TRILLIUM

Economic and Market Outlook

December 31, 2019 (4th Quarter)

Reconciling a Tame Outlook. As we survey data and the forecasts of our peers in the investment industry, the near-term economic outlook appears surprisingly calm. Economic data stabilized through the fourth quarter, and on average neither exceeded nor fell short of consensus expectations, as indicated by Bloomberg's Economic Surprise Index ending the year at an uncanny 0.000. The Federal Reserve also expressed confidence that current interest rates are appropriate for current conditions, and indicated that it is unlikely to change the Federal Funds Rate for at least the first half of 2020. Historically speaking, interest rates remain quite low, offering a slight economic tailwind that may balance the planned tapering of the fiscal stimulus implemented by Congress in 2017. Responding to the prospect of continued positive corporate earnings growth and easing trade tensions, equity valuations have marched higher, lowering the likelihood of repeated standout performance here in 2020. Taking all of this into account, tame market forecasts are not surprising because they are unfounded, but rather because they differ so sharply from the media's focus on negative environmental and geopolitical events.

"There is a lot at stake in 2020, across a range of urgent social and environmental matters, but there is also a lot to celebrate as we reflect on the past quarter, year, and decade."

The Long Arc of Sustainability. Dramatic recent headlines describing the historic ongoing Australian wildfires vividly remind us of the dangers of climate change, as did similar alarm about the burning of the Amazon rainforest earlier in 2019. Each case represents the worst regional fires in decades, and together renew our urgent concerns about global environmental risks. However, as we reflect on 2019 and the entirety of the past decade, we also reflect on the progress that has been made to address these risks. The cost of wind and solar energy has plummeted in recent years, becoming increasingly competitive with fossil fuels. In many cases, installing new clean energy projects has become cheaper than operating existing coal plants, and entire cities and states including New York City, Washington D.C., Oregon, California, and Hawaii have established timelines for decarbonization. The market for Green Bonds funding environmental initiatives by corporations and governments, first articulated only a decade ago, is rapidly approaching one trillion dollars in size. Following these trends, even in the context of ongoing environmental deregulation by the Trump administration, the fossil fuel-dominated Energy sector dramatically underperformed every other component of the S&P 500 for 2019. Similarly, the past decade brought concerns of inequality and gender bias in the workplace sharply to the fore, supporting progress alongside the painful recognition of these widespread problems. As we continue to enthusiastically advocate for corporate and government policies to confront domestic inequality, we celebrate the recent reduction of global poverty levels as supported by more transparent and responsible corporate supply chains. There is a lot at stake in 2020, across a range of urgent social and environmental matters, but there is also a lot to celebrate as we reflect on the past quarter, year, and decade.

Fourth Quarter Performance. Global equity markets exhibited continued growth during the fourth quarter, rounding out a year of extremely strong performance rarely seen more than once per decade. Defensive themes, including domestic, growth-oriented, and large-capitalization stocks, outperformed throughout the year, though cyclical themes revived in the fourth quarter. The S&P 500 gained +9.06% during the quarter and ended the year up +31.48%. The small-capitalization S&P 600 trailed just slightly for the quarter, up +8.20%, and gained +22.74% for the year. The Russell 1000 Growth Index increased +10.62% during the quarter, ending the year up +36.39%, while the Russell 1000 Value Index gained +7.39% for the quarter and +26.52% for the year. The MSCI All Capitalization World Index, excluding the U.S., increased by +8.95% for the quarter and +22.13% for the year, with emerging markets partially recovering from their underperformance earlier in the year. Bonds were nearly flat for the quarter but held on to their gains

continued >>

from earlier in the year when rates shifted lower. The Bloomberg Barclays US Government/Credit Intermediate Index returned +0.37% for the quarter and +6.80% for the year while the Bloomberg Barclays Intermediate 1–10Y Municipal Bond Index gained +0.86% and +5.63% for the quarter and year, respectively.

Valuation and Positioning. Increasing equity valuations were almost entirely responsible for the equity market's fourth quarter gains, with the price-to-earnings ratio of the S&P 500 ending December at 18.2 times next twelve month earnings. The cyclically-adjusted P/E ratio, based on the past ten years of earnings, climbed to 30.8 times. Each of these valuation measures are currently 0.6 standard deviations above their 25-year average, suggesting market optimism around corporate earnings growth. Recent economic data is consistent with continued positive economic growth in the near future, especially if trade tensions ease, and year-over-year earnings comparisons will also be easier this year, with new earnings no longer being compared to 2018 numbers inflated by tax cuts. Still, corporate profit margins are already elevated, and the labor market remains tight by most measures, which may make growth expectations difficult to beat. With valuations more likely to gravitate towards their historic averages than to increase further, the market's dramatic 2019 returns are unlikely to repeat in 2020 without the emergence of an unexpected tailwind for earnings growth. All in all, we consider the risk-reward ratio reasonably balanced at this point. The earnings yield of the S&P 500 decreased to 5.5% during the quarter, while 10-year Treasury Inflation-Protected Security yields increased to 0.13%, suggesting that stocks will return approximately 5.4% more than bonds in the next year. We continue to maintain a neutral asset positioning, and a neutral style within our equity strategies, while increasing our attention to more cyclical sectors as we look for economic conditions to improve. With so many social and environmental issues actively vying for our attention, we also maintain a deep conviction that our sustainable, responsible, and engaging investment practices will continue to provide critical value to our clients, to society, and to the planet.

Two Financial Center | 60 South Street, Suite 1100 | Boston, MA 02111 | 617-423-6655 | www.trilliuminvest.com