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Economic & Financial Market Outlook

Winter 2019

This summary is provided by BMT Wealth Management.

In this edition, the BMT investment team provides their economic and financial market outlook for 2019. As we forge ahead into 2019, much uncertainty remains regarding many key issues that could affect global economic growth and financial market returns. Areas such as central bank policies, foreign-trade negotiations and developments, and corporate profitability, to name a few, are issues at the top of our list.

Unlike in 2017, which delivered favorable investment results across a wide assortment of different asset classes (stocks, bonds, commodities, etc.), 2018 was much more challenging for investors. A combination of rising rates, especially on the short end of the yield curve, and rising equity market volatility, resulted in most asset classes delivering flat-to-negative returns in 2018.

Herein, we provide a more detailed overview of our expectations for the global economy as well as the global equity and fixed income markets. We appreciate the opportunity to share with you our thoughts and opinions and look forward to keeping you abreast of ongoing economic and financial market developments throughout the year.

On behalf of the BMT investment team, we want to begin the year by wishing you a healthy and happy 2019! Now on to our views…

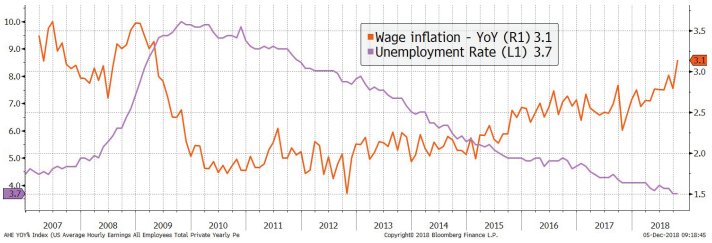
Regarding the Global Economy – Growth Continues but Slows

Growth rates to dip toward the 2% trend. In 2018, the U.S. economy is expected to grow at a 3% rate which exceeded the 2% trend growth rate witnessed following the Great Recession of 2008-2009. In our opinion, U.S. economic growth will continue in 2019, albeit at a slower pace relative to 2018, as the effects of stimulus measures (tax cuts, deregulation, fiscal spending) enacted at the end of 2017-early 2018 begin to wane. We would not be surprised to see growth rates start heading lower toward the 2% trend growth rate, especially in the back half of this year.

The economy is showing late cycle attributes such as a flattening of the yield curve, more restrictive monetary policy, and tight labor market conditions. We do not believe a recession is likely in the immediate future, given that consumer spending, which accounts for roughly 70% of the U.S. economy, is showing no visible signs of abating.

The labor market to remain healthy. Given the number of job openings available relative to the number of individuals unemployed, we expect that the unemployment rate will continue to decline through 2019 and into 2020. Upward pressure on wages will continue as the search for qualified labor becomes more difficult in an environment where the U.S. economy is still expanding. We expect the gap between the natural rate of unemployment, the rate of unemployment estimated by the Federal Reserve (Fed) if the economy operated at maximum capacity with stable inflation, and the actual unemployment rate to widen, causing wage inflation pressures to build.

Wage Inflation & Unemployment Rate
2007-2018



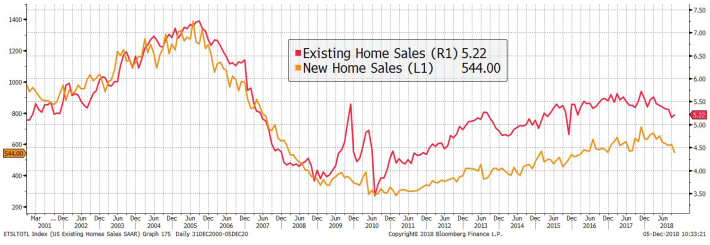
Source: Bloomberg Finance L.P.

A robust workforce should keep consumer spending strong. A larger number of individuals working and generating more income will support and contribute to ongoing consumer spending, a key driver for economic growth in 2019. Consumers are well-positioned financially relative to prior periods of economic expansion, which will help drive healthy spending levels. Consumers have made great strides over the years reducing, managing, and maintaining leverage at respectable levels.

Price inflation should remain relatively subdued and anchored at or around the Fed's 2.0% target rate. Inflation expectations have been stuck around 2.0% for multiple reasons, given technological innovation, demographics, and globalization, as well as the Fed's "anchoring," or policy goal to maintain a 2.0% targeted inflation rate. For these reasons, we believe prices will remain stable as the economy continues to expand. Ultimately, however, as conditions warrant, inflation will become problematic for corporations as a tightening labor market leads to wage growth that will eventually be passed on via higher prices for products and services. This trend will likely develop through this year and into 2020.

The housing sector will be an overall drag on U.S. economic growth in 2019 given higher mortgage rates and rising home prices. These factors have contributed to reduced housing activity in 2018 and will likely continue in 2019. Limited housing supply, partially due to higher input costs, will support home prices, offsetting pricing pressures from reduced housing demand. Overall, the housing sector will remain somewhat sluggish.

New and Existing Home Sales
2001-2018



Source: Bloomberg Finance L.P.

Corporate profits should remain positive given our expectations of healthy consumer spending. We expect corporate coffers will continue to feel the positive impact from the Tax Cut & Jobs Act (TCJA) in 2019 but with limited upside. The uncertainty around global trade will weigh on business sentiment and filter into corporate capital expenditures and spending plans. We believe corporate spending will ultimately be a modest positive on economic growth.

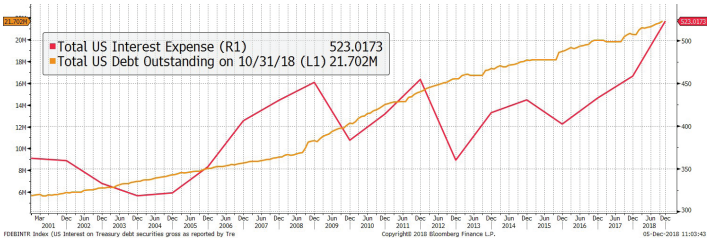
The Fed will maintain its course of removing accommodative monetary policy. However, the pace of removal will drop significantly during the year given the current interest rate environment. We expect that the need for any additional rate hikes will be limited to one, possibly two, in 2019. The direction of monetary policy will, however, ultimately depend on the overall strength of the labor market and its impact on inflation. Thus far, wage inflation, although on an upward trend, has been relatively subdued given the continued decline in the unemployment rate.

The Fed will be cautious when conducting monetary policy in 2019 and could err on the side of being too accommodative. With this theme in mind, any pause in rate hikes will allow inflation pressures to build and potentially lead to more aggressive Fed policy actions down the road. The strength of the economic data and investor and consumer/business sentiment will dictate whether a second rate hike is in the cards toward the end of 2019.

The Fed will continue to reduce the size of its balance sheet—currently at a rate of $50 billion per month. Financial markets will need to continue adjusting to the Fed's winding down of its bond purchasing program. U.S. Treasury and agency mortgage-backed securities (MBS) make up the bulk of the Fed's balance sheet. We do not believe that the unwinding of the Fed's balance sheet will materially affect interest rates.

Fiscal policy will be somewhat limited given increased government deficits in 2019 and beyond. However, the economy should still feel the positive effects from both the TCJA as well as the 2018 Bipartisan Budget Act. The U.S. government will be limited to the extent that it can provide any additional fiscal measures in 2019. Economic growth should still benefit, although to a lesser degree, from the stimulus measures noted above. It is also worth noting that the increasing amount of outstanding U.S. government debt, coinciding with higher borrowing costs, will lead to much higher interest expense—a negative for future discretionary government spending.

Total U.S. Government Debt ($ Trillions) and Interest on Debt ($ Billions)
1/1/2001-10/31/2018



Source: Bloomberg Finance L.P.

Developed international and emerging market economies should hold up better in 2019. Our expectations of global synchronized economic growth did not materialize in 2018, partly due to the strength of the U.S. dollar and uncertainties around trade and monetary policy. In 2019, as U.S. economic growth decelerates, and U.S. bond yields remain relatively stable, we believe economic growth should fare better around the globe. It is important to note that there remains a great deal of accommodative monetary policies outside the United States that will be supportive to global growth.

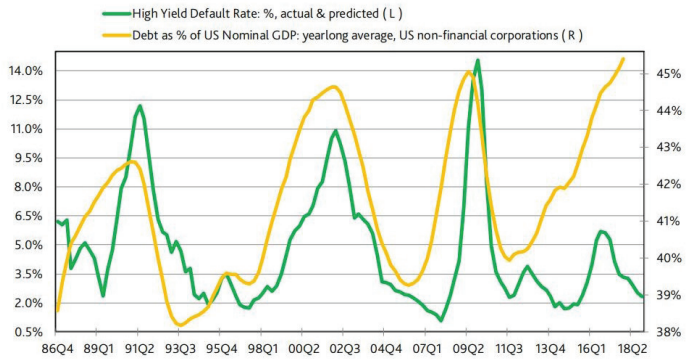
Potential Risks to U.S. Economy

There are many uncertainties and risks developing around the globe that may impact U.S. economic growth to varying degrees. **We expect that trade uncertainty will remain a primary concern in 2019.** Corporations may become more cautious with their spending plans as they continue to monitor ongoing trade discussions. Economic growth could be adversely affected because of the reluctance of corporations to spend—as opposed to the direct implications associated with the total dollar amount of tariffs imposed. The longer the uncertainty lingers, the more detrimental the impact.

Another risk is a potential Fed policy error. An overly hawkish Fed could be very disruptive to financial markets. The stock market sold off abruptly after the most recent FOMC (Federal Open Market Committee) rate hike, as markets seemed to think the Fed was raising rates too aggressively. We think the Fed will proceed with caution but there is a chance that the Fed's neutral interest rate target or federal funds rate that neither stimulates nor hinders economic growth, is at odds with what the markets think it should be.

Corporations have taken advantage of the low-interest rate environment over the years and have increased outstanding debt, relative to GDP, to pre-financial crisis levels. In aggregate, investment grade corporate issuers leverage and interest coverage metrics have worsened. M&A activity is partly to blame as well as stock buybacks and dividend payments. We expect net corporate issuance to taper back in 2019 given higher borrowing costs. The amount of corporate leverage in the system is somewhat alarming and is expected to lead to higher default rates as economic growth slows and borrowing costs increase. High corporate leverage coinciding with higher borrowing costs is a bad combination.

Recent Default Rate and Its Projected Trend
Defy Record Ratio of Corporate Debt to US GDP



Sources: Moody's Analytics, Inc. and Federal Reserve

In Europe, the two issues worth noting are the ongoing Brexit negotiations as well as Italy's budget issues. Both geopolitical issues will continue to weigh on markets. The Chinese economy will also be heavily scrutinized given the current trade war during a period of natural economic transformation. The Chinese economy has been shifting to a more developed, service-oriented economy relative to a historically export-, manufacturing-, and business investment-driven economy.

The final risk we want to point out is the effect market volatility can have on investor and business sentiment. Significant price declines in financial assets can adversely affect how consumers and even businesses spend and allocate capital. Volatility, and the subsequent impact it can have on the economy, is extremely difficult to predict but it is a risk worth noting.

Equities: 2019 Financial Market Expectations

Global equity markets will likely have muted returns in 2019—low-to-mid single digits on the positive or negative side—and higher volatility will likely persist. This dynamic, at least over the near term, will translate to lower Sharpe ratios (risk-adjusted returns) for most risky asset classes.

Using fundamental data, one can back into a low double-digit return for U.S stocks in 2019 using the following building block approach: Dividend Yield (%) + EPS Growth (%) + Δ in Multiple + Δ in FX (international only). The dividend yield for the S&P 500 Index is about 2%; EPS growth is forecasted to be in the high single digits in 2019; and the forward P/E (FY2) is not excessive, currently 15.0x. While this exercise can be useful in trying to gauge longer-term returns, short-term performance is arguably much more influenced by investor sentiment. A slight movement downward in the price multiple that investors are willing to pay for a dollar of earnings (i.e., 15.0x to 14.5x), can offset the positive contribution from EPS growth and dividend yield.

It makes sense in this environment to look for relative value opportunities. Based on our analysis, international stocks, especially emerging markets, continue to look attractive. After reviewing consensus estimates, it appears that U.S. earnings will grow faster in 2019 relative to most other regions/countries around the world; however, the rate of change compared to 2018 could be more subdued for U.S. stocks compared to those of both international developed and emerging markets.

There are no equity markets that are absurdly cheap on a geographic basis, but international equity market valuations are more favorable based on our analysis. In addition, the Fed will proceed cautiously in its campaign to raise short-term interest rates, which would likely put less pressure on foreign currencies. A less aggressive Fed, combined with higher fiscal and current account deficits, will likely cause the U.S. dollar to at least be range bound in the near term.

A strong U.S. dollar since 2011 has been a major headwind for foreign equities. Long-term return differentials (trailing 7-years), especially for emerging markets, are starting to get to extreme levels which historically has resulted in materially better returns for international equities.

Late economic cycle dynamics should probably favor large cap over domestic mid and small cap issues, though some of this may already be reflected in recent price movements. The Russell 2000 Index suffered a more pronounced decline in the fourth quarter of 2018 (-20.20%), compared to a -13.52% return for the S&P 500 Index. We have not reached an extreme reading based on historical return differences. However, if small caps continue to lag, we would look to add exposure in this area.

From a style perspective, value is moderately more attractive than growth. One may question this view given that growth-oriented sectors have typically performed better from the point in time that the yield curve inverts (higher short-term rates relative to long-term rates) to the onset of the next recession and market peak. The reason we like value over growth is that relative valuations are slightly more attractive for value.

In addition, operating margins and Return on Equity (ROE) are high within the style indices, especially large cap growth. We question how sustainable these levels are as the business cycle matures. Net Debt/EBITDA (Earnings Before Interest, Taxes, Depreciation, Amortization) is not excessive within large cap growth but the Russell 1000 Growth Index has the highest Total Debt/Total Capital ratio, as seen over the past 20 years. Large cap technology stocks have been in favor for some time. While this trend has started to unwind, there could be considerably more downside left if momentum investors unwind positions in a disorderly fashion.

Fixed Income: 2019 Financial Market Expectations

We believe long-term interest rates will continue to gradually trend higher in 2019 due to dovish monetary policies leading to wage inflation and above-trend economic growth. We anticipate that further rate hikes by the Fed will keep short-term interest rates rising but at a much slower pace relative to 2018. The Fed will continue with its balance sheet normalization policies while U.S. government deficits lead to more U.S. Treasury security issuance—both factors will put upward pressure on U.S. Treasury yields.

The yield curve will remain modestly upward-sloping, although short periods of inversion may occur. Cautious Fed policy will keep upward pressure on long-term yields while keeping a lid on short-term rates. However, given our expectations of wage pressures building due to a tighter

labor market, we believe the Fed will place more emphasis on controlling inflation at the expense of providing accommodative monetary policy.

We expect that the exchange rates between the U.S. dollar and foreign currencies will be mostly range bound in 2019. We have this view given our interest rate outlook—modestly higher interest rates coupled with decelerating although above-trend economic growth. It is also worth noting that any increased uncertainties around global trade and monetary policy will provide support to the U.S. dollar in 2019.

We expect both U.S. government bonds and higher quality investment grade corporate debt securities to hold up better in 2019. Credit concerns could surface as investors focus on the amount of corporate debt accumulated on balance sheets after many years of low borrowing costs. In our opinion, this will lead to wider credit spreads and, overall, government bonds outperforming investment-grade credit in 2019.

High yield and bank loans will face similar types of credit concerns. In aggregate, credit metrics in the high yield sector are favorable. Both leverage and interest coverage characteristics are at very healthy levels that have contributed to lofty valuations. However, given higher borrowing costs combined with slowing economic growth, we expect a less benign environment for the high yield sector and ultimately wider credit spreads in 2019.

Emerging market debt should fare better given our thoughts regarding global economic growth and a stable U.S. dollar. Although we expect U.S. Treasury yields to trend higher in 2019, we do not foresee the sizeable jump in yields experienced in both 2017 and 2018. It is worth noting that emerging market debt was the worst performing sector in 2018, leading to cheaper valuations and higher yields. Although uncertainty around trade will continue to weigh on prices, we believe current yields will provide a boost to income and, overall, outperform relative to other fixed income sectors.

Treasury Inflation-Protected Securities (TIPS) should fare better in 2019 alongside higher inflation and inflation expectations. Regarding the latter, investors are currently painting a rather lackluster environment for future inflation based on current financial market data. As noted, we believe a patient Fed will support higher wage inflation in 2019, which will lead to higher actual inflation as well as higher inflation expectations—both eventual positives for TIPS.

Mortgage-backed securities should fare well in 2019. We believe declining demand from the Fed will be partially offset by declining MBS originations related to limited refinancing opportunities. We expect interest rate volatility will remain supportive of valuations. The current spread over U.S. Treasury securities is appealing given the sector's higher credit quality and our expectations of supportive interest rate volatility.

Final Thoughts

The global capital markets are deep and varied. Utilizing a mix of investments can manage volatility and risk in a portfolio, helping investors achieve their long-term goals.

It is easy to become complacent as risk assets—stocks, high-yield bonds, etc.—are marching steadily higher and panic during precipitous market declines. Human emotion can be an investor's biggest enemy and can be harmful to long-term wealth creation.

Maintaining proper diversification and revisiting investment objectives and risk tolerance are always important; however, we cannot stress enough how imperative it is to maintain asset allocation discipline, especially given our outlook for continued volatility and more muted returns going forward.

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