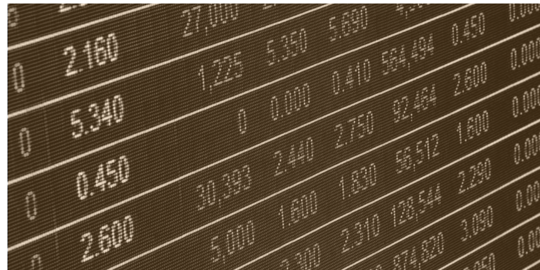
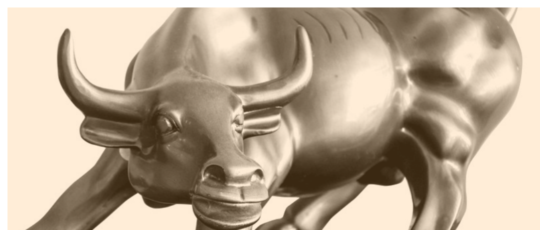
MARKET COMMENTARY

SECOND QUARTER 2019





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At a Glance

For the second consecutive quarter, positive returns were generated across the investment landscape, with notably solid performance in domestic markets, a theme generally in place since early-2018. While global macro risks such as unsettling trade tensions between the world's two largest economies, a lack of clarity around Brexit, and growing signs of an increasingly broad-based global slowdown captured market participants' attention, investors embraced a backpedaling Federal Reserve (Fed) by supporting demand for asset classes and categories along the risk spectrum. The combination of fundamental deterioration abroad and more recently domestically, along with policy makers' acknowledgment that the future path of monetary policy is likely to be incrementally more dovish than hawkish, provided a tailwind behind both risky and safe haven assets throughout the quarter and much of 2019.

Similar to numerous quarters in the post-global financial crisis period, domestic equity returns outpaced those internationally, with trade conflicts between the U.S. and China, Japan, certain European countries, and Mexico underpinning relatively stronger capital flows into U.S.-based equity markets. Stylistically, value's string of underperformance versus growth continued, as the energy and financials-heavy value indices saw relative headwinds in the way of sharply declining oil prices and plunging interest rates.

Mounting expectations for accommodative Fed policy and its perceived near-term support for risk assets did not detract from the relative safety of high-quality bonds, as the yield on the 10-Year Treasury Note dipped below 2% for the first time since 2016, bringing the year-to-date (YTD) yield decline to 67 basis points. The sharp rate decrease helped propel core bonds to a 3.1% quarterly return, the strongest quarterly gain since third quarter 2011. Furthermore, core bonds have returned a solid 6.1% YTD, a particularly impressive six-month performance when placed in the context of a lowly 3.3% starting yield to begin 2019. Below investment-grade credit generated positive performance but failed to match the blistering pace of total return growth emanating from the highest quality corners of the U.S. bond market.

Unlike the strong performance in global equities and fixed income, second quarter real asset returns were generally modest. With significant sensitivities to both economic activity and interest rates, real estate investment trusts (REITs) posted a slightly positive total return, despite a sizable decline in U.S. interest rates. For the first six months of the year, however, REITs performed tremendously well and were one of the strongest performing major areas of the global universe. Quarterly returns in energy infrastructure were essentially flat, with key headwinds in the way of plunging oil prices and global growth concerns weighing on the asset category.

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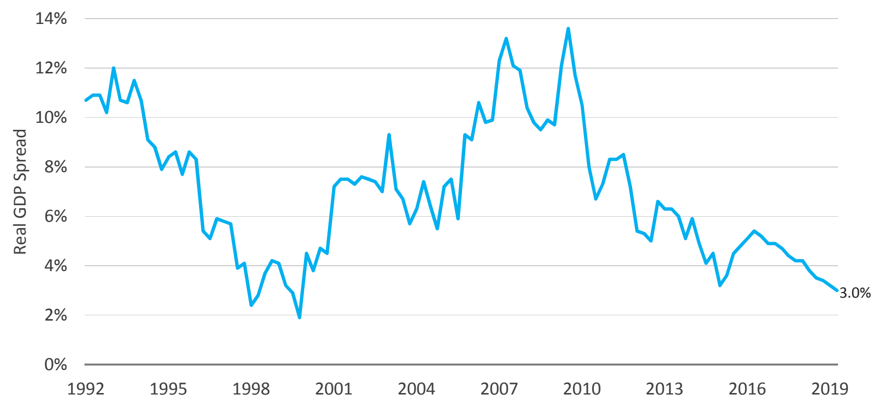
U.S. vs. China Trade Conflict Darkens

U.S. and Chinese trade relations took a significant step backwards in the second quarter, driving market volatility higher, particularly in May. At the forefront of the increasingly tense standoff between the world's two largest economies was the U.S. Administration's early-May announcement of a significant tariff increase from 10% to 25%. The 25% tariff on Chinese imports into the United States was levied on at least $250 billion of goods, the bulk of which were technology-related. If the 25% tariff announcement did not get the attention of the Chinese government, the U.S. Administration's additional threat of levying tariffs on all Chinese imported goods likely did.

The ongoing rebalancing of trade relations between these two economic superpowers and the potential for negative outcomes has been a perpetual topic among financial news outlets for the past 18 months. However, concerns that a tenuous global trade backdrop will ultimately weigh on the global economy became reality during the quarter.

Chinese GDP growth slowed to a 6.2% annual pace through the second quarter, the weakest growth rate in at least 27 years and just 3.0 percentage points above U.S. real GDP growth of 3.2%. If China seeks to become the world's premier (and largest) economic superpower, a trade conflict with the U.S. doesn't appear to be doing the Chinese economy any favors. In fact, the country's growth advantage versus the U.S. has narrowed to the lowest level since 1999.

CHINA'S GROWTH ADVANTAGE CONTINUES TO WANE



Data sources: BEA, Bloomberg, L.P.; China - U.S. Real GDP Growth Differential.
China data as of 2Q2019, U.S. data as of 1Q2019 March 31, 2019

In related fashion, the U.S. Administration has stepped-up its rhetoric and criticism related to China's alleged currency manipulation and their history of suppressing the exchange rate value of the yuan in a bid to boost exports. Ironically and perhaps surprisingly to some, the Chinese yuan actually appeared more expensive, not cheaper, than the U.S. dollar (USD) through the quarter.

Using Real Effective Exchange Rate (REER) data from the Bank for International Settlements (BIS), the chart on the following page shows that in trade-weighted, inflation-adjusted terms against a broad basket of currencies, the dollar and the yuan appeared similarly expensive through June. Because China still pegs the yuan to the dollar within a fairly narrow band, the directionality of these two currency valuations is intuitive.

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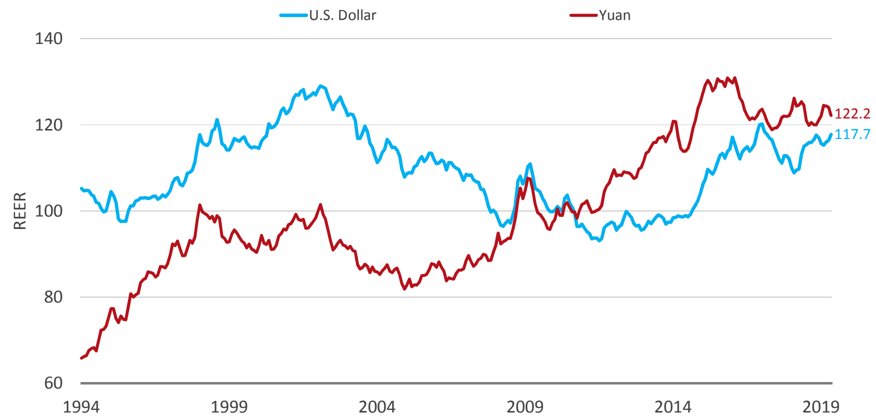

Data sources: BIS, Bloomberg, L.P.; data as of June 2019; base year 2019. Based on Real Effective Exchange Rates

For China to overtake the U.S. as the world's largest economy, the transition from a fixed-rate exchange system to one that fully floats (like the U.S.) would likely need to take place, with significant volatility likely to accompany the transition.

Surely both the U.S. and China would embrace cheaper currencies, particularly given historically large debt burdens plaguing both economies' growth potential, but this cannot come in isolation. For the USD or the yuan to depreciate, currencies of other nations would have to appreciate. With the fundamental underpinnings of the global economy shaky at best, few countries would welcome a sharply appreciating local currency with open arms, particularly those with export-dependent economic engines.

Global Fundamental Deterioration Becoming More Broad-Based

Over the five-quarter period of 2018 through first quarter 2019, the U.S. economy displayed impressive resiliency, while much of the international community succumbed to the disinflationary forces of global trade wars and return to more "normal" monetary policy regimes.

Through FEG's various publications over this 15-month period, FEG has expressed skepticism for the potential of this dynamic to persist, primarily due to the global economy's vast interconnectedness and zero-sum nature of global trade: one country's gain is often another country's loss.

In second quarter 2019, the fundamental deterioration that appeared isolated abroad swept upon the shores of the U.S., notably impacting data that are sensitive to manufacturing and industrial production. Markit Partners Purchasing Manager Index data, for example, reflected a notable slowdown across both the manufacturing and services sectors, with the Manufacturing PMI dropping to a 10-year low and nearing an outright contraction through June.

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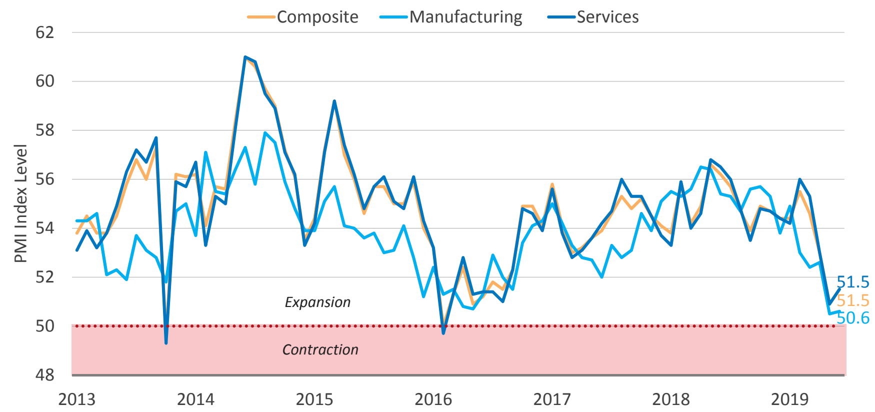
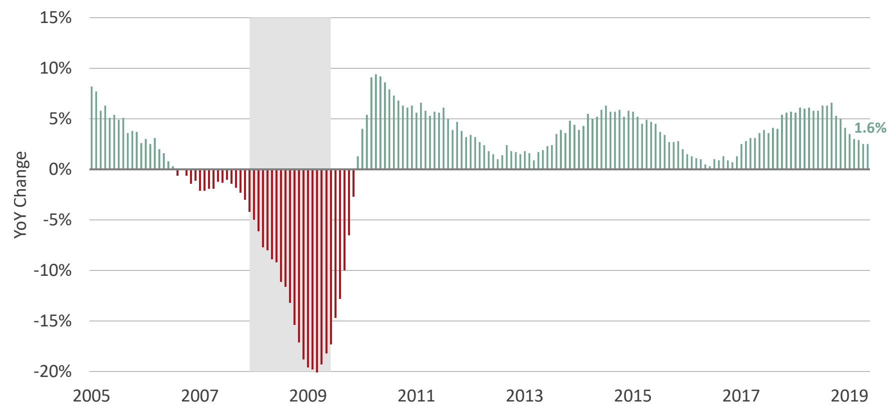
U.S. FUNDAMENTALS HAVE RECENTLY SOURED



Data sources: Markit Partners, Bloomberg, L.P. Purchasing Manager Indices; data as of June 2019.

Even more concerning than the coincident economic indicators slowdown is a material moderation in the pace of improvement in those economic data sets that lead the business cycle. The Conference Board's Leading Economic Index (LEI), a composite of inputs that foreshadow near-term economic conditions and includes factors such as stock prices, interest rate spreads, and new orders, weakened to an annual pace of 1.6% through June.

LEADING INDICATORS POINT TO SLOWER GROWTH



Data sources: Conference Board, NBER, Bloomberg, L.P.; data as of June 2019.
Note shaded areas represent recessionary periods.

The 1.6% growth rate of the LEI through June compares to mid-single digit growth rates witnessed just one year ago but thankfully remains in positive territory, as this composite's negative growth readings have reliably pointed to a near-term recessionary environment.

A historically strong labor market also appears stalled at a minimum and in the worst case, at risk of rolling-over. While on the surface labor fundamentals appear sound, if not historically tight, the pace of improvement has slowed meaningfully since last fall and is eerily reminiscent of conditions experienced during the last recessionary scare of 2014–2015.

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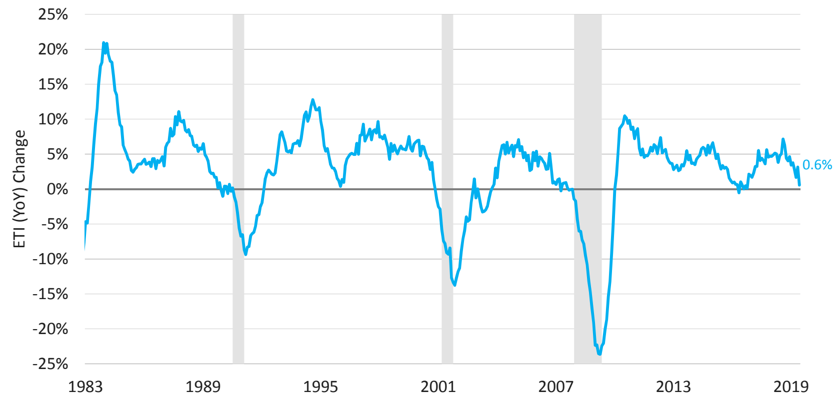
The Conference Board also maintains the Employment Trends Index (ETI), which aggregates fundamental labor variables such as unemployment insurance, job openings, and hiring tendencies and is intended to forecast labor trends. This labor gauge slowed to a near-zero annual pace through June and was one of the lowest readings in the post-Global Financial Crisis period.

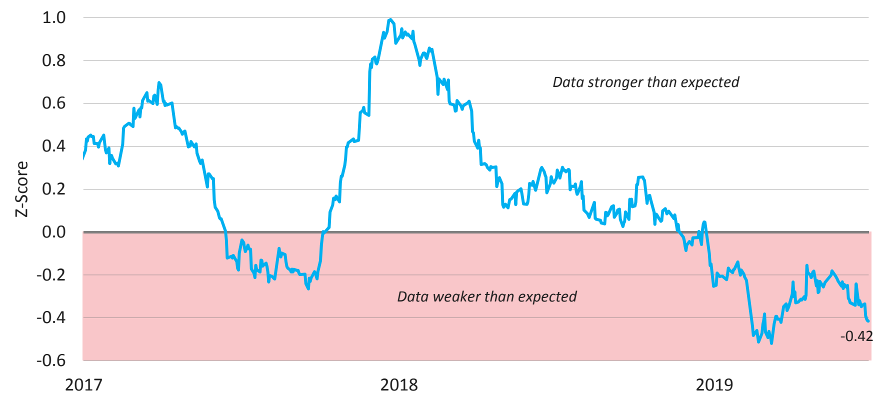
IMPROVEMENT ACROSS LABOR MARKET HAS STALLED



Data sources: Conference Board, Bloomberg, L.P.; data as of June 2019.
Note shaded areas represent recessionary periods.

The degree of moderation across several key U.S. data sets, which has become more broad-based in recent months, has been overshadowed by the incredibly strong YTD performance across nearly every corner of the market. In fact, incoming U.S. economic data has disappointed economists' estimates for the entirety of the YTD period through second quarter, after spending nearly all of 2018 exceeding street estimates.

INCOMING U.S. DATA HAS DISAPPOINTED ALL YEAR



Data sources: Bloomberg U.S. Economic Surprise Index. Bloomberg, L.P.; data as of 6/28/2019.

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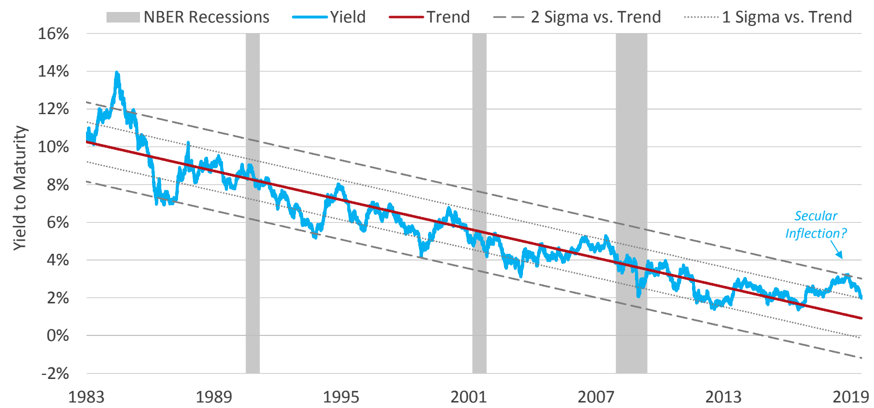
Global Interest Rates Sink as Share of Negative-Yielding Debt Spikes

One of the biggest surprises in the first 6 months of 2019 includes the magnitude of the decline across U.S. and global sovereign interest rates, particularly when viewed in conjunction with recent equity market strength. In the second quarter, the yield on the benchmark 10-Year U.S. Treasury Note dipped below 2% for the first time since 2016 and inverted to 3-Month Treasury Bill yields by more than 50 basis points.

Concerns of a secular move higher in U.S. interest rates have quickly faded into distant memory, with the 2.01% quarter-end yield on the 10-Year Treasury a full percentage point below the key 2-sigma-above-trend threshold level breached in early-2018.

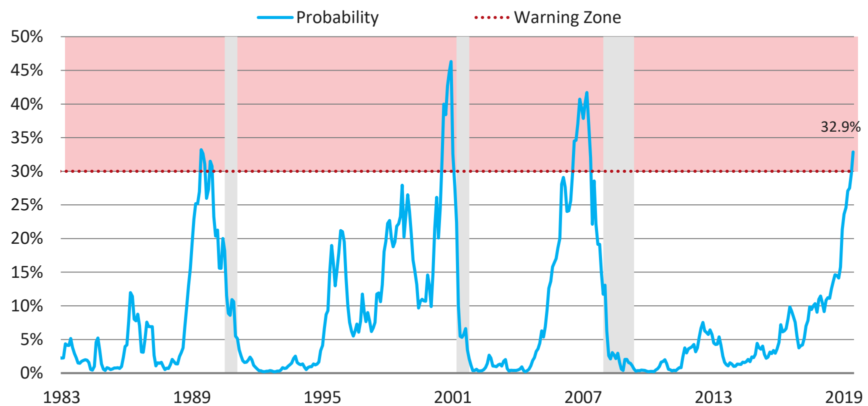
U.S. RATES HAVE RESUMED THEIR DOWNTREND



Data sources: Bloomberg L.P., NBER, FEG; data as of 6/28/2019.

The sharp decline in rates occurring in 2019, in conjunction with meaningfully downward pressure across the term structure, has increased the specter of a near-term recession. The New York Federal Reserve's Probability of Recession model, which utilizes the spread between 3-Month and 10-Year Treasury yields to extract the likelihood of a recession in the next 12 months, increased during the quarter to reflect a 33% chance of recession in the next year.

U.S. RECESSIONARY PROBABILITIES SPIKED



Data sources: New York Fed Probability of Recession Model, NY Fed, NBER, Bloomberg L.P.
Data as of June 2019.

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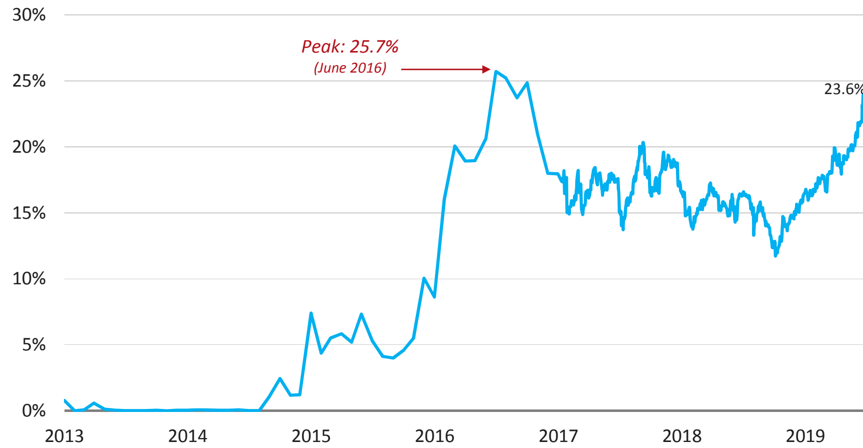
The 33% doesn't appear overly worrisome on the surface, but when viewing the past three cycle inflections from expansion to contraction, this gauge breached the 30%+ threshold in June 1989, July 2000, and August 2006, with an average lead time before each subsequent recession of just 12 months.

Not only have rates declined meaningfully domestically, but international sovereign markets have also experienced similar downward pressure on rates. In fact, nearly a quarter of the global investment-grade bond universe exhibits a negative interest rate, the largest share since 2016.

NEGATIVE-YIELDING GLOBAL DEBT NEAR PEAK



Share of negative-yielding global debt as percentage of market. Note: Benchmarke used = Bloomberg Barclays Global Aggregate
Data sources: Barclays, Bloomberg L.P.; data as of 6/28/2019.

By the time the quarter concluded and after generating a YTD total return of 6.1%, the Bloomberg Barclays U.S. Aggregate Bond Index's yield declined to 2.5%, implying muted potential for the current ~13% annualized pace of total returns growth to continue. Should recent strong equity market performance falter, though, the potential for continued downward pressure on interest rates would be present.

Global Uncertainty and Presidential Pressure Send Federal Reserve Retreating

A key pillar of support underneath the rally in equity and fixed income markets in 2019 includes growing expectations for a Federal Reserve policy reversal. The previous (and short-lived) expectation for a "pause" in the Fed's policy actions quickly transformed into a "put," particularly once already-elevated tensions between the U.S. and China deteriorated further in May. Moreover, President Trump has turned up the heat on Fed Chairman Powell, accusing the Fed Chair of keeping policy rates too high.

The Fed has formally laid the groundwork to officially shift gears into an easing bias, most recently at their June policy meeting, where an overwhelming majority of Fed members acknowledged rising downside risks to the U.S. economic picture.

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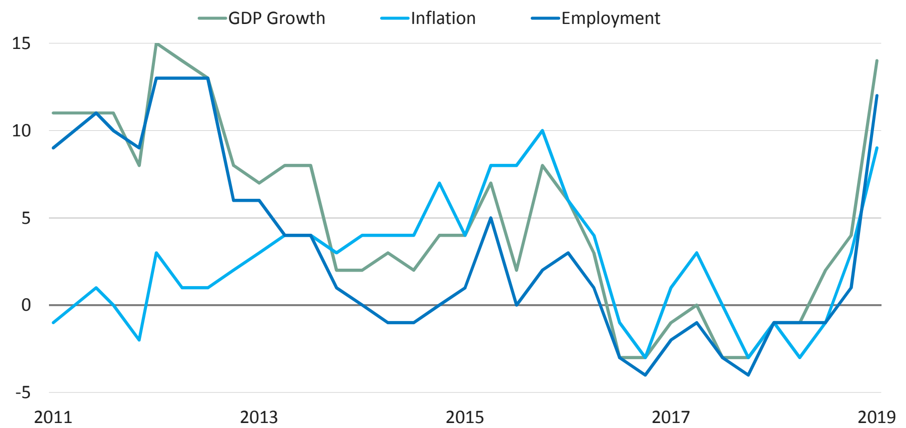
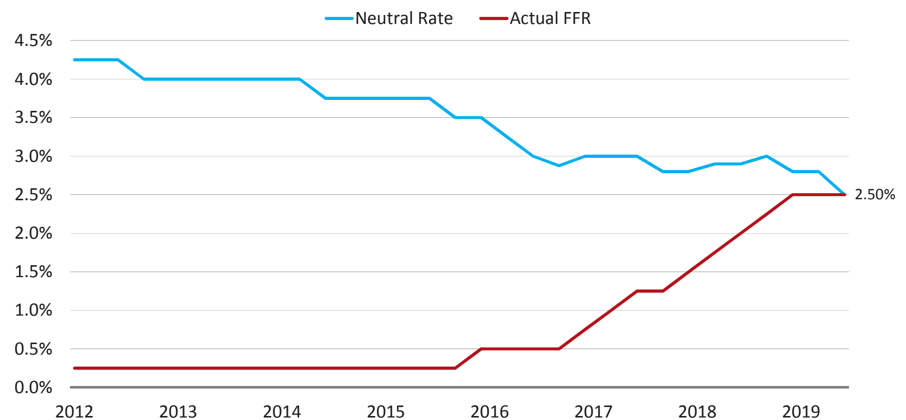
FED OFFICIALS SEEING RISING DOWNSIDE RISKS
Net # on FOMC seeing risks weighted to Downside



*Data sources: New York Fed Probability of Recession Model, NY Fed, NBER, Bloomberg L.P.
Data as of June 2019.*

Perhaps more importantly, the Fed lowered their estimate of the "neutral" rate, the rate level neither accommodative nor restrictive to the economy. This estimate was lowered to 2.50%, which matches the current federal funds rate (FFR) and implies an overall balanced monetary policy backdrop.

'NEUTRAL' FEDERAL FUNDS RATE vs. ACTUAL



*Data sources: New York Fed Probability of Recession Model, NY Fed, NBER, Bloomberg L.P.
Data as of June 2019.*

Fed funds futures traders have overwhelmingly priced in a cut to the FFR set to occur at the Fed's July 30-31st meeting, which would bring the upper bound to 2.25%, a mere 2 percentage points above where the FFR was when the Fed initially launched the tightening cycle in December 2015. Looking out to the rest of 2019 and into 2020, market-based measures point to an additional cut or two for the next 18 months. Investment markets have responded quite favorably to the prospect for a lower discount rate, which should help support equity valuations in the short-term.

As if appeasing the "market" wasn't a difficult enough job, President Trump has pressured Fed Chairman Powell, accusing the Chair of keeping policy rates too high.

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Chairman Powell has found himself in a philosophical battle between a Congressionally-directed mandate, the nature of the market's effective—and often rushed—discounting process, and a hyper-critical Commander in Chief.

Should Chairman Powell abandon the Fed's dual mandate, the future of monetary policy management could be questioned. Should the Chairman fold to the market, investors may simply turn to the S&P 500 to help forecast the direction of monetary conditions. However, should Chairman Powell fold to the President, the Fed's assumed independence could be compromised. To say the Chairman has his work cut out for him would be the understatement of the year, but an accurate one.

CONCLUSION

Market performance for the second consecutive quarter was strong, albeit with elevated volatility in May, when trade war tensions between the U.S. and China appeared to reach a boiling point. The second quarter was unique in that much of the rest of the world's problems became the U.S.'s problems, after displaying resiliency throughout 2018 and first quarter 2019.

Previously isolated pockets of weakness in the U.S. economy, such as the housing and manufacturing sectors, became more broad-based, with a material slowdown across the services sector, labor market, and composite business activity gauges. Furthermore, incoming economic data disappointed sell-side estimates for the YTD period's duration through quarter-end, after exceeding estimates for nearly all of 2019.

An increase in recessionary red flags in the U.S., similar to that experienced in 2014–2015, helped send interest rates to the lowest level in 3 years, a theme also shared abroad, where the share of negative-yielding global debt increased to a 3-year high of nearly 25%. The extremely low level of interest rates has supported elevated equity valuations and boosted fixed income returns.

On the policy front, a darkening global trade environment and increased downside risks to domestic economic conditions pressured the Fed to follow a path much easier than anticipated entering the year, supporting asset category returns across the risk spectrum. Unlike in past monetary policy regimes, the Federal Reserve must contend with a hyper-vigilant and often critical President, in turn risking its appearance of "independence."

As the overall set of risks have recently tilted modestly to the downside and market performance has greatly exceeded expectations, FEG has tempered its enthusiasm for the cyclical outlook. Our emphasis on a carefully-vetted suite of active managers with proven track records and the potential to adapt and flourish in challenging market environments remains a key focus. This discipline, combined with select opportunistic exposures that offer attractive risk-return profiles, we believe to be the favorable stance for client portfolios to weather an anticipated volatile market environment over the next 12-18 months.

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Published July 2019.

INDICES

The Alerian MLP Index is a composite of the 50 most prominent energy Master Limited Partnerships that provides investors with an unbiased, comprehensive benchmark for this emerging asset class.

The Bloomberg Barclays Capital Aggregate Bond Index is a benchmark index made up of the Barclays Capital Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.

The HFRI Monthly Indices (HFRI) are equally weighted performance indexes, compiled by Hedge Fund Research Inc., and are utilized by numerous hedge fund managers as a benchmark for their own hedge funds. The HFRI are broken down into 37 different categories by strategy, including the HFRI Fund Weighted Composite, which accounts for over 2000 funds listed on the internal HFR Database. The HFRI Fund of Funds Composite Index is an equal weighted, net of fee, index composed of approximately 800 fund of funds which report to HFR. See www.hedgefundresearch.com for more information on index construction.

The MSCI ACWI (All Country World Index) Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes. The developed market country indexes included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The emerging market country indexes included are: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey* and United Arab Emirates.

The S&P 500 Index is a capitalization-weighted index of 500 stocks. The S&P 500 Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Information on any indices mentioned can be obtained either through your consultant or by written request to information@feg.com.

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