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QUARTERLY UPDATE

Second Quarter / 2019

HIGHLIGHTS

- **U.S. equities closed Q2 on a high note after President Trump and Chinese President Xi agreed to suspend imposing additional tariffs and resume trade negotiations.**
- **Investor sentiment rose after the Fed indicated that a future interest rate cut may be appropriate should economic conditions deteriorate.**
- **A "great divide" keeps brewing between the stock and bond markets as U.S. Treasury yields drop amid rising equity prices.**

OVERVIEW

Following May's steep sell-off, U.S. equities marked one of their strongest June performances in decades, after the Federal Reserve (the Fed) asserted earlier in the month its willingness to "act as appropriate" in order to sustain the current economic expansion, leaving the door open for interest rate cuts later this year. In response, investors' appetite for riskier investments surged, since lower interest rates are likely to help stimulate the economy, as lower financing costs make it cheaper for companies to borrow and grow their businesses.

Meanwhile, President Trump agreed with Chinese President Xi at the Group of 20 (G-20) Summit in Japan to resume trade negotiations, alleviating investors' fears of a full-blown tariff war. President Trump further added that he would loosen up restrictions on telecommunications giant Huawei, allowing U.S. companies to sell their products to the Chinese company after previously imposing a ban due to national security concerns. In exchange for flexibility on Huawei, President Trump stated that China agreed to increase purchases of U.S. agricultural products. The long-running trade dispute between the U.S. and China has served as a handbrake on the global economy over recent months, dragging down global manufacturing and factory output as international imports and exports declined.

While the G-20 meeting didn't yield any major breakthrough in resolving the trade conflict, investors welcomed the more conciliatory tone from the leaders of the world's two largest economies. Trade negotiations had soured in early May, igniting a global market sell-off and a spike in corporate and investor uncertainty. However, hopes of looser monetary policy and optimism of a possible trade compromise helped the S&P 500 soar to record highs in June, marking its best first-half performance since 1997. Year-to-date, the S&P 500 rallied by 18%. In turn, the NASDAQ Composite index gained 21%. Further, July 1 officially marked the current expansion as the longest in U.S. history — ten years or 120 months — highlighting the resiliency of the U.S. economy despite a backdrop of heightened geopolitical tensions and expectations of slower global growth.

U.S. EQUITIES SURGE AS THE U.S. ECONOMY MARKS LONGEST EXPANSION IN HISTORY

During the second quarter, the U.S. economy continued to grow at a steady pace despite facing growing uncertainties. On July 1, the ongoing U.S. economic expansion reached its 121st month, becoming the longest in history. However, the current economic expansion has been relatively slower than previous periods of economic growth. The U.S. economy has grown at an average rate of 2.3% per year since 2009, well below the pace witnessed in previous years. And, while the U.S. economy at large has been able to absorb the damage from China's retaliatory tariffs, domestic manufacturing indexes have fallen to the lowest levels seen during the Trump administration, reflecting weaker demand and fears that recent trade escalations are leading companies at home and abroad to retrench on spending and investment. IHS Markit's Manufacturing Purchasing Managers' Index — a gauge used by economists to measure the health of the U.S. economy — declined to 50.1 in June from 50.5 in May, reaching multiyear lows. U.S. manufacturers attributed the pullback to several factors, including escalating trade tensions, cooling global growth and increasing costs stemming from tariffs. While the manufacturing sector accounts for a relatively small fraction of the U.S. economy, market participants have become increasingly concerned that the longer the slowdown continues and the wider it spreads, the more likely it is to drag on other parts of the economy.

Further, the escalation in trade and tariff tensions also shook consumers' confidence and future expectations. The Conference Board's consumer confidence index — a measurement of consumers' assessment of the current U.S. economic climate — declined to 121.5 in June, as consumers expressed fears about business and labor market conditions. The monthly gauge of consumer optimism is closely watched by economists as a predictor of future household spending and investment habits. The decline in consumer confidence came as President Trump threatened to impose tariffs of 10% on all Mexican imports to the U.S., along with another tranche of taxes on $300 billion in Chinese goods.

Yet many other economic indicators still point to a healthy economy. U.S. existing home sales rose 2.5% in May, fueled by low mortgage rates. Meanwhile, the number of Americans filing applications for unemployment benefits fell more than expected during the last week of June, showcasing the labor market's resiliency despite a sharp slowdown in job growth in May. Further, household debt is below the historical average, while low interest rates give consumers bandwidth to borrow in order to supplement household spending.

TRADE OPTIMISM BOOST:
INTERNATIONAL EQUITIES BEGAN THE SECOND HALF ON A BRIGHT NOTE

In international markets, emerging market equities remained on course for their best monthly performance since January, although risk appetite was kept in check by doubts the U.S. and China would make progress in resolving their trade dispute. The percolating trade spat is beginning to show signs of drag on the Chinese economy, with the Caixin/Markit Manufacturing Purchasing Managers' Index (PMI) for June falling below expectations to 49.4. Economists had expected the indicator to come in at 50. A PMI reading above 50 indicates expansion, while those below that figure signal contraction. To deal with the economic challenges, Chinese policymakers have released a range of stimulative measures and are expected to launch more if needed. Premier Li last week pledged to cut real interest rates on financing for small and micro firms.

Global markets also received a boost late in June when ECB President Draghi reiterated his view that the central bank is prepared to use all available tools at its disposal to support growth and reach its inflation target.

Oil prices jumped in June following reports that Saudi Arabia and Russia signaled their support for an extension of OPEC output cuts in response to a weaker demand outlook due to slowing global growth. Additionally, bellicose tensions between the U.S. and Iran escalated after Iran shot down a U.S. surveillance drone over the Strait of Hormuz earlier this month, further driving oil prices higher.

A "GREAT DIVIDE": RECONCILING MESSAGES FROM THE BOND AND EQUITY MARKETS

On the fixed income front, dovish monetary policy statements from the Fed, ECB and Bank of Japan sent global bond yields lower for the quarter. U.S. and China trade tensions, global growth concerns and falling inflation expectations drove demand for safe haven assets — such as U.S. government debt — higher, as investors risk appetite dwindled. Low inflation, particularly, boosted investors' demand for bonds as it is usually a sign of slowing growth ahead. In June, the U.S. 10-year Treasury yield dropped below 2.0%, its lowest level since 2016.

Bond investors see the falling 10-year yield — a barometer that helps set borrowing costs on everything from houses to corporate loans — as a sign that the U.S. economy is likely to continue growing at a slower pace. The drop in yields also reflects the challenges central banks across the globe are facing while attempting to normalize rates after a decade of unusually low levels. While global equities surged to close out the second quarter on a high note, the looming threat of a full-blown tariff trade war and a global growth slowdown shook financial markets. Throughout the quarter, the yield on the U.S. 10-year Treasury note moved lower as investors piled into less risky investments.

Investors have been worried that a fallout from the tariff dispute could hurt global economic growth and corporate profits. Those concerns prompted the Fed last month to declare its willingness to cut interest rates if the U.S. trade war with China deepens and poses a "downside risk" to its outlook. Consumer prices, as measured by the personal consumption expenditures (PCE) price index, rose 0.2% last month, meeting economists' expectations. In the 12 months through May, the PCE price index increased 1.5%, slowing from April's 1.6% increase and remaining well below the Fed's target level of 2%. Fed policymakers worry that if inflation remains below the target when the economy is healthy, prices could stagnate or even fall during a recession. A decline in the overall price level — called deflation — can prolong and exacerbate economic downturns by encouraging consumers and businesses to delay purchases and investments.

CONCLUSION

During Q2, investors witnessed conflicting signals from the equity and bond markets. U.S. stocks have rallied sharply since the late December sell-off and currently reflect a more optimistic outlook than the bond market, which views with caution the trend of falling Treasury yields. Further, the inverted U.S. Treasury yield curve — a formidable predictor of future recessions which occurs when long-term yields dip below short-term yields — widened, suggesting weaker growth ahead. This "great divide" between the messages stemming from the equity and bond markets is sending mixed signals to investors who are trying to get a read on the disconnect reflected by a simultaneous rally in both equity and bond markets.

While the current expansion is showing some signs of aging, it is worth noting that economic expansions have historically come to an end due to signs of over-exuberance (such as during the dot-com bubble), an external shock (oil), or overly restrictive monetary policy by central banks. Presently, we do not see any of those conditions threatening the decade-long expansion. And while inflation has been muted and the pace of growth has been slower than in previous years, we believe the current expansion still has room to run.

Investors can take steps to ensure that they are positioned properly in order to navigate the current investment environment by having an appropriate mix of equities and bonds in their portfolios that matches their risk tolerance. Diversification may also help investors mitigate risk in times of heightened volatility, while sticking to long-term investment goals can help provide perspective during periods of heightened market anxiety. We expect the market to continue to experience periodic spikes of volatility stemming from the ongoing — and developing — trade spat, among other geopolitical concerns, including the upcoming U.S. election and Brexit. However, corporate earnings and U.S. economic fundamentals are still likely to continue supporting U.S. equities, and investors should take advantage of periodic dips in the markets to increase diversification by adding quality assets with strong balance sheets at discounted prices.

FINANCIAL MARKET RETURNS

U.S. Equity	Q2 2019	YTD	1 Year	3 Year (Annualized)	5 Year (Annualized)	10 Year (Annualized)
DJ Industrial Average	3.2%	15.4%	12.2%	16.8%	12.3%	15.0%
NASDAQ Composite	3.9%	21.3%	7.8%	19.6%	14.0%	17.2%
S&P 500 TR Index	4.3%	18.5%	10.4%	14.2%	10.7%	14.7%
Russell 1000 Index	4.2%	18.8%	10.0%	14.1%	10.5%	14.8%
Russell 1000 Growth Index	4.6%	21.5%	11.6%	18.1%	13.4%	16.3%
Russell 1000 Value Index	3.8%	16.2%	8.5%	10.2%	7.5%	13.2%
Russell Mid Cap Index	4.1%	21.3%	7.8%	12.2%	8.6%	15.2%
Russell Mid Cap Growth Index	5.4%	26.1%	13.9%	16.5%	11.1%	16.0%
Russell Mid Cap Value Index	3.2%	18.0%	3.7%	8.9%	6.7%	14.6%
Russell 2000 Index	2.1%	17.0%	-3.3%	12.3%	7.1%	13.4%
Russell 2000 Growth Index	2.7%	20.4%	-0.5%	14.7%	8.6%	14.4%
Russell 2000 Value Index	1.4%	13.5%	-6.2%	9.8%	5.4%	12.4%

International Equity	Q2 2019	YTD	1 Year	3 Year (Annualized)	5 Year (Annualized)	10 Year (Annualized)
MSCI EAFE Index (USD, net)	3.7%	14.0%	1.1%	9.1%	2.2%	6.9%
MSCI AC World Index (USD, net)	3.6%	16.2%	5.7%	11.6%	6.2%	10.1%
MSCI AC World Ex U.S. Index (USD, net)	3.0%	13.6%	1.3%	9.4%	2.2%	6.5%
MSCI Emerging Markets Index (USD, net)	0.6%	10.6%	1.2%	10.7%	2.5%	5.8%
MSCI BRIC Index (USD, net)	-0.2%	13.8%	3.3%	14.4%	4.7%	4.8%

Fixed Income	Q2 2019	YTD	1 Year	3 Year (Annualized)	5 Year (Annualized)	10 Year (Annualized)
Bloomberg Barclays U.S. Treasury 1-3 Year Index	1.5%	2.5%	4.0%	1.3%	1.2%	1.2%
Bloomberg Barclays U.S. Treasury 5-10 Year Index	3.5%	6.1%	9.1%	1.4%	3.0%	4.0%
Bloomberg Barclays U.S. Long Treasury Index	6.0%	11.0%	12.3%	1.3%	5.7%	6.5%
Bloomberg Barclays U.S. Treasury U.S. TIPS Index	2.9%	6.2%	4.8%	2.1%	1.8%	3.6%
Bloomberg Barclays U.S. Govt/Credit Intermediate Index	2.6%	5.0%	6.9%	2.0%	2.4%	3.2%
ICE BofAML Municipals 1-10 Year A-AAA Index	1.5%	3.6%	5.1%	1.8%	2.1%	2.9%
Bloomberg Barclays U.S. Corporate High Yield Index	2.5%	9.9%	7.5%	7.5%	4.7%	9.2%
ICE BofAML Preferred Stock Fixed Rate Index	3.0%	12.0%	7.1%	4.9%	6.1%	8.6%
JPMorgan GBI EM Global Diversified Index	5.6%	8.7%	9.0%	4.2%	-0.5%	3.4%

Source: Bloomberg, Morgan Stanley Capital International, Russell®, Standard and Poor's and Barclays.

INDEX DEFINITIONS

U.S. EQUITY

Dow Jones Industrial Average: is a price-weighted average of 30 actively traded blue-chip U.S. stocks

NASDAQ Composite Index: is a market capitalization index of approximately 3,000 common equities listed on the NASDAQ exchange

S&P 500 TR Index: is a type of equity index that tracks both the capital gains of the equities in the S&P 500 and assumes any cash distributions (dividends) are reinvested back into the index

Russell 1000 Index®: measures the performance of the 1,000 largest companies in the Russell 3000

Russell 1000 Growth Index®: measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values

Russell 1000 Value Index®: measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values

Russell Mid Cap Index®: measures the performance of the 800 smallest companies in the Russell 1000 index

Russell Mid Cap Growth Index®: measures the performance of those Russell Midcap® companies with higher price-to-book ratios and higher forecasted growth values. The stocks are also members of the Russell 1000 Growth index

Russell Mid Cap Value Index®: measures the performance of those Russell Midcap® companies with lower price-to-book and lower forecasted growth values. The stocks are also members of the Russell 1000 Value index

Russell 2000 Index®: measures the performance of the 2,000 smallest companies in the Russell 3000 index

Russell 2000 Growth Index®: measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values

Russell 2000 Value Index®: measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values

INTERNATIONAL EQUITY

MSCI EAFE Index: is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada

MSCI AC World Index: is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets

MSCI AC World Ex U.S. Index: captures large and midcap representation across 22 of 23 developed marketing countries (excluding the US) and 23 Emerging Markets countries

MSCI Emerging Markets Index: is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets

MSCI BRIC Index: is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance across the following 4 emerging market country indexes: Brazil, Russia, India and China

FIXED INCOME

Bloomberg Barclays U.S. Treasury 1 — 3 Year Index: measures the performance of U.S. Treasury securities that have a remaining maturity of at least one year and less than three years

Bloomberg Barclays U.S. Treasury 5 — 10 Year Index: measures the performance of U.S. Treasury securities that have a remaining maturing of at least five years and less than 10 years

Bloomberg Barclays U.S. Long Treasury Index: includes all publicly issued, U.S. Treasury securities that have a remaining maturity of 10 or more years, are rated investment grade, and have $250 million or more of outstanding face value

Bloomberg Barclays U.S. Treasury U.S. TIPS Index: the index includes all publicly issued U.S. Treasury inflation-protected securities that have at least one year remaining to maturity, are rated investment grade, and have $250 million or more of outstanding face value

Bloomberg Barclays U.S. Govt/Credit Intermediate Index: the index measures the performance of the USD-denominated U.S. Treasuries, government-related and investment grade U.S. corporate securities that have a remaining maturity of greater than one year and less than ten years

Bloomberg Barclays U.S. Corporate High Yield Index: measures the USD-denominated, high-yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issues with an emerging markets country of risk, based on Barclay's EM country definition, are excluded

ICE BofAML Municipals 1-10 Year A-AAA Index: is a subset of the BofAML U.S. Municipal Securities Index and includes all securities with a remaining term to final maturity less than 10 years and rated AAA through A3, inclusive

ICE BofAML Preferred Stock Fixed Rate Index: this index is designed to replicate the total return of a diversified group of investment-grade preferred securities

JPMorgan GBI EM Global Diversified Index: is an investable benchmark that includes only those countries that are directly accessible by most of the international investor base. This index excludes countries with explicit capital controls, but it does not factor in regulatory/tax hurdles in assessing eligibility

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