Ken Leech
Chief Investment Officer

Webcast Summary

1Q19 Market & Strategy Update

Our cautious optimism continued into the new year even as we saw a slight downshift in global growth. This was not catastrophic by any means and along with subdued global inflation should provide monetary policymakers with a ramp to be more accommodative and pause or perhaps pull back from their normalization efforts. After a confusing about-face with contradictory comments from Federal Reserve (Fed) officials last quarter, we're encouraged by their latest commitment to be more data-dependent. The US and global economies are still burdened with debt and slowing growth prospects, but we think monetary policy can play a vital role in helping extend the global expansion, rather than respond to a phantom inflation that has yet to materialize. After a very challenging 2018 for emerging markets (EM), we continue to believe this sector is very well positioned to outperform in the year ahead.

Market Review

- US interest rates remained attractive relative to most of the developed world.
- US and global inflation both undershot expectations, with US inflation failing to reach the Fed's 2% target for the eighth consecutive year.
- Inconsistent messaging from the Fed caused confusion and market volatility.
- Trade policy and stagnant real wages continued to be the most substantial threats to the global recovery.

US Economic Outlook

- Low US inflation should give the Fed significant latitude to keep rates low and help maintain the US expansion.
- There continues to be slack in the US labor market, and there is still room for increases in capacity utilization.
- Headwinds to the US economy include stagnant real wages, ongoing trade policy issues with China, tapering home sales growth, subdued oil prices and the expiration of fiscal stimulus that helped boost 2018 growth.

Global Economic Outlook

- Global growth has been shifting downward, but we expect it to improve in the first half of 2019, although very slowly.
- Slowing money growth suggests a continuation of low global inflation.
- Eurozone growth and inflation will be slowly improving, albeit from low levels.
- Given very limited EM inflation, EM central banks have much more scope to develop conventional monetary policy.

- **Europe:** Despite pessimism surrounding issues with Italy, France and Brexit, eurozone domestic demand continues to slowly improve. Economic fundamentals are solid, and we expect inflation to rise gradually as economic slack diminishes.
- **Japan:** Even with continually improving employment, Japan's inflation continues to be very subdued.
- **China:** The trade tensions with the US forced China to reconsider its tight policy last year, leading to a very slow-rounding bottom in Chinese growth, and we expect stronger growth in the second half of this year.

Investment Themes

- The German bund market has overshot so extremely due to all the Europe-related pessimism; we think it's now the most over-valued government bond market in the world.
- After the protracted trade tensions between the US and China, we think there's a real possibility that we could arrive at a deal.
- **High-yield:** After the energy-fueled spike, the default rate has declined sharply; the fundamental credit story for European banks remains constructive, with improving fundamentals.
- **Investment-grade:** Spreads are now 54 basis points wider than in 2018. This is a much better entry point than a year ago, which presents a very attractive opportunity.
- **EM:** While this was the most challenged sector last year, we expect it to be the greatest candidate for outperformance this year.
- **MBS:** Mortgage pass-throughs are becoming attractive, with MBS option-adjusted spreads at multi-year highs and wider than the historical long-term average.

Q&A Highlights

- We don't think there's a risk that Fed officials are too reactionary to market conditions. In fact, we believe that they had a bit too much confidence in their forecast models, which turned out to be inaccurate, and that they could benefit from paying greater attention to the market.
- We are keeping an eye on the build-up of BBBs and the potential for fallen angels. This influences our issue selections based on industry and sector, but our opinion now is that this build-up is not by itself a source of systemic vulnerability for the US economy.
- The unprecedented debt loads around the world are something we're keeping a close watch on. We realize that leverage accelerates growth, but of course there are downside risks. Debt today is at the expense of future growth. We think that this is another reason for central banks to keep interest rates down in the current environment, and that central banks should be incredibly cautious.