Economic Update

A Review of Third Quarter 2018

The global economy continues to grow, led by strength here in the U.S. Domestically, this economic expansion has been supported by a combination of fiscal stimulus, relatively accommodative financial conditions and strong corporate earnings. The current bull market has been extremely long-lived. We now find ourselves in the second longest economic expansion since World War II. Yet, there are no immediate signs that the economy will slow down any time soon. Economic indicators are signaling that no near-term recession is on the horizon and both consumer and business confidence remain high.

Markets rewarded this strong U.S. economic performance with equally strong U.S. equity performance during the third quarter; although, those returns were not matched throughout the rest of the world. Concerns about escalating tariffs appear to have taken a toll on international market sentiment. As a result, international equity markets were mixed during the last three months even as the U.S. stock market surged.

U.S. Economy

GDP growth registered 2.9 percent year-over-year during the second quarter of 2018. This is fairly robust as compared to recent years. The Atlanta Fed currently predicts even higher growth at 4.1 percent during the third quarter as well. That is consistent with the most recent Chicago Purchasing Managers Index reading of 60.4 during September. Although that is the lowest figure in the last five months, it still is a very strong reading as anything above 50.0 predicts economic expansion.

Consumer sentiment picked back up again to reach 100.1 during September. Consumers have also followed through on their optimism by spending during the last few months. Household consumption, which represents approximately 70 percent of the U.S. economy, has been very healthy as of late. Retail sales during June, July, and August were up 6.5 percent from the same period one year ago.

Despite healthy retail sales growth in total, a number of individual retailers are still struggling in today's hypercompetitive marketplace. Amazon has become a threat in just about every sector. However, good stores in good locations continue to thrive. Overall, commercial real estate has remained strong as minimal new construction has kept vacancies low and rent growing. This is true in the retail sector as well as the office and industrial sectors too. Suitable urban land has become increasingly expensive and scarce while high labor and materials construction costs are the norm.

Inflation still remains as a potential problem at some point, but it appears to be under control for now. While the Consumer Price Index for All Urban Consumers (CPI-U) is up 2.7 percent year-over-year, most of that is due to the recent boost in oil prices. Excluding food and energy costs, core CPI increased just 2.2 percent over the last 12 months. Current expectations are for oil prices to moderate in the near term; therefore, headline CPI should soon start coming back closer to the 2.0 percent annual rate targeted by the Fed.

Similar to last quarter, the Fed once again raised the fed funds rate 25 basis points at their meeting in September. The new target range is now between 2.00 and 2.25 percent. Also noteworthy is that they continued to signal their intent for one more rate hike this year, with three additional more hikes expected during 2019.

This aggressive rate hike outlook, the reduction of the Federal Reserve's balance sheet, positive expectations for growth, and the elevated supply of U.S. Treasuries are likely to keep upward pressure on interest rates. Yet, despite this upward pressure, long-term bond rates remain stubbornly low. The 10- vs. 2-year spread continued to narrow during the last quarter and we are still close to inversion. Inverted yield curves make economists nervous, since they often indicate that a recession is on its way.

International Economy

Europe continues to show signs of life. However, they also seem to have settled into a slower pace of improvement than anticipated, with real GDP growth of just 2.1 percent during the second quarter of 2018. Concerns over growing protectionism coming out of the U.S. has also led to some cooling of future business expectations in the form of lower business sentiment survey readings as of late. Current fiscal uncertainty in Italy also weighs on their economy.

However, on a positive note, European unemployment continues to trend down, with the most recent measurement of 8.3 percent. That is down from 8.7 percent at the end of last year. Also, household consumption, which represents approximately 55 percent of GDP remains fundamentally strong.

Japan has slowed so far in 2018 after a relatively healthy 2017. Abenomics, named after Prime Minister Shinzo Abe, continues to dominate the conversation. His "Three Arrow" strategy includes long-term plans for monetary easing, fiscal stimulus, and structural labor/regulatory reform. All of these are expected to continue through at least 2019. While all of this has undoubtedly helped the economy in recent years, it has also come at a cost. The country now has outstanding debt equal to 253 percent of annual GDP.

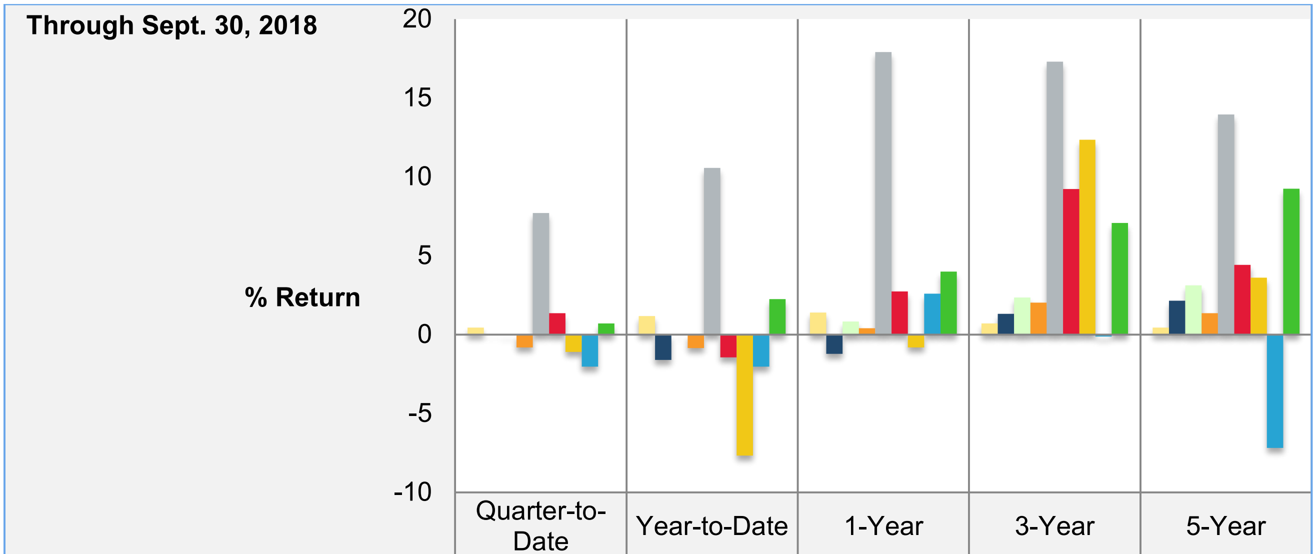
Current forecasted growth for China is 6.5 percent during 2018, which sounds like a lot but is actually much lower than the roughly 9.5 percent annual growth that the country has averaged during the last 30 years. Further escalation of the current trade war with the U.S. could cost the country an additional 0.5 percent growth. The country's trade imbalance during 2017 was approximately $421 billion, which has actually been trending down over each of the last three years.

Markets

Despite tariff concerns, U.S. large-cap equities finished the quarter with strong gains. Altogether, the S&P 500 Index gained 7.71 percent for the quarter and is now up 10.56 percent for the year thus far. Developed international equity markets, as represented by the MSCI EAFE Index, did not fare as well. They were up 1.35 percent for the quarter and are now down 1.43 percent year-to-date.

Emerging markets continue to be hurt by the escalating tariffs. The MSCI Emerging Markets finished the quarter down 1.09 percent and is now down 7.68 percent for the year overall. Alternatives such as commodities and real estate were mixed. The Dow Jones UBS Commodity Index lost 2.02 percent for the quarter while the Wilshire REIT Index gained 0.72 percent during the same time. For the year, the indexes are now down 2.03 percent and up 2.25 percent respectively.

With steadily rising interest rates, bonds have had a challenging year thus far. The Barclays U.S. Aggregate Bond Index gained 0.02 percent during the previous three months and is now down 1.60 percent for the year. The Barclays U.S. Inflation-Linked Bond Index lost 0.82 percent for the last three months and is now down 0.84 percent for the year thus far. Global bonds, as measured by the Barclays Global Aggregate Bond Index, finished the quarter down 0.05 percent and the first nine months of 2018 up just 0.02 percent.



	Quarter-to-Date	Year-to-Date	1-Year	3-Year	5-Year
T-Bills	0.45	1.18	1.39	0.71	0.45
Barclays US Agg Bond Index	0.02	-1.60	-1.22	1.31	2.16
Barclays Global Agg Bond Index	-0.05	0.02	0.82	2.35	3.13
Barclays US Infl Linked Bond Index	-0.82	-0.84	0.41	2.04	1.37
S&P 500 Index	7.71	10.56	17.91	17.31	13.95
MSCI EAFE Index	1.35	-1.43	2.74	9.23	4.42
MSCI Emerging Markets Index	-1.09	-7.68	-0.81	12.36	3.61
DJ UBS Commodity Index	-2.02	-2.03	2.59	-0.11	-7.18
Wilshire REIT Index	0.72	2.25	3.99	7.08	9.25

Source: Morningstar. Past performance does not guarantee future results. An investment cannot be made directly in an index.

(Refer to the end for index definitions.)

Outlook

Current economic conditions look favorable. GDP is growing and business and consumer sentiment are both optimistic. North American trade policy seems to have been settled for the time being as Canada and Mexico have both recently agreed to USMCA, which now takes the place of NAFTA. However, a similar new deal with China will likely be tougher. Continued trade war rhetoric, along with the expected rate increases out of the Fed, could lead to increased prospects for near-term financial market volatility.

Altogether, we still favor long-term exposure to equities at their current prices assuming that one has a long enough time horizon. International equities, in particular, seem to be considerably undervalued as compared to the U.S. Of course, international equities are also much more susceptible to headline risk depending on the whims of U.S. trade policy, so international managers must also be diligent in selecting the correct countries and industries on which to invest.

Barclays US Aggregate Bond Index: The Aggregate Bond Index is a broad-based benchmark that measures the investment grade, dollar-denominated, fixed-rate taxable-bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS. The Aggregate rolls up into other Barclays Capital flagship indices such as the multi-currency Global Aggregate Index and the Universal Index, which includes high-yield and emerging markets debt. The Aggregate Index was created in 1986, with index history backfilled to Jan. 1, 1976.

Barclays Global Aggregate Bond Index: The Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the Aggregate (USD 300mn), the Pan-European Aggregate (EUR 300mn) and the Asian-Pacific Aggregate Index (JPY 35bn). In addition to securities from these three benchmarks (94.0 percent of the overall Global Aggregate market value as of Dec. 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300mn), Euro-Yen (JPY 25bn), Canadian (USD 300mn equivalent) and Investment Grade 144A (USD 300mn) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized subindices by liquidity constraint, sector, quality and maturity. A component of the Multiverse Index, the Global Aggregate Index was created in 1999, with index history backfilled to Jan. 1, 1990.

Barclays Global Inflation-Linked Index: The Global Inflation-Linked Index (Series-L) includes securities that offer the potential for protection against inflation as their cash flows are linked to an underlying inflation index. All securities included in the index have to be issued by an investment-grade-rated sovereign in its local currency. The list of eligible currencies is the same set of currencies eligible for inclusion in the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) represents a stand-alone multi-currency index exposed to the real yield curve for each relevant currency. As such, the index does not contribute to the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) was created on Oct. 31, 1997.

S&P 500® Index: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard & Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. The returns presented for the S&P 500 are total returns, including the reinvestment of dividends each month.

MSCI EAFE Index: The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed-market equity performance, excluding the U.S. and Canada. As of April 2002, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI EMF (Emerging Markets Free) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of April 2002, the MSCI EMF Index consisted of the following 26 emerging-market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

DJ UBS Commodity Index: Dow Jones-UBS Commodity Index℠ and Dow Jones-UBS Commodity Index Total Return℠ The DJ-UBSCI℠ family includes both the DJ-UBSCI℠, which is calculated on an excess-return basis, and the DJ-UBSCITR℠, a total return index based on the DJ-UBSCI℠. The former reflects the return of underlying commodity futures price movements only, while the latter reflects the return on fully collateralized positions in the underlying commodity futures.

Wilshire US REIT Index: Introduced in 1991, the Wilshire REIT index is intended as a broad measure of the performance of publicly traded real estate equity securities. The index is market-capitalization weighted of publicly traded real estate securities, such as Real Estate

Investment Trusts (REIT), Real Estate Operating Companies (REOC) and partnerships. The index is composed of companies whose charters are the equity ownership and operation of commercial real estate.