ECONOMIC & CAPITAL MARKET
OUTLOOK 2019

WINTHROP
CAPITAL MANAGEMENT

ANNUAL REPORT

OVERVIEW

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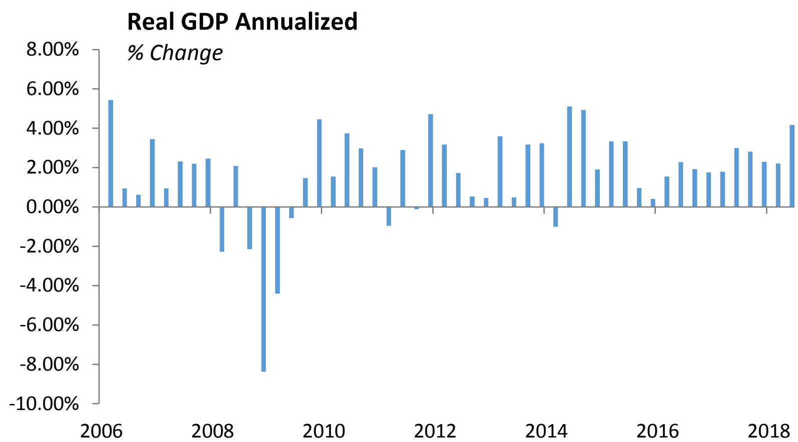
Based on current economic activity, monetary and fiscal stimulus, and current valuations, we are at an inflection point in the capital markets. As the domestic equity markets hit an all-time high in 2018, interest rates spiked to levels not seen in over five years. And, just when investors expected higher interest rates to become part of the equation, interest rates fell as investors' expectations were altered by slower earnings growth, long term trade tariffs, and the prospect of a slowing economy.

Since the Financial Crisis in 2008, the U.S. economy has depended upon low interest rates and easy money in order to stimulate economic growth. *It has been an expensive economic recovery*. On average, GDP growth has been around 2.5% over the past five years, and the equity markets have responded with solid performance. The S&P 500 posted a return of -4.38% for the year. However, in spite of the recent volatility in the last quarter, the cumulative return on the S&P 500 is over 100% since 2013.



Source: U.S. Department of Commerce

One of the characteristics of the recent bull market in equities has been its extremely low level of volatility. However, the fourth quarter of 2018 was marked by a sharp increase in volatility in the capital markets. The Fed's monetary tightening policy, tariffs with trading partners such as Europe and China, and the government shut down have all combined to raise uncertainty and caution investors on the potential for a slowdown in economic growth.

The economy is growing, businesses are hiring, and wages are increasing. The consumer appears to be on solid footing and consumer confidence is high. The economic recovery is now at a point where monetary stimulus is being pulled from the market and volatility is increasing. We have a broader expectation for continued moderate economic growth, low inflation and accommodative central bank policies; however, we expect returns on financial assets will likely be lower than previous years.

INVESTMENT THEMES - 2019

As we work through the economic and capital market data, we have identified the following Investment Themes for 2019:

- **Economic growth will slow in the second half of 2019**
- **Fed Monetary Tightening Will End Sooner Than Expected**
- **Interest rates will remain low as the rate of inflation measures near the low end of the Fed's target range**
- **Heightened level of global political risk will impact domestic capital market activity**
- **Our Form of Democracy and Capitalism will continue to evolve in 2019**
- **Credit markets will begin to show signs of stress.**
- **New Economy Stocks will continue to outperform the stocks of Old Economy Companies**

This period of recovery from the Financial Crisis has been described as a huge experiment in central bank governance and has reshaped modern capitalism. The advent of the quantitative easing programs by the Federal Reserve represented a shift to a new monetary regime. Now, we are in the process of unwinding this experiment. This involves normalizing the level of interest rates as well as reducing the bond portfolio that the Federal Reserve accumulated as part of its quantitative easing program. The result is a heightened level of uncertainty for investors.

We expect 2019 will be a challenging year for investors as volatility continues to be elevated and the markets digest changes in Fed policy, economic growth and global capital events.

ECONOMIC GROWTH WILL SLOW IN SECOND HALF OF 2019

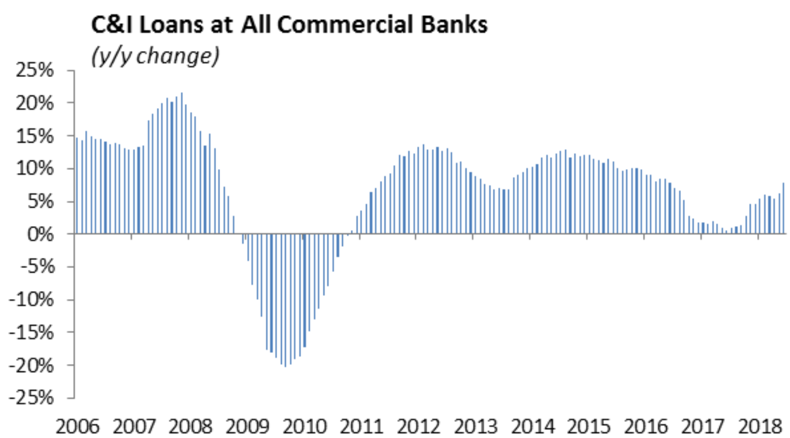
The U.S. economy is showing solid growth through 2018; however, we expect a downshift in the pace of growth over this next year. Third quarter 2018 GDP came in at 3.2%. We expect fourth quarter GDP to decline slightly; however, consumer activity, particularly around holiday shopping, should be strong. *While we expect a slowdown in the pace of economic growth, we are targeting growth in GDP in the 1.5% to 2.0% range for 2019.*

Leading indicators are starting to weaken. The manufacturing sector has been the pillar of strength in this economic expansion; however, we are seeing weakness develop in spite of continued strength in the ISM survey. We are seeing weakness come through the auto manufacturing and residential home building industries, which should result in weakness in ISM in early 2019. The tariffs will contribute to a slowdown in manufacturing and economic growth. This recovery has been marked by low productivity growth, and we would expect to see some improvement in productivity next year.

Source: The Conference Board

Growth in the domestic economy has been supported by a healthy employment market. The unemployment rate is coming in at 3.7% with the economy approaching full employment. We see evidence of this as the number of job postings exceeded the number of applicants last quarter. *This dynamic will put upward pressure on wages over the near term; however, we will likely see a shift in employment next year as layoffs increase in the face of a corporate restructuring environment as businesses attempt to preserve profit margins.*

The interest rate sensitive parts of the economy, which includes housing and autos, will also slow as higher short term interest rates take hold. We expect the housing market will soften as housing starts to slow and higher interest rates dampen housing prices.

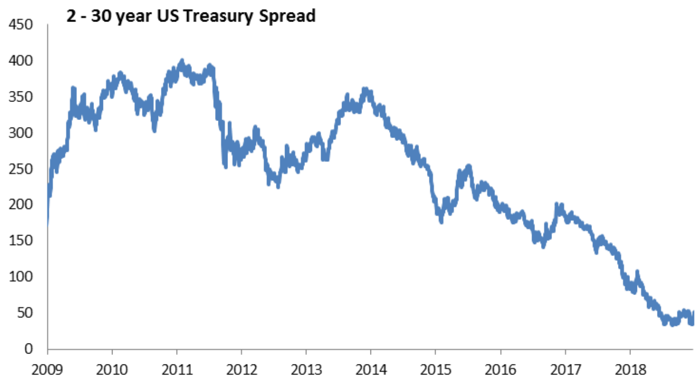


Source: Federal Reserve

Loan growth is an important contributor to sustained economic growth. While we have finally seen a meaningful increase in commercial & industrial loans, which increased by 6.0% over the past year, the slow pace of loan growth from the banking sector has inhibited business formation and economic growth over the past three years. *Bank lending is critical to business formation. Historically, the small business sector of the economy produces the vast majority of jobs in America. However, if the risks to start a new business are too high, the number of business formations will flounder.*

FED MONETARY TIGHTENING WILL END SOONER THAN EXPECTED

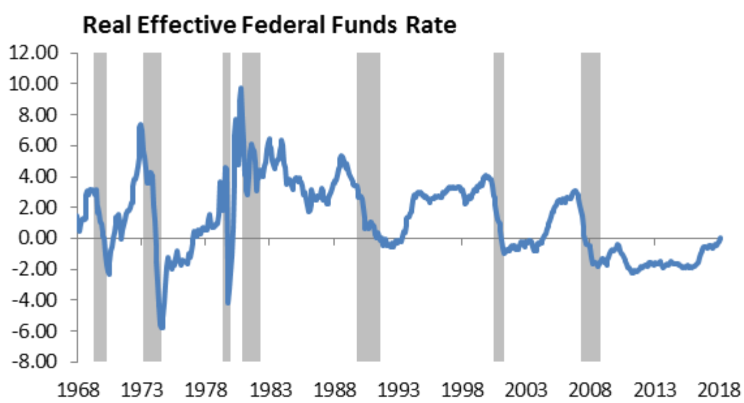
Since the Financial Crisis, the Federal Reserve has been navigating through an experiment in monetary policy in an effort to achieve sustained economic growth. The Financial Crisis ten years ago resulted in a very stimulative monetary policy that included dramatically low short term interest rates and open market purchases of bonds onto the central bank's balance sheet. This aggressive monetary policy was designed to stimulate growth in our economy which was stagnant due to an impaired banking system. *While the pace of growth has been slow following the Financial Crisis, we maintain that the policies largely worked.*



Source: Federal Reserve

However, as domestic economic growth begins to show signs of slowing in 2019, we expect that the Fed will begin to pause its push to raise short term interest rates. At this point, we believe the Federal Reserve is nearing the end of their ability to push rates higher. We expect the Federal Reserve may move short term interest rates higher one more time in the first half of 2019 before pausing their tightening policy.

Since 2015, the Fed has implemented a slow and managed movement of higher targeted short term interest rates, raising rates a total of nine times. Historically, the Fed would target a nominal Fed Funds rate of two percent over the rate of inflation. Yet, with inflation coming in near 1.9% and the current Fed Funds rate of 2.40%, the Fed will be nearer a real rate of 0.35%. *We expect the Fed will stop short of a one percent real Fed Funds rate, which would remain stimulative by historic measures.*



Grey bars indicate U.S. Recessions

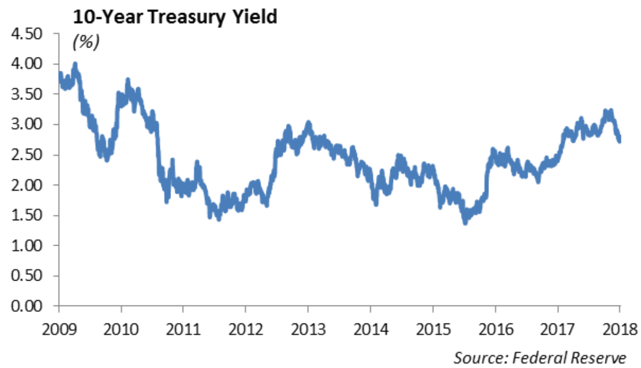
Source: Federal Reserve

Clearly, the push toward higher short term interest rates represents a shift toward a tighter monetary policy. The higher level of short term interest rates is forcing markets to reprice risk, which in turn, is causing an increase in the level of volatility in both the credit and equity markets.

We expect equity volatility will continue to be elevated as the market adjusts to a decline in earnings growth and slower first quarter economic data. This will provide investors with opportunity to add to the equity basis at more reasonable valuations. The dispersion in correlation between stocks has also allowed investors in individual stocks an opportunity to restructure their portfolio and add specific stocks of companies that may have been overvalued prior to the recent sell-off.

INTEREST RATES WILL REMAIN LOW AS RATE OF INFLATION MEASURES NEAR THE LOW END OF FED'S TARGET RANGE

We believe we have likely seen the high mark for U.S. interest rate over the near term. The yield on the ten year U.S. Treasury note peaked near 3.25% in the fourth quarter of 2018 and has settled in at 2.75% toward the end of December as trade tensions subsided and global growth expectations slowed. *In 2019, we expect domestic economic growth will be more closely linked to global economic growth. The key driver to U.S. interest rates will be expectations for domestic economic growth. With the potential for an economic slowdown in the second half of 2019, we expect the yield on the 10 year U.S. Treasury will trade below 3.0% for most of next year.*

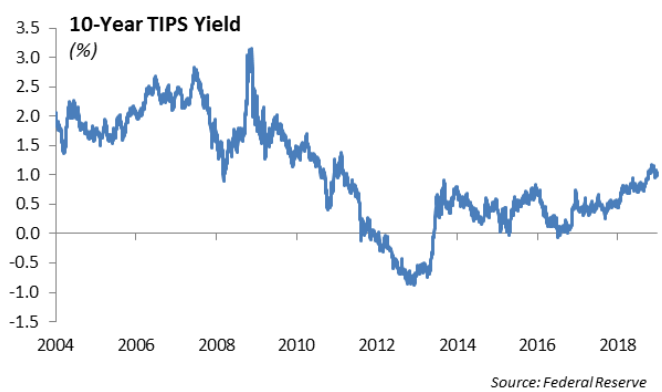


The Federal Reserve will have its hands full in 2019 as it deals with a slowing economy, muted level of inflation, regulatory reform in the financial sector, potential global shocks such as Brexit, and political pressure from a President critical of current monetary policy.

We expect the rate of inflation will persist at reluctantly low levels and not exceed the Fed's target of 2.0% PCE. The labor market remains tight, and near term wage pressure is real. Rising labor costs will put pressure on profit margins over the coming year. At the same time, we expect corporations to right size their employee cost structure in an effort to protect margins.

The Federal Reserve has reduced the size of its bond portfolio from a prodigious peak of $4.5 trillion to $4.1 trillion at the end of the year. We expect the Fed will exercise prudence as it reduces the size of the balance sheet in order to have a managed impact on interest rates. We believe the Federal Reserve would modify its balance sheet reduction program when signs of an economic slowdown appeared to be more severe than expected.

The interest expense on Treasury debt outstanding to the public will reach $364 billion next year. This represents roughly 8.5% of the total budget, a level not seen since 2008. However, the amount of U.S. public debt outstanding has tripled since the Financial Crisis.



Low interest rates will help to lubricate all fixed income asset sectors. New issue volume and liquidity for investment grade and high yield fixed income will benefit from low interest rates this year.

In addition, commercial real estate will benefit from low interest rates, which will help to support low cap rates. Commercial real estate has experienced solid growth over the past ten years, and low interest rates will help continued development.

HEIGHTENED LEVEL OF GLOBAL POLITICAL RISK WILL IMPACT DOMESTIC CAPITAL MARKET ACTIVITY

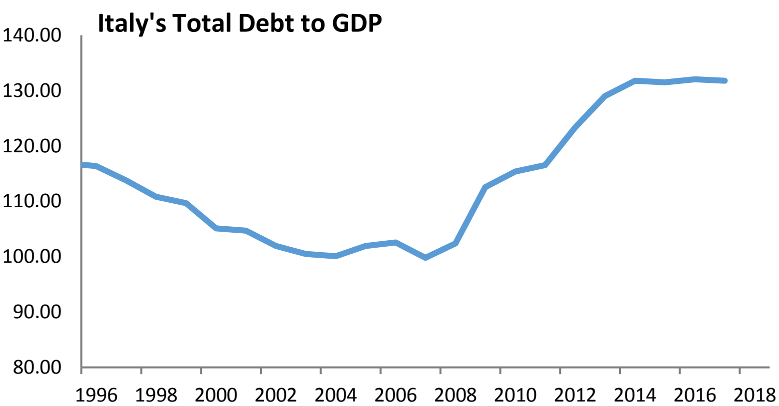
The political, economic, and capital market risks across the globe, both in developed and emerging market economies, has increased significantly over the past several years. We believe this has the potential to increase market volatility and keep interest rates suppressed in 2019. At the same time, emerging market equities have underperformed significantly over the past two years and now represents reasonable valuations relative to developed countries.
The recent increased military aggressiveness from both Russia and China foreshadows a potential shift in U.S. foreign policy and a reminder for those of us old enough to remember the Cold War. Near term, we expect U.S. foreign policy to shift toward tolerance as both China and Russia expand their global reach to support their economies and political agendas. However, the risk to the capital markets is that the U.S. eventually moves toward a more aggressive military presence facing both China and Russia.

Russia has continued to support the Bashar al-Assad regime in the Syrian civil war and has placed military troops permanently in Syria. We do not expect Putin's military ambitions to stop there. Russia's aggression towards Crimea and Ukraine culminated last month with the seizure of three Ukrainian military ships. In addition, Putin has indicated he will pull out of the 1987 Intermediate-Range Nuclear Forces Treaty between the U.S. and Russia if he deems it necessary. Adding confusion to the United States' initiative to obtain peace in the region, President Trump announced in December that he will pull 2,000 American troops out of Syria and claimed the mission to defeat ISIS is essentially complete. It is unclear on the timing and scope of this recent announcement.

At the same time, China has increased its military buildup and aggressively defended territorial waters in the South China Sea. *Trade tariffs are being used as leverage to gain concessions from China and attempt to address illegal intellectual property theft, unfair trade practices, and open China's markets to allow U.S. companies to compete.* At the same time, we believe China's economic growth has slowed sharply this year to roughly 6.25%. While China's government has made several initiatives to stimulate growth, the growing level of debt is a problem for their economy. We expect a breakdown in trade talks would increase market volatility as the Trump Administration layers on additional tariffs for Chinese goods.

Europe is battling several challenges, including negotiating an orderly Brexit agreement, Italy's dysfunctional budget, France's pro-business policy initiatives, and Germany's slowing economic growth. The growing level of populism across Europe is a response to the lack of opportunity many citizens are facing. Wage and employment growth, particularly in Italy, Spain and France, have been low.

The United Kingdom's exit from the Eurozone is one of the largest wildcards for the capital markets in 2019. We believe the most likely outcome is a hard exit if the United Kingdom cannot come to an agreement with European leaders. On the other hand, it is conceivable that the UK votes again on whether to remain in the Eurozone.



Source: International Monetary Fund

However, our biggest concern remains the fiscal deterioration of Italy. The new government continues its spending spree in an effort to stimulate its economy as its debt/GDP has hit 130%. The new Italian government reached an agreement with the EU for a budget deficit of 2.5% next year. With the end of the ECB bond buying program, there are fewer buyers of Italy's debt which will put upward pressure on yields.

OUR FORM OF DEMOCRACY AND CAPITALISM WILL CONTINUE TO EVOLVE IN 2019

We believe that democracy and capitalism go hand-in-hand. Our nation was built on free market capitalism, allowing capital to flow freely with minimal government intervention in the markets. Our country was founded as a democracy with three branches of government: the judicial, the legislative and the executive branch. *The structure of our democracy is firmly established. However, the ability to execute legislation effectively has evolved.*

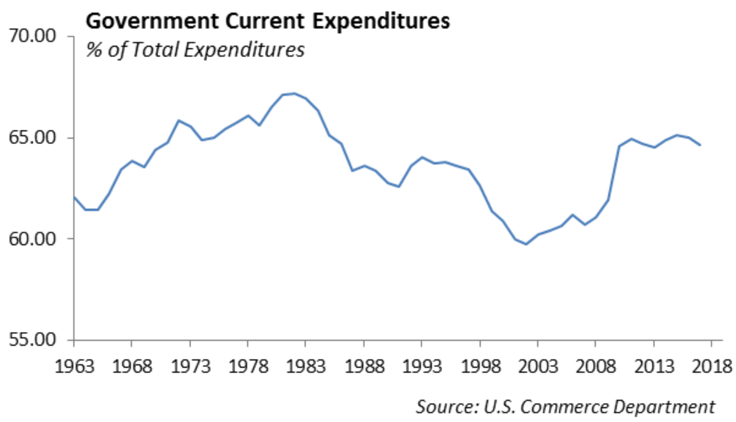
Congress has been stuck in partisan gridlock over the past decade, which has negatively impacted its ability to efficiently produce meaningful legislation. The result is a more autocratic role of the President and an increased use of executive orders to produce legislation.

We expect more executive orders from President Trump, and Congress will struggle to produce bi-partisan legislation as it has over the past twelve years. *As a result, fiscal discipline and the willingness to address the ballooning cost of entitlement programs has been ceded to a future generation. The cost of entitlement programs, including social security and Medicare, exceeds the growth rate of the annual total budget for the U.S. government. The consequence of this neglect is that the entitlement programs now represent over 50% of the total expenditures of the U.S. government.*

Number of Executive Orders By President

Year	President	Number
2017-2018	Donald Trump	90
2009-2017	Barack Obama	276
2001-2009	George Bush	291
1994-2001	William Clinton	308

The reliance on budget deficits and increased debt to fund our federal budget will continue. The lack of political will to address entitlement reform is sending the United States towards a deteriorating credit profile. *At the same time, the Tax Cut and Jobs Act of 2017 will reduce tax revenue at the time we need it most, which will further exasperate the budget deficit.* The full impact of the debt burden will be felt when the economy begins to slow, the employment picture deteriorates and the consumption pulls back.



Ultimately, sustained higher debt levels and stimulative monetary policy will have an impact on expected returns on financial assets. We expect horizon returns for financial assets will be lower than historic measures as we digest this period of debt accumulation and spending.

We maintain that our form of capitalism is also changing. Capitalism is not static, and we do not want to assume the playbook for investing is the same as it was thirty years ago. While many of the changes are subtle, some are more dramatic. A recent Wall Street Journal article indicated that nearly 85% of all equity trades are through passive strategies designed to match an index or placed by algorithms. *That means discretionary trades represent merely 15% of the market trading volume. Real investor sentiment is harder to recognize when machines place trades based on algorithms.*

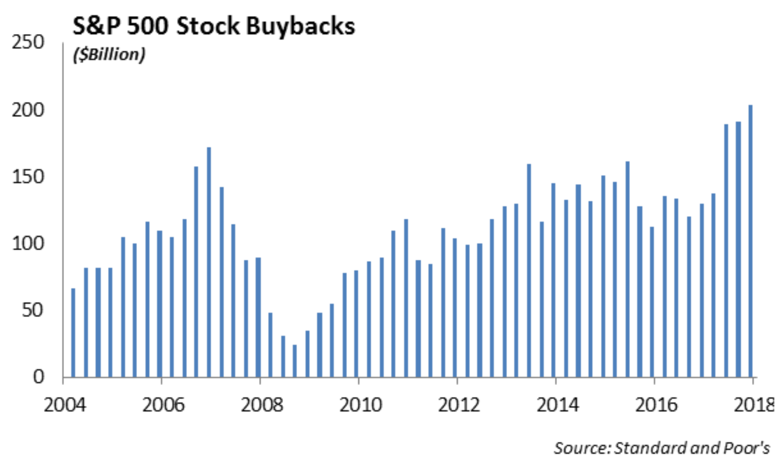
CREDIT MARKETS WILL BEGIN TO SHOW SIGNS OF STRESS

On a relative basis, the credit markets had a pretty good year in 2018. The BBG Barclays U.S. Aggregate was 0.01% for the year while the BBG Barclays U.S. High Yield Index was -2.08%. This year helped illustrate the value of diversifying a portfolio to include asset classes, such as fixed income, that are not correlated to domestic equities.

We believe that business and economic activity moves in cycles and not in straight lines. Since the Financial Crisis, the monetary and fiscal policies, combined with regulatory reform, have acted to extend the business and economic cycles. *We believe we are at the front end of a turn in the credit cycle, and we will see a deterioration in the quality of credit in 2019.* This deterioration in credit will manifest itself as an increase in the number of companies that are downgraded by the rating agencies and an increase in the number of credit events, including merger and acquisitions and fallen angels. This year, we have seen deterioration in the credit profiles of companies such as Xerox, GE, and AT&T.

Our primary concern for the credit markets is focused in the leverage loan market. Leverage loans are essentially bank loans to non-investment grade companies which have been syndicated in the capital markets. The leverage loan market surpassed the total size of the high yield market this past quarter with over $1 trillion of loans outstanding. Leverage loans are imbedded in products such as floating rate funds, closed end bond funds, Collateralized Loan Obligations, and Business Development Corporations. By pushing the risk into the capital markets and off the balance sheet of the banks, there effectively is a transfer of risk from the banks to investors.

The default rate in the leverage loan market today is below 2015 levels, which correlated with the turmoil in the energy sector. However, the default rate is rising over the past year according to data from LCD. We expect the leverage loan market will experience the brunt of the pressure in credit deterioration which will flow through to Business Development Companies and Collateralized Loan Obligations (CLO's). The banks will sail through relatively unscathed due to their more diversified business mix, conservative loan underwriting, and increased capital levels. Given the structural shift of leveraged loans from banks to the capital markets, investors will bear a larger burden of credit deterioration in this next cycle. Paradoxically, we expect to see more ratings upgrades in the bank sector this coming year.



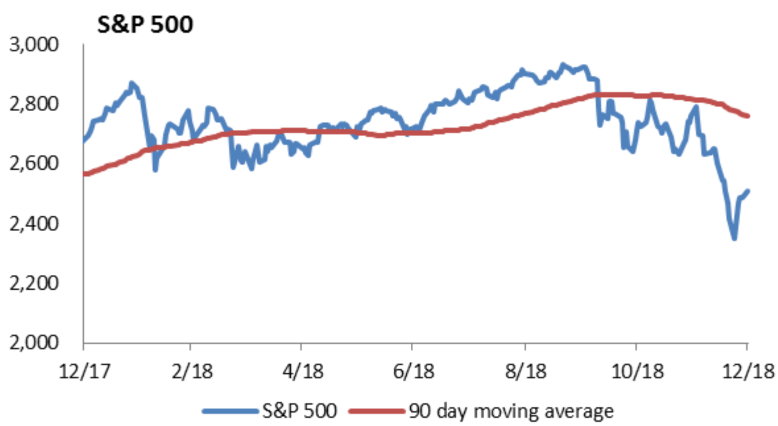
Debt used to repurchase company stock has been adding to the leverage on corporate balance sheets. In theory, management repurchases company stock when it believes it is undervalued and there are no other projects or investments they can fund that would earn an after tax rate of return that would exceed their company's cost of capital. The low level of interest rates has provided a huge incentive for corporate management to increase leverage to the balance sheet and repurchase their stock in the open market. Corporate management has rationalized that these stock buyback programs have allowed for a tax efficient transfer of value to the investor, even though the investor receives no direct cash as a result of the stock repurchase. *In 2018, there has been a record of $1.1 trillion of stock buy backs announced, and we expect that to increase with the recent decline in the overall market. Much of this stock was purchased at elevated prices during the first half of the year, which underscores the inability of some companies to recognize if their stock is undervalued.*

NEW ECONOMY STOCKS WILL CONTINUE TO OUTPERFORM THE STOCKS OF OLD ECONOMY COMPANIES

Across the global capital markets, companies and industries are dramatically being transformed by technology. For example, ride sharing services such as Lyft and Uber have altered consumer behavior and are changing the economics of owning a car. The auto industry is on the verge of self-driving technology. The telecom and media industry is consolidating, and consumers are rapidly transitioning from cable to internet bundles. The landline phone continues to get disconnected from homes. And, the use of technology in military applications, such as hypersonic missiles and drones, is changing how countries structure their military. We could go on and on.

In order to stay competitive and relevant in today's economy, nearly every company is being forced to rationalize new technology or processes to compete effectively. *We are still in the early stages of a dramatic shift in the transformation of the U.S. business sector. We expect this next year will see Initial Public Offerings of new economy companies including: Lyft, Uber, Airbnb, and Pinterest. We expect these IPOs will change the structure of indices and help support the higher valuations of technology growth oriented companies.*

For 2019, we expect the rate of earnings growth will decline. In addition, profit margins, which have been robust following the financial crisis, will feel more pressure. Three factors will affect profit margins over the next year: rising labor costs, increase in raw material costs, and higher interest expense.



Source: Standard and Poor's

This is not the end of the world, rather a slowdown in the pace of earnings growth. The EPS for the S&P 500 is roughly $174 per share. Simplistically, at 14.5 to 15.0 times forward earnings, we would expect the S&P 500 to be fairly valued in the range of 2523 to 2610. We would expect earnings growth to be near 5% in the near future. In general, U.S. companies are producing strong cash flow. When we measure the dividend yield plus funds used to repurchase stock, companies in the S&P 500 are producing 4.6% distribution rate to investors.

Companies will take aggressive steps to protect profit margins in 2019. Companies will pass on increased raw materials costs to the consumer where they can. Watch for mass lay-off announcements as companies take steps to reduce labor costs and control expenses in the face of margin pressure over the next year. General Motors, for example, recently announced plant closings and 14,000 reduction in head count.

EXPECTED RETURNS OF FINANCIAL ASSETS

FIVE YEAR ASSET CLASS RETURNS FORECAST				
	Asset Class	Proxy Index	2019 – 2024 (%)	Total Return 2018 (%)
FIXED INCOME	Cash	3 Month U.S. T-Bill	2.30	1.87
	Inflation-Linked	BBG Barclays U.S. TIPS	2.85	-1.26
	Investment Grade	BBG Barclays U.S. Aggregate	3.45	0.01
	High Yield	BBG Barclays U.S. High Yield	5.15	-2.08
	Municipal	BBG Barclays Municipal	3.10	1.28
EQUITIES	U.S. Large Cap	S&P 500	5.85	-4.38
	Europe	MSCI Europe ex-U.K.	6.00	-10.21
	Japan	MSCI Japan	5.75	-14.91
	United Kingdom	MSCI United Kingdom	6.25	-8.84
	Canada	MSCI Canada	5.35	-9.04
	Australia	MSCI Australia	6.75	-0.5
	Developed Markets	MSCI All World	5.95	-9.42
EMERGING MARKET	Asia	MSCI EM Asia	8.65	-15.49
	Latin America	MSCI EM Latin America	6.35	-6.21
	Emerging Markets	MSCI Emerging Markets	8.50	-14.58

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