Economic & Capital Market **Outlook**

WINTHROP CAPITAL MANAGEMENT

Second Quarter 2019

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By most measures, the first quarter of 2019 has been a great quarter for financial assets. The S&P 500 has rallied close to its all-time peak. The expectation that the Fed will continue to be accommodative has provided fuel for stock prices, which are increasing in the face of a deceleration in earnings. *However, with economic data showing signs of a slowdown and volatility declining, we are moving to reduce risk in portfolios.*

We have three general themes for the Second Quarter of 2019:

1. A general slowdown in economic growth will persist, and it will be compounded by slower earnings growth
2. The ultimate resolution of the U.S. – China Trade issues will be a positive for the economy and markets. However, there is no going back to the way things were. The trade issue is really a symptom of a bigger issue, which is the underlying economic war and challenges that China brings to free market capitalism.
3. The slowdown in Europe, which is complicated by Great Britain's complex divorce from the European Union, will persist through the first half of the year.

We are still early in the reporting season; however, first quarter earnings are coming in pretty much as expected. Generally, earnings for Financials have been strong with the exception of Goldman Sachs and BNY/Mellon. However, we expect a decline in the pace of earnings growth for the quarter.

Our second theme for the quarter is the ultimate resolution of U.S. China – Trade. We are expecting the grand resolution may be pushed out to early June, but meaningful progress is being made on issues around trade. However, this is not a trade spat. This is an economic war. China is actively competing for major infrastructure projects around the world and offering the financing to fund them. Picture a world where China can sell a competitive plane to Boeing and Airbus, has a military jet fighter that Middle Eastern countries would be willing to buy, and can offer 5G technology cheaper than the United States. We don't think this is out of the realm within the next decade.

Finally, there is Brexit. Great Britain has been able to earn an extension to its March 29 deadline. However, Theresa May has to navigate the chaos in her own government, the will of the people of Great Britain, and the growing impatience of the European Union. If a deal could not be coordinated over the past two years, we do not believe that a deal will be agreed upon in this overtime play either. The unintended consequence of the dithering is the economic slowdown in Europe. Draghi has indicated that the ECB will continue to provide accommodative monetary policy, including low cost loans to the European banks to help stimulate loan growth.

The challenge for investors is that, at elevated valuation levels, expected returns are going to be muted and correlations between asset classes will increase. Given the strong rally in financial assets during the first quarter, our preference based on current valuations is to reduce risk in portfolios.

Economy is Still Growing – Albeit Slower than Expected

We expect GDP for the first quarter to come in near 1.7%, much slower than the pace we were seeing last year. The economy benefited from the change in tax policy in 2018; however, most of that surge has already been realized. There are several barriers to continued economic growth, such as Brexit and the uncertainty over trade policy, which will impact the economy through the first half of this year. Still, once these issues are resolved, we expect the domestic economy will be slow to respond and growth will remain muted.

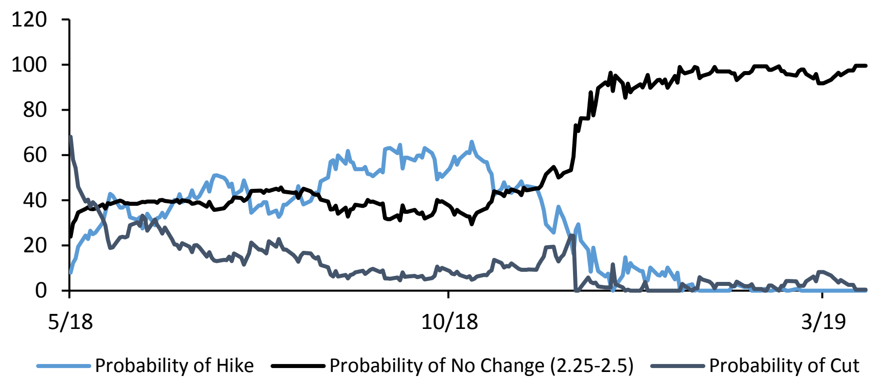
Manufacturing output has been generally flat in March as Federal Reserve data for the first quarter showed a decline at an annual rate of 1.1%, and industrial production declined 0.1% in March. Manufacturing has been a solid contributor to economic growth since the Financial Crisis; however, the lack of investment and soft demand is weighing on the sector.

Existing home sales declined 4.9% in March despite marginally lower mortgage loan rates and a healthy job market. In addition, housing starts declined 0.3% over the prior month in March, underscoring a growing weakness in the economy.

Fed Not Expected to Change Rates

The Federal Reserve released minutes from their March meeting last Wednesday. The tone of the minutes appeared accommodative, and the Fed indicated that they expected to keep the level of short term interest rates unchanged for the remainder of the year.

Probability of Fed Rate Hike by Dec '19 (%)



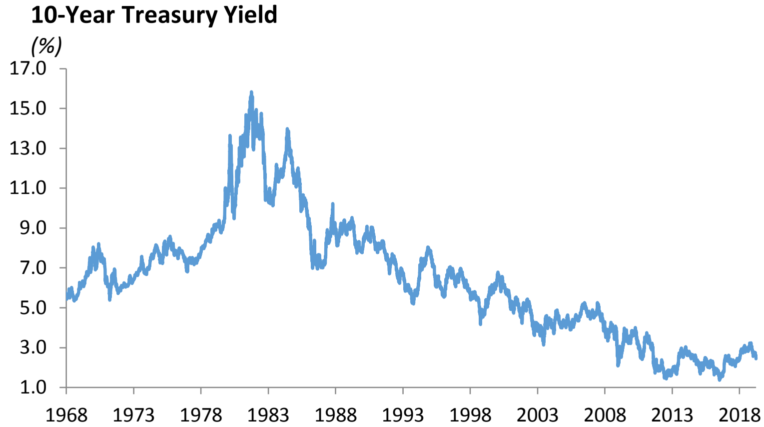
Source: Bloomberg

While there is some improvement in China's economic activity and parts of Europe, the global slowdown will likely keep the Fed monetary policy on a wait-and-see mode. We would expect the stimulus that China infused into its economy last year to begin to take effect. This includes low cost loans to Chinese banks and incentives to boost their housing market. A resolution to China – U.S. trade will likely push manufacturing output higher. *Any improvement in China's economic growth will marginally help push domestic growth rates higher.*

The Fed appears patient and comfortable with current policy. *We expect interest rates to remain unchanged for the remainder of the year, and the next move will be to lower rates.*

Fixed Income

The fixed income markets have been fairly quiet over the last month. Interest rates have traded in a tight range and volatility has been declining.



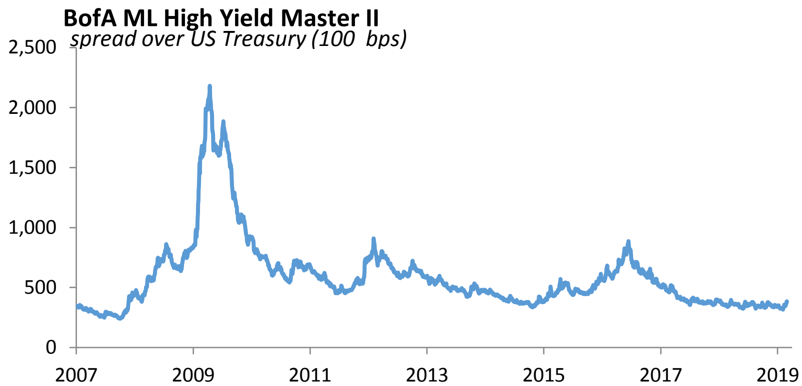
Source: Federal Reserve

With the decline in volatility, investment grade spreads have trended toward tightening. Strong domestic demand for credit and active Asian buyers have helped provide technical support. New issuance supply continues to be lighter than last year with month to date issuance at $70 billion. New issuance is 2.3% lower than it was at the same time last year.

Over the past several weeks, we have become more defensive in our total return bond portfolios as spreads continue to grind tighter. We sold positions in higher volatility credits, such as Vodafone and Telefonica, and we bought US Treasuries in an up in quality trade. Admittedly, we are finding new ideas in the investment grade space harder to come by in this rally, which is typically a sign that markets are becoming rich.

High Yield

The ICE BofA/ML High Yield Index tightened 18 bps to finish at an option-adjusted spread of 368 bps. This marks the tightest levels since November 2018. The high yield sector posted strong performance last quarter as the Index is currently sitting 165 bps tight to its year-end 2018 levels. Last week, high yield credit generated 0.57% of total return. Positive performance was led by the risk tiers. CCCs tightened 70 bps, while B's and BB's tightened 66 bps and 46 bps, respectively. This is a reversal from the BB outperformance that we saw through March. YTD total return for the Index is 8.58%. High yield fund flows have remained positive for the fifth consecutive week with inflows of $655 million.



Source: BofA Merrill Lynch

New issuance in the high yield market has been fairly quiet. With supply being slightly starved, we expect high yield spreads to continue to compress minus some unforeseen geopolitical event.

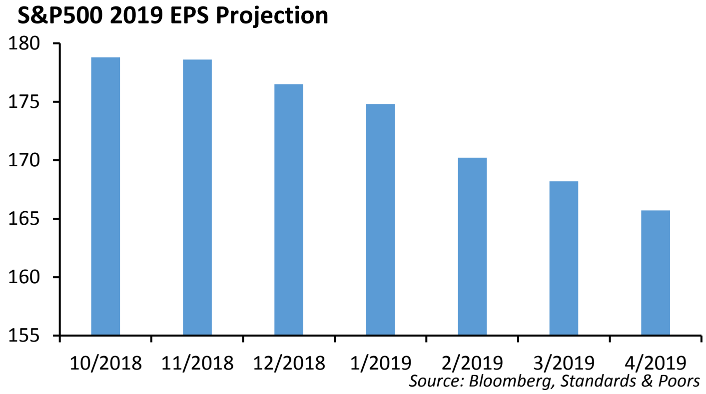
Look for developments in earnings in the coming weeks. With high yield bonds more correlated to equities than their investment grade counterparts, overall weak earnings could spell trouble for the high yield market. Generally, companies attempting to offset weaker earnings with changes in capital allocation, such as increased dividends or share buyback programs, will weaken balance sheets at the margin. The cumulative effect could have material negative effects on the overall high yield market. We continue to favor the BB space over CCCs as we are seemingly in the late innings of the credit cycle.

Equities

It was a quiet week for the S&P. It closed at 2905 and is still up 15% for the year, sitting less than 1% off highs. Of the companies in the S&P 500, 15% have reported results for the quarter. Of those, 78% reported positive earnings surprises, and 53% reported positive revenue surprises. If the S&P hits its projected earnings decline of -3.9%, it will be the index's first year over year decline in earnings since earnings fell 3.2% in the second quarter of 2016. The forward 12-month P/E ratio for the S&P 500 is 16.8x, which is above the 5-year average of 16.4x and the 10-year average of 14.7x.

Looking at reported sector earnings so far, the majority of companies in the following sectors have reported earnings above their estimates: technology, healthcare, communication services, and materials. In the energy sector, however, only half of the companies have exceeded their earnings expectations so far.

This will be a busy week in the earnings season, as 150 S&P companies are scheduled to report.



In IPO news, Zoom Video Communications (ZM) and Pinterest (PINS) both had their IPO's last Friday. ZM was up 72% at the end of trading day while PINS was up 28%. Micro cap company Zoom Technologies was up 80% at one point in the trading day in a case of mistaken identity (ticker ZOOM). Look for UBER to launch terms into next week, and to break $100B in valuation. The IPO market will be an additional catalyst for investor enthusiasm.

The healthcare sector continues to be under pressure, specifically healthcare insurers. UnitedHealth beat on both top and bottom line, and they raised FY year guidance. Its stock price tells a different story, however, as shares are now down 25% from recent highs due to noise from the Medicare for All concept. If there's a belief that this concept can take shape, then the market reaction is justified. However, if Medicare for All never becomes a law, there is an opportunity of a play on a stock with sound fundamentals.

Retail sales for March jumped 1.6%, solidly beating expectations of 0.9%. After negative sentiment from the -0.2% decline in February and an expectation for a Q1 consumer spending slowdown, the health of the consumer still appears strong.

Last week also revealed hopeful signs for the global economy, specifically China. China's Q1 GDP beat expectations with 6.4% Y/Y growth, March retail sales came in at 8.7% Y/Y, and industrial production was 8.5% Y/Y. These numbers have great implications for Asia, emerging markets, and the global economy, as we continue to monitor further upside surprises.