Investment Perspective

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Despite much skepticism, the stock market is advancing due to easing of tariff tensions and additional monetary stimulus from the world's major central banks. In response, the fundamentals that support equities – a combination of moderate growth, mild inflation and low interest rates – remain in place. Fortunately, the positives underpinning this powerful bull market have not elicited euphoria and valuations remain reasonable. Periodically, swift corrections help to cleanse the market of excess as seen in February 2016 and December 2018. We remain encouraged by the opportunity to earn attractive returns by investing in quality small and medium-sized growth companies. However, unresolved developments with Brexit, Middle East turmoil and trade conflicts increase uncertainty and volatility. A summary of year-to-date index returns for the quarter ending September 30, 2019 is as follows:

Dow Jones Industrials	+17.5%	Russell 2500	+17.7%
MSCI EAFE	+12.8%	S&P 500	+20.6%
NASDAQ Composite	+21.5%	Wilshire 5000	+19.6%

GLOBAL ECONOMY

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World economic growth (ex. U.S.) should increase 3.2% this year and improve moderately in 2020. The global economic tone remains cautious, but reflationary actions of the major central banks may boost prospects for global growth. Indeed, growth in Europe and Japan remains low at 1% compared to other regions as both economies deal with an aging population and slowing exports. The European Central Bank continues to battle sluggishness with the aid of negative interest rates and quantitative easing. Japan has adopted yield-targeting to break a multi-decade deflationary conundrum. China is expanding at a 6.0% rate with downside risk as trade problems weaken its export sector. As Brexit approaches, political and trade concerns may negatively impact western European economies. The global trade/industrial slowdown is reducing spending on capital expenditures (capex) while exerting disinflationary pressures. While it is too pessimistic to expect a global recession in the near term, caution is warranted as we are currently experiencing a synchronized worldwide slowdown.

The U.S. economy is expected to grow 2.3% in 2019 and 1.5% next year. Growth in 2020 could improve if trade tensions ease and the manufacturing sector recovers. This year, the consumer sector is growing 2.6%, non-residential capex at 2.5% and government at 2.2%. Positively, the employment situation is healthy with low unemployment (3.5%) supporting wage gains and consumer spending. The Conference Board Consumer Confidence Index

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remains robust at 125, but off the recent highs of the last 12 months. Additionally, household balance sheets remain strong with moderate debt levels compared to historical trends. On the other hand, housing is an area of weakness down 2.7%. Moreover, the manufacturing sector has slumped in the last 12 months. The Institute of Supply Management (ISM) manufacturing survey fell to 47.8 in September after rising to an expansion high of 61.3 in August 2018. Readings below 50 indicate a contractionary period. The combination of trade tensions and slower global growth has subdued activity. Overall, the economic environment is balanced with clear positives and some uncertainties, but U.S. resilience is being increasingly tested. We do not foresee a recession soon, but recognize that this long expansionary cycle will eventually slow down.

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MANUFACTURING & TRADE

The U.S. manufacturing sector is slowing, and some parts of the industrial base may be entering a mini recession like the one experienced in 2015-2016. Recent manufacturing surveys suggest a contraction is resulting from declining exports and continuing uncertainty regarding tariffs. In addition, spillover effects might further hurt demand as companies delay expansion plans due to the uncertain outlook. For example, capex for S&P 500 companies grew just 2% y/y in the second quarter, which is slower than the rate of sales. Trade uncertainty is not the only factor creating headwinds for manufacturing. Vehicle production is slowing both globally and in North America. In the U.S., auto sales have plateaued for the past five years at 17 million units and started to decline. Related, the GM auto workers strike will weaken the automotive supplier base. In the aerospace sector, Boeing's problems have hurt suppliers and are contributing to an overall slowdown in manufacturing activity. These problems may become positives next year. While there are several headwinds, it is important to note that the economy is stronger than weak manufacturing data would indicate. Areas of weakness often receive disproportionate attention by the media, while areas of strength – the U.S. consumer – are often overlooked. The duration of this expansion is longer than historic business cycles and it is normal to periodically experience sector-related weaknesses.

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INFLATION & INTEREST RATES

In response to a softening outlook, the Federal Reserve reduced the federal funds rate twice in the last several months with another cut likely during its next meeting on October 29-30. These are the first interest rate cuts of the new easing cycle. This newly adopted accommodative stance is a substantial change in policy from last autumn when the Fed raised rates for the ninth time in three years. In response, investors have pushed down the 10-year Treasury yield to 1.79% from 3.24% last fall. This decline in long-term interest rates reflects subdued inflation, slowing growth and negative interest rates in Europe. Worries of a potential inverted yield curve have diminished as investors see further declines in short-term interest rates. Importantly, inflation trends in the U.S. are subdued with all measures near the Fed's target range of 2%. The Consumer Price Index (CPI) is up 1.7% y/y and core inflation (excluding food and energy) is 2.4% y/y. The Fed's preferred inflation gauge, the Core Personal Consumption Expenditures (core PCE) Price Index, is up 1.8% y/y. The Federal Reserve is likely to extend the duration of the expansion with these changes in policy. It will take some time before interest rates are high enough on a "real" (inflation-adjusted) basis to suppress economic growth.

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INVESTMENT OUTLOOK

The outlook is mixed, but then again, the future is never clear. It is normal to worry about uncertainty in the investment business. Today's circumstances are not much different than past experiences as investor sentiment fluctuates between enthusiasm and pessimism. Alas, this oscillation creates volatility and potential opportunity! Positively, investors expect a rebound in earnings growth in 2020 with the aid of new monetary stimulus that started in July. Negatively, investors remain alert for "troublesome news" that may disrupt the outlook for earnings. Skepticism remains high as the market navigates various speedbumps.

Currently, S&P 500 operating earnings are forecast to increase 1% in 2019 to $164 with expectations of a reacceleration to 8% growth in 2020 based upon $177 of operating earnings. Earnings growth is negligible this year for two reasons. First, companies are lapping the benefit of tax cuts that boosted earnings in 2018. Second, global growth has slowed and the operating environment is weaker. In coming quarters, earnings growth is expected to trough and then accelerate due to the benefits of monetary easing and reduced tariff noise. This improvement may refresh the current bull market.

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Overall, the equity market is supported by a constructive backdrop that includes moderate growth, low interest rates and mild inflation. However, price gains may be tempered in the near term due to a lack of confidence. Investor sentiment would improve if the administration's tariff battle with China subsided. Importantly, the stock market is reasonably valued at 17.0x S&P 500 operating earnings of $177 per share for next year, especially considering dividend yields around 2% for the DJIA and S&P, a 10-year Treasury yield of 1.79% and core PCE inflation of 1.8%. Historically, equities perform well in periods when the opportunity cost of money is low. Today, investors can not earn a decent long-term return on fixed income instruments (which yield less than inflation). Investors will eventually expand into long-duration assets, like equities, in search of investment returns that exceed the hurdle rate of inflation and the financing cost of money.

Investor sentiment would improve if the administration's tariff battle with China subsided

Companies in the S&P 500 continue to repurchase stock at a brisk pace near record levels although somewhat less than in 2018. This year's buyback pace is approximately $750 billion, and the sum of dividends and buybacks will approximate $1.3 trillion, which equates to an "owner's yield" of 5.25%. This is impressive when you compare the 5.25% yield on ownership to the 1.79% yield for lending. Clearly, it is better to be an owner than a lender. Not only can you earn a better yield, but you have opportunities for growth in equities not possible with bonds.

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From a technical perspective, the secular bull market trend is intact. Positive trends are evident with the 50-day moving average higher than the upward sloping 200-day average. The market is experiencing industry rotation. Defensive sectors and bond proxies, such as consumer staples, REITs and utilities have been performing better recently, whereas the energy, healthcare and industrial sectors are losing momentum. Smaller growth companies, especially healthcare, have lost momentum, but look poised to benefit as investor sentiment improves. The VIX (CBOE Volatility Index) recently increased to 18 in early October, reflecting nervousness regarding trade tensions and a slowing economy, but has since subsided to 14.

From a seasonal perspective, we are entering a favorable period for stock market returns. Historically, the November to April period is the strongest for the market and combined with two recent cuts in the fed funds rate, the S&P 500 is usually up 11% and 18% in the next six and 12 months, respectively. The risks to the outlook primarily relate to politics and trade conflicts. Other risks include a Chinese slowdown, cyber-attacks, disappointing earnings, military conflicts, terrorism and unexpected inflation. The investment environment is marked by incredibly low interest rates and mild inflation, which should yield higher valuations for equities as the discount rate used by long-term investors declines. We are amidst a period of short-term headwinds running up against positive long-term tailwinds. Investors who react emotionally to short-term movements risk making ill-timed decisions that compromise long-term performance. Equities are inexpensive relative to bonds and we look forward to above-average performance results in the year ahead. We favor quality small and medium-sized growth companies as they are best positioned for success in most market environments.