MARKET OUTLOOK 2019

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CURRENT COMMENTARY

Prior to December, 2018 market participants could be best described as complacent and overconfident. In the face of escalating trade tensions, rising interest rates, and stretched valuations, U.S. stocks rose 11% at their height—setting all-time records—in 2018. Growth, at any price, was what investors favored. Just as they did 20 years ago, stocks with promising growth potential but no reported earnings had greater returns than stocks with tangible earnings per share. In December, complacency gave way to extreme anxiety as investors were hyper-focused on the same factors which were ignored earlier in 2018. Somewhere between these two extremes lies the appropriate analysis and response to the challenges and opportunities of a late-stage economic cycle and bull market.

Investors were comfortable assuming risk while the Federal Reserve (Fed) provided an accommodative monetary policy, often referred to as the "Fed Put." Even as the Fed began the process of reducing stimulus, the market discounted the impact it would have on global growth. With that safety net removed and the stimulative effect of the 2018 tax cuts waning, investors reevaluated risk in December. "Risk On" quickly became "Risk Off" in the blink of an eye.

According to Bank of America and The Wall Street Journal, market participants yanked $39 billion out of global equity funds in the week through December 12th, the highest weekly total ever. Additionally, $8.4 billion fled investment-grade bond funds, also an all-time high.

Relentless algorithmic trading (automatic trading driven by trends) intensified the speed and magnitude of stock market volatility. The S&P 500 registered its worst December since 1931 and the NASDAQ officially entered bear market territory on December 21. These negative market movements are in stark contrast to a strong third quarter GDP growth rate of 3.4%.

As we stated in our 12/26 commentary, we believed the market was oversold and that stocks were priced below their intrinsic worth given the economic conditions. With the S&P 500 trading at 2,467 as of January 3rd, the estimated forward price/earnings ratio (assuming 2019 earnings of $170 per share[1]) would be 14.5 versus a 25-year average of 16.1[2]. Given this perceived discount to fair value, the market's recent strength is not surprising. However, it is important to not read too much into this recovery. The opportunity for return is still present in today's market but a confluence of fiscal, monetary and geopolitical risks must be carefully monitored. What follows are our observations, analysis and strategy for how to invest assets in this changing landscape.

[1] Yardeni Research, Inc.
[2] JP Morgan Guide to the Markets

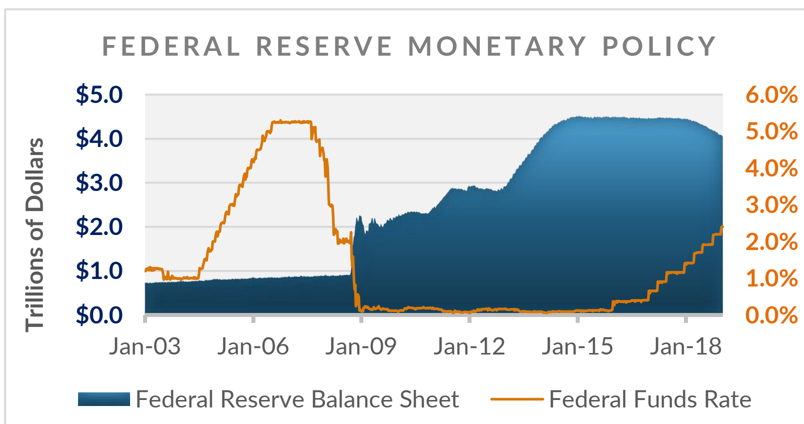
OUTLOOK

The Economy

We believe we are in the late stage of what has been a protracted economic cycle. In the early stage, economic growth recovers after a recession. The recent expansion has been weak from a historical perspective and one of the longest on record. In the middle stage, the economy advances towards—and eventually exceeds—full capacity. In the late stage, the economy slows and eventually slips into a recession. We see the waning impact of the 2018 tax cuts and the Federal Reserve's more restrictive posture combining to cause a deceleration in growth. Anecdotally, interest-rate-sensitive sectors of the economy, such as housing and autos, have shown early signs of weakening. Globally, we expect U.S. growth to remain higher than other developed nations, while growth in the emerging markets is expected to remain higher than that of the developed world. We see odds of a recession in the next twelve months as low; however, as time elapses the odds of a recession over the following 12 months will increase steadily, excluding any interim shocks to the economy. The low odds of a recession in the near term should not be interpreted as impossible, but rather unlikely. A mis-step by the Federal Reserve, geopolitical risks in the U.S. and abroad, trade tensions, and discord in the EU are all risk factors that could cause growth to slow faster and by more than anticipated. As a result, it is important to focus on a range of possible outcomes.

Federal Reserve Policy

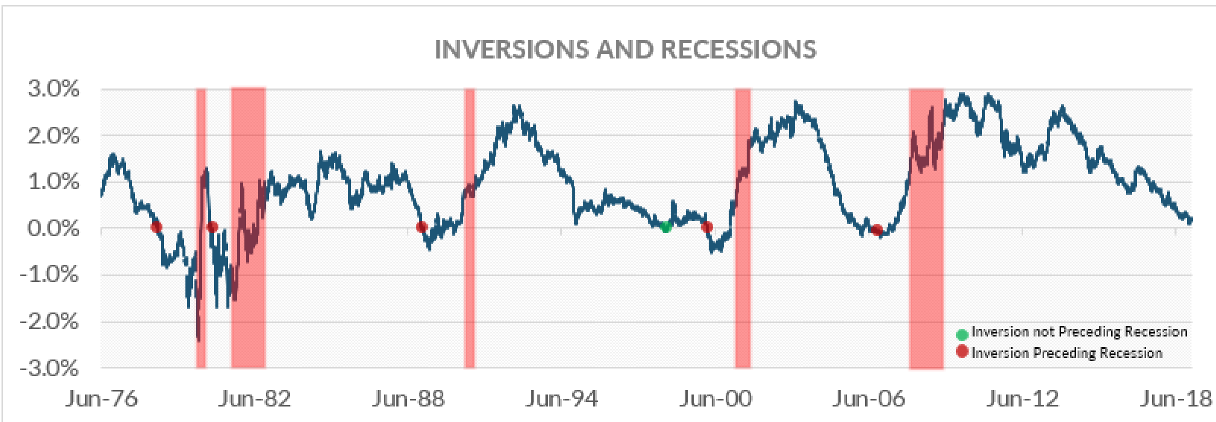
A major factor influencing the economy, and consequently the financial markets, is the actions of the Federal Reserve. In the wake of the Great Recession, the Federal Reserve responded aggressively by reducing interest rates and increasing the money supply to an unprecedented level using a technique called quantitative easing. Today's Federal Reserve has the unenviable task of unwinding this stimulus in an effort to avoid the potential inflation it could cause while—at the same time—not sparking a recession. A successful outcome to this balancing act is often called a soft landing. In normal times, this is a difficult task that requires a soft touch. Unfortunately, these are not normal times. No central bank (the Federal Reserve and its foreign counterparts) has ever had to unwind the amount of stimulus in today's economy, while normalizing negative real interest rates (nominal interest rates minus inflation). In a nutshell, today's Federal Reserve is attempting to achieve a soft landing without a playbook.



Data Source: Federal Reserve; LAMCO Advisory Services, Inc.

Complicating matters is the desynchronized monetary policy across global central banks. While the U.S. is reducing stimulus and tightening the money supply, other countries and regions are behind the U.S. with regard to their monetary interventions as they support economies that never fully recovered from the last recession.

The latest bout of market volatility is, in part, due to the Federal Reserve's actions. The market is signaling to the Federal Reserve that rather than engineering a soft landing, the central bank appears to be setting the U.S. economy up for a recession (hard landing). In addition to the stock market decline, this is best exemplified by the yield curve, which has flattened considerably and inverted in spots. The yield curve is a line that plots government-bond interest rates for different maturities. In a normal environment, the curve slopes upward from left (shortest maturities) to right (the longest maturities) reflecting the higher yield one expects to receive by lending money for a longer term. A flattening yield curve, where short and long rates are comparable, indicates investor concern about the economic outlook. An inverted yield curve, where the rates on shorter term bonds are higher than longer term bonds, is often cited as a predictor of a recession.



Data Source: Federal Reserve; LAMCO Advisory Services, Inc.

In his press briefing after the December 18/19 Federal Reserve meeting, Chairman Jerome Powell struck a less hawkish tone (focused on raising rates). In that briefing he indicated that he believed the Fed was nearing a neutral position, where interest rates were neither stimulating nor constraining economic activity. With forecasted economic growth above trend, he projected two interest rate increases in 2019, down from an earlier projection of three, and he noted that the Federal Reserve would alter this approach if new economic data suggested a weakening.

The Fed has now raised interest rates 9 times since December 2015. Given the fact that it takes 12 to 18 months for a change in interest rates to work its way through the economy, we believe the Fed should have taken a pause to assess the impact of the most recent hikes and evaluate whether additional hikes were warranted. Simply, we believe that the Federal Reserve is being too aggressive in its approach and that the upside of delaying future increases outweighs the downside of potentially higher inflation. While elevated inflation can be seen in some statistics, one must look very hard to find it. However, we think the market reaction has been disproportionate. Over the last 24 months, the market has worried about deflation, inflation, too-strong economic growth that would cause the Fed to act aggressively, and recession. With that as a backdrop, it is not surprising that Chairman Powell is tuning out the market reaction. If the Fed does take a pause with future rate increases, we would expect a strong upside move in the equity and other risk markets.

GEOPOLITICAL RISKS & TRADE

Trade

After being discounted for much of the previous two quarters, trade tensions have weighed heavily on the markets as of late. Foreign trade represents a meaningful percentage of U.S. GDP, albeit a smaller percentage than it does for the remainder of the developed world (20% versus 35%) [3]. However, from an equity market perspective, the percentage of S&P 500 sales from foreign countries in 2017 was significantly higher, at 43.6%.[4]

The ongoing trade war has operational implications as well. At some point, the multinational corporations that are caught in the middle will take steps to protect margins and reengineer their global manufacturing and distribution systems.

Collectively, ongoing trade tensions will result in decreased economic activity, higher costs that lead to lower margins for companies and/or price inflation for end consumers, and an erosion in business confidence.

We forecast that a de-escalation of the rhetoric between the U.S. and China will continue; however, we see tensions remaining as the issues at hand go beyond trade and extend to investment, technology and intellectual property rights. Both sides recognize no one will win through further escalation. Hopefully this keeps the focus on getting the issues resolved.

The U.S. and Europe also continue to work towards a trade resolution, which we believe will ultimately be accomplished. However, we expect trade tensions with Europe could flare up if President Trump follows through with his threat to impose tariffs on Europe's automobiles. This would not bode well for a European economy dependent on trade and already struggling to maintain growth.

Europe

Continued geopolitical tension in Europe is also an area of concern, as the single-currency euro faces mounting challenges. With the March 2019 Brexit deadline looming, it remains unclear how the departure of the UK from the European Union will play out. The longer it takes to arrive at an agreement, the higher the probability that the UK exits the EU in a disorderly and unplanned fashion. Given the strained UK-EU relationship, while not probable, a no-solution outcome is possible.

Elsewhere in Europe, the fiscal conflict between Italy's populist government and EU officials is adding to the anxiety. Italy's proposed fiscal stimulus plan exceeds the EU's 3% fiscal deficit limit, putting Italy and the EU on a collision course. The larger risk is that the European Commission imposes penalties on Italy, escalating the tensions between Italy and the EU and pushing Italy towards an exit from the Euro. While such a move is unlikely on the near term, Europe can ill afford further instability.

The refusal of the European Union to allow for stimulative fiscal policy has contributed to its slow recovery from the last recession. When combined with the differing fiscal conditions of its representative countries, as well as their differing fiscal philosophies, the European Union faces growing challenges in maintaining a single currency.

U.S. multinational corporations—with large investment stakes in the region and a reliance on Europe as a key source of sales and profits—are particularly at risk by these events.

[3] Vanguard
[4] S&P Dow Jones Indices LLC, S&P Global Market Intelligence

United States

Within the United States, political tensions are extremely high. Discontent among voters continues pushing political representatives towards the extremes of each party, making it difficult to get much-needed balanced legislation passed. This has been exacerbated by the current government shutdown, which is the longest in U.S. history. The negative rippling effect on the economy will continue to multiply the longer it continues. The impact on GDP is underway from lost wages and increased unemployment—not only from government workers, but also companies that contract with the government. This high level of political discontent is not confined to the United States. Brexit, the uprisings in France and the populist movement in Italy are indicative of a growing population that does not feel its interests are being properly represented. As the resulting divisiveness continues to shape policy—with Brexit representing an extreme example—it cannot be ignored as a factor that can influence the economy over the short and intermediate term.

Scenario Analysis

	Bad Case	**Base Case**	**Optimistic Case**
GDP Growth	**20%** GDP growth decelerates below 2%, further igniting fears of a recession.	**65%** GDP Growth decelerates to a range of 2.0% - 2.5% year-over-year growth.	**15%** GDP Growth surprises to the upside at greater than 3.0%.
Inflation	**20%** Inflation registers above 2.5% causing the Federal Reserve to take further tightening action.	**70%** Inflation registers 2.0-2.5%, within the Federal Reserve Target range prompting a slower pace of rate increases.	**10%** Inflation pressures are lower than expected but within the Federal Reserve range allowing for an end to Fed policy action.
Trade - China	**20%** The trade war escalates with significant retaliation from China. The impact to GDP could be more than 1%.	**50%** The trade war continues and the level and amount of tariffs increase. The expected impact on the global economy is 50 basis points.	**30%** The US and China settle their disagreement and existing tariffs are removed.
Trade – Europe	**15%** Unable to find common ground, the US implements the auto tariffs and the European government retaliates.	**55%** The US and Europe make mutual concessions as they work towards a bi lateral trade agreement. Auto tariffs as they have been outlined are not implemented.	**30%** The US and Europe agree on a bi lateral trade agreement.
Stability of the Chinese Economy	**20%** China's growth falls below 6%. Trade tensions and an insufficient stimulus response are largely to blame.	**65%** Tariffs are offset by monetary and fiscal easing. Domestic demand continues and growth moderates to 6.2% for 2019.	**15%** Growth is higher than expected either due to a US/China trade deal and/or overly accommodative policy adjustments.
Euro Break up risk	**10%** The EU sanctions Italy, escalating political conflict to political crisis and increasing probability of Italy departing the Euro. Fears of a domino effect with other Euro countries increase.	**70%** Recognizing the reality at hand, the Italian government complies with the Euro rules. The tensions subside, but little in the way of public and private sector deleveraging is accomplished. Euro breakup concerns de-escalate but are not eliminated.	**20%** The Italian government folds their hand and submits a fiscal austerity plan that causes public debt to fall more quickly than currently expected. The euro breakup concerns subside.

LOOKING FORWARD – IMPLICATIONS FOR PORTFOLIO DESIGN

Theme: Balancing Risk and Reward

We expect performance to be compressed in 2019 with a narrowing disparity between equity and bond returns. The range of potential outcomes will be wide, and the influence of external forces will create challenges for accurate forecasting. In this environment, risk should be a predominant consideration. Assets with limited upside if everything goes right, but meaningful downside if some things go wrong, should be avoided. Continuing the trend started earlier in 2018, the equity focus will be on quality companies with sustainable growth, low volatility and solid balance sheets. We anticipate a tilt towards larger-capitalization companies that tend to hold up better in the later stages of the economic cycle. Small caps are more at the mercy of rising rates, with more than 50% of small caps' debentures being floating rate, compared to 27% for large caps. Internationally, we believe emerging markets are poised to outperform; however, a more hawkish approach from the Fed could create a meaningful headwind for emerging markets, especially in countries with external liabilities. Not only does a strengthening dollar diminish the foreign returns as they are converted back to U.S. dollars, they also raise the cost of funding in dollars, which is effectively monetary tightening.

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