2018 MARKET REVIEW & OUTLOOK

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LOOKING BACK ON 2018

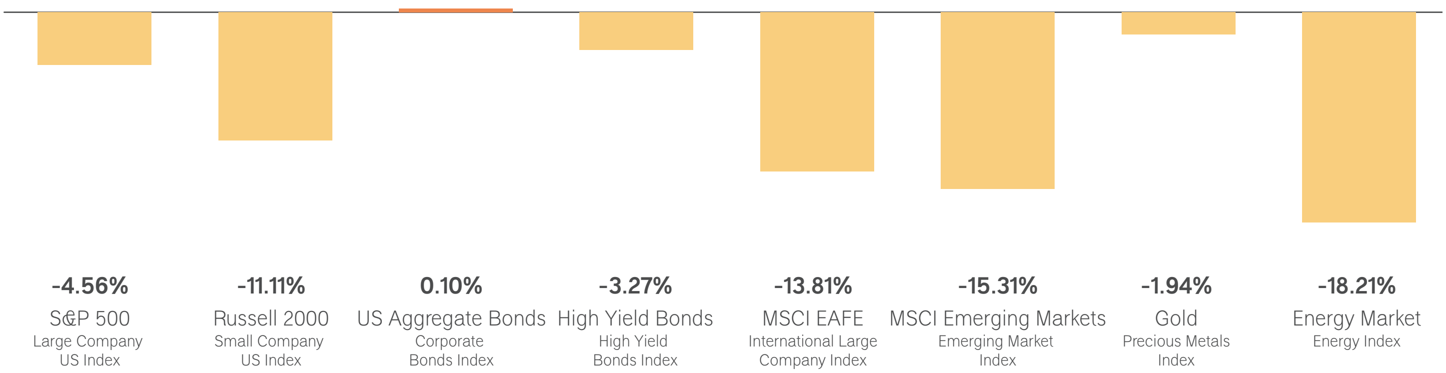
Market Overview

Market volatility provided quite the rollercoaster ride throughout 2018. The severe ups and downs were most likely attributable to trade war tensions and monetary policy. As the Fed drains liquidity from the system, after years of accommodation, while simultaneously raising interest rates, investors appear to have become reluctant to continue being risk-on. We believe this drove some repricing of equities and negative returns across most major indices (see Figure 1).

SFG
A Legacy of Trust and Innovation

A rocky start for most asset classes

FIGURE 1. **2018 CALENDAR YEAR RETURNS**



* The following indexes Year-to-Date total returns were found using the following tickers: SPY, IWM, AGG, JNK, EFA, EEM, GLD, and XLE respectively.
Source: Morningstar, data as of 12/31/2018.

The S&P 500 fell by over 19% between September 28 and Christmas Eve.[1] Apple, the largest company in the index at the time, declined nearly 40% between October 3 and January 3.[2] As risks began to be realized and priced into the market, we saw the rollback in prices.

To find out more about these risks and how we view these events, read our **Risk Factors and Recessionary Scenarios** section on page 11.

U.S. Economy

Consumer confidence surged to a nearly 18-year high[3] as workers began to see bigger paychecks following recently enacted tax cuts. Unemployment stands at 3.7%, which the Fed considers "full employment."[4] U.S. GDP grew at 2.2%, 4.2%, and 3.5% for each of the first three quarters of the year, respectively,[5,6] continuing the second-longest expansion in American history.

Trade Policy

Trade wars disrupted the stock market's momentum in 2018. In March, President Trump announced $50 billion in tariffs[7] on Chinese goods in response to their unfair trade practices over the years. China fired back a few weeks later by imposing tariffs on 120 U.S. products.[7] The back-and-forth has continued between the two countries, apparently fueling much of the market volatility throughout the year.

1 https://www.cnbc.com/2018/12/24/us-stock-futures-fall-slightly-as-the-dow-attempts-to-rebound-from-its-worst-week-in-a-decade.html
2 https://seekingalpha.com/article/4231734-investors-need-know-apples-40-percent-meltdown
3 https://www.whitehouse.gov/briefings-statements/februarys-strong-jobs-report-another-sign-resurgent-economy/
4 https://www.wsj.com/livecoverage/fed-jerome-powell-february-2018-testimony/card/1519751622
5 https://www.reuters.com/article/us-usa-economy-gdp/us-first-quarter-gdp-growth-revised-down-to-2-percent-idUSKBN1JO1QQ and https://www.statista.com/statistics/188185/percent-chance-from-preceding-period-in-real-gdp-in-the-us/
6 https://www.bea.gov/news/glance
7 http://money.cnn.com/2018/05/30/news/economy/trump-china-us-tariffs-trade-timeline/index.html

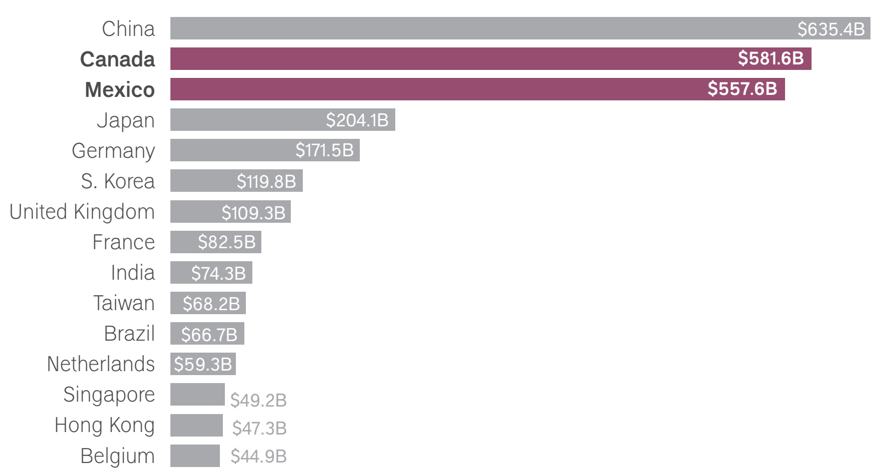
The North American Free Trade Agreement (NAFTA) was renegotiated in 2018 and ultimately replaced on September 30 with the United States-Mexico-Canada Agreement (USMCA). The new agreement must be ratified by each of the three country's legislatures before taking effect. The expectation is that the USMCA will not go into effect before 2020.

The purpose of NAFTA, the world's largest free trade agreement, was to make North America more competitive in the global marketplace.[8] It came under scrutiny when the Trump administration announced that they wanted to lower the trade deficit between the U.S. and its bordering trading partners. As you can see in Figure 2, aside from China, Canada and Mexico make up most of our imports and exports.

The new USMCA aims to boost U.S. job creation by demanding that more goods be manufactured in North America if they are to avoid tariffs. For example, under the old agreement, 62.5% of an automobile must have been manufactured in North America. Under the new agreement, it's now 75%. The goal is to prevent companies in Mexico and Canada from claiming parts were "assembled" in their countries while mainly being produced in China and other inexpensive labor markets.

THE NEW UNITED STATES-MEXICO-CANADA AGREEMENT (USMCA) AIMS TO BOOST U.S. JOB CREATION BY DEMANDING THAT MORE GOODS BE MANUFACTURED IN NORTH AMERICA IF THEY ARE TO AVOID TARIFFS.

FIGURE 2: VALUE OF IMPORTS AND EXPORTS WITH AMERICA'S TOP TRADING PARTNERS IN 2017 ($ IN BILLIONS).



Source: United States Census Bureau. By "The New York Times."

Interest Rates

The Federal Funds Rate currently sits between 2.25% and 2.5% after four hikes totaling 1% in 2018.[9] The Fed cited a strengthening economy, full employment, and a pickup in growth as reasons for the rate hikes.

[8] https://www.thebalance.com/donald-trump-nafta-4111368
[9] https://www.federalreserve.gov/monetarypolicy/openmarket.htm

The Fed has signaled two additional hikes throughout 2019, which would push its target rate to a 10-year high of 3%. Chairman Jerome Powell stated that he expects inflation to continue moving toward the Fed's 2% goal.[10] Powell is much more hawkish than his predecessor Janet Yellen, favoring higher interest rates to manage inflation expectations. He notes that, "It remains the case that raising rates too slowly would make it necessary for monetary policy to tighten abruptly down the road, which could jeopardize the economic expansion."[11]

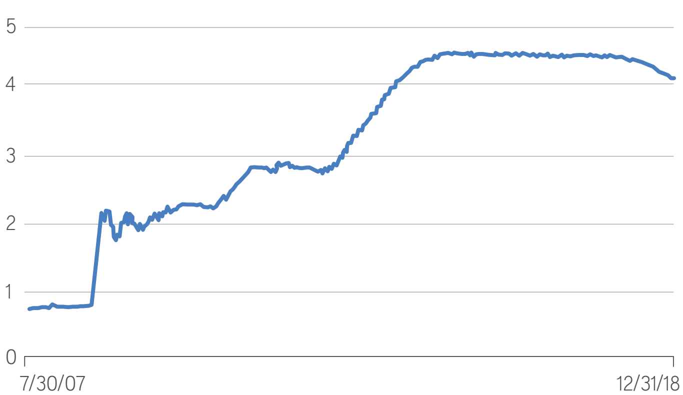
In an effort to "normalize" the economic landscape, the Fed's monetary policy has undergone a role reversal over the last decade. Instead of quantitative easing (QE) to aid in driving down borrowing costs and boosting economic activity, the Fed has switched to a quantitative tightening (QT) strategy to reduce its balance sheet. In the wake of the recession, the Fed's balance sheet ballooned to more than $4 trillion (see Figure 3). It began tapering in October 2017 and has continued throughout 2018 to reach its goal of removing $50 billion each month (see Figure 4).[12]

As you can see, the Fed has a long way to go to get its balance sheet back down to pre-crisis levels. Simultaneously raising rates while reducing a $4 trillion balance sheet is proving to be quite difficult as market volatility rises.

On a global scale, interest rates made uneven progress. The European Central Bank (ECB) maintained its commitment to low rates while cutting its asset purchase program in half. This appears to be a step in the right direction if the ECB wants to move toward normalization; however, it is a very small step.

Quantitative easing following the financial crisis

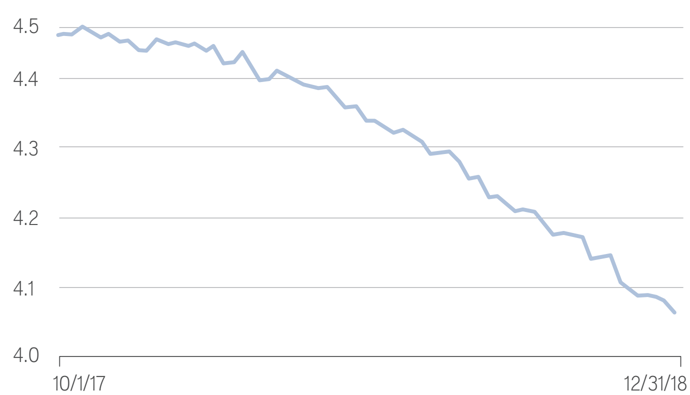
FIGURE 3. **GROWTH OF THE FEDERAL RESERVE'S BALANCE SHEET IN $ TRIL. (7/30/2007 – 12/31/2018)**



Source: Federal Reserve's Recent Balance Sheet Trends
(https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm)

Quantitative tightening in a growing economy

FIGURE 4. **REDUCTION OF THE FEDERAL RESERVE'S BALANCE SHEET IN $ TRIL. (10/1/2017 – 12/31/2018)**



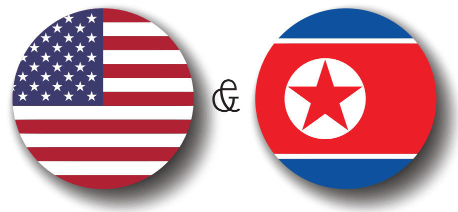
Source: Federal Reserve's Recent Balance Sheet Trends
(https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm)

[10] https://www.cnbc.com/2018/02/23/fed-sees-economy-past-full-employment-but-with-only-moderate-wage-gains.html
[11] https://www.federalreserve.gov/newsevents/speech/powell20180406a.htm
[12] https://www.cnbc.com/2018/09/28/feds-treasury-and-securities-holdings-fall-below-4-trillion-for-the-first-time-in-4-years.html

Elsewhere, the Bank of Japan (BOJ) continued its QE plan, with Japan's 10-year government bond yield sitting near its target of 0%. Because these central banks have committed to keeping yields low, foreign investors can continue to look to America for higher-yielding government debt. As they pour money into U.S. Treasuries, this effect could have possibly offset some of the impact of the Fed's monetary policy normalization.[13]

Geopolitics

KOREAN PENINSULA



For the first time since the Korean War, a North Korean leader stepped across the border with South Korea as part of an agreement to end the war after 65 years. "I would like to join hands together between the two sides so that we can open up a new chapter in our history,"[14] said North Korean leader Kim Jong-un. This interaction with South Korean President Moon Jae-in has been a monumental development in history, as tensions have eased ever since the Winter Olympics in February.

President Trump and Kim Jong-un held a summit in Singapore in June, the first-ever meeting between U.S. and North Korean leaders. It resulted in a signed joint statement agreeing on security guarantees for North Korea, new peaceful relations, reaffirmation of the denuclearization of the Korean Peninsula, and recovery of soldiers' remains. The two sides also agreed to hold follow-up meetings for further negotiations.

Since the signing of this statement, some soldiers' remains have been returned home safely, and Kim Jong-un recently sent a letter to request another summit with President Trump. The full details of the letter and follow-up meeting have yet to be released, but both governments are in the process of coordinating the event.

RUSSIA

Russia's main export is energy, specifically oil and petroleum products.[15] With oil entering a bear market toward the end of 2018, Russian producers stated that they feel comfortable with prices in the $50-60 range per barrel.[16] This is due to their low production costs and a weakening ruble as well as the natural hedge provided by falling taxes (which are based on oil prices).[16] Russia's low production costs could cause issues with OPEC, which has suggested that coordinated cuts in output would result in higher oil prices.

[13] https://www.bis.org/publ/arpdf/ar2018e.pdf
[14] https://www.cnn.com/asia/live-news/north-korea-south-korea-summit-intl/
[15] https://www.worldstopexports.com/russias-top-10-exports/
[16] https://www.bloomberg.com/news/articles/2018-11-29/resilient-russian-oil-companies-give-putin-leverage-with-opec

MIDDLE EAST

In 2018, we saw a major reduction of ISIS. According to President Trump, "the coalition to defeat ISIS has liberated very close to 100% of the territory"[17] they held in both Iraq and Syria. Near the end of the year, President Trump also revealed that the U.S. has a withdrawal plan to exit Syria. The announcement was met with concerns over pulling out of Syria too quickly. This situation will continue to develop into 2019.

LOOKING AHEAD TO 2019 AND BEYOND

We are optimistic about the future for consumers, and we often reflect on how the current decade has prepared us to propel into the next. We've seen technologies such as the smartphone completely transform social and consumer landscapes, and innovation remains at the forefront of most industries. Incredible strides have been made in robotics, energy efficiencies, and rocket technology, to name just a few. Data procurement techniques are pushing useful data collection to levels never seen before. The energy industry is changing rapidly, with many innovations arising outside the solar and wind spaces. All of these advancements give us reason to believe this coming decade will require many changes throughout various industries, which will open up new investment opportunities.

WE'VE SEEN TECHNOLOGIES SUCH AS THE SMARTPHONE COMPLETELY TRANSFORM SOCIAL AND CONSUMER LANDSCAPES, AND INNOVATION REMAINS AT THE FOREFRONT OF MOST INDUSTRIES.

Autonomous Vehicles

As we transition from the 2010s to the 2020s, we believe the focus will shift from collecting data to implementing it. We expect the use of data to spur the rise of self-driving vehicles and, as a result, provide a safer and more efficient driving landscape for all. The advent of autonomous ride-sharing has the potential to transform the transportation industry by providing a low-cost alternative to car buying, the second-most-expensive purchase most consumers make. Imagine a world in which you schedule an autonomous vehicle to pick you up every morning at 8 a.m. to take you to work. This vehicle then travels to other homes throughout the day, transporting people wherever they need to go. Transportation costs in this scenario would be a fraction of what they are today and would also eliminate numerous inefficiencies. Imagine never filling up your gas tank! No going out of your way to a gas station — the car fills itself up. Better yet, imagine not purchasing car insurance! This landscape needs time to develop, however, and may not be fully realized within the next decade.

[17] https://www.usatoday.com/story/news/politics/2018/01/30/state-union-fact-check-u-s-led-coalition-has-liberated-most-territory-held-isis/1081181001/

Ride-sharing is only one aspect of what autonomous vehicles will bring to the economy. If the technology is perfected and fully implemented among all active vehicles — which we believe would take quite some time — we would see entire generations of kids who never earn a driver's license. Vehicle designs could change from the typical forward-facing seating arrangement to an exciting new entertainment layout. Imagine the cars of the future not having windows and being Wi-Fi enabled, complete with flat screen TVs. The changes to consumers' lives will carry vast implications, but we believe the impact on the business world would be equally disruptive.

Autonomous driving could have incredible implications for the trucking industry, which has been quite busy in a strong U.S. economy. According to the American Trucking Association, there was a shortage of 51,000 truck drivers in the U.S. at the end of 2017, and that number was likely to climb by the end of 2018.[18] To keep their employees from going to competitors, trucking companies have to offer double-digit pay raises, which adds to the transportation costs often passed along to end consumers. We therefore believe that as electric semi-trucks and autonomous trucks become a reality, the cost of transporting goods will decline sharply. This could benefit consumers and help keep inflation low by eliminating labor constraints from the transportation equation.

Investment opportunities will arise with the advent of autonomous vehicles. We believe sensor manufacturers and software development companies will be able to transition well into this new industry. Additionally, as car interiors transform, many new devices and services will become available to meet the demand.

Artificial Intelligence

Artificial Intelligence (AI) has been fueling innovation. We recently came across a viral video showcasing a robot jumping on top of poorly balanced boxes, doing a backflip, and landing on its feet. As spectacular as it was to watch, the true value of the robot is its versatile capabilities. The robotics industry has a long way to go in terms of automation and capability, but it's making incredible strides to create cost efficiencies that often benefit consumers.

We believe the current state of robotics is at a tipping point. Some form of robotics is now used in nearly every manufacturing process in the U.S. Elon Musk, CEO and founder of Tesla, once gave an interview where he described both the usefulness and current limitations of robotics. When Tesla built their Gigafactory just east of Reno, their mission was to automate 100% of the manufacturing process. It was a lofty goal that ran into a wall at one point in production.[19]

Robots are currently great at doing the same task repeatedly; however, that task must be completely fixed in its execution. This is where AI could be coupled with robotics

[18] https://www.washingtonpost.com/news/wonk/wp/2018/05/21/america-doesnt-have-enough-truckers-and-its-starting-to-cause-prices-of-about-everything-to-rise/?noredirect=on&utm_term=.c4f94d8423b1

[19] https://www.wired.co.uk/article/tesla-model-3-production-stock-problems-engineering

technology. Musk described a massive problem where the process was incredibly easy for a human, but incredibly difficult for a robot. The problem was connecting a hose. For a human, it was as easy as grabbing the hose and connecting it. However, the robot was grabbing the hose at the wrong position, slamming it into the cars' freshly painted exterior, or even attaching it to the wrong place.

Musk has retracted his 100% automation goal for now and has been using people for a lot more of the mundane tasks that require a human touch.[19] AI will one day solve such problems and enable Musk to achieve his goal.

AI is also helping consumers discover new enthusiasm for shopping. For example, there is an AI that allows clothes shoppers to engage in an interactive buying experience. They can now walk into a fitting room to try on various outfits, and the AI will pair them with other products that coordinate. This software will soon use Augmented Reality (AR) to superimpose the suggested items onto customers, as if they were wearing everything together. This service could revolutionize the in-store shopping experience and may also be offered online and in homes through cloud computing and web cameras.

Imagine a world in which the checkout counter didn't exist. Time spent in stores would be dramatically impacted by this innovation, and it isn't just an idea anymore. In 2017, Amazon Go was launched in Seattle. It's a seemingly traditional grocery store that actually has millions of micro sensors to track which products you buy. It even knows when you return an item back onto the shelf. There are no cashiers or registers — only an array of gates located at entry and exit points. Once you walk through the gate, it bills your Amazon account, and that's it; no checkout line necessary.

AI has the potential to disrupt markets, but the change may be less impactful than some think. Some people believe AI will rapidly automate billions out of the workforce and that the world will not have a chance to adapt. We don't anticipate this will be the case. As an economy, we've been through an equally disruptive event — The Industrial Revolution — which displaced many workers through the implementation of machinery. Milton Friedman once famously quipped, "Why not give them all spoons" after a government official stated that giving men shovels to dig ditches creates more jobs than if a bulldozer were used.

Think about all the people who work in software development, app development, and smart devices — all jobs created from the invention of the smartphone. As the implementation of AI becomes more widespread, new industries currently obscured behind the cloak of innovation will be created and new investment opportunities will arise.

Healthcare Technology

Healthcare will undergo significant changes in the coming decades. Amazon, J.P. Morgan, and Berkshire Hathaway have partnered together to offer lower-cost health insurance to their employees. The details are still vague, but it is ventures like this that could disrupt the entire healthcare industry.

We anticipate that telemedicine will become a vital part of the healthcare delivery system. The FDA recently approved the new Apple Watch to be used as a medical device.[20] With more and more of these devices coming onto the market and being used to deliver healthcare, costs will dramatically decline over time. The old adage of having to go "see the doctor" will soon begin to fade as patients receive medical advice and prescriptions from the comfort of their own home.

KardiaMobile is a mobile EKG monitor that is FDA cleared. It captures the heart rate, rhythm, and symptoms for early detection of AFib. It connects to a smartphone and allows users to get medical-grade EKGs from anywhere with a Wi-Fi connection. Devices like these make healthcare more accessible while reducing costs for the consumer.

KARDIAMOBILE IS A MOBILE EKG MONITOR THAT IS FDA CLEARED. IT CAPTURES THE HEART RATE, RHYTHM, AND SYMPTOMS FOR EARLY DETECTION OF AFIB.

Other devices, such as Dario's All-In-One Glucose Meter, can measure and log blood glucose levels and immediately share results with caregivers. The device is like other glucose meters in that it samples your blood, but it differs by then plugging the test strip device into your phone's audio jack to process the information. This instantaneous feedback and sharing of information, coupled with new devices entering the healthcare marketplace, will continue to transform the industry over the coming decade.

Blockchain Implementation

Blockchain technology, originally devised for Bitcoin, is finding other potential uses outside of digital currency. Simply put, blockchain allows digital information to be distributed but not copied.[21] The benefit to users is greater safety than other alternatives employed today. A blockchain network cannot be controlled by any single entity and has no single point of failure. Because information is distributed among millions of computers rather than in a centralized version, no single point can be manipulated to change the integrity of a transaction. This technology is in its infancy, but its implications are significant to transaction-based industries.

Energy Transformation

The energy industry is always transforming. Every year, Royal Dutch Shell Petroleum publishes an outlook on the future of energy. Here are a few of their points of emphasis:[22]

- Since the 1970s, energy consumption has doubled, but sources of production have remained quite static due to the lack of technology. Looking forward, Shell believes that continued growth in demand for renewable energy, along with the

[20] https://www.cnbc.com/2018/09/12/apple-watch-series-4-first-look.html
[21] https://blockgeeks.com/guides/what-is-blockchain-technology/
[22] https://www.shell.com/energy-and-innovation/the-energy-future/scenarios/a-better-life-with-a-healthy-planet.html

emerging technological possibilities of the 21st century, will drive supply away from oil and into renewables.

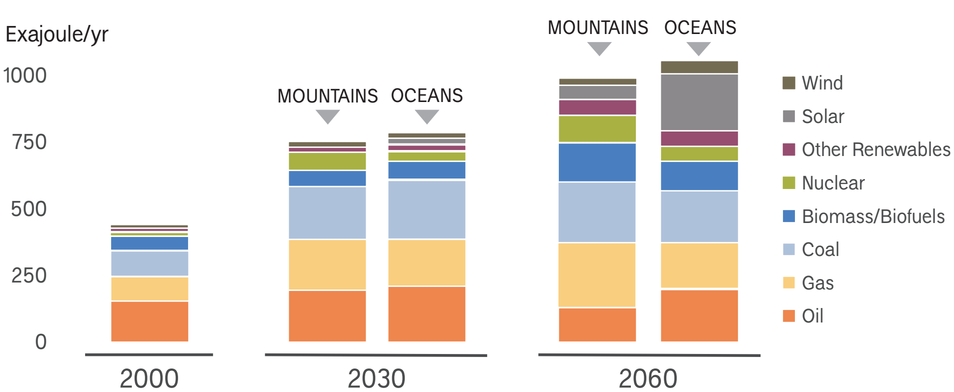
- The move toward renewables has been slowed by the ease and convenience of oil and gas, as well as the cheapness of coal.
- The impact of an energy revolution will "occur at different speeds, at different times, and in different locations" around the world. Change will be driven by both the political and economic circumstances of each geographic region.
- Each sector of the economy has its own challenges and implications when it comes to reducing environmental footprints.
- The rise of renewables is inevitable, but oil usage will remain for quite some time due to its low cost and convenience. Developed economies will transition to renewables much sooner than rural/frontier economies.
- By 2060, Shell believes the single largest primary energy source in the world will be solar. Today, it provides about 1% of all the energy demanded. By 2060, it's projected to account for 40% of the entire network.
- "In the future, as the cost of renewable energy falls, and as technical breakthroughs occur in storage and smart-grid technology, which will trigger a market response and business model innovations, it is possible that more facilities will be retired early, as is already happening in a number of countries today."

... CONTINUED GROWTH IN DEMAND FOR RENEWABLE ENERGY, ALONG WITH THE EMERGING TECHNOLOGICAL POSSIBILITIES OF THE 21ST CENTURY, WILL DRIVE SUPPLY AWAY FROM OIL AND INTO RENEWABLES.

As mentioned earlier, Shell projects that 40% of all energy supplied to the grid will come from solar by 2060. However, you can see in Figure 5 that oil, gas, and coal will still play major roles. Even though their piece of the pie may get smaller over time in this scenario, overall energy demand will be far greater than it is today. This is due, in part, to population growth in emerging countries and more power-consuming devices coming online. Consider this:

- While developed economies worldwide are converging around population growth of two children per woman, some emerging and frontier markets, such as

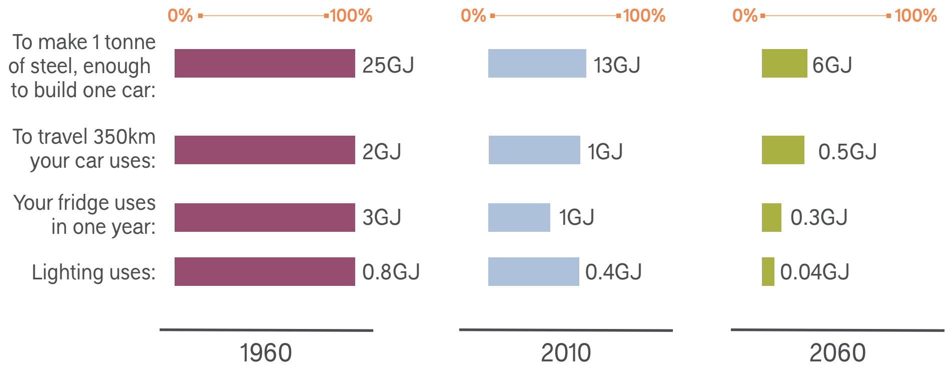
FIGURE 5: OIL AND GAS REMAIN CRITICAL COMPONENTS OF THE ENERGY SYSTEM INTO THE LONG TERM
SHELL "**NEW LENS SCENARIOS**"



Graph notes: Mountains and Oceans refer to Shell Global scenarios. Each scenario provides a detailed analysis of current trends and their likely trajectory into the future. For more information, see https://www.shell.com/energy-and-innovation/the-energy-future/scenarios/new-lenses-on-the-future.html

Source: https://www.shell.com/energy-and-innovation/the-energy-future/scenarios/shell-scenarios-energy-models/global-supply-model/_jcr_content/par/textimage

FIGURE 6: HISTORICAL CONTRAST — ENERGY EFFICIENCY (OCEANS)



In these sectors, efficiency has doubled over the last 50 years and could double again, or better, over the next 50 years.

Source: https://www.shell.com/energy-and-innovation/the-energy-future/scenarios/a-better-life-with-a-healthy-planet/_jcr_content/par/relatedtopics.stream/1475857466913/a1aa5660d50ab79942f7e4a629fcb37ab93d021afb308b92c1b77696ce6b2ba6/scenarios-nze-brochure-interactive-afwv9-interactive.pdf

Nigeria, are growing by more than five children per woman. This will increase not only global population, but also energy demand and consumption.

- Because the birthrate is so high in emerging/frontier countries, the people born there only have access to simple technologies generally powered by gas and coal. There are several reasons for this, but the main two are limited purchasing power and ease of use. It is much cheaper and simpler to store and maintain a tank of gas than a solar farm or windmill.
- Smart technology devices that didn't exist as recently as five years ago are now being created with increasing regularity. Smart shoes (track and analyze your movements), smart watches, and other wearable technology all require regular charging. As more of these devices come online, consumer demand for energy goes up.

RISK FACTORS AND RECESSIONARY SCENARIOS[23]

We continue, as always, to focus on risk management in guiding our investment selection process. During this period of market volatility, active management has outpaced passive instruments by investing in high-quality names able to better weather the storm.[24] As we navigate through 2019, we'll pay close attention to how markets react to the level of domestic and global debt, as well as a continued rising interest rate environment.

[23] Rising Corporate Debt Levels – Will these Lead to a US Recession? – Storm Clouds for 2020 – October 2018 - Number 163
[24] https://seekingalpha.com/article/4186482-2018-first-half-active-investment-wins-3x-capital-gains-passive-indexing

Corporate Debt

We have been in a near-zero interest rate environment for the past decade, which presents challenges when monetary policy shifts from accommodative to tightening.

When interest rates are as low as they have been, three potentially dangerous themes emerge:

1. When rates are low, corporations can be tempted to borrow excessively.

2. Investors can become what is known as "yield hogs," in which they focus on earning a certain yield causing them to purchase incredibly mispriced, risky assets to achieve their goal. This can result in market-wide underpricing of risk.

3. Servicing excessive corporate debt in a low interest rate environment typically results in artificially low payments.

Because of these three themes, credit risk can become mispriced in low interest rate environments as investors are led to believe that assets are less risky than they actually are. And unlike normal environments, because there are so many "yield hogs" in the market today, the power can shift from creditors to debtors.

When debtors are given the power of widespread access to credit due to a near-zero interest rate environment, we see weaknesses in the lending space result in covenant-lite deals. These poorly structured leveraged buyouts offered from private equity groups squeeze spreads between investment-grade and high-yield bonds to record lows.

High-yield bonds have historically yielded around 10%, enough to compensate investors for the additional risk they take. Currently, those bonds average around 6.5% yields.

U.S. Government Debt

The U.S. debt problem has not been solved. Our national debt now exceeds \$21 trillion[25] and continues to grow following recent tax cuts. We have identified three possible solutions:

1. GROWTH

It's been said that the U.S. never actually repaid its debts from World War II, it just outgrew them. Back then, the economy was in full force, baby boomers were being born, and we were entering a historically peaceful era. Today, those same factors aren't in place to support 5-6% economic growth. For starters, we don't have the

[25] https://fred.stlouisfed.org/series/GFDEBTN

same population growth. U.S. birthrates have declined nearly 50%[26] since then and are now nearing record lows. In addition, the method for calculating GDP has become quite antiquated and incapable of capturing true growth in today's technological environment.

2. DEFAULT

If the U.S. government defaulted on its debt, it would be disastrous for the global economy. Because many foreign countries carry much of their reserves in U.S. Treasuries, a default would decimate the value of those reserves. We believe the decline in equity prices would be similar to the stock market losses seen during the financial crisis in 2008. One key difference is that Treasury yields would likely skyrocket instead of contracting as they did in 2008.

3. INFLATION

Of the three potential solutions to the debt problem, we believe inflation to be the most likely. By printing money and injecting it into the economy, the U.S. can devalue its currency. Let's look at three scenarios:

01. GOOD — IT'S ALL UP TO THE FED!

The Federal Reserve's mandate boils down to achieving: 1) maximum employment, 2) stable prices, and 3) moderate long-term interest rates. Following zero interest rates over much of the last decade, a modest rise in inflation would allow the Fed to continue its rate hikes and get back on track toward its mandate.

02. BAD — RAPID INFLATION LEADS TO RAPIDLY RISING RATES

Historically speaking, when the Fed raises rates too quickly, stock markets tend to experience a correction. We saw this in February 2018. A slight uptick in inflation provided an early indicator that the Fed would raise rates, prompting investors to take profits and causing stocks to decline dramatically over a short period.

03. UGLY — STAGFLATION

In the 1970s, we entered into an economic climate known as stagflation — an unhealthy combination of stagnant growth and rising prices. Because commodity producers tend to trend with inflation, they performed well while the rest of the economy struggled with declining demand. A similar event now could trigger a recession like the one we saw in the first half of the 1970s.

[26] https://fred.stlouisfed.org/series/SPDYNCBRTINUSA

Rising Interest Rates

Mutual fund manager Jeffrey Gundlach (known as the "Bond King") has stated that the 35-year bull run for bonds would end once the yield on 10-year Treasuries surpassed 3%.[27] That barrier was broken in late April 2018.

Duration is your enemy in today's rising interest rate environment. The U.S. Corporate Aggregate Bond Index currently has a duration of more than six years, making it highly sensitive to interest rate spikes. This index and others with high duration suffered sharp declines during rate hikes throughout the year. With the Fed projected to continue raising rates in 2019 and beyond, it is crucial to manage duration risk.

Unfunded Pensions

Unfunded pensions are defined as a pension plan that uses the employer's current income to fund payments as they become necessary.[28] Many state-sponsored public pensions are unfunded and paid directly by the funds generated from current workers' contributions. These types of arrangements work when significantly more people are paying into the program than are receiving benefits. However, in our low birthrate culture, the economics of this policy do not add up.

As for private pensions, here's what was reported in an article from Bloomberg titled "S&P 500's Biggest Pension Plans Face $382 Billion Funding Gap:"

"People who rely on their company pension plans to fund their retirement may be in for a shock: Of the 200 biggest defined-benefit plans in the S&P 500 based on assets, 186 aren't fully funded. Simply put, they don't have enough money to fund current and future retirees. The situation worsened for more than half of these funds from fiscal 2015 to 2016. A big part of the reason is the poor returns they got from their assets in the super low interest-rate environment that followed the financial crisis. It's left a hole of $382 billion for the top 200 plans."

Non U.S. Debt

Debt is not only a problem in the U.S., but also globally. During 2018, the Turkish Lira declined roughly 40%, largely due to its debt fueled economy. The major source of the loans are from external sources denominated in a foreign currency. The issue is when a Turkish company, who generates most of its profits

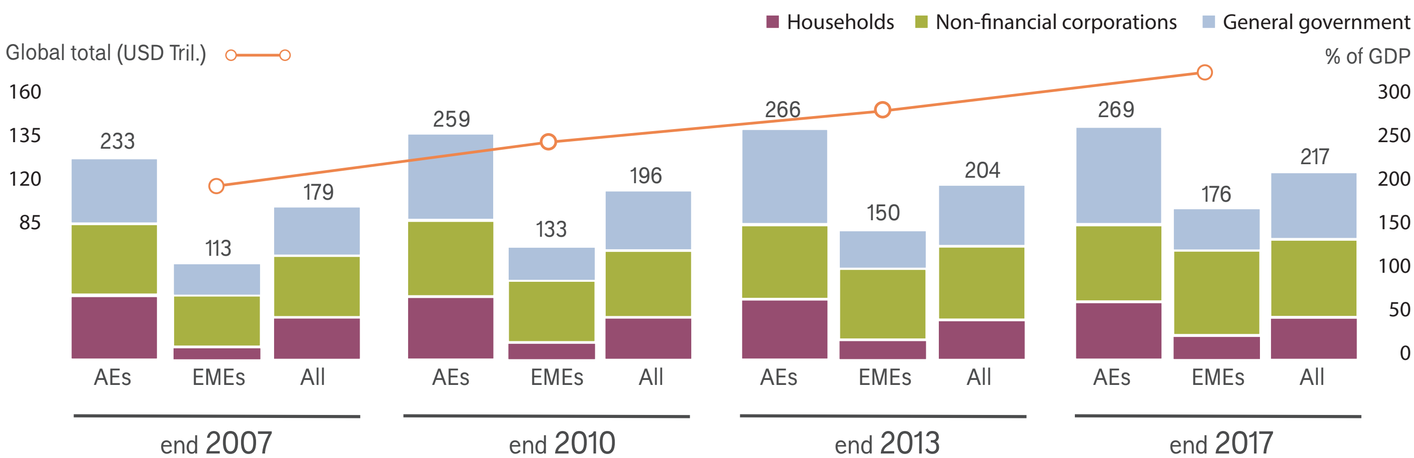
[27] https://www.cnbc.com/2018/03/14/gundlach-3-percent-yield-on-the-10-year-treasury-will-end-bull-stock-market.html
[28] https://www.investopedia.com/terms/u/unfunded-pension-plan.asp

denominated in the Lira, has to pay back the loan after the Lira has fallen off a cliff. The bond holders demand payment in the form of their own currency, which means that when the Lira is down 40%, the borrower has to pay out much more in an absolute sense.[29]

The situation in Italy is not much better. Italy's debt-to-GDP ratio sits at nearly 130% and it announced late last year that its new government plans to increase its budget deficit. This has reawakened the market's debt concerns and, subsequently, Italy has seen its borrowing costs go up. This could put the ECB in a precarious situation in that there is a possibility that this can turn into another Greece disaster. If Italy loses its investment-grade rating, the bonds they issue are no longer eligible for the ECB's bond buying stimulus program. This could surge borrowing costs, exacerbating the issue.[30,31]

Deutsche Bank has been under scrutiny throughout 2018. The creditworthiness of the company has fallen in 2018, resulting in a "doubling of the cost to insure against a default on its debt."[32] Because Deutsche bank has failed to shore up its balance sheet after the 2008 financial crisis, markets have put a downward pressure on the bank. This is forcing the bank to cut costs and restructure. Such a large financial institution in Europe exhibiting weakness this late in the market cycle could be indicative of further systemic issues in Europe.

FIGURE 7: GLOBAL DEBT CONTINUES TO RISE



Weighted averages based on GDP and PPP exchange rates. The sample includes all reporting economies except Ireland, owning to large data fluctuations caused by the restructuring of large multinational corporations. AEs: Advanced Economics; EMEs: Emerging Market Economics.

Source: https://www.bis.org/publ/arpdf/ar2018e.pdf, IMF, World Economic Outlook; BIS total credit statistics; BIS calculations.

[29] https://mailchi.mp/82ae40eca38e/the-lira-has-plummeted-and-its-turkeys-fault?e=42e5ce3b87
[30] https://tradingeconomics.com/italy/government-debt-to-gdp
[31] https://www.reuters.com/article/us-imf-worldbank-ecb-italy/ecb-cannot-come-to-italys-rescue-without-eu-bailout-sources-idUSKCN1ML2NE
[32]https://www.washingtonpost.com/business/why-deutsche-bank-cant-just-shake-off-its-problems/2018/10/24/5daa586a-d7a0-11e8-8384-bcc5492fef49_story.html?utm_term=.2b977a80dc08

Jeffrey Gundlach's Overview of 2018

DURING A DECEMBER 17, 2018 INTERVIEW, GUNDLACH DISCUSSED WHY VARIOUS EVENTS OCCURRED IN 2018 AND THE IMPLICATIONS FOR INVESTORS. HERE ARE SOME OF THE KEY TAKEAWAYS:[33]

- **The year kicked off with the end of Bitcoin mania.** He commented that cryptocurrencies ultimately may or may not work; however, the way Bitcoin was being treated in 2017 was a mania. Over the course of 2018, Bitcoin traded down around 85% from its high.
- **He believes market sentiment is currently bearish.** Markets in general, and bear markets specifically, have two legs down. This means that the market rolls over, then recovers a bit, and then rolls over again. The second leg down is generally more severe.
- **He expects this bear market to continue for quite some time.** We are in a situation he calls a "suicide mission of policy." We are increasing our budget deficit while raising interest rates and reducing the Fed's balance sheet. The official budget deficit, which never captures the total amount spent, is annualized at about $1.62 trillion dollars.
- **There may actually be no economic growth if you remove budget deficit spending,** a significant piece of the GDP equation. He is very concerned with deficit spending spinning out of control, especially now that we are in the latter part of the market cycle.
- **Over the next five years, around $7 trillion worth of Treasuries will be maturing.** The average coupon on those Treasuries sits at around 2%. Because of Fed tightening, the rate will be much higher (possibly 3% or more) when those Treasuries roll over. If that's the case, the government's interest expense may go up by as much as $140 billion.
- **A death cross occurs when the 50-day moving average falls below the 200-day moving average.** Currently, about 80% of the countries in the MSCI World Index are in a death cross, the highest level in the history of the data going all the way back to 1901.
- **The current problem is that the Fed shouldn't have kept rates as low as they did for so long.** Now, they have to raise rates while the U.S. budget deficit expands, which has never happened before. Additionally, the European Central Bank shouldn't have maintained negative rates and QE for so long.
- **He believes we're in a debt-based economy** and gave this example: Suppose you meet a friend from college who says, "I am doing well. I have a huge mortgage, a second on top of that, and I have four credit cards maxed out and a brand new watch." Compare that to someone who just paid off their mortgage, has a million dollars saved up, and has no credit card debt. Which person is actually doing better in this scenario? Gundlach believes that the first person is most of America right now, and that all of the growth is coming from debt expansion.
- **We can't blame CEOs for taking advantage of monetary policy that created a zero interest rate environment.** That environment collapsed yield spreads and made them narrower than at any time in history, which encouraged risk taking. Of course CEOs leveraged up and bought back stock because they were able to do so very inexpensively.

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[33] https://www.youtube.com/watch?v=hA_kg_nMGNU&t=320s

MEDICARE AND SOCIAL SECURITY: SUMMARY OF THE 2018 TRUSTEES ANNUAL REPORT

Medicare and Social Security are projected to run out of reserves by 2026 and 2034, respectively. For Medicare, this projection has been moved up from 2029 in the previous year's report.[34]

Treasury Secretary Steven Mnuchin noted in a statement that the programs remain secure and are on track to meet their obligations well into the next decade.[35] He also stated that there is still time to fix these problems. Short-term projections are shown as stable in the Trustees report, but long-term projections become dicey with more and more beneficiaries collecting benefits over the coming decades. According to projections, total costs begin to level off around 2040 due to a stabilizing number of beneficiaries. As part of our debt scenario, we will continue to monitor the economic longevity and sustainability of these programs.

PROGRAMS REMAIN SECURE AND ARE ON TRACK TO MEET THEIR OBLIGATIONS WELL INTO THE NEXT DECADE.

Treasury Secretary Steven Mnuchin

CONCLUSION

Investing in this current market cycle remains precarious, as fundamentals do not necessarily apply. Volatility has been the prevailing market theme over the past year. Historically, during times of turmoil, we believe value investing has outperformed.[36] We remain focused on risk management, portfolio diversification, and investment strategy selection because we believe that markets trade on fundamentals over the long term.

Underfunded and unfunded pension liabilities in the private and public sectors, rising interest rates, monetary policy that has appeared to encourage risk taking, and high debt levels all pose potential risks to the overall economy. Going forward, we remain focused on managing credit risk and equity exposure so that we can help navigate the next downturn, which may be triggered by the sheer amount of debt burden on the system.

Visit our blog at sfginc.com to read more about our review of the market, plus other relevant, timely articles or give us a call to discuss your situation at (775) 850-5620.

[34] Social Security Report-https://www.ssa.gov/OACT/TR/2018/tr2018.pdf; Medicare Report-https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/Downloads/TR2018.pdf
[35] http://www.chicagotribune.com/news/nationworld/ct-medicare-money-20180605-story.html
[36] https://blogs.wsj.com/moneybeat/2018/02/15/it-might-finally-be-value-stocks-time-to-shine/

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