As of 12/31/2018

<table>
<thead>
<tr>
<th>STOCKS</th>
<th>QTR</th>
<th>% Change</th>
<th>Div</th>
<th>% Change</th>
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</thead>
<tbody>
<tr>
<td>DJIA</td>
<td>23,327.46</td>
<td>-11.83</td>
<td>2.43</td>
<td>-5.63</td>
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<tr>
<td>S&amp;P 500</td>
<td>2,506.85</td>
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<tr>
<td>NASDAQ 100</td>
<td>6,329.97</td>
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<tr>
<td>S&amp;P MidCap 400</td>
<td>1,663.04</td>
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<tr>
<td>Russell 2000</td>
<td>1,348.56</td>
<td>-12.18</td>
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<table>
<thead>
<tr>
<th>TREASURIES</th>
<th>Yield</th>
<th>FOREX</th>
<th>Price</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>2-Year</td>
<td>2.49</td>
<td>Euro/Dollar</td>
<td>1.15</td>
<td>-1.18</td>
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<tr>
<td>5-Year</td>
<td>2.51</td>
<td>Dollar/Yen</td>
<td>109.69</td>
<td>-3.53</td>
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<td>10-Year</td>
<td>2.69</td>
<td>Sterling/Dollar</td>
<td>1.28</td>
<td>-2.13</td>
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<tr>
<td>30-Year</td>
<td>3.02</td>
<td>Dollar/Cad</td>
<td>1.36</td>
<td>5.65</td>
</tr>
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</table>

Source: Thomson Reuters & Bloomberg

Equities

Equity markets in 2018 proved to be a wild ride that took most investors by surprise. The year began with tremendous market volatility, but investor psychology was starkly different as the year concluded with pessimism and negativity. Equity investors started the year with great hopefulness that the synchronized global economic recovery would continue. Additionally, expectations for earnings and domestic economic growth were being boosted by the recently passed Tax Cuts and Jobs Act. With the $1.5 trillion tax cut and $390 billion in incremental deficit spending, fiscal stimulus drove forecasts of 3% growth for real GDP.

Equity markets soared in January with the S&P 500 lifting 6.7% to start the year. The strong rally was somewhat surprising on the back of a robust 20% plus return in 2017 that many pundits argued already discount the earnings recovery ahead.

The gains were short lived however. The equity market quickly corrected falling over 11% from its January close to its intraday low in February. The volatility was jarring in comparison to the placid equity markets during the prior two years. The rapid drawdown resulted from the anticipation of higher short rates caused by the normalization of rates by the Fed. With labor markets already tight and projected to tighten further with an accelerating domestic economy, rising inflation expectations seemed to justify a more aggressive Fed. Strategists began to speculate that the era of cheap money was coming to an end. The prospect of higher rates and elevated valuations made conditions ripe for higher volatility and market weakness.

Despite the emergence of the trade war toward the end of the first quarter, equities moved sideways for much of the second quarter and volatility eventually dampened down to prior levels. The CBOE VIX, which is a measure of implied volatility, spiked to the mid-thirties from the low teens during the hard selloff in the first quarter. Investors were unaccustomed to that level of volatility. To provide some context, the VIX averaged 11.04 in 2017 with a high of 17.28. By early May, the VIX had reset to the low teens and equity markets were once again poised to grind higher. Corporate earnings in the first quarter and forward guidance were remarkably strong. Rising earnings expectations supported stock prices and reestablished investor confidence.

Global stocks rose through the third quarter led by a strong performance in large-cap U.S. equities. From the early April lows (4/2) to 2018’s high toward the end of September (9/21), the S&P 500 rallied over 13.5%. A significant portion of the move higher was during the third quarter as the S&P 500 had the strongest quarterly performance in five years rising by 7.5%. International markets rallied as well with the MSCI ACWI Index turning in a solid 4.4% increase in the third quarter. International stocks lagged U.S. equities throughout the year as earnings growth of U.S. companies far exceeded their international brethren and a relatively strong dollar dampened international equity performance.

As the year progressed, three major themes emerged that impacted equity markets and dominated the investment conversation. First, the Federal Reserve pushed forward on normalizing both its balance sheet and interest rates. The Fed took advantage of fiscal stimulus expanding the domestic economy at an above-trend rate to hike the fed funds rate four times in 2018. The December increase marked the ninth quarter-point increase since the tightening cycle began in 2015. Second, trade and tariff concerns grew as tensions between the United States and China became increasingly contentious. The Trump administration trade policy has centered on China’s protection of and subsidies for domestic industries, and appropriation of intellectual property. So far, the Chinese have shown a limited interest in modifying their approach and the U.S. continues to insist on a course correction in Chinese trade policy. Third, global economic growth slowed as the year advanced. Not only has China slowed, but both Europe and Japan have not been able to sustain their growth rates due to inadequate reforms and heightened trade uncertainties. Additionally, emerging economies struggled due to a strong dollar, stricter monetary policy, and tighter financial conditions.

Volatility returned with a vengeance in the final quarter of the year as worries over global growth and the possibility of the Federal Reserve pushing too hard on short rates finally overwhelmed near-term fundamentals. By the end of the quarter, the S&P 500 was down roughly 14% and slightly more than 6% for the year. The government shutdown at year-end added to concerns over the dysfunction in Washington. With the new year, investors will be focused on fourth quarter earnings reports and forward guidance. Geopolitical headlines will weigh on investor sentiment as the market sorts through the current concerns.
Fixed Income

With the passage of the Tax Cuts and Jobs Act coupled with a rapidly expanding Federal budget deficit, 2018 was a year that experienced above trend economic growth. The Fed projected 2018 GDP would grow by 2.5% one year ago as they were not quite certain how much of an impact the fiscal stimulus would have on the economy. As the year progressed, the FOMC revised up their 2018 growth expectation to 3.0%. According to the latest Fed statement, “economic activity has been rising at a strong rate”. Moreover, employment gains have been robust and the unemployment rate is the lowest in almost 50 years. Despite the positive economic data, annual inflation, according to core personal consumption expenditures increased only 30 bps from 1.6% to 1.9% over the course of 2018 and still resided slightly below the Fed’s symmetric 2.0% target.

Looking back, when the FOMC met in December 2017, it had projected that by the end of 2018 the Fed funds rate would be 2.125%, according to the central tendency median. The market 1-year ago projected that the Fed funds rate would be 1.90% according to the Fed funds futures contract for December of 2018. With the Fed funds effective rate closing the year at approximately 2.40%, the FOMC proved to be a better Fed funds forecaster than the market in 2018. Fed Chair Jerome Powell had a difficult first year at the helm of the Fed. With economic growth accelerating in the first half of the year due to the above-mentioned tailwinds, tightening monetary policy was a nonevent for the markets. However, as the year progressed, financial conditions tightened, global growth decelerated and volatility increased. The Fed raised the Fed funds rate by 1.0% in 2018 and with monetary policy no longer considered accommodative and the fiscal stimulus fading, inflation expectations are decelerating. 10-year implied inflation according to the TIPS market decreased considerably from the May high of 2.20% to close the year at roughly 1.71%.

Heading into 2018, many financial market leaders were calling for a precipitous rise in U.S. Treasury (UST) yields. The 10-year (10Y) UST began 2018 at approximately 2.41% and climbed 30 basis points (bps) to close January at roughly 2.71%. On February 1st, the 10Y benchmark rose another 8 bps to 2.79% causing many investors to proclaim that the path towards a bond bear market was officially underway. By April 24th, the 10Y closed the trading day at 3.00% - a key psychological level for market participants. However, it would take until October 5th for the 10-year yield to break 3.20% when it closed higher by 5 bps on the day at approximately 3.23%. The 10Y peaked on November 8th at roughly 3.24% and steadily declined to close 2018 at approximately 2.69%.

Year-over-year, yields across the entire UST curve increased anywhere from 25.3 bps to 119.5 bps. Interest rates on UST Bills advanced the most, anywhere from 86.1 bps to 119.5 bps. Notably, the 3-month T-Bill increased 97.9 bps. Short-term rate increases were buoyed by approximately $9.8T of UST supply, an increase of $1.138T from 2017, and four 25 basis point Fed fund rate increases. The benchmark 2-year and 10-year Treasury Notes increased 60.5 bps and 27.9 bps, respectively, which narrowed the spread 32.6 bps to just 19.5 basis points. Furthermore, the commonly used 3-month T-Bill and 10-year Treasury Note spread closed the year at 32.9 bps, 62.5 bps below its year-to-date average of 95.4 basis points and nearly 3 standard deviations from the annual mean.

Fixed income asset classes that performed the best over the course of 2018 included international bonds (currency hedged), short-term U.S. Treasuries, and short-term high-quality bonds with year-to-date total returns of 2.81%, 1.56%, and 1.34%, respectively. On the other hand, emerging market bonds (non-currency hedged), preferred equity, and long-term high-quality bonds were the laggards of 2018 with year-to-date total returns of -5.47%, -4.63%, and -4.17%, respectively.

Slowing global growth coupled with geopolitical risks contributed to spread widening in both investment grade and high yield debt markets in 2018. The 5-year A-rated corporate bond spread above Treasuries increased 42.9 bps to end the year at approximately 91 bps. The move was even more dramatic in the high yield sector with the 5-year B-rated corporate bond spread widening 206.2 bps to end the year at 495 bps.

Top 10 Financial Stories in 2018

Factors that influenced the financial markets:
10) European Central Bank Ends Bond Buying
9) Revamped NAFTA
8) Brexit “Fireworks” and Italian Budget
7) U.S. Congressional Power Shifts; Democrats Win Control of The House of Representatives
6) The U.S. Withdraws from The Iran Nuclear Deal
5) GE Dropped from The Dow Jones
4) Domestic Economic Growth Accelerates to 3%  
3) U.S. – China Trade War
2) Fed Rate Hike Drama/Concerns
1) The Market’s Worst Performance in December Since 1931

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