

The Market Implications of Global Disarray

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The Ten Surprises of 2018

These surprises were announced Tuesday, January 2, 2018. The definition of a surprise is an event that the average investment professional would assign a one out of three chance of taking place, but where I believe the event is probable, with better than a 50% chance of happening

1. China finally decides that a nuclear capability in the hands of an unpredictable leader on its border is not tolerable even though North Korea is a communist buffer between itself and democratic South Korea. China cuts off all fuel and food shipments to North Korea, which agrees to suspend its nuclear development program but not give up its current weapons arsenal.
2. Populism, tribalism and anarchy spread around the world. In the United Kingdom Jeremy Corbyn becomes the next Prime Minister. In spite of repressive action by the Spanish government, Catalonia remains turbulent. Despite the adverse economic consequences of the Brexit vote, the unintended positive consequence is that it brings continental Europe closer together with more economic cooperation and faster growth.
3. The dollar finally comes to life. Real growth exceeds 3% in the United States, which, coupled with the implementation of some components of the Trump pro-business agenda, renews investor interest in owning dollar-denominated assets, and the euro drops to 1.10 and the yen to 120 against the dollar. Repatriation of foreign profits held abroad by U.S. companies helps.
4. The U.S. economy has a better year than 2017, but speculation reaches an extreme and ultimately the S&P 500 has a 10% correction. The index drops toward 2300, partly because of higher interest rates, but ends the year above 3000 since earnings continue to expand and economic growth heads toward 4%.
5. The price of West Texas Intermediate Crude moves above \$80. The price rises because of continued world growth and unexpected demand from developing markets, together with disappointing hydraulic fracking production, diminished inventories, OPEC discipline and only modest production increases from Russia, Nigeria, Venezuela, Iraq and Iran.

The Ten Surprises of 2018 (Cont'd)

6. Inflation becomes an issue of concern. Continued world GDP growth puts pressure on commodity prices. Tight labor markets in the industrialized countries create wage increases. In the United States, average hourly earnings gains approach 4% and the Consumer Price Index pushes above 3%.
7. With higher inflation, interest rates begin to rise. The Federal Reserve increases short-term rates four times in 2018 and the 10-year U.S. Treasury yield moves toward 4%, but the Fed shrinks its balance sheet only modestly because of the potential impact on the financial markets. High yield spreads widen, causing concern in the equity market.
8. Both NAFTA and the Iran agreement endure in spite of Trump railing against them. Too many American jobs would be lost if NAFTA ended, and our allies universally support continuing the Iran agreement. Trump begins to think that not signing on to the Trans-Pacific Partnership was a mistake as he sees the rise of China's influence around the world. He presses for more bilateral trade deals in Asia.
9. The Republicans lose control of both the Senate and the House of Representatives in the November election. Voters feel disappointed that many promises made during Trump's presidential campaign were not implemented in legislation and there is a growing negative reaction to his endless Tweets. The mid-term election turns out to be a referendum on the Trump Presidency.
10. Xi Jinping, having broadened his authority at the 19th Party Congress in October, focuses on China's credit problems and decides to limit business borrowing even if it means slowing the economy down and creating fewer jobs. Real GDP growth drops to 5.5%, with only minor implications for world growth. Xi proclaims this move will ensure the sustainability of China's growth over the long term.

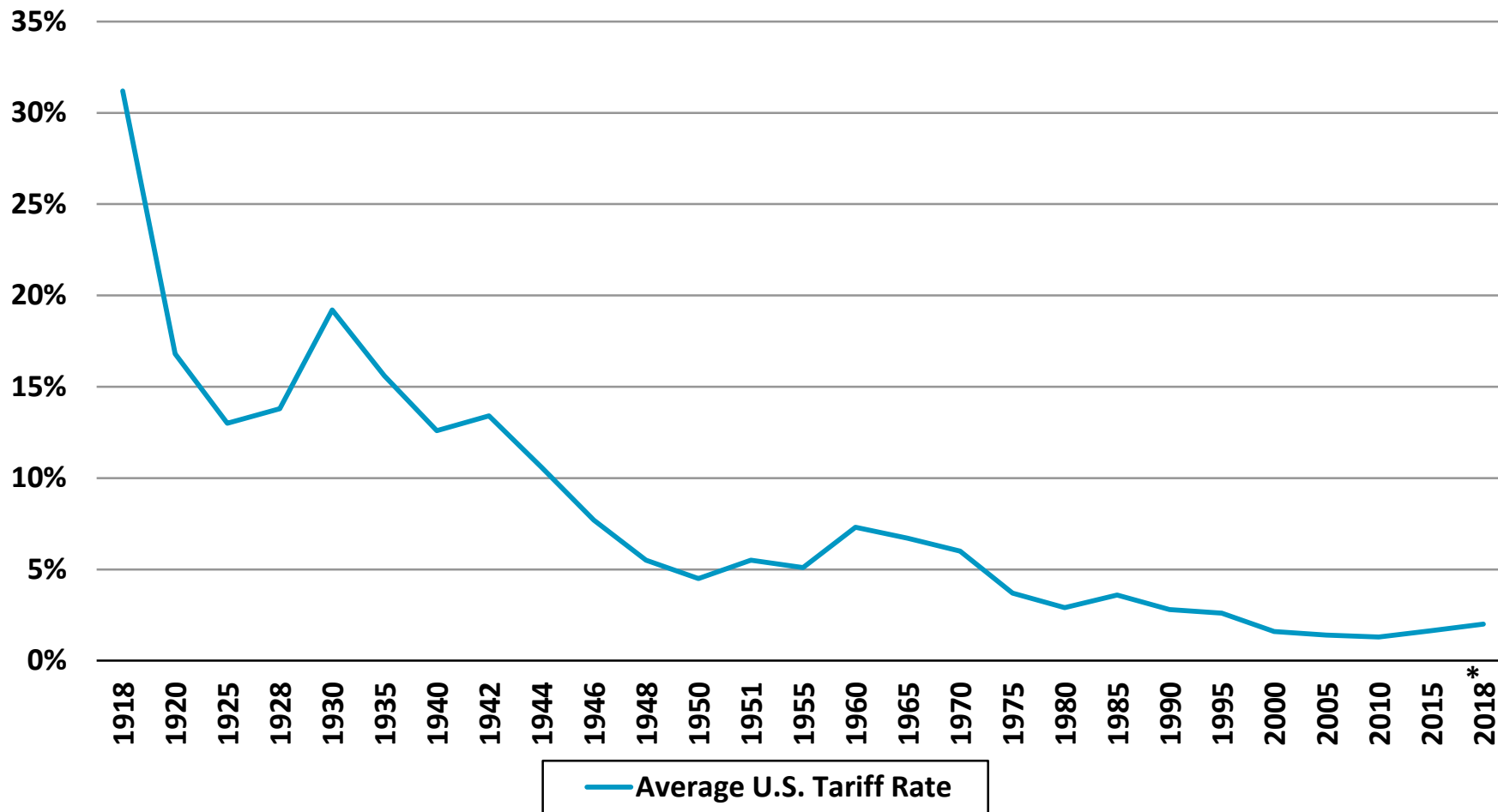
“Radical” Asset Allocation[^]

Asset Class	%	
Global large cap Multinationals	5%	Fair value in terms of yield and multiple
Other U.S. long only	10%	Moderate growth continuing
European long only	5%	Reduced the weight due to slowing growth
Emerging Market equities	10%	Growth accumulating
Japanese Equities	10%	Stimulus working; currency risk
Hedge Funds (all strategies)	10%	Selected strategies attractive
Private Equity	10%	Competition intense for deals
Real Estate	10%	Taking some profits
Gold	0%	
Natural Resources and agricultural commodities	5%	World standard of living rising
Non-conventional High Yield Fixed Income (Mezzanine, Leveraged Loans, Emerging Market Debt)	15%	Still some value in selective categories, willing to take credit risk over duration risk
Cash	10%	Added 5% to cash tactically, awaiting pullback
Total	100%	

[^] Note: As reflected on page 39 (“Disclaimer”), the above reflects the personal views of Byron Wien, Vice Chairman & Joe Zidle, Managing Director in the Private Wealth Solutions Group and does not necessarily reflect the view of Blackstone itself

Inward Thinking Takes Over

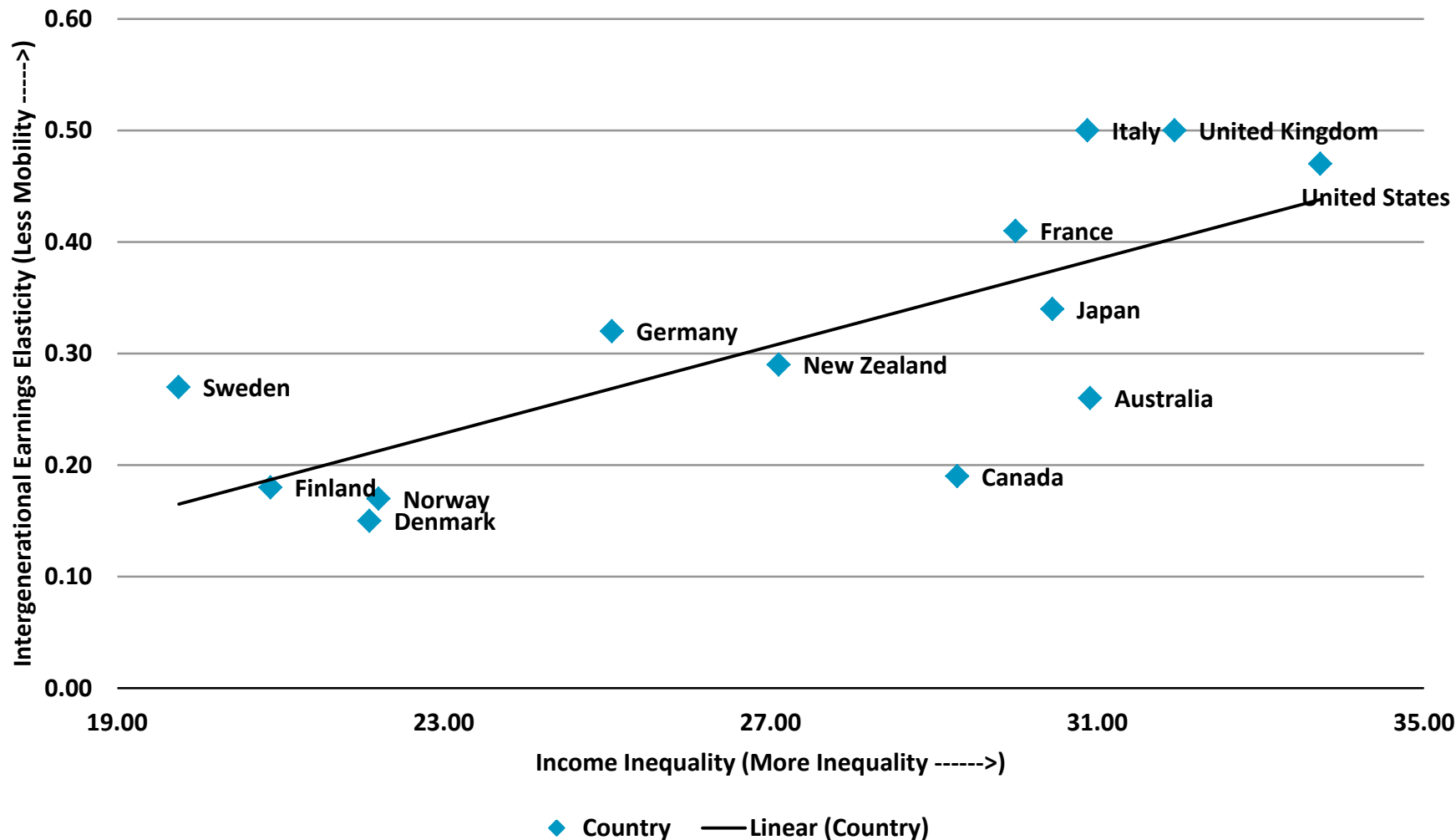
A Century of Reduced Tariffs Ends



source: Blackstone, USTR (June 2018).

The Gini Coefficient

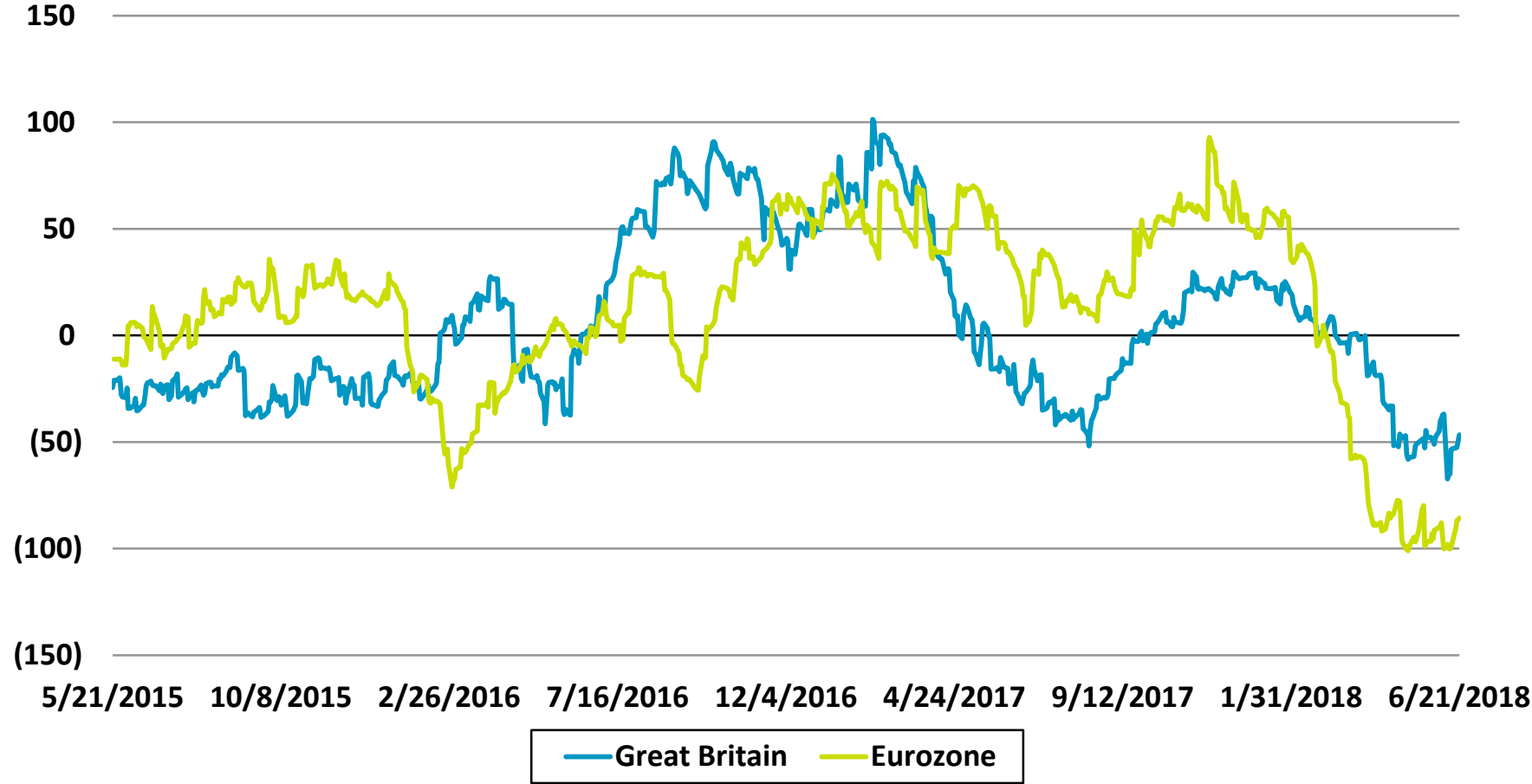
More Inequality is Associated with Less Mobility across the Generations



Source: Strategas Research Partners (June 2018).

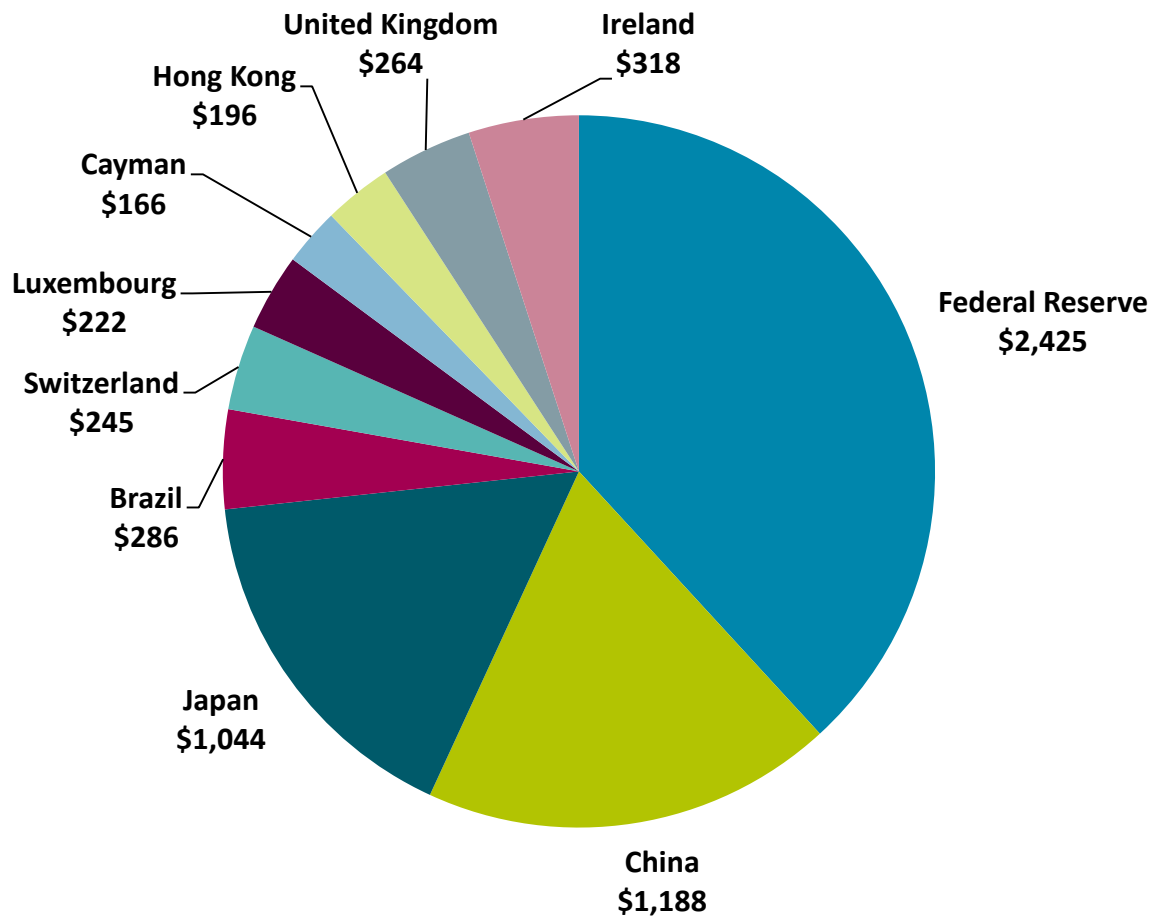
Eurozone and U.K. Struggling

Economic Data From Europe and UK is weaker than forecasted



Source: Bloomberg, Blackstone (June 2018).
Citi Economic Surprise Index: Y axis represents a diffusion index: each data point receives a score of +1 for beating consensus, 0 for meeting consensus and -1 for missing consensus forecast.

Major Holders of U.S. Treasury Debt (\$bn)



Source: Blackstone; Bloomberg (June 2018).

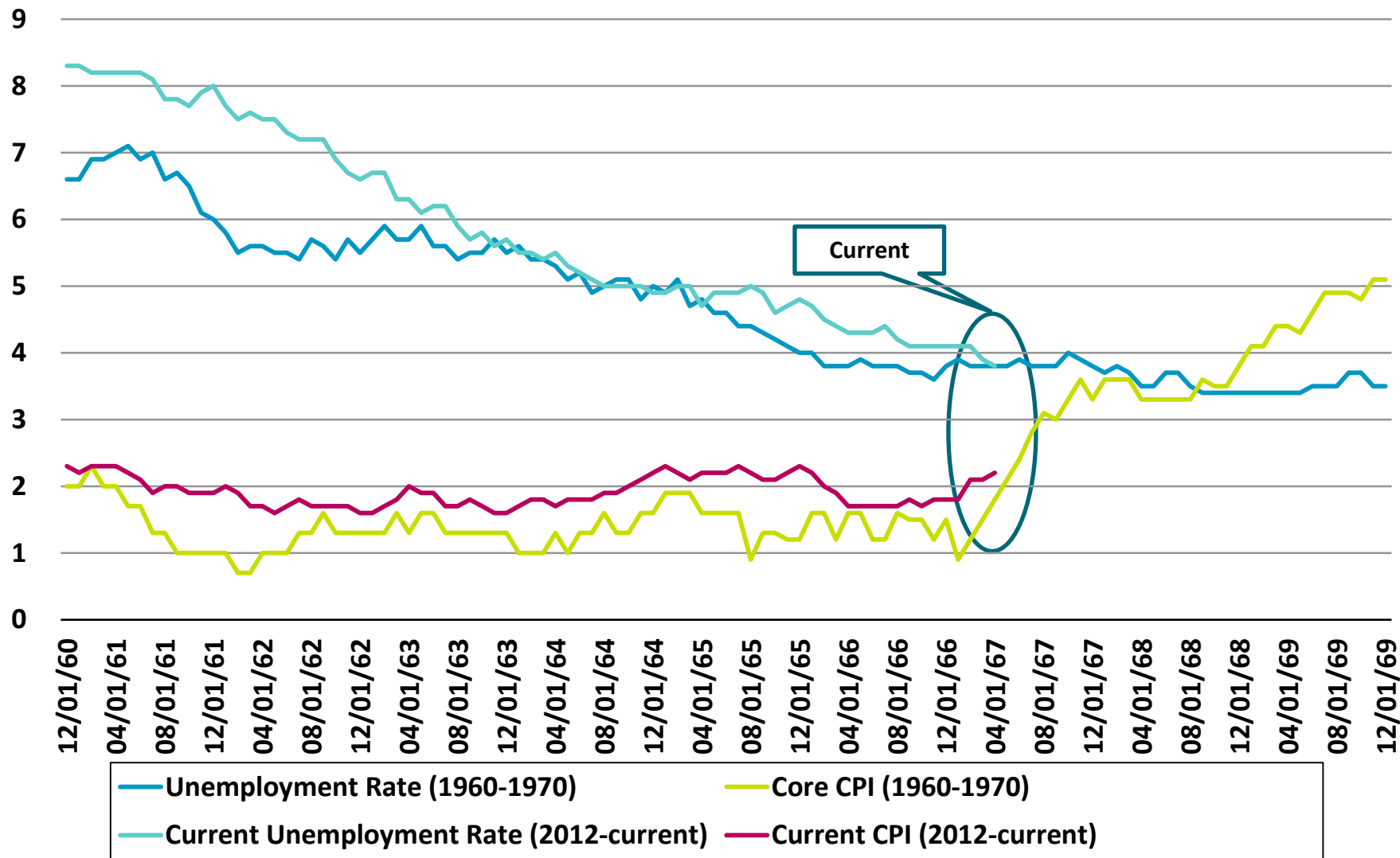
Returns from Debt-Financing by Decade

12/31/1949 – 3/31/2018
(\$ in billions)

Date Range	Decade Change in Debt	Decade Change in GDP	GDP/Debt
12/31/1949 – 12/31/1959	\$352.9	\$258.3	0.73
12/31/1959 – 12/31/1969	776.1	511.4	0.66
12/31/1969 – 12/31/1979	2,846.2	1,690.0	0.59
12/31/1979 – 12/31/1989	8,935.0	3,032.7	0.34
12/31/1989 – 12/31/1999	13,435.5	4,162.7	0.31
12/31/1999 – 12/31/2009	27,886.5	4,640.4	0.17
12/31/2009 – 03/31/2018 ⁽¹⁾	14,968.8	5,390.3	0.36

Source: Ned Davis Research (June 2018).

Inflation is Coming: 1960's vs Today



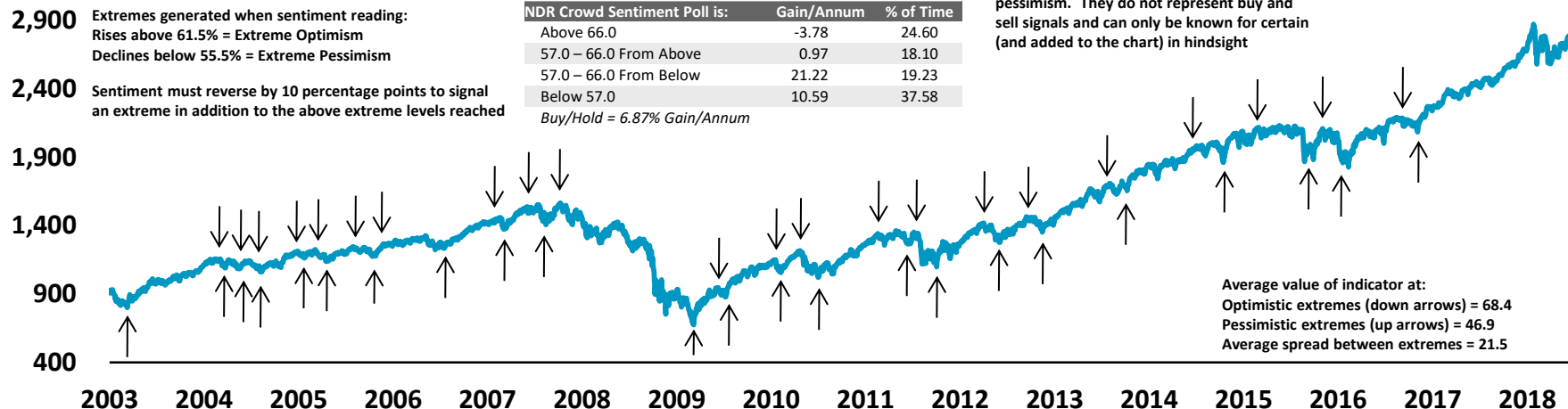
Source: Bloomberg, Blackstone (June 2018).

NDR Crowd Sentiment Poll (7/31/2002 – 6/26/2018)

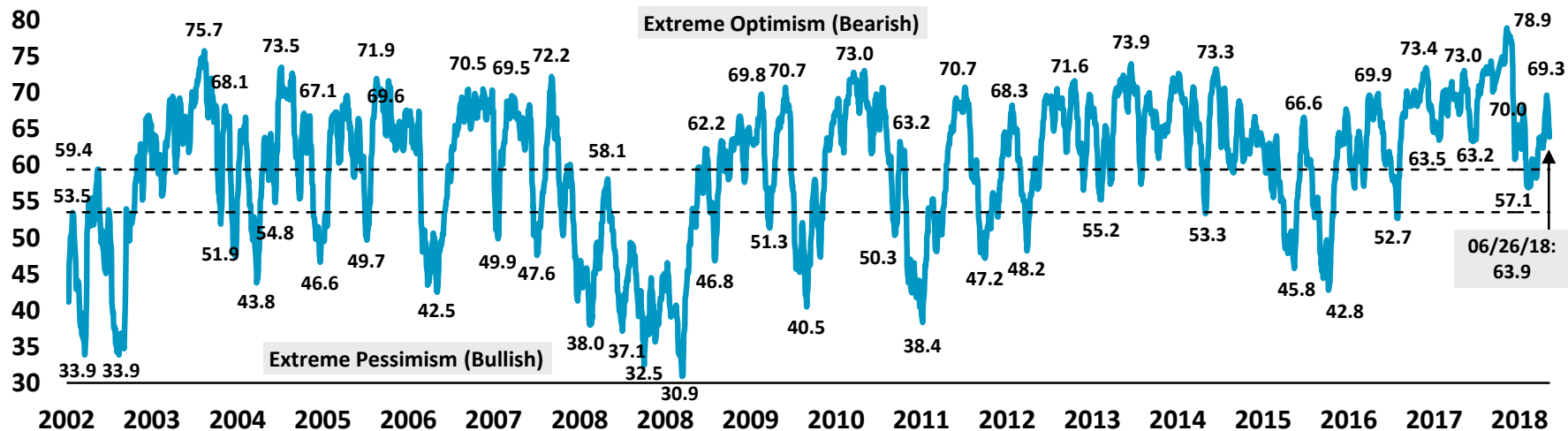
S&P 500 Composite Index⁽¹⁾⁽²⁾

S&P 500 Index Performance Full History: 12/1/1995–6/26/2018		
NDR Crowd Sentiment Poll is:	Gain/Annum	% of Time
Above 66.0	-3.78	24.60
57.0 – 66.0 From Above	0.97	18.10
57.0 – 66.0 From Below	21.22	19.23
Below 57.0	10.59	37.58
<i>Buy/Hold = 6.87% Gain/Annum</i>		

Arrows represent extremes in optimism and pessimism. They do not represent buy and sell signals and can only be known for certain (and added to the chart) in hindsight



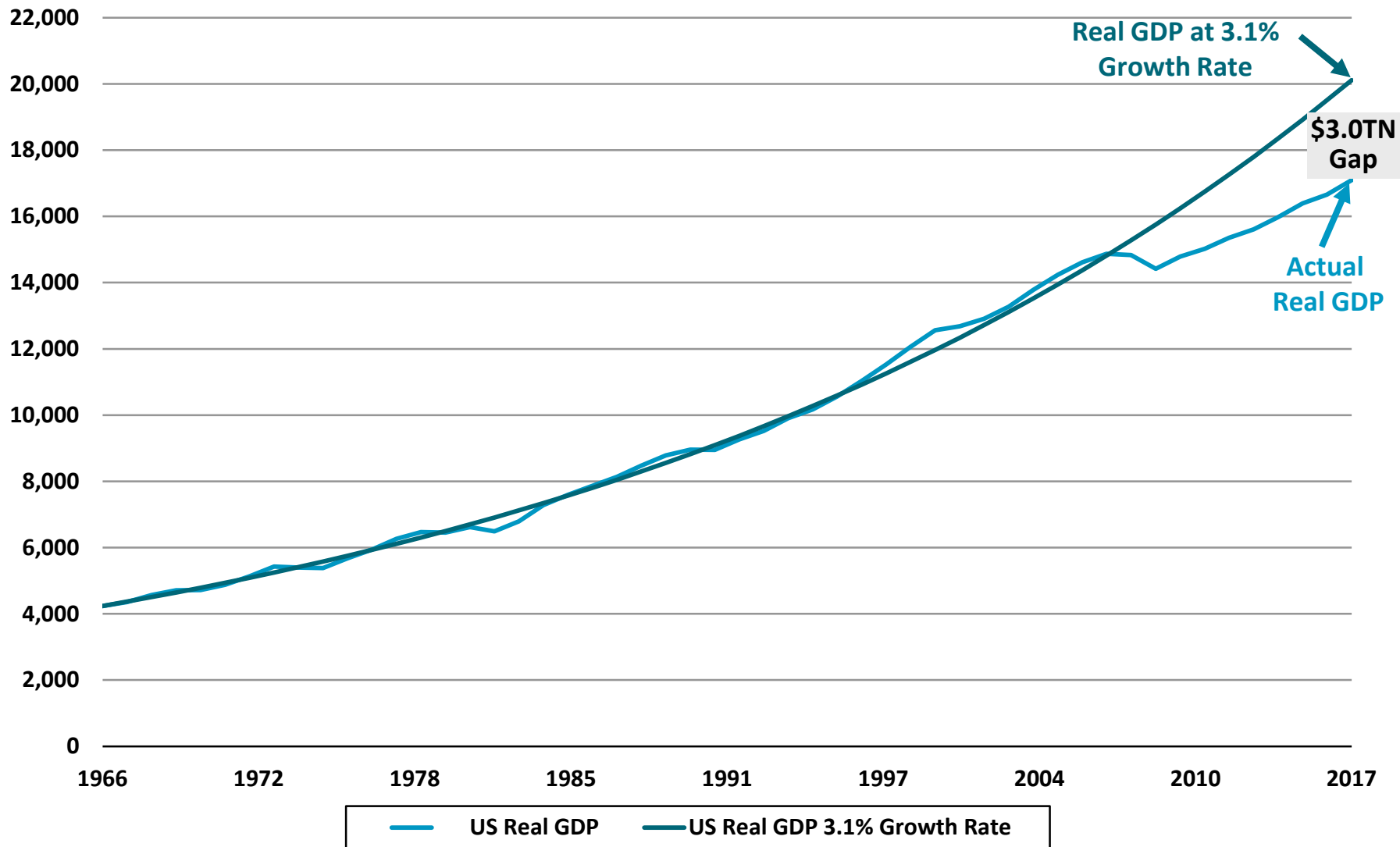
NDR Crowd Sentiment Poll⁽³⁾



Source: Ned Davis Research, Inc. (June 2018)

The Bright Spot: The US Economy

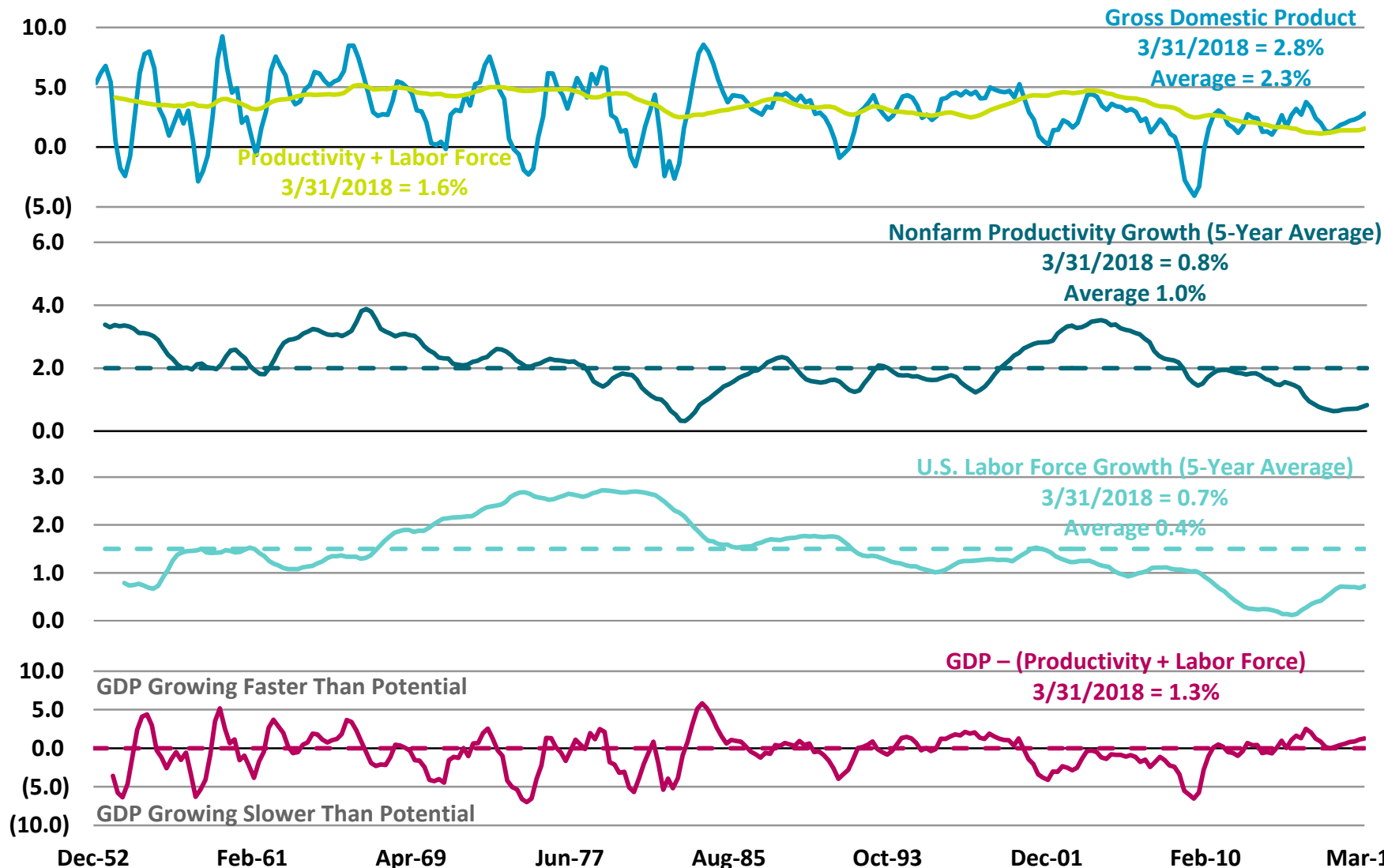
Real GDP Growth Has Broken from Its Trend since 2008



Source: Strategas Research Partners (June 2018).

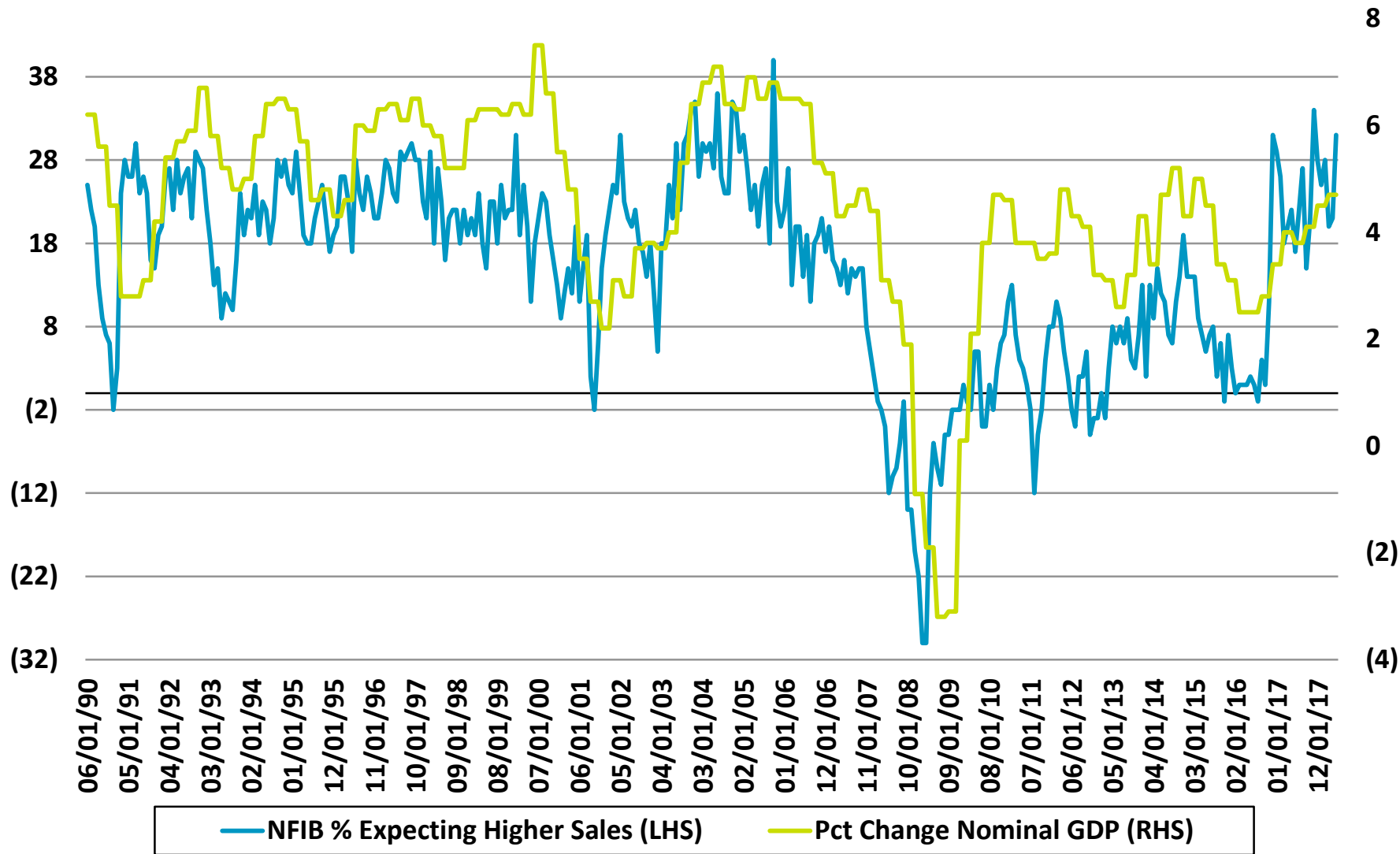
Labor, Productivity and the Growth Rate

Long-Term Composition of Real GDP Growth (5-Year Averages)



Source: Bureau of Labor Statistics. Net Davis Research Group. (June 2018)

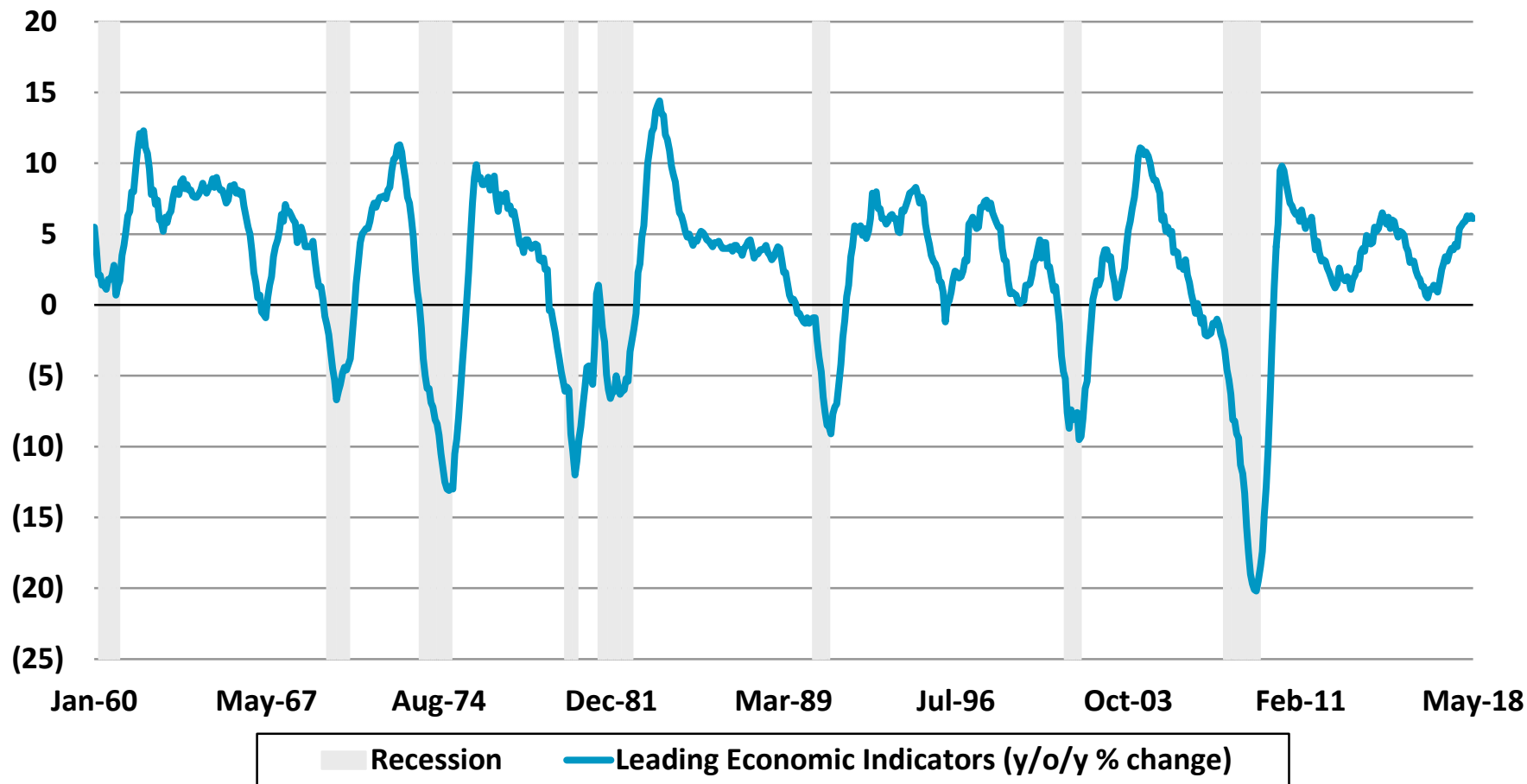
Small Business Sales Growth Expectations & GDP Growth



Source: Bloomberg, Blackstone, Strategas Research Partners (June 2018).

Leading Economic Indicators Still Rising

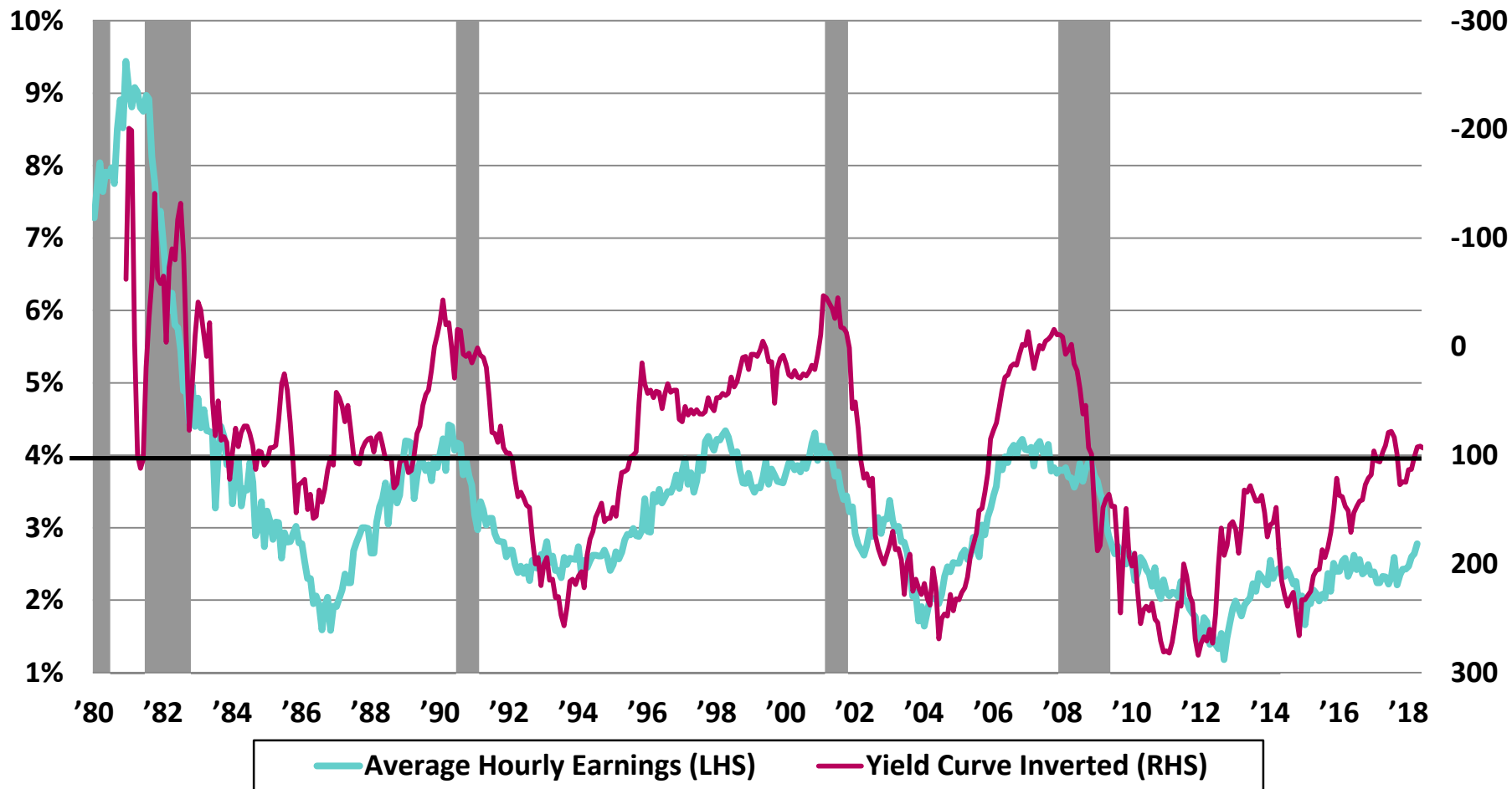
Average of 22 Months from Last Peak to Recession



Source: Bloomberg, Blackstone (June 2018).

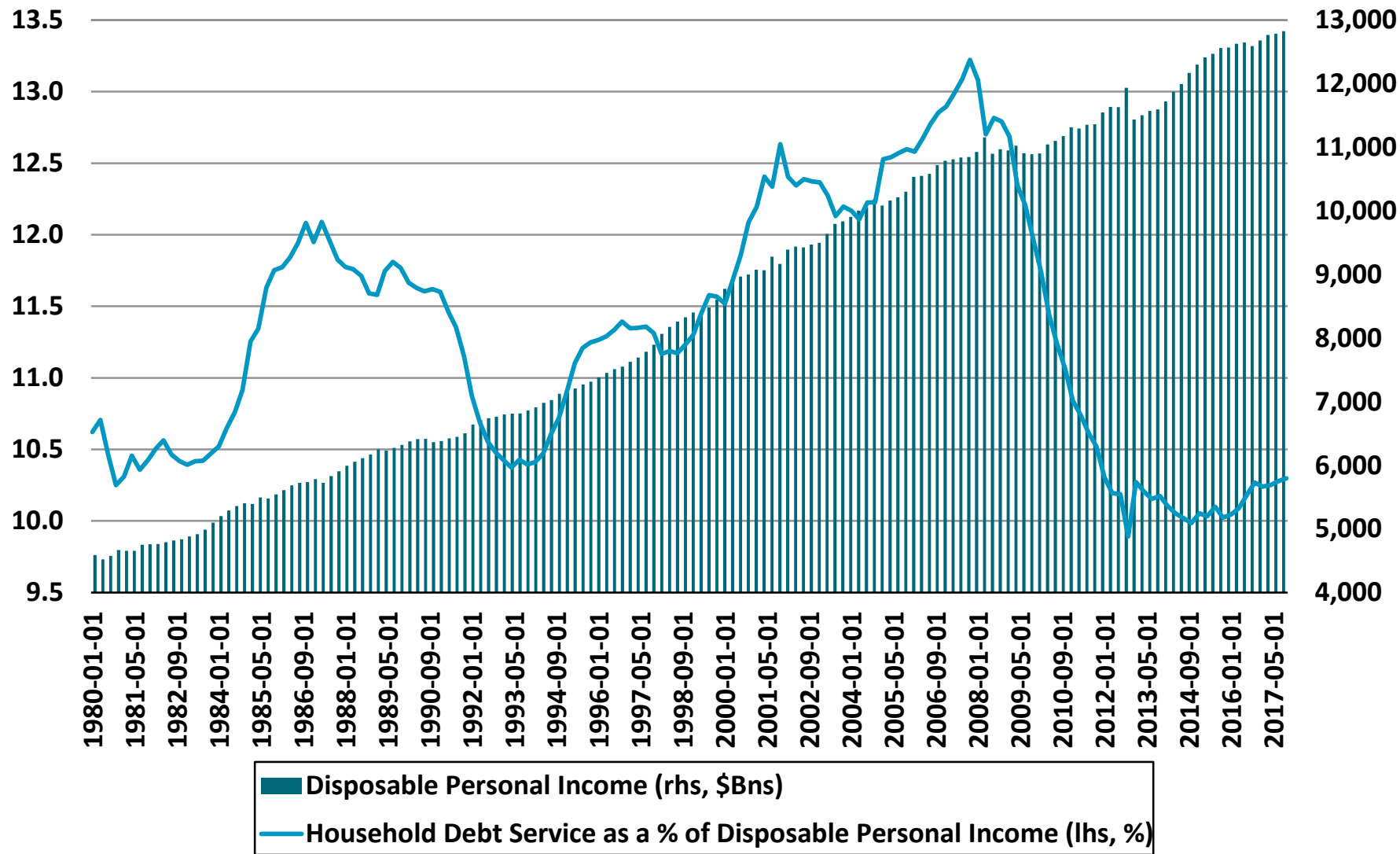
Average Hourly Earnings Are Increasing Slowly

The Yield Curve Inversion leads a recession by 17 months on average



Source: Strategas Research Partners (June 2018).

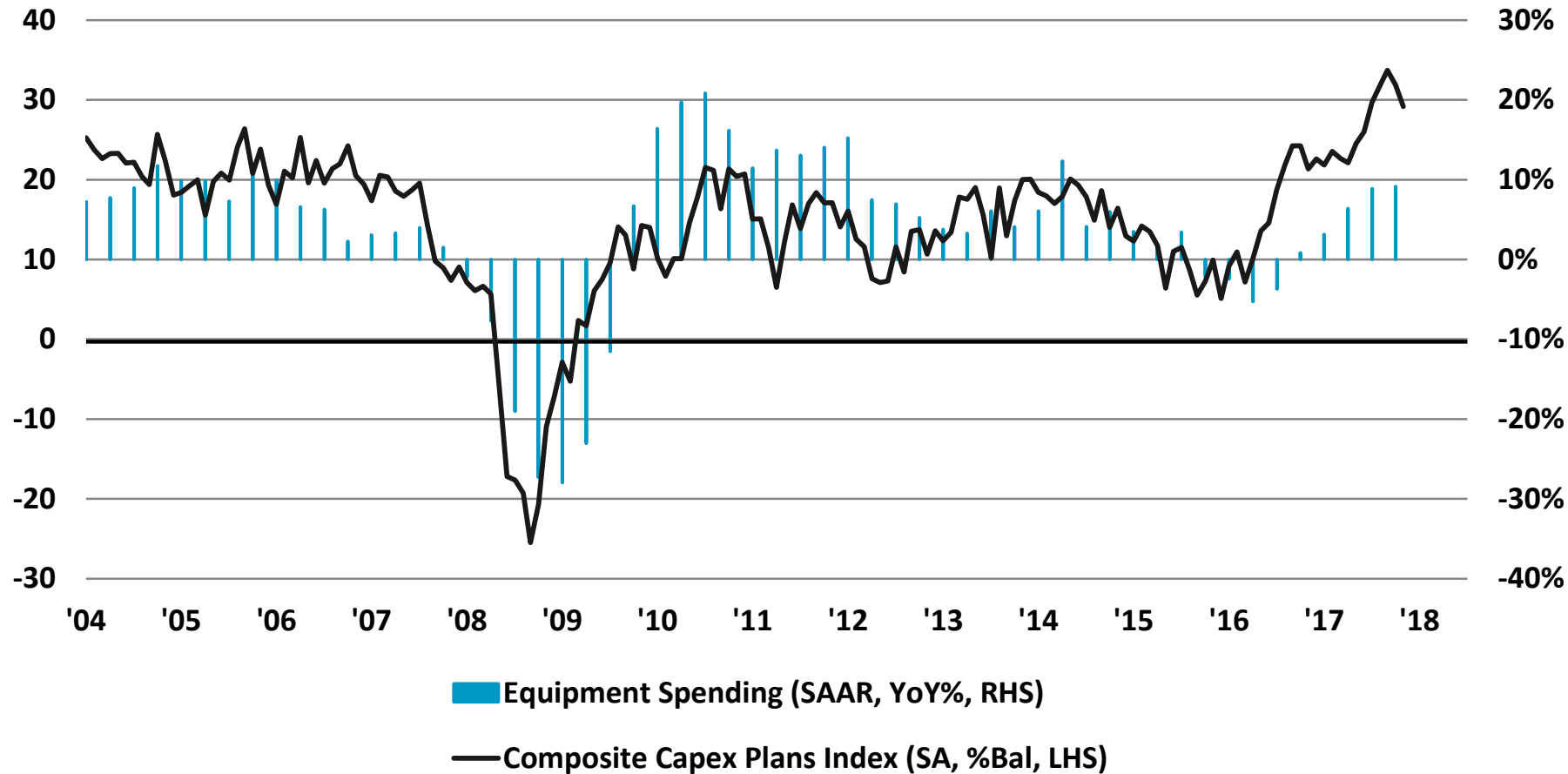
No Cracks in the US Consumer Story



Source: Blackstone, St. Louis Federal Reserve (June 2018).

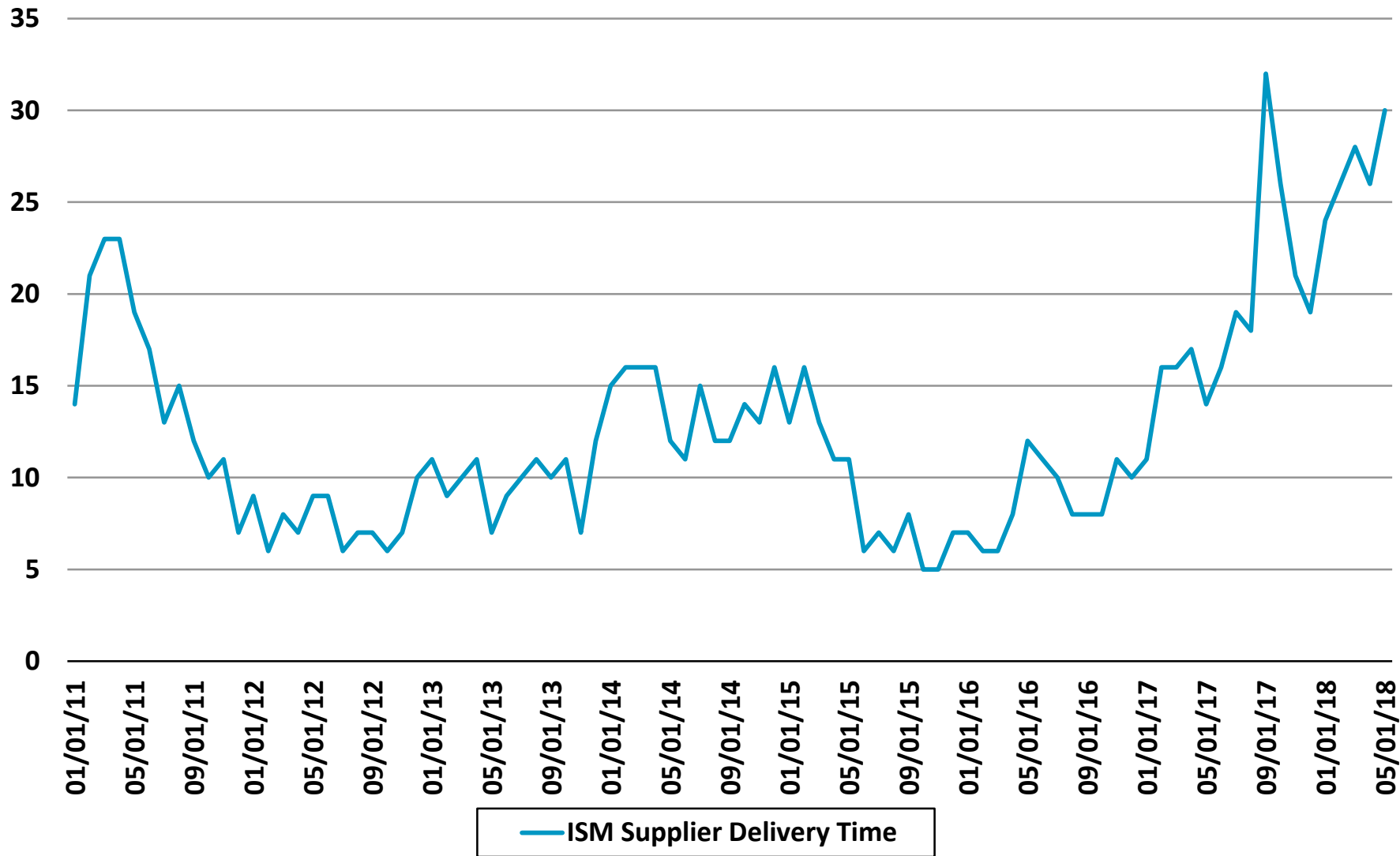
We're Counting on Capex

Correl = 0.74



Source: Strategas Research Partners (June 2018).

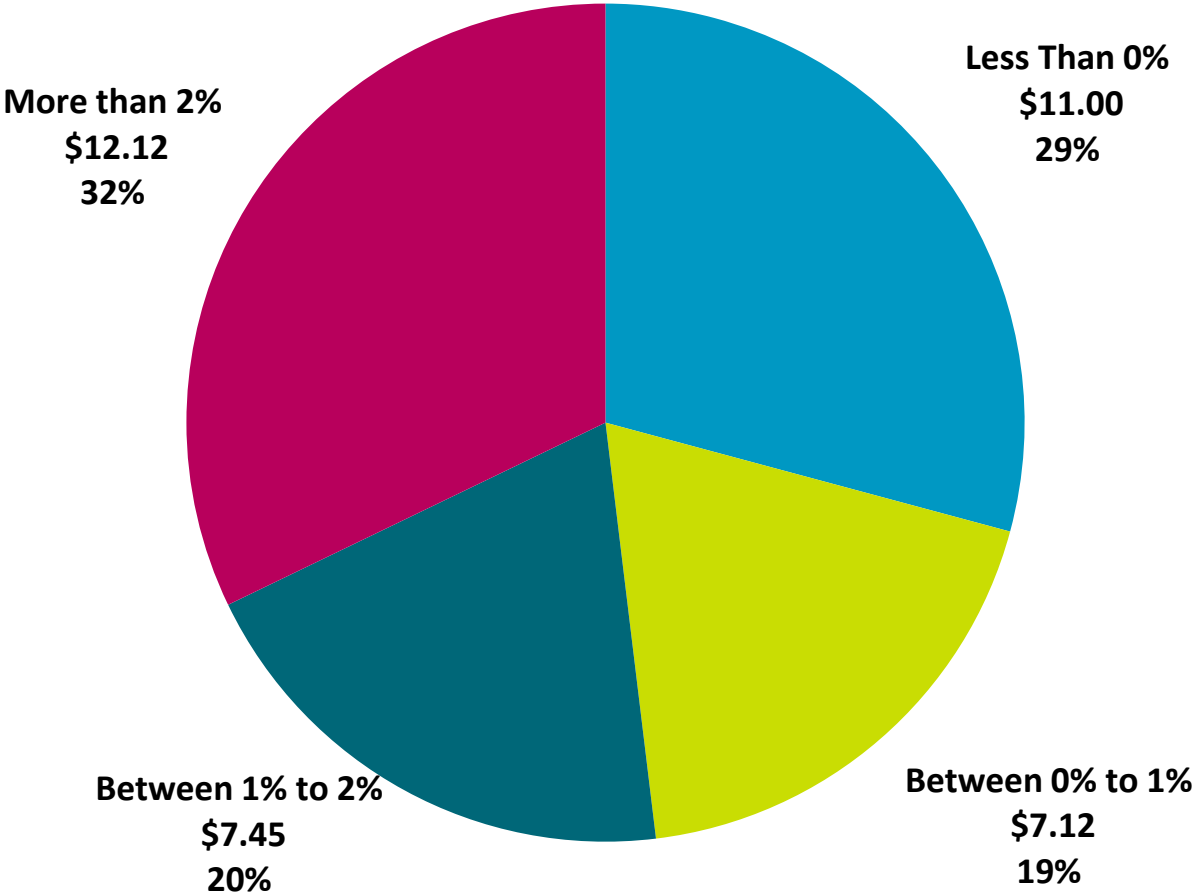
Delivery Times Increasing



Source: Blackstone, Bloomberg (June 2018).

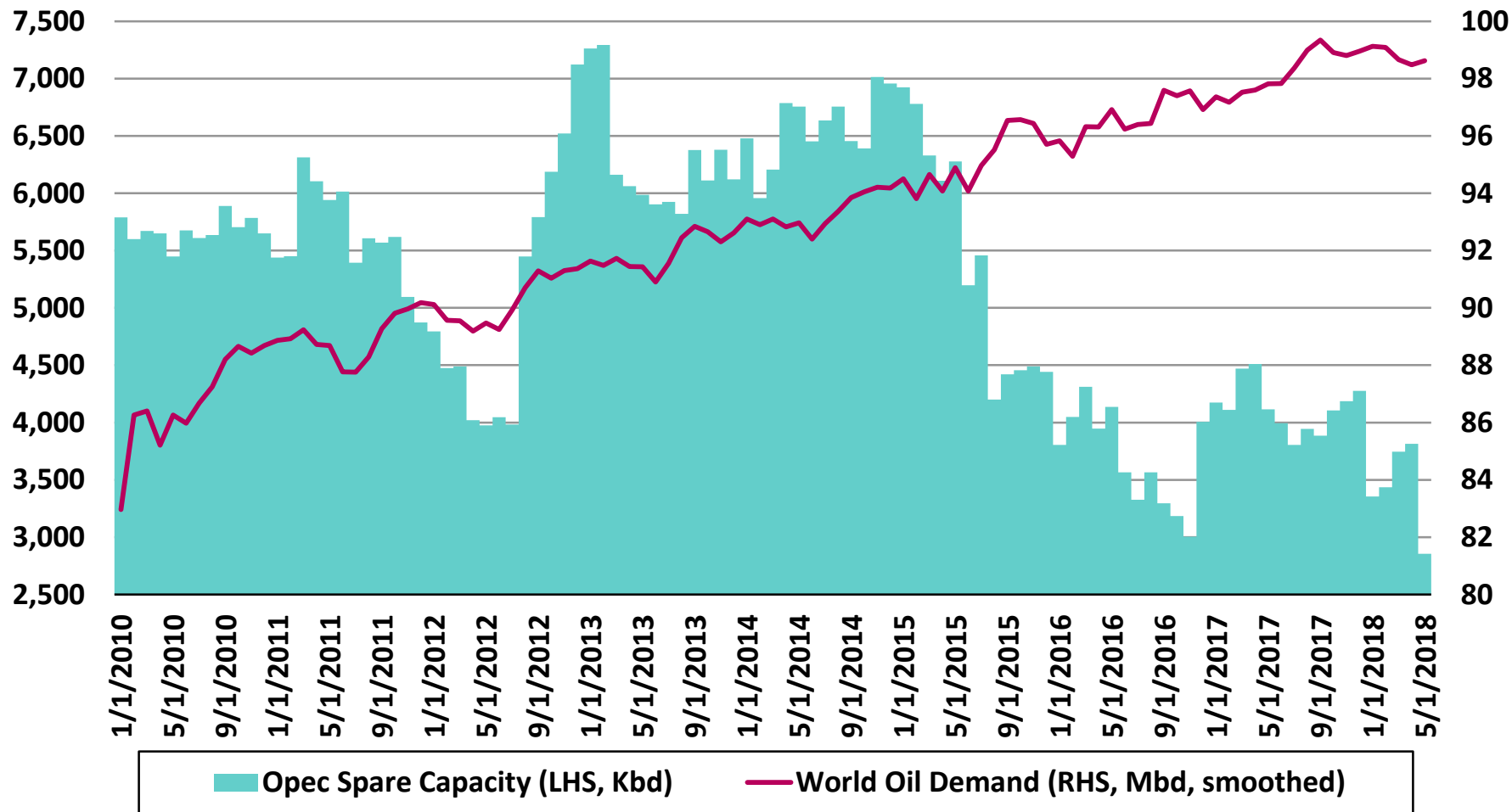
Current U.S. Rates Are Competitive

Total Outstanding Debt = \$37.69 trillion
(\$ in trillions)



Source: Bloomberg; Bianco Research (June 2018).

OPEC Spare Capacity

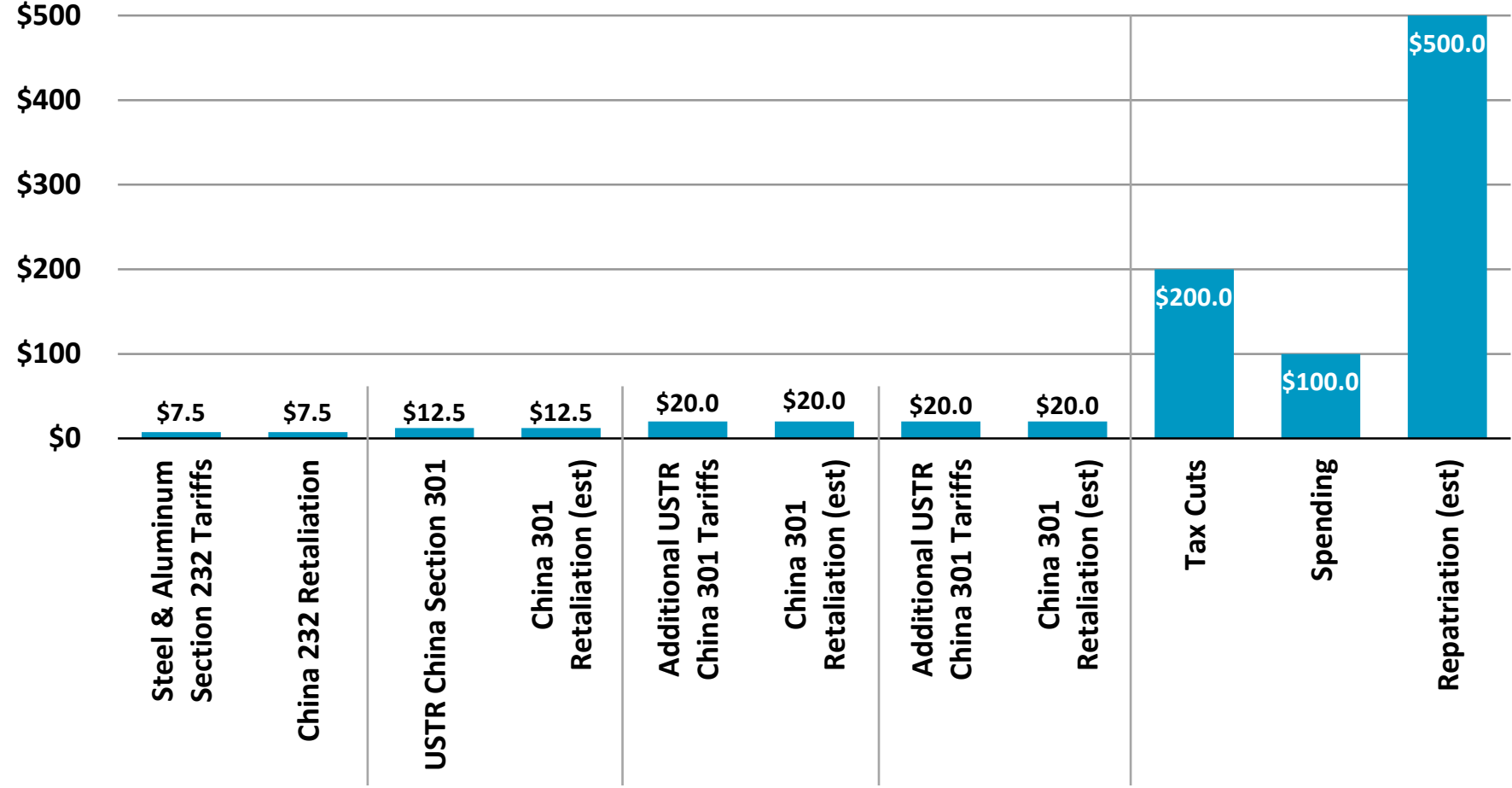


Source: Blackstone; Bloomberg (June 2018).

The Trump Presidency: Protectionism

Comparing the Size of Tariffs with Incremental Fiscal Policy

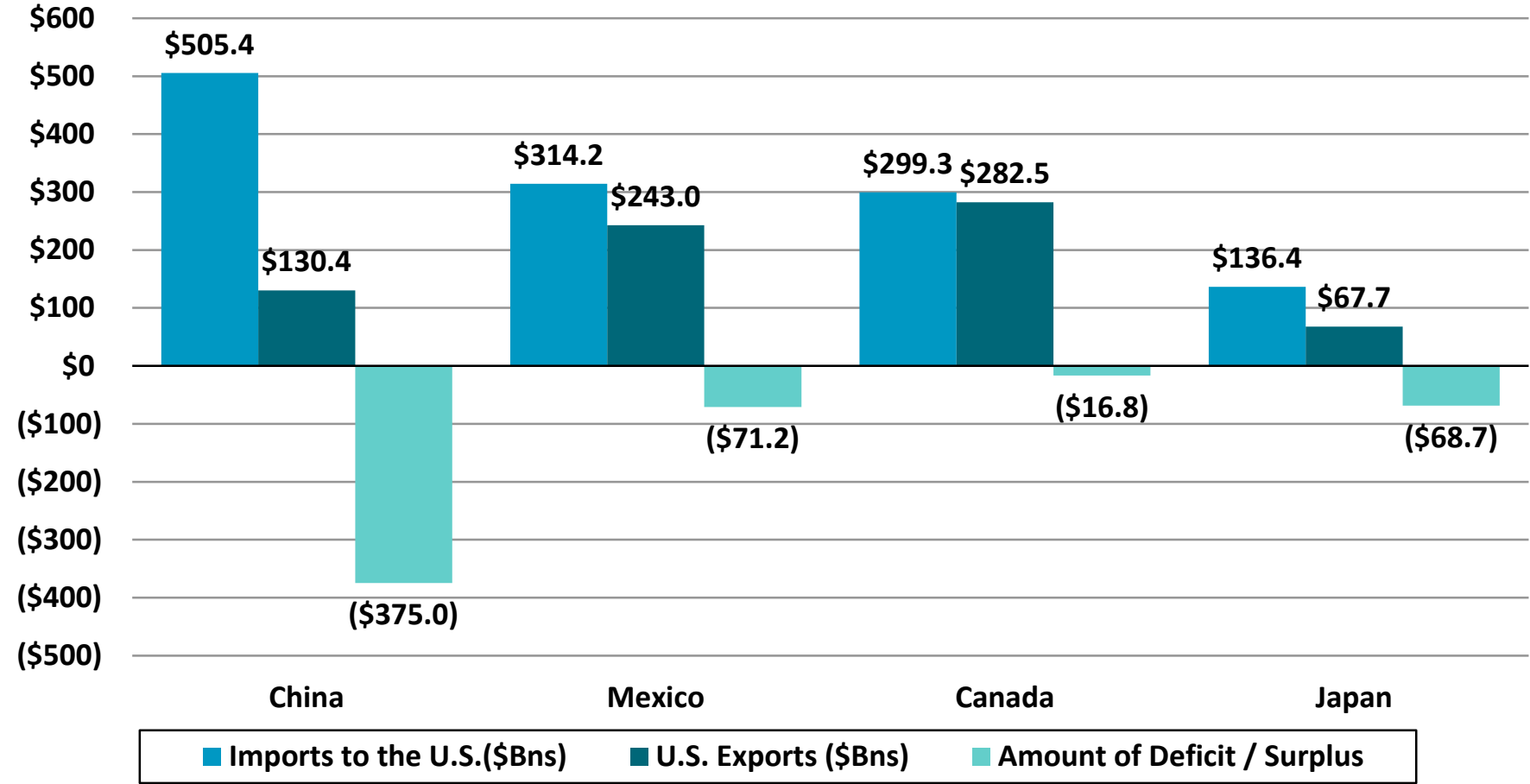
CY 2018
(\$ in billions)



Source: Strategas Research Partners (June 2018).

Top 4 Countries Exporting to the U.S.

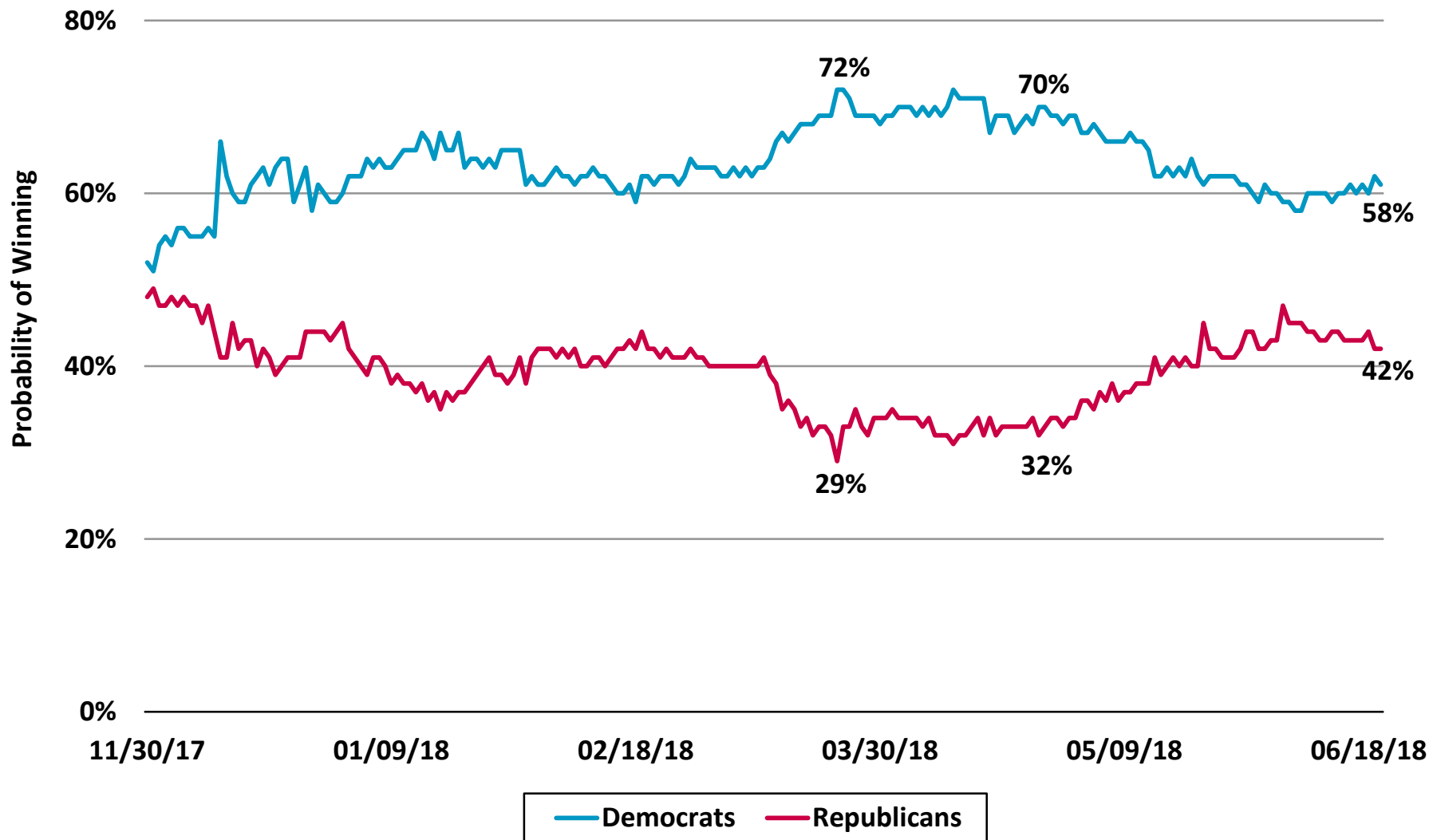
Protectionism and Implications (\$ in billions)



source: US Census Bureau, Blackstone (June 2018).

Who Will Control the House after the 2018 Midterms?

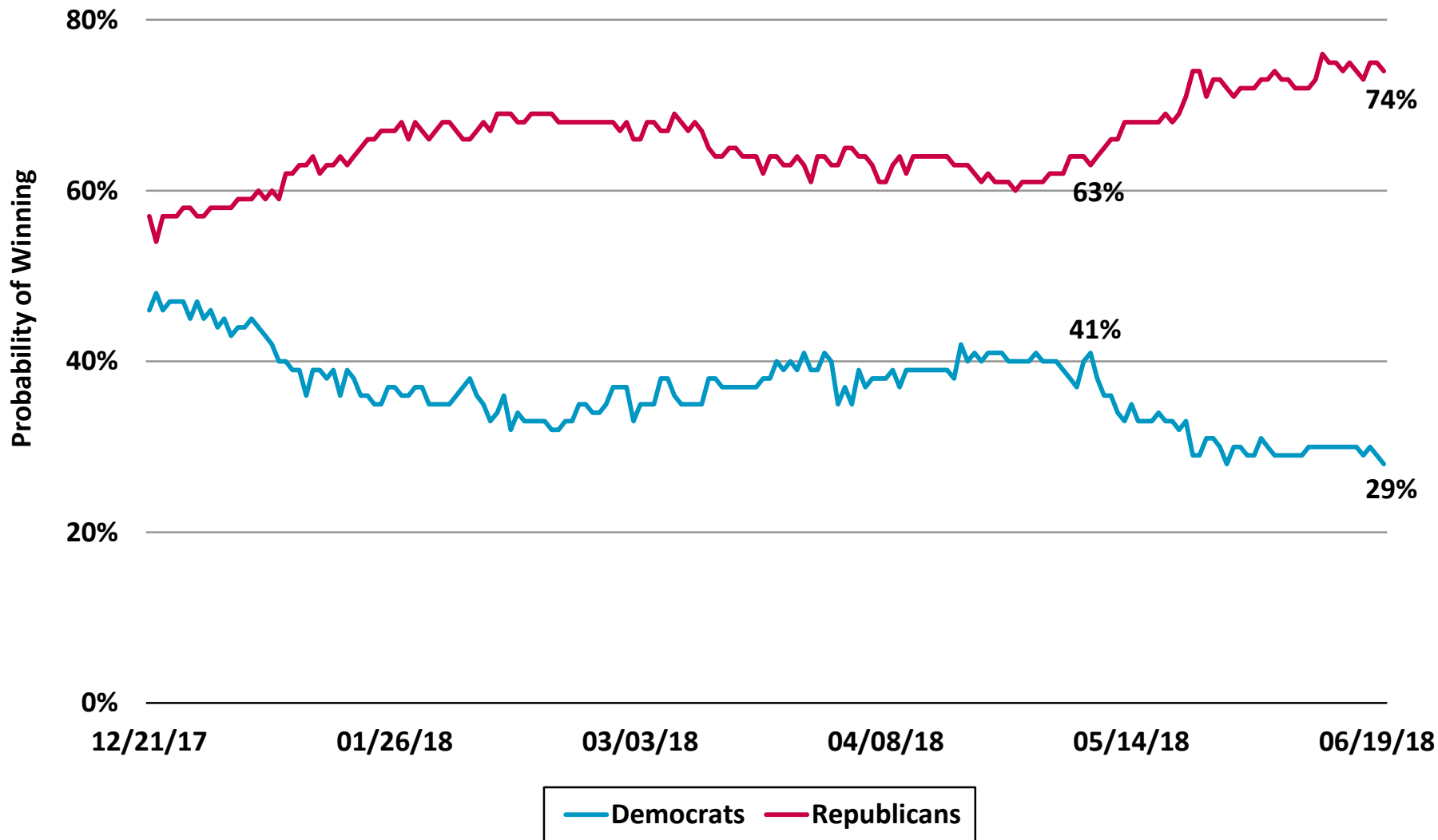
Predict.org Betting



Source: Predictit, Bianco Research (June 2018).

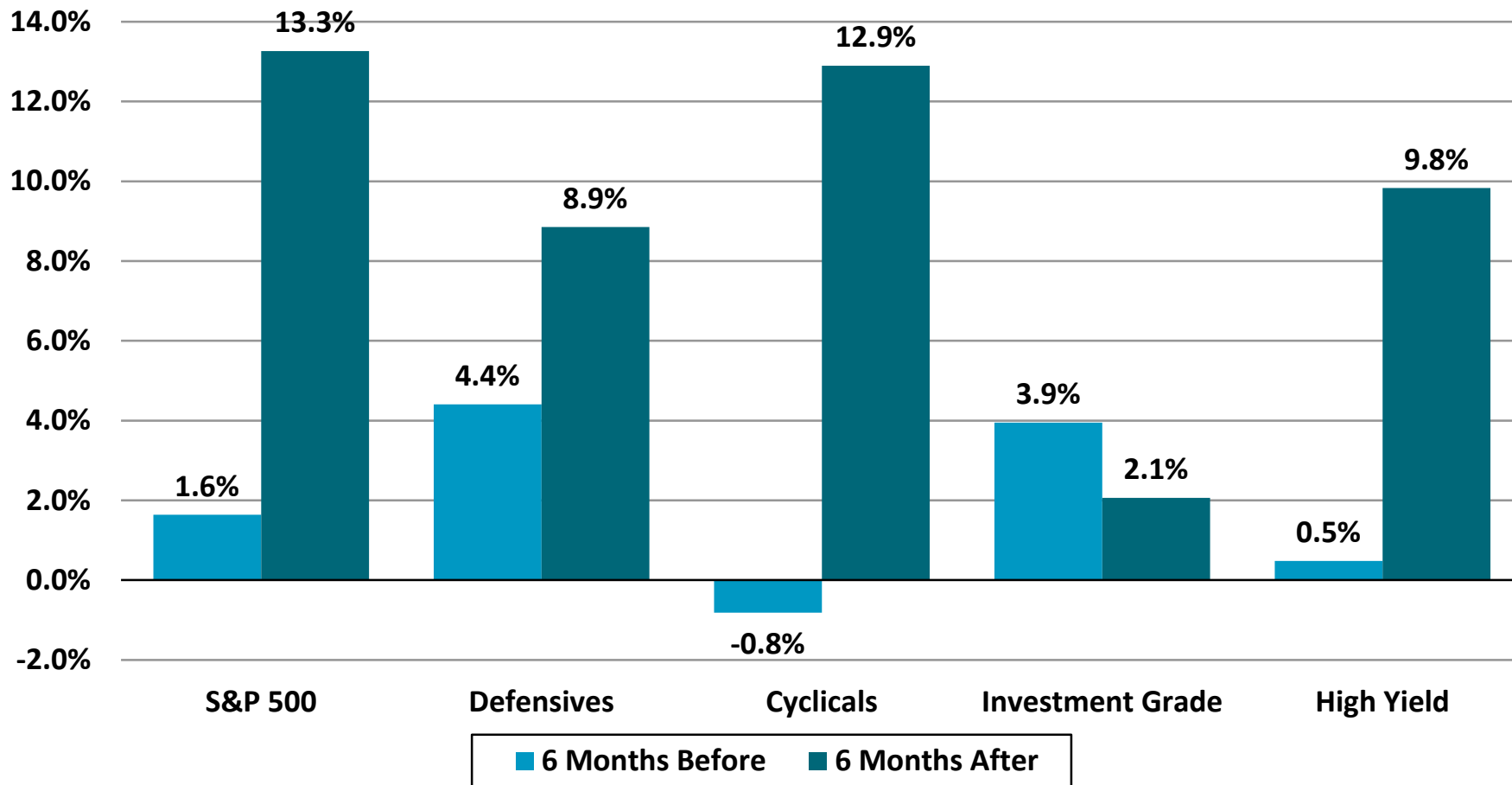
Who Will Control the Senate after the 2018 Midterms?

Predict.org Betting



Source: Predictit, Bianco Research (June 2018).

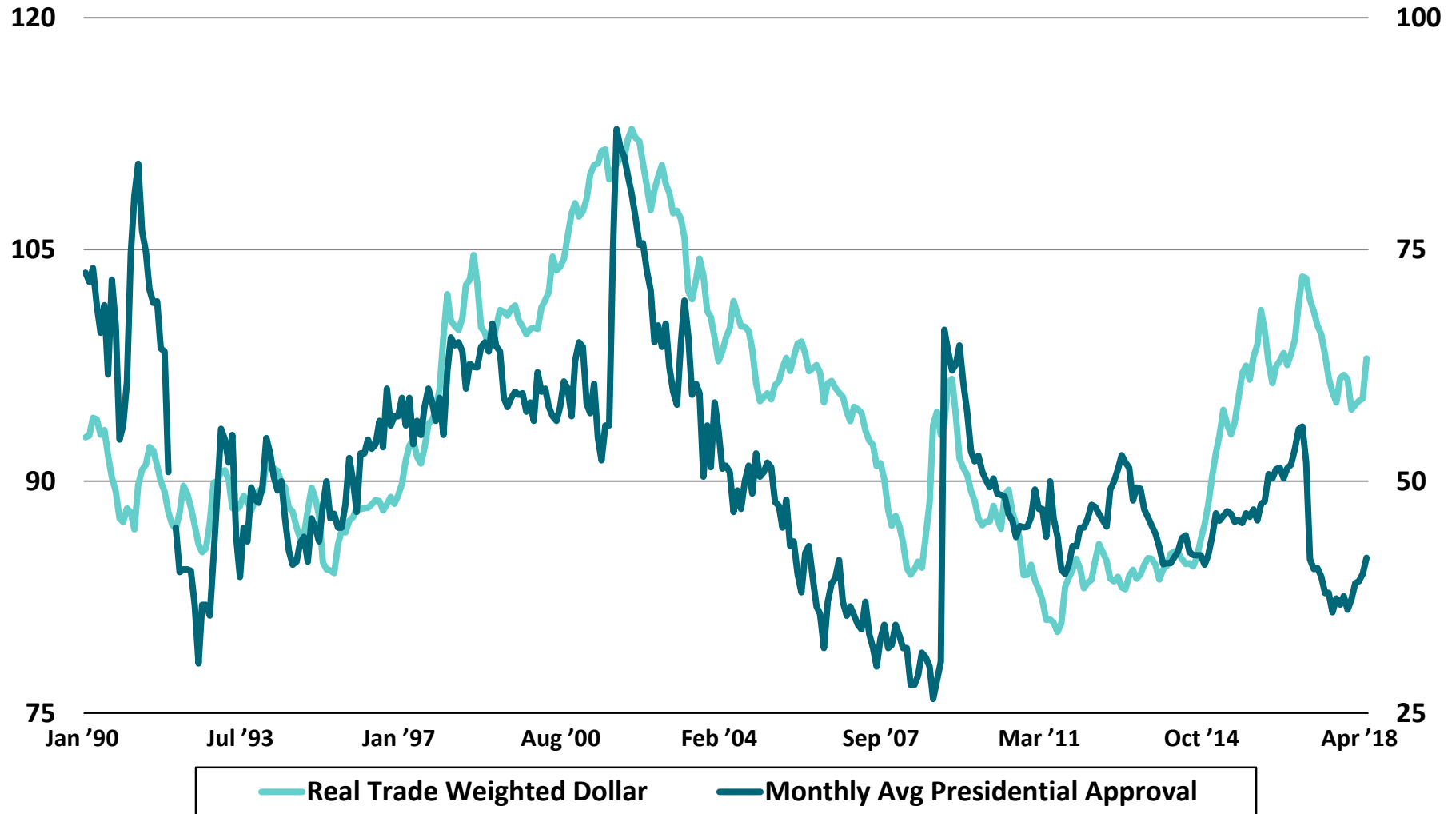
Asset Class Total Returns Before & After Mid-Term Elections



Source: Bloomberg, Blackstone (June 2018).

Real Trade Weighted Dollar Index & Presidential Approval Rating

For Discussion Purposes Only



Source: Strategas Research Partners (June 2018).

Financial Markets: Challenging Earnings

Dividend Discount Model

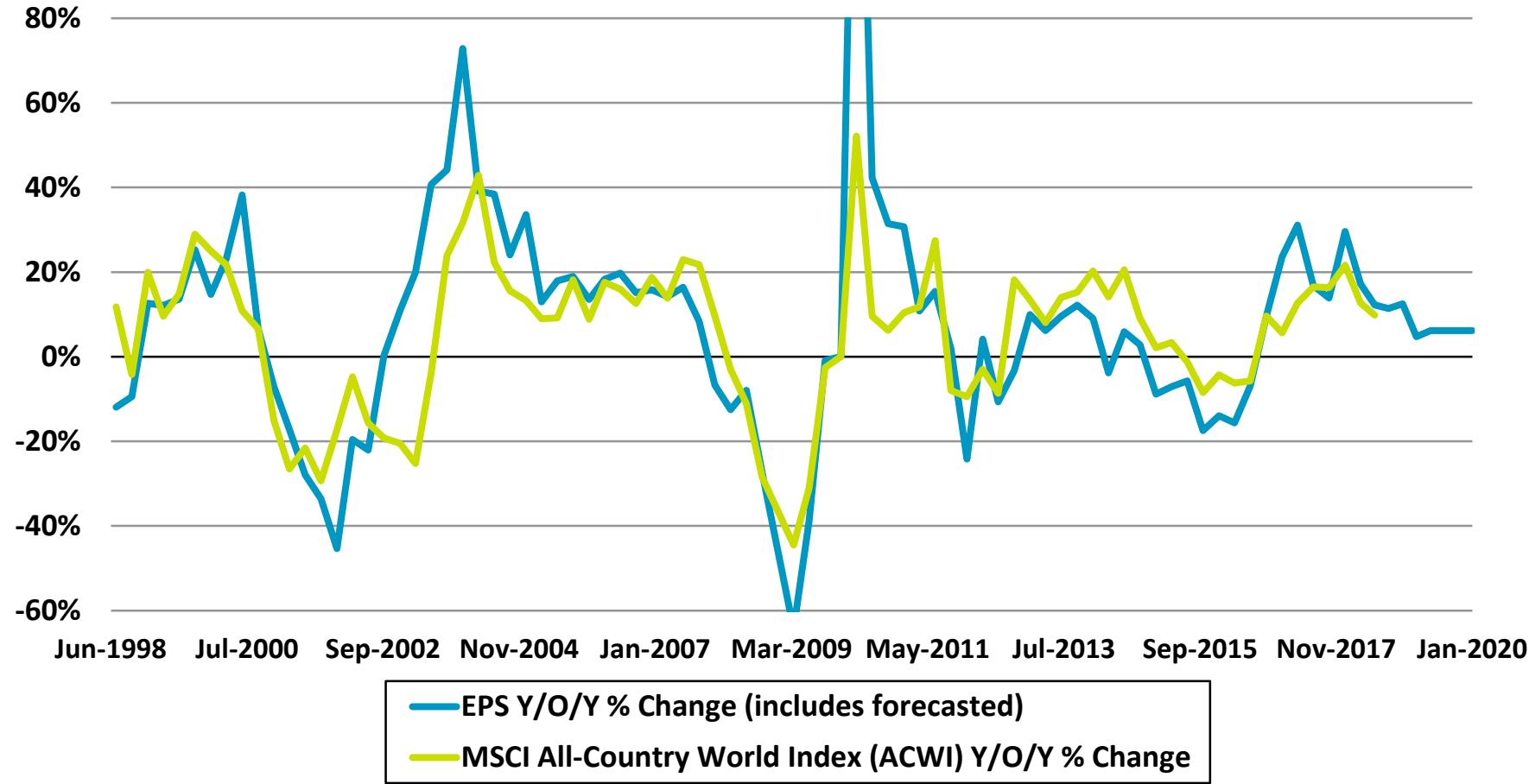
<u>1 Year</u>	10-year Treasury Yield												
	EPS \$	1.00%	1.25%	1.50%	1.75%	2.00%	2.25%	2.50%	2.75%	3.00%	3.25%	3.50%	3.75%
150	12,555	8,370	6,278	5,022	4,185	3,587	3,139	2,790	2,511	2,283	2,093	1,932	1,794
152	12,723	8,482	6,361	5,089	4,241	3,635	3,181	2,827	2,545	2,313	2,120	1,957	1,818
154	12,890	8,593	6,445	5,156	4,297	3,683	3,223	2,864	2,578	2,344	2,148	1,983	1,841
156	13,058	8,705	6,529	5,223	4,353	3,731	3,264	2,902	2,612	2,374	2,176	2,009	1,865
158	13,225	8,817	6,612	5,290	4,408	3,779	3,306	2,939	2,645	2,405	2,204	2,035	1,889
160	13,392	8,928	6,696	5,357	4,464	3,826	3,348	2,976	2,678	2,435	2,232	2,060	1,913
162	13,560	9,040	6,780	5,424	4,520	3,874	3,390	3,013	2,712	2,465	2,260	2,086	1,937
164	13,727	9,151	6,864	5,491	4,576	3,922	3,432	3,050	2,745	2,496	2,288	2,112	1,961
166	13,895	9,263	6,947	5,558	4,632	3,970	3,474	3,088	2,779	2,526	2,316	2,138	1,985
168	14,062	9,375	7,031	5,625	4,687	4,018	3,515	3,125	2,812	2,557	2,344	2,163	2,009
170	14,229	9,486	7,115	5,692	4,743	4,066	3,557	3,162	2,846	2,587	2,372	2,189	2,033
172	14,397	9,598	7,198	5,759	4,799	4,113	3,599	3,199	2,879	2,618	2,399	2,215	2,057
174	14,564	9,709	7,282	5,826	4,855	4,161	3,641	3,236	2,913	2,648	2,427	2,241	2,081
176	14,732	9,821	7,366	5,893	4,911	4,209	3,683	3,274	2,946	2,678	2,455	2,266	2,105
178	14,899	9,933	7,449	5,960	4,966	4,257	3,725	3,311	2,980	2,709	2,483	2,292	2,128
180	15,066	10,044	7,533	6,027	5,022	4,305	3,767	3,348	3,013	2,739	2,511	2,318	2,152

Note: The model assumes that S&P 500 Earnings per Share start the period growing at the short-term rate indicated in the rows. The growth rate declines linearly over 2 years to a 4% nominal growth rate then remains there in perpetuity. Analysis assumes the dividend payout ratio remains at the current level of 42% and the equity risk premium is a constant 3.5%.

Source: Bloomberg as of June 2018.

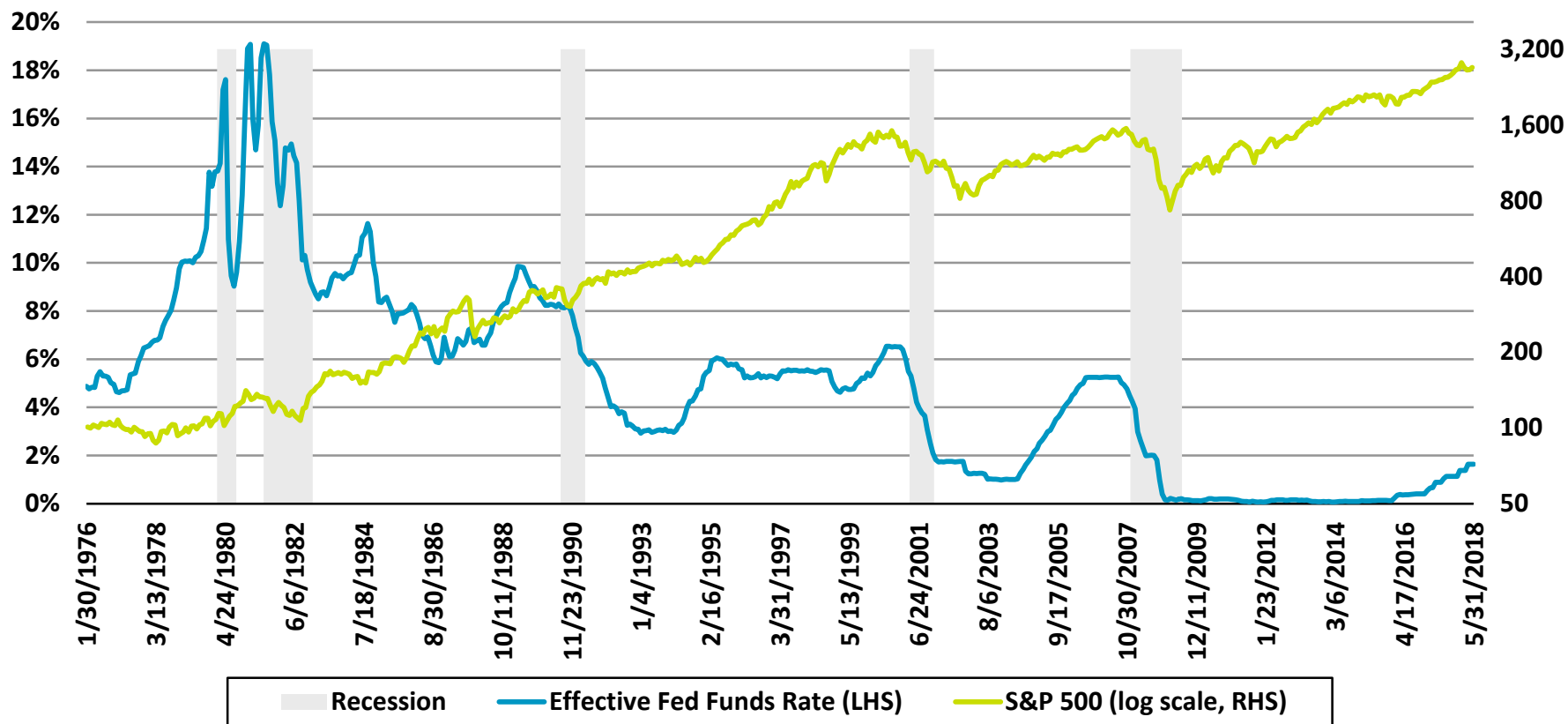
Global Share Prices vs. EPS

Global Share Prices follow Global Earnings



Source: Bloomberg, Blackstone (June 2018).
* Negative earnings excluded.

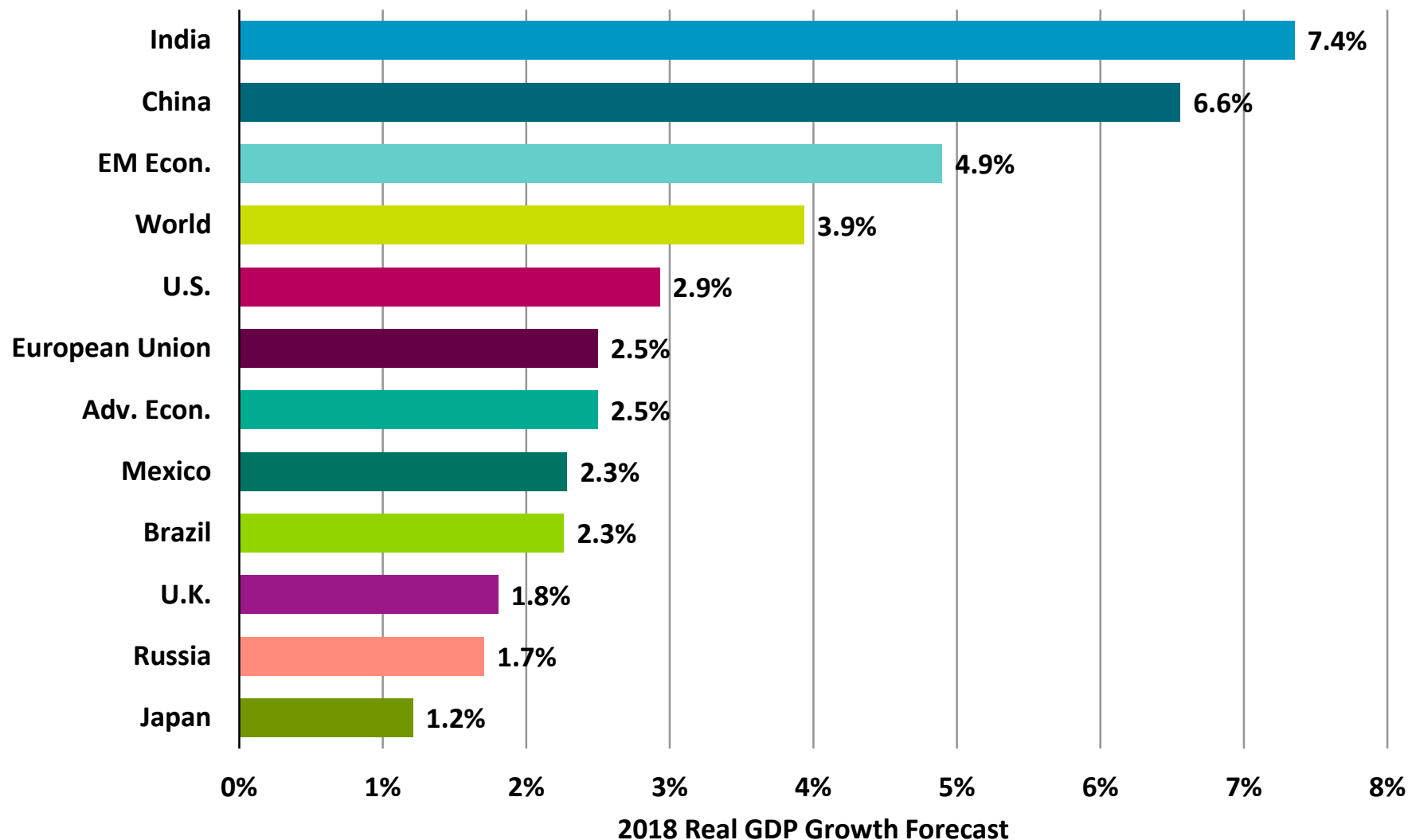
The Market Goes Up Until the Fed Stops



First Fed Hike	S&P Level	Last Fed Hike	S&P Level	Return	Stock Market Peaked	Recession Started
12/1/1976	102.49	3/3/1980	112.5	9.80%	2/13/1980	Feb-80
8/7/1980	123.3	5/8/1981	131.66	6.80%	11/28/1980	Aug-81
3/29/1988	260.07	2/24/1989	287.13	10.40%	7/16/1990	Aug-90
6/30/1999	1,372.71	5/16/2000	1,466.04	6.80%	3/24/2000	Apr-01
6/30/2004	1,140.84	6/29/2006	1,272.87	11.60%	10/9/2007	Jan-08

Source: Blackstone; Bloomberg; Strategas Research Partners (June 2018).

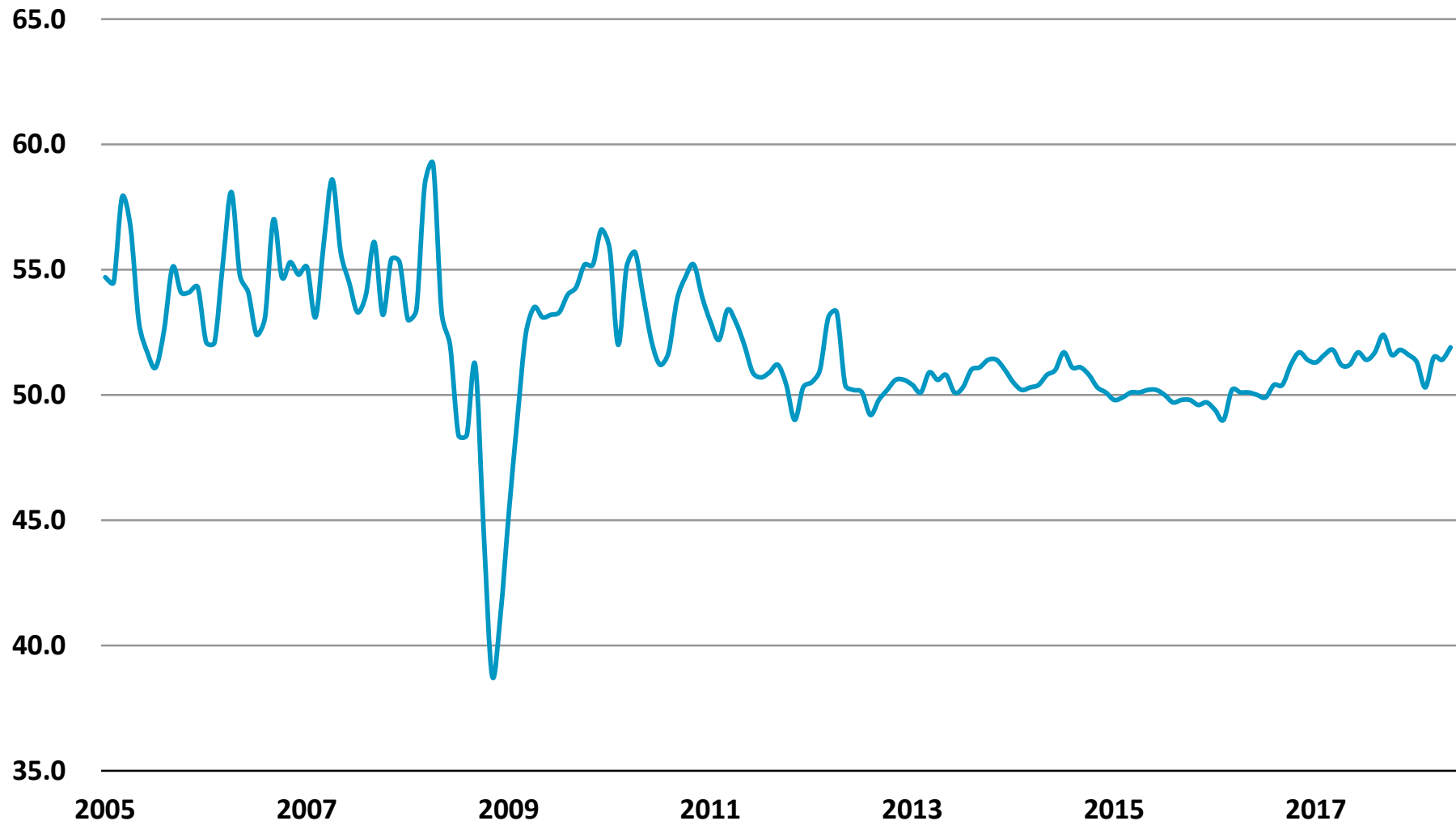
Global Real GDP Growth – 2018 – Forecast



Source: Monticello Associates (June 2018).

Sacrificing Growth for Long-Term Stability

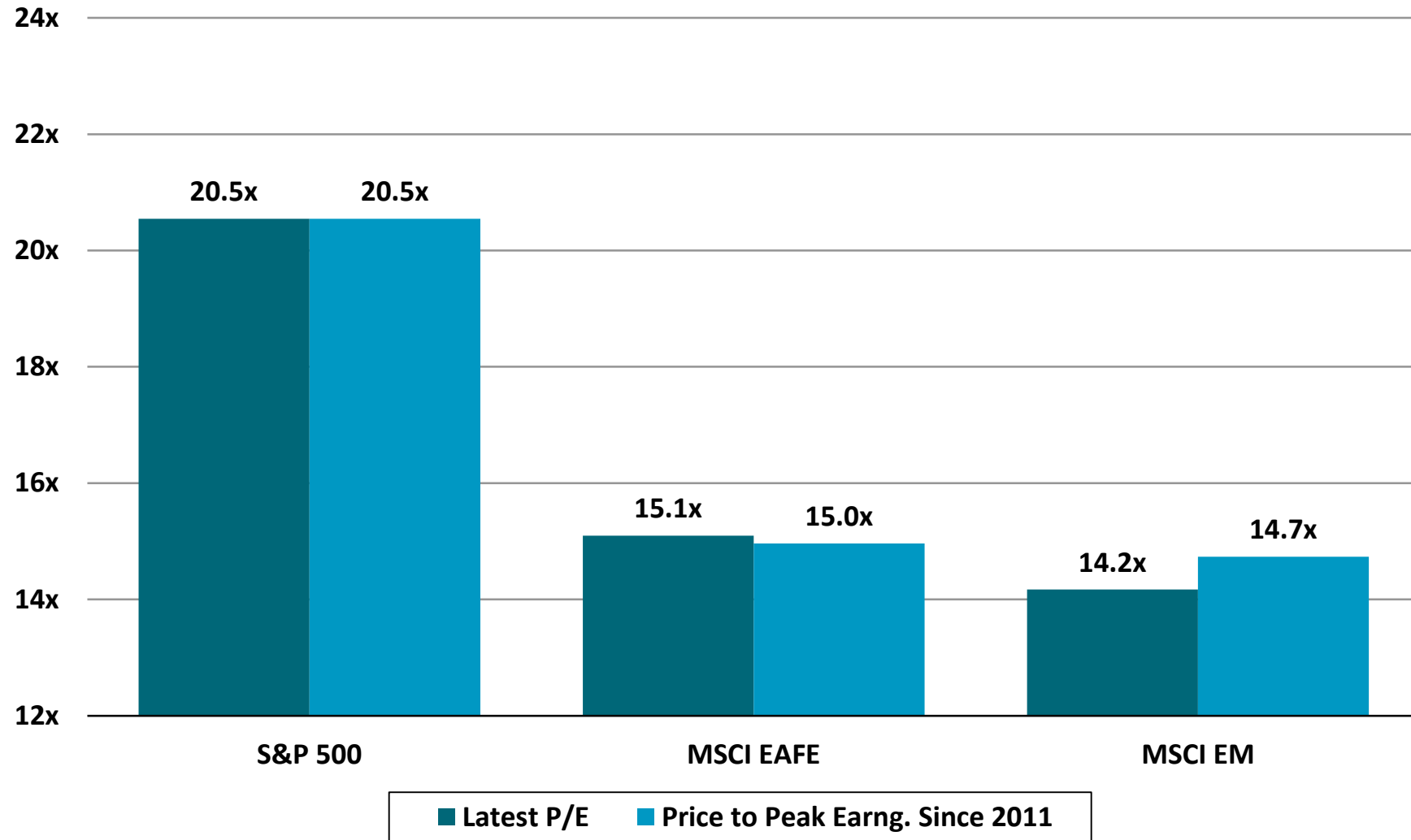
China CFLP Mfg PMI



Source: Strategas Research Partners (June 2018).

Current P/E

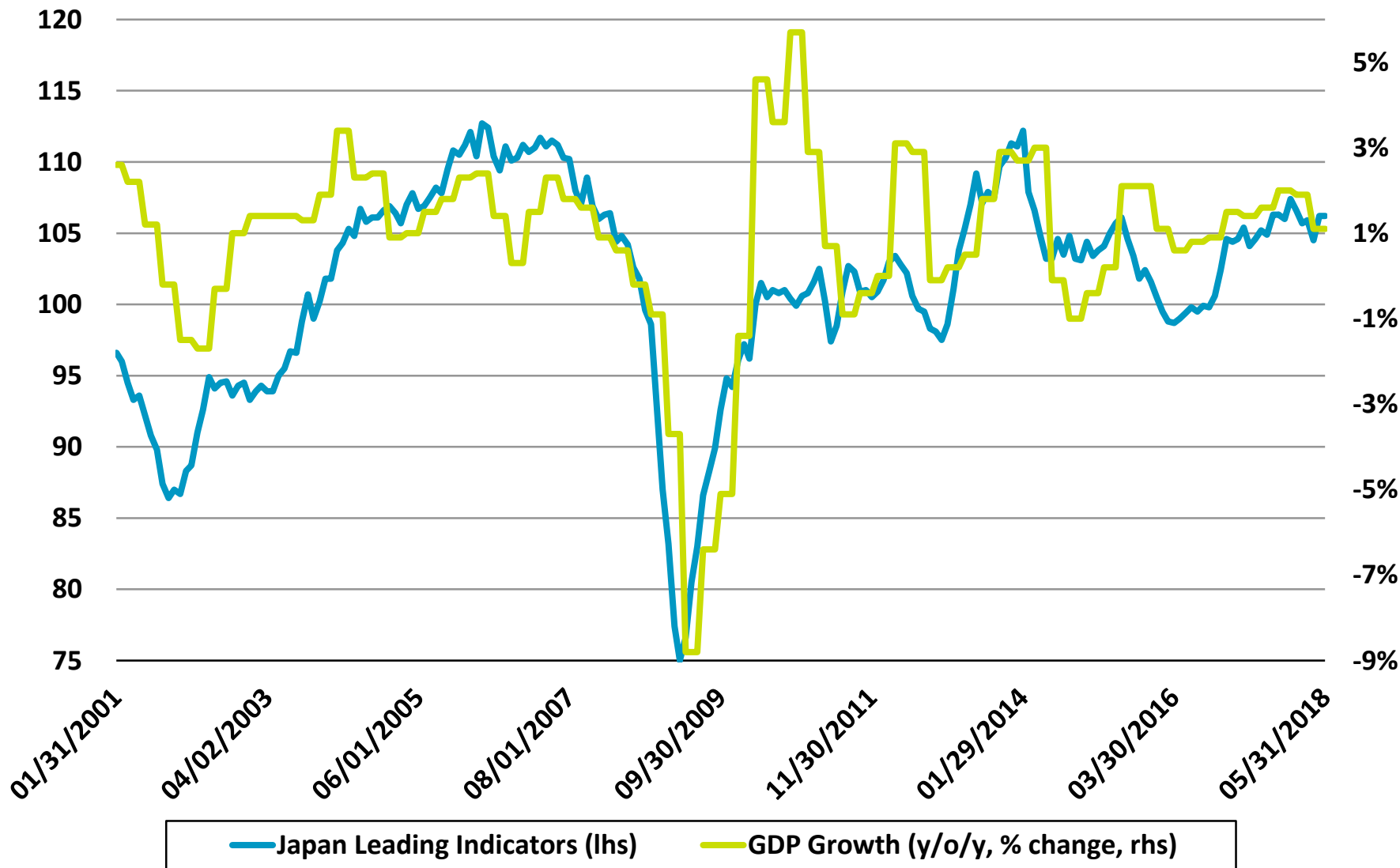
P/E - TTM



Source: Monticello Associates (June 2018).

Japan: A Path to Exiting QE

Japan's Leading Indicators Edged Higher



Source: Bloomberg, Blackstone (June 2018).

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Appendix – Life's Lessons

Life's Lessons

Here are some of the lessons I have learned in my first 80 years. I hope to continue to practice them in the next 80

1. Concentrate on finding a big idea that will make an impact on the people you want to influence. The Ten Surprises, which I started doing in 1986, has been a defining product. People all over the world are aware of it and identify me with it. What they seem to like about it is that I put myself at risk by going on record with these events which I believe are probable and hold myself accountable at year-end. If you want to be successful and live a long, stimulating life, keep yourself at risk intellectually all the time.
2. Network intensely. Luck plays a big role in life, and there is no better way to increase your luck than by knowing as many people as possible. Nurture your network by sending articles, books and emails to people to show you're thinking about them. Write op-eds and thought pieces for major publications. Organize discussion groups to bring your thoughtful friends together.
3. When you meet someone new, treat that person as a friend. Assume he or she is a winner and will become a positive force in your life. Most people wait for others to prove their value. Give them the benefit of the doubt from the start. Occasionally you will be disappointed, but your network will broaden rapidly if you follow this path.
4. Read all the time. Don't just do it because you're curious about something, read actively. Have a point of view before you start a book or article and see if what you think is confirmed or refuted by the author. If you do that, you will read faster and comprehend more.
5. Get enough sleep. Seven hours will do until you're sixty, eight from sixty to seventy, nine thereafter, which might include eight hours at night and a one-hour afternoon nap.
6. Evolve. Try to think of your life in phases so you can avoid a burn-out. Do the numbers crunching in the early phase of your career. Try developing concepts later on. Stay at risk throughout the process.

Life's Lessons (Cont'd)

7. Travel extensively. Try to get everywhere before you wear out. Attempt to meet local interesting people where you travel and keep in contact with them throughout your life. See them when you return to a place.
8. When meeting someone new, try to find out what formative experience occurred in their lives before they were seventeen. It is my belief that some important event in everyone's youth has an influence on everything that occurs afterwards.
9. On philanthropy my approach is to try to relieve pain rather than spread joy. Music, theatre and art museums have many affluent supporters, give the best parties and can add to your social luster in a community. They don't need you. Social service, hospitals and educational institutions can make the world a better place and help the disadvantaged make their way toward the American dream.
10. Younger people are naturally insecure and tend to overplay their accomplishments. Most people don't become comfortable with who they are until they're in their 40's. By that time they can underplay their achievements and become a nicer, more likeable person. Try to get to that point as soon as you can.
11. Take the time to give those who work for you a pat on the back when they do good work. Most people are so focused on the next challenge that they fail to thank the people who support them. It is important to do this. It motivates and inspires people and encourages them to perform at a higher level.
12. When someone extends a kindness to you write them a handwritten note, not an e-mail. Handwritten notes make an impact and are not quickly forgotten.
13. At the beginning of every year think of ways you can do your job better than you have ever done it before. Write them down and look at what you have set out for yourself when the year is over.
14. The hard way is always the right way. Never take shortcuts, except when driving home from the Hamptons. Short-cuts can be construed as sloppiness, a career killer.

Life's Lessons (Cont'd)

15. Don't try to be better than your competitors, try to be different. There is always going to be someone smarter than you, but there may not be someone who is more imaginative.
16. When seeking a career as you come out of school or making a job change, always take the job that looks like it will be the most enjoyable. If it pays the most, you're lucky. If it doesn't, take it anyway, I took a severe pay cut to take each of the two best jobs I've ever had, and they both turned out to be exceptionally rewarding financially.
17. There is a perfect job out there for everyone. Most people never find it. Keep looking. The goal of life is to be a happy person and the right job is essential to that.
18. When your children are grown or if you have no children, always find someone younger to mentor. It is very satisfying to help someone steer through life's obstacles, and you'll be surprised at how much you will learn in the process.
19. Every year try doing something you have never done before that is totally out of your comfort zone. It could be running a marathon, attending a conference that interests you on an off-beat subject that will be populated by people very different from your usual circle of associates and friends or traveling to an obscure destination alone. This will add to the essential process of self-discovery.
20. Never retire. If you work forever, you can live forever. I know there is an abundance of biological evidence against this theory, but I'm going with it anyway.