FINANCIAL MARKETS COMMENTARY

DECEMBER 2018

TELEMUS®

Diana Joseph, Co-Chief Investment Officer
Direct: (312) 870-1902 • djoseph@telemus.com

Enrich your life. Enjoy your wealth.

FOURTH QUARTER HIGHLIGHTS

The global expansion continued, but at a moderating pace of around 3.5%, as the world moves from mid-to-late economic cycle characteristics. Tariff travails increased volatility and roiled international supply chains, fostered uncertainty, reduced output and curbed still-high confidence levels.

The United States remains in good shape with the lowest unemployment in almost 50 years, the least exposure to tariffs as exports are a modest percentage of GDP, and high but moderating confidence. However, the tax reductions are fading as an economic stimulator, corporate earnings growth will moderate significantly, and the Fed's four interest rate increases curtailed lending and real estate activity. The prolonged government shutdown will likely impact first quarter growth and could contribute to further reductions in confidence and thus, spending.

The tailwinds are waning and the headwinds we have long predicted are strengthening. The slow transition from QE (quantitative easing) to QT (quantitative tightening) is removing the punchbowl from world and financial market growth; the ECB ceased QE at the end of 2018, the Fed raised the rate it controls four times this year and GDP growth is expected to ratchet down.

U.S. equity markets plunged in the fourth quarter with no sector or capitalization spared. The S&P 500 lost -13.52% while small caps fell over -17% and large caps dropped over -12%. Foreign stocks had already been falling and emerging markets lost only -7.47% in the quarter. The action dropped returns worldwide into negative territory for the year. Bonds provided an anchor to windward with U.S. paper closing positive and higher risk and foreign paper losing a lot less than stocks. Real assets closed the year down while most alternative strategies also fell.

INDEX RETURNS AS OF 12/31/2018

BASIC INDEX RETURNS

BASIC INDEX RETURNS	MONTH TO DATE RETURN	QUARTER TO DATE RETURN	YEAR TO DATE RETURN	LATEST 3 YEARS RETURN	LATEST 5 YEARS RETURN	LATEST 10 YEARS RETURN
BALANCED INDEX (50% ACWI, 35% US Gov. Cr 1-5, 5% HFRX, 5% commodity, 5% bill)	-3.60%	-6.70%	-4.96%	12.49%	11.94%	71.97%
HFRX GLOBAL HEDGE FUND INDEX	-2.23%	-5.85%	-7.01%	1.03%	-3.20%	16.23%
CPI - SEASONALLY ADJUSTED	0.00%	0.35%	2.00%	6.23%	7.79%	19.62%
S&P 500 COMPOSITE	-9.03%	-13.52%	-4.38%	30.42%	50.33%	243.04%
LIPPER LARGE - CAP CORE	-8.84%	-13.19%	-5.11%	28.81%	42.16%	212.66%
WISDOM TREE LARGE CAP DIVIDEND	-8.91%	-10.83%	-5.58%	29.63%	46.62%	219.76%
MSCI ALL COUNTRY WORLD INDEX NET	-7.04%	-12.75%	-9.42%	21.13%	23.19%	146.89%
MSCI EAFE NET	-4.85%	-12.54%	-13.79%	8.87%	2.69%	84.52%
BLOOMBERG BARCLAYS MUNICIPAL BOND 5Y (4 - 6)	0.97%	1.58%	1.68%	4.47%	10.42%	36.12%
BLOOMBERG BARCLAYS US AGGREGATE	1.84%	1.64%	0.01%	6.30%	13.26%	40.75%
BANK OF AMERICA / MERRILL LYNCH US T - BILL 3MONTH	0.18%	0.57%	1.88%	3.08%	3.17%	3.81%

EXTENDED INDEX RETURNS

EXTENDED INDEX RETURNS	MONTH TO DATE RETURN	QUARTER TO DATE RETURN	YEAR TO DATE RETURN	LATEST 3 YEARS RETURN	LATEST 5 YEARS RETURN	LATEST 10 YEARS RETURN
RUSSELL 1000 GROWTH	-8.60%	-15.89%	-1.52%	37.30%	64.03%	314.77%
RUSSELL 1000 VALUE	-9.60%	-11.73%	-8.27%	22.35%	33.48%	188.50%
RUSSELL MIDCAP GROWTH	-9.07%	-15.99%	-4.75%	28.07%	43.02%	308.77%
RUSSELL MIDCAP VALUE	-10.50%	-14.96%	-12.29%	19.31%	30.36%	240.37%
RUSSELL SMALL CAP COMP GROWTH	-10.19%	-18.78%	-5.39%	30.50%	39.09%	323.75%
RUSSELL SMALL CAP COMP VALUE	-11.11%	-17.16%	-12.90%	20.25%	21.05%	192.99%
MSCI EM (EMERGING MARKETS) NET	-2.66%	-7.47%	-14.58%	30.39%	8.51%	116.29%
BLOOMBERG BARCLAYS US TREASURY BILL 6 MONTH	0.24%	0.62%	1.94%	3.64%	4.03%	5.68%
BLOOMBERG BARCLAYS US AGENCY	1.42%	1.90%	1.34%	4.87%	9.73%	22.79%
JP MORGAN EMERGING MARKET BOND INDEX(EMBI) + COMPOSITE	1.61%	-0.66%	-5.33%	12.38%	21.47%	102.19%
CITI GROUP WORLD GOVERNMENT BOND	2.39%	1.75%	-0.84%	8.29%	3.92%	16.33%
BLOOMBERG COMMODITY	-6.89%	-9.41%	-11.25%	0.89%	-36.92%	-32.00%
ALERIAN ENERGY MLP	-9.36%	-17.29%	-12.42%	-3.14%	-31.57%	149.69%
PHILADELPHIA STOCK EXCHANGE GOLD / SILVER	9.62%	8.41%	-17.13%	55.98%	-16.03%	-42.95%
LIPPER GLOBL NAT RES	-9.14%	-21.69%	-22.35%	9.40%	-27.46%	30.35%
LIPPER PRECIOUS METAL FUND	10.83%	8.50%	-14.11%	39.72%	-2.22%	-13.89%
MSCI WORLD REAL ESTATE	-5.36%	-4.65%	-6.36%	10.39%	26.30%	147.46%
LIPPER REAL ESTATE FUND	-7.69%	-7.51%	-6.28%	7.00%	39.38%	157.91%

Note: The data is cumulative not annualized. All data in U.S. dollars.

THE GLOBAL ECONOMY - SYNCHRONOUS DECELERATION TO MORE MODEST GROWTH

The global economy continues to follow the path we have outlined in the past few years. As we correctly predicted, the transition from QE to QT, has begun to impact global growth and markets. Add in global trade disruption and apprehension around job security worldwide and the recent deceleration in growth is no surprise. Neither, however, is it cataclysmic. “Global GDP growth is projected to ease gradually from 3.7% in 2018 to around 3.5% in 2019 and 2020… . In the near term, policy support and strong job growth continue to underpin domestic demand.” OECD Economic Outlook, November 2018 (OECD). However, it clear that the mild deceleration in the developed world is broad-based.

Real GDP growth revised down

*Year-on-year, %. Arrows for 2018 and 2019 indicate the direction of revisions since September 2018.**

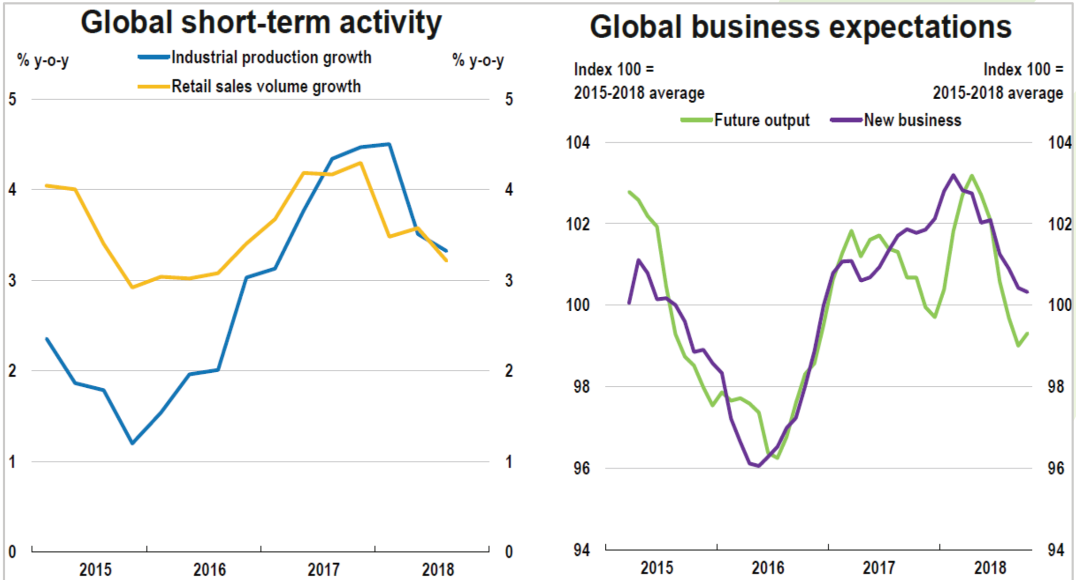
	2018	2019	2020		2018	2019	2020
World	3.7	3.5 ↓	3.5				
G-20	3.8 ↓	3.7 ↓	3.7				
Australia	3.1 ↑	2.9 ↓	2.6	Argentina	-2.8 ↓	-1.9 ↓	2.3
Canada	2.1	2.2 ↑	1.9	Brazil	1.2	2.1 ↓	2.4
Euro area	1.9 ↓	1.8 ↓	1.6	China	6.6 ↓	6.3 ↓	6.0
Germany	1.6 ↓	1.6 ↓	1.4	India[1]	7.5 ↓	7.3 ↓	7.4
France	1.6	1.6 ↓	1.5	Indonesia	5.2	5.2 ↓	5.1
Italy	1.0 ↓	0.9 ↓	0.9	Mexico	2.2	2.5	2.8
Japan	0.9 ↓	1.0 ↓	0.7	Russia	1.6 ↓	1.5	1.8
Korea	2.7	2.8	2.9	Saudi Arabia	1.7	2.6	2.5
United Kingdom	1.3	1.4 ↑	1.1	South Africa	0.7 ↓	1.7 ↓	1.8
United States	2.9	2.7	2.1	Turkey	3.3 ↑	-0.4 ↓	2.7

*The OECD Economic Outlook includes for the first time projections up to 2020.
Note: Dark orange for downward revisions of 0.3 percentage points and more. Light green and light orange for, respectively, upward and downward revisions of less than 0.3 percentage point. Difference in percentage points based on rounded figures. The European Union is a full member of the G-20, but the G-20 aggregate only includes countries that are also members in their own right.
1. Fiscal years starting in April.

Source: OECD, November 2018

THE GLOBAL ECONOMY - SYNCHRONOUS DECELERATION TO MORE MODEST GROWTH

The United States experienced a continuation of above trend growth, which did decelerate as the year progressed. The drag of rising interest rates was initially offset by tax cuts but eventually bit into lending and tariffs impacted. Growth in the Eurozone slowed more than expected in the second half of the year as trade wars moderated exports, and populism in the form of the yellow jackets and Brexit bubbled to the surface. Italy and France are likely to spend more to quell unrest while the U.K. may find itself in that same position. However, moderately expansionary fiscal policy should help to offset moderating monetary policy as the Eurozone ceases QE but does not yet embark on QT. China's growth was slowing before trade became an issue, as the country attempts to delicately navigate its transition from a producer to a consumer society. While the headlines blare about the Chinese GDP decline the fact remains that the 6.6% GDP growth projected for 2018 and the 6.3% growth projected for 2019 are the envy of all and represent very modest declines in the growth rate. Steadiness is partially attributable to a well-timed shift from tight to loose policy as the trade wars began to impact growth. The Japanese continue to grow beyond long term capacity as they keep long term interest rates near zero and QE gushing. History will tell if the debt accumulated was worth growth hovering around 1%.

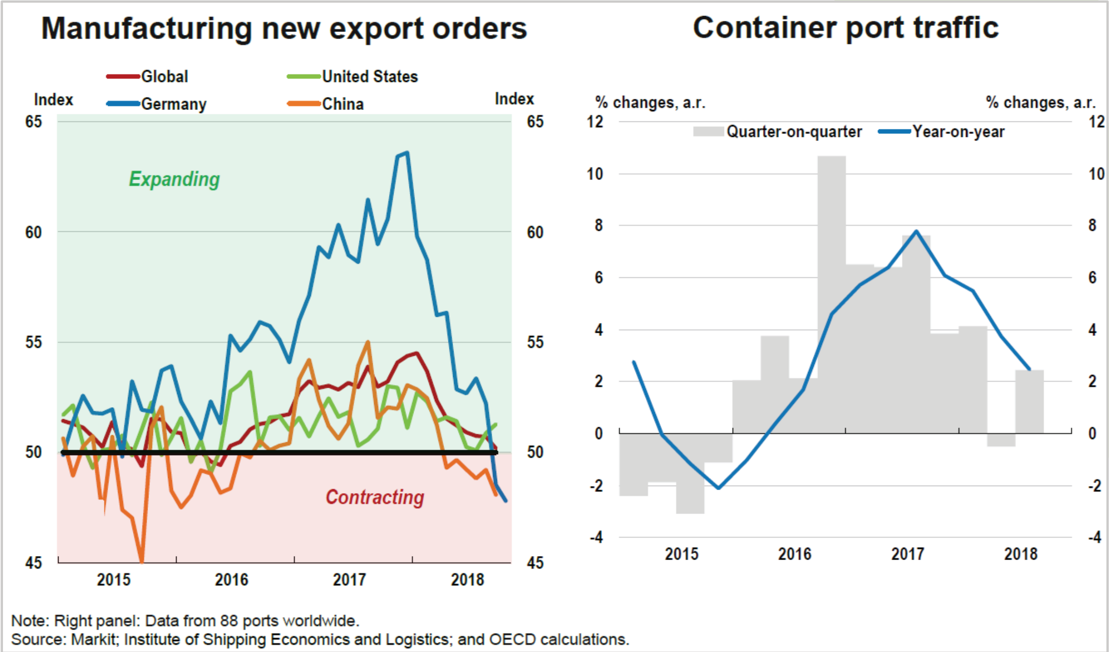


Note: Left panel: industrial production and retail sales aggregated using purchasing power parity weights. Data for retail sales volume growth are retail sales in the majority of countries, but monthly household consumption is used for the United States and the monthly synthetic consumption indicator is used for Japan. Retail sales data are not available for India. Estimates for 18Q3 based on data for the three months up to August. Right panel: Global composite PMI, 3-month moving average, data as of October 2018.
Source: OECD Economic Outlook Database; Thomson Reuters; Markit; and OECD calculations.

The central culprits of moderating growth in the developed world are the transition from QE to QT, less favorable macroeconomic policies, widespread trade friction and the advanced age of this economic cycle. The growth rates of global industrial production, retail sales volume and business expectations have all recently slackened somewhat.

THE GLOBAL ECONOMY - SYNCHRONOUS DECELERATION TO MORE MODEST GROWTH

Rising U.S. interest rates and currency are almost always detrimental for emerging economies. This year was no exception. [Trade wars and moderating developed country activity added to the uncertainty and projections for growth in the developing world dropped almost one-half percent from the 4.7% in our September letter to 4.2% now expected by the World Bank (Source, World Bank.2019. Global Economic Prospects, January 2019 (WB)].



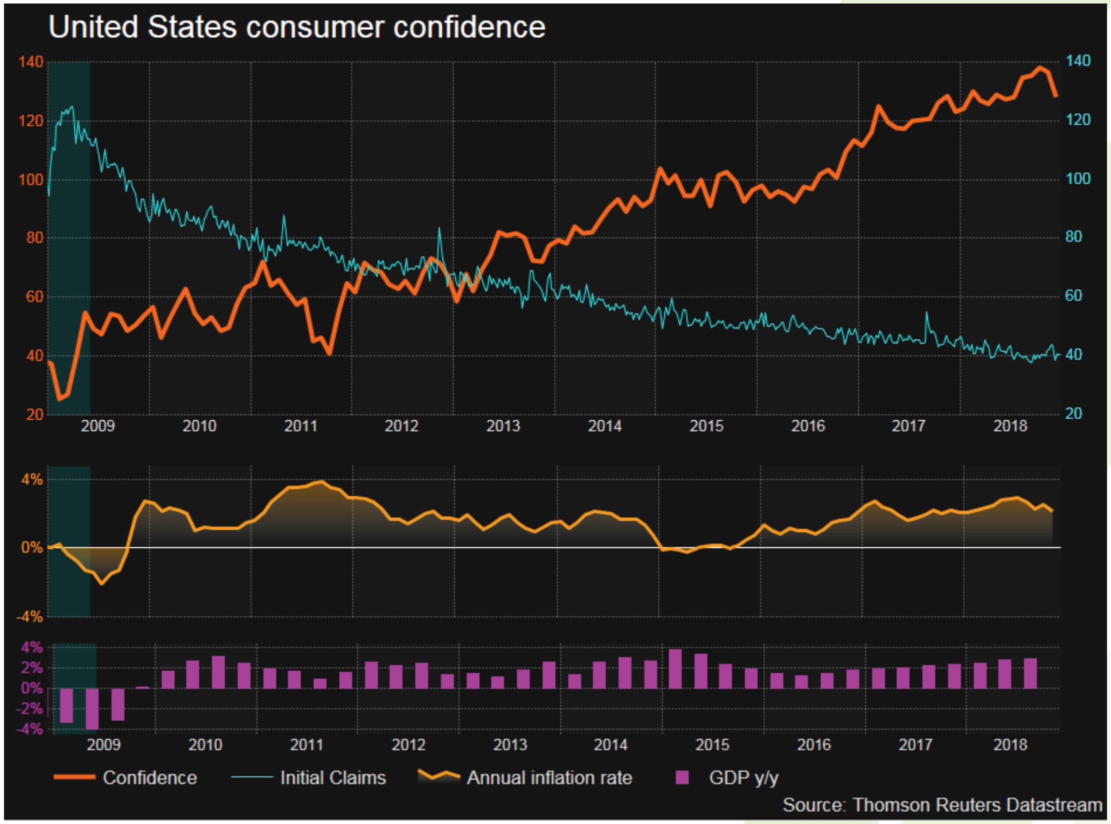
Source: OECD, November 2018

South Asia experienced the highest regional growth and is expected to retain leadership in 2019 led by India. The World Bank expects India to remain the fastest growing major economy in the world as the economy moves from the informal to the formal sector and the headwinds from demonetization and the Good and Services Tax wane. East Asia is also booming as growth in China, Indonesia and Thailand remain high. Latin American growth is improving from low levels led by Mexico and Brazil at growth projected at or a bit over, 2%. Not included is Venezuela whose economy has collapsed due to ferocious mismanagement. Inflation in Venezuela is expected to have hit 80,000% in 2018 (Source, Forbes.com/stevehanks). Russia, is expected to grow just 1.5% in 2019 while growth in the Middle East continues mixed with Saudi Arabia growing around 2%, Egypt's growth projected at 5.6% and Iran shrinking -3.6%.

Of course, tariffs have contributed to the global economic moderation. President Trump's bid to level what he perceives to be an unfair trade playing field has seriously disrupted business planning, supply chains and cross-country standing deals. Any progress on the trade front could be immediately positive worldwide.

THE U.S. ECONOMY - GROWTH IS MODERATING BUT AT A COMFORTABLE LEVEL

The Bureau of Economic Analysis, OECD and the Conference Board all expect full year 2018 GDP growth of 2.9% in the U.S. This is a comfortable number, albeit down in steps from the strong growth witnessed in the second and third quarters of this year. Consumer confidence remains at high levels despite drops in November and December, jobless claims continue to shrink to near 50 year lows recently, and inflation remains tame and close to target levels.



THE U.S. ECONOMY - GROWTH IS MODERATING BUT AT A COMFORTABLE LEVEL

The Federal Reserve however, acknowledged the moderating impact of trade dissonance, increases in U.S. interest rates and the waning salubrious effect of last year's tax cuts. "[T]here are two important differences in the policy outlook today versus next year. In early 2018 we saw a rising trajectory for growth; today, instead, we see growth moderating ahead… .The additional tightening of financial conditions we have seen over the past couple of months along with signs of somewhat weaker growth abroad have also led us to mark down growth and inflation projections a bit."(Source, Federal Reserve, Chairman Powell's Press Conference of December 19, 2018). At this conference the Fed dialed back projected continued rate increases, implicitly acknowledging that its move to QT coupled with its raising of rates could probably proceed more slowly given recent headwinds beyond its control. Note the reticence preceded the end-of-year stock market carnage.

With the government ratcheting up deficit spending, the world beginning to reel from tariff uncertainty and the recent government shutdown, the Fed is trying to navigate circumstances at home and abroad, not of its making. The government shutdown is now the longest in U.S. history. While estimates of its current and future impact vary widely, there is no doubt that the shutdown will slow first quarter GDP somewhat. Tariff tensions are also slowing growth so even if we reach a deal with China by the deadline, it is likely that first quarter growth will suffer. Longer term, growth here is expected to moderate. The Fed has a tough job, and one made bigger by the default of the grownups in charge of fiscal policy, the President and Congress. However, the capitulation raises the spectre that the 'Fed put' is alive and well and has been interpreted as such by the levitating markets in the New Year.

THE WORLDWIDE WIND DOWN IN QE WILL CONTINUE TO FOSTER VOLATILITY

The oceans of liquidity provided by Central banks to right the listing ship of the world economy post 2008 have accomplished their objective. They have also provided sustenance for a world intent on faster growth than it could generate without gimmicks and insulated world markets from normal declines. This cash cushion has bred dangerous complacency. There is a high correlation between market returns and QE.

Figure 4.

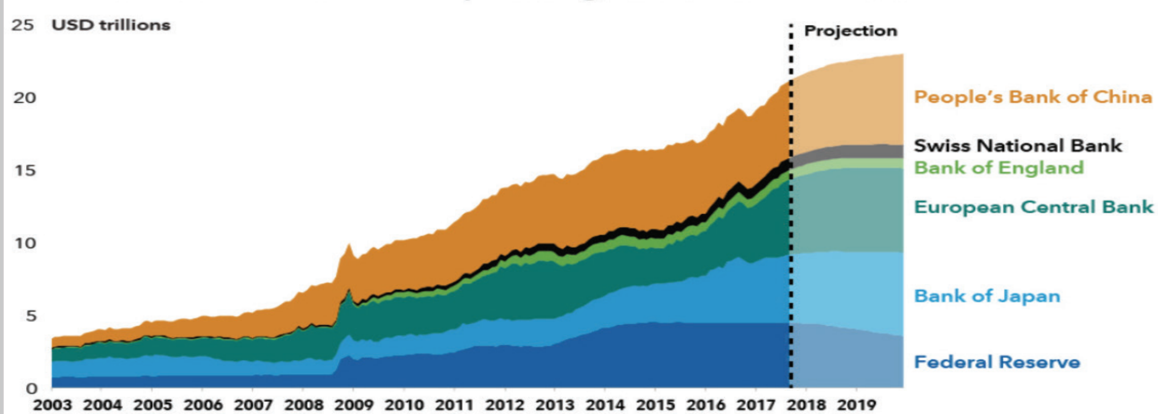
Note: QE1 (11/25/08) = Fed starts buying $1.24tn in mortgage securities. QE1 expanded (3/16/2009) = Fed starts buying $300bn in Treasuries. QE2 (11/3/10) = Fed starts buying $600bn in Treasuries. QE3 (9/13/12) = Fed starts buying $40bn/month in mortgage securities (open ended). QE3 expanded (12/12/12) = Fed starts buying $45bn/month in Treasuries.
Source: Federal Reserve Board, Standard & Poor's and Haver Analytics.

Source: Yardeni Research

Through March 2018

The chart of the largest Central banks' printing reveals that while the upward trajectory of printing has slowed in some places, it remains on full throttle in others. QE does not remain where it is printed but moves around the globe where companies and people spend on goods, services or investments. QE has become massive and will take a long time to normalize.

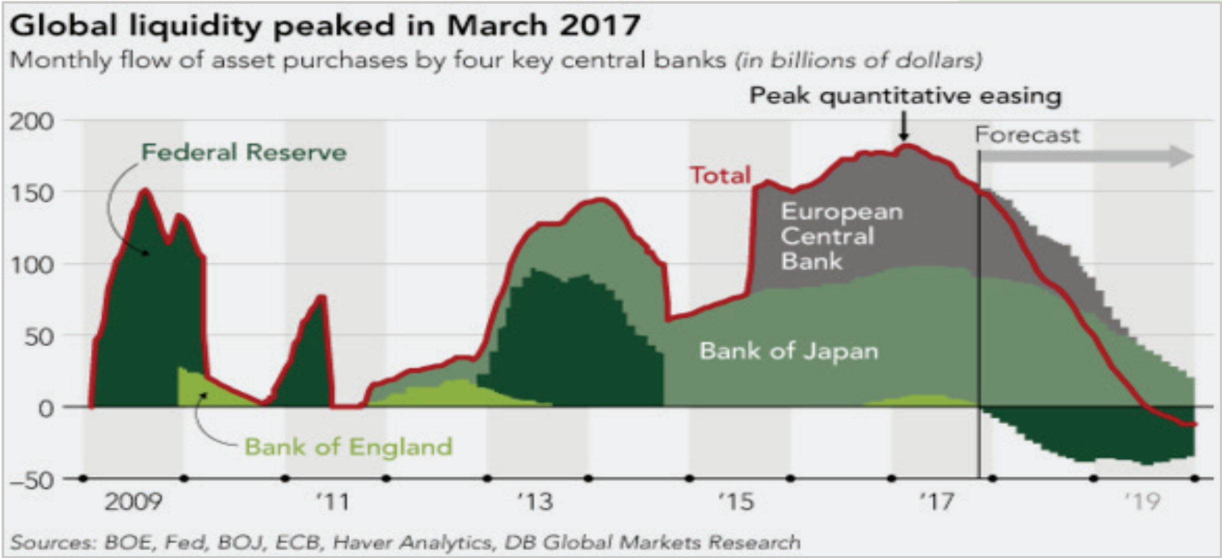
Global Central Bank Assets Will Keep Growing, Even as the Fed Pulls Back



Sources: Capital Group, Thomson Reuters. As of 8/31/2017.

THE WORLDWIDE WIND DOWN IN QE WILL CONTINUE TO FOSTER VOLATILITY

However, the rate of growth has fallen in 2018 and is forecast to plummet through 2019. Absent another gimmick to create faster-than-sustainable growth, or renewed QE to counter another crisis, it is clear that we are seeing, and will continue to see, a resumption of what is normal volatility.



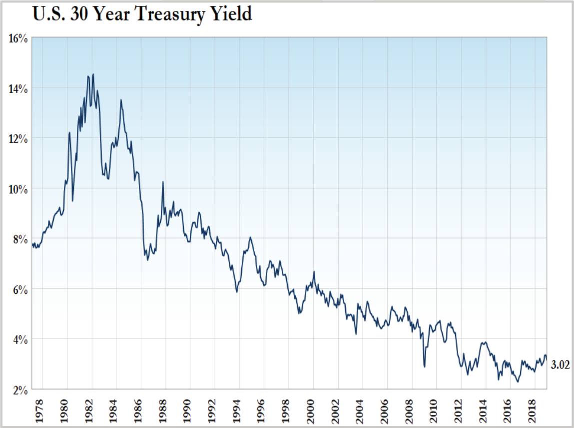
INTEREST RATES AND BONDS

What a difference a year makes! In the beginning of 2018 cries of 'the bond market is dead and rates will keep rising' were heard throughout the land, and the hysteria resounded across all segments of financial media. We said that ten and thirty year bonds must break out through prior highs in a decisive and sustained fashion (a couple months) before we would re-position for a break in the 37-year downtrend in falling interest rates. This is because a sustained rise in rates must be a response to burgeoning economic growth, which was unlikely given the developed world's demographics, or a response to the excesses of too much debt world–wide, a crisis we think will occur, but well in the future. Well, rates did breakout up past recent highs, for a nanosecond, before falling back decisively, and staying back.

Source: Eikon through 12-31-18

Source: Eikon through 12-31-18

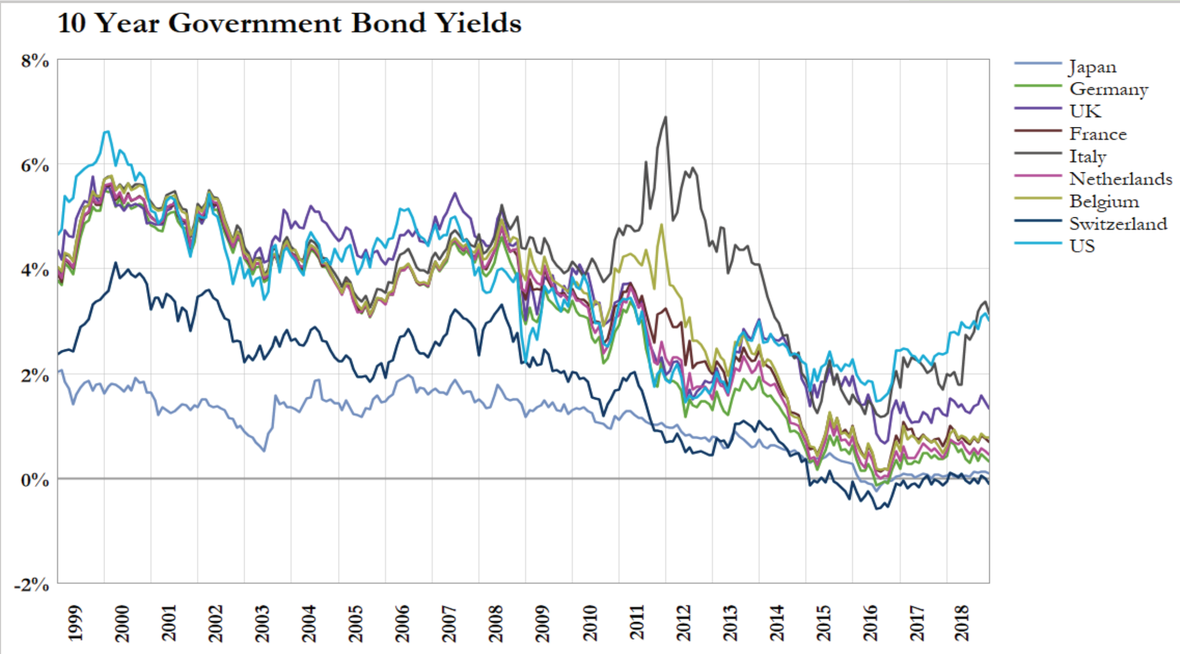
Source: Eikon through 12-31-18



Source: Eikon through 12-31-18

INTEREST RATES AND BONDS

Rate policy normalization is proceeding very slowly throughout the world as Central banks try to dial back the largesse provided to alleviate the 2008 financial crisis without destroying the fragile growth they have created by providing oceans of liquidity and rates near or below zero. Again, their actions were required in default of alternatives which should have been provided by our, and other, governments. Normalization is however, proceeding, as the chart reflects.



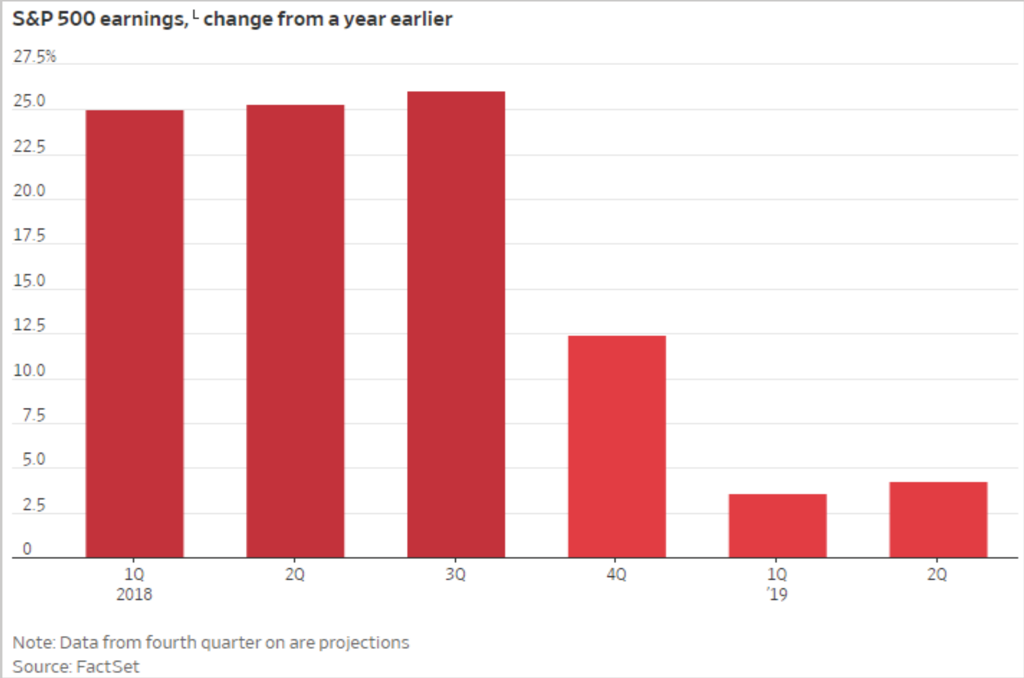
Source: Eikon as of 12-31-18

Fixed income provided an anchor-to-windward throughout the year, with short to intermediate maturities and high quality credits, performing the best. The 35 plus year downtrend in rates, remains intact. Shorter term paper was positive with 1-3 year Treasuries up +1.56%, 3 year municipals rising +1.76% and 1-3 year corporate paper gaining +1.64% for the year. The longer term 10-20 year Treasury index finished down slightly, at -0.02% while the Bloomberg/Barclay Municipal 10 year Index was +1.41%. Long bonds, as measured by the Bloomberg/Barclays Long Credit Index fell -6.76% as credit spreads widened. Floating rate notes ended the year up a scant +1.63% while TIPS declined -1.26% as expectations for global expansion moderated. Risk aversion ratcheted up so high yield corporate paper finished the year down -2.08% despite higher yields. Mortgage backed securities gained +0.99%, world government bonds lost -0.84% and emerging market paper fell -5.33% despite higher yields.

Neither strengthening economics nor Central banks will be the cause of rates rising past levels seen in the past ten years. Rather, a belated recognition of unsustainable debt levels across the globe will probably be the impetuous for the next break out in rates to the upside.

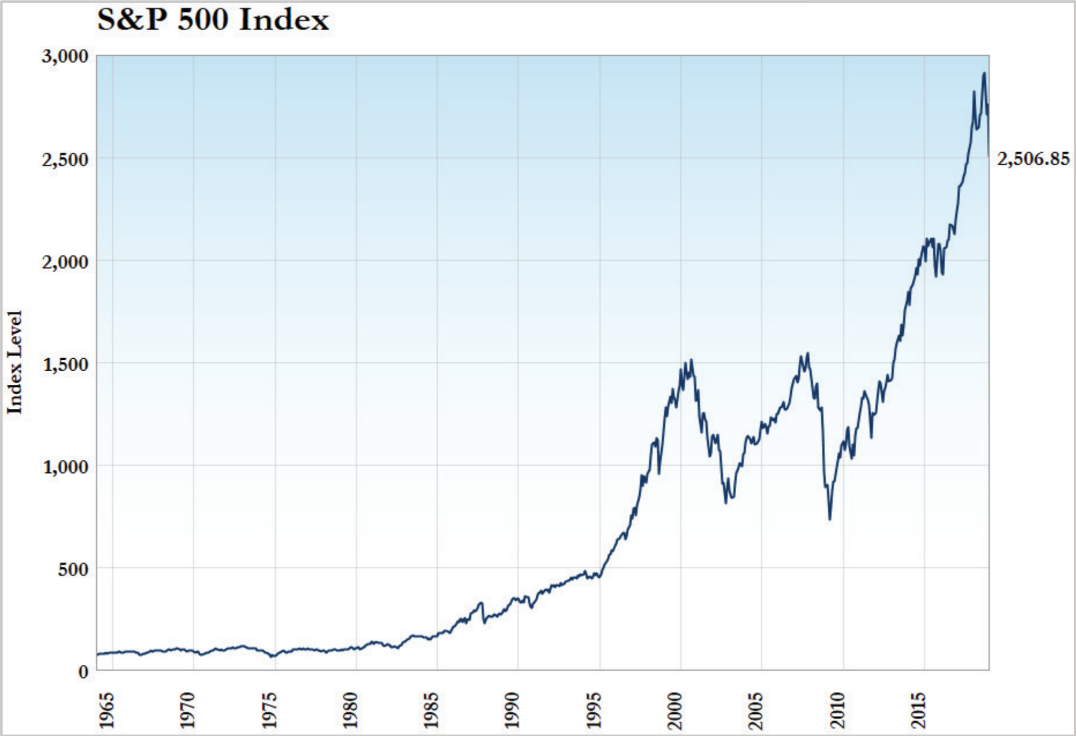
EQUITIES

Returns on diversified portfolios were mostly negative as late losses in U.S. equities were exacerbated by larger declines in international equities. The S&P 500 finished the year negative, down -4.38% while the MSCI EAFE declined -13.79%. High dividend payers lost -5.58%, while the NASDAQ had a more muted decline falling -2.84%. The disparity between the returns of 'growth' and 'value' stocks was particularly wide during the year. U.S. growth stocks finished down -1.52% (large cap growth), -4.75% (mid cap growth) and -5.39% (small cap growth). U.S. value stocks returned -8.27% (large cap value), -12.29% (mid cap value) and -12.90% (small cap value). Among international equities, the European component of the MSCI EAFE declined -14.86%. Frontier and emerging markets experienced the deepest losses as frontier markets ended the year down -16.41%, and emerging bourses were down -14.58% (in dollar terms). It is widely known that the corporate earnings growth rate will continue to decelerate into 2019 and beyond.



EQUITIES

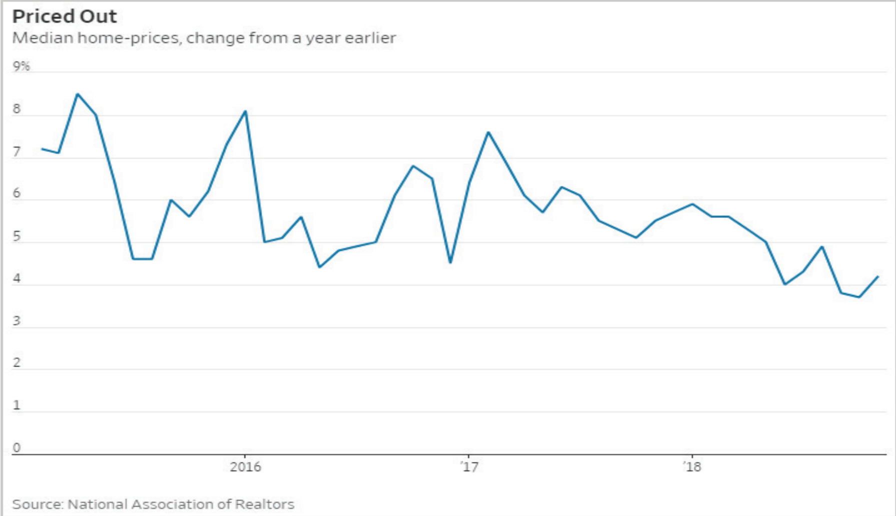
Stock and real estate have climbed in tandem with the growth in QE and we expect that the process of moving to QT will continue to impact equity markets. However, the steep market decline at year-end reset valuations closer to historical levels and this provides the opportunity for some growth in valuations of worthy companies during what we expect will be a choppy year. Despite how December felt, the markets have climbed long and far, and December was only a blip.



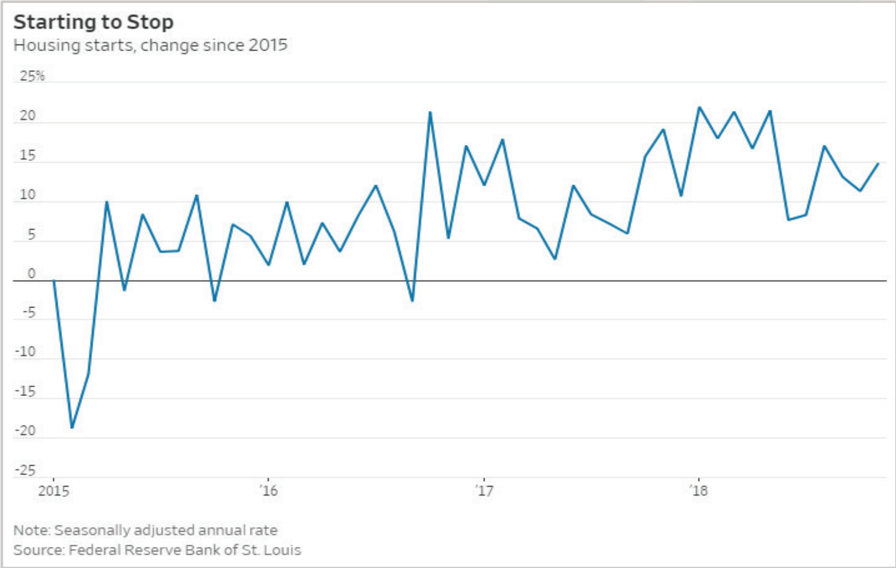
Source: Eikon as of 12-31-18

REAL ASSETS

Real asset returns were mostly challenged in the year, with the U.S. dollar being the notable gainer up +4.39%. For 2018, the Bloomberg Commodity Index lost -11.25%, as precious metals were down -14.11% and crude oil declined -25.32%. Global real estate lost -6.36% during the year. Global natural resources fell -22.35%, and world real estate lost 'only'6.36% as interest rates begun to moderate as growth slowed. U.S. housing may slow despite the recent decline in rates due to uncertainty around the government shutdown and world trade.



There is a chance that gold will shine a bit brighter this year as the Dollar should hold or lose value and major gold producers combine and rationalize costs.



ALTERNATIVES

Alternative returns were broadly negative. The HFRX Global Hedge Fund Index declined -6.72%. The HFRX Equity Hedge Index declined -9.42%; the HFRX Event Driven Index lost -11.68%, while macro strategies fell -3.25%. Agriculture lost -7.07% as tariffs upended global supply chains and some buyers found alternate sources. Many strategies marketed as "uncorrelated" did not deliver. Many low-beta strategies barely covered their fees while flawed assumptions and rapid packaging marred returns of some investments that were indeed uncorrelated.

CONCLUSION

The best market days are probably behind us but there is ample opportunity for opportunistic and strategic purchases/sales. Computer driven trading distorts moves up and down and present added help in buying at lower prices and selling at higher ones. Correlations should continue to widen as QE transitions to QT and we see potential in emerging markets and perhaps in some metals and energy. Get used to the volatility and use it.

TELEMUS®

Enrich your life. Enjoy your wealth.