Q3 MARKET INSIGHTS

Fall 2018

BEAUMONT
FINANCIAL PARTNERS

FUNDAMENTALS WIN AGAIN

The third quarter was the best-performing quarter for markets so far this year as the major U.S. stock indices hit new all-time highs. The broad market gains were driven by strong economic data and solid earnings growth. Interestingly, those positive factors were often overlooked as news headlines focused on various political firestorms and the continued uncertainty with regard to the U.S. and China trade relationship. But, in what has become a recurring theme for the 2018 market, positive economic and corporate fundamentals again outweighed unnerving political and geopolitical headlines. Strong market rallies in July and August helped U.S. stocks finish the third quarter in positive territory with the S&P 500® Index achieving a total return of 7.71%. This put the total year-to-date (YTD) return through September 30, 2018 at 10.56%. Looking internationally, foreign markets continued to lag the U.S. market, despite a rebound in September that was fueled by waning concerns over Italian budgets, Turkish inflation and U.S./China trade tensions. Overall, foreign developed markets, represented by the MSCI EAFE Index, ended up 1.42% for the quarter (down 0.99% YTD) while emerging markets closed in negative territory with the MSCI Emerging Markets Index finishing down 1.00% (down 7.49% YTD). Turning to fixed income, the leading benchmark for bonds (Bloomberg Barclays US Aggregate Bond Index) was up 0.02% in the third quarter, although it remains negative for 2018 (down 1.60% YTD). Continued strong economic growth, a reduction in political stress in the European Union and a September Fed rate hike were headwinds for the broad bond markets in the third quarter.

Economic strength was a key component of the U.S. outperformance theme that prevailed throughout the quarter. Gross Domestic Product (GDP) expanded at a 4.2% annual rate in the second quarter of 2018 (which was reported during the third quarter), marking the fastest growth in nearly four years. The composition of the report was also favorable with consumer spending and business investment among the bright spots. Looking ahead to the third quarter, an October Federal Reserve Bank of Atlanta report is forecasting GDP to be 4.1%. For context, the last time the U.S. economy posted two consecutive quarters of annual GDP growth above 4% was in mid-2014, and prior to that it was the first quarter of 2005. In addition to the robust GDP figures, employment data remained strong with the U.S. unemployment rate dropping to its lowest level in 48 years in September at 3.7%. Lastly, the Institute for Supply Management's (ISM) manufacturing and non-manufacturing indices show continued expansion in both factory activity and the services sector. The recent ISM manufacturing reading remains at its highest levels since 2004, while the most recent ISM non-manufacturing reading posted its highest figure ever, further reinforcing the strength of the economy.

The biggest tailwind for U.S. equities in the third quarter was continued strength in corporate profits. According to financial data firm FactSet, earnings per share (EPS) for the S&P 500 grew 25% year-over-year (YoY) in the second quarter. This was just above the outsized 24.8% growth rate in the first quarter and the strongest since the 34.1% rate reported in the third quarter of 2010. Aided by the tax cuts passed at the end of 2017, S&P 500 corporate earnings growth for fiscal year 2018 is expected to rise 20.3% YoY. Just as important, analysts expect solid earnings growth to persist into 2019, with current estimates calling for 14% EPS growth for the S&P 500 next year. Outside of tax reform, aggressive share buybacks also helped boost earnings. A September 18th article in The Wall Street Journal highlighted a report from Goldman Sachs noting that, for the first time in ten years, buybacks are garnering the biggest share of cash spending by S&P 500 firms. The article also observed, share repurchases were up almost 50% through the first half of 2018, and that through mid-September, buyback authorizations have totaled $762 billion, on track to set a new full year record of over $1 trillion for 2018. Lastly, revenue growth was at its highest level in nearly seven years coming in at 10.1% for the second quarter. Looking ahead to the third quarter, revenues are expected to grow 6.9% YoY, which is well above its 27-year average of 3.4%.

As we highlighted in our Q2 Market Insights, we did not expect the implementation of tariffs to have major repercussions on the U.S. macroeconomic environment, and that the impact on corporate earnings would vary by company. For the most part, companies downplayed the effects of tariffs during their second quarter earnings calls citing fairly minimal impact on demand. Again, the Trump administration appears to be using tariffs to gain concessions from trading partners who have been deemed to have abused the free-trade system. Concerns about the U.S. and Chinese trade relationship remain, but the third quarter also saw important resolution to numerous other trade situations. First, in July, the United States and the European Union (E.U.) reached a trade agreement that would prevent retaliatory tariffs and promised to investigate ways to further promote free trade between the U.S. and the E.U. In August, the United States and Mexico agreed to a trade framework to replace NAFTA, and on the final day of September, Canada and the United States reached an agreement for Canada to join the existing U.S./Mexico deal, settling another potential trade dispute.

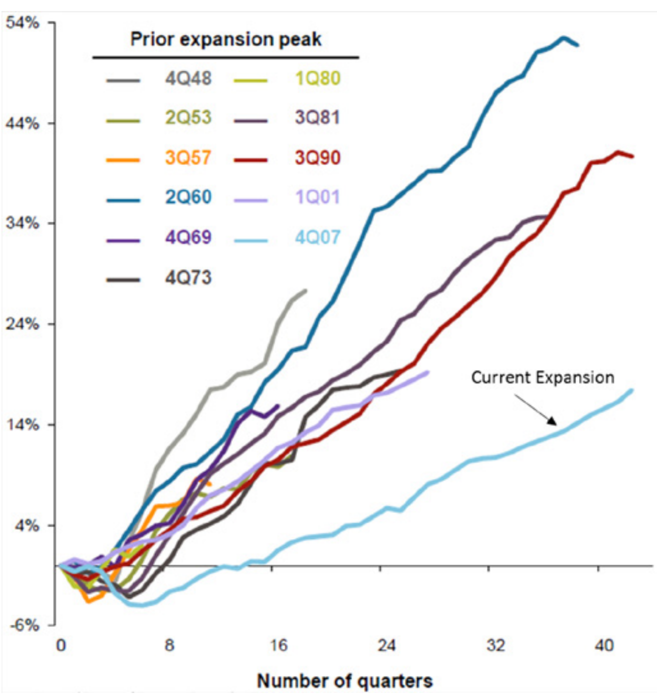
While uncertainty surrounding the U.S./China trade relationship is likely to cause increased volatility in the financial markets, it's important to remember that so far in 2018, a strong U.S. economy and healthy corporate fundamentals have powered stocks higher through multiple periods of trade, political and international instability—and that's critical context to consider as we enter the final quarter of the year.

"While uncertainty surrounding the U.S./China trade relationship is likely to cause increased volatility in the financial markets, it's important to remember that so far in 2018, a strong U.S. economy and healthy corporate fundamentals have powered stocks higher through multiple periods of trade, political and international instability—and that's critical context to consider as we enter the final quarter of the year."

THE GLOBAL FINANCIAL CRISIS AND THE LONG RECOVERY

Strength of Economic Expansions

Cumulative real GDP growth since prior peak, percent



Source: National Bureau of Economic Research, J.P. Morgan

This past September marked the 10th anniversary of Lehman Brothers filing for bankruptcy, an event that is considered to have triggered the start of the Global Financial Crisis of 2008 and the subsequent recession (commonly referred to as "the Great Recession"). While the recession became quite noticeable in late 2008, the National Bureau of Economic Research (NBER), the official arbiter of U.S. business cycles, has the Great Recession officially starting in December 2007 and ending 18 months later. Since June 2009 we have experienced one of the longest economic expansions since the WWII era. Interestingly enough, it is also the weakest economic recovery since WWII (see chart to the left).

Given the length of the current recovery, some investors are concerned that a recession is overdue. While a nine year economic recovery is long, it does not mean we are headed for a recession. We believe we are likely in the later part of the economic cycle, but we do not expect the U.S. to enter into a recession in the near-term. As we highlighted in previous paragraphs, strong economic growth, rising corporate earnings and a healthy labor market should provide continued support to the U.S. economy. However, the data has been so strong that the window for improvement is getting smaller and smaller and the rate at which the U.S.

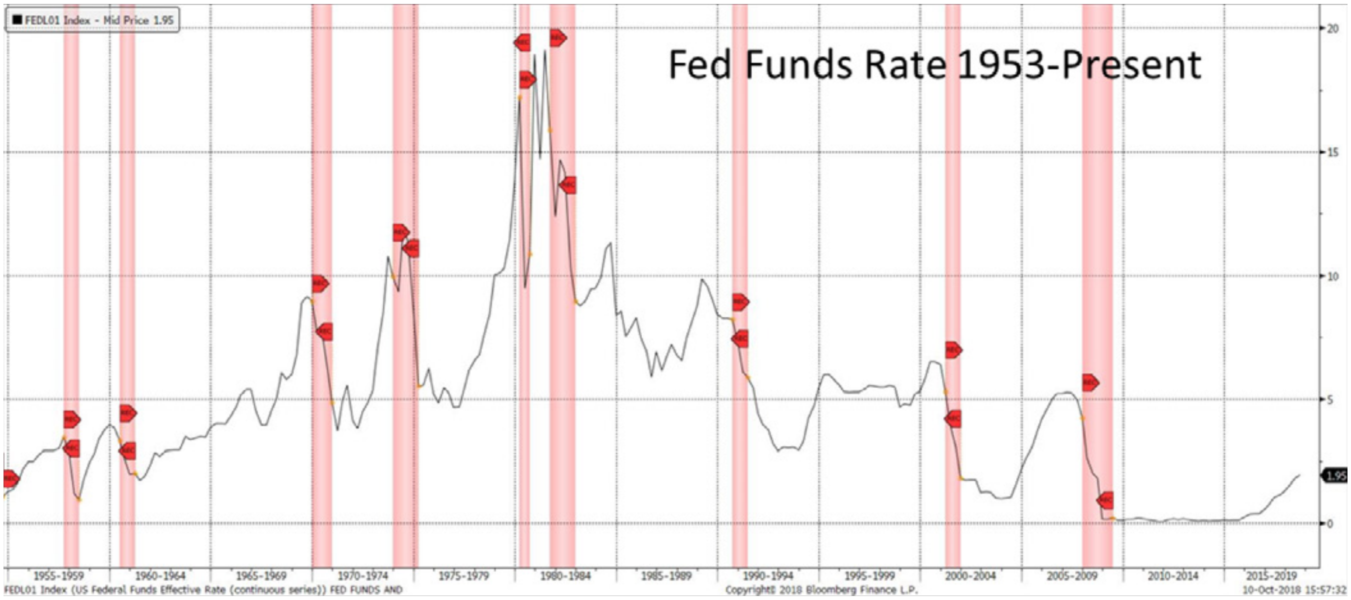
economy grows will likely begin to decelerate. That being said, many of the economic indicators that we utilize in our research, as highlighted in our last letter, continue to indicate low probability of a recession in the next two quarters. The Leading Economic Indicators (LEI) were at 6.4% as of its last reading in August (the highest level since 2014). As a reminder, the LEI is a composite of economic data points designed to signal peaks and troughs in the business cycle, and recessions have historically occurred when LEIs are *negative*. Consumer confidence is healthy, with the Conference Board's Consumer Confidence survey posting a September reading at an 18-year high. Small business owners appear to be as positive about the economy as they have ever been with the NFIB Small Business Optimism Index posting its highest level ever recorded in its 45-year history during the month of September. Lastly, the U.S. Treasury yield curve remains positively sloped (as you may recall a negatively sloped or inverted yield curve has been a precursor to recessions in the past).

There is an old economist's expression that says "economic expansions don't die of old age". We believe that to be true, as we observe that most economic expansions are usually halted by fiscal policy missteps. So what could cause this current recovery to end? Since World War II, most recessions have been caused by monetary policy tightening and oil shocks. A tightening of monetary policy (where interest rates are increased) usually leads businesses to reduce spending on inventories and capital projects, while individuals decrease investments in housing as homes become less affordable. In response to the Global Financial Crisis of 2008, The Federal Reserve ("the Fed") and other central banks of the world embarked on expansionary monetary policies in an effort to stimulate the economy. As short-term interest rates approached zero, global central banks adopted a policy known as quantitative easing (or "QE") where the central banks would buy predetermined amounts of government bonds or other assets in an effort to lower effective interest rates further out on the yield curve. The objective of these expansionary policies was to lower borrowing costs for businesses (assuming that they would invest in new projects and hire more employees) and individuals (anticipating that they would consume more goods and services). As the economy has recovered, central banks are looking at ways to carefully unwind their expansionary policies (called "policy normalization"). In the U.S., the Fed ended its zero-interest rate policy by raising the Fed Funds rate by 0.25% in December 2015 and have raised it by 0.25% an additional seven times. Also, beginning in October 2017, the Fed embarked on a program to reduce the size of its $4.46 trillion balance sheet in an effort to reverse the effects of QE. Based on current forecasts, it is expected that the Fed will reduce the size of its balance sheet to $2.6 trillion by the end of 2021. The effect of these actions will have the opposite effect of QE and should reduce liquidity and tighten lending conditions. In our opinion, the Fed needs to be careful in how it proceeds with policy normalization. QE was an unconventional form of monetary policy that had never been utilized before, so the ultimate question of what happens when it is reversed is unknown. How sensitive the economy will be to this process will likely be dependent upon the speed at which the central banks proceed. This is especially true if one assumes that the Fed is willing and able to normalize policy as long as the economic fundamentals justify it. If the Fed is too aggressive, they could cause a recession. The chart on the next page shows the Fed Funds rate going back to 1953 as well as all the recessions that have occurred during that time (highlighted in red). As you can see, the Fed has had a habit of raising rates too aggressively, and as a result tightening too much and causing a recession. This is something we will continue to monitor over the coming quarters.

> **"In our opinion, the Fed needs to be careful in how it proceeds with policy normalization. QE was an unconventional form of monetary policy that had never been utilized before, so the ultimate question of what happens when it is reversed is unknown."**

Again, we want to reiterate that we do not expect a recession to occur in the near-term. However, could the next recession be as bad as the Global Financial Crisis of 2008? You may remember that this recession started with the bursting of the housing bubble in 2007. However, the root cause was not only tight monetary policy, but excessive risks taken on by banks during the run up in housing prices which compounded any ill effects of the downturn in housing. Since 2008, many regulations have been put in place to shore up the banking system. Capital and leverage requirements are significantly higher than they were ten years ago. In addition, the country's biggest banks must now undergo periodic stress tests to prove they could survive another crisis and draw up "living wills" so that they could be dismantled in an emergency without requiring a taxpayer bailout. Due to these regulations, the weaknesses that caused the last crisis are unlikely to be the cause of the next one. If it wasn't for the excessive risks taken by the banks, the Global Financial Crisis would likely have been avoided and the recession would probably not have been as severe.

Fed Funds Rate 1953-Present



Source: Bloomberg Finance L.P.

While we believe we could have another crisis, we do not know what may cause it, or when it could occur. In our view, the real lesson of the most recent financial crisis was that the system was more vulnerable than anyone thought. As such, most investors did not realize the risks they were taking. Since 2008, we have strived to focus on risks over returns. We try to stay focused on the data, set reasonable objectives and most importantly, remain humble. The truth is, nobody knows when the next crisis may hit. Therefore, it is important to remain humble in the face of uncertainty and try not to take on more risk than necessary if things go very wrong. Even if our models and predictions fail, if we are not overly exposed to excessive risks, the damage should be limited. That, in our opinion, is the real lesson of the Global Financial Crisis: take less risk. That lesson is as timely, and as unappreciated as it was in 2007, 1999 and prior to other financial crises.

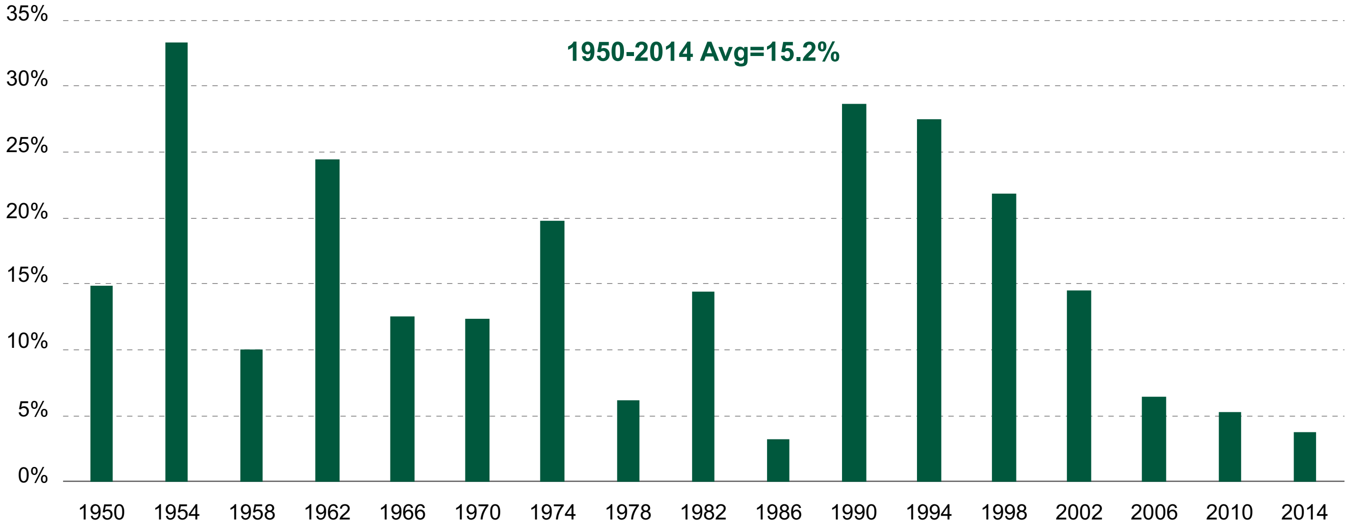
A QUICK NOTE ON MIDTERM ELECTIONS

What does history say about stock market returns beyond midterm elections? In the seventeen midterm years since 1950, the S&P 500 posted average price returns of 15.2% in the 12-month period following the midterm elections (see chart on next page).

However, circumstances entering each midterm election can vary, especially when it comes to which political party has control of certain branches of the government. Sometimes one party has control of the Presidency, the Senate and House of Representatives, like the Republicans today, while other times the control is split. So, in an effort to get a better idea of how the stock market may react to the upcoming midterm elections, we examined the returns following the elections held where either the Republicans or the Democrats had control of both the Presidency and Congress prior to the election. Of the seventeen midterm elections going back to 1950, eight of them occurred with one party in control. Of those eight elections, the party in control held on to a unified government four times, with the Democrats holding onto control in 1950, 1962, 1966 and 1978. The average 12-month price return of the S&P 500 for those four years was 14.51% with returns ranging from 6.2% to 24.4%. Of the elections where the ruling party lost majority control of either the Senate or the House (Republicans in 1954 and 2006, and Democrats in 1994 and 2010), the average 12-month price return for the S&P 500 was 18.1% with returns ranging from 5.3% to 33.3%. Based on this data, it appears there is very little difference as to whether or not the Republicans can keep majority control of the Senate and the House, or if the Democrats regain control of the House as is currently expected. If anything, we can observe two things from this study. One, that based on history, we are likely looking at positive price returns for the S&P 500 for the twelve months following the elections. And second, that we should avoid listening to all the political headlines and rhetoric, and simply focus on the underlying macroeconomic fundamentals.

S&P 500 Price Return

12 Mo. Period Following Midterm Election



Source: Bloomberg

CONCLUSION

As we start the final quarter of 2018, U.S. economic and corporate fundamentals remain very strong, and those two factors combine to provide firm support for the markets. That is an important fact to remember as those core fundamental positives have helped U.S. markets increase in 2018 despite a return of volatility. We expect continued market volatility in the fourth quarter, as investors face several potentially significant unknowns, including:

- Whether the U.S. and China can strike a trade deal
- The prospect and impact of higher interest rates
- If corporate earnings growth continues to meet expectations
- The possibility of disruptive political events from Washington (personnel turnover or spontaneous tweets)

Our current asset allocation remains generally unchanged. Within our fixed income allocation we continue to manage interest rate risk by keeping the duration shorter than the underlying bond market index. In order to make up for lost yield, we are maintaining some exposure to credit risk through short-term high yield corporate bonds, floating rate loans, and, for qualified investors, alternative investments as appropriate. We are closely monitoring the interest rate environment, and if interest rates continue to rise, we may increase our allocations to fixed income in client portfolios, while at the same time increasing duration and reducing credit risk. In equities, we continue to remain overweight U.S. stocks relative to foreign developed and emerging market countries. When evaluating individual equities we try to identify businesses with unique business models, skilled management teams, and competitive positioning which have also demonstrated an ability to grow intrinsic value at attractive rates over the long-term.

As 2018 has shown us thus far, trade conflicts, political dramas and short-term market volatility are unlikely to impact a diversified approach set up to meet your long-term investment goals. While strong fundamentals continue to support equity markets, we believe we are moving closer to the end of the cycle. As a result, we will continue to work diligently with you to establish a personal allocation target based on your financial position, risk tolerance, and investment time horizon. When investing for the long term, it is important to remain patient and adhere to a plan.

Thank you for your ongoing confidence and trust as we navigate this changing market environment. Please feel free to contact us with any questions or to schedule a portfolio review.

BEAUMONT
FINANCIAL PARTNERS

TRUST | TRANSPARENCY | TEAMWORK

Disclosures:

This material is provided for informational purposes only and does not in any sense constitute a solicitation or offer for the purchase or sale of securities nor does it constitute investment advice for any person. Investment themes and individual securities mentioned may or may not be held in any or all client accounts.

The material may contain forward or backward-looking statements regarding intent, beliefs regarding current or past expectations. The views expressed are also subject to change based on market and other conditions.

The information presented in this report is based on data obtained from third party sources. Although believed to be accurate, no representation or warranty is made as to its accuracy or completeness. Past performance is no guarantee of future results.

All performance data is as of 9/30/2018 unless otherwise stated. Diversification does not ensure a profit or guarantee against loss. An investment cannot be made directly in an index. As with all investments, there are associated inherent risks, including loss of principal. Sector investments concentrate in a particular industry and the investments' performance could depend heavily on the performance of that industry and be more volatile than the performance of less concentrated investment options and the market as a whole. Foreign markets, particularly emerging markets, can be more volatile than U.S. markets due to increased political, regulatory, social or economic uncertainties. Fixed Income investments include risks such as exposure to interest rate fluctuation, credit changes and inflation.

Past performance is no indication of future results

Definitions:

*S&P 500® Index is a registered trademark of Standard & Poor's Financial Services LLC, a division of S&P Global ("S&P"). S&P 500 Index is an unmanaged index used as a measurement of change in U.S. equity markets. Performance numbers for the index are total return with dividends reinvested in the index. The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East), excluding the US & Canada.

The MSCI EAFE Index is an equity index which captures large and mid-cap representation across Developed Markets countries around the world, excluding the US and Canada. With 913 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Indices are not managed and do not incur fees or expenses. Performance numbers for the index are total return with dividends reinvested in the index. The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries*. With 838 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Performance numbers for the index are total return with dividends reinvested in the index. The Barclays Aggregate Bond Index provides a measure of the total return performance of the U.S. dollar denominated investment grade bond market, which includes investment grade government bonds, investment grade corporate bonds, mortgage pass through securities, commercial mortgage backed securities and asset backed securities that are publicly for sale in the United States.