"An Investment in Knowledge Pays the Best Interest"
(Ben Franklin)

Always Look on the Bright Side of Life

Cheer up, Brian. You know what they say.
Some things in life are bad,
They can really make you mad.
Other things just make you swear and curse.

When you're chewing on life's gristle, Don't grumble, give a whistle!
And this'll help things turn out for the best.

And

Always look on the bright side of life!
Always look on the bright side of life!

If life seems jolly rotten,
There's something you've forgotten!
And that's to laugh and smile and dance and sing!

When you're feeling in the dumps,
Don't be silly chumps.

Just purse your lips and whistle -- that's the thing! And always look on the bright side of life!

(From "The Life of Brian", by Monty Python, 1979)

Last month we focused on separating out market "noise" from market "signals." As a reminder of what we considered "noise," we identified 1) political dysfunction in Washington, DC (but now it appears that there will be no more government shutdowns and that budgets will be passed); 2) the Robert Mueller investigation (which continues to drag on, with former Trump attorney Michael Cohen's just-delivered testimony before Congress setting DC politicians and partisans on both sides into outraged but contradictory rants – none of which appear to be disturbing the market); and 3) US-China trade negotiations (which now have been "kicked down the road" as President Trump agreed to delay tariffs and engage with Chinese President Xi). In other words, what we identified as "noise" turned out to be exactly that.

We thought Federal Reserve Bank monetary policy was a hybrid between noise and signal. The Fed seemingly has backed off for now any further "normalization" plan and turned decidedly dovish. The markets responded accordingly.

Finally, we identified GDP growth, earnings and revenue growth, inflation, and interest rates as market "signals". How have they turned out? Well, Q4 earnings and revenues were solid (though both are expected to slow as we move through 2019), GDP growth remains positive and non-recessionary, and both inflation and interest rates remain well under control.

Given the generally positive trends on both market signals and noise, is it any real surprise that the markets have rallied as they have so far this year?

As we look forward through the remainder of 2019, we certainly do not expect double-digit market gains every month. In fact, we think markets will stabilize and perhaps even give back some of the early year gains, as investors begin to price in decelerating economic and earnings growth. But we do not see a recession on the horizon in 2019 (though probably in 2020), and we see revenue and earnings growth potential sufficient to maintain a positive market return for 2019.

What could change that outlook? Once again, we have to focus on "non-fundamentals" or exogenous market events. Specifically, a negative outcome to US-China trade negotiations or Brexit (or both), Europe slipping into recession more quickly than we anticipate (Italy, Europe's fourth-largest economy, already is in recession), or impeachment proceedings against President Trump. None of these events have a zero probability of occurring, though we suspect that the odds of any of them occurring are low, and the odds of all four of them occurring are even lower.

The market overbought good news through the first three quarters of 2018, then oversold perceived bad news in Q4, and now perhaps has overbought once again as some of the perceived market risks have faded. We generally are constructive on both economic and market growth, but volatility will remain elevated (i.e., more historically "normal"), and "noise" will continue to drive market swings.

With that as a backdrop, looking out over the current economic and investment landscapes, here is what we see.

The Current Economic & Market Landscape

The global economy is still expanding but clearly decelerating:

- The consensus estimate for Q4 2018 GDP growth in the US is now 2.7%, bringing 2018 GDP growth to roughly 3.0%. Q1 2019 GDP growth is currently expected to come in at around 2.0%, and roughly 2.2% for all of 2019 (source: *The Wall Street Journal*);
- There remains some uncertainty regarding this forecast, however, as several exogenous geopolitical events may affect the ultimate outcome – Federal Reserve Bank policy, ongoing US-China trade negotiations, Brexit, Italy, North Korea, and so forth;
- Both the US manufacturing (PMI) index and services sectors (NMI) index remain in expansionary mode (56.6 and 56.7 in January, respectively; any reading above 50 is considered expansionary). The January PMI represented an increase from the December reading of 54.3, but the NMI showed a decline from the December reading of 58%;

- The manufacturing index has been in expansionary territory for 117 consecutive months, while the non-manufacturing index notched its 114th consecutive expansionary month – this economic expansion, while welcome, is getting "long in the tooth" (source: *Institute for Supply Management*);
- Inflation (as measured by CPI) fell to 1.6% year-over-year in January, down from 1.9% in December. This is the lowest inflation rate since June 2017, and some Fed members are beginning to publicly question if we are accurately capturing the actual inflation rate in the country (source: *TradingEconomics*);
- The Personal Consumption Expenditure (PCE) index – which is the Fed's preferred measure of overall inflation – came in at 1.84% year-over-year in November (the most recent reading), in line with but still below the Fed target rate of 2% (source: *TradingEconomics*);
- We believe that inflation will tick up slowly over the course of 2019, but that it does not constitute a primary risk to economic growth;
- After raising rates (as expected) in December, the Fed has completely backed off its previous fairly aggressive "normalization" plan, as the economy cools and inflation remains under control;
- After initially anticipating 3-4 rate hikes in 2019, the current Fed projection is now no more than 1-2, with the first not until Q2 at the earliest. Some market professionals do not believe the Fed will raise rates at all in 2019 and, in fact, there are some who believe the next Fed action will be to *cut* rates as the economy slows down;
- A slowing economy and the lack of inflation have driven the 10-year Treasury rate down to roughly 2.65% as of late February – there is little to suggest a significant rise (above 3%) in the foreseeable future;
- The yield curve remains very flat. Through the last week of February, there is less than 20 basis points difference between the yield on the 2-year and 10-year Treasury. We do not anticipate (or fear) an inverted yield curve – if it occurs, history suggests that any potential recession will be 9-18 months in the future;
- After stabilizing in Q4 2018, the US dollar has now strengthened YTD in 2019 (versus the yen and the euro – it actually has weakened slightly against the yuan). Despite a recentlyturned-dovish US Federal Reserve Bank, the US economy remains the "cleanest dirty shirt" in the global economy, and inflows continue to prop up the value of the dollar;
- With the Q4 reporting season largely finished (more than 80% have reported as we go to publication in late February), we experienced another solid quarter of US earnings growth. S&P 500 companies that have reported posted an earnings increase of 12.6% on a 5.9% growth in revenues. While this represents solid expansion, it is a marked decline from the first three quarters of 2018. Earnings growth rates actually are expected to decline in Q1 2019 (for the first time since Q2 of 2016), but overall earnings for 2019 are still expected to be positive (source: *Zachs Earnings Report*);
- Euro area GDP growth came in at 1.20% in Q4 2018, a decided and continued decline from previous quarters. Italy has slipped into recession (two consecutive quarters of negative growth), and Germany is on the brink of following suit;
- Manufacturing all across the Euro area dropped below expansionary levels, slipping to 49.5 in February, the steepest contraction since January 2013 (source: *TradingEconomics*);

- On the other hand, the Euro area Services index rose to 52.3 in February, from 51.2 in January (source: *TradingEconomics*);
- Euro area unemployment remained constant at 7.9% in December (the most recent reading), the lowest level since 2008 (source: *TradingEconomics*);
- Euro area annualized inflation slipped to 1.4% in January, down from 1.5% in December, the lowest rate since April 2018, due primarily to contained energy prices. This lack of inflation will continue to bedevil the ECB as it seeks to "taper" its quantitative easing program (source: *TradingEconomics*);
- Japan's Q4 annualized GDP grew 1.4%, following its second negative 2018 quarter in Q3 (source: *TradingEconomics*);
- China's (official) GDP growth in Q4 was 6.4% (annualized), the lowest reported growth rate since the Financial Crisis in 2008. For all of 2018, the Chinese economy expanded 6.6%, the weakest performance since 1990. As a result, China is in full fiscal and monetary stimulus mode.

The Towerpoint Wealth Economic & Market Outlook:

- ***The global economy continues to expand, though there are distinct signs of deceleration, both in the US and internationally;***
- ***US inflation is stable, and we maintain our belief that it (as of yet) does not represent a problem for continued economic expansion. Wages are increasing, and there are some who believe that the way Average Hourly Earnings are calculated understates the actual wage growth rate, but those increases have not yet translated to higher inflation rates;***
- ***Oil and other commodity prices generally have risen in 2019, but not to levels that threaten or suggest significantly higher input prices (and therefore inflation);***
- ***Outside the US, inflation simply is not a problem, due to slow growth and reasonable oil prices;***
- ***In the US, the stimulative impact of tax and regulatory reform are tapering off, but the economy remains in fairly solid shape, and expectations are for 2.0% -- 2.5% growth in 2019 – not exceptional, but certainly not recessionary;***
- ***The Fed has backed off its "normalization" plan, and there are some analysts who expect its next move to be a rate cut sometime in Q2. We do not agree, but we do believe the Fed will be reluctant to increase rates any further this year without tangible signals of rising inflation;***
- ***Following a dramatic "risk off" downturn in Q4 2018, and especially through the first three weeks of December, the market has come screaming back, with every major global index posting YTD double digit gains. We believe the market, though it was never "cheap", had oversold, and once investors focused again on underlying GDP, revenues, and earnings growth, they bought back into the proverbial "dip";***
- ***That said, we certainly do not expect the market to maintain its torrid pace. GDP growth is positive, and earnings are solid, but both are expected to slow down as we move through 2019 – the market will eventually begin to price that in and we expect a stabilization and perhaps even periodic declines as we move through the remainder of the year;***

- ***Several "exogenous" events are occurring fairly simultaneously as we head into the end of February, and all bode well for market sentiment, and therefore for the markets: (1) It seems that President Trump will extend trade negotiations with China past the existing March 1st deadline and not impose his threatened tariffs (at least not yet); "Brexit" talks also look to be carried past the existing end-of-March deadline as the EU and the UK seek a satisfactory settlement to "the Irish question" (i.e., a settlement of how to deal with trade flows between the EU member Republic of Ireland and the UK member Northern Ireland); and (3) The US Federal Reserve Bank has turned decidedly dovish, so that no rate increase is expected until Q2 at the earliest, and perhaps not even then;***
- ***Neither the US-China trade negotiations nor Brexit discussions are settled, and both pose the largest continued threats to the global economy, but both issues seem to have been "kicked down the road" for several months, and the markets are responding accordingly;***
- ***Continued (but slowing) US GDP growth, and solid earnings and revenue growth, make for a generally positive market environment. We think equity markets will stabilize and perhaps give back some of the early year gains, but will still end positive for the year. However, decelerating earnings growth and mildly rising interest rates will most likely combine to push valuations down and volatility up as we move through the year;***
- ***Italy has fallen into a recession (defined as two consecutive quarters of negative GDP growth), and Germany may not be far behind. Europe overall remains slightly expansionary, but recession is not out of the picture, especially given a volatile political environment in the UK, France, Italy, and Germany;***
- ***We still like EM and EAFE valuations relative to US valuations, but have lowered our expectations for EAFE markets given our views of the European and Japanese economies over the remainder of this year. We still like the EM markets, especially if the US-China trade negotiations reach a successful conclusion, but as long as investors continue to move money into the US (thereby strengthening the dollar), all non-US markets will face headwinds in terms of their dollar-based returns;***
- ***The US yield curve remains incredibly flat (there is currently less than a 20 bps difference between the 2-year and 10-year yields), as lower longer-term expected growth rates combine with modest inflation expectations on the long-end of the curve, but we believe the risk of inversion is low;***
- ***There currently is not a great deal of upward pressure on rates. Rates may "grind higher" over the course of 2019, and will probably end the year above the psychological barrier of 3%, but we do not expect them to rise above 3.5% by yearend – there simply does not appear to be any catalyst for a more significant rise;***
- ***After blowing out in late December, public credit spreads fell quickly back to "prepanic" levels, and therefore once again look expensive to us. Since corporate balance sheets are in pretty good shape, we think that current spreads fairly compensate investors for default risk, but there is not much margin for error. We are nearing the end of the current credit cycle and risks are increasing;***
- ***For investors who can access the private markets and handle some degree of illiquidity, we still believe there are better opportunities in the private markets versus the public markets,***

though investors face compressed premiums versus historical levels, driven by huge investment flows over the past 24 months;

- ***2019 will continue to be a litmus test for alternative investments (both hedge funds and liquid alternatives), as rising rates, higher volatility, and a better opportunity set for active management should be conducive for improved performance;***
- ***We thought the real assets and the commodity complex had been oversold in 2018, and we therefore were not surprised by (and actually anticipated) the solid bounce back in early 2019. A slowing global economy could dampen overall demand, and return expectations for this space will influenced by what happens to the US dollar as we move through the year.***

As the Rolling Stones sang, "*Time is on my side, yes it is"* (you will have to hear in your own heads Mick Jagger's accent and vowel extensions). We think time is on our side as well, at least for now, but clients need to have their expectations managed as to what a globally diversified portfolio can deliver over a full market cycle, they need to understand where we are with respect to that market cycle (i.e., later stages), and they need to be reminded to keep their investment horizon aligned with their long-term financial objectives, so that time can be on their side as well.

Warm Regards,

Joseph F. Eschleman, CIMA®

President

Towerpoint Wealth, LLC

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