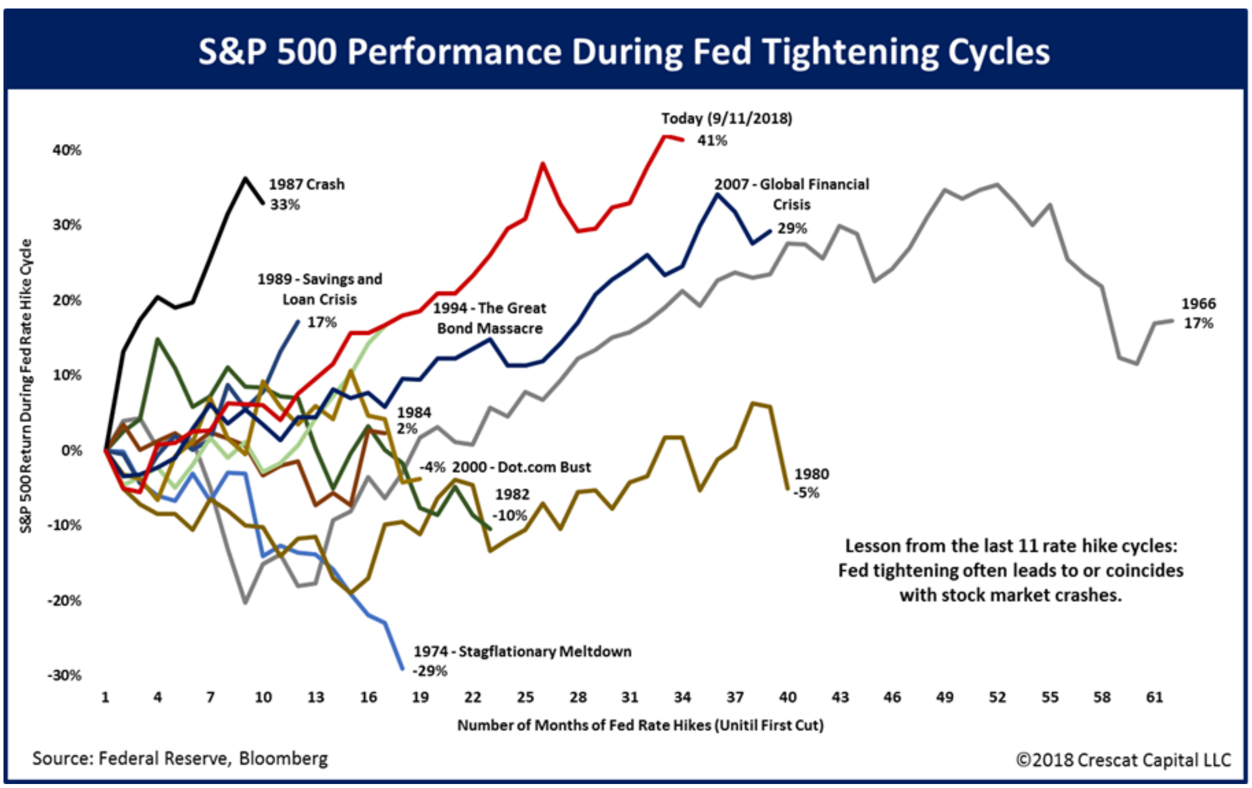
Third Quarter 2018 Commentary

October 10, 2018

Dear Investor,

The U.S. economy and financial markets continued to perform well in the third quarter despite end-of-cycle projections of recession and proliferating risk. U.S. Treasury yields backed up in Q3, with the 2 year yield rising from 2.57% in July to 2.81% at the end of September, and the 10 year yield rising from 2.87% in July to 3.05% to end the quarter. Though some have warned repeatedly about rising interest rates, Goldman Sachs published a note in July commenting on how they do not believe "[interest rates] have increased to a level that will derail this bull market… Currently, the strong economic environment is boosting earnings sufficiently to offset the impact of higher interest rates."



As a validation of sorts of Goldman's recent comments, major market stock indices, led by the Dow Jones Industrial Average, set record highs in Q3. Employment climbed to its highest level in decades, manufacturing surveys showed continued strength and wages rose as inflation remained docile.

At the same time, home sales—the backbone of the economy—remained sluggish while the arrival of mid-term elections stoked unease over the prospect of legislative gridlock. Worldwide, fears of a multi-front global trade war intensified as did apprehensions over Middle East violence and a consequential surge in oil prices.

Markets:

Investors responded warmly to some of the largest Fed bond issuances in a decade, snapping up tranches of more than $60 billion in debt and bidding yields up to 2.82%, the highest level since May 2008. The auction coincided with the Federal Reserve's announcement that its balance of Treasury securities declined by $23.7 billion to $2,313 billion, its lowest level since March 2014. A legacy of its post-crash quantitative easing, the Fed's balance has diminished by $152 billion worth of sovereign debt. What's more, beginning in October the Fed will increase its balance sheet roll-off cap from $40 billion a month to $50 billion a month, split between $30 billion in Treasury securities and $20 billion in agency securities.

Another specter of the crash—the credit default swap—may soon include among its institutional iterations an ETF version for retail investors. The news that UK based Tabula Investment Management may introduce such an instrument was met with jaundice in some quarters given the outsized role of credit default swaps in said crash.

On the equity side, industrial stocks led the Dow to record closes in September, making it the last of Wall Street's main indexes to fully recover since January's correction. All three major U.S. indices closed higher as technology companies carried both the Nasdaq and the S&P 500, the latter of which also hit a new closing high.

9/30/2018	Economic and Market Review									
Overall	Indicator Name	Value	1 Mo. Ago			3 Mo. Ago		1 Yr. Ago		
▲	S&P 500 Total Return	5,763	5,729	▲	0.59%	▲	7.71%	4,888	▲	17.91%
▼	Russell 2000 Total Return	8,424	8,589	▼	-1.92%	▲	3.58%	7,310	▲	15.24%
▲	MSCI EAFE Total Return	8,055	8,040	▲	0.19%	▲	1.42%	7,801	▲	3.25%
▼	MSCI Emerging Markets Total Return	2,335	2,351	▼	-0.67%	▼	-0.95%	2,346	▼	-0.44%
▲	10 Year Treasury Rate	3.05%	2.86%	▲	6.64%	▲	3.04%	2.33%	▲	30.90%
▼	Barclays US Aggregate Total Return	2,014	2,026	▼	-0.61%	▲	0.02%	2,038	▼	-1.22%
▼	Euro to US Dollar Exchange Rate	1.16	1.17	▼	-0.99%	▼	-1.36%	1.18	▼	-1.95%
▲	US Dollar to Chinese Yuan Exchange Rate	6.87	6.84	▲	0.39%	▲	3.79%	6.65	▲	3.23%
▲	US Dollar to Japanese Yen Exchange Rate	113.48	111.17	▲	2.08%	▲	2.50%	112.64	▲	0.75%
▲	WTI Crude Oil Spot Price	73.16	70.25	▲	4.14%	▲	4.69%	51.7	▲	41.59%
▼	VIX	12.12	13.53	▼	-10.42%	▼	-5.53%	9.51	▲	27.44%

Source: yCharts

On a more sobering note, TrimTabs Investment Research reported that the rate of corporate insider selling in September was the highest in a decade as corporate stock buybacks reached $827 billion in 2018, topping the previous record of $809 billion in 2007. A week earlier, Goldman Sachs cautioned that "global risk appetite is becoming increasingly fragile," adding that volatility is about to spike over the next month both due to seasonal factors and the midterm elections.

As if to validate Goldman's concerns, FactSet reported that, heading into the end of the third quarter, 74 of 98 S&P 500 or 76% companies that issued earning-per-share guidance issued negative Earnings Per Share guidance, above the five-year average of 71%.

Earlier in July, Morgan Stanley forecast a significant market correction. "The bottom line for us is that we think the selling has just begun and this correction will be the biggest since the one we experienced in February," the investment bank wrote to clients. At the same time, *The Wall Street Journal* implied that U.S. small-cap stocks, having over-performed for months on the strength of perceived insulation from trade tensions, may have peaked. On a total return basis, the Russell 2000 gained 3.6% in Q3 vs. the S&P 500's 7.7%, though the Russell 2000 has the upper hand YTD.

On the commodities front, crude oil prices rose to their highest levels in four years due to an Organization of Petroleum Exporting Countries (OPEC) decision against further increases in production despite calls from President Trump for more output. Brent soared as high as $82.72 per barrel, a level not seen since 2014, while Western Texas Intermediate climbed as high as $74.14 per barrel, its highest since this past June.

Crude prices also rose in anticipation of reprisal attacks following a deadly strike on an Iranian military parade as the U.S. prepares to re-impose sanctions on the Islamic Republic on November 4th.

US Economy:

According to the October 1st reading of the Atlanta Fed's GDPNow tracker, which estimates real Gross Domestic Product (GDP) growth, the economy expanded at an annualized rate of 4.1% in the third quarter. That compares with the 4.2% second-quarter growth rate (final reading) posted by the Bureau of Economic Analysis. A group of economists surveyed by the *Wall Street Journal* expect real GDP growth to come in at 3.1% for 2018.

Looking beyond this year, Ellen Zentner, Morgan Stanley's widely respected chief U.S. economist, shared in a speech that she anticipates growth will slow significantly in 2019 as the stimulus from tax reform and public spending fades. However, she also expected strong household consumption, higher disposable income and higher savings rates alongside continued, healthy job growth. Core inflation will likely hover at or above the Fed's two-percent goal, she forecast, adding that two interest-rate increases in March and June 2019 are likely before the tightening cycle ends.

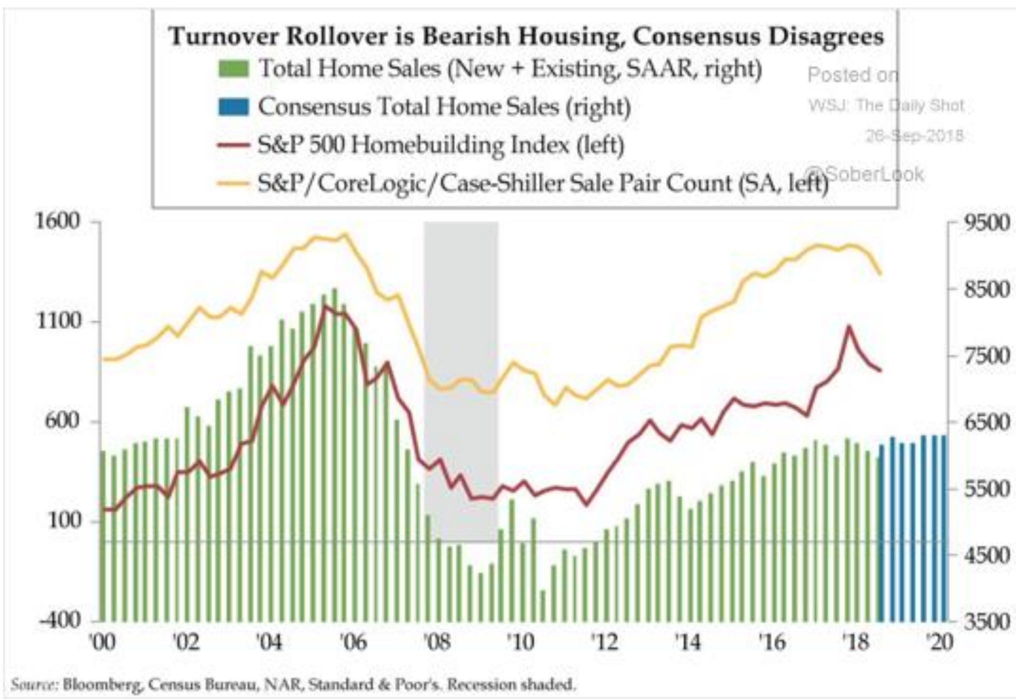
9/30/2018	Economic and Market Review						
		Last Reported	1 Mo. Ago		3 Mo. Ago	1 Yr. Ago	
Overall	Indicator Name	Date	1 Mo. Ago	% Change	% Change	1 Yr. Ago	% Change
▼	US Core Inflation Rate	8/31/2018	2.35%	▼ -6.58%	▼ -1.70%	1.68%	▲ 30.56%
▲	ADP Change in Nonfarm Payrolls	9/30/2018	168	▲ 36.52%	▲ 28.74%	84	▲ 174.37%
▬	US Unemployment Rate	8/31/2018	3.90%	▬ 0.00%	▲ 2.63%	4.40%	▼ -11.36%
▬	US Producer Price Index: Savings Institutions	8/31/2018	93	▬ 0.00%	▼ -1.69%	96	▼ -2.62%
▼	ISM Purchasing Managers Index	9/30/2018	61	▼ -2.45%	▼ -0.66%	61	▼ -1.64%
▲	US Housing Starts	8/31/2018	1,174	▲ 9.20%	▼ -3.54%	1,172	▲ 9.39%
▲	US 30 Year Mortgage Rate	9/27/2018	4.52%	▲ 4.42%	▲ 3.74%	3.83%	▲ 23.24%
▲	US Consumer Price Index	8/31/2018	251.3	▲ 0.22%	▲ 0.52%	245.3	▲ 2.68%

Source: yCharts

Inflation continued to defy forecasts of higher prices as the Consumer Price Index slowed to 2.7% Year-over-Year (YoY) in August versus expectations of a 2.8%. The numbers followed data showing a surprise drop in producer prices and suggested the path of inflation could be softer than expected. Both the dollar and bond yields retreated on the news. Nevertheless, the Fed once again demonstrated its commitment to normalizing monetary policy and raised its benchmark by 25bps to 2.00%-2.25% in its September meeting.

Despite still relatively low borrowing costs, existing home sales continued to weaken to their lowest level in 30 months. Inventories rose for the first time in three years following a decline in July, per the National Association of Home Builders. According to a July survey by the University of Michigan, the gap between home prices and average hourly earnings is almost as wide as it was in 2006, which means fewer buyers can afford to purchase a home in many cities.

In a related move, Bank of America declared that existing home sales have peaked due to declining affordability, aggressive price competition and a growing preference among consumers to rent. "The housing market is no longer a tailwind for the economy but rather a headwind," the bank concluded last month.



Average hourly earnings rose across the board, fueling talk of another interest rate hike in December. The IHS Markit U.S. Composite PMI™ Output Index fell to 55.7 in July to 54.7 in August to 53.9 in September, demonstrating solid growth albeit at a slowing rate. Chris Williamson, Chief Business Economist at IHS Markit, noted "the September survey adds to signs that the pace of economic growth cooled to the lowest since January but continued to run close to a 3% annualized rate over the third quarter as a whole." Meanwhile, the September Institute of Supply Management (ISM) Manufacturing Index fell to 59.8 percent from the August reading of 61.3 percent, though still higher than July's 58.1 percent reading. The September ISM Non-Manufacturing report registered 61.6 percent, which is 3.1 percentage points higher than the August reading of 58.5 percent.

U.S. retail sales rose 0.1% Month-over-Month (MoM) in August (advance estimate), or 6.6% YoY, while July's data was revised upwards to 0.7% MoM from 0.5% MoM. In trade related matters, the U.S. trade deficit reached a five-month high despite the Trump administration's aggressive campaign to wrest concessions from America's major trading partners. At $50.1 billion, according to data from the Census Bureau and Bureau of Economic Analysis, the gap grew 9.5% from June to July—its biggest monthly increase in over three years—while the deficit with China grew 10 percent to a record $36.8 billion.

Overall, consumer and business sentiment remained very strong. The Conference Board Consumer Confidence Index® rose to 138.4 in September, up from 134.7 in August, while the University of Michigan Confidence Index, led by low-income optimism, remained at favorable levels, with the index topping 100.0 for only the third time since January 2004. The National Federation of Independent Businesses, meanwhile, reported that its gauge of small business optimism rose to 108.8 in August, a new record in the survey's 45-year history, topping the July 1983 record of 108.0, as more small businesses committed to hire more workers, raise wages and increase capital investment.

International:

The Organisation for Economic Co-operation and Development (OECD) in its Interim Economic Outlook cut its global growth outlook by 0.1% in 2018 and 0.2% in 2019 for new projections of 3.7% for both years. It cited risk factors from an increasingly de-synchronized global economy and the possibility of contagion from the emerging market crisis. Separately, Germany's Bundeverban der Deutschen Industrie (BDI) industry association cut its 2018 forecast for German economic growth to 2.0% from the previous 2.25%, largely because Washington's punitive trade policy and Brexit are smothering demand for German goods. The association also lowered its export growth estimate to 3.5% in real terms from 5.0%. Germany's decline is well attested in recent manufacturing PMIs, in addition to an overall weaker Eurozone.

	Mfg PMI			
	Country	Dec-17	Sep-18	Change
1	Turkey	54.9	42.7	-12.2
2	Germany	63.3	53.7	-9.7
3	Austria	64.3	55.0	-9.3
4	Denmark	61.2	53.2	-8.0
5	Italy	57.4	50.0	-7.4
6	Czech Republic	59.8	53.4	-6.4
7	France	58.8	52.5	-6.3
8	Switzerland	65.6	59.7	-5.9
9	Hungary	59.6	53.8	-5.8
10	Taiwan	56.6	50.8	-5.8

Source: AIG-PwC, ALPIM, BER-SA, ICARE, IHS Markit, ISM, NIMA, SIPMM

Despite the economic slowdown brewing on the Eurozone horizon, the European Central Bank (ECB) pledged to end quantitative easing by the end of 2019 after keeping interest rates unchanged through the summer. The ECB reiterated that its Governing Council would reduce its monthly pace of net asset purchases to €15 billion until the end of December 2018 when, "subject to incoming data confirming the medium-term inflation outlook," said purchases would end altogether.

In August, China throttled back on growth; Japan continued to struggle with inert consumer demand; and South Korea, a proxy for the direction of the global economy for its export-centricity, sputtered on weak capital investment and slow growth.

In a September note, WisdomTree Japan Head, Jesper Koll, argued that Japanese prime minister Shinzo Abe's re-election as head-ruling party leader all but ensures him another three years as prime minister. This in turn bodes well for Japan's economy in general and Japanese risk assets in particular. Koll wrote that a Nikkei rally toward the 30,000 level over the next six months is likely, alongside a sharp upturn in the momentum of positive earnings revisions.

According to Bloomberg, this year's rout in emerging markets has inflicted more pain than any of the seven biggest selloffs since the 2008 financial crisis—a fact widely overlooked because it has lasted so long. The agency noted that the scope of the slide has persuaded some strategists to regard it as more than just a knee-jerk reaction to higher U.S. interest rates or an unfolding trade war. Rather, it has become a full-fledged crisis of confidence for investors in developing nations.

"The difference this time is the absence of even temporary resilience," Bloomberg wrote. "It's become a contest between the dollar and everything else denominated in the U.S. currency. That helps explain why there's been simultaneous selling in a haven asset such as gold and riskier emerging-market assets."

As the fourth quarter dawned, the global economy was propelling itself largely with the help of the U.S., followed by China and a distant Japan. Europe was slipping precariously and the EM was on the verge of collapse. Sooner or later, the world is going to feel the weight of de-synchronization.

Multi-Asset Portfolios

Attribution Based on Asset Classes

Multi-Asset portfolios participated pro-rata according to heir allocations to these building block strategies:

Equity:

- Positive Contributors: U.S. Large Caps, Non-U.S. Develope
- Negative Contributors: Emergining Markets

Fixed Income:

- Positive Contributors: Investment Grade, U.S. High Yield
- Negative Contributors: None

Alternatives:

- Positive Contributors: Private Equity / BDCs
- Negative Contributors: Frontier Markets

Portfolio Changes for Multi-Asset Portfolios

The following changes were made to holdings in the STAR Spectrum models:

- Frontier Markets (Ticker: FM) positions that were held in the Alternatives sleeve of most STAR Spectrum models were sold at the beginning of September and the Investment Management Committee is currently reviewing potential replacements. Until a replacement is identified, most models will carry excess cash in the portfolios. . While we firmly believe that Frontier Markets are not similar to Emerging Markets and that the risk of contagion is limited due to a lack of critical mass, the risk of Emerging Markets contagion has grown enough that we believe it could impact Frontier Markets in the future.

- Affinity Small Cap I (AISQX) was replaced with iShares Core S&P Small-Cap ETF (IJR) as the representative holding for U.S. Small Cap. Affinity Small Cal I has been on the Investment Management Committee's radar for possible replacement for some time, as it has lagged in performance versus its assigned Asset Class. In addition, the fund did not appear to be managed to its mandate of U.S. Small Cap and tended to behave similarly to U.S. Large Cap.

- Considering the model changes made earlier this year to exit Emerging Markets in all models along with the recent sell of FM and the replacement of AISQX with IJR, the Investment Management Committee is comfortable that the STAR Spectrum model holdings are well-positioned for the world at hand.

- While nothing rose to the level of challenging our high conviction positions, we will remain patient, but vigilant, in a few areas:

  - Germany: The leading economy in a slowing Eurozone
  - Japan: Recently reported second quarter growth at an annualized 1.9%
  - Corporate Financials: Have benefited from tax reform and regulation, but have to deal with the potentially slower loan growth and a flattening yield curve
  - Cash Holdings: STAR Spectrum models currently hold between 5-8% in cash, which can be deployed when we find attractive, fairly-priced opportunities.

Sincerely,

David Young, CFA
Chief Investment Officer

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