We remain concerned about weak gross private investment (the latest year-over-year figure is -3.4%). Investment is generally a strong signal for the direction of the economy, and to the extent that commodity prices, industrial production, and ISM readings are stabilizing, that could be a good sign that investment might not get worse from here.

The U.S. Federal Reserve held its annual economic policy symposium from August 25-27, and Chair Janet Yellen stated during the meeting that the case for an increase in the federal funds rate had strengthened in recent months. Nevertheless, she kept the Fed’s options open by reiterating that its policy rate decisions would be data-dependent. Labor market indicators are thought to be at the front of the Fed’s mind right now in weighing a potential rate hike, and the Fed could make a move as soon as its policy meeting on September 20-21.

Global Economy

In a big legislative victory for Prime Minister Narendra Modi, India’s upper house of parliament approved a goods-and-services tax (GST) that would create a single national market and replace a multitude of other taxes. This could be a significant breakthrough for India in terms of making it easier to do business within the country. It is important to note, however, that the bill has a few more steps to pass in the Indian government before implementation. There also could be delays to the bill. Regionally, there would be winners and losers with the GST. The southern and western Indian states, which are richer and more self-reliant, would lose tax revenue to the poorer states. The new
simplified tax would decrease both the richer states’ revenue and their allocated revenue from the central government. We believe that domestic cross-regional businesses would benefit the most from the GST since it would simplify tax-compliance across state lines.

Since Modi took office in 2014, the market has been waiting for “big-bang” type reforms. While we have been encouraged by the number of smaller reforms that should have an impact greater than the sum of their parts, the market has been disappointed. The GST is a significant reform the market has been looking for, and could prove to be a very important development over the long-term.

In China, authorities approved a stock-trading link between Hong Kong and the mainland city of Shenzhen, which is a step toward opening up the country’s equity market to international investors. The move could be a signal that Chinese officials, who’ve pledged to open their markets to foreign investors, are comfortable that the program won’t result in significant capital outflows. The link was intended to be opened last year, but was abandoned after that summer’s equity rout and this January’s botched introduction of market circuit breakers.

We were surprised by the timing of the decision because China has in the last year once again clamped down on its capital account, which has stabilized the country’s outflows. The timing of this reform could be an indication that China is more comfortable with domestic and international conditions, and is also less concerned about a stronger U.S. dollar (i.e., not concerned about a large weakening of the renminbi).

In Brazil, the Senate voted to remove Dilma Rousseff as president following her impeachment trial. Interim President Michel Temer, who was Rousseff’s vice president, will now finish out her second term, which runs through the end of 2018. The outcome of the vote was not a surprise, but having an official end to the country’s political crisis is a step forward. There have been some moderately positive indicators lately in terms of Brazil’s economy, but we expect economic growth to continue to be weak over the next year, and it is likely that unemployment will keep rising as well during that time.

Despite the political situation becoming more favorable, Brazil needs to make changes that include addressing its ballooning pension and social security payments, investing in infrastructure, removing barriers to foreign competition, and dealing with an indebted consumer. Brazil relied heavily on the commodity boom for its previous economic growth, which shielded many of the systematic problems in its economy. We will be watching to see if the new leadership demonstrates that it is serious about reforms designed to create a better investment environment. Right now the jury is still out.

Our Perspective
Global equity markets produced moderately positive returns during August on both a local currency and U.S. dollar basis, while U.S. markets were essentially flat on a total return basis. Valuations in the broad U.S. stock market remain somewhat elevated, but we continue to see little evidence of excesses in the market or economy that would need to be unwound. In this environment, discernment and flexibility are critical.

Given the slow global growth environment, in portfolios geared toward investors that need capital growth, we are targeting investments in fundamentally strong businesses that are not heavily reliant upon macroeconomic growth to drive sales and earnings. More specifically, we see value in businesses that we believe have control of their destiny and are taking share in large established markets or are creating new markets on their own. The goal is to identify companies trading at attractive valuations relative to their growth potential.

For fixed income investors and investors with a shorter time horizon or current income needs, we still see value in the corporate bond sector, but remain mindful that we are further along in the economic cycle and valuations are not as compelling as they were previously. We have in fact trimmed some of our credit exposure periodically this year, and could look to do so again during bouts of market strength. Regarding government debt in general, our portfolios continue to have a sizeable allocation to Treasury Inflation-Protected Securities (TIPS), and we increased intermediate-term nominal U.S. Treasury exposure earlier in the year to diversify sector allocation and yield curve positioning. Our short duration positioning has not materially changed, however. We believe a shorter duration remains in clients’ best interests because investors are still not being paid to take on significantly higher levels of interest rate risk (i.e., the term premium, which is the excess yield that investors require to hold a long-term bond instead of a series of shorter-term bonds, remains negative).

In our view, short-term and income-oriented investors should also explore equities that display stable fundamentals and are trading at attractive valuations. We believe companies that generate strong, stable cash flows and pay an attractive dividend could be compelling options for these types of investors in the current environment.

Source: FactSet. Analysis: Manning & Napier Advisors, LLC (Manning & Napier).

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