Quarterly Market Commentary | THIRD QUARTER 2018

- US stocks have posted solid returns this year, with large-cap stocks up 10.6% and small-cap stocks up 11.5%. International and emerging market stocks have lagged, down -1.4% and -7.7%. Bonds were also down (-1.6%), while hedge funds and real estate were slightly positive (+1.0% and +2.3%).

- Although global economic growth remains solid, it is slowing and becoming less synchronized, with accelerating growth in the US (from fiscal stimulus) and moderating growth elsewhere.

- While the current expansion is now the 2nd longest at 111 months, it's been a relatively weak recovery.

- The current bull market, on the other hand, is the longest on record and one of the strongest as well.

- Corporate profits and earnings remain strong, benefiting from deregulation and tax reform.

- However, there remains a long list of concerns, such as trade tensions, inflation, monetary policy, geopolitical risks, slowdown in China, and Brexit negotiations.

- Midterm elections are approaching and will draw increased focus, as historically the president's party has lost seats in Congress. However, we caution investors to avoid overreacting and making investment changes based on speculation over election outcomes.

- As we review portfolios, we remain mindful of the lower return potential for stocks and bonds over the next few years as central banks remove accommodation. We continue to focus on the basics: maintain a diversified portfolio, periodically rebalance portfolios, be mindful of cost, undertake unique investment opportunities when available, and avoid overreacting to short-term market movements.

Investment Performance (Total Return) 09/18

	3Q	YTD	1-Year	3-Year	5-Year	10-Year
S&P 500	7.7	10.6	17.9	17.3	14.0	12.0
Russell 1000 Growth	9.2	17.1	26.3	20.6	16.6	14.3
Russell 1000 Value	5.7	3.9	9.5	13.6	10.7	9.8
Russell 2000	3.6	11.5	15.2	17.1	11.1	11.1
Russell 2000 Growth	5.5	15.8	21.1	18.0	12.1	12.7
Russell 2000 Value	1.6	7.1	9.3	16.1	9.9	9.5
MSCI EAFE	1.4	-1.4	2.7	9.2	4.4	5.4
MSCI EAFE SC	-0.9	-2.2	3.7	12.4	8.0	9.7
MSCI EME	-1.1	-7.7	-0.8	12.4	3.6	5.4
Wilshire REIT	0.7	2.3	4.0	7.1	9.3	7.4
HFR Fund-of-Funds Comp	0.3	1.0	3.1	3.3	3.2	2.6
Barcap Aggregate Bond	0.0	-1.6	-1.2	1.3	2.2	3.8
Barcap Muncipal	-0.2	-0.4	0.4	2.2	3.5	4.8
Bloomberg Commodity	-2.0	-2.0	2.6	-0.1	-7.2	-6.2

Federal Reserve: Continuing On Monetary Policy Normalization Track

- At the September 26th FOMC meeting, the Fed raised the federal funds rate by 25 basis points to a target range of 2.0% to 2.25% and updated their forward guidance to an additional rate increase in 2018 and three rate increases in 2019. That would result in a federal funds rate of 2.25% to 2.50% by the end 2018 and 3.0% to 3.25% by the end of 2019.

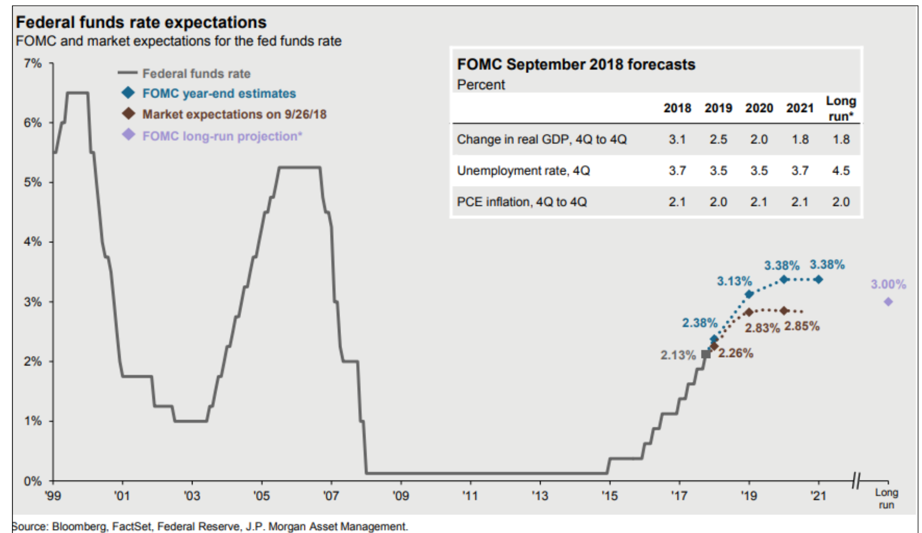
- The Fed dropped guidance in the statement that rates "will remain accommodative for quite some time", as the Fed's new projections imply that interest rates may be at or above their neutral level by the end of next year.

- The Fed continues to express a positive tone, describing economic activity as advancing briskly, the labor market as retaining solid momentum and inflation remaining near target.

- The Fed is continuing the process of normalizing its $4.5 trillion balance sheet by reducing their asset holdings. The reduction is gradual, but increasing to $50 billion per month in Q4, which translates to a $420 billion reduction in 2018.

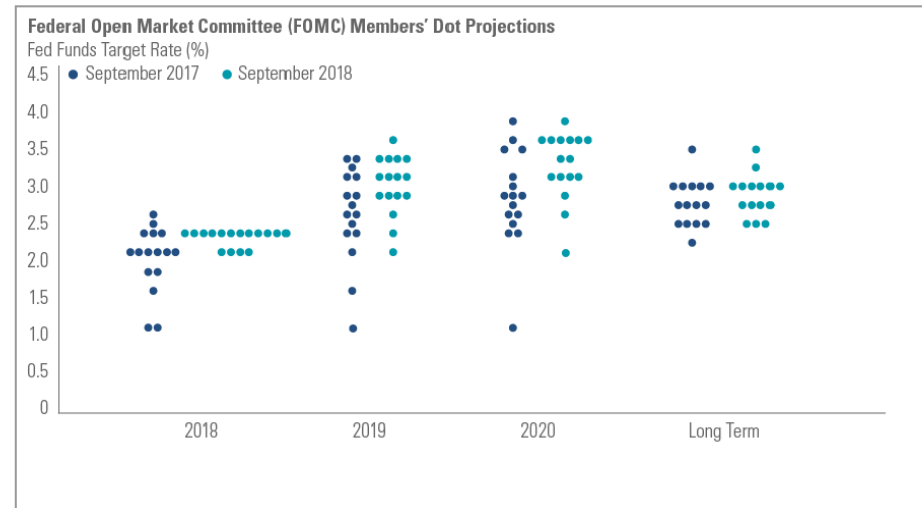
- Inflation is in-line with the Fed's 2.0% target, and the Fed seems okay with inflation rising above target without feeling the need to accelerate the gradual pace of rate increases.

- President Trump continues to reshape the seven member Federal Reserve Board of Governors, having selected Jerome Powell as Fed chair, Richard Clarida as Vice Chair and Randy Quarles as a board member. Two other nominees, Michelle Bowman and Marvin Goodfriend, await confirmation.



FOMC September 2018 forecasts
Percent

	2018	2019	2020	2021	Long run*
Change in real GDP, 4Q to 4Q	3.1	2.5	2.0	1.8	1.8
Unemployment rate, 4Q	3.7	3.5	3.5	3.7	4.5
PCE inflation, 4Q to 4Q	2.1	2.0	2.1	2.1	2.0



Source: Federal Reserve and GSAM. As of September 26, 2018.

Fixed Income: 10-Year Yield Around 3%

- The Barclays US Aggregate Bond Index was flat in Q3, and has declined -1.6% YTD, reflecting the rising interest rate environment. Emerging market bonds continue to struggle, down -3.04% YTD, while the BOA High Yield Index has fared a little better, up +2.52% YTD.

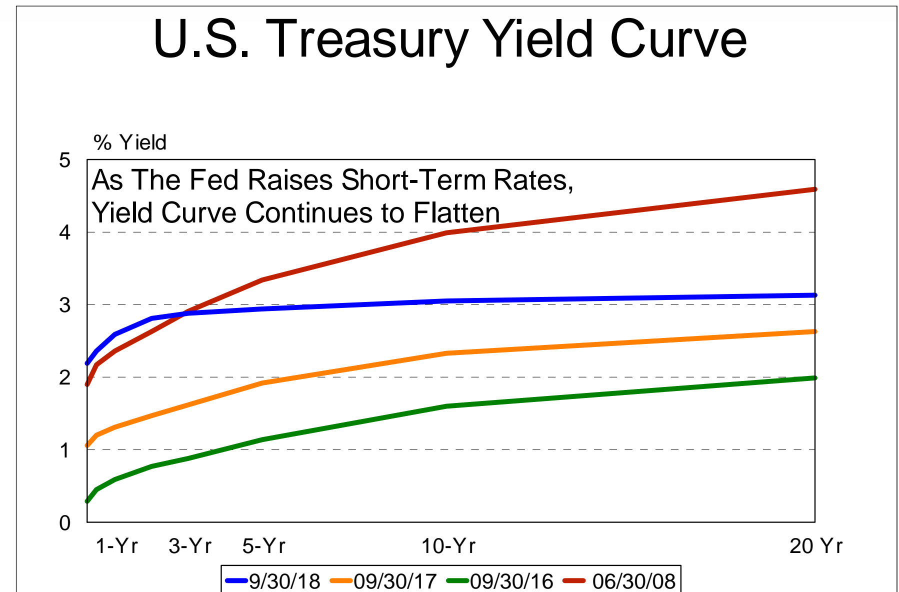
- The 10-Year Treasury yield remains range-bound around 3%, ending Q3 at 3.05%, but trading in a range of 2.82% to 3.10% during the quarter. The 2-Year Treasury yield ended the quarter at 2.81%, up substantially from 1.89% at year-end 2017.

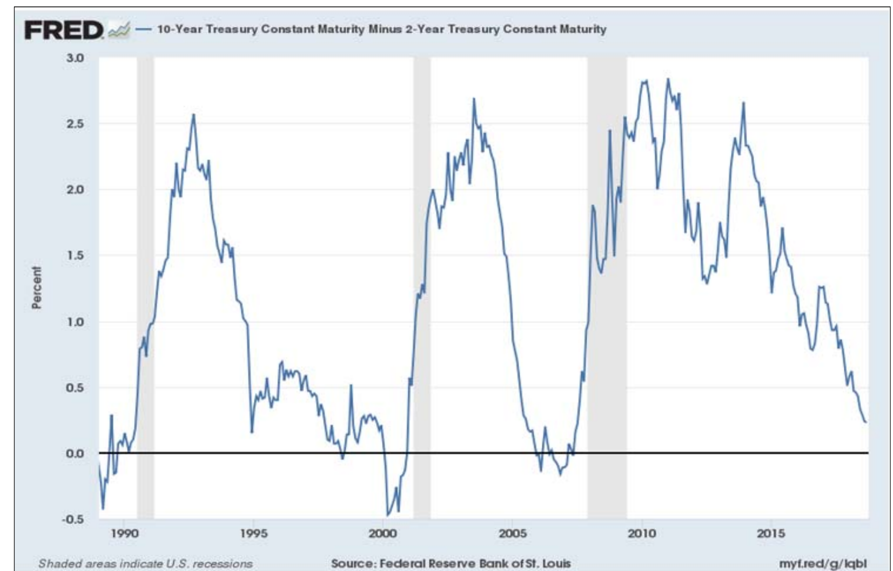
- The 2-year/10-year Treasury yield spread remains narrow, ending Q3 at 0.24%, but not inverted (which has historically been indicative of the conditions that occur ahead of recessions). In addition to Fed hiking, this is likely due to the anchoring effect of low global interest rates and the Treasury's decision to stop extending the weighted average maturity of its issuance.

- As we have noted previously, all major bond markets have seen an increase in duration since the financial crisis given low interest rates, leading to increased interest rate risk.

- While interest rates have risen across the yield spectrum, given the low growth environment and the Fed's gradual process of policy normalization, rates are likely to remain materially below their historical norms.

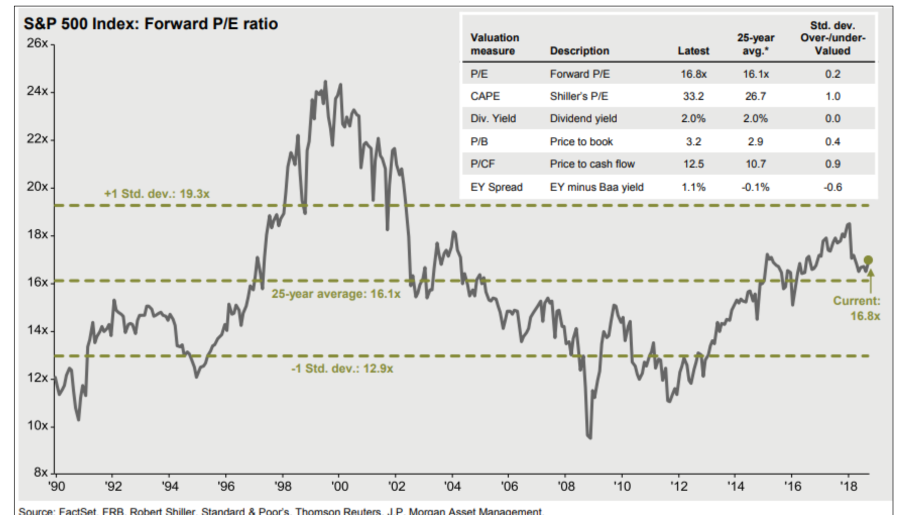
- While the environment for bonds remains challenging, bonds remain a very important part of a diversified portfolio, providing income and stability to offset equity volatility.





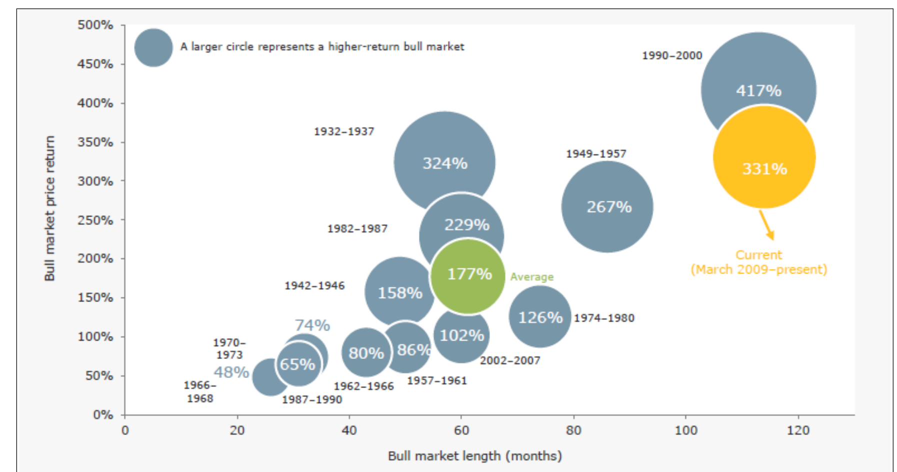
Equities: US Markets Going Their Own Way

- US large-cap stocks were up 7.7% in Q3 and are up 10.6% YTD. Small-cap stocks have performed even better, up 11.5% YTD.
- The current bull market became the longest on record in August, and has produced an annualized return of 19%, making it one of the strongest as well.
- The S&P 500 peaked on 10/09/07 and then experienced a 17-month bear market where the index fell -57% before bottoming on 03/09/09. Since then, the S&P 500 is up 331%, but has suffered 11 separate declines of 5% - 19% during this time period, including a 10% decline in January/February of this year.
- Corporate earnings continue to be strong, and the forward P/E for the S&P 500 is about in-line with the average over the past 25-years (suggesting the market is not overvalued).
- The Global Industry Classification System (GICS) sector methodology enacted changes at the end of September, renaming and expanding the Telecommunication Services sector to Communication Services and moving a number of prominent technology names (Alphabet, Facebook) as well as a number of media companies (Netflix, Disney, Comcast) into the new sector. This won't change the weighting of any security within the S&P 500, but will impact sector weightings
- While economic growth may moderate, it should remain positive, which combined with continued corporate earnings growth should allow the equity bull market to continue. However, investors should moderate their return expectations at this point in the cycle.



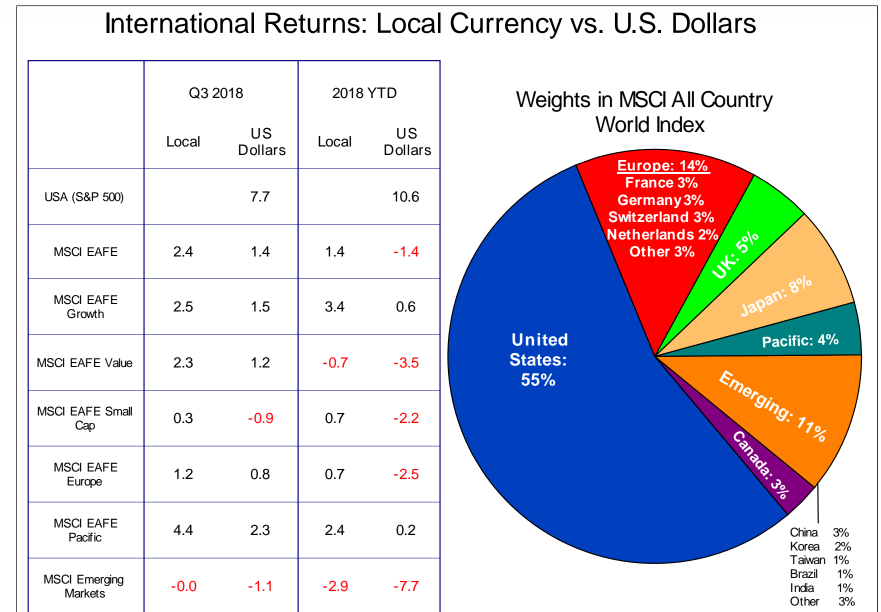
Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	16.8x	16.1x	0.2
CAPE	Shiller's P/E	33.2	26.7	1.0
Div. Yield	Dividend yield	2.0%	2.0%	0.0
P/B	Price to book	3.2	2.9	0.4
P/CF	Price to cash flow	12.5	10.7	0.9
EY Spread	EY minus Baa yield	1.1%	-0.1%	-0.6

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.



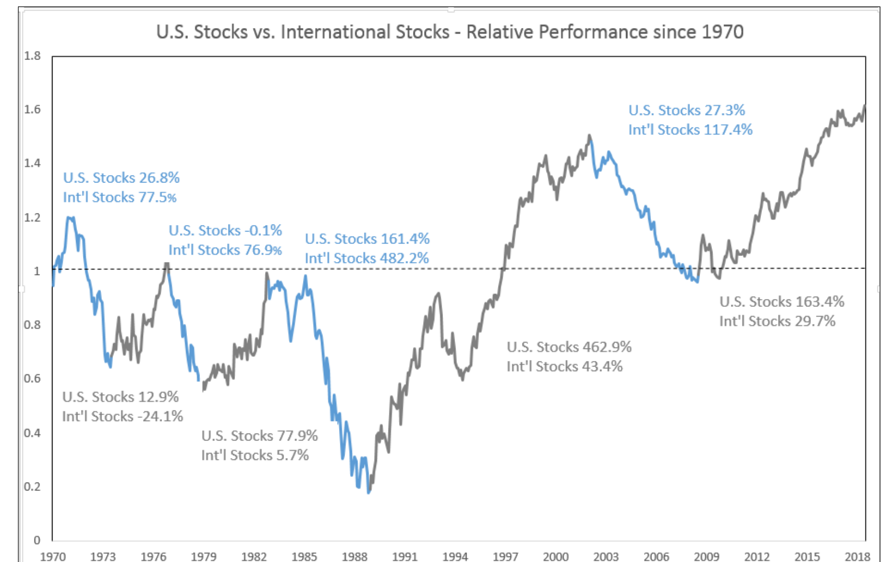
International Equities: Will Returns Eventually Mean Revert?

- International equities were up +1.4% in Q3, but are still down -1.4% YTD. International small-cap stocks were down -0.9% in Q3 and are down -2.2% YTD. Emerging Markets continue to struggle, down -1.1% in Q3 and down -7.7% YTD.
- Thus far in 2018, the US dollar appreciated about 5.3% vs. the world basket, stressing a number of emerging market currencies.
- The European Central Bank (ECB) is expected to end its bond purchase program at year-end, but will likely continue investing maturing bonds. Moreover, it seems likely they will maintain the negative interest rate policy through at least the first half of 2019.
- The Bank of Japan seems likely to continue its easy monetary policy, targeting a 10-year JGB yield of 0%.
- With Brexit set to occur on March 29, 2019, anxiety will likely impact financial markets as negotiations continue, especially if talks hit an impasse.
- We continue to believe international stocks are important for portfolio diversification. Non-US stocks represent about 50% of global market cap, 75% of listed companies, and 85% of the world's population. Investing in international stocks provides exposure to different economic conditions, demographics, political regimes and currencies.
- Although US stocks have significantly outperformed international stocks since the March 2009 market bottom, leadership is cyclical, and we would expect reversion to the mean over time.



International Returns: Local Currency vs. U.S. Dollars

	Q3 2018		2018 YTD	
	Local	US Dollars	Local	US Dollars
USA (S&P 500)		7.7		10.6
MSCI EAFE	2.4	1.4	1.4	-1.4
MSCI EAFE Growth	2.5	1.5	3.4	0.6
MSCI EAFE Value	2.3	1.2	-0.7	-3.5
MSCI EAFE Small Cap	0.3	-0.9	0.7	-2.2
MSCI EAFE Europe	1.2	0.8	0.7	-2.5
MSCI EAFE Pacific	4.4	2.3	2.4	0.2
MSCI Emerging Markets	-0.0	-1.1	-2.9	-7.7



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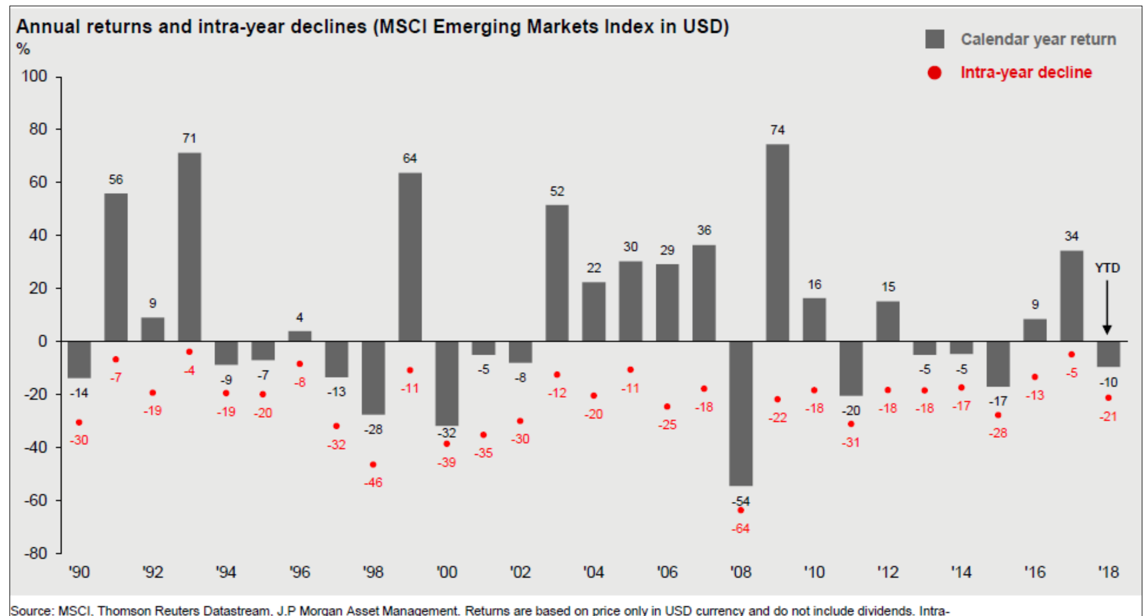
Emerging Markets: Addressing Recent Volatility

Thus far in 2018, emerging market stocks have struggled, down -7.7%. The selloff can be attributed to country-specific factors (Turkey, Argentina), trade tensions, rising US interest rates, a crowded election calendar, and tighter global financial conditions.



Source: MSCI, Thomson Reuters Datastream, J.P Morgan Asset Management. Returns are based on price only in USD currency and do not include dividends. Intra-

Volatility in emerging markets is not new. While emerging markets have performed well over time, they have done so with significant volatility. The MSCI Emerging Markets Index has experienced an intra-year decline of 10% or more in 14 of the past 15 years.

Despite the recent volatility, we continue to believe the long-term demographic and economic growth trends support maintaining an allocation to emerging markets stocks.

Hedge Funds: Better in a New Environment?

- The HFRI Hedge Fund-of-Funds was up 0.3% in Q3 and is up 1.0% YTD (although our hedge fund allocation has performed a little better).
- While hedge fund performance over the past decade has been disappointing, the long-term performance remains attractive. The question is whether the next decade is likely to reflect the attractive long-term returns or the disappointing recent experience. An environment with increased volatility, low bond yields, and lower expected returns for stocks may make hedge funds attractive again.
- The original appeal of hedge funds was their ability to generate attractive risk-adjusted returns with low correlation to traditional stocks and bonds. This is even more appealing in the current market environment, and thus we are maintaining our allocation with the expectation that the performance environment for hedge funds is improving.

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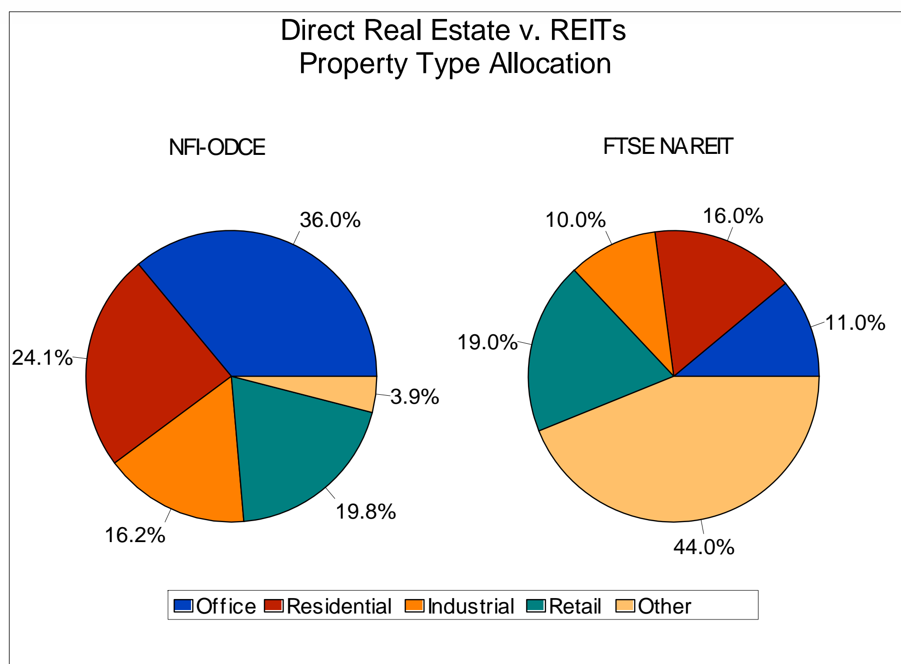
Real Estate: Challenging Investment Environment

- REIT returns were flat in Q3, but are up 2.3% YTD. Direct real estate returns have been slightly better, with the TIAA Real Estate Account up 1.2% in Q3 and up 3.8% YTD.
- Non-traditional real estate sectors (self-storage, student housing, senior housing, data centers, etc.) continue to show higher growth. As a result, non-core property types now account for about half of the FTSE REIT Index. In comparison, the NCREIF ODCE Index continues to have a much greater focus on core real estate – office, industrial, retail and residential (apartments).
- While we continue to slightly underweight real estate vs. our long-term target allocation, we recognize real estate continues to provide an attractive yield (versus bonds), potential for growth, and a hedge against inflation (from increasing rents and property values).



Master Limited Partnerships: Recovering

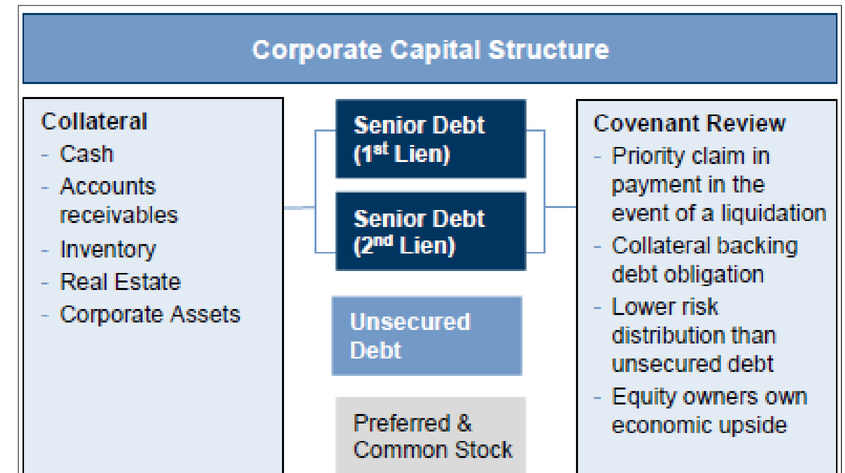
- MLPs performed well in Q3, up 6.6% and are now up 5.9% YTD. However, volatility remains high, as MLPs fell about 20% from their peak in late-January to their low in late-March before recovering in Q2 and Q3.
- As a reminder, MLPs are operating companies that invest primarily in U.S. energy infrastructure, engaging in the transportation, storage or processing of oil and natural gas. MLPs own and operate long-life assets that have steady, contracted, fee-based cash-flows with annual inflation escalators/rate renewals. MLPs tend to be dominant franchises and earn a fee for the *volume* of product they are transporting/storing/processing.
- While the US energy renaissance continues to play out (production has doubled over the past five years), unfortunately MLPs have not benefited thus far. With a distribution yield in the 8% range and the price of oil moving up, this may provide support for MLPs.

Business Development Companies (BDCs): Stable Returns

- The Wells Fargo Business Development ETN was up 4.2% in Q3 and is up 6.4% YTD. Our private BDC investments continue to provide steady returns, with yields in the 8% range.

- Middle-market direct lending involves loans to mid-market companies via senior loans used to finance things such as recapitalizations, capital expenditures and corporate acquisitions.

- Middle market loans are primarily floating rate (low exposure to interest rate risk), senior secured with covenants (limited credit risk), and have historically offered an attractive return uncorrelated with the overall stock and bond markets.



- We continue to prefer private BDCs given their moderate volatility, and we seek to partner with firms that seek to limit loan losses by investing in higher quality loans, such as Golub and Goldman Sachs.

Quotes of Note:

"While we reconfirmed our late-cycle thesis at the forum, one senior participant reminded us that a late-cycle environment can last a long time – in his words: "Think a fifth set at Wimbledon without a tie break." It can last if excesses and major policy mistakes are avoided. So while being mindful of risks of an early end, we think it is too early to run for the hills." *Growing, But Slowing, PIMCO Cyclical Outlook, September 2018*

"The U.S. economy continues to power ahead. Growth is running firmly above potential, labor markets are near full employment and still tightening (though with only scattered signs of overheating), and inflation is back near the Federal Reserve's (Fed's) target (but not overshooting). In short, the economy seems still to be in a cyclical sweet spot. And the near-term outlook remains bright. The economic expansion, already the second-longest on record, is showing little sign of wear, underpinned by sound domestic fundamentals, fiscal stimulus, and still-accommodative financial conditions. Against this backdrop, we expect growth to remain above potential into next year, enough to tighten labor markets modestly further and help solidify inflation's move back near target, though a material inflation overshoot remains unlikely in the near-term given well-anchored inflation expectations and the attenuated responsiveness of inflation to slack." *U.S. Economic Outlook, Joshua N. Feinman, Chief Global Economist, DWS, August 2018*

"At this stage in the business cycle, however, with the Fed actively hiking rates and reducing the size of its balance sheet, valuations have become stretched and we should start to see great dispersion in returns across sectors, regions and factor styles." *Late-Cycle Investing, PIMCO, August 2018 Asset Allocation Outlook Midyear Update*

"Recessions are notoriously difficult to predict, and sometimes are tricky to recognize even after they start. The recession that began in December 2017 wasn't officially proclaimed by the National Bureau of Economic Research's recession-dating committee until a year had gone by. Forecasters saw the chances of a recession rise back in 2011 and in 2016; both turned out to be false alarms." *Economists Think the Next U.S. Recession could Begin in 2020, Wall Street Journal 09/27/18*

"Alternative asset classes may reemerge as essential diversifiers, should equity and fixed income return correlations stay positive." *Goldman Sachs, Market Know-How, 2018: Edition 3*

"The US real estate market is in its mature phase as characterized by slowing rent and appreciation growth. However, real estate fundamentals remain solid with supply and demand largely in balance. The biggest risk to US real estate is exogenous. Should the geopolitical landscape hamper US economic growth, the US real estate cycle will suffer in tandem." *Nuveen/TIAA 2018 Global Research Outlook*

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