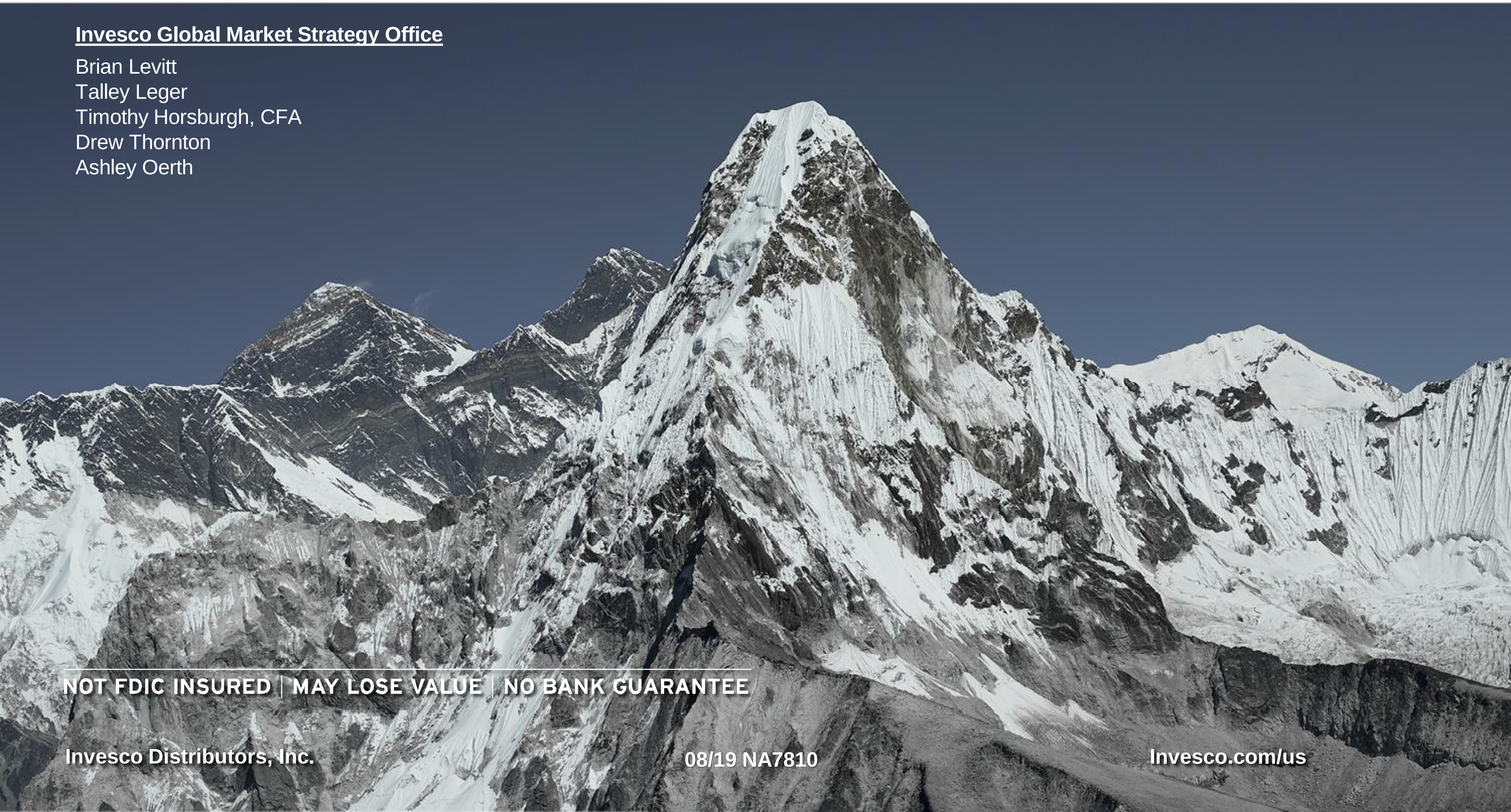
Mid Year Outlook: The More Things Change, The More They Stay The Same

June 2019



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Letter to Investors

This summer marks the 10th anniversary of the US economic expansion that began in June 2009. The current cycle is now officially the longest, no small feat considering that economists have been dating business cycles since 1854. Remarkably, the milestone, to many investors, is little cause for celebration. For one, this cycle's cumulative economic growth falls well below that of even much shorter cycles. Two, the rest of the world is in different stages of the cycle and there are no shortages of global geopolitical concerns — trade wars, Brexit, and countless others — to keep investors wary. Finally, investors may just be conditioned to dread anything that appears too good to be true.

Fortunately, cycles don't end simply because they have aged, and markets tend to climb the proverbial walls of worry. The current backdrop of modest US growth, modest US inflation, and relatively easy monetary policy can persist far longer than most expect. Recessions, instead, are the result of failed policy. In this cycle alone, US policymakers have tested faith (see Fed rate hikes in late 2015 and 2018) only to back down once financial conditions tightened meaningfully and growth had subsequently deteriorated. Ironically, the so-called trade war, for its part, is reducing global growth, thereby almost ensuring that US monetary policy will be accommodative for the foreseeable future. We believe this extends the US cycle, rather than curtailing it. In this environment, we expect US risk assets to continue to outperform.

While accommodative Federal Reserve policy has served as a primary underpinning of this cycle, so too have Chinese policymakers who inject stimulus each time growth slows. This time has been no different, although at a significantly lesser scale than in 2016, for example. Our base-case optimism on emerging markets is grounded in expectations of Chinese fiscal and monetary stimulus stabilizing economic activity. We are attracted by valuations outside the US, particularly in the emerging markets, and believe that stabilizing Chinese growth combined with more-benign US monetary policy could unlock that value and be supportive for the rest of the world. We recognize the risk of the trade conflict intensifying and inducing capital flows back to US dollar-denominated assets (the US consumer and services-driven economy is more insulated than is the emerging world). We believe investors should be selective with emerging market equities (we expect there to be winners and losers) and we stand ready to adjust our views on emerging markets accordingly if trade talks break down.

In closing, the more things change, the more they stay the same. The longest cycle on record continues, complete with stocks likely to outperform bonds and higher-yielding credit likely to outperform Treasuries. Investors will likely be celebrating more records from this cycle; at least until policymakers tighten financial conditions meaningfully and hasten its demise.

2019 Mid Year Outlook

Our Macro Views

We expect:

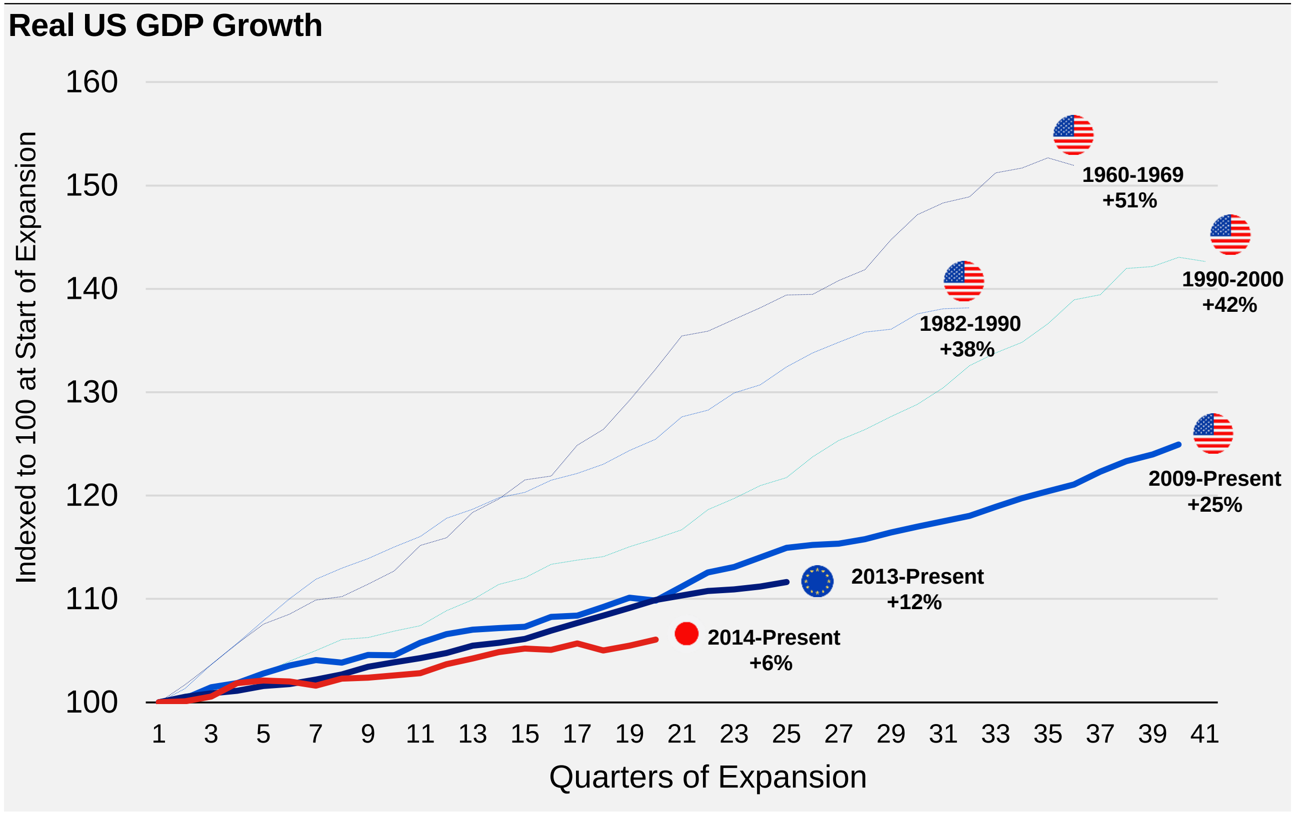
1. The cycle to continue, albeit at a slower pace.
2. The two primary underpinnings of this elongated cycle —accommodative Fed policy and Chinese stimulus to support growth – to continue.

Our Investment Views

We expect:

1. Markets to continue to climb a "wall of worry."
2. Easing financial conditions to likely stem volatility and be supportive of risk assets.
3. The US dollar to be stable or weaker.
4. Emerging markets (EM) to be supported by attractive valuations and improving growth.
5. Interest rates and inflation to remain low.
6. The search for real yields to continue.
7. Cyclical stocks to continue to outperform (if the cycle continues).

It may be the longest cycle, but the total economic advance has been relatively modest

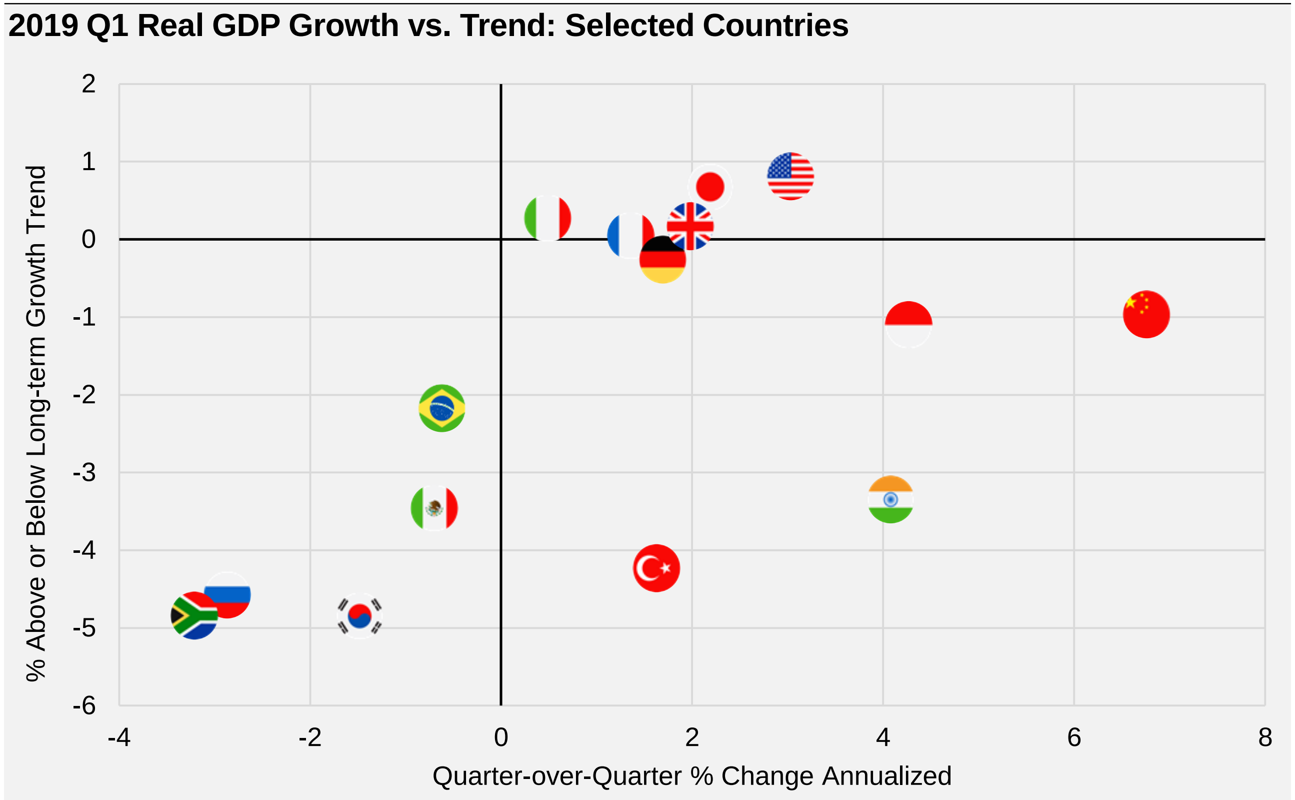


In July, the current US economic cycle will officially be the longest on record. The expansion, however, has been the weakest of the post-WWII period. Consequently, the classic late-cycle economic excesses that typically emerge have not been prevalent. At the same time, inflation expectations are weakening, suggesting that the Federal Reserve (Fed) monetary tightening cycles that have typically ended cycles may not be forthcoming. We expect the Fed to provide adequate accommodation, which help to continue to lengthen this business cycle.

- Europe and Japan are earlier in their economic cycles than the US but face heightened challenges in the second half of 2019. True, the European Central Bank (ECB) signaled that it's open to further stimulus, but we question how much it can meaningfully alter the European growth and inflation outlook by lowering rates further into negative territory or purchasing some more assets. As such, we expect the economic sluggishness to continue across the eurozone.
- Japan, for its part, has been experiencing an improvement in economic activity but faces a likely economically damaging sales-tax hike in October. The last sales-tax rise in 2014 damaged Japan's recovery. The latest increase will come at an inopportune time as Japanese growth is weaker now than it was in 2014 and the global geopolitical risks are more heightened.

Source: Bloomberg, L.P., 5/31/19. Past performance does not guarantee future results. An investment cannot be made directly into an index.

Most major economies of the world have grown below trend

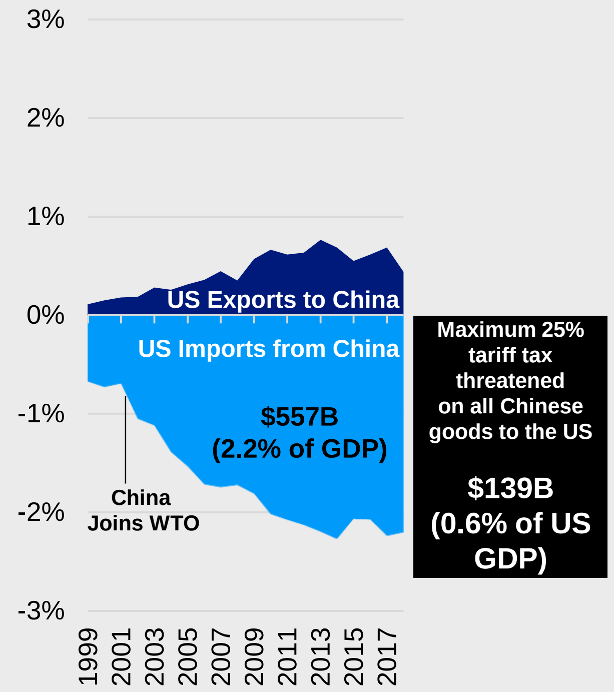


- Most of the major economies of the world have continued to grow at or below trend. The G-7 countries have generally grown at trend, while the larger emerging economies such as India and China have been producing stronger relative growth, but below that of their long-term trends. Other emerging economies such as Mexico and Korea have been harmed by the recent slowdown in global trade.
- The US economy, which has been growing above trend, has been an outlier, primarily the result of fiscal stimulus. In our view, US growth is likely to slow in the second half of 2019 as a result of fading stimulus, trade concerns, and the lagged effect of last year's monetary tightening. Paradoxically, we believe a slowdown in the US economy to a more moderate rate would likely serve to extend the US cycle.

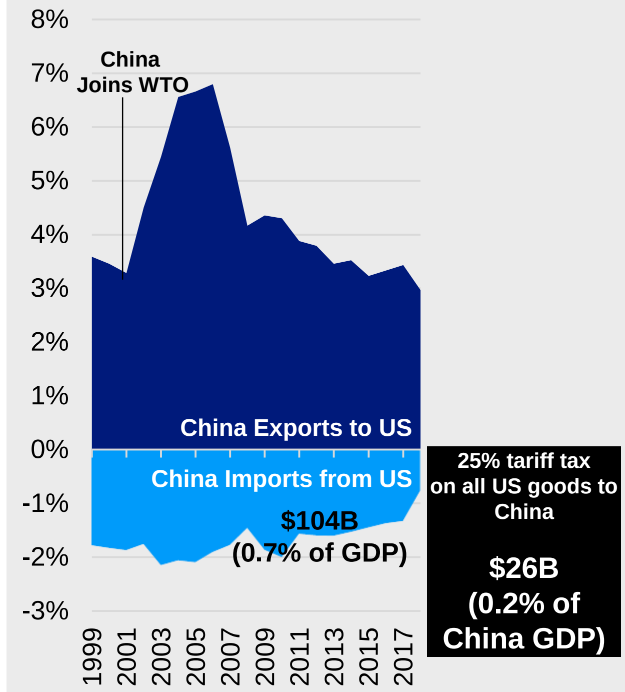
Source: Haver, Invesco, 6/19/19.

The direct impact of the ‘trade war’ on economic growth has been modest, but may weigh on sentiment

US Trade With China
(Percent of US GDP)



China Trade With US
(Percent of China GDP)



The effects of the “trade war,” barring an imminent truce between the US and China, are expected to further exacerbate the slowdown. It remains to be seen if the administration is willing to go through with imposing the new tariffs and the subsequent increases. If the administration proceeds, then we expect the risks to the global economic and financial outlooks to rise.

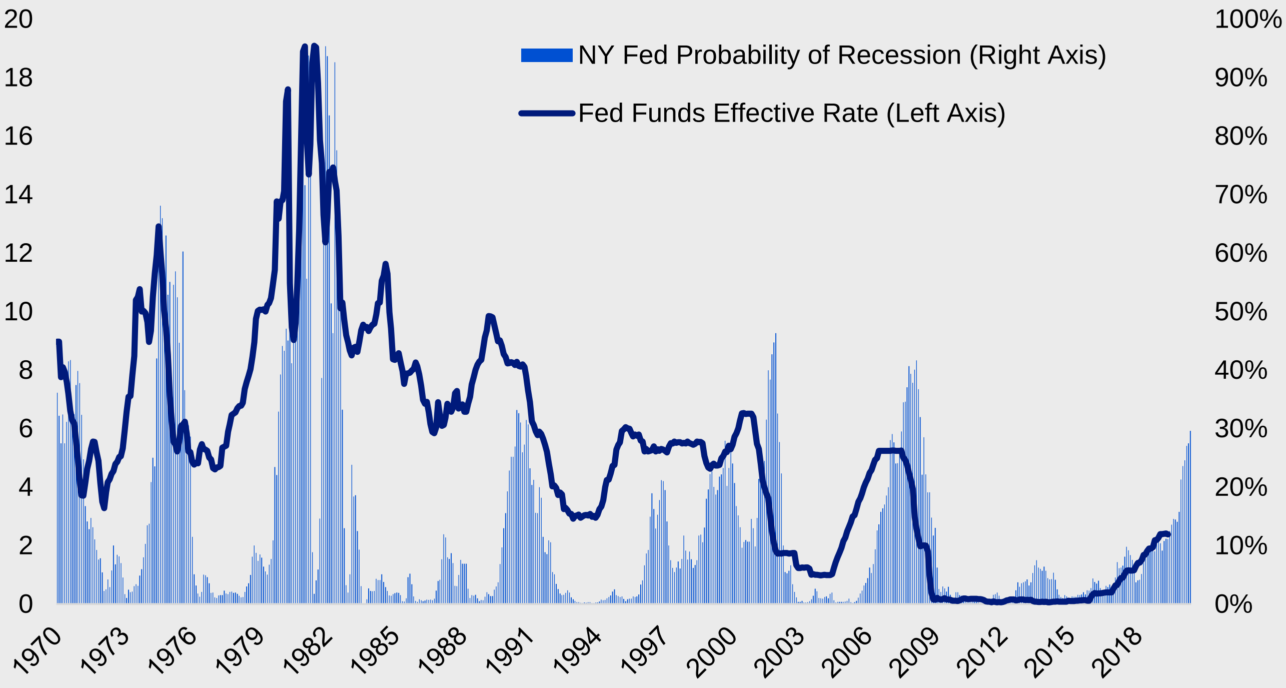
How big of a direct impact could the tariffs have on economic growth?

- It is difficult to quantify for a variety of reasons, but a back-of-the-envelope calculation reveals that the tariff tax to US consumers on Chinese imports is equal to roughly 0.6% of US GDP. The upshot is that annual US growth is likely to revert toward 2% or even moderately lower, in our view.
- The potential tariff tax to Chinese consumers on US imports is smaller, representing only 0.2% of China’s economic output.
- A bigger concern is the potential effect of tariffs on business confidence. To date, business confidence has been generally weakening, albeit from very high levels.

Source: Bloomberg L.P., Haver Analytics, 5/31/19.

The Fed's more dovish stance could likely extend the cycle

US Fed Funds Rate, % left-hand series and NY Federal Reserve One-Year Ahead Recession Probability Indicator, % right-hand series, Adv 1yr



It has been said that all economic cycles are ultimately ended by central banks with monetary policy tightening. This chart depicts the rising probabilities of recession over time as the Fed has raised and lowered interest rates. By mid year, the probability of recession had increased, the lagged result of Fed policy tightening. Fortunately, the Fed has since backed off its tightening stance, thereby easing financial conditions in June. The market, with growth slowing and inflation expectations weakening, has now been pricing in as many as two interest rate cuts before the end of the year.

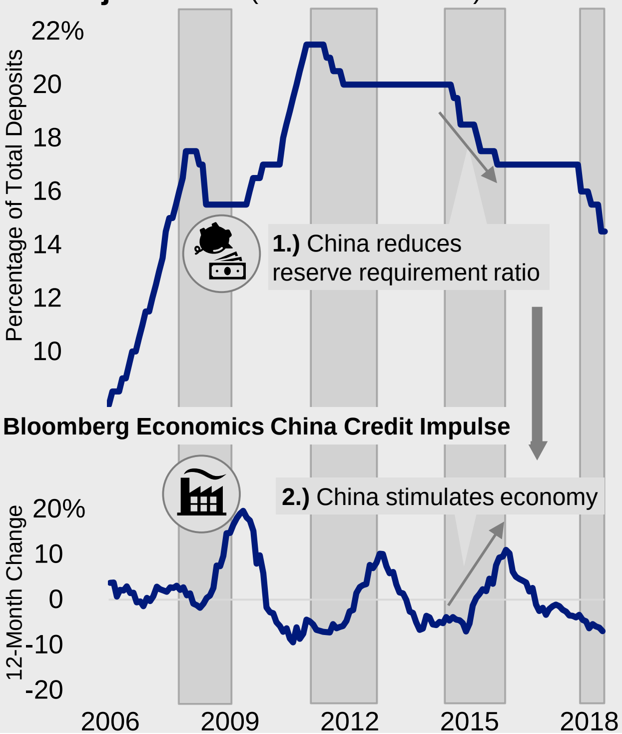
A big underpinning of this elongated cycle has been easy central bank policy. That story has not changed. We believe that this current backdrop of modest US growth, modest US inflation, and relatively easy monetary policy can persist far longer than most expect.

Source: FactSet Research Systems, Haver Analytics 5/31/19. See index definitions on page 15. Past performance does not guarantee future results.

China stands ready to support growth

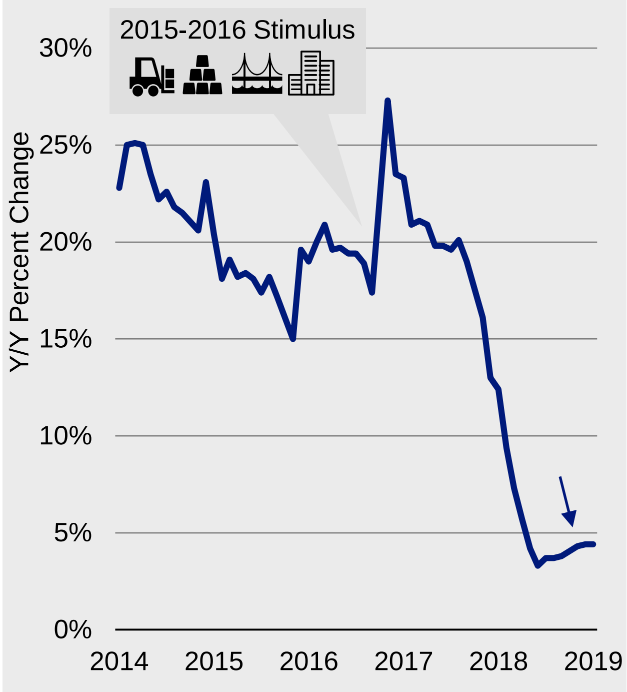
Step 1: Monetary Stimulus

China required deposit reserve ratio for major banks (7/31/06 – 11/30/18)



Step 2: Fiscal Stimulus

China fixed asset investment infrastructure (ex-electricity)
(4/30/14 – 4/30/19)

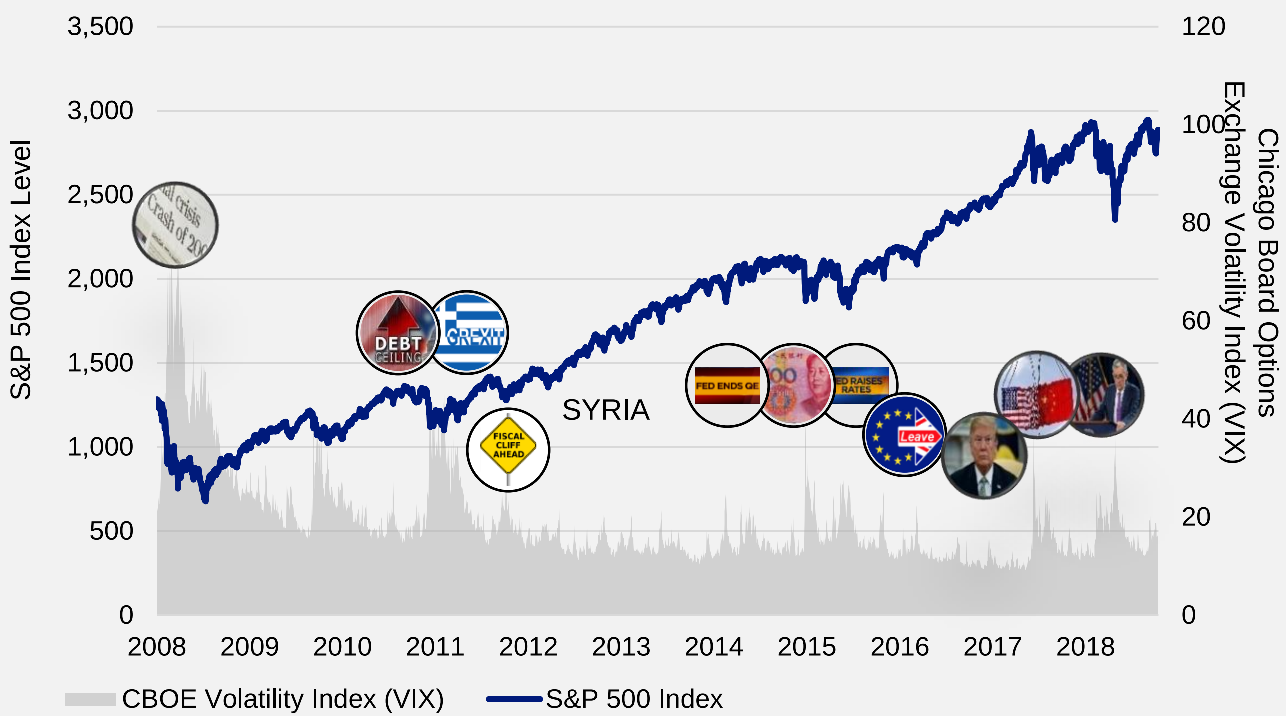


Another large underpinning of this cycle has been Chinese policymakers responding to slowdowns in Chinese economic activity with additional stimulus. Thus far, the Chinese response to slower growth and the ongoing “trade war” has been primarily on the monetary side, with cuts in the bank reserve requirement ratio. Fiscal stimulus (chart on the right) has also been increasing, likely providing a floor to Chinese slowing growth, in our view. China has made it clear that it will support its economy in order to ride out the ongoing trade war with the US.

Source: FRED, Haver Analytics, 5/31/19. See index definitions on page 15. Past performance does not guarantee future results.

Markets are likely to continue to climb a ‘wall of worry’

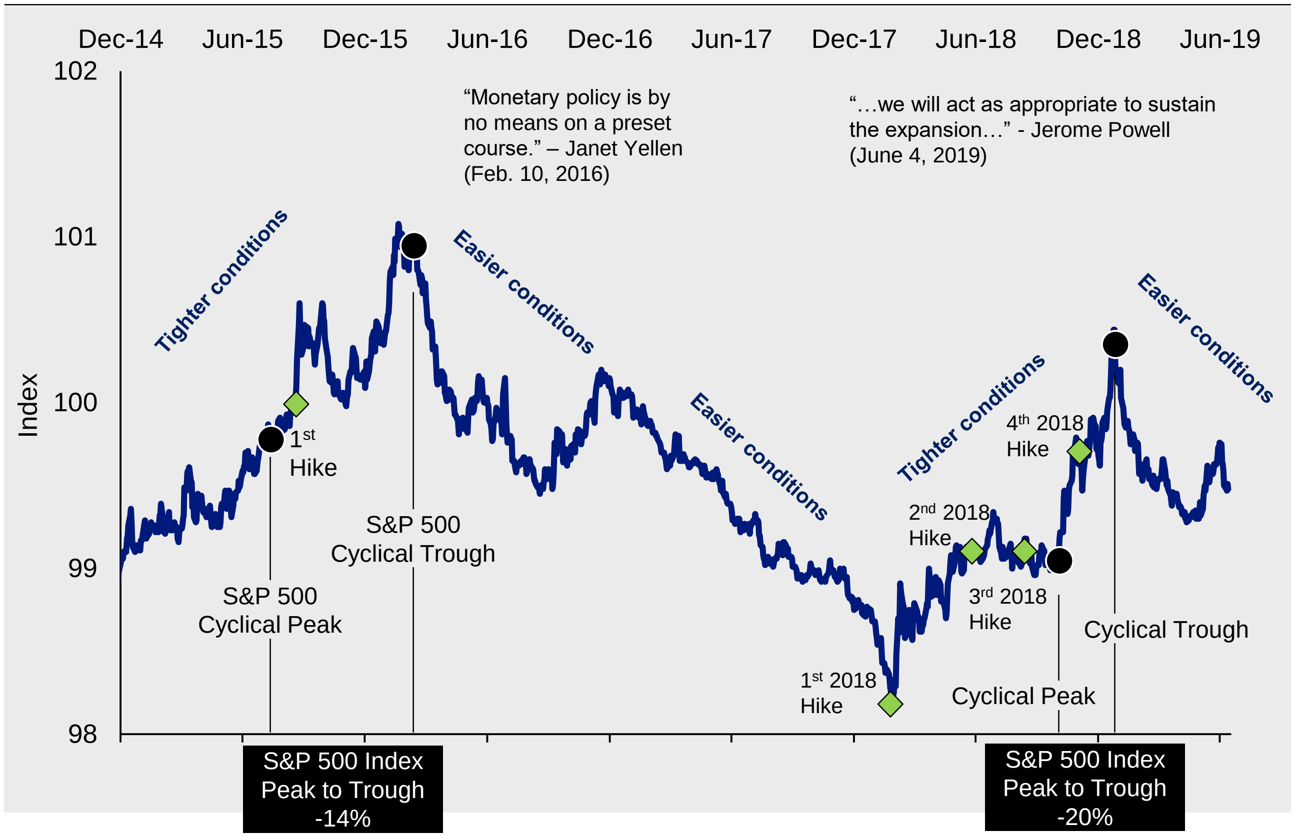
S&P 500 Index and Volatility (2008–2019)



Investors should recognize that risks have been increasing around the world, but also remember that markets tend to climb the proverbial wall of worry. Throughout this current cycle, there have been bouts of policy-driven volatility that have then receded as policymakers reversed course, and the markets pressed higher. The Fed’s recent about face on the direction of short-term interest rates is the latest example. We view the current US environment as being similar to that of early 2016 when the Fed’s changeover to a more accommodative policy stance resulted in the equity markets trading higher.

Source: FactSet, 5/31/19. See index definitions on page 15. Past performance does not guarantee future results.

Easing financial conditions likely to stem volatility and support risk assets



To further illustrate this point, we highlight US financial conditions, using an index that is a weighted average of riskless interest rates, the exchange rate, equity valuations, and credit spreads. The chart depicts the impact of Fed action on financial conditions in mid- to late-2015, and again in 2018. A conclusion is that it is unsustainable for the Fed to tighten financial conditions in what is still a slow-growth, benign-inflation world.

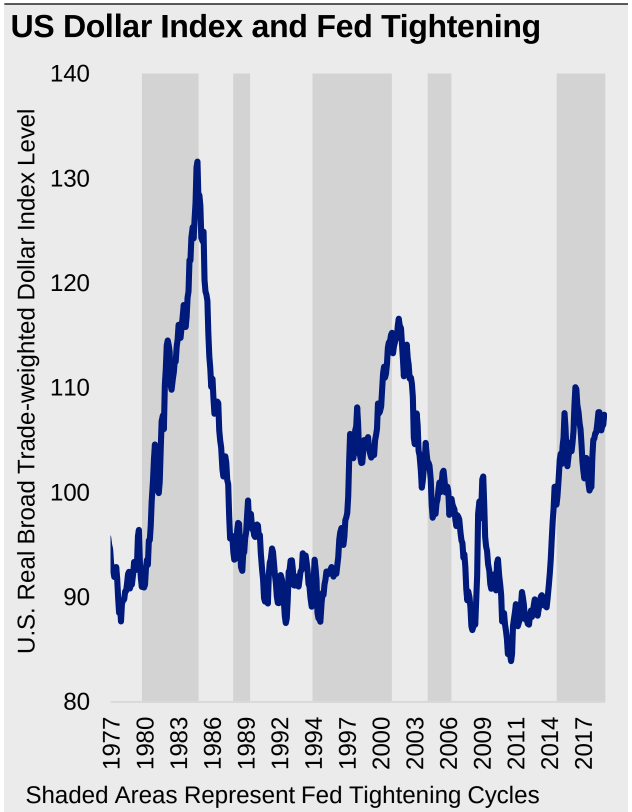
The result has generally been:

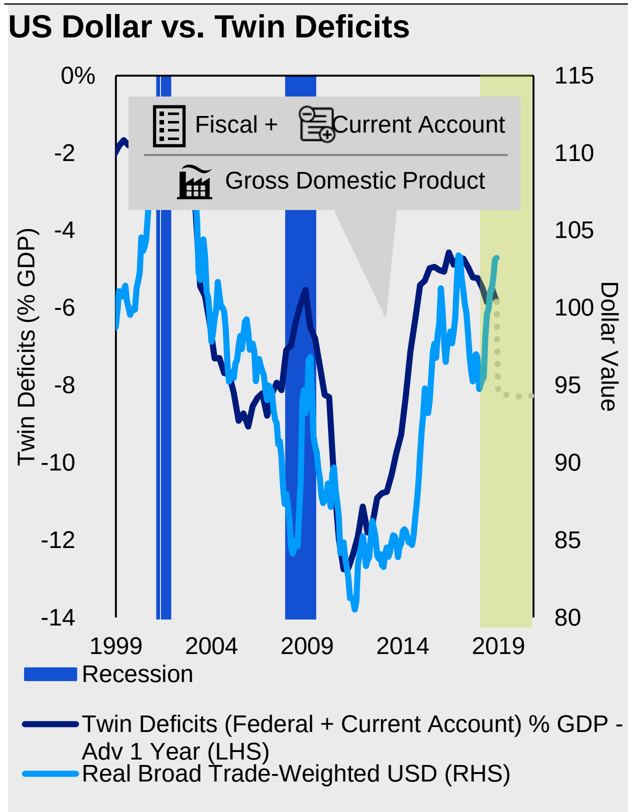
1. A stronger US dollar
2. A flattening yield curve
3. Weaker earnings growth
4. Slower economic growth
5. Wider credit spreads
6. Equity market drawdowns
7. Recession fears
8. The Fed pivoting away from its tightening stance

In this type of environment, we continue to expect drawdowns and volatility when/if policymakers choose to tighten conditions; only for markets to recover as policymakers pivot to more accommodative stances.

Source: Bloomberg L.P. 5/31/19. See index definitions on page 15. Past performance does not guarantee future results.

The US dollar expected to be stable or weaker





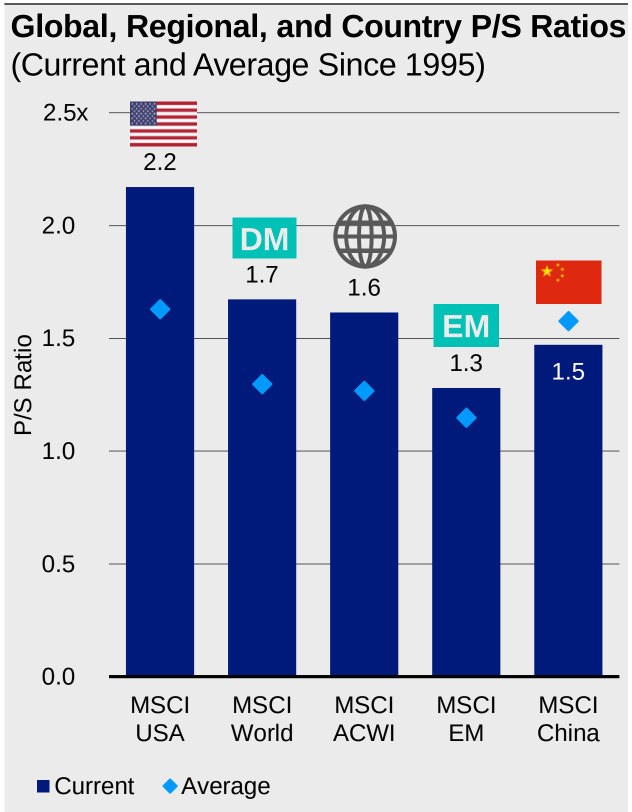
Making any call against the strength of the US dollar thus far in this cycle been has been wrong. Money tends to flow where growth is strongest relative to expectations, and that has favored US dollar assets for much of this cycle.

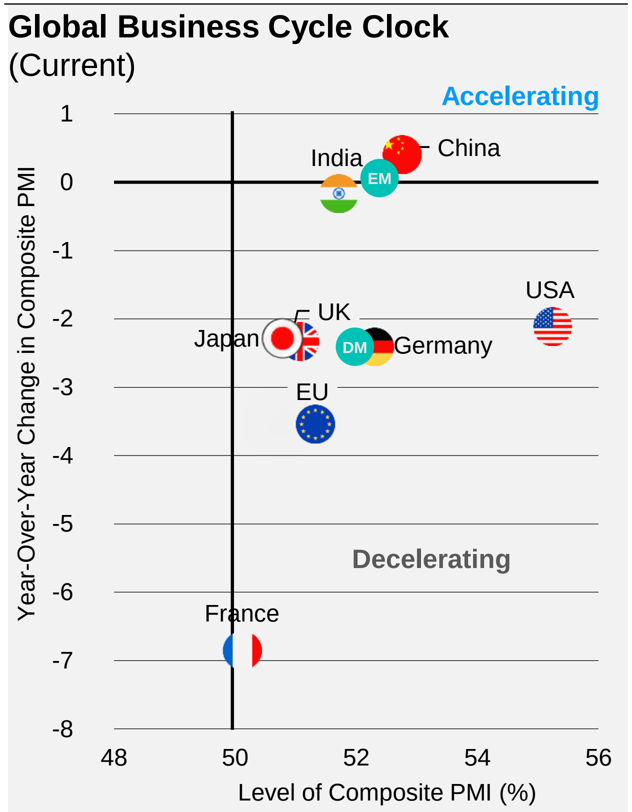
We do note, however, that dollar cycles have tended to end with the end of Fed tightening cycles (left chart) and the dollar has tended to weaken as the US fiscal and current account deficits widen (right chart), the latter of which is likely to happen in the coming quarters, in our view. We fall short of calling for a new dollar cycle, but instead expect the greenback, barring a major policy mistake in the US or China, to be relatively stable to moderately weaker in the coming months.

For investors concerned about the "trade war" and a potential recession, the US dollar will be a good barometer, in our view. A deterioration in the trade talks leading to another leg of US dollar strength would weigh on the earnings of US multinational companies and slow US economic activity. We would expect the Fed to respond to such a scenario with further policy accommodations.

Source: Haver Analytics, 5/31/19. Past performance does not guarantee future results. Index definitions can be found on page 15.

EM expected to be supported by attractive valuations and improving growth





Naturally, the longest bull market in US history has inflated developed market (DM) equity valuations relative to the global benchmark, emerging markets (EM) and their historical average. The rule of thumb is that overpaying for an asset reduces its prospective return over the long haul. That said, valuations are poor timing tools, and matter little in the near term. As such, we believe US stocks may enjoy solid late-cycle returns over the next couple of years.

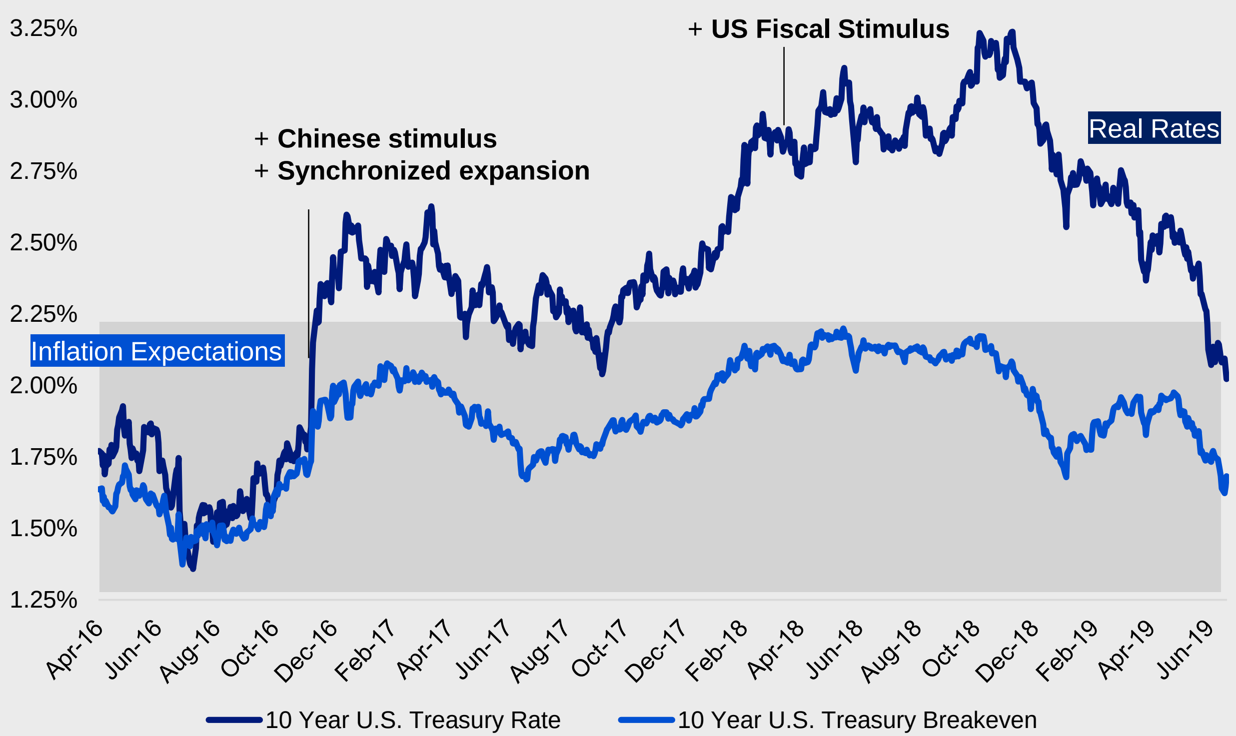
On the flip side, EM equity underperformance — including China — has compressed valuations to deep discounts. Compelling valuation opportunities exist for investors in EM stocks at a time when many emerging economies are still enjoying growth rates superior to their DM competitors. Indeed, leading indicators of business activity across the emerging world — China and India in particular — have been proving more resilient than those of the developed world, including Germany, the UK, Japan, and France. Moreover, the Fed's newfound openness to rate cuts is expected to ease upward pressure on the US dollar and reduce a key risk for EM. Low valuations, potentially improving growth, and recent Fed dovishness are a powerful combination for unlocking the potential reward embedded in EM share prices.

The price-to-sales ratio (P/S ratio) is a valuation metric calculated by dividing a company's market capitalization by its total sales over a 12-month period.

Sources: Bloomberg L.P., Haver, Markit, Invesco, 4/30/19. Note: P/S = price-to-sales ratio. Ranked from left to right—from highest premium to lowest discount. ACWI = All Country World Index. EU = European Union. Composite = manufacturing + services. PMI = Purchasing Managers Index. EU Composite PMI = France, Germany, Ireland, Italy, Spain, and the UK. See page 15 for index definitions. Past performance does not guarantee future results.

Interest rates and inflation expected to remain low

US 10 Year U.S. Treasury Rate Yield vs. Headline Consumer Price Index

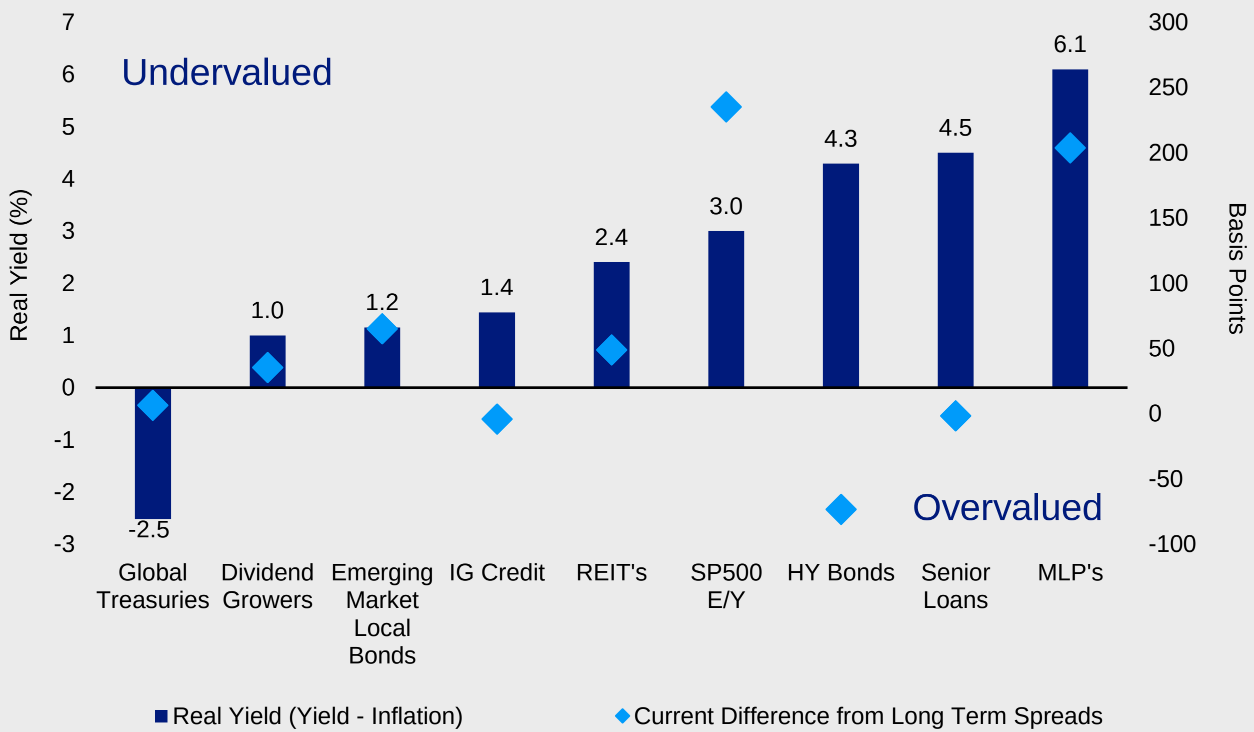


Higher real rates in the aftermath of the “synchronized” global expansion and the 2018 US fiscal stimulus proved unsustainable as inflation expectations remained well anchored. US interest rates will likely remain low for the foreseeable future, in our view, driven by a confluence of factors including slow global growth, virtually non-existent inflation globally, negative real yields in many developed markets, and aging populations searching for yield.

Source: Bloomberg L.P., as of 5/31/19. Past performance does not guarantee future results.

The search for real yields continues

Real Yields Among Diversifying Income Assets



Given that interest rates are expected to remain low for the foreseeable future, we believe investors will continue to seek income from other sources such as higher yielding credit and dividend-oriented income strategies.

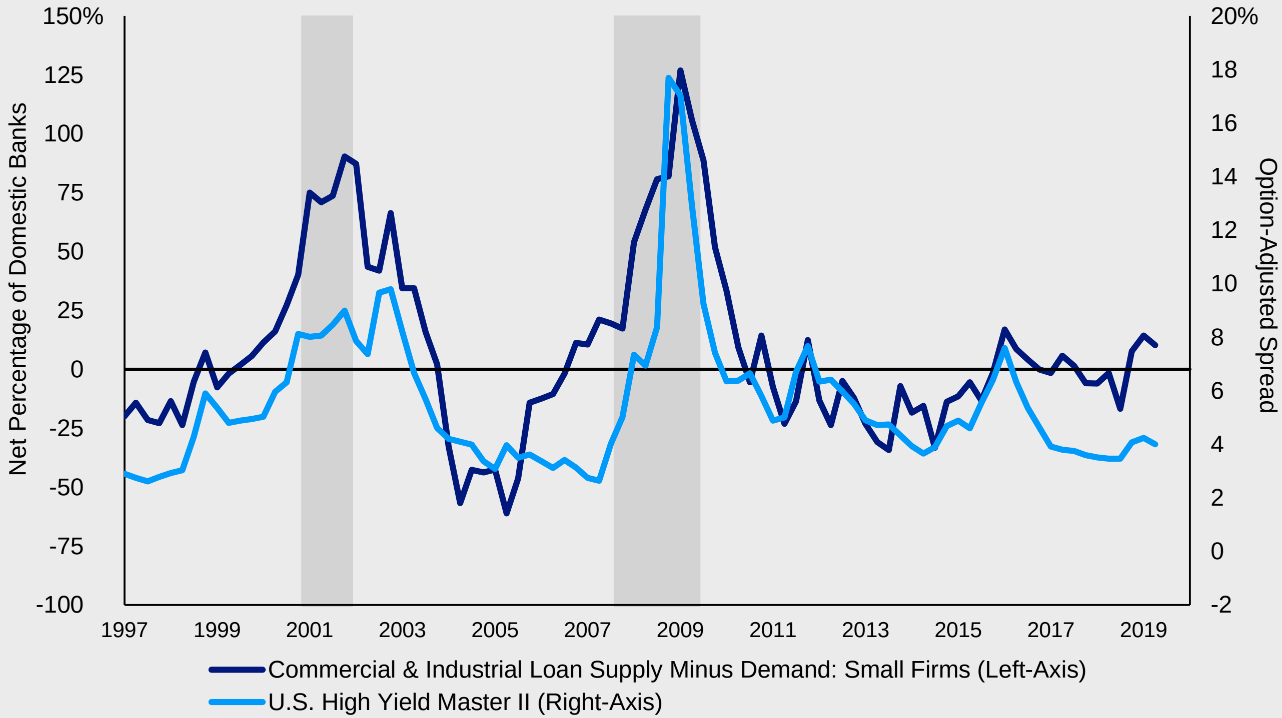
The chart presents the real yields (bar) of various income-generating assets and the degree to which the asset class is under/over valued compared to its long-term average.

- Credit is trading at tighter spreads compared to historical averages, with high yield bonds more overvalued than senior loans and investment-grade credit. Credit spreads typically remain tight for prolonged periods of time until there is an economic cycle.
- Equities continue to trade cheap to bonds, while dividend-growth equities and equity-like assets such as real estate investment trusts (REITs) and master limited partnerships (MLPs) appear to represent opportunity.

Source: Bloomberg L.P., Credit Suisse, JP Morgan. Global Treasury is represented by Bloomberg Barclays Global Aggregate Treasury Bond Index. Dividend Growers are Represented by the S&P Dividend Aristocrat Index. Emerging market global bonds are represented by the JP Morgan Emerging Market Bond Index. Investment Grade Credit (IG) is represented by the Bloomberg Barclays U.S. Aggregate Bond Index. REITs are represented by the FTSE NAREIT All Equity REIT Index. S&P 500 E/Y is the Earnings yield (the ratio of earnings to the price of the index) on the S&P 500 Index. HY Bonds are represented by the Bloomberg Barclays High Yield Index. Senior Loans are represented by the Credit Suisse Leveraged Loan Index and MLPs are represented by the Alerian Master Limited Partnership Index. All data as of 5/31/19. See index definitions on page 15. Past performance does not guarantee future results.

Net lending conditions for risky firms have been fairly normal, supporting below investment grade credit

Net Lending Conditions for Small Firms and High-Yield Corporate Bond Spreads Since 1997



Recently, the spread of high-yield corporate bonds above their Treasury counterparts has been at a tight or low level compared to history. In other words, the bulk of the significant price appreciation investors have enjoyed since 2009 is likely behind us, in our view.

Indeed, the supply of commercial and industrial loans to small firms has modestly outweighed the demand thereof, which has restrained high yield corporate bond prices.

Fortunately, the fundamentals for corporate borrowers — including low default rates, high interest coverage ratios, and no wall of maturities — have been sound, underpinning our belief that spreads can remain relatively stable.

Source: Bloomberg L.P., FRED, 5/31/19. Index definitions can be found on page 15. Past performance does not guarantee future results.

Index definitions

Consumer Price Index (CPI) program produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

The Bloomberg Barclays Global Treasury Index tracks fixed-rate, local currency government debt of investment grade countries, including both developed and emerging markets. The index represents the treasury sector of the Global Aggregate Index and contains issues from 37 countries denominated in 24 currencies.

The S&P 500 Index is a market capitalization weighted index of the 500 largest domestic U.S. stocks.

The MSCI All Country World Index ex-U.S. measures the performance of large and mid cap companies across 22 of 23 developed markets (excluding the U.S.) and 24 emerging markets countries.

The MSCI All Country World Index ex-U.S. Small Cap measures the performance of small cap companies across 22 of 23 developed market countries (excluding the U.S.) and 24 emerging market countries.

The MSCI Emerging Markets (EM) Index is designed to measure global emerging market equity performance.

The MSCI World Index is designed to measure the performance of developed market equities.

The MSCI China Index is designed to measure the performance of Chinese equities.

The MSCI USA Index is designed to measure the performance of United States stocks across all capitalization sizes.

S&P Dividend Aristocrat Index measures the performance of S&P 500 index constituents that have increased their dividend payouts for 25 consecutive years or more.

JP Morgan Emerging Market Bond Index is designed to measure the performance of bonds issued by sovereign and corporate issuers in the emerging markets

The Bloomberg Barclays U.S. Aggregate Bond Index is designed to measure the performance of investment grade bonds in the United States

FTSE NAREIT All Equity REIT Index is designed to measure the performance of publicly traded REITs in the United States.

Bloomberg Barclays High Yield Index is designed to measure the performance of below investment grade rated corporate bonds in the United States

Credit Suisse Leveraged Loan Index is designed to measure the performance of below-investment grade rated variable rate loans in the United States

The Alerian Master Limited Partnership Index is designed to measure the performance of master limited partnerships in the United States.

U.S. High Yield Master II Index tracks the performance of U.S. Dollar-denominated below investment-grade corporate debt publicly issued in the U.S. domestic market.

Indexes are unmanaged and cannot be purchased directly by investors. Index performance is shown for illustrative purposes only and does not predict or depict the performance of any investment. Past performance does not guarantee future results. Information as of June 2019 unless stated otherwise.

Disclosures

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial advisor or financial consultant before making any investment decisions.

These views represent the opinions of the authors and are not intended as investment advice or as a prediction of the performance of any investment. These views are as of the open of business on June 21, 2019, and are subject to change on the basis of subsequent developments.

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