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Quarterly Economic Review

October 2019

Economic Review

- **The third quarter of 2019 was a choppy one for financial markets as investors continued to weigh the overall health of the global economy against a host of uncertain macro factors.** Uncertainties included the ongoing trade war with China, a drone attack on Saudi Arabia's oil fields, the seemingly never-ending Brexit negotiations, and—as September wrapped—an official presidential impeachment investigation in Washington, D.C.
- **On the economic front, the Federal Reserve followed its 25-basis-point interest rate cut in late July with another 25-basis-point cut in mid-September.** This was in response to the weak global economic environment and the impact of trade policy on U.S. business sentiment and capital expenditure. The European Central Bank also cut its policy rate and announced it would launch a new open-ended asset purchase plan (i.e., quantitative easing) starting in November.
- **Amidst this backdrop, equity markets rose in July, fell in August, then rallied in September.** Large-cap U.S. stocks gained 2% for the quarter and have netted over 20% year to date. Smaller-cap U.S. stocks suffered more acutely during the market drops and ended the quarter down 2.3%. For the year to date, they are still up a healthy 14.1%.
- **Despite a rebound in September, foreign stocks posted negative returns for the quarter.** Developed international stocks fell 0.9%, European stocks fell 1.8%, and emerging-market (EM) stocks fell 4.1%. The U.S. dollar appreciated 2% to 4% versus other currencies during the quarter, which was an equivalent drag on foreign stock market returns for dollar-based investors.
- **Bond yields around the world continued to move lower in the third quarter as deflation concerns took hold.** The benchmark 10-year Treasury yield dropped to below 1.5% in early September as trade war and recession fears crescendoed. It then sharply reversed, then dropped back, ending the quarter at 1.68%, down from a 2% yield at the end of the second quarter.
- **U.S. core investment-grade bonds were flat in July, rallied sharply in August, then dropped in September as interest rates rebounded from historic lows.** For the full quarter, core bonds gained 2.4%.

Positive momentum continued for most asset classes in the 3rd quarter - although international markets were hurt by trade tensions.

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate		US Bond Market	Bond Market ex US
3Q 2019	**STOCKS**					**BONDS**	
	1.16%	-0.93%	-4.25%	5.72%		2.27%	2.83%
Since Jan. 2001							
Avg. Quarterly Return	2.0%	1.4%	2.8%	2.6%		1.2%	1.2%
Best Quarter	16.8%	25.9%	34.7%	32.3%		4.6%	4.6%
	2009 Q2	**2009 Q2**	**2009 Q2**	**2009 Q3**		**2001 Q3**	**2008 Q4**
Worst Quarter	-22.8%	-21.1%	-27.6%	-36.1%		-3.0%	-2.7%
	2008 Q4	**2008 Q4**	**2008 Q4**	**2008 Q4**		**2016 Q4**	**2015 Q2**

Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index [net div.]), US Bond Market (Bloomberg Barclays US Aggregate Bond Index), and Global Bond Market ex US (Bloomberg Barclays Global Aggregate ex-USD Bond Index [hedged to USD]). S&P data © 2019 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. MSCI data © MSCI 2019, all rights reserved. Bloomberg Barclays data provided by Bloomberg.

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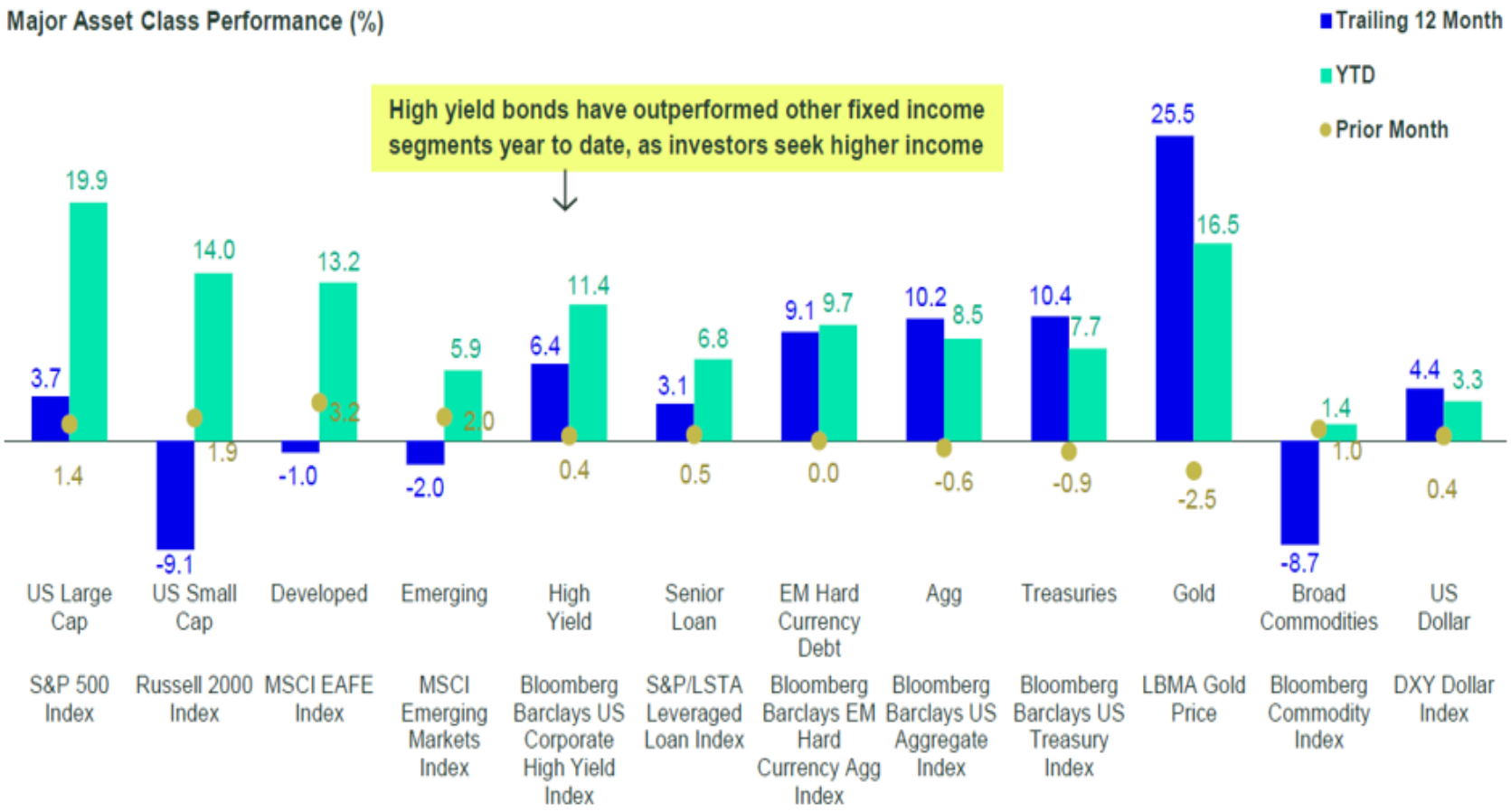
And, year to date returns are widely positive.



Source: Bloomberg Finance, L.P. As of September 30, 2019. Past performance is not a guarantee of future results. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income. Performance returns for periods of less than one year are not annualized.

In the US markets, value stocks out performed the general market.

Third-Quarter US Equity Style Funds Heat Map

	Value	Blend	Growth
Large	1.51	1.46	-1.82
Mid	0.45	0.11	-0.48
Small	-0.52	-1.27	-4.21

≤-2% 2%≥

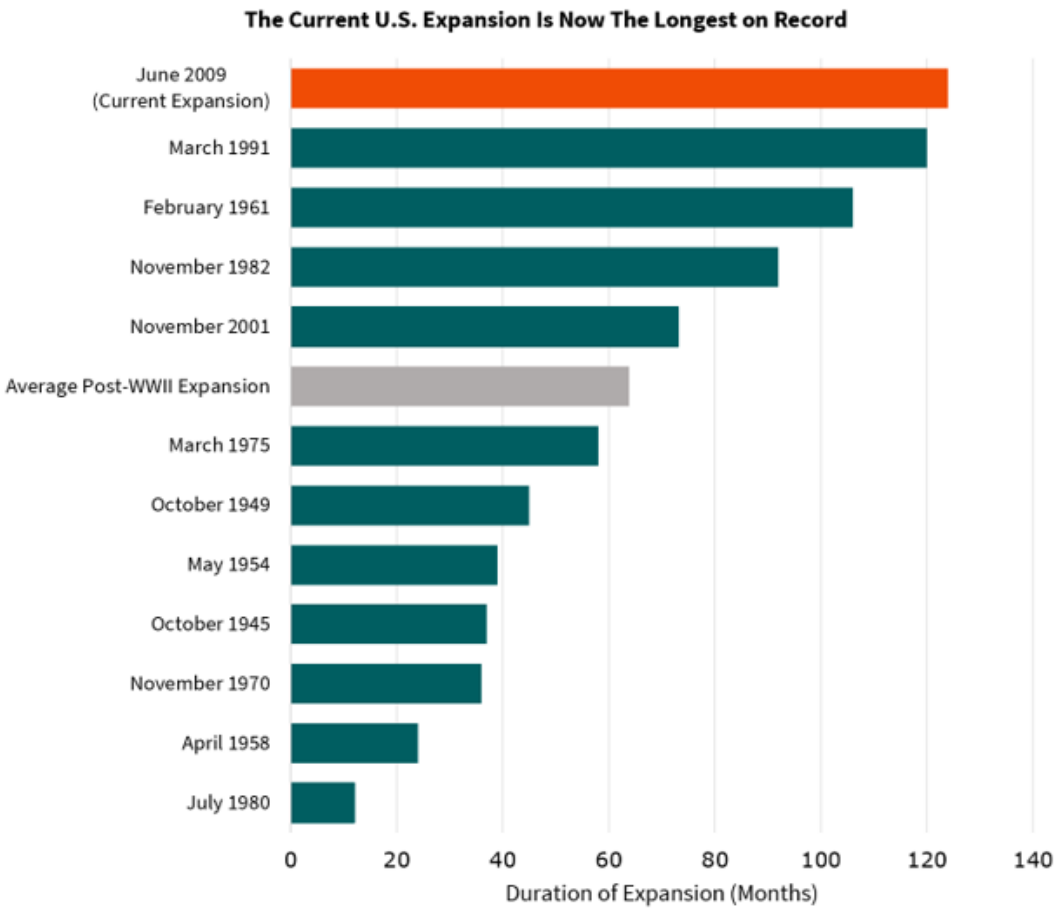
...as defensive sectors rotated back into favor.

Schwab Asset Class Quilt® showing sectors:

Oct-18	Nov-18	Dec-18	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19	Aug-19	Sep-19*
Cons. Staples 2.1%	Health Care 6.8%	Utilities -4.3%	Industrials 11.4%	Info. Tech. 6.6%	Info. Tech. 4.8%	Financials 8.8%	Real Estate 0.9%	Materials 11.5%	Info. Tech. 3.3%	Utilities 4.7%	Energy 5.8%
Utilities 1.9%	Real Estate 5.3%	Materials -7.2%	Energy 11.0%	Industrials 6.1%	Real Estate 4.5%	Info. Tech. 6.4%	Utilities -1.3%	Energy 9.1%	Comm. Serv. 3.0%	Real Estate 4.6%	Financials 4.7%
Real Estate -1.7%	Materials 3.8%	Comm. Serv. -7.4%	Real Estate 10.7%	Utilities 3.6%	Cons. Discr. 3.9%	Comm. Serv. 6.2%	Health Care -2.5%	Info. Tech. 9.1%	Cons. Staples 2.3%	Cons. Staples 1.6%	Utilities 3.8%
Financials -4.9%	Industrials 3.5%	Real Estate -7.9%	Cons. Discr. 10.2%	Materials 3.0%	Cons. Staples 3.7%	Cons. Discr. 5.7%	Cons. Staples -4.0%	Industrials 7.8%	Financials 2.3%	Health Care -0.7%	Industrials 3.1%
Comm. Serv. -6.0%	Utilities 3.1%	Cons. Discr. -8.4%	Comm. Serv. 10.1%	S&P 500 3.0%	Utilities 2.7%	Industrials 4.0%	Comm. Serv. -6.0%	Cons. Discr. 7.6%	Real Estate 1.7%	Cons. Discr. -1.4%	Materials 2.7%
Health Care -6.8%	Cons. Discr. 2.6%	Info. Tech. -8.5%	Financials 8.6%	Financials 2.2%	Comm. Serv. 2.4%	S&P 500 3.9%	S&P 500 -6.6%	S&P 500 6.9%	S&P 500 1.3%	Comm. Serv. -1.5%	S&P 500 2.0%
S&P 500 -6.9%	Financials 2.6%	Health Care -8.7%	S&P 500 7.9%	Cons. Staples 2.1%	Energy 2.0%	Materials 3.6%	Financials -7.4%	Financials 6.6%	Cons. Discr. 0.9%	Info. Tech. -1.7%	Comm. Serv. 1.8%
Info. Tech. -8.0%	S&P 500 1.8%	S&P 500 -9.2%	Info. Tech. 6.9%	Energy 1.9%	S&P 500 1.8%	Cons. Staples 2.3%	Cons. Discr. -7.7%	Health Care 6.5%	Industrials 0.6%	S&P 500 -1.8%	Info. Tech. 1.7%
Materials -9.5%	Cons. Staples 1.7%	Cons. Staples -9.5%	Materials 5.5%	Health Care 1.0%	Materials 0.9%	Utilities 0.9%	Industrials -8.1%	Cons. Staples 4.8%	Utilities -0.4%	Industrials -2.9%	Cons. Discr. 0.8%
Industrials -10.9%	Comm. Serv. -0.7%	Industrials -10.8%	Cons. Staples 5.0%	Real Estate 0.8%	Health Care 0.3%	Energy 0.0%	Materials -8.5%	Comm. Serv. 4.3%	Materials -0.4%	Materials -3.1%	Cons. Staples 0.4%
Cons. Discr. -11.3%	Info. Tech. -2.1%	Financials -11.4%	Health Care 4.7%	Comm. Serv. 0.8%	Industrials -1.2%	Real Estate -0.6%	Info. Tech. -8.9%	Utilities 3.1%	Health Care -1.7%	Financials -5.1%	Real Estate 0.2%
Energy -11.3%	Energy -2.2%	Energy -12.8%	Utilities 3.4%	Cons. Discr. 0.6%	Financials -2.7%	Health Care -2.7%	Energy -11.7%	Real Estate 1.3%	Energy -1.9%	Energy -8.7%	Health Care -0.2%

Source: Charles Schwab, Bloomberg, as of 9/25/2019. Sector performance is represented by price returns of the following 11 GICS sector indices: Communication Services, Consumer Discretionary, Consumer Staples, Energy, Financials, Health Care, Industrials, Information Technology, Materials, Real Estate, and Utilities. Returns of the broad market are represented by the S&P 500® index. **Past performance is no guarantee of future results.** For illustrative purposes only.

The current US expansion is now the longest on record.



- Economic signals are mixed, and analysis of the current economic environment continues to be challenging.
- On one side, we have a still-solid U.S. economy that has grown for a record number of consecutive years.
- On the other side, global economic growth remains weak and consensus expectations are for further slowing.
- The expansive monetary policies of central banks around the world continue to present an unknown risk factor.

Source: National Bureau of Economic Research. Data as of 09/30/2019.

...but the global landscape is challenging.

Navigating the Global Crosscurrents

The investment landscape, while still positive, is growing more challenging as investors adjust to more typical late-stage expansion conditions.

Positives	Cautionary Signs/Areas to Watch
▪ Fed dovish pivot	▪ Aging business cycle
▪ Positive corporate profit growth	▪ Slowing global growth
▪ Healthy consumer and business fundamentals	▪ Trade policy missteps
▪ High confidence	▪ Higher volatility
▪ Favorable financial conditions	▪ Fading fiscal stimulus
▪ Moderate inflation	▪ Acceleration in wages and other business costs
▪ Very few signs of imbalances — massive debt growth, overinvestment, capacity constraints	▪ Geopolitical shocks
	▪ Higher federal debt levels

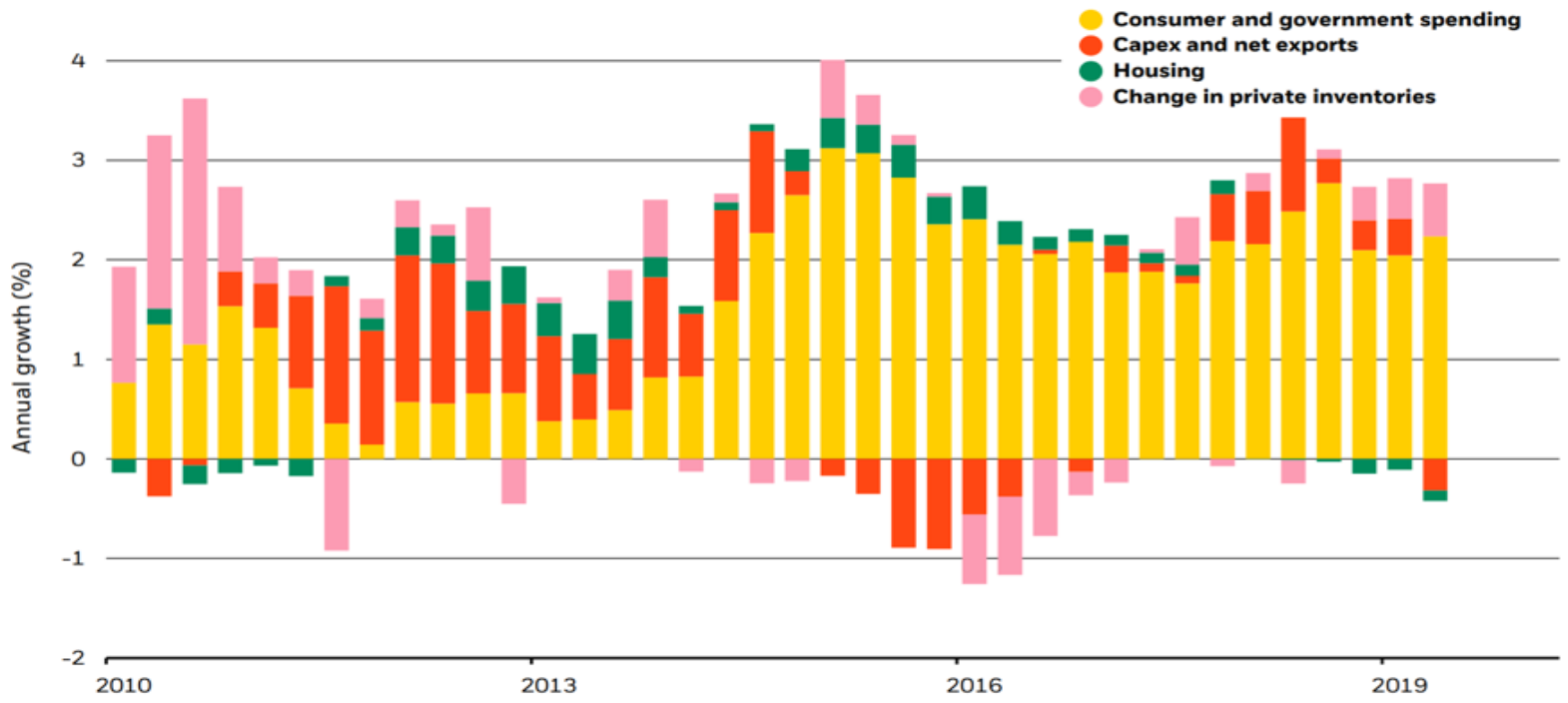
- Source: CNR

In the US economy, consumer spending remains strong offsetting much of the weakness in exports and capital spending.

Breaking down U.S. growth

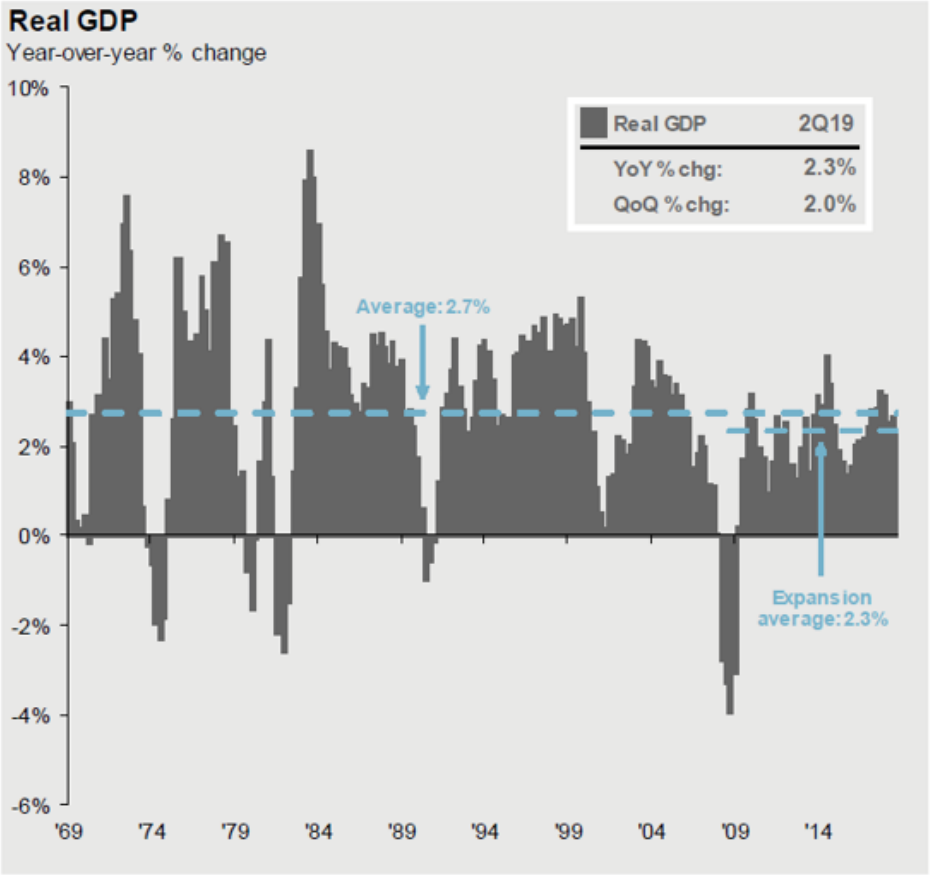
Companies are building up inventories in expectations of tariffs and cutting investment spending. Resilient consumption is helping offset manufacturing weakness.

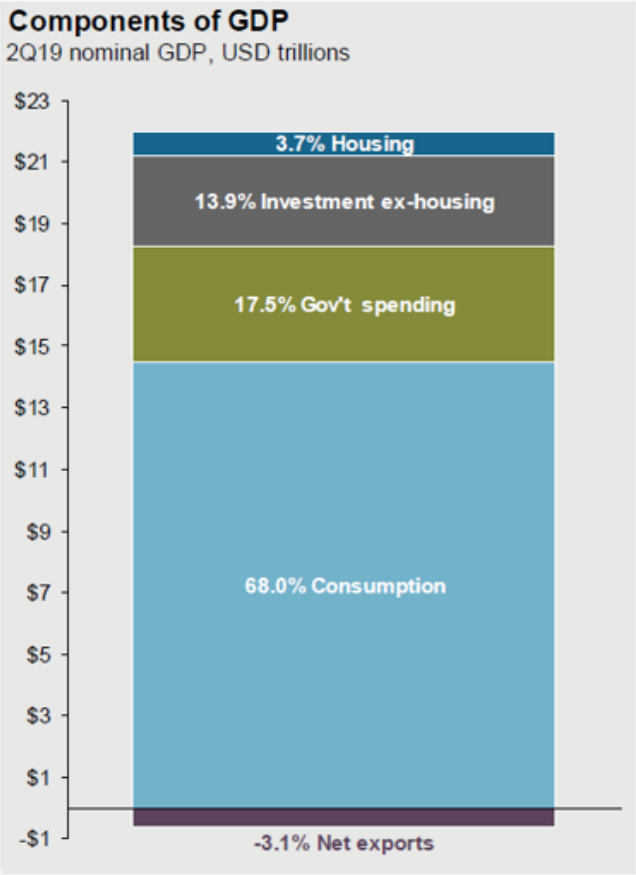
Composition of U.S. gross domestic product, 2010–2019



Source: BlackRock Investment Institute, with data from the U.S. Bureau of Economic Analysis, September 2019. Notes: The chart shows the annual rate of U.S. GDP growth broken down by components through the second quarter of 2019. Personal and government spending refers to a combination of personal consumption expenditures; government consumption expenditures and gross investment. Capex refers to non-residential domestic gross investment, and housing refers to residential investment.

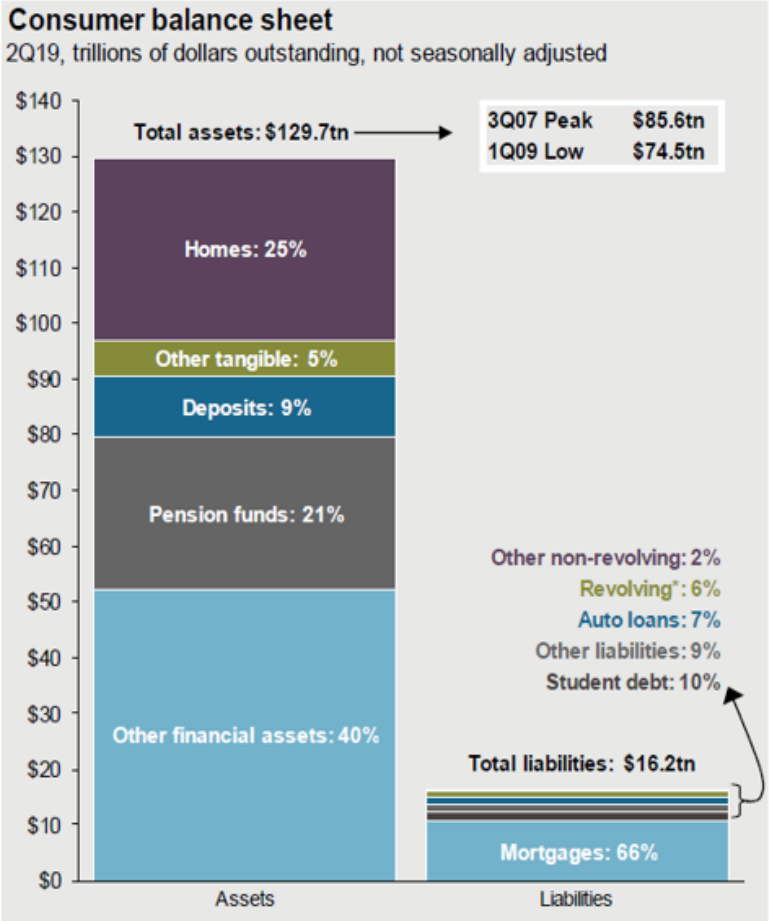
The US consumer makes up alomst 70% of the US GDP...

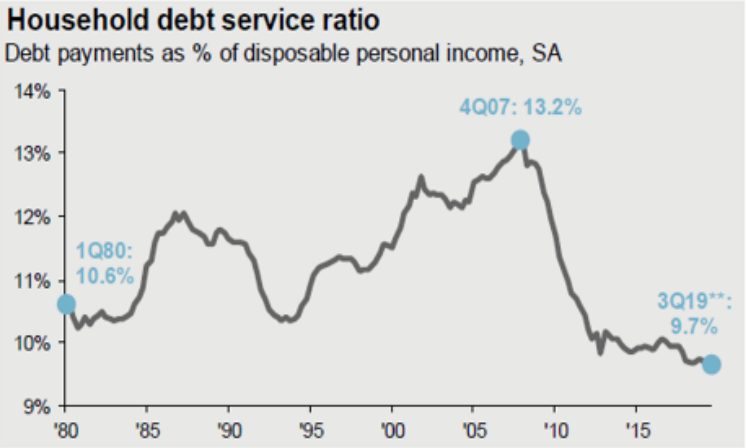


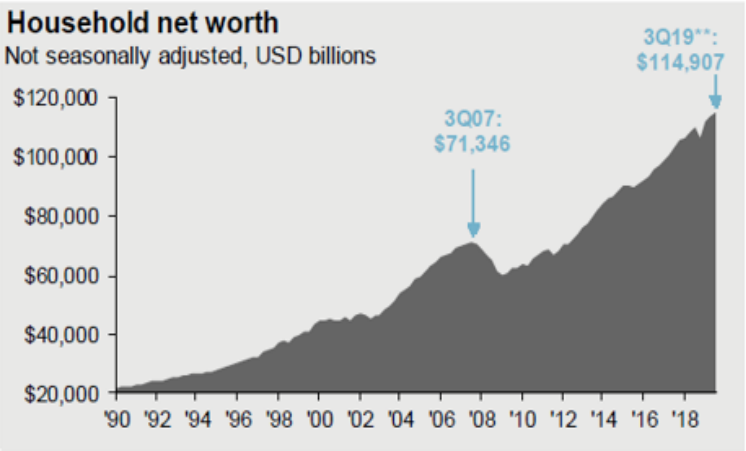


Source: BEA, FactSet, J.P. Morgan Asset Management.
Values may not sum to 100% due to rounding. Quarter-over-quarter percent changes are at an annualized rate. Average represents the annualized growth rate for the full period. Expansion average refers to the period starting in the third quarter of 2009.
Guide to the Markets – U.S. Data are as of September 30, 2019.

...and the consumer is in good shape with lower debt payments, high net worth...





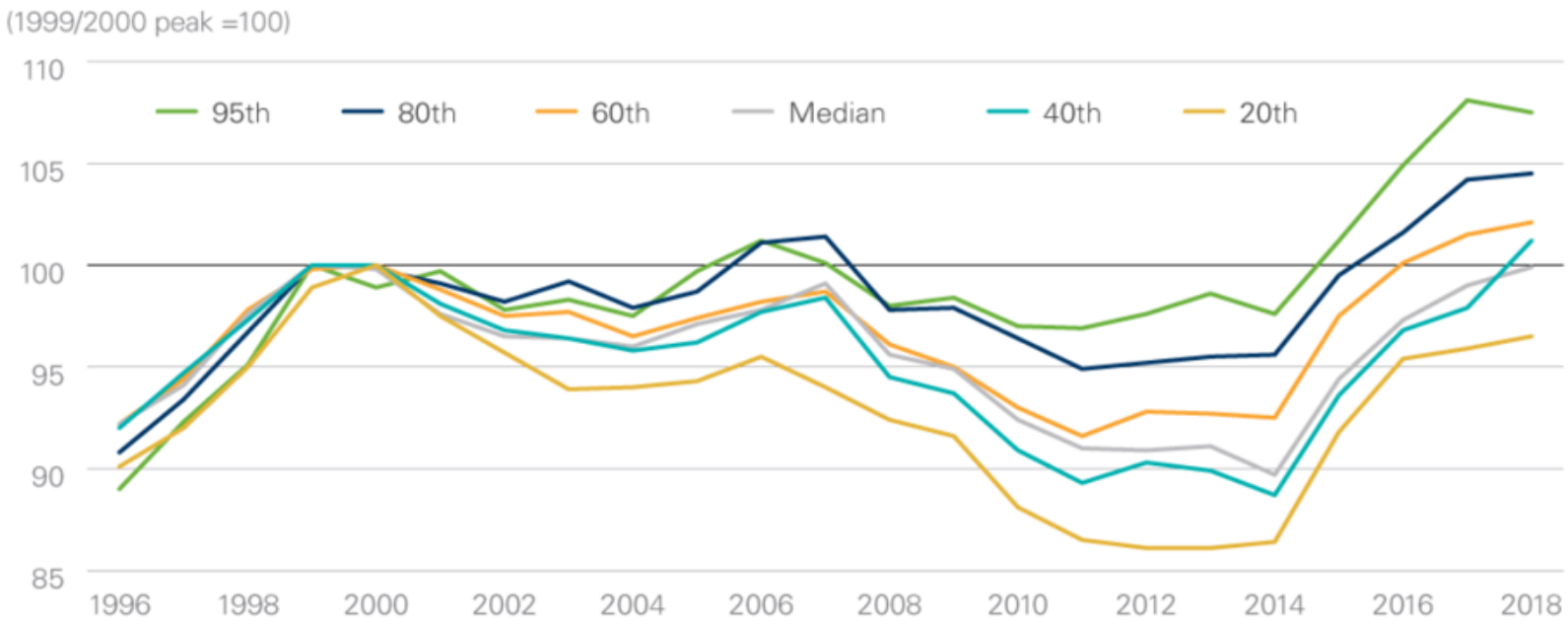


Source: FactSet, FRB, J.P. Morgan Asset Management; (Top and bottom right) BEA.
Data include households and nonprofit organizations. SA – seasonally adjusted. *Revolving includes credit cards. Values may not sum to 100% due to rounding. **3Q19 figures for debt service ratio and household net worth are J.P. Morgan Asset Management estimates.
Guide to the Markets – U.S. Data are as of September 30, 2019.

...and rising income.

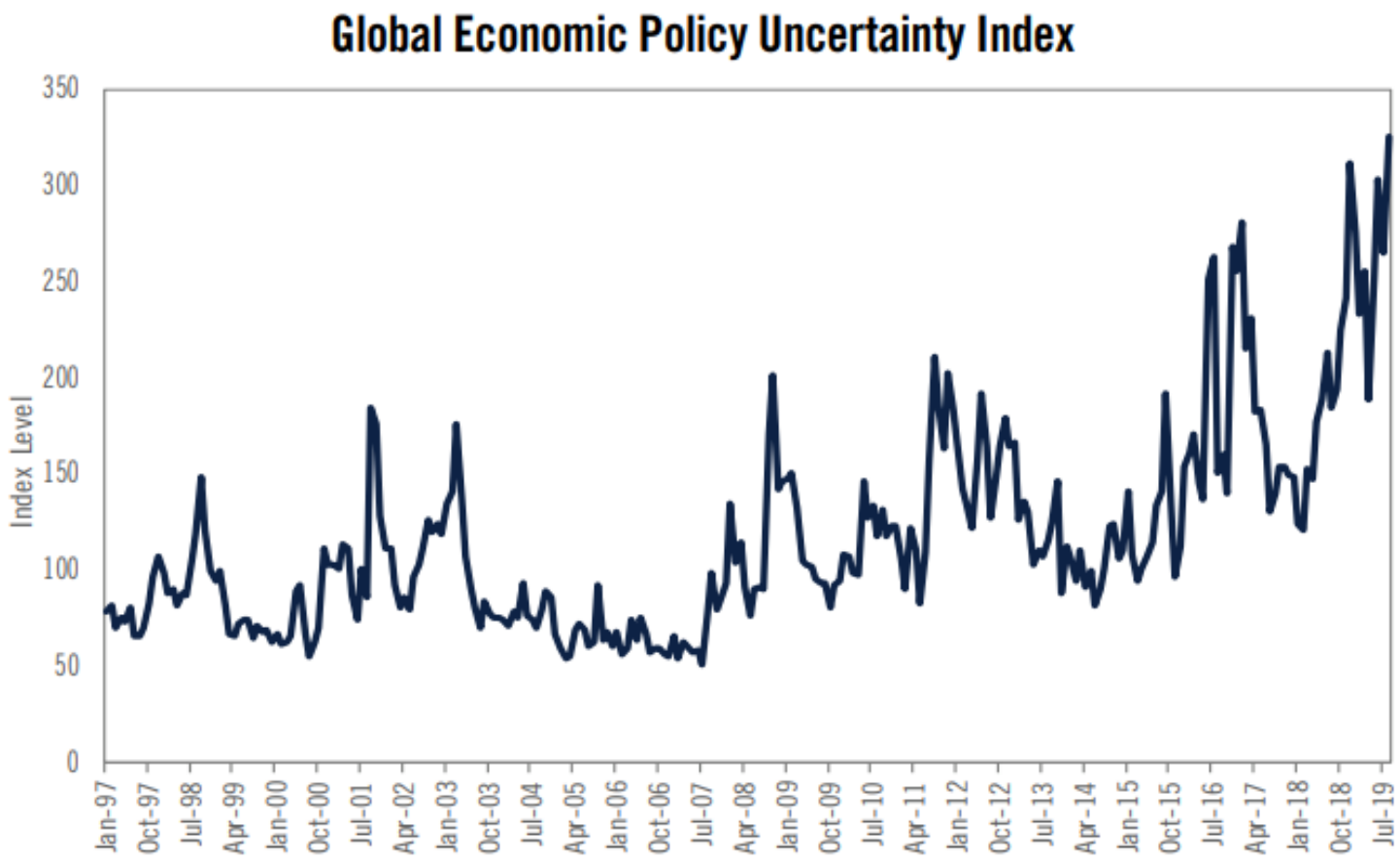
Exhibit 5: Real US Household Income Is Rising Across the Spectrum

Inflation-Adjusted Household Income by Percentile, Imputed



As of September 2019
Chart design indicates imputed history based on redesigned questionnaire (2014) and updated processing (2018). Imputations are based on the ratio of traditionally measured values versus values using new methodologies.

But, as global uncertainty rises...



As of 7/31/19.
Source: Bloomberg, Baker, Bloom & Davis.

...and many policy deadlines are on the horizon...

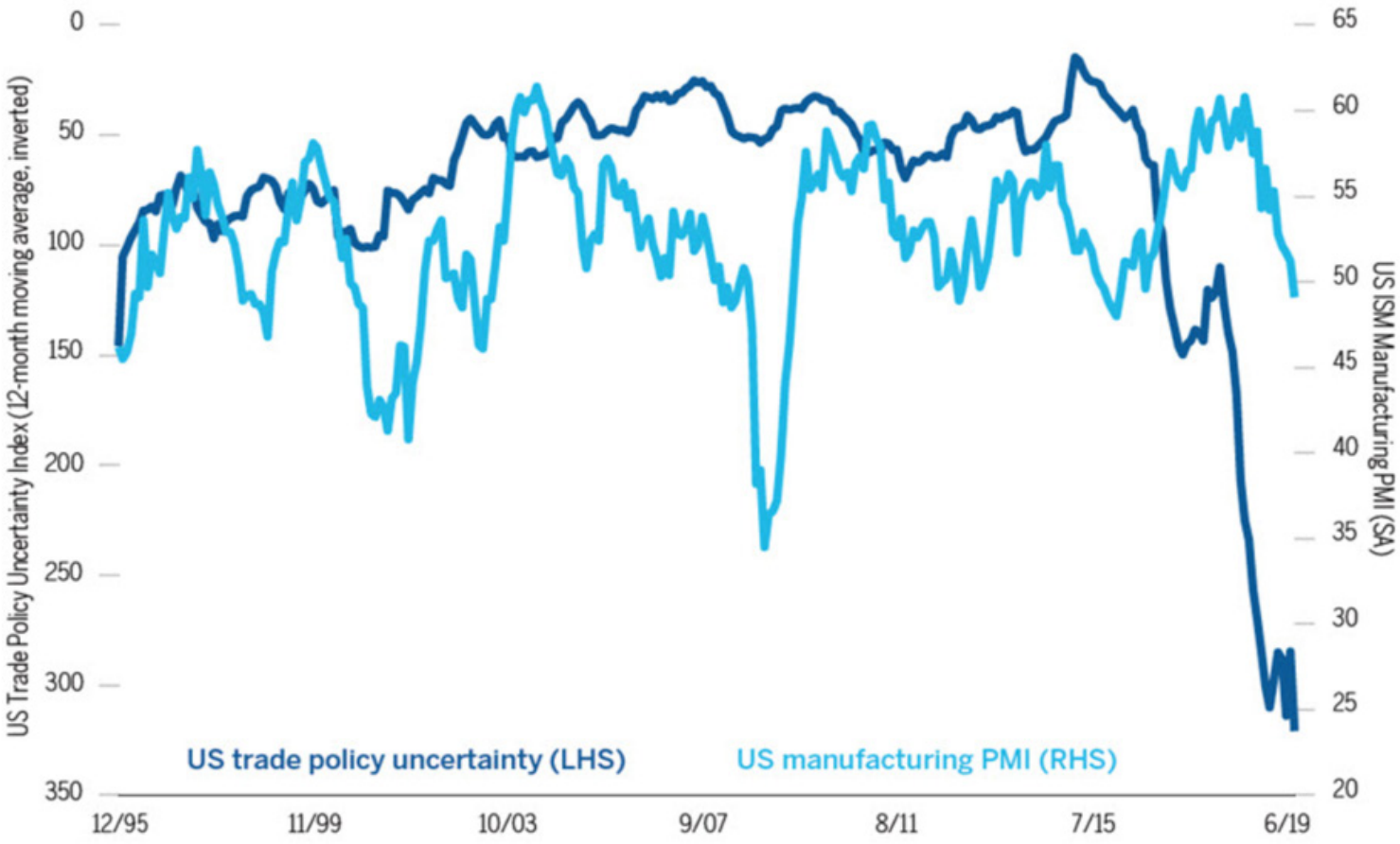
DATE	EVENT	COMMENT
TBD	Second ECRA consultation	Public consultation on identifying "foundational" technologies for export controls
TBD	Response on WTO ruling on aircraft subsidies	The US and EU both likely to levy tariffs on each other
Early October	US-China talks	Next round of US-China negotiations
October 12	Deadline for new ICT regulation	Executive Order on 15 May called for new regulations on foreign telecom firms supplying equipment to the US
October 15	List 1–3 tariff rate increases	25% tariff on List 1–3 imports from China increases to 30%
October 15	Treasury's currency report	Treasury's semiannual report to Congress on exchange rate policies
November 14	Deadline for auto tariffs	Deadline for President Trump to decide whether to levy national security tariffs on US auto and auto part imports. The EU, the largest exporter to the US, not yet exempted (Canada, Mexico, Japan)
November 16–17	APEC Summit	Presidents Trump and Xi might attend
November 17	Huawei temporary general license expires	Expiration of second 90-day temporary general license authorizing specific, limited transactions with Huawei. Can be extended
December 15	List 4b tariffs	Effective date for 15% tariff on second tranche of List 4 US goods imports from China ($300bn total across two tranches)

As of 27 September 2019
ECRA= Export Control Reform Act. "Lists" refer to successive tranches of threatened tariffs on China. ICT = information and communications technology.
Source: Lazard, Cowen and Co, Goldman Sachs

...businesses are slowing production...

Trade uncertainty weighs on US businesses

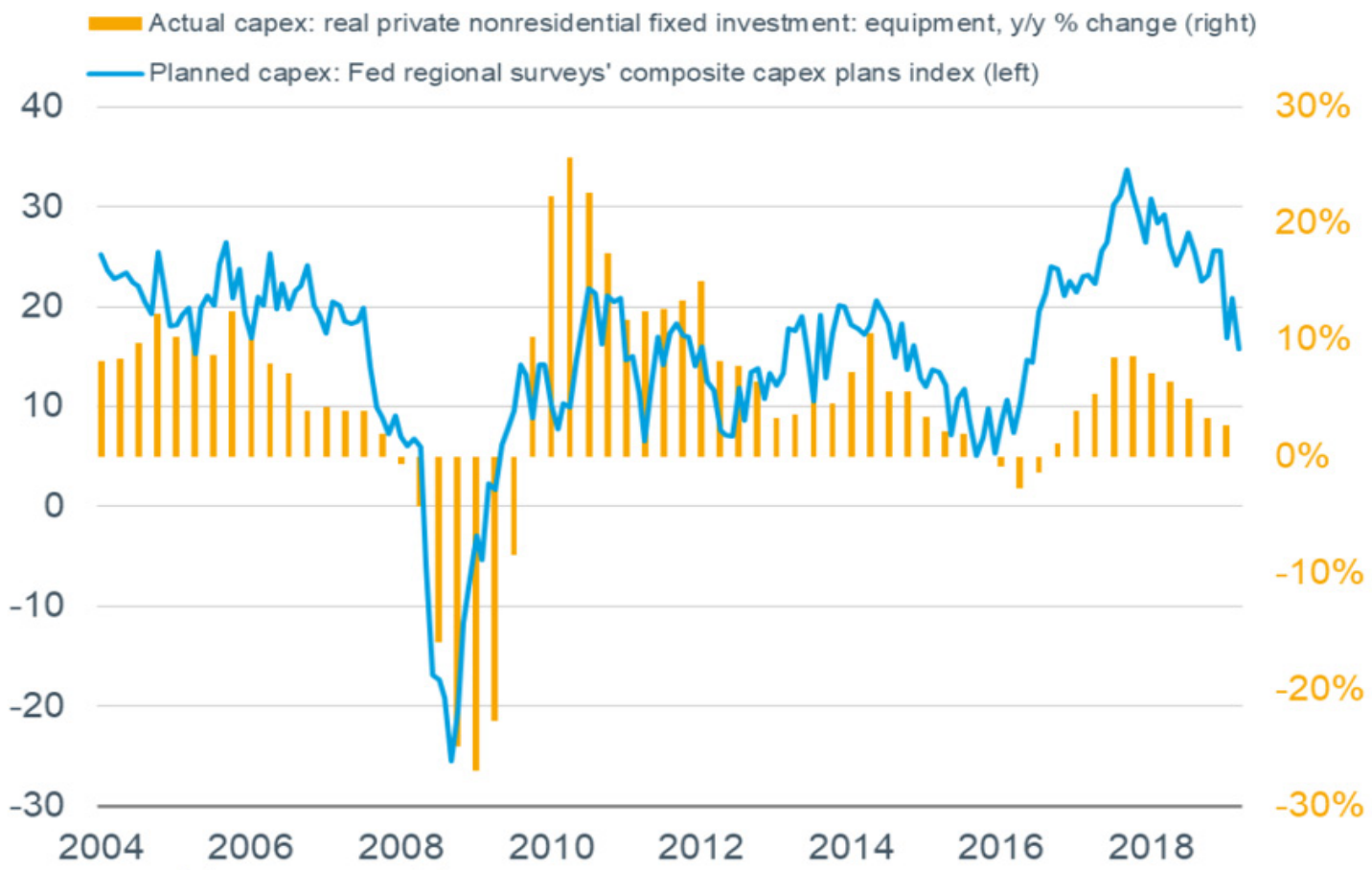
US Trade Policy Uncertainty Index and ISM Manufacturing Purchasing Managers' Index (PMI)



Sources: Baker, Bloom & Davis, Institute for Supply Management, Bloomberg | Chart data: December 1995 – August 2019

...not investing in capital expenses...

Capex is also suffering

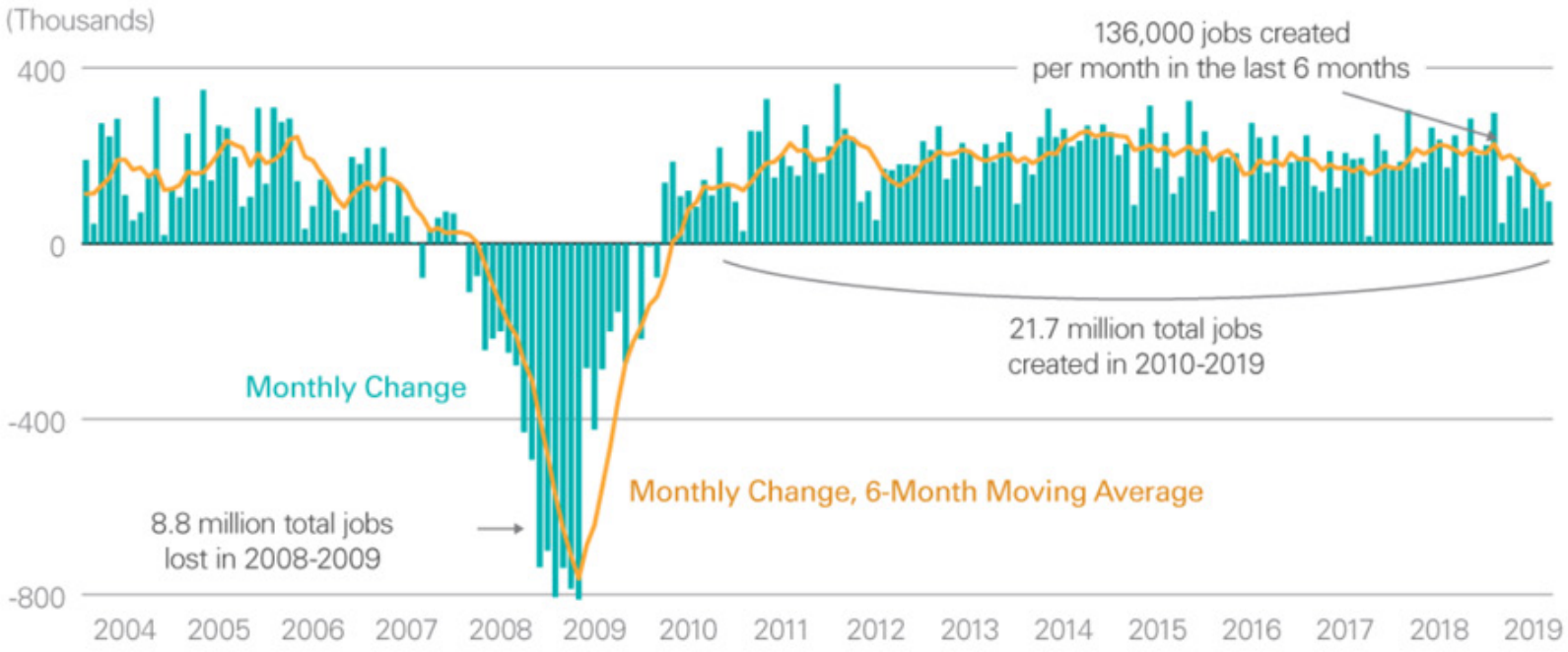


Actual capex as of 6/30/19. Planned capex as of 8/31/19. Source: Charles Schwab, Bloomberg, Bureau of Economic Analysis, Federal Reserve Banks of Dallas, Kansas City, New York, Philadelphia and Richmond, Strategas .

...and starting to reduce or freeze hiring.

Exhibit 6: Jobs Growth Has Slowed

Private Nonfarm Payrolls, Job Gain/Loss

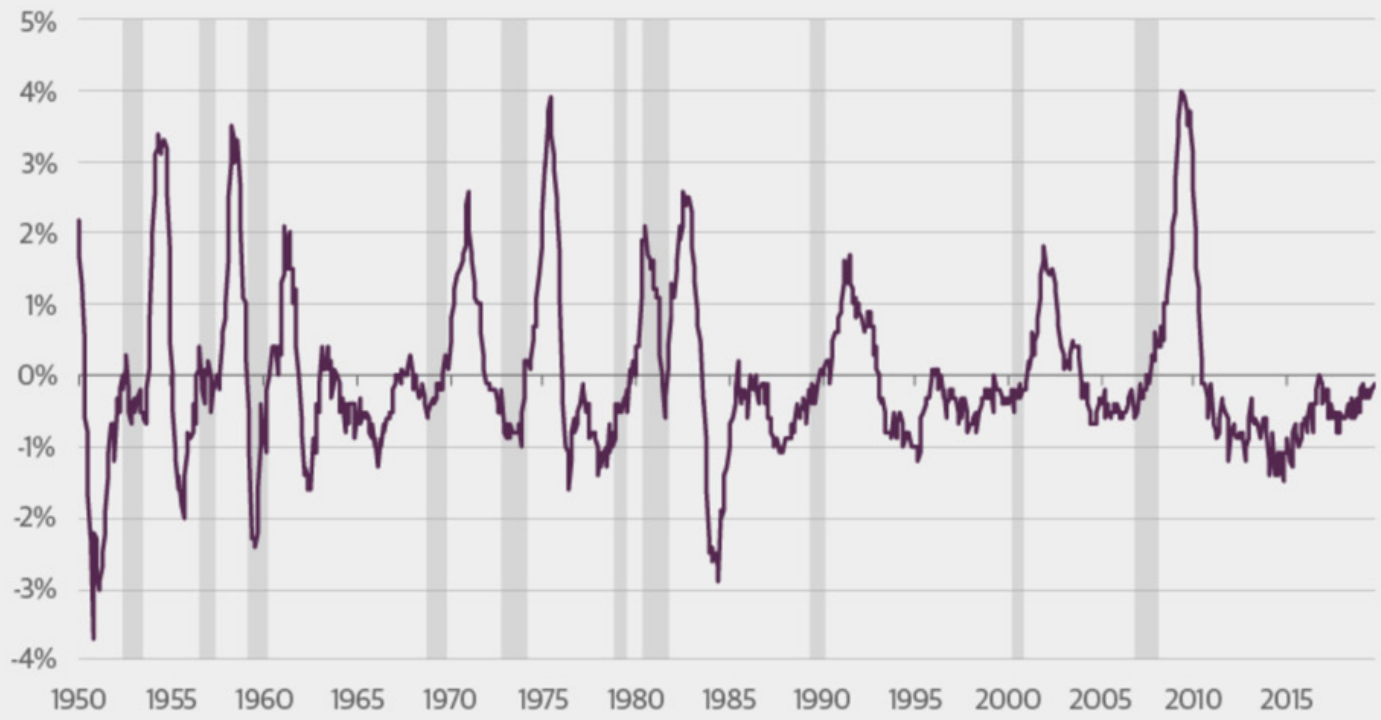


Historically, hiring freezes and reduced job openings preceed recessions.

The Pace of Decline in Unemployment Slows as Recessions Draw Nearer

One-Year Change in the Unemployment Rate

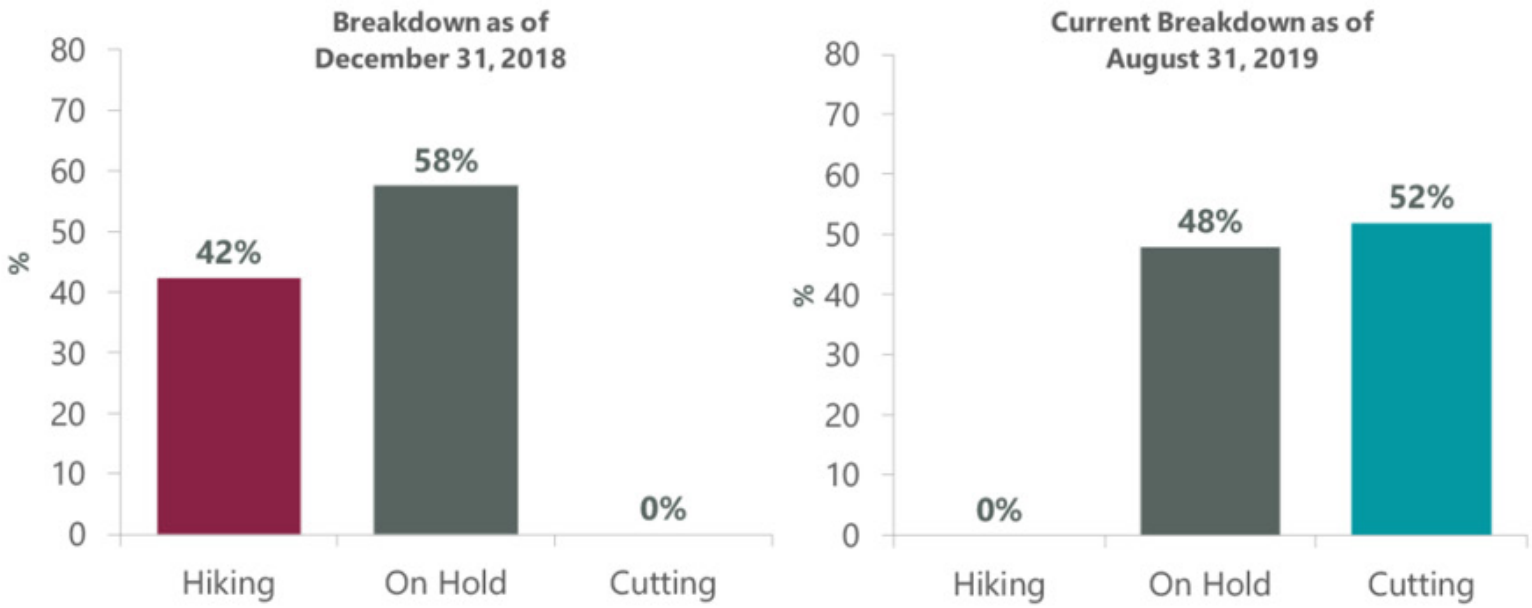
The labor market is losing momentum, a trend consistent with historical late-cycle dynamics.



Source: Guggenheim Investments, Haver Analytics. Data as of 8.31.2019. Shaded areas represent recession.

With the weakening of global manufacturing and business slowdowns, banks around the globe have switched from tightening to easing...

Exhibit 2: Global Central Banks are in Easing Mode

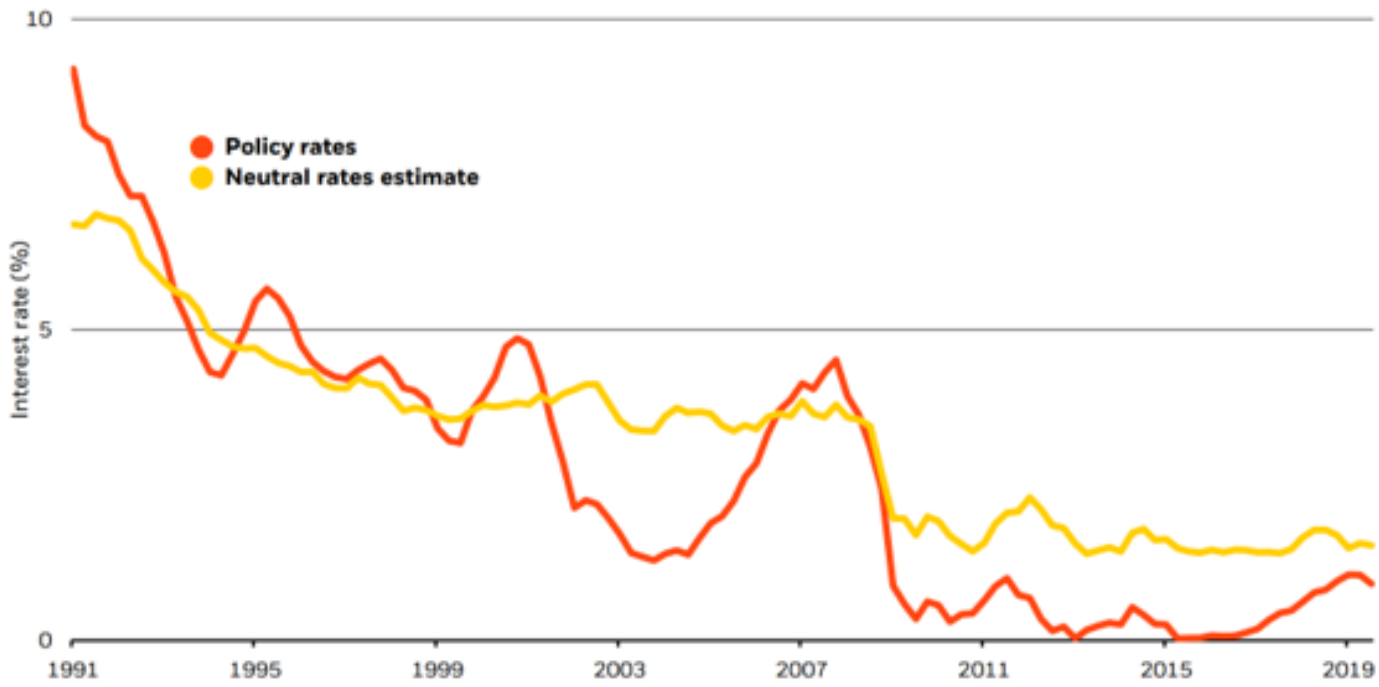


As of Aug. 31, 2019, latest available as of Sept. 30, 2019. Source: Bank for Int'l Settlements.

...hoping that lower rates will stimulate economic growth...

Policy rates at major central banks are falling again, backing away from neutral rates.
Central bank stimulus from an already loose policy stance should help sustain the expansion.

G3 policy interest rates and estimated neutral rates, 1991–2019

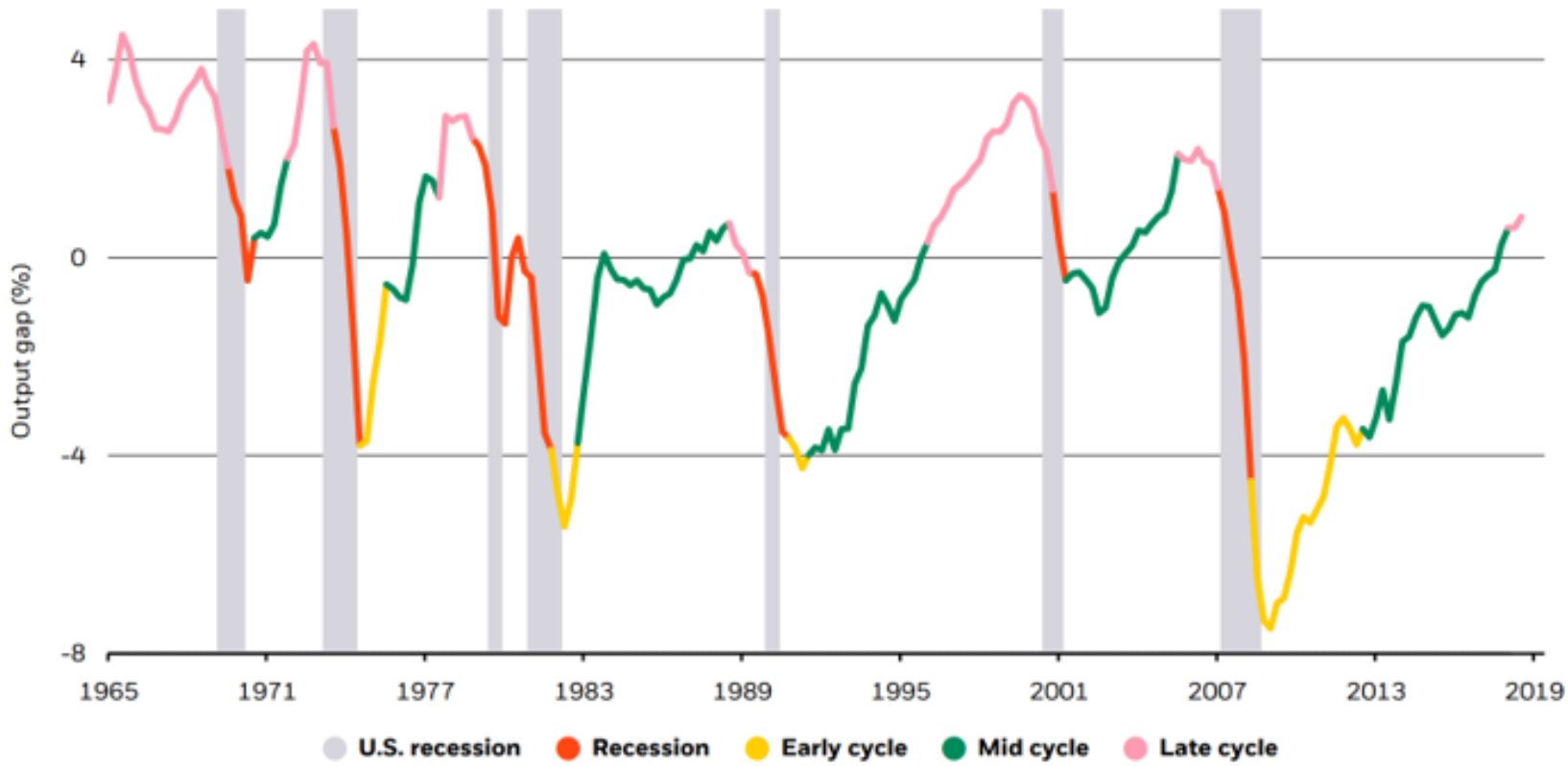


There is no guarantee that any forecast made will come to pass.
Source: BlackRock Investment Institute, Federal Reserve, National Bureau of Economic Research and European Central Bank, with data from Datastream Refinitiv, September 2019.
Notes: The chart shows our estimate of neutral rates (known as r-star) in nominal terms, adjusting for actual inflation, and the GDP-weighted nominal policy rates of the U.S., euro area and Japan. The neutral rate is an estimate of the short-term rate that neither fosters nor hinders GDP growth. The neutral rates are estimates based on an econometric model from a July 2018 ECB working paper. We detailed our estimates of neutral rates in the November 2018 Macro and market perspectives.

...and stretch the expansion cycle longer.

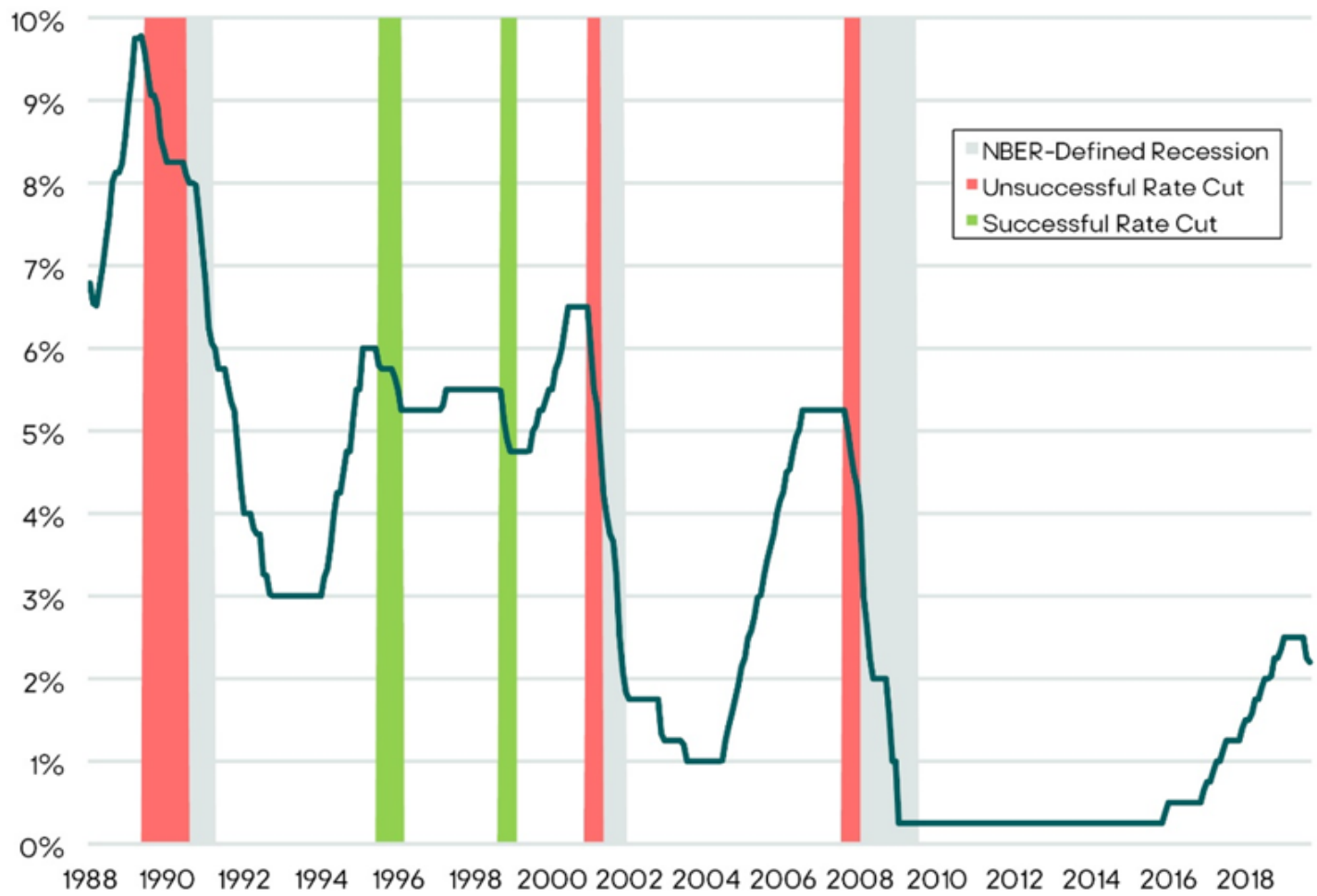
The U.S. economy entered the late stage of its expansion earlier this year.
Below-trend growth suggests it could revert to mid-cycle conditions in coming months.

Output gap and stages of the U.S. business cycle, 1965–2019



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, as of July 2019. Notes: This chart shows an estimate of the U.S. output gap (that is, GDP as a percentage of potential GDP). We have classified different time periods as belonging to certain stages of the business cycle. The classification of the stage is done via a 'cluster analysis' that groups together time periods where economic series have behaved in similar ways.

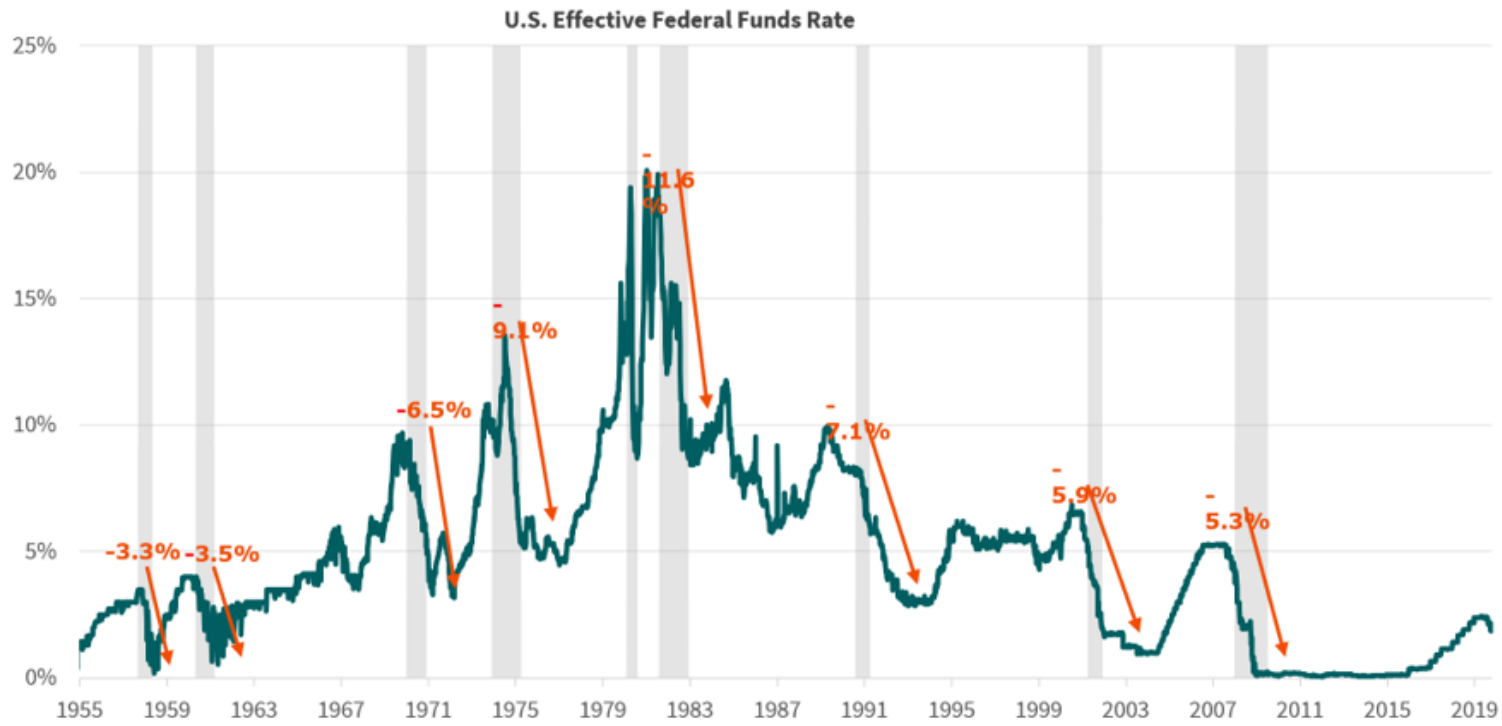
However, Fed rate cuts have a mixed track record of preventing recessions.



Source: Board of Governors of the Federal Reserve System. Data as of 9/24/2019.

And the benefit from additional rate cuts will likely be limited.

After nine rate *hikes*, the fed funds rate is barely above levels where it has ended most other *easing* cycles. Moreover, the Fed has historically cut rates by 5%–7% during a recessionary easing cycle, and there will be little room to cut rates before hitting the "zero lower bound."



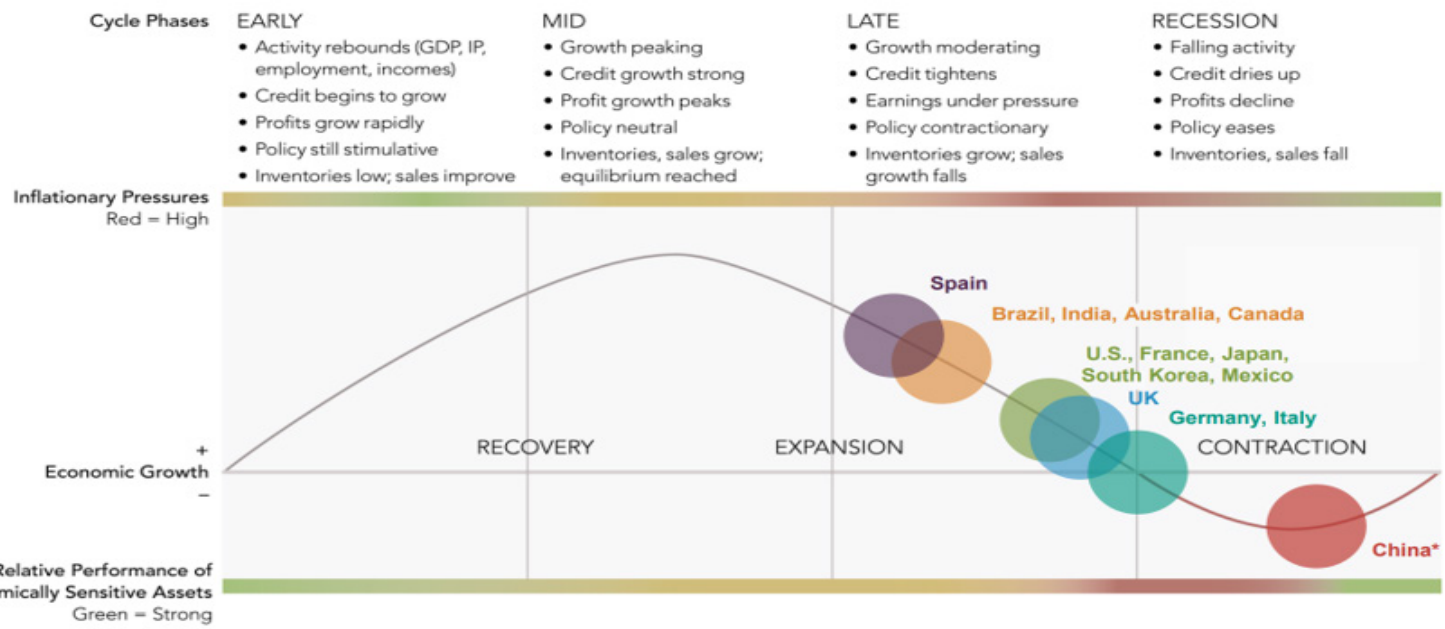
Shaded regions represent NBER-defined recessions. Source: Federal Reserve. Data as of 9/30/2019.

The US and global economies appear to be fully late cycle...

Mature U.S. and Global Business Cycles

The global business cycle continues to mature, with the U.S. and most major economies in the late-cycle phase. China's economy has stabilized, but a reacceleration from its growth recession has remained elusive. Overall, a global industrial and trade recession has shown few signs of abating, and it remains to be seen whether policy easing measures will prove sufficient to stimulate a sustained global reacceleration.

Business Cycle Framework



Note: The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. * A growth recession is a significant decline in activity relative to a country's long-term economic potential. We use the "growth cycle" definition for most developing economies, such as China, because they tend to exhibit strong trend performance driven by rapid factor accumulation and increases in productivity, and the deviation from the trend tends to matter most for asset returns. We use the classic definition of recession, involving an outright contraction in economic activity, for developed economies. Source: Fidelity Investments (AART), as of 9/30/19.

And market movement appears to refelct this sentiment.

This Is What Late Cycle Looks Like

Harder Fought Gains

We don't think the bull market is finished just yet, but investors should brace themselves for lower market returns, more volatility and bigger tail risks.

Source: FactSet. As of September 30, 2019.

- Source: CNR

As recession signals mount...

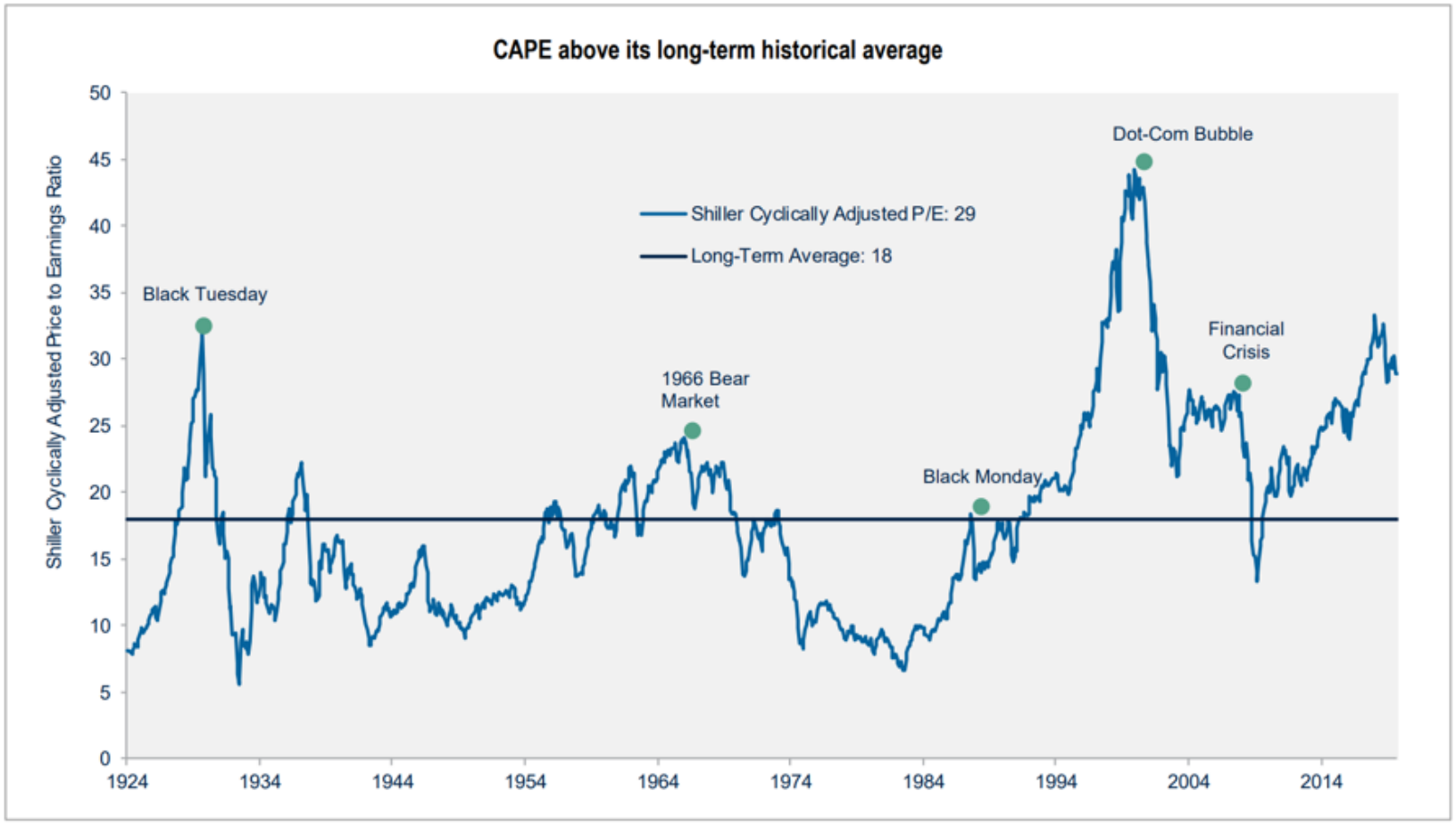
Exhibit 1: ClearBridge Recession Risk Dashboard

		Third Quarter 2019	Second Quarter 2019	First Quarter 2019
Financial	Yield Curve	✕	✕	✕
	Credit Spreads	↑	↑	↑
	Money Supply	●	●	●
Inflation	Wage Growth	●	●	●
	Commodities	✕	✕	●
Consumer	Housing Permits	↑	↑	↑
	Jobless Claims	↑	↑	↑
	Retail Sales	↑	↑	↑
	Job Sentiment	↑	●	↑
Business Activity	ISM New Orders	✕	●	↑
	Profit Margins	●	↑	↑
	Truck Shipments	↑	↑	↑
	Overall Signal	●	●	↑

↑ Expansion ● Caution ✕ Recession

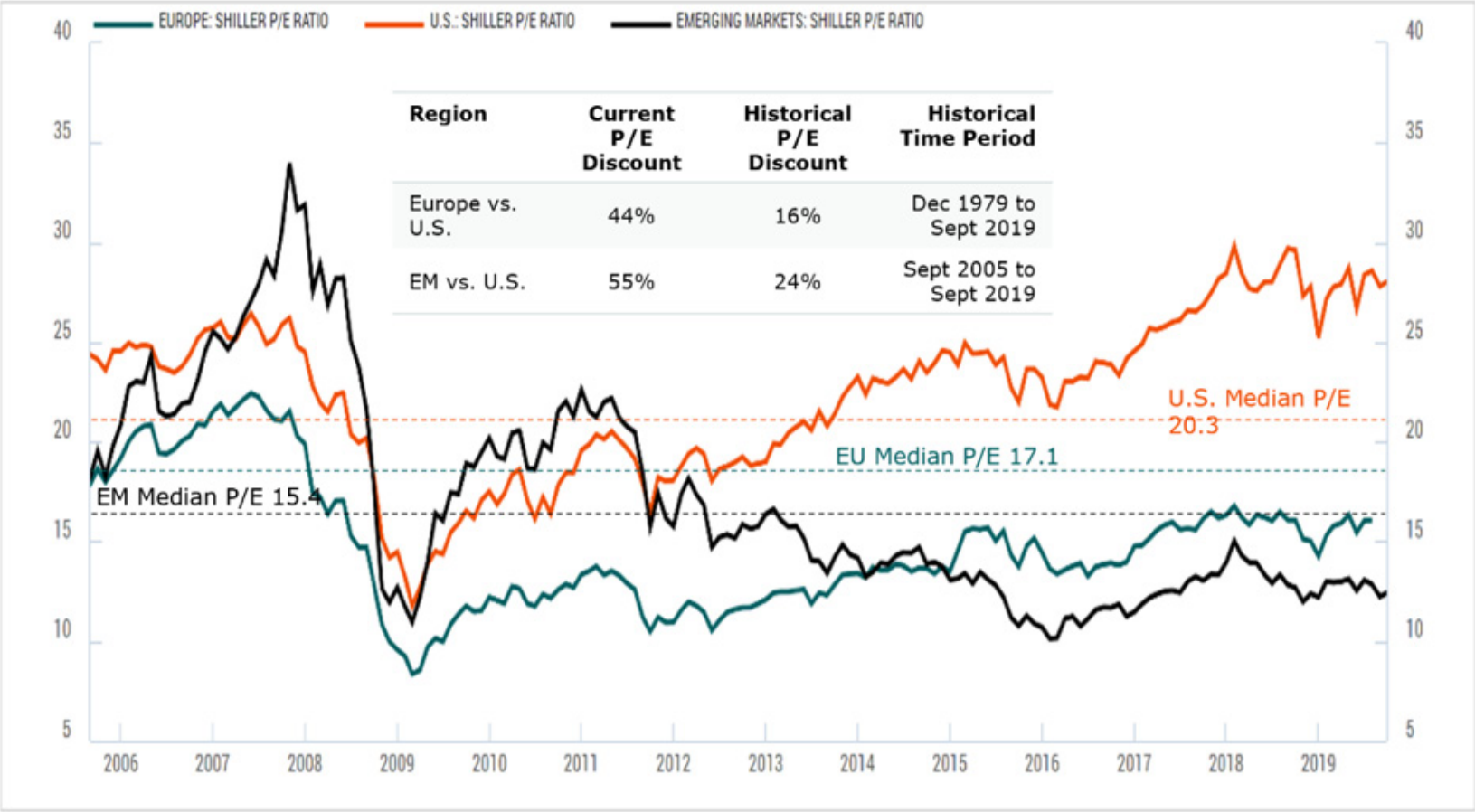
Source: ClearBridge Investments.

US equity valuations appear stretched.



Source: Bloomberg. Shiller Cyclically Adjusted Price to Earnings Ratio of the S&P 500 Index. Long-term average calculated from 1924 to present. Data as of 9/30/2019.

...while foreign stocks are trading at significant discounts to the US...



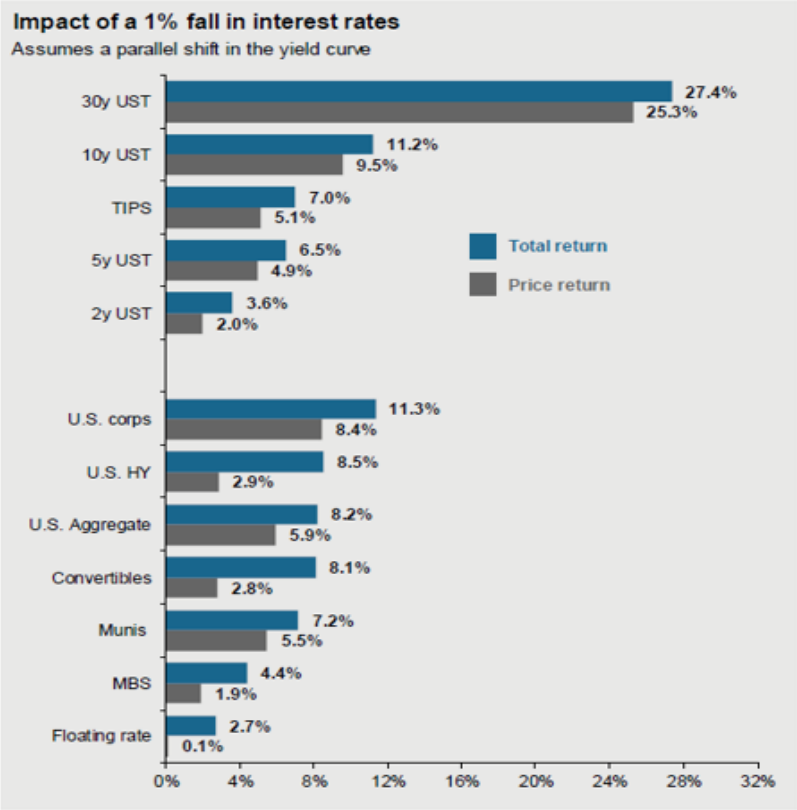
Region	Current P/E Discount	Historical P/E Discount	Historical Time Period
Europe vs. U.S.	44%	16%	Dec 1979 to Sept 2019
EM vs. U.S.	55%	24%	Sept 2005 to Sept 2019

Median P/E Data for Europe and U.S. begins 11/30/1979, and for Emerging Markets 8/31/2005.

Source: BCA Research and Ned Davis Research. Data as of 9/30/2019 except for EU which is as of 7/31/2019.

Fixed income securities should provide ballast to a portfolio, especially in falling rate environment.

U.S. Treasuries	Yield 9/30/2019	Yield 6/30/2019	Return 2019 YTD	Avg. Maturity	Correltation to 10-year	Correlation to S&P 500
2-Year	1.63%	1.75%	2.89%	2 years	0.68	-0.35
5-Year	1.55%	1.76%	6.11%	5	0.92	-0.32
TIPS	0.15%	0.31%	7.58%	10	0.62	0.13
10-Year	1.68%	2.00%	10.86%	10	1.00	-0.31
30-Year	2.12%	2.52%	22.40%	30	0.93	-0.32
Sector						
Convertibles	5.28%	5.87%	14.11%	-	-0.29	0.89
Floating Rate	2.56%	2.79%	3.42%	2.1	-0.20	0.38
High Yield	5.65%	5.87%	11.41%	5.8	-0.21	0.72
MBS	2.45%	2.70%	5.60%	4.5	0.82	-0.13
U.S. Aggregate	2.26%	2.49%	8.52%	7.9	0.88	-0.01
Corporates	2.91%	3.16%	13.20%	11.4	0.52	0.30
Municipals	1.70%	1.85%	6.86%	9.9	0.54	-0.02



Source: Barclays, Bloomberg, FactSet, Standard & Poor's, U.S. Treasury, J.P. Morgan Asset Management. Sectors shown above are provided by Bloomberg and are represented by – Broad Market: U.S. Aggregate; MBS: U.S. Aggregate Securitized - MBS; Corporate: U.S. Corporates; Municipals: Muni Bond 10-year; High Yield: Corporate High Yield; TIPS: Treasury Inflation-Protected Securities (TIPS); U.S. Floating rate index; Convertibles: U.S. Convertibles Composite. Yield and return information based on bellwethers for Treasury securities. Sector yields reflect yield to worst. Convertibles yield is based on U.S. portion of Bloomberg Barclays Global Convertibles. Correlations are based on 15-years of monthly returns for all sectors. Change in bond price is calculated using both duration and convexity according to the following formula: New Price = (Price + (Price * -Duration * Change in Interest Rates))+(0.5 * Price * Convexity * (Change in Interest Rates)^2). Chart is for illustrative purposes only. Past performance is not indicative of future results.
Guide to the Markets – U.S. Data are as of September 30, 2019.

J.P.Morgan Asset Management

Portfolio Implications

- Because our balanced portfolios are diversified beyond U.S. stocks and core bonds, the overall market trends in the third quarter were a drag on relative performance. However, performance was aided in September when interest rates moved higher, catalyzed by an apparent détente (at least for the time being) in the U.S.-China trade war.

- The economic environment continues to feel like a game of tug of war between the contractionary effects from U.S. trade policy and accommodative global monetary policy. The divergent outcomes we see as possible from here (recession vs. cyclical rebound) explain our balanced portfolio approach and focus on diversification. The upgraded quality of our fixed-income holdings should better protect portfolios in a recessionary event. Meanwhile, our tilt toward international and value stocks on the equity side should benefit portfolios if a cyclical rebound takes hold. Together with the broader diversification across asset classes and investment strategies, client portfolios should be resilient across a range of economic and market scenarios.

- In addition to broad risk diversification, our portfolios are tilted toward asset classes that we believe currently offer attractive risk-adjusted returns over a five- to 10-year tactical time horizon. And we are tilted away from areas offering a poor risk-return tradeoff.

Disclosures

- Please remember that past performance may not be indicative of future results. Therefore, no current or prospective client should assume that the future performance of any specific investment, investment strategy (including the investments and/or investment strategies recommended by the adviser), will be profitable or equal to past performance levels.

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- All investment strategies have the potential for profit or loss. Changes in investment strategies, contributions or withdrawals may materially alter the performance and results of your portfolio. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Meridian Financial Partners, Inc. ("Meridian"), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Diversification does not guarantee against market losses, it is a method used to help manage investment risk.

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