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Economic and Market Environment

Fourth Quarter 2019

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The Economy

- Despite rising recession fears, our overall assessment is that the U.S. economy is performing well.
- We believe the U.S. economy is trending towards a sustainable real growth rate of around 2%, and this growth will be accompanied by low inflation and interest rates. Viewed in its totality, this is a constructive outlook.
- Until significant excesses develop in the areas of inflation, spending, or speculation, the economy should be able to expand for a few more years, at least.
- There are areas of concern for the economy. Investment in capital projects is slowing, manufacturing is contracting, and the yield curve is suggesting caution. Trade tensions are causing uncertainty among business leaders.
- Global economic trends are not favorable. Japan, Germany, and the United Kingdom are experiencing very slow growth. Will the U.S. be infected by slow growth trends abroad?
- Interest rate policy is now in easing mode. Two federal funds reductions signal a willingness on the part of the Federal Reserve (Fed) to do whatever it takes to keep the economic expansion going.

Stocks and Bonds

- Stocks continued to advance in the third quarter, building on their strong performance in the first half of the year.
- The stock market is one of the official leading economic indicators. As such, it is not signaling the prospect of a recession.
- Stock valuations are slightly higher than long-term averages but seem reasonable given the outlook for inflation and interest rates.
- The signal from the bond market is mixed. Bond yields dropped sharply in the third quarter but partially snapped back late in the quarter.
- Bond investors have benefitted from the drop in yields in terms of total investment return.
- There are longer-term, secular influences in the domestic and global economies, which suggests that interest rates in general will remain lower than normal for the foreseeable future.

RECESSION TALK IS RISING: WHAT COULD TAKE THE ECONOMY DOWN?

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THE DRIVERS OF GROSS DOMESTIC PRODUCT (GDP)

	Consumption	+	Investment	+	Government	+ / -	Exports / Imports	=	GDP
Total GDP in $	$14.0 Trillion		$3.6 Trillion		$3.6 Trillion		$ -978 Billion		$20.5 Trillion*
% of GDP	68%		18%		18%		-4%		100%
Trending	↗		↘		↗		↘		↗

Consumption is the main driver of the U.S. economy. Currently, the consumer is in a strong position.

Investment is in a weakening trend as businesses are cautious in light of trade uncertainty.

Government fiscal policy is currently very loose as trillion dollar federal deficits are now the order of the day.

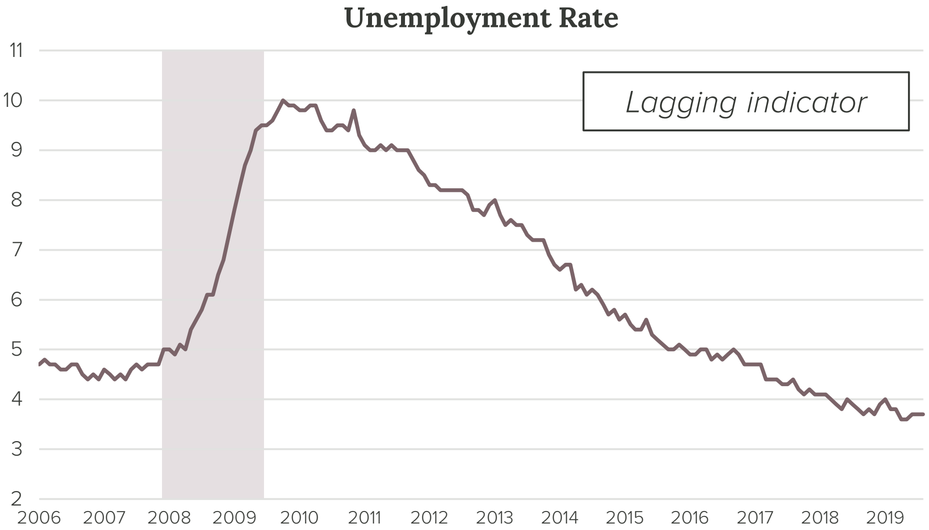
Exports / Imports – Imports are likely to remain strong relative to exports, which are hurt by a strong dollar.

A significant risk to GDP growth is a collapse in investment, which could lead to diminished confidence by the consumer and ultimately affect employment. However, 86% of GDP is trending in a positive direction. A consistent consumer and government spending are likely to support further growth.

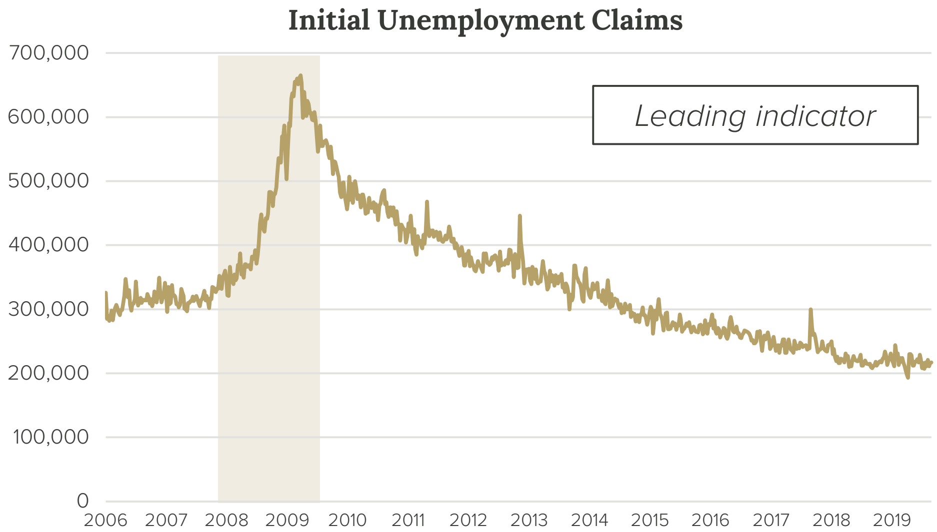
*As of 12/31/2018

Please see the last page for important disclosures.

EMPLOYMENT: CENTRAL TO A STRONG CONSUMER



Source: Federal Reserve Bank of St. Louis
Civilian Unemployment Rate, Percent, Monthly, Seasonally Adjusted (Data Through: August 2019)

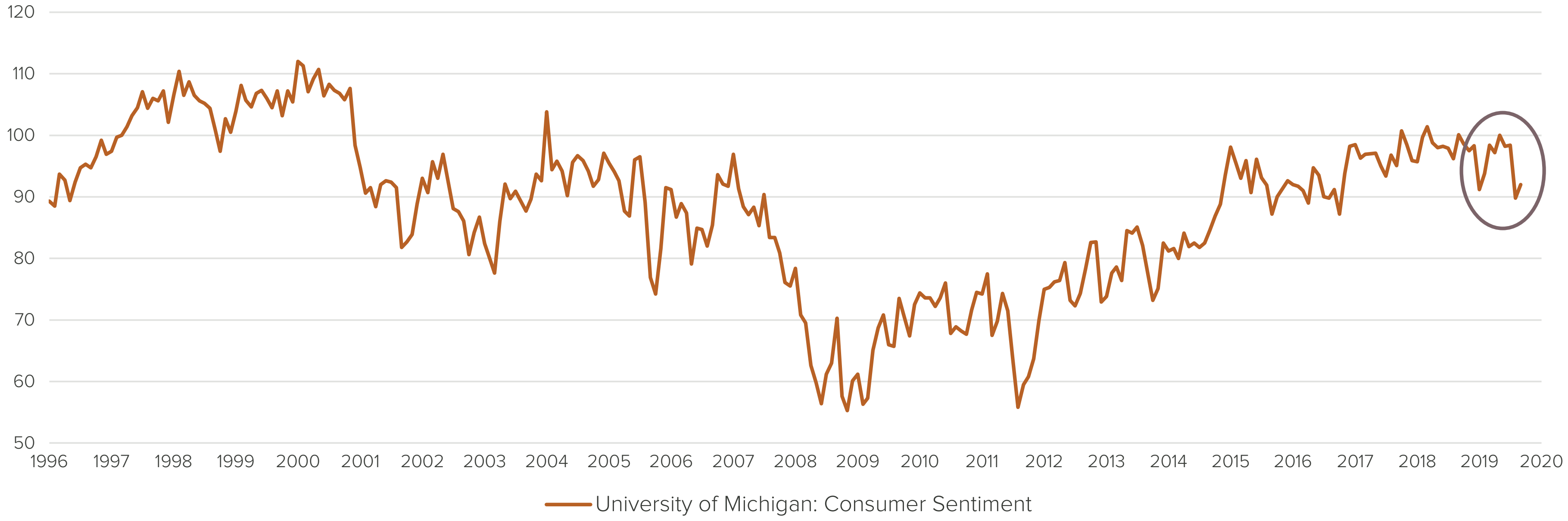


Source: Federal Reserve Bank of St. Louis
Initial Claims, Number, Weekly, Seasonally Adjusted (Data Through: August 2019)

- The unemployment rate at 3.7% is near a 50-year low. This is good. A fully employed workforce is more confident and is capable of spending.
- However, the unemployment rate report is a lagging indicator. It tells us nothing about what may happen in the future.
- The initial unemployment claims report is a leading indicator. Currently it is not pointing in the direction of recession but should be watched for any upturn in claims.
- Initial claims have leveled out and may not improve from current levels.
- The employment condition is sound.

Shaded areas denote NBER designated recessions. Please see the last page for important disclosures.

CONSUMER CONFIDENCE: STILL HIGH BUT BELOW ITS PEAK



Source: Federal Reserve Bank of St. Louis
University of Michigan: Consumer Sentiment, Index 1966:Q1=100, Monthly, Not Seasonally Adjusted (Data Through: September 2019)

- When consumer confidence is high, consumption trends are positive.
- Currently, almost anyone who wants a job can get one. Also, wages are rising moderately. These factors support consumer confidence.
- Confidence has been in a steadily rising trend since the end of The Great Recession. Lately, it has leveled off and declined from its highest levels. Tariffs are, no doubt, of concern to consumers.
- Confidence does not appear to be a problem at this time, but should confidence continue to slip, it would not augur well for the economy.

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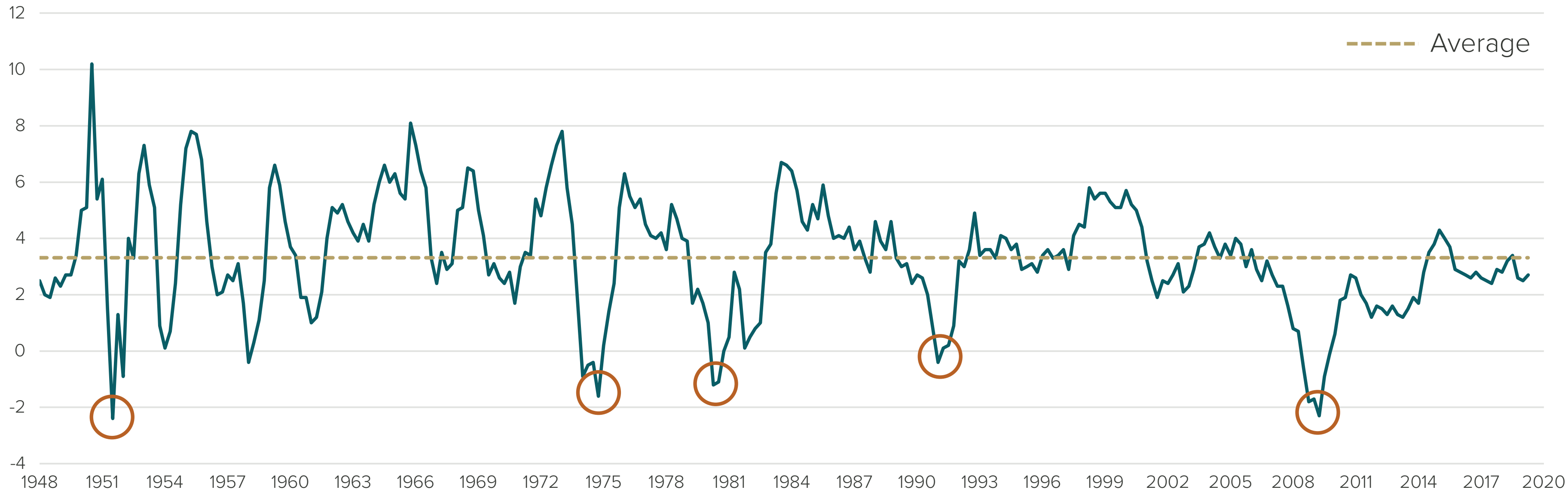
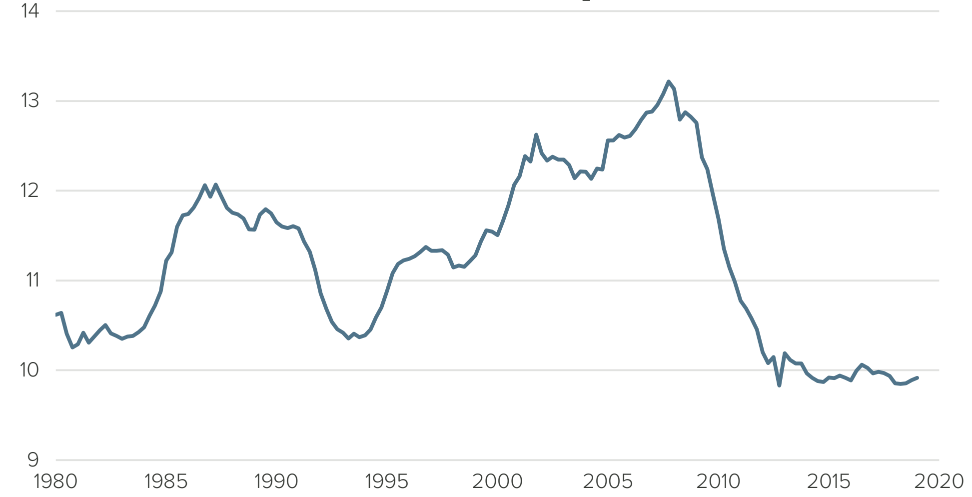


Source: Federal Reserve Bank of St. Louis
Real Personal Consumption Expenditures, Percent Change from Quarter One Year Ago, Quarterly, Seasonally Adjusted (Data Through: Q2 2019)

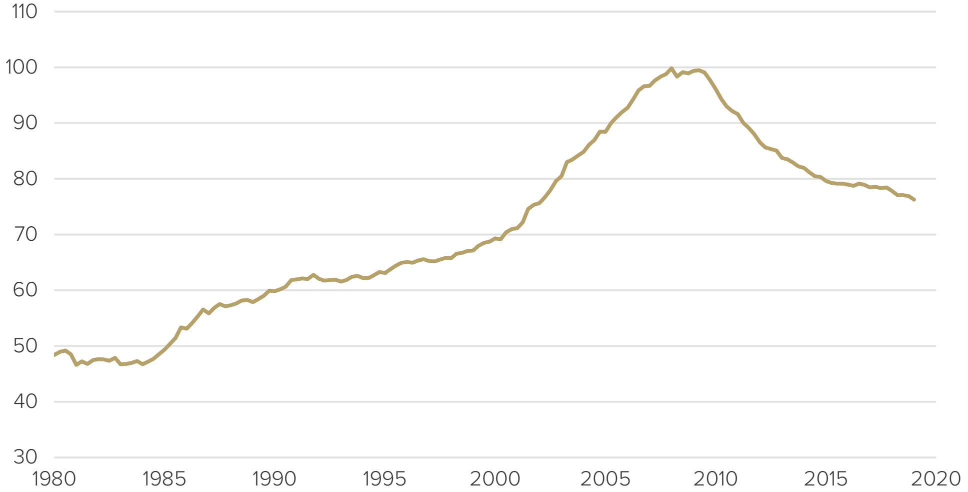
- Personal consumption expenditures are measured by the U.S. Bureau of Economic Analysis to gauge consumer spending. Over the last 70 years it has averaged some 3.3% per year.
- Consumption is normally positive and rarely contracts. Only on five occasions in the last 70 years has it contracted, and on each occasion it coincided with a recession.
- Real personal consumption expenditures are currently running at a healthy 3%.
- For now, the signal from the consumer is constructive.

Household Debt as a % of Disposable Income



Source: Federal Reserve Bank of St. Louis, FactSet
Household Debt Service Payments as a Percent of Disposable Personal Income, Percent, Quarterly, Seasonally Adjusted
(Data Trough: 1Q 2019)

Household Debt as a % of GDP



Source: Federal Reserve Bank of St. Louis, FactSet
Financial soundness indicator, households; debt as a percent of gross domestic product, Level, Percent, Quarterly, Not Seasonally Adjusted (Data Trough: 1Q 2019)

- Consumers spend when their finances are strong, as they are currently.
- Household debt service as a percent of disposable income came down sharply after The Great Recession and remains low.
- Household debt, measured widely as a percent of GDP also remains at a reasonable level.
- Strong finances undergird a confident consumer.

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Source: JPMorgan
JPMorgan Global PMI – Manufacturing Export Orders, index, seasonally adjusted (Data Through: May 2019)

Source: CPB Netherlands Bureau for Economic Policy Analysis
Global Industrial production volume excluding construction, fixed base 2010=100, production weighted, seasonally adjusted, yearly percent change (Data Through: June 2019)

- One factor leading to fears of recession is the slowdown in global manufacturing and industrial production. The concern is that weakness in these areas of the economy could spread to other areas.
- These two economic sectors are cyclical in nature.
- Notice that in recent years manufacturing and industrial production move in roughly three-year cycles – that is, 18 months up and 18 months down.
- Currently the trend has been down for about 18 months, suggesting a bottom may be approaching.
- The fact that manufactured goods have a long shelf life contributes to the cycle, leading to gluts and shortages that drive the cycle.

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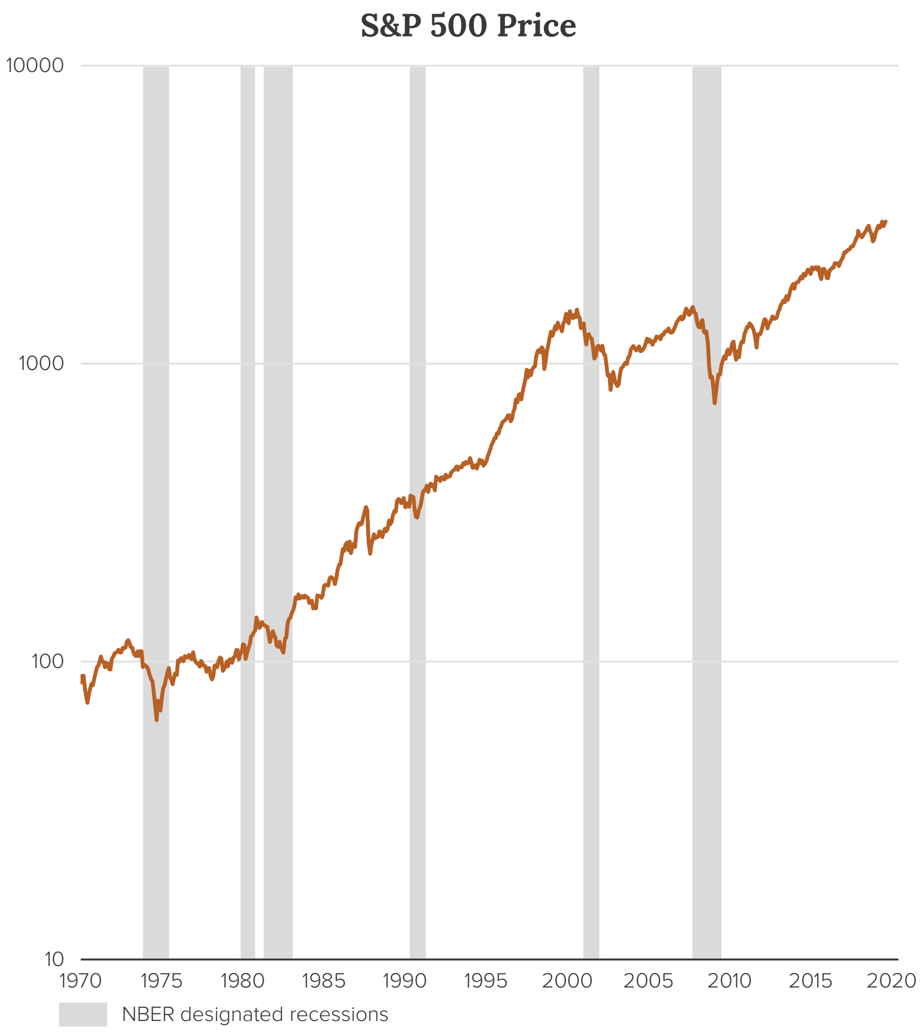
- Equity investors are correct to fear a recession. Bear markets in stocks occur around recessions, usually beginning some six to nine months before the recession begins.

- Outside of recessions, stocks tend to move upward. If a recession is not expected for a few years, stocks may continue to perform well.

- Common stocks are one of the official leading indicators. Currently, they are not forecasting one.



Source: Bloomberg (Data Through: September 17, 2019)
Log Scale

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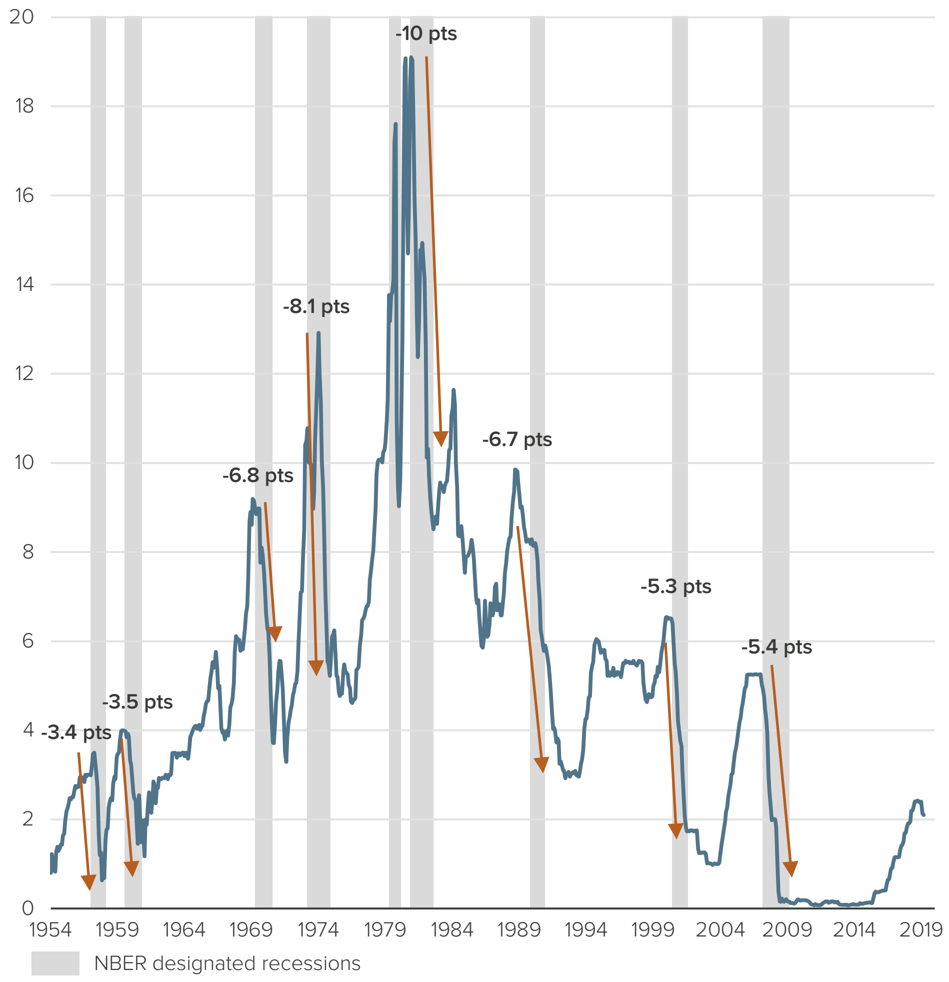
- With the U.S. economy appearing to be on solid footing, why should the Fed be shifting into an easing mode of monetary policy?
- Note that in the past, the Fed has been forced to reduce federal funds by an average 500 basis points in order to get the economy out of recession.
- This time they do not have the latitude to reduce rates by such a large amount, hence their willingness to move early and aggressively.

Effective Federal Funds Rate



Source: Federal Reserve Bank of St. Louis
Effective Federal Funds Rate, Percent, Monthly, Not Seasonally Adjusted (Data Through: September 2019)

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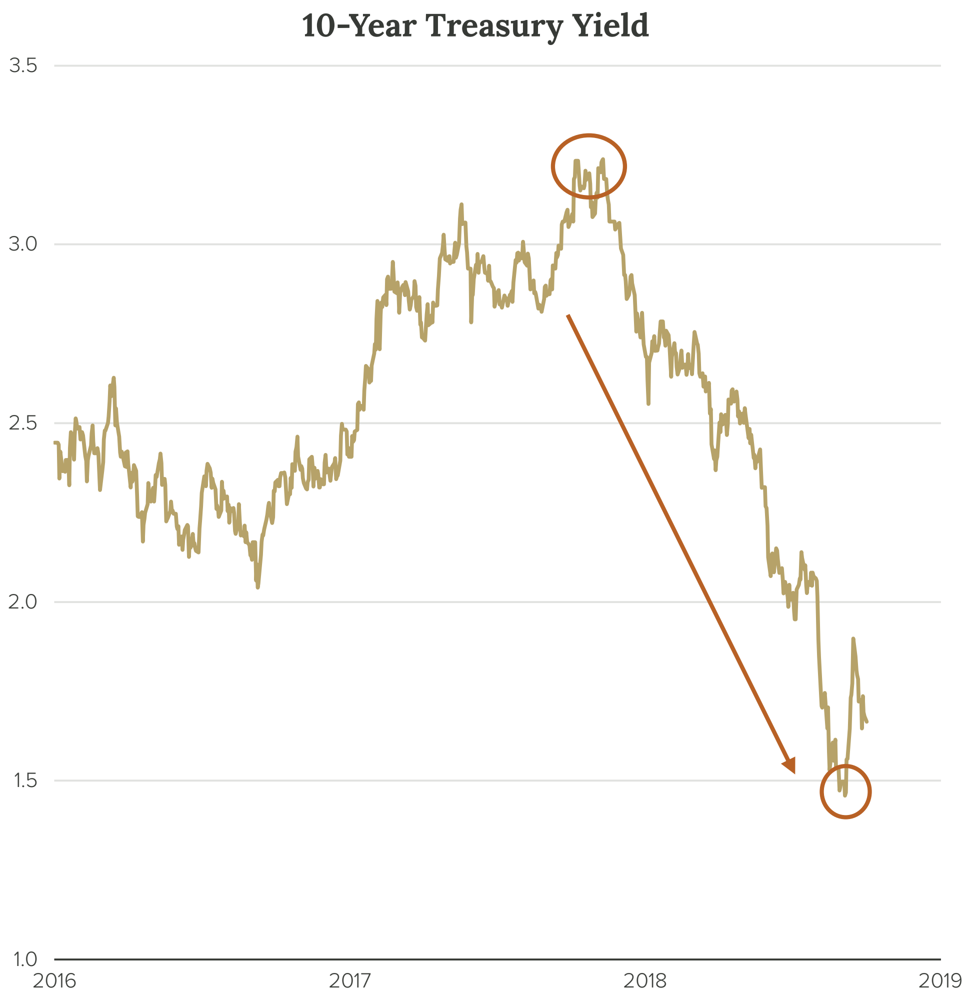

Source: Bloomberg (Data Through: September 30, 2019)

- The bond market has experienced huge volatility of late. What is that telling us?
- Since the fall of 2018, the yield on the benchmark 10-year U.S. Treasury note has plunged by 165 basis points.
- Such rapid declines reflect changing attitudes and, in this case, fear.
- Declining long-term interest rates usually anticipate slower economic growth, but this decline may be overestimating slowing growth.
- Signals from the bond market should not be ignored, but its volatility and implied message seem extreme.

DISCLOSURE STATEMENT

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