Quarterly Economic Update

March 14, 2019

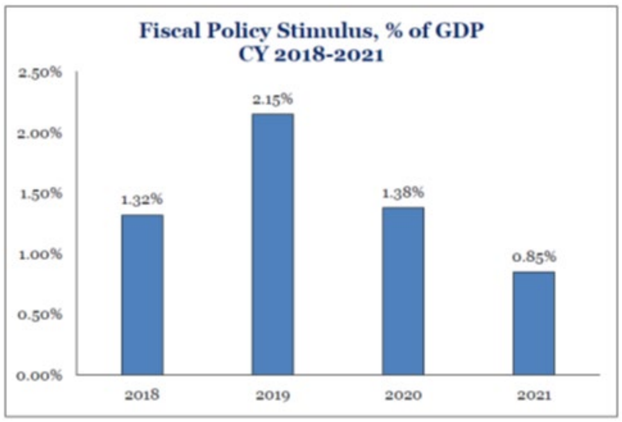
MACROECONOMIC COMMENTARY

Fiscal Policy

By Michael McNair

Tax season off to a slow start but Refunds likely be higher than 2018

Tax refunds are down 40% when comparing to the same point last year. However, this is because all of the Earned Income and Child Tax Credit refunds were distributed by this time in 2018 versus only half today. Dan Clifton, senior policy analyst at Strategas, believes that fiscal policy will be more stimulative in 2019 than in 2018 largely as a result of higher income tax cuts.



The biggest driver of this year's net tax cut is a result of Congress slashing the Alternative Minimum (AMT). Further, the child tax credit was expanded from $1,000 to $2,000 per child and eligibility to claim the child tax credit was also expanded from $100k to $400k of income. These tax cuts will be partially offset with deductions being closed or reduced, most notably the State and Local Tax deduction and removal of the personal exemption. However, Clifton believes the net individual tax cut for 2019 to increase from $100 billion in 2018 to $200 billion in 2019.

Itemizing Out Tax Cuts & Tax Increases, Calendar Year, $BN

Tax Cut	2018	2019	2020
Income Tax Cut	125.5	139.2	142.3
Standard Deduction	76.3	89.7	85.4
Small Business Deduction	36.9	50.3	50.4
Child Tax Credit	39.1	75.2	69.5
AMT	9.2	97.7	71.2
Estate Tax	1.6	9.9	8.9
Medical Deduction	5.1	0.1	0.0
Retirement Disaster	4.3	0.2	0.0
Total Tax Cut	**297.9**	**462.4**	**427.6**

Tax Increase	2018	2019	2020
Personal Exemption	124.4	141.4	142.8
Inflation Bracket	1.1	3.2	6.2
Pass Through Loss Disallowance	12.7	17.3	17.4
Child Credit Protection	0.0	4.9	3.8
Deduction Reform (SALT, etc)	58.0	73.9	73.3
ACA Individual Mandate	0.0	8.4	14.4
Total Tax Increases	196.1	249.1	257.8
Net Tax Cut	**101.7**	**213.3**	**169.8**

Trade War Update

It seems likely that the US and China will finalize a trade agreement within the next few weeks. However, we caution the consensus enthusiasm over the consequences of any trade deal. Market participants seem to have high expectations for what a US-Sino trade deal will mean for the global economy.

The economic impact of a US-China trade deal is likely to be limited to an indirect boost in business confidence. The deal will almost certainly fail to achieve its implicit goal of reducing the US' aggregate trade deficit.

In previous reports we discussed at length the economic consequences of persistent global imbalance. We believe President Trump should be commended for addressing the issue of global trade and capital imbalances; however, he and his administration have a fundamental misunderstanding of the global trading system. As a result, President Trump is perusing solutions that will fail to rectify the persistent US trade deficit.

The US delegation is explicitly focused on reducing the US bilateral trade deficit with China, which is economically irrelevant; while ignoring Chinese capital flows, which are necessary for any reduction in the US trade deficit.

Trade Account = Capital Account

Over the past year, the pages of the Fiscal Policy Report have been dedicated to explaining the oft misunderstood subject of global trade. One of the most important facts that we have explained is that a country's trade balance must always be viewed in the context of the capital account.

In June of 2018 we wrote:

"Most analysis of cross-border transactions is focused on the global trade of goods and services. However, 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. The Balance of Payments tells us that:

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*

The Balance of Payments equation tells us that any transaction that impacts one account will have an equal and opposite effect on the other. Movements in the trade account can just as easily be the result of a transaction on the capital account, and vice versa. As an example, if RSA invests $1 billion in the Brazilian stock market, all else equal, US net exports of goods and services will increase by $1 billion and Brazilian net exports will decrease by $1 billion despite the transaction having no connection to trade."

The balance of payments tells us that an imbalance in the capital account must be mirrored by the trade account. Thus, a trade deficit can be the result of a distortion on the capital account to which the trade account is forced to adjust.

One hundred years ago it was more likely that an imbalance 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, capital flows now dominate and it's the trade account that is forced to balance.

Further, large and persistent trade imbalances can only exist due to significant policy distortions because trade deficits and surpluses alter economic conditions in ways that cause them to automatically reverse. The policy distortion is much more likely to be on the capital account because governments have great control over their capital account and very little over trade. Further, WTO rules limit a government's ability to intervene on the trade account but not on the capital account, despite it having the same impact. As a result, capital and trade imbalances are now the results of distortions on the capital account.

Failing to Account for the Capital Account

The Trump administration is attempting to resolve the trade imbalance by focusing on trade policies. But persistent trade imbalances are no longer caused by explicit mercantilist policies which distort the price of relative goods between countries. Global imbalances are far more likely to be the result of capital flow distortions because of the scale of international capital flows relative to trade flows and the ease of effectiveness of government intervention on the capital account.

Foreign governments have used their control over their country's capital account – limiting capital inflows and directing outflows - to ensure a trade surplus for their country. A trade surplus in one country will automatically force an adjustment in the trade account in another part of the world (someone must run a corresponding deficit). However, the trade imbalance is being transmitted through the capital account rather than the trade account. Importantly, the countries most likely to absorb a trade imbalance in another part of the world are not the countries with the least barriers to the free flow of goods and services but the countries with the lowest barriers to the free flow of capital – i.e. the most open capital markets. The United States has been forced to bear the brunt of China's, and other countries', trade imbalance because they are the only country with deep enough financial markets to absorb the large amounts of capital and an open financial account that does not prevent countries from accumulating US assets. As a result, the US has absorbed half the world's net capital exports. And if the US is a net capital importer, then, by definition, the US must run a trade deficit.

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 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.

Bilateral Balances are Irrelevant in Today's Global Economy

Another reason that the potential trade deal with China will fail to reduce the US trade deficit is that President Trump is targeting a reduction in the bilateral trade deficit between the US and China and not China's total trade surplus.

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.

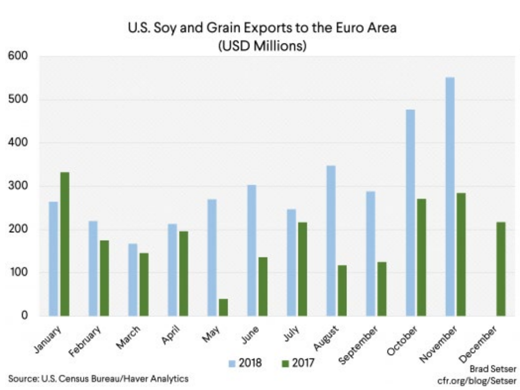
In a world with long global supply chains and minimal transportation costs, the bilateral trade balance between countries is often the result of factors out of either country's control. Mexico, for example, runs a bilateral trade surplus with the United States largely because Mexican companies often 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.

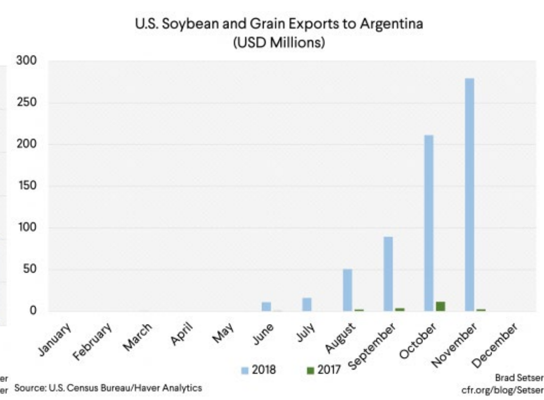
While Mexico runs a bilateral trade surplus with the United States, it runs the seventh largest aggregate trade deficit in the world. Mexico is not stealing demand from the US. Mexico's trade deficit actually reduces the US trade deficit. A policy focused on reducing Mexico's bilateral trade balance 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.

One of the best examples of the irrelevance of bilateral trade balances is provided by the recent trade war with China.

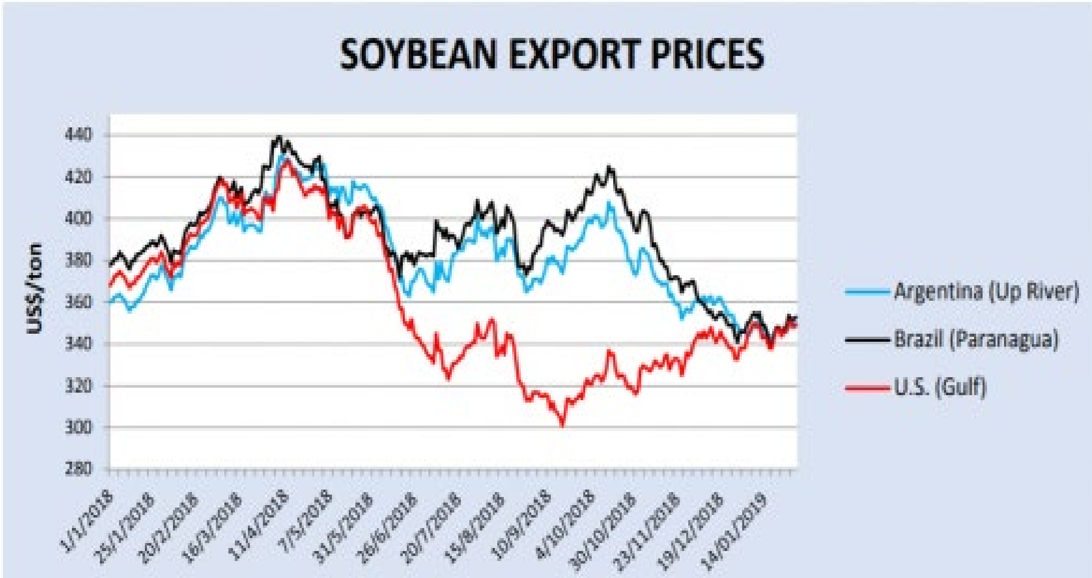
China has historically comprised 60% of all US soybean exports, but US exports to China came to a halt when Beijing slapped an import tariff on all US soybeans in July of 2018. Prices of US soybeans dropped nearly 20% from June to July. The media were sent into a frenzy proclaiming that farmers had unwittingly 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 in order to put political pressure on President Trump. However, in July, we stated 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."

Satisfyingly, reality played out exactly as 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 have adjusted and US soybean prices are no longer trading at a discount to world prices.



China's tariffs on US soybeans are now irrelevant. The US is no better or worse off than it would be without the tariffs. But this should come as no surprise since the tariffs only had an impact on China's bilateral trade balance with the US and not on its aggregate trade balance with the world (in fairness it did have a short-term impact on China's aggregate balance as trade flows were adjusting).

The US is explicitly targeting a reduction in the US bilateral trade deficit with China. It is clear that a major component of the 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 from 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.

If a US – China trade deal is announced and it does not include measures which address Beijing's ability to control China's capital account or it only targets a reduction in China's bilateral trade surplus with the US then it 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 in the first place.

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.

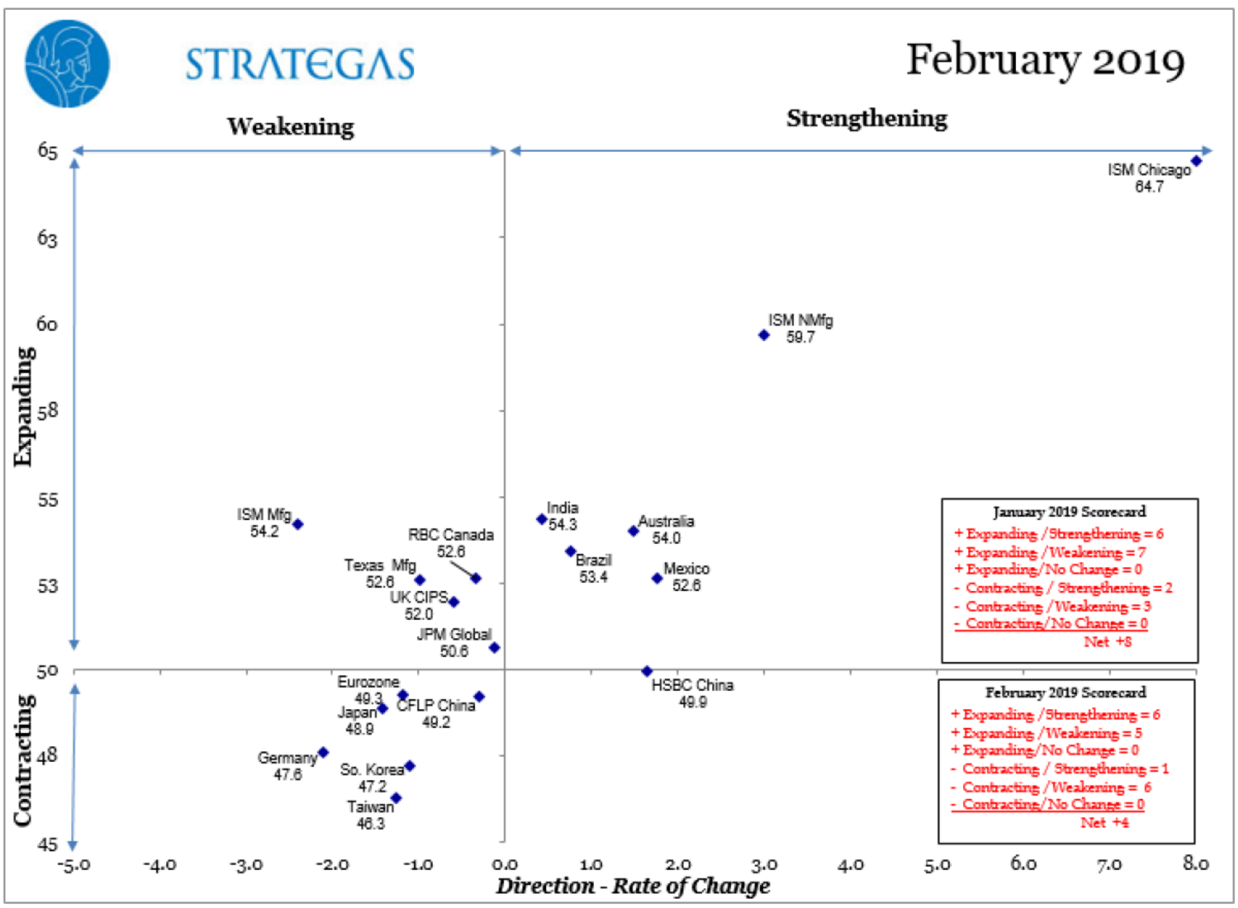
The Chinese economy is in a vulnerable position as they attempt to transition their economy after decades of over investment has left the country the most indebted in the world (3x higher debt to GDP than the US based on the most conservative estimates). Any reduction in China's trade surplus will worsen 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.

Economic Outlook

By Bobby Long

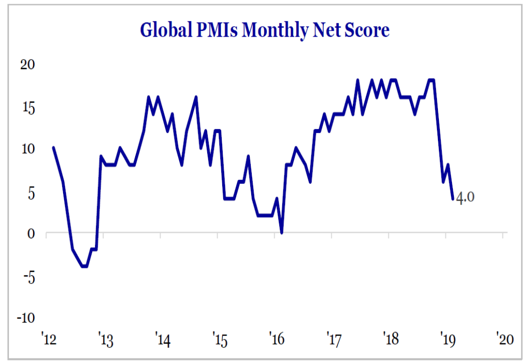
Given the age of the current economic expansion coupled with some weakness in the fourth quarter, more questions have been raised as to whether weaker data points are signaling an end to the current cycle. Recent US economic data has been mixed, but has overall remained supportive. However, when combined with weaker conditions outside the US, tighter monetary policy, uncertainty around the government shutdown and trade policies, and a sharp end of the year equity correction, concerns have risen whether conditions indicate a simple slowdown in the current expansion or a greater risk of an imminent recession. While these concerns have been present over the past several months, some of the concerns have also started to fade and underlying economic conditions seem supportive of a moderating but continued expansion.

While conditions in the US have remained supportive on the whole, global business surveys have indicated clear signs of a slowdown outside of the U.S. The chart below highlights the number of large economies that are experiencing weaker and contracting conditions.



Source: Strategas Securities, LLC

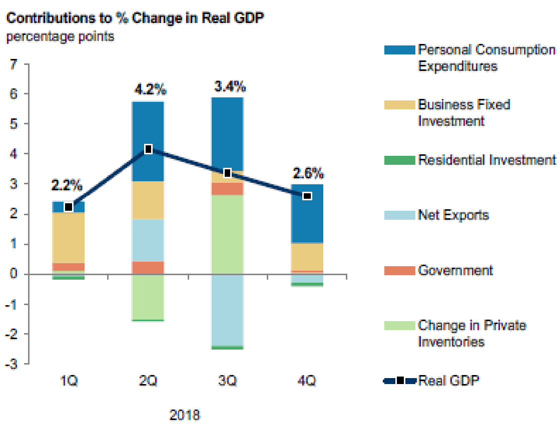
More economies have been shifting from the expanding category to the contracting category and the time series chart on the right shows the sharp decline in the net score more recently. Norbert Ore of Strategas Securities, LLC asks the question, "does the U.S. help raise the weak performers, or do they pull the U.S. down?"



Source: Strategas Securities, LLC

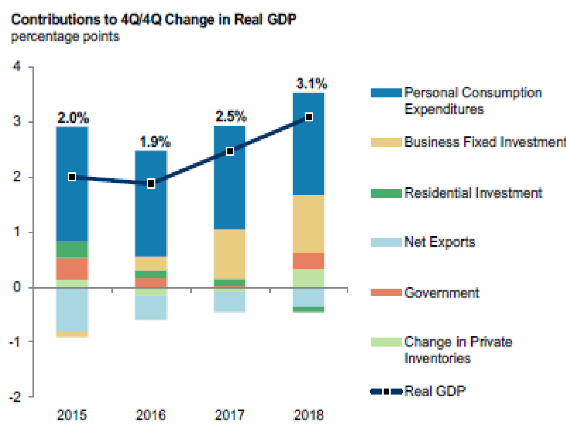
U.S. GDP declined in the fourth quarter following two back-to-back strong quarters in the middle of the year. While annualized quarterly growth fell to 2.6%, it was still a healthy level that reflects supportive underlying conditions. Consumption growth slowed a little during the quarter, but was offset by an increase in business fixed investment. For the full year, GDP grew 3.1%. The charts below show a breakdown of quarterly GDP and how it has trended over the past several years.

Exhibit 1: Contributions to %Q Change in Real GDP



Source: Bureau of Economic Analysis, Morgan Stanley Research

Exhibit 2: Contributions to 4Q/4Q Change in Real GDP

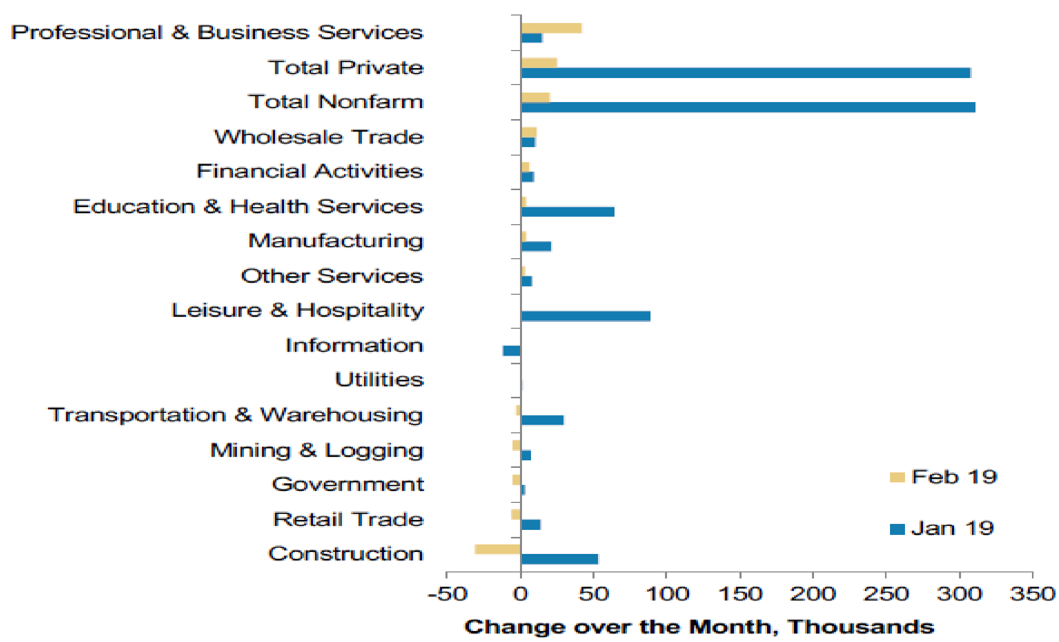


Source: Bureau of Economic Analysis, Morgan Stanley Research

Looking forward, 1Q19 GDP growth will likely come in weaker. The first quarter is seasonally weaker to begin with and the government shutdown will weigh on the number. The Congressional Budget Office has estimated that the government shutdown by itself will shave 0.4 percentage points off of GDP. This is a result of delayed discretionary government spending and ancillary effects the shutdown had on private sector businesses. The government spending will flow back in later with the shutdown having ended, but longer lasting effects on private businesses affected are harder to measure and may not be fully recouped. We have also seen some weaker coincident data such as retail sales, industrial production, and housing starts that indicate a lower level of growth. The weaker data that has shown up is not a cause for alarm, but simply bears watching whether it reflects a larger trend of negative data. It could be temporary weakness based on idiosyncratic events or a reflection of still healthy but slower growth. Overall, consumption has been steady and the consumer remains healthy, but business fixed investment has been an increasing percentage of GDP growth and could help support a continued expansion. A shift in manufacturing back to the U.S. and corporate tax reform is showing a positive effect on capex, which could drive productivity and growth. Coming off of stronger growth in 2018 and paired with tighter monetary policy and weaker growth outside the US, it is plausible that growth will moderate in 2019, but moderating and contracting are two very different things.

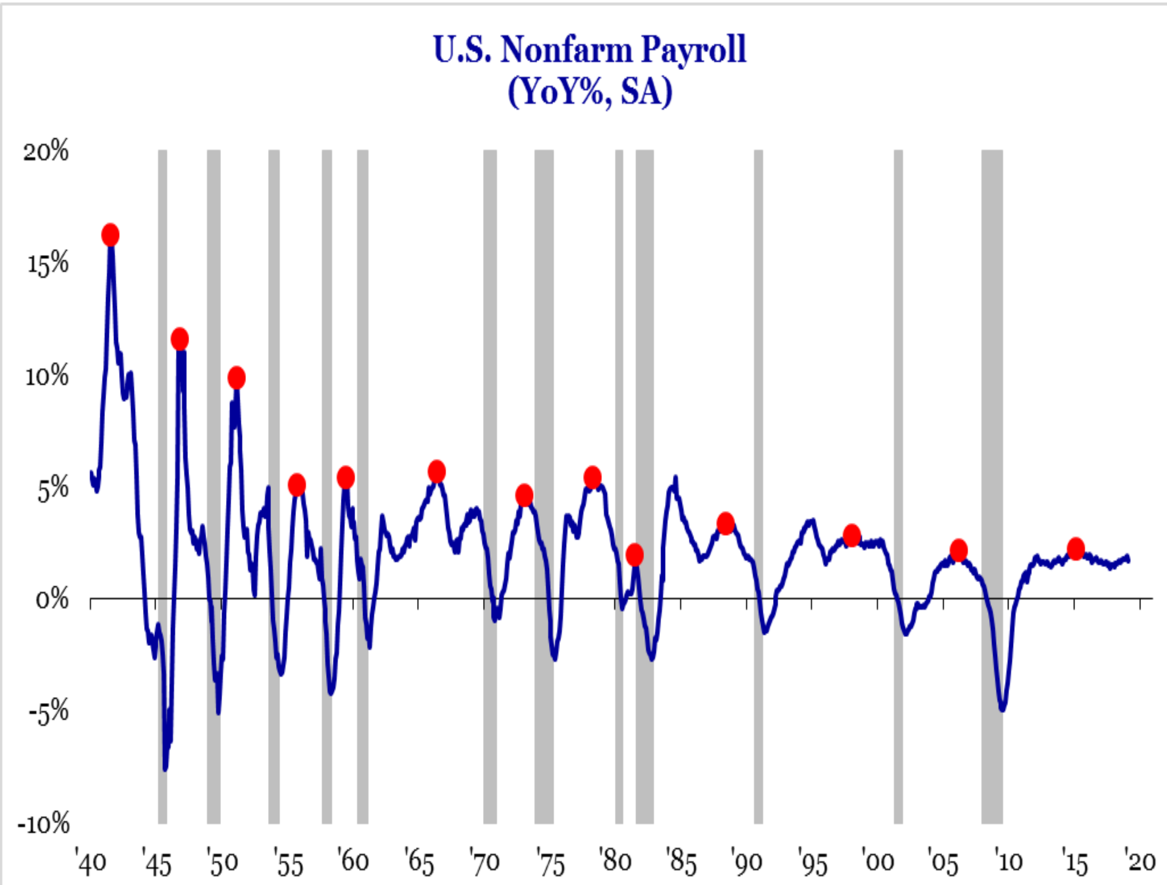
Employment has been strong. The Wall Street Journal recently ran a section headlined “The Great American Jobs Machine” with a subtitle claiming “this is the hottest labor market in 50 years” and further stating that “the job market doesn’t get much better than this.” The February unemployment rate came in at 3.8%. Nonfarm payroll growth did notably fall off in February only rising 20,000 m/m. This followed a strong +311,000 report for January and there were some nuances to the report that could have impacted the number. Some industries that had shown strong growth in the prior month reversed course, such as Construction swinging from a +57,000 job adds in January to -31,000 jobs in February. The chart below provides a breakdown by industry. Some of the variability could be attributed to seasonality, weather, or a reflection of lingering concerns around hiring decisions that crept up late last year with the government shutdown and equity market weakness. The payroll weakness combined with some other weaker data points is worth watching, but does not indicate a developing trend and probably shouldn’t raise any alarms for now.

Exhibit 1: Payroll Growth by Industry



Source: Bureau of Labor Statistics, Morgan Stanley Research

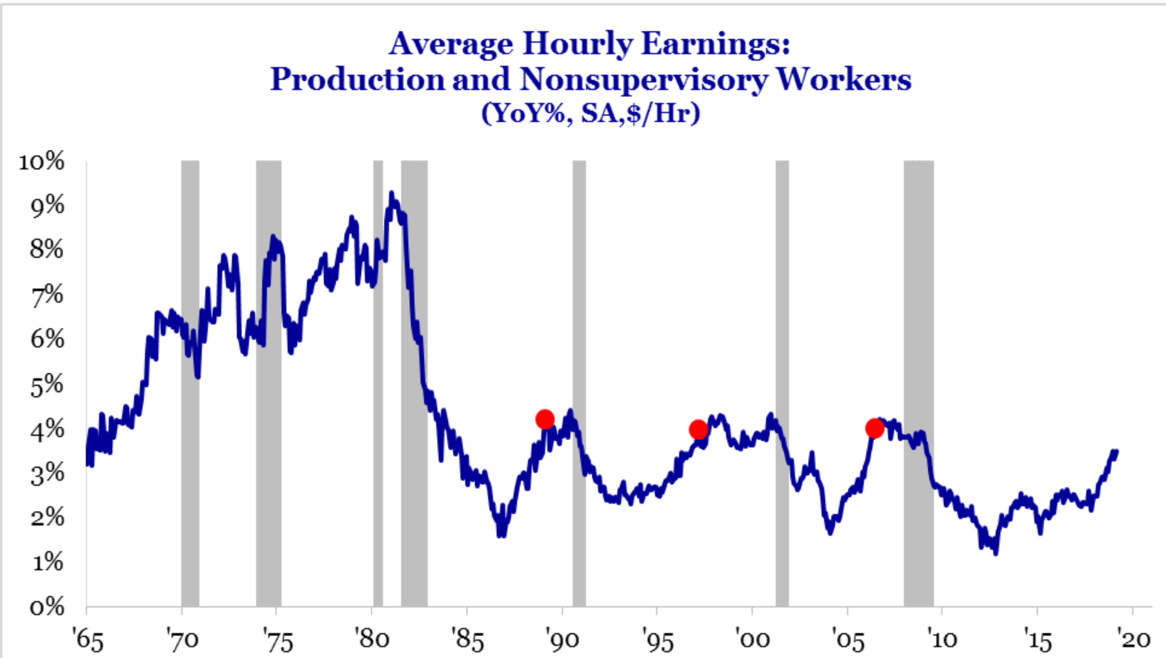
Nonfarm payroll growth did peak in February 2015, but it has remained strong. Typically, growth will decelerate over a period, on average two years, before the cycle ends and slips into a recession. As the chart below shows, following the peak four years ago, payroll growth has remained strong. The February report could be the beginning of a decelerating trend, but this cycle has already shown the ability to last longer than past cycles. This could be attributed to several factors, but the deep recession followed by extraordinary accommodative monetary policy and now followed by more accommodative fiscal policy could be supporting a prolonged cycle.



Source: Strategas Securities, LLC

Wages have also been improving. This has become more broad-based and have been increasing sharper at the low end. Average Hourly Earnings grew 0.4% in February, rising to 3.4% year over year. Despite the recovery in employment, wage growth has stubbornly lagged through this expansion. A large reason for this has been the low labor force participation rate following the last recession. Demographic factors have played a role in this, but a lot of workers have been slow to return to the workforce. The labor force participation rate for people in their prime working years remains low but has been increasing. This is positive for obvious reasons, but can explain how wages have grown at a more moderate pace with low unemployment as this labor supply is being added to the economy. It also can be a contributing factor to the longer nature of the current cycle.

Wage growth is positive for consumers, but like everything economics it feeds into the cycle. Stronger wages benefit the worker which can increase the consumption power of the consumer as long as inflation is stable, however this comes at the expense of corporate profit margins which signal a maturing business cycle. As Don Rissmiller of Strategas Securities highlights in the chart below, historically 4% growth in average hourly earnings begins to pressure profit margins. The fact that wages are now increasing may be a signal that the business cycle is maturing, but that does not necessarily mean it is coming to an imminent end. The chart also shows us that even once wage growth does reach 4%, it has historically been another 2 years before a recession. You can view this as we are in the later innings of the cycle, but you can also argue a more moderate but continued expansion still has more room to run in this already extended cycle.

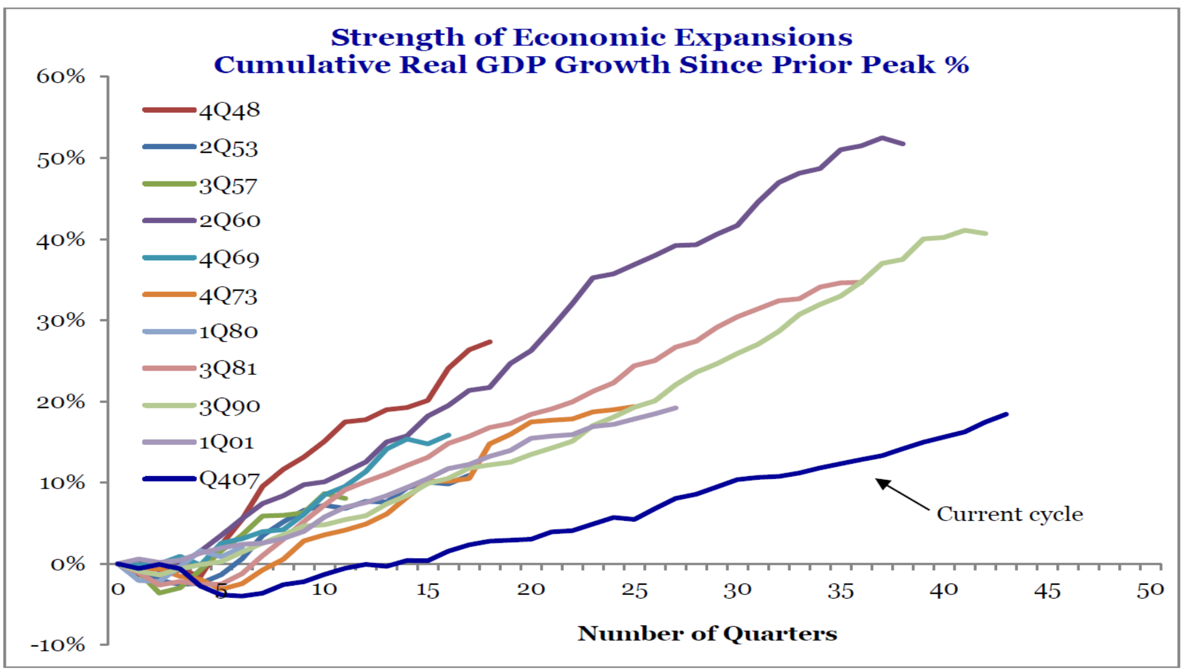


Source: Strategas Securities, LLC

Some of the concerns that crept up late last year have already been countered by more positive data, indicating they could have been simple pockets of weakness within a moderating economy that do not represent the formation of a more negative trend. Both consumer confidence and housing starts declined sharply, but have since bounced off the low data point. The dip in consumer confidence may have been related to the sharp decline in equity markets late last year, which has moved back up with the market. Housing starts had been trending down some with a rise in mortgage rates, which have now eased some and at least stopped rising further. Retail sales fell sharply in December causing some alarm. January retail sales were positive, but we would like to see some confirmation in the February numbers that the December weakness was an exception. The consumer is healthy and the personal savings rate is up with the latest reported at 7.6%. This has historically moved lower ahead of a recession, but the consumer has also shown a greater propensity to save since the last recession. The ratio of consumer debt to income continues to improve as well. Another concern has been lagging tax refunds, but after a slow start these have recently caught up with prior year trends.

Concerns have been strong enough to lead the FOMC to shift their stance toward a more dovish policy approach. After raising rates at the December meeting and indicating a continued approach to tightening monetary policy, they abruptly stepped back at the January meeting to communicate that they will take a more "patient" approach toward future adjustments. They have also indicated a looser approach to meeting their 2% inflation target as an average over time, which further signals a patient approach to future rate increases. In his recent testimony to congress, Federal Reserve Chairman Jerome Powell noted that "while we view current economic conditions as healthy and the economic outlook as favorable, over the past few months we have seen some crosscurrents and conflicting signals." In light of this shift, tighter monetary policy does not appear to be a headwind in the near term.

The current expansion has been weak by almost all measures. It has struggled to gain traction and only more recently has seen the sustained improvements that indicate a healthy economy. The chart below highlights just how much weaker this expansion has been relative to prior expansions.



Source: Strategas Securities, LLC

As the chart shows, while the length of the current expansion has matched some the longest prior expansions and surpassed many others, cumulative GDP growth has been very weak and remains well below prior expansions that have continued for this amount of time. This expansion is not likely to die of old age and can continue especially in light of the extraordinary stimulus that has been provided over the past several years. However, it may be more susceptible to any extreme shocks should they arise and growth may be more moderate and uneven going forward. For now, the evidence and data point more towards a mid-cycle slowdown within a continued expansion versus recessionary conditions.

RSA PORTFOLIO STRATEGY

Interest Rates and Fixed Income Strategy

By Julie Barranco

At the time of our last meeting the December quarter was coming to an end. The Fed had met and increased the federal funds rate by another .25% to 2.25 – 2.50%. The increase was widely expected however not well received by the markets. The Committee also reiterated its projection for at least two more rate increases during 2019, which was also not well received. Risk assets plunged with equities at one point down almost 20% from the highs; credit spreads widened significantly, led by high yield, on recession fears as well as fears of a too-aggressive Federal Reserve. For the quarter, Treasuries were the best performing asset class with roughly 2.6% return. High yield credit was the worst performing fixed income sector with a -4.67% return for the quarter, while equities declined over 13%.

As we moved into January, the New Year brought better news. The main concerns from December, recession fears and a hawkish Fed, were both addressed in January. Economic data was strong, starting with the December employment report which came in much better than consensus. The Fed changed its tune on rate hikes from insisting on two hikes in 2019 to a more dovish stance that emphasized patience with hikes and more data dependence. Later in the month, the government shutdown ended with funding provided through February 15th and risks related to the China trade talks were declining as well. Treasury yields were on a bit of a roller coaster during this time. Two-year yields started the month around 2.38%, rose to 2.62% and then declined back down to roughly 2.46%. Ten-year yields started the month at 2.55%, rose to 2.80% and then declined back to 2.63%. The yield curve, already extremely flat between two and ten year maturities, flattened a bit more by month end to 13bps. The very short end of the curve, which had slightly inverted in December, remained so during January however the spread between two-year and 10-year yields, which is often used as a recession indicator, remained positive.

Source: Bloomberg

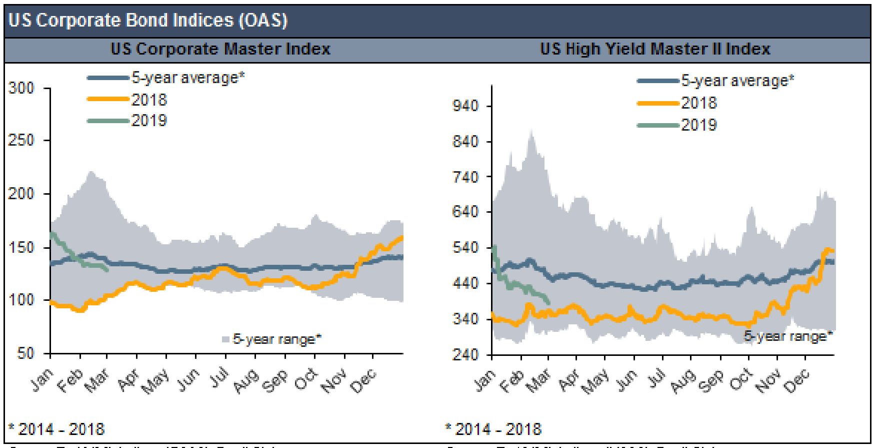
All of these events led to risk markets rallying during January. Equities performed the best, returning roughly 8% for the month. High yield returned 4.6% and high grade credit returned 2.1% for the month. Even Treasuries, despite their yield swings, provided a positive return for the month. January corporate supply volume was up notably from December as one would expect, but down from January 2018 levels.

February started off on a positive note as well, with the markets finding strength in Fed Chairman Powell's comments about stepping back from further rate hikes as well as further dovish commentary signaling the openness to modifying or ending their balance sheet reduction process if necessary. This was closely followed by additional strong economic data, namely the January employment report as well as manufacturing data which both came in well above consensus. The rally in Treasury yields after the Fed commentary was reversed, and yields moved higher on these strong data reports.

Also in February investor attention turned to global economic growth as well as ongoing trade negotiations with China. Both situations were concerning and kept some downside risk in the picture. When the much-anticipated minutes from the January FOMC meeting were released, the Fed mentioned these two things in particular as reasons to be more data dependent going forward. Other concerns mentioned included softness in inflation data, tightening financial conditions, the government shutdown and the lagged effects of policy tightening. Patience going forward was the overall theme of the meeting, to see how these factors continue to unfold. The Fed also acknowledged that the unwinding of their balance sheet may need to come to an end, and that more information about that would be given at upcoming meetings. Late in the month, Chairman Powell reiterated his "no rush to raise rates" commentary in his congressional testimony, closely followed by the fourth quarter GDP number that came in stronger than expected. Both helped to end the month on a positive note.

All of these events allowed risk assets to continue to rally throughout February, with equity markets performing the best. Within fixed income, high yield credit was the best performer, returning roughly 1.7% for the month. High grade credit returned .36% while Treasury returns were slightly negative for the month, returning -.28%. High grade supply was strong in February, totaling $106 billion, as issuers took advantage of the strong market tone.

March has gotten off to a fairly solid start although enthusiasm has waned a bit in recent days. As equities have declined, Treasury yields have also been declining as concerns around growth have risen yet again. Credit markets have performed well through early March and we feel that spreads could perhaps move tighter from here due to the strong economy, the Fed adopting a more dovish stance on rates and market technicals continuing to improve. Supply has been strong so far this month, which is typical for March. Presuming no one-off events taking place, we would expect healthy new issue supply to continue through the month. The chart on the following page shows credit spreads for the high grade and high yield sectors through early March and the tightening since year end:



Source:BofA/ML Indices (C0A0), CreditSights

Source: BofA/ML Indices (H0A0), CreditSights

	Mar 1 2019	Change (bp) Week	Month-to-date	Year-to-date
High Grade	128	-4	-1	-31
Financials	114	-6	-2	-37
Industrials	133	-4	-2	-30
Utilities	134	-3	-1	-25

	Mar 1 2019	Change (bp) Week	Month-to-date	Year-to-date
High Yield	386	-19	-6	-147

Source: CreditSights

The flattening yield curve and fears of inversion followed by a recession have subsided to a degree; as yields have moved higher, the curve has steepened a bit from the lows of a couple of months ago, mainly due to the change of tone from the Fed. The consensus is for one more rate hike in this cycle, which would get rates to the roughly 2.75% neutral rate the Fed seems to now envision. While we do not think that this will happen in the near term given current growth and inflation expectations, we will have to see how all the data comes in over the next few months to get a clearer picture of whether any further rate hikes are on the table or not. The weakening Euro-zone economy and continued monetary stimulus provided by the European Central Bank will be one of several factors being studied by the Fed when determining policy action in the U.S.

With the improved market conditions and declining volatility since year end, we have been somewhat active within the fixed income portfolio. Activity in the corporate sector has been in the secondary market as well as the new issue market as we have replaced maturities or just added new money outright. At different points over the past couple of months we added some short and intermdiate maturity issues, including Bank of America, Morgan Stanley, Altria, Boston Scientific and Con Ed. In these cases we were able to lock in very attractive spreads over comparable Treasuries yet not take on much interest rate risk in the process. Corporate spreads have been tightening steadily since January, after the weakness experienced late in 2018 as the equity markets were declining. High yield has been tightening at a faster pace than investment grade and while spreads are still somewhat narrow on a historical basis, the sector is still attractive. We will continue to look for attractive names/maturities to selectively add to the credit sector, particularly if we get any further weakness in spreads that provides an opportunity.

In the agency debt sector we have seen spreads remain stable and fairly tight. Over the past couple of months we have replaced a couple of maturities within this portfolio. Purchases include 2024 and 2025 bullet issues as well as a 2029 bullet issue. With yields declining throughout December, and then staying fairly range-bound since, we felt comfortable adding exposure in the intermediate part of the curve. With the global economic outlook being somewhat cloudy right now, coupled with the low volatility in the market, we felt more comfortable adding bullet exposure for the positive convexity that they provide, especially if interest rates begin to tick lower again. These purchases also helped to move the duration of the portfolio closer to neutral, which we also felt was prudent at this time. We would expect any upcoming trades to be maintenance type trades to replace a call or maturity, or perhaps a swap to adjust interest rate risk. We do not anticipate adding any significant new money to this sector given the tightness of spreads versus Treasuries.

Spreads have remained fairly stable within the mortgage sector as well. With rates staying in a fairly narrow range since January, we have been fairly active within this sector. We added money to the sector through outright purchases, adding GNMA and FHLMC 30-year 4% pools. After the large decline in rates in December, this structure looked attractive as it allowed us to lower duration a bit but also improve the carry earned. Additionally, we also swapped out of some 15-year 2% pools and swapped into a 30-year 4.5% pool. This swap allowed us to sell a lower yielding pool to buy a much higher yielding pool, and better diversify the portfolio so as to bring it more in line with its benchmark index. The duration of the mortgage index has been fluctuating the past few months, therefore these swaps have helped to adjust our duration accordingly. Despite adding money to the sector, we are still underweight versus the index, and therefore have room to add to the sector when opportunities arise. We will also continue to monitor interest rate movements and adjust duration as needed.

Lastly, we added to the Treasury portfolio, purchasing two-year notes to reinvest funds from recent maturities and add to the sector. With global economic uncertainties still present, adding short Treasuries seemed like a good hedge. If the Fed raises rates later in the year, the shorter duration positioning of the portfolio will outperform. If recesssion fears grow stronger and risk free assets rally, then we will be better off from adding more Treasury exposure. We are still underweight the sector as a whole and our duration is currently a little short versus the Index. We continue to watch yield levels closely and will adjust our Treasury positions and duration as needed.

Domestic Equity Strategy

By Hunter Bronson

Happy birthday wishes are in order, as the current bull market turned ten years old this past Saturday. Oddly enough, the anniversary of the second longest bull run in history has received very little fanfare – a sign of just how unloved the rally has been. We suspect that the average investor **still** remains skeptical despite a run from intraday lows of 666 on the S&P 500 on Friday, March 6 to today's mid-2700s.

Figure 1: A decade of the SPX; From 666 to today

Remarkably, despite this 300+% run in the S&P 500, retail investors have actually withdrawn $330B from U.S. equities since 2009. The $1T of inflows into domestic equity ETFs have been more than offset by $1.33T in domestic equity mutual fund outflows.

Net Flows into Mutual Funds + ETFs ($BN)						
	Domestic Equity		International Equity			
Year	MF	ETF	MF	ETF	Bond	Money Mkt
2009	(27.6)	30.9	29.6	39.6	417.2	(539.1)
2010	(81.1)	46.7	56.7	41.5	262.0	(525.1)
2011	(133.3)	47.3	4.1	24.3	163.7	(124.1)
2012	(159.1)	80.9	6.4	51.9	358.5	(0.2)
2013	18.1	104.1	141.4	62.8	(59.0)	15.0
2014	(60.2)	141.5	85.4	46.6	94.5	6.2
2015	(170.8)	65.4	93.9	109.7	29.4	21.5
2016	(235.4)	167.6	(24.5)	20.1	190.1	(30.3)
2017	(236.0)	186.0	76.7	159.8	381.1	106.9
2018	(253.2)	139.1	(7.3)	70.3	103.0	158.8
TOTAL	(1338.5)	1009.4	462.4	626.5	1940.5	(910.5)

Figure 2: Domestic equity fund flows have been weak; Source: Strategas

Equally as noteworthy, in our view, is that endowments' allocation to equities are flat-to-down since the financial crisis. Figure 3 shows that endowments' allocation to alternatives still easily outweighs equities. It is hard to characterize this behavior as euphoric with respect to public equities; at best, we would describe it as skeptical.

Endowments Asset Allocation (Dollar-Weighted Average)

Year	Equities	Fixed Income	Alternatives	Cash/Other
2002	50%	23%	24%	2%
2003	49%	21%	27%	2%
2004	51%	17%	28%	4%
2005	48%	17%	32%	3%
2006	48%	15%	35%	2%
2007	47%	13%	37%	2%
2008	40%	13%	46%	1%
2009	32%	13%	51%	4%
2010	31%	12%	52%	5%
2011	33%	10%	53%	4%
2012	31%	11%	54%	4%
2013	34%	10%	53%	3%
2014	36%	9%	51%	4%
2015	35%	9%	52%	4%
2016	35%	8%	53%	4%
2017	36%	8%	52%	4%
2018	36%	8%	53%	3%

Figure 3: Cumulative Endowment Asset Allocations; Source: Strategas

On closer examination, it shouldn't be all that surprising that this bull run has lasted this long and generated so little excitement. Figure 4, below, shows length of U.S. recessions against the length of the subsequent expansions. With some expected degree of variability, we see that there is a clear positive relationship between the length of a recession and the length of its subsequent recovery. It should make some sense to us that the longest recession in history should birth one of the longest recoveries.

NBER Defined Recession Periods

End of Business Cycle	End of Recession	Peak to Trough Length of Recession (Months)	Length of Following Expansion (Months)
Feb-45	Oct-45	8	37
Nov-48	Oct-49	11	45
Jul-53	May-54	10	39
Aug-57	Apr-58	8	24
Apr-60	Feb-61	10	106
Dec-69	Nov-70	11	36
Nov-73	Mar-75	16	58
Jan-80	Jul-80	6	12
Jul-81	Nov-82	16	92
Jul-90	Mar-91	8	120
Mar-01	Nov-01	8	73
Dec-07	Jun-09	18	?
	Average	*11*	*58*

Figure 4: Length of Recession vs. Length of Expansion; Source: Strategas

Finally, this recovery has the unique distinction of being the slowest in U.S. economic history. In fact, as shown in Figure 5, it has generated the lowest real cumulative GDP growth over the longest period of accumulation. It's neither sexy nor exciting to get rich slow, but it is certainly lucrative for those willing to be patient (See Figure 1).

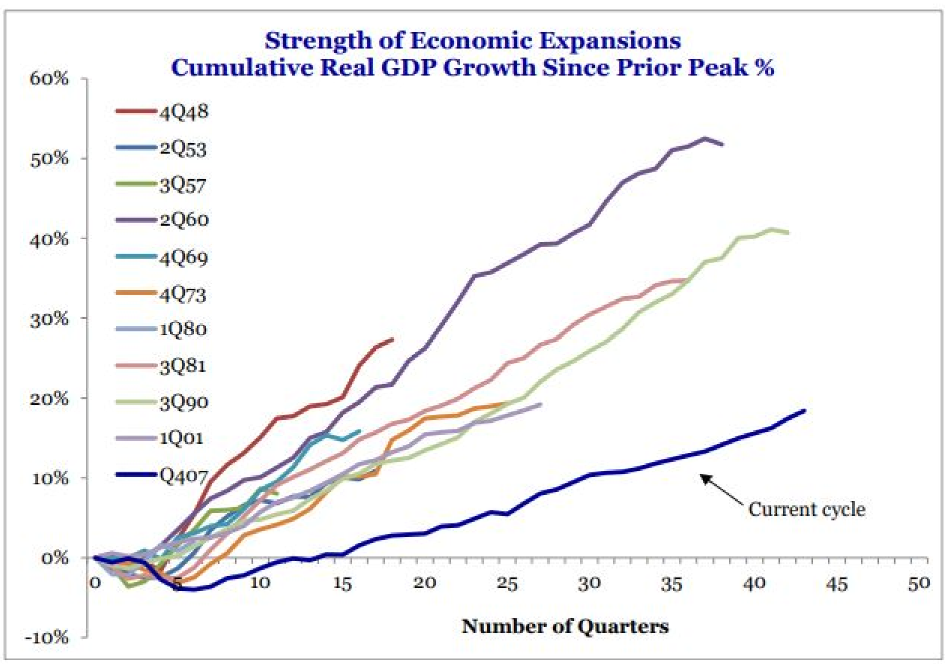


Figure 5: Cumulative Real GDP Growth vs. Length of Expansion

At the risk of beating a long-dead horse, we think it is worth repeating Sir John Templeton's adage, "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."

Moving on to more recent history - after grinding higher for the majority of 2018 and hitting an all-time high in September, the S&P 500 pulled back nearly 20% from the highs through Christmas Eve. As we stated in these pages during the correction, the most oft cited worries were over continuing Chinese trade uncertainties, slowing global growth, and perceived Federal Reserve hawkishness from Chairman Powell. Since that time, Chairman Powell has bent the knee to the market's will and pivoted to a more data-dependent stance, while investors are more optimistic about a potential China trade deal. As a result, the market is off to its strongest start since 1991 – up over 9% year-to-date at the time of writing.

Since our last update, consensus seems to have swung from acute fears of recession back to "no imminent recession on the horizon." The bears continue to worry that weakening global growth, fiscal & monetary uncertainty, executive trade volatility, and declining earnings estimates signal a more protracted decline. We don't wholly discount those fears, as they are legitimate concerns. However, we think the counterpoints are worth noting.

First, the U.S. has historically led the rest of the world into global recession – never the other way around. Next, corporate tax reform created unprecedented financial incentive for businesses to spend excess cash on productive capital investment. This CAPEX spending should provide a long-term tailwind to productivity and real GDP growth. However, we think it is important for business leaders to see some level of geopolitical & trade stability **before** they commit to long-term capital allocation decisions. We are hopeful for a satisfactory resolution to the Chinese trade spat, and we see some evidence that corporate leaders are becoming more comfortable in Figure 6.

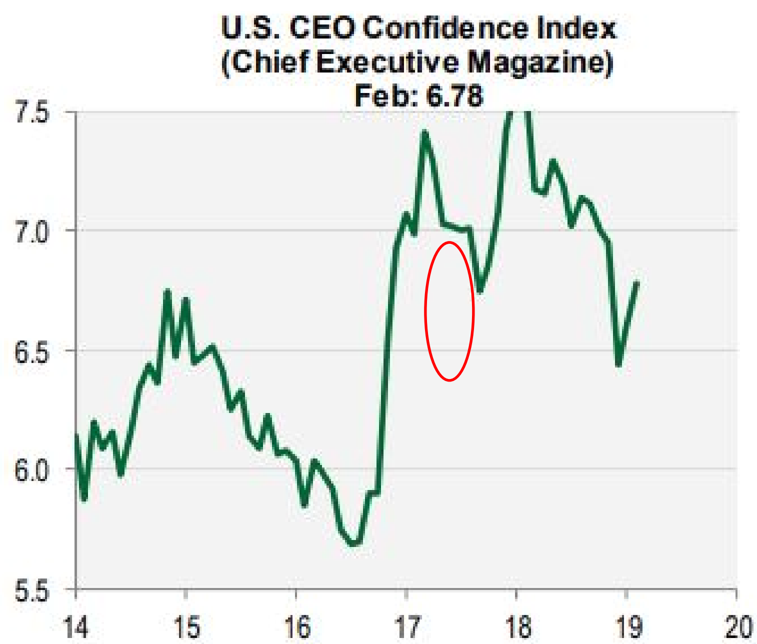


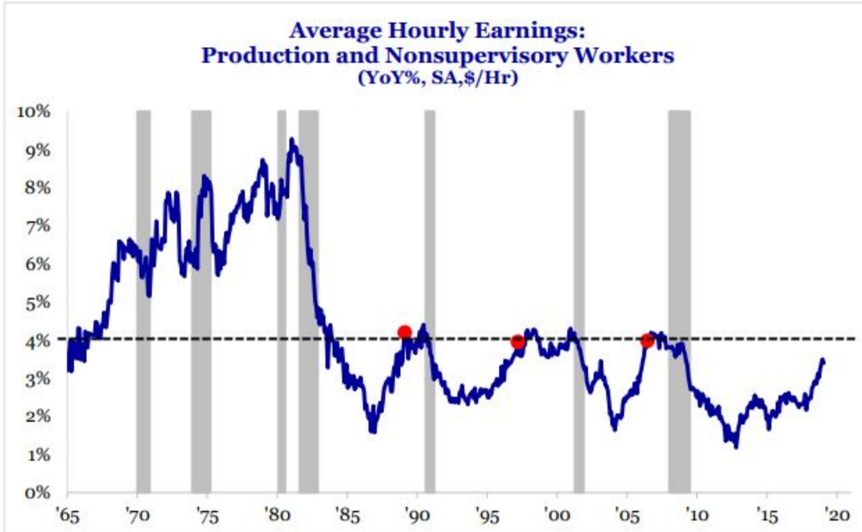
Figure 6: CEO Confidence Rebounding in FY19 Q1; Source: Cornerstone Macro

Finally, while earnings and growth expectations have been taken down recently, we suspect they were merely artificially high to begin with. Analysts tend to extrapolate current levels of growth forward, and the initial boosts from tax reform were likely unsustainable. Now that earnings expectations have come down to more reasonable levels, valuation should be more predictive of forward returns. Figure 7, below, shows that the S&P 500 is now actually trading **below** its 10-year average price-to-earnings ratio. In fact, at the December nadir, it nearly traded at 2 standard deviations below the 10 year average. These are not nosebleed levels of valuation, and by our estimation, don't indicate widespread euphoria.

Figure 7: 10-year S&P 500 Price/Earnings Ratio

There are a couple of issues that we continue to monitor for signs of an impending bull market top. We believe that as wage inflation approaches 4% it begins to feed into core inflation, profit margins come under pressure, and the Fed is more likely to favor a higher interest rate policy. Figure 8 on the following page shows that we haven't yet reached the breaking point with the most recent reading at 3.4%. On average, recession is two years away once the 4% level is breached. We are hopeful that an increasing labor force participation rate and renewed advances in productivity will continue to allow for healthy, but restrained wage growth.

The 2019 IPO class could shape up to be one of the largest in history. Flashy names like Uber, Lyft, Airbnb, Pinterest, and Slack are almost sure to generate retail investor IPO interest – something we haven't seen much of this cycle. Big pick-ups in M&A activity and retail IPO participation are usually signs of an impending top. The cat is still in the bag, but a more recognizable 2019 IPO class could generate some retail excitement.



Wage Growth 4%	Recession Begins	Months Between
Feb-89	Aug-90	18
Mar-97	Apr-01	49
Jun-06	Jan-08	19
	Average:	**29**

Figure 8: Wage growth has been strong as of late.

Figure 9: Anticipated 2019 IPO Class Standouts

All told, we continue to believe that the fundamentals underpinning the bull market in stocks outweigh the downside risks. We don't necessarily disagree with the bears that recession risks have increased, although we still think the chances are low. We believe the reset in both earnings expectations and valuations have priced in upside for stocks through the remainder of the year, barring some external shock. We will continue to monitor wage inflation and take the temperature of the retail investor for signs of frothiness, which we don't see much evidence for yet.

International Equity Strategy

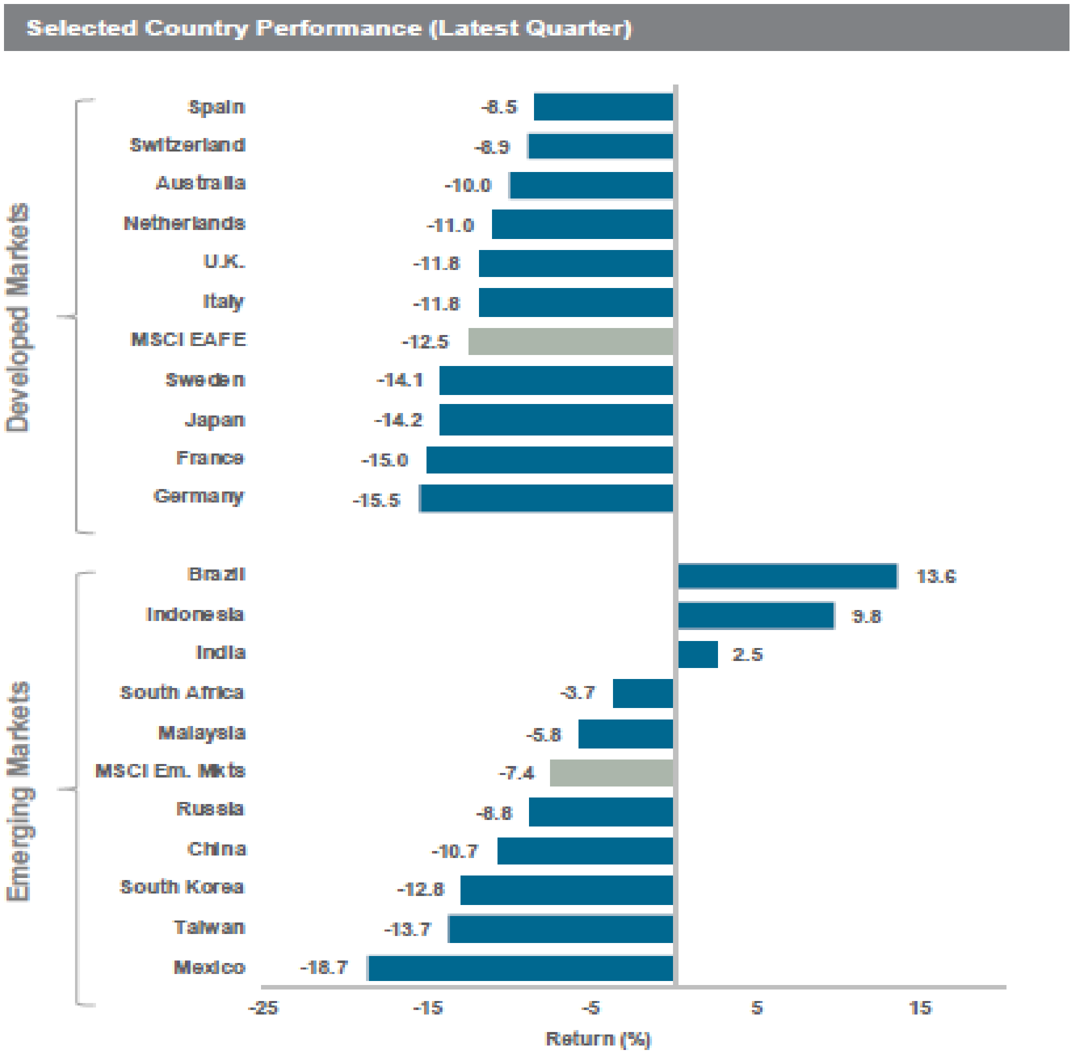
By Steve Lambdin

The final quarter of 2018 was a period of heavy volatility in the global equity markets, as many markets fell into bear market territory. Nearly all markets were affected as investors adopted a “risk-off” posture to a level not seen since the 2008/2009 financial crisis. A multitude of issues seemed to rattle investors during the period. The prospect of rising interest rates in the U.S., a slowing of the global economy, the continuing trade war with China, the lack of real Brexit progress, the steady diet of political issues in Europe, and the potential for a U.S. government shutdown all came together to force equity markets to the worst quarterly performance in nearly 10 years. Nothing was spared, as losses were spread across all geographical regions, sectors, styles, and company sizes. The most central issue during the period was the ongoing trade rhetoric with China. It seemed like every other comment in the media was affiliated with some type of trade tidbit on this front. It’s hard to know exactly how far apart both sides are as news flow changes dramatically almost on an hourly basis. Neither side wanted to show their respective hand in these tense negotiations. From the U.S. standpoint, the heart of these issues still seemed to be the protection of intellectual property rights, the transfer of technology, government subsidies of certain sectors, and the lack of open markets for certain goods and services. From the Chinese standpoint, most issues seemed to surround the aggressive use of tariffs by the U.S. in order to bring China to the discussion table. As the talks continued, President Trump used the cat and mouse game of tariff threats to no real progress on most issues. Investors were left to wonder just how far away both sides are as opinions differ quite dramatically. As we listened to comments from various management teams in the quarter, we find most damage from tariffs has been well contained as many companies have used the flexibility built into their respective supply chains as well as price increases to lessen the burden of the tariffs. This was a welcomed relief to most of us. With regard to the U.S. Federal Reserve Bank (Fed), we saw a bit of a reversal of strategy in late December, as rhetoric pointed to a substantial downshift in potential rate increases going forward. This could bring quite a bit of relief to equity investors in 2019 as we know that changes in U.S. interest rate policy can have a dramatic effect on global equity prices. As far as Brexit goes, things are still a mess in early 2019 as Theresa May continued to try to hammer out a deal with the European Union (EU). Key votes and deadlines still loom large in late March. We are still not very optimistic that everything gets worked out by then, but believe progress is being made on the margin and perhaps some type of extension can be passed to keep talks going.

Equity index returns (%)	December 2018 U.S. dollar	December 2018 Local currency	4Q 2018 U.S. dollar	4Q 2018 Local currency	YTD 2018 U.S. dollar	YTD 2018 Local currency
S&P 500	–9.0	–9.0	–13.5	–13.5	–4.4	–4.4
MSCI ACWI	–7.0	–7.3	–12.8	–12.5	–9.4	–7.7
MSCI ACWI ex USA	–4.5	–5.0	–11.5	–10.9	–14.2	–10.6
MSCI World	–7.6	–7.9	–13.4	–13.1	–8.7	–7.4
MSCI Emerging Markets IMI	–2.5	–2.4	–7.4	–7.4	–15.0	–10.5
MSCI EAFE	–4.9	–5.9	–12.5	–12.2	–13.8	–11.0
MSCI Europe	–4.6	–5.3	–12.7	–11.2	–14.9	–10.6
MSCI Pacific	–5.1	–6.6	–12.2	–13.8	–12.0	–11.7

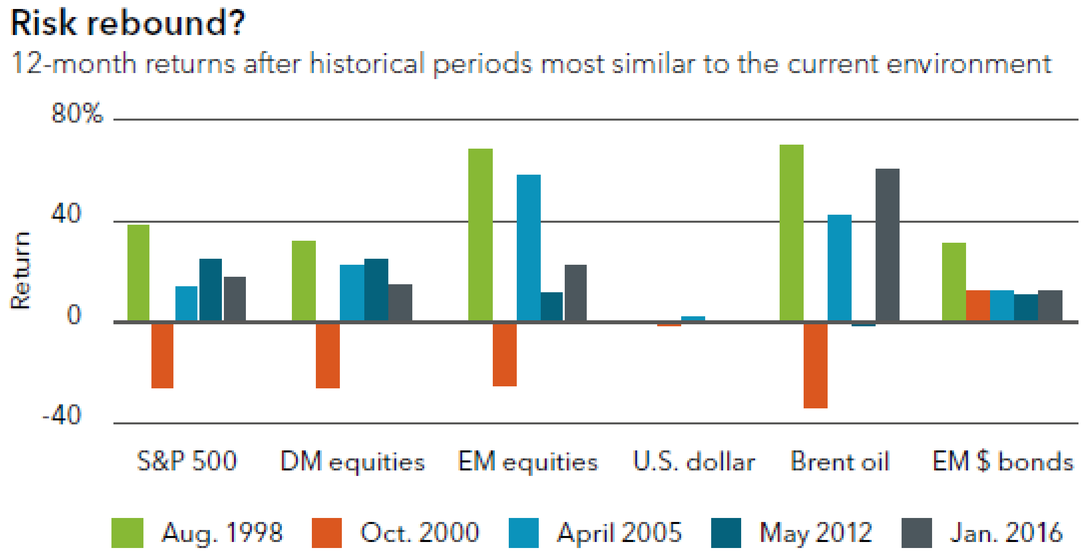
Source: RIMES and Capital Group World Markets Review Q4 2018

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned -12.5% and -7.5% respectively during the fourth quarter of 2018 vs. -13.5% for the S&P 500 Index. This pushed U.S. stocks into negative territory for the calendar year for the first time in a decade. Emerging markets did not fare not as bad in the quarter as several countries seemed to benefit from the dramatic fall in crude oil prices as they are net importers of the commodity. Also, The Brazilian equity market was strong on the prospects of further reforms from President Bolsonaro. The U.S. dollar was slightly stronger in the quarter, but was not a major detractor from performance. For the fourth consecutive quarter, the Pacific region was stronger than the European region, as Asian countries outside of Japan were not down as much as Japanese equities. From an economic sector standpoint, the defensive sectors of Utilities, Communication Services, and Staples were a bit stronger than the more cyclically oriented sectors. Crude oil fell -38% in the period and finished at the lowest levels in nearly 17 months. This was quite a dramatic slide not witnessed in a long time. This is definitely indicative of a slowing growth environment.



Sources: Baird Market Chart book; Morningstar Direct; MSCI

So far into the first quarter of 2019, global equities have staged an impressive rebound. Investors have become comfortable with the about face of U.S. Fed policy, growth slowing in 2019 that probably won't be as bad as feared a few months back, and perhaps the U.S. is a bit closer to some type of trade agreement with China. We have seen investors buying beat up quality stocks recently as they seem to be more comfortable with risk at the moment. The MSCI EAFE Index is up about +9.5% and the MSCI Emerging Markets Index is up approximately +9.45% through early March, vs. +11.7% for the S&P 500 Index. This is a stellar rebound thus far, but we are still down in equities in the current fiscal year.

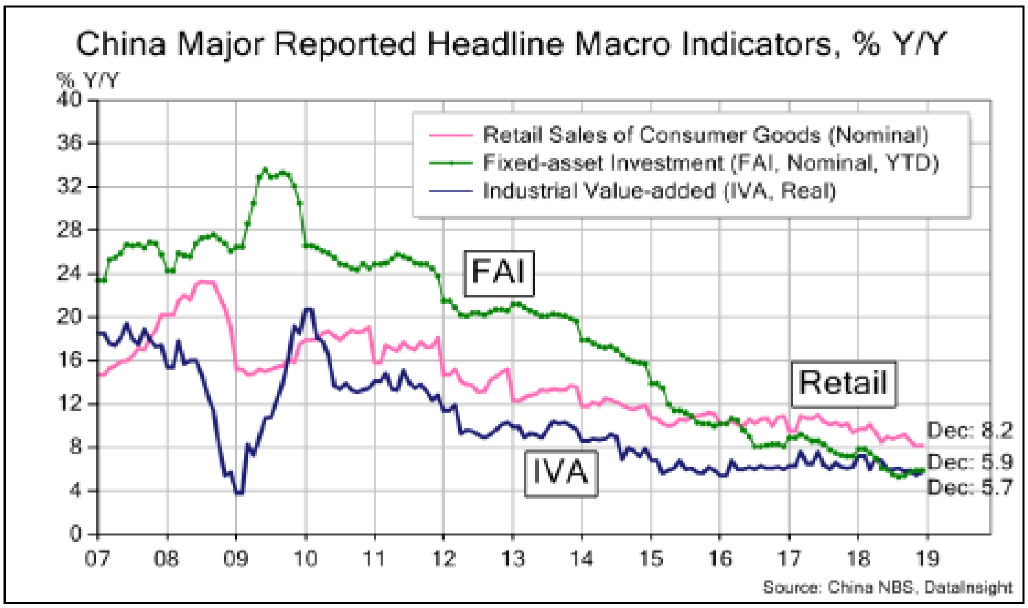


Sources: Blackrock Global Investment Outlook 2019; Bloomberg

Asia Update

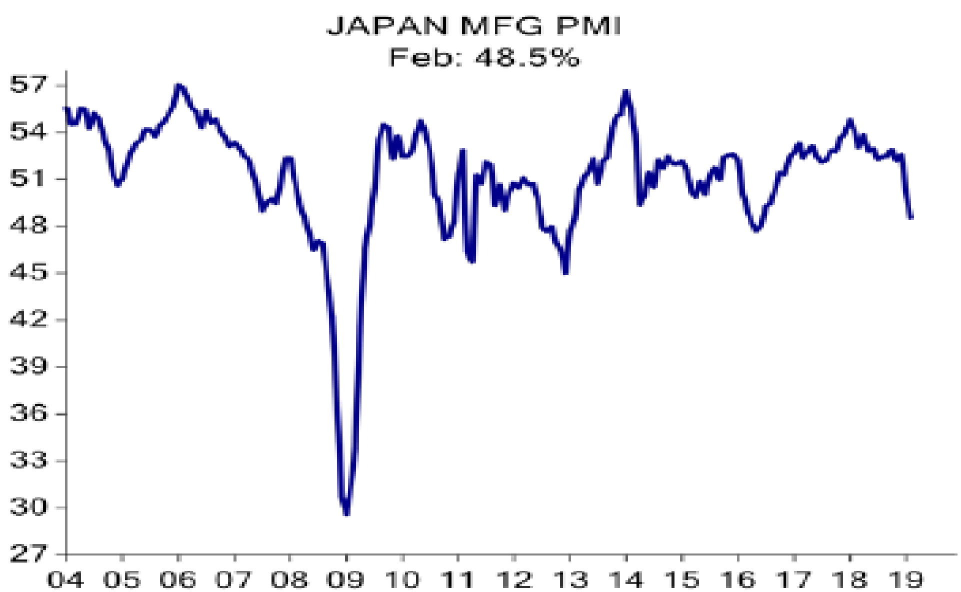
Equities in the Asian basin struggled in the fourth quarter as trade concerns and slowing economic growth prospects for most of the region sent investors running and pushed equity markets downward significantly. The MSCI Pacific region fell -12.2% in the fourth quarter. The Japanese equity market was the driving force behind this negative performance. Investors questioned future growth prospects in 2019 and seemed to find little to get excited about. Coming as no surprise, Chinese equities were weak again as the trade war with the U.S. escalated in the period. Chinese equities fell another -10.7% in the fourth quarter and were once again responsible for the subpar emerging market returns. The direction of trade talks with the U.S. will be the primary focus of investors in the next few months.

China's economic growth continued its pattern of weakening growth as fourth quarter GDP rose +6.4% from a year earlier, which set another record of the slowest pace of growth experienced since 2009. For all of 2018, the economy grew +6.5% from the previous year. Trade talks are beginning to take its toll on the growth outlook here and government officials have responded with loosened monetary policy and the pledge of more tax cuts to funds projects in an effort to spur growth and bring stability to the region. But this has won over very few investors the last few months. At this point, we still see a further slowdown here, with growth probably around the +6% area in 2019, depending on the outcome of the trade negotiations with the U.S. We also still expect to see efforts to grow the domestic economy with less reliance on outside growth as a continuing agenda. Surveying a few of the key economic data points from the quarter, industrial production rose +5.7% in December from a year earlier, which was a bit better than expected, as a temporary relaxation in some environmental standards came into play. Fixed asset growth seemed to stabilize in the fourth quarter and growth for all of 2018 came in at +5.9%, as additional government stimulus efforts are being felt. Exports fell -4.4% in U.S. dollar terms in December, which was the worst result since 2016, as the trade war with the U.S. and a slowing global economy are being felt. Retail sales growth slipped a bit from the previous quarter as fourth quarter sales were up +8.3% from a year earlier, which was about as expected with most investors. Inflation reversed course recently as December consumer prices rose only +1.9% from the year earlier period. Vehicle and energy prices fell more than expected in the period and pushed inflation back below the 2% level. This gives The People’s Bank of China (PBOC) plenty of room to loosen monetary policies to support a weakening economy. At this point, the world’s eyes are all on the U.S./China trade war. So far, both sides haven’t given much, but talks could be making some progress as we head into mid to late March. It is important for both sides to come to some agreement in order to not risk the global economy any further. As we have said, progress on this front will probably set the direction of the Chinese equity markets over the near term.



Sources: Evercore ISI; China NBS; DataInsight

The Japanese economy avoided a technical recession as the economy got back into positive territory as fourth quarter GDP rose +.5% from the previous quarter, or +1.9% from a year earlier. Private investment recovered in the period as the recovering effects of recent typhoons that disrupted factories and supply chains took shape. Inventories were also rebuilt in the period and wound up being a neutral contributor to GDP vs. a projected drag on growth. Also non-residential investment was revised upward and contributed nicely to the growth rate as well. However, the economy here still looks fragile heading into 2019 as the China/U.S. trade war remains heated and is hitting demand here as well. As a result, industrial production slipped again in December and fell for the seventh time in the last nine months. Japan's leading economic index continued to fall in the fourth quarter and December's reading of 97.5 puts this data point at a multi-year low at the moment. This does not set up well heading into early 2019. As has been the case for some time, the Bank of Japan (BOJ) kept its short term rate at -.10% and is still targeting a 10-year government bond yield at 0% at its January meeting. The BOJ remains one of the few central banks still finding it necessary to keep its stimulus flowing to support its economy. Most seem to believe this is the right path even in the face of an enormous debt burden relative to its economy. Consumer confidence continued its downward path as December's reading fell to 42.7, which is another year low. It's quite obvious what the consumer thinks about the outlook here. The labor market remained tight in late 2018 as the jobless rate remained at 2.4% in December, while the jobs-to-applicant ratio moved to 1.63, very near a historical record. Japan's labor market is amongst the tightest around the globe. Perhaps wage growth will accelerate at some point. As we move into the spring of 2019, we are not very positive on this region's near term economic outlook especially as the trade war drags on. This is just too much of a risk factor as we believe this could spell havoc with exports to China and the rest of Asia. Perhaps if an agreement can be made between the U.S. and China, then investors could get more positive on the outlook.

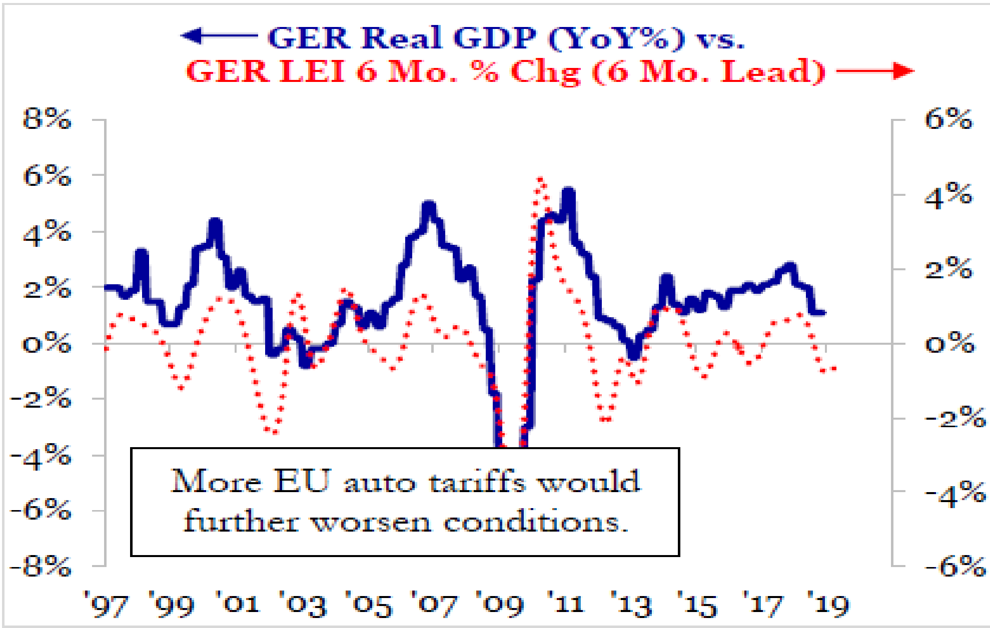


Sources: Evercore ISI

Europe Update

Along with the rest of the world, European stocks had a dismal fourth quarter as slowing economic growth, continued uncertainty over Brexit, and the escalating trade war between the U.S. and China were too much to overcome. As a result, this caused the International Monetary Fund (IMF) to cut its growth projections for the region for 2019. Business activity continued to decay and the consumer seemed to lose confidence in the forward outlook in the region. Cyclical stocks took it on the chin in the quarter as several well-known global companies sold off fairly heavy in the quarter. European stocks flirted with bear market territory late in December as the STOXX European 600 Index pushed near a -20% correction from highs reached in early 2018. The MSCI European Index (ex. U.K.) fell -13.1% in the quarter, which was one of the largest negative moves in this index in some time. The German and French equity markets were particularly weak as these export dependent countries depend on trade more than others. Italy's fiscal concerns were better on the margin in the period and Germany's newly elected leader to replace Angela Merkel might not be as bad a transition as many were expecting.

The European economy continued its slow pace of anemic growth as fourth quarter GDP only rose by +.2% from the previous quarter, or +1.1% from the year earlier period. This was the same growth rate as the previous quarter. Cleary, the Eurozone economy remains fragile. The German economy, which is the largest in the Eurozone, narrowly avoided a recession as growth in the quarter was zero after being negative in the third quarter. This economy is very dependent on exports, which is tough to overcome in a global slowdown. We saw no recovery in the key automobile industry in the quarter, as global demand remained very lackluster. As a result, Eurozone industrial production was very weak as December fell -.9% from a month earlier, or -4.2% from a year earlier. This was the worst plunge on a yearly basis since the financial crisis of 2009. The index of executive and consumer sentiment continued its downward spiral in late 2018 as it fell to 107.3 in December, which was the lowest readings of the year. Unfortunately, this reading could get worst before getting any better. Retail sales remained weak throughout the quarter, as sales in December were flat with the previous month, or up only +.8% from a year earlier. This sets another new mark for the weakest reading of the year. The consumer is reluctant to spend in such a weak business environment. Core CPI continued to be non-existent as December was reported to be up +1.0% from the year earlier, still indicating very little pricing power in the economy. Even though the ECB has curtailed its bond buying program, we see little to no chance of interest rate hikes over most of 2019 at this time. On a positive note, the employment situation continued to be a ray of hope in the region, as the December unemployment rate fell to 7.9%, which is another fresh new low since the great recession. We see this as a very positive sign in the face of mostly weak economic data points in most parts of the economy. As we digest the latest economic readings in this region, it's clear to us that most risks over the next few months are to the downside. There are just too many wildcards inside as well as outside of the Eurozone economy to see it any other way in early 2019. We believe most investors have a negative view right now on the region and are waiting for some clarity to develop on key issues before reassessing risk positioning. We would expect equity markets to be lackluster in the coming months based on this.

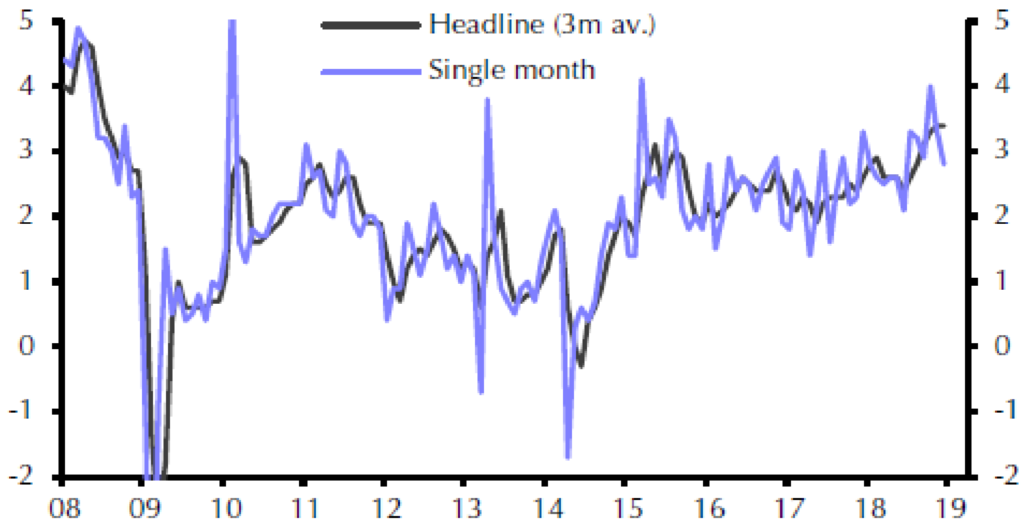


Source: Strategas

Brexit discussions continued to dominate news flow in the U.K. as this, coupled with the uncertain growth outlook going on around the globe, pushed equity markets downward again in the fourth quarter. Theresa May continued frantic discussions with the EU and her own government in the period only to come up with little true progress in this effort. As things stand now, Brexit can probably take three or four paths as we head into late March. Each path has its own perils. We will find out soon which path Brexit takes and investors will give their own interpretation of these results as they speak through the equity markets. The MSCI U.K. Index returned -12.7% in the fourth quarter on a U.S. dollar basis, about in line with the broader MSCI European Index (ex-U.K.). The British Pound fell to another low in December at the height of the late 2018 equity market route. The economy here continued to track slower in late 2018 as fourth quarter GDP grew +.2% from the previous period, or +1.3% from the year earlier period. This confirms to many that Brexit uncertainty is damaging growth in the region, as growth slipped significantly from the third quarter. Businesses continue to cut investment for the fourth consecutive quarter, giving little confidence until a Brexit decision is made. The services side of the economy seems to be holding up better than the production side. Net trade was a slight detractor to overall growth, but not by a huge margin. Industrial production fell for the fifth straight month in December as manufacturing remained very depressed. Retail sales remained weak as December sales fell by -1.3% from the previous month, or up only +2.6% from a year earlier. This is the weakest monthly reading in quite some time and is indicative of how the average citizen here feels about the current state of affairs.

Core CPI has seen very little movement lately as January's reading of +1.9% from a year earlier remains about where it has been for a few months now and is still well below the official Bank of England (BOE) targeted rate. At its recent February 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. The MPC cited the recent weakening in the region's economy as well as the global economy along with Brexit's uncertainty as key points to maintain the current level of interest rates. The fourth quarter unemployment rate fell to another multi-decade low of 4.0%. Employment increased by another 167,000 workers in the quarter with ending employment at yet another new record of 32.597 million workers. Wage growth continued to improve in the period, as wages grew by +3.4% in the three month period ending in December. As with the other regions of the world, we see low unemployment as a catalyst for further wage gains.

Chart 23: Average Weekly Earnings (%y/y)

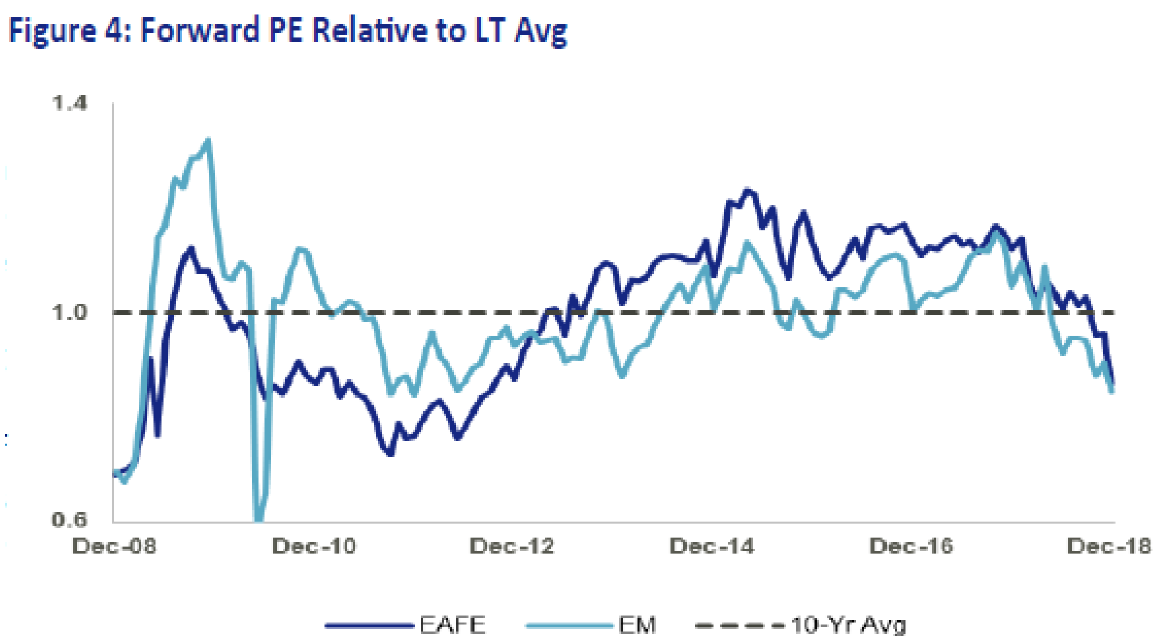


Sources: Capital Economics

Emerging Markets

Emerging market equities fell again in the fourth quarter as Chinese equities had a rough quarter from the lingering trade negotiations with the U.S. and a slowing economy. However, not everything was bad news in the emerging markets, as Brazilian equities rallied from Jair Bolsonaro's proposed reforms aimed at increasing the country's growth rate. This caused a relief rally in equities here with a lot of potential runway left if progress continues. Also, equities in Turkey, India, and Indonesia performed well on the heels of drastically falling crude oil prices. Falling crude oil has helped push inflationary pressures lower in these countries and was well received by investors. Even though the MSCI Emerging Markets

Index fell -7.5% in the quarter, it wound up being the best performing region in global equities vs. international large cap stocks as well as U.S. stocks. As mentioned above, Chinese equities were weak and fell -10.8% in the quarter, as trade and growth concerns were too much to overcome. Over the coming weeks, we expect the U.S./China trade talks to take center stage with rhetoric from these negotiations pushing these equities one way or another. This should result in a heightened level of volatility. We are very concerned what a slowing global growth environment will mean with this asset class going forward.



Sources: Morningstar; Baird Market Update Q4 2018

International Equity Activity/Strategy

As we look out into the landscape of the spring of 2019, the U.S. trade war with China and a slowing global economy seems to be garnering the bulk of the attention. We certainly believe that we are past the peak growth of this cycle, but we debate just how close we are to a recession. Many feared we were very near as equities were routed in late 2018, only to give way to a rebound thus far in early 2019. At this juncture, it's our best guess that a recession is not on the near term horizon. We see many countries slowing down to a long-run potential growth rate vs. being above potential for 2018. Europe's political landscape has cleared up a bit with a budget pact in Italy and a newly elected leader in Germany. Brexit still remains an issue at the present time. With the U.S. Fed shifting away from the multiple hike plan for 2019 that was in place a few months back, the greatest threat now is the trade war between the U.S. and China. It's just hard to handicap how close we are to an agreement. But many investors sense we are getting closer. Businesses need to see some resolution as this is hindering and delaying investment plans because of uncertain trade policy. Any escalation from here would not be welcomed by investors and equity markets could sell off to some degree.

We continue to remain active with our put writing on EEM since our last update and expect to continue to be going forward in an effort to bring in some current income and 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 2.7% of total assets and approximately 10.4% for MSCI EAFE equities across our TRS, ERS, and JRF portfolios. *(Credit is given to the following entities for charts provided: Capital Group, RIMES, DataInsight, China NBS, Capital Economics, Bank Of England, Bloomberg, Blackrock, Strategas, Markit, Fidelity Investments (AART), ISM, IMF, Baird Market Update, MSCI, Factset, Evercore ISI, John Hancock Global Market Outlook, China National Bureau of Statistics, and Morningstar Direct)*