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Quarterly Economic Review

December '19

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Economic Review

Among global equity markets, larger-cap U.S. stocks were once again at the top of the leader board. The S&P 500 Index posted gains in every quarter and surged 9% in the fourth quarter to end the year at an all-time high. Its 31% total return was its second-best year since 1997. (It was up 32% in 2013.) Smaller-cap U.S. stocks rose 25.4% for the year.
Foreign equity markets were also strong. European stocks gained 9.9% in the fourth quarter and 24.9% for the year. After struggling in the third quarter, emerging-market (EM) stocks shot up almost 12% in the fourth quarter and returned 20.8% for the year.

The core bond index was flat in the fourth quarter but gained 8.6% for the year. This was its best annual return since 2002. Below-investment-grade bonds also fared well in 2019. High-yield bonds gained 14.4% and the floating-rate loan index rose more than 8.6%.

Why did both stocks (risky assets) and bonds (defensive assets) appreciate sharply in 2019? The key driver was the Federal Reserve's sharp U-turn toward accommodative monetary policy. This was followed by other central banks across the globe. Coming into 2019, the Fed was indicating it expected to continue to raise interest rates. This led investors to fear that higher rates could tip the U.S. and global economies into recession, bringing an equity bear market with it. The ongoing U.S.-China trade conflict didn't help matters.

Review Continued

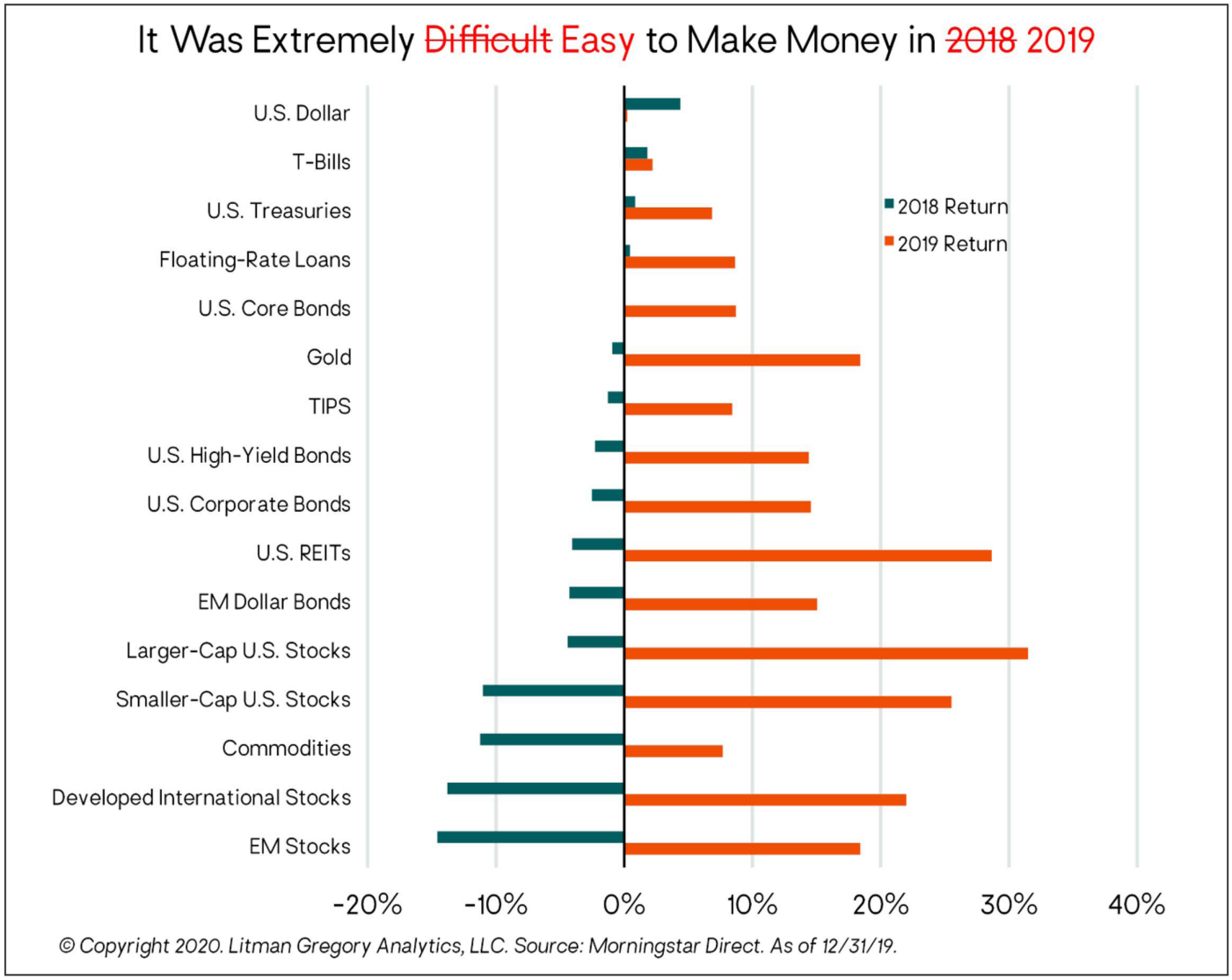
Ultimately, the Fed ended up cutting rates three times in the second half of 2019. Late in the year, it also started expanding its balance sheet again via purchases of Treasury Bills in order to boost banking system reserves and inject liquidity into the short-term lending markets. Other major central banks also cut rates and/or provided additional stimulus to the markets during the year. This lessened recession fears.

Meanwhile, inflation (and inflation expectations) remained at or below central bank targets. This lifted concerns that interest rates would be hiked anytime soon, and the bond market rallied.

U.S. equity investors responded to the Fed policy reversal and stimulus much as they have during the past 10 years—by bidding up stock prices and valuations. A détente in the U.S.-China trade war late in the year (the "phase one" deal) was an added boost to market sentiment. Importantly, earnings growth did not drive U.S. stocks higher; the majority of the S&P 500's return came from expanding valuations. Thus, the valuation risk in U.S. stocks, which we've highlighted for some time now, has only gotten worse.

There are reasons to be cautiously optimistic for financial markets in 2020: Monetary policy is easy, recession risks seem to be receding, and some geopolitical risks have abated. That said, we are watching a number of potential short-term risks. Given we think recent positive developments have largely been incorporated into prices and valuations are stretched for U.S. stocks and bonds, markets are particularly vulnerable to any disappointment or negative surprise. If that comes to pass, we stand ready to take advantage of any potential opportunities

In a sharp reversal from 2018, returns were postive across all major asset classes in 2019.



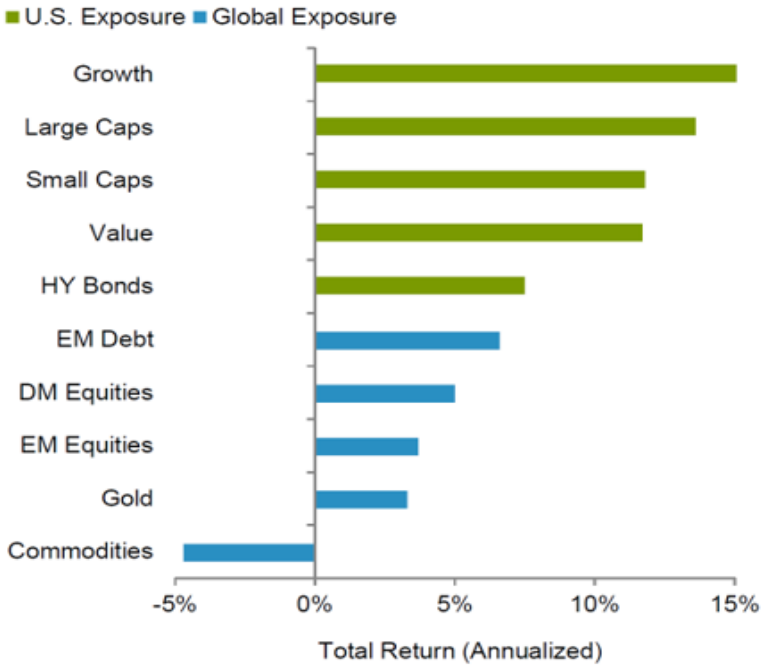
All equity markets had double digit growth in 2019...

...and 'the Aughts' were dominated by growth and tech stocks...

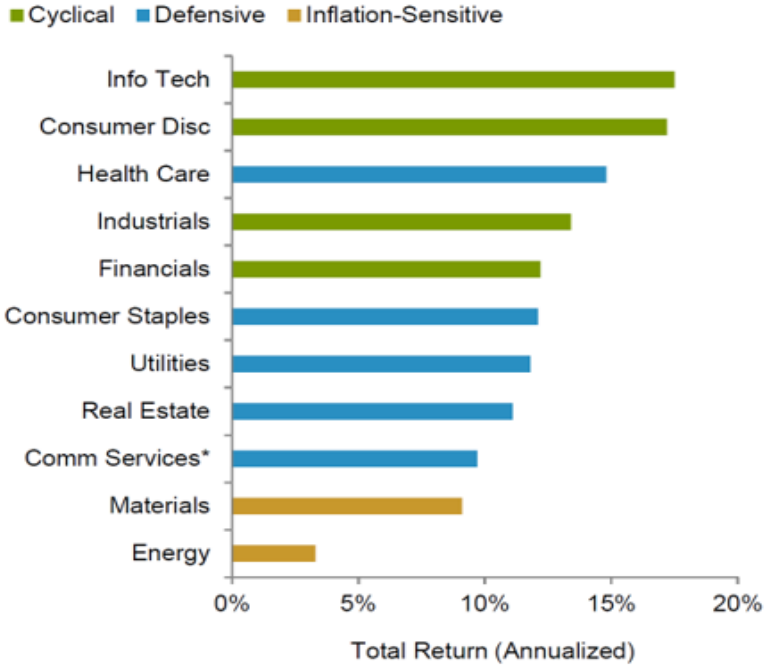
U.S. Growth and Tech Stocks Dominated the Decade

The supremacy of U.S. large cap equity returns during 2019, particularly in the technology sector, underscored the 10-year outperformance of growth stocks along with U.S. assets more generally. For the decade, the more cyclical U.S. equity sectors performed best, whereas non-U.S. assets, as well as market segments and equity sectors tied to global commodities, fared relatively poorly.

Performance of Major Risk Assets (2010–2019)

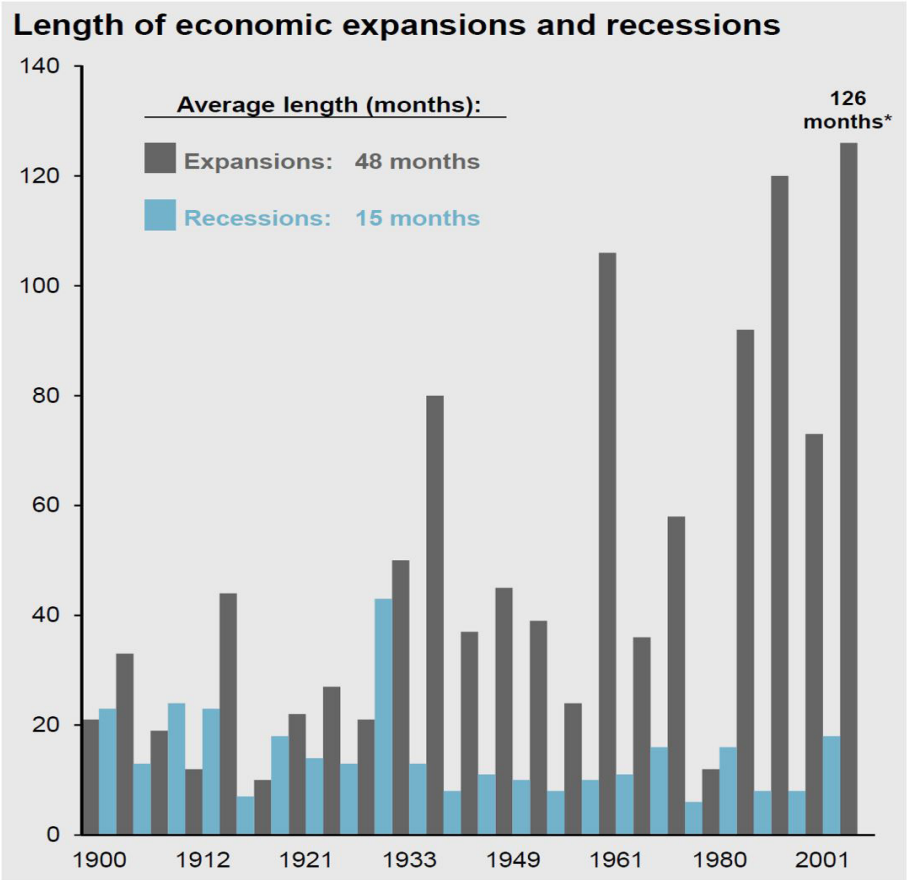


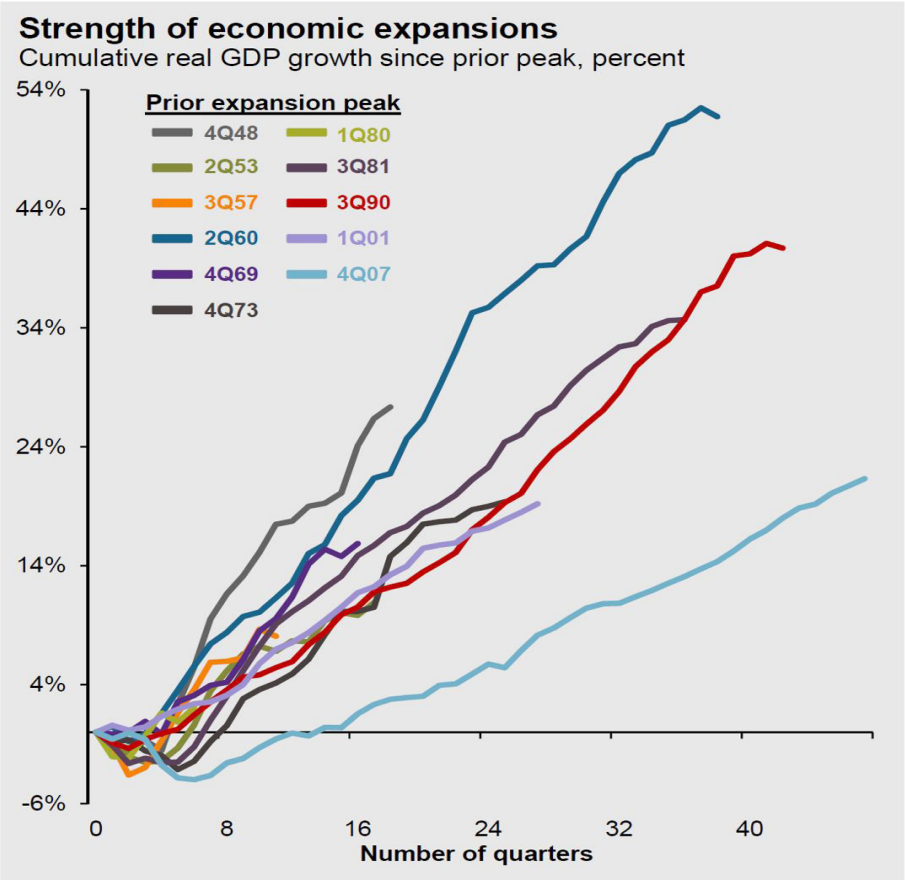
U.S. Equity Sector Performance (2010–2019)



* Sector was defensive for majority of period until change to GICS structure in 2018. Past performance is no guarantee of future results. It is not possible to invest directly in an index. All indexes are unmanaged. See Appendix for important index information. Assets represented by: Growth—Russell 3000® Growth Index; Large Caps—S&P 500; Small Caps—Russell 2000® Index; Value—Russell 3000® Value Index; High-Yield (HY) Bonds—ICE BofAML High Yield Bond Index; Emerging-Market (EM) Debt—JP Morgan EMBI Global Index; Non-U.S. Developed-Market (DM) Equities—MSCI EAFE Index; EM Equities—MSCI EM Index; Gold—Gold Bullion, LBMA PM Fix; Commodities—Bloomberg Commodity Index. Source: Bloomberg Finance L.P., Fidelity Investments (AART), as of 12/31/19.

...as the longest expansion in US history marched on!



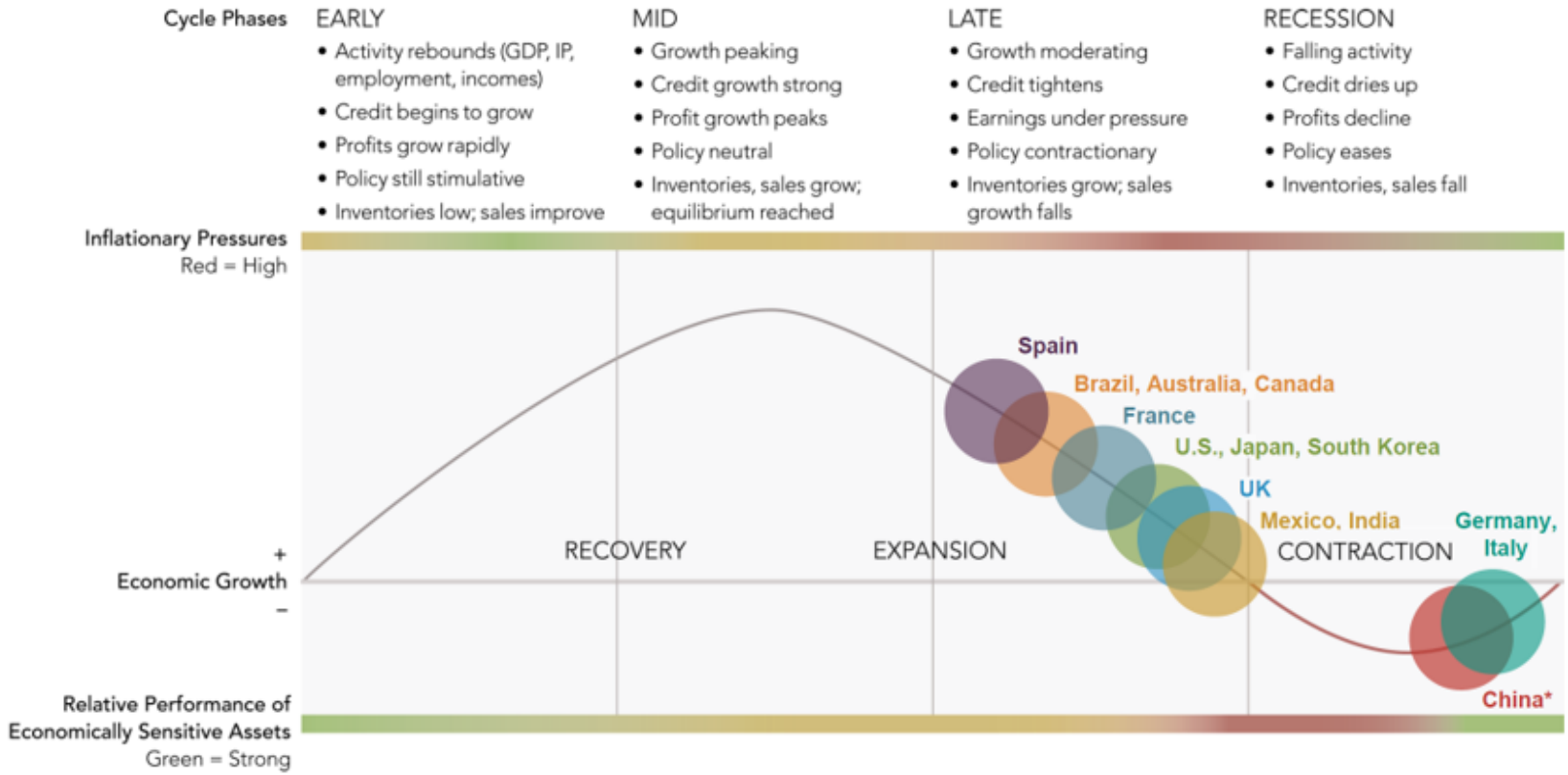


Source: BEA, NBER, J.P. Morgan Asset Management. *Chart assumes current expansion started in July 2009 and continued through December 2019, lasting 126 months so far. Data for length of economic expansions and recessions obtained from the National Bureau of Economic Research (NBER). These data can be found at www.nber.org/cycles/ and reflect information through December 2019. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of December 31, 2019.

J.P.Morgan Asset Management

Across the world, slowing growth rates indicate most world economies are firmly in late stages of expansion.

Business Cycle Framework



Note: The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. * A growth recession is a significant decline in activity relative to a country's long-term economic potential. We use the "growth cycle" definition for most developing economies, such as China, because they tend to exhibit strong trend performance driven by rapid factor accumulation and increases in productivity, and the deviation from the trend tends to matter most for asset returns. We use the classic definition of recession, involving an outright contraction in economic activity, for developed economies.
Source: Fidelity Investments (AART), as of 12/31/19.

And it is increasingly difficult to navigate global crosscurrents.

The investment landscape, while still positive, is growing more challenging as investors adjust to more typical late-stage expansion conditions.

Positives	Cautionary Signs/Areas to Watch
▪ Fed dovish pivot/favorable financial conditions ▪ Positive corporate profit growth ▪ Healthy consumer and business fundamentals ▪ High confidence ▪ Modest inflation ▪ Bottoming of global slowdown/reduced trade tensions ▪ Few signs of imbalances	▪ Aging business cycle ▪ Trade policy missteps ▪ Higher debt levels ▪ Fading fiscal stimulus ▪ Potential acceleration in wages and other business costs ▪ Geopolitical shocks ▪ Higher volatility and valuations

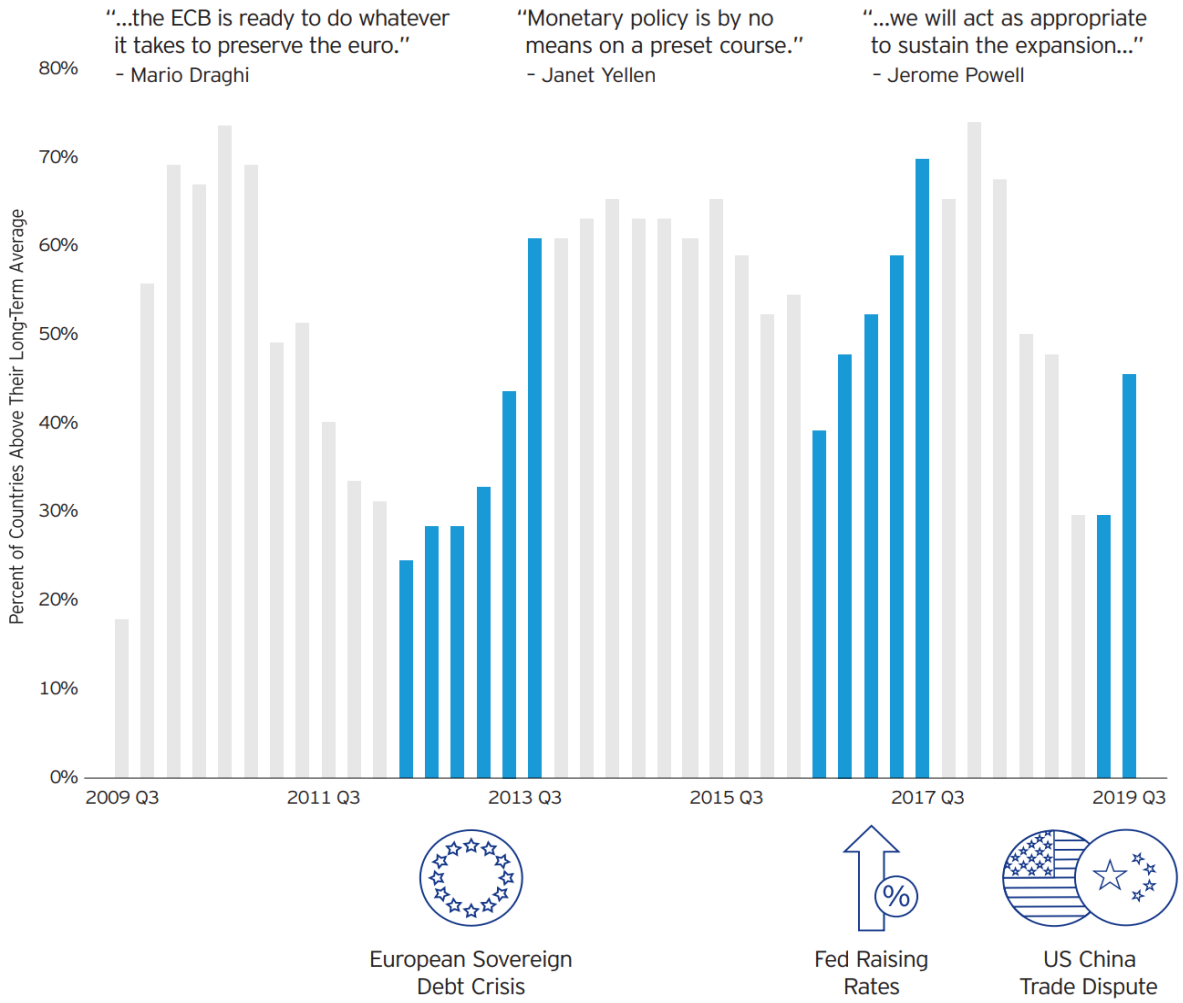
The accommodative position of central banks around the world have boosted this current expansion cycle...

The third growth scare of this cycle appears to be dissipating

The global economy is reemerging from the third growth scare of the current cycle, as evidenced by the rise in the percentage of world economies growing above their long-term averages. All three of the growth scares have been driven by fears that policy mistakes would prematurely end the cycle. Today, better news on trade and a more accommodative stance from the Fed should boost confidence in the durability of the current upswing. If 2018 was characterized by good growth and bad policy and 2019 was a story of slower growth and better policy, we think 2020 may be a story of acceleration back to trend growth rates for most of the world's economies.

For illustrative purposes only.
Sources: Haver, Invesco, 10/31/19.

Percent of Countries Growing Above Their Long-Term Average



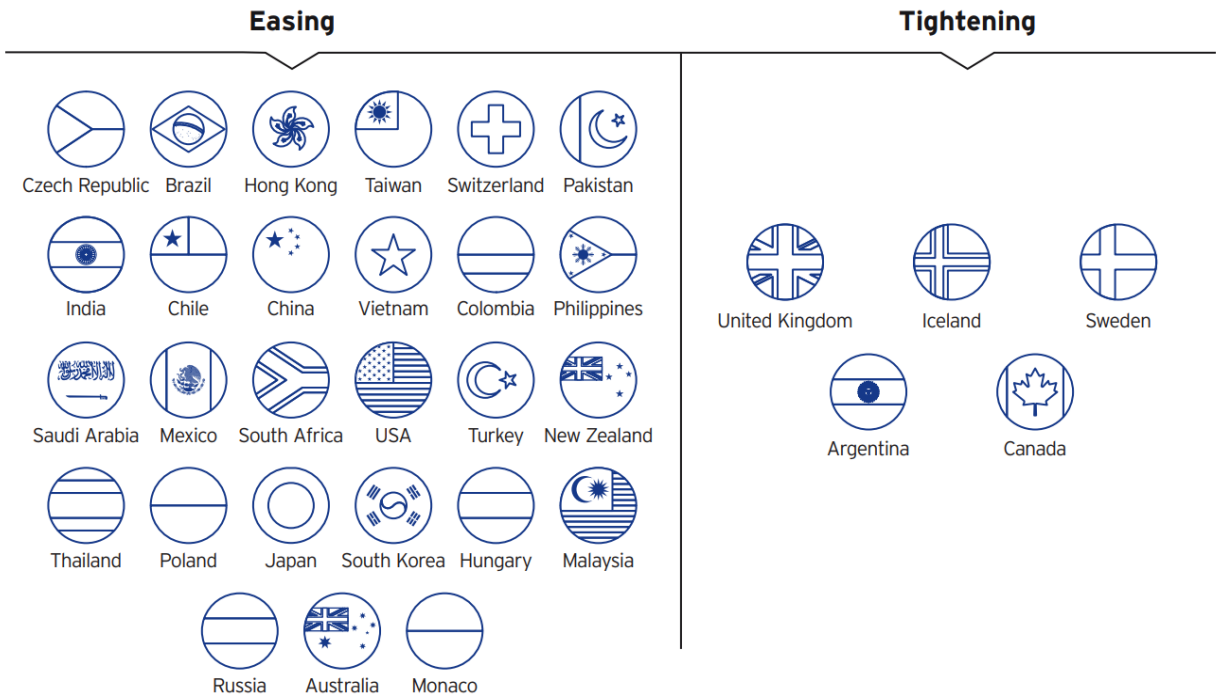
...with more central banks easing than tightening.

Central banks around the globe are easing policy

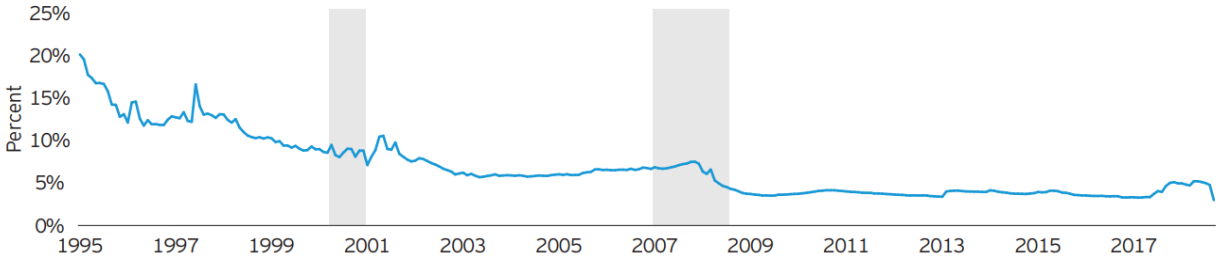
Central banks around the world have taken a cue from the Fed and started monetary easing. With global inflation largely absent (with a few idiosyncratic exceptions like Argentina and Turkey), the bias in most monetary policy decisions has been toward a looser policy. This shift should support global growth and ease funding pressures that were building in certain emerging market countries in 2018.

Sources: Bank of International Settlements, Haver Analytics 10/30/19. An investment cannot be made in an index.

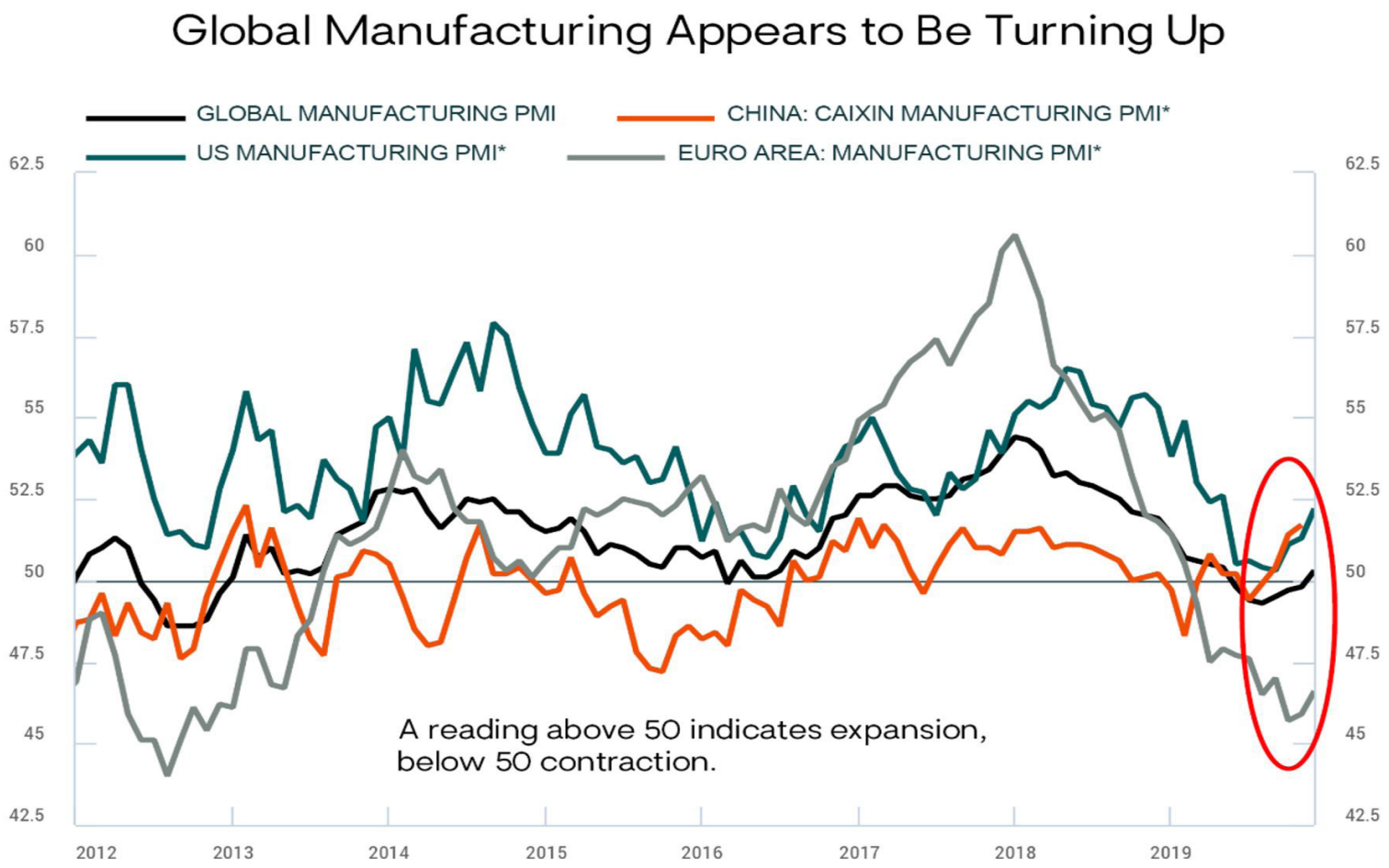
Last Rate Move: Easing or Tightening



Global Average of All Central Bank Policy Rates



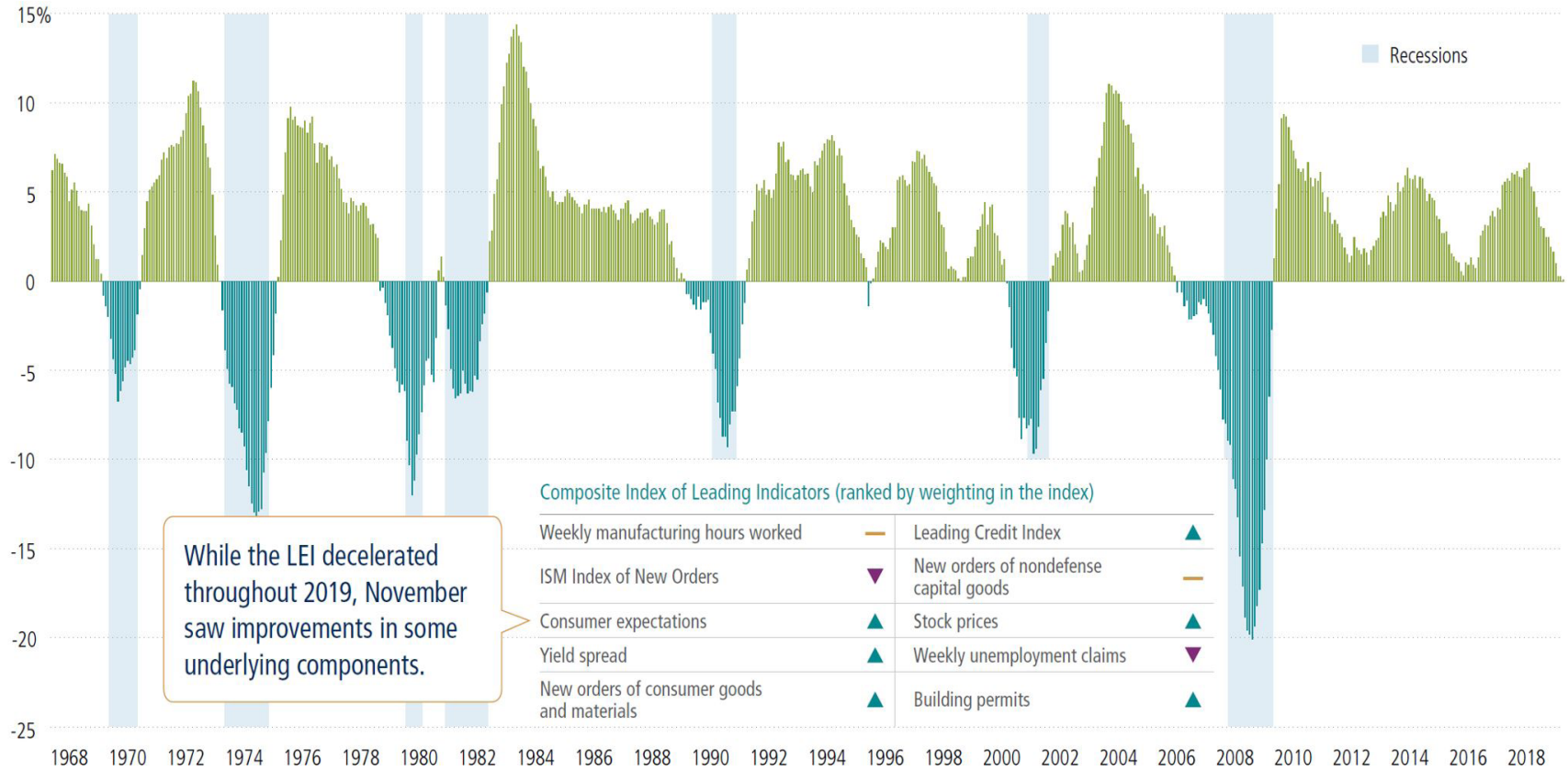
Global manufacturing seems to have bottomed and is regaining traction.



SOURCE: MARKIT ECONOMICS.
*SOURCE: MARKIT

And leading economic indicators remain positive for now.

Year-over-year change in the Composite Index of Leading Indicators

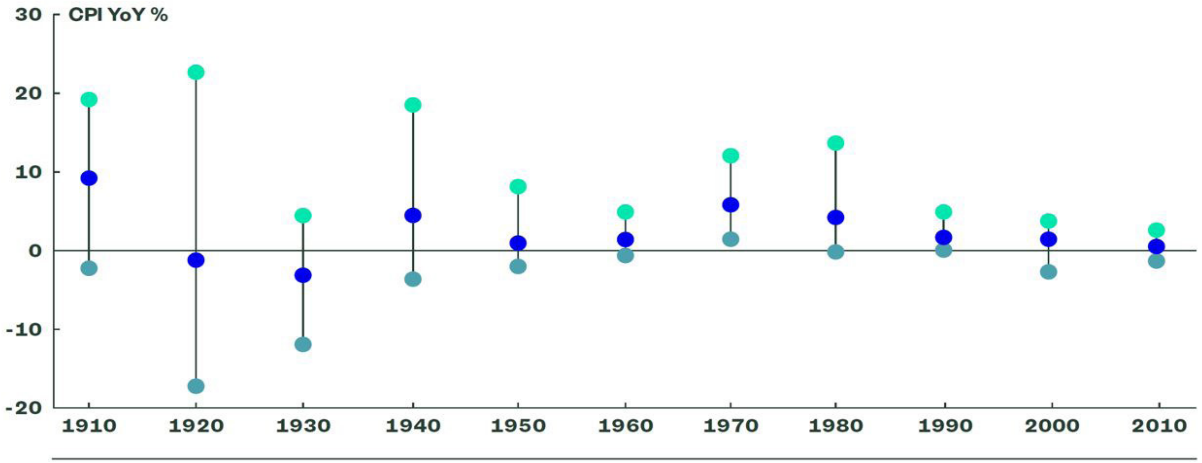


Source: The Conference Board, as of 11/30/19. The Composite Index of Leading Indicators (LEI) is an index published monthly by The Conference Board, used to predict the direction of the economy's movements in the months to come. The index is made up of 10 economic components whose changes tend to precede changes in the overall economy. It is not possible to invest directly in an index. Past performance does not guarantee future results.

This past decade saw the least volatile inflation in history...

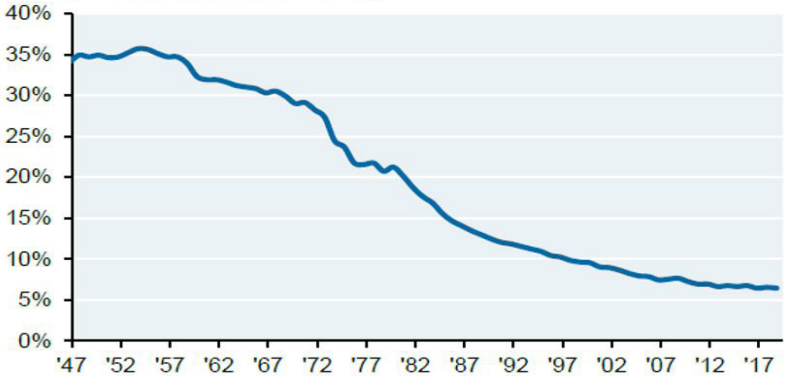
Figure 1

CPI Range By Decade: This Decade Has Seen the Narrowest Band of Price Fluctuations; the Average Inflation Rate Has Been 1.77%



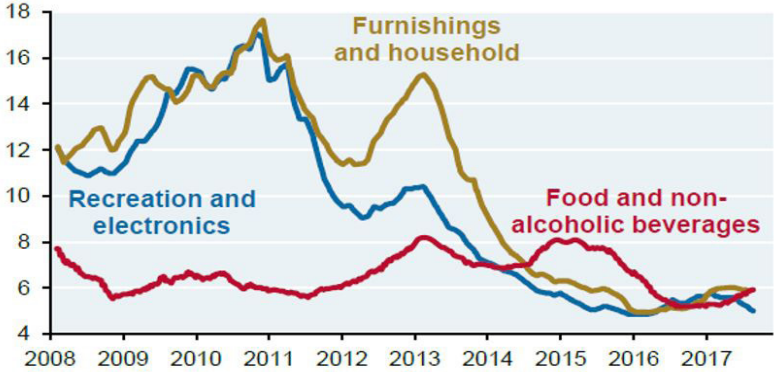
Source: Bloomberg Finance L.P., December 18, 2019.

Decline in labor bargaining power
Private sector union membership



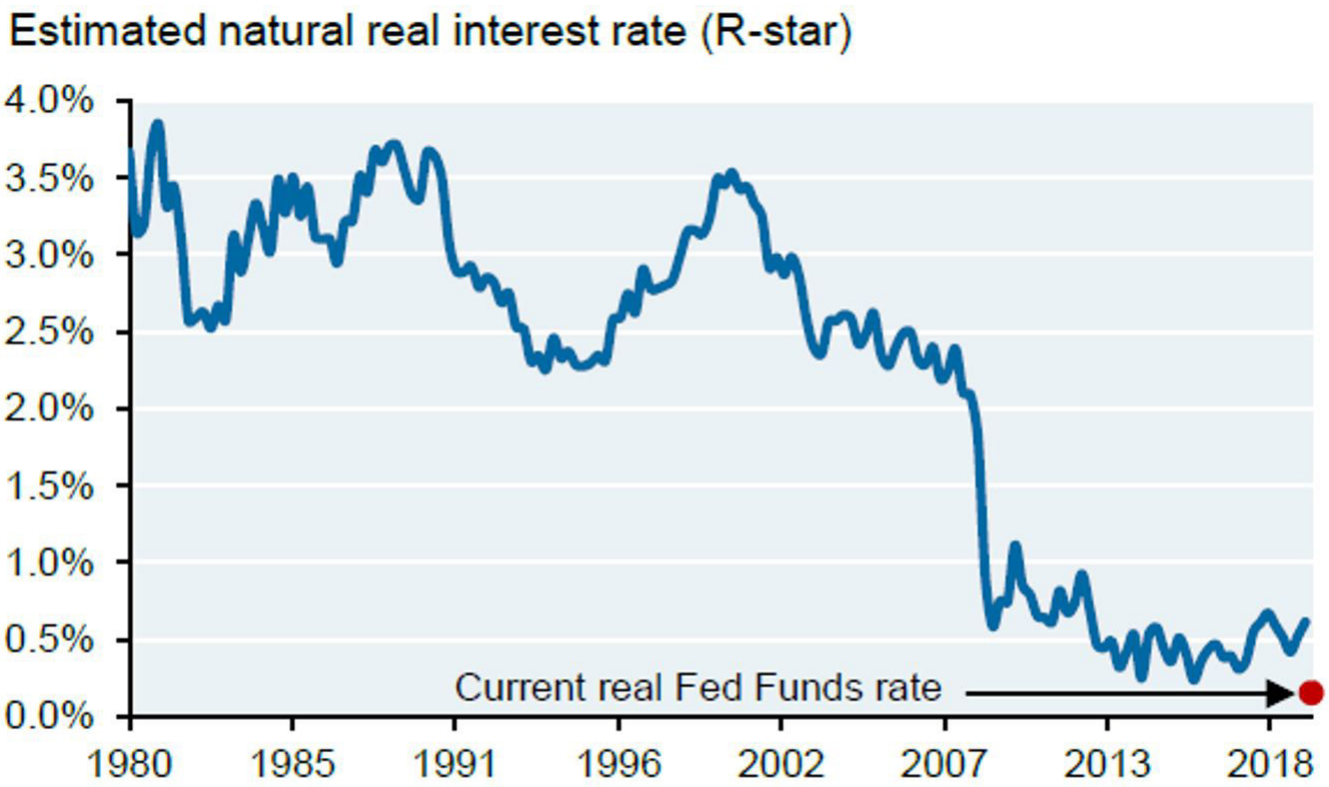
Source: Pre '83 Hirsch, post '83 BLS. 2018.

Online retailing increases price transparency
How long prices remain the same after a change (months)



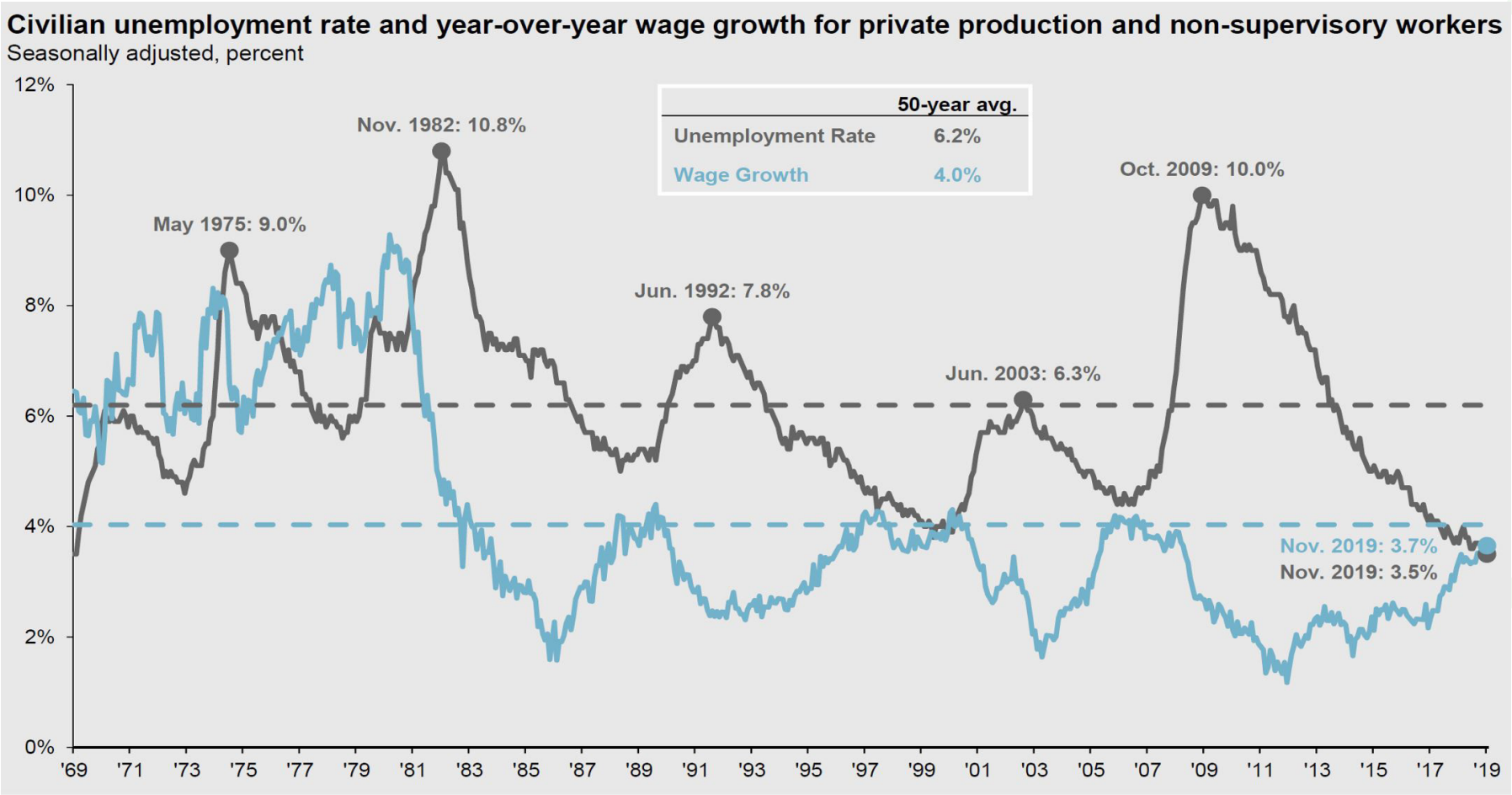
Source: A. Cavallo, NBER WP. 2018. Regular prices exclude sale events.

...and interest rates reflect a radical change in Federal Reserve philosophy.



Source: Laubach-Williams, Federal Reserve Bank of NY. Q3 2019.

Unemployment is near historic lows...

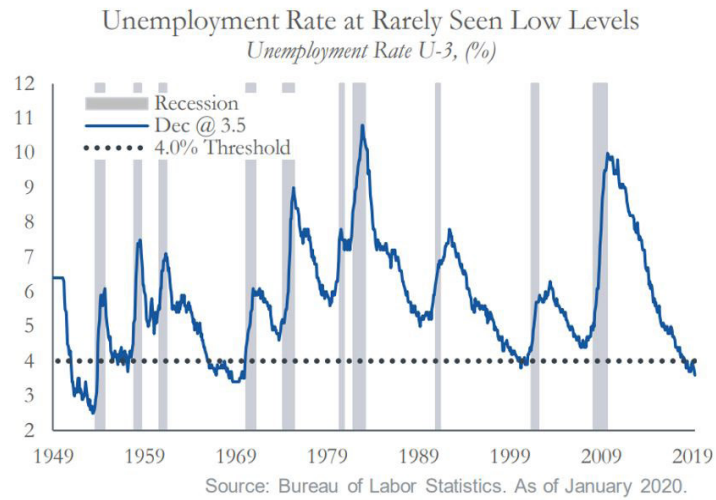


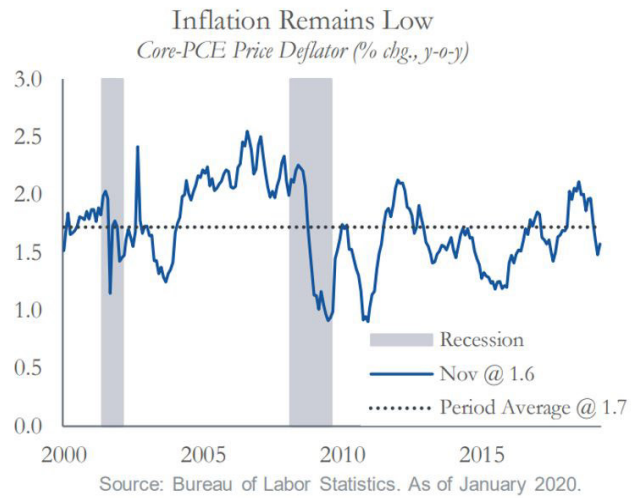
Source: BLS, FactSet, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of December 31, 2019.

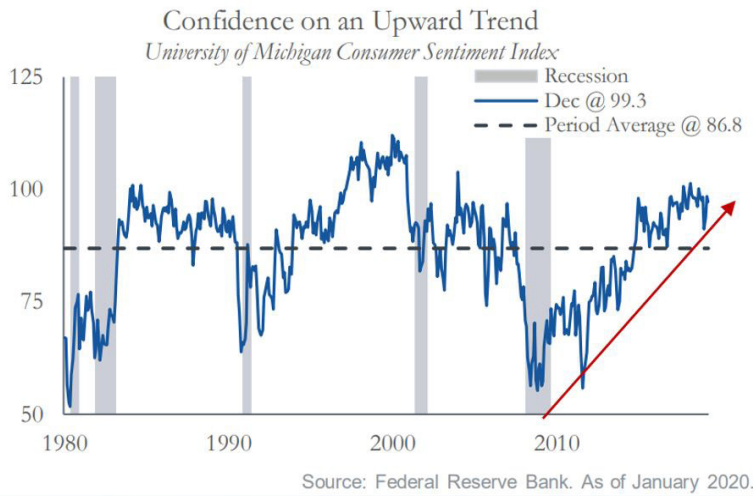
J.P.Morgan Asset Management

...economic fundamentals remain solid...

The U.S. economic fundamentals remain solid, with low unemployment, high confidence, modest inflation and falling interest rates.

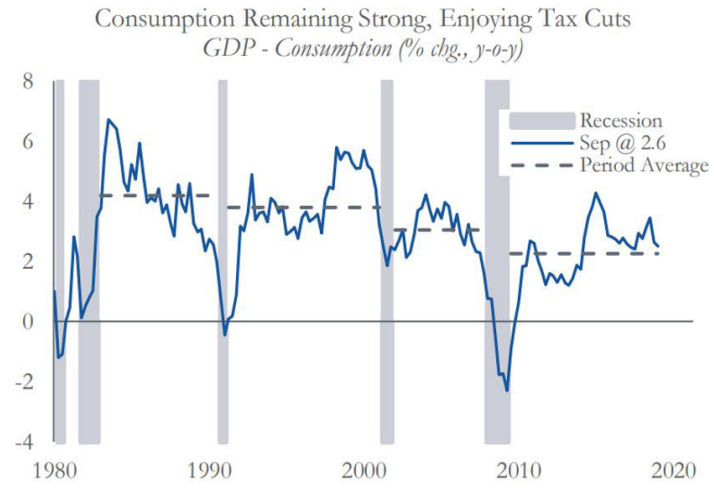




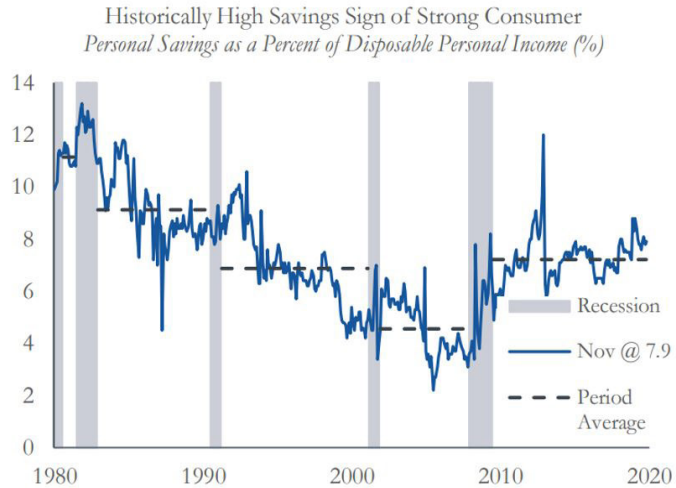


...and the US consumer is healthy...

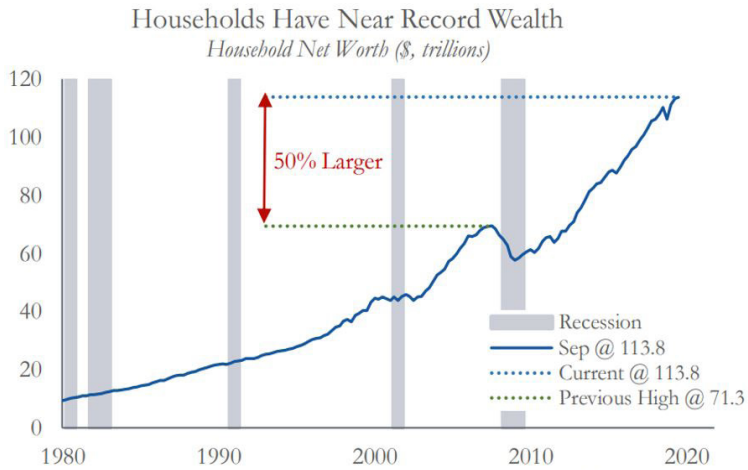
Household financial conditions are strong and supportive of further spending.



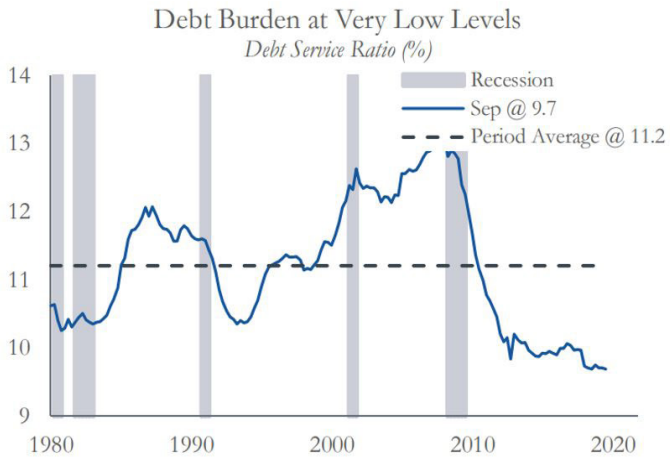
Source: Bureau of Economic Analysis. As of January 2020.



Source: Bureau of Economic Analysis. As of January 2020.

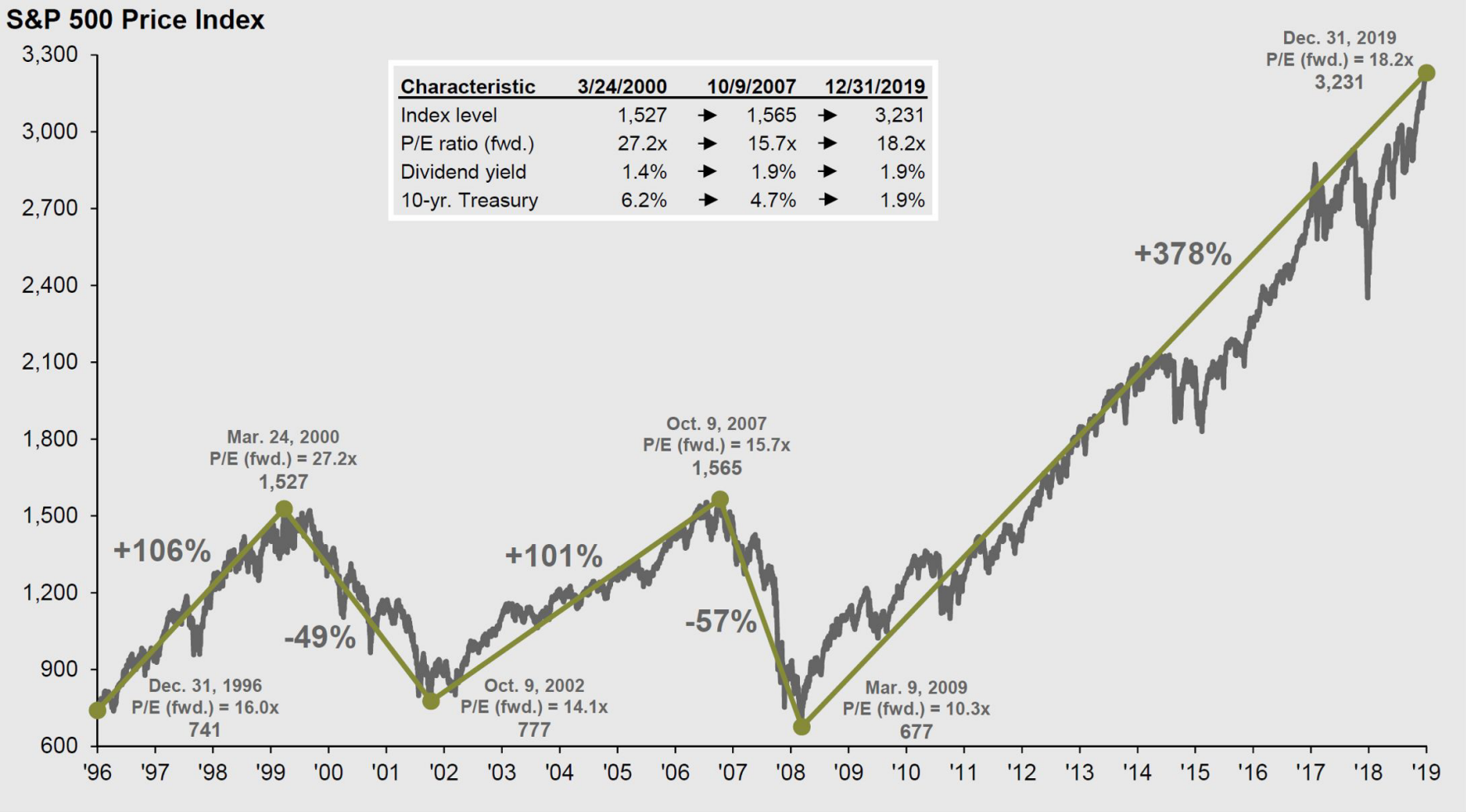


Source: Federal Reserve Bank. As of January 2020.



Sources: Federal Reserve Bank, Bureau of Economic Analysis. As of January 2020.

...pushing the S&P 500 to record levels!

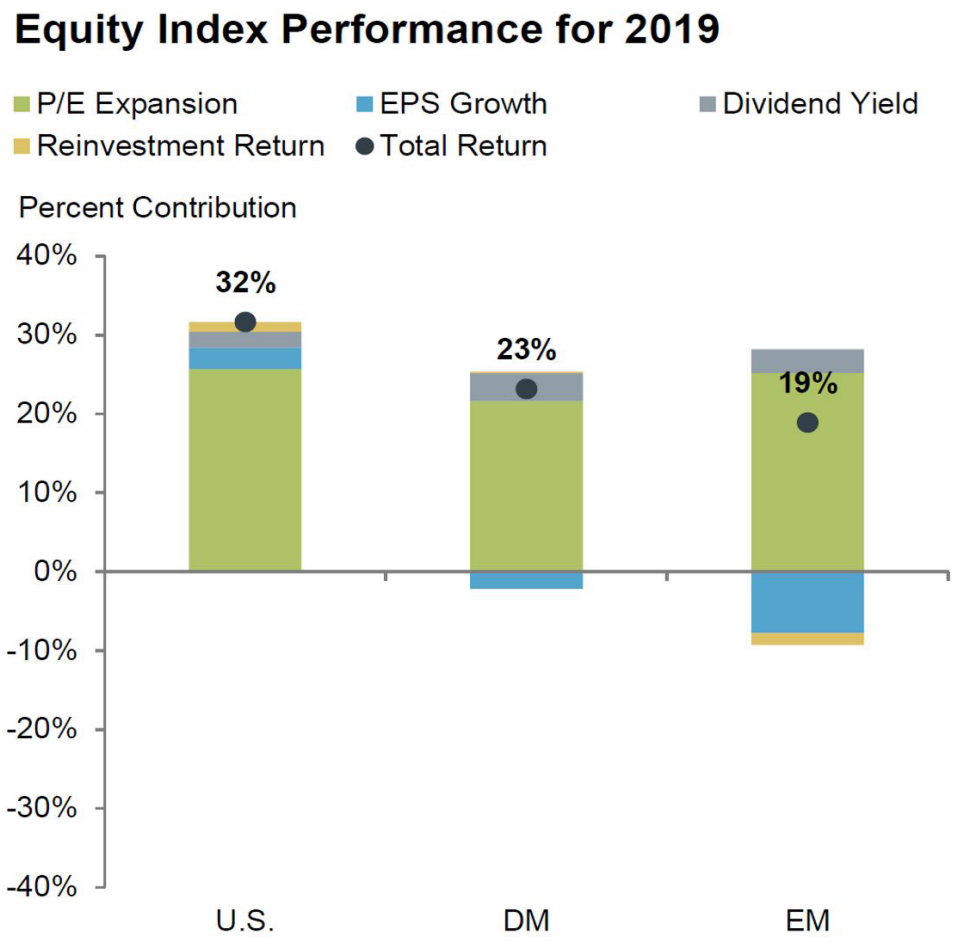


Characteristic	3/24/2000		10/9/2007		12/31/2019
Index level	1,527	→	1,565	→	3,231
P/E ratio (fwd.)	27.2x	→	15.7x	→	18.2x
Dividend yield	1.4%	→	1.9%	→	1.9%
10-yr. Treasury	6.2%	→	4.7%	→	1.9%

Source: Compustat, FactSet, Federal Reserve, Standard & Poor's, J.P. Morgan Asset Management.
Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by Compustat. Forward price to earnings ratio is a bottom-up calculation based on the most recent S&P 500 Index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of December 31, 2019.

J.P.Morgan Asset Management

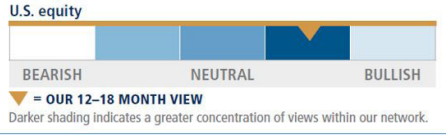
However, much of the growth of 2019 was due to multiple expansion (investors were willing to pay more per dollar of earnings)...



Past performance is no guarantee of future results. It is not possible to invest directly in an index. All indexes are unmanaged. DM: Non-U.S. Developed Markets. EM: Emerging Markets. Returns are Gross, USD. Equity indexes: United States—MSCI USA Index; DM—MSCI World ex USA Index; EM—MSCI Emerging Markets Index. Reinvestment Return is defined by Morningstar as the difference between compounded monthly total returns and the sum of the sub-components. Source: MSCI, Fidelity Investments (AART), as of 12/31/19.

...and not due to pronounced earnings growth.

U.S. corporate earnings growth has moderated



"Valuations have inched higher with the market's record-setting gains; however, an upward price trajectory is warranted in cases where earnings growth is powering the advance."

Manulife Investment Management

Earnings growth forecasts for U.S. companies have begun to level off

EPS growth estimates year over year (%)

	2019	2020
Utilities	8.49	4.70
Healthcare	8.38	8.55
Communication services	5.08	12.05
Financials	4.42	5.01
Real estate	3.40	5.63
S&P 500 Index	**0.32**	**9.55**
Consumer staples	0.11	5.95
Information technology	-0.12	9.58
Consumer discretionary	-1.66	12.56
Industrials	-3.27	14.89
Materials	-16.03	13.52
Energy	-27.95	19.93

Source: FactSet, as of 12/31/19. The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States. It is not possible to invest directly in an index. Earnings per share (EPS) is a measure of how much profit a company has generated calculated by dividing the company's net income by its total number of outstanding shares. Past performance does not guarantee future results.

The gap between S&P 500 Index performance and corporate profits is wide.

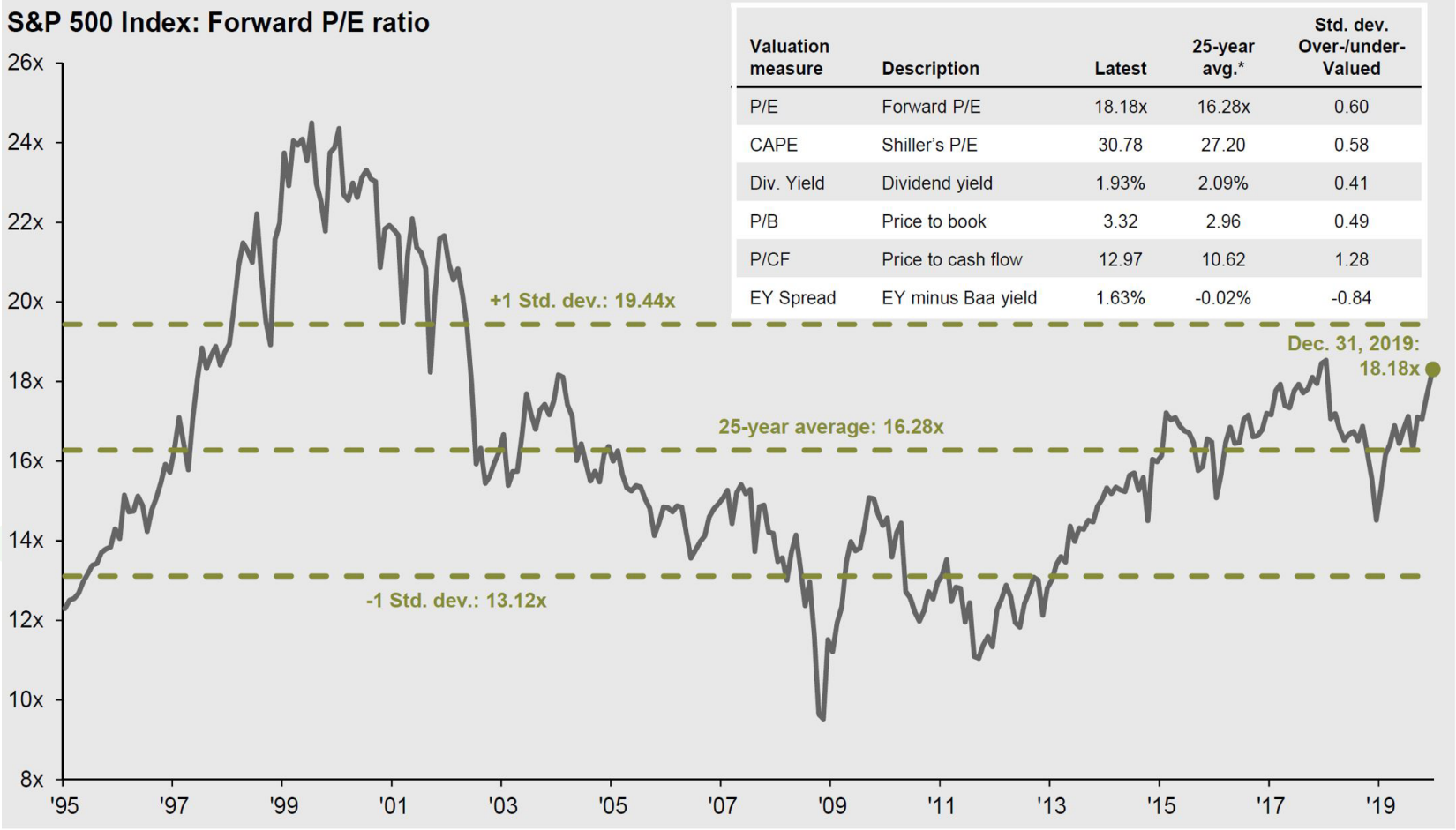
Shaded areas represent recessions.

S&P 500 Index (level) Corporate after-tax profits* (in billions)

*With inventory valuation and capital consumption adjustments.

Sources: Charles Schwab, Bloomberg, Bureau of Economic Analysis. S&P 500 Index data as of 11/29/2019. Corporate after-tax profits data as of 9/30/2019.

...and valuations are a bit stretched...



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	18.18x	16.28x	0.60
CAPE	Shiller's P/E	30.78	27.20	0.58
Div. Yield	Dividend yield	1.93%	2.09%	0.41
P/B	Price to book	3.32	2.96	0.49
P/CF	Price to cash flow	12.97	10.62	1.28
EY Spread	EY minus Baa yield	1.63%	-0.02%	-0.84

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since January 1995, and FactSet for December 31, 2019. Average P/E and standard deviations are calculated using 25 years of IBES history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price. Price to book ratio is the price divided by book value per share. Price to cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure.
*P/CF is a 20-year average due to cash flow data availability.
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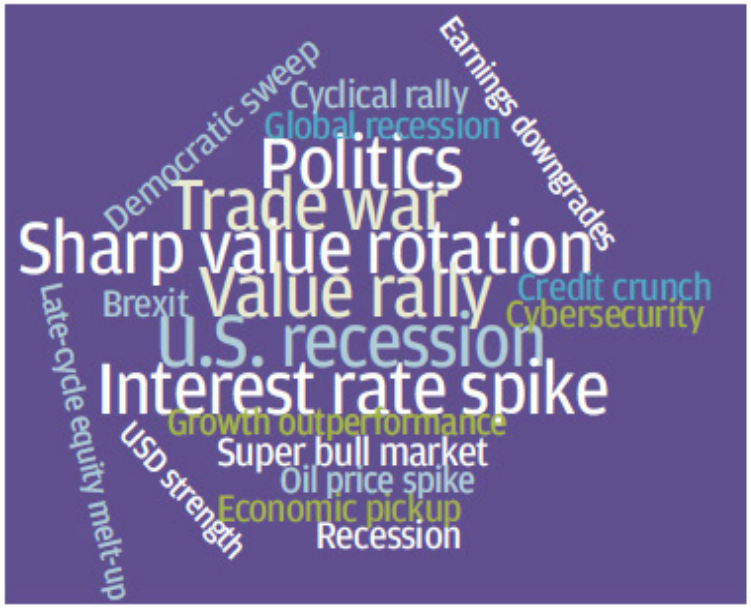
...which means any negative surprises may cause dramatic volatility.

- ✗ A Fed pause
- ✗ A more circumspect ECB
- ✗ No rollback of tariffs
- ✗ Earnings deterioration in 2020
- ✗ US GDP less than 2%
- ✗ An inflation spike
- ✗ A resumption of the global fundamental slow down
- ✗ European auto tariffs
- ✗ Hard Brexit or a second Brexit referendum
- ✗ Ineffective China stimulus and a hard landing

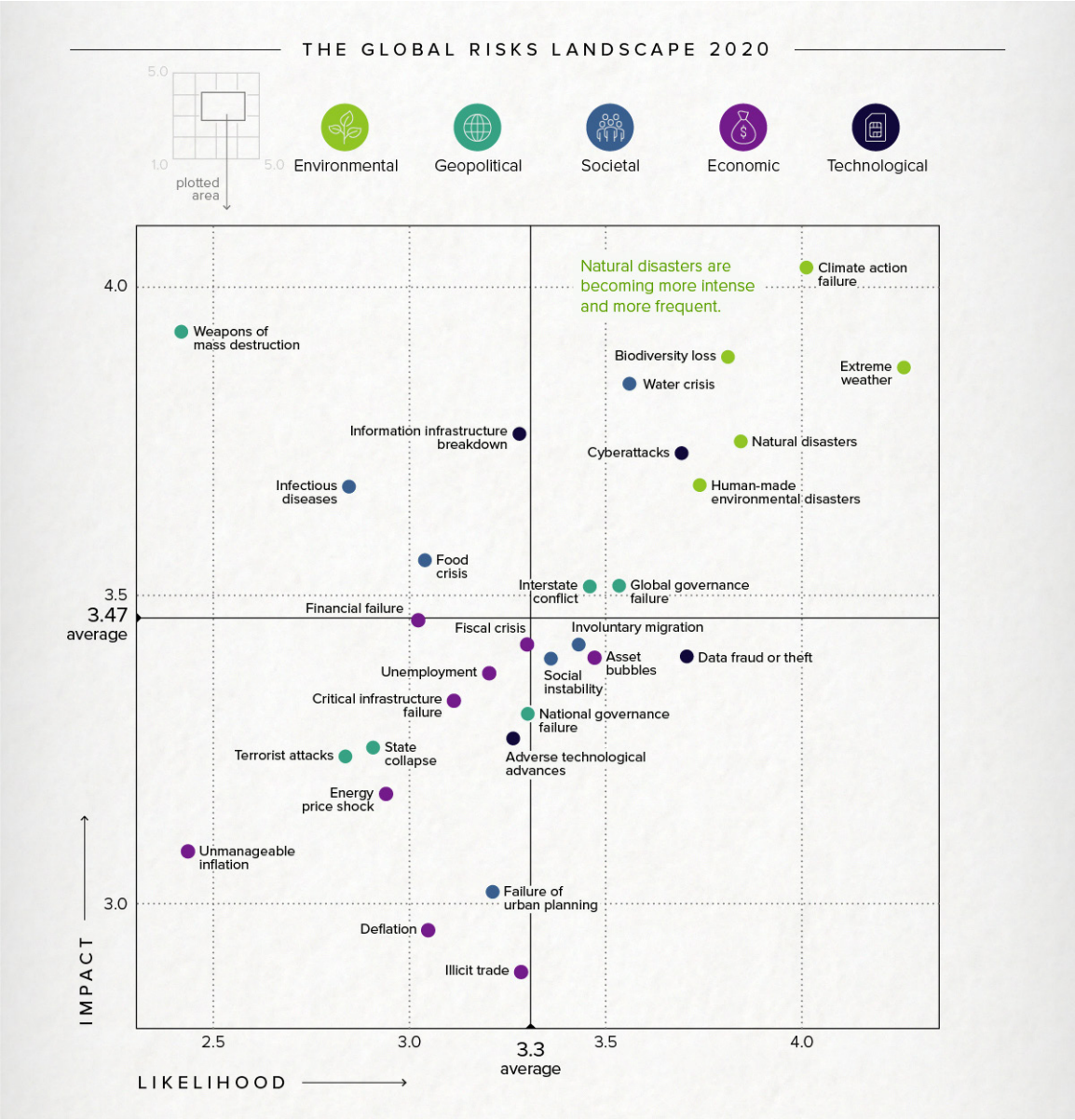
- ✓ A total of 25 bps cut in 2020
- ✓ Reimplementation of quantitative easing (QE) in Europe including purchase of equities
- ✓ A phase 1 trade deal with roll-back of September 1 tariffs
- ✓ 8% earnings growth in 2020 for the S&P 500
- ✓ GDP of approximately 2+% as the consumer and service sector remain strong
- ✓ Inflation never again
- ✓ Absorbable impact from tariffs as the Dec 15 "consumer tariffs" get delayed
- ✓ No European auto tariffs
- ✓ A negotiated Brexit
- ✓ More China stimulus and a China soft landing

And there are many things that could surprise the market...

BIGGEST RISK GLOBALLY?



...and huge risks globally.

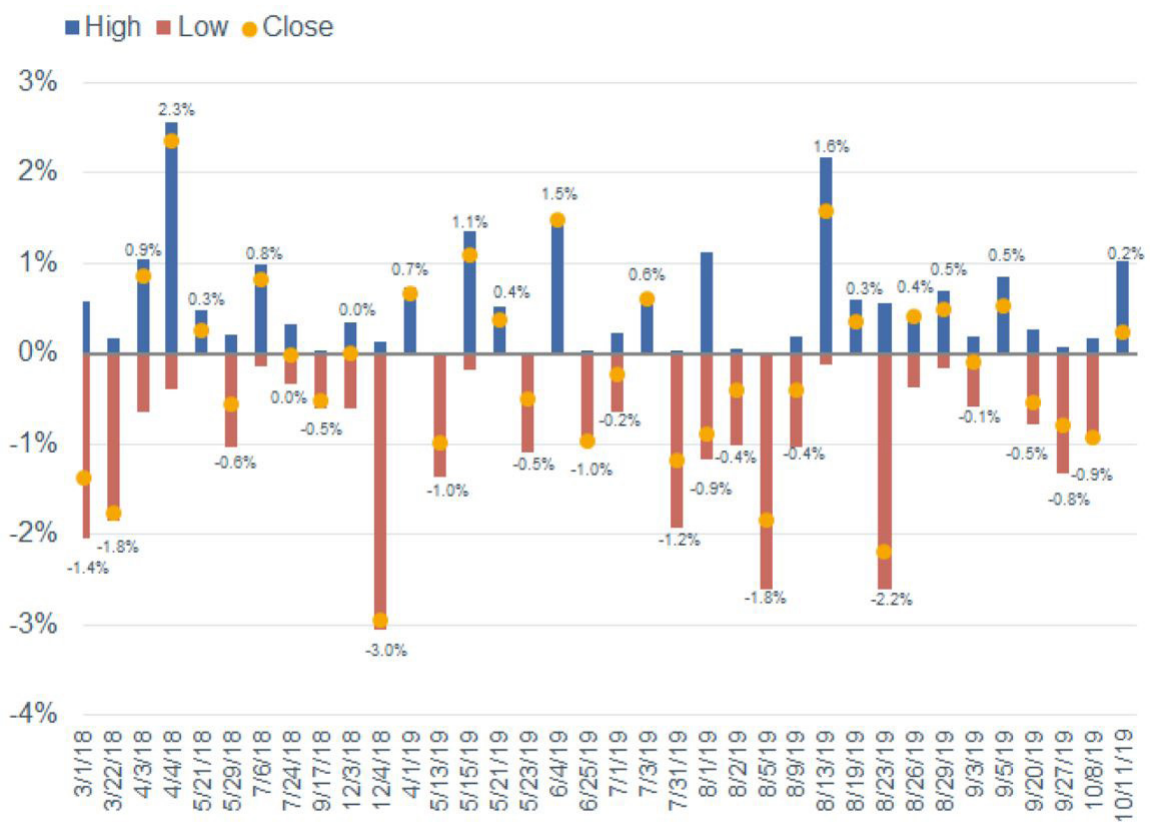


The trade war impacts market movements...

Source: Charles Schwab, Bloomberg data as of 12/5/2019. Past performance is no indication of future results.

...driving large market swings.

Trade News Drivers Larger Market Swings

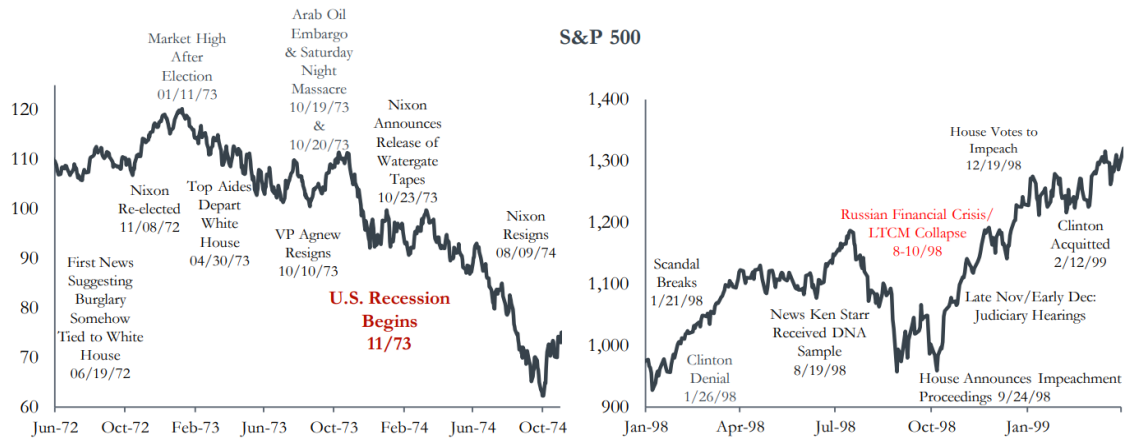


Source: Charles Schwab, Bloomberg, as of 10/24/2019. Close represents the percentage change from the opening price that day (as indicated by each dot and corresponding data label), not the closing price of the preceding trade day.

Impeachment is a concern, but the economy seems resiliant.

Stocks and Presidential Scandals

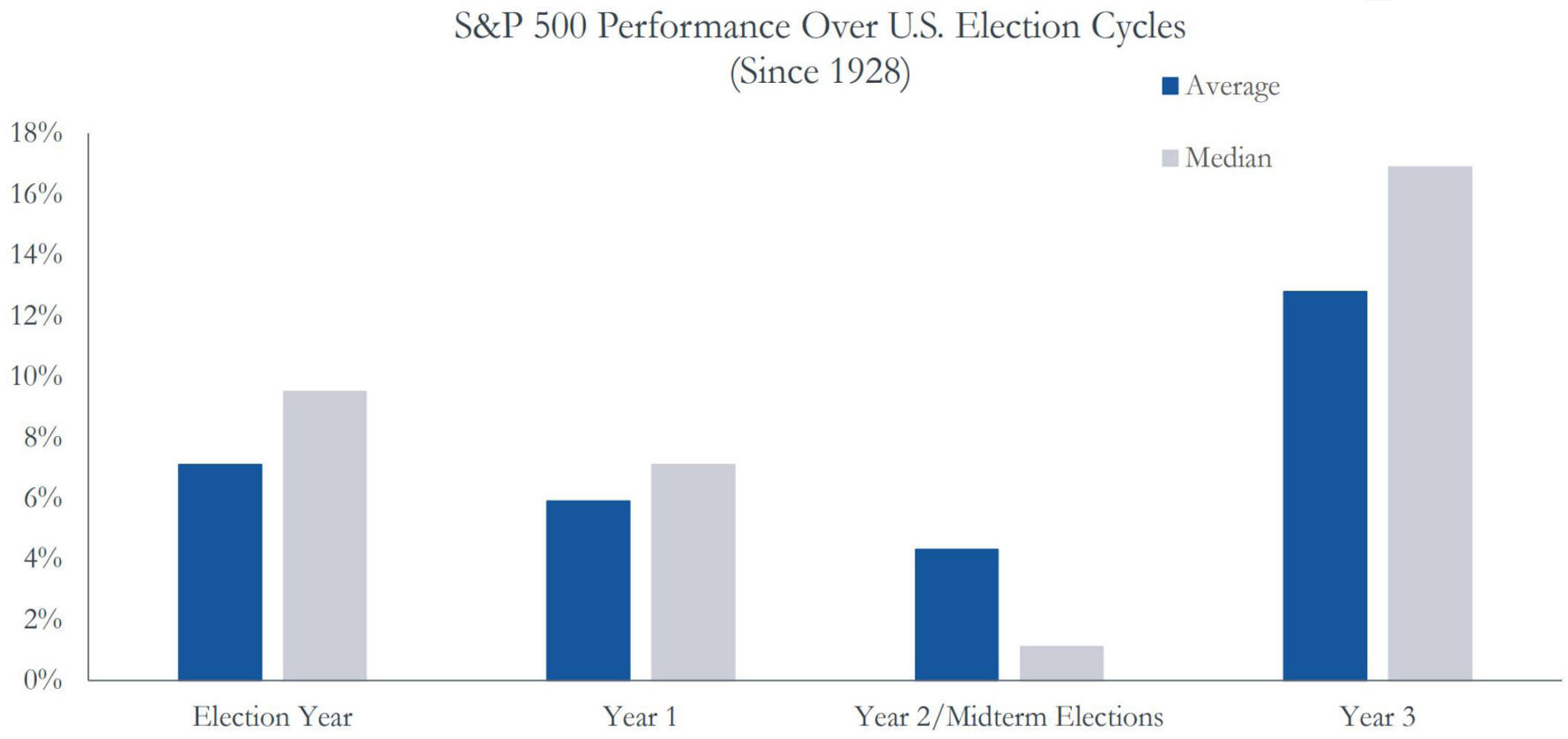
History suggests that despite any associated uncertainty, the impact of constitutional crises on financial markets in general and the stock market in particular is likely to be more influenced by economic conditions.



Nixon Watergate	Clinton Impeachment	Trump Impeachment Inquiry
U.S. recession: Nov 1973 – Mar 1975	Strong GDP growth	Slowing, but sustainable GDP growth
Rising unemployment	Low/falling unemployment	Low/falling unemployment
1973 oil crisis: prices +4x	Low inflation	Modest inflationary pressures
Falling confidence	Rising confidence	High confidence
Rising rates/Fast Fed tightening cycle	Slow Fed tightening cycle	Fed rate cuts
Falling corporate profits	Strong corporate profit growth	Modest corporate profit growth
Wage and price controls	Capital gains tax cut/Balanced Fed budget	Tax Cuts/ Rising Fed Deficits/Deregulation
Slowing global growth	Strong global growth/Globalization	Weakening global growth/Trade war

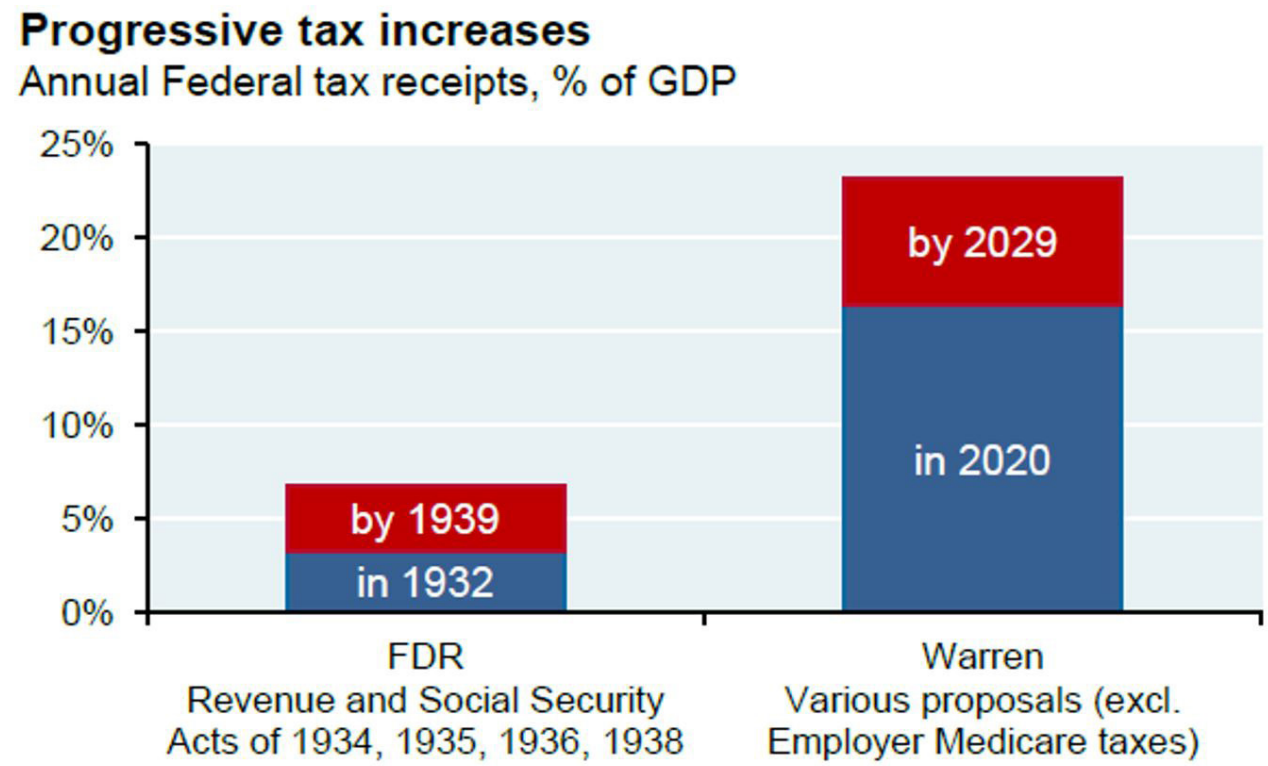
Source: S&P 500.

While the election is a concern, election years are typically good ones for investors.



Source: Factset. As of December 2018.

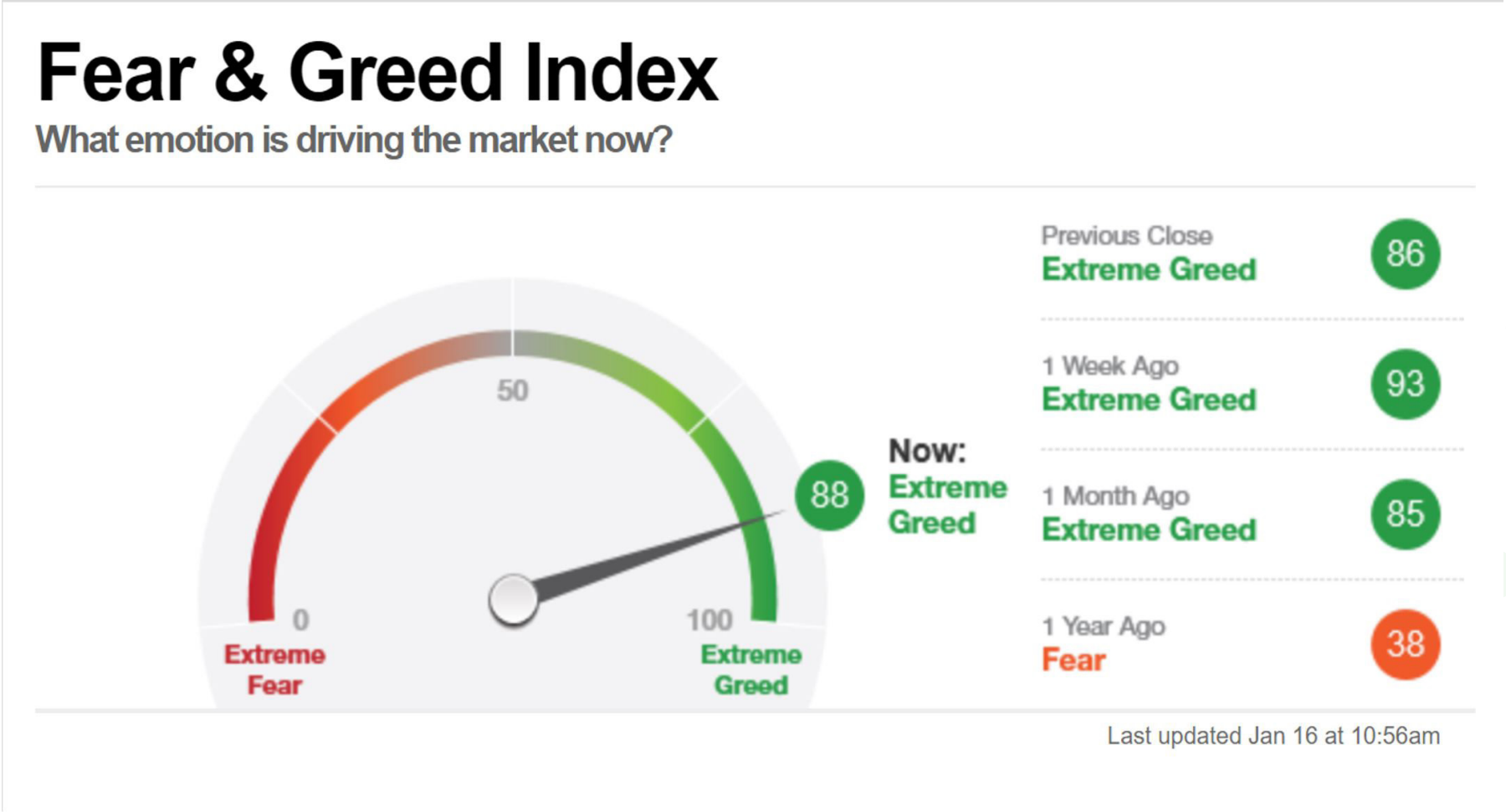
But policy changes that spring from election results could be problematic for markets.



Sources: JPMAM, FRB (St Louis), NTU, CRFB, CBO. 2019.

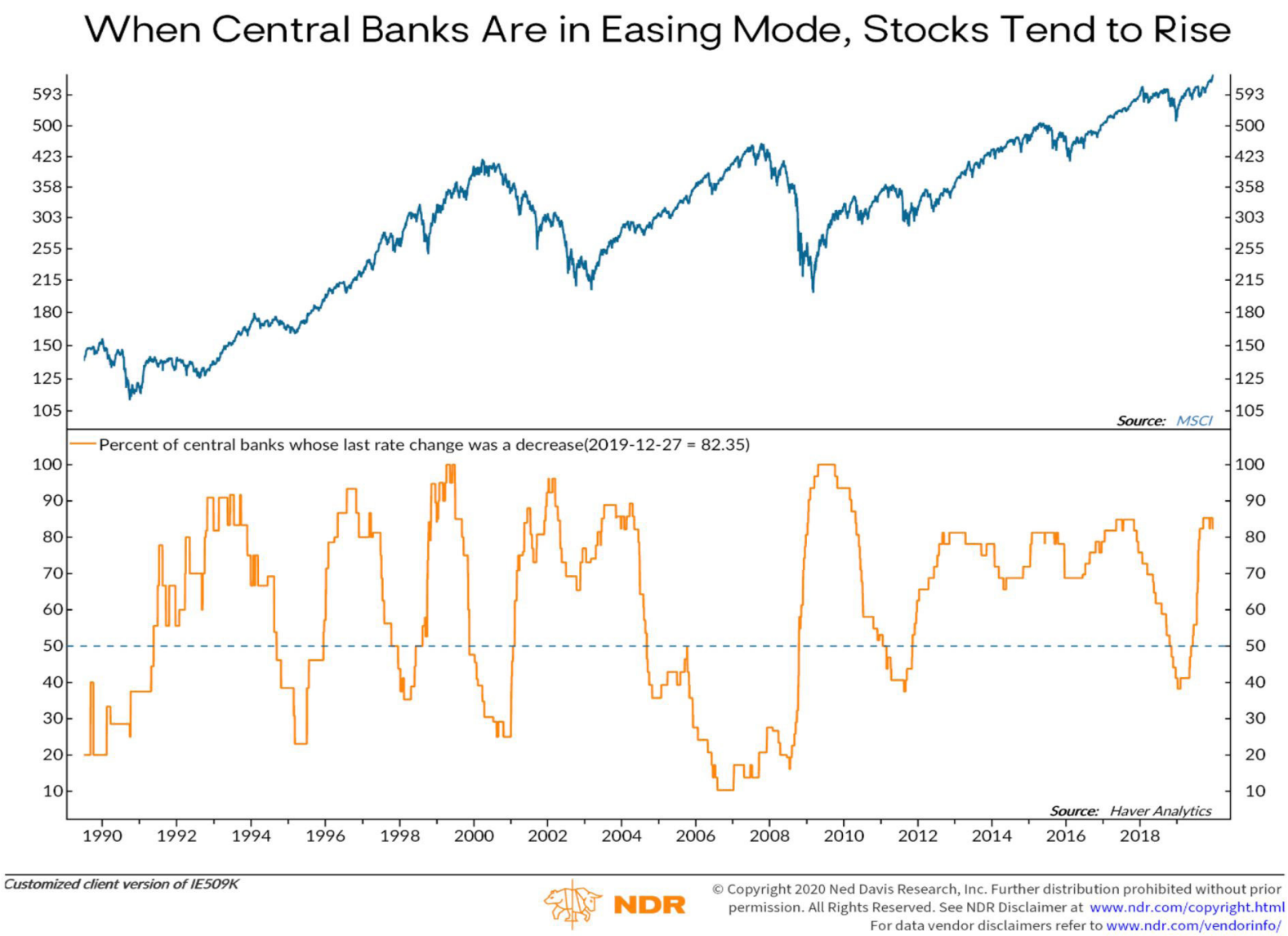
Big risk: US economic landscape changes with election results. I.E. Warren proposal dwarfs FDR proposal

And investors have swung from massive fear to massive greed very rapidly.



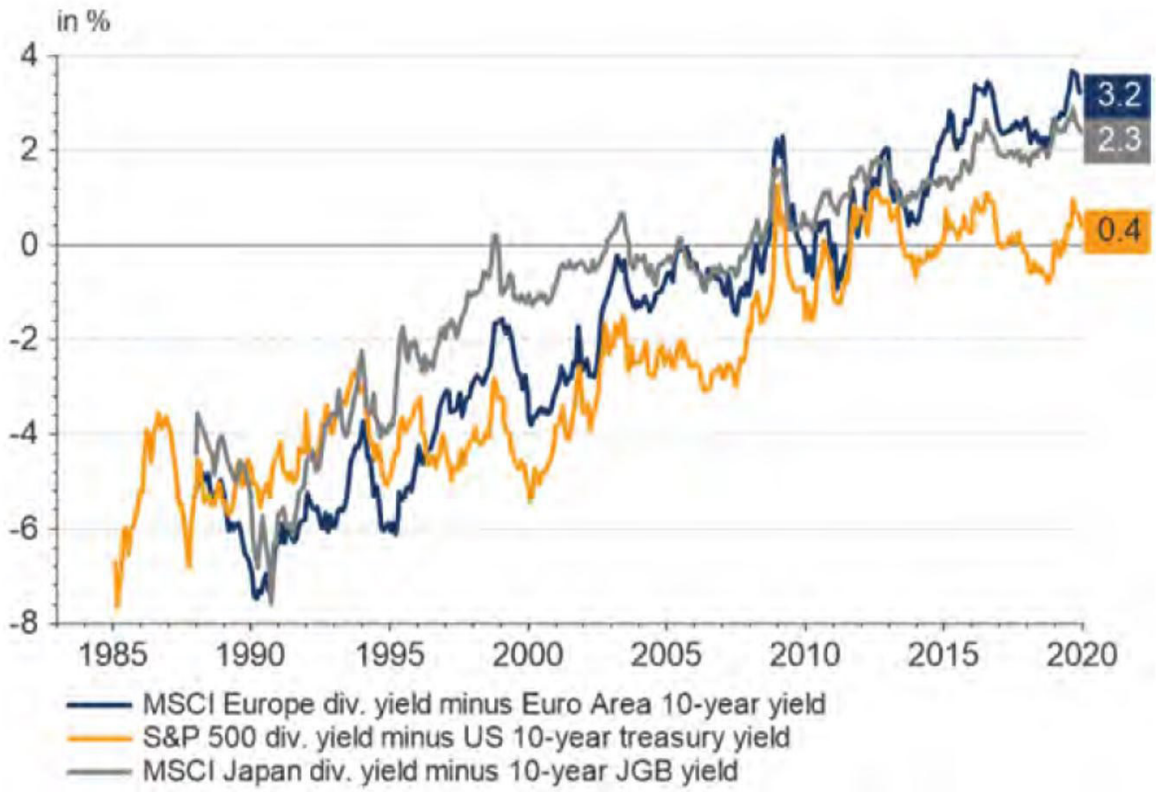
https://money.cnn.com/data/fear-and-greed/

On the postive side, when central banks are in easing mode, stocks tend to rise.



And stocks offer higher yields than bonds, so investors are paid to patiently ride out daily market fluctuations.

Dividend yield minus 10-year bond yield



1 Source: Ned Davis Research, as of 11/15/19 - DAVIS 207. Chart Right: *Source: Refinitiv Datastream, Riverfront; data weekly, as of 12/13/19. Shown for illustrative purposes only. Past performance is no indicator of future results. The 10-year yield is typically used by analysts to represent a "risk-free" return.*

With the US Economy in the late stages of expansion...

INDICATOR	TYPICAL LATE-CYCLE TREND	THIS CYCLE
Employment/Wages	Tighter labor markets, higher wages	✓
Monetary Policy	Tighter	✓
Yield Curve	Flatter then inverted	✓
Credit	Tighter lending standards and wider credit spreads	X
Corporate Profits	Margins decline, slower earnings growth	✓

Source: Fidelity Investments (AART), as of 12/31/19.

Fidelity INVESTMENTS

...history suggests late cycle returns can be very attractive.

Returns tend to be strong in the late stage of the business cycle…

…but don't overstay your welcome

Annualized Real Returns (%) Prior to Recessions:	Months Prior to Recession				
	13-24 Months	1-24 Months	7-12 Months	1-12 Months	1-6 Months
S&P 500 Average Returns	**14.2**	**6.8**	**8.0**	**0.1**	**-7.8**
JUL 1953 - MAY 1954	21.9	12	17.8	2	-13.8
AUG 1957 - APR 1958	15.8	7.1	-17	-1.6	13.9
APR 1960 - FEB 1961	31.3	16.8	6.6	2.2	-2.2
DEC 1969 - NOV 1970	13.4	-1.3	-11	-15.9	-20.7
NOV 1973 - MAR 1975	16.9	4.9	-11.3	-7.0	-2.7
JAN 1980 - JUL 1980	0.5	2.2	6.8	5.4	4.0
JUL 1981 - NOV 1982	…	…	32.2	10.5	-11.2
JUL 1990 - MAR 1991	14.3	13.1	22.2	11.9	1.6
MAR 2001 - NOV 2001	8.9	-0.7	20.0	-10.3	-40.6
DEC 2007 - JUN 2009	11.6	7.6	13.6	3.6	-6.3

In more recent cycles, investors have reaped strong returns in the 7 to 12 months prior to recession

Source: BCA Research. Data as of 12/31/2019.

So, balancing the opportunities with the risks, diversification is still key...

Business Cycle

U.S. firmly in late-cycle phase

China's economic slowdown has stabilized

Risks

Monetary and trade policy uncertainty

China's uncertain outlook and policy response

Asset Allocation Implications

Current environment warrants smaller asset allocation tilts and a diversified strategy

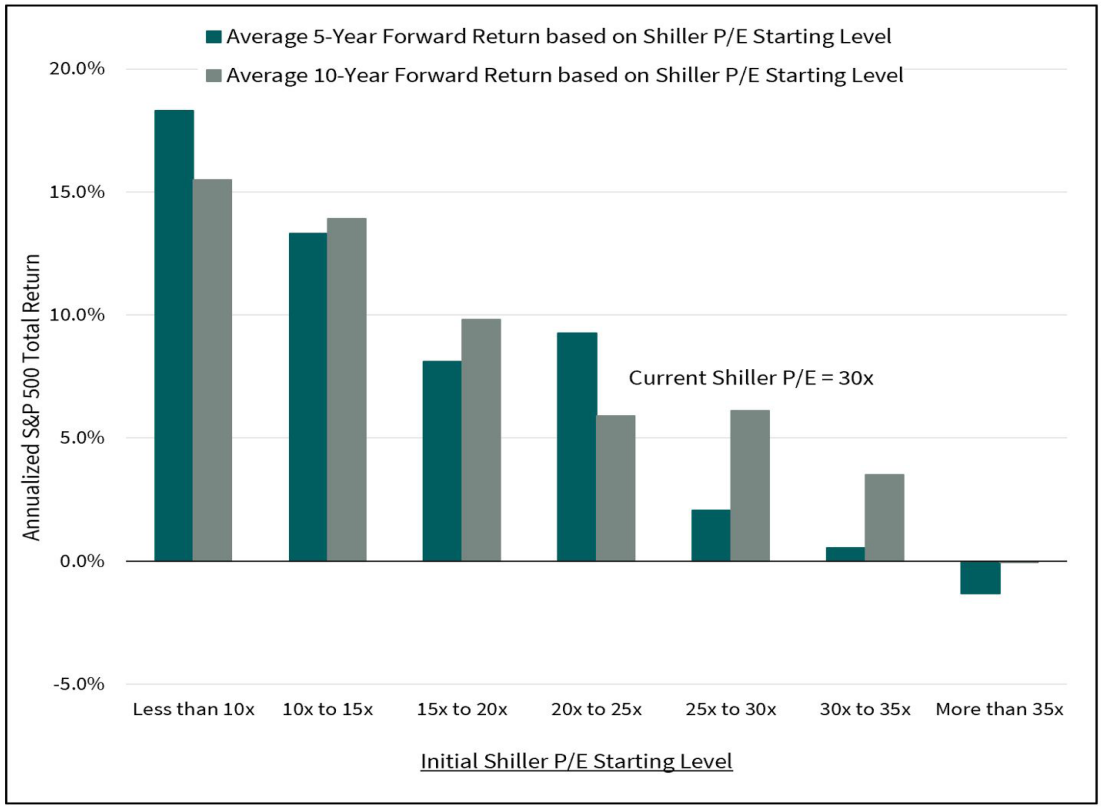
Policymakers' shift to a more accommodative stance may support global asset markets

Non-U.S. equities and inflation-sensitive assets are attractive from valuation and diversification perspectives

For illustrative purposes only. Diversification does not ensure a profit or guarantee against a loss. Source: Fidelity Investments (AART), as of 12/31/19.

...as are realistic return expectations. With stretched valuations the market historically has returned smaller annualized returns.

Higher P/E Ratios are Associated with Lower Future Returns

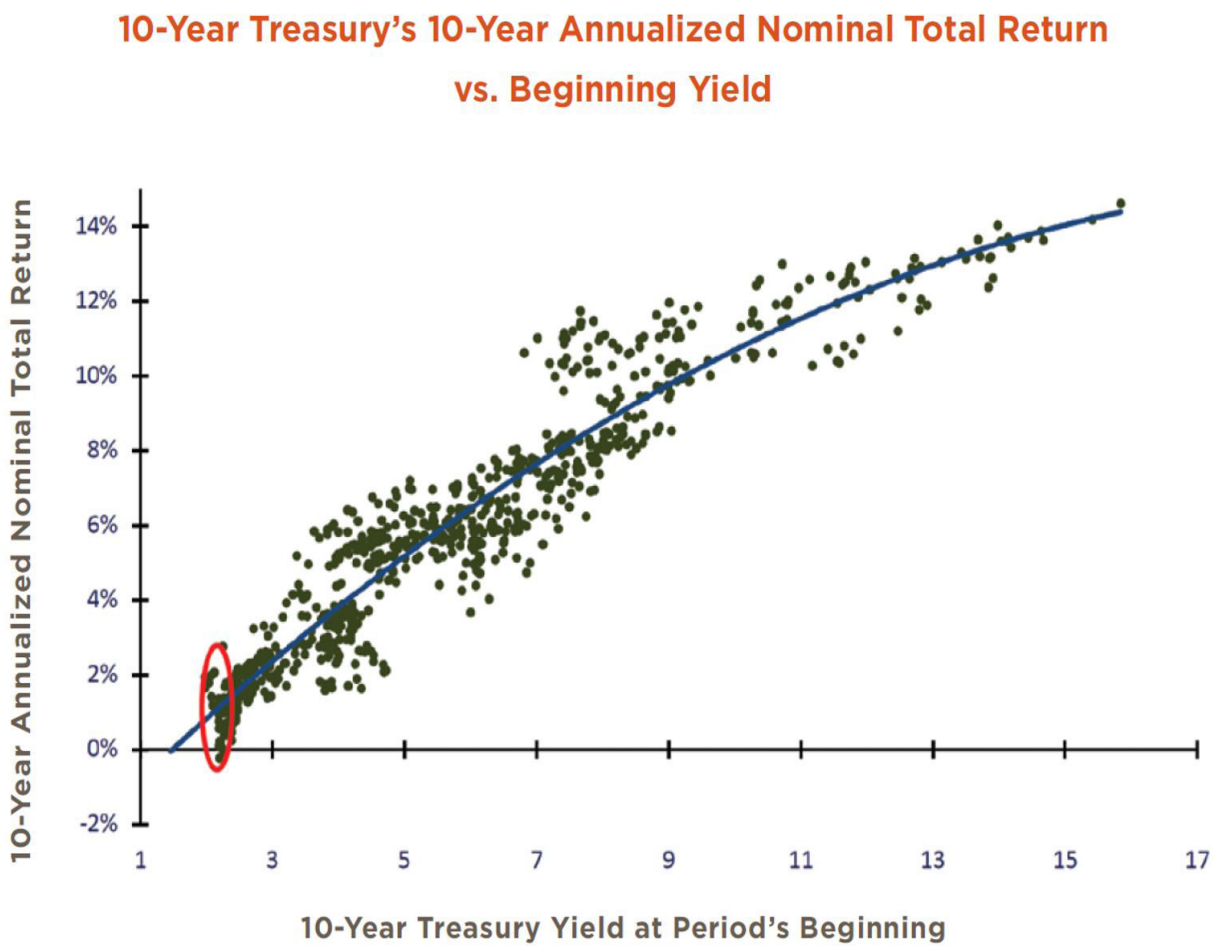


- History has shown that future stock returns are strongly linked to valuation levels. The higher the P/E, the lower the forward return with few exceptions.
- The current Shiller P/E level of 30 for the S&P 500 would indicate low single-digit returns annually on average over the next five years, and mid-single-digit returns annually on average over the next 10 years.
- When markets have excessively high valuations, they are vulnerable to disappointment or negative surprises.

Source: Robert J. Shiller and Morningstar Direct. Data as of 11/30/2019.

And with low interest rates on the forseeable horizon, portfolio fixed income returns maybe muted as well.

Source: RiverFront Investment Group, Center for Research in Security Prices (CRSP®), Booth School of Business, The University of Chicago. Data used to create this chart from April 1941 to November 2019. Shown for illustrative purposes, it is not indicative of RiverFront portfolio performance. In a rising interest rate environment, the value of fixed-income securities generally declines. Technical analysis is based on the study of historical price movements and past trend patterns. Past performance is no guarantee of future results. There are no assurances that movements or trends can or will be duplicated in the future. Views are current as of the date of presentation and subject to change.



Portfolio Implications

There are reasons to be cautiously optimistic for financial markets in 2020:

- Easy monetary policy should soon trickle down to boost the global economy. Global manufacturing is already starting to turn up and expand again.
- Stock markets tend to rise when central banks are in easing mode.
- Inflation is benign so central banks are unlikely to raise rates in 2020. Along with strong U.S. households, continued low interest rates should support consumer spending and the housing market.
- The U.S.-China trade war has de-escalated and Brexit fears have abated for now.
- And financial market imbalances, which triggered the past two U.S. recessions and bear markets, are not yet at the breaking point as long as the economy grows at a decent pace.

However, to some extent this outlook is already reflected in current market prices—at least for U.S. stocks—especially after the sharp year-end rally. CNN calculates a Fear/Greed meter based on internal dynamics in the U.S. stock market. Sentiment swung 180 degrees to Extreme Greed at the end of 2019 from Extreme Fear a year earlier. High valuations and excessive optimism make asset prices more susceptible to negative surprises. We think the wisest course for balanced investors continues to be a broadly diversified, moderately defensive posture.

Portfolio Implications Continued

We are closely watching and weighing the ramifications of several potential short-term risks beyond high U.S. stock valuations. These include a reigniting of the U.S.-China trade war, the risk of recession, volatility around the U.S. presidential election, a hard Brexit with no new trade agreement between the United Kingdom and the European Union, and as always, the chance of an unexpected geopolitical shock. (Iran tensions are one example.) We remain ready to add back to U.S. stocks when market volatility (a bear market) provides us the opportunity to buy them when they offer much better expected returns.

In the meantime, we are building portfolios meant to be resilient across a range of market/economic scenarios. They are positioned to withstand a severe market downturn, consistent with each portfolio's specific risk objective. Yet they also provide tactical exposure to asset classes and strategies that we believe currently offer attractive total-return potential over the medium and longer term.

Disclosures

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