GM ADVISORY GROUP
WEALTH MANAGEMENT

investment perspectives

July | 2019

Q3 MARKET OUTLOOK

Executive Summary

While others speculate about how quickly the Fed will cut rates, or if the US and China will come to an agreement on trade, we urge investors to tune out the noise and remain focused on what drives sound asset allocation: the economic cycle. Economic data continue to point to slowing growth as the cycle matures. The risk of recession has increased, dictating a cautious investment approach.

Second Quarter Review

Asset values rise on the back of the Fed

- First quarter real GDP accelerated, but speciously, as the key driver was a severe reduction in the GDP deflator rather than a true pickup in growth.
- Stocks and bonds rallied due to high hopes of monetary stimulus.
- Most recent economic data suggest that the US economy continues to decelerate.

Equities

Grinding higher, but with new leadership

- The Russell 3000 and MSCI ACWI returned +4.1% and +3.6%, respectively, in Q2.
- Defensive sectors are leading since US growth began slowing in Q4. Over that time, REITs (+15.8%), utilities (+16.3%), and consumer staples (+10.1%) have materially outperformed the S&P 500 (+2.5%).
- We continue to recommend being overweight defensive sectors, given our expectation that the US economy will slow over the next several quarters.

Commodities

Gold continues to shine

- The GSCI was down -1.4% in Q2, but gold outperformed significantly, up +9.3%.
- We continue to recommend gold to hedge against lower real interest rates, a pickup in market volatility, and a devaluation of the US dollar.

Fixed Income

Bonds rally on expectation of multiple rate cuts

- The US Barclays Aggregate Bond Index returned +3.1% in Q2, recording its best quarter since 2011.
- Duration-sensitive assets like intermediate and long-term Treasuries performed particularly well, up +4.0% and +6.1%, respectively.
- Corporate credit continues to get bid up as the search for yield ensues. Investment-grade and high-yield bonds were up +4.5% and +2.5%, respectively.
- Just +7 basis points separate the 1-year and 10-year Treasury bond yields.
- We continue to recommend increasing credit quality and duration given our expectation of slowing domestic growth and rising recession risk.

Looking Forward

US economy to slow over next several quarters

- The most recent data support our view that the US economy will slow over the next several quarters as inflation stabilizes. As a result, we recommend maintaining a defensive asset allocation.
- If growth slows and inflation is muted, then gold, US Treasuries, and defensive equity sectors should outperform as they have since Q4 2018.
- Recessionary indicators are flashing yellow, which dictates an even more cautious approach in case this cyclical growth slowdown escalates into a recession.

POSITIONING HIGHLIGHTS

OVERWEIGHT

Gold. We recommend being overweight gold as a hedge against lower real rates, increased volatility, and/or a debasement of the US dollar.

OVERWEIGHT

Fixed Income. We recommend moving up in credit quality and adding interest rate duration as a hedge against slowing US growth.

UNDERWEIGHT

Equities. We recommend being underweight equities and shifting away from growth styles to more defensive styles within equities.

Note: *This document contains important information and must be read in its entirety.*

Second Quarter Review

It was a volatile quarter for global equities. After falling **-5.9%** in May, the MSCI All World Equity Index rebounded in June to finish the second quarter up **+3.6%**, fully recouping the losses incurred during the fourth quarter of 2018.

Just like in Q1, the catalyst for the market rebound in Q2 was a uniform, accommodative stance from central banks globally, as they committed to stimulating their respective economies in the face of deteriorating economic data.

How dovish is the Fed? Let's just say that the market is expecting a lot of action out of the Federal Open Market Committee in the coming months. Currently, futures markets are predicting a 100% probability of a rate cut on July 31st and a 59% chance that the Fed makes at least three rate cuts by the end of this year. This stands in stark contrast to widespread views in December, when the market was pricing in two rate *hikes* in 2019. This flip-flop toward accommodation, coupled with high hopes about US-China trade negotiations, has provided a boost to risk assets as market participants speculate that the Fed and global central banks can engineer a "soft landing."

Dovish central bank policy has also perpetuated new highs in bonds as market participants discount the impact that lower interest rates will have on bond prices. The Barclays US Aggregate Bond Index was up **+3.1%** in Q2, posting its best quarter in 7.5 years. Bonds that bear greater interest rate sensitivity, like long-term US Treasuries, fared even better, up **+6.1%**.

Broad commodities were down slightly (**-1.4%**) in Q2 as oil pulled back **-2.8%**. Gold outperformed, rallying **+9.3%**.

MARKET REPORT CARD – June 30, 2019

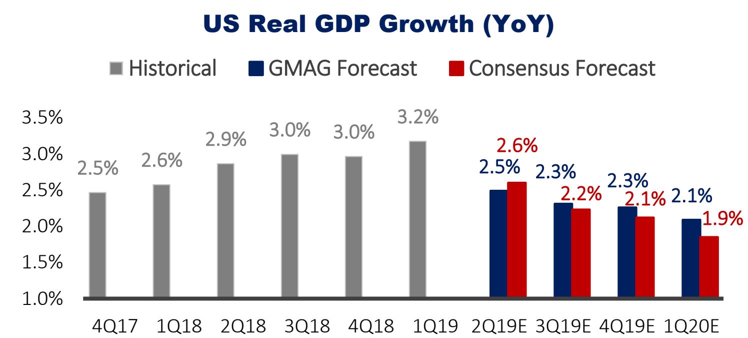
Performance Reported in US Dollars	YTD	2Q19	Since 4Q18
Equities			
United States (Russell 3000 Index)	+18.7%	+4.1%	+1.7%
International Developed (MSCI EAFE Index)	+14.0%	+3.7%	-0.3%
Emerging Markets (MSCI EM Index)	+10.6%	+0.6%	+2.3%
Bloomberg Barclays US Aggregate Bond Index	+6.1%	+3.1%	+7.9%
Long-Term Treasuries (Barclays 20+ Year)	+11.1%	+6.1%	+15.8%
Investment-Grade Bonds (Barclays US Corp)	+9.9%	+4.5%	+9.7%
High-Yield Bonds (Barclays US HY Corp)	+9.9%	+2.5%	+5.0%
Real Assets			
Commodities (S&P GSCI)	+13.3%	-1.4%	-12.7%
Oil (WTI Crude)	+28.8%	-2.8%	-20.2%
Gold	+10.3%	+9.3%	+18.7%
Alternatives			
HFRX Global Hedge Fund Index	+4.2%	+1.6%	-1.6%

Source: Bloomberg

Data Check: Growth Slowing, Inflation Rising Modestly

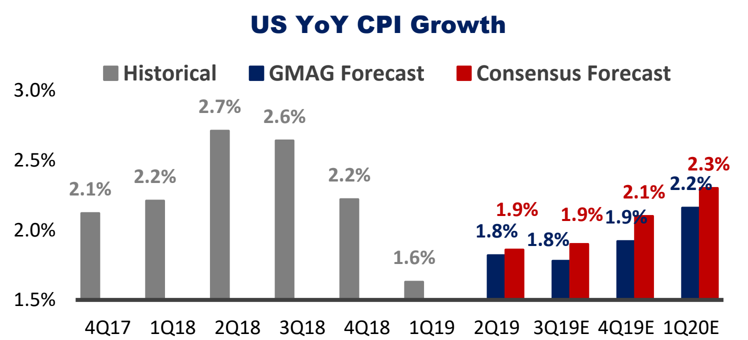
US real GDP growth accelerated in the first quarter, but in uninspiring fashion. Upon further review of the statistic, the acceleration shown on face was due to a sharp decrease in the GDP deflator, the component of real GDP that helps account for changes in prices of goods. Nominal growth actually slowed. Growth was also boosted by inventory stocking as companies front-ran potential tariffs. Looking forward, steepening base effects and the waning impact from high fiscal spending in 2018 present major headwinds to US growth and we expect the US economy to slow over the next several quarters. (See Figure 1.)

Figure 1: US Economy Likely to Slow Through 2019



Source: Hedgeye Risk Management, Bloomberg, GMAG Research

Figure 2: Inflation Expected to Stabilize After Q1



Source: Hedgeye Risk Management, Bloomberg, GMAG Research

Inflation bottomed out in the first quarter, and we believe it will rise modestly throughout the rest of the year. (See Figure 2.) Wage increases could stoke inflation further, although the relationship between wage inflation and headline inflation has gradually lessened over time. Furthermore, it will be difficult for inflation to rise materially, given the tough base comparisons that the Consumer Price Index faces in 2019 after reaching six-year highs in 2018.

Slowing growth and muted inflation have historically provided a more favorable backdrop for defensive assets than risk assets, which is why we recommend overweighting defensive assets at this time.

Lastly, it's worth noting that most of the top drivers of headline growth reached seven- or eight-year highs in the middle of last year. Given where we are in the current expansion, it's possible these data (Figure 3) represent the cyclical peak in growth, and if that is the case, extra caution is warranted.

Figure 3: Key drivers of US growth potentially put in their late-cycle peaks during the middle of 2018

Growth	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19
Real GDP YoY %	1.56	1.30	1.54	1.88	1.94	2.11	2.34	2.47	2.58	2.87	3.00	2.97	3.18	2.49*
Growth Drivers	**1Q16**	**2Q16**	**3Q16**	**4Q16**	**1Q17**	**2Q17**	**3Q17**	**4Q17**	**1Q18**	**2Q18**	**3Q18**	**4Q18**	**1Q19**	**2Q19**
Industrial Production YoY %Δ	-3.2	-2.4	-1.9	-0.3	0.8	2.8	2.1	3.6	3.6	3.3	4.9	4.0	2.8	1.5
Retail Sales Ex Food, Autos YoY %Δ	2.7	3.1	2.4	2.6	3.3	3.4	4.1	5.4	4.9	5.0	4.6	3.2	3.2	3.2
Retail & Food Sales YoY %Δ	2.9	2.3	2.3	3.4	4.9	4.0	4.1	5.5	4.7	5.7	5.6	3.4	2.8	3.3
Exports YoY %Δ	-5.9	-4.3	-0.5	1.9	7.0	5.1	4.6	8.0	7.1	9.5	6.4	2.5	1.7	-1.2
Average Weekly Hours YoY %Δ	-0.2	-0.3	-0.5	-0.5	-0.4	0.0	0.0	0.3	0.4	0.3	0.4	0.0	0.0	-0.3
PCE YoY %Δ	2.7	2.7	2.7	2.8	2.6	2.5	2.4	2.7	2.4	2.6	2.9	2.6	2.7	2.7
Imports YoY %Δ	-4.7	-3.4	-1.2	2.8	7.0	6.6	5.1	8.3	8.5	7.7	9.7	5.5	1.5	1.7
Manufactures New Orders YoY %Δ	-5.1	-4.4	-3.0	1.1	4.6	5.5	5.8	6.9	8.0	7.8	9.2	4.3	2.0	-0.3
Core Cap Goods New Orders YoY %Δ	-5.8	-5.5	-4.4	-2.2	2.7	6.3	7.9	9.9	6.6	7.3	6.2	4.0	3.5	1.3
Durable Goods New Orders YoY %Δ	-0.9	-2.2	-2.5	-0.3	1.2	6.8	5.5	6.6	9.3	7.9	10.0	5.7	3.0	-1.6

*Figure shown for Real GDP growth in 2Q19 is our current estimate and has not yet been reported.

Source: Hedgeye Risk Management, Bloomberg, GMAG Research

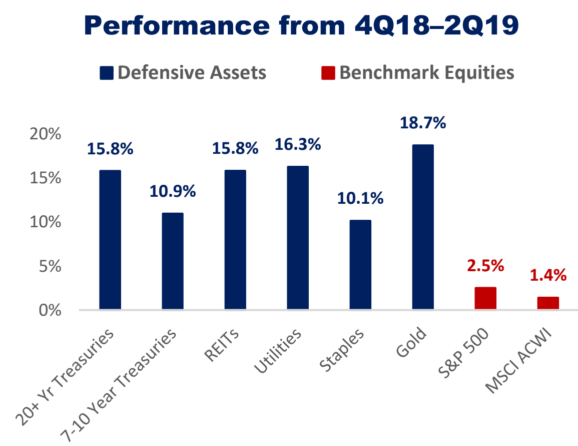
Investment Outlook

Asset Class

Underweight growth, overweight defensives

Because we expect the US economy to continue to slow over the next several quarters, we generally recommend being underweight growth assets like equities and overweight defensive assets like bonds, bond-proxies, and gold. Figure 4 illustrates how more defensive assets have performed relative to broad equities since the US economy began to slow in the fourth quarter of 2018.

Figure 4: Defensive assets have performed well since US growth began to slow in Q4

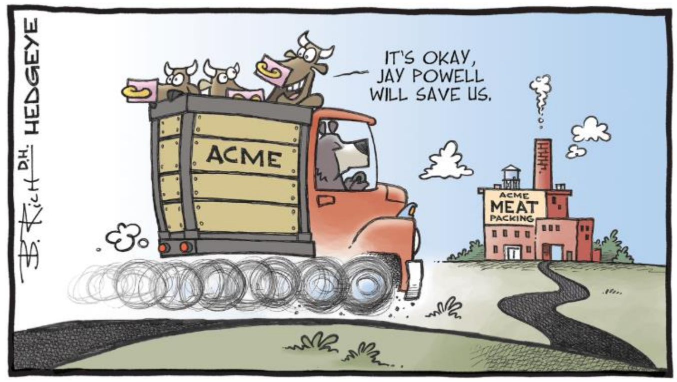


Source: Bloomberg, GMAG Research

Equities

Underweight equities, favor dividend payers

Over the past year, we have generally recommended reduced equity allocations as well as



rotation from growth sectors toward more defensive sectors whose underlying constituents generally pay out a larger portion of earnings as dividends. We maintain this bias because market participants generally hunt for yield when growth slows.

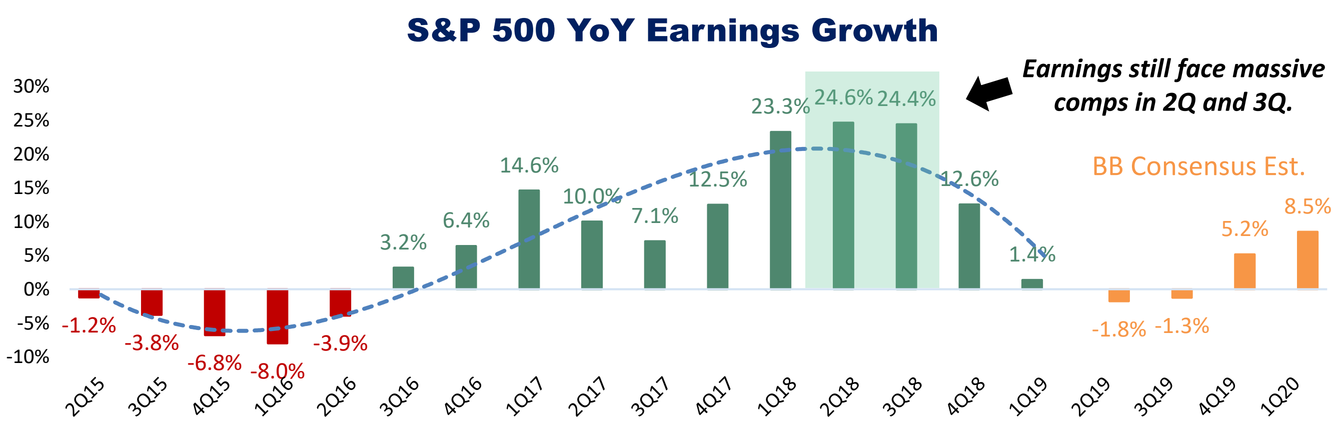
Thus far, the market has rewarded those who have positioned for this phase-transition from a growth acceleration to a growth slowdown. From the fourth quarter through the second quarter, defensive equity sectors like utilities (**+16.3%**), REITs (**+15.8%**), and consumer staples (**+10.1%**) have materially outperformed the S&P 500 (**+2.5%**). More recently, we're beginning to see the media as well as industry peers acknowledge this trend-shift.

Earnings Recession Ahead?

Market participants have also begun to fret over potential negative corporate earnings growth (i.e., an earnings recession). (See Figure 5.) We previously highlighted this concern as corporate earnings brush up against a myriad of headwinds including:

- Difficult base-comparisons
- Peak margins

Figure 5: Difficult base effects in Q2 and Q3 increase the risk of an earnings recession.



Source: Hedgeye Risk Management, Bloomberg, GMAG Research

- Rising labor costs
- Inventory overhang
- Fading demand (waning impulse from tax reform)

Although the market now expects an earnings recession, we believe participants remain too bullish on earnings. Our analysis indicates that even a mild 100-basis-point compression of EBIT margins could result in **-5%** to **-10%** earnings growth, as opposed to the **-1%** to **-2%** contraction that Wall Street analysts are forecasting. This is a risk we believe that neither equity nor credit markets are appropriately discounting.

International Equities Update

Though the US economy is just beginning to slow, most foreign economies have been slowing for the past five to six quarters, which is the primary reason that US stocks have outperformed international stocks by **+16.6%** since the start of 2018. Because foreign markets will face easier comparisons sooner than the US, we are watching for signs that foreign markets will also reaccelerate sooner. This would provide a foundation for outperformance by international equities. However, we cannot simply forecast growth based on base effects. We are concerned about momentum and the economic data we are seeing overseas.

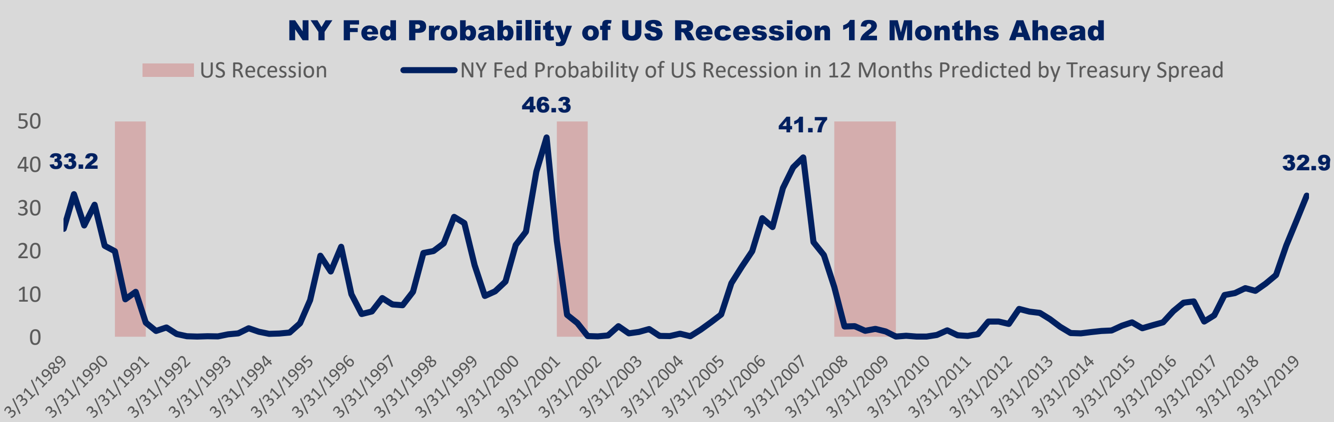
Tracking the Next Recession

Predicting the exact timing of the next recession is notoriously difficult, especially because human behavior is often a key factor in the process. However, we can still track economic data to help us estimate whether the risk of a recession is increasing or decreasing.

There are several datapoints that suggest that recession risk is growing:

- **Global Growth Is Slowing:** Key global economies are slowing and PMIs are signaling a contraction.
- **Yield-Curve Approaching Inversion:** Currently just +7 basis points separate the 1-year and 10-year Treasury yields. Historically, the yield-curve inverts about one year prior to recession. Similarly, the NY Fed Probability of US Recession Twelve Months Ahead Index, which is based on a similar Treasury spread, is accelerating upward. (See Figure 6.)
- **Rising Leverage:** Private sector leverage has reached new highs and is at a level consistent with previous recessions.
- **Deteriorating Credit Quality:** Underwriting standards in corporate credit have deteriorated substantially during the current economic expansion.
- **Rising Wages:** Labor costs are accelerating, which pressures corporate profit margins.
- **Full Employment:** Unemployment hit a 49-year low in May. Historically, unemployment has bottomed eight months prior to a recession on average.

Figure 6: Probability of recession occurring in the next twelve months is significant



Source: Bloomberg

More specifically:

- World PMI Indices, which measure manufacturing activity, have broken below 50, signaling that the global manufacturing economy is in contraction.
- China, the world's second largest economy, is slowing, and structural imbalances may limit the stimulus it can provide.
- Industrial production in the Eurozone and Japan, the world's third and fourth largest economies, contracted in the past three and four consecutive months, respectively.

Just because the base effects are getting easier does not mean that they are easy, and therefore it's certainly possible that foreign growth will continue to slow.

Another concern regarding international markets is the potential for a slowdown in the US economy to spill over internationally and adversely affect foreign growth prospects. This is not a risk that we can ignore, given that the United States economy is the world's largest and is therefore deeply integrated in global markets.

Can central banks offset a growth slowdown?

Stimulative monetary policy has been, in our opinion, the primary catalyst for the equity market rebound in 2019. Although we acknowledge that more accommodative central bank action has the potential to prolong the current economic expansion, we believe investors would be remiss to bet on a soft landing.

History shows how difficult it is for central bankers to engineer soft landings during any cycle, let alone the current one, after exhausting the most effective monetary policy tool–interest rate reduction. Interest rates across major developed economies are either near or below zero, and therefore it's unlikely that traditional monetary policy measures will provide the same efficacy that they have in the past. This is a serious consideration for policy makers, as key growth metrics are signaling that we may be beyond the peak in global growth.

Rather than subscribe to the proverbial advice, "Don't Fight the Fed!", we instead prefer that investors "Don't Fight the Cycle!" We do not believe it's prudent for investors to overweight assets that have a high degree of economic sensitivity, as we are likely to enter a growth slowdown that could last multiple quarters, particularly because we're also in the late stages of the longest economic expansion on record.

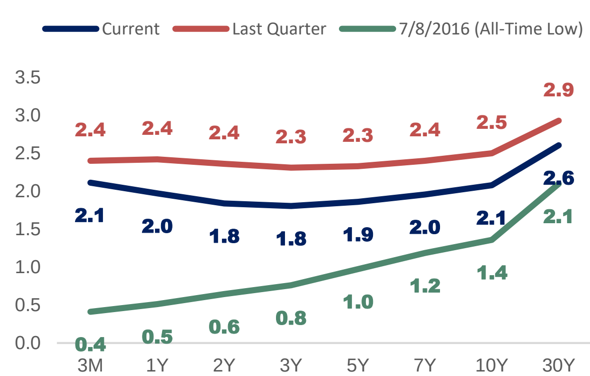
Fixed Income

Favor quality and duration

Since the middle of last year, we have generally recommended increased allocations to fixed income as our views on growth and inflation gradually soured. We continue to favor fixed income assets with higher credit quality, particularly those with greater interest rate sensitivity, like intermediate and long-term US Treasuries. The combination of slowing growth and tame inflation has historically placed downward pressure on interest rates and upward pressure on bond prices. Longer duration Treasuries often perform exceptionally well in this environment as they are more sensitive to changes in interest rates.

In our 2Q Market Outlook, we stated that the market was likely overly bearish on long-term Treasuries based on our expectation that the US economy would slow and that positioning in Treasury bond futures by speculators in the market showed that they were significantly short Treasuries. So far, our thesis has played out, as interest rates dropped by 30 to 40 bps across the yield-curve last quarter. We note that interest rates could grind lower as yields are still well-off of their lows from July 2016. (See Figure 7.)

Figure 7: Interest rates decreased materially since last quarter; still have room to move lower



Source: Bloomberg, GMAG Research

Favor consumers versus corporates

We continue to favor consumer debt over corporate debt. Even though the overleveraged consumer was at the epicenter of the 2008 Great Financial Crisis (GFC), the data show that household credit is in a much healthier position today. By contrast, underwriting standards in corporate credit have deteriorated, and ultra-low interest rates have led to substantial increases in corporate leverage. We believe that the next economic downturn may bring about a severe dislocation within corporate credit, and we prefer to remain on the sidelines for now.

Opportunity in Emerging Market Debt

Although the primary focus of our fixed income allocation is on higher-quality, higher-duration assets, we are always searching for yielding instruments with attractive returns relative to their risks. To that end, we recently began recommending exposure to low-duration, emerging-market (EM) debt.

The rationale is as follows:

- Low-duration EM Debt offers attractive yield while maintaining a defensive posture relative to US high-yield and EM equity.
- EM debt has historically performed well when US growth slows as investors search for yield.
- If economic growth in emerging economies reaccelerates after several consecutive quarters of deceleration, that could provide a tailwind to emerging-market assets, particularly if US dollar strength wanes.

Commodities

We expect commodities to perform generally well over the coming quarters as inflation continues to rise from its lows in Q1. However, we acknowledge that certain commodities like oil are more sensitive to economic growth than defensive commodities like gold. Given our subdued growth outlook, we recommend an overweight to gold versus other commodities.

The Case for Gold

There are multiple reasons why we like gold, given the current economic backdrop:

- Gold is inversely related to real yields. If US growth decelerates while inflation is stable-to-rising, this should place downward pressure on real interest rates and upward pressure on gold prices.
- Gold can provide a hedge against increased market volatility. Market volatility is more likely to increase when economic growth is slowing.
- The current low interest-rate environment makes gold more attractive. Because rates are near or below zero across most major developed economies, central banks are likely to generate more inflation the next time that they try to stimulate their respective economies. Given recent monetary policy developments, this could occur soon. Such policies are likely to have a positive impact on the price of gold as investors flock to hard assets to preserve purchasing power, just as they did during the GFC.

Conclusion

Because it is difficult to predict exactly when a recession will occur, we must instead focus on assessing whether risk-taking is being adequately compensated with expected return.

Currently, we believe the risk-versus-reward ratio for investing in risk-assets is highly unfavorable for a few reasons:

1. We expect the US economy to slow over the next several quarters. Stocks historically do not achieve materially higher highs when growth is slowing.
2. We are late in the economic cycle, not simply based on time, but also based on economic datapoints that indicate the economy is operating at full capacity. Over the next few years, we are likely to grow at a slower rate than we have throughout the course of this economic expansion.

3. When adjusted for cyclicality, equity valuations are above long-term averages. Historically, elevated equity valuations have corresponded with low future returns.

As a result, we recommend remaining defensively positioned in case this near-term cyclical slowdown in economic growth escalates into something more significant, such as a recession. Although one must forgo potential upside in order to benefit from a more defensively allocated portfolio, we believe this is the prudent approach given our belief that the downside risks outweigh the potential upside. We urge investors to avoid succumbing to any fear of missing out on the equity returns that have persisted in the first half of this year and to instead focus on the bigger picture.

As always, we will stay nimble and will not get hard-hitched to any single viewpoint. Instead, we pledge to remain data dependent and maintain the mental flexibility to change our outlook when the data dictate it.

Please give us a call any time to discuss our market views and how they are affecting your asset allocation. We will keep you apprised of any important developments.

Sincerely,

GM ADVISORY GROUP

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