Federated®

OnPoint

A Series of Industry and Investment Insights

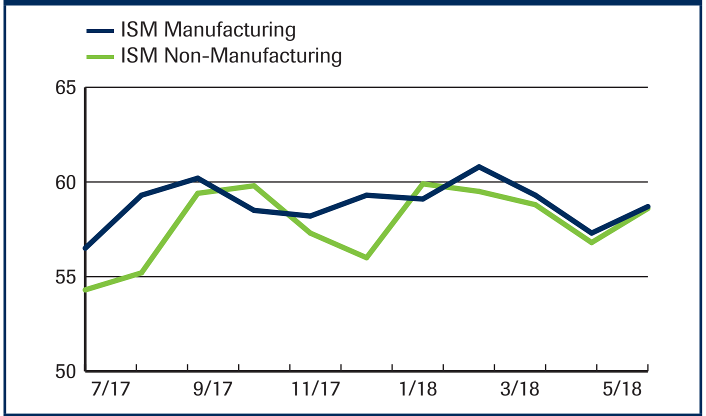
Geared up for a solid second half

Equity investors should expect robust economic and earnings growth in the months ahead. The environment is a little more challenging for fixed-income investors but opportunities in bonds remain.

Economy: Expansion aging gracefully

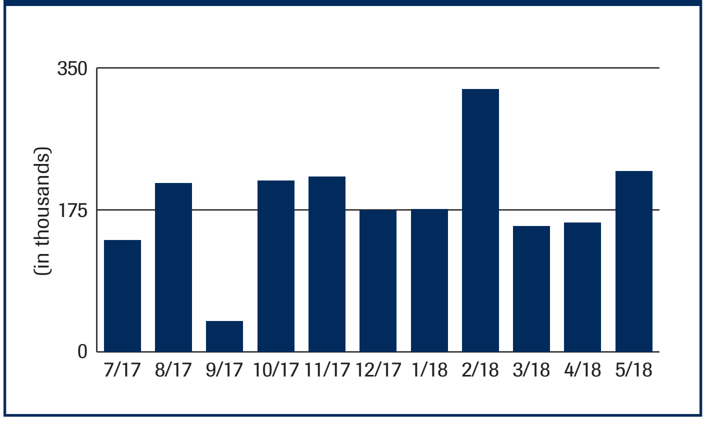
While there are signs of slowing in parts of Europe, Asia and South America, the U.S. story is solid and capable of carrying along the rest of the world. Manufacturing and service activity has hit a higher gear. Business confidence is at or near multi-decade highs. Ongoing job growth has pushed the unemployment rate to 18-year lows, lifting consumers' spirits. And while it's coping with the dual headwinds of supply restraints and rising mortgage rates, housing activity remains positive.

Manufacturing and services picking up steam



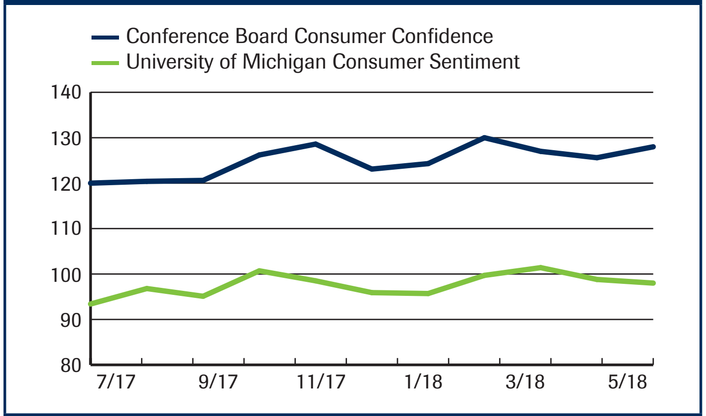
Source: Institute for Supply Chain Management, 7/31/17-5/31/18. Above 50 represents expansion.

Job growth perks up



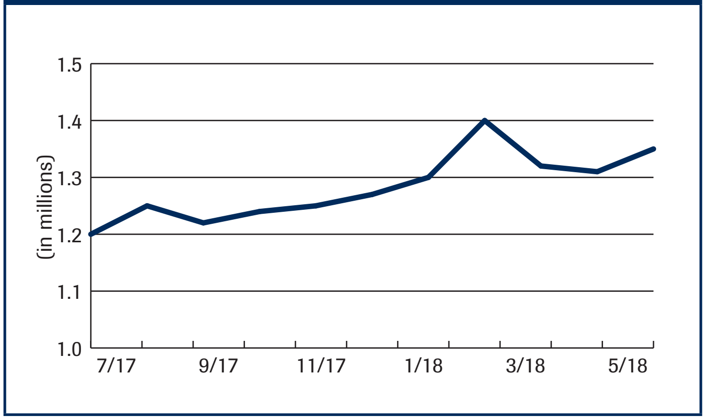
Source: Bureau of Labor Statistics, 7/31/17-5/31/18.

Consumers feeling frisky



Source: University of Michigan & Conference Board, 7/31/17-5/31/18.

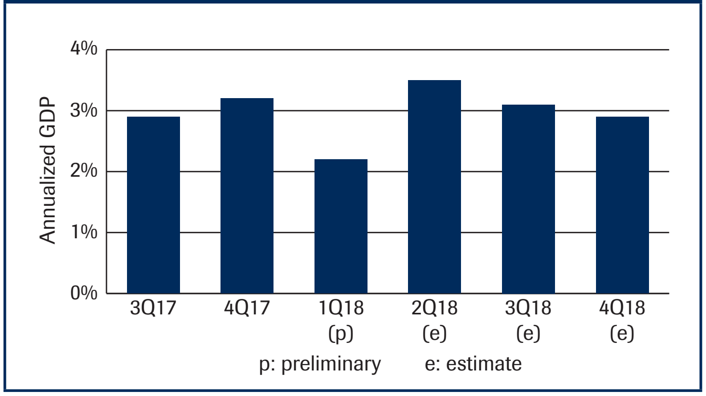
Housing activity rebounding



Source: Department of Commerce, annualized housing starts, 7/31/17-5/31/18.

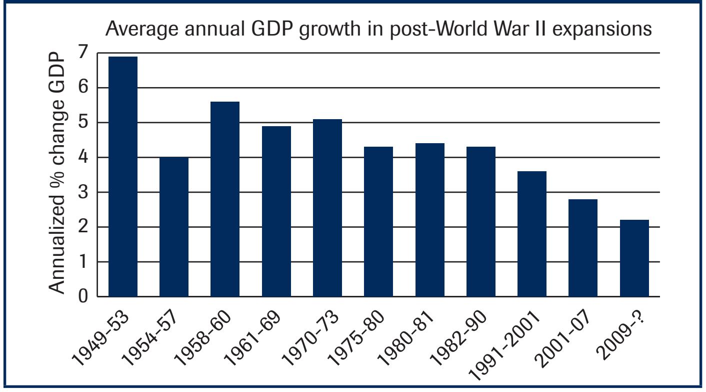
Longer term, even as this expansion has entered its 10th year and is now the second longest of the post-war era, its subpar performance relative to past recoveries suggests it's closer to the middle than the late innings. Indeed, the first eight years of this expansion encompassed one of the most tepid recoveries on record, averaging just 2.2% per year compared to the 4.3% average annual growth rate of the previous 10 expansions since World War II.

U.S. growth has 'mo'



Source: Bureau of Economic Analysis, Federated Investors

A slower for longer expansion



Source: Bureau of Economic Analysis, Federated Investors

Equities: Overweight large caps, small caps and developed international

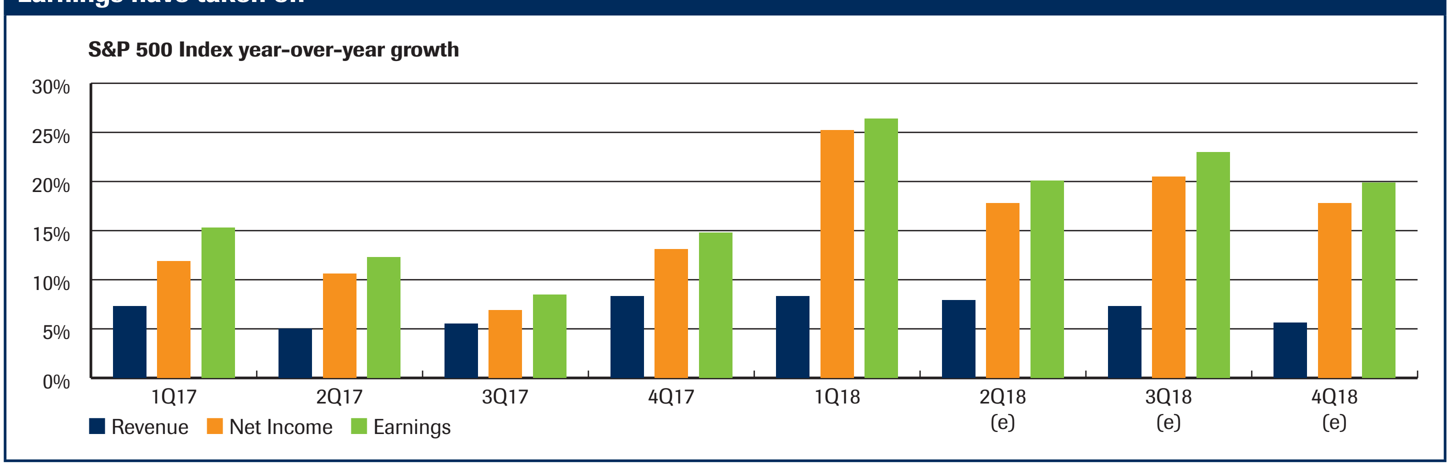
Federated's PRISM® asset-allocation model continues to recommend significant positions in most equity asset classes amid a supportive environment of strong earnings, accelerating domestic growth and relatively attractive valuations.

Aided by significant fiscal stimulus in the form of tax cuts and increased spending, earnings growth for the S&P 500 exceeded 26% in this year's first quarter, the best performance in seven years. With domestic growth expected to remain at a 3% trend-line over the course of 2018, earnings—the primary driver of share prices—are expected to remain robust.

The small-cap outlook may be even better. Federated Chief Equity Market Strategist Phil Orlando notes small-cap companies derive about 80% of their revenue inside the U.S., whereas large multinationals typically export half or more of their goods and services overseas. This helps insulate small caps from geopolitical tensions, currency fluctuations and trade-tariff flare-ups while allowing them to benefit from the positive effects of U.S. tax reform and deregulation. Indeed, as good as S&P earnings have been, small-cap earnings have been even stronger.

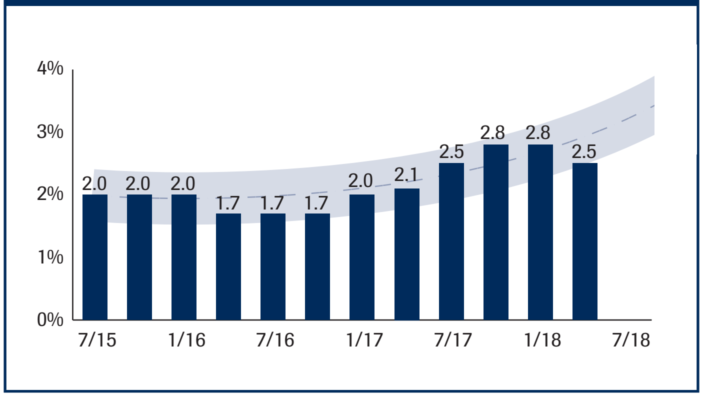
The overseas story is a little murkier but still positive. After outpacing the U.S. last year, growth in the eurozone has slowed. Some of that has been blamed on unusually bad weather in late winter and early spring. Despite uncertainty over Italy's new populist government, the backdrop remains positive, with the European Central Bank remaining highly accommodative, and manufacturing and services gauges firmly in expansion. Elsewhere, Japan is experiencing its first prolonged period of economic growth since 2001, China continues to be steady, Brazil's economy is growing again and India's economy is accelerating.

Earnings have taken off



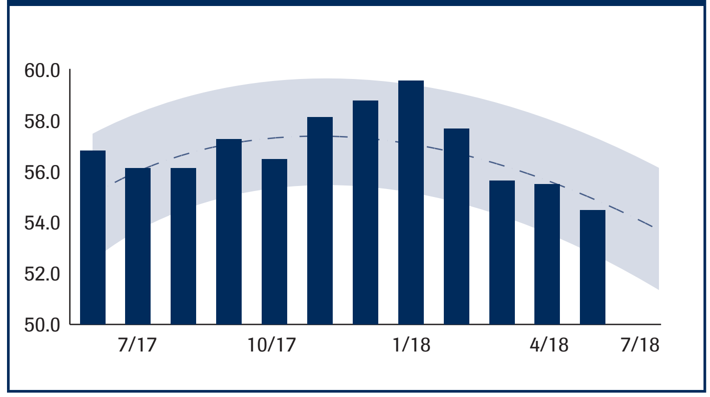
Source: Thomson Reuters I/B/E/S

Eurozone expansion slows; was it the weather?



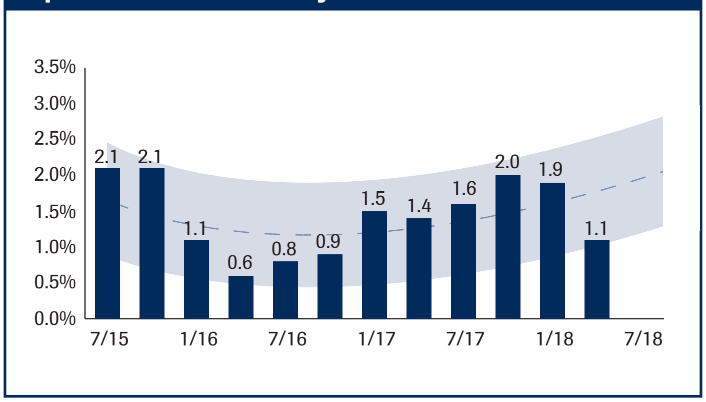
Source: Bloomberg, Euro area annualized GDP, shaded area represents data trendline

Eurozone manufacturing and services down, not out



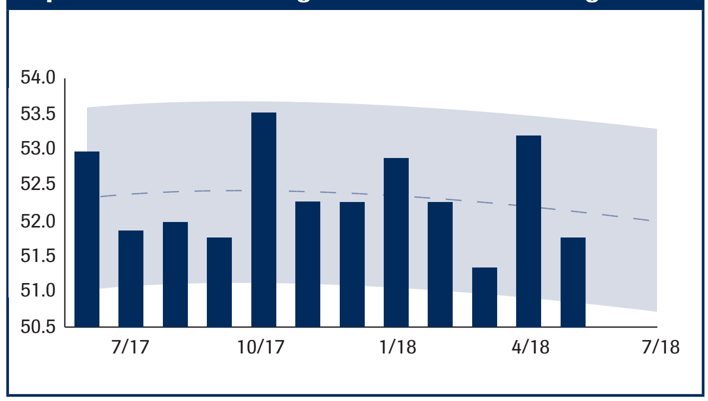
Source: Bloomberg, Euro area composite PMI, shaded area represents data trendline

Japan's 'lost decade' may end at two decades



Source: Bloomberg, Japan annualized GDP, shaded area represents data trendline

Japanese manufacturing and service industries grind on



Source: Bloomberg, Japan composite PMI, shaded area represents data trendline

Fixed Income: Keeping it short and favoring credit

The bias on global yields continues to be up, prompting Federated to maintain a short duration position to help protect fixed-income portfolios as rates rise. That said, rates and yields arguably may have made their biggest moves of this cycle—the 10-year Treasury yield is up nearly 100 basis points over the past year, the 2-year yield is up more than 120 basis points over the same 12 months and the Federal Reserve's target funds rate is up 175 basis points following seven quarter-point increases beginning December 2015, the last four coming in the past 12 months.

What short duration means

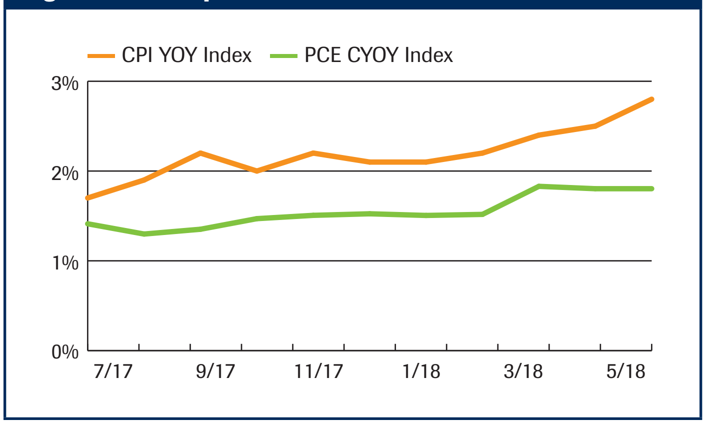
Duration reflects the sensitivity of a fixed-income instrument (or a fixed-income portfolio) to changes in market interest rates. Longer maturity bonds tend to have longer durations. Being "long duration" means a fixed-income portfolio has a duration that is higher—more sensitive to changes in market rates—than its benchmark and thus would gain in value relative to its benchmark if market yields decline. Short duration is the opposite, meaning a portfolio has a duration lower than its benchmark and the portfolio will decline in value less than its benchmark if market rates rise.

Wage growth, while improved, is still relatively tepid, oil prices have retraced some of their recent run-up, a growing number of more highly compensated baby boomers are leaving the workforce, global capacity is far from stretched and tech in all its forms—artificial intelligence, sharing economy, automation, etc.—is eliminating costs. The result: inflation is exhibiting few signs of breaking out beyond its moderate uptrend. This suggests interest rates are more likely to grind rather than spurt higher over the remainder of this year, even as mounting federal debt looms as a longer-term issue.

The combination—modest inflation, restrained rate increases and a robust economy with strong corporate earnings and balance sheets—makes for a constructive environment for corporate credit. Federated's fixed-income sector committee is maintaining modest overweight recommendations to investment-grade and high-yield corporate bonds, commercial mortgage-backed securities and emerging-market bonds, with the understanding the coupon rate is the primary attraction given yields are near historical lows relative to comparable-maturity Treasuries.

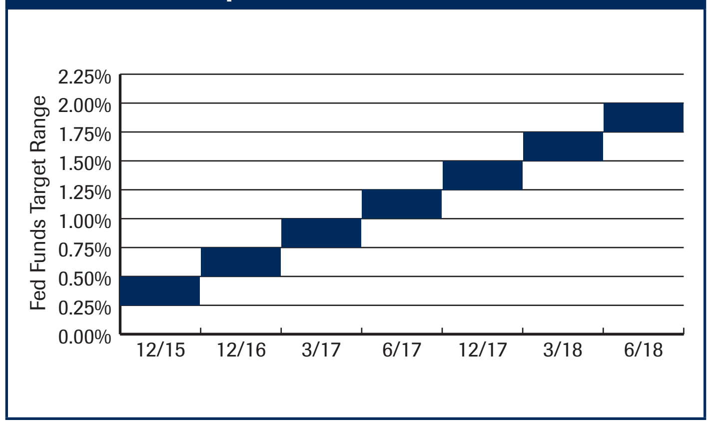
On the shorter end of the curve, the past year's run-up in yields has created better value in ultra-short bonds, variable-rate securities and other short-term oriented debt securities.

A grind, not a sprint



Source: Bureau of Labor Statistics & Bureau of Economic Analysis, 7/31/17-5/31/18.

The slow climb up



Source: Federal Reserve

Narrowing the gap

Source: Federal Reserve Bank of St. Louis, 7/3/17-6/14/18.
Past performance is no guarantee of future results.

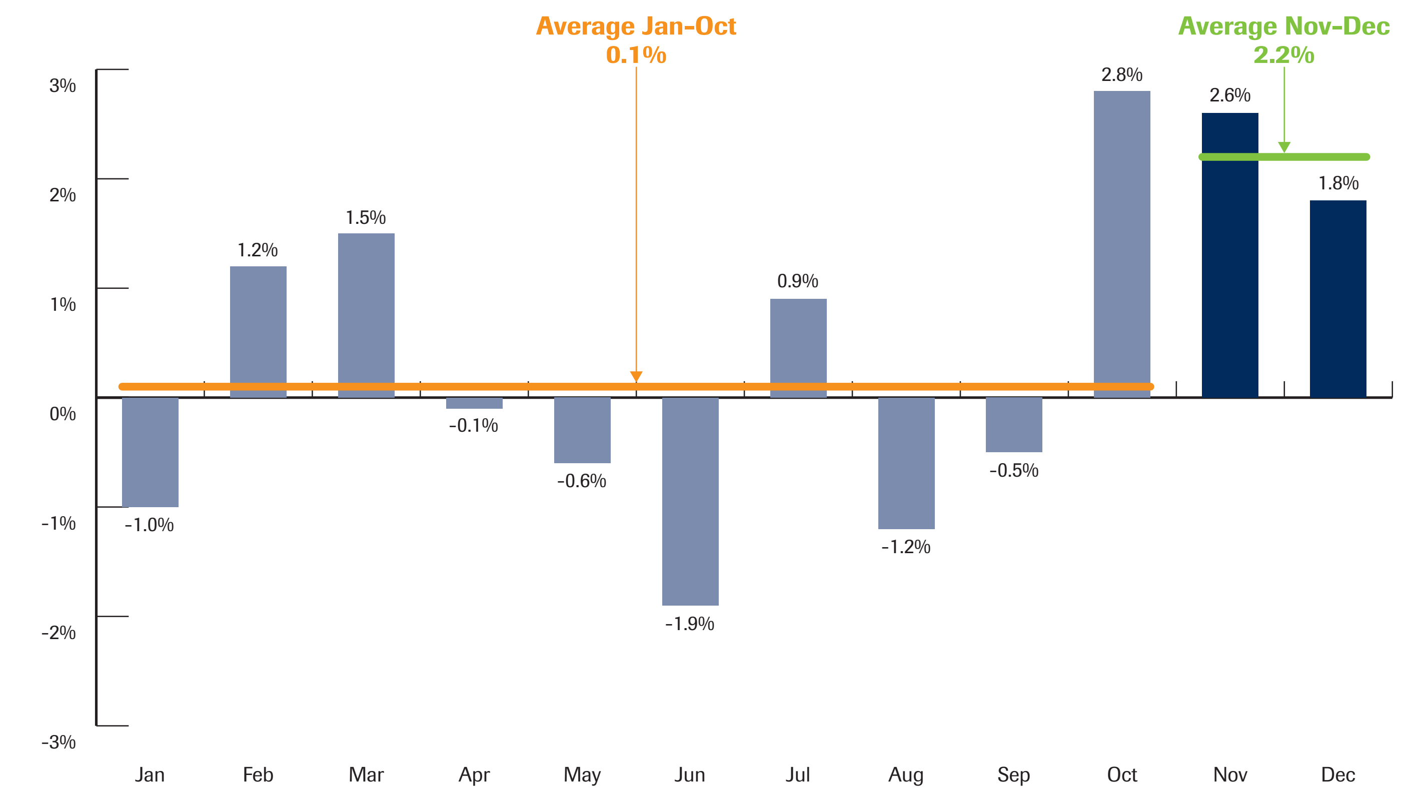
What are the risks?

Geopolitical worries always seem to hang over the markets. Might there be a potential trade war with our major trading partners? Or a push by Italy's new populist government to secede from the euro? Or a Democratic wave that upsets the Republican hold on Congress?

In the first case, the markets seem to have come to an understanding that all the bluster emanating out of the White House may be nothing more than a negotiating tactic from our transactional-minded president, even if it does create uncertainty and short-term pain. As for Italy, nothing seems imminent and even if a crisis ultimately develops, the lesson from Brexit is it will takes years, not months.

Finally, a lot can happen between now and the midterm elections. The latest polling shows Republicans have significantly narrowed the gap, cooling talk of a Democratic "wave." History suggests that, whatever happens, markets historically have rallied strongly once the election ends. So the message for equity investors is stay the course. Better days may lie ahead.

Watch for a strong midterm finish



S&P 500 Index monthly price return during mid-term election years

Source: S&P, FactSet and Federated. Data as of May 3, 2018. Past performance is no guarantee of future results.

Eurozone PMI Composite Output Index tracks business trends across both the manufacturing and service sectors, based on data collected from a representative panel of over 5,000 companies (60 percent from the manufacturing sector and 40 percent from the services sector). The index tracks variables such as sales, new orders, employment, inventories and prices. National data are included for Germany, France, Italy, Spain, Austria, the Netherlands, Greece and the Republic of Ireland.

Japan Composite PMI In Japan, the Nikkei Japan Composite Output Index tracks business trends across private sector activity, based on data collected from a representative panel of around 800 companies. The index tracks variables such as sales, new orders, employment, inventories and prices

Small company stocks may be less liquid and subject to greater price volatility than large company stocks.

International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards. Prices of emerging markets securities can be significantly more volatile than the prices of securities in developed countries and currency risk and political risks are accentuated in emerging markets.

High-yield, lower-rated securities generally entail greater market, credit/default and liquidity risks, and may be more volatile than investment grade securities.

The value of some mortgage-backed securities may be particularly sensitive to changes in prevailing interest rates, and although the securities are generally supported by some form of government or private insurance, there is no assurance that private guarantors or insurers will meet their obligations.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

Consumer Price Index (CPI): A measure of inflation at the retail level.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

The Institute of Supply Management (ISM) manufacturing index is a composite, forward-looking derived from a monthly survey of U.S. businesses.

The Institute of Supply Management (ISM) non-manufacturing index is a composite, forward-looking derived from a monthly survey of U.S. businesses.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

The University of Michigan Consumer Sentiment Index is a measure of consumer confidence based on a monthly telephone survey by the University of Michigan that gathers information on consumer expectations regarding the overall economy.

The Conference Board's Consumer Confidence Index measures how optimistic or pessimistic consumers are about the economy.

Views are as of June 20, 2018 and are subject to change based on market conditions and other factors. This should not be construed as a recommendation for any specific security or sector.

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