TFC FINANCIAL
The Financial Counselors

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OUR VIEW

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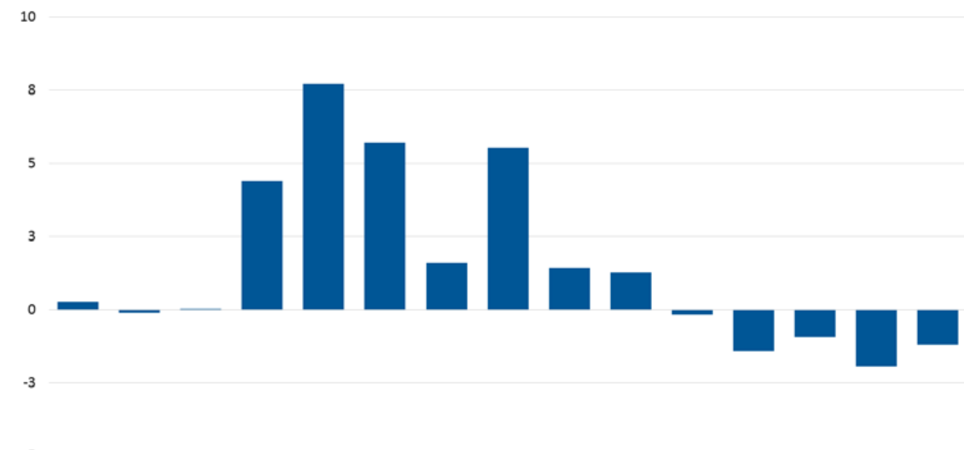
Third Quarter Review

Second quarter U.S. GDP growth of more than 4% was the second-strongest since 2014, setting the stage for a third quarter dominated by U.S. equities. U.S. companies reported strong earnings growth, with corporate tax cuts providing an additional boost to after-tax results. Outside the U.S., growth concerns for China and Europe made last year's synchronized global growth environment a distant memory for many investors. Rising interest rates in the U.S. made yields on short-term bonds more attractive, but caused losses in longer-term bonds. The U.S. dollar has strengthened this year, a function of faster economic growth and rising interest rates. An unfortunate side effect of the strong dollar is that economic imbalances have been exposed in countries such as Turkey and Argentina.

Global equities, as represented by the MSCI All Country World Index, rose 4.4% for the quarter. U.S. large company stocks continued to be the "safe haven," with the S&P 500 gaining 7.7%. International stocks rebounded slightly, gaining more than 1%, while emerging markets equities stabilized after a poor second quarter. Value stocks trailed growth stocks in much of the world. Short-term bonds provided slightly positive returns during the quarter.

Year-to-date through September 30, global equities, as represented by the MSCI All Country World Index, gained 4.3%. U.S. small company stocks have risen more than 11% year-to-date, and the S&P 500 more than 10%. Emerging markets equities have lost more than 7% for the year, giving back some of last year's gains. Short-term bonds provided slightly negative returns year-to-date, though short-term municipal bonds remain in positive territory. The Bloomberg Barclays Aggregate Bond Index, which has a longer duration than the benchmark index for TFC clients, is down 1.6% year-to-date.

Although the S&P 500 Index has advanced at a rapid pace this year, market averages are often deceiving. 2018 has been a year in which a very small number of stocks dominated the market surge. Four stocks - Amazon, Apple, Microsoft and Netflix - represented about 40% of the advance of the S&P 500 Index in the year-to-date period through September 30. Also notable is the dramatic divergence of performance between growth and value stocks. Despite brief periods of value outperformance in the last few years, the overall outperformance of U.S. growth stocks relative to value stocks is approaching "dot com" era levels. Growth stocks, as measured by the Russell 1000 Growth Index, have beaten value stocks, as measured by the Russell 1000 Value Index, by nearly 6% per year over the past five years.



	Short Term Bonds	Short Term Muni Bonds	Barclays Agg.	Global Equities	S&P 500	US Large Value	US Small Value	US Small Growth	Intl. Large Core	Intl. Large Value	Intl. Small Value	Intl. Small Growth	EM	Frontier Markets	Global Real Estate
QTD	0.3	-0.1	0.0	4.4	7.7	5.7	1.6	5.5	1.4	1.3	-0.2	-1.4	-0.9	-1.9	-1.2
YTD	-0.1	0.7	-1.6	4.3	10.6	3.9	7.1	15.8	-1.0	-3.0	-3.7	0.0	-7.4	-12.4	-2.1
Full Cycle*	2.4	2.3	3.7	4.7	8.4	6.4	7.4	9.3	1.7	0.7	4.4	4.7	0.5	-1.7	2.6

* Full Cycle is the annualized return from October 2007 peak to present.

Our asset allocation approach is designed to provide clients with diversified equity investments across regions, economic sectors and investment styles.

Most TFC client portfolios provided positive returns during the quarter and for the year-to-date period. However, after a good 2017 and a solid start to this year, we are disappointed with our year-to-date results for 2018. U.S. equities helped portfolio performance in absolute terms, unfortunately the downturn in non-U.S. equities pulled down overall results. In relative terms, TFC's emphasis on value stocks and away from some of the more richly valued growth companies contributed to TFC client portfolio performance lagging relative to our policy benchmarks. TFC's holdings in mostly high-quality, shorter-term fixed income investments lost a small amount of ground in a difficult market for bonds.

Our asset allocation approach is designed to provide clients with diversified equity investments across regions, economic sectors and investment styles. We are wary of "all or nothing" investment approaches, consequently TFC portfolios are "tilted" toward value but maintain an appropriate allocation to growth stocks. Although year-to-date performance lags TFC client benchmarks, the gap between TFC and benchmark performance was considerably narrower than the gap between value and growth referenced above.

Looking forward, we remain confident that value and international stocks will both return to favor. Value underperformance has been notable in recent years, however, over longer periods of time value stocks have outperformed relative to growth stocks. The valuation disparity between growth and value is at a high level today, leading us to be confident that value will ultimately return to favor. In our view, the time-tested value investment approaches of Benjamin Graham and Warren Buffett still make sense today.

With regard to investing internationally, Wall Street Journal columnist Jason Zweig made a point worth sharing in a recent article: "It still makes sense to add international stocks to a portfolio, probably more so than ever. Markets tend to lose their dominance right around the time it seems most irresistible." In our view, the case for investing internationally is still compelling for the short and long term. Last year's outperformance relative to U.S. stocks is worth noting.

Many of the world's leading companies are domiciled outside the U.S., while some of the best growth opportunities are found in Asia and priced at more attractive valuation levels than U.S. stocks. We don't know when the cycle will turn for value and international stocks, but are confident that it will ultimately turn.

Economic and Market Outlook

The decline in stock prices in the early days of October is in part attributable to fears that tariffs and trade tensions are already causing a slowdown in corporate earnings growth.

TFC has highlighted trade policy as a major risk for the markets since the 2016 election campaign. Trade tensions peaked during the third quarter. The deal with Mexico and Canada to make modest changes to the original NAFTA removes the uncertainty associated with the potential withdrawal of the U.S. from NAFTA. The new NAFTA provided only temporary relief from worries about trade. Tensions with China are likely to get worse before they get better, and the perception that the U.S. is "winning" the trade war may be a miscalculation. Tariffs often serve as a "tax" on consumers, so imposing tariffs on intermediate goods produced in China could lead to higher prices for many products bought by American consumers. Commerce Secretary Wilbur Ross may be right that consumers won't notice a one penny increase in the cost of a beer can. Unfortunately, the impact of a trade war could lead to price increases for goods including iPhones, autos, washing machines and cars. American exporters could also suffer if trade partners retaliate. American farmers have already been hurt by the threat of China buying more soybeans from Brazil than from the U.S., as soybean prices have fallen significantly. Although the U.S. may have the apparent upper hand in trade tensions, Americans may have less staying power than Chinese citizens if the trade war continues for a protracted period of time. The decline in stock prices in the early days of October is in part attributable to fears that tariffs and trade tensions are already causing a slowdown in corporate earnings growth.

Although we don't expect a repeat of the "dot com" meltdown of the early 2000s, many leading technology companies face challenges that may not be reflected in share prices. For example, Facebook and Google both face scrutiny regarding privacy of user data, and Google is also being scrutinized about prioritization of search results. Both will inevitably have to spend more money to address regulatory concerns. Although Amazon seems unstoppable, the company faces intensifying competition in cloud computing services from Microsoft, IBM and potentially Google. Given the significant role that cloud computing plays in Amazon's stock market valuation, competition could slow sales growth or erode margins.

Netflix doesn't have a monopoly on content or on access to the home, so competition from Disney, AT&T and Comcast may slow its momentum. Rising interest rates may be starting to have an impact on the lofty valuations of high growth technology stocks, as higher rates mean that earnings far in the future are worth less today.

Closing Thoughts

A severe slowdown in global growth does not appear imminent, even though growth may have peaked in much of the world. China's growth is slowing but still relatively robust, despite financial sector deleveraging, a crackdown on corruption, and ongoing (and unappreciated) restructuring of the industrial sector. China is gradually reducing leverage at financial institutions and state-owned enterprises, while slowing the pace of real estate speculation.

In the U.S., more than 75% of tax cuts went to individuals, providing a temporary boost that will fade by the middle of next year. We've expected rates to rise because of the strong economic environment, but interest rates and inflation are rising at moderate rates. The Federal Reserve is likely to raise short-term rates once more this year, but they may slow their pace midway through next year. Wage growth, stubbornly low during much of the expansion, is starting to pick up. However, it is unlikely that wages and prices will rise at the pace of the 1970s given the decline in union employment, the influence of automation, and far greater transparency of consumer prices. Inflation may become more of a challenge as entitlements get closer to a tipping point in the mid to late 2020s, but for now there may be a limit to how high U.S. interest rates and inflation may go. Interest rates and inflation are reasonably low relative to history and near-term economic growth should not be disrupted too much by moderate rate increases. We expect trade disputes to escalate, until unintended consequences backfire in a meaningful way. President Trump will be more likely to look for a resolution of trade conflict if unemployment rises or if consumer goods inflation becomes a problem.

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The most likely scenario for 2018 and 2019 is a growing but slowing economic environment. The worst case scenario involves the U.S. imposing high tariffs on all imports from China and an expansion of tariffs to the rest of the world on imported autos and auto parts. The likely retaliation would include a Chinese currency depreciation and retaliatory tariffs which ultimately would contribute to a more material slowdown in growth. We're optimistic that the worst case scenario won't happen. The best case scenario is that compromises are found, which would likely be a catalyst for a relief rally in many of the segments of the market that have struggled this year.

From a positioning perspective, TFC is positioned in line with long-term strategic targets for stocks given positive economic and earnings momentum; however we think this year will continue to be volatile. Long-term return expectations are somewhat subdued for the developed world given demographics and debt challenges. We have reduced our allocation to emerging and frontier markets because of near-term concerns, but continue to have a favorable long-term outlook.

Bonds are a necessary hedge against equity risks given the potential volatility in stocks. We expect that interest rates will continue their upward trend, but have supplemented the core of short-term bonds with slightly longer-term bonds that would provide diversification in the event of economic disappointment or a more severe stock market correction.

We monitor the risks outlined above and will incrementally adjust the portfolio based on new information. For our clients with ongoing income or anticipated liquidity needs, we have been raising and reserving cash in their portfolios. As always, we welcome your comments and questions.

Sincerely,

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