

2019 9 FOR

AAM's Best Ideas for 2019

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U.S. to Continue Late-Stage Expansion into 2019

2018 was the yang to 2017's yin. While 2017 was defined by low volatility, 2018 experienced the opposite. Investor sentiment swung sharply throughout the year as investors' focus switched from the impact of tax reform to fiery trade discord to mid-term (and global) elections to multiple natural disasters and, of course, the constant headline-making news. The U.S. equity markets hit new highs in January 2018 and by Thanksgiving, the markets had given back their year-to-date gains with some dramatic swings in between.

The Federal Reserve continued its move toward more restrictive monetary policy by trimming its balance sheet and raising short-term rates 75 basis points through the end of October, with another hike likely in December. The yield on the 10-year U.S. Treasury note increased over 80 basis points (as yield goes up, bond prices generally decline) to 3.21% as of 11/2/18, last hitting this level in 2011. The 30-year Treasury yield rose to a current level of 3.45% from 2.74%.

In simple terms, markets discount future expectations, but they are sometimes skewed by consensus optimism or pessimism and may overlook economic and/or corporate fundamentals. In fact, stripped of the "noise" mentioned above, we see several irrefutable facts that indicate to us that the U.S. will continue its late-stage expansion into 2019. While recession risks are higher than a few years ago, we don't see immediate warning signs that one is lurking around the corner. Keep in mind that at this point in the cycle, it's critical to be vigilant in monitoring changing conditions that could potentially propel a recession.

Let's take a closer look at several fundamentals that support continued economic growth in 2019.

Gross Domestic Product (GDP) Improvement

Annualized GDP growth in 2018 is expected to be 2.9% following 2.5% growth in 2017, 1.9% in 2016 and 2.0% in 2015. Although the Federal Reserve's attempt to balance raising rates with supporting economic growth will be a challenging task, we expect the U.S. economy will be able to

absorb the anemic pace of rate increases (relative to previous cycles). We also expect to see a rebound in both Europe and Emerging Markets believing the new trade agreements with Mexico and Canada are more indicative of the likely resolution to the current trade skirmishes, particularly with China.

Labor Market Strength

The unemployment rate remained at 3.7% in October, the lowest in nearly 50 years. The U.S. economy has now added jobs for nearly eight straight years. Continuing jobless claims hit a level not seen since 1970 and average hourly earnings rose to levels not seen since 2009.

Federal Funds Target Rate
Source: Bloomberg

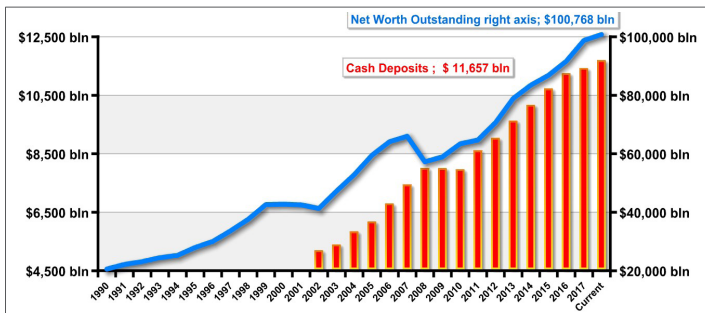


Strong U.S. Consumers and Businesses

Consumer and small business owner sentiment numbers remained high, as has the Conference Board Consumer Confidence Index. We expect U.S. consumer spending will continue to be supported by consumers' strong balance sheets and income statements—net worth and cash deposits are at all-time high levels and the debt-to-assets ratio has declined dramatically since the 2009 peak. With interest rates rising, the debt-service ratio is expected to rise, although it will take several additional rate hikes and an increased debt load to return to previous highs.

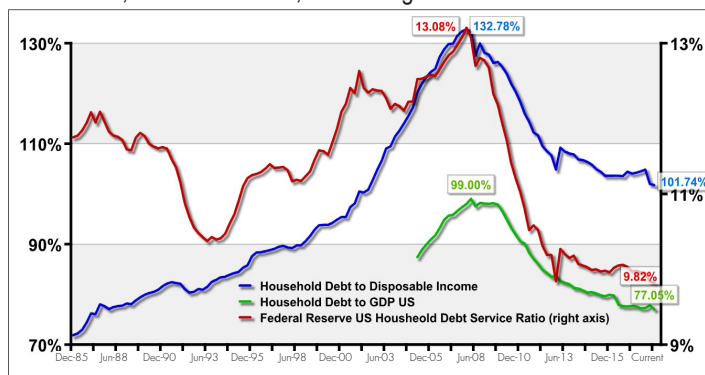
Household Net Worth and Cash Deposits

Source: Fed Flow of Funds



Household Debt Ratios

Source: IMF, Federal Reserve, Bloomberg

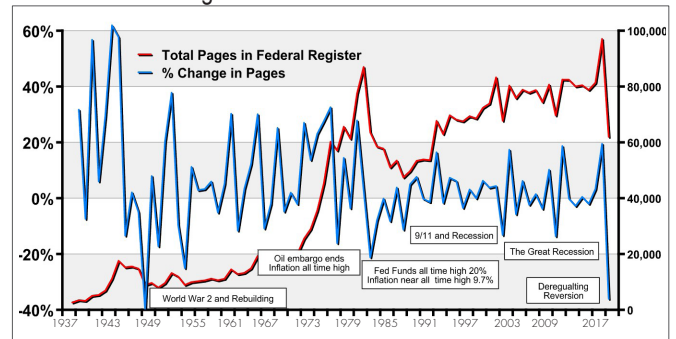


Deregulation

Deregulation holds the potential to extend this already historic expansion a bit longer. The impact on corporate sentiment generally requires several years for business owners to continue investing in their business and expanding versus meeting increased regulatory requirements. In the four-year period following consistent reduction in regulations, GDP increased to 4.3% annually, well-above the average over the last four decades.

Federal Register

Source: Federal Register

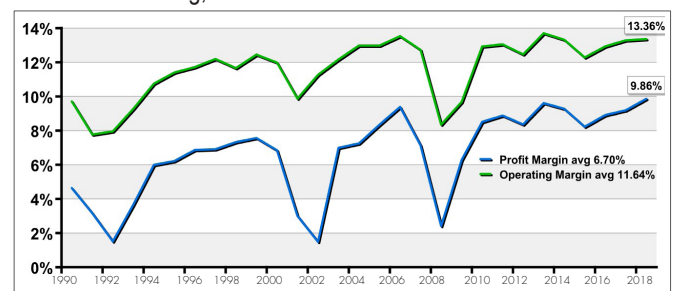


Corporate Earnings Growth

Earnings margins in 2018 have improved, albeit partially due to tax reform and the repatriation of U.S. dollars held abroad, both of which served to increase earnings per share (EPS) from a synthetic level. Expectations are for single-digit earnings growth in 2019 given more difficult year-over-year earnings comparisons, however we still expect earnings growth to remain above average.

S&P 500 Profit and Operating Margin

Source: Bloomberg, S&P



History as a Guide

If the previous fundamentals aren't telling enough, we have the definitive weight of history to help us better understand our current recovery. While recession lengths before and after the Great Depression were similar in length, the expansions were strikingly different. Expansions prior to the Great Depression—the closest comparison to the Great Recession of 2007-09—lasted only 25 months on average, while the two following lasted 65 months on average. The length of the average recession has declined over time, while that of the average expansion has doubled.

Business Cycles

Source: National Bureau Economic Research. Past performance does not guarantee future results

BUSINESS CYCLE REFERENCE DATES		DURATION IN MONTHS			
Peak	Trough	Contraction	Expansion	Cycle	
<i>Quarterly dates are in parenthesis</i>		<i>Peak to Trough</i>	<i>Previous trough to this peak</i>	<i>Trough from Previous Trough</i>	<i>Peak from Previous Peak</i>
August 1918 (III)	March 1919 (I)	7	44	51	67
January 1920 (I)	July 1921 (III)	18	10	28	17
May 1923 (II)	July 1924 (III)	14	22	36	40
October 1926 (III)	November 1927 (IV)	13	27	40	41
August 1929 (II)	March 1933 (I)	43	21	64	34
May 1937 (II)	June 1938 (II)	13	50	63	93
February 1945 (I)	October 1945 (IV)	8	80	88	93
November 1948 (IV)	October 1949 (IV)	11	37	48	45
July 1953 (II)	May 1954 (II)	10	45	55	56
August 1957 (III)	April 1958 (II)	8	39	47	49
April 1960 (II)	February 1961 (I)	10	24	34	32
December 1969 (IV)	November 1970 (IV)	11	106	117	116
November 1973 (IV)	March 1975 (I)	16	36	52	47
January 1980 (I)	July 1980 (III)	6	58	64	74
July 1981 (III)	November 1982 (IV)	16	12	28	18
July 1990 (III)	March 1991 (I)	8	92	100	108
March 2001 (I)	November 2001 (IV)	8	120	128	128
December 2007 (IV)	June 2009 (II)	18	73	91	81

BUSINESS CYCLE REFERENCE DATES		DURATION IN MONTHS			
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Average, all cycles:					
1854-2009 (33 cycles)		17.5	38.7	56.2	56.4*
1854-1919 (16 cycles)		21.6	26.6	48.2	48.9 **
1919-1945 (6 cycles)		18.2 ↓	35.0 ↑	53.2	53.0
1945-2009 (11 cycles)		11.1 ↓	58.4 ↑	69.5	68.5

With this as a backdrop, we turn to our Top 9 Themes for 2019

1. FAVOR LATE-STAGE INVESTMENTS

We favor late-stage cycle investments with an emphasis on Financials, Energy, Basic Materials, Consumer Discretionary and Industrials.

2. HIGHER U.S. EQUITY MARKET VOLATILITY – FAVOR LARGE CAP VALUE

We expect higher volatility in the U.S. equity markets; larger cap value stocks may benefit as we anticipate the U.S. dollar to rally early and then decline by year-end. In addition, telecommunications stocks may potentially outperform due to a shift in industry classifications.

3. FED PUSHES FED FUNDS RATE HIGHER

We expect the Federal Reserve to continue along its current path with an additional two or three rate hikes in 2019 given increased inflation and wage pressures, although they may be more data dependent and careful with timing.

4. RELATIVELY FLAT YIELD CURVE

The yield curve will remain flat and potentially invert in 2019. However, with the unwinding of the Federal Reserve's balance sheet combined with higher budget deficits, we may encounter some brief periods of steepening. In light of these oscillating spreads in the yield curve, we still maintain the late stage cycle investing theme and see the inversion as an affirmation of what we expect for the economy and capital markets.

5. HEALTHY REBOUND IN EMERGING MARKETS

We look for a healthy rebound in Emerging Markets (EM), particularly Asia, though still favor some broad-based exposure. We generally favor EM equities rather than debt though select debt may generate strong performance.

6. REBOUND IN EUROPE & JAPAN

We also anticipate a rebound in Europe and Japan, as the processing of the election results and resolved trade talks begin to improve economics and ease the anxiety of investors. The United Kingdom may experience pressure in the first half of 2019, but we expect a rebound as the Brexit strategy becomes more clear.

7. EMPHASIS ON COMMODITY SECTOR

We continue to emphasize the commodity sector, specifically Energy and Industrial Metals, as these areas tend to perform well during periods of inflation. The pressure that has pushed agricultural commodities lower may have some strong relative outperformance at points in 2019.

8. INCREASE CREDIT QUALITY

We have favored lowering duration in fixed income portfolios for some time and now look to methodically increase credit quality as well. This can be done in several ways including via higher grade municipals, agency callable debt, certain agency floating rate structures such as fixed to float and/or Consumer Price Index (CPI)-linked issues.

9. PRESSURE ON THE U.S. DOLLAR AND CHINESE YUAN IS THE WILD CARD

We see pressure on the U.S. dollar in the second half of 2019 as increased domestic budget deficits and global economic recovery may strain investors' appetite. We see gains in the euro, the pound and slight gain in the yen. The wild card is the Chinese yuan, determined by how quickly and to what degree trade tensions may be resolved.

What Could Change: Potential Risks to Our 2019 Outlook

- Increased inflationary and wage pressures force the Federal Reserve to be more hawkish in their rate hikes beyond market expectations.
- Consumer debt obligation ratios accelerate beyond past historic stress levels causing increased defaults and delinquencies.
- The political and economic transformation occurring within the European Union moves beyond a controlled evolution and hastens to fracturing of several economies from the consortium.
- The saber rattling of the trade tensions between the U.S. and China spiral to an actual trade war where global growth decelerates and internal price pressures advance.
- The expected downgrade cycle of investment grade corporate bonds occurs earlier than expected due to increased financial tensions, which prematurely advances the liquidity strains that occur during every cycle end.

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