MARKET UPDATE
NOVEMBER 26, 2018

As a result of recent market volatility, we wanted to provide you a brief update on some of the issues on our radar. So far in 2018, a majority of economic data points to a U.S. economy that has been performing pretty well (with the exception of housing). Business and consumer confidence remain near multi-year highs, the employment rate remains near multi-decade lows, wages are finally starting to rise, and corporate profits have increased more than 20% (on a year over year basis) for three straight quarters.

However, after a quiet third quarter, market volatility has started to pick up this quarter. Equity markets (based on the S & P 500) reached an all-time high not that long ago in late September 2018 (note: foreign markets and small capitalization U.S. stocks have lagged behind in recent months). More recently, after touching a level of 2,925 on October 3rd, equity markets declined 9.7% (bottoming on October 29th). Following that decline, equity markets rallied back somewhat and peaked for a second time on November 8th (Source: Factset).

In the current environment financial markets face a number of different headwinds. In this market update, we would like to share our current thoughts and address a few of these issues with you today. Yes, there are clouds forming on the horizon. Even though we are in the latter stages of the current expansion, it doesn't mean we are at the end of the expansion.

Looking ahead, GDP growth and corporate profits are likely to slow next year (but remain positive), short term rates are likely to move higher from current levels (although real rates currently remain low compared with past market cycles) and the ongoing trade battle with China remains a big question mark in terms of its future potential impact on U.S. and overseas growth. Other issues to consider (which are less important in our opinion) include budget problems in Italy, economic weakness in a number of emerging market countries and the longer-term impact of recent U.S. elections. Based on currently available information, we believe that forecasts of a recession over the next 2-3 quarters are premature and not supported based on the facts. However, growing uncertainty has led to a pickup in volatility across different regions of the world, asset classes and sectors of the market.

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If the U.S. central bank acknowledges that it may not need to boost rates 3 or 4 times next year (note: the next time we will hear from the central bank is at its December 16th meeting next month) and China and the United States are able to have a more productive dialog (when they meet later this week), we believe that market volatility should start to subside. We acknowledge that economic growth and corporate profits are likely to slow in 2019 versus 2018, but we believe the economy is still likely to generate moderate growth in the quarters ahead. At some point all economic expansions come to an end. Despite the many uncertainties that we face today, we think it is premature to make that call right now. We continue to monitor economic and market conditions and will have more to share with you in the coming weeks and months.

THE FEDERAL RESERVE BANK

The central bank started raising short term rates in December 2015 and has now raised rates from around 0% up to a level of 2.25%. When you consider that the level of core inflation is currently 2.20%, real short-term rates (i.e. actual rates minus inflation) remain historically low at just 0.05% or 5 basis points (i.e. 2.25% minus 2.20%). Over the past several weeks, financial markets seem to be reacting to the fact that back in early October, the Fed's Chairman, Jerome Powell, commented that short term rates remain accommodative, indicating that the central bank has much more work to do. The market seems to have gotten spooked that the central bank might 1) continue to raise rates aggressively without pause over the next several quarters and 2) choke off economic growth.

Recently, we are encouraged to hear comments from U.S. Federal Reserve Vice Chairman Richard Clarida, a Federal Reserve Governor (who is a permanent voting member of the central bank). Last week he stated that the neutral level of short-term rates (which is the central bank's unstated target range for short term rates) is likely to be in a range of 2.50% to 3.50%. If the central bank raises rates at its December meeting (which is widely expected), this would mean that short-term rates are almost within the Fed's target zone. Thus, it wouldn't take much more for the central bank to take its foot off the gas, stop raising rates and evaluate where the economy stands. We should have a better idea what the outlook for short term rates looks like following the next Fed meeting in mid-December, 2018.

CHINA AND TRADE TARIFFS

The U.S. / China trade battle has been brewing over the past several months and neither side has shown any sign of backing down yet. While GDP has increased a solid 3% year over year (as of last quarter), recent events may lead to increased uncertainty among corporate CEO's and individual investors in the new year. Higher tariffs act like a tax that leads to higher prices for a variety of different goods. Faced with potentially higher import prices, business executives have to decide if they should make changes to their global supply chains, raise prices (which could lead to lower demand) or accept lower margins (which would lead to a decline in earnings per share).

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According to research from JP Morgan Securities, if the U.S. goes ahead and implements 25% tariffs on a wider range of Chinese goods starting in 2019, that could raise costs for U.S. goods by $100 billion and wipe out a large portion of the 2017 household tax cuts. At the upcoming G20 meeting in Argentina next week, we need to see signs that there is a thaw in the relationship between the U.S. and China. It is impractical to hope for a trade deal between the two countries any time soon. However, signs that the two countries are starting to work together should help provide a more constructive backdrop for equity markets over the next several months and could avoid further escalation.

Corporate Profits

In late 2017, the 2018 outlook for year over year corporate profits for the S & P 500 in 2018 was around 11%. With most of the year now behind us, full year 2018 corporate profits are likely to generate almost double that, around 21% profit growth. We can thank the tax cuts for much of this although solid underlying economic growth in the economy and increased stock buybacks have also helped. Looking ahead to 2019, the current forecast (as per the data firm Factset) is for Y/Y EPS growth of 8.7% (versus estimates of 9.5% as of September 30, 2018). At least right now, all 11 sectors of the S & P 500 are currently projected to post positive corporate profits in 2019. Due to slower GDP growth at home and overseas, rising wages and interest rates, as well as the impact from tariffs, corporate profits are likely to come in below the figure highlighted above. However, if profits still rise in the mid-single digits, we think that should continue to provide a moderate tailwind for equity markets. In our opinion, peak growth (which we have likely seen) does not mean no growth.

The Economic Cycle

The current expansion has been the second longest in the post WWII period. Along the way there have been plenty of doubters that questioned how much longer the economic expansion would last. There have been plenty of 0-5% pullbacks and multiple 10-20% corrections along the way. This is a normal part of investing and something that investors have to live with in return for the gains equity markets generate over long time periods. According to research from Jefferies, equity markets have advanced 70% of the time in all years dating back to 1928. However, this doesn't mean that there are not downturns along the way.

If the current expansion lasts past next summer, it will turn into the longest expansion in the post WWII period. We acknowledge that we are probably in the late innings. After all, the unemployment rate is very low, wages are starting to rise, the country is running out of workers and the Fed is three years into its current rate cycle. One reason the recovery has lasted so long is because growth has been among the slowest over the past several decades. Thus, the economy has not built up the kind of excesses that have typically led to large economic downturns in the past.

We continue to monitor several leading economic indicators such as the Conference Board's Leading Economic Index, weekly jobless claims, credit spreads, consumer and

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business confidence surveys and the Federal Reserve Bank's quarterly senior loan survey and other indicators. With the exception of credit spreads (which have started to widen somewhat recently from very low levels), a majority of indicators remain positive. We will continue to keep an eye on these in the new year.

Is This the Beginning of The End of The Bull Market?

Investors have tried to call an end to the current bull market several times over the past few years only to be surprised by the market's ability to shrug off various concerns and headwinds. We continue to view the recent market pullback as a correction within an ongoing bull market. Except for a few very defensive areas of the market, we acknowledge that there have been few places to hide in recent days. The most recent area of the market to experience selling (which had held up better than many parts of the market until recently) has been the high growth technology sector. We believe the recent sell-off has been fueled by a number of concerns that include The Federal Reserve Bank, trade wars with China along with concerns about a slowdown in U.S. growth next year. Commentary on The Fed and Trade wars with China have previously been discussed. In terms of the outlook for 2019, GDP growth is currently forecast to slow next year but remain positive.

According to the latest survey of economists by the data firm Factset, U.S. real GDP is currently forecast to rise 2.5% in 2019 compared with estimated growth of 2.9% in 2018 and a three-year average (from 2016 – 2018) of 2.2%. If there is a shock to the economy, the central bank raises rates beyond levels necessary, or the relationship between President Trump and China gets worse, the outlook for the economy and the markets could take a turn for a worse and the nine-year old bull market might finally come to an end. This is not our base case but is certainly a possibility as we look out over the next several quarters heading into 2020.

Midterm Elections

Midterm elections are finally behind us. As expected, Republicans maintained control of the Senate and Democrats will once again control the House of Representatives. This could represent a problem for the Trump administration, which until now, has had little problem passing its pro-growth agenda. Historically market returns have varied depending on the political makeup in Washington. With a unified government (same party controls the White House and the Congress) annual returns for the S & P 500 since 1928 have averaged 9% per year. With presidential gridlock (one party controls the White House and one-party controls Congress) the average annual return for the S & P 500 has been 11.9% per year. Lastly, with congressional gridlock (with a split congress), average annual returns have been minus .2% per year (Source: Investech). However, there are two important factors to consider. There have only been 7 years when there has been congressional gridlock and if you take out the two years that were associated with bear markets (1930 and 2000), historical market returns were closer to

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those of the average year (which generated a return of 7.5% per year).

It's unclear whether we will see anything productive come out of Washington over the next two years. The most likely scenario is political fighting and the threat of impeachment hearings. One thing both parties might agree on is money for our nation's poor infrastructure. If both parties could come together on this issue, it would benefit all Americans. The main question is how something like this might be funded.

Technology & Future Growth Ideas

When building client portfolios, we think it's important to take an intermediate to longer term viewpoint. Looking ahead, we believe companies that operate in dynamic growth areas within the technology sector like cloud computing, cyber security, artificial intelligence, autonomous vehicles and big data (to name just a few examples) are likely to generate attractive sales and earnings over the next several years. Over the near term, while growth stocks take a breather, neglected value stocks may play catch up. We believe this is a healthy development within the market and one that we plan to incorporate into our investment portfolios over the next several months.

Summary

In summary, financial markets are currently being buffeted by several cross currents that have led to a more risk-off environment this quarter. Rising trade tensions, interest rate increases, a slowdown in corporate profits and weakness in overseas growth are all factors contributing to worries about the outlook for financial markets in 2019. Right now, our base is that over the next few quarters, economic growth and corporate profits are likely to slow from current levels but remain positive. Importantly, just because we may have seen peak growth does not mean that there will be zero or negative growth.

Looking ahead, we believe that investors should prepare for more moderate returns in the quarters ahead along with the likelihood of higher volatility than we have experienced in recent years. The investment landscape is becoming more challenging as we adjust to an economy in the later stages of an economic expansion. Patience (anticipating that returns in the period are likely to be more moderate) and discipline (having the right asset allocation) will likely be more important factors in the year ahead. Keep in mind that despite the headwinds we have cited above, there will still be investment opportunities. We may just need to be a bit more selective as we actively manage client portfolios in the year ahead.

We wish everyone a safe and happy holiday season, and plan to come out with a more detailed market outlook for 2019 in the weeks ahead.

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As always, if you have any questions please do not hesitate to reach out and give us a call.

Respectfully,

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