OUTLOOK 2019
MID-YEAR UPDATE

SEEING THE PICTURE WHEN THE VIEW IS LESS THAN CLEAR

Investment Strategy Group
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OVERVIEW

- Economic growth will remain positive, extending this record expansion well beyond this year, supported by a healthy level of consumption.
- Volatility will remain high until there is a market-satisfying Sino-American trade detente, or evidence emerges of an uptick in global economic conditions.
- Stocks have covered meaningful ground already this year, but the advance can continue if the macro landscape becomes more predictable.
- Fixed income markets had a strong first half, goosed by falling interest rates, low inflation expectations, and a benign monetary setting.
- The rapid decline in rates, however, may have overshot monetary expectations and the current phase of the economic cycle.
- Near term, there is potential for a backup in interest rates, but while a Federal Reserve rate cut is possible in 2019, up to four cuts in 2020 are more likely.
- We continue to recommend an up-in-quality bias, particularly in corporate bond markets where spreads are overly narrow relative to the risk.
- Given the stage of the credit cycle, high yield corporate bonds in particular appear to offer a poor risk/reward tradeoff.
- Below-average primary supply and steady demand, including a record pace of inflows to tax-free mutual funds, have supported strong municipal performance.
- With a tailwind from stronger-than-expected April tax collections, credit spreads of even fiscally stressed states—such as Illinois, Connecticut and New Jersey—are the tightest of the year.
- While restructuring efforts for Puerto Rican municipal debt are underway, the path is muddled by complicated litigation and court decisions.
- The outcome from the Puerto Rican debt settlement negotiations could have a broad and potentially negative impact on the public finance marketplace.
ECONOMY & EQUITY MARKETS

The Mid-Year Update presents a follow-up to our annual view published last December and affords a chance to make adjustments, if necessary, for what we expect to come during the remainder of the year. Much of what we expected has evolved in a fashion that requires little change from those views expressed six months ago. The economy has slowed somewhat, but remains on a positive track. This has enabled the Federal Reserve (Fed) to elicit a more dovish posture and patiently allow data to accumulate to shape future decisions around the appropriate monetary setting. In turn, the equity market has responded favorably and bond yields have drifted lower. To be sure, the risks associated with trade wars and other geopolitical tensions have not receded, which means volatility will remain heightened and the possibility of bimodal outcomes keeps our confidence interval unusually wide.

PRESENT

July 1st will mark 11 years of the current economic expansion, making it the longest in U.S. history. Its length is unusual even by global comparisons, but the fact that it actually accelerated in 2018 and should grow at or above trend again this year, is just as remarkable. The footing for a healthy economy is the strength of the consumer. Spending generates the majority of economic activity, so in order to gauge the prospects for the economy, one must test the hardiness of the consumer. Looking at current spending levels is helpful, but considering all the explanatory factors that enable the consumer to spend is more useful in making a judgment as to its viscosity.

Consider:

- Job growth continues to occur at a pace that holds the unemployment rate steady with a downward bias. Today, the ratio of open positions to those unemployed stands at the highest level in almost 20 years. Tightening labor markets are also helping to force wages higher. Small businesses—where most of the labor force is employed—cite plans to increase hiring and compensation in response to surveys, along with a lack of qualified applicants to fill the open jobs. While supply constraints could become a counterweight factor for the labor market, further job and wage gains are the likely path for now. A leading indicator for not only the job market but also the economy at large is weekly unemployment claims. As depicted in Chart 1, there is little sign of a marked increase in layoffs that would portend weakening business conditions. In fact, jobless claims continue to plumb the lowest levels in almost 50 years.

Consider:

- The savings rate is three times higher today than where it stood around the Great Recession over a decade. Consumer debt is the lowest in almost 20 years and the cost of servicing it is similarly low. The lift in housing prices since the Financial Crisis, and the enormous gains made in the stock market, have combined to drive aggregate household net worth to $109 trillion, approximately 57% higher than when it last peaked in 2007. Collectively this has helped to boost confidence levels for consumers near all-time highs (see Chart 2). Different surveys of the consumer show their outlook for the future and plans to spend on big-ticket durables as highly favorable. The current spending pattern is providing the U.S. economy a positive

Chart 1: US Initial Jobless Claims

Chart 2: Conference Board Consumer Confidence

(Source: Janney Investment Strategy Group; Department of Labor)

(Source: Janney Investment Strategy Group; Conference Board)
impulse and the holistic view of the consumer gives us reason to believe that purchasing power of this important cohort will propel it with vigor going forward.

- Businesses are highly profitable and industry surveys of activity across both the manufacturing and services sectors are eliciting expansionary readings. While confidence levels and capital expenditure plans have slipped from their highs, they remain elevated. To be sure, respondents’ list of concerns have been directed more toward trade than anything else, so a worsening view on that topic could begin to filter into actions that cool the labor market and curtail business investment. Indeed, spending on capital equipment has slowed, but it remains positive. In fact, the productivity boost that has occurred in the last couple of years is a testament to such activity. Therefore, the incentive to keep investing in order to maintain margins that might otherwise be eroded by having to absorb hiring and wage costs is high.

Chart 3: JPM Global Manufacturing PMI

News on the global front is less sanguine. Decelerating Chinese growth has had a biting effect on the export activity of many Pan-Asian and European countries. Since China alone is responsible for one-third of the world's growth impulse, the slowdown has broad implications. While Chinese officials began initiating measures to stimulate the economy as early as last summer, the responsiveness to their actions has been slow to develop. Measures that are more aggressive were taken in January, and further policy moves are being considered, so we believe these should begin to yield some tangible benefit shortly. As it follows, other economies should study in turn. Chart 3 is but one measure of global activity; however, it is an important one. The J.P. Morgan Global Purchasing Managers’ Index (Global Manufacturing PMI) is a poll of companies that provides a high frequency indication of manufacturing activity. This index collects data from companies around the world and aggregates its findings into a single index. Generally, a reading above 50 (an indication that 50% or more are reporting business activity is expanding) is good, while a reading below 50 is not, and is actually considered contractionary. The period of global synchronicity that began in the latter part of 2016 and ended unofficially at the end of 2017 can be observed in the run-up to the peak of the global PMI reading in December of that year. The index has now fallen in all but one month since, and May’s reading broke below the proverbial boom/bust line, coming in at a sub-50 reading of 49.8.

The global slowdown, however, may be getting long in the tooth. Besides China’s stimulus, financial conditions have eased in other economies. Central banks have responded by cutting interest rates, expressed that there will be an extended period of time rates will remain on hold, or are preparing other non-conventional forms of monetary policy to stimulate growth. One green shoot—among a few others that can be found, such as European economic sentiment, rising machinery orders in Japan and falling unemployment in South Korea—comes from Sweden. Sweden is a highly industrialized country with an open economy and a heavy reliance on exports. As such, it is economically geared and very sensitive to global trade. Recently, levels of industrial production, retail sales, manufacturing new orders, and its currency—the krona—have all improved. While it may be too much at this point to suggest this is more signal than noise, we will be using this and other factors to assess developments on the global front during the coming weeks and months.

**EQUITY MARKET**

Profit growth has slowed when comparing year-over-year results, but there are mitigating and defensible factors accounting for it. A primary one is that corporate profits grew so quickly last year that the pace was simply unsustainable. Another is the lapping effect of the corporate tax cuts that occurred in 2018. Investors have been willing to look through this period to estimates for earnings to come later this year. While those are anticipated to improve, a delay in better economic conditions abroad, or worse, a deterioration in business activity that compromises those forecasts, could pressure stock prices. The severity of a drawdown in equity markets would be predicated upon the circumstances accompanying the disappointment.

Our central case is that looser financial conditions and no new trade bouts should lead market participants to view the macro backdrop as favorable for risk assets. Yet we also believe that markets could move much higher, catalyzed by a Chinese-American trade agreement, or at least no further escalation and unambiguous evidence emerging that shows growth abroad starting to accelerate. Historically, stocks have performed best across the time span of a bull market in the very beginning and in the last decile of time it endured. If past is prologue, and if the expansion that has helped to underwrite this bull market is nearing its expiration, then investors should expect a sprint to the finish. Our central case and historical perspective merge to produce an investor-friendly, asymmetrical risk outcome that should prove rewarding over the balance of this year and into 2020. While we remain overweight U.S. equities in a global basket for now, a shift to raise international exposure, particularly in Europe and the Emerging Markets bourses, could occur later this year. Stay tuned.
VARIOUS ECONOMIC SCENARIOS AND PROBABLE OUTCOMES

We have made virtually no change from the yearly piece to our price targets across the three scenarios outlined below. However, we did change the odds placed on each outcome by pulling from our central case and adding to the extreme scenarios. This reflects our view that enough is at stake in the trade tensions, primarily to expand our confidence interval, but other factors as well. While our view is still skewed to the upside, reflecting our belief that the economy’s expansion and rally in risk assets has farther to go, the risk of a policy blunder is sufficiently high to have sympathy for its however unlikely outcome.

Scenario 1: Sprint to the Finish

While most of the fiscal boost from the Budget Act of 2018 was spent last year, there is residual for 2019 that is still incremental to the underlying strength in economic conditions. Trade negotiations with China are resolved in a deal that is strong enough to de-escalate tensions and economic activity in the People’s Republic steadies. This results in a positive feedback loop for global trade. Investors surmise corporate profit growth is secure and press equity share prices higher. The economically sensitive sectors rally most, including Energy, Financials, Industrials, and Materials, while safe-havens, such as Utilities, Telecoms, and gold lose their appeal. Foreign economic and currency strength is a boon for investors, and international equity returns surpass those earned in U.S. markets. The stock market powers up to establish a new cyclical high at 3,100.

Probability: 35%

Scenario 2: Moderating Growth

Growth remains steady, but downshifts near trend of about 2%. Low levels of inflation keep the Federal Reserve behavior benign and interest rates remain relatively low. Global conditions reach their nadir, but lack a catalyst for a sharp rebound. The lingering aspects of trade that are unresolved leave open the possibility that it will return now and again as a pressure point for risk assets. Elevated uncertainty—the kryptonite for stock market participants—ensures volatility is a matter of course, which dulls the spirits of investors. The stock market advances, but gains are muted and defensive sectors, such as Consumer Staples, Health Care, REITs, and Utilities, stay well supported. The S&P 500 oscillates higher, but cannot mount a sustained bid above the previous top. The level of 2,950 ultimately becomes its resting place.

Probability: 45%

Scenario 3: Economic Erosion

Slowing domestic growth, induced by intensifying trade tensions causing businesses to de-risk, as well as the trailing effects of the Federal Reserve’s previous rate hikes, increase the cry of oncoming recession. While one does not occur this year, the market begins to pull forward its prospect of starting in 2020. The Fed begins to lower interest rates to avert the economy’s demise, but policy acts with a considerable lag and market participants worry that the profit picture will turn bleak before a recovery occurs. Pro-cyclical sectors like Industrials, Financials, Energy, and Materials sour, and investors move to the classically defensive sectors, such Utilities and Telecoms, or to the sidelines. The S&P 500 index declines sharply, but a recession is avoided. The index bounces back from a plunge to 2,650 and finishes at 2,750.

Probability: 20%

BOTTOM LINE: ENSEMBLE FORECAST

Growth in the U.S. economy continues to evolve in a positive fashion. Without tangible signs of its near-term expiration, the climate remains suitable for investors to expect flattering returns from global equities during the next 12 months. China is undertaking myriad stimulus efforts that ultimately should help to improve their condition as well as those that depend on them for trade. While there is tentative evidence of improving global growth, which we expected around mid-year, it may be too soon to test in the affirmative of its resilience. We believe an overly cautious stance is unwarranted at this juncture, but the bimodal nature of the prospective outcomes will require ongoing vigilance and flexibility. Weighing the probabilities assigned to the scenarios presented leads us to an ensemble price target for the S&P 500 of roundly 3,000.
It is summer in the northern hemisphere, so flip-flops are a given. However, the flip-flops the dominant economic and financial market narratives have gone through during the past several months are truly something to behold. From panic in late December to euphoria in early April to a bizarre sort of in-between today, these narratives have driven some wild moves in the level of interest rates in particular.

From the beginning of 2019, benchmark 10-year Treasury yields have fallen -0.55% to touch their lowest levels since 2016, while two-year Treasury yields have fallen -0.60% – with more than half of those moves coming in the month of May. More remarkable has been the market’s anticipation of Federal Reserve rate cuts in 2019, with two 0.25% priced in before year’s end with certainty.

While the next phase of the economic cycle is likely weaker, we believe the interest rates markets have gotten ahead of themselves, and we may see weaker performance in the second half of 2019.

THREE THEMES UNDERLIE THAT EXPECTATION

Theme 1: Late-cycle economic trends tend to be volatile and noisy, with jobs data, for example, swinging better or worse with little evident reason. April’s +224K job growth and May’s +75K provide a great example. In May and June, data have been on the downswing relative to trend, but they are just as likely to trend higher for equally noisy reasons in the coming months—especially inflation readings.

Theme 2: Market expectations for Fed rate cuts are in contrast to the central bank’s stated intent to be “patient for some time.” Historically, the Fed has waited for economic evidence rather than cut rates for insurance against risks, so we may well see pushback against imminent rate cuts.

Theme 3: Tariffs, a major source of economic uncertainty, could disappear with the wave of a presidential pen. Much energy has been spent trying to ascertain the motivations of said pen, but tariff worries are reasonably well priced into fixed income markets, so the bias is for said worries to be priced out next.

The prescription for these themes is simple. Hold shorter-term and more liquid bonds for the moment, and take advantage by selling and reinvesting in longer-term bonds if 10-year Treasury yields rise to 2.25%.
In the corporate bond markets, the prescription for investing late in the economic cycle is to limit credit risk. That is, to forego some yield and buy higher quality and higher rated securities, and to avoid high yield altogether. It all comes down to the credit cycle, current pricing, and liquidity. The credit cycle is an artifact of human behavior in which exuberant lending expansion gives way to nervousness and eventually lending contraction. We are somewhere between exuberant (as evidenced by still-tight credit spreads) and nervous (as evidenced by market willingness to punish individual names). The biggest risk today is not a massive wave of defaults or ratings downgrades, but simply that investors are not well paid for taking aggressive credit risks. In other words, current pricing is expensive. If the credit cycle does indeed turn negative in the next 12 months, as it did rather violently in December 2018, the downside is substantial. Liquidity is the third piece of the puzzle.

Asymmetric liquidity—available when you do not need it, but absent when you do—accelerates the speed of credit selloffs, making it essentially impossible to time a bond sale only when conditions get bad.

Again, keep in mind that this is a recommendation based not on a particularly elevated risk of defaults or downgrade, but one based on behavior, pricing, and market structure. The only prescription against the late credit cycle, lofty pricing, and asymmetric liquidity trio is to reduce or eliminate high yield holdings and favor higher quality, higher rated credits. We would advocate buying high yield credit only when market-wide high yield spreads exceed 500 basis points and getting more aggressive on investment holdings only when market-wide investment grade spreads exceed 150 basis points. At that point, the risk/return tradeoff will be far more favorable.

Chart 5: Tight Spreads Suggest Conservative Strategy; IG Has Better Value than HY

(Source: Janney Investment Strategy Group; Bloomberg/Barclays Indices)
Strong investor demand for tax-free income fueled significant municipal market outperformance during the first half of 2019.

Mutual funds, key beneficiaries of this investor interest, gained more than $40 billion of new cash in an uninterrupted stream of weekly inflows, and municipal bond exchange-traded funds (ETFs) accounted for an additional $3 billion in the strongest annual start on record. Municipal new issue supply set no such records.

Through five months (January-May), issuers sold $134 billion of new debt, just below last year’s slow pace and the least since 2014. As steady new cash inflows outpaced the availability of new issue product, tax-free yields fell at a faster pace than same-maturity Treasury yields, captured by a drop in 10-year municipal-to-Treasury ratios, which fell from 88% in January to 72% in mid-May. Although a repeat of this significant outperformance is unlikely in the second half of 2019, we do not expect ratios to return to the high levels of last year, as the value proposition for tax-free investors remains strong, especially for high tax bracket investors.

During the post-recession decade, state and local governments have been slow to regain their pre-recession financial footing. According to The Pew Charitable Trusts, the 50-state median of reserves held in general and rainy day funds, measured by the number of days that available reserves would cover operating expenses, reached 40.4 days last year, just shy of the 41.3 days’ worth of spending held by states prior to the economic downturn. When the current fiscal year ends (on June 30th for most states) we expect that reserves will have finally topped pre-recession levels, since many states pulled in more tax revenue than budgeted in April 2019, putting revenues ahead of projections for the year in many instances.

Bolstered by stronger than anticipated revenues, this year’s state budget season is operating more smoothly than in some recent years. The budget battles and resulting impasses of the 2015-2017 time period, which had Illinois operating with no or minimal budget for more than two years, generated downgrades for states including Illinois and Pennsylvania. No state ratings have been

[Chart 6: 2019 Inflows to Muni Mutual Funds are Strongest Annual Start on Record]

[Chart 7: Strong Investor Demand Has Driven State Credit Spreads Tighter]
downgraded this year, and investors have become more comfortable with the lower-rated states, driving credit spreads tighter. We are encouraged by the stronger level of reserves, suggesting that most states are better prepared for the next recession than they were just a year ago.

Puerto Rico's debt restructuring saga continues after a significant portion of the island's debt ($17 billion Sales Tax/COFINA bonds) was restructured in February. Puerto Rico Electric Power Authority appears close to reaching a restructuring agreement, and negotiations are underway for lowering the island's general obligation and related debt through restructuring. Underlying litigation surfaced one unexpected result.

The bankruptcy court ruled that revenues, such as tolls collected by Puerto Rico Highways and Transportation Authority, could be withheld from bondholders. This ruling contradicts long-held opinions and practices that allowed "special revenue," as defined in Chapter 11 (municipal bankruptcy) of the federal bankruptcy code, to continue to flow during bankruptcy so that debt service payments to bondholders can continue.

Rating agencies and multiple commentators (our comments here) warn that the unexpected court ruling, which was upheld by a federal appeals court, could cloud the credit picture for other bonds secured by revenues, which could include municipal water and sewer bonds or turnpike revenue bonds. While the status of this issue remains uncertain, we advise that investors consider not only the specific credit aspects of a revenue bond issuer, such as debt service coverage, but also the financial stability of the supporting town, city, or state.

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Benchmarks

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