



The Fed Holds the Cards

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5 MAJOR INVESTMENT STRATEGY MESSAGES

1. A near-term sharp re-set continues: a broad macroeconomic slowdown has begun, with strong headwinds.
2. A long-term secular shift to higher rates, higher volatility (relative to previous decade) is underway.
3. Equity returns are expected to shift lower, to the mid-single digits or slightly higher, on average, in the late-cycle period.
4. Maintain slight equity bias for long-term appreciation, given our view that global demographics and structural growth themes are alive and well. A more defensive stance is warranted if a hard landing is forecast.
5. In the short term, cash flow, high quality, shorter term yields, and increased diversification are the most important factors for portfolio exposure during muted equity-return environments that contain elevated volatility.

WHAT FORCES ARE AT WORK?

There are powerful waves of change occurring, all around the world, at a macroeconomic, geopolitical, corporate, demographic, and investor-psychology level. These waves did not all happen at once; rather, they have been building for some time, primarily since the U.S. Federal Reserve (Fed) began to normalize monetary policy and the U.S. economy broke free from the rest of the world through the help of fiscal tax reform and wide-scale deregulation. This jump-start of rising business and consumer confidence, supported a corporate profits boom led by healthy capital equipment and consumer spending trends, spurred job growth to the point where job openings outnumber the people available to fill them, and eventually led the U.S. economy, the world's largest, to grow consistently above-trend.

This resulted in a powerful shift, from many years of economic stagnation and deflation worries, to a reflationary environment. This shift included a pivot from low growth, low inflation, record low rates, and low asset-price volatility, to an economic

period characterized by higher growth, higher inflation and rates, and a rise in volatility back to more "normal" levels. We view this as a secular change, one that can take a few years to play out, but also a shift that can spark volatility.

The global equity market performance in 2017 discounted many of the positive aspects of this secular change and drove the U.S. equity markets to record highs three times in 2018. The markets led the economy in the U.S., but much of the world struggled for most of the year, primarily as the strength of the dollar pressured non-U.S. growth, and global trade concerns spread throughout the summer months. Are the non-U.S. market corrections indicating that a much slower-growing U.S. economy is on its way? This is the second major wave of change involving the recent market activity.

In addition to the secular movement, from stagnation to fiscal reflation, another, more cyclical wave is currently gripping the markets – a shorter term re-pricing of risk and valuation led by a change in investor sentiment. Contrary to recent fears of an overheated economy, – many investors are now more concerned about a growth scare or economic hard landing. They point to a number of issues: the secondary effects of rising rates on the level of growth in the broader economy and corporate profits, Europe's fiscal inflexibility, Italy's budget woes, the potential for higher costs from a trade and tariff war between the U.S. and China, the Fed raising rates too far, and uncertainty over a divided Congress. Most of these concerns make sense to us and, yes, growth is set to slow next year, both globally and in the U.S. But we do not expect a hard landing or the economy to grow significantly below trend. The market needs time to adjust to both the long- and short-term realities. This is why investors should expect a divergent wave, one that carries us back to normalcy, in many respects. More normal monetary policy, asset price volatility, and lower equity returns versus what has been produced since the global financial crisis – these factors all require a wave of portfolio changes to be made. As we entered the fourth quarter of 2018, investors who were still overexposed to highly valued,

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growth and momentum segments of the equity market, as well as to areas that were considered low quality (companies with high debt loads, more volatile earnings, and/or firms in need of financing), were forced to re-balance portfolios for more diversification. The same holds true, in our view, for fixed income investors, who are coming to grips with a flatter yield curve and short-term yields that are more competitive than the dividend yield of the S&P 500. A combination of regime shifts and a re-pricing of valuation can create week-to-week asset price volatility (at times very sharp). It can also create opportunities for the patient investor who takes a long-term approach as markets overshoot.

This leads us to our final wave of change, a shifting political landscape around the globe. A number of elements are at the core of this shift: concern about Germany in the post-Angela Merkel, current Chancellor of Germany, era; the fate of the United Kingdom once it exits the European Union (EU), aka Brexit; and the growing rift between the two largest economies, the U.S and China. This geopolitical “triangle” has the potential to upset the global supply chain, which has been in place for years. Multinational corporations will likely begin a wave of adjustments in order to protect margins and maintain global distribution systems. Initially this could lead to higher costs; but eventually we expect new manufacturing centers using automation and robotics to kick-start a new supply-chain cycle in the years ahead.

It may be hard to imagine a long-term trade agreement between the U.S. and China being made anytime soon. However, we do expect a more temporary solution toward the end of the year, as both superpowers try to prevent growth from falling below trend levels and, at the same time, keep their home “base” from growing too frustrated. This is especially important in the U.S., given that the 2020 presidential election is right around the corner.

As equity-market volatility continues to edge its way back to higher, more “normal” levels, an overshoot to the downside is quite likely. A slower-growth environment is also likely to confirm this trend and keep investor sentiment from turning positive. Through this period of consolidation, caution is warranted, in our view.

WHAT SHOULD INVESTORS CONSIDER DOING IN 2019, WITH THE GROWTH SCARE AS THE PRIMARY CONCERN?

Although we continue to believe that the U.S. economy should grow at trend levels (approximately 2.5 percent) in 2019 and

expect earnings growth to stay positive, at about 5 percent, over 2018, we recognize that investor sentiment continues to be affected by concerns about multiple Fed hikes in 2019, Italy’s budget battle with the European Commission, Brexit, oil price signals, and the rising trade-and-tariff tension with China. The “growth scare” has re-gathered steam as 2018 comes to an end, suggesting that an economic hard landing could be around the corner and price-to-earnings multiples are still too high.

We recognize the strong headwinds but are not proponents of market timing, particularly for individual investors and long-term institutional investors. Our view would change in this regard if we felt we were headed toward a recession in the near term. Market timing requires a decision to be made at exactly the right moment, not once but twice: the exit from the market and the eventual move back in. This is extremely difficult to do effectively and also involves many decisions within a decision, so to speak, with tax implications, potential additional costs, and could significantly alter long-term investment plans.

In addition, given our view that we are still in a very long, multi-decade bull market that involves many cycles and a few re-sets (corrections and recessions), we prefer to maintain a strategically diversified core allocation across equities, fixed income, alternatives, and cash, where appropriate. We regard this as imperative in order to meet long-term objectives through various business cycles, economic transitions, and emotionally-driven volatile market periods.

We will continue to weigh all the short-term concerns along with the more favorable long-term global demographics and structural growth themes when making near-term adjustments to our overall view and portfolio positioning. At this point we believe we are in a sharp re-set period that is close to ending (an almost 20 percent valuation correction in equities since the September 2018 highs). Although caution is warranted, and keeping risk balanced is important during more volatile times, we maintain our slight equity overweight. Further downside risks are certainly possible, particularly given the Fed’s strong view on getting rates to neutral, but we would expect the Fed to capitulate and pause their hiking cycle, if growth slows too aggressively. This would stabilize investor sentiment and wipe away a major concern, in our view. In other words, *the Fed holds almost all the cards.*

POTENTIAL PORTFOLIO CONSIDERATIONS

- Keep portfolios appropriately diversified across multiple asset classes. Higher volatility will mean greater discipline. Consider

re-balancing equity positions back to original plans if markets overshoot and a hard landing does not materialize.

- Consider not completely abandoning international investments (particularly if the U.S. dollar weakens) as they possess attractive attributes for long-term patient investors – cheaper valuations, disliked, weak fund flows.
- Move up higher in quality across the portfolio.
- Favor large-cap stocks over small-caps:
 - Companies with healthy balance sheets and wider economic moats, i.e. pricing power
 - Dividend growth should be rewarded – stability of cash flows is important
 - Favor U.S. equities over international for more stability and for top-line growth fundamentals, improving cash flows augmented by repatriation
 - Lower exposure to leverage as a factor. Use more diversified investment managers
- The growth-versus-value decision is not clear-cut given that we are in the later stage of the cycle. Value is gaining momentum. Maintain a more balanced view.
- Best environment in a while for income generation – cash and short-term fixed-income yields, dividend growth.
- Raise exposure to strategic allocation levels in non-correlated strategies as appropriate.

WHAT'S ON THE TACTICAL WATCH LIST HEADING INTO 2019?

Given the slowdown in growth, the geopolitical headwinds, and risks of the dollar not reversing its strengthening course early in 2019, we have the following observations:

- Cash is on the potential upgrade list for purposes of hedging downside in risk assets and the attractive levels of shorter-term yields.
- The commodity asset class should benefit if our dollar weakness expectations pull through. However, any potential benefit could be muted, given the slower growth environment. If we are correct, and growth remains above trend while the dollar weakens, there is potential for positive adjustments.
- U.S. small caps (higher beta risk), non-U.S. developed markets (slower growth, fiscal inflexibility, Italy's budget woes) and emerging markets (need a weaker dollar, less Fed tightening) stay on the potential negative watch list.
- In fixed income, we do not foresee any change to our preference for higher-quality, lower-duration bond (short-term fixed income) positioning and the attractiveness of yields in this section of the yield curve relative to longer-duration areas. Corporate credit spreads have recently widened out as growth concerns have risen. This is an area to watch closely. We are analyzing balance-sheet trends closely for any signs of a significant deterioration in corporate fundamentals.

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