CLEARBROOK

Geo-Political Uncertainty and Global Growth Plateauing:

The Search for Safety and Return

Investment Outlook 2019

Clearbrook Investment Consulting: Research Economic and Investment Outlook

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Topics

Geo-politics, trade and interest rates weight on markets and the global economy, but a recession is not foreseen

- The year of 2018 began with a great deal of hope, as global asset prices were slated to move higher on the back of solid coordinated global economic growth, increases in employment and wages, turbo-charged by the recently enacted corporate and individual tax cuts in the U.S. A strong equity market rally which drove global markets higher by 4.0% to over 10% in January, gave way to negative sentiment engendered by rising interest rates in the U.S., trade disputes across the global, and geo-political uncertainty in Europe. This has led us to a year-end where stocks, bonds and asset classes are more volatile, and the ability to generate returns will be predicated upon a highly selective approach.

- A key issue will be the direction of interest rates, with the US Federal Reserve playing the main role. After nine rate hikes since November 2015, markets are concerned about a mis-step by the Fed. Though recent comments from Fed Chairman Jerome Powell and other officials have been more dovish, both rate hikes and the wind-down of the $4.5 trillion Fed balance sheet have a tightening effect. Thus, an over-zealous pursuit of a less accommodative policy could inadvertently slow the world's largest economy, negatively affecting consumer spending and corporate earnings. The Fed will need to walk a tightrope and find the "neutral" rate to stem inflation and sustain economic growth.

- On the trade front, corporations are beginning to feel the impact of the U.S./China trade dispute. Should negotiations fail to achieve a solution by the March 1st deadline, an increase in tariffs as threatened by the Trump administration would have a negative effect on global growth and corporate earnings. We believe once we get beyond the expected rhetoric from both sides, reason will prevail and a new trade will be hammered out. Also, remember in the background is still the unfinished trade deal between the U.S. and the European Union.

- The political landscape is changing, particularly in the U.S., as the Democrats gained control of the House of Representatives on January 3rd. Will a divided Congress temper President Trump's obstinate stance on trade, or derail the Republican's pro-growth agenda? As promised by some Democrats, is the pursuit of an impeachment proceeding against President Trump likely to take place, which undoubtedly would unnerve the markets? And across the ocean, how will Angela Merkel's decision to step down as German Chancellor affect the EU's leadership? On top of this, we still have "Brexit" with a March 31 deadline, Italy's budget concerns and unrest in France which all cast a pall over the markets.

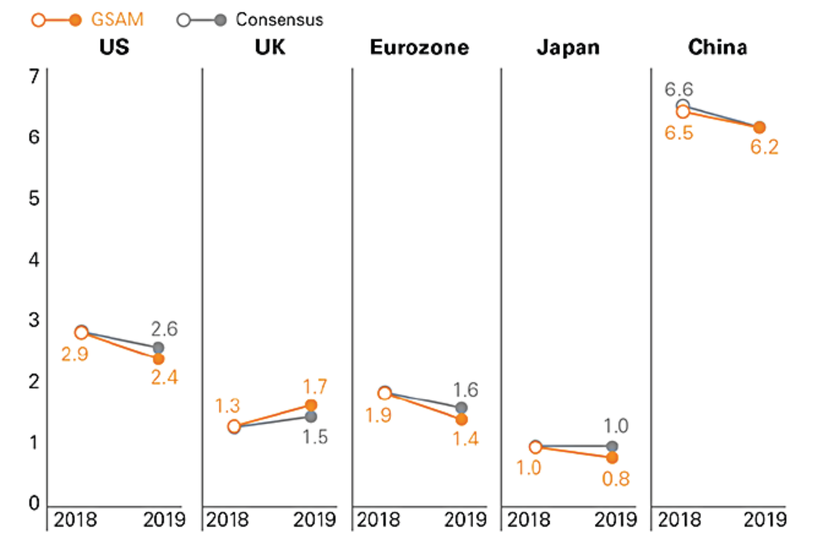
- Even though an unsatisfactory resolution to any of these geo-political issues would negatively impact global markets, and on the flip-side, any resolution would provide support to the aging bull market. Should markets continue to fall as seen in Q4 (worse global equity quarterly results since Q1 2009), it could prompt the Fed to slow the path of rate hikes which is a positive for investors. Overall, we believe the probability of a recession is 2019 is low, and we expect equities to persevere and move higher. Returns will be lower and higher levels of volatility a constant. We favor U.S. equities, particularly quality and value, and see selective opportunities in Emerging Markets based on growth and cheap valuations. The preference is equities versus bonds, but as rates stabilize, opportunities will be seen in bonds as well.

Overview

Synchronized global economic slowdown will be supported by late cycle fiscal stimulus

- The global economic expansion will continue in 2019, but will slow as the positive effects of the U.S. tax cuts and stimulus fade, weighting on year over year growth comparisons. The OECD is projecting 2019 global GDP to grow at 3.5% versus 3.7% in 2018.
- As shown in the Grow chart below left, U.S. economic growth will stabilize at a higher level than other developed countries, but will converge after seeing divergent growth close to 3.0% in 2018. Late cycle stimulus programs in the U.S., Europe and China may add 0.3% to global growth according to J.P. Morgan.
- The projected global slowdown in growth is being prompted by the decline in global trade and business investment due to tariff concerns, and the continued de-leveraging of the U.S. Fed and ECB balance sheets which are tightening global liquidity.

Grow Forecast (%)



Source: GSAM, Bloomberg. As of December 2018.

% Pt Impact on Real GDP Growth

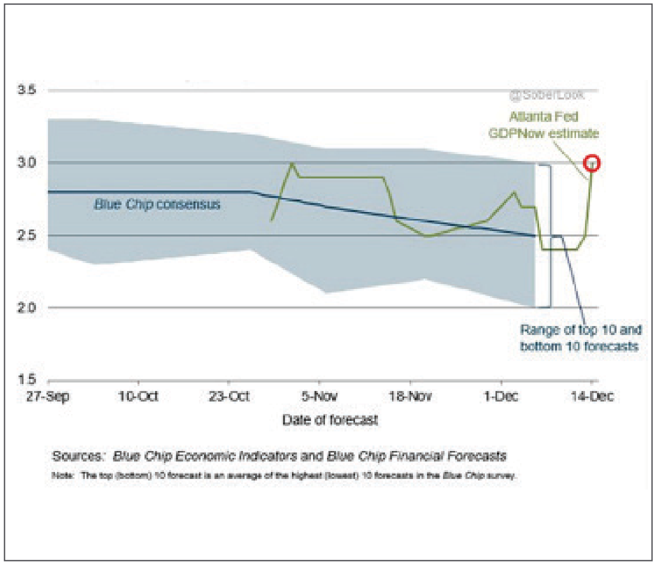
Source: OECD, IMF, J.P. Morgan

U.S.

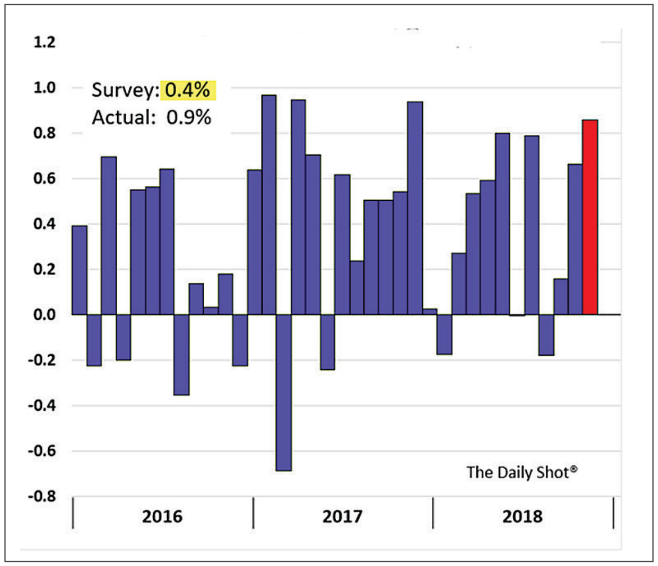
Economic growth in the U.S. slows, but remains the global growth engine

- Economic forecast for the U.S. GDP growth is a consensus 2.6%. Economic forecasts for the Q4 GDP growth are still strong, with many ranging between 2.5% and 2.9% (annualized). The Atlanta Fed GDPNow model is at 2.9%.
- Even though there a number of calls for recession sending equity markets lower, overall U.S. growth remains robust. The U.S. consumer continues to surprise on the upside.
- Economic expectations have declined from the recent highs over the past few months, but remain elevated.

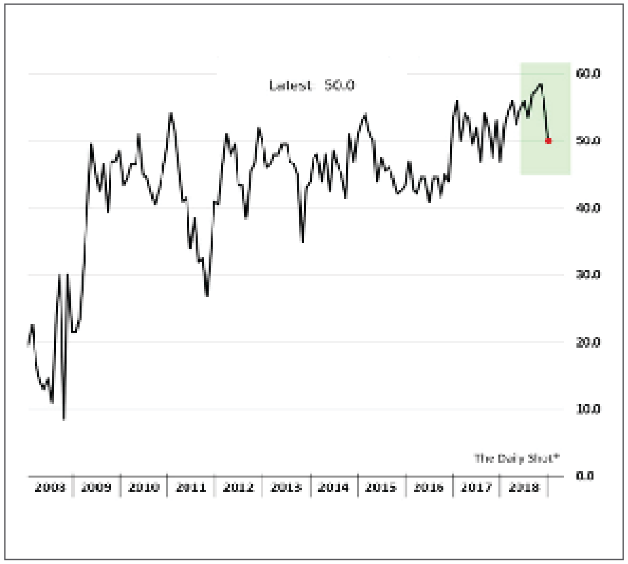
Evolution of Atlanta Fed GDPNow Real GDP Estimate for 2018: Q4 Quarterly percent change (SAAR)



Retail Sales Ex Food Services, Autos, Build Materials & Gas MoM% (Control Group)



Bloomberg U.S. National Economic Expectations

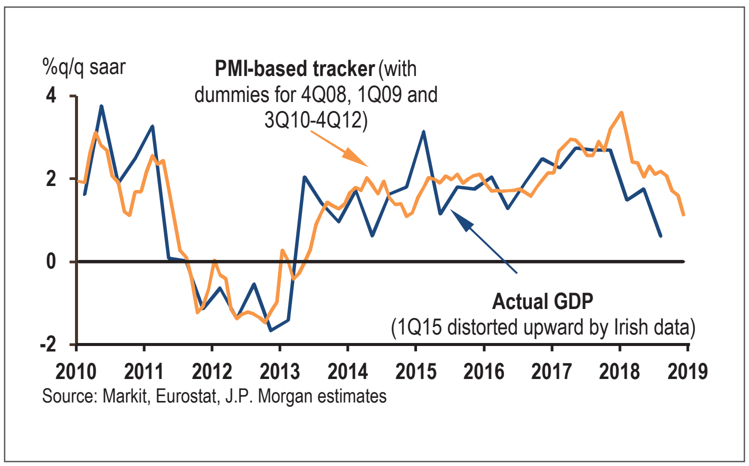


Europe

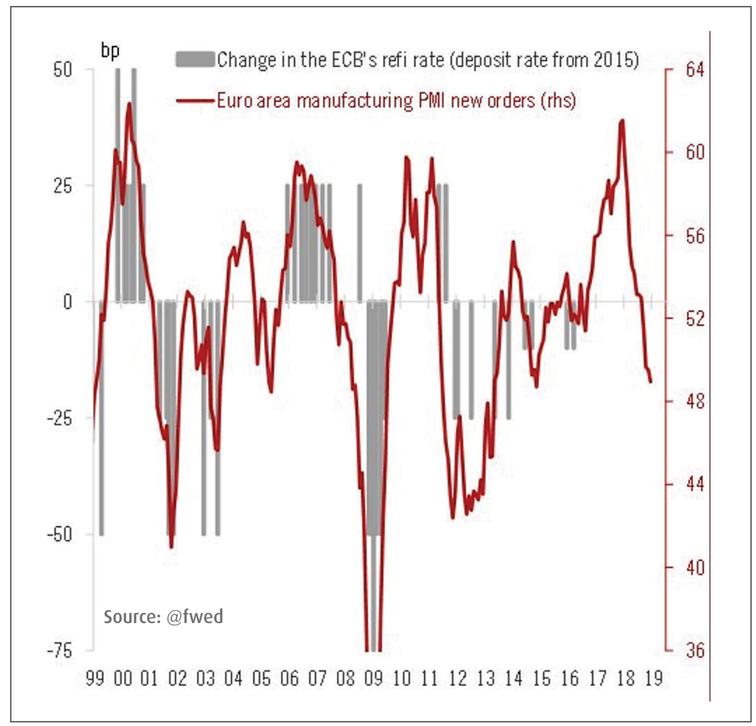
Euro-zone growth slows on Brexit uncertainty and regional geo-political concerns

- GDP growth for the Euro-zone in 2019 is projected at 1.6%, down from recent consensus estimate of 2.0%. Concerns over Brexit, fiscal tightening in Italy, protests in France and the drop in auto sales from Germany are taking their toll on growth.
- The composite Purchasing Manager's Index show worsening economic conditions in Europe for manufacturing and services.
- The decline in the Eurozone's new manufacturing orders (a component of the PMI index) has been particularly sharp.

Tracking Euro area GDP Growth with the PMI



Euro Area Manufacturing and PMI New Orders

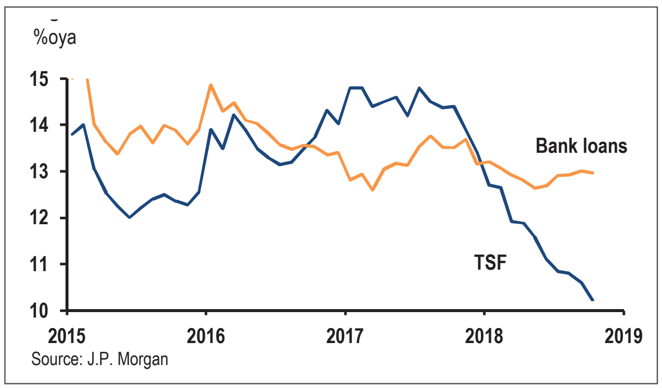


Asia

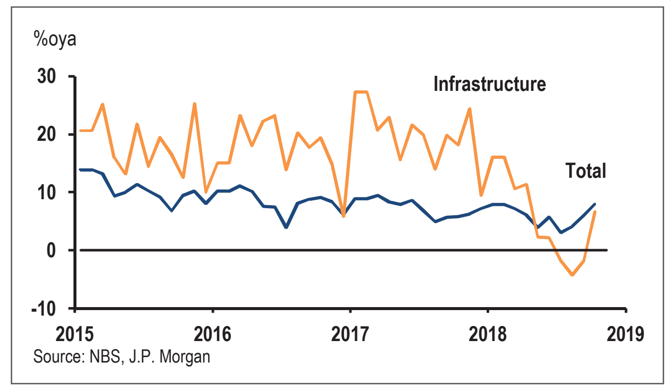
Asia growth supported by fiscal stimulus in China and revival in Japan

- Economic growth in Asia should be supported by the projected 6.2% GDP growth from China in 2019, down from 6.6% in 2018. The slowdown in the real estate sector and industrial production should be offset by infrastructure spending, tax cuts and easing credit conditions.
- Economic projections for China assume a resolution to the U.S./China trade dispute and no ill effects from the high debt/GDP ratio.
- For Japan, economic growth is projected to remain stable at 1.0%, as there should be a rebound from the growth volatility seen in 2018 due to poor weather and natural disasters. Consumption could take a hit later in the year as the increase in VAT will be implemented in October.

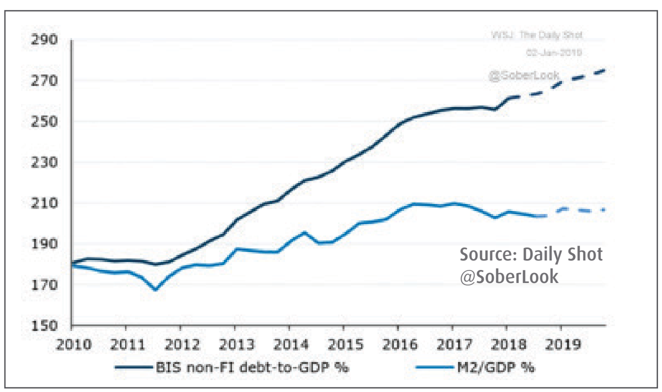
China Credit



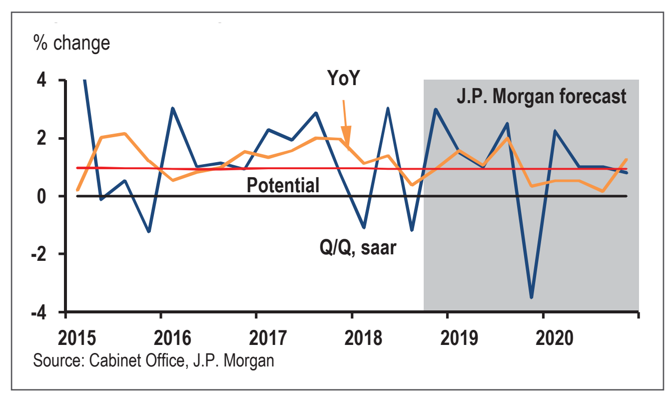
China Fixed Asset Investments



China Debit to GDP Ratio



Japan Real GDP Growth Forecast



Emerging Markets

Emerging Market growth solid with lessening of U.S./China trade tensions and a drop in oil prices boosts consumption

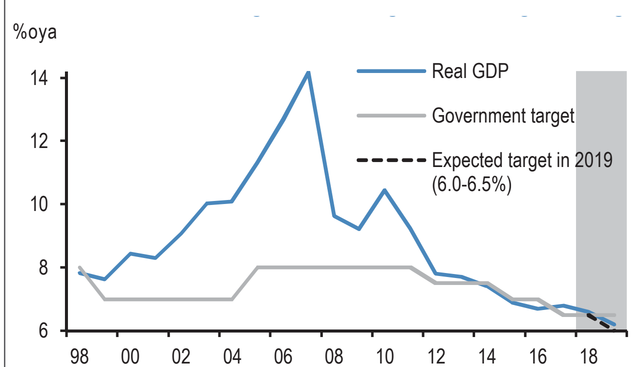
- Emerging Market growth is projected at 4.5% in 2019, helped by easing trade tensions between the U.S. and China and potential positive contributions to China growth from lower individual taxes (supports consumption growth) and a lower CNY (boost to export growth.)
- China is fostering goodwill with the U.S. by increasing the purchase of U.S. goods and making positive comments regarding loosening restrictions on foreign banks. China is also revising its patent laws and enforcement in IP protection to help meet government targets for GDP growth.
- Decline in oil prices has lowered EM inflation, which should boost household purchasing power and EM growth.

Real GDP Growth Forecast

	Real GDP %oya			
	2018	2019	2020	Potential
Developed markets	1.2	2.0	1.6	1.4
Emerging Markets	4.8	4.5	4.6	4.7
EM Asia	6.0	5.7	5.6	5.8
EMEA EM	2.8	1.9	2.5	2.5
Latin America*	1.2	1.8	2.2	1.9

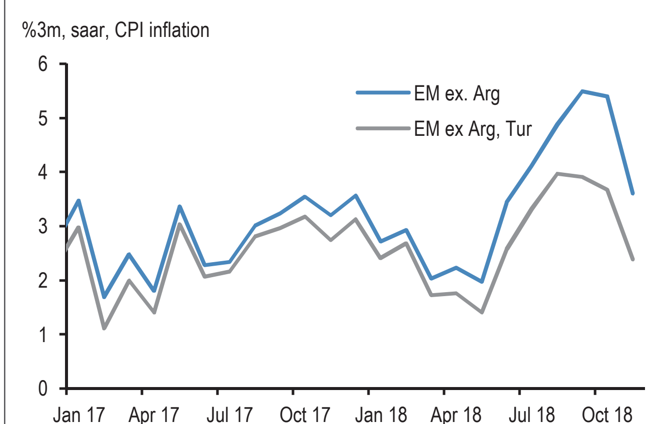
Source: J.P. Morgan

China Real GDP Growth vs the Government's Growth Target



Source: NBS, J.P. Morgan

EM CPI Inflation



Source: J.P. Morgan

Best Ideas – Finding positive returns in market pricing in a global recession

- Global market sentiment heading into 2019 is being shaped by not only fundamentals and geo-political issues, but also by behavioral factors.

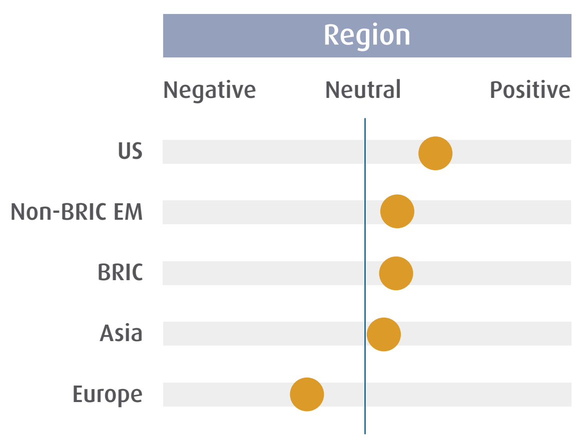
  Despite the backdrop of solid economic fundamentals and corporate earnings, investors are pricing global assets on par with a recessionary period. Global economic growth and corporate earnings are slowing from heights not seen in decades, but any sense of a decline is prompting investors to sell global assets with impunity. The predisposition of investors to sell has been prompted by continued uncertainty over global trade, geo-political issues involving "Brexit", France and Italy, China economic slow-down, and the path of interest rates in the U.S. The markets are also recovering from the liquidity high they have enjoyed since the Great Recession, as the Fed, ECB and BOJ will be winding down a total of $14.3 trillion of balance sheet assets. The selling of assets which begun in October, has led a majority of assets into correction if not bear market territory. According to the latest Deutsche Bank global asset report, of the 70 major global assets they track, well over 90% posted negative returns in 2018.

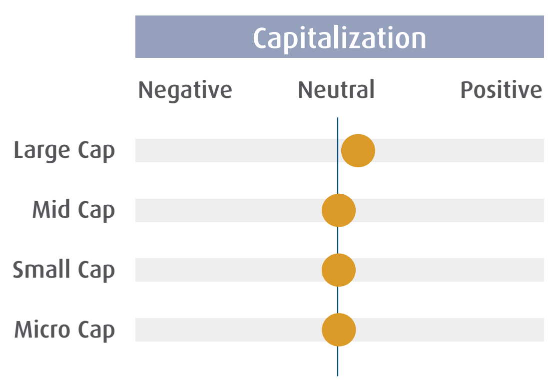
- The sharp decline in global asset prices has created attractive valuations across asset classes not seen in years. As long-term investors, we may be able to take advantage of these pricing dislocations, to generate positive returns in 2019. Within the projected investment environment, selective and active management will be crucial as global equities should provide a mid to high single digit return. Value can be found in IG and Emerging Market debt in light of recent spread widening. Commodities will be mixed, while hedge funds and real assets can serve to lower equity beta and serve as a fixed income surrogate, while insulting portfolios from duration and downside equity market risk.

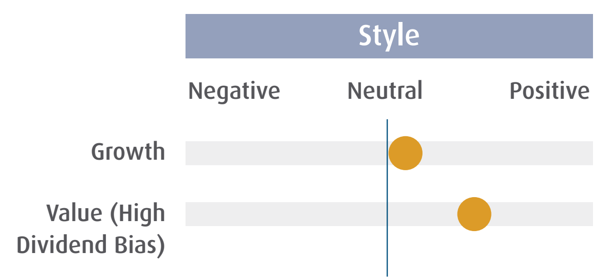
Equities

Selective Opportunities in U.S., Emerging Markets, Quality and Value

- Global equities should post positive returns, as earnings in the U.S. and EM should remain stable, and valuations are cheap.
- U.S. Quality and Value are preferred due to solid balance sheets and stable earnings, versus momentum and growth. U.S. equities per the S&P 500, are trading at a forward P/E of 14.3, below the five year average of 16.4. FactSet estimates EPS growth of 7.9% for 2019.
- European equities will see a deceleration of corporate earnings to mid-single digits and face several geo-political headwinds.
- Emerging markets are attractive selling at a forward P/E of 10.6. We expect that China will continue to re-ignite its economy and positive sentiment is emanating out of Brazil after the recent elections.
- Risks to our recommendations include: a pro-longed U.S./China trade dispute, a policy over reach by the U.S. Fed that would cause a re-rating global equity valuations, and a decline of investor sentiment causing a large exodus from the equity markets.



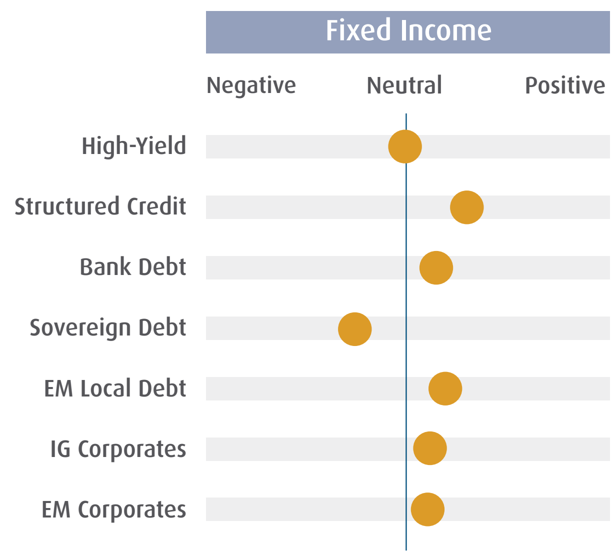




Fixed Income

Rate Normalization Poses Risk to Core Fixed Income, Opportunities for Securitized Credit

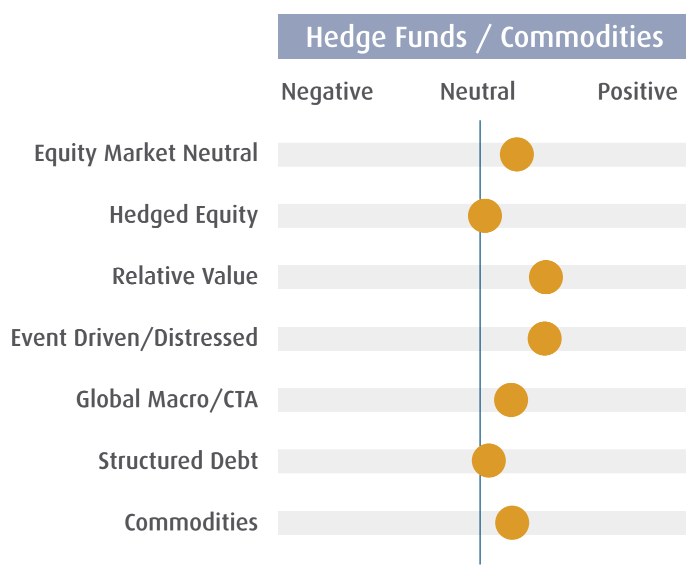
- The U.S. Fed, the BOE and ECB are on the path of policy normalization; we have seen recent spread widening in investment grade and HY, all of which provides investors with a higher starting point yield and higher return from fixed income in 2019.
- In the U.S., strong employment and consumer confidence provides a positive backdrop for securitized credit in non-agency MBS and ABS. Short duration floating rate IG corporate debt is attractive for yield pickup and to hedge duration risk. We favor an upgrade in quality and seek opportunities to selectively add duration as rates normalize and stabilize.
- In Europe with the halt of bond buying by the ECB and rates to move higher by Q3, duration is neutral with preference for higher yielding peripheral bonds from Ireland and Portugal.
- In Emerging Markets, economic fundamentals are stable, though there is always some geo-political risks (Russian sanctions, power struggle in Turkey), the recent spread widening has pushed EM debt yields to attractive levels.



Hedge Funds/Commodities

Favor Long/Short U.S. and Europe, Event Driven/ M&A and Relative Value Fixed Income

- Discretionary Macro should benefit this year due to geo-political uncertainty, divergence in economic growth between developed and emerging market countries, and desynchronization of central bank policy.
- Event should thrive in 2019 after seeing over $4 trillion in M&A deals in 2018. M&A activity from a capital perspective should be bolstered by corporate cash repatriation and P/E funds that have record levels of capital to deploy.
- Relative Value Arbitrage should benefit this year as the pickup in volatility and the sustained level of higher volatility should create opportunities in relative value, fundamental equity and fixed income trading.
- In Commodities, we believe there is upside potential in oil. The eventual resolution of global trade disputes and the stabilization of economic growth should raise energy demand, coupled with a coordinated decrease in production by OPEC. Gold is attractive as it serves as a hedge against a financial crisis.



Private Equity/Real Estate/Direct Lending

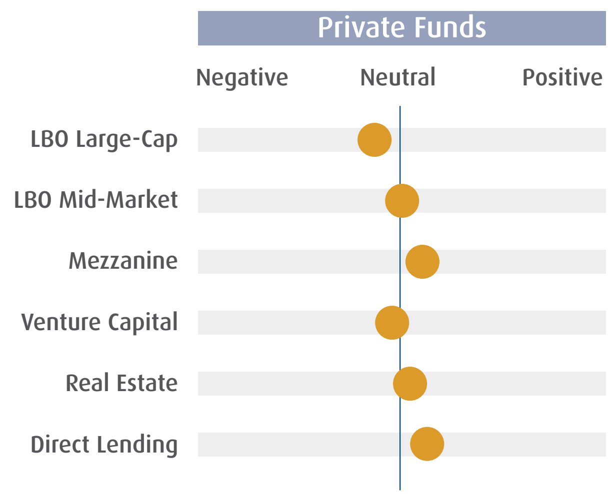
Infrastructure, Value Add and Niche Real Estate

- Private equity has seen a rise in valuations to high levels due to competition from private equity managers, strategic buyers and new investors in the market, seeking above market yields and return. This has caused quality assets to trade at EBITDA multiples in the mid-teen range. High valuations and recent turmoil in public markets lowers P/E expected returns.

- The eventual rise in inflation makes investment in infrastructure attractive, as infrastructure companies in many countries such as electric, water and transportation, can change rates that are partially or completely tied to the rate of inflation.

- We are cautious on real estate, as the rise in U.S. rates has reduced the spread between cap rates and the 10-year U.S. Treasury yield. To drive NOI (net operating income) growth, investors should seek core plus strategies in best in class assets in high rental growth markets that generate returns by taking short term lease risk.

- Industrial properties can provide attractive returns as occupancy is high, rental rates are rising, and strong demand is emanating from the growth of Ecommerce. Senior housing is attractive due to the aging demographics in the U.S.



Timothy C. Ng, Chief Investment Officer

Tim joined the firm in 2010 and is Chief Investment Officer and Head of the Clearbrook Investment Committee. Within this role, Tim is involved in global macro and manager research, portfolio analysis and risk management. Prior to Clearbrook, Tim was President and Chief Investment Officer of Structured Investments Group, LLC. He began his career in 1982 and has served as an alternative investment and hedge fund advisor in numerous capacities. Previously, Tim was a Managing Partner with Access International Advisors and has held the title of Senior Vice President in varying roles at Prudential Securities, Smith Barney, and Oppenheimer & Company. During his career, Tim was one of the first advisors to place investor capital into hedge funds, portable alpha portfolios, structured/hedge fund linked notes, and insurance dedicated hedge fund products. He has had oversight of more than $5 billion of investor capital on behalf of corporations, pension funds, endowments and foundations, banks, investment advisory firms, and family offices. He has been a holder of securities licenses Series 3, 7, 24, 63 and 65. Tim received a BA in Economics from Stony Brook University and an MBA with honors from Long Island University.

Mark N. Hong, CFA, Managing Director, Head of Research

Mark joined Clearbrook in 2010 and is a Managing Director and Head of Research at Clearbrook, responsible for manager research, capital markets research, due diligence, structured finance and corporate analysis. Prior to Clearbrook, Mark was co-founder and Principal of Structured Investments Group, LLC. Previously, Mark held several roles at Sands Brothers & Co., Ltd., serving as a Vice President in their asset management division, where he was a member of the firm's Investment and Manager Selection Committees. Mark also served as Director of Research and Vice President of their Critical Capital Growth Fund, LP, where he completed several senior secured and mezzanine debt transactions. During his career, Mark has been involved in the sourcing, evaluation, structuring, financing, and monitoring of numerous transactions. Before joining Sands Brothers, Mark served as an Analyst with Prudential Financial's Asset Management Division, where he supported the investment grade corporate trading desk. He is a CFA Charterholder and is a member of the New York Society of Securities Analysts and received a BBA in Financial Engineering from James Madison University.

Contact Us

We'll help you make sure you're not just sourcing, but **Rightsourcing**^{sm} the management of your investment portfolio. Clearbrook can help you objectively evaluate your needs from total-portfolio to asset-class-specific solutions. Our solutions are flexible, transparent and customizable, structured at a level that makes sense for your resources, objectives and risk tolerance.

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