FINANCIAL MARKETS COMMENTARY

SEPTEMBER 2018

TELEMUS®

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THIRD QUARTER HIGHLIGHTS

September marked the 10-year anniversary of the inception of the Great Recession. We delve into the current quandary we are faced with right after the returns page.

The global growth rate ratcheted down slightly to about 3.7% as uncertainty around tariffs and trade accelerated.

Projections for U.S growth in the third quarter have moderated to a still healthy 3.2% pace. However, GDP growth is projected to decline from here.

The tailwinds are slowing, and the confluence of difficult events which we have discussed for a long time is in sight. Rising interest rates, slowing GDP growth and the transition from Quantitative Easing (QE) to Quantitative Tightening (QT) will likely increase volatility and reduce future returns.

U.S. stock markets rose broadly, paced by large growth stocks while international equities struggled. Short-term fixed income remained positive, but returns fell with duration. Emerging equity and debt were hit by currency and monetary tightening. Alternative returns remain broadly mixed at low levels while real assets mostly sank.

INDEX RETURNS AS OF 9/30/2018

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 (25% ACWI, 60% US Gov. Cr 1-5, 5% HFRX, 5% commodity, 5% bill)	0.21%	2.13%	1.86%	22.70%	24.45%	61.48%
HFRX GLOBAL HEDGE FUND INDEX	-0.69%	-0.39%	-1.23%	6.66%	5.20%	7.19%
CPI - SEASONALLY ADJUSTED	0.00%	0.39%	1.59%	6.01%	7.65%	15.07%
S&P 500 COMPOSITE	0.57%	7.71%	10.56%	61.43%	92.10%	209.62%
LIPPER LARGE - CAP CORE	0.63%	7.37%	9.32%	57.53%	79.35%	180.37%
WISDOM TREE LARGE CAP DIVIDEND	0.67%	7.15%	5.89%	55.19%	80.35%	182.44%
MSCI ALL COUNTRY WORLD INDEX NET	0.44%	4.28%	3.83%	45.82%	51.52%	119.68%
MSCI EAFE NET	0.87%	1.35%	-1.43%	30.34%	24.12%	68.88%
BLOOMBERG BARCLAYS MUNICIPAL BOND 5Y (4 - 6)	-0.55%	-0.20%	0.10%	3.52%	9.62%	39.27%
BLOOMBERG BARCLAYS US AGGREGATE	-0.64%	0.02%	-1.60%	3.99%	11.28%	44.82%
BANK OF AMERICA / MERRILL LYNCH US T - BILL 3MONTH	0.15%	0.49%	1.30%	2.53%	2.60%	3.45%

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	0.56%	9.17%	17.08%	75.18%	115.36%	280.75%
RUSSELL 1000 VALUE	0.20%	5.71%	3.92%	46.41%	66.35%	154.35%
RUSSELL MIDCAP GROWTH	-0.43%	7.58%	13.39%	58.73%	84.26%	253.44%
RUSSELL MIDCAP VALUE	-0.79%	3.30%	3.14%	44.67%	66.39%	191.42%
RUSSELL SMALL CAP COMP GROWTH	-1.75%	6.79%	16.49%	66.49%	85.71%	276.70%
RUSSELL SMALL CAP COMP VALUE	-1.73%	1.97%	5.15%	48.60%	58.68%	166.87%
MSCI EM (EMERGING MARKETS) NET	-0.53%	-1.09%	-7.68%	41.85%	19.43%	69.25%
BLOOMBERG BARCLAYS US TREASURY BILL 6 MONTH	0.16%	0.47%	1.31%	3.00%	3.41%	6.14%
BLOOMBERG BARCLAYS US AGENCY	-0.43%	-0.01%	-0.54%	2.26%	7.50%	28.13%
JP MORGAN EMERGING MARKET BOND INDEX(EMBI) + COMPOSITE	2.79%	1.48%	-4.70%	15.13%	23.06%	93.80%
CITI GROUP WORLD GOVERNMENT BOND	-1.02%	-1.62%	-2.55%	5.12%	1.02%	24.40%
BLOOMBERG COMMODITY	1.92%	-2.02%	-2.03%	-0.34%	-31.10%	-47.49%
ALERIAN ENERGY MLP	-1.57%	6.57%	5.90%	13.88%	-12.89%	140.75%
PHILADELPHIA STOCK EXCHANGE GOLD / SILVER	-1.60%	-20.11%	-23.56%	40.93%	-30.23%	-50.32%
LIPPER GLOBL NAT RES	2.05%	-1.10%	-0.83%	40.29%	-4.43%	6.00%
LIPPER PRECIOUS METAL FUND	-0.28%	-15.32%	-20.84%	26.86%	-21.75%	-27.61%
MSCI WORLD REAL ESTATE	-2.32%	-1.04%	-1.79%	21.39%	31.24%	81.32%
LIPPER REAL ESTATE FUND	-1.69%	1.18%	1.34%	23.25%	49.34%	73.02%

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

THE BEGINNING OF THE END OR THE END OF THE BEGINNING?

Easy money becomes tighter, debt piles up but economic growth is good.

A host of unconventional emergency measures, including quantitative easing, prevented a global depression in 2008 and its aftermath. However, Central banks kept printing long after the acute crisis was averted on the theory that only heroic and prolonged stimulus measures could conquer the economic damage which had been inflicted. These oceans of liquidity have provided the sustenance for a world hungry for more growth than is reasonable or sustainable given where we are. The cash cushion thus provided has bred unjustified complacency, and as with so many 'fixes', it planted the seeds for future problems. The future is in view. The Central banks would like to return to normalcy slowly so that they again have the arrows of monetary stimulus and lower rates in their quivers to address the next crisis.

There has been a high correlation between market returns and QE. Is it reasonable to expect the correlation to hold as tightly on the way down as it has on the way up? Yes, but there are so many other factors to consider that you cannot just take your chips and go home. First, where would you put the money? If inflation heats up, it would lose value just sitting. Second, global growth is strong and may take the supportive baton from QE. Third, there is the 'Fed put', the high likelihood that the Central banks would renew money printing (and asset price appreciation) should the markets really wallow. So while the caution flag is up, no one is smart enough to call the final play and the principles of diversification continue to apply.

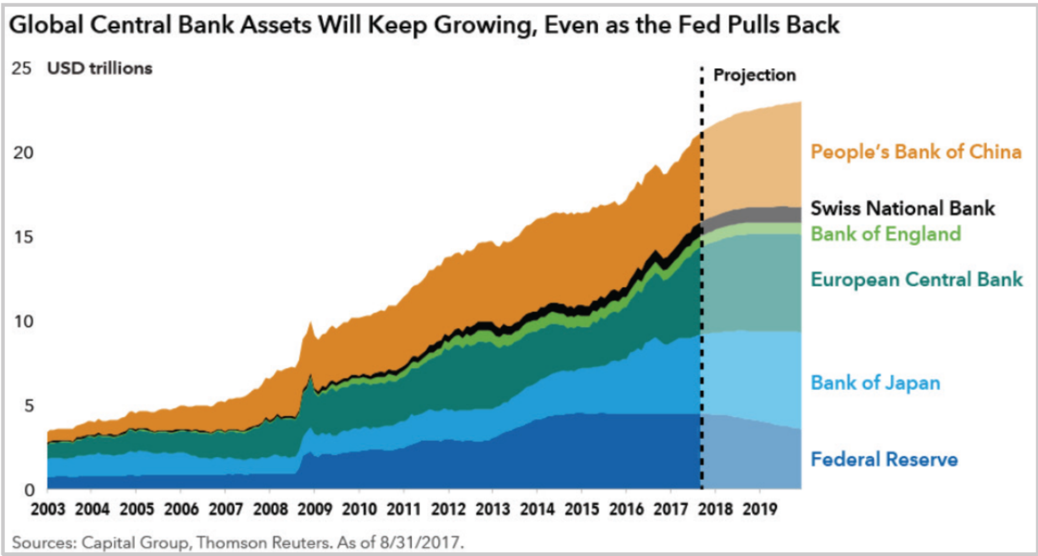
Figure 4.

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

SPECIAL UPDATE ON WHERE WE ARE TEN YEARS POST-CRISIS

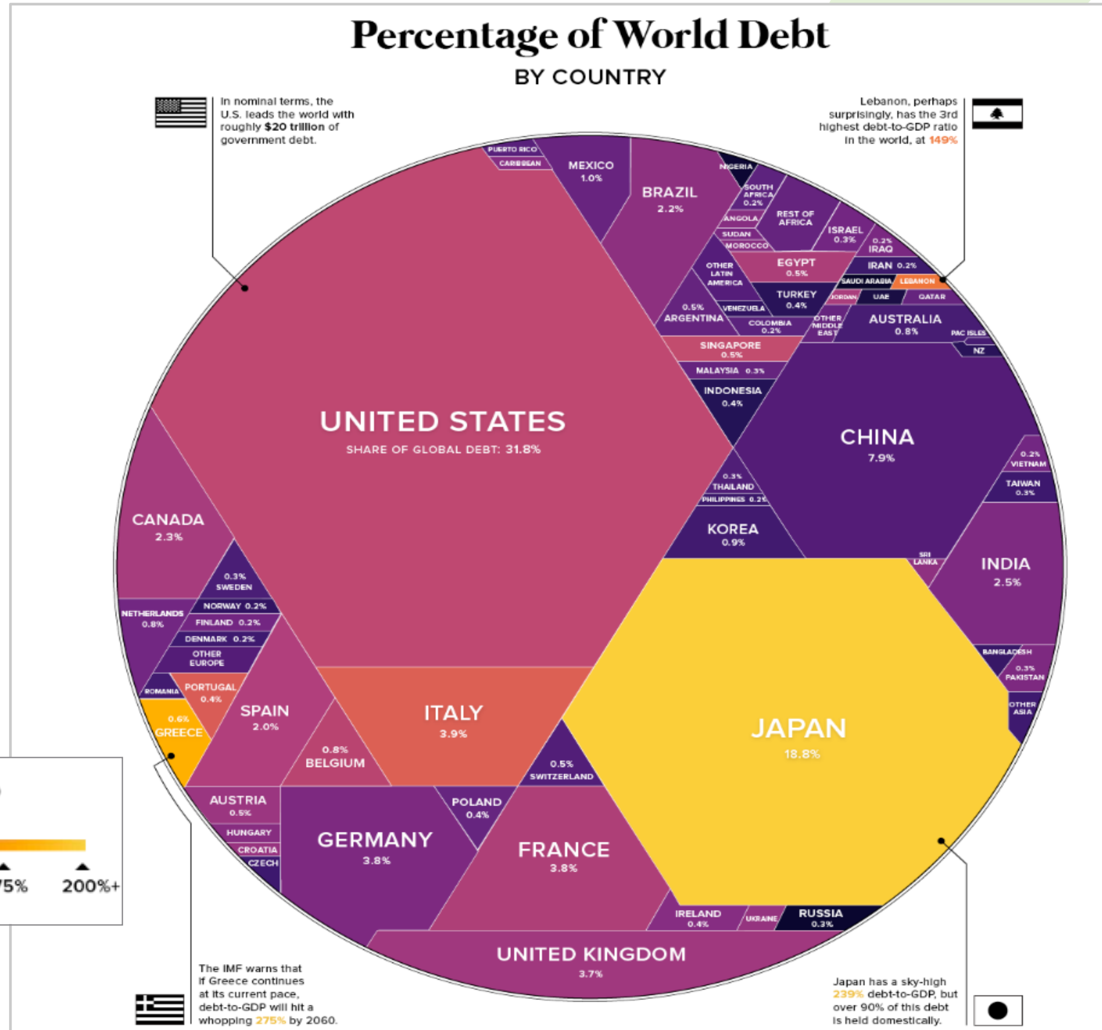
The growth rate of QE has been slowing and transforms to QT (quantitative tightening) in 2019. That is, the world's Central banks will start removing the punchbowl in early 2019. The United States has been the first of the Central banks to stop printing. The European Central Bank (ECB) ends printing in December of this year, and the trajectory of world printing growth is projected to slow dramatically. Compare the trajectory of printing on each side of the dotted line in the chart to the right.

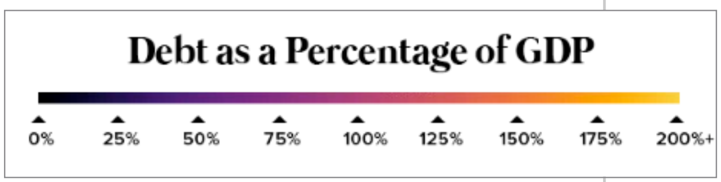


SPECIAL UPDATE ON WHERE WE ARE TEN YEARS POST-CRISIS

The result of global QE is that the governments of the world are severely indebted. The International Monetary Fund (IMF) most recently estimated that governments have amassed 63 trillion dollars in debt, of which the U.S. constitutes almost one-third.

United Nations of Debt





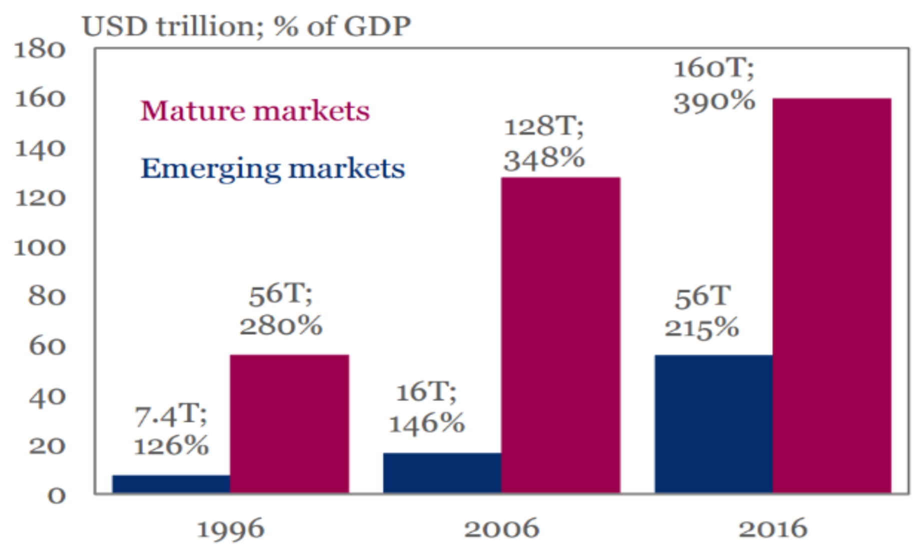
Source: Visual Capitalist

SPECIAL UPDATE ON WHERE WE ARE TEN YEARS POST-CRISIS

The debt explosion has not been limited to the developed world. The chart below reflects that the increases pervade both mature markets and developing markets. The chart also reflects the almost unfathomable percentages that debt has become of GDP. Some say that we can 'grow' our way out of the debt. Others have extended the idea that perhaps the debt does not ever have to be paid back. At a minimum, it is likely that the current debt levels will foreclose as much printing the next time it is needed.

The confluence of flat but now rising interest rates, the substitution of QT for QE and reduced growth present strong headwinds. Fortunately, the global economy remains strong enough for now. However, we have warned often of increased resulting volatility and think it will continue. This presents both risks and opportunities; unemotional assessments should continue to prove rewarding.

Chart 1: Total Global Debt (all sectors)



Source: IIF, BIS, Haver.

THE GLOBAL ECONOMY –
STILL GROWING BUT SYNCHRONICITY FRAYING

"The steady expansion underway since mid-2016 continues, with global growth for 2018-2019 projected to remain at its 2017 level….[H]owever, the expansion has become less balanced and may have peaked….Downside risks to global growth have risen in the past six months and the potential for upside surprises has receded." International Monetary Fund (IMF), World Economic Outlook (WEO), October 2018. Both the IMF and the Organization for Economic Cooperation and Development (OECD) in its Interim Economic Outlook (IEO) now project a 3.7% rate of global growth for 2018-2019. This represents a downshift of 0.2% for the IMF and 0.3% for the OECD over the past few months. The chart below reflects the direction of revisions by country since May.

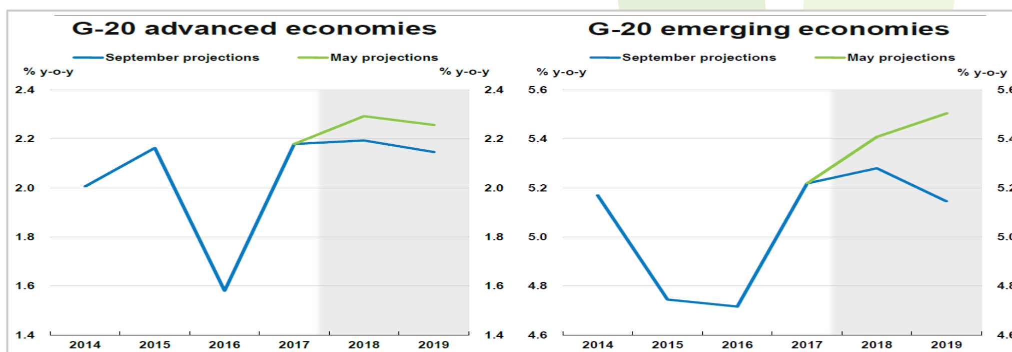
Downward revisions reflect numerous factors. Rapidly rising U.S. interest rates and normalization of U.S. monetary policy are spurring capital outflows from the 'innocent bystander' emerging markets. To contain these outflows developing countries have rapidly increased rates, undermining growth. Increasing trade frictions are hitting exporters where they live while slightly softer Eurozone growth also contributed. Note, the steeper revisions to the growth of emerging economies.

Real GDP growth revised slightly down

Year-on-year, %. Arrows indicate the direction of revisions since May 2018.

	2017	2018	2019		2017	2018	2019
World	3.6	3.7	3.7	G-20	3.8	3.9	3.8
Australia	2.2	2.9	3.0	Argentina	2.9	-1.9	0.1
Canada	3.0	2.1	2.0	Brazil	1.0	1.2	2.5
Euro area	2.5	2.0	1.9	China	6.9	6.7	6.4
Germany	2.5	1.9	1.8	India[1]	6.7	7.6	7.4
France	2.3	1.6	1.8	Indonesia	5.1	5.2	5.3
Italy	1.6	1.2	1.1	Mexico	2.3	2.2	2.5
Japan	1.7	1.2	1.2	Russia	1.5	1.8	1.5
Korea	3.1	2.7	2.8	Saudi Arabia	-0.7	1.7	2.6
United Kingdom	1.7	1.3	1.2	South Africa	1.2	0.9	1.8
United States	2.2	2.9	2.7	Turkey	7.4	3.2	0.5

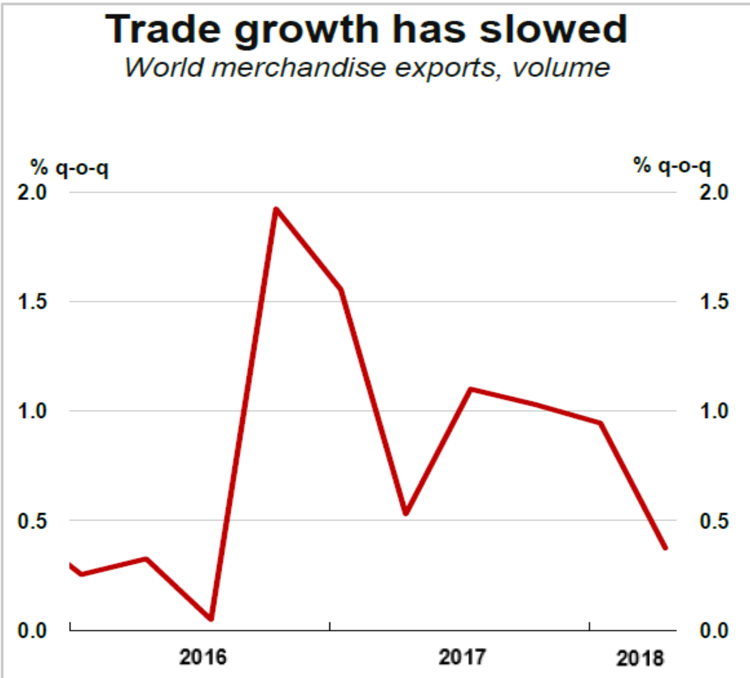
1. Fiscal years starting in April. Source: OECD Economic Outlook released on 9/20/18



Source: OECD Economic Outlook released on 9/20/18

THE GLOBAL ECONOMY –
STILL GROWING BUT SYNCHRONICITY FRAYING

Growth in world trade has fallen off dramatically as tariffs start to really bite.



Source: OECD Economic Outlook released on 9/20/18

THE GLOBAL ECONOMY – STILL GROWING BUT SYNCHRONICITY FRAYING

While tariffs might hurt U.S imports, exports represent only 8% of U.S.'s GDP versus 19% of China's GDP, 37% of South Korea's GDP, 16% of Eurozone's GDP and 25% of Canada's GDP. It is easy to see why the U.S. might have chosen this battle rather than some other fight.

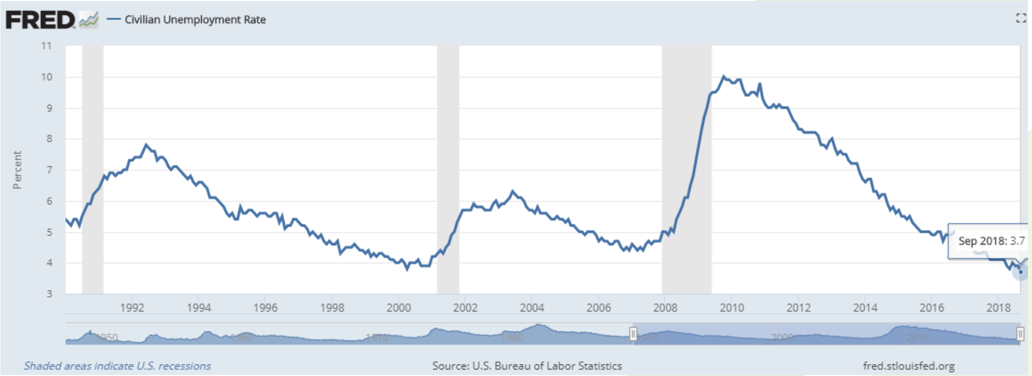
Longer term, growth in the developed and developing parts of the world is expected to diverge further. Demographics haunt productivity in the developed world while benefiting the emerging world. More young people help support the growing population of elderly and move growth forward. Of course, the economic argument ignores the environmental one. We truly have reached the zero-sum game. Growth in the developed world is still projected to peak in 2018, slow in 2019 and slow a bit further in 2020 before normalizing closer to long-term potential under 2.0%. The U.S. should peak at about 2.9% in 2018 and slow to 1.8% by 2020; the Eurozone is expected to peak at 2.0% in 2018 and decline to 1.9% growth in 2019 as Germany is hard-hit by trade; U.K. growth is expected to remain tepid, in the 1.5% area; Japan's growth rate is expected to slow to a bit over 1.0% in 2018 and fall to under 1.0% the following year; Canada's growth will moderate in 2018 to about 2.1% and to about 2.0% in 2019; while Korea should grow 2.8% in 2018 and 2.6% in 2019. China should maintain growth over 6.0%, India over 7.0%, and Indonesia growth over 5.0% through 2019. Growth in developing economies overall is expected to remain around 4.7% in 2018/2019 and to then rise a bit over ensuing years.

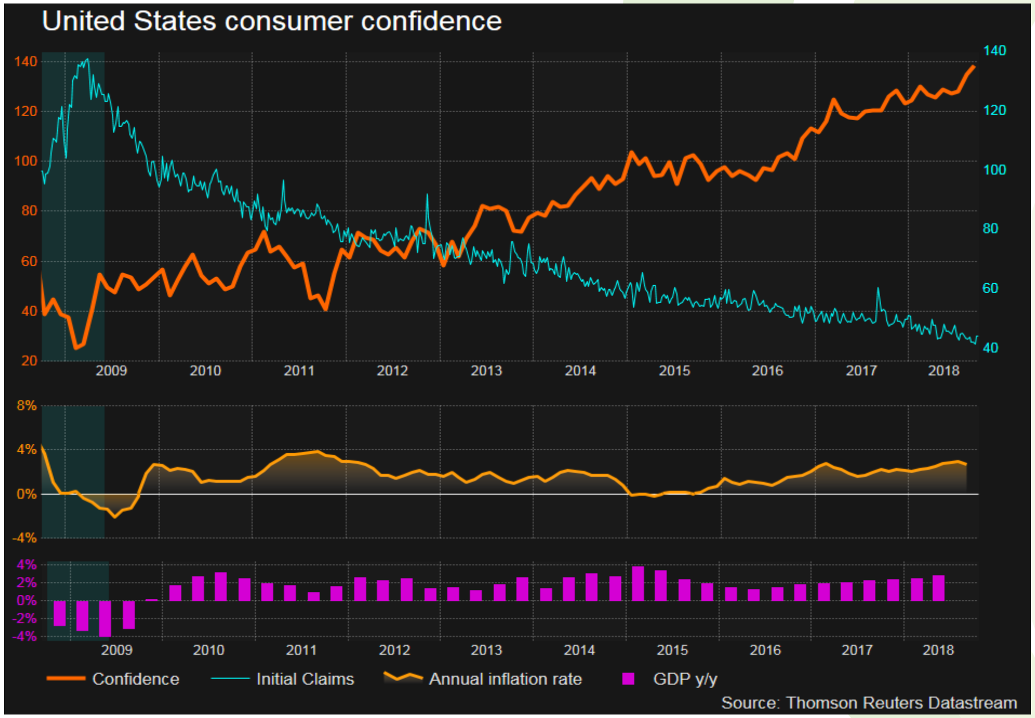
THE U.S. ECONOMY–
WE HAVE PROBABLY PLATEAUED BUT THE ECONOMY REMAINS STRONG

The rate of U.S. GDP growth cooled somewhat from the second quarter's blistering pace. The Wall Street Journal's September consensus of economists reflects a 3.2% growth rate for the third quarter, down from 4.2% in the second quarter. America's economy has been resilient and strong. Despite slowing momentarily in August, U.S. retail sales rose 6.6% year-over-year which followed an 0.8% jump in July alone. The unemployment rate fell to 3.7% in September, its lowest level in almost 49 years.

Average hourly earnings continue to trend up and have risen 2.8% year-over-year. With the job market tightening, it is likely that wage pressure will continue, thus providing consumers with more spending power. Consumer confidence remains robust and savings are healthy.

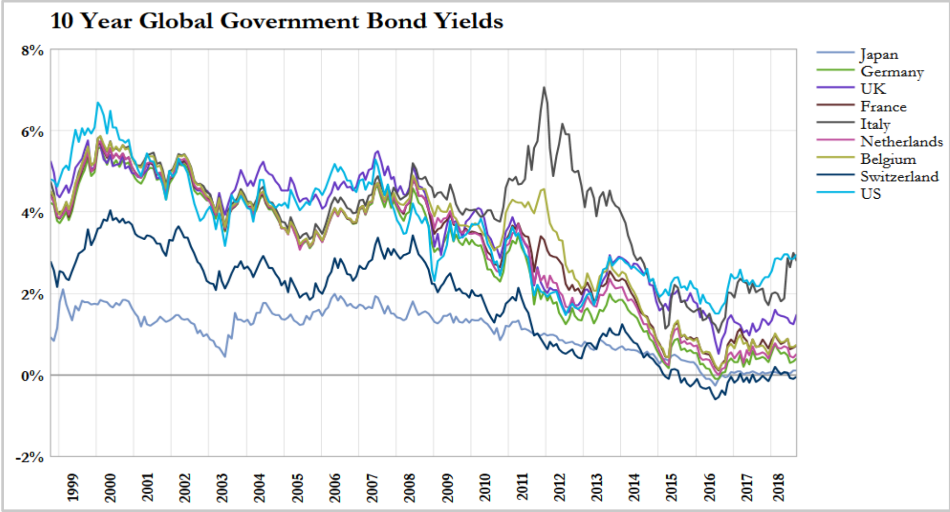
Longer term, the adrenalin rush of tax cuts and deficit spending will wane as the impact of long-term demographics reasserts itself. Labor force participation has fallen to a little under 63% of the population, life expectancies continue to extend, and productivity remains relatively low. Accordingly, growth in America is forecast to slow to potential of around 1.8-2.0% in 2020 and beyond.



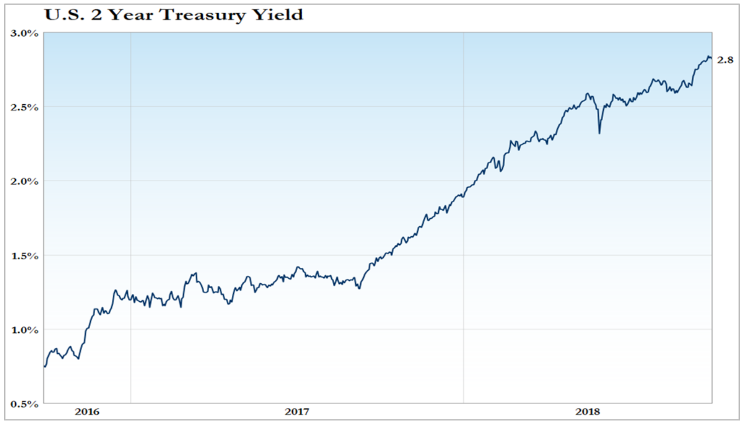


INTEREST RATES AND BONDS

Interest rates rose in the third quarter globally, reversing their second quarter meandering. First, U.S rates rose across the curve as the Fed raised short rates again, and the U.S. economy continued to hum. Second, emerging markets, in an effort to defend their currencies against the resultant rise in the dollar and capital outflows, were forced to raise their rates defensively. Other countries did as well.



Source: Eikon as of 09-30-18



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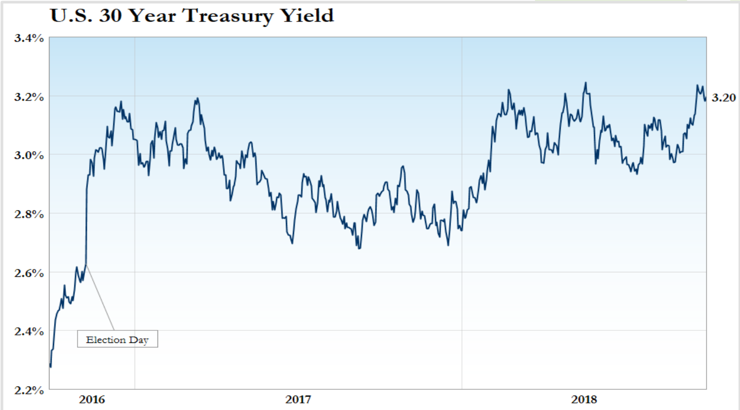

Source: Eikon as of 09-30-18

INTEREST RATES AND BONDS

We have remained skeptical of a sustained rate increase on the long end as fleeting high growth meets imbedded and sustained demographic headwinds for demand. Immediately following quarter's close, long rates popped above their recent highs. This is the first test. We require a sustained move of at least several months to conclude that long-term interest rates have indeed broken out from an almost 35 year downtrend. The next few months will hold the key.

Source: Eikon as of 09-30-18

Source: Eikon as of 09-30-18

MARKET REVIEW

Market volatility has increased, as we have continuously posited. While the U.S. and global economies remain strong, growth has likely peaked and should ratchet down slowly. Economic growth is battling restrictive monetary policy here in the U.S. QE is transforming to QT, and the Fed remains on track to keep lifting the short-term rate it controls. Hence, we expect continued volatility. Interest rates globally are on the way up from historically low levels. However, we believe the trajectory might be limited by demographics and permanently reduced global demand. China is actually loosening policy, and many emerging economies are raising rates only to defend currencies under siege from the strong U.S. dollar. U.S. stocks beat most other bourses this quarter while fixed income was mixed. Short durations were positive, and longer durations lost value. Hard assets were largely negative, and alternative assets were mixed.

According to Factset, the S&P 500 earnings growth rate is expected to hit 19.1% this quarter, which remains comfortably above the S&P 500 forward PE of 15.7. Earnings growth is expected to ratchet down very slowly; remaining robust well into 2019. In addition, sales growth remains strong at over 7.0%, and net profit margins are at record beating 11.6%, both of which will further support the continuation of earnings growth.

EQUITIES

The third quarter was broadly mixed for stocks. Japan led as the Nikkei rose 8%. The S&P 500 was a close second with a 7% gain. MSCI EFA eked out a +1.35% return, and emerging markets fell a bit over 1% in their struggle with tariffs and exchange rates. China fell over 7% as did the markets of many countries whose currencies were challenged by tariffs and rising U.S. interest rates. U.S. healthcare and technology led the quarter while natural resources lagged, and precious metals plunged. Growth continued its outperformance against value, and large caps continued to outperform small caps.

For the year, global equity returns remain broadly mixed with more negatives than positives. Large decliners include Brazil -15.84%, Chile -13.16%, Belgium -11.68%, Greece -19.32%, South Africa -22.57% and China -10.77%. Tariff fallout including currency weakness was the hallmark of most decliners. EAFE is down -1.43%, Europe has fallen -2.46%, and frontier markets have lost -12.63%. On the other hand, U.S. stocks, while mixed, are up broadly. The disparity between the returns of 'growth' and 'value' continues to widen. U.S. growth stocks are up +17.08% (large cap growth), +13.39% (mid cap growth) and +16.49% (small cap growth). U.S. value stocks have eked out returns of +3.92% (large cap value), +3.14% (mid cap value) and +7.14% (small cap value).

FIXED INCOME

Fixed income returns were surprisingly mixed during the quarter as interest rates climbed back to the February and May highs. In general, credit was positive across all maturities, short treasuries were positive, but gains evaporated with increased duration. Municipals were negative across the curve which is surprising given that issuance has been sparse. Specifically, the Bloomberg Barclays 1-3 year credit index was up +0.62%, 3-Month Treasury bills were up +0.49% and Bloomberg Barclays 3 year municipal bond index was down -0.12%. The Bloomberg Barclays U.S. Credit Long Bond Index was + 1.26% and the Bloomberg Barclays 1-20 Treasury Index lost -1.56%. High yield gained +2.40% while world government bonds lost -1.62%.

For the year, fixed income returns remain modest and variable. Short-term paper of all flavors remains up a bit. Longer term, returns follow duration down. 1-3 year Treasuries are up +0.24%, 3 year municipals are up +0.64% and 1-3 year corporate paper gained +0.73% year-to-date. Conversely, the 1-20 year Treasury index is down -4.14%. The Bloomberg Barclays Municipal 10-year index has lost only -0.66%, and the Bloomberg Barclays long credit index has lost -5.20%. Floating rate notes are up +1.99%, high yield paper is up +2.57%, and world government bonds have lost -2.55%.

REAL ASSETS

The prices of real assets generally continued down in the quarter. The Philly Stock Exchange Gold/Silver Index lost a whopping -20.11%, global natural resources fell -1.10%, and global real estate dropped -1.04%. However, energy rose +5.18%. It is not surprising that values in this group would fall as interest rates rose. It will be interesting to see how prices react to increased market volatility- i.e., does gold again become a 'safe-haven'? For the year, real asset returns have been mixed and volatile. The Bloomberg Commodity Index is down -2.03%, precious metals are down -20.84%, energy has gained +16.10%, and world real estate has lost -1.04%.

ALTERNATIVES

Alternative strategies did not move much during the quarter. The HFRX Global Hedge Fund Index lost -0.39% while the HFRI Fund of Funds Composite gained +0.47%. For the year, alternative returns have been broadly mixed at very low levels. The HFRI Fund of Funds Composite has eked out a +1.45% year-to-date while the HFRX Global Hedge Fund Index is down -1.23%. Hedged equity strategies are up +1.85%, Event driven strategies have gained +2.34% while Macro strategies lost -1.82%.

CONCLUSION

Ten years post the worst financial crisis since the Depression our economy is growing, the unemployment rate is low and corporate earnings growth remains robust. We do think we are closer to the end than the beginning though. So, we are planning ahead. Making sure our asset allocations reflect our risk tolerances and timeframe, weeding out investments that might be unduly roiled in more difficult times but also focusing on the opportunities that continued volatility will bring our way.

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