation out of credit. In addition, future budget deficits, term premiums, and short-term real rates will determine where on the curve the Treasury will issue debt. Currently, issuance will not be focused on the long end but will be concentrated in the “belly of the curve”—the 2-, 3-, and 5-year sectors.
We believe it is important to note that the Fed’s forward guidance and global considerations have also played a role in holding term premiums lower than historical levels. Term premium can be considered the compensation market participants require for holding the risk of fixed rate long-term debt as opposed to a series of shorter-term debts—e.g., a 10-year Treasury versus a series of 1-year Treasuries over a 10-year period. The term premium compensates investors because it is more difficult to forecast Fed policy and inflation over a 10-year period than over a 1-year period. The Fed’s forward guidance, along with contained inflation expectations, placates that risk, thus lowering the premium, all else remaining equal.

Lastly, we find it notable that the current Fed leadership has extensive crisis and market experience. Jerome Powell, Chairman of the Fed, was trained as a lawyer and has been an investment banker, a partner in private equity firms, an Under Secretary of the Treasury, and a member of the Federal Reserve Board of Governors before ascending to his current role. As Under Secretary of the Treasury for Domestic Finance, he oversaw the successful unwinding of several bank failures associated with the savings and loan crisis, the insolvency of the FDIC’s Bank Insurance Fund, and the Salomon Treasury auction bid-rigging scandal in the early 1990s. Randal Quarles, the Vice Chair of the Federal Reserve for Supervision, was also trained as a lawyer and has extensive real world experience in investment banking, private equity, and crisis management while in government. Quarles worked on bank failures associated with the savings and loan crisis in the early 1990s and, at the IMF, worked on responses to debt crises in Argentina, Turkey, and Brazil, among others. Similar to Powell, he also served as Under Secretary of the Treasury for Domestic Finance.

Given this experience, we believe the Fed will continue to focus on data rather than models, which would otherwise have them raise rates much more quickly than expected. Absent data that clearly demonstrates that the economy has entered the last stages of the current recovery cycle, we do not believe the current leadership will risk embarking on a tightening path that may prematurely end it.
Outlook on the United States

Notes
1. As of 17 September 2018. Source: Credit Suisse
2. US Census Bureau, Income and Poverty in the United States: 2017, September 2018
3. Households in which the householder was under 25 years old experienced real median income growth of -5.8%. Households in which the householder was an unmarried female, black, Asian, or lived inside a principal city also experienced less negative real median income growth at levels that were not statistically significant.
4. While households do have a number of other income sources—social benefits; retirement income; interest, dividends, and rents; child support and alimony; etc.—earnings made up 79% of aggregate pre-tax total money income in 2017.

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Published on 4 October 2018.
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