COHO PARTNERS, LTD.
Economic Commentary

Second Quarter 2019

"The biggest single thing that has lifted people out of poverty is free trade."

-- ***George Osborne***

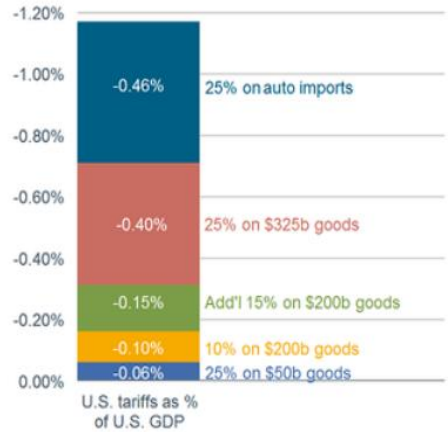
Before we try to escape the ultra-short-term noise and delve into the longer-term implications of the current trade and tariff war between the U.S. and China, let us address some basics including how we got to this point. Tariffs are a 'tax' on imported goods and are paid directly by U.S. importers of Chinese goods. The tariffs are paid to the U.S. Customs & Border Protection Service at the U.S. border by a U.S. broker representing a U.S. importer. They are not paid by the Chinese to the United States. Tariffs generally will increase the risk of higher inflation, lead to softer capital expenditures, slower productivity growth and lower employment growth mostly due to the uncertainty that would befall corporate America.

China has grown into a global power over the last four decades through hard work, smart infrastructure building and advanced education of its people. Following some smaller regional trade agreements in the 1980s, China sought to be included in the World Trade Organization (WTO) that regulates international trade between nations. China's admission in 2001 was in conflict with its prior economic strategy as China was now beholden to trading rules in an open system.

Though buying products from the U.S. and others, China ignored many WTO rulings, stole intellectual property, forced technology transfers from U.S. companies, and maintained high tariffs. China argued with the WTO that they were still a poor developing country and needed protection even as they became the world's leading manufacturer. As prices declined, the U.S. basically accommodated and facilitated China's ascent and benefitted from the relationship.

Eventually the goals of the two global superpowers conflicted as China, under President Xi, embarked on the "Made in China 2025" initiative with the goal of making their own companies global leaders in supercomputing, A.I., robotics, facial recognition and many other futuristic high tech industries that compete directly with America's leading technology companies. Major industrialized economies can no longer afford to allow China to compete on the uneven playing field that moved them from poverty and, on this point, there should be bipartisan and international support.

The charts on the following page from Credit Suisse highlight the chronology of the tariffs actually imposed and threatened with the commensurate estimate as a percentage of gross domestic product. The initial 25% tariffs on $50 billion of Chinese goods that went into effect last summer applied to only about 8% of imports from China and equated to less than 2% of total U.S. imports. Now with 25% tariffs on another $200 billion of goods from China in effect, the heat on U.S. firms reliant on goods from China has been turned up. Not only are import costs of Chinese goods poised to jump under the widening net of tariffs, but non-Chinese producers, whether American or other foreign companies, would then likely take the opportunity to raise prices.



Although the United States and China are the key players in this game of tariffs, the impact has spread to the broader global economy not only via declining confidence, but also global trade volumes. As you can see in the chart below from Credit Suisse, although not (yet) in deep negative territory, there has been enough of a falloff in world trade volumes that we're looking at the weakest year-over-year reading since the Great Recession (as well as prior to that in the 2001 recession).

With world trade having slumped, the rebound in oil prices (up around 30% this year through the end of 2Q) and the very strong U.S. dollar are added headwinds to the hoped-for next leg of the economic expansion. Although the impact to-date of the trade war has not been substantial in terms of either economic growth or inflation, if it continues to heat up, the impact will be increasingly felt. Trade war risks intensified after U.S. and China trade talks broke down in early May. The longer the tariffs remain intact, the greater the negative consequences of slower growth, higher prices, disrupted supply chains, and heightened uncertainty, which would weigh on business and consumer confidence. Indeed, surveys of capex intentions for manufacturers have plunged by almost 50% from the highs reached in October of 2017 when optimism was at its peak courtesy of the expected corporate tax cut. According to the IMF, the current tariffs in addition to those envisioned could shave -0.3% from global growth in the short-term.

We continue to believe trade will be an important determinant of the length of runway between now and the next recession and largely because of this confidence transmission mechanism. The fiscal stimulus of last year helped boost animal spirits through the business confidence channels; along with hopes for a capex-led next leg to the economic expansion. Absent a comprehensive trade deal that would be adhered to, it's hard to imagine a scenario where those animal spirits are reignited, thus the anticipation of the G20 summit.

At the G20 summit in Japan, the U.S. and China agreed to resume trade talks and the U.S. agreed to hold off on additional trade sanctions on $300B more of Chinese imports that had been threatened. An even larger concession to China was the lifting of the ban on sales by U.S. companies to Huawei, a Chinese multinational technology company that is viewed as a threat to U.S. national security.

While the markets are enthusiastic about the just completed G20 Summit, we remain pretty much where we were in early May with a 25% tariff on $250B of imports. While certainly a positive to continue to have open discourse between the two nations, there remains major distrust between the U.S. and China and it is still hard to be optimistic that China will agree to the intellectual property protection desired by the U.S. or enforce it in the way we desire. Still, the resumption of talks and pressing the pause button on more tariffs will be seen in the short term as positive for markets and American businesses. Those have already complained about the cost of further tariffs saying that if they had gone ahead - American consumers would have ended up paying something like $12bn more in higher prices.

Chinese businesses have been suffering too as the trade war has hit investment plans, business confidence, and exports in the world's second largest economy. But pressing pause doesn't mean the trade war is over. Tariffs on hundreds of billions of dollars' worth of goods are still in place. And the two sides still have much to agree on.

Washington wants Beijing to fundamentally change the way China's economy has grown over the past four decades, getting rid of subsidies to state owned companies, open up the domestic market and most importantly, hold China to account if it fails to deliver on any of these commitments. This remains an uphill climb and will continue to weigh on global, and, thus, U.S. economic growth in 2019

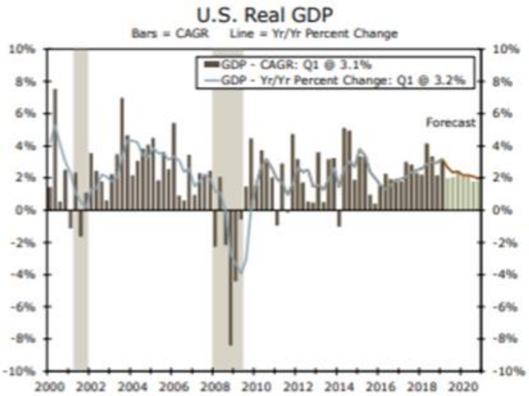
UNITED STATES:

In a large surprise versus expectations of a soft 1Q reading, U.S. real GDP grew at an annualized rate of 3.1%. Not only was the tally stronger than most analysts expected, but it also represents a pick-up in growth relative to the 2.2% rate that the economy registered in the fourth quarter. However, the underlying details of the report show an economy growing far slower than the headline rate of growth suggests.

In a surprising irony, the implementation of trade tariffs has contributed to overall GDP growth in a powerful, yet likely temporary, way. Since the first tariffs were levied last summer, we have seen three consecutive large accumulations of inventory by companies frontrunning the impact of the increased levies. In 1Q, there was a sizeable build of inventories ($123 billion at an annualized rate), which added 0.65% to topline GDP growth, and we estimate each of the prior two quarters also benefitted by over 0.5%. Given the lackluster rate of domestic final spending, it is apparent that this inventory build was not done to meet end demand. Over time, inventories accumulate and are drawn down as demand picks us so this inventory accumulation should fall back in coming quarters. This will likely exert a headwind on the overall rate of GDP growth for the remainder of the year.

Additionally, net exports added 1.0% to the overall rate of growth, which is among the largest positive contributions this component has made in this cycle. Although exports grew at a modest rate of 3.7%, imports fell -3.7%. Given continued modest growth in domestic demand, real imports likely will rebound in coming quarters, which also will exhibit a drag on growth.

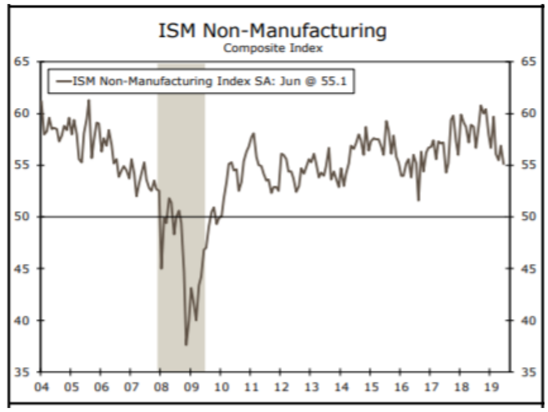
Personal consumption expenditures which represent almost 70% of the domestic economy continued to soften during the quarter growing at a disappointing 0.9% a/r. Next to the chart on the following page from Wells Fargo on real GDP, we have included a chart on the trend of real final sales to private domestic purchasers that we have used before. This excludes the impact of business inventories and trade that are highly cyclical and focuses on the core components of personal consumption expenditures and gross private fixed investment. By this analysis, final sales adjusted for inflation grew only 1.3% at an annual rate during 1Q continuing a concerning trend from the consecutive readings since 2Q 2018 of 4.3%, 3.0% and 2.6%.



Fortune 500 CEOs were recently surveyed as to their views on the economy. In May of 2018, this same survey showed heightened optimism that has now dramatically reversed. In the current survey, almost 50% of CEOs are forecasting a recession by 2Q 2020 with almost 70% seeing a downturn by the end of that year. While this certainly does not imply that those numbers reflect the actual odds of a recession, the results were quite sobering to us as hard data analysis often takes a back seat to decisions driven by confidence, and confidence is not a friend of uncertainty. If the majority of Fortune 500 chief executive officers believe a recession will strike the U.S. economy by the end of 2020, it's worth wondering whether they will act on that belief, for example, by curbing investment and hiring. Below is the historical chart of that survey compared with the Institute of Supply Management (ISM) survey on manufacturing showing their tight correlations.

Manufacturing activity continued to weaken in June, with the ISM index slipping to 51.7 marking the slowest pace of growth for the factory sector since October 2016 (see chart on the next page from Wells Fargo). With the recent collapse in many of the regional manufacturing indices, the final reading was a little better than feared. No doubt the recent escalation of these trade tensions continues to have an adverse impact, and this manifested in the new orders component of the survey hitting a three-year low of 50.0. Additionally, the inventory component indicated that stockpiles are more than right-sized in today's environment giving further credence to our view that inventories will soon be a headwind to quarterly growth readings.

As trade tensions continue to vacillate, further weakening in the ISM remains a real possibility. Though manufacturing represents only about 11% of GDP and 8.5% of total employment, there remains a strong risk of this weakness spilling over into the larger services component. The June report on services from ISM does indicate that a bleeding of the weakness is starting to occur with the index declining to 55.1, the lowest point since October of 2016. Though this does represent an expansionary reading, it is down from a cycle peak of over 61 as recently as September of last year. Economists at Markit (a global information provider that releases much of the manufacturing and services data) described these releases as, "A major change since the first quarter has been the broadening out of the slowdown beyond manufacturing, with the service sector growth now also reporting much weaker business activity and orders trends than earlier in the year."

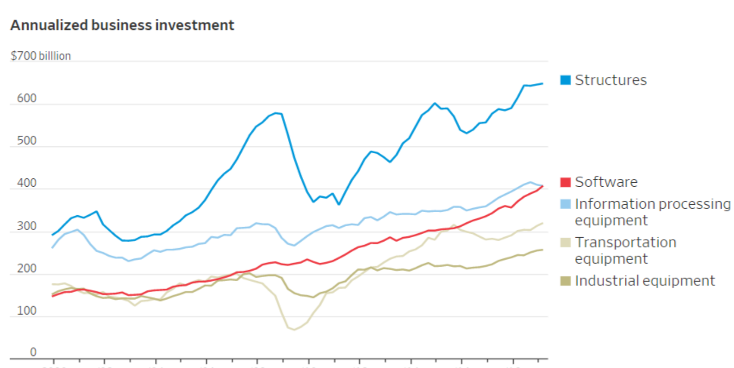


Despite being beneficiaries of lower interest rates, housing and autos are no longer contributing much to economic growth. With global trade slowing and inventory growth set to reverse, we see the next two quarters of GDP growth closer to 1.5% and continue to maintain our full year estimate at 2%-2.25%. The odds of recession continue to rise but there are few of the traditional economic excesses found in the current data. For now, our baseline case is for a slowdown in the balance of 2019. Yet there remain some recent reasons for longer term optimism.

We have often referenced that the long-term sustainable growth of an economy is the product of labor force growth (specifically aggregate hours worked) and productivity growth. With an aging demography and lower levels of immigration, the Congressional Budget Office estimates the trend of labor force growth to be around 0.5% over the next decade and can say that with a reasonable degree of accuracy.

Productivity is much harder to forecast as it is challenging to measure in a society that has long ago moved from industry towards services. The recent trend of productivity growth has been around 1% and economists often use that estimate for future GDP forecasts. Increasingly, productivity and economic growth are flowing not from equipment or buildings or even computer hardware but from processes, coding, data that all emanate from software. From the digitization of everything from phone calls to cars to retailing and more, software programming and cloud-based computing are at the forefront of greater technological advances in artificial intelligence, machine learning that may all lead to a new productivity boom.

Recently there have been intriguing signs a boom may be in the offing. In 1Q, American companies for the first time invested more in software than in information-technology equipment with software surpassing every other type of investment outside of buildings and other structures (see chart below from the Wall Street Journal). Real software investment grew over 12% in 1Q 2019 and is now up 11% over the last year. Overall productivity growth is now up over 2.4% in the last year, the fastest pace since 2010.



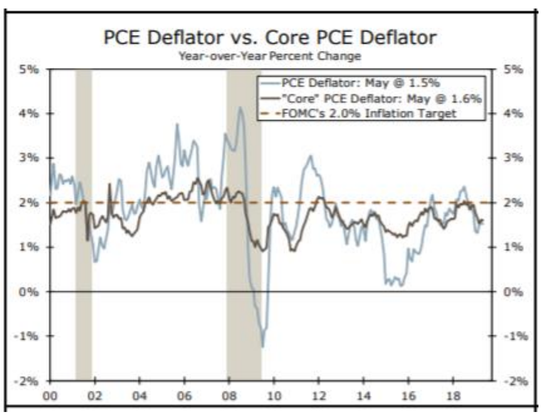
Early signs in 2Q indicate that business investment and productivity growth may have slowed and whether this will continue remains debatable. However, a recent survey by Morgan Stanley indicates proposed software budgets to be increased this year by 5% with cloud computing the main target. Meanwhile, hardware budgets are estimated up only 2%. This trend should be quite positive for future productivity and the benefits for economic growth and inflation.

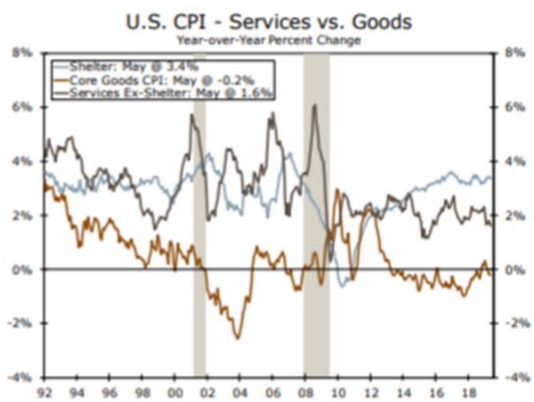
INFLATION:

In our annual commentary we had noted our view that despite rising input costs from tariffs and modestly increasing wages, inflation may have already peaked for this part of the economic cycle. Our view remains that secular trends of an aging demography, rapidly advancing technologies alongside heavy levels of debt that crowd out spending would likely overwhelm the cyclical moves up in cost pressures including much of the impact of tariffs. Continued productivity gains if maintained would only help contain prices as they would offset any increase in wage costs.

The Fed's preferred gauge for inflation, the core personal consumption expenditure (PCE) deflator, quickened slightly to 1.6% on a year-over-year basis in May (chart below left from Wells Fargo). A softening in the core PCE deflator earlier this year after briefly achieving the target of 2% was a big factor in the Fed's shift to a more accommodative stance. The Fed wants to maintain a healthy buffer against deflation, a problem that racked Europe and Japan in recent years and that central bankers view as more challenging to address than inflation. The recent uptick in PCE should do little to dissuade the Federal Reserve from cutting rates at the upcoming meeting later this month.

Still the reading from this inflation metric remains decidedly below the consistent core 2% reading on the CPI, the more popular gauge among economists. The reason is the main component of the PCE is in healthcare and is made up by the reimbursement rates of Medicare and Medicaid that are artificially price fixed lower by the government thus understating inflation readings. Service inflation has also recently slowed from over 3% to 2.5% while the strong dollar continues to keep goods inflation near or below 0% (chart below right from Wells Fargo). The prime inflationary component remains shelter, as housing costs continue to rise with the most recent reading up 3.4% versus a year ago.





THE FEDERAL RESERVE:

As noted above, there are several alternative inflation gauges outside of the PCE deflator that the Federal Reserve could or even should target. The core CPI index noted above has been north of the 2% target for over 15 months now. We also noted in a previous commentary that the New York Fed maintains the Underlying Inflation Gauge (UIG) that also includes asset inflation. It has run a full one percent higher than the PCE and makes intuitive sense in an environment where excess liquidity seeks a home and seems to find it in asset prices.

The choice of the metric alongside the seemingly arbitrary choice of a 2% target of inflation has seemingly hamstrung the Federal Reserve. Former Fed Chairman Ben Bernanke insisted on the 2% target though his predecessors, Paul Volcker and Alan Greenspan suggested that the best inflation rate for businesses and households is 0%. Had former Fed Chair Janet Yellen used a more realistic inflation gauge or target, the Federal Reserve balance sheet would have been run down more quickly and earlier and the process of normalizing rates started sooner. Instead, current Fed Chair Powell has been stuck playing catch up amidst the liquidity concern of what might happen to the $250T of worldwide debt if he returned to tightening mode. We are falling further into the rabbit hole of unconventional monetary policy.

At the June meeting, the Federal Open Market Committee (FOMC) decided to leave the target for the fed funds rates unchanged between 2.25%-2.5%. While the central banks did downgrade the economic assessment modestly indicating that a rate cut "may be warranted soon.", it is not softening payroll growth that seems to have the concern of the Fed. While the central bank's mandate is domestic, global problems are starting to seep into its decision-making - from the trade war and China's slowdown to Europe's economic sluggishness. The decision may be more about the positive second-order effects that a rate cut may have to jump start global economic activity rather than the direct impact on the U.S. economy.

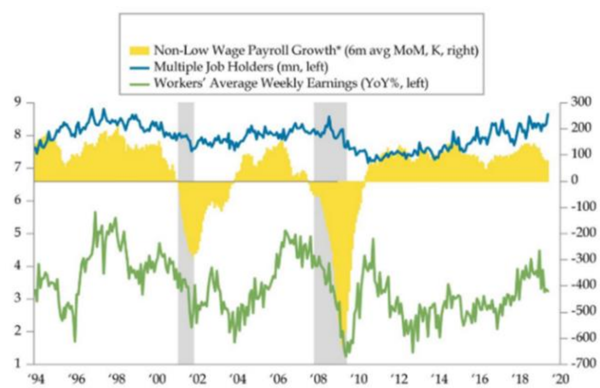
Concerns are rising that when a recession arrives and raises unemployment and moves inflation towards zero that the Fed would quickly run out of conventional ammunition to combat these forces. In the last two recessions from 2001-03 and 2007-08, the Federal Reserve cut interest rates by more than five full percentage points each time. It now has less than half of that ammunition available. Rather than viewing the cuts as wasting the potential bullets for when they are needed, it is likely that Powell views recession prevention as the preferred alternative and will most assuredly be lowering rates by 0.25% at the late July meeting.

EMPLOYMENT & WAGES:

The headline nonfarm payroll data for June showed an increase in net new jobs of 224K pushing the three-month average back up to 171K. Though this is below the 12-month average of 193K and the 2018 tally of 223K per month, these remain solid growth numbers and have calmed some of the bearish concerns of weakening employment growth. Underneath the surface, we note a deteriorating job market condition.

Prior to the release of the June report, annual payroll growth from the Labor Department's Establishment survey had slowed to a 13-month low. This is a survey based on a broad sector of businesses and government agencies. The sister survey is called the Household Survey and is based on actual Labor Department surveys of households and is used to determine the unemployment rate. By this survey, year-over-year employment growth is plumbing a near 5-year low.

The need for employees to hold multiple jobs continues to rise with the latest employment report showing a gain (+301K) in this metric greater than the entire overall gain in payrolls. Americans now working in more than one job is up 6.3% over the last year and compares with the overall total employment gain of only 0.9%. Meanwhile, average weekly earnings are well off of their peak and payroll growth in all but the lowest wage sectors continue to soften. All of this is depicted below in the chart from the Bureau of Labor & Statistics.



Source: BLS. Recession shaded. *Excluding retail, education & health care, leisure & hospitality and "other" services.

Average hourly earnings were up only 0.2% in June, leaving the over year-ago figure unchanged at 3.1% and solidly below the cycle peak of 3.43% reached early in the year. For the full 2Q period, wages gained at an annual rate of only 2.7%, the slowest quarter since late 2017. Solid productivity gains have been the key component of our view that wage gains would be able to follow without a correlated impact on inflation. Though productivity has risen, wage gains have not through the first half of the year. This is consistent with the chart above showing the growth of higher paying jobs has demonstrably slowed.

Additionally, aggregate hours worked (the product of total employed persons multiplied by average weekly hours) for the second quarter gained only 0.6% following a 1.8% increase in the first quarter representing the lowest level during the 10-year economic recovery. Taken together, the aggregate income proxy continues to slow from 4.3% in January to the most recent reading of 2.68% (see chart below).

Though the trend in initial jobless claims remains historically low, business surveys on hiring plans and job openings have softened in recent months. Our view remains of a slowing economy with job growth slowing towards 100K per month.

CONSUMER:

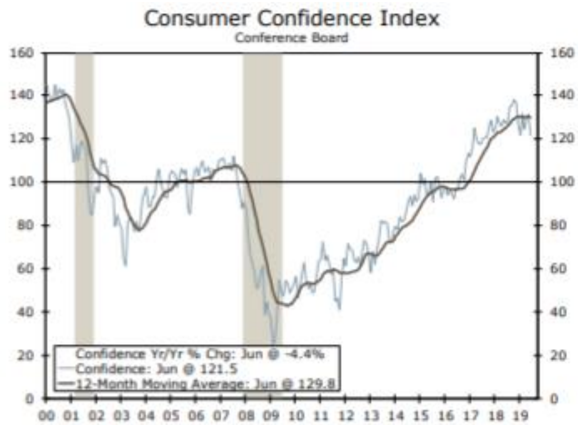
We have often discussed the concept of animal spirits and the impact this can have on the economy in both directions. The "soft" data for many businesses has been discussed above in the CEO surveys alongside the ISM reports. For consumers, this is best uncovered in the readings on consumer confidence which for the majority of the period since the most recent election have remained at or near cycle highs. This may be changing.

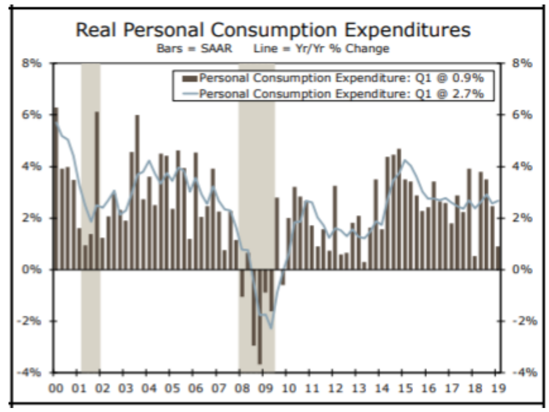
It appears that between an ongoing trade war and a soft May jobs report, consumers were shaken. The 9.8-point drop for the final June reading of the Consumer Confidence index (see chart on the following page from Wells Fargo) represents the largest monthly decline since 2015. From the initially reported print of 134.1, the decline was 12.6 points, the biggest monthly drop since 2011. Even with this deterioration, confidence is still elevated by historical standards. However, the fallout here in June is likely attributable to concern about the trade war and is an indication of vulnerability in the labor market.

Within the details of the report we note the quick decline in the view of the labor market. The rolling-over that we are seeing here in the survey category of "jobs plentiful" is worryingly reminiscent of what we have seen late in prior cycles. It would be too soon to mark-down spending estimates for the second half; but if past patterns hold, without a turnaround in this series, job growth could slow in coming months.

Though the strong June payroll reports may have assuaged some concerns of a slowing job market, most of this gain came from workers adding a second job, not a sign of a robust market. In fact, median household income fell -0.6% from April to $63,799 a level only 3.4% higher than January of 2000.

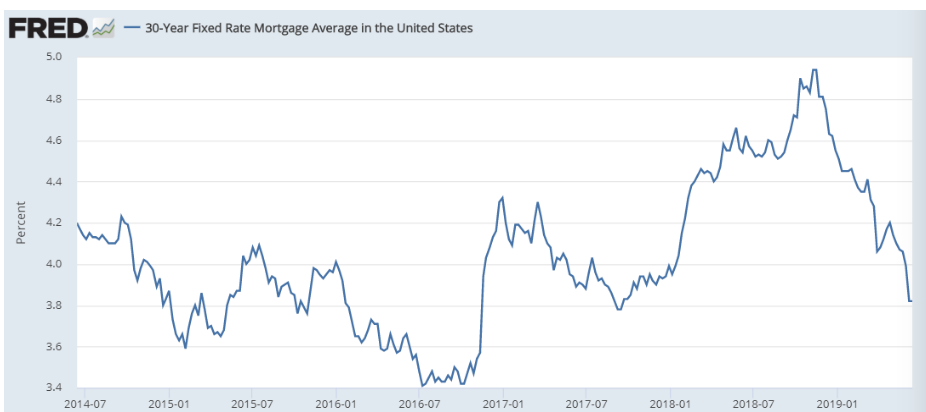
Retail sales have picked up so far in 2Q, and we do expect an increase in consumer spending from a very soft 1Q and the slowdown over the last year. However, the keys to consumer spending in the second half of the year will likely revolve around labor market prospects and developments in the trade war. These confidence surveys are critical to watch now as the consumer remains the stalwart in a softening economy.





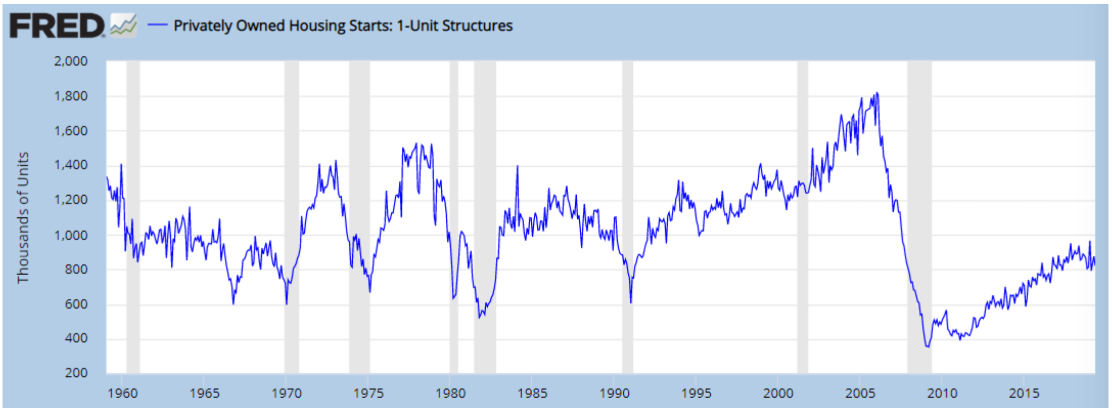
HOUSING & AUTOS:

The precipitous drop in mortgage rates to 3.8% from cycle highs of just below 5% in November (see chart below) would normally be an elixir to a housing market that has stumbled recently under the weight of diminished affordability. But while the lower rates have somewhat stabilized the housing slowdown experienced in 4Q of last year, the Spring selling season has, so far, been less than stellar. Rather than sparking a resurgence in home buying, it appears that lower mortgage rates are merely cushioning the blow from slower global economic growth.



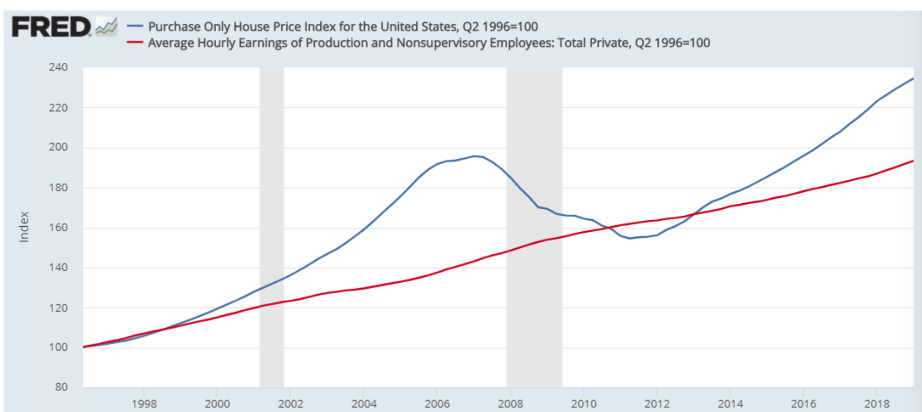
The most recent data on housing starts released in late June continues the trend of multi-family starts (mostly apartment units) leading the gains that are realized. Preceding the Great Recession, single family housing starts consistently comprised about 80% of total housing starts. In the most recent decade, this has averaged closer to 69%. Much of this decline reflects the fallout from the housing crisis and the large increase in student debt that has held back the first-time home buyer from entering the market. Multi-family starts have a far lower impact on GDP than do single family starts and the most recent period has witnessed five consecutive declines in the contribution of residential investments to this total.

Through the first five months of 2019, single family housing starts have annualized at a rate of 857K units, a pace that though about two percent below the level of 2018, still reflects strong increases from the years following the housing crisis. The concern is that the market appears to have plateaued near this level since the start of 2016 despite extremely attractive financing rates. In fact, as the chart below depicts, this remains about 23% below the 50-year average of 1,092 units prior to the downturn despite large population growth.

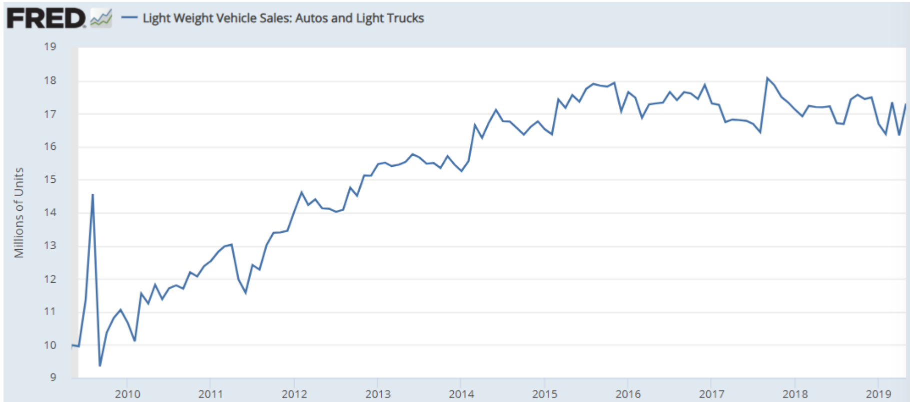


Still there are sociological changes that also continue to impact the housing industry. Demand for living in and around major urban areas has continued to rise but land is scarce and, thus, expensive. Many nearby suburbs are rapidly urbanizing to meet these demands creating communities that are more walkable and with easy access to the major cities. Locally, we have seen this with Town Center in King of Prussia and the areas around Ardmore and Bryn Mawr in the western suburbs of Philadelphia. These trends will likely keep residential development more heavily weighted toward multi-development than in past cycles with a lower contribution of residential investment to GDP.

While low interest rates are a positive, they have been more than offset during this period by increases in home prices that have far outpaced those of wages. The chart below compares the average hourly earnings of workers in red with the purchase only house price index. Since the trough in house prices in 2012, home values have appreciated at an annual rate of 6.0%. This compares to average hourly earnings increasing at only a 2.4% annual rate increasing the challenges of affordability during this period. While low mortgage rates mitigate part of the monthly cost of home ownership, increasing prices raise the initial requirements for a down payment that alongside major increases in student debt continue to act as a restraint on housing demand.



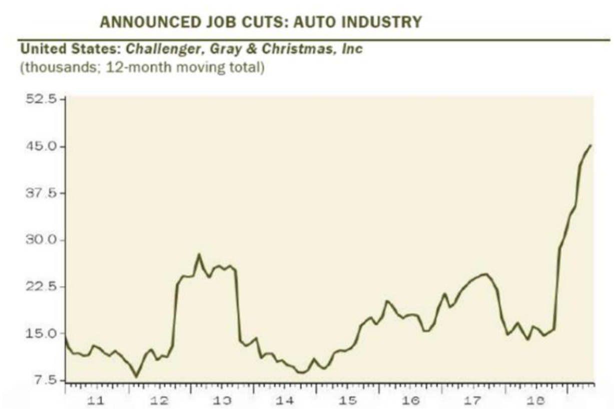
Light vehicle sales in the U.S. have modestly declined on the headline readings, (off -2.2% through May according to data from Cox Automotive). In contrast, commercial and governmental fleet sales that benefitted from tax reform are up 6.9% so far in 2019 and have obscured the decline of -5.2% in retail sales. Total sales have softened to an annualized rate of 16.8MM as of May. This compares with peak levels of over 18.0MM vehicles in September of 2017 (see chart on following page).



Despite this slowdown in demand, pending tariff concerns have increased production and the number of new vehicles sitting on dealer lots is rising. On average, new vehicles sold in May spent 74 days on dealer lots, the highest level for the month of May since 2009 when the industry was dealing with the effects of the Great Recession. In fact, according to ALG (Automotive Leasing Guide), 29% of vehicles sold in May have sat on lots for 90 days or longer, up from just over a quarter of vehicles last year.

As one might expect, manufacturers are responding with larger discounts. Incentive spending per unit in May is \$3,722, up \$25 from last year. While the increase is modest, it is notable for breaking a 10-month trend of lower year-over-year discounts. Transaction prices are continuing to rise. New-vehicle prices in May averaged \$33,457, the highest ever for the month and are up more than 4% (+\$1,345) from last year. The record prices reflect higher prices for both cars (up 3% to \$27,259) and trucks/SUVs (up 4% to \$36,388) according to JD Power.

Autos are among the most interest sensitive industries in our economy and are critical for employment. With sales not responding to lower rates and foreign demand dropping quickly, we may be seeing the early stages of a reversal in employment growth centered in this sector (see chart on the following page).



INTERNATIONAL:

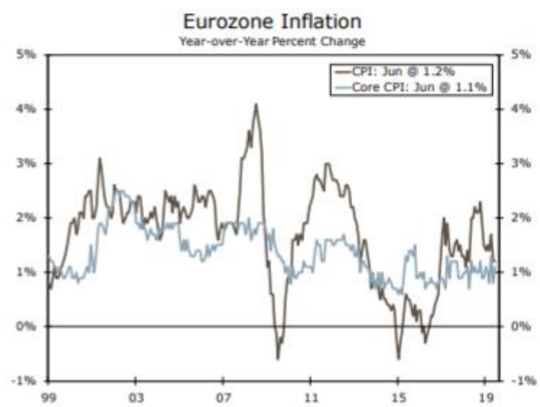
The global growth backdrop continues to soften heading into the peak of summer. The Eurozone economy continues to wobble on the edge, with economic growth neither fast enough to reassure officials at the European Central Bank (ECB) nor slow enough to warrant more monetary stimulus. China faces headwinds from another escalation in the trade dispute, and analysts continue to lower growth forecasts for real GDP growth in the country. In North America, the outlook outside of the United States is not much better with GDP growth in Canada and Mexico both slowing towards 1%.

Possible tariffs on American imports of European and Japanese autos linger in the background, as do questions about the prospects for USMCA, the heir apparent to NAFTA. Another escalation in the ongoing trade spat, should it occur, could push the global economy to lows not seen in a decade. Concerns about the escalation of the U.S./China trade war have impacted the expectations for growth in the China-dependent economies that have now been halved since 1Q 2018 and are below 2% for the first time since 2009.

EUROZONE:

The annualized growth rate of GDP for the Eurozone (EZ) in 1Q increased at an annualized pace of 1.5%, an acceleration from the 0.9% rate of growth recorded in the final quarter of 2018. Compared with a year earlier, GDP was 1.2% higher. As with other developed economies, the plans to raise interest rates were scuttled as the global slowdown in the second half of 2018, moved the peak of 2.7% year-over-year growth of 2017 far in the rear-view mirror. As Europe is the economic region with the largest percentage of GDP derived from trade, they have been impacted by the global contraction in trade more than other economies.

Concerns continue about the sustainability of the economic expansion and are heightened by the purchasing managers indices (PMI-equivalent of our ISM indices) that have moved into contraction territory (see chart below left from Wells Fargo). These levels are consistent with prospective GDP growth of 0.9%.



The inability of the ECB to raise inflation anywhere close to the 2% target along with the underwhelming performance of the Eurozone economy led ECB President Mario Draghi to again try to reassure markets in mid-June that they are more likely to ease policy relatively soon if the economic situation does not improve. Though the June reading on core inflation did move up to 1.2% (chart above right from Wells Fargo), we have seen this movie before and expect Draghi will likely again go to the toolkit of further interest rate cuts and additional asset purchases.

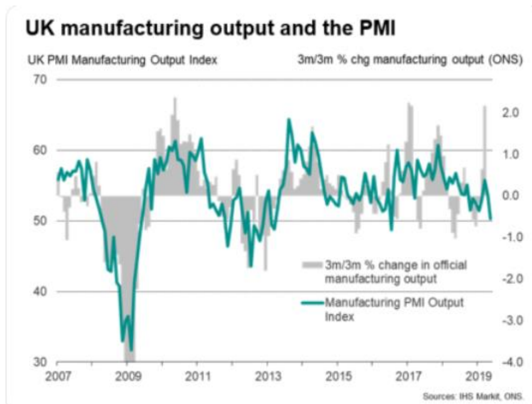
With negative yields on 10-year government bonds in Germany and France and with the ECB already holding over 40% of government debt, these policies have proven to be ineffective. The role of fiscal policy that is sorely needed is absent in a construct such as the Eurozone. Economies that differ both in their structures and cultures create imbalances that would normally be adjusted via the currency. With the common Euro, this is impossible. The individual governments have relied solely on the ECB and monetary policy and have done little to improve their respective country's fiscal position. The recent choice of former IMF Managing Director, Christine Lagarde, to succeed Mario Draghi as President of the ECB has further fueled expectations that this will continue in perpetuity. We continue to look for slowing overall growth in the EZ economy below 1%.

UK:

On June 7th, Theresa May stepped down as Conservative Party leader after failing to deliver a successful withdrawal agreement to her Members of Parliament (MPs) that she had negotiated with the European Union. The comments above on the challenges of economic and political structures and cultures facing the Eurozone may apply even more to the United Kingdom.

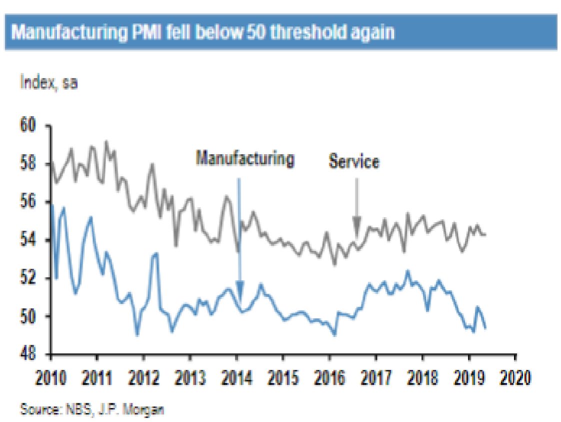
When compared with Continental Europe, the British people are far more freedom and free market oriented. Socialism is not embedded in a society where government spending as a percentage of GDP is 38% compared with 45% for the EU in total and 56% for a country such as France. Though in future years, the UK may be better off freed from the baggage imposed on members by the EU, that will likely not be the case in the short-term. In the immediate future, a "no-deal" Brexit would be very disruptive and the additional cost to the economy might be immense as standard trade agreements need to be negotiated and have long transition periods.

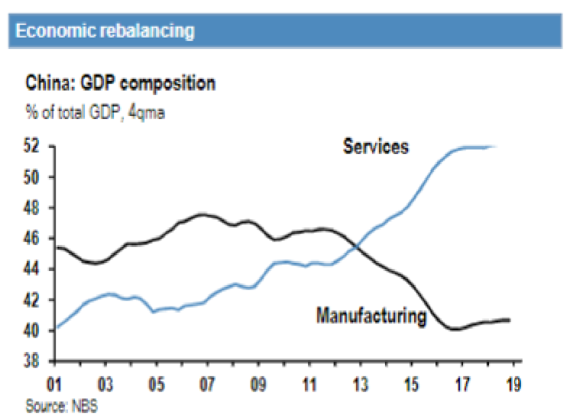
What we have seen so far is economic data through 1Q continuing to come in a little better than feared with GDP rising from 1.4% y/y growth in 4Q 2018 to 1.8%. However, this is likely due to the continued stockpiling by firms in preparation for the worst outcome, a "no-deal" Brexit. Indeed, following May's resignation the manufacturing PMI for the month of May plummeted into contraction of 49.4 from 53.1, a near three year low (see chart below). We expect 2Q growth to slow substantially from the recent levels.



CHINA:

Following strong stimulus in the second half of 2018, 1Q GDP in China did surprise to the upside with growth unexpectedly holding steady at 6.4% y/y. It appears the lead in to the second quarter was also solid as March retail sales firmed to 8.7% y/y while industrial production also beat forecasts. Despite these more upbeat figures earlier in the quarter, the impact of slowing global trade became more pronounced in May and June as can be seen in the chart below left from the National Bureau of Statistics of China (NBS) showing plunging manufacturing PMI readings. The service sector continues to be a larger component of China's growth but is still not large enough to offset the decline in trade.





China cannot continue to apply monetary stimulation along with fiscal adjustments as they did during 1Q without risking a sharp decline in the renminbi. Letting the currency drop more would risk closing the door indefinitely to a potential trade agreement with the United States as a weakening dollar is a major issue with the current administration.

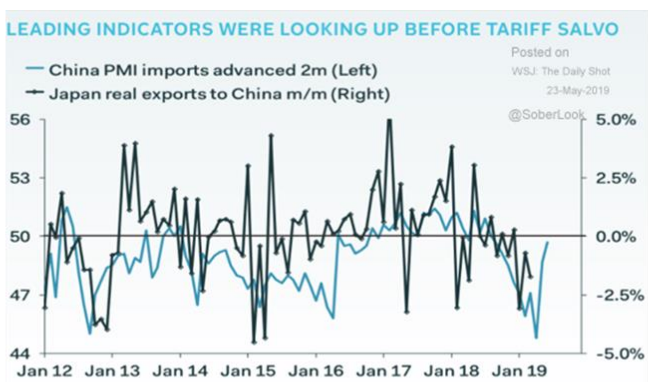
Despite his seemingly secure position, President Xi may fear the inflationary consequences of decisive monetary stimulation and what it could mean for the social cohesion of the nation. A sharp decline in the currency would have the potential to threaten the Communist Party's ability to maintain control. The bureaucrats know that the Communist Party came to power because the former regime created too much inflation, which led to revolution by the Communists. Still, we do not expect China to bend to U.S. demands. They are powerful and proud nationalists with a long-term vision and will likely execute accordingly.

JAPAN:

Economic growth in Japan for the first quarter was revised to a strong 2.2% annualized rate with capital expenditures in the non-manufacturing area leading the improvement. This followed a solid 1.6% a/r in the final quarter of 2018. The revised figures reaffirmed that imports fell faster than exports in the first quarter, underlining rising pressure across the economy as consumers hesitate to spend. Private consumption accounts for nearly 60% of gross domestic product in Japan.

Many analysts believe the economy was not as strong as the GDP numbers show and that overall capital spending and personal consumption remained sluggish, posing a downturn risk to the Japanese economy. This will be tested in October with the planned hike in the VAT consumption tax that will rise from 8% to 10%. If the strong GDP readings encourage Prime Minister Shinzo Abe to press ahead with the sales tax increase, we fear the Japanese economy will slow back towards 1% growth.

The Japanese government maintains that the world's third-largest economy is recovering moderately despite an uncertain global outlook amid growing trade tensions between China and the United States. Data on the trend in trade between Japan and China appear to support that as Japan's exports to China were about to recover earlier in the year (see chart below showing the start of a potential reversal). But with the renewed US-China tensions, the rebound is much less certain now.



EMERGING MARKETS:

In April, the International Monetary Fund cut its estimates for global growth, pointing to increased trade tensions and tariff increases between the U.S. and China as a key factor. Yields on government bonds around the world fell to fresh 2019 lows at the time of this writing with flaring trade worries driving investors into safe-haven assets. China is a key market for the goods of developing countries, making its conflict with the U.S. particularly worrying for emerging-market investors. Satellite economies such as South Korea send around a quarter of its exports to China, which is also an important consumer of commodities such as Chilean copper, Brazilian crude and Indonesian palm oil. Many fear that demand for these products will suffer if the trade conflict squeezes China's economy, hurting commodity producers and weighing on raw materials prices all over the region.

Though we do not believe China policymakers will allow this, many investors are also concerned that a broad range of developing countries will be forced to loosen monetary policy and weaken their currencies if China lets the yuan depreciate to spur economic growth. Currencies like the Taiwan dollar, Korean won and Chilean peso extended their declines in May and June before reversing modestly in early July. If emerging countries want to avoid a crisis, issuing a greater share of debt in their own currency is key. This avoids the risk that a devaluation can force them into default, and it leaves them with the option (not necessarily a good one) of printing money to escape difficulties.

China does more than 90% of its borrowing in local currency, which limits the risks somewhat and almost all large emerging markets now do more than half of their borrowing in their own currency. However, not all emerging markets have made uniform progress in converting to local market debt. The two biggest exceptions are Argentina and Turkey and we see the result as these two countries both slipped into crisis during 2018 as a strong dollar put pressure on their currencies.

Decelerating global growth continues to move the U.S. dollar higher which, in turn, heightens the challenges for emerging markets. We see three items that would create optimism on these regions moving forward: 1) an easing Fed rate cycle 2) a U.S./China trade deal and 3) strong China stimulus. So far, we are certainly seeing a Fed pause and possible rate cuts but this is somewhat due to the failure of the other scenarios to materialize and even become less favorable. The economic policy uncertainty continues to prevent a meaningful acceleration in these economies.

MARKETS:

Though the textbook definition of asset valuation may be the present value of all future cash flows, as with any commodity, the prices of stocks are in their most basic form a function of supply and demand. Wall Street analysts and strategists analyze various assumptions of revenue growth, margins, expenses, tax rates, interest rates, etc…to aid in the determination of value and, thus, future return expectations. Still, over much of that time frame, equities can spend long periods during which price and value are not in concert. Demand is often a function of the animal spirits that we have often discussed but we spend little time on supply. Corporate America has had a major impact on both.

In the post-crisis investing environment, it has often been said that this has been one of the most unloved bull markets as participation by the individual investor has been somewhat constrained. This has not been the case with corporate America that has enjoyed the benefit of historically low interest rates and have gorged at the debt trough to expand operations, increase dividends, and, especially, buy back stock.

Since 2010, net buybacks (repurchases less new issuance) from corporations averaged about $420 billion annually. This contrasts with buying from households, mutual funds, pension funds and foreign investors that have been less than $10 billion over that same period. The period of the last five years is shown in the chart below based on data from the Federal Reserve compiled by Goldman Sachs.

Corporations are the largest source of equity demand

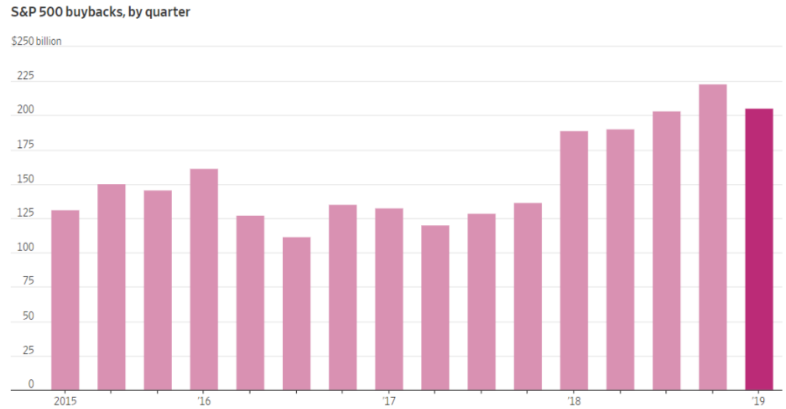
as of 4Q 2018

	Net US equity demand ($ billions)				
Category	2014	2015	2016	2017	2018
Corporations	**$ 442**	**$ 508**	**$ 697**	**$ 296**	**$ 509**
Foreign Investors	114	(191)	(188)	125	(94)
Pension Funds	(272)	(7)	(217)	(162)	(243)
Mutual Funds	95	58	(112)	(134)	(124)
Households	95	(138)	(151)	226	191
Life Insurance	(5)	31	98	(45)	(18)
Other	12	(7)	(12)	(17)	9
less					
Foreign equities bought by US	432	197	22	167	128
Credit ETFs	50	57	96	123	100
Included among holders above are:					
Equity ETF purchases	$ 191	$ 174	$ 188	$ 347	$ 210

Source: Federal Reserve and Goldman Sachs Global Investment Research

Buybacks boost earnings per share (EPS) by reducing the denominator of total stock outstanding. It is estimated by Goldman that over the last 15 years the difference between aggregate profit growth and EPS growth has been north of 2.5% per year. Though this subject is fast becoming a political football, we are not here to argue the value of such capital allocation decisions but rather note that this equation may be changing.

Trade tensions and slowing economic growth may be forcing some challenging allocation decisions for corporate leaders and the most recent quarter for which we have information shows the first sequential decline in buybacks in almost two years (see chart below showing gross levels of stock repurchases from the WSJ).



Though still at a robust pace in 1Q 2019, repurchases of $205B according to S&P Dow Jones data is down from a record in 4Q of 2018 of $223B. Entering 2Q earnings season, analysts for FactSet note the S&P 500 revenue growth is expected to slow to 3.8%, a level that would represent the slowest pace since 3Q 2016. As buybacks are correlated to cash flow, they tend to exaggerate cyclical moves in each direction adding fuel to stock prices as profits rise but potentially removing a key support as this slows. As this source of liquidity is removed, we can expect increased volatility.

In the face of concerns of rising global tensions and slowing economies, the capital markets enjoyed a powerful quarter with the S&P 500 rising 4.3% bringing the return for the year to 18.5%. The Russell 2000 index of small cap domestic companies enjoyed a more moderate return of 2.1% and is now ahead 17% for the year.

Returns outside the U.S. also enjoyed the tailwinds of global central bank easing policies with the MSCI EAFE index of developed international companies moving ahead 3.7% for the quarter and now up 14% for the year. The MSCI Emerging Market index remains the performance laggard but is also up 10.6% for the year following a return of only 0.6% for 2Q.

Additional signs of strong pro-risk behavior have also been noted in portion of the credit space in fixed income where despite noted concerns by the Federal Reserve, lower-rated debt continued to appreciate during the quarter. The Barclay's High Yield index has returned over 9.9% so far in 2019 with the S&P Leveraged Loan index up over 5.7%.

We have noted in the past that the domestic economic recovery is still highly correlated to the markets and, in turn, the actions of the Federal Reserve. Faced with the potential for further escalation in trade and tariff wars alongside a slowing global environment, the markets are vulnerable to more volatility. This is precisely why we at Coho Partners always strive to construct a differentiated portfolio populated with high quality companies with resilient earnings streams, growing dividends, strong balance sheets and reasonable levels of expectations and valuations.

Sincerely,

Rick S. Wayne, CFA

Eric M. Hildenbrand, CFA