Market Update Audiocast
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One hand gave, which was the Fed's rates mid-cycle adjustment, while the other hand took away which recently was the new tariffs on Chinese goods, which triggered significant down-side pressure and volatility across all asset classes. The trade truce between the U.S. and China came to an abrupt end with the August 1st communication that the U.S. was planning a 10% tariff on some $300 billion of Chinese imports beginning September 1. The tariffs, if implemented, will target consumer goods for the first time, and has the possibility to open up a whole new front on the U.S.-China trade war. One of the policy's responses was to allow China's currency, the yuan, to drop below CNY7.00 to the U.S. dollar for the first time in over a decade, which in the very short term is a major reason for the latest sharp pullback in equities as well as the large fall in treasury bond yields. In addition, Fed funds futures for September are now suggesting a 60 percent probability of a 50 bps rate cut at that month's meeting.

As we have discussed in the past year, short-term market direction is clearly taking its cue from the on-again, off-again trade negotiations as investor sentiment remains very nervous. However, more importantly, trade is secondary, in our view, versus what the yield curve in the U.S. is indicating. This line of thinking is squarely on the basis of how the strength of the economy and long term inflation expectations drive the level of growth over the medium and long term. Trade battles that may alter the supply chain and add costs to multinationals can be balanced out in time. What is much more difficult is creating a monetary environment that stops deflationary forces in its tracks and helps support an expansion that pushes nominal growth higher. In summary, the most important question, in our opinion, is not necessarily the end-game on trade rather it is now how aggressive is Fed policy likely to become in the coming months? The yield curve is telling us and the Fed that financial conditions are simply too tight.

We expect equity markets to remain volatile in the short-term given seasonal patterns, the spate of corporate earnings news in the next month, and the fact that the next major Fed communication and action is more than 6 weeks away. The next Fed meeting is on September 17 and 18. Therefore, technical factors in the markets are likely to pressure equity prices with the likelihood that the S&P 500 falls to its 200 day moving average of around 2800. This would equate to close to 7.5% pull-back from recent S&P 500 highs of 3025 at the end of July. We view pullbacks like this as normal occurrences in a bull market. Investors should step back and

allow markets to settle down before adding to equity allocations at this time but be ready to increase risk, where appropriate, the closer we get to the next Fed meeting. It is our belief that the yield curve is suggesting that the Fed should consider getting more aggressive in order to right-size the curve and ultimately help move inflation expectations above their 2% target rate. Each time that financial conditions tightened post credit-crisis risk assets corrected mainly due to a fall in nominal growth as inflation expectations peaked and eventually declined. In the most recent tightening of conditions which was the move that the Fed created a policy normalization starting in 2017 and '18, the rest of world, and more specifically manufacturing, came under significant pressure. This was first evident in early 2018 and before the trade battle even ensued with China. Weakness gathered momentum as tariff and trade grappling picked up and rates in the U.S. were hiked further throughout 2018. The U.S consumer, however, led by the strength of the job market remained strong and continued to power the U.S. economy. This still remains at present time but the clock is ticking. The yield curve is telling us this and rates overseas, particularly in Germany and Switzerland which have their entire yield curves from 1 to 30 years in negative yielding territory, continue to suggest deflationary shocks are still gripping their economies. The Fed is likely to further recognize this in coming meetings. Our partners in BofA Merrill Lynch Global Research Economics continue to believe the Fed is likely to cut a cumulative 75 basis points in this "mid-cycle correction", with the next cuts in September and October. But if the trade war escalates, they believe it won't be a midcycle correction and instead will be the start of a real easing cycle.

We will continue to watch trade developments and the level of China's currency depreciation as this places more pressure on the Fed. The more inverted the curve gets the higher the probability of an economic recession. We do not see this materializing any time soon given the underlying strength of the U.S. consumer, and the Fed's potential more aggressive tone in the coming months. Therefore, we remain overweight equities and view this latest pull-back as a rebalancing of expectations, a valuation reset, and also a reset back to more attractive levels. We continue to prefer the U.S. versus the rest of the world and, specifically, large caps relative to small caps. We emphasize a balance of value and growth for style based investors and view a cross section of sectors that offer both an attractive level of yield and earnings growth as areas that are likely to be in demand in this current low rates, complex global economic environment., these sectors include Technology, Industrials, Healthcare, and Financials. In fixed income, we view government bonds as a hedge on equity risk and prefer shorter dated yields given the shape of the yield curve. We are also still emphasizing higher quality across the board. For now, with a lack of concrete catalysts in the short term, we are likely to experience further headline risk and media reports expressing more bearish viewpoints. This is to be expected, especially when negative volatility is as sharp as the recent days. Therefore at this time we believe it is best to let the dust settle but be prepared up ahead of this next September Fed meeting to buy on weakness. Longer term investors should view the latest turn of events as short-term challenges that actually present opportunities to add to a well-diversified portfolio; a portfolio that is designed to take advantage of the innovation cycle we are currently in and that we foresee in the next few years, and the rising equity culture, driven by long-term, favorable demographics.

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