Q1 2019
ECONOMIC OUTLOOK

By the LNWM Investment Strategy & Research Group

"The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavioral discipline that are likely to get you where you want to go."

– Benjamin Graham

SUMMARY

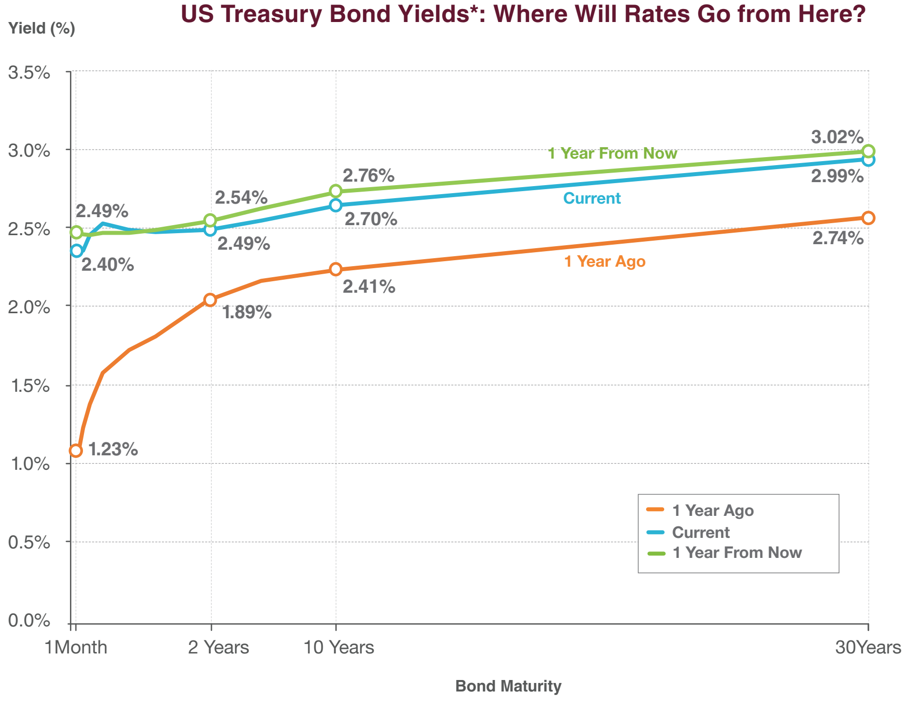
- **We are in the later stages of the current economic cycle.** The US economy seems to be clearly in the later stages of what has been a very long period of growth. That is not to say that we expect a recession but rather expect slowing growth rates, which will likely be reflected in higher market volatility.
- **Further interest rate hikes will be more "data-dependent."** As recently as Nov. 2018, the Federal Reserve was steadfast in their message of two to three additional hikes in 2019 along with continued reduction of the fixed-income securities on their balance sheet. Capital markets reacted negatively in December, which caused some change in rhetoric from Fed Chairman Powell. Given that there are no signs of an overheating US economy, the Federal Reserve will have reason to pause and reflect on economic data in 2019.
- **Global growth rates will continue to diverge.** This is not new but recent events in Europe (Brexit, French protests, Italian budget) will likely cause the difference in growth rates to grow wider. Emerging markets are likely to benefit from lower energy prices but any repricing will depend on a US-China trade war settlement.
- **Portfolio positioning will be more conservative.** Given the later stages of the economic cycle, global debt levels (government and corporate), and the escalating geopolitical issues, we are positioning our portfolios more conservatively. We think there may be an opportunity to add risk later this year, but we think the currently available risk/reward ratio justifies some caution.

2019: Changing Tide Will Not Lift All Ships

On Dec. 24, 2018 in an email to clients, we talked about a shift in market sentiment, which has largely carried over into the first part of 2019. What has shifted? There is now more concern and even fear than there has been for quite a while. Virtually all the concerns we expressed in our *Q4 2018 Economic Outlook* about global economic growth and the possibility that we are nearing the end of a bullish cycle are still with us, except now they are being more widely acknowledged.

To be sure, we are entering a late-cycle phase, particularly in the US, which does not portend a recession (we expect to hear that more frequently in 2019) but does increase market vulnerability, i.e. volatility. At the same time, however, the fundamentals are actually quite strong, with historically low US unemployment, and corporate earnings growth that is in most cases meeting expectations.

December was especially difficult. The S&P 500 dropped nearly 10%, wiping out all gains for the year and finishing down just over 4% for 2018, including dividends. We think the root cause of the December debacle was the market's uneasiness with the path laid out for interest rates by the Federal Reserve. We've highlighted in past Outlooks the importance of the Fed's target interest rate and why it is so influential on asset pricing, and we also recognize that there is an optimal level that reflects current levels of unemployment and inflation. Recent market moves are to a large extent a repricing of assets to reflect higher interest rates, with the added concern that the Fed may raise rates too far and fast, stifling US economic growth. While we think these initial market moves were extreme, and the Fed is likley to tread carefully here out, we are not sitting idly as we think there is reason for caution as well as some optimism for future opportunities.



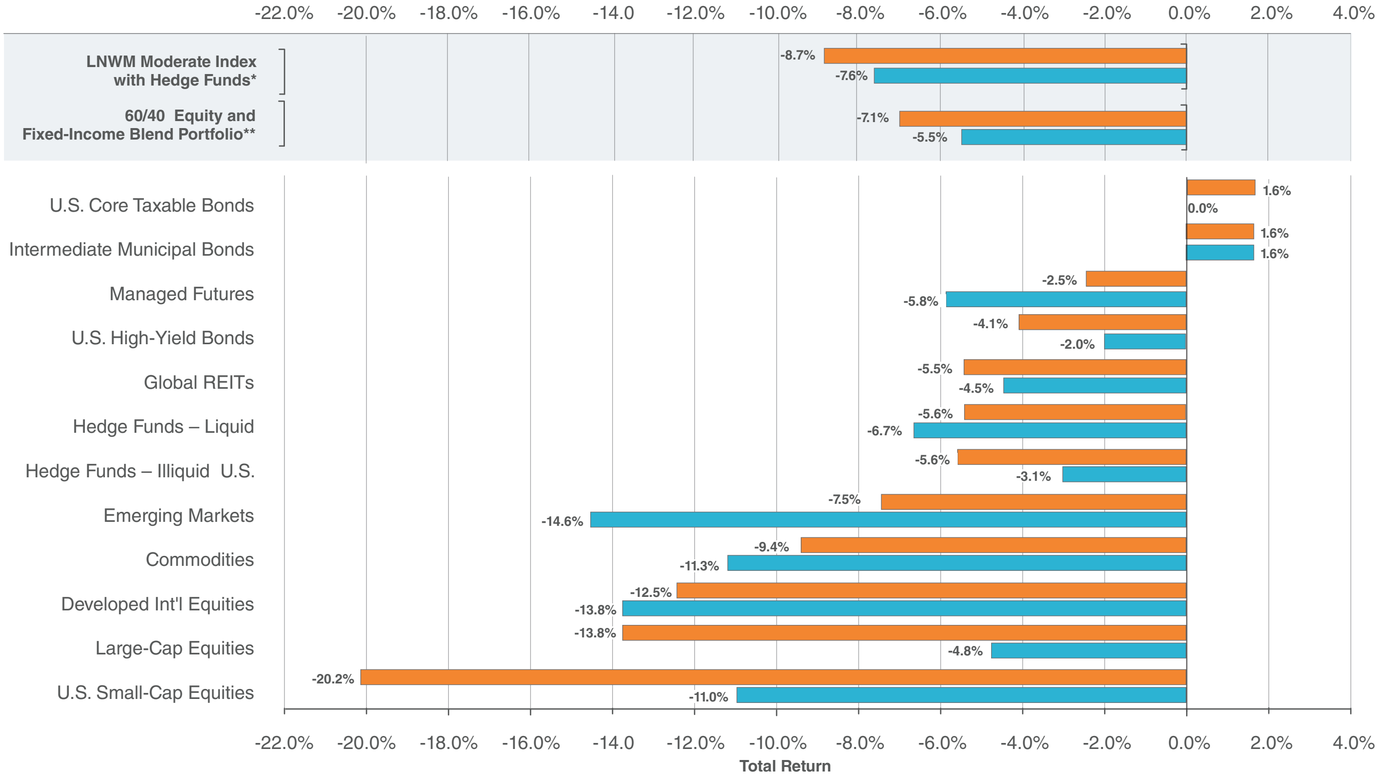
*Yields as of Dec. 31, 2018. **Estimated yields based on pricing of derivate contracts.
Source Data: Bloomberg.

US interest rates have risen but primarily on shorter maturities as the Federal Reserve hiked its target interest rate four times in 2018. This is in part why we believe shorter maturities offer a better risk-reward opportunity compared to longer-term bonds at this time.

Portfolio Performance and Positioning

The 4th quarter of 2018 was disappointing, to be sure, as we underperformed our 60/40 passive benchmark, which drove the underperformance for the year. However, our asset manager selection was additive for the quarter and for the year, as the funds we are invested in generally outperformed their benchmarks. Further, the asset allocation changes we made to LNWM portfolios in early and mid-December (see next paragraph) have proven additive, as our portfolios have rebounded so far in 2019 to outperform the benchmark, although we acknowledge this is a short period of time. We are well aware that the global diversification we maintain in our portfolios was not beneficial at the end of 2018, when virtually all asset classes suffered losses. However, over longer periods of time we believe that diversification will continue to add value.

Performance of Asset Classes
Quarter-to-Date and Year-to-Date (As of December 31, 2018)



*Net of manager fees, gross of LNWM fees | **Assumes no manager fees

Source of Data: Morningstar, Bloomberg, Hedge Fund Research. Please see the disclosure and definitions.

Generally speaking, we are taking a cautious approach to start 2019, having in December increased our allocation to short-term fixed income and reduced our exposures in three areas: (1) hedge funds; (2) high-yield fixed income; and (3) foreign equities. Maintaining an increased allocation to short-term fixed income, which is now offering the highest yield in several years, will allow us to take advantage of opportunities as they present themselves later this year and provide downside protection should the economy turn for the worse. Additionally, we have topped off our allocations to infrastructure, which is an area that offers portfolios both real return potential and some measure of diversification.

Several asset classes (US equities and corporate bonds, for example) are now trading at relatively attractive levels, which we think could become more compelling in time. By contrast, foreign markets are facing stiffer headwinds. After a great 2017, last year proved to be difficult for foreign equities, emerging markets (EM) in particular. EM investments have long been volatile and 2018 was no different. That said, we continue to see value in emerging markets given their potential for growth. In China, there are increasing concerns for growth, which seem to be directly related to the ongoing trade war with the US. We think this will force both countries to the table to negotiate a trade deal. Should a deal be struck, it would almost certainly improve the short-term prospects for EM equities, which we think offer attractive longer-term potential.

In foreign developed markets, the story is a bit different, as we see signs of increasing risk. In Europe, both Italy and Britain are likely to lead the headlines in 2019. Italy has presented a budget to the EU showing a 2.04% deficit relative to GDP, which, given the current populist government, will be difficult to achieve. Interestingly, by some measures, Italy's deficit is more fiscally responsible than the current deficit of the US.

The official Brexit date is March 29, 2019 and the British Parliament on January 15 voted down the Brexit deal proposed by Prime Minister Theresa May. A close friend who is proudly British and lives in London understandably said to me: "There is absolutely no plan for how to deal with this. In fact, there are thousands of people who don't know how long they will be able to remain in Britain." The difficulties for Europe that are likely to be caused by Italy and Britain in 2019 have caused us to trim our exposures there as we don't think the risks have been completely priced in.

Looking Forward

Historically, equity markets have performed well during years with split governments as we have now (Democrats control the House, Republicans the Senate), although there is no economic basis for this. However, the current US government is embroiled in a series of investigations with the threat of more to come, which we think will not be well-received by capital markets.

As 2019 progresses, we think these two economic factors will increasingly weigh on the markets: 1) The continued growth of the US deficit and the related change in Fed policy; and (2) China-US trade relations. Combine the nearly $1 trillion increase in the US federal budget deficit with the Fed reducing its holdings of fixed-income securities plus continued trade negotiations with the largest holder of our debt (China) and it is difficult to have an optimistic outlook for US bond yields. To be clear, this is a long-term concern but one that it seems no political party has the courage to confront.

Still, there is much that can go right in 2019, as well as wrong. Since our email to clients on Dec. 24, Fed Chair Jerome Powell has indicated that the Fed remains open to fewer interest rate hikes going forward. Markets have certainly reacted positively to this and are even pricing in a cut in interest rates in 2020. In 2019, the markets would welcome a pause in US interest rate increases, given that decelerating global growth is now more apparent from the macroeconomic data, and earnings releases from globally exposed corporations are revealing slowing revenue growth and shrinking profit margins.

The impact of the trade dispute with China and the longest-ever US government shutdown (now in effect) will also increasingly factor into the outlook for corporate earnings. We think first-quarter 2019 earnings will be particularly meaningful since the benefit of the 2017 corporate tax cuts will be fully baked into comparisons. In the second quarter of 2018, S&P 500 companies averaged a tax rate of just under 20%, the lowest tax rate since 1993, according to Blackstone.

Another positive is robust spending by US consumers, which makes up 67% of the US economy. Unemployment remains at historically low levels which has driven some wage inflation. Further, the fall in energy prices during the second half of 2018 should provide a further boost for consumers. We acknowledge that we are in the later stages of an economic expansion but feel the US consumer is the most likely catalyst to extend it. Along with that, it seems the Federal Reserve has reason to pause on their tightening of monetary policy, which should serve to calm markets.

Key Economic Drivers 2019

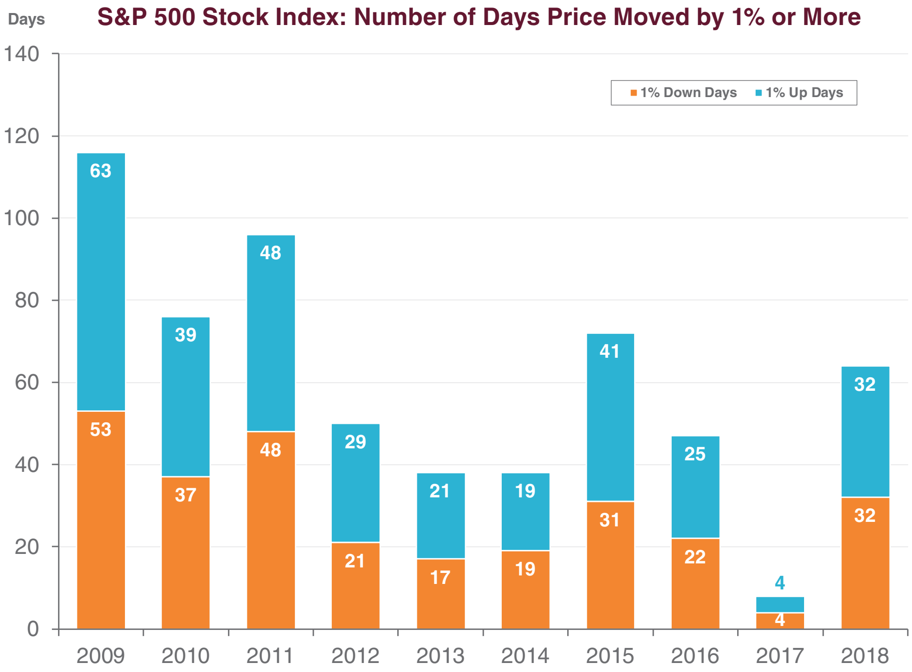
Central Bank Policy. December 2018 demonstrated how sensitive the markets are to central bank policy, especially that of the Federal Reserve. Sensitivity to central bank policy exists globally, including moves by the European Central Bank and the Bank of Japan. The Federal Reserve finds itself in an unenviable position as it tries to reduce its fixed-income holdings (unwind its balance sheet) and normalize US interest rates without derailing the economy. We think a pause in interest rate increases is likely and justified given price stability and tame US inflation. Current market pricing is implying the same. Other central banks find themselves in an even less desirable position, with similar balance sheet issues but economies that are not growing as quickly.

Europe (Brexit, France, Italy). With the looming Brexit deadline quickly approaching – March 29, 2019 — the UK parliament has yet to approve a strategy. The lack of clarity could cause significant price swings in UK assets with secondary effect for European assets. It's clear that the honeymoon period for France's Macron is over given his 23% approval ratings. He seems unable to implement the additional necessary reforms to move France forward. Italy's budget deficit, lack of growth, and lack of willingness to reform will continue to be a headwind for Europe. One must begin to question how unified the European Union really is.

Credit-Driven Concerns. For many years, cheap credit was available to corporations, consumers and governments alike. We have long said that corporations with healthy balance sheets did the right thing by increasing the debt side of their balance sheets while reducing equity; however, debt has become more costly given the rise in yields, and it will only take one or two significant defaults to cause contagion in credit markets. It will be no surprise to see defaults this year in lower-quality credit, which is covered by loose or no covenants. Consumer balance sheets are generally healthy, though student loans will be an increasing issue in the coming years. Foreign government debt has long concerned us although in the near term it should only be an issue for countries with other fiscal problems, i.e. Italy, Greece, and to a lesser extent, France.

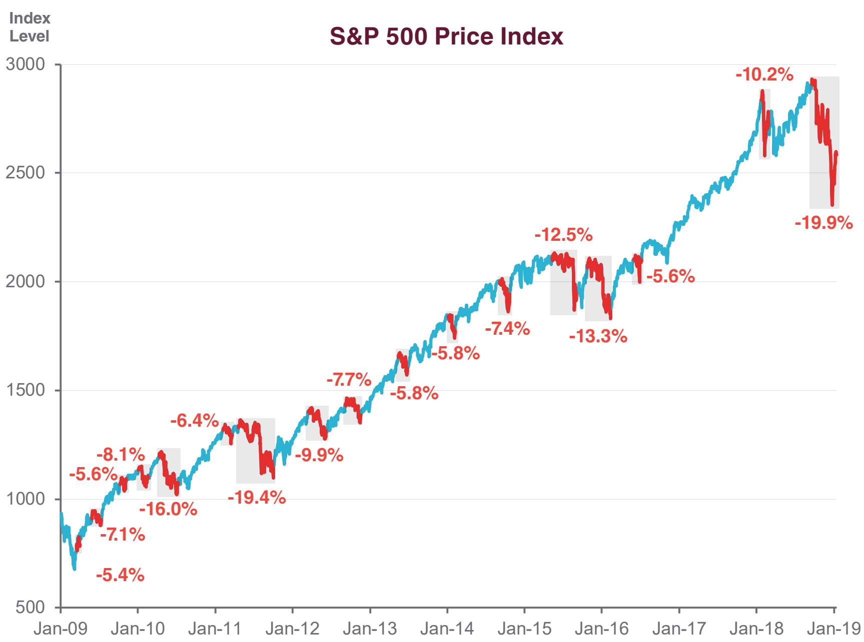
Asset Price Correlations. The 4th quarter of 2018 was troubling on many fronts but the change in correlation among asset classes could easily lead one to question diversification. In other words, assets that were supposed to zig when others zagged, didn't. We saw some reversal toward normalcy late in December. We continue to believe in the principles of diversification and will maintain diversified portfolios. In fact, we think recent volatility will demonstrate the benefits of active management (as opposed to index investing) more so than in the past.

US-China Trade. We've discussed this for some time. As one of the largest and fastest growing economies, there is no dispute of the importance of China in the global economy. Since the beginning of the tensions between the US and China, the Chinese equity market has sold off by more than 20% and recent data show signs of slowing growth there. While the US economy is actually more isolated (less dependent on trade), we will certainly feel the effects of an ongoing trade war. We believe markets will force both countries to the table in 2019 to iron out a solution, although it is very difficult to assess timing.



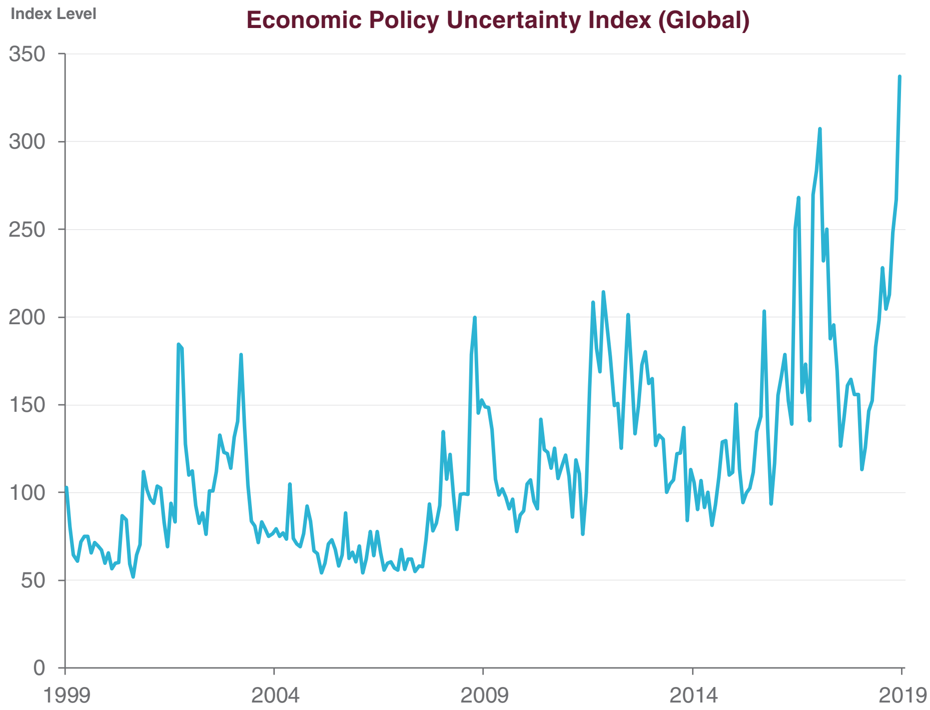
Source of Data: Wall Steet Journal.

The 4th quarter of 2018, especially December, featured much more market volatility than we have seen in quite a while, given a very calm 2017. That said, the number of trading days in 2018 with moves of at least 1% in equity prices was roughly in line with the average since 2009. Interestingly, we had 32 up days of at least 1% in 2018 and 32 down days of at least 1%.



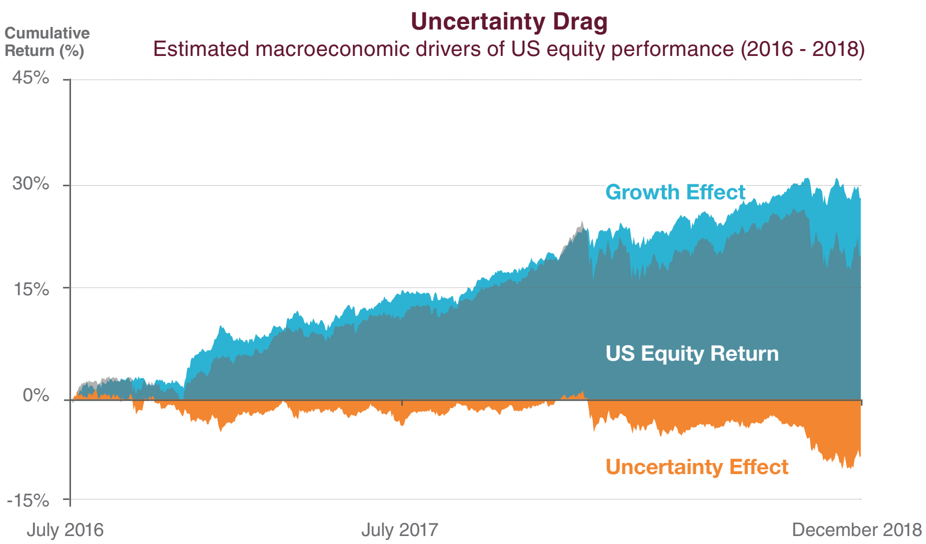
Source of Data: Wall Street Journal, Bloomberg.

Stock market declines like that of Q4 2018 are not unusual and have not been unprecedented in the current expansion, now the longest on record. Since 2009, there have been 17 declines in the S&P 500 Index of 5% or more, and six declines of more than 10%.



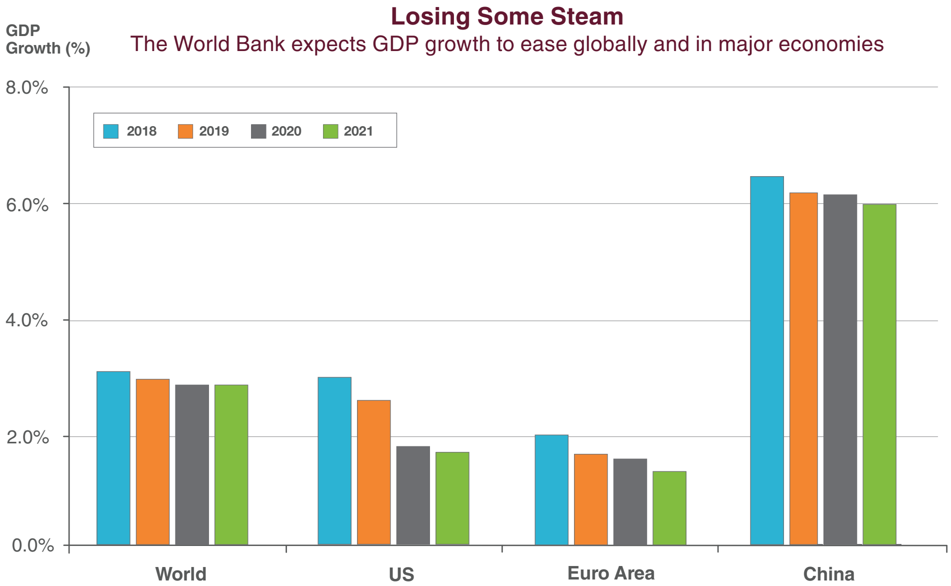
Source of Data: Bloomberg.

Uncertainty about government economic policy around the world (see chart at left) soared in 2018 and reached its highest level on record. Investors are getting mixed messages regarding both monetary and fiscal policy. A high and/or rising level of uncertainty about policy makes it difficult for businesses to invest and is a headwind for continued economic expansion.



Source of Data: BlackRock Investment Institute.

Looking back at the last few years underscores how much of a toll that uncertainty can take on financial market performance. Growth expectations generally drive equity market returns. However, according to BlackRock, uncertainty regarding US trade and other economic policies have subtracted roughly 10% from the US equity returns.



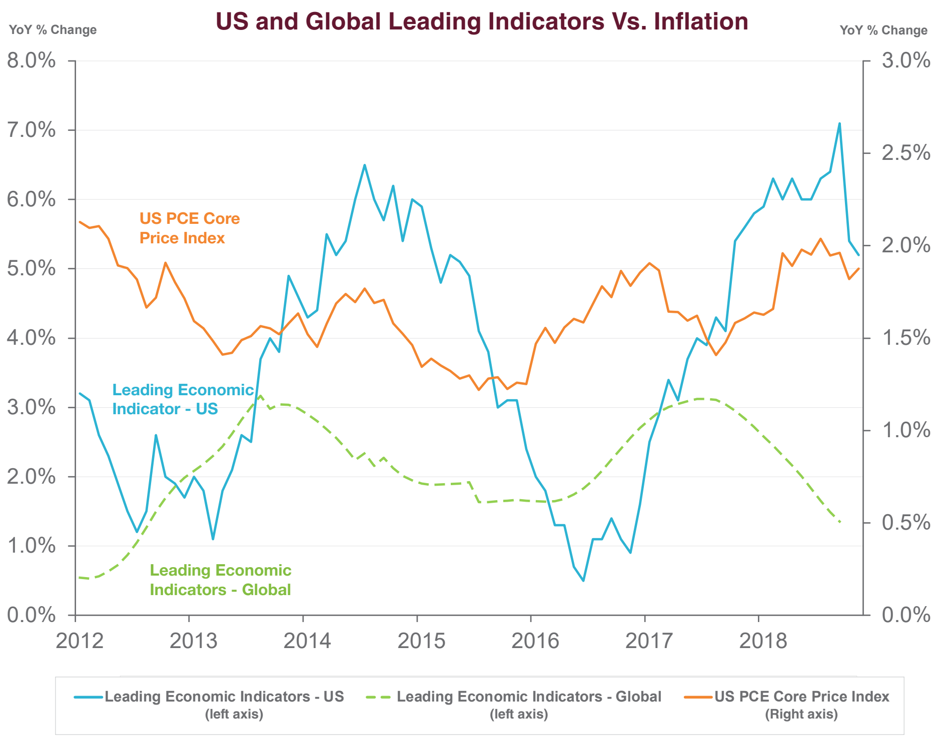
Source of Data: World Bank's January 2019 Report.

Expectations for GDP growth worldwide were very strong going into 2018, whereas GDP growth is anticipated to slow down across most economies in 2019 and 2020. That said, growth is expected to remain positive in balance, and, as we've seen, markets often do well at times of moderate economic growth.

Source of Data: Bloomberg.

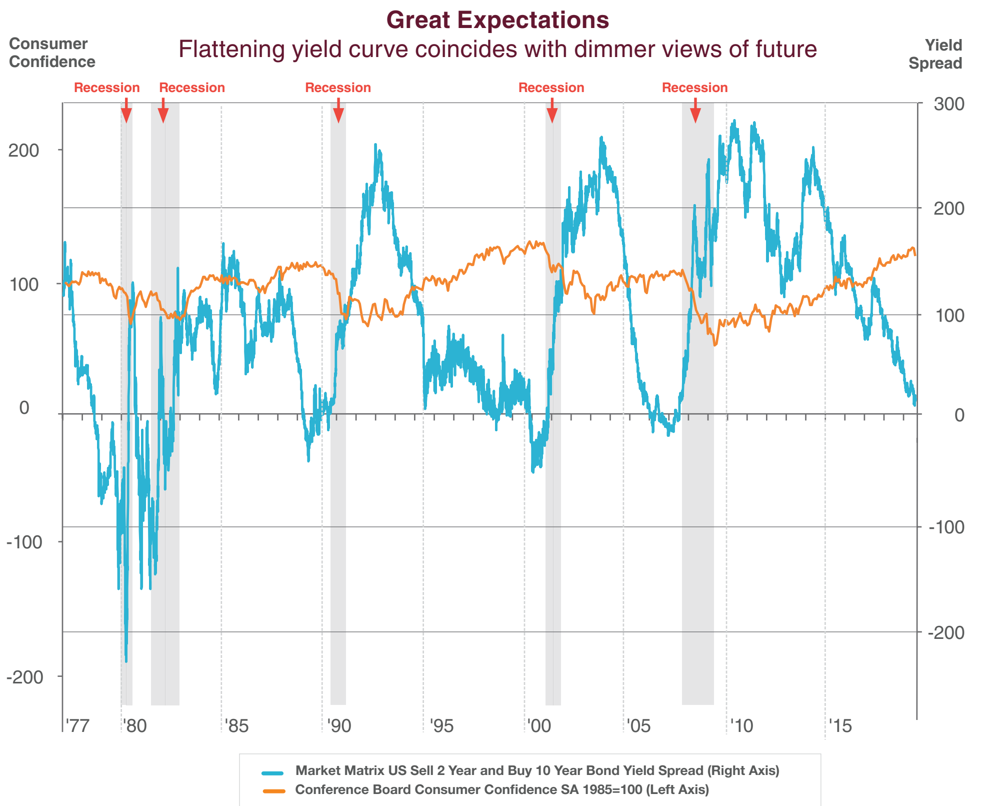
Manufacturing expectations continue to indicate economic expansion globally. That is based on readings above 50 on the regional Purchasing Managers Indexes, or PMIs. Readings below 50 indicate contraction.

The highest PMI readings are now in the US, while in most other regions those making major purchasing decisions in the manufacturing sector are less optimistic than they have been over the last few years. Nowhere has that change been more dramatic than in the Eurozone, an area that faces both geopolitical and economic obstacles in 2019.



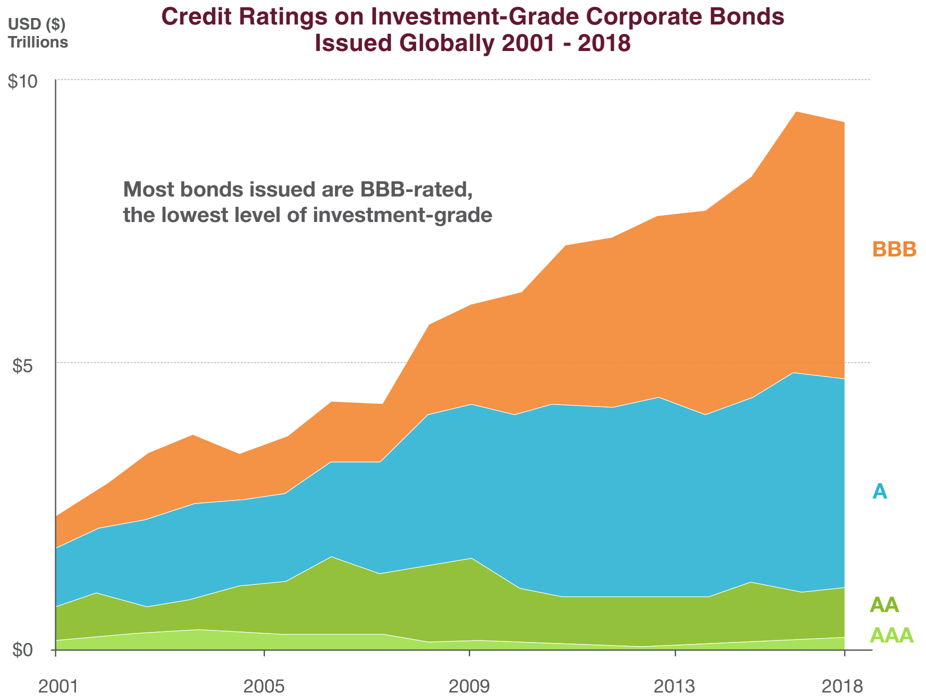
Source of Data: Bloomberg.

One of the greatest threats to economic stability is the Federal Reserve raising interest rates too much or too fast. The recent downturn in global leading indicators (in the US and abroad), at a time when inflation has stabilized, makes it more likely that the Fed will reassess its timeline for raising interest rates in 2019.



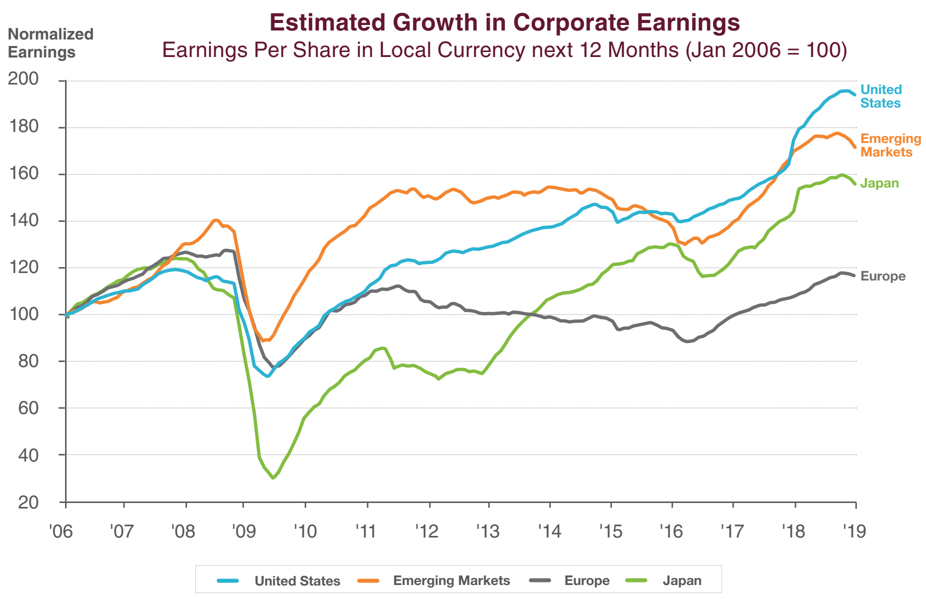
Source of Data: Bloomberg.

Much attention is being given to the flattening in the US Treasury yield curve (the yields on short and long-term bonds converging). Typically the yield curve flattens and inverts (shorter-term bonds yield more than longer-term ones) a year or more before a recession. We think a more timely indicator of recession is a drop in US consumer confidence. At this point, we haven't seen a meaningful deterioration in this metric.



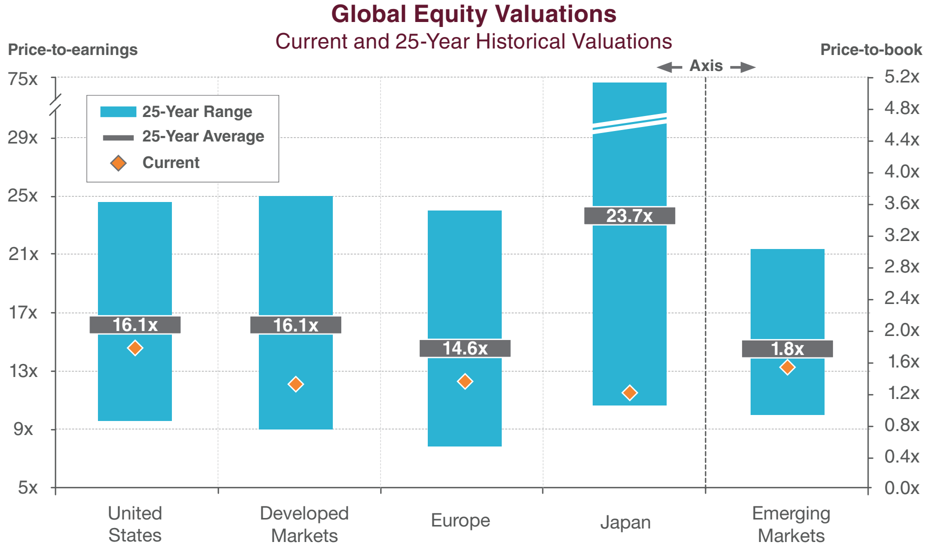
Source of Data: BlackRock Investment Institute.

Since 2000, corporate debt levels have risen and creditworthiness has fallen. This has not been lost on us. We continue to be cautious regarding credit exposure. However, we do not see the credit market going into a major decline in 2019, since corporate profits and cash flow are generally quite high, and US consumers (the buyers of corporate goods) are benefiting from a good job market and rising wages.



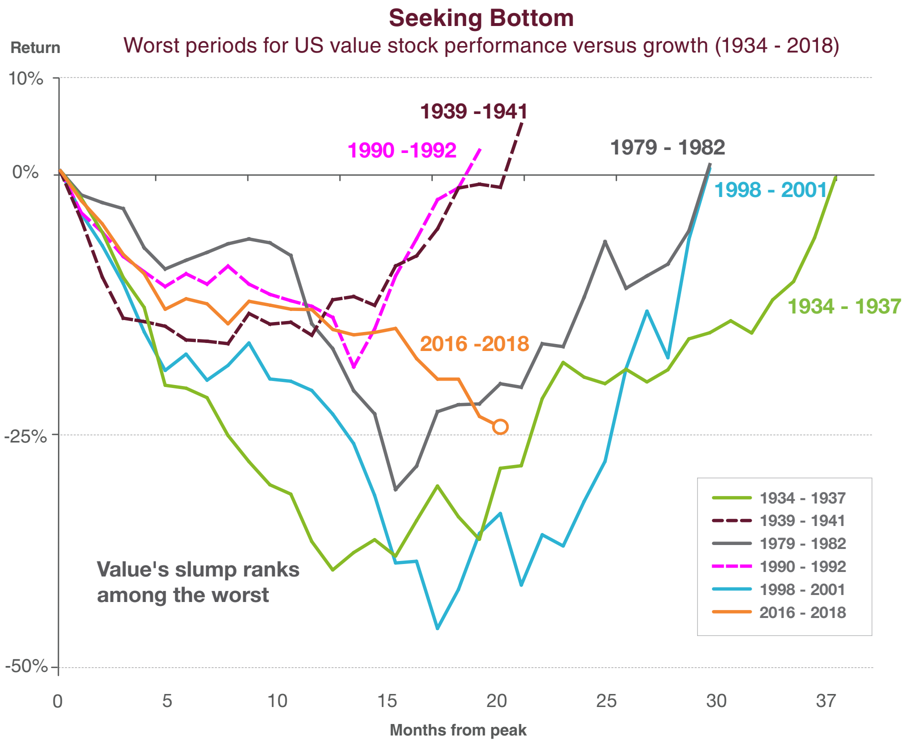
Source of Data: FactSet, MSCI, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

Corporate earnings growth has been very strong, especially in the US, during the last few years with a sharp acceleration beginning in 2016. More recently, however, we have seen a deceleration, as the benefits of the 2017 corporate tax cuts are now fully reflected in earnings, and global trade is slowing down, giving us reason to be cautious.



Source of Data: FactSet, MSCI, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

While acknowledging that equity valuations could get cheaper, we continue to be positive on the outlook for equities with valuation a key component of our analysis. Globally, equities are undervalued to varying degrees, relative to their long-term average. We are most optimistic about Asia and emerging markets.



Source of Data: BlackRock Institute.

Value stocks, which comprise a meaningful portion of the actively managed stock funds we invest in, have been in a downturn since 2016, while growth stocks have been very much in favor. Multi-year underperformance by value or growth stocks is not rare; however, this is the 4th longest period of underperformance by value stocks since 1934. We think a reversal in this trend will benefit LNWM portfolios.

ABOUT THE AUTHOR

Gino Perrina, Ph.D., CFA is the Chief Investment Officer at Laird Norton Wealth Management and has more than 15 years of experience in investment analysis, strategy and risk management. Prior to joining LNWM in November 2015, Gino was a Managing Director at BlackRock Inc. in New York City, responsible for managing risk in the firm's alternative asset portfolios (+$100 billion in total investment). He was also Managing Director of Research and Risk Management at BlackRock Alternative Advisors (2006 to 2010), Head of Fixed Income Research at Russell Investments (2010 to 2012) and a fixed income analyst and portfolio manager at Microsoft and IAC/InterActive Corp.

ABOUT LAIRD NORTON WEALTH MANAGEMENT

With nearly $5 billion in assets under advisement, Laird Norton Wealth Management is the Northwest's premier wealth management company. Founded in 1967 to serve the financial management needs of the Laird and Norton families, the firm now provides integrated wealth management solutions to more than 600 individuals, families, business leaders, private foundations and nonprofit organizations.

LNWM ASSET CLASS RETURNS CHART INDEX DEFINITIONS

Intermediate Municipal Bonds: Barclays Municipal Bond 1-10 Year Blend Index that measures the performance of municipal bonds with maturities between one and 10 years.

U.S. High-Yield Bonds: ICE BofAML US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

U.S. Core Taxable Bonds: The Barclays Capital U.S. Aggregate Bond Index covers the USD denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS, ABS, and CMBS sectors.

U.S. Large-Cap Equities: The Russell 1000 Index is an index of approximately 1,000 of the largest companies in the U.S. equity market.

U.S. Small-Cap Equities: Russell 2000 Index, a measure of the performance of the 2,000 smallest companies in the Russell 3000 Index, representative of the U.S. small capitalization securities market.

Developed International Equities: MSCI EAFE Index, a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada. As of June 2014, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

Emerging Markets: MSCI Emerging Markets Index, a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of June 2014, MSCI Emerging Markets Index consisted of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

Commodities: The Bloomberg Commodity Index is made up of 22 exchange-traded futures on physical commodities. The commodities are weighted to account for economic significance and market liquidity and weighting restrictions on individual commodities and commodity groups promote diversification.

Global REITs: FTSE EPRA/NAREIT Global Equity REIT Index, a measure that tracks the performance of listed real estate companies and REITs worldwide.

Managed Futures: The SG CTA Index provides the market with a reliable daily performance benchmark of major commodity trading advisors (CTAs). The SG CTA Index calculates the daily rate of return for a pool of CTAs selected from the larger managers that are open to new investment.

Hedge Funds – Liquid: HFRX Global Hedge Fund Index – A daily-valued index designed to be representative of the overall liquid hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry. For

Hedge Funds – Illiquid: HFRI Fund Weighted Composite Index – A global, monthly-valued, equal-weighted index of over 2,000 single-manager funds that is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies. Constituent funds report monthly net of all fees performance in U.S. dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

BENCHMARK 60/40 BLEND PORTFOLIO

The 60/40 Equity & Fixed-Income Blend Portfolio: Annually rebalanced blend of the Barclays Capital US Aggregate Bond Index and the MSCI All-Country World Index (ACWI). The blend is intended to reflect a typical moderate asset allocation without active management or manager fees for comparison.

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A benchmark is an unmanaged index, and its performance does not include any advisory fees, transaction costs or other charges that may be incurred in connection with your investments. Indices are statistical composites and are shown for informational purposes only. It is not possible to invest directly in an index. Indices are unmanaged and are not subject to management fees. Any benchmark whose return is shown for comparison purposes may include different holdings, a different number of holdings, and a different degree of investment in individual securities, industries or economic sectors than the investments and/or investment accounts to which it is compared. Comparisons of individual account or portfolio performance to an index or benchmark composed of indices are unreliable as indicators of future performance of an actual account or portfolio. Actual performance presented represents past performance net of investment management fees unless otherwise noted. Other fees, such as custodial fees or transaction related fees may not be reflected in the actual performance results shown.

The LNWM Moderate Model Index with Hedge Funds performance shown is comprised of a hypothetical combination of actual investment returns generated by investment managers and funds recommended by LNWM during the time period indicated. Past performance is no guarantee of future results. The Index allocation ranged from 20%-33% fixed income, 36%-67% equity, 10%-33% hedge funds and 0-5% cash. The actual allocations at any given time are available upon request. Within equities there is a mix of active and passive strategies, value and growth, various capitalizations and international stocks. The Index reflects all changes in LNWM's recommended managers during the period. The investment results include the reinvestment of dividends and other earnings. The Index is net of mutual fund fees and gross of LNWM management fees.

The Moderate Index with Hedge Funds is not an actual portfolio and it is not possible to invest in the Index directly. Neither is it possible to invest directly in any index used in the comparative asset allocation blends shown. The Index investment performance does not represent the actual performance experienced by any client or group of client accounts. Actual performance results in client accounts will have varied substantially from the performance shown as a result of the inception of the investment, the timing and expenses of trades in the portfolio, the addition or withdrawal of cash, funds or securities, the imposition of taxes, expenses of custody and other variables not accounted for in the Index.

Fees charged by Laird Norton Wealth Management will reduce the net performance of your investment portfolio. For example, a $3,000,000 investment for the 10-year period ending December 31, 2016, allocated in line with a Moderate Index, would have a value of approximately $4,863,109 at the end of the period. A 1% annual fee, collected monthly in arrears, would reduce the ending balance to approximately $4,403,809. The Laird Norton Tyee Asset Strategies, LLC standard schedule of fees is set forth in our Form ADV Part 2A and is available upon request. Fees for accounts managed by Laird Norton Trust Company are based on the trust company's standard fee schedule and may include fiduciary fees and related expenses in addition to investment management fees.

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