2020 Outlook

What Goes Up

Christopher Pike, CFA
chris.pike@northeastprivate.com
973-422-9140

Christopher Viola
chris_viola@northeastprivate.com

Contents

Executive Summary

What Goes Up

- 2019 has been the year of the "everything rally." Investors' fear of missing out (FOMO) combined with there is no other alternative (TINA) has helped offset the 4Q18 sell-off.
- Volatility has been muted from a historical perspective throughout 2019, helping a "melt-up" in risk assets, increasing asset correlations, and providing both equity and bond investors with outsized relative returns.
- The geopolitical outlook remains uncertain and poses a significant risk to any economic and capital market outlook going forward. Investors may find that similar to 2016, positioning portfolios based on polling data may result in counter-intuitive and unexpected outcomes.
- Barring any cataclysmic drop in economic activity or a black-swan geopolitical event, we believe President Trump has a solid chance for re-election.
- The current capital market and economic cycle seem extended from a historical perspective, driven by extraordinary monetary stimulus, deregulation, and contrarian fiscal stimulus enacted during the declining phase of the business cycle.
- Most sell-side analysts, strategists, and portfolio managers believe there is still room for markets to run, driven by dovish monetary policy, a relatively stable economy, and no inflation pressure. But we see economic cracks forming, and fear the unintended consequences associated with near-zero global short rates.
- Markets appear priced to perfection, in our opinion, with the S&P 500 trading at over 18x forward 12-month earnings, and credit spreads being at their tightest levels in over five years.
- Our Interest Rate Regime framework defines our economic and capital market outlook going forward. Specific client positioning across asset allocation, styles and sectors remains subjective, but we believe following a 10-15% retracement in asset prices, cyclical growth sectors will lead equities higher, along with a renewed focus in credit for fixed-income investors.

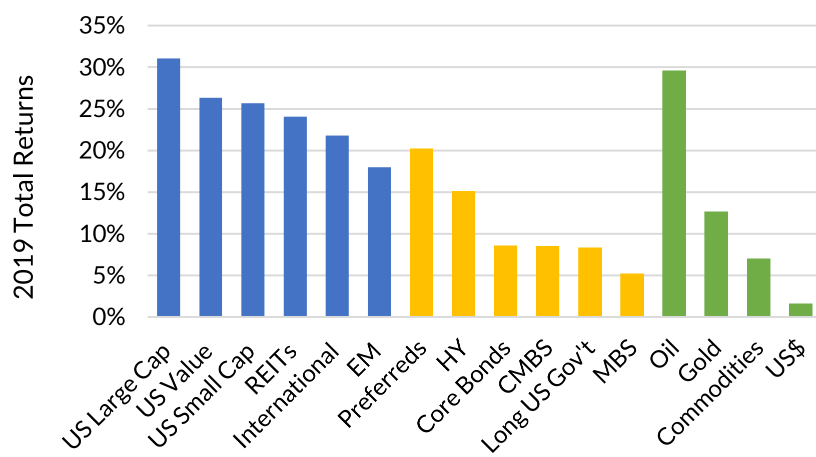
2019 Performance Review

The Everything Rally of 2019

Investors have been quick to chase capital market returns throughout 2019, perhaps in response to having no other alternative (TINA) or a fear of missing out (FOMO). As of December 2019, the U.S. economy is in the 126-month (10 ¾ years) of an economic expansion. Yet several Wall Street strategists and professional money managers suggest there is still upside in both the economy and capital markets.

Absent any significant inflation threats or tightening of financial conditions, equity prices moved to record levels in 2019. The S&P is up by over 31%, while the NASDAQ Composite is higher by over 35%, bringing their compound annual return (CAGR) since the end of the Global Financial Crisis[1] (GFC) in 2009 to 31%, and 35%, respectively.

Exhibit 1: 2019 Capital Market Returns



NEPCG and FactSet, data as of 12/20/2019

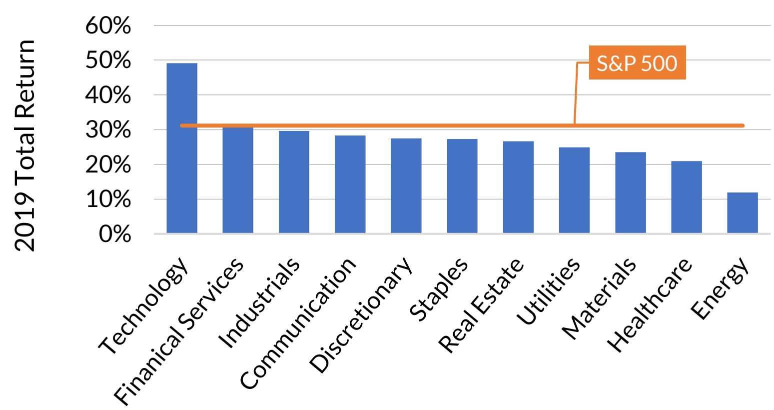
However, these outsized returns in 2019 were not confined to equities alone, but risk-mitigating assets as well. 2019 was truly the year of the "**everything rally**." Preferred Equities returned over 20%, and High Yield bonds were higher by 15% on a total return basis. Even long-duration U.S. government bonds returned almost

[1] The global financial crisis (GFC) refers to the period of extreme stress in global financial markets and banking systems between mid-2007 and early 2009.

9%. Real assets, such as Oil (WTI[2]), returned over 30%, while Gold recovered from its 2018-lows, returning over 13% for the year.

Technology was the top-performing sector in 2019, returning over 49% and outperforming the S&P 500 by over 18%. This was followed by Financial Services, which returned over 31%. Underperforming sectors included Healthcare, which still returned a positive 21%, but underperformed the S&P by almost 10%, and Energy, which returned roughly 12% for the year, underperforming the S&P by over 20%.

Exhibit 2: 2019 Total Returns by Sector



NEPCG and FactSet data as of 12/20/2019

From a style perspective, Growth[3] outperformed for most of 2019, a trend that has been in place for the better part of the last decade. Growth strategies returned almost 31% in 2019, outperforming Value[4] by almost 900bps, or 9%. Since 2016, there have been only a few periods whereby classic Value investing thrived. The first was during the 4Q18 correction, and more recently, during late-August through late-September 2019. Cyclical[5] sectors also outperformed throughout 2019, returning about 31%, compared to Defensive[6]

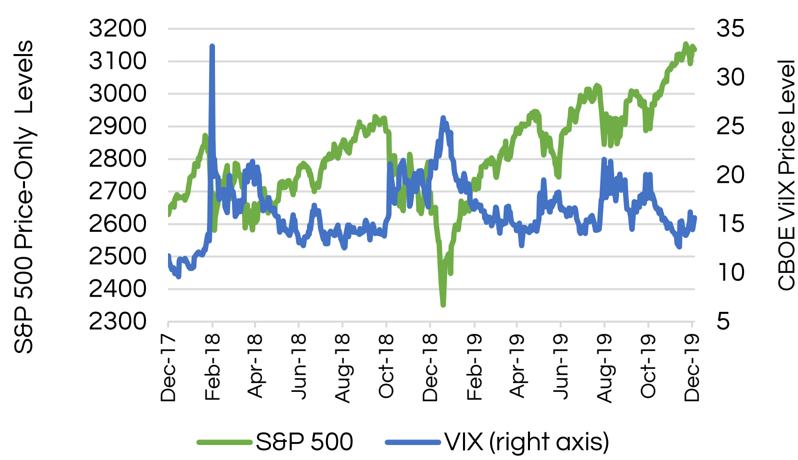
[2] West Texas Intermediate (WTI) crude oil is the underlying commodity of the New York Mercantile Exchange's oil futures contracts. WTI is a high-quality oil that is easily refined.
[3] Growth investing is a style of investment strategy focused on capital appreciation. Capital appreciation is the goal of an investor seeking long term growth on the principal amount invested, not necessarily current income from the asset. For this comparison, we measured the performance of the Russell 1000 Growth Index, versus the Russell 1000 Value Index.
[4] Value investing is an investment paradigm that involves buying securities that appear underpriced by some form of fundamental analysis.
[5] Cyclical stocks represent companies that make and/or sell discretionary items and services many consumers buy when the economy is doing well.
[6] Defensive stocks have historically outperformed the market when economic growth slows. Non-cyclical securities are generally profitable regardless of economic trends because they produce or distribute goods and services we always need, including things like food, power, water, and gas.

sectors, which delivered a 17% total return, in aggregate. Much of the Cyclical's outperformance was booked at the beginning of 2019, following a rotation into Defensive names during the 4Q18 sell-off.

Lower Volatility Means Higher Equities

Volatility ebbed and flowed throughout 2019, but as in similar "melt-up" years, volatility was modest overall. We find that risk assets and equity markets, in particular, enjoy robust returns during periods of limited volatility. Below we illustrate this relationship through looking at the VIX, or the CBOE Volatility Index and the S&P 500. The VIX is accepted as a popular measure of the stock market's volatility, employing a complicated algorithm using S&P 500 index options.

Exhibit 3: Volatility And Market Returns



NEPCG and FactSet

What Exhibit 3 illustrates is a negative correlation[7], or in the simplest terms, a relationship between two variables, such as when one moves up, the other moves down.

Going forward into 2020, we do not anticipate a repeat of 2019. As we discuss in the next several pages, we believe 2020 will exhibit plenty of capital market volatility driven by a plethora of variables, both economic and geopolitical.

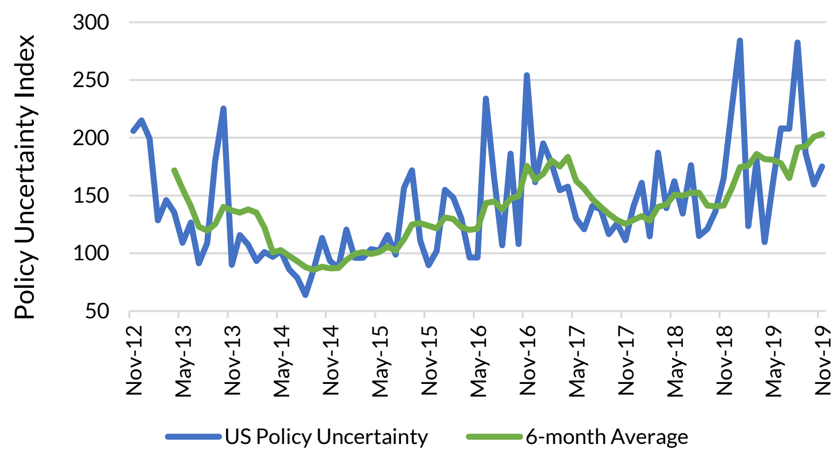
[7] Negative correlation is a relationship between two variables in which one variable increases as the other decreases, and vice versa. In statistics, a perfect negative correlation is represented by the value -1, a 0 indicates no correlation, and a +1 indicates a perfect positive correlation.

Political And Geopolitical Outlook

Buckle Up

We believe the U.S. economy and capital markets remain highly sensitive to near-term geopolitical risks. While this type of risk is always present in speculative markets, it is our opinion that the current geopolitical backdrop is particularly tenuous. According to policyuncertainty.com, global policy uncertainty (both domestic and foreign) is trending toward all-time high levels. And while the U.S. has recently experienced a reprieve following the preliminary Phase-I trade accord with China, the last 12-18 months have carried a fair amount of unpredictability and volatility.

Exhibit 4: US Policy Uncertainty



PolicyUncertainty.com[8] and NEPCG

As we illustrate in Exhibit 4, the rolling 6-month average of U.S. policy uncertainty has now bounced back to above pre-2016 election levels.

The most significant policy uncertainty, in our opinion, continues to revolve around global trade. Trade-war implications have negatively impacted global growth throughout 2019. According to the World Trade Organization (WTO), shipments of goods between

[8] To measure policy-related economic uncertainty, PolicyUncertainty.com constructs an index from three types of underlying components. One component quantifies newspaper coverage of policy-related economic uncertainty. A second component reflects the number of federal tax code provisions set to expire in future years. The third component uses disagreement among economic forecasters as a proxy for uncertainty.

global trading partners remain sluggish, and future trade uncertainty remains elevated.

Together with depressed (negative) sovereign yields globally, sluggish global economic growth, and a brief spell of inverted yield curves here in the U.S., many investors pulled forward recession expectations. But even if a Phase-I trade deal with China is upheld and enforced, we believe tariffs will continue to be adopted as an accepted form of foreign economic policy, both here and abroad. And while political analysts and prediction markets are discounting the probability of any further tariff escalation between the US and China, the ability to stop, start or expand tariffs via a 144-character tweet suggests to us that we are far from any comprehensive trade resolution or subsequent enforcement.

In our opinion, China has no motivation to move forward with any real reform initiatives as time is on their side. Why would a developing economic superpower agree to disadvantageous economic concessions, only to potentially renegotiate with new a U.S. President in less than 12 months?

Other conflicts investors should remain cognizant of include saber-rattling across the Middle East, a break-down of denuclearization talks with North Korea, and further EU fragmentation. Further, we cannot discount any potential conflict with Russia relating to NATO, or their involvement in the Syrian/Turkish crisis. Finally, despite the United Kingdom elections and the ensuing and overwhelming support for current PM Johnson, we still believe there remains a lack of visibility surrounding an orderly BREXIT.

We also caution investors that geopolitical headwinds, and additional political shocks here and abroad, may impact the U.S. capital markets in a counter-intuitive manner. For example, if we assume a constructive BREXIT outcome (as it relates to trade, migration, and the hard-boarder with Northern Ireland), economic and political uncertainty across Europe could diminish which could help restore growth, create a “value” opportunity for equity investors, and potentially draw investors away from U.S. capital markets.

And finally, there is the 2020 Presidential Election, the circus surrounding impeachment, and the possibility of an additional 11th-hour democratic candidate. We believe our dysfunctional Congress, preoccupied with a partisan impeachment process, will have limited lawmaking capacity over the next year. Investors should abandon any hopes and expectations for growth-targeted fiscal stimulus or meaningful legislative advancement. While reports of an additional middle-class tax cut/tax-relief or infrastructure bill are floated out of the White House, we believe this is a low probability event heading into an election year, especially given the contentious relationship between the Executive Branch and the Congress. And while we think the likelihood of the Senate voting to convict President Trump is very low, as we found in the 2016 Presidential Election, in today's manic geopolitical environment, investors need to discount any forgone political assumptions or media poll.

Still, the latest polls suggest that not only are Americans less inclined to change their original bias on impeachment based on the information, testimony, and circumstances uncovered during the public hearings held in the House of Representatives, but quite frankly, are growing tired of the endless media barrage on the subject.

Further, a growth-scare (similar to late 2018) could be amplified if the U.S. electorate embraces more progressive fiscal ideologies. We fear that the market will not accept, or the economy cannot withstand, an increased degree of socialized medicine, higher capital-gains taxes, a wealth-tax, a roll-back in regulation, or significant environmental reform such as the Green New Deal.

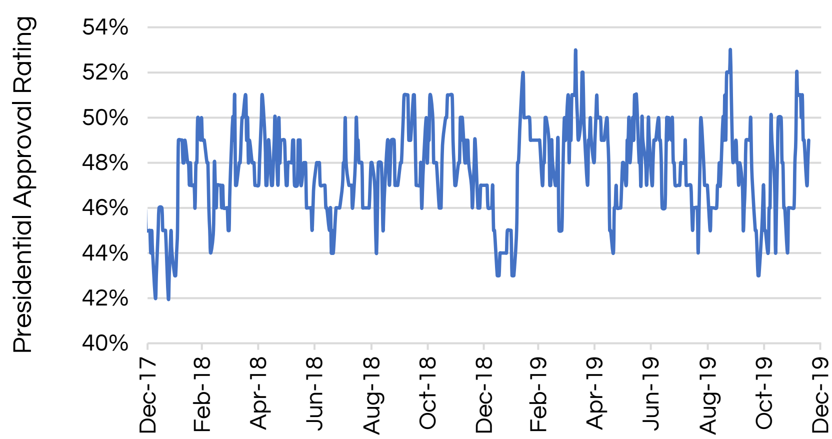
And The Survey Says…

As of January 2, 2020, according to RealClear Politics, former Vice-President Biden has regained the Democratic front-runner position, capturing roughly 28% of the vote. Senator Elizabeth Warren's polling numbers have plunged from a high of 27% in early October to 15% currently. At the same time, Senator Sander's polling has steadily moved higher, current at about 19%. South Bend Mayor Pete Buttigieg's polling numbers are falling, now at only 8%, compared to a campaign high of 11% back in late-November.

Moving into a national election, each of these democratic nominees seem to fair well against President Trump, with both former Vice President Biden and Senator Sanders posting a modest lead, whereas President Trump holds a similar lead when compared to either Senator Warren, or Mayor Buttigieg. But as we saw in 2016, sometimes polls are only as good as the pollsters.

In addition, according to Rasmussen Reports, President Trump's approval rating (as of December 31, 2019) has now rebounded off of recent lows and sits at almost 50%, inline where President Obama's approval rating stood through a similar tenure in his first term as President.

Exhibit 5: POTUS Approval Rating



Rasmussen and NEPCG

But in the end, we believe, and as a Democratic strategist said in 1992, "The economy, stupid[9]," suggesting that an incumbent President has a greater chance of re-election if the economy is doing well. Therefore, barring any cataclysmic drop in economic activity or a black-swan geopolitical event, we believe President Trump has a solid chance for re-election.

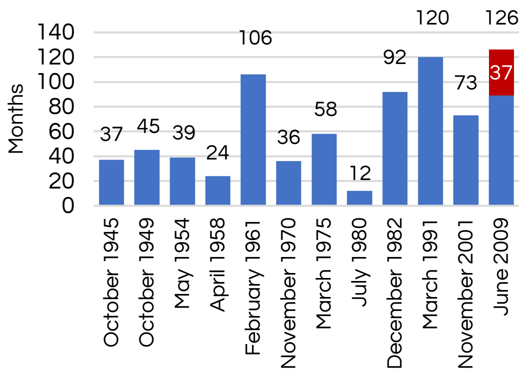
[9] A phrase coined by James Carville in 1992. It is usually mistakenly rendered as "It's the economy, stupid." Carville was a strategist in Bill Clinton's successful 1992 presidential campaign against incumbent George H. W. Bush.

Economic Outlook

The Diamond Anniversary

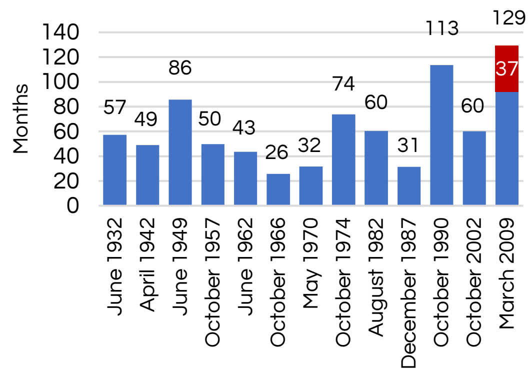
The U.S. economy is now in the 126th month (10+ years) of economic expansion[10] and in the 129th month of an equity bull market. Also, according to several sell-side analysts, strategies, and portfolio managers, there is still room to run.

Exhibit 6: U.S. Economic Expansions



FactSet and PCG

Exhibit 7: U.S. Bull Markets



FactSet and PCG

However, as we consider the classic characteristics of an economic life cycle, we are uncertain of how much more runway the U.S. economy has left.

As we illustrate in Exhibit 8 and further discuss in the following pages, we believe the U.S. is currently somewhere in the tail-end of the declining phase of an economic life cycle. A segment characterized by a topping out in corporate profits, non-existent inflation prospects, declining consumer and business confidence, as well as plateauing employment growth and a bottom in unemployment.

The exact location remains elusive, as the passing of the Tax Cuts and Jobs Act of 2017[11] at such a late phase in the economic cycle, together with the still unknown impact of zero interest rate policies[12] following the GFC, has disrupted the classic

---

[10] Defined herein broad terms as positive GDP growth.

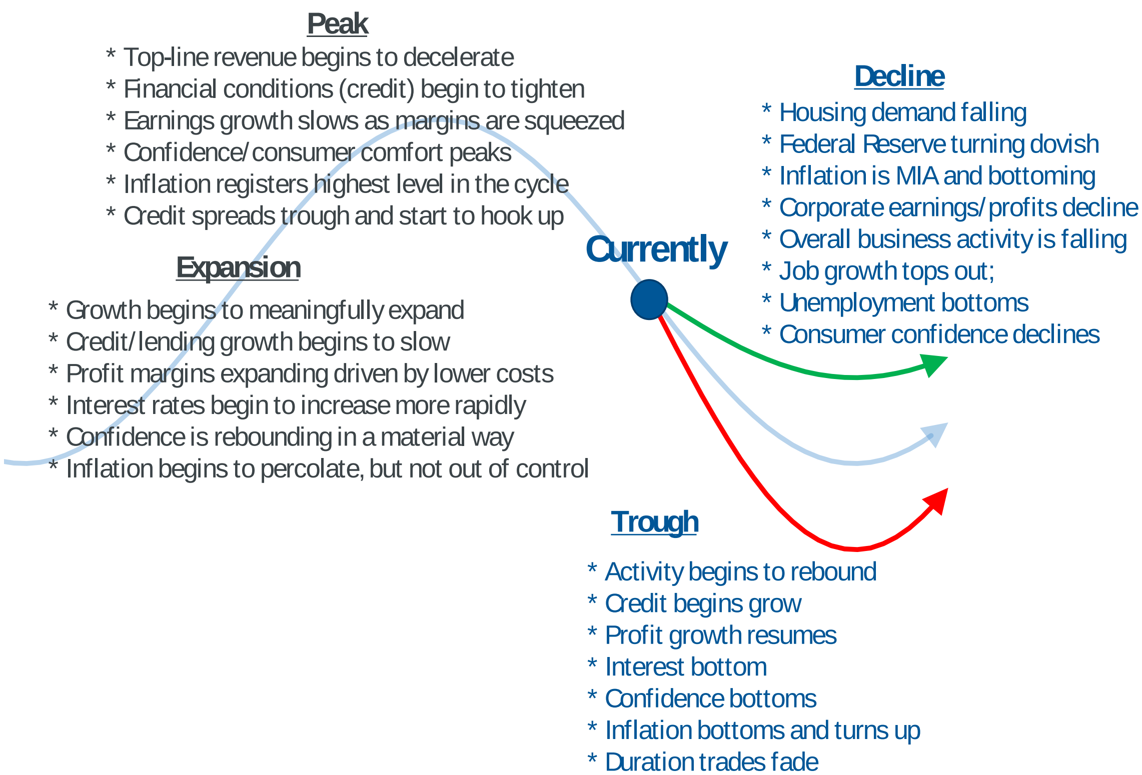
[11] The Tax Cuts and Jobs Act of 2017 (TCJA) provided for small reductions to income tax rates for most individual tax brackets and reduces corporate income taxes. It also provides a tax deduction for owners of pass-through entities and significantly increases individual alternative minimum tax and estate tax exemptions. Much of the tax relief is only temporary.

[12] Zero interest-rate policy (ZIRP) is a macroeconomic concept describing conditions with a very low nominal interest rate, such as those in contemporary Japan and December 2008 through December 2015 in the United States. ZIRP is considered to be an unconventional monetary policy instrument and can be associated with slow economic growth, deflation, and deleverage.

macroeconomic policy feedback loop. In other words, just as the cataclysmic economic downturn from 2007 through 2009 was uncharted, so has the been the recovery.

And while we believe that any subsequent economic trough will be short-lived, we still believe the economy must trough before it reaccelerates.

Exhibit 8: Typical Economic Life Cycle



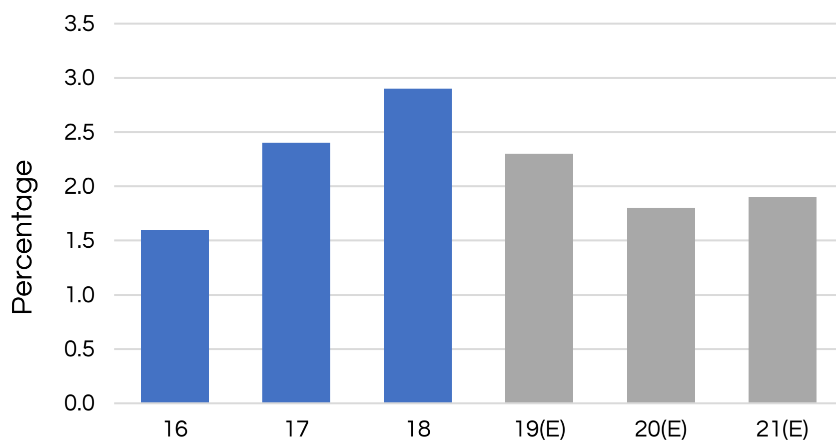
NEPCG

This view is contrarian, and not reflected in consensus economic estimates provided by FactSet[13]. According to FactSet, real GDP growth in the U.S. will decelerate to 1.8% in 2020, down from a projected 2.3% in 2019 and 2.9% in 2018.

As a result, this implies the U.S. economy will not contract into recession (loosely defined as two consecutive quarters of negative real GDP growth), but instead barely stay in expansion mode.

[13] FactSet Research Systems Inc., or FactSet, is a financial data and software company that provides integrated data and software solutions to investment professionals across the world. FactSet monitors economies, industries, and companies with FactSet's fully global economic data, accessing 1.9 million economic series with economic data readily available alongside in-depth company and market statistics enabling streamlined, centralized analysis and economic intelligence

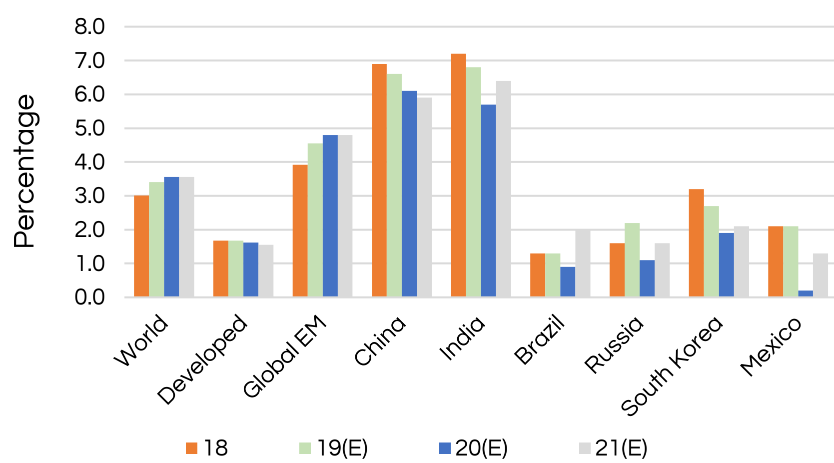
Exhibit 9: Consensus GDP Growth Expectations



FactSet and FactSet consensus estimates; as indicated by (E)

The consensus holds a similar viewpoint for the global economy, assuming both developed and emerging economies will only decelerate into 2020, with no outright contraction forecasted.

Exhibit 10: Global GDP Growth Expectations



FactSet and FactSet consensus estimates; as indicated by (E)

Global inflation prospects are following a similar trajectory to global growth, with expectations of bottoming by 2019 with only a slight uptick through 2020 and 2021.

In our opinion, the more upbeat forecasts and lack of recession expectations have been driven by the extraordinary response by global central banks via a synchronized effort to cut short interest rates[14] and ease monetary policy[15]. According to Bloomberg, there have been 32 interest rate cuts conducted by central banks during 2019, reducing short-term borrowing rates by almost 14%. Also, this could be just the beginning with over 50 more cuts expected over the 12 months.

Exhibit 11: Global Central Bank Easing vs. Tightening

Source: The Council on Foreign Relations' Global Monetary Policy Tracker

In Exhibit 11, we illustrate the comparative magnitude of these moves by central banks by presenting the Foreign Relations Board's Global Monetary Policy Tracker. Based on this measure, the current easing conditions rival that of the post-2007 GFC at close to negative 10.

In addition to this global "race to the bottom" in short-rates, many developed central banks are expanding their balance sheets again, or conducting other quantitative easing[16] initiatives. By expanding their balance sheets, these central banks aim to increase the monetary supply of bank reserves, thus providing increased liquidity to the banking system and the overall economy.

Unintended Consequences

However, the goal of igniting economic growth through monetary easing has potential unintended consequences we need to point out.

1. First, lower central bank short rates pull down longer duration government and corporate credit yields. In turn,

[14] Short rates refer to the interest that central banks sets in order to influence the monetary variables in the economy such as credit expansion, consumer prices, or exchange rates with the ultimate goal to either promote economic growth or cool down inflation prospects.
[15] In an easing monetary policy environment, the central bank lowers rates to stimulate growth in the economy. Lower rates lead consumers to borrow more, also effectively increasing the money supply.
[16] Quantitative easing is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to increase the money supply and encourage lending and investment.

this results in reduced savings or, worse yet, causes investors to take on undue risk as they stretch for yield; this typically does not end well.

2. Next, with so much liquidity in the global economy, the risk of inflation rises. Money is worth less when there is too much of it in the economy. Further, this compounds our initial concern, as the reduced savings level is worth even less. Also, labor is worth less as workers face reduced spending power, despite working the same number of hours.
3. Third, with global rates already so low, there remains little slack to cut rates further if a recession were to take hold. For example, the typical Fed Funds interest rate cut here in the U.S. to promote growth during recessions is about 500bps or 5%. The current Fed-Funds rate post the recent "mid-cycle" adjustment[17] is only 175bps, leaving five to six 0.25% cuts in short term rates if the economy stalls.
4. Finally, we are also concerned regarding booming deficits and aggregate debt levels caused by next-to-nothing borrowing rates. Moreover, this could potentially lead to the acceptance of modern monetary theory (MMT)[18], creating monetary imbalances and similar conditions that drove the 2007-2009 global market sell-off. Further, with all the liquidity and QE from both developed and emerging markets following the GFC, we have yet to observe its benefits through consistent and measurable economic growth.

Is The U.S. Still The Cleanest Dirty Shirt?

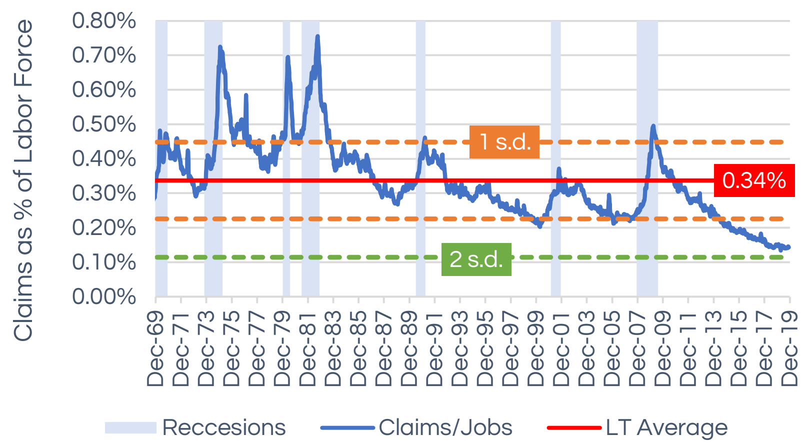
Currently, the U.S. remains the relative bright spot across the global economy. Job growth remains stable, the U.S. economy is experiencing near record-low unemployment, and the consumer appears to be spending. Since the end of the GFC, the U.S. economy has added over 22 million jobs, averaging about 196,000 over a six month period.

On the surface, the U.S. is and should remain the best place to invest capital globally. However, a closer look at the data suggests that

[17] The first mid-cycle adjustment was September to November 1998, as easing was largely in response to the threat to growth associated with turmoil in markets after Russia defaulted on its debt and the LTCM hedge fund had to be bailed out. the second mid-cycle adjustment was November 2002 to June 2003, whereby easing was in response to worries about a double-dip recession triggered by rising geopolitical tensions ahead of the U.S. invasion of Iraq in March 2003.
[18] Modern Money Theory (MMT) is a unorthodox macroeconomic theory framework that says that sovereign countries like the U.S., U.K., Japan and Canada are not constrained when spending since they can print as much as they need.

cracks may be forming. And together with a capital market that appears to be priced to perfection and an uncertain geopolitical backdrop, risk assets could be sailing into a perfect storm.

Exhibit 12: Claims As A Percent of Jobs



FactSet consensus estimates, the IMF and NEPCG

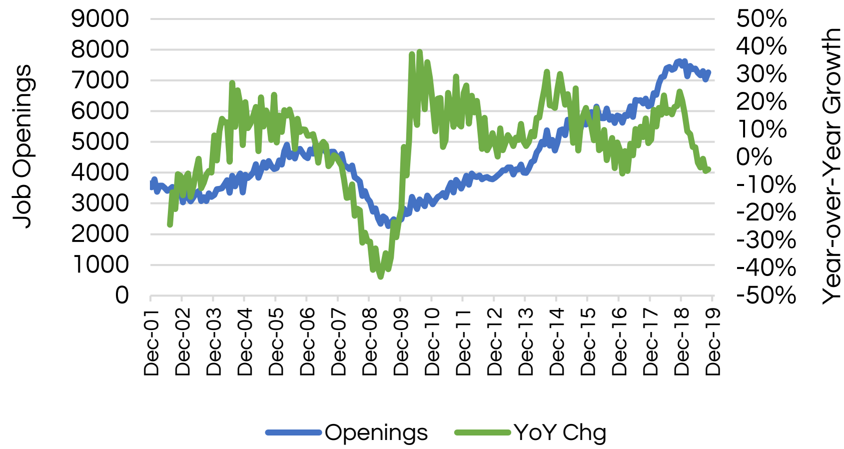
Whereas the unemployment rate is at half-century lows, when we consider the unemployment claims as a percent of the total employment base, we find this ratio is historically stretched and seems poised to hook up. And as we illustrate in Exhibit 12, when this happens, the economy typically begins to stall.

Based on our analysis and according to the U.S. Department of Labor, unemployment claims are averaging about 220,000 per week throughout 4Q19. As a percentage of our 152 million employment base, this equates presently to 0.14%, compared to the historical average of 0.34%. Further, this ratio is at the 2-standard deviation level, suggesting the current level of claims to the employment base is highly unexpected and unusual, given their normal historical relationship.

We also analyze other employment-related data, including the Job Openings and Labor Turnover Survey[19], conducted by the Bureau of Labor Statistics. As we illustrate in Exhibit 13, while Openings (job vacancies) remain elevated, they seem to be rolling over, while at the same time, the year-over-year trend has decelerated since December 2018, and is now at negative 4%.

[19] The JOLT survey is a survey conducted by the US Bureau of Labor Statistics to help measure job vacancies. It collects data from employers about their businesses' employment, job openings, recruitment, hires and separations.

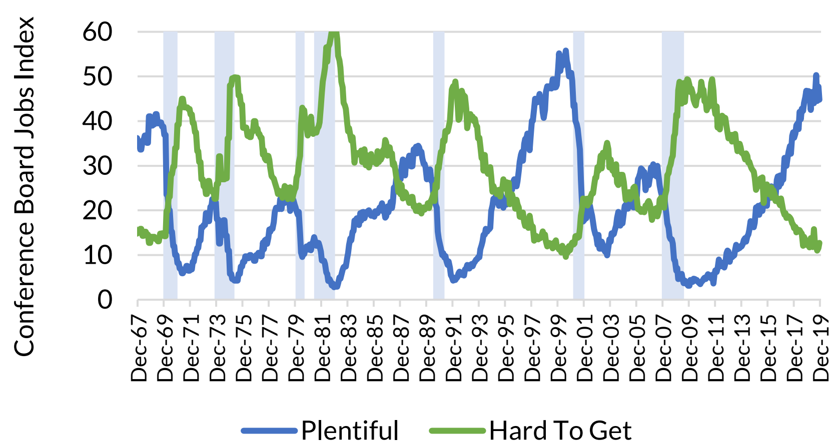
Exhibit 13 : Job Openings



FactSet and NEPCG

We also analyze employment data sourced from the Conference Board[20], which we present in Exhibit 14. Although the Conference Board Employment Report continues to suggest a relatively stable U.S. employment backdrop, an index of respondents suggesting that jobs that are "hard to get" seems to be bottoming, while an index of respondents indicating that "jobs are plentiful" appears to be topping out. And similar to our claims/jobs analysis, when these trends emerge, the economy soon thereafter falters.

Exhibit 14: Jobs Plentiful vs. Hard To Get



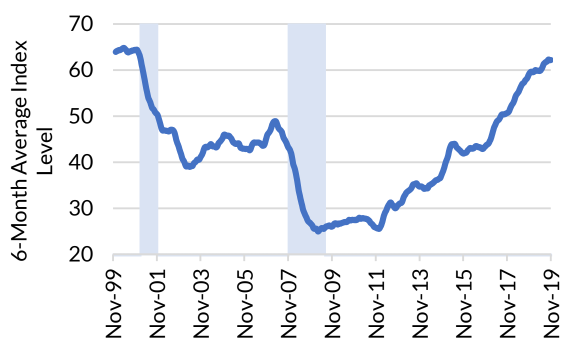
FactSet and NEPCG

[20] The Conference Board, Inc. is a non-profit business membership and research organization. It counts approximately 1,200 public and private corporations across 60 countries. The Conference Board convenes conferences and peer-learning groups, conducts economic and business management research, and publishes several widely tracked economic indicators.

It's All About The Consumer

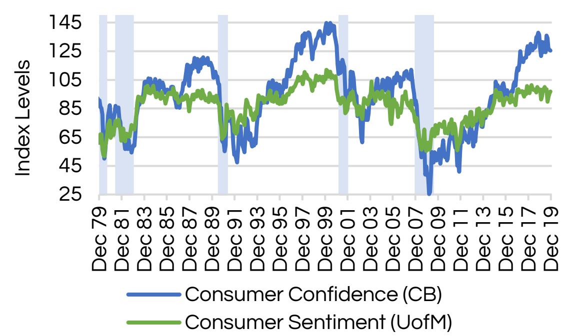
Turning the discussion to the consumer. Whether it be survey data, hard data, or even more anecdotally, walking through our local shopping mall, the U.S. consumer seems to be on solid footing. According to FactSet, the Bloomberg Consumer Comfort Index trailing 6-month average continues to trend higher and is showing no sign of slowing. But as with our analysis of employment data, we are becoming mindful of moderating trends. Also, as we illustrate in Exhibit 16, we are noticing a topping out in both the Conference Board's Consumer Confidence Index, as well as the University of Michigan's Consumer Sentiment Index. Once again, when these decelerating trends emerge, the economy soon after that begins to stall.

Exhibit 15: Bloomberg Consumer Comfort



FactSet and NEPCG

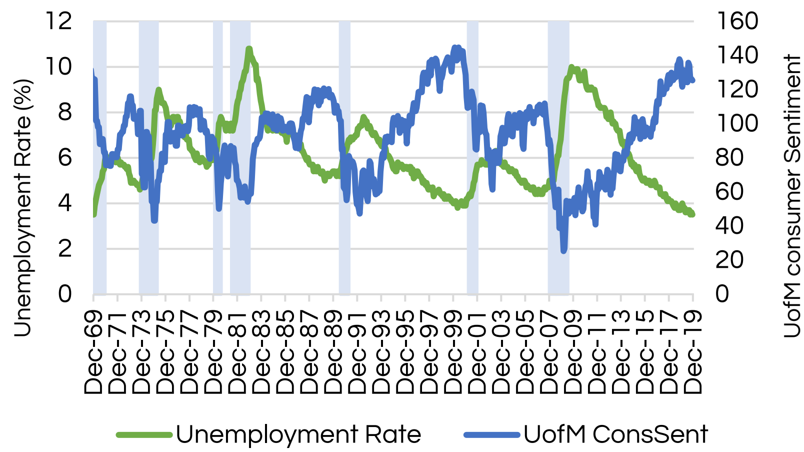
Exhibit 16: Consumer Sentiment Indices



FactSet and NEPCG

And when we combine employment data and consumer sentiment data, we arrive with potentially alarming results. In Exhibit 17 below, we plot the relationship between unemployment and the University of Michigan Consumer Sentiment Index and the U.S. Unemployment Rate. In our opinion, it is evident that when sentiment tops and unemployment bottoms, the economy soon after weakens.

Exhibit 17: Unemployment vs. Consumer Sentiment



FactSet and NEPCG

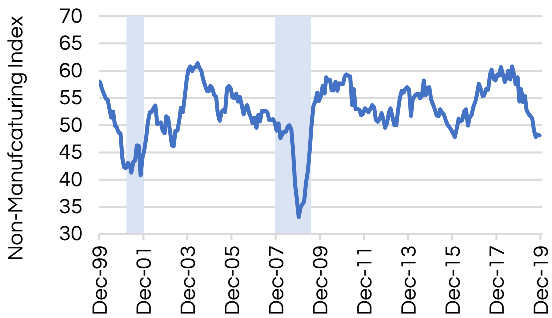
Are Tariffs Alone Holding Business Sentiment Back?

These more sobering consumer sentiment trends are also observed when analyzing business sentiment indicators. It should be no surprise that the U.S. manufacturing sector has been struggling over the last several years. However, more recent trends suggest economic softness is evident across the service sector as well; a segment believed to be less exposed to the negative overhang from the trade war.

As we highlighted in Exhibit 18, the ISM Non-Manufacturing Index is now rolling over similar to the ISM Manufacturing Index[21]. Traditionally, investors follow [The ISM Manufacturing Index] (Exhibit 19) as a popular economic indicator and forecasting tool. When the ISM Manufacturing Index is increasing, investors foresee a bullish stock market in response to higher corporate profits, and vice-versa. But as the ISM Non-Manufacturing Index is also rolling over, investors are becoming increasingly concerned that tariffs alone, are not the only thing holding the economy back.

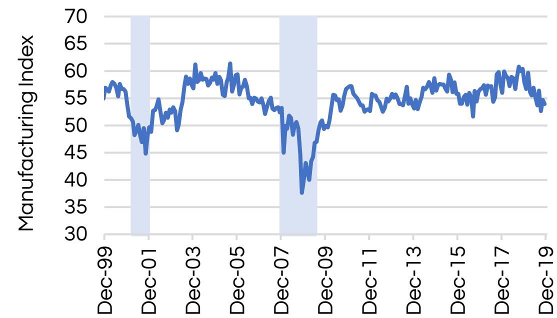
[21] The ISM Manufacturing Index is a widely watched indicator of recent U.S. economic activity. The index is often referred to as the Purchasing Manager's Index (PMI). Based on a survey of purchasing managers at more than 300 manufacturing firms by the Institute for Supply Management (ISM), the index monitors changes in production levels from month to month.

Exhibit 18: ISM Non-Manufacturing Index



FactSet and NEPCG

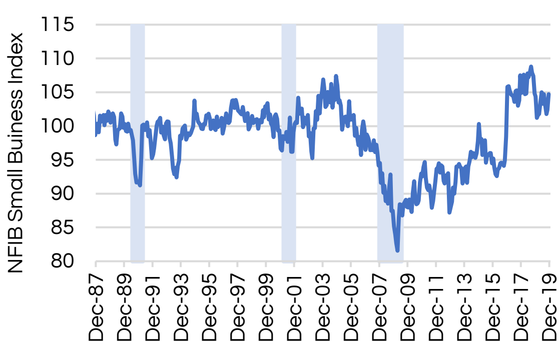
Exhibit 19: ISM Manufacturing Index



FactSet and NEPCG

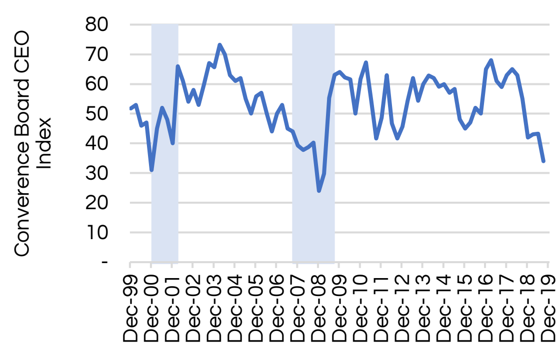
These more broad-based concerns are evident when analyzing the NFIB Small Business Optimism Index (Exhibit 20), provided by the National Federation of Small Businesses[22] (NFIB). We observe that despite a recent move higher, business sentiment topped out during the fourth quarter of 2018.

Exhibit 20: NFIB Small Business Optimism



FactSet and NEPCG

Exhibit 21: CEO Confidence



FactSet and NEPCG

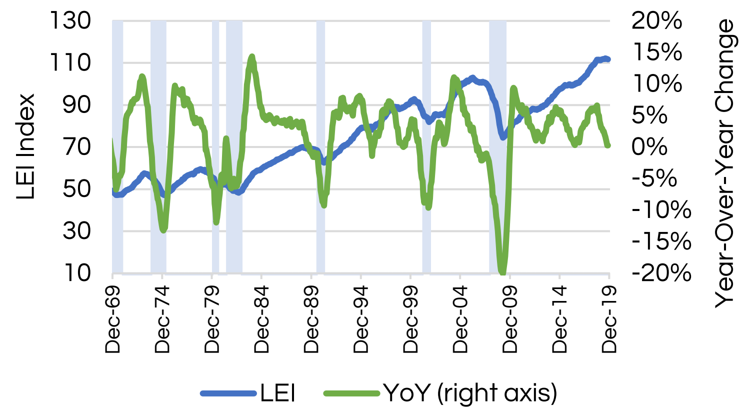
Further, in Exhibit 21, we provide the recent trends obtained from the Conference Board's CEO Confidence Index. Here too, the latest trends are not promising. However, if there is one encouraging observation from both the NFIB and Conference Board data, it is that any subsequent recession lags the peak levels of both indices by roughly 3-4 years, suggesting that a recession may not be just around the corner.

Finally, we turn to the Conference Board's Index of Leading Indicators[23], or LEI, for a foreshowing of economic trends to come.

[22] The National Federation of Independent Business is the largest small business association in the U.S.
[23] The ten indicators used to create this index include: 1) average weekly hours worked by manufacturing workers, 2) initial unemployment claims, 3) the volume of manufacturers' new orders for consumer goods

The index consists of 10 components combined into a composite that indicates the short-term course of various economic sectors and a general path of economic performance. As we illustrate in Exhibit 22, while the LEI is at an all-time high, the year-over-year trend is flat. Further, we observe that after topping in August of 2019, the LEI has registered flat-to-declining readings since.

Exhibit 22: Leading Economic Indicators



FactSet and NEPCG

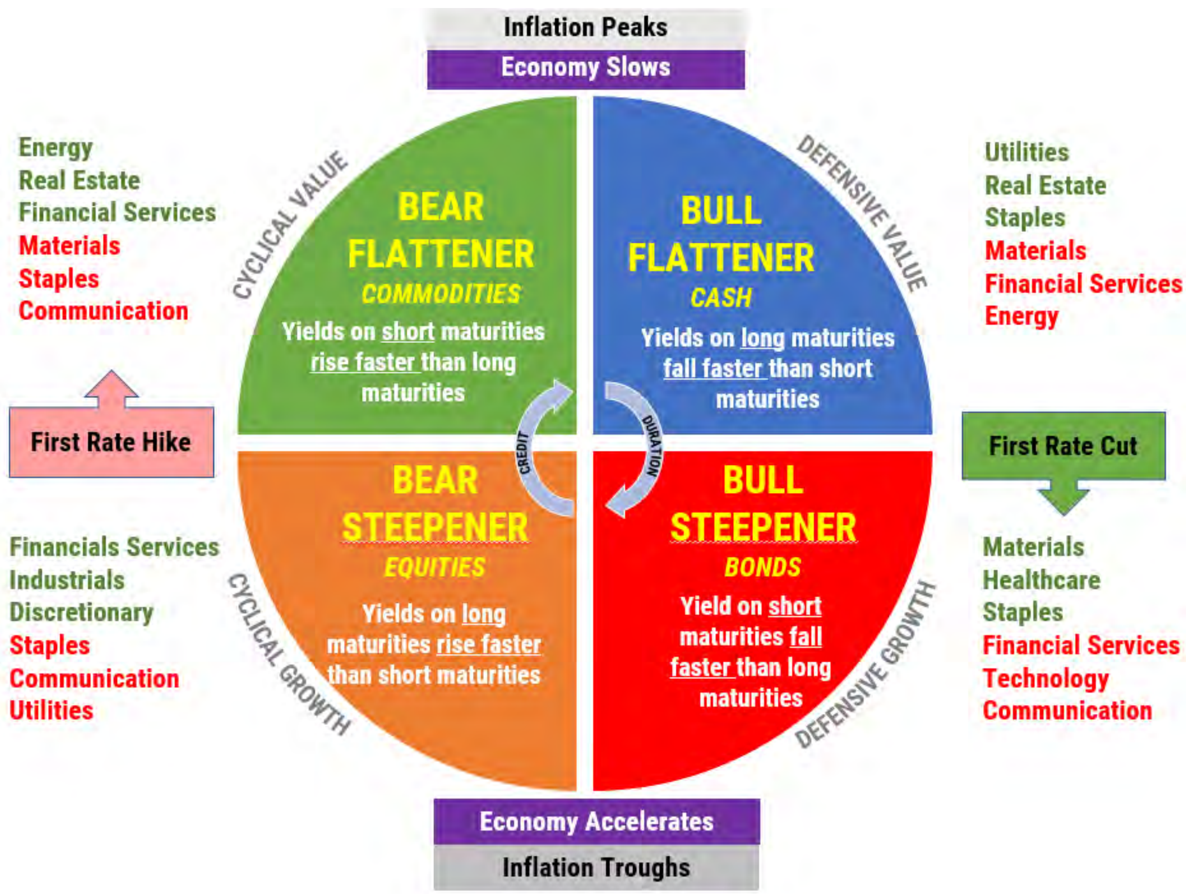
and materials, 4) the new orders index (from the Institute for Supply Management PMI), 5) the volume of new orders for capital goods (except aircraft), unrelated to defense, 6) the number of new building permits for residential buildings, 7) S&P 500 stock index, 8) the inflation-adjusted monetary supply (M2), 9) The spread between long and short interest rates, and 10) Average consumer expectations for business conditions indicate forward-looking consumer sentiment for the next six to 12 months.

2020 Positioning

Bonds Can Help Us See Around Corners

Our readers have heard us utter this phrase before, suggesting that bond managers seemingly have an open window into future economic dynamics, as well as offering some predictive value to equity investors. Much of our portfolio positioning discussion is based on this premise, which we begin to frame out through our Interest Rate Regime illustration below. Based on historical changes in bond prices and yields, aka the yield curve [24], we can overlay economic and capital market trends and responses.

Exhibit 23: Interest Rate Regimes and Preferred Sector Positions



NEPCG

First, we need to define each of the four interest rate regimes; Bull Flattener, Bull Steepener, Bear Steepener, and a Bear Flattener.

---

[24] A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity.

In a **Bull Flattener** (blue shaded area), yields on long-maturity bonds fall faster (price increases quicker) than the yields on shorter-maturity bonds (prices increase slower). This historically happens after the inflation peaks, and the economy begins to slow. At the same time, central banks become more dovish[25], ultimately leading to the first-rate cut of the cycle. During these periods, we find that defensive-oriented value equities tend to perform well, led by Utilities, Real Estate and Staples; underperforming sectors include Materials, Financial Services, and the Energy complex. Also, during this interest rate regime, we find that duration begins to outperform credit, meaning as the economy starts to cool, credit spreads[26] start to widen. In other words, investors will opt to invest in the full-faith and guarantee of U.S. government bonds (or cash) over corporate bonds, thus lowering corporate bond prices and increasing their yields.

In a **Bull Steepener** (red shaded area), yields on short maturity bonds fall faster (prices increase quicker) than yields on long-maturity bonds (prices increase slower). This historically happens as the economy is moving toward recession with a bottoming in economic activity and inflation prospects. During this interest rate regime, central banks are in full cutting mode, resulting in a preference for risk-free duration (government bonds over corporates or high yield), with the Material, Healthcare, and Staple sectors outperforming. On the downside, we typically observe Financial Services, Technology, and the Communication sector to lag the overall market.

In a **Bear Steepener** regime (orange shaded area), yields on long-maturity bonds rise faster (price falls quicker) than yields on short maturity (prices fall slower). At the beginning of this regime, the economy emerges from an economic trough, and inflation begins to drive growth, ultimately moving toward the first rate hike of the cycle. During this period, cyclically oriented growth sectors and stocks historically tend to outperform the overall market, including Financial Services, Industrials and Consumer Discretionary. To the downside, underperforming sectors include Staples, Communication Services, and Utilities. Also, lower-credit quality

---

25 A dove is an economic policy position that promotes monetary policies that usually involve low interest rates, which may promote inflation.

26 A credit spread is the difference in yield between a U.S. Treasury bond and another debt security of the same maturity but different, typically lower, credit quality.

fixed-income investments typically begin to recover and start to outperform government and other relatively low-risk bonds.

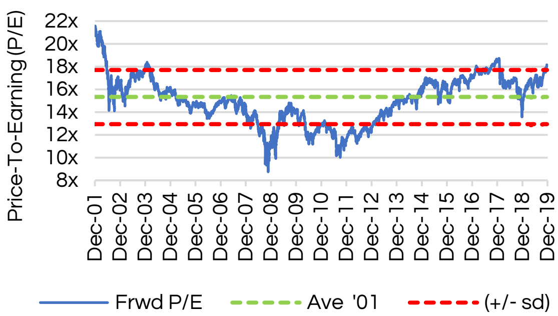
A **Bear Flattener** Regime (green shaded area), historically begins with the first rate hike of the cycle and is characterized by yields on short maturity bonds rising faster (prices falling quicker) than long-maturity bonds (prices falling slower). During this regime, inflation is accelerating, and the economy typically peaks. Especially toward the latter stages, cyclical-value oriented sectors and stock outperform. We observe that Energy, Real Estate, and the Financial Services sectors have historically done well, while Materials, Staples, and the Communication Services sectors have lagged the overall market.

So What Does This All Mean?

At this point, we believe the U.S. capital market is somewhere between the end of a ***Bull Steepener*** (red shaded area) and the beginning of a ***Bear Steepener*** (orange shaded area) regime. We have already experienced several rate cuts, and inflation is decelerating (if not already bottomed). The broader U.S. economy is 10+ years through the longest expansion since the end of WWII, and the Federal Reserve seems to be on hold at least through 2020. At the same time, we have witnessed the 10yr Treasury Note tick up from lows of 1.5% in August of '19 to most recently, almost 2.0%, resulting in the re-steepening of the yield curve after briefly turning negative. Further, certain Defensive Growth sectors and companies have been outperforming recently. Also, following a trough in performance in late 3Q19 to early 4Q19, high-yield bonds are for bid, while long-duration government bonds are lagging.

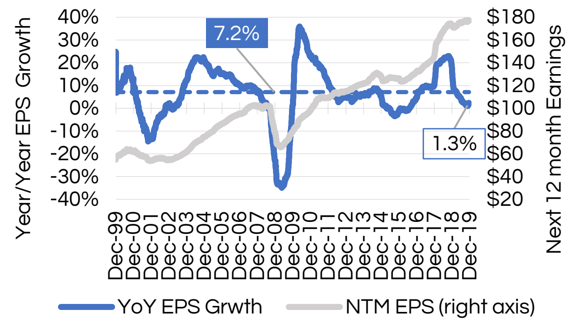
Going forward, our outlook calls for the eventual bottoming of the economy, albeit not to any cataclysmic degree, which we experienced during the 2007 recession and commensurate GFC. Further, we believe that as our Interest Rate Regime thesis suggests, specific sectors, styles and allocation have already begun to price this rebound. The rub to us, however, is that equity markets appear to remain priced to perfection, currently trading at 18.2 times next twelve-month earnings (or P/E ratio), slightly above one standard deviation wide of historical norms. This also compares to the long-term average P/E of 15.3x. We note the last time the S&P traded at these levels was January 2018, right before the U.S. first levied tariffs on solar panels and washing machines.

Exhibit 24: S&P 500 Priced To Perfection



FactSet and NEPCG

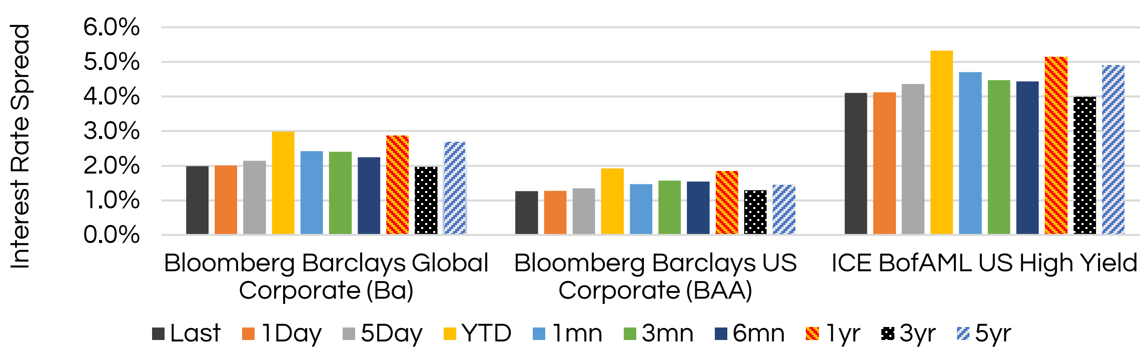
Exhibit 25: S&P 500 Operating Earnings



FactSet Consensus Estimates

In addition, as we illustrate in Exhibit 26, given the extraordinarily low yields here and abroad, fixed-income securities remain overbought, and credit spreads remain tight.

Exhibit 26: Credit Spreads Remain Tight



NEPCG and FactSet

Therefore, we are looking for at least a 10-15% retracement in equity prices (S&P 500), and a 60-80 basis point back up in yield spreads in order for the capital markets to reset, and then resume a path higher. **Further, we believe the triggers to these capital market moves may be more geopolitical in nature than economically driven, for the most part.** Hence, as we look out 12-18 months, we expect equities to lead bonds from an allocation perspective. We expect cyclical growth sectors to outperform as the Federal Reserve remains on hold and inflation troughs. Within fixed income, we believe corporate credit (higher default risk) will outperform governments. However, we believe that as inflation begins to percolate, Treasury Inflation-Protected Securities (TIPs) may provide investors with a much-needed hedge to an over-heating economy.

Disclosures:

The information in this publication and references to specific securities, asset classes, and financial markets are provided for illustrative purposes and do not constitute an offer to sell, or solicitation of an offer to purchase any securities, nor does they constitute an endorsement with respect to any investment area or vehicle. This material serves to provide general information to clients and is not meant to be legal or tax advice for any particular investor, which can only be provided by qualified tax and legal counsel. Certain information contained herein is based on outside sources believed to be reliable, but its accuracy is not guaranteed. Investment products (other than deposit products) referenced in this material are not insured by the FDIC (or any other state or federal agency), are not deposits of or guaranteed by Northeast Private Client Group, and are subject to investment risk, including the loss of principal amount invested. Portfolios are subject to investment risks, including possible loss of the principal amount invested. In addition, foreign investments may be less liquid, more volatile and less subject to governmental supervision than in the United States. The values of foreign securities can be affected by changes in currency rates, application of foreign tax laws, changes in governmental administration and economic and monetary policy. Investors should consider the investment objectives, risks, charges, and expenses of ETFs carefully before investing. This and other information are contained in the fund's prospectus, which may be obtained from your investment professional. Please read it before you invest. Investments in ETFs are subject to risk, including possible loss of the principal amount invested. This information is being provided to current Northeast Private Client Group clients and should not be further distributed without Northeast Private Client Group's approval. S&P 500 Index is a market index generally considered representative of the stock market as a whole. The index focuses on the large-cap segment of the U.S. equities market. Dow Jones Industrial Average is a widely used indicator of the overall condition of the stock market, a price-weighted average of 30 actively traded blue-chip stocks, primarily industrials, but also includes financial, leisure and other service-oriented firms. Russell 2000 Index measures the performance of the smallest 2,000 companies in the Russell 3000 Index of the 3,000 largest U.S. companies in terms of market capitalization. NASDAQ Composite Index is a market value-weighted index that measures all NASDAQ domestic and non-U.S. based common stocks listed on the NASDAQ stock market. Each company's security affects the index in proportion to its market value. This commentary contains forward-looking statements and projections. Actual results may differ from current expectations based on several factors including but not limited to changing market conditions, leverage and underlying asset performance. Northeast Private Client Group makes no representation or warranty, express or implied that this information should be relied upon as a promise or representation regarding past or future performance. This material contains the current opinions of the author but not necessarily those of Guardian or its subsidiaries and such opinions are subject to change without notice. Past performance is not a guarantee of future results. Indices are unmanaged, and one cannot invest directly in an index. Data and rates used were indicative of market conditions as of the date shown. Opinions, estimates, forecasts, and statements of financial market trends are based on current market conditions and are subject to change without notice. Securities products and advisory services offered through Park Avenue Securities LLC (PAS), member FINRA, SIPC. OSJ: 200 Broadhollow Road Suite 405, Melville, NY 11747, 631-589-5400. PAS is an indirect, wholly-owned subsidiary of The Guardian Life Insurance Company of America® (Guardian), New York, NY. Northeast Private Client Group is not an affiliate or subsidiary of PAS or Guardian. **2020-91779** Exp.12/20.

NORTHEAST SEQUOIA
PRIVATE CLIENT GROUP
103 Eisenhower Parkway, 2nd Floor, Roseland, NJ 07068
973-422-9140 • info@northeastprivate.com