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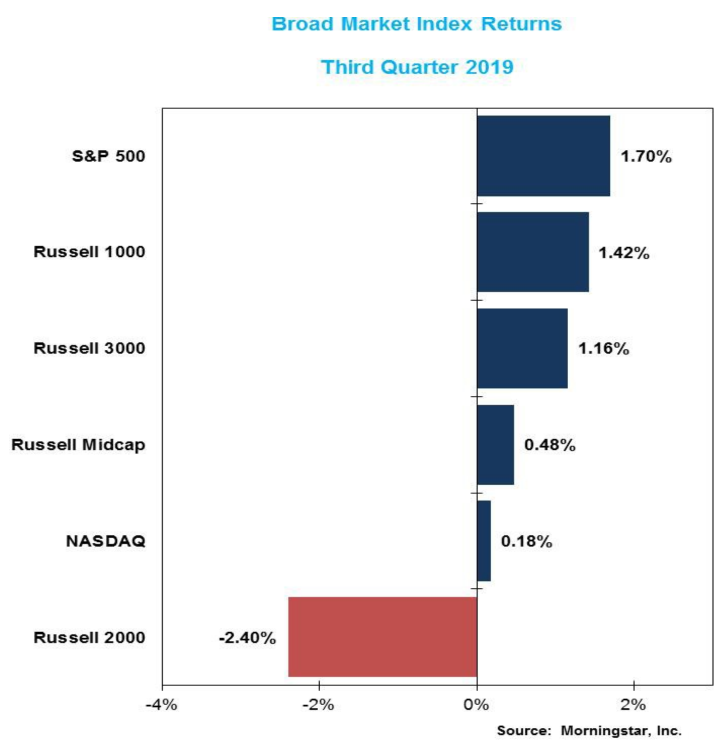
Compared to the first half of the year, the stock market this past quarter was fairly sedate. While small caps were down a bit, the rest of the domestic market was largely up slightly. In fact, the market continues to be up quite substantially for the year. In step with stocks, bonds also posted positive total returns for the quarter and also have done well for the year. While we've been very happy with the market so far this year, we also want to acknowledge the potentially changing economic landscape.

THE ECOMONY

The US economy's growth slowed modestly in the quarter. The Bureau of Economic Analysis reported its third estimate of second quarter 2019 gross domestic product (GDP) of 2.0%, in line with the prior estimate, but lower than the first quarter's 3.1% reading. The employment situation moderated further in the latest month, with an average of approximately 156,000 jobs added each month of the quarter. The unemployment rate held steady at 3.7%. The Federal Open Market Committee (FOMC) modified its interest rate policy by lowering the federal funds rate target two times, to a range of 1.75% to 2.00%. Economists expect the FOMC to lower the fed funds rate at least once more by the end of the year.



The global economic environment continued to decelerate, driven by trade uncertainty, the lingering questions regarding how Brexit will be resolved, and heightened geopolitical risks. Eurozone economic growth slowed after growing in the prior two quarters, led by a decline in household consumption. China's economy has also decelerated significantly since the onset of the trade frictions with the US. The country's most recent real GDP growth was and annualized 6.2%, the slowest rate in 27 years.

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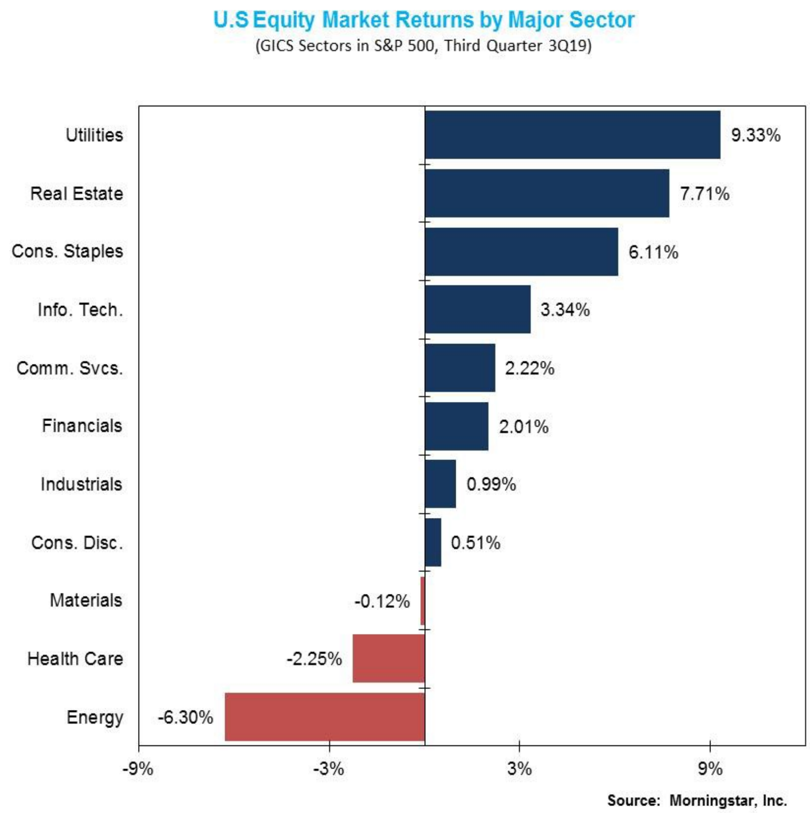
HIGHTLIGHTS

GROSS DOMESTIC PRODUCT (GDP)



The Bureau of Economic Analysis released the third estimate of the second quarter 2019 real GDP, a seasonally adjusted annualized rate of 2.0%, lower than the first quarter's 3.1% annualized growth, and in line with the prior estimate. It was the lowest annualized growth rate in the past eight quarters, with the exception of the fourth quarter of 2018. Trade issues were the primary driver of the quarter's slowdown, but the effects of last year's fiscal stimulus have also dissipated. Corporate profits rose by 3.8% (not annualized) during the quarter, while real disposable income rose by 1.8%. Economists pointed to the fading benefits from 2018's deficit-financed tax cuts and the Trump administration's trade war with China and other trading partners as being the key reasons for the slowdown, as they combined to undermine business sentiment. Some analysts estimate that the trade war with China has resulted in a reduction in real GDP of 0.3 percentage points, and a loss of 300,000 jobs. Since the economic impact of the trade war arguably has been worse for China, economists hope that some sort of rapprochement may be in the offing, particularly as President Trump heads into an election year.

HOUSING

The housing segment continued its steady improvement of the past nine months. One of the primary reasons for the recovery from the 2018 drop is the decline in mortgage rates, which have fallen approximately 1.2% since November 2018. Existing-home sales for August (the latest monthly data available) grew at an annualized rate of 5.5 million units, 1.3% higher than the results from July, and up about 2.6% from year-ago levels. The inventory of existing homes was at about four months of supply, in line with levels of the prior year. Existing-home prices in August increased 4.7% from August 2018. In the new-home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at 68, slightly higher than both the prior month's and year-ago levels. The data indicates that homebuilders have a very positive outlook for the housing market.

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EMPLOYMENT

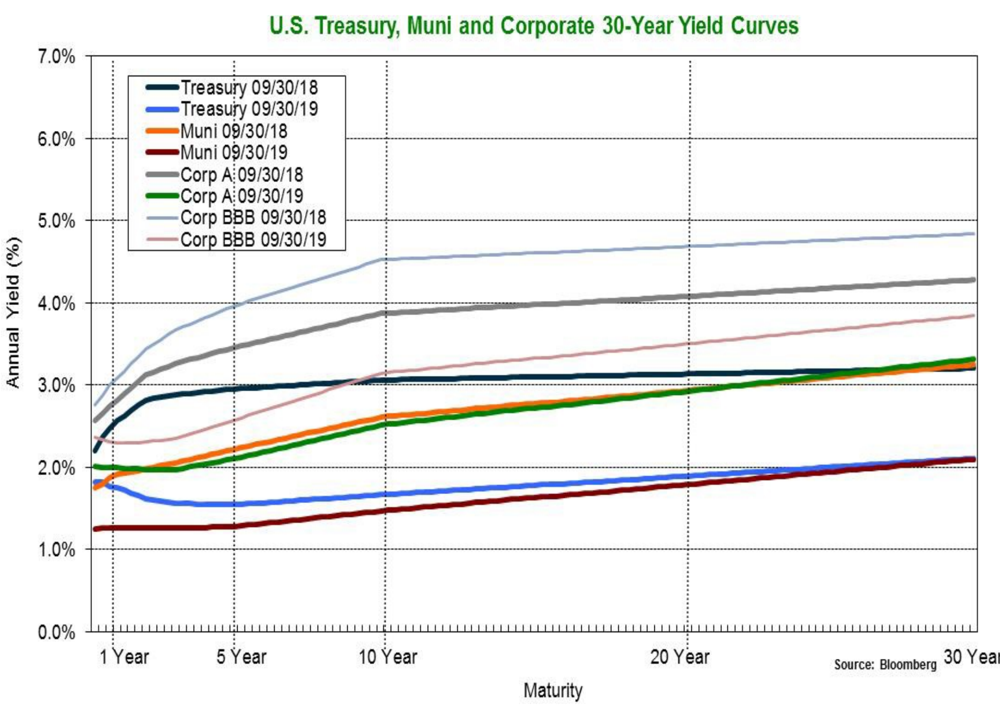
The employment situation deteriorated somewhat in August, continuing the slowing experienced during much of 2019. Employers added 130,000 jobs during the month, below the consensus expectations of 158,000 new jobs, and below the prior month's gain of 159,000. Waning business and consumer confidence resulting from uncertainty around frictions with various trading partners contributed to the lackluster gains in payroll growth. The three-month moving average actually rose modestly despite the lower-than-expected gains in August, coming in at 156,000. The unemployment rate in May remained at 3.7%, and the labor force participation rate rose to 63.2%, its highest level of the year. Average hourly earnings increased by 3.2% from the year-ago level.

FED POLICY

The FOMC ended its recent September meeting by announcing that there would be a reduction in the federal funds rate target range to 1.75%-2.00%. This was the second 0.25% reduction in the quarter, following the one approved at the FOMC's July meeting. The move was widely expected and had been fully priced into the market. For the first time since 2016 there were three dissenters on the committee, with one seeking a more aggressive cut of 0.50%, and two others not seeing the need for a reduction. Economists viewed the cuts in the quarter as an insurance policy against a further slowdown caused by trade developments. The consensus among analysts is that there will likely be one more reduction this year, perhaps at the FOMC's October meeting.

INTEREST RATES

Fixed income securities' prices and yields were buffeted by several factors during the quarter, foremost of which was the deceleration in economic growth resulting from the escalation in the trade war with China. Other issues prompting investor concern were the ongoing drama surrounding the UK's Brexit decision, and geopolitical tensions with nations such as Iran. The FOMC responded to the moderating growth in the US by lowering interest rates twice during the quarter, bringing the target federal funds rate range to 1.75%-2.00%. The slowing growth produced a rally in bond prices, and a drop in yields.



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Economists expect this trend to continue, as seven FOMC committee members anticipate cutting the fed funds rate by an additional 0.25%.

Overall, the Treasury curve moved lower from the prior quarter. In addition, the yield curve briefly inverted during the quarter, meaning that the yield on the 10-year Treasury declined below the yield on the 2-year Treasury. Historically, yield curve inversions have predicted economic recessions 9-12 months in the future. Some analysts, however, point out that the current situation may differ from previous instances in that there is heavy demand for U.S. Treasury debt because of low (or negative) yields on sovereign debt issued by other nations. Such demand drives up the prices of the securities, and lowers the yields. By the end of the quarter, the yield on the benchmark 10-year US Treasury note was lower, ending at 1.67%, compared to 2.01% on June 30.

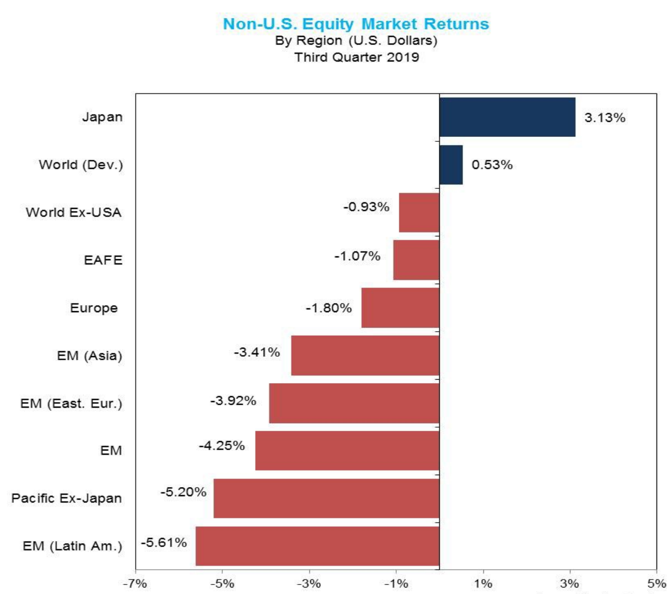
Interest rates spent much of July in a tight range hovering around the 2% yield level on the 10-year Treasury. In August, however, yields declined sharply as the trade war escalated. Yields bottomed out early in September after there appeared to be some softening of the trade rhetoric between the US and China. Investors also grappled with the seemingly never-ending Brexit theater, as the new UK Prime Minister, Boris Johnson, has so far failed to deliver a solution palatable to all parties. Geopolitical tensions also spiked during the quarter, as Iran responded to heavy economic sanctions by firing missiles at Saudi Arabia's oil infrastructure. Inflation expectations were somewhat lower, with the Fed's gauge of five-year forward inflation expectations declining slightly from 1.80% on June 30.

Total returns on fixed income securities were positive across most of the market segments. The Bloomberg Barclays Treasury 5-7 Yr. Index rose by +1.7% for the quarter. The Bloomberg Barclays US Corporate 5-10 Yr. Index gained +2.4% during the three months. High yield securities, which often follow the performance of equities, climbed, posted a return of +1.3%. Municipals also rose, as the Bloomberg Barclays Municipal Bond Index gained +1.6% during the quarter. Prices of non-US fixed income securities were lower in the quarter, as the Bloomberg Barclays Global Aggregate ex-US Index declined -0.6%. Emerging markets bonds continued their positive trend, with the JPM EMBI Global Index gaining +1.3%.

EQUITY MARKET

Equity markets tracked the news on the trade front, posting gains in July before dropping sharply in August before recovering in September as both the US and China seemed to soften their respective stances. The market's recovery was also partly based on the FOMC's decision to lower interest rates for the second time in the quarter. Within that context, the S&P 500 Index finished the quarter with a gain of +1.7%.

Performance of the eleven primary economic sectors was mixed during the quarter, with eight sectors delivering positive gains and three producing negative returns. Utilities, Real Estate and Consumer Staples were the strongest performers on a relative basis, generating returns of +9.3%, +7.7%, and +6.1%, respectively.



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The Energy, Health Care, and Materials sectors were the poorest relative performers, posting returns of -6.3%, -2.3%, and -0.1%, respectively.

The Russell 1000 Index of large capitalization stocks generated a +1.4% total return. Within the large cap segment, growth stocks slightly outperformed value stocks. Small cap stocks, as represented by the Russell 2000 Index, underperformed large caps, and finished the quarter with a total return of -2.4%. Small cap value outperformed small cap growth. The NASDAQ Composite, dominated by information technology stocks, finished the quarter with a gain of +0.2%. The Dow Jones Industrial Average of 30 large industrial companies advanced +1.8%.

Real Estate Investment Trusts (REITs) posted robust gains during the quarter, with the DJ US Select REIT Index up +6.8%. Commodities were modestly lower, with the Bloomberg Commodity Index losing -1.8% for the quarter.

International stocks had a difficult time during the quarter, and were generally not able to match the performance of U.S. equities. In the Eurozone, economic growth has slowed for several reasons, including ongoing uncertainty around Brexit and the impact of global trade tensions and geopolitical fissures. The MSCI ACWI Ex-USA Index, which measures performance of world markets outside the US, declined by -1.8%. The MSCI EAFE Index of developed markets stocks fell by -1.1%. Regional performance was largely negative for the quarter. Japan was the strongest performer on a relative basis, with a return of +3.1%. Latin America was the poorest relative performer, declining -5.6%. Emerging markets performance was weak, as the MSCI Emerging Markets Index was lower by -4.3%.

LOOKING FORWARD

While growth has moderated somewhat in 2019, the current US economic expansion is now the longest in history. The US economy is very resilient, so far withstanding the negative impact of the heated trade war, heightened tensions with Iran and the deep and growing political divisions in Washington. While the FOMC has stepped in to provide an insurance policy to the markets in the form of two interest rate reductions, growth is dependent on a cooling of the tariff tit-for-tat. Many economists believe there is reason to feel optimistic that President Trump and China's President Xi Jinping will soon find common ground, as China's economy has slowed significantly and President Trump seeks re-election next year. It is somewhat difficult to assess the importance of the recently inverted yield curve. While inversion has typically presaged a recession 9-12 months in the future, analysts are not quite as confident in this environment, believing that unprecedented foreign demand for US Treasury securities may be creating distortions in the yield curve. In addition, stock prices do not yet seem to be signaling a recession is on the horizon, as they have recovered from an August swoon to once again approach record highs. The consensus among economists is that at this point a recession does not seem likely until near the latter part of 2020.

Please be sure to let us know if you have any questions or concerns regarding your portfolio or if you feel your portfolio is no longer appropriate for your situation.

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