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Economic and Market Environment

Fourth Quarter 2018

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The Economy

- The U.S. Economy is growing at its fastest rate since first quarter 2014. Investor and business confidence is high, and corporate profits are booming. Sustaining higher levels of growth will depend on greater capital investment and productivity. Recession fears have receded.

- The Federal Reserve (Fed) intends to continue its interest rate normalization policy. The extent to which this policy can be completed will depend on longer-term bond yields, inflation and inflation expectations. We assume the Fed will not invert the yield curve.

- The fiscal condition of the economy has deteriorated. The Trump tax cuts will widen out the federal budget deficit, a trend that is expected to continue for years.

- Long standing U.S. trade policy is being reversed by President Trump. The longer-term implications are unclear, but most economists view this as a risk factor for the economy.

Stocks & Bonds

- Stocks are now trading at all-time-high levels. Very strong corporate earnings growth, strong stock buybacks and dividend increases are driving stock prices higher.

- Stock valuations are elevated relative to historical averages, but not dramatically. If inflation and interest rates remain relatively low, higher valuations may be justified. Investors seem to be projecting strong earnings growth into the future.

- Bond yields have risen this year, providing bond investors with slightly negative returns year-to-date. Fed increases in the federal funds rate are pushing bond yields higher, yet inflation expectations remain steady.

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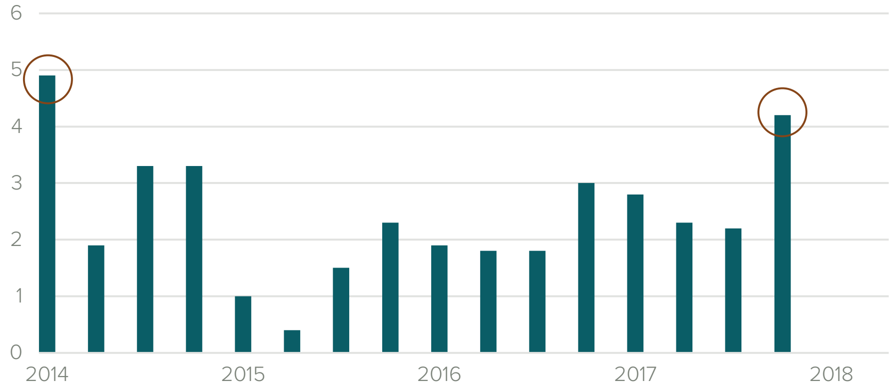
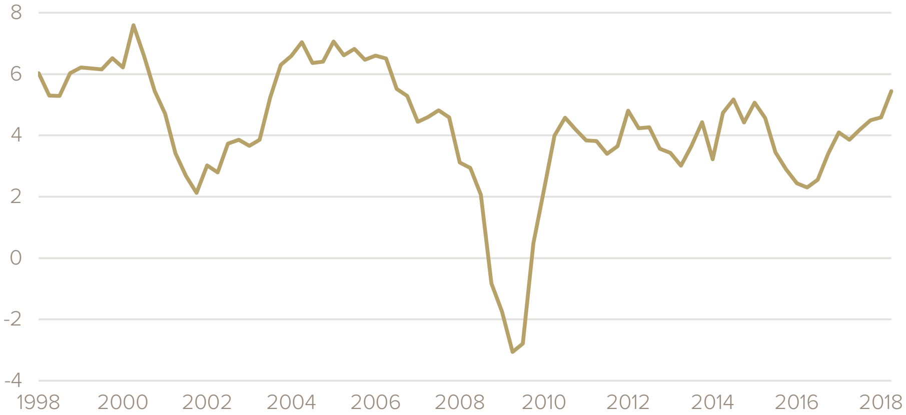
Real Gross Domestic Product



Source: Bureau of Economic Analysis
Real Gross Domestic Product, percent change from preceding quarter (Data Through: June 2018)

Nominal Gross Domestic Product



Source: Federal Reserve Bank of St. Louis
Gross Domestic Product, Percent Change from Year Ago, Quarterly, Seasonally Adjusted Annual Rate (Data Through: April 2018)

- Whether measured in real or nominal terms, in the second quarter of 2018 the U.S. economy enjoyed its highest quarterly rate of growth since 2014.
- Faster growth is being powered by fiscal policy (the corporate tax cut) and a healthy and confident consumer.
- Real Gross Domestic Product (GDP) is adjusted for inflation. Nominal GDP is not. It is important to monitor both.
- The importance of nominal GDP growth lies in the fact that the nominal world is the actual world that companies must compete in.

FINAL SALES TO DOMESTIC PURCHASERS: ANOTHER IMPORTANT SERIES

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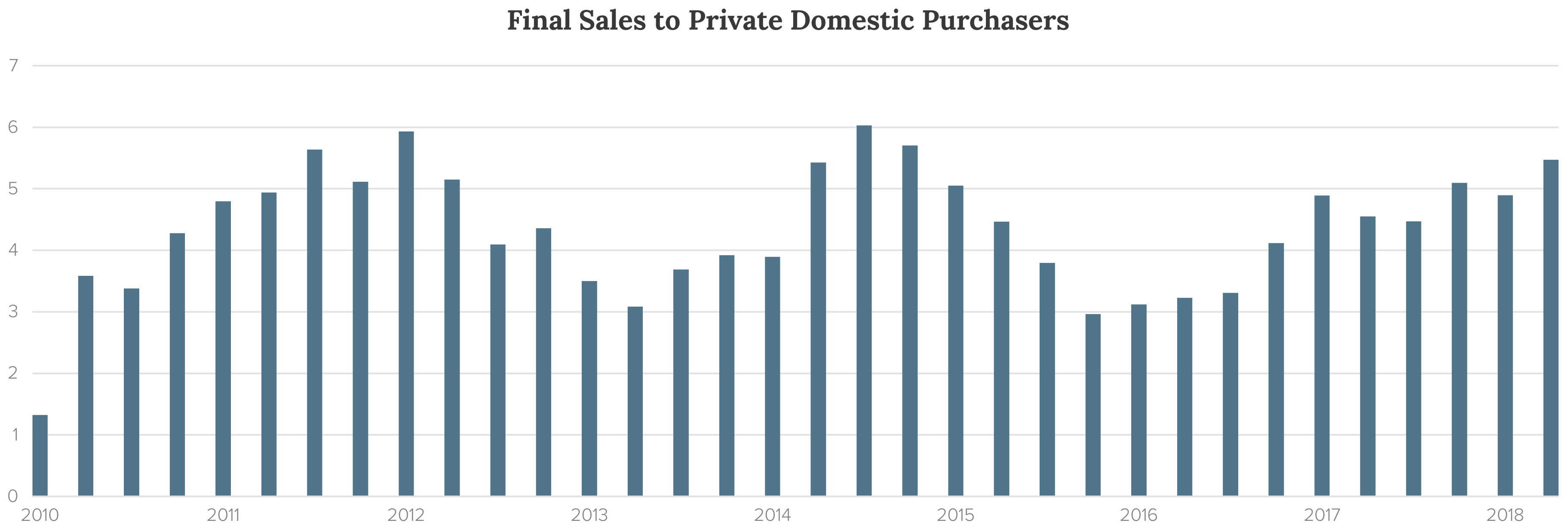

Source: Federal Reserve Bank of St. Louis
Final Sales to Private Domestic Purchasers, Percent Change from Year Ago, Quarterly, Seasonally Adjusted Annual Rate (Data Through: April 2018)

- Final Sales to Domestic Purchasers is an important economic series, one that indicates underlying demand in the economy.
- This series strips out the impact of inventories and exports/imports, two of the more volatile elements of GDP.
- The Final Sales series confirms that underlying demand in the economy is currently the strongest since 2014. The above chart is in nominal terms.

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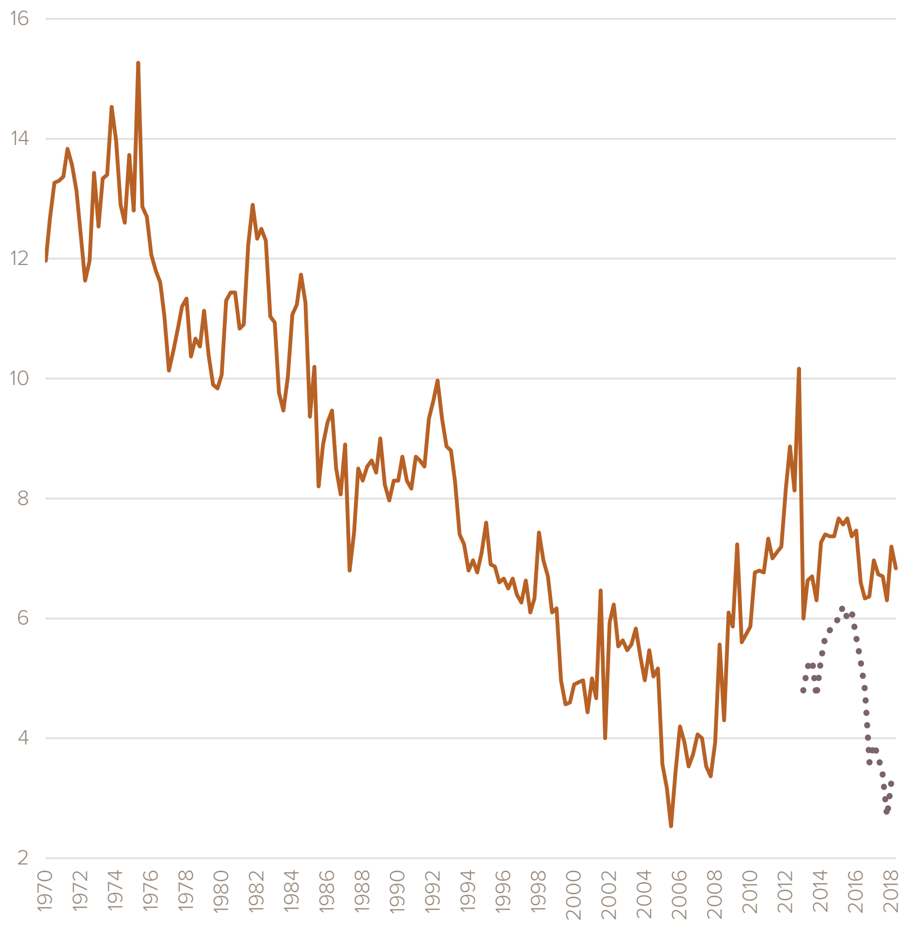
- The Personal Savings Rate is a good measure of consumer purchasing power.
- After trending lower for 35 years, it bottomed in 2006 and has been in an uptrend ever since.
- The Bureau of Economic Analysis, which compiles the savings rate, recently revised upward the savings rate from around 1% to 7%.
- This dramatic increase suggests a much stronger consumer with considerably more purchasing capability. This augurs well for future economic growth.

Personal Savings Rate



Source: Federal Reserve Bank of St. Louis, Bureau of Economic Analysis
Personal Saving Rate, Percent, Quarterly, Seasonally Adjusted Annual Rate (Data Through: April 2018)

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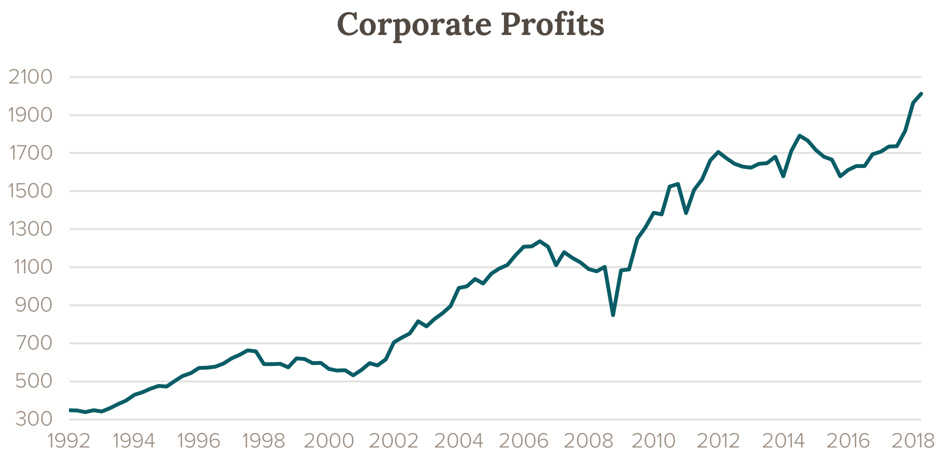
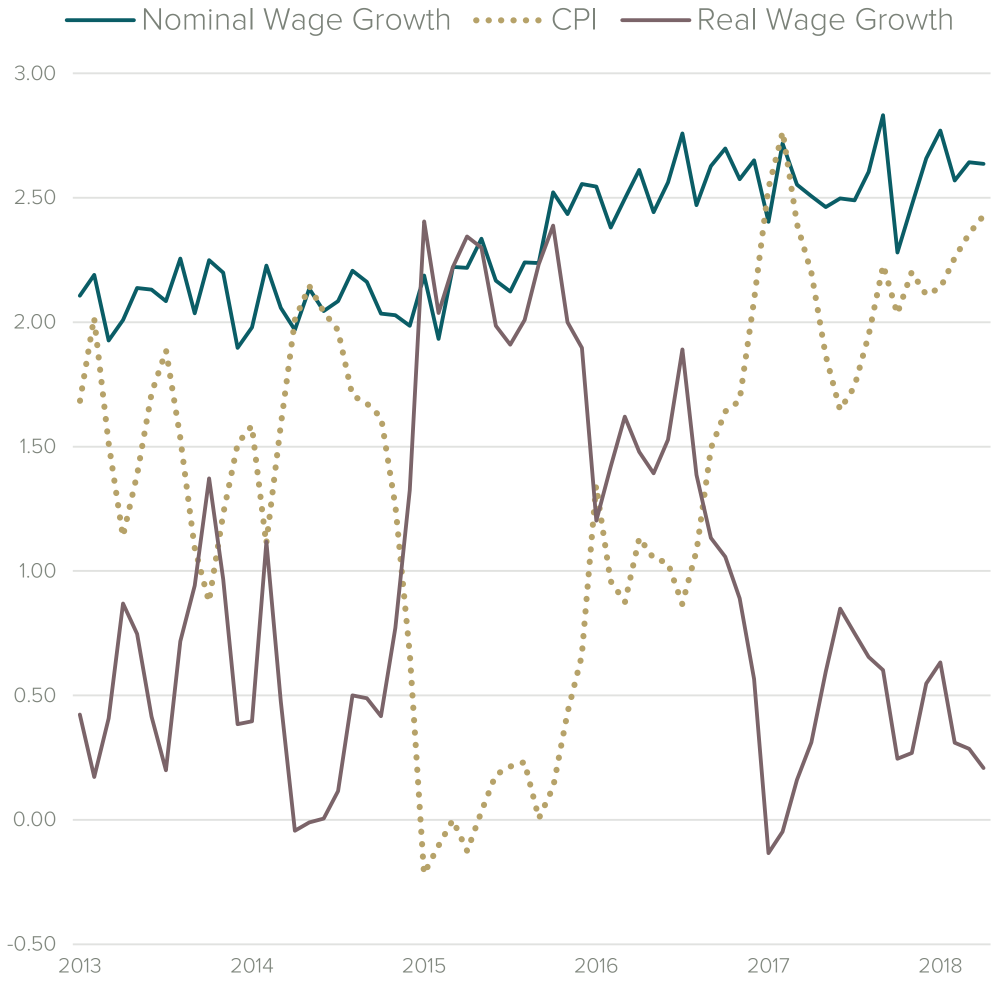


Source: Federal Reserve Bank of St. Louis
Corporate Profits After Tax with Inventory Valuation Adjustment (IVA) and Capital Consumption Adjustment (CCAdj), Billions of Dollars, Quarterly, Seasonally Adjusted Annual Rate (Data Through: April 2018)

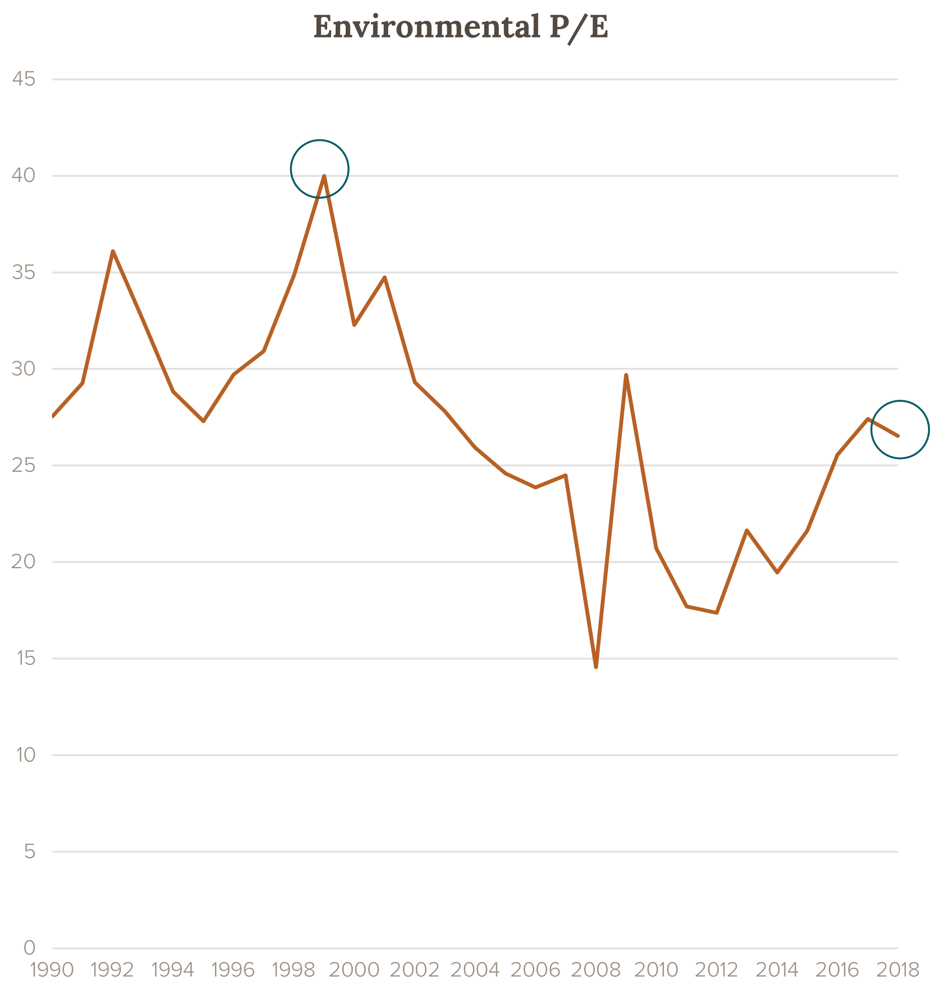
Source: Federal Reserve Bank of St. Louis
Corporate Profits After Tax with Inventory Valuation Adjustment (IVA) and Capital Consumption Adjustment (CCAdj), Billions of Dollars, Quarterly, Seasonally Adjusted Annual Rate (Data Through: April 2018)
Gross Domestic Product, Billions of Dollars, Seasonally Adjusted Annual Rate (Data Through: April 2018)

- Corporate America is capitalizing on a stronger economy and the Trump corporate tax reduction. Record profits are the result.
- These accelerating earnings are the main reason behind all-time-high levels for common stocks.
- Corporate profit growth should continue, but expectations for future growth may need to be moderated. Wall Street analysts are now projecting three to five year growth in earnings of 16%.
- Corporate profits are not only high on an absolute basis, but also as a percentage of GDP. Corporate America may be in its strongest position ever.



Source: Federal Reserve Bank of St. Louis
Average Hourly Earnings of All Employees: Total Private, Percent Change from Year Ago, Monthly, Seasonally Adjusted (Data Through: April 2018)
Consumer Price Index for All Urban Consumers: All Items, Percent Change from Year Ago, Monthly, Seasonally Adjusted (Data Through: April 2018)

- Wage growth, one of the more important underpinnings of overall economy growth, has been rising over recent years, but only gradually.
- With unemployment nearing historic lows, workers should be in a stronger position to command wage increases. It seems reasonable to expect so eventually.
- Importantly, adjusted for inflation, wage growth remains near zero. Concentration of monopoly power in corporate America may be restraining wage growth.



Source: FactSet, Federal Reserve Bank of St. Louis
Sum of PE Ratio (LTM), 10 Year Treasury Bond Yield, Annual CPI Inflation

- Traditional valuation measures such as price-to-earnings ratio and the Shiller P/E do not take into account changes in the economic environment.
- The Environmental P/E takes into account both inflation and interest rates as well as the traditional P/E ratio.
- Currently, inflation and interest rates are low relative to history. Both series have an effect on how investors price future prospects for companies.
- Low interest rates and inflation imply a lower discount rate on future earnings, justifying higher current valuations.
- This Environmental P/E is suggesting that stocks are more moderately priced than indicated by traditional measures.

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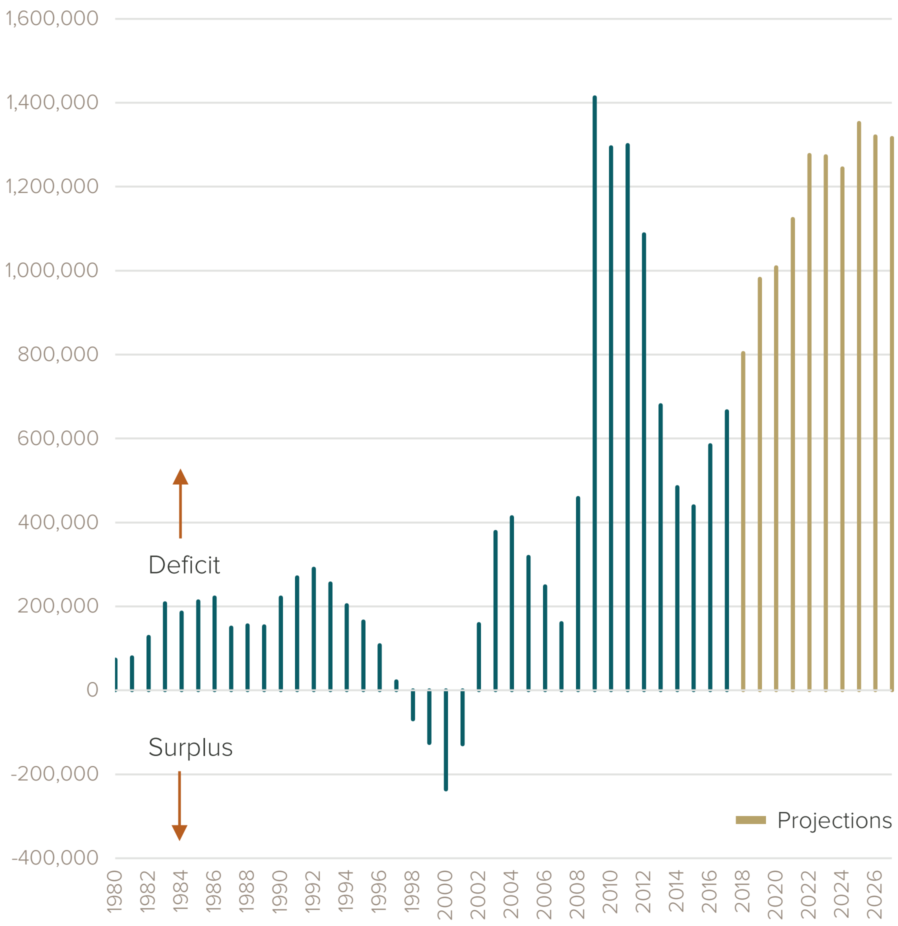
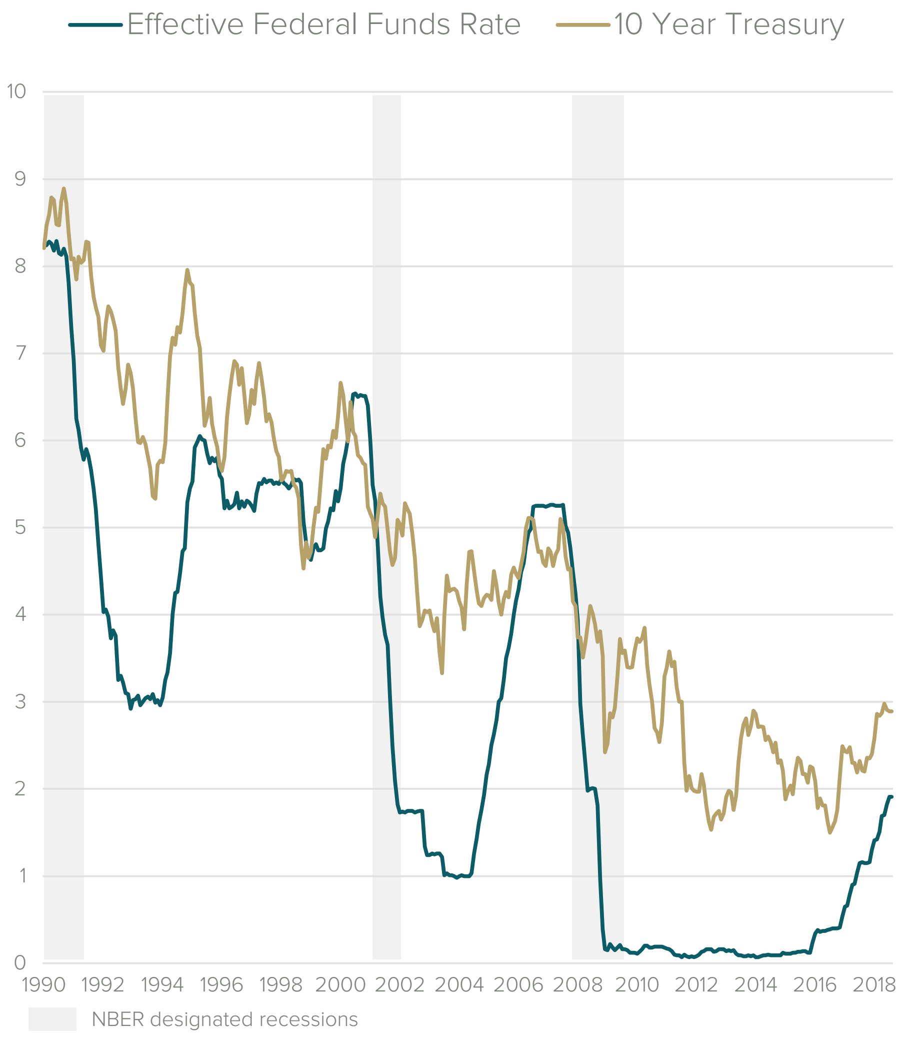
- Remember the good old days? The federal budget actually produced surpluses in 1998-2002.
- Tax cuts and recessions have changed everything. Fiscal conservatives can only weep when viewing this picture.
- Although markets are not worried about deficits currently, there can be negative implications for bonds and stocks.
- Persistent and large deficits may push interest rates up, and common stock valuations would likely suffer. Lower economic growth could also be a longer-term result.

Federal Surplus or Deficit



Source: Federal Reserve Bank of St. Louis
Federal Surplus or Deficit [-], Millions of Dollars, Annual, Not Seasonally Adjusted

THE YIELD CURVE: WATCH IT CLOSELY



Source: Federal Reserve Bank of St. Louis
Effective Federal Funds Rate, Percent, Monthly, Not Seasonally Adjusted (Data Through: August 2018)
10-Year Treasury Constant Maturity Rate, Percent, Monthly, Not Seasonally Adjusted (Data Through: August 2018)

- Investors have traditionally considered the 2-year Treasury to the 10-year Treasury as the most appropriate yield curve.
- The yield curve has a good record of forecasting recessions. An inverted curve has preceded almost all recessions.
- Recently, the San Francisco Federal Reserve published a paper suggesting the best yield curve for forecasting a recession is the federal funds rate compared to the 10-year Treasury.
- Currently, this yield curve is positively sloped by about 100 basis points.
- Since the Fed is intent on moving the federal funds rate upward, the action of the 10-year Treasury will be all important.

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