2018 REVIEW

2018 was marked by a divergence in the performance of the U.S. economy and that of the equity markets. As expected, U.S. economic growth accelerated in 2018 supported by the healthy consumer and increased business spending. While the pace of growth in the final quarter of the year likely fell to around 2.5%, the economy grew at a 3.0% pace for the full year. This is the fastest growth in more than 10 years. The impact of deregulation and tax cuts helped drive increased demand and led to strong gains in corporate sales and earnings. Sales for S&P 500 companies were up around 7% for the year, while earnings-per-share rose about 20% versus 2017. Despite all the positive news, we experienced increasing volatility, especially in the fourth quarter, and a significant correction in the equity markets as fear overcame fundamentals. Investors became increasingly concerned about the potential for a policy mistake from the Federal Reserve (Fed), a trade war with China and an overall slowdown in global economic growth leading to a recession. After reaching a high of 2,931 in September, the S&P 500 fell during the fourth quarter to end the year at 2,506, a decline of 19.8% from the peak. For the full year, the S&P 500 fell -4.4%. The energy sector struggled throughout the year as the price of oil dropped 25%. Healthcare, Utilities and Consumer Discretionary sectors were the only ones to end the year with positive returns. Fixed Income markets also saw some increased volatility driven by an active Fed that raised the Federal Funds rate (Fed Funds) three times during the year. Ten-Year Treasury yields reached a peak of 3.24% in November, before falling to 2.68% at year-end, as investors shifted to the relative safety of Treasury securities.

THE DRIVERS OF ECONOMIC GROWTH REMAIN FOR 2019

As 2019 begins, the fundamental outlook remains positive. The key drivers of economic growth remain in place, including a healthy consumer and a supportive business environment. The fiscal stimulus enacted last year will continue to benefit both consumers and businesses and provide an additional tailwind for the economy. Economic growth in the U.S. and internationally is expected to be above trend, albeit slower than in 2018. While many of the concerns that weighed on investors' minds remain, we do not expect them to have a significant impact on economic activity. Instead we expect these concerns to increase the level of volatility in the market. Financial market corrections are not an unusual occurrence and short-term dislocations between the fundamental performance of the economy and the performance of equity markets can occur, but generally do not persist over the longer term. Equity markets remain attractive supported by economic growth and rising profitability.

The Strong Labor Market and Tax Policy Continue to Support the Consumer.

Despite the equity market decline in December, consumer confidence, which is correlated with consumer spending, remains near recent highs. The consumer's contribution to GDP growth has been a constant throughout most of this economic recovery, and we do not expect that to change as we move into 2019. Consumer spending accounts for about 70% of GDP and the consumer continues to benefit from the strong labor market. The U.S. added 2.3M new jobs in 2018, including 776,000 in the fourth quarter. Disposable income is rising through wage increases and the impact of tax cuts. Average hourly wages rose 3.2% in 2018, the fastest pace since the end of the recession in 2009. The tax cuts had an immediate impact on workers' paychecks last year and, for many taxpayers, will lead to larger refunds this year. The recent decline in oil prices has also had a positive impact on the consumer as the average cost of a gallon of gas has fallen 24.5% since its peak in May. While somewhat higher interest rates have had an impact on interest rate sensitive sectors like Autos and Housing, overall consumer spending remains strong. Early data shows the holiday shopping season was strong, with sales increasing 5.1% versus last year, the largest increase in six years. Consumer debt levels have increased somewhat, but remain manageable at current income levels, and we have not seen a deterioration in consumer credit performance.

Deregulation and Tax Policy Drive Business Optimism.

The outlook for the business sector is also positive. The impact from corporate tax cuts and repatriation will continue to drive business spending and add an additional support to overall GDP growth. Small business, in particular, is benefiting from the ongoing effort to reduce regulation and make it easier for people to start and grow businesses. While optimism, as measured in both small-and-large business surveys, declined a bit in the fourth quarter, it remains near record highs. Business leaders have expressed some concerns about the timing of new investment, considering the uncertainty of the outcome of trade deals. In the first quarter, we expect Congress to debate and eventually pass the newly-negotiated trade deal with Mexico and Canada that will replace NAFTA. In addition, the temporary pause in tariff escalation and restarting of trade talks with China are positive signs. Once the uncertainty of the tariffs is resolved, businesses will have a better ability to plan and invest for the future.

The Outlook for the Global Economy Remains Positive.

While the pace of growth is slowing globally, economic activity is still above trend and overall global GDP growth is expected to exceed 3.0% again this year. Following the fiscal stimulus passes in the U.S. in 2018, it is expected that we will see some fiscal stimulus enacted in other regions and countries this year to support further economic growth. Growth in China has been slowing for the past several years as the government implements structural changes focused on the quality of growth and not the quantity of growth. It is expected that Chinese GDP will expand between 6.0% and 6.5% in 2019. Both Europe and Japan are expected to show modest positive growth this year. Europe is forecast to grow 1.5% and Japan around 1.0%. While lower than U.S. growth, these levels are above trend since the end of the recession. Emerging market economies in Europe are expected to grow 2.5%, while emerging Asia is forecast to generate economic growth around 6.3%. After several years of struggling, Latin American countries are expected to see growth accelerate from 0.7% to 2.6%. Central Banks outside of the U.S. still maintain accommodative monetary policy, and any new fiscal stimulus could provide an additional boost. There remain some headwinds from Brexit and other geo-political risks, but overall the positive outlook for the global economy remains intact.

FINANCIAL MARKET VOLATILITY IS RETURNING TO MORE TYPICAL LEVELS

Prior to 2018, Market Volatility was Historically Low

Market volatility is a by-product of investor uncertainty and fear. For the last several years, we have seen historically low levels of volatility in both equity and fixed income markets. That began to change in 2018, and we expect continued volatility in 2019. In part, the low level of volatility we have experienced over the last 6 years is due to the unprecedented accommodation from the Fed, which kept interest rates near zero, while providing excess liquidity to the markets in the form of quantitative easing. This easy-money policy led to some complacency as investors believed that the Fed action would mitigate any short-term disruptions. We are now several years into the normalization of Fed policy, and it is not surprising that the unwinding of easy policy would lead to more volatility in the markets. That, along with concerns about trade, global growth and the hyper partisan political environment are adding to investor uncertainty and leading to greater fluctuations in market pricing. However, it is important to put this volatility in context. It is not unusual to see greater levels of volatility and to experience market corrections like we had in February and December. Large swings in the market intra-day, typically occur more than 33 times a year. Between 2012 and 2017, we averaged only 11 days where the intra-day trading range exceeded 2.0%. In 2018, we had 38 instances of a 2.0% move intra-day, only moderately above average. As we move back to an environment of higher, but more typical levels of volatility, it is even more important to focus on the fundamentals, which remain solid.

Concerns about Fed Policy and the Yield Curve are Adding to Volatility.

For much of the year, monetary policy took a backseat to fiscal policy, as investors focused on the benefits of fiscal stimulus, rather than rate increases. However, throughout the summer, as longer-term interest rates started to rise, concerns about future economic growth and the potential for a yield curve inversion began to rise. A yield curve inversion occurs when the yields on short-maturity debt are higher than the yields on longer-maturity debt. An inverted yield curve does not cause a recession, but it can be a signal of a future recession. In this case, the Fed increased rates three times in 2018 and has raised a total of 8 times since December 2015, increasing short-term interest rates by two percentage points. Monetary policy is still somewhat accommodative, but it is getting closer to a neutral rate, which does not stimulate or restrict the economy. The yields on long-maturity bonds are most closely correlated with inflation expectations, and with core inflation at or below the Fed's 2% target, long yields have not moved as significantly during this time. Longer-term yields have also been impacted by the recent flight-to-quality with the equity market sell-off and the overall attractiveness of U.S. yields relative to foreign sovereign debt. These factors impacted longer-term yields and led to the narrowing of the spread between short-term and long-term yields. The Fed has a dual mandate to pursue monetary policy that supports price stability and full employment. With the unemployment rate at 3.9% and inflation below the Fed's 2.0% target, the market is expecting the Fed to slow its rate hikes. More recently, we have seen the Fed lower its forecast for future rate hikes and to acknowledge that the current Fed Funds rate is getting closer to neutral. The disconnect between the markets expectations for Fed action and the Fed's own forecast has led to the increased volatility in both equity and bond markets. As the gap between those two views narrows, we expect to see the concerns about an inverted yield curb subside and the investor focus to return to the fundamentals of the economy and market.

CONCLUSION

The performance of the equity markets and that of the broader economy decoupled in 2018 due to increasing short-term investor concerns that led to fear-based selling of assets. While these concerns are real, they must be viewed in the context of the overall economic strength. Over the long term, the fundamentals of the economy and the outlook for corporate profits are what drive market returns.

IMPACT ON YOUR INVESTMENTS

We still believe that the fundamentals of the U.S. economy are solid and as such we have positioned your portfolio to benefit from positive economic growth and increasing corporate profitability. The companies in the Growth portfolio are well-positioned to benefit from on-going economic growth around the world. The Income Portfolio will continue to provide high and growing dividend payments, while still participating in the solid economic environment. We continue to minimize the exposure to higher interest rates in the Fixed Income allocation, by holding high-quality, short-maturity corporate bonds. We will continue to monitor the global economy and financial markets for signs of any shift in the long-term outlook. We remain poised to act if and when we see conditions changing. In the meantime, we expect to remain close to fully invested.

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