Market Observations – October 2018 Recap

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The S&P 500 was down 6.8% in the month of October. This made for the worst performing month in more than 7 years. The peak to trough drawdown that began on September 20th was 10.9%. However, it is important to keep in mind that the average intra-year drawdown since 1980 is 13.8%. While the current decline is not pleasant to go through, it is not out of the ordinary for a given year. Additionally, we see the drawdown being orderly, where lower beta investments (investments with less market sensitivity) are holding up better than higher beta investments (investments with higher market sensitivity).

To provide a little more color on this, we are seeing dividend focused strategies and high quality strategies holding up best during the drawdown. Value-style investments in general are holding up better than growth-style investments. The exceptions here are value-style strategies with a heavy emphasis on industrials, materials and energy, which are among the weakest sectors during the market decline. Growth-style investments that have been benefiting from recent market momentum are faring the worst. Small cap strategies (typically higher beta) have underperformed large cap strategies. This change in investor sentiment is due to a number of catalysts: rising interest rates and trade tensions being front and center, along with signs that corporate earnings may be peaking while inflation is picking up.

Equity markets outside the US were not immune to the pull-back. The MSCI EAFE index was down 8.0% in October while the MSCI Emerging Market index was down 8.7%. The value style outperformed the growth style in both developed and emerging markets, which in our view is not surprising during a drawdown. In addition to the rising Fed rates and trade tensions, a strong US Dollar has hurt non-US markets as the cost of debt denominated in U.S. Dollars becomes more expensive.

In the bond markets we did not see the protection that we typically see from the asset class. U.S. Treasuries and investment grade credit were negative performers for the month as yields increased. The increase in yields and widening credit spreads was due to a combination of inflationary fears as well as skepticism that this second longest bull market in history can continue for much longer, in our opinion.

The good news, from our perspective, is that equity valuations have come down to normal levels due to a combination of the market pull-back and strong corporate earnings. Additionally, we feel that the economy continues to look strong. We do not believe that this is the end of the market cycle and as a result could be a good buying opportunity.

Below is a summary of what occurred in the markets globally during the month of October.

US Equity Summary:

- The S&P 500 returned -6.8% for the month. Large cap stocks outperformed mid and small cap stocks.
- The Value style outperformed the Growth style across all market cap segments.
- Defensive sectors outperformed while cyclical sectors underperformed.
- Based on JPMorgan factors Quality and low Beta outperformed while Growth and Momentum were the weakest performing.

Developed and Emerging Market Equity Summary:

- The MSCI EAFE Index was down 8.0% for the month, while the MSCI EM Index returned -8.7%.
- Small cap stocks underperformed Large Cap stocks in both developed and emerging markets.
- Just as in the US, defensive sectors outperformed cyclical sectors within developed markets.
- Emerging markets were led by the Utilities, Financials and Energy sectors. Healthcare, Tech and Consumer Discretionary were the weakest.
- In both developed and emerging markets low Beta and Value factors performed best. Momentum and Growth performed the weakest.
- Frontier markets underperformed the broad emerging markets, as the MSCI Frontier Markets index posted an August return of -5.4%.

Fixed Income Summary:

- All US bond segments posted negative returns with the exception of 1-3 year U.S. Treasuries..
- The Bloomberg Barclays US Treasury index was down 0.6% while long-dated Treasuries (20+ years) were down 3.2%.
- Within corporate credit, broad high yield underperformed higher quality credit. CCC-rated credit underperformed BBB-rated credit.
- Investment grade CMBS and municipal high yield was also down modestly during the month.
- Global bonds also declined broadly. Emerging market corporate debt, denominated in USD, was the best performing segment at -0.8%. As most foreign currencies declined against the US dollar, locally denominated debt fared worst. European sovereign debt, per the JPMorgan EMU Index, declined 2.5% for the month.

Disclosures

Indices are unmanaged and presented for comparison purposes only. Please note that the returns displayed for indices do not take into account any of the costs associated with buying and selling individual securities. Individuals cannot invest directly in an index.

Bloomberg Barclays US Corporate High Yield TR USD: *Bloomberg Barclays US Corporate High Yield TR USD*

Bloomberg Barclays US Treasury 1-3 Yr TR USD: *The Bloomberg Barclays Capital US Treasury Bond 1-3yr term index measures the performance of short-term government bonds issued by the US Treasury.*

Bloomberg Barclays US Treasury 10 Yr USD: The index *measures the performance of government bonds issued by the US Treasury.*

Bloomberg Barclays US Treasury 20+ Yr TR USD: *The Index is market capitalization weighted and includes all of the securities that meet the Index criteria. The index includes all publicly issued, U.S. Treasury securities that have a remaining maturity greater than 20 years, are non-convertible, are denominated in U.S. dollars, are rated investment grade (Baa3 or better) by Moody's Investors Service, are fixed rate, and have more than $150 million par outstanding. Excluded from the Index are certain special issues, such as flower bonds, targeted investor notes (TINs) and state and local government series bonds (SLGs), and coupon issues that have been stripped from assets already included.*

Bloomberg Barclays US Aggregate Bond Index: *The U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The Index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM pass throughs), ABS, and CMBS sectors. The U.S. Aggregate Index is a component of the U.S. Universal Index in its entirety.*

MSCI EM Index: *The MSCI Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country*

MSCI EAFE Index: *The MSCI EAFE Index is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America: Europe, Australasia and the Far East.*

S&P 500 Index: *The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted Index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. The Index is one of the most widely used benchmarks of US Equity Large Cap performance.*

Alerian MLP Index: *The Alerian MLP Index is the leading gauge of energy Master Limited Partnerships (MLPs). The float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).*

J.P. Morgan Factor Definitions

Yield: *Stocks are ranked by trailing 12 month dividend yield. Positive factor performance indicates that the highest yielding stocks outperformed the lowest yielding stocks (as well as those stocks that did not pay any dividends) in the universe.*

Size: *Stocks are ranked by their month end market cap. A negative Size factor return would indicate that smaller cap stocks generally outperformed larger cap stocks.*

Quality: *Combines ROE and Earnings Risk (inverted such that stocks with tightest forecasts are rewarded with a higher score).*

Price Momentum: *The 12 Month Price Momentum factor is calculated by ranking stocks by their total return over the previous 12 months.*

Earnings Momentum: *This factor ranks stocks by their forward earnings momentum (1Mth + 3 Mth). For each stock, the change in FY1 earnings over the last month and the last 3 months, and the change in FY2 earnings over the last month and the last 3 months are calculated. A 3-month revision number and a 1-month revision number is calculated by taking the average of the change in FY1 and FY2. A composite value as the average of the 1 month and 3 month values is then calculated.*

Book-to-Price: *Stocks are ranked by their 12 month trailing Book/Market ratio with the cheapest stocks exhibiting the lowest ratio. A positive factor return indicates that stocks with a lower book-to-price ratio outperformed higher book-to-price stocks in the universe.*

Beta: *Beta for the stock relative to its local benchmark index. Note this is a fundamental beta not a calculated Beta.*

USD: United States Dollar.
EURO: The official currency of the Eurozone.
CAD: The official currency of Canada.
AUD: The official currency of Australia.
BRL: The official currency of Brazil.
CHF: The official currency of Switzerland.
JPY: The official currency of Japan.
INR: The official currency of India.

West Texas Intermediate (WTI): *West Texas Intermediate (WTI) crude oil is the underlying commodity of the New York Mercantile Exchange's oil futures contracts. The success of an investment program may be affected by general economic and market conditions, such as interest rates, availability of credit, inflation rates, economic uncertainty, changes in laws and national and international political circumstances. These factors may affect the level and volatility of securities prices and the liquidity of a portfolio's investments. Unexpected volatility or illiquidity could result in losses.*

Investing in securities is speculative and entails risk. There can be no assurance that one's investment objectives will be achieved or that an investment strategy will be successful. Significant losses could result if a strategy involves the use leverage, short sales and derivative transactions, investment in foreign or illiquid securities, and potentially limited diversification.

The opinions expressed herein can change anytime without notice.

Any forward looking statements are not guaranteed and can be affected by inaccurate assumptions or by known or unknown risks and uncertainties. Given these uncertainties, you should not place undue reliance on these forward-looking statements.

Special Risks of Foreign Securities
Investments in foreign securities are affected by risk factors generally not thought to be present in the US. The factors include, but are not limited to, the following: less public information about issuers of foreign securities and less governmental regulation and supervision over the issuance and trading of securities.

Special Risks of Master Limited Partnerships
Master limited partnerships (MLPs) are publicly listed securities that trade much like a stock, but they are taxed as partnerships. MLPs are typically concentrated investments in assets such as oil, timber, gold and real estate. The risks of MLPs include concentration risk, illiquidity, and exposure to potential volatility, tax reporting complexity, fiscal policy and market risk. MLPs are not suitable for all investors.

Special Risks of Small Market Capitalization Securities
Investments in companies with smaller market capitalization are generally riskier than investments in larger, well-established companies. Smaller companies often are more recently formed than larger companies and may have limited product lines, distribution channels and financial and managerial resources. These companies may not be well known to the investing public, may not have significant institutional ownership and may have cyclical, static or moderate growth prospects. There is often less publicly available information about these companies than there is for larger, more established issuers, making it more difficult for the Investment Manager to analyze that value of the company. The equity securities of small and mid capitalization companies are often traded over-the-counter or on regional exchanges and may not be traded in the volume typical for securities that are traded on a national securities exchange. Consequently, the Investment Manager may be required to sell these securities over a longer period of time (and potentially at less favorable prices) than would be the case for securities of larger companies. In addition, the prices of the securities of small and mid capitalization companies may be more volatile that those of larger companies.

Special Risks of Fixed Income Securities
For fixed income securities, there is a risk that the price of these securities will go down as interest rates rise. Another risk of fixed income securities is credit risk, which is the risk that an issuer of a bond will not be able to make principal and interest payments on time.