Boston Trust Commentary

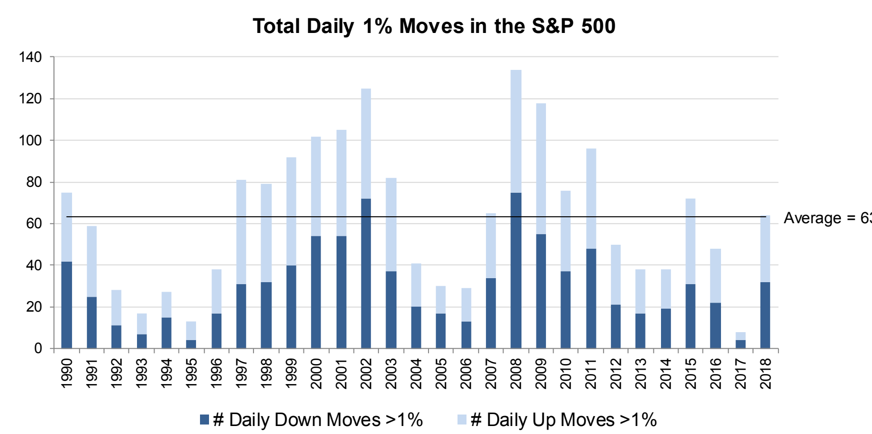
December 31, 2018

FINANCIAL MARKETS

Total Returns through December 31, 2018		
US Stocks	**4th Qtr**	**1 Year**
Standard & Poor's 500	-13.5%	-4.4%
Russell 2000®	-20.2%	-11.0%
International Stocks		
MSCI World Ex-USA	-12.8%	-14.1%
MSCI Emerging Markets	-7.5%	-14.6%
US Fixed Income		
Bloomberg Barclays Gov't/Credit	1.5%	-0.4%
US Treasury Bill	0.6%	1.9%

Virtually all equity markets fell sharply during the final quarter of 2018. Large cap US stocks, as measured by the S&P 500, declined by 13.5% in the fourth quarter, dragging the full year return down to a loss of 4.4% – the first negative calendar year for the broad market index since 2008. Stocks of smaller US companies fared even worse, while major indices of international stocks registered double digit declines for the full year. High quality fixed income was a bright spot during the quarter as investors sought the security of long and intermediate term government bonds, pushing the Bloomberg Barclays Government Credit Index up by 1.5%; but bonds offered little protection for the full year, as the Index fell 0.4%. It is a rarity for both stocks and bonds to register negative returns in the same calendar year. This was the first such occurrence since the bond index was created in 1979.

Perhaps making the negative returns even more unsettling, the stock market's oscillations felt extraordinary following years of general market calm. Market pundits didn't hesitate to cite a plethora of triple digit Dow Jones Industrial Average swings (and even a couple 1,000+ point moves last February) as evidence of historic volatility. But, on a percentage basis, these shifts were not record-breakers, and not a single day cracked the top 20 in terms of largest percentage moves. On balance, the market's fluctuations in 2018 more closely resembled normal conditions than something exceptional. As shown in the chart, the past year included 64 days of 1% market moves (in either direction), almost exactly the annual average of 63 days of such moves since 1990. To be fair, this pattern was juxtaposed to the exceptionally tranquil market of 2017, so it's understandable that investors turned the calendar to 2019 with some unease.



INVESTMENT PERSPECTIVES

Domestic Expansion Continues

In contrast to the market's volatility, virtually all available data indicate a US economy that is still on firm footing. The labor picture is exceptionally robust, with the unemployment rate firmly below 4%; according to the latest reports, average hourly wages are increasing by over 3% – almost a full percentage point higher than inflation – providing a real increase in consumers' spending power. The recent pullback in oil (and gasoline) prices has provided an additional boost to disposable income. Confidence readings from both consumers and manufacturers remain positive, and only modestly lower than the highs reached a couple months ago. GDP expanded at an annualized rate of 3.5% during the third quarter; this pace surely reflects a short-term lift from the 2017 tax cut, but normalized growth of 2-3% is still expected for the coming year.

For its part, the Fed raised its benchmark overnight interest rate by another quarter point at its December meeting – the fourth such increase of 2018 – but cautioned that changing global economic conditions could influence their decisions regarding future rate increases. And therein lies the current paradox of strong data, yet concern regarding rising risks. As we've previously noted, the Fed controls short-term borrowing rates, but market participants set the price and yield of longer maturity bonds. With unevenness in international economies as well as pockets of political unrest, global investors have continued to seek the safety of long-term bonds issued by secure governments; by way of global financial markets, this also puts a governor on US rates, and indeed, the yield on the 10-year US Treasury declined substantially during the latter part of the year.

10-Year Government Bond Yields

Italy	2.89%
United States	**2.74%**
Canada	1.98%
United Kingdom	1.27%
France	0.67%
Germany	0.25%
Japan	0.01%

Data as of January 10, 2019.

By nodding to global developments and the possibility that they weigh on US growth, the Fed has indicated to investors it is willing to pause what has been a steady schedule of rate increases. This accommodation may alleviate concerns of a predetermined path of tightening that had the potential of inverting the yield curve – a frequently noted indicator of impending (domestic) recession.

European Challenges

It was only six months ago that nearly all developed economies were growing in tandem, a development widely noted for its rarity. Economic data has largely remained positive since that time, but decidedly less so. To boot, the less robust economic backdrop comes amid considerable political uncertainty. This is particularly true within the European Union, a bloc that, in aggregate, is only second to the US in terms of nominal GDP. With rising concern among investors, in addition to evidence of slower growth in other large markets (e.g. China), it's unsurprising that global growth forecasts have been lowered in recent months.

Political challenges are occurring in Europe's four largest economies – a group that comprises close to 70% of the EU's output. Concern regarding Brexit has been at the forefront for some time, but the ebb and flow of negotiations regarding the United Kingdom's future relationship with the European Union is becoming increasingly unnerving as we approach Brexit's March 2019 deadline. The new Italian government is similarly trying to live up to campaign promises while also burdened by the realities of a high debt load and flagging growth. Germany's export driven economy is growing, but remains at the mercy of trade relations (particularly as it relates to US tariffs on European car imports). Complicating forecasts, Chancellor Merkel is set to leave office in 2021 after more than 15 years in power. Meanwhile, protests against gas taxes in France are indicative of unrest relating to economic policy. These uncertainties can provide a headwind to business investment, and in turn, economic output. And while there are no signs that the region is devolving into a recession, the political tumult raises the risk that an economic dislocation would not be met with a coordinated and sufficient policy response.

Trade Agreements Near and Far

Global trade disruption remains a significant risk for the US economy. It should be noted, however, that progress has been made. The recently signed United States Mexico Canada Agreement (USMCA), an update of the North American Free Trade Agreement (NAFTA), took much uncertainty off the table. The adjustments to NAFTA include increased access to Canada's dairy market, additional incentives for domestic auto production, and improvements to environmental, labor, and intellectual property protections. Even in aggregate, these modifications are minor relative to the damage that would have been caused by a North American trade war. The US conducted over $1.1 trillion in total trade with its immediate neighbors in 2017, and a disruption to deeply intertwined manufacturing/supply chains would likely wreak havoc on the domestic economy. The new pact has yet to be ratified by each country's legislature (NAFTA is still in force in the meantime), but we are pleased by the recent progress.

The same can't be said for the trade dispute with China. 2018 brought multiple high-profile discussions regarding the bilateral relationship. Investors hung on each twist in the ongoing saga, with every development seeming to result in additional market volatility. The world's two largest economies are inextricably linked; China is the largest holder of US government debt, and each is the other's largest trading partner with $630 billion of total trade between them in 2017. The $370 billion US deficit is front and center, but with $170 billion of it stemming from computers and electronics, it is no surprise that intellectual property protections are key to discussions as well. The backdrop to talks now includes rising concerns about the persistence of US economic growth and clear signs of a slowing Chinese economy. Given that the political fortunes of leaders on both sides of the Pacific hinge on a positive economic outcome as well as a winning message for their constituents, we remain optimistic there will be a deal. In the meantime, however, continued posturing will likely result in additional market volatility.

Outlook

Despite the market's recent correction, we believe that most evidence supports a positive outlook for stocks. Low interest rates, a strong labor market, and healthy corporate cash flows reflect a robust domestic economy. And while economic indicators and geopolitical matters bear watching, most global economies continue to expand. The combination of rising corporate profits and the market pullback has produced equity valuations that are reasonable by recent and historical standards, as well as our own metrics. As such, we continue to favor equities over both fixed income and money market instruments in mixed asset portfolios and remain steadfast in focusing investments in financially strong companies that we believe are well-suited to weather potential economic turbulence.

Data Sources: Bloomberg, FactSet.