Monthly Market Commentary

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ReDefine
Wealth Management

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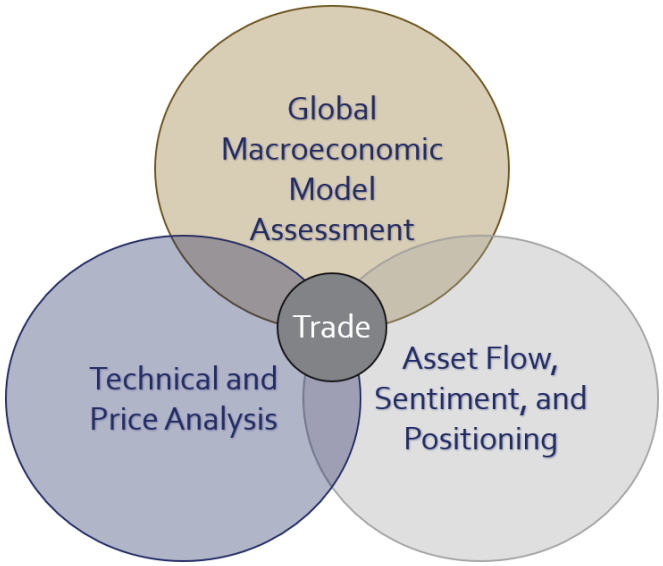
October 3, 2018: *ReDefine Wealth Management* provides clients and business partners with a differentiated suite of services and products. This monthly commentary encapsulates how our team is looking at the world and the practical implications of our approach. It is designed to illuminate the process behind the implementation of investment decisions within ReDefine Wealth Management portfolios.

ReDefine Investing *with Global Thematic Portfolio Management*



Anecdotal and historical evidence suggest that mitigating portfolio draw-down has the greatest impact on portfolio success.

Quite simply, it is more efficient to grow wealth by not losing wealth.

In order to facilitate portfolio success, ReDefine Wealth Management employs a Global Thematic approach to our investment portfolios. Meaning that our *Global Macroeconomic Analysis* provides the basis for attractive reward versus risk within global investment opportunities.

The findings of our macro analysis help to narrow down the field of potential investments and, coupled with our asset flow and sentiment analysis, works to inform our *Strategic Asset Allocation.*

Wherein we divide assets between the best opportunities that we can source within three primary portfolio components – *Global Equities, Fixed Income/Cash, and Real Assets.*

Then we work to further divide the primary components into sub-components, for example Global Equities may be divided between disparate geographies and various capitalization sizes.

Once the general allocation is decided, we begin our *Tactical Investment Selection* to specifically choose the financial instruments we will use to implement our globally thematic strategic asset allocation. During this phase we employ our technical and price analysis to pinpoint our investments. It is important to note that our tactical investments are also directional – i.e. long and short.

Our disciplined processes allow us to handpick and tactically manage highly-liquid financial instruments, such as: *ETFs, Mutual Funds, Stocks, Bonds, CEFs, and Options.*

So, while we may hold similar "investments" as traditional portfolios, it is our approach and flexibility that allows for asymmetric returns relative to risk.

Fundamental Global Macroeconomic Backdrop

While the US Federal Reserve (Fed) has followed through with plans to end Quantitative Easing (QE), begin raising interest rates, and then begin Quantitative Tightening (QT), the European Central Bank (ECB) has merely laid out plans to do the same, but has taken little action - thus far.

For its part, the Fed's actions in 2018 have been aligned with the consensus market predictions and we do not see that correlation changing in the near future. *As we expected – and wrote about - the US Federal Reserve raised interest rates by 0.25% in September.* And as we enter the much anticipated fourth quarter of 2018, we expect one more rate hike – most likely in December - to finish out the year.

The Fed's preferred measure of inflation, Core PCE – which is intended to be the average rate of inflation - has met the Fed's goal rate of 2.0% in the past two months (Exhibit 1). Core PCE paired with comments from various Fed Governors lead us to expect the Fed to allow Core PCE to continue to rise above the target 2.0% rate.

Fortunately, the recent Fed action has been in line with several of our 2018 Global Investment Themes, most notably "Interest Rates will Rise" and "Bond Prices will Stair-step Lower". However, a key point moving forward is what, if any, actions will be taken by the ECB. We do expect QE to slow in Europe later this year and continue into next, although timing is going to prove an extremely important variable.

The Federal Reserve is expected to have another $50bn worth of bonds roll off its balance sheet this month. If this were to happen at the same time as the ECB winds down its own QE, *there is the potentiality of a liquidity "vacuum" that may be difficult for the markets to digest cleanly.*

We believe it's appropriate to bring to your attention the chart on the following page – again (Exhibit 2). The chart illustrates what could happen if the relationship between the Fed's balance sheet and the overall US Equity markets were to be reestablished.

Spoiler alert: it could mean a sizable US equity market correction within the next few months.

This potential scenario is a great reminder as to why it's important to stay nimble and ever vigilant. Let's walk through our views on the three major strategic allocation components: Global Equities, Global Bonds & Cash, and Real Assets.

*As a reminder, our four major **Global Investment Themes** and general market assumptions at the beginning of 2018 were:*

Stock Prices Will Stair-step Higher While Bond Prices Stair-step Lower

Global Inflation and US Interest Rates Will Rise

US Dollar Will Strengthen and Global Political Unrest Will Increase

Global Market Volatility Will Rise

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Fundamental Global Macroeconomic Backdrop (cont.)

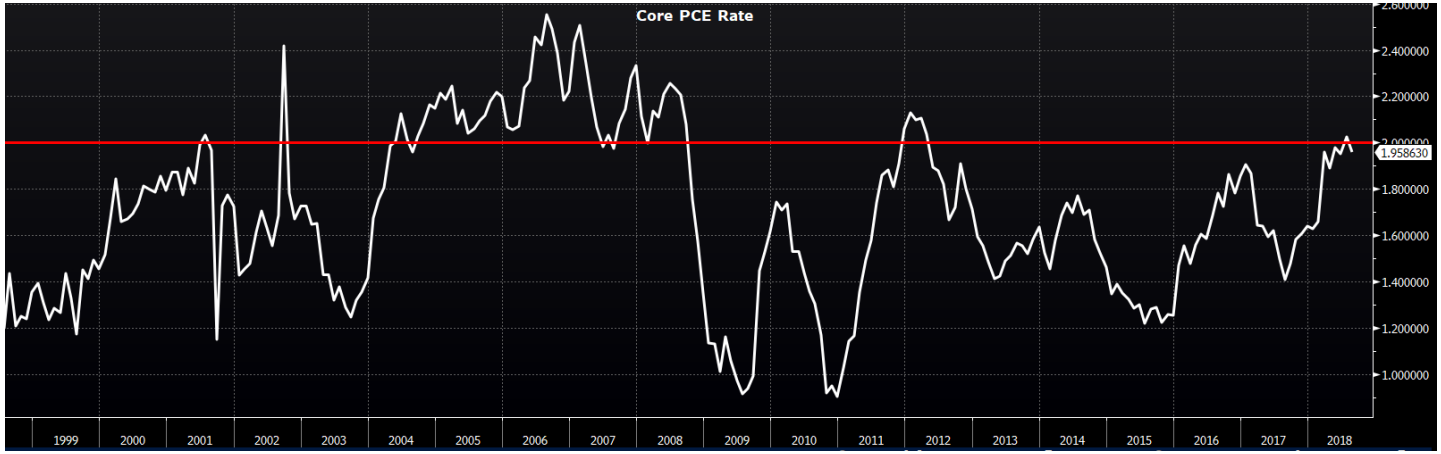


Exhibit 1 *Source: Bloomberg*

Exhibit 2 *Source: MI2 Partners, Bloomberg*

Global Equities

As mentioned in preceding editions of this commentary, *we continue to believe that US Equity Markets provide the best risk/return opportunities within the Global Equity continuum.*

Domestic equity markets continue to grind higher, albeit with a few fits along the way. In retrospect, while the Nasdaq has been strong for nearly the entire year, it took the S&P 500 until August to surmount its previous highs from January. The Dow Jones Industrial Average followed suit as the index finally broke through to new highs in September.

The price action of these indices suggests that "value"-oriented names could strengthen and begin to close the gap with the "growth"-oriented names. However, the chart on the next page (Exhibit 3) shows that the spread between growth and value continues to widen, represented by the declining yellow line. Contrarily, small and mid-cap equities entered a bit of a corrective phase over the last couple weeks - which would suggest that the large-cap growth names are driving current out-performance.

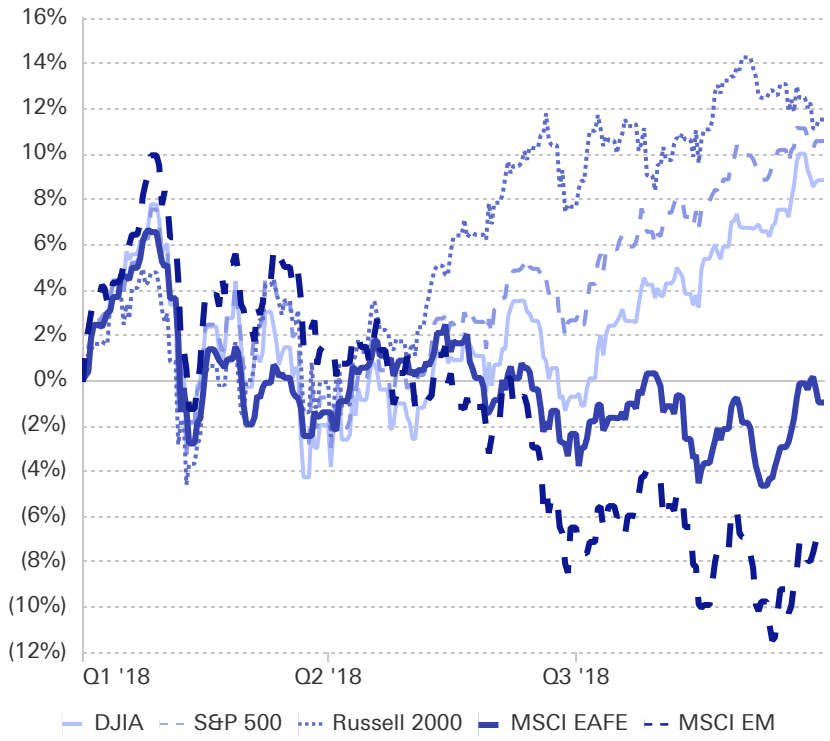
Over the longer-term we believe there will be a reversion to the mean which will allow value equities to again have their spot in the sun. However, in the nearer-term we are cautiously benefiting from the current momentum behind growth equities.

Laboring beneath the success of US Equities, foreign markets have been struggling for most of the year. Although developed overseas equity markets, as represented by the MSCI EAFE Index, showed some signs of life late in the third quarter, the index is still negative for the year. The major German Equity Index (DAX) and various EuroStoxx markets are also in negative territory year-to-date (Exhibit 4).

If the ECB reverses course on liquidity, this under-performance will likely be exacerbated.

Although the heavy bleeding in Emerging Market Equities has slowed of late, we continue to believe - barring extreme policy shifts - that the *Strengthening US Dollar* will continue to move Emerging Markets lower.

Year to Date Global Equity Performance



	CURRENT PERIOD	YTD
Dow Jones Industrial Average (TR)	1.97%	8.83%
S&P 500 (TR)	0.57%	10.56%
Russell 2000 (TR)	(2.41%)	11.51%
MSCI EAFE (TR)	0.91%	(0.98%)
MSCI Emerging Markets (TR)	(0.50%)	(7.39%)

Global Equities (cont.)

The current under-performance overseas likely fore-shadows further weakness in Europe and Emerging Markets alike, however there is a possibility that this weakness could foreshadow a sizable correction in domestic markets.

Recently we continued to increase our allocation to the Global Equities sleeve of our portfolios to 68% of the overall Strategic Allocation, which represents an 8% overweight to our global equity target weight of 60%.

As written in the last commentary, one of our Burgeoning Investment Themes is *Actively Managed Individual Stocks Will Outperform Passive Stock Indexes*. As with our other burgeoning, i.e. "not yet ready for prime time" themes, positions will be woven into our portfolios slowly and opportunistically.

As such, our core allocation to US Equities has increased with the addition of individual US Equities. Core US Equities are augmented by our momentum allocation to high-dividend US Equities. Our Sector Rotation allocation is at goal with our newly established positions within the Aerospace & Defense Sector. Opportunistically, we maintain a small overweight to actively managed Small/Mid-Cap US Equities and our short position in Emerging Market Equities.

Exhibit 3 ***Source: Bloomberg***

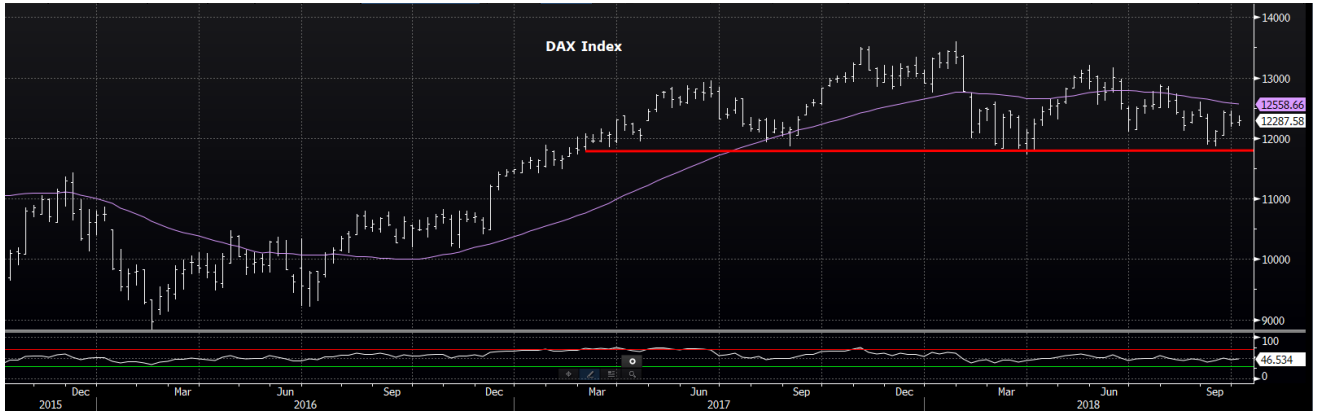


Exhibit 4 ***Source: Bloomberg***

Global Fixed Income & Cash

As mentioned, the Fed raised rates in September and we expect them to do so again in December. *Although economic growth data in the US appears to remain robust, rate hikes are causing yield curves to flatten.* The chart on the next page (Exhibit 5) illustrates the current Treasury Yield Curve (green line) has become quite a bit "flatter" than the same Treasury Yield Curve from a year ago (yellow line).

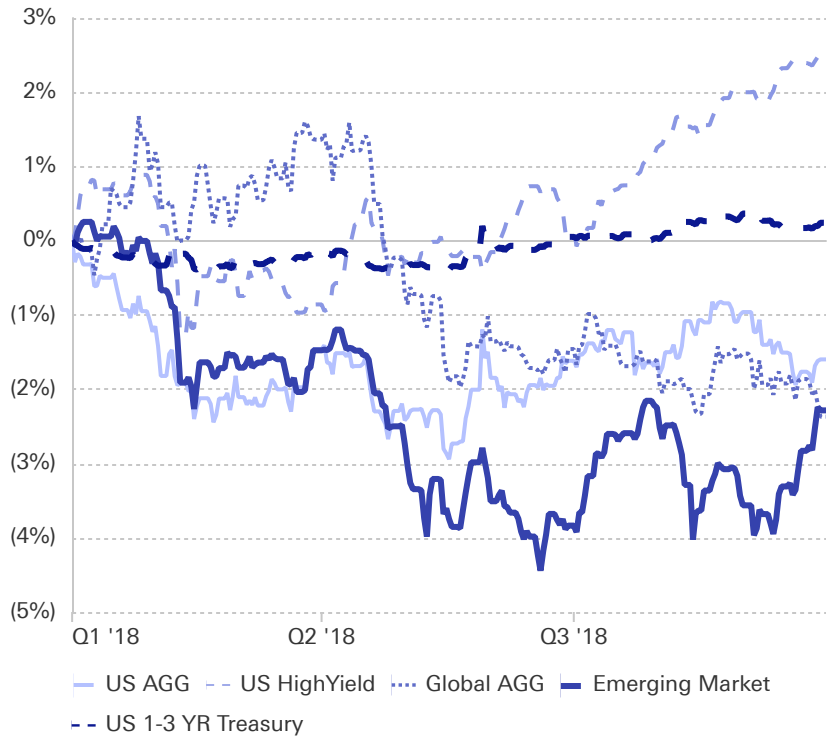
Historically, recessions are preceded by an inversion of the yield curve. Inversion happens when long-term rates yield less than short-term rates, typically due to rising uncertainty presented in the immediate future. The Fed is aware of this historical relationship and is cautious to not cause such an inversion… on purpose. However, the curve inversion/recession relationship is one of *correlation, not necessarily causation*. That is to say an inversion does not cause a recession but does historically occur in the 12 months before a recession. Therefore, the Fed will not be able to avoid a recession simply by keeping the yield curve from inverting.

From a performance standpoint, 2018 has not been a good year for bond markets thus far. The Bloomberg Barclay's Aggregate index has returned -1.60% (Total Return) through September 2018 (Exhibit 6). This is in line with our *Bond Prices will Stair-step Lower* theme. There are sectors of the bond market that have performed well, and those are the spaces where we continue to have exposure, such as: asset-backed credit and high-yield municipal bonds. We expect these areas to continue to perform well despite the global bond market suffering.

Our allocation to the Global Fixed Income & Cash sleeve of our portfolios has been reduced to roughly 27% of the overall Strategic Allocation, which represents a very slight under-weight from our model target of 30%.

Overall, we maintain a low-duration stance across our fixed income investments. Our allocation remains "bar-belled" between high quality bonds and higher-yielding, more consumer credit-oriented bonds.

Year to Date Global Bond Performance



	CURRENT PERIOD	YTD
US Aggregate Bond	(0.64%)	(1.60%)
US HighYield	0.56%	2.57%
Global Aggregate Bond	(0.86%)	(2.37%)
Barclays Emerging Markets	1.33%	(2.28%)
US 1-3 YR Treasury	(0.12%)	0.24%

Global Fixed Income & Cash (cont.)

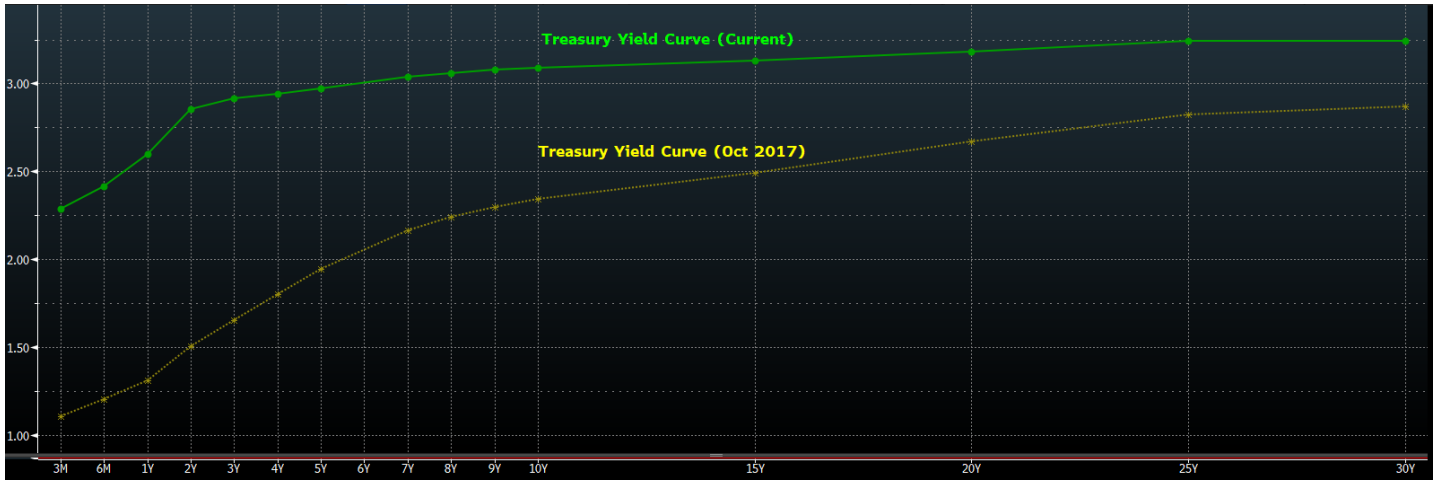


Exhibit 5 *Source: Bloomberg*

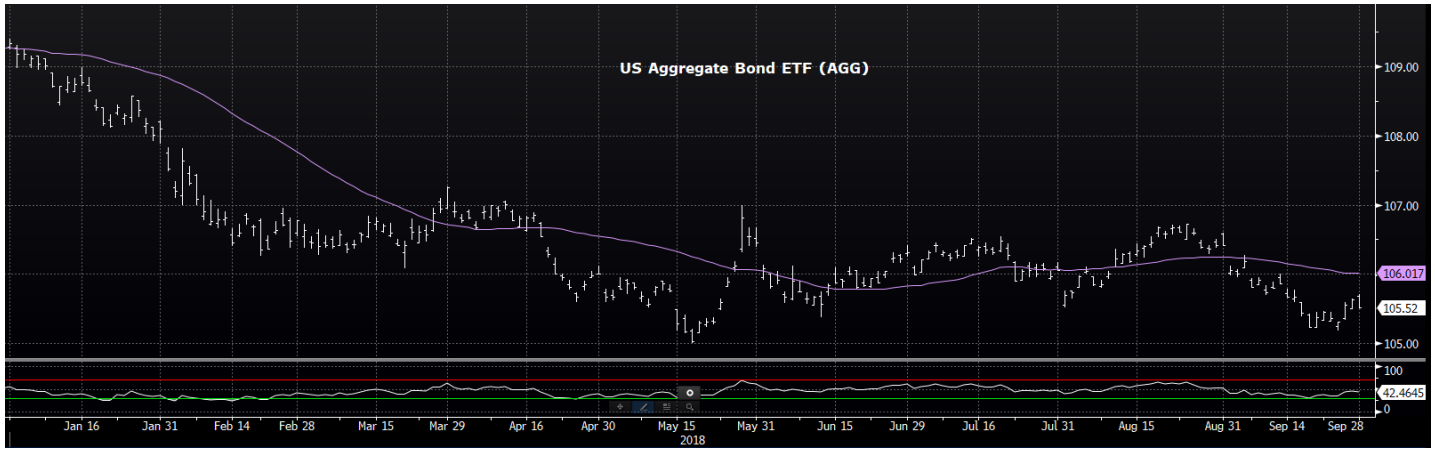


Exhibit 6 *Source: Bloomberg*

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Global Real Assets

The strength of the US dollar continues to keep a limit on most Real Asset prices. As we do not anticipate the dollar weakening in the near future, we would expect this relationship to stay intact.

Although short-term volatility in the Real Asset space continues to be driven by tariff negotiations, the overall trend remains dollar driven. We do not expect tariff news to wane in the near-term and have a suspicion that it could even escalate into the new year.

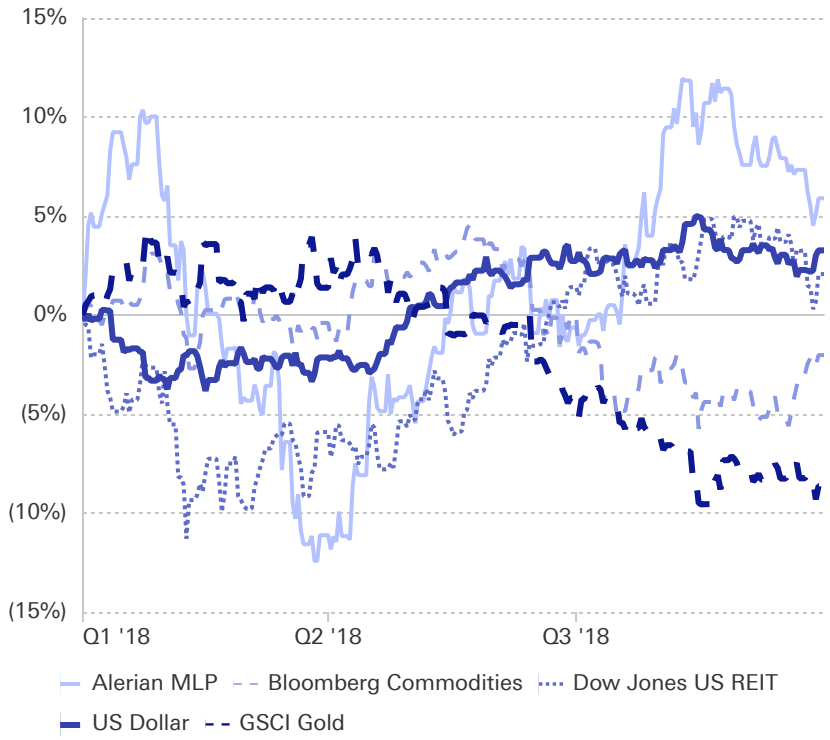
We are carefully monitoring to see if/how a potential "risk-off" environment would benefit safe-haven assets such as gold. There is a strong possibility that investors would move into currencies instead, like the dollar and yen.

We can foresee a scenario where both the dollar and gold move higher and we remain open to that possibility. Only time will tell.

We continue to be faced with a dearth of opportunity in the Real Asset space, so *we maintain our lowered Strategic Allocation weighting in our Real Assets sleeve at 5%.*

This allocation is solely our strong dollar trade, and as mentioned in our last few Commentaries, we continue to monitor for a potential "risk off" environment and potential investments in this area.

Year to Date Global Real Asset Performance



	CURRENT PERIOD	YTD
Alerian MLP	(1.57%)	5.90%
Bloomberg Commodities	1.92%	(2.03%)
Dow Jones US REIT	(2.57%)	2.07%
US Dollar	(0.01%)	3.27%
GSCI Gold	(0.87%)	(8.64%)

Conclusion

In short, our 2018 themes remain intact and with the summer behind us we can envision an exciting 4th quarter in the global markets. Political events in Europe and mid-term elections in the US will most likely create an uptick in volatility. But equally as interesting will be policy evolution from global central banks. We could make the argument that much of the rally behind global markets over the past 8+ years has been made possible by monetary policy accommodation and access to cheap money.

Should the European Central Bank begin tightening procedures at the same time as the Fed continues to raise interest rates - global liquidity could prove problematic.

We will continue to allow the markets to dictate how and where we invest. For the time being, it appears domestic equity markets want to move higher, foreign equity markets do not, nor do bond markets. So until liquidity proves to be a problem we will continue to stay invested - yet nimble. We remain cautiously confidant that our major themes will continue to provide our investors with the greatest opportunity to grow wealth by not losing wealth.