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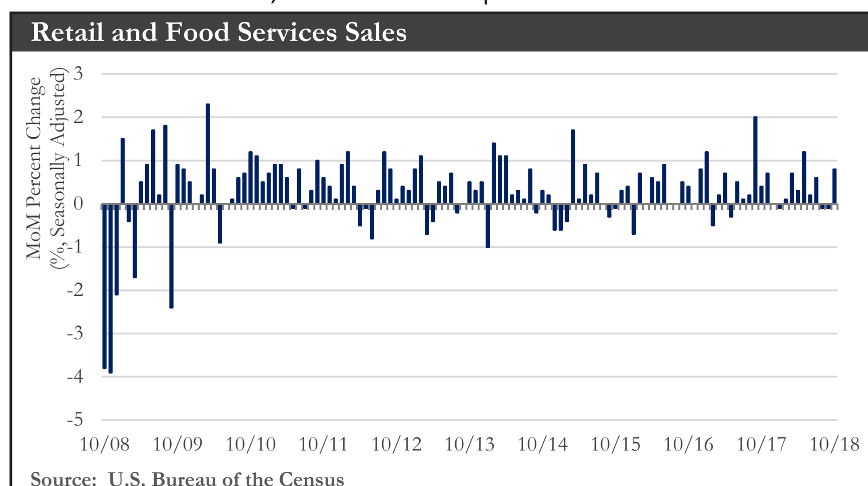
ECONOMIC COMMENTARY AND CAPITAL MARKET UPDATE DECEMBER 2018

Recap: The economy clearly had strong momentum heading into the final month of 2018. Real GDP grew at a 3.5% annual rate during the third quarter and the most recent employment data has shown nonfarm payrolls adding an average of 218,000 jobs per month for the past three months. Unemployment dropped to its lowest level since 1969, wages climbed 3.1% year-to-year, and the latest indicators—such as consumer confidence and new claims for unemployment insurance—showed no signs of trouble.

Despite the recent string of strong economic reports, few signs were apparent that the economy was on the verge of overheating. Inflation remained close to the Fed's target and slowing global growth appeared to be weighing on commodity prices. With inflation having run close to the Fed's target, the Fed is likely to stick to its previously announced plan to modestly nudge interest rates higher. Economic growth should gradually moderate to its long-term trend. The benefits from tax reform have continued to propel growth moving into 2019, but should fade over the course of the year, as interest rates continue to rise.

Consumption and Inflation: U.S. consumers, powered by strong income gains, increased spending in October, driving economic growth, while other sectors such as home building and exports showed signs of softness. At the same time, inflation was subdued, which has taken pressure off the Federal Reserve to keep raising short term interest rates in 2019.



Consumer spending registered its largest gain in seven months in October, rising 0.6% from September. Incomes were up 0.5%, the largest monthly increase since January. In addition, an inflation measure watched closely by the Fed, the personal consumption expenditure price index excluding food and energy, was up 1.8% in October from a year earlier, which was below the central bank's 2% target and down from 1.9% the month before. Overall inflation, including food and energy, was 2%, but has been heading lower as volatile gasoline prices have fallen. One factor behind muted inflation has been the stronger U.S. dollar, which has made imports cheaper.

Two things have become obvious. First, a range of recent indicators have suggested U.S. economic growth may be slowing, in part because global growth has lost momentum. The latest data showed that American consumers, who power about two-thirds of U.S. output with their spending, were still an important source of momentum behind growth.

Second, the Fed has been debating how far to push interest-rate increases. If inflation undershoots the Fed's target, that could cause the central bank to halt its campaign of interest-rate increases next year. On the other hand, price increases could accelerate if pressure from labor shortages and tariffs intensified or oil prices picked up after the recent slump. A pickup in inflation would likely prompt the Fed to raise interest rates more quickly to prevent the economy from overheating.

Housing: Housing has been a notable weak spot for the economy, with real residential investment declining in five of the past six quarters. The weakness was evident across all aspects of the housing market. More than five years of rapidly rising prices, combined with higher mortgage rates, have made homes increasingly unaffordable for buyers.

Current conditions have provided little comfort for homebuilders. With interest rates rising, resale activity has remained soft. Inventory levels have been historically low and this imbalance has helped housing starts retain their mild upward

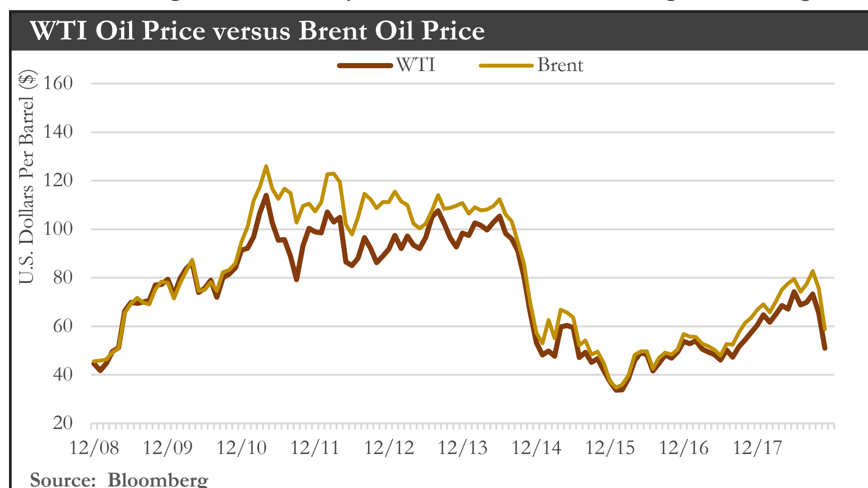
trajectory over the medium term.

Mid-Term Election: Political events took center stage in November, as the Democrats regained control of the House and the Republicans maintained control of the Senate, largely in line with expectations. A divided Congress will temper President Trump's agenda, but much depends on the Democrats' strategy for working with the GOP.

Several issues to consider:

- Currently 25% of discretionary spending for the 2019 fiscal year is under a temporary funding agreement until early December. The current Congress will likely kick the can into early 2019, setting up a potential funding battle and risking a partial government shutdown.
- The debt ceiling is set to be re-instated in March 2019. It must be raised or suspended again to prevent a debt crisis or huge fiscal contraction. Congress will come to an agreement to avert a crisis, but there could be some fireworks in the process.
- With a Democratic House, repeal of the Affordable Care Act is likely off the table, which could help the health care sector. However, there is a chance there could be some compromise on drug pricing.
- U.S.-based multinationals may benefit from reduced trade tensions around NAFTA and Europe. Tariffs have already disrupted supply chains of some of the largest U.S. firms so any easing in tension is a plus. The risk of an escalation in trade disputes with China remains, however.
- With a divided Congress, additional fiscal stimulus is less likely, which means potential for slower growth, easier Federal Reserve policy and a weaker dollar. That can help emerging markets, which typically sell commodities in dollars and have debt denominated in dollars.

Oil: Oil prices have been in a rapid descent since October, losing nearly a third of their value in about eight weeks. What sparked the reversal? A number of factors have been identified: booming U.S. output, increasing Iranian oil because of U.S. sanction waivers, Russia and Saudi Arabia ramping up production, rising oil inventories, growing anxieties over the health of the global economy and bullish investors being forced to get out of crude positions as the price drop steepened.



Because of the surge in supply, inventories have risen again. If they keep rising, that would put even more pressure on prices to fall the way they did in 2014 when inventories swelled. The steepness of the drop has prompted Saudi Arabia and the OPEC to consider a plan to quietly cut production to bolster prices.

The recent collapse in the price of oil has sparked higher volatility in the markets. And prices have remained volatile leading up to the OPEC meeting in early December, when it will become clear whether the cartel is prepared to remove more oil from the global market.

Markets have been skeptical that the December meeting of OPEC will be able to turn the tide on oil supply enough to support prices. A big reason has been the emergence of the U.S. oil industry, with ballooning shale production, as one of the world's most important players and exacerbating worries about a global glut of crude.

Uncertainty on the geopolitical front has also contributed to worries about oversupply. The strength of global production has threatened to overwhelm demand. This could pressure OPEC and its allies, such as Russia, to cut back when the group meets in December in hopes of regaining more direct control of global supply.

Adding to the pressure on oil has been a stronger U.S. dollar. Since crude is priced in dollars, it has become more expensive for foreign buyers when the U.S. currency rises.

The recent price drop has acted as a double edged sword for the U.S. If the price of oil drops too far, too fast, that could also hurt U.S. producers, especially in the shale patch. Most shale drillers have maintained they can break even at $50 or lower. But the falling prices have begun to eat into their profitability, and some may be forced to curtail spending next year and reduce ambitious growth plans if prices decline much more.

On the positive side, U.S. consumers have enjoyed lower prices at the gasoline pump. This has provided a boost to consumer spending in other parts of the economy. Higher oil production helped the U.S. lower its merchandise trade deficit and insulated the country from global price swings.

Eurozone: The eurozone economy will cool in 2019 as global demand for the bloc's exports declines, with a sharper slowdown possible if the U.S. economy overheats or trade tussles escalate. The Eurozone GDP is still expected to grow by 2.1% this year, having expanded by 2.4% in 2017, which was the currency area's best year in a decade.

The eurozone has faced a number of external threats, chiefly the possibility that the U.S. economy has grown too rapidly in response to cuts in taxes and increased government spending, prompting the Fed to raise its key interest rate more rapidly than currently anticipated. This could spread turmoil through global financial markets and weaken growth in eurozone as well as other developing and developed economies.

There have also been threats to growth from within the bloc, such as, increased borrowing by Italy's new government and the possibility that the U.K. could leave the bloc in March abruptly and without a new trade agreement.

Brexit: British and EU leaders have signed off on a 'withdrawal agreement,' setting out the terms surrounding the U.K.'s exit from the EU. Along with the withdrawal agreement, which is legally binding, the leaders have ratified a statement setting out the parameters of future trading, as well as economic and security relations between the EU and the U.K.

Now the U.K. Prime Minister Theresa May has to win approval for the agreement in the U.K. Parliament in December. There has been strong opposition against the agreement among both the government and opposition Parliament members.

As a result, less than four months from Britain's departure from the EU, Brexit has remained a leap into the unknown, with businesses, banks and households unsure how to prepare. Minister May's domestic travails could mean an abrupt and messy break with the EU when the clock runs down on Brexit talks in March. Such an outcome would leave the U.K. facing significant tariffs and regulatory hurdles with a bloc that has accounted for half its trade.

The short-term consequences could include severe disruption to everyday economic activity when the U.K. exits the EU's legal regime. Longer-term, according to the IMF, a no-deal scenario would leave the British economy as much as 8% smaller by 2030 than it would have been had Brexit never happened.

While a final agreement being reached by the March 2019 deadline is seen as likely, look for Brexit uncertainty to remain after this timeframe, which could limit U.K. economic growth prospects and potential upside for the pound. If a deal is reached before March 2019, a modest pickup in economic growth compared to this year is in the cards as is some strengthening in the pound in coming months. Given a successful withdrawal deal the Bank of England is likely to gradually resume its tightening path in the second half of 2019.

Italy: Italy's coalition government has been staking its future on a 2019 budget that would lower the pension age, raise welfare benefits for the poor and jobless and cut income taxes. The measures have been popular with voters but the

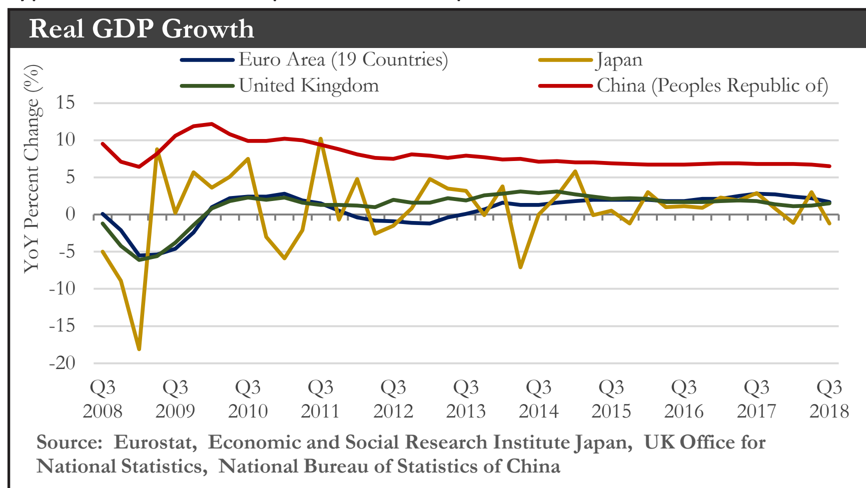
European Commission rejected the country's 2019 budget proposal for a second time and is expected in December to begin disciplinary proceedings against Italy that could lead to fines.

Italy has said the budget will stimulate growth. If it does not, Italy will be left with an even bigger debt burden, already one of the highest in the world. That would lead to further market turbulence, credit downgrades, and more problems for Italian companies.

An eventual compromise could occur before financial penalties have been imposed on Italy, though it may take several months before that compromise would be reached. It is also quite possible that the Italian government could collapse, given the history of instability in Italy and the strain of maintaining a coalition government with a finite degree of fiscal stimulus to parcel out. Financial penalties have seemed possible; however, they would probably not take place for quite some time.

The challenges of stagnant living standards and high debt levels that have sparked the current political situation are unlikely to abate anytime soon. Even if Italian policymakers thread the needle on fulfilling their campaign promises while avoiding sanctions from EU, rising interest rates in Europe in the years ahead would likely put additional pressure on the sustainability of Italian debt, making future policy choices even more difficult. Furthermore, unless real GDP per capita rises in a meaningful and sustained way, the populist rumblings in the Italian political system are unlikely to completely fade away. Thus, Italian budget drama would periodically come into focus for financial markets for years to come.

Global: The global economy has hit a soft patch, putting the U.S.'s robust growth at risk should the slowdown persist. Economic output in Japan and Germany contracted in the third quarter, while in October consumer spending in China hit its slowest pace in five months and bank lending fell. One-time events played a role in some of these bumps, including a typhoon and an earthquake that hit Japan and bottlenecks at German auto plants associated with new emission standards.



Source: Eurostat, Economic and Social Research Institute Japan, UK Office for National Statistics, National Bureau of Statistics of China

But across the globe, a common denominator that has hurt growth is the trade battles among the U.S., China and others. Tariffs have hit some businesses, and worries about the impact of worsening trade discord have also weighed on sentiment and decisions.

A month-long slowdown in China's economy, driven in part by a crackdown on risky financing and jitters over the trade dispute between Beijing and Washington, has hurt spending there. China's slowdown has been most felt in factories around the world.

Outlook: Growth in the U.S. economy will moderate during the current quarter. The moderation is expected to extend into 2019. Fiscal stimulus will provide less of a boost during the coming year, while rising interest rates will weigh progressively more on growth. Housing, the most interest-rate-sensitive part of the economy, has already been flashing warning signs, with residential investment declining in five of the past six quarters.

While consumer spending is expected to moderate in coming quarters, gains should be fairly solid. Stronger job and income growth have continued to boost consumer confidence and provide ample support for spending over the next few quarters. The moderation in growth should help restrain inflation.

Deceleration in global GDP growth should continue in 2019. Headwinds due to escalating trade tensions between the U.S. and China, along with the removal of accommodative monetary policy, will weigh on the global growth outlook, with the impact largely being felt in 2019.

Although global growth is likely to be led by developing economies in 2019, one of primary concern is a sharper than expected growth slowdown in China. Should this come to pass it will likely cause a material slowdown in developing economies, which would weigh on global growth in 2019. In contrast to the U.S., stimulus efforts to boost China's economy have been less impactful and their effects have begun to fade.

The European Central Bank is on pace to begin hiking rates towards the end of 2019. Higher policy rates may also create headwinds for the Eurozone and lead to slower growth, while also restraining inflation throughout broader Europe. The removal of accommodative monetary policy from major central banks will also play an important factor in the outlook for growth across the globe.

Risks to the outlook seem to be tilted to the downside, which may result in slower global economic growth than is currently expected. The primary concern would be a further escalation in trade tensions between the U.S. and China. There is also some possibility of faster monetary tightening, especially in the U.S. and Canada, if labor markets improve and wage pressures continue to increase. This may lead to central banks removing accommodative policy conditions at a quicker pace than currently expected. If this were to occur, the global slowdown could be faster than currently anticipated, while financial markets could experience significant levels of volatility.

Sources: Department of Labor, Department of Commerce, Morningstar, Eurostat

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Index Performance as of: 11/30/2018

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
3000 Value	3.54	2.89	-2.73	-2.73	1.33	2.62	9.84	8.50
3000	4.69	2.00	-5.51	-5.35	4.48	5.53	11.80	10.62
3000 Growth	5.92	1.10	-8.23	-7.93	7.36	8.14	13.66	12.66
1000 Value	3.64	2.99	-2.35	-2.15	1.48	2.96	9.81	8.65
1000	4.82	2.04	-5.19	-4.83	4.76	5.92	11.94	10.89
1000 Growth	6.09	1.06	-7.98	-7.46	7.75	8.59	13.96	13.04
Mid Cap Value	2.72	2.40	-4.98	-5.73	-2.00	-0.79	8.90	8.39
Mid Cap	3.51	2.46	-6.05	-6.66	0.95	1.89	9.83	9.14
Mid Cap Growth	4.69	2.54	-7.61	-8.00	4.75	5.32	11.24	10.17
2000 Value	2.18	1.61	-7.49	-9.78	-0.88	-1.83	10.08	6.71
2000	3.04	1.59	-9.44	-11.62	0.98	0.57	10.08	7.50
2000 Growth	3.89	1.56	-11.29	-13.36	2.69	2.81	9.97	8.22
S&P 500	4.91	2.04	-4.94	-4.40	5.11	6.27	12.16	11.12
Consumer Disc	6.55	2.81	-8.78	-7.83	10.04	12.70	11.73	12.14
Consumer Staples	2.97	1.94	4.29	5.37	0.81	3.04	7.43	8.44
Energy	3.50	-1.65	-12.72	-10.47	-6.21	-1.63	2.14	-2.37
Financials	3.90	2.80	-2.07	-4.24	-1.98	-0.06	12.91	11.26
Health Care	6.01	7.05	-0.11	2.82	16.50	15.75	12.09	13.33
Industrials	4.13	3.84	-7.38	-5.36	-2.90	-1.06	11.03	9.29
Information Technology	6.14	-1.88	-9.70	-10.00	8.93	8.94	18.93	17.94
Materials	2.56	4.05	-5.81	-7.77	-8.38	-6.61	8.26	6.33
Real Estate	2.79	5.63	3.86	1.11	5.60	5.07	7.33	10.84
Communcation Services	5.51	-0.65	-6.36	-2.37	-5.66	-0.21	5.39	4.09
Utilities	2.79	3.58	5.61	4.98	8.47	1.81	13.05	11.86
Dow Jones Industrial Avg.	5.32	2.11	-2.98	-1.07	5.59	7.62	15.77	12.39
Wilshire 5000 (Full Cap)	4.66	1.92	-5.65	-5.58	4.42	5.61	11.82	10.42
MSCI EAFE	0.97	-0.13	-8.08	-7.28	-9.39	-7.94	4.12	1.84
MSCI EM	2.65	4.12	-4.95	-5.45	-12.24	-9.09	9.41	1.90

Index Performance as of: 11/30/2018

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
MSCI Frontier Markets	1.09	2.17	-1.44	-1.50	-13.89	-11.20	5.14	1.71
MSCI ACWI	3.31	1.46	-6.14	-5.73	-2.55	-0.98	8.56	6.16
MSCI ACWI Ex USA	1.40	0.95	-7.26	-6.84	-10.13	-8.12	5.43	1.79
MSCI AC Asia Ex Japan	2.92	5.31	-6.11	-7.41	-11.99	-9.61	9.39	4.37
MSCI Brazil	2.18	-1.97	15.51	23.59	1.34	5.99	25.67	0.11
MSCI BRIC	3.49	5.72	-1.16	-2.26	-9.62	-7.02	12.13	3.41
MSCI China	3.77	7.33	-4.98	-6.31	-13.65	-12.00	9.83	5.23
MSCI Europe	0.85	-0.93	-8.49	-8.17	-10.74	-9.40	2.82	0.78
MSCI India	4.83	10.37	2.67	-6.68	-7.18	-2.65	9.15	8.81
MSCI Japan	1.49	0.40	-8.09	-5.30	-6.64	-5.99	5.93	4.67
MSCI EM Latin America	1.68	-2.19	1.19	5.94	-5.80	-1.62	13.50	-2.06
MSCI Russia	0.78	-1.16	-5.67	3.56	2.90	5.82	14.57	-0.95
Barclays U.S. Aggregate	0.13	0.60	-0.20	-0.84	-1.79	-1.34	1.33	2.03
ICE BofAML US 3M Trsy Bill	0.05	0.21	0.38	0.53	1.69	1.80	0.97	0.59
Barclays U.S. Gov't	0.15	0.88	0.41	-0.51	-1.22	-0.92	0.64	1.38
Barclays U.S. Credit	-0.13	-0.07	-1.47	-1.80	-3.56	-2.79	2.39	2.86
Barclays High Yield Corp.	0.44	-0.86	-2.45	-1.90	0.06	0.36	7.09	4.39
Barclays Municipal	0.54	1.11	0.48	-0.17	0.08	1.13	2.13	3.52
Barclays TIPS	0.35	0.48	-0.96	-2.01	-1.80	-0.90	1.66	1.28
Barclays Gbl Agg Ex USD	-0.15	0.11	-1.28	-2.33	-4.27	-4.01	2.82	-0.57
Barclays Global Aggregate	-0.02	0.31	-0.81	-1.66	-3.16	-2.82	2.20	0.56
JPM EMBI Global Div	0.50	-0.42	-2.57	-1.10	-5.53	-4.84	4.20	4.62
Alerian MLP	1.52	-0.83	-8.76	-10.19	-3.38	1.21	1.00	-5.16
Bloomberg Commodity	1.37	-0.56	-2.71	-0.84	-4.68	-1.83	1.64	-7.26
FTSE NAREIT Equity REIT	2.40	4.74	1.63	-0.95	3.93	3.70	6.52	9.82
S&P Global Natural Res.	1.03	-3.57	-12.34	-9.17	-7.89	-2.64	12.38	1.03
S&P N. Amer Natural Res.	2.29	-2.08	-13.82	-13.10	-11.12	-6.07	1.63	-3.85