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MARKET SUMMARY

Equities

S&P 500	2,914
Price / Earnings	21.0x
Dividend Yield	1.9%
MSCI AC World	524.25
Price / Earnings	17.8x
Dividend Yield	2.4%

US Treasury

2 Year Yield	2.8%
10 Year Yield	3.1%
30 Year Yield	3.2%

US Corporate Spreads

Investment Grade	1.0%
High Yield	3.7%

Equity Volatility

CBOE Market Volatility	12.1

US Economic Figures

GDP Growth 2Q18	4.2%
Unemployment	3.7%
Inflation	2.2%
Fed Funds Rate	2.25%
3 Month LIBOR	2.4%

Commodities

Oil (Brent)	$82.72
Natural Gas	$3.01
Copper ($/lb.)	$2.81
Gold ($/oz.)	$1,191

Foreign Exchange

Euro	$/€	1.16
Japanese Yen	¥/$	114
Chinese Yuan	元/$	6.88

Market summary data as of:
September 30, 2018

Taking the Punch Bowl

Investors through the ages have contended with constant change and inevitable decisions made with partial information and uncertainty regarding the future. To cope, investors have accumulated various rules in the form of common sense sayings – some backed by fact and some less so – such as “sell in May and go away”, “don’t catch a falling knife”, and “don’t fight the Fed.”

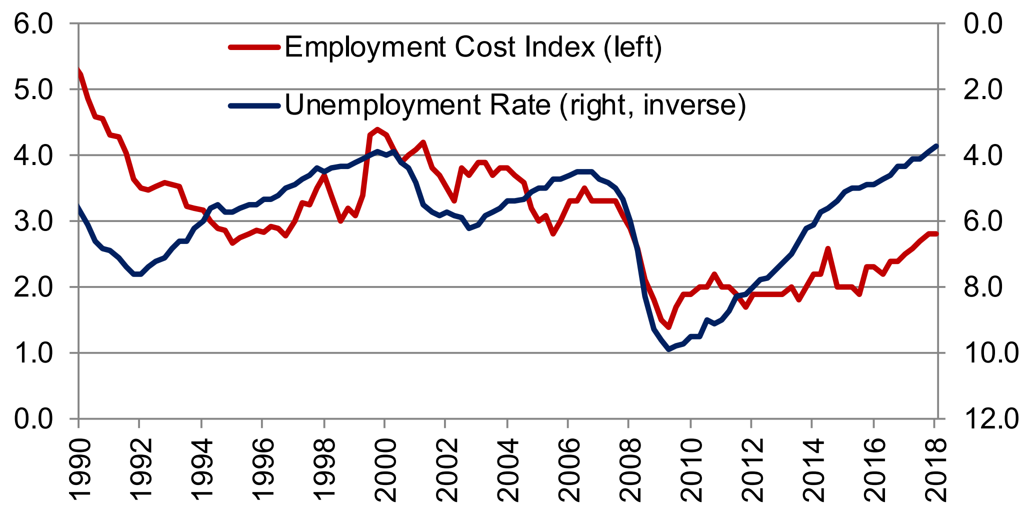
The last nugget of wisdom speaks toward the effect that central bank policy has on the economy and capital markets. In the last ten years, that effect has been outsized. The unconventional and accommodative policies that helped calm the financial crisis and drove upward the price of financial assets in subsequent years are normalizing.

The size of the Fed’s balance sheet is tapering at a modest pace, and short-term interest rates are 2% higher than when rates began to rise in 2015. Expansion of the European Central Bank’s balance sheet is scheduled to end in December, with an initial rate increase possible in late 2019.

As we approach the three-year anniversary of the Fed’s first post-crisis increase in the short-term policy rate, we believe investors will soon need to assess whether they are "fighting the Fed" rather than the recent convenient reality of "co-investing with the Fed" and other loose policy central banks.

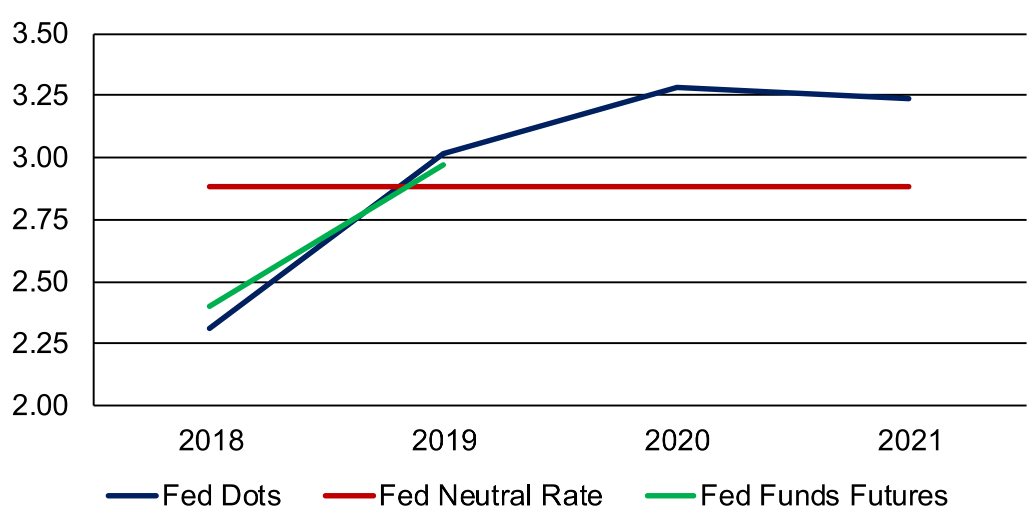
Current economic conditions warrant tighter policy, and we expect upward pressure on inflation to drive further rate increases. Unemployment has reached 3.7%, a multi-decade low and well below average unemployment of 5.9% over the last 30 years. As seen in Exhibit 1, data from the Bureau of Labor Statistics show low unemployment is historically correlated with higher inflation.

Exhibit 1: Tight Labor Market May Push Inflation Higher



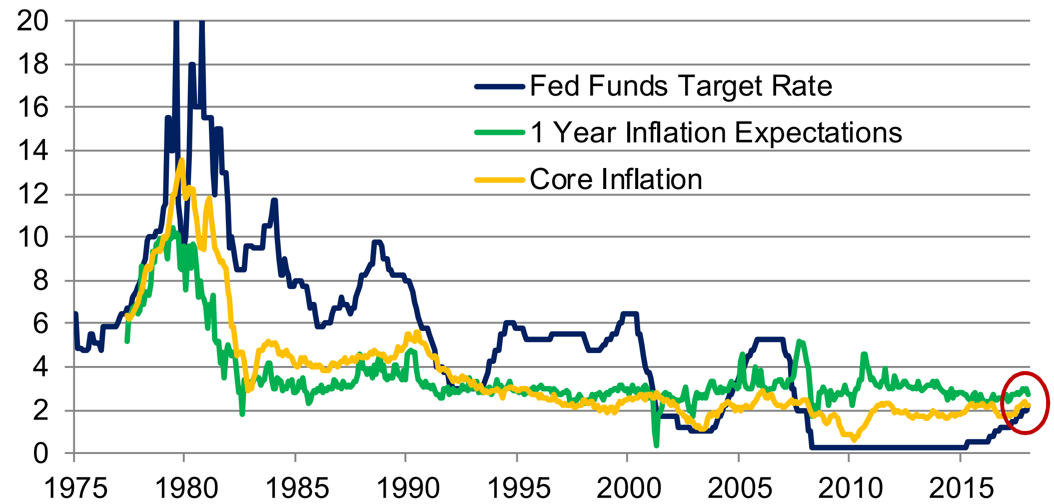
As such, as seen in Exhibit 2, higher rates are forecasted by both the Federal Reserve governors, who publish a consolidated picture of their individual rate expectations, and traders in the fed funds futures market. An additional rate hike is expected in December with three in 2019 and one more in 2020 that would take the policy rate above the Fed's estimated neutral stance.

Exhbit 2: Fed & Market Forecasts for Short-Term Interest Rates



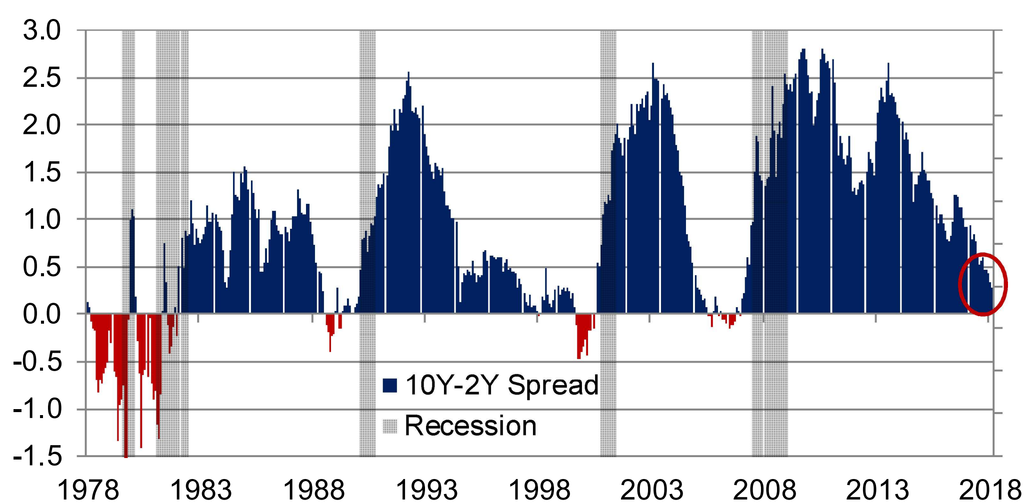
So are investors fighting the Fed at this point? We think no, but it's likely to be the case sometime in 2019. Current policy is still loose, and we have a few more hikes to go before rates can be considered tight. Meanwhile, rates futures markets in Europe and Japan suggest negative interest rates from their central banks will remain in place through 2019. As illustrated in Exhibit 3, higher rates in the US over the last three years have merely eliminated a decade-long negative spread versus inflation compared with a historically normal positive spread: a move from super duper accommodative to merely accommodative.

Exhibit 3: Short-Term Interest Rates versus Inflation



Therefore, we see a policy rate of 3% or higher as a zone where investors *may* be fighting the Fed who will, at that point, have rates higher than their estimate of neutral and the rate of inflation. An inversion of the yield curve – when short-term rates exceed long-term rates – would be more ominous and definitively indicate that investors *are* fighting the Fed. As seen in Exhibit 4, inverted yield curves have a historically strong record of preceding economic downturns and cyclical bear markets in stocks and credit spreads.

Exhibit 4: Slope of the Yield Curve – Not (Yet) Negative



Outlook & Strategy

In our last quarterly letter, we highlighted a positive environment for economic growth and earnings and the potential risks from changes in trade policy and signs of stress in credit markets. The intervening period has presented data that confirms the growth trajectory (see Charts 3, 7, 9, and 10 in the letter's last page). Trade policy has provided little economic disruption and some progress toward reciprocity in terms. The recently established USMCA, the new trade agreement among the US, Mexico, and Canada that replaces NAFTA, should not be growth limiting. Credit conditions, meanwhile, have improved. The brunt of the fund flows associated with repatriation of foreign profits hitherto held in corporate bonds has largely passed, and credit spreads have contracted in recent months.

While the overall investment backdrop remains positive, it isn't without risk, especially when viewed through the lens of valuation. Speculative stocks with high expectations and low earnings relative to high valuations have become a large portion of the overall market. Meanwhile, the US stock market seems to reflect a much rosier outlook regarding growth and trade than the rest of the world – an unusual dichotomy that we think will moderate.

We believe our preference for reasonably-valued, globally-diversified stocks and well-vetted corporate credit fits well with an outlook for continued late-cycle global growth and the market environment where value is not particularly easy to find.

Market volatility early in the current quarter that accompanied higher rates and comments from Fed Chairman Jay Powell that current rates are "a far way from neutral" and from European Central Bank President Mario Draghi citing a "relatively vigorous" pickup in inflation suggests risk management remains important as rates rise. Fed Chairman William McChesney Martin said in 1955 that raising interest rates puts the central bank "in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up." We expect the proverbial punch to run less plentifully in coming quarters and will endeavor to manage well the risk in client portfolios.

We appreciate your trust in our management of your capital and would welcome further discussion of our outlook and the strategy reflected in your portfolio. Please contact us with any questions. We welcome your call or email.

With best regards,

Jeff　　　Greg　　　Steve

Jeffrey E. Bernardo, CFA　　Gregory M. Estes, CFA　　Steven M. Herbert, CFA

Neil　　　Fred

Neil J. Sullivan, CFA　　Frederick M. Blum

Austen　　　Milena　　　Franco

Austen P. Cornell, CFA　　Milena D. Spasova, CFA CIPM　　Franco Cirelli, CPA CFP®

Chart 1: S&P 500 Index

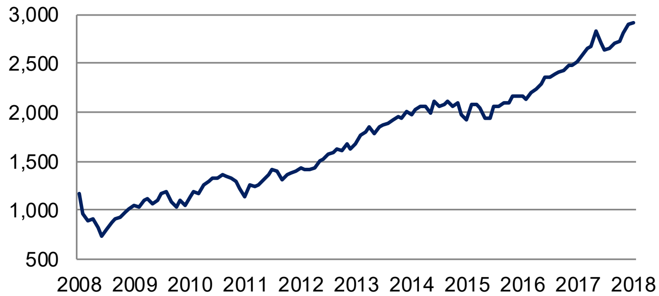


Chart 2: US Treasury 10 Year Yield %

Chart 3: US Annualized GDP Growth %

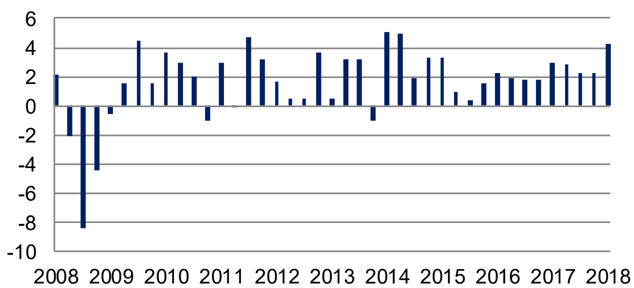


Chart 4: US Core Consumer Price Index %

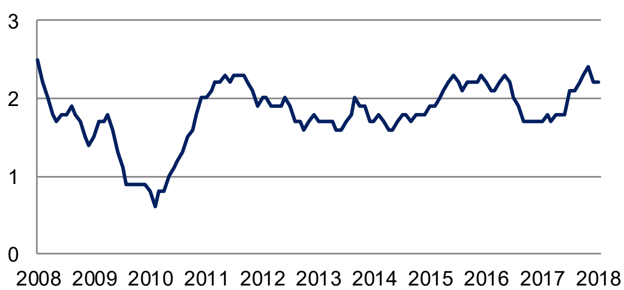


Chart 5: Trade-Weighted US Dollar Index

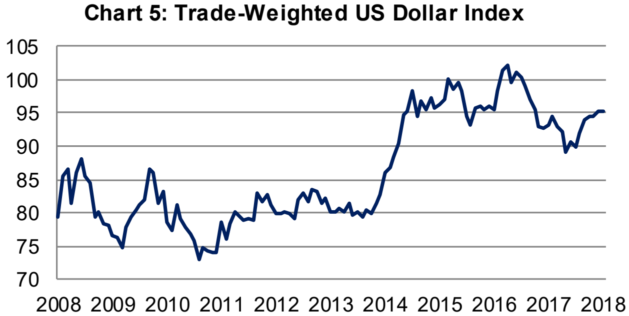


Chart 6: US Unemployment Rate %

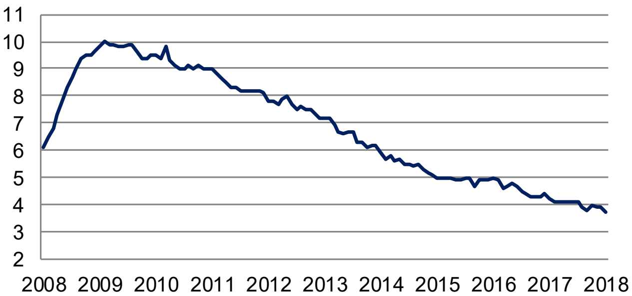


Chart 7: US Consumer Confidence Index

Chart 8: US Retail Sales Growth %

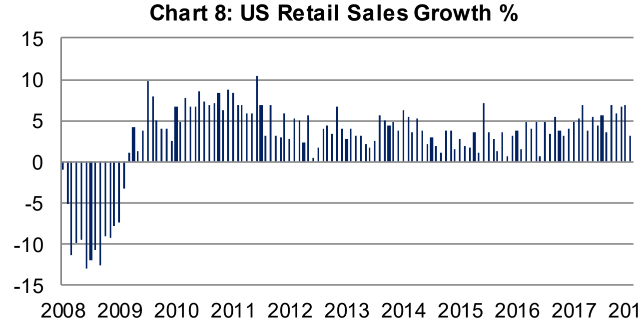


Chart 9: US ISM Manufacturing Index

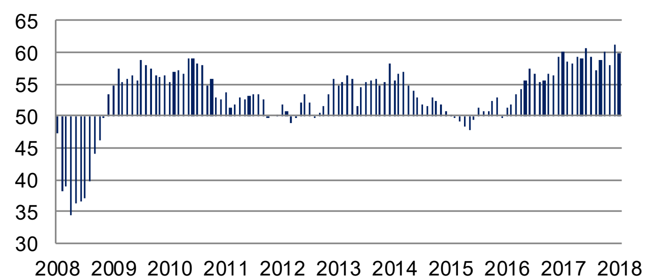


Chart 10: Conference Board Leading Index