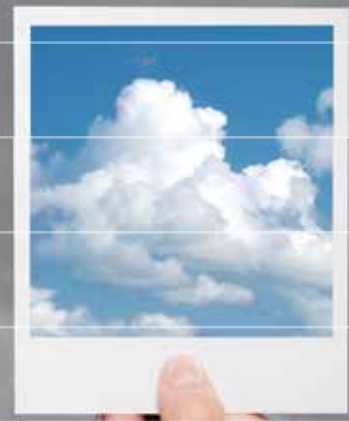


PERSPECTIVE



SEPTEMBER 2019

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ECONOMIC AND INVESTMENT OUTLOOK

We See Smoke, but Is There Fire?

A quick survey around the global policy mix reveals a lot about the way markets have behaved this year. There has been a pronounced and unexpected increase in uncertainty around trade and global growth. With US and China trade tensions approaching a one-year anniversary earlier this summer, investors, and the public more generally, may have hoped to be celebrating a conclusion to trade negotiations by now.

Instead, a new round of tariffs announced on August 1 directed at consumer goods generated headlines that President Trump may have finally gone too far, reducing his political goodwill with those close to him. The tension between the two economic powerhouses may finally be bleeding into slowing global trade data and weakening growth. Throw in monetary policy, which has at times been stubbornly hawkish, and you

have the recipe for heightened volatility in financial markets.

Despite this backdrop, it might be surprising to realize that the S&P 500 is essentially flat since the end of the third quarter of 2018 thanks to a strong start this year. What this emphasizes is that the past 12 months have been a bumpy ride, characterized by frequent spikes of volatility and two notable periods of severe downside moves. It has been extraordinarily challenging for market participants to assess this fluid and uncertain global economic and policy environment.

View from the Interest Rate Complex

The same characterization cannot be applied to global bond markets, where the interest rate complex has seen yields decline precipitously and persistently over the past year. The magnitude of the move is nothing short of astonishing. Over the past year, the 10-year US Treasury has actually declined by more

(continued on next page)

than its current level, shaving 175% in yield to fall below 1.50% at the time of this writing.

Unrelenting demand for income and safety has led to bonds outperforming equities during this period. Moreover, the rally has resulted in many bond markets with negative yields, exacerbating an issue which has plagued markets for years now. An accounting of sovereign bond yields globally shows that issues with negative yields have doubled to over \$17 trillion.

Low absolute yields are nothing new in the post-Great Financial Crisis period, but 10-years in, one must wonder what interest rates are telling us. The global bond market is the largest and deepest capital market and represents the best barometer for the health of the global economy. Global central banks' foray into unconventional monetary policy and ensuing asset purchase programs in the wake of the financial crisis left banks with historically bloated balance sheets and helped drive rates artificially lower. In an environment where the search for yield-producing assets has increased, we must therefore strive to appreciate and understand the acute changes in fixed income markets.

How Did We Get Here?

It was not supposed to go like this. After a decade of near-zero interest rates, we believed the Federal Reserve, along with other global central banks, had embarked on a course to normalize monetary policy.

The Federal Funds rate was expected to keep rising as inflation slowly returned to its 2% target. The income was back in fixed income and investors were adjusting to cash as an interest-generating portfolio allocation.

This narrative was derailed this year as 2019 brought capitulation across the global fixed income complex. Rather than normalizing to the upside, global yields have plummeted dramatically, leaving the US Treasury market now as one of the few positive-yielding developed markets.

What Bond Markets Are Telling Us: Our Framework

Globalization has decreased the ability to look at markets through one lens, leaving us to decompose the various aspects that have contributed to the current environment through a more holistic framework, as follows:

- **Slow Economic Growth**

Growth prospects have clearly taken a turn for the worse, both domestically and internationally. Looking back to 2018, it looked like the US was primed to accelerate on the heels of expansionary fiscal policy and resynchronized global growth. To the contrary, the stimulus measures now appear to have provided only a one-time boost and the promise of animal spirits percolating through the economy has evaporated. Now, businesses are left with shaky confidence and a reluctance to make

meaningful capital investments under the overhanging cloud of trade policy uncertainty. 2018's GDP growth of 3% looks more like an outlier, and a return to the muddle-through 2% range to which we have become accustomed since 2008 leaves us in reluctantly familiar territory.

- **Looser Monetary Policy**

Abroad, a sluggish growth backdrop and tangible risk of recession has made it impossible for central banks to normalize policy. By necessity, monetary policy will remain accommodative relative to history, and there is no clear path to higher rates anytime soon. Investors have priced this belief into markets, as evidenced by the German yield curve being entirely in negative-yielding territory (CHART 1).

- **Low Inflation**

As US inflation continues to fall short of the Fed's 2% target, we wonder if lower inflation is here to stay. Lower inflation expectations are reflected in fixed income markets via lower rates, and more specifically can be implied from forward markets where inflation expectations, even five years in the future, are still below the 2% threshold. Global inflation trends, just like growth, have been even more challenged abroad. There is no better poster child than Japan, which has battled with weak inflation for the better part of two decades.

- **Flat Yield Curve**

Few finance topics have garnered more attention in 2019 than the state of the yield curve. Treasury yields have collapsed as investors tried to front-run anticipated Fed rate cuts, fueling Treasury returns in excess of the S&P 500 on both a year-to-date and one-year basis.

The 2-year/10-year part of the yield curve briefly inverted, flashing a well-studied and well-known recession warning. We believe flat yield curves and periods of inversion are likely here to stay and may increase in frequency given the proximity to the zero-boundary. This is especially so given the persistence of lower inflation, both in the US and internationally.

- **Demand for Yield and Safe Assets**

Another dynamic worth focusing on is the technical backdrop with fund flows. The years following the financial

crisis saw massive flows into bond mutual funds and ETFs as investors sought safety and income. The widely held expectation, known as the ‘Great Rotation,’ was that this condition would eventually reverse when the economy recovered. But fund flows have yet to subside, and the persistent buying of bonds has been a major factor in keeping interest rates subdued (CHART 2).

To that end, US Treasuries remain the largest, most liquid safe asset in the world, but they are not alone. To opportunistic global investors constantly seeking yield, Treasuries—even at historically low yields—offer an obvious advantage to negative yields seen in other traditional safe-haven assets like German bunds and Japanese government bonds. This illustrates an important tenet of markets today; they are indeed more global than ever.

- **Graying Demographics**

As the global population ages, there is an increasing number of savers boosting demand for safe-haven and income-producing assets like government debt. In the US, demographics have consistently looked better than the rest of the developed world, but this was predicated on immigration-led growth. As voices espousing a more nativist populism have grown in strength, the ability to see demographics as a driver of higher potential growth in the US has waned. This has led to increasing demand for fixed income instruments, combined with a weaker growth backdrop, lowering yields.

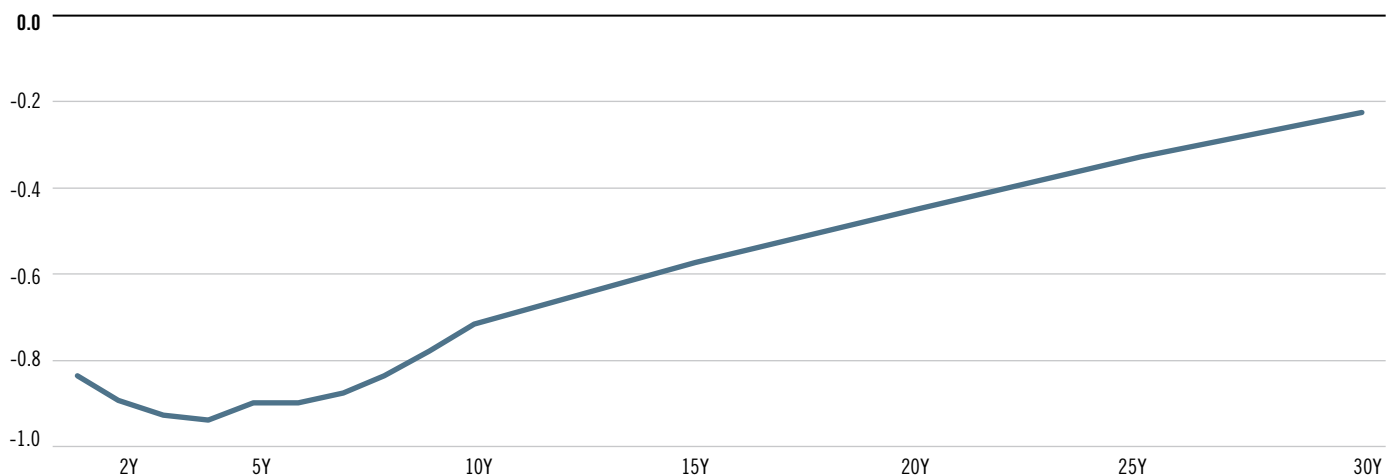
Our View: We Are Mindful of Warning Signals, but Do Not See an Imminent Recession

Left with such stark signals from bond markets, one may endeavor to make

CHART 1:

The Entire German Yield Curve Is Negative

German yield curve on August 28, 2019



Source: Bloomberg.

sense of it all. But making inferences from today's market based on historical observations is increasingly challenging. Never in history have we seen trillions of dollars of negative-yielding debt. Never in history have central banks accumulated such vast balance sheets.

In the past, we have taken a yield curve inversion as a signal for an impending recession, but now we need to appreciate the complexity of this environment and employ a multi-dimensional framework. Market signals need to be assessed in the context of a highly complex, interconnected global financial system. Central banks cannot conduct monetary policy in a vacuum and investors should not consider assets in isolation.

As we think about debt markets today, we believe that global interest rates have been driven by the confluence of individual factors we highlighted. Aggregated through our framework,

we are left to digest slowing growth, constantly evolving monetary policy, deflationary technological advancements, seemingly unending flows into bond funds, an inverted yield curve, a globally interconnected rate complex and an aging population. In our view, these factors are not only operating in tandem, but are more permanent in nature. We refer to this as bond market capitulation, meaning bond investors now universally acknowledge that real rates at or below zero are warranted. Given this collective view, we would expect a period of low or modest market returns going forward.

While we continue to view the yield curve through our lens—which is to say we do not necessarily see an imminent recession—we are mindful of the warning signal given by yield curve inversion. Obviously, only time will tell if we can continue “muddle-through” economic growth or if a recession is looming, but

we believe it is the former environment that persists. However, given the implications of what is unfolding in the global interest rate complex, we continue to monitor both global financial markets and underlying economies for clues.



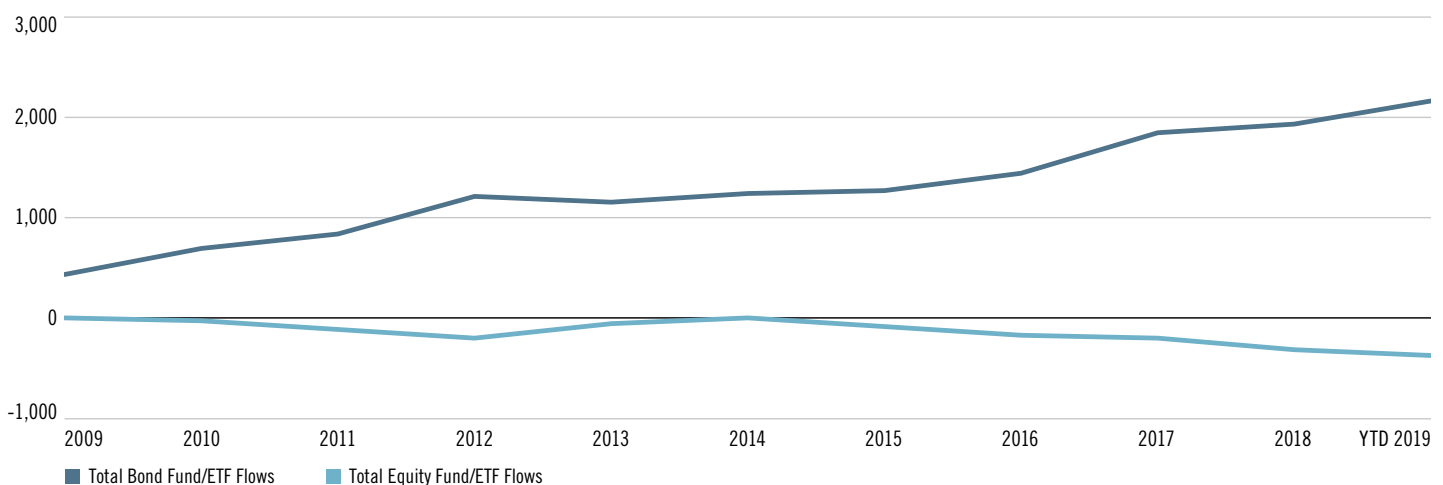
RONALD J. SANCHEZ, CFA®
Chief Investment Officer
September 1, 2019

Kyle Baker, Senior Investment Associate, and Douglas Tommasone, Senior Portfolio Manager, contributed to this report.

CHART 2:

Investors Continue to Favor Bond Holdings Over Equities, a Major Factor in Keeping Interest Rates Subdued

Bond mutual fund/ETF flows versus US equity mutual fund/ETF flows (USD, Billions)



Source: Bloomberg.

Adopting a Cautious Stance

Uncertainty Remains as Fundamentals Deteriorate

The escalation in trade policy and growing uncertainty around monetary policy has increased the potential for downside surprises. This, coupled with signals from markets such as yield curve inversions, has led us to reduce portfolio risk and adopt a more cautious stance toward global equity markets.

US Equities: Weakening Growth Outlook

We recently reduced our exposure to US equities to underweight. Though earnings have been coming in better than expectations, they have slowed from 2018. We believe continued trade uncertainty could weigh on third and fourth quarter earnings estimates. While the consumption and service portion of the economy have held up, weak manufacturing poses a headwind and may create a negative spillover effect.

International Developed Markets: Limited Growth

We recently recommended an underweight position in international large-cap equities. Continued trade uncertainty weighs on these markets as they are more exposed to global trade and manufacturing weakness. We believe growth opportunities may be limited, especially as investors worry about the limits of monetary policy in these regions to boost growth.

Emerging Markets: A Neutral Stance

We maintain our neutral positioning to emerging market equities. Though policymakers continue to promote new measures to support growth, currency weakness has led to tighter financial conditions for most emerging market economies, offsetting some of the stimulus measures that were implemented.

Fixed Income: Lower Rates

Interest rates have plummeted around the globe driven by fears of a global recession and heightened risks around trade policy. Central banks globally have made a renewed push toward more accommodative policies but doubts about the economic and policy backdrop have led to heavy demand for bonds. This demand caused a record amount of sovereign bonds to drop into negative-yield territory. We believe the potential for a move higher in longer maturity rates still exists, especially in the US, but rising downside risks and uncertainty are weighing on the near-term outlook.

Cash: Maintaining Nimbleness

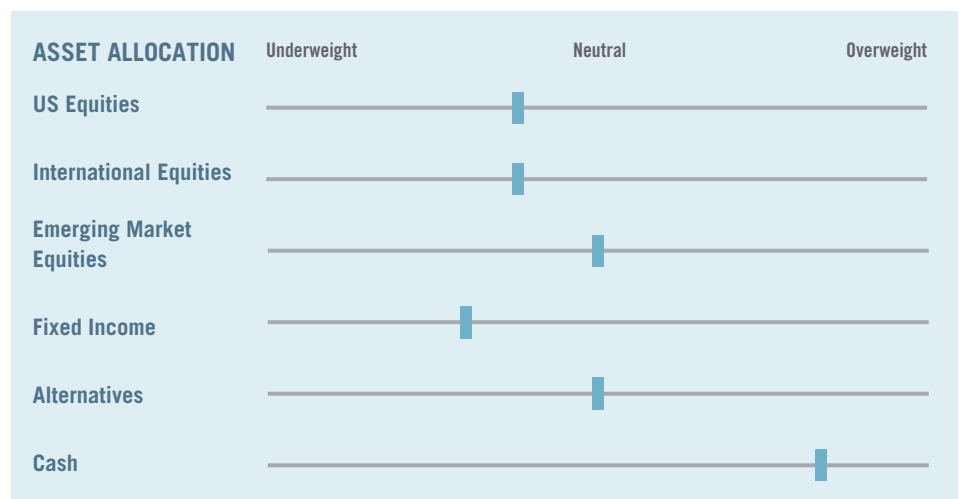
We have increased our overweight allocation to cash as we look to preserve capital and to have cash on hand to take advantage of potential market opportunities presented by increased volatility.

Alternative Investments: A Hedge Against Volatility

We continue to recommend a strategic allocation to alternative investments for their potential for downside protection, broader diversification and better risk-adjusted returns.



VIRAJ B. PATEL,
CFA®, FRM®, CAIA
Head of Asset Allocation



Strengthening Client Experiences: From Conference Rooms to Living Rooms



Rod Sayegh, Head of Digital Strategy, shares his perspective on modern digital experiences and how technology can help investors gain greater control of their financial lives.

Q: How is digital innovation providing investors with greater control over their finances?

Rod: I believe information is power, and digital brings that information to investors in real time and in an easy-to-digest format. With more knowledge comes the power to control your finances better and ultimately gain control of where you want to go in life from a financial perspective.

Consider this: Do you know exactly how much you spend in any given year? It is common for people's best guesses to be off by 10% or 15%—or more. In fact, investor surveys show only about one fourth of clients discuss their savings strategies with their wealth manager, let alone with their spouse or significant other, and they often struggle to understand how much and when to save. Since financial planning conversations usually begin with determining how

much wealth you expect to need in retirement, how can anyone answer that question if they don't have their current financial picture in front of them?

Gaining control of your financial well-being starts with having your financial information at your fingertips and being able to surface that information how and when you need it.

Q: How can clients take advantage of both the high-tech and high-touch aspects of their relationship with us?

Rod: High-tech and high-touch are not independent of each other—you can still have high-touch in high-tech, and you can still have high-tech in a high-touch business. People often separate those two, but I believe integrating them leads to the ability to provide advice and planning that is both timely and built on an aggregate understanding of a client's personal financial situation.

The fact is, humans will always be at the center of advice and planning. Money is personal and emits emotions that can't be easily conveyed in a digital format, at least for now. We have found that clients want high-touch human interactions when it comes to managing their assets, making planning decisions, receiving advice and for other more personalized aspects of their wealth management experience. That's why they come to us.

They generally do not find value in having human interactions for repetitive tasks. I have not seen a client who thoroughly enjoys repeating instructions to someone for things like wire transfers, providing account numbers or a beneficiary's name and address over the phone. Digital interactions can replace the mundane and the repetitive, and clients often enjoy the flexibility of using online tools from their living rooms, after hours or anytime, to manage these tasks.

Q: Technology enables our advisors to really get to know clients.

How can this knowledge lead to better results?

Rod: Wouldn't it be great if any company you dealt with knew what you like and don't like so you didn't have to tell your story over and over again, and that there was a language there that was already understood? Think about when you go to get your hair done. If you are like me, you have probably been with the same hair stylist for quite some time. You don't necessarily need to explain what you want—they say “the usual,” and you say “yes.”

Similarly, getting to know clients and understanding what really matters to them is core to how we help our clients achieve success. Technology enhances this knowledge because it enables information across all touchpoints to be captured and placed at the forefront of everything we do. This way, our clients know that we have heard them, and our advisors can coalesce around a client with an aligned understanding of each situation. From there we develop a unified plan that becomes the cornerstone of the relationship.

This enables us to spend our time with our clients moving their plans forward, without needing to spend time reviewing information that's already been shared. It ultimately leads to much more meaningful, personalized conversations and greater transparency.

Q: What is the most valuable benefit of a technology-enabled experience with a wealth manager?

Rod: In my mind, technology provides the ability to distill complex information into easy, memorable and tactile format that a document or printed statement will never be able to deliver.

If we are presenting information to a client, we have to think about how much information a person can retain at any one time. For example, information in a quarterly review is detailed and can be a lot for a client to absorb at once. Rather than keeping that document on the shelf at home until the next review, imagine if the client went home that night and accessed their financial information online. They are reminded of their plan, see their progress in real time and can connect the information they are seeing to the discussion they had with their portfolio manager. That's not something you can do with a static document.

And, technology aids both the client and advisor. It prompts thoughtful questions and helps them explore 'what if' scenarios to help make important planning decisions. What if the client would like to retire early? What if she would like to purchase a vacation home? Online planning tools powered by algorithms can help advisors run the numbers for different hypothetical circumstances to determine what changes may be necessary in their plans to help clients achieve these goals.

Using technology helps advisors and their clients connect and consolidate information, understand spending patterns, predict future wealth and use this information to make proactive adjustments to plans. Achieving clear outcomes for clients is the ultimate benefit.



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