ECONOMIC REVIEW AND OUTLOOK April 2019

Over the last year, each quarter's *economic growth* has been less than the prior quarter (4.2% Q2, 3.4% Q3, and 2.2% Q4). However, this slowing is from a level that was artificially pumped up by last year's tax cuts. Fiscal policies are relatively short-lived; thus, the tax cuts had a positive effect that had largely dissipated by the end of the year. The first quarter looks like it may come in above 2% on an annualized basis, pretty good for a quarter that was hammered by bad weather and a government shutdown.

The Institute of Supply Managers *manufacturing* survey indicates that business is strong with most categories such as new orders growing faster. By contrast, the *service* sector, while still growing, has slowed.

Consumer and small business *confidence* has declined but is still at relatively robust levels. Small business plans to expand and make capital improvements have increased from January. Therefore, it appears that the slowing economy and the stock market downturn in the 4th quarter only dented expectations.

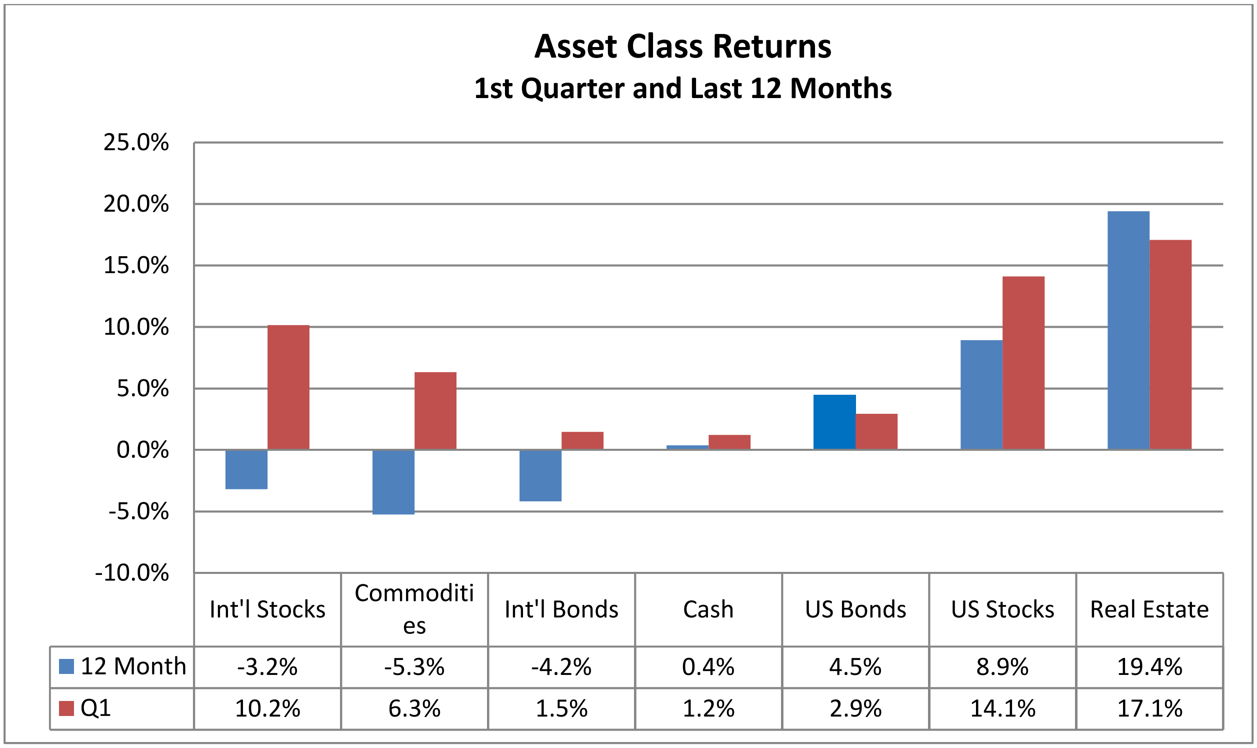
Globally, manufacturing looks less positive, especially in developed countries such as Germany where a contraction may be underway. Similarly, confidence is weaker globally. However, the United States is relatively insulated from other economies because net exports are a small portion relative to the U.S. economy.

Monetary policy has changed from restrictive to neutral. However, monetary policy works with long lags. The nine rate increases began at the end of 2015 and monetary growth peaked late in 2016. Emerging markets complained of the effects of U.S. monetary policy on Dollar liquidity last year. While the accumulated effect of several years of restrictive monetary policy could slow the economy further, we think it will also take a change in the availability of credit to push the economy into recession.

CAPITAL MARKET REVIEW AND OUTLOOK

All Assets Classes Gain

In the first quarter, risk assets – stocks, commodities, and junk bonds - continued to rally and rebound from the downturn in the 4th quarter. However, defensive assets such as bonds also continued to rally as monetary authorities, concerned about slowing growth, signaled that they would not raise interest rates. For the last 12 months, international stocks and commodities have suffered because of the strong Dollar.

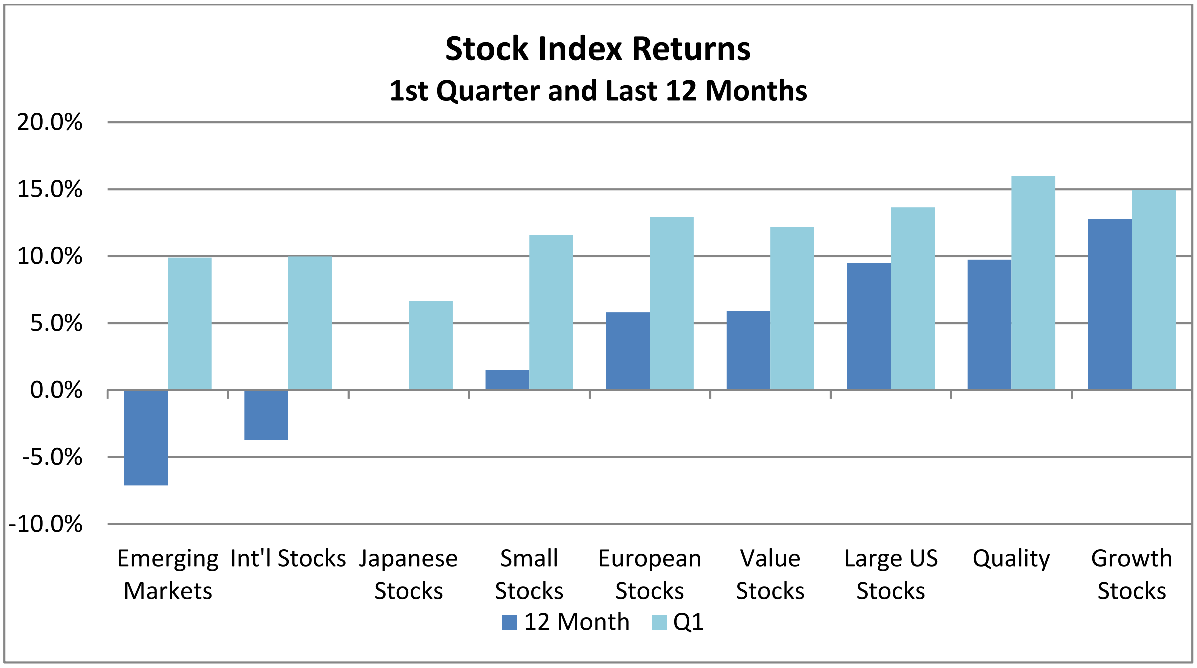


	Int'l Stocks	Commodities	Int'l Bonds	Cash	US Bonds	US Stocks	Real Estate
12 Month	-3.2%	-5.3%	-4.2%	0.4%	4.5%	8.9%	19.4%
Q1	10.2%	6.3%	1.5%	1.2%	2.9%	14.1%	17.1%

CAPITAL MARKET REVIEW AND OUTLOOK

Stocks Continue to Post Strong Gains

All stock categories rose in the quarter, while international stocks lost value over the last year. The 13% gain in domestic stocks was extraordinary: the last time domestic stocks gained this much in a quarter was in 2009 and before that in 1998.



Stock Market Expectations

Earnings growth is slowing. Year over year earnings growth is expected to decline by 4.2% in the first quarter. However, the tendency of companies to beat (lowered) expectations suggests that earnings may not decline by that much. Year over year revenue growth is expected to be 4.7%.

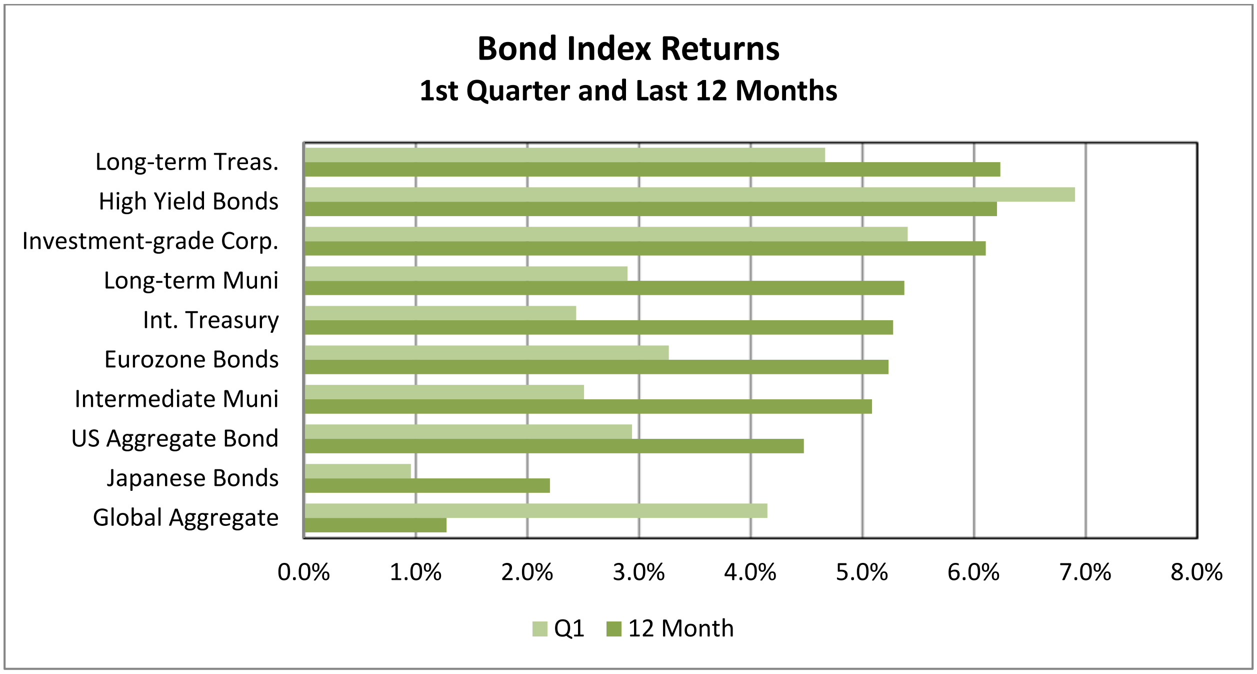
In general, stocks reflect an optimistic view of earnings growth. Earnings are expected to pick up as the year progresses, from flat earnings in the 2nd quarter, 1.6% growth in the 3rd quarter, and 8.2% growth in the 4th quarter. Analysts have an average price target close to 8% above today's levels; thus, earnings are the main driver for price appreciation. However, historically analysts have been over-optimistic with respect to both earnings and future prices. Furthermore, late in an economic cycle, margins typically decline; thus, the expected earnings gain would be unusual.

Stock buybacks, when companies buy their own shares, will continue to be a positive factor for stocks. Buybacks have been the largest source of demand for stocks with buybacks totaling $1 trillion last year. In recent years, buybacks and dividends have equaled operating earnings. However, companies buyback less stock when the economy is in a downturn.

CAPITAL MARKET REVIEW AND OUTLOOK

Slowing Economy and Federal Reserve Policy Change Boost Bonds

The decline in yields that began in the 4th quarter gathered steam in the first quarter, when the Federal Reserve took a more conservative view of the economy and suspended their plans to continue raising rates. The decline in interest rates has boosted bond prices, leading to the strong gains for the quarter and last 12 months.



Bond Market Expectations

We do not expect a significant decrease or increase in rates from current levels. The decline in rates and expectations the Federal Reserve will cut rates by year-end reflect the bond market's negative view of the economy as well as inflation. However, as noted earlier, most of the economic data suggests that the economy is relatively healthy, although the global picture is deteriorating with global leading indicators are at their lowest level since 2009.

The restrictive Federal Reserve policy has resulted in pressures on Dollar liquidity that have affected emerging markets. Domestically the relationship between monetary policy and growth is weak and subject to long lags. While the restrictive monetary policy from last year would be expected to have a negative effect on economic growth the extent and timing of the effect is unclear. However, further economic weakness would result in a shift to a more accommodative policy and lower interest rates.

INVESTMENT STRATEGY UPDATE

Allocation: We have reversed last year's conservative under-weighting of stocks and bonds. While valuation remains a concern, reversals in inflation trends and Federal Reserve policy have taken away the rationale for under-weighting bonds. With respect to stocks, our stock market gauge has shifted back to a positive reading, which supports a return to a neutral stock allocation. As pointed out earlier, the positive case for stocks is an earnings recovery later this year, which is dependent on an expansion of margins. Since margins usually decline late in the cycle (rather than expanding), we are averaging back into stocks, monitoring earnings developments.

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. However, as noted previously, value stocks typically out-perform growth stocks in a downturn, if growth stocks out-performed prior to the downturn. Thus, not surprisingly value out-performed growth in the 4^{th} quarter. And, in 2000, value stocks fell by a third of the growth stock decline and then gained 50% more in the subsequent bull market. However, in the 4^{th} quarter, smaller value companies did not act defensively; therefore we will emphasize somewhat larger companies and more defensive value strategies.

Quality Stocks: Quality stocks perform well in downturns, and they have done well for most of the current bull market. Quality stocks out-performed in the 4^{th} quarter of last year. And because they had less to make up in the 1^{st} quarter recovery, they are well ahead of most strategies over the last 6 months. We are continuing to hold and add to quality stocks in order to maintain overall stock risk at a moderate level.

International Stocks: We are emphasizing international stocks because of much better valuations than domestic stocks that imply better long-term returns. Similar to value stocks, international stocks out-performed in the 4^{th} quarter. 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 earnings surprises.

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.