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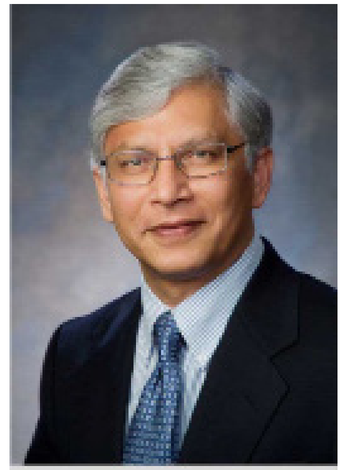
Economic and Capital Market Commentary • Q1 2019



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Recap: It has now become evident that GDP growth in the first quarter of 2019 will come in well below the pace seen in the past several quarters. American consumers barely increased their spending in January after a sharp pullback in December, adding to recent evidence the economy may have slowed after strong growth in 2018. In addition, the PCE price index fell for the first time in almost two years, underscoring the Fed's struggle to get inflation up to its 2% target. Q1 GDP growth was expected to come in at a scant 1.5% (annualized), which, if realized, would be the slowest growth rate in more than three years.

This slowdown has been partly a function of timing and partly an extraordinarily bad December and January for consumer spending. Businesses faced slower consumer spending and rising labor costs, which signaled more moderate growth this year despite a strong labor market. However, barring another market selloff, a spring pickup in growth should occur with rising incomes and strong consumer sentiment. Moderation rather than a serious slowdown for the rest of the year is expected with 2019 GDP growth to be around 2.0-2.5%.

While the U.S. economy held up reasonably well in Q4, signs of slower growth were widespread across the globe. Other major economies in Europe, North America, and Asia registered only marginal growth late last year while China's economy has extended its ongoing gradual and orderly economic slowdown.

Against this backdrop of slower international growth, many foreign central banks have adopted a more dovish stance. Most notably the Federal Reserve and the European Central Bank (ECB) have signaled that policy rates may now be on hold through all of 2019. Several other major central banks have explicitly acknowledged in recent months that the next move in policy interest rates could be down.

On a positive note, trade tensions with China appeared to be easing somewhat. Substantial progress on a trade deal has been made. However, the progress on talks may have come too little too late and the tariff cloud may continue to cast a shadow on global economy for some time, reinforcing the Fed's patient stance.

Economic activity in the developing world is expected to heat up later this year. An anticipated improvement in global manufacturing activity, weaker inflation, and lower global interest rates have all supported a firmer outlook in emerging market economies. That said, a slowing Chinese economy and elevated trade policy uncertainty vis à vis the U.S. could weigh further on major trading partners, stifling any sort of rebound in global economic activity.

Homebuyer Affordability Composite Index

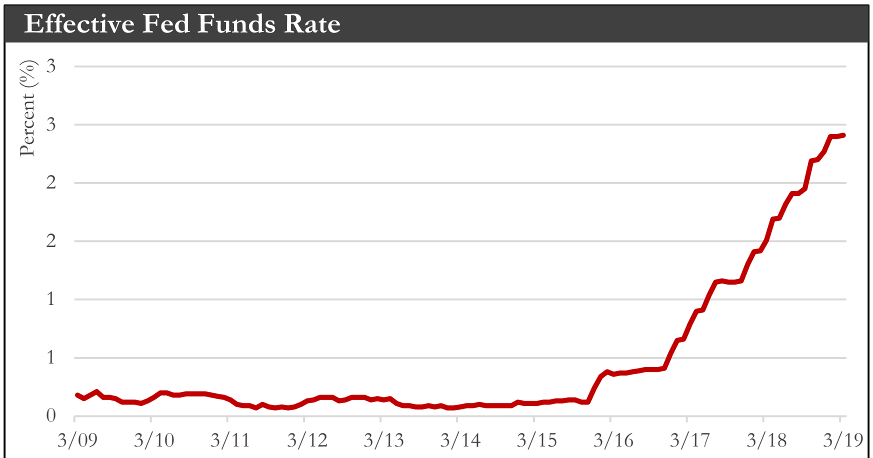
Source: National Association of Realtors

Housing: The housing market had a rough go over the past year. Existing home sales and housing starts both ended 2018 down more than 10% from year ago levels. These two indicators have been the latest signs of how much the housing market struggled in the last few months of 2018. Higher mortgage rates, political uncertainty, stock market turbulence and growing frustration over a lack of starter home inventory has caused many buyers to pause.

The critical question has been whether the market could rebound in time for the crucial spring selling season. There have been some positive signs: political jitters have eased with the midterm elections over, and slower price growth during the crucial spring selling season could pull buyers back into the market.

Due to lower mortgage rates, home builders have also started to feel better about market conditions. What is more, the deterioration in housing affordability over the past several years has reversed in recent months. Mortgage rates have emerged some 60 basis points below their peak, and home price growth has slowed just as wages have accelerated. All of this would suggest that fundamentals are ripe for a rebound in home sales and gains in residential investment in 2019.

Federal Reserve: After a period of exceptional market volatility late last year—brought on by concerns over slowing global growth, trade tensions and the Fed's policy stance—the Federal Reserve seems unlikely to raise interest rates this year and may be nearly finished with the series of increases they began more than three years ago now that U.S. economic growth has been slowing. The FOMC meeting in late March left its policy rate unchanged in a range between 2.25% and 2.5%.

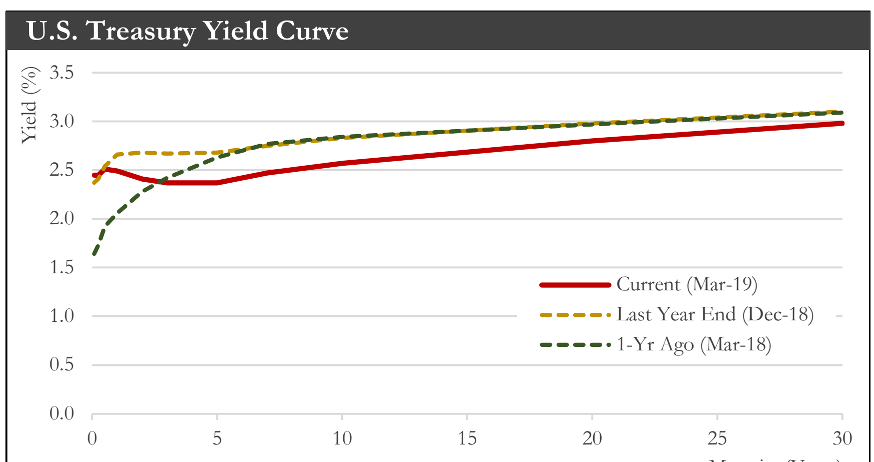


Source: Board of Governors of the Federal Reserve System

Mild inflation pressures, a sharp pullback in financial risk-taking and clear threats to U.S. growth have led to the Fed's new wait-and-see stance. Given a muted inflation backdrop and global economic and financial developments, this period of patience will likely last into next year. Beginning in May, the Fed will also slow to $15 billion the amount of bonds it allows to mature every month and will stop the runoff of the Treasury holdings in October.

Yield Curve and Recession: The financial press has been filled with stories about the recent inversion of the yield curve, which historically has been a reliable predictor of recession. The yield curve had inverted before each of the last seven recessions. Is recession around the corner?

The answer could be nuanced. The idea that the gap between short- and long-dated Treasury yields has been a rock-solid predictor, and which could be relied on for portfolio positioning is mistaken in several ways.



Source: Board of Governors of the Federal Reserve System

The purchase of Treasury securities by the Fed as part of the quantitative easing (QE) program has collapsed the term premium on longer-dated Treasury bonds. Before QE, there was usually some extra yield, known as the term premium, built into 10-year Treasuries as compensation for locking money up for so long. That meant in order to get to an inversion, investors had to expect significant cuts, which rarely happen without recession.

But the bond market has changed with quantitative easing, thus making inversion much easier. The term premium has been nonexistent or negative so the gap between the 10-year and three-month yield was lower to start with. Even anticipation of quite small cuts can make the curve invert.

Which part of the curve one looks at matters too, and how long an inversion lasts matters as well. Recent studies have shown that it needs to be inverted, on average, over a quarter to provide a solid signal. Otherwise it could merely predict a slowdown.

Furthermore, the yield curve, at present, has really been the only indicator that signaled any sense of trouble. Monetary conditions have not been all that restrictive compared to previous recessions. The stock market has generally remained supported, credit spreads have remained tight, and growth in bank lending has remained positive.

The recent inversion of the yield curve was interesting but did not necessarily signal that recession was around the corner. A further sustained inversion of the curve, along with generalized restriction in financial conditions, as well as deterioration in economic fundamentals would have to occur before one should be worried.

Eurozone: Europe had the misfortune of a collision of two downturns. The first included temporary production disruptions related to new environmental standards. This influence should slowly unwind in 2019. The second downdraft, however, has the potential to be more detrimental to the outlook. Early data signals have pointed to an underlying malaise in core European economies that likely reflects the layering of elevated trade uncertainty, slowing foreign demand, and related declines in consumer and business sentiment. This bears closer monitoring for evidence of stabilization.

The eurozone's unemployment rate fell, while its inflation rate picked up, a double dose of encouragement for a European Central Bank seeking signs of stabilization in the currency area's economy. The eurozone's jobless rate fell again in December and stayed at that level in January, indicating that eurozone businesses continued to add jobs despite cooling growth. At 7.8%, the jobless rate was the lowest since October 2008.

The inflation rate has remained below the ECB's target of just under 2% in February. However, consumer prices in the currency area were 1.5% higher than in February 2018, a slight pickup from 1.4% in February. To be sure, the acceleration in inflation was driven by volatile energy prices, and the prices of services—which have been more closely tied to domestic demand—slowed. But it was the first increase in the inflation rate since October.

While there have been some hints of stabilization, there have continued to be reminders of fragility from across the currency area. Across the eurozone, the export-reliant sector has been hit by weak demand from previously strong export markets, such as China and the U.K.

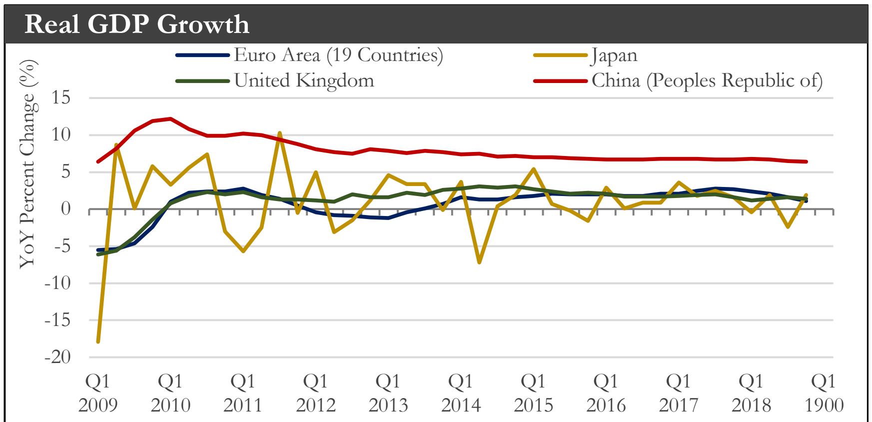
In addition to widespread trade war worries, often linked to U.S. tariffs, and concerns regarding the outlook for the global economy, companies have reported that heightened political uncertainty, including Brexit, has hit demand and driven increased risk aversion.

Brexit: Adding to Europe's economic woes has been the extended period of Brexit uncertainty. The British Parliament rejected Prime Minister Theresa May's Brexit deal for a third time, leaving the country no closer to an exit plan after more than two years of bitter wrangling. Now the Brexit outcomes that once seemed radical have become more likely. These have included another referendum to revoke the exit altogether, a general election or a sudden breakaway from the EU. It is expected that the most likely short-term outcome will be that the government will ask the EU to postpone Brexit again to avoid the expected widespread disruption arising from severing current trading arrangements with the U.K.'s closest trading partner.

The upside of a shorter extension would be that it would reduce the duration of Brexit-related uncertainty, which has been exacting a toll largely on UK economic activity, but also weighing on European sentiment.

In its recent decision to leave rates on hold, the Bank of England (BoE) continued to fret about Brexit developments. With Brexit developments in flux and weak foreign demand, the BoE is likely to remain on the sidelines through 2019.

China: Beijing lowered its economic-growth target this year to between 6% and 6.5%, after reporting the slowest economic growth in nearly three decades last year. To counter the slowdown, the authorities have ramped up spending on rail and other infrastructure projects, urged banks to lend more to small businesses and lowered taxes for households and businesses.



Source: Eurostat, Economic and Social Research Institute Japan, UK Office for National Statistics, National Bureau of Statistics of China

Those efforts have appeared to gain traction with investment growth warming. However, uncertainties about the outcome of trade talks between the U.S. and China have persisted and will likely weigh on export-oriented manufacturers in the short run as Beijing's latest tax cut for the manufacturing sector will take a while to show its effects.

However, the relative stability in retail sales along with the gradual slowdown in industrial output have suggested that China's economic slowdown should remain orderly, especially given continued monetary and fiscal policy support.

Outlook: The outlook for 2019 remains positive, underpinned by rising wages, low unemployment and high levels of household confidence. However, there are a few risks to this view such as slowing growth in Europe and China and uncertainty surrounding U.S. trade policy. While fiscal-stimulus measures shielded the U.S. economy last year from such headwinds, the effects of 2017 tax cuts and 2018 spending increases have faded. Further clouding the outlook, the U.S. government shutdown in December and January delayed the release of most official economic data, making it harder to gauge how much steam the economy has lost.

For 2019, the U.S. outlook faces crosscurrents. A global slowdown is unfolding precisely as the domestic economy has gotten off to a slow start due to idiosyncratic reasons. The typical "residual seasonality" phenomenon that has historically depressed growth in the first quarter was compounded by the 35-day partial government shutdown. Real GDP growth is expected to hover near the 1.5% mark (annualized) in the first quarter. Since both depressing forces are likely temporary, activity should rebound to roughly 2.5% in the second quarter.

Looking through the quarter-to-quarter volatility, the GDP pattern is likely to average roughly 2% over the year. This will be consistent with the long-standing narrative that the economy will continue to face a gravitational pull towards potential growth under fading fiscal stimulus. Ongoing fiscal injections may yet occur, but it would be hard-pressed to be of the scale and scope of past measures due to ballooning deficit and debt levels.

The two main risks to this outlook stem from policy decisions in Washington. The current budget deal expires at the end of September, and it is assumed that Congress will agree to extend spending at 2019 levels. This would avoid automatic spending cuts.

In a test of Congress' resolve around higher debt, they will first need to agree to raise or suspend the debt ceiling, which came into effect on March 2nd. The Treasury can fund government operations until roughly September using accounting moves called "extraordinary measures." However, if the clock runs down, volatility would likely kick-up in financial markets. The other policy-induced risk to this outlook has come from the impact to business confidence from ongoing punitive tariffs and unresolved trade disputes. Despite some optimism recently expressed on a China-U.S. trade compromise, there is little scope for a quick resolution on the weightier topics of corporate malfeasance. Furthermore, a China deal would not remove trade risks altogether. The U.S. administration would then pivot to the EU as its next target, wielding the threat of auto tariffs to enhance its position in trade negotiations this year.

Market Commentary

Recap: Following a difficult fourth quarter during which the S&P 500 dropped 13.5%, optimism returned during the first quarter of 2019. Boosted by a suddenly dovish Fed and a White House that now seems reluctant to further increase tariffs on China, the S&P 500 posted its best quarterly gain since the third quarter of 2009 and its best first quarter since 1998. The benchmark S&P 500 index rose 13.7% during the first quarter, the Dow Jones Industrial Average was up 11.8%, and the Nasdaq jumped 16.9%. Results overseas were also positive as the MSCI EAFE index rose 10.0%, and the MSCI Emerging Markets index produced a 9.9% return. Fixed income markets generated positive results as well as global bond yields fell. The Barclays U.S. Aggregate Bond index gained 2.9% while the Barclays Global Aggregate ex. USD Bond index rose 1.5%.

Domestic Equities: It can be argued that the market's first quarter rally was driven by policy reactions to the weakness experienced in the fourth quarter. Part of the first quarter's rally can certainly be attributed to a softer stance by the Fed. Following its March FOMC meeting the Fed left interest rates unchanged and projected no rate hikes in 2019. As recently as December, two rate hikes in 2019 were expected. The Fed also laid out a plan for stemming the reduction of its balance sheet. Also contributing to the first quarter rally was improving sentiment surrounding U.S.-China trade negotiations. President Trump cited "substantial progress" in ongoing negotiations with Beijing when announcing a delay in increasing tariffs on Chinese imports that were scheduled to go into effect March 1st. Both policy shifts – the newly restrained Fed and the Trump administration's less aggressive approach to trade negotiations – were undoubtedly influenced by the financial market weakness experienced in December. Thus, in can be argued that the stock market decline late last year set the table for policy shifts this year which reduced two major risks and drove equity markets higher in the first quarter.

International Equities: Calendar year 2018 was a disappointing one for international equities as the asset class largely underperformed the U.S. stock market. Weakness overseas was driven by concerns about slowing global economic growth and the resulting potential impact on corporate profits. The first quarter of 2019, however, saw a shift in sentiment as investors became optimistic that economic growth would stabilize, and earnings growth would turn modestly positive. Key drivers of this shift in sentiment have been a seemingly less hawkish Federal Reserve, a decrease in trade tensions, and early signs of stabilization in China. As the world's second largest economy, China is a key driver of both developed and emerging investment markets. After being a drag on global growth since early 2018, China may be poised to turn things around in 2019. Beijing has begun to ease fiscal and monetary policies and U.S.-China trade talks appear to be moving in a positive direction. A turnaround is already evident in its services sector, although international trade and manufacturing continue to lag.

Fixed Income: Fixed income markets generally produced positive results during the quarter as a more cautious Fed ended three years of monetary policy tightening. Coming into the quarter, markets expected the Fed to continue raising rates well into 2019 and, perhaps, into 2020. Rising rates combined with the continued balance sheet runoff and hawkish comments from many other central banks set the expectation that yields would be moving higher and credit spreads would be widening. Following its March FOMC meeting, however, the Fed left policy rates unchanged and articulated a surprisingly detailed plan for concluding the balance sheet runoff. Falling interest rates positively drove returns as the 10-year Treasury bond yield dropped from 2.7% to 2.4% during the first quarter.

Outlook: In the U.S., equity markets resumed their uptrend following a short pause late in 2018. The economy, however, continues to slow, the yield curve has inverted, and year-over-year corporate earnings growth will likely be negative when first quarter results are reported. The year-to-date rally has pushed equity market valuations significantly higher. Margins are under pressure as a result of a stronger dollar and rising wages and input costs. Analyst revisions have moved into negative territory. Given these dynamics, it would be reasonable to conclude that a market pullback is becoming increasingly likely. Recent responses from policymakers, however, do have the potential to extend market gains and postpone such a pullback. Specific policy-related market tailwinds include: (1) Chinese stimulus is ramping up and is likely to stabilize the world's second largest economy at a growth rate of about 6%. This should be supportive of U.S. multinational earnings. (2) U.S.-China trade talks appear to be moving in a positive direction. Although the details of any final resolution are difficult to forecast, an announced trade deal in the second quarter wouldn't be a surprise. (3) A recent turn toward a less aggressive Fed. The Fed's dot-plot of rate forecasts from its most recent meeting shows no rate hikes in 2019 and a rate cut this year is even possible.

In developed overseas markets, European equities remain challenged by weak economic momentum and political risks. Significant corporate earnings growth may prove difficult in this environment. Japanese equities are supported by attractive valuations, shareholder friendly corporate behavior, central bank stock buying, and political stability. Uncertain earnings growth, however, is a key risk. Finally, a solid macro backdrop, near term resilience in China, and solid corporate earnings serve as tailwinds for Asia ex-Japan equity issues. A disruption in global trade or a greater-than-expected slowdown in China are significant risks to the region, however.

In emerging markets valuations remain attractive, even after the year-to-date rally, and fears about broad emerging market contagion from mid-2018 have fallen. Accommodative policy measures in China and a dovish shift by the Federal Reserve are tailwinds. Risks to the asset class do exist, however. If the Chinese economy fails to avoid a significant slowdown despite stimulus efforts by the government or if the U.S.-China trade dispute escalates or drags on, emerging market stocks are likely to suffer.

A slowing, but still growing, global economy should be supportive of fixed income markets. Global inflation pressures remain subdued and are unlikely to drive short term changes in world monetary policy. The current less aggressive stance from the Fed has eased pressure on fixed income assets from rising short term rates. Coupon income, rather than capital appreciation, should be the dominant driver of bond returns in the quarters ahead. Given late cycle dynamics and the expectation of volatility, the historically negative correlation between U.S. equity and government bond returns should hold in the near term. In other words, Treasuries would be expected to act as a buffer when risk assets sell off.

Sources: Department of Commerce, Department of Labor, Bloomberg, Morningstar,
European Central Bank, People Bank of China