ECONOMIC OVERVIEW

Steve Scranton, CFA
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SUMMARY:

- Economic growth is on track to reach a 3% growth rate for all of 2018.
- Consumers continue to be the engine of growth but their increased spending is on things they have to buy versus things they want to buy.
- Business confidence is translating into increased spending on technology and plant and equipment.
- For all of the media coverage, tariffs have had a small overall impact to economic growth although isolated industries have been hit.

OBSERVATIONS

Despite all of the noise and drama emanating from Washington, D.C., businesses and consumers continue to respond to the $200 billion of tax cut stimulus that is flowing into the economy in 2018. After a modest 2.2% annualized growth rate in the 1st quarter and a strong 4.2% surge in the 2nd quarter, 3rd quarter economic growth is forecast to reach 3.5%. **First estimates of 3rd quarter growth will not be out until the end of October, but the data released throughout the 3rd quarter indicates a solid result is in store.**

CONSUMER SPENDING

Consumers continue to put their tax savings to work as personal spending rose by 5.3% on a year-over-year basis, as of 8/31/18. This compares to a 3.9% rate as of 8/31/17. That does not mean that all consumers were happy with how they spent their tax savings. Analyzing the data shows that of the $120 billion that consumers received from the tax cuts, approximately half of it has been spent on higher fuel costs. With oil averaging close to $67 per barrel, that translates into approximately $60 billion in higher fuel costs. From an emotional standpoint, spending your tax cut on things you have to buy versus things you want to buy may ultimately leave some people feeling dissatisfied. That has not shown up yet in the consumer surveys as the consumer confidence indices continue to hover near record highs.

BUSINESS SPENDING

Business confidence surveys are also at or near record highs. This is translating into increased spending from businesses. Businesses continued to focus their spending on improving productivity via investments in software, hardware, and plant and equipment. Tariffs have had a minimal impact on an overall basis since the tariffs on $200 billion of goods will not take effect until the 4th quarter. In the meantime, core capital expenditures (excluding defense and aircraft) have grown at an average annualized rate of 7.4% so far this year. Over the same time period last year, capital expenditures averaged 4.5%. Durable goods orders have averaged an annualized rate of 7.8% versus 5.5% for the same time period last year.

GOVERNMENT SPENDING

Government spending has also contributed to the better economic growth this year. The biggest contributor from government spending has been defense spending.

CONCLUSION

The US appears to be on track to achieve a 3%-or-better growth rate for all of 2018. If this happens, it will be the first time in the current business cycle that the economy achieves a 3%-or-higher growth rate for the full year. As discussed in previous newsletters, 3% was an average growth rate between the end of World War II and the Financial Crisis. Given the fact that the average annual growth rate for this business cycle is 2.2%, psychologically, 3% seems like a robust rate for many people. This probably helps explain why some media outlets, analysts and economists are describing the current growth as robust growth.

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ALTERNATIVE STRATEGIES

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Equities marched higher despite the possibility of a trade war with China. Much of the risk with other trading partners has abated as progress on trade continued; however, the risk with China has grown.

For the 3rd quarter the S&P 500 gained 7.7%, 10.6% year-to-date. Small cap stocks lagged, gaining 3.6%, but have outpaced large caps year-to-date with an 11.5% gain.

For multi-asset class investors, returns have not kept pace. The threat of tariffs, along with a rising dollar, has adversely impacted foreign stocks, as well as emerging market bonds. Through the first three quarters, international large and small cap stocks, infrastructure stocks, emerging market stocks, and emerging market bonds are all in negative territory.

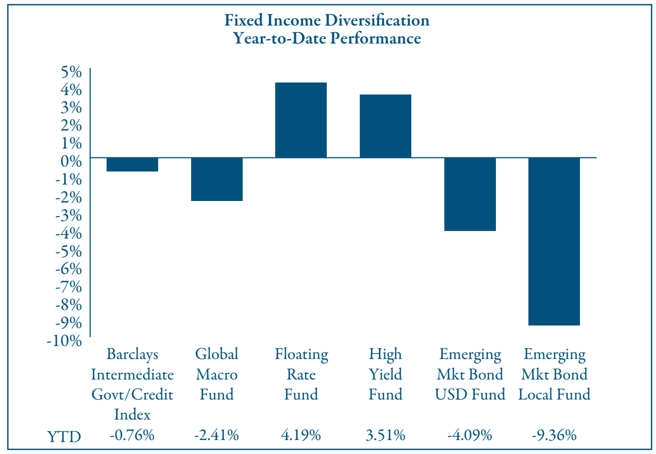
Oil was flat as OPEC output slumped due to problems in Venezuela. However, production increases in Russia and the US offset this reduction. Still, price declines in hard and soft commodities pushed the index 4.8% lower, bringing the index to a decline of 3.9% year-to-date.

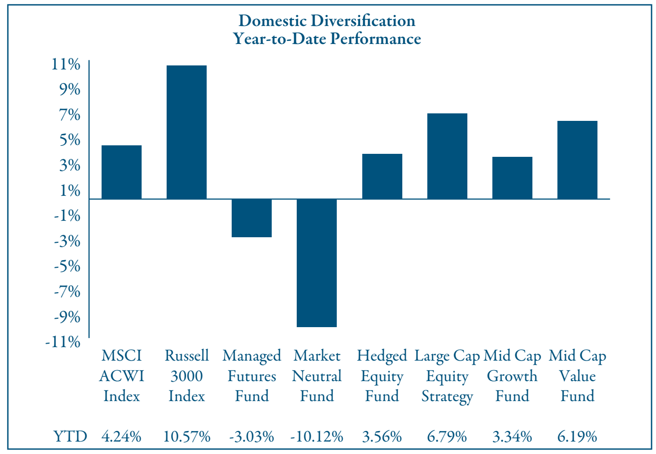
Many other alternatives have struggled this year as well. Real estate is barely positive, while managed futures, market neutral, and global macro strategies remain under water.

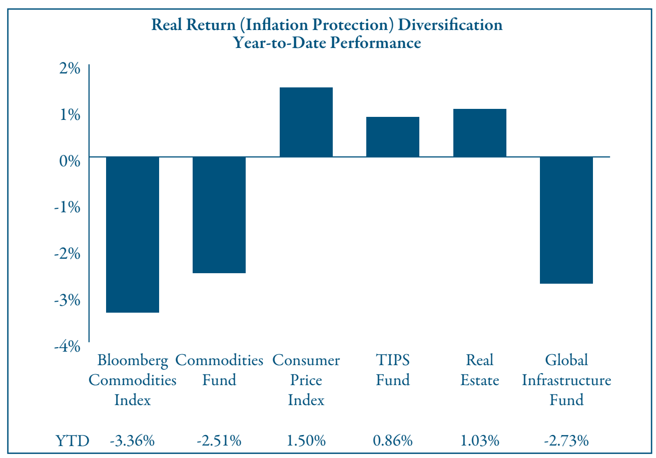
The Fed continued to push rates higher and raised the benchmark rate .25% for the third time this year. Low inflation and unemployment are allowing the Fed to move rates higher; however, the rise has led to a flat yield curve. Yields on 10-year Treasuries ended at about 3%, with yields on 2- and 30-year Treasuries below and above that mark by approximately 20 basis points, respectively. **Consequently, holders of shorter term bonds saw returns hovering about 1%, while holders of longer-term bonds saw negative returns.**

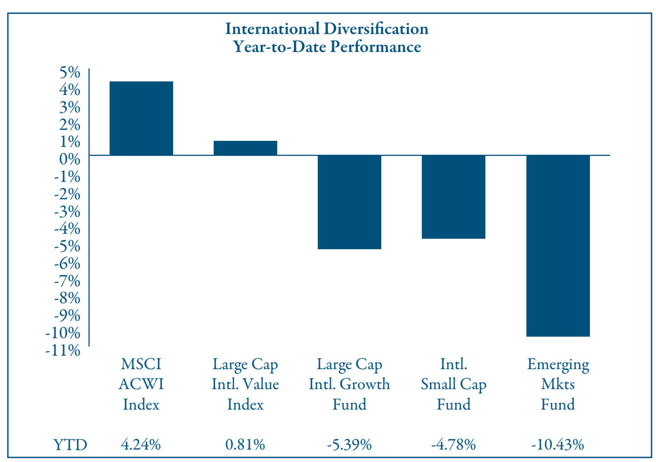
While domestic stocks remain pricey, they have cheapened due to strong earnings growth. And although rate rises tend to dampen growth and prices, historically, when the 10-year Treasury is below 5% stocks have risen along with the rate hikes.

Equities have moved higher for an extended period. But fiscal stimulus and earnings growth bode well for prices in the near term and tariffs should not derail the current optimism.









DOMESTIC EQUITIES

Gayle Sprute
Senior Portfolio Manager

The 3rd quarter was littered with media headlines, events, and political drama that fueled an equity market "wall of worry." This list included, among other things:

1) persistent global trade negotiations and tension;
2) political wrangling and uncertainty about the outcome of the upcoming mid-term congressional elections;
3) possible fading economic strength after this year's tax benefit and in the face of continuing interest rate increases;
4) a flattening US yield curve (and fear that it could invert);
5) peak earnings (and where they go from here);
6) a strengthening dollar; and
7) concern that turmoil in Turkey and Argentina could trigger global contagion.

Surprisingly, though, even with these concerns percolating, the major domestic equities indices fared quite well: Dow Jones Industrial Average (Dow) up 9.6%, S&P 500 up 7.7%, Nasdaq Composite up 7.4%, and Russell 2000 up 3.6%. Throughout the year, investors have been struggling with whether the "story is over" regarding corporate fundamentals. But during the 3rd quarter, that worry seemed to ease. Earnings season confirmed that revenue and earnings (as represented by the S&P 500 companies) remain upbeat. Revenue growth is running in the high single digits this year, with earnings up over 20%. Next year, that trend will decelerate as this year's strong earnings results, aided by lower taxes, are "lapped." Revenue growth in 2019 is currently estimated to slow to the mid-single-digit range and earnings growth is expected to slow to around 10%. The view about this deceleration softened during the 3rd quarter as investors seemed to reassess whether or not the "story is over." As with all estimates, time will tell what the actual outcome will be. In the meantime, the impact of enacted trade tariffs thus far has been manageable for overall corporate revenue and profitability, and the economic outlook remains solid.

Looking ahead, there are a number of potential headwinds looming, including the outcome of the mid-term elections, future trade negotiation outcomes, fiscal stimulus actions, whether global economic growth remains synchronized, and the trajectory of interest rate increases — and how the economy and corporate earnings are affected by these.

FIXED INCOME

Brian Brill, CFA
Senior Portfolio Manager

The Yin and Yang of positive economic expectations from fiscal expansionary policies versus the beginnings of a trade war with China led yields to appear stuck in the middle of the summer doldrums. But as September came, so awakened the fixed income markets.

In the 3rd quarter, investors continued to face a Federal Reserve that perceived the economy as doing well and likely to do better. The policymakers thought that fiscal expansion would boost the economy in the near term and expected inflation to run above the 2% target for some time. On the flip side, most policymakers viewed a trade war as being a threat to growth. **With countering forces, the 10-year Treasury yield traded in a narrow range and, in fact, July saw the smallest monthly range since 1973.**

As September kicked off, some of the data, namely the employment report, began to support the Fed's views while trade war rhetoric was being ignored. Also, with corporate issuance picking up, and the end of tax incentives for pension contributions on September 15th, yields began to take off. Any doubt that investors had regarding a Fed rate hike at its September meeting on the 26th was erased.

At that meeting, the Fed raised the target fed funds rate 25 basis points to 2.00% – 2.25%. Importantly, the Fed indicated another rate increase in December and three more next year. While the market has priced in the December rate increase, investors only see two increases next year. So far this year, the 2-year Treasury yields have increased 93 basis points (+28qtd), 5-year yields have increased 74 basis points (+21qtd), and 30-year yields have increased 48 basis points (+23qtd).

With short-term interest rates reaching multi-year highs, investors will be keeping an eye on Europe and Japan. The European Central Bank (ECB) is set to end asset purchases in December and the Bank of Japan (BOJ) is decreasing the amount it purchases. For its part, the Fed continues to decrease the amount of assets it holds on its balance sheet.

Washington Trust Bank
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INTERNATIONAL REVIEW

Derrick Wilson
Portfolio Manager

Another quarter has come and gone, yet it feels much remained the same from the prior quarter. Trade wars between the US and China linger on. The US dollar remains strong and interest rates are rising, which continue to put pressure on emerging markets.

Emerging markets came to the forefront as losses continued to mount with growing concerns of contagion. Countries like Turkey and Argentina experiencing economic difficulties saw their currencies, the Turkish lira and Argentine peso, tumble against the US dollar. Inflation ran rampant in Venezuela, which also saw its currency fall. At one point, the bolivar lost 95% of its value overnight as internal changes were made in an effort to combat hyperinflation.

Asian markets continued to decline. Hong Kong's Hang Seng index slipped into bear market territory in mid-September, falling 20% from its peak in January. This followed a bear market the Shanghai index entered in late June, also down from a January peak.

In Europe, negotiations pressed on regarding how the post-Brexit relationship will look between the UK and the EU. The impetus to make a deal is critical as deadlines are fast approaching. Key issues in the discussions involve trade, immigration and national security. It has been an uphill battle for UK Prime Minister Theresa May, faced not only with opposition from the EU, but also from some members within her own cabinet. Both sides are hoping to agree on terms by November 2018, allowing enough time for preparation for the pending March 2019 deadline.

As we move into the 4th quarter, expect there to be a continuation of these items grabbing headlines. Looking ahead, results of upcoming US mid-term elections could make things interesting on the global stage. European economic data has shown signs of softening more recently. This could be an indication of a slowdown in international economic growth and something to keep an eye on.

Correction: the Q2 Newsletter inadvertently referenced an incorrect index. We regret the error. It should have read as follows:

	Year-to-date	Latest 12 Months
DXY Dollar Spot Index	-2.55%	1.21%

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ECONOMIC OUTLOOK

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Chief Investment Officer & Economist

- There is sufficient momentum to allow the current business cycle to surpass the previous record of 10 years.
- Business spending will be the key to watch over the next 12 months.
- Real wages need to rise at a faster pace in order to sustain the current pace of consumer spending.
- Rising interest rates, labor availability and tariffs are the threats to watch.

Consumer

Wage growth will be the key for consumer spending in 2019. Currently, consumers are spending at a faster pace than their income growth. As of 8/31/18, the year-over-year growth rate for personal income is 4.7% while personal spending rose 5.3%. Wage growth is clearly on an upward trend but real wage growth is not. After adjusting for inflation, year-over-year wage growth grew at 0.2%. At the current pace, consumers are funding their "budget deficit" by either borrowing or drawing down savings. That is not a sustainable process.

Businesses

Businesses have the benefit of being able to 100% deduct capital expenditures through 2022. This should continue to support business spending in 2019. With growing labor shortages in many industries, investments in technology and equipment may be a key focus for businesses as they strive to increase productivity to be able to produce more with the same amount of employees (or less).

Government

Government spending is set to continue increasing as all of the appropriation bills are passed to implement the 2-year spending bill that Congress passed in the 1st quarter of this year. Any additional spending such as infrastructure spending will depend on the results of the mid-term election. A split Congress could result in gridlock similar to what the economy experienced over the previous eight years.

Threats That Could Change the Momentum

1. **Monetary policy.** With record levels of consumer, business and government debt, every increase in rates means that new, renewing and adjustable rate debt will be at higher rates. Every dollar that goes to higher interest payments rather than the purchase of goods and services risks slowing or stopping economic growth.

2. **Labor availability.** The #1 concern expressed from businesses is the lack of qualified help. If businesses cannot increase supply to meet increased demand, prices should rise. Rising prices risk causing the Federal Reserve to raise rates faster.

3. **Trade policy.** Tariffs have had minimal impact, except for isolated sectors of the economy, because the actual amount of tariffs has been small. If the Administration follows through with increasing the tariffs on the $200 billion of Chinese imports to 25% in January, and then imposing a 25% tariff on an additional $250 billion of Chinese imports, this risks causing a materially negative impact to economic growth. This could cause a ripple effect of disrupted supply chains and higher costs to businesses and consumers.

Perhaps the simplest description of the prospects for economic growth over the next 12 months is to modify part of Sir Isaac Newton's Law of Motion by saying that an economy in motion will remain in motion until outside forces cause it to change. While times are good, do not lose track of the threats that could change the economic momentum.

Market Overview

Cumulative Periods *as of September 30, 2018*

			Annualized		
	Year-to-Date	1 Year	3 Years	5 Years	10 Years
Russell 3000 Index	**10.57**	**17.58**	**17.07**	**13.46**	**12.01**
S&P 500 Index	10.56	17.91	17.31	13.95	11.97
Russell Mid Cap Index	7.46	13.98	14.52	11.65	12.31
Russell 2000 Index	11.51	15.24	17.12	11.07	11.11
FTSE NAREIT All Equity REITs Index	**1.78**	**4.31**	**8.97**	**9.57**	**7.77**
Bloomberg Commodity Index	**-2.03**	**2.59**	**-0.11**	**-7.18**	**-6.24**
MSCI ACWI All World Index	**3.83**	**9.77**	**13.40**	**8.67**	**8.19**
MSCI EAFE Index	**-1.43**	**2.74**	**9.23**	**4.42**	**5.38**
MSCI EAFE Small Cap Index	-2.19	3.73	12.39	7.96	9.68
MSCI EM Index	-7.68	-0.81	12.36	3.61	5.40
Barclays Govt/Credit 1-5 Yr. Index	**-0.07**	**-0.38**	**0.72**	**1.06**	**2.30**
Barclays US Treasury TIPS Index	0.60	0.73	1.33	0.60	1.75
BOAML US High Yield Master II Index	2.52	2.94	8.19	5.54	9.38
JPM GBI Global Diversified Index	-8.15	-7.40	5.17	-1.68	2.70
Barclays Municipal 1 Yr. Index	**0.95**	**0.57**	**0.71**	**0.71**	**1.30**
Barclays Municipal 3 Yr. Index	**0.64**	**-0.13**	**0.75**	**1.05**	**2.15**
USTREAS Stat US T-Bill 90 Day Index	**1.36**	**1.66**	**0.88**	**0.54**	**0.33**