ECONOMIC REVIEW

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Chief Investment Officer & Economist

Perhaps the best characterization to describe the 3rd quarter economic growth is to use a medical analogy and say that the economy continues to have the economic fever that developed in the 2nd quarter. The indicator for the fever was the inverted yield curve. An inverted yield curve means that 10-year Treasury yields are lower than 3-month Treasury yields. Normally longer-term yields should be higher than shorter-term yields to compensate for locking your money up for a longer period. A medical fever does not guarantee that the problem develops into something far worse. This is true for an economic fever as well. An inverted yield curve does not cause a recession or guarantee a recession. Instead, an inverted yield curve is signaling that a problem is developing and, unless action is taken, the problem could become more severe. For a medical fever, normally you would take some aspirin and monitor to see if the problem gets worse. For our current economic fever, the Federal Reserve has administered two interest rate cuts of .25% each and is monitoring the situation.

Lost in the discussion about an inverted yield curve and recession risk was the good news that the economy continued to grow in the 3rd quarter. We will not get the first estimate of 3rd quarter Gross Domestic Product (GDP) until 10/30/19, but current forecasts range between a 1.5%-2.0% annualized growth rate. GDP growth in the 1st quarter was 3.1% and 2.0% in the 2nd quarter. If 3rd quarter GDP comes in below 2.0% then we have a clear pattern of slowing.

Contributors and detractors to economic growth remain in place from what existed in the 2nd quarter. The goods producing side of the economy, especially manufacturing, is suffering, while the service side of the economy is plugging along. The goods producing side of the economy is clearly feeling the negative impact of tariffs. The most recent reading of manufacturing activity provided by the Institute of Supply Management (ISM) shows manufacturing activity is clearly contracting. This poor performance is being offset by positive performance from consumer spending. Despite all of the noise and drama emanating from Washington DC, consumers continued to see their salaries slowly increase. This translated into solid spending patterns in the 3rd quarter. Real personal consumption expenditures are currently growing at a 2.3% annualized rate. This is down from the high of 3.7% that occurred last August but it is still a positive pace. Since consumer spending currently makes up 69% of GDP growth, a 2.3% rate of growth means that GDP is growing at a 1.59% pace just from the consumer's contribution. Consumer confidence also continues to remain at elevated levels although it is also off its highs and has slipped recently. Government spending has helped economic growth as government agencies are spending the money allocated to them from the budgeting process that concluded in the 1st quarter of this year.

Currently, we are still on course to achieve 2% growth for all of 2019 if 3rd quarter GDP comes in between 1.5%-2.0%. We cannot ignore the warnings that are coming from the financial indicators that traditionally have been leading indicators for a recession. There has clearly been a change in the pace of growth for the economy. It would be a mistake to fall into the trap of saying that "this time is different" as it relates to the warning from the inverted yield curve. The Federal Reserve and Congress still have time to enact monetary and fiscal policy to offset the threats to the economy. The question is whether they will and, if so, will it be a proactive response to the growing threats or a reactive response once damage occurs? The outlook going forward is discussed in the Economic Outlook section of this newsletter.

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ALTERNATIVE STRATEGIES

Rick Cloutier, CFA
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The uncertainty over trade and global growth generated volatility throughout the quarter. In addition, political risk increased. The stand-off between the US and Iran resulted in several tanker attacks, the shoot down of a US drone, and the missile strikes on Saudi oil facilities. Despite this, large cap stocks managed to eke out a gain; however, small cap and foreign stocks posted losses. While the S&P 500 gained 1.7%, the Russell 2000 declined 2.4%, the MSCI EAFE lost 1.7%, and the MSCI Emerging Market dropped 4.3%. Year to date, equities continued to provide above average returns with the S&P 500 rising 20.1%, the Russell 2000 gaining 14.1%, the MSCI EAFE returning 12.8%, and the MSCI Emerging Market climbing 5.9%.

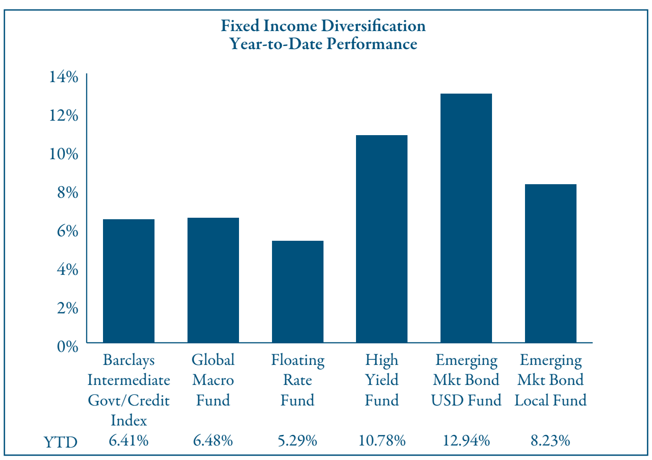
As anticipated, the Federal Reserve reversed last year's course and cut interest rates twice this year. The European Central Bank also loosened policy by reviving quantitative easing and cutting rates to -0.5%. As a result, high quality bonds and high yield achieved modest gains of around 1%.

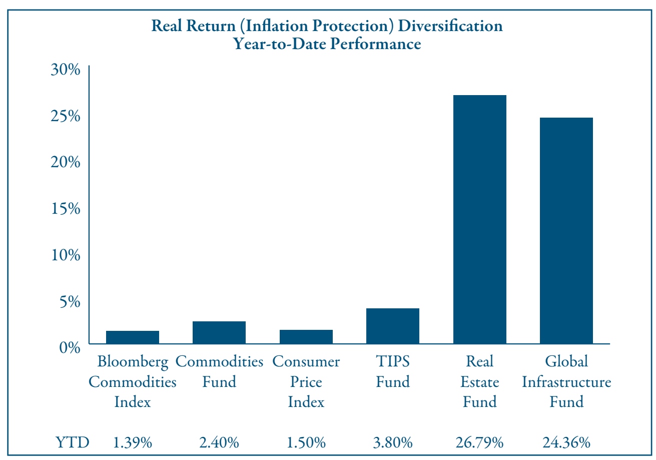
Because of the Fed's reversal, we made a shift in our portfolios to profit from the change, replacing our floating rate allocation for exposure to GINNIE MAEs. Along with higher credit quality, GINNIE MAEs are more sensitive to interest rate changes, and returns should benefit from the rate declines.

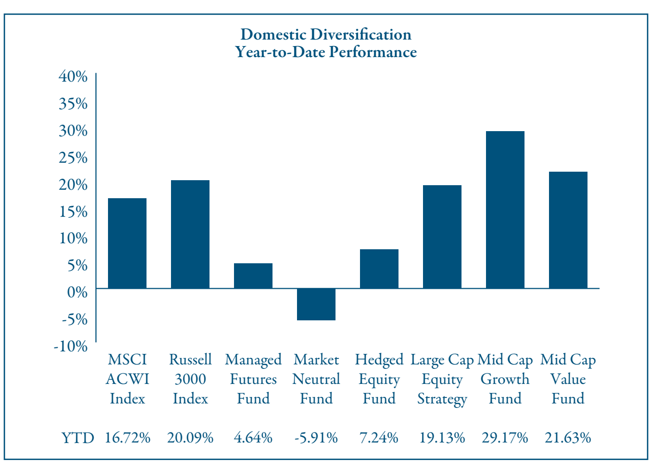
For the most part, our alternative strategies, both real and absolute return, were able to outpace stocks and bonds. Real return strategies, or strategies that hedge inflation, include real estate, global infrastructure, and commodities. Real estate had a stellar quarter and gained 7.1%. Global infrastructure returned 2.0%. Only commodities, although still positive year to date, detracted from returns and declined 2.25%.

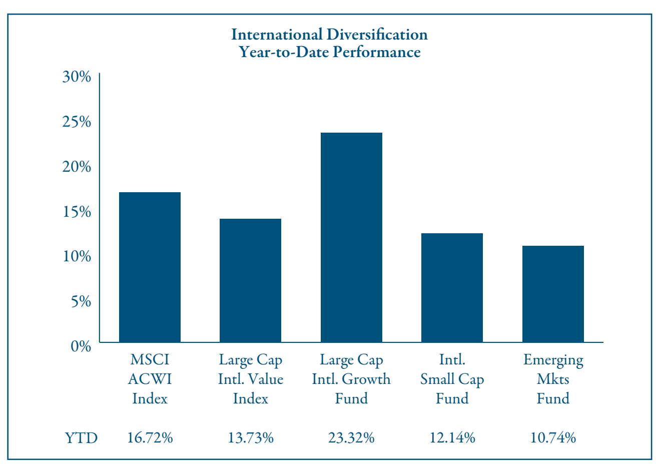
The absolute return, or risk management strategies, which include global macro, market neutral, and managed futures, provided returns between 1.5% and 2.5%.

Although the trade war between China and the US seemed to simmer by quarter's end, stark differences remain and resolution seems nowhere in sight. Adding to this tension, political risks around the globe have increased. Consequently, **we expect heightened volatility to remain.**









DOMESTIC EQUITIES

Gayle Sprute
Senior Portfolio Manager

Domestic stock market indices chiseled out modest gains during the 3rd quarter. The caveat was that the small-company laden index (Russell 2000) bucked that trend and fell by 2.4%. The journey through the quarter was a sometimes-volatile ride. Gains were achieved early in the quarter, as investors increasingly speculated about the possibility of an interest rate reduction by the Federal Reserve (Fed). While the Fed did deliver a 0.25% rate cut in late July, not all of the market's wishes were met. Hopes of a 0.50% cut were not fulfilled. In addition, the Fed characterized the decision as a "mid-cycle adjustment" instead of the beginning of a monetary easing cycle. The market wanted more cuts as an aid to offsetting tariff-related economic pressures. Disappointment fueled a "rate temper tantrum" and a sharp ~6% sell-off in late July – early August.

Sentiment during the quarter was also plagued by ongoing US-China trade war gamesmanship. Negotiations in July failed to yield a resolution, amidst gridlock on several structural issues. The subsequent parade of threats, posturing and announcements of additional tariffs increased concern about the possible damage to economic activity and corporate earnings. September, however, brought some hopefulness about possible progress. Both countries exchanged apparent olive branches by walking back some of the threats of action, including tariff increases. However, the de-escalation did not yield a resolution to the trade war by quarter's end.

Stocks have posted some rather impressive year-to-date gains in the face of uncertainties. The Nasdaq Composite, S&P 500 and Dow Jones Industrial Average posted gains of 21.6%, 20.5%, and 17.6%, respectively, through September 30th. The Russell 2000 is lagging the group, with a gain of 14.1%. **As we enter the 4th quarter, investor psychology is being challenged by concern about:** 1) the Fed's future rate actions to potentially offset trade war pressures; 2) prospects for US-China trade negotiations; 3) trade war impacts to the global and domestic economy; and 4) the outlook for corporate earnings in the face of a slowing economic backdrop and an unresolved trade war. The market will be looking for clues about these concerns.

FIXED INCOME

Brian Brill, CFA
Senior Portfolio Manager

It was a volatile 3rd quarter for interest rates as investors were torn between ongoing weakness in the global economy, the up and down trade war between the US and China, the resilience (to date) of the US consumer, and changing Federal Reserve (Fed) policy.

Acknowledging the global economic weakness and its potential effects on the US, the Fed began to telegraph its intentions to change the course for monetary policy early in the quarter; fulfilling the foreshadowing on July 31st. **At that time, the Fed cut interest rates 25 basis points** and ended its balance sheet runoff program early. The reason for the cut was "the implications of global developments for the economic outlook." This was interpreted as the implications caused by trade policy.

Taking the cue that the rate cut was because of trade policy, President Trump, who wants the Fed to cut rates faster and further, tweeted that he was going to impose an additional 10% tariff on the remaining $300 billion worth of Chinese imports. With China responding by weakening its currency and stopping agricultural purchases, concerns of a full-fledged trade war between the two largest economies ignited fears of a slowing global economy and potential recession.

Investors' reaction was swift as they tried to lock in yields for as long as possible. The US 30-year at one point reached an all-time low of 1.91% and the amount of negative yielding global debt broached $17 trillion.

Meanwhile, US policymakers continued to face a conundrum as domestic economic growth, led by the consumer, remained positive even with the manufacturing side clearly affected by trade.

The Fed cut rates 25 basis points once again in September for the same reasons as in July but Fed officials were clearly divided by the weakening global economic environment and a resilient US consumer.

The trade war with China will continue to be a main concern in the 4th quarter but what investors will be most concerned with is if the weakness in manufacturing will negatively affect the consumer, forcing the Fed to become more aggressive.

Washington Trust Bank
WEALTH MANAGEMENT & ADVISORY SERVICES

INTERNATIONAL REVIEW

Derrick Wilson
Portfolio Manager

This quarter certainly did not lack for news that kept markets questioning what comes next. Economic, geopolitical and trade pressures have continued to leave investors uneasy about where things are headed.

Europe and Asia signaled continued weakening in their economies, furthering concerns of slowing global growth. July started off with reports of lower than expected manufacturing data across both continents as they slipped further into contractionary territory. The services sector is not yet in contraction but is showing signs of slowing. Italy fell into recession in the 1st quarter, and Germany is seemingly next to enter a technical recession if a negative reading comes with its next GDP report.

Brexit continues to add to troubles in Europe. New Prime Minister Boris Johnson came in determined to get things done but looks to be in no better position than his predecessor, Theresa May. Despite the threats of exiting with no deal, chances look to be higher that the process could be extended, yet again. Unsure when this will reach a conclusion, businesses and individuals in the UK are left hanging in the balance when planning for the future, hampering economic growth and investments.

Tensions remain high in Hong Kong since protests started in June over the proposed Fugitive Offender amendment bill. The bill was officially withdrawn on September 4th, although that did not put an end to the protests. Violence has only escalated since. Conflict in the Middle East between Saudi Arabia and Iran persists with the latest drone attack on a Saudi processing plant and oilfield last month. Oil prices spiked following the attack due to supply concerns but slowly subsided as operations began to be restored quicker than anticipated.

As news and events unfold at a rapid pace, it is easy to get caught up in all that is happening. Even as a grim picture appears, global equity markets have experienced positive returns year-to-date. **Where we ultimately end up to close out this year remains unclear. What is clear is volatility should remain.**

Additional and expanded information to this newsletter discussion may be obtained by contacting your Relationship Manager. We will be happy to expand our discussion with you to meet your individual requirements as a client of Wealth Management & Advisory Services.

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