Trumbower Financial Advisors, LLC
3rd Quarter 2018
Investment Market Commentary

Emerging Issues Trigger Global Headaches

Commenting on last quarter while the tables are turning has been challenging. We hope this offers some perspective on your Q3 performance as well as what is happening now.

The US stock market turned a blind eye on the drama playing out in a Senate hearing room and didn't let Hurricane Florence drown the rally. With limited exceptions, the economy and stock prices failed to exhibit symptoms of trade trauma. US indices topped January 2018 highs during Q3. Large Caps towered over their smaller counterparts rising 7.71%. Mid and Small Cap US stocks advanced 3.86% and 3.58%. For the year, Small Caps edged ahead of the S&P 500 by nearly 1% (11.51% and 10.56%, respectively). Mid Caps traipsed forward more delicately yet respectably at 7.5%. Robust economic data, particularly employment, coupled with expectations for higher corporate profits in 2019 inspired unwavering investor confidence.

Developed Foreign equities inched ahead by a measly 0.76% during Q3, stalling near 2018 lows. Emerging Market equities sank once again (-1.09%) and were -7.68% lower for the year through 9/30. Problems plaguing Emerging regions sent their stocks into official bear territory (measured from January 2018 peak). Steadfastly dominant dollars exacerbated losses suffered by US investors holding overseas equities converted from local currencies. The dollar ascended 1.9% in Q3 and was 4.3% higher against a basket of major currencies for the year.

Growth stock enthusiasts continued to eclipse Value lovers. This trend has prevailed within Large Cap asset class since July 2013. Style preference among Mid and Small Cap stocks has been far less consistent, waffling back and forth over the past five years.

Sectors propelling Growth mania include Healthcare (+14.04%) and Technology (+8.49%). Losing sectors in the S&P 500 were traditional

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Selected Benchmark and Category Average Returns

Large Cap Equity

*Benchmark Indx & Category Average**	*(Total Return)* **3rd Q 2018**	**12 Mos.**
S&P 500 Growth	9.28	25.21
Large Cap Gr Avg	7.40	23.71
S&P 500 Value	5.86	10.06
Large Cap Val Avg	5.44	10.17
S&P 500 Index	7.71	17.91
Large Cap Blnd Avg	6.59	14.67

Mid Cap Equity

*Benchmark Indx & Category Average**	*(Total Return)* **3rd Q 2018**	**12 Mos.**
S&P MC 400 Growth	3.95	16.55
Mid Cap Gr Avg	7.06	22.22
S&P MC 400 Value	3.77	11.72
Mid Cap Val Avg	2.90	8.06
S & P 400 Index	3.86	14.21
Mid Cap Blnd Avg	4.04	*10.58*

Small Cap Equity

*Benchmark Indx & Category Average**	*(Total Return)* **3rd Q 2018**	**12 Mos.**
Russell 2000 Growth	5.52	21.06
Small Cap Gr Avg	6.88	24.33
Russell 2000 Value	1.60	9.33
Small Cap Val Avg	0.88	7.98
Russell 2000	3.58	15.24
Small Cap Blnd Avg	2.39	10.94

International Equity

*Benchmark Indx & Category Average**	*(Total Return)* **3rd Q 2018**	**12 Mos.**
MSCI EAFE	0.76	-0.01
Intl Equity Avg	0.48	1.33

* **Category average** calculated using *Morningstar Direct*. Fund universe screened to include funds that meet the following criteria:

A. M-Star Category consistent with designated asset class and management style.
B. M-Star Style Box consistent with designated management style.
C. Fund's Objective consistent with asset class.
D. Excludes Index Funds.

We have not independently verified *Morningstar* data.

3rd Quarter Equity Market Results

	3rd Qtr. % Chg.	12-mo. % Chg.
S&P 500	7.71	17.91
S&P 400	3.86	14.21
Nasdaq	7.41	25.17
Russ 2000	3.58	15.24
MSCI EAFE	0.76	-0.01
MSCI Emg MMkt	-1.09	-0.81

Go Global With Bonds?

30 years ago, 60% of global bonds were issued by US entities. Emerging Markets ("EM") comprised only 1%. Financing growth spurts in developing regions coupled with investor appetite for yield catapulted EM debt up to $22 trillion, now 20.6% of global credit and not far below the US's share at 36.7%. Bonds floated by the rest of the developed world grew modestly to $45 trillion, or 42.7%. Now that 60% of the bond market originates outside our borders should we consider larger portfolio allocations to overseas debt? Are there superior returns and diversification properties that compensate for risks that are avoidable by staying closer to home?

The US Aggregate Bond Index ("US Agg") measures the universe of US investment-grade government and corporate issues. Barclays Global Aggregate Bond ex-US ("Agg ex US") reflects the performance of investment grade debt principally within Developed countries other than the US. JP Morgan tracks diversified Emerging sovereign debt denominated in US dollars ("EMBI") and local currency (GBI-EM)[1]. Bank of America maintains a well-known US High Yield ("HY") index.

Index Anecdotes

Investment grade International bonds (<5% EM) have underperformed comparable US securities over the 5 and 10 years ended June 30, 2018[2] by more than 1%. Quantitative easing kept yields abnormally low in both arenas but more so in Europe where negative yields persist today. Unhedged index comparisons echo the more or less consistent ascent of the US dollar against other major currencies during the period. (It took a breather during 2017 and early 2018 before ramping back up). More recently, investment grade overseas bonds tell a different story. Agg ex US has returned almost 4% and 2+% more than US Agg over 1 and 3 years, respectively.

EMBI delivered a premium of 2.4% to 3.1% over US Agg during the past 3, 5 and 10 years. Remember, this index is limited to US dollar denominated government paper so it skirts currency concerns and less creditworthy enterprises. EM corporate hard currency index also avoids more vulnerable issuers and returns were attractive relative to the US Agg until recently. Local currency EM debt wouldn't be in the running based on performance over 5 and 10 years. It beat US Agg over the past 1 and 3 years but 5-year rolling returns - embattled by the almighty dollar - ran consistently in the red since 2010. There have been no negative rolling 5-year returns for hard currency EM bond indexes.

Lately, EM Fixed Income has tanked along with the regions' equity markets. The US Agg was down -1.5% YTD but EMBI and GBI-EM toppled -4.08% and -3.69%, respectively. Over 3, 5 and 10 years, EMBI returns slightly lagged US HY. The negative spread has widened so far this year. Looking solely at relative total returns, International bonds might make a positive contribution – especially Emerging Markets – but we must evaluate the opportunity on a risk adjusted basis.

Hedging Risk vs Diversification

Of course, debt denominated in foreign currency injects additional risk and, therefore, volatility. Rising dollar values can easily wipe out yield advantages. Softer dollars augment performance. Currency risk, however, is avoidable. As noted, many foreign countries and corporations issue dollar denominated securities. US investors avoid currency risk but may face higher default rates in the EM space when the dollar persistently overwhelms local tender.

Foreign bond funds can hedge currency risk and significantly reduce volatility using derivatives – but at a cost. The hedged version of the Agg ex-US was 30% less volatile than the unhedged. Hedging cuts both ways, however, and results will be disappointing relative to unhedged funds when the dollar drops. Tactical hedging is often used by active managers to smooth out and enhance returns, but the risk is that their efforts can backfire.

Investors also give up diversification benefits by

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[1] This is the index most widely followed by active managers.
[2] Index statistics are for the period ending 6/30/18 unless otherwise noted.

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hedging as evidenced by correlation statistics. Correlation of the unhedged Agg ex US to the US Agg is .44 over the last 5 years compared to .81 for the hedged. The correlation of local currency EM bonds is just .29 to US Agg and .19 to the 1-5 year Treasury. Dollar denominated EM indices share a correlation to US Agg that is similar to unhedged Developed International.

Putting the Data to the Test

To find some useful guidance from these fun facts, we ran a series of portfolio return simulations using index proxies for these Fixed Income asset classes and security options: Conservative Fixed Income ("CFI"), Broad Domestic Fixed Income ("BDFI"), Developed Foreign Bonds (unhedged) ("DFB"), Developed Foreign Bonds (hedged) ("DFBH") and Emerging Markets Bonds ("EMB") represented by the dollar denominated EMBI. Our control Base Case portfolio consisted of 50% CFI (Barclays 1-5 Treasury) and 50% BDFI (Barclays Aggregate Bond – aka US Agg). All portfolios tested started with 50% CFI. Our goal was to see if we could enrich total returns on an otherwise lower risk Fixed Income portfolio component by introducing an International element.

Over rolling 5-year periods going back to 1994, the Base Case averaged 4.84%, annualized, with a standard deviation of 2.63% and topped inflation in 97% of the iterations. Splitting the BDFI position between US Agg and Agg ex US was not successful. Returns were diminished modestly with higher volatility and failed to preserve purchasing power 11.6% of the time. A 12.5% stake in EMBI paired with 12.5% Agg ex US boosted average annualized returns to 5.35% and this portfolio beat inflation 99.1% of the time. The tradeoff was increased volatility.

Results using the hedged version in lieu of 25% DFB were very similar to the Base Case. Leaving DFB out of the equation and pairing 10% EMB with 40% BDFI generated average annualized returns of 5.33%, volatility comparable to the Base Case and beat inflation 99.6% of the time. EMB delivered positive returns over all rolling 5-year periods but not without some excitement. Downside deviation has subsided since 2008 but remains 2.25 times higher than CFI and can be extreme, such as the -20.74% decline experienced during the heat of the last financial crisis.

The Conclusion

Unless you strongly believe the USD is poised for more than momentary dethronement, the argument in favor of Developed International Bonds is not very compelling – especially as a component of a long-term allocation. As a matter of principle, we don't make predictions about macro-economic trends and avoid market timing for fear of doing more harm than good. We also acknowledge that, in our experience, all trends ultimately come full circle. At some point an actively-managed International bond component is bound to add alpha to an otherwise mundane Fixed Income allotment.

Emerging Market bonds are more intriguing. Downside deviation has moderated over the last decade and the asset class offers higher return potential relative to Developed. Even though our study suggested that a fairly small (10%) allocation to Emerging Market Bonds can improve returns and the likelihood of preserving purchasing power, the risk of a steep drop in the midst of deteriorating broad market conditions makes us reluctant to carve out a dedicated spot for it.

Instead we offer strategic exposure, when appropriate, to both Developed and Emerging foreign bonds through a handful of skillfully managed active Fixed Income funds. In addition to minor positions in Templeton Global Bond, we use three PIMCO funds, Vanguard ST Investment Grade, Dodge & Cox Income and PGIM Total Return. These managers hold varying amounts and types of International debt but as of July 31st they own from ~3% to ~13% Emerging and ~8% to ~22% Developed. They also employ derivatives to manage exposure to regions and currencies – but they are not, strictly speaking, hedged. We are comfortable that this approach has the capacity to juice up results without compromising the intrinsically more conservative Fixed Income asset class objective.

Emerging Issues
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Value like Materials (-0.15%) and Energy (-0.11%).

Growth cravings have contributed to the widening disparity between US and foreign stock performance. Growth sectors are not as well represented in the EAFE Index. 8% of the EAFE resides in Technology versus 23% for the S&P. Healthcare comprises 14% of the S&P and 10% of the EAFE. Value sectors like Financials and Materials are 4% and 6% higher in the EAFE. Value emphasis proved to be a headwind for total returns but it also explains EAFE's 1.35% dividend yield premium.

Other trials and tribulations troubling European stocks include uncertainty surrounding Brexit negotiations and Italy's budget deficit – viewed as more serious than the Greek crisis and responsible for weakening French and Spanish banks. According to the head of European Equity Strategy at Société Générale, Europe's connection to Emerging countries has strengthened and their stock markets are increasingly correlated.

Strong dollars coupled with rising interest rates rattled Emerging Market economies laden with US dollar debt. Under extreme circumstances defaults become more likely. China is renowned for its stockpiles of US debt, but it also holds paper issued by the poorest developing countries. They don't reveal the size of their potentially shaky loan portfolio but they are known to be major lenders to countries that have already fallen behind on obligations according to the World Bank. Experience warns us that tremors in China are felt around the globe.

Investors who stay clear of Emerging stocks should not feel insulated from the fallout of economic decline in regions that collectively comprise 59% of global GDP. The barrage of US tariffs on Chinese goods may ultimately weaken Beijing's resolve but in the process jeopardize its smaller trading partners. According to the *Economist* 30% of China's exports to the US originate in some form from other Asian countries. A tariff induced decline in Chinese currency pressures others to devalue to remain competitive. Already weakened by capital outflows, the value of Emerging Market currencies will continue to shrink making it more and more expensive for them to repay debt and buy already pricier oil. As their economies retrench, productivity wanes siphoning off demand for goods and services which stifles global growth.

Serious economic regress in China and Europe will dial back profit expectations for US S&P 500 constituents that generate more than 40% of their revenues overseas. Growth in US corporate earnings has been largely credited with the longevity of this bull run. If stimulus from tax savings dwindles along with profits the US stock market inevitably takes it on the chin.

The impact of tariffs on US consumers has been muted so far. While the US economy is in a better position to play hardball with China, when the full effects of tariffs kick in we may be faced with considerably higher prices. Harley Davidson and GM say the cost of their products will escalate as the tax on steel and aluminum is passed on to customers. By the way, the new tri-lateral US-Mexico-Canada agreement does nothing to alleviate this concern. Tariffs on Canadian metals remain and if the deal is ratified new rules of origin and labor policy will make building cars in North America more expensive and complicated.

The financial difficulties confronting Emerging nations cannot be denied but there are bright spots. Markets are diverse and some have fared better than others. Overall, valuations are 30% cheaper than within Developed markets – 20%-25% is an historical average. As today's issues subside, growth prospects become more compelling. Most emerging regions lay claim to three if not four of the features essential to competitive advantage: attractive demographics, productivity growth, low cost production and rich natural resources. Which developed economy boasts of more than one?

Behind this backdrop, the Fed followed through on its promise to raise its short-term rate by a quarter point. The stock market has since responded quite poorly although the move was widely anticipated. Rates have started to climb at the long end of the curve. Still historically temperate, the 30-year rate busted out over 3.25%. This won't help those suffering from ascending dollars, but it does lessen the likelihood that the dreaded inverted yield curve will haunt us this Halloween.