The Advisor

4Q 2018

EXECUTIVE SUMMARY

- Economic growth backed off as third quarter 2018 GDP decreased to a 3.5% annualized rate; this decrease in momentum is expected to continue into the fourth quarter.
- Global manufacturing PMI data weakened in the fourth quarter, while services remained steady.
- Economic data remains strong, but favorable trends may have peaked.
- Global economic growth has decelerated, hampered by tariff disputes and geopolitical concerns.
- Weakening growth and inflation expectations have slowed investment.
- The Fed's December rate hike put it at odds with decelerating global growth and below target (2%) inflation, distressing the equity and credit markets. Subsequent comments by Chairman Powell emphasized patience, a commitment to risk management strategies and a flexible approach to monetary policy.
- U.S. equity markets begin the year at attractive valuation levels, relative to recent past years; analysts expect favorable earnings growth to continue.
- Equity market volatility is expected to remain elevated with increased economic and geopolitical uncertainties and aggravated by algorithmic trading.

ECONOMIC REVIEW

The U.S. economy began the fourth quarter with a positive outlook calling for clear skies, but clouds began to develop over concerns of economic and policy fundamentals. U.S. economic data remained strong, with recent growth exceeding 3%, the unemployment rate at a 48-year low, and inflation on target, but it appears that these favorable trends may have peaked, as trade policy concerns have offset much of the pro-growth sentiment stemming from the corporate tax cut. Uncertainties around mid-term election results and a partial federal government shutdown over budget negotiations also began to erode business and consumer confidence by quarter-end.

The Federal Reserve ("Fed") met twice during the quarter and, after taking no action at the November meeting, raised the federal funds target rate to 2.25% to 2.50% at the December meeting against a controversial backdrop. A rate increase was widely anticipated at the beginning of the quarter, but recent slowing in economic data trends and the mounting turmoil in global financial markets raised doubts about the necessity for further increases by December. The Fed appeared to pay little attention to weakening financial market signals, or hectoring over higher rates from the White House, and maintained its somewhat hawkish approach towards monetary policy.

The U.S. Economy appears healthy, but global economic growth has decelerated. Trade negotiations between the U.S. and China appear to have stalled, while Europe appears to be struggling to maintain its coalition in the face of increasingly populist movements in Italy, France, Brexit, and other sovereign issues among its members. Demand for oil weakened in recent months, while supply was stronger than expected, necessitating a response from OPEC that it would cut supply, nevertheless oil prices continued to tumble. The weakness in energy markets was corroborated by falling prices for many industrial metals. All this uncertainty comes at a time when the global expansion has already begun to slow.

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Published:

January 14, 2018

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MACRO SUMMARY

GDP

- Third quarter GDP growth backed off to 3.5% as consumption fell from an annual rate of 4.0% to 3.6%, business investment grew 3.5%, and trade was a net detractor from growth.
- GDP growth in the fourth quarter is expected to slow to around 3.0% and carry into early 2019, with further slowing to approach 2.5%.
- Strong employment supports consumption growth.
- Increased business investment is required to boost productivity, which was at 2.2% in the third quarter; growth in capital goods orders (equipment, machinery, etc.) remains flat.

Employment

- December's unemployment rate ticked up to 3.9% from the 50 year low of 3.7% in September, while the underemployment rate increased slightly to 7.6%.
- Average hourly earnings reported a 3.2% annual growth rate.
- The rate of voluntary separations ("quit rate") remains elevated. Americans feel confident about the job market.
- Small business hiring plans also showed a marked improvement, with the sub-index hitting a record high. This suggests that the labor markets will continue to tighten.

Housing

- Demand is transitioning from multi-unit to entry-level single family, which are in short supply.
- High-end home demand is slowing and deduction limits under new tax laws will affect demand further.
- Existing home sales have stalled over the past couple of years, held back mostly by the lack of supply. Inventories of existing homes for sale remain at multi-year lows for this time of the year.
- The median new home price declined as fewer high-end homes were sold, but there was an increase in starter home sales.

Consumer

- The Conference Board Consumer Confidence Index fell from its October peak, as optimism dimmed for business conditions and income, but consumer sentiment remains healthy.
- October's 6.2% personal savings rate is well off its January 7.4% high.
- Consumer debt service rate is at historically low levels.
- Lower retail gasoline prices will help bolster consumer confidence.

Business

- The December ISM Manufacturing slowed, but still indicates expansion. Services also slowed, but "New Orders" rose with capacity constraints easing; employment challenges remain.
- December's U.S. CFO Optimism dropped from September's record high level; 49% of CFOs believe that the U.S. will be in a recession by the end of 2019 and 82% say it will be by the end of 2020.
- Globally, CFOs are even more pessimistic.
- The NIFB Small Business Optimism Index fell from its all-time high in August, though still elevated.

The Fed

- The Fed's decision to raise interest rates by 25bps to 2.25%–2.5% in December was anticipated, but coolly received by financial markets.
- Fed officials modestly reduced their projections for the federal funds rate to just two rate hikes in 2019 with a targeted of 3.00%-3.25% by the end of 2020.
- The Fed left the rate of its balance sheet run-off on "autopilot" of $50 billion per month, but subsequent comments by Chair Powell assured that Fed will be flexible with its policy tools.

Inflation

- The Personal Consumption Expenditure (PCE) deflator in November dropped to a 1.8% annual rate of increase, with the Core PCE's growth rate slipping to 1.9%.
- November's Headline and Core CPI both registered a 2.2% annual growth rate.
- Costs of services are increasing; higher labor and transportation costs for manufacturers are pressuring them to raise prices.

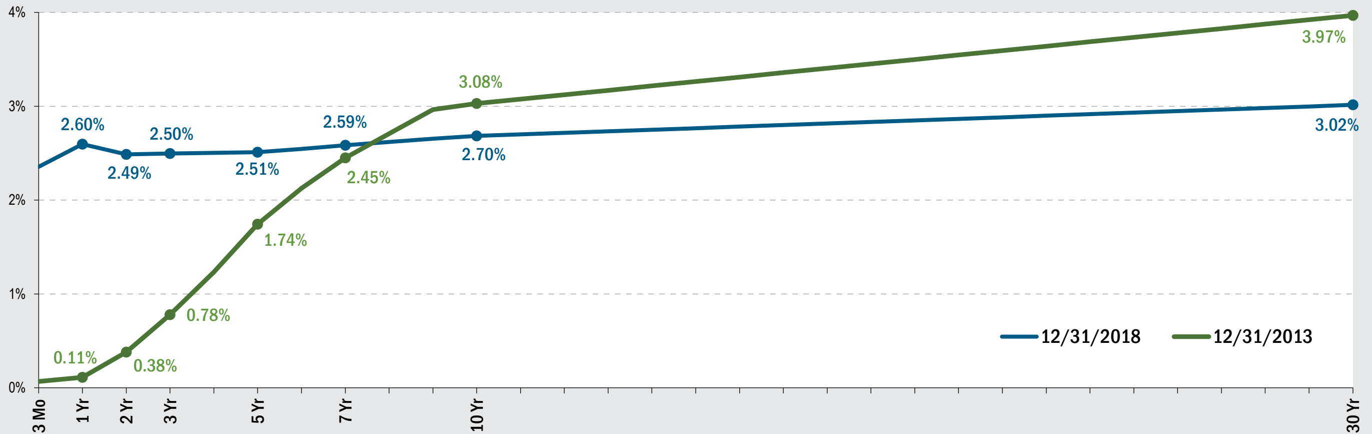
Commodities

- The U.S. Dollar Index rose 1.1% in the fourth quarter and has become a headwind, but a more dovish Fed may mitigate further dollar strength.
- The price of West Texas Intermediate oil fell to 38.0% during the fourth quarter, as supply remained steady in the face of waning demand.
- Industrial metal prices significantly weakened in the fourth quarter.

MACRO SUMMARY

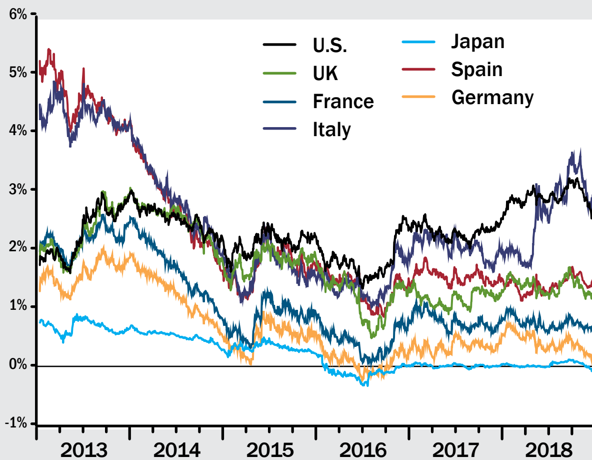
Yield Curve

As of 12/31/2018 Source: Bloomberg



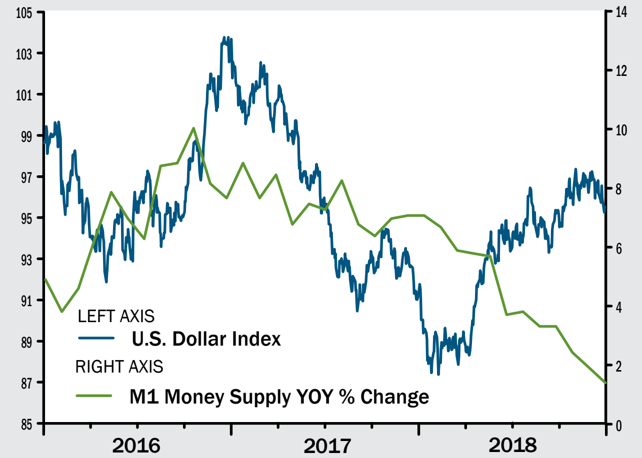
10-Year Sovereign Yields

As of 12/31/2018, Source: Bloomberg



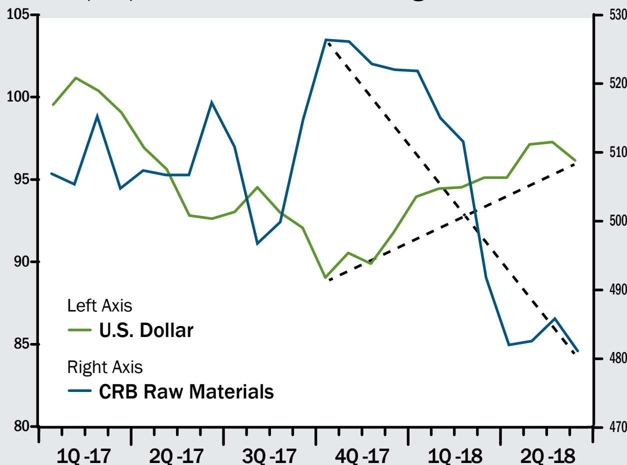
Money Supply vs U.S. Dollar

As of 12/31/2018 Source: Bloomberg



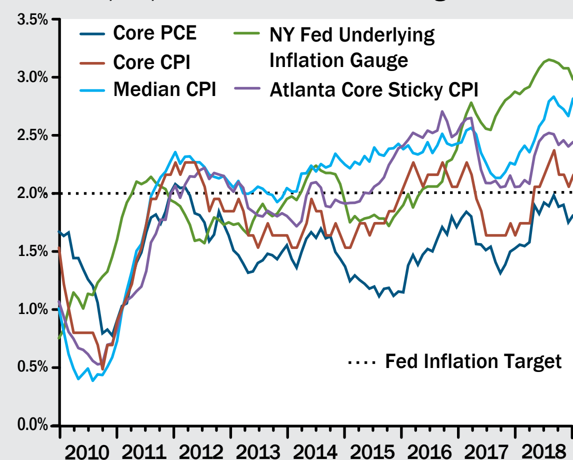
U.S. Dollar Strength = Commodity Weakness

As of 12/31/2018 Source: Bloomberg



Inflation Data (YOY percent change)

As of 12/31/2018 Source: Bloomberg



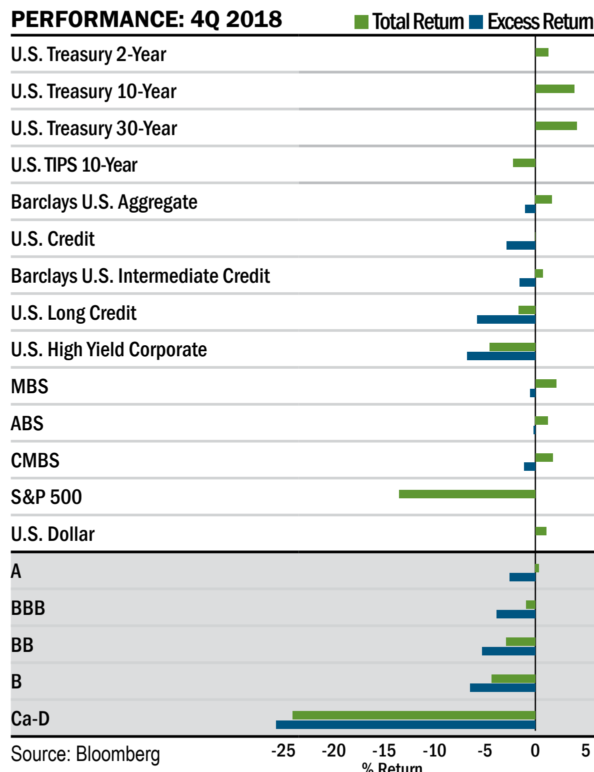
FIXED INCOME MARKET REVIEW

In the fourth quarter, the fixed income markets were not able to shrug off the mounting risks from trade negotiations and tariffs, plunging oil, slowing global growth, Brexit, and a flattening yield curve. The final setback was a more hawkish Federal Reserve Board at the meeting on December 20, as they made little recognition of tighter financial conditions. Treasury yields fell during the period with the 10-year reaching 2.68%, down almost 38bps. The Bloomberg Barclays U.S. Long Treasury Index outperformed for the quarter and year-to-date, though it still had a -1.84% return for the year ended 2018. The Bloomberg Barclays U.S. Aggregate Index squeaked out a 0.01% return for the year, even with poor performance from risky asset classes. U.S. corporate credit struggled as the Bloomberg Barclays Corporate Index widened 47bps to +153bps. Fourth quarter corporate returns were negative, with the Index producing a -2.51% total return for the year. High Yield was resilient until the fourth quarter, with the Bloomberg Barclays U.S. Corporate Index ending the year with a -2.08% return.

The U.S. Treasury yield curve was flatter for the year with the spread between the 2-year and 10-year reaching 20bps. Though during the fourth quarter, the yield curve deviated from a bear flattening pattern. The flattening was due to longer rates falling faster than short rates (bull flattener). The spread between the 2-year and 5-year moved flat to inverted, while the 10-year rallied 4bps versus the 2-year. However, the relationship between the 2-year and 30-year steepened, increasing by 15bps.

Inflation expectations collapsed during the fourth quarter as worries of an inverted yield curve, the fear of recession, and the dramatic fall of oil prices jolted the market. 10-year break-even inflation rates fell from 2.15% to 1.71%, as U.S. Treasury Inflation Protection Securities ("TIPS") underperformed nominals.

Increase in Treasury volatility and falling yields were not a good combination for positive excess returns in mortgage backed securities. The Bloomberg Barclays MBS Fixed Rate Index had -0.53% excess return for he quarter, while maintaining a positive 0.99% total return for the year. Higher coupons struggled, losing more than all of their excess return for the year, while 30-year conventional 3% coupons outperformed.



Source: Bloomberg

EQUITY MARKET REVIEW

Year-to-date 2018: Equities began the year with strong performance and experienced increased volatility throughout the year before settling into a loss after a severe fourth quarter sell-off.

- Large cap growth stocks significantly outperformed value stocks in 2018.
- For the year, stocks with larger capitalization, strong price momentum, better capital efficiency, and rising analyst estimates generally outperformed smaller company stocks with higher valuation and volatility.

Fourth Quarter 2018: Equity market returns fell precipitously or the quarter, stocks with larger capitalization, strong price momentum, and better capital efficiency generally outperformed smaller company stocks with more attractive valuation and volatility.

- For the quarter, stocks with larger capitalization, strong price momentum, and better capital efficiency generally outperformed smaller company stocks with attractive valuation and higher volatility.
- S&P 500 Index operating earnings rose 27% year-over-year ("YOY") in the third quarter and reported an above-average rate of earnings estimates "beats", but the magnitude of the beats appear to have peaked in the second quarter.

PERFORMANCE: YTD 2018	Value	Core	Growth
Large Cap	-8.97%	-4.39%	-0.01%
Mid Cap	-11.90%	-11.10%	-10.34%
Small Cap	-12.68%	-8.52%	-4.09%
PERFORMANCE: 4Q 2018	**Value**	**Core**	**Growth**
Large Cap	-12.05%	-13.52%	-14.71%
Mid Cap	-16.91%	-17.28%	-17.63%
Small Cap	-20.56%	-20.12%	-19.65%

Source: Bloomberg As of 12/31/2018. Returns calculated on S&P's equity market indices.

EARNINGS REPORT

The positive earnings results for the quarter reflected favorable corporate fundamentals, rising confidence, supportive tax policy, and strong economic growth. Nevertheless, equity markets plummeted on concerns over higher interest rates, tariffs and slowing economic growth.

- The old Telecom Services sector was folded in to the new Communication Services ("CS") sector, which carried a 10% weight in the S&P 500 Index and includes contributions from Consumer Discretionary ("DISC") and Information Technology ("IT"), which reduced their respective weights in the index.
- 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.

MARKET VALUATION AND ESTIMATED GROWTH

U.S. equity markets begin 2019 at attractive valuation levels, relative to recent past years', and analysts expect continued favorable earnings growth. The following chart summarizes valuation and expected growth across the various market cap indices at the beginning of 2019:

	Current Fwd P/E	15 yr. Average Fwd P/E	2019 Est YOY EPS %	Average Growth 14 Yrs.
S&P 500	14.7	16.1	11.0%	6.6%
S&P 400	14.0	18.8	16.0%	11.7%
S&P 600	15.0	20.8	23.4%	11.9%

Source: S&P Cap IQ;
Earnings estimates are bottom-up operating earnings as of 12/31/2018

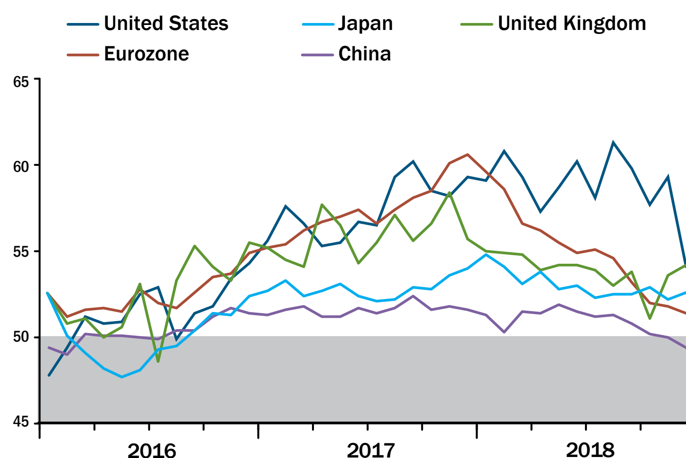
ECONOMIC OUTLOOK

The U.S. economy is beginning to slow, but fundamentals indicate that a recession remains unlikely in 2019. The classic causes of recessions (overheating or financial imbalances) are absent, raising the likelihood that the current economic expansion remains on track to become the longest in U.S. history. However, evolving trade negotiations have increased risks to the global outlook, which could jeopardize the U.S. expansion, while a strong dollar becomes a drag and the effects of fiscal stimulus fades. Capital spending is expected to make only modest contributions to GDP growth in 2019, as businesses continue to hold off significant investment over uncertainties of trade negotiations. Consumer and government spending will be the primary drivers of the expansion and housing remains only a marginal contributor to growth.

U.S. financial conditions remain fairly accommodative, despite the Federal Reserve's ongoing rate hikes. However, financial and monetary indicators suggest the Fed rates have reached equilibrium and there is risk of placing the economic expansion in jeopardy if the Fed continues to tighten policy. The Fed's tightening policy has left it at odds with the decelerating global growth environment.

China's economy is saddled with excessive debt and excess capacity in a number of areas that would have crippled other economies, but the government's control over banking and other sectors has prevented a crisis. China has moved swiftly to stimulate its economy and stands ready with further monetary and fiscal stimulus if necessary. While China's rate of economic growth has slowed over past years, the size of the economy rivals that of the U.S. and its 6.0 - 6.5% projected growth for 2019 is still an impressive accomplishment.

Global Purchasing Managers' Index (PMI)



Source: Bloomberg. As of 12/31/2018.

FIXED INCOME MARKET OUTLOOK

- Premature fears of recession precipitated by partial U.S. Treasury yield curve inversions and an overly hawkish Fed have created an opportunity within U.S. Corporate Credit. The correction in equity and other risky asset valuations lead credit spreads wider, not the usual other way around. Sentiment is overly negative and not supported by the fundamental economic data. We increased our overweight to corporate credit, maintaining an overweight to BBBs, financials, and energy while adding to higher quality liquid credits that got swept up in the de-risking.
- As long as the more prescient parts of the U.S. yield curve (1-year/10-year and 2-year/10-year) do not invert, risk assets should be able to recoup most losses incurred in fourth quarter. Importantly, should a trade deal with China be finalized as we anticipate, we could see the yield curve steepen on heightened growth expectations.
- We remain underweight duration at 97% of the benchmark – up from 90%. We are nearing the end of the Fed tightening cycle and European sovereign yields (depressed due to slowing growth) will cap near-term upside in U.S. yields. We are underweight the front end of the U.S. Treasury yield curve, neutral the belly and back end. As the market reprices in rate increases for 2019, we will look to increase duration exposure on the front end and reduce exposure further out, anticipating a steeper curve.
- We remain underweight U.S. Treasuries in favor of spread product, especially U.S. Corporate Credit. Deficit spending and the unwinding of the Fed's balance sheet is increasing U.S. Treasury supply at the same time foreign demand is waning in the face of unattractive currency conversion. Longer term, we are wary of the buildup of U.S. debt and its potential push to higher treasury yields.
- Absent a recession, below investment grade credit with yields close to 8% remains an attractive investment.
- U.S. Treasury Inflation Protected Securities ("TIPS") are attractive vs nominal treasuries as most break even rates of inflation are trading well below many alternative measures of core inflation. We are mindful of and positioned for recent gains in wages and overall compensation that could lead to elevated core consumer inflation readings near term.
- We believe the market is incorrectly assuming the Fed is done raising interest rates. A pause seems more realistic. Given this, we continue to favor high coupon mortgages, but are overall neutral the basis, preferring credit. We will move to an overweight in securitized products (Mortgage Backed Securities ("MBS") and /or Agency Commercial Mortgage Backed Securities ("CMBS")) when corporate valuations richen over the course of the first half of 2019.
- We continue to favor and overweight Asset-backed Securities ("ABS") and taxable municipals for their quality and diversification benefits.

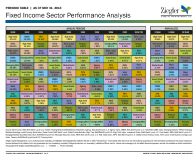
EQUITY MARKET OUTLOOK

- Current quarter environment: Fourth quarter EPS estimates for S&P 500 Index indicate 19.3% YOY growth, a marked slowdown from third quarter's 32% growth rate, but still positive.
- Stock Market: Growing earnings and historically low interest rate levels support market valuation with traditional indicators of an overheated business cycle absent.
- Smaller companies stand to benefit more from tax reform and a stronger dollar. They are also more insulated from trade disputes, but more susceptible to recession fears.
- Slowing growth and recessionary fears have recently benefited defensive sectors, but growth typically does well late in the cycle and is now more reasonably priced. A flat yield curve continues to hurt Financials, while energy suffers from low oil prices, creating a drag on Value indices' performance.
- Earnings: consensus analysts' 2019 estimates of $171 translate to 9.0% YOY growth and their 2020 estimate of $194 would equate to 13.4% YOY growth.
- At quarter-end, the S&P 500 Index traded at 14.7X its $171 one-year forward operating earnings estimate, 17% below its 20-year average of 17.8X.
- Volatility is expected to remain elevated with increased economic and geopolitical uncertainties, exacerbated by algorithmic trading.

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 sectors.

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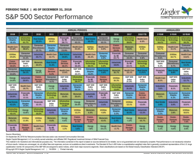

Periodic Table: S&P 500 Sector Performance

A detailed look at the Fixed Income performance over the past decade, broken down by sectors.

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DEFINITIONS

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).

The Bloomberg Barclays US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

The Bloomberg Barclays U.S. Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes U.S. Dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers. The U.S. Corporate Index is a component of the U.S. Credit and U.S. Aggregate Indices, and provided the necessary inclusion rules are met, U.S. Corporate Index securities also contribute to the multi-currency Global Aggregate Index.

The Barclays Mortgage-Backed Securities Index is a measurement of the movement of the 15- and 30-year fixed rate securities backed by mortgage pools of the Government National Mortgage Association (GNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal National Mortgage Association (FNMA). All returns are market value-weighted inclusive of accrued interest.

The S&P MidCap 400 Index, more commonly known as the S&P 400, is a stock market index that serves as a barometer for the U.S. mid-cap equities sector and is the most widely followed mid-cap index in existence. To be included in the index, a stock must have a total market capitalization that ranges from roughly $750 million to $3.3 billion.

The S&P 600 Index is a capitalization-weighted index that represents the U.S. small capitalization market, including companies with a market cap in the range of $300 million to $2 billion. This index consists of 600 domestic stocks chosen for market size, liquidity, and industry representation. The S&P index committee uses the 50th and 83rd percentile of market value of all U.S. companies as a general guideline to identify small cap. None of the companies in the S&P Small Cap overlap with those in the S&P 500 nor the S&P Mid Cap 400.

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.