Economic Review & Outlook

SECOND QUARTER 2019

The Great Expansion

Over the last decade, the U.S. economy has enjoyed a dramatic recovery and expansion—one that will be the longest economic expansion in U.S. history if it lasts until the summer. While non-U.S. economies struggled to recover from the global recession of 2008, the U.S. has enjoyed a steady and deliberate march forward in job growth, corporate profits, and consumer confidence. Industries like automotive and housing are now healthy, robust, and even vibrant—a stark contrast to their former selves. These strong fundamentals have not been lost on the stock market, which is up over 300% from its March 2009 bottom.

In this quarter's Economic Review & Outlook, we take a closer look at economic expansions—why they matter, how long they tend to last, and what usually brings them to an end. We also attempt to address the burning question on most everyone's mind: when will the current expansion end?

Economic Review

The Federal Reserve Steps Back

After three rate hikes in 2017 and four hikes in 2018, the Federal Reserve stated in late January that it "will be patient" when determining the need for future interest rate increases. Stock markets celebrated this news and continued their strong run throughout the first quarter. Interest rates subsequently fell further after the Fed stated in late March that "economic activity has slowed," making future hikes much less likely, at least for the time being.

Mixed Signals on the U.S. Economy

Early in the quarter, two robust employment reports eased investor concerns about the health of the U.S. economy heading into 2019. However, weak retail sales data, soft manufacturing survey results, and housing market weakness seemed to overwhelm the positive case for healthy growth moving forward. Financial market participants are likely to fixate on each and every economic data point in the months ahead in an attempt to discern our economy's future path.

Global Economic Growth Slows

From factory output declines in Europe and softer domestic demand in China to an overall slowdown in global trade, the global economy showed signs of pressure in the first quarter. The uncertainty created by Brexit and the unresolved trade spats between the U.S. and China served to undermine confidence in continued growth. Central banks took note as the European Central Bank (ECB) announced monetary policy easing, following the lead of China and India. China responded by tweaking fiscal policy measures to bolster growth.

Asset Class Performance

January	February	March	Q1
Emerging Market Stocks 8.8%	Commodities 4.0%	U.S. Stocks 1.9%	Commodities 13.8%
Commodities 8.4%	U.S. Stocks 3.2%	Diversified Bonds 1.9%	U.S. Stocks 13.6%
U.S. Stocks 8.0%	Int'l Developed Stocks 2.6%	Commodities 1.0%	Int'l Developed Stocks 10.1%
Int'l Developed Stocks 6.6%	Emerging Market Stocks 0.2%	Emerging Market Stocks 0.9%	Emerging Market Stocks 10.0%
Gold 3.1%	Diversified Bonds -0.1%	Int'l Developed Stocks 0.7%	Diversified Bonds 2.9%
Diversified Bonds 1.1%	Gold -0.5%	Gold -1.6%	Gold 0.9%

Indices used: Commodities—Credit Suisse Commodity Index, Diversified Bonds—Barclays Aggregate U.S. Bond Index, Gold—S&P GSCI Gold Index, U.S. Stocks—S&P 500 Index, Int'l Developed—MSCI EAFE Index, Emerging Markets—MSCI Emerging Markets Index. Indices do not reflect the deduction of advisory fees, transaction charges and other expenses. You cannot invest directly in an index. Past performance does not indicate future returns.

Following a year in which virtually no asset class achieved positive returns, financial markets came roaring back in the first quarter of 2019. Market pessimism, which pervaded in the final months of 2018, was replaced by optimism fueled by the Fed's more patient stance and two robust employment reports. Stocks around the globe rebounded strongly as evidenced by returns in U.S. (+13.6%), international developed (+10.1%), and emerging markets stocks (+10.0%). Notably, U.S. stocks achieved their best quarterly return in almost 10 years.

Commodities recovered from a dismal fourth quarter, gaining +13.8% in the first quarter, with gold up just under +1.0%. Bond returns were also strong during the quarter, rising +2.9% in response to lower interest rates.

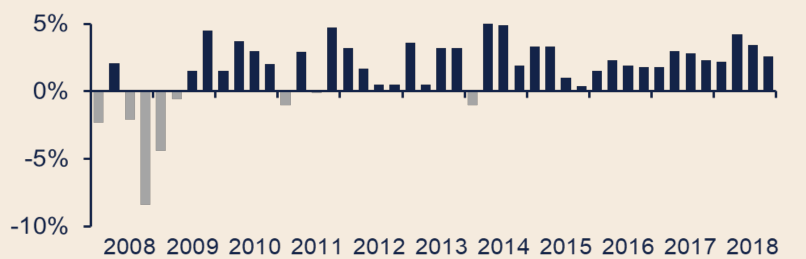
While financial markets are off to a great start in 2019, the first quarter was essentially the opposite of the previous quarter, when nearly all asset classes fell in eerily similar amounts to what they gained in the first three months of 2019. Nevertheless, we're reminded that markets fluctuate, returns can be volatile, and investing is stressful at times. Over the long term, market ups and downs tend to smooth out, and asset class returns migrate to their historical averages.

Our Perspective

Milestones can give life order and cadence; recognizing recurring events like birthdays and anniversaries comes naturally to most everyone. This summer, the U.S. economy will likely reach a milestone worth noting as the current economic expansion becomes the longest in U.S. history, turning in 120 months of virtually uninterrupted growth.

Since March 2009, the U.S. has experienced sustained economic growth without meaningful pause or contraction (see chart below). Moreover, the number of jobs created during this period has far surpassed the number of jobs lost. The Great Recession truly has become the Great Expansion!

Change in Real Gross Domestic Product (GDP)
Percent Change at Annual Rate (Seasonally Adjusted, Per Quarter)



Source: National Bureau of Economic Research (NBER)

It's difficult to forget the turmoil of a decade ago and the tumult of those uncertain days. The sustainability of our entire financial system was in question, but recovery eventually followed, albeit sluggishly. Growth returned, jobs were created, and confidence reemerged.

The pain we felt during that period has made the duration of this expansion even sweeter. Still, after 10 years of sustained economic growth, investors are beginning to question how long it can continue and what will provoke another recession. This is both valid and timely, and in the proceeding paragraphs we'll attempt to address some common investor concerns.

Do recessions even matter?

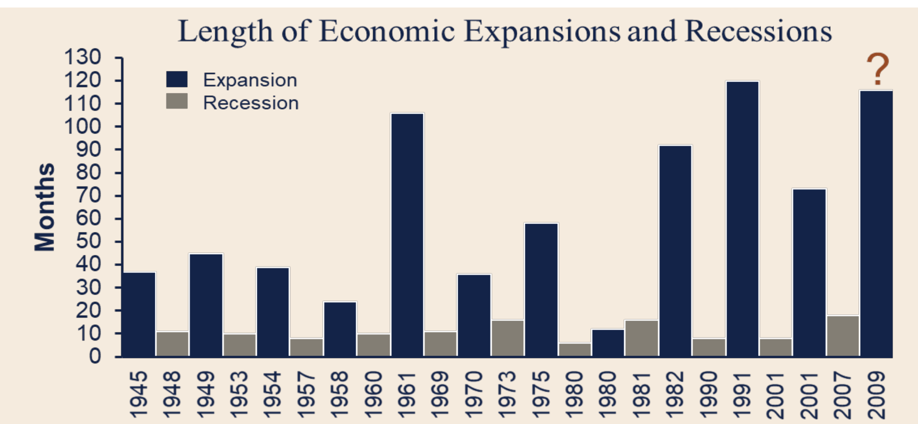
A healthy and growing economy has many benefits—employment opportunities and job security, wage growth, peace of mind when planning for the future, and even wealth accumulation as asset prices appreciate. On the other hand, economic contractions and recessions threaten each of these benefits as uncertainty replaces confidence.

From an investor's point of view, the last two recessions ushered in significant stock market pullbacks. From peak to trough, stock prices fell on average about 50% during the Great Recession. Such extreme setbacks are likely to get anyone's attention. So, yes, recessions matter.

Does the current expansion need to end?

The idiom "all good things must come to an end" can be traced all the way back to the 1300s, appearing in Geoffrey Chaucer's poem Troilus and Criseyde. (If you were thinking Shakespeare, you're not alone.) Unfortunately, this common turn of phrase rings true when it comes to the economy.

Yes, this expansion will eventually end. So long as we have a business cycle, the economy will expand and contract accordingly. On the bright side, economic expansions in recent history have lasted much longer than contractions, seen below. The last three periods of economic growth lasted eight years on average, while contractions have averaged a brief 11 months.



Source: National Bureau of Economic Research (NBER)

Some believe that the Fed has done a much better job managing the economy lately than in the past. Others point to improvements in technology and the ensuing evolution of our economic system as the underlying reason for this trend. Regardless of the cause, we are heartened that periods of growth have far surpassed periods of decline in recent decades.

What causes a recession?

Recessions have no single, easily identifiable cause. Looking back over history, we can identify various culprits for why recessions happen. In the 1970s, a war in the Middle East and a revolution in Iran each led to soaring oil prices and an overall "energy crisis." Two recessions resulted. Then, the Fed raised interest rates dramatically in the early 1980s to combat double-digit inflation. The "medicine" worked, but another recession was the unfortunate side effect.

Asset bubbles (and bursts) have also been the cause of several economic downturns—and some quite severe. From the tulip mania in Holland in the 1600s to the stock market crash in 1929 to the housing bubble in 2007, each of these events was associated with an economic contraction.

Is another recession on the horizon?

What sparks the next economic downturn may be entirely different from what we have seen in the past. Whether it's a trade war, a political crisis, or another event altogether, we simply cannot predict what the trigger will be. Although the current economic expansion appears to be heading for the record books, we don't believe a recession is imminent. Nevertheless, there are undeniable signs that global growth is slowing.

In the U.S., the benefits we enjoyed due to fiscal stimulus in the form of tax cuts and increased government spending are waning. And let's not forget that until its recent pivot on policy, the Fed has been steadily raising interest rates since 2015. While this course of action was necessary to bring interest rates back to normal levels, we expect a lagged effect on the economy from higher short-term rates.

Perhaps most importantly, economic growth overseas has appeared more fragile in recent months. Europe's economic prospects are dimming, and uncertainty over Brexit doesn't help. Tussles over trade between the U.S. and China have cast a pall of hesitation over global trade activity. And, the health of China's economy—second largest in the world, by most measures—is in question. Though growth is clearly slowing, no one yet understands by what magnitude.

These concerns deserve attention, and we take them seriously as potential threats to future economic growth. Still, we are not heading for the hills just yet.

How can you prepare for the unknown?

We don't know when this expansion will end or when the next recession will begin. What we do know is that the effects of an economic downturn—lower confidence, less capital investment, fewer jobs, a decline in consumption, and of course, falling stock prices—tend to be much more uniform. Therefore, we can prepare accordingly.

We believe the best preparation is having a financial plan and an investment strategy that considers your near-term and long-term goals and cash flow needs. A goals-based plan serves as a great defense against the instability and uncertainty that, at times, characterize our financial markets.

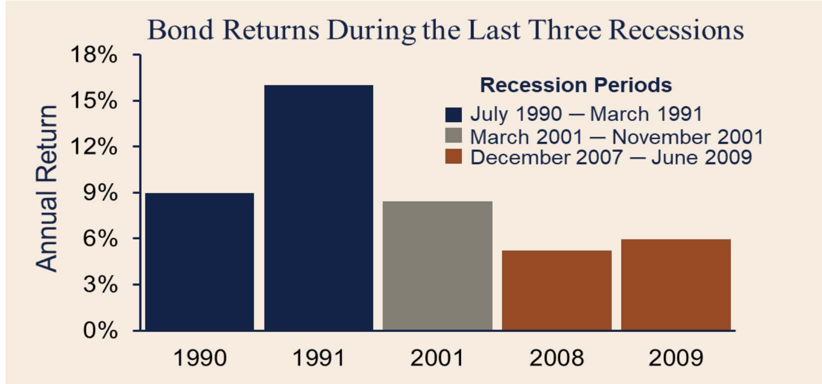
Our Investment Strategy

Our investment process is not predicated on correctly predicting the future. The ability to successfully time financial markets twice—getting out and getting back in—eludes even the most seasoned and talented investors. We don't believe this approach can be implemented successfully over time. Instead, our investment strategy is based on identifying growth opportunities in relation to price and diversifying portfolios globally and across asset classes to manage risk.

Importantly, investor goals and future cash flow needs are at the core of our portfolio management process. An economic recession will have varying impacts on different types of assets. While we don't expressly exit certain markets or asset classes in anticipation of them declining in value, we do make sure that the assets we hold are consistent with the portfolio's time horizon—in other words, the number of years until investors in that portfolio must meet a financial obligation.

Growth-oriented assets are typically impacted most negatively in a recession since lower economic growth leads to lower corporate profits, which implies lower stock prices. Despite this understanding, we stay invested in growth assets throughout an economic downturn because growth inevitably returns, and stock prices recover. Consistently maintaining exposure to these assets allows investors with cash flow needs at least 10 years in the future to participate in the ensuing upside, which ultimately increases the likelihood that they'll meet their financial goals.

On the other hand, more stable asset classes like bonds can be expected to fare better during a recession. Since interest rates often fall during periods of economic decline, bond prices (which are inversely related to interest rates) tend to rise. The chart below illustrates the positive returns bond investors realized during the last three recessions.



Source: FactSet

In addition, the coupon payments bonds make help boost their return potential and allow for a more predictable stream of income. Consequently, bonds are well suited for investors with cash flow needs in the next three to nine years due to their resilience in difficult economic environments.

Finally, investors with near-term cash flow needs (less than three years) will have a larger allocation to cash and cash equivalent reserves in their portfolios. We believe this approach ensures that our investors are prepared—and protected—even in challenging economic and market environments.

In Conclusion

The U.S. economy's performance over the last decade is literally one for the record books. Coming out of the worst economic period since the Great Depression, this recovery and expansion has raised the fortunes and quality of life of virtually all Americans. It's been an incredible run. However, we don't believe this expansion can continue indefinitely.

The uncertainty of the future implies the need for preparation. A well-constructed financial plan is a potent defense against the emotions that often accompany investing in changing economic environments. We believe that when your investment strategy is aligned with your future financial goals, you're prepared for whatever obstacles markets try to throw in your path.

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