COHO PARTNERS, LTD.
Economic Commentary

Fourth Quarter 2018

*"Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of **animal spirits**—a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities."*

--***John Maynard Keynes 1936***

Though any negative impacts to the U.S. economy so far have been minor, we have been citing trade and tariff wars as one of the largest risks to our economic growth over much of the last year. Following the excitement and the unleashing of animal spirits in the aftermath of growth enhancing policies via increased deregulation and corporate tax reform, the Trump administration may have missed an enormous opportunity.

With annualized growth rates in 2Q and 3Q of 4.2% and 3.4% respectively, the U.S. economy was growing at the fastest pace since the middle of 2014. A year of aggressive trade policy rhetoric (and some outright tariffs) appear to have taken its toll. While the confidence levels of households and small businesses remains near cycle peaks, confidence levels of corporate executives who make the business decisions impacted by these policies have receded at a fast pace.

According to the Duke/CFO Global Business Outlook Survey released in mid-December, 82% of CFOs believe the U.S. will be in recession in 2020. This may be self-fulfilling as 53% of those surveyed said they would increase capital expenditures (capex) in 2019 down from 68% of those polled in November and the low water mark for the year. Without the animal spirits dictating action, there can be no capex boom. Without a capex boom, there can be no sustained 3% growth of GDP.

So, while there has been little direct impact on economic growth from the trade wars in 2018, we are afraid that may be changing as an accumulating list of concerns on trade spill over into less direct avenues such as confidence, corporate investment and financial markets

Even as the Administration pauses on the threat of a 25% levy on all Chinese imports that had been scheduled to take effect on January 1 of 2019, the business impact is already being felt. Moving supply chains and finding new markets take time and cost money. The declining confidence levels of the CFOs noted above reflect the confusion on the new rules of the game and corporate executives are unlikely to make critical and expensive decisions until clarity emerges. A comparison may be found in the United Kingdom since the Brexit referendum in 2016. A paralysis on the part of business and consumer spending caused by the uncertainty has left the British economy as much as 2% smaller according to IMF estimates.

The administration felt confident that the economy was strong enough to withstand a trade war as the tax cuts, fiscal spending boosts, strong oil prices and rising financial markets created strong tailwinds. These have been fading. The impact of a reduction in liquidity from Federal Reserve interest rate hikes alongside the unwinding of the Fed balance sheet have now combined with collapsing oil prices to create a risk aversion in the markets not seen in years.

Though trade conflicts have been a worry over the last year, for far longer we have expressed concern as to the impact on financial markets of Federal Reserve machinations following the Great Recession leaving near zero interest rates. Extreme interest rate policy has incented corporate America to increase leverage and misallocate resources towards share buybacks and large dividend increases favorable to current shareholders at the expense of corporate reinvestment that would likely increase productivity, and enhance growth, over time.

To be naïve as to the potential impact on consumer and business confidence that the unwinding of fiscal stimulus (via the reversal of Quantitative Tightening through the reduction of the balance sheet of the Federal Reserve) might have is to disbelieve the causation that such interest rate manipulations have had on all financial assets. The recent return of volatility and risk to the equity and credit markets has added a cold shower to the face of Wall Street participants who have been spoiled by this easy money policy and the consequential suppression of volatility.

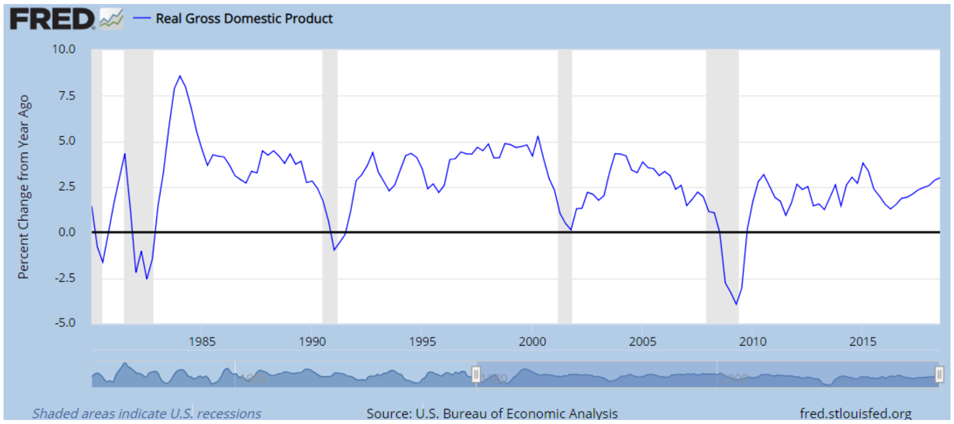
The trade wars along with the seeming end of the era of easy money and low interest rates head up the list of challenges the global markets and economies face as we enter 2019. But they are not the only ones. The global economic synchronization that we experienced in 2017 has morphed into a slowdown facing the major economies of China, Europe and Japan that have preceded a clear deceleration in our domestic growth. With the economies of our major foreign trading partners slowing and facing the anniversary of the profit benefits of corporate tax reform, analysts are expecting a pronounced slowdown in corporate earnings in the new year. In each of the first three quarters of the year just ended, profits of S&P 500 companies rose about 25% from a year earlier. According to data from FactSet, the increases in 4Q earnings may be cut in half and 2019 profit growth may slow to the low-single digits.

Still, we expect the key to the markets and economy in 2019 may reside with the actions of the Federal Reserve. Though Federal Reserve Chairman Jay Powell may be attempting to be the first Fed chief since Paul Volcker to attempt to separate Federal Reserve policy from the dependence of the stock market, there are many critics on all sides that this economy may not be strong enough to withstand higher interest rates that are still historically low.

On one side are those who view a secular paucity of demand caused by low productivity growth, excessive debt levels and an aging demographic as requiring far lower current interest rates than historical levels. On the other side are those that feel the Federal Reserve is ignoring troubling signs from the financial markets. Either way, if economic data experience a sharp slowdown in the coming months, a quick shift towards easier monetary policy is likely.

UNITED STATES:

We are now almost a full year into the enactment of the $1.5T Tax Cuts and Jobs Act, which reduced the corporate income tax rate to 21% from 35%, and in 2018. the economic effects were quite apparent. The reductions added octane to an already solid recovery and helped lift growth well above its trend rate and towards 3% GDP growth for the full year (see chart on top of following page). The strongest back-to-back quarterly growth in three years was achieved in the middle two quarters with gains of 4.2% and 3.4%, respectively, led by a buoyant consumer. Consumer spending comprises nearly 70% of the calculation for gross domestic product. Following a two-year period during which personal consumption averaged less than 2.4%, the unleashed animal spirits generated spending of over 3.6% during this period.



There are no doubting the short-term growth effects of the deficit-fueled package. Analysts from Citigroup estimate a 0.7% boost to growth in 2018 from tax cuts and public spending. It is the sustainability of this expansion that is far less sure, however.

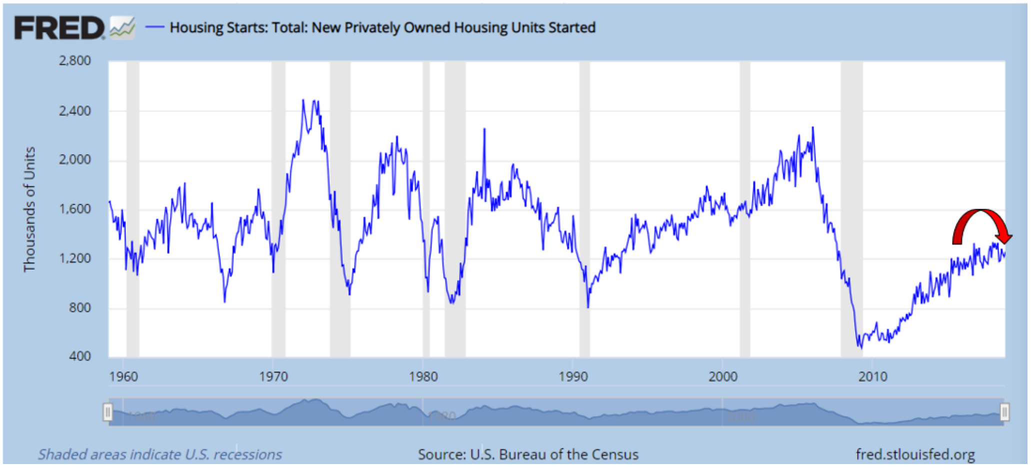
The Federal Reserve still maintains a long-term trend growth of 1.9% that is no higher than before the package was passed. Following the enactment of the huge corporate tax cut, companies made bold promises. These included pledging a total $194bn for investments, wage boosts for around 2M employees and one-off bonuses of $7B, according to the same Citigroup analysis. Assuming that spending is realized but spread over a five-year period, the positive impact on overall growth is modest, estimated at about 0.2% per year. Senior administration officials disagreed and believed the big corporate tax cut would unleash a wave of sustainable growth in business spending that would lead to further job gains and higher wages and generate growth in the 3% area rather than near 2% as most economists expected.

Analysis from Barclays argues that investment levels are still far too low to provide the kind of long-term lift in GDP growth that the current administration has predicted. They estimate that to boost growth to 3% over a sustained period solely on the back of capital formation would require business investment to leap by 30%, dwarfing the growth seen to date. Business fixed-investment did accelerate in the first half of 2018, rising 11.5% in the first quarter and 8.7% in the second, before reverting to a 2.5% increase in the third. Data to date for 4Q suggests an even slower pace. The near 40% decline in oil prices in 4Q will add to this slowdown. It is important to note that a good chunk of the tax cut went to stock buybacks, which are estimated to have exceeded a record $1 trillion in 2018.

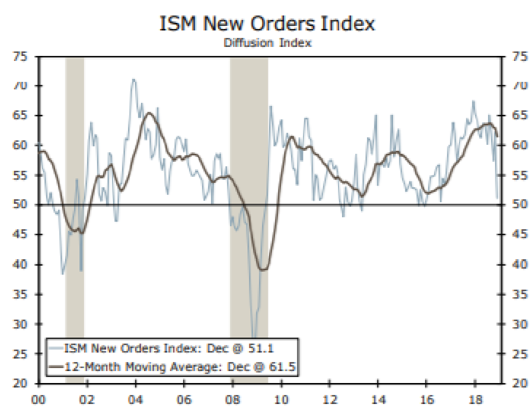
In 2019 we will learn whether the Tax Cuts and Jobs Act was truly a stimulus for productivity-enhancing capital investment or merely a stimulus for corporate profits. The U.S. economy is not sending out alarm bells just yet, but we do hear some ringing.

The strongest part of the economy continues to be employment. At 3.9%, the civilian unemployment rate sits near a 49-year low. Wages are finally rising at a 3.3% annual rate for the first time since the Great Recession. Continued job growth and rising wages have engendered the highest consumer confidence levels of this economic cycle and appear to have continued through the holiday season. The 5.1% increase in holiday sales was the biggest in the last six years, according to Mastercard Spending Pulse. Though auto sales may have peaked two years ago, they have remained at high levels throughout 2018.

Housing has been a reluctant participant throughout this business cycle after overplaying its hand in the previous one, and we noted early this year that housing appeared to have peaked. Even at the high point for single-family housing starts earlier this year, builders were breaking ground on new homes at rates that paled in comparison to those of previous expansions over the last half century as the chart on the following page indicates.



However, the ringing sounds we hear may primarily relate to a change in animal spirits and is why we chose the opening quote. A global economic slowdown has been precipitated by the removal of global liquidity and the impact on global trade and supply chains from the escalation of trade and tariff wars. The Duke University CFO survey referenced above was 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 almost half of U.S. chief financial officers believe a recession will strike the U.S. economy by the end of 2019, it's worth wondering whether they will act on that belief, for example, by curbing investment and hiring. Indeed, the most recent ISM Manufacturing Index that surveys more than 300 manufacturing firms on employment, production, inventories and new orders witnessed the largest one month decline since November of 2008 with new orders declining precipitously (see chart from Wells Fargo below). The decline in these leading components suggests that output and manufacturing employment are both likely to slow further in coming months.



Another survey by the Federal Reserve recently found that most bank loan officers would curb lending if we experienced a prolonged yield curve inversion (whereby longer-term interest rates are lower than shorter-term rates), a situation that is perilously close to occurring. Declining confidence runs the risk of becoming self-fulfilling.

With company confidence waning, the primary theme in 2019 may turn to corporate deleveraging as cash flows and nominal GDP growth slows amid rising wages and interest expense. With almost $3 trillion of BBB-rated corporate paper, CFOs will be focused on avoiding the impact on their cost of capital that a re-rating to junk status would entail. With about $3.5 trillion of debt rolling over and needing to be refinanced (and an equal amount over the following three years), we can further expect a crowding out of stock buybacks and dividend hikes that have been a massive source of stock market support.

The new year will also offer the challenges of the continuing lagged impact of interest rate increases by the Federal reserve along with the fading of the fiscal stimulus and, perhaps, the impact of a negative wealth effect from the decline in equity prices and the softening of home price gains. For now, consumer confidence is high, but history notes the ephemeral nature of such readings.

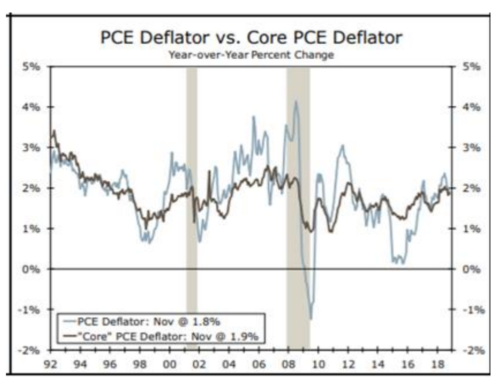
Though this is a binary comment, we do not feel that a recession is in the cards for 2019. However, we are mindful of the signals and there is no doubt that the risks for 2019 have increased and that the domestic economy is slowing. The tariff and trade negotiation with China are the biggest wildcards and has the potential of moving the economy either way depending on a resolution or a trade war. With affordability still a challenge, residential fixed investment may be a drag on growth, and we fully expect that trade will also not contribute positively. We still feel, however, that the consumer will remain in solid shape. With wages rising and inflation (gas prices) moderating, real wage growth is strengthening. Though spending may slow from the torrid pace of 3.6% enjoyed in the middle of 2018, we still expect spending near 2.25%, which should support GDP growth for the full year in the neighborhood of 2.0%-2.25%.

INFLATION:

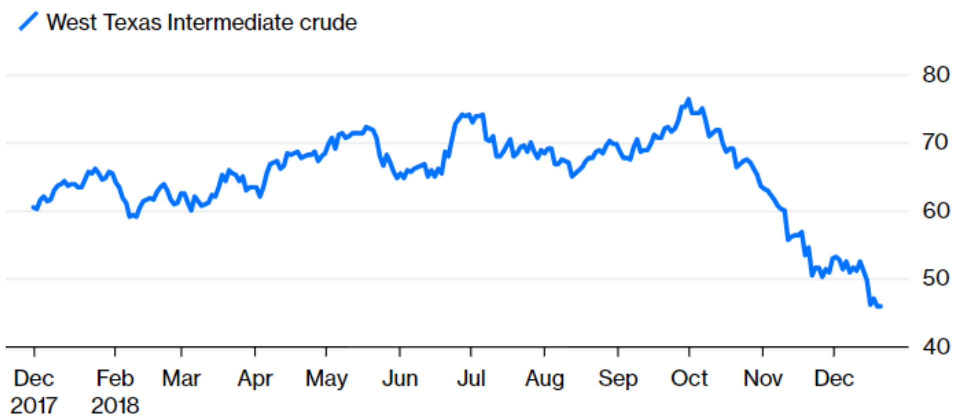
While many have viewed the financial crisis as the primary cause for the slowdown in inflation during the economic recovery and therefore cyclical, we have maintained that there are overwhelming secular trends that will remain dominant and unlikely to reverse in the future. The predominant trends are demographics, debt and rapidly advancing technologies.

An aging population combined with slowing overall population growth reduces aggregate demand. Excess debt, exemplified by household debt relative to median income way above historic averages, reduces the potential increase in the money supply as borrowing cannot expand substantially as more and more of household income is directed towards existing debt paydown. Technological innovations continue to reduce labor and manufacturing costs. Though cyclical forces will elevate and lower price trends, these structural impacts are clear and should place a ceiling on the level of price pressures we should expect.

Despite the increases in input costs from tariffs and solidly increasing wages, inflation concerns may have already peaked for this part of the economic cycle as price trends appear to be topping out and potentially receding. Following a modest rise of +0.1%m/m in November for both the headline personal consumption expenditure (PCE) deflator and the Core PCE, the two readings are now back below the Federal Reserve's 2% target at 1.8%y/y and 1.9%y/y, respectively (see chart from Wells Fargo below). This mark the first month since February that 12-month price gains fell materially below the symbolic 2% level, dealing a setback to policy makers' hopes of meeting the goal for the first time since 2011.



Much of the shortfall owed to a sharp decline in energy costs, as crude oil prices fell last month amid concerns about an oil glut in the global market. Despite an agreement early last month between OPEC and Russia to reduce oil output by 1.2 million barrels per day starting this month, the price of West Texas Intermediate crude has fallen more than 38% from its high of over $73/bl entering October to $45 as the year ended. This is because the demand for energy is expected to fall even more than the reduction in production that the OPEC+ countries will implement (see chart below from FactSet).



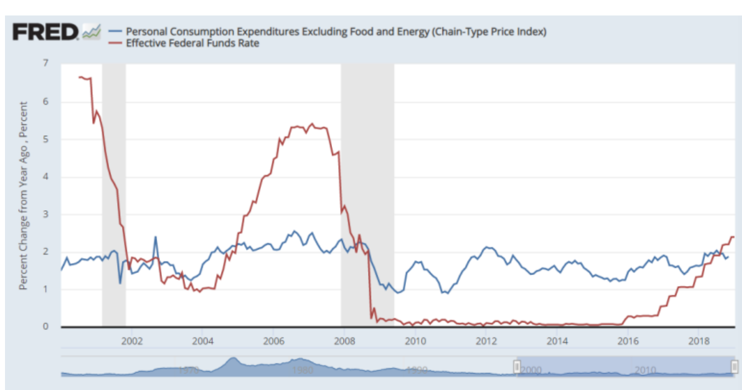
The inflation readings could exacerbate policy makers' recent concerns about weak inflation. Though the Fed raised rates in December by a quarter-percentage point (the fourth increase for the year) officials lowered their forecasts for the PCE price index for 2018 and 2019. While they have signaled a willingness to tolerate PCE prices rising slightly faster than 2% annually, policy makers are likely to be troubled if prices continue to undershoot their target at a time when hiring and spending are strong, and wages are growing.

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 FEDERAL RESERVE:

Negative real interest rates are defined as nominal interest rates that are below the level of inflation. They are usually the product of an aggressive monetary policy stance by a central bank commonly introduced at the height of an economic recession to spur demand via borrowing and reducing the cost of debt financing.

While everyone (except the lender) enjoys the benefits of lower debt financing costs, maintaining interest rates below the level of rising prices causes savers to see their safe rates of return more than eaten away by rising costs. This is not true for corporate America. Such a condition may allow a company to refinance their debt and reduce their overall interest expenses for years in the future thus boosting bottom line profits and being welcomed by the stock market. This condition has prevailed during almost the entire economic recovery from the Great Recession as the chart below of PCE inflation (blue line) and the Fed Funds rate (red line) indicates.



With most of the benefit of negative real rates inuring to the wealthier (greater ownership of financial assets that benefit the most), income inequality increases. Additionally, negative real rates may encourage the misallocation of resources as lower rates may ease the pressure on over leveraged firms to repair their balance sheets while allowing the funding of projects via low cost debt that are sub-optimal. Many even have borrowed to pay their dividends as it is profitable in the short term to do so.

The unemployment rate is currently near a 49 year low of 3.9% with inflation vacillating around 2%. The Fed has arguably achieved its dual mandate of full employment and price stability. With the long run potential growth rate (product of employment and productivity growth) of the U.S. economy estimated to be around 1.9% and the current rate of GDP growth approximating 3%, it is inappropriate for the real federal funds rate to be a crisis-management level of 0% and the majority of FOMC voters agree. The stock market has a different opinion.

We have long been of the view that the markets and economy have become tethered to low interest rates and that removing the easy accommodation of the post Financial Crisis period, would be painful and not like "watching paint dry" as former Federal Reserve Chair Janet Yellen proclaimed in 2017. Nonetheless, we continue to feel that Federal Reserve policy needs to revert to more normal market-determined interest rates and divorce interest rate policy from the stock market. "Asset bubbles have been a far greater source of economic disruption over the past 25 years than any increase in inflation," says Dr. David Kelly of JPMorgan. "While the Fed has kept policy tight enough to restrain general inflation, this has not been enough to slow a too-fast increase in asset prices."

In addition to the nine increases in the Federal Funds rate, we must note the quantitative tightening policy (reversal of QE) has increased to a monthly pace of $50B equating to $600B of balance sheet reduction for all of 2019 from $450B in 2018. The Fed's balance sheet has contracted over 7.7% from levels of late 2018. This is the first contraction since the market bottomed almost a decade ago. This is happening while both the ECB and the Bank of England (BoE) ended their respective QE programs while the Bank of Japan has slowed interventions. The combined central bank balance sheets for the Fed, BoJ, ECB and BoE are now contracting at over a 1% annual rate and may be the primary reason why synchronized global growth transitioned to synchronized global slowing in 2018

Recessions are typically triggered by policy mistakes and the stock market clearly feels that the Federal Reserve is on the road to making one. The policy statement that accompanied the Fed's latest rate hike attempted to allay fears the Fed would tighten too much by acknowledging the economic outlook has diminished and that the balance of risks was now roughly even. For now, chalk one up for the stock market.

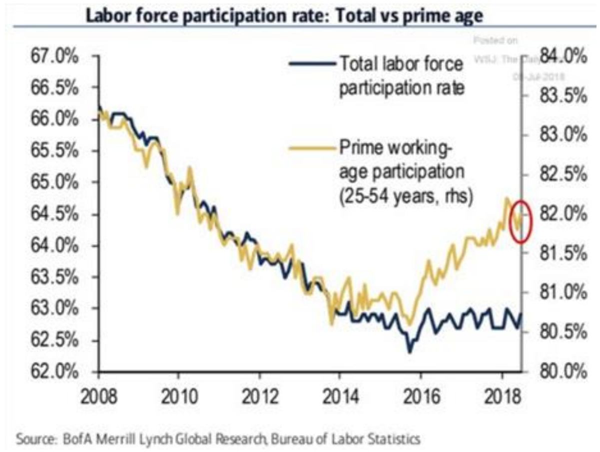
EMPLOYMENT & WAGES:

For many quarters, we have anticipated a deceleration in the pace of job growth as the pool of available labor dwindles, and for many quarters, we have been wrong. In fact, the U.S. job market continued to expand at an accelerating pace as 2018 drew to a close.

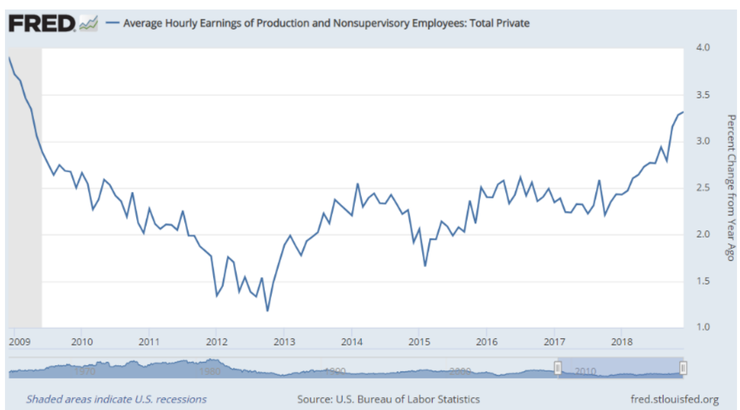
Following a weak November report that appeared to some to be the start of a slowdown, the nonfarm payroll report for December walked back any signs of the labor market cooling. Hiring in December blew out expectations with a gain of 185K, as employers added 312K new jobs. Additionally, previous months' numbers were revised higher by 58K bringing the 3-month average to 254K. The full year pace of 220K jobs per month compares with a 2017 average of 182K and a 2016 average of 195K.

Economists have debated how tight the pool of available labor is in the U.S. as the implications for wage gains are critical in determining Fed policy. With the aging baby boomer cohort having the anticipated effect of decreasing the overall labor force participation rate (see blue line in chart on following page) even after years of strong employment gains, there remains the very real question as to how much slack is truly available in the labor force.

Critical to any analysis in this area is the data on the prime-age (25-54-year-old) labor force participation rate that excludes the impact of demographics found in the overall labor force data. This participation level is now up to 82.4% or within 0.5% of the levels prior to the Great Recession.



Though the unemployment rate did jump to 3.9% from a 49-year low of 3.7%, it was for a great reason - an increase in the labor force. We are finally starting to see Main Street enjoy the benefits of a solid economy and with the drum tight labor force, wages are following suit. The chart below shows wage gains are now up to 3.3%y/y and are accelerating as the 3-month annualized increase is now 4.0%.

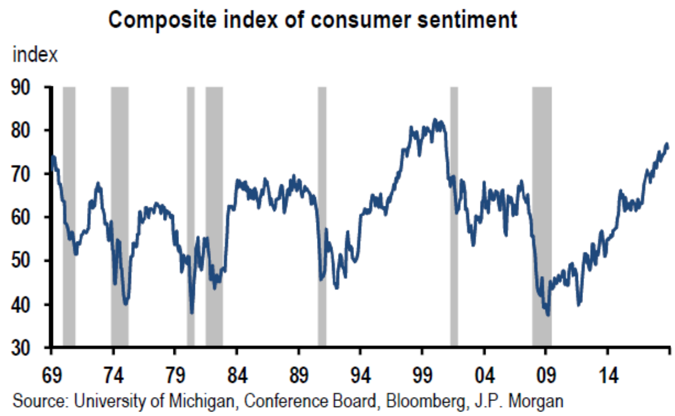


We expect hiring to slow to an average of around 150,000 jobs per month alongside our expected moderation in overall economic growth in 2019. In addition to the structural concerns of historically slow growth in the labor force, we are seeing deteriorating sentiment readings on employment in the corporate sector in both the ISM Manufacturing and Services data. Tepid labor force growth may still push the unemployment rate down further as hiring still exceeds labor force growth and we would not be surprised to see a new cycle low in the unemployment rate by the end of the year. The good news for Main Street should continue as we expect wage growth to strengthen further.

CONSUMER:

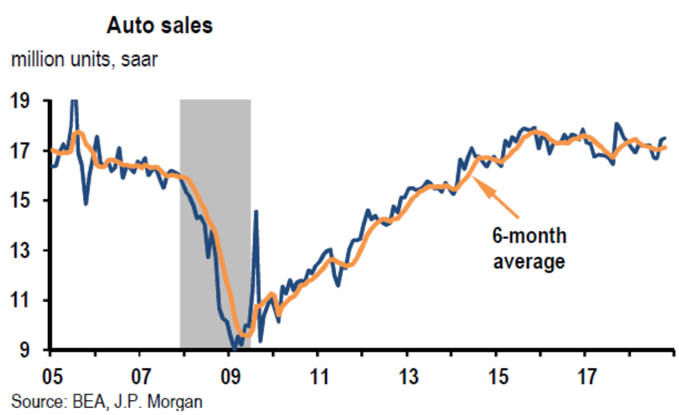
Following very strong readings on consumption during the 2Q and 3Q periods averaging over 3.6%a/r, real consumer spending appears on track to grow about 2.8% for full year 2018 modestly higher than 2017. As consumers received a substantial income boost from the tax cuts that took effect early this year, merely maintaining a similar rate of growth suggests that other drivers of spending have softened since last year, and it is unclear how much the disposable income boost from the tax cuts has translated into increased consumer spending.

One of the distinctive characteristics of the economy during the current administration has been the elevation of the animal spirits apparent in both business sentiment readings and especially consumer confidence levels that have moved to the highest readings since 2000. Unlike some of the signs of softening we have seen in the business sentiment indicators, consumers appear to remain quite optimistic as we look ahead despite recent declines in equity markets. The chart below combines the readings on both the University of Michigan Sentiment survey and the Consumer Confidence readings from the Conference Board and shows that the composite measure of consumer sentiment remains near the highest levels on record with only a slight tick down from recent peaks.



Even so, financial conditions do still matter for the household sector. Mortgage and credit card borrowing rates are already at their highest levels in five years or more. Given that GDP is roughly 68% consumption, deterioration in economic confidence is a hugely important factor, and we will be focused on this area. Rising interest rates which bite into discretionary cash flows, falling house and stock prices, and job losses weigh heavily on spending decisions by consumers.

We have seen growth slowing in the most interest sensitive sectors of the economy. Smoothing through the monthly noise, the six-month average rate of auto sales reached its peak in late 2015 and has drifted down on net since then (see chart below).

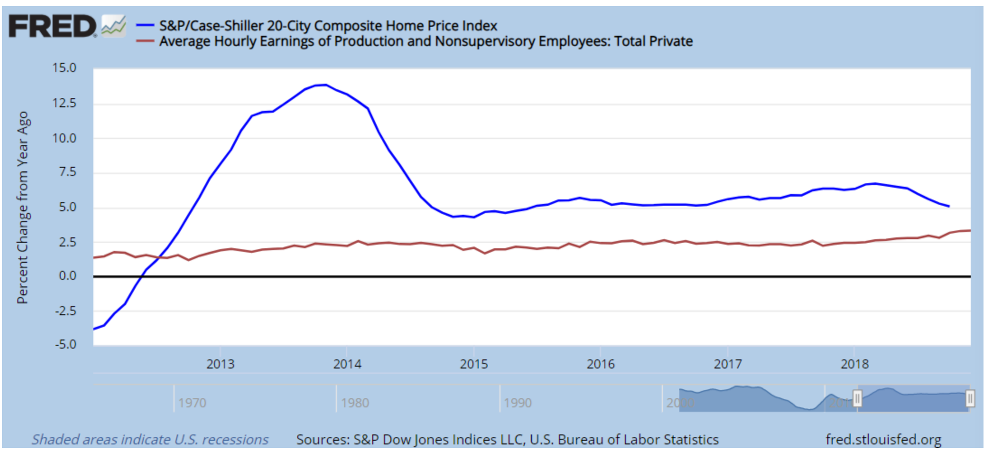


We feel the tax cuts likely provided a modest boost to spending and the largest growth impact from the tax cuts is likely behind us suggesting less support from this source as we enter 2019. Though we expect wage growth to remain strong and job growth to slow, we look for consumer spending to moderate from the levels of the last two years. Waning fiscal stimulus and tightening financial conditions lead us to lower our view of real consumption down to the 2.25% level.

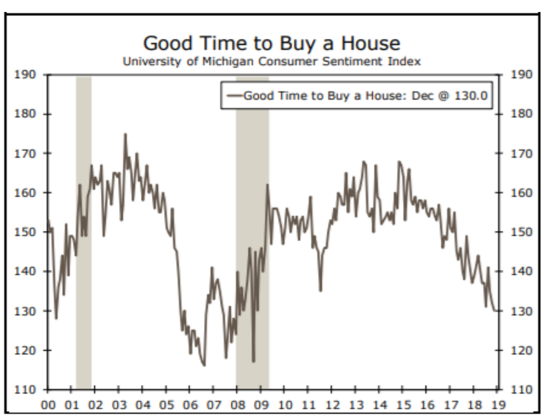
HOUSING:

We have noted for many quarters the peaking and rolling over of housing data at a time when traditional drivers of demand such as wages and employment have been accelerating. Higher steel tariffs, municipal impact fees, the dearth of buildable lots, and delays in securing building permits have all contributed to rising building costs. Additionally, the especially tight construction labor market – in which the jobless rate is near a half-century low – is also weighing on home building costs by boosting construction sector wage growth, which has been outpacing overall average hourly earnings growth since mid-2017. The confluence of these factors clearly led to a slowdown in housing starts and a paucity of available inventory for new home buyers.

This lack of inventory, in turn, engendered house price appreciation averaging about 6% per year during the recovery far outpacing wage gains of around 2.5% per year (see chart below). Despite these headwinds, very low mortgage rates averaging around 3.8% for the three years ending in 2017, still made housing affordable for many. With average mortgage rates rising throughout 2018 to near 5% before receding back to 4.5%, affordability has become an increasing concern and recently accelerating wage gains are still not keeping up.



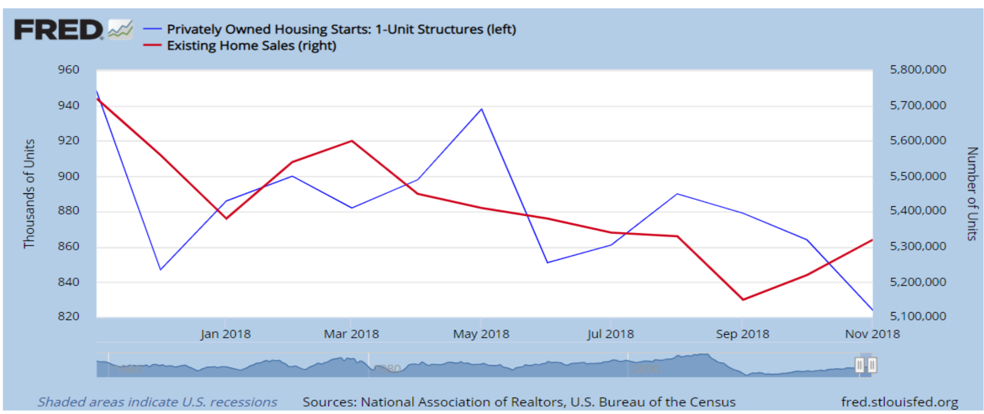
For illustration, imagine a young couple looking to buy the median price house of around $267K only two years ago at the then prevailing conventional mortgage rate of about 3.8%. With a 20% down payment the cost of servicing the mortgage (excluding taxes) would have been about $995 per month. With housing prices increasing about 6% annually during the recovery, the same house would now be worth around $300K. Even with the recent decline in mortgage rates to about 4.5%, the cost to finance an 80% loan to value mortgage would be $1,216 per month, an increase of over 22%. It is no wonder that the proportion of consumers stating now is a good time to buy a home in the University of Michigan's Survey of Consumer Sentiment survey has fallen 25 points since April 2017 (see chart below from Wells Fargo).



While many analysts have pointed to supply and affordability as the causes, perhaps there are secular and not just cyclical aspects to the slowing of home ownership. Household formation has been slow in this recovery as many younger households deferred marriage to start careers and pay down higher levels of student debt than prior generations. Indeed, according to the Pew Research Center the average age for first marriages for both men and women has increased five years since 1980.

In addition, the geography of residential development has reversed from builders pushing further into the suburbs to a shift towards central business districts. Part of this may be due to the increased costs of building noted above but also reflects traditional suburban benefits disappearing. Shopping centers and suburban office development have been restrained during this cycle due mainly to changing shopping habits (online) and the fact that most high-paying information-age jobs are closer to the urban districts. These urban economies are growing much faster than the national average and this demand has pushed housing prices much higher. This keeps younger generations in the rental market longer than prior generations.

As the chart below indicates, single family housing starts have declined -8.8% while existing home sales have dropped -7.7% in the 12-month period ending in November. Residential fixed investment has been a detractor from GDP growth in each of the last three quarters. It is not surprising to see that the National Association of Home Builders (NAHB) survey has dropped from a cycle high of 70 in May to 56 in the most recent December reading of sentiment.



With home price appreciation expected to slow further towards a 4% annual rate in the new year and mortgage rates to remain more stable, we expect the housing declines to be arrested but are not expecting a strong contribution to overall GDP.

INTERNATIONAL:

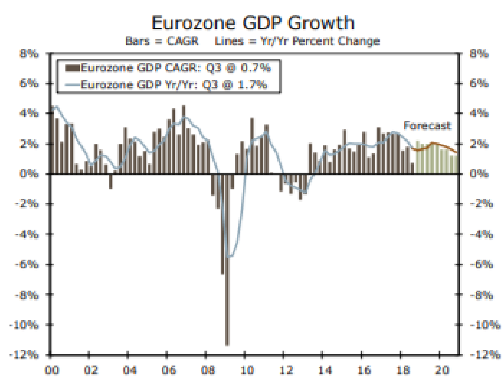
The global economy enters the new year amidst rising concerns of slowing economic growth, and the primary concern will still center around China's declining economy and the high stakes for the U.S.-China trade talks. Political developments continue to focus on the uncertainty in resolving the Brexit withdrawal from the European Union, the deteriorating fiscal and banking situation in Italy and the recent political turmoil in France and on the Eurozone's eastern border, in addition to a dangerous escalation of tensions between Russia and Ukraine. This uncertainty comes as foreign central banks are slowly removing liquidity in following the lead of the Federal Reserve.

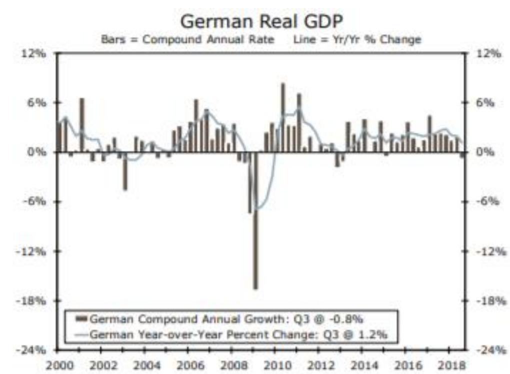
While the Federal Reserve is long into the normalization of monetary policy, central banks in the Eurozone, Japan and United Kingdom have lagged this process in recent years. The European Central Bank and Bank of Japan have not yet begun the process of interest rate normalization, with the ECB signaling its first rate hike will likely come during the second half of 2019. Meanwhile, the BoJ has not signaled any intention of a cycle of short-term policy rate increases any time soon. The Bank of England has been saddled by Brexit concerns since mid-2016, which led the central bank to cut rates 0.25% in the immediate aftermath, while it has raised its policy rate only 0.50% since then to 0.75%.

Collectively, we are concerned that most developed economies generally have limited policy capacity to fight the next recession and stimulate economic growth. This is particularly true for central banks, many of which have only just begun the process of monetary policy normalization and are, in general, less well equipped at present to ease policy compared to their level of preparedness before the 2008 crisis. While this may suggest more reliance on fiscal policy during the next downturn, we are not confident of coalitions in this area. Monetary leaders may return to the aggressive measures of low or negative interest rates and re-emergence of unconventional measures such as QE. This lather, rinse, repeat policy playbook does not engender confidence and may leave the global economy more vulnerable in the case of a global downturn.

EUROZONE:

Following a strong economic performance in 2017 where GDP firmed steadily with a 2.8% growth rate peak registered in 3Q, recent economic reports from the 18-member Eurozone (EZ) are more sobering. Clearly, the EZ has slowed with credit concerns in the emerging markets and the slowdown in China having negative consequences. The most recent print for 3Q 2018 depicted an economy now growing at only a 1.7% pace year-over-year (y/y) with the 3Q reading annualizing at only a 0.7% rate of growth (chart below left from Wells Fargo). In fact, third quarter economic output in Germany, the largest economy in the Eurozone, contracted for the first time in more than four years (chart below right from Wells Fargo) while Italy, the EZ's third largest economy, also receded.





A generally slower global growth environment has given businesses fewer incentives to ramp up production amid ongoing political and trade uncertainties and this has manifested itself in weak industrial production figures and slowing export growth.

Though the 3Q GDP release showed consumer spending at a tepid pace, consumers appear to still be well positioned. The labor market continues to improve, with the unemployment rate sitting at a 10-year low of 7.9% in November. At the same time, stronger wage growth has finally begun to materialize. Recently released data showed that wages rose at their fastest pace of the current expansion in 3Q, with compensation per employee up 2.5%y/y. Relatively low inflation has also likely supported consumers' purchasing power, and consumers have likely been buoyed by interest rates that remain at historic lows.

A major concern in the EZ continues to be centered in the banking sector that is currently priced at a 40% discount to stated book value. Credit default swaps (insurance against the risk of loss) on these institutions have doubled in cost in 2018. Unlike their U.S. counterparts, the European banks never did recapitalize and were not prepared for negative interest rates. This instability in a critical economic foundation adds heightened risk to our outlook.

With Germany reporting recession-like industrial production (now -4.7% y/y) and factory orders, we see rising risk of another quarter of contraction. This increases our concern for overall Eurozone growth in 2019 and we now expect further slowing towards 1.25% in 2019.

UK:

Our long-held skepticism on the successful execution of Brexit may be growing. Recently, Prime Minister Theresa May has been touring European capitals in an attempt to renegotiate her Brexit deal with the European Union (EU) after she canceled a parliamentary vote, which would have taken place right after Christmas. To some, Brexit should have been the most predictable of all the 2019 geopolitical events as we have known for two years that the UK is scheduled to leave the EU on March 29, 2019. However, May continues to face formidable obstacles in getting assurances from the EU that might be palatable to her needed parliamentary backing. Negotiations will be in flux until the deadline approaches.

As we approach the deadline, the likelihood of Britain changing course and deciding to stay in the EU is becoming a greater probability as on January 15th, the UK Parliament is expected to reject the current withdrawal deal. At that point, the options for May become challenging. A split from the EU with no deal might engender a 2008-like economic crisis or she could do an about face and allow a new popular vote that might reverse Brexit.

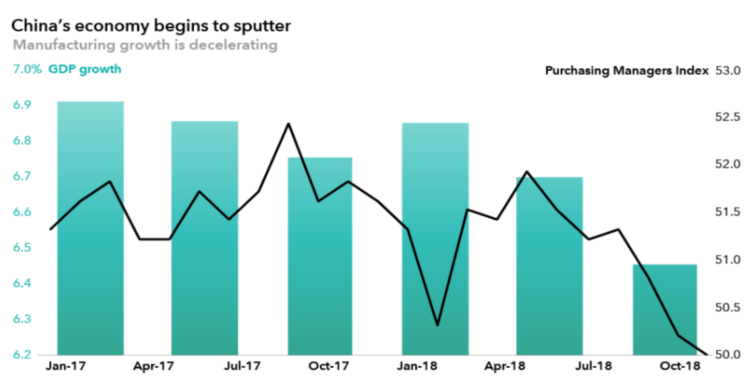
CHINA:

2018 was a year marked by US-China confrontation over technology and trade. For China, the episode exposed a glaring vulnerability in the long game played by President Xi. Despite ambitions to turn his country into a high-tech superpower, Xi and China are still dependent on US exports and technological expertise and innovation. Xi is now more determined than ever to break that dependence. President Trump and the China hawks around him may be feeling emboldened about their own leverage. The question may be how far they intend on going to exert that leverage. That's crucial for how the world's most important fight plays out.

Moreover, the trade dispute is complicating Beijing's multiyear plan focused on quality of growth, reducing debt and curbing risks in parts of its economy. China's economy is still growing 6.5% annualized, according to the most recent government figures but few express confidence in the accuracy of the data.

Most economists estimate the rate of growth of China's economy to be lower than the published figure referenced above and feel the deceleration in growth is having a further dampening effect on other areas of the global economy such as Europe and the emerging markets. Credit growth is slowing, the housing market is softening after several years of robust growth and the manufacturing sector is decelerating. Consumer confidence also is off its highs, reflecting some nervousness within China over how Beijing will respond to the U.S. over trade.

Another data point reflecting a further slowing was released by the Chinese government in the first few days of January as the manufacturing PMI fell to 49.4 (see chart below from Thomson Reuters). This represents the weakest reading since early 2016 and the first outright contraction (a reading of 50 is the demarcation between expansion and contraction).



Subsequent to this soft release, Chinese authorities announced a 100-bp cut in the reserve requirement ratio (RRR) for major banks to 13.5%, a move which follows 250 bps worth of RRR cuts and other easing measures from China in 2018. While the government and the People's Bank of China have promised additional stimulus measures to support growth, escalating trade tensions with the U.S. may start to have more material impacts on the Chinese economy in 2019 and offset any new policy accommodation from authorities. As China's economy continues to show signs of slowing, the stakes remain high for ongoing U.S.-China trade talks. As a reminder, if a deal is not reached by March 1, U.S. President Trump has threatened to raise tariffs from 10% to 25% on $200B of additional Chinese goods. Analyst estimates indicate this scenario may cut another 0.8%-1.0% off China GDP growth, which could have large implications for global activity.

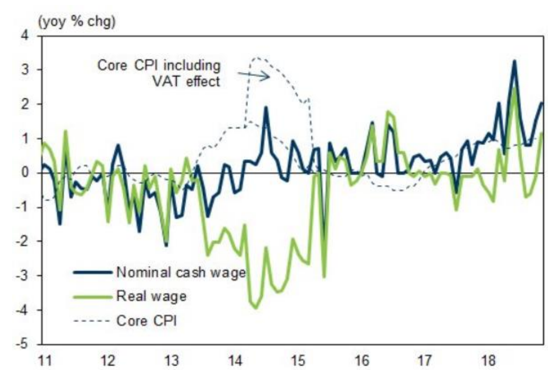
JAPAN:

Following eight consecutive quarters of flat to expanding growth and a full year 2017 GDP growth rate of 1.7%, Japan fell back in the third quarter of the year. Though growth in the 2Q period was 3.0% a/r (the fastest since 2016), Japan was hit by several natural disasters over its summer, including one of the country's worst floods in decades, an earthquake and a deadly typhoon that disrupted factories and domestic spending. Due largely to these, Japan's economy contracted at a larger than expected annual rate of -2.5% in 3Q.

Demographics and deflation continue to represent the most critical challenges for Prime Minister Shinzo Abe. Perversely, the stability engendered in the economy characterized by the current long expansion, has led to a deepening shortage of labor. The dependency ratio is a measure of the amount of a population below the age of 14 and above the age of 65 to the working age population between 15-64. A higher ratio illustrates the extra burden placed on working age citizens to support those outside the workforce. At 47%, Japan has the highest ratio among G20 nations and by 2050, this ratio is projected to explode to 77%.

In addressing this challenge, Abe continues in his efforts to change the culture by focusing on the growth of women and immigrants in the labor force. Japan's unemployment rate fell to 2.4% in January, the lowest in over 24 years, and job availability remained at a four-decade high illustrating that increasing the supply of labor is critical. This has resulted in a focus on immigration where laws have been relaxed with the Japanese government loosening the rules for becoming a permanent resident of Japan. Recently the Diet (Japan's legislature) passed laws designed to increase foreign workers. Though immigrants currently make up less than 2% of the total population, the group grew by 150,000 in 2017, and the new law is expected to increase the foreign worker ratio to 3% by 2023 helping counterbalance the aging demographics of the country.

Companies are facing intensifying competition to secure workers in this economy and this tightness in the job market may finally be translating into robust wage growth. November saw regular base pay in Japan rise by 1.6%y/y, the fastest pace of gains since 1997 (chart below from Zero Hedge) and possibly removing the headache for policymakers grappling with pulling the economy out of deflation. With inflation low, real wage gains are finally occurring and strength in domestic consumption is seen as vital to maintaining the recent growth momentum. The expected implementation of an increase in Japan's consumption tax from 8% to 10% in the second half of 2019 represents another headwind to this positive development. Unless consumption increases, we anticipate GDP growth in 2019 to approximate the 1% growth rate of 2018.



EMERGING MARKETS:

Globalization has been the key process that has lifted emerging markets over the last quarter century. Trade clashes between the U.S. and China along with the U.S moving towards a more protectionist policy has placed major tension on this thesis. With many analysts fearing potential panic and contagion in this region caused by debt levels that have grown substantially since the financial crisis, fears of the impact of a strong dollar are pronounced.

Much of emerging market debt is denominated in the dollar. A rise in the dollar means it costs more in local currency to pay back these debts. When the dollar appreciates, foreign central banks (particularly emerging economy central banks) tend to lean against local currency weakness by tightening policy. When the dollar declines, the opposite is usually the case. Hence, the close inverse correlation between the dollar, commodity prices and emerging market risk assets. After financial crises in Latin America in the 1980s and Asia in the 1990s, emerging market governments drastically reduced their foreign currency borrowing denominating an increasing amount of their debt in local currencies to ameliorate this concern. Still, increased stress in emerging markets is evident when the U.S. dollar rises. The chart below from FactSet shows about an 8% increase in the trade-weighted dollar from early February until the end of the year coinciding with emerging market stock market weakness of almost 25% over the same timeframe.

Largely due to the continued slowdown in China, the growth outlook in emerging economies has weakened slightly in the past two quarters. We now look for emerging markets GDP growth to ease towards 4% in 2019 from an expected final growth rate of 4.6% in 2018. Although there are idiosyncratic cases of acute weakness (Turkey and Argentina come to mind), the moderation in growth is broad based across regions. However, we expect GDP and final demand growth in developed markets to remain strong, which should support activity in emerging markets, trade disputes notwithstanding.

The feedback of weaker emerging market economic conditions back into the United States and the rest of the developed world may act as a catalyst to future growth and improved market returns. Sensitivity of central bankers (particularly the Federal Reserve) to the potential contagion of weak developing economies is likely to increase the probability of a pause in the monetary tightening process. This will likely allow developing economies equity markets to rally (perhaps powerfully) as this pause would likely cause a weakening in the U.S. dollar. A recovery in China would be an additional benefit but we are not optimistic of that outcome.

MARKETS:

Following one of the most benign investing environments in recent memory in 2017, volatility returned with a vengeance in 2018 owing to a slowing global economy, a more aggressive Federal Reserve and mounting geopolitical and trade tensions. The signing of the Tax Cuts and Jobs Act built on an already growing economy and investor optimism about the Trump administration's deregulatory instincts to bolster market sentiment at the start of 2018. The rally that greeted the new tax legislation was short lived, ending by late January with the first 10% correction since 2015 and only the second in the last seven years.

U.S. markets picked up steam again as the strength of earnings and buyback spending became clear. After retesting the early February lows, the S&P 500 roared ahead over 12% to set new highs as we ended 3Q. Meanwhile, a strong U.S. dollar along with reduced global policy accommodation and increasing interest rates combined with heightened trade tensions to negatively impact international markets. A bear market in international equities bottomed a full 23% lower than levels reached in late January.

It was with that backdrop that we headed our 3Q commentary with the following quote from Alan Greenspan from 1998, *"Moreover, it is just not credible that the United States can remain an oasis of prosperity unaffected by a world that is experiencing greatly increased stress."*

What changed the mood? In part, the administration's trade policy. In March, tariffs on imported steel and aluminum went into effect, delighting domestic steelmakers but leaving manufacturers of everything from washing machines to cars counting the cost. From June onwards, the administration ratcheted up penalties on a host of Chinese imports, prompting price rises and sweeping reviews of supply chains. The mood swings were visible from the Business Roundtable's quarterly survey of CEO confidence. Its index of sales projections and hiring and investment plans jumped 21.8 points in the first quarter of the year to 118.6, its highest level since the survey began in 2002. Executives' confidence peaked in February, however, with the index losing half of that gain by the fourth quarter (see chart below).

The hit to CEO confidence and disruption of supply chains combined to restrain business spending and, perhaps, clarify to many investors that the capex boom expected by the new tax laws would not be forthcoming. Without the hoped for increases to productivity and enhanced job growth, investors turned towards 2019 with a greater concern of a slowdown and deceleration in earnings growth.

With the tailwind of major corporate tax cuts, earnings growth in 2018 dramatically exceeded our and analyst expectations with the first three quarters showing earnings increases of over 25% in aggregate with top line revenue growth of over 8%. With our view that GDP will slow towards 2% and inflation staying contained also around 2%, nominal GDP growth should approximate 4%. In such an environment, we foresee revenue growth slowing to the 4%-5% area. With the lagged impact of the strong dollar, rising wages and input costs, margins that have been at all-time highs should recede and slow earnings growth.

In December, according to data from FactSet, analysts cut their earnings forecasts for 2019 on more than half the companies in the S&P 500, the first time that has happened in two years. For now, analysts still expect profits to keep growing in the coming year, but at a slower pace. They expect earnings for S&P 500 companies to grow 7.8% in 2019, down from their forecast of 10.1% at the end of September. With the anniversary of the tough comparisons from the boost to profits from the tax cuts, we are less sanguine and look for earnings growth to slow to the 3%-5% range that characterized the period from 2012-2016 that averaged 3.2% EPS growth.

Gains enjoyed in the opening three quarters for the major averages were more than wiped out in an ugly final quarter. The S&P 500 declined -13.5% to finish the year with the first loss since 2008 at -4.4%. The tech-laden Nasdaq Composite suffered through a -17.5% quarter to close the year in the red at -3.9%. The Russell 2000 index of small cap companies fared even more poorly with a -20.2% correction in the quarter alone to complete the year with a loss of -11%.

As noted before, foreign markets were more challenged with losses that were more centered in the first three quarters of the year. The MSCI EAFE index of developed country markets declined -12.5% during 4Q and -13.8% for 2018 while the MSCI Emerging Markets index surprisingly fared better during the quarter with a loss of only -7.5% to finish the year -14.6%.

After starting 2018 at a yield of 2.43%, the 10-year U.S. Treasury bond rose to 3.25% in early October before reversing as a proverbial flight to safety trade lifted bond prices and drove the yield back down to close the year at 2.68%. The credit space was more challenged as historically low spreads (whereby lower credit bond yield differentials are slim compared to riskless treasuries) widened dramatically in the final quarter as concerns for a downturn heightened. For the year both high grade and low-grade bonds finished with modest declines.

Though at a varied pace, global central banks will continue the process of removing liquidity from the system alongside escalating geopolitical tensions and potential trade wars. Investors should continue to expect high levels of market volatility. At Coho Partners our focus continues to be on downside protection. We seek to provide this from the construction of 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 Wayne

Rick S. Wayne, CFA

Eric M. Hildenbrand, CFA

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