February 2019

Major Markets Jump in January

Overview

In January, U.S. and foreign stocks and bonds moved higher. The monthly return for the S&P 500, for instance, was 8.01%, the highest monthly gain in more than 8 years, and the best January since 1987. This turnaround from the stock market weakness in December was welcome. Conditions looked oversold at the end of the year, perhaps from a combination of tax-loss harvesting and investors' waiting on the sidelines for a new year. A change in policy expectations across the globe seem to have had a positive influence. In particular, markets responded favorably to Fed Chairman Powell's comments in late December and other statements in January. There are also signals of fiscal policy shifts in Europe. While pleased with January's gains, we also encourage restrained expectations. In this issue of *Insights*, we focus on our guarded outlook in view of (1) the Fed's current and likely future policy path relative to U.S. economic data, (2) European economic data, and (3) key outstanding geopolitical concerns such as Brexit and the U.S./China trade policy dispute.

Performance

Following a difficult final month of 2018, major asset classes jumped sharply higher in January (see table below).

	Jan./ 2019 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.76	3.57	4.55	US Muni Bonds
BarCap US Agg Bond TR USD	1.06	2.44	3.68	US Taxable Bonds
BoAML US High Yield Master II TR USD	4.59	4.61	10.91	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	4.41	5.85	8.53	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	5.46	1.05	4.64	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	3.92	0.73	1.79	Hybrid/Hedged Equity
DJ Industrial Average TR USD	7.29	12.44	15.00	US Equity -- Large
S&P 500 TR	8.01	10.96	15.00	US Equity -- Large
NASDAQ Composite TR USD	9.79	13.45	18.63	US Equity -- Large
Russell 1000 TR USD	8.38	10.68	15.17	US Equity -- Large
Russell Mid Cap TR USD	10.79	8.89	16.09	US Equity -- Mid-sized
Russell 2000 TR USD	11.25	7.26	14.52	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	7.56	3.11	8.35	Int'l Equity -- Comprehensive
MSCI EM NR USD	8.77	4.77	9.66	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	5.45	-7.88	-2.74	Commodities
HFRX Global Hedge Fund USD	2.13	-0.12	1.65	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 1/31/2019

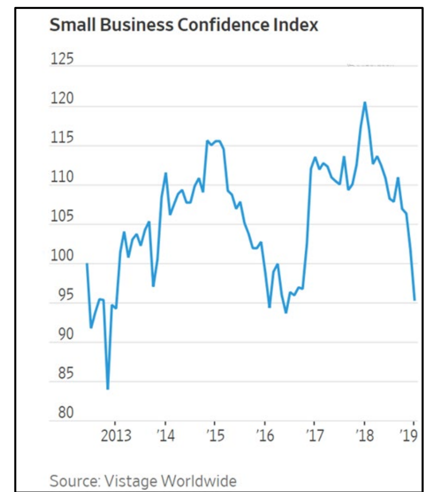
The S&P 500 rose 8.01% on the month, and the tech-heavy NASDAQ moved up 9.79%. The Russell 2000 Index of small companies appreciated 11.25%. The MSCI ACWI Index Ex-USA index, which is a measure of all stocks

outside the U.S., rose 7.56%. The MSCI Emerging Market Index also performed well, posting a strong 8.77% gain for the month.

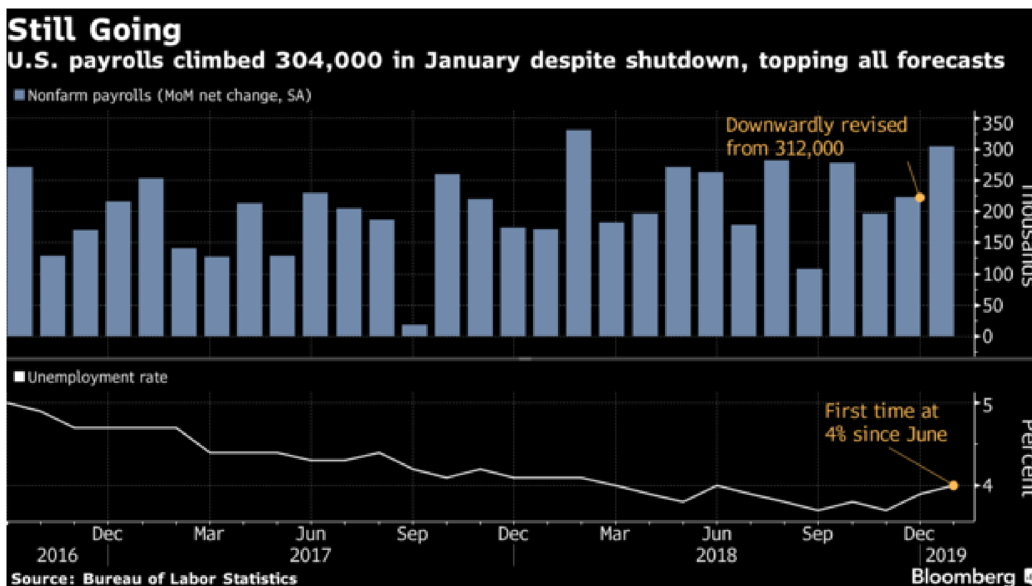
The Bloomberg Barclays U.S. Aggregate Bond Index rose 1.06% primarily due to lower yields caused by anticipation that the Fed would become less aggressive in its monetary policy. On the increased optimism for steady rates policy and increased risk sentiment, high yield bonds rebounded and gained 4.59%. Foreign emerging market bonds, both U.S. dollar-denominated and local currency, gains 4.41% and 5.46%, respectively, according to the JPMorgan EMBI Global Diversified and the JPMorgan GBI EM Global Diversified indices.

Outlook

Economic data in the U.S. remains solid, but consumer and business sentiment has weakened despite the sharp stock market gains this year through January. The release of some government economic data has been delayed due to the recent partial shutdown. What data have appeared paint a somewhat mixed picture. For instance, small business sentiment at the end of January has declined, as you can see in the nearby chart. In fact, *The Wall Street Journal* recently reported (2/4/19) that economic confidence among small firms, which were surveyed by Vistage Worldwide, has eroded, and many of them are delaying both hiring and spending plans. A decrease in such activity should portend a slowdown in both employment gains across the economy and GDP growth.



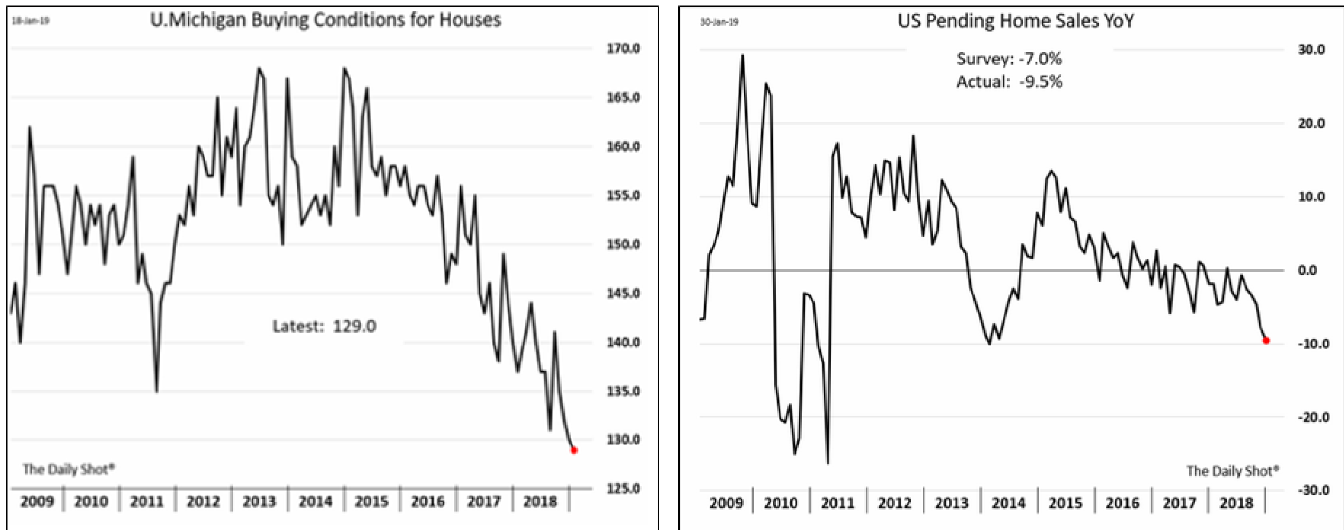
The employment landscape itself suggests something of a mixed bag. The most recent labor report showed that 304,000 jobs filled in January, but the December jobs number was revised downward from 312,000 to 222,000. The official unemployment rate is still low at 4.0%, but it ticked up for the second consecutive month. The rate may decline again slightly, depending on the strength of the economy and the smoothing out of data from the partial government shutdown, but we think that it is in the process of stabilizing somewhere between 3.5% and 4%.



These small business and employment dynamics are characteristic of late-cycle expansions. So are ups and downs in cyclical areas, such as the automobile sales, semiconductors, and the real estate market. Gyrations in home sales can be noisy. We pay most attention to longer-term trends. The available evidence suggests reason for

some caution about residential real estate purchases and related consumer spending.

As you can see in the nearby chart, the University of Michigan "Buying Conditions for Houses" index hit its lowest level in the current economic expansion (left chart below). This has translated into a 10% year-over-year decrease in U.S. pending home sales. They are now at their lowest level since 2014. The higher cost of borrowing, in part due to the Federal Reserve rate tightening policy, has likely contributed to this development.



The Fed seems poised to implement less aggressive tightening policy measures, and this may help to reverse some of these declines (i.e., lower interest rates may stimulate "big ticket" purchases like housing). But consumer sentiment has also weakened recently, and that affects decisions about future spending on both big and small ticket items.

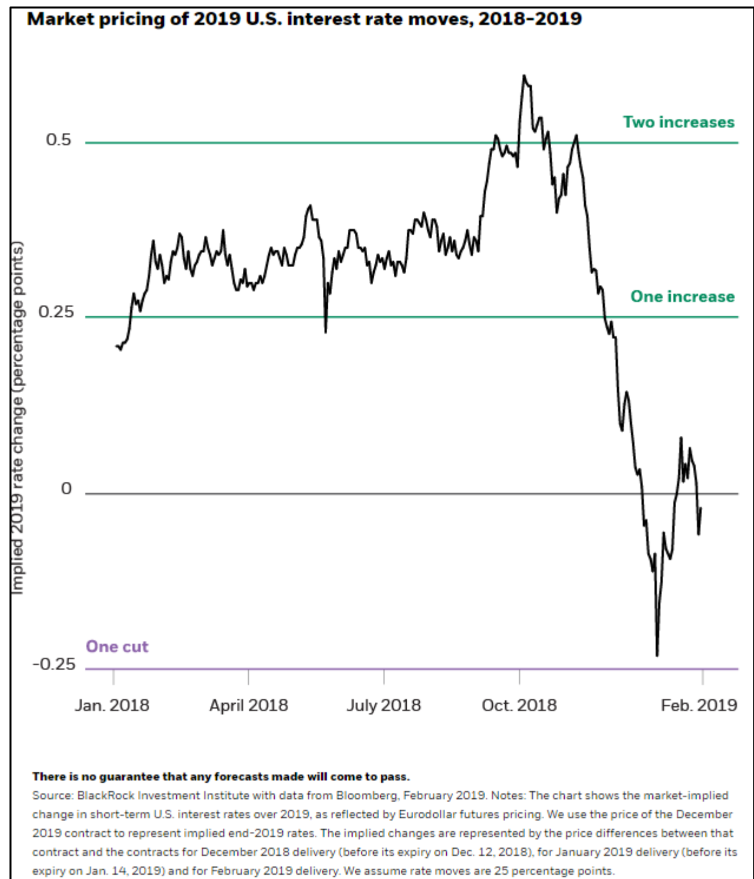
Federal Reserve Policy

In January Chairman Jerome Powell sought to, and largely effectively did, reassure financial markets that the Fed would in fact be more flexible, data-dependent, and patient than his comments immediately after the December Federal Reserve meeting indicated. This course reversal in policy indicators was confirmed both in the January FOMC meeting statement, which mostly eliminated rate hiking guidance, and the post-meeting press conference, which emphasized the committee's "patience" in the face of "muted" inflation. The Fed also indicated that it is willing to adjust its balance sheet normalization process (i.e., possibly maintain a larger-than-expected balance sheet) "in light of economic and financial developments." This normalization, or reduction, process (sometimes referred to as "quantitative tightening") has, along with higher rates policy, made borrowing costs more expensive and constricted financial conditions. Finally, the Fed's meeting statement downgraded its assessment of overall U.S. growth conditions to "solid."

All of these developments fit into the three key reasons that we outlined last year why Chairman Powell and the FOMC may decide to pause rate hikes in 2019: (1) global growth deceleration, (2) stable inflation and wage growth, and (3) the lack of risks of financial imbalance amid weakness in cyclical sectors. In view of the Fed's recent explicit pivot on policy guidance, the broad futures market has come around to share our viewpoint. As you can see from the chart immediately below (on the next page), the bond market has moved from expecting two quarter-point rate increases as recently at November to currently pricing in zero additional rate hikes this

year, as well as the slight possibility that the Fed might even cut rates at some point in 2019. We are currently unsure about a rate cut this year, but we do think that the Fed rate hiking program will pause in March.

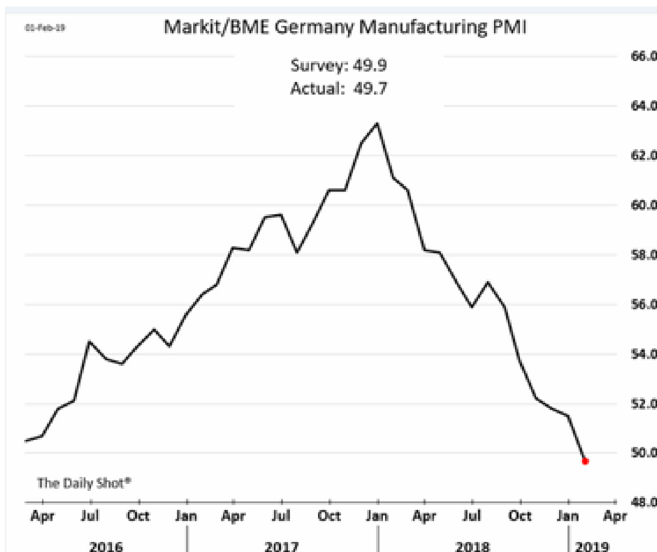
The FOMC tries to strike a balance between raising interest rates too quickly, which would shorten the economic cycle, and too slowly, which risks runaway inflation or other financial imbalances (e.g., housing in 2006-2007). Cyclical industries such as housing and auto sales that began to show weakness in 2018 have continued to be weak in 2019. Overall, the Fed seems to want to avoid prompting additional deceleration of the economy as an effect of aggressive tightening in 2019. These factors are central to why it will almost certainly take stock of the evolving situation by pausing rather than hiking according to its now accustomed quarterly schedule in March.

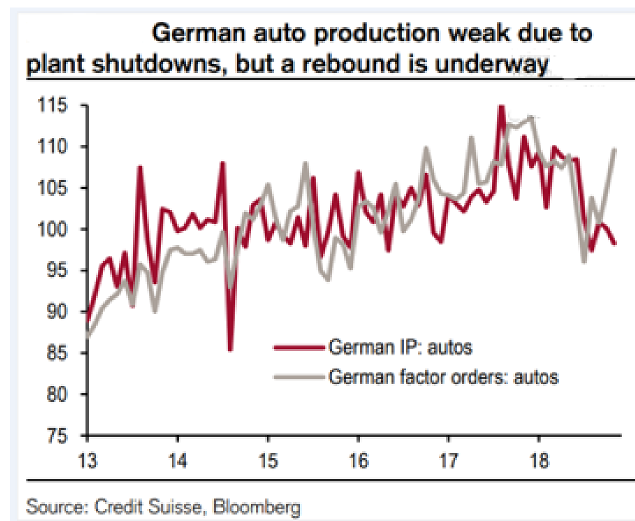


There is no guarantee that any forecasts made will come to pass.
Source: BlackRock Investment Institute with data from Bloomberg, February 2019. Notes: The chart shows the market-implied change in short-term U.S. interest rates over 2019, as reflected by Eurodollar futures pricing. We use the price of the December 2019 contract to represent implied end-2019 rates. The implied changes are represented by the price differences between that contract and the contracts for December 2018 delivery (before its expiry on Dec. 12, 2018), for January 2019 delivery (before its expiry on Jan. 14, 2019) and for February 2019 delivery. We assume rate moves are 25 percentage points.

Foreign Economic Developments

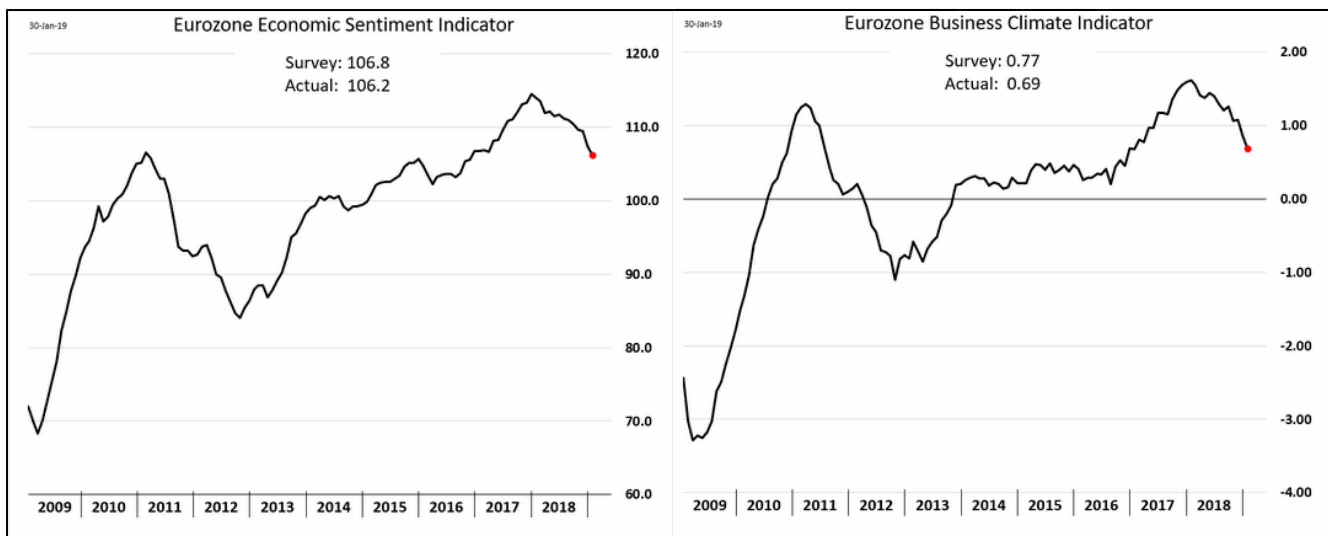
Economic data from Europe in particular is weaker than a year ago. Germany's manufacturing activity indicator (PMI) slipped below 50, signifying that the manufacturing economy in the eurozone's largest economy is contracting (chart on the left below). However, some of this weakness in Germany may be temporary. Autos, which make up a large part of its manufacturing, have seen positive signs from increased orders after earlier plant shutdowns ended (chart on the right below).





The possibility of a rebound in German autos is encouraging, but the trend in economic activity in places like Germany and France has been generally downward for the last year. Economic output is slowing abroad, particularly in Europe, and that looks set to continue. Recognition of this likelihood has prompted some government policy pivots.

Just as the monetary policy shift by the Federal Reserve in the U.S. has lifted market sentiment, perceived policy changes in Europe also may have helped raise appetites for risk assets in Europe. We are seeing a shift toward expansionary fiscal policy in Europe this year: Italy and Spain are already increasing public spending, France has vowed to reduce taxes and raise wages, and Germany is pondering a reduction in taxes. Still, economic sentiment and business climate indicators both have declined (see charts below), and the latest Eurozone 2019 GDP forecast, according to Bloomberg, has declined to just 1.40% from 2.0% as recently as May 2018.



These policy shifts in Europe may help with short-term sentiment, but whether they are sufficiently potent enough to reverse the downward economic growth and sentiment trends is an open question. We encourage investors to remain cautious.

Geopolitical Risk Update

The two main geopolitical risks that we are tracking are the U.S./China trade dispute and Brexit.

On the trade front, the U.S. and China still have many details to work out before an agreement is reached, but both sides appear increasingly motivated to find middle ground and reach an accord. The meeting between the two sides in Washington, D.C., on Jan. 30-31 seemed productive.

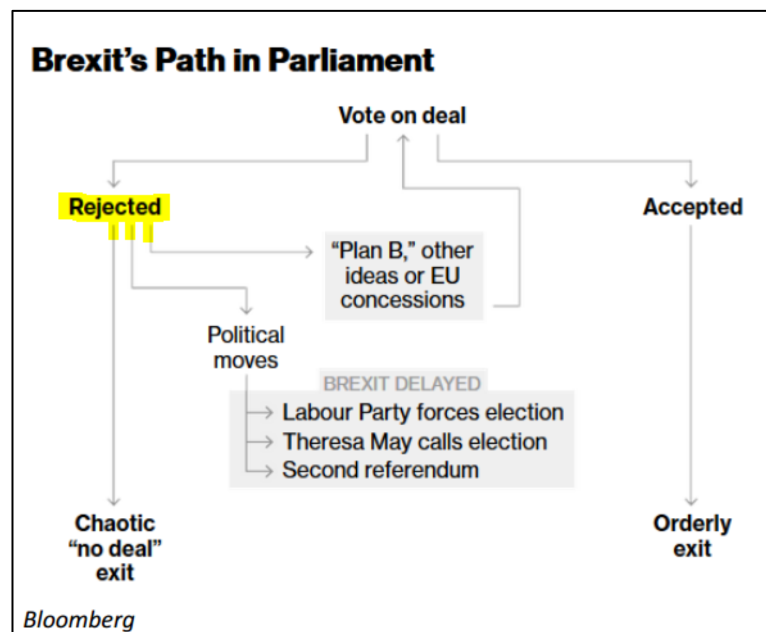
China posted a Q4 GDP growth rate of 6.4%, in line with expectations. Its pace of continued economic growth remains largely stable but bears watching. China has implemented policy moves to ease credit and fiscal conditions as a way to stimulate economic activity and confidence among businesses and consumers. We expect China's full-year 2019 GDP rate to slow further, but the magnitude of that slowdown (it could be modest, it could be marked) will depend to a great deal on whether U.S. tariffs remain in place and increase (and for how long), or whether the two countries reach a trade agreement in relatively short order. We are optimistic that such an agreement will be concluded, and possibly sometime in the first half of this year.

As for predicting the path of Brexit (the U.K.'s potential exit from membership in the European Union), humility is required. At its first attempt in the House of Commons on January 16, Prime Minister May's Brexit deal was voted down handily with 432 votes against and only 202 in favor. This margin of defeat was much wider than expected. Immediately after the result, the leader of the opposition Labour Party made a motion of "no confidence" in the Tory/Conservative government, which Prime Minister May avoided. May met with Jean-Claude Juncker of the European Commission on February 7 to seek additional concessions that might make some deal palatable to more members of the House of Commons. That meeting ended in no breakthrough but a declaration of openness to find some greater agreement about future U.K. and E.U. relations.

We are uncertain as to what will likely occur from here. Four paths seem most probable:

(1) that a close variant of the latest Brexit deal will ultimately receive a majority vote in the House of Commons after a series of amendments and follow-up elections;
(2) that there may be a softer, later Brexit (delayed after the current March 29 deadline);
(3) that there may be no Brexit at all; or
(4) that there may be a "no-deal" Brexit (departure without agreement on terms).

The situation remains very fluid, and parliamentary drama abounds. Three weeks ago, we would not have listed a "no-deal" Brexit vote as one of the most probable options, and it is still something that both the U.K. and E.U. want to avoid. The nearby flowchart graphically depicts the major options.



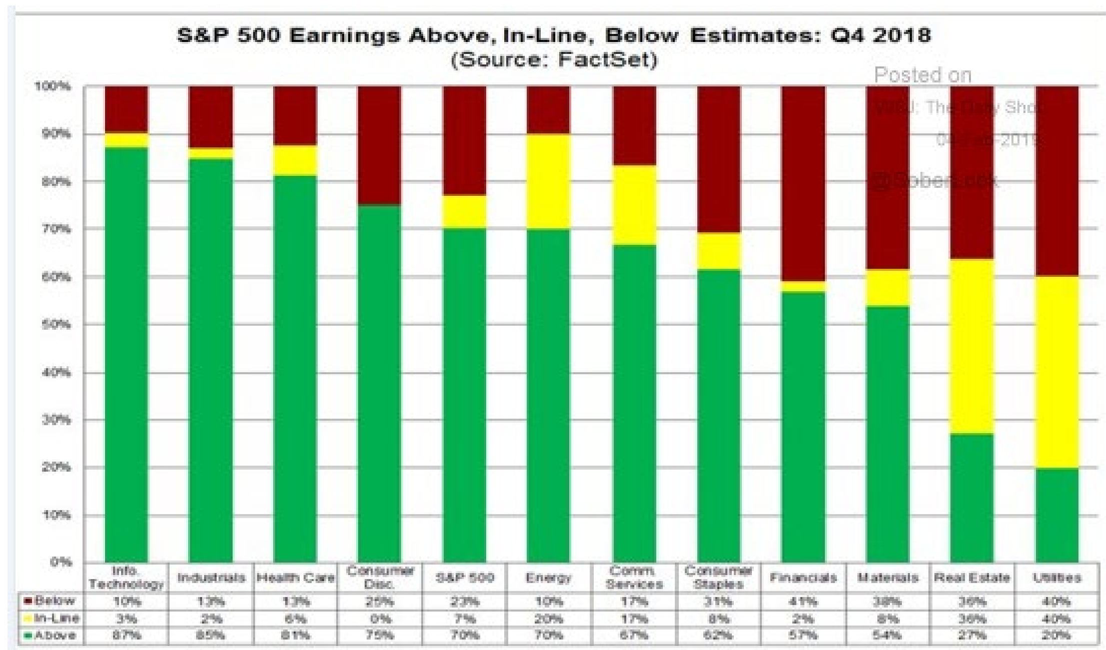
A "no-deal" Brexit vote would be the worst-case scenario and likely trigger immediate risk aversion in financial markets. Trade terms between the U.K. and E.U. would revert to less favorable World Trade Organization rules, and economic growth in the U.K. would likely slow further. At the same time, departure without agreement could be the impetus for a faster agreement between the two parties, albeit with some trade, economic, and market upheaval in the interim.

A delayed exit, or even no exit, would likely be welcomed optimistically by markets because the worst-case scenario would have been avoided. Which road is actually taken, however, remains unclear. Because the outcome for equity markets is so potentially binary, we are content to remain patient with our basically neutral foreign developed market stock positions rather than try to guess the precise outcome.

Summary and Conclusion

U.S. stock markets seem fairly valued following sharp earnings estimate cuts and modestly lower interest rates. For instance, the forward Price/Earnings ratio for the S&P 500 Index is now approximately 16, right at the long-term historical average. There are still some risks ahead, but progress has been made on four major fronts:

1. Jerome Powell's dovish statements about Fed policy,
2. Agreement by OPEC on supply cuts, which have provided support to oil prices,
3. U.S./China temporary trade truce (although there is still an uncertain road ahead), and
4. Better-than-feared U.S. corporate earnings season in which 70% of companies have beaten EPS expectations, especially with tech and industrials leading the way (see chart below).



	Info. Technology	Industrials	Health Care	Consumer Disc.	S&P 500	Energy	Comm. Services	Consumer Staples	Financials	Materials	Real Estate	Utilities
Below	10%	13%	13%	25%	23%	10%	17%	31%	41%	38%	36%	40%
In-Line	3%	2%	6%	0%	7%	20%	17%	8%	2%	8%	36%	40%
Above	87%	85%	81%	75%	70%	70%	67%	62%	57%	54%	27%	20%

In the U.S., cyclical industries have shown signs of weakness due to higher rates (e.g., housing, automobiles, semiconductors). We still do not anticipate a recession to occur this year, but the risks are rising, and financial markets may begin to experience some turbulence before an economic recession occurs. Overall, the global economy remains relatively strong, although there are increasing divergences and signs of economic slowing. We expect modest deceleration in GDP growth in 2019 when compared to last year's above-trend results. We believe that the Fed will not raise interest rates again in March and possibly for all of 2019. Chairman Powell in January raised the hurdle that must be reached for the Fed to hike again this year, and currently factors in the labor market and on the inflation front do not in our view justify another rate increase.

Europe's GDP growth and corporate earnings likely peaked in 2017, and political uncertainty remains high (e.g., Brexit). Leading economic indicators have turned weaker in recent months, including certain measures of production, which have been decelerating since last January. China's growth continues to decelerate, and its economy is still making the transition to a service-based economy in a moderate fashion, but the ongoing trade war has raised uncertainty about potentially "faster deceleration." The GDP growth differential remains wide between emerging markets (EM) and developed markets. That higher growth and increasingly stable currencies could be tailwinds for emerging markets throughout 2019.

All told, domestic economic growth seems durable if decelerating, inflation remains low, and employment remains high. The U.S. economy is likely to continue to grow but at a slower pace than it has recently, as fiscal stimulus slows and the cost of borrowing remains higher than a year ago. We remain generally positive on the global economic outlook despite ongoing trade concerns and uncertainties in Europe, including the nature of Brexit and other forms of populism. We remain of the opinion that in time China and the U.S. will strike a trade deal, but the path to that point remains murky and likely filled with ups and downs.

In our view, as we progress into 2019 investors should realize that the rate of gains realized in January are most unlikely to continue in subsequent months throughout the year. We are taking a more guarded view and suggest that investors remain balanced in their asset allocations and avoid overemphasis of one or two investments relative to others.

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