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QUARTERLY MARKET DIGEST

October 26, 2018

More U.S. Decoupling

Equity market differences between the U.S. and the balance of the world widened. While the S&P 500 Index is positive for the year, both the MSCI EAFE and MSCI Emerging Market Indices are trading well into the red.

Q3 Quick Summary

- U.S. equity markets continued to markedly outperform foreign equities as financial conditions eased in the U.S. despite more tightening from the Federal Reserve. Advanced economies outside the U.S. recognized tightening financial conditions as did emerging markets, most notably.
- During Q3, U.S. bond markets operated within an established, narrow range, leaving the Bloomberg Barclays U.S. Aggregate flat for the period. Long-term Treasury yields rose modestly while corporate spreads tightened and prices rose.
- Coming off a robust start to the year, the global economy continued their modest fade through Q3. Deterioration was most prevalent in emerging economies, while the U.S. remained as the key ballast globally.
- The U.S. Federal Reserve raised its benchmark rate once in Q3; pushing the upper bound to 2.25%. The European Central Bank reaffirmed its intentions to end bond purchases by January 1, but will maintain its benchmark rate through the summer of 2019. Emerging market central banks, meanwhile, struggled to bolster weak currencies.

Financial conditions eased: During Q3 the St. Louis Federal Reserve Financial Stress Index fell back to levels witnessed in February.

Extensive tables of asset class and market segment returns are available at the back of this report.

Table 1: Key Asset Class Returns - Q3 2018

Source: Bloomberg; BBG=Bloomberg Barc = Barclays

Asset Class	Benchmark	Total Return
Global Equity	MSCI All-Country World Index	4.4%
Foreign Developed Equity	MSCI EAFE Index	1.4%
Foreign Emerging Equity	MSCI Emerging Markets Index	-1.0%
Domestic Large-Cap Equity	S&P 500 Index	7.7%
Domestic Mid-Cap Equity	S&P 400 Midcap Index	3.9%
Domestic Small-Cap Equity	Russell 2000 Index	3.6%
U.S. Bond	BBG Barc U.S. Agg Bond Index	0.0%
U.S. Bond	BBG Barc U.S. High Yield Index	2.4%
Commodity	Bloomberg Commodity Index	-2.0%

U.S. Equity Market Leadership...Again

Sustainably bullish economic data in the U.S. and Federal Reserve policy reaffirmed a favorable foundation for risky U.S. assets. The S&P 500 Index (up 7.7% in Q3) and the Bloomberg Barclays U.S. High Yield Index (up

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Table 2: S&P 500 Index Sector Returns - Q3 2018
Source: Bloomberg

Sector	Cyclical or Defensive	Total Return	Sector	Cyclical or Defensive	Total Return
Consumer Disc.	Cyc	8.2%	Info Tech	Cyc	8.8%
Consumer Stpls.	Def	5.7%	Materials	Cyc	0.4%
Energy	Cyc	0.6%	Real Estate	Cyc	0.9%
Financials	Cyc	4.4%	Comm Svcs.	Cyc	9.9%
Health Care	Def	14.5%	Utilities	Def	2.4%
Industrials	Cyc	10.0%			

2.4%) highlighted the period. Again, the U.S. performance contrasted with modest gains in other developed markets (MSCI EAFE Index up 1.45) and troubled conditions in the emerging world (MSCI Emerging Markets Index down 1.0%). Material economic and equity weakness in Turkey helped sustain the EM stumble for another quarter, while China equity markets also suffered. Elsewhere, lingering risk of unsettling political leadership in Italy, waning economic numbers, and Brexit missteps prompted investors to forgo some exposure to the non-U.S. developed world. Japan's equity market was one of the lone EAFE bright spots.

The U.S. Health Care sector (+14.5%) lead all major S&P 500 Index groups, followed by a 10% gain for Industrials. Both groups have benefitted from stronger fundamentals of late, and gains have also been helped by some rotation out of other sectors. The newly-minted Communication Services sector rose 9.9% and Technology, again, had a strong quarter (+8.8%). Consumer Discretionary also did well as retailers continued to advance.

Prominent to the downside, Materials names came under some relative pressure (+0.4%), as did the Energy sector. Despite oil prices that continued to rise, Energy names likely lost ground due to some profit-taking that followed robust Q2 returns. The Real Estate group rose a modest 0.9% for the period as higher market interest rates weighed on the space.

Investors showed a lack of confidence in emerging market assets during the third quarter.

Emerging Market Concerns Remained Front-and-Center

Emerging market risks remained elevated in Q3 as currency weakness strained the financial flexibility of some economies A stronger U.S. dollar, fiscal conditions in Turkey, trade tensions, and concern over a China slowdown contributed to a laundry-list of issues that prompted investment outflows in emerging markets. These issues lead to considerable weakness in emerging market currencies, and a widening of sovereign debt spreads for bonds denominated in U.S. dollars and those in a local currency. While the spread widening was notable and indicated risk aversion, emerging market bond conditions have yet to reach other post-crisis periods of weakness.

Broader macro risk levels (Figure 1), however, point to concerns that rival

those found during the financial crisis. The current contrast, with what many believed were favorable emerging markets conditions just ten months ago, has left some market participants flat-footed. In our view, the stronger dollar revealed notable risks in the U.S. dollar (USD) denominated debt market, which has sparking some early emerging market contagion concerns. Emerging market bond issues denominated in USD have reached record levels. This leaves sovereign and corporate debt issuers vulnerable to a rising dollar and resulting weakness in local currency; making it more difficult to pay back debt upon maturity. To combat weak currencies, many emerging central banks have had to raise interests rates, effectively causing economic pressures. This dynamic can lead to an additional confidence erosion and thus spawn the contagion concerns. Notably, elevated risk levels and capital outflows in the developing world (see Figure 1) have already helped lead to a 7.5% drawdown in the MSCI Emerging Markets Index year-to-date (through 9.30.2018).

Capital has steadily flowed out of emerging markets since the start of the year.

Figure 1: Emerging Market Macro Risk & Capital Flows

Source: Bloomberg, Citigroup

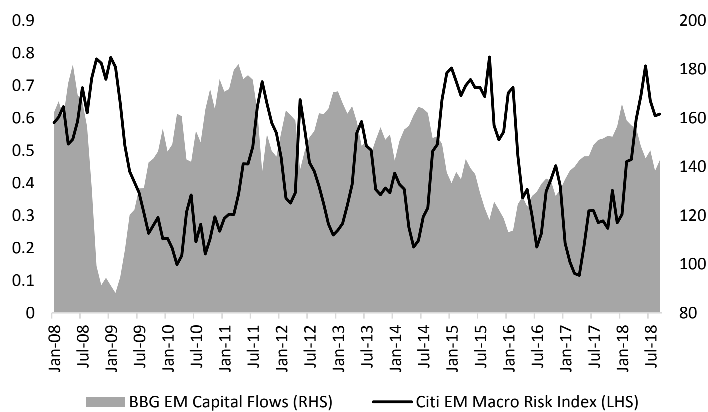
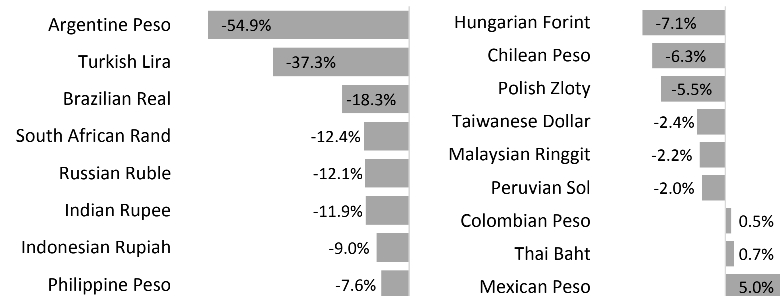


Figure 2: Key Emerging Market Currencies - YTD as of Sept. 30

Source: Bloomberg



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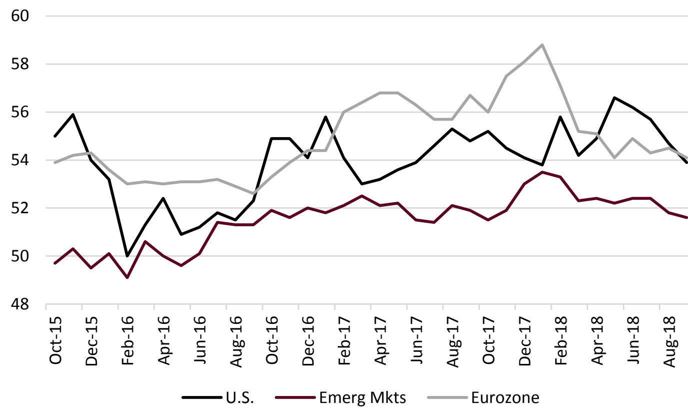
Have Advanced Economies Peaked?

Across developed economies, ex the U.S., economic momentum continued to wane in Q3, and expansion across the developed world became less synchronized. High-frequency data indicated that Q3 economic activity in the Eurozone, the United Kingdom, and Japan slowed from Q1 and Q2 levels. Indeed, these regions may have peaked economically in Q4 2018. Manufacturing and Services Composite readings seem to point to just that (see Figure 3).

Markit Composite numbers are derived from surveys of corporate managers. These managers are asked about conditions across various aspects of their business.

Figure 3: Markit Composite PMI Readings

Source: Markit



Meanwhile, slower export growth, driven in part by tariff uncertainty and higher oil prices, were key variables in the easing of economic activity in the developed world. Auto tariff worries were notable for key exporters such as Germany and Japan. Political uncertainty in Italy and the United Kingdom likely contributed to more cautious activity as well. The weakening momentum was evident in less-than-expected Q2 GDP readings, and the slower pace induced economists to lower their forecasts in the out quarters. Without the fiscal (tax) boost, similar to that found in the U.S., its seems other developed regions may have run out of economic

In its latest World Economic Outlook published on October 9, the IMF downgraded its GDP outlook for many countries and regions of the world.

Table 3: IMF 2018 and 2019 GDP Forecasts for Key Countries/Regions

Source: International Monetary Fund Note: ASEAN 5 = Malaysia, Philippines, Indonesia, Thailand, Vietnam
"Prior Forecasts" refers to IMF GDP forecasts published in April 2018

	GDP Forecasts (%)		Diff. vs Prior Forecast	
	2018	2019	2018	2019
U.S.	2.9	2.5	0.0	-0.2
Euro Area	2.0	1.9	-0.4	-0.1
Japan	1.1	0.9	-0.1	0.0
United Kingdom	1.4	1.5	-0.2	0.0
China	6.6	6.2	0.0	-0.2
India	7.3	7.4	-0.1	-0.4
ASEAN 5	5.3	5.2	0.0	-0.2
Brazil	1.4	2.4	-0.9	-0.1

steam more quickly. In its most recent World Economic Outlook, the International Monetary Fund reduced many 2018 and 2019 GDP outlooks for the developed and emerging world, including those for the Eurozone, Japan, and the United Kingdom (Table 3).

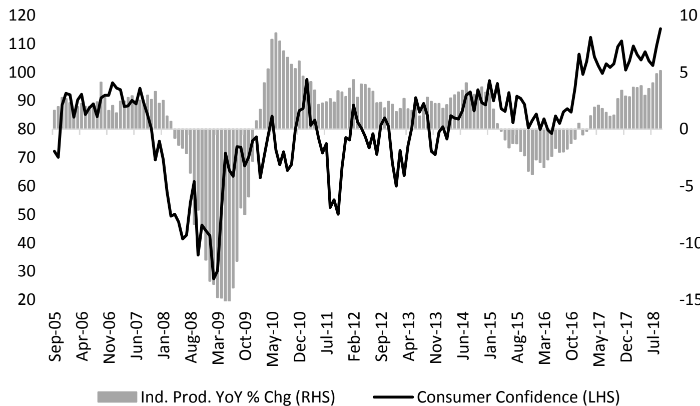
While U.S. manufacturing and services activity has eased just a bit from their summertime crescendos, U.S. Industrial Production, on a year-over-year percentage basis, is at highs last reached in December 2010. Meanwhile, NFIB Small Business Optimism remains at record levels for a data series that dates back to the 1970s.

Elsewhere, U.S. jobs numbers and consumer sentiment continued to improve in Q3. Highlighting the consumer strength, U.S. Retail Sales ex Autos grew 7.7% year-over-year in July and followed that with 7.3% August growth. Such data has not been that robust since 2011. At approximately 70% of the U.S. economy, the recent strength expressed by the consumer has helped set the U.S. apart from its global counterparts in terms of economic momentum. Through Q3, it seems the tailwind of U.S. fiscal policy continued to provide the differentiated horsepower.

High frequency data such as Industrial Production and Consumer Sentiment highlight a currently divergent economic path between the U.S. and the rest of the world.

Figure 4: U.S. Industrial Production and Consumer Sentiment

Source: Federal Reserve, Conference Board



Global Sovereign Bonds Lose Ground; U.S. Credit Gains

Sovereign debt yields rose across global bond markets in Q3 as the Bloomberg Barclays Global Aggregate Bond Index fell 0.9%. Buoyed by U.S. Credit, the Bloomberg Barclays U.S. Aggregate Bond Index was flat for the period. However, the U.S. Treasury component of the U.S. Aggregate Index finished 0.6% lower. The specter of the European Central Bank rolling back its bond purchases contributed to the rise in Eurozone yields, although inflation in the Eurozone remained well-contained. Brexit uncertainty, as well as concerns over the fiscal policy direction of Italy, also added to the bond sell-off in the Eurozone and the U.K. Japan government bond yields also moved higher in Q3 as the Bank of Japan (BoJ) unexpectedly

trimmed purchases of JGBs due beyond 25 years. Despite the slight policy shift, the BoJ continued its dovish commentary. Inflation in Japan remains stubbornly low (less than 1%), indicating that that rates may be capped by structural issues that are unlikely to be overcome in the near-term.

The Federal Reserve raised its benchmark rate in September from 2.00% to 2.25% (upper bound) and implied probabilities are currently signaling a likely 25 basis point hike in December.

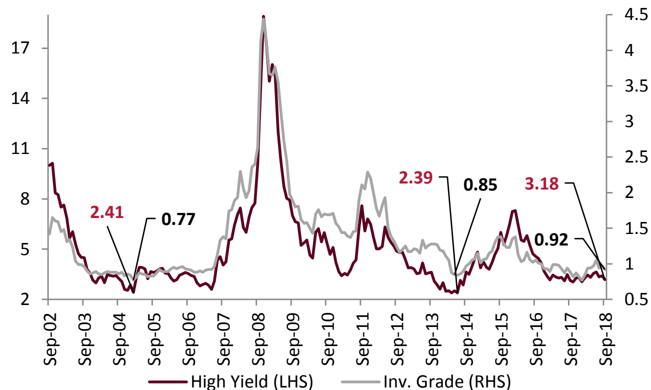
In the U.S., markets interest rates rose through much of the third quarter, prompted by Fed policy and upticks in inflation. CPI, excluding Food and Energy, rose to 2.35% in July - the highest level since 2008 - before sliding back to 2.16% in September. The Federal Reserve marched along on its path to increase its policy rate, moving the Fed funds target upper bound to 2.25% in late September. The Fed funds rate began the year at 1.50%. Fed policy and some inflation pressure contributed to a 20 basis point rise in the 10-year Treasury yield in Q3, leaving the benchmark rate at 3.06% to end the period.

While global Treasury rates moved higher and pressured prices, U.S. credit was the bond sweet spot in Q3. The Bloomberg Barclays U.S. Investment Grade Corporate and the Bloomberg Barclays U.S. High Yield Corporate indices returned 1.0% and 2.4%, respectively. Favorable economic and corporate conditions in the U.S. lead to a narrowing of credit spreads relative to corresponding U.S. Treasuries. Both spread series moved back toward their cyclical lows, indicating investors remained decidedly comfortable taking material U.S. credit risk.

We question how much lower credit spreads can go at this point in the cycle.

Figure 5: U.S. Investment Grade and High Yield Credit Spreads

Source: Bloomberg;



Risks

Investors should be aware of the risks associated with all portfolio strategies and variable market conditions. Monetary policy changes, global military activity, the level and change in market interest rates, corporate earnings, domestic and foreign governmental policies, global economic data, and other geopolitical events can have a substantial effect on portfolio performance and the effectiveness of strategic and tactical portfolio approaches.

MULTI-ASSET/SECTOR/STYLE RETURNS		Returns as of September 30, 2018							
		Q3 - '18	YTD	2017	2016	2015	2014	5-Yr. Ann.	260D Vol
Mkt/Sector/Style	Benchmark Index	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
U.S. EQUITY (Total Return)									
BROAD MARKET	RUSSELL 3000 INDEX	7.1	10.6	21.1	12.7	0.5	12.6	11.9	13.1
LARGE-CAP	S&P 500 INDEX	7.7	10.6	21.8	12.0	1.4	13.7	12.4	13.4
MID-CAP	S&P 400 MID-CAP INDEX	3.9	7.5	16.2	20.7	-2.2	9.7	10.1	12.7
SMALL-CAP	RUSSELL 2000 INDEX	3.6	11.5	14.6	21.3	-4.4	4.9	9.0	14.1
GROWTH	RUSSELL 3000 GROWTH INDEX	8.9	17.0	29.6	7.4	5.1	12.4	14.3	14.9
VALUE	RUSSELL 3000 VALUE INDEX	5.4	4.2	13.2	18.4	-4.1	12.7	9.3	12.3
SECTOR	S&P 500 CONSUMER DISC INDEX	8.2	20.6	23.0	6.0	10.1	9.7	14.1	14.7
SECTOR	S&P 500 CONSUMER STAPLES INDEX	5.7	-3.3	13.5	5.4	6.6	16.0	8.4	13.0
SECTOR	S&P 500 ENERGY INDEX	0.6	7.5	-1.0	27.4	-21.1	-7.8	0.1	18.6
SECTOR	S&P 500 FINANCIALS INDEX	4.4	0.1	22.1	22.7	-1.6	15.2	12.0	17.1
SECTOR	S&P 500 HEALTH CARE INDEX	14.5	16.6	22.1	-2.7	6.9	25.3	13.9	14.5
SECTOR	S&P 500 INDUSTRIALS INDEX	10.0	4.8	21.0	18.8	-2.6	9.8	11.5	15.7
SECTOR	S&P 500 MATERIALS INDEX	0.4	-2.7	23.8	16.7	-8.4	6.9	6.9	16.2
SECTOR	S&P 500 REAL ESTATE INDEX	0.9	1.7	10.8	1.1	1.2	26.1	6.1	13.7
SECTOR	S&P 500 TECHNOLOGY INDEX	8.8	20.6	38.8	13.8	5.9	20.1	20.2	19.1
SECTOR	S&P 500 COMMUNICATION SVCS INDEX	9.9	0.8	-1.3	23.5	3.4	3.0	5.3	19.4
SECTOR	S&P 500 UTILITIES INDEX	2.4	2.7	12.1	16.3	-4.8	29.0	11.2	13.7
BOND (Total Return)									
BROAD MARKET	BBG BARC US AGGREGATE BOND INDEX	0.0	-1.6	3.5	2.6	0.5	6.0	2.1	2.8
TREASURY	BBG BARC TREASURY BOND INDEX	-0.6	-1.7	2.3	1.0	0.8	5.1	1.3	3.0
INV GRADE CORP	BBG BARC INV. GRADE CORP INDEX	1.0	-2.3	6.4	6.1	-0.7	7.5	3.3	3.4
HIGH YIELD CORP	BBG BARC US HIGH YIELD INDEX	2.4	2.6	7.5	17.1	-4.5	2.5	5.2	2.2
MORTGAGE-BACKED	BBG BARC US MBS INDEX	-0.1	-1.1	2.5	1.7	1.5	6.1	2.0	2.5
COMMODITY (Total Return)									
BROAD MARKET	BBG COMMODITY INDEX	-2.0	-2.0	1.7	11.8	-24.7	-17.0	-6.8	10.0
ENERGY	BBG ENERGY INDEX	4.4	17.6	-4.3	16.3	-38.9	-39.3	-13.1	18.6
INDUSTRIAL METALS	BBG INDUSTRIAL METALS INDEX	-6.9	-11.8	29.4	19.9	-26.9	-6.9	-1.4	18.1
PRECIOUS METALS	BBG PRECIOUS METALS INDEX	-6.0	-10.7	10.9	9.5	-11.5	-6.7	-3.0	11.9
GRAINS	BBG GRAINS INDEX	-3.0	-6.2	-11.3	-5.9	-19.4	-9.4	-10.7	17.1
SOFTS	BBG SOFTS INDEX	-13.0	-23.9	-15.6	12.8	-9.9	-10.1	-9.1	17.1
	BBG=Bloomberg								
REAL ESTATE (Total Return)									
TOTAL REIT MKT	BBG NORTH AMERICAN REIT INDEX	0.7	1.6	9.0	9.0	3.2	29.1	8.1	12.9
APARTMENT	BBG REIT APARTMENT INDEX	4.9	5.0	5.4	3.4	15.5	38.1	10.9	15.8
HEALTH CARE	BBG REIT HEALTHCARE INDEX	2.5	3.9	0.6	7.0	-6.5	33.6	4.0	18.3
WAREHOUSE/INDUST.	BBG REIT WAREHSE./INDUST. INDEX	1.3	7.0	20.8	31.5	5.9	21.5	14.4	16.9
MORTGAGE	BBG REIT MORTGAGE INDEX	2.5	3.0	20.3	22.3	-9.9	19.4	9.8	11.3
OFFICE PROPERTY	BBG REIT OFFICE PROP INDEX	-2.0	-3.5	2.2	10.6	-0.2	24.4	4.8	15.1
RETAIL	BBG REIT RETAIL INDEX	2.6	0.0	-4.8	1.1	3.7	29.1	4.0	16.5

Data source: Bloomberg; BBG=Bloomberg; Barc=Barclays
260D Vol = 260-day volatility

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