1919 INVESTMENT COUNSEL
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100 YEARS

October 2019

Investment Review and Outlook

Q3 2019 AT A GLANCE

- The third quarter brought market volatility, heightened trade rhetoric, and two fed funds rate cuts.
- Slowing global growth and a negative interest rate environment continued to present challenges for many of the world's economies.
- Positive U.S. economic growth resulted from a healthy and confident consumer—fueled by wage growth and historically low unemployment.

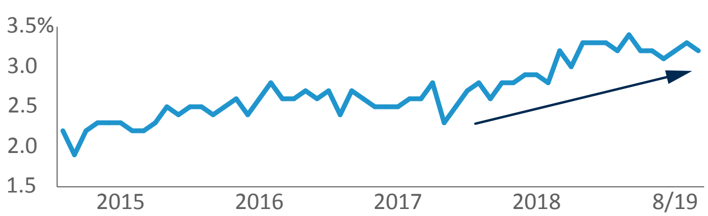
THE ECONOMY

Consumer Savings And Spending Drive Economic Growth

The U.S. economy continues to be on solid footing. The key driver of economic growth is the strength of the American consumer. Unphased by the trade war and tariff rhetoric, the consumer continues to spend while maintaining a higher savings rate.

- Wage growth and an unemployment rate that is near a 50-year low support consumer spending.
- The U.S. savings rate, which reached 7.7% as of July 2019, bodes well for future purchasing power.

Annual Wage Growth Continues



Source: Federal Reserve Bank of St. Louis

Waning Business Confidence Dampens Corporate Spending

While the consumer has remained upbeat, economic growth has been somewhat dampened by lackluster spending by U.S. companies. As the uncertainty surrounding the trade war and tariffs continued, business confidence waned and, as a result, capital expenditures stalled.

The Business Roundtable* CEO Confidence Q3 2019 Survey reported:

> ***"This quarter, CEO plans waned likely due in part to growing geopolitical uncertainty, including U.S. trade policy and foreign retaliation, and slowing global economic growth."***

The impact of tariffs is not uniform throughout the U.S. business community. The manufacturing sector, which represents 11% of U.S. gross domestic product (GDP), stands to be the most affected by increased tariffs. Therefore, any impact felt by this sector should not completely overwhelm U.S. economic growth, which remains primarily consumer driven.

Performance Summary
Total Returns & Values for Selected Assets as of 9/30/19

	QTD Return	YTD Return	Price/ Value
Dow Jones Industrial Average	1.8%	17.5%	$26,917
S&P 500 Index	1.7	20.6	2,977
Russell 2000 Index	-2.4	14.2	1,523
MSCI EAFE Index	-1.0	13.3	1,846
MSCI EM (Emerging Markets)	-4.1	6.2	992
Bloomberg Barclays U.S. Aggregate	2.3	8.5	106
Bloomberg Barclays Municipal Bond	1.6	6.7	112
Gold (NYM $/ozt) Continuous	3.3	12.6	1,472
Crude Oil WTI (NYM $bbl) Continuous	-7.5	16.1	54

Source: FactSet

**Business Roundtable is an association of the CEOs of America's leading companies.*

THE ECONOMY (CONTINUED)

Political Pressure For Trade Talk Resolution

Heightened trade tensions persisted throughout 2019. As the U.S. presidential election gets closer, we expect trade negotiations to progress as political pressures intensify and expectations for a final resolution from the executive branch grow. However, whether China's leadership also will finalize trade terms for a meaningful deal within this time frame remains to be seen.

Two Rate Cuts By The Fed

In July, the Federal Reserve decreased the fed funds rate by a quarter point (0.25%), the first interest rate cut since the 2008 financial crisis. A second rate reduction followed in September. These cuts were in reaction to the negative economic implications of global developments, including the uncertainty surrounding trade talks. A third rate cut may be in store for 2019, although Fed board members are divided as to whether this will be necessary in order to maintain positive U.S. economic growth.

According to Fed Chairman Jerome Powell, although the United States economy remained strong and unemployment low, "there are risks to this positive outlook." If the economy weakens, he said, a "more extensive sequence" of rate cuts could be appropriate.

The Impact Of Central Bank Policy And Slowing Global Growth

Fed Chairman Powell also noted the diminishing impact of monetary policy in stimulating global growth. A more unified fiscal policy in Europe might help but is difficult to achieve. Europe operates on a country-by-country basis and continues to struggle with declining and aging populations as well as complex regulations that hamper productivity.

- Germany, Europe's economic engine, is verging on recession as a large percentage of its GDP is derived from a struggling manufacturing sector.
- Europe is not the only developed region experiencing headwinds. In Japan, aging demographics, deficit issues and immigration policy continue to present challenges, and the country is another example where monetary policy has failed to stimulate growth sufficiently.

Economic growth is driven by population growth and rising productivity, both of which have been relatively more positive in the U.S. Absent those drivers, lower corporate profit growth follows. This is one reason why we have maintained a bias towards domestic equities.

M&A Transactions Slow Down

We saw a slowdown in mergers and acquisitions (M&A) activity due primarily to economic uncertainty. The initial public offering (IPO) market also was muted, and some healthy skepticism of new IPO contenders took hold.

- M&A was a big driver of corporate bond issuance over the past three years but was negatively impacted in 2019 due to uncertainty surrounding trade and tariffs.
- It is healthy to see the market scrutinize the valuations, business models and corporate governance issues represented by the WeWork IPO. This is a sign that there is still a decent level of skepticism and lack of euphoria in the markets—an indication that the positive equity cycle may not be over.

On The Topic Of Oil

The attacks on Saudi Arabian oil facilities have reinserted geopolitical risk into the energy markets. However, in the U.S., any increase in oil prices is not the inflationary shock it once was. Oil consumption makes up a much smaller percentage of U.S. GDP than in the past due to productivity enhancements and new technologies. Nonetheless, a rise in oil prices should be viewed as a tax on the consumer which, if it persists, will reduce consumer spending.

EQUITIES

Third Quarter Equity Overview

The U.S. and global equity markets posted modest positive returns for the third quarter, with the S&P 500 up 1.7%. Declining global interest rates had a pronounced effect on sector and industry allocation.

- The 10-year Treasury yield started the quarter at 2.00%, declined to a low of 1.46%, and ended the quarter at 1.68%.
- Germany's 10-year Bund started at -0.32% and ended at -0.58%.

This drove investors towards bond proxy sectors such as utilities (+9.3%), real estate (+7.7%) and consumer staples (+6.1%).

From a sector perspective, the political rhetoric around healthcare costs continued to challenge the healthcare sector, which returned -2.2% for the quarter. While the attack on Saudi oil facilities drove oil prices sharply upward, crude prices still declined 8% in the quarter as global demand concerns persisted, resulting in the energy sector posting a negative 6.3% return.

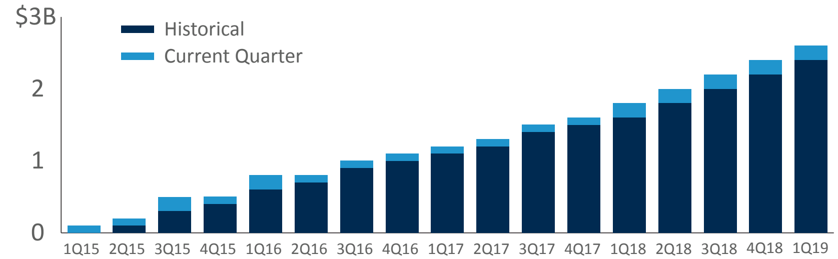
Lack of investor euphoria was further evidenced by continued outflows from U.S. equity funds and ETFs and inflows into bond funds, coupled with investor scrutiny of IPO valuations. As previously mentioned, this may be an indicator that the positive equity cycle is not yet over.

Share Buybacks Fuel The Equity Market

By far the biggest source of demand for equities has come from companies purchasing their own shares. In fact, share buybacks are a critical factor in the supply/demand equation of equities. Over the past several years, many companies implemented share buybacks using inexpensive corporate debt and tax savings. Buybacks over the last 12 months reached a record $750 billion, which drove increases in earnings per share at a much higher rate than overall corporate profits.

While corporate leverage is well below the levels from before the financial crisis, it has rebounded to the long-term average. Low interest rates keep debt service manageable. Therefore, share buybacks represent an appropriate option for many companies to generate shareholder value.

Share Buybacks Increase



Source: S&P Dow Jones Indices

Trade Rhetoric Sparked Volatility

Trade and tariff rhetoric sparked market volatility in the quarter as uncertainty took its toll. The manufacturing sector and related industries including transportation—shipping and rails—felt the immediate impact.

However, the consumer-driven, service-based U.S. economy is less exposed to the manufacturing sector as compared to countries where manufacturing makes up a larger percentage of GDP. Trade and geopolitical concerns (impeachment, BREXIT, Hong Kong, Iran, etc.) will continue to be major influences on investor sentiment, driving asset and sector allocation decisions. We expect market volatility to be elevated with news headline ebbs and flows.

Technology And Healthcare Continue To Drive Growth

In the quarter, the utilities sector led the charge in terms of performance, followed by real estate, communication services and consumer staples. Less volatile, dividend-paying stocks were the winners.

EQUITIES (CONTINUED)

While political debate on healthcare and technology issues remains a near-term headwind, both of these sectors offer important long-term growth opportunities for well-managed companies:

- Software and cloud computing continue to be faster growing than the semiconductor and hardware spaces in the technology sector.
- Healthcare represents a significant percentage of spending in the U.S. economy.

Solutions that boost efficiency and improve healthcare outcomes are in high demand and should ultimately generate attractive returns for shareholders. With the election year upon us, the political focus on healthcare spending, pricing and distribution channels will cause a degree of uncertainty. As always, we will monitor developments and potential impacts.

Follow-On Effect From Tax Cuts Not Evident

From a corporate profit perspective, the uncertainty surrounding trade and tariffs reduced the confidence needed for executives and business owners to increase spending. Additionally, the earnings boost generated from the 2018 corporate tax cuts did not fuel the desired increase in capital expenditures. We anticipate low-single digit earnings growth in 2019 and mid-single digit earnings growth in 2020.

A Word About Valuations

Dovish central bank policies provide support to equity valuations, which are considered to be at reasonable levels. While we may experience a short-term rotation in favor of value stocks, we believe investors will continue to reward companies and sectors that deliver growth of revenues, cash flows and earnings. Increasing dividend streams also will be an important contributor to equity returns.

Economic and Market Drivers	
Tailwinds	**Headwinds**
Low but Positive Inflation Expectations	Trade Conflict Escalation & Expansion
Lower Interest Rates	Scarce Global Pricing Power
Healthy U.S. Consumer	Slowing Profit Growth, Reliance on Buybacks
Low Expectations, Lack of Investor Euphoria	U.S. Election Rhetoric & Uncertainty
Slower but Positive Revenue & Income Growth	U.S. Business Optimism Waning
Fed and Global Central Banks Easing	Exogenous Shock Risk Higher

FIXED INCOME

Our Interest Rate Outlook

Despite two fed funds rate cuts this quarter, there is the potential for another rate cut by the Fed in 2019. However, members of the Fed do not currently share a unified perspective on the most appropriate future monetary policy action. A meaningful deterioration of the economy likely would be needed for the Fed to cut rates further. While central banks around the world responded to slowing global growth by easing monetary policy, and in some cases permitting negative rates, we do not believe the U.S. is on the same path.

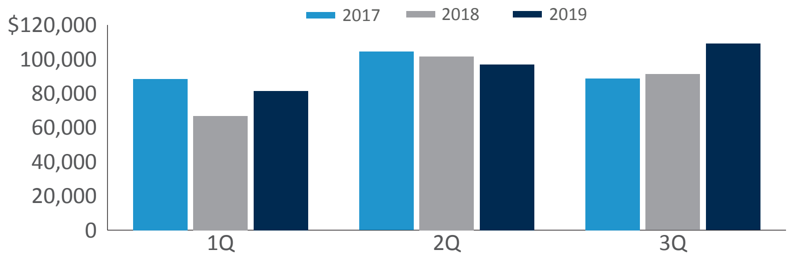
We do believe that longer-term rates will trend slightly higher due to the strength of the economy and rising inflation rate expectations—the core Consumer Price Index (CPI less food and energy) reached 2.4% at the end of August. However, we do not anticipate a significant interest rate increase unless the U.S. achieves a final trade deal with China. As a result, we favor fixed income portfolios with shorter durations that reflect these interest rate expectations.

New Issuance Was The Name of The Game

A flood of new Treasury bill issuance hit the market this quarter to help fund the U.S. government's $1 trillion deficit. Issuance across the municipal and corporate sectors also was robust during the quarter. Municipal bond issuance in August was the highest since 2017, and corporate issuance at quarter-end was strong. Skittishness in the equity markets drove inflows into fixed income, which boosted investor appetite for this increased supply.

FIXED INCOME (CONTINUED)

Municipal Bond Issuance Returns to 2017 Levels



Source: Federal Reserve

In the municipal bond market, we saw new issuance from a wide range of municipalities across the country. The rainy day funds of these municipalities significantly increased post financial crisis. Many jurisdictions are ready to proceed with deferred projects and are issuing bonds for funding.

Why We Do Not Expect A Recession

The yield curve inversion that occurred briefly during the quarter does not necessarily indicate a recession is imminent. The U.S. is in a unique situation where:

- Global flows into the U.S. fixed income market are strong as a result of negative rates abroad.
- The appetite for U.S. fixed income is keeping interest rates at the longer end of the yield curve lower than they would otherwise be, based on domestic economic data and the inflation rate.
- In addition, geopolitical tensions, such as the bombing of oil facilities in Saudi Arabia and the uncertainty surrounding the trade wars, have created a flight-to-quality.

The fact that there continues to be strong demand for U.S. fixed income securities from overseas reflects investor confidence in U.S. economic growth. These various factors, along with healthy consumer spending and less reliance on manufacturing, allow us to be less concerned about a potential recession in the U.S.

Our Defensive Stance Continues

The high volume of corporate bond and municipal issuance this past quarter, after a period of comparatively lighter issuance over the past year, posed no problem for the market to absorb. This reinforced our reasons for overweighting corporate bonds for the incremental yield they provide. However, with more issuance expected for the remainder of the year, shorter durations and fixed income portfolio maturities provide us with the flexibility to take advantage of higher interest rate opportunities as they arise.

CONCLUSIONS

- The probability of a U.S. recession in the near-term is fairly low at this time due to a healthy consumer and a dovish Fed.
- Yields on long-term bonds will rise modestly.
- Slower revenue and earnings growth will lead to modest equity returns. Earnings and dividend growth will be in demand.
- Volatility will continue to be elevated while uncertainty persists from the trade war, tariffs and political rhetoric.
- The risk of a trade and tariff policy error is high, which would challenge consumer confidence and overall economic growth. We continue to review portfolio asset allocations and manage exposures in line with long-term guidelines. ■

The views expressed are subject to change. Any data cited herein have been obtained from sources believed to be reliable. The accuracy and completeness of data cannot be guaranteed.