

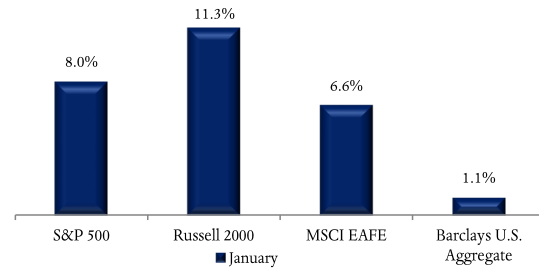


## MARKETS

The S&P 500 equity index posted its best January in more than 30 years, rising +8.0%, on the back of better-than-feared corporate earnings results, a more dovish Federal Reserve, as well as improving rhetoric towards China from the White House. The technology-heavy Nasdaq, and smaller capitalization Russell 2000 indexes, outperformed, +9.8% and +10.9%, respectively. Overseas equities also rallied +6.6%, as measured by the MSCI EAFE index. The European Stoxx 600 index advanced +6.4%. In Asia, Tokyo's Nikkei 225 benchmark rebounded +3.8%, and the Shanghai Stock Exchange composite added +3.6%. Emerging market stocks were the strongest of the foreign group, rising +8.8%, supported by US Dollar depreciation.

Global government bonds, as well as investment grade and high yield credit, all produced positive returns in January, with the latter outperforming, as risk assets rallied. For the month, the Barclays US Aggregate index advanced +1.1%, while high yield bonds rose +4.6%. The Federal Reserve surprised markets with a clear dovish shift, leading the 10 Year US Treasury Note yield to decline 6 basis points to 2.62%. This coincided with further moderation in economic data in Europe, where ECB President Mario Draghi acknowledged downside risks to the economy.

The commodity complex rose in January, driven by a rebound in crude oil. WTI ended the month at \$53.79/barrel, nearly flat with two years ago. The industrial metals component was also firmer with iron ore and nickel prices particularly robust amid concerns that Brazilian producer Vale would cut supply after a mining-waste dam collapsed. Soft commodities rose, led by gains in sugar and soybeans. Precious metals also continued their ascent.



## GEOPOLITICS

The US government entered the year partially closed on account of a funding impasse over border security. This led to a 35-day limited shutdown of civil services, the longest in history. The Antideficiency Act prohibits federal departments or agencies from conducting non-essential operations without appropriations legislation in place. As a result, nine executive departments with approximately 800,000 employees had to close, either partially or in full, affecting about one-fourth of government. On January 25, 2019, President Trump agreed to endorse a stopgap bill to reopen the government for three weeks, during which time negotiations over a bipartisan appropriations bill would take place. Trump also insinuated that if Congress failed to reach a deal by February 15, he would either shutter the government again, or declare a national emergency in order to use military funding to build a border wall.

Brexit uncertainty continued to dominate the headlines in the UK, after a Parliamentary vote, on the deal that prime minister Theresa May had negotiated, failed to pass by a significant margin (432 vs. 202). Subsequent events have shown that there is a majority in parliament against a no-deal scenario. In addition, the majority of MP's would apparently support May's deal if she can renegotiate an acceptable "backstop agreement," which would allow for the avoidance of a hard border between Northern Ireland and the Republic of Ireland.

## UNITED STATES

Preliminary signs that the US economy is being affected by the trade tensions with China have begun to surface. The most recent ISM manufacturing surveys have started to decline year-over-year. January's reading of 56.6 did, however, show a rebound from December's 54.3 (which had registered the largest monthly decline since 2008). Similarly, The University of Michigan's Consumer Sentiment Index for January fell to 90.7 from 98.3 previously and the Conference Board's measure of consumer confidence fell from 126.6 to 120.2.

January's employment reporting data was affected by the government shutdown, due to polling errors, and so should be discounted. Officially, the US economy added 304,000 jobs (well above expectations of 160,000), while the unemployment rate rose to 4.0% (6.5 million persons). Of note, year-over-year average hourly earnings rose a healthy 3.2%.

On the monetary policy front, the Board of the Federal Reserve Bank, led by Chairman Jerome Powell, reversed course, indicating a willingness to be patient regarding the path of monetary tightening, including both interest rate increases as well as the sale of balance sheet assets (circa \$4 trillion). Inflation, which is hovering below the central bank's target of 2.0%, thanks in part to lower energy prices, has relieved some of the urgency to continue raising interest rates. Further, US economic growth is expected to have decelerated to 2.7% in Q4. Looking ahead, the IMF's economic forecast calls for 2.5% GDP expansion in 2019. In turn, bond markets are no longer pricing in any US central bank rate hikes during the coming year.

## EUROPE

The European economy has been hurt by a drop in demand from China (Germany's largest trading partner), thus recent economic data continues to be tepid. EU GDP figures showed growth of 0.2% quarter-over-quarter in Q4, the same as in Q3. The manufacturing new export orders component of the Purchasing Managers' Index (PMI) for the eurozone remained below 50

## January 2019 Economic Statistics

	Jan-19	Dec-17	Dec-16
Federal Funds Target Rate	2.25 - 2.50%	1.25-1.50%	0.50 - 0.75%
Consumer Confidence Index	120.2	122.1	113.7
Manufacturing PMI Index	56.6%	59.7%	54.7%
Unemployment Rate	4.0%	4.1%	4.7%
JPY / USD	108.87	112.67	116.87
USD / EUR	1.1444	1.1996	1.0513
Gold / oz.	\$1,320.56	\$1,302.45	\$1,151.46
Oil (WTI) / bbl	\$53.79	\$60.42	\$53.72

(i.e. in contraction mode). In France, the flash composite PMI fell further to 47.9, despite a reduction in "yellow vest" protests that have caused significant violence and disruption to the country. On the positive side, consumer confidence in France and the eurozone as a whole picked up slightly. Further, the Euro Area unemployment rate for December remained at 7.9%, well below the 8.6% level of a year ago, and the lowest rate since October 2008. Reassuringly, domestic demand has remained fairly resilient despite the numerous political and trade related worries, indicating that consumption remains fundamentally intact.

The Italian government budget was approved, after much negotiation with, and scrutiny by, the EU. The two main areas where slack was allowed, citizens' income and pension reform, are unlikely to be beneficial to fiscal sustainability in the longer term, however the near-term risks appear to have eased. Italy's preliminary Q4 GDP estimate showed a contraction of 0.2%, heralding a technical recession, given this was the second consecutive quarterly decline.

Despite the UK's political gridlock, the local labor market remains healthy. The unemployment rate fell to 4.0%, while wage growth picked up to 3.4% year-over-year. The Pound Sterling also strengthened during the month, reaching the midpoint of its trading range over the past two years, perhaps signaling hope that the UK will avoid a "no deal" Brexit.

Given the acknowledgement of unexpectedly and persistent slow eurozone growth by the European Central Bank, as well as forward-looking downside risks, we don't expect further monetary tightening for the foreseeable future.

## ASIA

Concerns over an economic slowdown in China are ongoing. Fourth quarter Chinese GDP came in at 6.4% year-over-year, at the low end of the historical range. Given the rising uncertainty, amidst tightening credit conditions, as well as trade tensions with the US, Chinese authorities have begun to provide stimulus to the economy. The People's Bank of China (PBoC) announced that it would cut the Reserve Requirement Ratio for small and large banks by 100 basis points during January, potentially boosting nominal GDP by 0.8%. The PBoC also telegraphed further easing is expected to help support the domestic economy. In a positive sign, the most recent retail sales and industrial production data exceeded expectations. There were also reports that infrastructure spending was picking up, which should trickle through the economy.

Japan's manufacturing economy failed to grow for the first time in two and a half years, prompting the Bank of Japan (BoJ) to revise down its economic forecasts. The ongoing global trade decline has taken an increasing toll on the country's exporters and pushed business sentiment to its lowest level in six years. The central bank's inflation forecast for 2019 was reduced to 0.9%, from 1.4%. This year's GDP is expected to grow at a reduced pace of 1.0%, followed by a deceleration to 0.5% in 2020 on the back of a consumption tax hike from 8.0% to 10.0%, scheduled for this coming October. Given the lack of economic progress, the central bank decided to keep its robust monetary stimulus policy unchanged. The Bank of Japan now owns approximately 45% of all Japanese government bonds and its balance sheet totals more than the entire Japanese economy.

## OUTLOOK

Two significant shifts are important for investors to note. First, the Fed's move to a more dovish stance regarding its rate guidance (and Quantitative Tapering) has helped to ease the market's fears about rates rising too fast, and liquidity getting too tight, at a time when the pace of global growth looks to be slowing. This reduction in urgency to tighten monetary policy has been echoed by other major central banks. Second, trade rhetoric from the US administration towards China has softened. Tensions and uncer-

tainty have hurt Chinese, European and finally US businesses, so a deal should benefit all sovereignties, and provide relief for financial markets. There is a lot of work to be done to bridge the gap between the US and China, but we are hopeful an amicable deal can be reached, as the alternative would not be palatable.

At this late stage of the economic cycle, where the macroeconomic data is more mixed, and political uncertainties abound, some vigilance by investors is warranted. While we are constructive with regard to our favored large capitalization globally-oriented equities, due to a combination of their growth prospects and reasonable valuations, there are some short-term headwinds to be contended with. Themes that have emerged post the year-end earnings reporting season include customers being increasingly cautious due to economic uncertainties, as well as deteriorating macroeconomic conditions, particularly in China. Counterbalancing these worries is a valuation underpinning; the S&P 500 index is trading at 15.6x 2019 earnings, which is attractive based on historical trading and relative to the very low level of interest rates.

We remain skeptical regarding fixed income investments, especially those with lower credit quality and longer duration. Last year, the US government borrowed an additional \$1.36 trillion, raising the national debt to \$22 trillion (up from \$9 trillion in fiscal 2007, pre-financial crisis). In addition, there is record student (\$1.5 trillion) and automobile (\$1.3 trillion) debt. Along with mortgage and other debt, US household borrowings have reached record \$13.5 trillion. However, while the US is the world's largest debtor, the issue is a global one. According to the Organisation for Economic Cooperation and Development (OECD) gross borrowing among member states will top \$11 trillion this year, exceeding the previous record of \$10.9 trillion registered in 2010. Given this level of indebtedness, coupled with the current low level of interest rates, we don't believe that most fixed income investors are being properly compensated for the risks they are taking.

Therefore, we recommend an allocation to select alternative assets that can offer resilience in the face of volatility and the ability to dynamically shift risk exposure to take advantage of opportunities that may arise.

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Sources: Barclays, Bloomberg, Bureau of Labor Statistics, Conference Board, Department of Agriculture, Federal Reserve, Financial Times, IMF, Institute for Supply Management, MSCI, Reuters, Russell, Standard & Poor's, and the Wall Street Journal