3Q 2018

The Advisor

EXECUTIVE SUMMARY

- Economic growth picked up as second quarter 2018 GDP increased to a 4.2% annualized rate; momentum is expected to continue into the third quarter.
- Global manufacturing and services PMI data weakened in the third quarter, though U.S. data remained strong.
- Consumer confidence readings reflect heightened levels of optimism from tax cuts and a strong jobs market that is expected to translate into more spending.
- U.S. dollar strength could become a headwind.
- Business optimism is high, but uncertainties over tariffs have slowed investment.
- Escalation of trade wars could increase downside risks to the global economy.
- The Federal Reserve's ("Fed") upbeat assessment of economic conditions has positioned markets to expect further interest rate increases.
- Higher Treasury yields, on the heels of strong U.S. economic data, helped lower quality Credit outperform all other fixed income sectors during the quarter.
- Inflation will continue the work of the Fed in 2019 and will be the key to movements in the U.S. Treasury yield curve and overall fixed income returns.
- Equity market volatility has fallen over the third quarter as investors become more risk tolerant.

ECONOMIC REVIEW

U.S. economic activity picked up significantly in the second quarter to an annualized growth rate of 4.2%, fueled by the highest final sales growth in twelve years. Net exports reversed the declines of the previous two quarters and contributed strongly to growth — helped by slowing imports of raw materials as tariffs began to take effect. Also, weather damage from Tropical Storm Gordon and Hurricane Florence was less destructive than last year's storms so the impact to productivity was less severe.

Spending by consumers remains strong, as wage and job growth and job security are huge positives offsetting concerns of escalating tariffs. Business optimism also remains elevated and, while concerns over tariffs have begun to hinder certain segments of the economy, the effects are mixed and haven't appeared to significantly harm the aggregate economy yet. Good news arrived in the form of a last minute deal struck with Canada to provide the three North American parties a replacement for NAFTA with the U.S.-Mexico-Canada Agreement (USMCA).

The Federal Reserve met twice during the quarter and, after taking no action at the July/August meeting, set the federal funds target rate at 2.00% to 2.25% in a widely anticipated raise at the September meeting. The Fed communicated its recognition that the outlook for U.S. growth has continued to improve and in its announcement dropped the "monetary policy remains accommodative" language of previous statements.

China's campaign to fortify its financial system through tighter credit has helped produce a general slowdown in the economy that, along with the advent of a trade war with the U.S., has led to a sharp decline in its currency, increased capital flight, and the precipitation of a bear equity market. Turkey experienced a currency crisis sparked by concerns over President Erdogan's economic policies and a trade and diplomatic dispute with the U.S. These events, coupled with a strengthening U.S. dollar and weak commodity prices, negatively affected many emerging market economies in the third quarter, threatening a slowdown in global growth.

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MACRO SUMMARY

GDP

- Second quarter GDP growth jumped to 4.2%, reflecting strong growth in consumption, business investment, government spending, and net exports.
- Lower inventory investment leads to favorable growth in the second half of 2018.
- GDP growth in the third quarter is expected to be above 3.0%.
- The savings rate for the first quarter was revised up from 3.3% to 7.2%, but decreased somewhat to 6.7% at July end.

Employment

- August's 3.9% unemployment rate was steady, but underemployment continued to improve.
- Unemployment claims hit the lowest level since 1968.
- August's 2.9% real wage growth is the highest since 2009.
- Non-farm productivity growth surged to a better-than-expected 2.9% annualized growth for the second quarter, which must be sustained for real growth to remain above 2.0%.
- Productivity gains have slowed and labor's share of income has declined over the last decade.

Housing

- The median existing-home price for all housing types in August ($264,800) was up 4.6% over the previous year.
- Higher mortgage rates are becoming a drag on the housing market.
- Rising interest rates, along with high home prices and low inventory, continue to keep entry-level home buyers out of the market.

Consumer

- The Conference Board Consumer Confidence Index's August measure of 138.4 is at an 18-year high, as households begin to see the recently passed tax cuts show up in their paychecks.
- July's 6.7% personal savings rate, coupled with relatively low debt service and rising incomes, bodes well for future spending.
- The positive condition of consumers' personal finances more than offsets their concerns over tariffs and/or political uncertainty.

Business

- The September ISM Manufacturing Index's 59.8 reading showed slowing new orders and inventories, yet remains elevated.
- ISM Non-Manufacturing Index's 58.5 August reading suggests solid GDP growth will be sustained.
- Duke University's September CFO Survey showed the highest level of optimism for "own-firm" since 2007.
- M&A activity is strong, driven by companies' need to bolster modest organic growth and aided by the desire to lock in a low cost of capital.

The Fed

- The Fed's decision to raise interest rates by 25bps to 2.00%–2.25% in September was widely expected.
- Fed officials increased their projections for the federal funds rate to 3.25-3.50% by the end of 2020.
- The Fed will increase the rate of its balance sheet run-off to $50 billion per month in the fourth quarter.
- The Fed sees strong GDP in 2018, with growth slowing to below 2.0% by 2021. Inflation is expected to remain near the Fed's 2.0% goal and unemployment begins to edge higher in 2021.

Inflation

- The Personal Consumption Expenditure (PCE) deflator in August was steady at a 2.2% annual rate of increase, with the Core PCE's 2.0% growth rate meeting its target.
- August's Core CPI, at 2.7%, also exceeds the Fed's target, but was skewed by higher energy prices. August's one year Core CPI increased 2.2%, driven by increases in services.
- Costs of services are increasing, but pricing for goods remains weak.

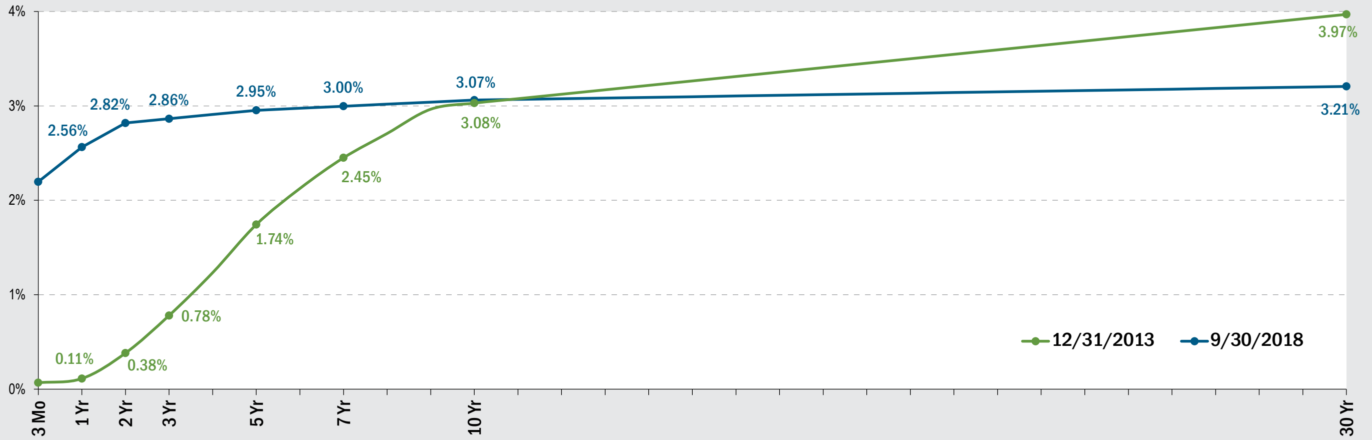
Commodities

- The U.S. Dollar Index was essentially flat in the second quarter, though beginning to strengthen in the third quarter and could become more of a headwind in the future.
- The price of West Texas Intermediate oil maintained its highest level since fall of 2014, as OPEC's decision to keep production constant in the face of 'turmoil' in Iran and Venezuela led to worries over supply shortages.
- Agricultural commodity prices took a large hit on trade tariffs in the second quarter, but found some support in the third quarter.

MACRO SUMMARY

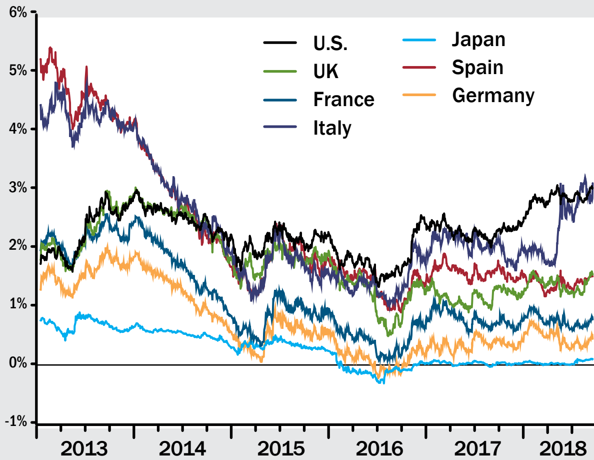
Yield Curve

As of 9/30/2018 Source: Bloomberg



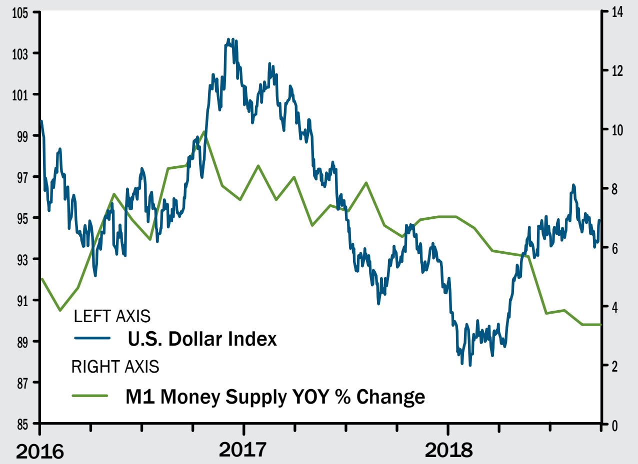
10-Year Sovereign Yields

As of 9/30/2018, Source: Bloomberg



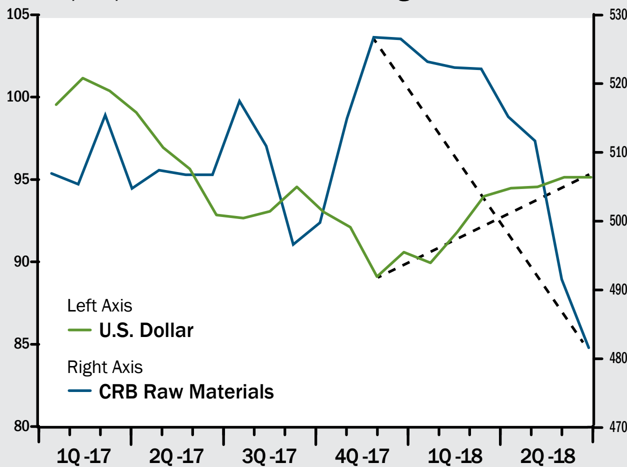
Money Supply vs U.S. Dollar

As of 9/30/2018 Source: Bloomberg



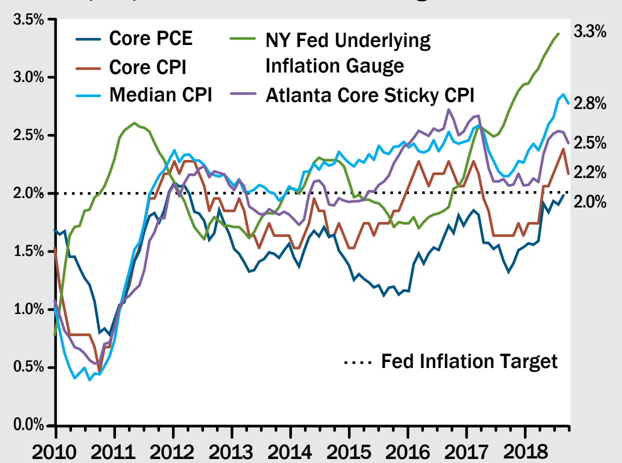
U.S. Dollar Strength = Commodity Weakness

As of 9/30/2018 Source: Bloomberg



Inflation Data (YOY percent change)

As of 9/30/2018 Source: Bloomberg



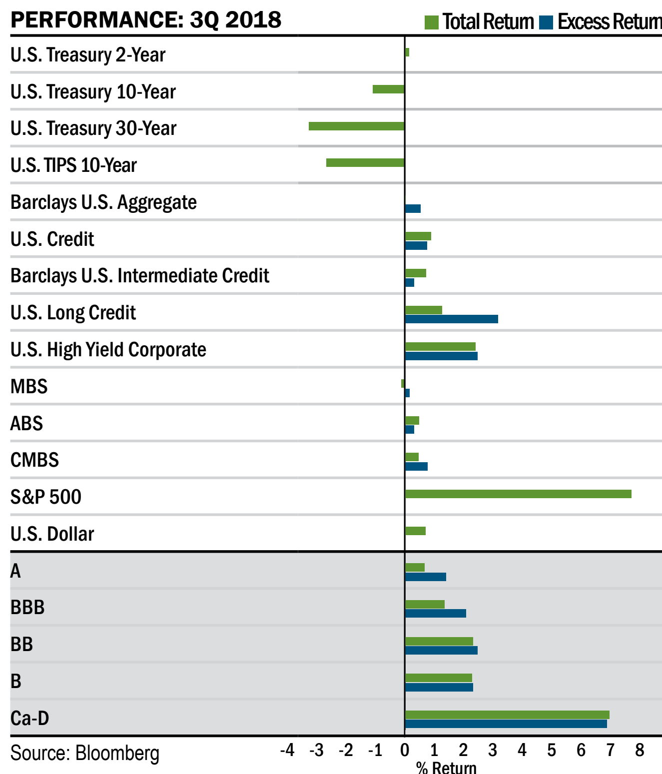
FIXED INCOME MARKET REVIEW

Shrugging off emerging market jitters, trade wars and tariffs, risk assets staged an impressive comeback in the third quarter as strong corporate profits, along with upside surprise readings in key economic data, helped Treasury yields to rise and make credit once again an attractive investment. Long-end investments performed particularly well with all in yields surpassing the key 5% level. Long financials returned 1.70% — even as the U.S. 30-year Treasury yield rose 22bps to end the third quarter at 3.21%. The Barclays Aggregate Corporate Bond Index tightened 18bps during the quarter, but the Bloomberg Barclays Long Credit Index tightened 24bps. With that rally, credit excess returns turned flat for the year, with long credit still slightly negative. Total returns for 2018, however, are still steeply negative at (2.12%). Credit spreads, at 100bps, are at the midpoint between the tights established in January and the wides seen in June. High yield continues to confound, tightening 45bps and producing over 300bps of excess returns against Treasuries for the year. Ca-D rated companies have returned over 30% so far in 2018.

The U.S. Treasury yield curve continued its descent flatter with the spread between the 2-year and 10-year hitting only 19bps in August before settling in at 24bps at quarter end. Similarly, the spread between the 2-year and 30-year flattened from 46bps to 38bps over the quarter.

Inflation expectations were virtually unchanged over the quarter. 10-year break-even inflation rates held steady at 2.13%. The entire 20bps rise in 10-year Treasury yields over the quarter — from 2.86% to 3.06% — was due to a rise in real rates. 10-year U.S. Treasury Inflation-Protected Securities (TIPS) hit 0.92%, the highest yield reached since 2011. The 2-year Treasury yield hit a post-recession high of 2.82%.

Muted Treasury price volatility at higher yield levels was the recipe needed for positive excess returns in Mortgage Backed Securities (MBS), especially higher coupon conventional TBA 5.5s that delivered over 90bps of excess return for the quarter.



EQUITY MARKET REVIEW

Equity markets advanced in the third quarter of 2018 despite apprehensions over trade tariff announcements. The positive results for the quarter are a reflection of favorable corporate fundamentals, rising confidence, supportive tax policy, and accelerating economic growth.

PERFORMANCE: 3Q 2018	Value	Core	Growth
Large Cap	5.86%	7.71%	9.28%
Mid Cap	3.77%	3.86%	3.95%
Small Cap	2.60%	4.71%	6.98%

Source: Bloomberg
As of 9/30/2018. Returns calculated on S&P's equity market indices.

- For the quarter, stocks with larger capitalization, strong price momentum, better capital efficiency and rising analyst estimates generally outperformed smaller company stocks with higher valuation and volatility.
- S&P 500 Index operating earnings rose 26.7% Year-over-Year (YOY) in 2Q'18, the highest rate of growth since the beginning of the economic recovery in 2010.
- Companies in the S&P 500 Index reported an 80.0% rate of earnings estimates "beats" in the second quarter – the highest in the past 7 years.
- Stock buybacks by companies over the last several years, coupled with favorable tax reform, have provided a tailwind for earnings growth, but a stronger dollar and rising costs will slow the trend.
- Market volatility gauges abated throughout most of the third quarter.

GICS SECTOR/INDUSTRY RECLASSIFICATION

S&P Dow Jones Indices reclassified the Telecommunications (TEL), Information Technology (IT) and Consumer Discretionary (DISC) GICS sectors at the end of September to more accurately categorize Communication Service (CS) stocks. The previously labeled TEL sector has been expanded to include the Entertainment and Interactive Media & Services industries that were previously in the IT sector, and the Media industry from the DISC sector, into what is now called the CS sector. The following chart captures the effects of this change upon the S&P 500 Index Sectors' weights, valuation and earnings for 2018:

	Old GICS Classification			New GICS Classification		
	Weight	2018 Est Oper. P/E	5-Yr Projected Annual Growth	Weight	2018 Est Oper. P/E	5-Yr Projected Annual Growth
S&P 500		18.6	13.8		18.5	13.9
Communication Services	2.0%	10.6	9.0	10.0%	13.7	15.4
Consumer Discretionary	13.7%	23.3	24.2	10.3%	23.7	26.1
Consumer Staples	6.7%	19.1	8.5	6.7%	18.7	8.5
Energy	6.0%	19.3	19.7	6.0%	19.6	18.2
Financials	13.1%	13.8	10.8	13.3%	13.4	11.3
Health Care	13.5%	19.6	11.4	15.0%	19.8	11.4
Industrials	9.7%	17.8	12.8	9.7%	17.5	12.7
Information Technology	27.7%	20.3	14.1	21.0%	19.9	13.0
Materials	2.2%	16.3	12.0	2.4%	15.7	11.9
Real Estate	2.6%	37.2	7.3	2.7%	36.0	9.0
Utilities	2.8%	16.9	4.0	2.8%	16.6	7.2

Source: S&P Dow Jones Indices

- The weight of old Communications Service sector increased from 2.0% to 10.0% of S&P 500 Index; DISC and IT sector allocations were reduced.
- Price multiples based upon 2018 estimates increased significantly for the CS and slightly for DISC, while IT dropped.
- Five-year projected growth increased significantly for CS and moderately for DISC, but dropped for IT.

ECONOMIC OUTLOOK

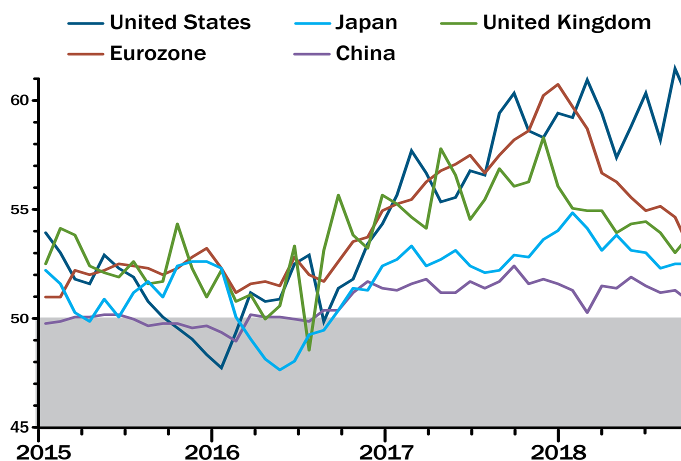
U.S. economic data remains strong going into 2019 and the current expansion is on track to become the longest on record. The labor market is near full employment, nominal growth has moved back up to the high end of the recovery range and inflation remains tame. Indicators reflect an ideal environment for the U.S. economy. However, the growing disconnect between the strong U.S. and the weaker global economy is a source of concern.

The evolving trade war is becoming more worrisome and it has increased risks to the global outlook, which could jeopardize the U.S. expansion. The passage of USMCA brings some welcome relief to what appeared to be an escalation of trade disputes, but China will not likely back down on its tariffs before the U.S. mid-term elections. A Wall Street Journal survey of economists reported that the average probability of a U.S. recession in the next year increased from 13% in January to near 18% by September-end.

U.S. financial conditions remain fairly accommodative, despite the Fed's ongoing rate hikes. The favorable economic data should provide the Fed with more confidence to keep tightening toward their objective of a "soft landing" for the economy. The Fed signaled that another rate hike is likely in December and the potential for an additional three to four rate hikes in 2019. Fed officials expect federal fund rate hikes to gradually move higher over the next few years before leveling out by 2021.

In Europe, the combination of weaker inflation, slower economic growth, new political risks in Italy and the UK's Brexit present uncertainties for the region's economic health. China has begun to prepare for a trade war with the U.S. by moving to a more accommodative posture, which should help it attain its 6.5% growth target for the year. The Xi administration will likely employ a strong fiscal response combined with a weak-to-moderate credit response to prevent asset bubbles while supporting growth. However, growth has slowed in many emerging markets exacerbated by their vulnerability to the stronger U.S. dollar, weakening commodity prices and geopolitical anxieties.

Global Purchasing Managers' Index (PMI)



Source: Bloomberg. As of 9/30/2018.

FIXED INCOME MARKET OUTLOOK

- The U.S.'s potential economic and productivity growth rate — fostered by deregulation, tax reform and a tight labor market — should allow the Federal Reserve Board ("Fed") another increase in the federal funds target rate in 2018 and to continue raising in 2019 according to their median estimates.
- The yield curve should not invert in the near term and could actually steepen on a trade deal with China.
- In light of this macro view, we remain underweight duration at close to 90% of the benchmark, underweight the front-end of the U.S. Treasury yield curve, neutral the belly, and slightly underweight the long-end. As the market continues to price in the Fed's stated path of rate increases, we will look to increase duration exposure on the front end and reduce exposure further out, anticipating a steeper curve.
- We will continue to underweight duration as long as inflation readings and European sovereign yields maintain their upward trajectory — or at least not revert to lower levels. It will be difficult for Treasury yields to maintain an upward bias without these conditions in place.
- We remain underweight U.S. Treasuries in favor of spread product, especially U.S. Corporate Credit. Higher all in yields, coupled with record S&P profit margins and increasing CapEx, should attract flows into the asset class, especially on the long end. Deficit spending and the Fed's balance sheet unwind are increasing U.S. Treasury supply at the same time foreign demand is waning in the face of unattractive currency conversion.
- The down in quality cyclical trade has not yet run its course, and we therefore maintain an overweight to BBBs, Financials, and Energy.
- High yield remains attractive.
- U.S. Treasury Inflation Protected Securities (TIPS) are attractive compared to nominal Treasuries as most break even rates of inflation are trading well below many alternative measures of core inflation.
- With interest rate volatility at multi-decade lows and rates on the move, we continue to favor high coupon mortgages, but are overall neutral the basis, moving to an underweight in the near term as the Fed's balance sheet runoff ramps up.
- We continue to favor and overweight Asset-backed Securities ("ABS") and taxable municipals for their quality and diversification benefits.

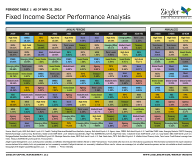
EQUITY MARKET OUTLOOK

- Current quarter environment: Earnings Per Share (EPS) growth remains strong, supported by tax reform and relatively low interest rates.
- Stock Market: economic cycle and historically low interest rate levels support market valuation, but trade-war with China remains the major current worry.
- Earnings: analyst consensus estimates for = $157.63 for 2018 and $176.86 for 2019, with the expectation of 26.6% and 12.2% year-over-year growth, respectively. CFOs of U.S. companies are split as to the effects of the trade wars and tariffs, with an equal number saying trade conditions will help versus hurt them.
- The fast pace of technological change, combined with the current economic environment and geopolitical conditions, is hampering the ability of companies to plan for the future causing them to reduce their planning time horizon and adopt plans with shortened expected lives.
- The outperformance of Growth styles over Value appears to be reaching extreme levels, but could decrease with a rally of the Financial sector or a sell-off of the Information Technology sector.
- Growth/Value differential: slow growth continues to benefit Growth styles, while Value styles are caught between rising interest rates that hurt bond proxies (Utilities, Real Estate, Staples) and a flattened yield curve which hurts Financials.
- At quarter-end, the S&P 500 Index traded at 17.0X a $172 one-year forward operating earnings estimate, just below its 20-year average of 18.8X.

About Our Firm

Ziegler Capital Management is a premier asset management firm comprised of investment teams employing repeatable processes providing tailored investment solutions across the fixed income and equity markets.

Other Market Insights



Periodic Table: Fixed Income Sector Performance

A detailed look at the Fixed Income performance over the past decade, broken down by 13 sectors. Recently Updated through May 2018

VIEW NOW

Periodic Table: S&P 500 Sector Performance

A detailed look at the Fixed Income performance over the past decade, broken down by 13 sectors. Recently Updated through May 2018

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Too Much Tech

Tech, which has long been the darling of our current bull market, has had a series of unexpected misses in recent months. What happens when these giants run out of room to grow?

VIEW NOW

Strategies

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The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.

The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).

There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events.

The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.