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ECONOMIC COMMENTARY AND CAPITAL MARKET UPDATE JANUARY 2019

Recap: The U.S. economy struck mixed chords as it rounded out 2018, with consumer confidence high and households spending robustly, but with manufacturers pulling back as the global economy cooled.

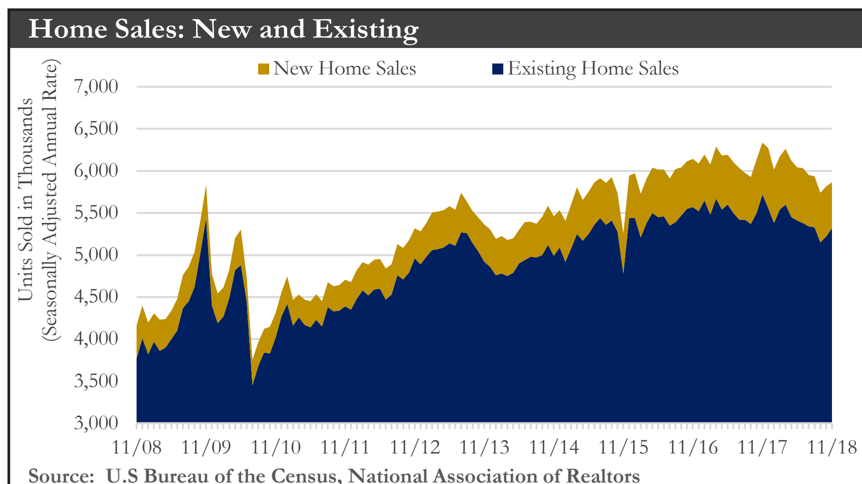
U.S. real GDP appeared to be on pace to rise 2.9% in 2018, making it one of the strongest years of the expansion. Employment growth showed persistent strength in the face of near record low unemployment. There have been more job openings than unemployed persons. The tight labor market has pushed wages and salaries higher, and productivity growth has also picked up which should help offset some of these increases.

Recent macro indicators have continued to confirm several running themes. First, inflation has remained very close to the Federal Reserve's 2% target, which provided policymakers with some leeway in normalizing interest rates. Second, U.S. consumer spending has remained hot as evidenced from personal income and spending data. Third, the housing market has remained soft but recent improvements are encouraging.

As the boost from strong consumer spending and fiscal stimulus wears off, U.S. growth should slow to a still-healthy 2.5% in 2019. The Fed's decisions in 2019 will hinge on what happens next for inflation. If the Fed believes inflation has stabilized at 2%, it will pause the rate increases. Recent soft inflation readings have suggested the probability of such a pause in 2019 is rising.

The global economic outlook has been shifting, which could lead to new turbulence in the U.S. economy and financial markets in 2019. Some of the world's major economies, including China, Germany and Japan, have seen growth contract in recent months. A global slowdown will be felt in the U.S. to a degree that will largely be determined by its magnitude and duration.

Housing: Recent housing data has been mostly disappointing. Sales of new and existing homes and new home construction have continued to come in below expectations, and most of the leading indicators have shown the trend is likely to continue and perhaps intensify. Builders have also faced intensifying margin pressures, as potential buyers have demanded more affordable product. However, builders have seen little to no relief in land development costs and have seen costs rise for building materials, financing and labor. The pronounced weakness in home sales has been particularly vexing because it has come at a time when consumer confidence is near multi-decade highs and the unemployment rate is at its lowest level in decades.



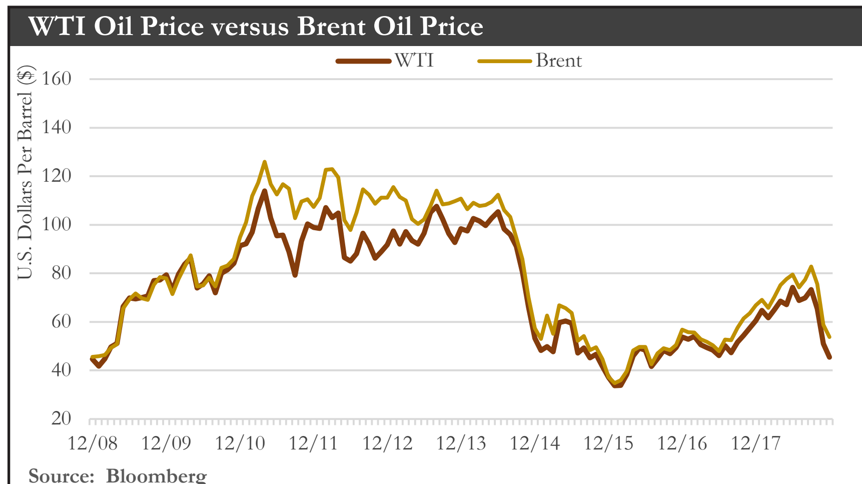
Home Sales: New and Existing

Source: U.S Bureau of the Census, National Association of Realtors

While the recent slide in home sales has likely been prompted by higher interest rates, the persistent weakness in housing has likely been due to demographic shifts and the exceptionally high costs of suburban development. These hurdles are unlikely to relent in coming quarters, which means home sales and new home construction should continue to underperform the overall economy and underlying growth in households.

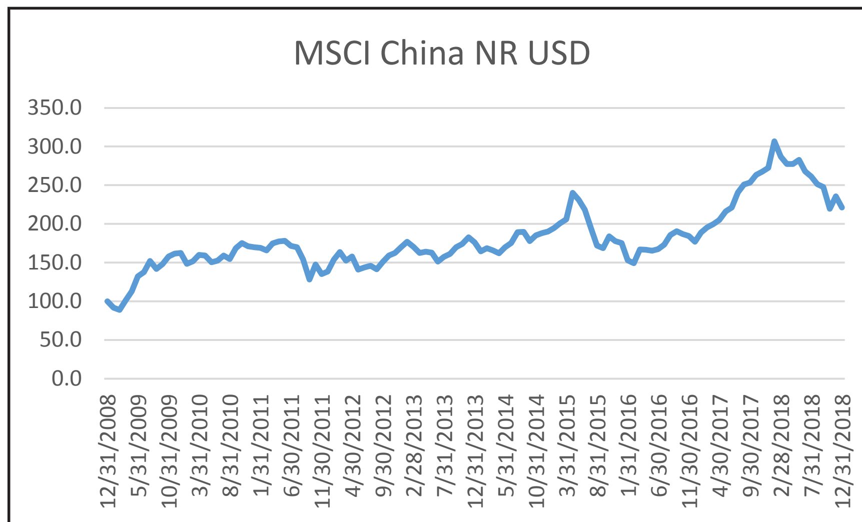
Oil Market: Oil prices continued to fall. The U.S. benchmark, West Texas Intermediate, has been down 40% since a high in October. The large decline has been largely attributed to an oversupply of oil, caused by U.S. shale production, timid production cuts by OPEC nations, and generous sanctions waivers by the U.S. for Iranian oil.

But the demand side has started to flash red and could grow at its slowest pace in eight years. Signs have been mounting that oil consumption in China, India and other economies across emerging Asia—the source of two-thirds of global oil-demand growth—has slowed, and uncertainty around the U.S.-China trade spat has further clouded the outlook. Problems in the Eurozone, including recent protests in France, could also crimp oil purchases.



Tariffs and Stock Markets: Investors have been on edge about whether the U.S.-China trade dispute will deepen in 2019, curtailing global growth and hurting stock prices. The S&P 500 in the U.S. has struggled to stay in positive territory in 2018. Trade tariffs have factored largely into the increased volatility. In China, though, the trade spat has been more punishing as the country's Shanghai Composite has sunk into bear market territory and has seen its worst annual performance since 2008.

If the tariffs escalate after the 90-day truce agreed upon between the two countries, many companies in the S&P 500 that have significant revenue exposure to China will struggle. Technology manufacturers will be among the most affected.



Companies that have a high level of asset exposure to China, such as iPhone-maker Apple and casino-operator Wynn Resorts, would also be at risk as ongoing trade tensions could lead many to make costly changes to their supply chains.

Brexit: A withdrawal agreement has been reached between the UK and the EU in principle, but still awaiting parliamentary approval from the UK and EU. Recent events however, have suggested the process is far from over. A no-deal or hard Brexit could severely reduce UK economic activity after the March 2019 deadline.

Deal or no deal, both near-term and longer run growth in the UK could suffer as a result of leaving the EU. A Brexit deal before March outlining the terms of exit would alleviate some uncertainty, but a new trading arrangement between the UK and the EU would still need to be struck in upcoming years.

Eurozone: Real GDP growth in the Eurozone downshifted in 2018 after the more solid pace of growth seen in 2017. Several countries saw outright contractions in output in the third quarter, and while some of the weakness was likely due to temporary factors, the recent stagnation has led many to question the durability of the present expansion. But the underlying health of the Eurozone economy should display resilience in coming quarters. Consumer spending will likely rebound, buoyed by accelerating wage growth.

While the European Central Bank has remained accommodative amid continued sluggish price pressures and the recent

growth slowdown, its bond purchase program is likely to end soon before beginning to slowly raise interest rates from the fall of 2019. Price pressures should slowly pick up as labor costs continue to rise and monetary policy becomes tighter after several years of historically low interest rates. The fundamentals of the Eurozone economy should remain intact and real GDP is expected to rise about 2% in 2019.

Emerging Markets: As the primary engine of global growth, emerging markets (EMs) have continued to struggle with both common and idiosyncratic factors that are hampering efforts to keep growth at a long-run trend. Although capital outflows have recently eased, the strong U.S. dollar and rising domestic and international interest rates have limited the ability of emerging market growth to re-accelerate. Debt sustainability concerns have remained, particularly in countries that are in the midst of a balance of payment crisis, such as Argentina and Turkey. However, poor fiscal positions in Brazil, along with fiscal and banking sector concerns in India, have raised the risk of further bouts of capital outflows and weaker economic growth as contagion fears spread.

More concerning has been the risk that China's economy decelerates more-than-anticipated over the next few years. The recent slowdown has evolved largely as prescribed by domestic policymakers, who are deliberately reining in credit growth in order to reduce future financial stability risks. But U.S. tariffs have added to that drag on growth, with related spillovers to China's trading partners in South East Asia, such as Taiwan, Singapore, Hong Kong, and the ASEAN.

Slower growth in EM economies is expected to last for the next few quarters, after which some of the near-term pressures should lift. Even so, longer-term growth concerns are likely to remain.

China: China's growth has been on a controlled descent for most of this decade, propped up at times by easy credit that has made debt a long-term threat for the maturing economy. During the past two years, with growth still buoyant, policy makers have taken aim at debt and other financial risks to put the economy on sounder footing.

In recent months, however, that campaign has resulted in an economy decelerating faster than Beijing expected. China's economy has faced growing headwinds— from weakening household spending and declining industrial output to anemic investment in factories and other big-ticket projects. The trade fight with the U.S. has made the debt-control initiative even more unsustainable.

China has had to strike a balance between the needs to stabilize growth and the needs to continue fending off financial risks. Policymakers have to ensure China's growth within a reasonable range in 2019 with a combination of measures aimed at spurring investment and consumption. These measures have included allowing easier credit, especially to local governments, and expanding tax cuts. This would help to keep China's economic growth rate between 6.0-6.5%.

Financial Markets and Recession Fears: The volatility sweeping financial markets has underscored investors growing unease about the durability of the nearly decade-long bull market, even as there is little risk of a near-term recession.

Investor's worries have run deep, taking into account not only the negative impact of a trade war but also fading fiscal stimulus, rising short-term interest rates, U.K.'s uncertain departure from the European Union in March, fiscal crisis in Italy, and declining bond buying by the major central banks—all of which have exacerbated long-running worries that the U.S. economy is due for a contraction after a lengthy expansion.

But many economic trends have not fit with patterns that preceded previous downturns. The behavior of the data over the last four quarters in the U.S., Eurozone and Japan has been completely incongruous with any of the recessions that took place since 1980. A sharp slowdown in global growth is expected, but not the end of the business cycle.

By most measures, the U.S. economy has remained in a stable position. Not only has the pace of economic growth topped 3% for two straight quarters, but consumers appear to be on particularly strong footing, having reduced leverage since the

financial crisis while benefiting from an increasingly tight labor market.

Productivity growth and consumer spending, for example, have tended to slow before downturns set in. In the U.S., they have picked up. In Japan, employment has marched steadily higher, while investment in the Eurozone has increased, both inconsistent with previous downturns.

Still, there have been a few concerning developments: business investment growth has fallen in the third quarter - a possible sign that the impact of corporate-tax cuts have started to wear off and the uncertain trade outlook has begun to weigh on business investment decisions. Home sales have also been sputtering, hurt by high prices, rising mortgage rates and growing consumer anxiety that the market has peaked.

Moreover, the volatility in financial markets could itself have economic impact. As investors have sold not only stocks but also other risk assets such as corporate bonds, there has been a sharp slowdown in debt issuance by businesses. This could ultimately hurt the economy if it translated to less investment.

There has been a risk that investors' pessimism, to an extent, could become a self-fulfilling prophecy. Rising borrowing costs could lead to a reduction in corporate leverage, which in turn could lower future earnings and cash flow growth for even companies that have not reduced leverage.

Poor investor sentiment has colored the market's reaction to even good economic data. However, caution should be exercised in reading too much into recent market volatility. The shift from stocks to bonds could reflect seasonal factors, as traders have tried to limit risk-taking heading into the end of the year. In addition, some measures of corporate-borrowing costs, while higher than in early 2018, have remained well below heights reached as recently as 2016, when previous recession fears gripped the market.

Recession risks are real, but not for three to four years. The risk should be low in the next twelve months. Markets might be responding to that longer-run risk or expecting it much sooner than the data reveals. But the economic data have not said it has happened yet. Plenty could still go wrong for the global economy in 2019, including trade confrontations between major economies that could turn into a new cold war.

Outlook: Some of the factors that have contributed to strong economic growth in 2018 are beginning to fade. The income-lifting effects of the tax cuts will dissipate in 2019, which should lead to some deceleration in real personal consumption expenditures. Growth in real government expenditures is also set to slow. Higher interest rates appear to have weighed on the housing market recently, and the Fed is not completely done yet with its process of removing policy accommodation.

That said, the U.S. economy has strong momentum behind it at present, which should keep the expansion intact. Business confidence has been buoyant, thereby underpinning investment spending and employment growth. Real consumer spending should be supported by continued growth in real disposable income, upbeat confidence and record levels of household wealth. The high personal saving rate has given households the financial ability to maintain solid rates of spending growth.

Unemployment has receded to its lowest rate in nearly five decades, which has led to some acceleration in wages. Modest rates of wage inflation have put some upward pressure on rates of consumer price inflation. Consequently, the Federal Reserve has been gradually removing policy accommodation, and is expected to tighten even more in 2019.

The trade-weighted value of the U.S. dollar against other major currencies has risen about 5% on balance since the beginning of 2018. The strength of the U.S. economy relative to most other major economies has led the Fed to hike rates at a faster pace than other major central banks, thereby supporting the dollar. But many other major central banks should start to catch up to the Fed in 2019. This monetary policy convergence should lead to dollar depreciation vis-à-vis most

other major currencies in 2019. The dollar's performance should be generally mixed against emerging market currencies.

But there are also some credible downside risks to this outlook. First, although inflation has generally remained benign, it could conceivably rise more rapidly in coming months if wages accelerate further due to tightness in the labor market. In that scenario, the Fed could end up tightening policy too forcibly. Second, trade tensions between the United States and China have risen in 2018. Although the "first order" effects of the trade war do not appear to be large enough to derail the U.S. expansion, "second order" effects on investment and consumer spending could be more meaningful. Third, there has been broad asset price appreciation in recent years, and a significant selloff in asset markets could weaken confidence and erode household wealth.

Deceleration in the global economy should occur in 2019. Slower growth in China should also be due, at least in part, to the trade war with the United States. The Japanese economy should also decelerate a bit in 2019, although the pace of economic activity in the Eurozone and in the United Kingdom should hold up reasonably well. A 'disorderly' Brexit and political tension between the Italian government and the European Commission represent possible downside risks to this outlook, but both issues should be resolved.

Market Commentary

Recap: The fourth quarter proved to be difficult as the S&P 500 and the Nasdaq turned in their poorest quarterly performances since 2008, dropping 13.5% and 16.8%, respectively. And the Dow Jones Industrial Average generated its worst quarterly return since 2009, falling 11.3%. A significant portion of these losses came during the month of December. The DJIA and S&P 500 recorded their weakest December performances since 1931 and their largest monthly losses since February 2009. Results overseas were also negative as the MSCI EAFE index fell 12.5% during the quarter, and the MSCI Emerging Markets index dropped 7.5%. Fixed income markets benefited from a flight-to-safety dynamic. The Barclays U.S. Aggregate Bond index gained 1.6% during the quarter while the Barclays Global Aggregate ex. USD Bond index rose 0.91%.

Domestic Equities: The quarter began on an upbeat note as markets responded positively to a deal forged by the U.S. and Canada to salvage NAFTA as a trilateral pact with Mexico, rescuing a three-country, $1.2 trillion open-trade zone that had been about to collapse after nearly a quarter century. Volatility, however, quickly returned as investors worried about late cycle dynamics, seemingly focusing more on earnings growth sustainability than on generally strong third quarter corporate results. The recent tax cuts provided a boost to corporate earnings but investors, aware that its impact will begin to diminish in 2019, began to digest the prospect of a slowdown. And the likelihood of future stimulus fell when November midterm elections resulted in the Democrats winning the House. Uncertainties regarding monetary policy also contributed to market volatility. Comments made by Federal Reserve chairman Jerome Powell early in the quarter implied the Fed would continue raising interest rates. Later in the quarter, sounding more dovish, the Fed chair stated that rates were "just below" the range of estimates for neutral. Finally, trade concerns continued to be a theme during the quarter. Some measure of hope was provided when President Trump and Chinese President Xi Jinping agreed on a trade dispute ceasefire following a meeting at the G20 summit. Despite the positive headlines coming from the G20 summit and the aforementioned NAFTA update, the threat of a trade war persists.

International Equities: Economic concerns weighed on international markets as global growth became less synchronized. A key theme for 2018 was the strength of U.S. markets, relative to the rest of the world. For the year, the S&P 500 returned a negative 4.4% while the MSCI EAFE index dropped nearly 14%. China, the world's second largest economy, faced headwinds from high levels of debt, slowing construction activity, weak demographics, and the ongoing trade dispute with the U.S. With expected GDP growth of about 6.5%, the Chinese economy is growing at its slowest pace since 1990. Amongst the so called BRICs, China was the weakest by a large margin with the MSCI China index down nearly 19% for the year. And weakness in China certainly had an effect on other regions. The slowdown in Europe can be attributed to, at least in part, a sharp decline in the manufacturing sector's new export orders amid a slowdown in demand from China. Germany, the region's largest economy, experienced its first quarter-on-quarter economic contraction since the first quarter of 2015.

Weakness was also displayed in Japan, where a series of natural disasters caused this country's economic growth rate to also turn negative in Q3.

Fixed Income: Fixed income markets generally produced positive results during the quarter as investors sought refuge from volatile equity markets. Government issues led the way with the Barclays U.S. Government Bond index up more than 2.5%. In contrast, credit markets lagged. Non-financial corporate debt-to-GDP has risen to its highest level in over 70 years, and the credit quality of U.S. investment grade debt has deteriorated. By some estimates, nearly 50% of investment grade debt is rated BBB, or one step above junk. A wave of downgrades as the cycle matures could put further stress on credit markets. Finally, concerns have emerged about covenant quality in the leveraged loan market. The Barclays U.S. Credit index was flat for the quarter, while the Barclays High Yield Corporate Bond index fell 4.5%.

Outlook: In the U.S., the outlook for 2019 is generally positive and reflects a constructive view on economic growth, inflation, and earnings. Furthermore, the potential for greater clarity on trade and Federal Reserve monetary policy may well emerge. Risks to this outlook include the potential of a Fed mistake, slowing global growth, and declining margins as corporate America absorbs rising wages and other input costs. Signs of slowing global growth and signals from the Fed will be key to market behavior. It can be argued that these two factors have been the primary drivers of recent market weakness. Trade related issues continue to be a risk as they have the potential to negatively impact global growth rates. In short, U.S. markets are late but not at the end of the cycle. No recession is expected in 2019, and equity bear markets typically don't begin until about six months before a recession. So, the expectation is that the current market does have some upside.

In developed overseas markets, Europe and Japan are expected to rebound from recent, temporary setbacks. In Japan, rising household incomes and strong business confidence are tailwinds. And in Europe, credit is expanding and financial conditions remain supportive of growth, while issues in Italy and Brexit pose risks. Solid, single digit earnings growth is expected in Europe. Recent market declines have pushed popular valuation measures to their cheapest levels in many years.

Valuations are compelling in Emerging Markets, but trade related issues, a slowing Chinese economy, and further U.S. dollar strength are concerns.

Fixed income investors should expect greater volatility as markets adjust to tightening financial conditions. This is certainly the expectation in riskier, higher leveraged parts of the market, including bank loans, high yield, and emerging market debt. It may be appropriate for some investors to limit their exposures to these asset classes and/or move up in credit quality. Greater duration exposure may also be appropriate as the rise in rates may slow. Tighter global monetary policy, a strong U.S. dollar and slowing global growth are likely to limit the rise of bond yields, going forward.

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

Securities are not insured by FDIC or any other government agency, are not bank guaranteed, are not deposits or a condition to any banking service or activity, are subject to risk and may lose value, including the possible loss of principal

Index Performance as of: 12/31/2018

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
3000 Value	5.90	-9.78	-12.24	-12.24	-8.58	-8.58	7.00	5.77
3000	6.69	-9.31	-14.30	-14.30	-5.24	-5.24	8.97	7.91
3000 Growth	7.49	-8.83	-16.33	-16.33	-2.12	-2.12	10.85	9.99
1000 Value	5.94	-9.60	-11.72	-11.72	-8.27	-8.27	6.95	5.95
1000	6.70	-9.11	-13.82	-13.82	-4.78	-4.78	9.09	8.21
1000 Growth	7.49	-8.60	-15.89	-15.89	-1.51	-1.51	11.15	10.41
Mid Cap Value	5.54	-10.50	-14.95	-14.95	-12.29	-12.29	6.06	5.44
Mid Cap	6.22	-9.92	-15.37	-15.37	-9.06	-9.06	7.04	6.26
Mid Cap Growth	7.21	-9.07	-15.99	-15.99	-4.75	-4.75	8.59	7.42
2000 Value	5.46	-12.09	-18.67	-18.67	-12.86	-12.86	7.37	3.61
2000	6.52	-11.88	-20.20	-20.20	-11.01	-11.01	7.36	4.41
2000 Growth	7.55	-11.68	-21.65	-21.65	-9.31	-9.31	7.24	5.14
S&P 500	6.67	-9.03	-13.52	-13.52	-4.38	-4.38	9.26	8.50
Consumer Disc	8.02	-8.37	-16.42	-16.42	0.83	0.83	9.55	9.69
Consumer Staples	4.28	-9.11	-5.21	-5.21	-8.38	-8.38	3.09	6.26
Energy	6.45	-12.67	-23.78	-23.78	-18.10	-18.10	1.07	-5.56
Financials	6.92	-11.28	-13.11	-13.11	-13.03	-13.03	9.27	8.16
Health Care	7.21	-8.62	-8.72	-8.72	6.47	6.47	8.14	11.12
Industrials	6.88	-10.70	-17.29	-17.29	-13.29	-13.29	7.65	5.95
Information Technology	7.62	-8.46	-17.34	-17.34	-0.29	-0.29	16.37	14.93
Materials	6.85	-6.90	-12.31	-12.31	-14.70	-14.70	7.22	3.84
Real Estate	4.08	-7.41	-3.83	-3.83	-2.22	-2.22	3.87	8.84
Communcation Services	6.09	-7.29	-13.19	-13.19	-12.53	-12.53	2.17	2.58
Utilities	2.74	-4.02	1.36	1.36	4.11	4.11	10.71	10.75
Dow Jones Industrial Avg.	7.04	-8.59	-11.31	-11.31	-3.48	-3.48	12.93	9.70
Wilshire 5000 (Full Cap)	6.71	-9.30	-14.43	-14.43	-5.29	-5.29	9.01	7.69
MSCI EAFE	1.03	-4.85	-12.54	-12.54	-13.79	-13.79	2.87	0.53
MSCI EM	1.55	-2.66	-7.47	-7.47	-14.58	-14.58	9.25	1.65
MSCI Frontier Markets	0.99	-2.93	-4.33	-4.33	-16.41	-16.41	4.20	0.67
MSCI ACWI	4.17	-7.04	-12.75	-12.75	-9.42	-9.42	6.60	4.26
MSCI ACWI Ex USA	1.33	-4.53	-11.46	-11.46	-14.20	-14.20	4.48	0.68
MSCI AC Asia Ex Japan	1.38	-2.71	-8.66	-8.66	-14.37	-14.37	8.56	4.02

Index Performance as of: 12/31/2018

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
MSCI Brazil	3.16	-1.81	13.42	13.42	-0.49	-0.49	27.09	0.69
MSCI BRIC	1.87	-4.21	-5.32	-5.32	-13.43	-13.43	11.22	2.96
MSCI China	1.57	-6.05	-10.73	-10.73	-18.88	-18.88	8.04	4.65
MSCI Europe	0.88	-4.62	-12.72	-12.72	-14.86	-14.86	2.10	-0.61
MSCI India	2.43	-0.13	2.53	2.53	-7.30	-7.30	8.23	8.07
MSCI Japan	0.88	-6.68	-14.23	-14.23	-12.88	-12.88	3.41	3.07
MSCI EM Latin America	2.53	-0.82	0.36	0.36	-6.57	-6.57	14.85	-1.73
MSCI Russia	0.36	-3.49	-8.97	-8.97	-0.70	-0.70	17.38	-1.96
Barclays U.S. Aggregate	0.28	1.84	1.64	1.64	0.01	0.01	2.06	2.52
ICE BofAML US 3M Trsy Bill	0.04	0.18	0.56	0.56	1.87	1.87	1.02	0.63
Barclays U.S. Gov't	0.28	2.13	2.54	2.54	0.88	0.88	1.41	1.99
Barclays U.S. Credit	0.10	1.50	0.01	0.01	-2.11	-2.11	3.16	3.22
Barclays High Yield Corp.	0.59	-2.14	-4.53	-4.53	-2.08	-2.08	7.23	3.83
Barclays Municipal	0.14	1.20	1.69	1.69	1.28	1.28	2.30	3.82
Barclays TIPS	0.14	0.55	-0.42	-0.42	-1.26	-1.26	2.11	1.69
Barclays Gbl Agg Ex USD	0.45	2.22	0.91	0.91	-2.15	-2.15	3.15	-0.01
Barclays Global Aggregate	0.37	2.02	1.20	1.20	-1.20	-1.20	2.70	1.08
JPM EMBI Global Div	-0.02	1.35	-1.26	-1.26	-4.26	-4.26	5.15	4.80
Alerian MLP	4.93	-9.36	-17.30	-17.30	-12.42	-12.42	-1.06	-7.31
Bloomberg Commodity	-0.60	-6.89	-9.41	-9.41	-11.25	-11.25	0.30	-8.80
FTSE NAREIT Equity REIT	4.14	-8.23	-6.73	-6.73	-4.62	-4.62	2.89	7.90
S&P Global Natural Res.	2.95	-5.08	-16.79	-16.79	-12.57	-12.57	12.36	-0.53
S&P N. Amer Natural Res.	6.31	-11.19	-23.47	-23.47	-21.07	-21.07	1.50	-6.50