

IN THIS ISSUE

SPOTLIGHT 2  
ECONOMY 3  
EQUITIES 5  
FIXED INCOME 7  
OUTLOOK 9  
DISCLOSURES 12

QUARTERLY MARKET INSIGHTS  
3RD QUARTER 2018



## ARTIFICIAL INTELLIGENCE: A BRAVE NEW WORLD

Many of the highest profile companies with the best performing stocks over the past two years including NVIDIA, Amazon.com and Microsoft have been world leaders in the research and development of artificial intelligence ("AI"). From speech recognition software, like Amazon's Alexa, to Intel's summer 2017 \$15 billion purchase of Mobileye, an Israeli manufacturer of vision sensors for autonomous vehicles, AI-related products and concepts have begun to infuse consumer and business environments.

AI is an area of computer science that focuses on the creation of machines that can think and learn like humans. These machines can understand and speak language, recognize patterns and solve problems. AI machines create phenomenal new applications but also can cause significant disruption as they evolve. AI is based on three main components: machine learning, deep learning and neural networks. Machine learning is usually based on "trial learning" wherein machines are given large data sets and asked to repeat a task in order to achieve an objective. For example, a machine may be fed millions of images to analyze. After going through endless repetitions, the machine acquires the ability to recognize a pattern, shape or human face.

Deep learning involves machines training or learning from their mistakes. The process involves feeding a computer program massive data sets and asking it to make decisions about other data. The learning can be supervised, semi-supervised or unsupervised. Deep learning models are based on information processing or biological functioning, like human brains. Generally, some form of a neural network is developed to conduct the learning and training. A neural network is organized as a layer made up of interconnected nodes or decision points. The system learns from the output of each layer. The "deep" refers to the number of layers through which the data is transformed. Similar to a young child learning to speak, the neural net is supposed to learn how to process information via practice, trial and error.

Consumers engage with AI every day at home, at work and at play including Apple's Siri and Amazon's Alexa. While vehicles may not be fully autonomous yet, semi-autonomous driving fleets are on the roads. Manufacturers like Tesla have connected all their vehicles with knowledge learned by one car shared across all models. Shared experiences provide a critical feedback loop in the machine learning process.

Within social media, AI works through users' past web searches and interactions, to deliver a customized experience. Music and media streaming services like Spotify, Netflix and YouTube deliver introductions or recommended lists of new or related content based on current or previous selections. Gamers, whether on PUBG or Fortnite often play against AI powered "bots" while in some games such as Middle Earth, the AI enemies evolve based on their interaction with users. Online advertising networks and navigation and travel applications such as Google Maps or Uber were early adopters of AI technologies. Now the banking and finance industries are heavy AI users in areas of customer service and fraud protection with AI-driven emails alerting users when an unusual transaction occurs.

Looking forward, AI will likely incentivize firms to rethink their enterprise structures for sales, cybersecurity, procurement, logistics and human resources. While the advancement of AI seems certain, predictions relating to workers, jobs and training are far less certain. While AI-driven technology may displace or eliminate jobs, it should not eliminate work. In the near term, machine learning is most adept at replacing individual tasks. The authors of a recent paper in the *American Economic Association* state "full automation will be less significant than the reengineering of processes and the reorganization of tasks" leaving workers with more time for higher level tasks. While workers will need to adapt and mid-career training will become more important, difficulty in retraining may grow as the skills gap continues to widen. For many workers, more specific and advanced education may be required as roles and responsibilities evolve alongside smart machines.

Machine learning and automation will probably have lesser impacts on jobs that involve managing people, creative and design functions, technology professionals and occupations involving human or social interactions such as veterinarian, lawyer, pharmacist, nurse, school teacher, surgeon, childcare and eldercare. Jobs conducted in unstructured environments such as gardeners or plumbers may also be minimally impacted. Globally, AI and machine learning may have drastically different impacts. Advanced economies may be more affected than developing ones, driven in part by differing wage levels, demand growth, industry mixes and demographics.

Predicting the long-term scope of economic change is notoriously difficult, especially given today's rapid pace of technological change, enormous sums of capital investing in research and the speed with which new products penetrate markets. Throughout history, automation has consistently driven productivity higher, in turn driving profits and incomes higher. Higher incomes lead to greater demand for goods and services which then create newer or different jobs. This cycle continues today, only at a much faster pace and simultaneously across multiple industries and global regions. While the potential for short-term disruption from AI may be greater, the probability of unheralded innovation and growth is staggeringly higher.

## ECONOMY

### ECONOMIC OUTLOOK REMAINS POSITIVE FOLLOWING STRONG Q2

U.S. corporate profit strength has carried over to the broader economy in recent quarters, as the final reading on annualized gross domestic product ("GDP") growth in the second quarter came in at a healthy 4.2% rate. It is the highest growth rate since the third quarter of 2014. Net trade made the highest contribution since the last three months of 2013 mainly due to a rise in exports of soybeans and other goods before tariffs take full effect. Consumer spending was also a highlight of the report, up 3.7% on an annualized basis. Consumer confidence appears to be unwavering as it increased to 138.4 in September. This is the highest reading in 18 years and near the all-time record of 144.7 achieved in 2000. Consumers' optimism was largely driven by robust job growth. The current unemployment rate is now at a nearly two-decade low, while August marked 95 successive months that the U.S. economy added jobs, the longest stretch on record. Wall Street forecasters see GDP up 3.1% in the July-to-September period.

The Federal Reserve ("Fed") raised interest rates by 25 basis points to a range of 2.00% to 2.25% at their September meeting. Policymakers indicated their decision was made due to strong economic growth and the potential risk of capacity constraints with signs of rising inflation. Central bank officials project one more quarter-point interest rate hike in 2018 followed by three in 2019. In a statement after the two-day meeting, the Fed removed its prior assertion that interest rate policy "remains accommodative," an acknowledgment that rates are drifting closer to normal levels. This is the first time in the past ten years that the fed funds rate is now above consumer inflation, excluding food and energy costs. Excluding the volatile food and energy components, in the 12 months through August, the Core Consumer Price ("CPI") increased 2.2%. The Fed's decision regarding rates going forward will be impacted by several issues including inflation, economic growth, trade tensions and labor market trends. European Central Bank ("ECB") President Mario Draghi said the ECB plans to begin raising interest rates next fall and end bond purchases this year. The Bank of England left interest rates unchanged as expected and highlighted greater uncertainty about the European Union withdrawal process.

ECONOMIC INDICATORS	LATEST	3MO PRIOR	CHANGE*
REAL GDP (QoQ ANNUALIZED)	4.2%	2.2%	▲
TRADE BALANCE	-53.2	-42.6	▼
UNEMPLOYMENT RATE	3.7%	4.0%	▲
NON-FARM PAYROLLS	134K	208K	▼
ISM MANUFACTURING	59.8	60.2	▼
ISM NON-MANUFACTURING	61.6	59.1	▲
RETAIL SALES (LESS AUTOS)	0.2%	1.2%	▼
INDUSTRIAL PRODUCTION	0.4%	-0.8%	▲
HOUSING STARTS	1282M	1329M	▼
CONSUMER PRICE INDEX (YoY)	2.7%	2.8%	▲
CONSUMER CONFIDENCE	138.4	127.1	▲
EXISTING HOME SALES	5.34M	5.41M	▼
CONSUMER CREDIT	20.07B	22.23B	▼
CRUDE OIL PRICE	73.25	74.15	▲

Source: Bloomberg. Past performance does not guarantee future results. \*The change arrow is indicative of a positive or negative change in the economic nature of the data series. For example, a downward-pointing change arrow assigned to the crude oil price field will correspond with an increase in the actual price of crude oil over the last three months. This is because a short-term increase in the price of crude oil has historically been detrimental to U.S. economic growth.

#### EMPLOYMENT & MANUFACTURING

Employment remained strong in the third quarter despite the September jobs number coming in below expectations. Total nonfarm payroll employment increased by 134,000 in September, below the average monthly gain of 201,000 over the prior twelve months, according to the Bureau of Labor Statistics. However, upward revisions of the previous two months offset the weaker September report. The gain in total nonfarm payroll employment in August was revised up from 201,000 to 270,000 and July was revised up from 147,000 to

## ECONOMY CONTINUED

165,000. With these revisions, employment gains in July and August combined were 87,000 more than previously reported. The unemployment rate in September fell to its lowest level since 1969 with a reading of 3.7% while average hourly earnings increased year over year by \$0.73 or 2.8% to \$27.24. This was slightly slower than the 2.9% wage growth reported for August.

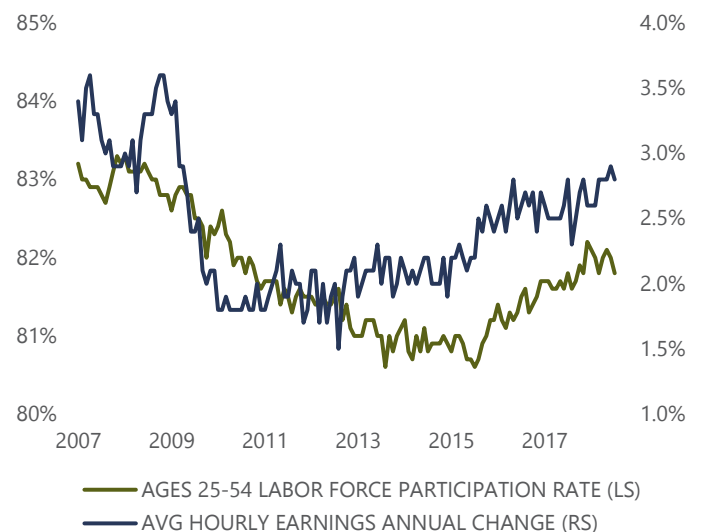
Economic activity in the manufacturing sector expanded in September with the overall economy growing for the 113th consecutive month, according to the latest Purchasing Manager's Index ("PMI") report from the Institute for Supply Management ("ISM"). The increase was achieved on the back of robust demand. Despite escalating trade tensions remaining a concern for factories, the ISM stated that manufacturing activities have been improving steadily, which point toward a resilient and growing economy. The ISM Manufacturing Index came in at 59.8 in September, in line with the consensus estimate. Although the reading came in lower than the 61.3 reading in August, a level above 50 implies that manufacturing is expanding. The Production Index surged 63.9 last month, increasing 0.6 from August. Further, the Employment Index increased to 58.8 in September, registering a 0.3 point increase from the prior month. This was its highest reading since February. New Export Orders Index gained 56 in September, an increase of 0.8 from August. This was the 31st consecutive month of gains for the metric. Of the 18 manufacturing industries which were surveyed, 15 reported growth. Such industries include textile mills, miscellaneous manufacturing, plastics & rubber products, computer & electronic products, food, beverage & tobacco products, machinery, apparel, leather & allied products and paper products.

### HOUSING

Housing has been one soft area for the economy, likely influenced by rising interest rates and higher home prices. Pending home sales fell 1.8% for August, below the consensus range of -0.5% to 2.0%. New home sales registered at a 629,000 annualized rate in August, well below the 712,000 peak in November 2017.

U.S. homebuilding increased more than expected in August, a positive sign for the housing market which has underperformed the broader economy. Housing starts rose 9.2% to a seasonally adjusted annual rate of 1.282 million units in August, according to the Commerce Department. Sales of existing U.S. homes remained unchanged last month but inventory increased for the first time in three years. The National Association of Realtors announced that existing home sales were unchanged at a seasonally adjusted annual rate of 5.34 million units in August. This follows four straight months of declines as a lack of properties for sale has pushed up prices, sidelining many would-be homeowners.

### U.S. LABOR FORCE PARTICIPATION AND WAGE TRENDS MARCH 2007 THROUGH SEPTEMBER 2018



Source: Bloomberg. Past performance does not guarantee future results.

## EQUITY

### EARNINGS PUSH U.S. AVERAGES TO ALL-TIME HIGHS

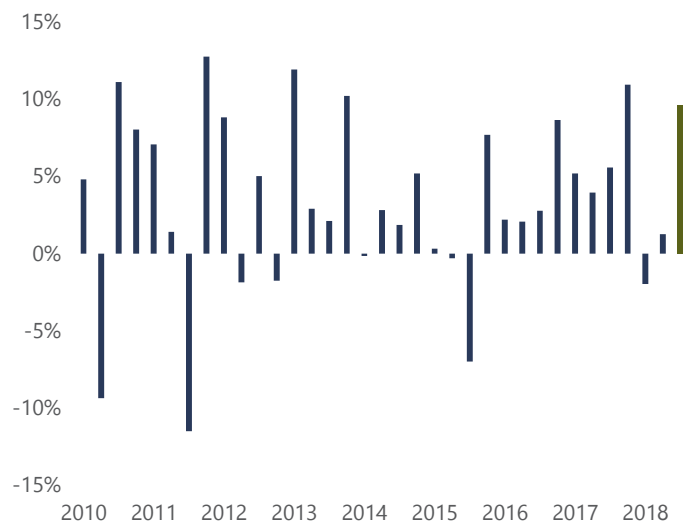
In the third quarter, investors were given a front row seat to a tug of war that played out across financial news headlines. Strong corporate earnings growth and positive economic data were on one side, while concerns over escalating trade tensions and emerging markets stress were on the other. Despite some hiccups, the market friendly forces prevailed in a resounding fashion, as large capitalization U.S. stocks supported gains across the global equity asset class in the third quarter. The MSCI ACWI Index, a widely used global stock benchmark, advanced 4.4% for the three months ending September 30. All three of the major U.S. stock averages posted quarterly total returns of at least 7.4%, led by the blue-chip Dow Jones Industrial Average's 9.6% period return.

The Dow notched its sixth best quarterly performance of the 35 quarters in the books since the beginning of the current decade, and its best third quarter since 2010. The S&P 500 Index posted gains in 10 of the 13 weeks in the third quarter, highlighted by five all-time closing highs including its highest ever close of 2,930.75 on September 20. Annualized domestic GDP growth of 4.2% in the second quarter paired with nearly 25% year-over-year second quarter earnings-per-share growth for the S&P 500 Index provided fertile ground for strong equity market gains. Stock investors received some reprieve from escalating trade tensions in August and September with the materialization of a new trilateral deal between the U.S., Canada and Mexico to update the current NAFTA framework.

Looking under the surface of the S&P 500's quarterly performance into the eleven major sectors, the healthcare group provided clear leadership propelled by pharmaceutical and healthcare equipment companies. Mega-cap names Eli Lilly & Co., Pfizer Inc., Abbott Laboratories and Thermo Fisher Scientific Inc. all climbed by more than 17% in the quarter. The main ingredients in the recent healthcare sector renaissance appear to be strong upward revisions of earnings expectations from Wall Street analysts, the perception of a less damaging regulatory backdrop than was widely feared in 2017 and reasonable valuations.

In the 30-stock Dow, four of the six top performing stocks in the third quarter were healthcare-related: Pfizer Inc., Walgreens Boots Alliance, Inc. Merck & Co. Inc. and Johnson & Johnson. Growth style stocks as measured by the Russell 3000 Growth Index outperformed their value style peers as measured by the Russell 3000 Value Index for the seventh consecutive quarter. Over the period January 1, 2017 to September 30, 2018 the total return difference between these two indexes is a cumulative 33.7% in favor of the Russell 3000 Growth Index.

DOW JONES INDUSTRIAL AVERAGE QUARTERLY RETURN: JANUARY 2010 THROUGH SEPTEMBER 2018



Source: Bloomberg. Past performance does not guarantee future results.

## EQUITY CONTINUED

One popular growth stock that had a rough third quarter and couldn't shed the negative headlines was social network Facebook Inc. Shares of the Menlo Park, CA firm plunged nearly 20% on July 26, shedding \$119 billion in market value and suffering the largest one-day loss of market capitalization in U.S. market history. Management's indication of slowing revenue growth and higher expenses related to content monitoring drove the explosion in negative sentiment, resulting in Facebook shares declining 15.4% in the quarter. Also in the consumer technology space, shares of iPhone-maker Apple Inc. surged 22.0% in the third quarter on better-than-expected demand for its premium-priced iPhone X and impressive growth in its software and services revenue segment. Apple's strong momentum propelled it to be the first company ever to eclipse \$1 trillion of market capitalization. E-commerce and cloud computing giant Amazon.com Inc. briefly surpassed the \$1 trillion market capitalization in early September before consolidating gains during the remainder of the quarter. Elsewhere in the technology sector, semiconductor-maker Broadcom Inc. made the largest acquisition of the third quarter with its \$19 billion purchase of business-to-consumer software firm CA Technologies. Other notable deals this quarter included subscription radio company Sirius XM Holdings Inc.'s \$3.5 billion acquisition of streaming music firm Pandora Media Inc. and American affordable luxury conglomerate Michael Kors Holdings Ltd.'s \$2.2 billion purchase of high-end luxury Italian fashion label Gianni Versace SpA.

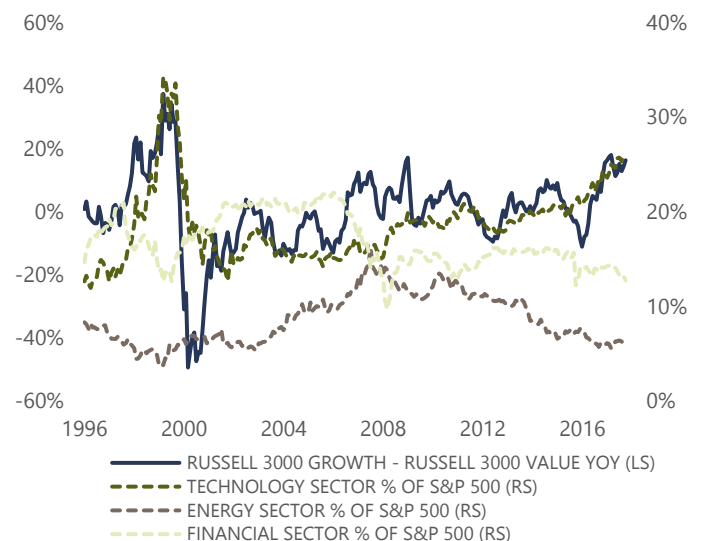
Outside of the U.S., Turkey was one of the major flashpoints for broad emerging market stress this summer. In early August, President Trump announced a doubling of tariffs on Turkish steel and aluminum amid an escalating diplomatic dispute surrounding the detention of an American pastor. The Turkish lira plunged 41.0% against the U.S. dollar from July 9 to August 13 while the MSCI Turkey Index declined 39.7% in U.S. dollar terms over the same period. This stress fanned fears that other emerging market nations with weak currencies and large trade deficits could encounter trouble servicing government and corporate debt issued in U.S. dollars.

In price terms, the MSCI Emerging Markets Index entered bear

market territory for several days in mid-September, having suffered a 21.2% decline over the eight-and-a-half month period from January 26, 2018 to September 11. Other notable weakness across the international equity market landscape during the third quarter included declines of at least 7.0% for the MSCI Indexes of China, India, Greece, Argentina and South Africa.

Looking forward to the fourth quarter, equity investors will likely keep a close eye on the recent increase in U.S. government bond yields. Historically, rising bond yields have supported relative outperformance for cyclical sectors including financials and industrials, while pressuring areas of the market traditionally viewed as "bond proxies" like utilities, telecommunications and certain packaged food stocks.

U.S. GROWTH VS. VALUE YOY AND KEY SECTOR WEIGHTS: JANUARY 1996 THROUGH SEPTEMBER 2018



Source: Bloomberg. Past performance does not guarantee future results.



## FIXED INCOME

### INFLATING BOND YIELDS

Most U.S. bond benchmarks posted positive returns during the third quarter of 2018 except those tracking bonds of the highest credit quality and longer maturities. However, despite a relatively positive quarter, most bond indexes are still below water on the year. Year to date, a bond investor focusing on shorter maturities, lower credit quality, and floating rate securities would have fared well relative to broad indexes such as the Bloomberg Barclays US Aggregate Bond Index ("Agg"). Much of the outperformance can be attributed to reduced price sensitivity to rising interest rates than exhibited by the Agg. In the case of corporate credits, ranging from A-rated to high yield, relatively higher coupon income was also a factor for their quarterly outperformance. In addition, high yield has seen some spread compression that also contributed to its relative outperformance versus the Agg. Emerging Market ("EM") bonds performed well in the third quarter after a significant selloff earlier in the year. Similar to U.S. high yield, higher coupon income helps offset principal losses, but the performance of EM bonds is still largely dependent on the value of the U.S. dollar.

After spending much of the third quarter yielding around 2.90%, the 10-year U.S. Treasury note climbed in September to end the quarter yielding 3.06%. The change appears to be influenced by a few factors, most of which are interrelated. For one, the likelihood of the Fed raising rates four times in 2018, as indicated by the Fed funds futures market, increased from roughly 60% on August 20 to 70% by the end of the quarter, but not before climbing as high as 78% in mid-September. Over that same time period, spot prices of U.S. WTI crude oil at Cushing, OK climbed from \$66.43 per barrel to \$73.25 on the last day of the quarter. In addition, various measures of inflation also moved higher on balance and likely led investors to expect more pronounced inflationary pressures in the future, which in turn, caused yields to move higher.

Another motive for rates to trend higher during the quarter was the Fed's communication. Most notably, Fed Governor Lael Brainard indicated that given recent fiscal stimulus and relatively easy financial conditions, the neutral level of interest rates in the short term might be higher than the longer run neutral rate. This is consistent with the idea that the Fed could likely push the Fed funds rate higher than what some investors had initially thought was a ceiling. Additionally, while she acknowledged that yield curve inversions are one indicator of a future recession, she also noted that it is just one indicator that the Fed utilizes in assessing the economy. She further stated that a depressed term premium could also be a reason to give inversions less weight.

FLATTER CURVE, BUT NOT INVERTED (IN BASIS POINTS)  
DECEMBER 2004 THROUGH SEPTEMBER 2018



Source: Bloomberg. Past performance does not guarantee future results.

## FIXED INCOME CONTINUED

On the other hand, the St. Louis Fed President James Bullard has been much less content to ignore the possibility of a yield curve inversion, and has even stated that the Phillips Curve (the relationship between the unemployment rate and inflation) is relatively non-existent as inflation expectations are too well anchored around 2.0% for that phenomenon to manifest itself in a manner that materially alters realized inflation rates due to wage pressures. As monetary policy operates with long and variable lags, and given the changing composition of the Federal Open Market Committee in 2019, the Fed could potentially let off the tightening pedal next year. We observe that this potential outcome is reflected in the Fed funds futures market.

The spread between the yields on the 90-day T-bill and the 10-year U.S. Treasury note compressed eight basis points, or 0.08%, in the third quarter as the yield curve experienced a relatively parallel shift higher during the quarter. The spread between the two Treasury obligations currently stands at 86 basis points, suggesting that a curve inversion may still take some time to materialize. If the yield curve flattens dramatically from here that would suggest the Fed has probably pushed short rates too far too fast. Yet, if steepening occurs, that might be a signal that the market thinks the Fed is still too accommodative on balance. In an environment of significant flattening, investors would want to begin adding to longer duration government bonds, whereas in a steepening environment investors should consider floating rate and credit securities as they provide higher levels of income to offset any loss of principal, and the principal value of the floating rate paper should remain relatively stable. Presently, it is our view that extending bond maturities out past 3 to 4 years does not offer an attractive risk-reward tradeoff.

Nevertheless, the credit cycle appears long in the tooth to many observers. Issues carrying a rating of BBB have grown to be roughly 50% of the intermediate investment grade corporate universe and spreads remain near historic lows. Even so, we recommend a focus on higher quality issuers when buying individual bonds, and allocating to active manager strategies with sound credit analysis processes for mutual fund exposure.

Many corporate issuers have maintained their existing ratings despite adding significant leverage since the end of the recession. As a result, any significant economic downturn could impede their ability to pay down or refinance their current debt levels, which could lead to credit downgrades. In our view, this is a larger concern for the bond market performance than the current size of BBB corporate credit. As we move forward this may drive us to suggest a higher allocation to U.S. government bonds.

DEBT TO EBITDA RATIO FOR MAJOR U.S. EQUITY INDEXES  
SEPTEMBER 2004 THROUGH SEPTEMBER 2018



Source: Bloomberg. Past performance does not guarantee future results.



## OUTLOOK

### ECONOMIC GROWTH EXPECTATIONS & EQUITY MOMENTUM

The third quarter of 2018 was quite rewarding for investors in domestic equities. Though not a quarter that earned double-digit returns for any of the three major U.S. benchmarks, the quarterly pace of gains was well above historical averages. Reasons for the quarter's stock market growth stem mainly from continued strength in corporate profitability, robust consumer spending and rising personal incomes. These equity gains are even more impressive in consideration of the signals from the domestic economy overall.

Though investors cheer the latest news on quarterly GDP, having put in now two quarters in a row of above a 4% annualized rate, the stock market may not be as optimistic. Consider the outsized equity returns in 2017 which happened in an economic growth environment that accelerated from 2.0% to just over 3.0% by year's end and compare those to date in 2018. Recall that when market participants derive fair prices for equities today, they are placing a value on future earnings. It is possible that the 20-30% equity returns in 2017 were forecasting 4.0% (or higher) GDP growth in 2018. With lower equity returns year to date this year compared to last, it is possible market prices could be forecasting a deceleration in economic growth in 2019.

In fact, this may be exactly what the Fed wants to happen. Generally speaking, real (inflation adjusted) growth rates for developed economies like the U.S. rarely grow over 4.0% for too long without stoking inflationary pressures. There is a narrow needle to thread between economic growth that is strong enough for double-digit equity returns, and growth that risks inflation.

Compared to a few years ago when annual inflation, as measured by the Consumer Price Index ("CPI"), was less than 1.0%, today's CPI readings near 2.5% could be somewhat troublesome for the Fed. Under new Fed Chairman Jerome "Jay" Powell, the Fed has continued their policy of gradually hiking interest rates. With the Fed removing the word "accommodative" as a descriptor of monetary and interest rate policy, business leaders and investors may now consider the federal funds rate as neutral. Investors could begin to consider the possibility that the Fed's next descriptor for monetary policy could be "restrictive."

As the Fed has changed monetary policy from "accommodative" to "neutral" it is natural for expectations of economic growth to moderate. We view stocks as a forward discounting mechanism for economic growth. Put differently, if stock prices today reflect expectations of economic growth tomorrow, then perhaps the deceleration of domestic equity returns in 2018 compared to 2017 foretells a deceleration of economic growth. Investors ought to be prepared for changes in economic growth rates, so that they may better withstand potential short-term swings in valuation when the markets digest these changing growth rates, often with price changes that can both overshoot and undershoot fair value.

ECONOMIC INDICATOR	LATEST	SIGNAL
FED FUNDS POLICY	2.25%	BEAR
UNEMPLOYMENT RATE	3.90%	BULL
STEEPNESS OF YIELD CURVE	0.86%	BULL
PRODUCER PRICES INDEX	3.60%	BEAR
S&P 500 INDEX	2913	BULL
WTI OIL PRICES	\$ 73.25	BEAR
S&P / CASE-SHILLER HOME PRICE INDEX	214.00	BULL
PHILADELPHIA FED SURVEY	19.9	NEUTRAL

Source: Bloomberg.

## OUTLOOK CONTINUED

In addition to taking clues from equity prices for economic activity, there are eight macro-economic factors we follow that can help set expectations for equity returns over the next 12 months. These eight factors are summarized in the table on the previous page, and at present three are bearish (Fed policy is raising interest rates, oil prices are more than 20% higher than 12 months ago, producer prices have changed by more than average); four are bullish (the yield curve is positively sloped, unemployment has improved from six months ago, the S&P 500 is higher than the average of the past 10 months, home prices are higher than six months ago); and one is neutral (Philadelphia Federal Reserve Business sentiment). Though the economic data currently provides support for better-than-average equity returns over the next 12 months, the margin for these factors to hinder equity returns has narrowed.

### EQUITY MARKET MOMENTUM

The chart at the right depicts the monthly close of the S&P 500 compared to its ten-month average, statistically referred to as a simple moving average (SMA), over the last 20 years. Historically, when the S&P 500 is higher than its ten-month SMA, it has remained in a bull market. As noted in the chart, more recent measurements show that weakness in market momentum from the spring almost broke the trend line.

With a bit of hindsight, the weakness in stock momentum during the late winter and spring may have been attributed to changes in trade policy and the implementation of tariffs by the Trump administration. Notice how the S&P 500 declined so quickly in February and March that it almost broke below its ten-month SMA.

It is possible that domestic equities may have overreacted to the prospect of a trade war during those earlier months. As time has passed, these new trade policies may have become perceived by stock investors as less dire than initially feared. In fact, news coverage of renegotiating the North American Free Trade Agreement turned from a negative to more neutral tone in the final weeks of the third quarter. Additional factors behind the summer rally, including corporate profit growth and domestic economic strength, may have helped stock investors overcome their fears for a worsening trade war being a near-term risk for stocks. At the current time, the message from stocks appears bullish, but we will continue to monitor market momentum and other economic indicators for changes in direction and strength.

S&P 500 MOMENTUM (BASED ON CLOSING PRICES)  
DECEMBER 1999 THROUGH SEPTEMBER 2018



Source: Bloomberg. Past performance does not guarantee future results.

## ECONOMIC OUTLOOK

ECONOMIC FACTORS	CURRENT OUTLOOK
U.S. GDP Growth	The Atlanta Fed's GDPNow forecast for third quarter annualized U.S. GDP is 4.1%, down from 5.0% on August 1.
Federal Funds Rate	The FOMC hiked its benchmark federal funds rate to a range of 2.00% to 2.25% in September and expects one more quarter-point hike in 2018.
Inflation	Market participants expect inflation to average approximately 2.05% per year over the next five years based on breakeven inflation rates.
Employment	In its September statement, the FOMC now expects the headline unemployment rate to bottom at 3.5% in 2019 from its current 3.7% level.
Consumer Confidence	Despite recent trade disputes, consumer optimism should remain high heading into 2019 given a healthy labor market.
Oil	Sanctions on Iranian supply and bottlenecks in West Texas combined with steady global demand could further boost oil prices in the fourth quarter.
Housing	A shortage of inventory and elevated prices in the previously owned U.S. home market may continue to weigh on sales heading into 2019.
International Economies	The IMF reduced its global growth forecast for 2019 to 3.7% from 3.9% citing escalating trade tensions and tighter liquidity for emerging markets.

	UNDERWEIGHT	NEUTRAL	OVERWEIGHT	CURRENT OUTLOOK
<b>FIXED INCOME</b>				
Core Bonds				<p>We expect the U.S. Federal Reserve to maintain its steady pace of interest rate hikes over the next several quarters against a domestic backdrop of very strong labor markets supported by healthy consumer and business confidence. This suggests to us that the path of least resistance for U.S. bond yields over the next six to twelve months may be higher. As such, we believe an underweight to the broad fixed income asset class relative to our strategic target allocations remains justified. Outside of our core, investment grade allocation, we believe our recently increased exposure to floating rate securities could serve as a hedge against both rate hikes and inflation looking into 2019.</p> <p><i>Benchmark: BB BC Intermediate Government/Credit Index</i></p>
TIPS				
Non-Investment Grade				
International				

	UNDERWEIGHT	NEUTRAL	OVERWEIGHT	CURRENT OUTLOOK
<b>EQUITIES</b>				
Large Cap				<p>We believe an overweight to equities relative to our strategic allocation and versus fixed income remains appropriate. Current valuations of many global equity indexes are not much higher than long-term averages and appear well supported given a backdrop of still-accommodative monetary policy in Europe and Japan and a resurgence in U.S. corporate profits. While we acknowledge the risk that escalating trade disputes between the U.S. and China pose to global equities, we have observed some trade-related pro-market developments in recent months including a productive NAFTA renegotiation. We believe it is still too early to project with any confidence the impact of the simmering trade tensions on economic growth and corporate profits.</p> <p><i>Benchmark: MSCI All Country World Index (ACWI)</i></p>
Mid Cap				
Small Cap				
Developed International				
Emerging Markets				

	UNDERWEIGHT	NEUTRAL	OVERWEIGHT	CURRENT OUTLOOK		
<b>ALTERNATIVES*</b>						
	CAP PRES	IWSG	BAL	GWSI	GROWTH	
Global Real Estate						<p>Given our expectation for a continuation of volatility in both equity and fixed income markets in the final months of 2018 and first half of 2019, we believe an overweight to alternative investments remains sensible. It is our view that the broad fixed income asset class is most likely overvalued, while the broad equity asset class is near full valuation and becoming increasingly exposed to Fed interest rate hikes and a deceleration of economic growth outside of the U.S. As such, we have constructed diversified alternatives portfolios meant to decrease the risk profile of their respective recommended total Alternative Investment portfolios, which are listed to the left (CAP PRES, IWSG, BAL, GWSI, GROWTH).</p> <p><i>Benchmark: HFRX Global Hedge Fund Index</i></p>
Global Infrastructure						
Hedged Equity						
Arbitrage						
Strategic Income						

The above underweight/neutral/overweight calls represent the current positions relative to our Strategic Asset Allocation weights.

\*Cap Pres: Capital Preservation, IWSG: Income with some growth, Bal: Balanced, GWSI: Growth with some income.

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