Economic & Investment Perspectives

2019: When Deficits, Debt and Division lead to Regulation, Recession and Revaluation

In our 2018 outlook commentary titled "The year of preserving your income, wealth, and sanity"[1], we asked the question:

"Can the buzz and euphoria surrounding… [ill-timed and unfunded tax cuts along with increased regulations disguised as 'defense of national interests' in the U.S., and lavish but empty promises of economic nirvana and prosperity from nationalists on both sides of the Atlantic]*…coupled with the associated revaluation of financial assets and balance sheet risks (to levels not seen in many decades), bring about a promised 'era of permanent prosperity' with new rules and standards that their promotors would so strongly have us believe, or is Yogi Berra's quote…*[It's Deja Vu All Over Again]…*alive and well?"*

Our answer was:

"… for investors, any short run gains from being part of a foolish crowd are dwarfed in the long run by the inevitable costs of being over exposed to overvalued assets."

We prioritized five risks facing investors in 2018: (1) excessive economic exuberance in the U.S., (2) reckless fiscal policy coming out of Washington D.C., (3) monetary policy-induced flattening of the yield curve in the U.S., (4) unjustifiably high valuations in U.S. equity and select corporate debt markets in the developed economies, and (5) the rising economic threats to commerce and free trade coming from the ascent of nationalist and populist sentiments, especially in the North Atlantic.

The above five risks were not commonly shared by the consensus at the beginning of 2018, although they were not altogether dismissed. Generally speaking, many firms included these risks in their downside scenarios, though with subjective probability assessments far lower than we believed to be justified. However, much to our dismay (though not necessarily to our surprise), as the year progressed and evidence began to mount that these risks were indeed real, the consensus merely transitioned to accepting or raising their probabilities of these events occuring, while simultaneously minimizing their downside impacts on the financial markets.

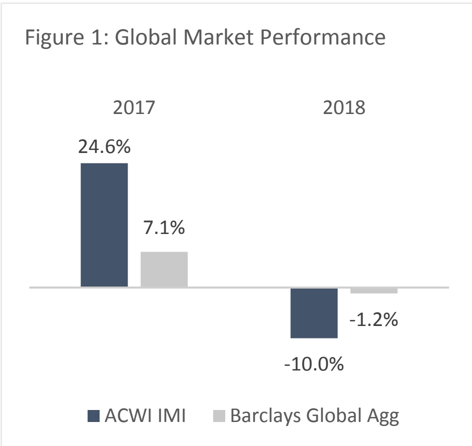
As we begin 2019, we remain out of the consensus. While global financial markets corrected sharply during 2018, we conclude there remains a strong unappreciation within the fiscal policy making circles of many Atlantic economies (particularly in the U.S.) of the folly of populist nationalism, its misunderstanding by the consensus, and therefore mispricing of risky assets by investors.

As such, our concerns and themes for 2019 center on the continued realization of the impacts of prior policy errors **(rising deficits in the U.S.)**, continued elevated exuberance **(high corporate leverage)**, potential for new policy errors **(political divisions across the globe)**, the intended and unintended consequences of new and prior errors **(increased net regulation)**, the natural course of economic cycles **(recession in the U.S.)**, and the continued repricing of risk **(revaluation in the U.S. and attractiveness of international markets)**.

2018: Year in Review

Global equities began 2018 where they left off 2017, and rallied over 7% into the last week of January. A confluence of primarily U.S.-centric macro events (higher inflationary expectations coupled with much wider deficit projections), which forced interest rates higher throughout January, finally capped exuberance for equities. In US Dollar terms, with the exception

[1] *ACIMA Private Wealth 2018 Outlook*



of the U.S. and a handful of select emerging and frontier markets, global equities peaked during the last week of January, as measured by the MSCI All Country World Index (ACWI IMI).

While equity market volatility during February capped long term interest rates in many of the developed economies, the U.S. and most emerging markets continued to experience higher rates well into May. This divergence, along with technicals relating to the repatriation of US Dollars by foreign affiliates of U.S. companies (in order to take advantage of temporary benefits from the Tax Cuts & Jobs Act of 2017), ended a sixteen month downtrend in the US Dollar. A weaker Dollar was one of our primary calls for 2018, and though we were surprised by the degree of weakness (the US Dollar Index had declined 4.2% by mid-February) early in the year, the subsequent strength into August surprised us even more.

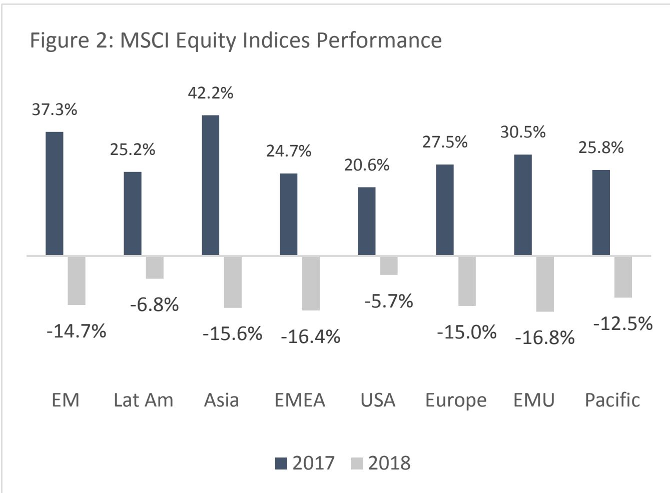
A stronger US Dollar, coupled with what was on the surface strong U.S. economic data (more on this below), stabilized and in the case of select sectors (Consumer Discretionary, Healthcare, and Technology) even allowed for a rally to new bull market highs as late as early October. In the meantime, emerging markets were in turmoil across asset classes. While we had expressed some concerns over the degree of strength in select segments of emerging markets equities in our 2018 outlook, the seemingly indiscriminate rout experienced during the summer was overblown, particularly as it related to currencies and bond markets.

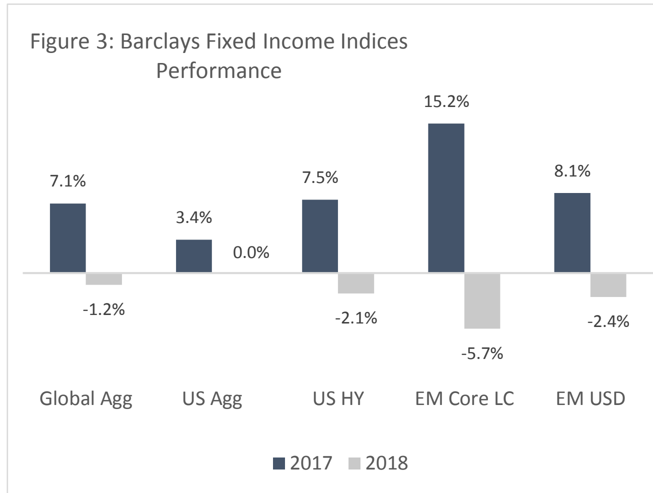
The mounting evidence that the Trump Administration's trade policies were not only backfiring but only in their infancy, along with weaker U.S. housing and manufacturing, finally peaked U.S. equities and widened corporate credit spreads beginning in late September. In addition, weaker growth reports from China, Europe, and emerging markets overall raised the prospects of a synchronized global slowdown heading into 2019 (a 180-degree turnaround from forecasts made earlier in the year). Despite the sharp 4.5% rally in the ACWI IMI during the last week of December, the fourth quarter of 2018 ended as one of the worst quarters for global equities since 2008, led by the U.S. and Japan.

For the year, the ACWI IMI dropped 10.03%, its worst annual performance since 2008, and significantly underperformed the Barclays Global Aggregate Bond Index (Figure 1). Regionally, the drop was led by Asia, Eastern Europe / Middle East / Africa (EMEA), and Europe. Despite dropping by 5.7%, equities in the U.S. outperformed all other geographies by a significant margin (Figure 2).

Within fixed income, credit spreads widened during the fourth quarter on expectations that U.S. growth would weaken in 2019. This resulted in a flight to quality move into long-term U.S. Treasury and Agency debt. The Barclays U.S. Aggregate Bond Index was one of the few major bond market indices to finish the year with positive returns (Figure 3). Weaker FX markets within EM significantly and negatively impacted returns of bonds denominated in local currencies vs those denominated in US Dollars.

Commodities (another sector which we favored for 2018) rallied during the first five months of the year, led by Oil and Agricultural products, before the impacts of tariffs and weaker economic data negatively impacted the demand side of the equation. Despite a 4.5% rally in the Bloomberg Commodity Index into the last week of May, the index subsequently dropped 15% to finish the year down 11.25%, slightly underperforming global equities. There was no place to hide in 2018, and cash was the best performing asset class for the first time since 1992. Investors should not expect the same levels of growth and returns in the late stage cycle of markets, rather they should be globally opportunistic yet realistic about returns over the next 12 months.





Deficits

An intergenerational borrowing scheme administered by a central government very late in the economic cycle in the hopes of generating current investment succeeds in only generating larger government deficits.

In our 2018 Outlook we argued that "*Haphazardly put together policy prescriptions—meant for a different time, different place, and a different problem—do not create* [sustainable] *economic growth."* We were referring to the recently passed Tax Cuts & Jobs Act of 2017 (TCJA), which among other things lowered corporate tax rates and provided a significant one-time tax incentive to boost repatriation of earnings held overseas by U.S. based corporations.

The promotors of the tax cuts argued—convincingly to many—that depressed economic growth since the end of the Great Recession was hampered by excessive taxation and regulation of the very corporations that have been the engines of economic growth and jobs creation (more on this later).

While we agreed with the initial facts (that economic growth was depressed relative to prior cycles), the premise of the argument—that growth will accelerate to a sustainably higher level due to a simple cut in the marginal rate of taxation for one segment of the economy—was flawed on many points, the most important being that for-profit enterprises make decisions at the margin of what their income tax rates are as opposed to operating profit margins, underlying demand, and impacts from external factors such as fiscal and monetary policy.

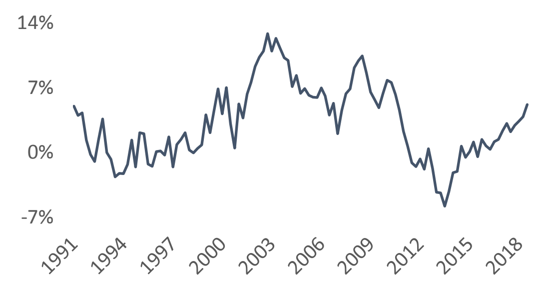
We concluded that ignoring the fundamental reasons why long-term U.S. growth rates had slowed, the aging of the present economic cycle, and why U.S. corporations operate overseas was simply going to lead corporations to use the tax breaks to financially engineer their balance sheets further, essentially artificially boosting overall growth for a brief two or three quarters before payback began. And the payback was going to be a significant rise in budget deficits beginning in 2018 that would need to be financed via the domestic banking and financial system. This in turn would crowd out credit for the private sector, forcing an unnecessary deleveraging process that would eventually lead to a significant economic slowdown beginning in 2019 and lasting well into 2020.

Our forecast was for U.S. GDP growth of 2.8% for the first half of 2018, followed by 2.1% for the second half. In fact, growth averaged 3.2% for the first half, and if consensus is correct regarding Q4 growth, the second half of 2018 should average 3.0%. So where did we go wrong? Or did we?

Thanks to the passage of the Bipartisan Budget Act of 2018 (BBA), the spending caps imposed by the Budget Control Act of 2011 (BCA) were removed, and limits on discretionary spending for 2018 and 2019 rose by a total of $295 Billion. This resulted in year-on-year government spending increases not seen since the end of the financial crises (Figure 4). Additionally, uncertainty regarding trade and tariffs caused a significant amount of volatility in the balance of trade figures, leading to an unusual positive contribution to growth in Q2 and a give back in Q3. By our calculations, excluding these distortionary impacts, GDP growth would have averaged 2.9% during the first half, and only 2.5% in the second half, still higher than our forecasts for the second half, but more in line with our thesis of it being but a temporary boost to output.

More important than the impact on growth, and from an investment perspective, is the net financial impact on the economy. As seen in Figure 5, by our calculations, the positive impacts of the TCJA of 2017 and the BBA of 2018 has been roughly $95 Billion in additional economic activity for the private sector during 2018 as compared to the trend from the end of the recession thru the end of 2017. However, the cost of this additional growth has been an increase in the deficit of $235 Billion, primarily as a result of the drop in corporate income taxes. That's $2.47 in additional debt for every $1 increase in private economic activity during 2018, and the picture for 2019 and 2020 looks even bleaker.

Figure 4: Federal Govt Spending as % of GDP



While our forecast of 1.7% growth for 2019 remains the lowest in the "Blue Chip Economic Indicators" survey (Figure 6), the consensus forecast of 2.5% remains below 2018, and it is likely to move lower over the coming months including significantly lower growth estimates for business investment. Our 1.2% growth for 2020 while again lower than the consensus forecast of 1.9% (though not the lowest in the survey), is considerably lower than 2019 and is indicative of our high probability of a recession forecast. As a result, we have once again raised our forecasts for the budget deficits for fiscal years 2018, 2019, and 2020 by $115 Billion combined, and are now approaching the combined $1 Trillion mark for additional deficits for these years as compared to the CBO forecast of June 2017 (Figure 7).

Figure 5: Tax Cuts & Jobs Act Effect	Q1 2018	Q2 2018	Q3 2018	Q4 2018F
(in Nominal $bn)				
Private Final Sales plus Inventory Inv.	$17,223.39	$17,455.13	$17,761.01	$17,968.00
Annualized Trend	4.76%	5.38%	7.01%	4.66%
Annualized Trend from Q3 2009 to Q4 2017	4.38%	4.38%	4.38%	4.38%
Difference in Trend	**0.38%**	**1.00%**	**2.63%**	**0.28%**
Difference, Quarterly	**$2.60**	**$11.91**	**$39.20**	**$41.22**
Running Total				**$94.92**
Initial CBO Estimate of Monthly Budget Deficit for FY2018	($46.92)	($46.92)	($46.92)	($57.42)
Impact from the End of Sequestration on Monthly Deficit	($11.92)	($11.92)	($11.92)	($12.66)
Adjusted Estimate of Budget Deficit, Quarterly	($176.50)	($176.50)	($176.50)	($210.24)
Actual NIPA-based Deficit, Quarterly	($242.48)	($248.43)	($241.83)	($242.00)
Difference, Quarterly	**($65.98)**	**($71.93)**	**($65.33)**	**($31.76)**
Running Total				**($234.99)**
Taxes of Corporate Income (Actual, Quarterly)	$37.26	$39.52	$40.42	$40.00
Taxes of Corporate Income (Excluding TCJA, Quarterly)	$82.09	$82.96	$84.49	$84.00
Difference, Quarterly	**($44.83)**	**($43.44)**	**($44.07)**	**($44.00)**
Running Total				**($176.33)**

Figure 6: Distribution of Blue Chip Real GDP Forecasts (%)

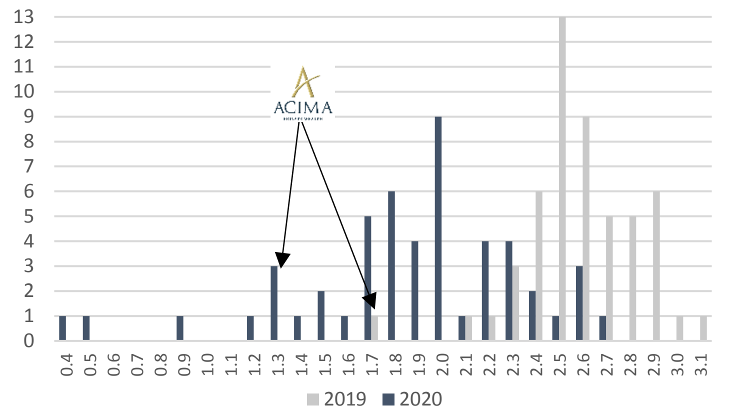
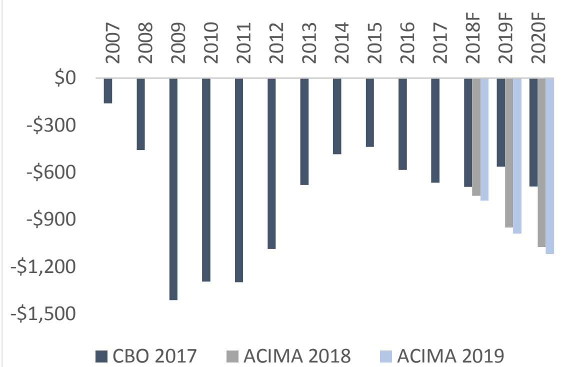


Figure 7: Federal Budget Deficits and ACIMA Forecasts
($bn, Fiscal years ending 9/30)



Debt

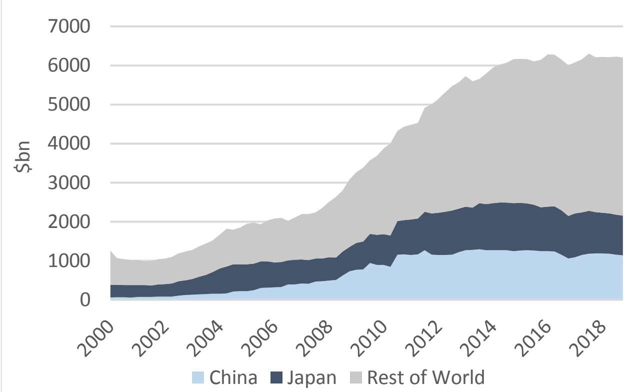
Economic cycles are stories of credit bubbles/cycles. They move up together and eventually down together.

Following the Asian financial crisis of 1997-98 and the bursting of the technology bubble during 2000-02, we observed a significant rise in the global savings of US Dollars. This, along with easier monetary policy during and following the recession of 2001, transferred a significant amount of low-cost credit to the U.S. consumer and the housing market via the U.S. banking system. The over-leveraging of the consumer eventually burst this credit bubble and led to the financial crisis of 2008-09 (though there was plenty of leveraging on the corporate side as well). Consistent with history, where no two cycles are ever the same, the story of the current cycle has been the re-leveraging of the U.S. government and corporate sector.

Given the adjustments we made to our deficit forecasts for 2018-2020, the U.S. government will need to borrow $850 Billion more than what the CBO (and ACIMA) was projecting a year ago for fiscal years 2019 and 2020. In addition, as the Federal Reserve's portfolio of debt securities begins to mature and the balance sheet continues to shrink (Figure 8), we expect an additional $550 to $600 Billion in Treasuries will need to find a home during the same period. While foreigners were large buyers of Treasury debt throughout the first decade and a half of this century (holdings rose from approximately $1 Trillion in 2001 to over $6 Trillion by 2015), their appetite has since waned thanks in part to Chinese and Japanese decisions to reduce their holdings beginning in late 2013 (Figure 9). Most economists and strategists are concerned about the impact on the

Figure 8: US Fed Balance Sheet as a % of GDP

Figure 9: Foreign Holders of US Treasury Debt



"absolute level" of interest rates from this massive financing need, and while we agree that the bias should be for higher rates, we believe it should be "higher rates than otherwise," and not necessarily actual higher rates. Our main concern is the crowding out effect this will have on credit availability to the private sector. Private domestic savings via the financial services sector (banks, insurance companies, pension and endowment funds) will end up shouldering the bulk of the weight of financing the government at a cost of credit availability to the private sector at precisely the wrong point and time in the economic cycle. Our forecast is for the federal debt held by the public as a share of GDP to rise from 76.5% in 2017 to over 81.5% by the end of 2020 (on a recession neutral basis).

As mentioned above, a story of this cycle is corporate re-leveraging. Total debt (publicly traded debt plus bank loans) of nonfinancial business relative to GDP broke above the previous peaks of 2001 and 2009 of 45% in early 2016 and has steadily climbed higher since (Figure 10). Much of this re-leveraging has occurred by companies that are barely investment grade rated. In fact, according to Bloomberg, BBB rated debt (only two notches above high yield) now represents over 50% of all investment grade corporate debt, and is over 2.4 times the outstanding amount of high yield corporate debt. Downgrade risks, be they factors unique to many of these industrial giants, or business cycle related, or due to crowding out effects as financial conditions tighten further, are significant and have the potential to disrupt the corporate bond markets to degrees we haven't observed since the financial crises.

From a forward-looking perspective, what concerns us is where this leverage has been used over the years. According to Goldman Sachs, since the bottom of the financial markets in 2009, 82% of the gains in the S&P 500 have come from earnings growth, while 18% from P/E expansion. In other words, of the slightly over 300% increase in the index, 250% is explained by the growth in earnings including the impacts from retirement of shares outstanding due to buybacks and/or mergers & acquisitions (M&A). However, according to the Bureau of Economic Analysis (BEA), over a similar time period overall corporate profits have risen by only 145%, leaving a large gap of over 100% that can only be explained by the impacts of share buybacks, M&A and leveraged buyouts (LBOs).

Unfortunately for present shareholders, and consistent with history, most of the share buybacks did not occur early in the cycle when prices were low (Figure 11). More than half have occurred since 2015, after the bulk of the upward move in equities had already occurred. In fact, in just the first three quarters of 2018 companies have used lower taxes and repatriated cash from the TCJA of 2017 to buy back $765 Billion in stocks. In addition, according to Guggenheim Investments, the number of LBOs over $2.5 Billion have not only doubled in 2017 and 2018 relative to the trend of 2000-2016, the transactions have occured at average multiples of over 10 times earnings compared to the 8-9 times range just before the bursting of the housing bubble and the peak of the previous economic cycle. This credit cycle is not only aged, but has been further stretched by having financed some of the most expensive mergers, buyouts, and stock buybacks in history.

Figure 10: Nonfinancial Corporate Debt as a % of GDP

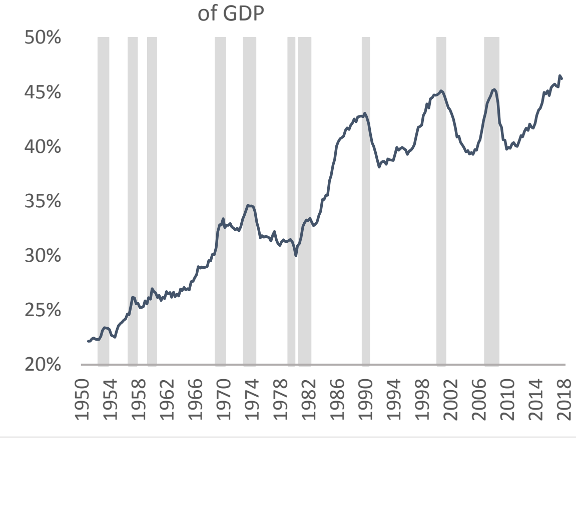
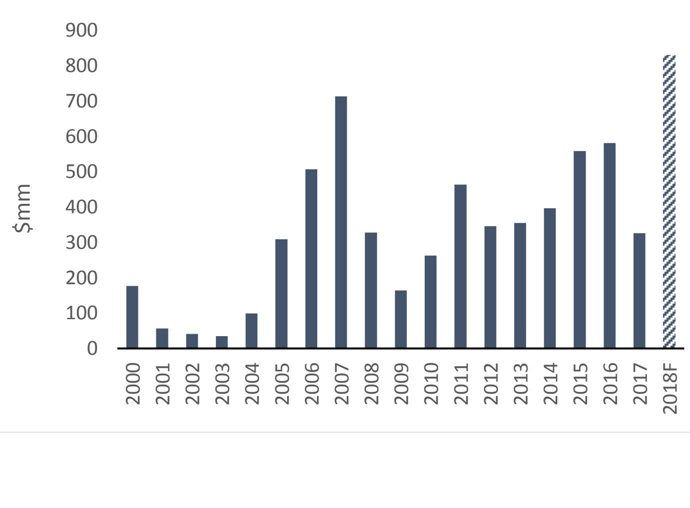


Figure 11: US Corporate Stock Buybacks



Division

Breaking up is hard to do. Or is the outcome hard to take?

There was no shortage of economically significant elections globally in 2018, especially amongst the members of the G-20. Three in particular—Italy, Brazil, and the United States—along with the ever present and dragged out Brexit process, top our lists of candidates for creating "division" with major spillover risks globally.

Italy

The Italian results were particularly interesting, especially as it concluded with the two largest parties, the right leaning E.U. critic "Lega Nord" and the left leaning anti-E.U. "Movimento 5 Stelle" forming a coalition government. To this day this odd union of Trumpist and Sanderist populism in the Eurozone's third largest economy has not resulted in a budget resolution with the E.U. nor made any meaningful attempts at domestic reform. From our perspective, budget proposals to date will do nothing other than require an E.U. bailout of the country when the next recession comes around, something not lost on the E.U. nor Germany nor France. On the other hand, the governing coalition knows that significant proposals (if only at that level) on economic reform will be needed for the E.U. to be satisfied with any compromise over the budget in 2019 or beyond.

So long as this impasse drags on, growth in Italy will not match pre-election levels, though will not necessarily be derailed from its present cycle either. We would wager on new elections before a recession, but both risks will continue to assist the anti E.U. rhetoric of left- and right-wing populist movements during 2019. The budget impasse with the E.U. is not likely to be resolved in the near term, and while the risks of an Italian exit from the E.U. are miniscule, the idea of "division" will remain part of the political landscape, especially as we get closer to the European Parliamentary elections in May.

Brazil

As shown earlier, Latin American equity markets were one of the shining spots within emerging markets in 2018, due primarily to high expectations coming out of the election results from the region's two biggest economies, Brazil and Mexico. The optimism around Brazil is centered around the potential for reform and fiscal prudence coming out of the Bolsonaro administration, while for Mexico it stands for pragmatism coming from the Andrés Manuel López Obrador (AMLO) administration. Count us out of that optimism, especially for Brazil.

Brazil needs very serious fiscal reforms, in particular entitlement reform. While the technocrat Michel Temer made some marginal progress in a short period, we are very doubtful a populist from the right wing of the political field who will need substantial support from a wide spectrum of Brazil's political world can achieve anything substantial. Marginal progress is a yes, but anything consequential is not likely. In our opinion, the risks are high that an impatient and impractical Bolsonaro administration will attempt to leverage its election victory and engage in an ideological battle with the opposition (not too different than what is happening in the U.S.), deepening "divisions" within the system and failing to achieve much if any during its first several years, other than damaging the improved optimism in the country since the recession of 2015-16.

U.S.

Unlike the 2016 elections, midterm elections in the U.S. actually ended without any surprises in aggregate. Democrats, as expected, took back control of the House of Representatives, while the Republicans held onto the Senate. Divided government returns to Washington after a brief two-year hiatus.

Historically speaking, a divided government in the U.S. seems to have worked out well. This has been most evident when the Republicans control the White House and Democrats control the House of Representatives. The appetite for fiscal stimulus and spending seems to reach an elevated level with this combination, and many analysts are expecting a similar outcome this time around as well. An argument for infrastructure spending as a common ground between the two sides dominates the universe of opportunities. But we disagree.

The appetite for confrontation and divisiveness is plentiful, as exemplified with the government shutdown. The Democrats' desire to investigate the President and his businesses have seemingly unlimited appetite, not to mention the ongoing Mueller investigations. We expect a significant amount of pushback from the executive branch as well as Republicans in Congress, in the form of delays, lawsuits (and countersuits), court decisions and appeals, leaks and counter leaks, not to mention tweets as 2019 progresses.

With the 2020 presidential primaries in the not-too-distant future, we have serious doubts that any of the Democratic candidates, many of whom will be coming from Congress, will have the slightest desire to hand President Trump any significant victories on the economic front in 2019 or 2020.

Brexit

For the third year in a row, the outcome of the U.K.'s division from the E.U. remains one of the top risks facing the global economy. With the March 29th deadline for resolution ever so close, the range of possible resolutions and their probabilities seem to be rising by the day.

A "no-deal" exit from the E.U. is now a real possibility, although it is not the preferred route for anyone on either side. Such an outcome would require many more years of hard and difficult negotiations beginning essentially from scratch and may end up being forced on all if the U.K. continues on its present path of paralysis on all fronts.

The present negotiated deal with the E.U., essentially a gift from the E.U. (a point seemingly missed by the Parliament in London), was not anyone's ideal outcome when negotiations began. The E.U. could have insisted on a far more punitive deal. From where we see the matter, neither the governing conservatives nor the Labor Party seem to appreciate that what Theresa May's government is presenting is the most viable (though again not anywhere near what the voters were promised when negotiations began) path given the time frame at hand. May's poor credibility, her divisiveness, and her lack of leadership has a lot to do with this low level of support. But it's still no excuse for rejection.

We are not surprised that talk of a new referendum (which would be our ideal outcome) is being floated by many. However, unfortunately given the path that the May government has taken over the past two years, and the limited amount of time left (though extensions to the deadline are always possible), we don't see this having a significant chance.

We still believe the most likely outcome will be a withdrawal with an agreement very similar to the one already negotiated, but it may require an extension of the deadline to perhaps the end of Summer 2019.

Major Implications for 2019

So, with more government deficits on the horizon, an over leveraged corporate sector in the U.S., political divisions that raise the level of noise and volatility, not to mention continued overvaluation of equities in many developed economies especially in the U.S., where do we see the global economy and financial markets heading in 2019 and beyond? From where we stand, as policymakers find themselves restricted by debt and division, they will find solace in regulation, and as companies burdened by debt find themselves even more limited by increased regulation, the economy will suffer and financial markets will revalue.

Regulation

We have previously discussed our concerns regarding the "real" regulatory trends in the U.S. and the impact they are likely to have in the coming years[2]. Contrary to what is prevalent in the markets, when it comes to trade agreements, foreign direct investment, and corporate decision making, the U.S. is heading in the direction of greater regulation with major implications for economic growth, business investment, and corporate earnings. And while the U.S. is the one country where we are

[2] *Mobasheri, Ardavan, May 19 2018. "Trump the deregulator? Au contraire." The Virginian Pilot*

concerned the most, populist nationalism in places such as the U.K., E.U., Brazil, Mexico, India, and the Middle East have the potential to magnify the issue.

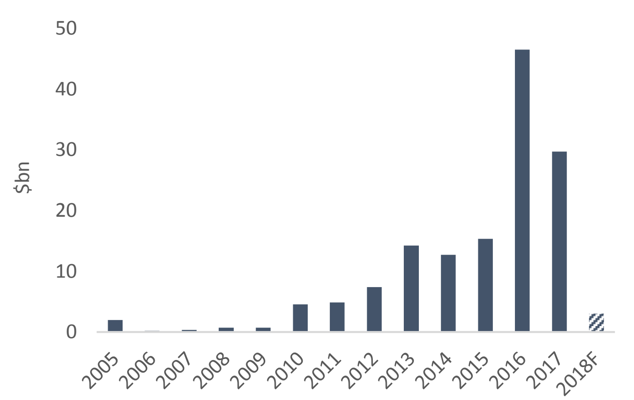
While the Trump Administration touts the recently renegotiated trade deals with Canada, Mexico, and South Korea as better and stronger deals, the proof is in the pudding. The renegotiated NAFTA agreement (also known as the USMCA, CUSMA, ACEUM, and TMEC depending on which country you are in) is simply a smaller and more restricted trade agreement, which includes many of the provisions that were already negotiated in the Trans Pacific Partnership (TPP) which the U.S. withdrew from in 2017. Likewise, the renegotiated agreement with South Korea is smaller and more restrictive, and amongst other things, includes provisions that continue to tax trucks imported into the U.S. for several more decades, and further limits the importation of steel into the U.S. for years to come.

The Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), which was passed with overwhelming bipartisan support, will restrict investment in the U.S. for decades to come, and oddly push the U.S. into zones of even further restrictions which for decades it had argued against when implemented by other countries. Matters will only get tougher in 2019 and 2020.

A meaningful trade deal with China is simply out of the question (though a face-saving one for the U.S. is still possible over the coming months). In fact, the continued trade war between the U.S. and China has not only discouraged China from purchasing U.S. Treasuries, but FIRRMA is also having a significant impact on Chinese investment into the U.S. (Figure 12). China has been one of the largest investors in the U.S. over the previous decade, and the loss of their capital will be difficult to replace at exactly the moment the federal government is crowding out private sector savings to finance its operations.

> "We therefore believe the risks to a U.S. recession beginning either during the later half of 2019 or first half of 2020 are much higher than what markets and/or investors are anticipating at the moment"

Figure 12: Foreign Direct Investment from China



A divided government and the need to prepare for the 2020 elections will further pressure the U.S. administration to propose if not implement populist regulatory measures. We expect drug price control proposals to grab significant attention over the coming months, as well as new proposals to restrict immigration, although this time focused on "legal" immigration. On the trade front, we expect the administration to gradually shift away from China and begin to focus on the E.U., Japan, and Southeast Asia (the ASEAN economies). Tensions with India regarding work visas for the technology sector will also begin to rise as we approach 2020.

We are forecasting an approximately 0.6% hit to U.S. GDP growth for 2019, and 0.5% for 2020 coming from these measures and uncertainties.

Recession

Our ACIMA Economic Exuberance Index (EEI) for the U.S. peaked in Q4 2017 and remained very volatile throughout 2018 (Figure 13). The risk of the exuberance bubble bursting was high on our lists of concerns for 2018, and the continued flattening of the yield curve, the drop-in equity prices, multiple contraction, and the weakening of forward expectations relative to the present conditions in consumer confidence significantly weakened the EEI during 2018.

Our index has proven to be an excellent forward-looking measure for the NY Fed's Recession Probability Indicator, which is based exclusively on the yield curve. By our estimates, this measure should peak at some point during 2019 in the zone of a 35%-50% probability of recession over the next 12 months. Historically speaking, whenever the index reaches such heights, a recession had either already started or would begin within a quarter or two.

To date, the data has indicated that the TCJA of 2017 failed to have any structural impacts on corporate decision making. According to the Commerce Department, after jumping by over $300 Billion during the first quarter of 2018, the rate of repatriation of overseas cash slowed significantly and ended the year at approximately $500 Billion, a rate slower than what occurred with a similar holiday back in 2004. In terms of where the tax savings and repatriated cash were used, while actual spending briefly rose during the first half of 2018, in relative terms, neither Capital Expenditures nor R&D spending have seen any expansion in their corporate spending role (Figure 14). As such, on a forward growth basis we should see a significant slowdown and negative hit as we move into 2020 for such spending.

Figure 13: ACIMA EEI vs NY Fed Recession Probability Indicator

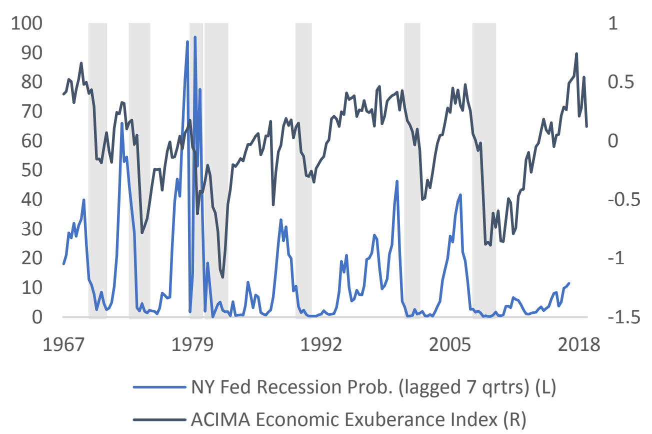
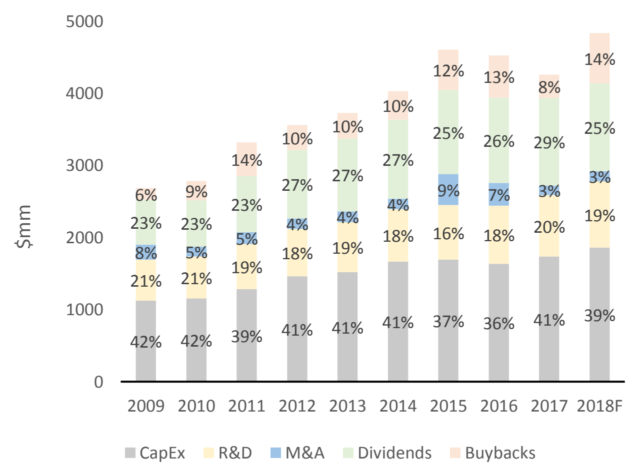


Figure 14: Flow of Funds - US Domestic Business



We therefore believe the risks to a U.S. recession beginning either during the later half of 2019 or first half of 2020 are much higher than what markets and/or investors are anticipating at the moment (the consensus view is presently at a 20% probability for the coming 12 months). Our growth forecast presently stands at 1.7% for 2019 and 1.3% for 2020, and we believe that under these circumstances the unemployment rate should trough out shortly (if it hasn't already), and begin to rise into 2020.

Spillover risks into other economies remain high given the size of the U.S., economic ties with the U.S., and the stage of the cycle for those economies. High on our list of concern are Mexico and Chile in the Americas, South Korea and the ASEAN economies in Asia, and the United Kingdom. While Canada, Japan, China, and the E.U. will be negatively impacted, given the internal dynamics of their cycles this time around, we believe these economies will be less at risk of a contraction due to influence from the U.S. than from their own internal trends.

Revaluation

Equities

While the press and pundits are busying themselves with whether to call the market drop of Q4 2018 a correction or a bear market, and if a bear market, whether it is a cyclical bear market within a secular bull market or something more, what matters to us is the drop itself.

Wall Street still seems to be consumed with what economic growth and earnings will be for 2019 as the reference for market returns. We would like to put ourselves in the forward-looking camp and believe that the market reactions of 2018 were the forward reaction to 2019, and therefore 2019 is already priced in. What matters to us for 2019 market performance is what the picture for growth and earnings will be for 2020.

> "What matters to us for 2019 is what growth and earnings will be for 2020, not 2019"

With the ten-year anniversary of the current economic cycle just around the corner (end of June 2019), and with our indicators pointing to a high probability of a recession or recession-like slowing (i.e. more than just a soft landing) for 2019-2020, the question for us becomes how much further will prices need to adjust before a fair level of valuation is achieved.

We continue to believe that in a recession or recession-like environment, U.S. corporate earnings can and will drop over 20%, and this time will not be any different. And while markets are forward looking and multiples expand during and the immediate aftermath of a recession, the driving force will be earnings. With the risks of recession high, we have a very difficult time accepting the near double digit rise in earnings expectations priced into U.S. equities for 2019 and 2020, and we firmly believe that a significant downward adjustment to earnings will be forthcoming, further pressuring equity prices. As such, we are at our most underweight allocation to U.S. equities and the most cyclically-sensitive sectors (i.e. basic materials, consumer discretionary, financials, industrials, and technology).

We also remain underweight the economies most tied to the U.S. and mentioned above. But given the underperformance to date of many of these markets, we will allow valuation measures, especially those in emerging markets, to drive our decision-making process. The economies least tied to the U.S. and/or those with preferable economic cycles relative to the U.S. and with the most attractive valuations remain our favorites. In developed markets, these include Australia, Canada, and Japan, and in emerging markets we favor Brazil, China, Turkey, Russia, and South Africa.

Fixed Income

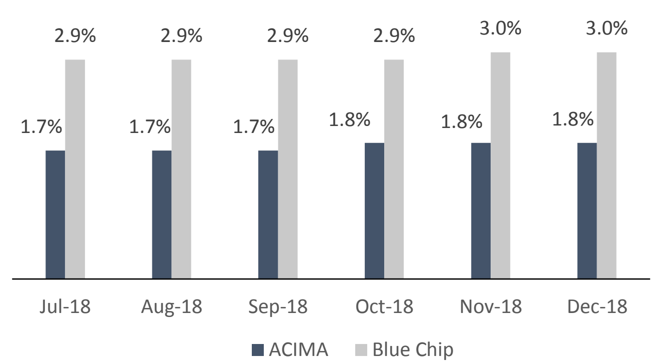
Our call for an earlier end to the Federal Reserve's interest rate hikes was out of consensus as late as the Fall of 2018. As discussed above, we believed that while stronger economic growth was somewhat impacted by the TJCA of 2017, it had a lot more to do with government spending and international trade dislocations than the consensus was giving the economy credit for, and would eventually lead to a slowdown in 2019.

Our call as early as January of 2018 was for rate hikes to peak in Q4 at 2.5%, and while that remains our forecast, we do believe there remains a good chance that we could see one more rate hike during Q1 2019. Our forecast is for rate cuts to commence in Q3 2019 (Figure 15), and for the yield curve (as represented by the difference between the 2-year and 10-year Treasury yield) to be inverted at some point in Q2 2019. Consistent with our probability of recession risks, we believe the term structure of the Treasury yield curve will be lower than present levels by year end 2019, and riskier corporate spreads much wider. We remain overweight U.S. Treasuries and Investment Grade corporate debt, and at our most underweight in US High Yield corporate debt.

We remain overweight U.S. Treasuries and Investment Grade corporate debt, and at our most underweight in US High Yield corporate debt

Internationally, we believe a more "patient" Fed, the end of rate hikes, and the beginnings of rate cuts in the U.S. will lead to Dollar weakness relative to the Euro, the Yen, and Canadian Dollars, and we are overweight debt denominated in those currencies (especially investment grade corporate debt). We are also overweight select emerging markets, especially the higher yielding markets with earlier stage economic cycles that have seen substantial weakness in their currencies to date.

Figure 15: Fed Funds Rate: Blue Chip Consensus for YE2019 vs ACIMA Forecast



Commodities

Our expectations for a weaker US Dollar, weaker developed market equities, and wider credit spreads will bode well for commodities, especially in the non-energy complex, and as such we continue to believe outperformance relative to financial assets is likely in 2019 and 2020.

Conclusion

Whether 2019 turns into a pivotal year for the global economic cycle as we expect remains to be seen. However, symbolism and its ability at times to widen our perspectives on longer-term trends around the world is never lost on us, especially when over the short horizon darker clouds seem to dominate the landscape. 2019 will have no shortage of such:

- Europe will celebrate 20 years of the Euro currency, and in our opinion will continue to strengthen its role in the global economy in the coming years despite recent skepticism.
- China will celebrate 40 years since the economic reforms of Deng Xiaoping began the long process of returning the country to global economic prominence. 2019 will also be 40 years since the U.S. officially recognized the Peoples Republic of China.
- India, the other great emerging economic power, will likely surpass the United Kingdom and become the fifth largest economy in the world as measured by nominal GDP.
- In the United States, the millennial generation will exceed the baby boomer generation in size for the first time, and will become the largest population group in the country, impacting trends in technology, consumer spending and financial services for decades to come.
- NASA will celebrate the 50^{th} anniversary of the moon landing, and how appropriate that the new economic power on the block (China) was recently able to successfully land a rover on the dark side of the moon.

Wishing you and yours a happy, healthy, and prosperous 2019.

As always, stay tuned;

Ardavan Mobasheri
Chief Investment Officer
January 18^{th}, 2019

IMPORTANT CONSIDERATIONS:

IMPORTANT DISCLOSURE INFORMATION

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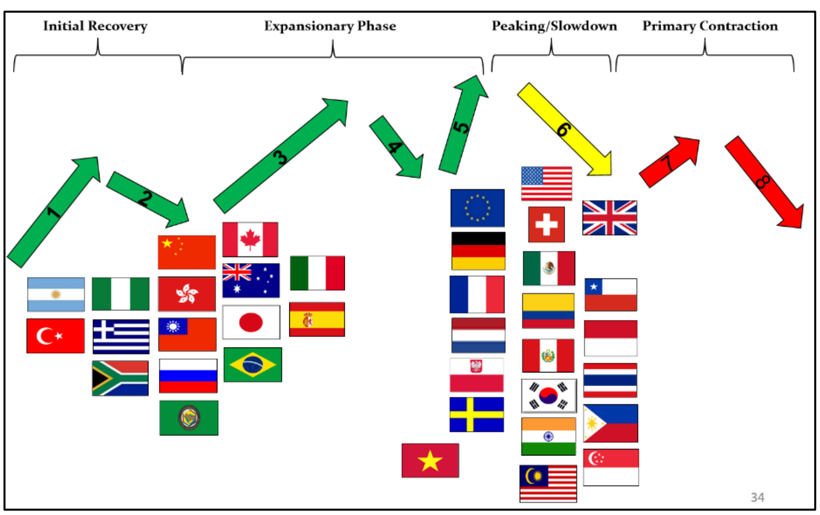
<u>Sources:</u>
Fig 1: Bloomberg
Fig 2: MSCI
Fig 3: Bloomberg
Fig 4: Bloomberg
Fig 5: CBO, FDIC, US Treasury, Federal Reserve
Fig 6: Blue Chip Survey
Fig 7: ACIMA Private Wealth, CBO
Fig 8: Federal Reserve
Fig 9: Federal Reserve
Fig 10: Federal Reserve
Fig 11: Bloomberg
Fig 12: Bloomberg
Fig 13: ACIMA Private Wealth, Bloomberg
Fig 14: Bloomberg
Fig 15: Blue Chip Survey

Capital Markets

	Asset Class	Return Assumption*	Volatility Assumption
Equity	Domestic Equity	-2.9%	16.1%
	International Equity	5.9%	17.3%
	Emerging Markets	11.2%	24.1%
	Real Estate	-2.9%	14.8%
Fixed Income	Muni Bonds	1.6%	4.6%
	U.S. Govt	1.6%	4.9%
	Int'l Developed (Govt)	-0.3%	3.3%
	EM Debt (Govt)	5.1%	12.5%
Alts	Commodities	2.5%	15.1%
Cash	Cash	2.0%	0%

*5-yr Annualized Returns except USA (7-yr)

Stage of Economic Cycle



Asset Allocation Recommendations

		Positive	Neutral	Negative
Primary Asset Class	Equities	○ ○ ○	○	🔴 🔴 ○
	Fixed Income	○ 🟢 🟢	○	○ ○ ○
	Alternatives	○ ○ ○	🟡	○ ○ ○
	Cash & Equivalents	○ ○ 🟢	○	○ ○ ○

			Positive	Neutral	Negative
Equities		U.S.	○ ○ ○	○	🔴 🔴 🔴
		North America (Ex-US)	○ ○ 🟢	○	○ ○ ○
		Europe	○ ○ ○	○	🔴 🔴 ○
		Asia	🟢 🟢 🟢	○	○ ○ ○
		Latin America	○ 🟢 🟢	○	○ ○ ○
		EMEA	○ ○ 🟢	○	○ ○ ○
Fixed Income	US	Government / Agency	○ ○ ○	🟡	○ ○ ○
		Investment Grade Corp	○ 🟢 🟢	○	○ ○ ○
		High Yield	○ ○ ○	○	🔴 🔴 🔴
	Int'l	Government / Agency	○ ○ 🟢	○	○ ○ ○
		Investment Grade Corp	○ ○ ○	🟡	○ ○ ○
		High Yield	○ ○ ○	🟡	○ ○ ○

Investment Philosophy

ACIMA
PRIVATE WEALTH

INDIVIDUAL IN FOCUS:

You are Unique

- Your Risk Tolerance does not fit a predetermined box
- Your Portfolio should be carefully crafted in accordance to your goals
- Past experiences have created understandable biases, which we will seek to appreciate and discuss with you

GLOBAL IN PERSPECTIVE:

We Believe You Should be Positioned for Global Opportunities

- The world today is connected more than ever
- Opportunities are found globally, not limited regionally
- Investment returns can be enhanced and volatility mitigated through global diversification

PROACTIVE IN APPROACH:

We Believe in Being Proactive, not Reactive

- Each stage of a business cycle presents unique investment opportunities
- Asset allocation is a meaningful driver of investment returns
- Proactive is also being sensitive to taxes and fees