Second Quarter 2019

Far From Shallow, Economy Falling in the Deep End?

Key Takeaways:

- Economic data is trending lower on many metrics. A return to slow growth does not mean a recession is imminent in 2019.
- The S&P 500 has been in a bull market for over 10 years. After the new tax legislation was enacted, corporate profits jumped over 20% last year, pushing down valuations relative to long-term averages.
- Treasury yields of short and long maturities are similar, signaling bond investors are not optimistic about the future economy. Yet credit spreads are below their 15-year averages. Bonds are giving mixed signals.
- The risks in the market are the same culprits as last quarter, but risks around the trade war and the possibility of the Fed over-tightening have come down.

The economy seems to be singing Lady Gaga's award-winning song, *Shallow,* right now. After the Fed took away the raft for the economy in 2018, raising rates four times, the economy is far from "the shallow" being in the second longest expansion since World War II. It is safe to say we are in the deep end of the pool right now. The economy is having a hard time keeping it "so hardcore" and is "falling".

It is widely expected that economic growth in the U.S. will continue to slow, the question is by how much. If it slows to expected levels, that would be in line with prior years before the tax legislation boosted markets and economic growth in 2018. The expansion's length is a product of its pace too. Growth has been slower compared to prior expansions, and the economy has not overheated. While growth is anticipated to slow this year, we still do not anticipate a recession in 2019. The economy may be trending lower, but it won't sink quite yet.

Following the economic tailwind, equities are in the longest bull run ever, despite narrowly missing a correction in December. The surge in earnings, coupled with the stock market sell-off late in the year, lowered valuations such as (P/E) ratios to near their 15-year averages. This year, stocks had their best start since 1991 as the Fed renewed its dovish stance and trade negotiations between the U.S. and China seemed to advance in the right direction. Now that a lot of the good news has been priced into stocks, there are fewer catalysts to move the markets higher. Equity markets appear fairly valued right now.

Equity investors are also paying attention to the bond market for clues about the economy. The U.S. Treasury yield curve is flat, but generally not inverted, which could be a sign that future economic growth prospects are dim. An inverted yield curve, where short-term yields are higher than long-term yields, can be a leading indicator for a recession. Credit markets are telling a slightly different story though. Credit spreads, the extra compensation or yield spread for taking on downgrade and/or default risk, have compressed this year.

Risks to the outlook appear similar to those of last quarter, although they may have shifted to some degree. The risk that the Fed will continue to hike rates into 2019 has come down substantially, as has the risk of a trade war. The U.S. economy was somewhat immune from the global economy, but more recently has become more susceptible to slower global growth. The major risk now appears to be economic growth slowing more than projected and lower than expected corporate earnings.

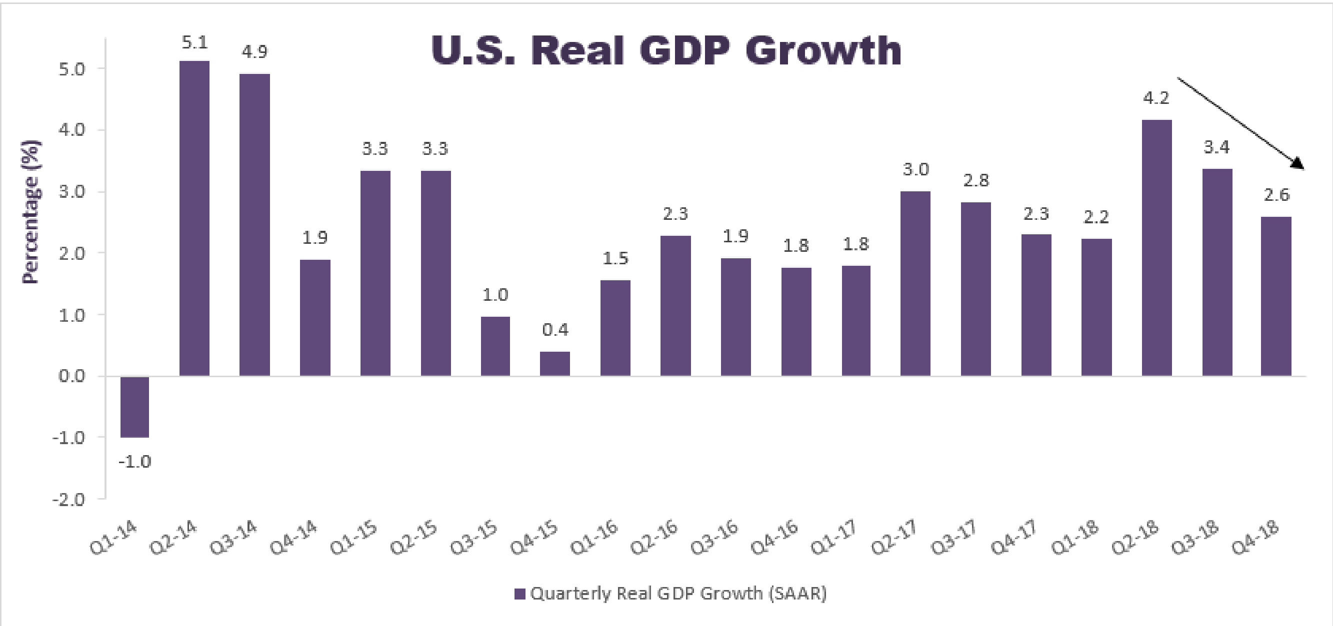
To recap, while the economy may be in the deep end, we think it should stay afloat and do not see a recession this year. Equity markets seem fairly valued and lack some of the upside catalysts from prior quarters. We think volatility will pick up after a calm start to 2019. Fixed income markets are giving mixed signals with a flat yield curve and narrow credit spreads. Overall, we balance the risks in the outlook and lack of positive catalysts in equities by increasing duration in fixed income to buffer against volatility that we anticipate in the second half of the year. Keep in mind that we are still underweight duration as bond yields have already come down off their highs.

Global Economy

We don't like to place too much weight into GDP numbers since they are backward looking, but we think the trend is important here. Fourth quarter U.S. real GDP was 2.6%, a decent number on its own, but down from 3.4% in the third quarter and 4.2% in the second quarter. Growth in the fourth quarter was also pushed lower by the longest government shutdown in history. The Congressional Budget Office estimates the 35-day partial government shutdown lowered the quarterly GDP by 0.2% and could lower first quarter's GDP by double that.

The Atlanta Fed, which forecasts real time GDP numbers, is estimating first quarter real GDP at a measly 0.4%, although the Blue Chip consensus among economists is higher at around 1.5%. To put this in historical perspective, 2% real GDP growth is roughly the average annual growth in this 10-year expansion that started after the great recession. In Exhibit 1, we illustrate the downward trend in quarterly GDP and the low levels of GDP seen prior to this year.

Exhibit 1



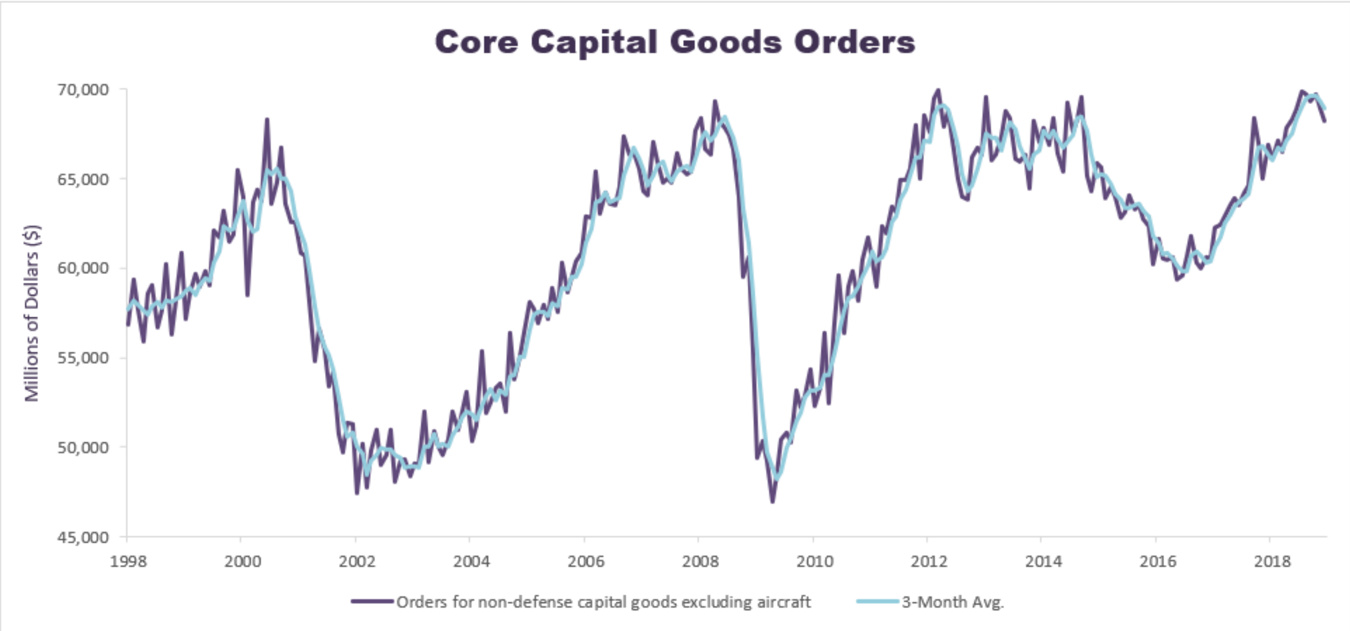
Source: Cetera Investment Management, Federal Reserve Bank of St. Louis, U.S. Bureau of Economic Analysis. SAAR is seasonally adjusted annual rate.

The biggest component of GDP, consumer spending, bumped up in the middle of 2018, then trailed off at the end of the year. Consumers remain confident, but the government shut down and Fed rate hike at the end of the year, gave many cause for concern. Consumer spending in December dropped by the most since 2009. January spending was also down. With the end of the government shutdown in January and the Fed issuing statements suggesting they will pause with rate hikes, consumer confidence picked up again in February. After big job gains in January, February's employment gains were very weak. These reports tend to be volatile, so we are not reading too much into the weak February report just yet. Unemployment is still at very low levels below 4% and wage growth rose to 3.4% in February, a 10-year high. Parlayed with cheaper oil prices, the consumer still has room for optimism.

Housing was a weak spot last quarter, and while it has been slowly improving since 2009, it still isn't at pre-recession levels in many metrics like housing starts and housing permits. Housing is important for economic growth because of the multiplier effect. People spend a lot of money constructing and furnishing a home.

Outside of building homes, businesses did spend money on capital expenditures, such as property and equipment or technology, in 2018. They used the $1.5 trillion dollars in corporate tax cuts to go on a spending spree. Manufacturers' new orders of non-defense capital goods excluding aircraft (core capital goods orders), which tends to be more volatile, rose to a record high. See Exhibit 2.

Exhibit 2



Source: Cetera Investment Management, Federal Reserve Bank of St. Louis, U.S. Census Bureau. Data as of 12/31/2018.

We saw a record in capital spending last year. Looking forward, the trend here is also important. Recently capital spending dropped, and surveys of business managers suggest it may continue to drop. This makes sense considering the uncertainty business owners are facing. Businesses are reluctant to spend money on expanding operations when they don't have a clearer picture of the future. Mudding the picture, the U.S. is in a trade war with China, global growth is slowing, the Fed, although dovish for now, is a wild card after last December's rate hike, and impact from the government gridlock that was responsible for an extended shutdown, is still to be realized.

The good news here is that we do expect a trade agreement between the U.S. and China soon. China is deleveraging its economy and dealing with demographic problems as they look to transition from a manufacturing economy to a consumer-driven economy. On the other side, President Trump would like to get a resolution on trade going into the 2020 presidential elections. Unfortunately, gridlock in Congress is not going to get any better. This also puts a lid on government spending, although we are already running around a $1 trillion annual deficit. With the tax cuts, government revenue is down, limiting the capacity for additional government spending.

We mentioned the Fed creating uncertainty in December by raising rates, which rattled equity markets. The Fed has a dual mandate to promote employment and keep prices stable. In December, with the backdrop of a weakening global economy in 2019, unemployment near 50-year lows, and inflation slightly below the Fed's own target of 2%, the Fed still raised interest rates a fourth time in 2018 and gave a signal to the market that they would raise rates an additional two times in 2019. Since the equity market sell off that followed this announcement, the Fed has backed off future hikes. Fed funds futures currently are expecting the Fed Funds Rate to remain where it is now at the end of this year with a 30% chance that it may be lower, implying rate cuts, not rate hikes, in 2019. The Federal Reserve Bank of Cleveland estimates that the public currently expects the inflation rate to be below 2% on average over the next decade. In [last quarter's outlook](), we disagreed with future rate hike expectations and thought there could be one hike in 2019. With the continuing slowdown in growth, we think no hikes in 2019 is reasonable.

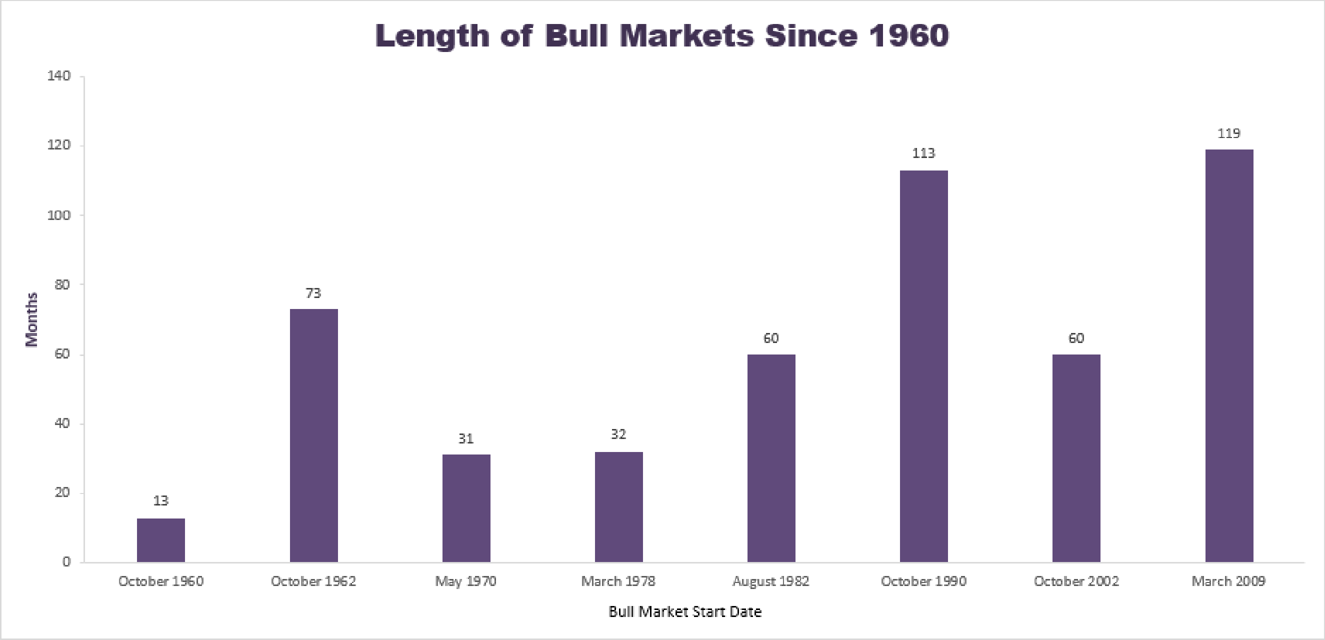
Looking at economic growth outside the U.S., the downward trend remains. The U.S. has been the strongest developed market economy and this is expected to continue, as other economies are expected to slow even more. Italy has the greatest chance of entering a recession in 2019. Growth in Japan will likely slow as the government increases its sales tax. GDP growth in the Eurozone and Japan are both expected to be 1% this year. Emerging Markets have higher growth rates, but they are expected to fall into 2019 and 2020. China makes up much of the emerging markets universe and is struggling with previous policy tightening and deleveraging, as debt fueled their economy in recent years.

With economies around the world slowing, recession risks move higher. We do not see a U.S. recession in 2019, but we are continuing to watch these trends into 2020. GDP is a lagging indicator, so we will be paying more attention to surveys of purchasing managers at manufacturing companies and non-manufacturing (service companies) along with consumer surveys to gauge their confidence and if they may be spending more in the future.

Equity Markets

There were some bumps along the way, but the S&P 500's bull market run hit its 10-year anniversary in the first quarter, its longest in history. The long run almost came to an end twice in 2011 and last December. In both cases, the S&P 500 had a drawdown of 19% based on closing prices. The technical definition of a bear market is a drawdown of 20% or more based on closing prices. Even with the many corrections that have occurred since the market bottom of March 9, 2009, the S&P 500 has managed to generate an annualized total return of over 17% in the 10 years since. The current length of the run is 119 months as seen in Exhibit 3.

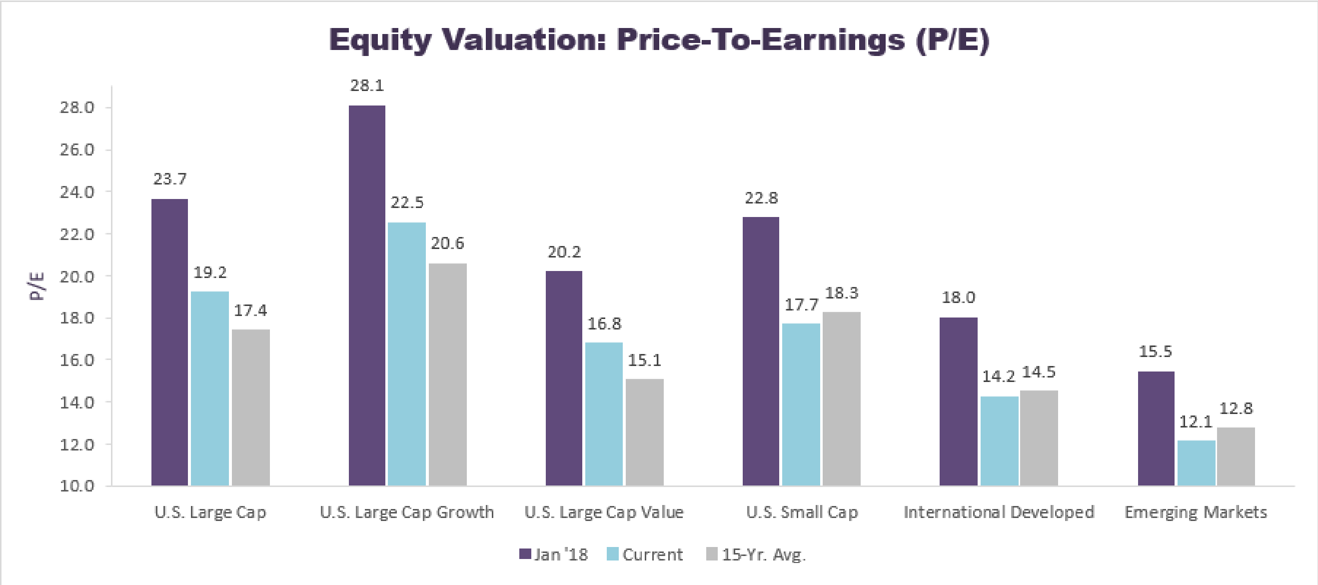
Exhibit 3



Source: Cetera Investment Management, JPMorgan, Standard & Poor's. Data as of 2/28/2019.

Low interest rates have been supportive for corporations, as they can borrow cheaply to finance debt and projects. The low borrowing costs also justify higher stock prices relative to their earnings. Hence, (P/E) earnings ratios have been elevated compared to historical averages. At the beginning of 2018, several categories in equities were at or near 15-year highs using this metric. With prices falling at the end of last year and earnings growth over 20% due in part to the new corporate tax cuts, P/E ratios have moved closer to their long-term averages for large cap stocks and below their averages for small cap stocks and international equities. What was a headwind at the beginning of last year is no longer a headwind. Exhibit 4 shows P/E ratios now versus the beginning of last year and their 15-year averages.

Exhibit 4



Source: Cetera Investment Management, Morningstar, Russell Investments, MSCI. US Large Cap Equities (Russell 1000), US Growth Equities (Russell 1000 Growth), US Value Equities (Russell 1000 Value), US Small Cap (Russell 2000), International Developed Equities (MSCI EAFE), and Emerging Markets (MSCI Emerging Markets). P/E is the Price-to-Earnings Ratio, based on trailing 12-months earnings. Data as of 2/28/2018.

Future earnings growth is expected to slow. Last year, earnings growth spiked primarily due to corporate tax cuts. Earnings growth in 2019 will not match those growth rates. Over the course of the year, we could see rising wage pressures as companies compete for labor. We have had 11 straight months with more job openings than unemployed workers looking for work. Wage inflation in January was 3.4% higher than the year prior, a nine-year high. Rising wages could eventually squeeze profit margins. We mentioned an end to the trade war in the economic section and investors are already anticipating this. After the rebound in the stock market when the Fed signaled they would be more patient, the market continued to climb on positive news around trade.

Within style boxes, value stocks' P/E ratios are more attractive than growth stocks. Also, we continue to note that popular indexes such as the S&P 500 have high concentrations. For example, the growthy FAANG stocks represent over 10% of this index. When the market sold off late last year these stocks sold off more than others.

International stocks are still cheaper on a price to earnings basis but face more headwinds. In Europe, Brexit negotiations are increasingly uncertain, and Theresa May has indicated that she may be stepping down as the British Prime Minister before 2022, the next general election. Japan is struggling with demographic issues and prolonged slow growth. South Korean stocks sold off on news the North Koreans are rebuilding their missile sites and China is deleveraging and may have to start adding stimulus again leading to potential policy mistakes along the way. International markets may be cheaper for good reason. We are not completely negative on international and emerging markets though. European economic recovery is less mature than that of the U.S. and is still expected to be in a low growth environment while emerging markets continue to be supported by good fundamentals. They can provide diversification to U.S. equities, who have outperformed for some time and have a much larger concentration in technology stocks.

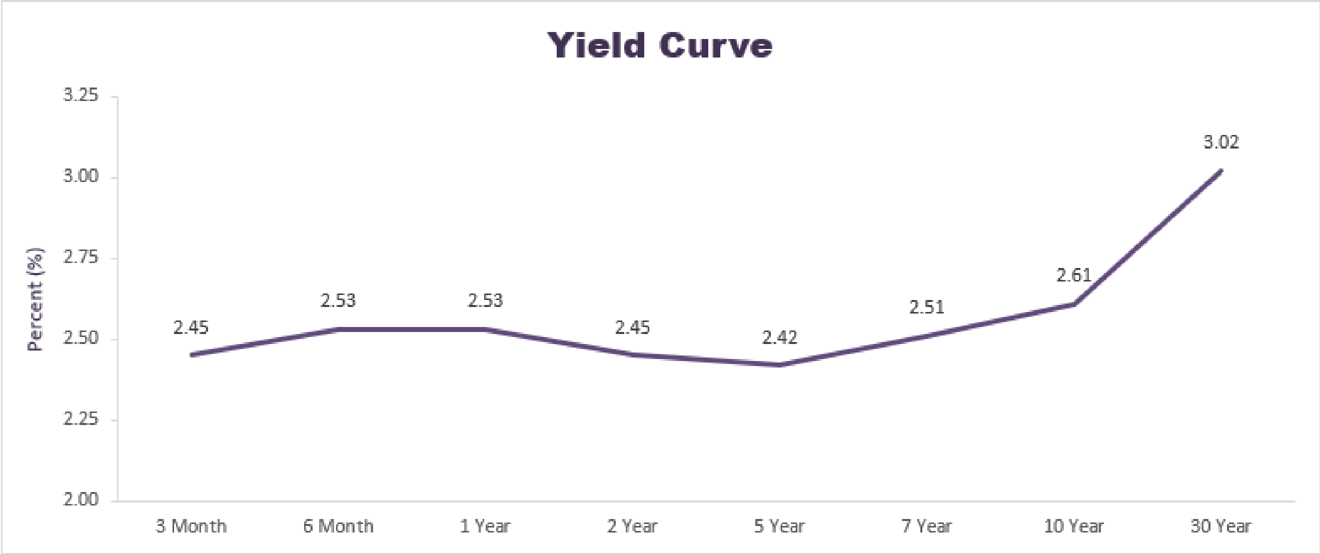
With the Fed showing restraint, earnings slowing, and trade optimism being priced into the stock market, we think the second half of the year could be more volatile for equities. The catalysts that drove returns in the first half of the year may be absent in the second half of the year. In addition, global growth is slowing, putting even more pressure on corporate profits.

Fixed Income

With the equity market selloff at the end of last year, bond prices rallied, and yields fell. Again, bonds were one of the few asset classes that were positive when equities sold off. The Barclays U.S. Aggregate Bond index was poised for only its fourth calendar year loss in 40 years, but narrowly avoided a negative return, eking out the slimmest of gains at 0.01%. Interestingly, the index has not had a negative year since the Fed began hiking interest rates in 2015. After nine rate hikes, the Fed is very close to its terminal rate, the rate at which it will stop raising interest rates. Fed members have signaled they will be patient with the economy slowing. We agree with Fed funds futures rates which currently are implying a zero percent chance of a rate hike in 2019. Inflation expectations remain low, allowing the Fed to remain patient.

Investors in recent years have shunned bonds because of their low yields, but that is starting to change. The yield on the aggregate bond index is above 3% and high yield bonds could yield nearly double that. With the flat yield curve, meaning long duration bonds and short duration bonds yield close to the same amount, short duration bonds are relatively attractive with less duration risk, since they are less sensitive to rising yields. See Exhibit 5 for the current yield curve. You can see parts of the yield curve are even inverted with two-year yields higher than five-year yields. The yield curve does steepen after 20 years.

Exhibit 5



Source: Cetera Investment Management, Federal Reserve Bank of St. Louis, U.S. Treasury Department. Data as of 3/13/2019.

We continue to watch this development because the yield curve can be a predictor for a recession. When bond investors are willing to hold longer-dated bonds for the same reward as shorter-dated bonds, it is signaling they feel future growth prospects are meek. They believe that growth will slow, and yields will fall in the future. This indicator of a recession does not always hold true in our view.

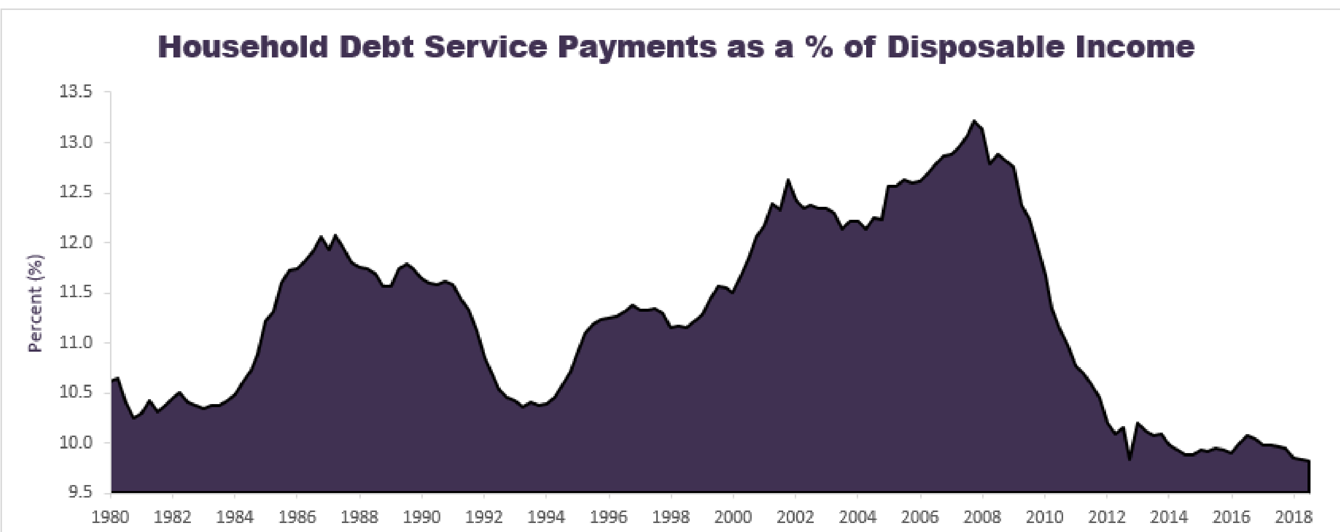
Slowing growth is definitely a factor, as we discussed in the economic section, but there could be more reasons for a flat yield curve. U.S. bond yields are higher than in most countries, so from a relative perspective, international bond buyers continue to buy long dated U.S. bonds. Insurance companies and pensions have also been buying long term bonds to match liabilities. The demand for these bonds pushes yields lower. And, let’s also not forget that the Fed which has been raising short term rates, is pushing up yields on short maturity bonds. The shape of the yield curve may be partly about future growth prospects but also about supply and demand, coupled with Fed policy impacting the short end of the curve.

Shifting away from treasuries and into the world of corporate bonds, credit spreads have narrowed after widening in December. A credit spread is the yield spread over treasuries a bond holder receives for taking a downgrade and default risk. That spread is still wider than it was at the start of 2018 and close to 15-year averages. If spreads are tight, that means investors are compensated less for these credit risks. Some think the risks in this category are higher now due to the record amount of corporate debt, which stands at over $9 trillion, implying spreads should be wider.

A closer look though reveals a different story. Much like households across America refinancing their mortgages at cheaper rates, corporate America has been doing the same. The ratio of short term debt to long term debt stands at 0.11, compared to historical averages around double that. While debt is high, it is not all due in the near term. Fitch Ratings forecasts defaults in 2019 to be the lowest in seven years. Corporations have also been deleveraging with the new tax legislation. So, we are not worried about credit defaults at this time. If yields rise in the coming years and companies find themselves looking to roll debt, that could cause problems in the future. That is something we will monitor.

You may also hear a lot about household debt levels being at all-time highs, with people strapped with longer-dated car loans and student loans. While we are at all-time highs in total debt, the debt servicing payments as a percentage of disposable income is actually pretty good. In Exhibit 6, you can see that this ratio is relatively low from a historical perspective. While households may have a lot of debt in aggregate, the debt seems sustainable at these low interest rates.

Exhibit 6



Source: Cetera Investment Management, Federal Reserve Bank of St. Louis. Data as of 9/30/2018.

Due to tax regulations capping the deduction of state and local taxes, municipal bonds saw $15 billion in inflows during the first eight weeks of the year, the most in this period in over a decade. Comparing the yield curve of AAA municipal bonds to Treasuries, the yields become similar at maturities over 20 years even without the tax benefit factored in. Demand for municipal bonds should remain strong for the rest of the year. However, due to the increased demand, the compensation one receives for taking the added credit risk in municipal bonds has fallen for lower maturity bonds.

While we think some of the concerns in credit-sensitive bonds are overblown, we are still cautious in high yield bonds. Credit spreads are narrower, and we anticipate a rise in equity volatility. If equities sell off like in the fourth quarter of last year, high yield bonds and floating rate notes will follow equities lower. We still recommend exposure to high yield for diversification as yields are attractive, but we like having high-quality bonds to buffer equity volatility. While we are still underweight duration, we are adding duration as the Fed pauses and is near their terminal rate. In addition, we feel equity volatility may pick up later in the year.

Risks to Our Outlook

Many of the risks to our outlook have not changed from the prior quarter. We are still watching the trade negotiations between the U.S. and China, political risks in Europe, monetary policy, and slowing global growth. While the risks have not changed, the level of risks in these areas has shifted downward.

We think the U.S. and China will come to a trade agreement sooner rather than later as it is in the best interest of both parties. President Trump wants a deal to help bolster his 2020 election campaign. China has enough issues struggling with their economy as they deleverage it while dealing with an aging population and transitioning from manufacturing economy to a service economy like the U.S.

Europe is experiencing slow growth which is becoming prolonged. The term “Japanification” is trending on Twitter to describe Europe. Many are worried Europe is headed for an even longer period of low growth and low inflation similar to that in Japan. We think this could be an overreaction, but slow growth and populist movements could cause more volatility in the region.

The risk of the Federal Reserve making a policy misstep seems to have been reduced. After the year-end sell-off due to the fourth rate hike in 2018, the Fed members have been using the word “patient” to describe their interest rate policy for 2019. They can be patient given the low levels of inflation and unemployment. We are watching wage inflation closely, however. With near 50-year lows in unemployment, employers may need to compete for labor and raise salaries which could cause inflation, giving the Fed a reason to hike rates. Separately, higher wages would also squeeze corporate profits.

Overall, risks to the market are less than they were a quarter ago. Slow economic growth and earnings misses may be the biggest risks at this point. Volatility was low at the beginning of the year but should return to normal levels as that which we experienced in 2018. We could get an upside surprise if a trade deal is signed, but this is has begun to be priced into the market already.

Appendix – U.S. Economic Overview

Economic Indicator	Source
US Nonfarm Monthly Payrolls ('000)	U.S. Bureau of Labor Statistics
US Total Nonfarm Payrolls - YoY Change	U.S. Bureau of Labor Statistics
U3 Unemployment Rate	U.S. Bureau of Labor Statistics
U6 Unemployment Rate	U.S. Bureau of Labor Statistics
Quit Rate	U.S. Bureau of Labor Statistics
Initial Jobless Claims ('000) 4 Wk. MA - Month End	U.S. Employment and Training Administration
KC Fed LMCI Momentum Indicator	Federal Reserve Bank of Kansas City
Employment to Population Ratio	U.S. Bureau of Labor Statistics
US Retail Sales - YoY Change	U.S. Bureau of the Census
Vehicle Sales (Mil. Units, annualized)	U.S. Bureau of Economic Analysis
Personal Savings Rate	U.S. Bureau of Economic Analysis
Industrial Production - YoY Change	Board of Governors of the Federal Reserve System (US)
Capacity Utilization	Board of Governors of the Federal Reserve System (US)
Core Capital Goods Orders - YoY Change	U.S. Bureau of the Census
Building Permits ('000)	U.S. Bureau of the Census
Housing Starts ('000)	U.S. Bureau of the Census
New Home Sales	U.S. Bureau of the Census
S&P/Case-Shiller Home Price Index (20 city) - YoY Change	S&P Dow Jones Indices LLC
Total Construction Spending - YoY Change	U.S. Bureau of the Census
ISM Manufacturing Composite	Institute for Supply Management
ISM Manufacturing New Orders	Institute for Supply Management
ISM Non-Manufacturing Composite	Institute for Supply Management
ISM Non-Manufacturing New Orders	Institute for Supply Management
U. of Michigan Consumer Sentiment	University of Michigan
Consumer Price Index (CPI) - YoY Change	U.S. Bureau of Labor Statistics
Personal Consumption Expenditure (PCE) - YoY Change	U.S. Bureau of Economic Analysis
Producer Price Index (PPI) - YoY Change	U.S. Bureau of Labor Statistics
Average Hourly Earnings - YoY Change	U.S. Bureau of Labor Statistics
Real GDP - QoQ (SAAR)	U.S. Bureau of Economic Analysis
Real GDP - YoY Change	U.S. Bureau of Economic Analysis
Yield Curve - Month End	Federal Reserve Bank of St. Louis
Leading Index for the United States	Federal Reserve Bank of Philadelphia

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Glossary

The S&P 500 is an index of 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

The Bloomberg Barclays US Aggregate Bond Index, which was originally called the Lehman Aggregate Bond Index, is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government–related and corporate debt securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency) debt securities that are rated at least Baa3 by Moody's and BBB- by S&P. Taxable municipals, including Build America bonds and a small amount of foreign bonds traded in U.S. markets are also included. Eligible bonds must have at least one year until final maturity, but in practice the index holdings has a fluctuating average life of around 8.25 years. This total return index, created in 1986 with history backfilled to January 1, 1976, is unhedged and rebalances monthly.