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MARKET COMMENTARY - OCTOBER 2019

Emotions & Contradictions

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WHAT'S INSIDE? A SUMMARY OF TOPICS WE ADDRESS

1) Investors and markets can be irrational. The phenomenon of behavioral economics/finance creates opportunities for those that can look beyond biases and manage mental shortcuts. We highlight several entertaining and important biases.
2) Trade tensions, geo-politics, political unknowns and soft economic news is creating volatility. Add to this list that we are amidst the longest economic recovery ever albeit the slowest since WWII. While a historical comparison of cumulative growth suggests there is more room on the road ahead, we should focus on cause and effect relationships.
3) Monetary policies of central banks are accommodative for economic growth. However, negative and low interest rates give the appearance of exhaustion with growth expectations declining and a soft-patch of economic news.
4) The yield curve inverted in the U.S. during the third quarter. We highlight why this may not be as serious of a concern for a recession.
5) Inflation is stubbornly low. The Federal Reserve should get comfortable with this. Prepare for lower for longer interest rates. This has negative ramifications for those in retirement.
6) The U.S. consumer is powering through – unemployment is low, wages are growing, debt service levels are manageable and net worth is at record highs. The U.S. consumer is the largest portion of the global economy and approximately 70%of the U.S. itself.
7) Government fiscal policies are increasing and may be a helpful ingredient to sustain economic growth here and abroad.
8) Many investors in the U.S. are excited about patriotism, yet concerned about tariffs. Does this mean we should abandon international investment opportunities? A closer look at home bias and the opportunities may surprise you.
9) Market Recap – We provide a market recap. It's been an impressive year-to-date period. However, volatility is back!
10) Portfolio Implications – There are so many moving pieces. We read between the lines of news events and provide implications and recommendations regarding how portfolios should be positioned.

Emotional. Irrational. These are often characteristics that define markets, particularly in the short-term. Being that markets are made of investors that are human, it is wise to study the nature of human decision making, particularly relating to biases and mental heuristics (ie., error- making mental shortcuts) when making investment decisions. This is known as the field of behavioral economics/finance that has won several Nobel prizes in economics, including Richard Thaler (2017) and Daniel Kahneman (2002).

Understanding behavioral biases and how they can impact decision-making is important to successful investing. Behavioral biases have caused many people to say, "Markets are at all-time highs. I think we are going to have a correction," or "I'm concerned about tariffs, so I don't want to own any international stocks." These are many of the types of questions that we receive that are often based on biases or mental shortcuts.

While behavioral finance may sound like heady stuff – and it is – it is something that afflicts everyone. Bias is rooted in how our brains function. Here are two basic, but interesting examples:

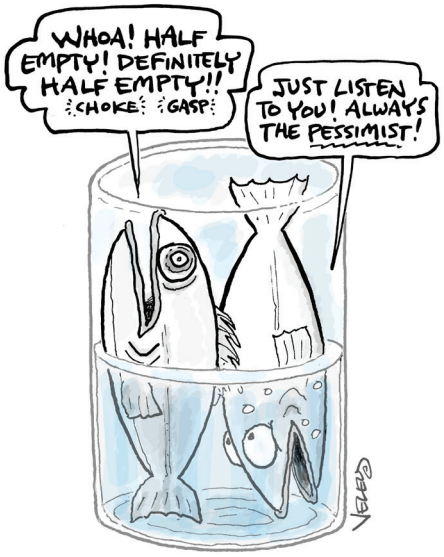
Overconfidence Bias – When asking a large group of people if they are better than average in their jobs or at driving a car, approximately 75% of people usually say they are above average. This is simply mathematically impossible and demonstrates that overconfidence can impact decision-making.

Bandwagon (Groupthink) Bias – This is a bias borne out of people framing an issue based on the feedback of those around them or those with the same perspective without applying critical thinking. Perhaps one of the greatest examples of this is the Tulip mania that occurred in Holland in the early 1600s. People became so enamored with tulips that prices of tulip bulbs exceeded 10x the average annual income of a skilled crafts worker. And, Holland had one of the highest per capita income levels at the time. Today, speculative bubbles and manias in markets are often compared to this irrational episode.

As the cartoon to the right illustrates sometimes markets become irrational due to pundits talking up the most optimistic or pessimistic of situations, often for their own benefit. This leads to camps with built in "half-full" or "half-empty" views. It can leave people wondering what's actually good and bad. For example, aren't low interest rates good? Not necessarily. Depends on your perspective. More on that later.

While these behaviors make us scratch our heads, they can create risks and opportunities in the markets. In this market commentary we take a look at several contradictions that allow us to see through the crowd noise and biases and focus on the fundamentals.

EXHIBIT 1: OPTIMISM & PESSIMISM – WHAT'S GOOD? WHAT'S BAD?



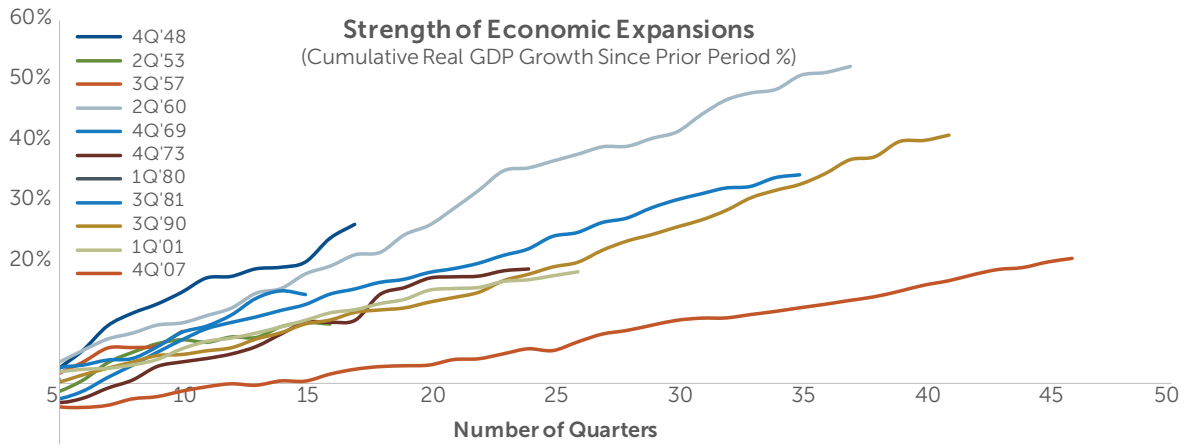
Source: Cartoonstock.

Economic Backdrop

While we don't see many traditional sign-posts of a recession, we are in an environment of extraordinary disruptions, politics, and policies. This environment leads to high levels of uncertainty and less room for error. As we highlighted in our last Quarterly Market Commentary, contributing to this predicament is the concern for the age of the current U.S. economic expansion. The U.S. economy is now amidst the longest expansion in history. For some this would suggest we are due for a recession. However, that view would not be based on a critical evaluation of causes and effects. So, let's take a closer look.

While today's expansion is the longest, it has been the slowest since World War II, and has occurred following the deepest recession over that same time period. As Exhibit 2 illustrates, we have captured less than 50% of total economic growth (i.e., gross domestic production or GDP) relative to the two other longest expansions. Based on this comparison, there appears to be more room on the economic runway ahead.

EXHIBIT 2: U.S. EXPANSION - LONG AND SLOW



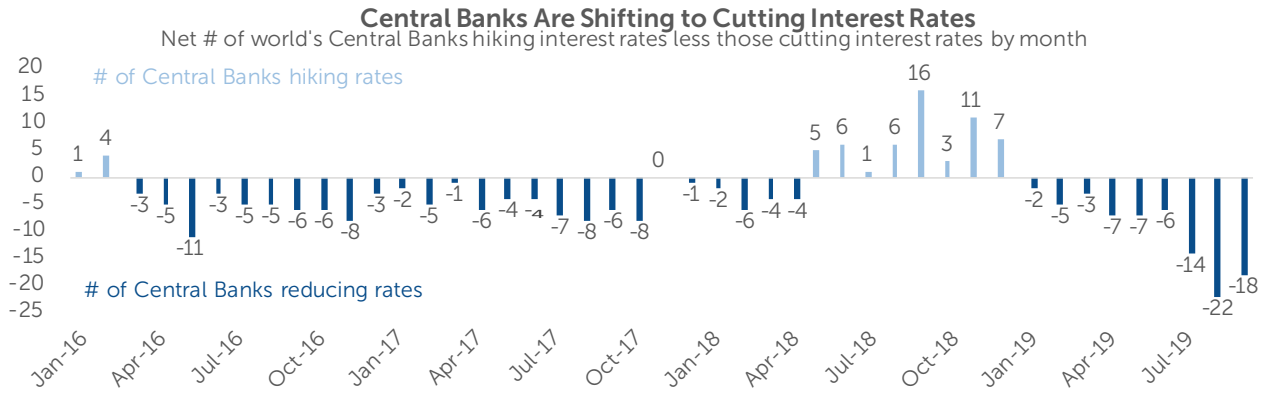
Source: National Bureau of Economic Research. Data as of 9/30/2019.

While many glass-half-empty prognosticators are suggesting the odds of a recession have increased in recent months, we find that there is more good than bad and remain cautiously optimistic. Let's take a closer look at some of the major themes that are playing out and how they define where we are and where we may be heading.

Accomodative Monetary Policy

Central banks across the globe have been cutting interest rates from already accommodative levels. In fact, after a period of more increases than decreases in interest rates during much of 2018, we are now experiencing a significantly larger number of interest rate reductions. See Exhibit 3. In fact, after eight rate hikes beginning in December of 2015, the U.S. Federal Reserve has now cut rates twice this year. Not only do rate cuts provide stimulus for the economy, the already low levels are also accommodative for economic growth.

EXHIBIT 3: CENTRAL BANK MONETARY POLICY EASING



Source: Schwab.

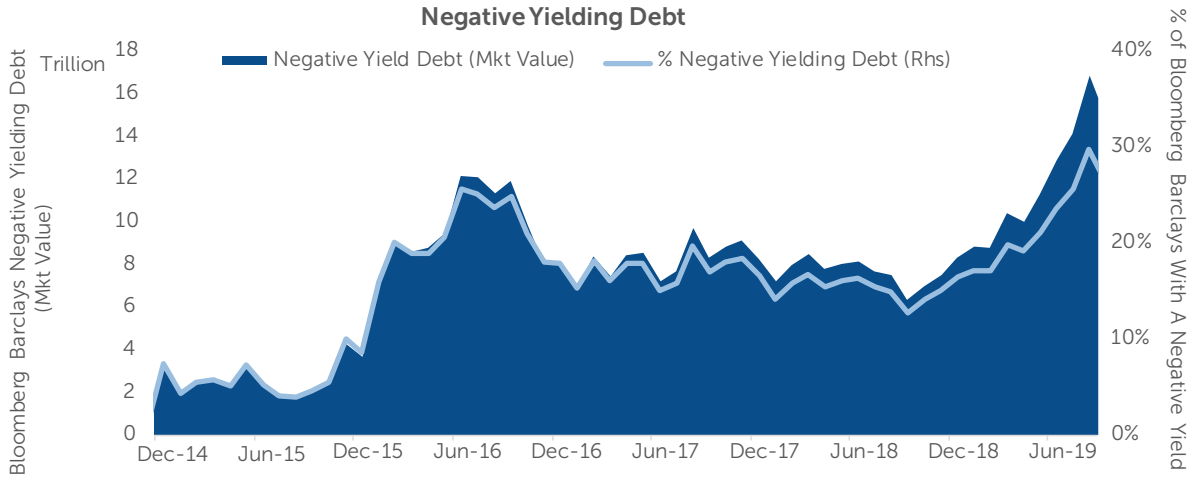
However, this is not necessarily translating into robust economic growth. While it is traditionally accepted that it takes approximately 12 months for interest rate cuts to impact an economy, economic growth is tepid and slowing. In fact, the International Monetary Fund (IMF) has downgraded global and U.S. economic growth. The IMF is an organization of approximately 190 countries working in cooperation to foster global economic growth and stability.

In the spirit of highlighting contradictions, low interest rates sound great for stimulating loan growth and an economy, but it is harmful to those relying on income either for funding projects or for living in retirement. Something else needs to stimulate growth.

Central banks have been telegraphing the message that they can't be the only support for economies. Consider the following:

- A large portion (Exhibit 4) of foreign governments have negative yielding rates. This is a sign that interest rate cuts and low rates may not be enough and that monetary policy may be exhausted.
- Austerity measures from governments coming out of the Great Recession, which actually hurt low and middle-income citizens, are crumbling to the pressures of populism.
- The outgoing and new incoming European Central Bank presidents are suggesting more support and government spending from European governments.
- A U.S. Federal Reserve board member recently stated that companies aren't having problems obtaining low interest rate loans. Rather, companies are showing reservations to borrow and invest based on the unknowns around trade tariff policies as an example.

EXHIBIT 4: FIXED INCOME MARKETS ARE BEING DISRUPTED BY NEGATIVE YIELDS



Source: Bloomberg.

Before we address the fiscal policy environment as potential support, we would be remiss to not discuss the recent yield curve inversion and the impact of inflation. The Fed has played a role in this dynamic.

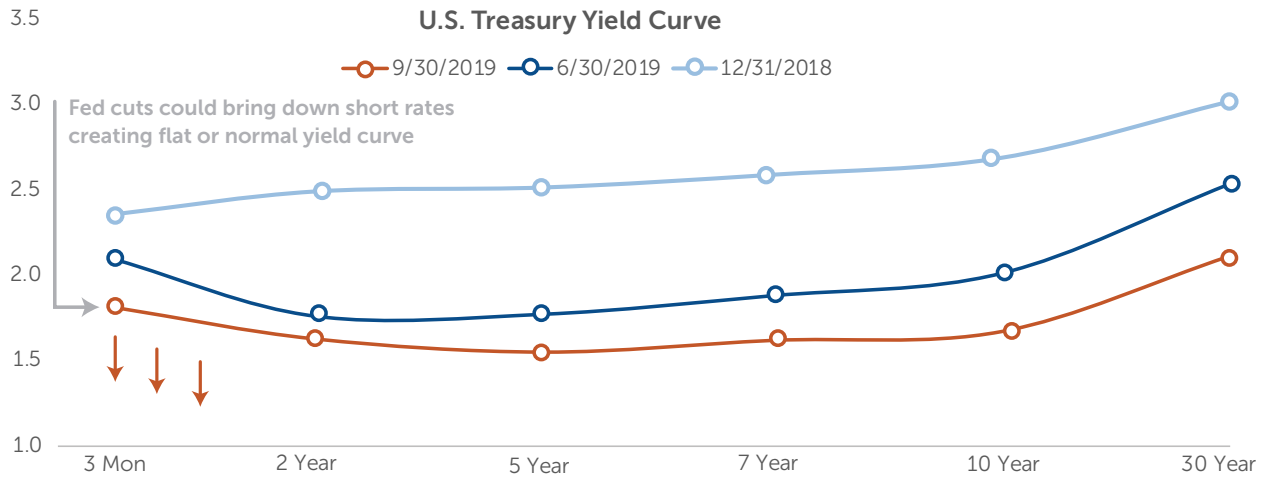
Parabolic Interest Rates & The Yield Curve

Interest rates went parabolic during the third quarter with the 10-year Treasury rate dropping from 2.0% on July 1st to bottoming on September 3rd at a paltry 1.46%. Considering that the Federal Reserve increased short-term Fed Funds rates twice last year, this move by the market to lower longer-term U.S. rates caused alarm. Furthermore, it took the yield curve inversion conversation to another level. Let's take a closer look.

This move drove U.S. interest rates into an official yield curve inversion with the 10-year U.S. Treasury bond yielding less than its 2-year equivalent and less than inflation and the Fed Funds rate – a very rare occurrence. (The Fed Funds Rate is the interest rate at which banks lend money to each other, usually on an overnight basis).

This also led to talk of an imminent recession. A yield curve inversion suggests monetary tightening, restrictive lending and, consequently, slow economic growth and/or a recession. Okay, not so fast. A closer look at the inversion suggests folks shouldn't jump the gun. The stock market generally continues to increase after an inversion. And, the spread between the 2-year and 10-year is now back in positive territory. And, there is a growing economic view that an inverted yield curve is actually much less concerning when interest rates are so low.

EXHIBIT 5: YIELD CURVE INVERSION WATCH



Source: Bloomberg.

Furthermore, I would add that when the curve inverts it is generally a sign that the Fed has made a policy error. They tend to continue with the error into a recession. With the Fed's moves to cut rates, it is highly possible that they averted such an error that could create the next recession. Time will tell.

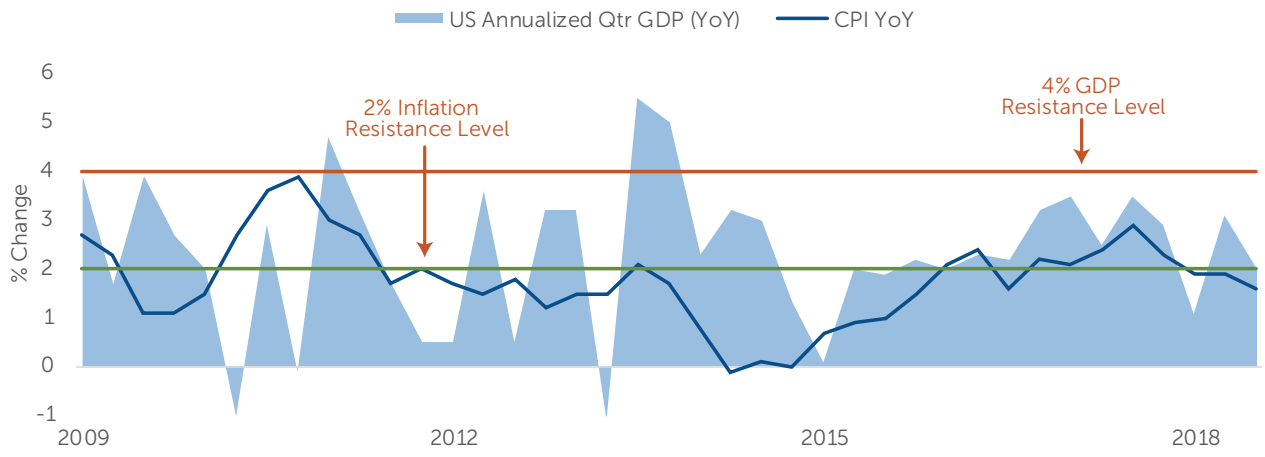
Inflation, GDP & Proper Expectations

Central banks, including the U.S. Federal Reserve, are intensely focused on maintaining a healthy level of inflation. This requires economic growth (i.e. Gross Domestic Production or GDP), so the Federal Reserve has been attempting to keep interest rates low in order to manage inflation up to a 2% target. However, as Exhibit 6 highlights, an inflation level above 2% in the U.S. is hard to maintain. There are many reasons for this, including disinflationary pressures due to technologic disruptions (i.e., goods and services are displaced by cheaper alternatives, or costs decline due to productivity enhancements).

Nonetheless, the Fed will most likely have to come to grips that inflation of 2% may be hard to maintain. This is one reason why we believe interest rates will be low for a long time to come.

GDP growth is also struggling to reach higher levels. In fact, real GDP of 4% has been hard to come by. More recently, the Fed raised rates twice in 2018 based on fiscal stimulus from U.S. tax cuts boosting domestic GDP growth to above 3% for a period of time, however expectations are for slower growth around 2% for the second half of 2019. The trade war has damaged capital expenditure plans, which negatively impacts manufacturing, which in turn can negatively impact corporate earnings, hiring, and wages and overall economic growth. In fact, the Atlanta Fed's tracking estimate for U.S. real GDP in the third quarter of 2019 was 1.8%.

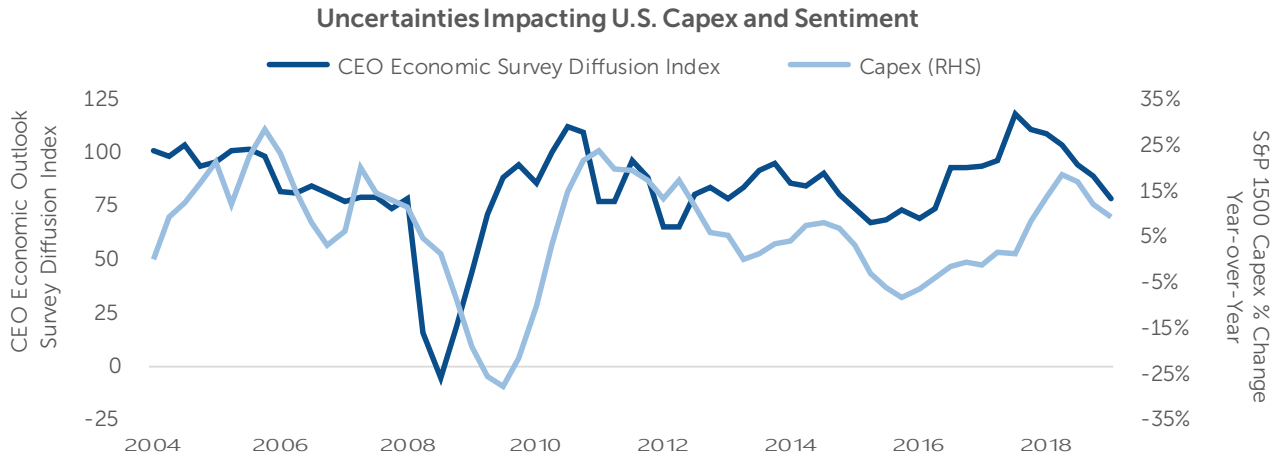
EXHIBIT 6: INFLATION & GDP – HARD TO MANAGE



Source: Bloomberg.

Looking at the current environment we note that animal spirits appear to be dampened as actual capital expenditures have declined recently. Moreover, forward-looking surveys of sentiment (i.e., corporate confidence and capex plans) has hooked much lower. Both of these issues are illustrated in Exhibit 7. These issues have translated to other recent concerning economic numbers. Providing we climb the wall of worries, uncertainties such as trade agreements are removed, and animal spirits return, then capex could help elongate the current economic expansion and support market prices.

EXHIBIT 7: UNCERTAINTIES IMPACTING SENTIMENT AND U.S. CAPEX



Source: Bloomberg, Business Roundtable (as of 9/30/2019)

Eyes are turning more and toward fiscal policies.

Increasing Fiscal Policy

In tandem with central bank monetary policies, governments are also increasing fiscal stimulus either through tax cuts, spending , etc. Exhibit 8 illustrates fiscal stimulus announcements just since the August 2019 Jackson Hole Symposium, an annual event focusing on an important economic issue facing world economies.

EXHIBIT 8: FISCAL POLICY ANNOUNCEMENTS PICKING UP

# of Countries Announcing Fiscal Stimulus Since Jackson Hole Symposium	Country	Date	Fiscal Stimulus
1	Indonesia	Aug-19	The President of Indonesia proposed a 2020 budget 3% larger than 2019's, reflecting an increase of about 8% of actual spending (according to the latest government estimates).
2	Finland	Aug-19	Finland's unveiled fiscal stimulus plans for 2020 include a budget deficit of 2.3 billion euros, a modest increase from the deficit target of 1.7 billion in 2019.
3	South Korea	Aug-19	South Korea drafted its most expansionary budget since the 2008-09 global financial crisis, with an 8% boost to spending focused on creating jobs, expanding welfare and developing new drivers of growth.
4	Japan	Sept-19	Japan's finance ministry submitted a record budget request for 2020, while spending on the 2020 Tokyo Olympics continues to climb.
5	Germany	Sept-19	A 54 billion euro climate change spending package for 2020 - 2023 was unveiled. Additionally, the Finance minister has discussed the subject of tax cuts.
6	Netherlands	Sept-19	The Dutch government presented its plan to cut corporate tax rates in the lower House, which lowers the tax rate on the first 200,000 euros of taxable profits from 19% in 2019 down to 16.5% in 2020 (and further down to 15% in 2021).
7	India	Sept-19	India announced a surprise cut to the corporate tax rate from 30% to 22%, amounting to approximately 0.7% of India's GDP.
8	France	Sept-19	The French government's 2020 budget includes over 10 billion euros in new tax cuts, primarily paid for by lower borrowing costs thanks to low interest rates.

Source: Bloomberg.

Regarding the second largest global economy (not listed in Exhibit 8), China has already made stimulus moves focused on bank lending, borrowing cost, tax cuts and local government bond issuance to fund infrastructure projects, and more stimulus is expected. In September, the People's Bank of China announced measures that would free up nearly $126B for loans, which follows a package of roughly $40B in May and $112B in January. In July 2019, China's economy recorded its slowest rate of economic growth in almost three decades as the government aims to shift toward a domestic consumption based economy while dealing with trade cross-currents.

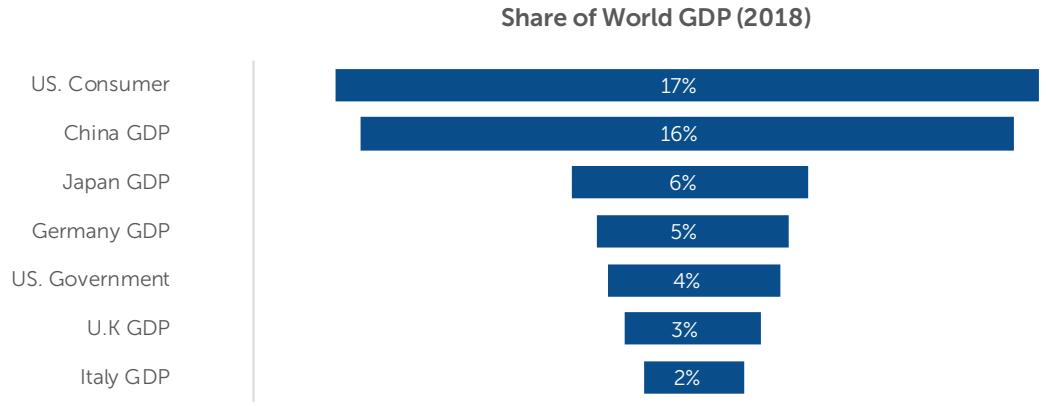
Furthermore, the final outcome of Brexit, new leadership developments in the European Union and the European Central Bank are a few other issues worth watching. As such, we suspect new fiscal spending may be the appeasement path politicians take that could also support economies and equity markets.

U.S. Consumer Powering Through

Despite recent soft and disappointing macro-economic news, the U.S. consumer is powering through. Unemployment is low. Wages are growing, albeit slowly. Debt servicing levels are good. Consumer net worth is near record highs. These trends should allow the U.S. consumer to remain resilient. This translates into healthy consumption. And, since the U.S. consumer makes up nearly 70% of the U.S. economy, this bodes well for continued positive economic growth.

As Exhibit 9 on the following page shows the U.S. consumer is actually a larger share of the overall global economy than all the other major economies.

EXHIBIT 9: U.S. CONSUMER IS A WORK HORSE



Source: Bloomberg.

Familiarity/Home Bias - International Highlight

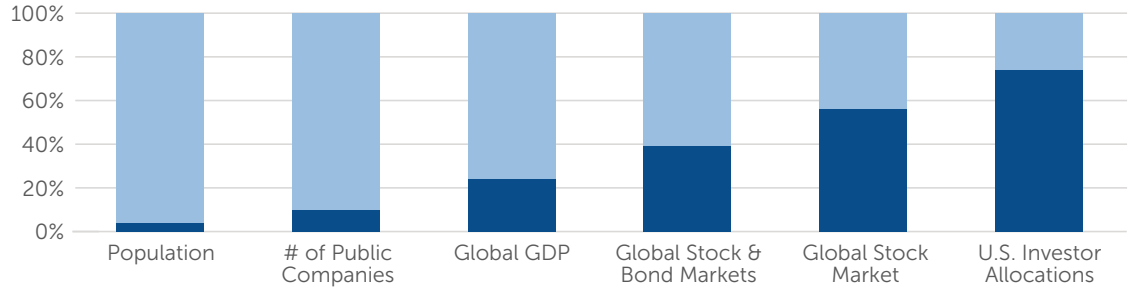
Many investors have expressed concerns over international markets, based either on tariff noise or U.S. patriotism excitement. While patriotism is something we all share, avoiding international markets due to a protectionist or nationalistic view is short-sighted from an investment standpoint. After all, many of the successes we have as a domestic economy are based on our relations with other countries and their consumption of our products and services or their inclusion in our supply chain for production.

The avoidance of investments that we either don't understand or are less familiar with is a classic form of familiarity or home bias. It exists within all humans and applies to others living in other countries as well. However, from a pure investment perspective, investing in international markets makes considerable sense.

There are several fundamental issues to consider before making an emotional decision to avoid international equities, as many investors considered doing after the last U.S. election. Consider this context. The U.S. only represents 4% of world's population, 10% of the world's publicly traded companies, 24% of world's economy, and 56% of its total stock market. However, as shown in Exhibit 10, U.S. investors allocate a disproportionate 74% of their overall equity allocation to the U.S.

We highlight some of the positive fundamentals for international markets in the Portfolio Implications section.

EXHIBIT 10: U.S. INVESTORS SHOW HOME BIAS DESPITE MORE OPPORTUNITIES ELSEWHERE



	Population	# of Public Companies	Global GDP	Global Stock & Bond Markets	Global Stock Market	U.S. Investor Allocations
International	96%	90%	76%	61%	44%	26%
U.S.	4%	10%	24%	39%	56%	74%

Source: Bloomberg, Business Roundtable, (as of 2/28/2019)

MARKET RECAP

Global equity markets had a bumpy ride during the quarter after investors were unimpressed by the Fed's language around its 25 basis point cut at the end of July, followed by a presidential tweet on August 1 announcing more tariffs, swift retaliation by China, and yet another tariff-raising tweet. By the end of August, trade tensions had cooled somewhat, but the damage to most equity markets was done.

While U.S. large cap stocks, as represented by the S&P 500 recovered enough to gain 1.7% in the third quarter, foreign equity markets did not fully recover with developed markets down 1.0% and emerging markets down 4.2% over the same period. These divergent returns highlight that, while the U.S. consumer is still in good shape, weakness in global trade and manufacturing is dampening the outlook for global growth.

A similar story presented itself in the fixed income markets, but in the opposite way. As shown earlier in Exhibit 3, there have been a significant net number of central bank interest rates cuts in response to the tepid growth outlook based largely on tariff concerns. As such, interest rates decreased dramatically across the globe throughout August specifically and the quarter over all. This decrease was especially felt in the U.S., where rates had farther to fall relative to other developed countries, briefly driving the 10-year Treasury rate below that of the 2-year rate. This trend reversed somewhat in September, but the Bloomberg Barclays U.S. Aggregate Index still gained 2.3% during the quarter, once again led by corporate credit which gained 3.0%.

Municipal bond yields continued to drift lower, providing total return gains of 6.7% this year through September, against a solid fundamental and technical backdrop. Through September 18, the Investment Company Institute has seen positive inflows into munis every month this year, totaling $72 billion, which is equal to the previous full-year record set back in 2009.

Finally, convertible bonds declined slightly in both the U.S. (-0.3%) and globally (-1.0%) during the third quarter. Generally speaking, convertible bond issuers tend to be smaller companies, and in the U.S., small cap stocks were down 2.4% during the quarter, so this decline is understandable due to the equity-like components of convertible securities.

PORTFOLIO IMPLICATIONS

It appears that we are amidst a domestic economic soft-patch. Economic growth estimates are declining and recent Purchasing Manager Index ("PMI") for Manufacturing data points have dropped below the 50 level (a reading below 50 suggests contraction) in the U.S. with similar readings internationally. On a related note, we expect a softening in domestic corporate earnings for the third quarter. However, there are counterbalancing positive economic numbers, particularly related to the U.S. consumer. And, there are signs that we may be bottoming in many economic indicators, domestically and internationally.

While tariffs and tensions appear to be the main culprit in soft economic data and the biggest threat to the U.S. and global economies going forward, supportive monetary policy and fiscal stimulus throughout the world is likely to help support a continued economic expansion here and abroad - even eclipsing additional recent levels of political uncertainty.

As we have noted before, investors should settle in for continued higher levels of overall volatility and invest accordingly. Pulling all this together, we provide portfolio implications for the following investment categories.

EXHIBIT 11: GLOBAL MARKET RETURNS

EQUITY

World Equity	Q3-'19	YTD	2018	1Yr	3Yr	5Yr
World Equity	0.1%	16.7%	-8.9%	2.0%	10.3%	7.3%
U.S. Equity	**Q3-'19**	**YTD**	**2018**	**1Yr**	**3Yr**	**5Yr**
U.S. Large Cap	1.7%	20.6%	-4.4%	4.2%	13.4%	10.8%
U.S. Small Cap	-2.4%	14.2%	-11.0%	-8.9%	8.2%	8.2%
Non-U.S. Equity (in USD)	**Q3-'19**	**YTD**	**2018**	**1Yr**	**3Yr**	**5Yr**
Int'l Developed	-1.0%	13.4%	-13.3%	-0.8%	7.1%	3.9%
Emerging Markets	-4.2%	6.1%	-14.3%	-1.7%	6.3%	2.7%
Europe	-1.5%	14.2%	-14.3%	-0.1%	7.2%	3.0%
Japan	3.2%	12.0%	-13.2%	-4.6%	6.6%	5.9%
China	-4.7%	7.8%	-18.9%	-3.8%	7.9%	6.2%

CONVERTIBLES

Convertibles	Q3-'19	YTD	2018	1Yr	3Yr	5Yr
U.S. Convertibles	-0.3%	14.4%	-2.0%	3.5%	9.8%	7.4%
Global Convertibles	-1.0%	10.2%	-4.0%	1.5%	7.0%	5.1%

FIXED INCOME

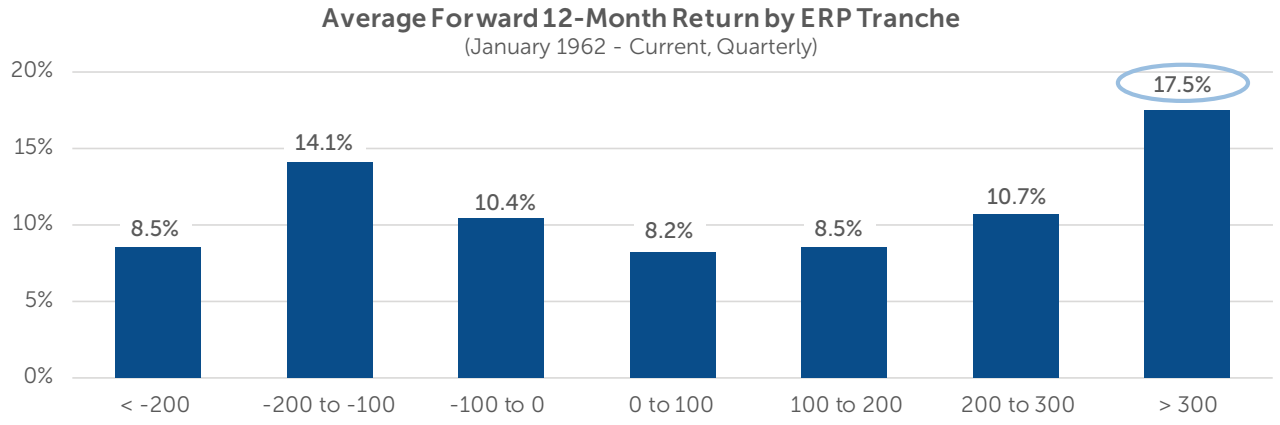
Fixed Income	Q3-'19	YTD	2018	1Yr	3Yr	5Yr
Global Aggregate	0.7%	6.3%	-1.2%	7.6%	1.6%	2.0%
Global Aggregate ex. US	-0.6%	4.4%	-2.1%	5.3%	0.4%	0.9%
U.S. Aggregate	2.3%	8.5%	0.0%	10.3%	2.9%	3.4%
U.S. Corporate	3.0%	13.2%	-2.5%	13.0%	4.5%	4.7%
U.S. Municipal	1.6%	6.7%	1.3%	8.6%	3.2%	3.7%
U.S. High Yield	1.3%	11.4%	-2.1%	6.4%	6.1%	5.4%

Returns for periods greater than 12 months are annualized. **Past performance is no guarantee of future results.** *Source: Bloomberg. As of 9/30/2019. MSCI ACWI, S&P 500, Russell 2000, MSCI EAFE, MSCI EM, MSCI Europe, MSCI Japan, MSCI China, Bloomberg Barclays US Convertibles Composite, Bloomberg Barclays Global Convertibles Composite, Bloomberg Barclays Global Aggregate, Bloomberg Barclays Global Aggregate ex USD, Bloomberg Barclays U.S. Aggregate, Bloomberg Barclays Municipal Bond Index, Bloomberg Barclays US Corporate High Yield.*

Equities

While absolute valuation levels for domestic equities are above historical norms, it is important to compare the landscape of other investment options. As such, stocks continue to be more attractive than bonds. One metric for evaluating these comparisons is the equity risk premium. From a basic standpoint, this measures the difference between the earnings yield of stocks (S&P 500) and bond yields (10-Year U.S. Treasury). This spread is currently clocked in at 344 bps (i.e., 3.4%). Exhibit 12 shows that when the spread is at these levels, the historical average forward 12-month return of the S&P 500 is favorable. While we can't rely solely on this data point, the context is informative.

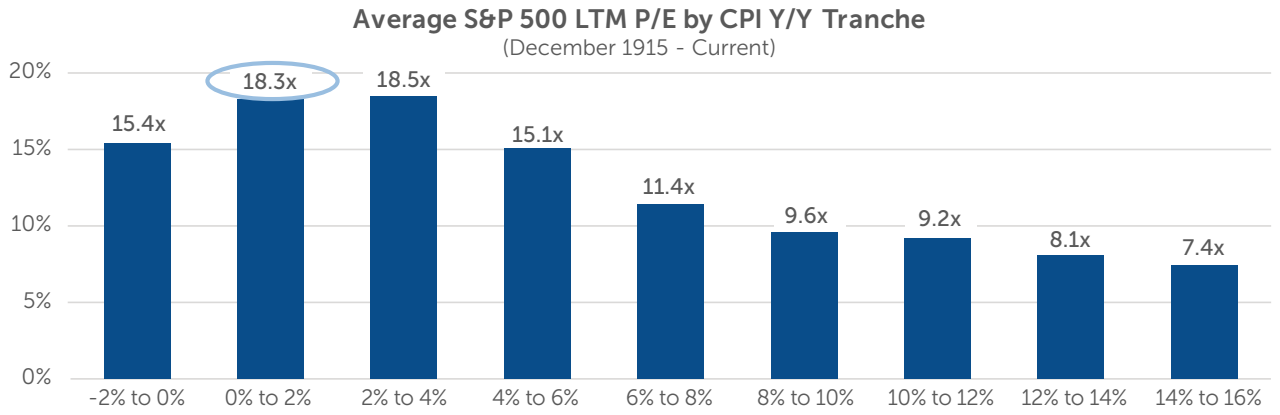
EXHIBIT 12: HISTORICAL S&P 500 RETURNS



Source: Bloomberg. **Past performance is no indicator of future success.** *Data as of 9/30/2019.*

When considering valuation levels it is also important to measure levels relative to inflation. Exhibit 13 illustrates that the historical average price to earnings ratio (P/E) when inflation is in the 0% to 2% tranche is approximately 18.3. With the current trailing PE ratio at approximately 19.6, we are above this historical average. This supports our position that PE multiples are likely capped and further U.S. stock market appreciation may be spotty and will likely be driven by earnings growth. And, when evaluating forward earnings expectations, then these PE valuation levels are more attractive.

EXHIBIT 13: S&P 500 VALUATIONS RELATIVE TO INFLATION



Source: Bloomberg. Data as of 9/30/2019.

International equities provide more attractive absolute and relative valuation levels. Exhibit 14 highlights that international markets are not only cheaper relative to their own historical average (e.g., top rows), but they are also historically cheaper relative to their discounted relationship to domestic equity markets. And, with international markets trailing domestic stock returns on a rolling 10-year basis, the question remains when they will once again take the lead. More importantly, many international managers aren't buying the entire market. Rather, they are buying the best investment opportunities within specific countries. Either way, portfolios should generally include an international equity component.

EXHIBIT 14: INTERNATIONAL EQUITIES PROVIDE MORE ATTRACTIVE VALUATIONS

PRICE TO BOOK VALUE			
Index (Relative to Self)	Current PB	Historical Avg[1]	Ratio
S&P 500	3.4x	3.0x	1.14
MSCI EAFE	1.6x	1.9x	0.81
MSCI EM	1.5x	1.6x	0.96
Relative to S&P 500	**Current PB**	**Historical Avg[1]**	**Ratio**
S&P 500	1.00	1.00	1.00
MSCI EAFE	0.46	0.64	0.71
MSCI EM	0.44	0.52	0.84

PRICE TO EARNINGS (TTM)			
Index (Relative to Self)	Current P/E (TTM)	Historical Avg[1]	Ratio
S&P 500	19.6x	19.4x	1.01
MSCI EAFE	16.6x	25.7x	0.65
MSCI EM	13.3x	14.8x	0.90
Relative to S&P 500	**Current P/E (TTM)**	**Historical Avg[1]**	**Ratio**
S&P 500	1.00	1.00	1.00
MSCI EAFE	0.85	1.32	0.64
MSCI EM	0.68	0.76	0.89

[1] Historical average range is from Jan'95 to Sept'19

Source: Bloomberg.

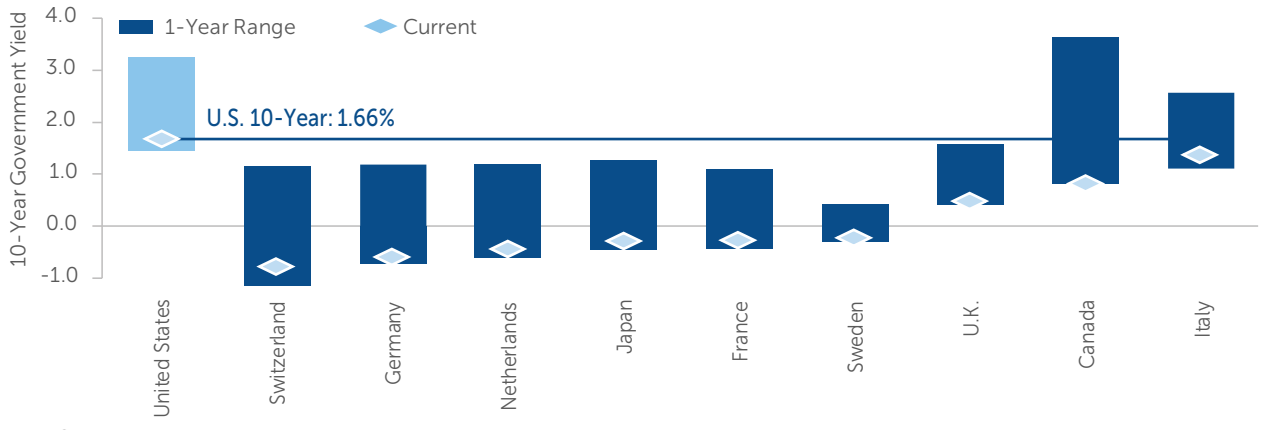
Exposure to international equities is also supported from a fundamental perspective. Despite a home bias view and all the negative headlines regarding China, there are numerous compelling opportunities. China has over $3 trillion in excess reserves (aka. dry powder for fiscal stimulus). The People's Bank of China (China's central bank) is already amidst a monetary stimulus with more on the way. And, a lesser known fact: China's A-share market, which has historically been closed to non-Chinese investors, is starting to open to foreigners and present many potentially favorable opportunities. To put this into context, the China A-share market is considered the second largest equity market in the world behind the U.S. And, as international indices and the Morgan Stanley Emerging Market Index specifically increased its exposure to just the A-share market from 0.8% to 4.0% in 2019 (and with expectations of approximately 17% in future years) there will be a significant amount of passive index fund money supporting demand for and potentially the prices of many of those companies. Nonetheless, investing is usually best obtained through active management to find the best opportunities.

While China is the second largest economy in the world and growing, they are experiencing some pains from recent tariff policies. Many companies are moving their supply chains out of China into other Asian companies. Considering that the Asian region contains 4.5 billion of the world's 7.6 billion people, there are extraordinary demands for commerce and consequently positive trends for investments.

Fixed Income

Domestic bonds are expensive. Likely price appreciation potential on shorter duration bonds will be offset by lower yields as the Fed reduces short-term rates. Longer duration rates should remain low as inflation is tepid and foreign demand for higher U.S. rates will keep downward pressure on longer rates. Exhibit 15 shows the relative difference in yields of domestic bonds to select other developed country markets.

EXHIBIT 15: U.S. AND INTERNATIONAL DEVELOPED MARKET YIELDS



Source: Bloomberg. Data as of 9/30/2019.

With nearly $14.8 trillion or 26% of developed international government bonds yielding below 0% (Exhibit 4), these markets are precarious, particularly when considering that their risk profile, as defined by total volatility, is higher than in the U.S. However, that does not suggest there aren't opportunities for international fixed income.

We believe rates are clearly heading back to a lower-for-longer baseline and that U.S. fixed income should be considered for its safe-haven characteristics during periods of turmoil. While the fixed income market is challenging, we believe utilizing opportunistic strategies may be helpful as a component within some portfolios.

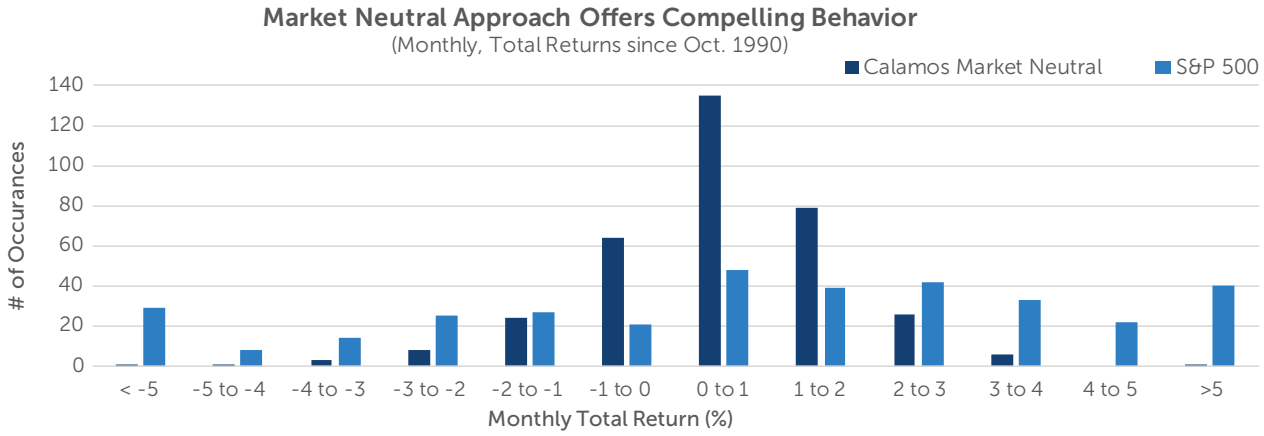
Alternatives

Given the state of equity markets and the unappealing fixed-income outlook, it is important to cast a wider net and consider non-traditional strategies to provide returns and manage risk.

Based on our expectation of volatility, we believe investors will be well-served by strategies that provide risk-managed equity exposure, such as convertible securities. Convertible securities can provide upside equity market participation with potentially less exposure to equity downside.

We also see considerable advantages in market neutral strategies for their diversification (i.e., lower correlations to stocks and bonds) and historically lower volatility. In addition, as low and negative yields dominate global bond markets, income strategies that are not reliant on interest rates can provide an attractive complement. Exhibit 16 shows the performance behavior of the Calamos Market Neutral Income Fund that we often use in portfolios.

EXHIBIT 16: MARKET NEUTRAL APPROACH OFFERS COMPELLING BEHAVIOR



Past performance is no guarantee of future results. *Source: Bloomberg, Data from first full month since inception (10/31/1990 through 9/30/2019) for CVSIX. While the strategy in this fund is the same as the shorter lived institutional share class CMNIX, Calamos Wealth Management tends to use the cheaper institutional share class.*

Summary

In summary, we are pleased with robust equity and bond returns year-to-date, but tempering temptations and avoiding the pitfalls inherent in behavioral finance is ever more prudent. We continue to be vigilant in cutting through the noise of those bent on glass half-full or glass half-empty views and managing risks and opportunities within portfolios. We are focused on fundamentals and valuations as we work with clients in an individually defined goals-based framework.

Please contact your wealth management advisor for further information.

Global Market Returns

World Equity: MSCI ACWI – Index designed to provide a broad measure of equity-market performance throughout the world. **U.S. Large Cap:** S&P 500 – Index of the 500 largest corporations by market capitalization listed on the NYSE or NASDAQ. **U.S. Small Cap:** Russell 2000 – Index of approximately 2000 small-cap companies within the Russell 3000 index, which is made up of stocks of the largest 3000 U.S. companies. **Int'l Developed:** MSCI ACWI – Index designed to provide a broad measure of equity-market performance throughout the world. MSCI EAFE – Index designed to measure the equity market performance of developed markets outside of the U.S. and Canada. **Emerging Markets:** MSCI EM – Index designed to measure the equity market performance of 23 emerging economies selected by MSCI. **Europe:** MSCI Europe – Index of large and mid-cap companies across 15 developed countries within Europe. **Japan:** MSCI Japan – Index designed to measure the performance of large and mid-cap equities within the Japanese market. **China:** MSCI China – Index designed to capture large and mid-cap segments with H shares, B shares, red chips, P chips and ADRs of Chinese stocks. **U.S. Convertibles:** Bloomberg Barclays US Convertible Composite Total Return Unhedged USD – Index designed to represent the market of U.S. convertible securities, such as convertible bonds. **Global Convertibles:** Bloomberg Barclays Global Convertible Composite Total Return Unhedged USD – A global convertible index composed of companies representative of the market structure of countries in North America, Europe and the Asia/Pacific region. **Global Aggregate:** Bloomberg Barclays Global Aggregate Bond Index – A measure of global investment-grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. **Global Aggregate x USD:** Bloomberg Barclays Global Aggregate Bond Index not USD-denominated. **U.S. Aggregate:** Bloomberg Barclays US Aggregate Bond Index – A broad-based index that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-through), ABS and CMBS (agency and non-agency). **U.S. Municipal:** Bloomberg Barclays US Municipal Index – Index that covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds. **U.S. High Yield:** Bloomberg Barclays US Corporate High Yield Bond Index – Index that measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

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