

Economic & Market Review
~ THIRD QUARTER 2018 NEWSLETTER ~

EXECUTIVE SUMMARY

The U.S. stock market soared during the third quarter, the sole bright spot in the global investing markets. All other major asset classes were challenged as investors worried about trade tensions, geopolitics, rising U.S. interest rates and spiking oil prices. Although the current global economic environment is healthy, the outlook appears less favorable, causing investor concern. The U.S. dollar strengthened versus a basket of currencies, paring back returns from international investments.

Although U.S. stocks were broadly positive, a narrow group of stocks in the healthcare and telecommunications/media sectors drove the strong returns for the quarter. Growth stocks again outperformed value stocks and the dispersion between the two investment styles far wider than usual. Value strategies have been hampered by outsized exposure to interest rate sensitive sectors such as real estate and materials. Large capitalization companies returned to favor after underperforming versus smaller companies earlier in the year. Volatility was low amid a strong earnings season.

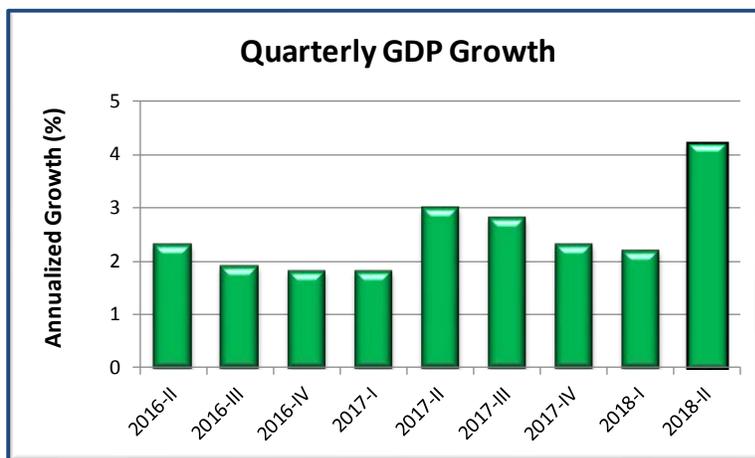
Developed international and emerging market stocks continued to struggle. Oil prices reached new highs, raising concerns for countries that are large energy importers. European markets were roiled by ongoing trade tensions, political instability, and renewed alarm over the health of the banking system. Corporate earnings have been improving in Europe and Japan and stock valuations are attractive.

Rising interest rates have been a headwind for the U.S. fixed income markets for much of the past year. In September the Federal Reserve raised rates for the third time this year and signaled additional hikes are to come if the economy stays on its current path. High yield and short-term bonds were the only sectors to generate positive returns. High yield bonds are less sensitive to interest rate changes because they provide a credit premium over high-quality bonds and tend to move more in tandem with the stock market. This premium is well below its long-term average and may not be enough to offset price declines if the credit environment deteriorates. Corporate debt is near a historical high which could lead to a rise in defaults and credit downgrades.

If history is a guide, U.S. stock market dominance is likely to falter at some point while international stocks are poised to rebound. High-quality fixed income can hold up during a stock market downturn and can therefore serve to stabilize portfolio performance. Diversifying investments such as alternative hedging and tactical strategies are intended to provide stability when both stocks and bonds are challenged. The divergence in the capital markets and the long list of risks that could cause market disruption makes this an opportune time for investors to review their asset allocation and investment goals to ensure they have a diversified portfolio with an appropriate mix of defensive and growth assets.

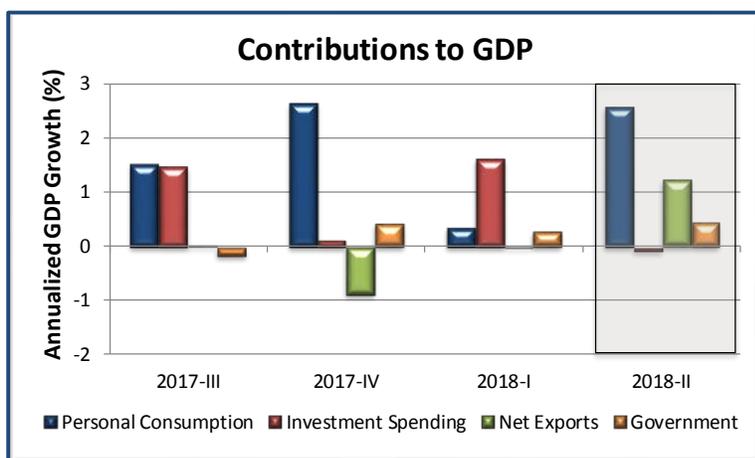
ECONOMIC REVIEW AND OUTLOOK

Key Economic Fundamentals



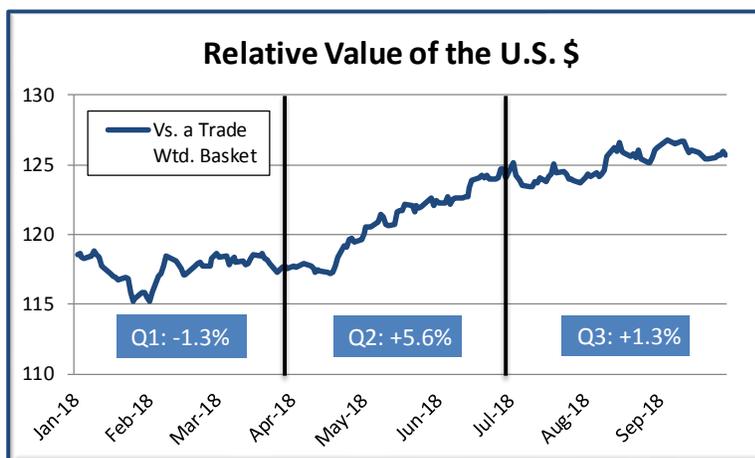
Data Source: U.S. Department of Commerce

U.S. economic growth came in at an annualized pace of 4.2% in the second quarter. As of this writing, the Atlanta Fed’s “GDPNow” estimate for third quarter growth is 4.1%. Interestingly, most economists predict Q3 GDP to be significantly lower, with most estimates ranging between 2.9% and 3.7%.



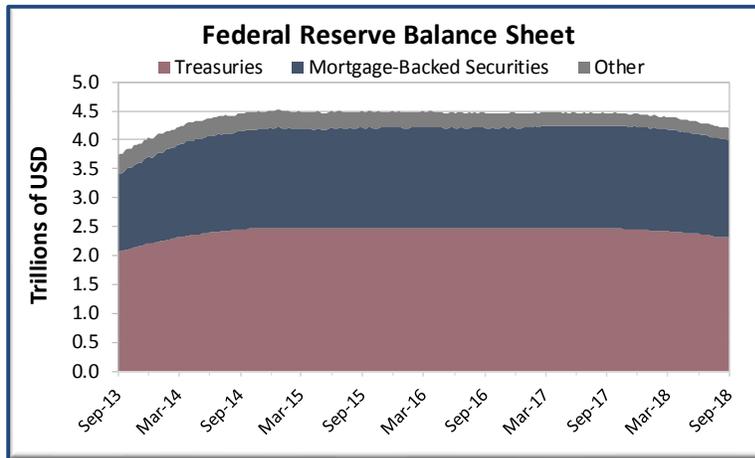
Data Source: U.S. Department of Commerce

Q2 growth was catapulted by an atypical source - net exports. Domestic businesses bolstered and accelerated export shipments in advance of retaliatory tariffs from China. Personal consumption was also very strong, contributing 2.6% to Q2 GDP, the highest in over three years. Government spending (federal, state, and local) was additive as well.

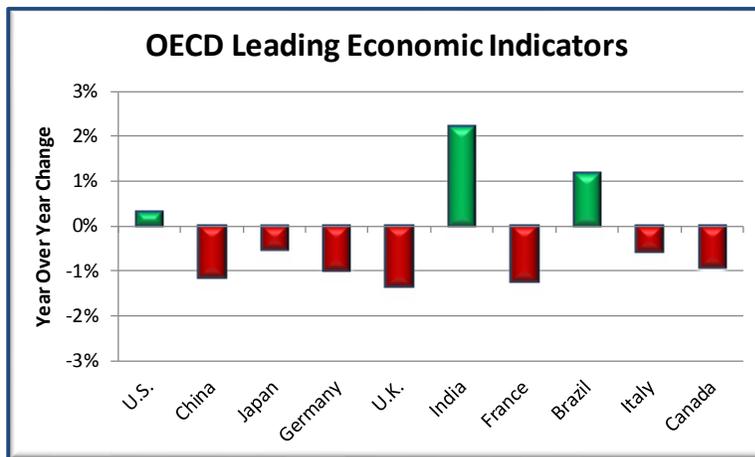


Data Source: U.S. Federal Reserve

The dollar rose towards the end of August, ending up 1.3% for the quarter. Domestic currency volatility was muted compared to other regions, particularly emerging markets. The worst performing currencies were the Argentiniane Peso and Turkish Lira, which lost 30% and 24% respectively versus the dollar. The Euro stabilized after weakening materially in Q2.



Data Source: U.S. Federal Reserve



Data Source: Organization for Economic Cooperation and Development

Global Growth Rates¹ (%)

	Q2 2018	Q3 2018	Q4 2018	2017	2018	2019
Advanced²	3.0	2.2	2.5	2.3	2.3	2.1
Euro²	1.5	1.7	2.5	2.5	2.1	2.2
U.S.²	4.2	3.5	2.5	2.2	2.8	2.3
Japan²	3.0	0.5	2.5	1.7	1.1	1.3
U.K.²	1.8	2.0	2.3	1.7	1.4	1.8
Canada²	2.9	2.5	2.5	3.0	2.2	2.2
Emerging	4.2	3.9	4.1	5.1	4.8	4.5
China	6.7	6.0	6.1	6.9	6.6	6.1
India	7.6	7.1	7.0	6.7	7.3	7.3
Russia	3.2	0.3	1.2	1.5	1.7	1.4
Brazil	0.7	2.4	2.5	1.0	1.2	2.3
World	3.5	2.9	3.1	3.4	3.3	3.1

Data Source: J.P. Morgan & U.S. Department of Commerce

¹Q2 2018 and 2017 are actual, all others are forecasts

²Quarterly numbers are sequential annualized, others are year-over-year

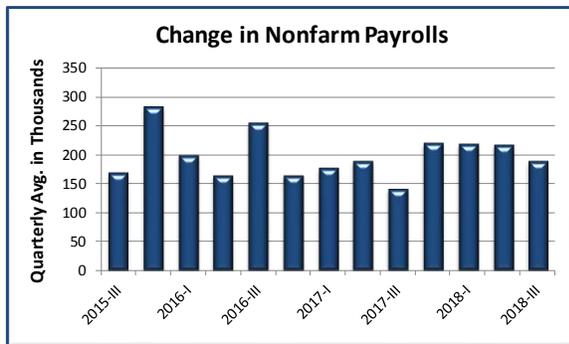
Quantitative tightening (QT), while still in the early innings, has resulted in a 7.2% decrease in the size of the Fed's balance sheet from early 2015. The endgame for QT (coupled with interest rate hikes) is a return to more traditional monetary policy.

Leading economic indicators (LEI) have deteriorated for the world's top ten largest economies. Designed to identify inflection points before they occur, LEI data only portends well for India, Brazil, and the U.S. Weakness is seen outside of the top ten countries as well, with roughly 80% of the remaining countries tracked by this indicator showing year over year declines.

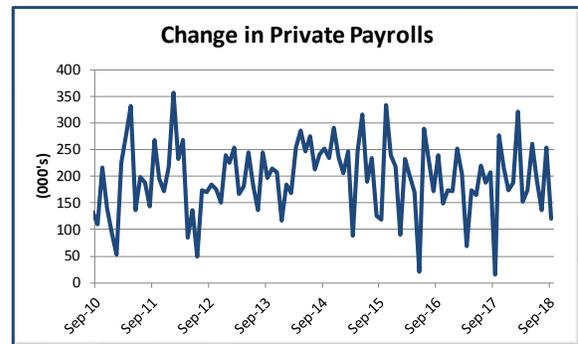
Global growth expectations have decreased as of late, primarily due to economic turmoil in certain emerging markets, unresolved trade tensions between the U.S. and China, and elevated risks in Italy. The IMF recently lowered its outlook for global growth by 0.2% and many prognosticators have followed suit. Global economics will be interesting in the coming quarters as economic crosscurrents abound.

Employment

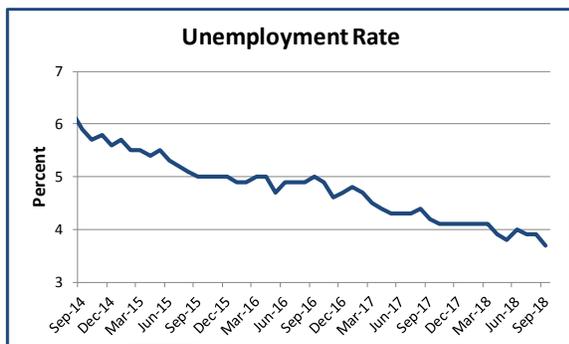
While weakness may exist in pockets of the domestic economy and in other regions around the globe, the employment situation in the United States is very strong. Jobs are being created at a consistently strong pace relative to history. Private payroll expansion continues to extend its record streak of growth, and the unemployment rate dropped to a new cycle low of 3.7% in September. Job openings have never been higher, setting a record in July (the most recent reading), although the mismatch between workers' skill sets and employers' demands remains a nagging concern. The number of people receiving unemployment claims is lower than it has been in the past 45 years, and as a percentage of the labor force, the figure has never been lower. All the while, wage growth remains subdued below 3%. The curious lack of accelerating wage inflation in such a low unemployment environment has led many economists to call into question the formerly revered "Phillips Curve," an oft-used model describing the inverse relationship between unemployment and inflation.



Data Source: U.S. Department of Labor



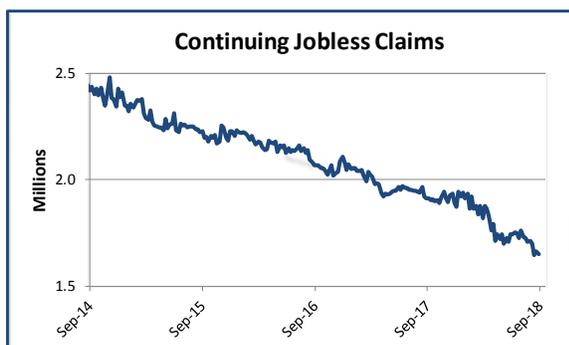
Data Source: U.S. Department of Labor



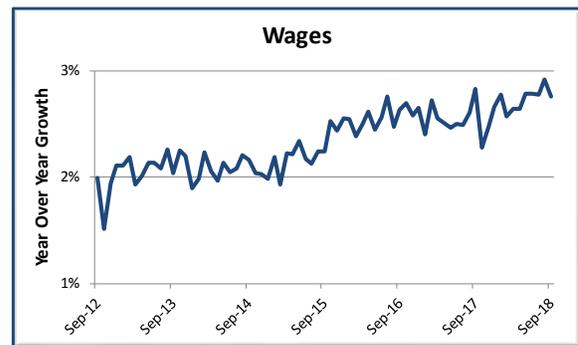
Data Source: U.S. Department of Labor



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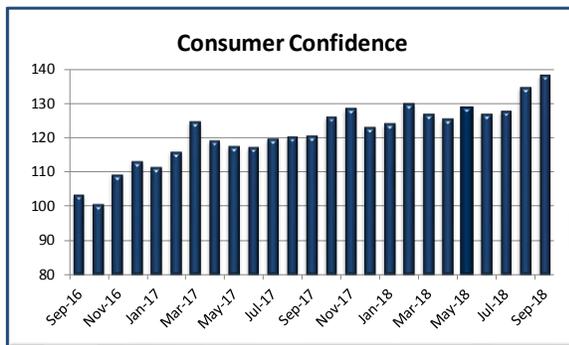
Data Source: U.S. Department of Labor



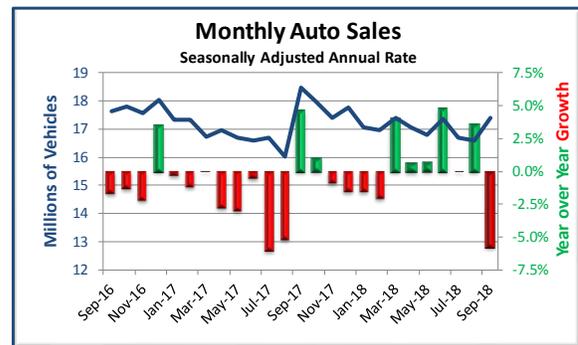
Data Source: U.S. Department of Labor

Consumer

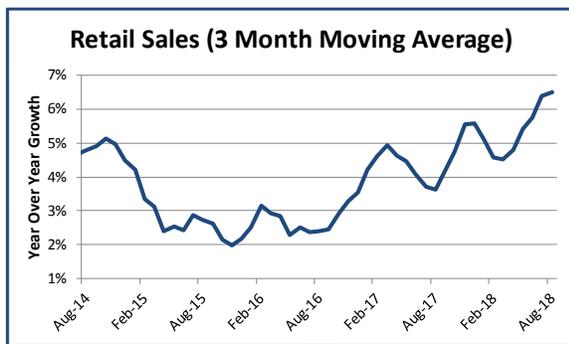
U.S. consumers, in aggregate, are the beneficiaries of historically low unemployment, continued strong domestic equity market returns, and contained inflation. These factors are more than offsetting rising fuel costs, which could ultimately prove to be a thorn in the consumer's side. Confidence reached an 18-year high in September – undoubtedly positive news on the surface. However, when confidence reaches levels this high (the index has only been higher 2% of the time since 1967), some argue it is a contrarian indicator..., a harbinger of lower future returns. A corroborating negative data point is September's plummeting auto sales, down over 5% from last September. However, investors may not want to put much stock in this anomalous metric, since last year's figure was bloated by buyers rushing to replace automobiles destroyed by Hurricane Harvey. Retail sales continue to paint a bright picture, up nearly 7% over last year. Notably strong components of retail sales were the online, clothing and accessory, and health and personal care categories. Overall, households are in a strong financial position. Household net worth rose by over 8% in the 2nd quarter, and now stands 86% above the trough reached during the climax of the Great Recession. Households' debt burden has remained stable in recent quarters, showing the consumer has maintained discipline after the broad-based post-crisis deleveraging.



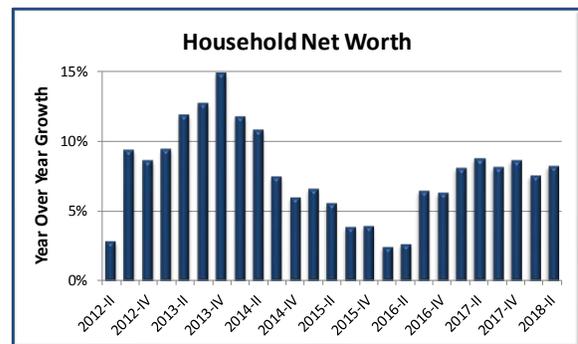
Data Source: The Conference Board



Data Sources: Bloomberg



Data Source: U.S. Department of Commerce

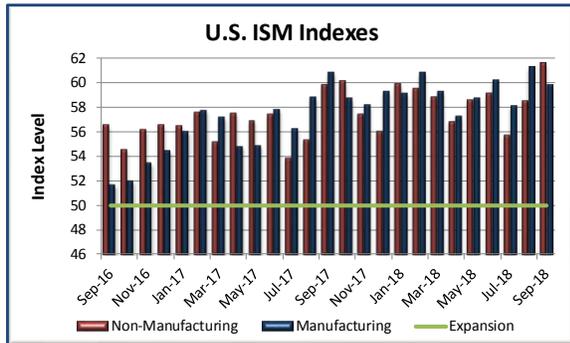


Data Sources: U.S. Federal Reserve

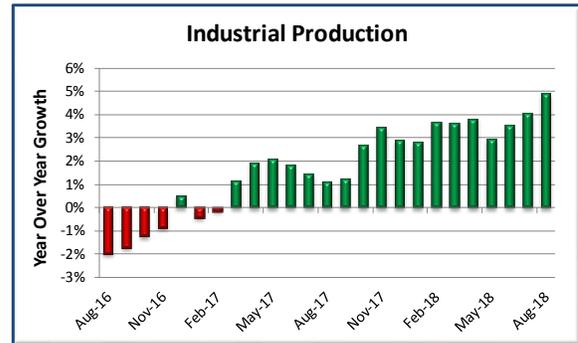
Business Activity

The ISM non-manufacturing index rose to 61.6 last month, the highest level since the inception of the index in 2008. As with the 18-year high in consumer confidence, this may reflect late-cycle jubilation and be indicative of an upcoming peak in the economic cycle. Alternatively, such robust data could simply be the result of fiscal stimulus and not necessarily a harbinger of

an impending economic slowdown. The ISM manufacturing survey came in strong as well at 59.8, notching the 113th straight month of growth. Corroborating the strength seen in the ISM surveys is the industrial production index, which in September grew at the fastest annual pace since January of 2011. An ongoing concern worth monitoring is the driver shortage that has led to increased freight costs and margin compression for suppliers nationwide. If this continues, until the advent of autonomous driving vehicles, businesses may pass costs on to consumers, resulting in higher inflation.



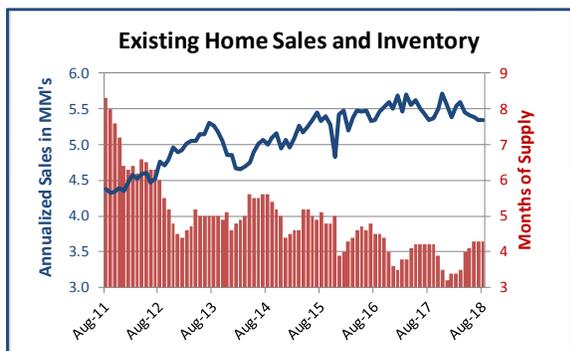
Data Source: Institute for Supply Management



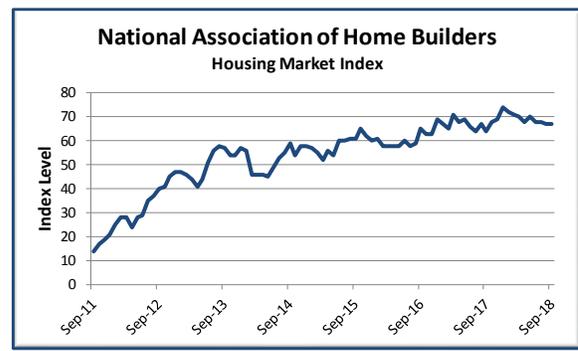
Data Source: U.S. Federal Reserve

Real Estate

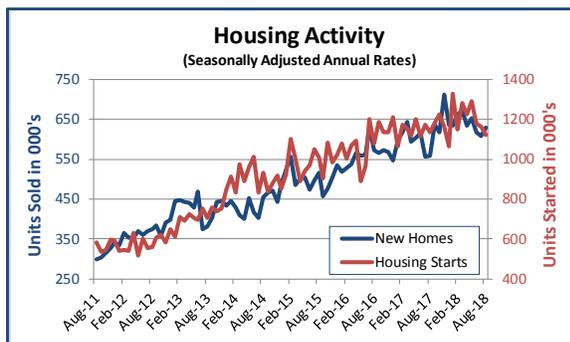
Data suggests a strong but decelerating housing market in the U.S. Existing home sales have tailed off since March. Builder sentiment has trended lower since January. New housing activity has slowed, and price growth has decelerated. While slowing, the *overall* housing market remains in fine shape. However, a dichotomy exists between the high-end and low-end markets. The luxury sector, more impacted by tax-reform, has weakened, particularly in high income tax states, while the “starter” and “trade-up” home markets remain strong.



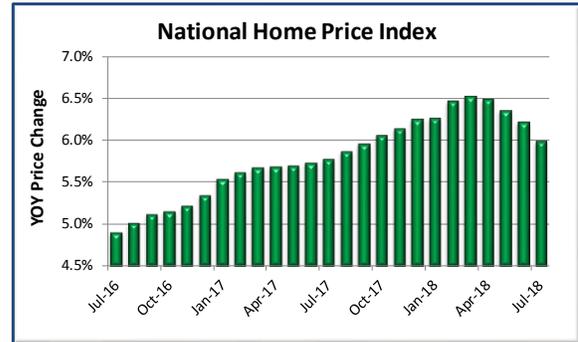
Data Source: National Association of Realtors



Data Source: National Association of Homebuilders



Data Source: U.S. Census Bureau



Data Source: S&P/Case-Shiller

CAPITAL MARKETS REVIEW

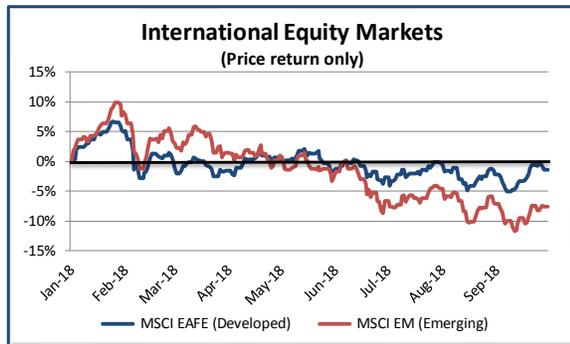
Returns

	3 rd Qtr 2018	YTD 2018
Cash and Fixed Income		
U.S. Treasury Bills	0.5%	1.3%
Barclays U.S. Aggregate Bond	0.0%	-1.6%
Barclays Municipal Bond	-0.2%	-0.4%
Barclays Global Agg. ex. U.S.	-1.7%	-3.0%
Hedge Funds and Alternatives		
Bloomberg Commodity	-2.0%	-2.0%
DJ US Real Estate	0.6%	2.1%
HFR1 FOF Composite	0.4%	1.2%

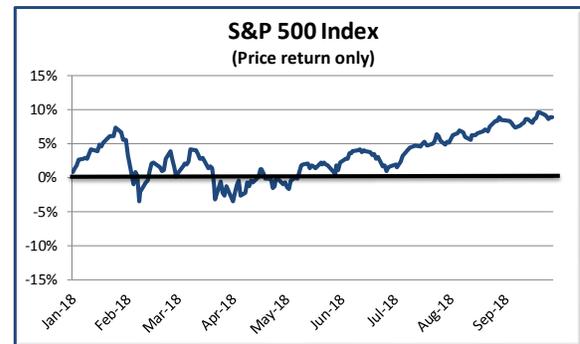
Data Sources: Morningstar & Hedge Fund Research, Inc.

	3 rd Qtr 2018	YTD 2018
Domestic Equities		
Wilshire 5000	7.3%	10.5%
S&P 500	7.7%	10.6%
Russell 2000	3.6%	11.5%
International Equities		
MSCI ACWI ex. U.S.	0.4%	-3.3%
MSCI EAFE (Developed)	1.4%	-1.4%
MSCI EM (Emerging)	-1.1%	-7.7%

Equity Markets



Data Source: Morningstar

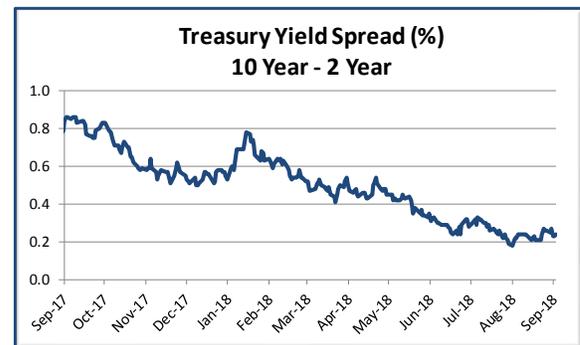


Data Source: Morningstar

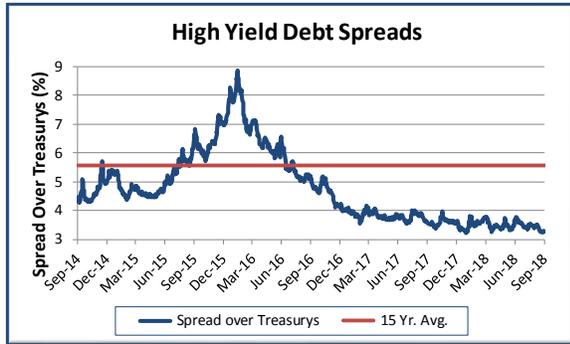
Fixed Income Markets



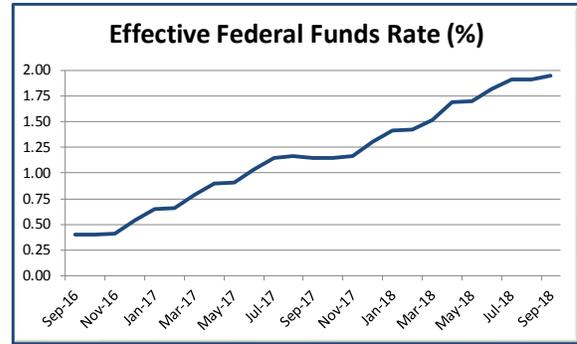
Data Source: U.S. Department of the Treasury



Data Source: U.S. Department of the Treasury

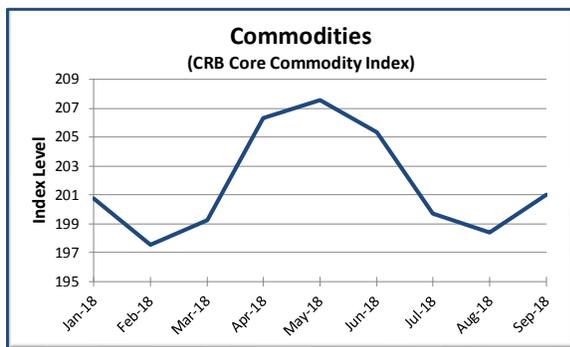


Data Source: BofA Merrill Lynch

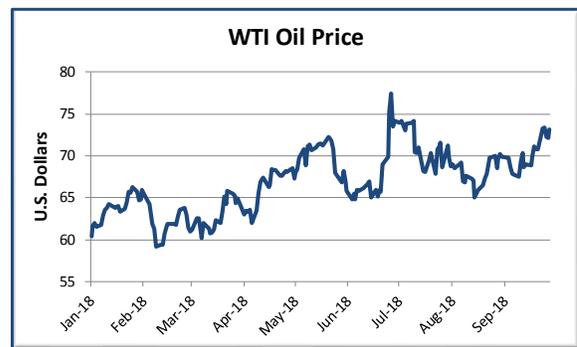


Data Sources: U.S. Federal Reserve

Alternatives



Data Source: Thomson Reuters



Data Source: U.S. Energy Information Administration

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