JOHNSON FINANCIAL GROUP®

BANKING WEALTH INSURANCE

ECONOMIC & MARKET OUTLOOK

FIRST QUARTER 2019

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EXECUTIVE SUMMARY

Asset Class Returns – 2018 Review

The return environment in 2018 proved to be challenging, with most major asset classes posting losses for the year [Exhibit 1]. 2018 also saw the return of volatility, which had been at unusually low levels throughout much of 2016 and 2017. While returns were volatile during the first 3 quarters of the year, it was during the final quarter that volatility spiked higher and risk-assets, such as equities, saw their weakest returns. The fourth quarter sell-off brought the returns for most segments of the equity and fixed income markets into negative territory, giving back a portion of the strong gains that were achieved during 2017.

Economic Outlook

- Recent financial market volatility has contributed to concerns that a recession is imminent, but economic data do not support this conclusion.
- In 2019, we expect economic growth in the U.S. to moderate to a more sustainable pace of about 2% based on the continued positive impact from fiscal stimulus, deregulation, low unemployment and strong consumer and business confidence.
- Risks to this outlook include an escalation of trade tensions, a Fed policy mistake, a continuation of the slowdown in China, or an unexpected surge in inflation.

U.S. Equity Outlook

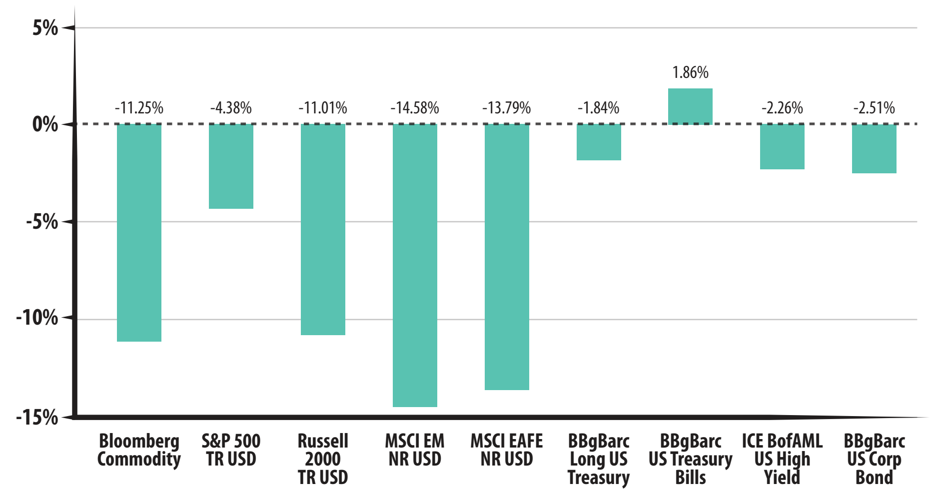
- With investor sentiment low heading into 2019, market participants will need evidence that the fundamental backdrop remains healthy. At year end, sentiment began to price in recession risk for 2020 with price to earnings ratios for the S&P 500 Index pushed down to nearly 14x 2019 expected earnings.
- While earnings growth will slow from the torrid pace of 2018, positive earnings growth in the range of 5% remains the most likely outcome for 2019.
- Upside potential to our base case of a 10% increase in equities may come from better than expected earnings, an end to the rate hike cycle or a positive resolution to the U.S./China trade war.
- Downside risks stem from a slowing global economy that leads to recessionary conditions in 2020. Causes may include restrictive monetary policy, an escalation of the trade war and slower global growth.

U.S. Fixed Income Outlook

- The Fed continued on its gradual pace of tightening in 2018, increasing the federal funds rate four times to 2.38%. Recent commentary indicates a pause in the rate hike cycle, which has led to a decline in interest rates.
- The 2018 increase in bond yields means higher potential bond returns in 2019. A diversified portfolio of investment grade bonds, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, now yields between 3 and 4%.
- While the yield curve has flattened, short-term interest rates have risen faster than longer-term interest rates, the curve remains positively sloped signaling that a recession is not likely in 2019.

Exhibit 1

2018 ASSET CLASS RETURNS



ECONOMIC OUTLOOK

During a fourth quarter 2018 speech, Federal Reserve Chairman Jerome Powell indicated that the U.S. economy is going through a "remarkably positive" period. As Powell stated, "This historically rare pairing of steady, low inflation and very low unemployment is a testament to the fact we remain in extraordinary times." This nearly perfect backdrop was not expected to last forever. In 2019, we think the U.S. economy will become less-perfect, but we need to remember that 'not as good' does not mean 'bad'.

Sustainable Growth

Final Real GDP for 2018 will be released March 28, 2019 and is estimated to be 2.9%, above the 2.3% average for this expansion [Exhibit 2]. Growth in 2018 benefitted from the Tax Cuts and Jobs Act which the President signed in late-2017. The bill helped raise real disposable income, increased government spending, and provided businesses with incentives for capital investment.

While economic momentum has moderated, as we enter the first few months of 2019, the U.S. economy remains healthy. The current 3.9% unemployment rate is near a 48-year low and wage growth has been improving. In addition, there should be a positive economic impact from the recent decline in oil prices. The price of oil declined by about 40% during the fourth quarter of 2018 primarily due to excess supply [Exhibit 3]. While a decline in energy prices will negatively impact the portion of our economy involved with production, lower energy prices will be a positive for many consumers and businesses as it increases consumers' disposable income and reduces fuel costs for businesses.

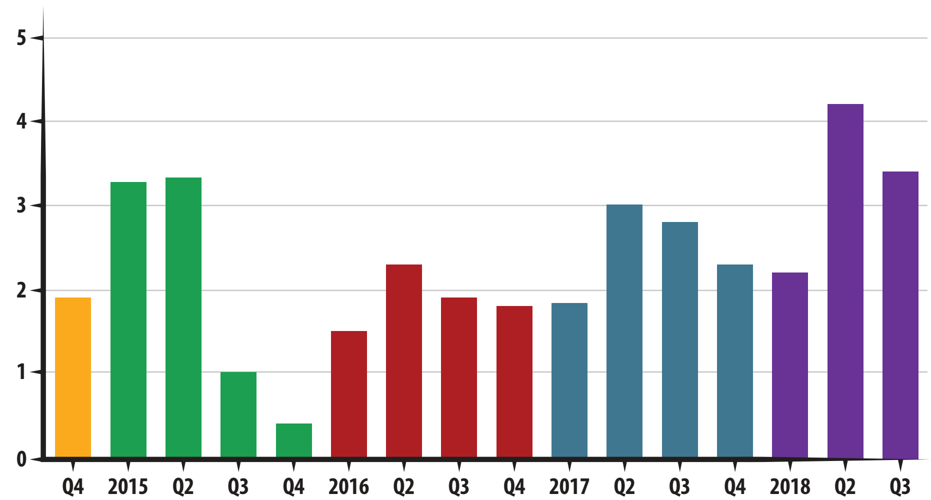
The current economic expansion will hit its 10-year anniversary in June 2019. If growth continues past that point, the expansion will become the longest on record, surpassing the 120-month expansion of the 1990s. Can we achieve a new record? We think so.

> "While economic momentum has moderated, as we enter the first few months of 2019, the U.S. economy remains healthy."

Exhibit 2

REAL GDP

Percent Change from Preceding Quarter



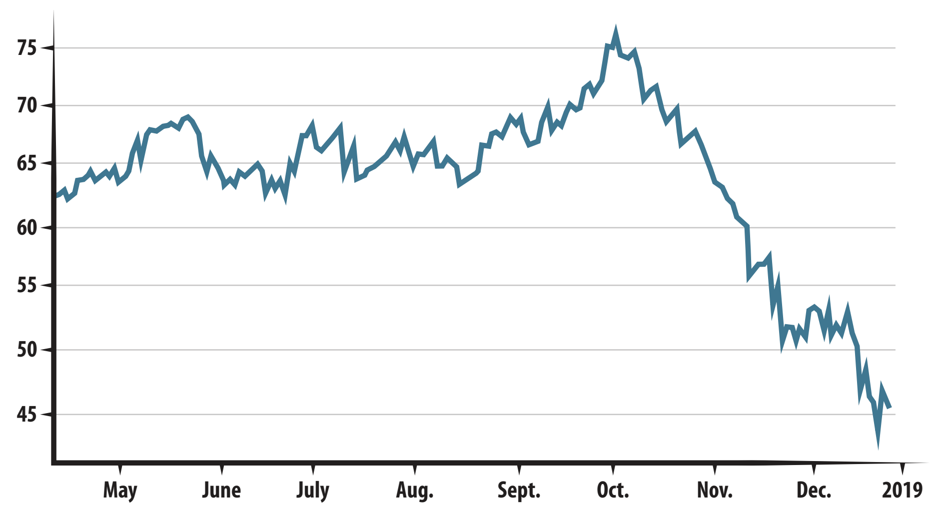
Seasonally adjusted at annual rates.

Source: U.S. Bureau of Economic Analysis

Exhibit 3

LIGHT CRUDE OIL FUTURES (WTI)

1D, NYMEX

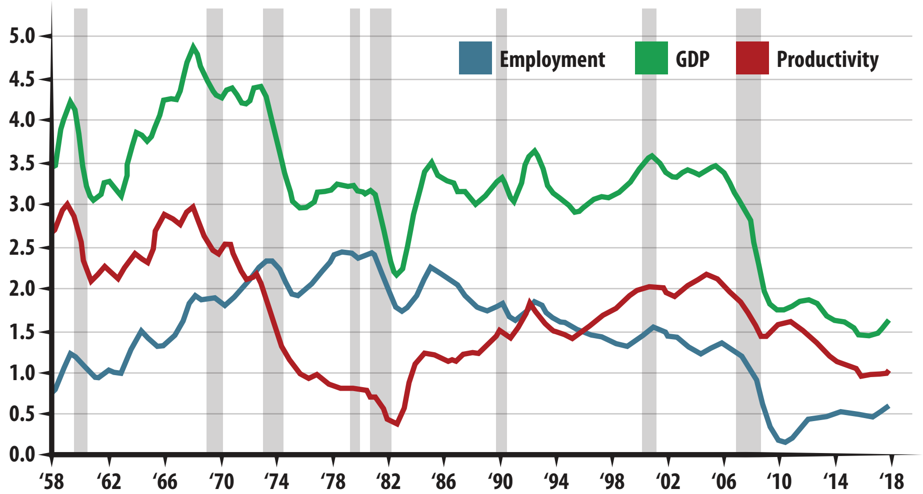


West Texas Intermediate (WTI) is a blend of several streams of light sweet crude oil.

Source: CME Group

Exhibit 4

DECOMPOSITION OF REAL GDP
10 Year Annual Growth Rates

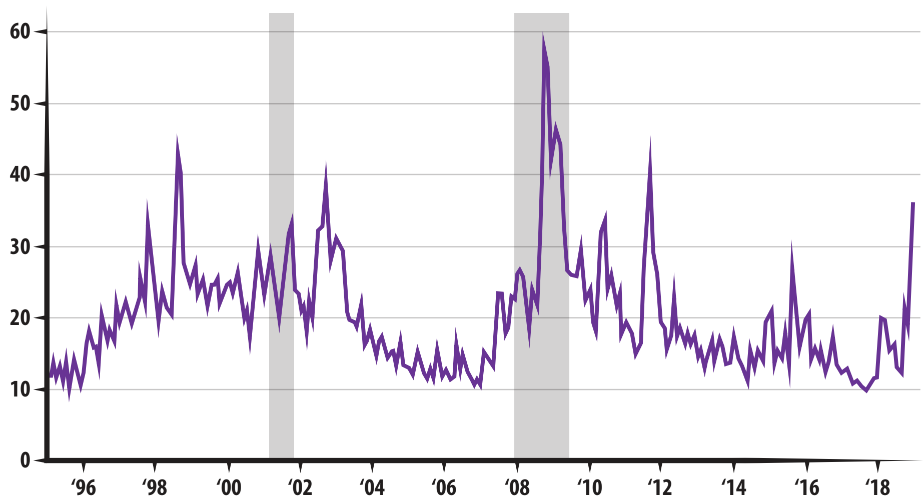


Productivity is calculated as real GDP per employee, from the Household Survey

Source: Bureau of Economic Analysis and Bureau of Labor Statistics via Haver Analytics

Exhibit 5

CBOE VOLATILITY INDEX
VIX



Shaded areas indicated U.S. recessions.

Source: Chicago Board Options Exchange

The continued positive impact from fiscal stimulus, deregulation, low unemployment, and strong consumer & business confidence support a continuation of the current expansion-- but at a more sustainable rate.

The pace of economic growth in 2018, which included a 4.2% growth rate during the second quarter, is not a sustainable rate. In 2019, we expect to move to a more sustainable pace of about 2%. The potential growth of the U.S. economy can be broken down between employment growth (i.e., growth of the labor force) and productivity (i.e., real output per worker) [Exhibit 4]. While workforce growth will be challenged by demographic trends, upside exists to potential GDP to the extent that we can get improvements in productivity, which has been on a downtrend for several years. If capital investments and technological advancements help improve labor productivity, there could be upside to the sustainable rate of economic growth.

Recent financial market volatility has contributed to concerns that a recession is imminent. Data do not support the pessimism as the economy looks to be reasonably solid based on most measures. As economic growth decelerates from an above-trend rate to a more sustainable rate, we've seen increased financial market volatility as investors grapple with whether or not a recession is on the horizon. Financial market participants are adjusting to the fact that economic conditions are becoming 'worse', even though they are still quite good.

The CBOE Volatility "VIX" index, sometimes known as the "Fear Index", measures the market expectation for volatility that is implied by option prices. This measure of volatility has recently spiked as investor sentiment has turned negative [Exhibit 5]. In our view, market participants have over-reacted to the expected deceleration in growth.

> **"Financial market participants are adjusting to the fact that economic conditions are becoming 'worse', even though they are still quite good."**

Investors still remember the pain from the financial crisis and do not want to re-live another severe downturn. That said, the Great Recession was one of the deepest downturns in history and the next recession, when it comes, is not likely to be as severe. While this recovery has been one of the longest, it has also been relatively sluggish. As the graph in Exhibit 6 shows, the cumulative growth in this economic recovery (shown in purple) is quite low when compared to prior expansions [Exhibit 6]. This argues for a longer cycle as it has taken longer to recover and excesses have not developed. Recessions have historically been caused by an overheating economy or financial imbalances. Neither of these appear to be problematic at this time. Core inflation is 2% (near the Fed's target) and inflation expectations implied by financial markets is below the Fed's target. The types of imbalances that existed during the Great Recession such as housing in 2007 or the technology bubble of the early 2000s are not evident.

While a recession is not our base case scenario for the coming year, the probability of a recession has risen to the highest point in this expansion—even though it is still quite low. For example, the New York Federal Reserve Bank's recession probability indicator using Treasury spreads shows the risk of a recession in the next twelve months increasing, but a low absolute probability. The current recession probability indicated by this model is 21.3%, well below the 30-40% level that has preceded prior recessions [Exhibit 7].

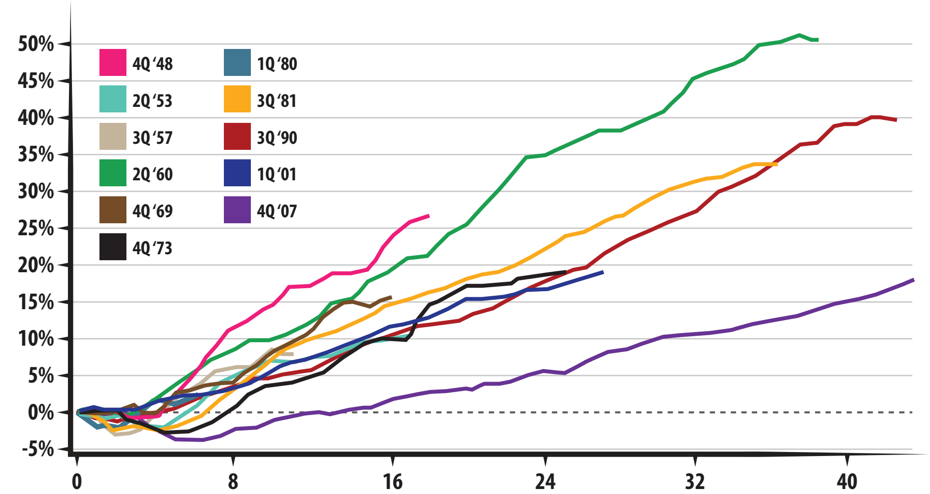
Global Economy

The economic recovery outside of the U.S. has not been as consistent or robust as we have seen domestically. While earnings have steadily improved in the U.S. from financial crisis lows, Europe and EM (emerging markets) earnings improvements have been inconsistent [Exhibit 8, page 5]. A strong dollar has stressed the global financial system, significantly impacting emerging market economies in particular.

With accommodative monetary conditions, falling unemployment, and rising wages, we should see improvement in foreign growth following 2018's disappointing performance. The two biggest risks to international growth prospects come from Brexit and trade. Given that the terms of Britain's departure from the E.U. remains unresolved, this is a significant source of uncertainty. Tariffs are also an uncertainty as the U.S. and China try to work out a resolution to their trade disputes. While the ultimate outcome is difficult to forecast, any additional tariffs beyond what has already been announced or communicated could cause further weakness to global economies.

Exhibit 6

STRENGTH OF ECONOMIC EXPANSIONS
Cumulative Real GDP Growth since Prior Peak

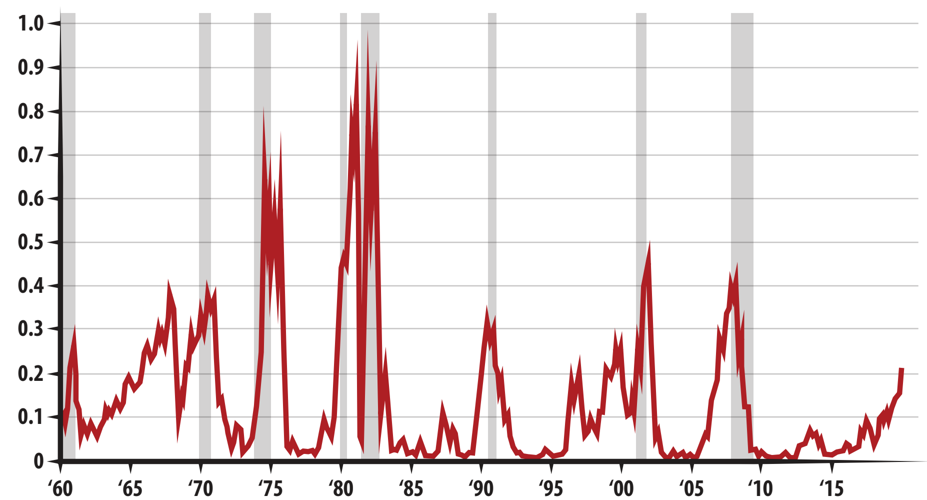


Number of quarters since prior peak.

Source: JP Morgan Guide to the Markets 12/31/18

Exhibit 7

PROBABILITY OF US RECESSIONS PREDICTED BY TREASURY SPREAD
Twelve Months Ahead



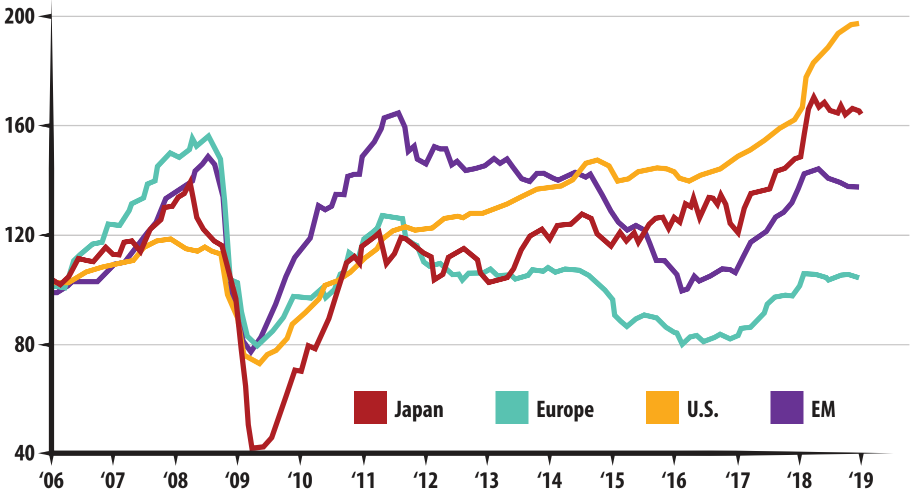
Monthly averages. December 2019 = 21.3459%.

Source: Federal Reserve Bank of New York

Exhibit 8

GLOBAL EARNINGS

EPS, US Dollar & Next 12 months

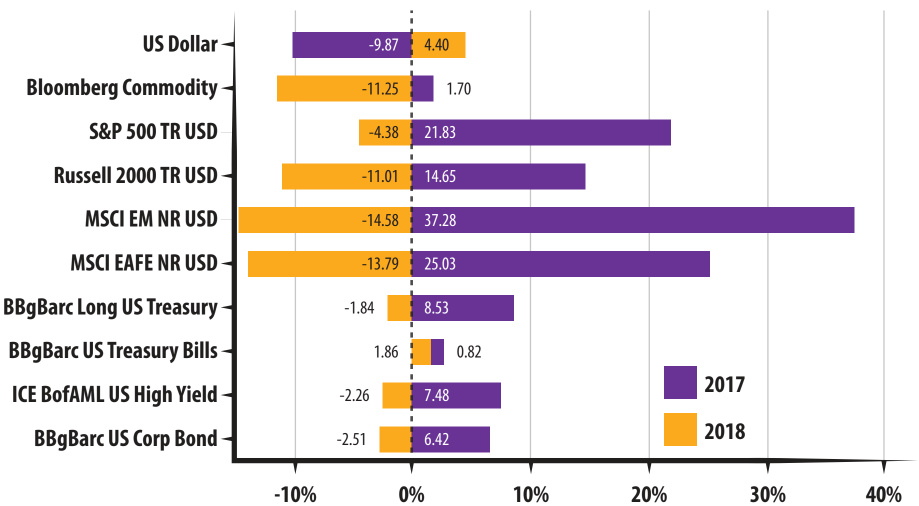


January 2006 = 100..

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

Exhibit 9

2018 & 2017 CY PERFORMANCE PERCENT



Source: Morningstar Direct

China is the world's second largest economy and an uptick in China would be a positive for global growth. China's government has been providing stimulus in attempt to help support its economy. The Chinese government has lowered their interest rates by 50%, reduced tax rates on individuals and corporations, reduced their anti-corruption measures and used other monetary policy means to stimulate growth. This should result in improved economic conditions and are a welcome change from 2018's measures to restrict credit growth. Furthermore, favorable demographic trends provide a positive backdrop in emerging market economies such as India & China as the middle class continues to both grow and become more affluent.

Bottom line, our macro outlook is cautiously optimistic. We believe the backdrop for 2019 remains positive though acknowledge that any number of factors could disrupt our base case outlook. Most notably, an escalation of trade tensions, Fed policy mistakes, a continued slowdown in China, or an unexpected surge in inflation. As always, we continue to monitor the risks and will adjust our outlook accordingly as new information becomes available.

> **"With accommodative monetary conditions, falling unemployment, and rising wages, we should see improvement in foreign growth following 2018's disappointing performance."**

U.S. EQUITY MARKET

2018 Recap

[Exhibit 9] reflects on major asset class returns in 2018 and 2017. Asset returns were volatile during 2018 and ended in the red for most segments of the equity and fixed income markets. This was a reversal of 2017 when most segments of the equity and fixed income markets recorded strong returns with low volatility.

Equity markets experienced two corrections during 2018 [Exhibit 10]. The first was in February and followed a euphoric rise in January that carried over from 2017. The 10% correction was triggered by a rapid increase in interest rates over the previous six months alongside the first shot across the bow in the trade war with tariffs on solar panels and washing machines in January and on steel in March. U.S. stocks managed to recover into the fall on the back of 25% earnings growth and strong returns from the technology sector while international markets struggled in the face of heightened trade tensions and a strong U.S. Dollar.

The second and more severe correction started in early October and measured 20% for the S&P 500 Index and pushed the index into the red for the year despite a rally in the final week of the year. This correction was once again triggered by interest rates as hawkish comments from the Federal Reserve led to a 25 basis point spike in rates to 3.24% on the 10-year U.S. Treasury Bond in September. Trade risks heated up with concern that tariffs would be increased at year's end, but a 90 day truce was reached between the U.S. and China pushing off this risk. The final and most important trigger came from a disappointing earnings season in which companies, including the red hot technology stocks, guided investors toward more conservative assumptions and noted that slower global growth were impacting sales and tariffs and wages were beginning to impact profitability.

2019 Outlook

With sentiment low heading into 2019, investors will need evidence that the fundamental backdrop remains healthy. Looking at the economy, recession risk in 2019 remains moderate although the risk has risen. Recent softness in economic data and the expected slowdown in earnings growth is due in large part to difficult comparisons as we move past the strongest growth of the cycle. According to FactSet [Exhibit 11], 2018 sales are estimated to have increased 8.9% driving 20.3% earnings growth, which also benefited from a reduction in the top corporate tax rate to 21% from 39%. Sales in 2019 are expected to slow, but remain at a solid rate of 5.3% with earnings growth of 7.9%. While actual results may come in modestly below these levels, positive growth remains the most likely outcome.

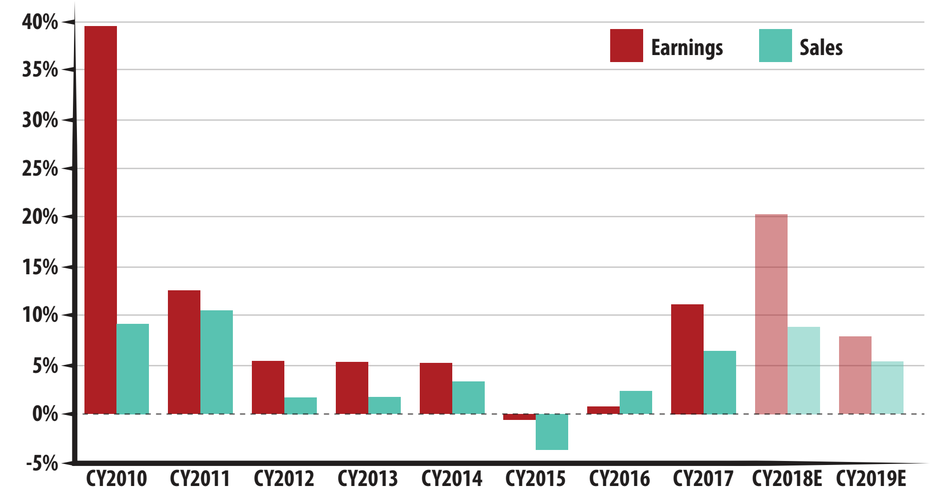
Exhibit 10

S&P 500 INDEX

Source: Thomson ONE

Exhibit 11

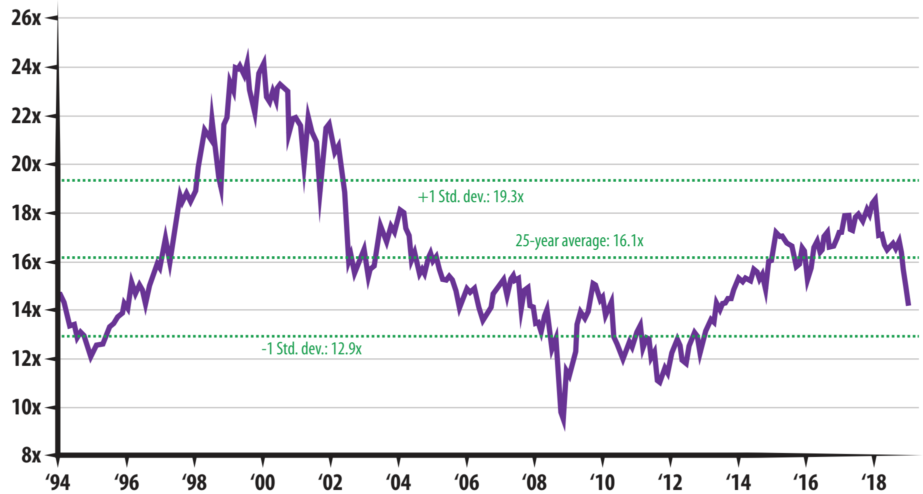
S&P 500 EARNINGS & REVENUE GROWTH 2010 - 2019



Source: FactSet Earnings Insight December 21, 2018

Exhibit 12

S&P 500 INDEX
Forward P/E Ratio



Source : FactSet, FRB, Thomson Reuters, Robert Schiller, Standard & Poor's, JP Morgan Asset Management

If the earnings outlook comes to pass, the price decline as of the end of the year appears to have reflected the increased risk of slower growth as the average valuation for stocks declined to 14.4x next year's earnings compared to 16.8x at the October peak and 18.2x at the end of 2017 [Exhibit 12].

[Exhibit 13] frames our 2019 outlook within three hypothetical scenarios. With a lower valuation to start the year than we've had since 2016, our outlook for stocks is tilted to the upside. However, the upside may be limited by the fact that we are late in the economic cycle. Investors will likely be quick with the sell trigger as they were in December with any disappointment in the outlook for growth to continue beyond 2019. Among the potential catalysts for upside for stock prices are better than expected growth, the Federal Reserve indicating that they are near the end of their rate hike cycle or a positive resolution to the U.S./China trade war. In thinking about the downside scenario, we recommend that investors make sure they have at least a 5 year time horizon for any stock investments.

Exhibit 13

2019 S&P 500 INDEX SCENARIO ANALYSIS

	12.31.18 Price	2018 EPS	2018 EPS % Chg	2019 EPS	2019 EPS % Chg	PE Multiple	2019 Target	2019 Target % Chg
Upside Scenario	2506	$163	23%	$172	6%	19	3268	30%
Base Case	2506	$163	23%	$172	6%	16	2752	10%
Adverse Scenario	2506	$163	23%	$155	-5%	13	2015	-20%

Source: FactSet, FRB, Thomson Reuters, Robert Schiller, Standard & Poor's, JP Morgan Asset Management

Exhibit 14

MSCI ALL COUNTRY WORLD EX-US & S&P 500 INDICES
September 1996 = 100, U.S. Dollar, Price Return

Source: FactSet, MSCI, Standard & Poor's and JP Morgan Guide to the Markets – December 31, 2018

INTERNATIONAL EQUITY MARKETS

Expectations were high for international stocks heading into 2018. Relative to the U.S., international economies trade at valuation discounts that are above historical averages [Exhibit 14]. However, international stocks struggled in 2018 leading major markets on the downside. Without the benefits of tax cuts as implemented in the U.S., economic growth slowed in most international economies in 2018. The U.S. Dollar Index increased by 6% in 2018 due to better relative economic growth and rising interest rates in the U.S.

After slowing for much of the past year, international economic growth may also be the first to stabilize. Easier comparisons, an increase in competitiveness from weaker currencies and stimulus from China are supports to the 2019 outlook.

> "Among the potential catalysts for upside to stock prices are better than expected growth, the Federal Reserve indicating that they are near the end of their rate hike cycle or a positive resolution to the US/China trade war."

U.S. FIXED INCOME MARKET

2018 Recap

U.S. fixed income returns ranged from slightly positive to slightly negative for the year. Bonds with shorter maturities performed better than bonds with longer maturities and higher quality bonds performed better than lower quality bonds.

The Federal Open Market Committee continued its gradual pace of tightening, increasing the federal funds rate four times; a total annual increase of 1%. Short maturity U.S. Treasury yields were impacted most by Fed actions, while the ten year U.S. Treasury yield increased by only 0.28% [Exhibit 15].

Corporate bond yields [Exhibit 16] increased more than U.S. Treasury yields due to investor concerns about potential additional fed funds rate hikes, higher perceived global risks, and a flight to the safety of U.S. Treasury bonds.

Exhibit 15

RATES HAVE BEEN INCREASING GRADUALLY

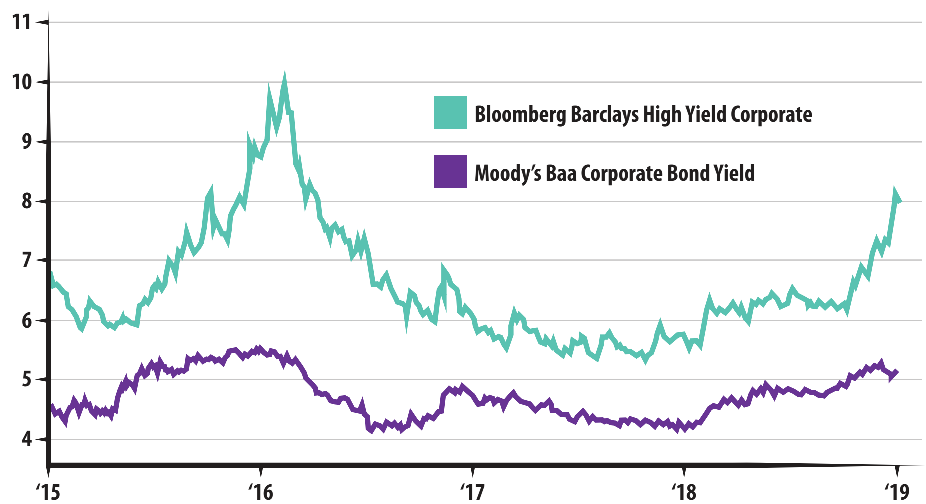
10 Year U.S. Treasury Yield

CT10 Govt (US Treasury N/B) 10 year annual changes daily.

Source: Bloomberg

Exhibit 16

CORPORATE BOND YIELDS ARE HIGHER



MOODCBAA Index (Moody's Bond Indices Corporate BAA) Credit Spreads.

Source : Bloomberg Finance L.P.

Exhibit 17

U.S. TREASURY YIELDS ARE NOT IMPLYING RECESSION IN 2019

10 Year vs. 2 Year U.S. Treasury Yield Difference

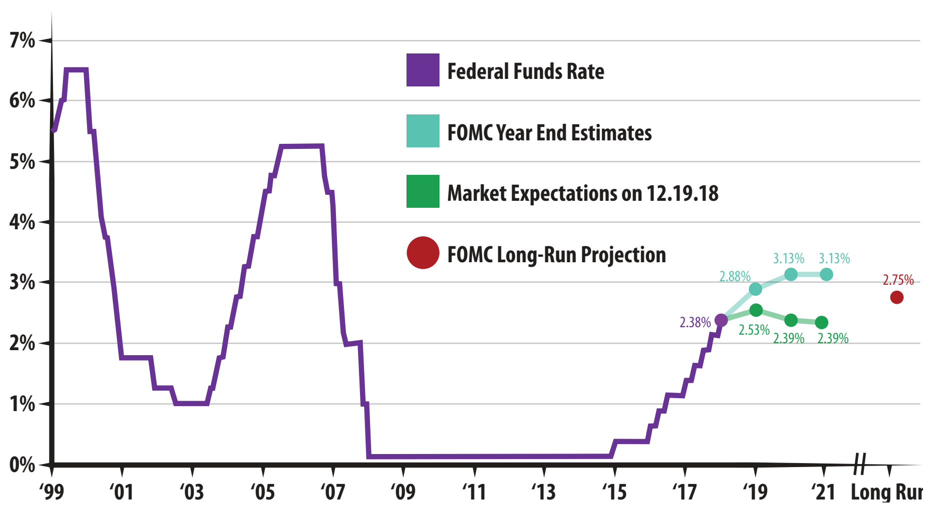
CT10 Govt (US Treasury N/B) Treasury Inversions 2.

Source: Bloomberg Finance L.P.

Exhibit 18

THE DIRECTION OF INTEREST RATES

Federal Funds Rate Expectations



FOMC & Market Expectations for the Federal Funds rate

Source: FactSet, Federal Reserve, Bloomberg and JP Morgan Guide to the Markets – December 19, 2018

2019 Outlook

U.S. Treasury yields tell us a recession is not likely this year. As shown on [Exhibit 17], past recessions (shaded areas) have been preceded by an inverted yield curve, with the 2 year U.S. Treasury bond yield exceeding the 10 year U.S. Treasury bond yield (resulting in a difference of less than zero). Typically, recessions have followed inversion by 9 months or more. Based on this historic relationship and a U.S. Treasury yield curve that is not inverted, a 2019 recession is not expected.

Federal funds rate expectations of both the Federal Open Market Committee (FOMC) and the market are illustrated in [Exhibit 18]. The FOMC raised the federal funds rate at its December meeting, leaving the current median rate at 2.38%. At the same time, the committee revised its growth and inflation expectations slightly lower and removed one hike from its 2019 expectations. The Fed is now projecting two additional hikes in 2019 to a 2.88% median rate, while the market believes the Fed is done raising rates. A first quarter pause is likely as the Fed gauges the lagged economic impact of prior rate hikes, global concerns, and changes in sentiment.

Bond yields may move modestly higher until it is clear the fed funds rate has reached or exceeded the neutral rate – the rate that is just right for the economy and results in continued stable inflation near the Fed's 2% target, as well as full employment near the Fed's estimated 4.4% long run sustainable unemployment rate.

> **"Typically, recessions have followed inversion by 9 months or more. Based on this historic relationship and a U.S. Treasury yield curve that is not inverted, a 2019 recession is not expected."**

[Exhibit 19] illustrates that higher bond yields in 2018 means higher potential bond returns in 2019. A diversified portfolio of investment grade bonds, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, now yields between 3 and 4% and is expected to generate an average annualized total return of over 4% over the next three years, assuming rates increase modestly and bond income is reinvested at the higher rates. Bond returns are dominated by income over time and bond income helps offset price declines brought on by rising rates, often in a relatively short period of time. Additionally, core bonds may help reduce volatility in a balanced stock and bond portfolio.

CONCLUSIONS

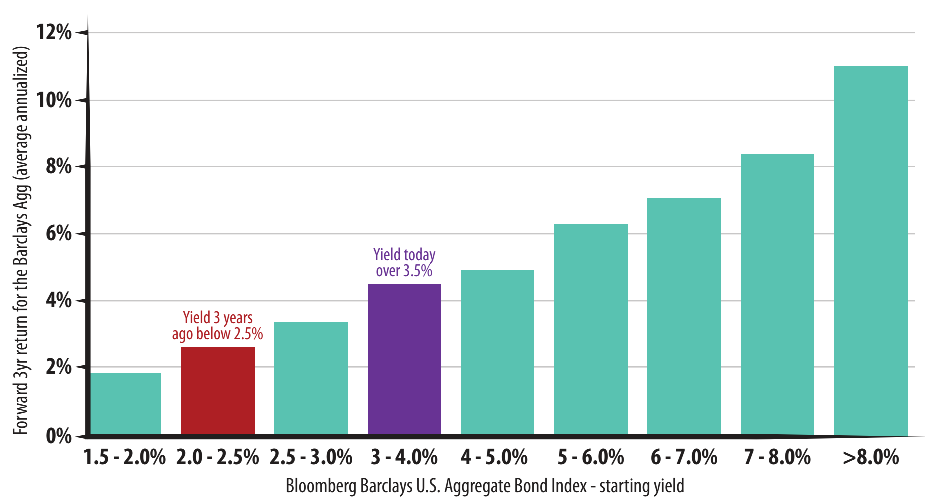
Financial markets were confronted with an uncertain future, which led to low or negative 2018 returns in most asset classes. However, we must remember that 2018 began in a state of optimism for global economies that drove the strong returns in 2016 and 2017. As we look forward to 2019, we have identified the following swing factors:

- **Federal Reserve** – The hawkish Fed of 2018 has turned more dovish lately. If this continues, financial conditions may ease and the economic expansion may continue.
- **Trade** – The escalation of tariffs in 2018 remains an unresolved concern for investors. Tariffs and other trade barriers may put upward pressure on inflation, impact supply chains and increase populism. In late 2018 and so far in 2019, these risks appear to be reduced as representatives from the U.S. and China continue discussions.
- **Growth** – Economic growth in the U.S. will certainly slow in 2019 from the lofty levels the year prior. However, recession appears unlikely and growth near 2% remains our base case.

Exhibit 19

HIGHER RATES MEAN HIGHER RETURN POTENTIAL OVER TIME

Bloomberg Barclays U.S. Aggregate Bond Index



Starting yields plus reinvestments at higher yield, buffers the price impact of rising rates.

Source: Bloomberg Barclays U.S. Aggregate Bond Index