ECONOMIC REVIEW

Steve Scranton, CFA
Chief Investment Officer & Economist

Summary:

- 4th quarter economic activity slowed from the 3rd quarter but remained positive.
- Consumers continued to be the workhorse for economic growth.
- The manufacturing sector showed clear signs that the trade tariffs and strong dollar are hurting the sector.

Consumer Spending

The consumer remained the driver of economic growth in the 4th quarter. Consumer confidence held up for most of the quarter despite all of the noise and drama emanating from Washington, D.C. Consumer confidence dropped in December — perhaps because of the financial markets' volatility — but remains at elevated levels.

Consumer confidence, combined with gradually rising wage growth, has supported continued spending by the consumer. During the 4th quarter, average hourly earnings rose from a 2.8% annualized rate at the end of September to a 3.2% annualized rate at the end of December. More importantly, the annualized growth rate for inflation — as measured by the Consumer Price Index — declined during the quarter thanks to falling energy prices. The net result is that real average hourly earnings — earnings after inflation is subtracted — rose. This gives the consumer more purchasing power.

Business Spending

Business spending was under pressure during the 4th quarter for several reasons:

- Shortages of qualified help are forcing businesses to raise compensation for employees.
- Rising raw material prices for imported goods rose due to the impact from the trade tariffs.
- Export sales declined due to a combination of a stronger dollar — up 2% for the quarter and 6.7% for the year — and trade tariffs.

Data from the Census Bureau illustrates the impact of the US-China trade tariffs. Over the last three months, US imports from China are up 7.7% while US exports to China are down 18.7%. Manufacturing was also negatively impacted by the decline in energy prices as this hurt the oil industry and the manufacturing companies that make the equipment for the energy sector.

Government Spending

Congress managed to pass legislation funding 75% of the spending bill that was passed in the 1st quarter. As a result, government spending was a positive contributor to economic growth throughout the year and continued that pattern in the 4th quarter. The government shutdown at the end of the year had no impact to economic growth in the 4th quarter.

Conclusion:

Although the first estimate of 4th quarter GDP will not be out until the end of January, the economic data that were released during the quarter indicate that the pace of economic growth slowed from the 3rd quarter levels but was still positive. It appears that the fiscal stimulus enacted at the end of 2017 and beginning of 2018 will result in total year economic growth close to or slightly above 3%. **If we achieve 3% growth for the year, it will be the first time in this business cycle that we have had full year economic growth at or above 3%.**

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ALTERNATIVE STRATEGIES

Rick Cloutier, CFA
Chief Investment Strategist

The year began like the last few years with US stocks moving markedly higher. After a quick blip in February, through September domestic equities continued the rise to which we have become accustomed, despite the Fed raising interest rates, slowing growth in China, and the potential for a trade war.

Unfortunately, the effects of quantitative tightening finally caught up. Equity investors have enjoyed the benefits of quantitative easing, and stock prices have moved precipitously higher for nine consecutive years. But, since 2015 the Fed has raised interest rates eight times and central banks around the globe have begun winding down their accommodative policies. The tightening of the money supply has led to the worst year for investors in the last 100 years. With over 90% of the 70 asset classes tracked by Deutsche Bank providing negative returns, there were few safe places to hide.

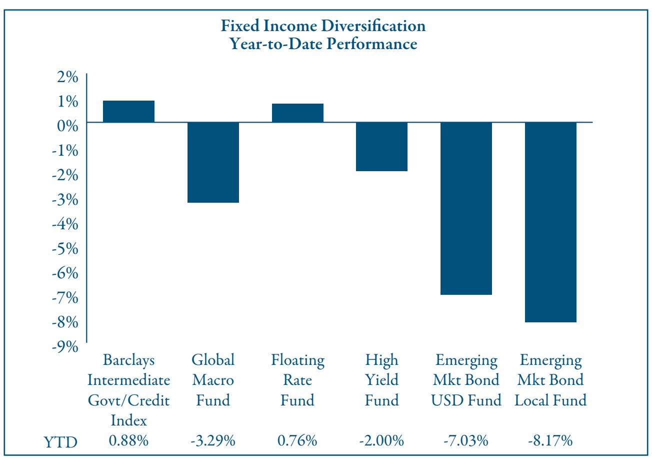
Until September, US equity investors remained unharmed, but from its peak, the S&P 500 dropped 19.8% when it hit its low on Christmas Eve, narrowly missing bear market territory. After nine consecutive years of growth, the S&P 500 broke this abnormal trend and declined 5.24% in 2018. Small cap investors fared more poorly, losing over 11%. International stocks and emerging market stocks declined even further.

With the rise in rates, fixed income markets provided little relief. Short term, high quality bonds gained approximately 1%, but long-term, high yield, international, and emerging market bonds all delivered negative returns.

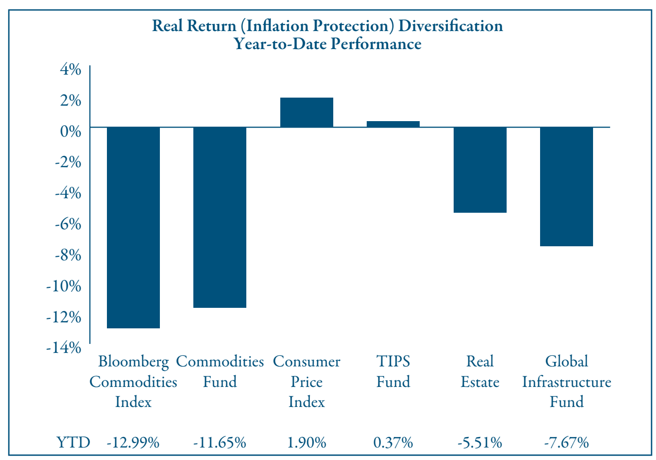
Alternative asset classes did not offer positive performance as well. Real estate was off 4.0% and commodities, led by the drop in crude prices, declined more than 11%. Due to increased production in the US, Russia, and Saudi Arabia along with waivers granted to India, China, and other countries for Iran deliveries, oil fell more than 30% from a four year high in a matter of weeks.

Despite the 4th quarter volatility swings, the volatility index remained within normal ranges and only triggered our dynamic hedging strategy twice during the year for two brief periods.

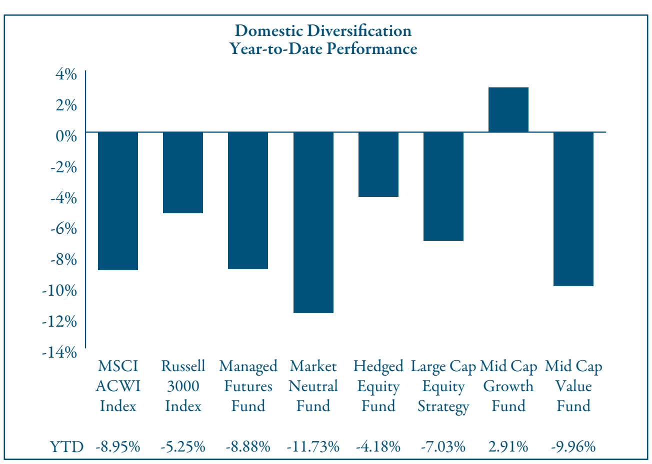
While investors did not suffer the pain of 2008, the decline in almost every asset class left few investors unharmed.



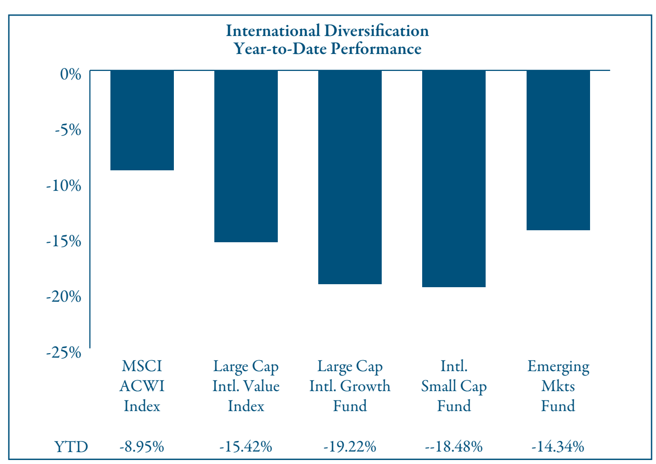
Fixed Income Diversification
Year-to-Date Performance



Real Return (Inflation Protection) Diversification
Year-to-Date Performance



Domestic Diversification
Year-to-Date Performance



International Diversification
Year-to-Date Performance

DOMESTIC EQUITIES

Gayle Sprute
Senior Portfolio Manager

What a difference one quarter can make. Going into the 4th quarter of 2018, year-to-date gains for the major domestic indices were very firmly in positive territory. However, the last three months of the year proved to be exceptionally challenging. During the quarter, the Dow Jones Industrial Average (Dow), S&P 500, Nasdaq Composite, and Russell 2000 fell by 11.3%, 13.5%, 17.3%, and 20.2%, respectively — and all of the indices ended in negative territory for the year.

Pessimism surged during the final three months of 2018 and there was no respite to be found amongst the list of worries. Political battling between the Trump administration and Democrats continued, no real progress was made in the US-China trade negotiations, the Chinese and global economies continued to show signs of slowing, and the Federal Reserve (Fed) signaled its intent to continue increasing interest rates into 2019. These layered onto the backdrop of worries about "peak" US economic and corporate earnings growth.

The market expects a slowdown in economic and earnings growth in 2019. However, the unknown pressures from the areas mentioned above leave the equities market highly uncertain about how the future will unfold. This caused a sharp pullback in risk tolerance and a downward re-rating in valuation during the 4th quarter. The forward 4-quarter price/earnings (P/E) multiple for the S&P 500 compressed to 14.6X at year end — down significantly from 17.3X at the end of the 3rd quarter.

The market's appetite for risk has declined significantly, and market psychology is on edge as we enter 2019. Investors are very much in need of certainty in regards to the areas of worry discussed above — and in need of certainty regarding how corporate earnings will be affected. The market recognizes that earnings will slow in the coming year. Estimates for 2019 earnings growth (for the S&P 500 companies) have fallen to 6.7% from over 10% at the end of the 3rd quarter. What matters is not so much the deterioration, but how far the deterioration goes relative to current expectations — and whether the current compressed valuation appropriately factors in the risk level for the prevailing macro landscape.

FIXED INCOME

Brian Brill, CFA
Senior Portfolio Manager

As the US Federal Reserve (Fed) seemed to be set in its ways in fulfilling its September rate projections, investors this quarter became more and more adamant that this course of action may be a mistake, especially in light of the US trade disputes and the ongoing tapering of asset purchases (quantitative tightening).

The Fed's projections in September indicated that it would raise rates 25 basis points again in December, three more increases in 2019 and one more in 2020. Back in early 2018, these projections seemed reasonable given the recently enacted tax reform changes that would increase economic activity. But as the year progressed, the increased economic activity in the US was not matched by other nations. As a result, with rates continuing to increase in the US, but not in other countries, the value of the dollar increased versus our trading partners'. This dynamic made US products less competitive in the world market place. US trade disputes with NAFTA, the EU, and China also negatively affected global economic activity.

These concerns came to a head in the 4th quarter. The Fed raised rates by 25 basis points in December and continued on a pre-set course of decreasing re-investments from their balance sheet, thus disappointing investors who viewed the Fed as being more aggressive than prudent. As a result, Treasury yields have inverted in parts of the yield curve — the Fixed Income market's way of saying that monetary policy is too contractionary.

Fixed Income investors have responded to these concerns by bidding rates lower for longer dated securities even though the Fed has pushed short maturity rates higher. As an example, 3-month Treasury yields have increased 20 basis points, while 10-year Treasury yields have declined by 38 basis points this quarter.

Concerns of slowing economic growth are also manifesting in the rising yield differential between yields of US corporations and US Treasury securities. Investment grade and high-yield yield spreads (borrowing costs) have increased 47 and 205 basis points respectively this quarter. **In fact, due to the weakness of this quarter, the general investment grade sector finished with its worst year-to-date returns since 2008.**

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INTERNATIONAL REVIEW

Derrick Wilson
Portfolio Manager

Looking back, 2018 was a bit of a tumultuous year in the global markets. Coming off the euphoria that was 2017, it seemed as though that feeling would continue. This was short lived, however, as the end of January brought the end of the perpetual upward movement in global equity markets and volatility re-introduced itself.

While the US narrowly escaped a bear market (measured by the S&P 500), several major international equity market indices entered bear market territory: China's Shanghai index in June, Hong Kong's Hang Seng index in September and Japan's TOPIX index in December. All three had fallen more than 20% from their peaks back in January.

What was concern earlier in the year over anticipated slowing international economic growth is now becoming evident in the data. China's most recent annual growth rate of 6.5% shows a slowdown from 6.7% previously reported. The same goes for the Euro Area with its 3rd quarter annual growth rate of 1.6%, less than the prior quarter of 2.2%.

News headlines that remained constant throughout the year were those regarding tariffs and the trade war between the US and China and the soap opera that is Brexit. In both situations, the question remains, "Will they or won't they?" (agree to terms in negotiations). These events have also proven their ability to move markets both positively and negatively, depending on the day. Anxiety could be higher in the coming quarter over Brexit as the March 29, 2019, deadline draws nearer and Britain is set to officially break from the European Union.

Emerging markets declined over the course of the year, with the MSCI Emerging Market Index finishing down 14.58%. The US dollar led to much of this decline as it strengthened against major foreign currencies from its calendar year low in mid-February through year-end. Political and economic struggles had investors worried during the summer months of contagion spreading to other countries and markets, but that worry faded through the second half of the year.

Moving forward into 2019, expect continued volatility, at least in the near term. Along with slowing economic growth, global central bank actions (or words) could continue to weigh on markets as well. Here's to a New Year!

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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Highlight

ECONOMIC OUTLOOK

Steve Scranton, CFA
Chief Investment Officer & Economist

Summary:

- 2019 growth will not match 2018 growth but it should remain positive, resulting in the US breaking the record for the longest US business cycle in history.
- Consumers will remain the engine driving the economy.
- Business spending will be a key determinant of economic growth.
- Interest rates and trade are the biggest threats to economic growth.

As has been discussed in previous quarterly newsletters, momentum is a key force in keeping an economy moving forward. If we focus on the fundamentals of the economy, here are the positive fundamentals that should support positive economic momentum in 2019:

- Fiscal policy is still providing fiscal stimulus in 2019.
- Wages are rising and lower energy prices should support consumer spending. This should allow the consumer to remain the workhorse for economic growth.
- 100% expensing of capital expenditures and repatriation of dollars from overseas provide the potential for businesses to increase spending on productivity-focused capital expenditures.

Here are the reasons 2019 economic growth should be slower than 2018:

- Although the US economy has been solid, the global economy is clearly slowing and US growth is not immune to a globally slowing economy.
- The cumulative impact from three years of rising interest rates is going to create a drag for those consumers and businesses who are funding their purchases with debt. Every dollar that goes to higher interest payments is a dollar not available for higher spending.
- The goods producing sector of the economy, especially the manufacturing sector, showed clear slowing at the end of the 4th quarter. Tariffs, a strong dollar, a slowing global economy and labor shortages are hurting the goods producing side of the economy.

Conclusion:

The US economy still has enough momentum to keep economic growth positive in 2019. Growth may well slow back to the 2% level that existed before 2018. As always, we need to consider potential “wild card” events that could derail or boost the economy.

Risks:

- A policy mistake by the Federal Reserve by draining liquidity from the economy too quickly. This could cause interest rates to rise more than their models project.
- A failure to reach agreement on trade policy with China and the implementation of 25% tariffs on all Chinese imports would hurt both businesses and consumers through higher prices.
- A financial crisis in Europe or China would pose a risk to all global economies.

Potential events that could provide an additional boost to the economy are:

- Congress and the Administration actually working together to pass additional legislation to support the economy. History has shown a propensity for Congress and the Administration to pass fiscal stimulus in front of an election year. Infrastructure is a potential candidate.
- Favorable resolution of the trade dispute between China and the US.
- The Federal Reserve slowing or stopping the draining of liquidity.

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Market Overview

Cumulative Periods *as of 31 December 2018*

			Annualized		
	Year-to-Date	1 Year	3 Years	5 Years	10 Years
Russell 3000 Index	**-5.24**	**-5.24**	**8.97**	**7.91**	**13.18**
S&P 500 Index	-4.38	-4.38	9.26	8.49	13.12
Russell Mid Cap Index	-9.06	-9.06	7.04	6.26	14.03
Russell 2000 Index	-11.01	-11.01	7.36	4.41	11.97
FTSE NAREIT All Equity REITs Index	**-4.04**	**-4.04**	**4.24**	**8.32**	**12.53**
Bloomberg Commodity Index	**-11.25**	**-11.25**	**0.30**	**-8.80**	**-3.78**
MSCI ACWI All World Index	**-9.42**	**-9.42**	**6.60**	**4.26**	**9.46**
MSCI EAFE Index	**-13.79**	**-13.79**	**2.87**	**0.53**	**6.32**
MSCI EAFE Small Cap Index	-17.89	-17.89	3.73	3.06	10.51
MSCI EM Index	-14.58	-14.58	9.25	1.65	8.02
Barclays Govt/Credit 1-5 Yr. Index	**1.38**	**1.38**	**1.40**	**1.32**	**2.09**
Barclays US Treasury TIPS Index	0.41	0.41	1.44	0.60	2.34
BOAML US High Yield Master II Index	-2.26	-2.26	7.27	3.82	10.99
JPM GBI Global Diversified Index	-6.21	-6.21	5.91	-0.96	3.45
Barclays Municipal 1 Yr. Index	**1.74**	**1.74**	**0.99**	**0.83**	**1.20**
Barclays Municipal 3 Yr. Index	**1.76**	**1.76**	**1.13**	**1.16**	**1.99**
USTREAS Stat US T-Bill 90 Day Index	**1.94**	**1.94**	**1.06**	**0.65**	**0.38**