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INDEPENDENT INVESTMENT COUNSEL

QUARTERLY NEWSLETTER

2018: THIRD QUARTER **119TH EDITION**

It won't be the economy that will do in investors, it will be the investors themselves. Uncertainty is actually the friend of the buyer of long-term values. *Warren Buffet*

When an investor focuses on short-term investments, he or she is observing variability of the portfolio, not the returns—in short, being fooled by randomness. *Nassim Nicholas Taleb*

In the short run, the market is a voting machine, in the long run, it is a weighing machine. *Ben Graham*

TABLE OF CONTENTS

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CAPITAL MARKETS SCOREBOARD

Equities					
Indices	3Q18 Total Return (%)	2018 Total Return (%)	Index Characteristics		
Domestic			NTM P/E	P/B	Div. Yld. (%)
S&P 500	7.7	10.6	16.8	3.4	1.74
DJIA	9.6	8.8	15.9	4.1	1.97
NASDAQ	7.4	17.5	22.3	4.6	0.93
Russell 1000 Growth	9.2	17.1	21.3	7.3	1.06
Russell 1000 Value	5.7	3.9	14.1	2.1	2.34
Russell 2000	3.6	11.5	22.2	2.1	1.18
International*					
MSCI EAFE	1.4	-1.0	13.6	1.6	3.18
MSCI Emerging Markets	-1.0	-7.4	11.2	1.6	2.70
MSCI United Kingdom	-1.7	-2.7	12.8	1.7	4.19
MSCI France	2.9	3.6	13.8	1.7	3.09
MSCI Germany	-0.6	-7.3	12.4	1.7	2.94
MSCI Japan	3.8	1.9	13.5	1.4	2.08

Fixed Income		
Indices**	3Q18 Total Return (%)	2018 Total Return (%)
Domestic		
U.S. Corp - Gov (1-3 Years)	0.4	0.5
U.S. Corp - Gov (3-5 Years)	0.2	-0.7
U.S. Corp - Gov (10+ Years)	-0.7	-5.3
U.S. Treasuries Master	-0.7	-1.8
U.S. Corporates Master	1.0	-2.2
U.S. Municipals Master	-0.3	-0.5
U.S. High Yield Master	2.4	2.5
International*		
Developed Markets Sov Bond	-1.8	-2.5

Commodities		
Resource	3Q18 Total Return (%)	2018 Total Return (%)
Precious Metals		
Gold	-4.8	-8.8
Silver	-10.7	-15.2
Industrial Metals		
Copper	-5.4	-14.9
Aluminum	-7.9	-10.3
Energy		
Brent Crude Oil	6.7	23.8
WTI Crude Oil	-1.3	21.1
Natural Gas	3.1	2.0

Key Rates				
Rates	9/30/2018	6/30/2018	12/31/2017	9/30/2017
U.S. Target Fed Funds Rate	2.13	1.88	1.38	1.13
2-Year U.S. Treasury	2.81	2.52	1.89	1.45
10-Year U.S. Treasury	3.05	2.85	2.40	2.31
30-Year U.S. Treasury	3.19	2.98	2.74	2.87
10-Year German Bund	0.47	0.30	0.43	0.48
10-Year Japanese Bond	0.12	0.03	0.05	0.06
30-Year Fixed Mortgage	4.97	4.84	4.25	4.11

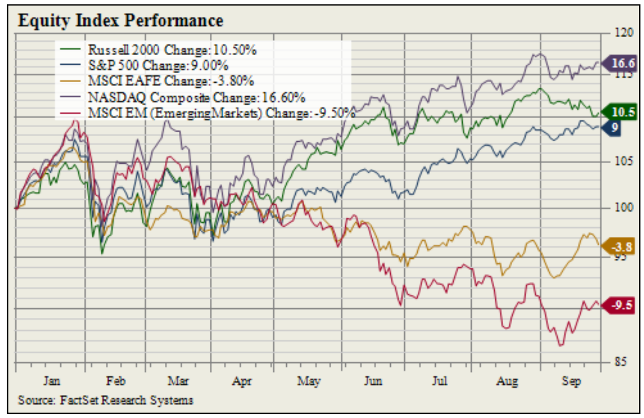
Currencies				
Indices/ Exchange Rates	9/30/2018	6/30/2018	12/31/2017	9/30/2017
ICE U.S. Dollar Index	95.13	94.64	92.12	93.08
USD per EUR	1.16	1.17	1.20	1.18
USD per GBP	1.30	1.32	1.35	1.34
JPY per USD	113.69	110.75	112.71	112.46
CAD per USD	1.29	1.31	1.26	1.25

*Returns denominated in U.S. dollars

**ICE Bank of America Merrill Lynch (BofA-ML) indices

EQUITIES

- The Standard & Poor's 500 (S&P 500) index finished the third quarter with a total return (price appreciation plus dividends) of 7.7%. Small cap stocks underperformed larger stocks, as the Russell 2000 Index returned 3.6% for the quarter. On a global basis, the MSCI Europe, Australasia, and Far East (EAFE) Index generated a total return of 1.4% when priced in U.S. dollars, or 2.4% priced in local currencies. The MSCI Emerging Markets Index produced a total return of -1.0% in U.S. dollar terms and 0.1% in local currencies.

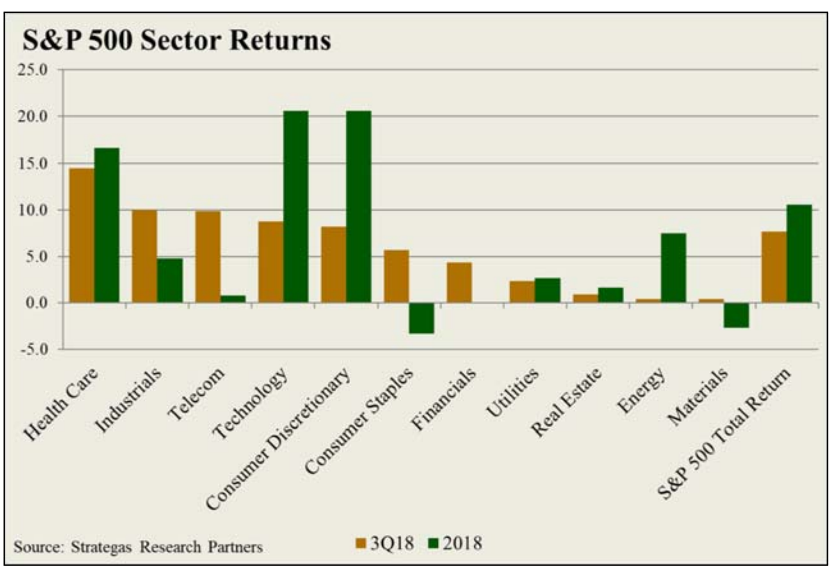


Source: FactSet Research Systems

- Market pundits generally agree that a bear market is defined as a drop of 20% or more from the peak in a cycle, while a bull market is measured from the lowest point reached until the next cycle peak. There is some contention, however, whether intraday prices (highs and lows) or simply closing prices should be utilized in defining bull and bear markets. Using closing prices, the current bull market began on March 9, 2009 and became the longest on record at 3,453 days on August 22, 2018, surpassing the previous record from 1990 to early 2000 (although that bull market's resetting decline was *technically* only 19.9%). In contrast, if intraday highs and lows are used, the S&P 500 was down 21.6% from its post-crisis intraday high to the intraday low of October 2011, casting doubt on whether the current bull market is really the longest in history.

- The U.S. equity market continued to exhibit low volatility in the third quarter. At the close of the quarter, the S&P 500 had not experienced a daily move of 1% in either direction since falling 1.4% on June 25, when trade fears gripped global markets. In January, the S&P 500 ended a streak of 94 days without a 1% move, its longest since 1995. During the third quarter, the S&P 500, Dow Jones Industrial Average, NASDAQ Composite, and Russell 2000 all reached record highs. In contrast, international indices such as the MSCI Emerging Markets, Hang Seng, and Dow Jones Shanghai entered bear markets in U.S. dollar terms during the quarter.

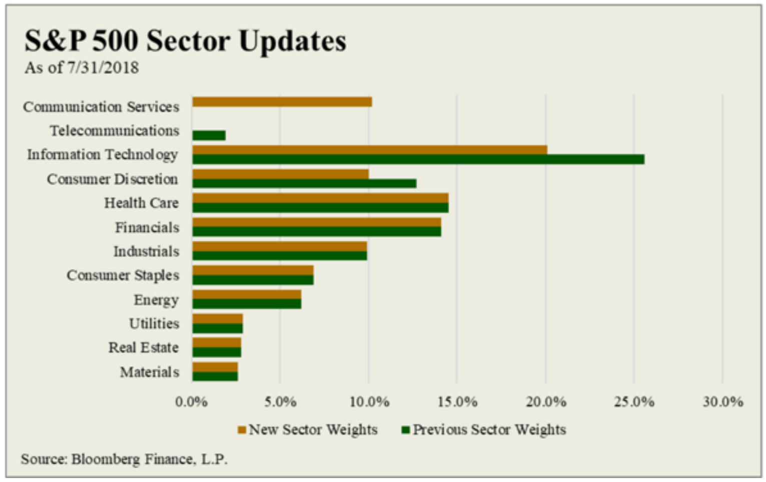
- The Health Care and Industrials Sectors were the strongest S&P 500 performers for the third quarter, returning 14.5% and 10.0%, respectively. Industrial and consumer staples companies staged a rebound in the quarter after producing negative returns in each of the first two quarters of the year. Every sector in the S&P 500 produced positive returns during the quarter, although the Materials, Energy, and Real Estate Sectors struggled to gain momentum with returns of less than 1% each. Year-to-date (YTD), consumer discretionary and technology stocks have posted the strongest performance, returning 20.6% each, while the Consumer Staples and Materials Sectors remained in negative territory.



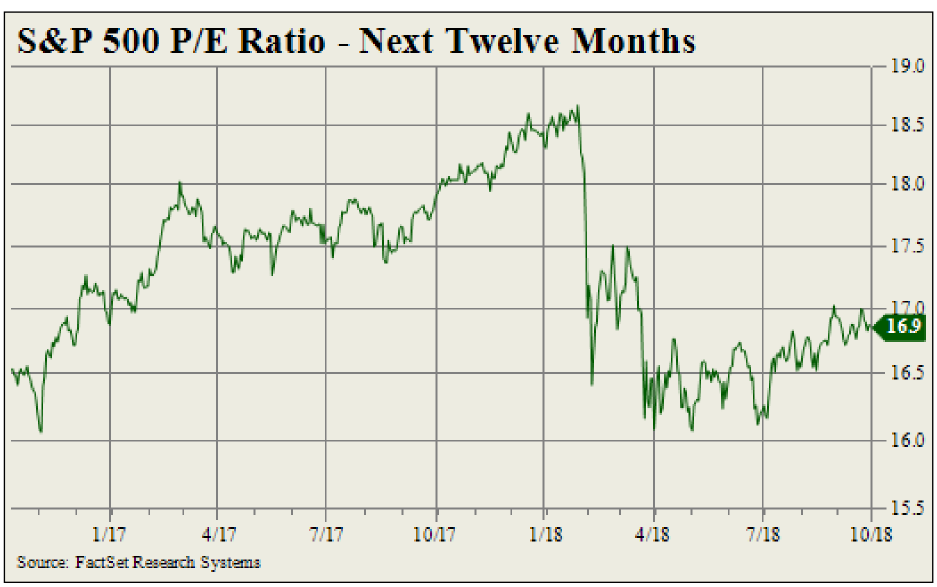
Source: Strategas Research Partners

EQUITIES

- Index providers such as Standard & Poor's and MSCI made sweeping changes to the Global Industry Classification Standards (GICS) to better organize companies based on their core operations and revenue generation. A new Communication Services Sector was created to replace the Telecommunications Sector, the smallest sector in the S&P 500. As a result, 22 S&P 500 companies worth a collective $2.7 trillion were shifted from the Technology and Consumer Discretionary Sectors to the new Communication Services Sector. One company, eBay Inc., was shifted from the Technology Sector to the Consumer Discretionary Sector. As part of this shift, providers of exchange-traded funds (ETFs) were compelled to buy and sell more than $20 billion of the affected stocks.



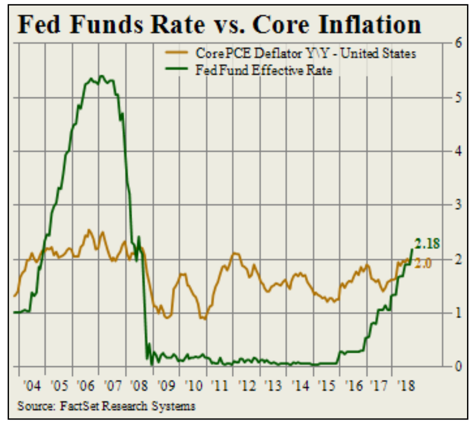
- Second quarter earnings growth of 24.9% for S&P 500 companies nearly matched the first quarter's growth rate of 25.0%, the strongest since the third quarter of 2010. Top-line revenue growth in the second quarter was 9.9%, the strongest since the third quarter of 2011. As of September 28, third quarter earnings growth expectations were projected at 19.1%. Seven of the 11 sectors are projected to report double-digit earnings growth. However, of the 98 companies that issued earnings per share guidance for the third quarter, 74 (76%) were negative, which is above the five-year mean of 71%. Recently, many companies have been negatively impacted by parts shortages brought on by years of making supply chains as lean and efficient as possible. As a result, many suppliers have been unable to keep up with demand, which has led to higher costs and in some cases forced end customers to idle production as they wait for parts to arrive. Concerns about slowing earnings growth have resulted in the S&P 500 trading at a lower multiple of earnings; the price-to-earnings (P/E) ratio of the S&P 500 was 18.7x next twelve months earnings on January 26, 2018 but closed the third quarter at 16.9x next twelve months earnings.



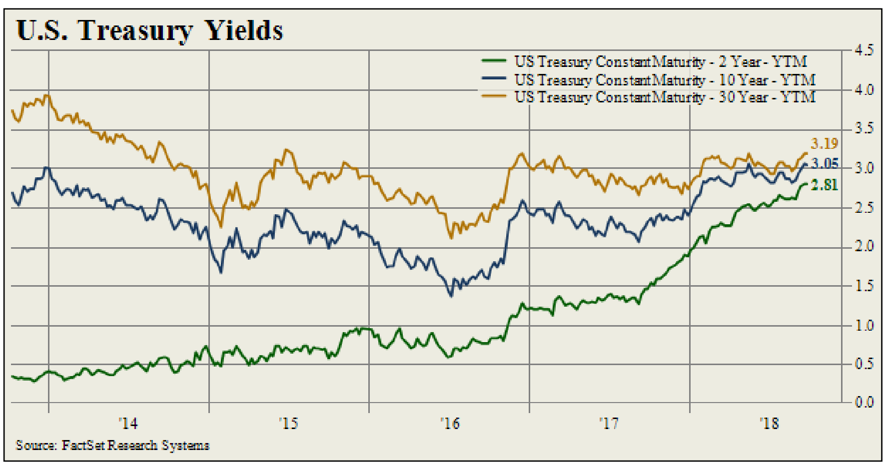
FIXED INCOME

- Fixed income markets continued to lag in the third quarter amid a backdrop of increasing interest rates. As measured by BofA-ML indices, U.S. Treasuries (USTs) in aggregate returned -0.7% for the quarter. Interest rate sensitive long-term corporate and government bonds with over 10 years until maturity also lost 0.7%, while short-term corporate and government bonds with one to three years until maturity offered a 0.4% total return.

- The Federal Open Market Committee (FOMC) opted to increase the federal funds rate in September, a well-telegraphed and anticipated move. This decision took the target federal funds rate to a range of 2.00-2.25%, while the Federal Reserve's (Fed's) preferred measure of inflation, the Core PCE Deflator, increased 2.0% year-over-year (YOY) in August. Unless inflation increases unexpectedly to end the year, this would mark the first time the "real" (inflation-adjusted) federal funds rate was positive since 2008. While the FOMC is projecting another rate increase in December and three additional increases in 2019, the UST market is priced for only two to three increases through 2019.



- As the Fed continues to pressure short-term rates with actual and projected fed funds rate increases, longer-term yields have increased as well, albeit at a slower rate. The 10-year UST yield surged back above 3% during the quarter, ending September at 3.05%. This marks the first time the 10-year UST has ended a quarter yielding over 3% since December 2013 and the second time since 2011. 30-year UST yields remain under pressure due to secular long-term growth concerns but still reached their highest level since 2014, closing the quarter at 3.19%.

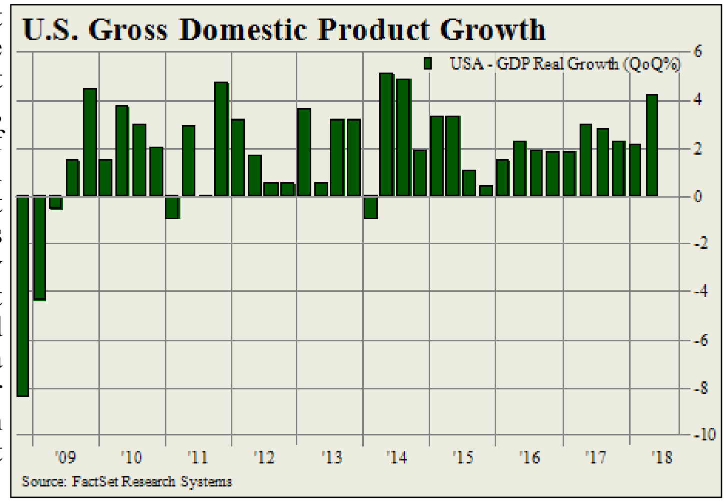


- After widening through the first half of the year, credit spreads (the yield differential between corporate and government bonds) declined through the third quarter, providing relative strength in the corporate bond market. Corporate bonds provided a 1.0% return for the quarter, reducing their YTD loss to 2.2%. Treasuries are still outperforming for the year, however, losing 1.8% YTD. The high-yield (junk) bond market has provided more shelter from increasing interest rates, generating a 2.4% total return for the quarter and 2.5% total return for the year.

- Spreads between 10-year UST yields and 10-year German bund yields remained close to their highest level since the 1980s. Even though spreads to 10-year Japanese bonds remained near their highest level since 2007 as well, foreign demand for USTs has remained low. Issuance of USTs has increased to finance the Tax Cuts and Jobs Act, but foreign holdings of such securities have remained relatively flat. While this is in part due to international concerns over the level of U.S. borrowing, other factors appear to be in play as well. The strong U.S. dollar has created an environment where hedging the currency risk associated with investing in USTs has become increasingly expensive for foreign investors, further reducing demand and putting upward pressure on interest rates.

ECONOMICS

- Real growth in U.S. Gross Domestic Product (GDP) reached an annual rate of 4.2% in the second quarter (latest available), its highest level in four years. Consumer spending, which accounts for roughly two-thirds of GDP, was the largest catalyst, posting annual growth of 3.8%. Strong business investment and a narrowing trade deficit (total exports minus total imports) were the other primary growth drivers. A reversal in the trade deficit is anticipated in the coming months, and although growth is expected to cool as a result, the consensus expectation of 3.2% for third quarter GDP still reflects strength relative to previous quarters of the current expansion.

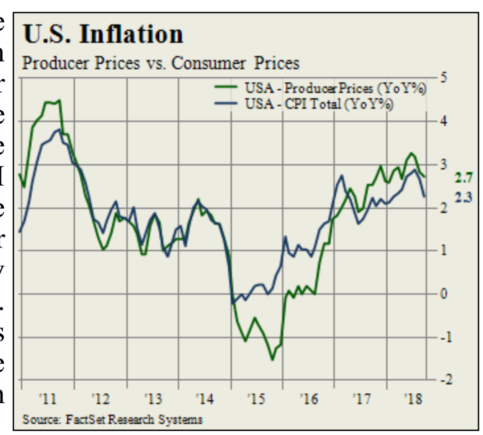


- In April, job openings exceeded those seeking employment for the first time since the Labor Department began tracking the ratio in 2000. That trend continued into the third quarter. The ratio hit its lowest level on record (0.9 unemployed persons per job opening) in July as 650,000 positions remained unfilled, and those filing new claims for unemployment reached a 49-year low. Manufacturing and skilled labor jobs such as construction showed notable strength in the last two months of the quarter while retail jobs lagged.

- With tightening in the labor market has come steady inflationary pressure on wages. Average hourly earnings growth ticked up 0.3% for the month to hit a YOY rate of 2.9% in August, its highest yearly rate since June 2009. September followed suit at 0.3% despite some displacement from Hurricane Florence but narrowly missed expectations on a yearly basis at 2.8%. Additionally, labor productivity increases have been positive thus far in 2018, as increases in output have outpaced increases in hours worked. In all, the labor market continues to be at the forefront of positive news for the U.S. economy.

- Consumers and business owners remained optimistic throughout the third quarter as job growth, a strong economy, and a positive outlook on business conditions continued to squelch concerns over tariffs and the potential for a tightening labor market to overheat the economy. Consumer confidence hit an 18-year high in the third quarter, and small business confidence matched its previous record high set in the first quarter of this year. While household borrowing reached $13.3 trillion, stock market and real estate value gains and an increased personal savings rate drove household net worth to a record of nearly $107 trillion by the end of the second quarter.

- While a tight labor market and strong economic growth have caused inflationary wage pressure, supply chain prices have been less intensive. Price inflation on both the producer and consumer sides moderated as the third quarter progressed. In August, the Producer Price Index (PPI) experienced its first monthly decline (-0.1%) since February 2017. Over the last twelve months, PPI increased 2.8%, significantly below estimates of 3.2%. On the other side, the Consumer Price Index (CPI) increased 0.2% over the month of August for a YOY growth rate of 2.7%, slightly below expectations at both the monthly and annual level. Historically, an inverse relationship has existed between changes in unemployment and inflation – a relationship referred to as the "Phillips Curve." Given historical norms, one may expect inflation to be running higher given current employment conditions.



U.S. China: Escalating Trade Tensions

U.S. trade with China has escalated from a tit-for-tat dispute to what some now consider a trade war. In September, the U.S. imposed 10% tariffs on $200 billion of exported Chinese goods after imposing 25% tariffs on $50 billion of their exports in July and August. China retaliated as expected, imposing 25% tariffs on $50 billion of U.S. exports to China and 5% to 10% tariffs on another $60 billion of U.S. exports. The Trump Administration threatened to raise the tariffs to 25% on the latest $200 billion of goods in 2019 and on the remaining goods exported to the U.S. out of China, which could exceed $250 billion.

From multiple perspectives, it appears that the U.S. has a distinct advantage in a trade war with China. The U.S. imported $505.5 billion of goods from China in 2017 and exported $130 billion of goods to China. Currently, only about $20 billion of U.S. exports to China are not subject to tariffs, far below the $250 billion in remaining Chinese exports not subject to U.S. tariffs. The Trump Administration believes this one-sided goods trade deficit gives the U.S. an advantage since China has much more to lose.

Economically, the U.S. appears better able than China to withstand a trade war. The U.S. has economic momentum as reflected in second quarter GDP growth of 4.2% and above-average economic growth in the last five quarters. Manufacturing output is booming, labor markets are the strongest they have been in a generation, wage growth is accelerating, productivity has improved, corporate capital investment has increased, and inflation is moderate. The strong trends in the U.S. economy are expected to continue through 2019. On the other hand, while China's economic growth rate is the envy of developed countries, its momentum is slowing; 6.8% in the first quarter, 6.7% in the second quarter, and an estimated growth rate of 6.3% next year. For years, China's economic growth model was based upon exports, housing, and infrastructure spending, and supported by massive amounts of debt by local and provincial governments and state-owned corporations. The last four years, China has instead emphasized domestic personal consumption, which has now become the biggest driver of its GDP growth. However, China's household debt is soaring. The country's ratio of household debt to GDP hit a high of 50% in 2017, an increase of 20 percentage points over the last five years. When combined with local government and state-owned corporate debt, China's total debt is now problematically at 270% of its GDP. The absolute level of debt to GDP is not the primary problem; its the rapidity with which the debt has increased. The Chinese government was in the process of slowing down the growth rate of debt but had to relent due to increasing trade tensions with the U.S. Now, they are stimulating the economy with easier monetary and fiscal policies. This momentum differential between U.S. and Chinese economies has been reflected in the financial markets. The U.S. stock market hit record highs in August and September, while China's stock markets have been in bear territory, falling by more than 20%. Currencies provide a similar view, with the Chinese yuan depreciating nearly 10% relative to the U.S. dollar in recent months.

The U.S. has another economic advantage relative to China due to the smaller overall role foreign trade plays in its economy; U.S. goods exports are 8% of GDP and imports 12%, while China exports 18% of its GDP and imports 12%. China's economy is much smaller than the U.S. economy, but it has been the largest exporter in the world since replacing Germany in 2009. China has also become the largest trading nation in the world, a position previously held by the U.S. China's attempt to redirect its economy to a consumption-based economy has successfully caused exports as a percent of GDP to fall by nearly 50% in the last decade. Fixed asset investment (machinery, equipment, etc.) has also declined to 18-year lows. In the process, China's trade surplus with the U.S. has fallen from 6% of its GDP a decade ago to 3% today and its share of global trade has also fallen in recent years.

While the U.S. appears to have an economic advantage, narrowing the trade deficit with China is much more complicated. Foreign-owned or foreign-invested companies account for 43% of China's exports. For example, Foxconn, Apple's longest running partner in building iPhones, currently assembles most of the phones in Shenzhen, China. Also, 13 of the top 20 exporters from China are foreign. In addition, corporate supply chains have globalized in recent decades and China plays a prominent role in most global supply chains. Tariffs will not impact them much in the short-term since it will take years to relocate and develop new suppliers. Inflation in the U.S. could rise as consumers could be forced to buy more expensive goods not made in China. Further, a U.S. priority is the denuclearization of the Korean peninsula and China is the only country with much leverage on North Korea. A trade war will not motivate China to help with this endeavor. China also has a "nuclear" option in its arsenal since it is the largest foreign owner of U.S. Treasury securities ($1.1 trillion). Dumping them on the market, while costly for China, would raise U.S. interest rates and disrupt global bond markets. China could also pursue non-tariff barriers that are often just as effective as tariffs; fostering patriotic consumers, requiring obedient bureaucrats to inspect 100% of all imports making it less timely and more expensive for U.S. products to reach Chinese buyers, hampering foreign corporate activities, or unfairly manipulating their currency to make Chinese goods cheaper and buoy exports.

Another complicating factor is whether China is able to change its foreign trade policies and practices as the U.S. would like by reducing their trade surplus (import more/export less). Wages in China have tripled in the last decade, forcing China to de-emphasize the production of low-end goods and move to middle-range goods. China is following the typical path of countries such as Japan and South Korea by moving up the value chain as their economies develop. China has become the dominant producer in medium-high-tech industries, with its global share tripling in the past decade to 32% according to the National Science Board. They surpassed the U.S. in this category in 2009. Production of lower-cost goods such as footwear and textiles are rapidly moving to lower-wage countries such as Vietnam. Much of the movement has been to more sophisticated telecommunications and transportation equipment and auto parts, which play a much more prominent role in global supply chains.

China's ambition to move further up the value chain is of even greater concern to the U.S. than the trade deficit. The goal of "Made in China 2025" is for China to become the global leader dominating some of the world's most advanced technologies (e.g. artificial intelligence, robotics), where they barely have a presence in export markets today. The U.S. and other countries, including those in the Eurozone, believe that China has moved up the value chain thus far by the theft of intellectual property. These countries are convinced China has forced intellectual property transfers by permitting foreign companies access to the Chinese domestic market only through the formation of joint ventures with Chinese companies, giving those companies access to foreign technology.

How strained trade relations progress between the U.S. and China is highly uncertain. It is too soon to know what the effect will be from the recently imposed tariffs on $200 billion of Chinese exports and if indeed the tariffs will be raised to 25%. For the foreseeable future, the U.S. does not have the needed workers to replace Chinese exports to the U.S. nor does it currently have the industrial capacity. Businesses will not invest unless they think the tariffs are permanent. Thus, total disengagement with China on trade is probably not possible in the short-term but might be in the long-term. Jack Ma, founder of Alibaba, thinks a trade war could last 20 years. Politics also play a role here as President Trump will be around for two or six more years. Meanwhile, President Xi Jinping has eliminated term limits for Chinese presidents and may be around for 20 years. According to Wang Yong, Director of the Center for International Political Economy at Peking University, "You have an economic relationship which is valued at nearly $700 billion and that is more than any bilateral relationship has ever involved. So the two countries are mutually dependent." Wang believes economic interdependence will eventually win out. For that to occur, at a minimum, China should be forced to end its parasitic approach to gaining dominance in the world by intellectual property theft and industrial espionage.
