INVESTMENT STRATEGY UPDATE

MIXED MARKETS

Markets delivered mixed results through the third quarter with US equities outperforming most other asset classes. Technology continued to lead the market with the NASDAQ up 16.56%, and consumer discretionary and health care also posted strong returns. Again this year, there has been a clear favor for growth over value, with the Russell 1000 Growth Index up 17.09% versus the Russell 1000 Value Index up only 3.92%.

Whereas in 2017 when most global equity markets moved together, this year we have seen a sharp divergence in performance. Overshadowed by the potential effects of a trade war, emerging markets were down, the MSCI Emerging Markets index at -7.68% through the end of Q3. Developed foreign markets were less painful but also negative. The pressure from trade negotiations is expected to continue, at least until after the mid-term elections in November. The passing of a new NAFTA bill at the beginning of October is an encouraging sign that compromise is possible.

The US economy remains on strong footing, with unemployment the lowest it has been in decades at 3.7%, reasonable GDP growth around 3.0% for the year, and low inflation. Given the economic backdrop, the Federal Reserve raised interest rates again in September, and is expected to do so again in December. Short term interest rates again rose faster than long term rates, with US Treasury yields closing the quarter at 2.88% for 2-year, 3.05% for 10-year, and 3.19% for 30-year maturities.

Index	*2018 (through 09/30)*
S&P 500	+10.56
DJIA	+8.83
EAFE (Int'l)	-1.43
BC Ttl Bond	-1.60

Dow Jones Relative Risk Benchmarks	
Conservative	+0.64
Moderate	+2.70
Aggressive	+5.37

2018 OUTLOOK

FIXED INCOME — Bonds have been a drag on most portfolios year-to-date. With interest rates normalizing, fixed income investors are beginning to see better yields. However, bond prices have fallen putting many bond portfolios in negative territory for the year. The average yield on the 10-year US Treasury over the past 50 years has been 6.05%, while it is currently 3.05% (JP Morgan). We feel rates will continue to rise, putting bond investors at risk for sub-par returns. That being said most investors should have fixed income in their portfolio to act as a ballast against equity market volatility. Given where yields are at, and the potential for continued rate increases, we recommend keeping bond maturities short and using active fixed income managers that can respond to changing conditions.

Our View — *Keep maturity short, employ active fixed income to remain flexible for changing conditions*

US EQUITIES — Buoyed by tax reform, a strong economy, and share buybacks, US corporate earnings per share are up 27% year-over-year, leaving equity valuations in the US relatively close to their long-term average despite price gains. The 25-year average price to earnings ratio for the S&P 500 is 16.1 and currently the S&P is trading at 16.8 times forward earnings. Stocks are generally not "on sale," but they are not really overpriced either. Looking forward, earnings growth in 2019 is expected to remain strong at around 10%. Growth stocks have been the clear winner for the past few years, which has been justified by higher earnings growth rates and innovation. However historically growth and value have taken turns outperforming, and we currently recommend a relatively equal weighting. We are also in favor of an overweight to small and mid-sized US companies due to a strong economy and the ongoing impact of trade negotiations on larger global companies.

Our View — *Equal weight growth/value, maintain overweight to small & mid-sized companies*

INTERNATIONAL EQUITIES — Foreign stocks have been a hindrance on portfolios, underperforming by a wide margin this year. Foreign markets continue to face headwinds related to trade negotiations, both with the US and within the European Union. Earnings growth outside of the US has been more muted, and the impact of tariffs has the potential to be more significant for companies in emerging economies that depend heavily on exports. However, foreign stocks remain cheap relative to historical averages, and may offer higher long-term growth rates, particularly in emerging markets. We expect further progress on the trade negotiation front after the November mid-term election in the US, and recommend maintaining exposure to foreign stocks.

Our View — *Maintain current position, monitor trade negotiations*

> "When the sun is shining, should we be making hay or fixing roofs? The answer is a little of both."
>
> Dr. Kelly, JP Morgan Asset Management, October 2018

Why am I diversified?

Looking at headlines touting new highs for the Dow or S&P 500, diversified investors might be looking at their portfolios scratching their heads. In 2017, performance for equities and bonds was positive across the board, so most portfolios grew nicely. So far in 2018, the story has been much different, with a wide divergence in performance between US stocks and other assets. While US equity indexes are up double digits, bonds and international stocks are both in negative territory. In fact, small cap US stocks are outperforming emerging market stocks by almost 19%, and large growth US stocks even more than that.

For a diversified portfolio that is a mix of all of these investments, returns have been modest. So why diversify? It is extremely difficult to predict which asset class is going to do the best in any given year, as the chart illustrates. Risk and return are correlated, so the more volatile assets such as emerging market and small cap stock have done the best over time, but often end up either at the top or bottom of the pack. Most investors are better able to tolerate a more balanced, diversified portfolio that contains a variety of these different assets. The downside is that in some years such as this, strong performance in some assets is offset by the underperformance in others. Over time, however, a diversified portfolio can offer a smoother ride with reasonable returns. Diversification accepts the fact that we cannot predict with certainty the direction of markets, and we avoid being all wrong by not trying to be all right.

Asset Class Returns

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	2003-2017 Annualized	2003-2017 Volatility
Bonds 5.2%	Int'l-Emerg 79.0%	Small Cap 26.9%	Bonds 7.8%	Int'l-Emerg 18.6%	Small Cap 38.8%	Large Cap 13.7%	Large Cap 1.4%	Small Cap 21.3%	Int'l-Emerg 37.8%	Small Cap 11.5%	Int'l-Emerg 12.7%	Int'l-Emerg 23.0%
Small Cap -33.8%	Int'l-Dev 32.5%	Int'l-Emerg 19.2%	Large Cap 2.1%	Int'l-Dev 17.9%	Large Cap 32.4%	Bonds 6.0%	Bonds 0.5%	Large Cap 12.0%	Int'l-Dev 25.6%	Large Cap 10.6%	Small Cap 11.2%	Small Cap 18.8%
Large Cap -37.0%	Small Cap 27.2%	Large Cap 15.1%	Small Cap -4.2%	Small Cap 16.3%	Int'l-Dev 23.3%	Small Cap 4.9%	Int'l-Dev -0.4%	Int'l-Emerg -11.6%	Large Cap 21.8%	Int'l-Dev -1.0%	Large Cap 9.9%	Int'l-Dev 18.4%
Int'l-Dev -43.1%	Large Cap 26.5%	Int'l-Dev 8.2%	Int'l-Dev -11.7%	Large Cap 16.0%	Bonds -2.0%	Int'l-Emerg -1.8%	Small Cap -4.4%	Bonds 2.6%	Small Cap 14.6%	Bonds -1.6%	Int'l-Dev 8.6%	Large Cap 14.5%
Int'l-Emerg -53.2%	Bonds 5.9%	Bonds 6.5%	Int'l-Emerg -18.2%	Bonds 4.2%	Int'l-Emerg -2.3%	Int'l-Dev -4.5%	Int'l-Emerg -14.6%	Int'l-Dev 1.5%	Bonds 3.5%	Int'l-Emerg -7.4%	Bonds 4.1%	Bonds 3.3%

Source: J.P.Morgan - Asset Management, *Guide to Markets*, Sept 2018

Indices representes are: Large Cap- S&P 500, Small Cap- Russell 2000, Int'l Dev- MSCI EAFE, Bonds- Barclays US Aggregate, Int'l Emerg- MSCI Emerging Markets

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