Economic and Market Overview

Contributed by | Jon Augustine, CFA, Chief Investment Officer

Tenets of Investing

At BTC Capital Management, the process used in the management and oversight of client portfolios is driven by our "Tenets of Investing." The tenets are comprised of four overarching principles applied across all client portfolios, including:

- Preservation of Capital During Difficult Markets
- Investment Decisions Based Primarily on Strong Fundamentals
- Long-Term View of the Markets
- Risk-Aware Portfolio Construction

While these tenets can be viewed individually, they really build on each other, reflecting an investment process committed to the achievement of our clients' goals and objectives. For example, regarding the first tenet, Preservation of Capital During Difficult Markets, successful execution of the other three tenets helps increase the likelihood we can preserve a client's capital during difficult market periods.

Emphasizing strong fundamentals is a foundation of our selection process. When choosing the investments to be utilized in a client's portfolio, it helps to ensure these holdings could endure throughout difficult market environments. And, our Long-Term View of the Markets, as stated in the third tenet, reflects our focus on filtering through the short-term, day-to-day noise. This allows us to better discern risks to a client's capital versus momentary blips on the financial market radar screen that do not warrant changes to portfolio structures.

The fourth tenet, Risk-Aware Portfolio Construction, is probably the one that is most tightly linked with our efforts to successfully deliver the desired results sought in the first tenet. As much as we define ourselves as investment managers, we know the other role we have in helping to ensure clients meet their goals and objectives is just as important, and that role is risk management.

There are a variety of tactics used in the evaluation of risk, whether evaluating an overall asset class or individual security. For example, we have specific allowable ranges for the weights of asset classes represented in our strategic benchmarks. This ensures client portfolios maintain a sufficient level of diversification and increases the likelihood portfolio performance outcomes will be in the expected range over time.

In addition to our policy-driven diversification efforts, we incorporate alternative asset classes into portfolios if their inclusion enhances the risk/reward relationship of the overall portfolio. For example, in the past we have maintained commitments to the high yield bond segment of the fixed income markets, as well as targeted positioning in real estate.

> ***Trade-related issues are impacting economic data.***

Our efforts to preserve capital in difficult markets are, as discussed above, driven by the positioning of asset classes within client portfolios and by determining what specific asset class segments are represented in the portfolio. And, of course, another key is for clients to have the appropriate investment objective in place that reflects their time horizon, need for current income and risk tolerance.

Economic Outlook

The rate of GDP growth for the U.S. economy is expected to continue at the modest level seen throughout most of the 10 years since the end of the 2008-2009 financial crisis. Currently, estimates for the third quarter are hovering around 2.0%, the same level seen in the second quarter, with some estimates registering slightly lower levels of expected growth. While we have grown weary over the past several years with using "modest" to describe the performance of the U.S. economy, it does represent growth and we are not expecting a recession at this time. The current outlook for the fourth quarter includes estimates between 1.5% and 2.0%.

Some industry experts feel positive economic growth will continue, while others see a potential decline into recession. On the negative side, we have the impact of ongoing trade disputes. Most specifically, the dispute between China and the United States has received most of the publicity, but potential tariffs imposed on the European Union by the United States are now a real possibility. Trade-related issues are impacting economic data such as the ISM figures for the manufacturing and service sectors of the economy. Manufacturing data is also being negatively impacted by the labor strike at General Motors.

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On the more positive side we have the state of the housing industry. With the August data release, both housing starts and building permits registered the highest levels seen in this economic cycle. Historically, a peak in housing starts occurs approximately two years before a recession. In reviewing data back to 1969, the shortest time period between the peak in housing and recession was 10 months.

Another indicator on the positive side is the Citi Economic Surprise Index. This index evaluates whether economic indicators are coming in above or below expectations. At the end of June, the index registered -70. Now it is at a positive reading of approximately +35. What this transition means is economists have now lowered estimates to the point where actual data is exceeding forecasted results. This is more representative of what is actually taking place in the economy.

Allocation Overview

We are currently maintaining our existing asset allocations, which includes an overweight to domestic equities and an underweight to fixed income. With the strong relative performance of U.S. equities compared to fixed income and international equities year-to-date, the current positioning has performed well. This performance is illustrated by the 20.1% return for the Russell 3000 Index of domestic stocks compared to the 8.5% return generated by investment grade bonds, and the 11.6% provided by international equities. While volatility has increased from the more modest September levels, we continue to focus on the tenets of our investment philosophy, specifically the third one, a Long-Term View of the Markets.

Fixed Income Commentary

Contributed by | Jeff Birdsley, CFA, Senior Managing Director

Dear Mr. Powell, Please Replenish the "Punch Bowl" Again

As the quarter ends, investors in unison are asking Chairperson Powell for one more rate cut by the Federal Reserve before year-end. Twice this quarter the Federal Reserve cut the Fed Funds Rate by 0.25% to reduce borrowing costs and keep the longest recorded economic expansion going. Investor consensus is one more cut in 2019 and a couple more in 2020 are just the recipe to keep the economy growing and stave off the trade policy and economic blues.

Economic data reports for the quarter remain mixed, suggesting moderate growth in consumer spending, but weakness in business investment. Consumer spending, 68% of Gross Domestic Product, rose just 0.1% in August after recording 2% gains over the previous five months. In business activity, both ISM Manufacturing and Service Indices reported orders for manufactured goods are contracting, while service sector growth is the lowest in three years.

As the risk increased this quarter, investors sought out safe haven investments, such as Treasury bonds, pushing demand higher and yields lower. We saw the bellwether 10-year U.S. Treasury decline by nearly 0.5% from its high point during the quarter to end at 1.66%. Declining rates also pushed bond prices for high quality corporate and mortgage holdings higher. The broad market index of high-quality bonds returned 2.3% this quarter, boosting the year-to-date return to 8.5%. An anchor pulling domestic interest rates lower has been $16 trillion of overseas debt with a negative yield. The fact that overseas savers are willing to pay a borrower for the right to own their debt shows how far central banks will go to fuel economic growth. For example, back in 2011 when the Greek government was near bankruptcy, its 10-year bonds paid a yield of 35%. Today, those same bonds yield 1.3%, lower than current U.S. Treasury levels.

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As mentioned in our lead article, one sign of economic strength has been housing. Rising home values are a primary source of increased revenues for municipalities. This has strengthened municipality balance sheets and is supportive of outstanding debt and credit quality. Tax-exempt municipal bonds returned 7.3% year-to-date and 1.6% for the quarter. On a relative basis, municipal bonds have become more attractive as yields have not declined as much as Treasury or Corporate bonds. Municipal markets are partially isolated from those global drivers of interest rates that impact other bond sectors. This global economic "moat" is one reason our outlook for this segment is positive relative to other bond sectors.

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We see the Federal Reserve refilling the monetary punch bowl with further cuts to its borrowing rate to head off declining economic growth. These cuts will help shield the U.S. economy and support our view for steady economic growth. Our outlook for bonds under this scenario is that most of the gains in the bond market have been achieved. It would take a catalyst from politics, trade policy or lower consumer spending for further advances.

Equity Commentary

Contributed by | Kuuku Saah, CFA, Investment Analyst

"Uncertainty is the only certainty there is."

The title quote is from mathematics superstar, John Allen Paulos. This quote, coming from someone in a field as seemingly defined as math indicates the variability of life. At BTC Capital Management, we do not start with a premise of, "This is how markets should behave." Instead, we consider potential outcomes based on a combination of looking at the market's reaction to past events and projections of future market growth.

This year, we have seen more uncertainty than expected. There isn't a yearly index of uncertainty we look at. There is, however, a higher degree of uncertainty as to the impact of geopolitical events on the market.

Earnings growth for the second quarter of 2019 was better than expected. The MSCI USA Index, an index that tracks large and mid-sized public U.S. companies, beat analyst earnings expectations by 4.3%. Even though earnings growth decelerated in the quarter by 0.7% year-over-year (YOY), the slowdown in growth was less than expected. Revenues also surprised positively by 0.5%, but with growth of 4.0% YOY. The cause of the divergence of earnings and revenue growth is margin compression. Earnings before interest and taxes (EBIT) margin for the year is expected to contract to 15.9. Compared to last year's EBIT margin of 16.3. Why? Primarily because companies are paying more for production inputs and are not fully passing on the costs to customers. Increasing costs in manufacturing and production are also expected in the third quarter data. Earnings growth is expected to decline by 4.0% YOY, but sales are expected to increase by 2.7% YOY. Analysts have been reserved with their earnings estimates this year. They tend to lean toward conservatism when there is increased uncertainty on possible outcomes.

The single greatest factor contributing to this uncertainty is trade disputes. We have seen spikes in market volatility whenever President Trump mentions trade talks. When the mention is positive, markets trade up. When the mention is less positive, markets trade down. This uncertainty in the resolution of trade disputes has led to a wider than normal range of market outcomes. Even though there has recently been higher volatility, the market is doing its best to absorb the hits. The MSCI USA Index is up 20.74% for the year. Returns for the third quarter were modestly positive at 1.56%. If returns stay flat for the year and end at 20%, this will be the second-best year of calendar returns in five years. International market returns are also positive for the year. The MSCI All Country World Index USA returned 14.23% in the first three quarters of the year.

Valuations are close to five-year averages. The MSCI USA Index ended the quarter with a trailing 12-month price earnings ratio (P/E) of 19.2x and a forward 12-month P/E of 17.1x. The five-year averages are 18.9x and 16.8x respectively. We have not seen a large increase in P/E ratios despite the strong year to date return number. This is due to the one-year return number being at only 4.1%. The market decline last December put a lid on potential overvaluation. The reasonable valuation numbers coupled with positive U.S. macroeconomic data leads us to believe a significant market decline is not imminent.

Stay the course

We continue to be upbeat on U.S. equity markets, and see more opportunity from equity markets relative to other asset classes. The expectation is for U.S. company earnings growth to turn positive in the fourth quarter and to remain positive throughout 2020. A resolution of trade disputes has the potential to accelerate returns in equity markets. The low interest rate environment will also contribute to the potential for positive equity returns.

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BTC CAPITAL MANAGEMENT

- Preserve Capital In Difficult Markets
- Make Decisions Based on Fundamentals
- Maintain a Long-Term View of the Markets
- Practice Risk-Aware Portfolio Construction

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