

IN THIS ISSUE

MARKET BRIEF	2
ECONOMY	4
EQUITY	5
FIXED INCOME	6
ALTERNATIVES	7
DISCLOSURES	8

MARKET REVIEW
MARCH 2019

COULD THE MARKET'S WORRIES BE WRONG?

Inflation and geopolitics could be viewed as the market's biggest risks. Current worries about inflation harken back to the so-called "wage-push" inflation of the 1970s, while geopolitical risks are ever present in the markets. Brexit seems a manageable near-term concern, but the risk from a growing rivalry between the U.S. and China, both industrially and diplomatically, loom larger these days. Could the markets be wrong to worry about inflation and China? This Market Brief argues these fears might be overstated.

WAGE-PUSH INFLATION

The worry the market has over the current historically low level of unemployment is driven by a fear the pool of job candidates has become so small that the primary way to acquire the next new employee is to hire one from another firm – and the main inducement is to offer a higher wage. This competition for workers eventually becomes so fierce that businesses are forced to raise prices to cover higher wages of new hires. Hence the name "wage-push" inflation can be understood as rising wages push inflation higher.

To assess whether or not the dynamics of the current labor market are conducive for wage-push inflation, other labor metrics are more illustrative than the unemployment rate. Rather than focus on the number of unemployed, this analysis instead focuses on the number of people employed. The Employment and Wage Inflation chart at the top left of page three depicts the Labor Force Participation Rate (LFPR) and the Employment to Population Ratio (EPR) beginning in 1948 through the present and compares them to the annual percentage change of Unit Labor Costs (ULC).

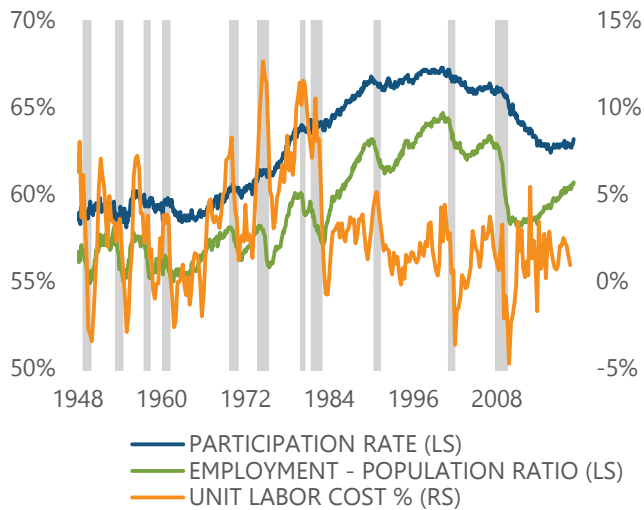
The LFPR measures the proportion of people who are working out of all those who are employed or seeking employment. If you are unemployed and not looking for work, you are not counted in the LFPR. The EPR is the number of employed adults in proportion to the entire adult population, whether or not they are seeking employment.

It can be seen on the Employment and Wage Inflation chart on page three that LFPR and EPR were fairly stable until the mid-1970s, and ULC rose and fell in line with EPR. The impact of women and younger baby boomers entering the workforce can be seen in both the LFPR and EPR rising during the 1970s and 1980s. This rising supply of workers may have offset growing labor demand and staved off wage inflation. Since the early 1980s, ULC has been more stable outside of recessions.

Also displayed on the chart is the impact of the recessions following the early 2000s "tech wreck" and 2008s sub-prime mortgage crisis. As the EPR fell during recent recessions, ULC also fell, but failed to accelerate as rapidly post-recession as it did in the past. A potential reason wages did not climb rapidly could be the greater supply of workers (LFPR) is higher today compared to the 1950s, 1960s, and most of the 1970s.

EMPLOYMENT AND WAGE INFLATION

1948 THROUGH JANUARY 31, 2019



Source: St. Louis Federal Reserve Database. Grey bars indicate recessions. Past performance does not guarantee future results.

PRICE CHANGE BEFORE AND AFTER PEAK

7 YEARS PRIOR | 11 YEARS AFTER



Source: Bloomberg. Past performance does not guarantee future results.

The market could be worried that EPR's rise over the last five years signals that wage-push inflation may be approaching. Yet, wage pressure as measured by ULC remains muted. The fact that LFPR is below the prior peaks could indicate people are out of the workforce, but ready to come back in. If the EPR was rising and the LFPR was at the prior peaks, the excess supply of idle workers could be absent. A lack of untapped labor at a time of rising labor demand would be theoretically inflationary, but that is not the situation today because LFPR is considerably below its all-time high.

ASIAN ASCENSION

The current anxiety over Chinese economic and political ascension resembles that of Japan in the 1980s – fear of a rival and excessive leverage in the rival's economy. In the 1980s, Japanese manufacturers were making such solid inroads into the American economy that some feared U.S. companies would eventually be put out of business or taken over. Simultaneously, Japanese conglomerates and wealthy individuals were acquiring major commercial and residential real estate properties in major metropolitan areas. The amount of leverage for these purchases may have been obscured by opaque accounting rules and the practice of cross holding of corporate ownership. It took both the crash of 1987 and the recession of the early 1990s for these excesses to come to light. Japanese stocks had a nearly fourfold increase in the seven-year run up to their peak in 1989, and were not able to recover in the following eleven years.

Today, the hopes and dreams placed upon recent trade negotiations with China resemble previous sentiment towards Japan nearly 30 years ago. Similar to Japan, China has its own real estate investment concerns. A recent Wall Street Journal article titled 'There's No Money Right Now': China's Building Boom Runs Into a Great Wall of Debt¹, provides insights into China's real estate binge. Similarly, the Chinese stock market had a near fourfold run up to its peak in late 2007, and is currently less than half that level. Despite a Chinese stock rally in 2014, the pattern of these two nations' stock markets seven years before and eleven years after the peak bear some similarities.

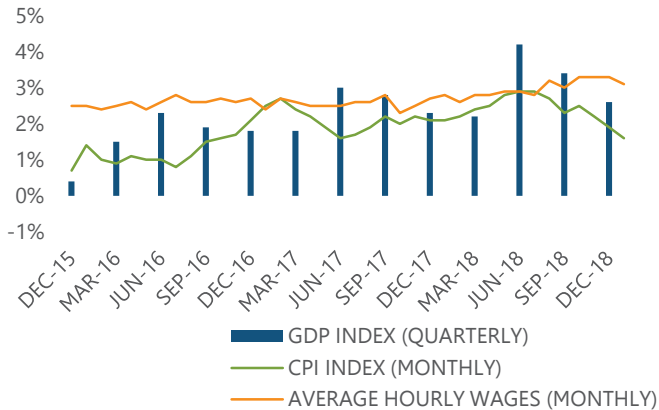
CONCLUSION AND INVESTMENT IMPLICATIONS

What if the market has it wrong? What if instead of worrying about potentially higher inflation, the market focused on slack in the labor force? What if instead of worrying about China's growing strength, they became more aware of some of its weaknesses? Instead of focusing on what worries them, markets could instead focus on what's going right: strong domestic economic growth, historically low interest rates and historically low inflation. Focusing on the positives could result in lower volatility, and in turn spur investor confidence. That's nothing to be worried about.

¹"There's No Money Right Now': China's Building Boom Runs Into a Great Wall of Debt. *The Wall Street Journal*, 27 Feb. 2019

ECONOMY

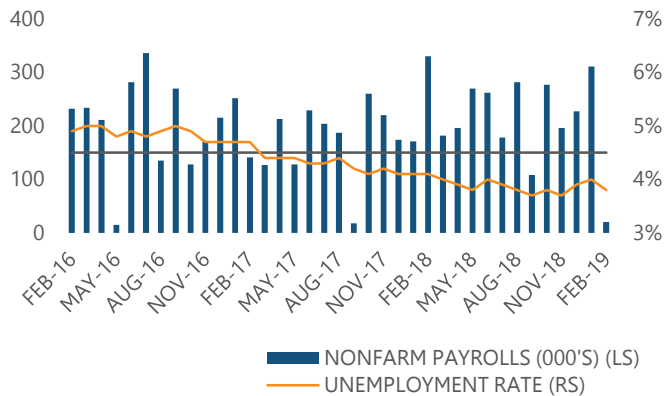
GDP, CONSUMER PRICES AND WAGE INFLATION DECEMBER 2015 THROUGH JANUARY 2019



Source: Bloomberg

- U.S. economic growth slowed to an annualized rate of 2.6% in the final quarter of 2018 which was better than economists' consensus estimate of 2.2%. The growth was supported by a 2.8% increase in consumer spending.
- The Core Personal Consumption Expenditure (PCE) price index, the Fed's preferred inflation measure, was unchanged in December at 1.9% year over year.
- The Core Consumer Price Index (CPI), which excludes volatile food and energy costs, climbed 0.2% in January. The year-over-year reading for Core CPI remained steady at 2.2%.

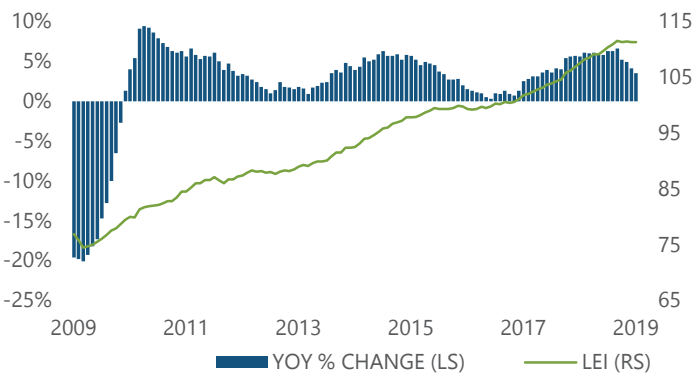
LABOR MARKET FEBRUARY 2016 THROUGH FEBRUARY 2019



Source: Bloomberg

- The U.S. labor market added 20,000 non-farm payrolls in February, significantly lower than the consensus estimates of 180,000 for the month according to Bloomberg data.
- Market commentators forecasted a much lower reading than the previous months due to the effects of the government shutdown and extreme cold weather. Goods-producing and construction jobs were impacted the most out of all sectors, dropping by 32,000 and 31,000, respectively.
- The unemployment rate dropped to 3.8% as the number of unemployed fell by 300,000 for February. Average hourly earnings rose 0.4% month over month and 3.4% on a year-over-year basis, marking the largest annual gain in the post-financial crisis era.

LEADING ECONOMIC INDICATORS JANUARY 2009 THROUGH JANUARY 2019



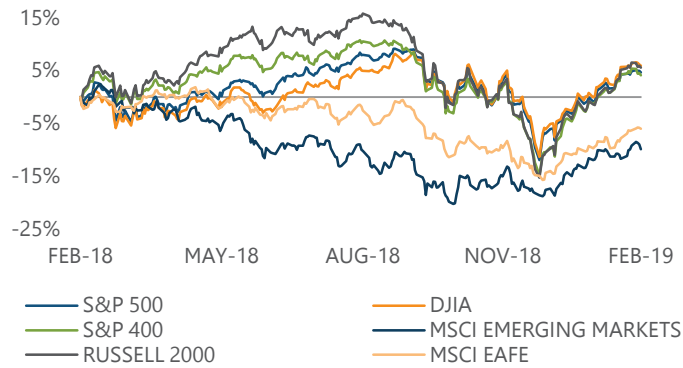
Source: Bloomberg

- The U.S. Conference Board Leading Economic Indicator (LEI) Index remained unchanged at 111.3 in January. This followed a 0.1% decline in December and 0.1% increase in November. On a year-over-year basis, the Index continued to decelerate to 3.5% from 4.1% in December and 4.9% in November.
- Positive contributions within the financial components were offset by weaker-than-expected data from the labor components. Most notably, an increase in average initial unemployment weekly claims and weakened consumer expectations for business conditions weighed on the LEI Index's overall reading.
- January's unchanged reading extends the relatively flat month-over-month trend in LEI growth seen since October 2018; however, the year-over-year growth rate has continued to slow.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, FEBRUARY 2018 THROUGH FEBRUARY 2019

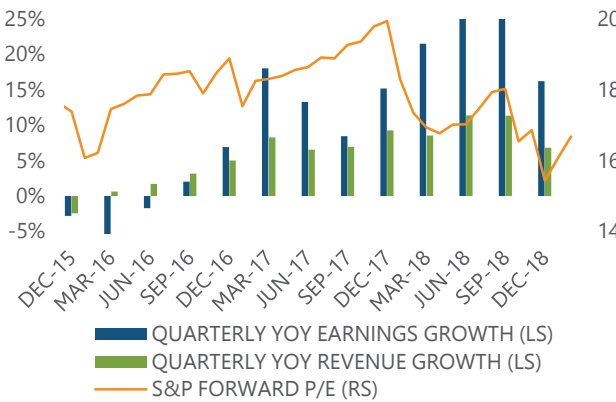


Source: Bloomberg

- Global equities continued their recovery in February after posting high single-digit returns in January. The S&P 500 gained 3.2%, bringing its return this year to 11.5% which erased most of its 13.5% fourth quarter decline. Strong fourth quarter earnings and trade negotiation progress between the U.S. and China have supported equities thus far in 2019.
- Despite signs of weakening economic momentum abroad and European political uncertainty, foreign developed equities are not far behind their domestic counterparts. The MSCI EAFE index gained 2.6% in February and 9.3% year to date.
- Weaker-than-expected fourth quarter economic growth in multiple countries weighed on emerging market equities in February.

S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, DECEMBER 2015 THROUGH FEBRUARY 2019

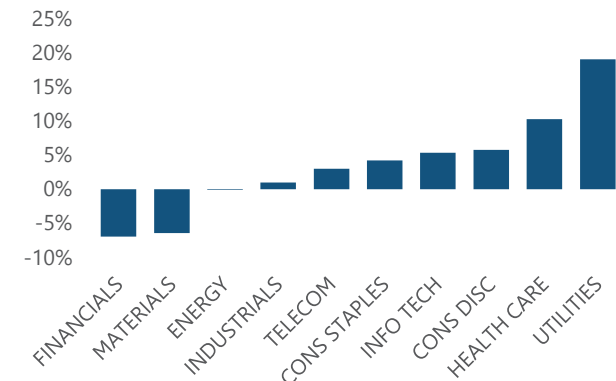


Source: Bloomberg

- Fourth quarter earnings reporting season is almost complete with results reported from 96% of S&P 500 companies. Earnings are on track for 16.2% year-over-year growth, the fifth consecutive quarter of double-digit growth. The last time the S&P 500 experienced an earnings growth streak this strong was in 2011.
- The six sectors that experienced double-digit earnings growth in the fourth quarter were energy, materials, technology, industrials, financials, and consumer discretionary. Utilities was the only sector with negative earnings growth.
- S&P 500 sales growth is on pace for 6.9% in the fourth quarter. Three sectors experiencing sales growth above 10% include health care, consumer discretionary and technology.

S&P 500 SECTORS 12-MONTH PRICE RETURNS

FEBRUARY 2018 THROUGH FEBRUARY 2019

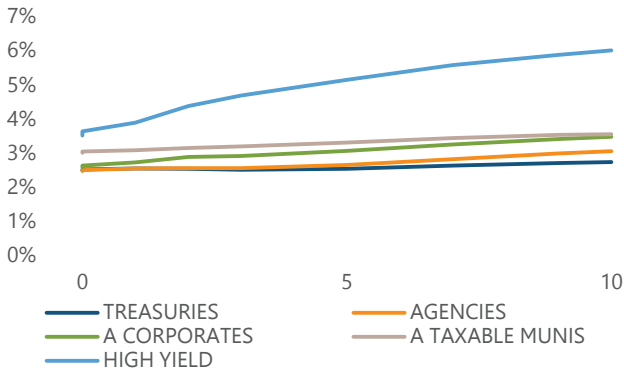


Source: Bloomberg

- The industrials sector was among the top performing groups for a second consecutive month in February with a monthly gain of 6.4%. The sector's 18.6% return in 2019 was the best of the 11 sectors. The trade sensitive industrials sector continued to benefit from trade negotiation progress between the U.S. and China and strong earnings growth.
- The technology sector's 6.9% return in February and 14.3% year-to-date return made it the best performing sector in February and second best this year. Strong earnings and sales growth continue to support the sector.

CURRENT YIELD CURVES

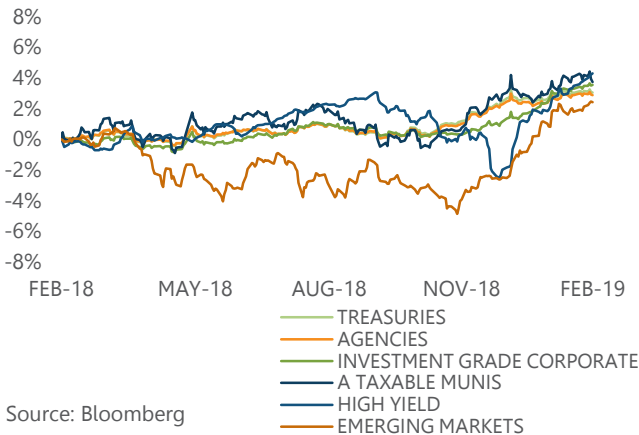
YIELD CURVES AS OF FEBRUARY 2019



Source: Bloomberg

- The U.S. Treasury yield curve remained flat in February. The portion of the curve between the two year and the five year remained inverted in February after initially inverting in December.
- After pledging patience in January around rate hikes, members of the Federal Open Market Committee spent much of February discussing the Fed's balance sheet runoff. Most members signaled a willingness to end the runoff in the near future, with some indicating that the process would be completed by the end of 2019.
- While market-based measures of expected inflation ended the month unchanged compared to where they started February, the 10-year U.S. Treasury yield climbed 9 bps during the month.

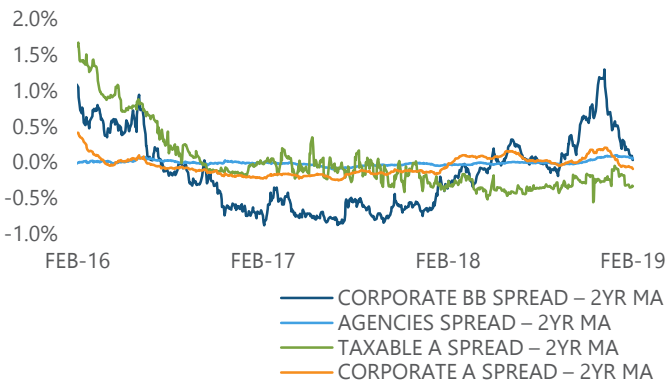
12-MONTH RETURNS, TAXABLE BOND SEGMENTS FEBRUARY 2018 THROUGH FEBRUARY 2019



Source: Bloomberg

- Of the spread sectors we follow, high yield bonds posted the best performance over the last twelve months, recording a total return of 4.26% over that time period.
- In contrast, the emerging market bond category trailed all bond sectors that we follow, but saw its twelve-month performance climb back into positive territory as risk assets recovered.
- Many investors have noted that emerging market bonds' recent underperformance might indicate some value at current levels and often cite the potential for dollar weakness as a potential catalyst. While there might be some value in the short term, future dollar weakness seems uncertain as non-U.S. banks grapple with slowing economies.

SPREAD VS. TREASURY LESS 2-YR MOVING AVG FEBRUARY 2016 THROUGH FEBRUARY 2019

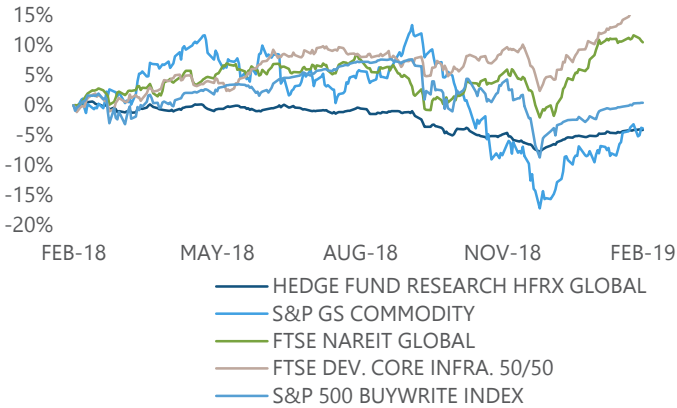


Source: Bloomberg

- High yield bonds, U.S. Agency bonds, and A-rated corporate bonds are all now nearly the same price as they were two years prior.
- In February, U.S. Agency bonds picked up some spread relative to their lower quality high yield and A-rated investment-grade counterparts.
- High yield spreads peaked this year on January 3 at a level of 536 basis points. Spreads tightened rapidly thereafter to 450 basis points by January 11, followed by a slower pace of tightening to end January at 427 basis points. Spread tightening continued throughout February, leading to a spread of 382 basis points by month end.

ALTERNATIVES

ALTERNATIVES, 12-MONTH RETURNS FEBRUARY 2018 THROUGH FEBRUARY 2019

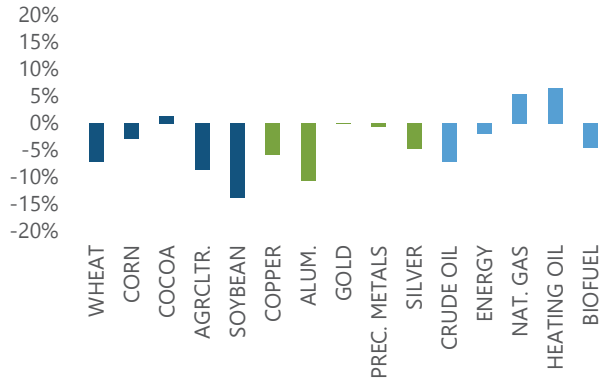


Source: Bloomberg

□ During a choppy twelve-month period ending February 2019, the global REIT and developed market infrastructure indexes significantly outpaced the MSCI ACWI Index's -0.3% total return. The global hedge fund, commodities, and hedged equity indexes produced flat to slightly negative returns over this period.

□ The broad commodities asset class continued its recovery in February, as the S&P GCSI Commodities Index advanced 4.5%, driven by a 6.4% advance in U.S. crude oil prices from \$53.79 per barrel on January 31 to \$57.22 on February 28.

COMMODITIES, 12-MONTH SPOT RETURNS FEBRUARY 2018 THROUGH FEBRUARY 2019



Source: Bloomberg

□ The Bloomberg Agriculture Commodity Spot Index reached a two-year low in 2018 amid record corn and soybean yields. Looking forward, low Brazilian stockpiles of grain and a possible peak in U.S. stockpiles could support corn and soybean prices in 2019.

□ Bloomberg Intelligence analysts have noted that gold ETF inflows have increased nearly 60% since the Federal Reserve's first rate hike of this cycle in December 2015. Meanwhile, the spot price of gold has increased just 30% over this period.

□ Despite flare-ups of extreme cold weather across large swathes of the U.S. this winter, natural gas prices plummeted from \$4.61 MMBtu on November 30 to below \$3.00 MMBtu for all of February.



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