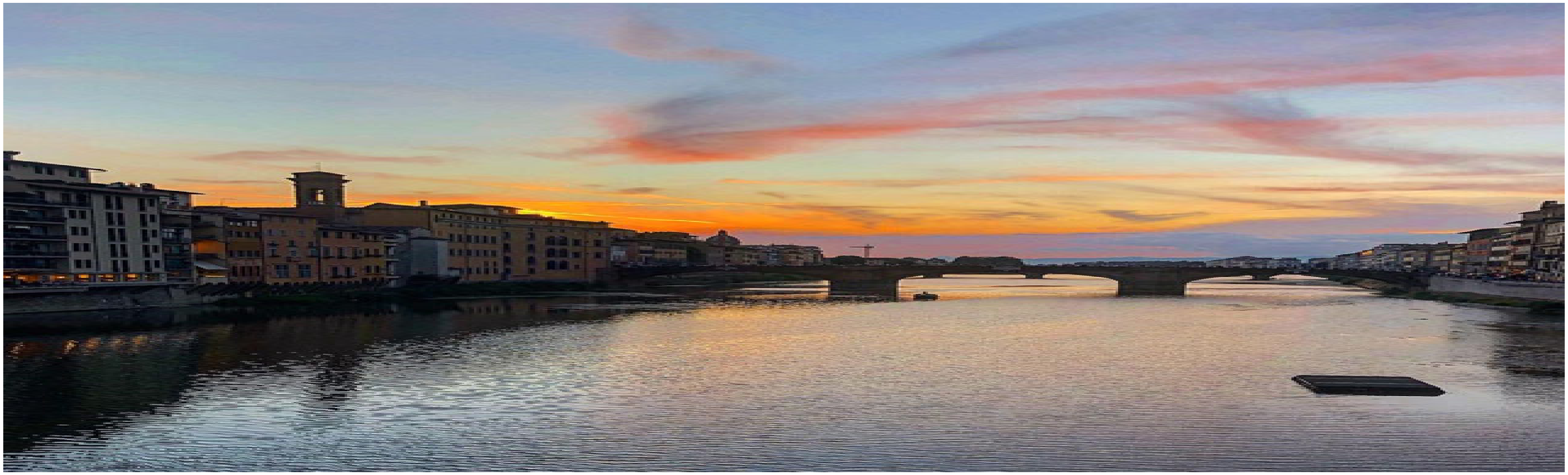


Photography: Jimmy Pickert - Italy 2018

Quarterly Update & Economic Commentary—September 30, 2018

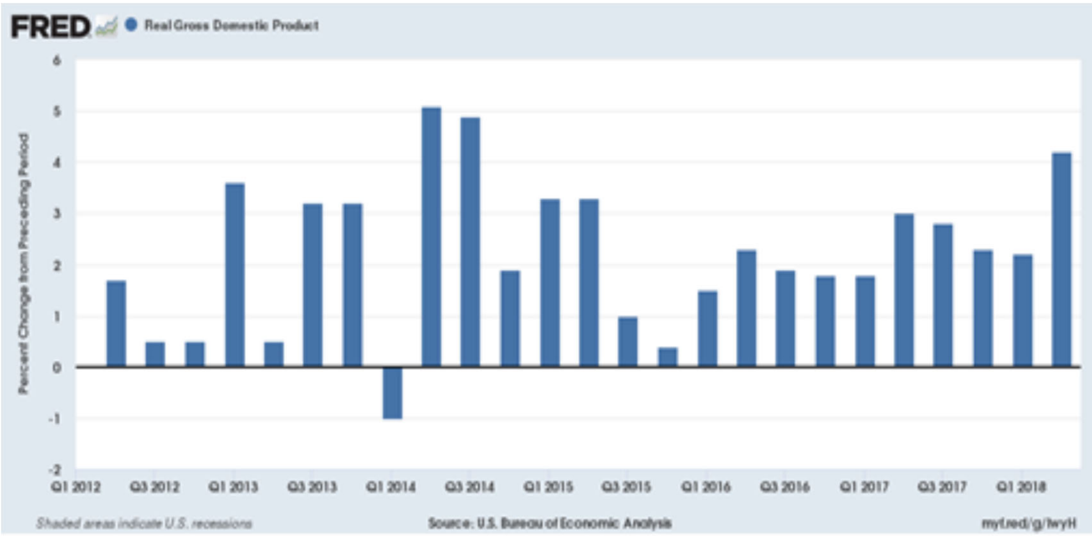
QUARTER IN REVIEW

The third quarter was a strong quarter for the S&P 500. The index's total return of 7.71 percent was its best quarterly return since the fourth quarter of 2013. The index was led by the Health Care sector (14.53 percent) and Industrial sector (10 percent). Domestic small cap companies did not do as well as large cap companies but still had a good quarter. The S&P SmallCap 600 TR index returned 4.71 percent during the quarter. Domestic small cap stocks are outperforming large cap stocks for the year; small cap stocks are positive by 14.54 percent while large cap stocks are positive by 10.56 percent.

Developed international markets had a positive quarter (1.35 percent) while emerging markets suffered its third straight negative quarter, down 1.09 percent. Both developed and emerging market indexes are negative year-to-date; the developed index is off 1.43 percent while the emerging market index is off 7.68 percent. The strengthening U.S. dollar has been a major headwind to international market returns. In local currency terms, the developed market index is positive by over two percent while the emerging market index is off by 2.86 percent.

Core bond positions were essentially flat for the quarter but remain negative year-to-date. The yield on the 10-year Treasury bond jumped 21 basis points during the quarter and is up 65 basis points so far this year. The yield ended the quarter at 3.05 percent. Low quality bonds, referred to as high yield bonds had a good quarter. The BBgBarc US Corporate High Yield index finished the quarter positive by 2.40 percent and is positive by 2.57 percent for the year. Rising yields also means rising lending rates. As of the end of the quarter, the average rate on a 30-year fixed mortgage was 4.97 percent compared to 4.22 percent at the beginning of the year and 4.11 percent from a year ago.

The third quarter got off to a great start as the market rallied on a solid corporate earnings season. Based on FactSet's numbers, earnings of S&P 500 companies grew at pace of 25 percent, the best earnings growth rate since the third quarter of 2010. Of all of the companies reporting earnings in the S&P 500, a record 80 percent issued earnings that exceeded analyst expectations. Corporate earnings are a driver of the stock market returns.



As a whole, other economic readings were also very positive. The economy grew at a pace above four percent, a growth level not seen since the third quarter of 2014. The unemployment rate continues to hover around four percent and wages continue to climb higher. Inflation readings are reaching the Federal Reserve's targets. Headline CPI is about 2.7 percent while Core CPI which excludes food and energy is running at about 2.2 percent. The Federal Reserve tends to follow the PCE (Personal Consumption Expenditure) measure, which is currently at about 2.2 percent for headline and 2.0 percent for core.

The Fed raised rates again in September as expected by the markets. They also dropped the word "accommodative" when describing the Fed's policy stance. The Fed continues to believe that the economy is strong and plans to stay on the current path of future rate hikes. The Fed continues to act rationally and transparently which the markets appreciate. The only headline news related to the Fed was President Trump expressing his disagreement with the Fed's decision to hike interest rates. The President and the Fed are independent, although the President continues to voice his wishes over social media or during press conferences.

Trade and tariffs have been some of the most discussed terms over the past six to nine months. FactSet reported that during second quarter earnings conference calls, the word "tariff" was mentioned at least once during 179 conference calls. Trump has been talking about unfair trade deals since the campaign trail, like most presidential candidates, but he was the first to really push the issue once getting into office. It has been unconventional and sometimes uncomfortable for Americans but he got his first victory at the end of September when it was announced that Canada had agreed to join the previously negotiated deal with Mexico and the United States. As of this writing the deal lacks details (the actual signing is not scheduled until December 1), but the important consideration is the preservation of a trade relationship. The new United States-Mexico-Canada Agreement as it will now be called, is similar to the original NAFTA deal but with changes that benefit all three countries, however with a relative edge to the U.S. The deal gives the market hope that the President's bark is bigger than his bite.

The Chinese stock market and economy is being negatively impacted by the Trump-imposed tariffs. The President and his team see the impact and continue to put additional tariffs on Chinese goods, despite the Chinese's willingness to hold trade discussions. The Chinese cancelled a scheduled meeting between the two leaders after the President added additional tariffs. The escalation of the trade wars is a negative for both countries but much worse for China.

A LOOK AT THE NUMBERS

Name	Third Quarter Performance (%)	YTD Performance (%0)
DJ Industrial Average TR USD	9.63	8.83
S&P 500 TR USD	7.71	10.56
S&P MidCap 400 TR	3.86	7.49
S&P SmallCap 600 TR USD	4.71	14.54
NASDAQ Composite TR USD	7.41	17.48
MSCI EAFE NR USD	1.35	-1.43
BBgBarc US Agg Bond TR USD	0.02	-1.60
Wilshire US REIT TR USD	0.72	2.25
IA SBBI US 30 Day TBill TR USD	0.48	1.24

FORECAST IN BRIEF

The markets will try to finish off the year on strong footing after what has been a strong year through three quarters.

A catalyst for finishing the year on a strong note could be the strength of the consumer and holiday shopping. The combination of a strong jobs environment, tepid inflation, higher wages and all-time high consumer net worth should lead to a strong fourth quarter for retail companies. The National Retail Foundation is expecting higher holiday shopping growth than the average of the past five years but slightly slower growth than what was observed last year.

The Fed will have two meetings during the fourth quarter. The November meeting is not expected to bring any changes to interest rates, but the December meeting has an 82 percent probability of another rate hike as of September 27th, according the CME FedWatch Tool. The Fed continues normalization of interest rate policy and the Fed believes the economy is strong enough to withstand further increases. As long as the long end of the yield curve continues to rise at a faster pace than the Fed influenced short-end, the Fed should not dramatically slow economic growth. However, if the long-end increases too fast, lending rates for products like mortgages will also increase quickly, ultimately hurting areas of the economic sectors that depend on lending, like housing.

The mid-term elections will be held in early November. Campaign ads will be all over radio and television commercials, and the nighttime news will be providing nonstop coverage. We are still a number of weeks away from the actual election but it is projected that the Democrats will take over the House while Republicans will keep the Senate. Should Democrats take both the House and Senate, markets would likely sell-off briefly due to expectations around impeachment. But once the dust settles we don't believe there will be significant impact from a divided government.

The trade discussions will be another closely watched item. The new USMCA is expected to be signed on December 1st. It will be important for the markets to actually see the details and ensure that the deal is signed as expected. Based on past actions, it is expected that President Trump will continue to put pressure on China in the form of tariffs, but it will be important to watch if the Chinese decide to counter with non-trade related actions, like selling U.S. Treasury debt. An elevated trade war could put pressure on the economy, especially for China, but how long they are willing to let it go on is a major question. Trade deals with Europe and the U.K. will also be necessary but any trade talks with Britain may have to wait until after the separation from the European Union.

Another story to follow during the fourth quarter is the price of oil. Oil prices have been steadily climbing over the past year. With global economic growth expected to continue, the demand for oil should remain strong. Supply may be hurt by Iranian oil coming off market after the U.S. pulled out of the Iran nuclear deal and reestablished sanctions. While the U.S. may have the oil in the ground, it still lacks the infrastructure to move oil around efficiently. If OPEC does not increase its supply as expected, you could see oil prices continue to steadily move higher.

As we close out this quarter's commentary, we will take a moment to discuss expectations for returns for this year. The headline equity returns look good; both large cap and small cap broad indexes are positive by over double-digits. But when investing for long-term success you typically should have a diversified portfolio, because if you don't you may expose yourself to more risk than might otherwise be prudent or necessary. In a diversified portfolio, you may own fixed income, international stocks or value stocks. All three of these sectors are performing noticeably worse than the S&P 500. Core fixed income is slightly negative, the all-cap world index ex-US is negative by around three percent and the large cap value index is only positive by around three percent. Depending on your risk tolerance, these asset classes may predominate your portfolio. In a year like this, with riskier equities leading the pack and with rising interest rates hurting fixed income, more conservatively-positioned portfolios will have lackluster performance. We understand this is frustrating, but it's critical to remember why you're invested this way: to preserve your capital more effectively when markets sell off. We strongly discourage our clients in conservative portfolios from chasing the returns they see in the headlines and losing sight of their goals and the timeline surrounding those goals.

If anything has changed with your financial picture that may affect your investment strategy, please let us know so we can make any necessary changes.

— Robert Moyer, CFA, CFP®, CAIA

Director of Research

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