



Recap: The general theme of the U.S. economy, currently growing above potential in the near term before gradually losing some momentum remained more or less intact in the third quarter. The economy maintained solid momentum heading into the last quarter of the year. Strong consumer spending boosted US economic growth in the third quarter, helping to offset a decline in business investment and exports. GDP grew at 3.5%.

Despite a slight pullback in the NFIB small business optimism measure this past month, the narrative has remained broadly unchanged – confidence among small businesses remained the most upbeat it has been in decades. Trade however has been a slight drag on growth. Recent preliminary agreements with Mexico and Canada helped relieve some of the market’s lingering anxiety about international trade. The trade war rhetoric with China has continued to escalate, however, and remains a future downside risk.

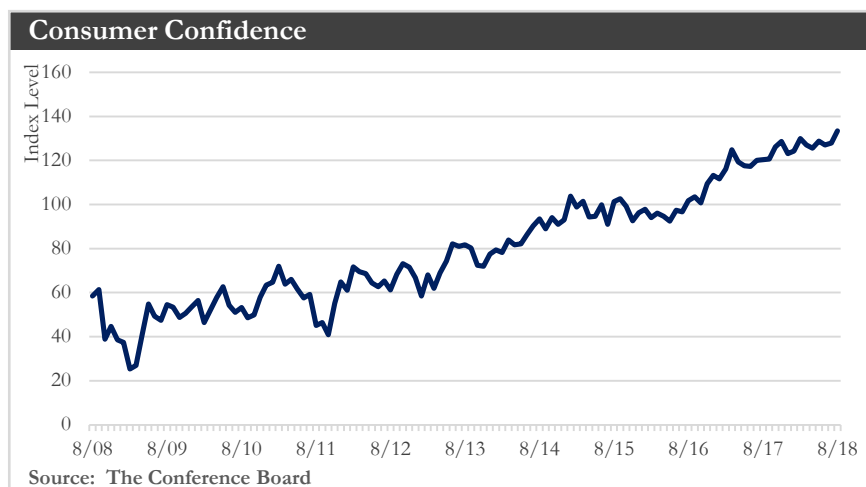
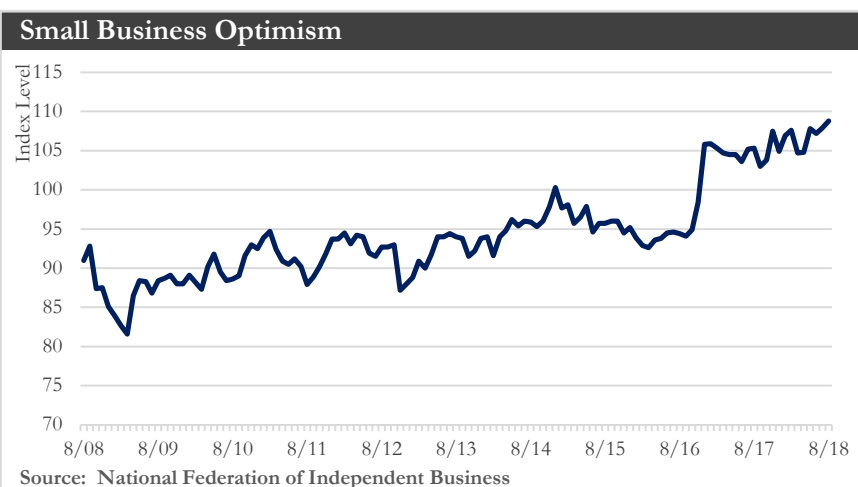
Hiring has run slightly ahead of the year-ago pace, and the unemployment rate sits at 3.7%, a level last reached in 1969. Tighter labor markets have led to higher wages, as businesses have boosted compensation to retain employees. Inflation has gradually trended higher, which has encouraged the Fed to continue nudging the federal funds rate higher and probably through 2019. Fears of an inverted yield curve appeared to have been premature. The business cycle was nearing record length.

The global economy maintained a steady and solid pace during the first half of 2018, with Q2 GDP growth for the G-20 economies at 3.9% year-over-year, near the fastest rate of growth since mid-2011, earlier in the global recovery. Still, this relative calmness on the surface masked some areas of instability which lurked among the details. Growth for the G7 economies, besides the U.S., has slowed noticeably. There has also been a similar split among the emerging economies, with areas of both strength and weakness. Markets have noticed this dispersion in economic performance.

Consumption Spending: The American consumer appeared to be in good shape heading into the final quarter of the year, which includes the busy holiday-shopping season. Consumer spending cooled in August though strong growth was expected in the final stretch of the year.

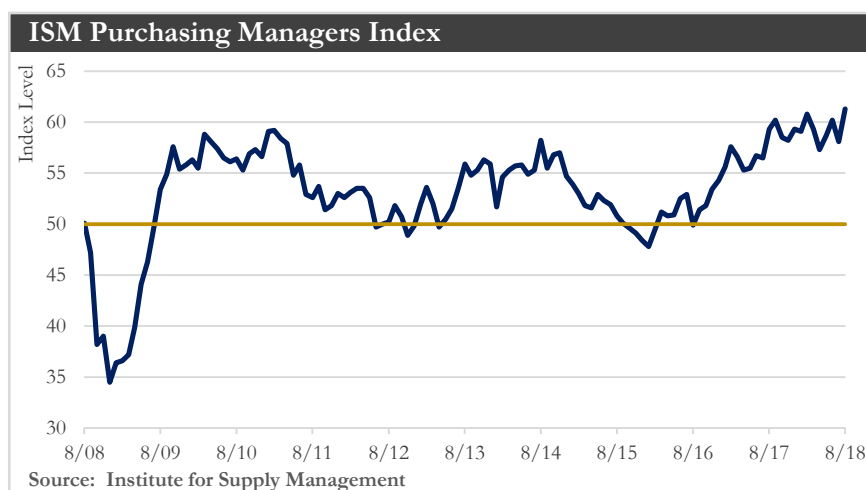
Consumer confidence climbed to an 18-year high in September, supported by a strong labor market. Consumer savings matched July’s pace.

Discretionary stocks have outperformed the broader U.S. stock market, signaling consumers were confident in the health of the economy and willing to part with their disposable income. Still, within the consumer discretionary sector, department stores and companies selling textiles, apparel and luxury goods have raced past retailers in the automobile and household durables space. The U.S. consumer should keep supporting



economic growth unless oil prices keep rising which could dent spending.

ISM Manufacturing Index: Activity in the U.S. manufacturing sector decelerated in September yet remained in expansion territory. It is possible the industry could be reaching a peak. The Institute for Supply Management's (ISM) manufacturing index fell to 59.8 in September from 61.3 in August, the highest level since May 2004.



Sales of factory-made products, production and employment have continued to grow. ISM's new orders gauge and its supplier delivery index have both declined. The Federal Reserve's recent interest-rate increases could also affect the sector because tighter financial conditions could impede demand. The stronger dollar could hinder demand if U.S.-made products get progressively more expensive to foreign buyers.

ISM's Non-manufacturing Index: Purchasing in the services sector and spending by local governments at the end of their fiscal year pushed services- sector activity to the

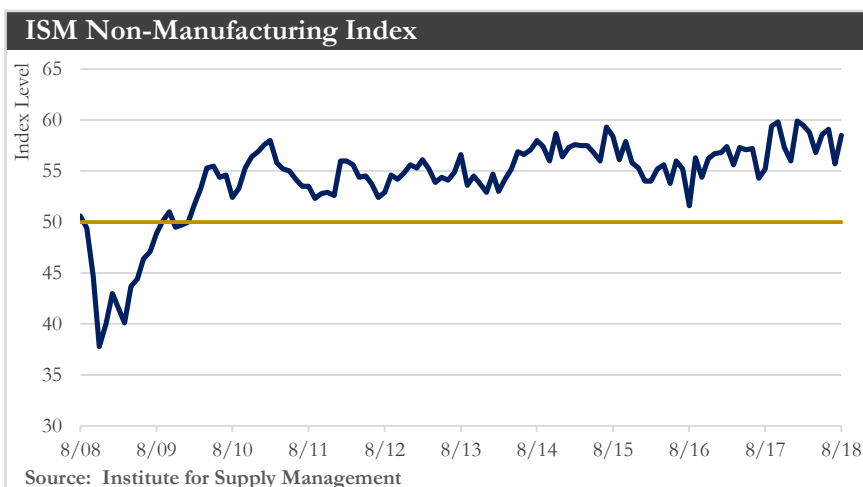
highest level on record. The Institute for Supply Management's nonmanufacturing index rose to 61.6 in September, the highest reading going back to 2008.

Production, new orders and employment have all picked up rapidly, with businesses feeling the current euphoria of robust economic and job growth, strong consumer confidence and spending. Though the figure bodes well for economic growth in the coming quarters, much of the sector's September growth appeared to have come from purchases pulled forward in advance of the Trump administration's tariffs and retaliatory tariffs from foreign countries.

Inflation: Headline consumer prices rose a mild 0.1% in September. CPI, excluding food and energy, also rose a modest 0.1%. The modest gains in September saw headline inflation decelerate on a year-over-year basis to 2.3%. The modest monthly gain in core prices left the annual pace of core inflation steady at 2.2%.

While inflation has simmered away at around a 2% pace, there have been few signs that it is starting to boil. Price pressures for core services have been described as steady. Meanwhile, a strong U.S. dollar and a competitive retail sector have kept core goods inflation weak. Going forward inflationary pressures are expected to pick up slightly over the coming quarters. There has been little debate that the labor market is tight, and domestic demand is being buoyed by tax cuts and spending.

Housing: The slowdown in housing has been blamed on a number of factors, and the bad news is they are all likely to get worse. Single-family permits, which measure how much construction was in the pipeline, fell to their lowest level in a year. Other housing



measures, including existing and new home sales have also been slowing in recent months.

The reasons for the weakness have been clear. Mortgage rates have been near seven-year highs and rising prices have cut into affordability. A tight labor market and steep construction material prices raised builders' costs. The new tax law's limit on deductions for mortgage interest and state and local taxes have made owning a home less enticing in a number of states.

But if those things were headwinds for the housing market, they could become even stronger later. With the Federal Reserve on course to keep on raising rates through next year, long-term rates have been on the rise. A strong economy should keep driving unemployment lower, making the shortage of construction workers even more intense. For home buyers, the consequences of the tax-law changes may not have fully sunk in yet. Housing's recovery after the financial crisis has been much weaker than anyone hoped for. The risk now is that it has been cut short.

Federal Budget Deficit: The U.S. government ran its largest budget deficit in six years during fiscal year 2018, an unusual development in a fast-growing economy and a sign that—so far at least—tax cuts have restrained government revenue gains. The deficit totaled \$779 billion in the fiscal year that ended Sept. 30, up 17% from \$666 billion in fiscal 2017.

The federal budget deficit should widen once again in FY 2019 to just around \$1 trillion. The tax cuts enacted were only in effect for about two-thirds of FY 2018, compared to all of FY 2019, barring an unexpected change in policy. Furthermore, the increase in discretionary spending as a result of the budget deal reached earlier this year has occurred at a slower pace than initially anticipated. As a result, more of the newly granted budget authority could be spent in FY 2019 than initially expected.

Tariff and Trade pacts: The U.S., Mexico and Canada reached a last-minute deal for a successor to the tri-country NAFTA Pact. The U.S.-Mexico-Canada Agreement (USMCA) marked a new era for trade among the three countries. There are still vital steps ahead for USMCA implementation, but the agreement in principle allowed auto manufacturers in all three countries to breathe a sigh of relief. The deal, however, should raise U.S. vehicle prices in the future given new provisions on wages for auto workers.

The agreement means the U.S. should no longer be fighting a trade war on multiple fronts. The trade deficit with China has worsened despite tariff measures. It remains to be seen if the latest tranche of tariffs imposed on China will be up to the task of correcting perceived imbalances and how it will impact growth.

US Dollar: A dollar rally that has pressured everything from emerging markets to commodities in 2018 has reversed into the year's end. A number of factors have dovetailed in recent months to weigh on the dollar. A gradual U.S. approach toward imposing tariffs on Chinese goods has sparked hopes that the U.S. and China may eventually resolve their trade dispute. Investors may begin to cut back on safe haven bets such as the dollar and U.S. equity shares, and go back into emerging market currencies and stocks.

Dollar strength, based on macroeconomic and monetary policy divergence, may be nearing the end of its current advance. The dollar should remain flat against the euro this year and depreciate against it next year.

Emerging Market Currencies: Emerging market currencies have recovered as U.S. Treasury yields and the dollar have fallen back from the highs that sparked sharp declines across the developing world. Further volatility is expected for emerging markets, given continued trade tensions between the U.S. and China and uncertainty over global economic growth. Emerging market currencies spiraled lower through the summer as U.S. interest rates and the dollar rose, making dollar-denominated debt more expensive and risk-free Treasury yields more attractive. Trade tensions added to the negative conditions, as did domestic troubles in countries like Argentina and Turkey.

To be sure, the emerging market recovery may be temporary. The U.S. economy has remained strong and the Federal Reserve has continued to raise interest rates. Trade tensions between the U.S. and China also haven't gone away and

questions have remained over growth in emerging markets. Add to this mix rising oil prices have climbed to a four-year high. The price of oil has risen amid concerns about falling supply from Iran due to U.S. sanctions and supply outages in Venezuela. Countries like Turkey, India, the Philippines and South Africa import most of their oil. So rising prices have spurred higher inflation and expanded already large current account deficits in some countries.

Eurozone: Eurozone retail sales fell for the second straight month in August, a fresh sign that economic growth has yet to rebound significantly from a slowdown in the first half of the year. A surge in exports drove Eurozone economic growth to a decade-high pace in 2017 but weakening overseas sales have been behind a loss of momentum this year. While service sector growth remained resilient in September, it would be unusual for this to be sustained in the absence of improved manufacturing growth. An economy more reliant on household spending to drive the expansion with falling retail sales should be a worrying sign.

The 0.2% drop in retail sales in August came despite a fall in unemployment and a pickup in wage growth. But energy prices have risen more sharply over recent months, eating into the income available to spend on other goods and services. There have been few signs the economy will rebound strongly in the remaining months of the year.

The European Central Bank recently confirmed its intention to end the quantitative easing program in December. But fresh signs of faltering growth have reinforced its cautious approach to removing crisis-era stimulus measures and not raising the key interest rate until the end of summer 2019.

Meanwhile, with only moderate financial headwinds and as Brexit uncertainty lessens, the Eurozone and U.K. growth are expected to firm going forward.

Outlook: The U.S. economy powered ahead in the third quarter of 2018 driven by robust consumer and government spending, though there were warning signs that the business sector would face turbulence that could hold back the expansion in the months ahead.

Two big drivers of growth this year—consumers and government spending—will slow in the months ahead. Consumer spending picked up, thanks to tax cuts. The spending impetus from income-tax cuts has tended to be greatest in the first two quarters after they're enacted, and then fade over about eight quarters. Thus consumer-spending growth, which hit a robust 4% annual rate in the third quarter, should slow in the months ahead, though strong household saving and low unemployment will prevent a sharp drop-off.

In February, the White House and Congress agreed to increase federal government spending by \$300 billion above earlier spending caps. That will propel government spending for several more months, boosting growth, but the budget agreement runs out next September. That means its impact, too, will fade, unless the next Congress agrees to more.

The big wild card for growth has been business investment. Business tax cuts are meant to increase investment in software, plants and equipment, boosting the economy's growth rate now and its potential to grow far into the future. Business investment grew at an 11.5% rate in the first quarter, with gains across many categories, including machines, intellectual property and big structures. But it has faded since, registering just 0.8% growth in the third quarter including a drop in investment in structures such as oil-and-gas rigs, which had been a big driver of growth.

There are plenty of downside risks lurking around corners for the U.S. economy, including tariffs, higher government deficits leading to a rise in Treasury yields and the risk of a Fed policy error. But, at the moment it must be acknowledged that the U.S. economy is growing strongly, a healthy labor market is increasing the share of people with jobs, and wages are gaining ground. At the same time, inflation pressures remain very well behaved. That helps ensure the Fed can remain patient as it raises interest rates. It would take a much more severe tightening in financial conditions than recently observed to put this pace at risk.

On the international front, Brexit has remained a source of uncertainty, while recent developments in Italy have also become a major cause of concern. The EU Commission has determined that Italy's draft budget is in serious breach of EU

budget rules and may reject it. Chinese economic growth is slowing and policymakers there have a tough balancing act between deleveraging and maintaining adequate growth. A recent sour exchange between trade representatives of the EU and U.S. also serves to remind that the Trans-Atlantic trade truce rests on feeble foundations. All told, plenty of risks remain and it will not be an easy path to navigate.

Sources: National Federation of Independent Business, Department of Commerce, Department of Labor, Institute for Supply Management, Bloomberg, Morningstar, European Central Bank, Eurostat, Congressional Budget Office

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Index Performance as of: 9/30/2018

	<u>1 Week</u>	<u>1 Month</u>	<u>QTD</u>	<u>3 Month</u>	<u>YTD</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>
3000 Value	-1.65	-0.00	5.39	5.39	4.17	9.46	13.74	10.65
3000	-0.53	0.17	7.12	7.12	10.57	17.58	17.07	13.46
3000 Growth	0.58	0.33	8.88	8.88	16.99	25.89	20.35	16.23
1000 Value	-1.66	0.20	5.70	5.70	3.92	9.45	13.55	10.72
1000	-0.51	0.38	7.42	7.42	10.49	17.76	17.06	13.67
1000 Growth	0.65	0.56	9.17	9.17	17.09	26.30	20.55	16.59
Mid Cap Value	-1.62	-0.79	3.30	3.30	3.13	8.81	13.09	10.72
Mid Cap	-1.01	-0.64	5.00	5.00	7.46	13.98	14.51	11.65
Mid Cap Growth	-0.10	-0.43	7.57	7.57	13.38	21.10	16.64	13.00
2000 Value	-1.51	-2.48	1.60	1.60	7.14	9.33	16.12	9.92
2000	-0.86	-2.41	3.58	3.58	11.51	15.24	17.12	11.07
2000 Growth	-0.23	-2.34	5.52	5.52	15.76	21.06	17.98	12.14
S&P 500	-0.51	0.57	7.71	7.71	10.56	17.91	17.30	13.95
Consumer Disc	0.63	1.04	8.18	8.18	20.64	32.54	18.50	16.05
Consumer Staples	-2.01	1.04	5.70	5.70	-3.34	2.93	7.56	9.20
Energy	0.82	2.59	0.61	0.61	7.46	13.94	10.72	1.32
Financials	-4.02	-2.22	4.36	4.36	0.09	8.73	16.74	13.46
Health Care	0.90	2.93	14.53	14.53	16.63	18.35	14.80	15.37
Industrials	-1.68	2.19	10.00	10.00	4.84	11.18	17.65	12.88
Information Technology	0.84	-0.33	8.80	8.80	20.62	31.49	27.67	22.41
Materials	-4.42	-2.09	0.36	0.36	-2.73	4.01	15.52	8.79
Real Estate	-1.51	-2.65	0.86	0.86	1.67	4.95	8.16	9.72
Telecom Services	1.06	4.26	9.94	9.94	0.75	4.39	9.75	6.65
Utilities	-0.69	-0.60	2.39	2.39	2.72	2.93	10.61	11.06
Dow Jones Industrial Avg.	-1.07	1.97	9.63	9.63	8.83	20.76	20.49	14.57
Wilshire 5000 (Full Cap)	-0.51	0.08	7.06	7.06	10.68	17.73	17.03	13.26
MSCI EAFE	-0.88	0.87	1.35	1.35	-1.43	2.74	9.23	4.42
MSCI EM	-0.26	-0.53	-1.09	-1.09	-7.68	-0.81	12.36	3.61
MSCI Frontier Markets	-1.57	-0.05	-1.98	-1.98	-12.63	-7.73	5.32	2.87

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	<u>1 Week</u>	<u>1 Month</u>	<u>QTD</u>	<u>3 Month</u>	<u>YTD</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>
MSCI ACWI	-0.60	0.44	4.28	4.28	3.83	9.77	13.39	8.67
MSCI ACWI Ex USA	-0.74	0.46	0.71	0.71	-3.09	1.76	9.97	4.12
MSCI AC Asia Ex Japan	-0.65	-1.38	-1.57	-1.57	-6.26	1.45	13.29	6.64
MSCI Brazil	2.18	7.00	6.07	6.07	-12.26	-14.01	20.52	-2.94
MSCI BRIC	-0.78	-1.12	-4.12	-4.12	-8.56	-2.51	13.75	4.43
MSCI China	-1.39	-1.40	-7.51	-7.51	-9.12	-2.20	13.69	7.85
MSCI Europe	-1.44	0.36	0.80	0.80	-2.46	-0.30	7.71	3.70
MSCI India	-2.91	-9.10	-2.25	-2.25	-9.60	1.09	7.00	9.67
MSCI Japan	0.44	3.04	3.68	3.68	1.58	10.20	12.13	6.76
MSCI EM Latin America	1.20	4.69	4.77	4.77	-6.91	-9.09	13.67	-2.27
MSCI Russia	4.92	9.79	6.15	6.15	9.08	13.73	19.42	-0.04
Barclays U.S. Aggregate	0.17	-0.64	0.02	0.02	-1.60	-1.22	1.31	2.16
ICE BofAML US 3M Trsy Bill	0.05	0.15	0.49	0.49	1.30	1.59	0.84	0.52
Barclays U.S. Gov't	0.13	-0.91	-0.57	-0.57	-1.62	-1.57	0.26	1.34
Barclays U.S. Credit	0.21	-0.34	0.89	0.89	-2.12	-1.10	2.98	3.40
Barclays High Yield Corp.	0.17	0.56	2.40	2.40	2.57	3.05	8.15	5.54
Barclays Municipal	0.17	-0.65	-0.15	-0.15	-0.40	0.35	2.24	3.54
Barclays TIPS	0.01	-1.05	-0.82	-0.82	-0.84	0.41	2.04	1.37
Barclays Gbl Agg Ex USD	-1.07	-1.07	-1.74	-1.74	-3.03	-1.45	2.40	-0.33
Barclays Global Aggregate	-0.52	-0.86	-0.92	-0.92	-2.37	-1.32	1.98	0.75
JPM EMBI Global Div	0.73	1.51	2.30	2.30	-3.04	-1.92	6.04	5.38
Alerian MLP	-1.34	-1.57	6.57	6.57	5.90	4.89	4.43	-2.72
Bloomberg Commodity	0.99	1.92	-2.02	-2.02	-2.03	2.59	-0.11	-7.18
FTSE NAREIT Equity REIT	-1.10	-2.54	0.79	0.79	1.81	3.35	7.63	9.17
S&P Global Natural Res.	0.00	3.61	1.32	1.32	5.07	14.09	19.69	4.12
S&P N. Amer Natural Res.	0.14	0.84	-2.05	-2.05	3.13	9.25	10.29	-0.35