CAPITAL ADVISORS

Overview

January 2019

Key Points

- Despite the recent volatility in the asset markets, we are reasonably optimistic about 2019 for both the equity and fixed income markets.
- Earnings drive stock prices, and earnings estimates have been drifting lower since the fall.
- We believe an "earnings recession[1]" is possible in 2019, but we do *not* expect an economic recession.
- Historically, the stock market has been far more resilient to earnings recessions vs. economic recessions.
- We should learn a lot about the health of corporate profits over the next 4-5 weeks as companies report their fourth quarter earnings and discuss their outlook for 2019.
- There are a handful of variables capable of driving stocks higher, or lower in the near term, but we believe these issues are most likely to evolve without causing lasting damage to the stock market.
- Recent developments in the bond market and at the Federal Reserve support this optimism, but these signals can admittedly change quickly.
- Bond yields have risen materially over the past year, enabling a reasonably attractive potential return from the fixed income asset class, and a more appealing return profile for balanced investment portfolios more broadly.

Please see important disclosures at the end of this document.
Supplemental to a fully compliant presentation.

[1] An "earnings recession" refers to two or more quarters of negative year-over-year comparisons for the earnings per share of a broad market index like the S&P 500.

Sometimes Corporate Profits Drop without a Recession

Last summer when global trade frictions began to escalate we said the following:

> *To the extent that global trade restrictions continue to escalate, the disproportionate burden sharing between capital and labor suggests that America's most noteworthy vulnerability might be the consensus earnings estimate for the S&P 500 Index.*[2] *Increasing trade barriers can be expected to disrupt global supply chains in unpredictable ways that would probably do more harm to corporate profits than household incomes. This may pose a greater threat to the stock market than it does to the economy as a whole.*
>
> -Capital Advisors Overview, June 26, 2018

The scenario above expresses a distinction between an "earnings recession" and an economic recession. An earnings recession is characterized by two or more quarters of declining corporate profits. An economic recession is typically defined by two or more quarters of negative growth for the economy as a whole, as measured by gross domestic product, or GDP. Historically, economic recessions have always coincided with earnings recessions, but the reverse has not been true. Occasionally, corporate profits back-track without an economic recession.

The stock market has not reacted well to either situation in the past, but the damage has been far more palatable when the overall economy avoids a recession. Specifically, the average drawdown for the stock market during the 12 earnings recessions since 1955 has been approximately –24.3%. However, the average decline for the three instances that did not include an economic recession was just –10.1%. These occurred in 1967, 1985 and 2015.[3]

We suspect the stock market's more favorable reaction to isolated earnings recessions might be explained by investors' willingness to assume the stumble might be temporary. Applying this logic to 2019, as long as the outlook for the overall economy remains fairly stable, whatever might cause earnings to stall in the near-term – the roll off of easy comparisons from the corporate tax cut; unexpected costs from trade-related supply disruptions; the sharp drop in the price of oil – might eventually be accepted by investors as a solvable challenge for companies to overcome.

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[2] The S&P 500 Index measures the price and yield performance of the leading companies in the U.S. stock market. The index is maintained by Standard & Poor's.

[3] Source: The source for all data quoted in this paragraph is Bloomberg and LPL Research.

Our Best Guess for 2019

We believe the U.S. stock market faces a potential earnings recession *at worst* in 2019,[4] but for reasons we have described in recent commentaries, we do not expect an economic recession for the foreseeable future. If we are correct, the recent drawdown in stocks may have mostly run its course in magnitude, if not duration. We caution that there are numerous risks that could cause stocks to re-visit their lows in the coming weeks, or even extend their losses a bit further. These risks include:

- Potential for disappointing corporate profits over the next 4-5 weeks
- Possible set-backs in the U.S.-China trade negotiations
- Hawkish signals from the Federal Reserve (Fed)
- Negative surprises from China or the euro zone

However, even if one or more of these risk factors extends the duration of the recent stock market disruption, we suspect stocks can eventually emerge from the turmoil having suffered a peak-to-trough decline not too far from the lows we already experienced on Christmas Eve. Moreover, these same risk factors might be the catalyst for a *positive* move in the stock market should any of them be resolved favorably throughout the year.

More broadly, it seems worth remembering that stocks are not the only asset class. For balanced portfolios the allocation to fixed income should provide ballast in 2019 without sacrificing a reasonable rate of return, adjusted for risk. We expect greater stability in the fixed income markets in 2019 relative to last year, which should allow today's portfolio yields to offer a reasonable forecast of expected returns for the year. As of today this implies 3.0% to 4.0% for investment grade taxable bonds within the short-to-intermediate maturity range (short-term portfolios currently offer yields closer to 3.0%...longer-term maturities offer ~4.0%).

Reassurance from the Bond Market and the Fed

Two recent developments help to reinforce our hopeful outlook. First, credit spreads in the bond market reversed course in early January after several months of widening. Here we refer to the difference in yield, or "spread," between sub-investment grade corporate bonds and U.S. Treasuries. When credit spreads become excessively wide it can be a signal of stress in the economy. The recent narrowing of spreads has returned this indicator to the comfort zone, for now.

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[4] In the month of December alone analysts cut their earnings forecasts for 2019 on more than half the companies in the *S&P 500 Index* (Source: FactSet). Following these cuts the estimated growth rate for the index as a whole dropped to 7.8% in 2019. As recently as September the estimated earnings growth rate for 2019 was 10.1%, while earnings are expected to have grown approximately 22% in 2018 on the heels of a strong economy and a materially lower tax rate (Source: Bloomberg; FactSet).

The second material development, in our view, was a panel discussion with Fed Chair, Jerome Powell, on January 4th, where the chairman seemed to signal a pause in the Fed's plans for raising interest rates in 2019. Forward guidance from the Fed has become increasingly confusing in recent months, so we cannot rule out a negative surprise from the Fed in the near future. For the moment, however, Powell's tilt toward caution on monetary policy provides support for our no-recession forecast.

Current Design of Our Investment Strategies[5]

The remainder of this report addresses the current positioning of each of our investment strategies. To the extent possible within the structure of each strategy, we have positioned these portfolios for the following broad perspectives:

1) Many risks remain unresolved, but our base case outlook assumes the bulk of the downside from the recent stock market pull-back has already been achieved (although we might re-visit the lows again before a lasting recovery takes hold).
2) We believe the bulk of the adjustment toward higher interest rates has occurred for now, although the Fed might raise rates another 1-2 times if the economy continues to perform well throughout 2019.
3) Principal areas we are watching closely for negative surprises include interest rates, trade policy, and the behavior of international markets, particularly China.

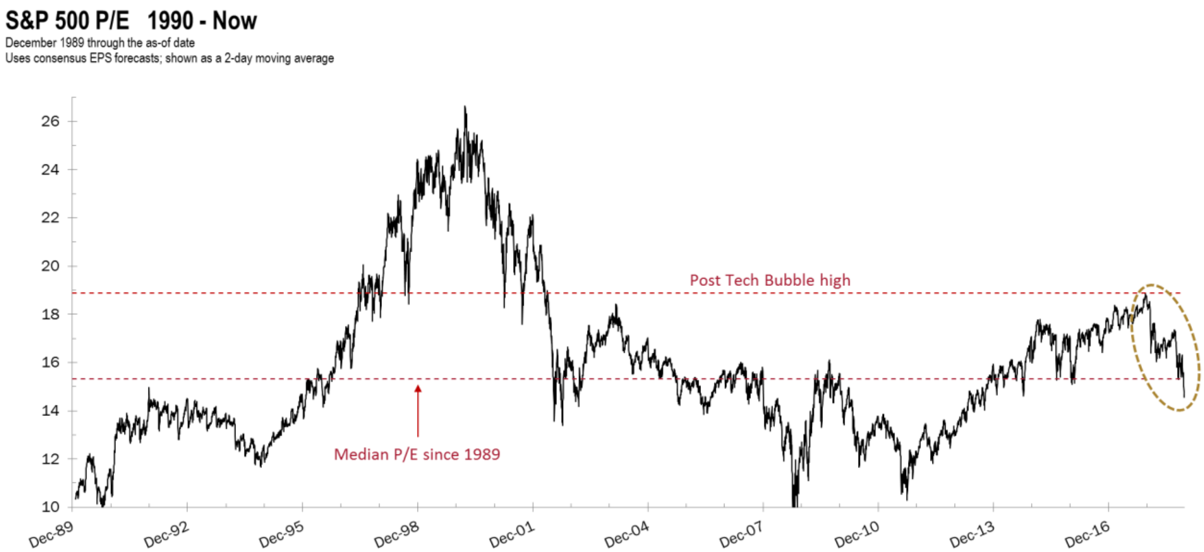
Managed Equity Strategies - Looking for opportunity in volatility

This quarter, we highlight four items we believe are particularly timely: Volatility, Valuation, Cash Flow and Innovation.

Valuation

Tighter monetary policies and economic slowdown worries caused significant equity volatility last quarter. Investors pushed the S&P 500 price-to-earnings ratio (P/E) to approximately 14x late in December, its lowest level since 2013[6]. At this writing, the PE stood just below 15x, still below the median since the Berlin Wall came down in 1989/90.

[5] The portfolio strategy discussions in this section are supplemental to a compliant presentation. A complete list of Capital Advisors' portfolio models and compliant presentations are available by contacting Capital Advisors.
[6] Source: Bloomberg



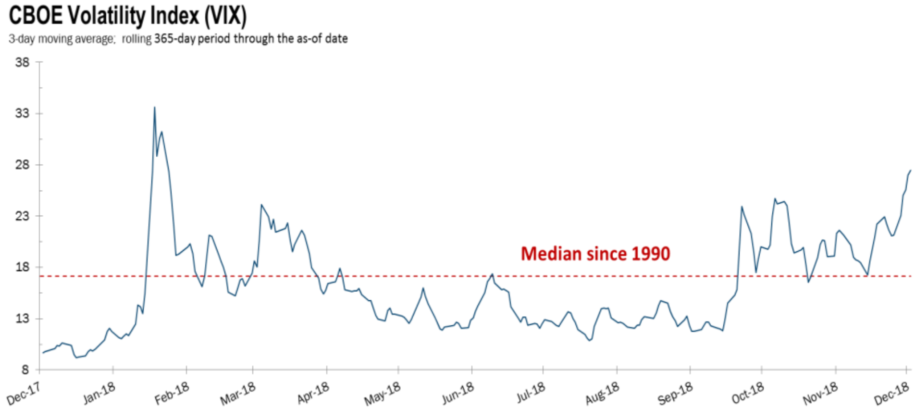
Source: Bloomberg **It is not possible to invest directly in the index**

We use the Berlin Wall event as a benchmark since it keyed the opening of global markets, began the low-cost global supply chain, and coincided with the proliferation of the internet. These things have helped companies reduce costs, and in many cases, enabled them to increase sales.

A low P/E does not necessarily mean a stock is inexpensive. "Garbage in / garbage out" – if the earnings expectation (E) is too high, the stock price (P) may be exactly where it should be. That certainly may be the case with some companies – earnings expectations may have simply risen too high. However, companies that have strong management teams, business models and other sustainable competitive advantages could be less likely to have significant or lasting earnings shortfalls – and be more likely to have sustainable earnings growth. Given our outlook that an economic recession is unlikely, we believe opportunities may arise in the midst of volatility, as some stocks overshoot to the downside.

Volatility

Within our managed equity strategies we have tried to exploit recent volatility to opportunistically increase allocations to companies that we feel have the recipe above – including strong management, healthy balance sheets, stable cash flows and defensible competitive advantages. **PayPal (PYPL: ~$89)** and **Inuit (INTU: ~$202)** are Growth Strategy examples. **Lockheed Martin (LMT: $264)** and **Leggett & Platt (LEG: $38)** are similar in the Dividend Strategy. We are also looking outside our current holdings to identify companies we may have avoided in the past due to excessive valuation.

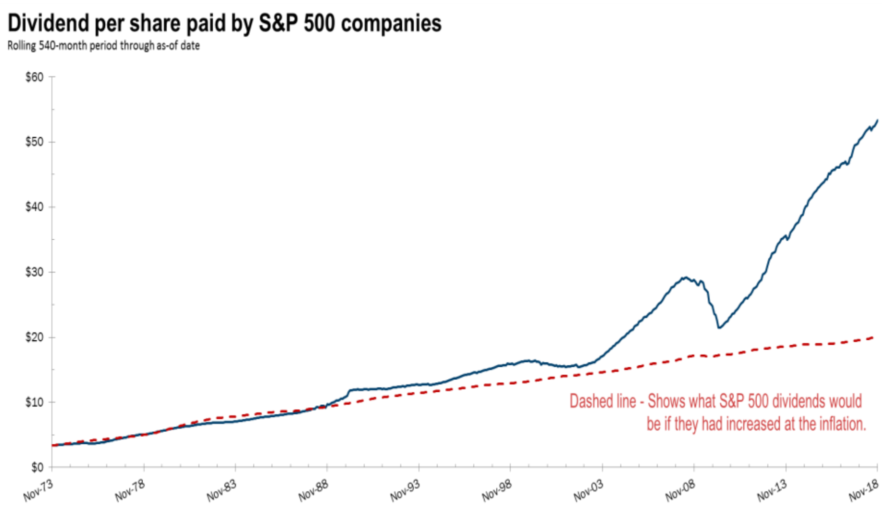


Global financial markets are adjusting from Quantitative Easing (QE), fiscal tightening and high regulation to Quantitative Tightening (QT), fiscal stimulus and de-regulation. We would expect this process to introduce sustained volatility levels higher than the near-record-lows achieved since the 2007/2008 Financial Crisis.

Source: Bloomberg **It is not possible to invest directly in the index**

Cash Flow

We have spoken to Volatility and Valuation – now a tidbit on Cash Flow. Dividend growth remains strong in corporate America. Since at least 2003, corporate dividends have been increasing well in excess of inflation. This is in addition to increased share repurchases. As supply chains have become significantly more cost efficient, and digitization has helped further increase corporate returns, companies have improved their cash flows. Former growth companies that became cash rich as they matured now find themselves sharing the wealth more directly with shareholders through dividends and share repurchases. The Technology sector includes prime examples of this dynamic.



S&P 500 dividends have increased at a faster pace than inflation. Corporate sales tend to rise during periods of inflation and higher interest rates, as companies raise prices and rents. There can be a lag, however, between rapid interest rate increases and management's ability to further raise dividends.

Source: Bloomberg **It is not possible to invest directly in the index**

At the same time that corporate profit margins have increased and interest rates have remained very low, companies have increased their borrowing substantially over the past decade. Corporate debt is now a record 46% of GDP[7]. If interest rates rise materially, companies will need to service or replace this debt at higher costs.

In this environment we believe it makes sense to elevate the importance of balance sheet strength when identifying potential investment opportunities in the stock market. We have been "overweighting" this fundamental factor in recent weeks as we adjust the Managed Equity portfolios to take advantage of opportunities created by market volatility.

Innovation

We believe innovation is at the heart of value creation in the stock market. Following is a brief outline of several innovations we believe may hold promise as a source of investment opportunity. While our equity strategies have dedicated exposure to each of these themes, we hope to continue strengthening this exposure, and when necessary, adapt it to the ever-changing industry developments that are customary of innovative sectors.

Artificial Intelligence: Data analytics, self-driving cars, robotics, intelligent homes, smart utility grids. This is a broad category with potential opportunities among the providers of AI technologies, and the beneficiaries of AI adoption.

Cloud Services: This involves global businesses shifting their technology operations to the cloud to save money and gain capabilities. For instance, technology is not Wal-Mart's core competency, retailing is. As data gathering and analytics becomes an ever-larger portion of what nearly every business does, we believe cloud (internet) services could post healthy growth rates over the foreseeable future.

Robotics: A rapidly evolving market with the potential to have significant near-term impacts on the Industrial, Medical and Consumer sectors. At present, we view Medical as the highest-value segment.

Biotechnology: We believe emerging technologies like immune-therapy, CAR-T, gene therapy and gene editing have the potential to unleash a wave of medical innovation in the field of biotechnology over the next 5-10 years. The potential for new medications to make a significant difference in formerly incurable diseases, including cancer, seems plausible over the next several years as exciting programs in various stages of clinical development advance through the FDA approval process.

[7] Source: Bloomberg

E-Payments: Adds simplicity, efficiency and security to everyday transactions. Enables new business models, particularly those based on mobile transactions, or other online payments.

Emerging Market Consumer: In Asia alone, approximately 525 million people are already in the middle class - more than the European Union's total population. Over the next two decades the middle class could expand by another three billion, coming almost exclusively from the emerging world[8].

New Retail: We expect technology to continue reshaping the retail shopping experience in stores as well as online.

Social Change: Two-income families, demand for higher education and retraining, and productivity initiatives for younger workers are examples within our current portfolio companies.

Fixed Income

Our Fixed Income strategies are customized according to three broad priorities – Liquidity, Income or an Aggregate of the two. A Liquidity portfolio invests exclusively in high credit quality securities and short-term maturities to ensure stability of principal and ready access to capital. An Income portfolio extends further out on the yield curve and includes a broader range of credit quality to generate a higher level of income. The Aggregate approach incorporates elements of both designs for a "core" exposure to the fixed income asset class.

The Fed has increased its borrowing rate from ~1.0% in mid-2017 to ~2.5% today. At this point, we believe they are very close to, or are already done with their current tightening program, and we expect the Fed to remain on the sidelines for the foreseeable future. By structuring bond portfolios in a "ladder" with maturities typically contained within the 1-to-10-year range, the cost of being wrong should be minimal unless rates rise much further and faster than we currently expect. Conversely, if rates stay lower for longer as we currently expect, we can be thankful for the extra income provided by the longer bonds in the portfolios.

Looking forward, we believe capital allocated to the fixed income market can once again earn a respectable cash flow after nearly a decade of paltry yields anchored to zero. Consider that the yield-to-maturity for the *Barclays U.S. Intermediate Credit Bond Index* recently hit 3.74%, while the tax equivalent yield to maturity for the *Barclays Municipal Bond 10-Year Index* reached 4.19%[9] (for investors in the top income tax bracket).

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[8] Ernst & Young, "Middle class growth in emerging markets: Hitting The Sweet Spot," April 23, 2015

[9] Source: Bloomberg; Barclays; The Barclays U.S. Intermediate Credit Bond Index measures the yield and return of a diversified basket of investment grade corporate bonds with maturities in the 1 to 10 year range; The Barclays Municipal Bond 10-Year Index measures the yield and return of a diversified basket of investment grade municipal bonds with an average maturity of 10 years.

This is significant because the starting yield for a laddered bond portfolio (like the indexes above) accounts for the vast majority of its expected return over the subsequent 4-6 years. This happens because the staggered maturity schedule of a bond "ladder" creates periodic liquidity events that allow the portfolio to adjust to changing market conditions. If interest rates rise the ability to reinvest bond maturities into a higher rate environment helps to offset the negative price change among the longer term bonds in the ladder (over time….not month-to-month). When interest rates trend lower, price gains at the long end of the ladder serve to offset the lower reinvestment rate from maturing bonds.

The table below illustrates the resilience of "bond math" for laddered portfolio structures. Note how the starting yield of the index correlates with its subsequent 5-year total return. This dynamic held true regardless of the subsequent path of interest rates over each 5-year measurement period:

Barclays Aggregate Bond Index
Starting Yield vs. Subsequent 5-Year Return
Dec. 31, 1990 to Dec. 31, 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	2.05	(3.0 Years to 12-31-18)
12-31-18	3.28	??	

Source: Barclays, Bloomberg

It is not possible to invest directly in the index

We seek to enhance the benefit of the laddered portfolio structure with active management. By deliberately emphasizing certain maturities, and diversifying across different sub-sectors and credit profiles, we hope to optimize the risk and return profile of our fixed income strategies.

Tactical Dynamic Allocation

The *Tactical Dynamic Allocation* strategy is designed to be highly responsive to changing market conditions. By systematically responding to a quantitative indicator called a "moving average," this strategy is likely to be mostly exposed to risk assets when the recent trend in these markets has been positive, and mostly out when the recent trend has been negative.

This strategy was very helpful in 2018 due to several timely shifts out of risk markets throughout the year, resulting in a *much* shallower drawdown during the fourth quarter compared to benchmarks like the *S&P 500 Index* or the *MSCI World Index*[10]. As of year-end this strategy held just 10% of its assets in risk markets – domestic equities – with the remainder in short-term fixed income and cash reserves.

The chart below reflects the current position of one of the five risk markets within the strategy – emerging markets – to demonstrate the investment process. The index for emerging markets (white line) traded well above its moving average trend line (green) early in the year before crossing below the moving average in late-April. At each monthly review for this sector, when the current price of the index is higher than its moving average, the ETF for that index stays in the portfolio for another month. When the current price drops below the moving average as of a monthly review date, the ETF is sold and replaced with cash reserves and an ETF for investment-grade fixed income. The emerging markets ETF was sold from the strategy model in May as a result of this discipline.

MSCI Emerging Markets Index
Daily Closing Price (white) vs. 150-Day Moving Average (green)
Jan. 9, 2018 to Jan. 9, 2019

Source: Bloomberg **It is not possible to invest directly in an index**

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[10] The S&P 500 Index measures the price and yield performance of the leading companies in the U.S. stock market. The index is maintained by Standard & Poor's. The MSCI World Index measures the price and yield performance of stocks throughout the world, including the U.S. market.

As we enter the New Year the moving average trend line for emerging markets has drifted lower, while the current price of the ETF seems to be stabilizing. At this point the emerging markets ETF needs to rise approximately 3.5% to cross back above its moving average (far right side of the graph), thereby triggering a return to the portfolio.

The other four risk markets are in a similar state today, with an advance of anywhere between 4.5% and 9.5% needed to trigger a return to the portfolio.[11] Due to the staggered timing of each portfolio review – approximately one-quarter of the portfolio each week – and the variability of each sector's crossover point, we would expect this strategy to become incrementally more aggressive in stages if/when asset markets recover throughout the year.

International Focus

The *International Focus* strategy delivers broad exposure to the global equity markets outside the United States. The strategy seeks to capture a return premium relative to common international equity benchmarks through disciplined exposure to three market factors that have demonstrated a long-term history of producing attractive risk-reward characteristics – value, momentum and low market capitalization.

The portfolio model is strategically diversified across four ETFs that provide exposure to international stocks and emerging markets. One of the four ETFs uses a quantitative discipline to overweight securities that exhibit characteristics of value such as low price-to-book, low price-to-earnings or low price-to-sales. One ETF applies a quantitative process to overweight securities that demonstrate recent price momentum. The other two ETFs focus on emerging markets and small-cap companies, respectively.

This strategy was not been immune to the weakness in international markets in 2018. Exposure to value stocks and emerging markets was particularly challenging for the strategy last year as these two subsectors of the international equity universe suffered disproportionately during the year. While frustrating, this is a good time to remember that the rewarding long-term track record for both of these asset markets includes numerous periods of similarly poor results. We suspect the current setback may prove equally irrelevant to the long-term success of international equity markets, *particularly* the value and emerging market subsectors that performed so poorly in 2018.

As of this writing the international equity markets in general, and this strategy in particular, have started the New Year off well.

[11] Source: Bloomberg

Tactical Global Strategies

The *Tactical Global* strategies participate in the long-term growth of the world equity markets, including the U.S market. Both strategies spread investments among 10 broad sectors of the global asset markets using ETFs for each market sector. A discipline of systematically tilting the sector weightings toward relative strength incorporates a momentum effect into the portfolios. These strategies can serve as a core position for investors seeking global diversification within the equity portion of their portfolio.

We have nearly completed the process of consolidating the *Tactical Global Growth* and *Tactical Global Income* strategies into a single approach by top-grading the ETFs for each market sector into the best option from each portfolio. The end result will be a single strategy with a lower underling expense ratio among the 10 ETFs in the portfolio, and greater trading liquidity.

We have been sensitive to the trading activity this change entails, preferring to wait until a particular sector needs to trade anyway (due to its systematic over/under-weight discipline) before consolidating that sector into a common ETF for both strategies.

During the upcoming quarterly holding period these strategies will include over-weight positions in the domestic large-cap growth, large-cap value, and small-cap sectors, while international equities, emerging markets and international small-cap will be under-weighted.

January 10, 2019

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The **MSCI Emerging Markets Index** seeks to track the price and yield performance of emerging market equities, as determined by MSCI. The index is calculated on a total return basis with dividends reinvested and is not assessed a management fee.
The **Barclays U.S. Intermediate Credit Bond Index** measures the yield and return of a diversified basket of investment grade corporate bonds with maturities in the 1 to 10 year range.
The **Barclays Municipal Bond 10-Year** Index measures the yield and return of a diversified basket of investment grade municipal bonds with an average maturity of 10 years.
The **Barclays Aggregate Bond Index** is a broad base index, maintained by Barclays Capital, which took over the index business of the now defunct Lehman Brothers, and is often used to represent investment grade bonds being traded in United States.
The **Consumer Price Index (CPI)** is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them.

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The information provided is supplemental to a fully compliant presentation. A complete list of Capital Advisor's portfolio models and compliant presentations are available by contacting Capital Advisors at the number listed below. The actual return and value of an account fluctuate and, at any time, the account may be worth more or less than the amount invested.

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