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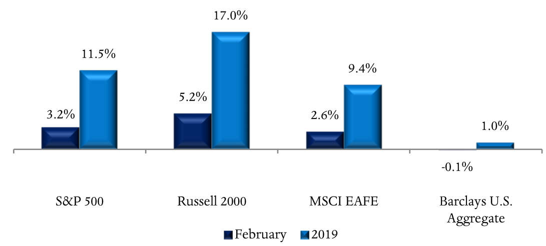
Markets

Stocks advanced strongly in February, leading the S&P 500 index to its best start to a year in more than three decades. Investor sentiment was bolstered by a combination of constructive US-China trade talks, an accommodative stance from the US Federal Reserve, and the implementation of Chinese stimulus measures. US markets were led higher by smaller capitalization stocks, as seen by the Russell 2000 index's +5.2% advance (+17.0% ytd). Overseas stocks also fared well, with the MSCI EAFE benchmark rising +2.6% (+9.4% ytd). In Europe, the Stoxx 600 index added +4.2%, bringing 2019 returns to +10.8%. Asian equity markets were also higher, led by Shanghai's +13.8% rise (+17.9% ytd), while Tokyo's Nikkei 225 benchmark added +3.0% (+6.9% ytd).

The minutes of the last Federal Open Market Committee (FOMC) meeting confirmed the dovish shift in thinking at the central bank. The FOMC indicated that it will maintain a larger balance sheet by ending the process of quantitative tightening. Nevertheless, the 10-year US Treasury yield is largely unchanged from its 2019 starting point, as the core CPI (excluding food and energy) has held steady at 2.2%. In February, the Barclays US Aggregate index declined -0.1% (+1.0% ytd).

A number of emerging markets continue to feel the effects of currency depreciation, which has triggered inflation, particularly in agricultural products. In India, core inflation remains above 5%, while in Turkey inflation has climbed above 20%. Hope for a US-China trade deal has bolstered industrial materials and energy. Copper has firmed, trading near the upper end of its five-year trading range. Crude oil prices have also rebounded but still remain below trend after the very severe fourth quarter decline. In all, the S&P Global Natural Resource index rose +1.5% in February (+11.3% ytd).



Geopolitics

US-China trade negotiations continued in February, achieving solid progress. Areas of focus include tariffs, as well as intellectual property and Chinese state-led subsidies to the technology sector. Discussions proceeded well enough to avert the increase in tariffs that was scheduled for March 1. Further, it appears likely that a Trump-Xi summit could occur later this month, at which point it is expected that both sides will remove all, or nearly all, the tariffs presently being imposed on one another. In addition, China has indicated it will remove barriers blocking access to certain markets (like autos and financial services) while stepping up its purchase of American goods. According to the U.S. Census Bureau the US deficit on goods hit a record $891 billion in 2018, up from $807 billion in 2017, and exceeding the previous peak of $828 billion in 2006. This is despite the imposition of tariffs on imports from China and on steel and aluminum from a range of countries. Given the difficulty in balancing the trade of goods, there has been criticism of the purported compromise, which apparently fails to achieve many of the structural objectives sought by Washington.

Brexit uncertainty continues to weigh on UK sentiment as the March 29 deadline to leave the European Union draws closer. Prime Minister Theresa May is presently trying to obtain some concessions from the EU on the backstop arrangement, aiming to prevent a hard border between Northern Ireland and the Republic of Ireland.

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If an amendment were to be secured, another parliamentary tally on the Brexit deal can be expected in mid-March. Failing which, a vote to see whether parliament would accept leaving the EU with no-deal would ensue. Polls suggest there is a strong aversion to leaving without an agreement, indicating a higher likelihood of a compromise, or an extension to the Article 50 negotiation process.

United States

Economic growth in the US remains on a moderating trajectory, declining from 3.4% in the third quarter, to 2.6% in the final quarter of 2018. Looking ahead, first quarter US GDP growth is expected to hit its nadir, with the Atlanta Fed's GDPNow model forecasting a modest 0.5% advance. The deceleration in growth partially reflects temporary factors including seasonality, the government shutdown, and tax refund delays. Economic growth for the full year 2019 is expected to remain sturdy, approximating 2.3%, but a fair bit below the 2.9% achieved in 2018.

Recent lackluster economic data, corroborating the slower growth, includes US personal income, which fell for the first time in more than three years, as well as consumer spending which dropped the most since 2009. But there were signs of a bounce back in February. The US composite purchasing managers' index (PMI) improved to 55.8, which points to an ongoing rate of growth in the US economy of approximately 2%. Meanwhile, inflation remains relatively muted, registering an increase of 1.6%, the lowest rate in more than 18 months.

Europe

Signs of broader and more persistent economic weakness were evident in the Eurozone, as fourth quarter annualized economic growth registered 1.2%, near a four-year low. Showing resiliency, France's 0.9% GDP growth came in better than expected and the German economy's 0.6% advance avoided recession (Q3 GDP had shown a contraction of 0.2%). Italy, however, entered a technical recession due to a fall in domestic de-

February 2019 Economic Statistics

	Feb-19	Dec-17	Dec-16
Federal Funds Target Rate	*2.25 - 2.50%*	*1.25-1.50%*	0.50 - 0.75%
Consumer Confidence Index	*131.4*	*122.1*	113.7
Manufacturing PMI Index	*54.2%*	*59.7%*	54.7%
Unemployment Rate	*3.8%*	*4.1%*	4.7%
JPY / USD	*111.37*	*112.67*	116.87
USD / EUR	*1.1370*	*1.1996*	1.0513
Gold / oz.	*$1,312.66*	*$1,302.45*	$1,151.46
Oil (WTI) / bbl	*$57.22*	*$60.42*	$53.72

mand. By way of full-year 2019 projections, the OECD halved its estimate for German GDP growth to 0.7%, and is predicting a light recovery to 1.1% growth in 2020, as Europe's largest, export-reliant, economy is particularly affected by weaker global demand and rising trade barriers. The OECD's overall economic growth forecast for the Eurozone was downgraded from 1.8% to 1.0% for 2019.

Recent guideposts include the Eurozone composite PMI which improved to 51.4, but the manufacturing index fell below 50, indicating an outright contraction in manufacturing activity. On the positive side, consumer confidence increased for the second month in a row and there are signs of a significant improvement in car registrations, which suggests the auto industry is beginning to adjust to the new auto emissions regime.

The current €719 billion batch of targeted long-term refinancing operations (TLTROs), which maintain cheap refinancing conditions to commercial banks in the euro area, will mature between mid-2020 and early 2021. Were the TLTROs to expire, interest margins of banks, especially in Southern Europe, would be negatively affected, reducing the availability of credit. Hence, the ECB has commenced discussions to extend, and possibly augment, the TLTROs.

Asia

China is seeking to shore up its slowing economy, affected by reduced domestic demand and a trade war with the US, through billions of dollars worth of planned tax cuts and infrastructure spending. Policymakers have begun implementing a mix of fiscal and monetary measures to support growth. Total social financing, a key measure of lending, reached record highs (equivalent to $685b) in January. Local government bond issuance also increased, raising funds that will be directed towards various value-added projects.

Japanese fourth-quarter GDP rebounded to growth of 1.4% (from a compression of 2.6% in the third quarter). The expansion was supported by increased private consumption and capital expenditures. However, the underlying pace of activity remains subdued, with the latest manufacturing PMI falling to 48.5, signaling a contraction. The Bank of Japan remains far from meeting its inflation target and is likely to continue pursuing very loose monetary policy for the foreseeable future.

Outlook

Investors have been heartened by the Federal Reserve's pivot to a dovish monetary policy stance, the benefits of Chinese stimulus, as well as improved trade relations between the US and China. Global GDP growth, which has been negatively affected by a high level of policy uncertainty, ongoing trade tensions, as well as the erosion of business and consumer confidence, appears to be bottoming, and is forecast to rise by 3.3% in 2019 and 3.4% in 2020. While the downturn has mostly affected industry, consumers continue their spending thanks to strong labor markets, which are providing for real, inflation-adjusted, wage growth.

Federal Reserve Chairman Jerome Powell upheld the new "patient" view on monetary policy in his semi-annual Congressional testimony on the economy. He also acknowledged the Fed is close to agreeing on a plan to end the balance sheet runoff (Quantitative Tapering). Given that inflation expectations are subdued at the moment, a new Fed policy framework is expected, akin to average inflation targeting, which would raise inflation expectations and steepen the curve. To do this the central bank likely lets the economy run "hot" by keeping rates lower than it otherwise would, for a longer time. This backdrop should be constructive for risk assets as 2019 unfolds.

Equities have rebounded strongly from the oversold conditions of December and appear to have reached a short term equilibrium. Since the October 1, 2018 peak of the tech-heavy Nasdaq 100 index, we note there has been outperformance in select commodities (gold +10.5%, copper +6.6% and palladium +46.0%), followed by Chinese (+4.7%) and emerging market (+1.3%) equities, while the S&P 500 (-4.2%), MSCI World (-4.5%) and Nasdaq 100 (-6.7%) indexes have trailed. This indicates that there has been a shift in the market leadership favoring inflation sensitive assets. Looking ahead, this change in investor asset preference may bode well for the relative performance of generally underfollowed stocks, which have lagged equity benchmarks for an extended period of time. With regard to valuation, the S&P 500 index trades at 15.7x 2019 earnings, a reasonable multiple given the current low level of interest rates and the easy monetary policies in force. Valuation multiples of overseas stocks appear to be trading at a modest discount, adjusting for lower long-term growth prospects.

The global, publicly traded, non-financial corporate bond market has reached $12 trillion in size. Not only has the amount of credit outstanding increased dramatically, the quality has been in decline, as seen by the average debt-to-EBITDA ratio which has doubled to 2.5 times since 2007. Notably, the lowest level of investment grade bonds (BBB tranche) account for half the market, the highest percentage ever. The current US corporate BBB effective yield is 4.4%, indicating a credit spread of approximately 1.7%. In light of this dynamic, and the absolute low level of interest rates, we remain of the belief that investors are not being properly compensated for exposure to fixed income, especially those assets at the lower end of the investment grade spectrum.

Given the recent period of volatility, in both equity and credit markets, risk-averse investors may wish to consider building some resilience into their portfolios. Our favored value added alternative investments may be considered useful tools to dampen short term oscillations, while diversifying portfolios and reducing overall market correlation.

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

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