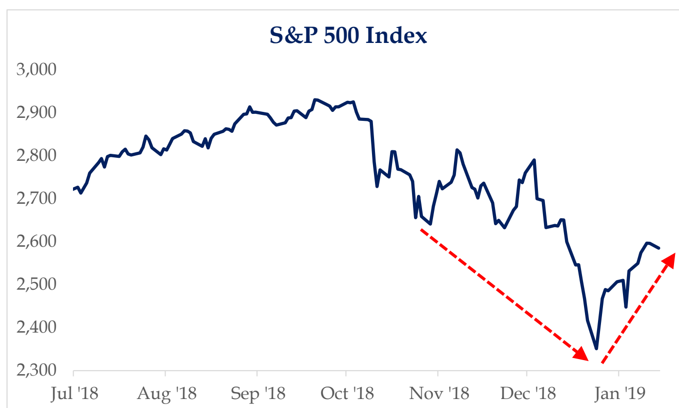
January 2019

In this month's *Insight*

Give A Little, Get A Little

The S&P 500 was down -19.8% percent from it's all-time closing high in September (9/20/18) to its December closing low (12/24/18) – and was down -9.2 percent in December alone! Nice way to end the year. This accelerating sell profile was more than enough to seriously rattle investors' confidence throughout and in the end a good many (most?) capitulated to a less optimistic intermediate-term view on the durability of the long cycle and duration of the bull market. Of course, with respect to the latter, the year ending drawdown in equities did breach levels convention would associate with the onset of a bear market, but not surprisingly, asset allocators *reacted* by reducing forward exposure to equities – some to below 50 percent of their all asset allocation. However this market phase is ultimately qualified – *and we're not big on labels* – dramatic moves to one extreme are generally met with, if not equal, spiritually similar reversals to the other. Indeed, just as quickly as the market descended to confidence crushing lows, the Index has rebounded +11.3 percent from its Boxing Day session to last Friday's close (1/11/18). Against this improved backdrop, pessimism has moderated. So what's our course forward? Is the cycle's endgame at hand, or did the perception that a policy error was nigh – *either through the Fed's monetary course, the Administration's trade pursuits, or both* – prove too much to bear? With respect to the later, it would seem an unlikely coincidence that the Fed chairman's comments acknowledging recent market volatility while reiterating the central bank's increased dependence on data were reported at roughly the same time as positive (and equally boring) progress reports from senior staff discussions between U.S. and Chinese trade negotiators emerged.



But have we seen the all clear? Let's consider the answer from two vantage points: the economy and the markets.

By our lights, a look at the economic landscape shows little to be out rightly negative about. Without being Pollyannaish, while the economy has certainly shifted into its "Slowing Expansion" phase – *evidenced by the persistence of continued improvement in the various and sundry economic data, albeit at a decreasing rate* – a Recession does not appear imminent. The ISM's[1] New Orders Index fills this bill most acutely and inasmuch certainly warrants greater consideration in the months ahead. As a refresher, New Orders fell to 51.1 in December from 62.1 the prior month. Readings above 50 are generally associated with expansion but as Strategas' Norbert Ore, a former chairman of the ISM, commented, "supply chain managers tend to use pre-buys as their basic hedge. So when the demand picture changes quickly, they change inventory strategy… New Orders sounded an alarm that there is a major shift in inventory policy. However, Customer Inventories (another ISM series) indicates there is still significant room in the supply chain for replenishment." Said another way, expect a bounce in the January data. As an aside, the -11 point M/M decline in New Orders was the 14th most severe since the series' inception in 1948. For the twelve months following the thirteen declines of greater magnitude, the S&P 500 advanced an average of +8.1 percent, evidencing just four discrete negative twelve month performance readings (from Dec'80, Jan'62, Oct'01, and Jul'73). Punchline, the market can move higher from shock data episodes.

Additionally, we continue to monitor credit markets for signs of stress, particularly High Yield spreads and the 2s/10s Treasury curve. High Yield spreads widened to ~530 basis points last month before settling back, as equities rallied, to the 440 area in January. Over the last twenty-five years, we have seen High Yield spreads widen by this order of magnitude on seven occasions, just two of which (2001 to ~1,000bps and 2008 to ~2,000bps) were associated with Recession. As Strategas' fixed income strategist Tom Tzitzouris tells us, historically, once spreads eclipsed the ~700 basis point threshold, credit contraction amplified weakness in the broader economy and Recession generally followed. But on the last two occasions (in 2011 and again in 2016) this reaction function did not ignite. Thus, in the current episode, while the fuse may have been lit, it appears, at worst, to be a bit longer.

The Treasury curve flattened to 9 basis points in December, steepening – *modestly* – to 17 basis points in recent weeks. All in, these are fluctuations at the fringe, and while we are reminded of extended periods of time in which the curve can remain flat, and not invert (e.g. 1994-1998), we remain well within the zone for heightened observation. To wit, a "kink" has worked its way into the short end of the Curve, highlighting investors' disagreement with the previously prescribed (too far, too fast) pace of Fed tightening. To smooth this out, policy

[1] Institute for Supply Management

makers and investors are engaged in a high stakes "negotiation." What's been agreed to? A less aggressive, more data dependent, tighten course – *as noted above* – in exchange for investors' acquiescence to the notion that the <u>level</u> of interest rates the U.S. economy can withstand is higher than the level financial markets are entirely comfortable with. Agreeing to this equilibrium – and negotiating the <u>timing</u> to get there – is the mother's milk of volatility. Give a little, get a little. Take a little, well, forget it…. For the time being, it seems both sides (policy makers and investors) realize they're better off trying to work it out.

A far less optimistic assessment can be leveled on the President's showdown with Congressional Democrats over funding for a wall along the 1,954 mile U.S.-Mexico border. As the Shutdown drags into its record setting fourth week, concern is mounting for its impact on the already slowing economic growth profile. Historically, the transitory shutdown of the federal government has not had an outwardly negative effect on the broader economy. Here the duration of the Shutdown, more than its severity per se, may prove to have the greater impact. With earnings season now underway and a rash of companies – *notably Apple, Delta, and Macy's* – already revising their outlook for CY'19 lower from the lofty levels suggested a year ago, any further cut at confidence will increase the number of management teams unwilling forecast continued improvement in activity, reinforcing investors' case with the Fed… In this vein, it is worth considering the technical contours of the market's recent price action. Regardless of your investment posture or economic disposition, we would encourage investors to tread carefully over the next several months as the market settles out. Given the tenor of price action from the September highs, a re-test of the December lows is likely. More importantly, if not frustratingly in the shorter waves, fundamentals may likely have little to do with it. Keep your head on a swivel.

Over the intermediate-term we remain constructive on the equity market and maintain our recommended overweight of the asset class (70 percent against a 60/40 multi-asset benchmark). Continuation of the long cycle remains our base case in 2019 with, as Strategas' chief economist Don Rissmiller points out, a "soft landing" for the U.S. economy possible given positive outcomes on a number of macro issues (re-opening of the U.S. government, a U.S.-China trade deal, soft Brexit, among others). Stay tuned.

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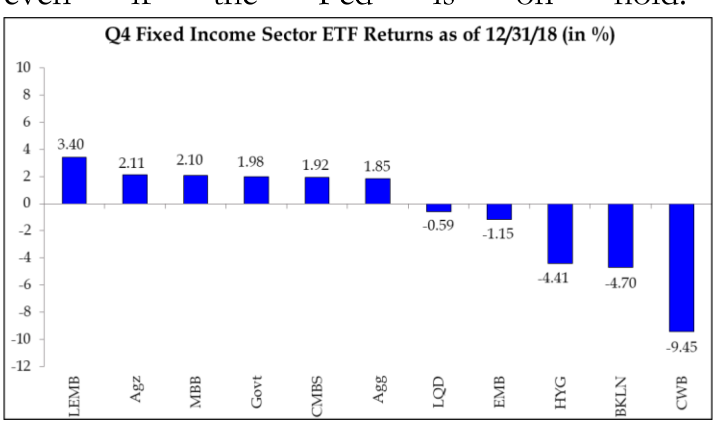
Nicholas Bohnsack is the President & Chief Executive Officer of Strategas Asset Management and a Managing Director of Baird.

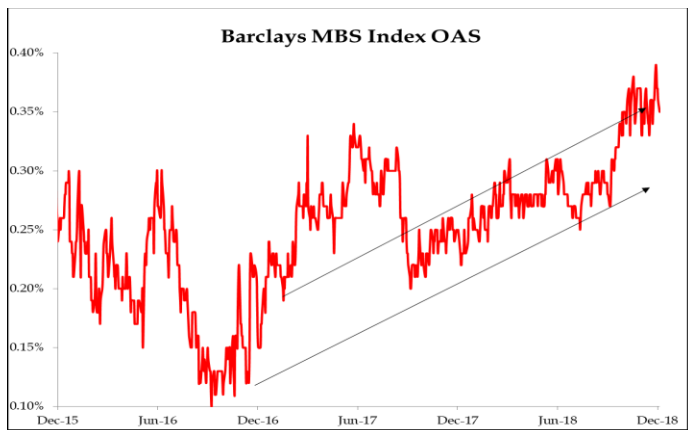
Active Opportunities In Credit

Credit was cheap again by the end of December, with both HY spreads and IG spreads at about 2 year highs, as risk off sent beta tumbling. But alpha was cheaper too, at least on a spread basis, as MBS spreads drifted higher to end the year. It's been rare in this post crisis, QE-laden world, to see MBS spreads widening alongside corporate credit spreads, but Dec gave markets this rare opportunity to buy dips. In anticipation of credit weakness in the 4th quarter, we trimmed our exposure to extended sector corporate credit, though our Core and Go Anywhere strategies still lagged behind the Treasury heavy Aggregate index in the last quarter. Looking ahead to Q1, we believe we will see a reversion lower in corporate credit spreads, though a bumpy one, with stable MBS and EM spreads, along with a slowly weakening dollar, all of which should allow for both pure alpha and alpha through increased beta. But, as always, there are qualifications to this view. First, even if the Fed pauses in 1H 2019, as we expect, the credit cycle is still progressing, and the floor on HY and IG spreads in 2019 should still be well above the lows seen in 2018 and second, geopolitical risks will weigh heavy again, even if the Fed is on hold.



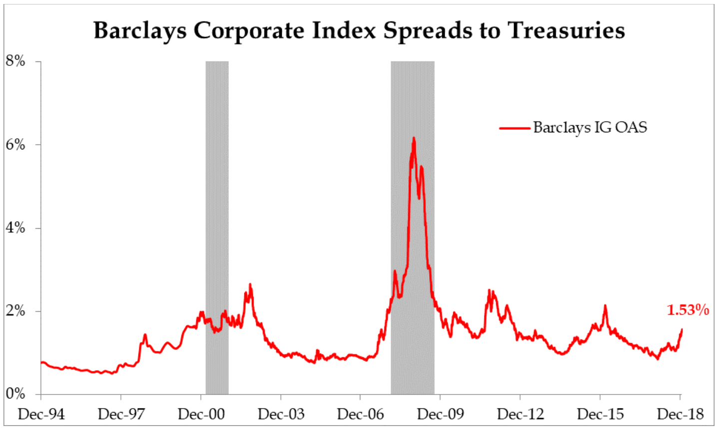
MBS Spreads Continue A Bumpy Drift Higher

We estimated that based on balance sheet runoff alone, assuming a small increase in housing activity today vs a year ago, and assuming a modestly higher nominal growth trend today vs a year ago, that broad market MBS spreads should have been just above 35 bps as of end of 2019. So despite the fact that MBS spreads were higher in Q4, they outperformed where we expected them to be by finishing the year around 33 bps. This helps to keep us restrained as we increase our MBS exposure here, because, although MBS has gotten cheaper, it hasn't yet reached levels that we think are fundamentally cheap.



IG Spreads Were Wider Throughout 2018

Investment grade spreads ended the year around 150 bps, and saw a bumpy ride higher throughout 2018, as the market, well aware of the risk posed by many large BBB issuers with decaying credit profiles, began to price many of these names to downgrade, or worse. But there was a "punish them all mentality" by year end that opened up a window for a tactical increase in exposure here once spreads pushed to about 150 bps.



HY Spreads Lagged The Broader Move Then Snapped Higher The Last 3 Months of the Year

The only surprise here for HY was that the move higher in spreads was so lagged compared to IG credit. But digging deeper, this should come as no surprise, as HY is now codependent to lagging equity markets, rather than leading equities, as investment grade credits still are, in our view. The reason for this is that with yields and spreads both so low today by historical standards, the equity residual piece in the event of a rise in defaults is a bigger piece of spreads than normally observed. All of this is to say that HY is likely to trade more like low beta equity than high beta credit in 2019. With this in mind, and given our view that equity markets may have been tactically oversold by end of 2018, we believed it was a good entry point for a small, tactical increase in HY exposure as well. But our longer-term strategic view is that credit quality is likely to deteriorate further in 2019, and we would expect to see HY spreads higher by year end than they were at mid-January.

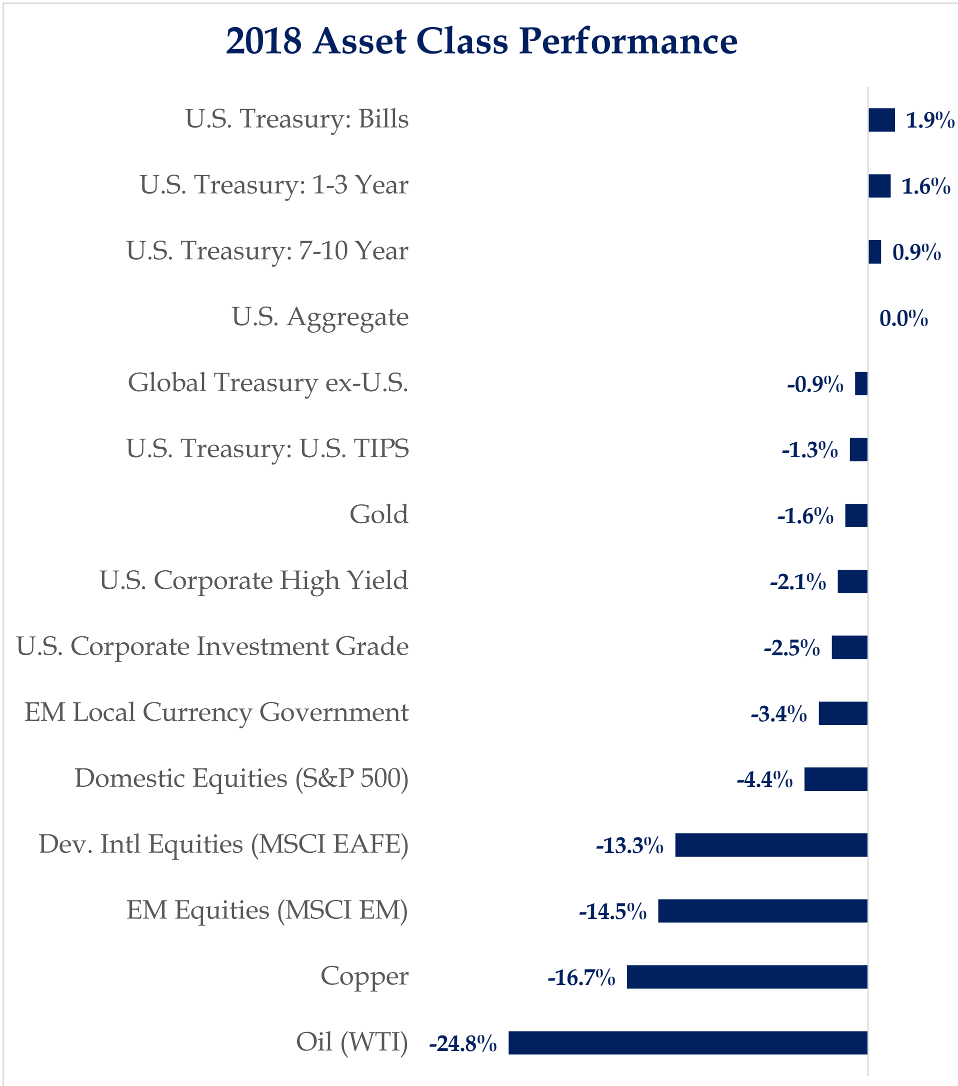
Tom Tzitzouris is the Head of Fixed Income Research at Strategas.

January Recommended Asset Allocation

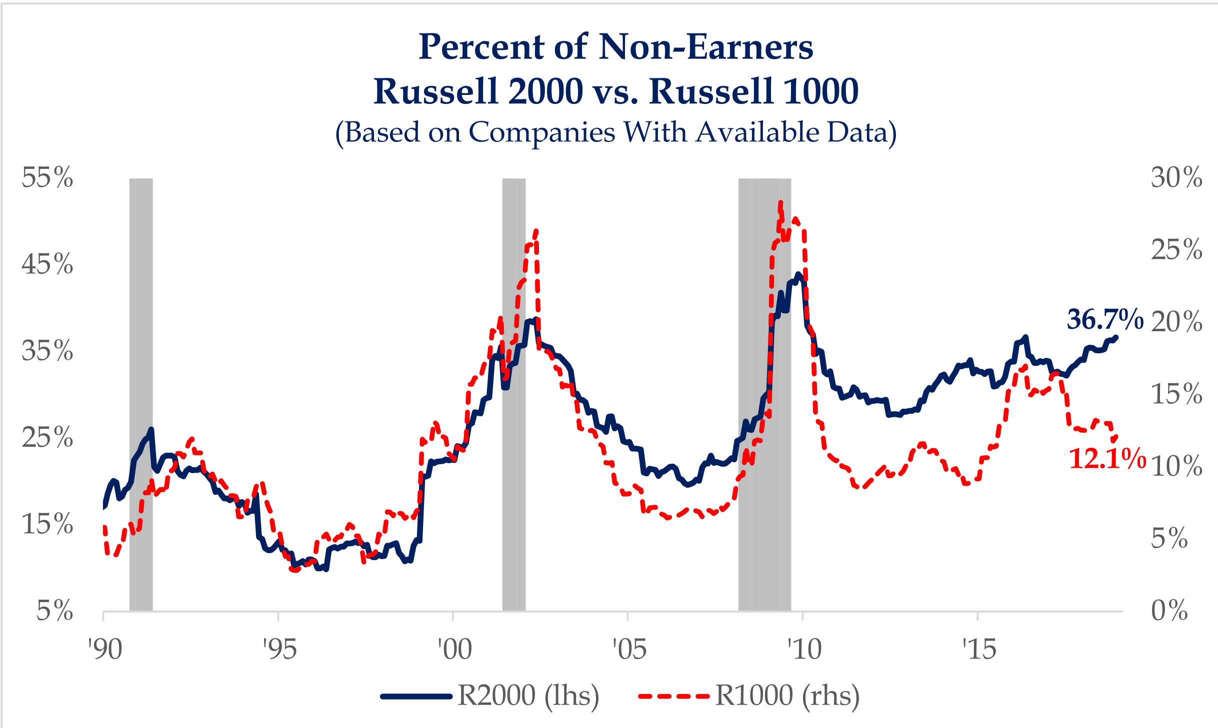
Strategas Recommended Asset Allocation (Jan'19)

	Equities			**Bonds**			**Cash**
		70%			**27%**		**3%**
B'mark	MSCI ACWI	60%		Barclays Agg	38%		2%
			M/M CHG			M/M CHG	
	Domestic	39%		Core Credit	23%		
	International	31%		Extended Credit	4%		
Overweight	Dev AC Core	21%		IG Corporates	10%	+100bps	
	US LC Value	12%		Local Currency EMD	2%		
	EM AC Core	10%		US Dollar EMD	1%		
	US MC Value	5%					
Neutral	US LC Growth	9%		Agencies	1%		
	US LC Core	7%		US High Yield	1%		
	US MC Growth	3%		TIPS	0%		
	US MC Core	2%					
	US SC Core	1%					
Underweight				US MBS	9%	+100bps	
				U.S. Treasuries	3%	-200bps	
				ABS/CMBS	0%		
				Convertibles	0%		
				Bank Loans	0%		

Cash Like Asset Classes Were The Best Performers In 2018



Continue to Maintain a Bias Toward Large-Caps As Non-Earners Are More Prevalent In Small-Caps

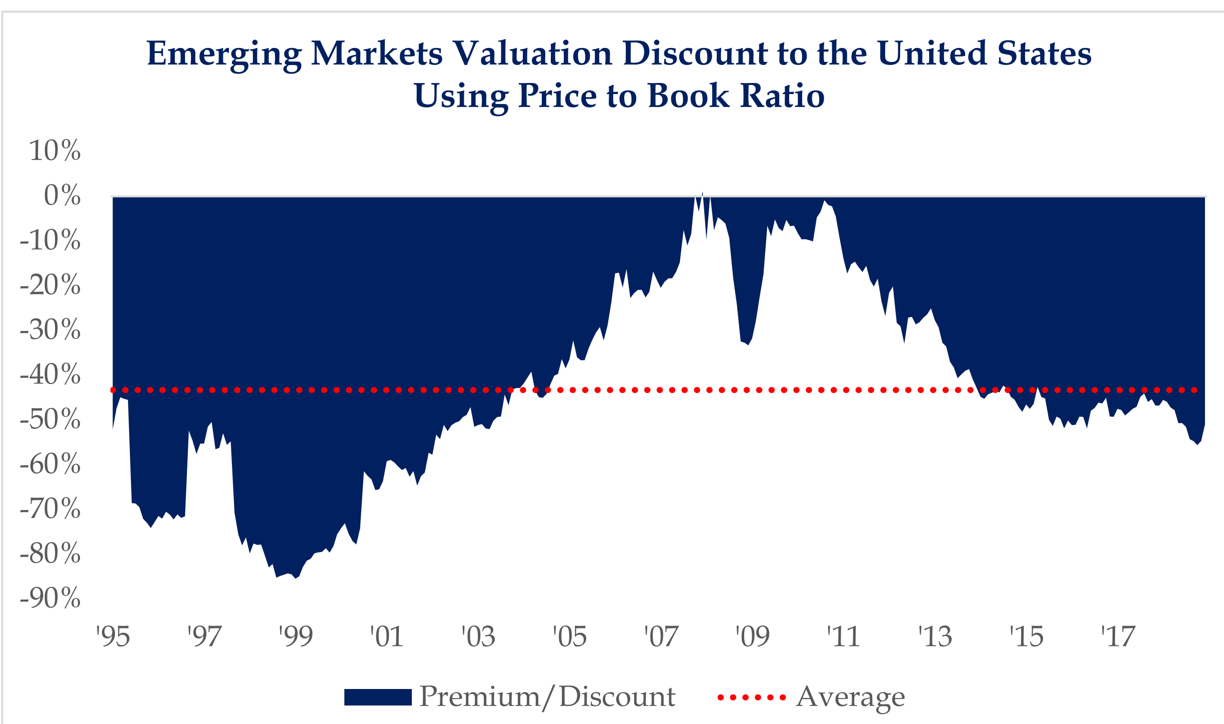


Percent Of Non-Earning Companies

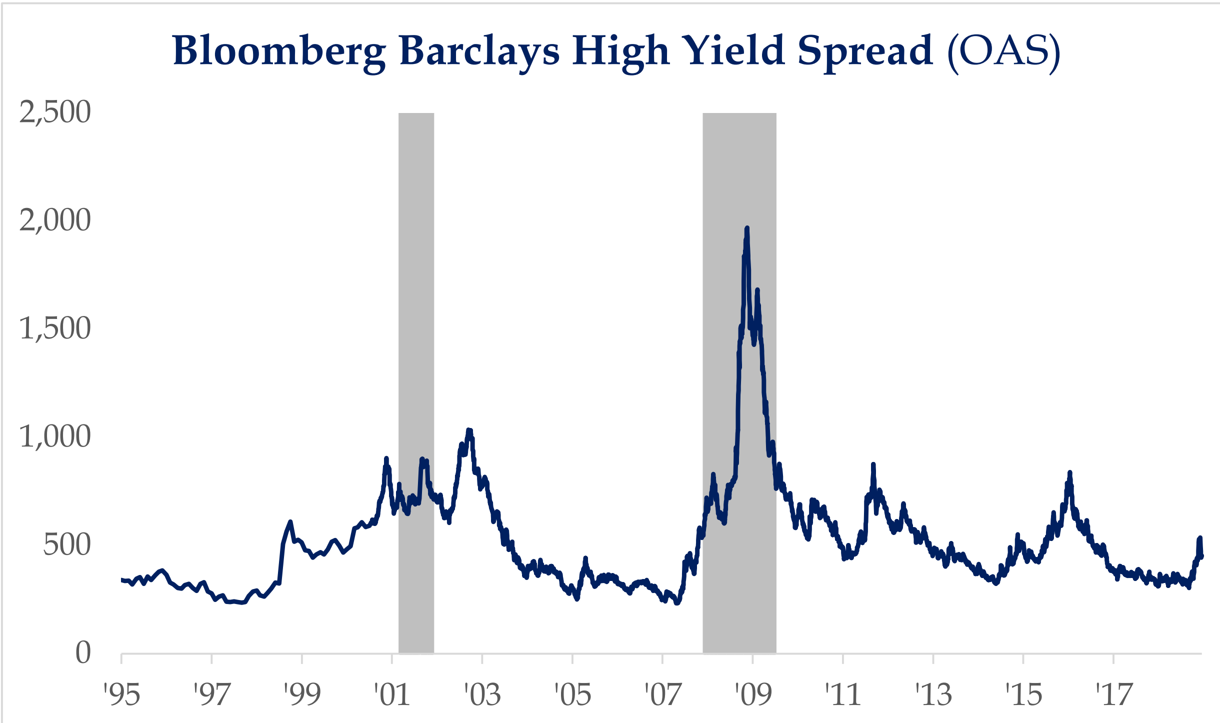
	Current Reading	Long-Term Average	Highest Reading Since 1990
Russell 1000 Growth	11.9%	9.8%	33.5%
Russell 1000	12.1%	10.9%	28.4%
Russell 1000 Value	11.7%	12.3%	37.0%
Russell 2000 Growth	42.7%	27.1%	44.9%
Russell 2000	36.7%	25.6%	44.0%
Russell 2000 Value	30.7%	23.3%	46.2%

A Weaker USD Should Benefit EM

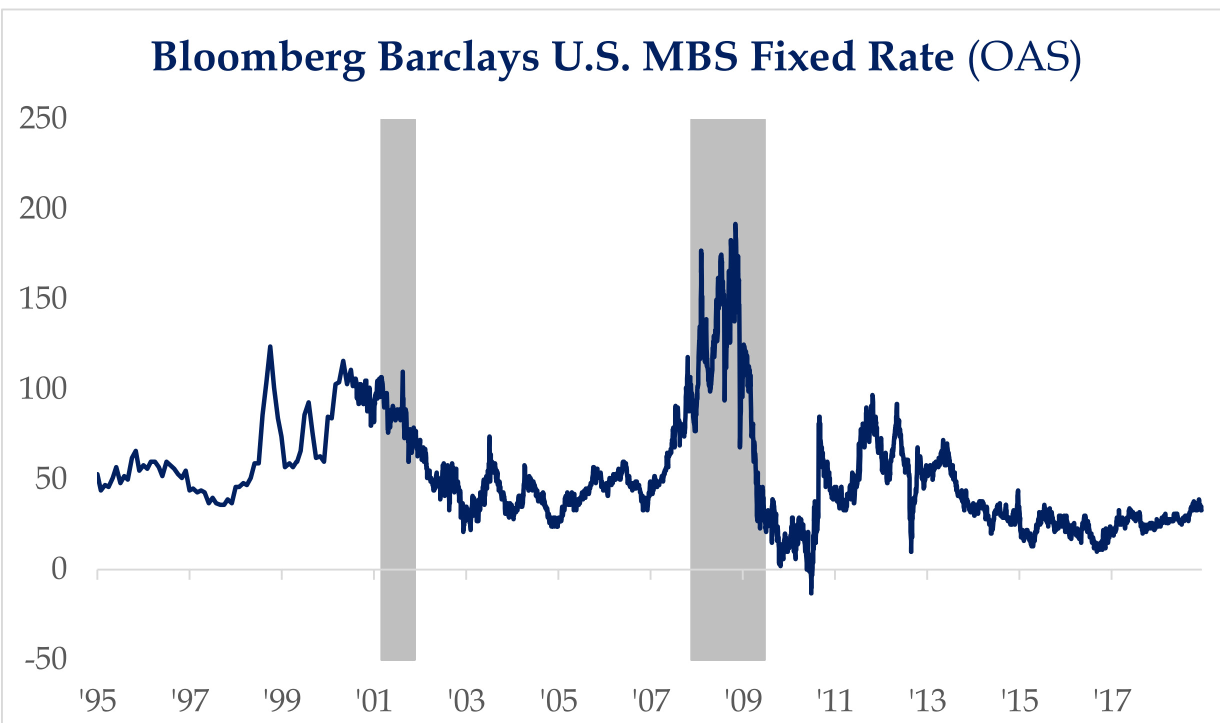
EM Trading Below the Long Term Historical Discount to U.S. Markets



A Wild Ride For High Yield Spreads Recently



MBS Spreads Continue To Grind Higher



No Questions Asked The MFG. Data is Weakening

Global Manufacturing Summary

		Most Recent Data			Current Reading vs.	
		Period	Current Reading	Prior Reading	6 Mo Avg.	12 Mo Avg.
Developed Markets	**Americas**					
	Canada	Dec-18	53.6	54.9	-1.6	-2.0
	United States	Dec-18	54.1	59.3	-4.3	-4.7
	Europe					
	Austria	Dec-18	53.9	54.9	-1.3	-2.9
	Denmark	Dec-18	58.1	57.9	-0.4	-0.4
	France	Dec-18	49.7	50.8	-2.1	-3.6
	Germany	Dec-18	51.5	51.8	-2.2	-4.6
	Ireland	Dec-18	54.5	55.4	-1.3	-1.3
	Italy	Dec-18	49.2	48.6	-0.5	-3.2
	Netherlands	Dec-18	57.3	56.1	-0.6	-2.4
	Norway	Dec-18	55.9	56.2	0.4	0.0
	Spain	Dec-18	51.1	52.6	-1.1	-2.3
	Switzerland	Dec-18	57.8	57.7	-2.1	-3.7
	United Kingdom	Dec-18	54.2	53.6	1.0	0.4
	Pacific					
	Australia	Dec-18	49.5	51.3	-5.0	-7.1
	Japan	Dec-18	52.6	52.2	0.1	-0.5
	New Zealand	Nov-18	53.5	53.7	0.9	0.0
	Singapore	Dec-18	51.1	51.5	-0.9	-1.3
Emerging Markets	**Americas**					
	Brazil	Dec-18	52.6	52.7	1.1	1.0
	Mexico	Dec-18	49.7	49.7	-1.0	-1.6
	Europe					
	Czech Republic	Dec-18	49.7	51.8	-3.3	-5.7
	Greece	Dec-18	53.8	54.0	0.2	-0.2
	Hungary	Dec-18	54.2	53.5	-0.5	-1.0
	Poland	Dec-18	47.6	49.5	-2.7	-4.5
	Russia	Dec-18	51.7	52.6	1.3	1.2
	Asia					
	China (CLFP)	Dec-18	49.4	50.0	-1.1	-1.5
	China (Caixin)	Dec-18	49.7	50.2	-0.5	-1.0
	India	Dec-18	53.2	54.0	0.4	0.9
	Indonesia	Dec-18	51.2	50.4	0.3	0.3
	Korea	Dec-18	49.8	48.6	0.0	0.1
	Malaysia	Dec-18	46.8	48.2	-2.6	-2.5
	Philippines	Dec-18	53.2	54.2	0.5	0.7
	Taiwan	Dec-18	47.7	48.4	-2.6	-5.0
	Thailand	Dec-18	50.3	49.8	0.5	0.3

APPENDIX – IMPORTANT DISCLOSURES

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