AEPG WEALTH STRATEGIES

INVESTMENT COMMENTARY
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Is this a "Buy the Rumors, Sell the News" Moment?

By: Gary Quinzel, Vice President, Chief Investment Officer

- **U.S. and China move closer towards a trade deal, but it appears the good news is already priced into the market.**
- **The probability of a Hard Brexit is rising as we get closer to the March 29 deadline.**
- **What indicators we are watching right now: 10-year versus 2-year Treasury Spread, unemployment claims, wage growth, and the Leading Economic Indicator components.**
- **While a recession this year is looking less likely, we might experience more volatility based on slowing growth and other geopolitical events.**

What Piqued Our Interest

The market has largely recovered its losses following a steep December drop-off, based primarily on optimism of a U.S.-China trade deal. While the two largest economies in the world are in the final stages of securing a deal, much skepticism remains regarding several structural issues. It appears for now that China has offered to lower tariffs and restrictions on U.S. farm, auto, and other products, while the U.S. will remove most of the tariffs levied against China last year. China has also pledged to help "level the playing field" by removing some foreign ownership limitations, and to step up their overall purchase of U.S. goods. However, what appears to be missing from the deal are details about intellectual property theft, and Chinese subsidies to state owned properties, not to mention the question of enforceability. It is evident that both President Trump and President Xi are anxious to make a deal; Trump to prop up the markets before his next reelection campaign, and Xi to legitimize China's place as an economic superpower. Regardless of who "wins" the negotiations, the markets in general can breathe a sigh of relief once a deal gets done. ***But this pause may be short lived, and the benefits of the trade deal have already been priced into the market***. In a prototypical "buy the rumor, sell the news" moment, the market climbed relentlessly in February, right up until March 3 when news of the trade agreement was released. Also, as we bore witness to Trump's unsuccessful summit with North Korean leader Kim Jong Un, we know not to assume a deal is made before its done.

When the U.K. invoked Article 50 which began their withdrawal process from the European Union, the March 29, 2019 deadline seemed like a distant and sufficient timeframe to negotiate Britain's exit terms. After Prime

Minister Theresa May's failure to win Parliamentary approval of her exit treaty with the EU, they now have less than a month to figure things out. The risk of a "No Deal Brexit" is growing by the day, which could be devastating for commerce and travel between the U.K. and the Euro Area. Other options include extending Article 50 (which May has proposed but needs to be approved by all EU leaders) or holding a second referendum allowing residents to vote again on leaving the union. All options have their own hurdles amongst a deeply divided government (sound familiar?) as calls for a second referendum are coming from the opposing Labour party. Three votes are planned on March 12-14th, first on an amended withdrawal agreement which we believe will likely fail. The next vote on the 13th is key as Parliament will vote on a no-deal Brexit, which as we mentioned could be disastrous for both U.K. and Euro Area stocks. Finally, if both of the previous votes are rejected, they will vote on whether to ask for an extension. A delay might be the most likely scenario, but regardless there might be additional volatility leading up to and after these key votes.

Market Review

Equities in general turned out another strong month in February, although the markets have pulled back a bit after stalling at the 2,800 level. The S&P 500 is now up over 11% for the year, while small-cap stocks have climbed more than 16%. Industrials have been the leading sector (+16.1%), followed by Energy (+14.1%) and Technology (+13.6%). Trailing sectors include the traditionally defensive industries such as Healthcare (+4.4%), Consumer Staples (+6.3%), and Utilities (+7.8%), although all of those returns are very respectable over a two-month timeframe. From a style perspective, Growth stocks have continued to outperform Value stocks by a subtle margin (+12.3% vs. +10.2%), as the return of risk-taking has ultimately benefitted cyclical stocks. Volatility has receded significantly in 2019, as the VIX index is now at 16.5, down from about 25 at the start of the year, and well below the 15-year average of 19. Turning our focus to the foreign arena, the U.S. is still besting both developed and emerging international stocks, but overall the All Country ex-USA index is still up an impressive 9.6% year to date. Returns have been fairly consistent across both Europe and Asia-Pacific, with most countries posting high-single digit returns. Chinese A-shares have risen almost 32%, but it should be noted their index was also down by the same percent last year.

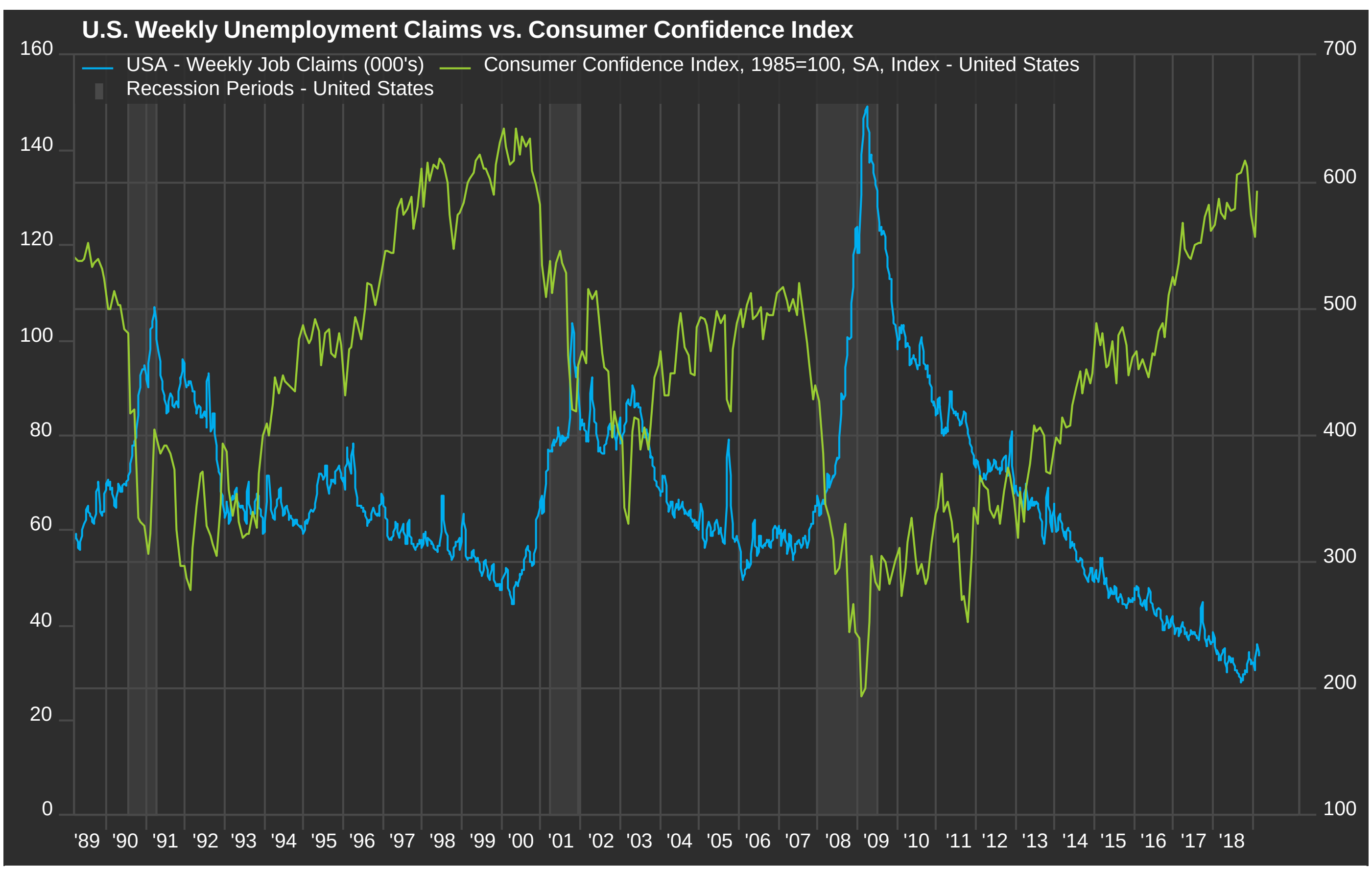
In fixed income, the yield on the 10-year Treasury is largely unchanged from where it started the year around 2.7%. The U.S. Aggregate Bond Index was virtually unchanged in February and is up just 1% year to date. While returns on treasuries have been lackluster, high yield corporate bonds have staged two consecutive impressive months and are now up over 6% on the year. In a reversal from last year, the spread between high yield bonds and 10-year treasuries has tightened from 2.38% to 2.26% implying easier credit conditions. Leading up to prior recessions and bear markets, this spread has been a somewhat reliable leading indicator as high yield spreads generally widen prior to major equity selloffs. For now, it seems that spreads could

Index Name	1 Month	YTD	1 Year
S&P 500	3.14	11.36	4.05
Russell 2000 (Small Cap)	5.16	16.97	5.17
Russell 3000 (All Cap)	3.45	12.29	4.46
MSCI AC World ex USA	1.95	9.66	-6.46
MSCI EAFE (Developed Intl)	2.55	9.29	-6.04
MSCI EM (Emerging Markets)	0.22	9.00	-9.89
Bloomberg Barclays US Aggregate Bond	-0.06	1.00	3.17
Bloomberg Barclays US High Yield - Corporate	1.66	6.26	4.31
Bloomberg Barclays Municipal Bond	0.54	1.30	4.13
Bloomberg Barclays US Short Treasury	0.19	0.42	2.12
Bloomberg Commodity Index	1.01	6.51	-5.67
MSCI US REIT INDEX	0.60	12.39	19.80

Total Return Performance through February 28, 2019. Source: FactSet tighten further based on ideal fundamentals, low default rates, and decreasing trade concerns. On the tax-exempt side, the broad municipal index is now up 1.3% on the year. Muni yields are currently priced around 75% of comparable treasury yields, which is in-line with long term averages and implies that they are neither cheap nor expensive relative to past history.

AEPG Perspective

The spread between long term (10 year) and short term (2 year) bonds is now down to just 0.20%, as we move ever closer to an inverted yield curve. We believe there is a fairly high chance that we see the curve invert later this year, which historically has preceded recessions by several months, if not longer. As we have mentioned in the past, like the spread of high yield bonds over treasuries, the yield curve has been a predictable leading indicator prior to economic recessions. However, we never look at any one indicator in isolation, as we are also closely following several other measures including the consumer confidence index and weekly unemployment claims, amongst others. Consumer confidence peaked back in November, and then dropped by 11.75% before rebounding in February. We have also witnessed unemployment claims steadily decline ever since the height of the financial crisis, reaching as low as 209,000 last Fall before edging higher. Like the yield spreads referenced, these measures usually reverse prior to a recession, ***but the question looms whether last quarter was just a head fake or the start of a new trend.*** When one factor reverses for good it is likely the others will follow, at which point we would expect to be months away from the next economic downturn. We have also referenced the Conference Board's Leading Economic Indicators Index several times in the past, which is still near its multi-decade high but has stalled the past several months. Several components of the index turned negative last month, including average weekly manufacturing hours, as well as unemployment claims and consumer expectations. However, the results were mixed, as stock prices, manufacturer's new orders, and the leading credit index all increased. Finally, we're also closely monitoring U.S. wage growth, which has grinded its way higher to 3.4% annual growth. Wage growth is a key contributor to overall



inflation, and historically has reached 4% prior to past recessions.

While things don't look quite as bad as they did just a few months ago, we still believe that we are nearing the end of this market and economic cycle. In its latest economic outlook, the OECD downgraded their projection for global growth to 3.3% for 2019, down from 3.5%, and lowered their projection for 2020 as well. Corporate earnings expectations in the U.S. have been lowered as well. Obviously, much depends on how the U.S.-China negotiations end up, and whether the U.S. decides to extend the trade war to Europe or beyond. On the positive side of things, inflation remains well in check, helped by cheaper oil prices and slowing growth concerns. This may in fact help elongate the cycle by keeping rates lower for longer, just as we recently heard that Europe will now hold rates steady till 2020 or longer and announced a new round of long-term loans to eurozone banks. Here in the U.S., it seems more likely that rates will hold steady for the rest of the year, which would certainly benefit U.S. equities and bonds alike. However, ***there are several upcoming geopolitical events which could create future volatility***, as we cannot dismiss the possibility that the trade deal falters, the upcoming results of the Mueller investigation, multiple Brexit outcome scenarios, and of course the 2020 election cycle.

For now, our thesis remains consistent: We believe that U.S. equities are still the most attractive asset class overall, but we are more cautious towards the latter half of the year as we feel the cycle may be coming to an end. Our style allocation has moved from overweight growth to neutral and will likely rotate towards value in the coming months. In fixed income, we will likely move out in duration where we have remained short for the past several years. We like corporate credit in the short run, but also have an overweight to AAA bonds for protection against equity volatility. While it has been pleasant to witness the sharp reversal of last year's selloff, we will continue to focus on high quality and more conservative investments as we prepare for the next market downturn.

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