

CAPITAL MARKET REVIEW

Third Quarter 2018



The Economy

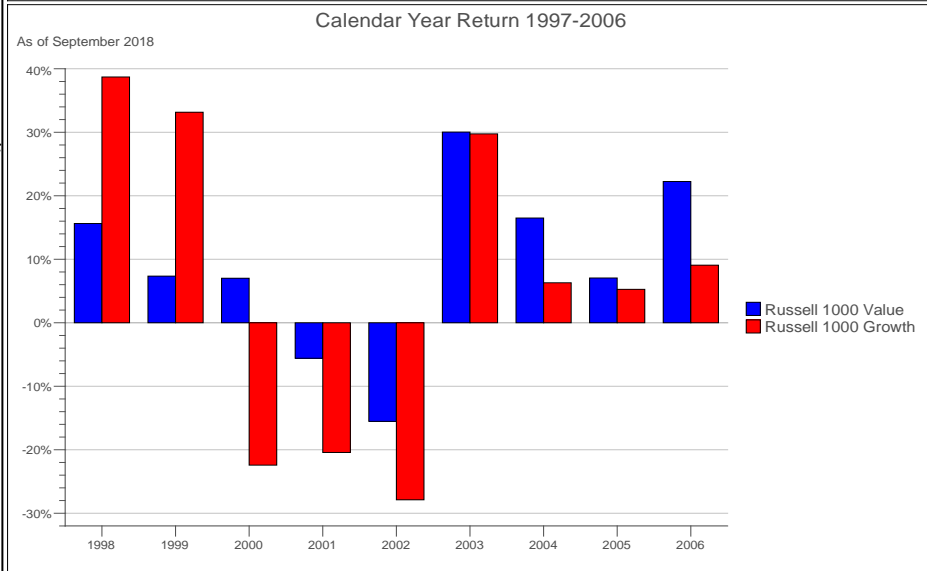
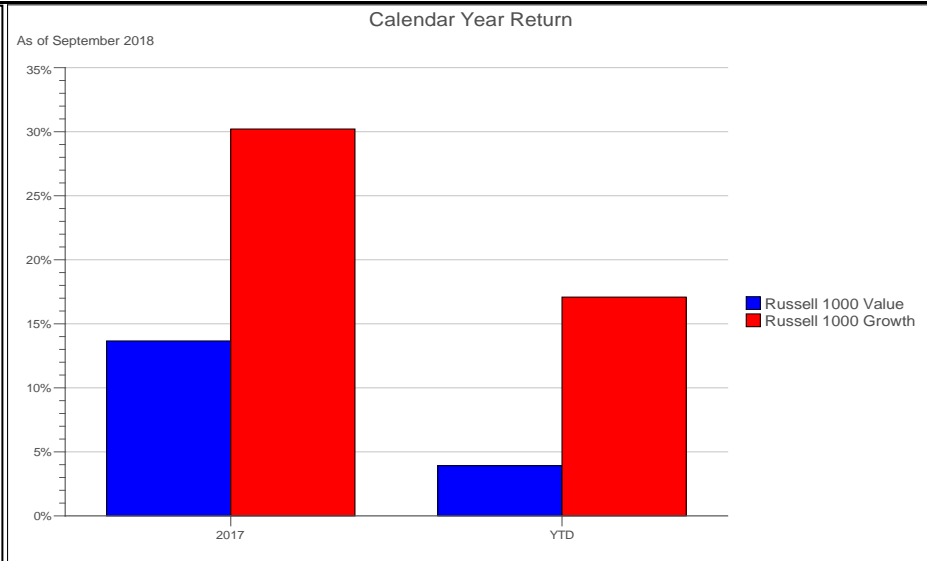
The gap between growth stocks and value stocks is becoming alarming. This has not happened since the market boom leading up to the Dot-Com bust.

As a reminder, no corporate board ever meets and says, “Hey, our stock should be undervalued so we can be called a value stock.” When we use these terms, we are actually referring to the investment manager’s philosophy and process for selecting investments. Investors that look for companies that are growing rapidly and are willing to pay more for that growth are called growth investors. Investors who are looking for bargains are value investors. The stocks which these different investors would typically find attractive are then labeled as growth or value stocks.

Over the last twelve months ending September 30, growth stocks as measured by the Russell 1000 Growth index, are up 26.30 percent. Value stocks, as measured by the Russell 1000 Value index, are up only 9.45 percent. That is an extremely large gap.

What does this mean for the future? Well, the last time I saw such a gap was during the late 1990’s and that was followed by a decade of value outperformance. This is almost certain to happen again, as reversion to the mean is a very powerful force. The question is when? It could be the second half of 2018, or it could be in 2022. That is a large gap, I know, but last time this happened people called for the switch well before it actually occurred in 2000.

As fiduciaries, it is not appropriate for us to make guesses. We should remain prudent, and be patient and understanding with our value oriented managers. Their day will come.



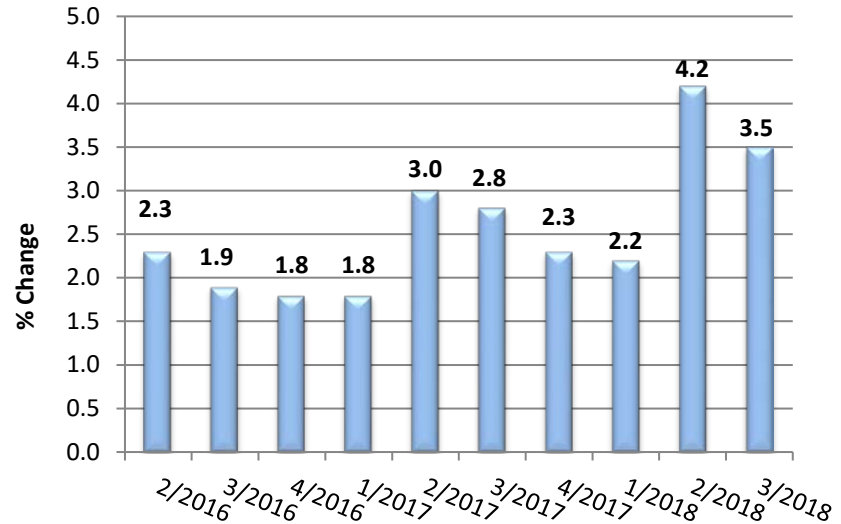
The Economy

The 3rd quarter GDP growth came in at 3.5 percent after 2nd quarter came in at 4.2 percent. We seem to be finally breaking out of the so-called new normal, and the impact of tax reform is just beginning to be seen.

The official unemployment rate dropped to 3.7 percent in September. The labor market keeps improving and perhaps, more importantly, we are seeing wage growth in the 3 percent range. That is an encouraging sign.

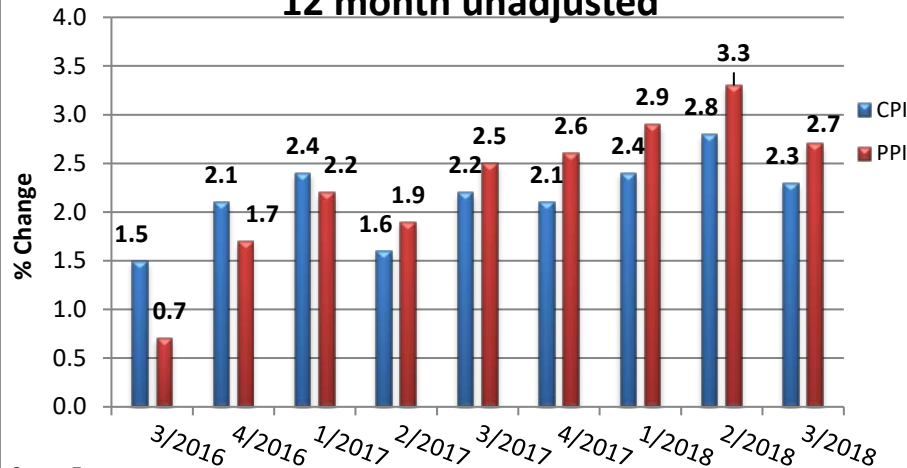
Inflation is at 2.7 percent based on the latest consumer price index report. Core inflation stands below the Fed target at 2.2 percent. This has leveled off and is slightly lower than last quarter. Still, there is plenty of room for more rate hikes from the Fed.

Domestic GDP



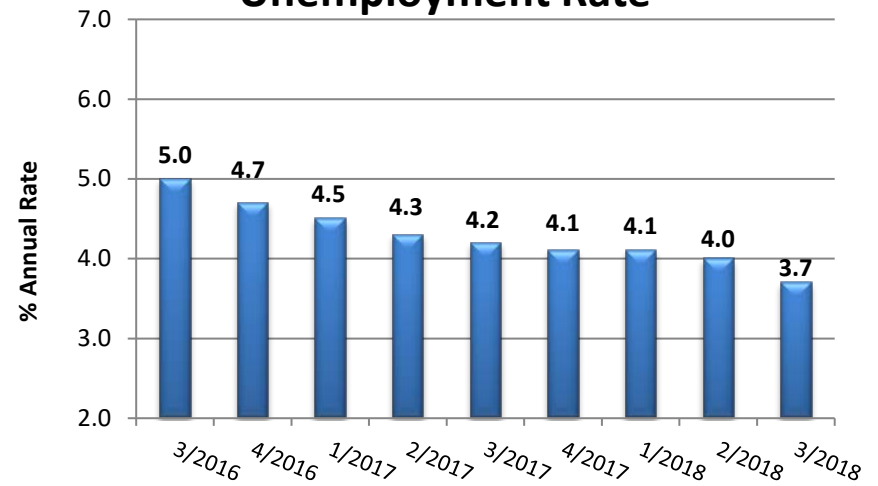
Source: Factset

Inflation Indicator 12 month unadjusted

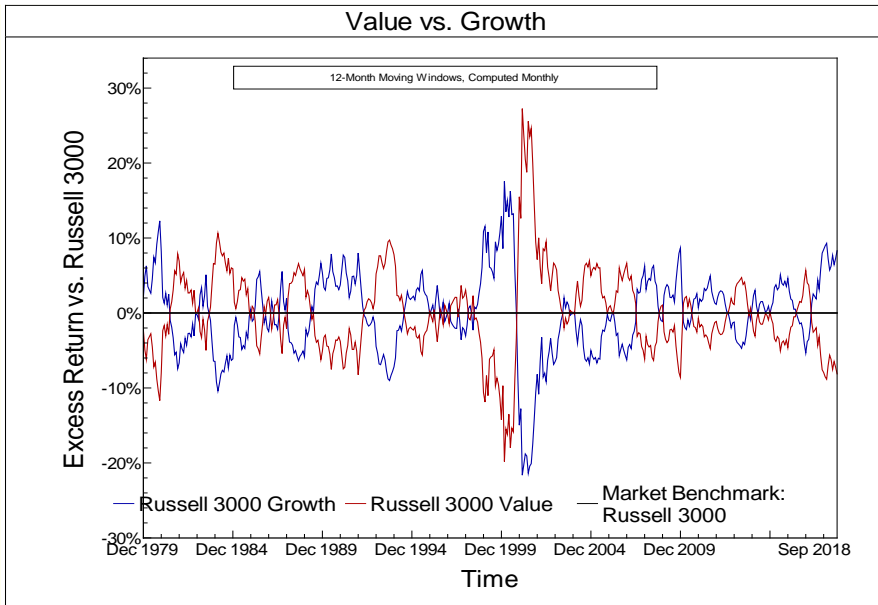
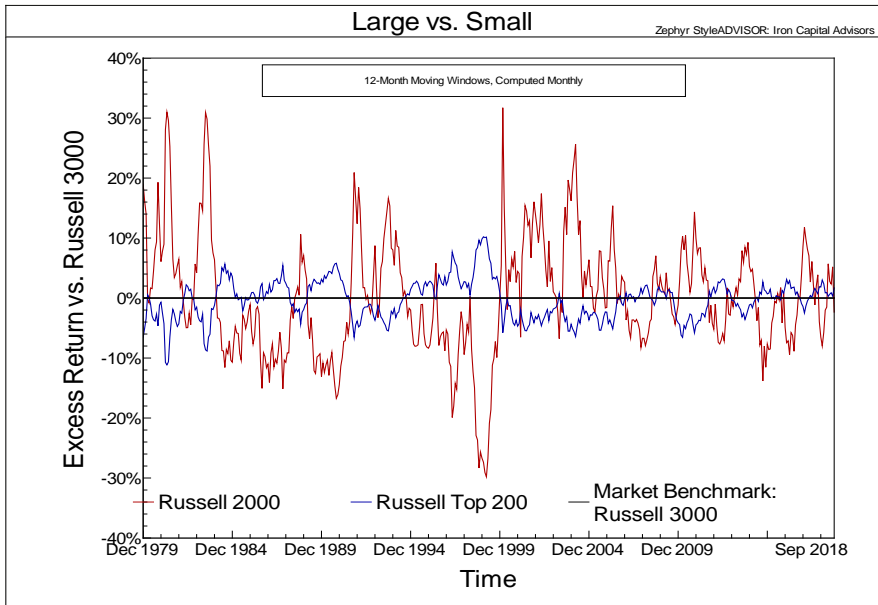
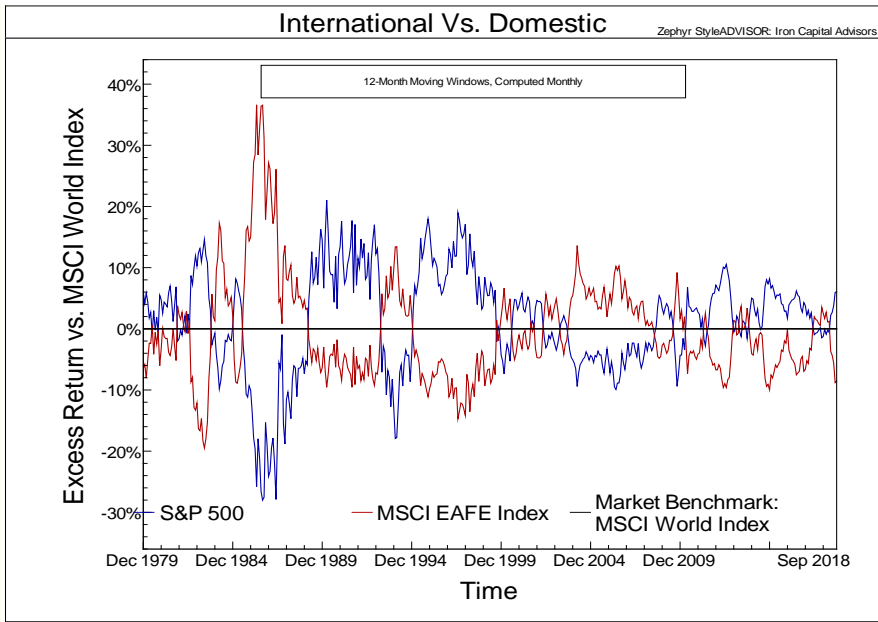
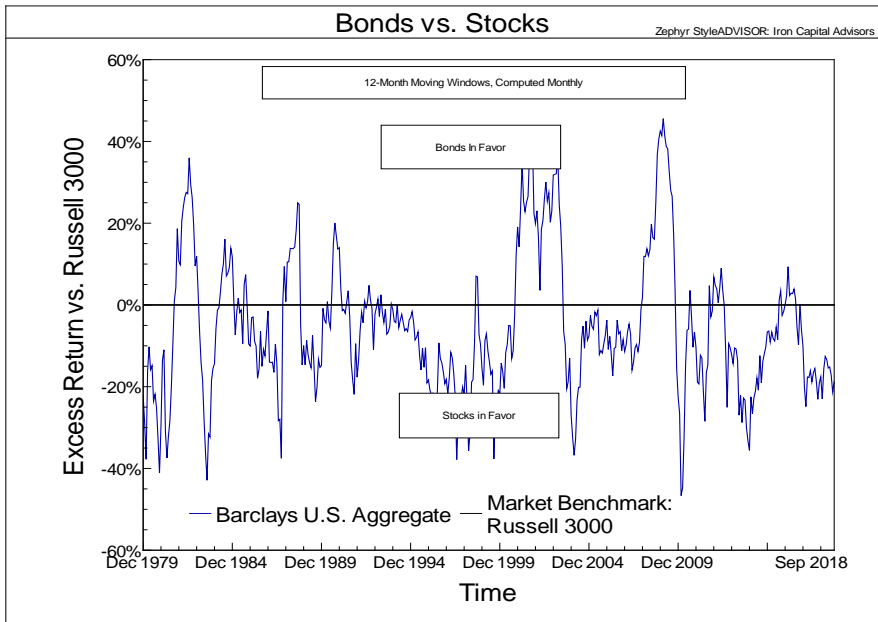


Source: Factset

Unemployment Rate



Source: Factset



Domestic Equity Markets

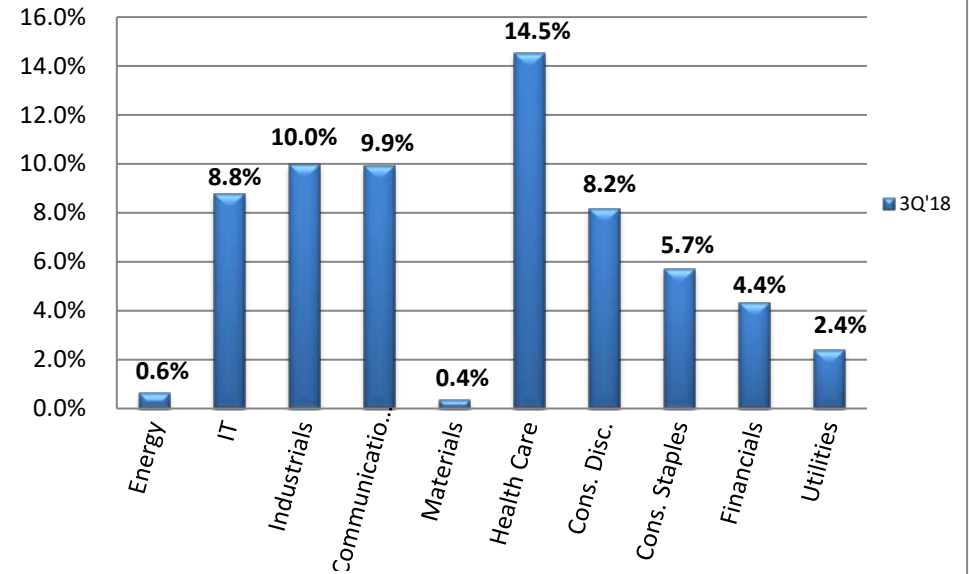
Markets diverge. For the quarter, the S&P 500 finished up 7.71 percent but not all ships rose as quickly. Growth outpaced value for the seventh quarter in a row. The Russell 1000 Growth index finished up 9.17 percent, while the Russell 2000 Value index was up only 1.6 percent.

This divergence will eventually be corrected, the only question is how? Do small company stocks rally or do large company stocks drop? Does value lead the market or just go down less in a selloff? These questions are impossible to know, but one thing is for sure, the reversion to the mean is the most powerful force in long-term investing. Stock returns will eventually converge.

Domestic Indices Three Months Ending September 30, 2018

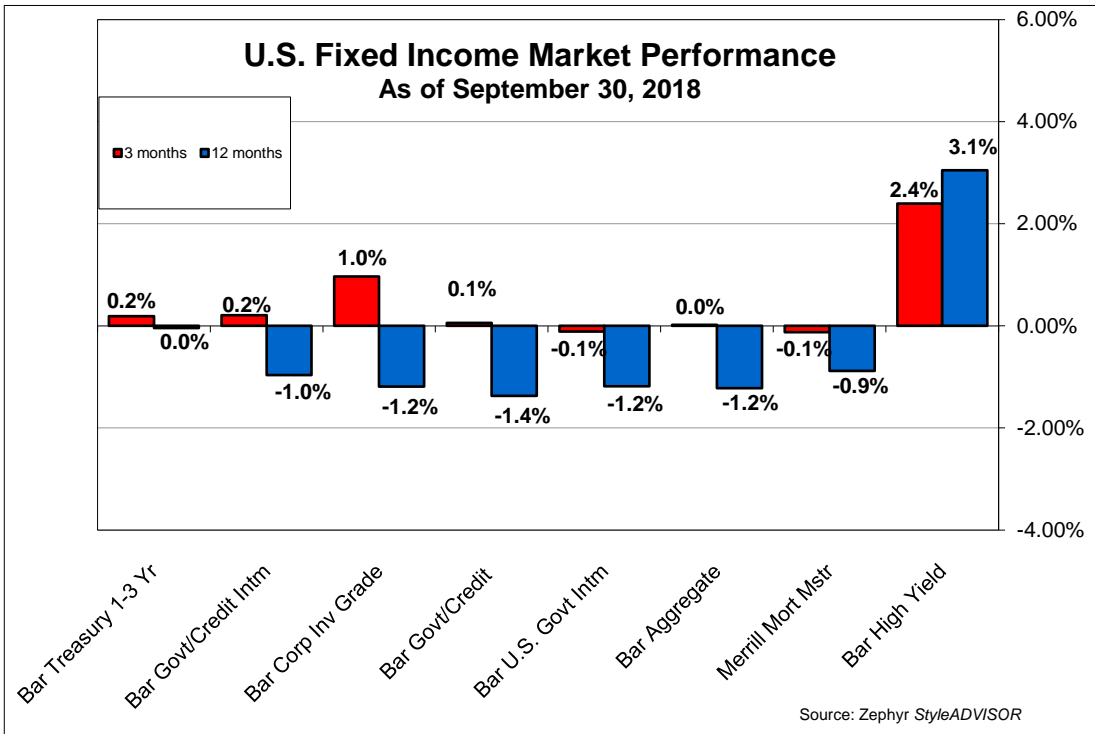
	Yield	Price/Earnings	Price/Book
S&P 500	1.74%	21.5	3.47
Russell 1000 Gr	1.06%	28.9	7.97
Russell 1000 Val	2.33%	17.3	2.12
Russell Midcap	1.52%	21.3	2.87
Russell 2000 Gr	0.52%	74.1	4.78
Russell 2000 Va	1.86%	22.7	1.55

S&P GICS Sector Returns



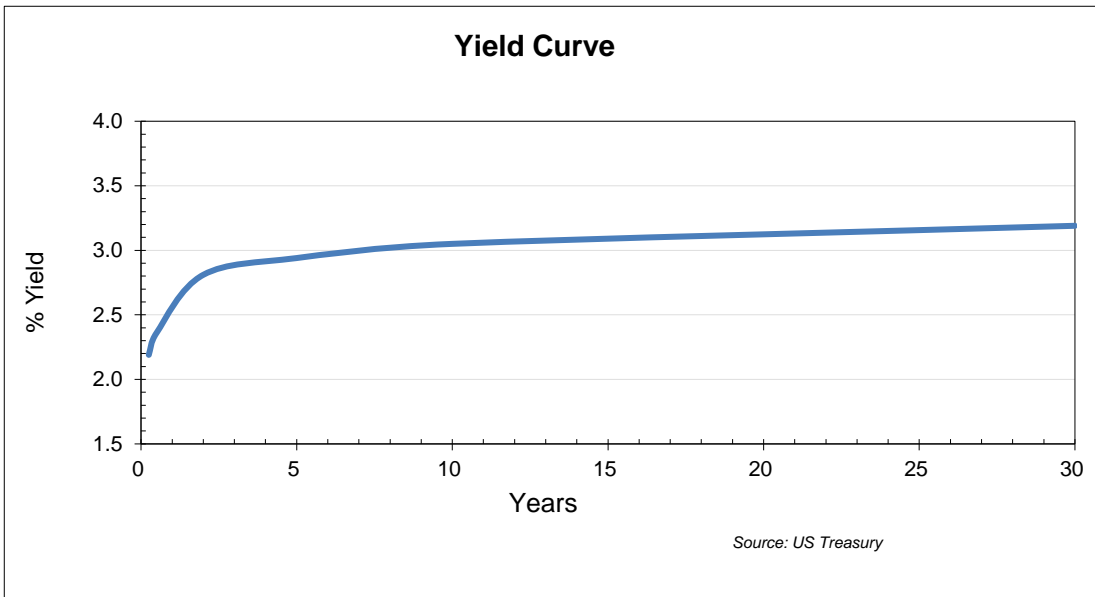
Source: Factset

DOMESTIC FIXED INCOME MARKET



Bonds remained flat for the quarter. The Barclays US Aggregate Bond index ended up 0.02 percent. High yield bonds ended the quarter up 2.44 percent.

We have broken and held the 3 percent barrier on the ten year treasury. It is becoming safer to wade back into bonds.



Yield Curve as of September 30, 2018

Time to Maturity	Interest Rate
3 Month	2.19
6 Month	2.36
2 Year	2.81
5 Year	2.94
10 Year	3.05
30 Year	3.19

INTERNATIONAL MARKETS

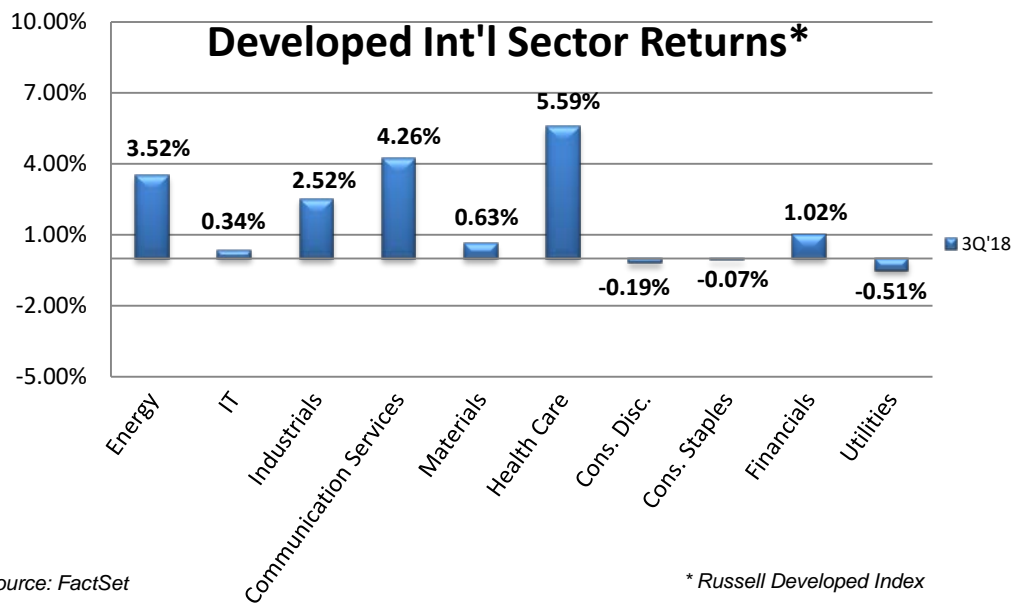
International stocks suffered over trade. The EAFE index finished up 1.42 percent while the MSCI Emerging Markets index ended the quarter down 0.95 percent.

The tariffs have not seemed to slow down the US economy, as of now, but they do seem to be having an affect elsewhere in the world. The global GDP is growing at 3.1 percent in 2018 but the worry is that this is beginning to slow. This is leading to further strength in the dollar which is also boosted by higher interest rate in the US and the trade fears.

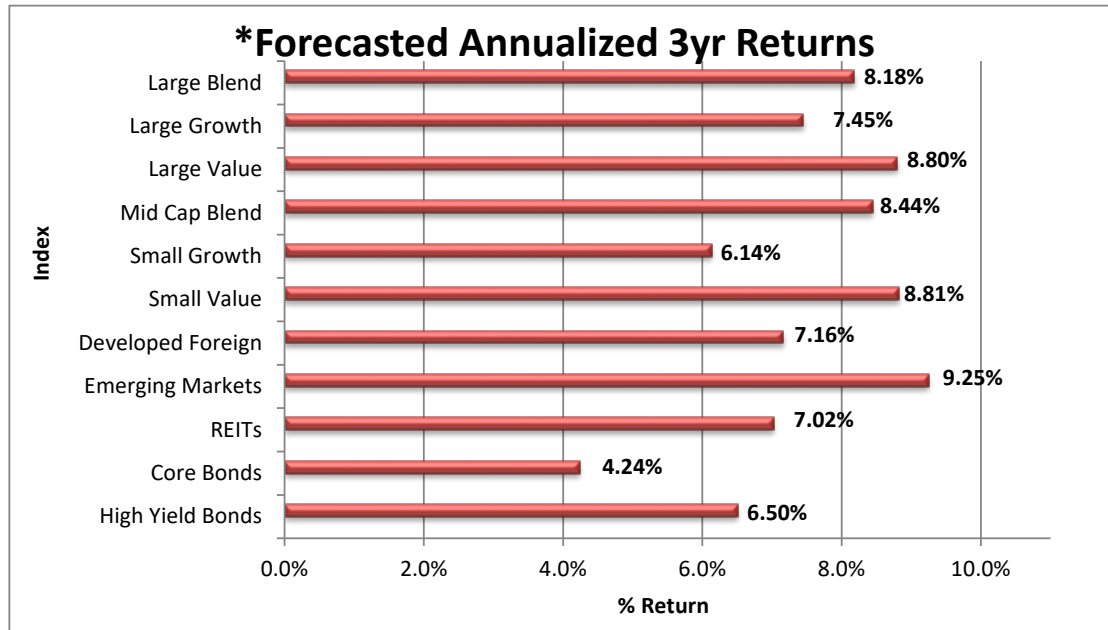
The trade tension is especially strong in China where markets have been down all year. The economy in China is growing at a slower pace already as it matures and the added pressure of US tariffs does not help. Will this be enough to spark real negotiations towards a deal? That will be the big question for international investors.

MSCI Country Returns Three Months Ending September 30, 2018

	Return US\$ (%)	Return Local Currency (%)	Currency Effect(%)
Europe			
Austria	0.38%	0.90%	-0.52%
Belgium	-5.17%	-4.67%	-0.50%
Denmark	2.42%	3.04%	-0.62%
Finland	3.20%	3.73%	-0.53%
France	2.87%	3.41%	-0.54%
Germany	-0.57%	-0.05%	-0.52%
Ireland	-5.33%	-4.84%	-0.49%
Italy	-4.27%	-3.77%	-0.50%
Netherlands	-1.42%	-0.91%	-0.51%
Norway	6.86%	6.76%	0.10%
Portugal	-0.38%	0.14%	-0.52%
Spain	-2.29%	-1.78%	-0.51%
Sweden	7.02%	6.39%	0.63%
Switzerland	7.30%	5.55%	1.75%
UK	-1.65%	-0.43%	-1.22%
Pacific			
Australia	-0.91%	1.19%	-2.10%
Hong Kong	-0.95%	-1.21%	0.26%
Japan	3.81%	6.46%	-2.65%
New Zealand	2.56%	4.74%	-2.18%
Singapore	2.19%	2.40%	-0.21%
Emerging Markets			
Brazil	6.17%	10.21%	-4.04%
Canada	0.98%	-0.78%	1.76%
China	-7.42%	-3.86%	-3.56%
Greece	-17.59%	-17.16%	-0.43%
Hungary	4.65%	3.38%	1.27%
India	-2.25%	3.42%	-5.67%
Indonesia	1.98%	6.05%	-4.07%
Mexico	6.97%	1.76%	5.21%
Poland	11.07%	9.35%	1.72%
Russia	6.60%	11.35%	-4.75%
Thailand	13.72%	11.01%	2.71%



Market Forecast



Indices Three Months Ending September 30, 2018

	Yield	Frwd Earnings Yield	**Hist. Return	***Hist. Risk Prem. + RF Rate
Large Blend	1.74%	7.66%	10.61%	6.43%
Large Growth	1.06%	5.76%	10.73%	6.43%
Large Value	2.33%	9.43%	10.32%	6.43%
Mid Cap Blend	1.52%	7.45%	11.78%	6.43%
Small Growth	0.52%	3.19%	8.78%	7.43%
Small Value	1.86%	8.33%	10.85%	7.43%
Developed Foreign	2.95%	10.30%	5.57%	4.56%
Emerging Markets	2.16%	11.18%	9.88%	6.06%
REITs	3.93%	6.12%	10.24%	5.00%
Core Bonds	3.56%	3.56%	6.06%	3.33%
High Yield Bonds	6.79%	6.79%	8.12%	4.50%

Eventually, markets must revert to the mean. We are still positive on the markets for the year as the economy and corporate earnings remain strong and those are the things that really matter. However, all the returns cannot come from just large growth companies.

Small company stocks should be doing better as should value as a whole. Emerging markets still look attractive as do international stocks but momentum has remained negative with trade talk.

Bonds are finally breaking out of the multi-year historic low rate environment. A 10 year Treasury over 3 percent makes bonds look more attractive for the long haul.

* Weighted average using 40% earnings yield, 30% historic return and 30% historic risk premium + RF rate

**Annualized 30 Yr return

***Hist. risk premium of domestic and international equity as defined by Zephyr Style Advisor's GFD Long Term Index database except for REITs and High Yield which are based on average 20 year rolling returns of the NAREIT Equity REIT Index and the Barclays Corporate High Yield Index minus the average 20 year rolling returns of the 3-month T-Bill and scaled using proprietary data. The Current 3-month T-Bill yield (as of 09-30-2018) is added back to each risk premium.

SELECTED INDEX RETURNS - PERIODS ENDING September 30, 2018

	Quarter	Year-to-Date	One Year	Three Years	Five Years	Ten Years
US EQUITIES						
Broad Stock Market - Russell 3000	7.12%	10.57%	17.58%	17.07%	13.46%	12.01%
Large Stocks - S&P 500	7.71%	10.56%	17.91%	17.31%	13.95%	11.97%
Dow Jones Industrial Average	9.63%	8.83%	20.76%	20.49%	14.57%	12.22%
Medium-Size Stocks - Russell Mid-Cap	5.00%	7.46%	13.98%	14.52%	11.65%	12.31%
Small Stocks - Russell 2000	3.58%	11.51%	15.24%	17.12%	11.07%	11.11%
Small Value Stocks- Russell 2000 Value	1.60%	7.14%	9.33%	16.12%	9.91%	9.52%
Small Growth Stocks- Russell 2000 Growth	5.52%	15.76%	21.06%	17.98%	12.14%	12.65%
Large Value Stocks - Russell 1000 Value	5.70%	3.92%	9.45%	13.55%	10.72%	9.79%
Large Growth Stocks - Russell 1000 Growth	9.17%	17.09%	26.30%	20.55%	16.58%	14.31%
US FIXED INCOME						
1-3 Yr Treasury (Gov't) Bonds - Barclays Capital	0.19%	0.24%	-0.04%	0.36%	0.56%	1.10%
US Government Bonds Int - Barclays Capital	-0.11%	-0.78%	-1.18%	0.19%	0.93%	2.22%
US Corporate Inv Grade Bonds - Barclays Capital	0.97%	-2.33%	-1.19%	3.12%	3.54%	6.35%
Government/Credit (Corp) Bonds - Barclays Capital	0.06%	-1.85%	-1.37%	1.45%	2.23%	3.95%
Int Govt/Credit (Corp) Bond - Barclays Capital	0.21%	-0.76%	-0.96%	0.91%	1.52%	3.22%
US Aggregate Bond Market - Barclays Capital	0.02%	-1.60%	-1.22%	1.31%	2.16%	3.77%
Mortgage Master - Merrill Lynch	-0.12%	-1.02%	-0.88%	1.00%	2.00%	3.33%
US Corp High Yield Bonds - Barclays Capital	2.40%	2.57%	3.05%	8.15%	5.54%	9.46%
INTERNATIONAL (Measured in US Dollars)						
Non-US Stocks - MSCI EAFE	1.42%	-0.98%	3.25%	9.77%	4.90%	5.87%
World Stocks (includes US) - MSCI World	5.10%	5.89%	11.84%	14.18%	9.89%	9.18%
European Stocks - MSCI Europe	0.84%	-1.89%	0.33%	8.37%	4.29%	5.49%
Japanese Stocks - MSCI Japan	3.81%	1.89%	10.57%	12.51%	7.11%	6.21%
Asian Stocks (Ex-Japan) - MSCI Pacific ex-Japan	-0.53%	-2.49%	4.39%	12.87%	3.99%	7.82%
Chinese Stocks - MSCI China	-7.42%	-8.98%	-2.05%	13.89%	8.08%	8.50%
Indian Stocks - MSCI India	-2.25%	-9.60%	1.09%	7.00%	9.67%	6.53%
Emerging Markets - MSCI EM	-0.95%	-7.39%	-0.44%	12.77%	3.99%	5.76%
Int'l Gov't Bonds -Citi World Gov't Bond (Non USD)	-2.19%	-3.09%	-1.57%	2.39%	-0.23%	1.99%
REAL ESTATE						
FTSE NAREIT Equity-Reits Index	0.79%	1.81%	3.35%	7.64%	9.16%	7.44%
SHORT TERM INTEREST RATES						
T-Bills	0.50%	1.29%	1.57%	0.80%	0.49%	0.32%

Note: Returns for periods longer than 12 months are annualized.