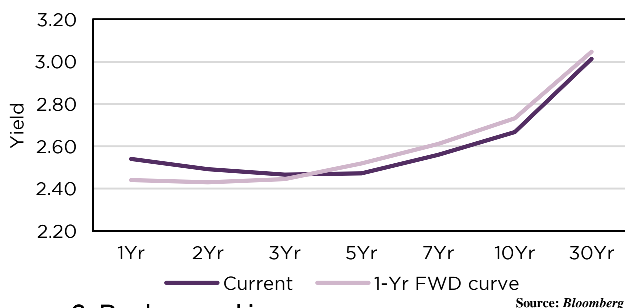
Economic Review

PAVILION

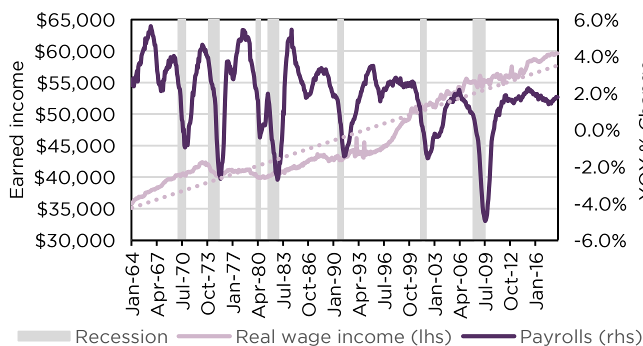
JANUARY 2019

While December delivered the worst December equity market performance since the Great Depression, January saw the best January performance in more than 30 years. U.S. recession fears, stoked in December by measures of slowing growth, were allayed in January as data rebounded. The Federal government went from closed to open, and Federal Reserve (Fed) commentary went from ambiguously hawkish to decidedly dovish. December saw FedEx stumble, but in January UPS delivered, Facebook did an about-face, and Apple went from rotten to delicious. Earnings reports proved more positive than the Wall Street whispers - many of which were portending doom. With almost 50% of S&P 500 firms having reported fourth quarter earnings, 70% have reported a positive surprise. Unfortunately, not all of December's concerns were reversed. Global growth continued to slow, most notably in China and Europe, where Italy appears to have fallen into recession. Brexit concerns persist and are likely to become more acute as the March 29 exit date approaches with no apparent agreement in place. The trade conflict between the U.S. and China remains unresolved, despite some reported progress. The resolution of the U.S. government shutdown may prove to be temporary. The agreement reopened the government only until February 15, and the President's policy priorities are inconsistent with those of the parties charged with negotiating a more permanent solution. Adding to this threat is the looming challenge of reaching a new debt ceiling agreement before the September deadline. And, 2019 earnings estimates, although positive, are being cut. The bottom line is that investors must remain wary of a host of potential threats despite the market's recent bout of optimism.

1. Expected Treasury yield curve change

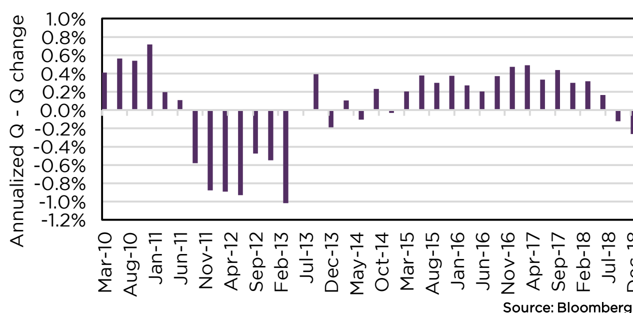


2. Real earned income



Source: Federal Reserve FRED data

3. Italian GDP



Market returns

	January	QTD	YTD
S&P 500	8.0%	8.0%	8.0%
Russell 1000 Value	7.8%	7.8%	7.8%
Russell 1000 Growth	9.0%	9.0%	9.0%
Russell 2000	11.2%	11.2%	11.2%
MSCI EAFE	6.6%	6.6%	6.6%
MSCI Emerging Markets	8.8%	8.8%	8.8%
Bloomberg Barclays Agg	1.1%	1.1%	1.1%
3-Month T-Bills	0.2%	0.2%	0.2%

Source: Factset

The pause that refreshes? The Fed kicked off the year by voting at its January meeting to hold policy rates steady, which was largely expected. The unexpected move was the dovish tone of the statement released at the meeting's conclusion, a message reinforced by Fed chair Powell's comments in his post-meeting press conference. What has changed? Clarity. Previously, Fed officials emphasized that future policy changes would be gradual and data dependent. With slowing growth globally, including the U.S., the concern was that Fed policy might choke off growth prematurely. Fed officials addressed these questions explicitly in the recent policy announcement stating, "In light of global economic and financial developments" and "muted inflation pressures" the "Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate." Markets took this to mean the Fed was hitting pause. This can be seen in Figure 1, with interest rates one year from now projected to be little changed. Fed chair Powell also made it known that policy makers were prepared to slow or pause the pace of balance sheet reduction – or quantitative tightening ("QT") – in order to maintain appropriate levels of liquidity. Whether this can extend the expansion is unclear, however, market concerns have been salved for now.

Continued U.S. economic growth: Economies go into recession due to excesses that have built up over time, and are no longer economically tenable. The correction may involve a reduction in output, in household consumption, or some combination of the two eventually causing growth to stall (recession). While downturns are notoriously difficult to forecast, Figure 2 provides some insights into where to place focus. Figure 2 plots, over time, the average real earned income for a continuously employed worker in 2018 dollars. The series includes wages and salaries for employed individuals (not unemployed), as opposed to just the hourly wages reported in the monthly payroll report. It excludes unearned income such as dividends and capital gains, so it is not a measure of total income. The figure provides insight into what employers do not do as a recession sets in – they don't cut wages. Instead, they reduce head-count, inventories, and investment, which affects initial unemployment claims, fixed investment, and inventories to sales. None of these series are flashing red, yet. The figure also highlights the growth in real earnings since the financial crisis. This income growth combined with low unemployment and record low debt service costs have allowed households to improve balance sheets and increase savings. These factors should reduce the degree to which consumers have to trim spending in the face of a future downturn, thereby lessening the severity of any future recession.

Not just an Italian job: Recent economic data suggest the Italian economy may have slipped into recession in the fourth quarter of 2018. Unfortunately, Italy's economic woes may not be unique, as a broader slowdown appears to have set in across Europe. While there are numerous factors contributing to the downturn, two stand out. Firstly, the growing concern over Brexit. Although the bulk of any economic impact from Brexit will fall on the U.K., uncertainty appears to be creating a significant drag for the European economy. This uncertainty has reduced incentives for capital investment, as managers await clarity. The second factor impacting Europe is the slowdown in China. China represents one of Europe's largest trading partners with slightly more than 10% of China's total imports coming from EU members. As a result, the slowdown in China has created a material headwind for the EU economy. Although Chinese policymakers have been working to stimulate China's growth, efforts have yet to bear fruit. The bottom line is that while these circumstances will sort themselves out, the path is unclear.

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Market Review

January 2019

Overview

Markets roared to start the year, as the S&P 500 experienced its best January since 1987. Risk premia tightened and treasury yields remained stable, benefiting from economic growth, marginal declines in uncertainty, and cautionary monetary policy. Economic data and earnings affirmed ongoing growth, albeit at closer to trend, with earnings expected to rise +12% in the fourth quarter and +20% for 2018.[1] Domestically, the end of the government shutdown temporarily alleviated some uncertainty, and trade negotiations helped bolster likelihood of at least a partial resolution. Outside the U.S., political tensions and regional slowdowns continued to weigh on markets. The U.K.'s Brexit plan remained mired in limbo, and France, Italy, and China contended with declining growth. Broadly, global central banks maintained policies while forward guidance limited the potential for restrictive changes. While fundamental data were little changed, markets appear to have repriced the potential for an adverse slowdown.

1. FactSet as of February 1, 2019

Index Total Returns (%)

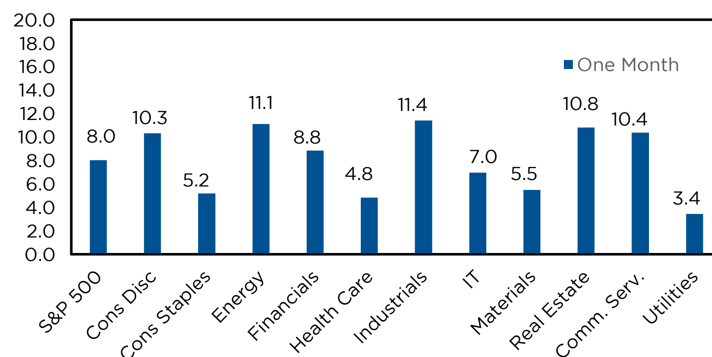
As of January 31, 2019

Domestic Equity Indices	Month	Quarter to Date	One Year
Dow Jones Wilshire 5000	8.7	8.7	-2.2
S&P 500 Index	8.0	8.0	-2.3
Russell 1000 Index	8.4	8.4	-2.2
Russell 1000 Growth Index	9.0	9.0	0.2
Russell 1000 Value Index	7.8	7.8	-4.8
Russell Midcap Index	10.8	10.8	-2.9
Russell Midcap Growth Index	11.5	11.5	0.5
Russell Midcap Value Index	10.3	10.3	-5.4
Russell 2000 Index	11.3	11.3	-3.5
Russell 2000 Growth Index	11.6	11.6	-2.6
Russell 2000 Value Index	10.9	10.9	-4.5
International Equity Indices			
MSCI EAFE Index	6.6	6.6	-12.5
MSCI EAFE Growth Index	6.5	6.5	-11.3
MSCI EAFE Value Index	6.7	6.7	-13.7
MSCI EAFE Small Cap Index	8.1	8.1	-15.6
MSCI AC World Index	7.9	7.9	-7.5
MSCI AC World Index ex U.S.	7.6	7.6	-12.6
MSCI Emerging Markets Index	8.8	8.8	-14.2
Fixed Income Indices			
Bloomberg Barclays Aggregate	1.1	1.1	2.3
Bloomberg Barclays U.S. Int. Gov/Credit	0.9	0.9	2.7
Bloomberg Barclays U.S. Long Gov/Credit	2.2	2.2	-0.5
Bloomberg Barclays U.S. Corp: High Yield	4.5	4.5	1.7
Bloomberg Barclays U.S. Treasury: U.S. TIPS	1.4	1.4	0.9
Citigroup Non-U.S. World Government	2.0	2.0	-3.0
JPM EMBI Global Div (external currency)	4.4	4.4	0.0
JPM GBI-EM Global Div (local currency)	5.5	5.5	-5.3
Real Asset Indices			
Bloomberg Commodity Index	5.5	5.5	-8.2
Dow Jones Wilshire REIT	11.5	11.5	10.3

- U.S. and emerging markets surged in January, as declining trade tensions dampened uncertainty, but regional headwinds limited developed international equities' participation.
- Across the risk spectrum, narrowing credit spreads helped enhance fixed income returns.
- After pulling commodity prices down in the fourth quarter, energy climbed +9.2% in January.

S&P 500 Sector Total Returns (%)

January 31, 2019



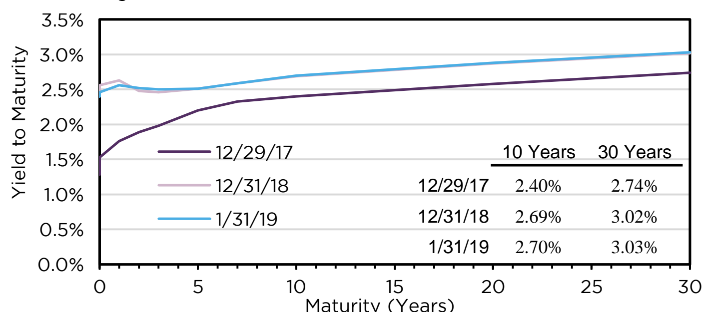
- January's recovery nearly negated December's weakness. While all sectors generated positive performance, cyclical sectors were the greatest benefactors of improving market sentiment.
- Expectations have declined since year-end, but markets appear to be coalescing around decelerating rather than declining growth.

Duration-Matched Excess Returns to Treasuries

	Month to Date (bps)	Year to Date (bps)
Barclays Aggregate	58	58
Agency	31	31
MBS	32	32
ABS	16	16
CMBS	51	51
Corporate	183	183
High Yield	408	408
Emerging	268	268

- Investors were compensated for bearing risk in January, with all sectors to outperforming similar duration treasuries.
- The market's broad repricing helped boost higher risk sectors which suffered in the fourth quarter.

Treasury Rates



- Treasury rates traded in a narrow range through January and settled near year-end levels.
- As expected, the Federal Open Market left rates unchanged at its January meeting. Forward guidance, however, emphasized data dependency of any future changes, deemed dovish by the market.

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