IN THIS ISSUE

MARKET REVIEW
DECEMBER 2019

SMB Trust Services

UNDERSTANDING THE ECONOMIC IMPACT OF GLOBAL AGING

The populations in many developed countries are undergoing a transformative demographic shift that may have long-term economic consequences. Populations in these countries are rapidly growing older as the baby boomer generation ages, life expectancy rises, and fertility rates decline. In developed countries, by 2025 the number of people over age 65 is projected to surpass the number of people under 20 years old for the first time in recorded history, according to the United Nations (UN). Many economists believe aging populations will have negative economic implications such as lower economic growth and increased pressure on government finances. The economic and financial market impacts of these shifts are highly uncertain due to their unprecedented magnitude coupled with the potentially mitigating factors discussed below.

ECONOMIC IMPLICATIONS

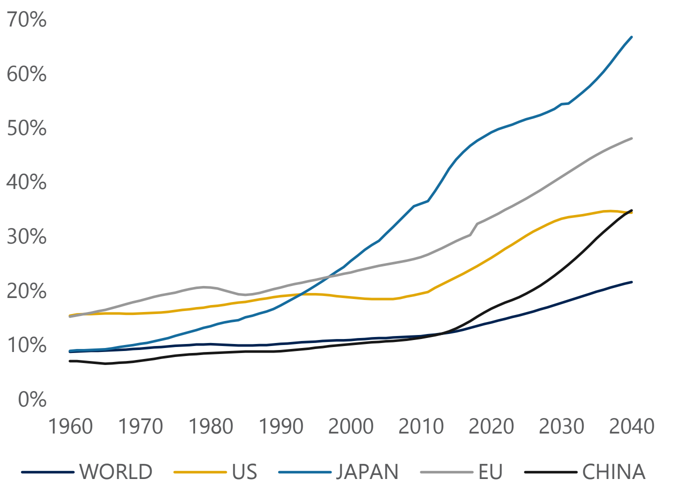
The International Monetary Fund (IMF) projects that the impact of aging populations and lower fertility rates could reduce longterm economic growth in developed economies by about 0.5% per year. Over the long term, economic growth largely depends on an economy's labor force growth and worker productivity. Labor force growth is expected to be weaker in developed countries due to the baby boomer generation exiting the labor market in larger numbers as they age; on the other end of the age spectrum, low fertility rates have constrained the supply of new workers. Although migration trends are another component of labor force growth, in most countries, birth rates are a much larger driver of population.

Aging populations can also reduce economic growth through lower worker productivity. Economists at Harvard University and the global policy think tank, RAND Corporation, looked at the varying effects of aging across the United States and concluded that slower labor force growth explains about one-third of reduced economic growth attributed to aging. The remaining two-thirds of the reduced economic growth are due to weaker worker productivity, as measured by output per hour. In countries such as the U.S. where services are a larger driver of the economy as compared to manufacturing, productivity is more reliant on experience and cognitive skills than on physical output which leads to workers becoming more productive as they gain experience. One study concluded that productivity peaks around age 50 at which time, on average, productivity is 60% higher than that of someone 20 years of age. As the baby boomer generation retires, their experience, knowledge and generally higher levels of productivity are also leaving the work force.

Another factor that may contribute to slower economic growth is the reduction in capital available to fund investment projects. In theory, the savings rate is higher for the working-age population and declines in retirement as people deplete their savings to fund their consumption needs. Rising life expectancy and declining fertility have led to an increase in the number of people over age 65 relative to the working age population in most countries, as measured by the age dependency ratio in the chart on page 3. The working-age population as a percent of the total population has been shrinking in the U.S., Europe, Japan and China. The UN projects the labor forces of G7 countries will continue to contract relative to the overall population.

AGE DEPENDENCY RATIO*

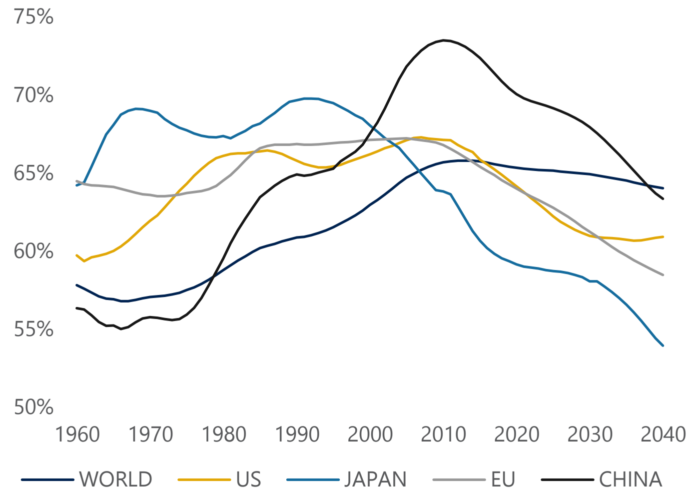
POPULATION: ABOVE 65 YEARS OLD / WORKING AGE



Source: Organization for Economic Co-operation and Development (OECD)
* OECD Forecast 2020 - 2040

WORKING AGE POPULATION*

WORKING AGE POPULATION / TOTAL POPULATION



Source: Organization for Economic Co-operation and Development (OECD)
* OECD Forecast 2020 - 2040

As people of retirement age become an increasingly larger percentage of the total population, the savings rate is expected to decline. A lower savings rate will likely reduce the capital available to fund investment projects which, in turn, could decrease economic growth.

Another economic implication of aging populations is increased pressure on government finances as spending rises for health care and public asset transfer programs such as pensions and Social Security. The IMF projects government spending for health care and pensions in developed countries could rise by around 7.0% of GDP in the coming decades. The financial burden on governments from retirees living longer will be exacerbated by the shrinking working-age population. As previously described, the age dependency ratio is rapidly rising in many countries. As a result, the financial obligation to support each retiree is becoming dependent on the taxes provided from fewer workers. In 1980, the U.S. population had five workers per retiree. This ratio has declined sharply in developed countries, and by 2035 it is expected to reach 2.5 workers per retiree in the U.S., 1.8 in Europe and 1.3 in Japan. Absent policy reforms for health care and pensions, the IMF believes increases in spending related to aging could lead to public debt rising to unsustainable levels, severe spending cuts in other government programs, or large tax increases which could weigh on economic growth.

MITIGATING FACTORS

There are a number of factors that could alleviate some of the potentially harmful economic effects of aging populations. First, increased labor market participation rates among workers 65 and older combined with longer life expectancies would likely slow declines in labor force growth and productivity growth. Some European countries have already implemented pension reform policies to gradually increase the retirement age over the next several years. Second, increased migration and investment from younger and rapidly growing populations in emerging countries, excluding China, could reduce the age-related economic pressure in developed countries. Lastly, a shrinking labor force relative to the overall population may incentivize companies to invest more in productivity-enhancing equipment and technology. These potential new technologies, such as robotics and artificial intelligence, could help boost productivity.

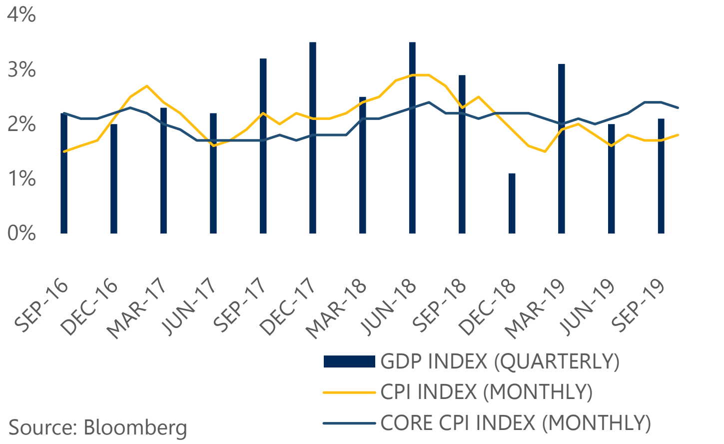
CONCLUSIONS AND INVESTMENT IMPLICATIONS

Many economists believe aging populations, longer life spans, and lower fertility rates in developed countries and China will lead to lower levels of economic growth. Slower economic growth can impact financial markets through lower corporate sales and earnings growth. In addition, asset prices and returns could be pressured as the large baby boomer generation stops accumulating assets upon retirement and presumably sells assets to fund their retirement. The wealth gap between baby boomers and younger generations likely indicates there is insufficient domestic household demand to completely absorb the baby boomers' asset sales. Demographic changes are an important part of financial market and asset allocation analysis due to their ability to change the economic landscape over long periods of time. However, some caution is warranted in relying on demographics alone for investment decision making. Because demographic shifts occur incrementally over extended time periods, their effects can be completely offset over shorter periods by largely unrelated economic, financial and political developments. As such, we believe investors with a long-term focus would be well served to incorporate the economic impacts of global aging trends as an important, but not paramount, factor that influences their portfolio construction and market expectations.

ECONOMY

GDP AND CONSUMER PRICES

SEPTEMBER 2016 THROUGH OCTOBER 2019

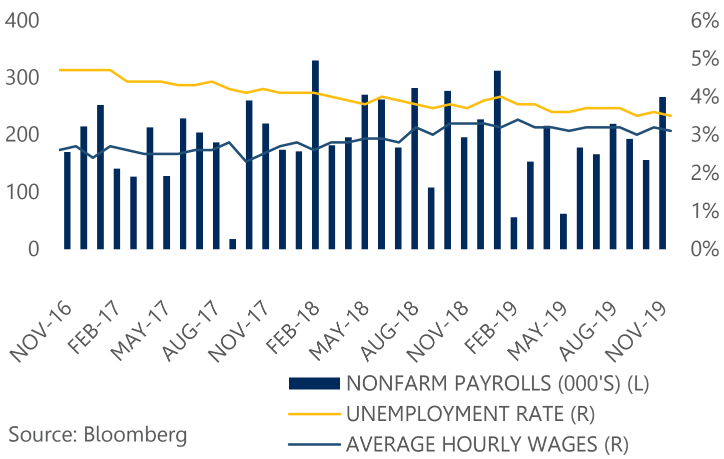


Source: Bloomberg

- U.S. third quarter economic growth was revised slightly higher to a seasonally adjusted annualized rate of 2.1%, up from the initial estimate of 1.9% issued last month.
- Fourth quarter economic growth is projected to decelerate to 1.6%, according to economists' consensus estimate compiled by Bloomberg. Economists expect 2.3% year-over-year growth for 2019 followed by slower growth of 1.8% in 2020.
- Underlying U.S. consumer prices, measured by the Core Consumer Price Index which excludes the volatile food and energy components, rose 0.2% in October. Despite fresh tariffs on Chinese goods and three rate cuts from the Fed, prices paid by consumers are up just 2.3% for the 12-month period ending October 2019.

LABOR MARKET

NOVEMBER 2016 THROUGH NOVEMBER 2019

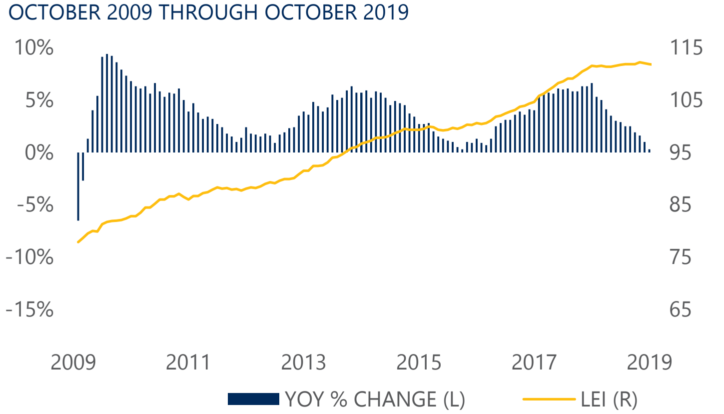


Source: Bloomberg

- The U.S. added 266,000 nonfarm payrolls in November, easily topping economists' consensus estimate of 187,000. The unemployment rate dropped back to its 50-year low of 3.5% and average hourly wages rose 3.1% from a year ago.
- A recent report by the National Federation of Independent Business showed qualified workers remain in high demand and the number of small business owners with plans to increase employee wages in the coming months reached its highest level since 1989.
- Consumer spending has been a key driver behind the current economic expansion which is the longest economic expansion in U.S. history. The healthy labor market should continue to support household spending and help the economic expansion continue for the near-term.

LEADING ECONOMIC INDICATORS

OCTOBER 2009 THROUGH OCTOBER 2019



Source: Bloomberg

- In October, the U.S. Conference Board Leading Economic Index (LEI) dropped for its third consecutive month to a level of 111.7. The 0.1% decline followed a 0.2% drop in both September and August.
- Although the November employment report showed strength, the labor market components of the LEI were among the largest detractors in October. ISM New Orders remains the weakest LEI component.
- Economic growth in the U.S. has abated in recent quarters partially due to the ongoing trade war between the U.S. and China; however, a phase-one trade deal could improve growth above current estimates.

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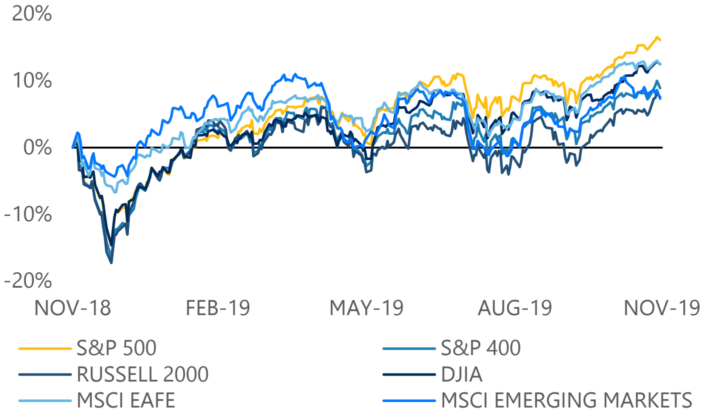
EQUITY

TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, NOVEMBER 2018 THROUGH NOVEMBER 2019



Source: Bloomberg

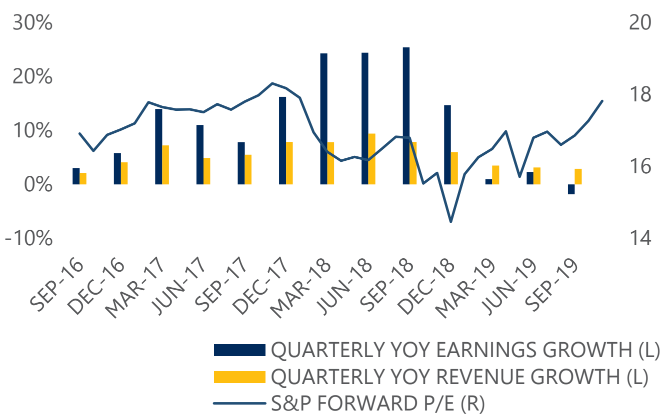
- Domestic equities continued their climb higher in November amid hopes for a U.S.-China phase one trade deal and better-than-feared third quarter earnings. Small cap stocks led markets higher with a 4.1% monthly gain and broke out of a nine-month trading range to reach a new one-year high. The S&P 500 rose 3.6%, its biggest monthly gain since rising 7.1% in June.

- Foreign developed markets also rose in November, supported by an improvement in some economic data including the struggling manufacturing sector. The MSCI EAFE index was up 1.1% in November.

- Emerging Markets lagged with a roughly flat monthly return, following October's strong 4.2% return.

S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, SEPTEMBER 2016 THROUGH NOVEMBER 2019



Source: Bloomberg

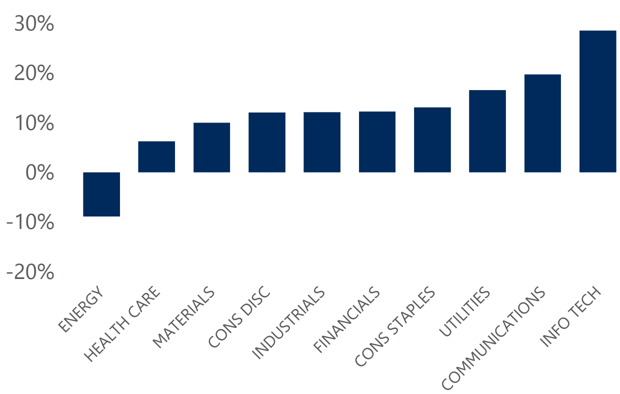
- Analysts once again underestimated the resiliency of S&P 500 earnings in the face of slower global economic growth and tough year-over-year comparisons. For a third straight quarter, earnings growth was better than analysts' pessimistic expectations.

- Earnings growth was negative 1.3% compared to the original analysts' consensus estimate for a 3.6% decline. Excluding the energy sector's 39.6% earnings decline, S&P 500 earnings rose 1.2%. Revenue growth of 2.8% matched analysts' estimates.

- Analysts are forecasting an improvement in earnings growth next year to 9.2% due to easier year year-over-year comparisons and modestly better sales growth.

S&P 500 SECTORS 12-MONTH PRICE RETURNS

NOVEMBER 2018 THROUGH NOVEMBER 2019



Source: Bloomberg

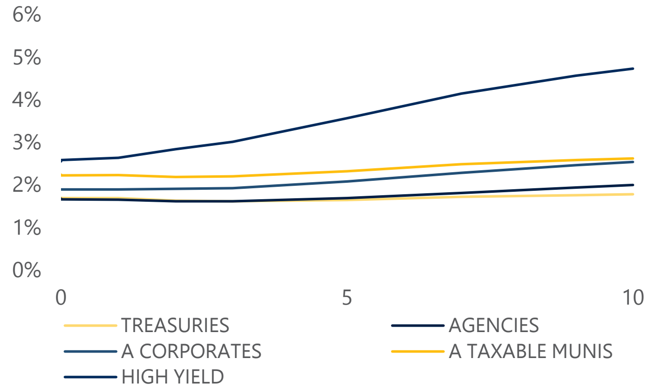
- The technology sector's 5.4% return in November led all sectors. Technology is on track for its best year since 2009 with a year-to-date return of 43.8%. Microsoft and Apple, technology's two largest holdings, have gained 50.1% and 71.4% this year, respectively.

- Health care's resurgence continued in November after lagging most of the year. The sector posted a second consecutive monthly gain above 5.0%, making it the best performing sector over the last two months. The sector's recent strength was driven by surprisingly strong third quarter earnings growth of 8.7% and analysts' comments about easing risk for a potential Medicare-for-All policy.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF NOVEMBER 2019

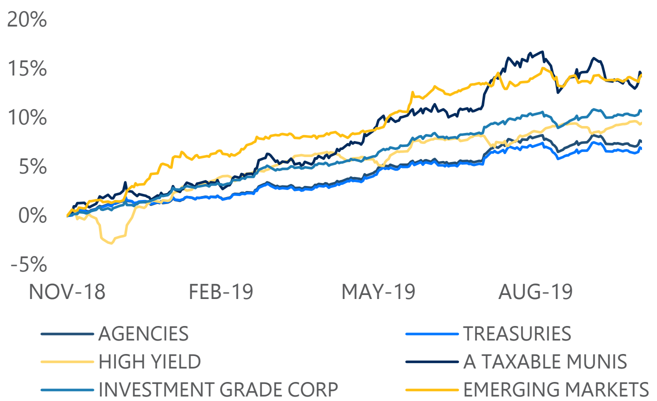


Source: Bloomberg

- U.S. Treasury bonds spanning the entire maturity range, from one month to thirty years, experienced an increase in yields in November.
- High quality government agency bonds have begun to have some spread versus Treasuries five years out.
- The spread on high yield bonds compared to single A-rated corporate bonds begins to widen significantly around five years out.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

NOVEMBER 2018 THROUGH NOVEMBER 2019

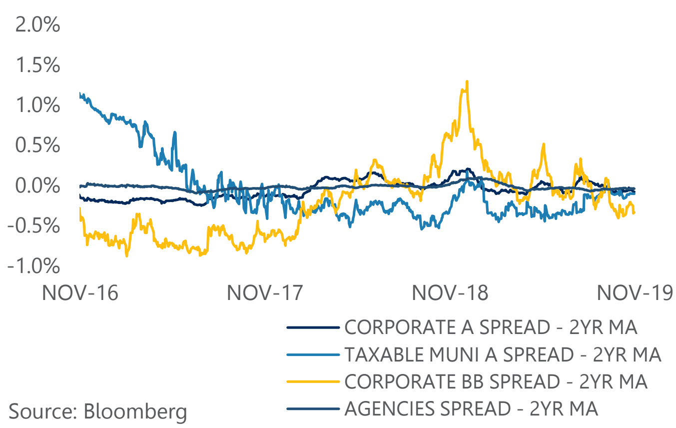


Source: Bloomberg

- Each of the fixed income sectors shown in the accompanying chart generated a healthy price return above 6.5% in the past 12 months as yields have continued to decline over the period.
- Each of the fixed income sectors has maintained a positive rolling one-year price return since January.
- Single A-rated taxable municipals posted the best one-year return of 14.4%, while Treasuries recorded the weakest performance of 6.7%.

SPREAD VS. TREASURY LESS 2-YR MOVING AVG

NOVEMBER 2016 THROUGH NOVEMBER 2019



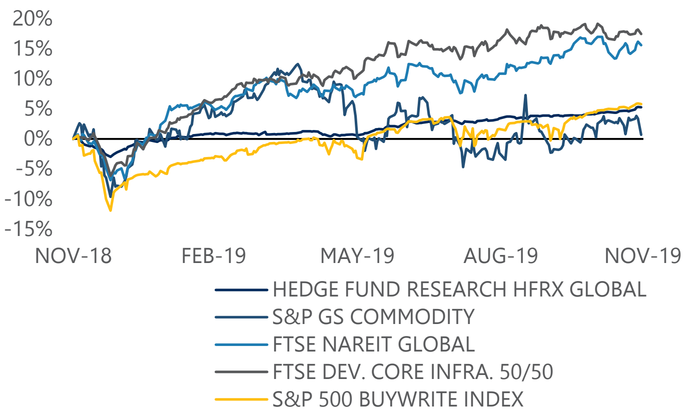
Source: Bloomberg

- The spread environment for the two fixed income sectors with corporate credit exposure shown in the accompanying chart, Corporate A and Corporate BB, worsened in November as each saw spreads tighten during the month. This signals that investors view corporate credit as becoming safer.
- The single A-rated taxable municipal spread widened in November; however, all fixed income sectors' spreads are currently below their two-year average spread.
- Agency spreads were unchanged in November.

ALTERNATIVES

ALTERNATIVES, 12-MONTH RETURNS

NOVEMBER 2018 THROUGH NOVEMBER 2019

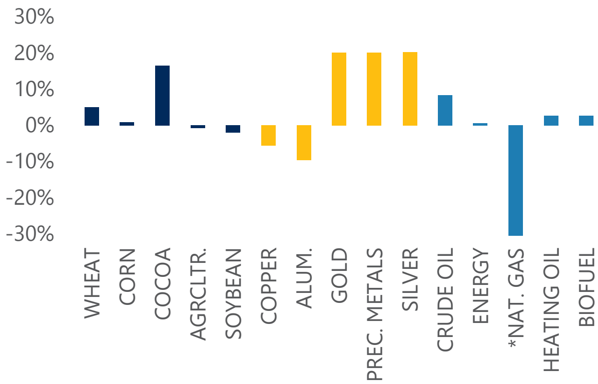


Source: Bloomberg

- Against a backdrop of strong equity market returns over the last two months, the interest rate-sensitive global real estate and developed market infrastructure indexes cooled off in November.
- The hedged equity and global hedge fund asset classes extended their October gains in November such that both have generated about a 5% return over a trailing 12-month period.
- After climbing 19.3% in the first four months of 2019, the broad commodities asset class has declined 8.4% from May through November. With the exception of gold prices, the broad commodities asset class will likely struggle to achieve durable price gains without improvements in the simmering U.S.-China trade dispute.

COMMODITIES, 12-MONTH SPOT RETURNS

NOVEMBER 2018 THROUGH NOVEMBER 2019



Source: Bloomberg

*Chart not to scale; actual decline for Natural Gas is -50.5%.

- The 50% decline in natural gas prices over the last 12 months is largely explained by a price spike to near $5 per MMBtu in the fourth quarter of 2018 related to an unusually cold start to winter one year ago. Signs of increasing supply throughout 2019 have prevented prices from recovering to $3 MMBtu for most of the year.
- After peaking near $1,550 per ounce in the first week of September, gold prices have cooled off in recent months.
- In 2019, gold prices have been driven higher by the Federal Reserve's three quarter-point interest rate cuts and lingering concerns about the prospect of recessions in key international economies.

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