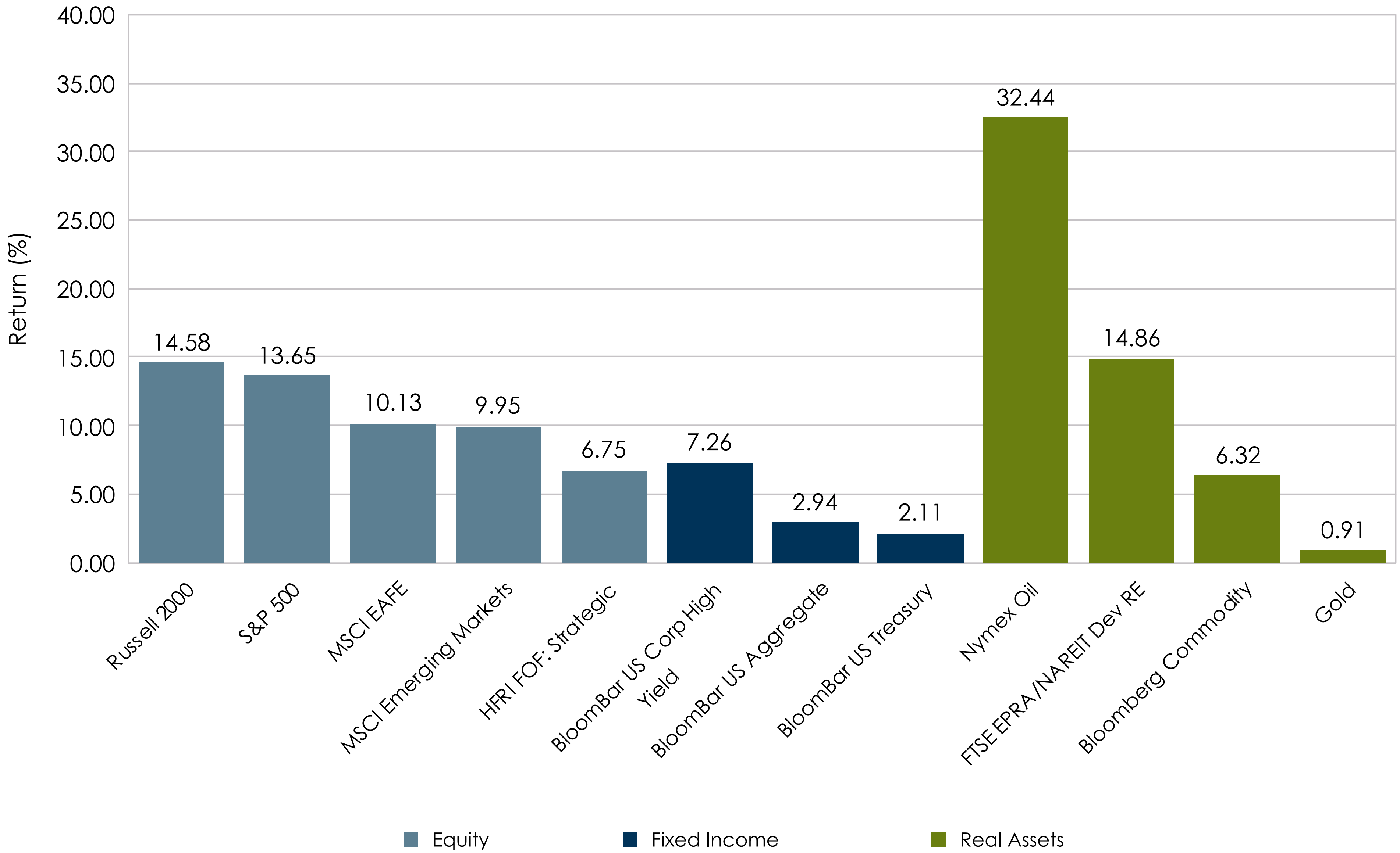
Global Economic Update

Second Quarter 2019

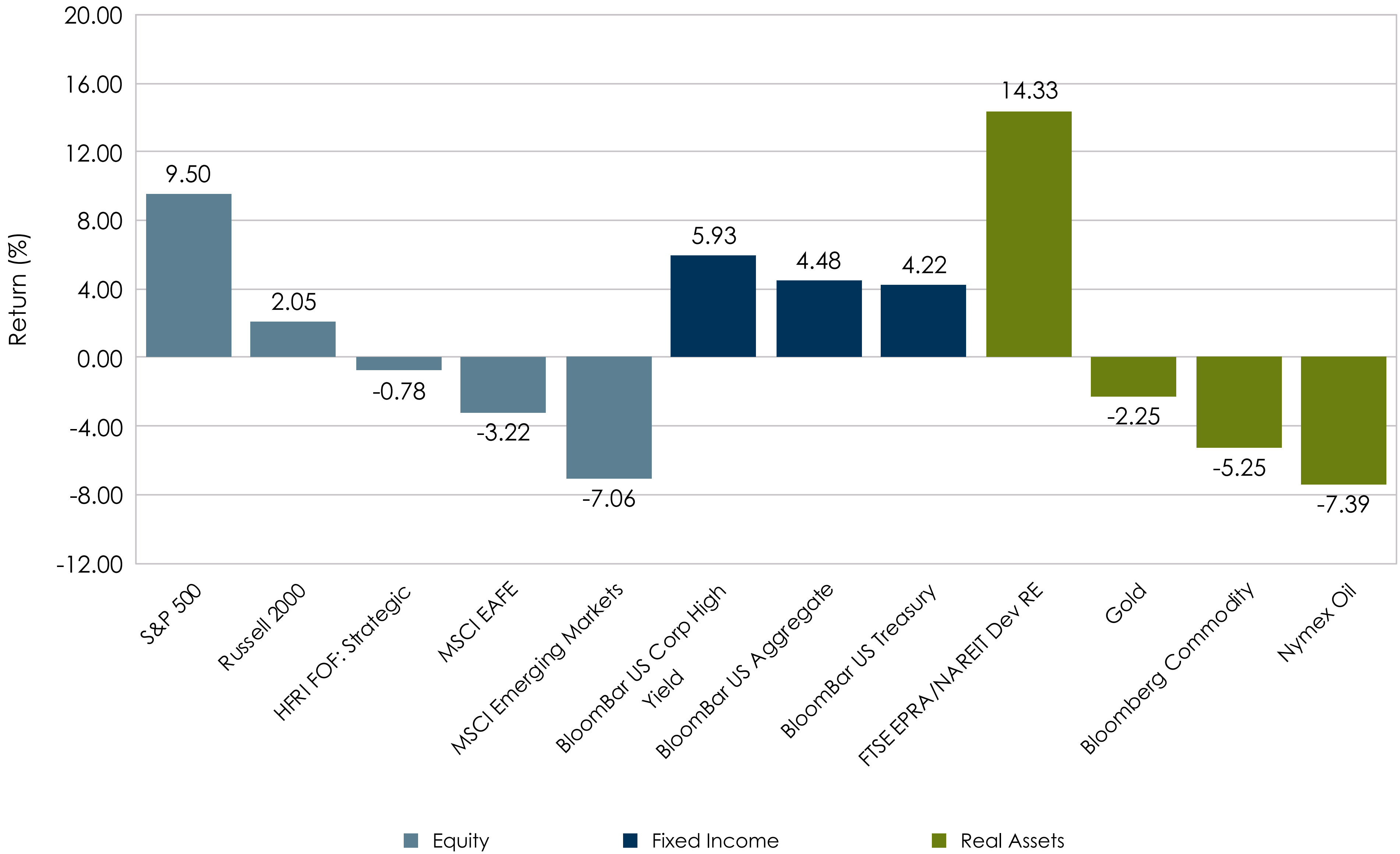
Market Returns

For the YTD Period Ending March 31, 2019



Market Returns

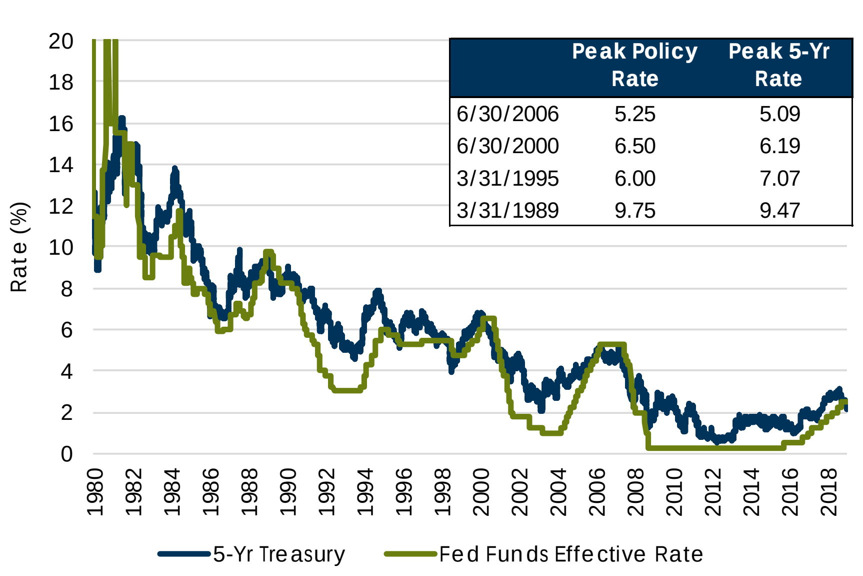
For the 1 Year Period Ending March 31, 2019



US

- **4Q-18 Real GDP grew at an annualized rate of 2.2%,** down slightly from initial estimates. For the year, Real GDP grew at 2.9% compared to 2.2% for 2017. Economists are projecting a seasonally-slower 1.4% for 1Q-19.
- **Labor conditions remain robust,** with the 3.8% unemployment rate reflecting the ongoing addition of new jobs in early 2019. Most economists are forecasting continued hiring demand, and average hourly wage gains have pressed above the 3% threshold on a year-over-year basis.
- **Sentiment indicators have been mixed**, and surveys of corporate CFO priorities show a shift into more defensive strategies (away from expansion). Perhaps the uncertainty of the 2020 election is already starting to build.
- While taking no action on short-term interest rates, the more "patient" tone of **Federal Reserve's** communication completed the dovish pivot that had been foreshadowed in late-2018. The dot-plot removed two previously anticipated rate hikes throughout 2019, with an even more cautious futures market actually pricing in policy easing by year-end.

Potential Peak In Federal Reserve Policy Rate



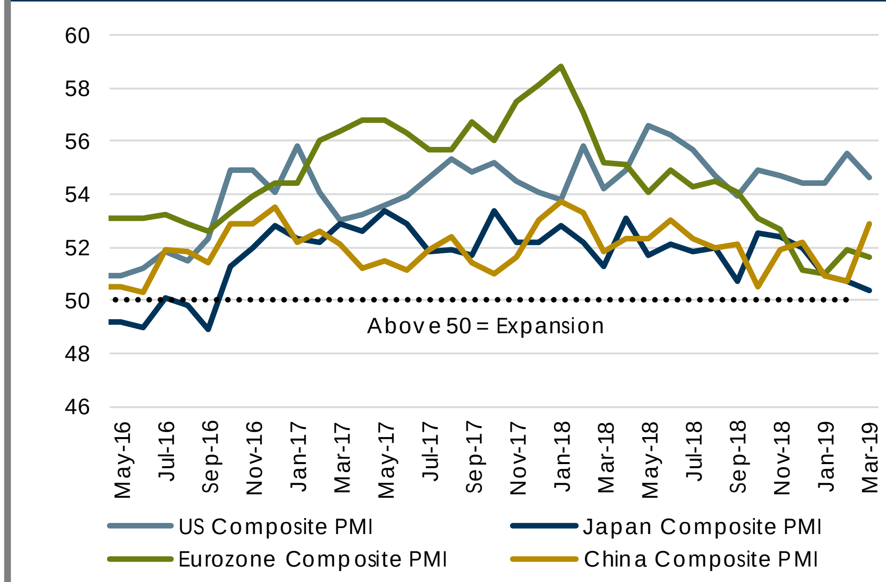
	Peak Policy Rate	Peak 5-Yr Rate
6/30/2006	5.25	5.09
6/30/2000	6.50	6.19
3/31/1995	6.00	7.07
3/31/1989	9.75	9.47

Source: ACG Research, Bloomberg, Federal Reserve

Global/Non-US

- Discussions between the **US and China regarding trade/tariff i**ssues remain fluid. Markets are increasingly optimistic that an agreement can help restore globalization trends, but protectionism could still weigh on growth.
- The **European economy continues to report signs of weakness**, most notably as it relates to German manufacturing. The ECB has responded by lowering expectations for growth & inflation, and indicating that policy rates will remain on hold at least through 2019.
- Current activity indicators in major economies, particularly within China, are showing **tentative signs of stabilization.** With global expectations quite subdued, the markets would welcome any meaningful resuscitation.
- **International political tensions are mixed,** with the original Brexit deadline (March 29th) having now been extended slightly by the EU. **Solid recoveries in oil and other commodities** combined with easier global financial conditions should support emerging market economies. That said, idiosyncratic volatility will continue to be present within this category.

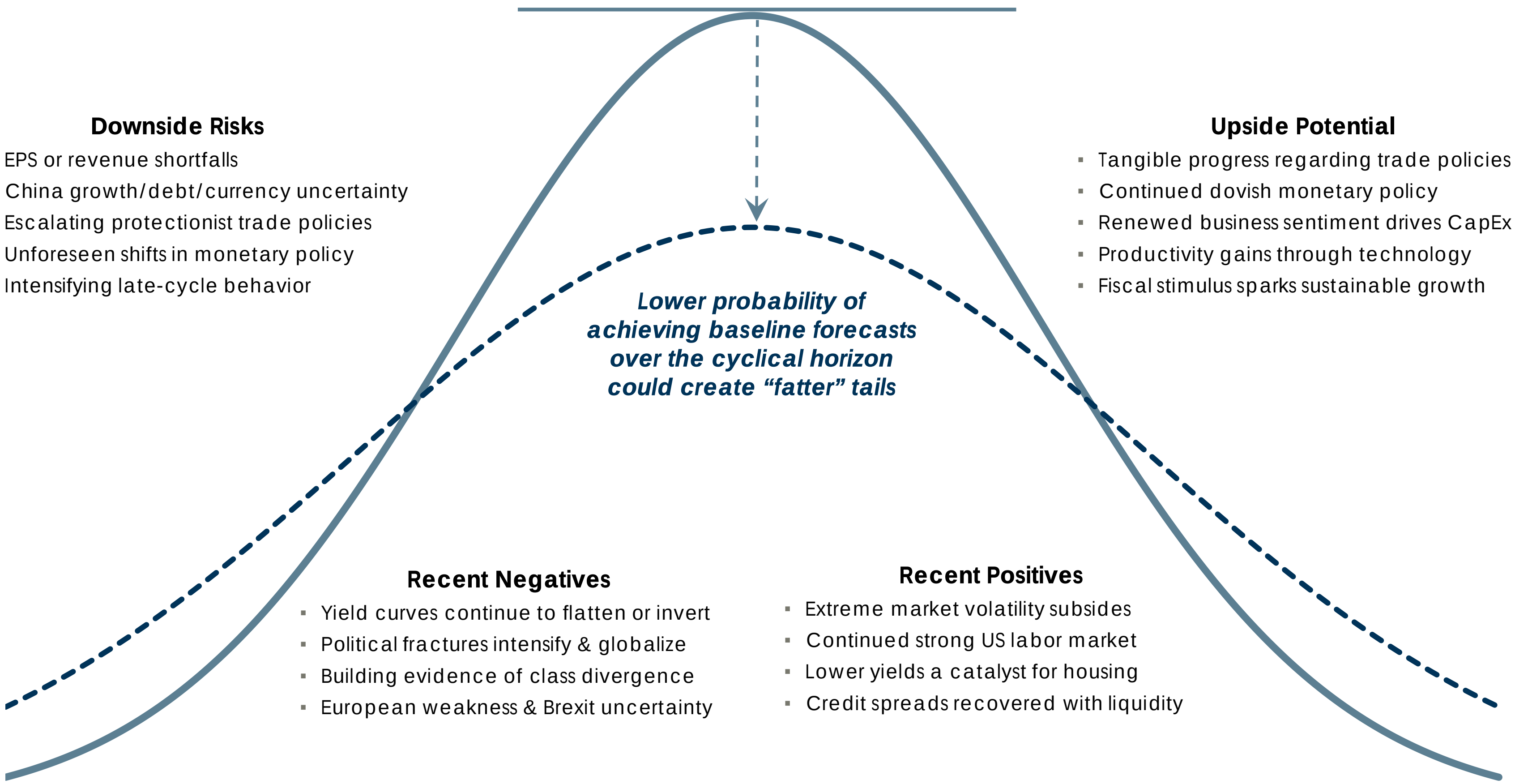
Advanced Indicators of Growth Stabilizing



Source: ACG Research, Bloomberg

Baseline Assumptions

- Global economic growth of 2.5% - 3.5%
- Developed market inflation to remain centered around 2.0% target
- Equities to perform in line with earnings growth
- Short-term bond yields lose upward momentum



Downside Risks

- EPS or revenue shortfalls
- China growth/debt/currency uncertainty
- Escalating protectionist trade policies
- Unforeseen shifts in monetary policy
- Intensifying late-cycle behavior

Upside Potential

- Tangible progress regarding trade policies
- Continued dovish monetary policy
- Renewed business sentiment drives CapEx
- Productivity gains through technology
- Fiscal stimulus sparks sustainable growth

Recent Negatives

- Yield curves continue to flatten or invert
- Political fractures intensify & globalize
- Building evidence of class divergence
- European weakness & Brexit uncertainty

Recent Positives

- Extreme market volatility subsides
- Continued strong US labor market
- Lower yields a catalyst for housing
- Credit spreads recovered with liquidity

What is the issue?

- When short-term interest rates are higher than long-term interest rates, the yield curve is said to be “inverted”
- An inverted yield curve has preceded each of the last nine recessions over the past 65 years, with only one false positive in the mid-1960’s
- Higher short-term rates occur when the Federal Reserve raises them to slow economic growth or to prevent excessive inflation
- Lower long-term rates can occur when the demand for risk assets is reduced, reflecting less optimism about future growth

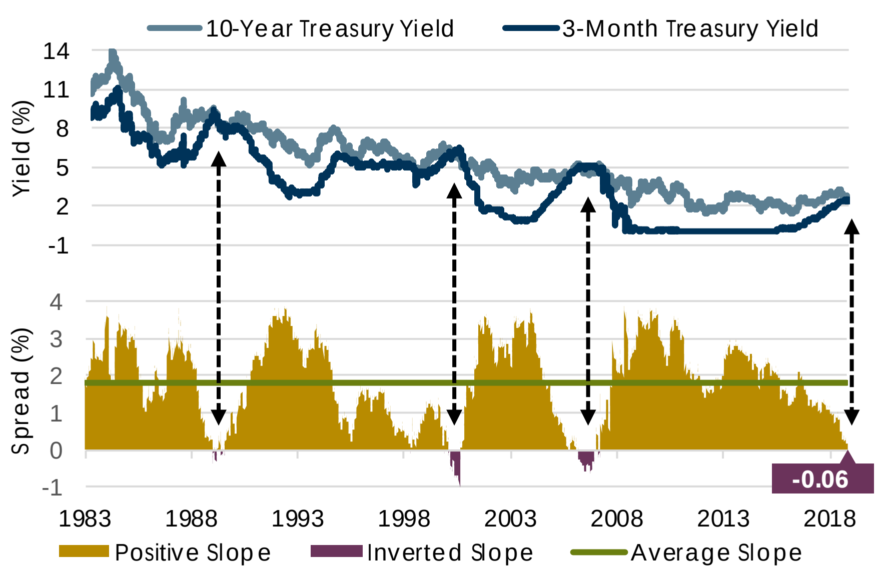
Where do things stand?

- As of the end of March, the US Treasury yield curve was essentially flat for tenors up to 1-year, with yields residing around 2.40%
- The primary point of inversion is between 6-months and 5-years, with the commonly cited 10 year – 2 year spread remaining very flat but positive sloping
- With the Federal Open Market Committee (FOMC) having signaled a meaningful pause to rate increases, short-term rates are unlikely to rise near-term
- Longer-term rates are all relatively low when considering nominal levels over time, although muted inflation suggests real rates are less abnormal

ACG Thoughts:

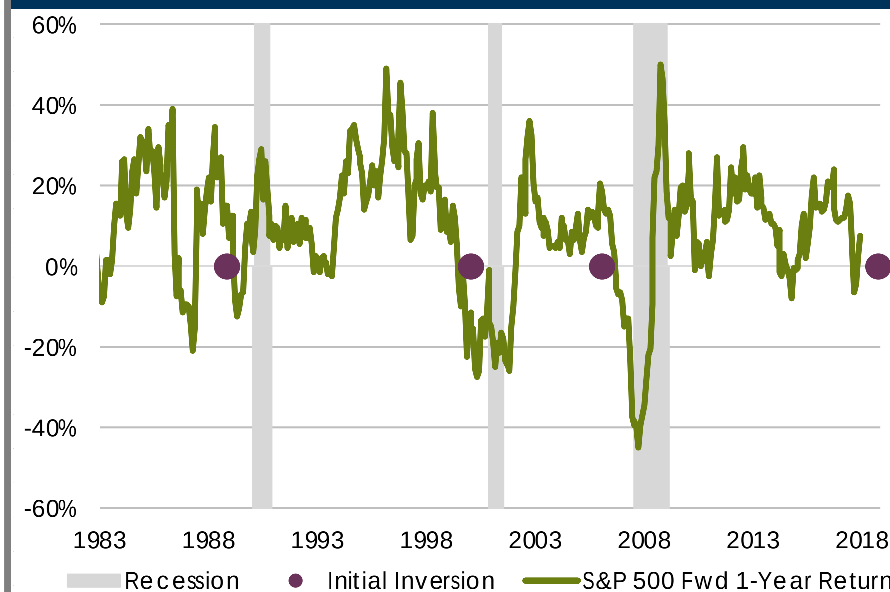
- Given secular trends in rates and monetary policy that appears more market-sensitive, it’s difficult to define “normal” in today’s world
- The yield curve’s shape has a predictive past, but technical factors should be considered and equity performance is not uniform following inversions

3-Month/10-Year US Treasury Rates & Curve



Source: ACG Research, Bloomberg

Recessions, Yield Curve Inversions & Forward Returns



Source: ACG Research, Bloomberg

What is the issue?

- While it takes opposing views to "make a market," there appears to be an abundance of mixed messaging in the current environment
- As investors must focus forward, it will be critical to separate the noise from those pieces of information that will truly impact returns
- Importantly, it's outcomes relative to expectations that typically influence markets, so determining and understanding the consensus is key
- Given the vagaries of potential policy response, it's often difficult to judge outcomes whenever "good news is bad" and "bad news is good"

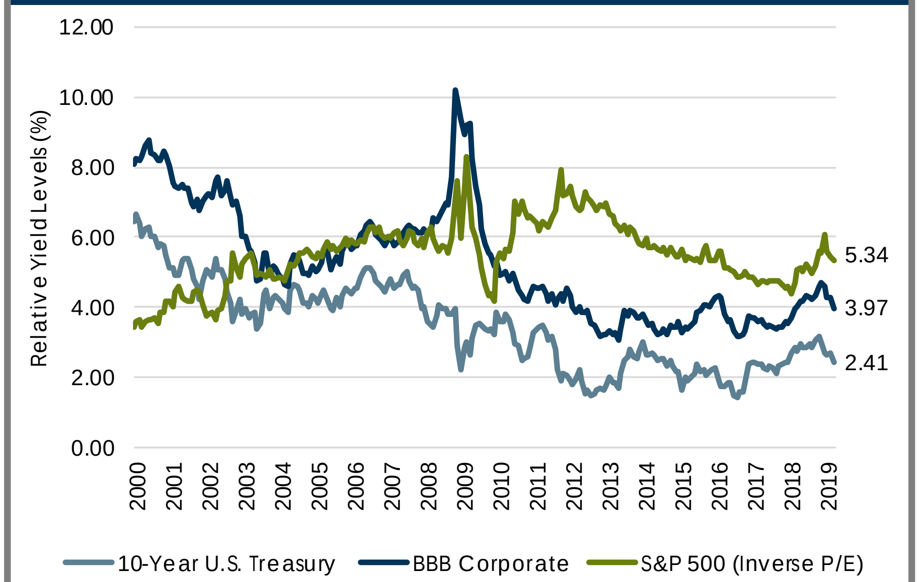
Where do things stand?

- Most will at least agree that the US economy is in the late-cycle phase, but identifying the catalyst to trigger the next downturn is difficult
- Corporate earnings were exceptionally strong in 2018, but growth has moderated as policy impacts wane and year-over-year comparables are challenging
- While wage growth is important in any consumer-driven economy, corporate profits as a share of GDP appear to have peaked
- Despite a strong rally back in 1Q-19, equity valuations remain attractive relative to domestic and global bond yields which have fallen back

ACG Thoughts:

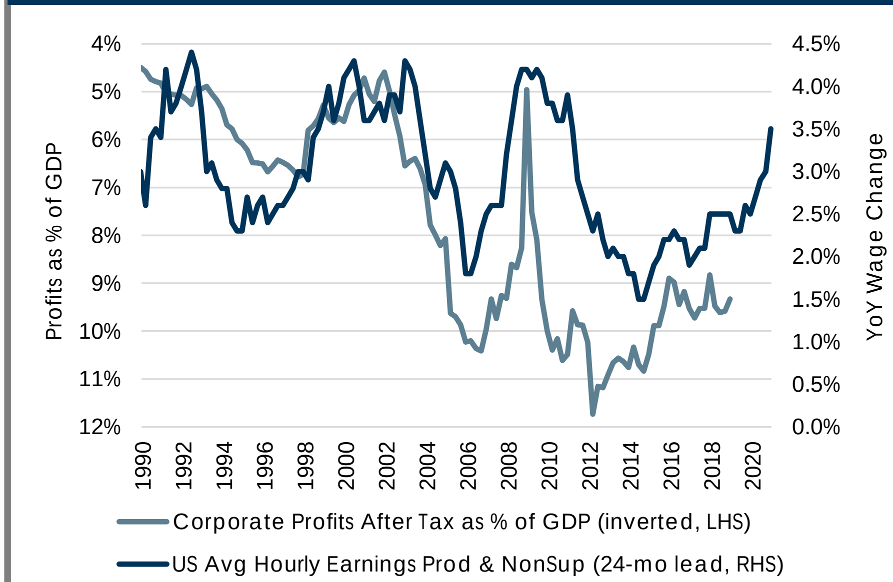
- With the expectations bar set quite low, in the context of easing financial conditions, any evidence that global growth is reaccelerating could support risk-assets
- Any unexpected breakaway in inflation could cause interest rates to adjust higher, thereby increasing the discount factor and reducing the appeal of equities

Traditional Earnings Yield Metrics Favor Risk



Source: ACG Research, Bloomberg

Impact of Higher Wages on Profits a Threat



Source: ACG Research, Bloomberg

What is the issue?

- The primary benefit of diversification is to dampen the impact to an investor's portfolio from exposure to any single asset class, style, or approach
- However, this introduces challenges when economies, asset classes, and investor perceptions invariably cycle relative to each other
- Market timing has proven to be a less-than-optimal approach to achieving long-term goals in cyclical environments
- Despite the lack of reliable foresight, investors often overlook the importance of a strategic approach and a discipline around rebalancing

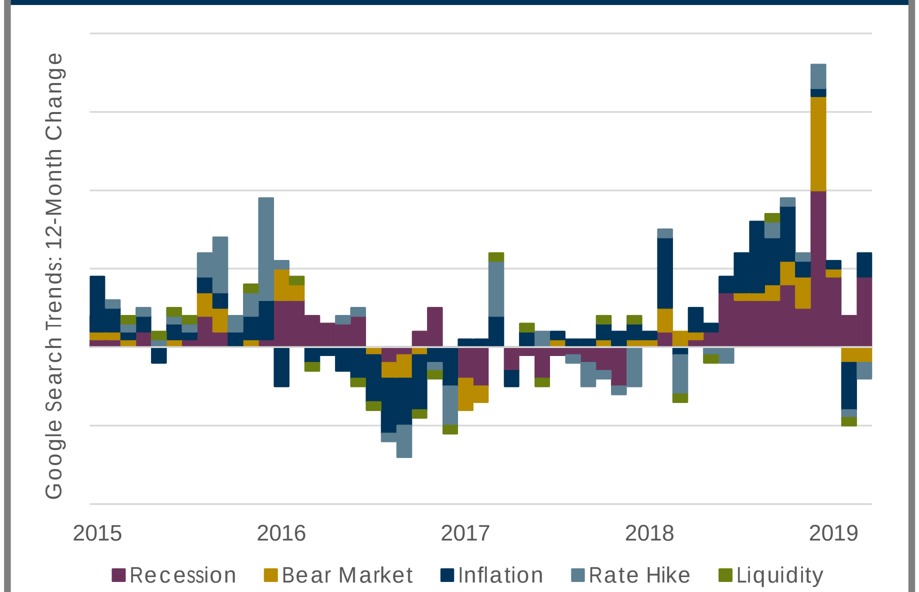
Where do things stand?

- Given the extended nature of the current cycle, and the volatile end to 2018, recession concerns are trending at their highest level since the financial crisis
- At the same time, investors have become less focused on the potential for higher inflation that would require restrictive policy rate hikes
- The relative strength of the US economy and the US dollar has contributed to underperformance for many internationally-based holdings
- An extended rally in risk assets has ultimately favored growth over value, and challenged the long/short investment style dependent upon manager skill

ACG Thoughts:

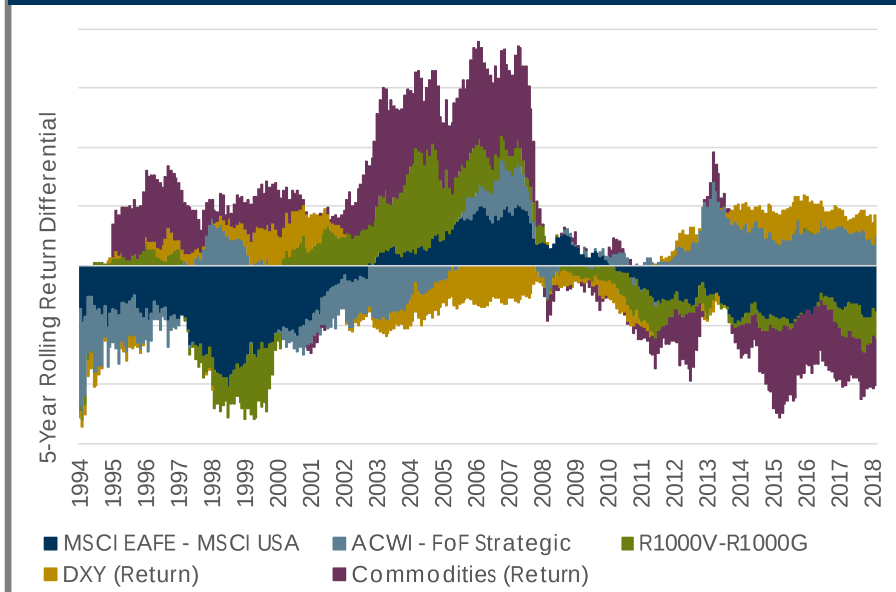
- A more supportive policy regime, in the US or abroad, could restore investor enthusiasm and potentially act to extend the current cycle of economic growth
- The ongoing potential for heightened volatility, combined with global valuation dispersions, could cause seemingly well-entrenched trends to revert in time

Investor Focus & Concern Cycles Through Time



Source: ACG Research, Google Search

Markets Have Always Experienced Similar Rotations



Source: ACG Research, Bloomberg

Investment Themes

Theme	Considerations (3-5 Years)	Implementation Strategy
Growth	▪ Late-cycle slowdown ▪ Withdrawal of monetary stimulus ▪ Slowing productivity and population trends ▪ Earnings deceleration ▪ China's increasing role	▪ Maintain long-term strategic allocations ▪ Passive exposure in efficient markets ▪ Active/focused/opportunistic in less efficient areas ▪ High-quality orientation
Yield Environment	▪ Short-term real yields improving ▪ Policy shifts affecting supply/demand ▪ Underwriting standards a late-cycle risk ▪ Liquidity challenges may increase volatility	▪ Maintain high-quality core fixed exposure ▪ Shorter-dated assets provide attractive yield ▪ Yield enhancement via private debt or opportunistic strategies (e.g. HY, Loans, EMD) ▪ Absolute return strategies
Inflation	▪ Expectations falling short of 2% target ▪ Tight labor markets - building wage pressure ▪ Uncertain impact of technology, global market efficiency, secular demographic trends, trade policy	▪ Rising prices – benefit earnings (equity) ▪ Rising rents – benefit core real estate (RE) ▪ Active managers with niche alpha strategies ▪ Shorter-dated fixed income - positive real yield
Risk & Uncertainty	▪ Waning gov't influence - high debt, demographics ▪ Disparate global fiscal/monetary policies ▪ Trends toward protectionism ▪ Political polarization and rising inequality ▪ Immigration, war, climate change, social media, cyber attacks, terrorist activity	▪ Global diversification ▪ Private strategies can limit near-term price impacts ▪ Enhanced liquidity ▪ Disciplined rebalancing strategy
Return Expectations	▪ Policy stimulus acted to "pull forward" returns ▪ Potential for increased market volatility ▪ Economic slowdown could cap equity valuations ▪ Low yield and inflation environment still challenging	▪ Revisit investment objectives and constraints ▪ Employ risk-reducing/hedged strategies ▪ Maintain liquid and illiquid assets exposure ▪ Seek active strategies with enhanced flexibility

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231 South Bemiston Avenue ♦ 14th Floor ♦ Saint Louis, Missouri 63105
www.acgnet.com
314.862.4848