

ECONOMIC REVIEW AND OUTLOOK – July 2019

Real GDP growth in the first quarter registered a surprising 3.1%, surprising because of expectations for a more meaningful slowdown from last year's tax stimulus. Currently, expectations for the second quarter's growth are below 2%. This economic expansion from 2009 has now tied the duration of the 1990's expansion and will in all likelihood become the longest expansion in U.S. history. However, the cumulative growth in this expansion has only been average, despite the record length, because of generally weak annual growth.

Concerns about economic growth have originated in weak manufacturing reports here and abroad. The J.P. Morgan Global Manufacturing Index signaled the 10th contractionary reading in a row for new export orders. In the U.S., the Institute of Supply Managers *manufacturing* survey registered 51.7, above the 50 percent mark between contraction and expansion. The low exposure of the U.S. economy to trade means that we are relatively insulated from the global slowdown.

The Small Business Economic Trends report indicates "optimism among small business owners has surged back to historically high levels, thanks to strong hiring, investment and sales." The most recent jobs report confirms the strong hiring, highlighting the difference between domestic growth and the rest of the world.

Recessions are difficult to predict because there are relatively few in the post war period and those have varied in duration and depth. Generally, before a recession, the economy is operating at full capacity with low unemployment that is creating signs of inflation. Given concerns about inflation the Federal Reserve pursues a policy of increasing interest rates in order to temper inflation risks.

The Federal Reserve writes, "The yield curve, a graphical representation of yields for Treasury securities with different maturities, has an amazing record at predicting recessions and capturing downside risks to the outlook. Since the 1950s, every recession in the United States has been preceded by an inversion of the yield curve, measured here by when the difference between the 10-year and 1-year yields turns negative. The only instance in which the yield curve has inverted without a subsequent near-term recession was during the mid-1960s.

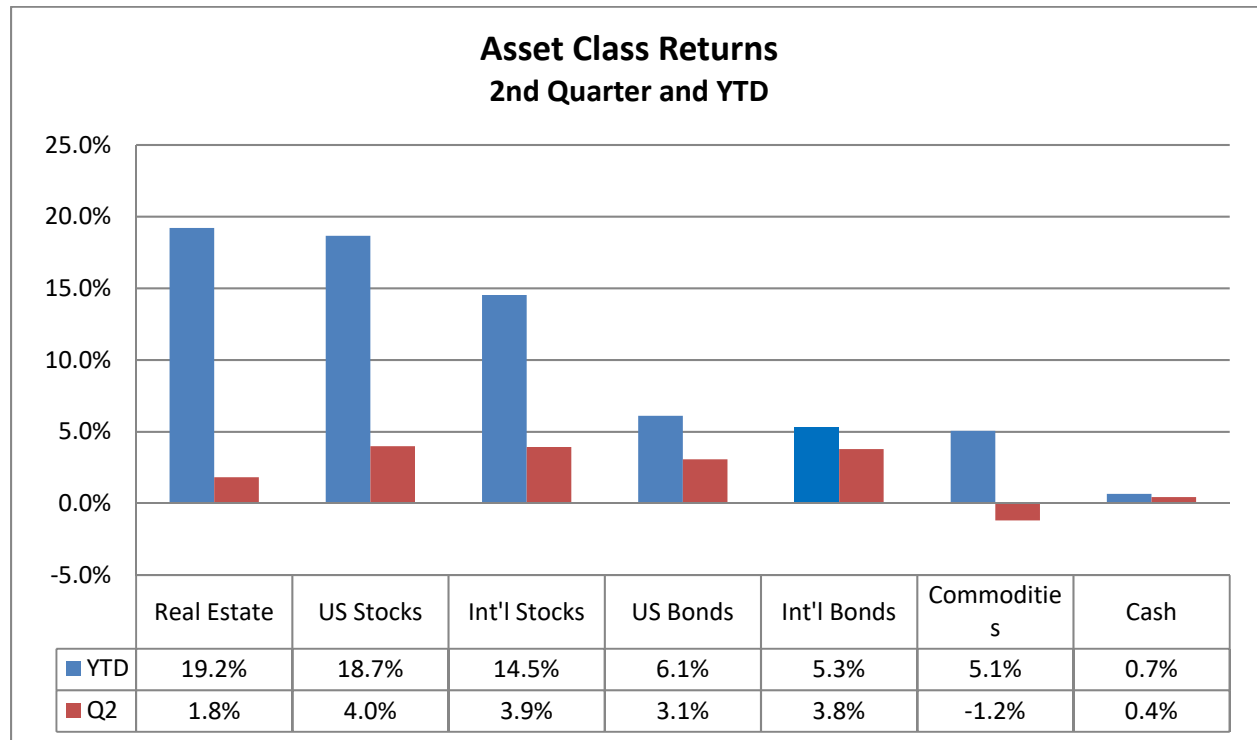
"In late March and again in May, the yield curve inverted by the above-mentioned measure but then rebounded within several days. By contrast, past yield curve inversions occurring before recessions lasted much longer and were more pronounced. The question now arises as to whether an inversion of the yield curve in the current economic environment signals substantial recession risk or primarily reflects other financial influences."

Focusing on the labor market, research suggests that once the unemployment begins rising a recession is generally imminent. Combining the yield curve indicator, which is a financial indicator, with a fundamental economic indicator such as unemployment provides a more robust assessment of recession risk. Presently, the labor market has not confirmed the yield curve indicator.

CAPITAL MARKET REVIEW AND OUTLOOK

More gains for most assets

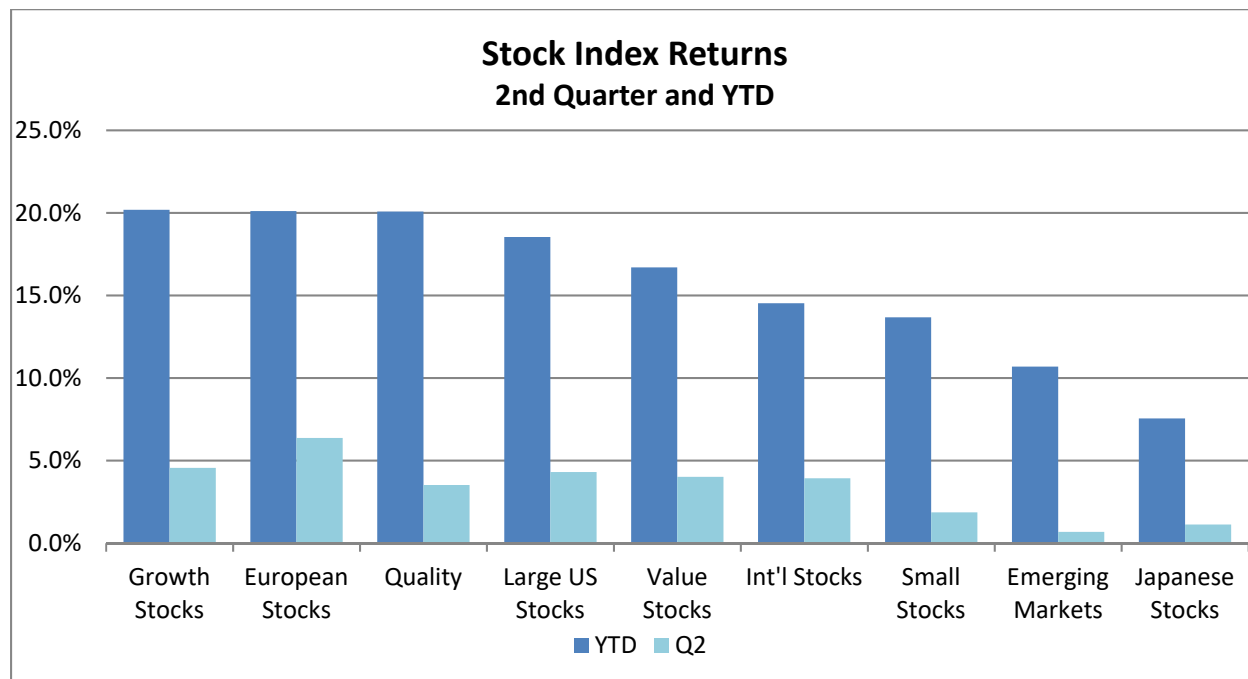
In the second quarter both stocks and bonds rallied. Concerns about slowing economic growth drove interest rates down, resulting in a rally for bonds. Ironically, the concerns about growth also drove stock prices up as investors expect the Federal Reserve to cut rates, concluding that such a policy change will increase future economic and earnings growth. Commodities declined because there was no silver lining for slower growth, which will reduce demand. Nonetheless, Mideast tensions boosted energy prices and Midwest flooding pressured the supply of some crops. The U.S. Dollar weakened in the quarter.



CAPITAL MARKET REVIEW AND OUTLOOK

Stocks have a good year for the first 6 months

All stock categories rose in the quarter, boosting year to date gains to close to 20% for several categories. Growth stocks gained as investors returned to the strategies that have fueled much of the bull market. However, lower risk strategies based on higher dividends and quality also were strong in the quarter, because lower interest rates made higher yielding stocks more attractive, and concerns about growth made defensive securities like quality stocks more appealing.



Stock Market Expectations

Earnings growth expectations continue to erode. Year over year earnings growth is expected to decline by 2.6% in the second quarter, after flat growth in the first quarter. Over the course of the second quarter, estimates were marked down by 2.6%, which is actually better than the average 3.3% markdown, historically.

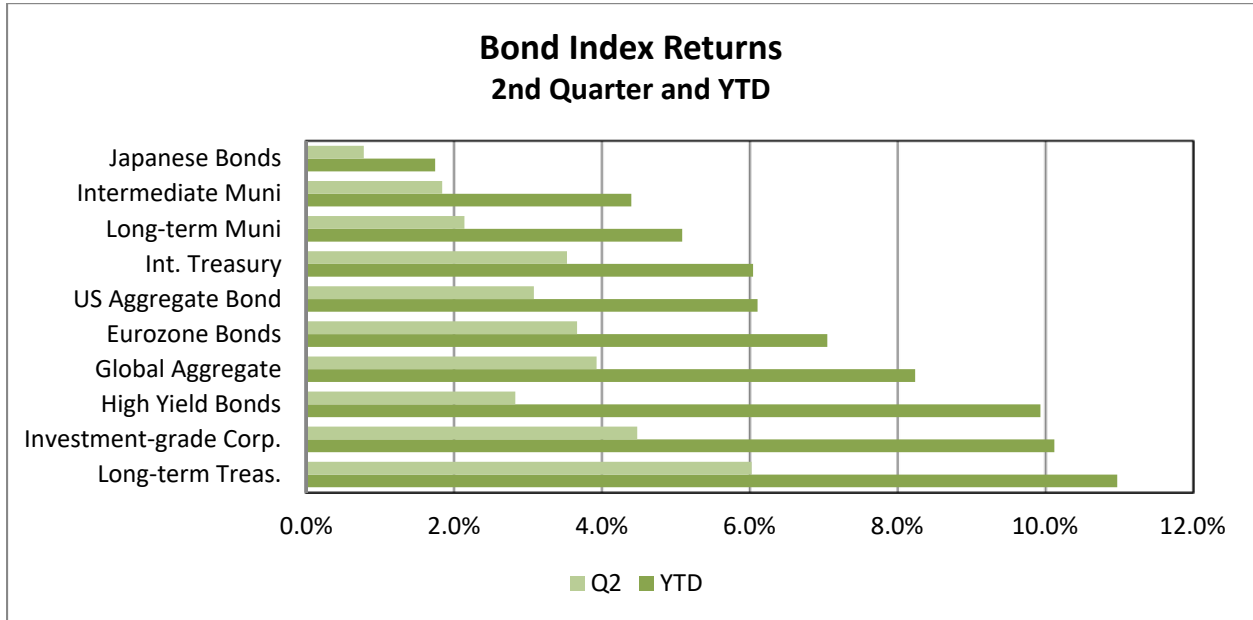
Analysts have an optimistic view of earnings growth: despite expectations of another decline in the 3rd quarter, earnings are expected to grow by 6.3% in the 4th quarter and then accelerate in the first half of 2020 with double digits earnings gains.

Although, historically, analysts have been over-optimistic with respect to both earnings and future prices, they have an average price target for the next 12 months that is close to 8% above today's levels. At the sector level, energy stocks are expected to gain the most over the next 12 months, while utilities are expected to see the smallest price gains.

CAPITAL MARKET REVIEW AND OUTLOOK

Slowing Economy and Federal Reserve Policy Change Boost Bonds

Interest rates declined further in the 2nd quarter with the benchmark 10 year Treasury yielding close to 2.0% at the end of the quarter. Interest rates declined across the maturity spectrum. Longer maturities had the highest returns, since their longer maturities magnify the effect of a rate decline. In addition, credit spreads widened as investors put a premium on higher yields, despite the risk that lower credit bonds could suffer in an economic slowdown.



Bond Market Expectations

We do not expect a significant decrease or increase in rates from current levels without a further improvement or decline in economic data. The Federal Reserve slightly modified its press release, which investors took as a near commitment to lowering rates. However, with the labor market strong, wage growth healthy and inflation within an acceptable range, the rationale for cuts in rates is relatively weak.

INVESTMENT STRATEGY UPDATE

Allocation: We have a neutral position. Our stock gauge indicates a buy condition with momentum, liquidity and earnings offsetting over-valuation and over-optimism. Furthermore, our internal indicators that monitor trading within the stock market suggest neutral to positive conditions. Furthermore, our rebalancing model is presently neutral.

Stock Risk: We are focusing on maintaining stock risk at a level below that of the market. High valuations and a late cycle environment have raised downside risks for stocks, despite the relatively benign environment suggested by our stock gauge. Therefore, we are targeting risk levels below 90% of the stock market risk, in addition to seeking out under-valued segments of the market such as value stocks and international stocks.

Value Stocks: Value stock out-performance hinges on a re-acceleration of growth. Value stocks are concentrated in the financial and cyclical sectors that perform best when growth is expected to accelerate. Since we are in a slowing environment, value stocks will probably struggle. Despite cyclical effects, value stocks have out-performed in past downturns.

Quality Stocks: Quality stocks perform well in downturns, and they have done well for most of the current bull market. We are continuing to hold and add to quality stocks in order to maintain overall stock risk at a moderate level. In general, quality has out-performed over the last 9 months, including the 4th quarter downturn as well as the strong recovery this year. Interestingly, quality strategies, which tend to emphasize profitability and lower leverage, have benefited from an emphasis on dividends.

International Stocks: We are emphasizing international stocks because of much better valuations than domestic stocks that imply better long-term returns. In addition to below average valuations compared to the United States, expectations are low for the rest of the world, suggesting a higher chance for positive earnings surprises. It is worth noting that countries with low valuations have historically out-distanced those with strong growth. The U.S. Dollar was weaker in the 2nd quarter, benefiting international investments.

Bonds: Slowing growth and a potentially more accommodative Federal Reserve policy suggest that the risk of rising interest rates has receded. We are targeting a duration of 5 years, which is historically a neutral level of interest rate risk. Finally, we are emphasizing high quality bonds, since the late cycle environment suggests a greater risk that credit may deteriorate.