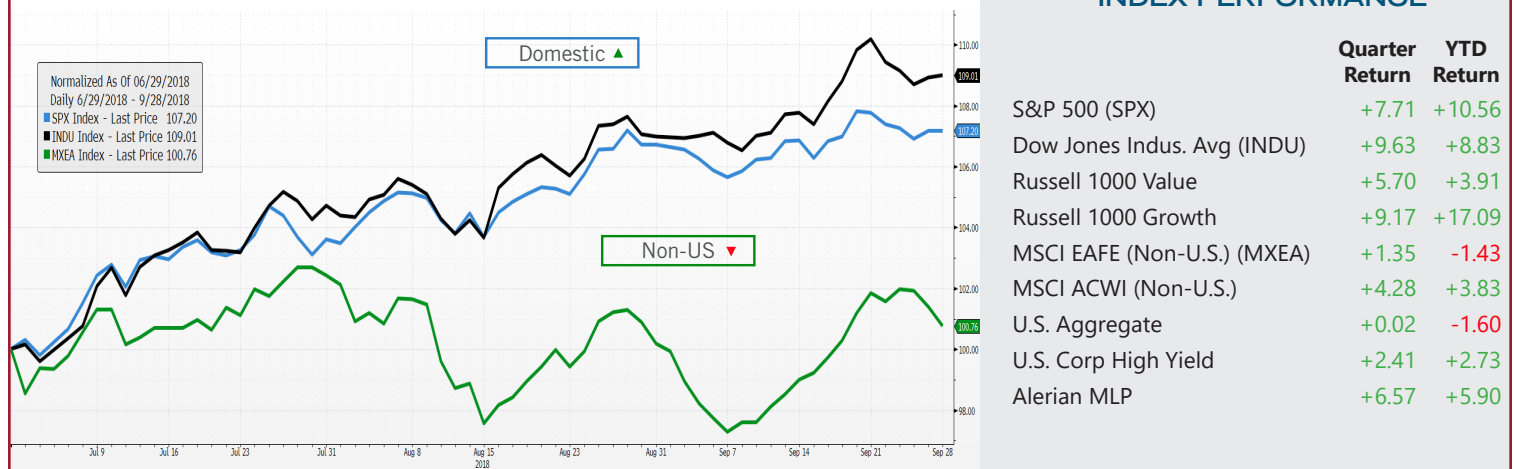




Q4 2018 Quarterly Newsletter

WHERE IS MY PARADIGM?

Chart 1. Index Performance Q3 2018

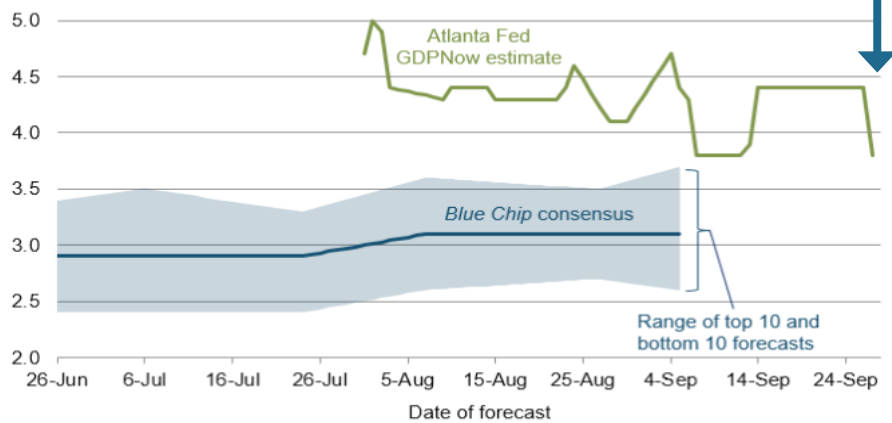


Source: 2018 Bloomberg Finance L.P.

Mohamed El-Erian and his former PIMCO colleagues coined the term “New Normal” in 2009 after the 2008 Financial Crisis. He seems to have recently abandoned the term and the paradigm. The New Normal was roughly defined as a prolonged period of stagnant growth, political gridlock and increased regulation. In a recent article published by Bloomberg, El-Erian who is now Allianz’ chief economic adviser, believes the world’s largest economy has finally broken out from its post-crisis melancholy. “The US on a standalone basis has exited this New Normal, is now finding a higher growth (GDP Growth) equilibrium, 2.5% to 3%.”¹

The U.S. gross domestic product (GDP) rose by 4.1% quarter-on-quarter from April through June 2018 at a seasonally adjusted annualized rate, its fastest pace of growth since 2014. This is enough to put the economy on track for average growth of 3%. With this, we believe the stage is set for sustainable economic growth. Moreover, the Atlanta Fed’s GDP Now Estimate puts the 3Q 2018 real GDP estimate at 3.8%, down from 4.4% but still above consensus and robust in our opinion (See Chart 2 on next page). According to El-Erian, labor force participation is expected to rise while the unemployment rate remains low. This combination means the Fed can “safely raise rates” without fearing it will choke off activity. “We may well have a situation where things come together,” he said. “The disruption to that comes from the outside, not within the U.S.”²

Chart 2. Evolution of Atlanta Fed GDPNow real GDP Estimate for 2018: Q3



Sources: Blue Chip Economic Indicators and Blue Chip Financial Forecasts
 Note: The top (bottom) 10 forecast is an average of the highest (lowest) 10 forecasts in the Blue Chip survey.

With the New Normal in our rear-view mirror, the new paradigm will be more about a return to economic growth, divergence of returns, stock picking, and once again quality will count. In this new period of transition, our investment process will continue to include quantitative and fundamental analysis, factoring in macro themes such as Fed policy changes, political changes, and market changes, among others.

FED POLICY CHANGES

Fed Chairman Powell has begun making broad changes to Fed policy. This is evident in the most recent Fed announcement where he removed the phrase “accommodative.”³ There have been other changes as well that depart from the policies of the previous two Fed Chairs. For example, Powell is a skeptic on the Dot Plot and a fan of Greenspan who was much less data driven and tended to be more instinctive and less transparent than former Chairs Bernanke or Yellen. According to Bloomberg, his speech at Jackson Hole shortly after he took over as Chairman, was almost a tribute to Greenspan. And, while we do believe the Fed will continue to be data dependent, it will perhaps be less than in the past.

The “normal” that will be important is the normal, or formally, the neutral rate of interest. The neutral rate provides an important benchmark for policymakers to compare with the market rate. When interest rates are neutral the economy is on a balanced path, and it is deviations from neutrality that cause disruptions in the economic cycle. If the Fed can get the rate policy correct and find that normal rate without overshooting, the current positive trajectory can be maintained. In our opinion, the economy has reached escape velocity, and if we avoid any fiscal and monetary policy missteps, then current growth can continue. The current Dot Plot data and Fed governor comments put that rate at 3%-3.5%. To arrive at that neutral rate, we should expect 2 - 3 more rate hikes.

POLITICAL CHANGES

Just as change is occurring in Fed policy and leadership, it is similarly occurring in governmental and fiscal policies. Lower taxes and less regulation are both very supportive of long-term growth. President Trump’s policies, for the most part, are pro-growth. That said, we continue to observe his protectionist leanings and are closely watching trade developments, as well as other potential issues that could cause us to shift our view. The mid-term elections could play a large part in re-shaping, for good or bad, some of these potential policies such as infrastructure spending or further tax-reform. There is always the potential for unseen or low probability shocks from the mid-east or North Korea, but the market climbs a wall of worry with a foundation of what-ifs. We call that noise and choose to focus on the data.

MARKET CHANGES

The continued growth and divergence of market performance between the best and worst performing stocks, sectors, and asset classes will drive risk and return going forward. We believe this will fuel the return of stock picking and active management during the next phase of the US market cycle. Growth stocks will likely lead, although we think the relative performance will become more muted, whereas Value stocks will start to pick up pace. Historically, when value and dividend stocks take over it is a strong signal that we are approaching the last phase of the market cycle. The length of the final phase will depend on the effectiveness of monetary and fixed policy, and any potential exogenous shocks.

US MACRO REVIEW

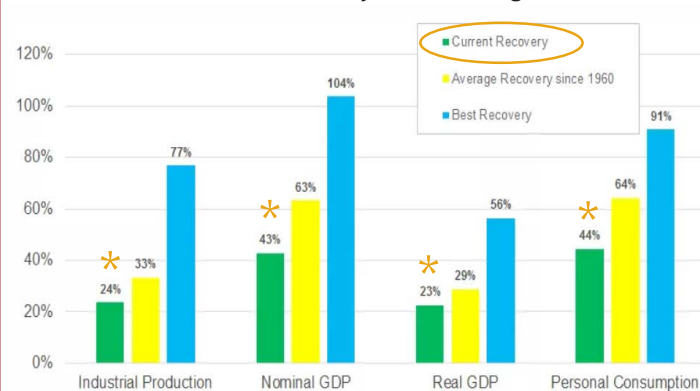
Given our strong reliance on research and data-driven decisions, we frequently find ourselves challenging conventional wisdom. Recently, there has been plenty of talk about the length of the economic expansion and the age of the current bull market. While this is notable, we prefer to look beyond one-dimensional themes. Instead of only considering *time* in this case, let us also consider *magnitude*. According to the National Bureau of Economics Research (NBER) the current economic expansion began in January 2009 and is 111 months old. In a recent article on the Enterprising Investor blog, Mark Armbruster, CFA gives some interesting perspective. He asks, “**could the present bull run simply die of old age?...**” No one has been able to consistently predict the length and magnitude of business cycles, but there is a strong case to be made for significant further growth. Many have noted that the current expansion has been weaker than historical recoveries. Indeed, despite its august age, the present expansion lags behind the mean.”

Chart 3 compares the current recovery to the average since 1960, as well as the best recovery over that same time period; the one that ran from February 1961 to

December 1969. This recovery has been long in duration, but when we look at the magnitude of the current recovery, which has been weaker, it looks like we still have some opportunity for further growth.

While the US stock market has experienced a lengthy bull run, market bears cite this and other reasons such as valuation and magnitude as major concerns. The length of the bull market is one of the most commonly cited reasons for worry, but according to Bloomberg the data since WWII shows that the two prior bull markets (1949-1968 and 1982-2000) lasted 19 and 18 years respectively. If history is an indicator, the current bull market which started at the market low of 2000, might only be at its halfway point. The post-World War II bull resulted in a 665% price gain versus the 1,150% surge during the 1980-90s; well above the current 325% S&P 500 advance since the March 2009 low.⁴ (See Chart 4)

Chart 3. Current Economic Recovery vs. The Average and Best



Source: 2018 Bloomberg Finance L.P.

Chart 4. Current S&P Price/Earnings: Historical Perspective

The current price to earnings of S&P 500 companies stands only slightly above the 20 year average



Source: 2018 Bloomberg Finance L.P.

INTERNATIONAL MACRO REVIEW

Despite some negative short-term forces at play, we remain positive on international markets and we believe that most of the damage appears to be in the rear-view window. That said, business activity in Europe has slowed on account of higher tariffs imposed by the US, along with the natural softening of demand from both the EU and China. Additionally, we have seen the European financial system come under pressure as financial problems within Argentina and Turkey have weakened banks in France and Spain due to the origination of loans to those countries. The International Monetary Fund (IMF) has had to step in to assist Argentina from defaulting on their debt and recently raised their credit-line to shore up investor confidence. Despite all of this, ECB President Mario Draghi strengthened his message on inflation, saying he sees a “relatively vigorous” pickup in underlying Euro-area inflation, signaling that the ECB is well on track to raise interest rates late next year.⁵

BREXIT - As Brexit negotiations continue, one thing is certain. There continues to be ambiguity surrounding the breakup with the following developments coming to light:

- EU leaders bluntly rejected Theresa May’s Brexit blueprint.
- Top Brexit leaders David Davis and Boris Johnson both resigned.
- The UK faces growth of 1% this year, although some suspect in the final outcome the EU will avoid placing hard trade measures on the country as both sides would be hurt in their already vulnerable state.
- The UK will continue to work on their border and travel controls as whispers out of London say they will do everything they can to avoid a hard-Irish border.

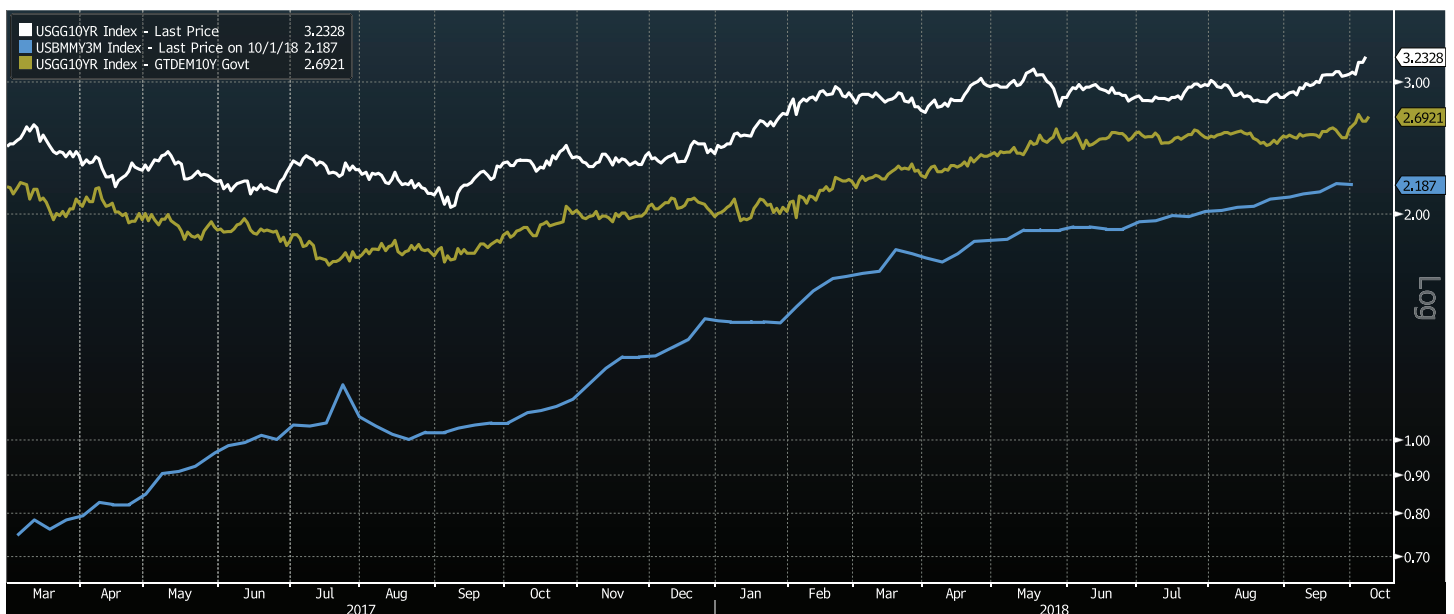
EMERGING MARKETS - The strengthening United States Dollar has created problems within emerging markets and has weighed on overall world GDP growth. Some countries remain more exposed than others as investors worry over tariffs, US Fed policy, and the stronger USD. After peaking in January, emerging market equities entered bear market territory in early September. Since 2008 there have been multiple periods when the EM Index has declined by 20% or more, this according to Byron Wein of Blackstone. Despite the pullback of long-term growth prospects, current valuations are difficult to ignore. According to Wein, “valuations would, however, argue that the market has discounted a significant portion of the risk to the entire group: the forward price to earnings ratio of EM is around 10.6 today compared to an average P/E of 13.2 since 2000. This time last year the P/E was over 500 basis points higher. Historically, a valuation at these levels or lower tends to be fairly good for EM returns, averaging about 21.2% twelve months later vs. approximately 14.1% for all rolling 12-month periods inclusive of dividends.”

ASSET ALLOCATION REVIEW & OUTLOOK

The Fed is tightening monetary policy by raising short term rates and shrinking their balance sheet. This activity begs the question - How has the Fed's policy affected current financial conditions in the US? As measured by the Bloomberg US Financial Conditions Index, US financial conditions are as accommodative as they have been at any time during the last 20 years.

Financial conditions remain accommodative primarily due to the actions of other central banks, mainly the European Central Bank (ECB) and the Bank of Japan (BOJ). These central banks are just starting to scale back on their own bond buying programs (QE) and likely will not raise interest rates until mid-2019 at the earliest. This contrast in central bank behavior creates an international demand for U.S. government bonds, simply because yields are much higher than the comparable bonds in the EU and Japan. The effects of this can be seen in Chart 5. While the yields on a 3-month U.S. Treasury Bill (blue line) have steadily increased as the Fed has boosted short-term interest rates, the rates on the 10-year U.S. bond (white line) have risen even more slowly. The middle (gold) line on the charts represents the spread or carry earned by shorting the German 10-year bund and buying the U.S. 10-year bond. This has the effect of boosting prices and restraining yield on the longer dated U.S. bond, and therefore keeping monetary conditions accommodative. This may also have an effect on high yield spreads as the available liquidity can help to compress those spreads, but this is not without risk. Just as this condition has been very helpful to the U.S., allowing the Fed to raise interest rates without hurting the economy or depressing financial asset prices, the reverse could occur when the ECB and BOJ terminate their QE programs and begin to raise interest rates overseas.

Chart 5. U.S. 10-Year Bond vs. 3-Month T-Bill vs. 10-Year U.S. Bond/German Bund Spread



Source: 2018 Bloomberg Finance L.P.

ALLOCATION OUTLOOK

Looking ahead in the Fixed Income space, we advocate an underweight in duration and a cautious exposure to credit spreads. In practice, this means exposure to areas such as short-term and floating rate securities. As interest rates continue to rise, we think these allocations should continue to outperform the U.S. bond market as measured by the Barclays AGG Index. In equities, we continue to monitor financial conditions and market returns to determine our best asset allocation. Relative to benchmarks, we recommend allocation that are slightly overweight equities in general (relative to fixed income), overweight U.S. equities, and overweight small/mid-cap equities. Conversely, we recommend underweight allocating Europe and Emerging Markets, although we are closely watching these areas for opportunities as valuations in many of these markets have become inexpensive.

THANK YOU!

Investment Committee

IMPORTANT INFORMATION

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. The economic forecasts set forth above may not develop as predicted and there can be no guarantee that strategies promoted will be successful. All performance referenced is historical and is no guarantee of future results. No strategy including asset allocation assures success or protects against loss. All indices are unmanaged and may not be invested into directly.

Stock investing involves risk including loss of principal. Value investments can perform differently from the markets as a whole. They can remain undervalued by the market for long periods of time.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

The Standard & Poor's 500 index is a market capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The MSCI World ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries--excluding the United States. With over 1,000 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The CBOE Volatility Index® (VIX®) is meant to be forward looking, showing the market's expectation of 30-day volatility in either direction, and is considered by many to be a barometer of investor sentiment and market volatility, commonly referred to as "Investor Fear Gauge".

The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the Nasdaq. Price-weighted means stocks with higher share prices are given a greater weight in the index. The DJIA is a stock market index that shows how 30 large, publicly owned companies based in the United States have traded during a standard trading session in the stock market. The value of the Dow is not a weighted arithmetic mean and does not represent its component companies' market capitalization, but rather the sum of the price of one share of stock for each component company.

The Russell 1000 Index is a market capitalization weighted stock market index that tracks the highest-ranking 1,000 stocks in the Russell 3000 Index, which represent about 90% of the total market capitalization of that index. The Russell 1000 is a subset of the Russell 3000 Index. It represents the top companies by market capitalization. The Russell 1000 typically comprises approximately 90% of the total market capitalization of all listed U.S. stocks. The Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI EAFE Index consists of the following developed country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

The Bloomberg Barclays U.S. Corporate High-Yield Bond Index is an unmanaged market value weighted index composed of fixed-rate, publicly issued, non-investment grade debt.

The Alerian MLP Index is the leading gauge of energy Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).

IMPORTANT INFORMATION

¹ 2018 Bloomberg Finance L.P.

² 2018 Bloomberg Finance L.P.

³ Fed Minutes Sept, 2018

⁴ 2018 Bloomberg Finance L.P.

⁵ 2018 Bloomberg Finance L.P.