Investment Update

July, 2019

2019 Second Quarter Update

Review: The S&P 500 generated a 4.3% return in the quarter. Trade tensions led to a decline in May, but the market bounced back in June on the increased likelihood of a cut to the Fed funds rate and, to a lesser extent, the potential for improved China trade relations heading into the recent G20 meeting. Bond markets also rallied during the quarter, partly due to the potential for a Fed rate cut but also due to concerns about weaker global growth, which led to a decline in yields in most developed markets.

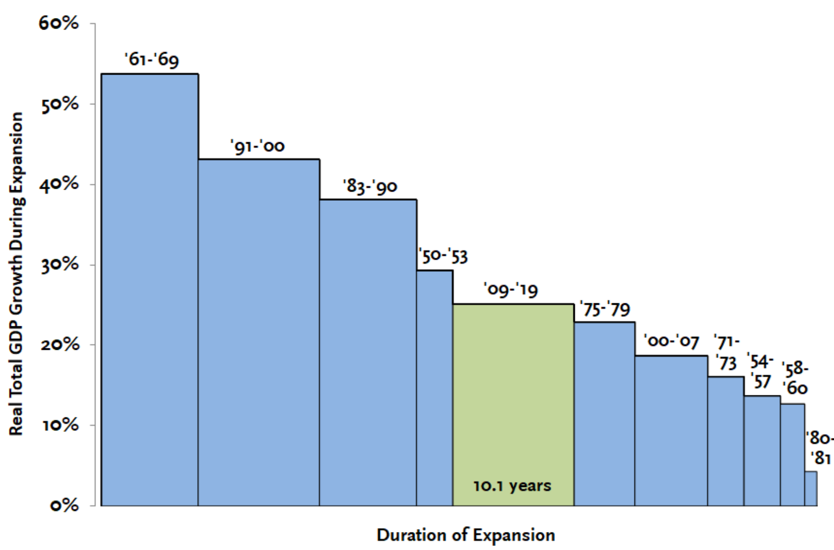
Period	2Q19	1Q19	2018
S&P 500	4.3%	13.6%	-4.4%
MSCI EAFE[1,2]	4.0%	10.1%	-13.4%
MSCI Emerging Markets[2]	0.7%	10.0%	-14.3%
Barclays U.S. Aggregate Bond	3.1%	2.9%	0.0%
Barclays Municipal Bond	2.1%	2.9%	1.3%

[1]Europe, Australia, Far East
[2]MSCI returns are in U.S. Dollars

Longest Economic Expansion on Record

This July will mark the 121st month of the current economic expansion, making it the longest expansion in the US postwar era and, according to the National Bureau of Economic Research (NBER), the longest on record going back to 1854. However, as the chart below indicates, it has not been a robust expansion in terms of cumulative growth. Also, research by the Fed has shown that the duration of expansions in the postwar era is unrelated to the likelihood of recession—that is, expansions do not die of old age. Rather, two key factors have had a meaningful role in economic cycles: 1) actions of the Federal Reserve; and 2) excesses in the financial markets.

Length and Magnitude of U.S. Economic Expansions



Source: Bloomberg May 2019 updated by Middleton in July; original sources NBER and US Bureau of Economic Analysis (BEA)

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Outlook: In its June statement, the Fed noted that it will act "as appropriate to sustain the expansion," implying that a rate cut is more likely than further rate hikes in the near term. We do not take the view that a Fed rate cut is inherently a bad sign about the US economy. The combination of a strengthening dollar, disinflation, and more accommodative policies by the European Central Bank (ECB) and other global central banks makes a Fed rate cut a reasonable course of action at this time. Thus, a Fed-driven recession is less likely in the near term.

Regarding excesses in the financial markets, leverage and debt service obligations among businesses and households are lower than levels seen prior to the last two recessions. This fact, along with accommodative central bank monetary policy, leads us to believe that the economic expansion can continue.

In aggregate, US consumer data continue to be healthy—e.g., solid jobs/wage growth, retail sales growth in line with recent years, and low credit delinquency rates. The biggest question right now is whether trade tensions lead to a slowdown in business spending. Growth in new orders of durable goods has decelerated so far this year, so it will be important in the coming months to see if lower interest rates and a potential de-escalation of trade tensions could reinvigorate new orders.

One additional risk will be potential regulatory headwinds. This could come in the form of antitrust investigations against big tech firms or, depending on the outcome of 2020 elections, attempted changes to the US healthcare system or other policies. However, this risk is difficult to handicap and does not currently factor into our base case projections.

Outside the US, growth continues to decelerate in key economies such as the Eurozone, Japan, and China. Europe faces a critical test in the near term as the ECB will likely resume quantitative easing in an attempt to reaccelerate growth. In the case of China, it is still too early to see if current stimulus efforts there are sufficient to prevent GDP growth from decelerating too rapidly, particularly while trade negotiations with the US are ongoing. Absent further deterioration of international growth, we do not see a significant impact on US earnings beyond what is already factored into estimates.

Strategy: Given our view of US economic conditions and the likelihood of interest rate cuts by the Fed, we continue to prefer domestic equities in the near term, although we will continue to closely monitor economic and market indicators. In fixed income, due to the significant decline in yields during the quarter, we see more value in shorter maturities.