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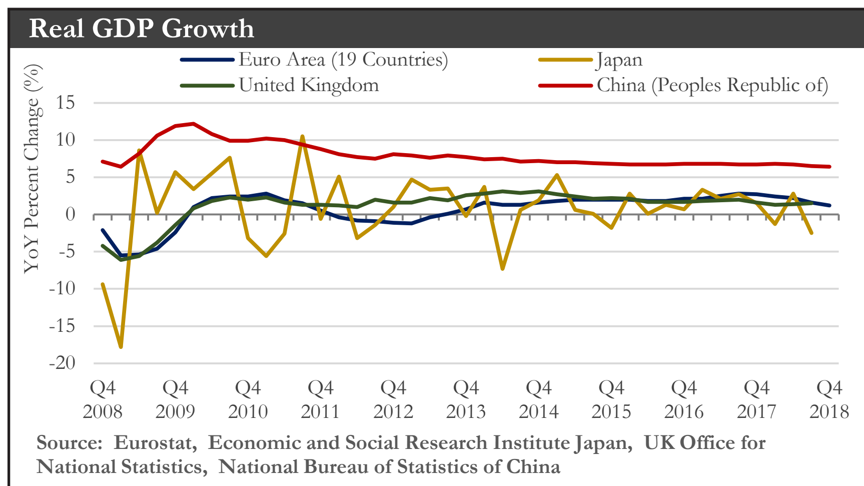
ECONOMIC COMMENTARY AND CAPITAL MARKET UPDATE FEBRUARY 2019

Recap: A few short months ago, the U.S. economy was cruising along with strong growth momentum. Through the first three quarters of last year, GDP growth averaged 3.2%. When the final data for the fourth quarter have been released, they will show the economy likely grew at 3% or a little faster in 2018.

If so, economic growth in 2018 would have been the fastest annual growth rate recorded in 13 years. Initial jobless claims declined to the lowest level since 1969, suggesting the labor market has remained on solid ground. A historically low unemployment rate, solid job creation and steady wage growth have also painted a picture of labor-market health. Such job-market strength has been a critical pillar for consumer spending. Inflation over the past 12 months has been running close to the Fed's target of 2%.

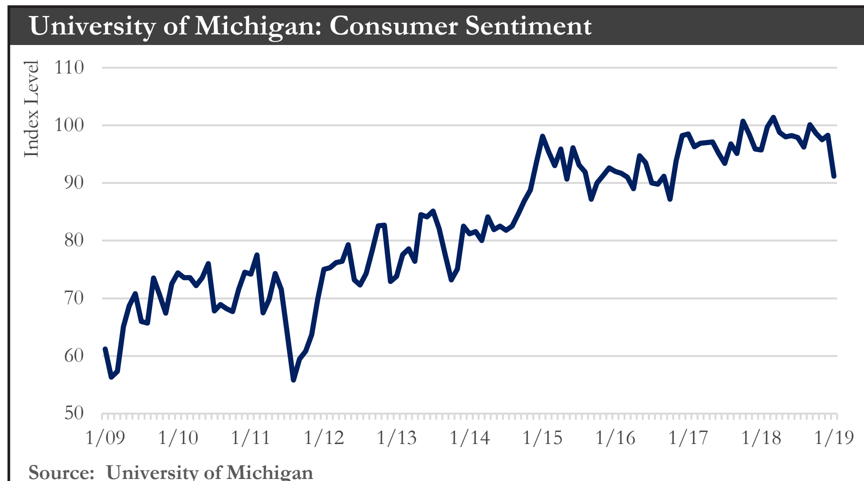
But the above environment clearly has changed in the last two months. Financial markets have encountered turbulence and economic growth has slowed. What happened?

Some of the deceleration in economic activity was policy induced. Higher rates, brought about by Fed tightening last year, has appeared to weigh on the housing market. Chinese tariffs on American goods, which were levied in retaliation for American tariffs on Chinese products, have caused U.S. exports to China to weaken significantly. In addition, slower global growth, in conjunction with booming petroleum supply in the United States, have led to a sharp decline in oil prices in the fourth quarter.



Economic growth in many foreign economies also appeared to have slowed. Eurozone real GDP, which rose 2.8% in Q3-2017, the strongest year-over-year rate in six years, grew just 1.6% in the third quarter of last year. American tariffs on Chinese goods have also led to weaker growth in China.

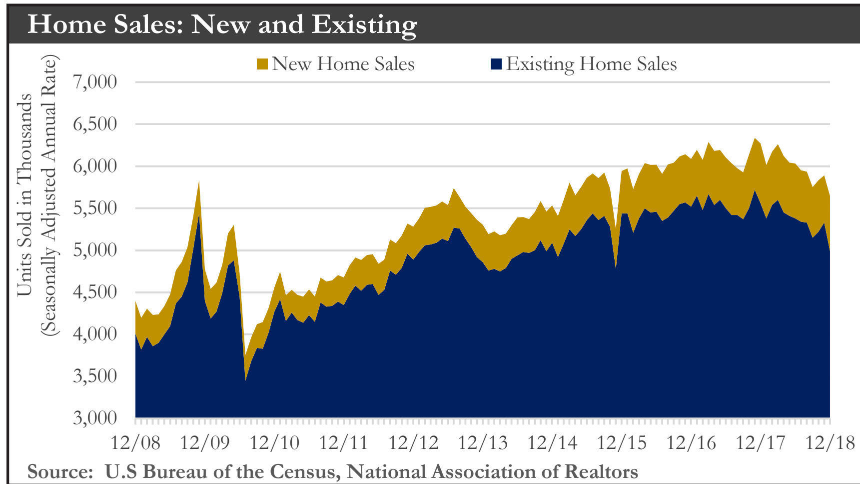
Consumer sentiment: Fears over the global economy have weighed on American households even though demand for factory goods remained solid. An index of U.S. consumer sentiment fell to 90.7, its lowest level in more than two years in January reflecting worries about the government shutdown, trade tensions, volatile markets, cooling global economy and uncertainty over what the Federal Reserve will do next.



Yet American manufacturers were still churning out goods at the end of last year. Industrial production rose 4% in December from the previous year. Americans may be wary about the future but for now, the underpinnings of the economy have remained solid. Hiring has been robust and wages have risen, boosting retail sales last year. Consumer sentiment should rebound once the government shutdown has been resolved.

Housing: The housing market lost considerable momentum over the course of 2018. Buyers pulled back as affordability succumbed to years of price gains that have been well in excess of income growth. Higher mortgage rates reduced affordability even further.

Home sales tumbled in December to their weakest level since 2015. Home sales were weighed down by a surge in stock-market volatility, uncertainty as the government shutdown began and a dearth of starter homes in major markets, a nagging problem for much of last year that has shown little sign of abating.



The weather and natural disasters have added to the industry's woes, as unusually wet weather plagued much of the South during the fourth quarter and wildfires in northern and southern California kept potential buyers indoors.

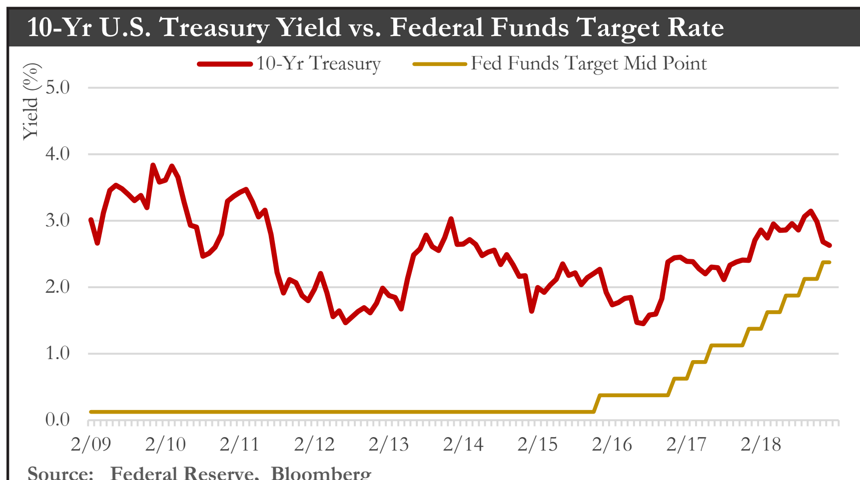
The housing market should continue to ease gradually, rather than fall hard as it did a decade ago. Strong underlying demand, especially from millennials who were unable to buy homes when the market was frenzied, will help keep the market relatively flat this year. The future path for mortgage rates have remained uncertain. If rates continue climbing, housing demand may chill further, unless wage growth accelerates significantly. A solid labor market should also be supportive of housing.

ISM Manufacturing Index: In the latest validation of slower growth ahead, the ISM manufacturing index lost ground for the third time in four months suggesting a moderation in the pace of growth broadly and perhaps the end of an era of near-euphoria in the manufacturing sector.

December's ISM drop was driven by slowing new orders for American-made products. Although a gradual slowdown in manufacturing activity amid headwinds from trade uncertainty, reduced fiscal stimulus and weaker global activity has been expected, the risks of a sharper deceleration have increased.

If followed by other data pointing to a worse-than-expected loss of economic momentum, the Federal Reserve will likely break from its recent pattern of raising interest rates by 25 basis points each quarter.

Government Shutdown: President Trump reached a deal with Congressional leaders to reopen the government until February 15th while negotiations over border security funding continue. However, the absence of any deal after the three-week period will determine the overall impact. Output should grow at around 2% pace in the first quarter. Those first-quarter estimates will likely slip further if there is another shutdown after February 15th. The economic costs rise with time.



Federal Reserve: The Fed appears increasingly likely to hit the "pause" button in March amid financial market volatility, trade uncertainty and an overall moderation in economic growth. The Fed is expected to exercise patience and watch the economic data carefully. Given a strong labor market and contained inflation, two rate hikes from the Fed are likely to occur in 2019. However, the Fed has clearly struck a more dovish tone recently making a pause in March more likely.

China: China's economic expansion fell to its slowest pace in nearly three decades in 2018, as a bruising trade fight with the U.S. exacerbated weakness in the world's second-largest economy. The slowdown has worsened in recent months, with labor-intensive industries that Beijing has counted on for employment and output getting pinched. China's 6.6% growth rate for 2018, was its slowest recorded annual pace since 1990.

Behind the slowdown has been a weakening in several key areas: manufacturing, big-ticket investments by government and businesses, property sales, and consumer spending. Adding to the gloom have been the continued trade tensions between China and the U.S., which have caused companies throughout the country to delay investment and hiring.

Troubles in areas that have reliably produced growth for years posed a challenge for China's policy makers. Easy credit that propped up growth in the past has increasingly reached its limits as the country's debt levels have continued to climb. China's economy has been decelerating partly due to the government's initiative of the past three years to contain debt and fend off financial risks. That campaign has curbed borrowing by local governments and businesses and caused a sharp fall in spending. The government has started reversing course on the debt-control effort in recent months, though the easing measures taken so far have failed to rejuvenate fixed-asset investment.

Particularly worrying for Beijing has been declining wage growth. With costs rising for housing, health care, and other necessities, consumers have reined in spending for durable and luxury products. The uncertain outlook for Chinese exporters has also caused companies to delay investing and hiring and, in some cases, even resorting to layoffs.

For now, despite the gathering economic gloom, the government appears determined not to deploy a massive pro-growth package and instead should be taking a path of gradual policy-easing. The central bank has been injecting additional cheaper funds into the banking system to encourage lending; the central government has removed tightfisted controls on local borrowing. Beijing has planned more tax cuts for both businesses and individuals, particularly those involved in the technology sector. The government may have to step up stimulus measures should trade tensions with Washington worsen in the coming months.

Brexit: With less than eight weeks to go until Britain's scheduled departure from the European Union, nobody knows how it will happen—or if it will happen at all. If the British Parliament does not settle on an outcome that is also acceptable to the EU, the U.K. could drop out of the bloc on March 29 without a withdrawal agreement, disrupting trade and travel.

A bad Brexit—where the U.K. would abruptly leave the bloc, terminating a host of longstanding security and economic agreements and triggering tariffs and other obstacles to trade—would be a strategic and economic loss to the EU, though a bigger blow to Britain. Attempts to find a way out of the current deadlock could lead to a delay of the U.K.'s departure at least into the summer.

A spectrum of outcomes—ranging from no deal, to a deal that would continue very close ties, to no Brexit at all—have remained possible. A "no deal" Brexit would be possible, but given the potentially significant downside economic impact, it would seem the least likely outcome. A second referendum could also be possible, but a repeat parliamentary vote on the withdrawal deal would be more likely, particularly if financial market volatility coerced members of U.K. Parliament to vote through the deal. In any event, financial market volatility in the United Kingdom should remain elevated and even push higher in the coming days and weeks until there is a clearer path forward for the Brexit process.

Eurozone: The 19-nation eurozone economy enjoyed its fastest growth in a decade during 2017, at 2.4%, but it grew by just 1.9% in 2018. The outlook for the Eurozone economy has deteriorated since December due to the persistence of uncertainties related to geopolitical factors and the threat of protectionism, vulnerabilities in emerging markets and financial market volatility.

Financial markets have grown fractious in recent weeks as investors worried about a possible turning point for the global economy, which has been buffeted by headwinds ranging from a slowdown in China to a possible messy Brexit.

In response, the European Central Bank opened the door on new stimulus measures to prop up the region's stumbling economy, underscoring a new mood of caution among major central banks as they navigated fractious U.S.-China trade negotiations and disruptive political events such as Brexit.

While the ECB left its key interest rates and policy guidance unchanged, the slowdown would delay a move by the ECB to raise short-term interest rates, currently set at minus 0.4%. One easy option would be to provide a new batch of cheap, long-term loans to banks, which would help support lenders in Spain and Italy.

Outlook: The U.S. economy enters 2019 after a year of strong growth, with inflation near 2% and the unemployment rate near 50-year lows. That said, U.S. growth and growth prospects in other economies around the world have moderated somewhat in recent months, and overall financial conditions have tightened materially. These recent developments in the global economy and financial markets represent crosswinds to the U.S. economy.

U.S. GDP growth in 2019 has been forecasted to slow for some time. The dampening effects of higher interest rates on GDP growth have been expected. Furthermore, the fiscal stimulus the economy received in 2018 via tax cuts and spending increases will fade as 2019 progresses. As the sugar high from monetary and fiscal stimulus wears off, growth is expected to slow to a still-healthy 2.5% in 2019.

On the positive side, the decline in oil prices should help support real disposable income growth, which should underpin continued solid growth in real personal consumption expenditures. Low overall inflation should also keep interest rates lower than they would otherwise be, which will lend some much-needed support to the housing sector.

Fifty bps of interest rate hikes by the Federal Reserve in 2019 is still expected, but the FOMC will likely wait until the June meeting to lift its target range of 25 bps for the fed funds rate. The FOMC will likely hike again in December before ultimately reversing course in late 2020 as real GDP growth decelerates further.

Several potential potholes lie in the path ahead. The partial government shutdown is but one example. Given that shutdowns typically prove to be short-lived, history has suggested a limited economic impact. However, the hit to market confidence could prove more damaging. Given expectations for slowing growth and the pronounced late-year selloff in equity markets, the "recession" word has gained traction recently. The likelihood of recession in the U.S. is considered low, given solid employment trends, rising wage growth, lower energy prices and favorable financing conditions. That said, negative expectations have the potential to become self-fulfilling.

The prospect of another budget battle, potential automatic spending cuts and a hard debt ceiling deadline occurring simultaneously in mid-to-late summer would suggest the current fiscal drama occurring in Washington, D.C. is just the opening act. With concerns swirling about global growth, monetary policy mistakes and other recession risks, a fiscal fumble from policymakers in Washington is another major risk to the macroeconomic outlook as 2019 progresses.

Global economic developments remain in focus as well. The economic slowdown in China, uncertainty relating to Brexit, and questions over Italy's fiscal condition are just a few to mention.

Sources: Department of Labor, Department of Commerce, Institute for Supply Management, the Conference Board, National Bureau of Statistics of China, European Central Bank

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Index Performance as of: 1/31/2019

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
3000 Value	1.92	8.00	8.00	0.26	8.00	-4.76	11.79	8.20
3000	2.45	8.58	8.58	0.45	8.58	-2.26	14.19	10.41
3000 Growth	2.99	9.18	9.18	0.63	9.18	0.03	16.51	12.57
1000 Value	1.91	7.78	7.78	0.34	7.78	-4.81	11.61	8.33
1000	2.46	8.38	8.38	0.51	8.38	-2.17	14.14	10.68
1000 Growth	3.02	8.99	8.99	0.68	8.99	0.24	16.59	12.97
Mid Cap Value	2.73	10.29	10.29	1.08	10.29	-5.43	11.67	7.90
Mid Cap	2.84	10.79	10.79	2.25	10.79	-2.90	13.29	8.89
Mid Cap Growth	2.99	11.49	11.49	3.95	11.49	0.51	15.59	10.27
2000 Value	2.14	10.94	10.94	-0.90	10.94	-4.51	13.76	6.62
2000	2.41	11.25	11.25	-0.41	11.25	-3.52	14.71	7.26
2000 Growth	2.67	11.55	11.55	0.06	11.55	-2.63	15.55	7.83
S&P 500	2.38	8.01	8.01	0.26	8.01	-2.31	14.02	10.96
Consumer Disc	2.79	10.30	10.30	3.90	10.30	1.71	15.18	13.23
Consumer Staples	2.98	5.19	5.19	-2.54	5.19	-5.13	4.62	8.48
Energy	2.57	11.11	11.11	-4.56	11.11	-12.34	5.76	-2.29
Financials	0.56	8.84	8.84	-0.73	8.84	-11.10	15.93	10.82
Health Care	2.02	4.84	4.84	2.57	4.84	4.67	12.79	11.97
Industrials	3.70	11.41	11.41	3.32	11.41	-8.26	13.81	9.27
Information Technology	1.92	6.96	6.96	-3.93	6.96	-0.90	20.99	17.09
Materials	2.31	5.49	5.49	2.19	5.49	-13.59	13.29	5.94
Real Estate	4.82	10.79	10.79	8.36	10.79	10.41	9.17	10.45
Communcation Services	3.75	10.37	10.37	1.66	10.37	-3.99	3.31	5.29
Utilities	1.25	3.43	3.43	2.82	3.43	11.08	10.18	10.84
Dow Jones Industrial Avg.	1.83	7.29	7.29	0.14	7.29	-2.19	17.77	12.45
Wilshire 5000 (Full Cap)	2.49	8.85	8.85	0.62	8.85	-2.15	14.37	10.19
MSCI EAFE	2.02	6.57	6.57	1.27	6.57	-12.51	7.74	2.66
MSCI EM	3.00	8.77	8.77	10.24	8.77	-14.24	14.89	4.77
MSCI Frontier Markets	0.76	4.76	4.76	3.89	4.76	-17.18	8.36	1.44
MSCI ACWI	2.39	7.90	7.90	1.76	7.90	-7.48	11.62	6.72
MSCI ACWI Ex USA	2.35	7.56	7.56	3.66	7.56	-12.58	9.59	3.11

Index Performance as of: 1/31/2019

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
MSCI AC Asia Ex Japan	2.98	7.31	7.31	9.95	7.31	-14.57	14.13	6.59
MSCI Brazil	2.83	17.76	17.76	13.35	17.76	0.30	37.65	6.39
MSCI BRIC	3.17	9.86	9.86	11.25	9.86	-14.68	18.85	6.61
MSCI China	4.37	11.06	11.06	11.98	11.06	-19.91	17.07	8.36
MSCI Europe	2.07	6.59	6.59	0.72	6.59	-13.91	6.69	1.47
MSCI India	-0.30	-1.93	-1.93	8.10	-1.93	-12.12	10.11	8.49
MSCI Japan	1.77	6.10	6.10	-0.60	6.10	-11.62	8.53	5.12
MSCI EM Latin America	2.46	14.95	14.95	11.50	14.95	-5.09	22.21	3.07
MSCI Russia	2.28	13.89	13.89	8.63	13.89	0.46	22.93	2.79
Barclays U.S. Aggregate	0.63	1.06	1.06	3.53	1.06	2.25	1.95	2.44
ICE BofAML US 3M Trsy Bill	0.04	0.20	0.20	0.59	0.20	1.95	1.08	0.67
Barclays U.S. Gov't	0.45	0.47	0.47	3.50	0.47	2.72	0.87	1.82
Barclays U.S. Credit	0.88	2.16	2.16	3.63	2.16	0.94	3.72	3.31
Barclays High Yield Corp.	0.90	4.52	4.52	1.40	4.52	1.73	9.41	4.61
Barclays Municipal	0.40	0.76	0.76	3.09	0.76	3.26	2.15	3.58
Barclays TIPS	1.04	1.35	1.35	2.39	1.35	0.93	2.06	1.57
Barclays Gbl Agg Ex USD	1.26	1.86	1.86	4.24	1.86	-3.26	3.61	0.20
Barclays Global Aggregate	0.98	1.52	1.52	3.90	1.52	-0.88	2.92	1.17
JPM EMBI Global Div	0.72	4.41	4.41	5.37	4.41	0.01	6.74	5.85
Alerian MLP	2.04	12.64	12.64	1.25	12.64	-6.73	7.06	-5.19
Bloomberg Commodity	0.69	5.45	5.45	-2.37	5.45	-8.23	2.66	-7.89
FTSE NAREIT Equity REIT	5.02	11.75	11.75	7.41	11.75	11.23	7.99	9.43
S&P Global Natural Res.	3.80	9.62	9.62	0.35	9.62	-8.93	18.74	2.50
S&P N. Amer Natural Res.	3.31	12.81	12.81	-1.90	12.81	-13.00	7.38	-3.33