Market Perspectives

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Investment Committee
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January Re-Cap

Markets staged a rare broad-based, V-shaped recovery from the deep December sell-off. Following a remarkably strong employment report and Fed guidance that surpassed even the most dovish expectations, equity investors quickly reversed their assessment of the risks U.S. recession and a Federal Reserve Bank (Fed) tightening overshoot. The hard data of moderating U.S. growth in the face of deteriorating conditions overseas merely confirmed pre-existing trends. Optimism that worst-case outcomes would be avoided with respect to Brexit and the U.S./China trade war contributed to the risk-on sentiment. Credit markets were the natural beneficiary of the renewed optimism: an 18% bounce in crude oil prices, and stable benchmark-Treasury yields with the high-yield market having its best month since 2011.

U.S. equities gained 8.6% and narrowly (20 basis points) beat out emerging markets for top monthly honors. Growth, cyclicals and small-caps outperformed with Russell 2500 small-cap growth's and cyclical's 12-13% gains nearly doubling those of the Russell 250 large-cap value and more defensive issues. While the defensive utility, consumer staples and health care sectors lagged at 4-5%, gains from the remaining sectors were tightly bunched in the 9-11% range, with energy placing second to industrials despite the oil price spike.

Global Markets

Global equities gained 8%, turning in their best January since 1987. There was little differentiation across market segments, although 5.5% gains in the Eurozone and Japan restrained overseas developed markets (+7%). Currency strength and outsized Latin American gains boosted emerging markets (+8%). Developed market small-caps and more volatile cyclic stocks outperformed by at least 150 basis points (bp)

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International equities gained 7.6% with little distinction between growth and value. Emerging market issues beat developed market peers by 150 bp while receiving their biggest fund inflows in 12 months. Higher risk and commodity-exporter markets outperformed, led by gains in Latin America (Argentina 21%, Brazil 18%, Columbia 14%), Turkey 17%, Russia 14%, Canada 13% and South Africa 11%. While energy importer India fell 2%, more idiosyncratic factors drove a few markets significantly in the red, with Ghana down 4% (on a 10% fall in cocoa prices) and Romania plunged 7% over concerns about a punitive tax on bank assets.

Economic Reports

The strong December jobs report pushed out investor recession timelines, but a very weak Institute for Supply Management (ISM) manufacturing number may have been the "smoking gun" that triggered the Fed's switch in rate-raise guidance from the expected "pause" to a full-on "stop." The sharp decline in the U.S. indicator from 59.3 to 54.1 suggested that the international growth slowdown might finally be hitting

home. Furthermore, the international environment continued to deteriorate, with Eurozone growth and German manufacturing falling to 4-year lows and Italy currently in recession. China growth is also the lowest in nearly 30 years and China exports have contracted from 15% growth to a 5% decline. Fed Chair Powell probably gave greater weight to the forward-looking manufacturing indicator (in combination with the December market plunge) than the lagging employment report in concluding that "the case for raising rates has weakened."

Interest Rates and Bonds

Disappointing overseas growth reports and the dovish Fed guidance helped Treasuries "overcome" the pronounced risk-on environment. They generated a 0.5% return as yields fell 3-6 bp across the curve. Similarly, while German yields fell 5 bp on continued disappointing economic news, renewed investor spirits chased yield in Europe's periphery. Greek yields fell 50 bp after the government survived a non-confidence vote and settled a dispute with Macedonia. Italian bonds lost another 15 bp following the recent budget compromise with the European Union (EU).

While U.S. municipals outperformed with a 1% gain, the real news was in the credit space, particularly in high yield and emerging markets. Investment-grade corporate bonds gained 2% as spreads tightened 25 bp. The high-yield market recaptured nearly all of its fourth quarter losses by gaining 4.5%, with higher oil prices contributing to a nearly 6% gain for CCC-rated issues. As an aside, the Pacific Gas and Electric (PG&E) bankruptcy did not impact high-yield returns, as the issue "bypassed' the high-yield universe by plunging directly from investment grade to distressed. The emerging market segment was similarly strong, with dollar-denominated issues gaining 4.4% as spreads fell 58 bp, while local-currency issues gained 5.5%, the beneficiary of dollar weakness.

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Currencies and Commodities

The 0.6% decline in the dollar index understated the broader-based dollar weakness, particularly against emerging market currencies, which gained 3%. The Swiss Franc fell 1% on safe-haven selling and India fell 2% on concerns over higher oil import costs and central bank independence. However, there were noteworthy gains elsewhere. The Chinese Yuan and China-sensitive Australian Dollars were up 3% on trade war resolution hopes. Resource-rich Brazil's Real and Russia's Ruble were up 7%.

Commodities gained between 5-9%. The 19% spike in crude prices (its third largest monthly percentage gain in nearly ten years) accounted for the dispersion among indices. Oil was supported from both demand and supply perspectives. There were reduced fears of both a U.S. recession and an escalating trade war. Plus, there were hopes for continued OPEC production restraint as 1) Saudi Arabia's production fell 500,000 barrels per day in December and 2) new sanctions were placed against Venezuela's state-owned oil company (which portended near-term political instability). Industrial metals recovered from their late 2018 lows with double digit gains for nickel and zinc, while copper rose 6%. Despite the risk-on environment, gold and silver rose 3-4% on the weaker dollar and the surprisingly dovish Fed guidance.

February Positioning

Early month economic reports remained consistent with our perspective that U.S. growth was indeed moderating, but from unusually high levels, and that near-term recession risks were overstated. For example, while February's 300,000 job growth was partially offset by downward revisions, the 6-month average increased to 230,000 which is quite large for this late in the cycle. Consequently, wage pressures are increasing with year-over-year aggregate payrolls gaining 5.7%. Perhaps more importantly, the Fed's much feared ISM-manufacturing indicator actually rebounded, showing big increases in new orders and production. In addition, bank lending accelerated in December to its fastest pace in two years, with lower rates spiking mortgage applications to the highest levels since 2010. To be fair, the forward-looking services indicator showed a precipitous fall in new orders, with export orders hitting a 14- month low. A slowdown in auto-loans warned that consumer durable purchases might be rolling over.

Fed Watch

The Fed's move to a neutral rate bias, suggesting that the next move will be a cut, surprised markets. Current conditions are seemingly much stronger than in early 2016, when the Fed simply paused in view of plunging oil prices, slow growth (0.4% in the fourth quarter of 2015), China hard-landing, capital flight risks, and outlier dollar strength. Whether or not the Fed's about face represents a wimpy capitulation to the financial markets or a prudent assessment that economic risks are biased to the downside remains to be seen. Regardless, it does little to change our outlook, other than making the Treasury curve steepening even more likely. As discussed previously, the issue is less the overall growth than its run-rate by the end of the year. I will pencil in a 2.5% growth for the year (higher than private economist consensus), with growth

slowing to 2.0% in the fourth quarter. While admittedly less likely given the Fed's removal of the tightening bias, I continue to project one rate increase in June, with a second bump near year-end as growth, while slowing, should be sufficient to further tighten the labor market.

The U.S. economic outlook is partially driven by the international backdrop, where growth has continued to deteriorate from even low fourth-quarter levels. Will international growth stabilize as the year progresses, removing negative external pressures, or will some combination of adverse global event risk (trade wars and Brexit) and an unexpectedly abrupt slowdown in the U.S. lead to something much worse? While international growth has even fallen short of my modest expectation of a continued crawl forward at fourth-quarter rates, further downside risks seem overstated as evidence of widespread resiliency seems unappreciated.

International Growth

It is undeniable that non-U.S. growth has continued to deteriorate, with some individual manufacturing growth metrics approaching zero or negative levels. The global manufacturing Purchasing Managers Index has fallen 12 of the last 13 months to 50.7, not far from an outright contraction; Germany has fallen below the key 50 (zero) level. The global new-orders-to-inventory ratio and the percent of countries reporting year-over-year increases (15%) both fell to 6-year lows. Brexit business sentiment has fallen to levels approaching actual post-Brexit-vote 2016 lows. Japanese industrial production fell the most in several years and China exports fell 4.5% in December, suggestive of the slowdown and disruptions to the global supply chain.

Nevertheless, with the international growth slowdown already quite advanced from its 2017 peak, I expect a near-term stabilization and a modest second-half recovery brought about as fiscal stimulus and even more supportive interest rates further tighten strong underlying labor markets. The Eurozone is a good example. While potential growth is only 1.2%, recession fears are overstated especially with new fiscal stimulus being added (0.5% in Italy and 0.3% in France - payoffs to populists and yellow vests-) at a time when:

- negative deposit rates are expected to continue into 2020,
- unemployment is the lowest in a decade,
- all countries show positive growth sentiment and
- wage and bank loan growth is the fastest in at least five years.

More importantly, in China I may have relied too heavily on data from the slowdown in the "old economy" as it is hard to square my fears of 2% growth with both consumer sentiment and the job-openings-to-applicant (1.3X) levels near all-time highs. The combined effect of bank liquidity measures and fiscal policy is significant, with the additional tax cuts announced late last month adding 1.2 percentage points to the stimulus package. While Japan's economy faces a near-term consumption tax increase, its job-openings ratio is the highest in 40 years and this year's earthquake and typhoon impact will hopefully be more benign.

Given an economic outlook that remains muted in an absolute sense, but more optimistic than consensus, what portfolio actions might be appropriate, considering the increasingly aggressive purchases of cyclical U.S. shares and high-yield bonds after the ongoing weakness in December? Domestic equities should be trimmed on strength. While the overall market might have been only mildly overvalued at the December lows, the subsequent 16% recovery without any real change in fundamental outlook reduces their appeal, particularly as defensive shares are overvalued and elements of froth still remain. For example, the "most shorted tech stock" index has gained 28% since December 24, far surpassing 16% gains for both global technology stocks and the broad U.S. market. In contrast, while currency gains have contributed to the relative outperformance of emerging market shares over all recent sub-periods (since 9/30, 11/30 and 12/24), international developed market shares are now lagging U.S. shares since September 30, after bouncing almost 10 percentage points less than U.S. peers since the Christmas lows.

Fixed Income Prospects

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The call to add to developed market equity exposure is also accompanied by a further downgrade of global fixed income prospects as markets have overreacted to the disappointing news abroad and the dovish Fed rate guidance. A telling statistic is that global bond yields have plunged since November 30 at the same time as global equities are virtually unchanged whether looking at German Bunds (0.31% to 0.12%) or U.S. Treasuries (2.99% to 2.66%). Japanese bond yields are once again negative. These moves reflect more than risk aversion, as peripheral (Spanish) yields have also fallen (1.50% to 1.24%). I continue to believe that U.S. yields are likely to steepen, particularly if

the Fed remains on hold, given the tightening labor market, negative term premium (despite the outlier 5% budget deficit) and likelihood of core inflation picking up in the near term. These global yield changes appear even more disproportionate when viewed relative to September 30 levels, even allowing for the subsequent 7% global equity decline, given falls of 50 bp, 67 bp and 45 bp in the 10-year yields of Spain, the U.S. and Germany. On the other hand, if I am wrong and global bond markets are correctly priced, equity markets have meaningful downside.

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