Economic Update

A Review of Fourth Quarter 2019

Given the strong year for markets overall, it is hard to remember that we actually started 2019 with tremendous uncertainty. Stocks in the U.S. had just experienced a very poor fourth quarter during 2018 and pessimistic market sentiment was rampant. At that time, we saw a tightening Fed policy, slowing global growth and political uncertainty including potential tariff escalation and the ongoing partial government shutdown - all of which seemed to be stoking fears of a looming recession.

But most of those fears did not actually materialize. The shutdown ended, the Fed is now likely done tightening and there is now more optimism concerning trade negotiations with China. The next round of tariffs were put on hold and President Trump is expecting to sign phase one of a new Chinese trade deal sometime later this month. While global GDP growth is still relatively slow, we did not tip into a worldwide recession. The IMF is now expecting global growth to pick up slightly during 2020.

Also, for the first time in over 170 years, we just closed an entire decade without experiencing a single recession in the U.S. We remain in the midst of the longest economic expansion on record. While our GDP growth has remained slow for most of the last 10 years, it has been fairly steady. The only negative is that we seem to have financed most of this economic expansion through borrowing, as our total national debt roughly doubled during that time.

U.S. Economy

The yield curve finally reverted back to a more normal slope during the fourth quarter after being inverted throughout most of the year. A rate cut by the Fed during October seemed to help. The 30-year treasury yield reached 2.39% at the end of the year after hitting record lows of just below 2% during September.

Markets are currently expecting at least one more cut during 2020 but it wouldn't surprise us if we don't actually see anything until after the election. Historically, the Fed has tried not to influence elections, and in this case, Chairman Powell was clear that he did not expect to make another rate cut unless the economy were to significantly weaken.

There are very few signs of economic weakening at this point. Certainly, no weakening is showing up in jobs numbers, which have been fairly strong during the past few months. It was just announced that 145,000 jobs were created in December. This follows 152,000 new jobs created in October and 256,000 created during November. This calculates to a three-month average of approximately 184,000, which is well above the 150,000 benchmark that economists have historically thought was needed in order to keep up with expected population growth.

A more appropriate jobs growth target in today's world might actually be closer to 100,000 per month. This is because the total U.S. population only grew by approximately 1.5 million people during 2019, representing a 0.5% increase from the prior year. That represents the lowest total population growth rate experienced by the U.S. in over a century. This is a result of our aging population along with recent reduced immigration.

Our tight labor market continues to be moderately good for wage growth. The Federal Reserve Bank of Atlanta's three-month moving average hourly wage for November showed a 3.7% increase from November 2018. This is consistent with readings throughout the last nine months and higher than we had been seeing for most of the past decade.

The most recent Chicago Purchasing Managers Index reading came in at 48.9 in December. While readings below 50.0 predict economic contraction, the report was seen as positive since sentiment has been trending up over the last four months. Increased sentiment is likely a result of recent optimism concerning the ongoing trade war with China.

U.S. GDP growth is expected to have slowed to approximately 2.3% during 2019 after reaching 2.9% growth during the prior year. Most economists are predicting similar 2.0-2.5% real GDP growth during 2020 as well.

International Economy

The IMF recently downgraded its global growth expectations for 2019 to 3.0%, which would be the lowest since the financial crisis of 2008-2009. However, they currently expect a small rebound to 3.4% during 2020.

The Eurozone continues to struggle, as Germany and Italy both teetered on the brink of recession throughout much of 2019. Continued low PMI numbers indicate that this will probably continue for at least the start of 2020 as well.

Over in the U.K., it finally looks like Brexit will happen. Prime Minister Boris Johnson's conservative party won a large majority in last month's election. This should pave the way for him to complete a Brexit departure agreement by the end of the month, thereby committing the U.K. to leave the European Union by the end of 2020.

Once the departure agreement is made, the country will then be in a transition period until the end of the year in order to redefine its relationship with the EU. This includes new trade terms, customs procedures and regulations. Removing the previous Brexit-related uncertainty should help the British economy. However, if they are unable to negotiate a new relationship, then trade will default to basic general WTO terms, which would be a considerable risk for European markets.

The Japanese economy has continued to struggle. In addition to their general aging problem, recent household spending has been further hindered by a new consumption tax hike. However, both $120 billion in recent policy stimulus, as well as additional expected tourism revenue from the upcoming Summer Olympics, should greatly help their economy during 2020.

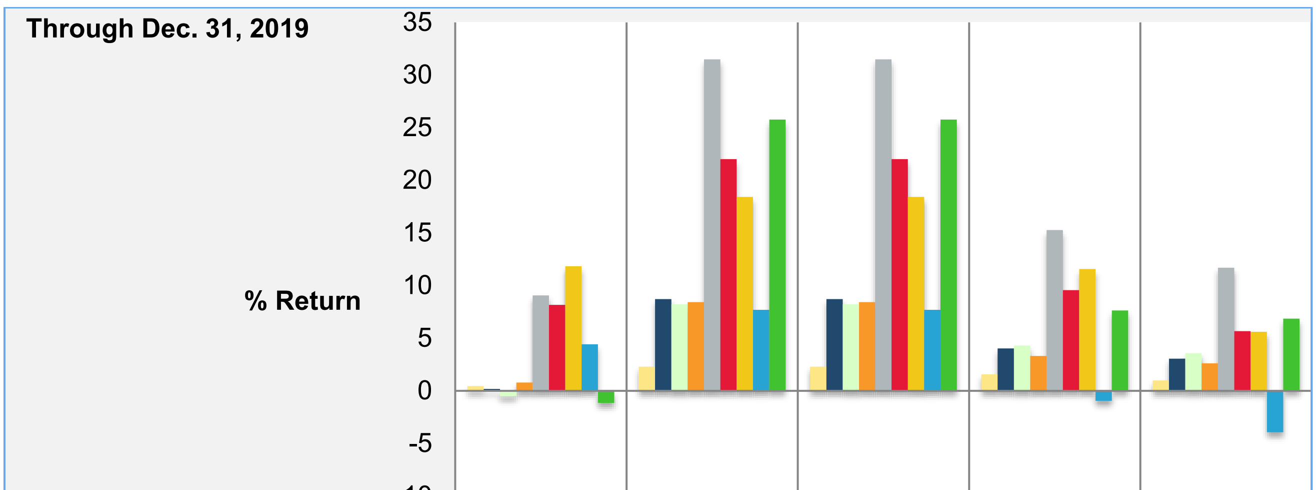
China's economy has been slowing during the past few years due to its ongoing trade war with the U.S. While the recent limited phase one trade deal is a step in the right direction, the current tentative agreement fails to address many core issues that led to the original dispute. Further negotiation breakthroughs are probably unlikely as the country will probably be unwilling to give President Trump any sort of additional perceived victory ahead of the upcoming 2020 U.S. election.

Markets

The fourth quarter of 2019 was strong for markets throughout the world. U.S. large-cap equities, as represented by the S&P 500 Index, gained 9.07% for the quarter and finished the year up an eye-popping 31.49%. Developed international equity markets, as represented by the MSCI EAFE Index, finished the quarter up 8.17% and were up 22.01% for the year as a whole.

Emerging markets closed the year with even stronger gains. The MSCI Emerging Markets Index finished the quarter up 11.84% to give them a total gain of 18.42% year-to-date. However, alternatives such as commodities and real estate did not fare as well. The Dow Jones UBS Commodity Index gained 4.42% for the quarter. The Wilshire REIT Index was down 1.14% during the period. For the year, the two indexes were up 7.69% and 25.76% respectively.

Moderately higher interest rates throughout the world resulted in mediocre performance from bonds. The Barclays U.S. Aggregate Bond Index gained 0.18% for the quarter and finished the year up 8.72%. The Barclays U.S. Inflation-Linked Bond gained 0.79% for the quarter and was up 8.43% for the year. The Barclays Global Aggregate Bond Index lost 0.49% during the quarter but still finished the year up 8.22% overall.



	Quarter-to-Date	Year-to-Date	1-Year	3-Year	5-Year
T-Bills	0.46	2.30	2.30	1.57	0.99
Barclays US Agg Bond Index	0.18	8.72	8.72	4.03	3.05
Barclays Global Agg Bond Index	-0.49	8.22	8.22	4.30	3.57
Barclays US Infl Linked Bond Index	0.79	8.43	8.43	3.32	2.62
S&P 500 Index	9.07	31.49	31.49	15.27	11.70
MSCI EAFE Index	8.17	22.01	22.01	9.56	5.67
MSCI Emerging Markets Index	11.84	18.42	18.42	11.57	5.61
DJ UBS Commodity Index	4.42	7.69	7.69	-0.94	-3.92
Wilshire REIT Index	-1.14	25.76	25.76	7.63	6.87

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

Last year's gains have made the stock market valuation more stretched than it was at this time last year. Still, given the current state of interest rates, it is hard to envision any better options than equities right now. With the recent Fed rate cut, money market funds are generally not keeping up with inflation. Longer duration fixed income is also challenging given that long-term interest rates are still well below historical norms. Credit spreads on high-yield bonds are compressed, so there seems to be some outsized risk there as well.

Given all of that, equities still look like the place to be for the near future. Low long-term interest rates continue to be very supportive for stocks, so they could very well still continue to climb from here.

The primary near-term risk to this forecast is if we were to see escalating tensions with Iran. This could result in short term market volatility at any time. Note, however, that the shale boom has now allowed us to be a net oil exporter for the first time since the 1940s. Consequently, our country is well positioned to withstand any resulting oil price shocks emanating from the Middle East.

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% 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 sub indices 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.