# Global Economic and Market Commentary

## Summary

- We do not foresee a recession in the US in 2019. Fed easing should extend the current expansion, although we are unlikely to see a pick-up in growth in 2H 2019, both in the US and abroad.

- Earnings growth will be flat in coming quarters and the forecasted fourth quarter jump looks less likely. Dividends, slow earnings growth and multiple compression will likely lead to modestly negative returns for US equities through year end.

- Compared to the US equity market, non-US DMs feature lower valuations, higher dividends and comparable earnings growth. We expect modest positive returns with a higher potential upside from a resolution in the US-China trade war.

- EM equities will be impacted negatively by slower global growth and a trade war but buoyed by Fed easing. Previously forecasted 2H Chinese growth is likely to disappoint, so we are cautious on EM equities.

- The Fed is concentrating on the detrimental effects of tariffs on economic growth at the expense of future inflation. Treasury yields are more likely to be anchored, but we favor shorter duration, investment grade credit and non-Agency MBS as protection against an upside growth or inflationary surprise.

"This trade war could be considered the start of a cold war between China and the West or state capitalism and free market capitalism."

*–William Priest, Barrons, July 15, 2019*

While tariffs and US – China relations dominated headlines in the second quarter, global equity markets advanced after a brief correction in May. Decelerating global growth and an absence of inflation motivated the ECB and Federal Reserve to dust off their easing playbook in June which drove global yields lower and global equities higher. Historically, positive returns from both bond and equity markets are common around central bank easing cycles. Looking forward, with virtually all asset classes at the expensive end of their respective valuation ranges, we forecast modestly negative returns from global equities and fixed income for the remainder of the year but still substantially positive for the full year.

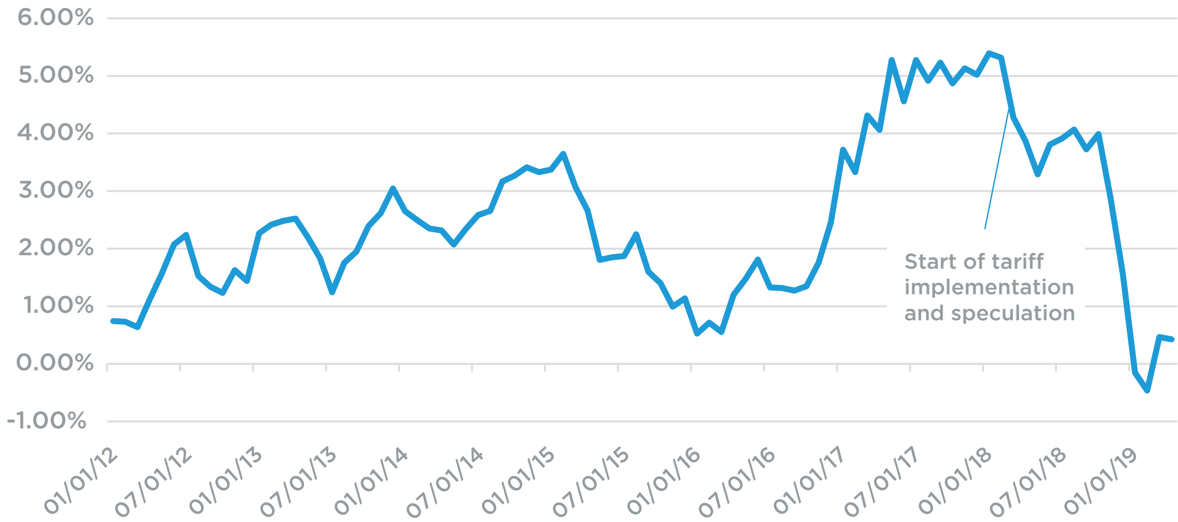
The near-term probability of a recession is still low despite a barrage of negative headlines. Recent data releases confirm that the tariffs currently in place have negatively impacted growth and global trade, but uncertainty surrounding future tariffs has proven more destructive, delaying business investment and weighing on business sentiment. See Exhibit 1. The global economy has proved resilient, and the OECD forecasts 3.3% global growth in 2019 and 3.4% in 2020.[1] Central bank easing and relief from tariff uncertainty could further buoy future growth, especially for

> The near-term probability of a recession is still low despite a barrage of negative headlines

[1] OECD Interim Economic Outlook, June 3, 2019.

export reliant countries. We characterize the recent slowdown in growth as a temporary soft patch not a long-term phenomenon, although a resumption of trend growth appears more likely than a return to 2017 or 2018 growth levels. Additional tariffs would undermine our position, so we don't believe an overweight to equities is warranted at this time.

### EXHIBIT 1: GLOBAL TRADE VOLUME 3-MONTH MOVING AVERAGE % CHANGE YoY

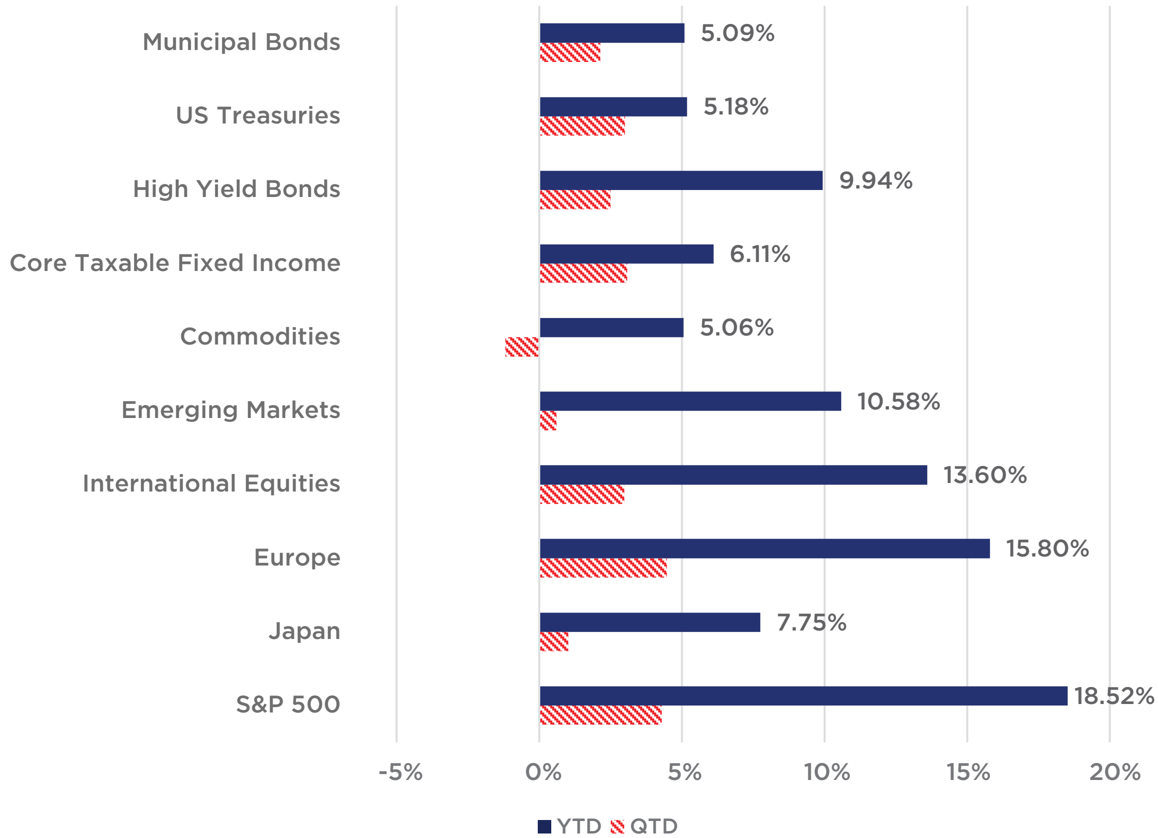



Source: CPB (CPB Netherlands Bureau for Economic Policy Analysis)

The S&P 500 finished the quarter up 4.3% and up 18.5% year to date. Non-US developed markets and emerging markets trailed domestic equities with MSCI EAFE Index returning 3.7% in the quarter and 14.0% year to date. The MSCI Emerging Markets Index returned only 0.6% in the quarter and 10.6% year to date. Non-US valuations are attractive relative to US valuations but remain near 25-year averages. Trade related risks give us caution to establish a meaningful overweight. US dollar appreciation has slowed year to date, a headwind for international equity returns in 2018. Federal Reserve easing could catalyze a long-awaited decline in the dollar and alleviation of trade policy uncertainty would benefit non-US equities as well. We have kept portfolios near target weights for US and international equities, favoring higher quality companies with predictable earnings and stronger balance sheets. Additionally, valuation disparities between value and growth companies support a closer look at increasing our weighting to value-oriented strategies.

Amidst the strength in the equity markets, interest rates fell globally and credit spreads tightened. The Bloomberg Barclay's Aggregate Index returned 3.1% in the quarter and 6.1% year to date. As of June 30, the 10-year US Treasury yield is hovering around 2.0% and over $13 Trillion of global sovereign debt is trading with negative yields. With central banks likely to ease, we are less concerned with duration risk than in previous quarters, but we expect low single digit medium-term returns from investment grade dollar denominated fixed income. In our allocations, we remain in favor of strategies which feature higher yields with limited duration and corporate credit risk, such as non-Agency MBS over core fixed income.

### EXHIBIT 2: GLOBAL CAPITAL MARKET RETURNS YTD AND QTD THROUGH JUNE 30, 2019

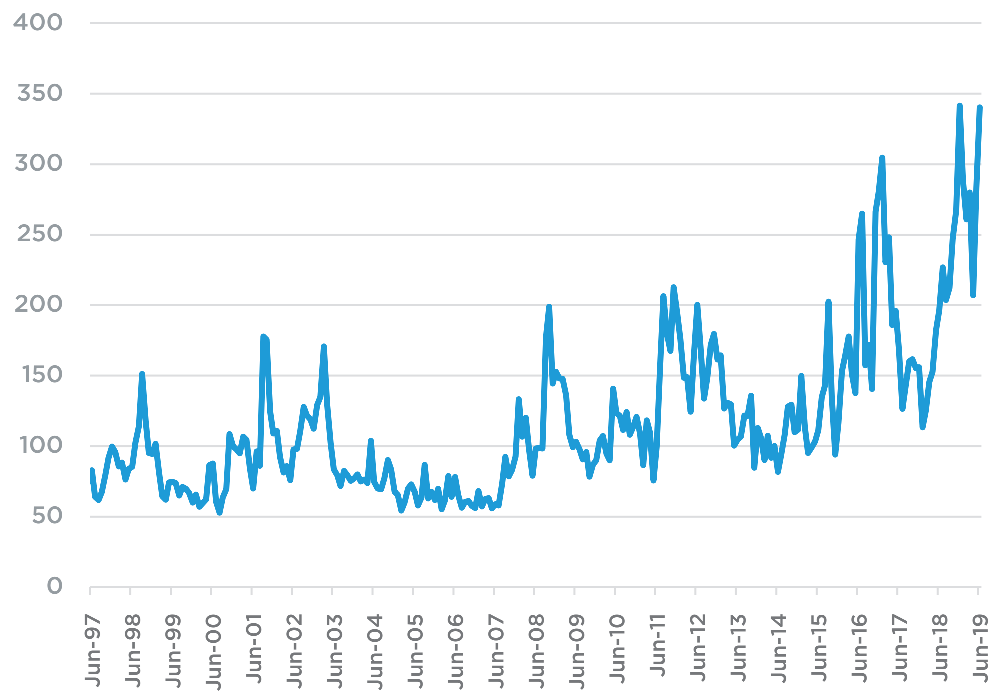



Source: Bloomberg

## Outlook for the US Economy and Equity Markets

Our base case outlook calls for the US economy to grow slightly above trend, but below 2% in the second half of the year. This represents a downward adjustment from our previous forecasts which is attributable to two factors. First, higher than anticipated policy uncertainty should depress fixed investment expenditures in the second half. See Exhibit 3. Second, increasing visibility of the trade war effects on inflation numbers should diminish consumer spending power.

### EXHIBIT 3: MONTHLY GLOBAL ECONOMIC POLICY UNCERTAINTY INDEX




Source: www.policyuncertainty.com

US economic growth outperformed expectations in the first quarter of 2019. Real GDP advanced at a 3.1% annualized rate, boosted by unsustainable inventory and export increases. As inventories are drawn down to normal levels, growth should slow to 1.5% in Q2. It should remain below 2% with the subsequent two quarters of year-over-year GDP growth coming in at 1.8% as compared with 2.9% in 2018 year-over-year. Since September 2018, the US has imposed a 25% tariff on $50 billion of imports from China and a 10% tariff on another $200 billion. The tariff rate on this $200 billion rose to 25% in June. The process to impose a 25% tariff on the remaining imports from China, over $300 billion, was started prior to the G20 meetings at the end of June but was stopped by an agreement between Trump and Xi Jinping at those meetings. Taken by itself, the impact of the tariff increases imposed thus far on GDP will be relatively small, but much will depend on how spending and investment react to further ratcheting up of trade conflicts.

As inventories are drawn down to normal levels, growth should slow to 1.5% in Q2

Manufacturing sentiment has already begun to converge to lower levels seen abroad. Witness the decline in the Chicago Purchasing Managers Index to below 50 in June and the substantial decline in the hours worked in the manufacturing sector last month. Discussions between China and the United States have now resumed and semblance of a Sino-American trade agreement may occur this year which, in Barclays' view, "would be weaker than the c. 150 page 'grand deal' that Trump could have advanced before the May breakdown." However, even in the event of a deal, it is unclear at this stage whether the weight on the US economy and stock market sentiment would fully lift. Important to the forecast, a deal would need to unwind all tariffs placed on Chinese goods shipped since September 2018 and China would need to remove all retaliatory tariffs on US exports in order for there to be a significant rebound in US and global growth. Our base case outlook calls for tariff rates to remain fixed at current levels through 2020. Sino-American relations are so complex that a trade agreement will have to be written over years not months. In addition, Trump wants to put off accepting a watered-down version of the earlier 'grand deal'. This can be accomplished by prolonging the discussion in a way that keeps clear of escalation but maintains the Fed's concern about potential economic weakness.

However, buoyed by a strong consumer, the US economy will continue to expand at a moderate pace despite trade uncertainties and weakening business investment. We expect consumer spending to rebound in the second quarter with a 3% rise even though it was up only 1.5% in the first quarter. After that, we expect it to settle in at a pace of around 2% over the remainder of the year. The fundamentals support consumer spending. Job gains, while slowing, have averaged 171,000 per month over the past three months ending on June 28. Soft inflation, thus far, means real wage gains have strengthened offering a strong foundation for domestic demand at least through the first half of the year.

> Buoyed by a strong consumer, the US economy will continue to expand at a moderate pace despite trade uncertainties and weakening business investment

Despite solid GDP increases, business capital spending has been weaker than expected in the first quarter, advancing just 2.3%. Recent high frequency data suggest that momentum has softened further, with overall business spending likely to contract in the second quarter. This is not surprising given the extent to which business uncertainty has been elevated by the US-China trade dispute and by threatened tariff increases on Mexican and Vietnamese imports. In addition, the Administration looks to open up another front with Europe which could further undermine business confidence. Once again, our base case forecast is predicated on the assumption that tariffs will remain at current levels, although any positive development would help to lift business confidence and investment, particularly in 2020 and beyond. In the interim, the risks to our business investment forecasts are to the downside.

Despite the tariffs imposed through June 1, inflation has remained contained. Admittedly, Fed Chairman Powell has characterized the recent bout of weaker than expected inflation as transitory and other inflation indices, such as the Trimmed Mean PCE Inflation Rate of the Dallas Fed, have shown the largest month-to-month increase over the entire expansion and now stands at a year-over-year rate of just over 2%. Still, consistent with their dovish pivot early in the year, Chairman Powell and other Fed officials are emphasizing that the 2% inflation target is symmetric and will require conclusive proof that inflation is turning higher before imposing any further rate increases. Once they are fully passed on, even existing tariff increases are likely to raise consumer prices, but unless this results in an upward shift in several measures of inflationary expectations, the Fed is likely to ignore tariff-induced inflation increases and concentrate on their detrimental effect on economic growth.

The Fed Funds futures curve is pricing in several cuts to the Fed's target rate over the next 24 months, which is also weighing on long-term Treasury yields. Assuming no further escalation of tariffs, we expect some unwinding of these dovish expectations in the coming months. In addition, a neutral analysis of the data situation, especially the June employment report, hardly indicates that a cut in the interest rate is required. Still higher labor productivity growth and low increases in unit labor costs despite higher wage gains suggest that the US economy is not yet capacity constrained and can afford the Fed taking a risk management approach by providing a modest accommodation of two separate 25-basis point cuts, later this year as insurance. The June employment report showed a level of job growth stronger than those that have prompted Fed rate cuts in the past but we still expect a weakening economy to induce the Fed to ease policy, starting in July, given that the protracted nature of the US-China talks will continue to weigh on manufacturing output.

Escalating tariffs have put upward pressure on the US dollar, especially relative to Emerging Market (EM) economy currencies. Assuming trade tensions ease as a result of the US-China ceasefire and the Fed cuts its policy rate, this should not continue. As US growth and short-term interest rates converge a little closer to those of its trading partners, a modest weakening of the trade-weighted dollar should occur over the second half of the year.

## Outlook for S&P 500 Earnings

The last part of 2018 saw major downward revisions in earnings estimates for S&P 500 companies which, in many cases, were excessive. They implied a year-over-year decline in average per-share earnings for the Index. This year-over-year decline did not occur; S&P 500 earnings were up 1.6% in Q1 and earnings for most S&P 500 companies exceeded expectations.

Current expectations for earnings in Q2 and Q3 are hardly exuberant, with estimated earnings projected to decrease by -1.6% and increase 0.4% in Q2 and Q3, respectively.[2] The street's calendar year earnings increase of 3% results mainly from a large fourth quarter rebound, which may be unrealistic.

It is reasonable to view the current consensus earnings outlook for 2019 as a whole as flattish. This is consistent with the global slowdown and the US China trade war which are having an impact, especially in the technology sector. Tech earnings estimates have been trending downward all year and are only expected to recover modestly in the fourth quarter as the table on the following page shows:

[2] YRI S&P 500 Earnings Forecast, July 8, 2019. Yardeni Research, Inc.

### EXHIBIT 4: S&P TECHNOLOGY SECTOR EARNINGS EXPECTATIONS

| Time Period | Earnings Estimate |
|---|---|
| First Quarter 2019 | Down 1.1% |
| Second Quarter 2019 | Down 7.9% |
| Third Quarter 2019 | Down 6.3% |
| Fourth Quarter 2019 | Up 4.1% |

Source: Refinitiv

These projections are based on the assumption that the existing tariffs will remain in place and that further increases will not occur.

Further rounds of tariff increases would really hurt US tech sector earnings and those of other trade sensitive sectors. Substantial import diversion has reduced the earnings impact of prior tariffs on imports from China. For example, US imports from Vietnam exploded in Q1, mainly because of the substitution effect from China tariffs. A 10 to 25% levy on the remainder of Chinese goods, which is currently off the table, would make import substitution much more challenging. Many of the imports from China subject to tariffs have a large China value added share, i.e., are not mainly produced in other countries. In other words, they are much less likely to provide scope for import diversion since sufficiently developed production chains are not yet in place in other countries.

> Further rounds of tariff increases would really hurt US tech sector earnings and those of other trade sensitive sectors.

The increased use of low-cost imported inputs has been one of the largest contributors to margin expansion for S&P 500 companies over the last 15 years. In 2017 net margins averaged 10.8%, up substantially from the 1995-2004 average of 7.6%. Lower cost of goods sold mostly due to cheaper imported inputs contributed 1.5 percentage points to this increase. If the protection push continues, we expect a profit deterioration for many companies without sufficient pricing power to prevent margin compression.[3]

## Outlook for the S&P 500

Our base case outlook is S&P 500 earnings at $168 in 2019, up 3.7% from the 2018 level, to which we assign a 40% probability. We are less certain about the 2020 earnings outlook. The 2020 figures depend on whether GDP growth remains the same, turns negative or rebounds and on whether tariffs remain the same or are increased or rolled back. Our base case assumes that US economy grows at about the same rate as it did in 2019 with tariff rates remaining about the same. This is consistent with the view that trade tensions will not be resolved in the near term,

[3] Heisenberg Report, "Thoughts for a pivotal weekend," Seeking Alpha, June 28, 2019.

but trade-related volatility will recede as markets become more accustomed to a new normal for the Sino-American relationship. Our bear case scenario calls for the trade war to escalate, an L-shaped rather than V-shaped recovery in China and for there to be a recession in 2020 with earnings declining by 12%, the historic recession average. Our bull case scenario predicts that tariffs will be rolled back and US and global economic growth will rebound in 2020.

To forecast the return on the S&P 500 for the remainder of the year we have estimated 12-month forward PE multiples at the end of 2019, as well as 2020 earnings per share. These forward PE estimates reflect different estimates of the equity risk premium (ERP). The ERP is the expected excess return on equities relative to the risk-free interest rate and is the compensation that investors require to hold riskier assets. The difference between the equity earnings yield and the Treasury yield is a rough approximation of the ERP.

The base case predicts the S&P 500 at 2870 by the end of the year,

In our base case, the forward PE ratio is 16.4 at the end of 2019. This multiple is lower than the current forward PE, which is 16.9 times estimated earnings for the next 12 months. It is based on a projected end of year Treasury yield of 2.6% and an ERP estimate of 1.2% above the historic average. Heightened policy risk, as well as an artificially low 10-year Treasury yield require a higher than normal risk premium. The forward multiples for the bear and bull cases involve increases and decreases in the yield-based ERP, changes that more than offset the projected changes in the 10-year Treasury yield. The implied earnings yields represent 0.5% and 1.0% decreases and increases, respectively, in forward earnings multiples. The former is somewhat less than the recession average multiple decline; the latter raises the forward multiple to a level close to the recent high.

The base case predicts the S&P 500 at 2870 by the end of the year, 4.5% below the current, elevated level of 3000. The bear case scenario predicts a much larger (33%) decline in the average; the bull case scenario involves a 7.3% change by the end of the year. We believe that the bear case scenario has a 25% probability of occurring, the base case scenario a 40% chance and the bull case scenario a 35% probability.

### EXHIBIT 5: S&P 500 EARNINGS TABLE

| | Bear | Base | Bull |
|---|---|---|---|
| Probability | 25% | 40% | 35% |
| Estimated 2020 Earnings | 148 | 175 | 184 |
| Multiple | 15.3 | 16.4 | 17.5 |
| Estimated 2019 Year End S&P 500 Value | 2264 | 2870 | 3220 |

Source: DMCA

## Europe and the UK

During the third quarter, the MSCI Europe ex. UK Index appreciated 5.8% and the MSCI UK Index appreciated 0.9%. Year to date, the returns have been 16.9% and 12.9%, respectively. Underperformance in the UK reflects continued uncertainty from political turmoil related to Brexit. Ex-UK European markets slightly underperformed the US and have largely been in sync with US markets recently as central bank dovishness and trade war escalation and de-escalation have influenced investor capital flows.

After the failure of the UK Parliament to ratify Prime Minister May's Brexit agreement, Mrs. May agreed to step down from the post at the end of May. A new prime minister is expected to be appointed by the end of July.

EU elections were held at the end of May, and there continues to be disagreement on who will hold many of the top posts in the organization. This will further complicate matters as the deadline for the Brexit extension at the end of October will approach quickly. Christine Lagarde was recently nominated to succeed Mario Draghi as president of the ECB. She brings with her credibility as a leader and policy maker, as well as decades of experience related to politics and regulation but has limited experience with monetary policy. Viewed as a "dove," we would expect future rate cuts and a weaker euro upon her confirmation. European bond yields fell on the news of her nomination. We continue to maintain our "wait and see" approach to political developments in Europe as all attempts to predict an outcome have proven foolish.

We continue to maintain our "wait and see" approach to political developments in Europe

The Global Purchasing Managers' Index for the Euro Area declined to 47.6 in June and for the UK the reading was 48.0.[4] A reading below 50 indicates a contraction in the manufacturing sector. We believe the negative reading reflects the uncertainty of the global trade war (especially hurting the export driven German economy) and the lack of business confidence in the UK which will continue until a Brexit outcome is realized. In the meantime, European stocks are trading slightly below their 25-year average forward earnings multiple of 14.5.[5] This valuation multiple remains relatively attractive to the US and other developed markets. However, the ever-present uncertainty over US tariff policy and the possibility of a hard Brexit will continue to cloud the outlook for the next several quarters.

If global trade tensions continue to ease through the end of the year, and a resolution to Brexit can be realized, we believe that growth in Europe can still surprise to the upside. However, we are reluctant to prognosticate on the likelihood of these outcomes due to our inability to handicap them correctly in the past. We are maintaining an equal or slight-underweight to European equities but are closely monitoring any changes in the outlook.

[4] JPM JP Morgan Guide to the Markets 3Q19 p. 47.

[5] JP Morgan Guide to the Markets 3Q19 p. 44.

## Japan

During the second quarter of 2019, Japanese equities appreciated 1.0%. Year to date, the MSCI Japan Index has underperformed the MSCI EAFE Index by almost 6.3%. The significant underperformance during the year has been a blow to our belief that the benefit of market reforms in Japan would outweigh the effect of the global trade war sparked by the US government.

The Japanese economy shows no signs of significantly increasing economic growth as measured by GDP or achieving the 2% inflation target set by the central bank. Japan seems to be stuck in a state of suspended animation where things are not getting much better, but no crisis ensues. Donald Trump's increase in tariffs on Chinese imports during the second quarter is expected to reduce Japanese GDP by 0.2% over the next two years.[6] Any further escalation in global trade tensions will weigh significantly on the currently fragile economy.

At the end of April, the BOJ committed to maintaining its 0% interest rate target on the 10-year bond until at least the spring of 2020. While encouraging at the time, in hindsight this commitment was far less dovish than later pronouncements from the ECB and the US Federal Reserve. Given the continued low inflation in Japan, the 0% target rate on the 10-year is relatively attractive compared to German Bunds and other European debt which have substantially negative rates. Provided the Federal Reserve and ECB move into easing cycles in the near future, we would expect an appreciation in the Yen versus the US dollar and euro.

Japan seems to be stuck in a state of suspended animation where things are not getting much better, but no crisis ensues

Throughout the quarter, we have continued to witness progress towards the market reforms discussed in previous letters. After the news broke of ValueAct Capital's activist position in Olympus at the start of the year, the financial press has published numerous stories on the opening of historically insulated Japanese companies to global interest and financial innovation. Headlines such as, "A Successful Strategy for Activist Investors in Japan: Ask, Don't Tell,"[7] or "Once shunned, activist investors are now seeing a 'wave of change' in Japan"[8] and others have provided continued evidence of this change in the market. We believe this shift towards increased financial innovation has been underappreciated by global equity markets in 2019, and will continue to seek exposure to these opportunities.

In addition to the potential boost from market reforms, Japanese equities currently trade at a forward PE multiple of 12.6X which is attractive to both the 25-year average and other global equities.[9] Although economic growth has surprised to the downside, and earnings may be impacted in the near-term by nationalist trade policies in the rest of the world, we believe Japanese equities continue to provide a long-term value with a potential catalyst compared to much of the developed world.

[6] Gavin Davies; "Shinzo Abe contemplates one last throw of the economic dice;" Fulcrum Asset Management; May 19, 2019; www.fulcrumasset.com.

[7] Suryatapa Bhattacharya, River Davis, and Kosaku Narioka; The Wall Street Journal; April 17, 2019; www.wsj.com.

[8] Thomas Franck; CNBC; April 9, 2019; www.cnbc.com.

[9] JP Morgan Guide to the Markets 3Q19 p. 44.

## China

China's GDP stabilized at 6.4% in Q1 as market confidence recovered on the back of policy support and progress in Sino US trade negotiations. Also, GDP growth in Q1 was artificially supported by an upturn in net exports due to an import collapse. Since then economic activity in China slowed, with the escalation of trade tensions that occurred in May. The late June cease-fire had no effect on Q2 GDP growth, which came in at 6.2% per annum on a seasonally-adjusted basis. Export and domestic demand growth have been very weak during this quarter. For example, passenger car sales declined almost 15% in May from a year earlier, while imports dropped 8.5% in the same month. Home sales also slowed.[10]

It is important to note that the Chinese economy is much less dependent on exports (mainly manufacturers) than it was. Exports represent only a third of GDP. Thus, having the manufacturing PMI fall below 50, as it recently did, is less serious than it was in the past, since the services PMI has remained at 55, which indicates expansion, and services are more than 50% of GDP.

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Much of the decline in domestic demand growth is attributable to a decrease in export growth associated with US tariff hikes, which had depressed the manufacturing PMI.

Chinese authorities are using both monetary and fiscal stimulus to offset the depressing effect of reduced export demand. One indicator of liquidity conditions is the benchmark Shibor interbank rate. On June 26, this rate fell to its lowest point since April 2009, at a time when Beijing was rolling out its 4 trillion RMB ($502 billion) stimulus package.[11] However, the People's Bank of China, PBOC, is not injecting nearly as much money into the financial system as it was then. The low Shibor rate is not nearly as significant now as it was in 2009 since global short-term rates are substantially lower.

A return to the general monetary stimulus of 2009 and 2014 is very unlikely today. The PBOC is avoiding the general monetary stimulus seen in the past because of the danger that it would inflate housing prices above already excessive levels and cause consumer debt to become unsustainably high. Currently central bank easing is taking the form of small loans to shore up financial vulnerabilities where they occur. Cuts in policy rates are likely to occur only in response to reductions in the US federal funds target which are expected beginning in July. These will occur in order to avoid an unwanted appreciation in the Renminbi against the dollar.[12]

Starting with the tax reduction of 1.2% of GDP announced earlier in the year, China is using mainly fiscal, as opposed to monetary, measures to stimulate the economy. Additional fiscal stimulus is taking the form of: 1) more targeted fiscal support, such as tax exemptions for industries hit by tariffs; 2) stepping up financing for infrastructure investment; and 3) following up on the large tax cuts announced in March.[13]

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[10] James Kynge, "It is rash to expect a return of past market booms in China." Financial Times, July 4, 2019.

[11] "China Short Term Borrowing Costs Hit Post Crisis Lows," Financial Times, July 4, 2019.

[12] "Fed Easing Could Prompt First China Rate Cut in Four Years," Reuters, July 7, 2019.

[13] Barclays Global Outlook, June 27, 2019.

Recent stimulus measures are beginning to have an impact on Chinese economic activity. There are signs that manufacturing investment is increasing and that new orders are rebounding. Growth forecast revisions are no longer declining. Recent stimulus measures center more around tax cuts, in contrast to those in the past, which relied mainly on additional government spending. This is a more conventional approach which may provide a greater and longer lasting impact and is consistent with the growing role of consumption and services in China's economy today.

Assuming no further increase in US tariffs on Chinese imports, we anticipate some pickup in Chinese GDP growth in the second half of the year and we are projecting a modest year over year expansion rate of 6.3%, as compared with 6.5% GDP growth last year. Contrary to the recovery expected in early 2019, 2H 2019 GDP is likely to grow at a the same rate as the first half of the year.

## Emerging Markets in General

For EMs as a whole we are projecting a 4.5% GDP growth rate this year, down from 5% in 2018. In the DMs, we expect growth to come in at 2% year-over-year, down from 2.2% in 2018. Thus, we think that the gap between EM and DM growth, at just around 2.5% over the next 12 to 18 months, is stable in the context of what it has been since 2017 but in the lower quartile of the long-term distribution.

Goldman Sachs's current activity index suggests that the growth backdrop has stabilized after a sharp deceleration starting in 2018.[14] However, given that a significant rebound in EM growth from a low base was anticipated by investors in January, EM growth data are still coming in below expectations. Prominent examples include the recent fall in China's and India's manufacturing PMIs, alongside the reversal in growth recoveries in Brazil and South Africa.

We anticipate the falling dollar-denominated interest rates and some weakness in the trade-weighted dollar will enable EM growth to recover somewhat in the second half of 2019. Easing in the developed world provides central banks in the EMs with space for embarking on their own monetary easing cycles. Thus far in 2019, 27 EM central banks were in the process of reducing their policy rates, according to the global interest rate monitor, many of which had been tightening prior to the recent reversal in Fed policy. Lower interest rates should increase confidence, consumer durables spending, and business investment.

> Easing in the developed world provides central banks in the EMs with space for embarking on their own monetary easing cycles

The multiple on EM equities is presently at about 12 times forward 12-month earnings.[15] We expect this multiple to expand both because of a decline in the risk-free rate in both developed and developing countries and because estimates of EM economic activity will be revised upward, provided our base case assumption holds, i.e., the US does not increase tariffs. According to

[14] Goldman Sachs, "Solid Carry versus Soft Growth," July 10, 2019.
[15] Morgan Stanley, "Cross Asset Strategy," July 1, 2019.

Morgan Stanley, the composite valuation of EM equities, based on forward price to book and dividend yield is 75% of that of the MSCI All Country World Index. This ratio is below the 20-year median. Morgan Stanley also estimates the secularly adjusted earnings yield for EM equities which provides further evidence of relative cheapness. This earnings yield is in the third quartile for the last 20 years, whereas those for the US and Europe are in the second quartile.[16] Finally, EM equities since 1990 have proven to be more sensitive to changes in the Goldman Sachs Financial Conditions Index than DM equities and thus should benefit from the expected decline in this Index.[17] However, despite the compelling valuations of EM stocks, greater sensitivity to monetary easing and improving fundamentals, we are reluctant to overweight them because of their extreme sensitivity to possible escalation in trade tensions and further declines in world trade growth. Moreover, the upside potential of EM economies in the event of a reciprocal rollback in US and Chinese tariffs may not be as great as commonly believed. A greater than expected pickup in Chinese growth may not have the direct impact on other EM economies that it has had in the past. China's more consumer led economic model driven by services may cause it to have less influence on global commodity prices, which are the major determinant of growth for many emerging market economies.

## Fixed Income

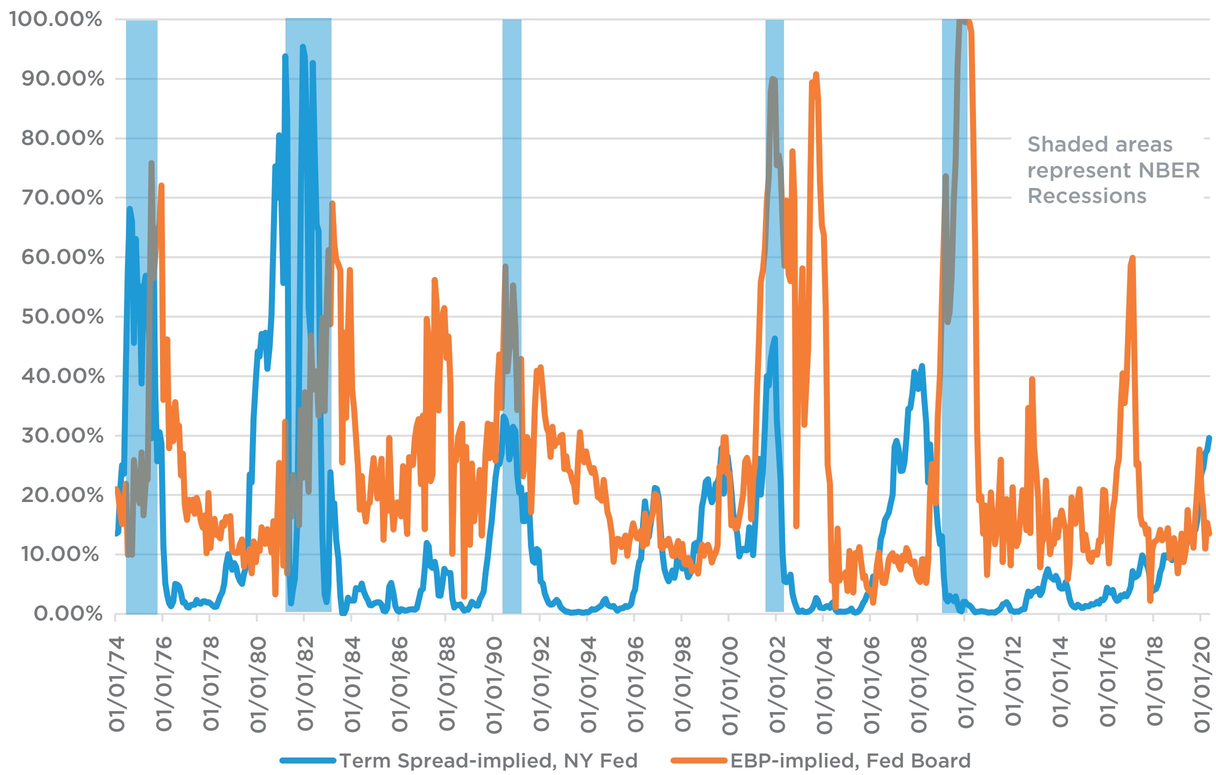
The Fed maintained its 2.25% to 2.50% policy rates through the May 1 and June 19th meetings as macroeconomic data deteriorated and global yields fell. Unlike previous risk off periods, the recent bond rally has coincided with strong global equity markets and was not exclusive to Treasuries. The reorientation of global inflation expectations and the start of Federal Reserve and ECB easing cycles have been the primary drivers of the decline in bond yields. At quarter end, the 10-year Treasury yielded approximately 2.0% and has consistently resided below the 3-month Treasury bill yield since May 22. Historically, yield curve inversions have preceded every recession However, the timing of recessions following inversions has varied widely. Often, yield curve inversions occur due to excessive Fed tightening to extinguish inflation or excessive growth. However, the current inversion has resulted from a decline in longer term rates which may render historical patterns less useful.

The Federal Reserve publishes two models which predict the likelihood of a recession in the next 12 months based on yield curve and corporate bond data. The first model, published by the Federal Reserve Board which incorporates the excess bond premium (EBP) in corporate bond yields, shows a recession probability of 13%. The second model, published by the New York Fed which observes the difference between the 10 year and 3-month Treasuries, predicts there is a 29% chance of recession. See Exhibit 6 on the following page.

[16] Ibid.

[17] Ross Roestrich, "The Pivot Favoring Emerging Markets." Seeking Alpha, July 1, 2019.

### EXHIBIT 6: PROBABILITY OF US RECESSION IN FED'S PUBLISHED MODELS



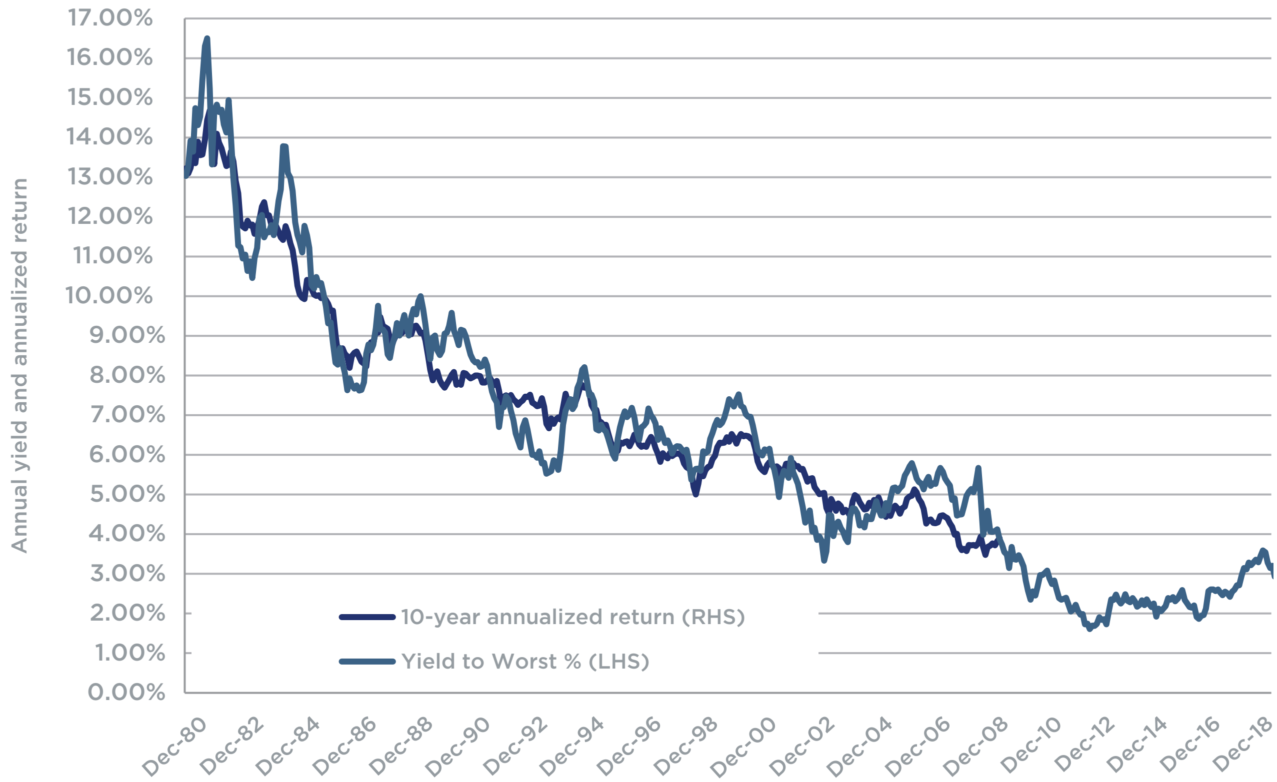

Source: Fulcrum, Federal Reserve System

Futures market are predicting a near 100% probability of a rate cut at the July 31st meeting and between two and three cuts by year end 2019 which will likely steepen the US Treasury yield curve. We believe the Fed will lower rates 50 bps in 2019, even though the Fed's dual mandates of low inflation and low unemployment are stable and don't warrant easing. Chairman Powell will provide more transparency, but future cuts will likely be characterized as "preemptive measures" taken to ensure the extension of the current expansion based on forecasted trends in economic data. President Trump's recent barrage of criticism should not play much of a role in the FOMC's decision making process, but it has been certainly hard to ignore.

> Futures market are predicting a near 100% probability of a rate cut at the July 31st meeting and between two and three cuts by year end 2019

Additional tariffs could ignite inflation concerns, but to date, companies have absorbed input price increases and we identify few catalysts to accelerate growth above trend in the US. The absence of inflation in the near term and the Fed's new easing posture have caused us to be less concerned with interest rate risk although we continue to favor shorter duration strategies. As seen in Exhibit 7, future 10 year returns for Treasuries are closely correlated with starting yield, so we remain underweight core fixed income in portfolios.

EXHIBIT 7: FORECASTED BOND RETURNS: YIELD-TO-WORST AND 10 YEAR ANNUALIZED RETURN FOR BARCLAYS US AGGREGATE INDEX




Source: Bloomberg

## Municipal Bonds

The Bloomberg Barclays Municipal bond index returned 2.1% in the second quarter lagging taxable bonds. The 10yr AAA muni-to-Treasury ratio stands at 81%, up from 77% at the beginning of the second quarter. The AAA municipal bond curve flattened further in quarter, but still remains relatively steep. We are less concerned about credit issues for short to medium term maturities, but for longer dated maturities, we favor bonds backed by issuers who are less exposed to an economic downturn.

Given the slope of the municipal curve, we are comfortable with adding duration and call risk when appropriate. We remain vigilant of sectors that have more sensitivity to an economic decline or may be politically vulnerable. Examples of sectors we have reduced exposure to include education and health care.

## Spread Product

After the year end spike in spreads, credit spreads in investment grade and high yield tightened by mid-April respectively before widening again on trade and tariff related fears in May. At quarter end, high yield bond spreads performed a round trip with a negligible decrease in spreads for the quarter. The Bloomberg Barclays High Yield Index returned 2.5% in the quarter driven by coupon carry and duration. The Investment Grade Corporate index has a higher duration and returned 4.5% in the quarter. We continue to favor higher quality investment grade bonds as we do not see attractive risk reward in high yield bonds. We prefer to take credit risk in equities which have a return profile that is less negatively skewed. Our portfolios still contain an overweight to the non-agency MBS market which offers attractive yield with low duration and low extension risk. Fundamentally, the strong housing and labor market has benefitted these bonds.

> We continue to favor higher quality investment grade bonds as we do not see attractive risk reward in high yield bonds

EM bonds outpaced domestic credit indices with the JPM Emerging Markets Bond Index (EMBI) Global Diversified Index returning 4.1% in the quarter and 11.3% year to date. While we are concerned about slower global growth, the ECB and Fed easing cycles will provide support to EM bonds. If EM central banks follow suit, EM bonds look attractive relative to domestic high yield. Country selection will be important as tariffs and a manufacturing slowdown will have varying impacts on local economies.

## Conclusion

As the old adage goes, expansions don't die of old age, they need to be assassinated. Based on research from Fed economist Glenn Rudebusch, expansions are no more likely to die in year 10 than year 5 or 3.[18] Expansions generally die from aggressive monetary policy or large financial imbalances and often the two are related. Neither plague the US economy currently. Housing is on firm ground; equity valuations have not reached nose-bleed levels and corporate interest coverage ratios are high due to low nominal rates. The Fed Funds rate is not restrictive. However, due to slowing growth, the Fed will be reducing rates, aptly named "insurance cuts." In essence they prefer to lower rates now to get ahead of potential weakness accepting the risk that the economy may run above trend and inflation may pick up if no slowdown occurs.

The second quarter of 2019 has featured negative data surprises and unpredictable trade policy, so the Fed's prudence seems warranted contrasting our views earlier in the year. We are confident that US growth will stay positive for the remainder of the year even with additional tariffs. Trade policies have hurt more open and export-oriented economies, namely Japan and Germany, and these countries fundamentally stand on weaker footing. Regional specific tariffs or escalation to the China-US trade war could push Japan or Europe into recession and their central banks now stand ready to respond. China, firmly in the crosshairs of our President, is a managed economy, but growth is slowing and the government has set forth stimulative policy to ensure growth is maintained.

Equities are at or near all-time highs, but global bonds offer limited returns and credit spreads are tight. The equity risk premia, or difference between the earnings yield (inverse of the P/E ratio) and the risk free rate, is attractive for global equities and specifically outside of the US. Earnings and revenue growth should remain positive for 2019 contributing to a more attractive outlook for equities vs. bonds. In our allocations, we continue to trim back appreciated equities and reallocate proceed back to cash and shorter term fixed income. We are hesitant to materially

[18] Glenn D. Rudebusch; "Will the Economic Recovery Die of Old Age?" Federal Reserve Bank of San Francisco; February 4, 2016.

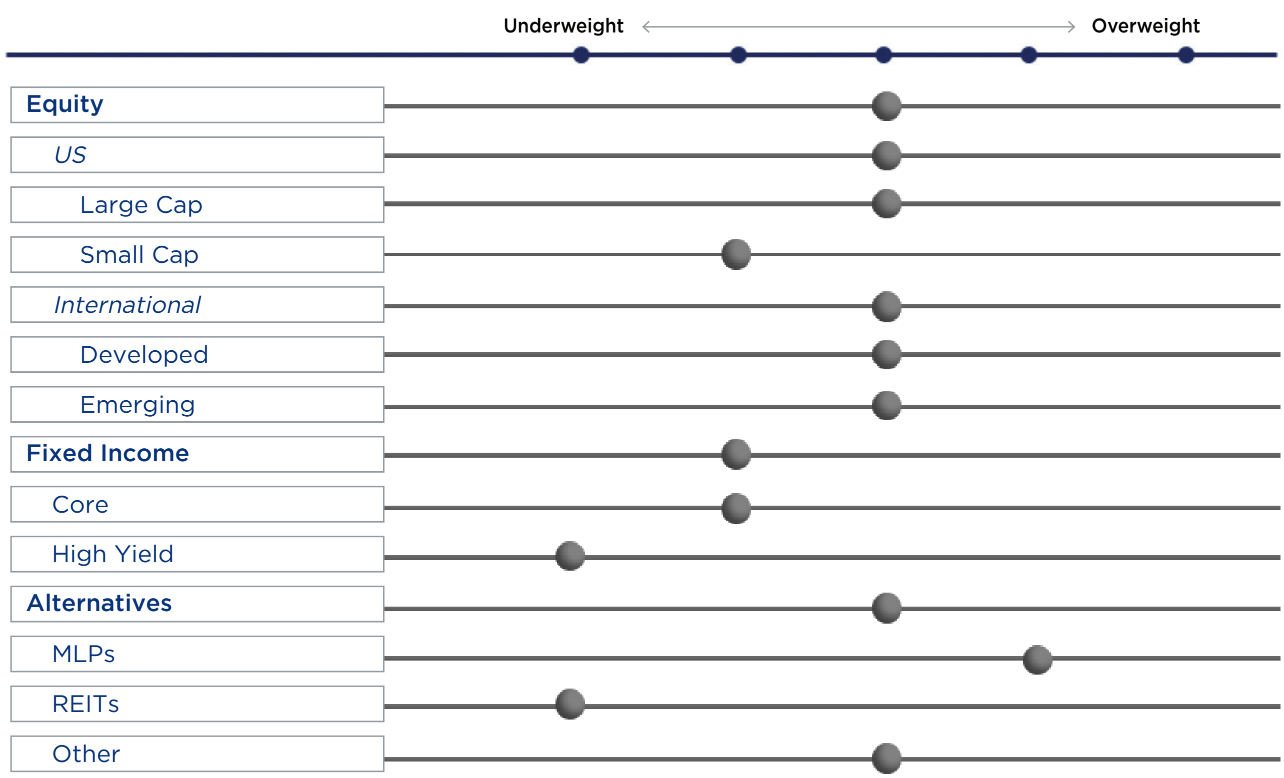
underweight equities heading into an easing cycle, because risk assets tend to perform well when the Fed is cutting rates. Additionally, there are few compelling asset classes that offer ample risk/ reward to justify a reallocation.

Within equities, our weights to US and non-US equities are equal to our policy targets. While non-US equities offer more attractive valuations and Fed easing should weaken the trade weighted dollar, non-US economies are more sensitive to a trade war escalation, a risk we cannot handicap. We have kept a quality bias in portfolios in our core, growth and value strategies which performed well in the quarter. We have not moved to overweight value to date despite a significant valuation discount to growth companies.

Expansions generally die from aggressive monetary policy or large financial imbalances

The valuation difference between the two styles has increased and is nearly one standard deviation above the long-term average, but the relative return benefit of value stocks may have been partially offset by a more stagnant macroeconomic environment. Value tends to underperform late in the business cycle. The counter to this view is a major reversal in the outperformance of technology stocks that we saw in 2000, the development of which would cause us to overweight value.

### EXHIBIT 8: DMCA ASSET CLASS VIEWS AS OF JUNE 30, 2019




Source: DMCA

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All information contained herein is based on past performance and is not intended to be indicative of future results. The indices used are unmanaged and return figures reflect the reinvestment of dividends and earnings. There is no guarantee that historical risk and rate of return will persist in the future.

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