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~OUR CHIEF INVESTMENT OFFICER'S COMMENTARY~

The summer months are often interesting in the equity markets, and this summer was no exception. In so far as the stock market is a clearing mechanism, pairing buyers with sellers, the lower participation due to vacations and reduced analyst coverage, combined with lower trading volume, often produces exaggerated responses to surprise announcements by individual companies. While these reactions are usually of short duration, they are often dramatic and disconcerting. While we saw quite a bit of this during the quarter, and surprising volatility in individual stocks, this volatility never really translated into broad market moves. **Indeed, after the brief period of increased market volatility during the first half of the year, with thirty-six days of greater than 1% volatility compared to eight days in all of 2017, there have been no days with greater than 1% volatility since mid-year.**

As we have explained in the past, volatility is not necessarily an indicator of future direction as much as it is a reaction to surprise or a reflection of uncertainty in the markets. **During the first half of the year, volatility expressed the market reaction to increased earnings growth due to the magnitude of corporate tax cuts, offset by a concern that the Federal Reserve Bank might become too aggressive in an effort to counter this aggressive fiscal stimulus with restrictive monetary policy.**

During the third quarter, the markets trended toward an equilibrium, or consensus, that the increased corporate profits resulting from tax reform were being used for investment in productivity to a greater extent than had been anticipated, instead of being returned to shareholders as special dividends, share buybacks, or mergers and acquisitions. **As a consequence, this has led many economists to extend the horizon for this already long economic cycle.**

The headlines, during the quarter, continued to focus on the so-called "trade war" between the U.S. and its trading partners. **While these headlines weighed on the market, investors are beginning to see the rhetoric as a hardball negotiating strategy to lower tariffs, rather than a move to isolationism.** We discuss this in detail in the international section of this newsletter.

As the quarter drew to a close, the markets began to recognize another source of meaningful near-term stimulus. Every four years, in the U.S., we hold mid-term elections. These are the elections where the public chooses state and local officials as well as representatives to the federal government. In order to help their re-election, incumbent politicians of both parties approve spending for public works projects to stimulate their local economies. Since this election is more controversial than usual, we expect higher spending for these projects. The money spent for these projects typically has a higher multiplier; i.e. it circulates through the economy with a greater impact than the initial dollars spent. In every mid-term election going back the past twenty-four years, this stimulus has produced higher stock prices, reflecting higher economic growth starting just before the election and lasting for a couple of quarters after the election. **Since this increased stimulus is adding to already robust earnings growth momentum, we expect upside surprise to both the economy and the stock market into 2019.**

Our outlook for the economy is further reinforced by the continuing positive trend of the Composite Index of Leading Indicators, which continues to signal a growing economy. The Index is comprised of 10 economic components whose changes tend to precede changes in the overall economy. As long as the Index continues to rise, the economy is expected to grow; when it turns down, the economy is expected to begin to slow. Recent data indicates one of the components, real consumption growth, remained strong in the quarter. **With consumer confidence remaining high due to labor market conditions and a boost to disposable income due to tax cuts, we expect consumer spending to remain strong through the remainder of the year.**

A modest offset to all this good news is that the dollar has appreciated more than 8% since mid-April, and that has begun to weigh on output in producer manufacturing. At the same time, energy prices are spiraling higher and are expected to remain strong for the rest of the year.

At a recent meeting of the Federal Reserve, initial guidance was provided for interest rate policy and the outlook for economic growth in 2020 and beyond. **While the Fed seems to support our positive view on near term earnings growth, of more significance is their forecast of continued, albeit decelerating, growth in 2020 with only the possibility of a shallow recession in 2021.**

Fixed Income

As expected, the Federal Open Market Committee (FOMC) increased the federal funds target rate by a quarter point during its September meeting, marking its third hike of the year. Over two and a half years into the Fed's tightening cycle, the federal funds rate has been gradually raised to a target range of 2.00-2.25%. **When the Fed raises interest rates, it is trying to increase borrowing costs for businesses and consumers to help keep the economy from overheating. So far, the impact has been modest.** The economy has continued to improve with unemployment reaching new lows and price inflation remaining stable. Although borrowing costs are rising, the depressed savings rate on cash may start to see a boost as well.

The level of interest rates relative to the neutral or equilibrium rate is what affects the economy, and the FOMC will continue to raise interest rates until this perceived rate is reached. The money tightening already in place will begin to have an impact over the next few years. That, together with the fading of the boost from fiscal stimulus, is why we expect the pace of quarterly GDP growth to begin to slow towards the end of next year. The market currently anticipates the FOMC will implement its fourth rate hike of the year at its December meeting, which would raise the fed funds target rate to 2.25-2.50%. **The big question is whether the Fed will maintain its steady pace of hiking rates in 2019 or halt its monetary normalization policy should economic growth begin to slow.**

The Fed's rate hikes have continued to push short-term rates higher relative to the movement in long-term rates, and as a result, the yield curve has continued to flatten. A flat yield curve generally occurs when the market is transitioning from a normal to an inverted yield curve. A normal yield curve occurs when investors expect higher yields for bonds with long-term maturities than those with short-term maturities, which generally carry less risk. The curve flattening has drawn investor attention due to a concern that anticipated higher short-term rates may eventually lead to an inverted yield curve. The spread between 2-year and 10-year yields has inverted before every recession since 1975, with only one inversion where a recession did not ensue. But, an inverted yield curve is only one leading indicator of past recessions which occurred during very different monetary policy circumstances. **Given the dynamics of the current Fed balance sheet normalization, which continues to pressure long-term rates lower, the past relationship between short and long-term rates and previous recessions may not be historically relevant. We therefore look to the Composite Index of Leading Indicators to provide a more reliable signal of future economic direction than the shape of the yield curve.**

Over the long-term, it's important to remember the fundamental benefits that bonds bring to a risk averse portfolio regardless of which way rates move – capital preservation, income and portfolio stability. While bond prices typically fall when rates rise, the yield for bonds also rises. Earning the yield and reinvesting into higher yields over time will help to offset any initial negative price impact of rising rates and may increase a bond portfolio's overall long-term return potential.

International Market

The trade conflict between the U.S. and China continued to dominate headlines during the latest round of tariff spats. The resulting uncertainty has not only stoked investor concerns, but also weighed on many corporations as the term "tariff" was mentioned repeatedly during quarterly earnings calls. **While the tariff disputes have been labeled a "trade war" in the headlines, in reality it is simply a renegotiation of trade treaties that is long overdue.** As we pointed out in our last newsletter, "during the renegotiation of any treaty, rigid postures and harsh rhetoric are merely tactics used to obtain the best possible deal acceptable to all parties. We continue to view the escalating trade tensions as a means to accomplishing a goal, not the goal itself." That belief has not changed, and our view is bolstered by the joint trade announcements from the bilateral agreement between Mexico and the U.S., and from the late-July meetings between E.U. President Jean-Claude Juncker and President Trump.

Despite the move forward, headlines continue to misleadingly label the tariff disputes as an escalating "trade war." Characterizations such as "the trade war between China and the U.S. would spark global economic crisis and trigger a recession" continue to flood the news channels, and many attribute the trade-related uncertainties as the disruptive force for the next global downturn. Although ongoing trade uncertainty has naturally increased volatility in the market, we view the reaction as psychological, not based on fundamentals, and short-term in nature. **Bilateral trade between the U.S. and China accounts for only 3.2% of world trade; although sizable, it is not a significant level that would likely reverse the trend of international trade. It is worth noting that a deterioration in trade from this bilateral relationship would shift demand to other trading partners who stand to benefit from an increased market share.** The relatively stable shipment of soybeans from the U.S. would serve as a prime example. After imposing tariffs on U.S. soybeans, China turned to Brazil to fulfill their soybean demand. Just as Brazil's supply is increasingly sent to China, other buyers of soybeans from Brazil must fill their demand elsewhere. This opens up increased demand for U.S. soybeans from other countries, in particular European countries. As a result, the net effect to the aggregate global economy has been greatly diminished.

We continue to view the "trade war" as trade tensions, which are not severe enough to trigger a major global downturn. Even in a worst case scenario where tensions escalate to a true global trade war with every government imposing tariffs on all imports, the most significant impact would be the costs associated with the loss of efficiency from businesses relocating resources to minimize the tariff. A study by Capital Economics concluded that if all governments were to impose a blanket tariff of 25% on all imports, the estimated impact to world Gross Domestic Product (GDP) would be a decline of 2 to 3%. This estimate is in line with similar analyses from governmental agencies such as The Organisation for Economic Co-operation and Development (OECD) and the World Bank, and from academic researchers such as 2008 Nobel Prize recipient, Professor Paul Krugman of Princeton University. **Impact of this magnitude would lower the world GDP growth rate for the next five years from an anticipated 3.5% annual rate to 3.3%; still a long way from the negative growth rate which would define a global recession.**

China has a bargaining disadvantage with the U.S. due to the imbalance of total goods and services that are exported versus the amount imported from the U.S. Despite the disadvantage, we view the potential negative impact on the real economy as still manageable in a worst case scenario. As China transitions away from a manufacturing and export-oriented economy to a consumer and service-oriented economy similar to the U.S., its growth becomes less reliant on exports. During the last four decades, China's export growth rates have fluctuated, yet GDP growth has remained relatively stable. Chinese dependence on exports has continued to decline over the past decade, with exports, as a percentage of total Chinese GDP, having fallen from a peak of 32.6% in 2006 to 18.1% in 2017. During the same period, the share of exports to the U.S. as a percentage of Chinese GDP has fallen from 10.5% to 4.1%. According to the National Bureau of Statistics of China, the direct domestic value-added content is roughly 25% on Chinese exports to the U.S. **These figures suggest that even if Chinese exports to the U.S. came to a complete halt, the real impact to China's GDP would be a decline of 1%. A reduction of this size is quite manageable in the aggregate, especially for an economy growing at an average annual rate of more than 6%.**

Uncertainty is never a friend to the equity market. **However, investors should avoid over-interpreting every twist and turn in the "trade war" saga and maintain a long-term perspective.** The more muted market reaction on tariff news toward the end of the quarter supports our earlier comment that "we, and the market, are beginning to see the rhetoric as a hardball negotiating strategy to lower tariffs, rather than a move to isolationism." We welcome this improvement and believe positive developments will continue. With more than 75% of global GDP generated outside the U.S., accounting for more than 80% of the growth, we continue to recommend holding an acceptable level of risk-adjusted exposure in international equities.