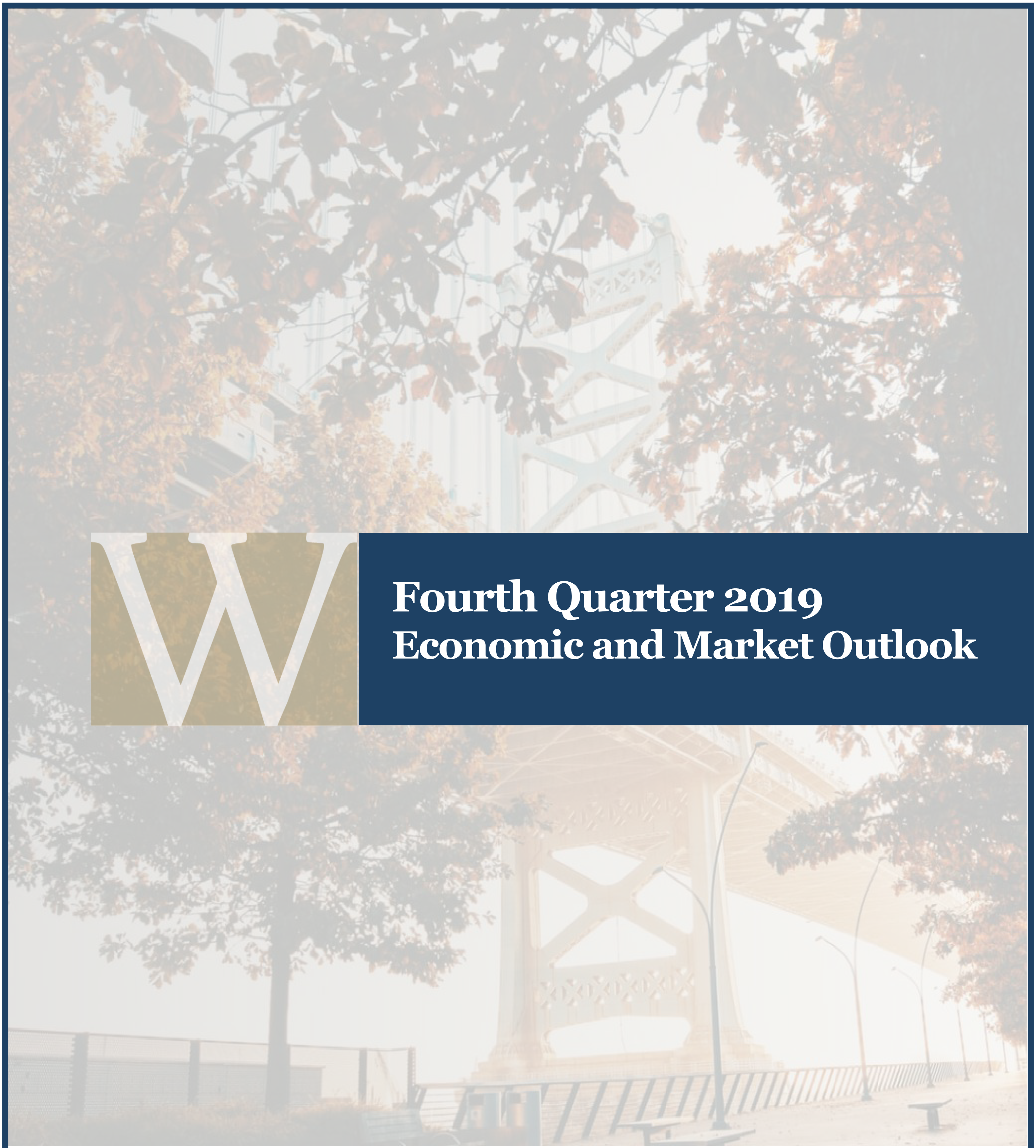

Fourth Quarter 2019
Economic and Market Outlook

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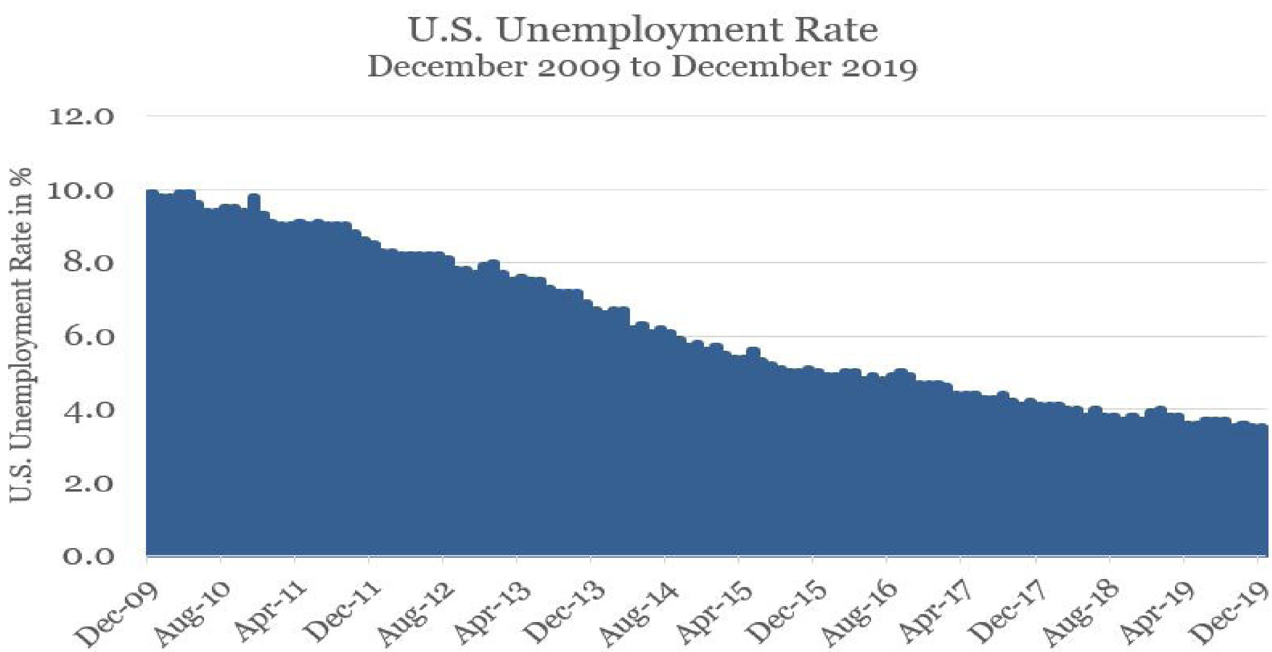
While financial market returns were very strong in 2019, economic growth and corporate earnings growth was relatively weak in comparison. The uncertainty surrounding the status of global trade, particularly between the U.S. and China, kept many business owners on the sidelines with respect to new investments. In addition, manufacturing activity in the U.S. and abroad came to a halt and fears of a global economic slowdown took hold. However, progress on the trade negotiations and a significant shift in monetary policy by the Federal Reserve gave markets hope that the worst was over.

Going forward, we anticipate a pickup in global growth and earnings, but stock markets may have already priced in this scenario given where they ended last year. Our view that economic growth will accelerate is based on the fact that central banks around the world, including the Federal Reserve, reduced borrowing costs in 2019 which tends to support growth going forward, albeit with a slight lag.

In addition, the Chinese economy which has been slowing due to trade related factors and a weaker auto market, is showing some signs of stabilization. Chinese growth is critical to global growth since it is a major buyer of goods and services from many countries around the world, including Europe and Asia, and to a lesser extent, the United States.

Outside of manufacturing, which was negatively impacted by the trade war, conditions in the U.S. economy remain strong, particularly the job market. Over the past decade, the U.S. unemployment rate has fallen from nearly 10.0% to 3.5% today, as illustrated in Figure 1.

Figure 1: U.S. Employment Situation Remains Strong which Supports Growth



Source: Federal Reserve Bank of St. Louis, FRED, U.S. Bureau of Labor Statistics

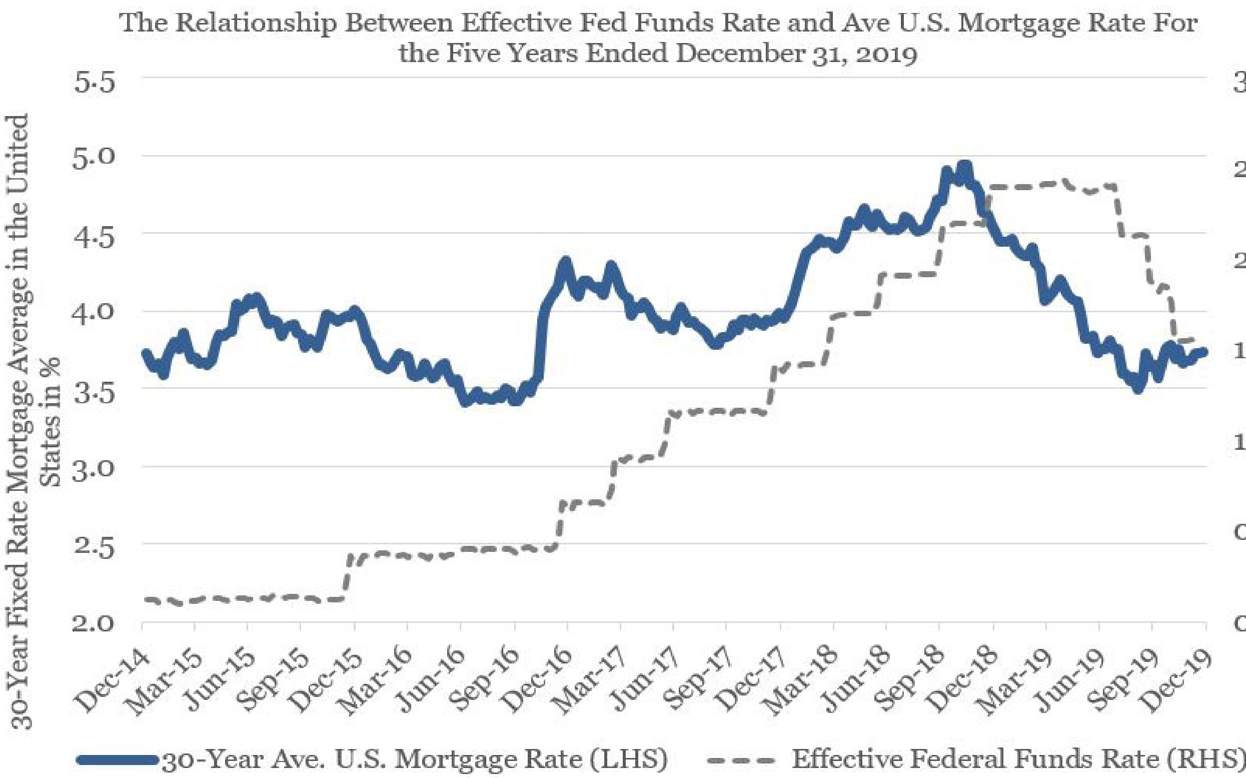
As unemployment has fallen, wages for U.S. workers have also started to rise, while overall inflation has remained quite modest. In fact, according to many business surveys, there is a shortage of skilled workers in certain industries. If this were to continue, wage growth may go even higher. Because real (inflation-adjusted) purchasing power has improved over the course of the last few years, expectations for future consumer spending remain bright.

Fed Decision to Cut Rates Helps the U.S. Housing Market

Against the backdrop of a strong and stable U.S. economy, the Federal Reserve's decision to reduce their policy rate meant that the Effective Federal Funds rate fell from modest 2.4% at the beginning of 2019 to a very accommodative 1.5% by the end. This had a direct impact on many aspects of the U.S. economy, not least of which was the U.S. housing market. As Figure 2 illustrates, the average U.S. 30-Year Fixed Mortgage Rate fell quite dramatically last year and now sits below 4.0% as of December 31, 2019, making home ownership more affordable for many.

The housing market did slow in 2018 as mortgage rates increased. This had a ripple effect in terms of home builders and home improvement plays such as Home Depot and Loews, whose stock prices were down in 2018, but recovered strongly last year. Going forward, the strength of the job market and the stability in the housing market provide a good foundation for continued economic growth in the U.S.

Figure 2: Lower interest rates lead to lower mortgage rates, supporting growth



Source: FRED Economic Data, Board of Governors of the Federal Reserve System

So What's Next?

With the U.S. economy on sound footing and a domestic stock market prices at record highs, the natural question is where do we go from here? While there are any number of risks that could temporarily disrupt the market's momentum, we do not anticipate a global recession in the near term. In addition, it is important to differentiate between record high prices and record high valuations. From a valuation standpoint, which considers price relative to earnings, the U.S. large cap stock market is more expensive than it was a year ago, although current valuations using a variety of measures are only modestly higher than their long-term averages and remain attractive when compared with bond markets.

It is worth remembering that in 2009, following one of the worst recessions in U.S. history, the mood of the average investor was far from opportunistic. The environment was characterized by heightened investor anxiety regarding the stability of the financial system and an unwillingness to put money into the market. However, from a valuation standpoint it turned out to be one of the most attractive periods to invest.

Today, the situation is different. A higher valuation at the start of a forecasting period often results in lower expected returns going forward. This is especially true of U.S. large cap stocks which have been the strongest performers over the past decade. We think it is prudent to lower return expectations for stocks going forward as a result. Compared to other markets, the U.S. is one of the more expensive on a price to earnings basis, a price to book basis and a price to cash flow basis. While valuation alone isn't likely to shift market sentiment and capital from the U.S. to Non-U.S. markets, when combined with other catalysts such as a falling U.S. dollar or an acceleration in emerging market growth, non-U.S. markets may begin to close the performance gap. Therefore, from an asset allocation perspective, we continue to allocate to both developed and emerging markets as their valuation levels are much lower than that of the U.S.

Summary

As we look forward to 2020 and beyond, there are a number of risks that could disrupt the market's momentum. With the U.S. Presidential election getting ever closer, markets will begin to anticipate the eventual winner. In our view, markets are currently pricing in the status quo and not expecting a major change in tax or regulatory policy. However, we do not construct portfolios based on a specific political outlook and have increased allocations to more defensive sectors, at the margin, to better manage any short-term volatility that may develop over the next year. Other risks that are worth monitoring include the progress of the current trade negotiations, the impact from increased military activity in the Middle East and market related risks such as stock market valuations and rising inflation expectations that could shift market leadership going forward.

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