



MARKET PERSPECTIVES

► QUARTER THREE 2018



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For the third quarter, the S&P 500 had its best quarterly performance in five years as U.S. equities continued their run of dominance over nearly all other countries and regions. Robust economic and profit growth were able to outweigh fears over an escalation in global trade tensions. The Federal Reserve hiked rates for the third time this year, which,

along with the strong economy, pushed interest rates higher. The 10-year U.S. Treasury rose from 2.86% to 3.06%, pressuring returns from government bonds (bond prices move inversely with yields). Corporate bonds, on the other hand, finished the quarter with slightly positive returns as spreads, the incremental yield on corporates relative to Treasuries, narrowed.

Markets outside the U.S. were not as buoyant as trade tensions and the rising dollar pressured countries with current account deficits and material amounts of U.S. dollar-denominated debt. Trade friction between the U.S. and China reduced investors'

appetite for risk, sending emerging market equities lower for the quarter. Developed international equities performed relatively better, albeit not as strongly as U.S. stocks.

In an interesting development, on the final day of September, Standard and Poor's made substantial changes to its global sector classifications for stocks. The Telecommunications sector, which was down to just three stocks (Verizon, AT&T, and CenturyLink) and comprised less than 3% of the S&P 500 index, was replaced with a new Communications Services sector. The new sector will incorporate the original stocks from the former Telecommunications sector along with certain industries that formerly were classified as Technology (internet software & services and home entertainment software) and Consumer Discretionary (advertising, broadcasting, cable & satellite, movies & entertainment, publishing, and internet & direct marketing retail). This sector has a roughly 10% weight in the S&P 500. Key names moving into the sector include Alphabet (parent of Google), Facebook, Netflix, and Disney. The Technology sector will see its weight decline from 26% to 21%, while the Consumer Discretionary sector moves from about 13% to 10%. We do not expect any material changes to client portfolios as a result of these modifications.

U.S. Midterm Elections

Many voters find the current political environment distasteful; yet they are sometimes unable to divert their attention. The spectacle will shift into high gear in the coming weeks as we approach the mid-term elections. The Republican Party currently controls the White House and has a majority in both chambers of Congress.

Single-party control is at risk from the impending elections. Current polling tends to project that the Republican Party will retain its majority in the Senate while the Democratic Party will gain control of the House of Representatives. Polls, however, have had their reliability challenged in the past few elections. As usual, voter turnout will be the most important deciding factor. As such, politicians have been focusing on partisan issues in an attempt to energize their bases.

Looking first at the Senate, Democrats are defending 26 seats while Republicans have only nine seats in play. Experts believe that Democrats are likely to hold 21 of their current 26 seats and Republicans five of nine. That leaves nine seats considered to be highly contested. With the Republican Party holding a two-seat advantage, the pathway to a Democrat-controlled Senate is challenging, needing to win six of these nine highly contested seats.

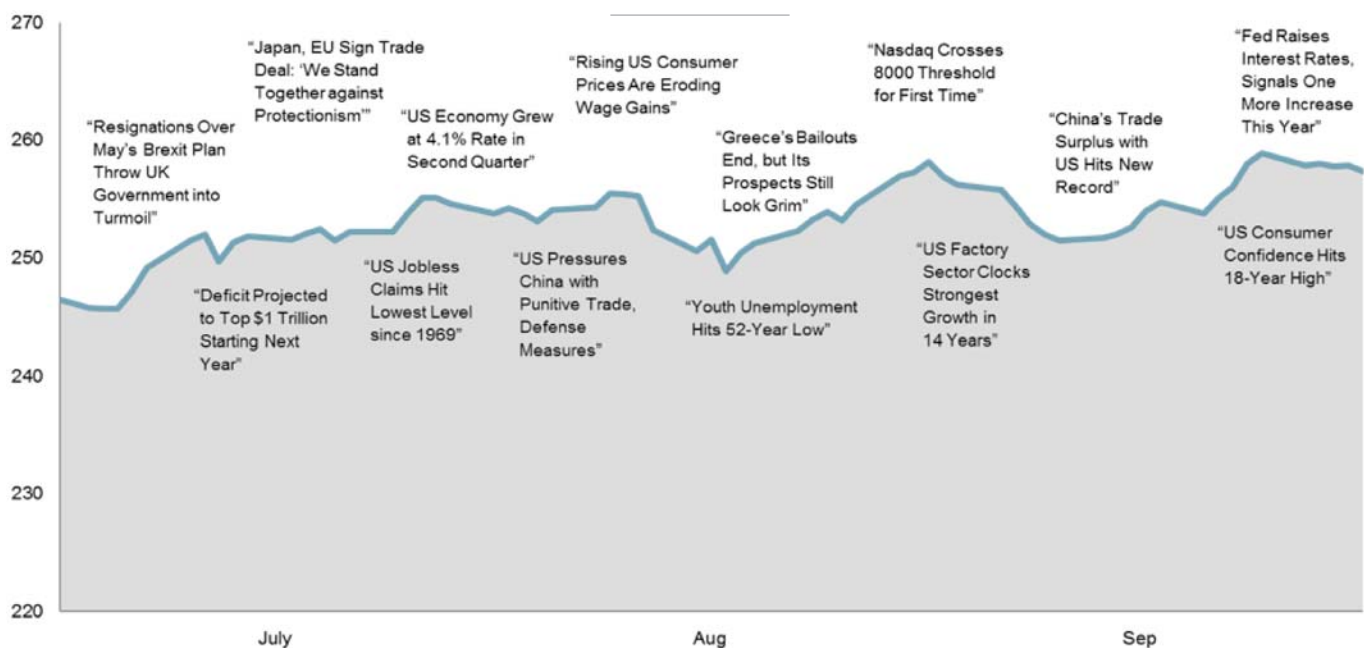
The House, on the other hand, is more likely to flip. There are several variables supporting this forecast. First, dating back to 1950, the president's party has lost, on average, 24 seats during the midterm

elections, with a higher probability of losses when the president's approval rating is below 50% (as it generally is now). Also, the Republican Party is dealing with an abnormally high number of retiring representatives. There are 42 Republicans leaving the House, well above the average of 22 per cycle as reported by Roll Call, compared with only 21 Democrats. This is important since, as noted by BCA Research, "Incumbency has a powerful effect in congressional races. On average, incumbents easily win over 90% of their races for the House."¹ The Democrats need to pick up 23 seats to gain a majority. The Cook Political report estimates that there are 66 Republican seats considered to be in play, up from 38 in January, compared with only five for the Democrats. With nine Republican-held seats currently leaning Democrat in the polls, Democrats would need to win only 12 of these 40 contested races to gain control of the House.

Most believe that Congress will become divided, with the Democrats winning the House and the Republicans retaining the Senate. Historically, the combination of a Republican president and divided Congress has generated double-digit returns, according to data collected by Strategas, slightly higher than the average of all periods. The probability of a "blue wave," where the Democrats win both chambers of Congress, is not trivial. Either way, we are likely to see more gridlock in Washington, perhaps restraining President Trump's legislative agenda.

¹ Papic and Shtrevensky, "A Story Told Through Charts: The U.S. Midterm Election," BCA Research Geopolitical Strategy, September 19, 2018, p. 10

MSCI ALL COUNTRY WORLD INDEX FOR Q3 2018



These headlines are not offered to explain marketplace returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: Dimensional Fund Advisors. MSCIACWI Index [net div.]. MSCI data © MSCI 2018, all rights reserved.

It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results.

WHAT THIS MEANS

Whereas the midterms may dominate the headlines leading up to the November 6th elections, and market volatility might become elevated as a result, their impact on the investment markets may be lower than most expect. The Democrats are unlikely to upset any of President Trump's major policy initiatives. We believe that, moving forward, economic and monetary inputs will continue to be the primary drivers of trading in risk assets.

Certainly, President Trump would be disappointed should his party lose both the House and Senate; however, it might not have much of an impact on his agenda. The Democrats are not expected to have a strong enough majority to overturn the Trump tax cuts. Moreover, the President is likely to continue to focus on trade and foreign policy, two areas that are less within the reach of Congress. His policy of "maximum pressure," largely directed at Iran, North Korea, and China thus far, should be reinvigorated once the election is behind us and the President no longer has to worry about the shorter-term

consequences of an adverse event. Lastly, President Trump will likely continue to roll back what some see as business-unfriendly regulations.

Another prospect we have seen discussed by the media and others is the possible impeachment and removal of President Trump from office. We believe the chances of this are remote. The Senate requires 67 votes to convict the President and remove him from power. It is nearly impossible for the Democrats to garner the necessary majority to do so without the help of Republicans. Republicans in Congress presumably would only join with Democrats if there were a total loss of confidence in the President among Republican voters, which would seem to require some dramatic new development.

We expect that the midterm elections will remain a focal point of the markets over the coming weeks. Yet, we do not believe they will meaningfully change monetary or economic policy, which are what matters most to the financial markets.

Divergence

Perhaps it is a reflection of the global political landscape, which is becoming increasingly polarized, but investment markets are diverging in ways not generally seen. Both across and within asset classes, correlations are deviating from generally-observed norms. Some of the more obvious digressions include a rise in U.S. short-term bond yields relative to the rest of the world, the performance of growth stocks versus value stocks, and returns from developed-market equities versus emerging-market equities. We believe that a return to past correlations is likely and are reminded of other periods when investors proclaimed that "this time is different."

Here in the U.S., the difference in performance among several equity asset categories has been striking. The prime example is the relative performance of growth stocks, which are the universe of companies that exhibit stronger than average growth and momentum, versus value stocks, or those companies that are trading inexpensively relative to intrinsic value. Indeed, BCA Research highlights that "Per the most commonly referenced growth and value indexes, growth has been outperforming value for over 11 years, the longest stretch in the history of the series."² This has caused widely varying performance among investments that focus on one or the other. We believe it is likely that this historically-wide discrepancy will close as monetary policy continues to tighten.

Another performance anomaly can be seen in the relative performance of domestic versus international equities. A recent article by the Financial Times explained, "The relative performance of the S&P 500 versus the rest of the world is now at its most extreme level since 1970."³ Bespoke Investment Group observed that the stronger performance from the MSCI U.S. index relative to the MSCI World ex-U.S. index has largely been driven by stronger earnings growth

from U.S. companies.

The disparity in relative earnings growth is mostly due to stronger U.S. economic growth relative to the rest of the world. U.S. policymakers were quicker to respond in the aftermath of the Great Financial Crisis by employing monetary and fiscal stimulus at a magnitude never before seen. Nine years removed from the crisis, the current administration is once again kindling growth through fiscal stimulus in the form of tax cuts and spending increases, a rare occurrence this late into the business cycle. Europe, on the other hand, prematurely raised interest rates in 2011 and continues to maintain strict fiscal austerity targets despite a sluggish and uneven recovery. There is hope, however, as some European countries are beginning to push back against fiscal austerity.

WHAT THIS MEANS

The economic environment over the last several years has been different, to say the least. Indeed, we cannot recall a period where the word "unprecedented" has been used so frequently. What has made it exceptional is the degree to which policymakers utilized unconventional policies, such as quantitative easing and fiscal stimulus, to such an extreme. This has served to distort investment markets.

By reducing interest rates to unprecedented (there's that word again) levels, policymakers pushed investors to take on more risk in order to generate the returns they required. Many of the anomalies highlighted above can be traced back to these unorthodox policies.

² McClellan and Peta, "It's Time to Buy Value Stocks," The Bank Credit Analyst, October 2018, p. 1

³ Smith and Wigglesworth, "Runaway US Stock Market Prompts Investors to Look Overseas," Financial Times (blog), September 25, 2018

As the Federal Reserve and other central banks begin to unwind these policies, we expect a return to historic correlations. This is not to say that we expect international to dramatically outperform domestic or value to dramatically outperform growth. Rather, the extreme performance divergence may narrow, and normally correlated assets classes might begin to trade as they have in the past. That would likely bode well for asset allocators moving forward.

Conclusion

It was another strong quarter for most asset classes; however, volatile trading following the close of the quarter reminds us to not be complacent. There are many risks that have investors worried, such as rising interest rates, trade tensions, slowing growth outside the U.S., and a more challenging policy environment. We are mindful of these risks and prepared to react if they become more severe. In the meantime, we are watching closely for signs of recession. Currently, very few of the indicators we watch are flashing red. This is important because nearly all bear markets were associated with a recession, and the few that were not were less severe than the others.

COLONY SPOTLIGHT

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Each year, Her Wealth awards a \$2,500 merit-scholarship to an undergraduate woman studying finance. The 2018 Her Wealth Scholarship winner was Elizabeth Friday, a senior at Virginia Polytechnic Institute and State University.

“We created the Her Wealth Scholarship to help advance women, like Elizabeth, in their academic pursuits and to provide a path for more careers for women in the financial services industry,” said Nina Mitchell, co-founder of Her Wealth; Principal, Senior Wealth Advisor; and Co-President, Colony Sports & Entertainment.



In photo: Elizabeth Friday with Her Wealth Scholarship Committee

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