ADVISER INVESTMENTS

Adviser Outlook

FOURTH QUARTER 2018

Headline rancor and investor caution characterized the year's third quarter. While bond markets were weak, stocks forged ahead undeterred. Our eyes were on the fundamental facts—earnings, interest rates and broader economic data—and we saw nothing to suggest that the U.S. economy has, as yet, detoured far from its slow-growth-not-no-growth road. The sugar-high of tax-cut-induced growth that has characterized the last couple of quarters may come to an end as we move into the new year, but it won't be the end of growth here at home.

The anticipated volatility in the run-up to the midterm election was noticeably absent in the third quarter, though it began to rear its head as we entered October, when bond yields started rising and U.S. stock markets began exhibiting more dramatic intra-day moves, notably the 3%-plus drop on October 10. The election's potential to distract traders and disrupt the markets remains elevated. Its outcome will remove at least one uncertainty from the stock market's wall of worry, but it could also create new uncertainties for us, and the managers we invest in, to actively navigate through.

Part of our job at Adviser Investments is to take politics out of client portfolios. We approach wealth management in a calm, reasoned and research-driven manner. But part of our job also entails considering how enacted policies affect economic and market outcomes. For example: We have been closely watching China's reaction to proposed U.S. tariffs because of the impact it could have on earnings and economic growth.

Even though the threat of a trade war with China has not diminished, the framework for a revamped North American Free Trade Agreement (NAFTA) delivered some relief to investor concerns over trade with our border partners. After Mexico made a deal with U.S. negotiators in August, Canadian officials found some common ground for agreement on new dairy and auto policies, paving the way for the renamed U.S.-Mexico-Canada Agreement (USMCA).

The newly negotiated deal, which still needs to be ratified by Congress (meaning the outcome of the midterms could rekindle this as a flashpoint), retains much of the existing NAFTA structure, with most of its changes around the edges.

Another theme that received plenty of press, mostly negative, during the third quarter was the increased pace of stock buybacks, which were held up as a sign of corporate or economic dysfunction. We don't think they deserve the bad rap. Our research team provides our perspective in our latest Special Report, *Stock Buybacks: Public Enemy Number One?* You can find it on the "Free Resources" section of our website.

There are solid reasons for further economic expansion and the potential for the U.S. bull market to run longer. From jobs to earnings to interest rates, the economy is on firm footing. Federal Reserve policymakers have given their votes of confidence by following through with regular increases to the benchmark fed funds rate. Consumer sentiment is at high levels.

Third Quarter Review

Trade-war fears did not dissuade investors during the third quarter. The Dow Jones Industrial Average returned 9.6%, the S&P 500 advanced 7.7% and the MSCI U.S. Broad Market Index (a measure which captures the returns of more than 3,000 public stocks) gained 7.1%. (Small- and mid-cap stocks were weaker than large-caps.) Over the past 12 months, the three indexes advanced between 17.6% and 20.8%.

Overseas, the view was (and still is) more cloudy. The MSCI EAFE Index, a measure of developed foreign markets, earned a tepid 1.4% return during the third quarter, and is down 1.4% year-to-date, having only gained 2.7% over the last 12 months. To blame: Slowing growth in Europe, lingering questions about Brexit implications, trade-war fears and concerns relating to the financial health of certain members of the euro zone, including Italy, again. A foreign-market bright spot was Japan, where stocks gained 8.8% in Q3 and have mirrored gains in the U.S. over the year-to-date and 12-month periods.

Meanwhile, many emerging markets have been more heavily dinged by fears over global trade restrictions, particularly China, where by one measure stocks dropped 2.6% during the quarter, leaving that market down 8.2% for the year and off 2.9% over the past 12 months. The MSCI Emerging Markets Index declined 1.1% in the third quarter, and is down 7.7% year-to-date, having fallen 0.8% over the last year.

Diving a little deeper, every sector within the U.S. stock market made gains in the third quarter, led by health care and technology stocks, with 13.7% and 9.3% returns, respectively. Along with the consumer discretionary group, these three sectors have been the top performers over the last year. The tech sector's success continues to be driven by heavyweights Apple and Microsoft, which were up 34.9% and 35.4%, respectively, for the year through quarter-end.

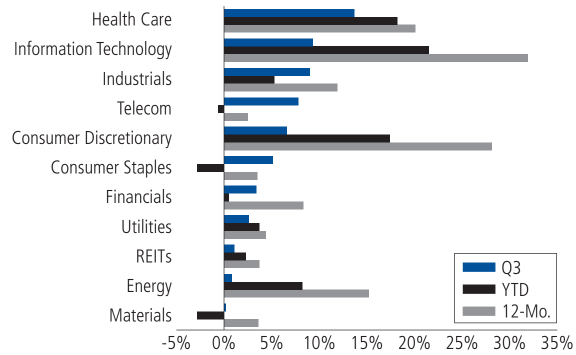
U.S. Stocks Forge Ahead

	Q3	YTD	12-MO.
Dow Jones Industrial Average	9.6%	8.8%	20.8%
S&P 500	7.7%	10.6%	17.9%
MSCI U.S. Broad Market	7.1%	10.6%	17.6%
MSCI EAFE	1.4%	-1.4%	2.7%
Bbg. Barc. U.S. Aggregate Bond Index	0.0%	-1.6%	-1.2%
MSCI Emerging Markets	-1.1%	-7.7%	-0.8%

Note: Performance numbers are total returns, reflecting reinvested dividends through 9/30/18. Source: Morningstar.

U.S. Sector Performance

Ranked by Q3 Return



Source: Morningstar.

Materials stocks, energy stocks and interest-rate-sensitive real estate investment trusts (REITs) lagged in the third quarter, although all eked out positive returns. Materials and consumer staples have been the worst sectors year-to-date, both down 2.8% (and among the worst over the last 12 months, with modest 3.6% and 3.5% returns, respectively), as the impacts (real and projected) of tariffs on their profitability have made investors wary.

The U.S. bond market ended the third quarter flat, but has declined 1.6% year-to-date and is down 1.2% over the last 12 months. As bond prices have fallen, yields have been rising. The benchmark 10-year Treasury note's yield finished September at 3.05%, having risen 65 basis points from its 2.40% yield at 2017's end. Federal Reserve interest-rate hikes have pushed yields higher on shorter-term bonds. Yields have also risen for longer-term bonds as inflation has begun to awake from its slumber. That said, we don't believe inflation poses a risk to consumers or the markets at this juncture.

We know that it can be disappointing for investors to see prices of "safe" assets like bonds falling, but those higher yields will make up for price declines over time with higher income for bondholders. Individual bonds and bond funds are still vital buffers against stock market risk in diversified portfolios and we don't believe that an exit from the bond markets is a prudent investment strategy. In fact, for some clients, we have added or are considering adding to bond positions to take advantage of improving yields.

Notable Investment Trends

Through year-end and well past the turning of the calendar, we expect an excess of misinformed chatter about the pace of earnings growth versus peak earnings as well as long-term expectations for market returns in light of backward-looking, point-in-time measures.

Earnings are an area of focus for managers like us, and they get a lot of coverage in the media too. As owners of shares in public companies, each of us is "entitled" to a portion of a company's earnings stream. If those earnings rise, then new buyers should be willing to pay more for shares to capture those increased profits and the potential dividend payouts, stock buybacks or growth initiatives they might fund.

The current bull market has been driven by earnings growth. Companies in the S&P 500 have reported positive year-over-year earnings for eight consecutive quarters, and it's anticipated that Q3 will make it nine. What you'll notice in the chart on this page is that the pace of growth over the last two quarters has been very strong, up near 25%. While these results have been boosted by a healthy consumer, companies also got a big hand from the corporate tax overhaul that went into effect this year—lower corporate taxes increased per-share profits dramatically. Early estimates put earnings growth around 19% in the third quarter, but we've also seen some initial reports that corporate managers may be lowering their expectations for future quarters.

Following the initial "sugar high" of the tax cuts, we think it's inevitable that the pace of earnings growth slows—20%-plus growth quarter in and quarter out is not sustainable. This does not mean an end of profitability or that we're heading for economic or profit contraction, though. It simply means that results will likely come back down to earth at some point. It would not be surprising to see a negative short-term reaction in the markets when this happens.

Another rare trend that is unsustainable: Synchronous double-digit returns. For the first time in nearly 20 years, annualized three-, five- and 10-year (as well as 12-month) returns for the S&P 500 have all been greater than 10% for each of the last four months. Those 10-year returns, in particular, will likely continue to look better and

Note: Chart shows year-over-year earnings-per-share growth for S&P 500 companies. 9/30/18 data is estimated. Source: FactSet.

better heading into 2019 as the worst months of the financial crisis roll out of the calculation.

The allure of those historical returns may entice investors to throw caution to the wind and venture out of their risk comfort zones to chase them. Considering that bond and foreign stock market returns have been weak relative to the U.S. stock market this year (and throughout the most recent recovery and expansion), we worry that some investors will lose sight of the virtues of diversification and fall victim to "recency bias," the assumption that what has just been predicts what will be.

As much as it is the case during protracted market declines, it is just as crucial to measure investment decisions against your long-term goals when the markets are steaming ahead. We continue to see value in owning a combination of U.S. stocks and bonds, as well as foreign stocks. U.S. stocks are somewhere in the fair-value to expensive camp, while foreign stocks offer better relative values. Bond investors are facing the headwinds of lower prices that go along with higher yields, but those loftier yields make them more attractive long-term investments.

Our Outlook

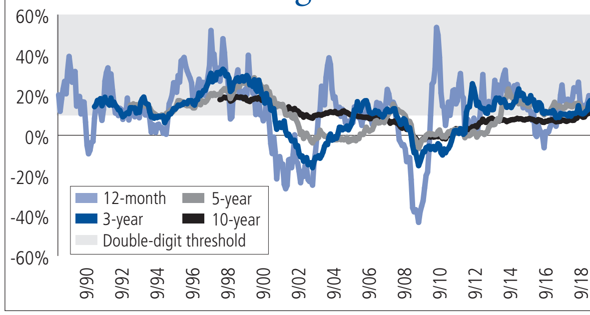
The U.S. economy is fueled by earnings and the consumer, and as noted above, earnings have been strong. Gross domestic product (GDP) grew at a 4.2% pace in Q2, up from 2.2% in Q1, and some early estimates suggest the just-ended quarter could see equally compelling economic growth.

We've seen strong back-to-back quarters before. The economy grew at a 5.1% pace in the second quarter of 2014 and 4.9% in the third. But this was followed by a reversion back to a trend behind the 2.8% pace of the last 50 years. We don't expect the U.S. economy to continue barreling ahead at 4%.

Meantime, with headline unemployment at 3.7%, its lowest level since 1969, and the total unemployment, or U-6, number (which takes into account the underemployed and the unemployed who are not actively searching for work) near a 17-year low, we would argue the U.S. economy is at full employment. While personal incomes have not shown dramatic improvement, they continue to grow faster than inflation year-over-year. And households are in good financial shape—the household debt-service ratio, which measures the percent of individuals' income that goes toward paying debt, is near all-time lows. So the consumer by most measures is well-employed and well-equipped to spend—as reflected in new-home, auto and retail sales. We expect a strong holiday shopping season, but with consumer spending recently beginning to outpace consumer earnings as savings rates have dropped, a whiff of caution is prudent.

Inflation has picked up this year and is hovering right around the Fed's 2% target rate. Along with other signs of economic growth, this gave the central bank's policymaking committee the impetus to raise interest rates for the eighth time in this cycle to a range of 2.00%–2.25% last month. By historical measures, that still means interest rates are low, and we're not concerned that it will discourage borrowing any time soon even if the Fed stays on this path (investors are pricing in another rate hike following the committee's December meeting).

The Siren Song of Double-Digit Returns



Note: Chart shows monthly rolling returns for the periods listed from 1/31/89 through 9/30/18; multi-year returns are annualized. Source: Morningstar.

All the above paints a picture of a healthy economy. This indicates to us that the expansion could remain on a slow-growth path for some time, though we are also cognizant of a litany of factors that could disrupt it. Other than the midterm elections, the biggest concern that lies ahead is the potential for a trade war with China.

As we write, the U.S. is still at odds with China and other trade partners, and the latest round of 10% tariffs (which will go up to 25% in 2019) on $200 billion of Chinese consumer goods could filter down and give U.S. consumers pause. Furniture, air conditioners, technology products and imported foods (among other things) may become more expensive, draining pocketbooks faster than anticipated.

Our clients rely on us to stay focused on the facts instead of headline foment. Doing so is key to helping them build wealth through market cycles, no matter how calm or contentious those cycles may be.

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