Fiduciary Trust International

PERSPECTIVE

JUNE 2019

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ECONOMIC AND INVESTMENT OUTLOOK

Inflation: Influencing the Economy and Markets

Despite the most recent market pullback, investors would be hard-pressed to find an asset class that has failed to produce positive returns in 2019. Returns so far this year have been broad-based and undifferentiated—even asset classes that often move in opposite directions have been moving in tandem.

Performance through the end of May:

Asset classes. The S&P 500 returned over 10.7% and US long-dated Treasuries gained almost 9.5%.

Investment styles. US growth stocks returned 13.7% and value stocks gained 8.5%.

Fixed income. Treasuries returned 4.2% and investment-grade corporate credits gained 7.2%.

Sectors. Consumer Discretionary returned 13% and Utilities gained 11%.

Commodities. Oil returned 16.5% and gold returned 1.9%.

What is notable is that investment styles and market sectors with different characteristics, including those that are generally sensitive to growth and others that are considered safe havens, are in sync. In an uncommon alignment, global equities, global sovereign bonds and commodities have all rallied this year.

Illustrating the depth and breadth of stock market returns, a little over 80% of the companies in the S&P 500 Index have positive performance so far this year.

An Ideal Backdrop for Both Stocks and Bonds

What environment is so favorable for both risky and risk-free assets?

When capital markets are moving higher in tandem and all investments within a balanced, diversified portfolio are performing well, it's usually reflective of an ideal economic and policy backdrop—a combination of moderate

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growth and low inflation commonly referred to as a "Goldilocks" environment.

The economy has been growing at approximately 2% a year for the last decade, which is roughly equal to the long-term trend growth rate of the economy. This alignment of actual growth with the long-term trend growth rate, and with little deviation, has created an ideal equilibrium that has extended the current economic cycle.

Of course, a broad range of technological, demographic and market factors have also affected inflation. But in simple terms, supply and demand are in balance, keeping inflation subdued.

It was this very dynamic that allowed the Federal Reserve to pivot away from its tightening policy bias in January after markets ran into severe volatility in the fourth quarter. Given the benign level of inflation, the Fed has the luxury of keeping rates steady at a lower rate than might otherwise be required.

The Fed Achieved Half of its Dual Mandate

Fed policy decisions are driven by a dual mandate of full employment and price stability. But with the unemployment rate at 3.6%, the lowest in 50 years, the Fed appears to have largely achieved the former and continues focusing on the latter. However, inflation has fallen short of the Fed's 2% target for most of the past decade, despite stimulative monetary and fiscal policy measures such as setting the fed funds rate at zero for several years and, more recently, passing tax reform.

The Fed's preferred measure of inflation, core Personal Consumption Expenditures (PCE), has remained stubbornly low—at the end of May it was up just 1.6% versus May of 2018. This struggle to generate higher inflation has been puzzling and difficult to explain for both Fed members and economists. And this phenomenon isn't limited to core consumer prices. It is also evident in wages and other labor costs.

Low Unemployment, But Modest Wage Growth

Although economic growth has been moderate, labor markets have been more robust. The unemployment rate in the US has dropped precipitously from the highs seen during the global financial crisis, and payroll growth has averaged 218,000 jobs per month for the past year, a pace which might be considered stellar given that we are entering the tenth year of economic expansion.

If there is a thorn in the side of employment data, it comes in the form of wage growth. Much like the measures of inflation we have discussed, wages have been slow to respond to the perceived tightening slack in the labor force. According to an economic theory known as the Phillips Curve, historically low unemployment should lead to higher wage growth. So, the absence of meaningful wage inflation has led some to believe that this relationship is disconnected.

The key takeaway is that markets are acutely attuned to inflation data and its influence on asset prices. Today, investors have a strong conviction that inflation will remain well contained, keeping global interest rates artificially low for a very long time. Thus, this outlook on inflation, for all intents and purposes, has effectively become the underpinning for capital market pricing.

Where Has Inflation Been?

Inflation has largely been absent for the better part of this decade. To find a similar environment, we would have to look back to the early 1960s.

From 1960 to 1965, increases in the Consumer Price Index (excluding volatile food and energy prices) averaged only 1.4% per year. It wasn't until later in the 60s that inflation finally caught up with healthy economic growth.

The next decade and a half would see inflation jump above 10% and US Treasury rates exceed 15%. It was during this period that Fed Chairman Paul Volcker decided growth prospects would have to be sacrificed in order to lift the economy out of stagnation and bring prices back to a more normal level. The primary mechanism by which he accomplished this was the federal funds rate, which he took to a historically high level of over 20%.

By finally getting inflation under control, Volcker launched what would become a three-decade-long bull market in bonds. During the decades that followed Volcker's tenure as Fed Chairman, inflation gradually trended lower. Where Volcker was tasked with taming inflation, more recent successors have battled to reignite economic growth and dormant inflation.

The Struggle Today: Reviving Inflation

Since the end of the global financial crisis, the core PCE index has averaged growth of just 1.6% per year. Theories for these persistently low levels of inflation range from globalization to technological innovation and demographic shifts. It is clear to us that this phenomenon is not limited to the US. Japan has dealt with its own inflation struggle for the better part of two decades and Europe has been even less successful than the US. In both Japan and Europe, this struggle and low economic growth has led to negative policy rates for quite some time, which has caused distortions in capital markets. Most notably, negative-yielding sovereign bonds have become pervasive, with some $11 trillion worth of government debt still carrying yields below 0%.

Low Rates Have Boosted Profits

The combination of negative and low rates globally has created favorable financial conditions, reducing the cost of borrowing and bolstering corporate profits. This has translated directly into higher valuations, as evidenced by various equity indexes reaching or exceeding all-time highs. For example, the S&P 500 reached an all-time high in May, although ongoing trade tensions have caused a pullback more recently.

One of the goals of low policy rates, however, is to spur economic activity; and the effectiveness of easy monetary policy in this regard is debatable.

The key takeaway is that a decade of struggling to lift inflation has arguably conditioned investors to believe pricing pressures will never manifest themselves. This firmly embedded view has the potential to be a growing risk and bears monitoring.

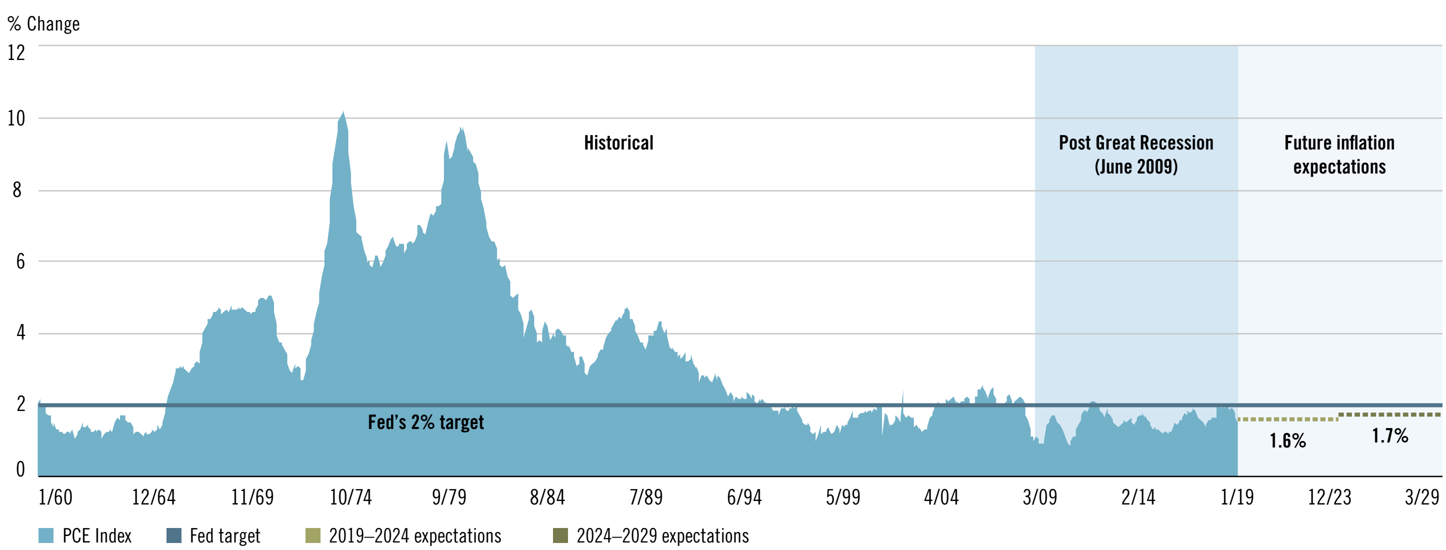
What Happens if Inflation Reappears?

Market signals suggest inflation will remain below the Fed's 2% target for the foreseeable future (Chart). In fact, markets are currently pricing in a higher probability of a Fed rate cut than a rate hike. But what happens if inflation actually rises? Implications would be wide-ranging and pervasive across capital markets.

CHART:

Inflation: Past, Present and Future Expectations

Core Personal Consumption Expenditure Price Index, Monthly Year-Over-Year Change



Source: FactSet

Borrowing Costs Would Rise

Persistently low rates have created an incentive for corporations to borrow. Access to cheap credit led companies to favor debt rather than equity financing, and the last several years have seen record amounts of share buybacks. Higher levels of financial leverage put these companies at risk, and the benign inflation backdrop could be leading to a false sense of security.

An inflation uptick and corresponding tightening of Fed policy likely would lead to an increase in borrowing costs, which could make refinancing maturing debt difficult. The impact to the bottom line would clearly be problematic, and equities, particularly those with weaker balance sheets, would likely suffer.

Companies Would Cut Costs

While higher wages might sound great for employees, the firms bearing these costs would inevitably explore ways to soften the blow. Price increases would certainly be an option, but many companies have already achieved historically high profit margins, and further price increases may prove unreachable. The other option would be to cut costs, and there is evidence showing that companies are using technology to reduce their reliance on manual labor.

Bond and Stock Prices Could Fall

Unexpectedly higher inflation would lead to higher nominal rates and force bond prices down. More importantly, however, price increases would lead the Fed to tighten policy, directly affecting the cost and availability of credit.

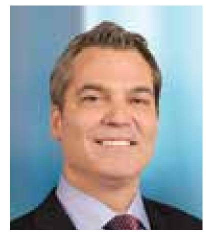
Equity multiples would also likely take a hit, given that valuations are already above historical averages. Interest rates have a direct impact on equity prices because they function as a discount mechanism for valuations.

Our View: Keep an Eye on Inflation Assumptions

Although there is no shortage of issues and headlines moving the market, we wanted to share our perspective on inflation and its impact on an interconnected economy and capital markets.

The consensus view regarding inflation is that it is well contained and unlikely to deviate much from the past decade. While we generally share that view, we also understand the risk of becoming complacent. Markets are relying heavily on a “lowflation” view, and in our view, this pervasive investment thesis might be akin to a “crowded trade.”

What should be clear by now is that low inflation has supported and continues to support financial markets. In our view, the continuation of this low inflation environment is the key to maintaining the current Goldilocks environment. But we also recognize the fact that markets are fluid and subject to change and wanted to shine a spotlight on this critical underpinning of inflation expectations and explain why they should not be overlooked.



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June 1, 2019

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ASSET ALLOCATION UPDATE

Fundamentals Have Been Slightly Better Than Expected, Despite Lingering Trade Tensions

Expectations for trade and monetary policy helped lift the markets from their December 2018 lows. However, these two policy pillars have recently become marginal headwinds and have weighed on financial markets and sentiment. Despite positive surprises from first quarter 2019 earnings, the recent rollover in leading indicators coupled with the slowdown in economic activity, has increased uncertainty and has clouded the outlook for global growth in the second half of 2019.

US Equities: Trade Tensions Leave Question Marks

We are neutral US equities. While we still see the potential for a rebound in economic activity and policy support from the Fed, further trade uncertainty coupled with economic weakness could increase downside risks. Although US mid- and small-cap equities could be isolated from increased trade risks compared to US large-caps, their higher beta could make them vulnerable in a risk-off environment.

International Developed Markets: Pros and Cons

We maintain our neutral positioning to International Developed Equity Markets. Despite experiencing weaker growth for much of the last year, we are seeing signs of stabilization and, in some instances, even green shoots. However, we are cautious about the increase in populism and limited policy space for central banks to ease.

Emerging Markets: A Neutral Stance

We maintain our neutral positioning to Emerging Market equities. Though we continue to see China stimulus filter through into the economy as policymakers take necessary and/or appropriate actions to support growth, currency weakness has led to a tightening in financial conditions for most emerging market economies.

Fixed Income: Limited Return Potential

The recent rally in fixed income markets appears to reflect worries around trade tensions and economic growth and has forced more dovish signals from the Fed. However, the increasing expectations of deeper rate cuts currently being priced in by markets are at odds with our outlook for economic growth, while more in line with shorter term trends.

Cash: Maintaining Our Nimbleness

The two policy pillars, monetary and trade policy, have supported the right side of the V-shape recovery. However, they have recently started to turn into marginal headwinds. For this reason, we maintain an overweight allocation to cash as we search for opportunities and guard against downside risk.

Alternative Investments: New Alpha Opportunities

We continue to recommend a strategic allocation to alternative investments, which can provide multi-asset-class portfolios with a degree of downside protection, broader diversification, and better risk-adjusted returns.

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Head of Asset Allocation

FIDUCIARY TRUST FORUM

Checking Your College Student's Checklist: Don't Overlook These Important Tasks

If your son or daughter is heading to college, you have undoubtedly created a long checklist of essentials to set them on the right path. From financing their education over the years to practical logistics like transportation or bedding for their dorm room, many items on your 'to do' list are most likely getting checked off as your child's departure date nears.

But before sending them off, take some time to consider several important legal and financial issues.

Send Your Child Off with the Right Documents in Place

It is important to understand that an 18-year-old college student is usually considered a legal adult. You might feel like the same parent you have always been, but your legal right to make decisions for your child changes abruptly. Except in unusual circumstances, you will no longer have automatic access to your child's health, financial and education records—including grades, schedules, illnesses and financial accounts—even if you are paying their tuition.

Privacy laws will limit your ability to obtain this information, even if you truly need it. If it is ever necessary for you to step in and make important health or financial decisions for your child, establishing your legal ability to do so ahead of time can be critical. We recommend taking the following steps before your child heads to school.

1. Name a Health Care Proxy

Have your child sign a health care proxy (also referred to as a durable power of attorney for health care) appointing you or another responsible adult with the power to make medical decisions if necessary. Without one, you might need court approval to act on his or her behalf if your child is in an accident and becomes disabled, even temporarily. Even in less serious situations, privacy laws may prevent doctors from sharing information about your child's condition if you do not have a signed health care proxy.

You should consider providing your child with a card to keep in their wallet or with their phone indicating they have appointed you as their health care proxy and providing your contact information.

2. Appoint a Durable Power of Attorney

Arrange for your child to sign a durable power of attorney to appoint you, or another responsible family member or friend, as an agent to act on his or her behalf, if need be, in a variety of financial and legal matters. For example, if your child is studying abroad for a semester, having a power of attorney makes it easier for you to contact the local embassy or wire money from your child's bank account. It could also be important if you need to sign a legal document, such as a lease, in your child's absence.

3. Consider a Will

Most young people, including college students, don't need a will because their assets are modest and intestacy laws typically provide that a parent will receive a child's property if the child dies without a spouse or children of their own. Nevertheless, a will can be worth considering if your child has more significant assets and you do not want their assets potentially to end up in your estate.

If your child is a trust beneficiary, you should review the terms of the trust to determine how the property would be distributed in their absence and whether there is any flexibility to adjust that distribution. In some cases, it may make sense for a child to exercise their "power of appointment" over the trust property to better align the terms of the trust with your family's general estate plan.

4. Understand Cyber Security

College is a good time to learn responsible banking habits and to understand cyber security. Make sure your child knows his or her dorm room, student lounge or library are not secure. They must remember to keep their banking account login information confidential, and to always log off after use.

Your child should understand basic ways to prevent fraud, such as never providing their social security number and not opening suspicious emails. Your child should also understand the immediate steps they need to take if they are the target of online fraud.

5. Obtain a Credit Card

Obtaining a credit card can be difficult for students. In the past, young adults could get started with their own credit cards as soon as they got to college. Today, the Credit CARD Act requires anyone under 21 to have a co-signer, unless they are earning enough income to repay the debt. Since most college students are not able to earn enough to meet this requirement, a co-signer is often required. If parents co-sign, they are ultimately responsible for making payments on their child's card. Parents sometimes simply do not want to take the risk of their child overspending or failing to make payments.

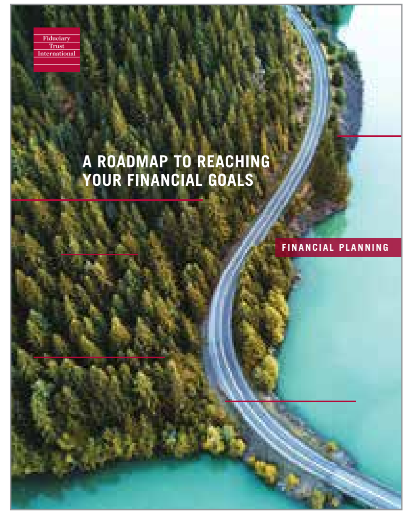
However, holding a credit card has several benefits for college students. Landlords, prospective employers and even cell phone providers may want to look at your child's credit report as part of a background check. Establishing a strong credit score during college is important, especially for life after graduation. Also, possessing a credit card can offer security if your child runs into an emergency situation far from home.

Sending your child off to college with these essential items in place can provide you with peace of mind and offer your child added security.

Build a Roadmap to Your Financial Goals

Achieving your financial goals starts by setting your short- and long-term priorities, developing a clear understanding of your financial picture and mapping out the journey that will lead you to your destination. We can help you get started and guide you along the way.

To create your financial roadmap, speak to your Fiduciary Trust contact or call us at (877) 384-1111.



GROWING AND PROTECTING WEALTH FOR GENERATIONS

Fiduciary Trust is a wealth management firm founded in 1931 by families for families, with a singular focus on growing and protecting your wealth through generations. We work closely with individuals, families and foundations to build and manage personalized investment portfolios, and to develop estate plans that extend wealth to future generations.

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