MARKET COMMENTARY & OUTLOOK

Fourth Quarter, 2018

LAMCO

LAMCO ADVISORY SERVICES, INC.

For much of the last 18 months, market participants could be best described as complacent and overconfident. In the face of escalating trade tensions, rising interest rates, and stretched valuations, U.S. stocks rose 11% at their height—setting all-time records—in 2018. Growth, at any price, was what investors favored. Just as they did 20 years ago, stocks with promising growth potential but no reported earnings had greater returns than stocks with tangible earnings per share.

Today, complacency has given way to extreme anxiety as investors are hyper-focused on the same factors they ignored earlier in 2018. Somewhere between these two extremes lies the appropriate analysis and response to the challenges and opportunities of a late-stage economic cycle and bull market.

Investors were comfortable assuming risk while the Federal Reserve (Fed) provided an accommodative monetary policy, often referred to as the "Fed Put." Even as the Fed began the process of reducing stimulus, the market discounted the impact it would have on global growth. With that safety net removed and the stimulative effect of the 2018 tax cuts waning, investors are reevaluating risk. "Risk On" has become "Risk Off" in the blink of an eye. 2018 had the rare distinction of being a year where both global stocks and global bonds posted negative returns.

Economic Statistics

	Current	One Year Ago
Real GDP Growth (Annl. % Change From Prior Qtr.)	3.40%	2.47%
Unemployment Rate	3.90%	4.10%
Labor Force Participation Rate	63.10%	62.70%
Core CPI (Year-Over-Year)	2.21%	1.76%
Real Personal Income Growth (Year-over-Year)	2.33%	2.70%
10 Year Treasury Rate	2.83%	2.40%

Data Source: Federal Reserve, LAMCO Advisory

During the final quarter of the year, strong employment results gave way to an unemployment rate of 3.7%—the lowest in 49 years. To date, however, we have not seen that result translate into significant wage inflation. The expectation back in October was that this economic metric, along with an above-trend growth rate, inflation on target around 2.0%, and positive consumer sentiment would give rise to further Fed rate increases well into 2019. That abruptly changed as investor skittishness increased over tariffs and trade, a flattening yield curve, falling oil prices and a growing choir of market experts calling for global growth to abruptly slow. Concerns over a peak in earnings, tighter financial conditions and trade risks negatively impacted markets and sent stocks on a path towards bear market territory. Moreover, volatility returned in a big way as the quarter progressed. As noted in our November commentary, VIX levels generated during the quarter had not been seen since early 2016.

We expect performance to be compressed in 2019 with a narrowing disparity between equity and bond returns. The range of potential outcomes will be wide, and the influence of external forces will create challenges for accurate forecasting. In this environment, risk should be a predominant consideration. Assets with limited upside if everything goes right, but meaningful downside if some things go wrong, should be avoided.

Continuing the trend started earlier in 2018, the equity focus will be on quality companies with sustainable growth, low volatility and solid balance sheets. We anticipate a tilt towards larger-capitalization companies that tend to hold up better in the later stages of the economic cycle. Small caps are more at the mercy of rising rates, with more than 50% of small caps' debentures being floating rate, compared to 27% for large caps. Internationally, we believe emerging markets are poised to outperform; however, a more hawkish approach from the Fed could create a meaningful headwind for emerging markets, especially in countries with external liabilities. Not only does a strengthening dollar diminish the foreign returns as they are converted back to U.S. dollars, they also raise the cost of funding in dollars, which is effectively monetary tightening.

US Equity Market

Observations

- The strong performance of the U.S. economy and stock market over most of the last two years is in part explained by significant support from lingering expansionary monetary policies and more recent aggressive fiscal policies.
- The S&P 500 Index reached a new all-time high in September, only to suffer a 20.2% intraday peak-to-trough drawdown.
- Relentless algorithmic trading (automatic trading driven by trends) has intensified the speed and magnitude of stock market volatility. The S&P 500 Index registered its worst monthly performance in December since 1931 and the NASDAQ officially entered bear market territory on December 21. These negative market movements are in stark contrast to a strong third quarter GDP growth rate of 3.4%.
- According to Bank of America and The Wall Street Journal, market participants yanked $39 billion out of global equity funds in the week through December 12, the highest weekly total ever. Additionally, $8.4 billion fled investment-grade bond funds, also an all-time high.
- Earnings estimates for 2019 have deteriorated over recent months, with declining oil prices, fears of a slowdown in global growth, trade wars and potential Fed over-tightening weighing on analyst expectations.
- We believe the market is oversold and that stocks are priced below their intrinsic worth given current economic conditions. With the S&P 500 Index trading at 2,467 as of January 3rd, the estimated forward price/earnings ratio (assuming 2019 earnings of $170 per share) would be 14.5 versus a 25-year average of 16.1. At its current level, investors are effectively assuming that earnings will be $153 per share, 10% lower than current estimates.
- None of this means stock prices will recover quickly or that the declines will abate in the near term. It does indicate, however, that a meaningful amount of negativity has been priced into the market and the current risk/reward relationship is tilted more in the investor's favor than it has been recently.

Major US Market Averages

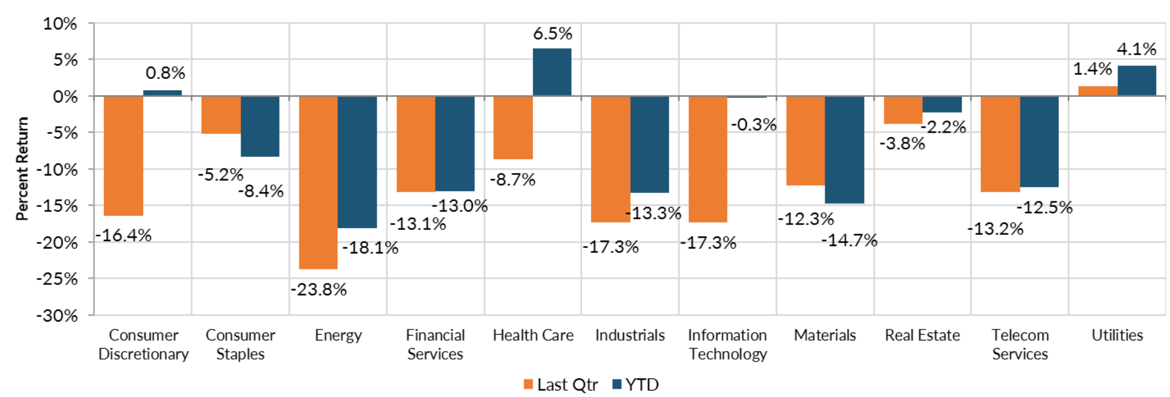
	Q4, 2018	YTD	1 Year	3 Year	5 Year	2017	2016	2015
Russell 3000 Index	-14.3%	-5.2%	-5.2%	9.0%	7.9%	21.1%	12.7%	0.5%
FTSE RAFI US 3000 Index	-14.2%	-8.5%	-8.5%	7.9%	6.5%	16.2%	18.1%	-2.7%
Russell 3000 Equal Weighted	-19.7%	-11.4%	-11.4%	7.6%	4.3%	15.6%	21.6%	-6.2%
S&P 500 Index	-13.5%	-4.4%	-4.4%	9.3%	8.5%	21.8%	12.0%	1.4%
Russell Mid Cap Index	-15.4%	-9.1%	-9.1%	7.0%	6.3%	18.5%	13.8%	-2.4%
Russell 2000 Index	-20.2%	-11.0%	-11.0%	7.4%	4.4%	14.6%	21.3%	-4.4%
NASDAQ 100	-16.8%	0.0%	0.0%	12.6%	13.3%	33.0%	7.3%	9.8%

Russell 3000 Style & Cap Summary

	Mo.	Qtr	Value		Core		Growth	
Large	Oct	Q4	-4.18%	-10.14%	-6.60%	-13.23%	-8.66%	-15.86%
	Nov		3.26%		1.87%		0.64%	
	Dec		-9.18%		-8.80%		-8.46%	
Mid	Oct	Q4	-7.20%	-14.95%	-8.31%	-15.37%	-9.90%	-15.99%
	Nov		2.40%		2.46%		2.54%	
	Dec		-10.50%		-9.92%		-9.07%	
Small	Oct	Q4	-8.95%	-18.67%	-10.86%	-20.20%	-12.65%	-21.65%
	Nov		1.61%		1.59%		1.56%	
	Dec		-12.09%		-11.88%		-11.68%	

	Value	Core	Growth
Large	-6.22%	-3.08%	-0.52%
Mid	-12.29%	-9.06%	-4.75%
Small	-12.86%	-11.01%	-9.31%

S&P 500 Sector Performance



Data Source: Morningstar

US Equity Market

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Dividend Yield [a]

	Avg. Weight %	Return %	Contribution to Return %
Dividend Yield [2.52 - 20.05]	26.39%	-9.20%	-2.43%
Dividend Yield [1.58 - 2.52)	22.99%	-12.23%	-2.81%
Dividend Yield [0.55 - 1.58)	23.55%	-16.46%	-3.88%
Dividend Yield [0.00 - 0.55)	26.78%	-18.82%	-5.04%
Attribution Total	**99.71%**		**-14.16%**

*Avg. Weight excludes cash (0.29%)

Capitalization [a]

	Avg. Weight %	Return %	Contribution to Return %
Mega Cap (>$85 Billion)	46.86%	-12.79%	-5.93%
Large Cap ($18 Billion -$85 Billion)	29.80%	-13.66%	-4.05%
Mid Cap ($3 Billion - $18 Billion)	16.63%	-16.88%	-2.85%
Small Cap ($700 Million - $3 Billion)	5.17%	-22.28%	-1.21%
Micro Cap (< $700 Million)	0.79%	-27.82%	-0.24%
Unclassified	0.46%	-4.38%	0.00%
Total	**99.71%**		**-14.28%**

Valuation [a]

	Avg. Weight %	Return %	Contribution to Return %
Fairly Valued	26.66%	-8.40%	-2.14%
Overvalued	14.25%	-7.84%	-1.08%
Undervalued	58.19%	-18.50%	-11.04%
Unclassified	0.60%	-14.49%	-0.01%
Attribution Total	**99.70%**		**-14.27%**

*Avg. Weight excludes cash (0.30%)

(a) = ishares Russell 3000 ETF
(b) = SPDR S&P 500 ETF

Data Source for all data in tables: Morningstar Direct

Top Weights [b]

	Weight	Return	Contribution
Apple Inc	3.86%	-29.88%	-1.25%
Microsoft Corp	3.59%	-11.19%	-0.40%
Amazon.com Inc	2.96%	-25.01%	-0.83%
Berkshire Hathaway Inc B	1.78%	-4.64%	-0.08%
Johnson & Johnson	1.64%	-6.01%	-0.09%
JPMorgan Chase & Co	1.57%	-12.89%	-0.20%
Facebook Inc A	1.52%	-20.29%	-0.33%
Exxon Mobil Corp	1.46%	-18.98%	-0.28%
Alphabet Inc Class C	1.44%	-13.23%	-0.20%
Alphabet Inc A	1.41%	-13.43%	-0.20%

Top Contributors [b]

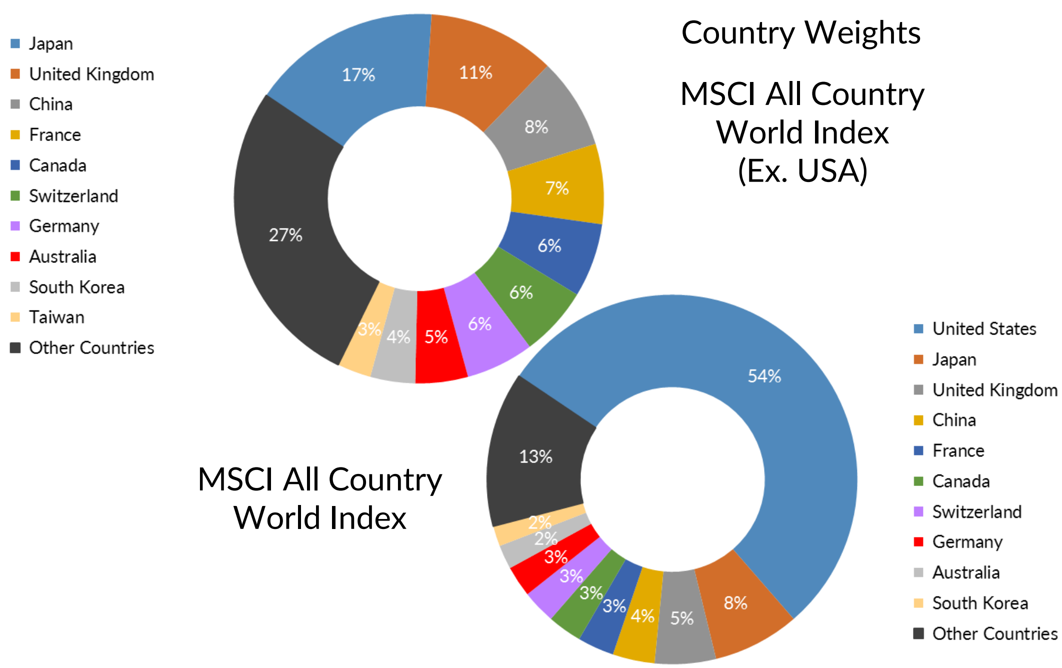
	Weight	Return	Contribution
Procter & Gamble Co	0.99%	11.43%	0.10%
Merck & Co Inc	0.86%	8.49%	0.07%
Verizon Communications Inc	1.03%	6.45%	0.06%
Starbucks Corp	0.37%	13.91%	0.04%
McDonald's Corp	0.61%	6.80%	0.04%
Eli Lilly and Co	0.47%	8.39%	0.03%
CME Group Inc Class A	0.27%	11.99%	0.03%
Red Hat Inc	0.12%	28.88%	0.03%
American Tower Corp	0.31%	9.45%	0.02%
Coca-Cola Co	0.80%	3.33%	0.02%

Top Detractors [b]

	Weight	Return	Contribution
Apple Inc	3.86%	-29.88%	-1.25%
Amazon.com Inc	2.96%	-25.01%	-0.83%
Microsoft Corp	3.59%	-11.19%	-0.40%
NVIDIA Corp	0.49%	-52.45%	-0.36%
Facebook Inc A	1.52%	-20.29%	-0.33%
Exxon Mobil Corp	1.46%	-18.98%	-0.28%
JPMorgan Chase & Co	1.57%	-12.89%	-0.20%
Alphabet Inc Class C	1.44%	-13.23%	-0.20%
Citigroup Inc	0.69%	-26.94%	-0.20%
Alphabet Inc A	1.41%	-13.43%	-0.20%

Observations

- After being discounted for much of the previous two quarters, trade tensions have weighed heavily on the markets as of late. Foreign trade represents a meaningful percentage of U.S. GDP, albeit a smaller percentage than it does for the remainder of the developed world (20% versus 35%). However, from an equity market perspective, the percentage of S&P 500 Index sales from foreign countries in 2017 was significantly higher, at 43.6%.
- Collectively, ongoing trade tensions will result in decreased economic activity, higher costs that lead to lower margins for companies and/or price inflation for end consumers, and an erosion in business confidence.
- We forecast that a de-escalation of the rhetoric between the U.S. and China will continue; however, we see tensions remaining as the issues at hand go beyond trade and extend to investment, technology and intellectual property rights. Both sides recognize no one will win through further escalation. Hopefully this keeps the focus on getting the issues resolved.
- The U.S. and Europe also continue to work towards a trade resolution, which we believe will ultimately be accomplished. However, we expect trade tensions with Europe could flare up if President Trump follows through with his threat to impose tariffs on Europe's automobiles. This would not bode well for a European economy dependent on trade and already struggling to maintain growth.
- U.S. multinational corporations—with large investment stakes in the region and a reliance on Europe as a key source of sales and profits—are particularly at risk by these events.
- Brexit, the uprisings in France and the populist movement in Italy are indicative of a growing population that does not feel its interests are being properly represented. As the resulting divisiveness continues to shape policy—with Brexit representing an extreme example—it cannot be ignored as a factor that can influence the economy over the short and intermediate term.



Data Source: Morningstar and iShares ETFs as the representative index proxies. Weights are average for Q4.

International Equity Market Performance

	Q4, 2018	YTD	1 Year	3 Year	5 Year
MSCI EAFE	-12.50%	-13.36%	-13.36%	3.38%	1.00%
MSCI EAFE Value	-11.65%	-14.26%	-14.26%	3.43%	-0.06%
MSCI EAFE Growth	-13.30%	-12.48%	-12.48%	3.28%	2.00%
MSCI EM	-7.40%	-14.25%	-14.25%	9.65%	2.03%
MSCI ACWI Ex. USA.	-11.41%	-13.78%	-13.78%	4.98%	1.14%

	Last Quarter			Year To Date		
	Local	USD	Impact Of US Dollar [a]	Local	USD	Impact Of US Dollar [a]
MSCI ACWI Ex USA	-10.83%	-11.41%	-0.58%	-10.21%	-13.78%	-3.57%
MSCI Europe	-11.20%	-12.68%	-1.48%	-10.02%	-14.32%	-4.31%
MSCI Europe Ex UK	-11.79%	-13.02%	-1.24%	-10.55%	-14.42%	-3.87%
MSCI United Kingdom	-9.66%	-11.77%	-2.11%	-8.76%	-14.10%	-5.34%
MSCI Pacific Ex Japan	-6.53%	-7.90%	-1.38%	-4.35%	-10.19%	-5.84%
MSCI Japan	-17.13%	-14.20%	2.92%	-14.85%	-12.58%	2.28%
MSCI France	-13.59%	-14.96%	-1.37%	-7.45%	-11.90%	-4.44%
MSCI Switzerland	-8.10%	-8.94%	-0.84%	-7.14%	-8.20%	-1.06%
MSCI Germany	-14.12%	-15.48%	-1.36%	-17.69%	-21.64%	-3.95%
MSCI Canada	-10.30%	-15.11%	-4.81%	-9.04%	-16.56%	-7.52%
MSCI China	-10.69%	-10.73%	-0.04%	-18.58%	-18.75%	-0.17%
MSCI India	-1.25%	2.53%	3.78%	1.39%	-7.30%	-8.70%
MSCI Brazil	10.21%	13.56%	3.35%	16.67%	-0.15%	-16.82%
MSCI Russia	-4.13%	-8.77%	-4.64%	17.76%	0.21%	-17.55%

Assumes Gross Reinvestment Of Dividends

Data Source: Morningstar

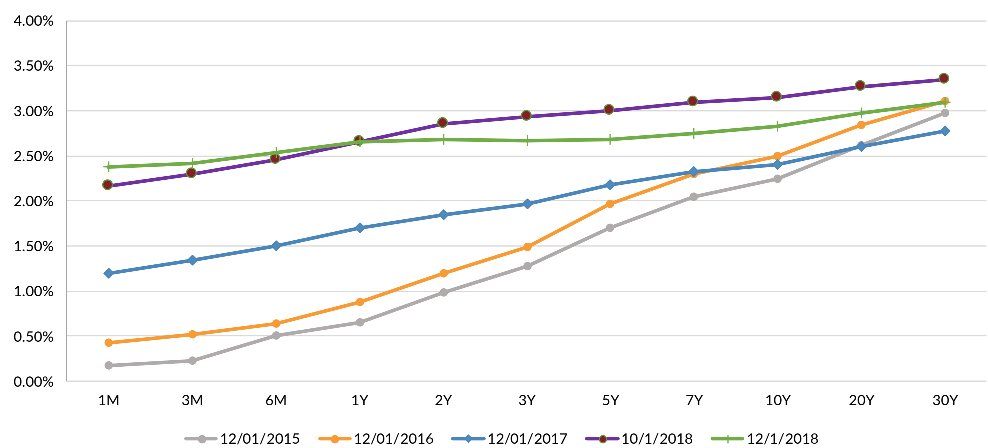
(a) Impact of Dollar: For a US investor, a strengthening dollar has a negative impact on non-US asset returns when converted to US dollars since the conversion requires more of a foreign currency to purchase the more expensive US dollar. A weakening dollar has the opposite effect; the foreign currency can buy more US dollars.

Fixed Income

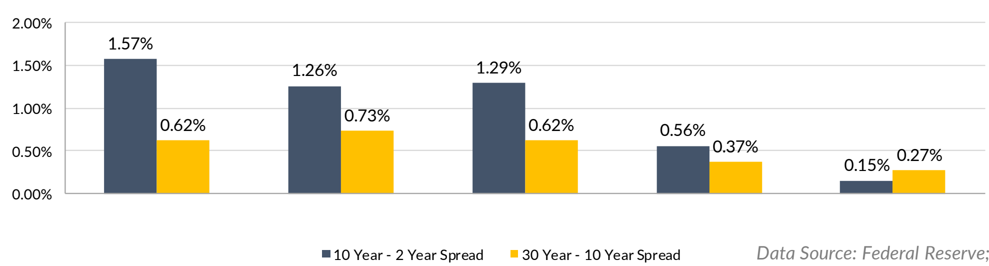
Observations

- Developed market central banks could be expected to continue pursuing a strategy of gradual normalization as measured increases in interest rates will be accompanied by a progressive unwind of global central bank net asset purchases (move from QE to QT).
- The Fed's mandate is to maximize employment (which has occurred) while maintaining price stability (which also has occurred)—leading investors to question the need to continue raising rates at an aggressive pace.
- In his press briefing after the December 18/19 Federal Reserve meeting, Chairman Jerome Powell struck a less hawkish tone (focused on raising rates). In that briefing, he indicated that he believed the Fed was nearing a neutral position, where interest rates were neither stimulating nor constraining economic activity.
- The current yield curve may move more towards a steeper slope as the Fed achieves normalization and assuming it can successfully engineer a soft landing.
- Interestingly, an inverted curve does not imply an immediate peak in U.S. equities. The peak may be more than a year away from when the yield curve actually inverts. For the 1-to-10-year spread, historically the S&P 500 Index has peaked 1 to 22 months after inversion (median: 16 months). For the near-term forward spread, historically the S&P 500 Index has peaked 2 to 20 months after inversion (median: 13 months).

Yield Curve



Spread Analysis



Data Source: Federal Reserve; LAMCO Advisory

Major Market Averages

Major Market Averages	Q4, 2018	YTD	1 Year	3 Year
ICE BofAML US 3M Treasury Bill	0.56%	1.87%	1.87%	1.02%
Bloomberg Barclays US Govt/Credit 1-3 Yr	1.18%	1.60%	1.60%	1.24%
Bloomberg Barclays US Govt Interm	2.22%	1.43%	1.43%	1.21%
Bloomberg Barclays US Govt/Credit Interm	1.65%	0.88%	0.88%	1.70%
Bloomberg Barclays US Govt/Credit	1.46%	-0.42%	-0.42%	2.19%
Bloomberg Barclays US Agg Interm	1.80%	0.92%	0.92%	1.72%
Bloomberg Barclays US Agg Bond	1.64%	0.01%	0.01%	2.06%
Bloomberg Barclays Global Agg Bond	1.20%	-1.20%	-1.20%	2.70%
Bloomberg Barclays US Treasury	2.57%	0.86%	0.86%	1.40%
Bloomberg Barclays US Treasury US TIPS	-0.42%	-1.26%	-1.26%	2.11%
Bloomberg Barclays US Corporate IG	-0.18%	-2.51%	-2.51%	3.26%
Bloomberg Barclays High Yield Corporate	-4.53%	-2.08%	-2.08%	7.23%
Bloomberg Barclays Municipal	1.69%	1.28%	1.28%	2.30%
Bloomberg Barclays Municipal 7 Yr 6-8	2.02%	1.66%	1.66%	1.86%

Credit Quality

Credit Quality	Q4, 2018	YTD	1 Year	3 Year
B of A/Merril Lynch US Corporate AAA	1.25%	-1.89%	-1.89%	2.88%
B of A/Merril Lynch US Corporate AA	1.18%	-0.54%	-0.54%	2.68%
B of A/Merril Lynch US Corporate A	0.51%	-1.94%	-1.94%	2.70%
B of A/Merril Lynch US Corporate BBB	-0.80%	-2.82%	-2.82%	4.10%
B of A/Merril Lynch US Corporate BB	-2.99%	-2.46%	-2.46%	5.77%
B of A/Merril Lynch US Corporate B	-4.85%	-1.54%	-1.54%	7.12%
B of A/Merril Lynch US Corp. CCC & Lower	-10.35%	-4.15%	-4.15%	13.09%

Data Source: Morningstar

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[2] *JP M organ Guide to the Markets*
[3] *Vanguard*
[4] *S&P Dow Jones Indices LLC, S&P Global Market Intelligence*