Video Transcript

Economic Review & Outlook

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Third Quarter 2019

Thanks for joining me for a recap of the latest economic and capital market developments from the third quarter of 2019. So let's begin.

As a reminder, these gauges represent the 5 major areas that help shape our view for the overall economic environment, which in turn drives our expectations for the stock market. Recall 12:00 is neutral, anything to the right of 12:00 is positive for stocks, and anything to the left of 12:00 is negative. We made two adjustments this quarter, increasing the Monetary Policy and Investor Sentiment gauges both to a slow forward position from neutral, which we'll discuss in this update.

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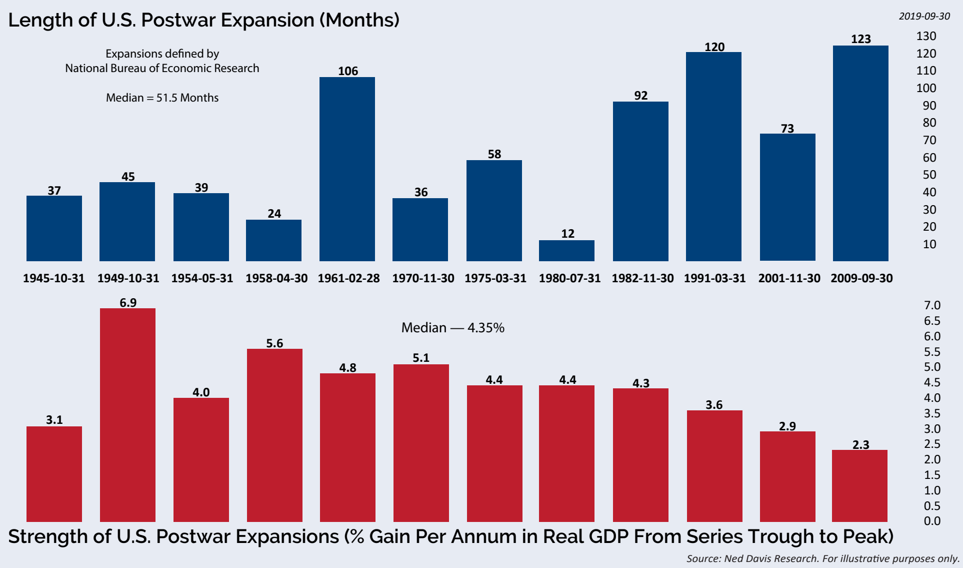
Economy

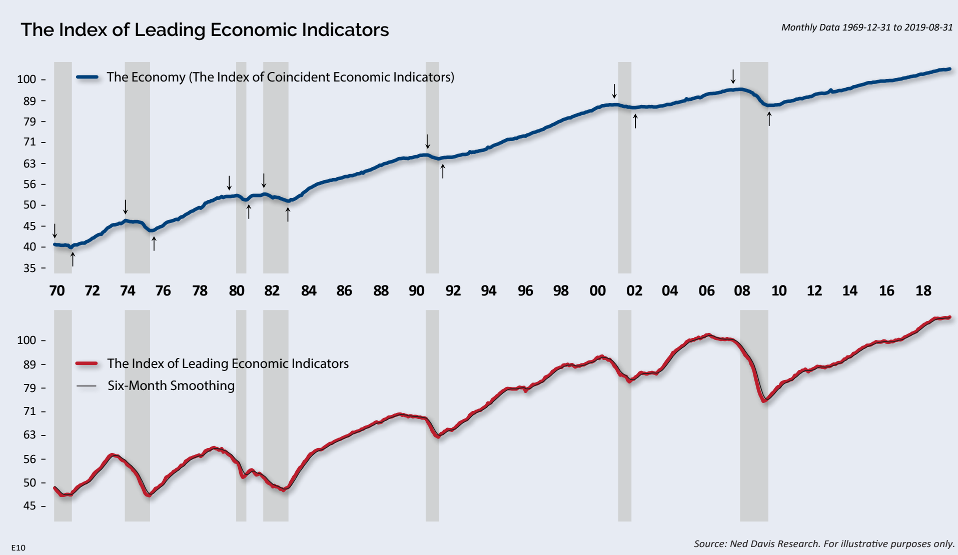
U.S. Economy

Our first gauge is the U.S. economy, which we leave in a slow forward position.



As the top part of this slide shows, this economic expansion has now become the longest on record surpassing 10 years, but the bottom half of this chart reflects that the growth during this expansion has been the slowest of any post-World War II period.

Key indicators on the front end of the economy continue to show more potential for growth for this expansion, and we do not see a recession on the horizon.



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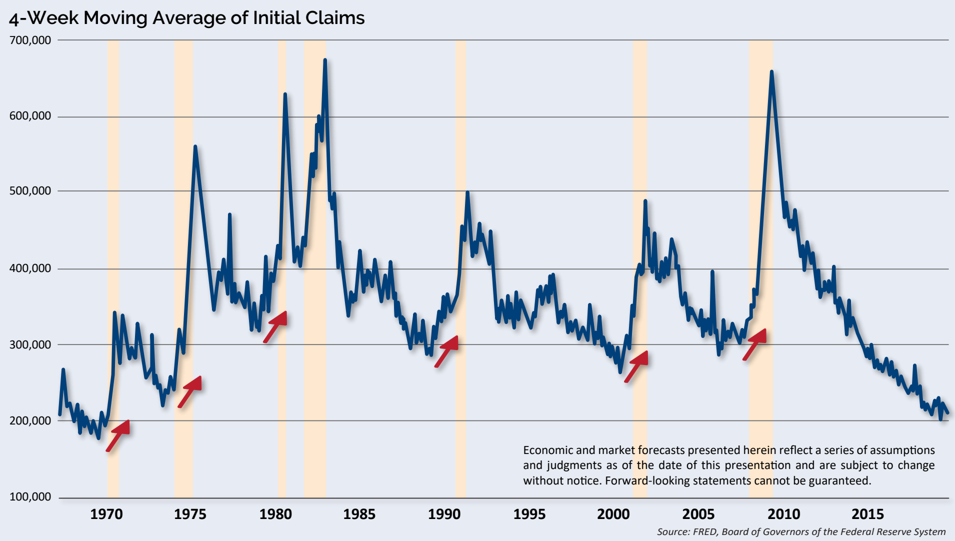
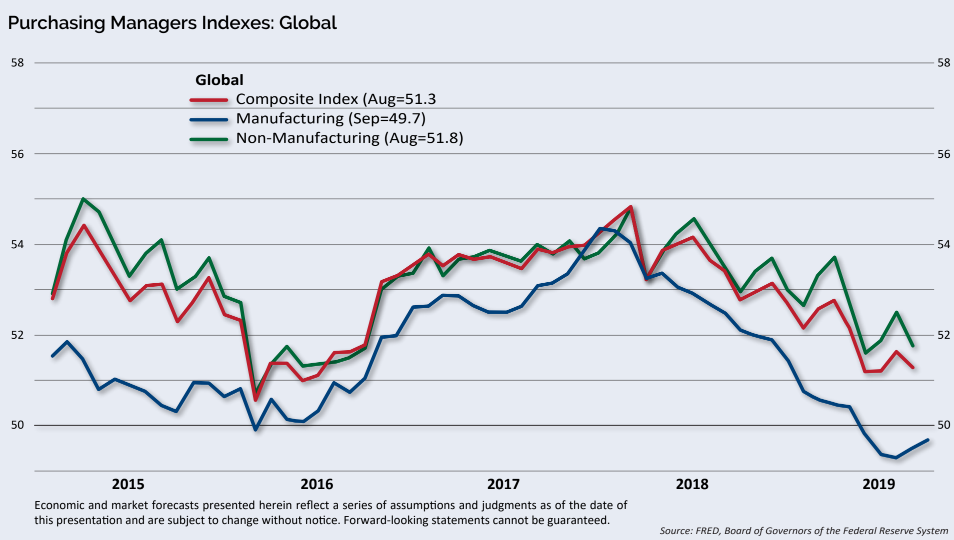
The Conference Board's Leading Economic Indicators Index (the red line on the bottom of this chart), has been putting in new all-time highs in recent months. Historically, this indicator peaks about 11 months prior to a recession and in the last 3 recessions, that lag time has been longer at 16 months and we have not seen that lower trend develop at this time.



Job market data continues to look strong as well. Weekly initial jobless claims continue to hover near their lowest or best levels since 1969, as seen on this slide, and the unemployment rate remains near 50-year lows as well. As a consumption driven economy, the financial health of the consumer is critical to the health of the economy, and job market indicators remain solid.



However, some signs of slowing growth have popped up in recent months. Global manufacturing PMIs moved below 50 – the demarcation line between expansion and contraction – earlier in the year as this chart indicates.

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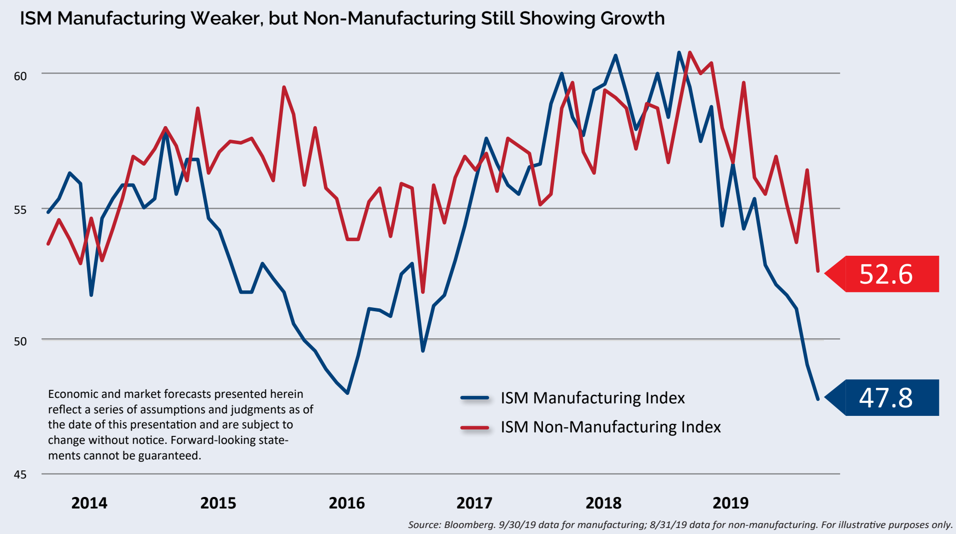
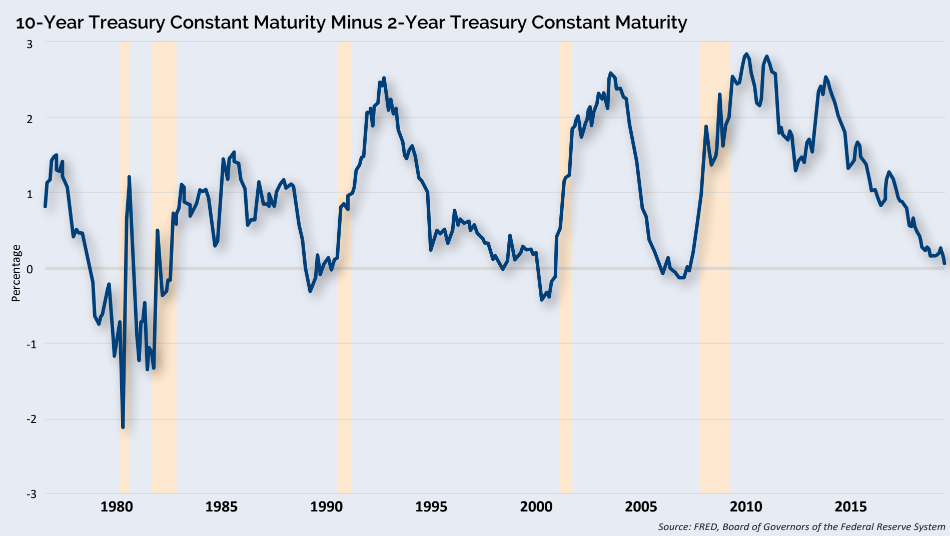


The U.S. had been bucking that trend, but the ISM Manufacturing Index recorded a reading in August below 50 for the first time since 2016 as seen here. Manufacturing is likely feeling the headwinds of higher tariffs and the uncertainty of U.S. and China trade negotiations. On a positive note, the ISM Non-Manufacturing Index, which covers the much larger service industries in the U.S. economy, has remained comfortably above the 50 level in recent years.



The yield curve inversion garnered new headlines in the third quarter. We have been talking about the inversion between 10-year and 3-month Treasury yields since May, but the 10-year and 2-year Treasury yields inverted in August, which received widespread attention.

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From our perspective, whether looking at the 10s and 2s or the 10-year and 3-month yields, the story is the same – an inverted yield curve has historically been a sign of upcoming economic headwinds, often induced by the Fed tightening rates too much.

As a reminder, the prior seven recessions dating back to 1962 have all been preceded by an inverted yield curve, but we have had two instances of an inverted yield curve without a subsequent recession as well. We continue to monitor the yield curve closely.

All in all, we believe the fundamental backdrop for the economy continues to look solid and we expect growth to continue throughout the rest of 2019 and into 2020.

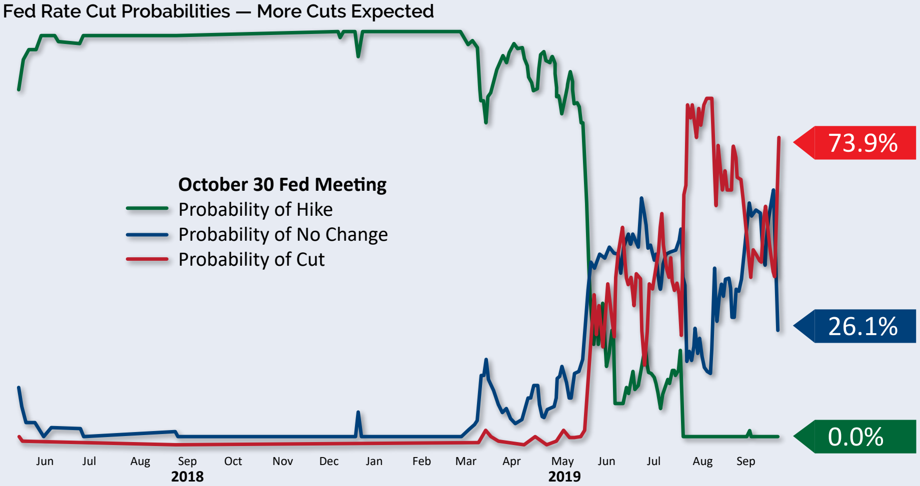
Monetary Policy

Monetary Policy

This leads us to Monetary Policy, which we improved to a slow forward position. The Fed followed through on dovish comments made earlier this year and cut policy rates twice in the third quarter – the first rate cuts since 2008 – compelling us to improve this gauge.

Although rate cuts have begun, the path forward is anything but certain. Fed Chairman Powell disappointed the markets after the first rate cut when he referred to the Fed's action as a mid-cycle adjustment. This slide shows that the market expects about 3 more rate cuts over the next 12 months at this time and we believe these expectations might be somewhat aggressive with economic growth still solid, unemployment near 50-year lows, and the S&P 500 near record highs.

Fed Rate Cut Probabilities — More Cuts Expected



Economic and market forecasts presented herein reflect a series of assumptions and judgments as of the date of this presentation and are subject to change without notice. Forward-looking statements cannot be guaranteed.

Source: Bloomberg. For illustrative purposes only.

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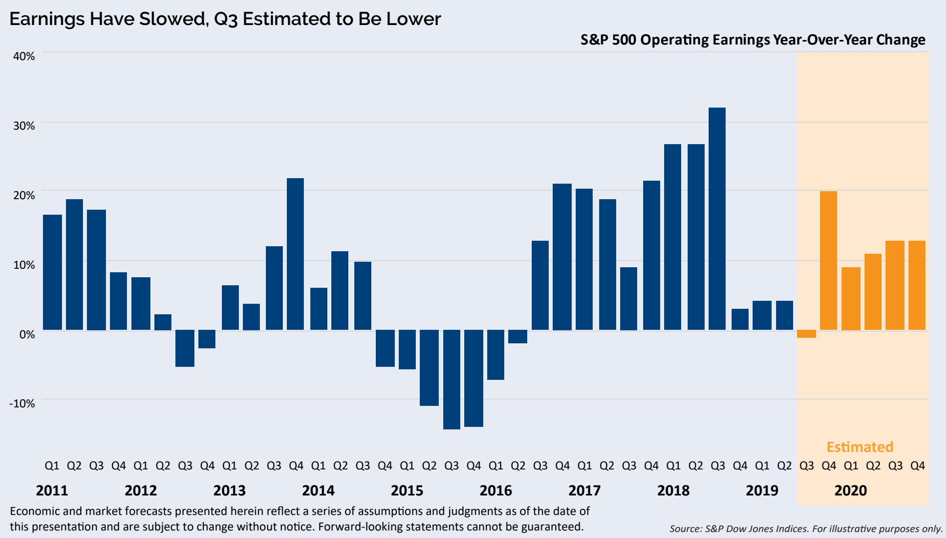
Valuations

Valuations

Next are valuations, which we maintain in a slow forward position.



Earnings growth has been lackluster this year, but that was expected following strong gains in 2018, which were fueled in large part by the tax cuts.

In this type of environment when stock prices are going up, but earnings are only flat to slightly higher, we see what's called P/E expansion. P/Es also tend to move higher when interest rates decline. Higher valuations have resulted and the market P/E ratio is somewhat above its historical average and we would consider this market fairly valued. We maintain this gauge in the slow forward position because we believe valuations remain in a reasonable range and stocks continue to look attractive relative to bonds.

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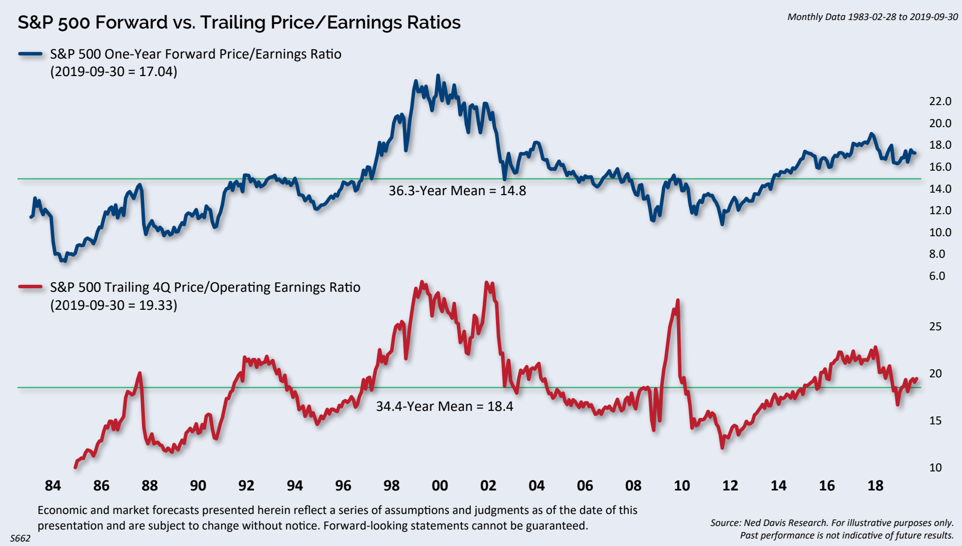
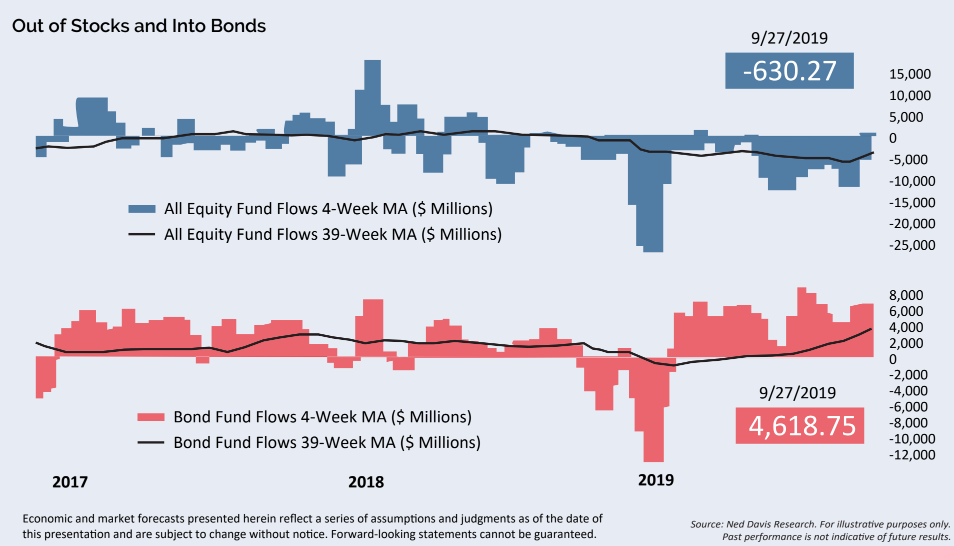


Investor Sentiment

Investor Sentiment

The next gauge is Investor Sentiment, which can be thought of as a measure of speculation. Recall this gauge is a contrarian indicator based on the behavior of investors. We improve this gauge to a slow forward position driven by a heightened level of investor skepticism towards stocks.



The chart here shows significant outflows of equity mutual funds and ETFs in 2019 with sharp inflows going into bond funds. The one way move out of stocks can result in pent-up demand for equities as stocks continue to perform well.

One interesting point this year has been that bonds have performed well too, so investors are probably not feeling the pain of missing out in equities as might typically happen in an improving stock market. However, this consistent fund flow pattern out

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Interest Rates

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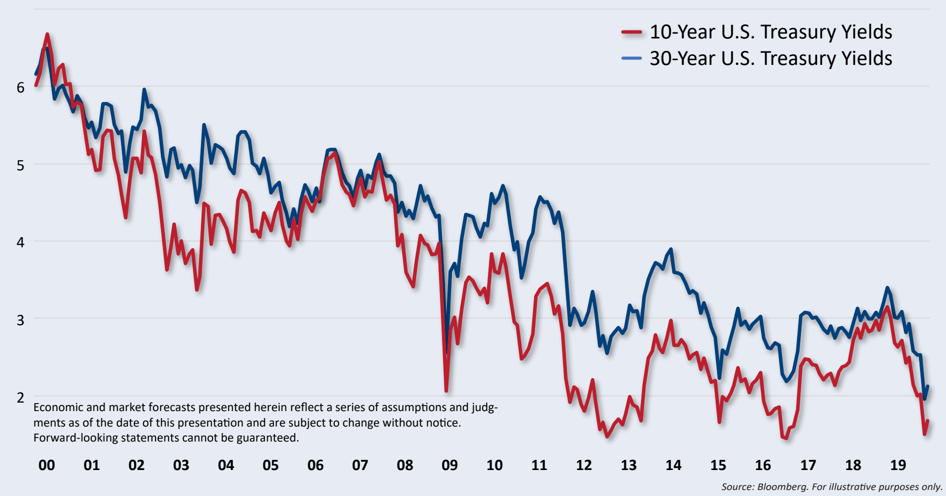
of stocks and into bonds shows too much pessimism from retail investors from our perspective, and compels us to improve this gauge by one notch.

Interest Rates

Our final gauge is interest rates, which we leave in a neutral position.

Lows for 30 & 10 Year U.S. Treasury Yields



Interest rates dropped dramatically in the third quarter. As this slide shows, the yield on the 10-year U.S. Treasury slid below 1.5% during the quarter and approached post-credit crisis lows last seen in 2012 and 2016. Even more dramatic, the 30-year Treasury yield dropped below 2% in August, an all-time low.

The bounce higher in rates in September is noteworthy, but overall, rates dropped significantly during the quarter. The anticipated and ultimate rate cuts from the Fed were one factor driving rates down.

$14 Trillion of Debt with NEGATIVE Yields

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In our opinion, another factor is the unprecedented amount of global bonds that currently are yielding negative returns. This chart shows that a significant amount of government bonds in several countries have negative yields.

In essence, the price of these bonds has moved so far above par value that the interest payments are not enough to overcome the loss in principal as the price moves toward par at maturity. We find it hard to believe that U.S. rates will go up too much with suppressed and even negative interest rates in much of the world.

While lower rates should be a net positive for an economy, the inversion of the yield curve continues to be a negative warning sign, so we keep this gauge in a neutral position.

Moving to capital markets, stocks generally moved higher during the quarter. Steady gains in July were followed by a very volatile August. September made up some of the ground lost in August, keeping the quarter positive for stocks.

A less-than-satisfying post July FOMC news conference, ongoing trade uncertainties and newly minted stock market highs succumbed to a late-month sell-off in July and volatile markets in August.

VIX Index — Elevated in Q3

Source: Bloomberg. For illustrative purposes only.

The VIX Index, a measure of equity market volatility, rose to its highest level in August since early January – approaching the 25 mark as shown in this chart – before settling lower by the end of the quarter.

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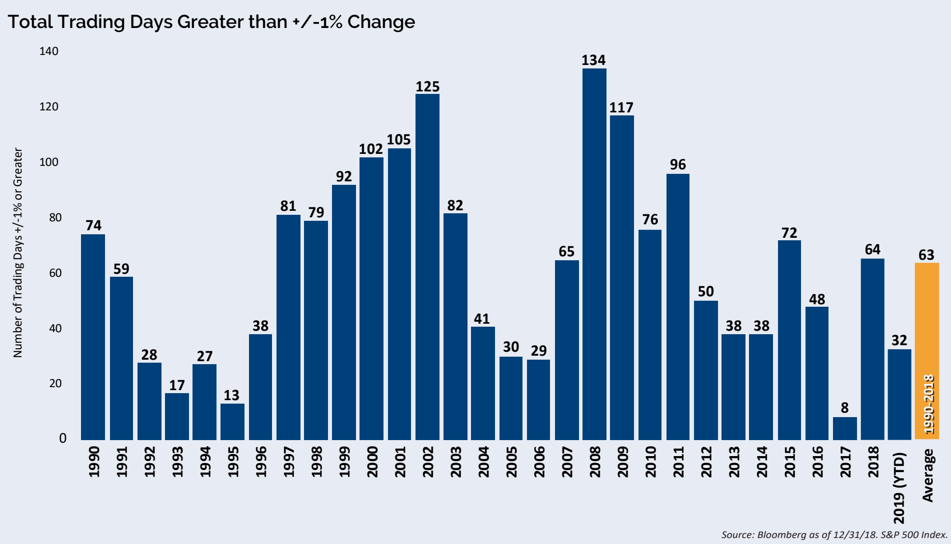
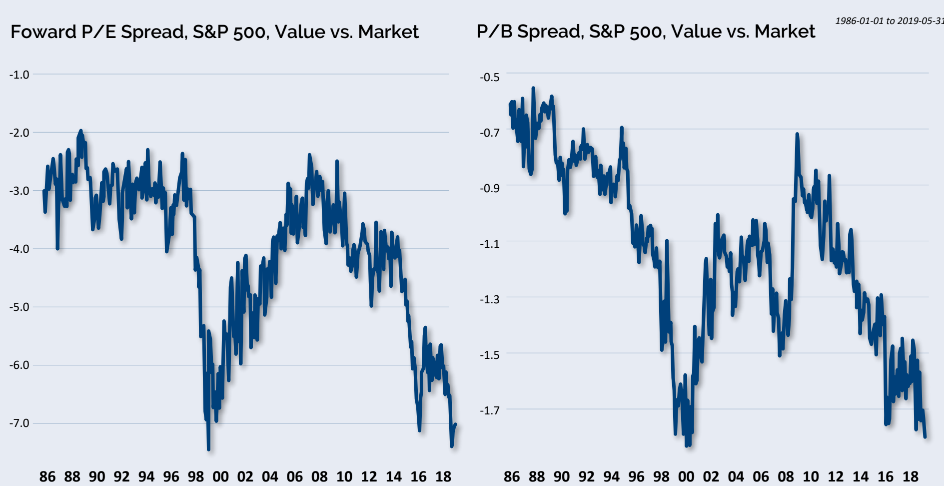


As you can see, the count on 1% trading days spiked during this time period as there were 14 days where the S&P gained or lost more than 1% in the 3rd quarter compared to 32 days for the entire year-to-date.

The nature of the equity market rally continues to be worth exploring. We have spoken in recent months about the disparity in returns in this market, which in general terms has been dominated by large-cap growth companies as seen on this chart.



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Source: JPMorgan US Equity Strategy and Quantitative Research. For illustrative purposes only. Past performance is not indicative of future results.

The valuation disparity we were seeing between value and growth stocks was approaching extremes and levels last seen during the late 1990s tech bubble. We believed that at some point during this market cycle, this trend would reverse and value factors would be rewarded.

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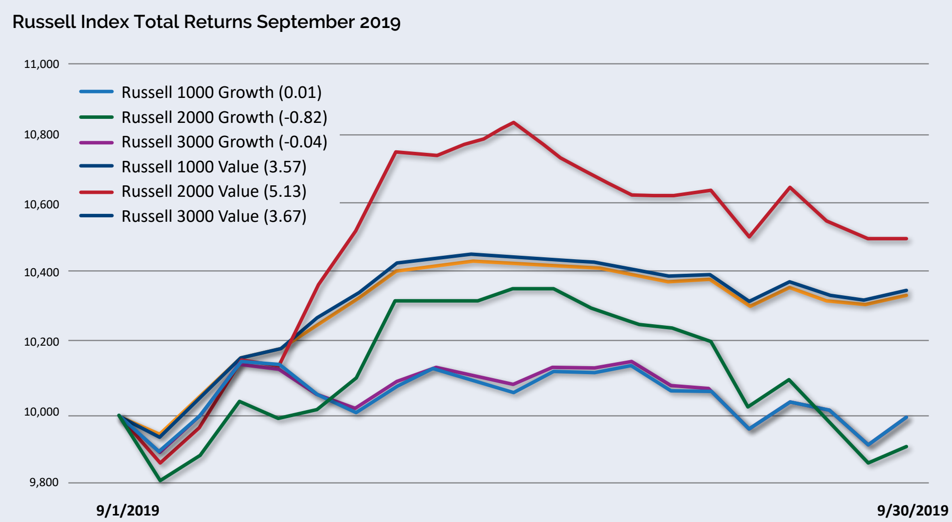

While too early to declare a reversal to this long-running trend, September saw a clear break as value outperformed growth, as seen on this chart, and small and mid-cap stocks outperformed large-cap stocks.

Turning to bonds, the overriding factor in fixed income returns was falling interest rates during the quarter. However, those bond gains lost some ground in September as yields bounced off their multi-year lows and bond prices slipped in September. Overall, most bond sectors enjoyed gains in the third quarter.

Despite all of the uncertainties surrounding the course of Fed action, trade negotiations with China, slowing global economic activity and ongoing discord in Washington DC with a formal impeachment inquiry beginning in late September, the S&P 500 ended the third quarter only modestly below its all-time high.

We maintain our price target range for the S&P 500 of 2800-3100 and acknowledge that depending on how some of these uncertainties progress – the dispersion of results could be wide. We continue to believe that fundamentals are what matter in the long run and that the current fundamentals remain positive for the U.S. economy.

Volatility will likely persist, especially as we approach the one-year mark until the presidential election, but we believe it is imperative for investors to stay focused on their long-term goals and not let short-term swings in the market derail them from their longer-term objectives.

Please contact your Investment Consultant to discuss how we can support your client reviews and how we can help you deliver successful outcomes to your clients.

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