Economic & Capital Market **Outlook**

Third Quarter 2019

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Over the first half of the year, performance of publicly traded securities was impacted by a perceived shift in the Federal Reserve monetary policy, a restructuring in trade tariffs with Europe, Mexico, Canada and China, and a general slowdown in the domestic and global economy. As we look toward the second half of the year, it is time to reassess our investment themes and current portfolio structure.

1. We expect domestic economic growth between 1.8% and 2.0% for 2019. Slower economic growth will help keep interest rates low and provide downward pressure on corporate earnings.

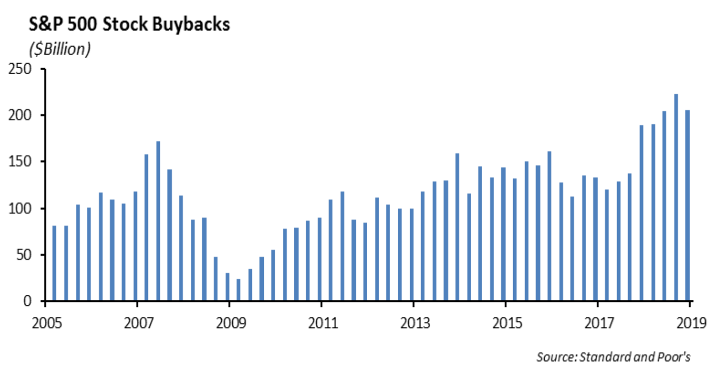
2. Corporate earnings will remain under pressure as revenue growth slows and profit margins are pressured. Corporate America is largely through the refinancing of debt, which has helped to lower their cost of capital and extend the credit cycle. We expect the next move to support earnings will be labor force reductions similar to Ford and Volkswagen announcements this past quarter. The rosy employment market, which has been the strength in the recovery, will likely deteriorate by the end of the year.

3. The trade war with China has contributed to the slowing domestic economic growth rate. We expect that Trump wants a trade deal nailed down with China heading into his re-election campaign. Recently, President Trump and Chinese President Xi Jinping agreed to renewed trade talks at the G-20 meeting in Japan. Discussion included a cease-fire on hostile initiatives toward Huawei and a commitment from China to buy large amounts of American agriculture products.

4. Boris Johnson is the apparent leader to replace Theresa May. The Brexit process has put a significant weight on both the U.K. and European economies, contributing to a slowdown in growth. We do not expect an acceleration in growth until the lines around Brexit are more clearly marked. We expect a hard Brexit by the fourth quarter.

5. We expect volatility to remain high this summer unless the China tariff issues are resolved quickly. Stock buybacks will likely be a major theme in the second half of the year as earnings growth slows.

6. Liquidity in the credit markets has been difficult at times. New issue volume is down significantly, and Asian buying has declined. While we do not see a significant shift in the credit cycle yet, the seeds are planted for a change. Leveraged loans and commercial real estate are both drawing significant capital, and valuations appear excessive.



The Federal Reserve's Conundrum – Wash, Rinse, Repeat

The voting members of the Federal Reserve published their rate outlook for the next year. Named the "Dot Plot," this report is effectively an inside view of how voting members of the Fed think rates will change based on the information they've been given. Interestingly, not a single member predicted that rates would be reduced this year. Every member expects the Fed will hold steady or increase rates. Conversely, the market is predicting 100% probability that the Fed will adjust short term interest rates lower in 2019.

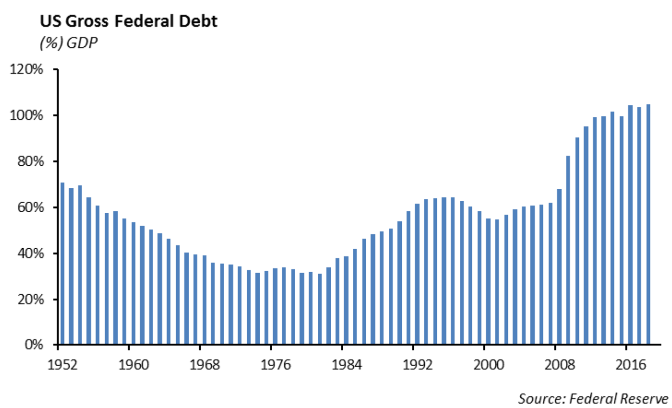
Why is there such a large disconnect on the direction of monetary policy?

In defense of the Federal Reserve, the economy is still fairly healthy and growing at a roughly a 1.8% pace. The economy is still producing jobs, wages are increasing, and the labor market appears strong.

However, there is a long list of economic issues that have the potential to negatively impact sustainable growth. With the back drop of slowing global economic growth, the trade war with China is weighing on business investment and corporate earnings. The rate of inflation continues to fall below the Fed's 2% target.

At the same time, increasing global political tensions between the U.S. and China, Russia, Iran and North Korea would support increased liquidity in the capital markets and easier monetary policy. Not to mention the President is openly badgering the Federal Reserve Chairman Powell to lower rates.

Wash, Rinse, Repeat. Like the directions on a bottle of shampoo, the Fed is stuck in the same monetary conundrum as several other developed countries. Lower rates, buy bonds through quantitative easing, then repeat. This is the new monetary regime, and we are stuck in it. Europe and Japan are also stuck in it. We expect that Europe Central Bank to ramp up its bond buying program next year if the Eurozone economy doesn't show signs of growth. Ultimately, the growing level of debt becomes a burden as the U.S. approaches 100% debt to GDP. However, when we add back the unfunded pension liabilities, the Social Security funding gap, and the Medicare funding gap, we are closer than we think.



Economy is Still Growing – Albeit Slower than Expected

We expect GDP for the first quarter to come in near 1.8%, much slower than the pace we were seeing last year. The economy benefited from the change in tax policy in 2018, however, most of that surge has already been felt. There are several barriers to continued economic growth including the uncertainty over trade policy and Brexit which will impact the economy through the second half of this year. Still, once these issues are resolved, we expect the domestic economy will be slow to accelerate and growth will remain muted.

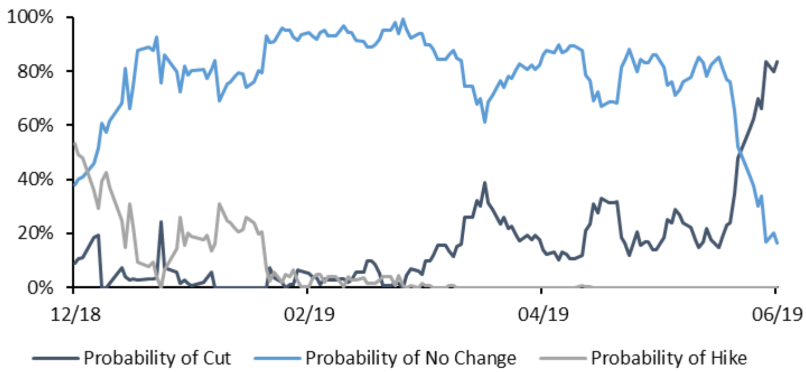
Manufacturing output has been generally flat through June. Data from the first quarter continued into the summer with a decline in manufacturing of 1.1% and industrial production increased 0.4% in May after falling 0.4% in April. Manufacturing has been a solid contributor to economic growth since the Financial Crisis; however, the lack of investment and soft demand is weighing on the sector.

Existing home sales rebounded 2.5% in May; however, total sales are down 1.1% from a year ago despite marginally lower mortgage loan rates and healthy job market. In addition, May's housing starts declined 0.9% over the prior month according to the Department of Commerce, underscoring a growing weakness in the economy.

The Next Move by the Fed is to Lower Rates

The Federal Reserve released their minutes from their May meeting. The tone of the statement remains accommodative, and the Fed indicated that they expected to be patient with the direction of monetary policy and the level of short term interest rates given the trade issues with China and Brexit.

Probability of Fed Rate Change
Current Implied Probabilities for 2019



Source: Bloomberg

While there is some improvement in China's economic activity and parts of Europe, the global slowdown will likely keep the Fed monetary policy on a wait-and-see mode. We would expect the stimulus that China infused into its economy last year begin to take effect. This includes low cost loans to Chinese banks and incentives to boost their housing market. A resolution to China – U.S. trade will likely push manufacturing output higher. *Any improvement in China's economic growth will marginally help to push domestic growth rates higher.*

The Fed appears patient and comfortable with current policy. *We expect the Federal Reserve to lower interest rates 50 basis points in the second half of the year given the slowing economic growth.*

Investment Strategy

1. We are reducing risk in our portfolios following the sharp rally in domestic stock prices in May. This includes lowering large cap domestic equity. Current valuations do not support slower earnings growth expectations.

2. We expect there is a point in which global markets begin to accelerate at a faster pace than domestic economic growth. We are not there yet. As a result, we have not added to international and emerging market exposure. We expect to increase international exposure in the second half of 2019.

3. We continue to shorten durations in bond portfolios given the sharp move lower in the ten year U.S. Treasury yield.

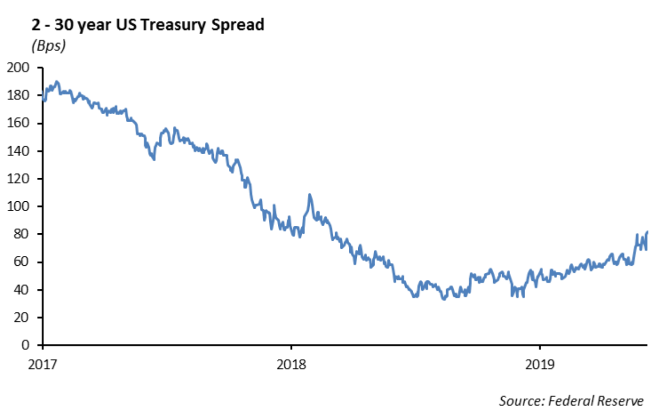
4. Tighter credit spreads are pushing the "up in quality" trade.

5. We are reluctant investors in publicly traded forms of real estate given the low cap rates and significant amount of money flowing into real estate development. In addition, the quality of underwriting has deteriorated for loans flowing into structured securities. We are extremely cautious on public forms of commercial real estate.

6. In general, leverage loans are problematic for us. The amount of "covenant light" loans coming to market is indicative of a peak in the cycle. Credit based mutual funds that use leveraged loans, as well as business development companies should be approached with reluctance given current valuations.

Fixed Income

The Fed has signaled that a potentially more accommodative monetary policy could be necessary as trade tensions extend and cause further global growth slowdowns. This led to a continued decline in interest rates across the globe. The 10-year US treasury dipped below 2% during the quarter. The increased likelihood of a short term rate cut by the Fed led to the 2-year treasury declining further than the long end. This shift created a steepening of the 2-year to 30-year curve from 60bps to 80bps, a contradiction of the inverted curve story often dramatized in the media.



US credit was notably weaker in May, widening roughly 20bps, but recovered by the end of the quarter. Spread widening was primarily driven by the rapid decline in interest rates, while credit issues had less of an impact. As spreads moved back to historic tights in June, we began reducing our credit exposure in portfolios and moved up in quality, buying US Treasuries. We also began shortening the duration of portfolios in a more defensive move as both rates and spreads seem overvalued.

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Municipal Bonds

Tax-exempt municipals outperformed treasuries during the quarter, and the 30-year Muni/UST ratio declined to 92%. Taxable municipals, on the other hand lagged both corporates and tax-exempts. Supply picked up during the quarter on the short end. Unlike the steepening of the corporate curve, the muni curve flatten 12bps during the quarter. We are currently building defense into our muni portfolios by shortening duration through cushioned callables. These bonds offer short call dates and a yield pick up to bullets, and in the event that rates rise dramatically, the yield kicks to a much higher yield to maturity.

High Yield

Spreads in the US high yield market tightened heading into the end of the quarter. Performance was driven mostly by dovish signals from the Fed and a rebound in oil prices. After a 64 basis point tightening in June, high yield now sits almost 140 basis points tight to year end levels. Total return for high yield credit was over a full percent at the end of the quarter, with performance led in BB and B credit. Year to date total return is now over 10 percent in the index, making it the best start since 2009. Quality ties lead the way with BBs over 10.5 percent, Bs over 9.5 percent, and CCCs just short of 9 percent.

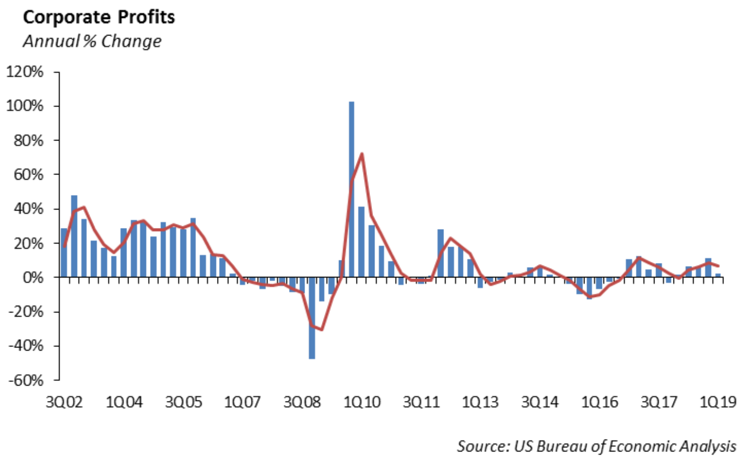
New issuance so far stands modestly above average for the month of June. Refinancing and Mergers & Acquisitions funding had dominated transaction activity last week. Clean Harbors issued $845 million to address 2021 maturities and Nexstar issued $1.12 billion to partially fund acquisition of Tribune Media.

During June, we saw WTI prices rise $5.02/barrel, which is roughly 10 percent on the backs of geopolitical concerns between the US and Iran, including attacks on oil tankers in the Persian Gulf and the shooting down of an American drone in the Gulf of Oman.

Equities

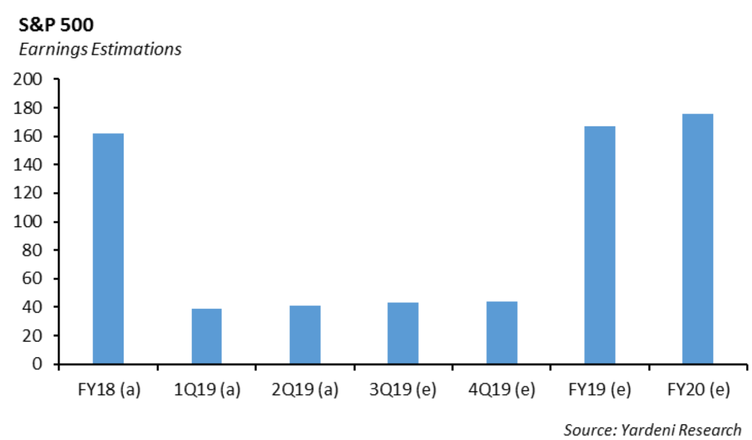
The S&P 500 ended the quarter up 4.30%, after declining roughly 10% during May. The index is now up 17.20% YTD. We are still near all-time highs as last month was the best June for the S&P since 1955.

Financials were the top performing sector this quarter, rising 7.99%. The Utilities and Real Estate sectors were the largest laggards during the quarter, up only 3.47% and 2.45% respectively.



It was a solid quarter for domestic equities. Of the companies in the S&P 500, 15% have reported results for the quarter. Of those, 78% reported positive earnings surprises, and 53% reported positive revenue surprises. If the S&P hits its projected earnings decline of -3.9%, it will be the index's first year over year decline in earnings since earnings fell 3.2% in the second quarter of 2016. The forward 12-month P/E ratio for the S&P 500 is 16.8x, which is above the 5-year average of 16.4x and the 10-year average of 14.7x.

Looking at reported sector earnings so far, the majority of companies in the following sectors have reported earnings above their estimates: technology, healthcare, communication services, and materials. In the energy sector, however, only half of the companies have exceeded their earnings expectations so far.



We are moving into earnings season, as 150 S&P companies are scheduled to report. We expect earnings growth to continue to rise at a slowing pace.

The new issue market continues to be active with Zoom Video Communications (ZM) and Pinterest (PINS) coming to market. Mergers & Acquisitions were also active this past quarter with AbbVie announcing their acquisition of Allergan for $63 Billion, at a premium of around 40%. AbbVie is best known for Humira, the world's top selling drug at about $20 Billion in revenue per year. They are acquiring the $8 billion Botox franchise.

The healthcare sector continues to face pressure, especially healthcare insurers. UnitedHealth beat on both top and bottom line, and they raised FY year guidance. Its stock price tells a different story, however, as shares are now down 25% from recent highs due to noise from the Medicare for All concept. If there's a belief that this concept can take shape, then the market reaction is justified. However, if Medicare for All never becomes a law, there is an opportunity of a play on a stock with sound fundamentals.

Retail sales for March jumped 1.6%, solidly beating expectations of 0.9%. After negative sentiment from the -0.2% decline in February and an expectation for a Q1 consumer spending slowdown, the health of the consumer still appears strong.