January 15, 2019

Dear Valued Client:

Happy New Year and welcome to the last year of this decade….and what a decade it has been!

Last quarter's volatility to the downside was not unprecedented but was unwelcome and disconcerting. There are many culprits for the volatility that we discuss below. As the New Year begins, we lean towards agreeing with Boston's own Eric Rosengren, president of the Federal Reserve Bank of Boston and voting member of the Fed committee in D.C.

Rosengren recently spoke at the Boston Economic Club and shared "I personally suspect that financial market sentiment may have become unduly pessimistic…I recognize that the risk of a U.S. economic slowdown, led by weakness abroad, has increased. But monetary policy remains accommodative, as does fiscal policy. Economic growth was quite strong in 2018, and some of that strength is likely to carry forward." He recommended the Fed wait for greater clarity before adjusting policy.

Clarity, as we discuss below, has been and will continue to be quite elusive. So far in the New Year, the markets have responded positively to the prospect of easing monetary policy, potential benefits from hoped for and improved trade agreements, and a very solid employment report. We anticipate a bumpy ride in 2019 and are positioning portfolios accordingly.

Fourth Quarter Market Review

Market Review

Global equity markets finished 2018 on a tumultuous slide, as concerns over slowing economic growth and US-China trade tensions contributed to sharp market reversals. The MSCI ACWI index fell 12.7% during the fourth quarter, while the Bloomberg Barclays Global Aggregate Bond index rose 1.2%.[i] The International Monetary Fund reduced its 2019 forecast for global economic growth from 3.9% to 3.7%, highlighting protectionist trade measures and policy uncertainty.[ii] Global stocks gave back the gains made during the first nine months of the year and declined 8.9% in 2018 - the worst year since 2008.

The S&P 500® index of US large-cap stocks was down 13.5% during the fourth quarter, with stimulus from lower taxes and government spending expected to taper off in 2019. Value-style stocks outperformed growth companies, as the technology sector lost 17.3%. Small-cap stocks were more sensitive to the market sell-off,

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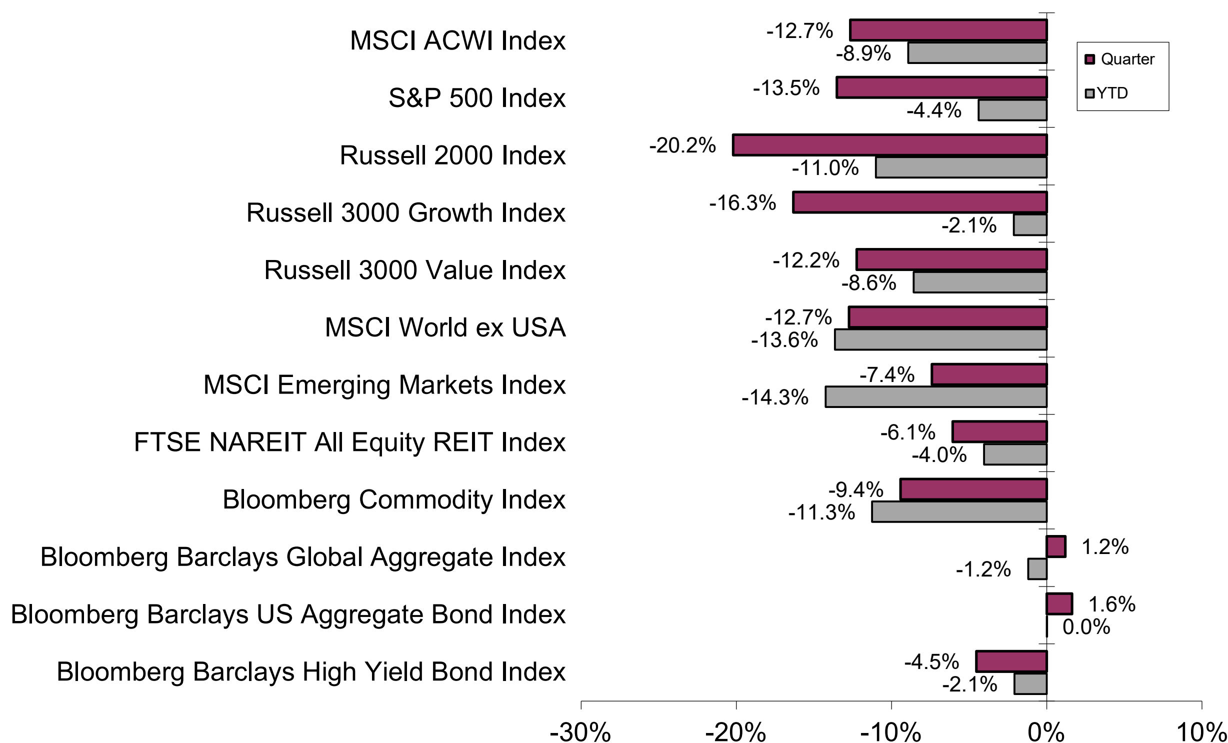
declining 20.2%. Energy stocks were also weak performers, down 23.8% on lower oil prices. Defensive and income sectors were more resilient, including utilities (+1.4%), real estate (-3.8%), and consumer staples (-5.2%). Overall, US large-cap stocks dropped 4.4% for the full year 2018.

The MSCI ACWI ex-US index of international stocks declined 11.4% for the quarter, with less favorable results from developed regions. Japan (-14.2%) continued to see low inflation readings with global trade tensions expected to hurt exports. Europe (-12.7%) was weighed down by weaker economic data as Germany's economy contracted in the third quarter. Emerging markets fell 7.4% but benefited from gains in Brazil (+13.6) and India (+2.5%). China declined 10.7% during the quarter and 18.8% for the year on worries over rising debt and slower growth. Overall, International Developed Country stocks fell 13.6% for the year while Emerging Market Stocks fell 14.3%.

In fixed income, the Bloomberg Barclays US Aggregate Bond index returned 1.6% in the fourth quarter but finished flat for the year (+0.0%). Government bonds (+2.5%) outperformed other sectors during the quarter as investors sought safer havens. Longer maturity bonds also benefited as the 10-year Treasury yield declined from 3.05% to 2.69%. Corporate bonds were sensitive to the declines in stocks, particularly high yield (-4.5%), as credit spreads widened. International bonds (+0.9%) rose as central banks maintained low rate policies and as the Japanese yen appreciated versus the US dollar.



Economic Highlights

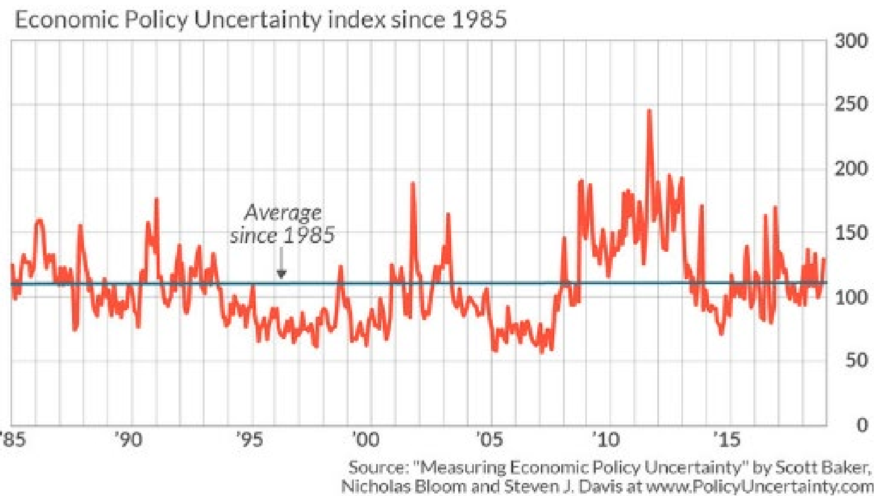
US economic growth was 3.4% for the third quarter, down from the 4.2% gross domestic product (GDP) reading in the second quarter. The Federal Reserve Bank of Atlanta forecast that GDP slowed to 2.6% in the fourth quarter, with economic reports indicating slowing demand due to trade frictions.[iii] Despite this, the US economy remained on track to grow roughly 3% for 2018. Analysts expect corporate earnings to rise 11.4% (year-over-year) in the fourth quarter and 20.2% for the full year 2018. Expectations for 2019 are more muted with corporate earnings expected to grow 7.4%.[iv] In particular, larger multi-national companies could see a negative impact due to trade tariffs and strength in the US dollar.

The Federal Reserve (Fed) continued to gradually increase rates, raising the new target range for federal funds to 2.25% - 2.50% at the December Federal Open Market Committee meeting. The Fed pointed to continued economic growth and strength in the labor market, with the unemployment rate at 3.9% in December. The Consumer Price Index inflation rate rose 2.2% for the 12-month period through November, as higher housing costs offset lower food prices. Core inflation (excluding food and energy) was also up 2.2%, with mixed results for energy prices.[v] The Fed maintained its balanced outlook, projecting two rate increases for 2019.

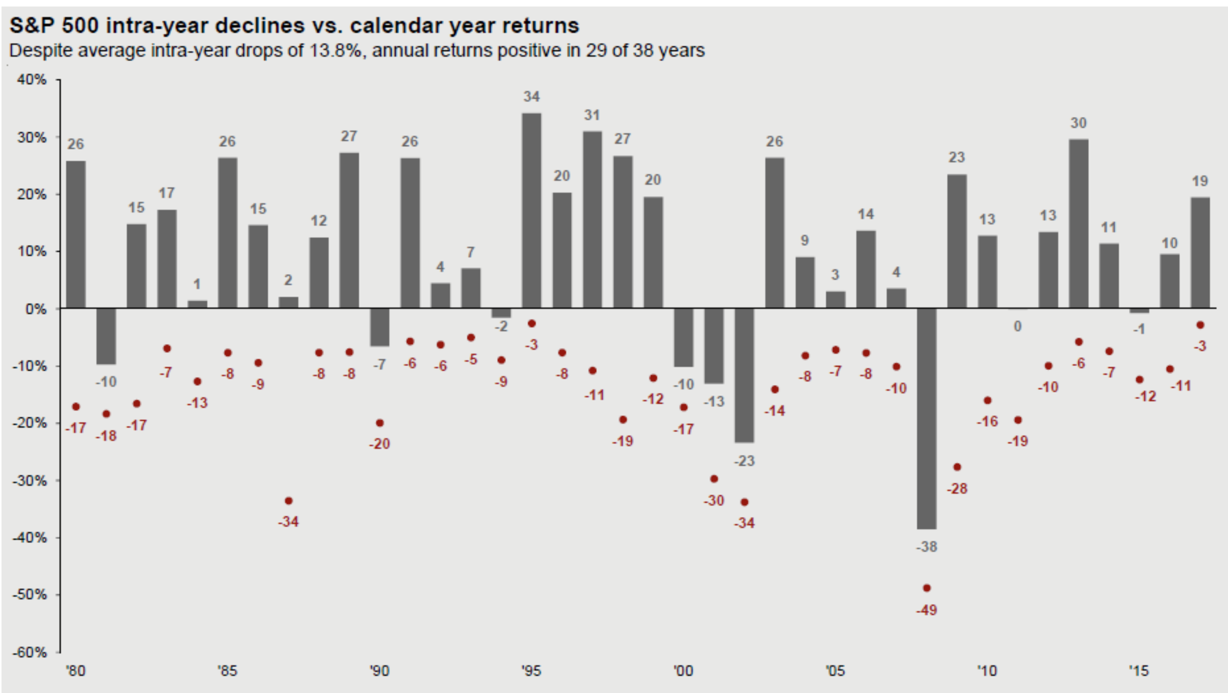
Volatility and Uncertainty

Volatility reared its ugly head in the fourth quarter, after being subdued for most of the year. The Chicago Board Options Exchange Market Volatility (VIX) index rose in October and again in December, peaking at 36.1 just prior to Christmas. Equity and fixed income markets could continue to experience sharp swings in performance looking ahead to 2019, with future Fed policy moves and the resolution of trade policy in focus. The bottom line is that the impressive return that the stock market has had and is expected to provide over the long-term is compensation for incurring uncertainty and risk.

In an attempt to put recent uncertainty and volatility into perspective, Mark Hulbert of Hulbert Financial digest cited the Economic Policy Uncertainty (EPU) Index, developed by Scott Baker of Northwestern University, Nick Bloom of Stanford University, and Steven Davis of the University of Chicago. The EPU reflects the frequency of news media references to economic policy uncertainty, the number of federal tax code provisions set to expire in future years, and the extent of forecaster disagreement over future inflation and federal government purchases. The chart below shows that we are currently just above the average uncertainty levels. The highest levels of the EPU came from late 2008 through 2012. During this time period, the market experienced one of its largest gains in decades.



Market drops that accompany uncertainty can be sharp and quick. Intra-year declines are normal and are well-illustrated on the chart from JP Morgan below. The red dots represent the low points achieved at any point in the year while the gray bars illustrate the actual return achieved by the index (price only - dividends not included). As noted, the average intra-year drops for the 38 years ended 12/31/17 were -13.8% while returns were positive in 29 of those 38 years.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2017, over which time period the average annual return was 8.8%.
Guide to the Markets – U.S. Data are as of December 31, 2017.

According to the Washington Post, intraday swings in stock prices of 1% or more totaled 110 in 2018 compared

with 10 in 2017. The average annual intraday swings since 1962 is 169 suggesting that we what we witnessed in 2018 is not abnormal. Volatility often begets more volatility. The instantaneous news cycle and algorithmic trading systems have taken some blame for the volatility, rightly so. We suggest that long-term investors look past the daily news and swings and focus instead on the long-term.

Outlook

This quarter marked the eighth time the S&P 500 has experienced a greater than 15% intra-quarter decline since 1946.[vi] Looking back at these periods, the market has on average rebounded in subsequent quarters. The S&P 500 has been down only once the following quarter (Q4 '08 to Q1 '09) and has never been lower two, four, or eight quarters later. The median gain following the down quarter was 23.5% over the next year. The S&P 500 declined 21.9% in the fourth quarter of 2008, but posted returns of 26.5% and 15.1%, respectively, in 2009 and 2010. While GDP growth slowed in Q4, the US economy is still expanding, and history supports maintaining core portfolio allocations with strategic exposure to stocks.

Volatility spikes do not portend bear markets as we illustrated above. We believe that the recent decline was a correction and not the sign of a recession. At some point, there will be a recession but the data at this time suggests that this inevitable event is not likely in 2019. Our thoughts are based on some of the data below:

1) The Federal Reserve remains accommodative and data dependent for future rate hikes. While this does not mean no more rate hikes, the timing is much more flexible than was expected just a few months ago.
2) Consumer spending remains strong and is still responsible for over 65% of GDP. With unemployment low, we anticipate that spending remains positive albeit slowing.
3) Corporate tax rate reform has put the U.S. on a more level playing field in the world while lower tariffs globally should help the U.S. economy.
4) Earnings, while not able to sustain the pace of 2018, are expected to be positive in 2019. The market price/earnings ratio at about 15X is not high on a historical basis.

On the flip side, we are wary of the items below as they continue to provide formidable headwinds:

1) The longest government shutdown in U.S. history will have a negative impact on GDP. Polarization in D.C. shows no signs of abating while the Mueller probe is likely to finish this quarter with the impact uncertain. Similarly, a divided Britain is struggling to finalize details of Brexit.
2) The impact of the "trade renegotiation" has been showing up in earnings and warnings. Until substantial progress is made, the markets will likely continue to react to the negative implications on company's results and planning. Recent reports show CFO optimism on the decline.
3) Global growth is slowing amidst a reduction in liquidity worldwide. Germany, a major European economic power, is seeing an unwelcome slowdown.
4) China's economy has faltered, with tariffs exacerbating this situation. Chinese leadership can stimulate the economy but how much and how effective they will be are worth watching.

We have adjusted our strategically developed portfolios to account for what we believe will be a more volatile but potentially rewarding year in the markets. Specifically, we have increased our allocation to alternative, volatility dampening assets, seized on several fixed income classes with reasonable yields and moderate risk, and focused on balancing the opportunity set in growth stocks with more defensive positioning in higher quality names. We continue to be globally diversified and believe that the strength of the U.S. dollar will moderate this year, which should help to reduce some of the headwinds that impacted international equity returns in 2018.

Patience and flexibility define the Federal Reserve's approach in 2019. As we've pointed out in this letter, we believe that long-term investors must adopt a similar strategy.

PRW Wealth Management News

During the quarter, Elliot Herman contributed to a piece for Investor's Business Daily that discussed ways in which advisors can help the newly wealthy to make sense of their brand-new life:

https://www.investors.com/news/management/financial-advisor-briefing/advisors-help-guide-newly-wealthy/

He also participated in a video series created by Investopedia in which he discussed ways to manage through volatile times.

Elliot and Senior Wealth Advisor Chris Stone attended the 2018 Schwab Impact Conference, which was highlighted by appearances from former Federal Reserve Chair Janet Yellen and former White House Chief of Staff Andrew Card. The conference was filled with presentations from many of the top minds in the investment business. Thematically, the messaging suggested a slowing economy in 2019 but not a recession, with financial markets weighing in on earnings and political and economic activity as they play out.

Bill Payne was joined in Dallas by Estate & Wealth Management Counsel Janice Forgays and Director of Advanced Planning Ted Dziuba for Lion Street's Annual "Indaba" conference. A South African word describing the gathering of tribal leaders to share ideas about what is best for the community, this year's "Indaba" conference was full of best practices and idea-sharing from some of the industry's top wealth transfer experts and included a keynote speech by Bill regarding Multi-Family Offices.

We wish you and your family a very Happy and Healthy New Year. As always, please contact us if there have been any changes to your financial situation, your investment objectives, or your instructions concerning your account(s).

We look forward to seeing and working with you in the year ahead. Thank you.

Sincerely,

William A. Payne Richard A. Renwick Elliot B. Herman

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Index Definitions

Bloomberg Commodity: A broadly diversified index that allows investors to track futures contracts of physical commodities traded on US exchanges. The component weightings are determined by several rules designed to ensure diversified commodity exposure.

Bloomberg Barclays Global Aggregate: An index of global investment grade debt from twenty-four local currency markets including treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. The index also includes Eurodollar, Euro-Yen, and 144A Index-eligible securities, and debt from five local currency markets.

Bloomberg Barclays High Yield Bond: An index measuring the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes emerging market debt.

Bloomberg Barclays US Aggregate Bond: An index covering the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM pass-through), ABS, and CMBS sectors. US Agency Hybrid Adjustable Rate Mortgage (ARM) securities were added to this index on April 1, 2007.

FTSE NAREIT All Equity REIT: A broad measure of the performance of publicly traded real estate securities, such as real estate investment trusts (REITs) and real estate operating companies.

MSCI ACWI (All Country World Index): A free float-adjusted capitalization weighted index that is designed to measure the equity performance of countries considered to represent both developed and emerging markets.

MSCI Emerging Markets: A free float-adjusted, market capitalization index that is designed to measure the equity market performance of countries considered to represent emerging markets.

MSCI World ex USA: An index that captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries – excluding the United States. With 1,020 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

Russell 2000: An unmanaged index that measures the performance of the small cap segment of the US equity universe. It is a subset of the Russell 3000 Index based on market capitalization.

Russell 3000 Growth: An index that measures the performance of the growth segment of the US equity universe. It includes those Russell 3000 companies with higher price-to-book ratios and higher forecasted growth rates.

Russell 3000 Value: An index that measures the performance of the value segment of the US equity universe. It includes those Russell 3000 companies with lower price-to-book ratios and lower expected growth rates.

S&P 500®: An unmanaged index that is generally considered representative of the US equity market, consisting of 500 leading companies in leading industries of the US economy (typically large cap companies) representing approximately 75% of the investable US equity market.

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[i] Unless otherwise indicated, all index returns are from FactSet
[ii] Source: International Monetary Fund. "World Economic Outlook – Challenges to Steady Growth (October 2018)"
[iii] Source: Bureau of Economic Analysis (Federal Reserve Bank of Atlanta GDP forecast as of January 3, 2019)
[iv] Source: FactSet
[v] Source: Bureau of Labor Statistics
[vi] Source: Ned Davis Research. "U.S. Comment – Q4 Is Bad. Is That Good? (December 26, 2018)"