INVESTMENT COMMENTARY
August 2019

Executive Summary

Despite a few bouts of volatility, risk assets are broadly higher thus far in 2019. Yet, bond yields have plunged, signaling a weak economic outlook and expectations of further central bank easing. To be sure, the global expansion has decelerated and become more uneven—but our base case macro assumption does not call for a further, significant deterioration in growth or an outright contraction. Central banks' dovish pivot and China's fiscal stimulus should help stabilize growth and extend the current cycle. However, we see a high degree of uncertainty and a wide range of plausible economic outcomes. At the same time, asset valuations across most categories are somewhat above historical levels.

In this environment, we expect lower-than-average positive returns from most asset categories and higher volatility as is typical of the later stages of the business cycle and as geopolitical risks remain elevated. As a result, we continue to recommend a slight defensive tilt in portfolio strategy. Our portfolio positioning themes include:

- Don't tilt too far away from an appropriate strategic asset mix but maintain an elevated cash/short-term fixed income position as "dry powder."
- Target an underweight position in US equities while emphasizing large cap, high quality stocks and more reasonably priced international and emerging markets.
- Target an overweight position to certain flexible/alternative strategies that are valuable for their diversifying returns and potentially benefit from elevated market volatility and increased dispersion.

Asset Category Performance (As of July 31, 2019)	YTD 2019	Full Year 2018	Last 5 Years*	Last 10 Years*
Fixed Income				
US Municipal Bonds (Barclays 1-10 Year Municipal)	+4.7%	+1.6%	+2.7%	+3.3%
US Taxable Bonds (Barclays US Aggregate)	+6.4%	+0.0%	+3.1%	+3.8%
Bank Loans (S&P/LSTA US Leveraged Loan)	+6.6%	+0.4%	+3.9%	+5.8%
High Yield Corporate Bonds (Barclays US High Yield)	+10.6%	-2.1%	+5.1%	+8.7%
Equities				
Global Stocks (MSCI All Country World)	+16.6%	-9.4%	+6.5%	+9.3%
US Large Cap Stocks (S&P 500)	+20.2%	-4.4%	+11.3%	+14.0%
US Small Cap Stocks (Russell 2000)	+17.7%	-11.0%	+8.5%	+12.5%
Non-US Developed Markets Stocks (MSCI EAFE)	+12.6%	-13.8%	+2.4%	+5.8%
Emerging Markets Stocks (MSCI Emerging Markets)	+9.2%	-14.6%	+1.8%	+4.6%
Real Assets				
Commodities (Bloomberg Commodity)	+4.4%	-11.3%	-8.3%	-4.1%
Energy MLPs (Alerian MLP)	+16.7%	-12.4%	-6.6%	+6.9%
Global REITs (MSCI ACWI REIT)	+20.4%	-4.8%	+7.8%	+12.8%
Flexible/Alternative Strategies				
Directional Hedge (HFRI FOF Strategic)	+8.3%	-6.7%	+2.5%	+3.4%
Less-Directional Hedge (HFRI FOF Conservative)	+5.1%	-0.9%	+2.2%	+3.0%

*Note: Data provided by Zephyr Associates. *Indicates annualized return. Past performance is not indicative of future results.*

Market Review

Equity markets and other risk assets categories experienced solid gains thus far in 2019, reversing 2018's fourth quarter sell-off. Yet, it certainly wasn't a smooth ride as investors experienced a few bouts of short-lived volatility driven by on again, off again US-China trade negotiations and a shift in central bank policy. Financial markets are experiencing another such spike in volatility in August, while equities have given back some of their year-to-date advance.

US stocks have been particularly strong performers so far this year, appreciating in anticipation of accommodative monetary policy and despite ongoing trade tensions and weaker expectations of economic growth. The US Federal Reserve (Fed) pivoted from hawkish in December to dovish in January with Chairman Jerome Powell indicating the central bank would be "patient" in its approach to monetary policy, increasing the likelihood of interest rate cuts. At its recent July policy meeting, the Fed delivered on these expectations by reducing its benchmark rate by 0.25% to a range of 2.0% and 2.25%—the first rate cut in over a decade. However, some market participants were disappointed that Powell characterized the move as a "mid-cycle adjustment" rather than the start of an easing cycle.

In fixed income markets, the 10-year Treasury bond yield continued to plunge from its multi-year high of 3.2% last October, dipping below 2% following the Federal Reserve's June meeting. The recent and continuing escalation of the ongoing US-China trade dispute has led to increased safe-haven demand, applying additional downward pressure on interest rates. The 10-year Treasury yield currently stands at about 1.60%, a three-year low and among its lowest levels ever, reflecting expectations of further Fed easing later this year. These falling yields have resulted in strong returns for investment grade bonds and riskier fixed income sectors as credit spreads remain tight. It is unusual for risk assets and Treasuries to both post significant positive results. Risk assets seem be discounting a "Goldilocks scenario" whereby the economy slows enough that the Fed cuts rates, but there is no recession with a significant negative impact on corporate profits.[1]

As an aside—and as further evidence of the consistently poor track record of market forecasters—the consensus of 69 economists and analysts surveyed in January 2019 by the Wall Street Journal was that the 10-year Treasury yield would rise to 3% by mid-year. *None* of them predicted the yield would fall below 2.5% this year, let alone below 2%. This reinforces our view that developing portfolio strategy isn't based on making predictions about the future but being prepared for a range of potential outcomes.

Macro Backdrop

The global economic expansion has decelerated and become more uneven. While strong labor markets have supported growth, the revival of trade tensions, imposition of additional tariffs, and uncertainty over further protectionist policies have taken a toll on global trade, manufacturing, and business sentiment. Yet, our base case assumption does not call for a further, significant deterioration in growth or an outright contraction. Central banks' dovish pivot, easing monetary conditions, and China's fiscal stimulus should help stabilize growth and extend the current economic cycle. At this stage, however, we see a high degree of uncertainty and a wide range of plausible economic outcomes. Put simply, macro risks have increased.

In our view, the US economy remains in decent shape. Not surprisingly, growth has slowed in large part due to the fading impact of fiscal stimulus. Yet, the outlook for the household sector remains solid as low debt levels, low unemployment, and rising wages should continue to underpin consumption—the most important driver of US economic activity. Growth outside the US has also continued to slow as other economies, including both Europe and Japan, demonstrate a sensitivity to global trade.

In July, the current economic expansion became the longest in US history. According to the National Bureau of Economic Research, since June 2009, the US economy has grown for 121 consecutive months following the Great Recession. However, it's also been the weakest recovery in the past 70 years, in large part due to the overhang of the housing crisis and associated deleveraging that has occurred. Real GDP growth has averaged just 2.3% per year during this expansion, compared to a median growth rate of 4.4% per year for the prior 11 post-World War II expansions. This sluggishness is perhaps one of the main reasons the expansion can continue. So far, none of the domestic imbalances that typically precede recessions have developed: over-consumption, over-investment, a housing bubble, or excessive wage growth.[2] Such excesses are typically what lead the Fed to tighten monetary policy and, ultimately, end the expansion. Of course, some other policy mistake or exogenous shock could also tip the economy into a recession. This risk always exists, and there's no shortage of potential geopolitical flashpoints. Tensions between the US and Iran have escalated, Brexit remains unresolved, and political unrest exists in Hong Kong and Argentina, among others.

Trade policy remains the most significant threat (or "known unknown") to the global economy but is also perhaps the most difficult to handicap. Businesses are already reporting cost pressures and disruptions from the ongoing US-China trade dispute. At this point, both sides have imposed tariffs on billions of dollars' worth of goods. However, the direct impact of tariffs could be of secondary importance to the indirect negative impact. It's the uncertainty created by a further escalation that could weigh on confidence, investment, and ultimately consumption.[3] Recent developments also highlight the unpredictable nature of the negotiations and how quickly the situation can change. Earlier this month, President Trump announced via Twitter that the US plans to impose a 10% tariff on the remaining $300 billion of Chinese imports not already being taxed. China responded quickly by halting imports of US agriculture and allowing its currency (the yuan) to depreciate to its lowest level in more than 10 years. Given the limited historical precedent, it's difficult to predict if this face-off will continue long term or be resolved quickly. The mutual interests of both sides demand cooperation, but neither the Chinese nor the Trump administration seem prepared to blink.[4]

Against this backdrop, interest rate markets continue to reflect a weak economic outlook and modest inflation expectations with global bond yields at extremely low levels. According to Deutsche Bank, there is about $15 trillion in government debt around the world, or 25% of the market, with negative yields. This number has nearly tripled since October 2018.[5] In the US, part of the Treasury yield curve remains "inverted." Specifically, the yield on the 3-month Treasury note is above the yield on the 10-year Treasury bond. Historically, yield curve inversions have been a reliable predictor of economic slowdowns. In fact, every recession since 1957 has been preceded by an inverted curve. Yet, there have been instances where the curve has inverted without a recession—the most recent false-positive occurred in 1998. Although we believe certain technical factors have contributed to the recent inversion, the yield curve remains an important indicator and is sending a clear message that monetary policy is too tight under the current circumstances.

Monetary Policy

During the past decade, investor sentiment and the broader economy have been increasingly at the mercy of central banks. Low interest rates and accommodative policy have become the norm as central bankers experimented with a range of unconventional measures aimed to combat the deflationary pressures of the 2008 global recession. In previous communications, we've highlighted global monetary policy as a key source of longer-term uncertainty and noted that the eventual exit of these unconventional measures could lead to increased financial market volatility.

In contrast to 2018, central banks are no longer talking about "policy normalization." Instead, there is a renewed focus on providing downside protection for the global economy.[6] According to Ned Davis Research, a majority of the world's central banks are now cutting rates (indicating an easing cycle), up from just 38% of banks easing in January. As previously mentioned, the US Fed delivered a quarter-point interest rate cut on July 31st, marking the first time the central bank reduced the benchmark interest rate since 2008. Fed Chairman Powell repeated the pledge to "act as appropriate to sustain the expansion." The European Central Bank (ECB) has also taken an increasingly dovish line and is widely expected to cut rates this September—the main deposit rate is already -0.4%—and to resume bond purchases later this year. With central banks in large, developed countries either lowering rates or poised to do so, emerging-market central banks have greater flexibility to stimulate their economies without having to worry about capital fleeing from their financial markets. As such, a number of central banks across the Asia-Pacific region have reduced policy rates in recent months.[7]

This recent dovish pivot indicates that central banks continue to have an asymmetric view of the world and will likely err on the side of accommodation in order to combat deflation and downside risk. In addition, the Fed, like most other major central banks, has become increasingly worried that the "neutral" rate of interest—the rate consistent with full employment and stable inflation—is extremely low. This has resulted in a major shift in its reaction function. The exact level of the neutral rate is unknowable, but if it turns out to be higher than expected and inflation starts to accelerate, then central banks can always raise rates. In contrast, if the neutral rate turns out to be very low, the decision to hike rates could push the economy into a recession.[8]

Market Outlook

Our base case view remains that positive (albeit slower) economic growth, tame inflation, and low interest rates will provide support to equities and other risk assets over the intermediate term. The decisively dovish shift by global central banks should help extend the global expansion and bull market. However, market expectations for additional central bank easing are high with Fed fund futures pricing in four rate cuts by end of year 2020. This leaves little room for upside surprises. In this environment, we expect lower-than-average positive returns from most asset categories and higher volatility as is typical of the later stages of the business cycle and geopolitical risks remain elevated. Trade tensions are also likely to persist and cause swings in market sentiment.

Overall, global equity valuations currently stand mildly above their longer-term averages and are most elevated in the US. For example, the forward price/earnings (P/E) multiple for the S&P 500 is now roughly 16.7x compared to the 10-year average of about 14.8x.[9] As a result, we believe prospective returns will be driven by modest earnings growth as profit margins will likely be pressured by rising wages. Yet, perhaps some valuation premium relative to history is appropriate given the low level of interest rates and muted inflation expectations. And for the foreseeable future, equities are unlikely to face the headwinds of central bank tightening. Historically, emerging markets stocks have benefited the most from easier financial conditions.[10] P/E ratios for international developed and emerging markets stocks also remain lower than those for the US, providing a relatively favorable long-term valuation backdrop for non-US equities.

Indeed, on a comparison of earnings yields to bond yields, stocks look *relatively* undervalued. Though this may say more about the overvaluation in bonds given historically low yields and tight credit spreads, it still suggests that equity market returns are likely to outpace fixed income returns in the long run.

Tactical Asset Allocation Views & Portfolio Positioning Themes

Within the context of a sound, long-term asset allocation framework, we believe that an active, flexible approach can enhance returns by shifting capital to attractive risk/reward opportunities. As such, portfolio strategy evolves over time based on ongoing assessment of the fundamental backdrop, asset class valuations and risks.

Currently, asset valuations across most categories are somewhat above historical averages while macro uncertainty has increased, reflecting a wide range of potential outcomes at this stage of the economic cycle. Our base case implies relatively low expected returns from both US stocks and bonds. Therefore, we continue to recommend a slight defensive tilt in portfolio strategy with an emphasis on opportunities we believe offer more attractive risk-adjusted return potential—specifically non-US stocks and certain flexible/alternative strategies.

Asset Category Tactical Views	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight
Cash					
Cash & Short-Term Bonds				✓	
Fixed Income					
US Investment Grade Bonds		✓			
Non-US Investment Grade Bonds		✓			
Tax-Free Municipal Bonds			✓		
Bank Loans/High Yield			✓		
Equities					
US Large Cap Stocks		✓			
US Small Cap Stocks		✓			
Non-US Developed Markets Stocks			✓		
Emerging Markets Stocks			✓		
Real Assets					
Commodities			✓		
Public Real Estate	✓				
Flexible/Alternative Strategies					
Directional Hedge			✓		
Less Directional Hedge				✓	

Note: Based on research and opinion provided by Greycourt & Co. Tactical views reflect a three-year investment horizon. Suggested asset class weights are used as a starting point in assessing client portfolio weights against strategic targets which typically reflect a ten-year investing horizon.

Based on our assessment of the macro backdrop and relative asset class valuations and risks, our current portfolio positioning themes include the following:

- **Don't tilt too far away from an appropriate strategic asset mix, but maintain a slight defensive tilt with an elevated cash position.** We continue to recommend staying broadly diversified across a range of risk factors but advocate holding some cash (and/or short-term fixed income) as dry powder to potentially take advantage of significant volatility.

- **Continue to target an underweight position and/or shorter-than benchmark duration in the core fixed income space.** Our return expectations for investment grade bonds remain muted given the low yield environment. However, we recommend continuing to own protective assets such as high quality, intermediate duration bonds to provide a source of stability, liquidity, and diversification of equity market risk.

- **Target an underweight position in US equities while emphasizing large cap, high quality stocks.** Although the backdrop of slow economic growth and low inflation/interest rates should continue to provide support, we believe US equity valuations reflect an overly optimistic outlook. Profit margins are elevated and likely unsustainable. Therefore, we recommend an underweight position. We also continue to prefer a tilt towards higher quality companies (those with strong balance sheets, stable earnings, and high margins) that typically exhibit more resilience in challenging economic environments.

- **Stay fully invested in more reasonably priced international developed and emerging markets stocks.** In our view, valuations are attractive on an absolute basis and relative to the US. While risks certainly exist at a time of decelerating global growth and ongoing trade frictions, we believe stock prices already reflect a good bit of pessimism.

- **Target an overweight position to certain flexible/alternative strategies that potentially benefit from elevated market volatility and increased dispersion.** We continue to believe that certain types of hedge fund strategies are valuable for their diversifying active returns. In our view, the potential attractiveness of these alternative strategies is increased given the current valuations of traditional asset classes.

- **Where appropriate, continue to develop private equity and private real estate investment programs to potentially enhance long-term returns.** Because of the associated illiquidity and inherent inefficiencies, private assets typically compensate investors with a premium return. Yet, these strategies are not immune to the factors that have compressed expected returns in public markets. As such, we suggest a selective approach that emphasizes lower middle market buyout and niche/opportunistic real estate.

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[1] *Corbin Capital Partners, "2019 Mid-Year Investor Letter."*
[2] *PIMCO Cyclical Outlook, "Growing, But Slowing."*
[3] *Enda Curran and Katia Dmitrieva, Bloomberg, "World Economy Edges Closer to a Recession as Trade Dread Deepens," August 7, 2019.*
[4] *Scott Minerd, Guggenheim Investments, "U.S.-China Trade War: The New Long March," May 23, 2019.*
[5] *Maggie Fitzgerald, CNBC, "Amount of Global Debt with Negative Yields Balloons to $15 Trillion," August 7, 2019.*
[6] *Russ Kosterich, BlackRock, "The Pivot Favoring Emerging Markets," July 1, 2019.*
[7] *Brian Blackstone and James Glynn, Wall Street Journal, "Trio of Central Banks Surprise Markets with Aggressive Rate Cuts," August 7, 2019.*
[8] *Peter Berezin, BCA Research, "Third Quarter 2019 Strategy Outlook: The Long Hurrah," June 28, 2019.*
[9] *John Butters, FactSet, "FactSet Earnings Insight," August 9, 2019.*
[10] *Russ Kosterich, BlackRock, "The Pivot Favoring Emerging Markets," July 1, 2019.*