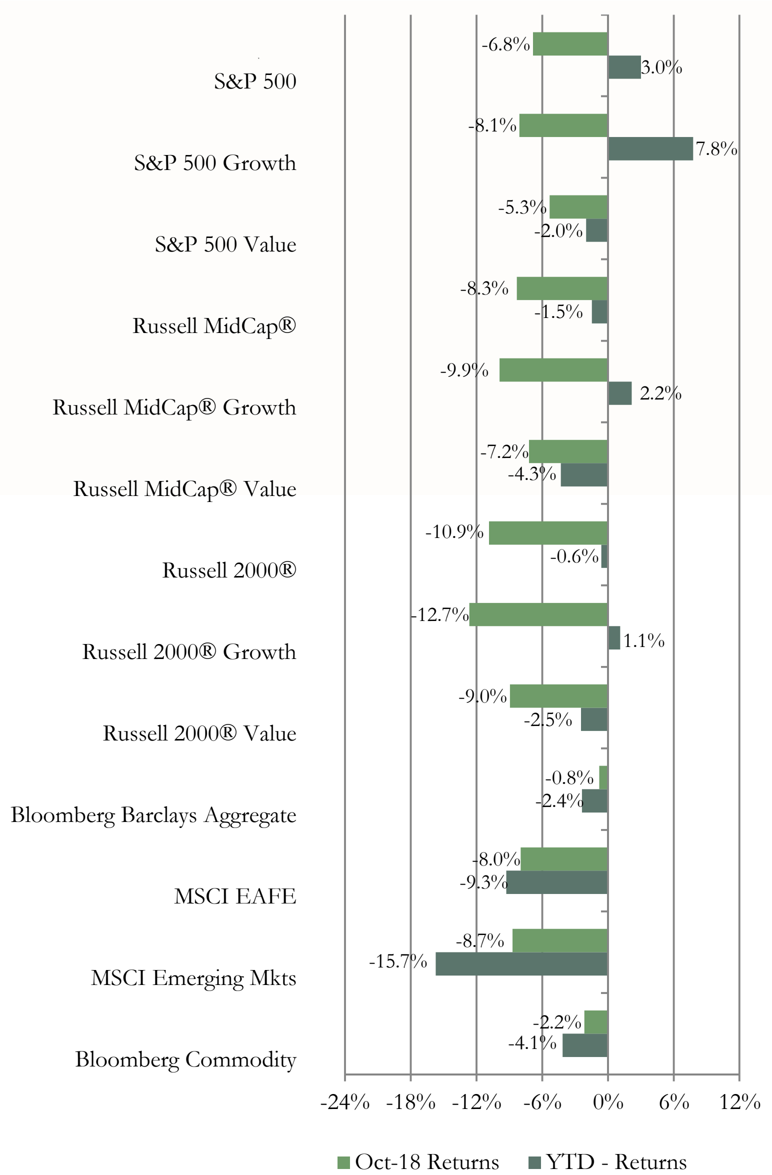
Monthly Market Summary – October 2018

October financial market results can best be described as the return of risk aversion. U.S. equity markets experienced a sharp sell-off. The S&P 500 index declined 6.8% and the mid and small-capitalization (cap) indices declined more. Headlines and pundits offered several explanations for the sell-off. The most common explanations included 1) concerns over slowing economic growth, 2) expectations for increasing pressure on corporate earnings from rising labor, materials, and transportation costs, 3) concerns about global trade, 4) a slowdown in China, 5) tightening financial conditions as interest rates rise, and 6) geopolitical issues. October is earnings reporting season which was also a major contributor to the market volatility. Third quarter earnings announcements were generally good. Earnings for the S&P 500 index are on pace to be up over 25% over the previous year and a majority of index companies reported revenue and earnings growth higher than analysts expected. However, in a change from previous quarters, earnings beats were not rewarded with higher share prices. Instead, market participants have focused on companies' comments about higher costs, the negative impact on sales from the strengthening dollar, and hints about the impact of trade tariffs as signs of slower future sales growth and increasing pressure on earnings.

Market Indices – October 2018



The equity market sell-off was a global event and equity market losses were widespread. The developed and emerging market equity indices we track declined more than the S&P 500 index. International equity market results reflected many of the same concerns as in U.S. markets. In addition, equity markets outside the U.S. also were pressured by factors such as concerns about Brexit negotiations and reports showing that some business activity measures, such as the manufacturing purchasing managers' index and industrial production have slowed noticeably.

The October sell-off was not limited to equity markets. Global bond prices declined and yields rose. During the month, the 10-year U.S. Treasury bond yield reached 3.26%, which was the highest yield since July 2011. The 2-year Treasury bond continued its march higher and ended the month just under 3%. Strong employment and wage growth reports along with the 3.5% gross domestic product growth reported for the third quarter gave support to the

Federal Reserves' plan to continue to gradually raise interest rates and pushed bond prices lower. Late month safe haven trading did limit the bond market decline. Most commodity markets declined as well, led by the sharp drop in crude oil prices. Gold, however, rose as investors shifted to safe haven assets as other markets sold off.

In the U.S. equity market, value stocks outperformed growth stocks across the market cap spectrum. In the risk-off climate during October, more defensive stocks, such as utilities and consumer staples, had the better returns. Energy was the worst performing sector in reaction to the sharp drop in the price of oil. Other economically sensitive sectors, such as industrials and materials were also very weak during the month on worries that economic growth and profits will be slowing going forward as financial conditions tighten, costs increase, and the impact of trade tariffs increase. Healthcare stocks were also weak in the mid and small-cap indices mostly due to steep declines in biotechnology stocks.

The MSCI EAFE index of developed international stocks had a return for the period of -8.0% and the MSCI Emerging Markets (EM) index had a return of -8.7% on a U.S. dollar basis. The currency impact was modest in October but had a negative impact for U.S. investors in foreign stocks since the U.S. dollar rose against most currencies. The local currency return was -6.5% for the EAFE index and -7.8% for the EM index. Just as in the U.S., value stocks outperformed growth in both the EAFE and EM indices. Each industry sector had a negative return for the period. Like in the U.S. equity market, more economically sensitive sectors had the weakest returns in foreign markets. Information technology was the worst performing sector on concerns about decreasing global demand. On a geographic basis, export-heavy economies had the worst returns in both developed and emerging markets. Results for certain countries stand out. For example, Brazil was a top performer for the month with a gain of almost 18% in a positive reaction to the results of the Presidential election. Mexico was one of the weakest performers declining about 17% largely in reaction to results of a referendum that will cancel plans for a $13 billion airport expansion project. Chinese equities continue to be weak performers as that economy slows and trade issues add to the uncertainty. The Chinese government has taken several actions aimed at stimulating the economy such as the recent move to cut the tax on auto sales in half.

U.S. bond market returns were mixed in October leading the Bloomberg Barclays U.S. Aggregate Bond index to post a return of -0.8%. Treasury bond yields rose, and prices declined, in reaction to strong economic news such as positive job and wage growth data. As mentioned above, the 10-year Treasury bond yield rose to 3.26% during the month but declined to 3.15% by month-end. As a reminder the 10-year Treasury bond yield was 3.01% at the end of September. Short maturity Treasury and credit bond indices were able to post small positive returns as the income received offset the price declines. All other sectors of the fixed income market posted negative returns. The high yield bond index had the lowest return hurt by weakness in oil prices and worries about increasing financing costs and slowing earnings.

The Bloomberg Commodity index had a return of -2.2% for October. The steep decline in the price of oil was the primary reason for the negative return since the energy sub-index had a return of -9.5%. The price of oil fell due to rising U.S. inventories, higher production by Saudi Arabia and Russia, and the strengthening U.S. dollar. The industrial metals sub-index also had a substantial decline on slowing demand worries. However, the precious metals sub-index had a gain due to the increase in the price of gold on safe haven trading. Agriculture prices were mixed during the month.

Vogel Consulting, LLC (Vogel) Tactical Recommendations

Our tactical allocation recommendations have not changed although we continue to monitor data closely. While we expect that the rate of economic and profit growth is likely to slow from recent multi-year high levels, economic conditions in the U.S. continue to be strong with employment, wage growth, manufacturing, and service sector indicators still solidly in expansionary territory. The strong dollar, increasing input costs due mostly to capacity constraints, gradually increasing interest rates due to Federal Reserve actions, and the impact of trade tariffs are headwinds. However, fundamentals do not appear to be weakening to the extent that would be consistent with a recession or bear market in the near-term. In addition, valuations have come down significantly. Low valuations are supportive of our emerging markets recommendation as well. In addition, government reforms, newly elected pro-business leaders, and stimulus actions are likely to support economic fundamentals in several emerging market countries.

Our tactical allocation recommendations include an equal weight to U.S. large-cap, mid-cap, and small-cap stocks and to developed international equities. We recommend an overweight to emerging markets equities. We continue to favor equities over bonds and retain our underweight recommendation for fixed income investments. Our underweight recommendation is because the return expectation for bonds is low since yields are likely to move higher (and prices lower) as the Federal Reserve continues to hike its policy rate. Within fixed income we continue to recommend a focus on short to intermediate term bonds. We also continue to favor non-Treasury bonds for the yield advantage they provide. We continue to favor hedge fund strategies over fixed income for the lower expected volatility portion of portfolios but also recommend an underweight allocation to hedge funds. Since our expectation is for a moderate rate of inflation, we recommend an equal weight to real assets. We continue to recommend an overweight to cash reserves that includes adequate cash to support spending needs over the coming 12-24 months.