Wealth Management Group

First American Bank

INVESTMENT PERSPECTIVES

THIRD QUARTER 2018

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First American Bank

3rd Quarter 2018

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Equity Markets
3rd Quarter Review

Steadily up and to the right. That best describes what a chart of S&P 500 price performance looked like in the third quarter. The index advanced 7.71% for the quarter. Unlike 2018's first two quarters, there were no particularly sharp or extended downdrafts in equity prices along the way. The two biggest declines for the S&P 500 in the quarter without an intervening rise both bottomed at -1.5%. One lasted all of six trading days and the other only three.

The strength in equity prices was sparked mainly by surging corporate earnings and steady domestic economic data. S&P 500 earnings for 2Q18 increased 25% versus the prior year and a record 80% of companies beat earnings expectations. U.S. GDP growth of 4.2% for 2Q was the strongest since 2Q14.

The one constant worry throughout the quarter that led to occasional down days was trade and the impact that tariffs could have on the economy and corporate profits. These trade-inspired bouts of uncertainty seldom lasted more than a day or two.

Small-cap stocks lost the leadership they held in 2Q by gaining only 3.57% in the third quarter. The NASDAQ Composite's performance also weakened relative to large-caps with a quarterly return of 7.42%. Mid-caps trailed the pack domestically with a gain of 4.29%. The Dow Jones Industrial Average was technically the best performing major domestic equity index for the quarter with a gain of 9.63%. However, we put less weight on the Dow as a measure of broad equity performance due to relatively small sample (30 stocks) and its price-weighted versus market-cap weighted methodology.

Growth outperformed value across capitalizations although by only 18 basis points at the mid-cap level. Growth's performance advantage narrowed across the board early in the quarter before rising through September, except for, again, mid-caps. The growth versus value performance differential held up despite the fact that the valuation gap between growth and value hit ten-year highs for large and small-caps during the 3Q.

International equity markets again struggled relative to domestic equities in the third quarter but performance improved on an absolute basis. The MSCI EAFE Index of developed market equities rose 1.42%. The MSCI Emerging Markets Index fell 1.00% but this

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marked a big improvement from the index's nearly 8% drop in the second quarter. The MSCI All-World Ex-U.S. Index posted a 0.79% gain for 3Q18 following a 2.32% loss in 2Q18. Concerns over the impact of tariffs, the stronger U.S. dollar and sovereign debt levels were drivers of weak international equity performance.

Valuations rose modestly across capitalizations in the quarter as confidence in earnings growth increased and the 1Q18 market swoon faded into the rearview mirror. Price-to-earnings ratios remain materially below the levels achieved in late January of this year. The market does not look quite as cheap when applying other traditional valuation measures that aren't impacted as much by the boost to net earnings from tax reform. The Healthcare sector was the top performer for the quarter with a gain of more than 14.5%. Industrials came in second with a 10.0% gain. Technology, which had led the way in the first half of 2018 and remains the leading sector year-to-date, faded to fourth place for 3Q as concerns over regulation and the sustainability of growth crept into investors' outlooks. The same fate befell the Consumer Discretionary sector. The Real Estate, Energy and Materials sectors brought up the rear with each returning less than 1% for the quarter.

Global Equity Index Returns (as of 9/28/2018) *** Periods beyond 1 year annualized.**

	3Q 2018	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500	7.71%	10.56%	18.33%	17.32%	13.95%	11.96%
S&P 500 (Equal Weight)	5.42%	7.27%	14.34%	15.44%	12.48%	12.80%
Dow Jones Industrial Average	9.63%	8.83%	20.89%	20.51%	14.58%	12.23%
NASDAQ Composite	7.42%	17.49%	26.04%	21.81%	17.83%	15.82%
S&P 400 Mid Cap	3.86%	7.48%	14.36%	15.68%	11.90%	12.47%
Russell 2000 Small Cap	3.57%	11.51%	15.40%	17.12%	11.07%	11.10%
MSCI EAFE (Non-U.S. Developed Markets)	1.45%	-0.99%	3.81%	9.84%	5.00%	5.97%
MSCI EM (Non-U.S. Emerging Markets)	-0.96%	-7.49%	0.37%	12.82%	4.00%	5.77%
MSCI All-World Excluding US	0.82%	-2.71%	2.83%	10.56%	4.67%	5.74%

Equity Markets

Outlook

Our 4Q18 equities outlook is decidedly cautious. Concerns about potentially peaking economic and corporate profit growth gripped the markets as the fourth quarter began leading to a correction similar to what we saw in 1Q18.

While we don't see a recession or a decline in corporate profits as likely over the next 12 months, we do think that growth may have peaked for the cycle. There could still be upside to equities over the rest of this year and into next but there are clear headwinds. Trade relations with China are still challenged and chances for a resolution in the short-term are limited. The U.S. dollar is rising again which presents challenges to many large-cap companies as nearly 40% of S&P 500 revenue is generated outside of the U.S. International developed market growth remains weaker than in the U.S. presenting another challenge for multinational corporations based here.

Further increases in interest rates could also serve to restrain equity appreciation. Short to intermediate-term risk-free rates now offer a positive real (after inflation) return. The one-year U.S. Treasury Note, for example, now yields almost 2.7%. That's the highest it's been since 2007. In all likelihood, the availability of such short-term risk-free rates is already negatively impacting demand for equities at the margin.

We are not calling an end to the bull market. We are, however, pointing out that returns on domestic equities over the next three years are unlikely to match the more than 11% annualized returns we have seen over the past three.

Equity Market Valuation

	12-Month Forward 9/28/2018	12-Month Forward 9/28/2017
S&P 500 P/E	16.5	17.6
S&P 500 Dividend Yield	1.9%	2.0%
S&P 400 Mid Cap P/E	18.1	21.1
Russell 2000 Small Cap P/E	27.4	30.8
NASDAQ Composite P/E	23.7	24.1
MSCI EAFE P/E	14.1	13.4
MSCI Emerging Markets P/E	11.7	13.7
MSCI World Excl-US P/E	13.7	15.1

Economics

3rd Quarter Review

2Q18 real GDP grew 4.2%, the strongest rate of growth since 2014 and the fourth highest quarterly performance of this expansion. Growth was powered by personal consumption expenditures which rose at a 3.8% rate. Private investment detracted from growth in the quarter due mainly to weak residential investment (housing) and a decline in inventories. Investment in nonresidential structures and intellectual property both expanded more than 10% for the second consecutive quarter. Federal government spending was also a big contributor to growth with a 3.7% gain.

Exports surged more than 9% in the quarter powered by a more than 13% jump in goods shipped abroad. Imports of both goods and services fell in 2Q.

Inflation, as indicated by the Fed's favorite measure, the Personal Consumption Expenditure Price Index excluding food and energy, increased at a 2.1% rate in 2Q. This was down slightly from the 2.2% rate in 1Q18 but still well ahead of 1.5% annual average from 2015 through 2017.

Personal income expanded at a 4.7% annual rate in the second quarter on a 4.9% increase in total wages and salaries. The strong personal income growth supported vibrant consumer spending.

3Q18 real GDP advanced at a 3.5% rate according to the first estimate from the Bureau of Economic Analysis making the middle two quarters of 2018 the second best back-to-back quarters of growth in this expansion (after the second and third quarters of 2014).

Private investment accounted for a large portion of economic growth in the quarter, but all of that growth was accounted for by inventory accumulation. Fixed investment actually declined for 3Q with both residential and nonresidential investment falling. Intellectual property investment (software, R&D and copyrighted material) was the lone fixed investment bright spot in the quarter with a 7.9% rate of advance.

Consumer spending growth accelerated to 4% in 3Q. Personal income growth decelerated slightly in the third quarter to a 4.6% annual growth rate and total wage growth similarly decelerated to 4.7% versus 3Q17. Wage and income growth are being supported by continued strong employment gains which remain remarkable this far into the economic cycle.

One sector of the economy that remains in a downtrend is housing. New home sales have dropped from a 636,000 annual rate at the start of 2018 to just 553,000 by the end of September. Existing home sales have performed similarly with the annual sales rate dropping from 5.56 million units as the year began to 5.15 million units in September. Mortgage rates, which have hit their highest level in seven years, are partially responsible for the fall. Home prices, where advancement has materially exceeded income growth for several years, have also played a role in the slowdown.

Economics

Outlook

While we expect economic growth to slow further in the fourth quarter, we still anticipate enough momentum to achieve roughly 3% growth for the full year.

Projecting growth for 2019 is more problematic. President Trump's proposed and potential tariffs are likely to have a modestly negative impact if fully implemented. However, handicapping whether the President is likely to cut a deal with the Chinese after the midterm elections is difficult. It is apparent that growth is becoming less robust in most of the world outside of the U.S. Although our economy is uniquely insular in the developed world, it's doubtful that we can fully avoid the impact of slowing global growth. Then there is impact of domestic fiscal policy. Some follow-on from the tax cuts and federal spending surge will likely linger but to what extent is not clear. The further unwind of global central bank monetary support should also serve to restrain growth.

More broadly there is a debate as whether the economy is currently more mid-cycle or late cycle. By temporal standards we're clearly late cycle. However, by cumulative growth from the previous bottom standards, the economy looks more mid-cycle. All in, we tend to lean toward the late cycle argument and therefore expect real GDP growth next year in the area of 2.0% to 2.5%.

Fixed Income

3rd Quarter Review

Fixed income markets were relatively quiet in the third quarter although rates continued to trend upward. The benchmark U.S. Treasury 10-year yield finished the quarter at 3.05% up 72 basis points from the end of 3Q17 and within five basis points of its high point for 3Q18. Corporate borrowing costs rose as well with the Baa yield-to-worst index up 90 basis points from a year ago and the high-yield index up 79 basis points.

Credit spreads widened only modestly with the corporate high yield spread up only six basis points over the past twelve months and the investment grade spread up just 19 basis points over the same time period. Spreads are being restrained by very low default rates. Default rates are defying record levels of U.S. non-financial corporate debt-to-GDP. Markets seem to be overlooking the build-up in corporate leverage at least partially due to the fact that the net corporate debt-to-GDP ratio (subtracting corporate cash balances from gross debt) rolled over in 3Q after peaking at a point well below the past three cyclical highs. While we understand the market's focus on the net debt metric, we would also caution that those cash balances are concentrated among a relatively small number of large-cap companies while the debt is more broadly dispersed.

The Fed raised its Target Rate twice during the third quarter to 2.25% bringing total hikes year-to-date to three. Chairman Powell and most of his FOMC colleagues appear committed to one more rate hike this year and at least a few more over the next couple of years. This suggests that, unless expectations for long-term economic growth in the U.S. pick up, the closely watched 2-yr/10-yr U.S. Treasury curve could flatten further and potentially invert at some point (short rates higher than long rates). Such an inversion would make investors nervous as it typically presages a recession. Due to the U.S. tightening cycle being out of synch with much of the rest of the developed world (i.e. our rates are higher) we're not too worried about this metric.

Fixed Income Rates

	9/28/2018	9/28/2017	Change
U.S. Treasury 10-Year Note	3.05%	2.31%	+74 bps
U.S. Treasury 2-Year/10-Year Spread	24 bps	85 bps	-61 bps
U.S. High-Yield/U.S. Treasury 10-Year Spread	318 bps	314 bps	+4 bps
Federal Reserve Discount Rate	2.75%	1.75%	+100 bps

Perspectives

Ten Years Gone

September 15th marked a milestone in America's economic history as the tenth anniversary of the collapse of the more than century old investment bank Lehman Brothers. Lehman's collapse didn't cause the Global Financial Crisis (GFC) but it helped ensure its severity and duration.

Warren Buffett recalled the news of Lehman's collapse as "really looking into the abyss." Bond guru Bill Gross phoned his wife on the morning of September 15th and instructed her to go to the bank and withdraw as much cash as she could. A leading money market fund "broke the buck", allowing its shares (valued for safety and absolute stability) to fall below $1 per share when it found its $785 million in Lehman short-term debt holdings to be worthless.

So deep was the crisis that, according to research from the San Francisco Fed, the U.S. suffered a persistent (i.e. unrecoverable) 7% drop in economic output. This amounts to a present-value lifetime income loss of approximately $70,000 for every American. More than six million jobs were lost and the unemployment rate hit 10%. The S&P 500 fell more than 55% from its 2007 high to the March 2009 bottom with more than three quarters of that drop coming after the Lehman bankruptcy. So many homes were lost to foreclosure that the nation's home ownership rate fell from nearly 70% to only 63%, wiping out more than three decades worth of advancement.

What caused Lehman's failure and catalyzed the GFC? In a word, leverage. Total financial sector debt more than doubled from 2000 to 2008. That closely matched the increase in residential mortgage debt over the same period. Many families bought houses with mortgages they clearly couldn't afford. Speculators leveraged up to buy multiple homes as investments with the intent of flipping them to other buyers in a few months at a large profit. Many repeated the process again and again. Still other buyers bought homes they could afford but repeatedly did cash-out re-financings or took out home equity lines as the value of their homes rose.

Ultimately, the nature of the housing bubble added to the length and severity of the GFC and resulting recession. America went on a debt binge to finance homes, experiences and (often imported) consumer products. Virtually none of the accumulated debt went to finance investments to make the nation more productive or competitive, or improve long-term living standards.

Lehman was at the front of the conga line for this debt party. Nearly all investment banks embraced the mortgage boom by originating, buying or trading mortgage-backed securities, collateralized debt obligations and associated derivative instruments. Lehman went even further getting into mortgage origination, specifically subprime mortgage origination. Air started escaping from the housing and subprime mortgage bubbles in 2006 but Lehman kept its foot on the gas in these businesses.

Ultimately, Lehman was done in by the dependence on short-term financing to fund its day-to-day operations. Skepticism of the firm picked up after rival Bear Stearns had to be rescued by JP Morgan Chase with assistance from federal regulators. Despite furious attempts to sell off assets in order to raise cash or find a white knight investor to inject funds, the music ultimately stopped for Lehman.

What has changed since the GFC? The U.S. financial system, though not without risk, is more

stable. Financial system leverage has dropped dramatically and the banking system is better capitalized and more focused on risk control. Consumer debt has fallen as a percentage of GDP due entirely to a drop in outstanding mortgage debt – although a significant portion of that drop was debt that was written off rather than collected. Of course much of the reduction in financial sector and consumer debt has been offset by the huge increase in federal government borrowing.

Historically, the U.S. has had a financial panic or bear market of some type roughly every 12 years on average. Where will the next financial crisis or bear market originate? Almost surely in a different corner of the economy than housing. Hedge fund titan Ray Dallio recently said he expects the next recession to be less severe than the last and we agree. He also said that with the increase in political polarization we've seen and the extensive use of unconventional monetary and fiscal policies used to pull the world out of the GFC, the next recession may be harder to fix. We agree with that too.

Asset Class Returns

2009	2010	2011	2012	2013	2014	2015	2016	2017	3Q 2018	10-YR Annualized
MSCI EM 78.5%	REITs 28%	REITs 8.3%	REITs 19.7%	Russell 2000 38.8%	REITs 28.0%	REITs 2.8%	Russell 2000 21.3%	MSCI EM 37.5%	S&P 500 7.7%	S&P 400 12.5%
S&P 400 37.4%	Russell 2000 26.9%	Barclay's Agg. Bond 7.8%	MSCI EM 18.2%	S&P 400 33.5%	S&P 500 13.7%	S&P 400 - 2.2%	S&P 400 20.7%	MSCI EAFE 25.7%	S&P 400 3.9%	S&P 500 12.0%
MSCI EAFE 31.8%	S&P 400 26.6%	S&P 500 2.1%	S&P 400 17.9%	S&P 500 32.4%	S&P 400 9.8%	S&P 500 1.4%	S&P 500 11.9%	S&P 500 21.8%	Russell 2000 3.6%.	Russell 2000 11.1%.
REITs 28%	MSCI EM 18.9%	S&P 400 -1.7%	MSCI EAFE 17.3%	MSCI EAFE 22.8%	Barclay's Agg. Bond 6.0%	Barclay's Agg. Bond 0.6%	DJ UBS Commodity 11.8%	S&P 400 16.2%	MSCI EAFE 1.5%	REITs 7.2%
Russell 2000 27.2%	DJ UBS Commodity 16.8%	Russell 2000 -4.2%	Russell 2000 16.4%	REITs 2.9%	Russell 2000 4.9%	MSCI EAFE -0.8%	MSCI EM 11.2%	Russell 2000 14.6%.	REITs 0.7%	MSCI EAFE 6.0%
S&P 500 26.5%	S&P 500 15.1%	MSCI EAFE -12.1%	S&P 500 16%	Barclay's Agg. Bond -2.0%	MSCI EM -2.2%	Russell 2000 -4.4%	REITs 6.7%	REITs 3.8%	Barclay's Agg. Bond 0.0%	MSCI EM 5.8%
DJ UBS Commodity 18.9%	MSCI EAFE 7.8%	DJ UBS Commodity -13.3%	Barclay's Agg. Bond 4.2%	MSCI EM -2.6%	MSCI EAFE -4.9%	MSCI EM -14.9%	Barclay's Agg. Bond 2.7%	Barclay's Agg. Bond 3.5%	MSCI EM -1.0%	Barclay's Agg. Bond 3.8%
Barclay's Agg. Bond 5.9%	Barclay's Agg. Bond 6.5%	MSCI EM -18.4%	DJ UBS Commodity -1.1%	DJ UBS Commodity -9.5%	DJ UBS Commodity -17.0%	DJ UBS Commodity -24.7%	MSCI EAFE 1.6%	DJ UBS Commodity 1.7%	DJ UBS Commodity 2.0%	DJ UBS Commodity -6.2%

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