INVESTMENT PERSPECTIVES

>> SECOND QUARTER 2019

China's "Belt and Road" revolutionizes global trade

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China's Belt and Road project sounds like a nostalgic reconstruction of ancient caravan routes, but it's much more than that. The ambitious project aims to build robust transportation networks from the Pacific to the Mediterranean. The infrastructure — roads, railways, ships, cargo terminals — may capture the headlines because of the immense amounts of money involved, but it's the softer aspects that are most revolutionary.

To make the Belt and Road useful, China must negotiate trade agreements with every country along the routes, including all of southern and central Asia, the Middle East, and even some NATO allies in Europe. The terminus would be Piraeus, the Greek port city that dominates eastern Mediterranean shipping. Completing trade agreements with all of those countries would effectively create the world's largest free-trade zone, dwarfing North America or the European Union. It could give China unparalleled economic clout.

The country's trade ambitions go hand-in-hand with its technological advances. China has developed some of the world's most sophisticated semiconductor factories, leading consumer electronics prowess, and even startling new automobile technologies.

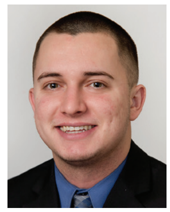
The Belt and Road project and superior technology might seem to make China invincible in the coming decades, but the nation still has serious problems to overcome. Demographics are unfavorable, as the long-term impact of the One Child policy has become evident in stagnant population growth. Its state-owned enterprises still owe far too much money. Domestic demand growth has been sluggish.

But perhaps the biggest problem for China is that it is still somewhat dependent on the United States and Europe. China's currency does not float freely and is not easily converted, making it unlikely that the yuan will become a truly global reserve currency at any time soon. That leaves China uncomfortably vulnerable to the kind of economic sanctions that have hurt Russia and Iran as punishments for their political actions. When the U.S. tried to shut down telecom company ZTE, China almost lost 70,000 jobs.

As much as China wants to share global leadership with the United States, it must recognize the limitations of its ambitions in a global context. As China's leaders learned a long time ago when they visited Disneyland for the first time, *It's a small world after all.*

>> PERSPECTIVES ON THE ECONOMY

The state of the U.S. consumer



By Timothy Garvey
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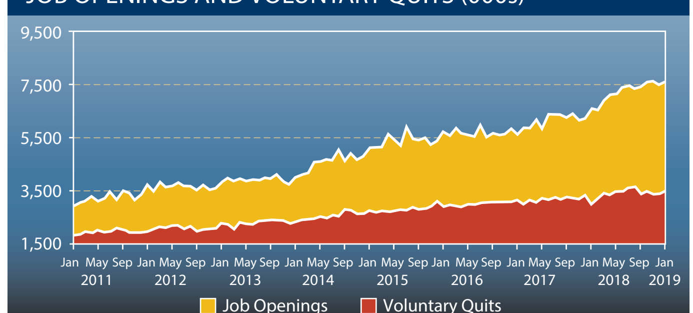
For the last several years the driving force behind the growing U.S. economy has been personal consumption. This makes sense, given the many tailwinds that have been driving consumer behavior: interest rates have been quite low, the labor market has been consistently strong, and the soaring stock market has helped boost consumer confidence. These factors, among others, contributed to a significant boost in discretionary spending since the Great Recession. After a decade of growth — approaching the longest U.S. economic expansion on record — is it prudent to depend on the consumer to continue propelling us forward?

In recent months, the toll of the Fed's two-year campaign to raise interest rates has begun to affect consumers' enthusiasm. Home sales have drifted lower as mortgage rates climbed. Vehicle sales have also shown signs of peaking. In addition, the stock market selloff at the end of last year has caused some uneasiness among consumers. Measures of consumer confidence and retail sales have both faltered recently.

Despite these negative developments, we believe we will see renewed strength in personal consumption. The Fed will likely not raise interest rates for the remainder of the year, hourly wages continue to rise amid historically low layoff rates, and the stock market has rebounded sharply off its December bottom. Perhaps most impressively, the number of people who voluntarily quit their jobs (not including retirements) has soared, as workers are more confident of finding new and better-paying jobs. These factors point to a resilient U.S. consumer.

JOB OPENINGS AND VOLUNTARY QUITS (000s)



Job openings and voluntary quits are at record levels, indicating high consumer confidence

Source: Bureau of Labor Statistics

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>> FOCUS ON EQUITIES

The equity markets take a wild ride

By Allen Laine, CFA
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The domestic equity markets have experienced violent swings since the highs achieved in September 2018. The S&P 500 index peaked that month at a level of approximately 2,930 and then plummeted to lows on Christmas Eve of roughly 2,350, a 20% tumble in mere months. 2018 was the year nothing worked: It was the worst for stocks in 10 years, and bad for many other asset classes too. However, markets have significantly rebounded this year, and closed the first quarter just fractionally below the highs witnessed in September.

Where the market goes from here is increasingly dependent on several drivers. Uncertainties remain regarding global trade, tepid global economic growth, muted domestic corporate earnings, political instability in Europe, and the partial inversion of the Treasury yield curve. Each of these represents a key catalyst for the stock market either to grind higher or to fall potentially precipitously. In our estimation, it likely will take some time before we can comfortably estimate the trajectory and impact. As such, market volatility will likely persist, especially as new information is released, and the impacts discounted into stock prices.

While the U.S. economy remains in reasonable shape, earnings expectations for S&P 500 companies have decelerated significantly since the peak growth rate experienced in the third quarter of 2018. Earnings per share grew over 20% in 2018, while expectations are for a muted 5% growth rate in 2019. Valuation is hovering around the 30-year historical average of a 16.5x price/earnings ratio. Is an average valuation multiple appropriate given today's combination of uncertain growth characteristics, economic ambiguity, and low interest rates? We think American stocks are a bit on the expensive side, but probably not overly concerning at this juncture. On the other hand, initial first-quarter earnings reports suggest that the outlooks offered by corporate America in January and February were too conservative; perhaps we'll see better than 5% for the year.

Given the combination of uncertainty, business fundamentals, and valuation, we are neutrally positioned with our equity allocation vis-à-vis fixed income assets. We are neither bullish nor bearish. We believe a balanced asset allocation is appropriate until more clarity regarding key issues is revealed.

>> FOCUS ON FIXED INCOME

The Federal Reserve sends Treasury yields lower

By Tom Bussone
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The Federal Reserve recently changed its outlook for future monetary policy, scaling back its projected rate increases this year and announcing that the bank would end the drawdown of its bond holdings in September — two years ahead of its prior schedule. This caught securities markets off guard and sent long-dated U.S. Treasury yields tumbling and bond prices rising. The rally led to the yield curve briefly inverting as the 3-month Treasury bill yielded more than the 10-year Treasury note.

Despite the cautious tone from the Federal Reserve and the unusual shape of the yield curve, money flowed into the credit markets as investors were in search of higher yielding assets. High-yield credit spreads collapsed by about 100 basis points, a counterintuitive move at a time when investors were worrying about a faltering economy. The credit markets are indicating that the decade-long expansion has room to run. Many bond investors expect that if the economic data begins to slow, the Federal Reserve will take action to support the "risk-on" trade. Interest rate futures are indicating the Federal Reserve's next monetary policy move will be to cut rates.

Investors are clearly comfortable owning credit risk. Yet in our view, investors are not being paid sufficient premia to take that risk, so we recently upgraded the credit quality of our clients' portfolios. In the late innings of the economic cycle, we prefer to decrease our exposure to corporate credit while adding to our U.S. Treasury holdings.

CORPORATE BOND SPREADS OVER TREASURY YIELDS

Caption: Corporate bond yields no longer offer much premium to Treasury yields.

Source: Bank of America Merrill Lynch