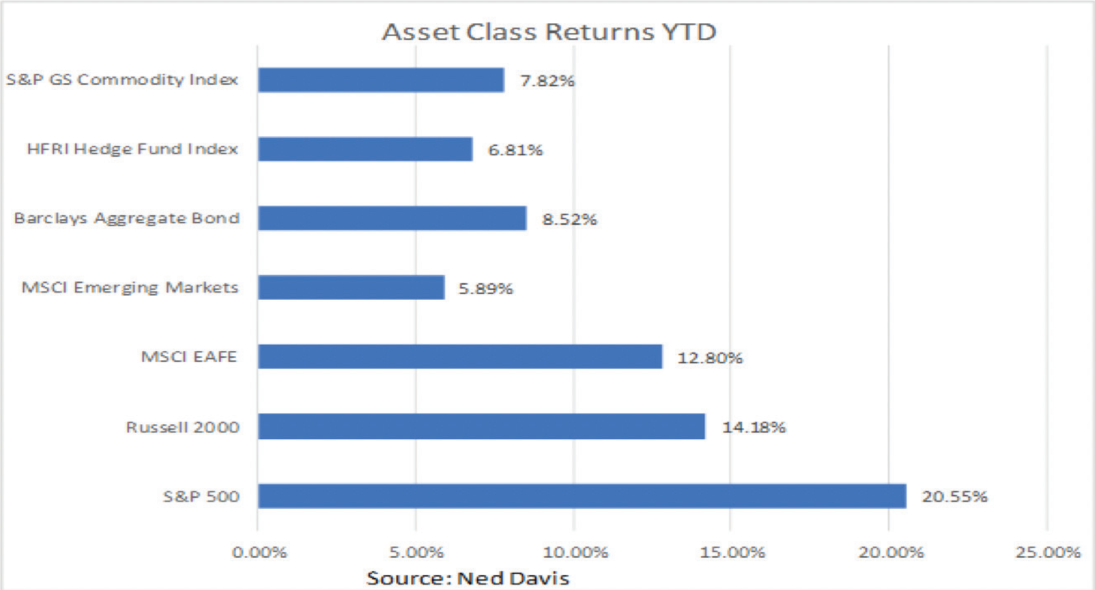
Market & Economic Review

Fourth Quarter 2019

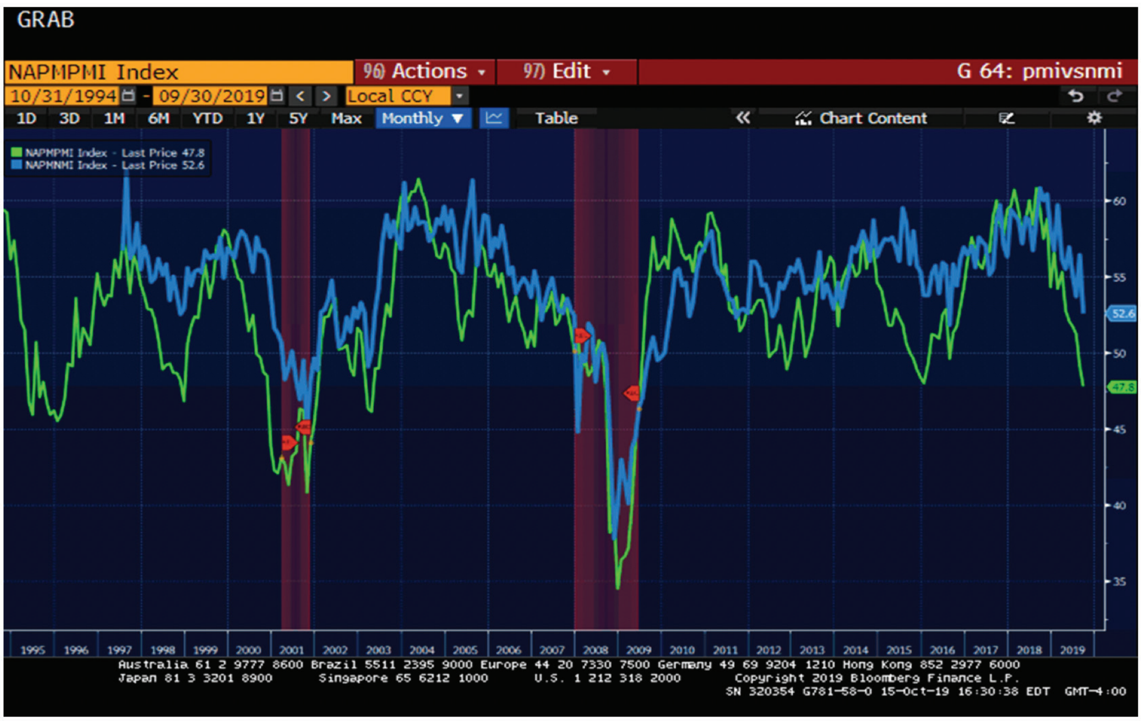
Q3 2019 Review

More signs of slowing global growth showed up during the third quarter. The effect of trade and economic uncertainty continues to be the biggest factors in the slowdown. Manufacturing production and capital expenditures have declined as confidence in future policy has diminished. The U.S. 10-year Treasury bottomed out at a 1.47% yield in the quarter as the yield curve (10 yr - 2 yr) inverted momentarily for the first time since 2007. Bond indices managed to outperform equity during the quarter placing the Barclays Aggregate Bond Index up 8.52% for the year and the S&P 500 up 20.55%. We saw a flight to safety as Bonds, Gold, and the Dollar outperformed major stock indices. The Fed reduced rates twice during the quarter in an effort to offset uncertainty but appear to be more reactionary and slightly behind the curve. While Government and Corporate sectors appear weak, the U.S. Consumer continues to hold up well. Low interest rates and record employment have allowed households to continue to spend at a steady rate and have yet to show signs of weakness.



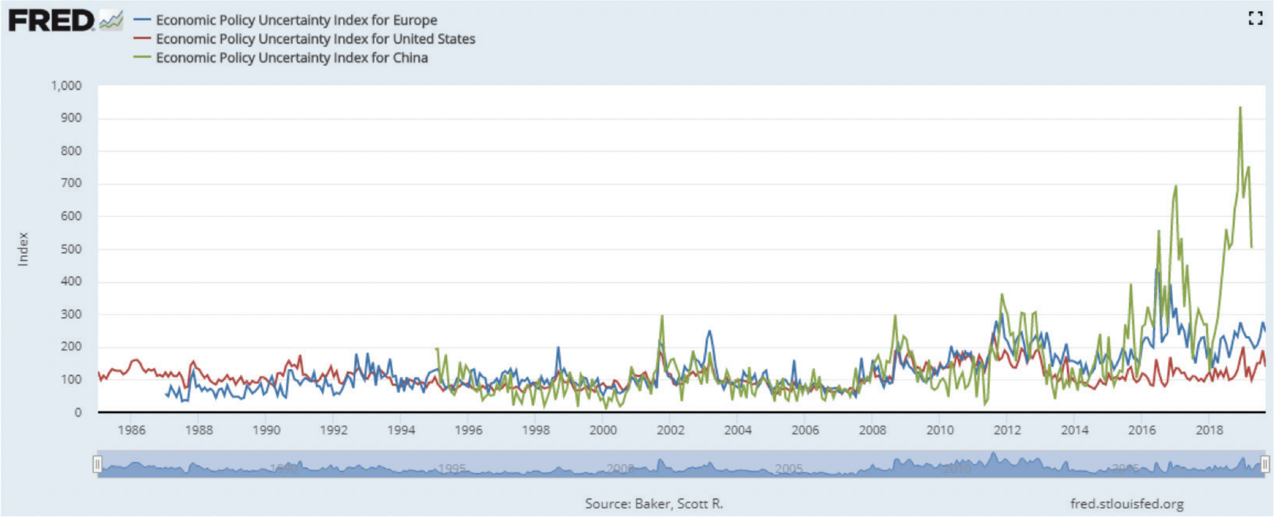
Economic Outlook

While we expected the ongoing trade war to weigh on global economic growth, we, like many, expected that by now there would be some certainty to how it would play out. Unfortunately, that uncertainty has only grown, pushing not only U.S. manufacturing lower, but now we are seeing a slowdown in Non-manufacturing as well. The PMI index and NMI Index (chart below) measures if the manufacturing and non-manufacturing sectors of the economy are growing or contracting. Any level above 50 indicates growth, while anything below 50 indicates contraction. As of the end of the third quarter U.S. manufacturing was contracting for the second month in a row, while the Non-Manufacturing sector was expanding, but at a slower pace. The manufacturing sector makes up a smaller share of U.S. output, but in an economy only growing around 2% a major contraction could pull GDP into negative growth. While the ISM Manufacturing Index can fluctuate above and below 50, the ISM Non-Manufacturing Index can indicate a higher probability of recession if it drops below 50.



The escalation of the Trade War and uncertainty around BREXIT have heightened overall global uncertainty to a level where it begins to have a major effect on capital expenditure and investment. While high levels of economic policy uncertainty (chart below) don't indicate a recession, it can cause a slowdown in capital expenditure and investment a year or two out. We have seen capex begin to slow and wage growth, which should be growing between

3.5% and 4% (based on the unemployment rate), slow to less than 3% recently. Previously we thought that a deal with China could be negotiated by the end of the year. It is beginning to look less and less likely. It is also likely that any deal, when it is agreed to, will not be as beneficial to the U.S.



The Federal Reserve's move to cut rates twice in the third quarter and one to two more times in the fourth quarter will help provide stimulus to alleviate the tightening that reduced trade has brought. Regardless, we continue to see the U.S. growing around 2% for the foreseeable future. As Central Banks continue to deploy most of their monetary policy tools, with very little growth to show, we may begin to see an increase in the discussion around fiscal policy. Infrastructure spending in the U.S. is needed, but with the deficit back to $1tn a year a test of political will may be necessary to pass.

We continue to be in the camp of lower but positive U.S. growth. The expectations are for GDP to average around 2%, inflation to average below 2%, and the 10-year U.S. Treasury Bond to average 2% or below. The Fed's move to lower rates should help to re-steepen the yield curve which is a positive sign.

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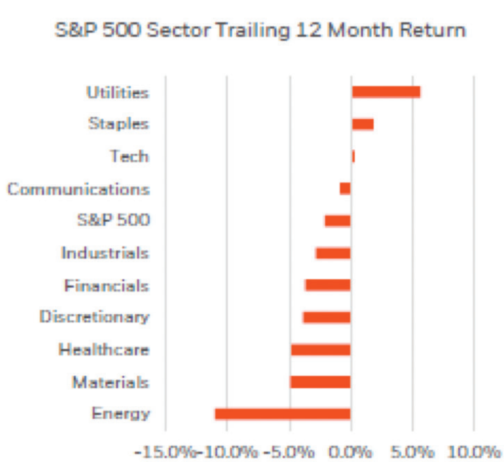
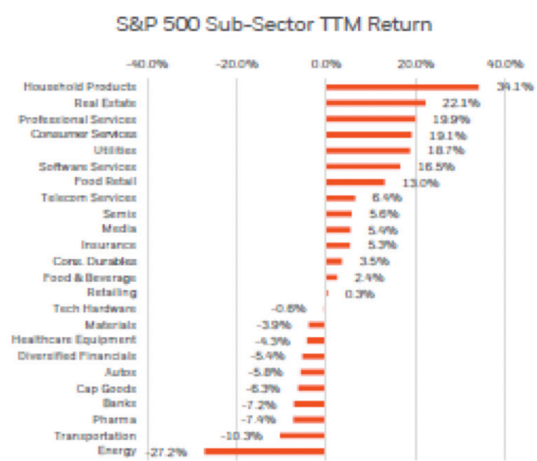
Equities

U.S. large cap stocks continued to lead in the third quarter, with growth outperforming value. Underneath the surface there was a flight to safety as those stocks sensitive to interest rates outperformed. Utilities, real estate, and consumer staples were the strongest performers for the quarter while energy and healthcare were down the most. For the year it has been a mixed bag with both growth sectors and defensive sectors up the most. We did see a sharp but brief rotation to value during the beginning of September, but not enough to outperform for the quarter. With the Fed looking to re-steepen the yield curve we could see an environment that is more conducive to value. Our allocation within equity has been slightly overweight growth, but we have shifted towards more quality and growth at a reasonable price. We believe this is a more prudent allocation and a sweet spot between traditional growth and value.

Over the past year, the S&P 500 is up marginally while beneath the surface there has been significant dispersion. Within sectors, utilities are up over 5% and energy down over 10%. If we drill down to the sub-sectors or industries within the S&P 500 there is over a 60% difference between the top performer and the worst performer (chart below). As dispersion has increased, we should be entering a period where active management can have a higher probability of outperforming. We continue to add exposure to long/short hedge funds who have the ability to discern the winners from the losers. Within our overall equity allocation we still remain slightly more passive, but are looking to move more towards a neutral to slight overweight to active.





Source: Blackrock

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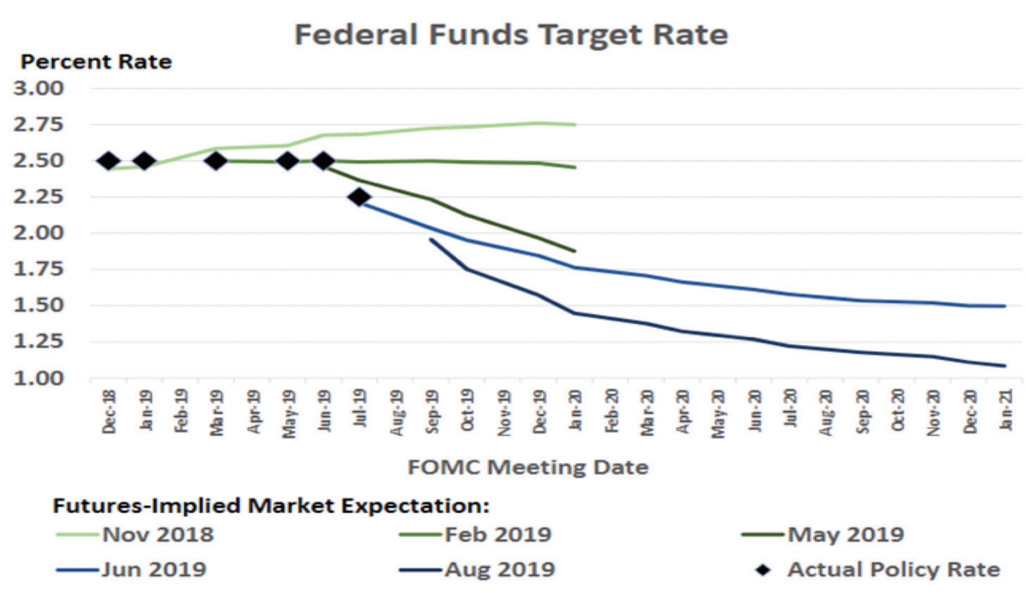
Fixed Income

The continued uncertainty in the global economy, specifically U.S and China trade discussions, pushed the 10-year U.S. Treasury Bond briefly below 1.5% and the yield curve (10 yr - 2 yr) slightly inverted for the first time since 2007. Globally, the level of negative yielding debt reached $17 trillion and the thought of negative interest rates in the U.S. reached the financial main stream. The Fed quickly went into action with two rate cuts, while injecting liquidity into the short term fixed income markets. U.S. intermediate and long term bonds had a higher return in the quarter than U.S. and global equity markets.

The outlook on interest rates by the Federal Reserve has taken a dramatic shift over the past nine months (chart below). In November, the expectations were for one to two possible hikes in 2019. By February the expectations were for none and by May the expectations were for multiple cuts. It was quickly apparent that the Fed's rate increase in December, along with Central Banks tightening, was too much too early. As trade discussions have dragged out longer than expected, Central Banks have had to inject more liquidity into the system to offset the slowdown in the global economy. We see the Fed cutting once and possibly twice by year end. Any cuts beyond that is likely to indicate more weakness than is priced into the market.



Source: Bloomberg

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We have written in the past several quarters on the quality position we have taken within our fixed income portfolios. While we have likely missed out on some upside by avoiding high yield, we continue to see the risk/reward get further and further less attractive. One area we see investors increasingly adding exposure to is the private credit market, typically through leveraged loans or Collateralized Loan Obligations (CLOs). The risk in that space is getting to be near that of the 2007 period. In fact, debt multiples in the middle market and leveraged loan space are higher than that period. As we have mentioned before, we want to avoid liquidity mismatches and more and more of these instruments with low liquidity are showing up in ETF and mutual fund structures. Many of the private credit funds that have popped up have little to no experience managing through a credit cycle. That fact along with possible liquidity matches could present a large downside relative to the modest upside. We are in the process of identifying managers who will be able to take advantage of the next dislocation.

Current Positioning

- **Equity:** Favor Large Cap and U.S.
  - Favor Quality and GARP (Growth At a Reasonable Price) managers
- **Fixed Income:** Quality bonds with average duration around 5 years
- **Alternatives:** Environment for Hedge Funds is improving we are slowly adding exposure
  - Private Equity exposure is increasing with focus on small-mid buyout funds and co-investments with small to mid-size funds

The Family Office at Synovus

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