Investment Themes for 2020

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As we look to next year, we have started the process of laying out our major investment themes. These themes will provide a back drop for our portfolio structure and, in many cases, impact valuations.

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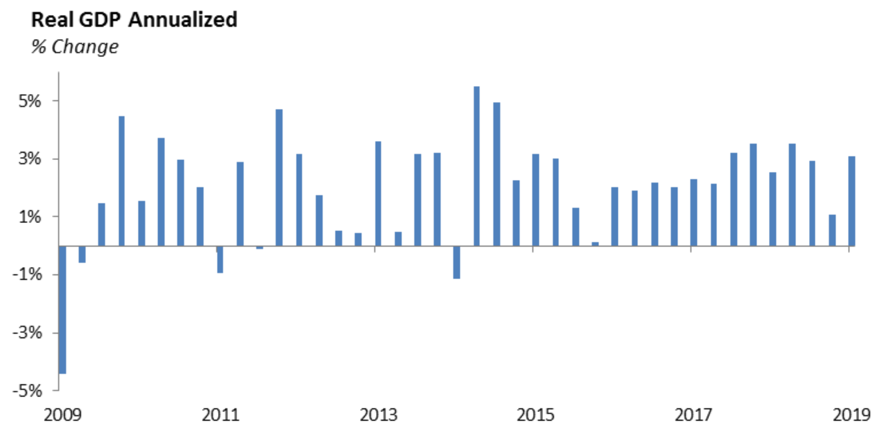
The Economy

We expect economic growth to be muted next year as the Consumer sector slows and manufacturing stabilizes. Bright spots exist in defense and technology. However, growth in the auto and housing sectors will likely slow. The health of the consumer, which is highlighted as a separate theme, will be the key to sustained economic growth.



Source: U.S. Department of Commerce

Global Trade and the Impact on Global Economic Growth

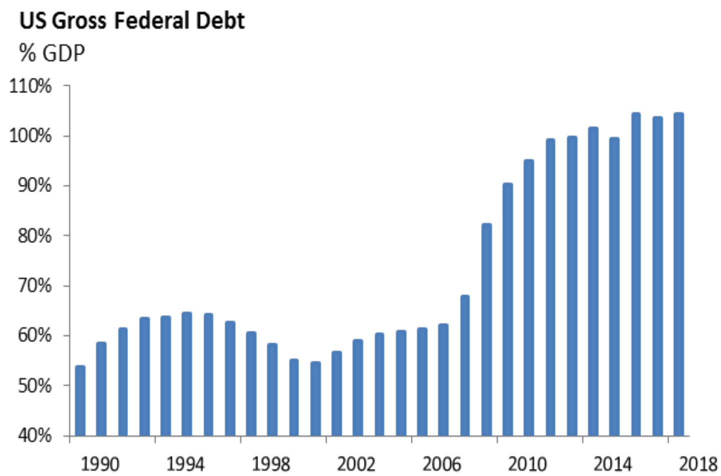
It is in the best interests of both China and the United States to complete a Phase One trade deal by early this year. This deal will lower recent tariffs on Chinese goods in exchange for the purchase of U.S. agricultural products by China. However, we do not expect to see any progress beyond Phase One heading into the election. A resolution to trade with China would bring a revival in global growth; however, we expect economic growth will be muted compared to historic measures. We expect supply chains to marginally shift away from China, and there is no going back to the old way of doing business. This will mark the beginning of a new *Economic Cold War* and a battle between a central state controlled form of capitalism (China) with an evolving version of capitalism under a democracy (the United States).

The Elections in November

Given the political agendas on both sides of the isle, the elections in November will likely have an impact on the economy and capital markets. The Democrats have various political agendas that will impact corporate profits and tax policy, and Republicans have an agenda that is heavy on U.S. fairness in global trade. Re-electing the President and maintaining a majority in the Senate will be a huge focus for the Republican Party.

The Growing Federal Debt is Supporting Economic Growth

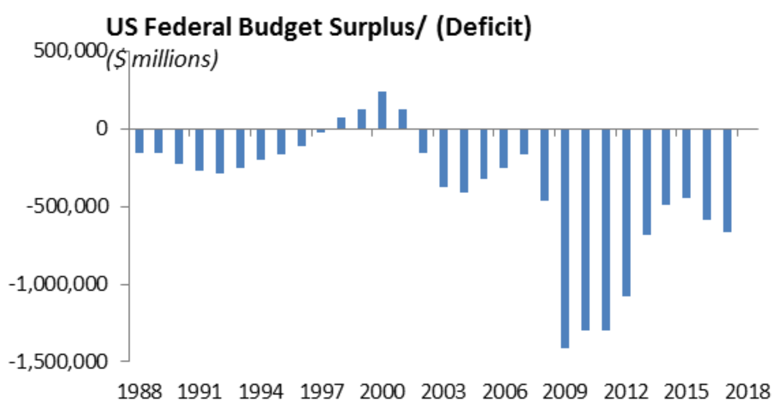
The chronic budget deficits since the Financial Crisis in 2008 have been financed through large debt issuance by the U.S. Treasury. We expect the debt issuance to continue to grow. As the average maturity of Treasury issuance increases, the durations of ETFs that are based on debt outstanding will also increase. Exposure to interest rate risk for investors increases as the U.S. Treasury and corporations extend the maturities of their debt.



Source: Federal Reserve

The Lack of Political Will to Address the Huge Federal Budget Deficit

This fiscal year's budget deficit is an astounding $1 trillion. During an economic expansion, to run a deficit over 5% of GDP is aggressive. We would expect economic growth to be moderate over the next two years, and the size of the deficit will likely grow further. Following the Tax Cuts and Jobs Act of 2017, realized tax revenue is below what was expected. There is a lack of meaningful political will to address the government spending, and entitlement programs have become a disproportionate size of the budget.



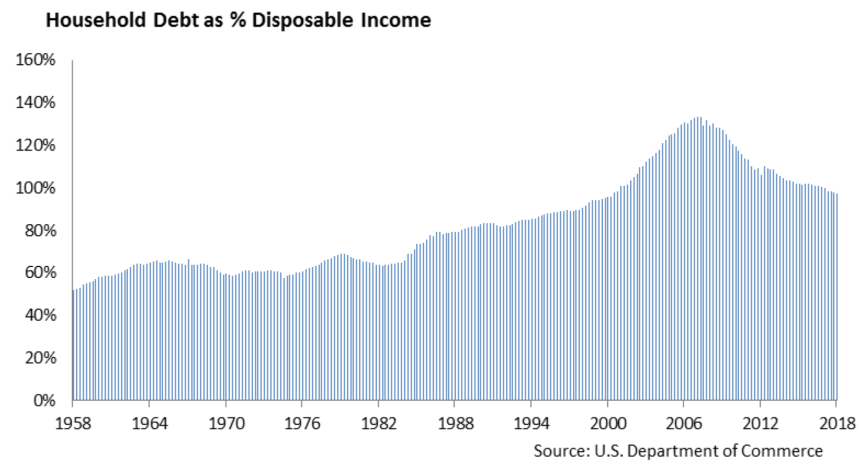
Source: U.S. Office of Management and Budget

The Independence of the Federal Reserve and its Impact on Monetary Policy

After a three year push to tighten monetary policy by increasing the Fed Funds rate, we expect the Federal Reserve to pause its tightening program during the first part of 2020. A continued strong labor market, combined with a revival in global growth, will be enough for the Fed to pause. In addition, we expect the Federal Reserve to structure new policy tools to help better manage liquidity in the money market and repo market. Leading up to the election, the President will likely be vocal about the Fed easing monetary policy and lowering rates. The Fed, in an effort to not be viewed as biased ahead of the election, will not make major policy moves unless warranted by the data. The independence of the Federal Reserve will be a theme next year.

The Consumer Sector

The consumer represents nearly 70% of economic output in the U.S. economy. As a result, the health of the consumer will be important to sustained economic growth next year. While wage growth and disposable income numbers appear favorable, the growth in consumer debt is a concern. Household debt as a percentage of disposable income is lower than in the Financial Crisis, but it is still near 100%. In addition, the growing income inequality raises concerns for ability of the consumer to maintain a consistent standard of living during the next economic downturn.



The Evolution of Capitalism.

Our country was founded on principles of democracy and capitalism. Capitalism, solely for the benefit of shareholders, will be challenged over the next few years. This past summer, the Business Roundtable released a statement that redefined the purpose of the American Corporation from serving the shareholder to now, serving all Americans. The notion that the corporation exists solely for the shareholder is one example of the growing shift in capitalism. Christine Lagarde, in her new role as the President of the ECB, has indicated she would like to explore monetary policy's impact on income inequality and climate change. However, the most significant challenge to our democracy and capitalism will come from competing with China and its form of central-state controlled capitalism in which the government directly controls and benefits from the Chinese corporation. We expect the conversation around what role capitalism plays in our society, and what role, if any, will government play in a capitalist society.

Growing Global Political Challenges

The current "America First" agenda has resulted in a shift in foreign policy and, in some cases, exposed an undercurrent of resentment toward the U.S. There has been no shortage of global geo-political challenges, and we expect that will continue into 2020. China has growing ambitions to grow its reach and has been aggressive in the South China Sea. Russia has been providing military support to Syria and Iran and has expanded trade relations with China. North Korea continues to play chicken with the U.S. and its nuclear program. And, the Middle East is a powder keg of anti-American sentiment waiting for a match. We expect growing hostility from Iran will challenge the United States' presence in the region.

There Are Growing Challenges in Corporate Fundamentals

Low interest rates have provided an incentive for companies to increase their debt load and leverage their balance sheet. There has been significant growth in the investment grade and high yield corporate markets. In addition, there has been significant growth in the leveraged loan market. We expect that there will be continued deterioration in the credit quality of the leverage loan market, which will eventually spill into the high yield market. Roughly 25% of the companies in the Russel 2000 are not producing positive cash flow. The bull market in stocks has been tolerant of private companies that have launched into the public markets having never turned a profit. This includes Uber, Lyft, Pinterest, and Peloton. Rational investor capital will begin to reassess the valuations on some of these companies, and the "circle of life" will inevitably die.

Lower Expected Returns on Financial Assets

With the rally in domestic stocks, valuations are elevated compared to historic measures. Over a near term horizon, our outlook for investment returns for domestic equities are mid-single digits. In addition, fixed income investment returns are likely to be low compared to historic periods as well. This will have a major impact on the return assumptions for pension funds over the next several years. It will also have an impact on individuals saving for retirement.