# THE NEXT GENERATION WEALTH PERSPECTIVE
## Focus on the Fundamentals

## Macro Summary

- **Gross Domestic Product (GDP) shows strong growth**
  Second quarter Gross Domestic Product (GDP) jumped to 4.2 percent, indicating strong growth in consumption, business investment and government spending. GDP growth in the third quarter is expected to be above 3 percent, with economic growth moderating to below 2 percent by 2021.

- **Labor and Inflation moderate, at target level**
  Labor cost inflation remains moderate. Core consumer consumption price inflation is at the Federal Reserve's target level, but officials have indicated a tolerance for somewhat higher inflation in the near-term.

  Unemployment claims hit the lowest level since 1968.

- **Consumer sentiment remains high**
  Consumer sentiment remains at near record high levels, as households begin to see the recently-passed tax cuts show up in their paychecks. The positive condition of consumers' personal finances more than offsets concerns over tariffs and political uncertainty.

  Duke University's September Chief Financial Officer Survey showed the highest level of optimism for 'own firm' since 2007.

- **Merger and acquisition activity is robust**
  Merger and acquisition activity is robust, driven by companies' need to bolster modest organic growth and the business acumen to secure a low cost of capital.

- **Oil maintaining highest levels**
  The price of West Texas Intermediate oil maintained its highest level since 2014, as OPEC's decision to keep production constant in the face of turmoil in Iran and Venezuela led to worries over supply shortages.

- **Housing market impacted by higher interest rates**
  Higher interest rates are impacting the housing market. Builders continue to note supply constraints (a lack of skilled labor and higher costs), which makes affordability a concern despite solid demand.

- **Global uncertainty spurring safer investing**
  Trade policy conflicts and concerns about global economic risks have led investors to seek safer investments in the form of US Treasuries and the dollar. A strengthening economy, a slight increase in inflation, Federal Reserve increasing interest rates, and increased government borrowing would normally send bond yields significantly higher; however, long-term interest rates remain low outside of the United States as there is strong global demand for safe assets.

## US Position in Global Neighborhood

During the third quarter, most of the major US financial market indices posted positive results and ignored the old adage to 'sell in May and go away.' The aforementioned advances were a favorable outcome despite the various parties involved in the ongoing trade negotiations throwing tariff tantrums. It was particularly strong in light of the emerging market meltdowns that occurred in the quarter from Turkey and Argentina, where they're battling skyrocketing interest rates, inflation and deflating currencies, to South Africa where the economy is falling into recession, and to China where the local stock market has fallen nearly 25 percent this year on fears of slowing growth.

| | Q3 RETURN | YTD RETURN |
|---|---|---|
| Standard & Poor's 500 | 7.71% | 10.56% |
| Balanced Portfolio - 60 / 40 | 4.41% | 5.05% |
| Dow Jones Industrial Average | 9.63% | 8.83% |
| MSCI EAFE | 1.35% | -1.43% |
| Barclays Aggregate Bond | 0.02% | -1.60% |
| Barclays Municipal Bond | -0.15% | -0.40% |

The United States once again was the best house in the global neighborhood at present as Europe's growth rate slowed to around 2 percent while the US Gross Domestic Product growth rate will come in close to 4 percent again in the third quarter. Optimism over tax reform and deregulation appears to be taking hold as consumer sentiment remains at near record high levels, and as corporate spending is accelerating on a number of fronts including capital expenditures, stock buybacks, dividends, and employee wages. We may be on the cusp of the first self-sustaining growth cycle in the United States since before the recession of 2008.

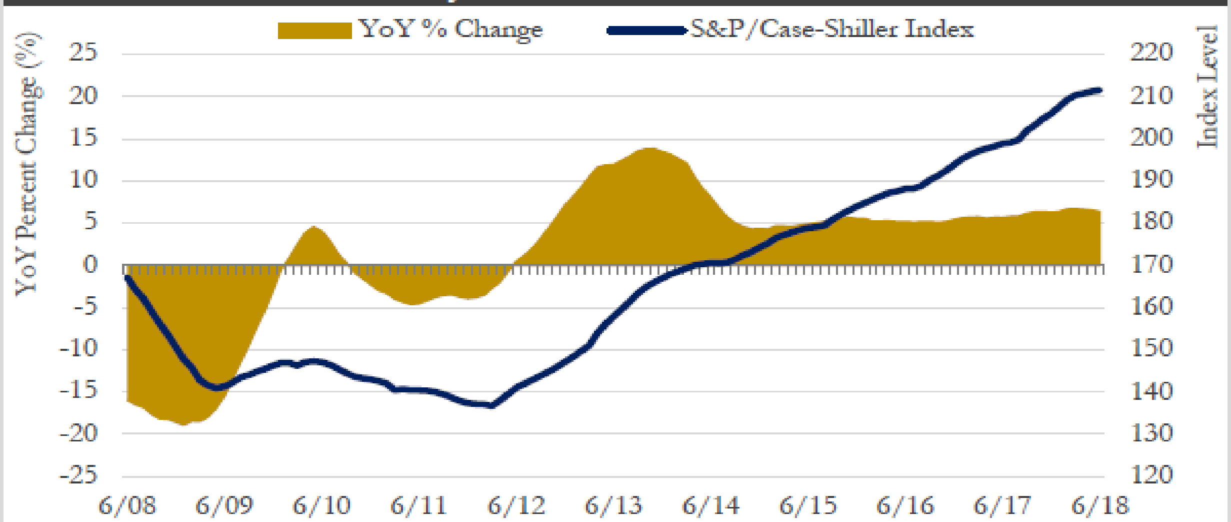
## The Economy

Evidence continued to mount that United States economic growth was poised to remain on solid footing for the second half of 2018. Real GDP appeared set to average at a 3 percent pace during the third quarter, led by continued growth in consumer spending and strong gains in business fixed investment. Business activity remained strong, as both the ISM manufacturing and nonmanufacturing indices advanced. Most importantly, job and income growth remained exceptionally strong, which kept consumers in good spirits and supported hearty gains in consumer spending.

The labor market continued to improve, and employers continued to add jobs across a wide array of industries. The unemployment rate remained below 4 percent while wage growth continued to trend higher. Robust job growth and a strong economic outlook bolstered Americans' expectations for the future.

Not all of the data was positive though, with soft pockets including housing and trade. Pending home sales, a leading indicator of sales activity, fell in August. This marked the fourth decline in five months, suggesting that sales should continue to languish in the near-term. New home sales rebounded in August after trending lower in prior months; however, affordability remained a concern as home prices continued to rise, and higher interest rates reinforced upward pressure on mortgage rates giving little room to see much upside to home sales later this year.

S&P Case-Shiller 20-City Home Price Index



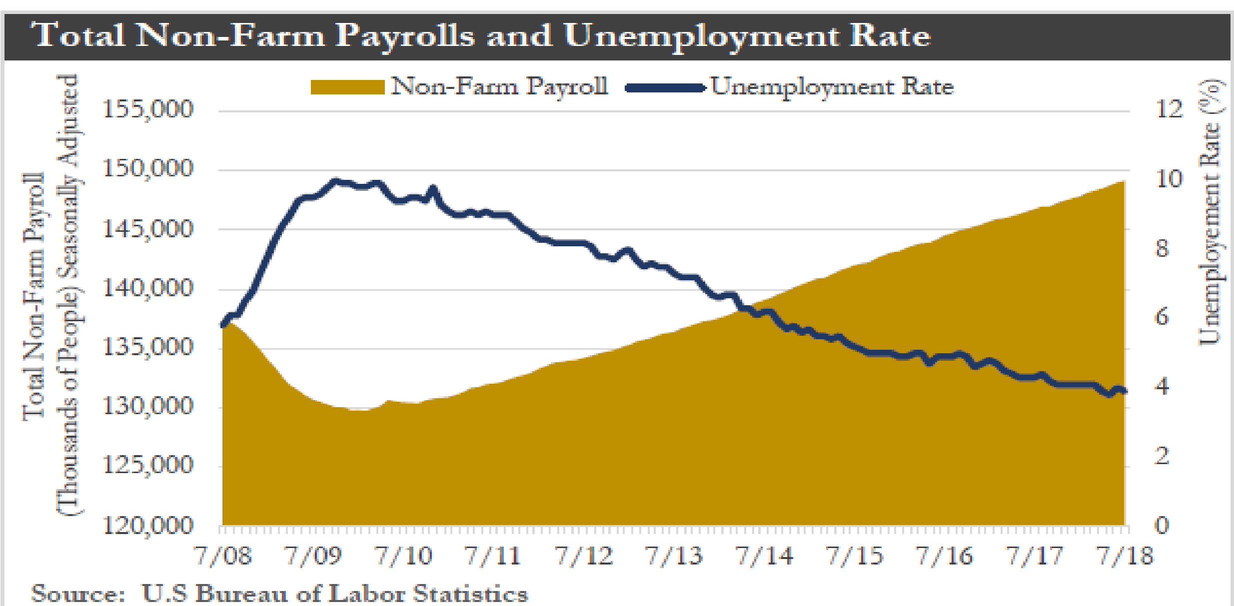

Source: S&P / Case-Shiller

The estimated impact of tariffs has so far been quite small; however, the tariffs in place have only been the tip of the iceberg relative to those under review or threatened. If implemented, they could place about 1.2 percent of US and 0.4 percent of global growth at risk. All told, an escalation in the trade spat with China and waning global demand could yet test the durability of the current expansion. However, for now, the United States economy has continued to prosper with little reason for the Federal Reserve to alter its interest rate plans for the remainder of this year.

## The Fixed Income Market

As I write, the equity indexes in the United States began the fourth quarter on a downward trend and grew steeper during the second week of October. What has been perhaps most noteworthy is that during this decline, bond yields have risen. Bond and stock prices have not fallen simultaneously since last February. Over the past month, the yield on the 10- and 30-year government bonds have increased to 3.2 percent, a level not reached in seven years. Historically, the fixed-income market has typically rallied when the stock market declined. As share prices fell, nervous investors would reallocate more funds to Government bonds in a flight to safety. A broad portfolio consisting of stocks and bonds would benefit from the diversification, as some of the losses posted by the equity positions would be offset by the gains from the bond holdings. This relationship has not been holding up of late, as was the case when the Federal Reserve cancelled its quantitative easing program (2014), and started to raise short-term interest rates (2015).

Indicators continue to suggest that the United States economy is expanding at a healthy pace. Though Gross Domestic Product growth most likely moderated in the third quarter, the recent non-farm payrolls report revealed tightness in the labor market as the unemployment rate reached levels not seen in about 50 years (see chart below). In addition, increases in the average wage may finally be starting to gain traction. Since salaries account for a large percentage of total production costs, wage gains can scare investors if they move higher too quickly. Moreover, rising wages put more funds in the hands of consumers, which should spur demand. That said inflationary pressures may start to build unless worker productivity improves, an indicator that has lagged throughout most of the nearly decade-long expansion. However, with companies being forced to pay better wages to attract labor, and the recent rise in the cost of raw materials, manufacturers are being faced with expenses that may well force them to raise the price of their products. This fear of potential inflation is obviously worrying investors.

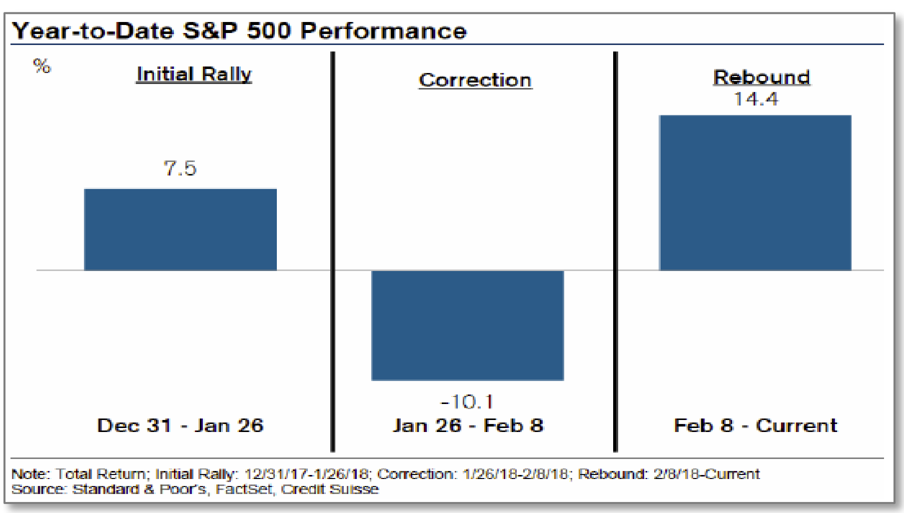


Thanks to comparatively low interest rates, many corporations have accessed the debt markets to borrow heavily over the past decade. Indeed, most companies are now more leveraged than they have been in the past. Also, much of the borrowing didn't get reinvested back into the companies via capital expenditures to build new plants and modernize existing facilities. A good portion of the debt was used to buy back stock on the open market (which, by reducing the amount of stock outstanding, makes per-share figures better), and to increase dividends. Companies often refer to these two policies collectively as 'returning funds to shareholders.' And, while it is true that distributing a portion of net income to shareholders in the form of a dividend is a return, only history will determine whether the wave of stock purchases has added value.

When the Federal Open Market Committee increased the federal funds rate to a range between 2 and 2.25 percent in September, Wall Street and professional investors across the globe took notice that 'accommodative' was removed from the wording in the press release. The financial markets, which don't like higher interest rates, still rose after this news perhaps feeling that this was a sign the economy was getting stronger. In an interview not too long after, Fed Chairman Jerome Powell stated that rates were still accommodative, and that there was still a ways to go before they were neutral. Should a lot of heightened uncertainty (a.k.a. volatility) persist in the markets, we would expect the Fed to tone down its rhetoric considerably to assuage investors' concerns that it may be moving too aggressively.

## The Financial Markets … Advantage USA

Domestic stocks recorded solid gains in the third quarter, with the Standard & Poor 500 Index (S&P 500) delivering its biggest quarterly advance in nearly five years. The small-cap benchmarks lagged the broader market, but all of the major indexes reached new highs. Once again growth stocks handily outpaced value shares, largely due to outperformance earlier in the quarter. Trading volumes were muted for much of the summer vacation season, and volatility was generally subdued relative to the previous quarters. The S&P 500 did not experience a daily swing of over 1 percent in either direction over the three months as compared with 36 such moves in the first half of the year.




Note: Total Return; Initial Rally: 12/31/17-1/26/18; Correction: 1/26/18-2/8/18; Rebound: 2/8/18-Current
Source: Standard & Poor's, FactSet, Credit Suisse

The continued strength in corporate profits appeared to drive much of the advance in financial asset prices. According to the research department at FactSet, after setting a multi-year record in the first quarter, profit growth for the S&P 500 accelerated a bit further in the second, expanding by 25 percent on a year-over-year basis. Leading technology company Apple established a market milestone in early August by becoming the first US Company to achieve a market capitalization over $1 trillion. The tax cuts passed in December 2017 deserved part of the credit for the steady rise in corporate profitability but companies' topline results were also impressive. In fact, corporate revenues for the Index grew by 10.1 percent on a year-over-year basis in the second quarter, which was the biggest gain since 2011.

Investors welcomed a series of new agreements with Europe, Mexico, and other trading partners during the third quarter; however, the escalating dispute with China periodically roiled the global markets and may have restrained some gains. The major indexes retreated at the start of the quarter following reports that the Trump Administration was planning to follow through on a threat to impose tariffs on an additional $200 billion of imports from China, and President Donald Trump stated that tariffs on a further $267 billion might be forthcoming. The Chinese responded with tariff threats, and Wall Street wavered over the following weeks as negotiations between the two countries faltered. Eventually, the United States imposed a 10 percent tariff on the original $200 billion in targeted goods on September 24th, with the tariff rate set to increase to 25 percent at the end of this year.

The intensifying trade conflict between the United States and China was an important one for foreign markets and emerging market stocks in particular. In the third quarter, and over the past twelve months, the S&P 500 Index significantly outperformed most other asset classes, continuing a theme that has been in place since the Financial Crisis. This disappointing performance from diversified portfolios will once again raise questions about whether diversification makes sense, and recognize that the allure to un-diversify can be tempting when investing in your home base is performing well.

That said, investing in today's winning strategies is far from a sure fire formula for success because winners regularly shift as seen in the table found on the following page. Yesterday's winner can become tomorrow's loser as was the case with treasury bonds in the 2008 and 2009 time period. Emerging markets might be setting up for a similar 'first to worst' performance in 2017 and 2018.

| 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 10 Year Average | Q3 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Treasury Bonds 13.74% | Emerging Market Equities 78.51% | SMID Cap 26.55% | Treasury Bonds 9.81% | Emerging Market Equities 18.22% | SMID Cap 35.87% | Large Cap 13.69% | Large Cap 1.38% | SMID Cap 22.49% | Emerging Market Equities 37.28% | SMID Cap 10.10% | Large Cap 7.71% |
| Fixed Income Inv. Grade 5.24% | High-Yield 57.51% | Emerging Market Equities 18.88% | Fixed Income Inv. Grade 7.84% | SMID Cap 17.40% | Large Cap 32.39% | SMID Cap 8.54% | Treasury Bonds 0.84% | High-Yield 17.49% | Developed Int'l Equities 25.03% | Large Cap 8.50% | SMID Cap 4.13% |
| Cash 1.77% | SMID Cap 33.48% | High-Yield 15.19% | High-Yield 4.38% | Developed Int'l Equities 17.32% | Developed Int'l Equities 22.78% | Fixed Income Inv. Grade 5.97% | Fixed Income Inv. Grade 0.55% | Large Cap 11.96% | Large Cap 21.83% | High-Yield 7.89% | High-Yield 2.44% |
| High-Yield -26.39% | Developed Int'l Equities 31.78% | Large Cap 15.06% | Large Cap 2.11% | Large Cap 16.00% | High-Yield 7.42% | Treasury Bonds 5.05% | Cash 0.03% | Emerging Market Equities 11.19% | SMID Cap 15.33% | Fixed Income Inv. Grade 4.01% | Developed Int'l Equities 1.35% |
| SMID Cap -34.67% | Large Cap 26.46% | Developed Int'l Equities 7.75% | Cash 0.07% | High-Yield 15.59% | Cash 0.05% | High-Yield 2.50% | Developed Int'l Equities -0.81% | Fixed Income Inv. Grade 2.65% | High-Yield 7.48% | Treasury Bonds 3.31% | Cash 0.48% |
| Large Cap -37.00% | Fixed Income Inv. Grade 5.93% | Fixed Income Inv. Grade 6.54% | SMID Cap -0.92% | Fixed Income Inv. Grade 4.21% | Fixed Income Inv. Grade -2.02% | Cash 0.02% | SMID Cap -2.11% | Treasury Bonds 1.04% | Fixed Income Inv. Grade 3.54% | Developed Int'l Equities 1.94% | Fixed Income Inv. Grade .02% |
| Developed Int'l Equities -43.38% | Cash 0.15% | Treasury Bonds 5.87% | Developed Int'l Equities -12.14% | Treasury Bonds 1.99% | Emerging Market Equities -2.60% | Emerging Market Equities -2.19% | High-Yield -4.64% | Developed Int'l Equities 1.00% | Treasury Bonds 2.31% | Emerging Market Equities 1.68% | Treasury Bonds -.59% |
| Emerging Market Equities -53.33% | Treasury Bonds -3.57% | Cash 0.13% | Emerging Market Equities -18.42% | Cash 0.08% | Treasury Bonds -2.75% | Developed Int'l Equities -4.90% | Emerging Market Equities -14.92% | Cash 0.26% | Cash 0.82% | Cash 0.34% | Emerging Market Equities -1.09% |

While acknowledging our preference for international companies has hurt performance this year, we remain constructive on the asset class, and below are our perspectives on why.

- Accommodative monetary policy has provided a positive underpinning for the global financial markets.
- The US Dollar may stop its secular rise, which could stabilize emerging market asset prices.
- The economic and earnings growth outlook for Europe, Japan and many emerging markets is in the early- to mid-cycle stages.
- The structural imbalances in China's economy and the unequal amount of trade leverage the United States exercises over China will lead to a resolution no matter how ugly the negotiations appear in the meantime.

The future is uncertain, which is why we diversify. Diversification is certainly not an assurance of higher returns or a protection from losses, and it is not a panacea. The precise timing is difficult, and momentum can persist longer than investor emotions can tolerate. In our experience, abandoning a diversified investment plan after it has underperformed a single asset class could be a decision that is later regretted.

## Concluding Thoughts

By our way of thinking, being an 'investor' is synonymous with having a *long-time horizon*. In the financial markets, almost anything can happen in the short run because market prices are driven more by investor sentiment, unpredictable events, and human herd emotions. But as you extend your investment horizon, market returns are ultimately determined by economic and business fundamentals.

Since our inception in 2005, we consistently monitor investments, financial markets, and the global economy in a disciplined process. We will continue to analyze new data and information, making purposeful long-term shifts to client strategies as needs arise. In the meantime, please let us know if you would like to have a personal conversation regarding your investments.

As always, we thank you for your continued confidence and trust.

Respectfully yours,

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