Sit Investment Associates

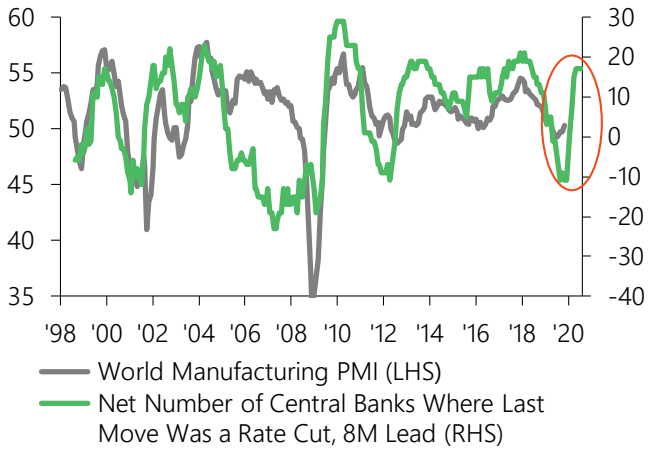
January 2020

GLOBAL INVESTMENT OUTLOOK AND STRATEGY

- **Special Topic: Favorable Outlook for Global Equity Markets in 2020**
- **Record-Long U.S. Expansion Will Endure; Recession Risks Ebbing**
- **Global Central Bank Easing Has Set Stage for Uptick in GDP Growth**
- **Trade-Reliant Economies to Reap the Benefits of Reduced Tensions**
- **Solid Growth + Mixed Inflation Signals = Steeper U.S. Yield Curve**

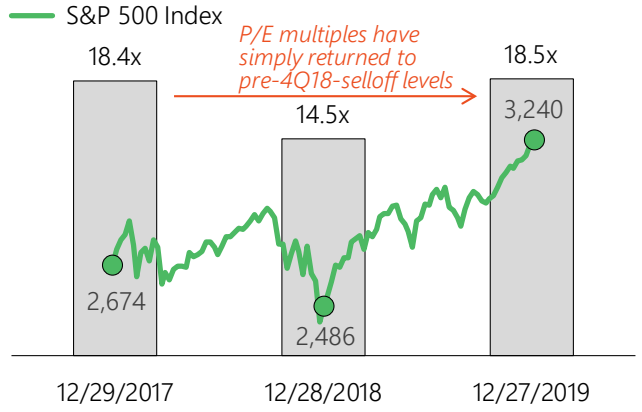
Handoff Underway from P/E-Driven to Earnings-Driven Equity Market

Policy Supporting a Manufacturing Rebound



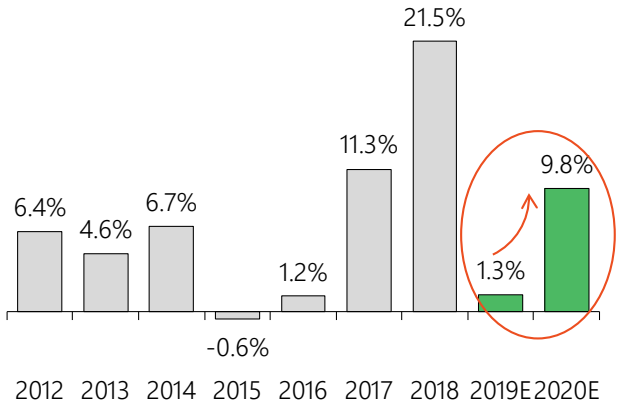
P/E Multiples Merely Back to 2017 Levels

S&P 500 Price-to-Earnings Ratio, Last Twelve Months

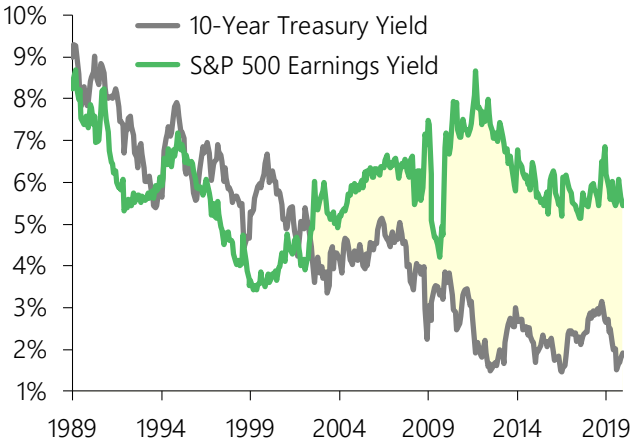


Stage Set for a Corporate Earnings Inflection

S&P 500 Bottom-Up EPS Growth



Equities Remain Attractive Relative to Bonds



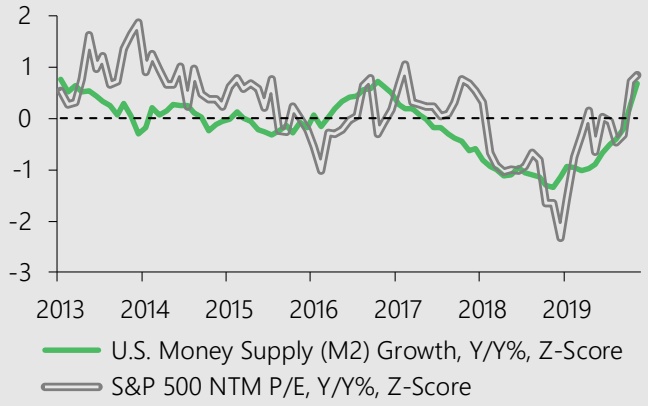
Source: Markit, JP Morgan, BCA Research, FactSet, 12/31/19

Favorable Outlook for 2020

After a turbulent end to 2018, the S&P 500 Index produced its second strongest gain in two decades in 2019, as investors battled their way through an often chaotic, news-driven year. While most equity indices are hovering near all-time-highs, fundamentals are broadly positive and point to further gains in 2020.

The negative influences that sparked the late-2018 stock market correction – rising interest rates and trade tensions – reversed course to become positive catalysts in 2019. Spreading signs of global macro weakness prompted interest rate cuts and revived quantitative easing programs, once again, reminding investors of the influence central banks have on markets. While investors may not be able to count on significant rate reductions from already low levels, major central banks are rapidly expanding their balance sheets. As shown below, reflationary periods (defined by growth in the money supply) have been strongly correlated to market valuations.

Liquidity Fuels Equity Market Valuations

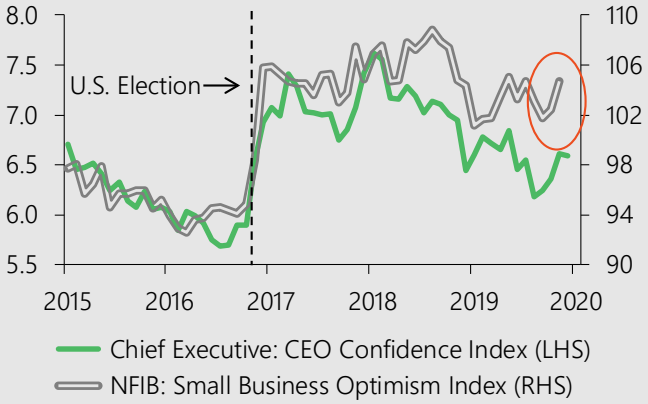


Source: U.S. Federal Reserve, FactSet, 1/3/2020

The U.S. consumer, buoyed by steady job and wage gains, has remained the key pillar of growth for both the U.S. and global economies. However, trade tensions and the lagged impact of previously restrictive monetary policy have weighed on the manufacturing sector over the past 18 months. Importantly, manufacturing and capital spending appear set to rebound, aided by the combination of central bank policy easing and more optimism on trade following the recently announced U.S.-China "phase one" deal. Recent economic data does, in fact, confirm a stabilization in the global manufacturing sector, including the beleaguered auto industry. Moreover, trade-dependent economies of Europe and Japan, along with key emerging markets, should incrementally improve relative to a more closed, consumer-driven economy such as the U.S. While we expect an uptick in global GDP, the improvement should be relatively modest and not enough to put central bankers on high alert. In fact, the absence of inflation has become key concern of policymakers, including the Federal Reserve. Therefore, we suspect it will allow the economy to run "hot" before it considers a tightening bias. Bottom line, the current "Goldilocks" backdrop for risk assets looks set to continue as we enter 2020.

With equity valuations now at "fair" levels, we believe an improvement in corporate earnings will be a key determinant of the direction and magnitude of equity returns going forward. The "earnings recession" that began in late-2018 coincided with the intensification of trade tensions and notably impacted manufacturing, including significant inventory de-stocking. In addition, surveys have repeatedly highlighted trade policy as injecting caution into capital spending plans. With recession fears fading and trade sentiment improving, we suspect the notable uptick in CEO confidence signals an uptick in capital spending in the year ahead.

Notable Uptick in Business Confidence

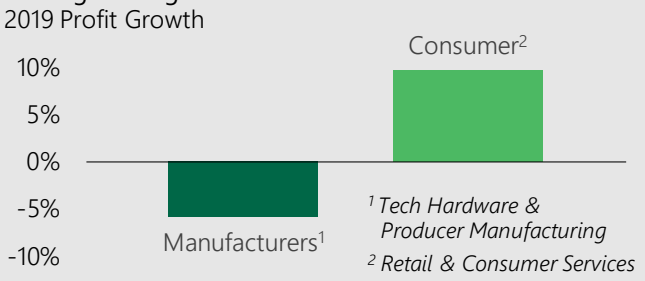


Source: Chief Executive Magazine, NFIB, 12/31/2019

Corporate earnings have been impacted by weaker manufacturing activity, and the following chart highlights the marked divergence between the consumer and manufacturing sectors' recent earnings. As noted, help for manufacturing is on the way in the form of trade (including tariff reductions) and monetary policy.

Difficult 2019 for Manufacturers

Earnings Divergence Within S&P 500
2019 Profit Growth



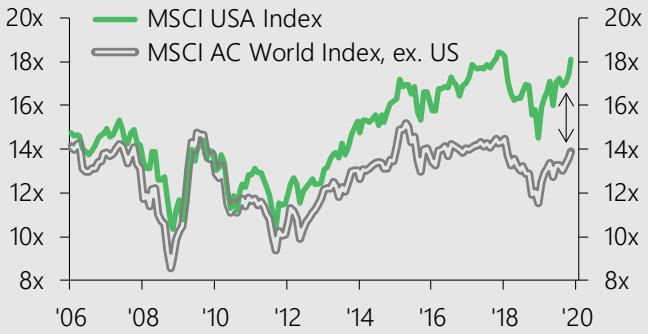
Source: FactSet, 12/31/2019

Sector-specific earnings pressures also appear to be ebbing, as higher oil prices will boost the energy sector, and a steeper yield curve will help bank earnings. Finally, the unrelenting climb in the U.S. dollar has continually pressured the profits of multinationals in recent quarters, but the retreat in the dollar in recent months implies a negligible impact if prevailing exchange rates hold. These factors should contribute to the end of the "earnings recession" fears that have periodically weighed on investor sentiment. Wall Street earnings forecasts have a long history of being overly optimistic, but the high-single-digit profit growth embedded in S&P 500 expectations may not be a stretch if current fundamentals persist. This is an important development considering the strong 2019 rebound in valuations.

In terms of equity valuations, price-to-earnings multiples are high from a historical standpoint but far from unprecedented and accompanied by rock bottom short and long-term interest rates. While it is true that higher price-to-earnings multiples account for most of the market gains in 2019, we must note that stocks are only marginally more expensive than they were before the fourth quarter correction in 2018. And despite the recent jump in the U.S. 10-year Treasury yield, it is approximately the same as the dividend yield for the S&P 500. While one could make a case for multiple expansion based on interest rates and the imminent return of corporate profit growth, we suspect "late cycle" psychology may restrain valuations from here. However, a re-rating of non-US stocks is quite possible given relatively depressed valuations. Most non-US markets are more influenced by cyclical swings in the global economy, and even a modest growth uptick could push valuations somewhat higher.

Valuation Gap Should Narrow

Next Twelve Month Price-to-Earnings Ratio



Source: FactSet, 12/31/2019

While the "Goldilocks" environment is supportive of stocks near-term, 2020 is not without risks, including a re-escalation of the trade war, a further step down in economic growth, and unexpected inflation. An inflation "surprise" may be the most underappreciated of these risks. The absence of inflation has been a feature of the ongoing bull market, but a resumption in global growth could reignite fears, particularly since labor markets have tightened globally, and commodity prices have recently been on the rise. Renewed trade tensions also represent a risk, and the prospect of a "phase two" U.S.-China trade agreement appears daunting. Finally, the U.S. election could bring uncertainty around policy, and the stakes are especially high this time around due to vastly different agendas among candidates. From our perspective, a key role of active management is to pivot, perhaps aggressively, when conditions warrant such a move. A focus on quality, including dividend-paying stocks, is a key element within our strategies that offer inherent downside protection should market conditions change.

From an investment perspective, the same set of conditions that has provided a near-perfect environment for stocks over the decade-long expansion appears sustainable over the intermediate-term, including slow economic growth and low interest rates underpinned by structural disinflationary pressures. Throughout this cycle, slow growth and the scars from the 2008 downturn have led to an extreme degree of caution among consumers and corporations. There are simply no systemic, obvious "excesses" – either in the real economy or asset prices – to unwind. Until these risks emerge, we expect this "aging" market cycle to get even older.

The United States

Positive developments on the trade front, accommodative monetary policy, and improving manufacturing activity have contributed to an incrementally better outlook for 2020.

The Record-Long U.S. Economic Expansion Will Endure for at Least Another Year

The U.S. economy enters 2020 on solid footing, aided by precautionary monetary easing, still-stimulative fiscal policy, a healthy consumer, muted inflation, reduced trade-related risks, and a prospective uptick in global growth. With the Federal Reserve now signaling an extended period of policy restraint, the lagged effect of the cumulative 75-basis point interest rate cut in 2019 will bolster domestic activity well into 2020. Finalization of both the "phase one" U.S.-China trade deal and U.S.-Mexico-Canada Agreement should boost business confidence and spur capital spending as well. Not only has the risk of recession ebbed, but 2020 could also be a year wherein the economy fires on all cylinders, albeit at a governed pace. As a result, we now forecast real GDP growth of +2.0 percent in 2020, with an upward bias as better trade and investment offset a lower fiscal thrust. Risks to the outlook include a lengthy pause in Boeing 737 Max assembly, an inflation "surprise," re-escalation of trade/geopolitical tensions, and credit market disruptions. The disparate policies of U.S. presidential candidates is also a risk in the runup to the 2020 election.

Imminent "Phase One" U.S.-China Trade Agreement a Positive Step Forward

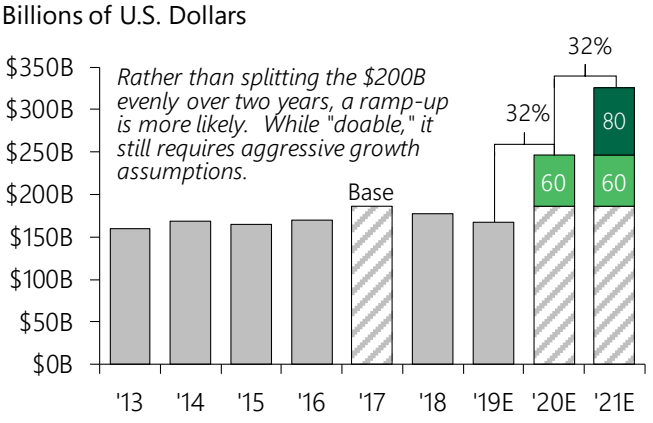
The mid-December announcement that the U.S. and China have agreed on the terms of a "phase one" trade deal, while not a game-changer, signified a significant ceasefire in the 18-month long battle. The specifics of the deal, yet to be signed, have not been revealed. However, China has ostensibly agreed to boost purchases of U.S. goods and services by at least $200 billion over the next two years in exchange for initially modest rollbacks in U.S. tariffs (Exhibit 1). The fact that duties will remain in place on about $370 billion in Chinese imports suggests (1) the U.S. is not merely taking China at its word, and (2) little enforceable progress has been made on some of the more contentious issues. Moreover, we are skeptical the asserted purchase target is even feasible. If the $200 billion increase, based off 2017 trade levels, is split evenly between 2020 and 2021, China would need to import $286 billion in U.S. goods and services in 2020 – 70 percent more than the 2019 run rate (Exhibit 2). If achieved, this would add roughly 50 basis points to GDP in 2020

Exhibit 1: U.S. Tariffs on Chinese Imports

Effective date	Tariff List & Value	Tariff rate
7/6/2018	List 1 (≈$34bn)	25%
8/23/2018	List 2 (≈$16bn)	25%
9/24/2018	List 3 (≈$200bn)	10%
6/1/2019	List 3 (≈$200bn)	↑ 25% from 10%
9/1/2019	List 4A (≈$120bn)	15%
Jan 2020 (est.)	List 4A (≈$120bn)	↓ to 7.5% from 15%
	Suspended	
	List 4B (≈$180bn)	15%
	List 1-3 (≈$250bn)	↑ to 30% from 25%

Source: CICC Research, 12/16/19

Exhibit 2: U.S. Exports to China



Source: Bureau of Economic Analysis, Sit Investment Associates, 1/4/20

according to Cornerstone Macro, exclusive of any positive knock-on effects. Despite the dubious purchase target, the deal is a vital step forward and likely additive to U.S. GDP.

Capex Set to Improve but Upside Likely Tempered by Ongoing Uncertainties

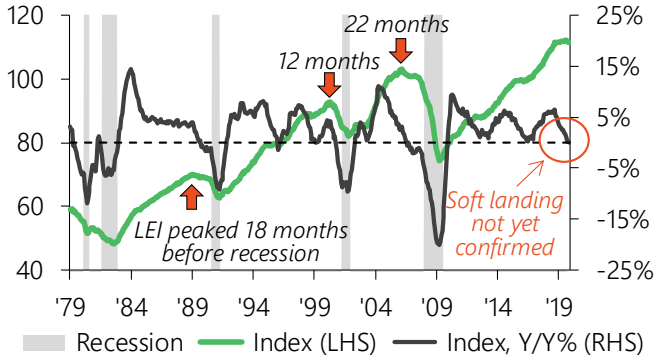
Business confidence, while still above pre-2016 election levels, has been on a downtrend for the past two years as the lagged impact of 2015-2018 Federal Reserve tightening and chronic trade policy uncertainty contributed to a slump in manufacturing and dampened economic prospects. Capital spending growth followed suit, steadily fading after an early 2018 peak. However, concurrent easing by central banks worldwide, fiscal stimulus, and diminished U.S-China trade tensions have since set the stage for at least a modest upturn in global growth. After six months of contraction, the world manufacturing PMI turned expansionary in November, with several measures signaling further improvement ahead. Although the year-over-year percent change in U.S. leading indicators has yet to bottom, as shown in Exhibit 3, financial conditions are conducive to improved economic activity. Business confidence has risen modestly in recent months, and we suspect this trend will persist with better news on the trade and global growth fronts. Capital spending, which expanded only +1.0 percent year over year in the September quarter, is now expected to rebound +4.7 percent in 2020 based on recent Duke/CFO Magazine survey results.

Another Government Shutdown Averted; Debt Burden a Mounting Concern

On December 20, President Trump signed into law two bipartisan spending bills totaling $1.4 trillion just hours before existing stopgap funding was set to expire, thereby averting a federal government shutdown. Whereas Congress enacted $899 billion in net spending cuts between 2011 and 2016 as the economy stabilized post-crisis, government spending has been decidedly stimulative since 2017 (Exhibit 4). Fiscal thrust, albeit moderating, is projected to add about 20 basis points to GDP growth in 2020. Ballooning federal debt, however, may not only limit a fiscal response to the next recession but also exert upward pressure on interest rates as Treasury issuance continues to swell – the current impact of which is being blunted by Federal Reserve purchases. The Committee for a Responsible Federal Budget estimates spending legislation passed in 2019 alone will add around $2.2 trillion to the federal debt over the next decade, which the CBO earlier projected would grow nearly 50 percent to $34.4 trillion by 2029. While modern monetary theorists tout this is of little concern in a low-interest rate, low-inflation world, the buildup in debt is a global phenomenon. Per the World Bank, the global economy is now in its fourth wave of debt accumulation in the last 50 years – the first three all ended in financial crises.

Exhibit 3: U.S. Leading Economic Indicators

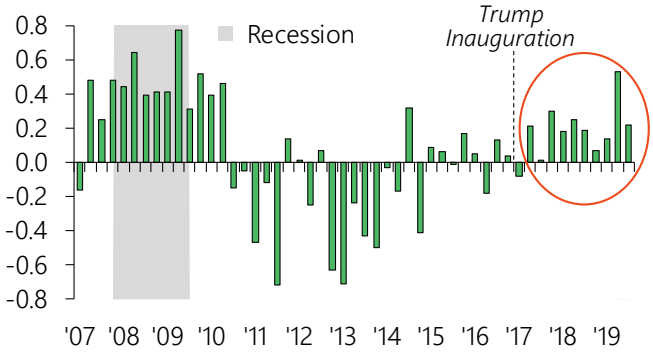
U.S. Composite Index of 10 Leading Indicators
2010 = 100



Source: Conference Board, 12/31/19

Exhibit 4: U.S. Federal Spending & Investment

Contribution to Percent Change in Real GDP Growth
Q/Q, SAAR

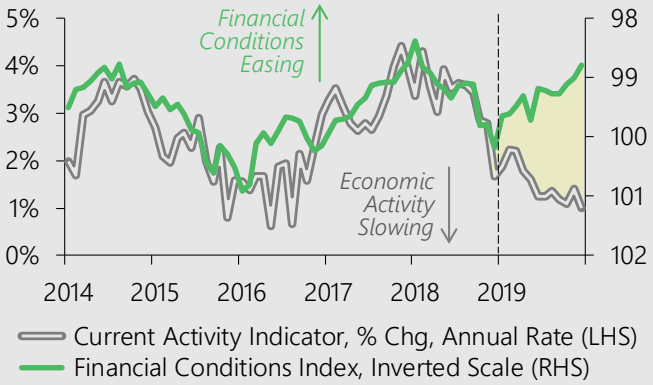


Source: Bureau of Economic Analysis, 12/31/19

United States: Notable Data Points

Financial Conditions Support Economic Growth

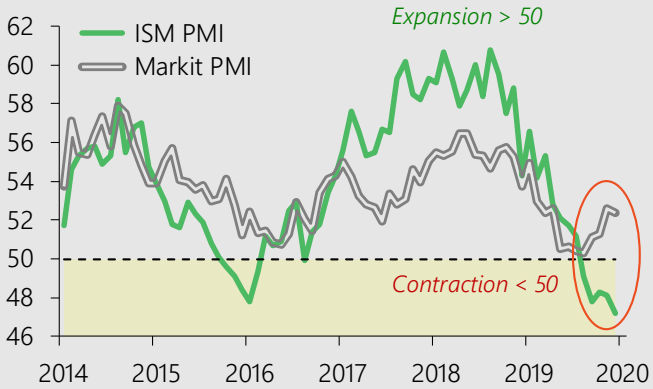
Current Economic Activity vs Financial Conditions
United States



Source: Goldman Sachs, 1/4/20

The Two Measures of PMI Have Diverged

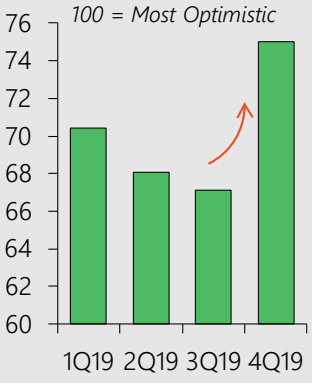
Manufacturing Purchasing Managers' Indices
United States



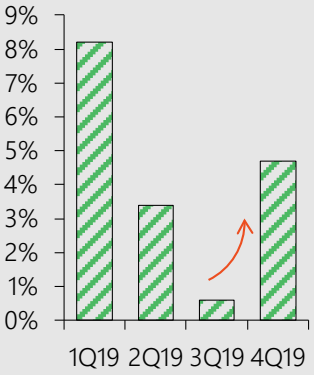
Source: Institute for Supply Management, IHS Markit, 1/4/20

Confidence & Capex Plans Improved Recently

CFO Optimism Index
Own Company, 0-100



Expected Δ in NTM Capex
Weighted Average, %



Source: Duke/CFO Global Business Outlook, 12/11/19

But Recession Risk Increasingly Top of Mind

Conference Board C-Suite Challenge 2020 (January 2020)

Top Concerns for Year Ahead	2020	2019	2018
Recession Risk	**1**	**3**	**21**
More Intense Global Competition	2	2	7
Tight Labor Market	3	n/a	n/a
Global Trade Uncertainty	4(T)	4	10
Global Political Instability	4(T)	6	n/a
Cybersecurity	6	1	6

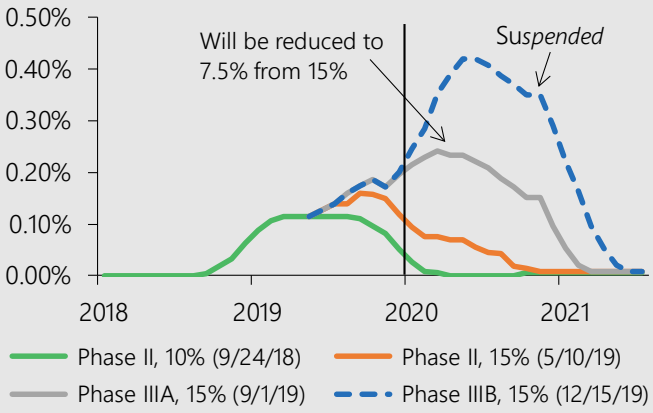
Duke CFO Global Business Outlook (December 2019)

When do you expect a U.S. recession?	
By the end of 2020	52%
By the middle of 2021	76%

Source: Conference Board, Duke/CFO, 1/2/20

China Import Tariff Risk Dissipates with Deal

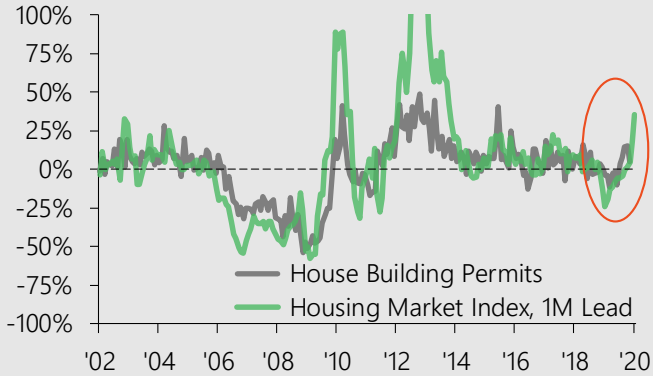
Cumulative Tariff Contributions to Y/Y% Change in CPI



Source: Cornerstone Macro, 1/6/20

Lower Interest Rates Boosting Housing Market

U.S. Housing Market Index vs Building Permits
Y/Y Percent



Source: U.S. Census Bureau, NAHB, 12/31/19

Europe

An upturn in global trade is a tailwind for the Euro Area, but we do not expect a repeat of the China-stimulus-driven boom of '16-'17. The UK will leave the EU, but uncertainty will stay.

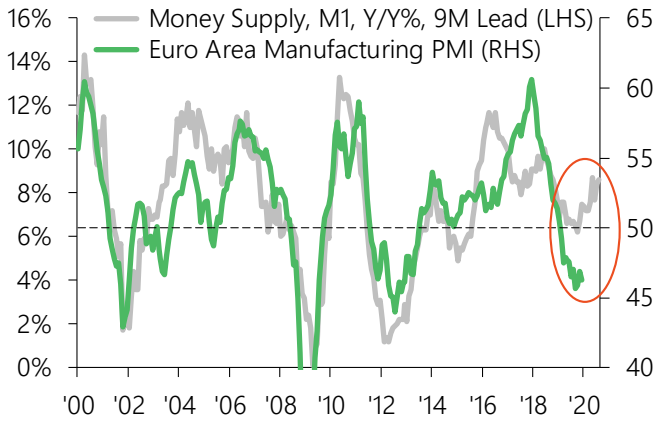
Euro Area Will Benefit from Accommodative Policy and a Recovery in Trade

Just as the trade-reliant Euro Area suffered the fallout from the downturn in global trade that began in early 2018, so should it reap the gains from the prospective modest upturn. However, a higher fraction of incremental global demand driven by emerging markets, in which the Euro Area has comparatively less trade exposure, may temper export upside. A shift in China's policy priorities, still-elevated Brexit-related uncertainty, possible U.S. trade actions, and structural issues within the auto sector may also hamper exports. Still, with domestic demand also bolstered by easing financial conditions and the largest fiscal thrust in a decade, money supply presages a decisive turn in the region's manufacturing PMI (Exhibit 5). With export demand stabilizing and the risk of contagion from a weak manufacturing sector lessening, a resilient services sector and healthy consumer spending will underpin modest GDP growth and keep recession at bay. We project Euro Area real GDP growth will remain above +1.0 percent for the full year in 2020, with modest sequential improvement as the year proceeds.

While a Tory Majority Now Assures Brexit, the UK Still Faces an Uncertain Future

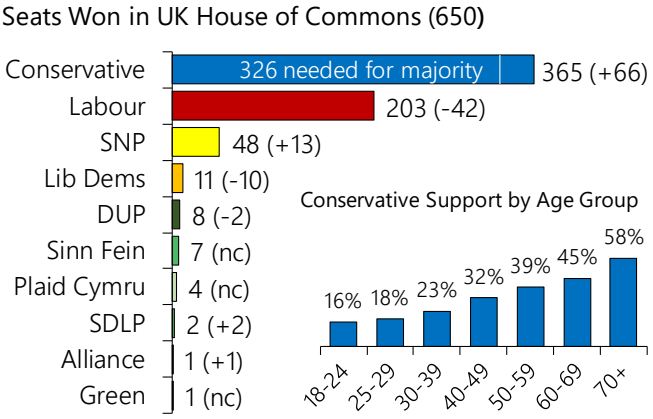
PM Johnson's bet on a snap election to end the prolonged stalemate over Brexit paid off big, with his Conservative party securing its largest majority in the House of Commons since 1987 (Exhibit 6). While ratification of the Withdrawal Agreement Bill by the end of January 2020 is now all but assured, uncertainty will remain elevated as both the terms of post-exit trade and departure timing are yet to be settled. Johnson's pledge to forego an optional extended transition period and exit the European Union at the end of 2020, with or without trade agreements in place, represents another "cliff edge" with which to contend. Forward momentum on Brexit, however, will enable companies to plan for the inevitable, possibly unleashing some pent-up business investment. A modest lift in fiscal spending, a pro-growth policy agenda, and potential cuts in interest rates, combined with an expected uptick in global trade, are additional tailwinds for the UK economy in 2020. Yet, a possible lack of progress on critical trade agreements risks denting confidence and economic growth once again in the second half of the year. Within the context of a fluid policy backdrop, we expect real GDP growth to stabilize at about +1.2 percent in 2020.

Exhibit 5: Euro Area Money Supply vs PMI



Source: European Central Bank, Markit, 12/31/19

Exhibit 6: UK General Election Results (12/12/19)

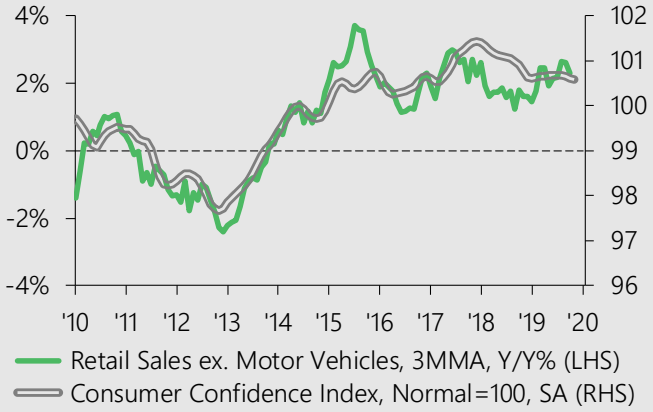


Source: Independent, YouGov UK, 12/16/19

Europe: Notable Data Points

Resilient Consumer Underpins Euro Area GDP

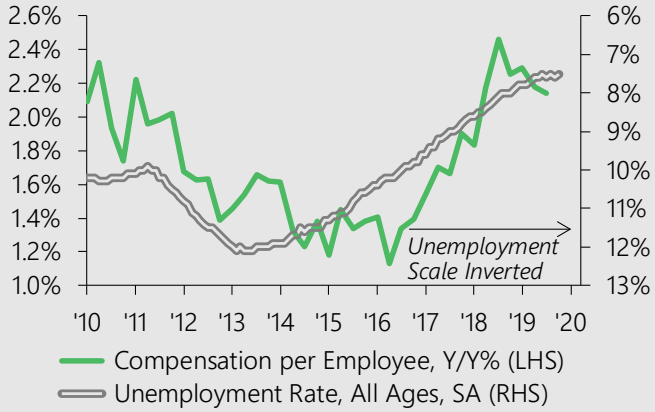
Euro Area Retail Sales vs Consumer Confidence



Source: Eurostat, OECD, 12/31/19

Euro Area Unemployment Down; Wages Up

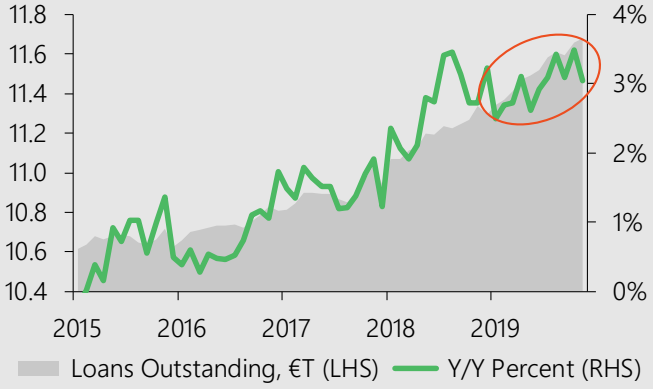
Euro Area Employee Compensation vs Unemployment



Source: Eurostat, European Central Bank, 12/31/19

Credit Supportive of Economic Growth, But. . .

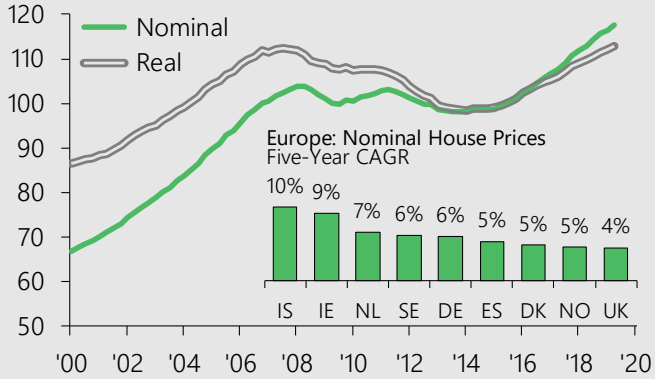
Euro Area MFI Loans Outstanding
€ Trillion



Source: European Central Bank, 12/31/19

Easy Money Contributing to Potential Bubbles

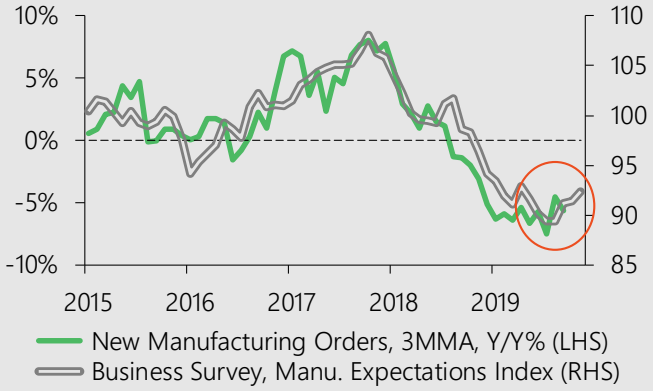
Euro Area House Prices
2015 = 100



Source: OECD, 12/31/19

German Business Expectations Recovering

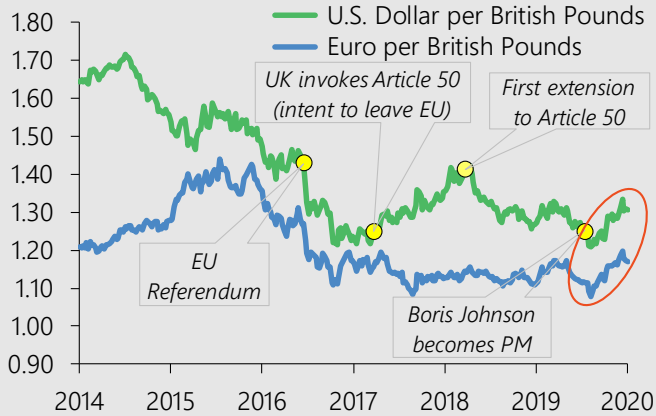
Manufacturing New Orders vs Business Confidence
Germany



Source: Statistics Germany, IFO National Institute of Research, 12/31/19

UK's Pound Sterling Continues to Strengthen

Pound Sterling Foreign Exchange Rates



Source: Reuters, 1/3/20

Japan

Growth in Japan remains uneven. The consumption tax hike will hold back the consumer, balanced by easing trade tensions, stabilizing manufacturing conditions, and fiscal spending.

Japan's economy is poised to grow at a modest pace of +0.5 to +1.0 percent in calendar 2020, though drivers will shift amid a continued uneven backdrop. Consumer spending, firm throughout 2019, is set to soften as the October consumption tax increase dampens activity. Early readings point to an initial pullback in spending as expected, though it will take time before the full impact of the hike becomes evident (Exhibit 7). Conversely, the industrial sector, pressured by moderating demand abroad and slowing capital spending since early 2018, may soon begin to reverse course. Tentative signs of stabilization from gauges of manufacturing activity, combined with the prospect of easing U.S.-China trade tensions, should lift corporate confidence and aid growth (Exhibit 8). Accommodative monetary policy will also remain in place, while fiscal spending will take on a larger role after the recent approval of a ¥13.2 trillion stimulus package. We project fiscal spending will contribute a cumulative +1.4 percentage points to GDP growth over the next few years, buoying the economy near term while the tax hike supports fiscal consolidation in the long run. However, the need for yet another stimulus spending package, the sixth since Prime Minister Abe took office in 2012, points to a still shaky growth outlook.

Emerging Markets

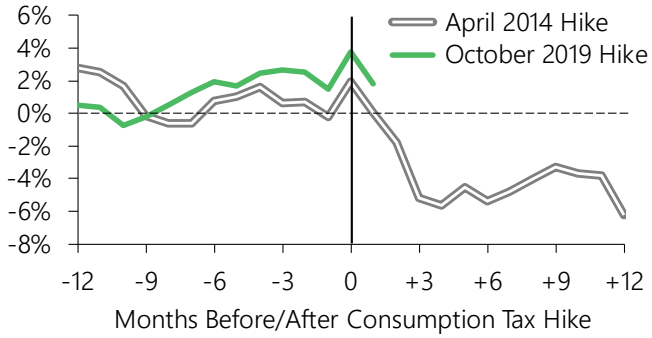
U.S.-China trade deal positive for emerging market growth; India's stimulus to help economy; S. Korea to benefit from improving trade; Brazil slowly growing while Mexico is stagnant.

A Finalized "Phase One" Trade Deal Would be a Clear Positive for China

While waiting for more clarity, most investors expect little real progress from the "phase-one" trade deal. However, even with anticipated limitations, we view this latest deal, if signed, as a turning point for U.S.-China trade tensions toward de-escalation. Despite a reported "snapback" provision, tariffs between the U.S. and China have likely peaked, at least through the end of 2020. We think a decline in U.S.-China trade-related uncertainty will have a positive impact on both Chinese and global economic growth. The partial rollback of the U.S. tariffs on Chinese imports implemented in September would reduce effective tariff rates on all tariffed Chinese goods to roughly 13 percent from 15 percent, which should lead to a modest recovery in export growth. Some relief in manufacturing

Exhibit 7: Japan Consumer Spending vs Taxes

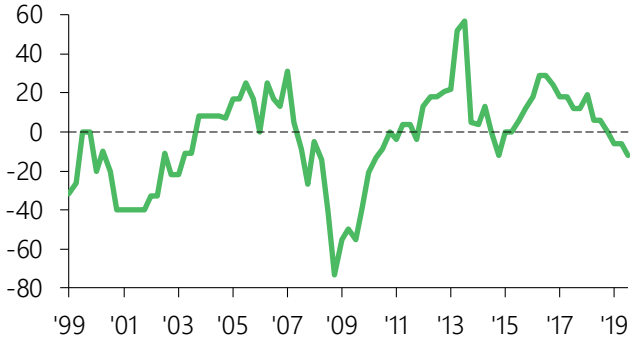
Japan Consumer Spending vs Consumption Tax Hikes
Y/Y% Change in Real Spending Before/After Tax Hike



Source: Ministry of Internal Affairs and Communications, 12/31/19

Exhibit 8: Japan Business Conditions

Tankan Business Conditions Diffusion Index
All Enterprises, All Industries, Percent



Source: Bank of Japan, 12/31/19

and business investment is also expected. Moreover, a trade truce provides a window of opportunity for Chinese policymakers to address structural reforms, which are needed to sustain China's long-term growth and likely be core issues for "phase-two" negotiations.

China's Economic Rebound Likely Shallow and Short Given Structural Challenges

Chinese economic data improved notably in November, especially industrial production and retail sales. However, as transitory factors such as warmer-than-normal weather, an early Chinese New Year, and higher inflation have also contributed to better growth, the sustainability of the rebound remains in question. While economic growth may stabilize or accelerate modestly over coming months, or even quarters, the longer-term trend is still downward in our view. A decrease in trade tensions with the U.S. will reduce a drag on China's economy and provide some relief in 2020. However, structural adjustments, which have been the main driver of economic malaise in the last two years, will continue to limit growth prospects in the intermediate term. Nearer-term, a key policy objective is to meet a pledge leadership made previously to double 2010 GDP within a decade, implying GDP growth of at least +5.9 percent in 2020 versus our forecast of +6.1 percent in 2019. Accordingly, both monetary and fiscal policy will likely remain accommodative, but the extent of easing will likely be reduced upon stabilization in economic momentum. At this point, we expect the focus of policymakers to shift back to structural reform to lay the groundwork for sustainable long-term growth (Exhibit 9).

India's GDP Growth Continues to Slow, but Signs of Stabilization

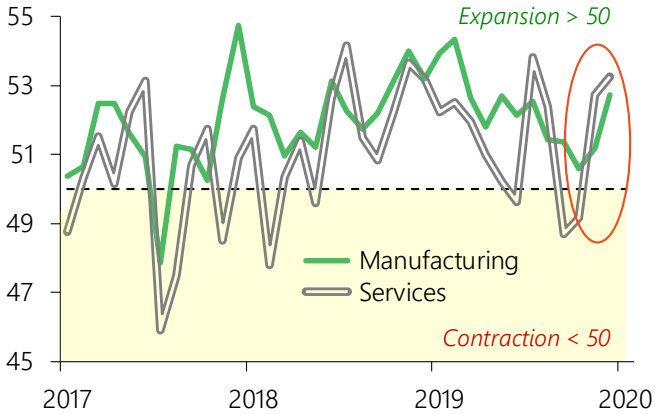
India's GDP growth moderated to +4.5 percent in the third calendar quarter of 2019, its slowest pace since 2013, on sluggish consumption, investment, and exports. However, there are signs economic momentum is bottoming, as industrial production expanded in October after two consecutive months of contraction, auto demand rose sequentially in both October and November, and PMI data improved to a 5-month high in December (Exhibit 10). We expect recent stimulus – which includes a reduction in corporate taxes, relaxed foreign direct investment rules, initiatives to increase credit to the private sector, and cuts in interest rates – to gradually filter through to the economy to support growth. In addition, while the Reserve Bank of India held interest rates steady at 5.15 percent in December, it will likely continue to lower rates as inflationary pressures moderate. We forecast GDP growth of +5.0 percent and +5.7 percent in fiscal years 2020 and 2021, respectively, driven by better consumption and investment. Risks include a worsening trade deficit, which widened to -$12.1 billion in November, and ongoing rural stress.

Exhibit 9: China – Areas of Structural Reform

Government	Fiscal reform, tax reduction, land reform, property tax reform, trade reform
Financial Market	Financial deleveraging, capital market opening, interest rate liberalization, FX reform
Corporate	Environmental protection, intellectual property protection, state-owned-enterprise reform, supply-side reform
Household	Pension reform, healthcare reform, household registration reform

Source: Blackrock, Sit Investment Associates, 1/6/20

Exhibit 10: India Purchasing Managers' Indices



Source: IHS Markit, 1/4/20

South Korea's Economy to Benefit from U.S.-China Trade Deal

South Korea should benefit from a U.S.-China trade deal, as exports represent over 40 percent of GDP, and about 70 percent of exports to China is for intermediate use. The U.S.-China agreement included a suspension of a 15 percent tariff on about $150 billion in Chinese goods, including smartphones, laptops, and toys scheduled to go into effect on December 15. As a result, South Korean export sectors connected to those products should benefit. Also, the South Korean government approved a 2020 fiscal budget that is +9 percent higher than 2019, to further buoy a faltering economy. One-third of the budget targets consumer assistance in the areas of healthcare, welfare programs, and employment. Moreover, the Bank of Korea cut its policy rate -50 basis points in 2019 to 1.25 percent, and we anticipate another 50 basis points in cuts given that inflation of +0.4 percent is below the target of 2.0 percent. We expect the trade deal and stimulus measures to help drive South Korea's economic growth to +2.2 percent in 2020 from +1.9 in 2019.

The Worst Is Over for Brazil's Economy, but Muted Pace of Growth for 2020

Brazil's GDP grew +0.6 percent on a quarter-over-quarter seasonally-adjusted basis in 3Q19 on a pickup in private consumption and investment. Although the pace of growth remains sluggish, we believe the worst is over for the economy. To spur growth, Brazil's central bank cut its Selic-rate by 50 basis points to 4.5 percent during the quarter, and we forecast further rate cuts to the tune of 50 basis points in 2020. We forecast GDP growth at +1.0 percent in 2019 and +2.0 percent in 2020, paced by improving domestic demand and investment. One upcoming risk in Brazil is the slow progress on a package of comprehensive reform bills of fiscal emergency funds, tax, and federal expenditures. These bills have modest support in Congress given weak governability conditions and that 2020 is a municipal election year, which reduces the legislative work calendar and appetite for amendments. Another concern is the U.S.-China trade deal that will boost China's purchases of U.S. soybeans at the expense of Brazil soybean exports to China. However, the impact on Brazil's economy should be relatively small, as soybean exports represent only about 2 percent of GDP.

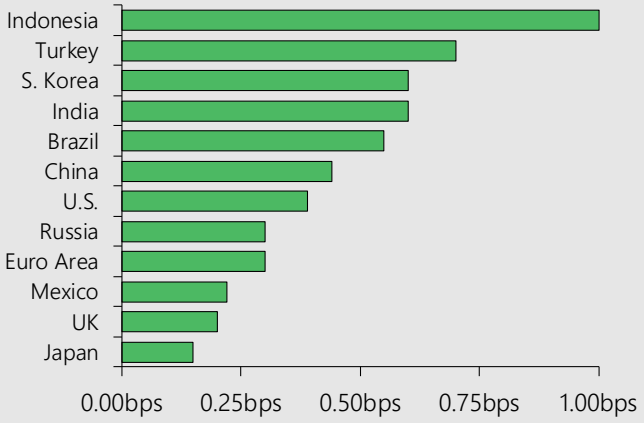
Mexico's Economy Barely Growing Despite Interest Rate Cuts

Pending ratification of the U.S.-Mexico-Canada Agreement (USMCA) by the U.S. Senate in early 2020 is a crucial milestone in providing trade clarity between these countries. A NAFTA breakdown and non-passage of USMCA would have resulted in higher inflation and lower trade owing to higher tariffs on agricultural and clothing exports to Mexico. Rabobank Research estimates a breakdown in NAFTA would have resulted in Mexico's inflation rising to 12 percent from 4 percent currently and a cumulative -2.6 percent loss in GDP by 2025. However, even with USMCA on track for approval, economic growth in Mexico remains dismal on weak domestic demand and investment. We lowered our GDP growth forecast for 2019 to +0 percent from +0.5 percent and project growth of +1.0 percent in 2020. Yet the government's minimum wage increase of +20 percent and a fourth -25 basis point cut to 7.25 percent, should help improve spending. We expect the central bank to maintain rate cuts next year, as inflation has been tame. However, there continues to be a lack of corporate investment, due to weak confidence in President Andres Manuel Lopez Obrador's policies.

Emerging Markets: Notable Data Points

Middle East Conflict Raises Risk of Higher Oil

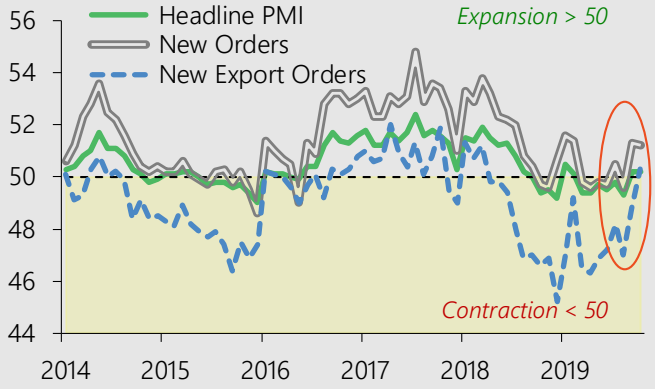
Impact on Headline CPI for Every US$10 Rise in Oil



Source: Morgan Stanley, 1/6/20

China New Export Orders Now Expanding

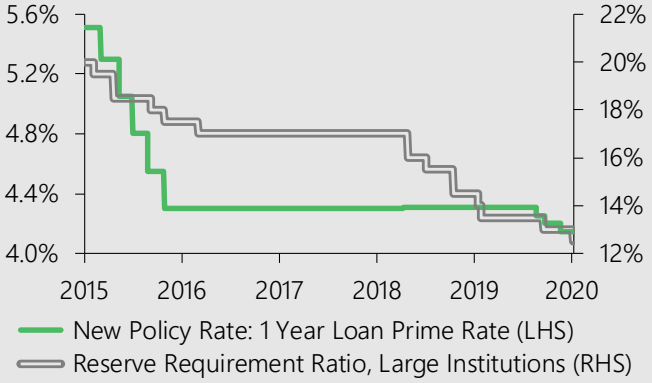
Manufacturing Purchasing Managers Index
China, Official Government PMI



Source: National Bureau of Statistics, 1/4/2020

Chinese Monetary Policy Incrementally Easing

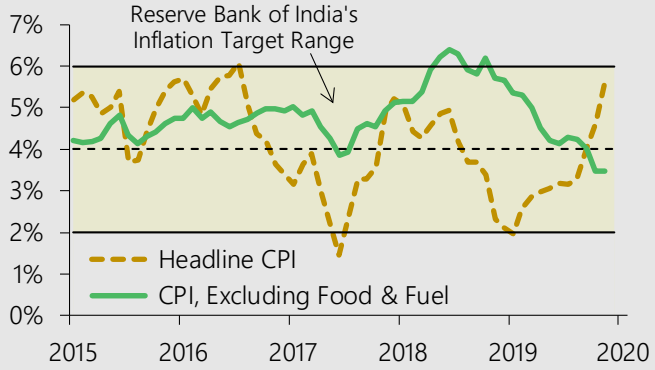
China Monetary Policy Rates
Percent



Source: People's Bank of China, 1/7/20

Ebbing "Core" CPI in India Supports Rate Cuts

India Consumer Price Index
Y/Y Percent



Source: MOSPI, CEICC, 12/31/19

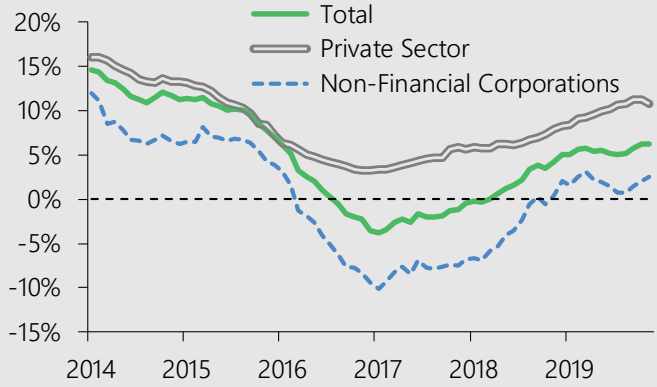
South Korean Exports Poised to Improve

South Korea Exports
3MMA, Y/Y Percent

Source: Korea International Trade Association, 12/31/19

Brazil's Credit Growth is Accelerating

Brazil Loans Outstanding
Y/Y Percent



Source: Central Bank of Brazil, 12/31/19

Taxable Bonds

Review of 2019 and Outlook for 2020

The Federal Reserve, which began lowering interest rates last July, cut the fed funds rate by a cumulative 75 basis points in 2019. While the U.S. Treasury yield curve spent most of the year inverted from 2-year to 5-year maturities, the interest rate cuts, along with an asset purchase program in T-bills, helped the yield curve steepen again in the latter part of 2019. The reduction in rates and accommodative monetary policy led to robust bond returns in 2019. However, we believe bond returns will moderate to more sustainable levels in 2020. The U.S. economy remains healthy, with high consumer confidence, low unemployment, and rising wages, all of which should boost inflation. However, we also think the Federal Reserve (Fed) will continue to struggle to maintain a healthy short-term repo market. While we see no looming economic need for future rate moves, persistent pressures in the repo markets may require ongoing accommodative monetary policies. As a result, we expect a steeper yield curve for 2020, with the short-end declining as the Federal Reserve continues to buy T-bills, and mounting inflation risks cause yields on longer-maturity bonds to increase. Finally, geopolitical risks and a presidential election year should provide attractive trading opportunities.

The Fed Provides Balance Sheet Support to the Repo Market

As discussed in our October 2019 report, disruptions in the repo market caused the Fed to intervene and calm markets with copious amounts of cash. In October, the Federal Reserve announced its intent to continue providing funding to the overnight markets through January of 2020 to avoid any funding disruptions over year-end. In addition, it announced the purchase of $60 billion per month of T-bills through the second quarter of 2020. Since September, the Fed has provided nearly $400 billion in liquidity to the market via these channels. (Exhibit 11). A key element of this intervention is to maintain overnight and short-term rates in line with the fed funds rate range, which is currently 1.50-1.75 percent. In its pursuit of avoiding year-end market disruptions in the $2.2 trillion repo market, the Fed has converted much of the overnight market to a short-term market, offering 3-15-day terms to fund the market beyond the turn of the year. We believe either a significant overhaul or discontinuation of the policy of paying interest on excess reserves will essentially need to happen before the Fed can get itself out of the repo business. Until such time, banks will continue to hoard cash rather than participate in the short-term cash markets.

PCE Inflation Will Move Higher as Measures of Consumer Prices Converge

Inflation will move higher in 2020 as U.S. economic activity should remain healthy and depressed inflation readings from early 2019 roll-off 12-month data. There is a growing disconnect between the two main gauges of inflation, core consumer price index (CPI) and core personal consumption expenditures (PCE) – using "core" for both measures strips out volatile food and energy components. PCE is the inflation metric favored by the Fed. The differences arise from the underlying components of the baskets of goods and nuances in their respective formulas. PCE will always understate CPI because it is assuming that consumers are purchasing substitute goods when their desired goods rise in price. This assumption becomes problematic on a fundamental level. If consumers are always purchasing substitute goods since the goods they want to buy are too expensive, this is essentially a degradation of their standard of living – CPI is essentially the actual inflation experience. Core CPI has generally been above 2 percent since early 2018. However, core PCE dropped substantially in early 2019 to 1.5 percent and is likely

to rebound in 2020 ((Exhibit 12). The recent low PCE numbers are artificially depressing inflation expectations, which should rise in 2020 as the metrics eventually converge.

Taxable Fixed Income Strategy

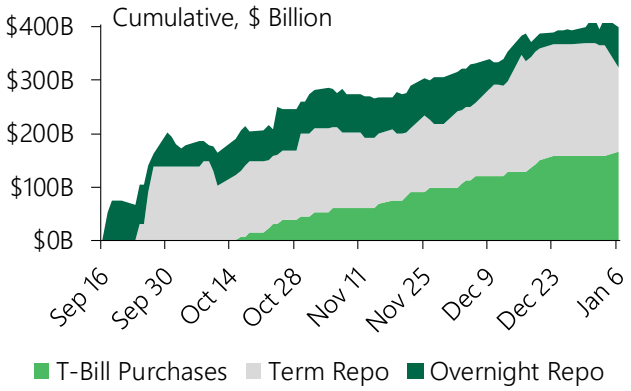
We have positioned portfolios for a steeper yield curve environment. The disruption in the repo market and the Fed's purchases of T-bills should anchor the front end of the yield curve with a downward bias on short-term rates. The continuation of healthy U.S. economic activity should increase inflation and put upward pressure on the long end. Uncertainty about the timing and scope of any trade deal, combined with ongoing debate surrounding impeachment, have led to the persistence of volatility-induced trading opportunities. Uncertainty around these issues has provided the opportunity to tactically adjust portfolios along with fluctuations in the news cycle, and we expect this to continue in the near term. We continue to favor higher-quality credits where appropriate for 2020.

Municipal Bonds

Steeper Yield Curve in the Fourth Quarter but Flatter and Lower for the Year

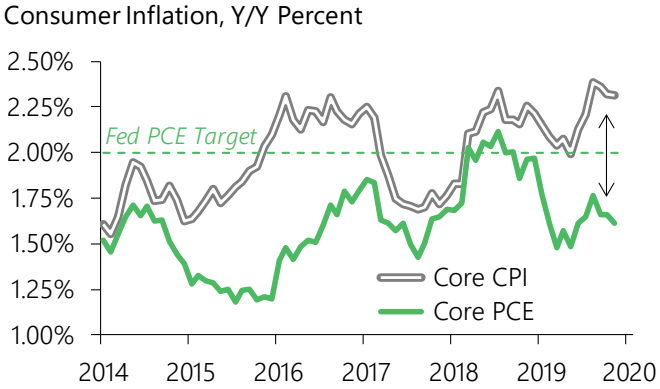
The tax-exempt yield curve, as measured by the Municipal Market Data (MMD) AAA GO steepened in the fourth quarter (Exhibit 13). Shorter yields out to 6 years decreased by approximately 10-20 basis points, while yields on bonds longer than 10 years increased modestly by 5-10 basis points during the quarter (Exhibit 14). Conversely, for

Exhibit 11: Fed Liquidity into Repo Market



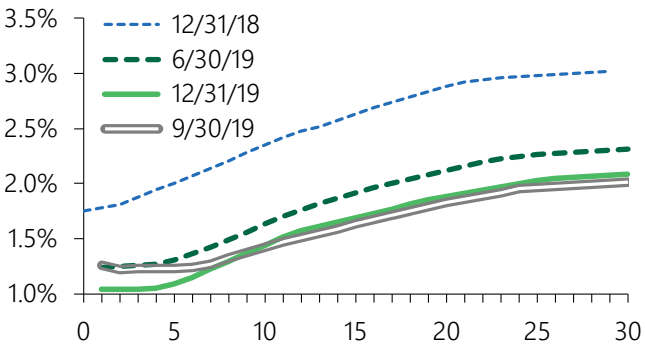
Source: Federal Reserve Bank of New York, 1/6/20

Exhibit 12: Measures of Consumer Inflation



Source: Bureau of Labor Statistics, BEA, 12/31/19

Exhibit 13: Tax-Exempt GO Bond Yield Curve



Source: The Municipal Market Monitor, 12/31/19

Exhibit 14: Municipal Bond Yields and Spreads

Yields	Dec 31 2018	Sep 30 2019	Dec 31 2019	4Q19 Δ (bp)	2019 Δ (bp)
2-Yr MMD AAA GO	1.78	1.22	1.04	-0.18	-0.74
5-Yr MMD AAA GO	1.94	1.23	1.09	-0.14	-0.85
10-Yr MMD AAA GO	2.28	1.42	1.44	0.02	-0.84
30-Yr MMD AAA GO	3.02	2.01	2.09	0.08	-0.93
2-10 MMD Spread	0.50	0.20	0.40	0.20	-0.10
10-30 MMD Spread	0.74	0.59	0.65	0.06	-0.09
2-30 MMD Spread	1.24	0.79	1.05	0.26	-0.19
Bond Buyer 40 YTM	4.09	3.59	3.63	0.04	-0.46

Source: Thomson Reuters, The Bond Buyer, 12/31/19

the year, high-grade tax-exempt yields fell markedly by approximately 70-100 basis points, and the slope of the tax-exempt yield curve flattened to 105 basis points between 2-30 year yields versus 124 basis points at the end of 2018. Tax-exempt yields decreased as a percentage of comparable maturity treasuries, leading to richer yield ratios across the yield curve for both the quarter and the year.

Duration and Credit Quality Drive Performance

Duration was the most significant factor driving performance for both the quarter and the year (Exhibit 15). Intermediate bonds in the 3-7 year range were the strongest performing part of the curve in the quarter. For the year, longer bonds outperformed shorter bonds consistently across the tax-exempt yield curve (Exhibit 16). Credit was also a meaningful driver of performance, as lower-quality bonds tended to outperform higher-quality bonds. Notably, returns on Baa rated bonds were meaningfully higher than returns on A or higher-rated investment grade issues for both the quarter and the year. Overall, the 2019 returns of most tax-exempt indices were the strongest since at least 2014. Tax-exempt closed-end funds were no different, with total returns approaching 20 percent for 2019.

Municipal Issuance Surges, Driven by Taxable Bonds

Total issuance surged by $143 billion in the fourth quarter to $422 billion for 2019 (Exhibit 17). Fourth-quarter issuance was nearly as high as the record of $155 billion in 2017. A significant driver behind this increase in issuance was the increased use of taxable refunding bonds. The low absolute level of interest rates and inability to use tax-exempt financing to pre-refund tax-exempt bonds, a result of tax code changes in the Tax Cuts and Jobs Act, drove issuers to the taxable bond market. Specifically, taxable

Exhibit 15: Bloomberg Barclays Municipal Bond Index Returns

	4Q19		4Q19		4Q19		4Q19
Muni Bond Index	0.74	AAA	0.72	Revenue Bond Index	0.71	Education	0.63
3-Year	0.87	AA	0.71	Electric	0.66	Water & Sewer	0.72
5-Year	1.03	A	0.71	Hospital	0.64	Resource Recovery	0.56
7-Year	0.95	BAA	1.02	Housing	0.85	Leasing	0.85
10-Year	0.79			IDR/PCR	0.92	Special Tax	0.64
Long	0.54	GO Bond Index	0.81	Tranportation	0.70	Tobacco Index	0.67

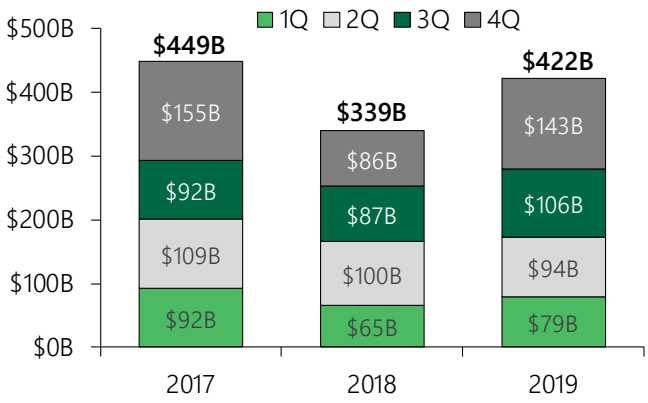
Source: Bloomberg, 12/31/19

Exhibit 16: Municipal Bond Index Returns

	2015	2016	2017	2018	2019
Muni Bond Index	3.30	0.25	5.45	1.28	7.54
3-Year	1.18	0.08	1.56	1.76	3.67
5-Year	2.43	-0.39	3.14	1.69	5.45
7-Year	3.26	-0.50	4.49	1.66	6.74
10-Year	3.76	-0.12	5.83	1.41	7.70
Long	4.52	0.88	8.19	0.34	10.26
AAA	2.73	-0.17	4.45	1.05	6.73
AA	3.16	0.05	4.96	1.22	7.12
A	3.71	0.85	6.16	1.34	8.10
BAA	4.25	0.35	8.74	1.96	9.94

Source: Bloomberg, 12/31/19

Exhibit 17: Municipal Bond Quarterly Issuance



Source: The Bond Buyer, 12/31/19

issuance totaled 16.7 percent of total municipal issuance in 2019, the highest since 35.1 percent in 2010, when interest subsidized Build America Bonds were an alternative to traditional tax-exempt issuance for issuers (Exhibit 18). This use of taxable refunding bonds also led to a marked increase in refunding volume to 25.3 percent of total issuance versus 17.5 percent of issuance in 2018, recovering approximately half of the percentage of total volume lost last year when the TCJA pre-refunding rules became effective.

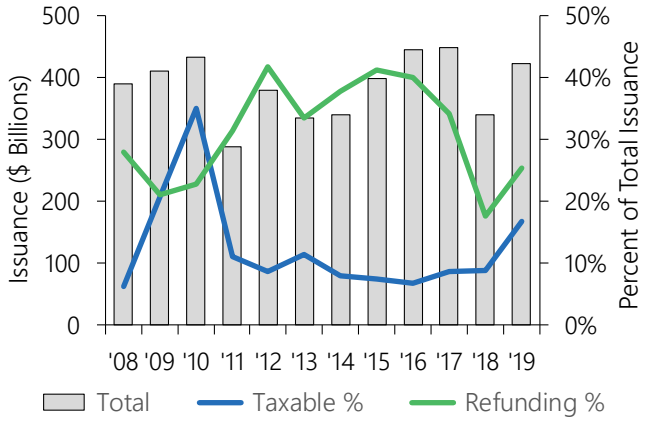
Strongest Annual Fund Flows on Record

The pace of tax-exempt mutual fund inflows remained strong in the fourth quarter, continuing the trend that persisted throughout 2019. Weekly fund flows remained positive throughout 2019 and totaled more than $92 billion versus net outflows of approximately $2 billion in 2018 (Exhibit 19). The total dollar value of tax-exempt fund flows for 2019 was the highest annual amount since Lipper began tabulating such flows in 1992.

Tax-Exempt Fixed Income Strategy

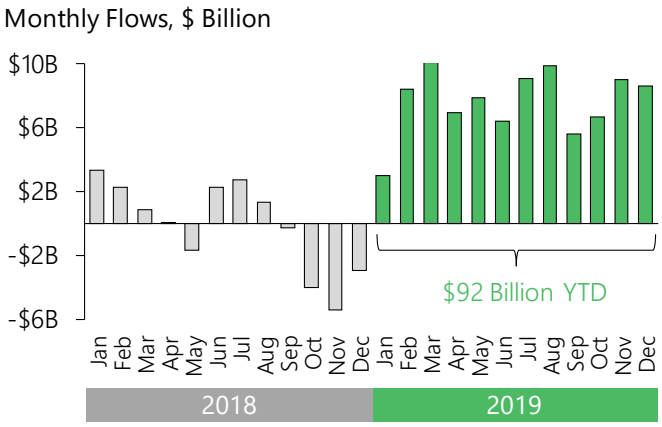
While our tax-exempt rate outlook is grounded in our taxable rate outlook, we need to modify the story based on tax-exempt market supply and demand. Tax-exempt supply is a shorter story. We don't expect a significant increase in tax-exempt issuance in 2020, as enabling legislation is often a catalyst and unlikely in an election year. Moreover, changes in economic growth or state and local tax collections can also drive changes in supply, but the economy seems poised to continue on its current path. The demand story for tax-exempt debt is more interesting. We concede that it would be optimistic to assume 2019's pace of tax-exempt fund flows would continue throughout 2020. Regardless, demand for tax-exempts is likely to remain strong, albeit likely not as robust as 2019. Thus, while short-term rates are likely to be constrained by the Fed, and long-term rates may increase, continued strong demand for tax-exempt bonds likely limits tax-exempt rate increases. To the extent the U.S. Treasury yield curve steepens, the tax-exempt yield curve is not likely to steepen as much. Our tax-exempt fixed-income strategy continues to emphasize income, which we believe is the primary driver of returns over full market cycles. We continue to use a barbell strategy in intermediate and long duration portfolios, investing in a combination of bonds with short call features and longer duration bonds with attractive relative yields. We expect to maintain most portfolio durations near their current levels and, as always, view diversification as a key tenet in managing portfolio credit risk.

Exhibit 18: Composition of Muni Bond Issuance



Source: The Bond Buyer, 12/31/19

Exhibit 19: Tax-Exempt Bond Fund Flows



Source: Goldman Sachs and Refinitiv Lipper U.S. Fund Flows, 12/31/19

GLOBAL EQUITIES: ENVIRONMENT AND STRATEGY

Positive equity market fundamentals are supported by easy monetary policy and signs an uptick in corporate earnings growth is underway. In terms of U.S. sector positioning, we expect pro-growth/cyclical areas to continue to outperform the market as recession fears continue to recede. Capital goods and technology stocks especially stand to benefit based on attractive valuations and the potential for an earnings inflection. Within technology, we expect investor enthusiasm for a 5G wireless spending cycle to boost select semiconductor companies, as well as firms leveraged to increasingly complex wireless ecosystems. Central banks' efforts to fend off deflation risks should also continue to steepen yield curves, lifting the financial sector. Healthcare remains the most attractive defensive sector of the market, as we believe growth and valuation support are enough to overcome election-related risks. Finally, we suspect defensive "bond proxy" areas of the market, including REITs and utilities, may underperform in the near term due to high valuations against an improving growth backdrop in other areas of the market.

We recognize increased equity valuations make the market more vulnerable to risks (i.e., trade, elections, Middle East tensions) and potentially increase volatility. Therefore, we continue to emphasize the importance of diversification within our strategies. Moreover, dividend-paying growth stocks are particularly appealing in the current backdrop, as they can provide a source of relative stability and capital appreciation potential as the market cycle progresses.

We remain overweight Chinese equities in global portfolios as projected GDP growth of +5.9 percent, albeit decelerating from high levels, still stands out relative to other major economies. The focus of our strategy remains on the transformation occurring within the Chinese economy. Thus, we continue to emphasize "new economy" opportunities such as e-commerce, healthcare, and information technology, where growth is solid, and structural issues present less of a risk. Conversely, we are underweight traditional cyclical sectors such as energy, autos, industrials, and financials, which are facing competitive challenges and economic changes. The MSCI China Index has rallied over 14 percent since early October amid the positive trade talk developments and a rebound in Chinese economic data. The strong performance in equities has now brought valuations to slightly above historical averages – a level still reasonable in our view given the above-average growth rate relative to other markets. Despite rising concerns of bond defaults in China, the overall default rate is still low, and policymakers appear willing to step in if needed. As a result, we think near-term credit risk is low. Some key structural risks we continue to monitor in the Chinese economy include excessive leverage, demographic trends, and slowing fixed asset investment. The key risk remains the U.S.-China trade confrontation, as we expect geopolitical tensions and uncertainties around "phase two" negotiations to stay elevated in 2020.

We remain broadly constructive on Indian and South Korean equities. India's recently-introduced stimulative actions, including tax cuts, borrowing incentives designed to increase outstanding credit, and interest rate cuts should support continued economic growth moving forward. As a result, our investments in India are concentrated in the more economically-sensitive areas of consumer, financials, energy, information services, and industrials. While the Indian market's valuation is elevated from historical levels, trading at 19 times 2020 earnings, we believe a strong earnings rebound should support valuations at current levels. In South Korea, the economy should benefit from the U.S.-China "phase one" trade deal and government stimulus for healthcare, welfare, and em-

ployment. Given that the trade deal should benefit exporters over domestic industries, South Korean industries with a high level of exports – such as computer chips, electrical machinery, smartphones, automobiles, optical medical products, and steel, should benefit disproportionately from the recent deal. Accordingly, our preferred South Korean holdings are in technology, financial, pharmaceutical, and material companies. On valuation, the South Korean market looks inexpensive relative to peers, trading at 11 times 2020 earnings with an expected growth rate of 28 percent in 2020.

We continue to underweight Europe in global portfolios. While the economic outlook for the region has incrementally brightened on improved prospects for global trade, stimulative fiscal policy, and easing financials conditions, growth remains constrained by persistent structural issues, rising populism, and the inability of central banks to stimulate the economies. Within Europe, we continue to prefer investments in the Euro Area as Brexit-related uncertainty will continue to be a headwind for the United Kingdom. Our sector strategy remains unchanged compared to last quarter. We prefer the technology services sector, given its better earnings growth projections relative to other sectors in 2020. Within the consumer space, we prefer discretionary stocks at the expense of more defensive-oriented companies as the industry growth profile is generally more favorable. We remain positive on the long-term prospects for health care, but the sector remains a market weight as we believe there are continued risks associated with the upcoming U.S. presidential elections.

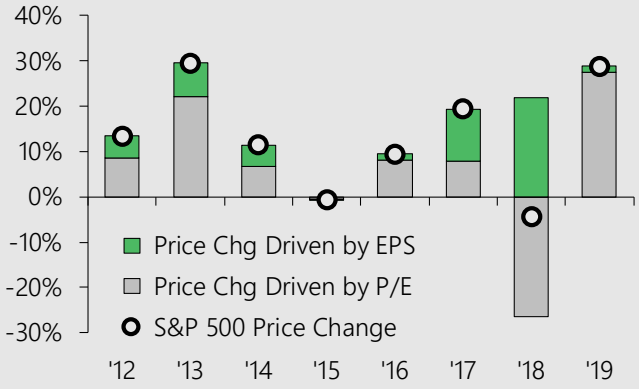
We remain underweight Japan due to continued concern about the country's structural challenges. An aging population, high national debt levels, and rigid labor market remain major obstacles to sustainable long-run growth. Despite some progress in easing trade barriers and fostering improved corporate governance, structural reform efforts have made limited progress overall. However, a pro-cyclical bent, rooted in the country's export sector, combined with early signs of an improving global growth backdrop may further extend Japanese equities' recent modest outperformance in the immediate term. This favors our continued positioning in overseas-exposed names which benefit from exposure to faster-growing areas of the globe. We balance with a mix of defensive domestic consumption holdings, such as healthcare, to guard against any setbacks to the growth outlook. Across all holdings, we continue to prefer high quality companies with sound financials and attractive business fundamentals.

In Latin America, we remain underweight the markets of Brazil and Mexico, due to their dismal economic growth outlook. As Brazil's consumer spending and fixed asset investment are slowly picking-up after a deep recession, we have become incrementally more positive on Brazil as GDP growth appears to have stabilized and Congress passed necessary pension reforms. Therefore, our investments in Brazil are concentrated in the sectors of consumer and financials, which should benefit from better consumer spending and higher bank credit growth. In Mexico, we remain underweight given weak economic growth. Though President Andres Manuel Lopez Obrador's approval ratings is high at 67 percent – helped in part by his agenda of socialist policies such as higher minimum wage – corporate investment has been falling, reflecting a lack of confidence in his policies. One bright spot in the Mexican economy is consumer staples, which should benefit from their defensive orientation and the recent hike in the minimum wage.

Equity Strategy: Notable Data Points

Equity Gains in 2019 Driven by a P/E Recovery

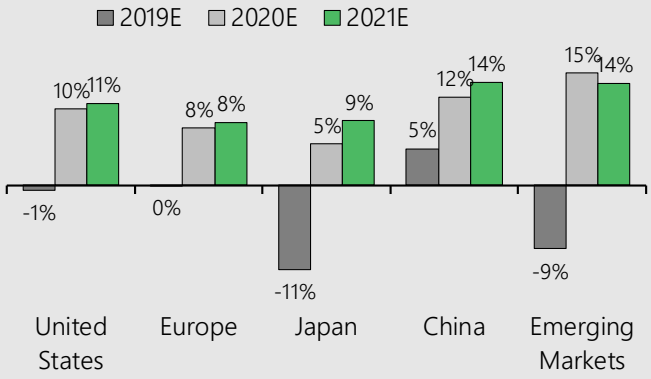
S&P 500 Price Returns
Contribution from EPS and PE



Source: FactSet, 1/6/20

EPS Growth Will Drive Performance in 2020

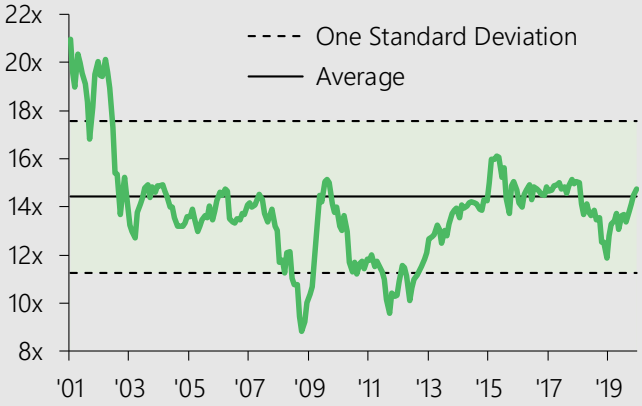
Bottom-Up EPS Estimates for MSCI Indices
Y/Y Percent Change



Source: FactSet, 1/6/20

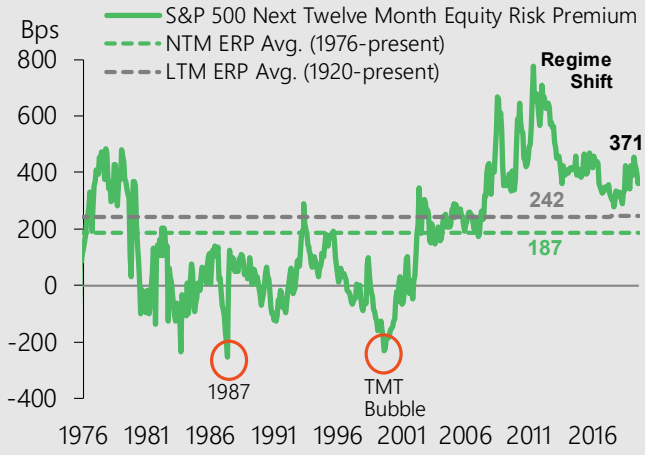
World Valuation in Line w/ Historical Average

MSCI World (ex. USA) NTM Price-to-Earnings Ratio



Source: FactSet, 1/6/20

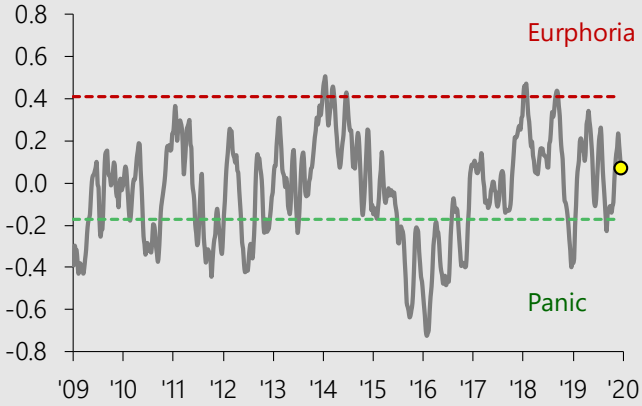
Equity Risk Premium Still Too High



Source: Morgan Stanley, 1/6/20

Sentiment Not Skewed in Either Direction

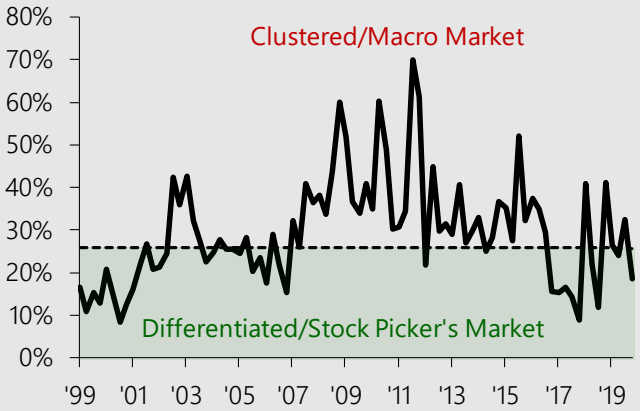
Citi Panic-Euphoria Model



Source: Citi Research, 1/3/20

The Stock Picker's Market Continues

Avg Pair-Wise Correlations of All S&P 500 Stock Combos



Source: Bank of America/Merrill Lynch, 1/6/20