JOHNSON FINANCIAL GROUP®

BANKING WEALTH INSURANCE

ECONOMIC & MARKET OUTLOOK

SECOND QUARTER 2019

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INTRODUCTION

The extreme volatility experienced in late 2018 and early 2019 serves as a reminder that investing is about staying the course and focusing on long-term investment goals rather than trying to predict short-term market moves. As seen in the performance overview in *Figure 1*, the bulk of the fourth quarter 2018 equity and commodity market losses were largely recouped in the first quarter of 2019.

Figure 1

1Q19 ASSETS COMPARED TO 4Q18 & FULL-YEAR 2018

Fixed Income	2018	4Q18	1Q19
Barclays US Aggregate Intermediate	+0.9%	+1.8%	+2.3%
Bank of America Merrill Lynch Municipals 1-12 Yr	+1.6%	+1.6%	+2.2%
US Equity			
S&P 500	-4.4%	-13.5%	+13.7%
Russell 1000 Growth	-1.5%	-15.9%	+16.1%
Russell 1000 Value	-8.3%	-11.7%	+11.9%
Russell 2000 (small cap)	-11.0%	-20.2%	+14.6%
International Equity			
MSCI ACWI Ex USA (international)	-14.2%	-11.5%	+10.3%
MSCI EAFE (developed)	-13.8%	-12.5%	+10.0%
MSCI EM (emerging markets)	-14.6%	-7.5%	+9.9%
Commodity			
Bloomberg Commodity	-11.3%	-9.4%	+6.3%

ECONOMIC OUTLOOK

Economic growth in the US has generally been in line with our expectations. The pace of growth in 2018 was above-trend, driven by benefits from the Tax Cuts and Jobs Act of 2017. In 2019, US GDP growth is decelerating to an expected annual growth rate near 2%. Furthermore, we continue to believe there will not be a recession in 2019. If the economic expansion continues for one more quarter, the current expansion will become the longest on record.

Outside the US, economic data has been mixed. Eurozone growth decelerated from an already meager pace and the uncertainty surrounding the Brexit saga drags on. Germany, Europe's largest economy and the fourth largest in the world, has been weaker than expected. In China, ongoing efforts to stimulate the economy are showing early signs of taking hold. A resolution to the current trade conflict would help the Chinese economy achieve the 6.0%-6.5% real GDP growth target that policymakers are intent on reaching.

Many of the factors that weighed on investors' minds during the latter part of 2018 have improved. Most notably, the narrative from the Federal Reserve has changed. Back in October, Federal Reserve Chairman Jerome Powell indicated the central bank was "a long way" from getting rates to neutral, which market participants took as an indication of more increases to short-term interest rates. Since that time, the Fed and other major central banks have adopted a more dovish tone. In March, the Fed signaled that it does not plan to raise interest rates this year and that it would end its balance sheet reduction program by September. Monetary policy should therefore be a tailwind later in 2019 and help extend the current economic cycle.

Financial markets also reacted favorably to a potential resolution to the trade dispute with China. Last year, President Trump announced an additional round of tariffs which were to have taken effect on March 1. These were delayed when President Trump announced in February that "substantial progress" had been made in trade talks and that he expects "very big news" in coming weeks. The increased likelihood of a resolution to this year-long dispute has been well received by financial markets and could provide a boost to global trade, which has been negatively impacted by the ongoing trade friction. Look to the Weekly Commentary from May 15th for more on the trade dispute.

At this point, we believe we are near the bottom of the current economic soft patch and that growth will gradually improve in the coming quarters. To provide a few data points to describe the slowdown, one can look at US GDP growth, which has slowed steadily from 4.2% in the second quarter of 2018 to 3.4% in the third quarter, 2.2% in the fourth quarter and an uptick to 3.2% in the first quarter of 2019, which was flattered by what are likely to be temporary factors. Looking at the slowdown through the lens of company earnings, growth has slowed from a peak of 27% in the third quarter of 2018 to 14% in the fourth quarter. Estimates are for a small increase to earnings growth in the first quarter, with gradual improvement through the year as comparisons get easier and global economic growth stabilizes and improves.

EQUITY MARKETS

While concerns about rising interest rates, trade tensions and global growth drove stocks lower in 2018, each of these concerns eased during the first quarter. Stocks posted strong gains with US stocks returning 13.7% as measured by the S&P 500 Index. This gain was the highest first quarter increase since 1998 and recovered most of the decline from the fourth quarter. International stocks returned 10.3% as measured by the MSCI ACWI Ex US Index and also recovered most of their fourth quarter losses. *(Refer back to Figure 1.)*

Figure 2

STOCKS RECOVERED AS GROWTH FEARS EASE

Stocks have now found a level that we believe reflects an outlook for modest economic growth. Investor psychology and positioning has changed from overly optimistic heading into October 2018 to a late fourth quarter panic that led investors to reduce risk as the perceived probability of a recession increased. However, as mentioned previously and reflected in *Figure 2*, gains in the first quarter largely reversed the losses from the fourth quarter as recession fears have eased and investors that sold in December have reluctantly been buying back stocks for fear of missing out. This microcosm of volatility is a good reminder for all of us as to how quickly investors can change their minds as to what constitutes "a fair price" for stocks.

We believe that stocks are now priced somewhat above fair value, although not at an extreme level. Therefore, we are positioning portfolios near our clients' target allocation, which in most cases has resulted in a reduction to equities in recent months. If our base case outlook for 2% GDP growth in 2019 comes to fruition, stocks may well grind higher over the remainder of the year. However, risk of price declines from disappointment has also increased as expectations are now higher. Like the Fed, we remain data dependent and are watching for confirmation of our view.

FIXED INCOME MARKETS

Treasury yields fell and credit spreads tightened during the first quarter, resulting in strong returns across fixed income markets. As with equities, some of the sectors hardest hit in the fourth quarter of 2018 rebounded the strongest, including high yield and emerging market debt. The Fed's pivot from a bias toward tighter monetary policy to a remarkably dovish tone following the steep swoon in equity markets in late 2018 emboldened investors to bet on lower Treasury yields. By taking further interest rate hikes off the table for the remainder of 2019, the Fed lent credence to the view that this economic cycle may last longer than anticipated, with continued profitability among corporations whose borrowing costs remain low.

The shape of the yield curve attracted investor attention during the quarter as the rate on the 3-month Treasury bill briefly rose above the 10-year Treasury yield for the first time since 2007. This inverted yield curve was widely reported as one of the most reliable indicators of recession. What was not as well reported is the fact that such inversions are poor predictors of the timing of recessions. In fact, lead times between inversion and recession have averaged 19 months and ranged from 10 to 33 months for the past five recessions. Inversion is one of many indicators we analyze as we assess recession risks and based on our overall assessment we do not expect a recession this year.

Bond markets also welcomed the Fed's decision to wrap up its balance sheet runoff earlier than expected. We estimate the Fed's balance sheet (composed mainly of Treasury bonds and mortgage-backed securities it purchased during and after the financial crisis) will be about $3.75 trillion at the end of September when the runoff ends. This is four times the pre-financial crisis level. With these changes, Fed policy has become more supportive to future growth at a time when the US economy is slowing toward its longer-term trend. Housing in particular may see tailwinds as mortgage rates decline.

All told, the interest rate environment is far more benign than a few short months ago when the Fed was predicting two more rate hikes in 2019. Aided by low unemployment and modestly growing wages, this Goldilocks economic environment (neither too hot nor too cold) could persist throughout 2019 with muted upside pressure on interest rates and sanguine credit markets buoyed by investors eager to lend to corporations for incremental yield over government bonds. As this long expansion continues, we favor investment grade credit and higher-quality securitized debt at current valuations.

CONCLUSION

The tone of the financial markets has changed considerably since the end of last year, with investors — bolstered by a less hawkish sounding Fed — plowing back into risk assets. "Worries about a recession?" they seem to be saying, "That's so 2018."

We are certainly glad investors appear to have come back around to our view that this record expansion still has some legs. After all, it's a lot more comfortable riding the market than fighting it. We won't, however, let their exuberance distract us. With all due respect to the crowd in the bleachers that was so certain of a recession back in December, we will look elsewhere for the play calls.

1 https://www.bea.gov/news/2019/gross-domestic-product-4th-quarter-and-annual-2018-third-estimate-corporate-profits-4th

2 Federal Reserve System October 2, 2018 release https://www.federalreserve.gov/newsevents/speech/files/powell20181002a.pdf

3 Federal Research System press conference transcript March 20, 2019 https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20190320.pdf