Quarterly Economic Update

February 25, 2020

MACROECONOMIC COMMENTARY

Fiscal/Monetary Policy

By Michael McNair

We finally have a signed trade deal between the US and China after two contentious years. However, the signing of the "phase one" China trade deal represents more of a start point than a finish line.

The US middle and working-class has shouldered the burden of the persistent US trade deficits and they have had enough. The motivation for Donald Trump's trade policy is that he correctly identified the opportunity to appeal to the discouraged American working-class. Donald Trump is not the cause of the trade war, he is the result.

Donald Trump's trade protectionist message resonated in key battleground states throughout the Midwest. Hillary Clinton's fatal mistake was allowing Trump to siphon these historically left-leaning voters with the traditionally democratic platform of trade protection. The Democratic nominee in 2020 will not make the same mistake. They will match Trump's protectionist rhetoric in an attempt to neutralize Trump's message with these crucial swing voters in a way that Hillary Clinton failed to in 2016. For that reason trade friction with China, and Europe is likely to pick-up after the election regardless of who wins the presidency.

We have made several non-consensus calls on how the economy will react to trade policy. In this edition of the *Fiscal Policy Report*, we will reexamine those predictions to see how they have played out.

Prediction #1: Tariffs are deflationary, not inflationary

Of all our predictions this might have been the most non-consensus. Today's economists can be forgiven for lacking the requisite knowledge of how tariffs impact the economy because they haven't played a major role in the global economy in their lifetime. This knowledge gap among today's economists is the reason we have dedicated the pages of the *Fiscal Policy Report* to explaining the workings of the global trading system over the past two years.

Most economists start with the a priori assumption that tariffs raise prices and never even consider the possibility that they would be deflationary. When forecasting how tariffs will increase inflation economists simply add up the cumulative cost increases that tariffs create. Economists often fall into the trap of using this type of reductionist approach to economics and only consider the first-order impact but fail to think deeply about the system as a whole.

A holistic examination of the system shows that tariffs might raise the price of some goods but it will cause the price of other goods to fall because it does not increase income in the economy - and by definition spending = income. For example, if US income is $14 trillion and $500 billion of taxes are placed on certain products, then consumers will buy $500 billion less of goods and services because they only have $14 trillion to spend.

<u>Tariffs work by increasing a country's savings rate.</u> The savings rate = domestic production – domestic consumption.

A tariff is effectively a tax on domestic consumers, whose real incomes decline, and a subsidy to domestic producers, whose prices fall relative to their foreign competition. A decrease in domestic consumer's real incomes and increases the competitiveness of domestic producers causes production to rise relative to consumption – in other words, a rise in the savings rate.

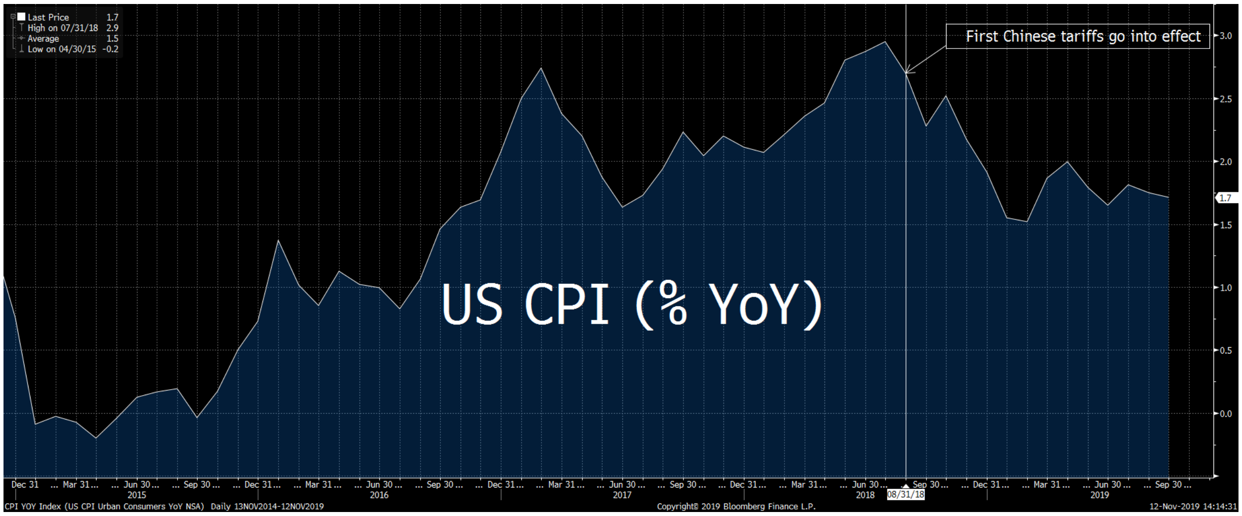
There are only two forms of demand: consumption and investment. Therefore, if consumption declines the economy can only grow if investment increases by a sufficient amount to offset the decline in consumption. Since tariffs reduce consumption, economic growth will only occur with a boom in investment.

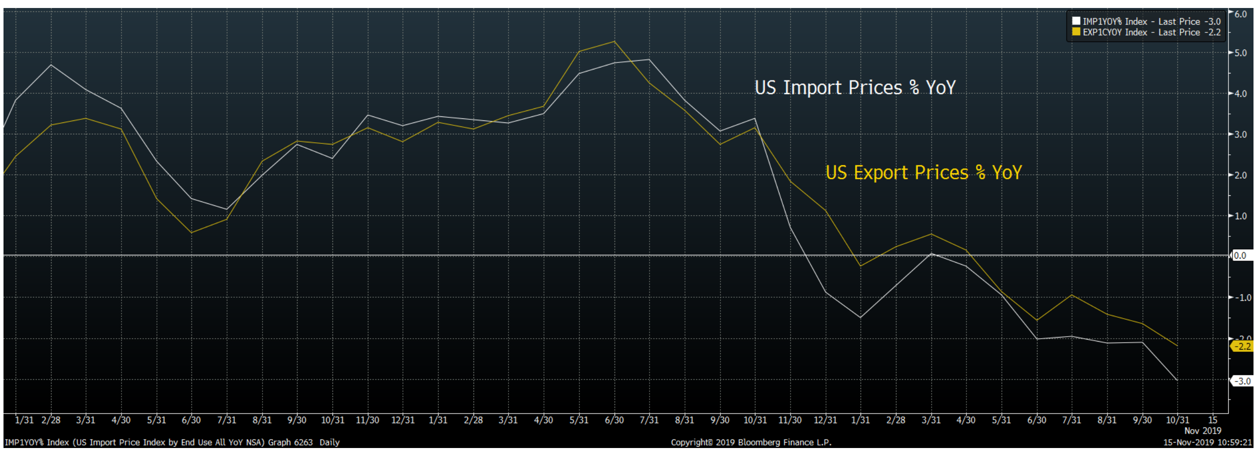
However, the tariffs will not lead to an increase in US investment under the current economic conditions. In our November 2018 *Fiscal Policy Report*, we stated that *"supply-side policies will fail in a world in which investment has not been constrained by a lack of savings. In this case, taxing consumption and subsidizing investment will only cause aggregate demand to decline. If supply is already sufficient to meet demand then businesses will react to falling consumption by also reducing investment.*

For at least the past two decades the world has been living in a savings glut. There have been no sufficiently profitable investments that have been prevented due to a lack of access to capital. It is just the opposite. Thus, in today's economy, Trump's supply-side policies will not only fail but lead to lower growth. ***We should expect tariffs to cause a drop in both consumption and investment…This is why, contrary to popular opinion, tariffs are more likely to be deflationary than inflationary."***

Conclusion:

Our forecast that "under the current economic conditions we expect the tariffs to cause a decline in inflation" has proven correct. Just six months after tariffs went into effect, US inflation (as measured by the consumer price index) was cut in half, from nearly 3% to 1.5%.





It is important to highlight that even if the tariffs remain in place they will have limited impact on inflation in 2020. Inflation is measured on a year over year basis; therefore, the tariffs would have to increase to continue dragging inflation and growth lower as we lap the tariffs in the fourth quarter of 2019 and into 2020.

Prediction #2: Tariffs will not reverse the US trade deficit

In our September 2018 *"Truth about Trade War"* note we explained that the international flow of money for the purchase of goods and services – international trade - is actually part of a larger system that includes the cross-border flow of money for the purchase of financial assets – what we refer to as the flow of capital (ex. RSA buying Brazilian government bonds).

The balance of payments is a bookkeeping system that divides a country's cross border financial transactions into the trade account and the capital account and allows us to see how these two seemingly unrelated activities are actually inseparably linked in a closed system. According to the balance of payments the trade account is equal to the capital account.

Trade Account* = Capital Account

*The technical BoP identity is: current account = capital account but I am using "trade account" in place of the "capital account" for simplicity. However, it should be noted that the current account differs slightly from trade account – a fact we can ignore for our discussion

Importantly, whatever happens to one side of the equation has the exact inverse impact on the other side. As an example, if Korean life insurance companies invest $1 billion in the US stock market, all else equal, US net exports of goods and services will decrease by $1 billion and Korean net exports will increase by $1 billion despite the transaction having no connection to trade.

The reason that the capital account equals the trade account is that US dollars can only be used for two things: purchasing 1) US financial assets - (ex. US Treasuries) a capital flow or 2) US goods and services – a trade flow. There are only two options; therefore, when foreigners use their dollars to buy more US stocks or bonds it automatically reduces US exports of goods and services and vice versa.

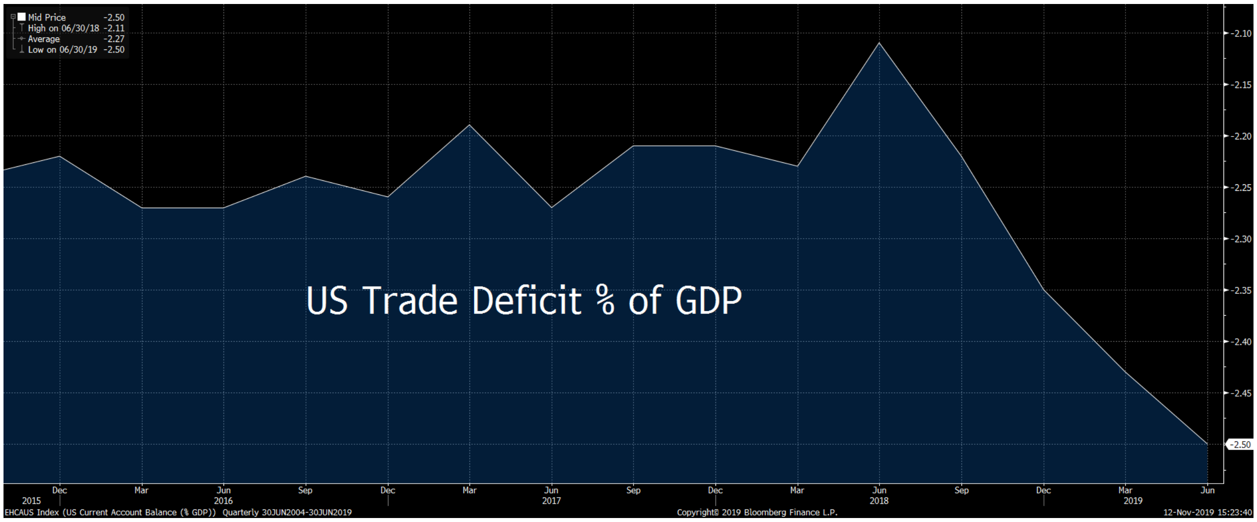
The balance of payment equation tells us that movements in the trade account can just as easily be the result of a transaction on the capital account, and vice versa. One hundred years ago it was more likely that an imbalance (a consistent trade surplus or deficit) was due to distortions on the trade account. However, capital flows now dwarf trade flows. The daily trading volume of foreign exchange is now 100x larger than the daily volume in international merchandise trade. As a result, the global imbalances are a result of distortions on the capital account, not the trade account. However, President Trump's administration is viewing trade the way it was a hundred years ago. Restructuring trade deals and placing tariffs on our trading partner's exports will not reduce the US' trade deficit because the trade account is forced to adjust to whatever decisions investors and foreign governments are making in the financial markets and those decisions have little connection with trade. In other words, the trade account is just adjusting to the decisions being made in the capital account.

In *Truth About Trade War* note, we stated that *"Tariffs can impact the economy, by reducing demand, but they will only impact the US trade balance to the extent that they affect capital flow decisions. Ironically,* ***tariffs are more likely to increase the US trade deficit by increasing risk-aversion in the global financial system****. When global risk-aversion rises, investors seek safety, which means moving capital out places like Emerging Markets and into US markets.*

Restructuring trade deals and placing tariffs on our trading partner's exports will not reduce the US' trade deficit as long as those countries are exporting capital to the US. Only policy prescriptions that focus on the capital account, such as limiting foreign central banks purchases of US foreign currency reserves, will ensure a reduction in the US trade deficit."

Conclusion:

It is safe to say that this prediction is confirmed. See if you can spot the date that US tariffs went into effect.

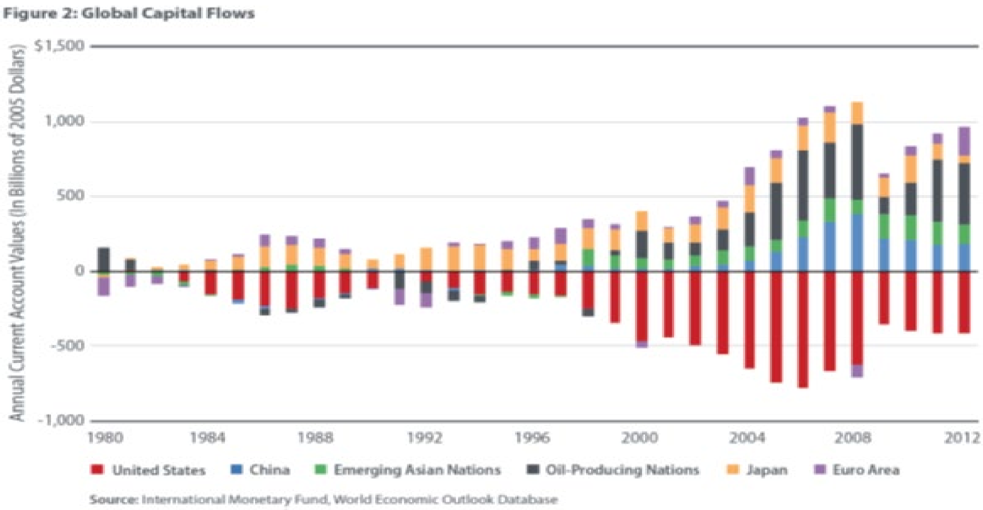


If you said the second half of 2018, the point where the US trade deficit dramatically deteriorates, then you are correct. The widening of the US trade deficit over the past year directly contradicts the consensus economic predictions of how the US economy should have reacted to tariffs. Admittedly, this is an unintuitive result. The widening trade deficit means that net imports increased despite the US placing a tax on over $360 billion of foreign goods.

However, we explained that it is capital flows, and not trade flows, that matter. Trump's tariffs increased risk aversion in the global economy, which in turn increased capital flows into the US, causing the US trade deficit to widen – just as we predicted.

The most important point that we have been making over the past two years is that the US does not run a trade deficit because of higher relative production costs. The US runs a trade deficit because it has been forced to absorb nearly 100% of the world excess savings (i.e. net capital flows) due to the fact that the US is the only country that allows the free flow of capital and has a large enough financial system to absorb the capital flows.

The chart below shows a breakdown of capital flows by country/region. The bars above zero are the countries exporting capital (thus increasing their net exports) and below zero are countries importing capital. Notice that the United States (red) has effectively been the only country absorbing the world's excess savings for well over 20 years. The graph stops in 2012 but the imbalance has actually worsened since that time. US net capital flows approached an all-time high in 2019.



Importing foreign capital automatically reduces net exports, which is a drag on GDP. However, countries can still benefit from importing foreign capital if they lack the domestic capital needed to fund domestic investment. In such a case, the increase in domestic investment would more than makeup for lower net exports. However, it is unquestionable that investment in the United States is not being held back due to a lack of capital. Therefore, importing foreign capital will not increase investment and will only serve to lower GDP through a reduction in net exports.

The United States needs the rest of the world to purchase more US goods and services and fewer US financial assets. But as long as the United States remains the only country willing, and able, to accept the world's excess savings then it will continue to run a trade deficit regardless of trade policy.

Prediction #3: Policies designed to explicitly reduce the US' bilateral trade deficit with China will not reduce the aggregate US trade deficit

In our March 2019 edition of the *Fiscal Policy Report*, we stated that *"President Trump is perusing solutions that will fail to rectify the persistent US trade deficit."* We explained that President Trump was explicitly targeting the reduction of China's bilateral trade surplus with the United States. However, bilateral trade balances are irrelevant in today's global economy. They tell us nothing about whether a country is adding to or subtracting from US growth. A country's overall trade balance is the appropriate measure to use in assessing a country's impact on global trade.

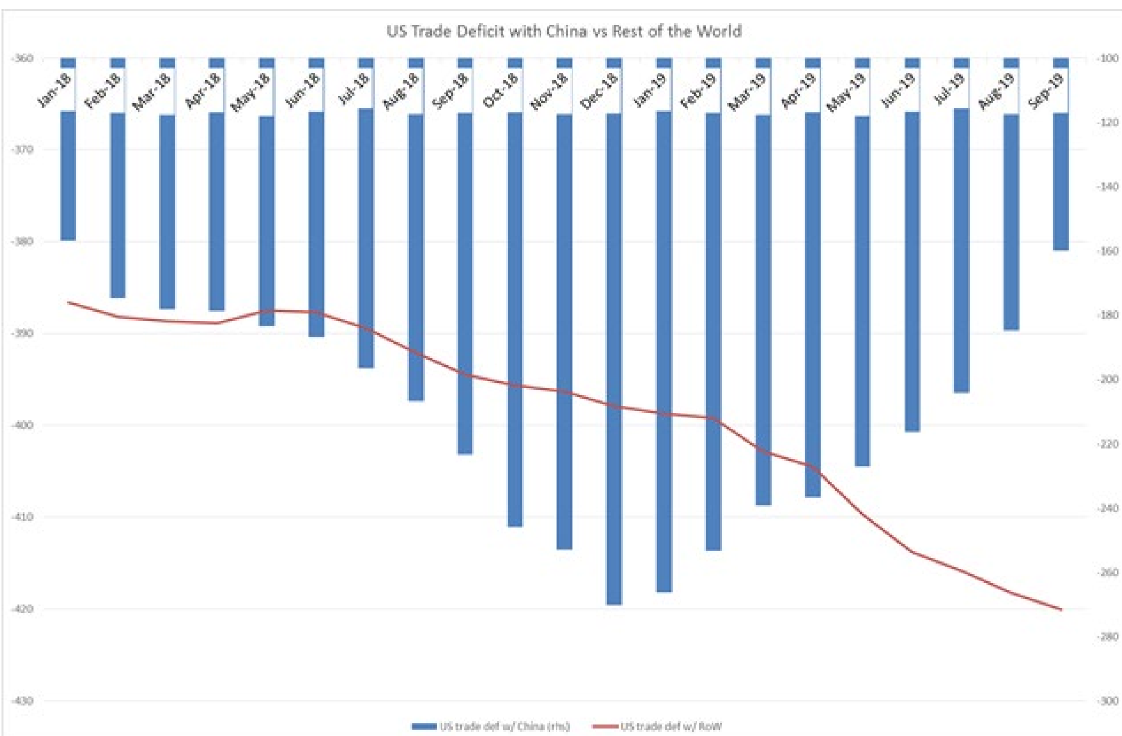
In a world with long global supply chains and minimal transportation costs, the bilateral trade balance between countries is often the result of factors out of either country's control. Mexico, for example, runs a bilateral trade surplus with the United States largely because Mexican companies often serve as the final stage in the production process for goods headed to the United States due to trade agreements between the two countries. If, for example, Japanese auto manufactures instead exported directly into the US, the

US' bilateral trade deficit with Mexico would decline but the US' aggregate trade balance would not improve because the US' bilateral trade deficit with Japan would increase. The US would be no better off. The point is that bilateral balances are irrelevant. Only aggregate trade balances matter.

While Mexico runs a bilateral trade surplus with the United States, it runs the seventh-largest aggregate trade deficit in the world. Mexico is not stealing demand from the US. Mexico's trade deficit reduces the US trade deficit. A policy focused on reducing Mexico's bilateral trade balance with the US will fail to achieve the goal of reducing the US' aggregate trade deficit. Similarly, any agreed reduction in the Chinese bilateral trade deficit with the US, driven by the Chinese agreeing to purchase more US goods, will have almost no impact on China or the US' overall trade balance."

Conclusion:

President Trump's tariffs have been successful in reducing the US trade deficit with China; yet, the aggregate US trade deficit increased in 2019. The US trade deficit with China has fallen by $40 billion but US trade deficit with the rest of the world has increased by $100 billion. Just as we predicted, the US trade deficit with the rest of the world has increased to more than offset the decline in the bilateral deficit with China.



US Trade deficit with China (blue, lhs); US Trade deficit with the rest of the world (red, rhs)

Prediction #4: The economic impact of a trade deal with China will be negligible because it will only impact the US' bilateral trade deficit with China and not the aggregate US trade deficit

We made the following prediction in our March 2019 edition of the *Fiscal Policy Report*: *It is clear that a major component of the US-China trade deal will be increased Chinese purchases of US soybeans (increased relative to pre-tariff import levels) since soybeans are politically import and easily the largest source of US exports to China. Yet, just as there has been no long-term impact from China cutting their soybean purchases, there will be no impact from China increasing their purchases. China will purchase more beans from the US and the US will sell fewer beans to elsewhere in the world. Increased US soybean exports to China might reduce the bilateral balance between the two countries but it will be economically meaningless because it will not affect their aggregate trade balance.*

A US – China trade deal that does not include measures which address Beijing's ability to control China's capital account, or only targets a reduction in China's bilateral trade surplus with the US, will fail to have a long-term impact on the US trade deficit.

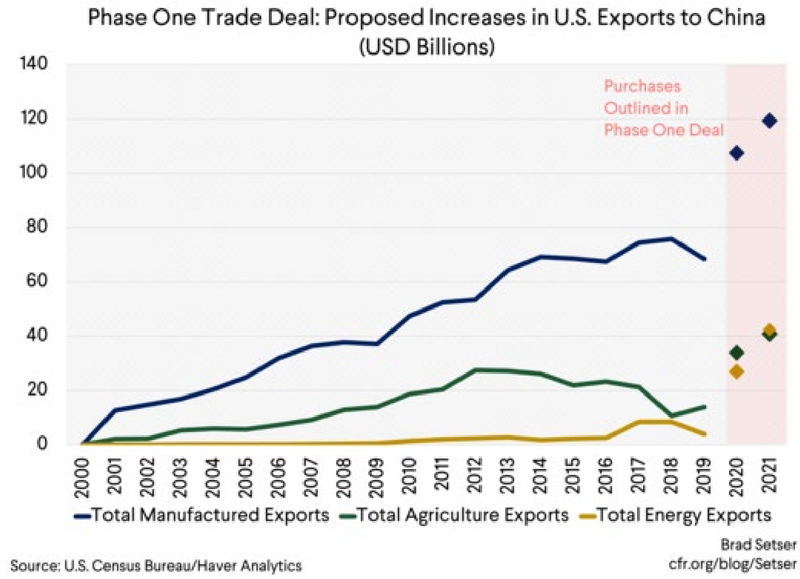
A US-China trade deal might have a short-term impact on economic growth but mostly by restoring some confidence that was eroded as a result of the "negotiating tactics" leading up to the deal.

We give a meaningful trade deal a low probability because it makes too much sense for both the Chinese and Donald Trump to reach an agreement which only reduces the US bilateral trade deficit with China.

The Chinese economy is in a vulnerable position as they attempt to transition their economy after decades of over investment has left the country the most indebted in the world (3x higher debt to GDP than the US based on the most conservative estimates). Any reduction in China's trade surplus will worsen their debt burden. However, reducing the bilateral surplus requires no economic sacrifice for China but provides President Trump with a highly publicized win he can point to on the campaign trail. Donald Trump, who portrays himself as a deal maker, will be able to go to Iowa and tell voters that he forced the Chinese to buy more US agricultural products or voters in Michigan that the Chinese are buying more US automobiles. The US-China trade deal will be significant politically but not economically.

Conclusion:

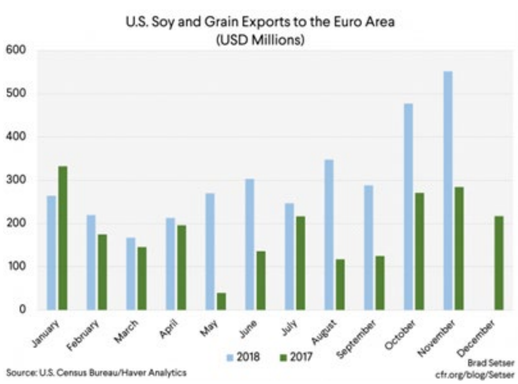
Now that the trade is deal signed, we can conclusively say that we were correct in our predication that the trade deal will be centered on China agreeing to raise its imports of US agriculture and energy products above pre-trade war levels.

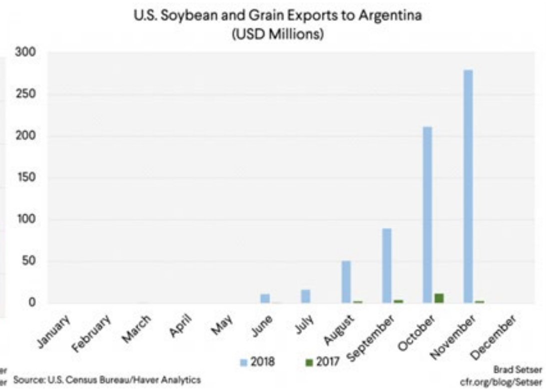


China was willing to raise their purchases of US commodities because, by definition, commodities are fungible. If China buys more oil from the US then they will buy less from Saudi Arabia, for example. In turn, the Saudi's will sell more oil to the rest of the world and the US less. Critically, China buying more oil or soybeans from the US does not allow the US to increase the production of oil or soybeans. US production is dependent on the aggregate level of Chinese purchases and not the geographic mix of those purchases. In other words, increased Chinese purchases of commodities will reduce the bilateral trade deficit with the China but it will not decrease the aggregate US trade deficit.

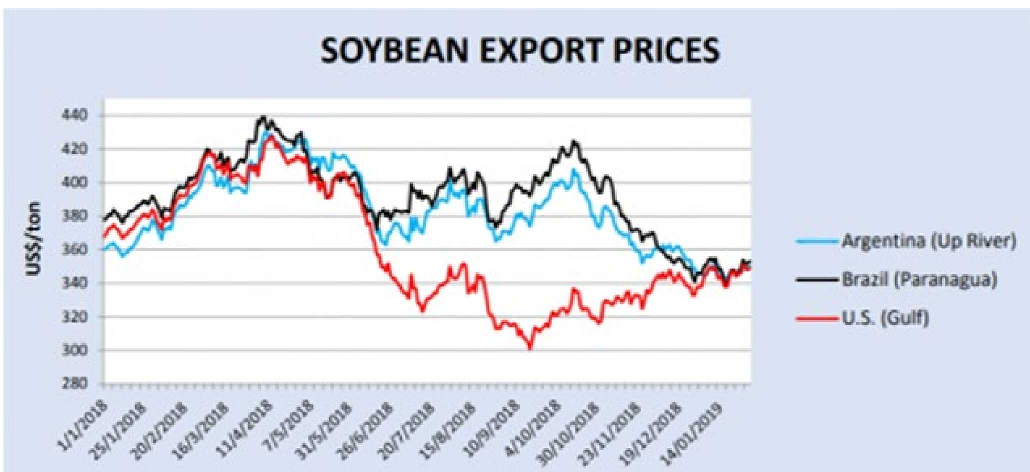
Reexamining our soybeans prediction shows why bilateral balances are irrelevant. In July 2018, Beijing slapped an import tariff on all US soybeans. Prices of US soybeans dropped nearly 20% from June to July. The media were sent into a frenzy proclaiming that farmers had unwittingly become the victims of Trump's trade war with China. There can be no doubt that the Chinese were targeting the politically important farm and agricultural interests within the US to put political pressure on President Trump. However, in July of 2018, we predicted that, *"Chinese tariffs on US soybeans will do little long-term damage to US farmers and the US economy. The tariffs will only lead to a change in trade routes. China will be forced to buy more beans from Brazil, for example, and Brazilian exports to Europe will be reduced; thus, Europe will buy more beans from the US. Once trade flows re-route,* ***US soybean prices will re-converge with global prices*** *since the difference in transportation costs is negligible at best."*

Reality played out exactly as standard trade theory predicts. In response to the Chinese tariffs, Europe started importing more US soy. Argentina also opened up as an interesting destination for US soybeans. Argentina has a large amount of crushing capacity; therefore, most of their US soybean imports were likely re-exported as soy meal. When US soybeans started trading at a discount to Brazilian beans, the Argentine producers bought US soybeans rather than Brazilian beans.



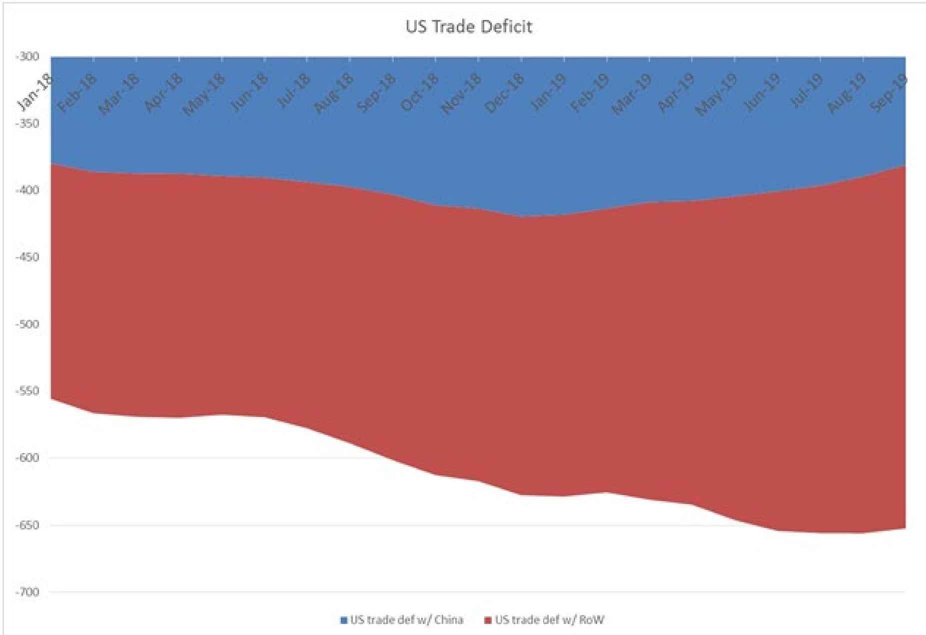


China went from buying 60% of all US soybean exports to nearly 0 almost overnight. Yet, in less than six months trade routes adjusted and US soybean prices were no longer trading at a discount to world prices.



Chinese tariffs reduced purchases of US soybeans but did not reduce their need to import beans from somewhere[1]. Tariffs influenced China's bilateral trade balance with the US but not their aggregate trade balance. Likewise, US tariffs on Chinese goods reduced its trade deficit with China but have not reduced its aggregate trade deficit because the US simply replaced Chinese exports with exports from the rest of the world. The increased trade deficit to the rest of the world more than offset the improvement in the US bilateral balance with China.

[1] It should be noted that while the tariffs didn't reduce China's need to import soybeans the African Swine Flu, which has wiped out 40% of the Chinese hog supply, has reduced soybean demand. Soybean meal for hogs represents the largest component of soybean demand.

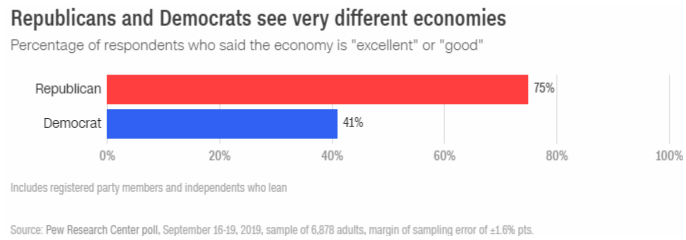


The aggregate US trade deficit widened in 2019 because net capital flows into the US increased – recall that increased net capital flows automatically cause a reduction in net exports. This brings us to the point that we have been making for two years: The US trade deficit is a result of capital flow decisions by the rest of the world and the trade flows are simply the residual.

Importing capital means lower economic growth for every developed economy in the world. As a result, capital is coming to the United States because it is the only country is willing and able, to accept the world's excess savings. As long as this continues the United States will run a trade deficit regardless of trade policy.

Economic Outlook

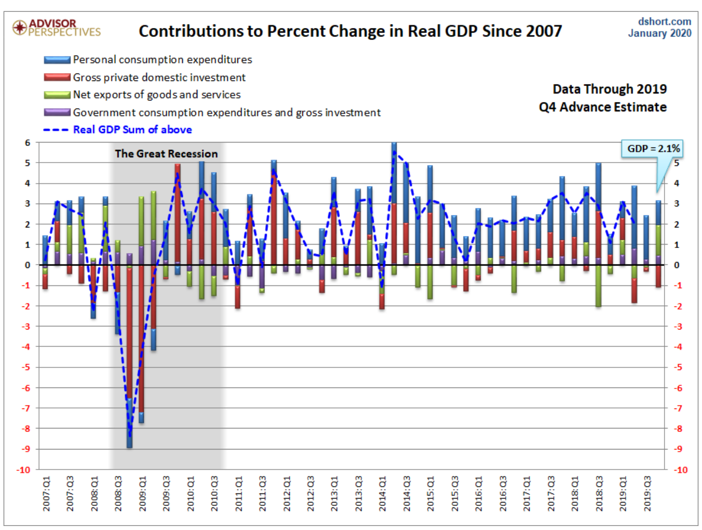
By Josh Husted



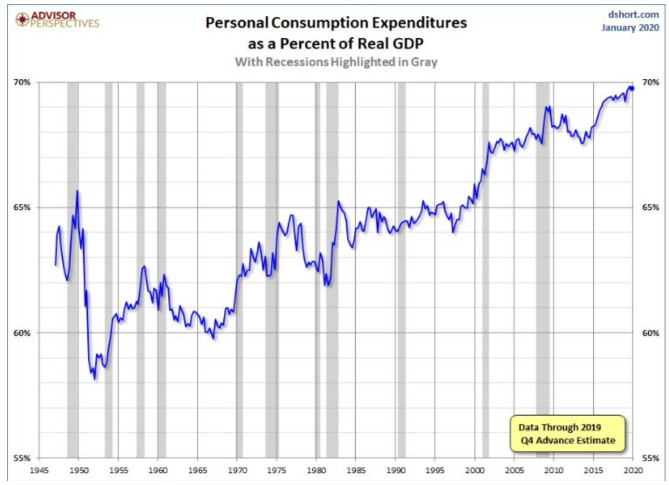
"Are you a Republican or a Democrat?" While this query *should* have no place in a quarterly economic update, our research has found an unusual degree of dissonance in the data on the strength of the economy. Despite record-low unemployment, a strong US dollar, all-time highs in US equity markets, steady wage growth, ultra-low borrowing costs, low inflation, and extraordinary technological achievements, our leading question drives an eye-popping 34% divide between respondents who see the economy as "good" or "excellent."

"For if they do these things in a green tree,
what shall be done in the dry?" Luke 23:31

What could explain the stark divide? Are Republicans the sole beneficiary of the economy's strength? Do only Republicans own stocks, buy houses, and get raises? Most assuredly not; no, we would hypothesize that the ideological leaders of each party trumpet the same general statistics but measure them in different ways. Trump and the GOP boast in <u>absolute</u> terms, while Sanders and the Democratic Party decry <u>relative</u> inequalities. The argument for the 59% of Democrats who fail to see the economy as "good" or "excellent" is this: "While wages may be growing, markets may be rising, and borrowing costs may be falling, wages are growing at different rates, rising markets only benefit the wealthy, and low interest rates don't matter if the bank won't approve you." It's a weaker argument than what the GOP has, but it does bear witness for a certain segment of the population, despite what the data show.



This matters, because the US economy is driven by consumption and consumer confidence. The latest economic data show Q4 US GDP at 2.1% growth Q/Q. Over the time frame of this chart, the Personal Consumption Expenditures (PCE) component has shown the most consistent correlation with real GDP itself. This quarter, PCE was 1.2%, accounting for almost half of US GDP. As illustrated in the chart below, the PCE-to-GDP ratio, since the inception of quarterly GDP in 1947, is at its record high of 69.8%.



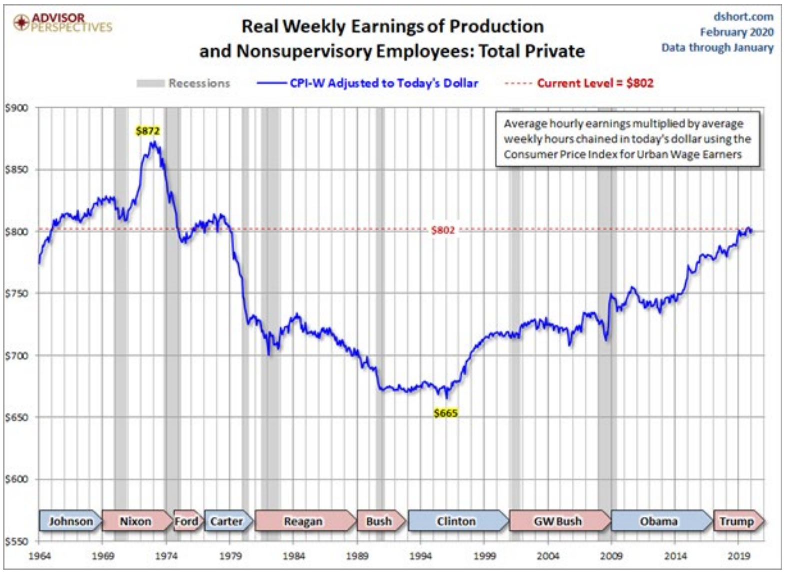
It bears noting that Net Exports swung strongly positive this quarter and were the largest driver of US GDP. This contribution came entirely from the significant drop in imported goods. Historically, the US has been a net importer. The last 12 quarters of Imports of Foreign Goods has detracted, on average, 36 basis points of growth from US GDP. The drop-off in imports this quarter, with exports remaining steady, kept US GDP positive for Q4. Without that boon, GDP would have been a mere 26 basis points. We would caution against any inference that this is a vindication of Trump's trade war. This dramatic of a drop in net imports is more consistent with companies not knowing how the trade negotiations were going to play out in 4Q, and deciding to hold back on activity (instead of choosing to draw on inventories). Production may be moving out of China, but it is largely reorganizing in other countries, not re-shoring domestically. US Industrial Production was flat in 4Q.

So why is a populist message of political revolution that highlights disenfranchised workers, rails against the wealthy, and promises a massive increase in government welfare programs leading the Democratic primary process? While there are plenty of non-economic explanations, we will hypothesize two with economic data.

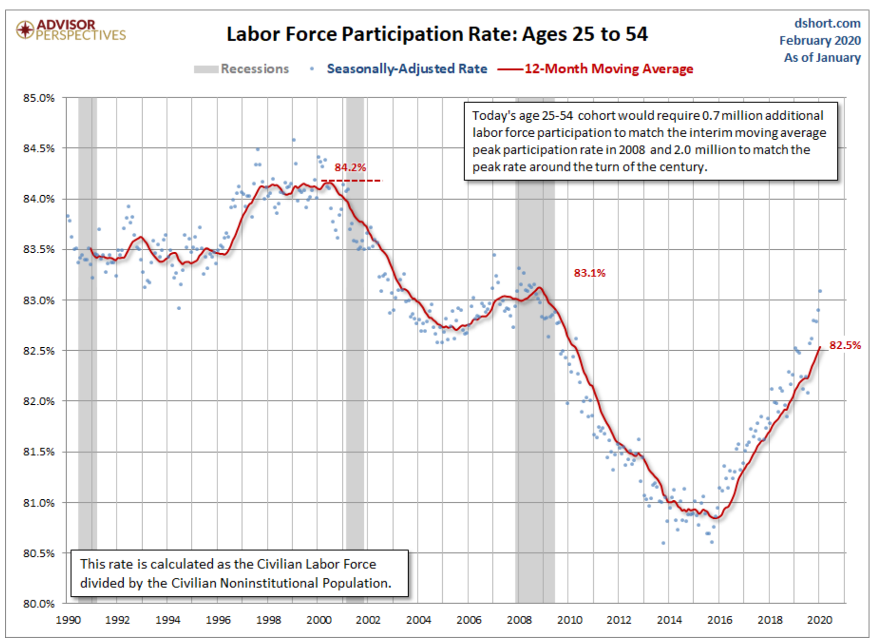
The first explanation could be rising inequality. The Gini coefficient is a measure of statistical dispersion intended to represent the income or wealth distribution of a nation's residents. While the US lags Scandinavian countries in this metric by a sizeable amount, the third column in the chart to your right illustrates a conveniently ignored point: the standard of living is much higher in the US. Would you rather own the smallest house in Malibu or own the same size house as all your neighbors in a dying suburb of Detroit? Unfortunately, we know that human beings tend to be more focused on relative rather than absolute outcomes; otherwise, envy would not be so cautioned against by King Solomon in his book of Proverbs. Trump was arguably the first candidate in the most recent election cycle to tap into the political message of envy from the Republican side. His brand of populism offered policy prescriptions designed to ease the pain of a middle class that largely felt left out of the bounty of "free trade" and the financial engineering of both the public and private sector (private equity, quantitative easing, etc.)

	Gini Coefficient*	Per Capita Income**	Standard of Living Relative to the U.S.
Sweden	24.9	$53,873	-14%
Germany	27.0	$48,264	-23%
Finland	27.2	$49,845	-20%
France	29.3	$42,878	-32%
Canada	32.1	$46,261	-26%
United States	45.0	$62,606	-
Singapore	45.9	$64,041	2%
Hong Kong	53.9	$48,517	-23%

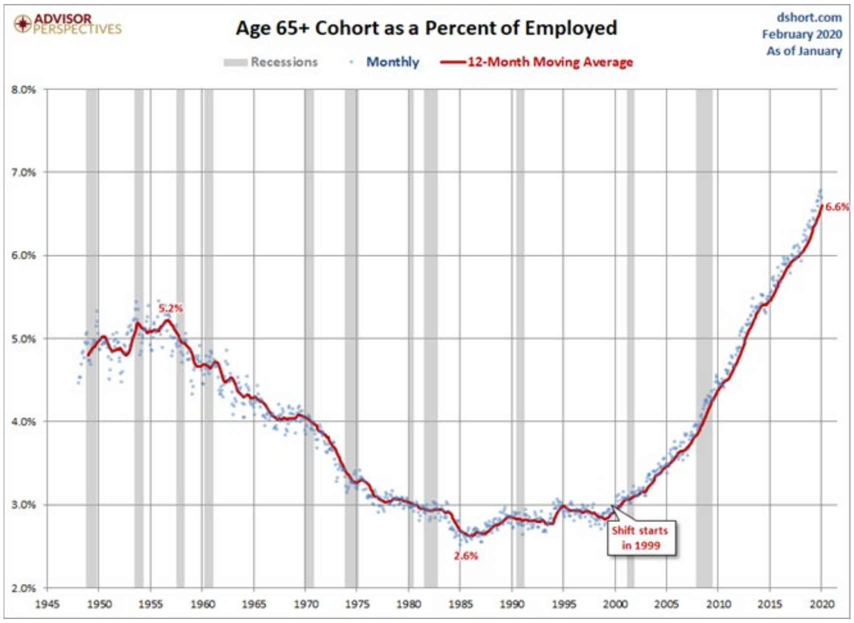
** CIA. Most recent data. 0 = perfect income equality. 100 = perfect inequality.*
*** IMF, 2018.*



The second explanation could be stubbornly low wage growth in the face of a poorly measured basket of goods with which to calculate "true" inflation. The chart to your left tells the story of a middle-class, blue-collar worker in America. You know, the one that every politician seems to have a story about? This chart takes their salary and adjusts it for changes in hours worked, US dollar inflation, and the cost of a basket of goods calculated by the CPI for Urban Wage Earners (this specific measure of CPI increases the weighting of fuel costs to better account for workers that commute). US workers earn $802 / week- roughly the same as they were earning in the 60s & 70s, despite the incredible increases in productivity from technology.



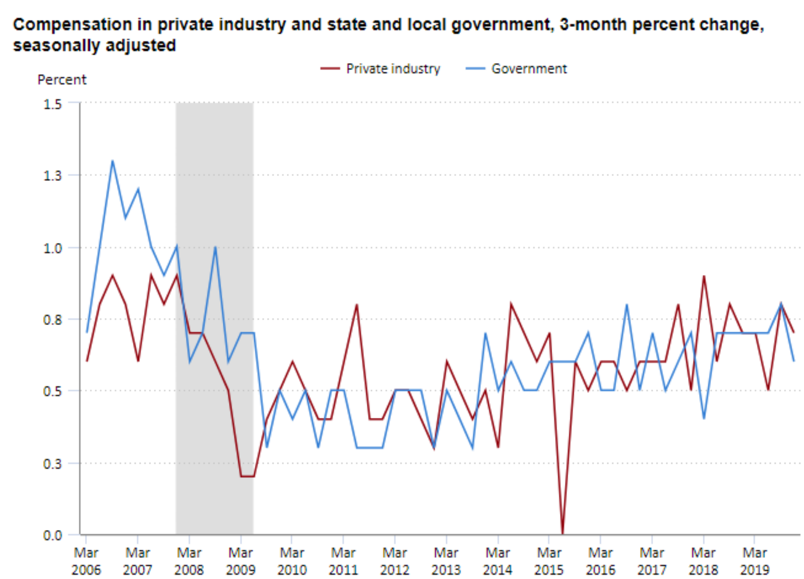
For the current cycle's bogeyman, we can blame "slack" in the labor market for the lid on wage growth. The labor force participation rate is still below pre-recession levels and 170 basis points below peak 90s levels. Another measure of unemployment called "Non-employment" measures the % of the working population that is either unemployed or not in the labor force. That measure is currently sitting at 28.1%. Even as the economy continues to expand, workers have just rejoined the labor force to fill demand. Contrast this with a simpler supply and demand function wherein fewer unemployed workers leads to wage growth as the demand for labor starts to reach the limits of supply. As we have previously written about, workers are coming in from many non-traditional areas, including disabled workers (currently rejoining the labor force at levels not seen since the 80s) and seniors.



The 12-month moving average of elderly employment is at its historic high of 6.6% — now over double its low in the mid-1980s. This is a trend with multiple root causes, most notably longer lifespans, the decline in private-sector pensions and frequent cases of insufficient financial planning. Reasons aside, this "golden-year" workforce is arguably less in need of a competitive wage since their motivation for work is supplemental in nature. This anecdotal piece of evidence can be shown for other cohorts as well, including the disabled and the teenage workforces. As technology advances to allow these non-traditional segments of the workforce to find gainful employment and productively contribute to the economy, wage growth can remain stifled.

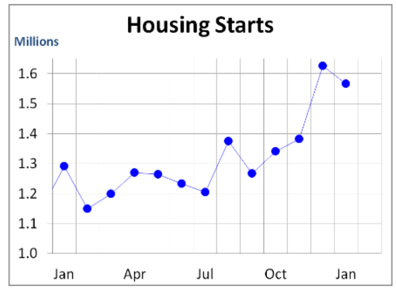
Consider the example of self-checkout technology. Historically, cashier positions required dexterity, mobility, and speed. If companies hired disabled workers or seniors for this position, they risked bottlenecks and frustrated customers. Since supply was restricted, wages were more elastic. With self-checkout technology, the hit to wage growth was two-fold. Now only one cashier was needed for, say, four lanes. In addition, that position demanded less physicality and could be filled by a disabled person or a senior, looking just to supplement social security or disability.

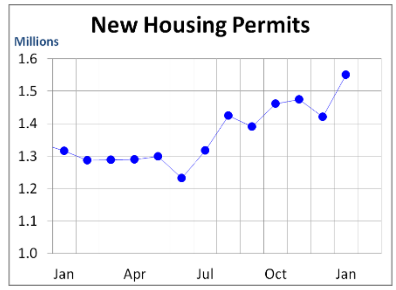
The bottom line on wage growth: the data still show slack in the labor market and employment costs growing at a manageable level. Until the LFPR peaks, organized labor begins to structurally reform and grow, and/or policy is amended to structurally change labor dynamics, expect anemic wage growth and a populist in the White House in 2021.

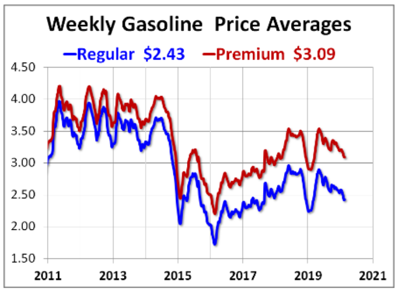


Hover over chart to view data.
Note: Shaded area represents recession, as determined by the National Bureau of Economic Research.
Source: U.S. Bureau of Labor Statistics.

For the part of the population that does not count themselves overly dissatisfied, there are plenty of rosy economic data points in which to take heart. As the Fed signaled rate cuts and mortgage APRs dropped, housing starts and new housing permits began to climb. This is always a positive sign for the economy as new builds reflect consumer confidence. Ostensibly, they should lead to increased consumption as families now have to furnish and fill the new houses they have built.







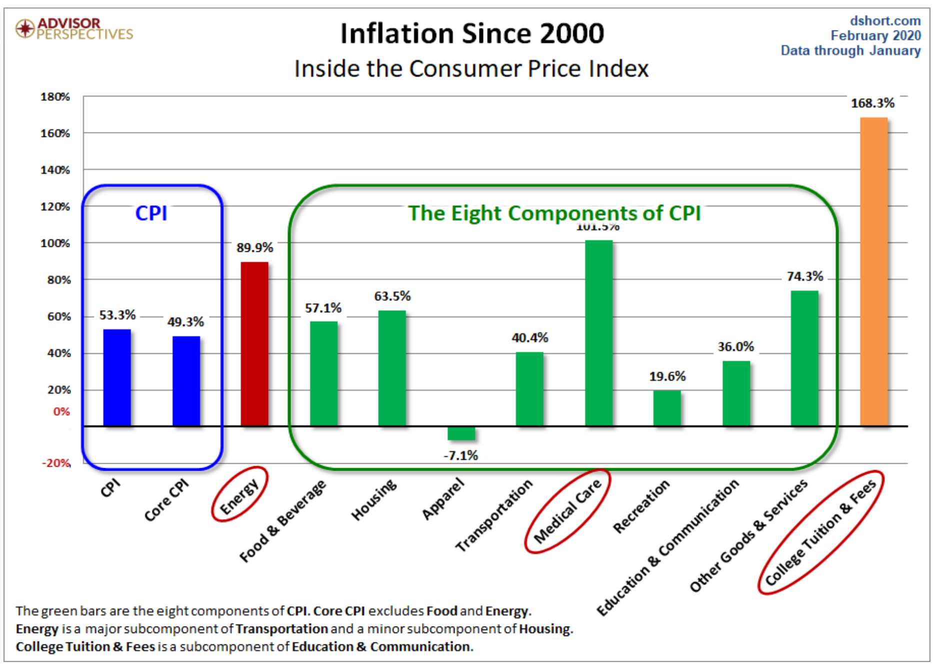
Fuel prices have plunged as fears over the coronavirus's impact on global GDP have risen. Incumbents would prefer to see this trend continue as it removes a potential source of complaint from consumers' minds as they head to the ballot box.

The U.S. consumer is slowing, but not contracting. Personal consumption expenditures slowed to 1.8% q/q AR in 4Q and 2.6% y/y in 2019. But retail sales accelerated 0.3% m/m and 5.8% y/y in December, signaling a solid holiday shopping season.

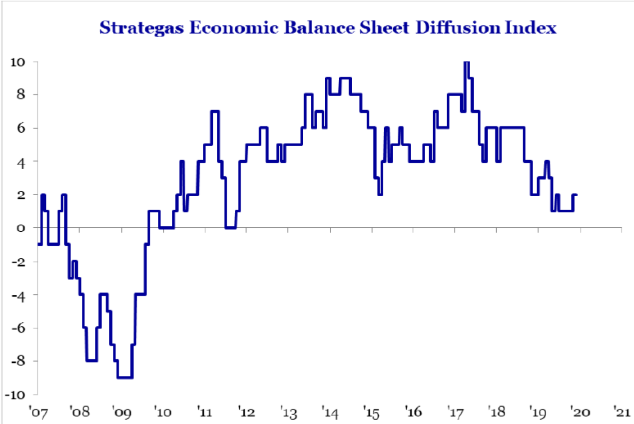
Consumer credit growth continues its moderate expansion as consumers' debt service burdens remain manageable. Banks are maintaining current credit standards to businesses so there is no large sign of strain here. Liquidity indicators are reaccelerating as the Fed eases and M2 money supply growth takes off.

We would be remiss to not address some of the transitory headwinds to growth, namely the coronavirus and Boeing's US production issues. Since manufacturing composes only 12% of the US economy, we will not focus too much on the size of the contribution. Instead, we recognize manufacturing's ability to add volatility to quarterly numbers.

Inflation remains muted as strong secular forces (technology, aging, demographics, etc.) are providing a restraint vs. prior decades. That is not to say that pockets of inflation could creep in of which we should be cognizant. We are skeptical of CPI's ability to accurately measure inflation. There is some debate within the economic community over the accuracy of the basket of goods that CPI uses to measure inflation. The chart below breaks out some subcategories of CPI to show how much more they have inflated since 2000 than other categories. You will immediately notice the parallel between the highly inflationary categories and the policy platforms of Trump challengers: energy costs, medical costs, and college tuition costs. While overall inflation may remain constrained, a useful exercise to understand the frustrations of the middle class could be to observe which categories have risen and fallen. Discretionary categories (apparel, recreation, communication, transportation) have all inflated below CPI. Non-discretionary categories (Energy, food/beverages, housing, medical care, college tuition) have all inflated well above the CPI headline. While anything keeping the overall basket of goods down is appreciated, one might hear less consternation if those categories were flipped. If apparel inflated well above CPI, consumers could alter behavior to purchase more used or value-priced clothing, wear their current clothing longer, or wear hand-me-downs. Sadly, consumers cannot make that choice for medical care or heating costs for their homes.



We conclude our discussion of the economic update with a visual holistic view of the economy compiled by Strategas Research Partners. This "Economic Balance Sheet" is still at a net +2 in Assets vs. Liabilities, a level one could compare to the Great Recession's negative inflection. While this is a largely subjective exercise, it is always profitable to take a step back and block out the daily noise. The US economy is in a prolonged economic expansion, with few signs of imminent danger, compared to other periods in our nation's history. While not all data we track are trending in the same direction (they rarely are), we remain constructive on the health of the US economy and its ability to drive strong returns. As always, we will continue to closely monitor risk factors and adjust our views accordingly.



Assets	Neutral	Liabilities
Credit Environ	Govt Deficit	Nonres Constr
Cons Spending	Trade Deficit	Capex Eqp
Employment	Wage Inflation	Mfg
Interest Rate Env	Price Inflation	
Housing	Business Conf	
	Cons Conf	

Economic:	Dec '18	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec '19
Assets	3	4	4	5	4	3	4	4	4	4	4	5	5
Liabilities	1	1	1	1	1	2	2	3	3	3	3	3	3
Net	2	3	3	4	3	1	2	1	1	1	1	2	2

RSA PORTFOLIO STRATEGY

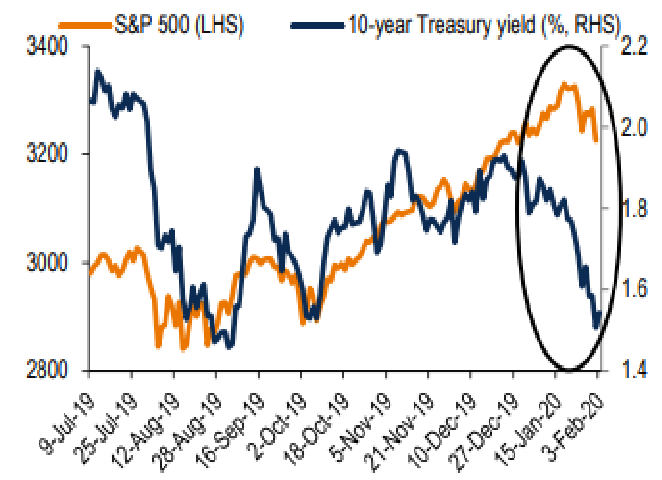
Interest Rates and Fixed Income Strategy

By Lance Lachney

The Federal Open Market Committee just lowered the fed funds rate another 25bps at the time of our last meeting, bringing its targeted range to 1.50-1.75%. After three insurance cuts, Chairman Powell stated that the current stance of monetary policy was in a “good place” and “likely to remain appropriate”. The fund was in the process of taking out a little insurance itself by adding to stable credits with maturities in the intermediate and long end of the curve. By mid-November, the 10yr treasury was hovering around the 1.85% vicinity, far below the 3.00% mark from a year ago. It finished the month at a slightly lower level as investors remained concerned about the trade war ramifications with China. Spreads in the corporate credit sector tightened during the month, providing an additional 60bps of compensation over its risk-free counterparts. Primary markets for investment grade and high yield debt remained healthy with the latter having one of the busiest months in a couple of years.

Treasury yields moved higher throughout the month of December, initially led by the release of a strong November employment report. Capital markets also received a boost from the limited Phase 1 deal reached with the Chinese. Energy markets were helped by the steeper-than expected production cuts announced at the Organization of Petroleum Exporting Countries (OPEC) meeting. Investors looking to rebalance their portfolios before year-end, moved capital away from risk-free assets and into securities offering higher expected returns in 2020. High-yield securities outperformed other fixed income instruments, providing a return over 2% during the holiday-shortened month. Investment grade debt was able to manage a positive return as well despite its longer duration profile as credit spreads tightened approximately 10bps. As expected, treasury securities relinquished over a .25%, while the 2/10s curve steepened out to roughly 35bps. The fund purchased a 10yr agency bullet, a healthcare credit in the intermediate part of the curve, and a mortgage-backed security in an effort to lengthen duration in these respective sectors.

Figure 2: US equities roughly flat but rates collapsed in January



Source: Bloomberg

The new calendar year started off fairly well as solid economic data and corporate earnings here at home were enough to offset the geopolitical tensions with Iran. Domestically, equity markets hit new highs and investment grade spreads tightened to two-year lows by mid-January. The strong start within risk assets came to a halt as the rapid and deadly outbreak of the coronavirus within the city of Wuhan drew investors' concern. Treasury yields fell meaningfully to the delight of those positioned in the long end of the curve. Treasuries had already remained somewhat stable despite the early move in risk assets as the Fed all but eliminated any chance of a rate hike for the upcoming year at its December meeting. As travel restrictions and cancellations of Chinese New Year festivities were enacted, yields on risk-free assets collapsed. Treasury yields declined approximately 40bps across the maturity spectrum starting with the 5yr note and moving out. Investment grade debt was able to provide a total return of 2.35% despite a moderate rise in corporate spreads. Long-term corporate yields finished the month sitting at historic lows after the sector returned close to 4% in January. High-yield however, was not as fortunate, as it underperformed treasuries by roughly 250bps as it experienced the largest outflow in half a year. The curve also flattened approximately 15bps due to the significant move lower in the long end.

Figure 8: Record low 30-year US IG corporate yields

Source: ICE Data Indices, LLC

So far this month, risk assets have been the beneficiary of an improvement in sentiment. The economy was able to add 225,000 jobs in January, coupled with an increase in labor force participation. The ISM manufacturing PMI was also able to eclipse the 50.0 threshold, a first since July of last year. Equity markets have been able recapture the losses of late January. Credit markets have bounced back as well with both investment grade and high yield debt outperforming. Kraft-Heinz has recently been downgraded to junk status and while that may alarm some investors about some of the larger BBB names, the yield to maturity on its 10yr and 30yr debt remains below 3.50% and 5.00% respectively. While treasury yield levels are off their recent lows, they remain at the low end of their most recent range.

Within fixed income, this remains one of the most difficult trading environments that I can recall. The amount of capital searching for income-producing assets has eliminated most money-making opportunities. Negative yields persist in many developed markets and those countries once thought to be uninvestable (Greece), now trade inside of the U.S. The buy side is heavily exposed to reinvestment risk as management refinances upcoming maturities at lower rates and tenders for its outstanding high coupon debt. Investors are so starved for yield that covenant-lite levered loans and zero new issue concessions are now the norm. I truly believe this is the reason why Kraft's management ignored the rating agencies' criteria to remain investment grade. There appears to be no downside at the moment. If the company can easily pay its interest (which it can), take its time on rationalizing its business, have confidence that the interest rate market isn't going to run away from it, and can still raise capital at historically cheap rates, then why should management care if it has one less "B" than it did a week ago?

The market is currently pricing in another rate cut from the Fed this year. Policymakers are also kicking the tires on its inflation targeting framework, as price levels have remained relatively low for some time despite unemployment falling to a 50yr low of 3.5% last year. The economic fallout from the coronavirus is anyone's guess but appears to be substantial for China at the moment. There is a real possibility that the epidemic could spread further in the Asian region. The fund's most recent purchases have continued to involve high quality names like IBM, CVS, and Campbell Soup. However, it has moved the maturity of these additions towards the front end of the curve considering the abrupt move lower in the long end. The fund anticipates playing the newly established range as uncertainty persists.

Domestic Equity Strategy

By Kevin Gamble

The performance of the U.S. equity market fiscal year-to-date has been nothing short of impressive and we are off to a great start! The United States continues to be the most desirable location for investment capital in a world full of rising uncertainty and historically low interest rates across the entire developed world. President Trump continues to remind the electorate that we are setting all-time highs in the broader US equity investing indices thus bolstering his reelection bid in November. Animal spirits are starting to take hold in some segments of the market and the American economy is as innovative as ever.

Exhibit 1: S&P 500 Fiscal Year-to-Date

Source: Bloomberg

What I would like to accomplish in this strategy piece is to outline the top 10 things that we as an investment team think you as a board member should know about the current state of the U.S. equity market. Will the current upward trajectory of the US equity markets be sustainable as we move through the remaining two-thirds of fiscal 2020?

RSA Top 10 list

1) The greatest risk to investing markets is often the unknowable – enter the Wuhan coronavirus into the investing picture

Whether it is the unfortunate events surrounding Kobe Bryant or the random outbreak of the Wuhan coronavirus in China, we were again reminded this quarter that none of us know exactly what tomorrow holds and oftentimes the greatest risk is the unknown. On the positive side, the markets have shaken off the negative effects of the virus pretty well so far, but will this continue?

The negatives of the virus outbreak including sickness and loss of life are pretty obvious. Conferences are being cancelled, restaurants and stores are being closed, cruise ships are being quarantined, technology supply chains are being disrupted, etc…..and the global economy is likely to generally slow at least temporarily due to these disruptions.

From an investing standpoint, there are some things to consider which are not all negative once we reach the other side of this outbreak. The Fed will likely come under increasing pressure from the President to be more aggressive, China has added stimulus to its economy, mortgage rates have fallen along with other interest rates as we enter into the important spring selling season, companies now have a convenient excuse for any upcoming earnings miss, and energy prices have fallen across the board.

While the deaths from the coronavirus have now exceeded that of the 2003 SARS outbreak in China, it is just very difficult at this point to know the final consequences as health authorities from the around the world scramble to contain and end the outbreak. As of this writing, over 2,000 deaths are attributed to the virus.

Exhibit 2: Worldwide Coronavirus Statistics

Currently Infected
58,167
Mild Condition
46,111 (79%)
Serious or Critical
12,056 (21%)

Cases with Outcome
17,138
Recovered/Discharged
15,126 (88%)
Deaths
2,012 (12%)

Source: World Health Organization

2) The backdrop for the remainder of the fiscal year will include the shadow of the Democratic primaries and the upcoming US Presidential Election

We are currently in the heat of the Democratic primaries as Iowa and New Hampshire are now in the rearview mirror and Super Tuesday awaits. There is unfortunately no way to avoid the political backdrop and associated swings as we navigate through the investing backdrop for the remainder of the fiscal year. The cast of characters on the Democratic side range from a Democratic Socialist to a more moderate multi-billionaire who hopes to outlast the field and perhaps take the nominating process to a brokered convention in Milwaukee in July. Should a brokered convention come to fruition, we might even hear Hillary Clinton's name again as a possibility for the top of the Democratic ticket. Healthcare stocks and particularly managed care stocks will likely remain front and center on investor's minds as investors weigh the probability of increased taxes and a single-payer healthcare system or Medicare for All.

Exhibit 3: United Healthcare (UNH) Fiscal Year-to-Date

Source: Bloomberg

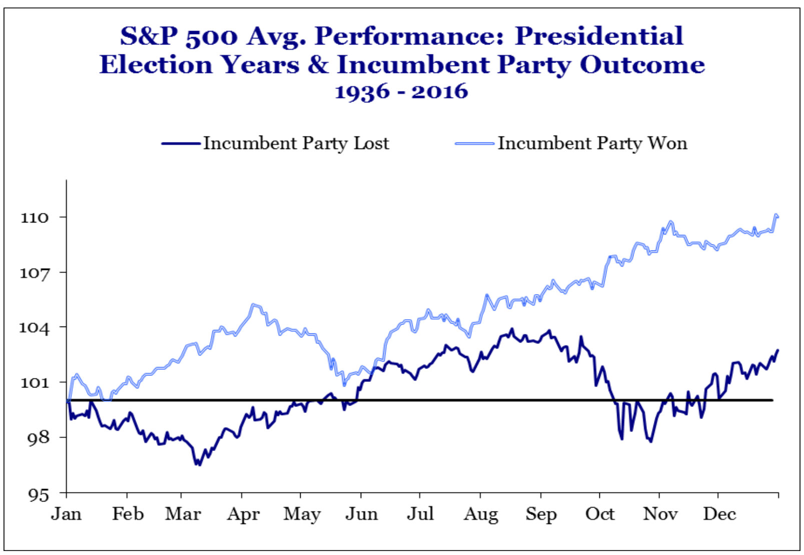
3) Markets were never concerned with the impeachment hearings and markets seem to currently think President Trump stands a good probability of being reelected

While impeachment hearings have dominated the headlines for the past few months, we think it is important to note that investing markets never really gave the impeachment efforts much of a chance. Given the fact that US equity markets continued to set new all-time highs during the process, investors clearly realized a two-thirds supermajority vote in the US Senate to impeach the President was just not likely to happen and perhaps even saw his inevitable acquittal as emboldening his reelection chances.

We have written much about how President Trump views the equity market as somewhat of a scorecard for his administration and just how market friendly his presidency has been to investors. We see the market continuing to set all-time highs at this stage as a pretty good tell that investors, at least at this point in time, feel his reelection bid stands a pretty good chance. It could also represent a belief from investors that he will do everything in his power to assure markets continue this upward trend in the upcoming months as we move into November, including potentially pressuring the Federal Reserve to be more aggressive as well as pushing for middle-class tax cuts 2.0.

One feather in the cap of the bulls is that US equity markets have not declined in a year in which the sitting President stands for reelection since 1940. Of note, this was the year in which FDR stood for reelection for his third term against businessman Wendell Willkie in the wake of the Great Depression and World War II in Europe.

Exhibit 4: S&P 500 Historical Performance in Presidential Election Years



Source: Strategas

4) Phase One China Deal is Complete…..Much Work is Left to Be Done

The United States and China are the two largest economies in the world. We have often made the case the global bull case includes economic rebalancing over time in both nations. Thus any trade deal which further opens up the Chinese consumption market to US goods and services is a positive development. Following many months of back and forth negotiations, the US and China finally agreed to a Phase One Trade Agreement and China has now begun to reduce tariffs on many US goods in February. Overall, we view this as a positive first step with more work to be done in the future, most likely post the presidential election.

Exhibit 5: Summary of US-China Phase One Trade Deal

Summary of US-China Phase One Trade Deal	
Intellectual Property	Addresses concerns in the areas of trade secrets, pharmaceutical-related IP, geographical indications, trademarks, and enforcement against pirated and counterfeit goods
Technology Transfer	China has agreed to: 1) end its practice of forcing foreign companies to transfer their technology to Chinese companies as a condition for obtaining market access or receiving advantages from the government; 2) provide transparency and due process in administrative proceedings and to have tech transfer and licensing take place on market terms; 3) refrain from directing outbound investments aimed at acquiring foreign technology pursuant to industrial plans that create distortion.
Agriculture	The agriculture chapter addresses structural barriers to trade, as well as a multitude of non-tariff barriers to U.S. agriculture and seafood products, including for meat, poultry, seafood, rice, dairy, infant formula, horticultural products, animal feed, pet food, and agriculture biotechnology products.
Financial Services	The financial services chapter addresses long-standing trade and investment barriers, like foreign equity limitations and discriminatory regulatory requirements, to U.S. providers of banking, insurance, securities, and credit rating services, among others.
Currency	The deal includes policy and transparency commitments addressing unfair currency practices by requiring high-standard commitments to refrain from competitive devaluations and targeting of exchange rates, while promoting transparency and providing mechanisms for accountability and enforcement.
Expanding Trade	Includes commitments from China to import various U.S. goods and services over the next two years in a total amount that exceeds China's annual level of imports for those goods and services in 2017 by no less than $200bn.
Dispute Resolution	The deal creates regular bilateral consultations at both the principal level and working level to ensure the effective implementation of the agreement and to allow the parties to resolve disputes in a fair and expeditious manner.

Source: Strategas

5) Performance of Megacap Names (MAGA) Has Been Especially Strong Bolstering Performance of the Market Cap Weighted S&P 500

The performance of megacap names has been especially strong fiscal year-to-date and the numbers are getting large and unprecedented. MSFT and AAPL combined represent 10% of the S&P 500. In other words, 10% of all money invested in the S&P 500 buys these two stocks alone. The over $1 trillion dollar market cap club now includes Microsoft, Apple, Amazon, and Google (MAGA). These four stocks all have strong positive momentum behind them in the short-term, but the law of large numbers is worth noting: a 3% move higher or lower in MSFT or AAPL adds or subtracts a level of market capitalization roughly equivalent to all the assets of the RSA. The market cap of MSFT and AAPL together is greater than the total value of all the stocks in the S&P 400 and S&P 600 combined!

Will government authorities allow these companies to continue to get bigger and more powerful without additional scrutiny? This is a relevant question at this point as the FTC has recently stepped up its efforts by announcing a review of past M&A transactions for this group of powerful companies including Facebook as well.

Exhibit 6: MSFT (5% of the S&P 500) Fiscal Year-to-Date

Source: Bloomberg

Exhibit 7: AAPL (4.85% of the S&P 500) Fiscal Year-to-Date

Source: Bloomberg

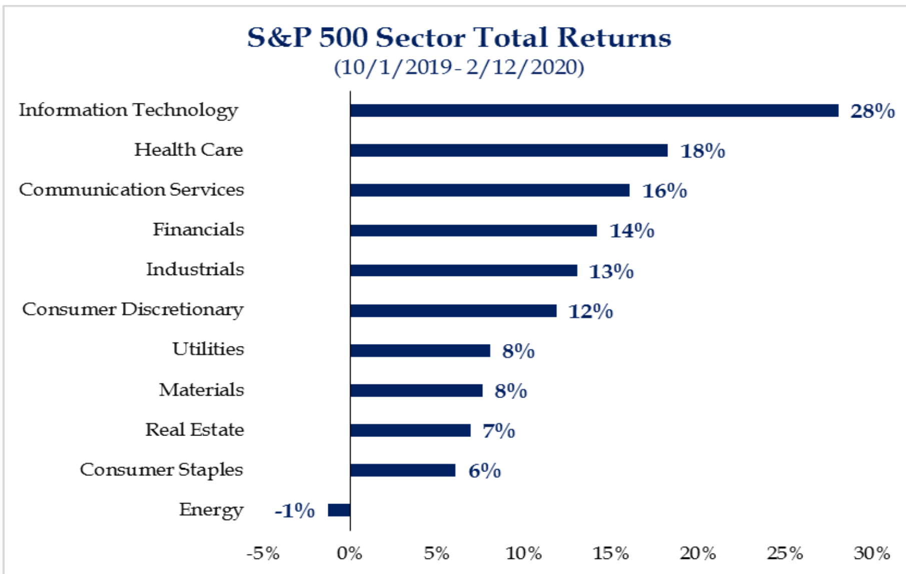
Exhibit 8: Market Cap Weighted S&P 500 (SPX) vs. Equal Weighted S&P 500 (SPW) Fiscal Year-to-Date

Source: Bloomberg

6) The Bull Market is Being Led By the Right Sectors For it to Continue

As investors, we like a bull market to be driven by technology, healthcare, financials, industrials, and consumer discretionary as these are the growth sectors of the market which can lead to strong sustainability of the rally. In fact, these are the sectors which are leading the market which we see as a positive sign moving forward. It would really be hard to draw up the sector performance any better from a bull's perspective.

Exhibit 9: S&P 500 Sector Returns Fiscal Year-to-Date



Source: Strategas

7) Animal Spirits and Aspirational Thinking Has Entered The Investing Picture

I recently saw an interview with Yale Professor, Robert Shiller, who famously wrote the book *Animal Spirits: How Human Psychology Drives the Economy.* In the interview, he was making the case that Trump has revived some of the animal spirits within both the markets and the economy. He has also revived an element of aspirational thinking which can even be seen in the creation of the United States Space Force which was signed into law December 20, 2019. This 6th independent military branch will be charged with preparing our nation for the great unknown. We will be the only nation with an independent space force and President Trump has requested $15.4 billion for the agency in the 2021 proposed budget.

Exhibit 10: Tesla (TSLA) Fiscal Year-to-Date

Source: Bloomberg

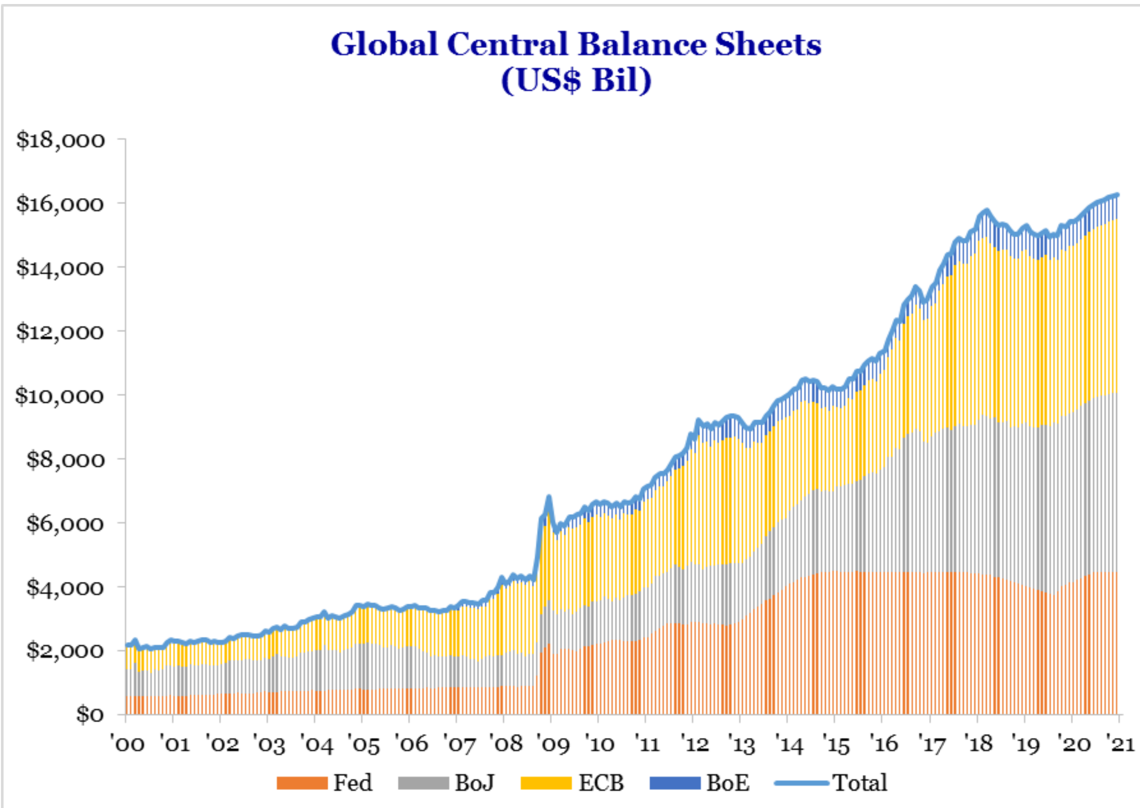
Exhibit 11: Virgin Galactic Holdings (SPCE) Fiscal Year-to-date

Source: Bloomberg

8) Central Banks Around the World Continue to Expand the Money Supply

Aggressive central banks from around the world have certainly been a part of the bull market narrative. Balance sheets have been expanded dramatically across the US Federal Reserve, BOJ, ECB, and the PBOC since the depths of the Great Recession. This dramatic monetary expansion has certainly been part of the reflation in financial asset prices across the board.

Exhibit 12: Global Central Bank Balance Sheets



Source: Strategas

9) Technological Innovation and Productivity Are Keeping Inflation in Check

I was watching *Meet the Press* recently and Tom Brokaw made the point that the United States economy is as innovative as it has ever been in his lifetime. That was a pretty striking point to me. After reflecting on his comment, he is probably right. 21st century advancements in communication, the Internet, robotics, artificial intelligence, and transportation continue to bolster productivity and have provided a much needed check against inflation creeping into the economic backdrop given all the aggressive monetary and fiscal policy. It is pretty amazing we are running $1 trillion dollar federal budget deficits, have expanded the Fed balance sheet and global central bank balance sheets as much as we have, and have record low unemployment without any signs of significant inflation!

10) Valuations Are Reflective of a World of Extremely Low Interest Rates

Without a doubt, current valuations across the US equity landscape reflect the fact that cash flows are being discounted at historically low interest rates. The forward P/E on the S&P 500 now stands at just over 19x and the P/S multiple of 2.4x trailing sales is higher than the level which was present at the great top in March of 2000! While valuation alone is rarely the cause for the market to go down, it does reflect an environment that is vulnerable on the downside to any sort of shock which could throw off the current Goldilocks scenario of modest growth with little inflation.

Equity Strategy Moving Forward

We continue to have an overweight stance toward US equity assets relative to international equities. The earnings yield and dividend yield on the S&P 500 continues to be attractive relative to the very low yields which are available to investors in the fixed income market. We have systematically layered some put spread collars on top of a portion of our long index portfolio as the setup has been ideal: strong gains early in the fiscal year available to protect while still leaving plenty of time to maintain further upside to the covered call strike levels (we are effectively willing to trim some equity exposure at these strike levels north of our actuarial rate).

In addition to being overweight the US equity class versus international equities, we like the overweight of largecap US equity assets relative to smallcap US equities. Given the change of leadership toward largecap that took place beginning in 2015 and the fact these trends tend to persist for many years prior to reversing in earnest, we like maintaining the largecap overweight stance. We are well positioned on this front for the current trend.

While we have yet to launch an equal-weighted S&P 500 index, we have had discussions as an investment staff on doing so and feel there could be some merit to this idea. The market cap weighted S&P 500 has outperformed the equalweighted index by 1000+ bps over the last 3+ years and these trends have tended to correct once reaching such shorter term extremes. Over longer periods of time, the two indices tend to produce similar return levels, but if we can arguably get similar return levels over time and reduce our year-to-year volatility in returns, then perhaps it makes some sense from a portfolio perspective. We could tactically be at a very good point to execute this launch given that the market cap weighted performance has exceeded the equalweight performance by over 400 bps this fiscal year alone.

We do see a risk that the investor class is too complacent about the US political backdrop as we move through the remainder of the year and doubt that markets continue on their straight up trend of the first third of the fiscal year without any sort of hiccup. There is obviously also the possible risk that the coronavirus is more disruptive over time to the global economy than many expect it to be.

In continually assessing where we are in the bull market, we are thrown for a loop as the economy is arguably great, but the last Federal Reserve move was a cut in October and not a hike, so this is not the traditional maturing business cycle dance that Ed Hyman at ISI has outlined below. There is however a general complacency that central banks around the world can solve all market problems with balance sheet expansion and that there is no issue with the potentially reinverting yield curve and this bears monitoring, no pun intended!

Exhibit 13: The Typical Maturing Business Cycle Dance

Here We Go,
Economy Good,
Rates Go Up,
Earnings Go Up,
Rates Go Up,
Economy Better,
Rates Go Up,
Economy Great,
Rates Go Up,
NEW ERA THINKING!
Yield Curve Inverts
No Problem!
Bear Market Starts
RECESSION
The End

Source: ISI

International Equity Strategy

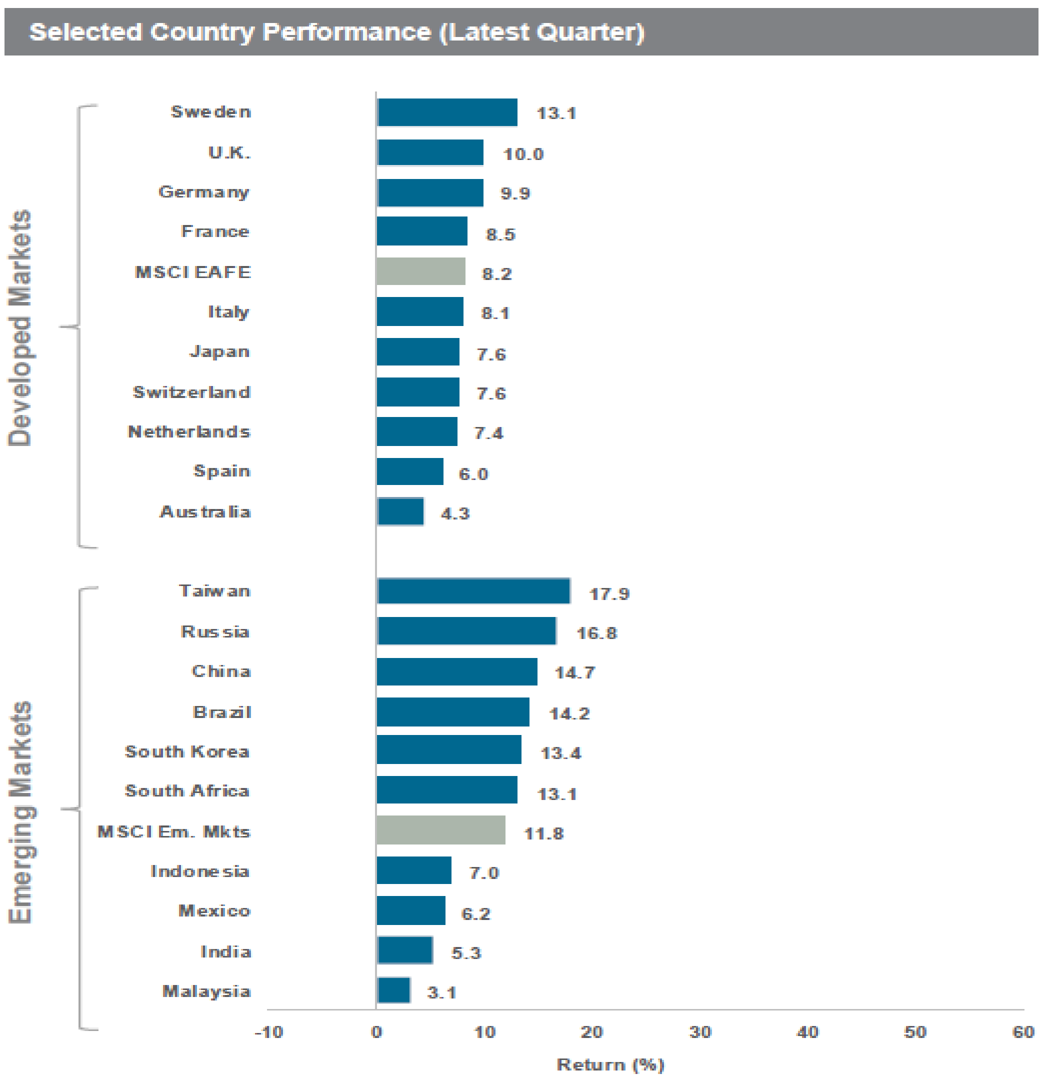
By Steve Lambdin

After lackluster returns in the third quarter, the global equity markets staged a nice rally in the fourth quarter and pushed returns for calendar year 2019 to the best levels in nearly 10 years. In fact, 2019 proved to be a great year for most types of “risk assets”, mainly equities. Most equity markets set new record highs in the quarter. Pushing the global markets higher in the fourth quarter was news of a “phase one” trade deal had been reached between the U.S. and China. This sent global equities higher as investors felt a huge weight had been lifted off the markets. We also saw good news on the Brexit front. Voters in the U.K. gave Prime Minister Boris Johnson and the Conservative Party a majority in Parliament and he has promised a negotiated solution with the European Union (EU) on trade and other issues in 2020. Economic data points in the period continued to be a mixed bag, but with a bias toward a perceived bottoming in some economic measures or developing green shoots in the outlook in many regions. With regard to the central banks around the globe, a clear accommodative bias remained in place in the period as most banks continued to view the global economy as rather delicate and in need of continuing stimulative policies. Nonetheless, investors liked what they saw. However, news on the geo-political front was a clear mess in the quarter. Political protests in Hong Kong continued and have hurt business confidence, tourism, and many other domestic measures of the economy. As a result, the economy here has been pushed into a recession as the outlook seems to be wildcard in the near term. Also, the Middle East remains in turmoil as the U.S. eliminated a top Iranian general believed to be plotting terrorist type actions against the U.S. and its allies in the region. Even a new threat emerged in the quarter, as the Wuhan Corona Virus is spreading across parts of China and perhaps beyond. This could have serious implications for the economy here and even across the globe. Investors will be watching developments here very closely.

	December 2019		4Q 2019		YTD 2019	
Equity index returns (%)	**U.S. dollar**	**Local currency**	**U.S. dollar**	**Local currency**	**U.S. dollar**	**Local currency**
S&P 500	3.0	3.0	9.1	9.1	31.5	31.5
MSCI ACWI	3.5	2.7	9.0	7.7	26.6	26.2
MSCI ACWI ex USA	4.3	2.4	8.9	6.2	21.5	20.7
MSCI World	3.0	2.3	8.6	7.5	27.7	27.3
MSCI Emerging Markets IMI	7.3	5.6	11.6	9.3	17.6	17.3
MSCI EAFE	3.2	1.3	8.2	5.2	22.0	21.7
MSCI Europe	3.9	1.7	8.8	4.5	23.8	23.8
MSCI Pacific	2.2	0.8	7.0	6.4	19.3	18.5

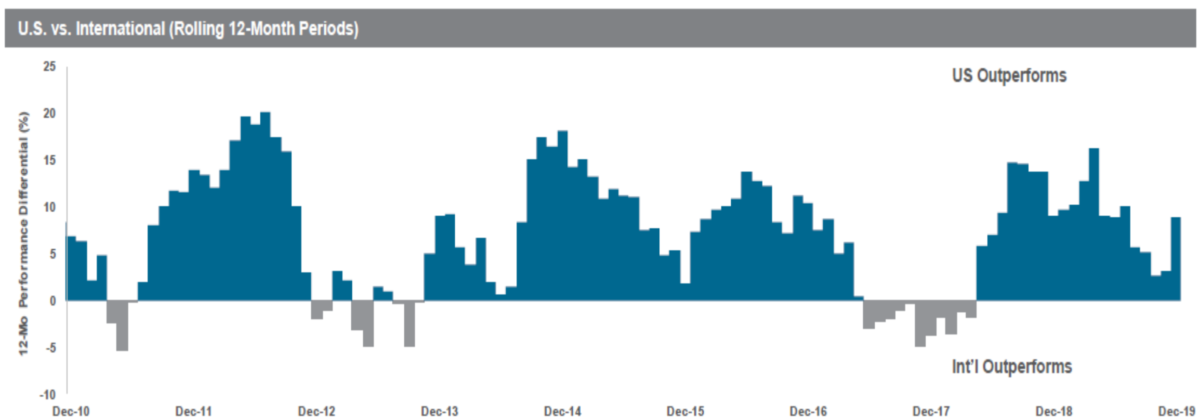
Source: RIMES and Capital Group World Markets Review Q4 2019

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +8.2% and +11.8% respectively during the fourth quarter of 2019 vs. +9.1% for the S&P 500 Index. As has been the case for some time, the S&P 500 Index continued to be the preferred place for global investors seeking returns from large cap equities. However, returns from outside the U.S. were still quite stellar and impressive in the quarter as well as for all of 2019. The U.S. dollar was weaker in the quarter and helped returns by about +3.0% for unhedged U.S. investors. The European region was stronger than the Asian region as the Australian equity market posted a flat return in the quarter as investors have concerns with the economic outlook in this region. Cyclical sectors were stronger than the defensive sectors of the markets as investors flocked toward riskier type assets in the period. Crude oil rose +12.9% in the quarter as unrest in the Middle East pushed this commodity much higher.



Sources: Baird Market Chart book; Morningstar Direct; MSCI

So far into the first quarter of 2020 thru mid-February, global equities have been a bit weak, with the exception of the U.S. equity market. The scare from the Corona virus has got investors a little edgy at the moment as everyone is scrambling to come up with their respective view as to what the effect this virus will have on the global economy. At this point, it seems the virus will have some short term negative growth consequences for China and the rest of Asia. As far as the U.S., the damage seems minimal at the moment with its large consumer driven economy. The more a region's economy depends on trade, the more the potential impact from this. However, things can change quickly and investors will be watching developments on this front. The MSCI EAFE Index and the MSCI Emerging Markets Index are down approximately -.3% and -.7% respectively through mid-February, vs. +4.8% for the S&P 500 Index. Again, the U.S. seems to be the best place to be as this unfolds.

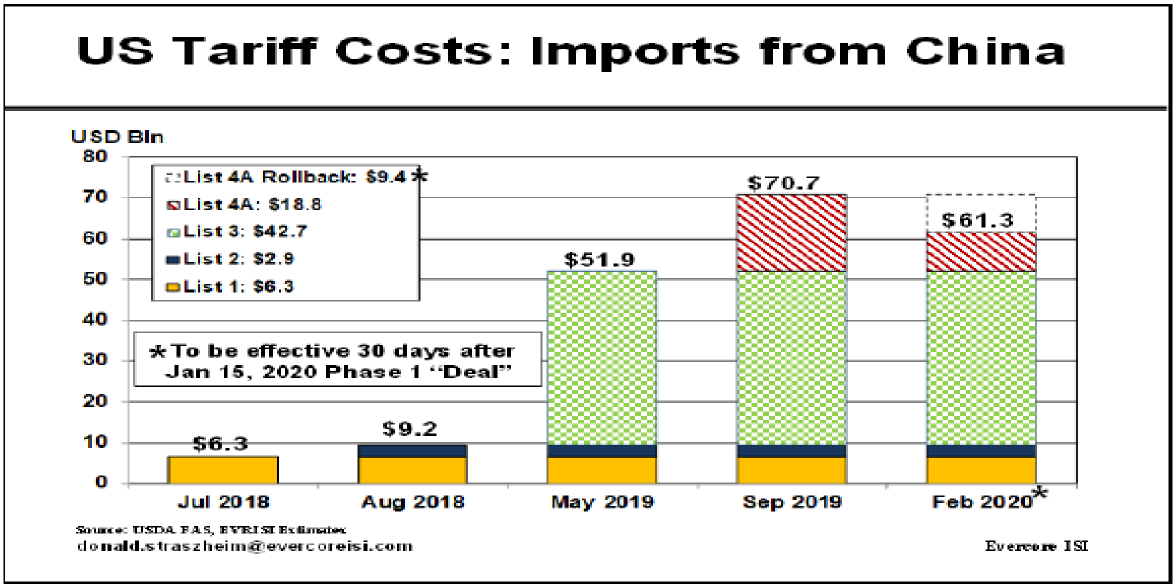


Source: Baird Market Chart Book

Asia Update

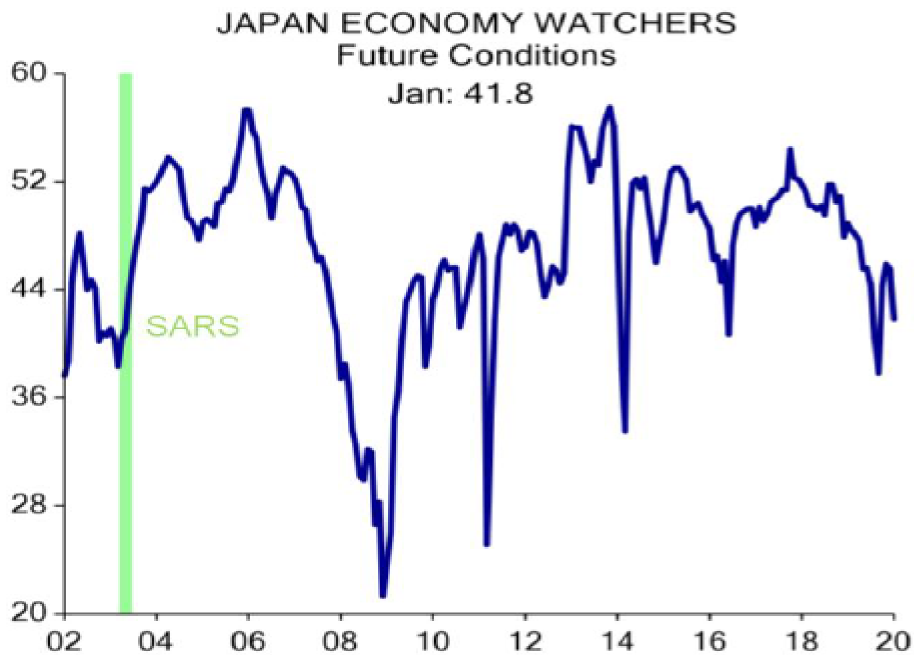
Asian equities turned around from the previous quarter and posted good returns in most countries in the fourth quarter. We were a bit surprised from the strength in many of these equity markets as we expected the recent consumption tax increase in Japan and the worst typhoon to hit Japan in 50 years to hinder returns in the region. However, good news on the trade front between the U.S. and China was more than enough to overcome these issues in Japan. The MSCI Pacific region rose +7% in the period, as the equity market in New Zealand was up +17% in the period on the heels of a massive infrastructure spending plan, while the Australian market struggled more than others as household spending took a turn downward.

We would characterize China's economy in late 2019 as fairly stable as fourth quarter GDP rose +6.0% from a year earlier, which was right in line with the previous quarter. This puts growth for all of 2019 at +6.1%, which was within the government's targeted growth rate of +6% to +6.5%. This still marks the slowest yearly growth in nearly 30 years. About 58% of China's growth came from domestic demand, below the contribution level of 2018. This still means China has a long way to go to rebalance the economy toward an internal demand economy and away from an investment-led economy. The "phase one" trade deal with the U.S. as well as further stimulus actions should provide some short term support for this economy for at least the first part of 2020. We see fiscal policy focusing on further infrastructure spending in 2020. Most expect the People's Bank of China (PBOC) to perhaps temper the pace of easing starting sometime in mid-year, depending on how much the Corona virus cuts near term growth. Industrial production rose significantly in November (+6.2%) and December (+6.9%) from a year earlier as automobile production rose significantly. In addition, we saw good growth in secondary type industries as well late in the quarter. Fixed asset growth was strong in December and pushed total growth for all of 2019 to +5.4%, a bit better than expected. Exports managed to grow +7.6% in December after four straight months of declines, as the U.S. fell to third place in China's trading partners. No doubt this trade war with the U.S. is being felt in this economy. Retail sales rebounded in December and were up +8% from a year earlier, putting growth for all of 2019 at +8% as well. This was a nice rebound from months earlier and surprised many economists. December CPI jumped to +4.5% from a year earlier and matching the rate we saw in November. Pork prices alone rose +97% from a year earlier as the region continues to feel the effects of swine fever. However, Core CPI, which excludes food and energy, still remains well contained and within forecasts. Over the near term, we just don't know how much growth in this economy will be trimmed by the Corona virus. Reports that are circulating are virtually all over the place on this issue. So stay tuned on this. Beyond this issue, we believe the "phase one" trade deal with the U.S. is a step in the right direction, but much work remains as this is not an all-encompassing solution to all trade issues with the U.S. Just how long the near term boost lasts with this agreement is up for debate.



Source: Evercore ISI

While Japan's economy was expected to be weak in the fourth quarter due to the consumption tax hike in October, growth surprised even further to the downside. Fourth quarter GDP fell -1.6% from the previous quarter, or a staggering -6.3% from a year earlier. This was much worse than what most had expected. The tax hike and the worst typhoon to hit Japan in 50 years proved just too much to overcome in the period. However, looking back at the last consumption tax increase in 2014, the economy actually fell a bit worse than what we just witnessed. The trade war continued to be felt here as exports fell -6.3% in December, which is the 13th straight month of declining exports. As expected, exports to China have been extremely weak. However, we expect this to be near a bottom and see better things on the horizon with exports. Industrial production in December rose +1.2% from a month earlier, but fell -3.1% from the year earlier. IT related equipment production was stronger than expected in the period. However, the Corona virus threatens production goals for early 2020 as this could be much worse than expected. Japan's leading economic index continued to be a slippery slope as December's reading of 91.6 was better than the November lows, but still remains very weak by any measure. We would not be surprised to see this fall again in the face of Corona virus concerns running rampant across Asia. 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 January meeting. We expect to see little shift in policy in the year ahead. Consumer confidence continued its recent upward trend from the September lows as December rose to 39.1, the highest level since May. However, we expect this to be short lived as we head into 2020 with Corona virus concerns. The labor market remained very tight in late 2019 as the jobless rate fell to 2.2% in December, while the jobs-to-applicant ratio remained at 1.57. While these are historic lows in these data points, it hasn't generated the kind of wage gains we would have expected at this point needed to put the economy in a better consumer consumption path. At this point, the outlook for early 2020 is cloudier than we expected a few months back. The Corona virus threatens any pickup from the recent phase one trade deal and could put this economy into a technical recession. We would not be surprised if this is the case. But we would expect this to be short-lived as the benefits from the recent trade deal between the U.S. and China begin to flow through the Asian region at some point in 2020. We will see how this plays out.

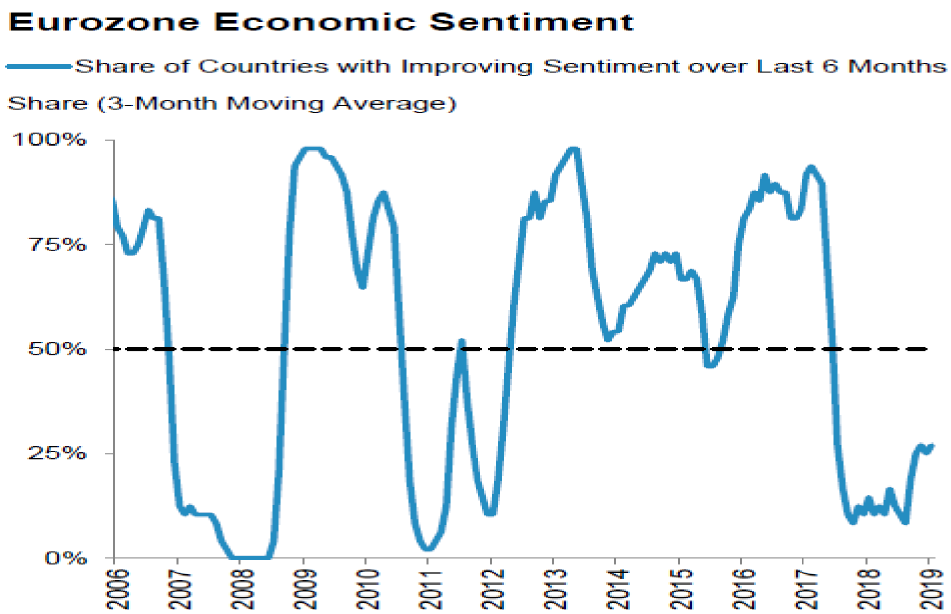


Sources: Evercore ISI

Europe Update

European stocks rebounded in the fourth quarter as progress on U.S./China trade negotiations coupled with a clearer strategy on the future of Brexit was more than enough for investors to look past weak economic readings in the region. The German equity market was particularly strong in period as improving trade relations affects this trade oriented economy more than most. The European Central Bank (ECB) continued to provide enormous support for the region through interest rate cuts, bond purchases, and measures to help banks in a negative interest environment. As a result, we saw German 10-year yields move up from the recent historic lows in a signal of perhaps better growth lying ahead. The MSCI European Index (ex. U.K.) rose +8.5% in the quarter as returns got a nice push from a weak U.S. dollar. For all of 2019, this index posted returns of nearly +25%, which we found to be very impressive when considering the issues facing the region.

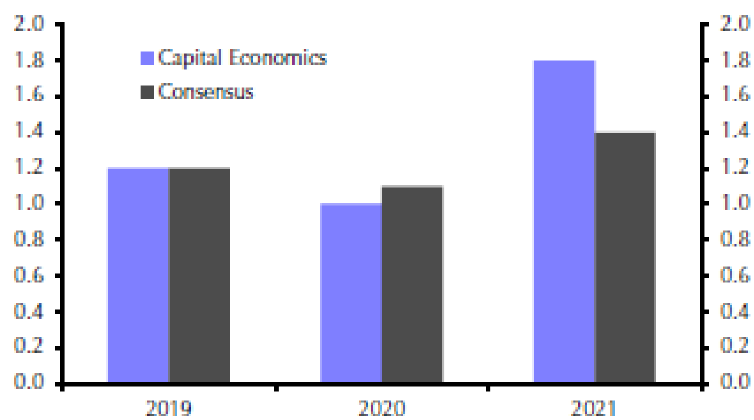
The European economy continued to move along at a snail's pace as fourth quarter GDP grew +.1% from the previous quarter, or +1.0% from the year earlier period. This was the weakest quarter of growth in nearly seven years. France and Italy both unexpectedly contracted and were responsible for the weak Eurozone growth. This did push yields on the German 10-year bond back below -.4% for the first time in recent months. The economy in Spain was a bright spot as strong exports and a firm services sector provided most of the strength here. Eurozone industrial production fell -2.1% in December, or -4.1% from the year earlier. The trade war has put pressure on supply chains across the Eurozone as disruption is common in many industries. However, on a slightly brighter note, the index of executive and consumer sentiment rose to 102.8 in January, the highest levels since August. This is perhaps a signal of better times ahead as we move through early 2020 with a trade deal and better news on the Brexit front. We did not see much help from retail sales as sales in the fourth quarter were up only +1.8% from the year earlier, as the month of December wound up being a bust for many retailers. Core CPI did accelerate some lately as December was reported to be up +1.3% from the year earlier, the fastest pace in eight months. However, this is not much of an issue as it remains well below targeted levels. The ECB made no change to interest rates at its late January meeting after cutting interest rates in September and restarting its bond buying program. We expect little change in ECB policy over the next several months. Employment indicators continue to trend in the right direction as December unemployment rate fell to 7.4%. This is the lowest rate since the great recession over 10 years ago. Looking out into early 2020, we see the potential for some level of economic strength building from a global cyclical recovery, but with some obstacles as well. The Corona virus is just a wildcard at the moment with a number of different directions this can take. We are also concerned about trade relations between the U.S. and the Eurozone. This could put a damper on any expected growth in the region if this spirals downward. Investors will be watching for any clues on these issues.



Source: European Commission; Haver Analytics; Fidelity Investments (AART)

Needless to say, rhetoric around Brexit continued to dominate the landscape in the U.K. over the last few months, much the same as the previous few months. The U.K. formally left the EU at the end of January 2020. We now have entered an implementation period which runs from February 1st to the end of December 2020. It is during this period that a free trade agreement is to be put in place. If one cannot be reached, then tariffs on U.K. goods traveling to the EU along with a multitude of others issues come into play. Prime Minister Boris Johnson insists the transition period will not be extended beyond December 2020. At this point, we would characterize talks as progressing slowly with much to be done. We still believe it is in everyone's best interest to have orderly trade agreements in place by the end of 2020. This would create the smallest amount of disruption and uncertainty in the marketplace. Investors do not like to be negatively surprised. The MSCI U.K. Index posted a strong return in the fourth quarter of +10.0%, with over +7% of this return coming from currency. This pushed the return of this index to a respectable +21% for all of 2019. We find this to be quite good especially with all of the issues going on in the U.K. during the year. Economic growth remained anemic as fourth quarter GDP was flat from the previous quarter, or +1.1% from a year earlier. Growth is just going to be hard to come by until more clarity or progress is made with these trade agreements. Industrial production continued to be weak in late 2019 as December rose just +.1% from a month earlier, or -1.8% from a year earlier. Basically, most components of industrial production were weak in the fourth quarter as Brexit uncertainty continued to play havoc with the outlook here. However, if there was one slight bright spot, then it was manufacturing as exports rose +4.1% from the previous quarter. Maybe momentum can be sustained with this going forward. Retail sales were weak in the fourth quarter as December sales rose +.9% from a year earlier. The consumer remains reluctant to spend with so much uncertainty in the current economic outlook. Inflation remained very little of an issue as Core CPI rose +1.4% in December from a year earlier. This is the lowest levels in three years with no acceleration in sight. At its late January 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. We believed there was a small chance of a rate cut at the meeting, but policy makers opted for another round of the wait-and-see approach. A cut seems unlikely at this point unless the economy takes a further turn for the worst. Employment indicators remained strong in late 2019 as December unemployment remained at 3.8%, which is steady over the last couple of months. The economy managed to add 180,000 jobs in December with a record 32.934 million workers. Wage growth cooled a bit in December as wages grew +3.2% from a year earlier as wage increases could get tougher in the coming months.

Chart 37: GDP Forecasts (%y/y)

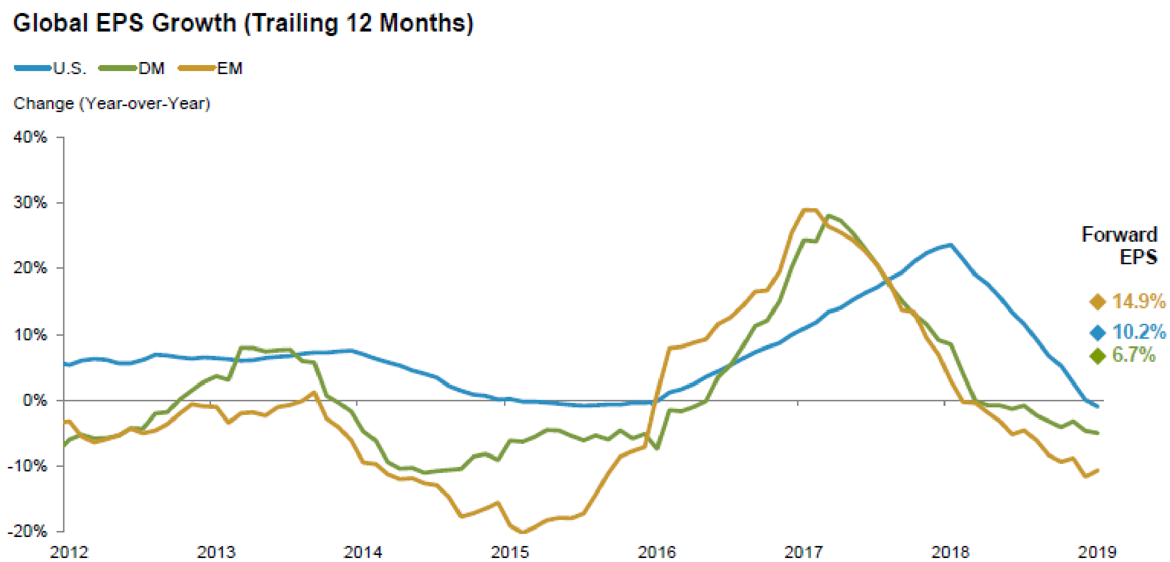


Sources: Capital Economics, Refinitiv, Bloomberg, IHS Markit

Emerging Markets

As investors shifted to a more “risk on” stance in the fourth quarter, emerging market equities proved to the best place to be for this view. We saw quite a rebound in equities in China, Taiwan, Russia, South Korea, and Brazil. The “phase one” trade deal between China and U.S. was the primary catalyst sparking these returns. Overall, the MSCI Emerging Markets Index rose +11.8%

in the period, which was the strongest quarterly gains in almost four years. However, for all of 2019, emerging market equities trailed large cap global stocks as well as stocks in the U.S. As we head into early 2020, emerging market equities could find a bit of tough treading as China, the largest market in the emerging markets index, struggles with being ground zero for the Corona virus. Swaths of workers have been ordered away from work and have stayed home as the streets in some cities are empty. However, longer term and post the height of this virus, we do see an accelerating economic backdrop in many of these markets. We expect to see increased industrial activity, accelerating corporate earnings, and increased investor appetite for exposure to the global cyclical recovery story. As this transpires, we see plenty of potential for good returns in this asset class. Most investors will be watching developments with the Corona virus as this issue seems to be garnering the majority of attention at the moment.



Sources: Fidelity Quarterly Market Update First Quarter 2020

International Equity Activity/Strategy

Looking into the first part of 2020, most equity markets around the globe remain at or very near all-time highs. We find this to be remarkable to a large degree in the face of a multitude of issues the markets have had to digest in the last several months. Many of these issues could have sunk the bull market, but they did not. With this in mind, we believe the outlook for equities still remains quite strong. First of all, and maybe the most important, we still see the global central banks maintaining a very accommodative stance going forward for at least most of 2020. They do not want to risk the growth outlook set to happen in many parts of the world as things still look delicate at the moment. Second, the "phase one" trade deal with China has huge implications for the global economy as well as investor outlooks. Any return to normalcy in global trade patterns will be very welcomed. Whether this transpires to the next phase of trade talks remains to be seen. We believe further rounds of trade talks will progress very slowly with many obstacles to overcome, which could dampen investor sentiment. Rhetoric around Brexit has been very positive lately as negotiations continue with the EU as we expect finality to this by the end of 2020. Economic data points are expected to turn up in many parts of the world which should support a decent earnings outlook in many markets. Inflation and interest rates remain quite low, which is supportive of strong equity markets. Even the political front seems to be helping the outlook for global equities, as President Trump looks to be the odds on favorite to win the upcoming U.S. presidential election, which seems to be what the global markets are pricing in at the moment. However, risks still are abound as we look around. Any re-escalation in the global trade war between the U.S. and China would not be well received. Other areas of risk are any sudden reversal in central bank policies, a swing in the U.S. presidential election forecast, and any shocks on the geo-political front could all serve to change the direction of the markets in a hurry. Beyond any of these issues jumping out, we see the global equity markets remaining strong over the next several months.

We have not added much of anything to our international equity portfolio since our last update. We expect to continue to remain active with our put and call writing strategy on EEM over the next 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. Emerging market equities remains an asset class that looks very attractive to us going forward. Premiums for doing this strategy still look attractive in the current low interest rate environment. Our current allocation to Emerging Market equities is approximately 3.1% 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: Baird Chartbook, MSCI, Refinitiv, HIS Markit, Morningstar Direct, ONS, Evercore ISI, ECRI, Ifo, European Commission, Haver Analytics, Fidelity Investments, Bloomberg, Capital Economics, RIMES, Capital Group World Markets Review)*