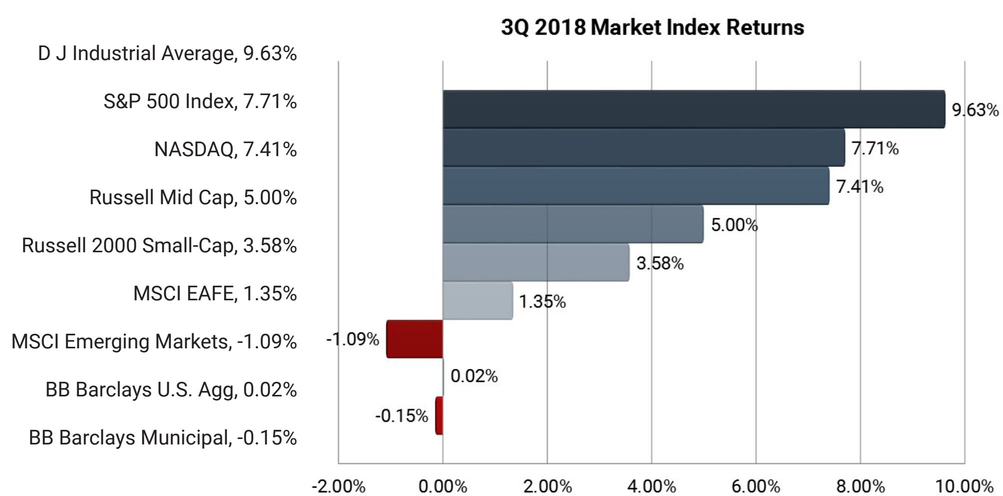
WEALTH MANAGEMENT SINCE 1971

QUARTERLY MARKET COMMENTARY: *Third Quarter 2018*

the ECONOMY

Last quarter, we noted that a Google Trends search for the term "trade war" hit a value of 100 in early July, which denotes peak popularity according to the firm's model, reflective of what was arguably investors' top concern over the first half of 2018. But how did stocks respond as fears of an impending trade war reached their peak? By rallying nearly 8 percent over the ensuing three months, hitting a new all-time high in the process. So, despite a seemingly daily deluge of headlines warning of imminent economic peril, investors who stayed the course were well rewarded. Markets have a funny way of doing that. And while the final resolution of various trade negotiations around the world are uncertain, the global economy remains on solid footing and corporate earnings continue to impress.

In the U.S., GDP growth accelerated to a 4.2 percent annual rate in the 2nd quarter, and Atlanta Federal Reserve Bank estimates peg the 3rd quarter near 4 percent as well. Heading into July, unemployment was already near historic lows, but that didn't stop it from falling even further. At the end of September, the headline unemployment rate was 3.7 percent, the best reading in nearly 50 years! A tight labor market has slowly but surely led to compensation increases, with wages up between 2.8 percent - 3.5 percent over the past 12 months. Due to a roughly 30 percent surge in oil prices this year, however, inflation has increased 2.7 percent over the same time period, dampening real purchasing power gains. Should oil prices moderate though, inflation likely drops back towards the "core" measure that excludes



food and energy, which is just above 2 percent. Nevertheless, the U.S. consumer appears to be in good shape, evidenced by total spending up over 3 percent so far in 2018. Also, recent revisions to income data resulted in an upgrade to the personal savings rate estimate, now at 6.6 percent, above the 25-year average of 6.1 percent.

Although it began the year in a down trend, the U.S. Dollar strengthened relatively quickly throughout the spring and summer, thanks to rising interest rates, an unexpected surge in domestic economic growth, and investor anxiety over potential ill-effects of shifting international trade policy. But on the latter point, there is little evidence yet of any deleterious fallout due to the Trump administration's stance. In fact, according to the IMF, the value of world exports is up 10.9 percent over the past 12 months. Another piece of positive news on the trade front was the agreement between the U.S., Canada, and Mexico to an updated North American Free Trade Agreement, commonly referred to as NAFTA. Markets took a sanguine view of the deal, as it preserves many features from the old NAFTA, thus shouldn't lead to any major disruptions. After some serious late night brainstorming sessions, it was decided that the fresh pact will officially be called the United States-Mexico-Canada-Agreement, or USMCA for short. Lack of easily articulable acronyms notwithstanding, there is one new provision in the USMCA that warrants especially close attention going forward. This provision effectively gives the U.S. a sort of veto power over Canada and Mexico's other free trade deals in order to ensure that they are governed by market principles instead of unjustified or unfair state intervention. It isn't difficult to imagine this as a stealthy way to exert further pressure on China, which the Trump administration appears keen on making a lasting feature of their agenda.

The aforementioned U.S. Dollar strength has negatively impacted financial asset performance internationally, but underlying economic fundamentals have held steady. Eurozone GDP grew at a near 2 percent annual rate in the 2nd quarter, and the European Central Bank (ECB) expects a similar pace for the next year. Like the U.S, unemployment is still moving in the right direction, down to 8.1 percent, lowest since November of 2008. Aside from currency weakness, much of the volatility in European assets can be attributed to political developments in Italy, the monetary union's 3rd largest member. The country's debt-to-GDP ratio is distressingly high, necessitating stricter fiscal policy oversight from the European Union (EU). Current rules limit government budget deficits to no more than 3 percent of GDP, but given Italy's elevated debt levels and meager economic growth, the EU wants it much lower for the time being. Italy's newly formed populist government, which has a bit of an anti-Euro bent, isn't thrilled about taking direction from Brussels though. This has led to an ongoing, and presently unresolved, conflict between the two entities. For an indication of the market's unease, take a look at Italy's short-dated government bonds, where yields were negative to start the year, but have since jumped above 1 percent.

After a brief dip in the 1st quarter, Japan has returned to growth. The commitment to enhance corporate efficiency looks to be bearing fruit, as many of Japan's large, and previously stingy, companies have announced new dividend increases and share repurchases. Furthermore, the reelection of Shinzo Abe for a 3rd term as President ensures a consistent legislative environment. Some high-profile corruption scandals early in the year had put Abe's political future up in the air.

The big story in emerging markets has been the dramatic economic and currency volatility out of Argentina and Turkey. But the two countries have unique problems, namely large current account deficits and high external debt levels, that aren't endemic to other emerging market countries. In addition, Argentina and Turkey are both quite small with relatively limited global linkages. So, while emerging market assets on the whole have significantly underperformed their developed market peers, the bottom line at this point is that this doesn't look like a widespread crisis.

CENTRAL BANKS

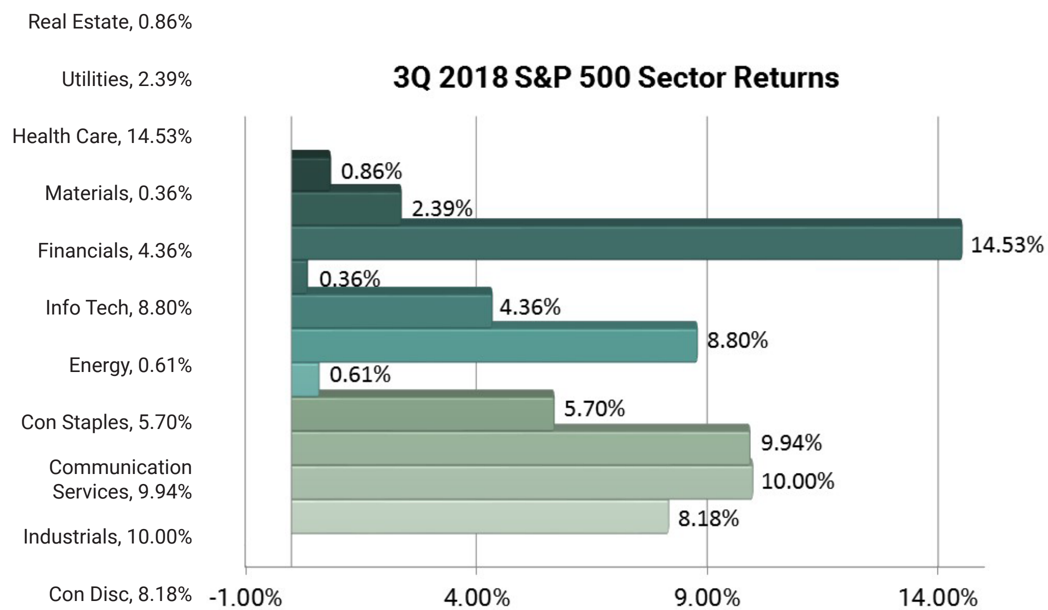
As expected, the Federal Reserve (Fed) raised the key federal funds rate another quarter-percentage point at its September meeting to a range of 2 – 2.25 percent, the 8th increase since moving off of zero in late 2015. It is notable that this is the first time during this business cycle that the "real" federal funds rate – that is, the rate once inflation is accounted for – is positive. At the post-meeting press conference, Chairman Jerome Powell reiterated his confidence in the economy as well as the plan for gradual, well-telegraphed rate increases. Also, outside of oil prices, the Fed and its respective committee members do not see evidence that inflation will accelerate in a worrisome manner.

Not much new to report from the ECB. The plan is still to conclude its asset purchase program by year end, but no consideration of interest rate increases until mid-2019.

The same can be said for the Bank of Japan (BOJ). It is committed to negative overnight rates and a 0 percent yield on 10-year government debt for the time being. If the Japanese economy progresses as the BOJ expects, it wouldn't be surprising to see a higher interest rate target on longer-term bonds. A steeper yield curve would be a welcome benefit to the country's financial institutions.

FIXED INCOME

Interest rates rose modestly over the 3rd quarter, putting downward pressure on bond prices. But offsetting coupon payments were enough to generate marginally positive returns overall. The Bloomberg Barclays Aggregate Index,



composed of high-quality corporate, treasury, and asset-backed bonds, gained 0.02 percent. Corporate bonds, a laggard through the first half of 2018, staged a nice rebound, rising 0.89 percent. Tax-free municipals on the other hand, were down slightly, off 0.15 percent. One key difference that has developed between taxable and tax-free markets is the shape of the yield curve, or the difference in longer-term rates versus shorter-term ones. While the taxable yield curve is historically flat, the municipal curve has retained a typical steepness, allowing investors to earn a meaningful premium to extend the maturity of their portfolios.

High yield securities and leveraged loans, both of which are less sensitive to interest rate movements but more correlated to equities, were standout performers once again. The two sub-asset classes returned 2.44 percent and 1.93 percent, respectively, over the past three months. High yield default rates remain at the very low end of their historical range, at just 2 percent.

European interest rates followed U.S. ones higher, creating a similar headwind for international fixed income investors. However, on an absolute basis, European yields are still extremely depressed. A German 10-year security gets one just around 0.50 percent per annum. This at a time when German inflation is over 2 percent! Not exactly a target rich environment for bond buyers overseas.

EQUITY

It took a little longer than most would've hoped, but after a rough correction early in the year, U.S. stocks fully recovered their losses and hit a new all-time high in the 3rd quarter. The S&P 500 climbed 7.71 percent, bringing its year-to-date gain into double digits. Leading the way were health care and industrial securities, up 14.53 percent and 10.00 percent, respectively. A persistent theme since 2017 has been the outperformance of the "growth" style against "value" style. It was the case again in the 3rd quarter as well, with the Russell 1000 Growth rising 9.17 percent versus the Russell 1000 Value's lower, but still respectable increase of 5.70 percent.

Previously volatile currency markets stabilized somewhat in the 3rd quarter, helping international markets to a 1.35 percent gain, reversing a portion of their losses from prior months. Emerging markets didn't hold up as well, falling 1.09 percent. Beyond the Turkey and Argentina situations, which appear contained, the ongoing and escalating tension between the U.S. and China is clearly softening investor sentiment towards emerging markets' assets more broadly.

A previous bout of international stock underperformance versus the U.S. occurred from mid-2014 to early 2016, but this more recent stretch looks quite different. While the former period experienced declining profits, in 2018 earnings outside of the U.S. have been steadily rising. The subpar returns have not been driven by poor corporate results, but rather a combination of currency effects and geopolitical risks depressing valuation multiples.

OUTLOOK

The global expansion hit a few bumps in the road this year, and an abundance of financial market volatility attests to that fact. Yet, we feel that growth around the world is sustainable through the end of this year and on into the next. In the U.S., fiscal stimulus is working its way through the system, which ought to support the economy in the near-term. Growth likely moderates from the current 4 percent pace, but isn't cause for concern. At 3.7 percent, unemployment is historically low which may limit upside in total job creation, but an expanding economy could push this rate down closer to 3 percent by the middle of 2019. Also, improving wages should keep consumer spending at healthy levels. Top line revenue growth exceeding expectations in combination with tax legislation has provided a major boost to corporate earnings. There's been quite a bit of navel-gazing in the media about firms' use of these profits to return cash to shareholders, often through share buybacks. Ostensibly, this return of cash is coming at the expense of investment in the underlying businesses and economy. However, the data doesn't necessarily bear this out. It is indeed true that a record amount of share buybacks has been announced this year, but capital expenditures are also up nearly 20 percent. In the current environment with a growing economy and solid earnings, there is plenty of room to both reward shareholders and invest for the future. And based off recent surveys that point to business confidence near cycle highs, it appears many companies are planning on doing just that.

The pace of expansion in international economies, Japan and Europe, in particular, has slowed relative to 2017, but it appears to be a return to a more normal growth rate rather than presaging any sort of downturn. Similar to the U.S., each region has seen better employment data and corporate earnings are heading in the right direction. Also, various trade issues seem to have been worked out between the U.S. and Europe for the time being, and Japan has largely avoided the Trump administration's ire on that front. The President has renewed his focus on China, which could potentially slow growth in the largest emerging economy. China is looking to counteract those effects with various stimulus measures including targeted loans and housing policy adjustments.

Our outlook is constructive on balance, however, there are a number of risks to this forecast. Most prominent among them is the progressively antagonistic relationship between the U.S. and China. The Trump administration announced more tariffs on Chinese imports, the value of which are set to increase in 2019, if no resolution is reached. While not our base case scenario, it's possible that these measures amount to around a 5 percent haircut to aggregate corporate earnings next year. We don't know if "winning" the trade war is the correct way to describe the situation, but the substantial outperformance of U.S. stocks versus Chinese shares this year may suggest to the President's economic team that they have the upper hand. Sticking with political risks, neither Britain nor Italy have much time left to settle their respective disputes with the EU. While we think each eventually gets worked out, the situations remain fluid. Two issues specific to the U.S. are the state of the housing market and monetary policy. New and existing sales, building permits, and housing starts are all down this year. A confluence of factors could be to blame including prices rising faster than overall inflation, a dearth of new supply, and more stringent mortgage rates. The U.S. economy is, of course, much more than just housing, and very well could power through much the same as it did during the energy downturn in 2014 and 2015. In regards to monetary policy, the Fed clearly wants to continue hiking interest rates. Now, we wouldn't classify the policy environment as restrictive in any way, but it is no longer the same tailwind it was when the federal funds rate was at 0 percent and quantitative easing was in progress.

These risks in mind, we believe that the U.S. and global economy are poised to extend this expansion. Corporate profits are up around the world, and recessions are almost always avoided when this is the case. Interest rates have risen which is a short-term headwind for bond returns, but will lead to higher yields on relatively safer fixed income investments going forward. Stock market valuations are higher than average by some measures in the U.S., but not extreme in our opinion. Comparatively cheaper equity options exist internationally. Further volatility in financial markets shouldn't come as a surprise to anyone, but the current environment is still generally supportive of asset prices. As always, we stand ready to adjust portfolios as needed.

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