MARKET COMMENTARY

3RD QUARTER 2019

Economic Summary

Amid fears of an economic slowdown, ongoing trade wars, impeachment proceedings and attacks on Saudi oil fields, equity markets continued to climb higher during the third quarter. The S&P 500 was up 20% through the end of the third quarter (Chart 1), the strongest start to a year since 1997. Despite this strong start, equity prices are still trading near their 25-year average in terms of price-earnings ratio.

The economic news remains generally good, with the latest unemployment reading at 3.5% (chart 2), a low not seen in more than 50 years. Leading economic indicators (Chart 3) continue to be positive, and inflation remains benign. The Fed has cut interest rates twice so far this year and will probably do so again soon.

Corporate earnings are likely to increase 2-3% in 2019, following a strong 20% increase in 2018. In 2020, analysts are looking for an additional 10% earnings growth for the year. Corporate profit margins continue to be very strong — a sign of a healthy economy.

Major central banks returned to accommodative monetary policies in 2019, as interest rate cuts and quantitative easing (QE) programs have been restarted. The Fed has cut the Fed Funds rate twice this year, and according to Bloomberg, the market is pricing in two additional 25 basis point cuts in 2019. The two additional cuts would bring the Fed Funds rate into the 1.25-1.50% range by year end. With interest rates already low, the Fed has also signaled its proclivity to engage in

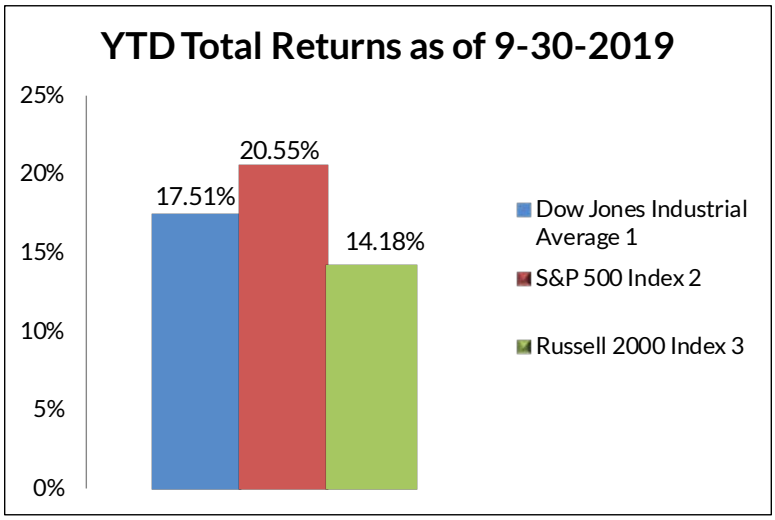

Chart 1
Source: Morningstar Direct

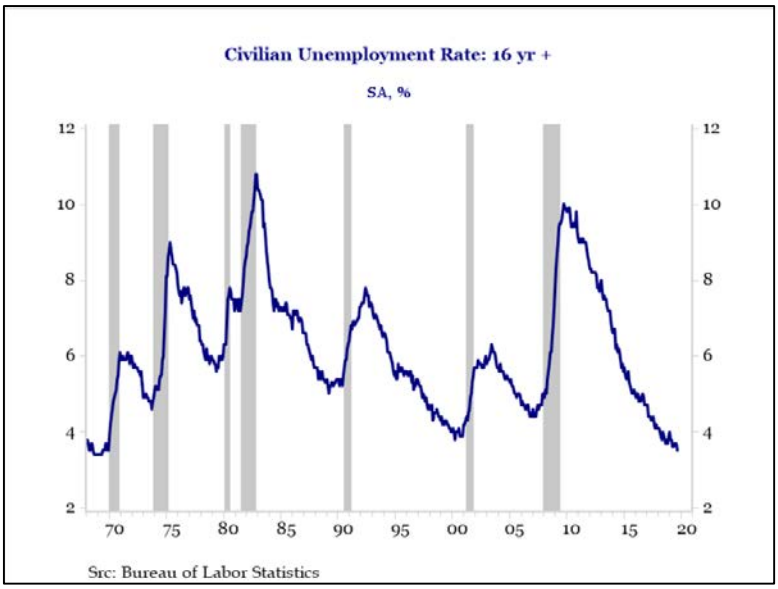

Chart 2
Source: Strategas Research Partners, "Quarterly Review in Charts",10/1/19

[1] The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ. [2] The S&P 500® Index is a capitalization weighted unmanaged index of 500 widely traded stocks, created by Standard & Poor's. The index is considered to represent the performance of the stock market in general. [3] The Russell 2000® Index is an unmanaged index of the smallest 2,000 stocks in the Russell 3000® Index. You cannot invest directly in an index.
Past performance does not guarantee future results.

Economic Summary (continued)

unconventional monetary policies, should the rate of economic growth slow further.

The Bond Market

During the third quarter, interest rates continued to decline, with the 10-year Treasury Note starting the quarter yielding 2.00% and finished yielding 1.68%. With short-term rates higher than the 10-year Treasury, the government bond yield curve is inverted. An inverted yield curve has preceded every recession since World War II, but importantly, not every inversion has led to a recession. We are not forecasting a recession in the foreseeable future.

Corporate credit spreads remained unchanged during the quarter. Unlike the Treasury yield curve, the investment grade corporate curve is still upward sloping. This divergence has created an opportunity to pick up yield on high-quality, intermediate corporate bonds without taking undue credit and interest rate risk.

The Stock Market

Growth stocks once again outperformed value on a quarterly and yearly basis. The Russell 1000 Growth Index posted a total return of 23.3% vs. 17.8% by the Russell 1000 Value Index (Chart 4) year-to-date. One explanation for this divergence is found in the different sector allocations of growth and value indexes. Growth indexes have high allocations to technology and consumer discretionary sectors which have been outperforming, while value indexes have

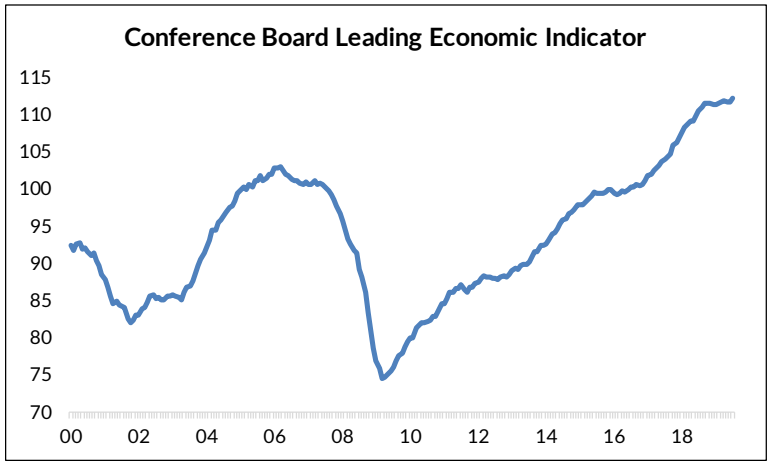

Chart 3
Source: Bloomberg

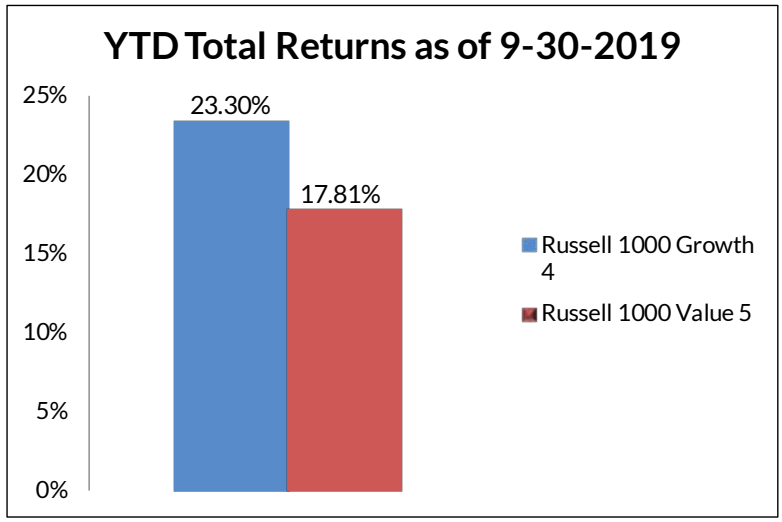

Chart 4
Source: Morningstar Direct

[4]The Russell 1000® Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. [5]The Russell 1000® Value Index Measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. You cannot invest directly in an index.
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The Stock Market (continued)

overweighted allocations to financial and energy sectors which have been underperforming. Another explanation for the growth/value divergence is the proliferation of passive investing, also known as indexing. As more investors allocate money to these passive funds, the passive funds themselves buy more stocks that have already gone up the most. This momentum makes one think that a cycle which feeds on itself will inevitably end, but who knows when?

Equity valuations are currently in line with historical averages, and once again the dividend yield on the S&P 500 is greater than the yield-to-maturity on the 10-year U.S. Treasury Note. With corporate earnings forecasted to improve again next year and leading economic indicators still looking positive, common stocks continue to look more appealing than bonds on a risk/return basis.

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Prospective investors should consider the account's investment objectives and risks carefully before investing.

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