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Registered Investment Advisor

QUARTERLY MARKET DIGEST

January 20, 2019

Risk Assets Experience Market Correction

U.S. economic and equity divergence from the rest of the world retreated in Q4.

Some synchronized deterioration replaced the synchronized global growth of late 2017/early 2018.

Investors seemed most concerned that the Federal Reserve would reel-in its historic post-crisis accommodation too-far and too-fast.

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

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Q4 Quick Summary

- A U.S. equity correction finally emerged in Q4 as the S&P 500 Index fell 13.5%. Broad global indices also suffered as the MSCI EAFE lost 12.5% and the MSCI Emerging Markets Index fell 7.6%
- During Q4, the core bond market recovered as a flight to quality ensued. The Bloomberg Barclays U.S. Aggregate rose 1.6% for the period. Long-term Treasury yields fell sharply, as did other benchmarks, developed market sovereign yields.
- Investor reaction was triggered, in part, by further signs of slowing amid global economies and concerns the Federal Reserve's policy tightening cadence would usher in a recession. Global trade issues, along with U.S. and U.K. political dysfunction, added to the discontent.
- The Federal Reserve stuck to its tightening pace and pushed the Fed funds upper bound to 2.50% in December. However, the central bank offered some offsetting dovish words in attempt to tamp down the notion its policy course was on autopilot. The Fed also referenced the cooling across global economies and lingering policy uncertainties as variables that would affect future policy decisions.

Table 1: Key Asset Class Returns - Q4 2018

Source: Bloomberg; BBG=Bloomberg Barc = Barclays

Asset Class	Benchmark	Total Return
Global Equity	MSCI All-Country World Index	-12.7%
Foreign Developed Equity	MSCI EAFE Index	-12.5%
Foreign Emerging Equity	MSCI Emerging Markets Index	-7.6%
Domestic Large-Cap Equity	S&P 500 Index	-13.5%
Domestic Mid-cap Equity	S&P 400 Midcap Index	-17.3%
Domestic Small-cap Equity	Russell 2000 Index	-20.2%
U.S. Bond	BBG Barc U.S. Agg Bond Index	1.6%
U.S. Bond	BBG Barc U.S. High Yield Index	-4.5%
Commodity	Bloomberg Commodity Index	-9.4%

Overdue...And Not Completely Overdone

The fourth quarter global equity drawdown was the worst quarterly performance we have seen since 2011. However, given the historic lows in volatility witnessed in 2017, a sustained equity setback in 2018 was not

Table 2: S&P 500 Index Sector Returns - Q4 2018

Source: Bloomberg

Sector	Cyclical or Defensive	Total Return	Sector	Cyclical or Defensive	Total Return
Consumer Disc.	Cyc	-16.4%	Info Tech	Cyc	-17.3%
Consumer Stpls .	Def	-5.2%	Mater als	Cyc	-12.3%
Energy	Cyc	-23.8%	Real Estate	Cyc	-3.8%
Financials	Cyc	-13.1%	Comm Svcs.	Cyc	-13.2%
Health Care	Def	-8.7%	Utilities	Def	1.4%
Industrials	Cyc	-17.3%			

***Overdue* - After enduring the longest post-war period without a 3%+ correction, between late 2016 and early 2018, the S&P 500 Index got back to its volatile norm late in the year.**

Since 1981, the S&P 500 Index has averaged an annual 13.9% intra-year decline.

entirely unexpected. It took until the last quarter of the year before it occurred. While some of the year-end weakness was technically overdone at its extreme, we believe the fundamental concerns that helped trip up this market were not without merit. That is, economies have indeed weakened. Broad data, we believe, points to that. The synchronized global growth noted just a few quarters ago has transformed into something quite different...synchronized economic deterioration. In addition, political risk across the globe (including developed market economies) are at notable levels. A U.S. government shutdown, Brexit, French uprising, and new political leadership in Italy and Brazil; to name only a few issues. Meanwhile, the directional change in monetary policy, as central banks reduced or markedly reversed historical accommodation, was bound to cause some unease. In a broader context, while a stock market correction is an inevitable part of stock ownership, market drawdowns provide an opportunity for investors to evaluate their investments and potential downside risks in their asset allocations.

Interestingly, some relatively bright spots did emerge in previously beaten-down emerging markets as expectations for less Fed tightening in 2019 slowed the US dollar's ascension and gave EM some life. China's long shadow of economic uncertainty, however, allowed for only sporadic gains in some markets.

Wringing Out Some Excesses

While we do not believe the Q4 market activity portends a U.S. or global recession over the next 12 months, we do think the period was the start of a necessary right-sizing in market risk-taking. This was most evident in U.S. markets where high-beta equity sectors lagged and high-yield spreads widened. From here forward, we anticipate the value equity style may come back to the fore as the higher-beta growth style outperformance could wane. In what is expected to be a low-return equity environment, a heightened search for total equity return, as opposed to the brazen leap for capital appreciation, may affect the way investors think about their investments.

In the fourth quarter, Energy, Industrials, Technology, Consumer Discretionary, and Communication Services were the five worst performing U.S. equity sectors, in that order. All are cyclical groups where investors

go to typically get "growth" or "beta" exposure. In contrast, the more defensive Utilities, Consumer Staples, and Health Care sectors led U.S. markets. Real Estate, a sector sensitive to changes in interest rates, also performed well.

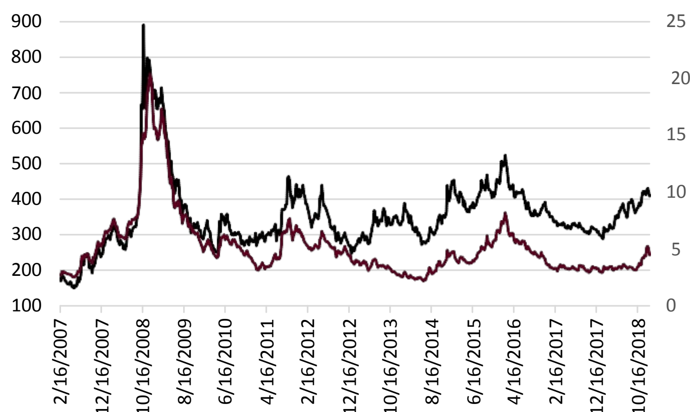
During the fourth quarter, we also saw some unwinding of extended risk-taking in the riskier segments of the global bond market. U.S. high-yield spreads widened to levels not seen since early 2016 and emerging market spreads illustrated a de-risking that has persisted for months. For several quarters, U.S. monetary policy had put continued pressure on emerging market bonds, but U.S. high-yield largely remained unscathed until Q4. This despite a higher volume of low-credit, high-yield issuance and easy covenant terms. Before the onset of Q4, volatility in high-yield was at lows which mirrored that of 2007. As with equities, we believe a correction in this market was overdue.

Like U.S. equities, U.S. high-yield also enjoyed an unusually long period of low volatility.

Volatility in EM debt was closely associated with Fed policy, dollar appreciation and EM currency weakness. The high issuance of dollar-denominated EM debt in recent years left EM economies vulnerable to such policy decisions and currency fluctuations.

Figure 1: U.S. High-Yield and Emerging Market Bond Spreads

Source: Bloomberg, Barclays, JP Morgan



Financial Stress Low, But Economic Data Deteriorates Further

Recent economic data might further confirm that global economic growth may have already reached an apex in late 2017/early 2018. And while economic data continues to undergo a notable directional change, there seems to be no broad economic unrest afoot as financial mechanisms remain sound. Indeed, global leading economic indicators and business conditions indicators are positive, yet the data's trend deterioration from recent highs has been notable. Economic forecasters have captured the aggregate condition in broadly lower GDP predictions over the next year. This includes outlooks from the Bloomberg consensus and such organizations as the International Monetary Fund.

The economic drawdown has perhaps been the most pronounced in developed markets where, following the U.S. tax boost, economies have

quickly lost momentum. Emerging market growth has also slid, although cyclical peak activities in Purchasing Managers' Indices, for example (Figure 3), were not as robust and they have not fallen as far.

Failing a more direct benefit from U.S. tax policy, other developed markets have seen reported and forecasted GDP deteriorate faster than the U.S. Emerging market GDP has sustained a sharp drop since mid-year, although growth rates are expected to be steady at or near current levels through 2019. Risks to global GDP forecasts, in our view, may be biased to further downside given China economic uncertainty and the potential lag of monetary policy impacts. More volatile financial markets, should they persist, could alter behavior of economic participants as well. The good news is global financial stress (Figure 5) remains tame by historical standards. This may offer some argument that economic growth could stabilize at lower levels and recessionary conditions may not be on the near horizon.

Markit Composite PMI numbers are survey results designed to measure activity in both the services and manufacturing sectors of the economy. Readings above 50 signal expansion and those below 50 signal contraction.

U.S. economic activity remains more robust relative to the rest of the world owing to the direct benefit of the U.S. tax plan.

Figure 2: Dev. Mkts Composite PMI w/ U.S. Composite PMI Overlay

Source: Markit Note: U.S. Composite PMI denoted by red line

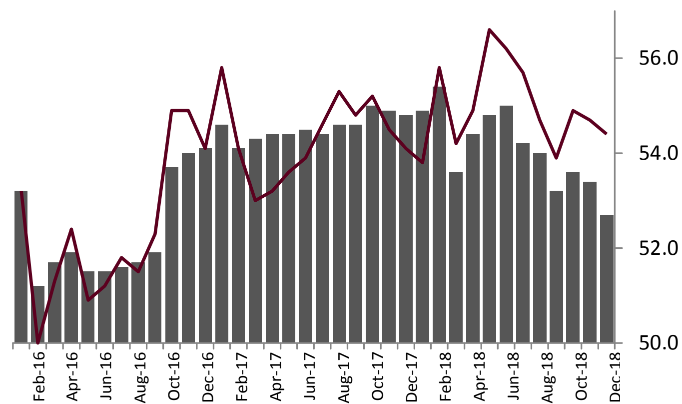


Figure 3: Emerging Markets Composite PMI

Source: Markit

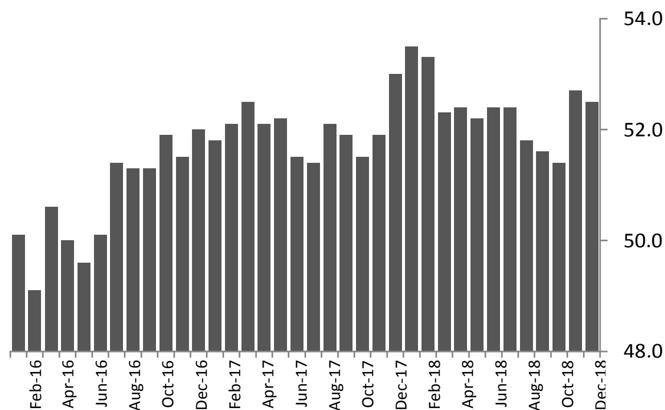


Figure 4: Global GDP - Quarterly YoY % Chg

Source: Bloomberg E = Bloomberg consensus estimates

We believe the apparent trend change in forecasted GDP is a basic reason for investors to be cognizant of any excessive risk-asset exposure. Forecasts simply indicate less global growth is expected in the coming quarters.

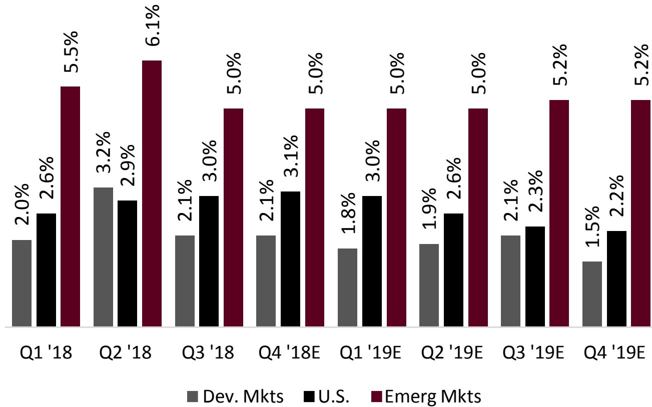
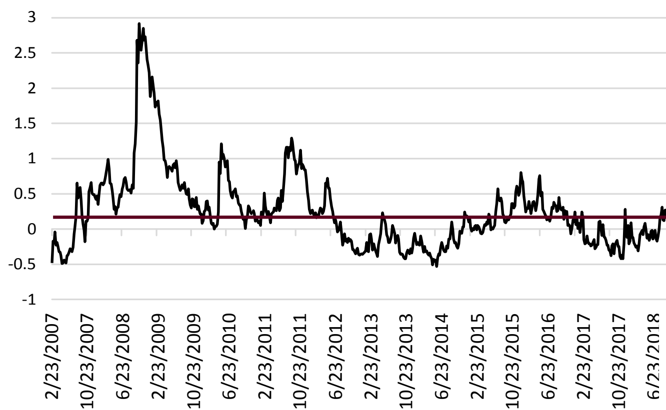


Figure 5: B of A ML Global Financial Stress Index

Source: Bank of America Merrill Lynch

Global financial stress has ticked up slightly from low levels but remains well below financial crisis and post-crisis highs.



Market Recalibrates Interest Rate Expectations

After reaching near-term peaks at the start of Q4, many developed market sovereign debt yields fell sharply as the risk-aversion trade took hold for the period. Investors exited risky asset positions in favor of the most solid sovereign debt exposures, including German Bunds, U.K. Gilts, JGBs (Japan), and U.S. Treasuries. The U.S. Treasury 10yr yield twice attempted to pierce through 3.24% early in the period before closing the year at 2.68%. The Bloomberg Barclays Treasury Bond Index closed Q4 with a 2.6% gain compared to the Bloomberg Barclays U.S. Aggregate Index gain of 1.6%. The U.S. Aggregate also includes mortgages, investment-grade corporates, and other asset-backed securities. This risk-averse performance contrasts with the Bloomberg Barclays U.S. High Yield Index which lost 4.5% for the period. Meanwhile in investment grade credit, spreads also widened as the Bloomberg Barclays Investment Grade Corporate Index fell 0.2%.

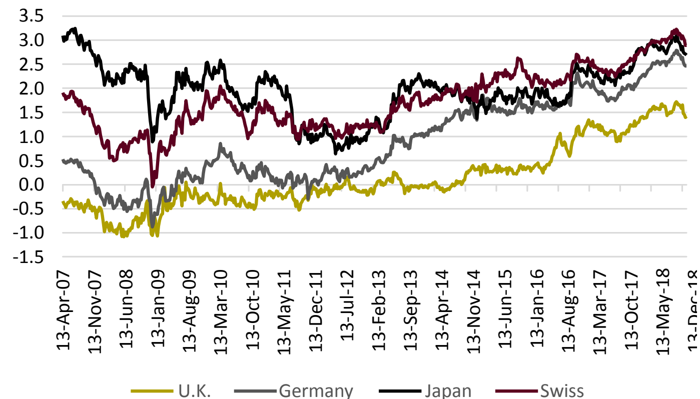
The risk aversion and gains in some core bonds (treasuries and mortgages) was prompted by weakening economies, an ease in recent inflation readings, and comments from the Federal Reserve suggesting its normalization of policy was near the end. This combination caused investors to rethink previous notions that rates would steadily move higher through 2019. The more sluggish economic data and stagnant inflation has likely thrown a bucket of cold water on that view. The market now seems faced with the "lower-for-longer" interest rate mantra.

Clearly this mantra was aided by an apparent about-face in the Federal Reserve's communication about its trek toward normalized rates. Many forecasters that we recognize seem to place the normalized Fed policy at 2.5% to 3.0%, in this environment. Previously, the Fed was targeting (via its dot plot) policy at or above the high side of that range. Late in Q4, Fed Chairman Jerome Powell messaged that Fed policy was not predisposed and members would consider many of the fundamental variables that left investors uneasy during the quarter. The shift in Fed tone aided the sharp fall in yields and the rise in bond prices in the U.S. and across other sovereign markets.

The wide differential in U.S. versus other sovereign debt yields is likely a cause for anticipating consistent demand for U.S. Treasuries, despite the expectation of added supply. i.e. "risk-free" Treasury securities offer a materially higher yield versus other sovereign debt instruments.

Figure 6: U.S. 10yr Treasury Yield Differential (%)

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 December 31, 2018							
		Q4 - '18	2018	2017	2016	2015	2014	5-Yr. Ann.	260D Vol
Mkt/Sector/Style	Benchmark Index	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
U.S. EQUITY (Total Return)									
BROAD MARKET	RUSSELL 3000 INDEX	-14.3	-5.2	21.1	12.7	0.5	12.6	8.9	17.5
LARGE-CAP	S&P 500 INDEX	-13.5	-4.4	21.8	12.0	1.4	13.7	9.4	17.7
MID-CAP	S&P 400 MID-CAP INDEX	-17.3	-11.1	16.2	20.7	-2.2	9.7	7.3	16.7
SMALL-CAP	RUSSELL 2000 INDEX	-20.2	-11.0	14.6	21.3	-4.4	4.9	5.8	18.8
GROWTH	RUSSELL 3000 GROWTH INDEX	-16.3	-2.1	29.6	7.4	5.1	12.4	11.0	20.4
VALUE	RUSSELL 3000 VALUE INDEX	-12.2	-8.6	13.2	18.4	-4.1	12.7	6.7	15.5
SECTOR	S&P 500 CONSUMER DISC INDEX	-16.4	0.8	23.0	6.0	10.1	9.7	11.5	20.9
SECTOR	S&P 500 CONSUMER STAPLES INDEX	-5.2	-8.4	13.5	5.4	6.6	16.0	6.9	14.9
SECTOR	S&P 500 ENERGY INDEX	-23.8	-18.1	-1.0	27.4	-21.1	-7.8	-3.6	23.0
SECTOR	S&P 500 FINANCIALS INDEX	-13.1	-13.0	22.1	22.7	-1.6	15.2	9.4	20.2
SECTOR	S&P 500 HEALTH CARE INDEX	-8.7	6.5	22.1	-2.7	6.9	25.3	10.9	18.1
SECTOR	S&P 500 INDUSTRIALS INDEX	-17.3	-13.3	21.0	18.8	-2.6	9.8	7.1	19.8
SECTOR	S&P 500 MATERIALS INDEX	-12.3	-14.7	23.8	16.7	-8.4	6.9	4.4	19.8
SECTOR	S&P 500 REAL ESTATE INDEX	-3.8	-2.2	10.8	1.1	1.2	26.1	7.2	16.6
SECTOR	S&P 500 TECHNOLOGY INDEX	-17.3	-0.3	38.8	13.8	5.9	20.1	15.4	24.8
SECTOR	S&P 500 COMMUNICATION SVCS INDEX	-13.2	-12.5	-1.3	23.5	3.4	3.0	4.3	21.7
SECTOR	S&P 500 UTILITIES INDEX	1.4	4.1	12.1	16.3	-4.8	29.0	10.7	15.7
BOND (Total Return)									
BROAD MARKET	BBG BARC US AGGREGATE BOND INDEX	1.6	0.0	3.5	2.6	0.5	6.0	2.4	2.9
TREASURY	BBG BARC TREASURY BOND INDEX	2.6	0.9	2.3	1.0	0.8	5.1	1.8	3.1
INV GRADE CORP	BBG BARC INV. GRADE CORP INDEX	-0.2	-2.5	6.4	6.1	-0.7	7.5	3.1	3.4
HIGH YIELD CORP	BBG BARC US HIGH YIELD INDEX	-4.5	-2.1	7.5	17.1	-4.5	2.5	4.3	3.3
MORTGAGE-BACKED	BBG BARC US MBS INDEX	2.1	1.0	2.5	1.7	1.5	6.1	2.4	2.6
COMMODITY (Total Return)									
BROAD MARKET	BBG COMMODITY INDEX	-9.4	-11.2	1.7	11.8	-24.7	-17.0	-7.9	11.7
ENERGY	BBG ENERGY INDEX	-25.8	-12.7	-4.3	16.3	-38.9	-39.3	-16.2	26.0
INDUSTRIAL METALS	BBG INDUSTRIAL METALS INDEX	-8.7	-19.5	29.4	19.9	-26.9	-6.9	-2.7	17.8
PRECIOUS METALS	BBG PRECIOUS METALS INDEX	6.8	-4.6	10.9	9.5	-11.5	-6.7	-1.3	11.7
GRAINS	BBG GRAINS INDEX	0.8	-5.5	-11.3	-5.9	-19.4	-9.4	-10.3	17.6
SOFTS	BBG SOFTS INDEX	0.1	-23.8	-15.6	12.8	-9.9	-10.1	-9.1	18.4
	BBG=Bloomberg								
REAL ESTATE (Total Return)									
TOTAL REIT MKT	BBG NORTH AMERICAN REIT INDEX	-6.1	-4.6	9.0	9.0	3.2	29.1	9.1	16.1
APARTMENT	BBG REIT APARTMENT INDEX	-1.8	3.1	5.4	3.4	15.5	38.1	12.5	18.5
HEALTH CARE	BBG REIT HEALTHCARE INDEX	3.1	7.1	0.6	7.0	-6.5	33.6	7.6	21.0
WAREHOUSE/INDUST.	BBG REIT WAREHSE./INDUST. INDEX	-8.9	-2.5	20.8	31.5	5.9	21.5	16.2	19.7
MORTGAGE	BBG REIT MORTGAGE INDEX	-5.8	-2.9	20.3	22.3	-9.9	19.4	9.5	12.7
OFFICE PROPERTY	BBG REIT OFFICE PROP INDEX	-11.8	-14.9	2.2	10.6	-0.2	24.4	4.5	17.7
RETAIL	BBG REIT RETAIL INDEX	-5.7	-5.7	-4.8	1.1	3.7	29.1	4.5	18.6

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

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