Economic & Capital Market **Outlook**

WINTHROP CAPITAL MANAGEMENT

Fourth Quarter 2019

Gregory J. Hahn, CFA
ghahn@winthropcm.com
317.663.7510

Adam Coons, CFA
acoons@winthropcm.com
317.663.7502

Lance Bertsch, CFA, FRM
lbertsch@winthropcm.com
317.660.7257

Freddy Lavric
flavric@winthropcm.com
317.663.7505

Charles Kovarik
ckovarik@winthropcm.com
317.663.7503

www.winthropcm.com

Over the past several weeks, there has been movement on both Brexit and the resolution of U.S. – China trade dispute. These have been two major structural impediments to global growth. We are changing our base case outlook to consider the resolution of both trade issues and Brexit in the 1Q 2020. This is not meant as endorsement on a positive outcome for either, but rather, a belief that resolving these barriers will lead to fixed investment, consumption and economic growth.

1. We are expecting domestic economic growth between 1.8% and 2.0% for 2019. However, massive global central bank stimulus combined with lower interest rates and progress on Brexit and U.S. – China Trade issues are enough for us to revise our outlook upward for global growth in 2020. While the current slow growth environment will help keep interest rates low, we may begin to see rates bottom as expectations for growth increase.

2. Global central banks have shifted to a more accommodative tone during the past year. This year's shift toward monetary stimulus contrasts policy theme in 2018, when the Federal Reserve was pushing interest rates higher and the ECB had ended its Quantitative Easing program. A more stimulate monetary policy will serve as a catalyst for global growth. *However, we expect the Fed will take a pause in its move to lower rates by December to reassess the need to reduce rates further.*

3. Corporate earnings are coming in stronger than expected; however, earnings growth will remain under pressure as revenue growth slows and profit margins are pressured over the near term. We still expect labor costs to be scrutinized in the fourth quarter, and we expect an increase in lay-offs to support operating margins. The rosy employment market, which has been the strength in the recovery, will likely deteriorate by the end of the year.

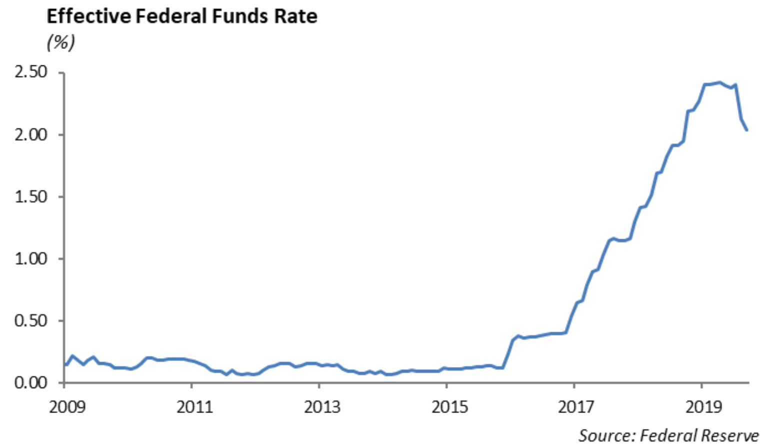
4. The trade war with China has contributed to the slowing domestic economic growth rate. We expect that Trump wants a trade deal nailed down with China heading into his re-election campaign in 2020. Recently, President Trump and Chinese President Xi Jinping agreed to renewed trade talks; however, it is not clear how substantive these talks are. Discussions include lowering U.S. hostile initiatives toward Huawei and a commitment from China to buy large amounts of American agriculture products. Our base case is that a resolution to the U.S. – China trade dispute will result in increased fixed investment and provide stimulus to global economic growth.

5. Boris Johnson has a deal with the European Union for the United Kingdom to exit the E.U. The next step is to get it through the U.K. parliament. The deal includes Northern Ireland remaining part of the U.K. customs union, which would allow seamless trading with Ireland to remain. As Lloyd Christmas once said, *"So, you're saying there's a chance."*

6. Liquidity in the credit markets has been difficult at times over the past year. After a surge in new issues in the third quarter, we expect new issue volume to decline significantly heading into year end. At this point, we do not see a significant shift in the credit cycle; however, the seeds are planted for some deterioration in credit. Leveraged loans and commercial real estate are both drawing significant capital, and valuations appear excessive.

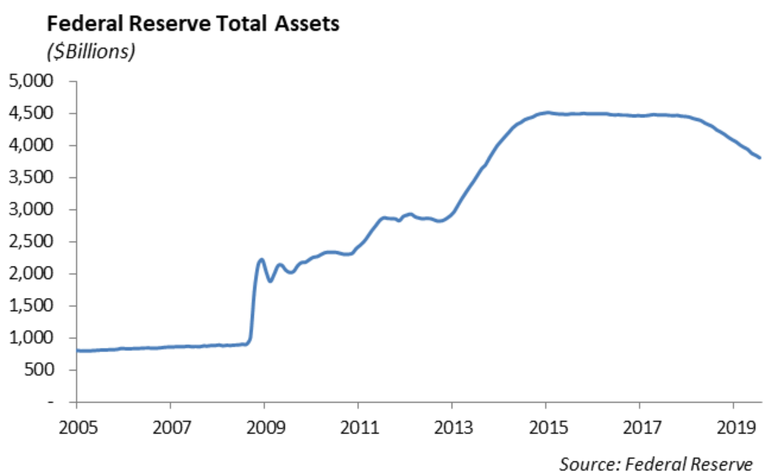
The Federal Reserve – We Expect a “Pause” in December

The Fed has hinted its concern that weaker business activity and investment could lead to slower hiring and consumer spending. The Fed has been on an accommodative push to lower rates in an effort to mitigate the impact of slowing global growth on the domestic economy. In addition, the Fed has signaled that it expects the economy to continue on a path of steady growth with the help of recent interest rate cuts. If there is meaningful progress in trade negotiations with China and a path is cleared for Brexit, we believe the Fed will pause its push to lower interest rates further in order to reassess the economic environment. This will put pressure on the 10 year U.S. Treasury, which has traded up to 1.75%



The Fed’s Balance Sheet

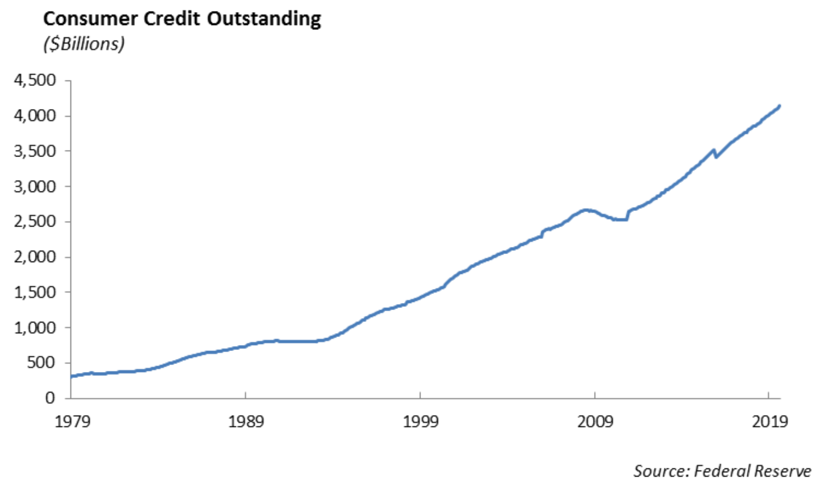
As the Fed has reduced the size of its balance sheet over the past two years, the reduction in the bond portfolio resulted in a reduction in reserves held at the Fed. The reduction in spare reserves that are used to support inter-bank lending resulted in the instability in repo rates last month. This week, the Fed announced an increase in monthly bond purchases of up to $60 billion per month in an effort to stabilize the short term lending market known as repurchase agreements. By growing the balance sheet, the Fed will only be buying short term Treasury Bills and without providing any additional monetary accommodation. The Fed will then adjust both the timing and amounts of bill purchases, and they might continue the buying into the second quarter of 2020. The additional liquidity aims to provide a backstop for the Fed to support repo rates and to maintain interest rates where they intend.



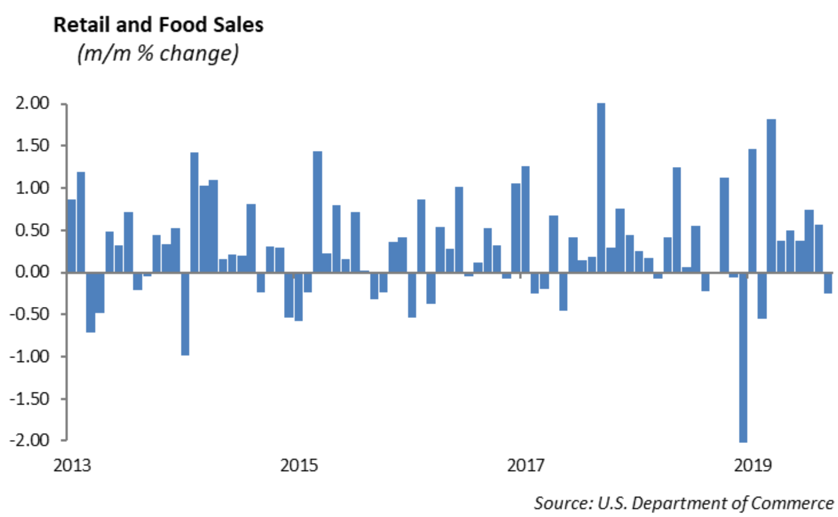
Economy – Expect a Shift toward Growth in 2020

We expect GDP for the year to come in near 1.8%, much slower than the pace we were seeing last year. Over the past year, the economy benefited from the tax reform in 2018; however, most of that surge has already worked through the economy. Now, there are forces that are working to counter the stimulus from the tax reform, including the uncertainty over trade policy with China, the concern over the disarray in Europe and Brexit, and the chronic bi-partisan politics affecting domestic policy initiatives. As each of these issues approach a more likely resolution, business investment and consumption should benefit. However, the global economy is slowing, and the domestic economy is showing signs of slow growth as well. In spite of a solid employee report last week, the manufacturing and service sectors continued to show signs of slowing last month.

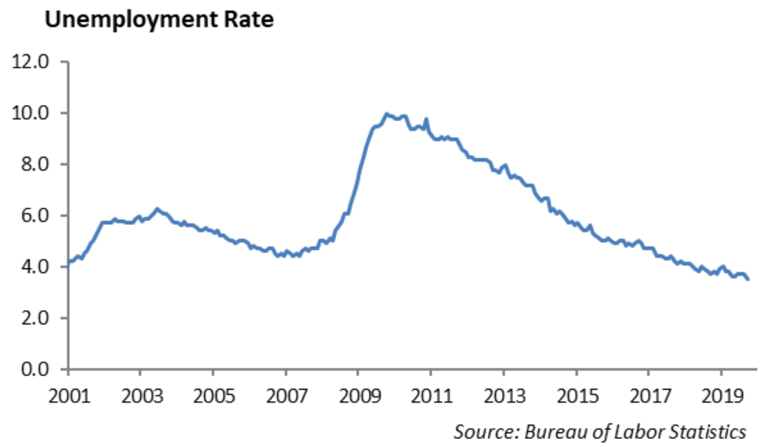
One issue that continues to be ignored is the significant growth in debt and the impact that it has on long term economic growth. Domestic debt is growing in all areas, including federal, state and local governments, student loans, credit cards, auto loans, and corporate debt.



Consumer spending is a major contributor to the domestic economy. Over the past year, we have seen evidence of some slowing in the consumer sector. The Commerce Department reported that retail sales in September fell by -0.3%, the largest amount in seven months.

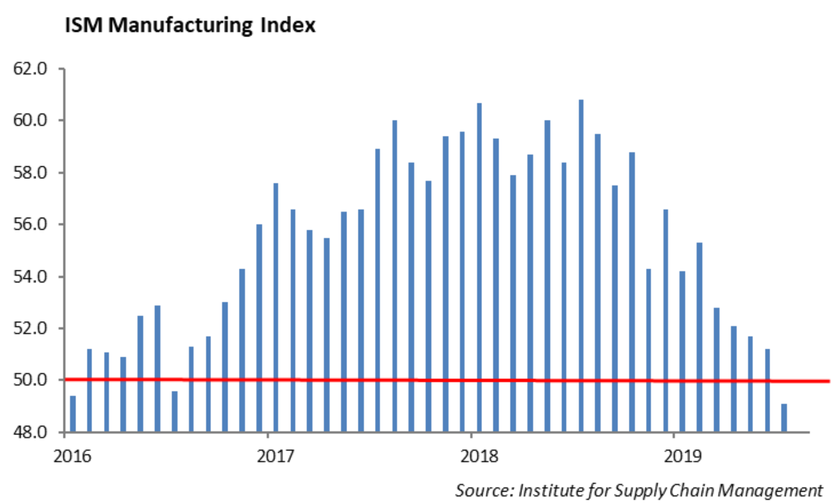


The economy added 136,000 jobs in September according to the Labor Department. The U.S. consumer is generally able to find work, which supports wage growth. The unemployment rate shifted to a 50 year low of 3.5% in September from 3.7% in August. At the same time, wage pressure is still relatively low. Job gains combined with low unemployment buffers the U.S. economy from weakness and supports wage growth, which in turn helps to spur consumer spending.



During the Financial Crisis, the economy lost over 8 million jobs over two years. Since 2010, the economy has produced nearly 22 million jobs, driving the rate of unemployment down to 3.5%. We are concerned that this rate of job growth and unemployment will not hold up into next year given the pressure on corporate earnings and the growing list of companies announcing restructurings and lay-offs. Earlier this month, HP announced a plan to reduce headcount by 7,000 to 9,000 employees.

The Institute for Supply Management (ISM) tracks both manufacturing and U.S. services sector activity each month. A reading above 50 shows growth, while a reading below 50 indicates a contraction in activity. The ISM manufacturing index dipped to 47.8 in September, its lowest level since June of 2008. The manufacturing sector has shown decelerating growth since August of 2018. This is a clear sign that the trade war with China and slowdown in Europe has an impact on manufacturing in the U.S. We expect trade flows with China this year to grow at its slowest pace since the Financial Crisis.



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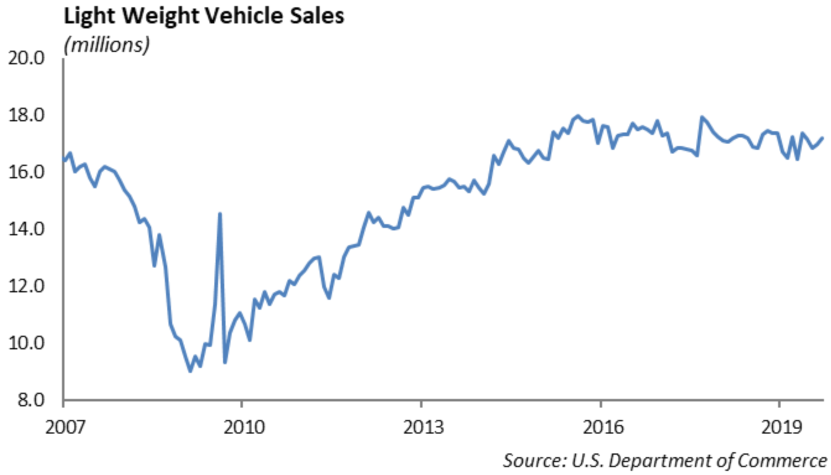
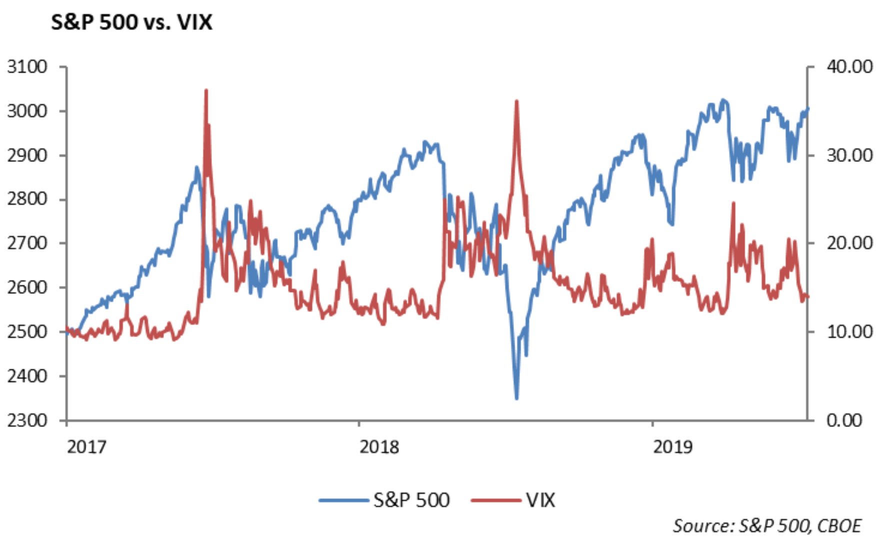
At the same time, auto sales are still tracking near 17 million units. We expect to see this figure begin to dip as general slowdown grips the domestic economy and the UAW strike at GM impacts production.



Equities

The equity market has been extremely resilient this past year with the S&P 500 returning over 18% to investors in 2019. In spite of massive monetary stimulus and a strong labor market, equities have hit resistance at the 3000 level on the S&P 500. While we are encouraged by the potential resolutions to structural barriers in the market, we are expecting compressed returns in financial assets over the next several years.



Small cap and mid cap stocks are undervalued, and we expect to reallocate from large cap over the next quarter. Small cap stocks generally perform well when private credit is expanding.

We have been slow to increase exposure to international stocks; however, with the potential for resolutions on trade and Brexit, we expect to increase exposure on both developed and emerging markets over the next quarter.

Sector Strategies

Heading into the end of the year, we are analyzing and reevaluating our sector allocations. Our sector strategies are implemented into the Core Sector model series, Large Cap Blend Strategy, and Dividend Growth Strategy.

Overweight: Communication Services, Financials, Healthcare, Industrials, Tech

Financials & Healthcare: We think Financials and Healthcare are cheap. Using 5 Year averages of price to earnings, Healthcare is trading at a 14% discount, and Financials are trading at a 20% discount. Performance wise, Healthcare is up 3% this year, and Financials is up 13% vs. the S&P gain of 18%.

Industrials: We do not care for many industrials at current valuations, but the sector fund is heavily weighted towards aerospace and defense names, which we believe in. Therefore, we are overweight in the sector.

Technology: We are in the early stages of cloud growth, and we believe that 5G communication is a growth driver for technology as a whole moving forward. MSFT, our favorite and top overall holding, makes up a large percentage of the sector (20%), so we continue to favor Technology.

Communication Services: There are many large names in this space that have seen pullback. We are buyers of Facebook, Disney, and Google. Short term, only 18% of the S&P stocks in this sector are trading above their 20 day moving averages, and only 29% are trading above their 50 day moving averages, which puts it at the bottom compared to every other sector.

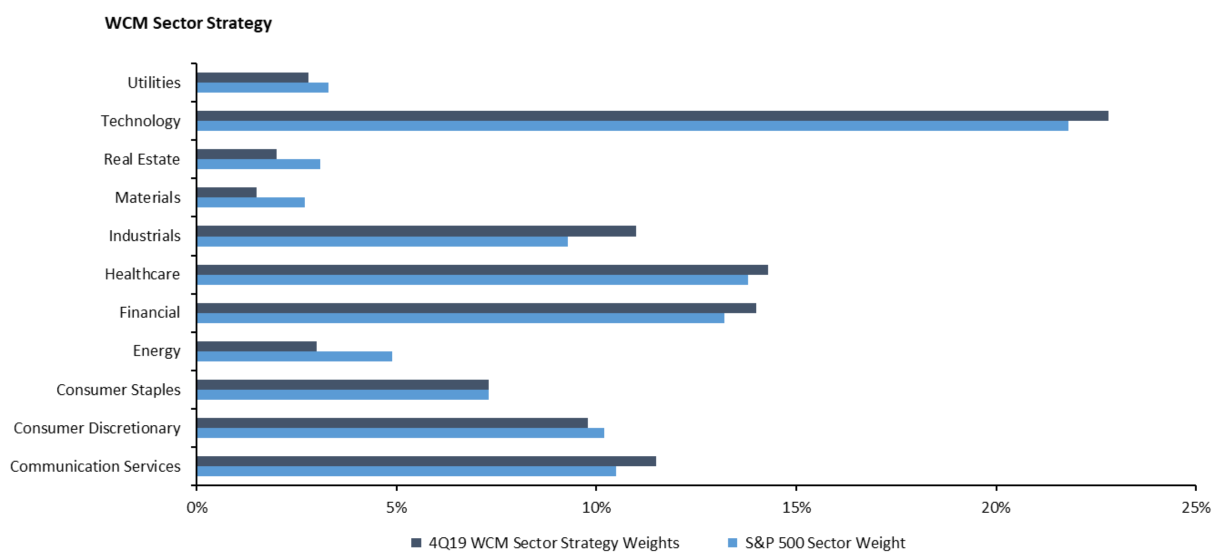
Neutral: **Consumer Discretionary, Consumer Staples**

Consumer Discretionary & Staples: Staples and discretionary sectors have been driven by the strong consumer over the past 2 years. While economic data continues to show strong consumer behavior, we believe this is a lagging indicator. We believe the weak manufacturing data and mass layoffs will lead to less consumer spending over the coming quarters.

Underweight: Energy, Materials, Real Estate and Utilities

Energy: As the global economy slows, so does the demand for oil. We see no catalysts for energy to outperform in the near term in this environment.

Utilities & Real Estate: Both utilities and real estate have been strong performers in 2019 as interest rates have declined sharply. This has led to an overvaluation in each sector. Utilities are trading at a higher P/E than tech and communications.



Fixed Income

"Risk on" was the name of the game across most asset classes last week, which resulted in an exodus from the safe haven of U.S. Treasuries. This drove interest rates higher by over 20 bps during the week. The 10-year treasury trades at 1.75%, but we believe rates will continue their downward momentum unless a more meaningful trade deal is inked. The Fed also announced their intent to begin growing its balance sheet once again as a defense against illiquidity in the repo markets. We see this as a short-term fix that's primary impact will be a steepening of the yield curve. Ultimately, we believe the Fed will step in with a more permanent facility to support the repo market.

Investment grade spreads tightened as investors were eager to capture credit risk in a higher interest rate environment. Spreads were generally tighter by 5-10bps depending on the sector, in which high beta TMT was the best performing sector. While energy finally saw some tightening, the sector was noticeably lagging the general market.

As credit spreads tightened in the third quarter, we reduced our credit exposure in total return portfolios. Recently, we reduced our holdings in 30-year Qualcomm and Charter Communications, and 10-year McDonalds and Coca-Cola. Going into the end of the year, we prefer to be light on credit as we see liquidity declining and the potential for volatility increasing.

Levered Loans

The levered loan market has continued to show cracks as the S&P Levered Loan index price hit a 10-month low last week, and levered loan funds saw their biggest outflow in 7 weeks. Collateralized Loan Obligations (CLO's) have also experienced weakness, and BBB CLO's are trading roughly 100bps wider today than this time last year. Issuance remains heavy in levered loans, while covenants appear to be declining. Additionally, ratings downgrades are outpacing rating upgrades 3 to 1 in the levered loan market. The floating rate nature of this asset class means it should be outperforming in a rising rate environment. However, a stretch for yield, low covenants, and deteriorating credit are all symptoms of the late stages of the credit cycle. We would caution investors from chasing yield in this sector until covenants and credit quality meaningfully improve. In addition, as risk is re-priced in this asset class, we expect it may bleed over into the high yield market, putting pressure on spreads.

High Yield

U.S. high yield markets have performed well this year, with high quality BB outperforming lower quality high yield on a year-to-date basis. At the margin, technical indicators in the sector are weakening as over $1.5 billion of outflows left high yield funds. Wealth managers and individual investors are most likely comfortable de-risking and taking their double digits gains for the year, leaving the street long these securities.

New issuance in the high yield market remains active with $3.4 billion pricing at the beginning of the fourth quarter. Notable deals included Terraform, the BB-/B1 rated software company pricing 10 year senior notes, and OCI, the BB rated chemical company pricing 5 year notes at the low end of price talk. Meanwhile, low quality issuer, TruckPro, had to shorten its offering and increase the interest they will have to pay out.

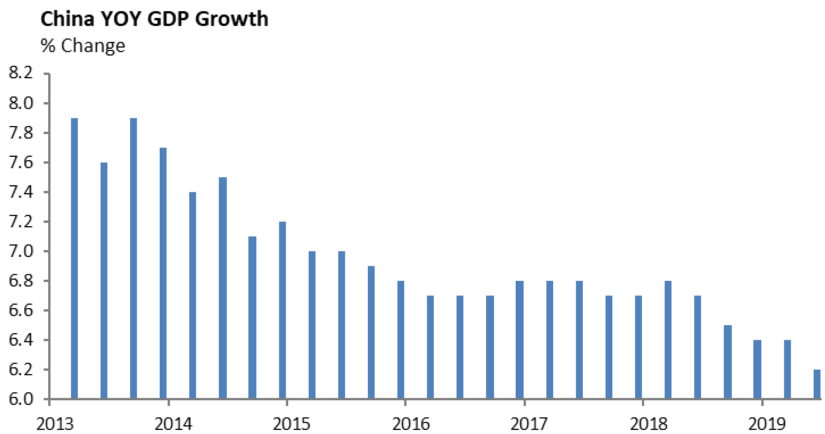
Energy prices rose 4% early in the quarter, driven by the U.S./China partial trade agreement and a missile strike on an Iranian oil tanker. Geopolitical risk in the Middle East still appears to be the major driver of short-term volatility in crude oil prices.

China

Earlier this month, Xi Jinping, General Secretary of the Communist Party in China, presided over the 70th anniversary celebration of the Communist Party's rule. In the background, the protests in Hong Kong continue to grow and become more violent. First, let's talk about China's economy.

In the face of proposed tariffs by the United States and reduced demand, China's economy is slowing sharply. We expect the Chinese government will take a wait-and-see attitude before stepping in to stimulate growth. So far, China's central bank has remained on the sidelines as other global central banks have lowered interest rates. China has other problems in its economy, including rising debt levels and a growing services sector that is putting pressure on its manufacturing base.

In the latest volley, the U.S. has agreed to suspend the tariff increase on $250 billion of Chinese goods that were set to kick-off in mid-October. In exchange, Beijing has agreed to buy $40 billion of American farm products.



Source: National Bureau of Statistics, China

We maintain that China has more to lose in the trade war with the United States in terms of economic growth. Over the past five years, China has been intentionally shifting the structure of its economy away from manufacturing, property, and investment, and instead, shifting toward technology and consumption. While Chinese leadership has pledged to not stimulate the property market this year, the central bank did lower the level on a new reference lending rate for businesses. The move toward moderation appears to be an attempt by policy makers to control asset bubbles.

So, why do the protests in Hong Kong matter to China's economy? Hong Kong rule was transferred from Great Britain over to China in 1997 under a "one country, two systems" political regime. China committed that for 50 years, they would all Hong Kong to operate independently without altering the political or economic systems. However, the protests bring attention to China's growing reach into Hong Kong. At the same time, Hong Kong is an important link between China and the global economy. It is estimated that over $1 trillion in money flows out of China through Hong Kong into the global economy.