MARKET REVIEW & COMMENTARY

AUGUST 2018

TELEMUS®

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MARKET REVIEW

THE END OF THE BEGINNING, THE BEGINNING OF THE END OR JUST A VERY LONG MIDDLE?

Although this is our August letter, you will be receiving it in September, which marks the ten-year anniversary of the demise of Lehman Brothers. This event marked the beginning of the worst financial crisis since the Depression. We don't think that anyone knows the answer to the question we posed above. However, we'll delve into this issue in the Macro section as well as upcoming letters. It is important to keep a few simple, irrefutable facts in mind not just now, but always:

- Confidence can be lost systemically in a heartbeat.
- Since the economic pipes and the markets are inextricably intertwined everything will be affected.
- Liquidity dries up so that you won't be able to exit except, if at all, at a bad price.
- In a crisis, cash (that you can freely access) is King.
- A 50% loss requires a 100% gain to just get back to even.

So, plan your asset allocation to incorporate the need for protection as well as the quest for gains and don't confuse which investments are supposed to do what. A properly diversified portfolio purposely contains pieces that behave differently in different financial situations. Of course, you seek the best in each niche. Adding a dash of opportunism and tactical tilts adds value while not forsaking stability.

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MARKET REVIEW

AUGUST

Equity markets were mixed in August, but U.S. stocks continued their ascent. The S&P 500 and the NASDAQ rose to incremental all-time highs. Last month's outperformance of value versus growth was short-circuited as growth stocks soundly beat value stocks across capitalizations. International stocks were uniformly negative in fact and in dollars.

Specifically, the S&P 500 rose +3.26% while high dividend payers rose +2.30%, large cap growth was up +5.46%, while large cap value increased only +1.48%. Mid cap growth gained +5.77% while its value counterpart rose only +1.36%. Small cap growth gained a robust +7.34% while small value stocks increased a more modest +2.06%. International equities were not able to sustain their July renaissance and resumed downturns. Europe lost -2.79% and EAFE fell -1.93%. Emerging markets lost -2.70%, and frontier markets were down a whopping -5.39% as currency and trade issues re-intensified.

U.S. fixed income returns continued July's positive performance and followed duration up. However, last month's rotation of best/worst returns continued. This month Treasuries did the best, credit the next best and municipals did the worst. Last month Treasuries were the big underperformer. Specifically, 1-5 year government/credit rose +0.50% while 1-5 year municipals lost -0.03% and 1-5 year Treasuries gained +0.42%. The Bloomberg Barclays long credit index rose +0.33% while 10-year municipals gained +0.31%, and the Bloomberg Barclays long Treasury index soared +1.33%. TIPS rose +0.72% while high yielders gained +0.74%. World bonds were down -0.20%, in dollar terms but emerging market debt sunk -3.13% reflecting the negative impact of trade and resultant currency woes.

Alternatives were mostly positive with the HFRI Fund of Funds Composite Index up +1.14 %, the HFRI Hedged Equity Index gaining +0.85%, Quantitative Directional rising a strong +2.63%, Event Driven gaining +0.19%, and Distressed up +0.16%. The HFRX Global Hedge Fund Index was up +0.45% while Macro gained +0.91%. Real assets were mostly down but mixed. The Bloomberg Commodity Index lost -1.77% in the month, The Philly Stock Exchange Gold/Silver Index plunged -14.31%, crude oil lost -3.80% and the dollar rose +0.68%. Alternatively, global natural resources fell -3.55%, global real estate was up +0.17% and U.S. real estate gained +2.98%.

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MARKET REVIEW

YEAR-TO-DATE

A balanced portfolio has modest returns, but a concentrated U.S. growth stock portfolio is doing much better. For this year and the past few, the investing tenet of diversification, even if implemented opportunistically, might well be called 'deworsification'. However, the principle is longstanding precisely because it works, longer term. Indeed, turning points tend to be marked by the slow portfolio creep toward what is 'working', that is evidenced by many now. So, it is not time to abandon diversification, but it is time to use the volatility opportunistically-pouncing as asset classes lose value and paring when they reach targets. The gap between the returns of 'growth' and 'value' stocks continues to widen. U.S. growth stocks are up between +18.56% (small cap growth) and +16.34% (large cap growth). U.S. value stocks on the other hand have returned between +7.00% (small cap value) and +3.71% (large cap value). The S&P 500 is positive year-to-date, up +9.94%, high dividend payers are up a more modest +5.18%, and the tech heavy NASDAQ has gained +18.31%. International bourses, which had appeared ready to lead the performance derby early in the year, continue to underperform as trade wars foster currency conniptions further undermining the returns of foreign bourses. For the year-to-date EAFE is down -2.28%, and Europe has fallen -2.80%. Frontier and emerging markets have experienced the deepest currency woes, and their market returns reflect that. Year-to-date frontier markets are down -12.58%, and emerging bourses are down -7.18% (in dollar terms).

Fixed income returns remain modest and variable. 'Bondaggedon' has still not occurred. Shorter term paper is positive across the board and returns continue to follow longer duration lower. While the Fed is raising the short rate it controls, our Treasuries continue to yield more than government paper of far less creditworthy countries. Accordingly, foreign buyers will continue to sop up the extra paper the U.S. issues unless/until their paper yields more or our creditworthiness sinks. One-three year Treasuries are up +0.37%, 3 year municipals are up +1.05% and 1-3 year corporate paper gained +0.70%. The 10-20 year Treasury Index is down -2.27%, the Bloomberg/Barclay Municipal 10yr Index has lost only -0.04% and the Bloomberg/Barclays Intermediate Corp Index is lower by -0.56%. TIPS are up only +0.21%, reflecting the tug-of-war between the growth of inflation-aware sentiment and longer duration. High yield U.S. corporate paper is up +2.00%, mortgage backed paper is -0.46%, world government bonds have lost -1.55%, and emerging market paper is has lost -7.29% year-to-date.

Alternative returns have been broadly mixed at very low levels. The HFRI Fund of Funds Composite Index is up +2.08 % year-to-date, while the HFRX Global Hedge Fund Index is down -0.55%. Hedged Equity strategies are up +2.64%, Event Driven strategies have gained +2.63%, while Macro strategies have lost -1.09%. Real asset returns have been broadly mixed and volatile. Year-to-date the Brent Crude oil is up +16.30%, the Bloomberg Commodity Index has lost -3.87%, precious metals are down -22.32%, the Bloomberg Ag Index is down -4.72% and global real estate has gained +0.54%. The U.S. dollar has been volatile but remains up +3.27% for the year-to-date.

INDEX RETURNS AS OF 8/31/2018

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)	0.50%	1.91%	1.64%	20.09%	27.54%	48.95%
HFRX GLOBAL HEDGE FUND INDEX	0.54%	0.39%	-0.46%	5.26%	7.03%	0.57%
CPI - SEASONALLY ADJUSTED	0.00%	0.17%	1.36%	5.61%	7.61%	14.87%
S&P 500 COMPOSITE	3.26%	7.10%	9.94%	56.55%	97.01%	180.43%
LIPPER LARGE - CAP CORE	2.67%	6.75%	8.69%	52.21%	84.39%	153.03%
WISDOM TREE LARGE CAP DIVIDEND	2.30%	6.44%	5.18%	51.57%	82.96%	166.48%
MSCI ALL COUNTRY WORLD INDEX NET	0.79%	3.82%	3.38%	39.93%	58.66%	91.39%
MSCI EAFE NET	-1.93%	0.48%	-2.28%	22.65%	32.14%	43.22%
BLOOMBERG BARCLAYS MUNICIPAL BOND 5Y (4 - 6)	-0.04%	0.36%	0.66%	4.73%	11.29%	37.15%
BLOOMBERG BARCLAYS US AGGREGATE	0.64%	0.67%	-0.96%	5.37%	13.06%	43.81%
BANK OF AMERICA / MERRILL LYNCH US T - BILL 3MONTH	0.18%	0.34%	1.15%	2.38%	2.45%	3.60%

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	5.46%	8.56%	16.43%	69.90%	123.70%	234.78%
RUSSELL 1000 VALUE	1.48%	5.50%	3.71%	41.70%	70.18%	135.19%
RUSSELL MIDCAP GROWTH	5.77%	8.04%	13.87%	53.25%	94.18%	200.74%
RUSSELL MIDCAP VALUE	1.36%	4.12%	3.96%	40.95%	74.72%	167.16%
RUSSELL SMALL CAP COMP GROWTH	7.34%	8.70%	18.56%	60.04%	101.74%	226.44%
RUSSELL SMALL CAP COMP VALUE	2.06%	3.77%	7.00%	45.37%	69.70%	151.04%
MSCI EM (EMERGING MARKETS) NET	-2.70%	-0.57%	-7.18%	38.32%	27.87%	40.38%
BLOOMBERG BARCLAYS US TREASURY BILL 6 MONTH	0.16%	0.31%	1.15%	2.97%	3.27%	6.44%
BLOOMBERG BARCLAYS US AGENCY	0.60%	0.42%	-0.11%	3.28%	8.74%	28.80%
JP MORGAN EMERGING MARKET BOND INDEX(EMBI) + COMPOSITE	-3.13%	-1.27%	-7.29%	10.77%	23.19%	75.89%
CITI GROUP WORLD GOVERNMENT BOND	-0.20%	-0.61%	-1.55%	7.01%	4.08%	24.18%
BLOOMBERG COMMODITY	-1.77%	-3.87%	-3.87%	-5.56%	-34.12%	-54.41%
ALERIAN ENERGY MLP	1.58%	8.27%	7.58%	-1.99%	-9.45%	102.58%
PHILADELPHIA STOCK EXCHANGE GOLD / SILVER	-14.31%	18.81%	-22.32%	36.77%	-35.96%	-55.61%
LIPPER GLOBL NAT RES	-3.55%	-2.38%	-2.11%	26.52%	-1.14%	-19.03%
LIPPER PRECIOUS METAL FUND	-11.44%	-14.76%	-20.32%	23.24%	-27.68%	-36.12%
MSCI WORLD REAL ESTATE	0.17%	1.31%	0.54%	25.27%	42.34%	65.77%
LIPPER REAL ESTATE FUND	2.08%	2.63%	2.79%	27.55%	55.30%	70.15%

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

MARKET REVIEW

Cash is a worthwhile asset class. Indeed, it retards positive returns in a bull market but it does not go down, provides ballast in a bear and allows you to pounce on opportunities when others cannot. As an added bonus, readily accessible and safe cash is paying pays interest again although not as much interest as some 'cash substitutes' that are NOT readily accessible.

Quantitative tightening (QT) continues in the U.S., but this only slows the rate of growth of QE globally. Since there is nothing obvious to end ten years of investment price inflation, it is logical that a combination of aggressive credit growth, slower growth of money printing and the end of the longest economic growth cycle in history could just converge to create the next downturn. Like squirrels preparing for winter, our constant rebalancing should husband gains redeployed consistently into lower risk assets over time.

MACRO REVIEW

2008 did not evolve into Depression only because policymakers identified the stratagem failures of the Depression and avoided them at all costs. As with any wholesale remediation, the seeds of the next destruction are sown in it. So quantitative easing (QE) or flooding the world with oceans of liquidity, lowering global interest rates to zero and pushing huge quantities of capital into the gray (un or less regulated) markets are a trio of items whose reversal could contribute to the next crisis. We are tracking the repatriation and interplay.

The continued reduction in QE has begun to impact asset returns.

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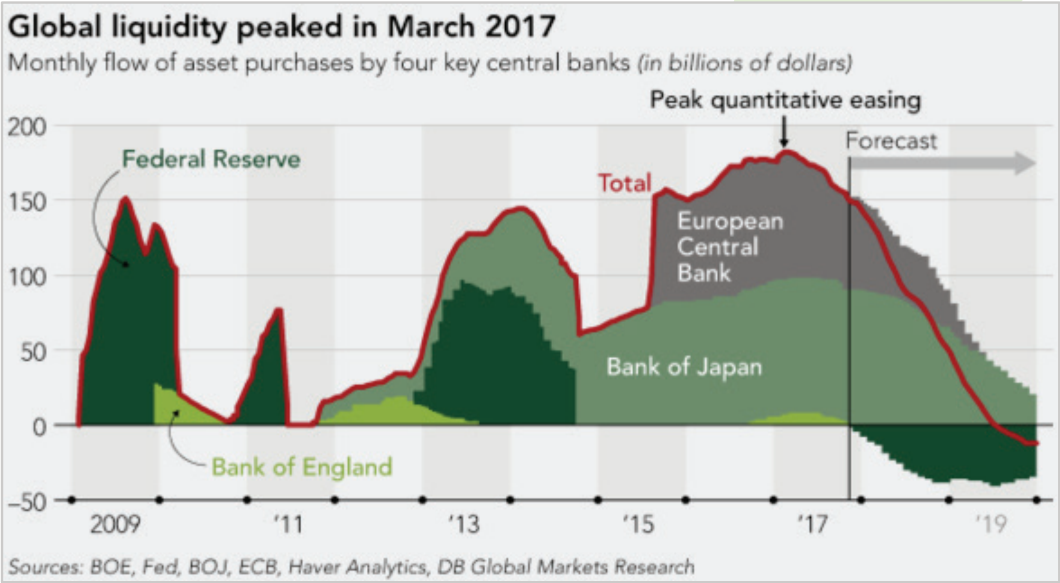
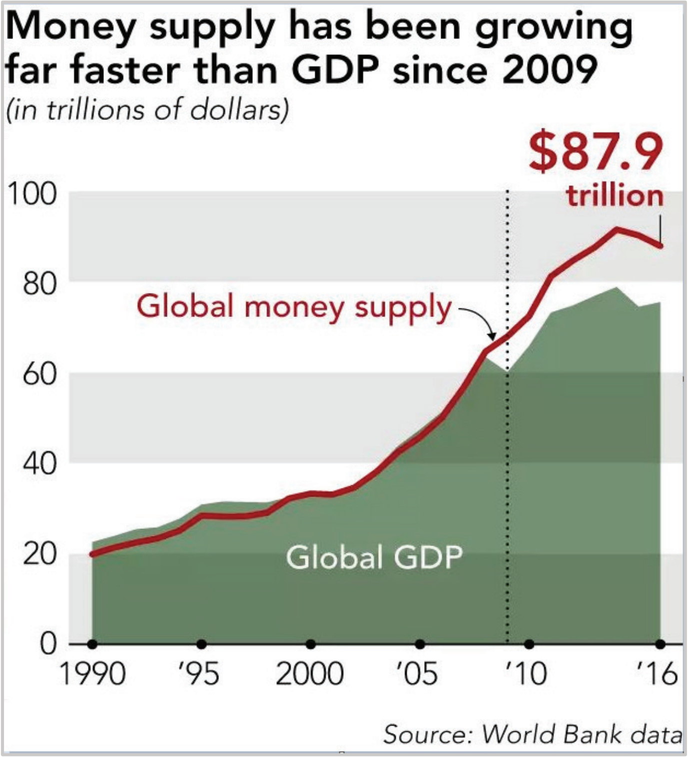
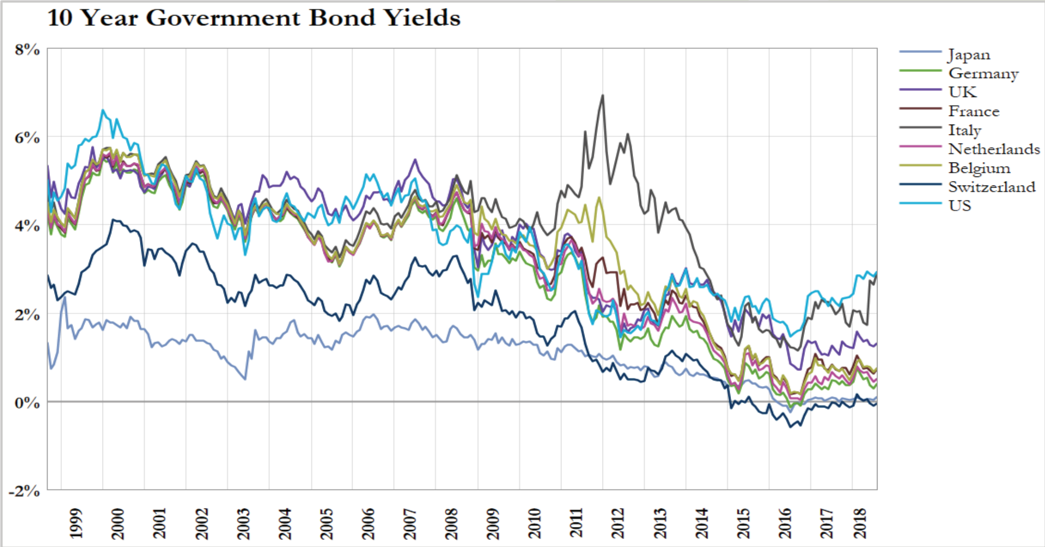


MACRO REVIEW

Flattish GDP growth combined with a slow downturn in world money supply growth should also strain the overleveraged.



Global yields have begun to normalize. Periods of rising yields are often associated with ultimate market declines.



Source: Thomson Reuters Datastream Through August 2018.

MACRO REVIEW

It is equally important to recall that the architects of financial salvation held hands and sang Kum ba yah. The divided Congress was forced to follow. Tim Geithner, first as President of the Federal Reserve Bank of New York and later as Secretary of the Treasury, under President Obama; Hank Paulson, former CEO of Goldman Sachs and Treasury Secretary under President George W. Bush and Ben Bernanke, our Fed chief. While none appeared to foresee the looming crisis in advance, they joined forces and saved the world. For now, however, the world continues to grow synchronously, if not harmoniously.

World growth is expected to continue at an approximate 3.9% pace through 2019 according to both the Organization of Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) in its World Economic Outlook Update (WEOU) of July16,2018 “although [t]he balance of risks has shifted further to the downside” (WEOU). We do not think growth will continue at this pace into 2020.

Synchronicity is fraying but intact. The U.S., most of Asia and Latin America are all expected to grow a bit faster than projected while developed and developing Europe, Japan and China are expected to grow a bit more slowly.

Real GDP growth

Year-on-year, %

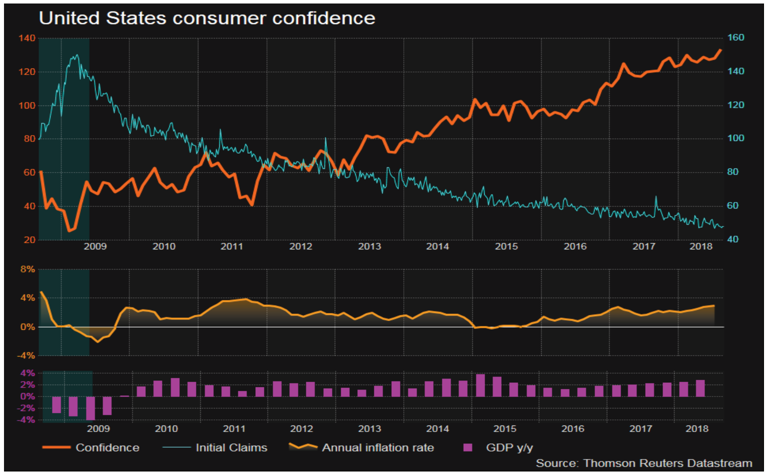
	2017	2018	2019		2017	2018	2019
World	3.7	3.8	3.9	G20	3.8	4.0	4.1
Australia	2.3	2.9	3.0	Argentina	2.9	2.0	2.6
Canada	3.0	2.1	2.2	Brazil	1.0	2.0	2.8
Euro area	2.6	2.2	2.1	China	6.9	6.7	6.4
Germany	2.5	2.1	2.1	India[1]	6.5	7.4	7.5
France	2.3	1.9	1.9	Indonesia	5.1	5.3	5.4
Italy	1.6	1.4	1.1	Mexico	2.3	2.5	2.8
Japan	1.7	1.2	1.2	Russia	1.5	1.8	1.5
Korea	3.1	3.0	3.0	Saudi Arabia	-0.7	1.6	2.1
United Kingdom	1.8	1.4	1.3	South Africa	1.3	1.9	2.2
United States	2.3	2.9	2.8	Turkey	7.4	5.1	5.0

Note: The European Union is a full member of the G20, but the G20 aggregate only includes countries which are also members in their own right.
1. Fiscal years starting in April.

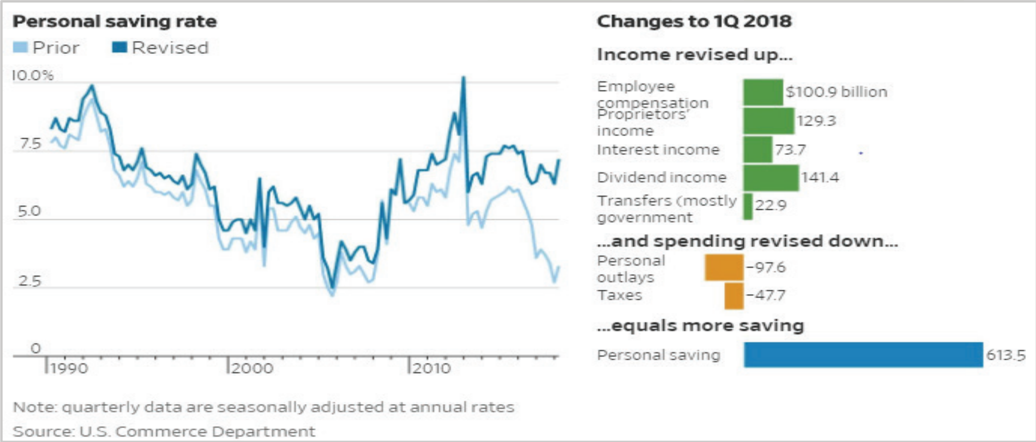
Source: OECD Economic Outlook; Released on 5/30/18.

MACRO REVIEW

Recently surging retail sales and growth in the manufacturing sector have been buoyed further by rising consumer confidence and falling unemployment in the U.S., as inflation has slowly reached the Fed's desired target.



Further good news is found in the Commerce Department's recent revision to the savings data for the U.S. You might recall that these numbers had reached almost cataclysmically low levels but the revisions to almost 7% for the most recent period give optimism that Americans may be a bit more prepared for trouble than we had thought.



MACRO REVIEW

Meanwhile, as we predicted, Treasury yields have not broken out to the upside, reflecting the demographic drag on long term U.S. and world growth.

Source: Thomson Reuters Datastream Through August 2018

The risks of a breakout remain about 50/50 with higher U.S. debt issuance to fund President Trump's increased spending, less demand from our Central bank as we proceed with QT and stronger economic growth all weighing in favor of an ultimate increase in yields. It is noteworthy that any sustained increase in rates would require huge increases in our payments of interest on our debt.

CONCLUSION

Ten years post the worst financial crisis we think the world and the U.S. economies are about the best that they can be, and we think some of our concerns will be realized in the same timeframe posing a soggier economic landscape.

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