Third Quarter 2018 Market Summary

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U.S. investors must have turned down the volume on the obligatory negative headlines from mass media during the quarter, as U.S. equities posted solid returns. Volatility in U.S. equities has been very low since June. For the quarter, the S&P 500 did not experience a single trading day with returns of +/- 1%. Investors are accepting as status quo the political headlines, continued U.S. economic growth, and the Federal Reserve raising interest rates. On the trade front, deals have been brokered between the United States and South Korea while NAFTA received a fresh makeover. A trade agreement with China has remained elusive as they work toward a solution in which both leaders can go back to their people and claim victory. While some market participants and corporations have felt the impact of the new tariffs, their overall economic consequences are undetermined at this point.

September marked the tenth anniversary of the Lehman Brothers collapse. Since that time, cautious optimism has pushed U.S. equities to record highs. Most recently, large U.S. companies have experienced the strongest revenue growth since 2011. As a result, these types of stocks were up 7.7% during the third quarter while small U.S. stocks were up 3.6%. Growth stocks, represented by sectors such as technology, continued to outperform value stocks, represented by sectors such as financials. Year-to-date, the U.S. economy and markets have been growing faster than those overseas. In addition, domestic interest rates have increased and are higher than most other regions around the world. This has led to capital flows to U.S. assets and a stronger U.S. dollar.

International stocks, represented by the MSCI ACWI ex US Index, were marginally up 0.7% for the quarter. Emerging market stocks, represented by the MSCI Emerging Markets Index, lagged and were down 1.1% for the quarter. Although international stocks outperformed U.S. stocks in 2017, this year they have faced headwinds due to the U.S. dollar appreciation and debt concerns in peripheral countries like Turkey and Argentina. As trade tensions ease and U.S. growth moderates relative to international markets, non-U.S. assets will likely recover.

For the quarter, the Barclays U.S. Aggregate Index, which represents a broad basket of bonds, was flat. Bond returns were mixed with some sectors posting positive returns, such as investment grade corporates and high yield. Other sectors, such as municipals and long dated taxable bonds, were down during the quarter. Interest rates moved higher, credit spreads generally narrowed and the yield curve flattened. In September, the Federal Reserve raised the Fed Funds rate 0.25%, for the third time this year, to a target range of 2.00% - 2.25%, which was widely expected.

The Fed continues to forecast an additional rate hike this year and three in 2019. Inflation is expected to slowly move higher as oil prices are now the highest in four years and wages keep increasing. This will likely put upward pressure on U.S. interest rates and allow the Fed to continue to raise rates. While bond prices have been hurt by rising rates over the past year, it is important to point out that intermediate-term bond funds now have yields of 3% - 5%. Therefore, on a go forward basis, interest income can better offset any further price declines. Furthermore, cash, that has essentially earned zero interest over the past half-decade, can now earn yields in excess of 2% through certain money market funds and even more through CDs.

As shown in the chart above, year-to-date, U.S. stocks have significantly outperformed both international stocks and fixed income markets. As a result, diversified portfolios have struggled to keep up with some of the most publicized indices, such as the Dow Jones Industrial and S&P 500, both of which are made-up solely of U.S. stocks. Nonetheless, maintaining a diversified approach remains a prudent approach for most investors, as U.S. stocks are not likely to continue indefinitely on their current trajectory. Furthermore, over the long-term, international and emerging market stocks offer compelling valuation opportunities while bonds provide greater stability in the event of a stock market correction.

Third Quarter 2018 Market Summary (continued)

As we enter the fourth quarter, the mid-term elections will garner a fair amount of attention. However, contrary to what some people believe, history has shown that the outcome of which party prevails during mid-term elections has very limited direct impact on equity market returns and thus should not dictate asset allocation decisions. Actually, regardless of which party prevails, historically the equities markets have rallied post mid-term elections as uncertainty subsides and investors focus on earnings. Longer-term, however, equity markets may be more challenged as the U.S. economy has been notably positive with exceptionally low unemployment, strong retail sales and consumer and business confidence near historic highs. Since markets tend to discount news in advance, the rate of change is often more important than the absolute level. As a result, expectations are likely to become harder to meet and higher interest rates will eventually cut into corporate profit margins.

Most recently, many market commentators have tried to describe the U.S. economy and overall markets by what "inning" we are in. While America's past time is a relatable metaphor, baseball is a sport with declining fan attendance, due in part to the increasing length of games. There is no shortage of stops and starts as relief pitchers are shuffled out of the bullpen and batters step out of the batter's box to obsessively adjust their batting gloves and helmet. Monetary and fiscal stimulus, through low interest rates, global central banks' asset purchases and then tax cuts, have prolonged the economic game. These accommodative policies originated out of necessity, but market participants have now come to expect the excessive support. This complacency indicates investors will remain in their seats to watch the cycle play out. We encourage our clients not to be mere spectators but to engage with us in reassessing their goals, risk tolerance and personal financial plans as these may have changed since the ceremonial first pitch.

HIGHLIGHTS

MACROECONOMICS

- The Bureau of Economic Analysis released the advanced estimate of third quarter 2018 real GDP, an annual rate increase of 3.5% from the preceding quarter. GDP growth was boosted by personal consumption; however, business investment and housing were weaker sequentially.
- The University of Michigan Consumer Sentiment Index final reading for September was 100.1, which was an increase from the second quarter. Consumer sentiment remains very strong.
- The ISM Manufacturing Index remained high during the quarter, finishing at 59.8 in September. Typically, when the ISM Index is above 55 it is bullish and when it is below 45 it is bearish.
- In September, the Conference Board Leading Economic Index increased 0.5% month-over-month to 111.8. The Index has shown steady economic growth over the past year.
- The price of WTI Crude Oil was $73.16 at the end of September, which is 1.3% lower than $74.13 at the end of June. The price of Brent Crude Oil increased 6.8% in the quarter to $82.72. The price of oil has now recovered to 2014 levels.
- In September, headline CPI increased 2.3% year-over-year, which is lower than the 2.9% realized in June. Core CPI, which does not include food and energy, had a 2.2% increase. Inflation is expected to remain contained but could drift higher as commodity prices and wages increase.

HOUSING

- The housing sector has been solid the past few years with increasing sales and rising home prices. However, over the past quarter or two the housing sector has softened as higher interest rates and home prices have caused affordability to decline.
- Preliminary existing home sales decreased in the quarter with a monthly average annualized rate of 5.27 million units from 5.41 million units in the second quarter. The September annualized rate is 4.1% lower than the 5.37 million units in September 2017. Unsold home supply remains at low levels.
- The preliminary existing home sale prices for September were 4.2% higher than the levels of one year ago. Prices have been trending up since the beginning of 2012 and are now higher than the previous peak in 2007.
- New home sales were weak during the quarter, down 0.6% on a year over year basis and they declined 9.6% vs. the second quarter 2018.
- S&P Case-Shiller 20-City Home Price Index (seasonally adjusted) showed home prices rose over 5.9% year-over-year in July. Of the locations in the Index, home prices in San Francisco, Seattle, Phoenix, Las Vegas, and Denver have risen the most since the 2009.

EMPLOYMENT

- The labor market has generally been healthy. The job growth rate has slowed slightly as employers are having difficulty finding workers with the required skills. Wages have moderately risen over the past few years.
- During the quarter, nonfarm payrolls averaged 190,000 jobs added per month, which is a solid level.
- The unemployment rate decrease to 3.7% during the quarter.
- Initial Jobless Claims have been decreasing since 2009 and dipped to lows last seen in 1969, reflecting a tight labor market.

DOMESTIC CORPORATIONS

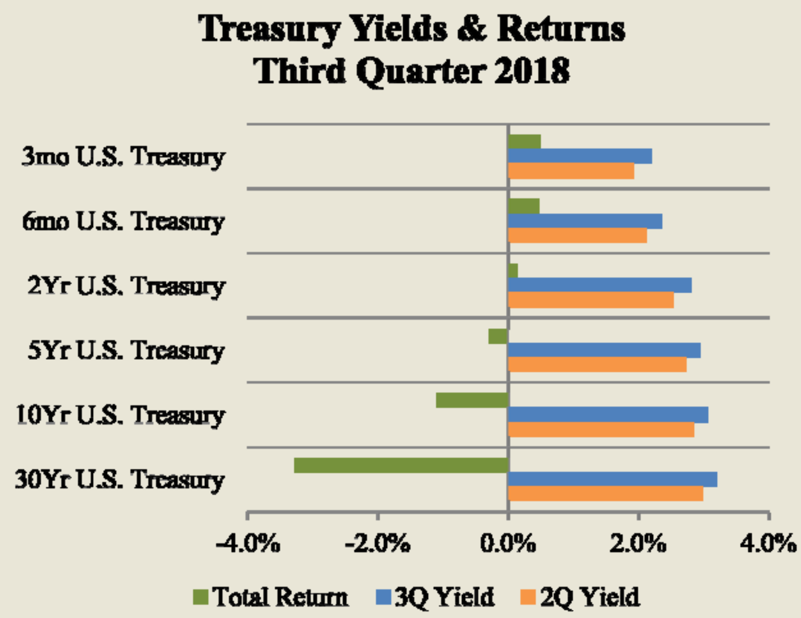
- Corporate operating earnings in the second quarter 2018 were much higher than the previous year. Estimates for the remainder of the year show very high levels of earnings growth. However, year over year comparisons get tougher in 2019 as we anniversary the tax reform act.
- Operating profit margins have increased over the past year and remain well above historical averages. Margins have benefitted from lower taxes but have yet to be pressured by increased interest rates nor wages inflation.
- With the recent volatility, U.S. equity forward P/E multiples have declined to historical averages while trailing P/E multiples remain above historical averages.

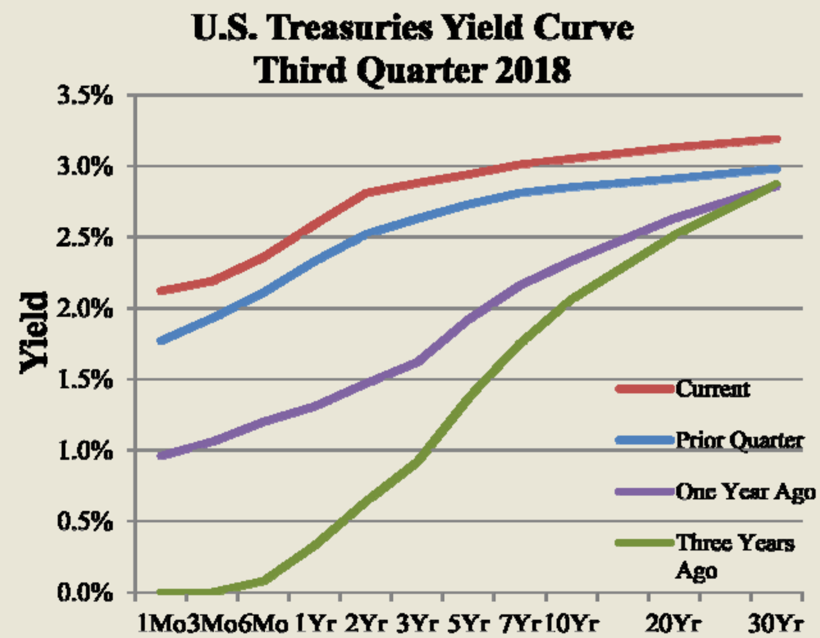
FED POLICY

- In September, the Federal Open Market Committee (FOMC) decided to raise the federal funds rate 0.25% to a target range of 2.00% - 2.25%, which was widely expected. The Fed noted U.S. economic growth is solid, the labor market continues to strengthen and inflation is near the Fed's target thus they continue to communicate their intentions of gradual tightening.
- The Fed is forecasting they expect to raise rates one more time in 2018 and three expected rate hikes in 2019. The federal funds rate remains below the Fed's target "neutral rate", which is the rate that monetary policy is neither accommodating nor restricting economic growth. The general view is the Fed wants to get the federal funds rate to neutral, prior to a recession. If they were able to accomplish this task, the Fed would have the monetary tool of lowering rates to stimulate the economy.
- The unwinding of the Fed's balance sheet may put upward pressure on interest rates and financing costs for corporations and consumers.

FIXED INCOME

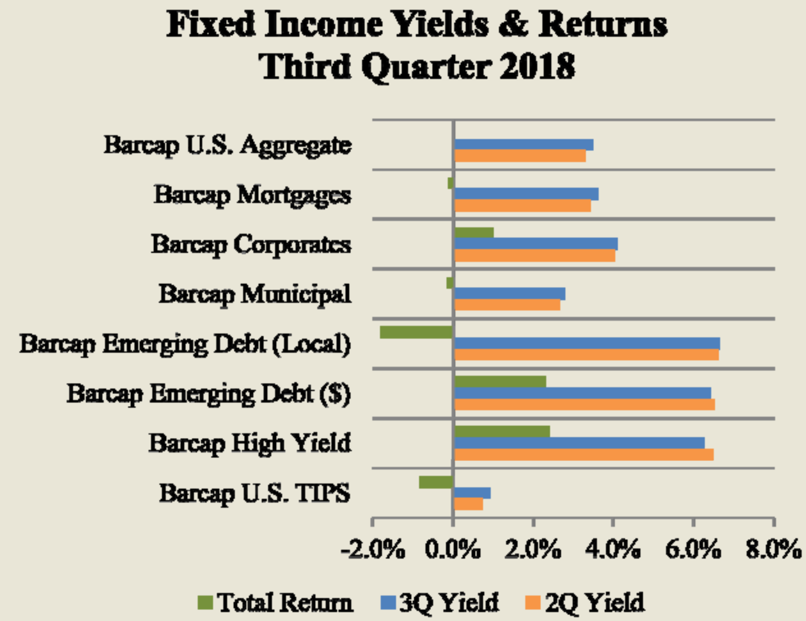
- Interest rates across the yield curve increased during the third quarter. The short end of the curve rose more than long-term yields causing the yield curve to flatten. Short-term interest rates are controlled or heavily influenced by central banks where as long term interest rates are controlled by market forces and economic growth.
- The yield on two year Treasury notes are the highest they have been since 2008.
- The U.S. Treasury yield curve continues to flatten. The 2-Yr. to 10-Yr. Treasury spread is the lowest it has been since prior to the financial crisis in 2007. Historically, the yield curve has flattened as the Fed raises interest rates and the business cycle matures. The yield curve is viewed as a recession indicator as it has inverted typically a year prior to the majority of the U.S. recessions over the past 50 years. However, the yield curve can remain relatively flat for extended periods without inverting, such was the case in the mid-1990s.

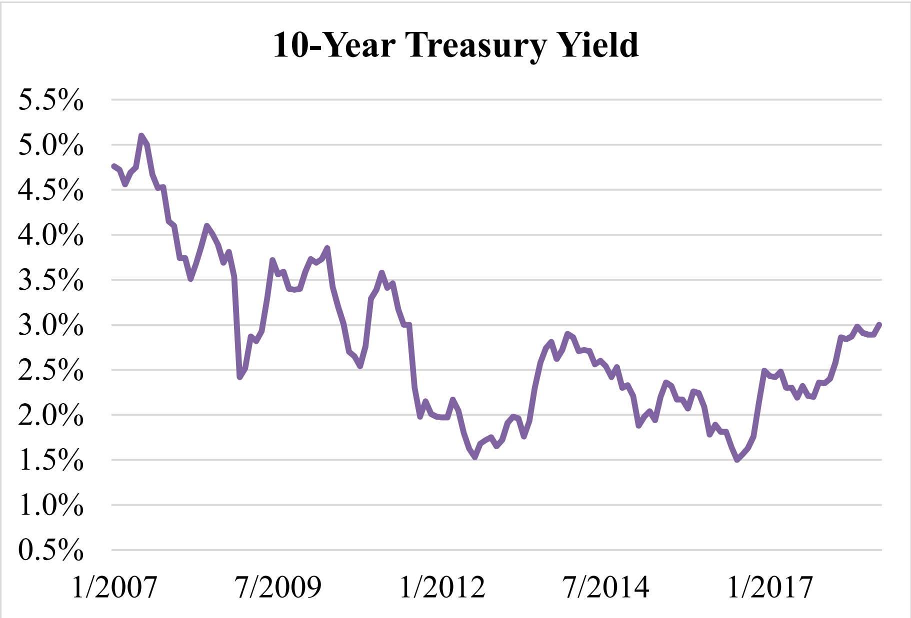


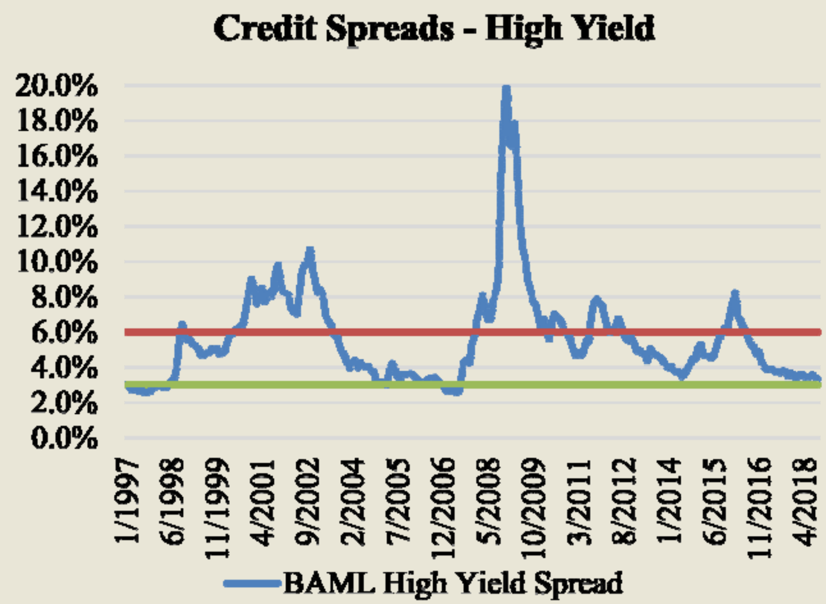


FIXED INCOME (continued)

- During the quarter, returns across fixed income sectors were mixed, with the Barclays U.S. Aggregate essentially flat. Corporate, high yield and dollar denominated emerging market debt performed well while local emerging market debt posted negative returns due to emerging market currency depreciation.
- Evidence of late cycle indicators are appearing such as poor valuations, weakening credit standards, and high leverage in corporate and consumer balance sheets. Rising interest rates and higher funding costs will create problems for companies with weak balance sheets. While these will be concerns going forward, credit spreads remain low currently.
- Fixed income returns have been challenged during the year as interest rates have risen to multi-year highs. Nonetheless, fixed income remains an important part of a diversified portfolio as it provides stability when equity markets decline.

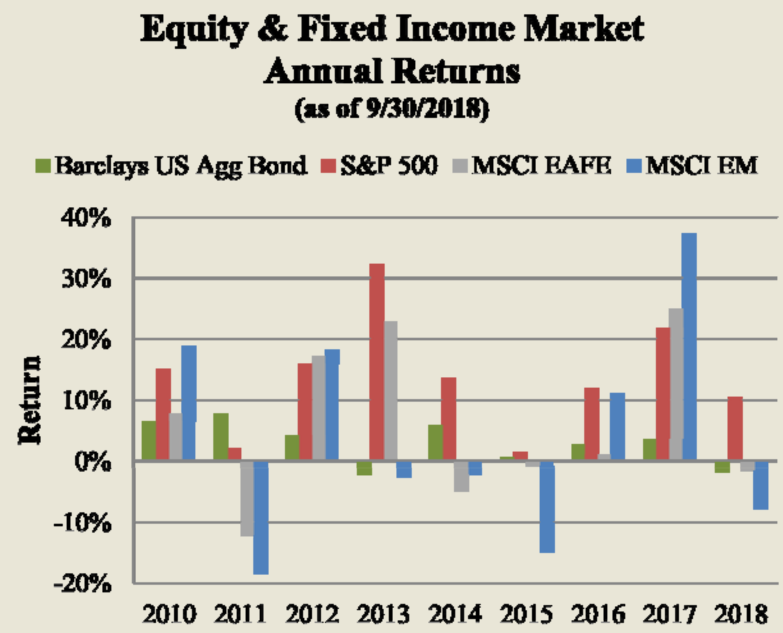


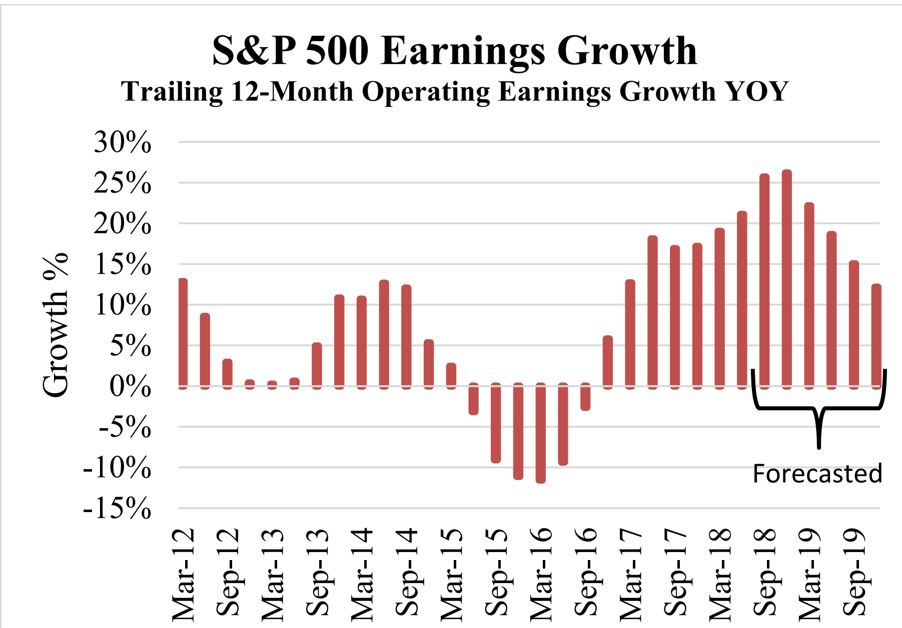


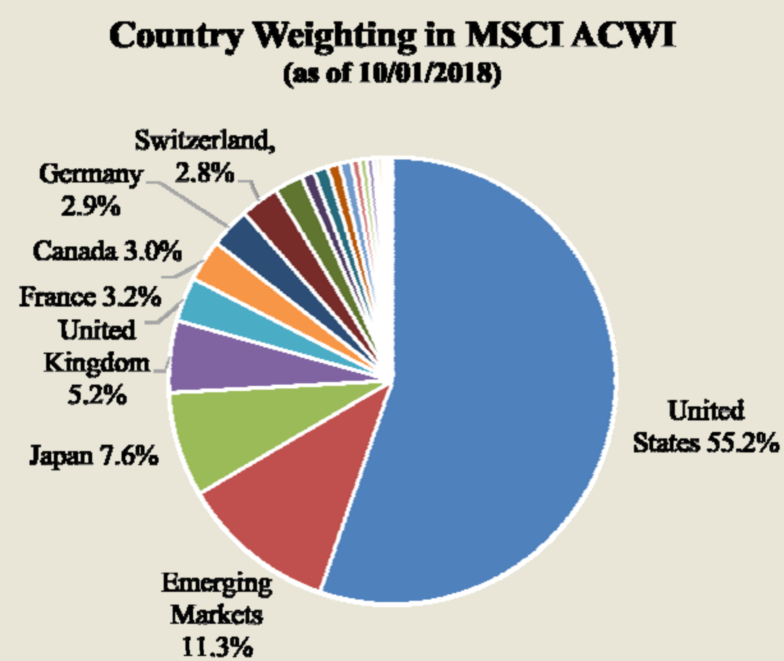


EQUITIES

- Globally, corporate earnings growth has remained solid, especially in the U.S. as lower tax rates provided a boost. Despite growth, economic indicators in Europe and Asia have negatively surprised relative to expectations during the past six months. This has led, in part, to a divergence in equity performance between the U.S. and the rest of the world.
- During the third quarter, the S&P 500 Index had one of its highest quarterly returns in the past five years. The current bull market is now the longest in US. Equity market history. Looking forward, many economic and market indicators are at highs which makes meeting or surpassing expectations difficult. Investor psychology will surely be tested during the fourth quarter as we roll off peak fundamentals and geopolitical risks remain.

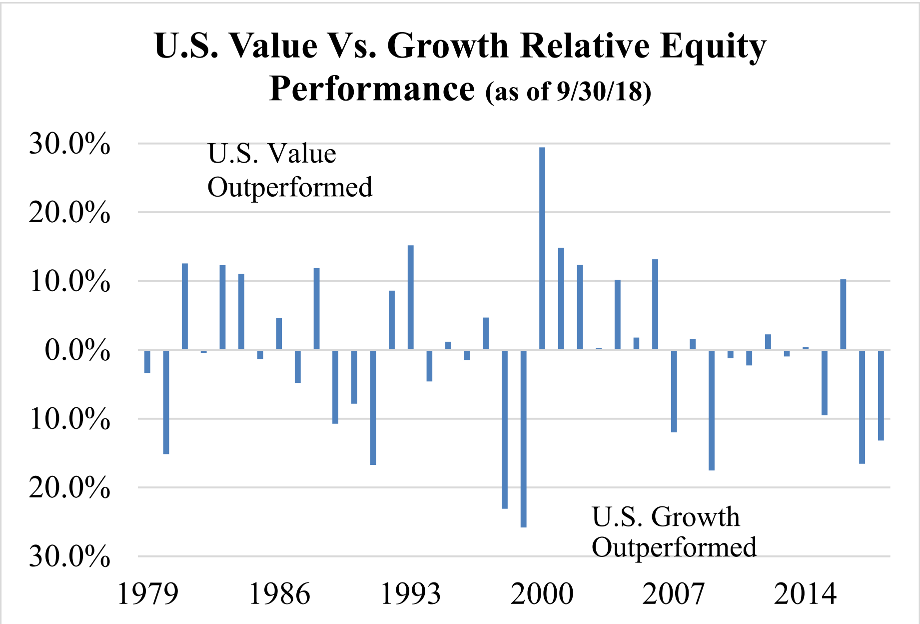






DOMESTIC EQUITIES (continued)

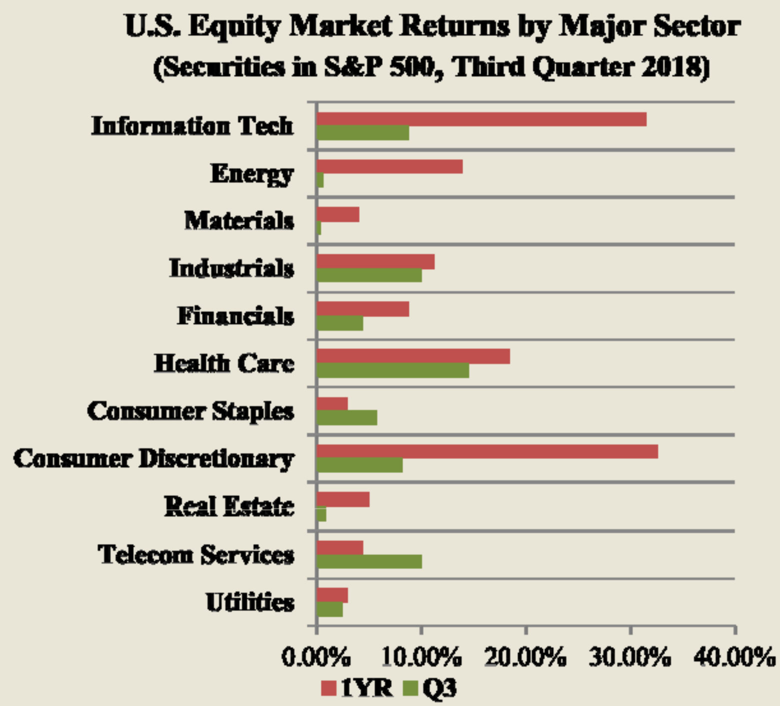
- The Russell 1000 Index, comprised of large and mid-capitalization stocks, posted a total return of 7.4% during the third quarter. On a year-over-year basis, the Russell 1000 Index has increased 17.8%.
- Small capitalization stocks, as represented by the Russell 2000 Index, posted a total return of 3.6% during the third quarter. On a year-over-year basis, the index has increased 15.2%. Higher interest rates hurt small caps as they tend to have more debt compared to large caps.
- Volatility was very low during the third quarter. Growth companies continued to lead the market, specifically technology and health care companies. The gap in returns between U.S. growth equities vs. U.S value equities is the widest it has been in 17 years as growth continues to outperform value.



Russell 1000 Growth TR vs. Russell 1000 Value TR

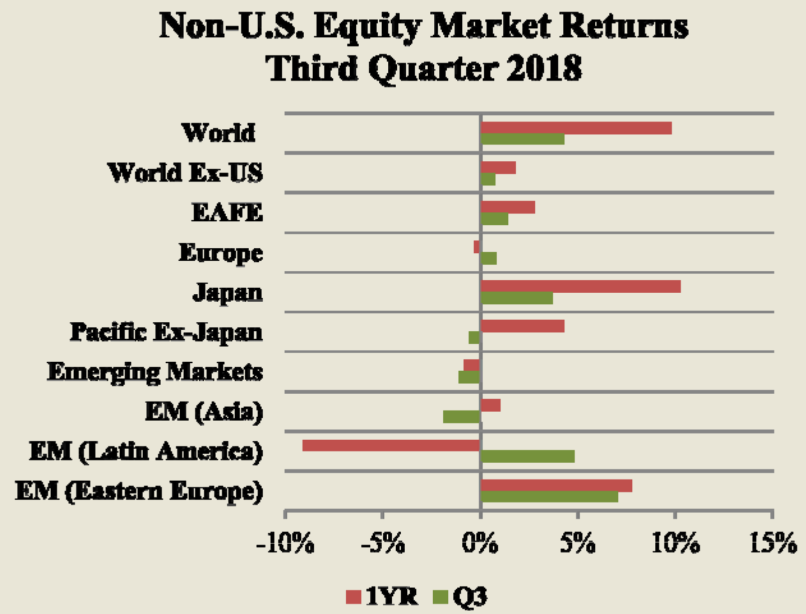
Third Quarter 2018 Returns

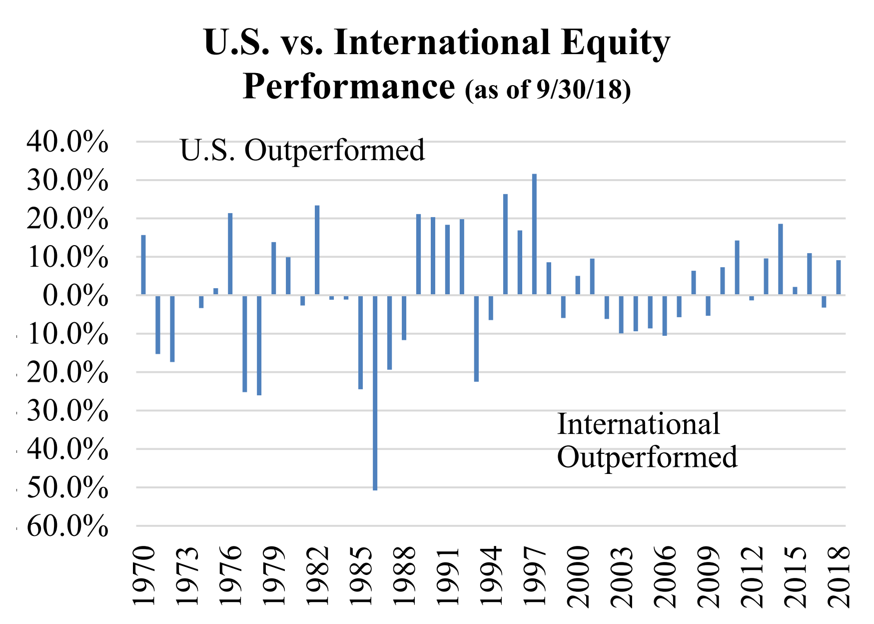
	Value	Core	Growth
Mega Cap		4.2%	
Large Cap	5.7%	7.4%	9.2%
Mid Cap	3.3%	5.0%	7.6%
Small Cap	1.6%	3.6%	5.5%
Micro Cap	-1.3%	0.8%	3.2%



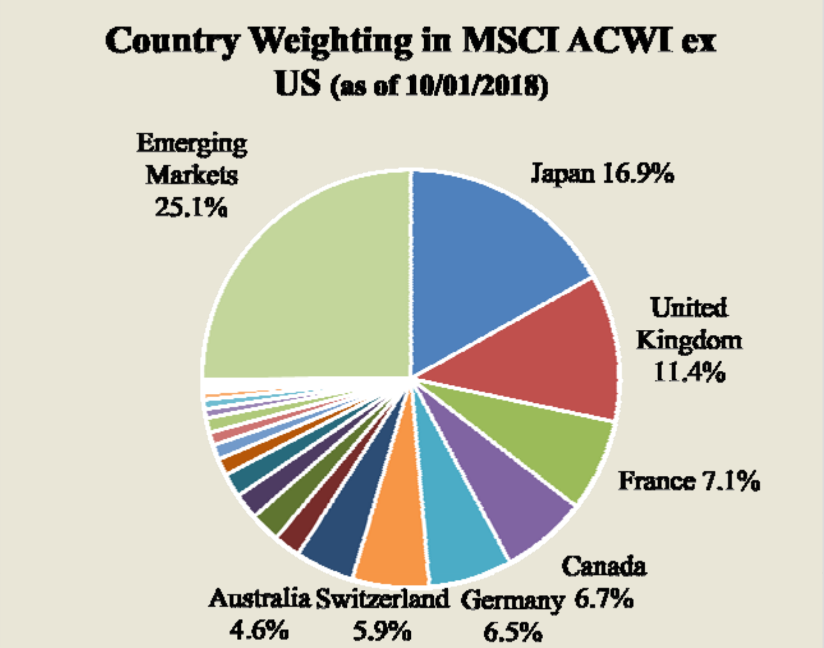
INTERNATIONAL EQUITIES (continued)

- Developed international stocks, as represented by the MSCI EAFE, were up 1.4% during the quarter. On a year-over-year basis, the EAFE is up 2.7%, performing worse than U.S. domestic equities. Brexit negotiations, Italy's budget issues and lower global trade have pressured international returns.
- Emerging market stocks underperformed developed markets during the third quarter as the MSCI Emerging Markets Index decreased 1.1%. A strong U.S. dollar and the ongoing trade dispute between the U.S. and China has weighed on emerging market equities. The emerging markets index is now down over 20% since its peak in January.





S&P 500 TR vs. MSCI EAFE NR



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