Over the last five years, investment returns on publicly traded domestic stocks have been exceptional in two areas: returns have been above historic norms and volatility has been unusually low. The total return on the S&P 500 over the past six years has been over 120%; while volatility, normally around 18%, averaged closer to 11%. In other words, investors have more than doubled their money investing in the S&P 500 Index over the past six years with far lower than normal volatility.

Equity Indices	MTD (%)	QTD (%)	YTD (%)	TTM (%)
Domestic				
S&P 500	-7.67	-12.23	-2.96	-2.98
S&P 600	-10.85	-19.00	-7.24	-6.81
S&P 400	-9.72	-15.80	-9.50	-8.77
DJIA	-7.55	-10.31	-2.38	-2.11
NASDAQ	-7.81	-15.84	-1.12	-1.56
Russell 3000	-7.93	-13.00	-3.80	-3.70
Russell 2000	-10.04	-18.55	-9.17	-8.79
Russell Mid-Cap	-7.75	-13.86	-7.44	-6.63
Wilshire 5000	-7.94	-13.31	-5.57	-5.52
International				
MSCI ACWI	-5.78	-11.56	-8.18	-7.04
MSCI ACWI ex US	-3.38	-10.40	-13.16	-10.85
MSCI EAFE	-3.37	-11.17	-12.45	-10.52
MSCI Emerging Markets	-2.67	-7.49	-14.59	-11.37
STOXX 600	-3.81	-12.17	-12.98	-10.90
STOXX 50	-3.24	-11.74	-13.70	-13.24
Nikkei	-3.78	-10.83	-3.84	-2.79
Shanghei	0.38	-7.89	-19.52	-18.51
Hang Seng	-1.57	-5.86	-9.71	-6.36
Kospi 200	-1.85	-11.37	-17.41	-16.61
FTSE 100	-2.94	-9.11	-8.27	-5.78
DAX	-4.31	-12.04	-16.61	-17.79
CAC 40	-3.97	-12.43	-6.94	-7.46
FTSE MIB	-2.57	-9.57	-11.90	-12.86
Mexico IPC	-3.34	-18.06	-16.54	-14.29
Bovespa	-3.47	8.89	13.09	19.00

Source: Bloomberg. As of 12/17/2018.

However, markets do not move in straight lines, and while it is difficult to identify when markets will pivot, we believe the recent shifts in the capital markets warrant prudence in portfolio structure. These shifts include:

1. A tightening in monetary policy, resulting in a sustained level of higher interest rates.

2. A flattening yield curve which impacts economic growth and arbitrage opportunities in the capital markets.

3. A deceleration in corporate earnings growth.

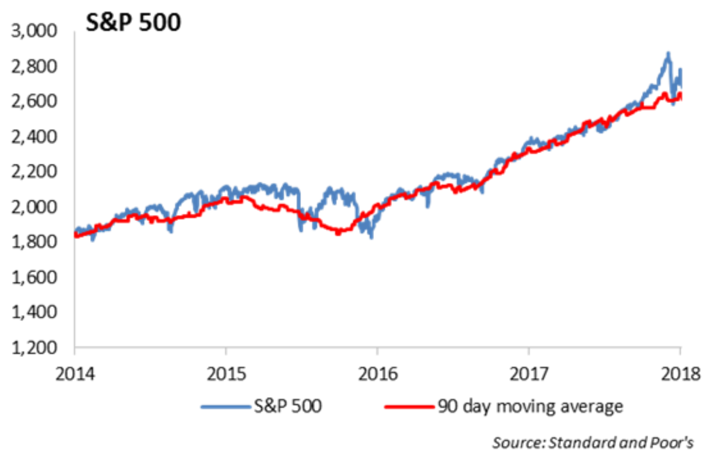
4. Unstable U.S. relationships with China and Europe may cause volatility to rise.

The keys to market momentum this quarter will be the consumer sector activity, impact of the tariffs on China, and expectations for corporate earnings. Strong wage growth and increased savings support the consumer sector. We expect consumer activity to be strong through the holiday shopping season and continue into next year. However, corporate earnings are giving us some concern. Shares of companies are rewarded when they exceed earnings expectations and grow revenue. Meanwhile, earnings misses and companies showing flat revenue growth are punished severely. As a result, if we remove the top 25% best year-to-date performing stocks from the S&P 500, 87% of the remaining companies are down 10% or more from their peaks.

Valuation

Currently, we expect earnings for 2019 of $174 on the S&P 500. If we assume a risk-free rate of 2.88%, slower earnings growth closer to 1%, and a forward earnings multiple of 15.3x, we would expect fair value on the S&P 500 to be around 2660. We expect cash payouts (dividends and stock buy backs) to continue to be over 90% of earnings.

We are closely watching operating profit margins and expect margin pressure to increase next year, which will put pressure on earnings. Increased raw materials costs, higher labor costs, and increased interest expense will put pressure on margins. Throw in the uncertainty around tariffs and, in the absence of revenue growth, we expect increased earnings pressure from multiple fronts next year.



One benefit from low interest rates over the past ten years is that corporate America was able to refinance high coupon debt with lower coupon debt. However, the increase in short term interest rates will reset coupon payments on variable bank loans, resulting in higher interest expense for the second half of 2018 and into 2019. As short term interest rates have increased by 200 basis points over the past two years, the yield curve has flattened. As a result, the spread between the yield on the 10 year U.S. Treasury and the 2 year U.S. Treasury has narrowed from 164 basis points to 17 basis points over the past three years. Historically, a flattening yield curve has been one of the best predictors of a slowing economy.

Equities

We expect Fourth Quarter 2018 earnings to be mixed as top line growth and margin compression begin to impact earnings. Rising materials and labor costs, as well as the uncertainty around China Tariffs, will begin to have a negative impact on industrial and semi-conductors. In addition, the sharp rise in interest rates will impact borrowing costs and ultimately increase interest expense.

We expect volatility to begin to decline moving into year end. With earnings on S&P 500 close to $174 and a Forward Price/Earnings ratio of 15.3x earnings, we believe near term fair value for large cap domestic stocks is 2660 on the S&P 500. This provides an estimated 1-year total return estimate of around 5.5%, inclusive of dividends, which is consistent with our expectations of horizon expected returns between 3.0% and 7.0%. *The risk to our thesis is that the amount of forward purchasing that companies affected by tariffs accomplished in 2018 was higher than expected. The increased tariffs will have a negative impact on raw material costs and will hurt several industries including technology and automotive.*

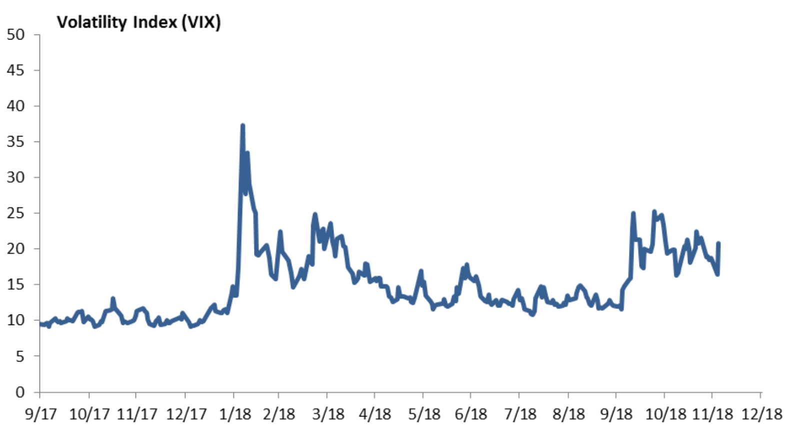
We expect earnings from the banking sector to slow as net interest margins contract and merger and acquisition activity slows. With solid balance sheets and low levels of nonperforming loans, we still favor the banks and expect both dividend growth and credit upgrades next year. The flattening yield curve will have a marginal drag on financials. However, the larger issue for the money center banks is their willingness to pay up to keep institutional deposits in the face of rising short term interest rates.

While the Energy sector has exhibited mediocre performance this year, it is one of our favorite sectors near term. Oil prices, which hovered above $65 per barrel for the past six months, dropped dramatically in the fourth quarter to $52.60. The United States became a net exporter of oil this past month, the first time since 1975. With OPEC supporting a reduction in output, and supply disruptions from Venezuela and Russia, we believe oil and gas has a positive outlook for the next year. Also, there is opportunity in oil field services companies which have lagged performance of the integrated oil companies.

An environment of government deregulation and more fluid bank lending favors small cap stocks; given current valuation, we believe investment return favors small cap over large cap.

Volatility

The number one rule of investing is to make sure you are adequately compensated for the risk being taken. Volatility levels over the past four years traded near historic low levels. As monetary policy tightens further and the Federal Reserve attempts to shrink its holdings of government securities, the risks to the market are expected to increase. Trade disagreements with China, which invests its trade surplus in U.S treasuries, are also expected to impact the markets. We would expect that volatility will be elevated as the market digests a paradigm shift for monetary policy and trade. *Investors should expect spikes in volatility and prepare to add to the domestic equity basis, particularly small cap, on weakness.*



Source: Chicago Board Options Exchange

International Equity

As global growth expectations declined this year, the international markets have been under more pressure than domestic equity markets. The MSCI EAFE Index underperformed the S&P 500 by 14.5% points in 2018. Protests in France, the budget challenges in Italy, a slowing industrial sector in Germany, and Brexit's impact on the Eurozone will have a collective negative marginal impact on European stock valuations. However, that will change, and we expect that the second half of 2019 will warrant another look at Europe and the Developed International sector.

Emerging Market equities have underperformed this year relative to domestic equities, and they have been under serious pressure recently given the heightened volatility. With the slowing global growth and increasing political friction between the United States, China and Russia, we remain pessimistic near term on emerging markets equities. China's economy is under pressure as tariffs weigh on the country's manufacturing and technology sector. We expect China's economic growth to surprise on the low side in 2019. In addition, Brazil and Russia will continue to suffer, and the economies of smaller countries such as Turkey and Argentina will also experience slow growth.

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