DUFF & PHELPS
INVESTMENT MANAGEMENT CO.
A VIRTUS INVESTMENT PARTNER

Proceed with Caution

Most world equity markets experienced double-digit declines in the fourth quarter and ended up in the red for 2018 overall. U.S. equities, as measured by the S&P 500® Index, declined 13.52% for the quarter and 4.38% for the year—the first negative annual return for the index since 2008. Still, U.S. equities fared much better than international equities. The MSCI EAFE® Index declined 12.54% and 13.79% for the quarter and year, while the MSCI Emerging Markets Index declined 7.47% and 14.58% for the quarter and year. While technology and FAANG stocks suffered losses, some of the hardest hit companies were in cyclical sectors like energy and industrials. Globally, defensive sectors held up relatively well, including real estate, utilities, and healthcare.

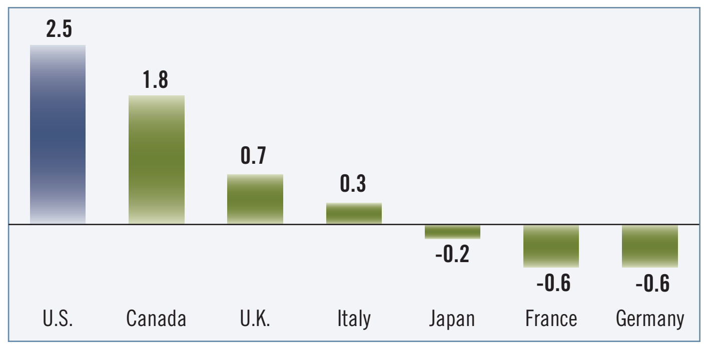
The fourth quarter proved that a soft landing in the U.S. economy does not necessarily make for a soft landing in the stock markets, and bears out what we wrote in last quarter's commentary, "What is likely to define the nature of the economy and the performance of financial assets in the next few years will be the degree to which the change in monetary policy does not overwhelm other economic policy tools—like tax cuts, spending, and regulatory policy. The Federal Reserve must walk a fine line between its wish to normalize rates and creating further dislocations."

As 2019 gets underway, it appears the two major headwinds that negatively impacted investors are starting to get resolved. The Federal Reserve appears to have come off autopilot, and investors are starting to see a possible resolution of U.S.-China trade discussions. Removal of tariffs should improve capital investment in the U.S. which has been hobbled in recent months. Additionally, the combined incremental benefit of consumer tax cuts and lower gasoline prices could be higher in 2019 than in 2018. The U.S. unemployment rate ticked down just 0.2% in December over the prior year, despite the creation of 2.6 million jobs in 2018. This indicates more Americans are coming into the labor force and productivity is improving, which is good for the U.S. and broader global economy.

Federal Reserve Policy – Fed over-tightening became the big theme of 2018, with most economists assuming officials would raise rates too far because "they always do." Fed policy has approached a critical juncture, particularly with the yield curve teetering on the brink of inversion. While U.S. officials have a habit of downplaying the yield curve's significance, history suggests they should proceed with caution. When yields invert, recession usually follows, though the data suggest, with long and variable lags. Fortunately, the current FOMC seems reasonably pragmatic. With financial markets wobbly coming into 2019, breakeven inflation rates falling, and no real evidence of wages spiraling higher (the Phillips Curve, which measures the relationship between inflation and unemployment, still isn't working—i.e., as the unemployment rate has gone down, wages haven't been going up accordingly), we are not surprised that the Fed signaled a pause at its late January meeting. The last two times the Fed did this—in 1998 and 2006—their action sparked a rally in risk assets, with U.S. equities bouncing strongly.

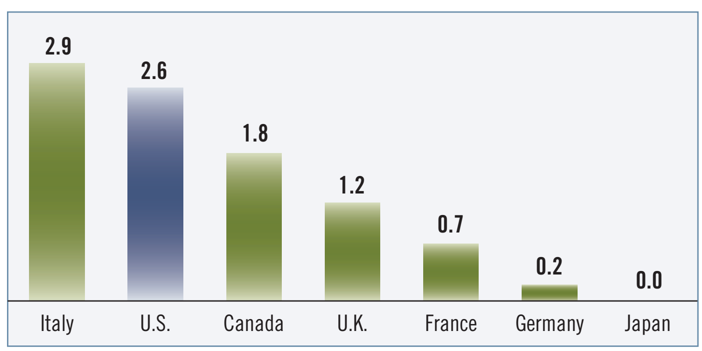
GLOBAL BOND YIELDS (%)

1-Year



Sources: The BLOOMBERG PROFESSIONAL™ service, Credit Suisse.

10-Year

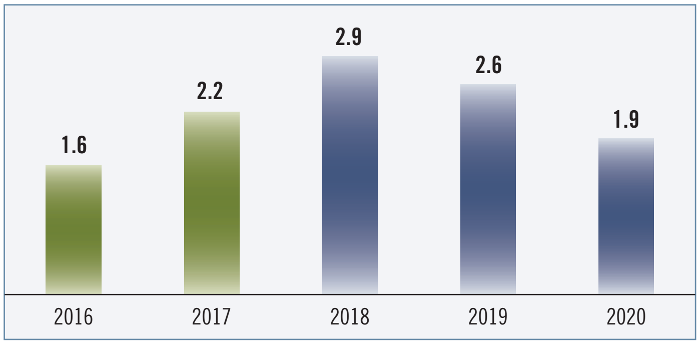


Sources: The BLOOMBERG PROFESSIONAL™ service, Credit Suisse.

U.S.-China Trade – Our optimism for a trade deal with China stems from the fact that the Chinese government is also facing a dilemma in 2019. Growth has dropped sharply over the past 18 months, as the authorities have tried to wind down the massive credit splurge that has kept their economy growing despite persistently weak global demand. Having overdone policy tightening, the consensus is hoping Chinese officials will announce another aggressive stimulus program in 2019 that would reflate the economy and lift global growth. But this would compound the economy's underlying imbalances, further inflating one of the biggest credit bubbles in history. China doesn't want to follow Japan's example and suffer a deflationary slump, which would be damaging longer term.

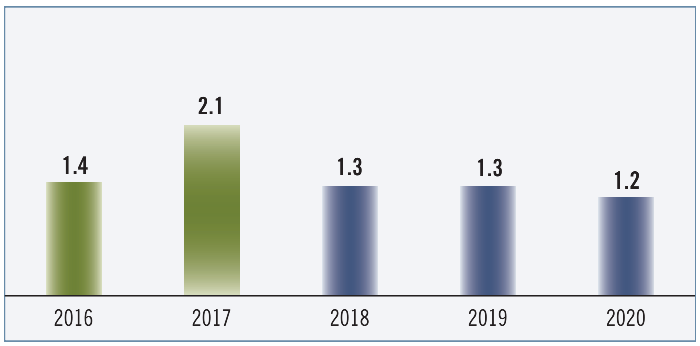
GLOBAL GDP GROWTH (%)

U.S. GDP



Sources: BEA, The BLOOMBERG PROFESSIONAL™ service, Haver Analytics®, Credit Suisse.

G7 Countries ex-U.S. GDP



Sources: BEA, World Bank, Deutsche Bundesbank, Institut National de la Statistique/ Economique, The BLOOMBERG PROFESSIONAL™ service, Haver Analytics®, Credit Suisse.

Global Growth – Even with global growth deteriorating faster than most people imagined in 2018, few on Wall Street are talking about a recession in 2019. Consensus forecasts for the world economy suggest only a modest dip in GDP growth, from 3.66% to 3.54%. Meanwhile, the inflation backdrop doesn't seem particularly scary either, with the economists expecting only a small price acceleration in 2019—certainly nothing to worry policymakers. Central banks are widely expected to tighten only modestly, with a couple of rate hikes from the Federal Reserve and perhaps token moves from the European Central Bank and the Bank of Japan. This uninspiring outlook doesn't sound particularly dangerous for financial markets, which would suit investors just fine after a more than eventful conclusion to 2018.

SECTOR HIGHLIGHTS

Our sector specialist investment teams remain focused on fundamentals and executing on our core values of quality, reliability, and specialization in the highly targeted strategies on which we have built our reputation.

Global Real Estate – Amid the precipitous drop of broader global equities, global real estate securities were a relative port in the storm in the quarter, declining only 5.7%, as represented by the FTSE EPRA Nareit Developed Index, expressed in U.S. dollars. The fourth quarter selloff led to significant discounts for REITs globally versus private market valuations. At the same time, capital continued to be raised for private real estate funds, boosting the potential of M&A.

> The **top-performing countries** in the FTSE EPRA Nareit Developed Index during the quarter were New Zealand, Japan, Belgium, Hong Kong, and Sweden, on a total return basis measured in U.S. dollars. Of these, New Zealand and Japan posted positive returns and all but Hong Kong outperformed the Index on the year. Beyond healthy underlying real estate fundamentals, New Zealand and Japan's quarterly performance was aided by positive movements in the New Zealand dollar and Japanese yen, both of which appreciated relative to the U.S. dollar.

> The **bottom-performing countries** were the Netherlands, France, Italy, Ireland, and Finland. European-focused retail real estate companies in the Netherlands and France continued to be under pressure given their mixed fundamental outlook and the expected negative impact to French retail sales from late-year populist protests. French office stocks also underperformed. Irish office and residential real estate shares performed poorly as contentiousness surrounding what to do with the Irish border after the U.K. leaves the EU continues to override a healthy Irish economy and real estate market.

Global Listed Infrastructure – The defensive nature of global listed infrastructure was evident in the quarter, as the benchmark FTSE Developed Core Infrastructure 50/50 Index, ended down 3.43%, significantly outperforming the broader global market. Less cyclical communications and utilities sectors posted gains, while transportation and energy infrastructure returns were negative. All regions had losses in the period, with Asia/Pacific infrastructure stocks performing the best and Europe (including the UK) a notable laggard once again.

> **Utility** stocks stood out as investors flocked to the sector looking for a place to hide. The key event in the industry was the devastating wildfires in California, leading to major losses for two California utilities, PG&E and Edison International, over concern about potential liability from the fires, combined with a limited response by the California legislature.

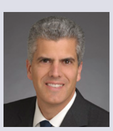
> **Communication** stocks performed relatively well, posting positive returns. The attractive business model of wireless tower companies was viewed favorably in the unsettled environment.

> While **transportation** had negative results for the quarter, it outperformed the broader global equity market. After three quarters of strong performance, U.S. railroads were hit by concerns of a slowing economy and escalating rhetoric around a trade war with China. European airports also were weak on worries surrounding global economic growth and decelerating traffic trends. Toll road performance was mixed, with Australian roads proving more defensive than those in Europe.

continued

> **Energy infrastructure** stocks were big laggards in the quarter. Oil prices, which were close to a 4-year high on October 3, plunged 40% the rest of the quarter. President Trump's decision to grant waivers to countries for the purchase of Iranian oil was the initial catalyst before concerns about global growth and the move to an overall risk-off environment took over. Despite a still improving story, energy infrastructure stocks followed oil prices down as tax-selling and tight trading liquidity in December steepened losses. For additional perspective on the energy infrastructure sector, read Duff & Phelps' Fourth Quarter Market Review & Outlook: Energy & MLPs.

Authored by:



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Duff & Phelps Investment Management offers specialty investment strategies that strive to enhance outcomes for clients. The product mix, which includes Global Listed Infrastructure, Global Real Estate, Energy & MLPs, and International Equity, developed from the in-depth fundamental research expertise in income-producing securities that the firm first established back in 1932.

S&P 500® Index: A free-float market capitalization-weighted index of 500 of the largest U.S. companies. **MSCI EAFE® Index (net):** A free float-adjusted market capitalization-weighted index that measures developed foreign market equity performance, excluding the U.S. and Canada. **MSCI Emerging Markets Index (net):** A free float-adjusted market capitalization-weighted index designed to measure equity market performance in the global emerging markets. **FTSE EPRA Nareit Developed Index (net):** A free-float market capitalization-weighted index measuring publicly traded equity REITs and listed property companies from developed markets, which meet minimum size and liquidity requirements. **FTSE Developed Core Infrastructure 50/50 Index**: A free float-adjusted market capitalization weighted index that gives participants an industry-defined interpretation of developed market infrastructure companies and adjusts the exposure to certain infrastructure subsectors. Constituent weights: 50% Utilities, 30% Transportation (including capping 7.5% for railroads/railways), and a 20% mix of other sectors including pipelines, satellites, and telecommunication towers. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.