2019 Market Outlook

Economic growth surged, interest rates rose, and volatility returned as we expected in 2018. There were also a few surprises, including disappointing economic data from overseas, and a worrisome decline in long-term interest rates, credit markets and commodities toward the end of the year. We begin 2019 with a mixed outlook and neutral positioning across many asset classes. Here are the pressing investment questions addressed in the following pages:

1 – Asset Allocation: How to invest when risks abound?

2 – US Stocks: Can they climb the proverbial "wall of worry?"

3 – US Bonds: Has the outlook improved with decelerating economic activity and disinflation taking hold?

5 – International Stocks: Have currency markets and lowered economic expectations reduced valuations to attractive levels after a disappointing 2018?

Asset Allocation

Strong returns and record-low volatility made 2017 one of the most pleasant years for investors in recent memory. Many investors expected 2018 to be a continuation of the year before as tax cuts, a relaxed regulatory environment, and a general sense of optimism pushed equity markets to all-time highs early in the year. This was followed by a sharp, albeit brief, bout of volatility that abruptly ended the sense of complacency that had settled over financial markets. Stocks rebounded to new highs by September, when a new batch of fears sent equity markets down sharply to end the year. While the latest correction has brought valuations down to more reasonable levels, the question of how equities and other risk assets will respond to an environment of slowing growth, high debt levels, diminishing support from central banks, and intractable global problems will be central to investment outcomes in 2019.

The volatility of late 2018 could be relatively short-lived like the last time the stock market experienced similar losses in late 2015 through early 2016, or it could indicate the beginning of a deeper slowdown. There are a number of key economic indicators that can provide context to recent market activity, including unemployment, the Composite Index of Leading Indicators , and the shape of the yield curve (the difference between long-term and short-term interest rates). Few of these data points are consistent with an imminent recession, so we are inclined to remain neutral on stocks and other risk assets for the time being. For the moment, stocks seem to provide the best risk/ return tradeoff among traditional investment options although there are real risks associated with equities. We are concerned about the recent decline in long-term interest rates and credit market conditions in particular and expect to adjust asset allocation positioning in 2019 as new data becomes available.

Asset allocation seems particularly challenging in the current environment where exogenous factors are in the driver's seat across many asset classes. Trade disputes, monetary policy decisions and geopolitical risks are all self-induced problems and could be reduced or eliminated at any time. The unpredictable nature of these problems has us expecting volatility to remain elevated in 2019 after the big increase from the unusually low levels experienced in 2017.

Given high volatility and heightened uncertainty, we have also gradually increased the quality of the underlying investments in our stock and bond portfolios in recent quarters and expect this trend to continue. We are targeting an overweight position in large- and mid-cap US Equities and an underweight position in all of the other riskier areas of the stock market. Similarly, while we remain overweight credit and short-term bonds in our fixed income portfolios, we increased quality by eliminating our targeted allocation to high yield bonds.

Another tool that we may utilize in 2019 is the often-overlooked asset class of cash and equivalents. Cash was a meaningful return contributor in 2018 for the first

Asset Allocation, continued

time in over a decade and outperformed stocks and bonds. While we don't normally hold large cash balances for extended periods of time, short-term investments can be a powerful tactical tool that provides significant flexibility in times of uncertainty. Lowly cash may have a meaningful role to play at some point in 2019, especially with treasury bill yields north of 2.3%.

In conclusion, we begin 2019 with our overall asset allocation in a slightly defensive position, but with a neutral allocation to stocks. We expect this will change over the course of the year as necessitated by incoming data, and that we will remain biased toward higher quality investments while remaining open minded, nimble, and cognizant of the downside risks of investing in the later stages of the economic cycle.

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US Equities

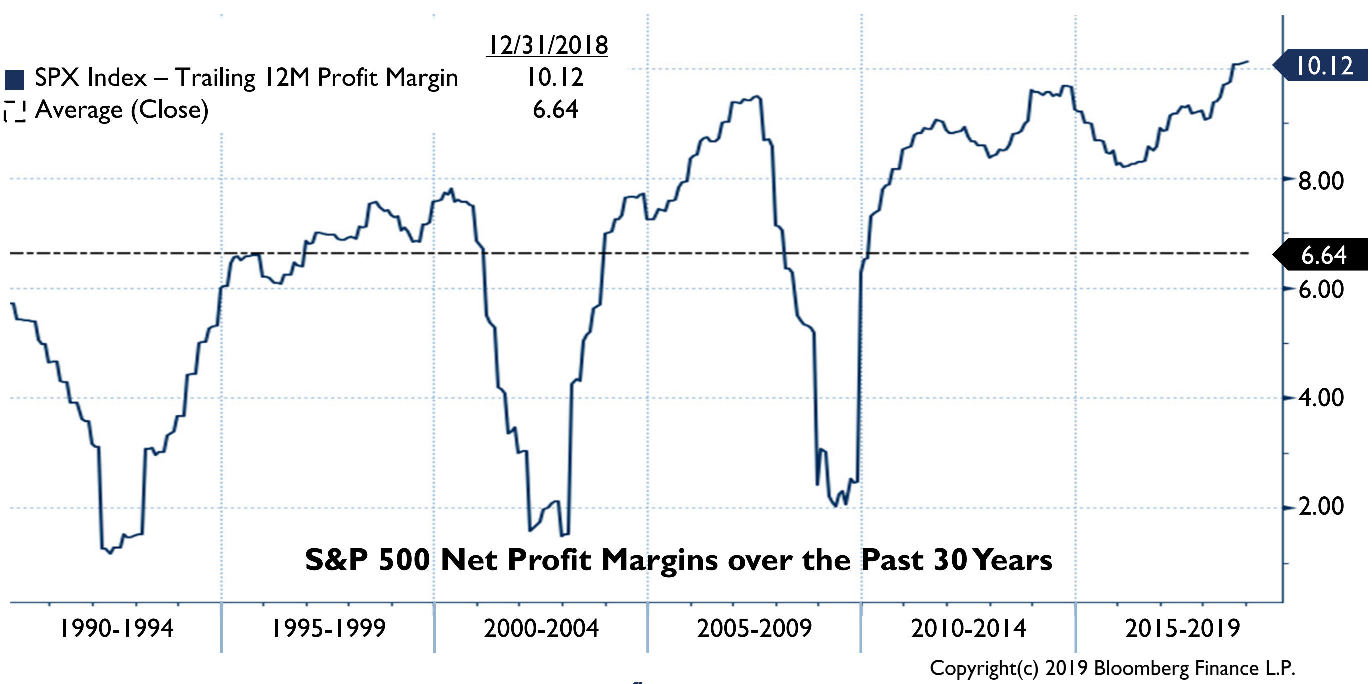
The outlook for corporate earnings growth was strong at the beginning of 2018. Analysts expected 12% growth and we ended up with 23% growth. During the year, the S&P 500 price-to-earnings (P/E) multiple decreased from 18x to under 15x as the market, always a forward-looking mechanism, declined as it sniffed out decelerating earnings growth in 2019.

The question now becomes whether this decline offers a reasonable entry point or if it portends a recession and further market weakness. As long as the underlying US economy remains solid, the US equity market should remain in a secular uptrend, provided that conditions in Europe and Asia, which weakened in 2018, stabilize. Even as excess valuations have been squeezed out of the market, the outlook for both the economy and equities continues to be reasonable.

Corporate earnings are currently expected to grow approximately 5% in 2019. Although it is well below the unusually high 23% growth seen in 2018 (largely due to the one-time benefit of the tax cut), 5% is in line with long-term averages and could support current equity market valuations.

At the same time, there are some negatives. The biggest risks we see to the US equity market in 2019 are a further earnings slowdown, Fed overshoot, and protracted trade conflict. Corporate margins (as measured by the S&P500) are at all-time highs. Rising wage pressures may increase the risk that corporate margins will decline, which would in turn reduce earnings growth. We will be watching for indicators that this is occurring and will reposition accordingly. US equity valuations, while lower than what they were entering 2018, remain high by most measures, including both price-to-sales and price-to-earnings.

There is a big difference between an equity bear market driven by a slowdown in corporate earnings growth versus one driven by an



US Equities, continued

economic recession. The first has historically led to approximately 20% market declines, as experienced in recent months; the second has historically led to much more severe market declines. Based on what we see today, the first seems more likely than the second, though again, global conditions are not as positive as those in the US.

Given the current economic uncertainty and the accompanying market weakness, we believe that it makes sense to focus on stocks offering solid earnings prospects regardless of the macroeconomic backdrop. Late in an economic cycle, quality stocks often perform better than the overall market. Thus, we increased the quality of equities held in client portfolios throughout 2018 and continue to do so entering 2019. We define quality along several dimensions. For example, we are gradually shifting portfolios away from growth stocks, which have gotten very expensive, toward high-quality value stocks, which have become relatively cheap. We are also moving toward traditionally defensive sectors, such as healthcare and consumer staples. An increasingly important measure of quality is debt; to reflect this, we are shifting both equity and fixed income portfolios toward companies with lower debt, and away from more leveraged companies. As always, we remain flexible to make real-time adjustments to respond to changes in the market environment.

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US FIXED INCOME

If there was a consensus trade during 2018, it was that interest rates were headed higher, perhaps materially so. US economic growth was accelerating on the back of President Trump's tax cuts, unemployment was at historic lows, and wage growth was finally accelerating. By February 1, 2018 the benchmark 10-year Treasury note yield was 2.79%, up from 2.40% at the start of the year, having experienced one of its steepest monthly increases of the post-financial-crisis era. It went on to break through 3% in April. By August Jamie Dimon, CEO of J.P.Morgan, said investors "better be prepared to deal with rates of 5% or higher – it's a higher probability than most people think."

As it turns out, the US 10-year yield ended 2018 at 2.72%, below where it was on February 1st. For a broad bond benchmark like the Bloomberg Barclays Intermediate US Government/Credit Index, that translated into a very un-bear-market-like total return of positive 0.88% for 2018 (interest income of approximately 2.28% and an interest-rate-induced price decline of roughly -1.40%).

Bonds sidestepped the apparently inevitable bear market as a slowdown in global growth led to fears that the Fed was tightening monetary policy too quickly. One might be tempted to think interest rates are ridiculously low here in the US, but they are quite high in global context. The recent dimming outlook for global growth sent Japan's 10-year bond yield back below zero for the first time since 2017. Similarly, the German 10-year yield (at 0.25%) finished 2018 near its lows after rising as high as 0.80% in February. US 30-year Treasuries meanwhile, saw their yields fall from near 3.5% in early November 2018 to about 3% at year end, representing a total return of approximately 8.5% in a little less than two months.

Also keeping US yields down is the risk that the Fed may be headed toward a policy mistake by further raising short-term interest rates. Recession, tabbed for 2020 at the earliest by most economists, started to creep forward in investors' minds on December 19th, when the Fed increased its target for the federal funds rate for the 4th time in 2018. While the rate hike itself was expected by

Fixed Income, continued

markets, it was Fed Chair Jay Powell's announcement that the central bank expects to raise rates two more times in 2019 that came as a shock. Powell then worsened the impact by stating that the Fed's balance sheet assets (all the bonds they bought during the financial crisis to reduce long-term interest rates) are on "auto-pilot." Those bonds are now rolling off the Fed's balance sheet at a rate of $50 billion per month and further tightening financial conditions. The bond market immediately reflected an increased likelihood of US recession, as the difference or spread between 10-year and 2-year Treasury yields narrowed to less than 10 basis points (0.10%) following Powell's comments. The 10-year/2-year Treasury spread has reliably gone negative (i.e., "inverted") in front of past US recessions.

Ominously, investment-grade corporate bonds, which are susceptible to recessionary fears and resultant credit losses, lost 2.75% in 2018, their steepest decline since losing almost 5% in 2008. The incremental interest these bonds pay above similar maturity Treasury yields (the "credit spread") has likewise risen to its highest level in more than two years as depicted below. Credit spreads consistently widened in the 4th quarter as all manner of US financial markets increasingly worried about recession. Non-investment grade (or "junk bond") credit spreads followed a similar, magnified pattern, and rose from about 3% to 5.2%.

As far as strategy, we think the tighter monetary policy engineered by the Fed, along with sluggish global growth exacerbated by trade conflicts, are likely to limit the rise of bond yields from here. The Fed seems intent on raising short-term rates to near 3%, but current global economic and market trends could curtail the rise in longer-term yields.

As such, while not abandoning our long-standing strategy of maintaining shorter maturities/durations, we are likely to opportunistically lengthen the maturity/duration of our fixed income portfolios. Similarly, while not abandoning our overweight call on investment grade corporate bonds, we'll likely be reducing that overweight somewhat, in recognition of softening economic data and the possibility of a Fed "mistake," and recession. As always, both moves will be incremental and subject to change as the outlook develops.

Bottom line: Fixed income is likely to continue to be a low-return asset class moving forward. With the long economic cycle now in question though, it makes sense to upgrade the quality of fixed income allocations.

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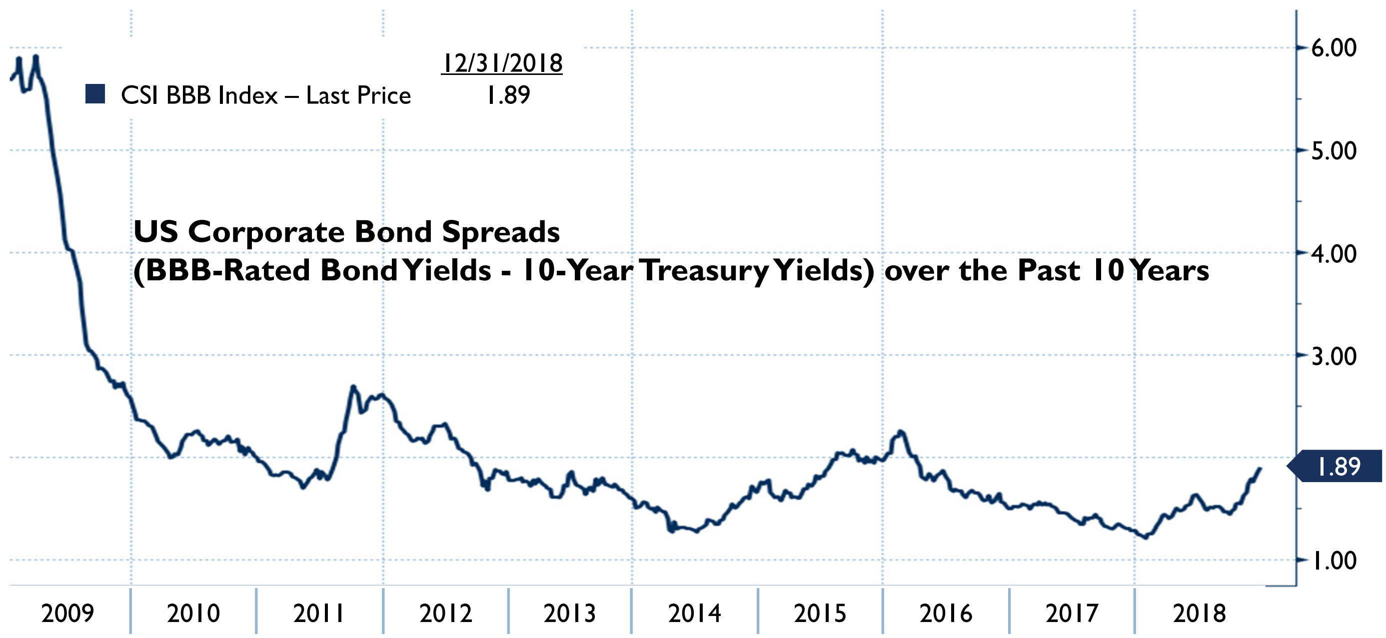
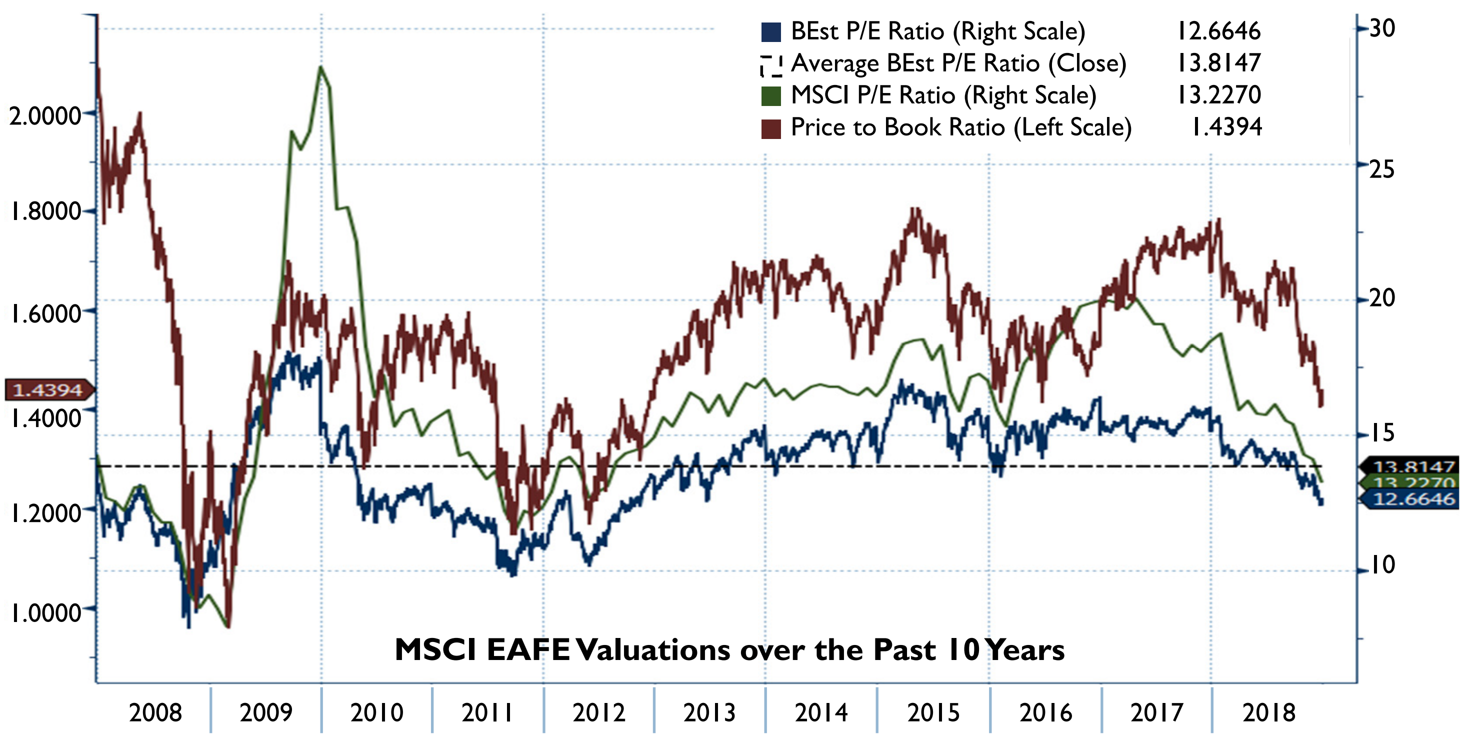


INTERNATIONAL EQUITIES

Poor performance has been exacerbated by external events

In 2018, developed international equity markets suffered their worst performance since 2008. The MSCI EAFE index, which represents major global economies outside of the US, ended 2018 down 13.25% in US dollar terms. This disappointing performance reflects a confluence of local economic and political developments whose effects were exacerbated by external events. International companies started the year off as laggards as US companies enjoyed an instant boost to earnings stemming from the 2017 Trump administration corporate tax cuts. Corporate earnings growth of international companies looked lackluster by comparison and their performance in financial markets quickly lagged that of their US peers. Then, as Japan suffered a series of natural catastrophes and Europe endured a bout of extreme weather events, all of which disrupted economic momentum, US-instigated trade disputes and tariffs crimped economic growth further. In addition, the United Kingdom's planned exit from the European Union and the rise of nationalist/protectionist interests throughout Europe not only raised concerns over the viability of European integration but engendered rising risks to the British pound and the euro. Weak economic data out of Japan, Europe and China, which at first seemed to be momentary blips, grew into a confirmed trend of economic deceleration. Recent concern over a slowdown in the US, together with the Fed's seemingly hawkish monetary policy stance evoked fears of a synchronized global recession.

Given the degree of volatility and the severity of recent pullbacks in financial markets, we are concerned with what this might portend. From a valuation point of view, international stock market multiples are at levels typically found during periods of financial turmoil or economic crisis. As shown in the chart below, on a price-to-book basis (the red line) that reflects only historical accounting values, the MSCI EAFE index is trading at 1.5x, a level last seen in 2016 when financial markets were gripped by similar fears of a global recession. On a trailing price-to-earnings basis, EAFE is trading at 14.1x (the green line); and on downwardly revised 12-month forward earnings estimates, it is trading at 12.2x (the blue line). Both these levels were last seen in 2010 and 2013, years that bookended Europe's sovereign debt crisis and Japan's pre-Abe-stimulus economic doldrums. More notably, price-to-earnings on a forward basis represent a 9% *discount* to its 10-year average, which takes into account the depressed valuation levels that prevailed during the financial crisis. The market is pricing in significant economic contraction and/or financial turmoil.



INTERNATIONAL EQUITY MARKETS UPDATE

Fear of global recession could be overdone as major headwinds could reverse

While we believe the US economy will likely slow down in 2019 from the breakneck pace of this past year, we question the severity of the pullback in international equities and wonder whether non-US economies will indeed fare as poorly as market valuations currently suggest. As we assess the current situation and look toward 2019, we must bear in mind several things:

- Europe and Japan are at earlier stages of economic recovery than the US and their central banks are committed to accommodative monetary policies.

- Since both Japan and Europe are heavily trade-dependent, we believe at least some of the expected economic slowing can be attributed to US trade policy, particularly the US trade dispute with China. Despite our recognition that this dispute is part of a broader strategic competitive repositioning on the part of the US vis-à-vis China and is therefore not prone to easy solutions, concessions on at least some of the constituent issues could be forthcoming and would be a boon to the markets.

- US Fed policy, however hawkish it may seem at the moment, will be data-dependent as Chairman Powell has articulated. Thus, if any change materializes in 2019 with respect to two of the most onerous headwinds this past year – US-China trade conflict and the path of US interest rate increases – then the markets could reverse course.

- Currency effects, which are significant for unhedged investors, may start to work in favor of US-dollar based investors. In 2018, widening interest rate differentials between the US and other countries resulted in significant US dollar appreciation, which detracted from investing abroad. Going forward, however, such interest rate differentials could narrow and dampen US dollar strength as US interest rate normalization peaks and other countries, particularly Europe, begin normalization.

Additionally, the United States' twin deficits – largely the product of the ballooning budget deficit – may result in additional pressure on the US dollar. Unless international economies are truly headed for a synchronized global recession in 2019, international equities at current depressed valuation levels could prove to be sources of attractive returns.

ASSET ALLOCATION FORECAST

EQUITIES	**US LARGE CAP**	Strong economic growth in the US, reduced corporate tax rates and strong profit growth have served to expand valuations and create expensive valuations in large-cap stocks relative to other asset classes. However, economic uncertainty and the late stage of the business cycle argue for continued relative momentum in this higher quality asset class.
	US MID CAP	Mid-cap equities have largely underperformed US equities over the last few quarters as there is less benefit from a strong dollar in this asset class. With the newly debatable trajectory of the dollar and US interest rates, valuations now seem attractive despite economic uncertainty and marginally higher risk than larger peers.
	US SMALL CAP	Small-cap stocks have been the worst performing asset class among the US equity segments in recent quarters. The prospects of domestic inflation and competitive labor markets limit upside in this asset class, while downside risk remains in a volatile market.
	INTERNATIONAL DEVELOPED LARGE CAP	A strong dollar and a weak economic environment relative to the US kept a lid on international equity returns in 2018. Equity valuations have diverged significantly from those of US counterparts. The disparity now stands at historically high levels arguing for longer-term allocations, despite elevated short term uncertainty.
	INTERNATIONAL DEVELOPED SMALL CAP	Anemic growth rates have proven a challenge for small-cap companies leading us to limit exposure to this asset class. Should economic activities pick up in developed economies, this asset class could provide substantial upside potential.
	EMERGING MARKETS	Emerging markets and China in particular have suffered from the escalation of trade skirmishes with the US and ongoing rhetoric regarding new and additional tariffs that could be imposed on Chinese goods. Until some formal progress is made on these trade issues, emerging market equities are likely to experience significant volatility and potentially lower returns than other equity asset classes.
	REITS	Low but likely rising levels of global interest rates limit upside in this asset class relative to other investments correlated to equity markets. Individual portfolios may have exposure to specific equities that are structured as a REIT.
FIXED INCOME	**US TREASURIES**	Low interest rates in the US make treasuries a tough asset class for anything other than investors seeking to protect capital in the event of a recession by investing in short-term treasuries.
	US TIPS	Tight labor markets and prospects for higher levels of inflation make this an attractive area of investment relative to other fixed income assets.
	US AGENCIES	US Agencies offer marginally better yields than US treasuries, but do not function as well as a hedge against an economic downturn, making the asset class relatively unattractive at this point in the economic cycle.
	US CORPORATES	Despite recent volatility, strong profit levels and a stable economic backdrop so far make good conditions for outperformance of corporate bonds relative to government securities.
	HIGH YIELD	High-yield spreads over investment grade securities have been volatile due to increasing economic uncertainty despite the strong economy and record profit levels for US companies. Any sign of a recession would be expected to lead to underperformance of this lower quality asset class, which leads us to limit exposure as economic growth is expected to slow.
	FOREIGN DEVELOPED	With extremely low yields available outside of the US, we prefer to remain within the US with our fixed income allocations.
	EMERGING MARKETS	For similar reasons as foreign developed fixed income, we continue to limit exposure to emerging market debt at this time.
	MUNICIPAL BONDS	Investors with high marginal tax-brackets should benefit from investment in municipal bonds relative to taxable bonds.

In Memoriam

It is with heavy hearts that we announce the passing of our beloved founder, David W.C. Putnam on November 1, 2018. In 1965, David began work at the F.L. Putnam & Company investment brokerage firm, which was founded by his father, Frederic Lawrence Putnam, in 1923. In 1969, David founded Boston Security Counsellors, Inc. He also worked for Burgess & Leith Companies as a senior vice president and was president of The Advest Advantage Investment Trusts. David furthered the F.L. Putnam name by founding and becoming president of the F.L.Putnam Investment Management Company in 1983. During that time, he developed a methodology for socially responsible investing (SRI). He continued working with F.L.Putnam Investment Management Company in various capacities until his passing. Highly regarded for his integrity, business acumen, and prudence, David served as a trustee for many individuals throughout New England and New York and served on many boards throughout his life. David was a true gentleman, thoughtful, kind, and generous. He enjoyed music, particularly classical, the way the wind would howl and stir up the surf during storms at the beach, and the antics of his three grandchildren. His love and guidance will be missed by us all.

About F.L.Putnam

Data as of 12/31/2018

$1.6 Billion: Total Assets Under Management

572 Client Relationships

- 101 Institutions
- 471 Individuals and Families

31 Employees

- 6 CFA® charterholders
- 3 CFP® practitioners

21 Years

- Average industry experience among the Investment Management Team

F.L.Putnam Investment Management Company provides a comprehensive range of investment advisory, investment management, and financial planning services to a nationally diversified clientele that includes endowments and foundations, as well as individuals and families. We are registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. We serve clients out of our Wellesley, MA, Portland, ME, Portsmouth, NH, and Providence, RI locations. The company was incorporated in 1983.

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