MARKET COMMENTARY **January, 2019**

Amid concerns over rising rates, trade and slowing global growth, the S&P 500 suffered a 14% correction in the 4Q2018 and finished the year down 4.5%. This marked the first negative total return year for the S&P 500 since the Financial Crisis, ending nine consecutive years of positive total return for U.S. equities.

The good news is that stocks are priced more attractively as a result of the market decline and global policy makers and central banks are moving to respond to slowing economic growth. We still look for global growth of about 3.5% and U.S. growth of 2% in 2019. We feel confident in continued growth but not so confident in the rate of growth. There are a lot of well publicized macro risks creating a high level of uncertainty and posing threats to the global economy at the same time central banks and other policy makers have started to respond to the changing environment. Depending on events (e.g. trade and tariff negotiations with China, the U.S. government shutdown, Brexit…) and the policy responses (e.g. does the Fed remain on hold in 2019, how aggressively does China move with its stimulative program of rate cuts and tax cuts…) growth could easily be higher or lower by a full half point.

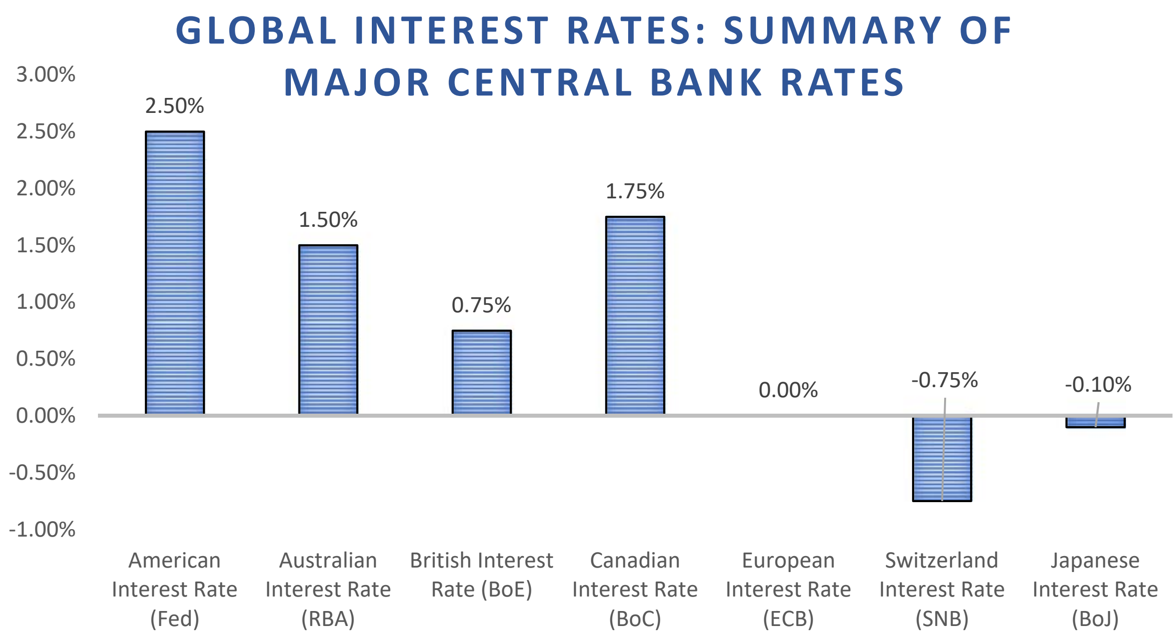
Corporate earnings are projected to rise by mid single digits in 2019 and the S&P 500 is valued at roughly 15x consensus earnings. This is an attractive valuation level, particularly given the continued structural conditions of low inflation, low interest rates, and slow but still positive growth.

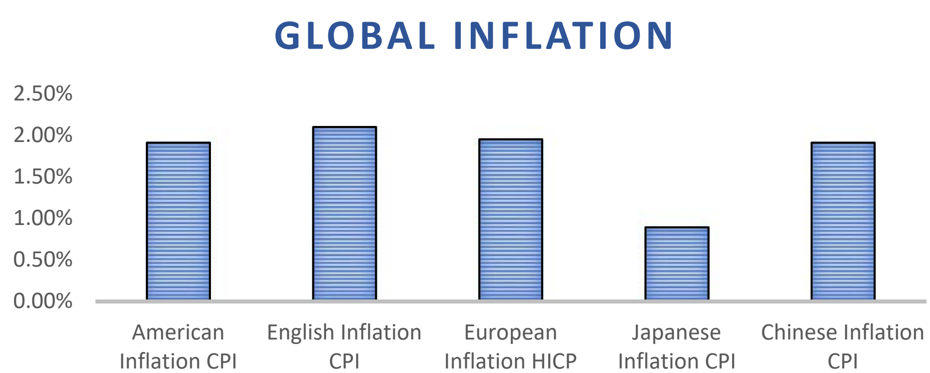
The Education of a Central Banker

A somewhat chastened Fed turned more dovish in late December and for now abandoned the idea of raising rates in the 1H2019. After a period of fits and starts, newly appointed Fed Chair Jay Powell and the Fed finally acknowledged the weakening global economy. Rates are viewed as "neutral" after the December hike to a 2.5% Fed Funds rate and monetary policy essentially "normalized".

A 2.5% Fed Funds also appears "neutral" given low and slowing inflation (still running below the Fed's 2% target), a plunge in oil prices and other commodities, a flattened yield curve, and comparative central bank rates in Europe and Japan that remain at or below 0.00%. Moreover, U.S. GDP growth may well slow significantly in 2019, pressured not only by a weaker global economy but by the U.S. government shutdown. Thus the Feds pivot to a "wait and see" stance was a game changer and appropriate to the changing economic environment. Better growth is unlikely to materialize until the second half of 2019 at the earliest, persuading the Fed to remain on hold.

For all of the reasons discussed above, the Fed and central banks around the world have lots of reasons to be cautious. While the Fed arguably succeeded in normalizing monetary policy and rates (providing room to lower rates and ease should future conditions warrant, and could easily slow or pause its gradual balance sheet reduction), Europe and Japan are another story. Central banks in Europe and Japan are under intense pressure from their weakening economies to abandon any hopes for incremental policy normalization this year and could join the Peoples Bank of China in renewed easing.





The China Story & Welcome to the NFL

China's economy has been ground zero in the global slowdown and tariff wars. One particularly telling indicator, vehicle sales were down 3% year over year in China in 2018. This was the first decline in 18 years of official records. The Chinese government is now responding aggressively to combat the slowdown and stimulate growth. The PBoC recently cut rates and further rate cuts are pending; the government cut tax rates and said more significant tax cuts are on the way (including personal, business and VAT taxes); and China's central bank injected record amounts of liquidity into the monetary system at the start of the New Year. The Shanghai Stock Exchange Index, which declined roughly 25% in 2018, held a major technical level in early January and has since moved higher along with other emerging markets.

Much depends on the upcoming US – China negotiations and some resolution of the trade disputes. Clearly the rising geopolitical conflicts between China and the U.S. are much bigger than the trade issues and many will take years, if not decades, to play out. However, it is both possible and in the best interests of both countries to maintain and expand trade, to avoid a tariff war, and to move toward a more fair trading system.

China is no longer just an emerging economy and political power, it is a major industrialized power. The U.S. and the other industrial nations can no longer afford to allow China to compete by a different and advantaged set of rules.

To use a sports analogy, China is playing in the NFL now. And it is already an NFL power with Super Bowl talent. They have to play by the same rules as the rest of the league. Even if Xi Belichick is the coach, no longer should they be allowed to hold when they need to, target the opposing quarterback, get an extra set of downs whenever they are behind, and to spy on the other team's practices and steal their playbook.

Keep Your Seatbelt Buckled

The market is likely to remain volatile during much of 2019. We are sanguine on prospects for the equities but investors must be prepared for a bumpy ride in route to their destination. A number of high profile geopolitical risks must be navigated in 2019. In addition to the trade issues and global slowdown discussed above, potential headwinds include:

- Fed Policy Error
- An Unconventional and Erratic White House that increases policy uncertainty and has a destabilizing effect on markets
- High levels of Government Debt around the world
- The U.S. Government Shutdown
- A move to the political left that could be less friendly to economic growth, business activity, and corporate profits
- Computerized "algorithm" based trading that heightens volatility
- Brexit and the ongoing existential Euro political crisis
- The Mueller Investigation and the increasing political discord in Washington

Conclusion: The Great Expansion and Tennis Down Under

The beginning and end to 2018 were almost mirror images of one another. The year began in great optimism as the market burst higher, it ended in pessimism and panic as headline fears mounted and stocks plunged. As a result equity valuations are more attractive today than they have been in some time and stocks are in a position to do much better in 2019. While economic growth is in a slowing mode, there is no U. S. recession in sight, no inflation to worry about, and central banks and policy makers around the world have awoken to the threat posed by a slowdown and incremental threats to continued growth from trade conflicts, deflation, and the challenges posed by Brexit, the China slowdown, and the U.S. government shutdown.

Market corrections during economic expansions are not unusual, and occurred during the bull market of the 1980s and 1990s, and as recently as 2011 (20% correction) and 2016 (14% decline). The U.S. economy and markets remain in a strong absolute and relative position. If growth slows to 2% in 2019 the Fed will be encouraged to remain dovish. 2% U.S. GDP growth, while far from robust, is close to the average of the past 7 years and well above what we expect out of the other major developed economies of Europe and Japan. Our banks and financial system are in much better shape than during the 2011 Euro contagion crisis or even the 2014-2016 oil collapse. The American consumer remains strong, spending and savings and wages all going up in the 4Q despite the stock downturn and gloomy headlines. While the government shutdown and other macro uncertainties will negatively impact confidence, cheaper oil prices and cheaper gas benefit the consumer and provide at least a partial offset. We believe the current economic expansion may have a few years yet left to run, and continue to confound conventional wisdom.

In fact, the U.S. is on track for the longest economic expansion in its history. The prior record was set during the 1990s when the domestic economy saw uninterrupted growth for a decade. If the current expansion lasts past July 2019 it will set the record. We think it can go on considerably further.

But we are far from threatening the world record. It's mid-January, and maybe some of you are enjoying the Australian Open which is the first of 4 Grand Slam tennis events held each year and marks the unofficial kick off of the tennis season. You can watch the splendid action down under late into the night, the Australians love their tennis and really do it right. But Australia is also notable for another remarkable but less widely known feat. Australia holds the world record for the longest stretch of uninterrupted economic growth in modern history – 27 years or 108 quarters and still counting. Truly the Great Expansion. Well done mates.

Global Economic Outlook & S&P Earnings - January 2019 (S&P 500 @ 2,507)	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019e**
Global Real GDP Growth (y/y rate)	3.3%	3.4%	3.1%	3.0%	*3.7%*	**3.8%**	***3.5%***
U.S.	2.2	2.4	2.4	1.6	*2.3*	**2.9**	***1.8***
Euro Area	-0.4	0.8	1.5	1.8	*2.4*	**1.9**	***1.4***
Japan	1.5	0.0	0.6	1.0	*1.8*	**0.8**	***1.0***
Developing Asia	6.6	6.4	6.2	6.2	*6.4*	**6.3**	***5.9***
China	7.7	7.3	6.9	6.7	*6.8*	**6.6**	***6.1***
Latin America	2.5	1.0	-0.5	-1.2	*1.2*	**0.8**	***1.8***
Emerging Market & Developing Economies	4.7	4.6	4.2	4.1	*4.7*	**4.7**	***4.5***
S&P 500 Aggregate EPS	109	118	117	118	*131*	**163**	***171***
Earnings (y/y rate)	12.6%	8.3%	-0.8%	0.9%	*11.1%*	**27.1%**	***6.1%***
PE Ratio (January 2019 price @ 2,507)						**15.4**	***14.7***

Sources: IMF, ISI Group, BAML