## Third Quarter 2018 *Key Takeaways*

**Large-cap US stocks hit new highs in late September and gained 7.7% for the quarter, while smaller-cap US stocks gained 3.6%.** S&P 500 operating earnings per share grew 27% year over year in the quarter—compared to their 6% long-term annualized growth rate. A record high 80% of S&P 500 companies reported earnings that beat the consensus expectations. Record levels of share buybacks (estimated by Goldman Sachs to reach $1 trillion for 2018) were another pillar of support for the US market.

**Developed international stocks gained just 1.2% in the quarter, while emerging-market stocks (EM) fell 1.7%.** Foreign stock markets were impacted by poor sentiment, and a rising US dollar was a further drag on returns for dollar-based investors.

**In fixed-income markets, the 10-year Treasury yield rose to 3.05% at the end of September, flirting with a seven-year high.** Consequently, the core investment-grade bond index had a negative return in September and was flat for the quarter.

**Credit-sensitive segments, on the other hand, performed well, with floating-rate loans gaining 1.7% for the quarter.** This was good news for our balanced portfolios, as our unconstrained managers were able to use the loans to improver the funds relative performance.

**Our active bond managers have also outperformed the core bond index for the year.** We expect these positions to outperform over the next several years as well, particularly as interest rates continue to rise. The Federal Reserve has raised rates three times so far this year with a fourth teed up for December. Policymaker forecasts call for three more increases in 2019.

**Our balanced portfolios also continue to hold liquid alternative strategies funds that we believe improve our portfolios' long-term risk-adjusted return potential.** We trimmed our managers this past quarter but still believe in the importance of the asset class. We will continue to evaluate new managers and strategies in order to provide diversity to both the asset class and the portfolios.

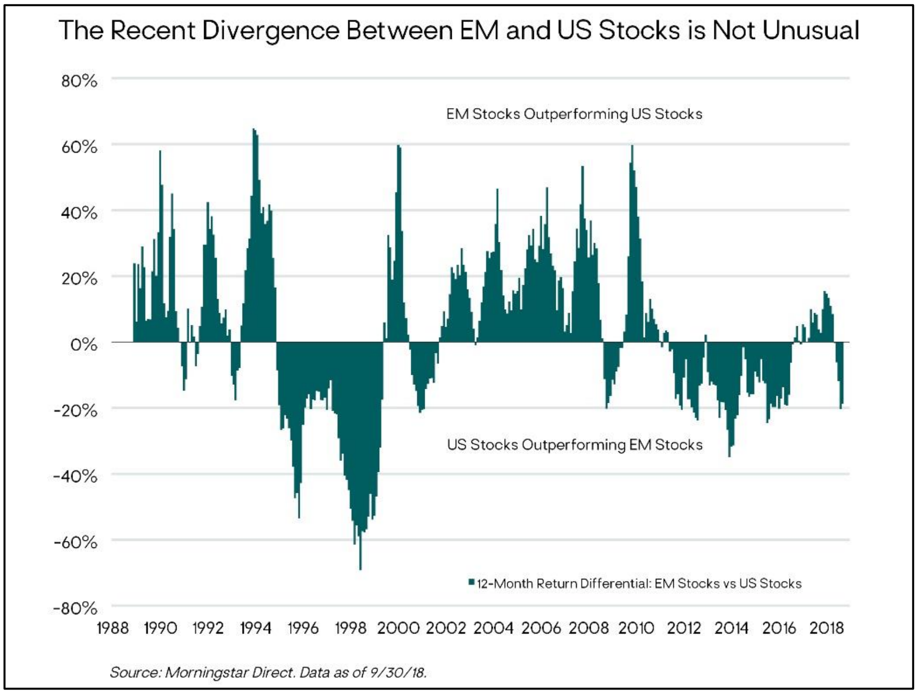
**In 2018, US stocks have strongly outperformed EM stocks, but this level of divergence is not unusual.** Still, given the negative headlines surrounding emerging markets, we highlight several points this quarter that indicate EM stocks remain attractive and their long-term growth outlook is intact. On the other hand, US stocks look expensive, and there are reasons to think the near- and medium-term outlook for them is not so rosy. The overvaluation of the US stock market represents one of the biggest risks to our portfolios.

# Third Quarter 2018 Investment Commentary

## Market Recap

Market trends in the third quarter were largely an extension of what we've seen so far this year, with a stark divergence in return between US stocks and EM stocks. The US market was propelled by continued strong profit growth, thanks in large part to the Trump corporate tax cuts, beating emerging markets by roughly 20 percentage points year to date through the end of September.

This level of divergence in relative performance is not unusual. It is common for US stocks or EM stocks to outperform the other over 12-month periods as shown in the chart to the right. Just last year, EM stocks gained 31.5% and outperformed the S&P 500 by roughly 10 percentage points. That has sharply reversed this year.




## Reiterating Our Outlook for EM and US Stocks

### EM STOCKS

While there are always multiple factors behind short-term market moves, there were two dominant headwinds facing EM stocks in the third quarter: the intensifying trade conflict between the United States and China, and the strength of the US dollar. While neither of these factors presents new or material threats to our analysis of EM stocks, they have impacted our portfolios' short-term returns given the magnitude by which they have lagged US stocks so far this year.

However, there are several points worth highlighting that give us confidence in our assessment that EM stock valuations are cheap and their attractive long-term return potential remains intact:

- Our base-case continues to be that a full-fledged trade war is unlikely as it is in neither country's best interest, despite the fact that we may be living in a world with an overhang of trade tensions for a while. It's also not clear US stocks would be less impacted than EM stocks given the former's global presence.

- US dollar strength has hurt dollar-based foreign stock returns, but longer term, there are reasons to think this will reverse. We believe the fiscal stimulus of tax cuts at a time when the US economy is strong will cause fiscal deficits and debt levels to rise—both potential headwinds for the US dollar.

- Economic crises in Argentina and Turkey have made headlines, but these countries' economies and financial markets are small. We see little risk of contagion to other emerging markets. In contrast to previous EM crises, the fundamentals of most other EM countries are much healthier in terms of debt levels, trade balances, dependence on foreign capital, foreign exchange reserves, etc.

- Within our normalized-earnings framework, we apply the historical discount EM stocks have traded at compared to US stocks and they are still attractive. EM stocks are even attractive after adjusting for sector differences between US and EM markets.

**US STOCKS**

As for US stocks, no one knows exactly when this confounding, record-longest US bull market will end. Despite their unattractive fundamentals, it's certainly possible US stocks will continue to be favored by investors over the short term. However, S&P earnings growth expectations are now exceedingly high, and the US economy is operating at or near full capacity and full employment. These are unsustainable conditions, and the direction in which they will move next is likely negative for stocks.

Our portfolios' tactical underweight to US stocks is based on conclusions drawn from our fundamental research on historical stock market valuations, earnings growth, and corporate profit margins. From current price levels, our base-case expectations for US stock returns over the next five years is in low single-digits (2-3%). To put these estimates in historical context, since 1950, the S&P 500 has generated an 11.1% average annual five-year (60-month) return.

No matter how we slice it, our analysis suggests the US market is the most expensive major stock market in the world. As a result, it presents one of the biggest risks to our portfolios. This is why we have diversified our portfolios' stock exposure by investing in foreign markets that, in contrast, look significantly cheaper and offer a much stronger medium- to longer-term growth outlook. But these positions come with additional shorter-term risk, as we've seen so far this year.

Outside of traditional markets, we have added and will continue to add lower-risk alternative investments to our portfolios for their risk management and portfolio diversification benefits. We expect them to shine when US stocks experience their inevitable periods of poor returns. We think these strategies can generate annual returns that are attractive relative to what we currently expect from a comparable mix of stocks and core bonds.

## In Closing

We strongly believe that a key element of our investment process and edge is our discipline in maintaining a multiyear perspective rather than over-reacting to short-term price volatility, performance swings, daily news flow, and other behavioral triggers. It's easier said than done, though, especially amidst an unprecedented stock market run and a seemingly unending string of unnerving geopolitical headlines. Rest assured, we remain ever-vigilant in analyzing new data and information, and if our analysis warrants a change in our views or portfolio allocations, we will act.

Thank you for your continued confidence and trust.

-ClearPath Capital Partners (10/9/18)