2020 MARKET OUTLOOK

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2020 MARKET OUTLOOK

ECONOMIC EXPANSION CONTINUES

Despite ongoing cross currents and headwinds related to special global factors, the U.S. economy is on solid footing. As it stands, growth has continued along the moderate 2% path that it has followed for the past 10 years. Yes, this has been the weakest recovery on record, but also the longest U.S. business cycle expansion ever witnessed. And economies are very capable of growing at slow rates for long periods of time. With no obvious excesses or systemic problems in view, this cycle has the potential to continue. In 2020, the U.S. economy is expected to grow 2.3%, while the global economy should be a bit stronger at 3.2% overall.

MARKET SUMMARY

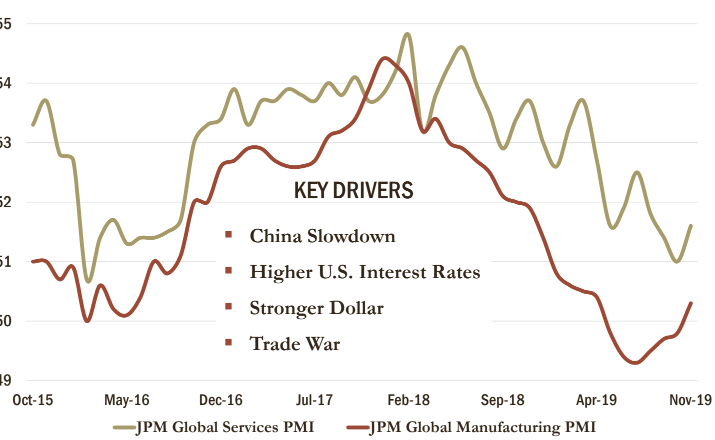
- Some confusion remains about phase one of the tariff trade truce between the United States and China, but reports on the recent agreement could shore up economic growth and consumer/business confidence
- U.S. job growth is tapering, but still solid enough to propel the economy forward with increasing wages and healthy household balance sheets
- While high-teens percentage returns for balanced portfolios in 2019 were great, 2020 should bring mid-single-digit returns
- With a lot of liquidity looking for a home, over 52% of the stocks in the S&P 500 Index yield more than the 10-year Treasury
- Declining interest rates and shrinking credit spreads in 2019 helped produce the best returns for most bond sectors since 2011

ECONOMIC OUTLOOK

After many months of gridlock, the United States and China said they agreed to the details of a "phase one" deal, which will reduce tariffs and help calm fears of an escalating trade war. The truce is expected to hold up and will probably be officially signed at some point over the next couple of months. After that, work can start on a phase two agreement. Also, Brexit is a step closer to resolution now that the December British national elections are completed. And in the Eurozone, there are tentative signs that the industrial sector may be bottoming out.

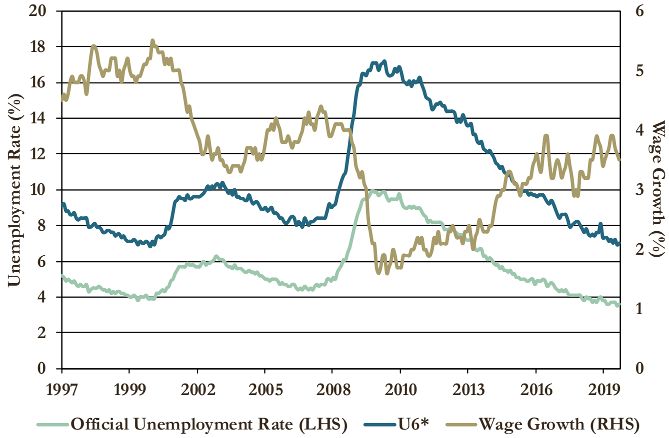
Over the first 11 months of 2019, job gains have averaged 180,000 per month. This is slower than last year's 223,000 jobs per month, but still solid enough to have lowered the unemployment rate to 3.5% – matching the lowest level since 1969. Also, the 12-month increase in average hourly earnings in November was 3.1%, in line with the recent trend. This bodes well for the consumer spending outlook, as a healthy labor market continues to drive wage gains and consumption, while supporting strong household balance sheets.

GLOBAL PURCHASING MANAGERS' INDEX WARNS OF CONTINUED SLOW DOWN (FIGURE 1)



Source: Bloomberg

UNEMPLOYMENT FALLS – WHILE WAGES RECOVER (FIGURE 2)



Source: Bureau of Labor Statistics, Bloomberg

2020 MARKET OUTLOOK

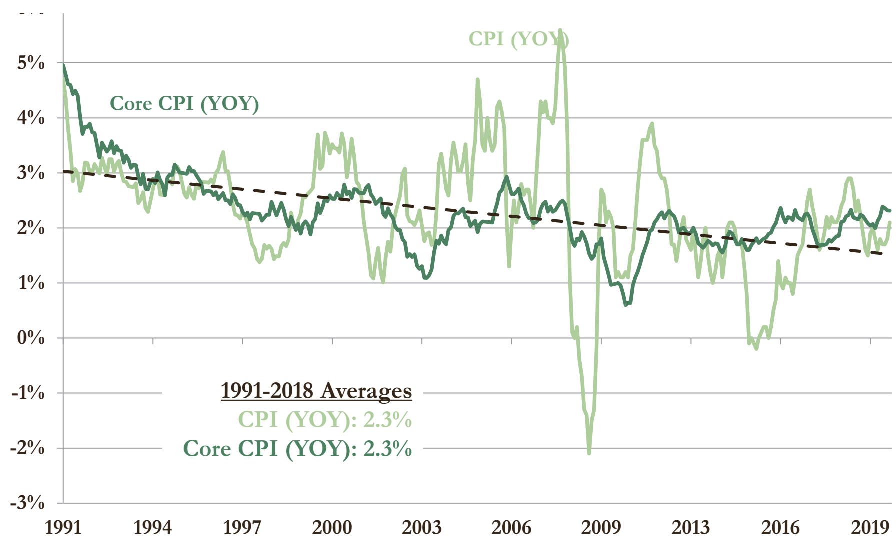
KEY TAKEAWAYS: ECONOMIC

- **A healthy labor market continues to drive wage gains and consumption, while supporting strong household balance sheets**
- **We expect mortgage rates to remain quite low in historical context, with the 30-year fixed rate averaging below 4%**
- **Weak manufacturing data, trade tensions, and slow business investment are being offset by a healthy job market and income growth, strong financial fundamentals and very low unemployment claims**

Over the past few years, inflation has remained generally muted as a result of flat oil prices, a rising dollar, moderate increases in labor costs, and global price competition. Earlier this year core inflation eased, but it has firmed in recent months, supported by stable long-run inflation expectations, and relatively tight labor markets. Easing trade tensions and better foreign growth could lead to a modest pickup in core inflation in 2020. However, longer-run inflation expectations appear to be well-anchored at a level broadly consistent with the Federal Reserve's 2% objective.

The housing market turned in solid third-quarter performance, aided by falling mortgage rates. New home sales and single-family housing starts both climbed to levels last seen in the third quarter of 2007,

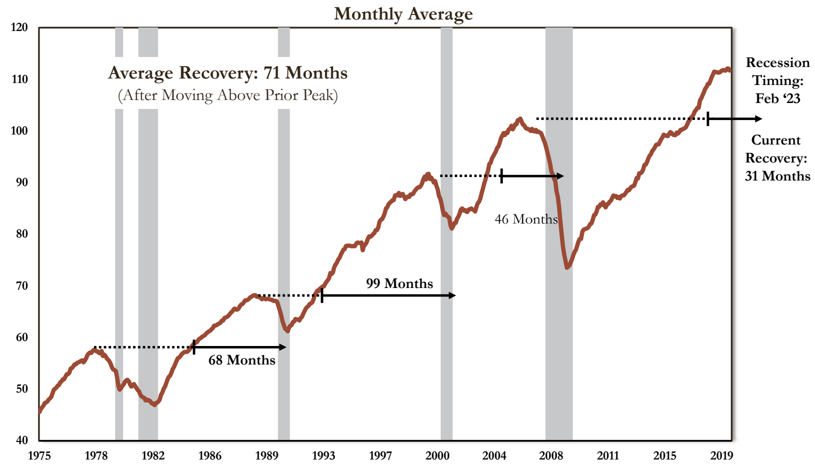
INFLATION – BENIGN BUT TURNING UP FROM BOTTOM (FIGURE 3)



Source: Bloomberg

while housing starts moved up to their second-highest level in 12 years. Existing home sales posted a third straight quarterly increase. The bottom line: residential investment increased at a 5.1% annual rate in the third quarter, contributing 0.2% to GDP growth. This followed six straight negative growth quarters. Mortgage rates tend to track the 10-year yield and have recently moved slightly higher. This will take some wind out of the sails that pushed the housing market in the third quarter. However, we expect mortgage rates to remain quite low in historical context, with the 30-year fixed rate averaging below 4%.

LEADING ECONOMIC INDICATORS TIMING FOR THE NEXT RECESSION (FIGURE 5)



Source: Bloomberg

One of the areas of economic weakness has been capital spending, export orders and manufacturing output. On a year-over-year basis, these indicators have been weak. The slowing primarily reflects trade policy uncertainty, tighter bank lending standards as well as the halt in deliveries of Boeing's 737 MAX. We assume these drags will dissipate over the coming quarters, as there has been some improvement in the recent data. This could provide a material boost to spending early in 2020.

Recessions typically follow periods of excesses (i.e., overheating home prices, surging inflation, broad optimism) rather than periods dominated by modest risk appetites such as we have today. The current economic news has been mixed. Weak manufacturing data, trade tensions, and slow business investment are being offset by a healthy job market and income growth, strong financial fundamentals and very low unemployment claims.

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So, it's not slow growth that triggers a recession; it is too much risk taking and too much optimism that eventually gets derailed by tight central bank monetary policies. These conditions are not in place today, as central banks in advanced economies are not expected to raise interest rates for the foreseeable future.

EQUITY OUTLOOK

2019 was a terrific year for equity investors around the world. The large price gains were unfortunately made with limited growth in earnings, which we expect to show 2% to 3% gains year-over-year when fourth quarter reports are tallied final.

As we begin 2020, we see little room left for price-multiple expansion. The current Operating Price Earnings ratio is above 20.5 times, well above a 50-year normal level of 16.3 times. Our projection is the economic slowdown ends in the fourth quarter of 2019 and shows improvement in 2020. With stronger economic growth, we believe earnings will grow 6% to 8%, which is essential for further market price gains. Some would argue with low interest rates and little inflation that the price-multiple can even move higher. While that is true, high valuation levels leave little room for any disappointments as the year progresses.

Low interest rates and an accommodative Fed does make income from dividends look attractive to investors. With a lot of liquidity looking for a home, over 52% of the stocks in the S&P 500 Index yield more than the 10-year Treasury. The added benefit stock dividends have over the 10-year Treasury interest rate is that dividends grow. Over the last 12 months, dividends of companies in the S&P 500 have increased 8.4%.

History suggests the Presidential election will cause a few bumps in the road over the first half of the year. Looking at all election years since 1900, the stock indices trade in a narrow range bouncing off the high and low as investors get a clearer picture of who the two candidates are along with their proposed policies. By early August the market stages a rally until October and then declines into the election, only to rally when the results are known. The odds

for a positive year in the stock market in the high-single-digits are strong based on history.

Investor sentiment as we close out 2019 has clearly improved from last summer, but not close to the jubilant levels that caused us concern, like in September 2018. Concerns over trade negotiations, Brexit implementation risks, impeachment proceedings, a slowing Chinese economy and a sputtering U.S. economy keep investors cautious.

KEY TAKEAWAYS: EQUITY

- **With stronger economic growth, we believe earnings will grow 6% to 8%**
- **Low interest rates, falling money market returns, and an accommodative Fed does make income from dividends look attractive to investors**
- **We continue to underweight our long-term 30% target for international stocks in equity portfolios**

Over the last 1-, 3- and 5-years, large-cap equity returns have exceeded both mid-cap and small-cap returns. Historically mid-cap and small-cap equities outperform their large-cap peers. Over the last several months we have possibly seen a shift with small-cap equities outperforming. We will be watching to see if this trend continues into 2020.

We continue to underweight our long-term 30% target for international stocks in equity portfolios. International returns continue to be less than domestic returns, as has been the case for the last 10 years. This trend is expected to continue if the technology sector, which is 27% of the S&P 500, continues to lead all the other sectors. The 27% weighting in the S&P 500 is considerably higher than in international indexes.

ALTERNATIVE INVESTMENTS OUTLOOK

Many investment professionals hold firm in the belief that a traditional 60% Equity and 40% Fixed Income portfolio can provide the desired portfolio attributes of strong performance, capital protection and diversification. In 2019 a portfolio with a 60% S&P 500/40% Barclays Aggregate Bond mix returned percentages in the high teens. Investors also benefited from the return of negative correlation between stocks and bonds. The only two negative months for the S&P 500 (May and August) coincided with some of the best returns for fixed income.

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KEY TAKEAWAYS: FIXED INCOME

- **After a strong 2019 for the bond market, a repeat of such performance in 2020 is not likely**
- **Credit spreads are at risk of widening in 2020, hindering performance, especially for Corporates**
- **The recent global economic slowdown is likely to keep U.S. inflation at bay for most of 2020**

After a banner year for public equities and fixed income, it may be time for alternative investments to make a meaningful contribution. They can improve portfolio diversification and deliver a smoother ride when markets turn volatile, as they inevitably do. With many stock indices at record highs and bond yields at generational lows, the outlook for returns are below their long-term averages. Constructing a portfolio with a diverse set of performance drivers takes on more importance in an environment of muted returns for traditional assets. Conservative hedge funds may reduce volatility from the equity allocation, while REIT investments provide exposure to real estate and real assets.

Private equity is often classified as an alternative investment, but is part of the equity asset class. It is characterized by a long investment horizon, lack of liquidity, exclusivity, and the potential for returns higher than those of the broad equity markets. Committing to a private equity fund forces an investor into a buy and hold discipline and places the exit decision in the hands of experienced professionals who are closest to the underlying assets. Emotional selling during volatile markets is prevented due to the illiquid nature of the investments and keeps the investment strategy on course.

FIXED INCOME OUTLOOK

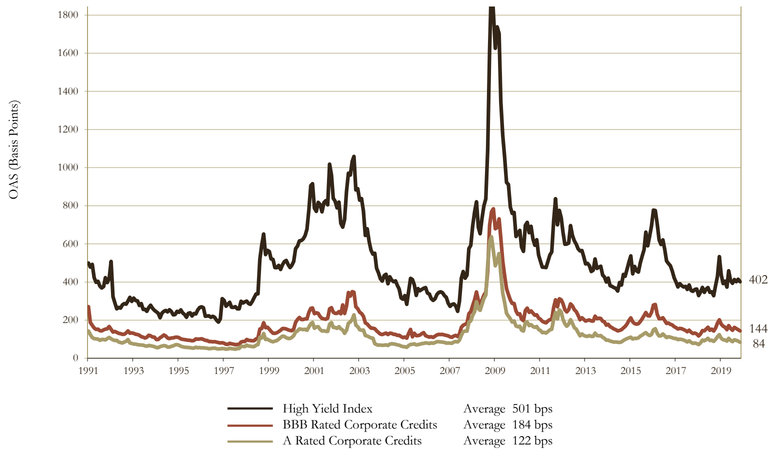
The fixed income market had a good year in 2019. Declining interest rates and shrinking credit spreads (the yield premium investors receive for investing in riskier bonds) helped produce the best returns for most sectors since 2011. Inflation remained subdued as countries worked through a global economic slowdown and trade wars.

The trade war with China and previously unresolved Brexit issues contributed to market volatility in the past year. Credit spreads were on a roller coaster moving down, up, and down again. With Treasury yields declining during the period the net effect was respectable positive returns for all fixed income sectors. Corporate investment grade bonds

were the top performer year-to-date (through 11/30/2019), followed closely by High Yield. Asset-Backed Securities (ABS) and other short maturity holdings trailed the other sectors. The Barclays Aggregate Bond Index generated an 8.91% year-to-date return (as of 12/11/19).

CORPORATE CREDIT SPREADS

1/31/91 THROUGH 11/30/19 (FIGURE 7)



Source: BBG Barclays, ICE BofA ML

The Barclays Municipal Bond Index is up 7.58% year-to-date (as of 12/11/19), as strong demand persists for tax-exempt holdings. A resurgence in supply (up 18% year-to-date), spurred from an increase in taxable municipal issuance, did not offset the positive demand side effect on taxable municipal bonds (munis) performance. The Tax Cuts and Jobs Act eliminated the ability to advance refund municipal debt using tax-free bonds. The same restrictions do not apply to taxable munis. With rates falling this year, issuers have been able to advance refund outstanding debt with taxable munis.

The recent global economic slowdown is likely to keep U.S. inflation at bay for most of 2020. This will allow domestic interest rates to stay low. Core Personal Consumption Expenditure (PCE), the Fed's favored inflation measure, are up about 1.6% and will need to rise through 2.0% for a couple of quarters before investment markets are convinced that a higher level of inflation has returned. Until then Treasury yields are likely to remain range-bound with the 10-year Treasury yield expected between 1.50% and 2.50% for most of the coming year.

Credit spreads are at risk of widening in 2020, hindering performance especially for Corporates. Spread levels for investment grade credit are well through their historic averages and the U.S. economy is already in the late innings for this cycle. Resolving trade tensions and improvements in global growth should help make the roller coaster ride smoother.

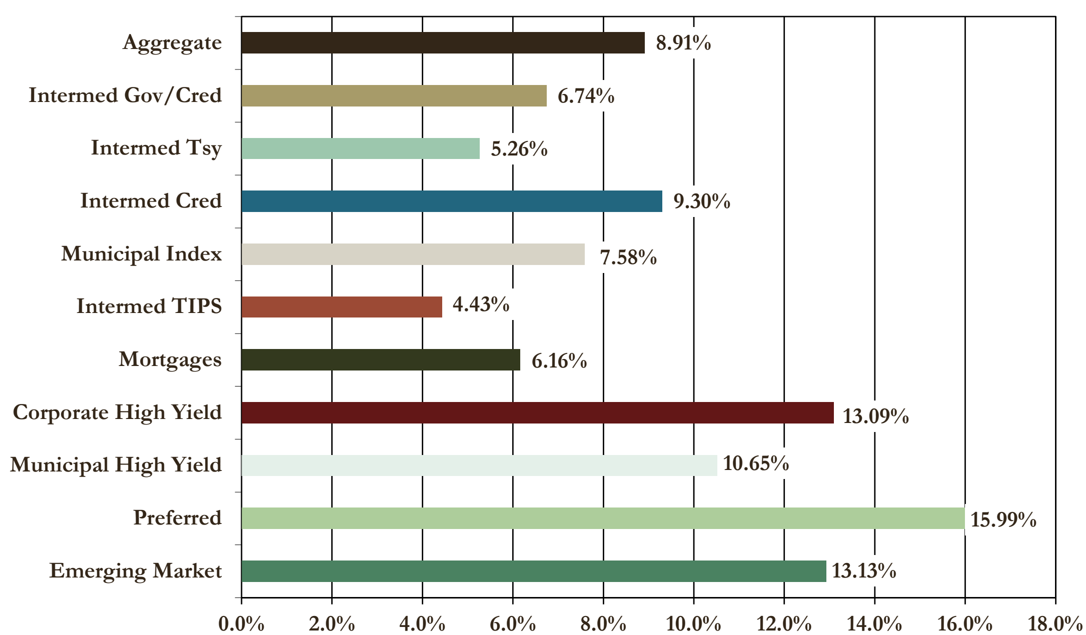
2020 MARKET OUTLOOK

After a strong 2019 for the bond market, a repeat of such performance in 2020 is not likely. If negative yields persist in Europe and Japan, minimal upward movement in U.S. yields is expected. Positive returns in the low-single-digits are feasible given low inflation conditions, continued economic growth, and a marginal anticipated change in interest rates. With the Fed on hold for an extended period, portfolio duration targets should be maintained close to neutral relative to their corresponding benchmarks.

The upside looks limited for High Yield given their current valuation levels and gradually rising default rates. Improving economies in Europe and China could help Emerging Market Debt show stronger gains. Healthy demand should remain in place for munis in 2020, but likely not to the level experienced in 2019. The technical environment for munis is expected to deteriorate somewhat next year as supply is expected to increase. A challenging year confronts most sectors of the fixed income market.

FIXED INCOME – YTD RETURNS

AS OF 12/11/19 (FIGURE 8)



Source: Bloomberg

CONCLUSION

What do we see looking forward into the new year? We believe in 2020 it will be nearly impossible to replicate the excellent returns in the equity, fixed income and alternative markets achieved in 2019. Instead of last year's double-digit returns of balanced portfolios, we expect returns in the 4% to 8% range in 2020. With the backdrop of steady domestic economic growth of 2.0% to 2.5%, equities should post returns in the 5% to 10% range and fixed income in the 0% to 4% range.

As we look out globally, the clarity of the mandate Britain received from voters to leave the European Union may help propel European markets in the coming year to more growth. Trade war tensions between the United States and China may simmer down and also allow international markets to collect their breath after a tumultuous year.

Stay tuned to the U.S. presidential campaign as it heats up this spring. Health care, the environment and wealth redistribution will most certainly be hot buttons of debate. For now, the U.S. economic expansion seems quite ready to head further into record territory.

INVESTMENT POLICY TEAM - DECEMBER 12, 2019

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KEY STATS

2.3%
2020 U.S. GDP GROWTH FORECAST

27.74%
S&P 500 YTD*

3.50%
2020 UNEMPLOYMENT (ESTIMATE)

1.79%
10-YEAR U.S. TREASURY YIELD*

8.91%
BLOOMBERG BARCLAYS AGGREGATE BOND INDEX YTD RETURN*

7.58%
BLOOMBERG BARCLAYS MUNICIPAL BOND INDEX YTD RETURN*

* AS OF 12/11/19

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