MARKET UPDATE
NOVEMBER 6, 2018

It may be hard to believe, but as recently as October 4, 2018 (just a few short weeks ago), the S & P 500 index was flirting with all-time highs. Since that time, there has been a notable pick up in volatility. After not a single 1% daily move during the third quarter of this year, the S & P 500 experienced 10 daily moves of 1% or more in the market last month (source: FactSet).

We thought it would be helpful to provide some historical perspective on the market's recent movements. The recent decline in stock prices (which started on October 4th) has resulted in a 9.9% pullback and almost turned into the 8th correction (technically a decline of between 10 and 20%) during the current bull market. Looking back since 1945 (more on this below) there have been a total of 27 market corrections. Ultimately, we believe that following market fundamentals, as opposed to letting emotions dictate investment decisions, is the best way to help our clients achieve their long-term investment goals.

Turning to the markets, the past several years has been marked by a period of relatively steady and uninterrupted economic growth in the United States. Yes, there have been bumps along the way and this recovery has trailed the growth rate of prior economic recoveries. However, at least so far, there has been nothing significant enough to totally derail the nine-year economic expansion. Looking back, October was definitely a challenging month for the markets. We are happy to say goodbye to October and look ahead to November and December, which have at least historically been more positive months for the market (especially during mid-term election years).

LOOKING FORWARD…

One question that we face today is whether we are experiencing another correction within the current multi-year bull market or something larger and more serious. Over the past few quarters, we have highlighted a number of concerns including continued rate hikes by the Federal Reserve Bank, rising 10 Year Treasury

Yields, worries about a growing trade war with China and rising government debt levels. Other issues we are monitoring include economic problems in a number of emerging markets (such as Turkey and Argentina) and ongoing budget woes in Italy.

Importantly, as of this writing, we do not see imminent signs of a recession. From our perspective, what we are likely experiencing is a "reset" whereby investors are now re-evaluating their outlook for the economy and financial markets in 2019. This year may represent "peak" growth in terms of variables such as GDP growth and corporate profits. However, peak growth does not mean no growth. In 2019, we are likely to experience more moderate growth, which we believe can still represent a constructive back drop for financial assets.

WHAT IS A CORRECTION?

Turning back to the stock market, there have been 27 market corrections in the S & P 500 since 1945 (see chart below - source: Ned Davis Research). While corrections can be worrisome and difficult to stomach when they take place, they are something that occur from time to time and are a normal part of market cycles. According to research from Ned Davis, the average correction since 1945 results in a market decline of 13% and lasts about 4 months. One last point is that most corrections do not turn into bear markets. For example, since 1990, just three of 15 market corrections resulted in bear markets. As we have said before, trying to time short term pullbacks and corrections is very challenging and can also result in unwanted tax issues that affect long term performance.

Bear markets, on the other hand, are events typically associated with recessions (i.e. two consecutive quarters of negative GDP growth) and can lead to much larger and extended market declines (before equity markets ultimately recover lost ground). According to research from FactSet, over the past 50 years the average correction leads to a market

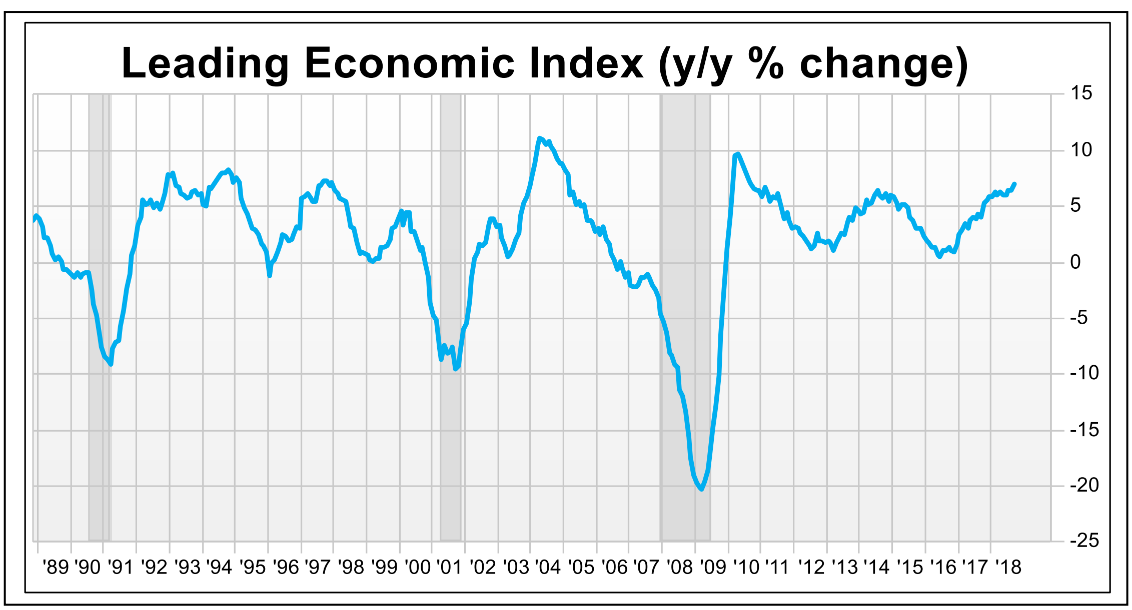
Decline %	Number of Declines	Average Decline %	Average Length of Decline in Months	Average Time to Recover in Months
5-10	78	(6)	1	1
10-20	27	(13)	4	3
20-40	8	(27)	11	15
40+	3	(51)	22	58

decline of 16% (note: the median decline is 14%) and lasts 134 days (70 days for the median correction). Bear markets, on the other hand, represent an average market decline of 42% (the same for the median bear market) and the recovery process takes an average of 542 days (570 days for the median bear market recovery). Importantly, just six of the 29 corrections dating back over the last 50 years have turned into bear markets.

Economic Fundamentals – Not Emotions

Looking at a range of leading economic indicators (many of which we have highlighted before), we still don't see a recession ahead looking out over the next few quarters. There has been a modest widening in credit spreads (and we have seen some weakness in the housing and auto sectors), but other leading indicators including weekly jobless claims, the Fed's senior bank lending survey and the Conference Board's monthly leading economic index, for example (see chart below – source: FactSet), point to continued growth in the U.S. economy. Historically, the Conference Board's Leading Economic Index has turned down several quarters ahead of a downturn in the economy and equity markets. Things may be different this time, but the Index has a solid track record dating back several decades.

Most of this market update is focused on the economy and the markets. However, we believe it's important to highlight that diversified portfolios typically experience less stress during market downturns, when they occur. At RDM Financial, an important part of the investment process is working with our clients to help determine: 1) the appropriate amount of equity versus fixed income



exposure; 2) the level of risk that clients feel comfortable with and 3) the RDM investment model that is best suited to help each client meet his or her long-term investment objective. When markets become more volatile (as they have been recently), we believe that having the appropriate asset allocation is an important part of the puzzle that should help clients ride out the inevitable ups and downs that come with stock market investing.

The Fed

Turning to the Federal Reserve Bank, Fed policy will continue to play an important roll in the direction of the economy and financial markets in the quarters ahead. Near term, we believe the central bank is likely to raise rates another quarter point this December, which would leave short term rates at a level of 2.50%. We do not believe that this is a level that should significantly impact economic growth. With Core CPI inflation at 2.3% (as of September, 2018), real short-term real rates would only be slightly positive (for reference, 2.50% short term rates minus 2.30% inflation = 0.2% real rates). This is barely above 0%. Looking back (using the Core Personal Consumption Expenditures Inflation Index), real rates rose to an average of 3.2% which is three full percent higher than current levels during each of the previous three rate tightening cycles (source: FactSet).

The bigger question is what comes next in 2019? If we have another rate hike next month followed by two more rate hikes in 2019, short term rates will be at 3%. At this point, the central bank should be able to step back and evaluate where things stand. In an environment where inflation, GDP and corporate profits are expanding (but at a more moderate rate than in 2018), the central bank's work may be done. If so, we believe that this development would be greeted favorably by investors and should help prolong the current economic expansion and bull market. If, on the other hand, the central bank gets overly aggressive and raises rates too high (without fully understanding the impact that past rate hikes have had on the economy), that could have a negative impact on the U.S. economy and financial markets as we progress through next year.

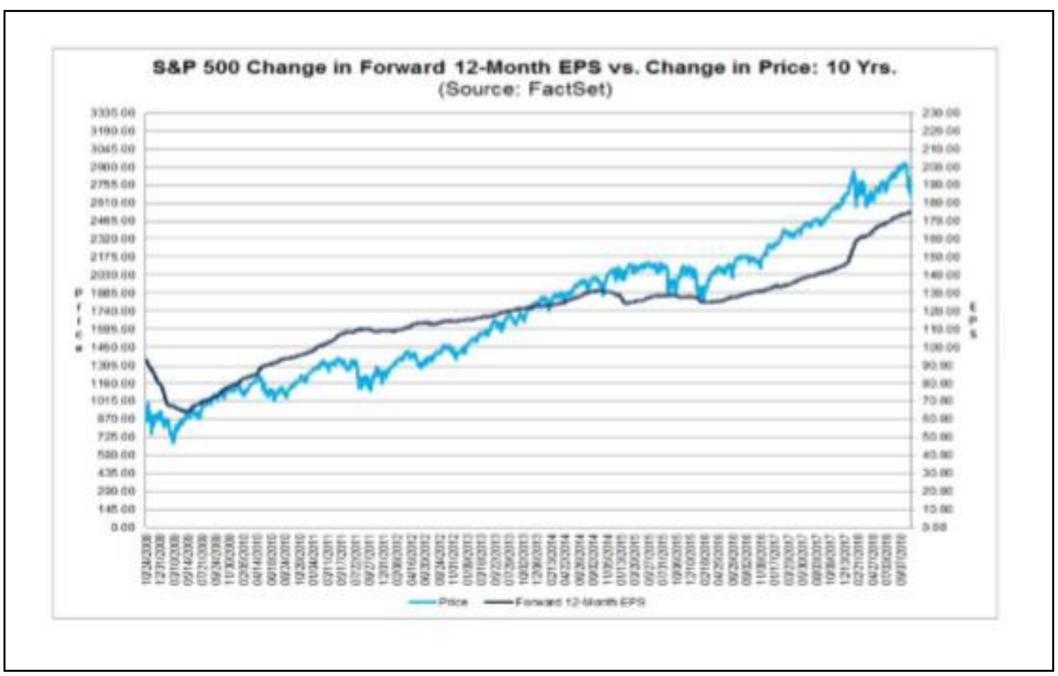
Bonds are for Safety as well as Income

As you many of you know, a significant amount of the assets we manage are in fixed income (mostly in individual bonds). Long ago, we decided it was much safer to put our client's fixed income assets in individual bonds that have a stated yield to maturity (at the time of purchase) as well as a specific maturity date (when capital is returned) if held to maturity. Now that interest rates seem to be ticking up, this strategy seems to be paying dividends compared with a majority of pooled fixed income investment vehicles (i.e. mutual funds and ETF's) that have generated significantly negative returns so far this year on a total return basis.

Outlook for Corporate Profits

Looking at corporate profits, with 75% of companies having reported third quarter 2018 results, earnings per share (EPS) for the S & P 500 are currently forecast to rise 24.9% on a year over year basis (versus estimates of a gain of 19.3% as of the end of last quarter). Full year 2018 EPS are currently forecast to rise 20.6% (up slightly versus estimates of an increase of 20.2% as of the end of last quarter) while 2019 EPS are forecast to rise 9.4% (down modestly versus an estimate of 10.3% as of the end of last quarter). In 2018, 9 out of 11 S & P 500 sectors are currently forecast to generate double digit EPS growth while in 2019, that number falls to 3 out of 11 S & P 500 sectors. While corporate profit growth is likely to remain positive next year, it appears clear that the sugar high from recent tax cuts are likely to fade next year. We need to prepare for slower EPS growth in 2019 (FactSet data as of November 2, 2018).

The chart below highlights forward EPS estimates for the S & P 500 (dark blue line) versus price changes in the S & P 500 (light blue line) over the past 10 years. What you can see is the two lines tend to trend in the same direction over time. As the benefits from recent tax cuts and stimulus spending eventually start to fade, more focus is being paid on the rate of EPS growth that we are likely to see in the quarters ahead (note: that is part



of the reason stock prices have become volatile in recent weeks). Given headwinds from rising interest rates, tariffs, wages and the dollar (in some situations), we think it is likely that 2019 EPS comes in below the current 10% consensus forecast next year. Even if the current forecast of 10% year over year EPS growth was cut in half (note: a 50% decline would be considered significant), we believe that 5% EPS growth next year along with a 2% benefit from stock dividends should continue to provide a positive tailwind for equity markets.

Looking Under the Hood

At RDM Financial, we focus on the long-term financial success of our clients, not on short-term trading and emotions. As a result, we focus mainly on business fundamentals (i.e. things like revenues, corporate profits, interest rates, inflation, Fed policy etc…). However, we also like to keep one eye on market internals. Recently, market internals have started to weaken. For example, in just the past few days, all of the U.S. major markets have suddenly gone from trading above their 200-day moving average (dma) to trading below their 200 dma. In addition, as recently as late September the advance-decline line for the S & P 500 was close to an all-time high. That too has started to weaken in recent days.

Taking a longer-term perspective, other indicators that we follow such as uptrend lines from the start of the current bull market several years ago and monthly MACD readings (which are measures of momentum) for the various major markets continue to remain positive. We are encouraged that equity markets ended the month of October on a positive note with two days of gains. When markets bottom, they can do so suddenly which makes it difficult to try and time short term market movements. We don't know if we are out of the woods just yet or if there is some further downside in equity markets in coming weeks. However, we believe that we are probably closer to the bottom of the current trading range and are likely to start recovering before too long.

Update on GDP

Last week, third quarter GDP was released and registered a solid gain of 3.5% (versus estimates of an increase of 3.4%). The rate of year over year real GDP has now reached 3% which is something we highlighted as a possibility in a BLOG earlier this year. For reference, last quarter's GDP report compares with GDP growth of 4.2% and 1.2% in each of the prior two quarters. While last quarter's GDP report looked like another impressive reading for the economy, components within the report were more mixed. On the positive side consumer spending continues to do well, supported by low unemployment, moderate wage gains and positive consumer confidence. On the flip side, inventory building added a sizable 2.1% to GDP growth last quarter and this is something that may be reversed somewhat next quarter (Source: Bureau of Economic Analysis).

For President Trump's tax cuts to be successful on a long- term basis, we will need to see a sustained pick up in capital equipment spending (which should in theory lead to a pick up in productivity and higher GDP growth over time). On that note, after strong business spending that averaged 10.1% during the first two quarters of 2018, business equipment spending (within the most recent GDP report) barely grew last quarter. We think last quarter's weakness likely reflects a short-term pause (since other business spending indicators are more upbeat) but this will need to be monitored. The basics of supply side economics (which is behind the recent Trumps tax cuts) is that stronger economic growth will lead to an increase in revenues and taxes for the government that will ultimately help pay for the tax cuts. We are certainly keeping an open mind, but we are not convinced (at least not yet) that things will actually work out the way the Trump White House expects them to.

WHAT ARE RECENT ECONOMIC DATA POINTS TELLING US?

This month the ISM Manufacturing Index (one of the most widely watched economic reports each month with a multi-decade track record) was released and registered 57.7 versus estimates of 58.9. As a reminder a reading above 50 signals expansion while a reading below 50 indicates contraction. Within the report, new orders, production and employment all declined somewhat versus last month (a negative) but for now, remain at relatively healthy readings (a positive). This month's ISM Manufacturing report fits in with our outlook that economic growth is likely to slow somewhat next year but remains positive. For reference, this month's ISM reading of 57.7 compares with a one-year average of 59.1 and a three-year average of 55.3. On the inflation side, the prices paid component of the ISM Report jumped from 66.9 to 71.6, indicating that companies are facing increased pressure to raise prices (which could put some downward pressure on margins in the months ahead).

Looking at other economic data, last week the monthly jobs report was released and the economy added a healthy 250,000 jobs. For reference, this compares with estimates of an increase of 190,000 and compares with a twelve-month average of 211,000. Overall, the jobs report had several positives. While the unemployment rate remained at a multi-decade low of 3.7%, the average work week expanded, the economy added another 32,000 manufacturing jobs (296,000 over the past 12 months) and average hourly earnings (i.e. wages) rose to a new cycle high of 3.1% on a year over year basis. Workers are finally starting to benefit from positive underlying economic growth. In addition, the diffusion index (i.e. the percent of companies adding workers) rose to 65.7% last month versus 63.2% the prior month.

Also worth noting, despite recent market volatility, political uncertainty ahead of mid-term elections, and talk of trade wars, the Conference Board's latest report on consumer confidence was released on October 29th and rose to a new cycle high. We find it encouraging that both the current outlook and future expectations parts of the consumer confidence report rose last month. Looking ahead, it is probably unreasonable to expect consumer confidence to rise much further from current readings (since it is already at historically high levels). However, consumer confidence could remain around current levels for some time if employment, wages and the economy continue to grow at a moderate rate in the quarters ahead.

Lastly on the elections, recent polls (which we know can be wrong) suggest that the most likely outcome of Tuesday's vote is that the Democrats take over the House of Representatives and Republicans retain their control of the Senate. We believe that this scenario is unlikely to have major market implications for now, given the low risk that this will lead to a reversal of the Trump administration's recent tax cuts and regulatory reforms. A divided Congress will likely lead to grid-lock but we may see agreement on badly needed infrastructure spending in the next year or two.

In Summary...

Looking ahead, GDP growth and corporate profits are likely to slow somewhat (but remain positive) next year and the Federal Reserve Bank will likely have raised short term rates a bit higher than current levels. Fiscal deficits are likely to continue rising which is a problem that will have to be addressed at some point in the future. The biggest worry for financial markets is the ongoing trade dispute with China. So far, tariffs that have been put in place have had a modest impact on U.S. economic activity and corporate profits. However, further escalation (were it to take place on a sustained basis) would add more uncertainty and could threaten the current economic expansion. On the other hand, if we can achieve a negotiated settlement, that should help restore corporate and investor confidence and would likely prolong the current expansion.

When the market experiences a short-term pullback or correction, it can be uncomfortable and worrisome. We generally try to avoid buying and selling during periods of short-term volatility because that is really like trying to time the market (in addition to creating unwanted capital gains). However, due to the pickup in volatility this month, we have raised a little cash in our “moderate risk” equity portfolios. We believe that this should help cushion equity portfolios somewhat from further downside over the near term.

Our base case right now is that over the next few quarters, we are likely to experience moderate economic growth along with positive but less robust growth in corporate profits. While there are challenges ahead and we may be in the latter innings of the current expansion, this does not mean that an economic downturn or bear market is right around the corner. The conditions typically associated with major economic downturns (i.e. large excesses in the economy, a sharp rise in interest rates, a spike in oil prices etc…) do not currently appear present. A major policy mistake by President Trump remains our biggest concern but we still believe that ultimately, we are likely to achieve some kind of negotiated settlement between the United States and China. Once we get past the mid-term elections, no matter what the outcome, at least some degree of market uncertainty will be removed and that may provide some support for equity markets.

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

Please note we will be sharing our outlook for 2019 with you in a few weeks.

Respectfully,

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Disclaimer:

S&P 500 - The S&P 500 Index is a market capitalization weighted index of 500 common stocks chosen for market size, liquidity and industry group representation to represent overall U.S. equity performance.

MACD – Moving average convergence divergence (MACD) is a trend-following momentum indicator that shows the relationship between two moving averages of prices.

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