DANN ASSET ADVISORS, LLC

Third Quarter 2018 Update

October 12, 2018

3Q18 Highlights

- U.S. stocks register best quarter since 4Q13; international markets continue to lag
- Strong earnings comparisons – aided by tax cuts – likely have fueled recent stock gains
- 3Q GDP growth expected to decelerate from 2Q level but remain above 3%
- Fed raises rates again in September and on track for future increases

The table below summarizes the performance of some key indices during the third quarter and year to date:

Market Performance		
Index	% Ch. 3Q18	% Ch. YTD
S&P 500	7.7	10.6
MSCI Developed Markets (excl US)	1.4	-1.4
MSCI Emerging Markets	-1.1	-7.7
MSCI All Country World	4.3	3.8
US Aggregate Bond (1)	0.0	-1.6
Liquid High Yield (1)	2.5	2.8
US Dollar Emerging Markets Bond (1)	2.5	-3.6

(1) Barclays indices

Equities. U.S. stocks had a strong quarter with the S&P 500 index (large company stocks) returning 7.7%. Based on data and forecasts from Yardeni Research, S&P 500 earnings growth likely will be 20%+ over the first three quarters of 2018, representing the best growth in years. We believe that this better than expected earnings growth has driven recent stock price gains. We also note that earnings comparisons become much more difficult in 2019, that the market tends to look ahead three to six months and that the market may have a more difficult time going forward.

The third quarter saw a narrowing of the difference in the performance of growth and value stocks. Over the first half of the year, as measured by the Russell 1000 indices, growth (led by technology) outperformed value by 900 basis points (nine percentage points). In the third quarter this difference narrowed to 350 basis points. Still, through the third quarter, growth had gained 16.8% vs. only 3.7% for value, an unusually wide variance. There were some signs late in the quarter that this trend, which has persisted since late 2016, may be changing.

The broadest international indices registered just above breakeven results and continued to badly trail the U.S. In our opinion, a strong U.S. dollar relative to some emerging market currencies, weaker than expected economic growth and trade issues all have weighed on international returns. It seems to us that the market is buying the argument that the U.S. has the least to lose (and may gain) from tougher trade policies. In some cases this likely is true (e.g., with respect to China’s treatment of intellectual property) but we believe inflexible policies based solely on perceived near term wins for the U.S. will be harmful for the long term. Other than during 2017, it’s been frustrating owning international stocks in recent years. However, as discussed later in the report, we continue to believe some international exposure makes sense.

Fixed income. The 10 year Treasury yield bounced between 2.82% and 3.10% during the quarter, ending at 3.06%. Short term rates as measured by the two year Treasury continued rising, ending

the quarter at 2.82%. The quarter-end gap between the 10 and two year bond yield was 24 basis points, compared with 30 basis points at the end of the second quarter and 51 basis points at year end 2017. With the Fed seemingly committed to raising rates into 2019, short term rates are likely to continue to increase. We note that the 10 year bond yield broke out to a new seven year high last week, hitting 3.25%.

With the rise in rates, the Barclays U.S. Aggregate Bond index (benchmark for U.S. investment grade bonds) was flat for the quarter with a still negative 1.6% return year to date. More aggressive sectors of the bond market bounced back a bit in the quarter, as indicated in the table.

Market sectors. As noted in our second quarter update, the firms that determine which stocks fall in which sectors (e.g., technology, financials, industrials, etc.) decided to make changes for 2018. As a result of this process, there have been significant changes to holdings in the technology, communications services and consumer discretionary sectors. The mutual fund company whose exchange traded funds (ETFs) we monitor to track sector performance began phasing in these changes during the second quarter.

One impact of the changes is a reduction in size of the tech sector. The tech sector had grown to 26.5% of the market during the third quarter, according to Barron's. With the move of Alphabet and Facebook from tech to the new communications services sector, tech will fall to under 21%. And communications services (which also gained media companies like Comcast, Disney and Netflix) has grown from one of the smallest sectors (only 2% of the market, dominated by Verizon and AT&T) to one of the five largest. With the new classifications Amazon will account for more than 30% of the consumer discretionary sector.

Given this flux we believe our usual discussion covering the quarter's best and worst performing sectors is a little less useful than usual. For example, the current tech sector has fewer big growth companies than before, and this impacts performance and comparisons to prior periods. Still, for what it's worth, during the third quarter, healthcare, technology and industrials were the best performing sectors and materials, REITs and energy were the three worst.

Portfolio Positioning

We made no material changes in fixed income during the third quarter and continue to be positioned most heavily in short duration (which we define as three years or less), investment grade funds. These are supplemented with modest exposure to more aggressive funds – also mostly short duration. On equities, for many clients we sold an international fund where we were concerned about the economically sensitive, cyclical stocks that comprised most of the portfolio. At this point in an already very long economic/market up-cycle, we preferred not having that cyclical exposure. Proceeds were put into existing investments, including international funds.

Economy

U.S. GDP grew 4.2% in the second quarter, the fastest growth since the third quarter of 2014 and a strong pickup from 2.2% during the first quarter. Consumer spending expanded 3.8%, likely helped by modest wage gains and tax cuts reducing withholding rates. Business investment and trade (the latter possibly inflated in advance of higher tariffs) also contributed to growth. Third quarter GDP will be reported in the next couple of weeks and is expected to be between 3.0% and 3.5% according to a recent Wall Street Journal survey of economists.

Based on GDP, the economy clearly is going through a stronger stretch. We have seen this before (in 2014 and 2015) so the issue, in our opinion, is whether current growth is sustainable. While not showing up significantly yet in the numbers, we hear management teams talking about higher wages and other rising costs (in addition to generally strong business conditions). We of course don't know what will happen but believe that one risk is that the economy, especially on the labor side, is running nearly at full capacity with the result that inflation could pick up. We note that the unemployment rate has been 4.1% or lower for the past 12 months. Taking a positive view, this situation could persist, draw additional people into the labor force and enable the economy to continue growing at a good pace.

Another risk is that the economy might soon slow – nearly the opposite scenario of that just mentioned. This possibility is not yet, in our opinion, reflected in economic numbers. Rather, we see the possibility of a slowing in the performance of certain sectors in the stock market. For example, the stocks of consumer discretionary companies (autos, homebuilders, RV manufacturers, jewelers, etc.) have been relatively weak over the past month or more. The stock market certainly is not always right, especially over short timeframes, but the performance of these types of stocks may be foreshadowing a slowdown in consumer spending.

Regardless of stock market indications, following its most recent meeting the Fed announced that it expects to raise rates one more time in 2018 and at least three times next year. Inflation as measured by the core personal consumption expenditure numbers, continues to run at a rate the Fed seems comfortable with. If inflation were to pick up the Fed likely would accelerate rate increases and potentially cause the economy to slow. Trade, of course, remains a wild card – for inflation and the economy more broadly.

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