Global Economic and Market Commentary

Summary

- Escalation of tariffs threaten to impact growth in the US and to a greater degree outside the US.
- The Fed has moved to a more dovish stance due to tighter financial conditions and lack of inflation.
- The dislocation of sentiment from sustainably solid US fundamentals has led to much cheaper equity valuations which should produce better performance in 2019.
- Given an aging business cycle, declining global growth, trade tensions and heightened geopolitical uncertainty, volatility will remain elevated.
- We anticipate positive US equity returns in 2019 driven by earnings which we expect to grow by 3-7% after accounting for margin compression.
- Non-US developed market valuations are at multi-year lows and we expect positive earnings growth and equity performance in 2019. The US dollar is unlikely to strengthen further. A resolution to the US/China trade war would be a positive catalyst.
- The EM/DM growth differential will widen in 2019 due to slowing in the US. China will dictate EM growth in 2019 but risk of contagion is low unless the trade war escalates.

"If you can keep your head when all about you are losing theirs and blaming it on you …" –*Rudyard Kipling*

"The economy started 2018 with a tax cut bang, but is ending the year with a trade war whimper." –*Mark Zandi*

While 2017 stood out in many positive ways, 2018 was the opposite. Almost every non-cash global asset class finished in negative territory for the year, and the rapid deterioration in global equity prices in the fourth quarter reminded us all that market sentiment is a powerful force. Trade policy uncertainty, a more hawkish Fed, non-US economic weakness and downgraded corporate outlooks catalyzed the downturn.

The Chinese economy slowed substantially in the second half of the year and the ECB was no longer able to offset the adverse effects of the euro on Italy and France bringing European growth down to 1%. Unlike 2017 and much of 2018, in Q4 US investors looked past positive current fundamental data to pessimistic 2019 and 2020 forecasts. Our simplest explanation is that we are experiencing a re-rating in equities to compensate investors for existing risks that were being ignored.

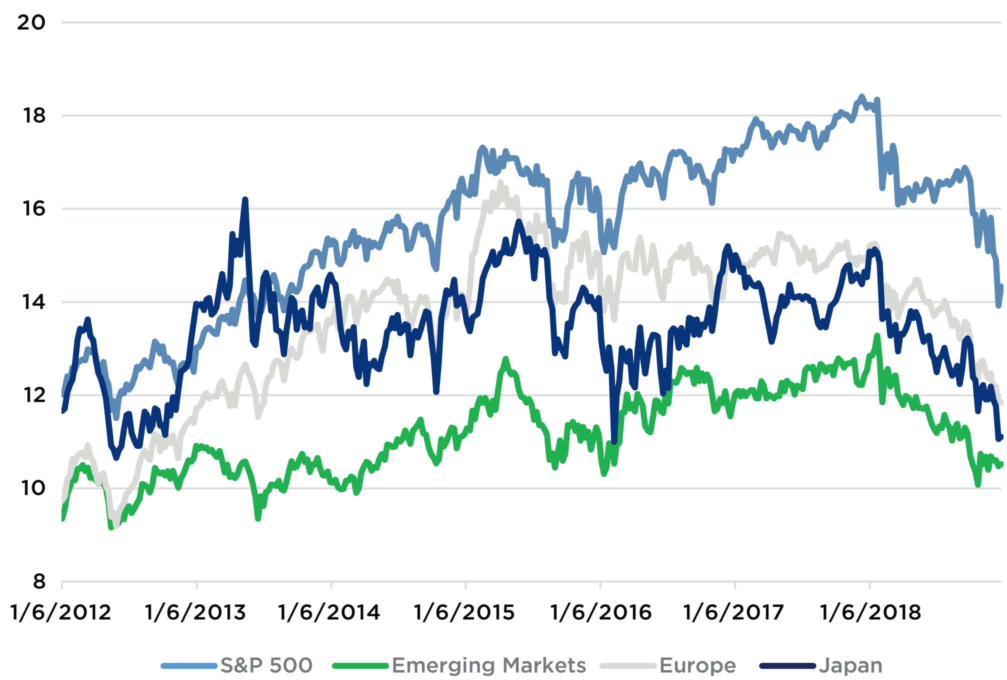
In the fourth quarter, domestic equities retraced -13.5% and ended the year down -4.4%. Non-US equities fared much worse reversing their 2017 outperformance. Emerging markets finished the year down -14.5% and returned -7.5% during the quarter while non-US developed equities returned -12.5% and -13.7% QTD and YTD, respectively.

US Treasuries rallied from early October through the end of the year. Strong domestic growth, tight labor markets, inflation expectations and Fed rate hikes had provided upward pressure on interest rates prior to the fourth quarter. The reversal in equity markets, policy uncertainty and China concerns reignited the demand for Treasuries in the fourth quarter. Credit spreads widened with high quality bonds outperforming low rated credits. The Bloomberg Barclays Aggregate Bond Index finished the year flat (0.0%) and returned 1.6% in the quarter. High yield bonds reversed their outperformance, down -4.5% for the quarter and -2.1% for 2018.

> Investor sentiment outweighed fundamentals in the fourth quarter

Despite recent turmoil in equity markets, our outlook for 2019 has not changed drastically. Recent economic data releases suggest a moderation in domestic growth and economists have also downgraded their estimates for 2019 global growth as well, albeit modestly.[1] The headwinds of tighter financial conditions, higher interest rates and tight labor markets are now upon us and recognized broadly. When coupled with uncertainty related to Italian debt, Brexit, Trump's trade policy and a slowing Chinese economy, it is easy to construct a narrative for a global recession in the next 12 months. While the probability of recession has increased, markets often move in advance of fundamentals or overreact to the upside and/or downside. Our challenge as allocators is to piece together a mosaic from relevant data points and build portfolios that reflect our fundamental outlook and long term approach but do not ignore shorter term market sentiment.

EXHIBIT 1: GLOBAL P/E RATIOS 2012-2018

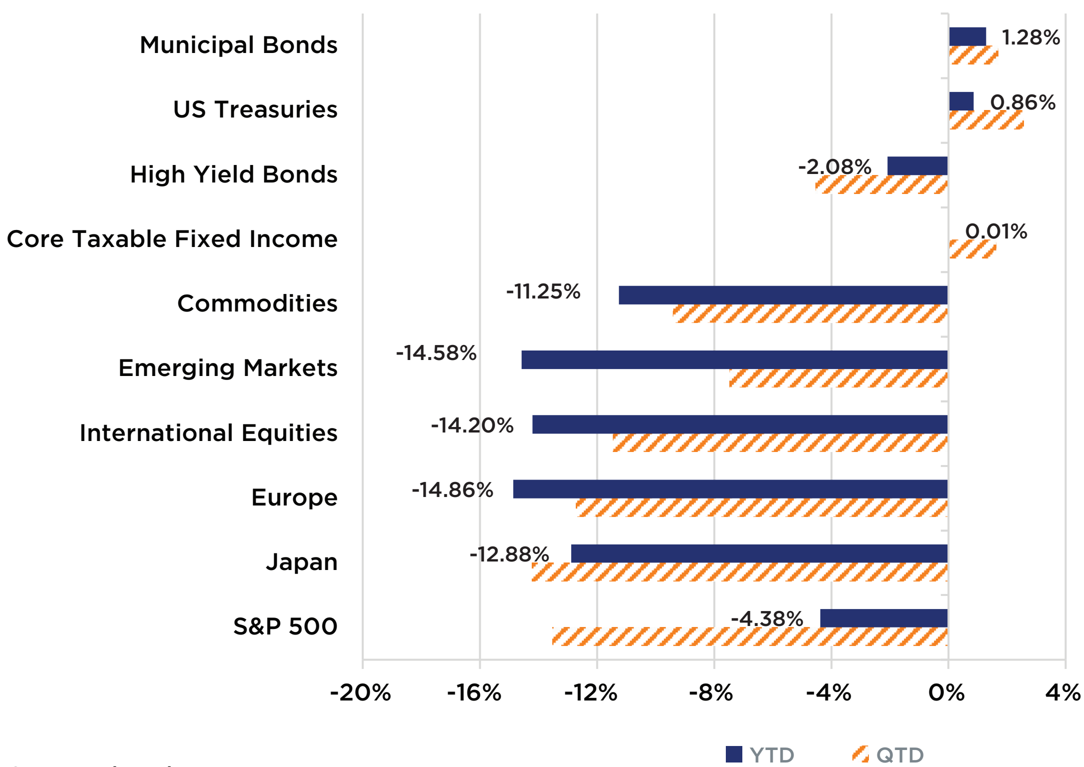


Source: Bloomberg

[1] OECD estimates for global growth are 3.5% for 2019 down from 3.7% in May.

Due to strong earnings growth in 2018 and negative price movement, US equity valuations have moved materially below 25-year averages based on forward P/E ratios. Non-US equity valuations are back to levels last seen in 2012 and 2013, depending on geography. Globally, equities are forecasted to generate positive earnings growth alongside positive economic growth. With increased vigilance, we have kept equity allocations in line with policy benchmarks and have a preference for companies with strong balance sheets, pricing power and less sensitivity to global growth. Our fixed income allocation remains in high quality and short duration strategies as we prefer to concentrate risk in our equity allocation.

EXHIBIT 2: GLOBAL CAPITAL MARKET RETURNS YTD AND QTD THROUGH DECEMBER 31, 2018

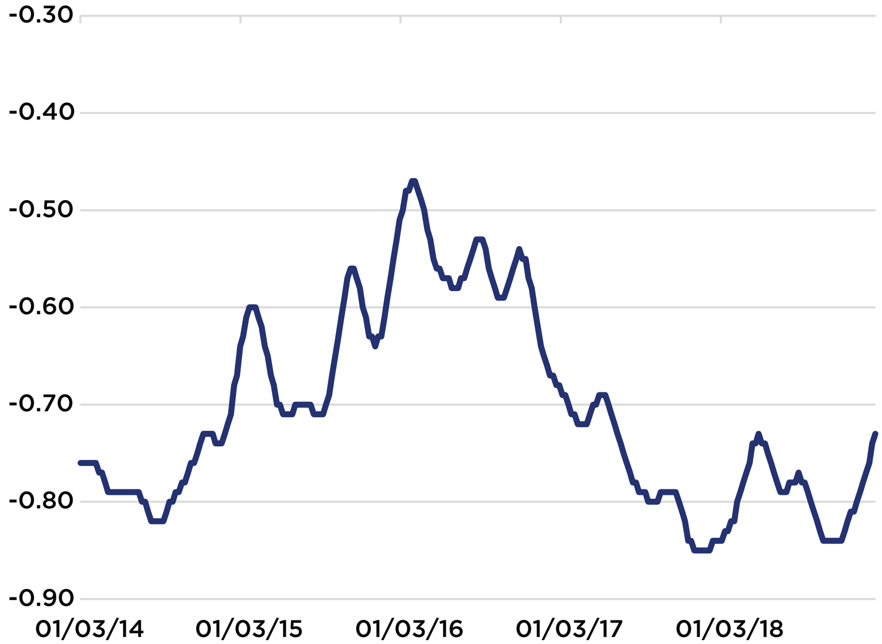


Source: Bloomberg

Outlook for the US Economy and Stock Market

The US economy enjoyed "extraordinary times" in 2018. GDP growth was at a post GFC high, inflation was right on target and the unemployment rate was at a 48-year low. We expect GDP growth to decline substantially in 2019 on a sequential basis to around 2.0% by the fourth quarter. With fading fiscal stimulus and tighter financial conditions, the US economy will encounter substantial resistance. Financial conditions have been tightening sharply since the beginning of 2018, in contrast to the loosening that occurred during the first years of the Fed's rate hike cycle which began in late 2015 (see Exhibit 3).

EXHIBIT 3: CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX JAN 2014- DEC. 2018



Source: Federal Reserve Bank of St. Louis

The slowdown should proceed at a measured pace with growth remaining above trend in the first half before falling slightly above its potential rate in Q4. According to Goldman Sachs, the economy's recent growth has been firmer than fiscal and financial stimulus alone would predict.[2] We expect that much of this self-sustaining momentum will fade in 2019.

Declines in the net trade balance and the housing sector should be more than offset by continued, though slower, consumption and business investment growth. Consumption gains should be supported by substantial wage growth, a moderate savings rate and above average, albeit slowly declining, consumer confidence. A high capacity utilization rate and better than average monetary accommodation should contribute to business investment growth.

While further escalation of trade tensions with China cannot be ruled out, we have found minimal effects on the US economy so far, though the next steps originally proposed by the Trump Administration, if fully carried through, could reduce per-share earnings growth by three percentage points and GDP growth by one percentage point. Our base case calls for the truce period to end with an agreement, the additional proposed tariffs on US imports of Chinese goods not to be implemented and some tariff rollback. China seems determined to make a deal as evidenced by the concessions it has already offered.

These include:[3, 4]

- Temporary reduction in tariffs on US autos from 40% to 15%.
- Greater enforcement of intellectual property theft with punishment including restricted access to Chinese government financial support.

[2] Jan Hatzius et al, Goldman Sachs, 2019 Economic Outlook.
[3] Hancock, Tom, "US and China to restart trade discussions," Financial Times, Jan. 5 2019.
[4] "China Scrambles to Sustain Trade Truce with America," Economist, December 18, 2018.

- Fewer restrictions on foreign investment in banking and autos.
- Near abandonment of the "Made in China 2025 Plan."
- New foreign investment law which would allegedly ban forced technology transfer.

President Trump is obsessed with the US stock market, and he is beginning to learn it does not like tariffs.

With growth falling eventually to potential, the recent impressive momentum is likely to diminish. We do not expect monthly payroll growth to slow to the 90,000 break-even pace until the second half of 2019. By then we expect the unemployment rate to have declined to 3.5%, well below our 4.0-4.5% estimate of the full employment rate consistent with the Fed's 2% inflation target. Other indicators support this picture of one of the strongest labor markets in history. The number of job openings per employed worker, the quit rate, the household reports of the ease of finding a job and employers' reports of the difficulty of finding workers all suggest workers' bargaining power has increased.[5] Based on this information, we expect the wage growth rate to reach 3.2% to 3.5% next year as the labor market approaches a pinch point. While we expect the rise in the earnings growth rate to continue, next year's expected wage growth rate is still relatively low when compared with similar cyclical periods of full employment earnings.

> Trump is beginning to learn that the stock market does not like tariffs

This increase in wage growth will be mainly offset by an increase in labor productivity growth of about 1.5% per annum. We expect the PCE deflator to rise by 2.2% from 1.9% in 2018 as a result of higher wage inflation, tariff costs being passed on to the consumer, a weaker dollar, rising natural gas prices and a new state level online sales tax.

We expect the Fed to deliver at most two rate hikes in 2019 after the 25 basis point hike in December. This last hike brought the Fed Funds target to a range of 2.25% to 2.50%. While the Fed Funds target is still quite low historically, the December hike was questionable. The housing market was turning over, energy prices were drawn down and the global economy was slowing. It is unclear whether the two additional rate hikes targeted by the Fed are required to bring the policy rate to a long-term neutral level. It is possible that a rising risk of recession in 2020 will make the Fed more dovish and may even preclude any rate hikes in 2019 and lead to a postponement of the proposed reduction in its balance sheet (quantitative tightening). We believe that the relatively tame inflation outlook reduces the probability of a Fed policy error, although higher than expected gains in unit labor costs cannot be ruled out completely.

Given the length of the US expansion, the US economy is under increased scrutiny for any signs of an advanced cycle turning into a recession. We believe that the probability of a 2019 recession remains in the range of 15% to 35% with the majority of credible estimates below the 25% mid-point.[6] Most signals point to a measured growth deceleration rather than an abrupt halt. However, it has been 20 months since the unemployment rate passed below the estimated 4.5% "natural rate" consistent with a stable inflation rate which has historically meant that the recession countdown clock had already begun. The historical range between the unemployment rate first falling below the natural rate range and the onset of a recession has been 21 to 50 months (see Exhibit 4). However, the true natural rate may be well below the 4.5% estimate since it can only be determined after the fact when enough data has been collected to confirm a sustained increase in core inflation.

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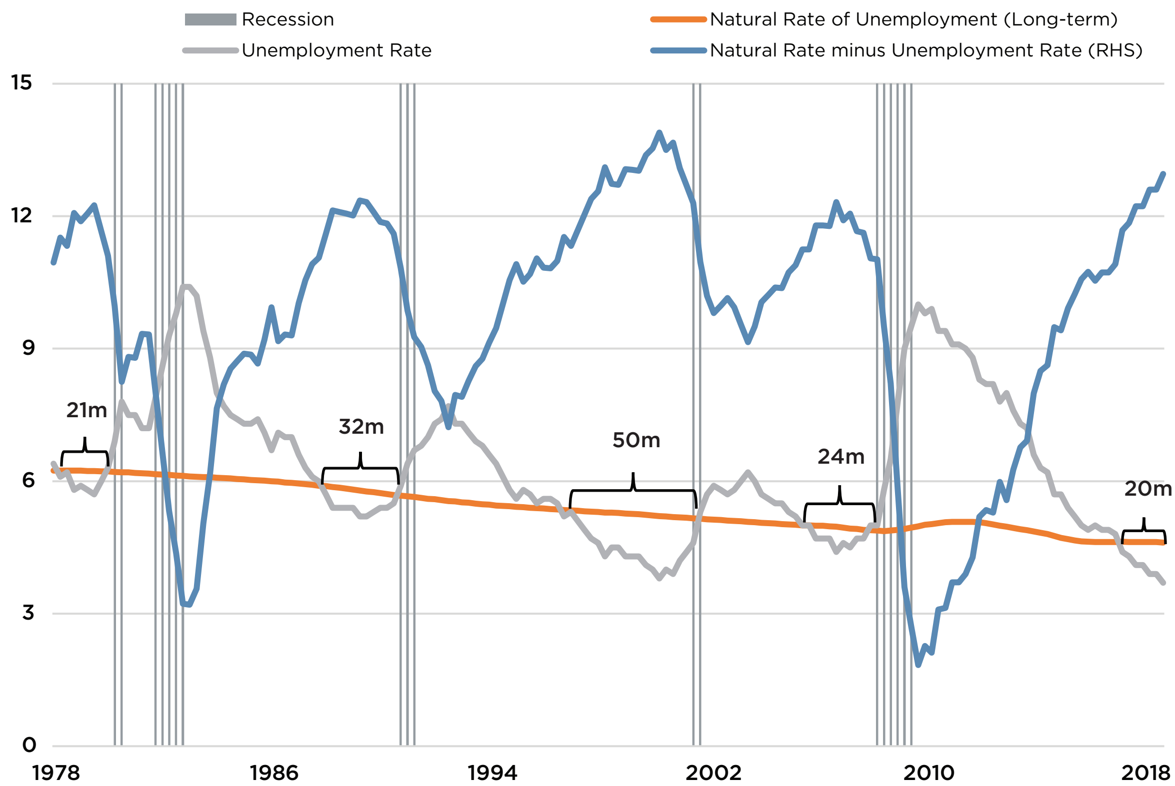
[5] Ibid.

[6] For example, based on various leading and coincidental economic and market indicators, Goldman Sachs, the New York Fed and JP Morgan estimate 15%, 16% and 35% chance of a recession occurring sometime in 2019.

EXHIBIT 4: UNEMPLOYMENT RATE VS LONG-TERM NATURAL RATE OF UNEMPLOYMENT 1978 - 2018



Source: Federal Reserve Bank of St. Louis

Outlook for the S&P 500

Our projected 2019 adjusted operating earnings for the S&P 500 are $171 net of tariffs. This is five dollars higher than our estimate last quarter because the consensus earnings for 2018 is now $164 against $159 three months ago. The 4% earnings growth rate is 0.25 percentage points below our estimate of S&P 500 sales expansion, indicating some profit margin compression. This will be brought on by the delayed effect of increases in the price of intermediate goods imports from China (probably through mid-year), increased transportation costs and some wage pressure. This is in direct contrast to the pattern since the global financial crisis when index level profit margins continued to climb, setting new records quarter after quarter. It is more in line with the pattern of profit margins for the median S&P 500 firm which has been flat for more than five years, according to Bloomberg.

We have a high degree of confidence in our earnings forecasts. However, the path of P/E multiples is more uncertain; our baseline forecast calls for the P/E multiple for the S&P 500 to trade at 15.3 times forward 12-month earnings at the end of next year. This forward multiple is slightly below the 15.5x multiple projected by Morgan Stanley.[7] It is consistent with a 3.5% 10-year Treasury yield and an earnings yield gap (a type of equity risk premium) of 305 basis points, 75 basis points above the long-term average of 230 basis points.[8] Our downside and upside market scenarios

[7] Morgan Stanley, Global Insight, December 2018, Exhibit 30.

[8] The yield gap is the difference between the trailing twelve-month earnings yield and the ten-year Treasury yield.

involve forward P/E rate multiples of 14.7 and 17.3 as shown in Exhibit 4. We have established a range of 2019 US equity forecasts based on these multiples. The baseline projection is for the S&P 500 Index to climb 9.4% to 2741 by the end of 2019 from the December 31, 2018 level of 2506. We assign a 50% likelihood to this outcome. The likelihood of the tail outcomes is not symmetrical; we estimate a 40% probability of the S&P 500 falling to 2394 by the end of this year and a 10% probability of this index rising to 3096. The bear outcome is consistent with a 5% expected earnings decline in 2020, a 380 basis point equity risk premium and a 14.7 forward earnings multiple. In this case we do not expect the 10-year Treasury yield to rise above 3% even though there may be some Fed tightening. The effect of the lower 10-year Treasury yield on required equity return will be more than offset by a 150 basis point rise in the risk premium above its historic average. This will be accompanied by increased scrutinizing of the maturity of the cycle and the durability of growth.

> We expect 4% earnings growth, slight multiple expansion and positive equity returns in 2019 in our base case

We believe our upside scenario has a substantially lower probability of occurring. In this case we expect a 230 basis point risk premium (the 25-year earnings yield gap average) and a 3.5% 10-year Treasury yield, implying a forward P/E ratio of 17.3. Together with our 2020 earnings estimate, these result in a 23.5% gain in the S&P 500 Index. In our opinion, such an increase is excessively optimistic though well below the 3400 upside of Goldman Sachs and other investment firms and the 12 month return of greater than 20% that has occurred almost half of the time following a 20% P/E decline which occurred in 2018.[9, 10]

EXHIBIT 5: DMCA FORECASTS FOR THE 2019 YEAR END VALUE OF THE S&P 500 INDEX

	Bear	Base	Bull
Average Long Term Equity Risk Premium (ERP)	2.3%	2.3%	2.3%
ERP Adjustment	1.5%	0.8%	0.0%
Estimate ERP	3.8%	3.1%	2.3%
Year End 10-Year Yield	3.0%	3.5%	3.5%
Estimated Earnings Yield	6.8%	6.6%	5.8%
Multiple	14.7x	15.3x	17.2x
2020 Earnings	162	179.6	179.6
Estimated 2019 Year End S&P Value	2381	2741	3096

Source: DMCA

[9] Goldman Sachs, US Weekly Kickstart, December 14, 2018.
[10] J.P. Morgan Private Bank, JPM Eye on the Market Outlook 2019.

Even though the S&P 500 was up over 10%, including dividends, for the year through September 30, 2018, driven by strong corporate earnings growth, the fourth quarter correction has more than wiped out these gains and prevented the S&P 500 from finishing the year with positive returns. The question remains whether we are facing a sustained and very deep bear market (like the ones that occurred in 2001-2002 and 2008-2009) or a brief downturn of 15% to 20% magnitude from peak to trough, such as the ones that occurred in 2011 and 2015-2016. We tend to argue that the present set of circumstances is similar to the latter, brought on by economic and market weakness outside the US. Neither of these substantial downdrafts derailed the economic recovery or bull market. They lasted three to five months.

The US equity market in the fourth quarter fell much more than the likely deterioration in fundamentals because of a poor liquidity backdrop and the behavioral biases of its participants. Despite a much healthier fundamental backdrop, the S&P 500 has now substantially exceeded the peak to trough decline seen during the last major drawdown in 2015-2016. The December 24 forward 12-month P/E at 14.0 times is lower than the 14.7 times where the market bottomed in that episode three years ago.

Yet at the 2015/2016 market bottom, fundamentals were substantially inferior to those at the December 24th bottom:

- The Conference Board Leading Economic Index had grown only 2% over the preceding 12-months versus a 5.2% trailing 12-month increase in December
- The S&P trailing 12-month earnings were expected to diminish in 2016, as opposed to an expected increase of 28% for 2018
- US and global purchasing managers indices for the manufacturing sector were below 50 indicating contraction versus above 50 in December 2018, indicating expansion.

Average market declines during a recession are 30%. The near 20% peak to trough decline in 2018 would indicate a 67% chance of a recession in 2019,[11] although the midpoint of the range of estimates made by Goldman Sachs, JP Morgan and others show the odds at about 25% based on a variety of economic and financial market indicators. We are not reducing our target US equity weighting and are waiting for buying opportunities which are less clear cut because of the overhang of central bank stimulus withdrawal and the unorthodoxies of the Trump administration. In cases where we are still overweight US equities, we will trim back if the equity market has a sharp snapback rally following a sharp decline, as it usually does. We are trimming our exposure only after the market gives us a solid rally and is not still significantly oversold.

Japan

Japanese equities declined -12.6% during 2018, outperforming the broader MSCI EAFE Index by 80bps. In the third quarter of 2018, Japanese GDP declined -2.5%, a much larger drop than anticipated. The sharp decline in GDP has been attributed to a series of natural disasters during the quarter which affected both tourism and exports. Additionally, the disasters caused a significant delay in capital expenditures, with business investment declining at an annualized rate of -10.6% during the quarter.[12] We expect most of these effects to prove transitory and positive GDP growth in Japan should resume, although at a slower pace than early 2018 due to increasing economic headwinds.

Softening economic data in the rest of the world and reduced inflation expectations within the country have reduced the likelihood that the Bank of Japan will allow the 10 year government bond yield to float in a wider band contrary to

[11] See Goldman Sachs, "American Preeminence in a Rattled World," January 7, 2019, page 61.

[12] Hudson Lockett and Robin Harding, "Japan economic contraction revised to 2.5% drop," Financial Times, December 10, 2018, ft.com accessed 01/02/2019.

earlier expectations. Global trade tensions will have a negative impact on Japanese GDP during the early part of 2019. Export growth in November came in below expectations as trade with both the US and China weakened. Additionally, the consumption tax will be raised in October.

While macroeconomic data have surprised to the downside, Japanese corporate profits have rebounded and Japanese ROE finally broke through the 10% barrier in 2018. The issue for the Japanese equity market remains stagnant wages and many consumers have not been able to rid themselves of a deflationary mindset. In October, data released indicate that there may be technical pressure on Japanese equities for the next two decades as well. In brief, the population of Japan continues to decline because of fertility that is below replacement rate. As the current over 65 cohort dies off, the demand for risky assets should decline since a large majority of likely inheritors of Japanese equities have stated that they had no desire hold risky assets that are bequeathed to them. This may result in a significant amount of equities being sold in future years regardless of company or economic fundamentals.[13] In previous letters we have vaguely hinted at the long-term risks in Japanese equities due to an aging population. This research highlights a possible transmission mechanism to keep valuations below long term averages.

> Japanese corporate profits have rebounded but Japanese equity markets face technical headwinds

Despite the macro headwinds, we continue to believe that Japanese equities are attractively priced relative to historical valuations and other regions. As of December 31, 2018, the forward P/E ratio of Japanese equities was 11.6x compared to a long-term average of 23.7x and 14.4x on the S&P 500.[14] We continue to maintain a slight overweight to Japan compared to other developed markets outside of the US, and we expect to maintain this position until new information changes our outlook.

Europe and the UK

The MSCI Europe ex-UK index depreciated -14.4% and the MSCI UK Index declined -14.1% during 2018, with the majority of the losses endured during the fourth quarter of the year. The decline in European markets reflected the global trade tensions that pervaded all equity markets, a slowdown in Chinese growth, the lack of a Brexit resolution and renewed political uncertainty within EU countries.

Brexit continues to dominate the headlines of the financial press, and the lack of clarity surrounding key terms of the agreement has delayed business investment, especially within the UK. In mid-November, a draft agreement was released which provided a smooth transition of the UK out of the EU but saddled the UK with significant commitments both to the EU budget and EU rules without a voice in governance of the union. The UK parliament refused to ratify the draft resolution, and British Prime Minister Theresa May has delayed a vote until January. In response, she was subjected to a confidence vote by her party in December. While she survived this vote, she has stated that she will not seek to remain prime minister after the current term.

> The chances of a "hard Brexit" have increased

[13] Leo Lewis, "Japan's dying shareholders signal somber outlook for stocks;" Financial Times, October 21, 2018; ft.com accessed 12/26/2018.

[14] JP Morgan 1Q2019 Guide to the Markets; p. 45.

The uncertainty surrounding Brexit has increased substantially compared to a year ago. While the details of the draft resolution were within our expectations of a gradual withdrawal from the EU, the sharp pushback by Parliament has increased the probability of a "hard Brexit" which would be a worst case outcome. Until Parliament approves an agreement, we expect continued curtailment in UK and EU business investment and underperformance of UK equities, which already trade at a discount to European equities. It is in most politicians' interest to reach a deal and approve an orderly Brexit; however, in almost two years, little has been accomplished and the process is unlikely to undertake a smooth and orderly path. Regardless of a "hard" or "soft" Brexit, a confidence vote in the government may be triggered at some point in 2019. In the event the current government is dissolved, both far right and far left politicians should gain power from new elections, further clouding an already murky political outlook. As we have experienced in the US, markets tend to price in increased volatility when the whims of the political class begin to stray from the status quo. We believe ultimately a "hard Brexit" will be avoided and upon confirmation of a plan, UK equities would likely outperform.

Elsewhere in the EU, politics have dominated headlines amidst a disappointing year of growth. Key events were the "gilets jaunes" (yellow vests) protests in France, elections in Germany, which led to Angela Merkel stepping down as head of her party as well as her positions as Chancellor during the next elections in 2021 and continued budgetary issues in Italy. In mid-December, the ECB announced that they would end the expansion of their QE (quantitative easing) program but delay any tightening measures until later in 2019. The ECB had long signaled it would end new purchases at their December meeting, but the slowdown in growth in 2018 from 2017 had left many investors hopeful for an extension of their bond buying program. Combined with the actions of the Fed, the end of European QE leaves only Japan actively employing QE.

2018 was a difficult year for European markets and the 2017 upside surprises in growth were reversed as slowing growth in China and emerging markets fed back on European exporters. The potential for increased tariffs on autos and other goods has delayed investment domestically, and a "hard Brexit" has now become a reality.[15] Growth has declined but remains above trend due to strong domestic demand. Absent a dramatic pick up in external demand, we see few catalysts for upside in growth with risks skewed to the downside. Most concerning, Europe lacks the policy flexibility to stimulate their economy if global growth turns down.

> A slowdown in Chinese growth hurt European economies in 2018

Our base case assumes that the EU and UK will reach an agreement for an orderly Brexit and there will be a decrease in global trade tensions; however, Italy will be an ongoing problem for the EU. In this case, we see upside in European markets from current levels though our expectations have been tempered from previous quarters as economic and earnings growth have stagnated in the region. A disorderly Brexit and increased tariffs, specifically autos, define our downside scenario which has increased in probability. Capital investment would freeze and goods and services would be subject to material delays until trade rules were negotiated amongst the UK, EU and other trading partners. We would also anticipate a decline in the euro and GBP and potential resumption of QE by the ECB to spur growth. Our upside scenario is based on a resurgence in Chinese growth through a stimulus package coupled with an improving pro-growth, pro-EU political environment.

[15] Barclays estimates that a hard Brexit could decrease euro area GDP by 0.4%. US tariffs on EU car imports would have a similar effect dragging down euro area growth 0.3-0.4%.

While the valuation discount to US equities stands at a higher than average level with a P/E multiple of 12.1x, the upside of our base case has declined and the risk of our downside scenario has increased.

Structural differences in EAFE compared to the S&P 500, such as less exposure to faster growing sectors and higher financial leverage, justify a longer term multiple discount; however, a greater than average discount may be warranted today. Therefore, we have reduced our overweight to non-US developed markets until we gain more clarity on the aforementioned events.[16]

Emerging Markets

After peaking on January 20, 2018, the MSCI Emerging Markets Index dropped 22% through the end of the year, greater than the fall in the S&P 500. It was crushed by negative news about a US trade war with China and debt crises in Turkey and Argentina. The weakness in emerging market (EM) equity prices has been accompanied by some slowing in EM GDP and earnings growth rates, partly attributable to slower expansion in Europe and China.

Higher dollar-denominated interest rates caused equity capital outflows from the EMs and resulted in some monetary tightening, which had a further depressing effect on growth and earnings. The greater than expected Fed rate hikes caused the US dollar to spike relative to EM currencies. Since many of those countries had undeveloped capital markets, their companies borrowed from abroad in US dollars. As the latter appreciated, EM companies were forced to pay much more in local currency to service their dollar-denominated debt payments. Economies were also damaged by worsening balance sheets as the domestic value of foreign currency denominated debt rose, which caused deleveraging, for example, through lower capital expenditure. EM central banks then raised their own rates to prevent their currencies from falling more, which also slowed their economies, further reducing the business and tax revenues needed to repay foreign lenders. This negative feedback loop caused a downgrade in EM credit. Thus as principal payments came due, overseas banks and bondholders demanded higher rates to refinance their loans. This vicious circle has already started to be reversed as a result of diminished growth expectations for the US and Europe. We expect minimal Fed rate increases in 2019 which, combined with higher EM policy rates in 2019, should cause EM currencies to continue to appreciate against the dollar after bottoming in early November.

> Dovish language from the Fed has provided a support to EM equities and currencies

Growth in EM Asia ex-China, Eastern Europe, Middle East and Africa (EEMEA) and Latin America is expected to weaken further due to some of the same external factors that adversely affected those regions in 2018, namely, slowing Chinese and Eurozone growth. Changes in Fed policy rates and exchange rates will provide tailwinds rather than headwinds. However, a fading tech cycle is likely to be an additional contributing factor in 2019. For this reason, we expect the industrialized economies of Korea and Taiwan to weaken along with China this year. Still there are some economies where country specific factors will dominate. For example, in Russia growth is expected to decline from 1.8% to less than 1% as a result of lower oil prices. In Turkey, against a backdrop of excessive dollar debt accumulation, an extreme lack of domestic policy credibility is expected to reduce growth from 3.8% to 0.7%. In Mexico, recent actions by the new president are creating uncertainty and concern about government interventionism which could lower private

[16] JP Morgan 1Q2019 Guide to the Markets; p. 45.

investment. The exception is likely to be Brazil where market friendly and reform oriented leadership should increase or maintain growth.

China's growth slowed more than expected to 5.9% quarter-over-quarter, 6.5% year-over-year in Q3 of 2018 and we see more headwinds in Q4 and in 2019. The latest indicators for the Chinese economy and US business subsidiaries in China, especially Apple, suggest softer economic activity. The weakness thus far mainly reflects domestic deleveraging policies. However, as the apparent strength in exports is the result of loading ahead of expected US tariff increases, lower exports could become an additional headwind soon. Because it has now lost patience with a slowing economy, the government has begun some monetary relaxation and fiscal support measures including tax cuts. Our base case growth forecast is 6.2% in 2019, down from 6.6% in 2018. The sequential 2019 GDP growth path assumes a week Q1 with an uptick as stimulus measures take effect and policy easing starts to gain momentum. If, as we expect, the policy easing in China begins to gain more traction, and trade tensions diminish, Chinese growth should rebound to 6.5% by the fourth quarter of 2019. Such an increase "would directly boost global growth by 0.3 to 0.4 percentage points", driving it slightly above trend if the EMs other than China rebound.[17] This, together with the anticipated termination of Fed rate hikes, would mark the end of the turmoil in EM assets.

EM economies and equity markets are the most at risk in a trade war

If, contrary to our baseline forecast, the trade war escalates, the RMB should depreciate 10-15% against the dollar. Since EM currencies are highly correlated with the RMB, such depreciation could be highly destabilizing for countries whose corporate sector borrowed extensively in US dollars and other hard currency.

Since markets anticipate a recovery in real economic growth about six months in advance, 2019 should present a major opportunity to purchase EM equities at exceptionally depressed prices by midyear, if not earlier. At the end of 2018, the cyclically-adjusted P/E ratio for EM equities was 12.5 against 29 for the S&P 500 which makes them 57% cheaper than US stocks. Their 12-month forward P/E discount was also higher than average. Given the higher earnings growth rates of EM equities, they are good long-term investments even though their volatility is substantially higher than DM equities. For these reasons, even though we are neutrally weighted in EM stocks at the beginning of 2019, we will consider overweighting them later in the year if there is a trade deal between China and the US and if Chinese stimulus policy starts to prove beneficial.

Fixed Income

Yields on Treasuries peaked in early October and again in early November before declining substantially in December's flight to quality trade. The 10-year Treasury yield reached 3.25% in the quarter and finished the year at 2.69%, up from 2.40% at the end of 2017. Global risks persisted throughout the quarter; however, the shift in investor sentiment in December led to an increase in demand for safe assets amidst concerns related to slowing growth. Much of the decrease in the nominal rate was due to a decline in inflation expectations, with the 10-year break-even rate declining nearly 40bps in the quarter to 1.78%, while the real yield actually rose approximately 10bps.

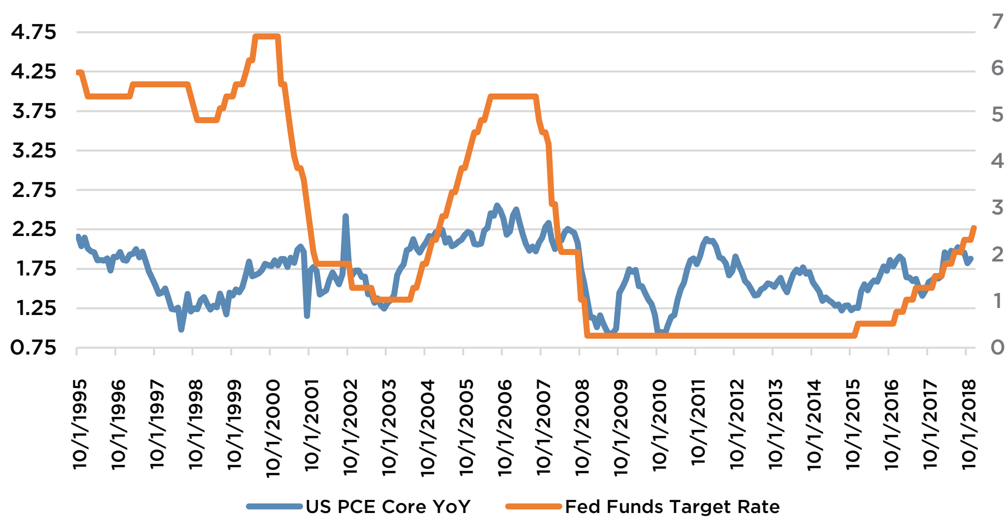
[17] Gavyn Davies "Trade truce provides time for Beijing to stabilize," Financial Times, December 2, 2018.

The Fed chairman, Jerome Powell, announced another 0.25% increase in the Fed Funds target rate in December, bringing the overnight target to 2.25-2.50%. Additionally, in his comments, he highlighted the Fed's adherence to targets of both inflation and employment. The Fed is forecasting two more hikes in 2019 and one in 2020 which would bring the Fed Funds Rate to a range of 3.00% to 3.25% and lower their medium term target to 2.75%. Fed Fund futures reversed course in December and currently predict less than a 10% chance of a single rate hike in 2019 down from 90% in November. In our view, the Fed will perform a simple function amidst moderate inflation and low unemployment - raise rates as much as possible without ending the expansion. The newly created caveat is that the derating of risk assets may influence the fundamentals, thus necessitating less monetary tightening. If Powell takes a page from Janet Yellen's book, the Fed Funds rate will remain unchanged until financial markets recover.

The Fed is likely on hold until volatility declines

We expect the yield curve to remain flat and potentially invert modestly in 2019. The current spread between the yields of the 10-year and 2-year Treasury bonds finished the year at 0.20%. While the instance of an inverted yield curve does not presage recession on its own, sustained inversion typically precedes a recession. In the most recent tightening cycles that have led to inversion, the Fed was hiking rates to curb inflation and/or asset bubbles. Following the fourth quarter sell off, there are few, if any, global asset bubbles and the decline in oil prices will drive headline inflation below core inflation which is unlikely to exceed 2.5%. We believe the Fed will adopt a more cautious stance and expect only one rate hike in 2019.

EXHIBIT 6: FED FUNDS TARGET RATE AND CORE PCE DEFLATOR 1995-2018



Source: Bloomberg

Given our expectation for a flat yield curve, we have adjusted the fixed income allocation in client portfolios to minimize exposure to the intermediate part of the curve (3-10 year maturities). We now have a "barbell" exposure by allocating to short maturities with attractive relative yields, low risk and high liquidity coupled with an overweight to the longer end of the curve which protects portfolios in a risk off scenario. Overall, we are underweight interest rate risk and we will be underweight credit risk and spread duration.

MUNICIPAL BONDS

In the fourth quarter, AAA Muni yields fell in tandem with US Treasury yields except for maturities under one year, where US Treasury rates rose, while AAA muni yields fell. Short term maturities fell 0.20% and longer term maturities fell 0.15% to 0.30%. The AAA Muni to Treasury yield ratio fell as supply was limited going into the holidays.

The Bloomberg Barclays Municipal Bond index returned 1.62% for the quarter compared to 1.34% for taxable bonds as measured by the Bloomberg Barclays U.S. Aggregate Index. The 10-year municipal to Treasury ratio decreased slightly to 83.4% in the quarter. Similar to taxable fixed income, we favor a barbell approach with an overweight in short and long maturities and less exposure to intermediate maturities. We also prefer better quality credits.

SPREAD PRODUCT

US investment grade (IG) bond spreads increased by 14 bps to 53bp during the quarter while high yield (HY) bond spreads widened by 215 bps from the beginning of the quarter. The Bloomberg Barclays Corporate High Yield index fell -4.5%in the quarter and leveraged loans had a similar fate, down -3.5%. At 531 bps, HY spreads have reached levels last seen in August 2016 during the energy crisis. We expect to see a heightened level of volatility in spreads related to the downgrades of highly levered BBB issues, technical pressure from fund flows and decaying sentiment. Fundamentally, interest coverage ratios remain strong and default rates should remain low in HY in 2019; however, we don't view current spreads as an attractive entry point particularly in HY. We foresee modest spread widening due to deterioration in fundamentals. Higher interest rates and sector specific margin compression are most concerning.

> We are underweight interest rate risk, credit risk and spread duration

We favor Treasuries and investment grade corporates over high yield bonds and have shortened maturities in the corporate bonds we own. We also maintain our allocation to legacy non-agency MBS which feature attractive yields and less sensitivity to risk assets.

The JP Morgan EMBI Global Index was down -1.26% in the quarter. Emerging market currencies have stabilized relative to the US dollar after declining persistency in the first half of 2018. While difficult to forecast in the short term, less Fed tightening creates a favorable backdrop for EM currencies and EM fixed income returns longer term. The monetary tightening from many EM central banks has supported their respective currencies and now these countries feature attractive short term yields. While EM growth may slow, the growth differential between EM and DM economies should widen. Shorter term maturity hard currency EM sovereign debt looks attractive in countries with sound governance and central bank policy, and our global fixed income manager maintains an allocation in select countries. Based on our outlook on the unpredictable nature of trade policy, we do not view current weakness as an opportunity to add broadly to the asset class.

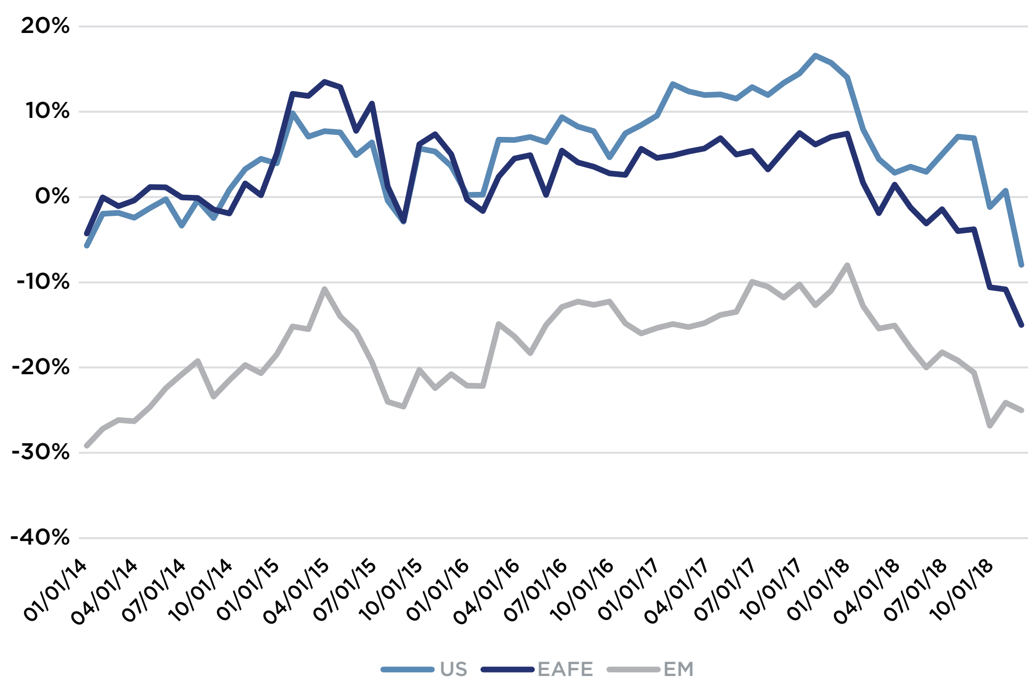
Conclusion

In contrast to the synchronized increase in global growth predicted at the beginning of 2018, the synchronized economic slowdown in the US, China and the EMs anticipated at the beginning of this year is less than encouraging. However, slowing growth is very different from a recession and growth prospects for non-US economies are likely to improve during the year. Even though the US post-crisis expansion is approaching record duration, recessions are triggered through a catalyst, not old age. Typically these catalysts fall into three categories: exogenous shocks, major financial or economic imbalances or excessive Fed tightening. The 48-year low in the unemployment rate was cited as a potential catalyst for overheating and inflation, but the US labor force participation rate is still low by historical standards as evidenced by the December employment report in which employment increased by over 300,000 in the month but the unemployment rate moved higher due to an increase in labor force participation. Now at 3.9%, unemployment is below the estimated 4% to 4.5% neutral rate, but it may still be possible for the US economy to grow above potential without creating excessive inflationary pressure and recession-provoking tightening measures by the Fed.

> Equity market valuations are below 30 year averages

US equity markets have now declined to a level where the P/E ratio is below the 30-year average and non-US market valuations have increased their discount to the US (see Exhibit 7).

EXHIBIT 7: FORWARD GLOBAL 12 MONTH P/E RATIOS RELATIVE TO 30-YEAR AVERAGES



Source: UBS, Bloomberg

These reduced multiples provide a cushion for disappointment that did not exist at the beginning of 2018 when equity markets had much more extended valuations. Because of such overvaluation at the start of the year a small decrease in activity, policy missteps or heightened uncertainty were enough to increase the perceived risk of recession and precipitate a downside overshoot. Starting in late September, there was a sudden sharp weakening of Chinese activity. At the same time, Fed chairman Jerome Powell indicated that the Fed funds rate was well below the neutral rate target, even after eight 25 basis point hikes. Given that the US equity market was priced to perfection this macroeconomic and policy news was enough to cause a significant correction in stock prices, particularly in the last month of the year.

With declines in the forward P/E ratio of global equities of 15% to 20% worldwide, investor concerns may be overdone or, in Mr. Powell's words, equity investors are pricing in downside risks that are "well ahead of the data."[18] Participants in the Fed funds futures market may have become overly worried that the Fed is ahead of the curve and are now pricing in a more than 50% probability the Fed will cut rates in 2019. The expected value of the net number of hikes this year was -0.4 on December 28, 2018. Mr. Powell's insistence on January 4 that the Fed is "always prepared to shift policy and shift it significantly" should reassure investors about the Fed's inclination to be less aggressive about tightening than it had previously indicated. This shift in posture could also constrain other central banks such as the ECB from raising rates.

Markets will be driven by sentiment and politics in early 2019

The main risks to global equity and credit markets arise mainly from sentiment and politics. As Mohamed El-Erian points out, an ugly stock and credit market can lower confidence and lead some companies and households to reduce spending and investment earlier than they would otherwise do, thus accelerating a growth slowdown resulting in self-reinforcing market declines. The political risks include escalation of the US China trade war, failure of the Chinese authorities to use tools to avoid an economic hard landing, disruption in the Eurozone, and a disorderly UK exit from the EU.

Our base case outlook assumes most of these sentiment and political issues will be avoided and that level headedness will prevail among policymakers. With regard to US China relations, that assumption may prove heroic in view of President Trump's belligerent personality. He might well heighten the dispute with China to distract attention from mounting clashes with the Democrats in the House of Representatives. However, he may well realize a rise in trade tensions would risk exacerbating the pressure on stock prices, US business and jobs to the point of undermining the president's hope for reelection.

A 2019 recession is unlikely

If the US market peaked on September 28, we would expect a recession to occur sometime this year, based on the historic time gap between the peak in markets and the peak in economic activity, ranging from 1 to 19 months.[19] However, substantial stock market declines do not always presage recessions. Given the recent increase in labor productivity growth and the potential for greater labor force participation, the likelihood of the economy hitting the full capacity ceiling and producing an inflationary shock does not appear high. This cycle probably has well more than a year to run before economic activity starts to decline and thus equity markets are unlikely to have peaked on September 28. Admittedly, if

[18] Statement by Chairman Powell on January 4th as cited in "Powell seeks to sooth markets after a year of shaky beginnings." Financial Times, January 5, 2019.

[19] J.P. Morgan Private Bank, JPM Eye on the Market Outlook 2019.

the US market is currently in a correction and not a protracted bear market, it is later than mid-cycle. However, history has shown that in this case the recovery in equity prices before the ultimate peak tends to be substantial. For this reason we are not reducing our equity target weighting, although we are ready to make adjustments if facts change.

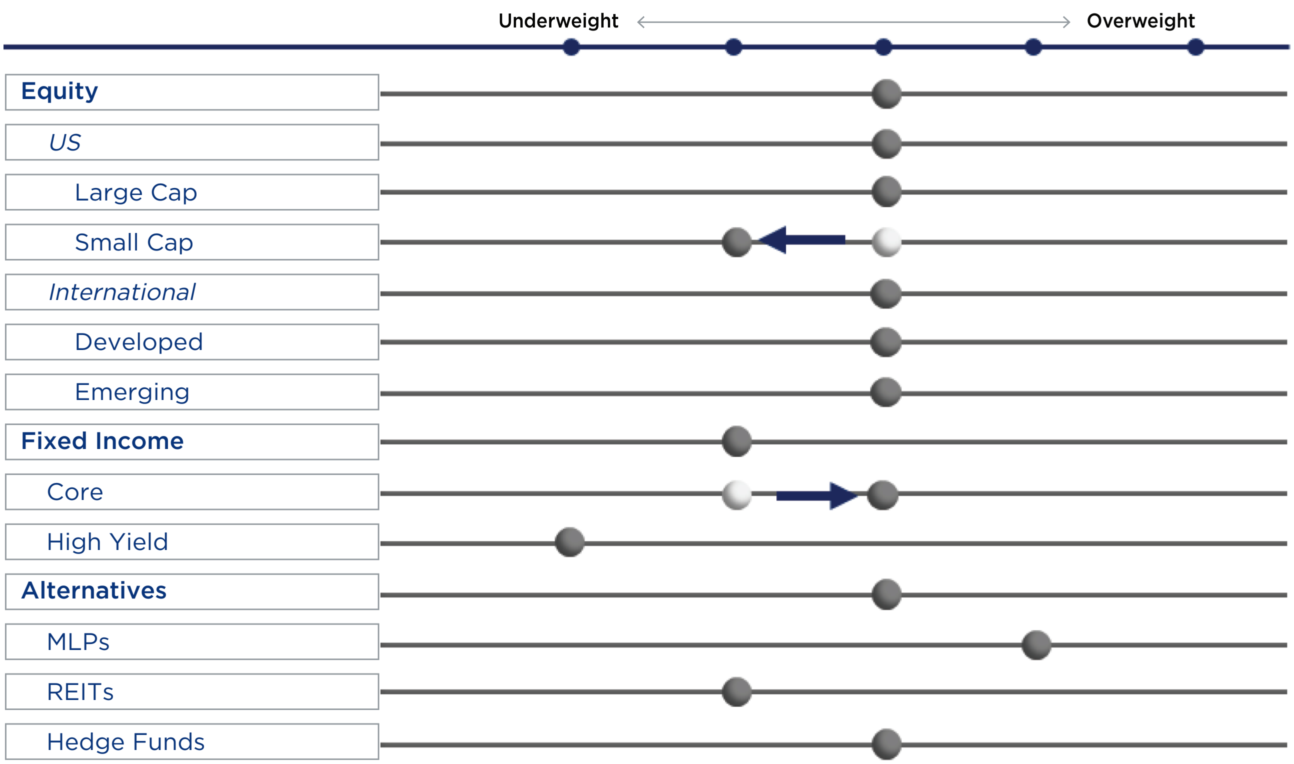
The valuation discounts of EM and EAFE in relation to US equities do not currently justify a significant tactical overweight of these markets. We believe the valuation discounts are warranted by differences in fundamentals and greater sensitivity to declines in the global benchmark. The performance of non-US equities this year is closely related to the performance of the Chinese economy since European, Japanese and non-China emerging market economy growth is highly dependent on exports to that country. The Chinese government seems to be stepping up support for growth as evidenced by the policy agenda set forth for the coming year at the annual Central Economic Work Conference in late December. We expect a pickup in Chinese growth in the second half of the year and are looking to tactically overweight non-US equities at that time if the US/China tariff dispute is resolved.

> We favor high quality companies in all regions

We are emphasizing high quality stocks in all regions, given their limited downside capture, highly predictable earnings and strong balance sheets. We are underweighting small cap equities since, in the US case, they have greater exposure to intermediate goods imports and have more levered balance sheets compared to large cap companies. We are underweighting stocks of multinational corporations with significant exposure to the Chinese economy and overweighting those with significant exposure to domestic markets.

Our fixed income positioning also remains conservative with a focus on liquidity. We are taking a barbell approach to benefit from further yield curve flattening in the US, which we view as highly likely. Also, we have improved the credit quality of portfolios until we see meaningful spread widening. Our target asset allocation is shown in Exhibit 8.

EXHIBIT 8: DMCA TARGET ASSET ALLOCATION AS OF DECEMBER 31, 2018



Source: DMCA

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