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Capital Markets Review and Outlook

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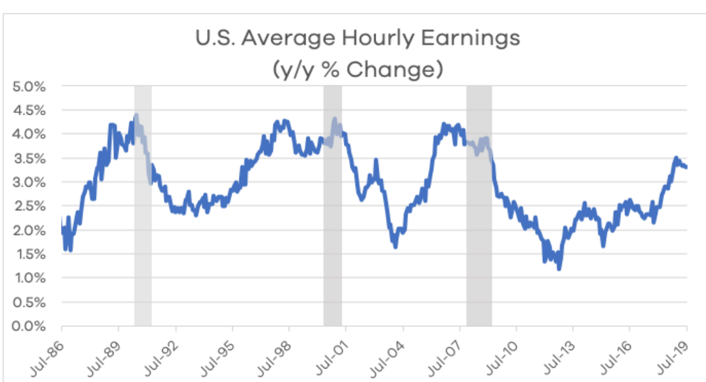
Economy and Outlook

July marked the longest economic expansion on record for the U.S. economy. Although widely telegraphed last month, the Federal Reserve paradoxically cut its official interest rate at the end of July for the first time in 11 years. The target for the Federal Funds rate was reduced by 25 bp to a range of between 2% to 2.25%. The Fed also announced it was ending its balance sheet runoff program (quantitative tightening) in August, two months earlier than previously indicated. While the U.S. economy remains firm with real GDP for the first half of 2019 growing at a 2.6% annualized rate, the Federal Reserve is concerned about the potentially negative effects of headwinds facing the U.S. economy: the weakening manufacturing sector, the slowdown in foreign economies, and low inflation. The on-going and prolonged trade war between the U.S. and China has undoubtedly played a major role in the downturn in the goods-producing sectors of the U.S. economy. While the U.S. employment picture remains bright with the unemployment rate near a 50-year low, and employers adding an average of 168,000 workers per month this year, there has been a marked slowdown in employment in the industries closely linked to trade such as manufacturing, mining and construction. Additionally, trade war related uncertainty in the corporate world is also reflected in the weakness in business fixed investment. Foreign economies have a much greater exposure to trade than the United States. As a result, these economies have experienced much more pronounced slowdowns. Despite these headwinds, the nature of the evolution of the trade war over the course of the past year suggests that it is possible for a rapid resolution to the conflict. A trade war, after all, is a negative sum game where both sides to the conflict lose. Therefore, a resolution remains the likely outcome.



The Fed has also expressed concerns about the continued low levels of inflation in the economy. The Fed's target for core inflation as measured by the core personal consumption expenditure price index (core PCE) is 2%. While core inflation is currently running around 1.5%, wage inflation has picked up in line with the strong employment backdrop for the U.S. economy. The chart on the left shows that hourly wages are now increasing at a rate of over 3% on a year-over-year basis. It is, therefore, unlikely that the Federal Reserve will institute a series of interest rate

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reductions. Such an action would only be warranted if the risk of a recession is high. Extraordinarily accommodative monetary policies across much of the world which have resulted in negative interest rates in several developed markets make this an unlikely outcome at this point in time. The caveat, of course, is a worsening and escalation of the U.S./China trade war with negative spillover effects into the broader global economy.

Equity Markets

The anticipated change in the Federal Reserve's interest rate policy together with better than expected company earnings reported for the 2nd quarter drove U.S. equity markets to record highs in July. The broad domestic equity market represented by the Russell 3000 index increased +1.5% in July bringing the return for the first 7 months of 2019 to a remarkable +20.5%. In terms of capitalization, Large Cap continued its trend this year and outperformed Small Cap by +100 bp. This brings the year-to-date outperformance of Large Cap over Small Cap to +300 bp. From a style perspective, Growth also continued to outperform Value across all capitalizations. The average outperformance was +125 bp for the month of July and over +800 bp year-to-date.

While equity market volatility continued to decline in July as investors gravitated further to risk assets, equity sector performance was uneven. Some Cyclical sectors had strong performance versus Defensives; for example, Technology's return of +3.3% for the month was a standout compared to the -1.6% return for Health Care. However, other cyclicals such as Materials lagged with a return of -0.4% while Defensive sectors like Consumer Staples outperformed with a return of +2.5%. The Energy sector gave back some of the strong gains from the prior month and posted a return of -1.8% in July as both crude oil and natural gas prices pulled back. Year-to-date the Cyclical sectors have outperformed Defensives by a wide margin.

Due to international countries greater reliance on trade for economic growth, equity markets outside the U.S. were negatively impacted in July by the spill-over effects from the on-going and prolonged trade conflict between the United States and China. The strength of the U.S. dollar was an additional headwind for investment returns. Developed and emerging equity markets posted returns of -1.3% and -1.2% respectively for the month. Year-to-date returns remain positive with +12.6% for developed markets and +9.2% for emerging markets. While the Federal Reserve's recent interest rate cut should theoretically weaken the U.S. dollar, other central banks are also easing their monetary policies which may negate the downward pressure on the dollar from the Fed's actions.

Fixed Income Markets

While Treasury bill yields (maturities shorter than 1 year) declined in July in line with the Federal Reserve's 25 bp cut in the federal funds rate, Treasury yields across the coupon curve rose for the month because expectations for an interest rate cut had already pushed Treasury yields sharply lower over the prior two months. Additionally, some market participants had been anticipating a deeper cut (-50 bp) in the funds rate. For the month, yields on 2-year and 5-year Treasury notes increased by 14 bp and 8 bp respectively. Further out the coupon curve, yields only increased marginally by 1 to 2 bp. As a result, the Treasury yield curve flattened with the 2-year/10-year spread differential narrowing by 12 bp and ending the month at just +13 bp. A year ago, the spread was more than double at +29 bp. The positive tone in the corporate bond market continued for the second consecutive month in line with the positive performance in the equity markets. For the month of July,

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investment grade credit spreads tightened by 6 bp resulting in a +59 bp outperformance over duration matched Treasuries. At month end, the 103 bp spread on the investment grade credit index was back to its level a year ago. Spreads also tightened in the high yield bond market in July resulting in a +0.6% return for the month. This brought the year-to-date total return for the high yield bond market to a strong +10.6%. Unlike the investment grade credit market, the quality curve steepened in the high yield market as the BB-rated sector outperformed lower quality rated sectors in July. Although government bond yields outside the U.S. declined in July as central banks further eased monetary policies in response to weakening domestic economies, the sharp rise in the U.S. dollar resulted in -0.7% return for the non-dollar government bond market. However, year-to-date, this market has had a respectable +4.8% return through the end of July.

			Returns as of 7/31/19 (In %)			
		Month	YTD	1 Year	3 Years	5 Years
Russell 3000®	US AllCap Equity	1.5	20.5	7.1	13.1	11.0
Russell 1000®	US Large Cap Equity	1.6	20.7	8.0	13.3	11.2
Russell 1000® Growth	US Large Cap Growth	2.3	24.2	10.8	17.1	14.3
Russell 1000® Value	US Large Cap Value	0.8	17.2	5.2	9.4	8.0
Russell Midcap®	US Mid Cap Equity	1.4	23.1	6.7	11.0	9.6
Russell Midcap® Growth	US Mid Cap Growth	2.3	29.0	14.1	15.5	12.3
Russell Midcap® Value	US Mid Cap Value	0.8	19.0	1.8	7.7	7.5
Russell 2000®	US Small Cap Equity	0.6	17.7	-4.4	10.4	8.5
Russell 2000® Growth	US Small Cap Growth	1.0	21.5	-1.2	12.7	10.2
Russell 2000® Value	US Small Cap Value	0.2	13.6	-7.7	8.0	6.7
MSCI ACWI ex-US	Global Equity ex-US	-1.2	12.2	-2.3	7.2	2.1
MSCI EAFE	Global Developed Mkts Equity	-1.3	12.6	-2.6	6.9	2.4
MSCI EM	Emerging Mkts Equity	-1.2	9.2	-2.2	8.4	1.8
Bloomberg/Barclays US Agg	US Core Fixed Income	0.2	6.3	8.1	2.2	3.0
Bloomberg/Barclays US Interm. Agg	US Intermediate Fixed Income	0.1	4.9	6.9	2.0	2.6
Bloomberg/Barclays US Credit	US Corporate Bonds	0.5	9.9	10.1	3.5	4.0
Bloomberg/Barclays US MBS	US Mortgage Backed Securities	0.4	4.6	6.8	2.1	2.8
Bloomberg/Barclays US Corp HY	US High Yield	0.6	10.6	6.9	6.8	5.1
FTSE Non-US WGBI	Global Fixed Income ex-US	-0.7	4.8	4.2	0.4	0.3