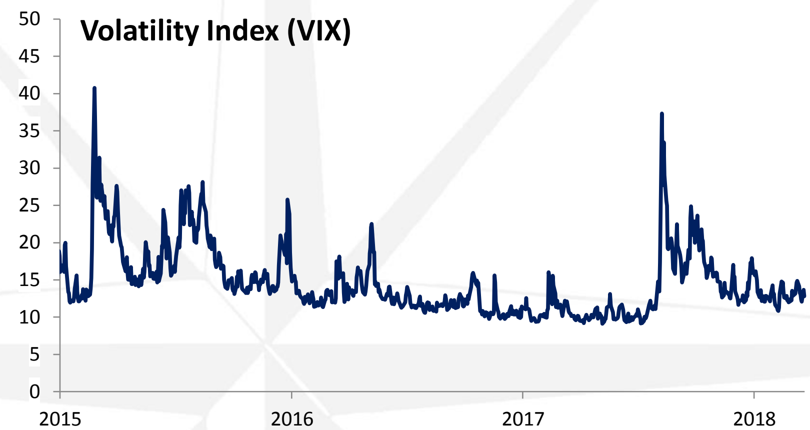
If you have been invested in the U.S. equity markets over the past five years, you have experienced a solid return and resurgence in the market value of your investment portfolio. In its basic form, a capital market, is simply a mechanism for pricing risk. Over the past five years, we have seen increases in prices on publicly traded risk assets, such as stocks and high yield bonds. However, markets are not necessarily efficient at pricing risk all of the time. Equity investors have been richly rewarded over the past five years in spite of growing global risks. *However, this period of rising equity prices and low levels of volatility is about to be tested as the global economy transitions and capital markets adjust to higher interest rates. The risk premium, which investor's demand on risk assets, needs to adjust higher.*

The U.S. economy is performing extremely well and remains one of the stronger pillars in the global economy. The unemployment rate is near record lows, wage inflation is taking root, and consumer confidence is high. In addition, excess resources that have persisted in the economy for many years are being put to use as capacity utilization improves and occupancy rates in real estate increase. We are even starting to see improvements in productivity gains that have been illusive throughout this period of economic growth.



Source: Chicago Board Options Exchange

After working through the Financial Crisis and slow economic growth that followed, we believe an inflection point is near. The Financial Crisis required massive Federal Reserve intervention, such as regulatory bank reform and quantitative easing, resulting in distorted economic and capital market activity. We are now experiencing an economic period unlike any other in history. This is evidenced by a zero percent real Fed Funds Rate and $4.2 trillion in debt on the Fed's balance sheet, which it had purchased in the open market. As a result, comparisons to past recoveries provide little guidance. So, within our investment matrix, we continue to cling to those things we are clear on:

1. When money supply grows, prices of financial assets rise.
2. When central banks reduce interest rates to low levels and keep them there for a long time, asset prices increase.
3. When monetary policy shifts tighter, volatility increases and markets inevitably dislocate.
4. The credit cycle still exists.

It is important to separate the corresponding impact of the cumulative regulatory, political and central bank decisions on the economy from its impact on the capital markets.

The Economy

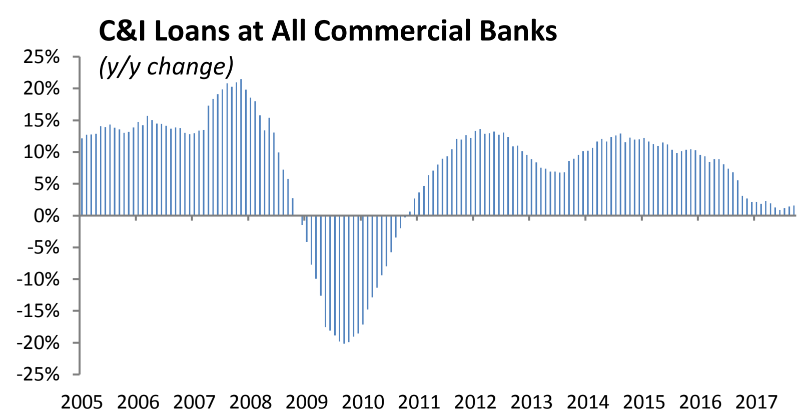
The U.S. economy is in the sweet spot, and we estimate current growth of around 3.0% as both the business and consumer sectors continue to show resilient strength this year. The continued improvement in job growth and employment is contributing to increased consumer strength, which in turn, supports growth in Retail Sales evidenced by a 5.3% increase over the summer. We expect the economy to show continued strength through the first half of 2019, and we predict it will begin to slow in the second half as the impact of higher interest rates takes effect. With stronger aggregate demand, the risk of a higher pace of inflation is real, as supply of labor tightens and raw material prices ratchet higher. The consumer, construction and energy sectors are showing solid growth. However, declines in auto sales and housing are early signs of the potential shift in economic activity.

While the domestic economy is humming along, capital market activity is giving us some heart burn. When we talk about the capital markets, we include publicly traded stocks and bonds, as well as other investable asset classes, such as leveraged loans, real estate, and private equity. *The transition from prolonged low levels of interest rates to a higher interest rate environment will inevitably cause dislocations in asset prices. Higher interest rates result in lower valuations. This happens as discount rates adjust higher on private equity transactions, the risk free rate moves higher when valuing private investments, and cap rates move higher when valuing real estate investments.*

Monetary Policy

Even though the Federal Reserve is two years into its tightening cycle, monetary policy still feels accommodative. The Fed has pushed short term interest rates higher eight times over the past two years and the Fed Funds rate is now at the same level it was at leading up to the Financial Crisis in 2008. However, the tightening cycle includes more than simply adjusting short term interest rates higher. The velocity of money and private credit expansion have been impediments to the acceleration of growth over the past ten years.

Business formation and economic growth has also been muted by the abysmal rate of loan growth from the banking sector. Growth in C&I loans over the past two years has been particularly weak. As a result, risk has been pushed from the banking sector into the private markets, where more lending now occurs. When the credit cycle turns down, the private investors will feel the brunt of it.



Source: Federal Reserve

Based on the strength in the domestic economy, we expect the Federal Reserve will raise rates another 25 basis points in December. However, with Brexit on the horizon, we expect there to be a global pause in monetary tightening to allow for sufficient liquidity in the global markets. In addition, we expect the Fed to begin talking about "a pause" in its rate hike program as uncertainty in the economic growth begins to form in 2019.

International and Emerging Markets

At some point, we expect the market will no longer ignore the growing risks weaving through the global capital markets. These risks include a collapse in emerging market economies such as Brazil, Turkey and Argentina, the growing trade war with China, a huge debt growth in global developed economies supporting spending and economic growth, the ill-fated exit of Great Britain from the European Union, and the growing populist movement throughout Europe.

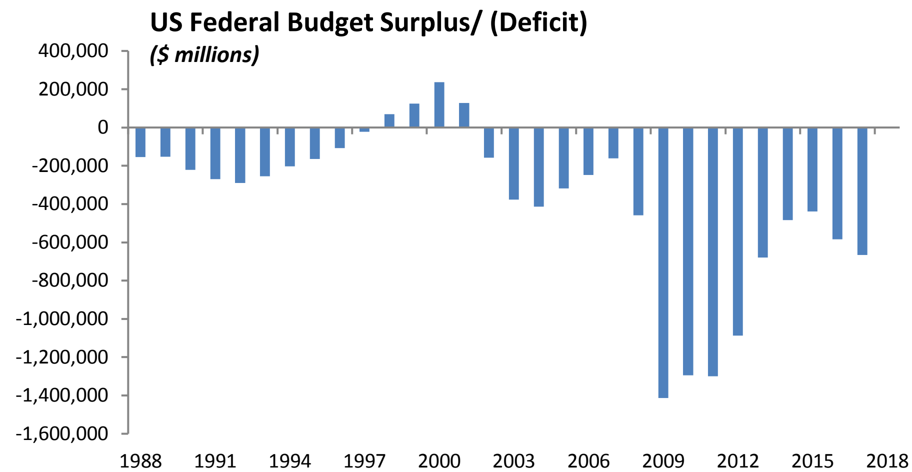
We have always pointed to Italy as the growing problem for Europe. Following the European financial crisis, Italy did not fully implement the austerity measures it promised. The Italian government kept spending, and through its budget deficits, the country has become the fourth largest public bond market. Last week, with its huge debt burden, weak banking system, and unwillingness to reign in its fiscal spending, Italy's new government delivered the irresponsible budget we had expected. The populist movement wants *lower taxes* and *higher spending* on social programs, which the country can't afford. *Trouble will come once the European Central Bank stops its quantitative easing program, which includes purchasing Italy's debt. At 3.50%, the yield on 10 year Italian bonds is only 30 basis points away from the yield on 10 year U.S. Treasury bonds!*

China is another major risk for investors. This risk has more to do with shifting U.S. policy toward China, which was underscored in an important speech that Vice President Mike Pence gave at the Hudson Institute last week. Reminiscent of Ronald Reagan, Vice President Pence bluntly accused China of abusing its economic power, bullying American companies and stealing their intellectual property. With the exception of the tariffs imposed on China, we believe the majority of tariff initiatives will be short lived and illustrate a strategy to renegotiate trade relationships with strong partners in a manner that, at the margin, better serves U. S. Companies. *However, we do not expect trade with China to be a simple matter of settling on tariffs for exports and imports.*

Vice President Pence's speech reveals a much broader agenda toward China, which addressed China's stealing of intellectual property for its own technological gain, its growing military and reach into the South China Sea, and its position within the global economy. The resolution of these issues will be long and arduous, and the tariffs on Chinese goods may persist for a long period depending on how the administration develops its agenda. *While President Trump has demonstrated his preference to get issues resolved quickly, the resetting of U.S. – China relations and foreign policy will go on for many years. We expect the uncertainty of U.S. policy and the disrupting impact of domestic supply chains to weigh heavily on domestic markets.* We believe that U.S. policy is designed to hurt China's already weak economy, which is showing slowing growth and an increase in problem loans. Last week, China reported an increase in the equivalent of $174 billion in liquidity into its capital markets. A sustained enforcement of tariffs, which now total over $250 billion, will have a negative impact on China's economy.

Get Ready Because Trouble is Coming

There's no other way to say it - the financial position of the United States is a disaster. After the Financial Crisis in 2008, the government went on a spending spree designed to stimulate economic growth. As a result, the U.S. has run budget deficits every year since 2001. The current budget deficit is projected to reach $650 billion in 2018. The total debt as a percent of Gross Domestic Product is now at 100%, a level not seen since the end of World War II.

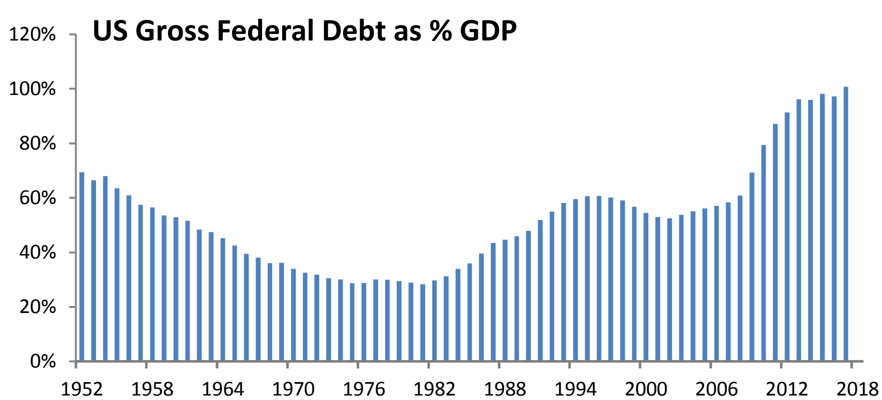


Source: U.S. Office of Management and Budget

We have benefited from nine years of ultra-low interest rates, which have helped to inflate asset prices. It worked. Now, as the Fed pushes short term interest rates higher, we expect asset prices should decline. *A sustained shift higher in short term interest rates will most likely lead to increased volatility and some dislocation in equity markets.*

Investors are used to being spoon fed by the Federal Reserve, and the financial press leads investors to believe that this low interest rate environment and record setting stock market will continue. In a recent interview with Bloomberg, Federal Reserve Chairman Powell even commented: "there is no reason to think this cycle can't continue for quite some time, effectively indefinitely."

We are always looking for indications of excesses in capital markets. We view the strong growth over the past 5 years in real estate development, leveraged loans, and high yield debt as three signs of excess developing in the domestic capital markets. In addition, the decline in the quality of loan covenants in leveraged loan transactions is a concern, and generally, it is presage of a decline in valuations.



Source: Federal Reserve

Prudence would dictate reducing risk in portfolios given the shift in monetary policy toward higher domestic interest rates. Interest sensitive sectors, such as autos and home builders, are having a rough year with Ford and General Motors stocks down 16.6% and 22.7%

over the past twelve months respectively. The dichotomy in performance between stocks in the "old economy" and "new economy" is significant and continues to warp the structure and performance of Index and Exchange Traded Funds. Ultimately, we believe we are moving into a period that will benefit the "stock pickers" approach to managing portfolios.

At the end of the day, valuation matters for investors. The "Follow the Herd" strategy and late stage market aggressiveness is more often an ill-fated and dangerous strategy.

While it is impossible to predict the timing, here's what to expect in the near future:

- Central bank balance sheets will continue to shrink, which will put additional pressure on interest rates to rise.
- Credit quality will deteriorate as corporate balance sheets show higher leverage. Expect more downgrades than upgrades from the rating agencies.
- As the credit cycle begins to turn, we expect an increase in debt restructuring and bankruptcies.
- Stock buy backs will continue and take priority over capital investment.
- Volatility will increase as capital markets adjust to higher interest rates.
- The pace of earnings growth in 2019 will begin to slow, as year-over-year comparisons become tougher after the initial impact of Tax Reform on earnings subsides.
- With higher capital levels and relatively solid loan portfolios, U.S. banks will weather market turbulence well.
- Corporate reorganizations will increase in late 2019, resulting in a rise in bulk layoffs.
- Expected returns in financial assets will be lower than normalized historic returns.

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