Quarterly Economic Update

August 15, 2019

MACROECONOMIC COMMENTARY

Fiscal Policy
By Michael McNair

On Monday, August 8th, the Chinese Yuan (CNY) closed above 7 to the US dollar for the first time since before the 2008 Financial Crises. It is well-known that China intervenes in the foreign currency market and the 7 CNY/USD was seen as a critical level that Beijing has defended. However, after President Trump announced a new round of tariffs on Chinese goods, the CNY was allowed to depreciate straight through the critical 7 level without intervention from the Chinese central bank (PBOC). CNY depreciation was a clear political warning signal to Washington that Beijing is willing to use their currency to retaliate against US tariffs.

In this edition of the *Fiscal Policy Report,* we explain why Beijing is constrained in their ability to weaponize their currency and their veiled threat is merely a bluff.

China has Few Options to Respond to US Tariffs

Beijing has preciously few options to fight a trade war with the US. The three the most commonly cited measures at Beijing's disposal are: 1) retaliatory tariffs on US exports to China, 2) selling of US treasuries, and 3) depreciate of the Yaun. The reality is that none of these are viable options for Beijing to use in a trade war with the US.

We have explained why Beijing is constrained by using the retaliatory tariffs as well as dumping US treasuries in previous editions of the *Fiscal Policy Report*. In this edition, we will explain the reasons why China is also unable to use currency depreciation as a tool for fighting a trade war with the US.

1) Currency devaluation targets all countries – not just the US

President Trump recently announced that the US would place 10% tariffs on the remaining $300 billion of Chinese exports to the US. We estimate that a 1.5% devaluation of the Chinese Yuan would be enough to fully offset the impact of these new tariffs - which occurs by reducing the price of Chinese exports and raising the price of Chinese imports. However, a 1.5% devaluation would impact import and export prices from all countries, not just the United States. The brunt of the adjustment would fall on China's other trading partners around the world – via lower net exports. A reduction in net exports is sure to anger China's other trading partners, especially considering that many of the countries are likely entering an economic recession. Chinese devaluations are likely to set off retaliatory tariffs and competitive devaluations from their other trading partners.

2) Currency devaluation furthers China's domestic imbalances

China is the most unbalanced economy in history, with investment making up the largest share of GDP ever recorded and consumption comprising the smallest share ever recorded by a diversified economy.

In 2015, we published *The Chinese Economy and the Path to Rebalancing*, which explained why China must urgently rebalance its economy (summary below). Rebalancing requires the consumption share of the economy to increase, which entails consumption consistently growing faster than GDP. A currency devaluation is in direct conflict with rebalancing because currency depreciation reduces real wages (which reduces real domestic consumption) and subsidizes domestic producers, as goods produced domestically become cheaper relative to their foreign competitors.

China has slowly started the long and difficult adjustment process. A currency devaluation, which is a tax on domestic consumers and subsidy to domestic producers, would undo what little progress China has made.

The Chinese Economy and the Path to Rebalancing:
Summary of the "trade constraint"

The foundation of China's investment-led growth model is that, through various ways, it "taxes" households in order to subsidize producers. The effect of these subsidies is to significantly increase the competitiveness of domestic industry and set forth rapid growth in investment in real estate, infrastructure, and manufacturing capacity; yet, this growth eventually comes at a significant cost.

A version of this economic growth model has been used numerous times throughout history including Japan in the 1960s and 70s, Brazil in the 1960s and 70s, the Soviet Union in the 1950s and 60s, and Germany in the 1930s. In each case, the model generated rapid growth but it always eventually runs into the same set of constraints: 1) the willingness of the rest of the world to absorb the trade imbalance and 2) an unsustainable build-up in debt due to overinvestment and gross misallocation of capital.

China is not choosing to abandon the growth model, they are being forced to because the model has hit the constraints that have always derailed the investment growth model. The history of the rebalancing process is crystal clear, in every case in which an economy has been forced to transition away from the investment growth model the economy endured years of economic hardship. These are the countries that experienced "lost decades".

Recall, that an investment-driven growth model is just a set of economic policies that channel savings into investment by constraining (i.e. taxing) consumption and subsiding production. The growth model essentially substitutes economic growth from consumption for growth from investment and production. For this reason, the hallmark of an economy employing a version of the investment growth model is extremely unbalanced growth.

Over the last thirty years, Chinese consumption growth has significantly lagged GDP growth while investment has consistently grown much faster than GDP. In the 1990s investment accounted for 23% of Chinese GDP. But the structural distortions inherent to the growth model caused investment to surge to 50% of GDP by 2011. This is the highest level recorded by any country in history. For perspective, most emerging market countries have investment at just 30% of GDP. Over the same time, consumption as a percentage of GDP fell from 52% to 34% in 2011 – the lowest level ever recorded by a diversified economy.

The consumption share of the economy is the lowest ever recorded in any economy and the investment share of the economy is the highest ever recorded in any economy. In other words, the Chinese economy is the most unbalanced in history.
It is important to emphasize that Chinese consumption is not low because of high household savings rates, it is low because it has the lowest income share of the economy ever recorded. The low-income share of the economy is a direct result of the policies (i.e. the investment growth model) which effectively taxes workers income and subsidizes producers.

The purpose of investment is to meet future consumption. Strategies that tax consumption and subsidize production would not work in a closed economy because production would exceed demand. Falling consumption would cause businesses to reduce investment and GDP would drop (because of production = consumption + investment). However, in a globalized economy Production = Consumption + Investment + **Net Exports**. Therefore, investment growth can be multiples of domestic consumption growth if the imbalance is resolved with increasing net exports (i.e. taking foreign consumption) Notice that this strategy only increases production domestically but leaves the world with less demand.

China's imbalance is important because of the impact that it has on the rest of the world. A natural consequence of China's investment growth model is that the economy tends to create far more production than it consumes. This excess production must be exported to foreigners for consumption. Therefore, China can only continue to grow investment as long as the rest of the world is willing to consume the excess production this investment eventually creates. Further, as China grew over the last several decades, the larger the gap between their production and their consumption became and the more the rest of the world had to consume.

If China runs a trade surplus, by definition, an equal trade deficit must be run outside of China. A trade surplus adds to a country's GDP, while a trade deficit subtracts from a countries GDP. When China runs a trade surplus they are capturing more than their share of global GDP, which comes at the expense of lower GDP for the rest of the globe. For the rest of the world to absorb all of China's excess production (i.e. their net exports) either production must drop, which means slower GDP growth or consumption must boom through an increase in debt.

As the supplier of the world's reserve currency, the US is forced to consistently run a trade deficit. As a result, most of the increase in China's GDP that has come from its trade deficit has come at the expense of US GDP.

For most of the last decade, the US responded to China's growing trade surplus, and the resulting loss of production, by easing credit standards and setting off a consumption and housing bubble. This surge in consumption kept the US economy growing despite the increasing amount of demand being lost through the trade account (equivalent to 6% of US GDP by 2006). However, this consumer debt binge could not continue for long and it inevitably led to a financial crisis in 2008.

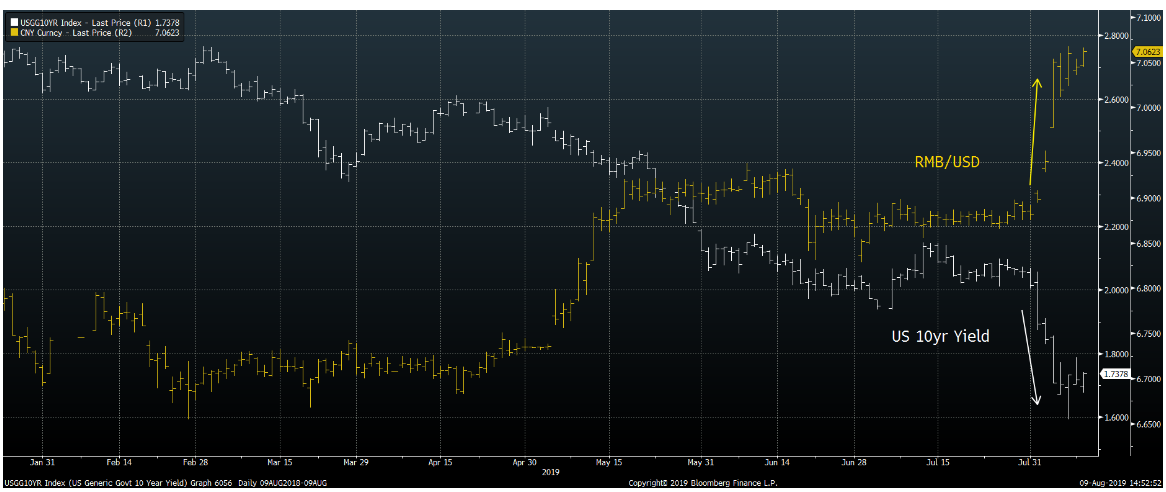
China can no longer count on the rest of the world to willingly absorb its excess production. The global economy is too weak and countries will no longer allow China to increase their trade surplus at everyone else's expense.

The current trade war with the US is a clear sign that China has hit the investment growth model's trade constraint.

3) Currency devaluation risks setting off a rush of capital outflows

Since 2016, Beijing has signaled that the Yuan should remain roughly stable against the dollar. As a result, speculative capital flows have remained subdued. However, breaking 7 CNY/USD unleashed a torrent of capital outflows from China. The PBOC did not intervene to prop up the currency (by selling foreign currency reserves as they did in 2015) and instead let the Yuan depreciated by 2.5% against the US dollar in just three days.

Chinese capital flowed directly into US treasuries and caused a three day, 30 basis point, drop in the US 10 year yield:



The "breaking of 7" was certainly meant for strategic reasons related to the trade war. However, Beijing is in the impossible position of trying to convince Washington that they are willing to devalue their currency, while simultaneously convincing markets that they are bluffing.

The truth is that Beijing is limited in its ability to threaten the US with currency devaluation because any threat becomes self-fulfilling. A credible threat to devalue the Yuan will, by definition, signal to the market that the Yuan will lose value. Anyone holding Yuan will, rationally, attempt to sell Yuan and buy Dollars. A credible devaluation signal is likely to be especially powerful in China due to the speculative nature of Chinese capital flows.

A devaluation threat is a risky strategy because speculative capital flows are highly pro-cyclical (i.e. they create positive feedback). It is also why Beijing has resisted using the currency as a threat until this past week. Even then, the Chinese government immediately issued a statement proclaiming that they will not use Yuan as a trade weapon. The threat has caused the currency to devalue, which has incentivized more holders of Yuan to sell, which puts further pressure on the currency. Beijing must now intervene to prevent any further depreciation in the Yuan or speculative outflows will overwhelm the government's capital controls.

Capital outflows are important because they tighten liquidity in the domestic banking system from which they are fleeing. Domestic liquidity conditions are particularly important for China because their banking system is insolvent. Insolvency itself is not a sufficient condition to cause a financial crisis. A crisis only occurs when the liquidity needed to bridge the gaps created by a mismatch between assets and liabilities suddenly becomes unavailable or insufficient.

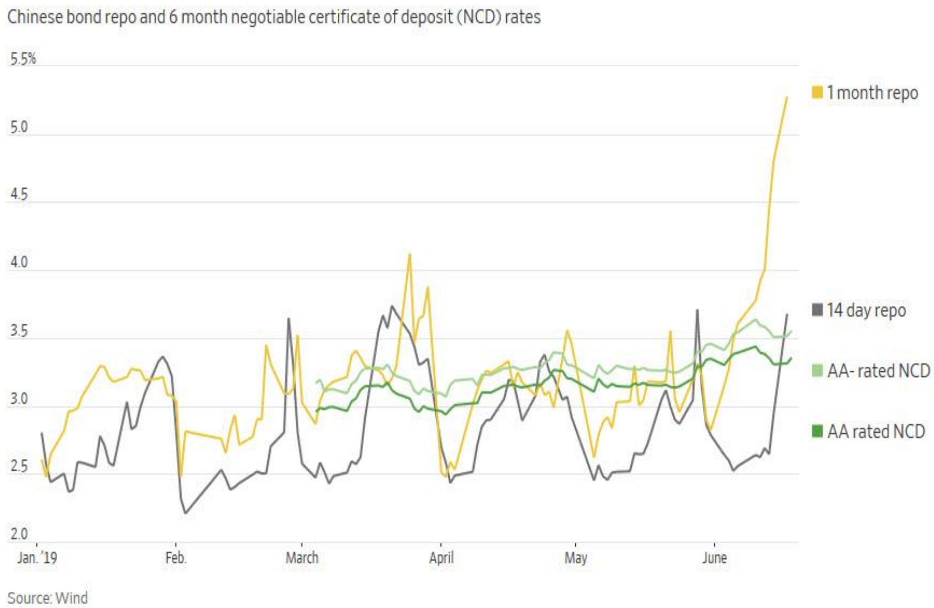
In our 2015 Report, *The Chinese Economy and the Path to Rebalancing,* we stated, *"China has an enormous amount of insolvent borrowers with significant mismatches between their assets and liabilities. However, we do not believe that China will experience a financial crisis because Beijing's implicit guarantee of most of the country's financial system ensures that much of the mismatch between assets and liabilities is spread out on a system-wide basis. Therefore, as long as investors remain confident that Beijing will continue to provide liquidity to any part of the financial system and even assume the debt of insolvent borrowers it is unlikely that deposits will flee the banking system to such an extent that it creates a financial crisis."*

We also stated that China's ability to avoid a financial crisis was dependent on economic rebalancing and reversal of their reliance on debt to attain unsustainably high growth rates. Unfortunately, China has only increased its reliance on debt. The Chinese banking system was already insolvent when we published our report just four years ago. Since that time Chinese debt has more than doubled. Chinese debt grew at an amount equal to 45% of GDP in just the past year. As bad debt in the Chinese financial system grows exponentially so too does the liquidity needs of the banking system. As a result, China is arguably more vulnerable to surging capital outflows than ever.

Financial system liquidity has become an increasingly important issue among Chinese authorities after the PBOC has been forced to inject emergency liquidity into its banking system on several occasions over the past few months. On May 24 Baoshang Bank, became the first Chinese bank to be taken over by the regulators in over 20 years. The

Baoshang take-over was followed by two more in as many months. The three banks have almost $400 billion in combined assets.

The impact of the Baoshang takeover caused interest rates to spike in the interbank market. The 7-day repo rate spiked 50 basis points, forcing the PBOC to inject 150 billion yuan through the open market. The PBOC was them prompted to inject even more liquidity into the market after 1-month repo rates climbed almost 200 basis points over the next month.



The recent bank nationalizations have sent shock waves through the Chinese banking system and it is taking increasing levels of liquidity injections from PBOC to prevent contagion.

We do not believe Beijing is planning to use Yuan devaluation as a trade chip, as Beijing can ill afford to set off a rush of capital outflows at a time when the interbank markets are already becoming increasingly difficult for authorities to control. However, we do not rule out the possibility that the “breaking of 7” has already set in motion the ingredients for market forces to devalue the Yuan against Beijing’s intentions.

Economic Outlook

By Katie Richard

The U.S. economy is increasingly bifurcating between two realities: certain segments appear stable and strong while others appear to be developing cracks and slowing. The US consumer segment is in great shape, and labor markets remain tight. But cyclical data, including PMIs and global indicators, are showing signs of further deterioration. The capex boom predicted for the second half seems less likely as uncertainty surrounding trade and global growth is weighing on business investment and causing pressure on the manufacturing segment as well. While we believe that cyclical data could act as a near-term headwind, we still believe near term recession risk is relatively low. Just before the Fed meeting, Credit Suisse released the following chart detailing states of the economy prior to a recession. Since the July Fed meeting and President Trump's tariff announcement, things do not seem as rosy, but most categories still remain in expansion. Due to the current administration and declining global outlook, we have grown accustomed to bracing for what is going to turn over next, i.e. the next wave of poor data, trade tensions, etc., but for now, there are enough signs that the economy is still doing fine for us to remain constructive. However, we are mindful that downside risks are certainly becoming more prevalent as trade tensions re-emerge, the yield curve remains inverted, and the global outlook continues to deteriorate.

Recession Dashboard

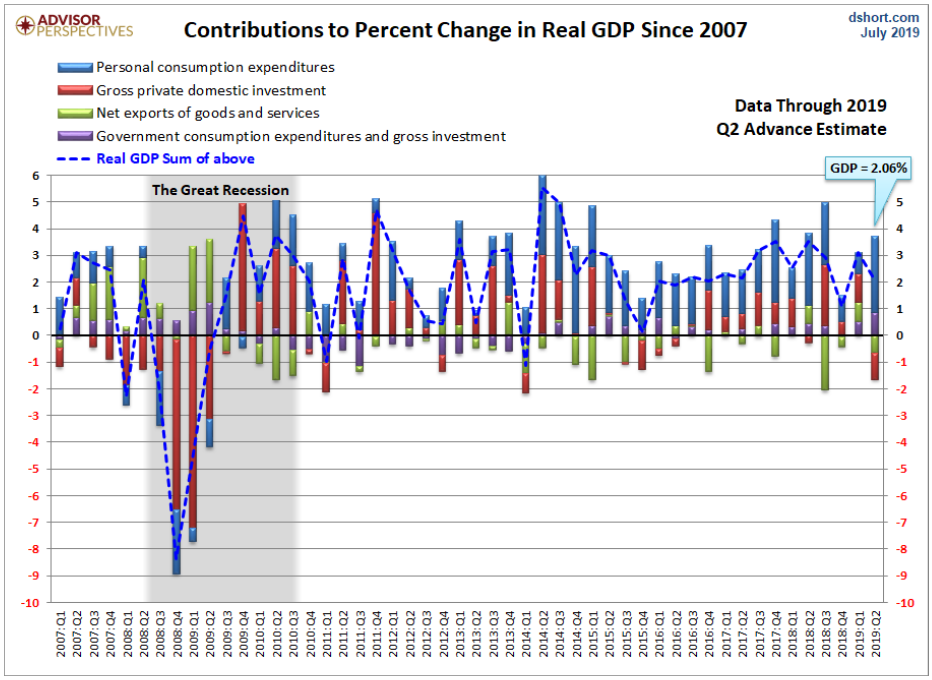
Start of Recession	Yield Curve	Inflation Trends	Job Creation	Credit Perform	ISM Mfg.	Earnings Quality	Housing Market
Nov-73	↓	↓	↓	--	↓	--	↓
Jan-80	↓	↓	↓	--	↓	--	↓
Jul-81	↓	↑	↑	--	↓	--	↓
Jul-90	↓	↓	↓	↓	↓	↓	↓
Mar-01	↓	↓	↓	↓	↓	↓	↔
Dec-07	↓	↓	↔	↓	↓	↓	↓
Present	↔	↑	↑	↑	↑	↑	↔

Key: ↓ Recessionary ↑ Expansionary ↔ Neutral

Source: Standard & Poor's, Federal Reserve, BLS, National Statistical Agencies, NBER, ISM, Census Bureau, Haver Analytics®, Credit Suisse

GDP Growth

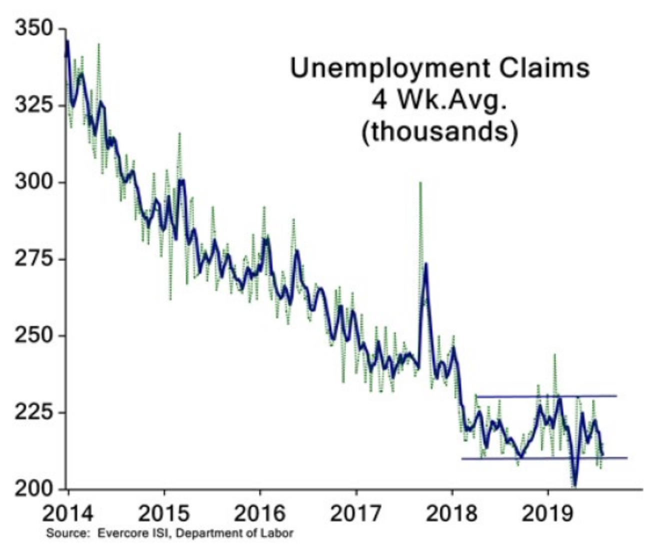
According to the advance estimate by the Bureau of Economic Analysis (BEA), second quarter GDP came in at 2.1%, declining from 3.1% growth in the first quarter but better than expectations. As shown in the chart below, personal consumption expenditures (PCE) was the largest contributor to GDP growth for the quarter at 69.6%, a record high. In addition to strong PCE, the increase in real GDP was due to positive contributions from nonresidential fixed investment and government spending. This was offset by a decline in inventory investment, exports, business investment, and housing. We expect that GDP growth will continue to slow over the second half of 2019.



The Consumer, Employment & Wage Growth

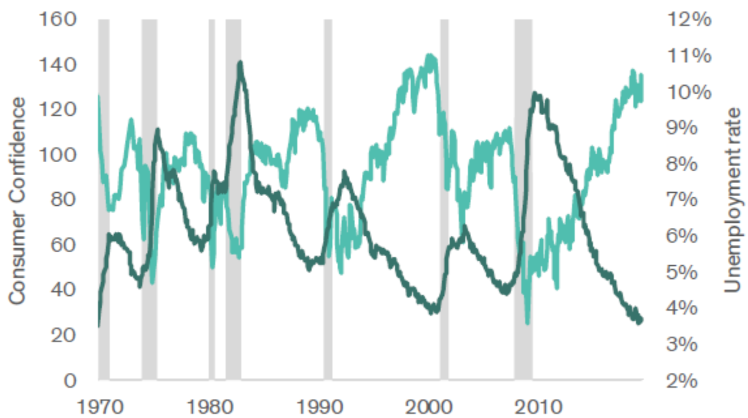
The consumer was a driving force of strength in the economy this quarter. De-levering, tax reform, and strong equity performance continue to improve household balance sheets. In addition to improving balance sheets, high savings rates, record high levels of consumer confidence, and healthy wage growth are all contributing to the health of the consumer. It is difficult to see a significant slowdown near-term unless we start to see notable stress on household balance sheets.

Despite trade fears and market volatility, the labor market is still very strong, which has helped drive the strength of the consumer this quarter. Last week, unemployment claims fell to 209,000 from 215,000, with the four week moving average edging up to 212,250. As the unemployment claims figure shows, it seems unemployment claims have become range bound between 210,000 and 230,000.



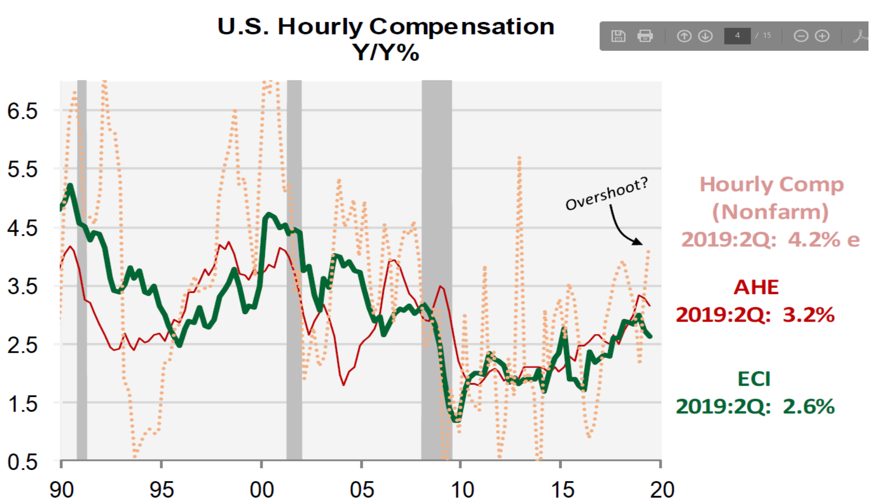
Payroll data showed 164,000 jobs were added in July. While the pace of payroll growth has slowed, the Fed opined that the pace is above what they view as required to keep the unemployment rate steady. Holding true in July, the unemployment rate remained steady at 3.7%. The labor force participation rate increased 0.1%, indicating that more workers are slowly being drawn back into the labor force and getting jobs. Given the strong correlation between unemployment and consumer confidence and the strength of both of these measures, we remain constructive on the U.S. economy.

EXHIBIT 13: **Consumer confidence and unemployment – mirror images**



Source: Bernstein

Wage growth continues to come in below expectations, despite such low levels of unemployment. Average hourly earnings (AHE) grew just 3.2% in July. While we need wage strength to support the continued health and momentum of the U.S. consumer, we monitor hourly earnings for overheating labor cost growth. As we have mentioned before, 4% growth in AHEs is where companies start feeling margin pressure. Historically, when AHE growth crosses 4%, it has signaled a recession that was, on average, two years away. As hourly pay continues to diverge with productivity growth, we do not think that AHEs will see 4% growth anytime soon.



Source: Cornerstone

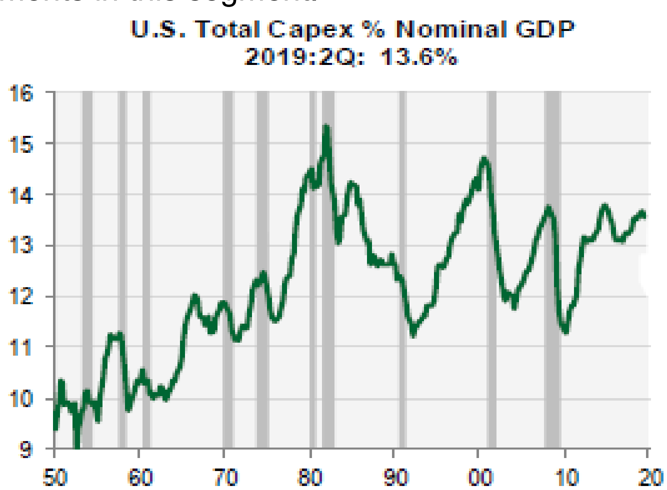
Corporations, Productivity and CAPEX

Business investment and the manufacturing segment are a big source of uncertainty moving forward. At the beginning of the year, there was a lot of hope for a capex boom in the second half of the year. However, the stimulus from tax cuts and higher government spending appear to be fading amongst more uncertainty regarding trade and the global economic outlook, which has led to a decline in business confidence and is hampering domestic business investment.

Global manufacturing PMIs have been slowing for some time. In the U.S., July manufacturing PMI expanded at a slower rate for the fifth consecutive month, up to 53% from 51.5%. The services PMI continues to signal an improvement in the overall rate of business growth, but the pace of the expansion remains a concern and reinforces the slowing growth thesis. The U.S. non-manufacturing sector has recently lost momentum, slowing to 53.7% in July from 55.1%. However, with continuing strong employment data, we believe it will remain at a fairly low, but sustainable level of growth.

Tight labor markets provide a tailwind for higher productivity growth, and accordingly, productivity growth has been strong. In the first quarter, productivity increased 3.4%, which was slightly below market expectations but followed a 1.3% rise in the prior quarter. Second quarter productivity will be released on August 15, but, along with other measures, we expect slower growth comparable to what we saw in the fourth quarter of last year.

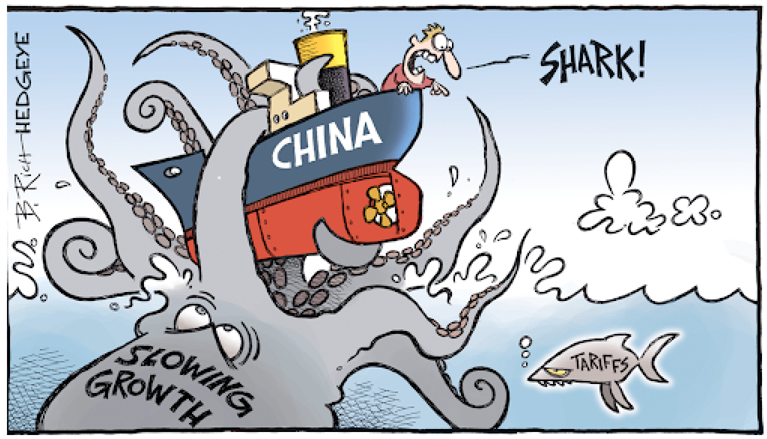
Long term, we believe capex will pick up as the effects of tax reform and government spending have made the U.S. a relatively attractive place to invest. Earlier in the quarter, we saw that the Philly Fed capex outlook and durable goods orders were starting to improve, indicating a potential pick-up in capex in the second half. However, it now seems that the tariffs and trade war situation will impact business confidence and, accordingly, the near-term capex outlook. While business investment has been a bit discouraging relative to expectations, the economy has continued to show resilience in the face of disappointments in this segment.



Source: Cornerstone

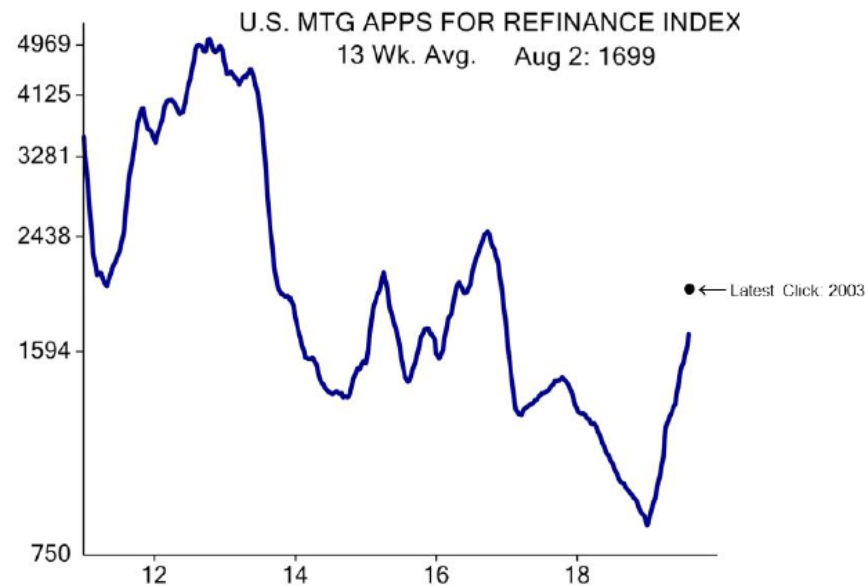
Trade

Trade continues to be a risk to the economy. President Trump recently announced another 10% tariff on $300B of U.S. imports from China. Immediately following this announcement, a US equity selloff commenced, and the yield on the 10 year fell sharply hitting the lowest level since before Trump's election in 2016. While trade between the U.S. and China has increased in recent years, you may hear that the volume and price impact are too small to do significant damage to the U.S. economy. Yet, the cumulative effect of the tariffs is not inconsequential, and the greatest risk from the tariffs that concerns us is the hit to confidence. Even though consumer confidence is driven mostly by the labor market and household wealth, volatile and declining equity markets due to trade uncertainty certainly do not help the consumers' confidence. Combined with potential price increases passed along to the consumer due to tariffs of consumer goods (such as phones, electronics, and apparel), we could see less money in consumers' pockets, hurting the principal source of strength in the economy this quarter-consumer spending. Regardless of whether these tariffs actually end up being implemented on September 1 or not, the continued uncertainty surrounding trade and Trump's tariff policy is enough to undercut business confidence and investment, potentially trickling down to consumer confidence and spending, which could potentially hamper economic growth in the months ahead.



Residential Investment

While residential housing continues to look challenged long term due to demographic and population growth trends, it has certainly improved recently. Though residential investment has been a headwind to GDP, housing activity has picked up as rates have fallen. The drop in mortgage rates has caused a surge in refinancing activity, which puts money back in consumers' pockets. Additionally, we saw two consecutive months of growth in pending home sales. While low rates will continue to help with housing affordability in the short term, the lower rates are reflective of weakening global economic outlook, which could eventually hurt job growth and trickle down to home buying and building. This is a risk worth monitoring; however, we believe the near term stimulus provided by an uptick in housing data and extra cash in consumers' hands due to low refinancing rates will be supportive in the immediate future.

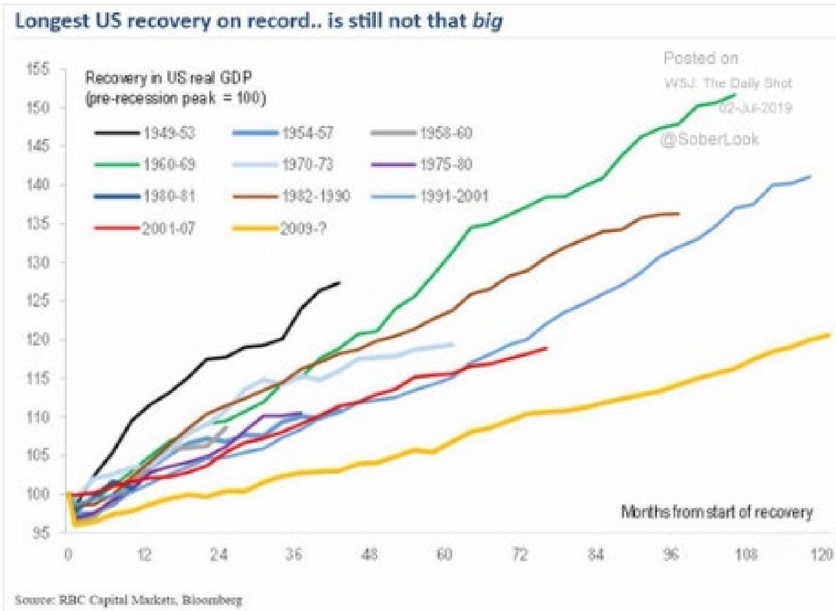


Inflation

Inflation remains subdued in the current climate and continues to fall short of forecasted levels. Additionally, the weaker global growth outlook continues to put downward pressure on inflation expectations. Headline PPI actually grew as expected in July, up 0.2%, which resulted in a +1.7% increase year over year. However, the core PPI fell for the first time in two years, down 0.1%, as did the core PPI excluding trade service prices. In the near term, the tariff hikes will likely boost core inflation; however, we expect that price pressure will be modest and likely temporary in part due to a stronger dollar and the growth picture.

The Fed and Rates

At its last meeting, the Federal Reserve cut the benchmark rate by 25 basis points. Despite this move being widely anticipated, it caused a big whirlwind in the market. Fed Chairman Powell characterized the cut as a "mid-cycle adjustment," which was interpreted to mean that the Fed may not cut again this year. In addition to two members voting against the recent rate cut, Powell's commentary seemed to indicate his own skepticism about further cuts as well stating that it was not the start of a lengthy cutting cycle and that their current view did not evidence the need for one. In addition to equity prices falling, the inversion of the yield curve was further intensified as the spread between the 10 year and 3 month treasuries declined further into negative territory. Powell later commented that he did not mean to suggest that there would only be one rate cut, but this did little to help markets or the curve as it was immediately followed by Trump's announcement to boost Chinese tariffs. Despite Powell's seemingly nontraditional approach, the Fed is importantly focused on extending the cycle and increasing inflation by maintaining accommodative financial conditions. Central bank policy is not as supportive as investors had initially hoped; however, it is not a headwind. We expect that under the current backdrop the Fed will cut at least another 25bps this year.



In summary, as the above chart shows, we think it is important to remember that the length of this entire expansion has been met with slow and, at times, weak data, which has helped elongate this cycle versus some of the boom then bust cycles of the past. While risks are no doubt rising, slowing growth can still carry this expansion, and we expect that there will be some form of fiscal policy intervention in 2020 prior to the election to bolster segments that are currently lagging. That said, we realize in this tape that things can change and deteriorate quickly; therefore, we continue to closely monitor the global economy, trade tensions, and other risks as they emerge.

RSA PORTFOLIO STRATEGY

Interest Rates and Fixed Income Strategy

By Nick Prillaman

At our previous meeting, the Federal Reserve had left rates on hold in early May as declining inflation was deemed to be "transitory". The month of May was driven largely by the break down in US-China trade negotiations which was then followed by "escalation from both sides, in terms of new trade barriers, rhetoric and other action" per BofA Merrill Lynch. President Trump's announcement on May 30 regarding the United States imposing "a 5% Tariff on all goods coming into our Country from Mexico" beginning June 10th further solidified the risk-off tone in the market. On the whole, the S&P 500 fell 6.35% for the month while on the opposite end of the risk spectrum, the Treasury sector returned 2.44%. The 2s-10s curve flattened as the yield on the 2-year Treasury fell 34 bps and the yield 10-year Treasury declined almost 38 bps.

The performance of spread products in this market was generally pretty good with the exception of high yield. The 30-year Fannie Mae mortgage index versus the 5-year Treasury tightened by 4 bps while the Credit Suisse Agency 1-3 Year Index widened by 7 bps. Both sectors posted positive monthly total returns but could not overcome the lack of duration when compared with the Treasury market. Corporate bonds also failed to match Treasuries as the high grade sector returned 1.43% and the high yield segment lost 1.27% versus the 2.44% total return for Treasuries. Spreads in high grade were 18 bps wider while high yield's gapped out by 86 bps. Along the ratings spectrum, AAA and AA-rated bonds were the best at only an 11 bp expansion in spreads while CCC-rated issues suffered greatly with 164 bps in adverse spread movement. While activity in the corporate new issue market fell off in the last part of the month, May total issuance for high grade was $108 billion and $26.3 billion for high yield per CreditSights.

The month of June saw a solid recovery in risk assets due to "the US and China re-engaging on trade, and indicated super-responsive monetary policy action by both the Fed and the ECB" per BofA Merrill Lynch. The initial move higher, a 2%-plus surge in the S&P 500, came on June 4th as comments by Federal Reserve Chairman Jerome Powell were interpreted in a dovish way by market participants. He said, "We are closely monitoring the implications of these developments for the U.S. economic outlook and, as always, we will act as appropriate to sustain the expansion, with a strong labor market and inflation near our symmetric 2% objective." The S&P 500 continued to trend higher and ultimately returned 7.05%. While certainly not as robust, the Treasury market posted gains as well, to the tune of .93 bps. Yields fell across various maturities with the 2-year Treasury declining 16.7 bps and the 10-year by almost 12 bps. The 25 bp drop in the 3-month Treasury yield was particularly telling of the future path in interest rates. This trend in yields was aided by the Federal Reserve who met on June 19th and said that "uncertainties about this outlook have increased."
Agency and mortgage spread movement was very lackluster for the month as the Credit Suisse Agency 1-3 Year Index widened by .3 bps and the 30-year Fannie Mae

mortgage index versus the 5-year Treasury expanded by 3 bps. As one would expect in a risk-on rally, corporates performed well. Investment grade corporates returned 2.30% while high yield bonds returned 2.45% as spreads tightened by 13 bps and 52 bps. BB-rated bonds were the clear winners along the credit spectrum at a 2.80% total return per CreditSights.

July was generally good for risk assets. Stocks jumped higher on July 1st after positive trade news came out of the G-20 summit. In describing what transpired, Everett Rosenfeld at CNBC stated, "The leaders agreed to hold off on new tariffs and to proceed with trade negotiations after a series of escalations to their nation's tariff battle threatened to disrupt the global economy." He also reported that "Trump suggested he will be reversing his government's decision to ban American companies from selling products to Chinese tech giant Huawei." Beyond trade, Federal Reserve Chairman Jerome Powell's dovish testimony to the House Financial Service Committee added to the risk-seeking behavior in the markets. He said, "Many FOMC participants saw that the case for a somewhat more accommodative monetary policy had strengthened. Since then, based on income data and other developments, it appears that uncertainties around trade tensions and concerns about the strength of the global economy continue to weight on the U.S. economic outlook." Strong domestic economic data like "jobs, retail sales, consumer confidence and GDP" also contributed to the rally per BofA Merrill Lynch.

The month concluded with the Federal Reserve's Federal Open Market Committee(FOMC) meeting on July 31st where it announced a cut in the federal funds target range by 25 bps. The FOMC also said it will end "the reduction of its aggregate securities holdings in the System Open Market Account in August, two months earlier than previously indicated." While the rate cut was a positive, Chairman Powell poured cold water on investor sentiment at the press conference when he described the change as "a "mid-cycle adjustment to policy" rather than the start of a more aggressive cycle of monetary easing" per James Politi at The Financial Times. Stock markets sold off in the wake of this comment.

In total for the month, BofA Merrill Lynch showed the S&P 500 returning 1.44% while high grade and high yield bonds gained 66 bps and 51 bps. All three of these sectors outpaced the negative 11 bp return for Treasuries. The Treasury market largely took a breather from its relentless move lower in yields though the 30-year Treasury did eke out a small drop yield. The 2-year Treasury yield rose 11.7 bps and the 10-year Treasury yield barely increased by .9 bps. The curve clearly flattened in this environment. Spreads in the Credit Suisse Agency 1-3 Year Index tightened by 3.1 bps and the 30-year Fannie Mae mortgage index versus the 5-year Treasury contracted by 2.2 bps.

August has so far been very volatile for investors. At one point, the S&P 500 had dropped by more than 5% while the Dow had almost lost 1000 points in a single day. Both, the 2-year and the 30-year Treasury, had shed almost 26 bps in yield. Markets have since recovered somewhat. The primary driver for the upheaval has been increased trade tensions between the U.S. and China. President Trump on August 1st said, "the U.S. will start on September 1st, putting a small additional Tariff of 10% on the remaining 300 Billion Dollars of goods and products coming from China into our Country." China retaliated on August 5th by "letting the yuan tumble to the weakest level in more than a decade and asking state-owned companies to suspend imports of U.S. agricultural products" per Bloomberg News.

From an activity standpoint, RSA made numerous adjustments to the fixed income portfolio since our last meeting. In Treasuries, we swapped out of a June 2022 issue and purchased a May 2020 security along with an August 2046 bond while also putting additional funds to work on the purchase side of the trade. The move gave us approximately 25 bps more in yield with only a slight increase in duration. It also helped us reduce our underweight in the long-dated part of the Treasury curve. The second trade we completed was the purchase of 3 securities, a February 2020 Treasury note, a 2046 Treasury bond, and 2048 McDonald's bond, in an effort to exploit the cheapness on the wings of the curve versus the middle. RSA was essentially able to create a hybrid Treasury/corporate security that yielded 2.70% until the short security matured in 9 months. The duration was close to that of the 10-year Treasury which was yielding 2.08%, so the spread pick-up was around 60 bps with only a 25% weighting in McDonald's. The trade increased our duration as well as our weighting in risk-free securities which we felt was prudent given our portfolio configuration.

Discerning the future path of interest rates is definitely a difficult one in this environment. We have experienced an impressive trend lower in yields since November of 2018. As seen in the chart below, the moving averages on the 2-year Treasury are clearly negative, so until the trend shows signs of changing, one must err on the side of lower rates. However, given the extent of the move lower and what appears to be climactic price action in the first week of August, the trend probably needs to a take a breather.

Source: Bloomberg

In the terms of the 10-year Treasury, the long term chart looks as though rates are just oscillating in a large sideways range. If the pattern continues, the 10-year should continue to drop to around 1.35% and then bounce off like it did in 2012 and 2016. A break below this level would be very problematic as it would indicate that something is very amiss in the economy.

Source: Bloomberg

While the Federal Reserve called their recent rate cut a “mid-cycle adjustment to policy”, the recent bout of trade war volatility has caused investors to bet that the change wasn’t a one-off. According to Bloomberg, there is a 77.3% chance that the Fed will lower their target rate range by 25 bps in September and a 61.9% chance that it will get cut again by 25 bps in October. In the absence of US/China trade deal, the Federal Reserve needs to cut rates as the shape of the Treasury curve indicates that monetary policy is too tight. The 10-year Treasury yield is currently at 1.72% which is well below the upper bound of 2.25% on fed funds. An inverted curve on this scale is not a positive for the market and hopefully, the Federal Reserve will alleviate the situation.

Trades in the Agency market were comprised of an outright purchase as well as a swap. We bought a June 2029 Federal Home Loan Bank note at a spread of 34 bps over the 10-year Treasury in an effort to add yield and manage duration. The swap was out of a 7-year Fannie Mae benchmark issue with a spread of 10 bps and into a 7-year Federal Home Loan Bank bond with a spread of 23 bps. We were able to add 13 bps in yield and get a higher coupon while only lengthening the maturity by one month. Our outlook in the space is neutral. Spreads are tight but we don’t see this changing anytime soon barring some adverse exogenous shock. We will continue to be opportunistic and look for trades like the 7-year swap mentioned above. One of our securities was recently called, so we plan on reinvesting the proceeds in a strategic manner depending on the landscape of the market and the needs of the portfolio.

In the terms of mortgages, we purchased two 4.5% coupon Fannie Mae pools to primarily reinvest prepayments but also to lower duration, improve carry, take advantage of the attractive spread in the coupon, and adjust the types of the securities within RSA's mortgage portfolio to better match those of the benchmark. Using Goldman's Sachs' 3-year prepayment projection, these securities were modeled to yield almost 2.91% with a modified duration of 2.94 years and a spread of close to 106 bps over the 3-year Treasury. The other pool we acquired was a 30-year 4.0% coupon Fannie Mae mortgage. The trade reinvested prepayments, lowered duration to help insulate against a rate backup, added new money to the sector, and took advantage of the good spreads in the coupon. Using the Goldman Sachs prepayment projection as well, this security was modeled to yield 2.79% with a modified duration of 3.09 years and a spread of 99.5 bps over the 3-year Treasury.

The big topic in the mortgage market right now is prepayment speeds. According to J.P. Morgan, Fannie Mae 30-year speeds surged 29% for July. As one can see in the chart below, 30-year mortgage rates have seen a big drop since the top in November 2018. The Bankrate.com US Home Mortgage 30 Year Fixed National Average is down 100 bps over that time. Fast prepayments when MBS prices are above par are clearly a headwind for the performance of mortgage-backed securities. The sector, however, does offer very attractive spreads when compared with other government-related bonds and does not have the credit risk of corporate bonds. RSA will continue to make adjustments depending on market conditions.

Source: Bloomberg

The Retirement Systems of Alabama invested in various corporate fixed income securities over the last few months. For example, we bought a 30-year first mortgage bond issued by The Public Service Co. of New Hampshire at a spread of 105 bps. This trade was completed to add duration in a safe name to hedge against further declines in interest rates. We participated in Occidental Petroleum's multi-tranche deal in early August where we bought the August 2022's at a spread of 120bps, the August 2026's at 160 bps over, and the August 2039's at 210 bps in spread. RSA also purchased 30-year McDonald's bonds on two different occasions. The first was part of the Treasury/corporate hybrid trade that was discussed earlier where McDonald's September 2048 bonds were acquired in conjunction with a short Treasury and a long-dated Treasury. The second purchase at a spread of 150 bps helped increase our duration to hedge against a further decline in rates. Welltower and Hartford Financial Services were other names that we acquired as well.

Corporate bonds continue to offer favorable spreads when compared with other fixed-income asset classes. As of August 2nd, high grade bond spreads were 119 bps while high yield spreads were 419 bps according to CreditSights. Over time, the spread difference should allow corporate bonds to outperform. The chart below shows the recent history in spreads which reveals that they are near the tighter end of the range. It is not a market where you find value across the board, but specific names and maturities can provide accretive returns for the astute investor. Our focus has been on high quality issuers. If a recession ends up coming to fruition due to the trade war, corporate bonds backed by strong balance sheets will hold up much better than those with questionable financials. High yield would underperform in that scenario. One can see in the chart that high yield spread widening can get incredibly pernicious when economic hiccups occur.

Source: CreditSights

Domestic Equity Strategy

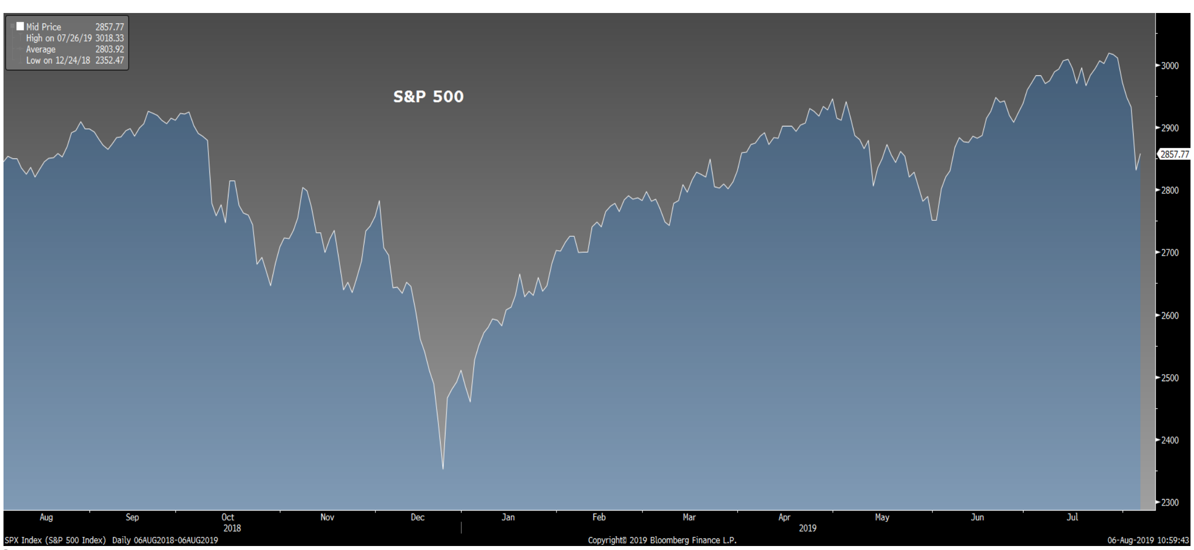
By Adam Rogers

Market Activity

"*Trade Tensions Adding to Worries of a Global Slowdown*." - To sum up 3 months' worth of news, that's the headline. Undeterred by this for much of the summer, the S&P 500 managed to scratch and claw higher, crossing 3,000 for the first time on July 10th and holding steady the rest of the month. The shrugging off stopped abruptly on August 1st after a mid-day tweet by the President declaring another round of tariffs on $300BN of Chinese goods, with China hitting back the following Monday with a sharply weakened Yuan. While trade wars have been an overhang for over a year now, these latest moves seem to have changed the base case from resolution to deterioration. The natural result of this being a larger risk premium in financial assets and likely further rate cuts by the Fed (which may be what the President is really after).

When markets get noisy, reaction is best delayed unless that noise is accompanied with signals from a reliable checklist or framework. We've had many reasons to be nervous over the past 10 years; PIIGS CDS, Cyprus, Euro monetary union collapse, Brexit, the Fiscal Cliff, etc… Now, trade policy and China have taken the reins. In times like these when the wall of worry seems insurmountable, we find it helpful to look back at what usually works in the long run and try to keep short term pain in perspective. Our simplified bear market checklist includes the following signals: **problematic inflation, tight monetary policy, euphoric investor sentiment, and extreme valuations relative to interest rates.** Historically, if the market is cycling into a bear, one or more of these is present. So on the following pages we will take a look at each of these, address some of the current known risks, and end with some longer term thoughts.

<u>Exhibit 1: S&P 500</u>



Source: Bloomberg

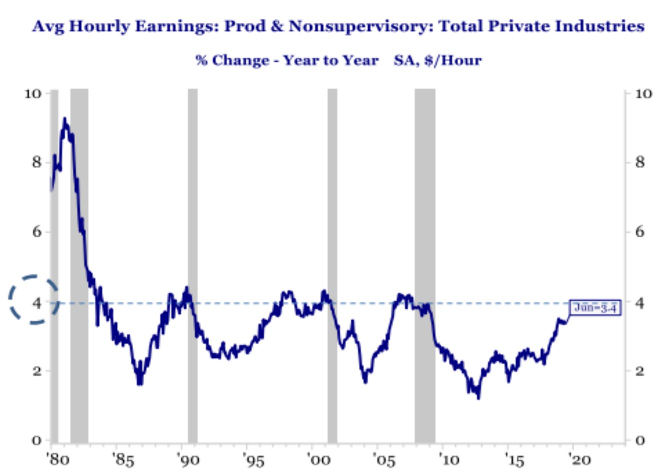
Inflation

First, going through the checklist one by one, what is the inflation landscape? We look for late-stage expansion signals where wages, oil prices, and inflation expectations steadily accelerate to worrisome levels. Any combination would be a reliable signal for future market weakness. Benign wage inflation has been a consistent theme over the past 10 years. Typically 5% unemployment is where acceleration begins but this cycle is showing a need for sub 4% to get wages going. It's frankly amazing to be reading statements like this from the Fed with unemployment so low, *"In light of the implications of global developments for the economic outlook as well as **muted inflation pressures**, the Committee decided to lower the target range for the federal funds rate to 2 to 2-1/4 percent".*

Exhibit 2: Inflation Measures

Source: Strategas

Average hourly earnings remain below 4%, which historically has been a pressure point for margins. At this point, the balance between higher money supply growth and lower velocity results in an inflation reading of low/stable.

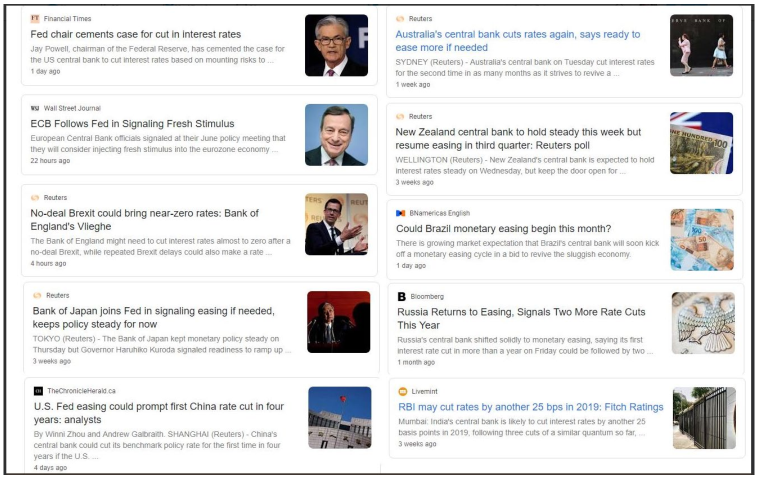


Source: Strategas

Fed Policy

Second, what is the tone from the Fed? This has changed drastically over the past year. The Fed has pivoted from hiking in December amidst balance sheet runoff, to cutting rates and halting the balance sheet runoff in July. More rate cuts are likely coming, though the Fed's lack of clarity isn't helping. They are not alone. Central banks around the world are working in concert to combat global deflationary forces. And even though the Fed may be a bit behind the curve momentarily, restrictive monetary policy doesn't appear to be a threat going forward.

Exhibit 3: Central Bank News



Financial Times
Fed chair cements case for cut in interest rates
Jay Powell, chairman of the Federal Reserve, has cemented the case for the US central bank to cut interest rates based on mounting risks to ...
1 day ago

Wall Street Journal
ECB Follows Fed in Signaling Fresh Stimulus
European Central Bank officials signaled at their June policy meeting that they will consider injecting fresh stimulus into the eurozone economy ...
22 hours ago

Reuters
No-deal Brexit could bring near-zero rates: Bank of England's Vlieghe
The Bank of England might need to cut interest rates almost to zero after a no-deal Brexit, while repeated Brexit delays could also make a rate ...
4 hours ago

Reuters
Bank of Japan joins Fed in signaling easing if needed, keeps policy steady for now
TOKYO (Reuters) - The Bank of Japan kept monetary policy steady on Thursday but Governor Haruhiko Kuroda signaled readiness to ramp up ...
3 weeks ago

TheChronicleHerald.ca
U.S. Fed easing could prompt first China rate cut in four years: analysts
By Winni Zhou and Andrew Galbraith. SHANGHAI (Reuters) - China's central bank could cut its benchmark policy rate for the first time in four years if the U.S. ...
4 days ago

Reuters
Australia's central bank cuts rates again, says ready to ease more if needed
SYDNEY (Reuters) - Australia's central bank on Tuesday cut interest rates for the second time in as many months as it strives to revive a ...
1 week ago

Reuters
New Zealand central bank to hold steady this week but resume easing in third quarter: Reuters poll
WELLINGTON (Reuters) - New Zealand's central bank is expected to hold interest rates steady on Wednesday, but keep the door open for ...
3 weeks ago

BNamericas English
Could Brazil monetary easing begin this month?
There is growing market expectation that Brazil's central bank will soon kick off a monetary easing cycle in a bid to revive the sluggish economy.
1 day ago

Bloomberg
Russia Returns to Easing, Signals Two More Rate Cuts This Year
Russia's central bank shifted solidly to monetary easing, saying its first interest rate cut in more than a year on Friday could be followed by two ...
1 month ago

Livemint
RBI may cut rates by another 25 bps in 2019: Fitch Ratings
Mumbai: India's central bank is likely to cut interest rates by another 25 basis points in 2019, following three cuts of a similar quantum so far, ...
3 weeks ago

Interestingly, this July marked the first time since 1996 that the fed has cut rates with equity markets near all-time highs. Since 1980, there have been 17 such occurrences, with the typical 1 year equity returns being consistently positive.

Exhibit 4: Rate Cuts Near Market Highs

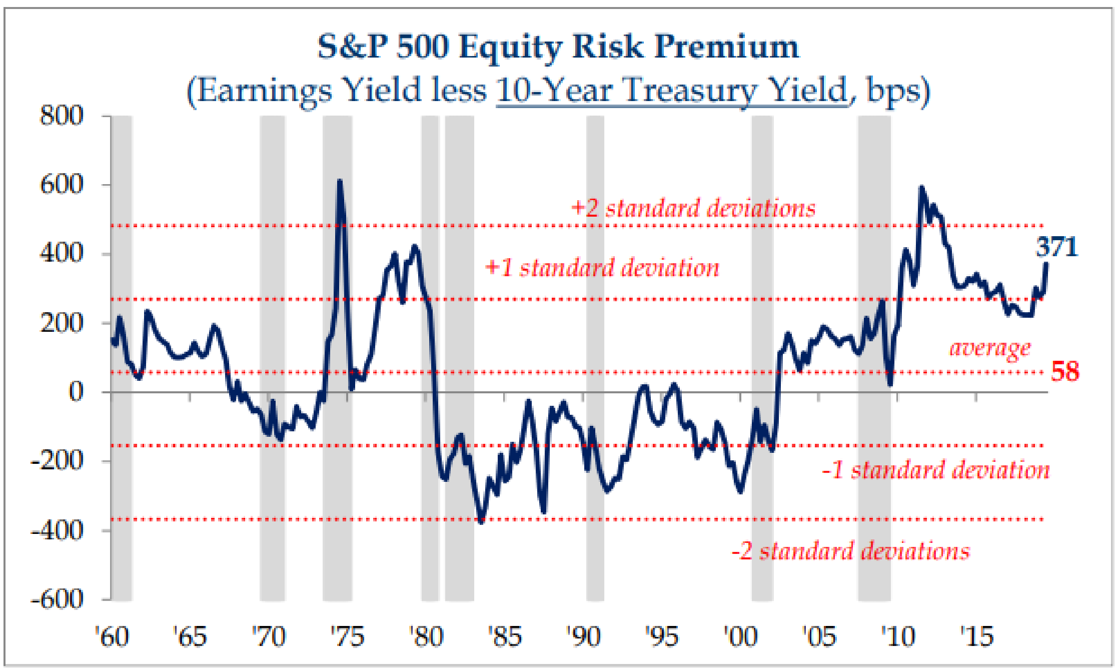
S&P 500 Returns After Rate Cuts Near New Highs (2% From Highs)				
Date Of Rate Cut	Fed Funds Rate	Rate Change	% Off All-Time Highs (Day Before Fed Cut)	S&P 500 Return 1-Year Later
1/31/1996	5.25%	-0.25%	0.0%	21.4%
7/6/1995	5.75%	-0.25%	-0.7%	23.1%
9/4/1992	3.00%	-0.25%	-1.7%	10.4%
7/2/1992	3.25%	-0.50%	-1.9%	9.1%
10/31/1991	5.00%	-0.25%	-1.0%	6.9%
8/6/1991	5.50%	-0.25%	-1.2%	10.4%
3/8/1991	6.00%	-0.25%	-0.4%	8.1%
7/13/1990	8.00%	-0.25%	-0.7%	3.2%
7/31/1989	10.50%	-0.50%	0.0%	8.6%
8/26/1986	7.50%	-0.50%	-1.9%	34.5%
4/21/1986	8.50%	-0.50%	-0.3%	16.9%
3/7/1986	9.00%	-0.50%	-0.8%	29.0%
5/20/1985	10.00%	-0.50%	0.0%	24.5%
1/15/1985	10.50%	-0.25%	-1.2%	21.2%
2/28/1983	10.50%	-0.50%	0.0%	7.6%
1/11/1983	11.00%	-0.50%	0.0%	15.1%
7/25/1980	11.00%	-0.50%	-0.6%	5.5%
			Average	15.0%
			Median	10.4%
			Higher	17.0%

Source: Ryan Detrick, LPL Financial LLC

Valuation

Third, is the market overvalued? There are many ways to look at this. Currently, the S&P500 trades at 18.6x earnings, roughly the same multiple it held in 2015 and down from 23x we saw in January of 2018. Price to Free Cash is 22x, EV/EBITDA is 12x. When answering the question if those are reasonable valuations, it helps to ask another question – relative to what? Let's look at equity valuations relative to the 10 year treasury. Following stronger than expected 2nd quarter earnings, and money flooding the bond market, the equity risk premium has spiked to 1.5 std deviations above the historical average. The average difference between the earnings yield on the S&P and the 10 year treasury is around 58 basis points. Today that gap has widened to 371 basis points. Which investment looks overvalued?

Exhibit 5: Equity Risk Premium



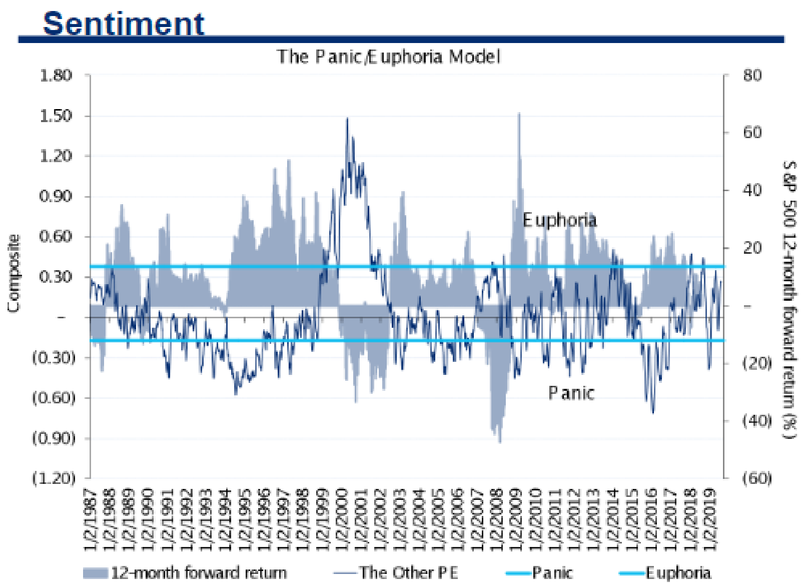
Source: Strategas

Sentiment

Lastly, we come to sentiment. Levels of fear and greed, exuberance and caution, are hard to measure with precision. But we have a few tools, such as fund flows and surveys, which are helpful. Below we highlight three of these indicators with the punch line being none are close to what we normally see at market tops.

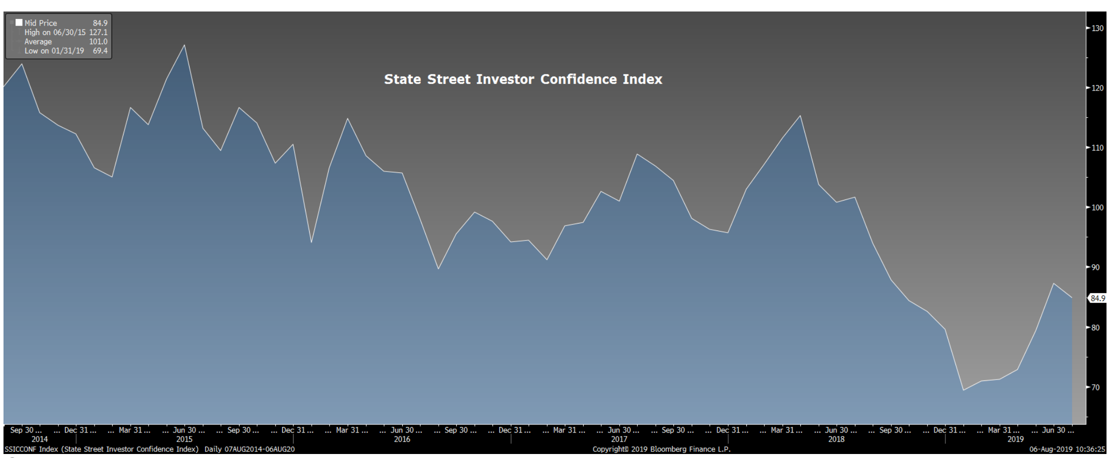
Exhibit 6: Sentiment Indicators

Citi's Panic Euphoria model, which combines short interest, margin debt, survey data, gas prices, fund flows, and derivative activity in order to gauge investor sentiment, remains in neutral territory.



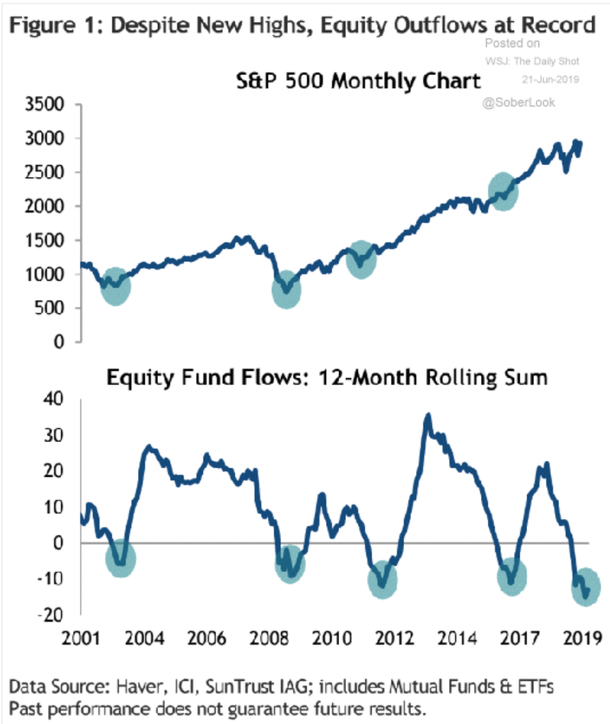
Source: Haver Analytics, Pinnacle Data, and Citi Research – U.S. Equity Strategy

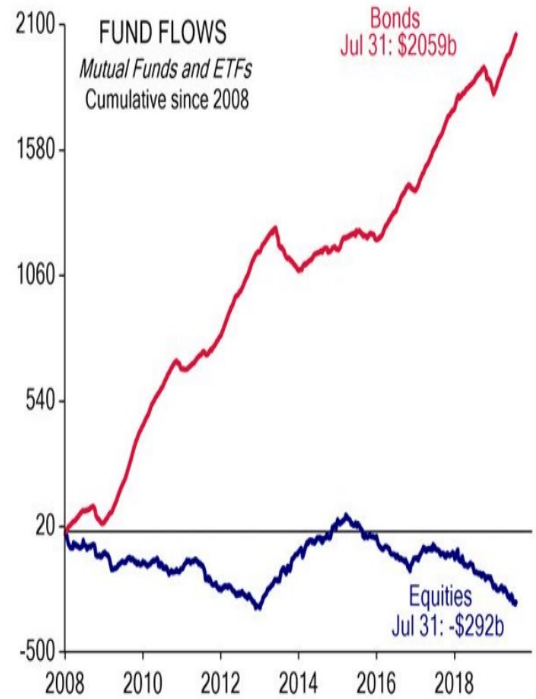
The State Street Investor Confidence Index analyzes changing levels of risk within portfolios - no exuberance here.



Source: Bloomberg

Equity fund flows are firmly in negative territory. The market has risen in the face of continued selling pressure by institutional and household investors.





Sources: WSJ, ISI

In summary, despite all the negative headlines swirling about lately, these four reliable signals remain supportive of bull market continuation. Inflation is not problematic, monetary policy is not hostile, sentiment is not euphoric, and valuations are not out of control relative to interest rates and inflation. Short term volatility and weakness can appear at any time, but absent a black swan, we don't see the makings of a big long-term market top at the moment.

An interesting study at this point, with negative sentiment readings and record withdrawals from equity funds, is discovering how the market continues to climb in the face of it. If everyone has been selling, why hasn't the market reflected it?

Who's Been Buying?

On June 27th, Wells Fargo announced that their capital plan for 2019 had been approved by the Federal Reserve Board, a plan covering the time between the 3rd quarter of 2019 and the 2nd quarter of 2020. This plan includes raising the common dividend from $0.45 to $0.51 and repurchasing up to $23.1 billion worth of stock, which amounts to roughly 11% of its shares at current prices. Add up the 4.3% dividend yield and the 11% "buyback yield" and you get a holding that "yields" 15% (we'll put yield in quotes because of the indirect nature of buyback additions to total return). Does this "yield" seem extreme in a world where government 10 year gets you 1.6%? Among the large banks it's only a little above average.

Using this methodology, JP Morgan “yields” 11.1%, Bank of America “yields” 13.7%, and Citigroup “yields” 13.3%.

Exhibit 7: Bank “Yields”

Total Yield for Banks (Buybacks and Dividends)					
	Buyback Approval (Billions)	Market Cap (Billions)	Buyback Yield	Dividend Yield	Total Yield
WFC	$ 23.1	$ 216	10.70%	4.30%	15%
JPM	$ 29.4	$ 369	8%	3.20%	11.10%
BAC	$ 30.9	$ 282	11%	2.70%	13.70%
C	$ 17.1	$ 164	10.50%	2.90%	13.30%

Source: John Huber

Buybacks are even more prevalent in the tech sector. Apple recently announced it would add $75 billion to its repurchase plans, less than a year after a $100 billion announcement, while also increasing its dividend on both occasions. Since 2013, there are now 30% fewer shares of Apple outstanding.

Cisco has bought back $94 billion since 2007, with about 30% of that coming over the past year following tax reform and repatriation of cash from overseas.
Juniper has reduced its share count by 35% since 2011.

The list is comprehensive. Below are a few selected charts representing the magnitude and effect corporate buybacks have had. For much of the past year there has been a disconnect between an equity market at all-time highs with global economies clearly slowing, trade-wars dominating the news cycle, and a momentarily inverted yield curve following a Fed that went a touch too far in December. Given this disconnect, we think it makes sense to take look at the supply side.

Exhibit 8: S&P Buybacks

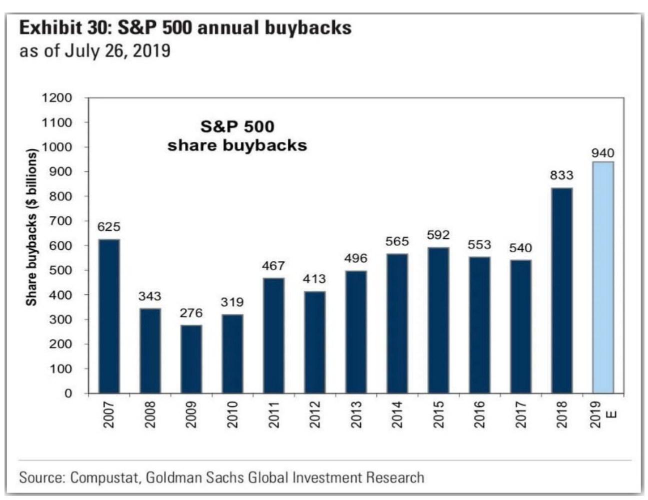
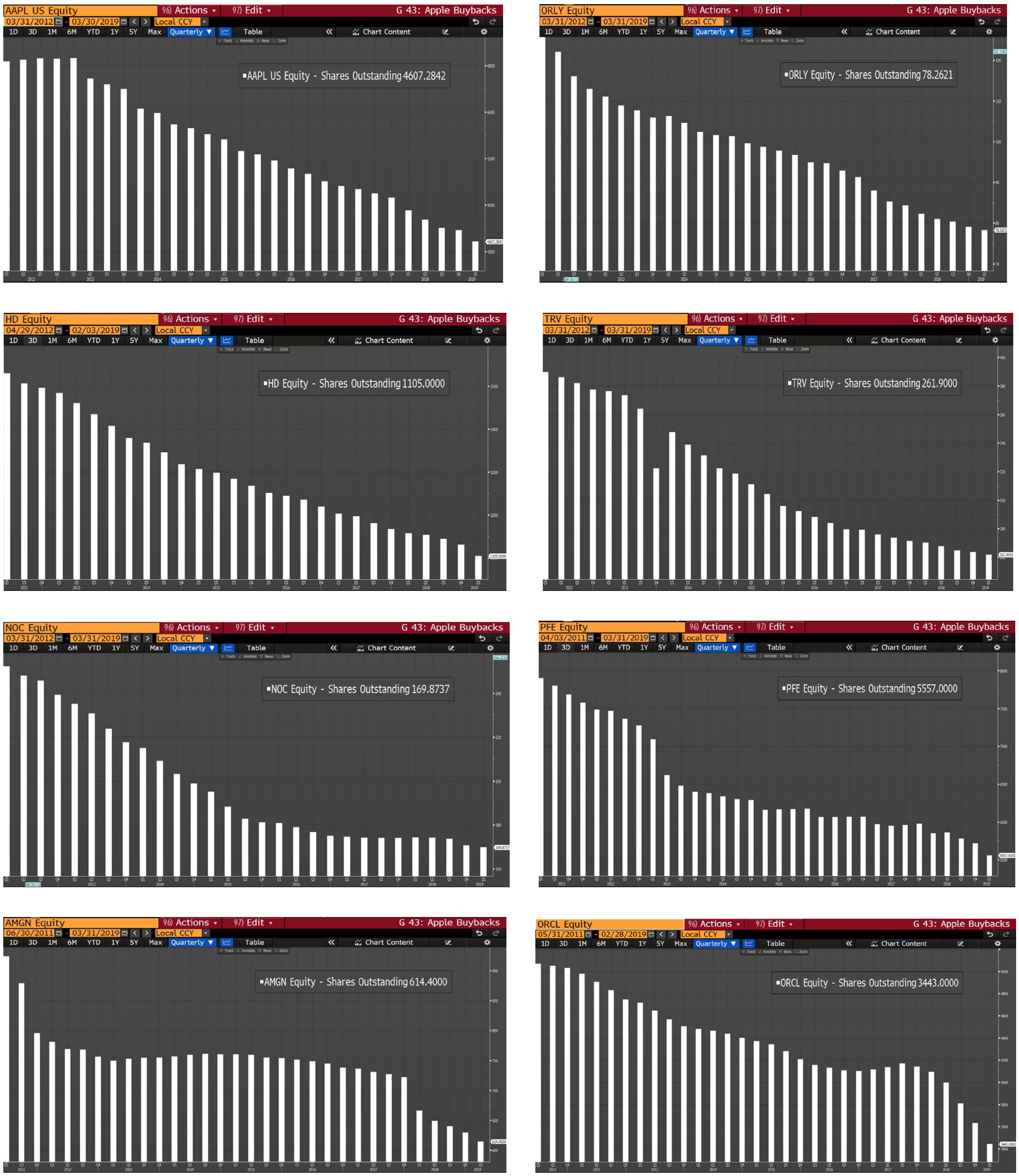


Exhibit 9: Shares Outstanding



In 2018, companies in the S&P 500 spent $833BN buying back their own stock, and 2019 is trending higher.

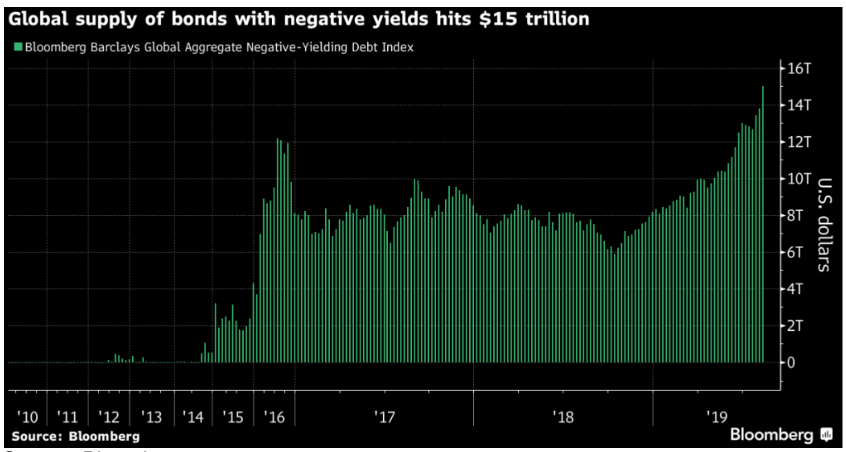
"Tax reform makes it possible for us to execute our program more efficiently, both through share repurchases and payment of dividend to the tens of millions of investors who own Apple stock either directly or indirectly from large pension funds to individuals with retirement accounts." – Tim Cook

Negative Rates

"There's no chapter in your bond math book on this" – Scott Thiel, Blackrock

In the world today, there exists roughly $15 trillion of bonds which if held to maturity are guaranteed to lose money. Powerful demographic and deflationary forces have created this phenomenon, which is being counteracted by inflation attempts by central banks. The forces for deflation in some parts of the world are more powerful than others with the US in much better shape than Europe or Japan. So it is understandable that the central banks of these areas are required to be more aggressive in their response.

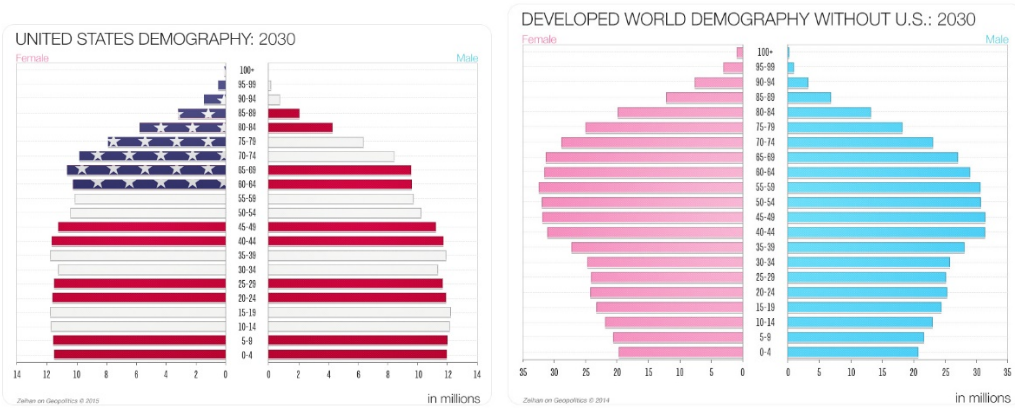
Exhibit 10: Negative Yields

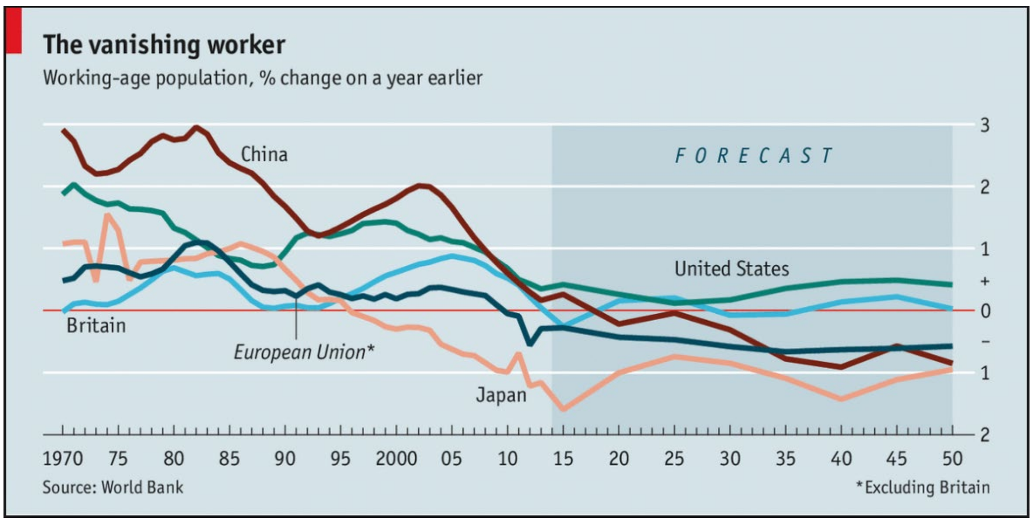


Source: Bloomberg

As populations age, the ratio of savers to borrowers rises. The largest population contingent in the world, the Baby Boomers, are finding it difficult to locate enough young borrowers of their capital. So as supply outraces demand, rates come down. This coupled with the fact that older generations spend less and generally take down their investment risk profile explains a lot about bond fund flows and the persistently low velocity of money across the developed world. This demographic deflationary force can only be counteracted by money supply growth. In our own country, with one of the better demographic profiles, the Fed is still fighting to get inflation up to 2%, as we are 10 years into an expansion.

Exhibit 11: Aging Demographics





We admit we don't know how this plays out. Some feel this is the new norm for a generation and sub-zero is just a number, while others say this will quickly lead to another banking crisis. In a recent call our staff had with Ed Hyman, we asked him his thoughts on the amount of global debt yielding negative returns. His perfect response was, "I don't know what it means, all I know is I'm waking up in a cold sweat thinking about it."

Trade Wars

This has been the red-hot topic for over a year now and its prevalence and effect on the market has waxed and waned. As with any issue, there is a cast of characters with predictions on both extremes. One camp will tell you that because of U.S. relative strength in these negotiations, victory by way of Chinese capitulation (or whoever we're currently targeting) is inevitable. On the other hand we've heard the arrest of the Huawei CFO likened to the assassination of Arch Duke Ferdinand which kicked off the First World War. It's helpful to keep in mind that the economic prediction business is closely related to the entertainment business.

Rather than speculate about hidden motives or the beginnings of a new world order of trade, we'd rather simply present the facts we know so far. Below is a succinct summation from Jason Trennert at Strategas.

1) Last night, the U.S. Treasury Department labeled China a currency manipulator for the first time since 1994. Usually, the mechanism for a resolution of this conflict would be the start of negotiations.

2) Unfortunately, most recent U.S.-China trade talks concluded without much progress and currently there are no additional dates set for further meetings. The trading relationship between the U.S. and China may need to get worse before it gets better.

3) President Trump announced that the U.S. would proceed with a 10% tariff on the remaining $300bn billion in goods from China that will go into effect on September 1. The worry here is that many of the remaining goods are those that directly affect consumers.

4) China's response to the Presidents tariff threat was to allow the Yuan to weaken and asking state-owned companies to suspend imports of U.S. agricultural products. The Yuan has weakened versus the dollar from roughly 6.25 in April 2018 to over 7 today.

5) America's biggest imports *from China* are electrical machinery ($152 billion), machinery ($117 billion), furniture and bedding ($35 billion), toys and sports equipment ($27 billion), and plastics ($19 billion). America's biggest exports *to* China aircraft ($18 billion), machinery ($14 billion), electrical machinery ($13 billion), optical and medical instruments ($9.8 billion), and vehicles ($9.4 billion).

6) The U.S. runs a trade deficit with China of roughly $420 billion. We import $540 billion worth of goods and export $120 billion worth of goods with China.

7) We estimated the hit to U.S. GDP from previous tariffs to be roughly -0.5% over a year. A little more than half of this is through reduced confidence & lower investment. These tariffs look like they are here to stay. Further tariffs in Sep at the 10% level would be an additional -0.2% drag, but this could intensify if the downward cycle that has already begun in mfg. spreads to other sectors of the economy (eventually resulting in credit stress & job cuts). Prospects for any rebound in global growth in the second half have clearly dimmed. An offset likely includes at least three fed funds rate cuts, in our base care, and likely other global central bank easing as well.

8) The hit to China GDP should be substantial as well; about -1% for a year though there may be offsetting local stimulus and/or an unwillingness to actually report a weaker number in China.

9) America runs a trade a deficit that is about 4% of its GDP. China runs a trade surplus that is about 2-3% of its GDP.

10) At the margin, we believe this makes the Fed even more likely to cut rates further in 2019 and probable they have to make additional cuts in 2020.

There is one other fact we would like to point out. The incentives for presidents to have the economy in good shape at the right time are fairly clear. Only one, Calvin Coolidge in 1924, was able to win a re-election following a recession within the previous 2 years. If I were betting on the market-friendliness of the President's trade tweets, I would wager they get friendlier as the election gets closer.

Exhibit 12: Economy and Elections

IS IT ALWAYS "THE ECONOMY, STUPID"?

No Recession in 2 Years Before Election

RECESSION?	President (Year)	REELECTION?
NO	Obama (2012)	YES
NO	Bush43 (2004)	YES
NO	Clinton (1996)	YES
NO	Reagan (1984)	YES
NO	Nixon (1972)	YES
NO	LBJ (1964)	YES
NO	IKE (1956)	YES
NO	Truman (1948)	YES
NO	FDR (1944)	YES
NO	FDR (1940)	YES
NO	FDR (1936)	YES
NO	Wilson (1916)	YES

Recession in 2 Years Before Election

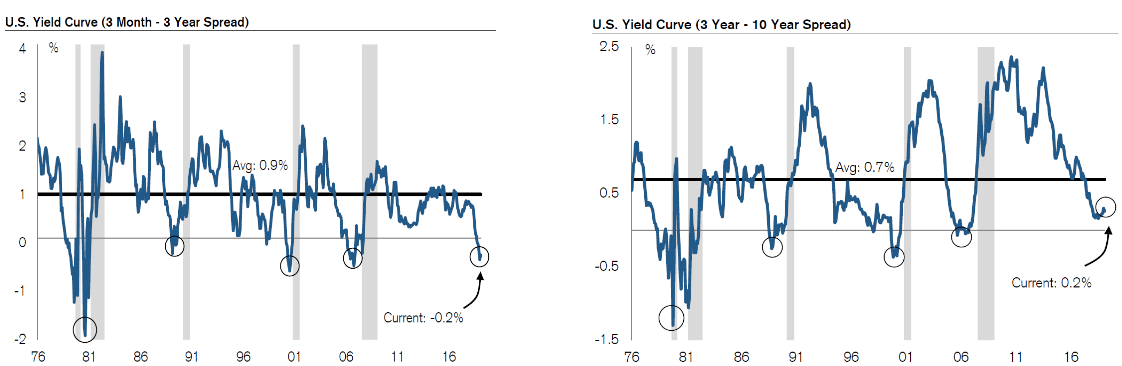
RECESSION?	President (Year)	REELECTION?
YES	Bush41 (1992)	NO
YES	Carter (1980)	NO
YES	Ford (1976)	NO
YES	Hoover (1932)	NO
YES	Coolidge (1924)	YES
YES	Taft (1912)	NO

Source: Mehlman & Assiociates

Yield Curve

After one rate cut, the short end of the curve remains slightly inverted while the longer end has retained its upward slope. We won't sugarcoat the fact that this a very clear late-cycle signal. As a quick refresher as to why this matters and how it happens: In order to snuff out inflationary pressures, the Fed raises short term rates. Anticipating this, the market sells off short-duration securities pushing the yield up and eventually above longer-dated yields. Banks, which borrow short to lend long, become discouraged as their margins are squeezed. Loan growth slows and money creation through credit halts, usually triggering a recession. Fed moves take time to work their way through the economy and the yield curve suggests the hike in December was too much to handle. Now that the Fed is firmly on the other side (cutting), and inflation appears a lofty goal rather than a nuisance, we would expect Fed efforts will be more focused on policies that result in a steepening of the curve.

Exhibit 13: Yield Curve

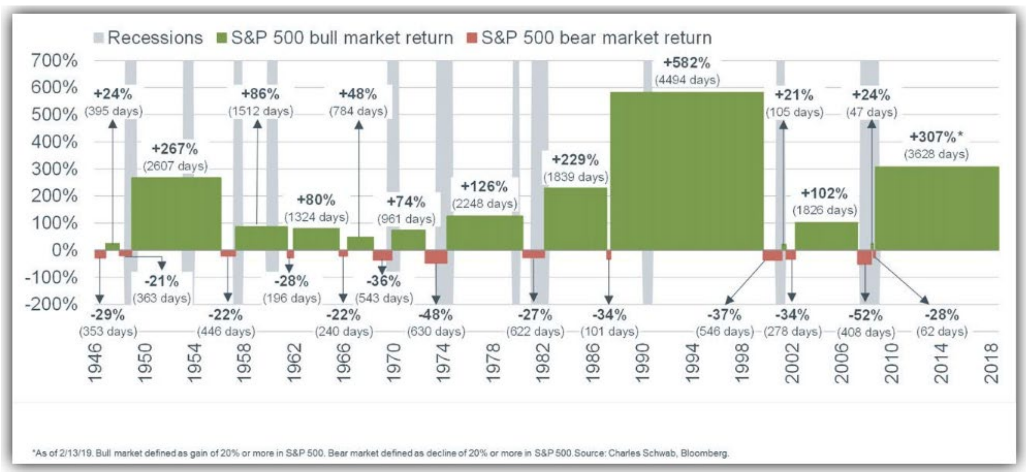


Note: 3-Year yield minus 3-Month yield; shaded area denotes recession
Source: Federal Reserve, NBER, Haver Analytics®, Credit Suisse

Note: 10-Year yield minus 3-Year yield; shaded area denotes recession
Source: Federal Reserve, NBER, Haver Analytics®, Credit Suisse

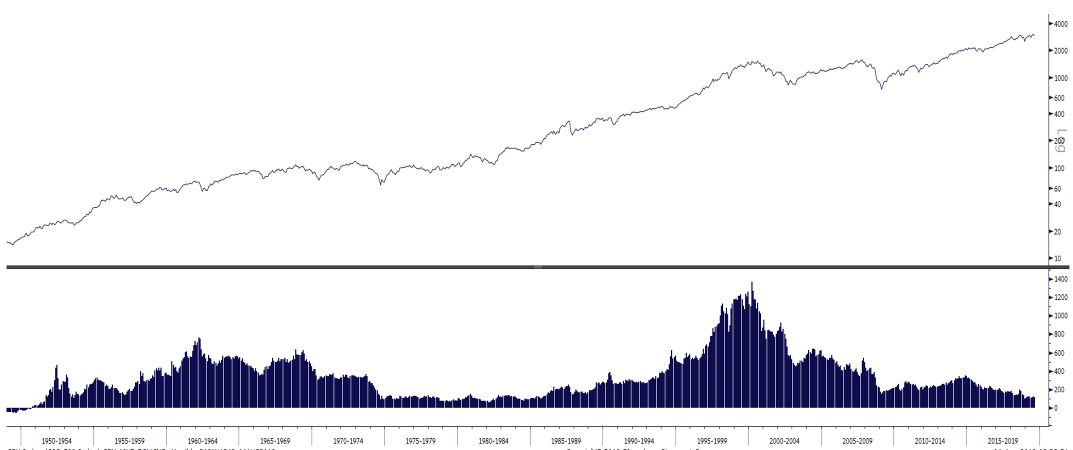
One last note for perspective: Our power as a pension fund, with the long-term always in view, lies in our ability to stay the course when it's uncomfortable. Market timing has been proven over and over again as a fruitless endeavor, especially when implemented as a policy over the long term (the more you attempt it, the worse your long term outcome). The chart below is a simple illustration. The green bars represent the total return of the S&P500 during bull markets and the red bars represent bear markets. The red bars are typically where bad decisions are made by asset managers and those decisions usually result in missing out on a portion of the green bars. Where should our attention be placed? As our time horizon is theoretically infinite, our efforts to mitigate the short term damage of bear markets should place a distant second to the more important goal of ensuring we are participating in bull markets.

<u>Exhibit 14: Bulls and Bears</u>



And finally, this is a look at the market's 20 year rolling return. As strong as the past 10 years have been, the 20 year still looks pretty average.

<u>Exhibit 15: S&P 20-year Rolling Return</u>



Source: Bloomberg

International Equity Strategy

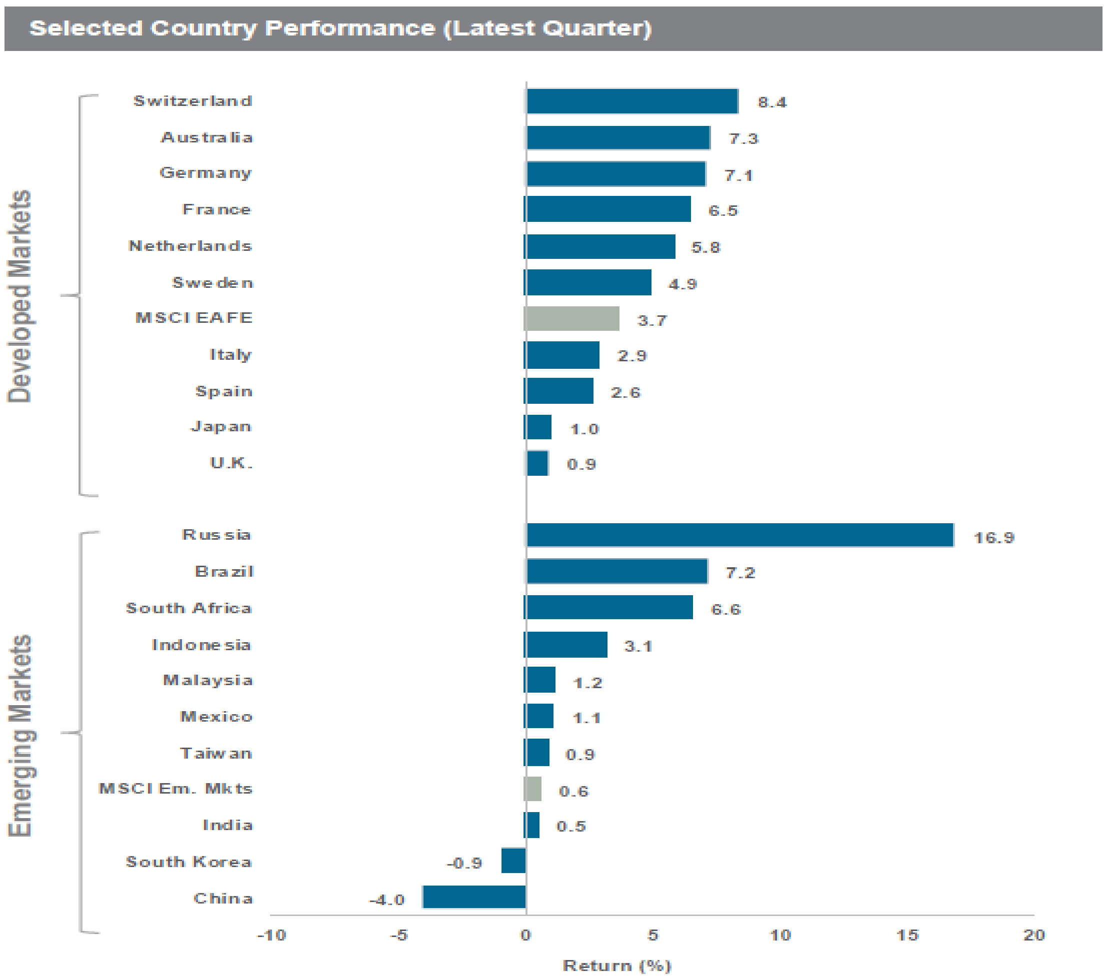
By Steve Lambdin

International equities managed to post decent gains in the second quarter of 2019 as central bank actions from around the globe were enough to overcome the continuing U.S./China trade war barbs, a weakening global economy, and heightened geo-political risks. However, these gains came with a high level of volatility as a smooth April gave way to a May downdraft only to be followed by very strong returns in June to finish the quarter. Needless to say, this is making investors very nervous having to live through these intra-quarter peaks and troughs. During the quarter, we saw several central banks around the globe adopt a more "dovish tone" and cut interest rates in order to re-invigorate economic optimism. If this is any indication of what is to come, then perhaps we will see more of this as we move through the rest of 2019. On the trade front, the world continued to watch the ongoing trade war between the U.S. and China. A breakdown in talks in May led to the announcement by the U.S. to raise tariffs on an additional $200 billion of Chinese goods as well as banning the Chinese giant telecom Huawei from doing business in the U.S. as well as barring U.S. suppliers from conducting business with the company. However, Trump relaxed these measures in late June as he met with China's leader Xi Jinping at the G-20 summit. As we found out later, these talks yielded nothing of real substance on the key issues of this trade war. As the Brexit saga continued, we saw a new leader take charge in the U.K. Boris Johnson was elected Prime Minister and has promised a final solution to Brexit by October 31st. This has increased the risk of a "no deal" scenario and could put this economy into a perilous situation as we move forward with this mandate. From an economic standpoint, we generally saw a weakening trend in global growth during the quarter, especially in the Eurozone and parts of the Asian basin. Global manufacturing PMI's look weak and could be trending downward. On the geo-political front, relations between the U.S. and Iran continued to deteriorate as Iran continued to pursue hostile actions toward the U.S. and some of our allies. The real risk here is further escalation of these hostilities in an already fragile region.

	June 2019		2Q 2019		YTD 2019	
Equity index returns (%)	U.S. dollar	Local currency	U.S. dollar	Local currency	U.S. dollar	Local currency
S&P 500	7.0	7.0	4.3	4.3	18.5	18.5
MSCI ACWI	6.5	5.7	3.6	3.2	16.2	15.9
MSCI ACWI ex USA	6.0	4.2	3.0	2.1	13.6	12.9
MSCI World	6.6	5.9	4.0	3.6	17.0	16.7
MSCI Emerging Markets IMI	6.0	4.3	0.4	0.1	10.1	9.7
MSCI EAFE	5.9	4.3	3.7	2.8	14.0	13.7
MSCI Europe	6.7	4.6	4.5	4.0	15.8	16.1
MSCI Pacific	4.6	3.7	2.4	0.8	11.2	9.9

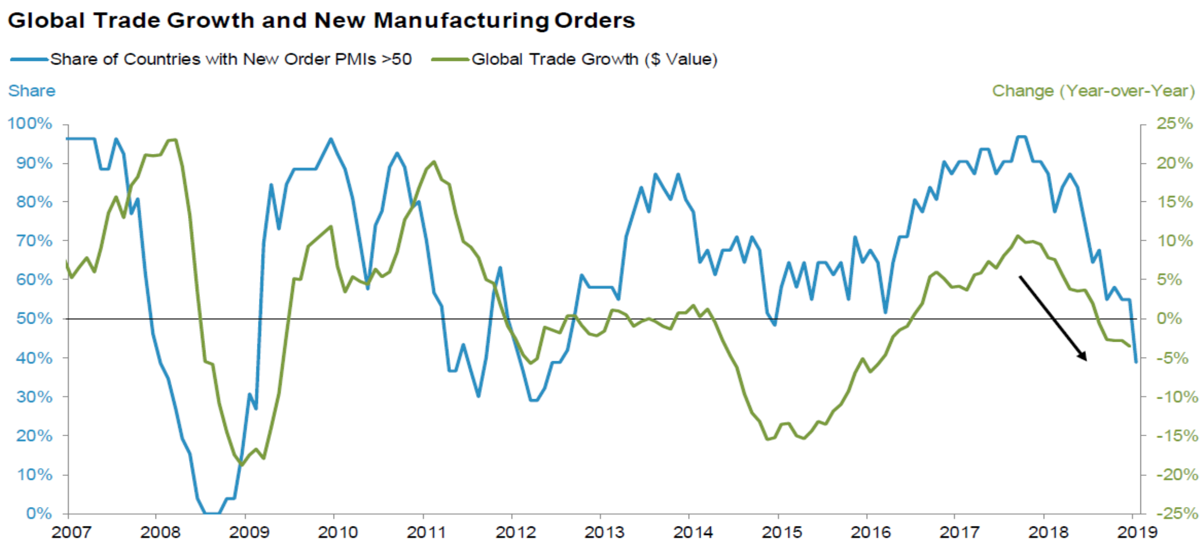
Source: RIMES and Capital Group World Markets Review Q2 2019

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +3.7% and +.6% respectively during the second quarter of 2019 vs. +4.3% for the S&P 500 Index. Large cap U.S. stocks continue to be the preferred destination for equity investors even though we saw gains in most equity asset classes in the period. The U.S. dollar was a bit weaker in the quarter and provided a small boost to returns for unhedged U.S. investors. For the second quarter in a row, the European region was stronger than the Asian region as the Japanese equity market was relatively weaker than most other Asian markets. All eleven economic sectors posted positive returns in the period. Gold finished up +9.6% in the quarter on the heels of an increasingly riskier global backdrop. Crude oil cooled off a bit, falling -5% from the previous quarter.



Sources: Baird Market Chart book; Morningstar Direct; MSCI

So far into the third quarter of 2019 thru early August, global equities have been on a downward path as fresh developments on the U.S./China trade war sent chaos through the global equity markets. Trump has proposed additional tariffs on another $300 billion of Chinese goods and China responded by letting the Chinese Yuan fall through a critical level. Subsequently, Trump has labeled China as a currency manipulator, which is little surprise to anyone. This is a further escalation in this trade war as both sides seem far away from any type of meaningful agreement. This just makes an already weakening global growth environment that much more perilous to navigate going forward. The MSCI EAFE Index is down about -3.7% and the MSCI Emerging Markets Index is down approximately -6.2% through early August, vs. a flat return for the S&P 500 Index. U.S. equities still seem to the "best house" in a not so good neighborhood at the moment.

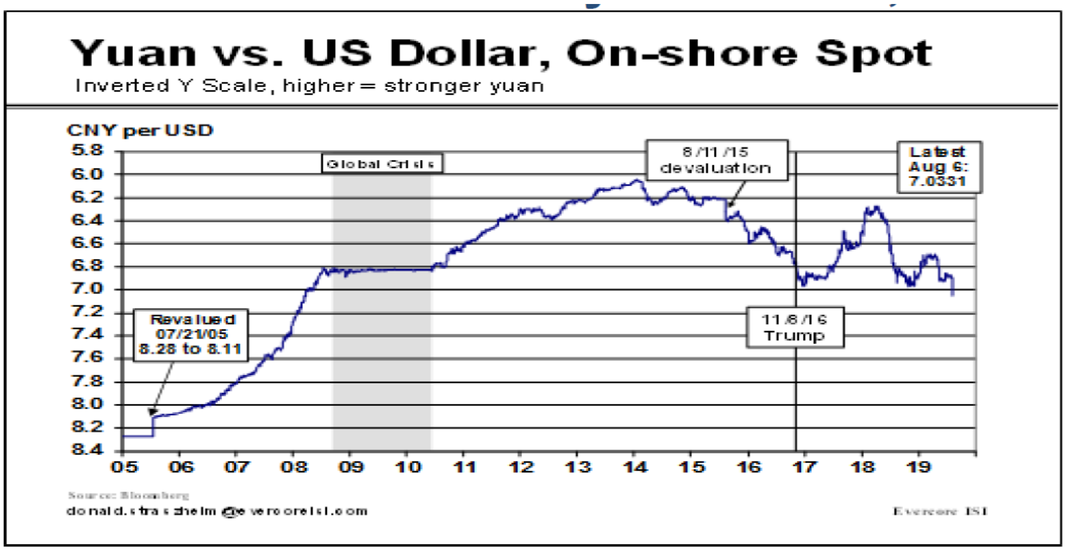


Sources: CPB Netherlands Bureau for Economic Policy Analysis; Markit; Haver Analytics; Fidelity Investments (AART)

<u>Asia Update</u>

Asian equities kept the recent momentum going and posted another positive return in the second quarter as investors embraced various central bank actions in the region to push equity markets higher. In addition, economic growth was not as bad as feared and was well received by investors. This was enough to counter the lingering effects of the trade war that appears to have no end in sight. The MSCI Pacific region rose +2.4% on the heels of a very strong equity market in Australia as the Reserve Bank of Australia (RBA) cut interest rates in the period and could cut them more in the months to come. Also, elections in Australia surprised most investors and provided a nice shot in the arm.

After taking a break in the first quarter, China's economy resumed its downward growth trend as second quarter GDP rose +6.2% from a year earlier, which was the weakest growth rate in 30 years. While this was very much anticipated and literally did not surprise anyone, it still is a clear indication the ongoing trade war with the U.S. is beginning to have some effect on the economy. At this point, we would expect to see a ramp up of stimulus measures aimed at stabilizing growth in region, as many expect the growth rate to inch downward for the balance of 2019. This will probably be domestically oriented and focus on infrastructure spending. Looking at a few of the key economic data points from the quarter, industrial production continued to slide as YTD production through June rose only +6% from a year earlier. This indicates to us that manufacturing is clearly being dented from the trade war. Fixed asset growth also trickled downward as second quarter growth came in at +5.8%, which is at a decade low as well. Net exports in this economy are trending down, as June rose +6.1% in U.S. dollar terms, and only remain positive due to the curtailment of imports in the period. Tariffs are having a significant impact on this key economic data point. Retail sales growth actually accelerated in the second quarter and was up +8.5% from a year earlier, which was above expectations. This was probably due more to an unexpected rise in automobile sales in June as well as rising CPI in the period. June CPI rose +2.7% from a year earlier and puts this statistic right near five year highs. Even at this level, we would not expect this to curtail any move by the People's Bank of China (PBOC) to cut interest rates in the future to keep the economy going through this trade war. Needless to say, the world remains focused on this trade war and developments on this front will set the direction and tone for the markets over the next few months in our opinion.



Source: Bloomberg; Evercore ISI

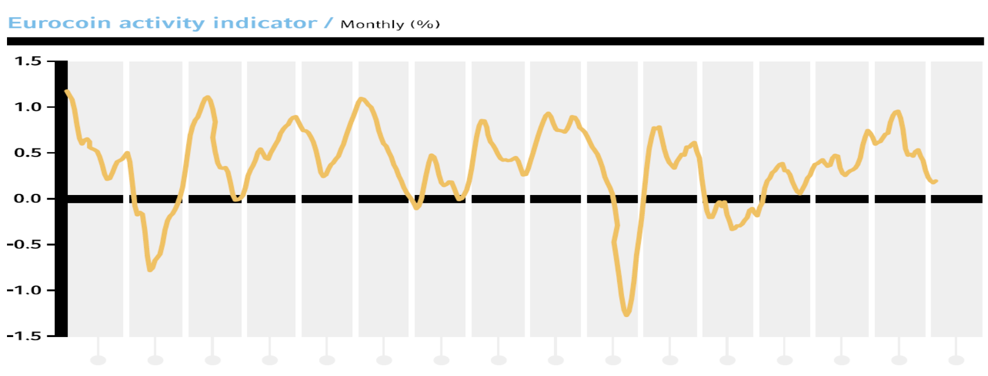
The Japanese economy surprised to the upside in the second quarter as GDP rose +.4% from the previous quarter, or +1.8% from the year earlier period. We believe this unexpected strength came from buying ahead of the anticipated October sales tax hike. We would not be surprised to see this repeat again in the third quarter, but not to the degree we just witnessed. Exports fell -.1% in the quarter and imports rose +1.6%, providing a net drag for overall growth. On another weak point, industrial production in June fell -3.6% from a month earlier as automobile and electronic production fell from trade issues and a weakening global outlook. Japan's leading economic index continued to fall in the quarter as June's reading of 93.3 is the lowest level in over nine years. Businesses in this region right now have little reason to be optimistic until some clarity develops on the trade front and some light can be seen on the economic growth front. The Bank of Japan (BOJ) kept its short term rate at -.10% and is still targeting a 10-year government bond target yield at 0% at its April meeting. The BOJ continues to acknowledge that risks to growth and inflation remain to the downside and its easing stance will remain in place. So basically nothing new on this front. Consumer confidence remains in a fall as July's reading fell to 37.8, which is another multi-year low with this data point. We are not looking for much of an improvement over the near term with the consumer. The labor market remains very tight as the jobless rate fell to a new low of 2.3% in June, while the jobs-to-applicant ratio fell slightly to 1.61, remaining very near a historical record. This tight labor market has now brought the female workforce to the 30 million level for the first time ever. This is one of the goals of the Prime Minister in order to expand the economy in the region. At this point, we still see the increase in the value added tax (VAT) as going through as planned in October. We believe this is the consensus view as the economy seems to be benefitting from buying ahead of this increase. However, this could create a headwind after this event, especially if we don't see some type of resolution to the U.S./China trade war, which looks increasingly likely at this point. Therefore, we could see this economy eke out some level of small growth in the third quarter. Whether this pushes equity markets higher here remains to be seen.

Sources: Evercore ISI

Europe Update

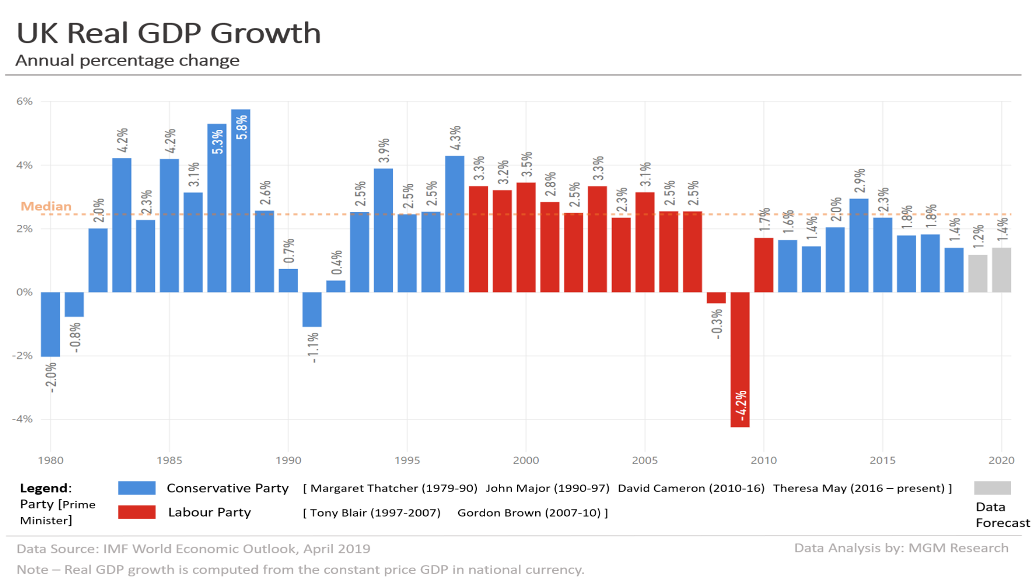
European stocks rose in the second quarter as the European Central Bank (ECB) indicated that it may slash interest rates and even restart their quantitative easing program in an effort to stabilize this region's economy in the face of a global slowdown. This posturing by the ECB was enough to shake off the continuing Brexit uncertainty, U.S./China trade war, weak economic readings, political turmoil in Italy, and the lack of any progress on a European Union (EU)/U.S. trade deal. All of this pushed the yield on German 10-year bund down to a historic low of -.58% as of early August. In fact, 10-year bonds in France, Switzerland, Sweden, and the Netherlands all lie in negative territory. Over the entire bond spectrum, a large percentage of European bonds lie in negative yield territory. This is something that has really never been seen before and is a sign of just how dire things have become in Europe. But nonetheless, Draghi's comments pushed bonds and stocks higher as loose monetary policies look here to stay. As one would expect, economically sensitive sectors such as Technology and Industrials performed the best vs. the more defensive areas of the equity markets. The MSCI European Index (ex. U.K.) rose +5.8% in the quarter as all but one sector moved higher in the period.

The European economy continued to post very marginal growth in the period as second quarter GDP only rose by +.2% from the previous quarter, or +1.1% from the year earlier period. This was a slight deceleration in growth from the first quarter, which was widely anticipated. This was the weakest growth seen in five years. Most of the major economies in the region saw a significant slowdown in the quarter. No doubt the global slowdown is effecting this economy as the region depends much more on exports than the U.S. economy. The German automobile sector was hit especially hard in the quarter from tariff related rhetoric. As expected, Eurozone industrial production was down about -.5% in the second quarter from a year earlier. Only some slight strength from the French and Spanish economies prevented this from being much worse, as the German production was down significantly in the period. We don't expect any recovery here over the next few months as factory orders look weak and the external risks of Brexit and U.S. trade issues are still firmly in place. The index of executive and consumer sentiment continued its recent trend, moving down to 102.7 in July, which is the lowest levels in over three years. Businesses leaders see very little to be positive about over the near term. Weakness is showing up on the consumer end as well, as retail sales were up only +2.0% in the second quarter, which is a slower pace than the previous quarter. It's hard for the consumer to help much when everything they hear seems very pessimistic at the moment. Core CPI has been relatively stable lately as July was reported to be up +.9% from the year earlier, still indicating very little inflation in the economy. As mentioned earlier, the ECB made no change to interest rates at its late July meeting, but did signal its intention to cut rates in the coming months as well as restarting their bond buying program. This is a drastic shift in policy and could be beneficial for the region's economic outlook in the coming months. Employment indicators actually seem decent at the moment as June unemployment rate fell to 7.5%, which is another fresh new low since the great recession. However, with the global slowdown taking shape now, we believe it will be hard to see much more improvement in this statistic going forward. Just recently, we saw Deutsche Bank announce plans to trim their global workforce by 18,000 employees as they shut down some business units. We hope this will be a fairly isolated occurrence. As things stand now, we see the potential for a lot of risk in the economic picture in the Eurozone from the global slowdown, the ongoing China/U.S. trade war, and a hard Brexit. Further escalation is a big risk for the region. With these issues in mind, we believe investors will be reluctant to invest heavily in equities until some clarity comes about.



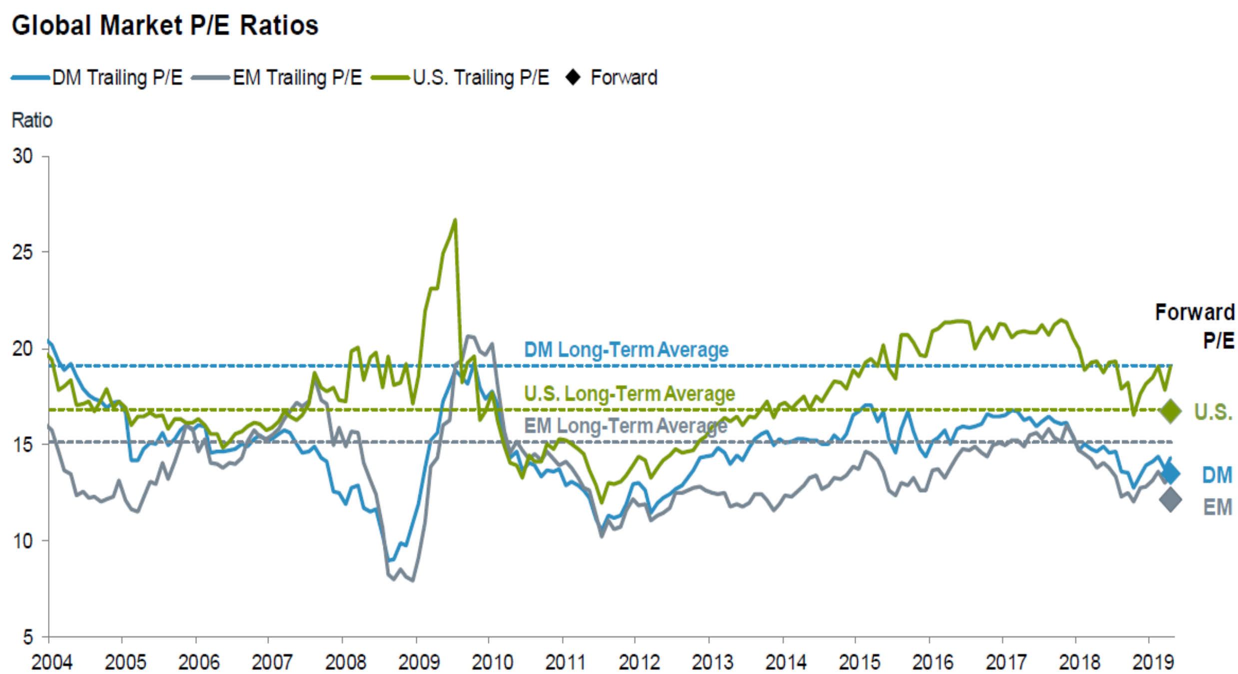
Source: Thomson Reuters Datastream; Bank of Italy; Russell Investments

The central issue facing the U.K. economy at this point still remains Brexit. These failed negotiations between the EU and U.K. ultimately led to the resignation of Theresa May and the subsequent election of Boris Johnson as Prime Minister. Johnson has promised some type of Brexit resolution by the end of October. Whether this is a hard exit (no deal) or a softly negotiated one remains to be seen. The EU has publically stated there will be no change in their position on Brexit. With this mind, we see escalating chances of a “no deal” as we move toward late October, with the potential of further economic disruption to follow. Ultimately, we do not know what this will look like and hope it does not come to this. Investors are becoming more anxious by each passing week they see no progress on this front. As a result of this uneasiness, the MSCI U.K. Index lagged most other European equity markets and returned only +.9% in the second quarter as the British Pound fell nearly -3% against the U.S. dollar. From an economic perspective, the economy here continued to slow as second quarter GDP fell by -.2% from the previous quarter, but grew by +1.2% from a year earlier. This was the first quarterly contraction in this economy since 2012. Industrial production fell -.1% in June from a month earlier, or -.6% from a year earlier. Most of the damage was done by a weak manufacturing environment stemming from all the trade issues circling the globe at present. Further evidence of this was reflected in exports falling by -3.3% in the second quarter. Most other sectors of industrial production were surprisingly decent. Retail sales have been a mixed bag lately, as June sales were stronger than expected and rose +1% after falling in both April and May. We see this pattern of volatility in this data point continuing over the next few months. Core CPI remained very steady lately as June’s reading of +1.8% from a year earlier is the same level it has been from previous months and is still below targeted levels. At its recent early August meeting, the Monetary Policy Committee (MPC) voted to maintain its benchmark interest rate at .75%, while maintaining its bond purchase target of 435 billion pounds, including 10 billion in corporate bonds. Nothing has changed on this front in quite some time. The second quarter unemployment continued to move in the right direction and fell to another multi-decade low of 3.8%. Employment increased by another 28,000 workers in the quarter with ending employment at yet another new record of 32.75 million workers. Wage growth remained very steady as wages grew by +3.4% in the three-month period ending in May. This is one data point that still look healthy at the moment.



Emerging Markets

Emerging market equities were the weakest performing equity asset class in the second quarter as Chinese equities fell -4% as the trade war with U.S. lingered on. This is also being felt in other Asian countries as the Korean, Taiwan, and Indian equity markets were weak as well. Negotiations with the U.S. have been up and down over this period and further escalation seems almost certain. Chinese internet companies were especially weak in the quarter as were energy companies from weak oil and gas prices. Outside of the Asian basin, Russian equities were very strong as many saw a less likelihood of U.S. economic sanctions over the near term and Brazilian stocks remained strong as the new leadership begins to overhaul the ailing pension system. Overall, the MSCI Emerging Markets Index only rose +.6% in the quarter, which was a significant "cooling off" from the previous quarter. We would expect these equities to remain a relative under-performer until investors see some type of positive news flow on the trade negotiations between the U.S. and China. No doubt, we still remain in a heightened risk environment as this unfolds.



Sources: Fidelity Market Update Q2 2019

International Equity Activity/Strategy

Over the next few months, we would expect global equities to be quite volatile as a multitude of issues remain in play. The on-going trade war with China appears to be escalating further as both sides are playing their respective hands and no progress appears to be made. Brexit remains the major issue in Europe as the newly established late October deadline looms ever closer. Neither side has offered any hope of moving toward an agreement. Geo-political tensions are running high in the Middle East with Iran and the riots seen in Hong Kong are growing more worrisome by the week. All of this is happening just as a global economic slowdown grows firmer with each new round of economic data points. However, on a positive note, we are expecting aggressive stimulus actions by many of the world's central banks over the next few months. This alone could give investors much needed confidence or at least cushion the blow from further equity market weakness. At this point, we still do not see a recession over the very near term, but are not as confident as we were just a few months back. We are seeing some recession indicators gaining more credence. Going forward, we must be watchful on developments in the China/U.S. trade war. This is probably the most important issue over the next couple of months and will ultimately set the tone and direction for most of the global equity markets.

We recently added $159 million to our Emerging Markets asset class in mid-May as the price of EEM finished below our put strikes for the month of May. We expect to continue to remain active with our put and call writing strategy on EEM over the next few months in an effort to bring in some current income as well as to add further to this asset class after an extended period of under-performance lasting several years. Premiums for doing this strategy still look attractive in the current low interest rate environment. Our current allocation to Emerging Market equities is approximately 3.0% of total assets and approximately 10.5% for MSCI EAFE equities across our TRS, ERS, and JRF portfolios. *(Credit is given to the following entities for charts provided: EU Commission, Thomson Reuters Datastream, CBOE, MSCI, Capital Group, RIMES, DataInsight, China NBS, Capital Economics, Bank Of England, Bloomberg, Blackrock, Strategas, ONS, CBI, Markit, Baird Market Chartbook, Fidelity Investments (AART), ISM, IMF World Economic Outlook, MGM Research, Baird Market Update, MSCI, Factset, Evercore ISI, John Hancock Global Market Outlook, China National Bureau of Statistics, CPB Netherlands Bureau for Economic Policy Analysis, Haver Analytics, Bank of Italy, Russell Investments, and Morningstar Direct)*