CHARTWELL REVIEW

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Extra Innings

Since the bear market bottom on March 9, 2009, the S&P 500 has gone 3,500 days without a 20% correction. After the market's sharp weakness in October, perhaps we should have ended this quarter's title with a question mark. It certainly feels like the game may be coming to an end.

The quarter was a strong one for US equity investors, and not really much else. Interest rates rose, resulting in enough capital depreciation to flatten out nearly all bond returns. However, credit spreads on high yield bonds hit a low for this market cycle, enabling them to outperform the other fixed income sectors; something we've now observed over every primary trailing timeframe during the past 10 years.

Conversely, the broadly diversified Bloomberg Commodity index was once again the quarter's laggard. The index has underperformed in virtually every primary trailing timeframe, on route to an incongruous (6.2)% rate of return during the past decade.

Bottom of the 9th inning for the US economy and stock market? Maybe. We believe the recent increased volatility is caused by numerous factors and cannot be isolated to one issue. Investor concerns include higher inflation, higher interest rates, a poor international trade picture, geopolitical uncertainty, a China slowdown – the list is long, and all point to a global economic slowdown in 2019.

Strategists suggest this will in turn lead to weakening corporate earnings and a serious stock market correction. We differ with that strident view, but not its direction. It certainly looks like we are at peak earnings growth for this cycle. There appears to be more downside risk in investment markets than upside potential. Accordingly, we think investors should be looking to reduce risk exposures and increase liquidity, but not completely collapse risk assets. The labor market remains very strong, credit spreads have not moved higher, and real interest rates remain low.

(The longest game in major league history went 25 innings)

Figure 1: Index Benchmarks

Market Index	Trailing Returns *				
	3Q 18	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	7.7	17.9	17.3	14.0	12.0
U.S. Top-cap Stocks	8.4	19.3	18.1	14.5	12.0
U.S. Mid-cap Stocks	5.0	14.0	14.5	11.7	12.3
U.S. Small-cap Stocks	3.6	15.2	17.1	11.1	11.1
Non-US Stocks (**EAFE**)	1.4	2.7	9.2	4.4	5.4
Non-US Stocks (**Emerg**)	(1.1)	(0.8)	12.4	3.6	5.4
3 mo. T-Bills	0.5	1.6	0.8	0.5	0.3
U.S. Aggregate Bonds	0.0	(1.2)	1.3	2.2	3.8
High Yield Bonds	2.4	2.9	8.2	5.5	9.4
Global Aggregate Bonds	(0.9)	(1.3)	2.0	0.8	2.9
Consumer Prices, p.a.	*0.7*	*2.3*	*2.0*	*1.5*	*1.4*
Blmbrg Commodities	(2.0)	2.6	(0.1)	(7.2)	(6.2)
MSCI World REITS	0.2	3.2	6.6	6.9	5.5

Figure 2: Average Mutual Fund Returns

Fund Category	Trailing Returns *				
	3Q 18	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
U.S. Large-cap	6.7	17.0	15.9	12.5	11.5
U.S. Mid-cap	6.0	14.9	14.4	10.8	11.6
U.S. Small-cap	3.2	13.8	16.0	10.3	11.2
International Lg. Cap	0.6	1.7	9.2	4.6	5.6
International Sm. Cap	(1.8)	1.9	10.6	7.2	9.8
Emerg. Mkt. Equity	(2.8)	(4.4)	10.2	3.0	5.1
Balanced/Hybrid	2.8	6.2	8.5	6.5	7.5
General Bond	0.2	(1.0)	1.7	2.2	4.4
High Yield Bond	2.1	2.6	6.4	4.5	7.8
Hedge Funds, Equity	0.7	5.3	7.4	5.1	5.2

*Annualized trailing returns for periods ending 9/30/18.

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Economies, Economics, Prices, and Policy

	9/2018	9/2017
CPI - headline, y-o-y	2.3%	2.2%
CPI - core, y-o-y	2.2%	1.7%
Unemployment Rate	3.7%	4.2%
Household Employment (000's)	155,962	154,324
Employment / Population %	60.4%	60.4%

The Federal Reserve is mandated to facilitate "full" employment and "stable" prices. The above amounts to its report card. Looks like an "A" for the past two years.

The American economy continues to expand. The final 2nd quarter numbers were quite favorable, stabilizing a negative trend and three straight sub-3% prints.

The 4.2% annualized increase in real GDP in Q2 was paced by strong growth in consumer spending, increased government spending, and a hefty contribution from foreign trade, with exports up strongly and imports down slightly. 2Q GDP growth would have been even stronger but for a big drag from reduced inventory investment.

Figure 3: Breaking Down 2nd Quarter* Real GDP

	% Change from Preceding Period			
Factor	2Q '18	1Q '18	4Q '17	3Q '17
Real GDP Growth	4.2%	2.2%	2.3%	2.8
Nominal GDP Growth	7.6	4.3	5.1	4.8
Real Final Sales	5.4	1.9	3.2	1.8
Personal Spending	3.8	0.5	3.9	2.2
Private Investment	(0.5)	9.6	0.8	8.8
- Fixed, Businesses	8.7	11.5	4.8	3.4
- Fixed, Residential	(1.4)	(3.4)	11.1	(0.5)
*- Chg. In Inventories **($bn)***	*($37)*	*$30*	*$16*	*$64*
Export growth	9.3	3.6	6.6	3.5
Import growth	(0.6)	3.0	11.8	2.8
Government Spending	2.5	1.5	2.4	(1.0)

** BEA final estimate on 9.27.18*

Consensus estimates of 3rd quarter growth are positive. The Atlanta Fed's forecast is 3.9%, down from 5% early in the quarter. This compares favorably to the *Blue Chip* consensus estimate of 3.3%, in a range of 2.9-3.8%.

The Commerce Dept. has just released their advance estimate of 3Q GDP growth. It is a "weak" 3.5%. Consumer spending was favorable. However, inventory building was especially robust, leading to weak final sales growth of only 1.4%. Net imports were a big drag, with imports up sharply and exports down sharply. That's the natural consequence of a very strong dollar. Residential and business fixed investment were also negative.

Businesses continued to hire during the quarter. The pace of payroll jobs growth remained favorable, with 569k created compared to 632k in Q2.

Non-farm payroll jobs have increased 2.5mm the past year. At quarter's end, the national unemployment rate stood at 3.7%, the lowest figure since 1969.

Inflation rates, which had bubbled up noticeably in Q2, fell back to levels consistent with the recent experience –

⇒ **"Headline" CPI** rose at an annual rate of 0.7% during the quarter and was up 2.3% year-over-year;

⇒ **"Core" CPI** (*ex-food & energy*) rose only 1.1% annualized during the quarter and 2.2% during the past year.

⇒ The headline **Producer Price Index** for final goods and services rose 2.6% during the past year, with energy prices up nearly 4.8%.

On the monetary policy front, the Fed again raised the upper limit target Fed Funds rate by 25bps following its September meeting, to 2.25%. Real rates across the yield curve are positive for the first time in a decade.

2017 tax rate cuts and 2018 spending increases resulted in a final federal deficit of $779 billion for the fiscal year just ended. The highest deficit since 2012, when the economy was coming out of a recession. Next year's deficit is forecast to rise to $980 billion, which is unprecedented fiscal "juice" during an expansion, and is a primary reason we doubt a full-fledged recession is on the horizon.

Existing-home sales ran at a seasonally adjusted annual rate of 5.15mm in September, a 3.4% decline for the month, a 4.1% decline from a year ago, and the lowest pace of sales since November 2015. The average rate for a 30-year, conventional, fixed-rate mortgage increased to 4.83% in September, its highest since 2011, compared to an average commitment rate during 2017 of 3.99%.

The IMF reported the global economy is now expected to grow at 3.7% this year and next year — down 0.2% from this year's earlier forecast. The Fund also cut its forecasts for global trade volume. Total good and services flows are expected to grow by 4.2% this year and 4% next year — down 0.6 and 0.5 percentage points, respectively, from earlier estimates.

The two economies in the center of the tariff fight - the U.S. and China - are also expected to grow slower than initially projected. The IMF maintains the U.S. and China will grow by 2.9% and 6.6%, respectively, this year but would slow more than expected in 2019 to only 2.5% and 6.2%, respectively.

Emerging markets - under massive selling pressure in recent months - saw larger cuts to their growth forecasts in the IMF report. "The negative revisions for emerging market and developing economies are more severe. Broadly speaking ... we see signs of lower investment and manufacturing, coupled with weaker trade growth."

Bond Yields Rise; Yield Curve Flattens

Per Figure 6, there are currently no developed market countries with higher sovereign bond yields than the U.S. This has led to a strong dollar rally versus most currencies, pushing down unhedged global bond returns.

The third quarter was basically rinse and repeat for the domestic bond market; just as the 2nd quarter reflected a continuation of the first. The Federal Reserve raised the Fed Funds base rate for the eighth time, to 2.25%. It characterized the U.S. economy as "strong" rather than "solid," the jobs market as strong, and inflation as low and stable. The Fed expects the unemployment rate to remain in the high 3's and inflation to remain in the low 2's through 2019. They also project as many as four increases in the FF rate through 2019, to just over 3%.

The domestic bond market once again reflected a period of very modest returns, as low yielding investment grade bonds absorbed gradually rising rates. Per Figure 4, investment grade bonds, especially Treasuries, returned less than 1%, or lost money. One-year returns for investment grade sectors generally reflect losses, led down by long-term Treasuries (declining 3.6%).

As we've seen for most of 2018, "high yield" bond and leveraged loan portfolios again led the bond market up in Q3. They were joined at the top of the return charts by US$ emerging market bonds, which had been the worst performing $-bond sector in Q2. Looking over the past three years, these three sectors' returns have handily beaten inflation, while almost none of the investment grade sectors have.

Rates again increased across the US$ curve, with the largest increases at the front end. The 3-month and 2-year yields rose approx. 30bps, while the 10-Year and 30-year yields increased by 20bps. The yield curve once again flattened, setting off more debate on whether an inverted yield curve will trigger a recession and a bear market.

The investment grade credit index returned +0.9%, after being down that much in the 2nd quarter. Adjusted for maturity differences, BBB credit spreads dropped by 20bps, to the 140bps range. High-yield bond credit spreads narrowed by approx. 40bps, to the 340bps range. This is a cycle low, and many bond managers are concerned the sector is overpriced. Outflows from high yield bond funds have been -$25 billion so far this year. Inflows to bank loan funds have been +$16 billion.

Structured bonds performance was once again mixed, generally underperforming corporate credit but beating the broader market. The shorter duration of ABS has enabled them to post a positive return for the past year.

A strong September led the broad $ EM bond index to its top-notch 3Q return. This only partially reversed a weak first half, and year-to-date performance is -3.5%. Non-$ EM bonds have been the fixed income market's weakest performer, dropping -8.2% year-to-date.

Figure 4: Primary Bond Sector Returns (%)

Index	**3Q '18**	**1 Year**	**3 Years**	**5 Years**
US Aggregate Bond index	0.0	(1.2)	1.3	2.2
US Gov't/Credit: (1-3yrs)	0.3	0.2	0.7	0.8
US Treasury: Long	**(2.9)**	**(3.6)**	0.7	4.4
US TIPS (1-10yrs)	(0.4)	0.3	1.7	0.9
Mortgage-Backed (MBS)	(0.1)	(0.9)	1.0	2.0
CMBS	0.6	(0.2)	1.7	2.4
Asset-Backed (ABS)	0.5	0.5	1.2	1.5
Inv. Grade US Credit	0.9	(1.1)	3.0	3.4
Leveraged Loans	1.9	5.3	5.1	4.5
US High Yield Credit	**2.4**	**2.9**	**8.2**	**5.5**
Municipal Bonds, broad	(0.2)	(0.4)	2.9	3.5
Global Aggregate, (hdgd)	(0.1)	0.8	2.4	3.1
Global Credit, (hdgd)	1.0	0.4	4.1	4.0
Emerg. Mkts Bonds (US$)	2.3	(1.9)	6.0	5.4

Figure 5: Fixed Income Yields – 3rd Quarter 2018

(YTM, % p.a.)	**Sep-18**	**Jun-18**	**Sep-17**	**Jun-16**	*1-Year Change*
US Treasuries					
3-month	2.21	1.92	1.05	0.26	***1.16***
2-year	2.81	2.53	1.47	0.59	***1.34***
5-year	2.95	2.73	1.92	0.71	***1.03***
10-year	3.05	2.85	2.31	1.49	***0.74***
30-year	3.20	2.98	2.87	2.31	***0.33***
BarCap Aggregate	3.46	3.29	2.55	1.91	***0.91***
BBB Credit	4.39	4.38	3.51	3.42	***0.88***
AA Credit	3.49	3.35	2.56	2.01	***0.93***
Agency MBS	3.59	3.41	2.81	2.07	***0.78***
Emerging Mkts ($)	6.40	6.52	5.19	5.37	***1.21***
US High Yield	6.34	6.53	5.43	7.27	***0.91***
UST30yr - UST2yr	0.39	0.45	1.40	1.72	***(1.01)***

Figure 6: Sovereign Bond Yields, selected countries

10-year yields (%)	**Sep-18**	**Jun-18**	**Sep-17**	**Jun-16**	*1-Year Change*
Switzerland	0.13	0.00	0.00	**(0.50)**	***0.13***
Japan	0.10	0.01	0.02	**(0.19)**	***0.08***
Germany	0.51	0.32	0.47	**(0.12)**	***0.04***
Spain	1.36	1.29	1.60	1.33	***(0.24)***
Britain	1.59	1.41	1.36	1.13	***0.23***
Australia	2.75	2.64	2.79	1.99	***(0.04)***
Italy	2.91	2.83	2.21	1.30	***0.70***
United States	3.05	2.85	2.33	1.49	***0.72***
Poland	3.24	3.23	3.36	2.93	***(0.12)***
China (5 year)	3.49	3.44	3.62	2.70	***(0.13)***
Greece (new bonds)	4.04	4.05	5.77	8.19	***(1.73)***
India	8.07	7.87	6.67	7.44	***1.40***
Russia	8.77	8.13	8.13	8.39	***0.64***
Brazil	9.45	9.50	8.72	12.15	***0.73***

US Stocks Rise Sharply

The tug of war between politics and fundamentals continued in the 3rd quarter. U.S. equities performed well, harnessing momentum from strong U.S. growth and profits. The S&P 500 posted its best quarterly result in 5 years, with a 7.7% gain, bringing the year to date return to 10.6%.

We started the quarter with the S&P at 2718. From there it was an upward climb with no interruption, to a new record high on September 20th of 2931. We've seen nothing but woe since, and are within 1% of a full correction in large cap stocks as we publish this *Review*. Small cap stocks reached a record high earlier, on August 31st, and have since fallen firmly into correction territory (down 14.7%). The easy blame has been laid at the feet of rising interest rates, but the 10-year Treasury traded at 3.11% on May 17th, and at 3.08% on October 26th.

Figure 7: U.S. Equity Market - Size/Style Returns

	Trailing				
	3Q '18	**1-year**	**3-yrs**	**5-yrs**	**11-yrs***
Growth					
Large Cap	9.2	26.3	24.1	16.6	10.1
Mid Cap	9.2	26.3	16.7	13.0	9.3
Small Cap	5.5	21.1	18.0	12.1	9.6
Value					
Large Cap	5.7	9.5	13.6	10.7	7.3
Mid Cap	3.3	8.8	13.1	10.7	7.9
Small Cap	1.6	9.3	16.1	9.9	7.3

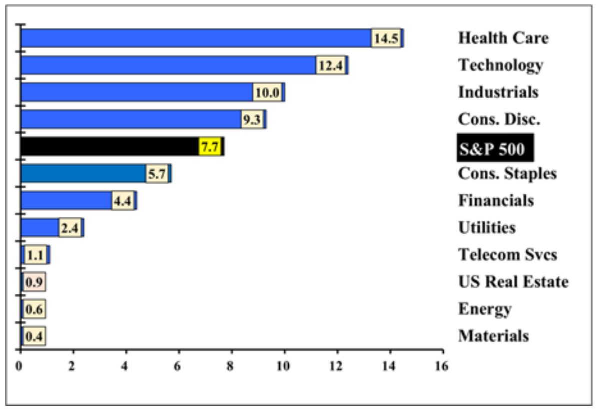
****represents the current market cycle from trough to present***

We did witness some changes in the market this quarter. In size terms, small caps gave up ground in favor of large caps, which was a reversal from the trend earlier this year. The S&P 500 index topped the Russell 2000 by approximately 400 bps. Larger cap stocks benefitted from President Trump's pivot on trade talks and the removal of concerns over the passage of NAFTA 2.0.

In terms of style, growth stock indices once again trumped value across the board, due to both sector allocation differences and stock selection. The quarter's top performing sectors - healthcare, tech, industrials and consumer discretionary, are traditionally "growth" sectors, comprising 74% of the Russell 1000 Growth index and only 38% of the Russell 1000 Value index. And, individual growth stocks in these sectors sharply outperformed value stocks in these sectors.

Stocks with higher positive price momentum, higher projected earnings growth, and low leverage were outperformers, while smaller names with low price/book ratios and high dividends lagged. Technology, the leadership sector for the first half of 2018, began to falter late in the quarter. The highflying FAANG stocks were down during the month of September.

Figure 8: US Sector Returns – 3rd Quarter 2018



Per Figure 8, every industry sector posted higher returns in the 3rd quarter, paced by healthcare (+14.5%). Energy, materials, and real estate stocks were essentially flat, before dividends. Materials firms were impacted by concerns over growing trade frictions.

Figure 9: Trailing P/E Ratios – September 2018

	Value	**Blend**	**Growth**
US Large	16.3	21.4	28.1
US Mid	17.0	19.9	26.6
US Small	17.5	20.6	25.6
EAFE		**14.4**	
Emerg. Mkts		**12.3**	

Trailing PE ratios were mostly unchanged at quarter's end, with two notable exceptions. At 14.4x, the PE of the EAFE index has dropped 21% during the past year, while that of the S&P 500 is unchanged. The Emerging Markets' PE has declined by 20%. Those two markets are trading at their lowest relative PE's in a decade.

We have been concerned that a markdown in earnings forecasts was behind the current market correction (after dividends, earnings growth is the lifeblood of equity returns). So far, this hasn't happened. Reduced tax rates and solid revenue growth has left the 3rd quarter's growth forecast at 27%, just as it was three months ago. Year/year 2018 earnings growth is still forecast to be 27% above 2017 actual. Looking forward, 2019 earnings growth is projected to be 12%. Three months ago, projected 2019 growth was 11%. There has been no markdown, **yet**, in the projected earnings of the S&P.

International Markets: Hits and Misses

Strong corporate earnings and steady economic growth helped propel developed markets into positive territory in 3Q. The MSCI EAFE index rose 1.35%. Emerging markets were flat to negative during the quarter, hurt by a strong US dollar, higher interest rates, and global trade tensions. The MSCI Emerging Markets index dropped -1.1%. As a new NAFTA agreement with Canada was being hammered out, the Canadian market rose only 0.8%. The broad MSCI AC World ex-US index rose 0.7%. In currency markets, the US dollar rallied against the euro, yen, and most other currencies. Several emerging market currencies fell to all-time lows against the dollar amid financial turmoil in Argentina, Brazil, and Turkey.

Figure 10: International Equity Markets – Returns

	U.S. Dollar Returns (%)		Local Currency Returns (%)	
thru 9/30/18	3Q '18	1-Yr	3Q '18	1-Yr
World ex-USA	**1.3**	**2.7**	**2.1**	**5.1**
- *MSCI Growth*	*1.5*	*5.5*	*2.1*	*7.9*
- *MSCI Value*	*1.2*	*(0.1)*	*2.0*	*2.3*
- Europe	0.1	(0.3)	1.2	2.0
- Pacific, ex-Japan	(0.6)	4.3	0.6	9.5
- Japan	3.7	10.2	6.3	11.2
- United Kingdom	(1.7)	2.9	(0.4)	5.8
Int'l Small Caps	**(0.9)**	**3.4**	**0.0**	**6.0**
Emerging Mkts	**(1.1)**	**(0.8)**	**(0.0)**	**2.7**
- *EM Asia*	*(1.8)*	*1.0*	*(1.2)*	*1.9*
- *EM Europe*	*2.2*	*(1.5)*	*7.1*	*12.3*
- *EM Lat Amer*	*4.8*	*(9.1)*	*5.6*	*4.8*
- *EM BRIC*	*(4.1)*	*(2.5)*	*(2.6)*	*3.4*

Within developed markets, the Pacific ex-Japan region trailed Europe. In Europe, the ECB indicated that slower-than-expected growth appeared to be temporary as the trade-dependent eurozone was hampered by uncertainty over global trade. The ECB remains on track to phase out its bond-buying program by year-end 2019. The euro slipped 1% versus the US dollar. Health care and energy were top performing sectors in 3Q, leading to Switzerland (+7.3%), Norway (+6.7%) and Sweden (+7%) being top performing countries. Concerns about reaching agreement on Brexit by the October summit weighed on UK (-1.7%) and Irish markets (-5.4%).

The Japanese market rallied late in Q3, returning 3.7% in US$ terms and 6.3% in local terms. Investors looked past global trade tensions and focused on the strength of the US economy – the top destination for Japanese exports.

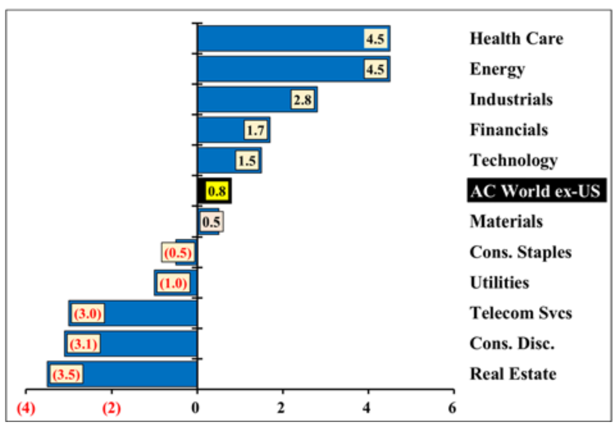
Prime Minister Shinzo Abe was re-elected to another three-year term, signaling continuity of his economic policy. Second quarter GDP growth was revised higher to 3% (from 1.9%; the fastest pace since 1Q16) and retail sales hit a 2018 high. Inflation rose to 0.9%, but remains below the BOJ's 2% target. The yen fell 2% versus the US Dollar. Top performing sectors included energy, telecom, health care, and financials.

In other areas of the Pacific region, Hong Kong pulled back -1% as property developers retreated amid expectations of higher mortgage rates. Macau casino stocks slumped on concerns that slower economic growth in China will hurt gaming revenue in the region. Australia fell -1% and New Zealand gained 2.4%.

Emerging markets retreated -1.1% in US$ terms in Q3. A combination of rising US interest rates and US dollar strength triggered a sell-off in Turkey (-20.5%) and Argentina (-9.4%, as the peso plummeted 29%), and raised concerns as to the vulnerabilities of other developing countries. Heightened US-China trade tensions and the slowing pace of economic growth contributed to a market drop of -7.5% in that country. Index heavyweights Tencent and Alibaba detracted significantly in 3Q (and year to date).

Indian markets declined (-2.5%) as nonperforming loans and the government's decision to consolidate ailing state banks rattled financial stocks. Going from "worst to first," Latin America (+4.8%) was the top performing emerging markets region. Mexico rose 6.9% after a new trade agreement was reached with the US. Brazil gained 6.1%, despite uncertainties ahead of October presidential elections. Emerging Europe rose 2.2%, as Russia, Poland, Hungary, and the Czech Republic all gained from 4% to 10.5%, and only Greece declined (-17%).

Figure 11: Ex-USA Sector Returns – 3rd Qtr 2018



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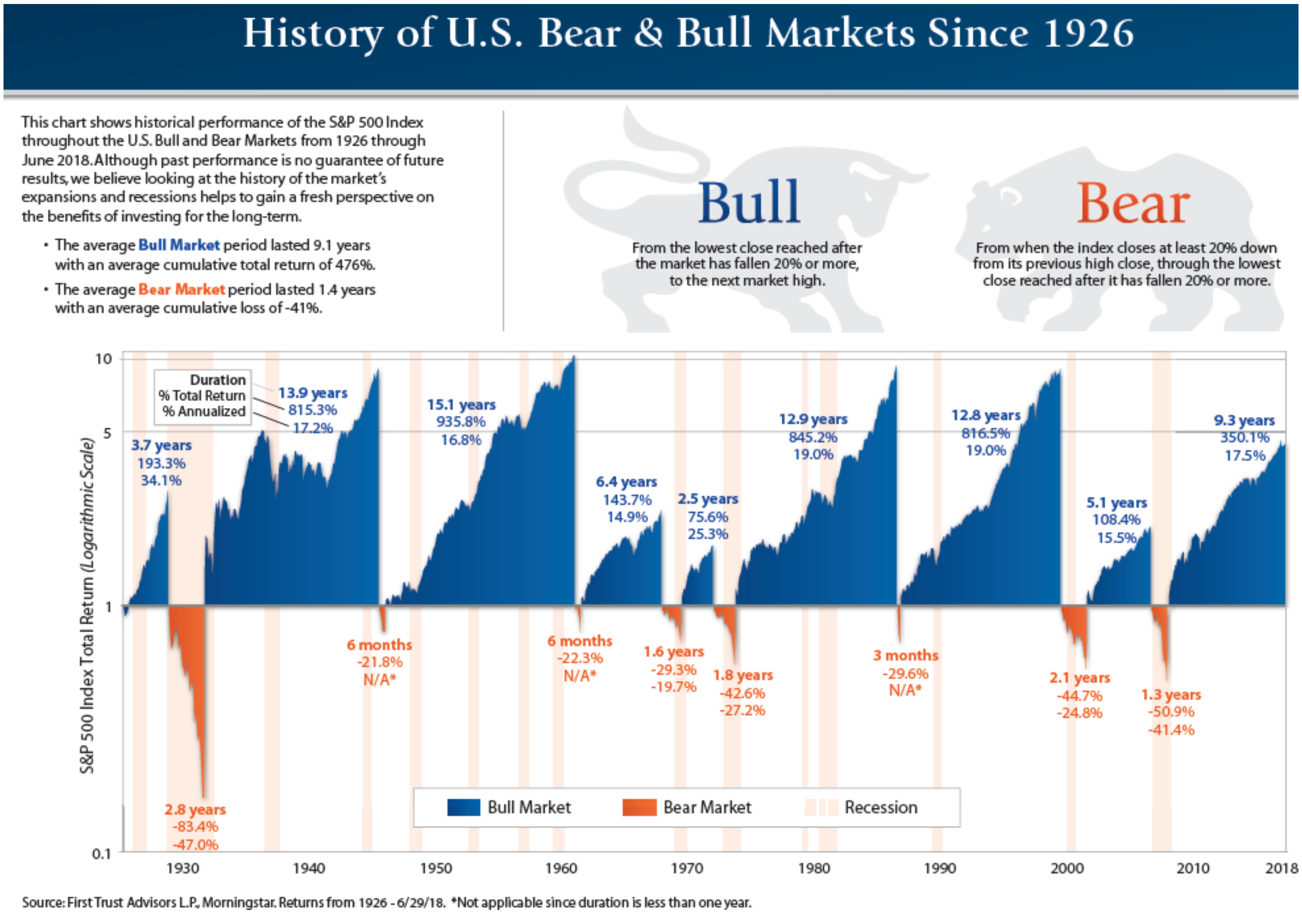

The above chart reflects very clearly that bull markets usually run a long time, while bear markets are short and savage. At 9.5 years old, the current recovery is longer than average. This cycle shares many late cycle characteristics with shorter cycles of the past (namely high debt levels, weakening credit standards, and limited excess capacity). Importantly, many metrics suggest that financial conditions are tightening, making it more difficult for the economy to continue to produce strong results.

A combination of factors has led to the current sell-off, which, in light of the still positive outlook for the US economy and corporate profits, is likely a normal pocket of volatility, rather than the beginning of a bear market. Daily market moves of 1% up or down are not uncommon and have occurred an average of 62 times a year since 1980. This year, we have seen 39 such moves; this feels high when compared to 2017 because 2017 was the least volatile year since 1965. In terms of volatility, this year's experience still remains below historical averages.

It is nevertheless a time for investors to be cautious. Monetary policy is gradually returning to normal, interest rates are moving higher, and the liquidity provided during and after the financial crisis is slowly being withdrawn. In some sense, the long US stock market uptrend since March 2009 was an extension or a derivative of monetary policy. Ultra-low interest rates pushed up the present value of future equity earnings, letting stock prices press higher. As interest rates return to more normal levels, this major propellent of stock prices will be fading.

Given a still constructive backdrop, investors should resist the urge to time the market or abandon equities altogether. Rather, given that the U.S. economy is into the "extra innings" of its cycle, this is a good time to ensure that portfolios are well balanced, diversified, and conservatively positioned, **with liquidity sufficient for the next 6-12 months of net spending.**

Sell high, buy low. See you next quarter!

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