

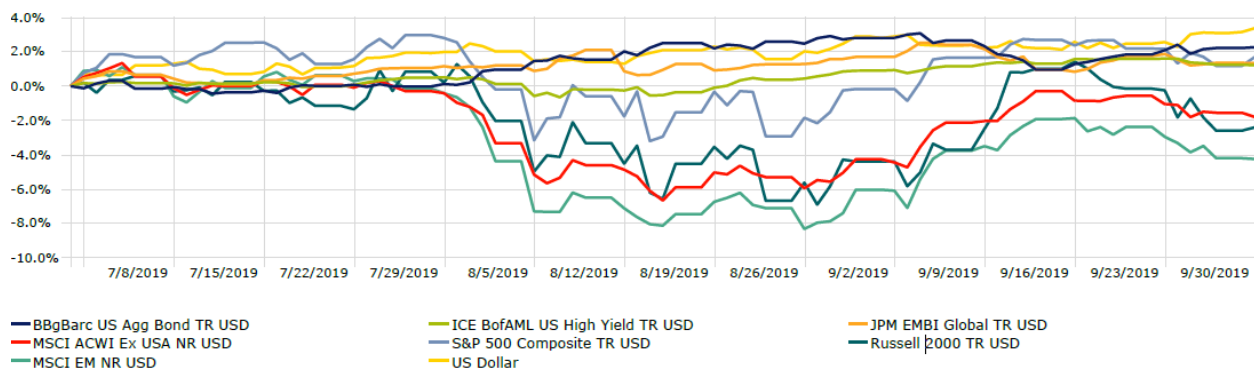
Q3 2019 Market Commentary

The US economy, while slowing, has remained relatively strong as the global economy trudges along. However, the markets, the media and many in the investment community believe that tough times lay ahead both at home and abroad.

Global Markets Performance

The US stock market, as represented by the S&P 500, finished up 1.70% on the quarter, adding to a positive return in the second quarter and a 20.55% return so far this year. Smaller US stocks¹ had a tougher time and sank -2.40% for the quarter but are still up over 14% year to date. International stock markets² and emerging markets³ have largely trailed domestic equity markets, with returns of -1.80% and -4.25% in the third quarter. On the credit side, core bonds⁴ rose moderately at 2.27% and high yield bonds⁵ rose as well, up 1.22% for the quarter, impacted by lower rates that more than offset somewhat widening spreads^a. Emerging market (EM) bonds⁶ rose moderately as well, up 1.34% on the quarter.

Historical Performance



Calendar Year Returns

	YTD	2018	2017	2016	2015	2014
BBgBarc US Agg Bond TR USD	8.52	0.01	3.54	2.65	0.55	5.97
ICE BofAML US High Yield TR USD	11.50	-2.26	7.48	17.49	-4.64	2.50
JPM EMBI Global TR USD	12.08	-4.61	9.32	10.19	1.23	5.53
MSCI ACWI Ex USA NR USD	11.56	-14.20	27.19	4.50	-5.66	-3.87
S&P 500 Composite TR USD	20.55	-4.38	21.83	11.96	1.38	13.69
Russell 2000 TR USD	14.18	-11.01	14.65	21.31	-4.41	4.89
MSCI EM NR USD	5.89	-14.57	37.28	11.19	-14.92	-2.19
US Dollar	3.33	4.40	-9.87	3.63	9.26	12.79

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The Tariff Man Cometh

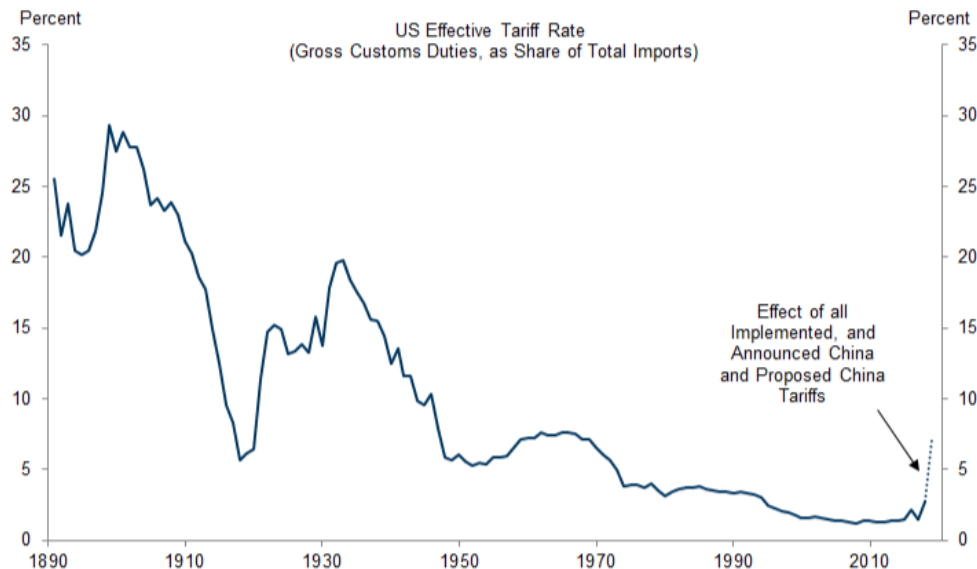
The United States' trade war with China is now well into its second year and shows no signs of slowing down. On the contrary, the fourth quarter of 2019 is set to see an expansion of tariffs through two separate episodes.

In mid-October, the Trump administration is likely to increase tariffs from 25% to 30% on approximately \$250 billion of imports⁷. Two months later, in December, it is scheduled to implement 15% tariffs on a basket of goods including mostly electronics and toys. Either of these planned tariff rounds could end up delayed, as they have before, but it's likely that at least one round will be implemented prior to year-end without substantial progress on a trade deal.

So, if tariffs have been in place for nearly two years and have had little effect on the US economy, why should we care now? There are two main reasons: scale and economics, and they happen to be intertwined. Tariffs (both implemented and scheduled) have now reached a point of scale that dwarfs any of the trade skirmishes of recent decades. Goldman Sachs estimates⁸ that these tariffs now account for 20% of total US imports; in past episodes that total never climbed above 1%.

Further, the breadth of these tariffs has already negatively affected economies around the globe, and we are beginning to see the first signs of potential weakening in the US⁹. If President Trump, the self-proclaimed 'tariff man', implements all tariffs scheduled for the rest of the year, the US will have import taxes in place on approximately \$550 billion of goods coming from China. This represents the majority of our import balance with China, so further escalation could see continued increases in existing rates. With the American consumer thus paying higher prices for imported goods, or American companies doing less business due to higher input prices, it's possible the trade war may continue to slow US growth until an ultimate resolution can be inked.

The US-China Trade War Is Unprecedented In The Postwar Era



Source: USITC, Goldman Sachs Global Investment Research.⁸

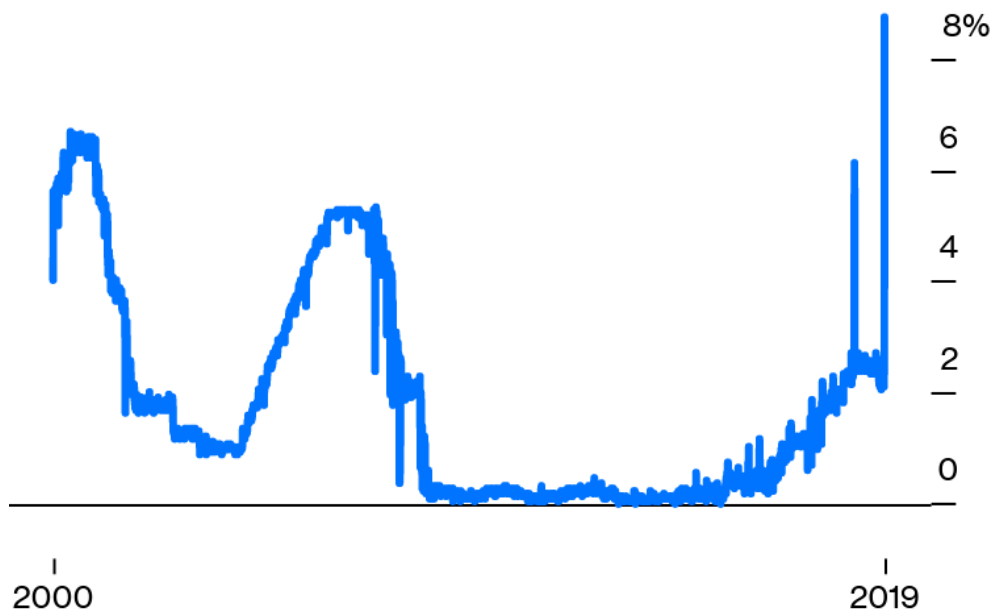
Repossessing Rates

While the stock and bond markets bear the brunt of public attention, one of the largest and most important markets in the world churns over \$2 trillion a day on average¹⁰. The repurchase agreement market, or repo market^b, is a short-term market utilized primarily by banks and large institutional investors. In the most basic instance, one side loans US government securities to the other in exchange for cash, and then promises to repurchase the securities plus a small amount of interest the following day.

Since the end of the financial crisis in 2009, the standard repo interest rate has generally remained at or below 2%¹¹. But on September 16th and 17th, that rate spiked north of 8% before eventually returning to more normal levels. The US Federal Reserve typically attempts to control rates in short-term markets by setting their own rate, called the federal funds rate, but in this case had to step into the market and exchange cash for securities in order to reverse the surge.

Surge Pricing

Overnight repo rate



Source: ICAP, CCN.com, Bloomberg.¹¹

So, what happened in the markets over those two days? There was a lack of cash available to be used for repos due to the confluence of several events including large government debt issuance, short supply of bank reserves, and quarter-end corporate tax transactions. In other words, the cash balances of many of the major players in these markets were tied up in other transactions, leaving less supply for repos. And in classical economic theory, decreasing supply while maintaining or increasing demand will lead to an increase in costs, represented here by interest rates.

Whether or not this event is a one-off or a foreshadowing of larger problems to come is currently being debated across Wall Street. If the latter proves to be the case and more of these events occur, the bigger issue is that the market may lose faith in the Federal Reserve's ability to control rates. And if the market loses faith in the Fed, then the companies that depend on the market will not be confident in receiving a reasonable funding rate. Thus, this chain reaction of uncertainty could ultimately lead to a

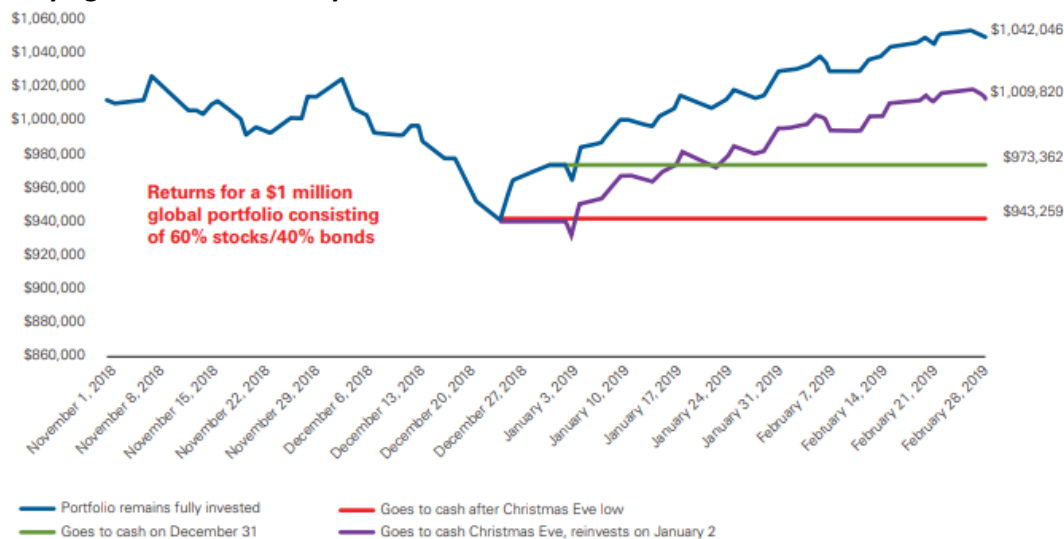
drastic reduction in business activity and a slowdown in growth. This will only become clear over time as the Federal Reserve’s role in this market is brought further to light, but it is a notable risk down the line.

Timing Troubles

Uncertainty is the punchline in the markets today, with growth nearly everywhere seemingly slowing down, geopolitics turning upside down, and businesses trying to make sense of it all. Many investors can become agitated by the uncertainty and volatility in the financial markets, and some choose to reallocate their investments or exit markets entirely in order to avoid potential losses.

In industry terms, this is known as market timing and is notoriously difficult to implement, especially over multiple time periods. As recently illustrated by Vanguard¹² in a case study on the market decline late last year, trying to time markets can lead to devastating results. Why? Because by the time it becomes clear the market is headed down, it’s likely too late. And by selling out of the asset that has just declined, you risk missing out on the bounce back. Depending on how much of that recovery you miss, the difference can be substantial.

Staying The Course Can Pay Off



Source: Vanguard¹².

The more insightful and higher probability-of-success outcome, in our opinion, is to stick with the strategic allocation on which your portfolios are based and the long-term plan on which you and your advisor have collaborated. This strategy is more likely to drive you towards your long-term goals than trading in and out of markets, and further, changes in your overall allocation should be driven by changes in your life and not by movements in the markets.



Looking Forward

Over the last few years, each passing quarter has promised political, financial, or macroeconomic events that would surpass prior ones. And as the trade war endures and the global political landscape continues to be upended, we can only expect more of the same.

The last quarter of this year will play host to two potential tariff additions, an exit of Britain from the European Union (Brexit) scheduled for October 31st, and a Federal Reserve fighting to keep control and retain its integrity as markets continue to form their own views. The holiday shopping season will also be monitored heavily later this quarter as markets look for clarity on how tariffs are impacting US retailers and their customers.

Bond markets are priced for slowing growth. US stock markets are buoyant and not far from their all-time highs. These are the times that try investors' patience, yet we believe exercising patience is the key to long-term success in the markets. Plan for the future, stay diversified, and consult your investment advisor on your unique circumstances.

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As Of September 30th, 2019.



References:

Smaller US stocks¹ – as represented by the Russell 2000 TR Index

International stock markets² – as represented by the MSCI All Country World ex-USA Index

Emerging markets³ – as represented by the MSCI Emerging Markets TR Index

Core intermediate bonds⁴ – as represented by the Bloomberg Barclays US Aggregate Bond Index

High yield bonds⁵ – as represented by the ICE BofAML US High Yield Index

Emerging market bonds⁶ – as represented by JPM Emerging Market Bond (EMB) Global Index.

Tariff increases⁷ – sourced from Goldman Sachs, “US-China Trade Talks: Not Getting Worse but Not Getting Much Better,” 22 September 2019.

Tariffs & Imports⁸ – sourced from Goldman Sachs, “Trade Conflicts Are Hard to End,” 27 September 2019.

Weakening US data⁹ – sourced from JPMorgan Guide To The Markets 4Q 2019, “Manufacturing Momentum”, 30 September 2019.

Repo Market Volume¹⁰ – sourced from SIFMA “2019 US Repo Market Fact Sheet”.

Overnight Repo Rate Chart¹¹ – sourced from CCN, “Are Banks Afraid to Enter the Repo Market Like in 2008,” 24 September 2019.

Vanguard¹² – sourced from Vanguard, “Beat the short-term market jitters,” 2019.

Glossary:

Spreads^a – the difference in bond yields of the same maturity but differing qualities, e.g. corporate bonds vs. US government bonds.

Repos (repurchase agreements)^b – in repurchase markets, borrowers needing cash offer lenders collateral, generally in the form of safe bonds (such as US Government bonds), and in return receive a short-term loan. Repo agreements can be as long as one year, but are generally three months or less, and the most popular tenure is an overnight loan.

Federal funds rate – the interest rate that banks charge other banks for lending them money from their reserve balances (held at the Federal Reserve) on an overnight basis.

Agency mortgage bonds – mortgage securities that are issued by government-sponsored entities (GSEs) like Fannie Mae or Freddie Mac, or guaranteed by a government agency like Ginnie Mae.

Strategic asset allocation – the long-term asset class goals for an investor which specify on average, how much of your money should be invested into stocks, bonds, etc.

Goldilocks – describes an economy that’s neither too hot as to spur rapid inflation or too cold to cause a recession; it characterizes an economy operating in an optimal state from a macroeconomic standpoint.

Yield curve – the graphic representation of US Treasury securities as defined by their yield and time to maturity.

One-month & ten-year rates – on the US government yield curve, the securities issued with maturities of one month and ten years, respectively. The US Treasury also issues securities between one month and ten years, and longer than ten years.

Asset location – the tax-arbitrage strategy of placing high-tax exposure assets in low tax-paying accounts, and vice versa. The theoretical benefit is to lower taxes from investments and compound higher long-term capital.

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