Monthly Market Commentary

10-31-2018

ReDefine
Wealth Management

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Market Performance Roundup

ReDefine Wealth Management

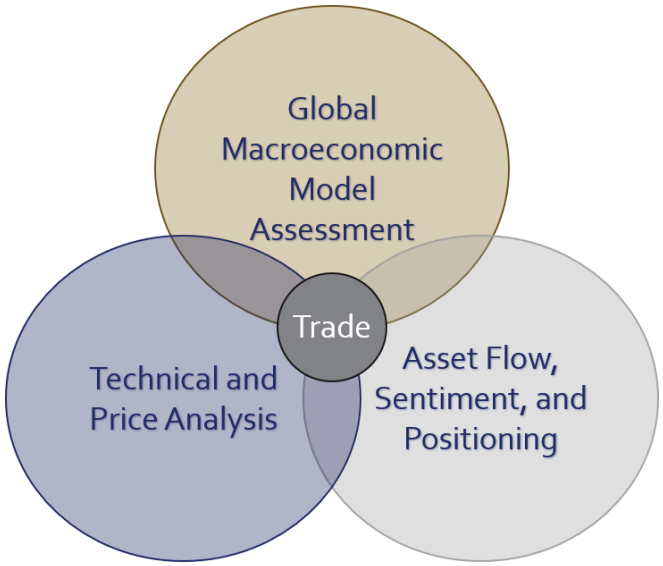
WORLD MARKETS

		1 MO.	2018	1 YR.	3 YR.	2017
Global Equities (USD, % chg.)	*MSCI All Country World (Total Return)*	*(7.47%)*	*(3.53%)*	*0.00%*	*8.32%*	*24.62%*
	MSCI World (Total Return)	*(7.32%)*	*(1.86%)*	*1.71%*	*8.52%*	*23.07%*
	MSCI EAFE (USD) (Total Return)	*(7.95%)*	*(8.86%)*	*(6.39%)*	*4.13%*	*25.62%*
	MSCI Emerging Markets (Total Return)	*(8.70%)*	*(15.45%)*	*(12.19%)*	*6.91%*	*37.75%*
Country Equities (Local, % chg.)	*Dow Jones Industrial Average (Total Return)*	*(4.98%)*	*3.41%*	*9.87%*	*15.23%*	*28.11%*
	S&P 500 (Total Return)	*(6.84%)*	*3.01%*	*7.35%*	*11.51%*	*21.83%*
	NASDAQ (Total Return)	*(9.16%)*	*6.71%*	*9.74%*	*14.36%*	*29.64%*
	Russell 2000 (Total Return)	*(10.86%)*	*(0.60%)*	*1.85%*	*10.67%*	*14.65%*
	Nikkei 225 Stock Average (JPY) (Total Return)	*(9.04%)*	*(1.95%)*	*1.57%*	*6.75%*	*21.33%*
	STOXX Europe 600 Euro (Total Return)	*(5.52%)*	*(4.13%)*	*(5.35%)*	*2.16%*	*11.22%*
	FTSE 100 (Total Return)	*(4.85%)*	*(3.89%)*	*(0.86%)*	*8.10%*	*11.95%*
	DAX 30 (Total Return)	*(6.53%)*	*(11.38%)*	*(13.47%)*	*1.80%*	*12.51%*
	Shanghai Composite	*(7.75%)*	*(21.30%)*	*(23.30%)*	*(8.36%)*	*6.56%*
Global Fixed Income (USD, % chg.)	*Barclays Global Treasury (Total Return)*	*(0.89%)*	*(3.32%)*	*(1.72%)*	*1.39%*	*7.29%*
	Barclays US Treasury (Total Return)	*(0.48%)*	*(2.14%)*	*(1.97%)*	*0.20%*	*2.31%*
	Barclays Global Aggregate (Total Return)	*(1.12%)*	*(3.46%)*	*(2.05%)*	*1.52%*	*7.39%*
	Barclays US Aggregate (Total Return)	*(0.79%)*	*(2.38%)*	*(2.05%)*	*1.04%*	*3.54%*
	Barclays Global High Yield (Total Return)	*(1.82%)*	*(2.40%)*	*(1.92%)*	*5.83%*	*10.43%*
	Barclays US Corporate High Yield (Total Return)	*(1.60%)*	*0.93%*	*0.97%*	*6.59%*	*7.50%*
	S&P Leveraged Loan Index (Total Return)	*0.00%*	*4.03%*	*4.54%*	*5.37%*	*4.11%*
	Barclays Emerging Markets (Total Return)	*(1.37%)*	*(3.62%)*	*(3.39%)*	*4.05%*	*8.17%*
Real Assets (USD, % chg.)	*USD DXY*	*2.10%*	*5.43%*	*2.72%*	*0.06%*	*(9.87%)*
	Dow Jones US Real Estate Index (Total Return)	*(2.73%)*	*(0.72%)*	*1.74%*	*5.77%*	*9.84%*
	Bloomberg Commodity Index	*(2.16%)*	*(4.14%)*	*(1.73%)*	*(0.69%)*	*1.70%*
	S&P GSCI Gold	*1.57%*	*(7.20%)*	*(4.37%)*	*2.10%*	*13.68%*
	S&P GSCI Precious Metals (Total Return)	*1.34%*	*(8.72%)*	*(6.11%)*	*0.78%*	*11.98%*

ReDefine Wealth Management

November 5, 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

What a difference a day - or a few days – makes.

As of the close on October 29th, the S&P 500 was down -9.36% for the month. However, thanks to a rally over the final two trading days, the S&P 500's overall performance was only off -6.94% for the month of October. Only -6.94%... Which represents the largest monthly decline in the index since September 2011. We didn't even have to wait a full week for an October downturn, as it started in earnest about six days after the following words were published in our October Commentary:

"…there is the potentiality of a liquidity 'vacuum' that may be difficult for the markets to digest cleanly… Spoiler alert: it could mean a sizable US equity market correction within the next few months."

Throughout the year, we have shared many indicators that we use to help guide our portfolio decisions. To continue that trend, we will again share one of our favorites, the chart from our last commentary but updated through the end of October (Exhibit 1). As we have mentioned previously – and continue to believe – the Federal Reserve's balance sheet projections could lead to increased volatility and negative equity performance. While most market pundits focus on the Fed's interest rate policies and actions, we believe it is also beneficial to monitor the Fed's balance sheet policies and actions. *As the Fed moves to reduce its balance sheet over time, the shrewd investor will focus more and more on global liquidity.*

When liquidity is high, more money finds its way into the stock and bond markets, driving prices up. The reverse is true when liquidity is low or "tight". We have illustrated global liquidity concerns through another chart (Exhibit 2), that of the Goldman Sachs Financial Conditions Index (FCI) and its trend line. FCI is a gauge that is closely watched by economists and is a weighted average of riskless interest rates, the exchange rate, equity valuations, and credit spreads, with weights that correspond to the direct impact of each variable on GDP.

To simplify the information, when the FCI (green line) goes down, financial conditions are "loose", and liquidity is high. When the FCI goes up, money is tight and therefore asset growth is likely to slow. The red line is the trend line, which shows the general pattern of the FCI.

Fluctuations in the FCI can be triggered by central bank activity, interest rates increasing, stocks selling off, or

*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

Fundamental Global Macroeconomic Backdrop (cont.)

currency strength, among other things. While it's difficult to predict the order in which these events take place, when the FCI breaks through its trend line, evidence would suggest that overall financial conditions are tightening. *And investors are be reminded that it is possible for prices to drop occasionally.*

For the remainder of 2018, we believe the markets will be much more reactive to geopolitics than global liquidity and other macroeconomic forces. *The midterm elections and China trade talks here at home, coupled with Brexit concerns and Italian negotiations across the pond, as well as general trade and political concerns globally will overshadow liquidity concerns for now.* However, looking ahead, we believe that global economic forces regain control in 2019.

Regarding US elections, consensus view is that if the GOP can retain both the House and Senate, markets will respond favorably. If Democrats can gain a majority in at least one of the two, again the consensus view is that volatility will continue, and markets could struggle. Our base case scenario is that the House will likely fall to the Democrats and the Senate will remain in Republican hands, causing a mixed market where *volatility will remain elevated, but giving way to overall positive performance* – higher highs and higher lows. Please note that we are NOT political pundits and tend to "play the odds". That said, we remain vigilant and responsive to events that differ from our base case scenarios.

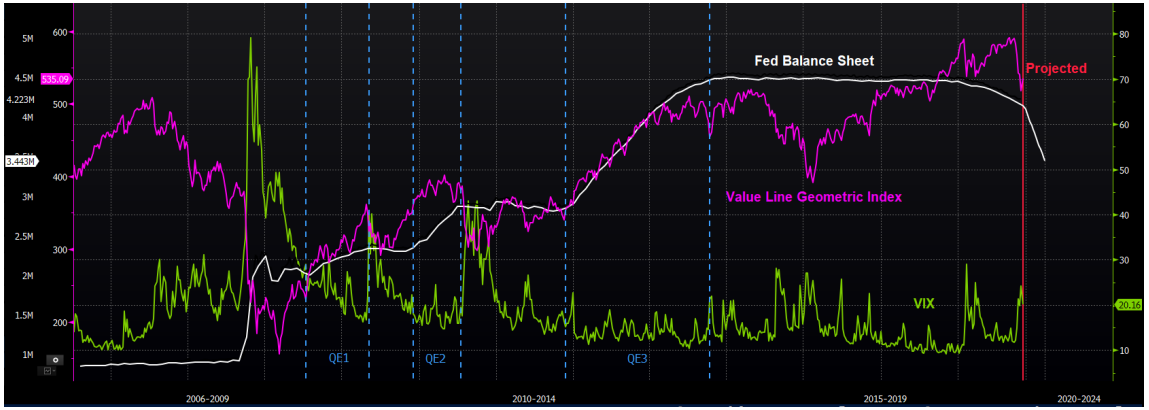


Exhibit 1 *Source: MI2 Partners, Bloomberg*

Exhibit 2 *Source: Bloomberg*

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Global Equities

Understatement Alert: *US equity markets sold off dramatically in October.*

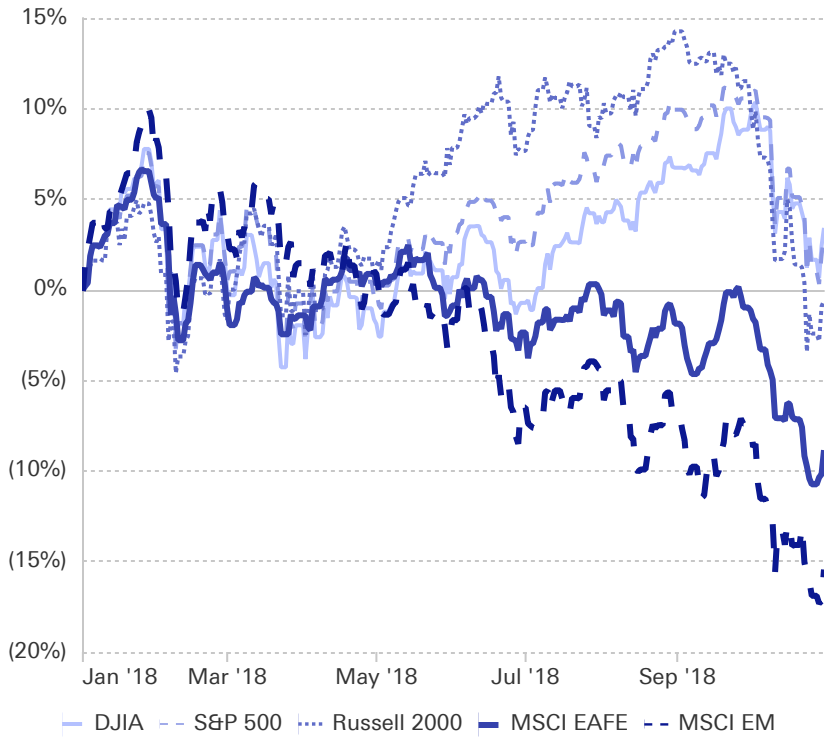
In general, we felt prepared for rising volatility and potentially negative markets in October. We were able to nimbly reallocate and raise cash throughout the month, and although it proved impossible to avoid loses entirely, we felt able to sidestep the outsized loses – especially those outsized loses experienced in the markets in which we were invested. For example, *in October the S&P 500 was down -6.8%, the Russell 2000 was off -10.9%, the Technology Sector lost -8%, and the Aerospace & Defense Sector was down -11.4%.* We were also able to cushion the blow and add value through our Fixed Income, cash, and inverse positions.

We believe we have a firm grasp on the driving forces behind the selloff, but the most difficult parts are always: the timing and what happens next? The investment landscape has changed since the last big monthly selloff in 2011. The Fed is raising rates and the European Central Bank is due to begin tightening procedures as well. Add in the plethora of geopolitical issues at hand and this environment is indeed different.

As of this writing, there are several indicators that have caused us to move towards neutral positioning in US stocks, which is a rare state. We do believe that our theme – *Stock Prices Will Stair-Step Up and Bond Prices Will Stair-Step Down* – remains intact. Therefore, we continue to look for buying opportunities. We may be starting to see a rotation in **which** stocks may outperform. For most of the past two years the leaders have been growth companies, specifically technology names such as: Facebook, Apple, Amazon, Netflix, and Google. *The recent market correction may be pointing to a resurgence in defensive sectors and value-oriented names.*

The chart on the next page illustrates the relationship between growth and value stocks (Exhibit 3). Quite simply, when the yellow line goes down, growth is out-performing value. The inverse is true when the yellow line rises. Value-oriented stocks have regained ground over the last month and this could be an early signal of future out-performance. As such, we have begun

Year to Date Global Equity Performance



	CURRENT PERIOD	YTD
Dow Jones Industrial Average (TR)	**(4.98%)**	**3.41%**
S&P 500 (TR)	**(6.84%)**	**3.01%**
Russell 2000 (TR)	**(10.86%)**	**(0.60%)**
MSCI EAFE (TR)	**(7.95%)**	**(8.86%)**
MSCI Emerging Markets (TR)	**(8.70%)**	**(15.45%)**

Global Equities (cont.)

to reposition our sector rotation allocation to attempt to take advantage of this relationship.

While we remain constructive on domestic equities, our outlook on foreign stocks is not as positive. Last month we showed a chart on the DAX, which is representative of the German stock market, and therefore a good barometer of Europe as a whole (Exhibit 4). At the time, the DAX was testing historic support levels (the red line). Unfortunately for the DAX – and Europe in general – the inability to hold above that line would suggest a technical breakdown, signifying potential further weakness ahead.

Overall, we maintain our conviction that equities represent the greatest opportunity for investor outperformance moving forward. Specifically, we remain bullish on US equities over European, Asian, or Far Eastern equities. We also maintain our belief that Emerging Market equities represent a better "short", than "long" opportunity, thus we maintain our short position on emerging market equities for the time being.

Investors should expect heightened volatility in the form of more daily >2% moves in the S&P 500, Dow Jones, and NASDAQ indices, caveated with the overall trend being a positive stair-step up in prices.

Exhibit 3 *Source: Bloomberg*

Exhibit 4 *Source: Bloomberg*

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Global Fixed Income & Cash

Interestingly, one of our burgeoning themes (i.e. not an "if", but a "when" theme) is *Stock and Bond Negative Correlation Turns Positive.* October may have been a harbinger of asset class behavior in times of future market stress, as "traditional" fixed income provided little ballast for falling equities. But more on this theme in future writings.

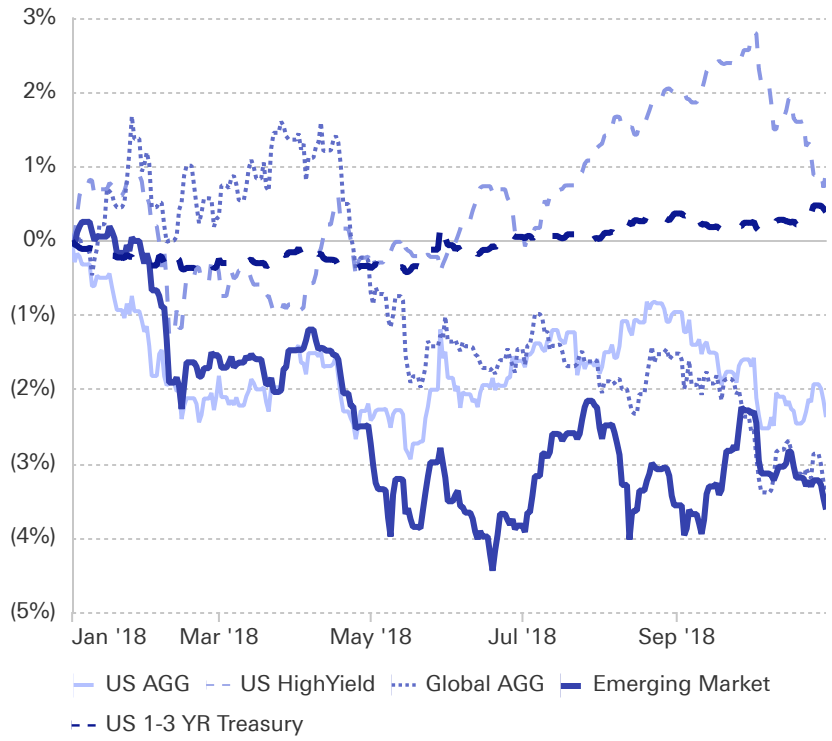
As referenced several times already in this piece, our theme - *Stock Prices Will Stair-Step Up and Bond Prices Will Stair-Step Down* – remains intact. The theme is meant to be one of general equity outperformance over bonds, and should continue to proceed in a stair-step manner, not in a straight line.

The chart on the next page (Exhibit 5), representing the S&P 500 Index (using the ETF proxy "SPY") versus that of the Bloomberg Barclays Aggregate Bond Index (using the ETF proxy "AGG"), illustrates the stair-step relationship to which we refer.

Global liquidity – or the lack thereof – can manifest itself in various parts of the markets. Yet another relationship affected by liquidity issues is the relationship between high yield bonds and investment grade bonds (Exhibit 6). The chart on the next page is used as a gauge of the overall mood of the fixed income investor. When the white line decreases, investors are more willing to invest in high yield bonds over investment grade bonds, as the risk is deemed to be less than the reward. However, as the white line turns upward, a "risk-off" scenario may be taking hold.

October provided just such an environment and will be one that we watch closely moving forward. As liquidity tightens and interest rates rise, we tend to favor bonds issued by stronger balance sheet companies – typically referred to as investment grade – over bonds issued by weaker balance sheet companies – typically referred to as high yield or junk bonds. *When we do reach for higher yielding fixed income, we continue to hold short-dated, well-managed, asset-backed credit funds - that subsequently have held up well through the recent stock market correction.*

Year to Date Global Bond Performance



	CURRENT PERIOD	YTD
US Aggregate Bond	**(0.79%)**	**(2.38%)**
US HighYield	**(1.60%)**	**0.93%**
Global Aggregate Bond	**(1.12%)**	**(3.46%)**
Barclays Emerging Markets	**(1.37%)**	**(3.62%)**
US 1-3 YR Treasury	**0.14%**	**0.39%**

Global Fixed Income & Cash (cont.)

Exhibit 5 *Source: Bloomberg*

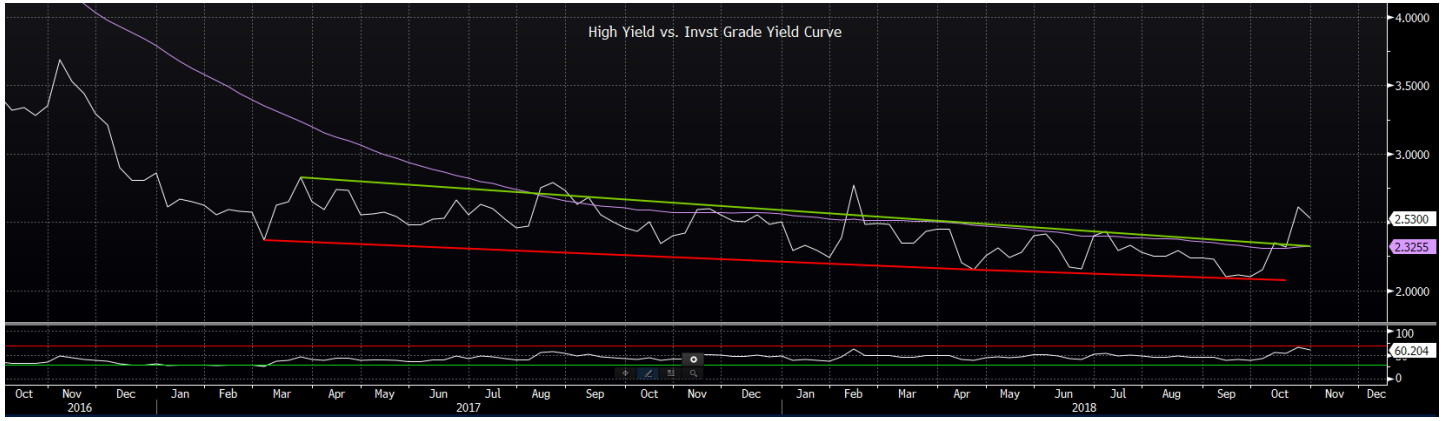


Exhibit 6 *Source: Bloomberg*

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Global Real Assets

In line with the rest of 2018, continued strength of the US dollar has made it difficult to invest in most commodities with any level of conviction (Exhibit 7).

The dollar has proven resilient, per our expectations, and we believe that the top of this valuation – although closer - is yet to be in focus. There are many possible triggers causing the dollar to move higher over the coming months, so we won't speculate as to which ones are most likely.

Until global macroeconomic forces subside however, we believe the early 2017 highs in the dollar are well within reach, if not higher.

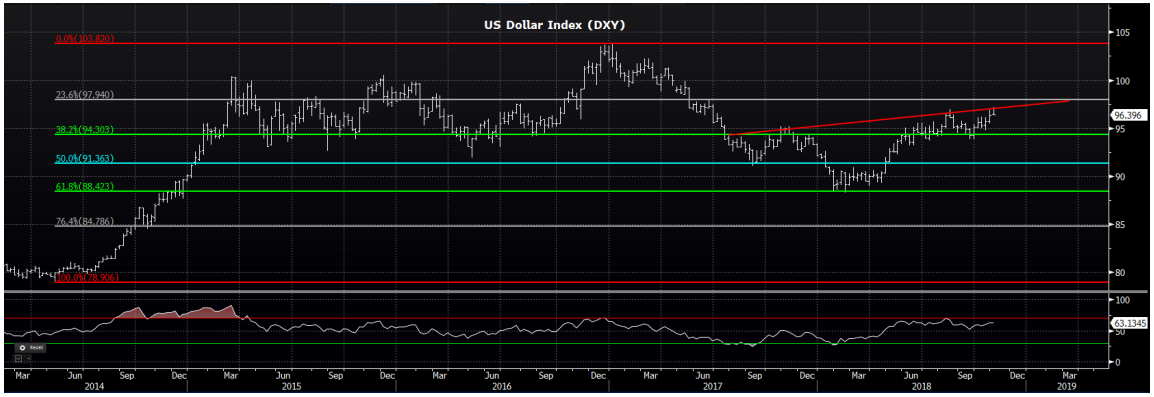
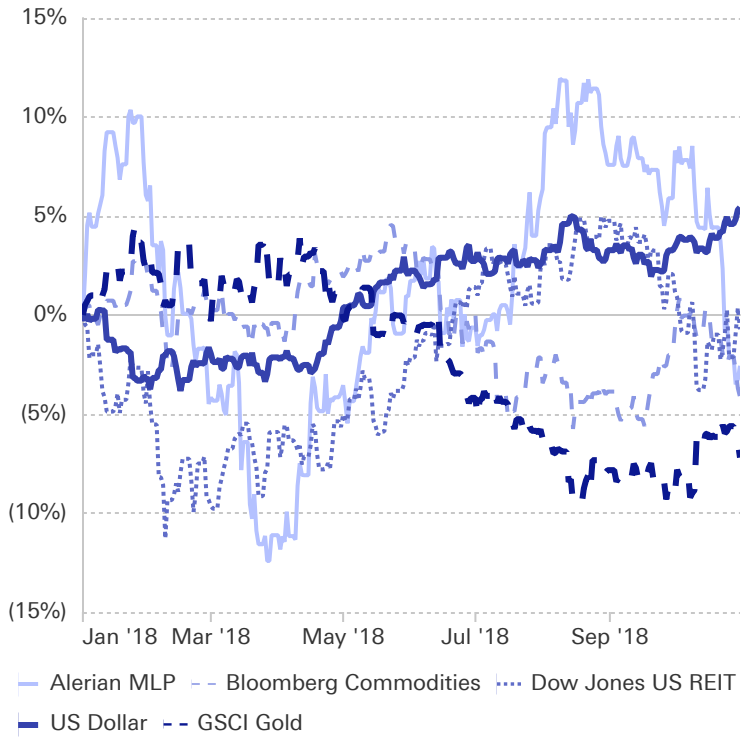


Exhibit 7 ***Source: Bloomberg***

Year to Date Global Real Asset Performance



	CURRENT PERIOD	YTD
Alerian MLP	(7.99%)	(2.57%)
Bloomberg Commodities	(2.16%)	(4.14%)
Dow Jones US REIT	(2.73%)	(0.72%)
US Dollar	2.10%	5.43%
GSCI Gold	1.57%	(7.20%)

Conclusion

The last month proved a challenging environment, but not a totally unexpected challenge.

We believe our main themes to be intact, and without significant contrary information, we will continue to rely upon them to guide the way. *While it appears that equity markets would prefer to rise into year-end, we understand that there are obstacles in the way.* Mainly in the form of geopolitical potential threats. This bull market has remained resilient and the overall trend it still rising prices. We continue to remain objective and invest where the markets guide us - regardless of the surrounding "noise".

As always, please don't hesitate to reach out with any questions.