ECONOMIC & MARKET COMMENTARY

January 7, 2019

Markets finished 2018 with a historically weak December and are setting up for a volatile 2019. Our base case for 2019 remains unchanged from our December 6th comments:

- The fourth quarter 2018 correction in equity markets did not change the fundamental economic backdrop.
- The US is still a strong economy, even with modest weakening from economic indicators.
- We are not headed for recession in 2019.

Many investors are asking what happened to cause the dramatic drop in equities over the last 90 days. Our view is that the swoon was primarily driven by:

- A perception the Fed Chairman Powell was out of touch with the modestly slowing US economy and would continue to raise rates regardless of the data from global and US economic indicators.
- Continued uncertainty over trade negotiations and continued weak economic data from trade-centric economies.

We view the market reaction as more psychologically than fundamentally driven. The US economy is marked by many data points that do not indicate recession, for example:

- Employment picture is strong.
- The real Fed Funds rate is low.
- The US consumer is healthy as evidenced by a strong, if not record, holiday retail season.
- Earnings growth remains high with third quarter S&P 500 year-over-year earnings growth of 23% beating forecasts of 18%.

Certainly, earnings growth numbers will retreat from the current peak levels during 2019, but we believe they will stay in the high single digits, which is not at all recessionary. Further, forward S&P 500 price-to-earnings (p/e) multiples measure mid-14x down from the high-16x across the summer and well below long-term averages.

In addition to the attractive multiple environment for US equities, credit market spreads widened significantly. While spread widening can indicate heightened fears of recession and signs of corporate distress, it also can create opportunities for active managers should a recession not materialize. We view the current environment as the latter scenario due to positive economic fundamentals and the low forecasted default rate.

Updates to Our Forecast

Since our last note on December 6th, we have seen the following changes:

- A clear change of tack, if not an outright capitulation, by Powell on January 4th lead to a super strong market day. Powell promised to be more data dependent and look at the Fed's impact on markets and economies in the US and, importantly, in other countries.
- Washington/Trump-driven uncertainty has increased with a government shutdown. Lack of progress on trade negotiations has started to impact confidence and inventory numbers in the US and abroad.
- Market technical indicators show the selling pressure is washing out. Look for a continuation of short-term strength with some retest of the December low after that. These kinds of downturns resolve themselves in months, not weeks, as the market sorts itself out.

The most important factor is the change of course by the Fed. We do not expect much inflationary pressure through 2019, which allows the Fed to follow their January statement with a more dovish stance through the year.

More dovish posturing should lead to a weaker dollar throughout 2019, giving opportunities to active non-US equity managers. That fact, combined with the attractive equity valuations in the US and the opportunity afforded to fixed income mangers via the credit spreads mentioned above create a rich opportunity set for our managers in early 2019.

Risks to Our Forecast

Recessions do not always occur due to weakening fundamentals. Exogenous shocks can spin an economy, or an eco-system of economies, into recession. A global trade war would significantly change the above forecast. We are confident that both the Trump Administration and the Chinese are motivated for a deal. We look for a resolution to the trade impasse in the next few weeks and firmly believe a deal needs to happen quickly before continued weakening confidence and trade war fears manifest in a more cautious tone by corporations, impacting inventory and expansion decisions.

As always, we are available to help make sense of the current environment and to support decision making that maximizes long-term probability of success.

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