



Market Recap

The divergence in global stock market performance we highlighted in the second quarter widened in the third quarter with US stocks gaining and emerging-market (EM) stocks falling. The US market was propelled by continued strong profit growth, thanks in large part to the Trump corporate tax cuts. S&P 500 operating earnings per share grew 27% year over year in the third quarter—compared to their 6% long-term annualized growth rate—and a record-high 80% of S&P 500 companies reported earnings that beat the consensus expectation. Record levels of share buybacks (estimated by some to reach \$1 trillion for 2018) were another support for the US market. Putting it all together, the S&P 500 index hit a new high in late September and gained 7.7% for the quarter (Vanguard 500 Index). Smaller-cap stocks gained 3.6% (iShares Russell 2000 ETF).

There are always multiple factors behind short-term market moves, but the intensifying trade conflict between the United States and China was an important one for foreign markets and EM stocks in particular in the third quarter. Another factor was the US dollar, which appreciated against other currencies during the quarter. This was a further drag on foreign stock market returns for dollar-based investors. For the quarter, EM stocks fell 1.7% (Vanguard FTSE Emerging Markets ETF). Developed international equities fared better, posting a slight gain of 1.2% (Vanguard FTSE Developed Markets ETF) while European stocks gained 0.6% (Vanguard FTSE Europe ETF).

In the fixed-income markets, the 10-year Treasury yield rose to 3.05% at the end of the third quarter, flirting with a seven-year high. As such, the core bond index had a negative 0.5% return in September and was flat for the quarter (Vanguard Total Bond Market Index). However, credit-sensitive segments performed well, with floating-rate loans gaining 1.8% for the quarter (S&P/LSTA Leveraged Loan Index). In addition, high yield bonds (which tend to be less interest rate sensitive) were higher 2.4% for the quarter. For the year, high yield bonds (ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index), to which we are tactically allocated, are up 2.5%, compared to a 1.7% loss for core bonds—a meaningful divergence that has benefited our portfolios.

At the end of September, the Federal Reserve raised the federal funds rate 25 basis points (0.25%) as expected to a range of 2% to 2.25%. The futures market is now discounting a fourth rate hike this year in December but doesn't (yet) fully reflect the Fed's own forecast of three more hikes next year.

September Benchmark Returns			
	MTD	QTD	YTD
EQUITY BENCHMARKS			
Vanguard 500 Index	0.6%	7.7%	10.4%
iShares Russell 1000 ETF	0.4%	7.4%	10.3%
iShares Russell 1000 Value ETF	0.2%	5.6%	3.7%
iShares Russell 1000 Growth ETF	0.6%	9.1%	16.8%
iShares Russell 2000 ETF	-2.3%	3.6%	11.5%
Vanguard REIT	-2.6%	0.5%	0.4%
FIXED-INCOME BENCHMARKS			
iShares MSCI ACWI ETF	0.6%	4.4%	4.2%
Vanguard FTSE Developed Markets ETF	0.7%	1.2%	-1.6%
Vanguard FTSE Europe ETF	0.1%	0.6%	-2.3%
Vanguard FTSE Emerging Markets ETF	-1.4%	-1.7%	-8.9%
FIXED-INCOME BENCHMARKS			
Vanguard Total Bond Market Index	-0.5%	0.0%	-1.7%
Vanguard Intermediate-Term Tax-Exempt	-0.6%	-0.2%	-0.5%
iShares TIPS Bond ETF	-1.0%	-0.9%	-0.9%
ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index	0.6%	2.4%	2.5%
S&P/LSTA Leveraged Loan Index	0.7%	1.8%	4.0%
ALTERNATIVE BENCHMARKS			
HFRX Global Hedge Fund Index	-0.7%	-0.4%	-1.2%
Bloomberg Commodity Index	1.9%	-2.0%	-2.0%
SG Trend Index	-1.0%	2.1%	-3.2%
3-Month LIBOR	0.2%	0.6%	1.5%



Quarterly Portfolio Performance and Positioning Recap

EQUITIES

All our globally diversified portfolios have meaningful *strategic* allocations to developed international stocks. Our portfolios also currently have a *tactical overweight* to European stocks and are underweight to US stocks. This positioning was beneficial in 2017, when foreign markets outperformed US markets. However, so far this year, it has been a drag on returns as US stocks have outperformed international markets. Considering this performance divergence, we include further details on our outlook and analysis for international and US stocks after this positioning recap.

FIXED-INCOME

Our balanced portfolios have a large allocation to an opportunistic, actively managed, fixed income portfolio consisting of individual high yield bond issues. In the third quarter, these assets contributed positively to portfolio returns and significantly outperformed the core investment-grade bond index. This is also true for the year-to-date period and the past several years. We continue to expect these positions to outperform over the next several years, particularly if interest rates continue to rise.

Reiterating our Outlook for US and International Stocks

A Full-Fledged Trade War is Unlikely

The prospect of an expanding trade war between the United States and China intensified in the third quarter and has caused investor sentiment to turn against international stocks all year. Uncertainties remain, but our base case continues to be that a full-fledged trade war is unlikely since it's in neither country's interest. It's also not clear that US stocks will be less impacted by a trade war than EM stocks given the former's global presence. At the least, we may be living in a world with an overhang of trade tensions for a while.

US Dollar Strength Is Likely to Reverse Longer Term

A strong US dollar, as we've seen lately, lowers international stock returns for US dollar-based investors and negatively impacts international markets with dollar-denominated debt. Longer term, we believe the fiscal stimulus of tax cuts at a time when the economy is at or near full employment may cause fiscal deficits and debt levels to rise. This could be a longer-term headwind for the US dollar and a positive for international stocks. Undervalued currencies are also a potential tailwind for international markets over the medium to longer term.

The Risk of Broad-Based EM Contagion is Low

Economic crises in Argentina and Turkey have made headlines. However, these economies and their financial markets are very small, and we see the risk of contagion to other more meaningful emerging markets as low. In contrast to the late 1990s emerging market crisis, most other emerging market countries' fundamentals are healthier: they have better current account balances, better debt coverage, lower dependence on foreign capital, floating rather than fixed exchange rates, and higher foreign exchange reserves. The rapid growth and high level of private sector debt in China is a potential source of concern. Though some potential for outperformance exists in emerging markets, we have very limited



direct exposure to companies located in emerging markets and prefer to remain invested in foreign developed markets due to better risk/reward tradeoff.

US STOCKS

Given the ongoing US bull market driven primarily by growth/momentum stocks, we thought it would be useful to revisit the rationale for our tactical underweight to the broader US market indices and why we focus instead on less expensive, undervalued stocks. Our portfolios' positioning is a function of our medium-term (five-plus-year) assessment of US market indices return potential, which we model across a range of scenarios and sub-scenarios we think have a reasonable likelihood of playing out.

Below, we review the key valuation and earnings growth assumptions that underlie our base-case expectation of *low single digit* returns from the US stock market *over the next five or so years* from current price levels. Incorporating bearish and bullish scenarios generates an expected return range of negative 9.4% to positive 8.0% annualized for the US market. To put these estimates in historical context, since 1950, the S&P 500 has generated an 11.1% average annual five-year (60-month) return, and the range of returns over rolling five-year periods has been negative 6.6% to positive 29.6%.

Our Valuation Assumptions

Before the 2008 financial crisis, our fundamental assumptions for key asset classes were dictated by post-1950s financial market history, with more emphasis on post-1980s data. However, when the housing bubble burst and the financial crisis hit, we believed the private sector—households and financial institutions—had reached their capacities to borrow and lend and that the US economy was likely facing either an acute or chronic period of deleveraging. This led us to study the US deleveraging cycle of the 1930s and, knowing history does not exactly repeat but often rhymes, we concluded this was not a normal business cycle/recession and that deleveraging would most likely lead to a subpar economic recovery relative to historical norms. The slow recovery would be a headwind for corporate earnings. Investor sentiment would be depressed and aversion to owning risky assets would be high. This would be reflected in lower valuation multiples for stocks.

As a result, in our base-case model for equity returns, we initially used a 15x price-to-earnings multiple on our estimate of normalized earnings. This was in line with the market's long-term historical average, but lower than the 18x to 20x multiples typically seen since the 1980s.

Given the economic unknowns at the time and the potential for further large market declines due to a full-blown debt-deleveraging cycle, we believed (and still believe) this was a prudent approach to balancing the potential risks and returns: neither assuming the world was coming to an end, nor that this was a typical cycle and everything would soon return to the "old normal."

In early 2014, observing the deleveraging process had progressed in a surprisingly benign fashion—due largely to unprecedented monetary stimulus in the form of QE—we raised our base-case scenario valuation multiple to 17x. We gave more weighting to the post-1980s history but factored in some unique risks and uncertainties looking forward; for example, we didn't (and still don't) know how disruptive the Fed's ultimate unwinding of QE will be on financial markets. This remains the valuation multiple we apply to our base-case normalized earnings estimate. For our optimistic scenario, we use the higher end of the post-1980s average of 20x. In our bearish scenario we use 16x, which is reasonably generous in our opinion.



Our Earnings Growth Assumptions

Our primary framework for S&P 500 earnings is based on estimating earnings growth relative to a long-term average earnings trendline growing at a constant rate of about 6%. We view this trendline as the normalized earnings power of the market—looking through the ups and downs of the business cycle. This 6% trend earnings growth is also consistent with long-term nominal US GDP growth.

Our base-case scenario assumes earnings will revert to the long-term trend over the next five years. To the extent companies are currently “overearning” relative to this trendline, our estimate of five-year forward earnings growth will be lower than the 6% annual trend growth.

Our analysis currently indicates that US companies are overearning by about 10% based on reported earnings as of June 30, 2018. Earnings are 16% above trend if analysts’ third quarter (through 9/30/18) earnings expectations are correct. (Actual third quarter earnings get reported in the fourth quarter.) Consequently, in our base case, we model US market earnings growth to be subpar over the next five years.

In our bear-case scenario, we derive earnings five years out by assuming S&P 500 profit margins revert to 6%, which is close to post-1980s averages. We assume S&P 500 sales grow at an annual rate of 4%, which is about the long-term average. In comparison, the S&P 500 profit margin is currently nearly 10% and year-over-year sales growth is 8.5%. Thus there is a large drop from current levels in the bearish scenario, even though we don’t believe our margin and growth assumptions are that pessimistic.

Finally, in our bull-case scenario, we assume earnings overshoot their normalized trend level by 20% five years out. This has happened periodically in market history. This outcome implies profit margins remain at historically high levels and US companies also achieve near historically high sales growth over the next five years. This scenario generates estimated market returns in the high single digits, still quite decent. This outcome is possible but unlikely in our view given how late we are in the cycle.

We are Getting Late in the Market Cycle, But the Timing of the Turn is Always Uncertain

No one knows exactly when this record-longest and second-strongest US bull market will end. However, that doesn’t stop lots of investors from fooling themselves into thinking they will see the signs before the rest of the market and be able to time their exit with minimal damage. It’s a nice fantasy, but that’s not the way markets work in the real world.

We don’t invest based on short-term market predictions or hunches. Our current underallocation to US stocks is based on our five-year tactical asset class analysis (described above) within the context of an even longer-term strategic allocation, consistent with each portfolio’s overall risk objective. However, below we discuss several reasons to think the shorter-term outcome for the US market may not be so rosy either.

As is often the case at turning points in financial markets, it is precisely *because* the recent cycle for US stocks has been so strong and market participants view the United States as the best game in town (or as economist David Rosenberg recently put it, “the smartest kid in the detention room”) that the outlook for the *next* phase of the cycle is darkening.

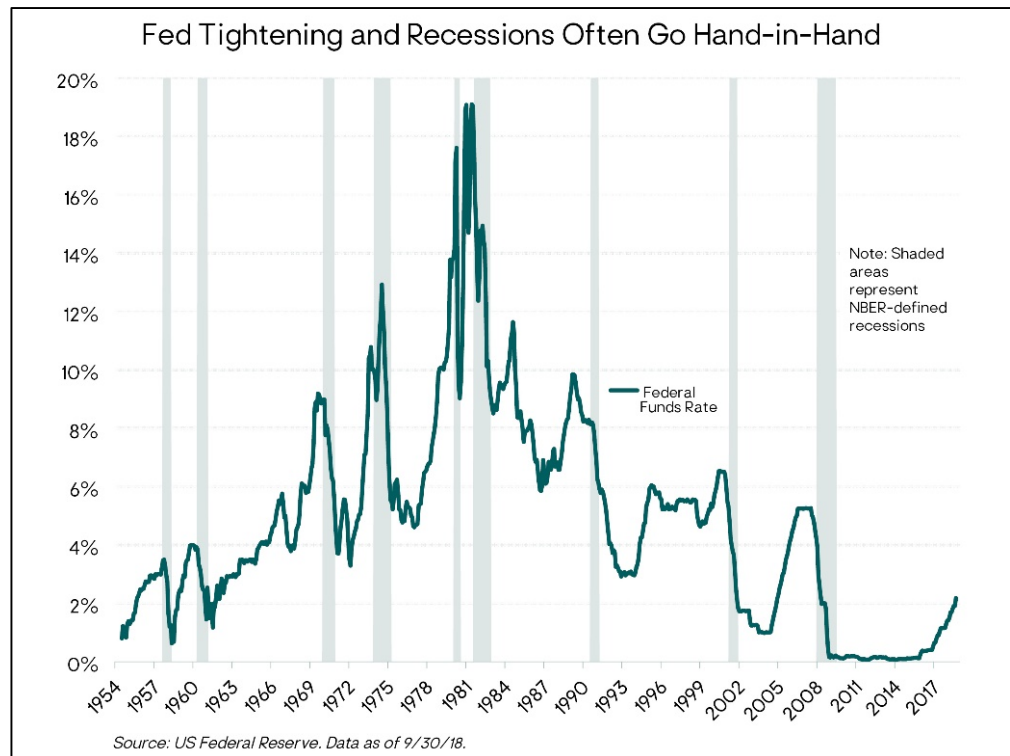


S&P 500 earnings growth expectations are now very high, and the US economy is operating at or near full capacity and full employment. These are likely unsustainable conditions, and the direction of their next material move is potentially negative for stocks.

The tight labor market has finally translated into wage increases. History and economic theory suggest wages will continue to rise. This could negatively impact corporate profit margins and earnings growth. It could also cause companies to raise prices, which would stoke further inflation and force the Fed to tighten even more. Generally, neither outcome is good for stock prices.

The recent rise in the dollar is likely to be another headwind for US multinational corporate profits, as it was in 2015 when the dollar rose. Trade wars, if they continue to escalate as they seem to be, will also have a depressing effect on sales growth and margins—both negative for earnings. The fiscal stimulus from the tax cuts has improved corporate earnings growth this year, but those benefits may fade next year (barring further cuts).

The tax cuts, along with tariffs and wage growth, may have inflationary implications. This in turn would suggest that the Fed will continue to raise interest rates. The Fed is projecting four more rate hikes through the end of 2019. Even some previously dove-ish Fed officials are indicating they are on board for continued hikes. In conjunction with the Fed's plan to unwind another \$600 billion in bonds from its balance sheet next year, the table is potentially being



set for more aggressive monetary policy tightening. This action could cause a recession should the Fed raise rates too quickly or be forced to do so due to rising inflation. If and when the next US recession occurs, it will certainly be accompanied by an equity bear market as it has under most historical periods. Of course, it is a fool's errand to guess when the next recession will occur and/or how long this strong economic cycle will continue. Our belief is that due to the tepid GDP growth of the economy over the past decade since the financial crisis, this cycle could continue for years to come.



Concluding Comments

By our way of thinking, being an “investor” is synonymous with having a *long time horizon*. In the financial markets, almost anything can happen in the short run because market prices are driven more by investor sentiment, unpredictable events, and human herd behavior. However, as you extend your investment horizon, market returns are determined by economic and business fundamentals (earnings and dividends) and valuations (what you pay for those earnings and dividends).

No matter how we slice it, our analysis suggests the overall US market (which has been driven by overvalued growth stocks), on a relative and absolute basis, is the most expensive major stock market in the world and, as a result, presents a poor risk-versus-return tradeoff. As such, we continue to focus on undervalued issues which also offer above average dividend yields to better enable us to weather inevitable market turbulence and recessions.

Further, based on our normalized-earnings framework mentioned above, we believe international stocks are currently and significantly cheap relative to their US counterparts. International equity valuations are attractive, and their medium- to longer-term growth outlook remains intact. Of course, these positions come with additional shorter-term risk. Poor investor sentiment and capital outflows could potentially trigger an adverse feedback loop between international stocks and economic fundamentals. However, this has always been a risk with international stocks, and we take it into account in our portfolio construction and risk management. China debt-deleveraging, trade wars, and a resulting growth slowdown are additional nearer-term risks.

Regardless, we are longer-term investors. While balancing the short-term risks, we are currently assessing whether the recent downturn in foreign stocks and divergence with the United States offers an attractive opportunity to increase our allocation to them. As always, we continue to analyze new data and information, and if our analysis warrants a change in our views, we will.

In terms of our other portfolio exposures, our high yield bonds continue to add value. We like their prospects looking forward, particularly in an environment of rising rates. We remain unconstrained in our approach and have the flexibility to invest in less efficient fixed-income sectors where we can still find some relatively attractive investments without taking undue risk. We also remain flexible in response to what the markets are offering in terms of yield and total-return potential and are remaining short-term in our duration to help potentially offset interest rate risk.

As always, we thank you for your continued confidence and trust.



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