JOHNSON FINANCIAL GROUP

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ECONOMIC & MARKET OUTLOOK

FOURTH QUARTER 2019

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INTRODUCTION

Uncertainty is the word on the street these days as investors seem focused on geopolitical risks.

Despite that underlying disquiet, bonds, stocks and alternative investments have all posted strong returns so far this year with the S&P 500 plus 21% and bond returns of 5-6%. *(Figure 1)*.

This broad-based positive performance masks the tension underneath the surface, which can explode into market-moving trend reversals on little news. For example, recently two "winning" investment trends in 2019 experienced dramatic reversals when the relevant "story" changed:

- **Interest-rate reversal:** The yield on a 10-year US Treasury Note had followed a long and steady decline from a peak of 3.24% in September 2018 to an eye-popping low of 1.46% in late August—only to reverse course with a 44 basis-point leap back upward to 1.90% in mid-September.
- **Momentum stock reversal:** At the same time, markets experienced a sharp three-day reversal that temporarily drove momentum stocks out of favor as investors embraced value stocks instead. That short reversal closed the year-to-date performance gap between the two styles from 12% to just 3%.

What's critical to note here is neither of these reversals was triggered by new fundamental data about companies and their economic prospects. Rather, the driving force was an easing of the geopolitical uncertainty, as investors embraced a positive outlook about U.S.-China trade.

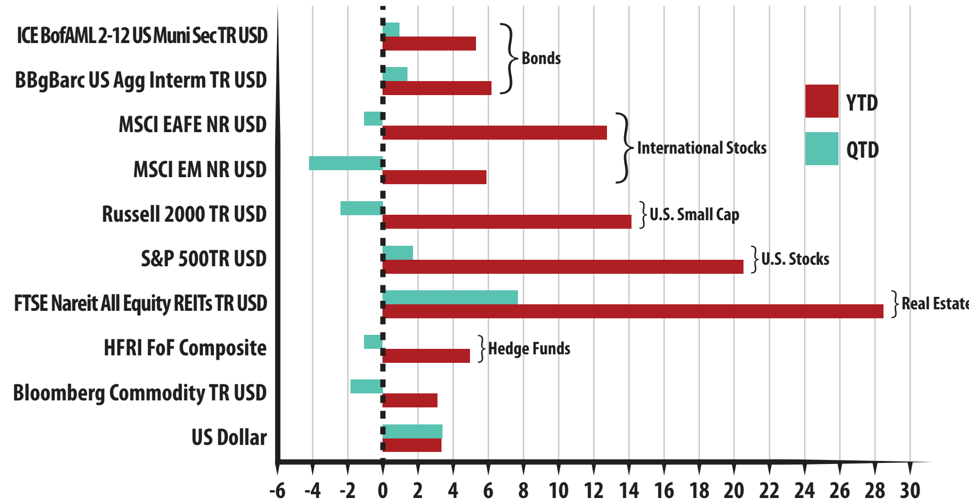
So, what's needed now? First, careful monitoring of underlying tensions that could at any time spark dramatic price changes in the market. And second, risk management and regular portfolio rebalancing while we patiently watch for opportunities—some of which may be created by the very tensions investors generally fear.

ECONOMIC OUTLOOK

U.S. real GDP increased at a rate of 2.0% during the second quarter of 2019, which is a downshift from the 3.1% pace during the first quarter. While the deceleration in economic growth bears watching, we need to remember that the average pace of economic growth during the last 10 years has been 2%—a pace that has enabled job gains in the form of both low unemployment and wage growth. Both metrics are near highs of the current expansion *(Figure 2)*.

Figure 1

QTD & YTD PERFORMANCE

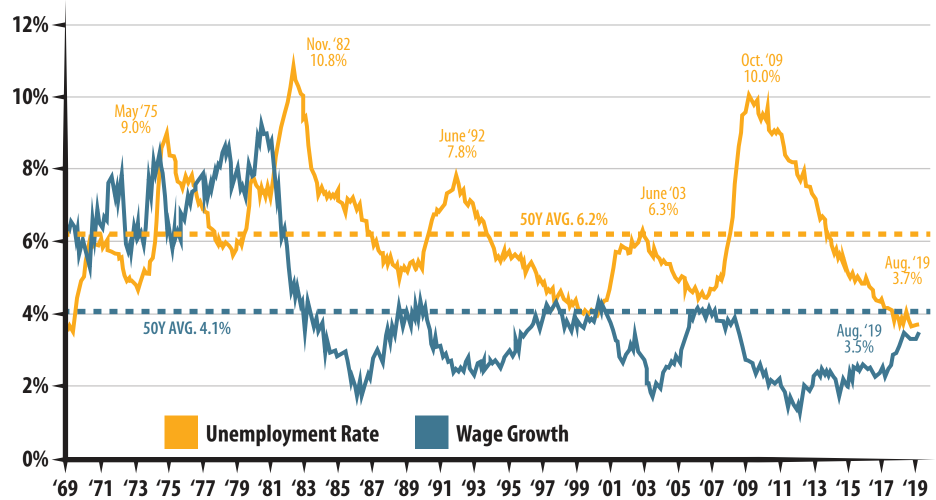


Source: Morningstar Direct

Figure 2

UNEMPLOYMENT RATE

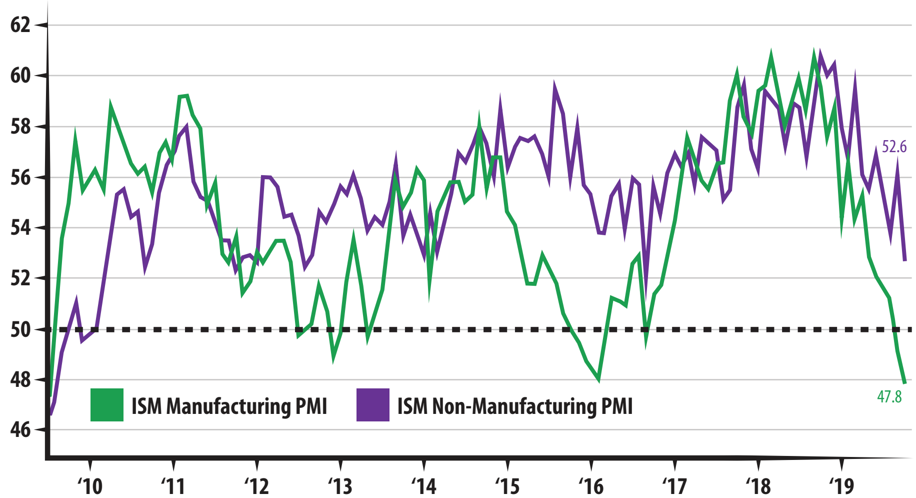
Private Production & Non-Supervisory Workers, Seasonally Adjusted



Source: BLS, FactSet and JP Morgan Guide to the Markets – July 31, 2019

Figure 3

U.S. ISM PURCHASING MANAGERS INDICES



Source: Bloomberg Finance L.P.

Those gains in the labor market have supported the consumer sector, but the industrial sector has had no equivalent driver. And recently, industrials have suffered from weaker global growth combined with trade-war headwinds and a stronger U.S. dollar.

Figure 3 illustrates this divergence of fortunes between consumer- and industrial-oriented industries. The chart shows two separate ISM (Institute for Supply Management) Purchasing Managers Indices: one for Services and one for Manufacturing. In each case, the index can be thought of as a gauge of the overall strength of each segment; values above 50 represent expansion, and values below 50 represent contraction. Both Services and Manufacturing have declined from their peaks a year ago, but the services sector is still showing growth, whereas the manufacturing sector dipped into contraction territory as of the latest reading.

This divergence brings us right back to the broad theme of the quarter: uncertainty. Now, investors face uncertainty about whether the manufacturing slowdown, in particular, points toward another mid-cycle slowdown (as we experienced in 2012-13 and 2015-16) or whether it's an early sign of recession.

Our view is this is another slowdown. Central banks, including the Federal Reserve, recognize the economic weakening and have been reducing interest rates to stimulate growth. Unfortunately, for the real economy, it takes time for lower interest rates to work. In fact, the current slowdown can partially be attributed to the nine quarter-point rate hikes the Fed delivered from 2015-18.

Although recession risk over the next twelve months is higher than when we started the year, we expect economic growth to continue into 2020. The key risks that could undo this solidly positive outlook are "unforecastable" by their nature: geopolitical events such as tariffs, Brexit, Iran and the impeachment inquiry launched by the House of Representatives in late September.

EQUITY MARKETS

Depending on the category, equities delivered either small positive or small negative returns during the third quarter. Intra-quarter volatility was driven largely by trade war sentiment, in our view, and not company fundamentals.

More specifically, a strong July gave way to a weak August as President Trump escalated the trade war by introducing additional tariffs that would take effect in October and December. By the end of August, however, tensions eased with hopes for a trade truce emerging in early October. Stocks then began a recovery that carried over into September.

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It's useful to put the third quarter's volatility into a larger context. Enthusiasm toward stocks peaked in January 2018. Since then, the S&P 500 Index has managed a net increase of only a few percentage points. *(Figure 4).*

But that doesn't mean fundamentals don't matter. What we know is U.S. economic fundamentals, supported by a resilient consumer sector, are solid despite slower growth.

Slower global growth, especially within manufacturing, is expected to result in just 3% earnings growth in 2019. That is a far stretch from the 23% earnings growth realized in 2018, but the slower earnings growth has the hallmarks of a mid-cycle slowdown. We expect further earnings growth in 2020, although likely below the current consensus estimate of 11% growth.

As for stock valuations, while they are certainly above historical averages, we believe the current levels are supported by low interest rates. Valuations will likely drift higher if uncertainty is reduced.

Current Positioning

Taking all these trends and risk factors into account, our take is cautiously optimistic. We are managing portfolios near long-term targets. Consistent with prudent caution, however, we have increased diversification and rebalanced portfolios to take profits in areas that appear overvalued, such as the growth style and highly momentum-driven investments. Proceeds from these adjustments have generally flowed toward more value-oriented investments.

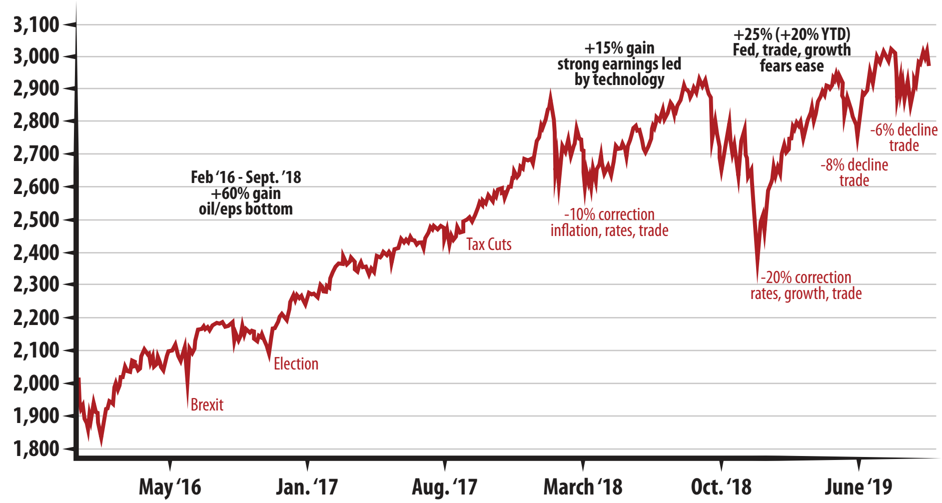
FIXED INCOME MARKETS

"Uncertainty" is the watchword in fixed-income markets as well.

Back in July, we suggested a possible trading range of 1.80% to 2.30% for the 10-year U.S. Treasury yield, while noting that trade and global growth concerns could widen this range materially. As those concerns flared, the bottom end of that trading range was indeed breached, with the 10-year yield bottoming at 1.46% on September 3 amid a confluence of events including the escalation of the U.S.-China trade war, weakening economic data in Germany and heightened chances of a no-deal Brexit.

Figure 4

S&P 500 INDEX



Source: Thomson ONE

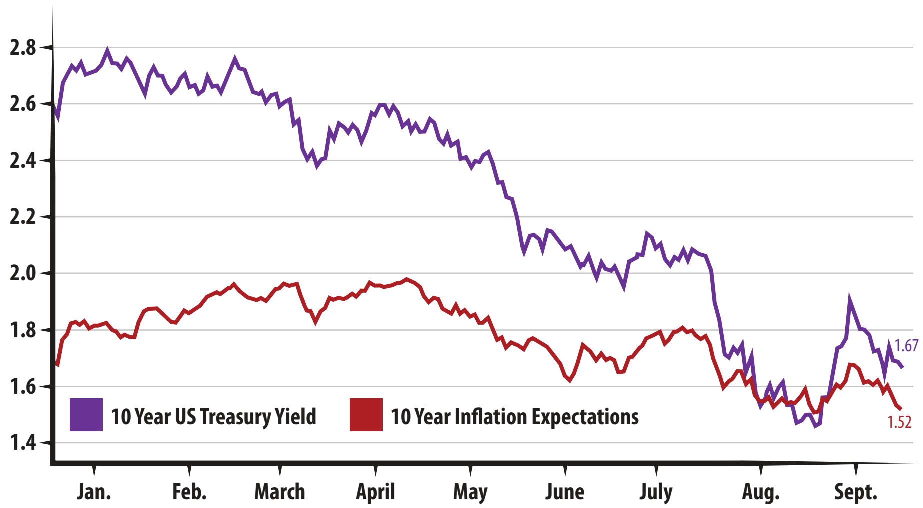
However, since the lows, yields quickly retraced their declines. The 10-year yield leapt 44 basis points from its low to reach 1.90% on September 13, where it finally met resistance. The reversal was driven largely by a perceived easing in the trade war and better-than-expected economic data in the U.S.

It's important to note here that these moves are truly extraordinary—historic, even—with respect to Treasury bonds. The price action in Treasuries underscores the deep uncertainty in the global economy; similar price action spread to other areas of the bond market such as high-yield and emerging markets.

Indeed, "uncertainty" surrounding trade and global growth was Fed Chairman Jerome Powell's rationale for cutting interest rates for the second time this year on September 18. Implicit in Powell's reasoning is this: *absent exogenous factors outside the Fed's control, the U.S. economy is strong and capable of withstanding higher rates.*

Figure 5

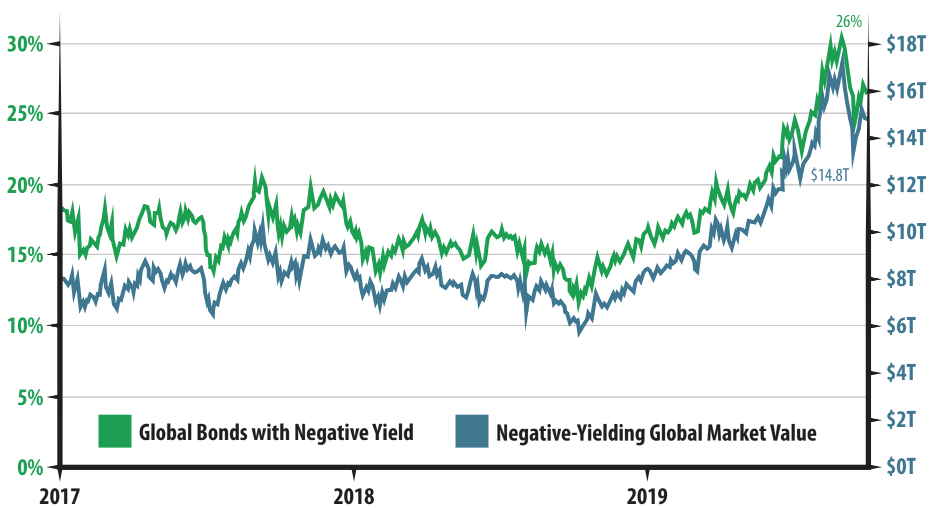
10 YEAR U.S. TREASURY YIELD & INFLATION EXPECTATIONS



Source: Bloomberg Finance L.P.

Figure 6

NEGATIVE YIELDING GLOBAL BONDS



Source: Bloomberg Barclays Global Aggregate Bond Index

One way to measure uncertainty in the economy is to study the market for Treasury Inflation Protected Securities, or TIPS. Professional investors look at the "breakeven inflation rate"—the difference between the yield of a nominal bond and an inflation-protected bond of the same maturity—to gauge the market's expectations for future inflation. As *Figure 5* illustrates, inflation expectations have been volatile this year and highly correlated to longer-term Treasury yields.

In our view, the overly pessimistic tone of late August, when investors were pricing in 10-year average annual inflation of just above 1.5%, has given way—as it should—to a slightly more optimistic view today. Still, the market remains skeptical that the Fed can achieve its long-run inflation target of 2%. Our view is that growth and inflation expectations are too pessimistic, and we may see the economic data surprise to the upside, which could lead to higher interest rates.

Any discussion about the world bond market would be incomplete without touching on the specter of negative-yielding bonds. As we noted in our mid-year outlook, trillions of dollars of negative yielding-foreign sovereign debt continue to place downward pressure on U.S. bond yields as investors worldwide hunt for income *(Figure 6)*.

With the European Central Bank (ECB) recently cutting its policy rate further into negative territory, observers are naturally wondering if negative rates will eventually make their way to the U.S. While negative rates in the U.S. are theoretically possible, we think the Eurozone's experience with sub-zero yields is likely more cautionary than exemplary.

Eurozone growth and inflation have remained stubbornly low despite the stimulus of low borrowing costs. Investors, seeing the inability of negative short-term rates to stimulate growth, have also driven down long-term rates, putting pressure on European banks' profitability (and stock prices), further contributing to foreign equity markets' inability to keep pace with the U.S.

Not surprisingly in this environment, ECB President Mario Draghi highlighted the limits of central bank power in his September post-meeting remarks. As he put it: "Now is the time for fiscal policy to take charge." Such policy would likely mean tax cuts and government spending programs. We have already seen the former in the U.S., and the latter may be on the horizon.

We believe the Fed is unlikely to cut the Fed Funds rate into negative territory, an action that would penalize both lenders and savers—including jeopardizing public pension funds' ability to meet their obligations. Rather, we believe the Fed is more likely to encourage fiscal stimulus and engage in further rounds of quantitative easing if today's uncertainties persist.

Current Positioning

For the first three quarters of 2019 investors have been rewarded for extending maturities and buying lower credit quality bonds as rates have remained in a secular downtrend and credit spreads have remained tight. Our portfolios have benefitted from these trends, but at current valuations, we believe the market is offering insufficient reward for **(1)** the interest-rate risk associated with long-term bonds, and **(2)** the credit risk associated with low quality bonds. We've increased our allocation to higher-quality, intermediate bonds.

> **"We believe the Fed is unlikely to cut the Fed Funds rate into negative territory, an action that would penalize both lenders and savers."**

CONCLUSION

No market environment is immune to unfavorable geopolitical news. What's unusual about recent market dynamics is the level of drama reflected in investors' responses to headlines that, while relating to serious issues, are not heralding particularly "big" news.

No question, investors are nervous. We suspect many are afflicted with a common late-stage bull-market malady commonly diagnosed as "fear of missing out." Those most infected are, in our view, especially prone to overdoing their responses to news as it plays out. One day, it's "everything's fine; I'll stay in." The next day, it's "the world is ending; I'm changing all my allocations."

Our take is what's needed is a strong dose of common sense and a few extra tablespoons of historical perspective. What's called for now is not so different from any other times—actively rebalancing portfolio exposures, such as trimming some winners with high valuations to realize those gains and redeploying the capital into other attractively valued opportunities.

In uncertain times, it helps to remember that *all* times are, without exception, uncertain.

10.2.19