Hindsight's 2020 for a Lofty 2019, but What's our Foresight for the Year to Come?

Awash in Liquidity

They say a rising tide lifts all boats, and in the case of 2019, everyone was swimming! Liquidity was the name of the game, as we experienced a stark reversal from the draining toilet sound we felt in the final quarter of 2018, when the Fed took the proverbial punch bowl away…and right before the holidays no less!

We are all learning what it means to unravel the world's greatest financial "experiment" (aka quantitative easing), and it's no surprise that we'll see some fits and starts, as the Fed strives to concoct a new well-balanced "cocktail" that suits the economy's pallet. While the Fed raised rates 4 times in 2018, they may have been a bit heavy handed, as they also reduced the balance sheet from a high of $4.5 Trillion to roughly $4 Trillion at the same time. Thus, creating a compounding effect on their tightening strategy, which the market dubbed way too strong. Everyone held their noses in preparation for Auld Lang Syne, kissing 2018 goodbye, with bright hopes for the future in 2019.

Despite the rough end to the year, very well established firms, such as Pimco, Goldman Sachs, and JP Morgan were still predicting 4 rate hikes for 2019. As we now know, those projections proved to be dramatically inaccurate. Indeed, after a long pause, the FOMC made a U-turn and cut rates three times, bringing the target rate to 1.50%–1.75%. Meanwhile, it continued its steady decline in the balance sheet, reaching a low of $3.7 Trillion in September, when the wheels fell off the repo market (overnight lending between financial institutions). This caused the Fed once again to reverse course, expanding their balance sheet back up to $4.1 Trillion and providing much needed liquidity at the short-term window.

These Fed cuts, along with increased liquidity, fueled risk appetite and all major asset classes posted above-average returns—many of them in double-digit territory. While negative returns in 2018 are part of this picture, this degree of broad-based outperformance is unusual, if not unprecedented. The Fed's "pivot" was the most obvious contributor to stellar performance given that the economic picture was largely unchanged.

Overall, the economy remained strong with unemployment at historic lows, GDP growth hovered around 2%, consumers continued to spend, and inflation remained benign. The manufacturing sector continued to be a relatively lone point of weakness, with the December Manufacturing ISM coming in at 47.2, below 50 (Readings below 50 signal contraction) for the fifth consecutive month. While manufacturing and capital expenditures remain low, we do believe these long celebrated metrics of economic expansion could be outdated and underestimate the growth in the cloud from "operating expenditures".

Equity markets were propelled to record highs and even fixed income investors were rewarded with nearly double-digit returns, an amazing feat given the sector's paltry yields. December capped a 129-month bull market for the S&P 500 Index, the longest ever and a cumulative return of nearly 500% since March 9, 2009. Going into year-end, perceived progress in U.S./China trade negotiations, some degree of closure around Brexit, and expectations for the Fed to remain on hold for the foreseeable future overshadowed various areas of concern including unrest in Hong Kong, tensions in the Middle East and North Korea, the ongoing impeachment proceedings in the U.S., and ballooning federal debt. Further, Boeing's temporary cessation of 737 Max production is expected to trim 0.5% off first quarter GDP growth. Outside of the U.S., rate cuts were prevalent across developed markets in 2019 but economic news was largely unchanged throughout the year. GDP growth across developed markets remained weak but largely positive.

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The most recent annual growth rate for the euro area was 1.2% and for Japan, 1.7%. As in the U.S., manufacturing continued to be a weak spot given a fall-off in global demand as well as the imposition of trade tariffs. The global manufacturing PMI was 50.3 in November, but that was due partly to modest expansions in emerging market countries Brazil, China, and India. Global inflation also remained benign at 2.0% in October, with the figure for developed markets being a more meager 1.5%, according to data from JP Morgan.

Equity Markets

The S&P 500 Index rose 9.1% in the fourth quarter, bringing its year-to-date result to a whopping 31.5%, the best calendar year return since 2013 and capping a decade of strong performance. Small cap stocks outperformed large caps in the fourth quarter, but trailed for the year (Russell 2000: +9.9%; +25.5% vs. Russell 1000: 9.0%; +31.4%). Growth stocks outperformed for both periods (Russell 1000 Growth: +10.6%; +36.3%; Russell 1000 Value: +7.4%; +26.5). From a sector perspective, Real Estate (-0.5%) was the only sector to post a negative return in the fourth quarter, though Utilities (+0.8%) was only modestly positive. Technology and Health Care (both +14.4%) were the twin "winners." For the year, all sectors posted double-digit returns—Energy (+11.8%) and Technology (+50.3%) were the bookends. The Tech sector is up a cumulative 840% since the market low in March 9, 2009. Notably, the stock market rally in 2019 was fueled largely by expansions in share price multiples in contrast to the rest of the decade, when returns were driven mostly by earnings growth. As a result, some term the market "overvalued" by a number of metrics relative to long-term averages.

Non-U.S. developed markets trailed the U.S. but were still up sharply in the fourth quarter and 2019 (MSCI ACWI ex-USA: +8.9%; +21.5%). Virtually all countries posted positive returns for both periods, though results were varied. Emerging markets outperformed developed markets in the fourth quarter but trailed for the full year (MSCI EM Index: +11.8% +18.4%). Chile (-8.8%; -16.9%) was the only country to deliver a negative return for both periods due to a sharp decline in the Chilean peso amid civil unrest. Russia (+16.8%; +50.9%) was the top performer for the year as its central bank aggressively cut rates. Returns for the BRIC countries were mixed. Brazil (+14.2%; + 26.3%) and China (+14.7%; +23.5%) also posted strong results while returns from India (+5.3%; +7.6%) were more modest.

Fixed Income Markets

Fixed income markets posted strong returns in 2019 fueled both by falling interest rates and strong investor demand, especially for higher-yielding sectors. The 10-year U.S. Treasury closed the year at 1.92%, up from 1.68% at the end of the third quarter and down sharply from 2.69% at the close of 2018. The Bloomberg Barclays US Aggregate Bond Index rose 8.7%, the best calendar year return since 2002, with the lowest-quality tier of the Index up 16.4%. Fourth quarter gains were more muted at 0.2% as Treasury yields rose modestly. Corporate bonds were the best-performing sector in the fourth quarter and 2019 (Bloomberg Barclays Corporate Index: +1.2%; +14.5%) with long corporates gaining nearly 24% in 2019. High yield corporates also posted sharp gains; the Bloomberg Barclays Corporate High Yield Index rose 2.6% in the fourth quarter and 14.3% in 2019. Leveraged loans suffered outflows throughout the year, but still posted a solid return (CS Leveraged Loan: +1.7%; +9.0%). The Bloomberg Barclays US TIPS Index sharply outperformed the Treasury Index in the fourth quarter as inflation expectations rose, more than offsetting underperformance earlier in the year. The 10-year breakeven spread ended the year at 1.77%, up from 1.53% as of Sept. 30, 2019, and 1.71% as of Dec. 31, 2018. Worries over an inverted yield curve were a distant memory—the spread between the 2-year and 10-year Treasury was 34 bps at year-end. Municipal bonds

(Bloomberg Barclays Municipal Bond: +0.7% and +7.5%) outperformed U.S. Treasuries in the fourth quarter and 2019 as the sector attracted record inflows.

Overseas, rates followed a similar path with most higher in the fourth quarter but lower for the year. The amount of negatively yielding debt declined from a high of $17 trillion in August 2019 to less than $12 trillion as of year-end. The U.S. dollar gave up some gains in the fourth quarter, especially versus the euro (-3%), the Australian dollar (-4%), and the British pound (-8%). It posted a modest gain versus the Japanese yen (+0.6%). The Global Aggregate ex-US Index rose 0.7% in the fourth quarter on an unhedged basis but fell 1.1% on a hedged basis. For the full year, the hedged version outperformed unhedged (7.6% vs 5.1%). Emerging market debt benefited from both rate cuts and a risk-on environment. Local currency emerging market debt, as measured by the JPM GBI-EM Global Diversified Index, gained 5.2% in the fourth quarter and 13.5% for the year. Russia (+10.0%; +34.0%) was a top performer on the back of rate cuts and a stronger ruble. The U.S. dollar-denominated JPM EMBI Global Diversified Index was up 1.8% in the fourth quarter and 15.0% for the year with mixed results across its 60+ constituents.

Real Assets

Real asset returns were mostly strong in the fourth quarter. The Bloomberg Commodity Index gained 4.4% and the S&P GSCI Commodity Index was up 8.3%; the deviation between the two indices was largely attributable to the price of oil (up 9% and a much larger allocation within the S&P GSCI Index). MLPs, however, declined (Alerian MLP Index: -4.1%). Spot gold prices were up 3.4%. The DJ-Brookfield Infrastructure Index rose 4.0%. REITs (FTSE Nareit Equity Index) posted a modest loss (-0.8%). TIPS also fared well as real rates fell; the Bloomberg Barclays TIPS Index rose 0.8%. For the full year, all returns were positive with Infrastructure (+28.7%) and REITs (+26.0%) leading the pack. MLPs (+6.6%) posted the lowest full-year return of the real asset category.

Closing Thoughts

While 2018 was an unusual year where virtually all asset classes posted negative returns despite strong earnings, 2019 was equally rare with all major asset classes delivering above-average returns. While our foresight is positive for 2020, we should cheers 2019 for the anomaly it was!

Regards,

John P. Ulrich, CFP®
President

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Chief Investment Officer

Returns for Various Periods - December 31, 2019

	Last Quarter	Year to Date	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
MSCI:ACWI	8.95	26.60	26.60	**12.44**	8.41	8.79	**6.86**
Russell:3000 Index	9.10	31.02	31.02	**14.57**	11.24	13.42	**9.03**
Russell:3000 Growth Index	10.67	35.85	35.85	**19.89**	14.23	15.05	**10.38**
Russell:3000 Value Index	7.48	26.26	26.26	**9.32**	8.20	11.71	**7.58**
MegaCap							
Russell:Top 50	10.46	32.86	32.86	**16.55**	12.77	13.27	**8.63**
Russell:Top 200	9.79	31.75	31.75	**16.23**	12.34	13.67	**8.97**
Russell:Top 200 Growth	11.28	36.48	36.48	**21.44**	15.69	15.58	**10.66**
Russell:Top 200 Value	7.95	26.36	26.36	**10.49**	8.65	11.56	**7.15**
Large Cap							
S&P:500	9.07	31.49	31.49	**15.27**	11.70	13.56	**9.00**
Russell:1000 Index	9.04	31.43	31.43	**15.05**	11.48	13.54	**9.12**
Russell:1000 Growth	10.62	36.39	36.39	**20.49**	14.63	15.22	**10.50**
Russell:1000 Value	7.41	26.54	26.54	**9.68**	8.29	11.80	**7.63**
MidCap							
S&P:400 Mid Cap	7.06	26.20	26.20	**9.26**	9.03	12.72	**9.48**
Russell:Midcap Index	7.06	30.54	30.54	**12.06**	9.33	13.19	**9.49**
Russell:Midcap Growth	8.17	35.47	35.47	**17.36**	11.60	14.24	**10.15**
Russell:Midcap Value	6.36	27.06	27.06	**8.10**	7.62	12.41	**8.82**
Small Cap							
S&P:600 Small Cap	8.21	22.78	22.78	**8.36**	9.56	13.35	**9.20**
Russell:2000 Index	9.94	25.52	25.52	**8.59**	8.23	11.83	**7.92**
Russell:2000 Growth	11.39	28.48	28.48	**12.49**	9.34	13.01	**8.81**
Russell:2000 Value	8.49	22.39	22.39	**4.77**	6.99	10.56	**6.92**
Russell:Microcap	13.45	22.43	22.43	**6.39**	6.57	11.26	**6.16**
Non-US Equity							
MSCI:ACWI ex US	8.92	21.51	21.51	**9.87**	5.51	4.97	**5.25**
MSCI:EAFE	8.17	22.01	22.01	**9.56**	5.67	5.50	**4.84**
MSCI:EAFE Growth	8.45	27.90	27.90	**12.84**	7.71	6.95	**5.84**
MSCI:EAFE Value	7.82	16.09	16.09	**6.31**	3.54	3.98	**3.77**
MSCI:EAFE Small Cap	11.52	24.96	24.96	**10.92**	8.85	8.74	**6.97**
MSCI:EM	11.84	18.44	18.44	**11.58**	5.61	3.68	**7.48**
Fixed Income							
Blmbg:Aggregate	0.18	8.72	8.72	**4.03**	3.05	3.75	**4.15**
Blmbg:TIPS	0.79	8.43	8.43	**3.32**	2.62	3.36	**3.78**
Blmbg:Long Gov/Credit	(1.12)	19.59	19.59	**8.07**	5.42	7.59	**6.71**
Blmbg:Long Credit A	0.51	21.77	21.77	**8.02**	5.95	7.75	**6.39**
Blmbg:HY Corp Cash Pay	2.62	14.33	14.33	**6.37**	6.13	7.59	**7.20**
Blmbg:Muni 1-10 Yr	0.86	5.63	5.63	**3.57**	2.60	3.15	**3.53**
Blmbg:Glb Agg xUSD	0.67	5.09	5.09	**4.36**	1.62	1.50	**2.41**
Blmbg:Glb Agg xUSD Hdg	(1.11)	7.57	7.57	**4.38**	3.87	4.29	**4.39**
JPM:EMBI Plus	3.38	12.60	12.60	**4.90**	5.20	6.10	**6.86**
Other Assets							
Blmbg:Commodity TR Idx	4.42	7.69	7.69	**(0.94)**	(3.92)	(4.73)	**(2.55)**
GS Commodity Index	8.31	17.63	17.63	**2.35**	(4.32)	(5.44)	**(4.63)**
S&P:Gold Spot Price Ix	3.41	18.87	18.87	**9.76**	5.16	3.34	**8.66**
FTSE:NAREIT Equity Index	(0.76)	26.00	26.00	**8.14**	7.21	11.94	**7.94**
Alerian:MLP Index	(4.08)	6.56	6.56	**(4.45)**	(7.00)	4.19	**6.40**

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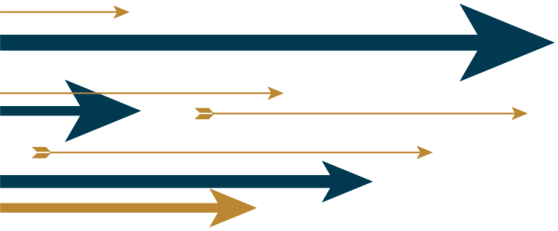
CAPITAL MARKETS REVIEW & OUTLOOK

First Quarter 2020



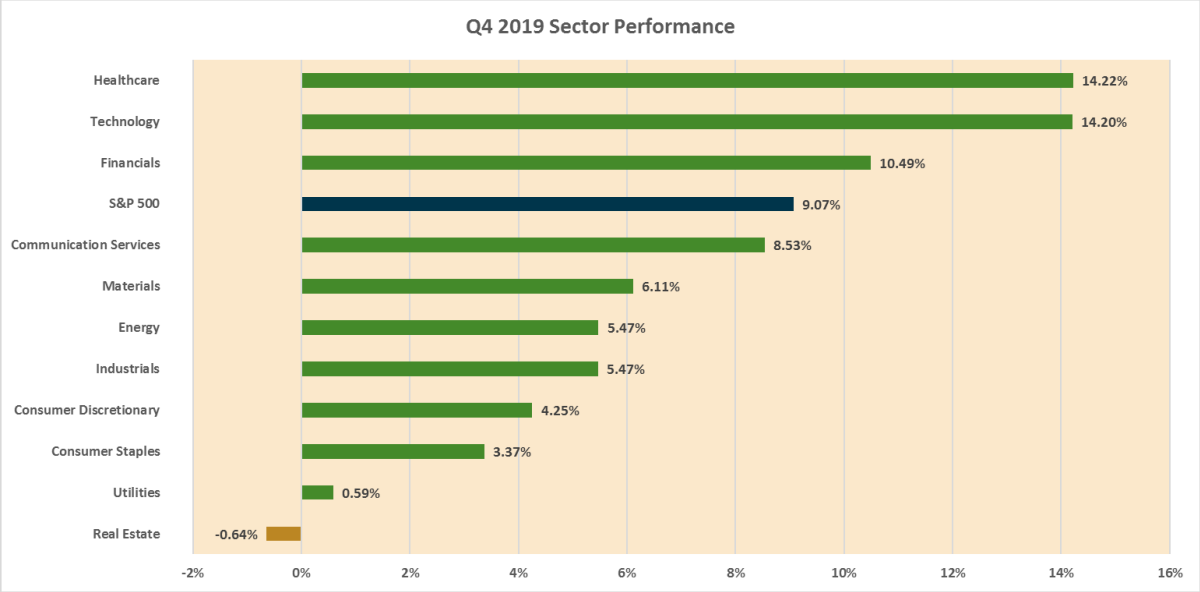
MAJOR MARKET INDICES (AS OF 12/31/2019)

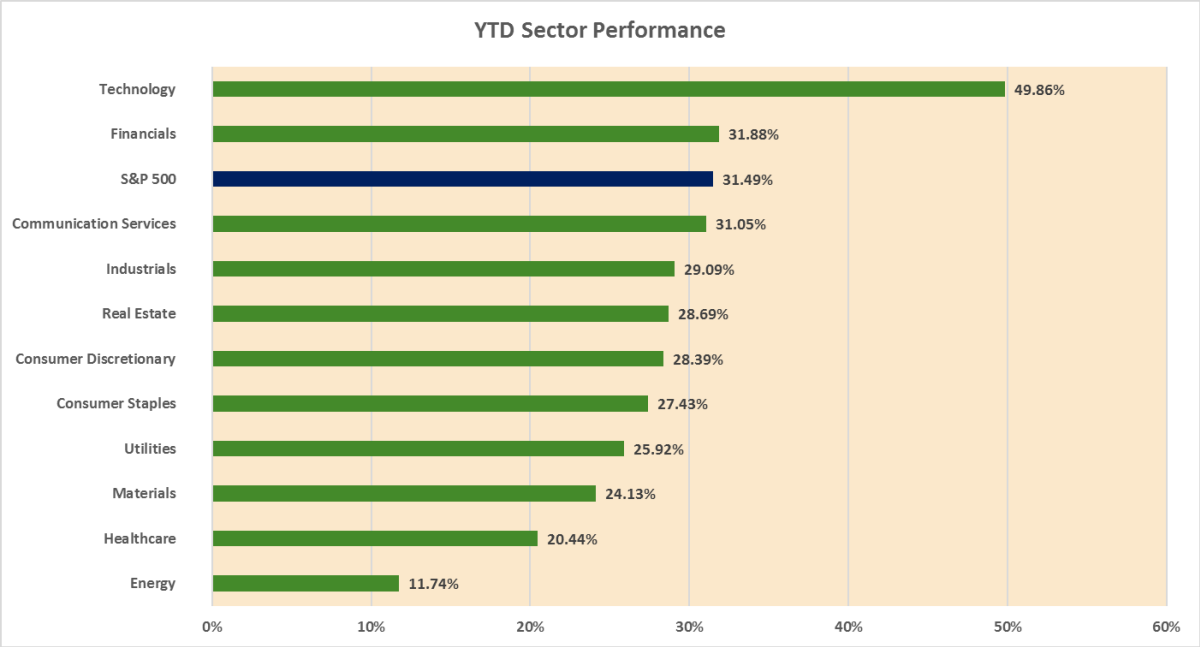
Domestic Equity	2019 Q4	YTD	Annualized 1 Year	5 Year	10 Year	P/E Ratio TTM
S&P 500	9.1%	31.5%	31.5%	11.7%	13.6%	22.6
Russell 3000	9.1%	31.0%	31.0%	11.2%	13.4%	22.2
Russell 1000 Value	7.4%	26.5%	26.5%	8.3%	11.8%	18.2
Russell 1000 Growth	10.6%	36.4%	36.4%	14.6%	15.2%	28.6
Russell 1000	9.0%	31.4%	31.4%	11.5%	13.5%	22.5
Russell 2000	9.9%	25.5%	25.5%	8.2%	11.8%	18.4
Russell 2500	8.5%	27.8%	27.8%	8.9%	12.6%	19.6
International Equity	**2019 Q4**	**YTD**	**Annualized 1 Year**	**5 Year**	**10 Year**	**P/E Ratio TTM**
MSCI ACWI Ex US	9.0%	22.1%	22.1%	6.0%	5.4%	16.2
MSCI EAFE	8.2%	22.7%	22.7%	6.2%	6.0%	17.4
Emerging Markets	11.9%	18.9%	18.9%	6.0%	4.0%	14.4
Fixed Income	**2019 Q4**	**YTD**	**Annualized 1 Year**	**5 Year**	**10 Year**	**Yield**
Barclays Aggregate	0.2%	8.7%	8.7%	3.0%	3.7%	2.3%
Barclays Universal	0.5%	9.3%	9.3%	3.4%	4.1%	2.7%
Other	**2019 Q4**	**YTD**	**Annualized 1 Year**	**5 Year**	**10 Year**	**Value**
US Dollar	-3.0%	0.2%	0.2%	1.3%	2.2%	$96.39
WTI	15.4%	30.5%	30.5%	2.9%	-2.9%	$61.19
Gold	1.2%	18.4%	18.4%	5.0%	3.1%	$1,517

- 2019 marked a stark reversal to 2020, boosting every major market index into strong positive territory
- Domestic equities continued to outperform their international counterparts, and large cap continued to outpace small cap, throughout the year, however, SMID names did rally into the 4th quarter.
- Growth continues to outperform Value for one of the longest periods in history.
- Developed countries outpaced emerging markets for the year, however, emerging outperformed in Q4, with Russia the best performing country due to aggressive cutting by their central bank.
- Bonds produced the majority of their strong results in the 2nd and 3rd quarter with falling interest rates and increased liquidity provided by the Fed.
- Oil rallied on middle east tensions and expectations of increased global growth.
- Despite positive market sentiment, gold continued to attract buyers as an alternative currency.

Source: Koyfin, Morningstar, JP Morgan

SECTOR PERFORMANCE

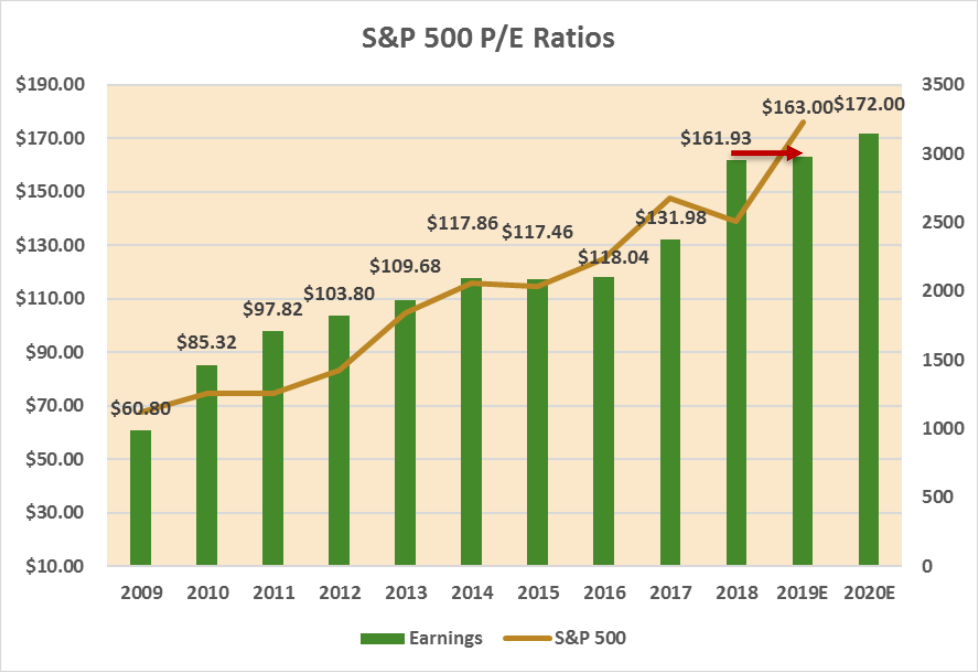


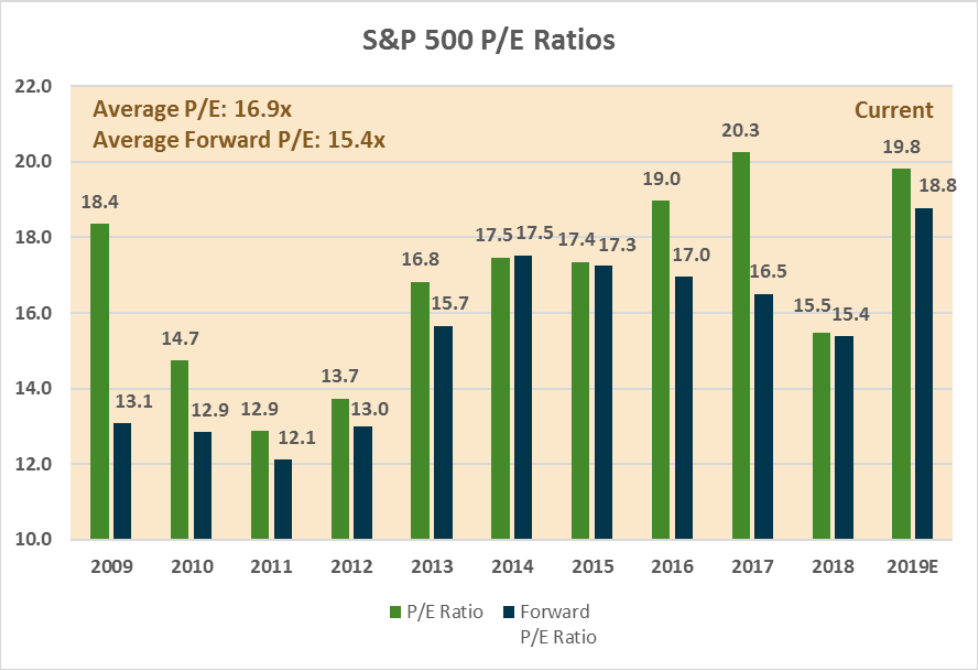


- Technology was the clear winner for 2019, boosting the S&P 500 higher, with the FAANMG stocks constituting roughly 17% of the index.
- Real Estate reversed its strong performance in the 1st quarter, as yield assets struggled.

Source: Koyfin, Ulrich Investment Consultants

EARNINGS AND VALUATION

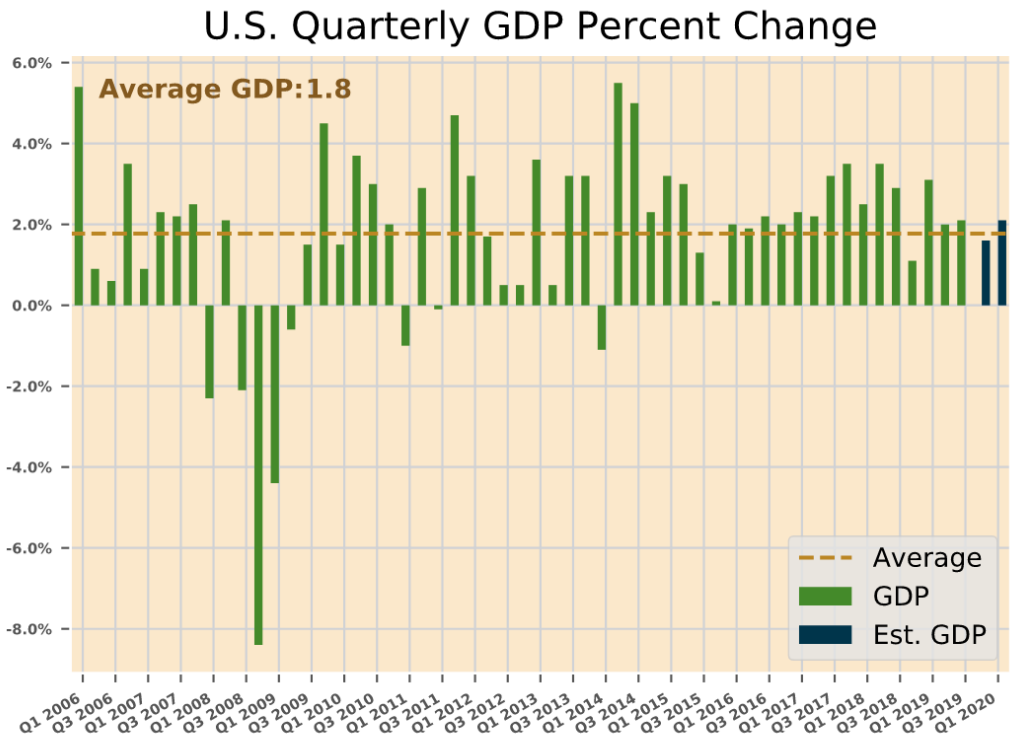




- Compared to 2018, when earnings rose roughly 20%, 2019 saw relatively little earnings growth, therefore the market rally was driven primarily by multiple expansion.
- Based on future earnings growth expectations for 2020, stocks appear slightly overvalued compared to their long-term averages, but with low inflation and low interest rates, these valuations can be sustained. Dividends, however will become much more important in 2020.

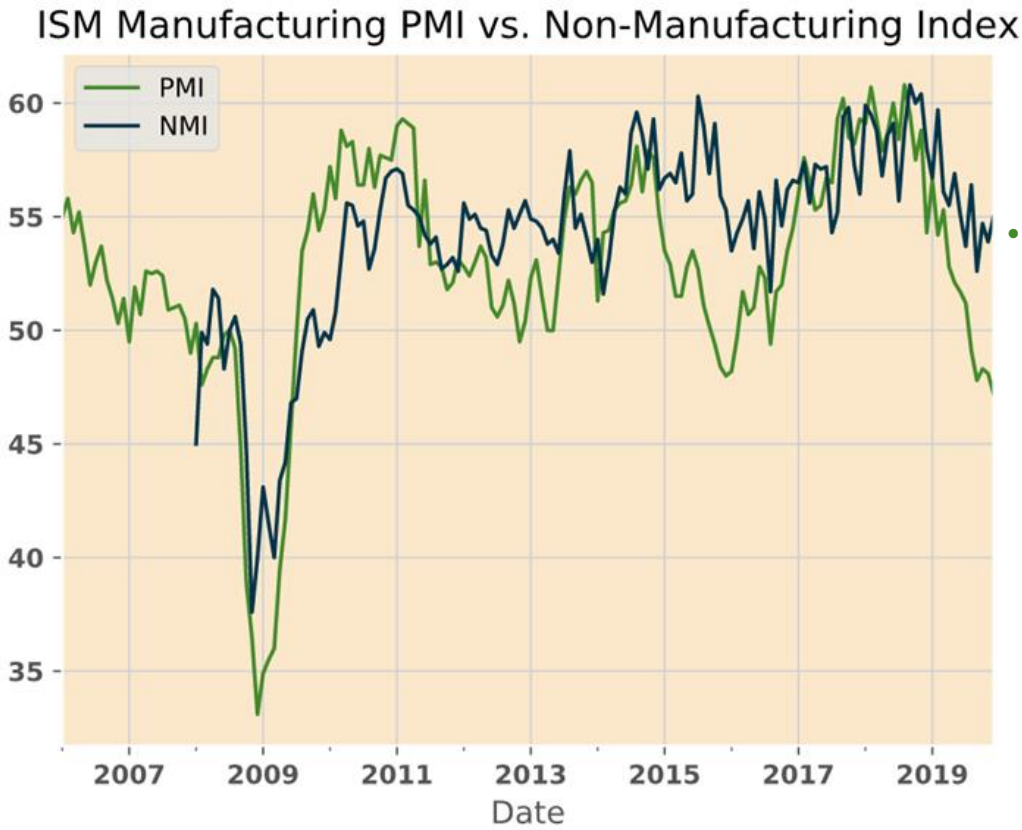
Source: Yardeni Research, Ulrich Investment Consultants

GROSS DOMESTIC PRODUCT



Estimates:
2019 Q4 – 1.6
2020 Q1 – 2.1

- US GDP hovered around 2% for the year, outpacing the Euro area at 1.2% and Japan at 1.7%.
- We anticipate a "growth-recession" with GDP of 1%, but not negative.



- While consumption continues to be strong, we have seen weakness in manufacturing with the December ISM Manufacturing data coming in at 47.2 (readings below 50 signal contraction).

Source: Federal Reserve Economic Database, Yardeni Research, Ulrich Investment Consultants

GLOBAL ECONOMICS & TRADE

As of Q3 2019

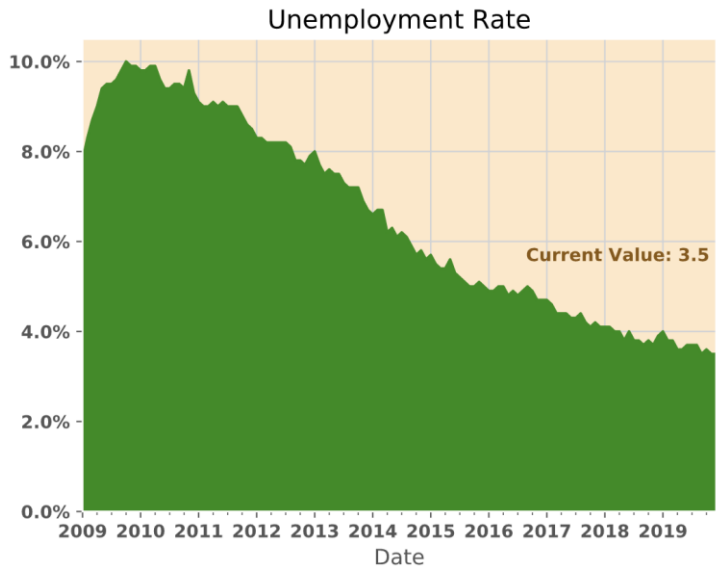
	GDP QoQ	GDP YoY	Core CPI YoY	Retail Sales	Industrial Production	Policy Rate	10Y Yield	Govt Debt/GDP	Jobless Rate
United States	1.90%	2.00%	2.30%	3.30%	-0.80%	1.75%	1.81%	106.10%	3.50%
Euro Zone	0.20%	1.10%	1.30%	2.20%	-1.50%	-0.42%	-	85.10%	7.50%
China	1.50%	6.00%	1.40%	8.00%	6.20%	4.15%	3.11%	50.50%	3.61%
Japan	0.10%	1.30%	0.50%	-2.10%	-8.10%	-0.10%	0.01%	238.20%	2.20%
Germany	0.10%	0.50%	1.40%	2.80%	-2.60%	-0.42%	-0.21%	60.90%	3.10%
United Kingdom	0.30%	1.00%	1.40%	1.00%	-1.60%	0.75%	0.72%	81.70%	3.80%
France	0.30%	1.30%	1.10%	2.60%	1.30%	-0.42%	0.08%	98.40%	8.40%
India	1.00%	4.50%	-	-	1.80%	5.15%	6.66%	68.30%	8.50%
Italy	0.10%	0.30%	1.00%	0.90%	-0.60%	-0.42%	1.40%	132.20%	9.70%
Brazil	0.60%	1.20%	3.48%	2.90%	-1.70%	4.50%	6.80%	77.22%	11.20%
Canada	0.30%	1.60%	1.90%	-0.60%	-1.87%	1.75%	1.59%	90.60%	5.60%
Russia	0.80%	1.70%	3.10%	2.30%	0.30%	6.25%	6.13%	13.50%	4.60%
South Korea	0.40%	2.00%	0.60%	3.70%	-0.30%	1.25%	1.72%	36.60%	3.80%
Australia	0.40%	1.70%	1.60%	2.90%	1.90%	0.75%	1.24%	40.70%	5.20%
Spain	0.40%	2.00%	1.00%	2.90%	2.10%	-0.42%	0.48%	97.10%	13.92%
Mexico	0.10%	-0.40%	3.59%	0.40%	-2.10%	7.25%	6.86%	46.00%	3.50%
Indonesia	3.06%	5.02%	3.02%	1.30%	4.50%	5.00%	6.86%	29.80%	5.28%
Turkey	0.40%	0.90%	9.81%	18.50%	5.10%	12.00%	10.89%	30.40%	13.40%
Switzerland	0.40%	1.10%	0.40%	0.00%	8.00%	-0.75%	-0.57%	27.70%	2.50%

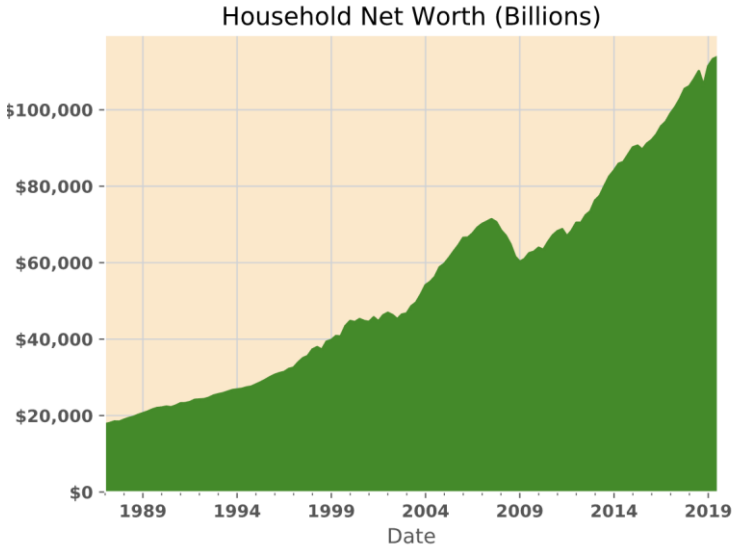
	Exports (% of GDP)	Imports (% of GDP)	Trade-to-GDP Ratio
Germany	47.0%	40.2%	87.2%
Mexico	39.2%	41.1%	80.3%
Canada	31.8%	33.9%	65.7%
France	31.3%	32.1%	63.4%
U.K.	29.9%	31.4%	61.3%
Italy	31.8%	29.3%	61.1%
Russia	30.7%	20.8%	51.5%
China	19.5%	18.7%	38.2%
Japan	17.8%	16.8%	34.6%
U.S.	12.1%	15.0%	27.1%

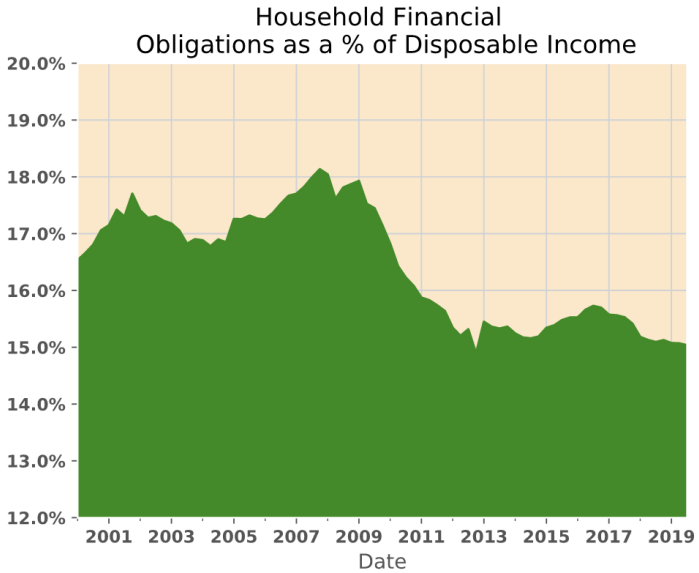
- Global economic indicators have slowly been improving, though industrial production is still laggard.
- Slowing global demand, the imposition of trade tariffs, and the disruption of supply chains has been much more impactful overseas than domestically, due to greater dependence on trade as a percentage of GDP.

Source: Koyfin, Callan, Ulrich Investment Consultants

THE STATE OF THE US CONSUMER



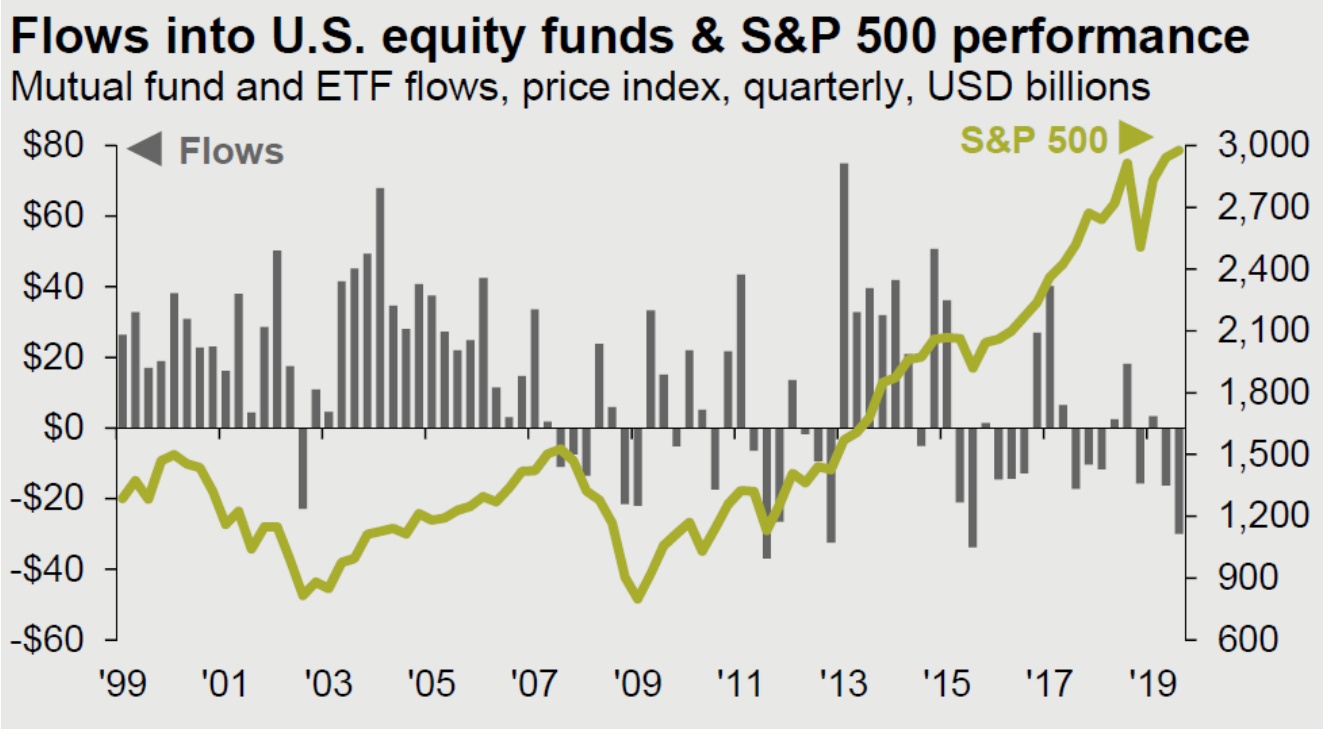


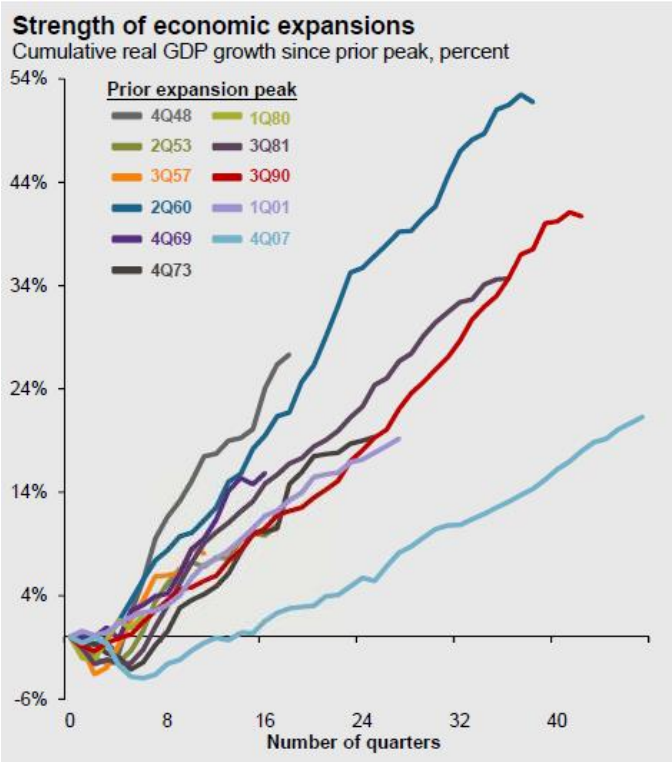


- With unemployment at all time lows, wages on the rise, inflation holdings steady(driven by low oil and food prices), and technological innovation and efficiencies, the consumer continues to feel strong.
- One area of dislocation is housing, which despite record low mortgage rates, has softened in areas due to changing consumption habits by Millennial consumers and downsizing by the baby boomer generation.

Source: Federal Reserve Economic Database, Ulrich Investment Consultants

THE UN-LOVED BULL MARKET

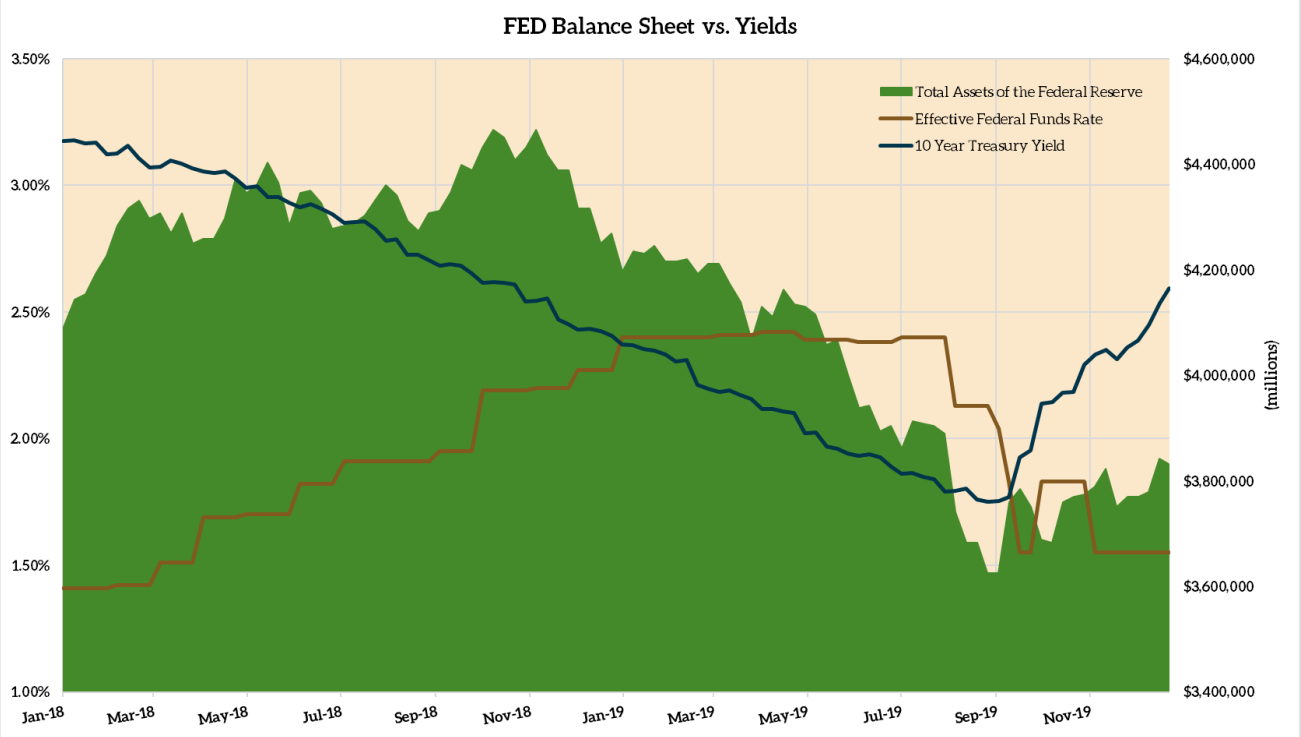


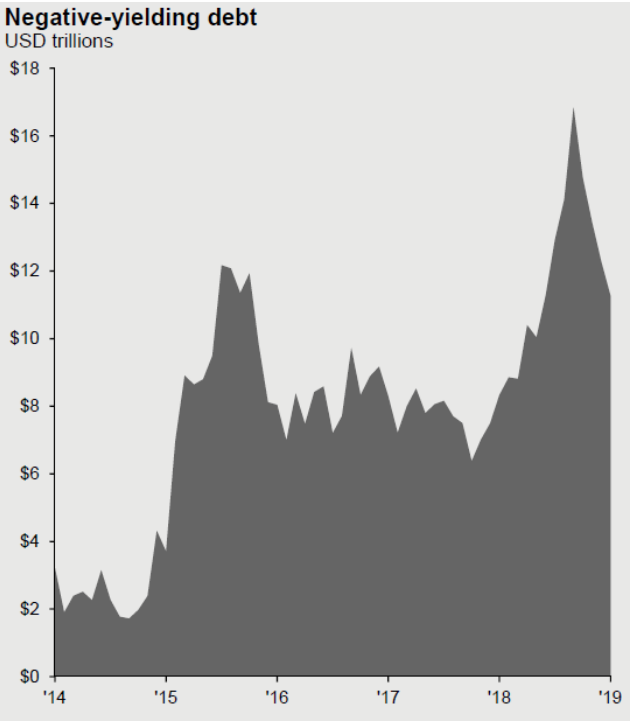


- Despite a strong consumer, this continues to be the most "un-loved" bull market of all time, with billions in outflows from the equity market.
- This "slow burn" higher has allowed us to grow slower for much longer without creating any imbalances.

Source: J.P. Morgan

THE FED PIVOT

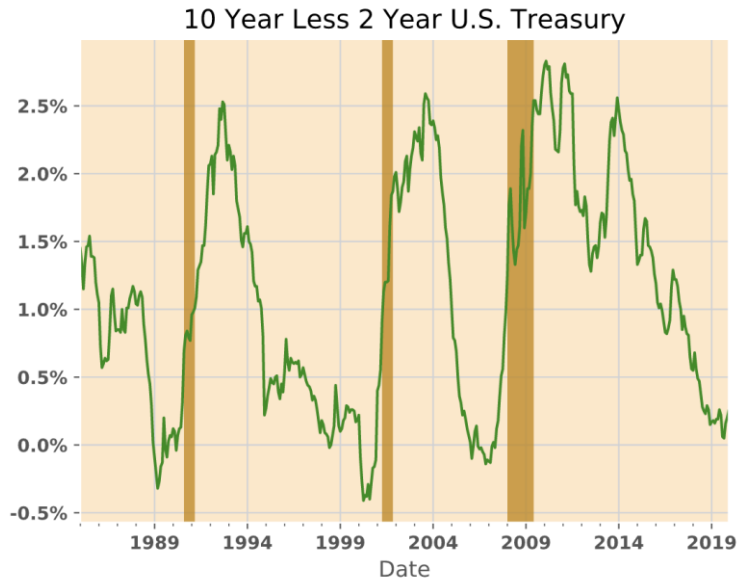


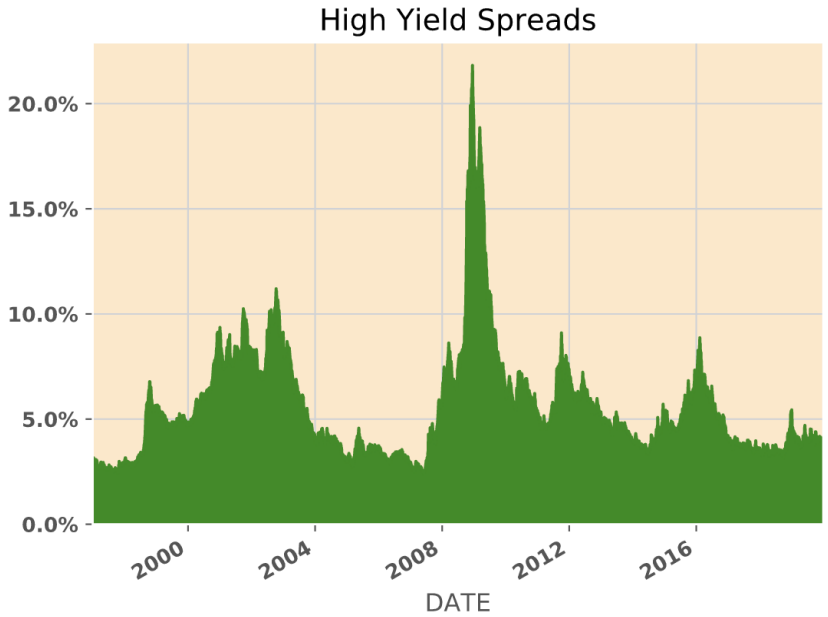


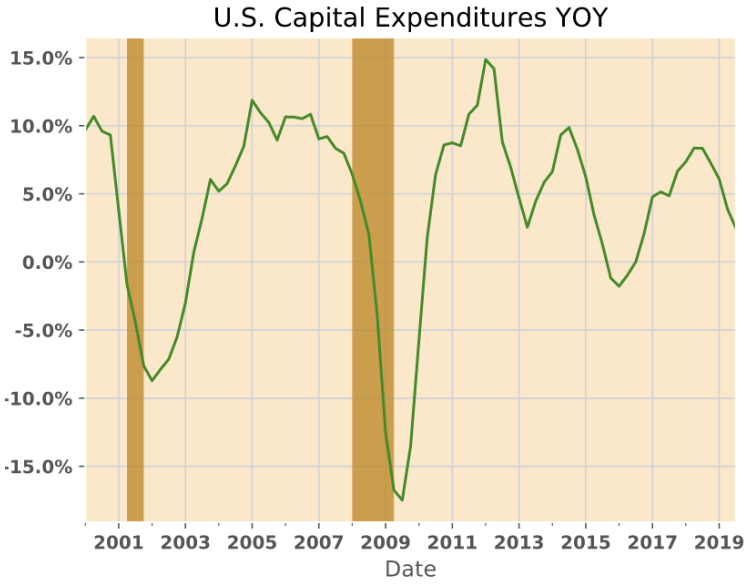
- While the rest of the world depended on negative interest rates, The Fed began to unravel the greatest "financial experiment" (AKA Quantitative Easing) on its own in 2018, by steadily increasing interest rates, and reducing its balance sheet.
- This led to a market temper tantrum in Q4 of 2018, and the inversion of the yield curve, causing the Fed to change course in 2019.
- This dual tightening also resulted in a liquidity crisis in the repo market, which led the Fed to respond with increased liquidity and further balance sheet expansion in September.
- Meanwhile, the effects of a more stable environment has brought global negative yielding debt down from its peaks.

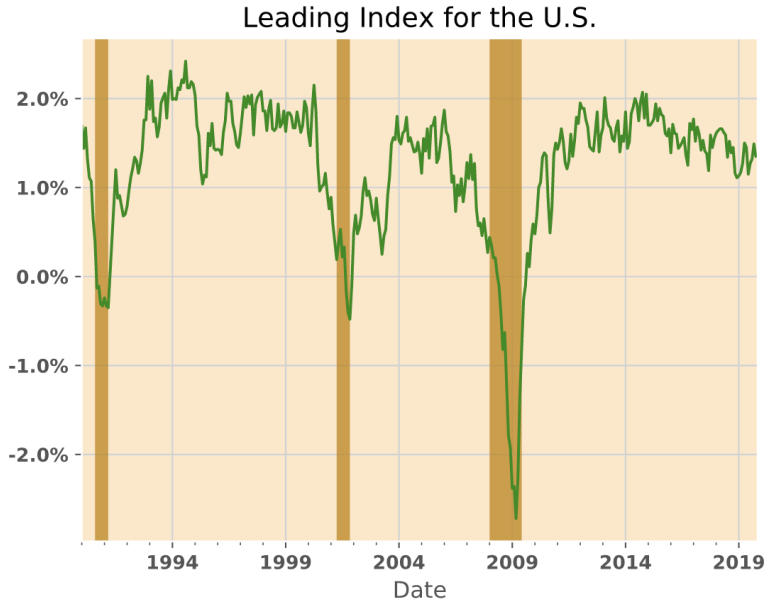
Source: Federal Reserve Economic Database, J.P. Morgan, Ulrich Investment Consultants

US ECONOMIC INDICATORS





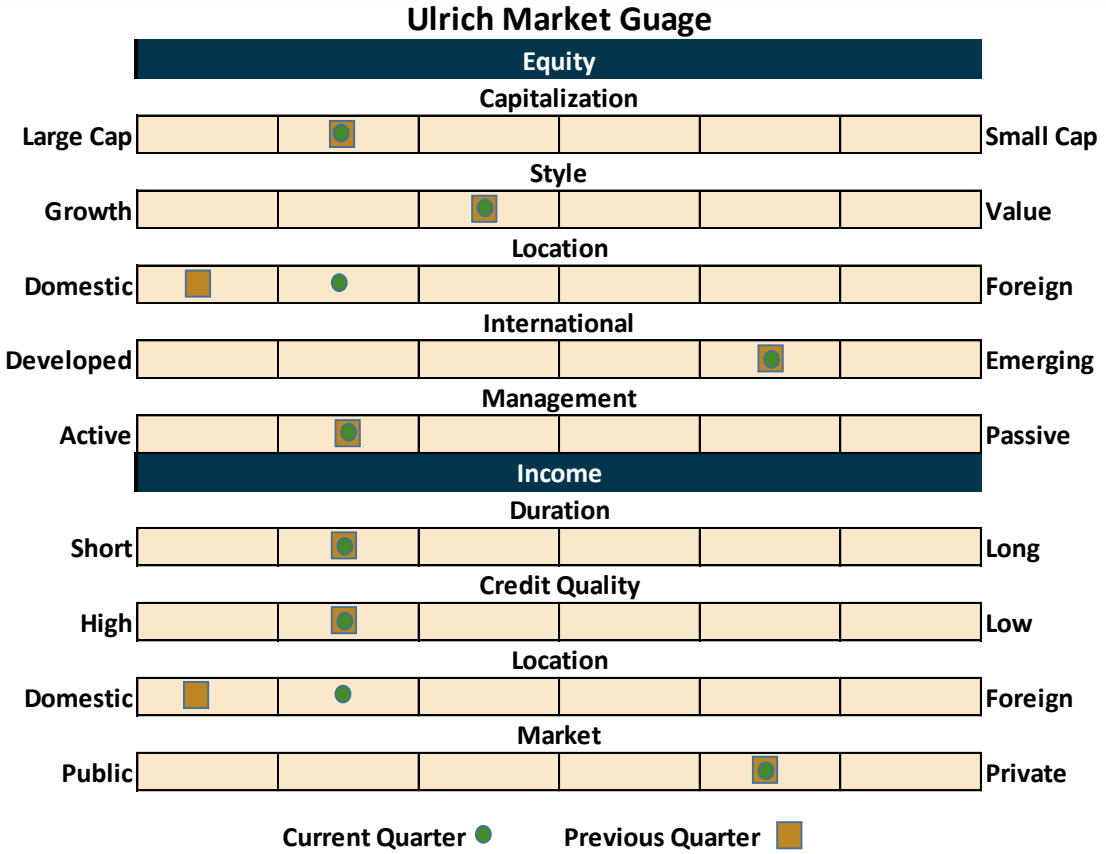




- Although capital expenditures (CapEx), has been on a steady decline, we believe the massive increase in investment in cloud computing and data storage, creating operational efficiencies for businesses ("OpEx"), has been far understated.

Source: Federal Reserve Economic Database, Ulrich Investment Consultants

SUMMARY AND OUTLOOK



- The Fed Pivot was the key driver to equity and bond markets. The QE Genie is out of the bottle, and it appears it will not be going back in, easing the outlook for an impending recession.
- We believe growth is slowing, but the US still remains the most attractive equity market despite the recent run-up, and while valuations are at the higher end, they are not irrational given the low interest rate environment.
    - We remain overweight to US equity over international, and overweight equities to bonds.
    - We have tilted market cap downward, and will continue to do so.
    - Emerging markets look more attractive to developed based on growth expectations and current valuation.
    - Active management should become more important as earnings should be more of a driver going forward.
- While global interest rates and inflation remain depressed, "real" yields in the non-bank market offer much more attractive sources of yield
    - We continue to diversify our income producing assets to incorporate a broader range of asset classes with less duration and interest rate risk
- While trade issues have appeared to have subsided, we still expect increased volatility in the latter part of 2020 as we approach the upcoming election. Markets should gain clarity once the democratic candidate is known.
- We expect technology and consumer services to continue to put downward pressure on inflation, keeping the consumer comfortable, and continue to invest in areas of innovation.