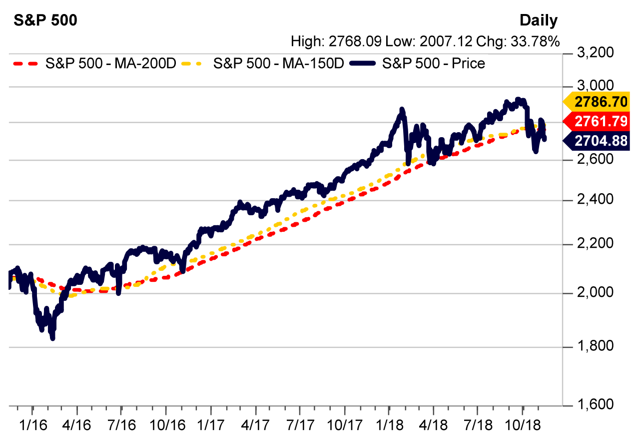
Observation Deck

Views from the Investment Policy Committee



4th Quarter 2018

Purpose

- The Observation Deck is a series of pictures designed to communicate points of view and to stimulate discussion and debate, it is NOT a set of recommendations
- Our commentary is not the result of any single data point or graphic, it is a reflection of the weekly conversations within the Investment Policy Committee and a set of perspectives that are derived from many observations accumulated over varying time frames
- Slides that are included in the Observation Deck are a subset of the scores of data points and graphics that the Investment Policy Committee views each week in assessing the status of the business cycle and the health of financial markets
- We hope that you enjoy the Observation Deck and recognize that the views and opinions expressed are capturing a moment in time and are subject to change without notice

Macro TIP Chart

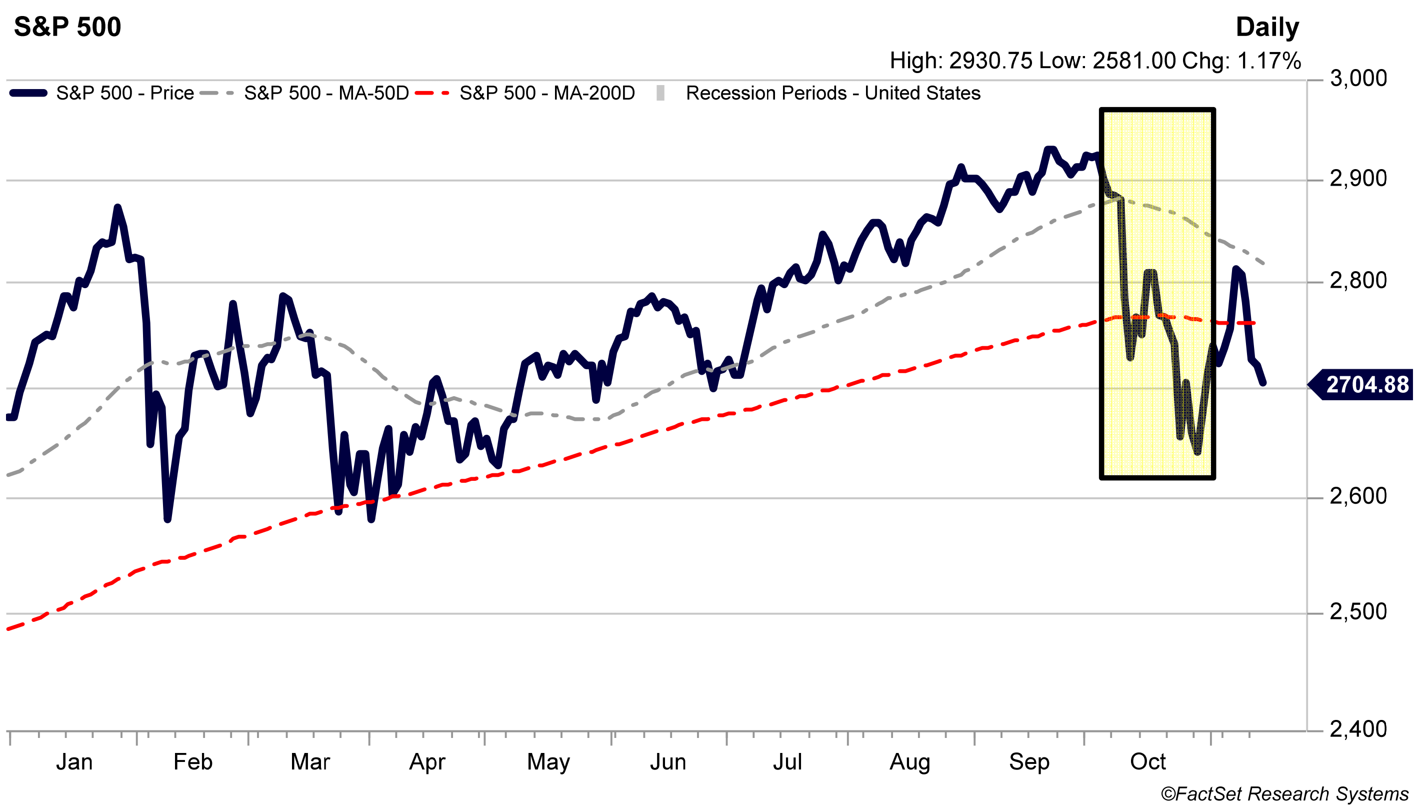
Tactical Investment Positioning

4th Quarter 2018

Strength of Conviction	**Chg**	**Negative** **Neutral** **Positive**	**Rationale**
Business Cycle			Excellent US GDP growth is likely to moderate toward trend in coming quarters. International economies slowing more quickly.
Financial Conditions			Monetary policy shifts toward tightening in many geographies. US rates starting to exert pressure. Fiscal stimulus complete.
Relative Preference	**Chg**	**Neutral**	**Rationale**
Asset Class		Bonds Stocks	Profit growth expectations are high and face increasing headwinds. Bond yields becoming more attractive.
Economic Sensitivity		Defensive Cyclical	Profit cycle may begin to face margin pressures and currency headwinds. Defensive sectors remain expensive.
Credit Quality		Sovereign Credit	Credit fundamentals remain mostly solid. However, spreads are very narrow and suggest valuations are full.
Duration Profile		Short Maturity Long Maturity	Yields responding to higher inflation expectations and monetary policy actions. Business cycle reaching late stage.
Commodities	←	Below Weight Above Weight	Very mixed picture within commodity prices, being influenced by tariff threats and changing supply relationships.
Cash		Below Weight Above Weight	Rising cash yields offer competition to financial assets for the first time in over a decade.

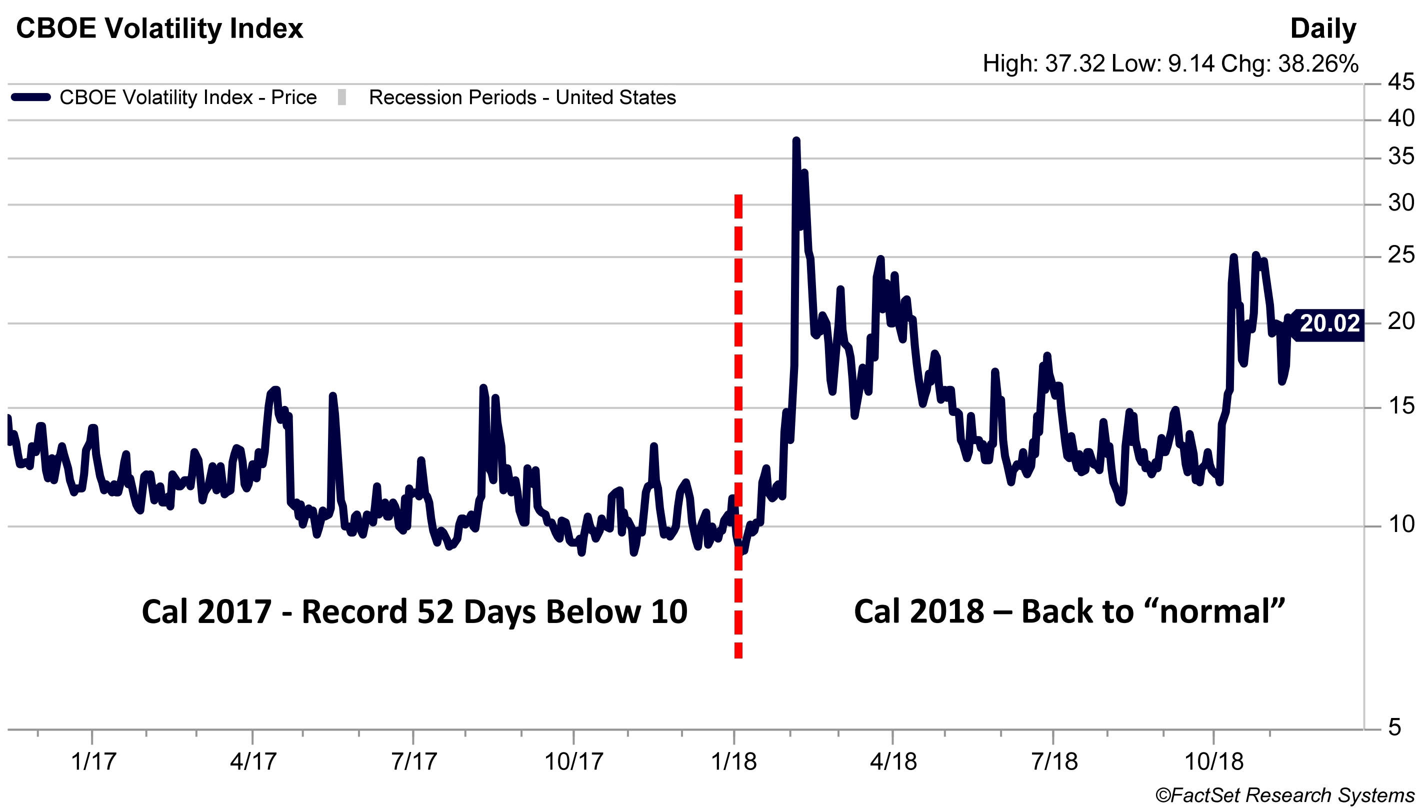
Observation #1
Volatility Returns to Stocks

- The S&P500 (blue line) experienced one of the strongest 3rd quarters in its history, soaring more than 7% from July through September. Over the past 24 months, inclusive of the October swoon, U.S. stocks have had an extraordinary run, rising over 23% plus near 4% cumulative dividend payments.
- But investor sentiment can change quickly, and it has. During the month of October (yellow box), stock investors witnessed an S&P500 that gave back all of its YTD gains and pierce two key technical moving averages.



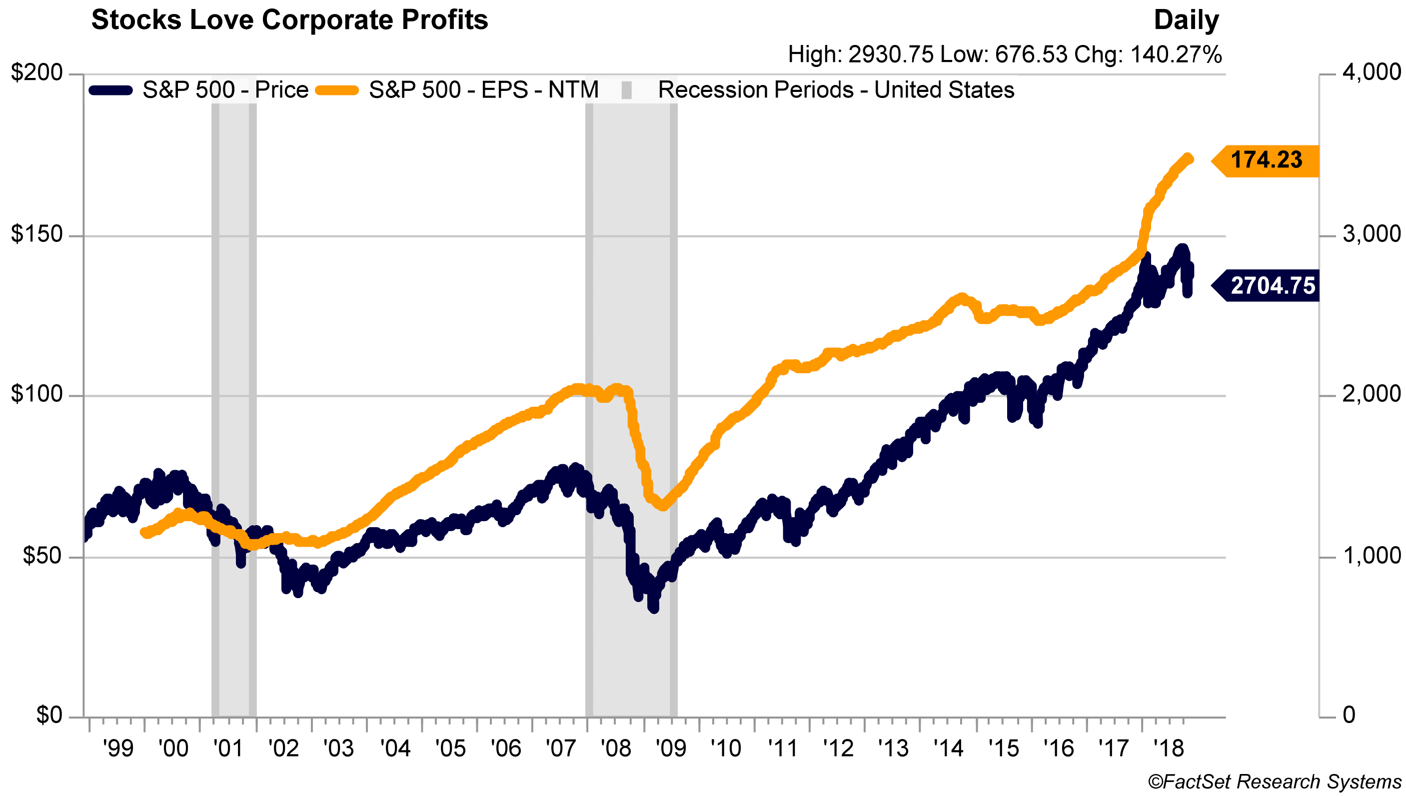
Observation #1
Volatility Returns to Stocks

- Bouts of anxiety are common after extended periods of strong market performance. Extraordinary optimism can quickly turn to a wall of worries and cause investors to pause and reassess their expectations. Each concern can appear rational in the moment, but many prove to be noise rather than signal.
- The incredible complacency displayed by stocks during 2017, has transitioned to volatility levels that reflect a greater dispersion of opinion regarding the future path of economic expansion and profit growth.



Observation #2
Stocks Love Profits

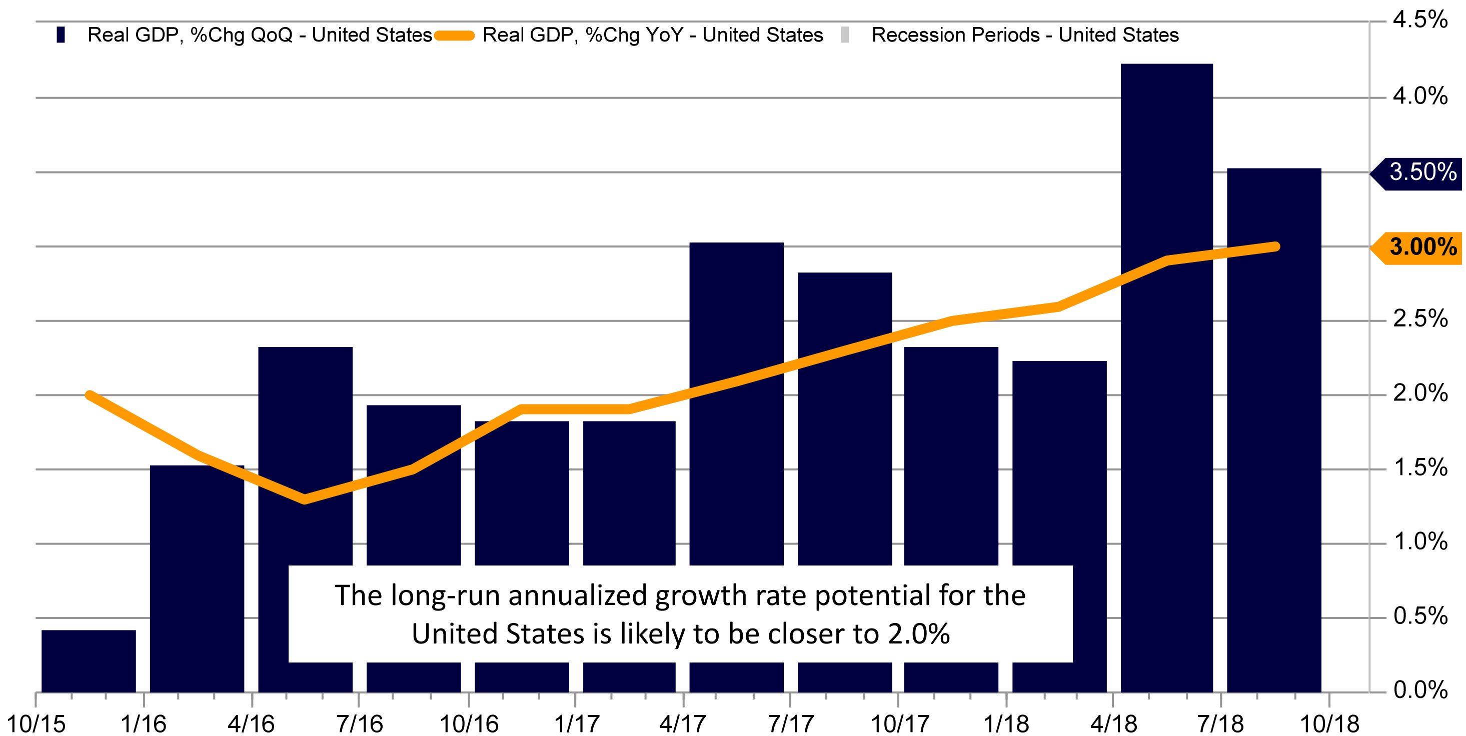
- If there is one primary factor that drives the direction of stocks, its profits. Despite all of the noise that surrounded markets during 2017, stocks (blue line) marched sharply higher because profits (gold line) were expected to expand at remarkably high rates.
- The earnings-per-share growth rate for the S&P500 will likely exceed 20% in 2018, thanks in part to a substantial corporate tax cut and large share repurchases, but largely driven by strong economic growth.



Observation #2
Stocks Love Profits

- Over the course of the last 12 quarters, economic growth (gold line) in the United States has been accelerating and broadening to a wider selection of participants. Record levels of employment have provided consumers with confidence to spend, and small business optimism has moved appreciably higher for the first time in years.
- The rate of quarterly GDP growth (blue columns) in 2Q and 3Q of 2018 delivered profit growth that matched, and often exceeded, the lofty expectations that had been established within stock prices earlier in the year.

USA Real GDP Growth



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Observation #3
Slowing Growth = Slowing Profits

- Measures of sentiment and confidence surrounding the economy are at or near all-time highs, but they are <u>lagging</u> indicators and suggest that it is a good time to re-evaluate the sustainability of elevated expectations.
- The direction of manufacturing activity can be a very valuable <u>leading</u> indicator of economic strength, and the data suggests that the synchronized global growth story peaked earlier in the year and has been slowing ever since. Financial markets are far more interested in the future than they are of the past.

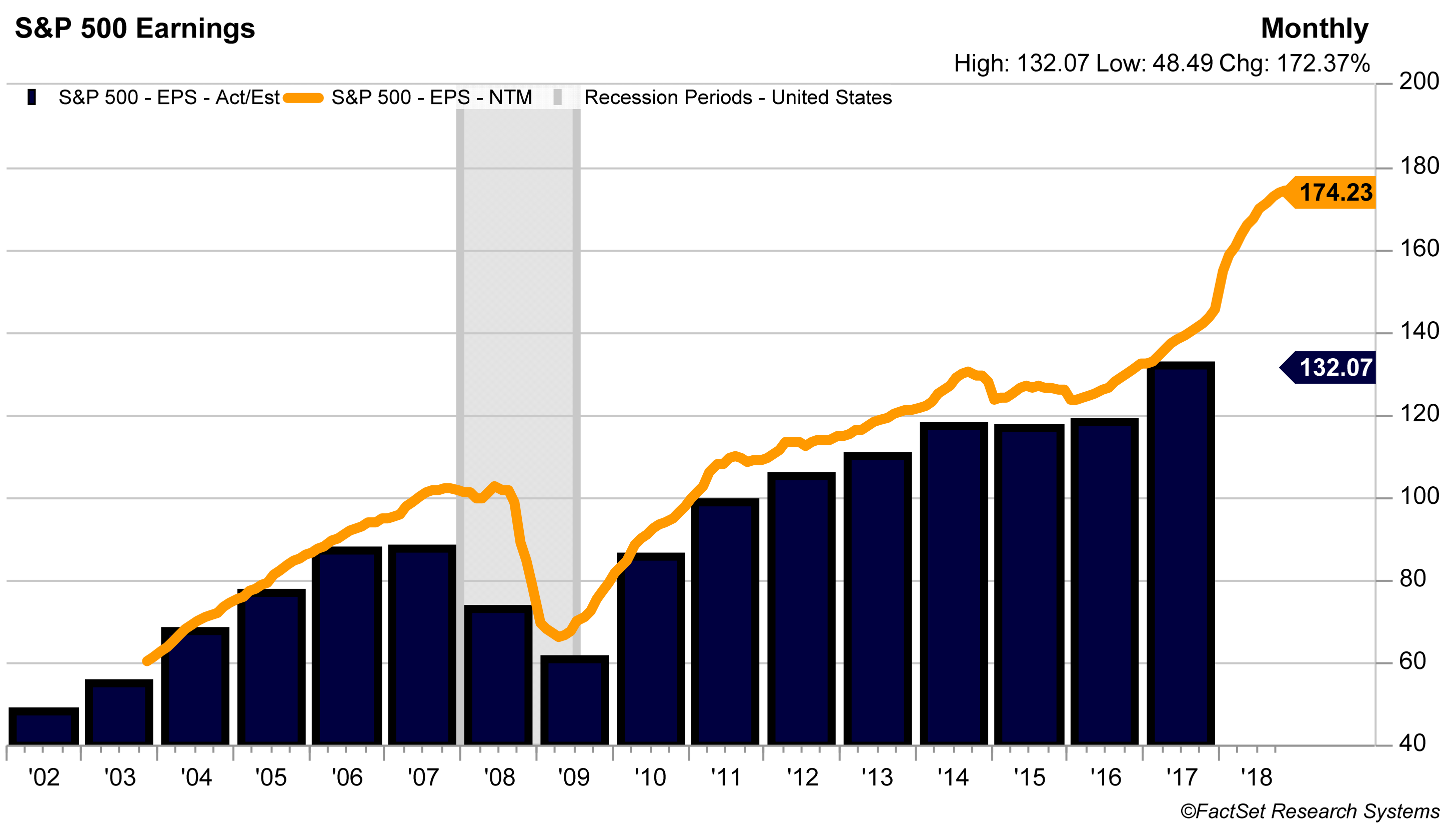
GLOBAL PURCHASING MANAGERS INDEX (PMI) FOR MANUFACTURING

	Nov-16	Dec-16	Jan-17	Feb-17	Mar-17	Apr-17	May-17	Jun-17	Jul-17	Aug-17	Sep-17	Oct-17	Nov-17	Dec-17	Jan-18	Feb-18	Mar-18	Apr-18	May-18	Jun-18	Jul-18	Aug-18	Sep-18	Oct-18
World	52.0	52.6	52.7	52.9	52.9	52.7	52.6	52.6	52.7	53.1	53.2	53.4	54.0	**54.5**	54.4	54.1	53.3	53.5	53.1	53.0	52.7	52.6	52.2	52.1
Developed	52.9	53.8	54.1	54.1	53.9	54.1	54.1	53.8	53.9	54.2	54.6	55.2	55.8	56.2	**56.3**	55.7	54.9	55.1	54.7	54.4	54.0	53.8	53.6	53.2
Emerging	50.8	51.1	50.8	51.3	51.6	50.9	50.6	50.8	50.9	51.7	51.4	51.2	51.6	**52.2**	51.9	52.0	51.3	51.3	51.1	51.2	51.0	50.8	50.3	50.5
USA	54.1	54.3	55.0	54.2	53.3	52.8	52.7	52.0	53.3	52.8	53.1	54.6	53.9	55.1	55.5	55.3	55.6	**56.5**	56.4	55.4	55.3	54.7	55.6	55.7
UK	53.2	55.7	55.3	54.6	54.1	57.8	56.5	54.2	55.4	56.9	55.4	56.7	**58.2**	56.1	55.2	55.0	54.9	53.9	54.2	54.1	53.8	52.8	53.6	51.1
Canada	51.5	51.8	53.5	54.7	55.5	55.9	55.1	54.7	55.5	54.6	55.0	54.3	54.4	54.7	55.9	55.6	55.7	55.5	56.2	**57.1**	56.9	56.8	54.8	53.9
Australia	54.2	55.4	51.2	59.3	57.5	59.2	54.8	55.0	56.0	59.8	54.2	51.1	57.3	56.2	58.7	57.5	**63.1**	58.3	57.5	57.4	52.0	56.7	59.0	58.3
Euro Zone	53.7	54.9	55.2	55.4	56.2	56.7	57.0	57.4	56.6	57.4	58.1	58.5	60.1	**60.6**	59.6	58.6	56.6	56.2	55.5	54.9	55.1	54.6	53.2	52.0
Germany	54.3	55.6	56.4	56.8	58.3	58.2	59.5	59.6	58.1	59.3	60.6	60.6	62.5	**63.3**	61.1	60.6	58.2	58.1	56.9	55.9	56.9	55.9	53.7	52.2
Italy	52.2	53.2	53.0	55.0	55.7	56.2	55.1	55.2	55.1	56.3	56.3	57.8	58.3	57.4	**59.0**	56.8	55.1	53.5	52.7	53.3	51.5	50.1	50.0	49.2
France	51.7	53.5	53.6	52.2	53.3	55.1	53.8	54.8	54.9	55.8	56.1	56.1	57.7	**58.8**	58.4	55.9	53.7	53.8	54.4	52.5	53.3	53.5	52.5	51.2
Ireland	53.7	55.7	55.5	53.8	53.6	55.0	55.9	56.0	54.6	56.1	55.4	54.4	58.1	**59.1**	57.6	56.2	54.1	55.3	55.4	56.6	56.3	57.5	56.3	54.9
Greece	48.3	49.3	46.6	47.7	46.7	48.2	49.6	50.5	50.5	52.2	52.8	52.1	52.2	53.1	55.2	**56.1**	55.0	52.9	54.2	53.5	53.5	53.9	53.6	53.1
Spain	54.5	55.3	55.6	54.8	53.9	54.5	55.4	54.7	54.0	52.4	54.3	55.8	**56.1**	55.8	55.2	56.0	54.8	54.4	53.4	53.4	52.9	53.0	51.4	51.8
China	50.9	**51.9**	51.0	51.7	51.2	50.3	49.6	50.4	51.1	51.6	51.0	51.0	50.8	51.5	51.5	51.6	51.0	51.1	51.1	51.0	50.8	50.6	50.0	50.1
India	52.3	49.6	50.4	50.7	52.5	52.5	51.6	50.9	47.9	51.2	51.2	50.3	52.6	**54.7**	52.4	52.1	51.0	51.6	51.2	53.1	52.3	51.7	52.2	53.1
Japan	51.3	52.4	52.7	53.3	52.4	52.7	53.1	52.4	52.1	52.2	52.9	52.8	53.6	54.0	**54.8**	54.1	53.1	53.8	52.8	53.0	52.3	52.5	52.5	52.9
South Korea	48.0	49.4	49.0	49.2	48.4	49.4	49.2	50.1	49.1	49.9	50.6	50.2	51.2	49.9	50.7	50.3	49.1	48.4	48.9	49.8	48.3	49.9	**51.3**	51.0
Taiwan	54.7	56.2	55.6	54.5	56.2	54.4	53.1	53.3	53.6	54.3	54.2	53.6	56.3	56.6	**56.9**	56.0	55.3	54.8	53.4	54.5	53.1	53.0	50.8	48.7
Indonesia	49.7	49.0	50.4	49.3	50.5	51.2	50.5	49.5	48.6	50.7	50.4	50.1	50.4	49.3	49.9	51.4	50.7	51.6	51.7	50.3	50.5	**51.9**	50.7	50.5
Russia	53.6	53.7	**54.7**	52.5	52.4	50.8	52.4	50.3	52.7	51.6	51.9	51.1	51.5	52.0	52.1	50.2	50.6	51.3	49.8	49.5	48.1	48.9	50.0	51.3
Brazil	46.2	45.2	44.0	46.9	49.6	50.1	52.0	50.5	50.0	50.9	50.9	51.2	**53.5**	52.4	51.2	53.2	53.4	52.3	50.7	49.8	50.5	51.1	50.9	51.1
Mexico	51.1	50.2	50.8	50.6	51.5	50.7	51.2	52.3	51.2	52.2	**52.8**	49.2	52.4	51.7	52.6	51.6	52.4	51.6	51.0	52.1	52.1	50.7	51.7	50.7

Heat Map = Monthly manufacturing PMI activity indices (Markit Economics)
Green = readings above 50 are indicative of manufacturing activity expanding
Red = readings below 50 are indicative of manufacturing activity contracting
Yellow = highest reading for that country during the 2 year time period

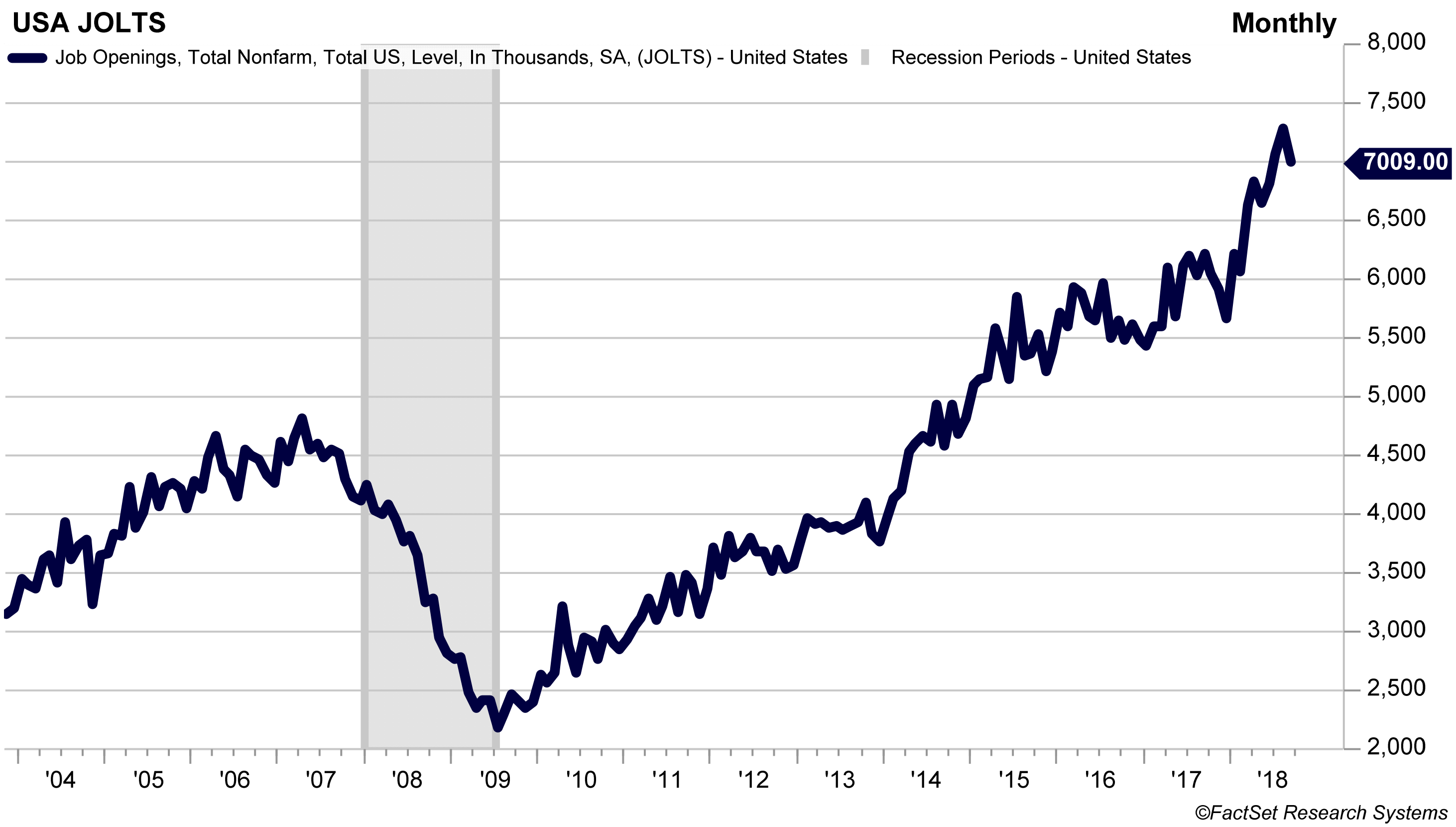
Observation #3
Slowing Growth = Slowing Profits

- Fractures within the synchronized global growth story and a recognition that the U.S. growth trajectory is cooling back toward trend, are eroding the confidence in elevated profit expectations (gold line).
- It should not be surprising that the rate of earnings growth experienced in 2018 will not be matched in 2019. **It is the uncertainty around profit growth that has caused the anxiety sweeping across stock markets**. Once expectations are recalibrated to a more reasonable path for profits, stocks are likely to regain their footing.



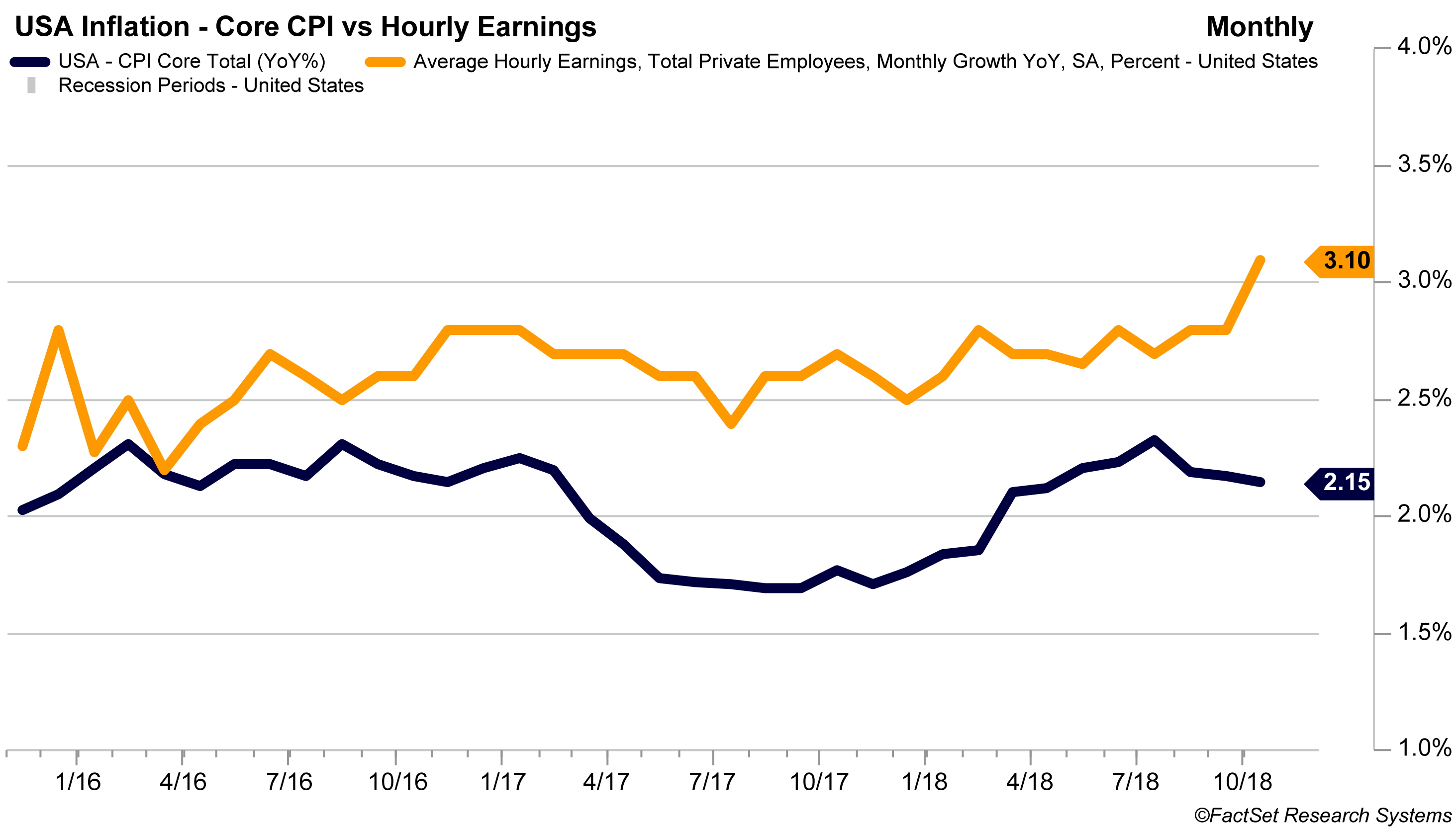
Observation #4
Economic Growth and Inflation

- There are many factors that influence the ebb and flow of economic conditions. The composition of jobs and the supply of labor can have profound impact on the economic growth trajectory and inflationary forces.
- The strength of the current economic expansion has produced a record number of job openings, more than 7 million across the United States. The lack of workers to match the skills required for these openings is proving to be a great challenge, and has likely restrained the U.S. economy from growing even faster.



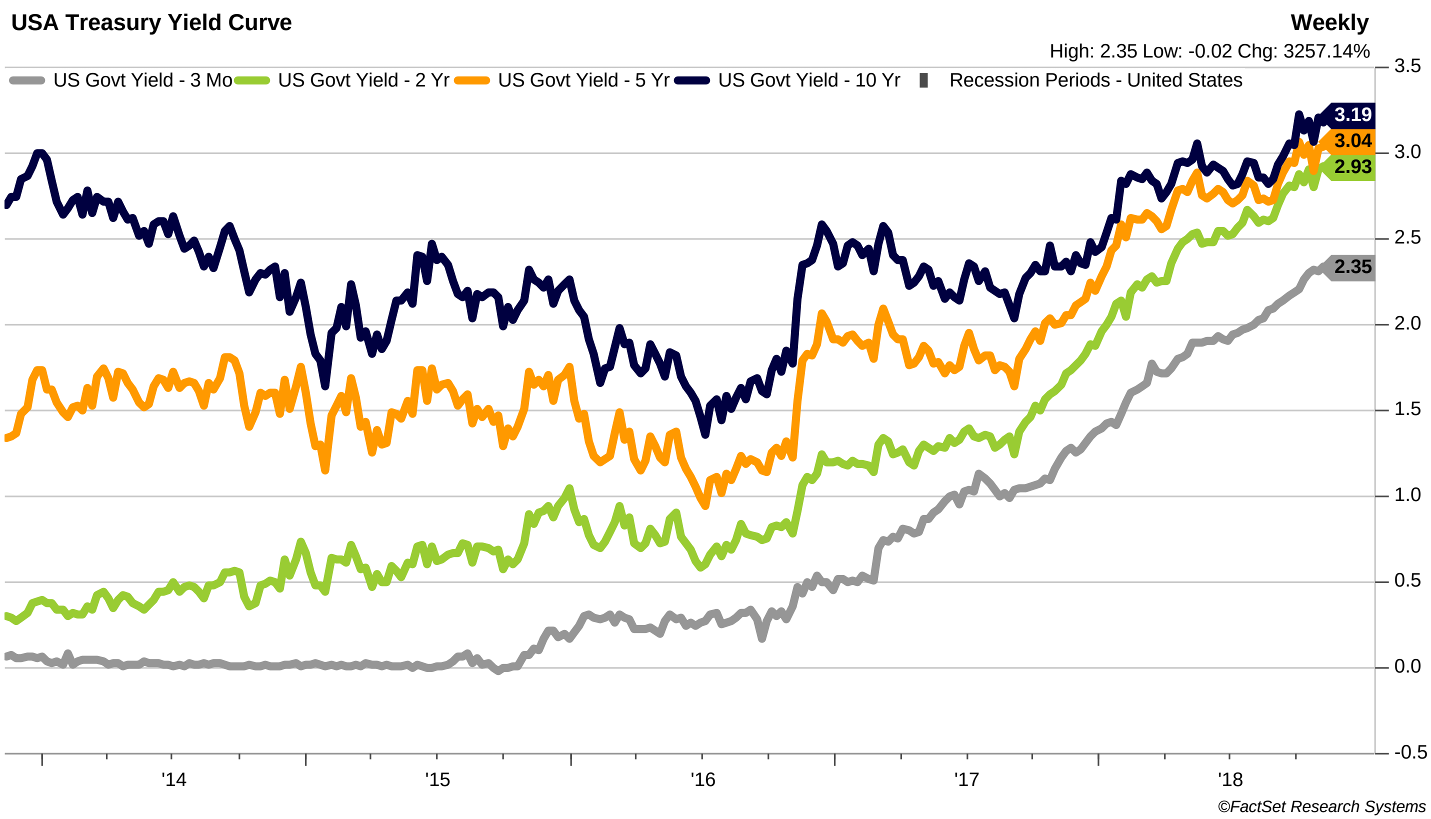
Observation #4
Economic Growth and Inflation

- Hourly earnings (gold line) for many Americans have been stagnant for years, but that may be changing as employers face tight labor conditions and a shortage of required skills.
- Fed officials monitor a variety of inflation measures, like the Core CPI (blue line) to assist them in establishing monetary policy. Decisions based on <u>lagging</u> indicators, like inflation, increase the risk of policy mistakes. Placing greater weight on <u>leading</u> indicators would perhaps generate better outcomes and greater stability.



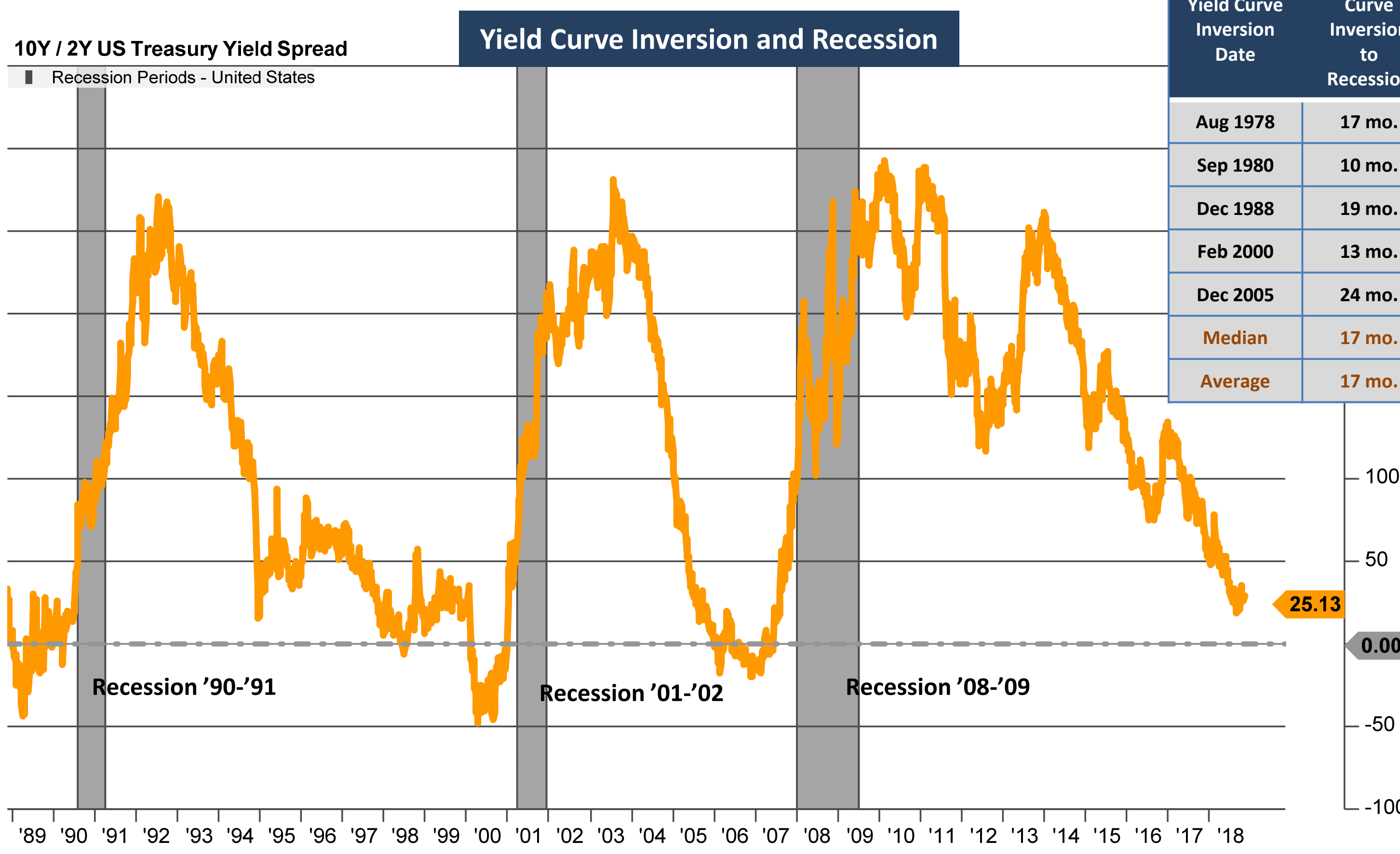
Observation #5
Are Bond Markets Smarter than Central Bankers?

- As excess labor, materials and capacity are absorbed by a stronger economy, bond markets anticipate policy changes at the Federal Reserve and a "normalization" of interest rates.
- Yields across all U.S. Treasury securities have been rising over the past two years, but the increases have been particularly pronounced on shorter maturing securities than for those that are longer dated. The flattening curve suggests that the further the Fed raises rates, the greater the risk that they stall economic growth.



Observation #5
Are Bond Markets Smarter than Central Bankers?

- Whenever Central Banks are raising short term interest rates, investors must evaluate the impact that higher rates may have on future economic growth, price stability and the path for corporate profits.
- Yield curve flattening is typical within a maturing business cycle, but history suggests that stock investors should take note when the yield curve approaches inversion.

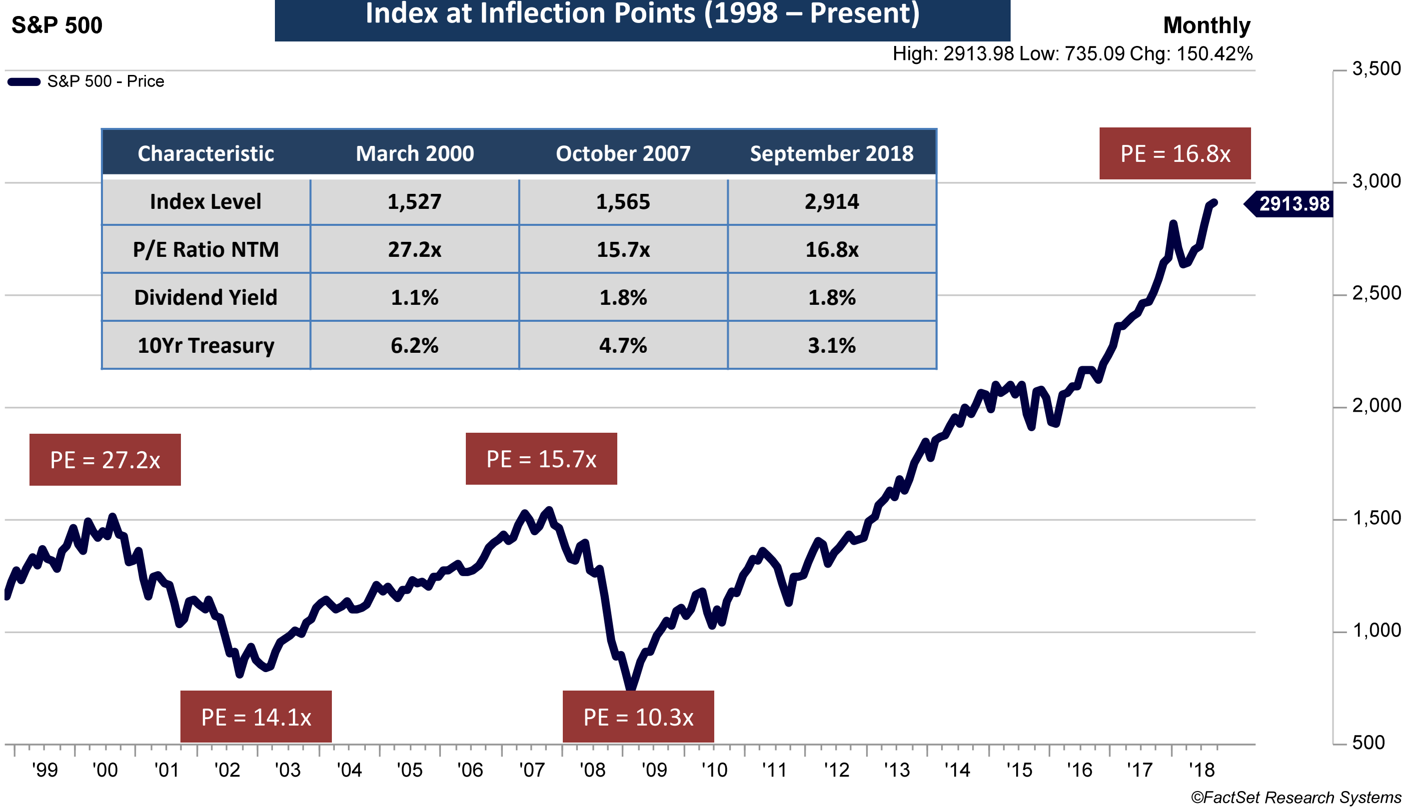


Yield Curve Inversion Date	Curve Inversion to Recession	Curve Inversion to S&P 500 Peak
Aug 1978	17 mo.	17 mo.
Sep 1980	10 mo.	2 mo.
Dec 1988	19 mo.	17 mo.
Feb 2000	13 mo.	6 mo.
Dec 2005	24 mo.	22 mo.
Median	17 mo.	17 mo.
Average	17 mo.	13 mo.

Observation #6
Are Stocks Too Expensive?

- The S&P500 (blue line) has experienced a tremendous bull market since achieving its cycle low on March 9th, 2009. The cumulative return of the index approached 330% at the conclusion of the 3rd quarter of 2018.
- Some observers may postulate that price appreciation of that magnitude is indicative of an expensive market. But price alone tells us very little about the value of stocks. Investors must consider the level of profits, dividends and interest rates, among other factors that help to illuminate a markets valuation.

Index at Inflection Points (1998 – Present)

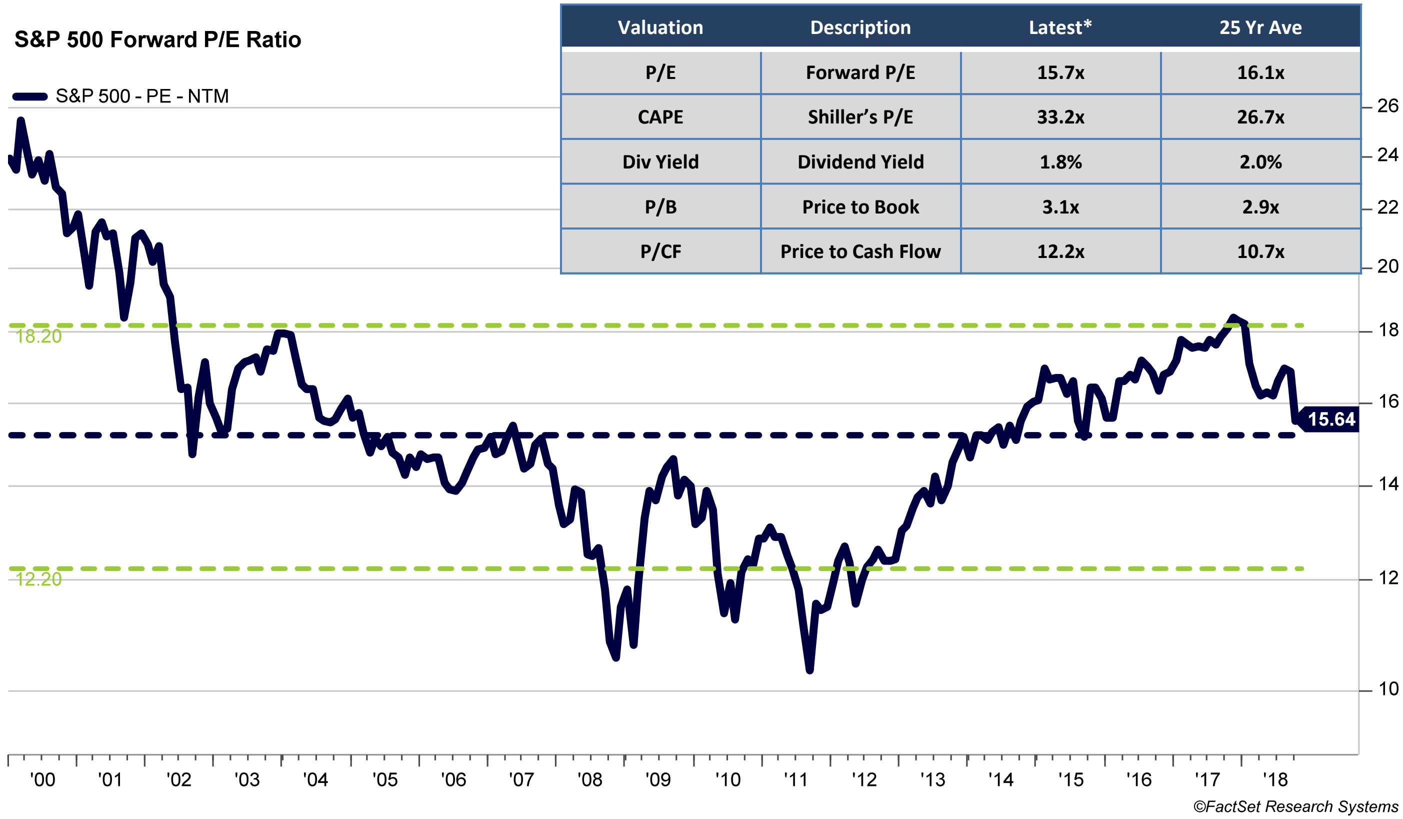


Characteristic	March 2000	October 2007	September 2018
Index Level	1,527	1,565	2,914
P/E Ratio NTM	27.2x	15.7x	16.8x
Dividend Yield	1.1%	1.8%	1.8%
10Yr Treasury	6.2%	4.7%	3.1%

Observation #6
Are Stocks Too Expensive?

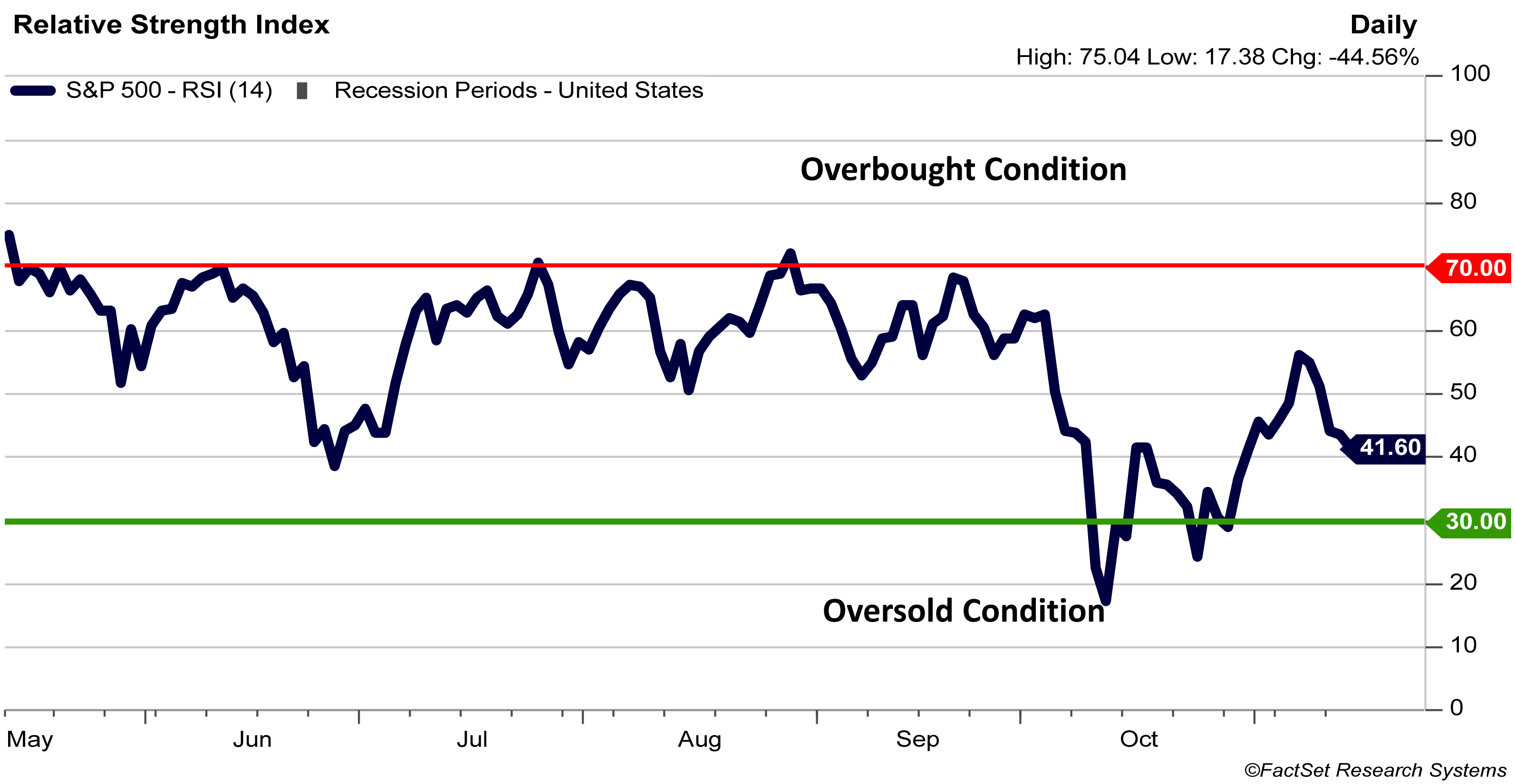
- Stock prices almost always follow the general direction of corporate profit expectations – lower when profits are expected to decline, higher when profits are expected to expand.
- Whether stocks are expensive or not, requires an opinion regarding the consensus expectation of future profits. If we believe that the current S&P500 estimate for $177 NTM earnings is too optimistic, then the actual P/E ratio (blue line) is perhaps not quite as 'average' as it may appear.

Valuation	Description	Latest*	25 Yr Ave
P/E	Forward P/E	15.7x	16.1x
CAPE	Shiller's P/E	33.2x	26.7x
Div Yield	Dividend Yield	1.8%	2.0%
P/B	Price to Book	3.1x	2.9x
P/CF	Price to Cash Flow	12.2x	10.7x



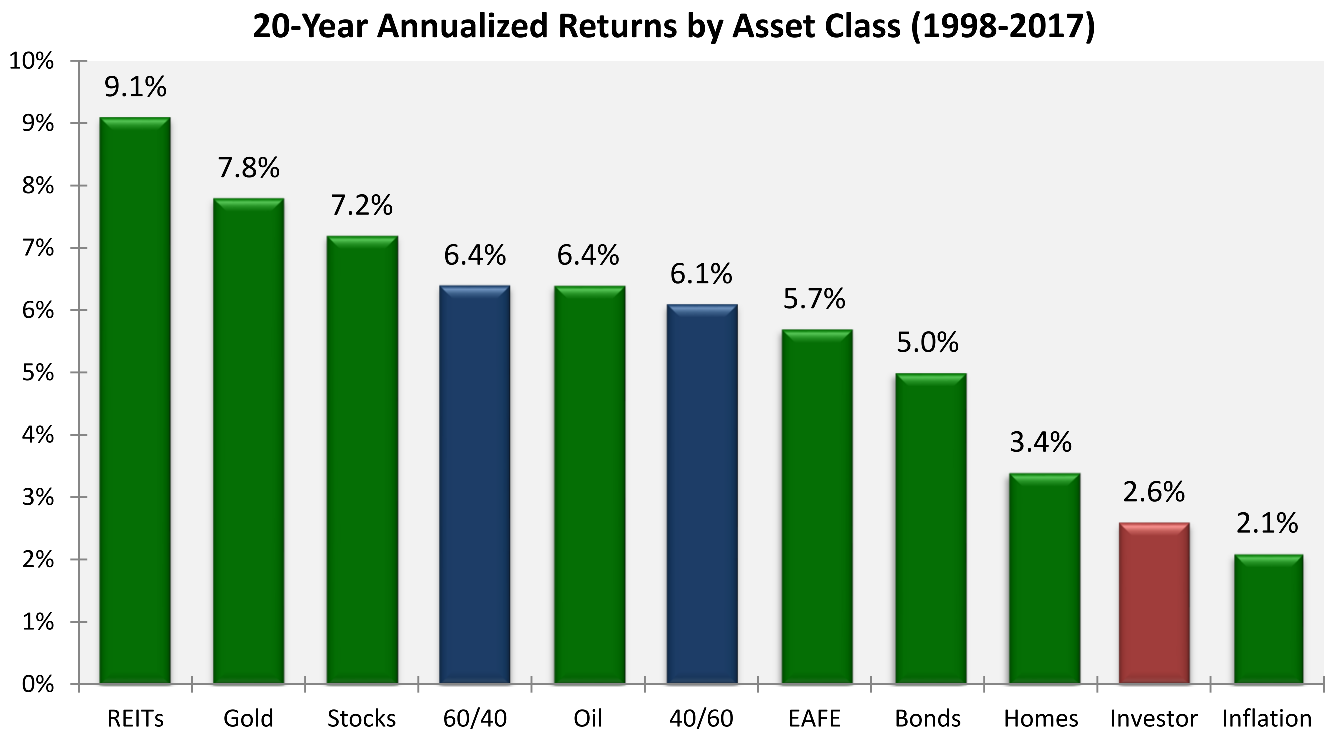
Observation #7
The Investors Emotional Pendulum

- We prefer to rely on fundamental analysis and valuation metrics for assessing a long-term investment opportunity, but observing various technical indicators may provide valuable near-term entry and exit signals.
- Unfortunately, the average investor gets caught in the Emotional Pendulum, swinging between moments of optimism and greed across to pessimism and fear. The power of emotion often results in the average investor buying high (red line) and selling low (green line).



Observation #7
The Investors Emotional Pendulum

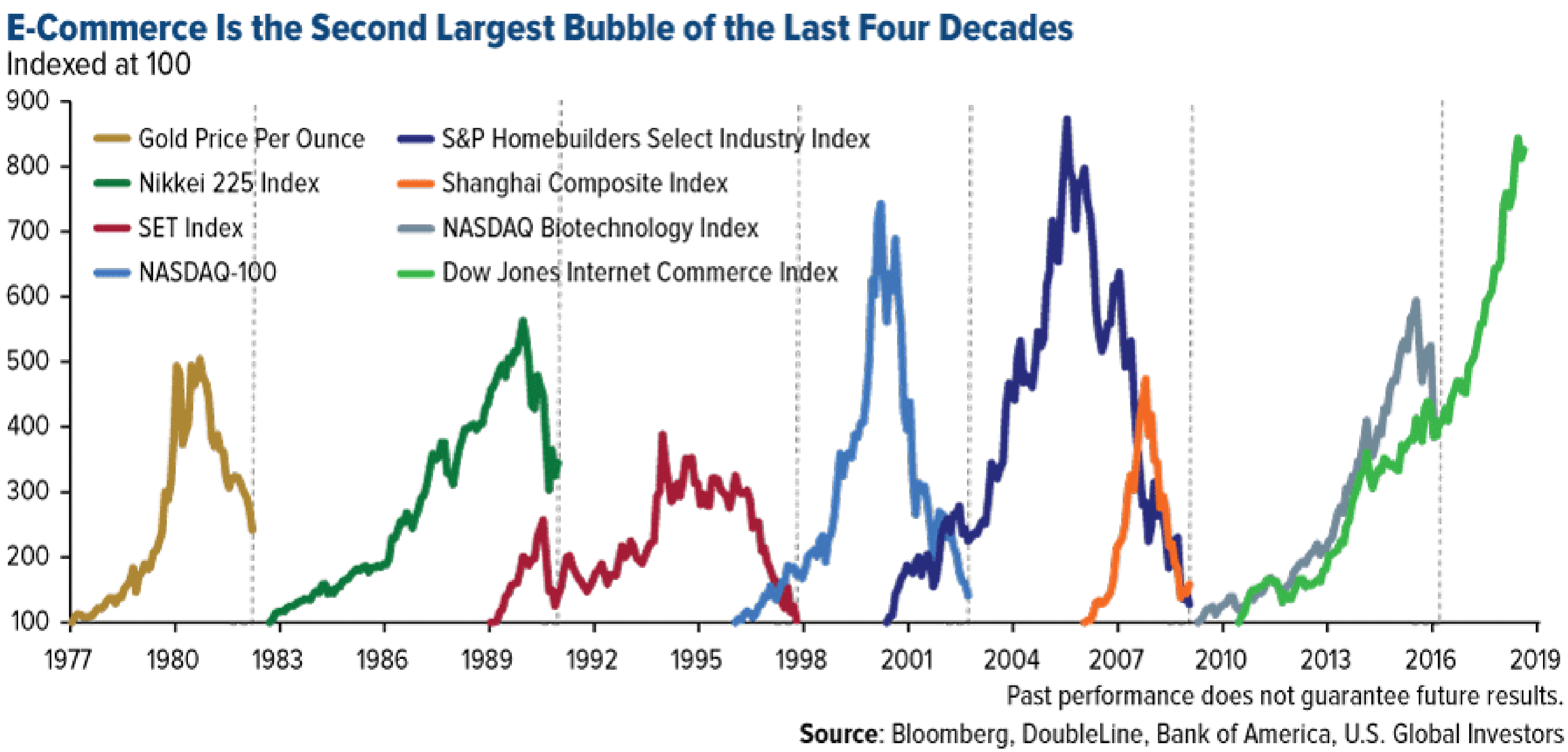
- A dollar of investment made 20 years ago would have enjoyed an attractive annualized return across a wide range of financial assets (green columns) and risk profiles (blue columns), despite periods of market volatility.
- But the average investor (red column) managed to dilute their return experience, likely the result of allowing the Emotional Pendulum to change their course at exactly the wrong times.



- Source: JP Morgan Asset Management, 2017; NAREIT Equity REIT Index, S&P 500 Equity Index, Barclays Aggregate Bond Index, USD/Troy Oz. Gold, WTI Oil Index, MSCI EAFE Equity Index, Median Sale price of Existing Single Family Homes, Headline CPI.
- 60/40 Portfolio is 60% S&P 500 Index and 40% Barclays US Aggregate Bond Index : 40/60 Portfolio is 40% S&P 500 Index and 60% Barclays US Aggregate Bond Index
- Average Investor = Dalbar Inc. analysis of monthly mutual fund sales, redemptions and exchanges

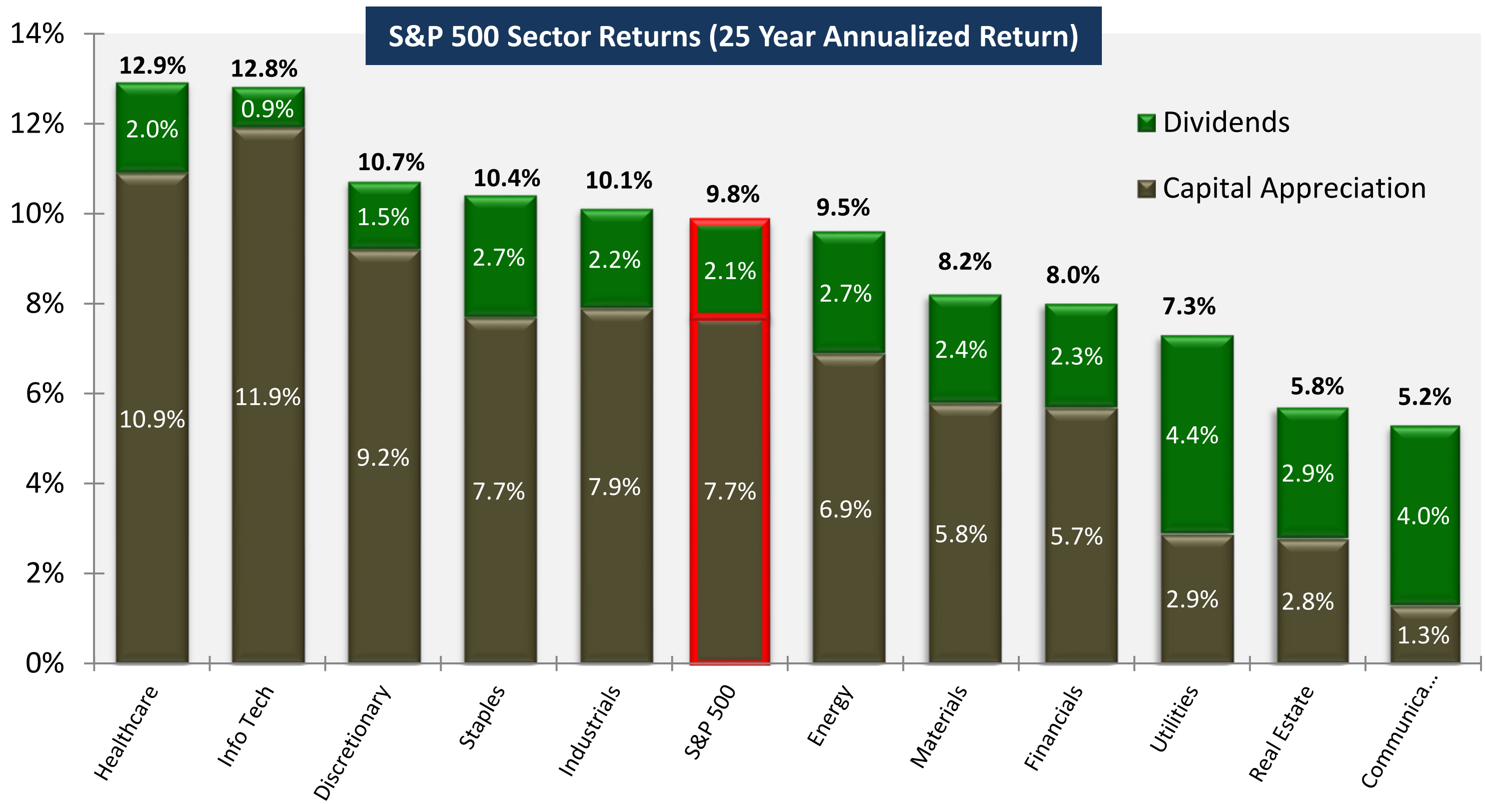
Observation #8
A Market of Stocks

- Time will tell whether e-commerce is the second largest bubble, but the chart is hard to ignore and highlights the power of the Emotional Pendulum. Investors are willing to rationalize the exuberant price appreciation to the very top, pushing the pendulum to maximum greed.
- Like bubbles past, the internet commerce index contains some excellent companies. But few, if any, will be able to live up to the lofty expectations and extreme valuations that have been assigned. The average investor is often the most vulnerable to the blind spot created by the Emotional Pendulum.



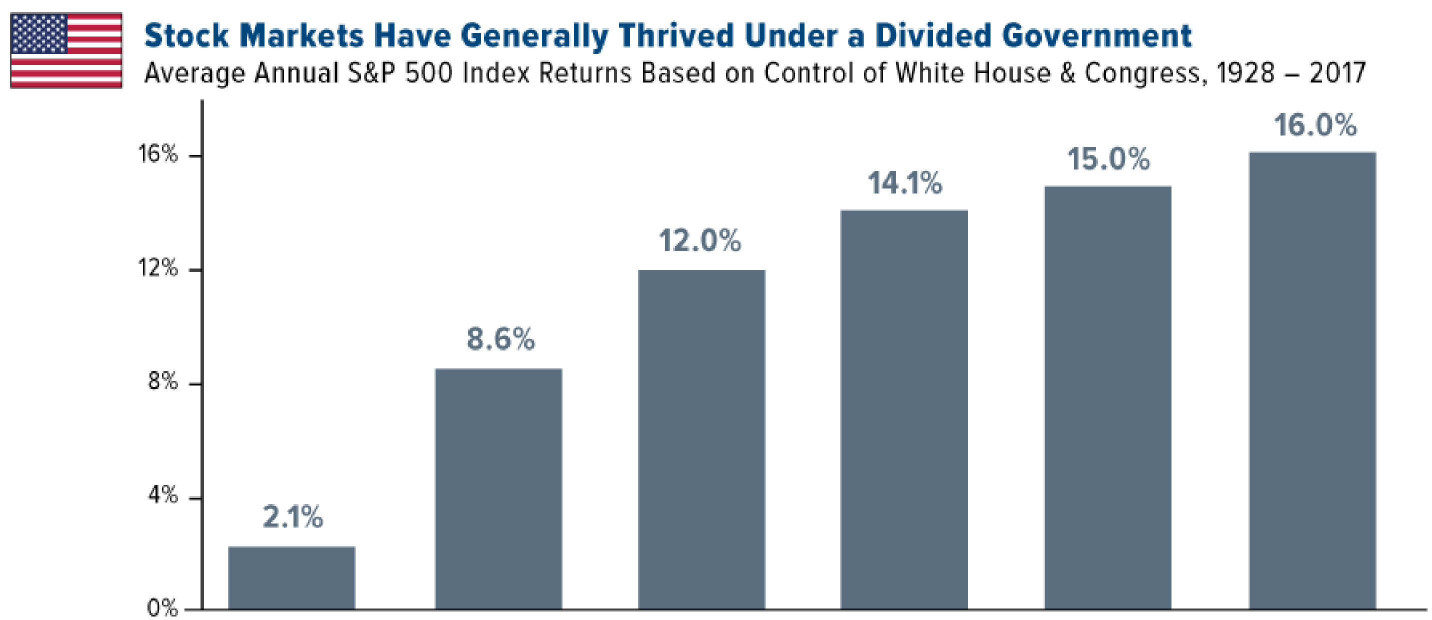
Observation #8
A Market of Stocks

- As an investor, studying the business and financial conditions of an economic cycle should provide insight and an opportunity to reposition a portfolio among and within asset classes. The data can present important signals for pivoting between “playing offense” and “playing defense”.
- Many sectors of the market contain attributes that have held true over the long-term. Understanding the attributes that best align with the position of the economic cycle can be rewarding.



Observation #9
Some Political Perspective

- In everyday life, gridlock is an anchor to economic growth. Consider the number of unproductive hours spent by Americans sitting in traffic each day. But when it comes to politics, markets prefer gridlock.
- We have entered the three most bullish quarters for stocks of the four year Presidential cycle. Average returns in the fourth quarter of year two have historically been 4 percent, followed by 5.2 percent in the first quarter of year three and 3.6 percent in the second quarter. Will the current period follow history?

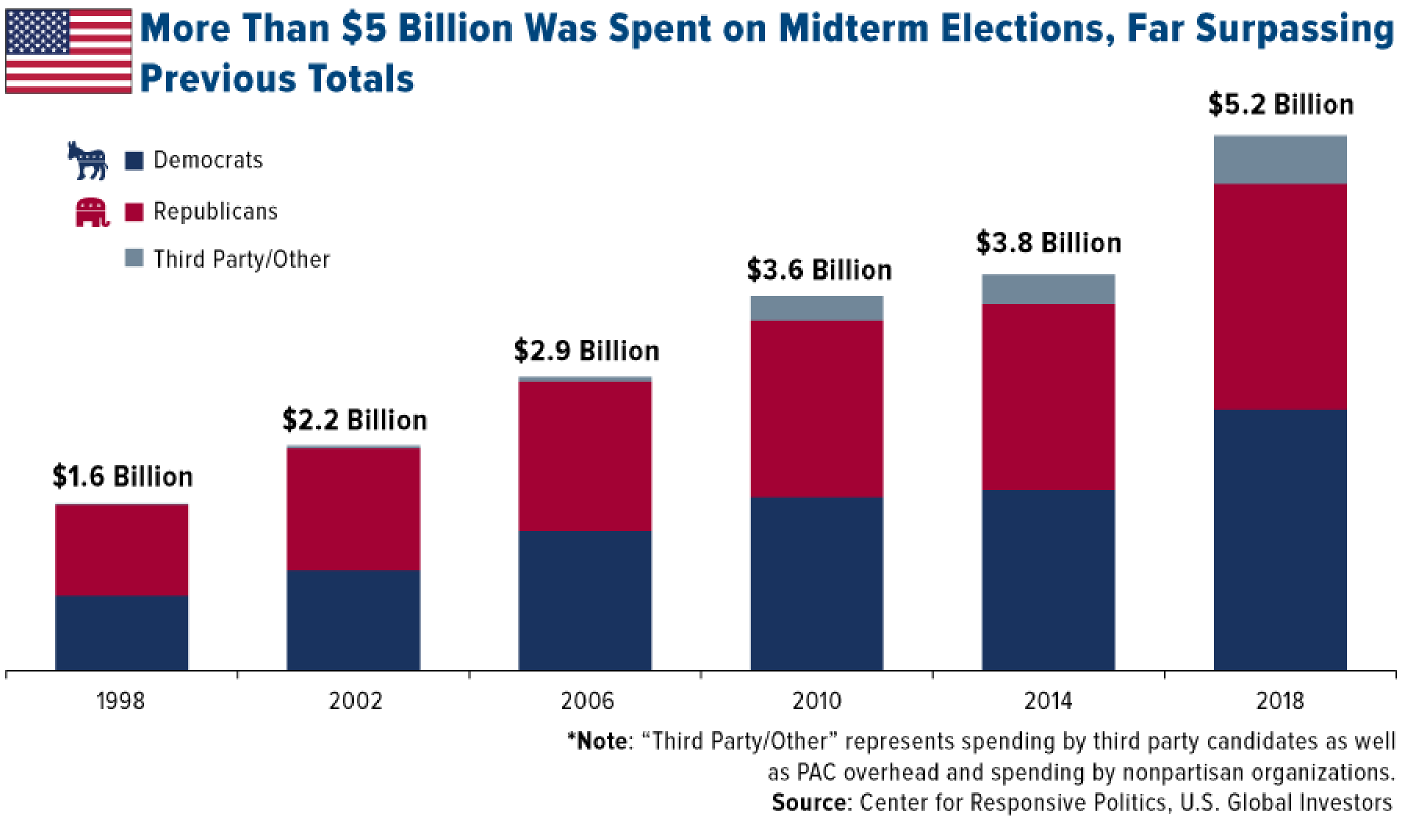


President:	Republican	Republican	Republican	Democratic	Democratic	Democratic
Congress:	Republican	Democratic	Split	Democratic	Republican	Split
# Yrs Occurred:	12	22	7	34	10	4

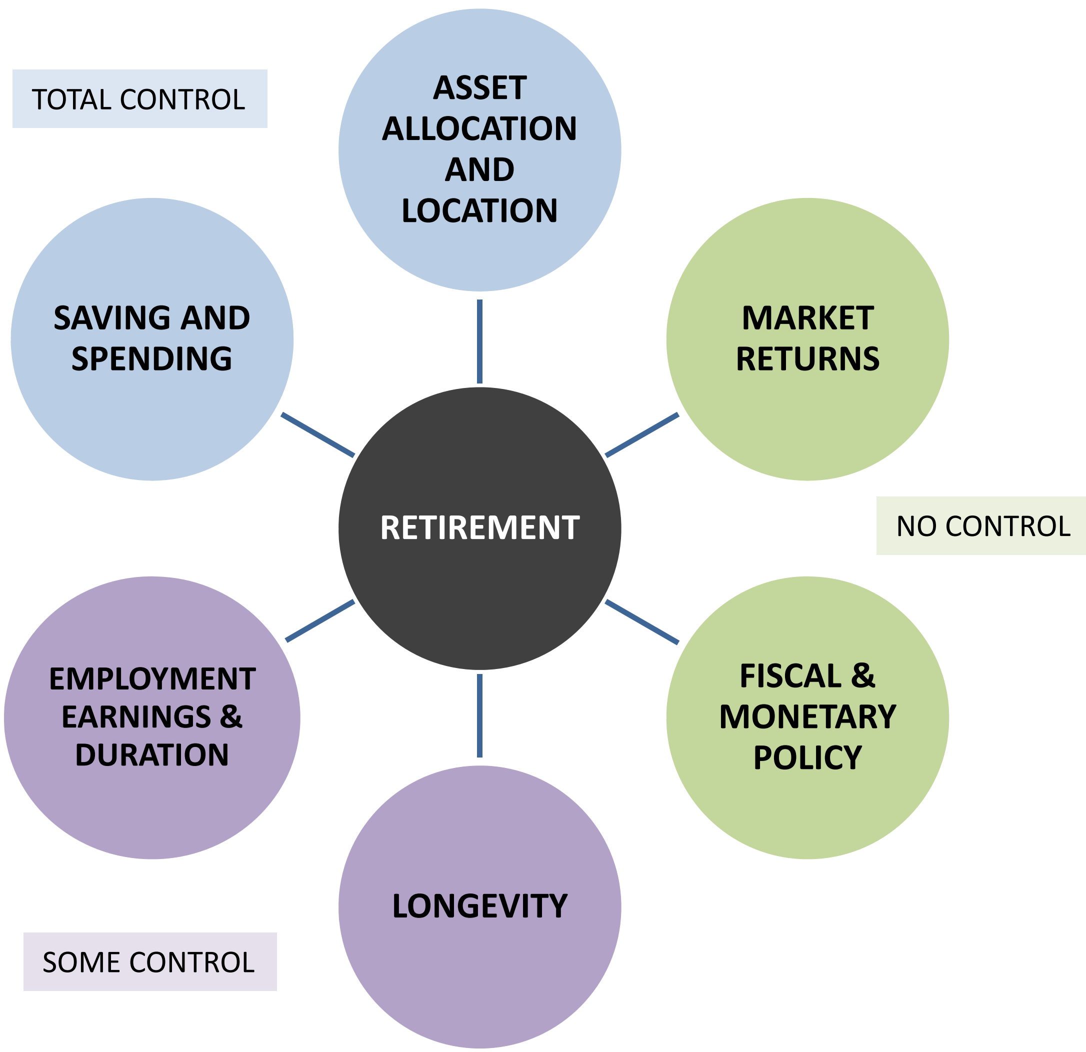
Source: S&P, FactSet, Bank of America Merrill Lynch, U.S. Global Investors

Observation #9
Some Political Perspective

- According to the Center for Responsive Politics, the dollars spent on the Midterm elections increased by an astonishing 40% over 2014 levels.
- It might help to put $5.2 billion into perspective. An estimated 113 million Americans showed up at the polls to participate in the Midterm elections, a record. That means approximately $46 was spent on each voter.
- Between the House and Senate, there were 470 seats up for grabs. That's approximately $11 million per seat.



Observation #10
The Most Important Decision - Asset Allocation



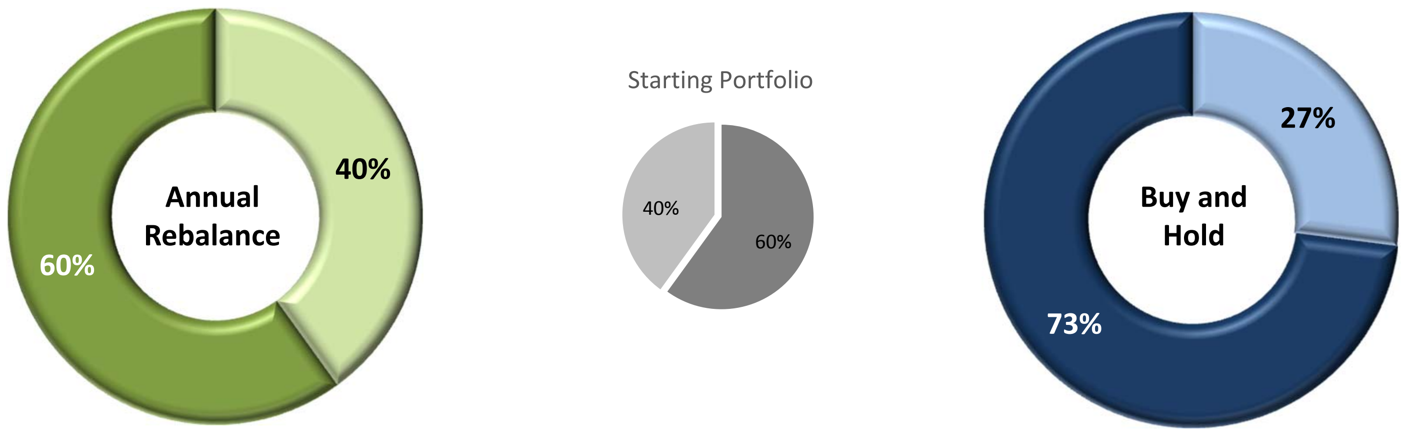
A SOUND RETIREMENT PLAN

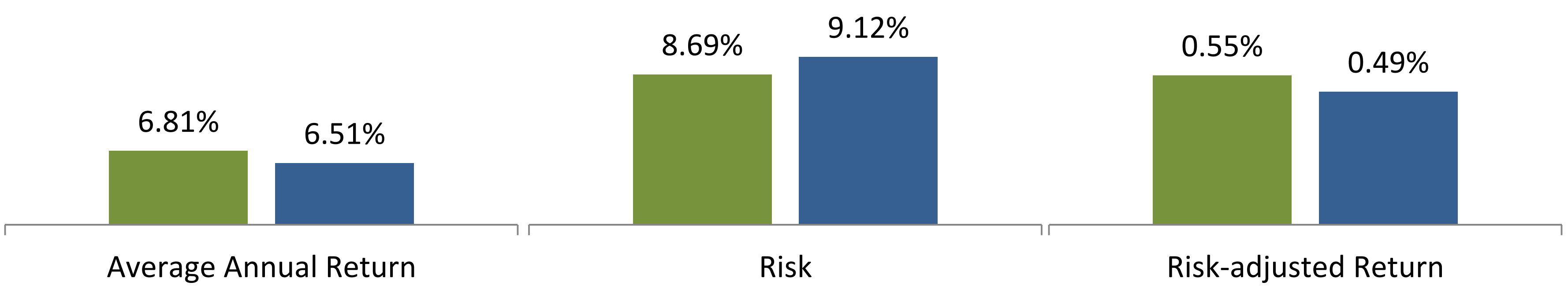
Investors can choose to evaluate many factors as they prepare their portfolios for retirement, but most are out of their control. Investors are best served when they focus on the factors that offer total control.

JP Morgan Asset Management "Guide to Retirement"

Observation #10
The Most Important Decision – Asset Allocation

20 Years: 12/31/97 to 12/31/2017





- Source: JP Morgan Asset Management, 2017; The Starting Portfolio of Equity (60%) and fixed Income (40%) are represented by the S&P 500 Index and Bloomberg Barclays US Aggregate Bond Index. The Annual Rebalance is executed on January 1st of each year. The Buy and Hold strategy floats with market performance over time and is never rebalanced. Risk is measured by standard deviation and risk-adjusted return is represented by the Sharpe ratio. This information is for illustrative purposes only, does not reflect actual investment results, is not a guarantee of future results and is not a recommendation.

Disclosure

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