Grant Street Asset Management, Inc.
INVESTMENT ADVISORS

GRANT STREET ASSET MANAGEMENT, INC.

QUARTERLY LETTER

3RD QUARTER 2019

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Geopolitical headlines at home and abroad dominated the market landscape in the third quarter. Economic data was mixed with a notable slow-down in global manufacturing and business confidence countered by a resilient U.S. consumer and record-low U.S. unemployment. Fresh monetary policy action from central banks around the world provided some support for global equity markets amid an environment ripe with uncertainty.

Equities around the world were mostly negative for the quarter except for large cap U.S. stocks, which posted a modest positive return. Positive returns in July and September were offset by a tumultuous August. U.S. economic data reflected a stronger domestic environment compared to other developed markets throughout the quarter, and this was reflected in stock returns.

Index	**3Q 2019**	**Year-to-Date 2019**
S&P 500 (Large Companies)	+1.70%	+20.55%
S&P 400 (Mid-sized Companies)	-0.09%	+17.87%
Russell 2000 (Small-sized Companies)	-2.40%	+14.18%
MSCI EAFE (Europe, Australia & Far East)	-1.07%	+12.80%
MSCI Emerging Markets	-4.25%	+5.89
MSCI ACWI (All Country World Index)	-0.03%	+16.20%

In August, the U.S. announced a 10% import tax on an additional $300 billion of "finished" Chinese goods such as consumer clothing and shoes. The White House postponed these tariffs until December 15 in an attempt to help retailers through the holiday season. China retaliated and placed a 30% tariff increase on $75 billion of U.S. goods, including cars and trucks, to which the U.S. responded again with an additional 5% hike on all previously announced tariffs. Negotiations broke down through the third quarter and are set to restart in Washington on October 10. On top of tariffs, China surprised the world in early August by devaluing its currency. By cheapening the yuan, China makes its exports more affordable to American buyers, effectively countering tariffs. Our optimism for a defined trade resolution in the near term is diminishing, and we are closely watching for any signs that the uncertainty that is affecting business sentiment and driving a sharp decline in investment spending will trickle over to the consumer side of the economy.

We believe the manufacturing slow-down, and in some cases manufacturing recession in countries like Germany, is a result of ongoing uncertainty regarding the possible outcomes of the trade negotiations. The Institute for Supply Manufacturing's Purchasing Managers Index (ISM PMI) for U.S. manufacturing fell below 50 in August, signaling an official manufacturing contraction. However, the non-manufacturing PMI

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(i.e. services) showed expansion with a reading of 56.4, comfortably in expansion territory. While manufacturing activity has weakened, manufacturing accounts for less than 15% of U.S. GDP growth. So far, weakness has not spilled over into the service sector, which is a more significant component of the U.S. economy.

Despite the cloudiness over trade and business investment, the U.S. consumer continues to remain resilient and the primary driver of economic growth. Second quarter U.S. GDP growth came in at 2.0%, driven by 4.7% annualized growth in consumer spending that offset negative business investment. Measures of consumer confidence continue to remain elevated, and the Conference Board's present situation sub-index (how consumers feel about the economy now) reached its best monthly reading since November 2000. Employment and hiring also remain robust, with the unemployment rate dipping to 3.5% as of the end of September, wages growing modestly at 2.9% year-over-year and unemployment claims remaining at historic lows. U.S. inflation also remains in check, at 1.7% headline and 2.4% core (excluding food and energy). As consumer spending historically drives at least two thirds of U.S. GDP growth, we are closely watching employment data for any signs that the consumer may face headwinds.

We did not just see volatility within equities during the third quarter. Central Bank activity in the U.S. and Europe prompted a sharp decline in interest rates as well. In the U.S., the Federal Reserve cut interest rates for the first time in over a decade. The first 0.25% reduction came on July 31 and a second 0.25% cut occurred on September 18, resulting in a target range of 1.75% - 2.00% for overnight rates. While the first reduction had strong support from most members of the Federal Open Market Committee with a vote of 8-2, the second move had a bit less support. Most Fed officials currently forecast no more rate reductions for the rest of 2019, but the reality of more cuts will be data dependent. While the Fed controls the very shortest-term rates of the yield curve, investors' demand for bonds causes shifts in longer-term rates. These longer-term rates drive borrowing rates for consumers in autos, credit cards and mortgages. Other interest rates fell in response to the Fed's moves, and the 10-year U.S. Treasury yield dropped from 2.00% to 1.68% through the quarter, hitting a low of 1.46% in early September. Falling rates push bond prices higher, as higher yielding bonds become more valuable. For the quarter, fixed income returns were positive, with longer-dated bonds outperforming shorter ones in the falling rate environment:

Index	**3Q 2019**	**Year-to-Date 2019**
Bloomberg Barclays U.S. Aggregate Bond	+2.27%	+8.52%
Bloomberg Barclays 1-3 yr. U.S. Treasury	+0.58%	+4.37%
U.S. 3-month T-Bills	+0.56%	+1.82%
Bloomberg Barclays U.S. Corporate High Yield	+1.33%	+11.41%
Bloomberg Barclays Municipal Bond	+1.58%	+6.75%
Bloomberg Barclays Municipal 5-year	+0.54%	+4.37%

The European Central Bank (ECB) also announced rate cuts on September 12, taking its overnight deposit rates further negative to -0.50%. It also announced that a 20 billion euro per month bond repurchase program will begin in November and that it will offer easier terms of long-term loans and tiered deposit rates to help banks. The Euro-zone has suffered more than the U.S. from the global manufacturing slow-down due to its higher reliance on exports as a driver of GDP growth. Inflation is also worrisome at only 1.2%. Despite low absolute levels, U.S. rates continue to offer the highest yields among developed nations, which led to a strengthening of the U.S. Dollar.

Three other geopolitical events added to the ever-growing list of investors' concerns in the third quarter: the attacks on Saudi Arabia's oil fields, the U.K.'s messy exit from the European Union, and a recent impeachment inquiry into President Trump. On September 14, two of the world's largest oil producing facilities in Saudi Arabia were damaged by drone attacks, reducing daily global crude output by about 5%.

Tensions rose as Iran was accused of the attacks. Despite a temporary spike in oil prices in response to this event, energy sector stocks continue to underperform the broader equity markets.

In the U.K., new Prime Minister Boris Johnson attempted to suspend Parliament for a month to squeeze through his unpopular plan for Brexit. The high court ruled this action unlawful, and many have called for him to resign. With only weeks left until the October 31 deadline for a no-deal Brexit, the outcome in the U.K. remains in limbo.

On September 24, House Speaker Nancy Pelosi announced a formal impeachment inquiry into President Trump as a result of a whistleblower claiming President Trump used the power of his office to pressure the President of Ukraine to investigate his political opponent Joe Biden. The inquiry is just a first step in the impeachment process to determine if sufficient evidence exists to write up articles of impeachment. If President Trump becomes the third U.S. President to be impeached by Congress, it does not necessarily mean he will be removed from office. The inquiry and the upcoming U.S. Presidential election are sure to heighten investors' sensitivity to political headlines, but we do not anticipate a direct influence on economic data driving the current market cycle.

Our portfolio strategy amid all the uncertainty is to build in more protection within the bond side and balance risk-taking on the stock side. Within fixed income, we have continued to increase the average length of our bonds and the quality to provide a true hedge in falling equity markets. Leading economic indicators in the U.S. continue to support our thesis that we will not fall into recession this year or perhaps even next year. Modest economic growth in the U.S. and accommodative central bank policy at home and abroad supports maintaining stock allocations to grow portfolios. Within stocks, we have made one notable adjustment to our strategy in the third quarter, and that was to sell the energy theme. The energy theme was added to portfolios in early 2016, when oil was priced at $26 a barrel. While valuations remain attractive and oil has doubled to $53 a barrel, we observed that beginning in the fourth quarter of 2018, the sector began trading in response to global growth headlines instead of sector fundamentals. While energy had a strong start and recovery earlier this year, the theme struggled to outpace the broader market beyond the first quarter. We used proceeds to add to our dividend growth strategy, which we introduced into portfolios in late 2018. Selling energy and adding to large-cap dividend growers slightly reduced the risk profile of the equity portion of portfolios and improved equity resilience in the wake of higher volatility.