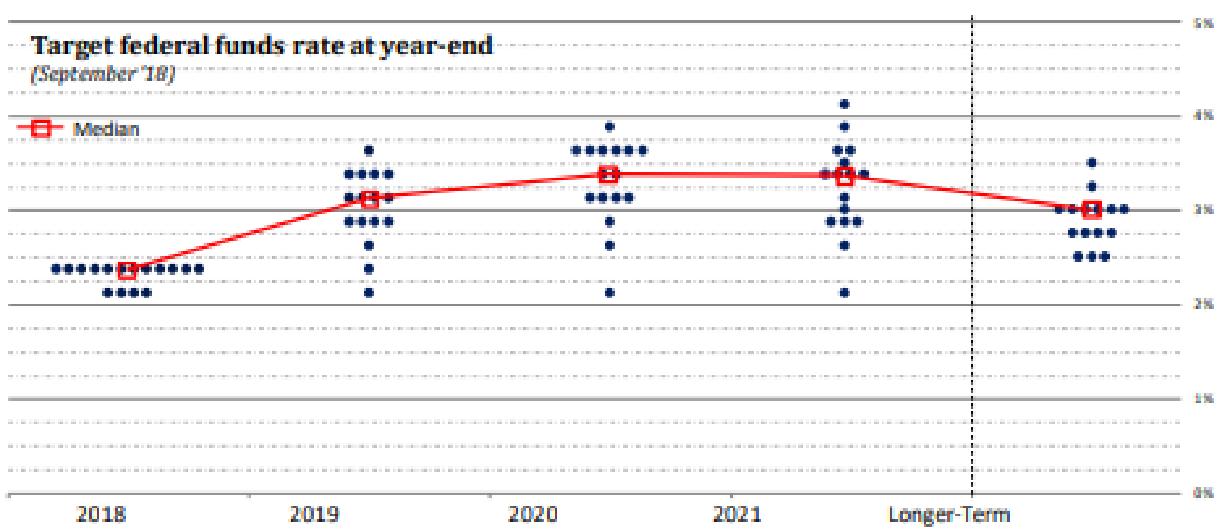
Three Triggers for the Recent Market Selloff

We believe the recent weakness in financial markets was triggered by an upward shift in three variables – U.S. interest rates, geopolitical tension with China, and Italian bond yields. We believe these developments are material enough to warrant a response through active adjustments to some of our investment strategies. However, we do not expect a lasting downturn for the economy, or the financial markets at this time. Clients can expect to hear more from us in the coming days and weeks as we explain specific actions through Research Notes.

Issue #1: Interest Rates

The table below was released by the Federal Open Market Committee (FOMC) after its September policy meeting. It reflects the collective view of the committee regarding the future path of short-term interest rates. The consensus view of "Neutral" – i.e. the interest rate level the Fed expects to settle into over the long-run – is 3.0%. It is noteworthy that seven participants believe Neutral is lower than 3.0%, while only two believe it might be higher (dot cluster on the far right of the graph).

Federal Reserve "Dot Plot"
Each Dot Represents the Most Recent Forecast for the Fed Funds Rate
For a Single Member of the Committee



Source: FTN, Bloomberg; Federal Reserve Board of Governors

The FOMC currently anticipates hiking interest rates above neutral for a year or two (dot clusters in the middle of the graph), before settling back toward the lower target of 3.0%. The consensus view of this temporarily restrictive policy rate is 3.5%. Here again, several participants believe the peak rate should be lower than 3.5%.

It is normal for the yield curve to flatten, or invert[1] during the tail end of an interest rate cycle. If the current cycle ends with a peak Fed Funds rate of 3.5%, as the Fed currently projects, it would be normal from a historical perspective for the 10-year Treasury yield to also peak around 3.5%. The current yield on the 10-year Treasury is 3.2%...not too far from 3.5%, to state the obvious.

Low and stable inflation and historically low interest rates throughout most of the developed world support an expectation that long-term interest rates need not rise substantially as the Fed continues its tightening cycle. Risks to this outlook include the possibility for a quicker pace of inflation, or a rise in "real yields" – i.e. the spread between nominal interest rates and inflation. Real yields are currently well below historical norms, implying room for yields to rise even if inflation remains stable. Neither of these risks is part of our baseline forecast, however, because we believe there are structural forces keeping inflation in check, while global interest rates anchored near zero are expected to act like gravity on U.S. rates for the foreseeable future.

It is also worth noting that U.S. interest rates have been rising for a very good reason…the economy is strong. Stocks have performed well historically when rising interest rates reflect a healthy economy.

Issue #2: China

Rising interest rates captured the headlines in the financial press last week, but developments in China might have been more important to the markets. Early in the week China announced changes to its cyber security policies that allow the state even greater access to the proprietary information of private companies. Later in the week *Bloomberg Businessweek* reported a scheme in which China allegedly planted tiny spy chips on computer motherboards that made their way into servers bound for computer networks throughout the world. It is important to note that China has denied the allegation, while alleged targets of the abuse, including Apple and Amazon.com, have reported no evidence of the scheme following extensive testing.

These developments followed shortly after finger-pointing from the White House regarding Chinese efforts to interfere in U.S. elections, a confrontational speech from vice president, Mike Pence, and a near collision between a U.S. Navy destroyer and a Chinese warship making aggressive maneuvers.[2]

Suffice it to say that many investors are probably assigning a higher probability for an economic "cold war" of indefinite duration between the U.S. and China. Moreover, it seems reasonable to expect many Western and Japanese technology companies might rethink China's presence within their supply chains, even if the story about secret spy chips turns out to be false. The potential disruption to the prevailing global supply chain could be material.

For a hint of how an economic cold war might impact the stock market, strategists at *JP Morgan* recently estimated that a 25% tariff on all Chinese imports to the U.S. would trim earnings for the *S&P 500 Index* by $8 per share, a haircut of roughly 5% from their baseline earnings estimate of $179 for next year.[3] While a 5% reduction in corporate earnings should not be too difficult for the stock market to absorb, it would mark an important directional shift after nearly two years of *upward* revisions to corporate earnings forecasts dating back to the fourth quarter of 2016.

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[1] A "flat" yield curve describes an interest rate environment where short term rates are approximately equal to longer term interest rates. An "inverted" yield curve means short term rates are higher than long term rates.

[2] Source: Barron's

[3] Source: Barron's; JP Morgan

Issue #3: Italy

We make brief mention of Italy to acknowledge its likely contribution to the recent volatility in global asset markets. Italian bond yields have been rising, and shares of Italian banks have been sinking in response to tensions between the nation's anti-establishment government and the European Union (EU). The recently proposed budget for Italy violates deficit limits for member countries in the EU. The geopolitical standoff at hand has potentially destabilizing implications for Italy and the EU. So far, this risk has expressed itself most clearly in the Italian bond market. Investors are watching carefully for hints of contagion.

Investment Implications – Fixed Income

We do not expect anyone to be happy with negative returns in their *Fixed Income* strategies year-to-date, but we are not concerned about the outlook for fixed income going forward, in part because we do not believe interest rates have too much further to go on the upside for the reasons cited above. Moreover, it is helpful to remember the role that bonds play in a diversified portfolio. Fixed Income seeks to provide a *stable* stream of cash flows and predictable principal value when bonds are held to maturity. As we have shown before, the beginning yield of a laddered bond portfolio indicates its expected return over the ensuing 4-6 years.

Barclays Aggregate Bond Index
Starting Yield vs. Subsequent 5-Year Return
Dec. 31, 1990 to October 5, 2018

Start Date	Beginning Yield	Subsequent 5-Yr. Return
12-31-90	8.52%	9.48%
12-31-95	6.01	6.46
12-31-00	6.43	5.87
12-31-05	5.08	5.80
12-31-10	2.97	3.25
12-31-15	2.71	1.29 (2.75 Years to 10-5-18)
10-05-18	3.60	??

Source: Barclays, Bloomberg

It is not possible to invest directly in the index

As the table above suggests, investors can finally expect a reasonable return around 3.6% from the "safe" assets in their portfolio. This is cause for celebration, not consternation.

If an expected return around 3.6% feels insufficient, remember the second reason to own bonds: stability of principal. Conservative bond strategies do not have a down-25% branch on their probability tree. We don't expect the risks cited above to trigger a sharp decline in the stock market, be we can't be certain. Fixed income can provide important ballast to a portfolio whenever risk markets turn downward.

Dividend Stocks

The *Managed Equity Dividend* strategy has also been frustrating this year for the same reason as fixed income – rising interest rates. Here again, it helps to remember the role this strategy plays in a diversified portfolio. The strategy seeks to deliver a growing stream of cash flows from the equity asset class. The price investors must pay for this growing source of income is volatility of principal. Dividend stocks fluctuate.

We are not overly concerned about the recent flattish performance of the strategy because we are confident in our ability to deliver on its long-term objective to provide a growing stream of cash flow from dividends. Since the inception of the strategy in January, 2012 the compound annual growth rate in the annual dividend stream has been approximately 5.6%.[4] Over this time period the current yield of the portfolio has hovered between 4.5% and 5.2%. We expect the long-term performance of the *Managed Equity Dividend* strategy can reflect a combination of the starting dividend yield and subsequent growth in the aggregate dividend, which adds up to 10% plus-or-minus over most market cycles. The actual experience of the strategy has been consistent with this expectation since its inception in 2012.

In the near-term we have tried to manage risk within the strategy by adding lower-yielding stocks with a higher growth element to the dividend stream. Examples include Cisco Systems, Coca-Cola, Colgate Palmolive, Intel, PBF Energy (prior to its recent sale), Pfizer and Valero Energy (prior to its recent sale). We expect these stocks to be less sensitive to rising interest rates compared to many higher yielding companies in industries like real estate and utilities.

Growth Stocks

The adjustments we plan to make in the *Managed Equity Growth* strategy reflect fundamental factors beyond interest rates. Specifically, we expect to reduce the strategy's exposure to the technology sector due to increasing legal/regulatory risk associated with data privacy in many countries, as well as the potential implications of an economic cold war with China for the tech sector.

Tactical Strategies

The Tactical Strategies have done a respectable job of navigating the global asset markets in 2018. *Tactical Dynamic* exited the international equity markets earlier this year, sidestepping some of the weakness in non-U.S. equities thus far in 2018. The *Tactical Global* strategies have been reducing their allocation international equities as well, although these strategies never exit an asset class entirely. Looking forward, we would expect the remaining risk market exposure within *Tactical Dynamic* to exit the portfolio in relatively short order if the U.S. stock market continues lower from here.

International Focus

The *International Focus* strategy is designed to remain committed to multiple sub-sectors of the international equity markets. We are currently exploring options to reduce the risk profile of the strategy through changes to its position in emerging markets.

[4] Source: Internal records maintained on the portfolio accounting system, *Orion*.

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