3Q18 REVIEW & 2019 OUTLOOK

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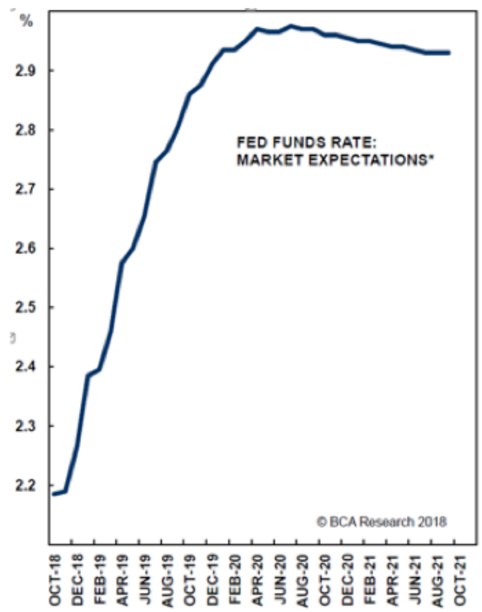
SUMMARY: RECONSIDERING THE FED

Prior to the October selloff, the market had shrugged off the increasingly negative trade rhetoric as well as the implementation of broader and higher tariffs over the course of the third quarter and reached new highs in August and September rallying 7.71% for the quarter and posting a 10.56% total return year-to-date (YTD). Second quarter earnings were above estimates and future estimates continued to rise for the second half of 2018. Meanwhile the U.S. economy posted an impressive 4.2% GDP growth rate for the second quarter and employment, manufacturing data and consumer sentiment remained strong. Additionally, NAFTA trade disputes were resolved in a revised agreement with Canada and Mexico in the last weeks of the quarter. Nevertheless, the market has pulled back almost 7% in October on concerns over rising interest rates. For most of the year, the market did not think the Fed could raise rates over 3% (please see Figure 1). In early October, new data showed employment numbers remained strong, but also revealed hints of inflation within manufacturing inputs. Meanwhile, Fed representatives reiterated that the Fed will stay the course with rate hikes. The sell-off in October now shows that the market believes the Fed will hike the Fed Funds Rate over 3%. While surprising that only now investors are pricing higher rates into the market, the size of the downward move appears rational. When the market multiple is adjusted for the 0.75% rate hikes this year, the multiple would be reduced by 5%-8% in line with October sell-off.

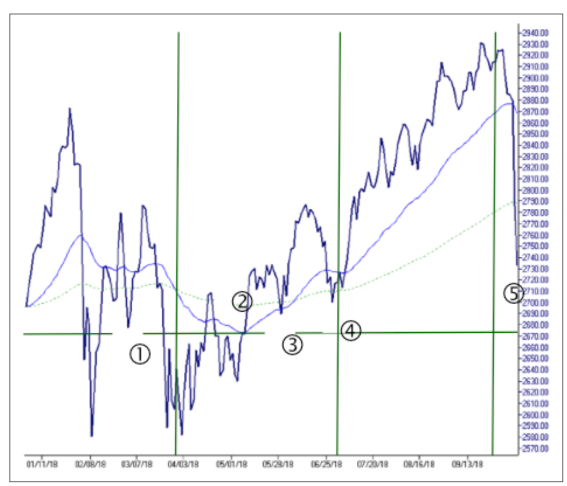
Figure 1: Expected Fed Funds 3Q18



Source: BCA Research

What started in early October as a pullback to adjust U.S. market values for a higher rate regime has been exacerbated by weakness in foreign economic fundamentals as well as a significant sell-off in foreign equity markets over trade fears. The U.S. trade war threat is hurting business and consumer sentiment to a greater extent in reports from overseas. Growth in trade last year was a key driver in the synchronized global expansion and market performance in 2017. As a trade war threatens to disrupt supply chains the drop in business sentiment is already driving capital spending lower in companies affected by trade. Furthermore, investment capital for new plants and operations in countries such as China is slowing and likely to worsen until the trade conflict is resolved or there is greater certainty over its impact. The Chinese market is down almost 25% (local currency) this year and Chinese officials started to coordinate efforts to bolster the market through assurances that the tariffs are having little impact as well as action via direct stock market purchases. We expect the U.S. market to remain soft until the mid-term elections and may need to see Asian markets stabilize to regain ground into the end of the year. We believe the economy and corporate earnings can grow in the face of Fed rate hikes and remain optimistic that the market will return mid single digits for 2018. For 2019 we think earnings estimates for the S&P 500 could be lowered a few dollars next year via the impact of trade conflicts on the dollar and global demand growth.

Figure 2: S&P 500 YTD 10/11/2018



Source for Table 1&2: Informa & Bloomberg

3Q 2018 MARKET REVIEW:

U.S. Stock Markets: U.S. Stock Markets: The S&P 500 opened the year at 2674 with perhaps the best economic and market setup in over ten years. Nevertheless, the market has made little progress this year rallying five times before returning to within 1%-2% of the 2674 starting point (please see Figure 2). The S&P 500 rallied 7.7% in the second quarter, making most of its gains during July and August. The S&P 500 returned 10.6% for the first nine months of the year. We believe

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economic and corporate fundamentals outweighed intensified trade actions during the quarter. The returns of the large cap S&P 500 (7.7%) surpassed small (4.7%) and mid-cap (3.9%) returns during the quarter (please see Table 1). We expected small and mid-cap indices, which are comprised of companies that sell most of their goods and services in the U.S., to outperform this year amid the negative trade rhetoric and larger positive impact from the tax legislation. The small cap indices have outperformed for the first nine months of 2018 as the S&P 600 Small Cap index generated returns of 14.5% and the Russell 2000 Small Cap index returned 11.5%. The S&P 400 Midcap index, however, trailed the large cap index returning 7.5% YTD. In the October downturn, however, small and mid-cap indices are below large cap indices. Large cap leadership was fairly narrow and is largely responsible for the outperformance relative to mid-cap stocks. Tech and Consumer Discretionary sectors each gained 21% and healthcare gained 17% YTD, which were the only outperforming sectors. On closer look, FAANG stocks drove their respective indices. During the first nine months, investors sold equities in sectors impacted by proposed trade tariffs, such as staples (-3.3%) and materials (-2.7%), which are expected to be impacted by tariffs. Interest rate sensitive sectors such as financials (+0.1%), telecom (+0.7%), utilities (+2.7%) and real estate (+1.7%) also underperformed the index (please see Table 2). At the end of the third quarter, Standard & Poor's changed the composition of the S&P 500 and created a new Communication Services sector and eliminated the Telecommunication Services sector. Three of the five FAANG stocks (Facebook - FB, Netflix – NFLX and Alphabet – GOOGL) will be moved from Tech and Consumer Discretionary as will other internet services stocks and cable/media stocks. Telecom stocks also have been folded into to the new sector.

Table 1: Index Returns

Index Returns ending 9/30/2018	3Q18	YTD	Last 12 Months
S&P 500	7.71%	10.56%	17.89%
Russell 2000 (Small Cap)	3.58%	11.51%	15.24%
MSCI EAFE (International)	1.35%	-1.43%	2.74%
MSCI EME (Emerging Markets)	-1.09%	-7.68%	-0.81%
BBG BARC Aggregate Bond	0.02%	-1.60%	-1.22%
Oil bbl. Price Changes	-1.21%	21.23%	41.90%
Gold Returns	-4.84%	-8.48%	-6.87%
Commodities Returns (CRB Index)	-2.61%	0.67%	6.59%

*Source: Informa & Bloomberg

Table 2: Sector Returns

of 9/30/2018	3Q18	YTD	Months
Info. Tech	8.80%	20.61%	31.47%
Financials	4.36%	0.10%	8.69%
Healthcare	14.53%	16.64%	18.35%
Consumer Staples	5.69%	-3.34%	2.93%
Consumer Discretion	8.18%	20.62%	32.51%
Industrials	10.00%	4.84%	11.15%
Energy	0.61%	7.47%	13.93%
Materials	0.36%	-2.73%	4.01%
Telecommunication Services	9.94%	0.73%	4.45%
Utilities	2.39%	2.71%	2.92%
Real Estate	0.86%	1.67%	4.95%

Source: Informa & Bloomberg

Global Stock Markets: International and emerging market stocks trailed the S&P 500 throughout 2018 despite strong outperformance in 2017. The EAFE developed market international stock index was up 1.4% in the third quarter, while the Emerging Markets index fell 1.1%. Both indices were down YTD (EAFE -1.4%; EM -7.7%). Both indices are selling off 8%-10% in October, even though the dollar remained relatively flat during the quarter. Developed international and emerging market equities still remain cheaper than U.S. stocks by many valuation metrics, but there is greater uncertainty relative to the economic fundamental strength of the U.S. At the beginning of the year most economies were in a synchronized growth mode, which led to outsized market returns in 2017. The growth rates started to turn over in the second and third quarters in international markets. Many forecasters point to China as the root of the slowdown. As China reforms slow its economy, lower incremental demand has caused its larger trading partners, the European Union and other Emerging Market countries, to slow down as well. By mid October, the Chinese market has sold off more than any major market in local currency terms.

Global Bond Markets: U.S. bond indices performed better (+0.02%) in 3Q18 vs. -0.92% and -0.87% for the BBG Global and EM Aggregate indices, respectively. The dollar finished the quarter up only about 0.5%, but spent most of the quarter 1%-2% higher. Taking out the currency impact, the BBG Global return was only a little below the U.S. return at -0.05%, while the EM bond index was above U.S. index returns at +1.61% during the quarter net of currency impacts. On a YTD basis the U.S. BBG Aggregate Bond index is down -1.60%. Year-to-date with the currency impacts, the BBG Global and EM Aggregate indices are down -2.37% and -6.93% , respectively, and up +0.02% and down -2.28%, respectively, with the currency hedged. The Fed hiked rates 0.25% three times this year and the 10-year treasury yield increased ~60bps from 2.447% at the beginning of the year to 3.056% at the end of the third quarter. Yields have climbed higher in October to 3.248%, which has spooked investors leading to the market sell-off in October.

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2018 ECONOMIC OUTLOOK: Strong U.S. Growth; Fading Global Performance

GDP growth was a very strong 4.2% in the 2nd quarter and estimates have been increasing. 2018 GDP is now forecast to be 3.1% up from 2.9% earlier this year. The forecast for 2019 was also raised from 2.3% to 2.4%. The 2019 estimates appears to be offsetting the tax cut with an impact from trade policy. On average, most forecasters expect the tax cut to increase GDP by 0.45% in each of 2018 and 2019. A few of the economic studies have forecast a 0.05% drag on U.S. GDP in 2018 rising to 0.250% in 2020 as a result of the tariffs and estimate that 100,000 to 200,000 U.S. jobs could be lost. Combining the tax, trade and underlying economic growth trends data, we think the 2019 GDP estimates are too low and should end up revised to the 2.5% to 2.75% range.

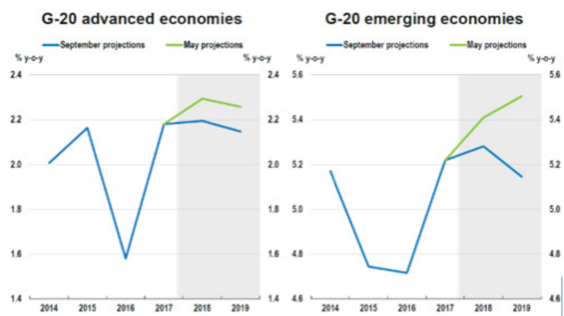
Table 3: GDP Growth

	Q1	Q2	Q3	Q4	Year
2016	**0.6%**	**2.2%**	**2.8%**	**1.8%**	**1.5%**
2017	**1.2%**	**3.1%**	**3.2%**	**2.8%**	**2.5%**
2018	**2.2%**	***4.2%***	*3.2%*	*2.9%*	*3.1%*
2019	*2.4%*	*2.5%*	*2.3%*		*2.4%*

Quarterly GDP = Q over Q growth. Year = annual Y over Y growth.
Source: Actual (Bold) Bureau of Economic Analysis as of 09/18
Projected (Italics) WSJ Economic Survey September 2018.

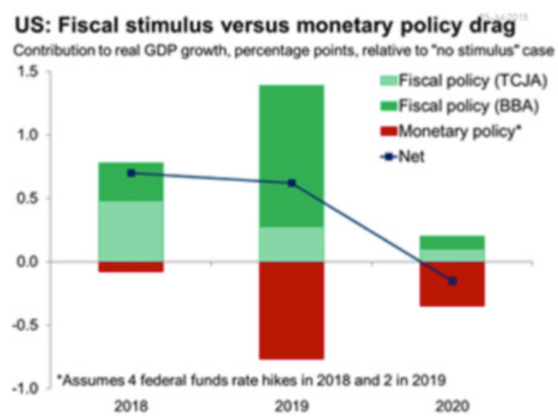
At the beginning of the year the global economic setup was the strongest of the post-recession business cycle. Alas, only the U.S. has been able to capitalize on this setup demonstrating stronger economic fundamentals than the Eurozone, Japan, China and most EM countries. Overall the global monetary policy regime remains accommodative, but the level of stimulus is declining. Fiscal policy has been loosening in much of Europe and Japan. Nevertheless, the current policy levels do not seem to be enough to stimulate growth back to historic levels. We believe austerity in China is contributing to the deceleration in Europe and Emerging markets. Upon his installation as "Premier for Life" at last year's National Congress, Xi Jin Ping started to reinstate fiscal reforms cracking down on inefficient manufacturers and lax lending standards by allowing over-levered businesses and their banking collaborators to fail. This has slowed China's growth and demand for goods with its major trading partners in emerging and Eurozone economies. The yuan has devalued almost 9% against the dollar from its peak in early 2018 largely as a result of the trade conflict. This creates incremental trading weakness for China's partners as its goods become cheaper and its trading partners' goods become more expensive.

Figure 3: OECD Lowers GDP Forecasts



Source: OECD Interim Economic Outlook, September 20, 2018

Figure 4: Waning U.S. Stimulus



Source: Oxford Economics & WSJ Daily Shot

Earlier this year, the OECD and IMF raised its world growth forecast to 3.9% for 2018 and 2019. Citing weakness related to trade tensions between the U.S. and China, the OECD and IMF cut its forecast to 3.7% in September and October. The IMF maintained its U.S. and China growth forecasts of 2.9% and 6.6%, respectively, but lowered the estimates to 2.5% and 6.2% in 2019. Both cut emerging market forecasts significantly (please see Figure 3). Looking beyond 2019, we see a slower U.S. growth picture as monetary policy continues on its tightening trajectory and the short-term stimulus effects from a tax cut and deregulation wane unless new fiscal policy, such as a large infrastructure bill, is passed (please see Figure 4). If the Republicans lose 23 seats in the House to Democrats, the legislature will return to gridlock and likely curb or halt the ability of the Administration to carryout additional fiscal spending policies such as its "Tax Cut 2.0" policy and $1.3 trillion infrastructure spending plan.

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2018- 2019 MARKET OUTLOOK: U.S. Economy to Remain Strong, but Fed and Trade Overhang Stays

Throughout 2018, the market has been in a three-way tug-of-war between 1) benefits from fiscal tax cuts that stimulate growth and dramatically increase corporate earnings; 2) a concern that the Fed will tighten faster than anticipated; and 3) worries that a trade war could slow both U.S. and international growth. This action is playing out in the form of a lower Price/Earnings market multiple (~16x) than would be expected in the latter stages of a bull market (18x – 20x) and in the face of strong upward earnings revisions. Neither the Fed action nor the trade policy is likely to be resolved in the next few quarters. Nevertheless, we expect the market to refocus its attention on earnings and begin to gain back some of the October losses into year-end. We believe we should still end 2018 with mid-to-high single digit returns. We think the current S&P 500 2019 forecast of $178 per share (10% growth) is probably a few dollars too high assuming the 25% Chinese trade tariffs are implemented in January. Nevertheless, the market should be able to grind higher to a mid-single digit return in 2019 applying current multiples. If trade issues can be resolved and/or the Fed signals a slowdown in its pace of rate hikes, we believe the market could be re-rated to a higher multiple resulting in high single digit returns for 2019.

U.S. Bond Market: The Federal Reserve hiked rates by 0.25% for the eighth time since the financial crisis in September. The rate hikes and stronger economic data enabled the 10-Year Treasury to break out of its four-year range of 2.1%-2.6% and move almost to 3.25% in recent weeks. Most investment grade bond indices generated losses for the year. The BBG Aggregate Bond index returned +0.02% for the quarter and -1.60% year-to-date.

- **Inflation Remains the Focus :** We expect fixed income returns to remain challenged in 2018 and 2019 as the Fed takes action to normalize rates up to historic levels. Fed Futures now forecast one additional hike in 2018 and two for 2019. Although inflation remains subdued, we think inflation may rise meaningfully above 2% in coming quarters, spurred by wage growth and the recent strength in GDP readings above 4%. Increases in inflation readings follow increases in GDP, albeit with a 6 to 9 month lag. The market fears that a few monthly core inflation readings with a 3% handle could cause the Fed to become more aggressive with rate hikes (more frequent hikes or greater than a 0.25% per increase per hike). Fed Chairman Powell has indicated in recent testimony that the Fed will take its time with hikes and will not overreact to spikes in inflation. Fed watchers have commented that it is easier for the Fed to correct an inflation policy mistake than a policy mistake that leads to higher unemployment and is willing to let higher inflation to persist without taking strong action.
- **Implications for Investors:** Over the next 2 to 3 years, the environment for intermediate to long term bonds is likely to remain bearish. We expect returns of 2% to 3% from core bonds depending on the speed of normalization. We think short-term bond investments offer the best risk/return opportunity while the Fed steadily hikes rates. We continue to reduce positions in intermediate duration investment grade bonds and reinvest the proceeds in a mix of short duration floating rate investment grade debt, short term credit bonds and short term high yield bonds. All of these strategies generated positive returns year to date versus the BBG index.

Figure 5: U.S. Stock P/Es More Expensive

Source: WSJ Daily Shot, JP Morgan

International Stock and Bond Markets: U.S. stock indices continue to outperform international stock indices in 2018 (EAFE: -1.4%; EM: -7.7%; S&P 500 +10.6%). Additionally, International indices sold off more in October. The outperformance is less about dollar strength (+3.3% YTD) and more about sagging Developed International and Emerging Market economic fundamentals compared to the acceleration in economic fundamentals in the U.S. Besides dipping fundamentals, several underlying markets such as Italy, Turkey and Argentina may have deep systemic problems leading investors to seek a deeper discount on the

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indices for the added risk presented by a few outlier countries, in our opinion. Despite the October sell-off, only four country indices are ahead of the S&P 500 and each of these countries have economies that are heavily reliant to oil, which is up 21% YTD.

We stopped putting money to work in international stocks this year and began trimming emerging market stocks and bonds over the summer. International and Emerging markets are cheap relative to U.S. valuations. Emerging market stock valuations are now at their lowest levels since the 2008 crisis (please see Figure 5). Nevertheless, we think it is still a little early to add to positions as earnings for global stocks continue to be revised downward.

MARKET RISKS: Near-term Risks More Likely to Limit a Market Breakout than Lead to a Correction

We think headlines regarding trade and mid-term elections may restrain the S&P 500 from making new highs in 2018, but we think markets are likely to recover in November and December to end the year with a mid-to-high single digit return. We think some of the market risks that the October sell-off seems to be pricing into the market are more secular in nature and may take a few years to lead to a correction/recession. We think the trade discussions are most likely to cause harm to the economy and corporate earnings via an increase in the dollar. While this could be a result of a sudden surge in the dollar, we expect the rise to occur over several quarters as global growth slows relative to U.S. growth. Despite the implementation of tariffs, rising rates and strong economic outperformance the dollar has remained relatively subdued this year rising roughly 3%. We suspect the Fed could make a policy error and raise rates too quickly leading the economy to stall. Again, we think the Fed's gradual pace of rate increases and its willingness to let the level of inflation increase beyond target for a period of time is constructive. The Fed has acknowledged that fixing a policy error related to inflation is much easier than an error that results in a resurgence in unemployment. Like many forecasters we remain optimistic that the economy and probably the market will continue to move forward until at least 2020.

Trade Conflict: Contributing to Global Slowdown?

While trade policy was largely rhetorical in the first half of 2018, tariffs were implemented and treaties were negotiated in the third quarter. Negotiations with the EU are progressing steadily, while U.S. trade negotiators reached an agreement with Canada and Mexico at the end of the quarter. Unfortunately, the conflict with China escalated throughout the quarter and remains at an impasse.

- **European Union:** After threatening a 20% tariff on European automobiles, the parties held meetings in late July. The Administration received concessions, developed a framework for future discussions and agreed to a standstill on new tariffs, particularly on automobiles. The U.S. and EU agreed to work towards zero tariffs on non-auto industrial goods as well as to reduce barriers and increase trade in services, chemicals, pharmaceuticals, medical products and agricultural products. The parties agreed to reform the World Trade Organization. The EU also agreed to buy more liquefied natural gas from the U.S. Details are supposed to be worked out and revisited in November.
- **USMC - Canada and Mexico:** After a two month waiver expired, tariffs on steel and aluminum went into effect in June. Over the course of the summer additional tariffs were threatened for agricultural products and automobiles. By the last week of the quarter, the U.S. Canada Mexico (USMCA) agreement emerged as a replacement to NAFTA. While the Administration is lauding the agreement, most critics view the changes as an incremental update to NAFTA.
- **China:** In July and August the U.S. phased in $50 billion in tariffs against large categories of abusive product dumping: steel and aluminum. China retaliated with $50 billion in tariffs on their large import categories: corn and soybeans. In September, the U.S. added 10% tariffs on 10,000 products totaling $200 billion in trade. In January 2019, the tariffs rise to 20%. In addition, the Administration threatened to add tariffs on all $505 billion in Chinese imports early next year. China countered each tariff announcement with tariffs matching the same aggregate dollar amount of U.S. exports, however, the U.S. does not export more than $200 billion annually to China. In late September, China walked away from the trade negotiations to protest the implementation of the 10% tariffs on $200 billion in goods.

Projected Impact of Tariffs: Assuming a 100% loss of trade for every dollar of trade tariff imposed then every $50 billion in proposed trade tariffs would create a loss of 0.25% of U.S. and 0.35% of Chinese GDP, respectively. Economic models of trade

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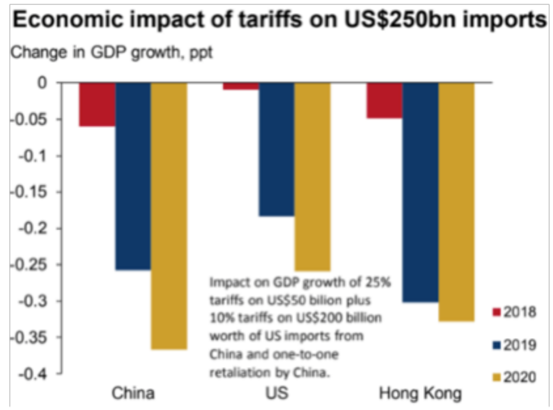
impact, however, take into account substitution of products, sourcing from non-tariff entities, etc. that mitigate the impact by roughly 80%. More sophisticated models suggest that the total drag on U.S. GDP over the next three years will be 0.20%-0.25% and a 0.35%-0.40% on Chinese GDP after $250 billion in reciprocal tariffs (please see Figure 6).

- **Collateral Damage – Can Indirect Impacts on Currencies and Equity Markets Cause More Harm than Tariffs?**
  - **Currency Rates:** Perhaps greater short-term pain may be inflicted on global trade relationships via currency exchange rates. Our greatest concern is the impact the trade conflict could have on the dollar. Economic data over the last 20 years show that a 5% increase in dollar causes about a 0.25% decrease in U.S. GDP. We remain concerned a rising dollar trend over the next couple of years could become a significant headwind to U.S. growth and corporate earnings. Partially in response to trade tensions, China let the Renminbi fall 9% against the dollar over the last two quarters (please see Figure 7). This move is expected to offset much of the 10% tariff implemented. Meanwhile, the Mexican Peso and Canadian Dollar regained ground against the dollar after reaching an agreement. Through September, the Euro has held up a little better against the broader currency basket than other currencies.
  - **Trade Sentiment Weighing on International Markets:** The U.S. trade threat is hurting business and consumer sentiment more significantly in reports from overseas. Growth in trade last year was a key driver in the synchronized global expansion and market performance in 2017. As a trade war threatens to disrupt supply chains the drop in business sentiment is already driving capital spending lower in companies affected by trade. Furthermore, investment capital for new plants and operations in countries such as China and Japan is slowing and likely to worsen until the trade conflict is resolved or there is greater certainty over its impact. The Chinese stock market is down almost 25% (local currency) this year and Chinese officials have started to coordinate efforts to bolster the market through assurances that the tariffs are having little impact on its economy and companies as well as action via direct stock market purchases.
  - **Advantage: United States:** Historically, the U.S. had one of the lowest aggregate tariff rates as a percentage of exports and was at a disadvantage relative to most trade relationships (please see Figure 8). While the timing is uncertain, we think the U.S. will successfully improve its global trade position. The U.S. has a two key advantages over almost all of its trading partners and a third advantage over China.

Figure 6: Tariff Impact

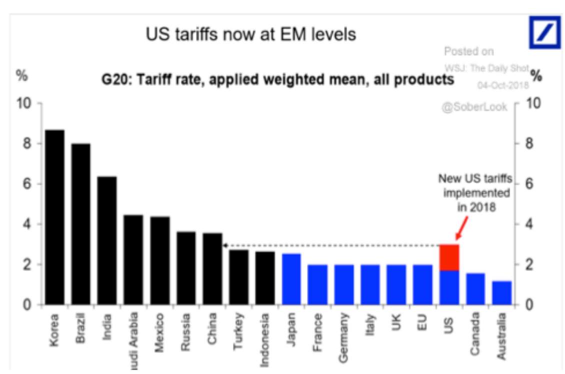


Source: Oxford Economics, WSJ The Daily Shot

Figure 7: CNY to USD YTD

Source: CB&T, Thomson Reuters

Figure 8: U.S. Tariffs v. ROW



Source: Deutsche Bank, WSJ: The Daily Shot

1. **Our trading partners sell more goods to the U.S. than U.S. buys from them.** As the world's largest economy, the U.S. tends to have asymmetric trading relationships, where the U.S. export market is more important to most

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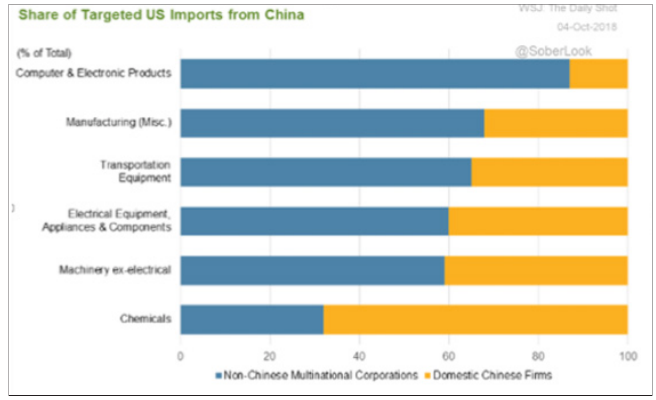
trading partners than their export markets are to the U.S. Another factor in some cases, such as China, the type of trade can also give the U.S. a slight advantage. About 20% of the products China imports from the U.S. are agricultural (soy beans, corn, wheat, cotton, hogs, etc.). In many cases, other countries cannot fully replace the U.S. agricultural imports. Therefore, the Chinese consumer is likely to be impacted more directly through the purchase of key, day-to-day staples. U.S. imports of Chinese goods tend to have a heavier weight towards components that impact businesses directly. The direct consumer goods imports from China tend to be more discretionary purchase such as athletic apparel and equipment, which are more easily substituted.

Figure 9: Share of Tariff Products: Multinational v. Chinese



Source: Lazard Insights, WSJ: The Daily Shot

2. **Exports are also a much larger part of these trading partners' economies.** For example, the U.S. and Canada are each other's largest trading partner and we sell about the same amount of goods to each other, approximately $400 billion annually. However, 75% of Canadian exports go to the U.S. vs. 16% of U.S. exports go to Canada. U.S. exports make up 20% of Canada's GDP. Canadian exports make up 2% of U.S. GDP. China ranks third in exports for the U.S. and sells three to four times as much to the U.S. as it buys from the U.S. More importantly, U.S. exports to China comprise less than 1% of GDP, whereas China's exports to the U.S. represent over 4% of its GDP.
3. **The mix of China's imports from the U.S. hurts the Chinese Consumer.** About 20% of the products that China imports from the U.S. are agricultural (soy beans, corn, wheat, cotton, hogs, etc.). In many cases, other countries cannot fully replace the U.S. agricultural imports. Therefore, the Chinese consumer is likely to be impacted more directly through the purchase of key, day-to-day staples. While the drag on China's GDP is expected to be less than 0.5%, estimates for job loss range from 300,000 to 1,000,000. The Chinese Communist Party is particularly sensitive to issues that may cause political strife among its citizens, particularly inflation and unemployment. U.S. imports of Chinese goods tend to have a heavier weight towards components that impact businesses directly. The direct consumer goods imports from China tend to be more discretionary purchases such as athletic apparel and equipment, which are more easily substituted.

- **Timing:** We do not think the Chinese trade disputes will be resolved before the end of the year. We believe the EU trade dispute will likely be settled before the end of 2019. China has more to lose in a negotiation, therefore they are more likely to stall and prolong negotiations. As we mentioned earlier, China's case for stalling is particularly interesting, because it is carrying out austere economic reforms. The trade conflict enables Chinese leaders to blame the austerity measures on the U.S. In October, the Chinese government appears to be flinching as several officials are making coordinated pronouncements that downplay the impact of tariffs to assuage investor fears as their stock market indices fall into bear market territory.
- **Corporate Winners & Losers: Not easy to determine.**
  - **Tariff on China ≠ Tariff on Chinese Company** - While it is easy to determine which goods will be penalized with tariffs, it is much more difficult to determine which companies will be hurt by the tariffs, because the global supply chain is so heavily intertwined. For instance, less than 20% of the tariffs on computers and electronics will impact Chinese companies, because mostly electronics assembly is occurring in China prior to export. More than 80% of the tariffs will be borne by non-Chinese multinational corporations (please see Figure 9), who finish their products in China.
  - **Impact on Corporate Earnings is Opaque –** It is also difficult to determine the impact of tariffs on a given company due to the flexibility of the global supply chain. The ability to substitute products from, move assembly

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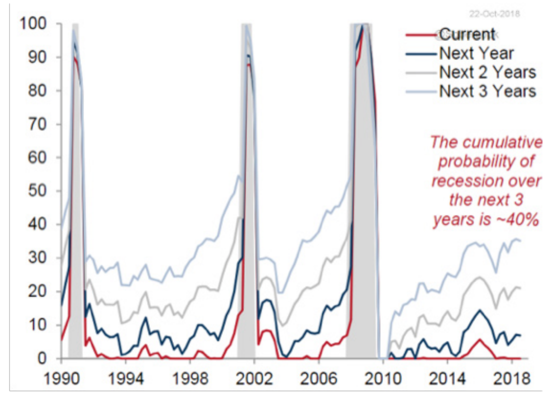
or manufacturing sites to, or source inputs from non-tariff geographies can mitigate the impact of tariffs. Investors have to rely on management guidance to understand the impact and make accurate forecasts.

Watching for Bear Market Warning Signs: Key Signs Remain Yellow

There are three key signs that signal a recession, which typically signal a recession or bear market 3 to 12 months in advance. None are signalling problems at the current time and most estimate a low probability for the next few years (Figure 10).

Figure 10: Recession Probabilities



Source: Goldman Sachs Asset Management, WSJ: The Daily Shot

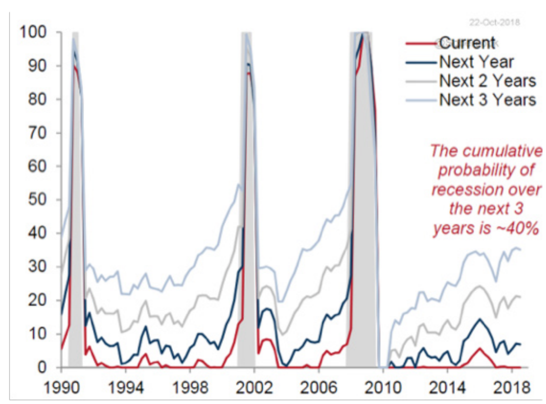
1. **Inverted Yield Curve**: An inverted yield curve is probably the strongest and most urgent warning sign, because most market participants recognize that the Fed is trying to put the brakes on the economy. It is typically in response to a significant pickup in inflation (3%+). In recent months the yield curve has steepened a little in response to Fed moves and stronger economic data, reversing an almost two-year period when the curve steadily flattened.
2. **Rise in Unemployment**: Each of the last 11 recessions since 1950 have coincided with a 0.3% rise in the unemployment rate, usually in the form of three successive 0.1% increases in the monthly unemployment announcement. The good news is the unemployment curve has a long forward momentum over time. Recent data suggests that unemployment is likely to continue to decline until mid-2019.
3. **Market Valuation:** TTypically, the last phase of a bull market coincides with multiples reaching 19.5x to 20.0x next year's earnings. Forward multiples range from 15x to 17x currently, which is about an average valuation during the last half of a bull market.

MARKET VALUATION, EXPECTED RETURNS & PORTFOLIO STRATEGY

While such concerns as a trade conflict and Fed/Inflation action are not likely to be resolved soon, the good news is that earnings have been revised upward significantly throughout 2018 as companies increased earnings guidance with the impact of the tax cut and robust economy (please see Figure 11). The current market valuation is about average based on 2018E earnings and 2019E earnings. Normally, we would expect investors to become overly bullish in the face of improving economic data and above average earnings results this late in the bull market, as they did in early January. Uncertainty over trade actions and concerns over Fed action and inflation are more likely, in our opinion, to continue to dampen late cycle exuberance for the rest of the year and into 2019.

Nevertheless, we think the market will have room to move higher on the increase in earnings reported in 3Q18 and expected in 4Q18, but we may not regain the 10%+ return level reached at the end of September (3Q18). We think mid-term elections are a toss-up. If the Democrats take the House it would be incrementally negative for markets for a short period of time, but most prior markets have operated under legislative gridlock and the market should shrug this off by year end. It may be harder for markets, however, to shrug off a ramp up in trade tariffs to 25% on $200 billion on Chinese goods as we approach the January 1 deadline. Additionally, the futures markets currently imply an 70% probability the Fed will hike rates again in December. We think the trade and rate headwinds are likely to restrain market returns to mid to high single digits for 2018. We believe the economy and corporate earnings will continue to grow in face of the expected pace of Fed rate hikes. We are a little more concerned that the Chinese trade conflict will be prolonged resulting in a strengthening dollar. We also are concerned the

Figure 11: EPS Growth Rates



Source: BofA Merrill Research, WSJ The Daily Shot, FactSet

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U.S. – China trade conflict will also create a spillover of negative trade sentiment and uncertainty that will hurt the global trade picture for EU and EM economies, which could eventually lead to lower earnings for U.S. companies.

Next year the EPS estimate for the S&P 500 is expected to increase 10% from $162 to $178 per share. We think the dollar which has only advanced 3% YTD is undervalued. We expect the trade picture paired with the relative economic outperformance and higher rates will likely result in a higher dollar. Higher dollar prices for goods should weaken demand for U.S. multinationals and we estimate that the 2019 estimate could be lowered between $3 to $5 or 2% to 3% next year. Based our adjusted estimates and continuing global growth headwinds we think the S&P 500 is like to deliver mid-single digit returns in 2019.

Table 5: S&P 500 Valuation

				Growth %
- S&P 500 Value 10/15/18:	2,751	- 2017 Actual:	$132	11.8%
- S&P 500 Forward Multiple 18E:	17.0x	- 2018 Estimate:	$162	22.6%
- S&P 500 Forward Multiple 19E:	15.4x	- 2019 Estimate:	$178	10.3%
- S&P 500 Forward Multiple 20E:	14.1x	- 2020 Estimate:	$196	9.6%

Implied S&P 500 Valuation

	$155	$160	$165	$170	$175	$180	$185
14.0x	2,170	2,240	2,310	2,380	2,450	2,520	2,590
14.5x	2,248	2,320	2,393	2,465	2,538	2,610	2,683
15.0x	2,325	2,400	2,475	2,550	2,625	2,700	2,775
15.5x	2,403	2,480	2,558	2,635	2,713	2,790	2,868
16.0x	2,480	2,560	2,640	2,720	2,800	2,880	2,960
16.5x	2,558	2,640	2,723	2,805	2,888	2,970	3,053
17.0x	2,635	2,720	2,805	2,890	2,975	3,060	3,145
17.5x	2,713	2,800	2,888	2,975	3,063	3,150	3,238
18.0x	2,790	2,880	2,970	3,060	3,150	3,240	3,330
18.5x	2,868	2,960	3,053	3,145	3,238	3,330	3,423
19.0x	2,945	3,040	3,135	3,230	3,325	3,420	3,515
19.5x	3,023	3,120	3,218	3,315	3,413	3,510	3,608
20.0x	3,100	3,200	3,300	3,400	3,500	3,600	3,700

Implied S&P 500 Price Change

	$155	$160	$165	$170	$175	$180	$185
14.0x	-21%	-19%	-16%	-13%	-11%	-8%	-6%
14.5x	-18%	-16%	-13%	-10%	-8%	-5%	-2%
15.0x	-15%	-13%	-10%	-7%	-5%	-2%	1%
15.5x	-13%	-10%	-7%	-4%	-1%	1%	4%
16.0x	-10%	-7%	-4%	-1%	2%	5%	8%
16.5x	-7%	-4%	-1%	2%	5%	8%	11%
17.0x	-4%	-1%	2%	5%	8%	11%	14%
17.5x	-1%	2%	5%	8%	11%	15%	18%
18.0x	1%	5%	8%	11%	15%	18%	21%
18.5x	4%	8%	11%	14%	18%	21%	24%
19.0x	7%	11%	14%	17%	21%	24%	28%
19.5x	10%	13%	17%	21%	24%	28%	31%
20.0x	13%	16%	20%	24%	27%	31%	35%

Source: Yardeni Research & CB&T. Note add ~2% in dividends for S&P 500 total return
Yellow box - rational expectations; Green box - "irrational exuberance"

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ASSET ALLOCATION OUTLOOK

LAST QUARTER			THIS QUARTER	
WE BELIEVED →	ACTIONS TAKEN →	RESULTS	WE BELIEVE →	ACTIONS WE ARE TAKING
DOMESTIC EQUITIES			DOMESTIC EQUITIES	
Fed/Inflation and trade would remain as a overhang. We were optimistic that small & midcap would continue to outperform.	Trimmed U.S. large cap stocks, maintained slight underweight. Maintained overweight on small/mid cap stocks.	Small (4.7% 3Q18; 11.5% YTD) and Mid cap (3.9%; 7.5%) stocks underperformed large cap (7.7%; 10.6%) during 3Q18, but small cap outperformed YTD.	Fed/Inflation and trade remains overhang. We think small & midcap may have peaked for the cycle as rising interest rates and labor costs may outweigh benefits from tax cut and domestic positioning.	Moving to slight underweight on small/mid cap stocks. Adding to U.S. large cap stocks moving to slight underweight, but leaning to adding more defensive, low volatility selections.
INTERNATIONAL EQUITIES			INTERNATIONAL EQUITIES	
We thought the dollar may continue to move higher, pressuring EM and developed international.	We began trimming emerging markets back to equal weight and were poised to trim EM and developed international stocks further on dollar strength and trade actions.	The dollar spiked ~3% during the quarter, but only finished 3Q18 up 0.8% and up 3.3% YTD. Emerging markets (-1.1% 3Q18, -7.7% YTD) underperformed and developed international stocks (+1.4%; -1.4%) also lagged.	We think the dollar may continue to move higher. We think EM is heading into a bear market with another leg down. We think international growth is slowing and markets may weaken.	We are trimming emerging markets back to significantly underweight. We are moving international stocks to slight underweight. We are maintaining a bias to higher quality international equities.
FIXED INCOME			FIXED INCOME	
We expected one more 0.25% Fed Funds rate increase this year in either September or December.	We remained underweight core bonds and overweighted short duration across most fixed income assets. We trimmed Emerging Market bonds as the dollar increases and China tightens.	The Fed raised the Fed Funds rate 0.25% in September. Core bonds returned +0.02% in 3Q18; -1.60% YTD, while high yield bonds generated higher returns (+2.42%; +2.50%). Our shorter duration bond portfolio outperformed benchmarks.	We expect one more 0.25% Fed Funds rate increase this year in December. With short-term yields rising above 2%, we upgraded our fixed income returns expectations for 2019 to 2%-3%.	We remain underweight core bonds and maintaining short duration across most fixed income assets. We are trimming Emerging Market bonds.
We believed munis are at fair value to slightly undervalued.	We maintained an equal weight to munis.	Munis underperformed core bonds in the quarter (-0.15% vs. +0.02%), but outperformed YTD (-0.040% vs. -1.60%).	We believe munis are at fair value to slightly undervalued.	We are maintaining an equal weight to munis at this time.
ALTERNATIVE ASSETS			ALTERNATIVE ASSETS	
We expected volatility to remain high in 2018. We thought trade tensions, Central Bank tightening and inflation surprises will continue to act as catalysts for higher volatility.	We increased our allocation to alternatives from 8% to 9%, focusing on managed futures, market neutral and other non-correlated alternatives.	Through mid-October, the market rallied 5 times before retreating to the beginning year level. The SG CTA alternatives index benchmark returned +1.27% in 3Q18 and -3.52% YTD. CB&T's Liquid Alpha alternatives underperformed in 3Q18 returning -2.24%, but outperformed YTD gaining +1.82%.	We expect volatility to remain high in 2018 and into 2019 over expectations of multiple Fed hikes, mid-term elections and the accelerating impact of tariffs.	We are reviewing our 9% allocation and may increase the allocation to 10% continuing to focus on strategies with no structural correlation to equities.

For more details on CBandT's investment outlook, please visit our Investment Commentary page at: https://cbandt.com/wealth-trust/resources/.