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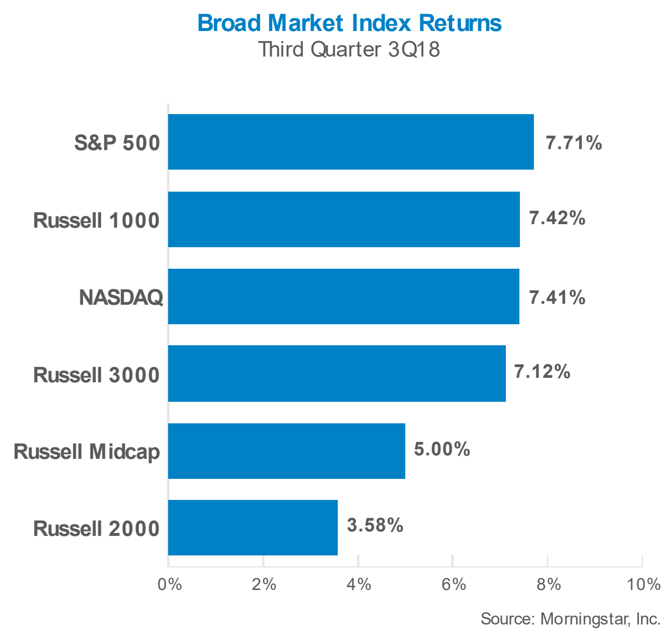
There were no market summer doldrums this year as the US stock market was largely up nicely for the quarter. In the domestic market, large caps outperformed smaller companies. International stocks were mixed with emerging markets continuing to be the worst performers. Total returns on bonds were also mixed as bonds continued to struggle with rising interest rates.

## The Economy




The US economy, buoyed by the effects of pro-growth fiscal policies, accelerated sharply in the second quarter. The expansion is currently 111 months old, the second-longest in history, and will become the longest if the economy continues to grow through July 2019. The Bureau of Economic Analysis reported its third estimate of second quarter 2018 gross domestic product (GDP) of 4.2%, in line with the prior estimate, and much higher than the first quarter's 2.2% reading. The employment situation continued to post gains, with an average of approximately 185,000 jobs added each month. At the same time, the unemployment rate remained steady at 3.9%. The Federal Open Market Committee (FOMC) modified its interest rate policy by raising the federal funds rate target 0.25% to a range of 2.00% to 2.25%. Economists expect at least one additional increase in 2018, as economic growth remains robust, and inflation and wage pressures increase.

The global economic environment has been strong in many areas of the developed world, but continues to be volatile in the emerging economies. In addition, many economists believe that the global economy may be nearing a peak. The eurozone economy has stabilized at an annualized growth rate of about 2%. Strong capital investment and consumer spending supported growth in the region during the quarter, and continued to be aided by aggressive monetary policy. Japan also gained ground, with GDP expanding due to solid capital expenditures. China's growth has continued to slow, generating 6.7% annualized GDP growth in the most recent report, the most sluggish pace since 2016. A deceleration in investment growth and industrial

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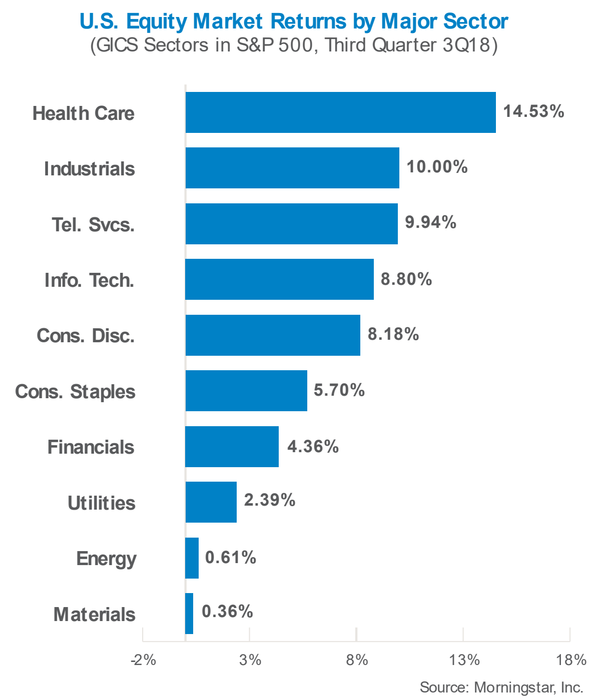
output, as well as uncertainty caused by trade friction with the US, were the primary reasons for the slowdown.

# Highlights

## GROSS DOMESTIC PRODUCT (GDP)

The Bureau of Economic Analysis released the third estimate of the second quarter 2018 real GDP, a seasonally adjusted annualized rate of 4.2%, up significantly from the first quarter's 2.2% annualized growth, and in line with the 4.2% prior estimate. The consensus among economists is that the economy is at its strongest since the expansion began in 2009. Large tax cuts and an increase in government spending have fueled the recent acceleration. Some analysts believe that the economy could post a 3% growth rate for the full year, a pace that is close to, or exceeding, its estimated potential. Consumer confidence is surging, and is at its highest level since prior to the bursting of the tech bubble in 2000. The current expansion is the second-longest in history, and will claim the top spot if growth remains positive through July 2019. The economy has not yet been adversely affected by the imposition of tariffs, but should the amount of tariffs increase materially, the drag on growth should rise. Inflation remained relatively benign in the quarter, with the personal consumption expenditures (PCE) index of prices rising 2.0%, following a 2.5% advance in the prior quarter. Corporate profits rose by 3.0% (not annualized) during the quarter. Economists believe that with the significant amounts of stimulus that have been implemented, the economy will have a difficult time being tripped up for the foreseeable future. However, the impact of trade skirmishes will be worth monitoring.



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## HOUSING

The housing segment has leveled off in recent months, as an increase in mortgage rates and reduced tax deductibility of home ownership have kept a lid on demand and price increases. Existing home sales for August (the latest monthly data available) grew at an annualized rate of 5.3 million units, in line with the results from July, and down about 1.5% from year-ago levels. The inventory of existing homes was slightly more than four months of supply, up somewhat from the prior year. Existing home prices in August have increased 4.9% from August 2017. In the new-home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at 67, the same as the previous month, but still at high levels. Homebuilders' confidence should continue to remain strong, as wage increases translate into heightened demand over the coming quarters.

## EMPLOYMENT

The employment situation remained strong in August. Employers added 201,000 jobs during the month, beating the consensus expectations of 190,000 new jobs, and outpacing the prior month's gain of 147,000. Despite August's solid results, the three-month moving average slipped due to July's softer gains, coming in at 185,000. The unemployment rate in August remained level at 3.9%, near its lowest level in 18 years. Average hourly earnings increased by a greater-than-expected 2.9% in the month, the strongest report in this cycle.

## FED POLICY

The FOMC ended its recent September meeting by announcing an increase of 0.25% in the federal funds rate target range from 1.75%-2.00% to 2.00%-2.25%. The rate increase was widely expected, and was the eighth time since 2015 that the committee has raised rates. The committee removed the "stance of monetary policy remains accommodative" language from the statement accompanying the increase. Economists believe that the FOMC will continue to raise rates to mitigate inflationary pressures and to bring the federal funds rate in line with that warranted by economic growth.

## Interest Rates

The factors affecting fixed income securities' prices and yields remained largely the same as in previous quarters. The surging economy, the FOMC's decision to raise short-term interest rates once again at its

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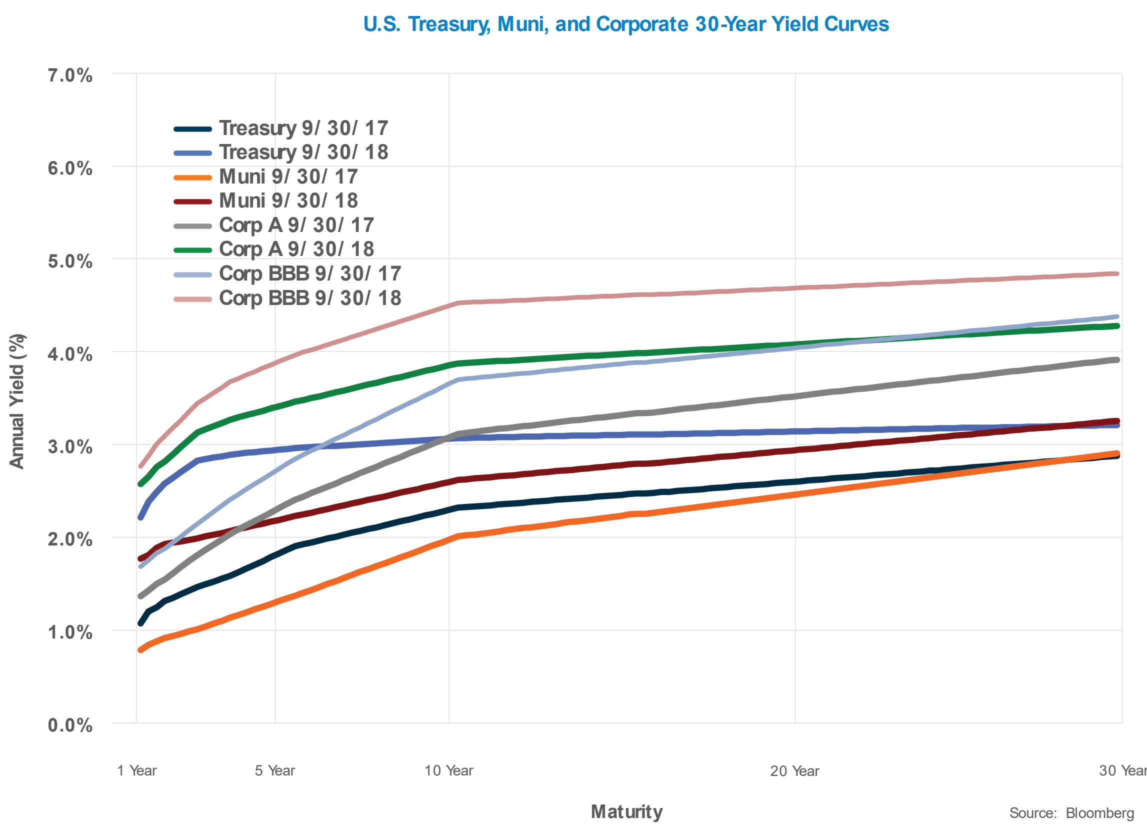
recent September meeting, and the escalating rhetoric with trading partners such as China and Canada were among the most important drivers. The employment situation has been very strong, increasing wage pressures and leading the FOMC to raise rates in an attempt to mitigate the resulting inflation. Interest rates have become more tied to the performance of the economy, which is accelerating due to the tax cuts and increases in government spending. Many analysts expect the FOMC to raise short-term rates at least once more in 2018.




In addition to rising, the shape of the Treasury yield curve flattened modestly during the quarter, with yields on short- to intermediate-term maturities climbing more than those for long-term issues. The yield on the benchmark 10-year US Treasury Note was higher, ending the quarter at 3.06%, compared with 2.86% on June 30.

As mentioned above, interest rates in the quarter continued to be driven by an improving economy, both domestically and in other developed markets throughout the world. The economy seems to have adjusted well to the FOMC's regime of raising interest rates in a measured way. Fixed income markets also have

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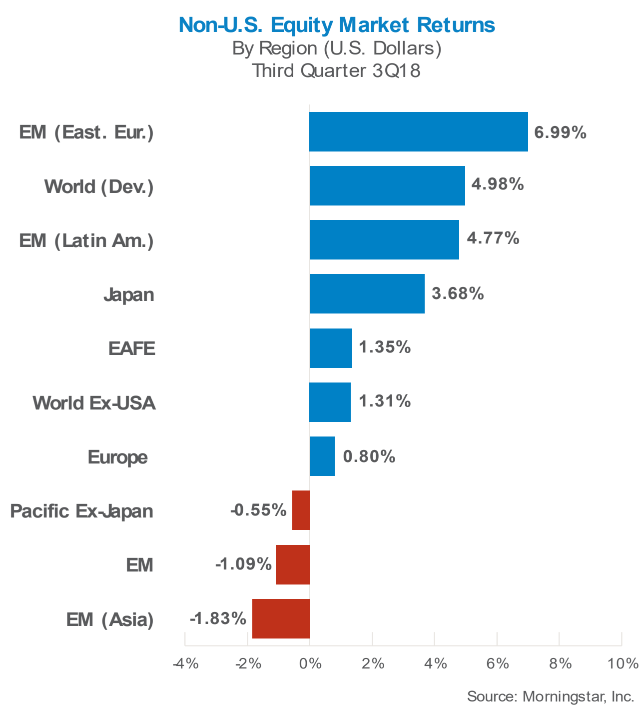
been able thus far to digest both the imposition of tariffs and the accompanying trade skirmishes with China and, more recently, Canada. Yields meandered during the first half of the quarter, and then rose steadily for the remaining several weeks.

Total returns on fixed income securities were mixed across the various market segments. The Bloomberg Barclays Treasury 5-7 Yr. Index edged lower by 0.4% for the quarter. The Bloomberg Barclays U.S. Corporate 5-10 Yr. Index rose by 0.9% during the three months. High yield securities, which often follow the performance of equities, delivered a positive return of 2.4%. Municipals were somewhat lower, as the Bloomberg Barclays Municipal Bond Index eased lower by 0.2% during the quarter. Prices of non-US fixed income securities also were lower in the quarter, as the Bloomberg Barclays Global Aggregate ex-U.S. Index declined 1.7%. Emerging markets bonds rebounded somewhat, with the JPM EMBI Global Index advancing by 1.9%.

## Equity Markets

Equity markets delivered strong gains during the quarter, bucking the negative seasonal trends of August and September. Stock prices thus far have shrugged off the ongoing trade disputes and higher interest rates. The focus has been primarily on the surging economy and the benefits of the tax cuts and increase in government spending. Consumer confidence remains elevated, and near the highest levels since prior to the bursting of the tech bubble in 2000. Against this backdrop, the S&P 500 Index finished the quarter with a solid gain of 7.7%.




The ten primary economic sectors produced performance results that on balance were very strong during the quarter. Health Care, Industrials, and Telecommunications Services were the strongest performers on a relative basis, generating returns of 14.5%, 10.0%, and 9.9%, respectively.

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The Materials, Energy, and Utilities sectors were the poorest relative performers, posting returns of 0.4%, 0.6%, and 2.4%, respectively.

The Russell 1000 Index of large capitalization stocks generated a 7.4% total return. Within the large cap segment, growth stocks once again outperformed value stocks. Small cap stocks, as represented by the Russell 2000 Index, materially underperformed large caps, and finished the quarter with a total return of 3.6%. Small cap value underperformed small cap growth. The NASDAQ Composite, dominated by information technology stocks, finished the quarter with a gain of 7.4%. The Dow Jones Industrial Average of 30 large industrial companies climbed 9.6%.

Real Estate Investment Trusts (REITs) generated modest gains during the quarter, with the DJ US Select REIT Index inching higher by 0.7%. Commodities were lower, with the Bloomberg Commodity Index declining 2.0% for the quarter.

International stocks generally posted mixed results relative to US equities. Economic growth has been modest throughout the developed world, but emerging economies have struggled in the face of rising US interest rates. The MSCI ACWI Ex-USA Index, which measures performance of world markets outside the US, gained a modest 0.7%. The MSCI EAFE Index of developed markets stocks advanced by 1.4%. Regional performance was mixed for the quarter. Eastern Europe was the strongest performer on a relative basis, with a return of 7.0%. China was the poorest performer, falling 7.5%. Emerging markets performance was again negative, as the MSCI Emerging Markets Index dropped 1.1%.

## Looking Forward

The US economy has experienced a late-cycle acceleration, and if growth remains positive through July 2019, it will become the longest expansion in history. Aggressive fiscal stimulus in the form of deficit-financed tax cuts and increased government spending are the primary drivers fueling the growth, and their effects are likely to result in solid growth for the next few quarters. Although the current economic conditions have created favorable conditions for earnings gains and driven stock prices to record highs, it also is worthwhile to consider potential risks. One such risk is an overheating economy that produces increased wage pressure and inflation. Inflation currently remains fairly well contained at about the 2% level, but with the economy at or near full employment, it will be more difficult to restrain prices if growth continues to accelerate. The trade war also poses risks. The financial markets have so far done an excellent

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job of digesting the heated rhetoric on all sides of the trade debate; however, if the size of tariffs ratchets higher, investors could expect volatility to ensue.

This bull market is now the longest on record. The economy continues to do well, and unemployment is low. However, as odd as it may seem, it is in this context that we feel it is important to talk about the next bear market.

While we have no idea when the next bear market will occur or how severe it will be, we do know that eventually it will happen. Because of the length of time since the last one, it is easy to get complacent and forget what it can be like and how far stocks can fall. To put things in perspective, in the 2000-2002 bear market stocks on average were down nearly 50% and in the 2007 -2009 bear market they were down over 50%.

A recent online article on MSN Money Watch by Mark Hulbert discusses the importance of limiting losses in a bear market. In discussing a new book by investigative journalist Brian Livingston, Hulbert states "Livingston's insight is that beating the S&P 500 during bear markets is far more important that during bull markets for two reasons. The first is mathematical: Big losses required even bigger gains to recover, and at some point the required gains become so large as to become improbable. So if you lag during bear markets you have to beat the S&P 500 by a lot during bull markets to come out ahead over the long term."

For example – if you have a $1 million portfolio and you lose 50% in a bear market, you will need to gain 100% just to get back to where you were before the bear market. However, if you "only" lose 25%, you "only" need to gain ~34%. This is one of the main reasons we feel it is important to focus on protecting on the downside vs. chasing returns in a bull market.

We want to provide the link to Hulbert's article as we feel it is well worth reading. (https://www.msn.com/en-us/money/markets/opinion-stock-investors-can-no-longer-ignore-the-next-bear-market/ar-BBNMm8V?li=BBnbfcN.

In an environment where the S&P 500 continues to hit new highs and bonds are struggling with rising interest rates, we totally acknowledge that a diversified portfolio can be frustrating. Yet, it is important to keep in mind that we will hit another bear market at some point and there are assets in our client portfolios that are in there to help dampen on the downside in a bear market. This does not mean those assets or mutual funds won't decline in value, but we anticipate that the downside potential is less than that of the overall stock market. When the S&P 500 is going gangbusters, our diversified client portfolios have no chance of

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keeping pace, but we also anticipate that when the S&P 500 hits the next bear market, diversified portfolios will hold up better than the S&P 500.

When the next bear market hits, it is important to be able to ride it out, both financially and emotionally. The best time to get ready for the next bear market is before it happens and not when we are in the throes of it. Therefore, if you have any cash needs upcoming in the next two years that we are not aware of or if you feel your asset allocation is no longer appropriate for your situation, please contact us so any appropriate adjustments to your portfolio can be made.