Q3 MARKET INSIGHTS

Fall 2019

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CAN THE EXPANSION CONTINUE?

Financial markets proved to be increasingly volatile during the third quarter of 2019. The S&P 500® Index got off to a strong start as anticipation of the first interest rate cut by the Federal Reserve (the "Fed") since 2008, combined with better-than-expected second quarter corporate earnings to propel the index to new all-time highs. However, disappointing Fed commentary, along with growing worries over future economic growth led to increased volatility in August. The S&P 500 rebounded solidly in September (coming close to matching July's all-time highs) as the Fed cut rates for a second time, and clearly signaled a willingness for future cuts if conditions warranted further action. Once again, the S&P 500 proved to be quite resilient during the quarter as the index posted a positive return of 1.70% (+20.55% YTD). Looking internationally, foreign markets saw negative returns in the third quarter, primarily due to concerns about global economic growth. Foreign developed markets declined, but outperformed emerging markets, as the European Central Bank (the "ECB") announced it was cutting interest rates and restarting its quantitative easing ("QE") program for the first time since September of 2018. For the quarter, foreign developed markets, represented by the MSCI EAFE Index were down 1.00% (+13.39% YTD), and the MSCI Emerging Markets Index finished down 4.16% (+6.14% YTD). Switching to fixed income markets, bonds were broadly higher in the third quarter, given global rate cuts, uneasiness about future economic growth, and subdued inflation readings. The leading benchmark for bonds, the Bloomberg Barclays US Aggregate Bond Index, returned 2.27% for the quarter (+8.52% YTD).

CENTRAL BANKS REVERSE COURSE

Economic data released since our last letter continues to suggest that the global economy is slowing down. The lagged effect of tightening monetary policy by the world's central banks, in an effort to reverse the QE programs put in place in response to the Global Financial Crisis of 2008, continue to impact the global economy today. As a result, central banks in both developed and emerging markets have reversed course, and are now starting to ease monetary policy to stimulate growth. Looking ahead, the health of the global economy will depend on the extent to which recent policy changes help stabilize weakening economic activity.

Moving overseas, the Eurozone economy appears anemic, with second quarter growth remaining below trend at a 0.8% annualized rate. Gross Domestic Product ("GDP") growth has contracted in Germany; is stagnant in Italy; and is slowing in France and Spain. Eurozone GDP is forecast to remain under 1% as retail sales and manufacturing activity, especially in Germany (the Eurozone's largest economy), are expected to remain weak. Germany's auto sector has been affected by economic and geopolitical issues in Turkey, France and Italy. In addition, sales of cars and machine parts to the Far East have declined as falling currency values have made it more expensive to import German goods. While the ECB announced that it was cutting rates and restarting its QE program during the quarter, we believe the central bank waited too long to loosen monetary policy, and that the new program will have limited efficacy.

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In the U.K., uncertainty regarding future economic policy (as it relates to Brexit) continues to adversely affect both investment and productivity. GDP in the U.K. contracted at a 0.8% annualized rate during the second quarter. Moving

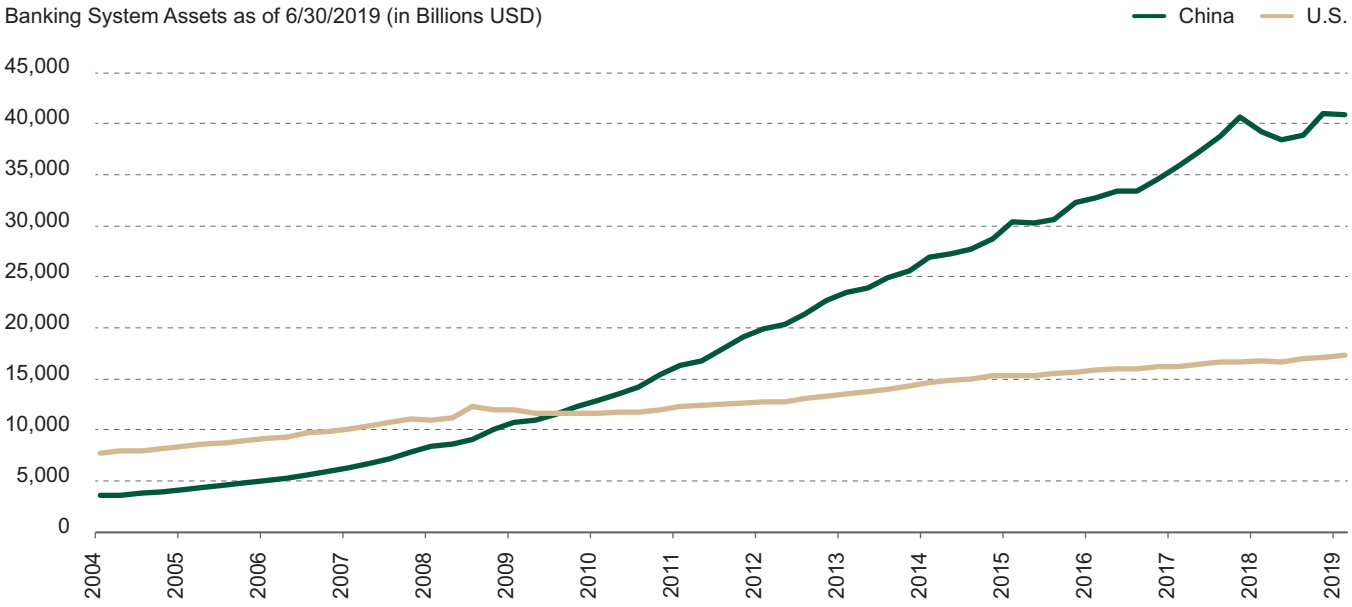
forward, GDP growth is expected to rebound in the third quarter, however, Brexit continues to weigh on trade and business confidence as well as manufacturing activity. Prime Minister Boris Johnson is struggling to push through a "no-deal Brexit" in Parliament (where the U.K. would leave the European Union without any agreements in place about what the relationship between the U.K. and the European Union will be like in the future). At this point, analysts expect that Brexit will be delayed beyond its current deadline of October 31, 2019, creating further uncertainty, and therefore, a difficult investment environment.

Economic growth in Japan has been growing at a slow pace, coming in at a 1.2% annualized rate for the second quarter, but the future looks to be challenging. Demand generated by the construction boom for the Tokyo 2020 Olympics has begun to fade. In addition, the Japanese government is raising its national sales tax to 10% from 8%, which takes effect in October. The reason for the tax increase is to cover the ever-growing social costs of supporting the country's aging population. Previous tax increases, a 2% increase to 5% in 1997 and another increase to 8% in 2014, brought on recessions. Japanese Prime Minister Shinzo Abe has delayed the increase twice, stating that at this point in time, it is unavoidable to delay the increase any further. The Abe administration is planning several stimulus measures to help soften the impact on consumer spending, however, consumer confidence has trended lower, raising concerns about domestic demand and future growth.

The outlook for China and emerging markets remains somewhat concerning. As we have highlighted in previous letters, we believe China has a debt problem (the chart below highlights the surge in debt relative to the U.S. since 2004). In recent years, China has fueled its economic growth with debt in an effort to prevent any significant slowdown, creating several imbalances. The Chinese government now must manage a delicate balance of providing stimulus in order to boost growth (which is forecast to fall at the lower end of the government's target of 6.0%-6.5% for 2019), while not allowing these fiscal imbalances to grow much worse. Credit growth in China is forecast to increase 10% for 2019, the lowest level in over 12 years, which will likely be enough to stabilize, but not boost growth. In other emerging economies such as India and Brazil, economic growth has slowed amidst weaker consumer spending and slow progress on much needed reforms. Furthermore, demand for the U.S. dollar as a safe haven within a slowing global economy, has pushed its value to multi-year highs. This has created headwinds for emerging markets by reducing their purchasing power. If global growth continues to stagnate, we would expect the U.S. dollar to remain strong. Despite having much higher levels of economic growth, these challenges make it difficult to make a sizable allocation to China and emerging markets.

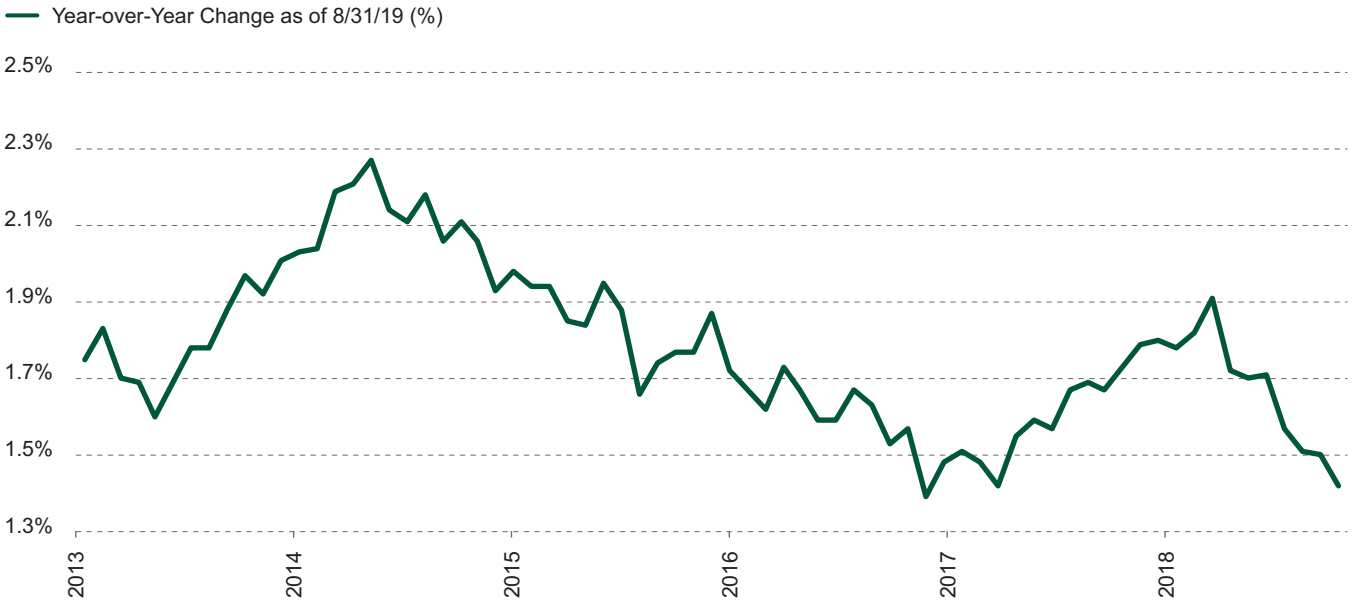
Economic growth in the U.S. has remained resilient when compared to the rest of the world, but as we look ahead, the economy seems to be sending mixed signals regarding its future health. The U.S. economy grew at a 2.0% rate during the second quarter, and is expected to grow at a 1.8% rate for

China: High Debt Levels Compared to the United States



Source: Bloomberg

U.S. Employees on Nonfarm Payrolls



Source: Bloomberg

the third quarter (Third quarter GDP data will be released at the end of October). However, this is down from the first quarter's brisk 3.1% pace. Growth in 2019 has been supported by a strong consumer as a result of steady employment gains and low interest rates. Nevertheless, there are some concerns as we look at some of the current data. While the unemployment rate in the U.S. remains at a 50-year low of 3.7%, year-over-year payroll jobs growth (which measures the percent increase in nonfarm jobs over the past 12 months) peaked at a three-year high of 1.9% in January of this year. Since then, it has dropped to an eight-year low of 1.4% (see chart above) suggesting a downward trend in job growth. In addition, manufacturing activity in the U.S. is showing signs of contraction.

The Institute for Supply Management (ISM) Manufacturing index fell to 49.1% during the quarter (a reading below 50% indicates a contraction in activity). While some of the fall is being attributed to Boeing and its cutback in the production of the 737MAX jet, it is something that bears watching. If economic growth and job growth keep slowing, there is a real risk that these slowdowns could culminate in a recession. Then again, we must remember that manufacturing only makes up approximately 11% of the U.S. economy. Looking at the rest of the economic data, the ISM non-manufacturing index (which measures activity in the service sector) posted a reading of 56.4% during the quarter, which represents its 115th consecutive month of overall expansion. The rate of change in the Leading Economic Indicators ("LEIs") remains positive, coming in at 1.1% in August. While momentum has slowed over the past several months, it is important to note that we have never had a recession without LEIs posting a negative reading. The yield curve between the 3-month U.S. Treasury bill and the 10-year U.S. Treasury note remains inverted, and has been since the end of May. This has historically been a strong recession indicator. It is worth noting, that the slope of the yield curve between the 3-year U.S. Treasury note and the 10-year U.S. Treasury note has always inverted prior to recessions, and it has yet to invert. Taken together, these mixed signals present an extremely challenging economic environment to analyze. While we believe the risks of a recession occurring have risen, we think the likelihood of a recession taking place within the next six months is relatively low.

Our asset allocation for both equities and fixed income continues to favor exposure to the U.S. as opposed to foreign markets, given the clear relative growth advantage of the U.S. economy. While equity valuations look expensive when compared to their longer-term history, they appear reasonable based on current levels of interest rates (in our Q1 Market Insights letter we detailed how low interest rates support higher P/E ratios). Within individual equities, we continue to focus on owning high quality companies that operate in industry segments with high barriers to entry, have strong balance sheets, stable revenue and earnings growth, generate above average levels of free cashflow, and trade at what we believe to be reasonable P/E multiples. It is our opinion that companies with these characteristics are best-positioned to withstand an economic downturn. As we

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highlighted earlier, the risks of a recession have definitely risen, however, we believe the likelihood of a recession occurring here in the U.S. within the next six months to be low. As a result, we do not believe it is time to take drastic action, but we are evaluating potential adjustments to strategic asset allocations targets should conditions change. As you may recall, we increased the credit quality within our fixed income portfolios during the second quarter. This quarter, we took steps to reduce some overweight equity positions (bringing them in line with their long-term suggested weightings) and added a small allocation to gold and silver (which can act as "safe havens" during periods of economic and geopolitical uncertainty) where suitable.

Whether or not the current slowdown morphs into a recession is apt to be dependent on Fed policy. Given the downward trend in the economic data, the Fed cut interest rates twice during the quarter in an effort to loosen economic conditions. As we look ahead, the key to our asset allocation remains dependent upon how quickly the boost from lower interest rates will start to feed through the economy as well as how accommodative the Fed will be in the future. We believe the key consideration, as to whether or not we enter a recession, is how much U.S. economic growth will continue to slow down before the effects of these rate cuts take hold. Based on the current data, it is too early to tell, however, the Fed's willingness to institute further rates cuts leads us to believe that the current economic expansion here in the U.S. will continue (albeit slowly). As we move forward, we will closely monitor the incoming economic data as well as future Fed commentary for any change that could compel us to change our asset allocation going forward.

MARKETS LIKELY TO IGNORE IMPEACHMENT

During the quarter, Nancy Pelosi initiated an impeachment inquiry against President Trump with regard to conversations he had with the President of Ukraine about investigating Joe Biden and his son. While stocks initially reacted poorly when it became clear that the House of Representatives would move forward with an investigation, we believe that impeachment proceedings will have little impact on the stock market. Market participants will likely ignore the political headlines and ultimately focus on the underlying economic fundamentals. To support this point, we look at the equity market performance during the last two instances where sitting presidents faced impeachment inquiries. Between September 1998 and February 1999, the S&P 500 rose 23% as prospects surrounding the adoption of the internet pushed technology stocks higher, despite impeachment proceedings against President Bill Clinton. The poor performance of the S&P 500 in the lead up to President Richard Nixon's resignation in August of 1974 had more to do with economic developments than Watergate. The Arab oil embargo of 1973 caused energy costs to triple and pushed the U.S. into a recession. From the time the Watergate scandal really intensified in October 1973 until Nixon's resignation, the S&P 500 fell 24%. In both examples, it appears that fundamentals drove market returns, not the possibility of the removal of a sitting president. While the headlines surrounding President Trump's impeachment may cause some uncertainty, history suggests the issue will likely have minimal impact on the financial markets.

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IN CLOSING

The year-to-date gains for financial markets have been impressive in spite of the challenging macroeconomic and geopolitical backdrop. Better than expected corporate earnings growth as well as the prospects of accommodative Fed policy have pushed the S&P 500 back to near-record highs. While some of the data remains mixed, we believe the late phase of this economic expansion here in the U.S. can continue. However, given the strong performance, we expect lower levels of returns and similar levels of volatility for the remainder of 2019. We understand that volatility, regardless of the cause, can be unnerving. That's why we remain committed to helping you navigate this ever-changing market environment, with a focused eye on ensuring we continue to make progress in achieving your long-term investment goals. Our years of experience in all types of markets (calm and volatile) have taught us that successful investing remains a marathon, not a sprint. Therefore, it remains critical to stay invested, remain patient, and stick to a plan. This is why we have established asset allocation targets for our clients that consider financial position, risk tolerance and investment time horizon.

We thank you for your ongoing confidence and trust. Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.

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Past performance is no indication of future results

Definitions:

S&P 500® Index is a registered trademark of Standard & Poor's Financial Ser¬vices LLC, a division of S&P Global ("S&P"). S&P 500 Index is an unmanaged index used as a measurement of change in U.S. equity markets. Performance numbers for the index are total return with dividends reinvested in the index.

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The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East), excluding the US & Canada. The MSCI EAFE Index is an equity index which captures large and mid-cap representation across Developed Markets countries around the world, excluding the US and Canada. With 913 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Indices are not managed and do not incur fees or expenses. Performance numbers for the index are total return with dividends reinvested in the index.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries*. With 838 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Performance numbers for the index are total return with dividends reinvested in the index.

The Bloomberg Barclays US Aggregate Bond Index provides a measure of the total return performance of the U.S. dollar denominated investment grade bond market, which includes investment grade government bonds, investment grade corpo¬rate bonds, mortgage pass through securities, commercial mortgage backed securities and asset backed securities that are publicly for sale in the United States.

Institute for Supply Management (ISM) Manufacturing Index® is a composite index based on the diffusion Indexes of five of the Indexes with equal weights: new orders (seasonally adjusted), production (seasonally adjusted), employment (seasonally adjusted), supplier deliveries (seasonally adjusted), and inventories. The index is used to measure activity in the manufacturing sector of an economy. An index value over 50 indicate expansion; below 50 indicates contraction. The values for the index can be between 0 and 100.

Institute for Supply Management (ISM) Non-Manufacturing Index is based on surveys of more than 400 non-manufacturing firms by the Institute for Supply Management. The index is used to measure activity in the services sector. An index value over 50 indicate expansion; below 50 indicates contraction. The values for the index can be between 0 and 100.

Leading Economic Indicators (LEIs) are a composite of economic data points put together by The Conference Board designed to signal peaks and troughs in the business cycle. The Conference Board is a global independent business membership and research association, founded in 1916, working in the public interest to deliver trusted insights for what's ahead.

Gross domestic product (GDP) is calculated by the Bureau of Economic Analysis that serves as a measure of total market value of the goods and services produced (output) in the U.S. GDP is the sum of consumer spending, investments made by industry, the excess of Exports over Imports and Government Spending.

Quantitative easing (QE) is defined as large scale purchases of securities, typically fixed income, by a monetary authority such as the Federal Reserve. In theory, the result is an increase in demand for those securities, putting upward pressure on their prices and pushing yields down. Quantitative easing allows a monetary authority the ability to influence longer duration securities, while traditional monetary tools can only directly influence shorter duration securities.

The price-earnings ratio (P/E) is the ratio of a company's share price to the company's earnings per share. The ratio is used for valuing companies and measures the price you are paying per unit of earnings.