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ECONOMIC UPDATE
SECOND QUARTER 2019

Quarterly Key Points

- The Federal Reserve turned dovish at its June policy meeting, signaling that it stands ready to ease monetary policy in order to prolong the current economic expansion. In the face of continued concern about the pace of economic growth, the expectation of rate cuts has reignited the rally in risk assets that started at the beginning of the year but stalled out in the second quarter.
- U.S. GDP growth rebounded nicely to 3.1% in the first quarter, picking up the pace after a lackluster end of the year in 2018. Personal consumption growth continued to trend lower, bottoming out at 0.9% q/q annualized in 1Q19; however, this was more than offset by strong business inventory growth.
- Incoming data suggest a reversal of these measures in the second quarter, with consumer spending rebounding to approximately 3.8% annualized, offsetting the negative drag from slower trade and inventory reversals. Nevertheless, broad measures of economic output have consistently slowed since mid-2018. Forecasts are now calling for GDP in the 1.5% - 2.0% range in 2Q19.
- The Consumer Price Index (Headline CPI) continued to struggle, rising briefly to 2.0% year-over-year in April before falling back to 1.8% in May. Meanwhile, Core CPI (ex-food and energy) has slipped to 2.0% and Core PCE, the Fed's preferred measure of inflation, has fallen to only 1.6%. Notably, market measures of inflation expectations, like the 5y5y Forward Breakeven and the 10-Year Breakeven Inflation Rate, suggest higher inflation is nowhere in sight.
- The Fed has not changed its policy rate yet in 2019; however, the shift in policy stance over the last six months has been dramatic. Since December, the Fed's message has gone from monetary tightening, to "patience", to dovish policy easing. The market started the year expecting 3-4 rate increases in 2019. Current expectations are for 2-3 rate cuts between now and year-end.

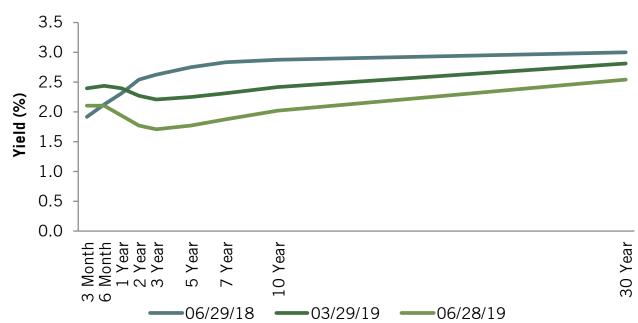
Our View

- Despite continued low unemployment, recent wage gains, and a rebound in consumer spending, expectations for 2Q19 GDP growth are in the 1.5% - 2.0% range.
- Business activity, while still expansionary, continues to slow. Uncertainty regarding U.S. trade policy with China, increased geopolitical risks, and the waning effects of tax related stimulus have reduced business investment. Furthermore, the economy is likely dealing with the lagged effects of tighter monetary policy put in place over the previous year. Meanwhile, job creation is also showing signs of slowing. Over the next several months, incoming data will shed light on these trends.
- Given the slowing trends in business activity and job creation, and underwhelming core inflation, the Fed will likely ease monetary policy in the second half of the year; however, the size and timing of rate cuts may be at odds with current market expectations. This disconnect has the potential to create some volatility should the Fed's actions underwhelm the market.
- We continue to advocate for investors to be cautious in the face of a global economic cycle in the late stages of expansion.

2Q SUMMARIZED BY SLOWING ECONOMIC TRENDS AND DOVISH POLICY EXPECTATIONS

The change in monetary policy since December has been nothing short of remarkable. When 2018 ended, the Federal Reserve was firmly on a path to tighter monetary policy in the year ahead. Fast forward to today, and we have dovish Fed policy signals and a market expecting around three rate cuts in the remainder of the year. How did we get here? Generally speaking, broad economic indicators have been on a slowing trend since mid-2018 (some of them even longer) and, at the same time, the Fed has been removing accommodative monetary policy since 2016. The market volatility that has ensued over the last four quarters has been the result of a tug-of-war between what the market believes is necessary for continued economic expansion and what policy makers are willing to provide. Recall that having heard the market's concerns regarding tighter policy, the Fed capitulated at the January policy meeting by holding rates steady and signaling "patience" going forward. Confidence was restored and markets rallied, but by the start of the second quarter, sentiment started to sour again with renewed fear that a patient Fed would ultimately show up late to the game.

FIGURE 1 U.S. TREASURY YIELD CURVE[1]



In response to subdued economic data, the Treasury market rallied considerably during the quarter. 10-year rates ended the quarter at around 2.00%, 40 bps lower than at the end of March. Furthermore, the short-end of the curve is inverted steeply out to three years (3-month at 2.09% and 3-year at 1.70% as of the end of the quarter). The 2s/10s curve has not yet inverted; however, the 3-month Treasury bill vs 10-year Treasury has been inverted since May 22nd. While not necessarily signaling that recession is imminent, the message from the Treasury market is that perhaps the economic slowdown is becoming more certain the longer the Federal Reserve remains on hold. On the other hand, it's "bad news is good news" again for equities with the S&P 500 at all-time highs at the end of June.

The Fed's message in June was a continuation of the policy shifts signaled earlier in the year. The policy statement removed the word "patient" and policy rate expectations for 2019 (dot plot) are now leaning towards multiple rate cuts by the end of the year. Meanwhile, forward rates markets imply a near certain series of rate cuts starting in July. This disconnect has the potential to create some volatility should the Fed's actions underwhelm the market.

The U.S. economy grew at 3.1% in 1Q19 on strong business inventory activity. Anecdotally, the run-up in inventory was partly an attempt to front-run tariffs on Chinese imports that have been set to accelerate multiple times over the past six months. After falling to the lowest level in almost ten years in the first quarter, personal consumption has rebounded nicely in the second quarter. Retail sales since February confirm this trend in spending. On the business side, the Institute for Supply Management (ISM) Manufacturing Index June reading

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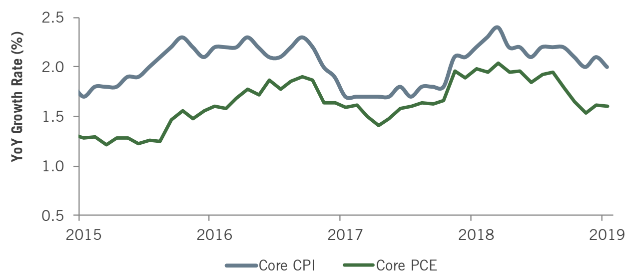
of 51.7 is the lowest since 2016. As we highlighted last quarter, similar trends have been emerging in measurements of business orders, construction spending, durable goods orders, and business sentiment since mid-2018. While all are still expansionary, these measures point to lower growth in economic output. As a result, market consensus is calling for 2Q19 GDP growth of 1.5% - 2.0%.

FIGURE 2 CORE CPI VS. CORE PCE[1]



LOW UNEMPLOYMENT AND TEPID INFLATION REMAIN

The unemployment rate continues to hover at the lowest level in 50 years, dropping back down to 3.6%, 3.6%, and 3.7% in April, May, and June respectively. Job creation, on the other hand, has been choppy again in the second quarter. After a 216k jobs number in April, May disappointed with only 72k jobs added. More recently, the June number came in hotter than expected at 224k. Looking at the broader trend, on a three-month rolling basis job creation is now at the lowest point since 2016. While many suggest that months like February and May are anomalies, there is growing concern that a subtle downward trend in employment is emerging. The idea is that slowness in business activity will eventually show up in employment. A slight uptick in Initial Jobless Claims confirms this thesis while Continuing Jobless Claims that are well behaved suggest job creation remains intact. Notably, both of these measures are at extremely low levels, historically speaking. Furthermore, Average Hourly Earnings have continued a solid trend that started in late 2017 by increasing by 3.1% - 3.2% year-over-year again in each month of the quarter. Should job growth remain strong and wage gains continue, solid consumer spending will likely continue as well.

Inflation continued along a muted path in the second quarter. By all measures, sustained 2.0% inflation consistent with the Fed's stated target remains elusive. Headline inflation briefly touched 2.0% year-over-year in April before slipping back to 1.8% in May. Meanwhile, the Fed's preferred measure of core inflation, the Personal Consumption Expenditures Core Price Index, slipped back to 1.6% in May. Core Producer Price Inflation has trended lower in every month this year, measuring only 2.3% in May. Perhaps more importantly, market measures of expected inflation, including the 10-Year Breakeven Inflation Rate and the 5y5y Forward Breakeven which ended the quarter at 1.70% and 1.85% respectively, suggest higher inflation is nowhere in sight.

LOOKING AHEAD

Incoming data for the U.S. economy suggests GDP growth in the 1.5% - 2.0% range in 2Q19. Business activity continues to slow while the consumer side of the equation is holding up, for the time being. Inflation is tame and the Fed's policy tone has shifted such that monetary policy easing will likely come in the near future. Looking forward, the disconnect between market expectations for multiple rate cuts starting in July and Fed policy action could be a source of volatility for risk assets.

[1]Source: Bloomberg