



Independence | Asset
Advisors

THIRD QUARTER REVIEW & GLOBAL MARKETS OUTLOOK

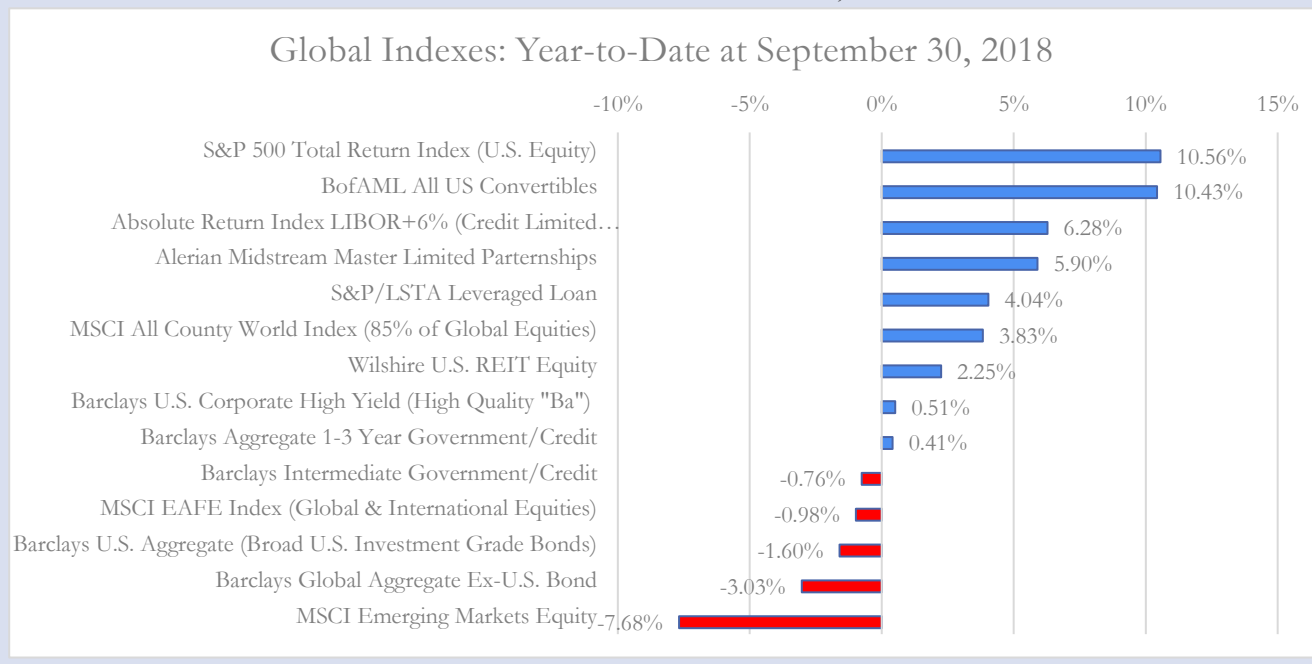
SEPTEMBER 30, 2018

DISCLAIMER

The views and opinions in this newsletter are solely those of Independence Asset Advisors (IAA). IAA has made every attempt to ensure the accuracy and reliability of the information provided, but it cannot be guaranteed. Past performance is no guarantee of future returns.

I. GLOBAL MARKETS REVIEW

GLOBAL BENCHMARKS: YEAR-TO-DATE AT SEPTEMBER 30, 2018



III. U.S. MONETARY POLICY

The U.S. Federal Reserve (“Fed”) has dropped the long-standing description of its monetary policy as “accommodative,” an acknowledgement that it is strategically moving to bring rates closer to neutral. A neutral rate, also called an “equilibrium” rate, is the Federal Funds rate that neither stimulates nor restrains economic growth. According to Federal Reserve Chairman Jerome Powell, the central bank has a ways to go before interest rates are neither restrictive nor accommodative. However, the Chairman freely admits that the pace of rate increases may be impacted by significant global issues. Trade remains the single greatest threat to the stability of global growth.

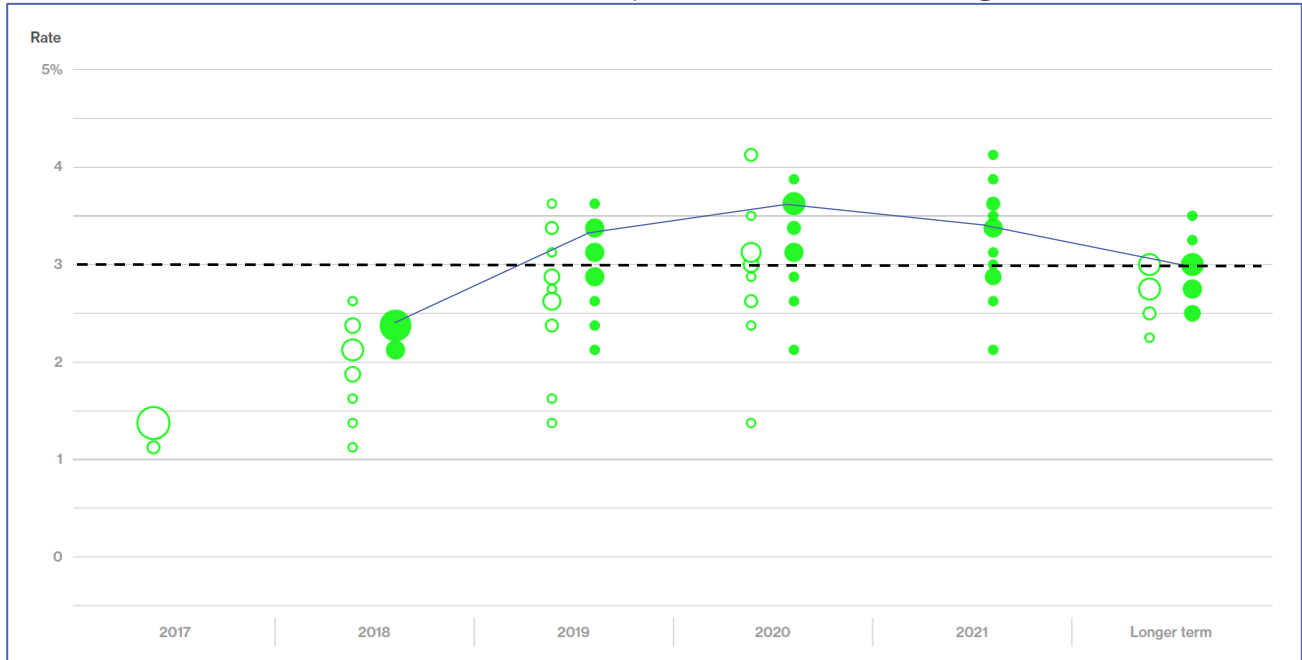
The Fed has initiated eight incremental 0.25% rate hikes since 2015. Barring a negative market event in the economy, the most recent Fed forecast suggests a December rate hike is nearly certain. In fact, the number of Federal Open Market Committee members expecting another incremental interest rate hike before year-end increased to twelve of sixteen, up from eight in June 2018.

The market forecast for the Fed funds rate is 3.1% by the end of 2019, which is above the Fed’s own longer-term neutral rate of 3.0% (Table 1). This has unnerved some investors who do not see enough inflation to justify the pace of tightening. However, based on historical averages, the Fed does not appear to be tightening too quickly. Looking back at the last five tightening cycles, the average annual rate increase has been 2.5%. The Fed is currently raising rates at an annual rate of only 1%. This moderate tightening pace allows the Fed to evaluate data each quarter and to hold before over-tightening.

In our view, the Fed is not tightening because of problematic inflation, rather it is bringing rates back to a normal level to prevent asset bubbles. Comparing the current 2.3% CPI inflation to the 2% to 2.25% Fed Funds target rate, rates do not provide real (after inflation) positive return found in “normal” markets.

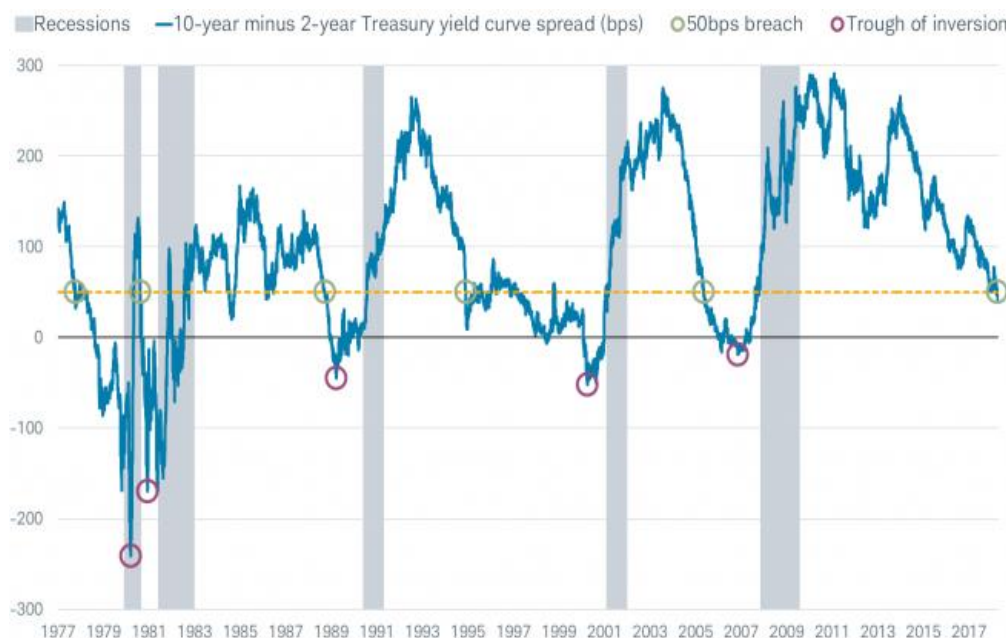
Based on the expectation that the Fed will move to normal real returns, we expect the Fed to increase rates in December and twice in 2019 to a rate of 3%, or more, depending on inflation data.

Table 1: FOMC “Dot Plot” Projections - Dec. 2017 vs August 2018



There has been significant press regarding the risk of an inverted yield curve. Some speculate that if the Fed raises rates four more times in 2019 to 3.25%, the yield curve could invert and that would signal, or even might lead to, a recession. The following charts help illustrate an inverted yield curve as a potential recession signal. (Charts above and below are produced from data provided by Bloomberg)

Prior to the last five recessions, the yield curve inverted an average of nine (9) months before the recession began. In fact, the yield curve inverted before eight of the last ten recessions. This points to an inverted

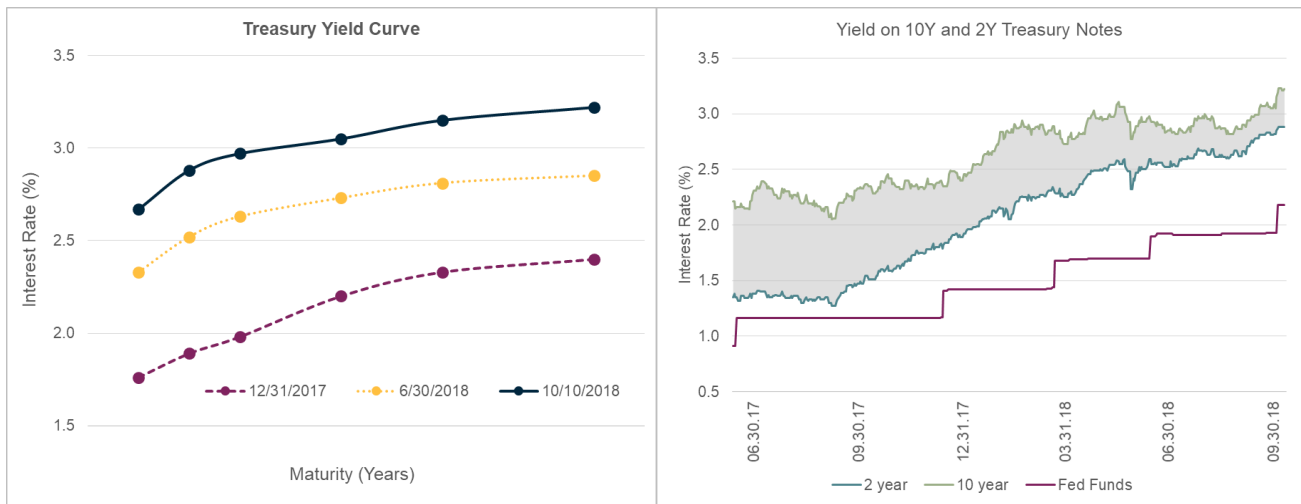


yield curve as both a leading and potentially reliable recession indicator.

Current Fed policy has been consistent, moderate and well communicated. It is based on inflation expectations. The Fed may increase too much, but it is certainly not moving too fast.

Depending on inflation trends, we might expect a “normal” Fed Funds rate to be 50 to 100 basis points above the rate of inflation the Fed believe is sustainable. If rates normalize to 3.25%, which would be a positive 50 basis points above the current rate of inflation, the yield curve would not be likely to invert. We will be watching this indicator, which may signal that it is time to reduce the equity risk in a portfolio.

The last rate hike led to an across-the-curve increase in rates. Although the short end rose by the Fed’s 0.25% rate increase, the long end also continued to increase as inflation expectations increased.



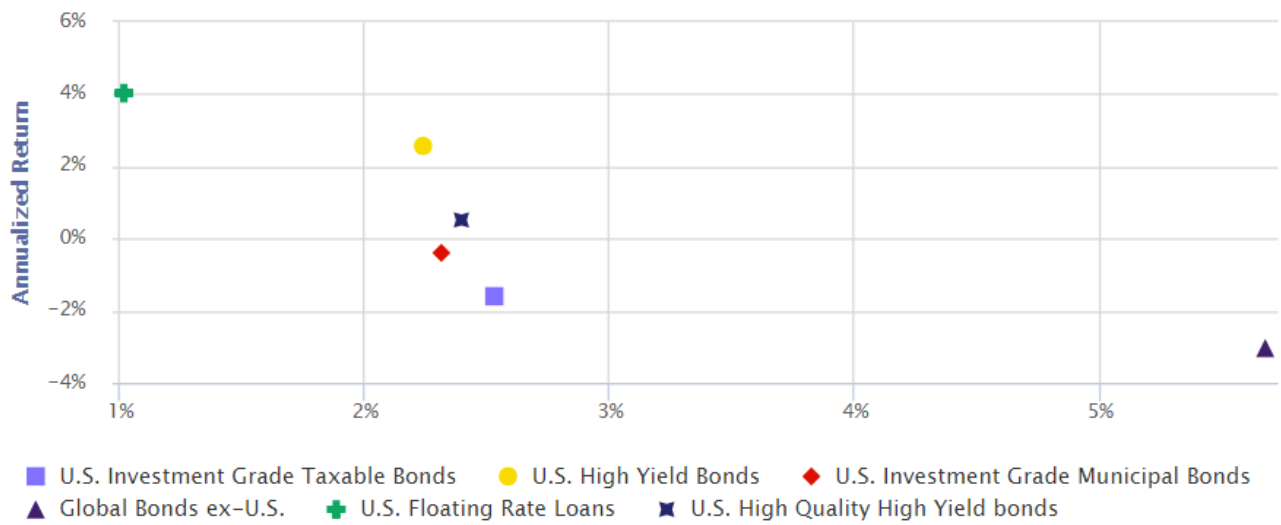
Spreads remain thin, but positive by 40 basis points. We would expect the long-term rates would also increase as the Fed tightens, but not by as much.

II. GLOBAL MARKETS REVIEW: YEAR-TO-DATE AT SEPTEMBER 30, 2018

Federal Reserve	The Fed raised short-term interest rates in September for the third time in 2018 by an incremental rate of 0.25%. This was anticipated and had minimal market impact. As of September 30, 2018, the Fed Funds Effective Rate was 2.18% and core inflation was 2.20%.
U.S. Dollar	The U.S. dollar strengthened against most major global currencies. Year-to-date the dollar strengthened 3.1%, including 0.5% during the third quarter. The U.S. dollar index (DXY) increased to 101 compared to 30-year high of 113 and its low in July 2011 of 81.
Bank of Canada	The Bank of Canada held interest rates steady at 1.5% in September, which was in line with market expectations. Canada's consumer price inflation climbed higher to 3% in July, which exceeded the central bank's target rate, but the increase appeared to be transitory.
Canadian Dollar	The Canadian dollar has generally weakened against the U.S. dollar, but that trend has recently reversed. Over the past year the Canadian dollar has weakened 3.4% against the U.S. dollar, but over the third quarter it strengthened 1.8%.
Yield Curve	The spread between short-term and long-term U.S. Treasuries has narrowed considerably over the past 12-months. The spread at the end of the Q3 of 2017 was 140 basis points, but narrowed to 39 basis points at the end of this quarter.
Treasuries	The September rate hike raised the short end of the yield curve and generally increased Treasury yields. The 2-Year U.S. Treasury yield increased 0.19% in September to 2.81% and the 30-Year U.S. Treasury yield increased by the same amount to 3.20%.
IG Bonds	Investment grade bond returns were muted in the third quarter, with the taxable aggregate ending September flat while the municipal aggregate declined 0.2%. Despite the lackluster returns, pricing to par has improved and yields have ticked higher to 3.5%.
High Yield Bonds	High yields bonds have performed well on a relative and absolute basis, gaining 2.4% in the third quarter. The aggregate U.S. high yield index ended September trading at a \$1.50 discount to par and yielding 6.3%. Higher quality high yield bonds are trading at par and yielding 5.2%.
Bank Loans	Senior floating-rate corporate loans have been a bright spot in 2018. Year-to-date the S&P/LSTA Leverage Loan Index is up 4.0% which is 5.6% higher compared to the Barclays U.S. Aggregate Index return of -1.6%. The annual default rate for loans remains low at 1.8%.
Global Bonds (ex-U.S.)	Global bonds have performed relatively well in local currency terms, but in U.S. dollars the returns over the past 12-months have been strongly negative. Global bonds (ex U.S.) have declined 3.0% year-to-date, and are trading at an \$8.30 premium to par and yielding 2.2%.
U.S. Equities	U.S. equities have performed well over the past three quarters, supported by a plethora of strong economic data and solid corporate earnings. Large-cap stocks set new all-time highs in the third quarter and established the current bull run as the longest in history.
Midstream Master Limited Partnerships	Midstream master limited partnerships gained 5.9% year-to-date after returning 6.6% in the third quarter. Headline risk and volatile energy prices suppressed MLP returns in 2017, but distribution growth guidance and improved debt coverage has bolstered investor sentiment.
International Developed Equities	International developed equities lost 1.4% year-to-date, despite gaining 1.4% in the third quarter. Economic results have been broadly positive, but unresolved trade negotiations and fears of a no Brexit deal have slowed U.K. growth and weighed on European valuations.
Emerging Markets Equities	Emerging markets equities have been the worst performing asset class in 2018. Year-to-date the asset class has lost 7.7%, a result of U.S. dollar strength, higher U.S. interest rates, unresolved trade negotiations and a slowing pace of Chinese growth (still a healthy 6.5%).

IV. GLOBAL FIXED INCOME MARKETS

RISK & RETURN: YEAR-TO-DATE AT SEPTEMBER 30, 2018¹



U.S. INVESTMENT GRADE TAXABLE BONDS [YTD AT SEPTEMBER 30, 2018 (1.60%)]

We have a neutral outlook for investment grade credit. U.S. corporations are fundamentally strong, but tighter monetary policy will make it more challenging to sustain corporate profits. The 3.3% yield on the Barclays U.S. Aggregate Bond Index is at its highest level in 10-years, but these bonds are expensive. Good credit research remains critical in this environment as individual bond evaluation is more important than sectors.

Assessing the hypothetical impact of a 1% rise in interest rates, investment grade bonds may lose 5.9% in price return, only partially offset by yield, for a total return of negative 2.4%. Longer-term, our base case 10-year return forecast for investment grade taxable bonds is 3.5%.

U.S. INVESTMENT GRADE MUNICIPAL BONDS [YTD AT SEPTEMBER 30, 2018 (0.40%)]

Municipal bonds remain attractive, and the combination of solid retail investor demand and muted supply is supportive. However, municipal bonds are expensive at a \$6.30 premium to par. In terms of income, municipals provide a 2.9% yield, which is low on a relative basis, but translates to a 5.2% tax-equivalent yield, which exceeds the yield of the Barclays Aggregate Bond Index by 1.7%.

Our base case 10-year return forecast for short- to intermediate-term investment grade municipal bonds is 2.5%. Over the near-term, however, we expect additional rate hikes will negatively impact total returns.

Assessing the hypothetical impact of a 1% rise in interest rates, municipals may lose 5.8% in price return, offset by the yield, for a total return of negative 3.1%.

U.S. HIGH YIELD BONDS [YTD AT SEPTEMBER 30, 2018 +2.57%]

High yield bonds remain attractive, especially those of higher quality. Higher interest rates have been a drag on most fixed income returns, but they have detracted less from high yield bonds. The asset class has benefitted from U.S. economic strength and earning results in 2018. Note that while the higher yield serves

as a cushion against rising interest rates, the higher correlation to the S&P 500 Index means this asset class is more susceptible to down market risk.

Assessing the hypothetical impact of a 1% rise in interest rates, high yield bonds may lose 3.8% in price return, offset by the 6.2% yield, for a total return of positive 2.4%. Over the longer-term, our base case 10-year return forecast for high yield bonds is 5.25%, and a somewhat lower return for lower yielding, higher quality high yield bonds.

FLOATING RATE LOANS [YTD AT SEPTEMBER 30, 2018 +4.04%]

Loans remain attractive, as their shorter maturities and variable rates help to weather rising rate environments. Our forecast based on rising rates supports mid-single-digit positive total returns due to high yields and low default risks. Coupon income has historically proven to be a reliable forward performance proxy. The yield on the S&P/LSTA Leveraged Loan Index was 5.8% at quarter-end, and is expected to rise as the Federal Reserve continues on a path of normalization.

Loan defaults are expected to increase, but given that loans are senior in the capital structure, the historical default recovery rate has averaged 77%, including recessionary periods. Assessing the hypothetical impact of a 1% rise in interest rates, floating rate loans may lose 0.1% in price return, offset by the yield, for a total return over 5%.

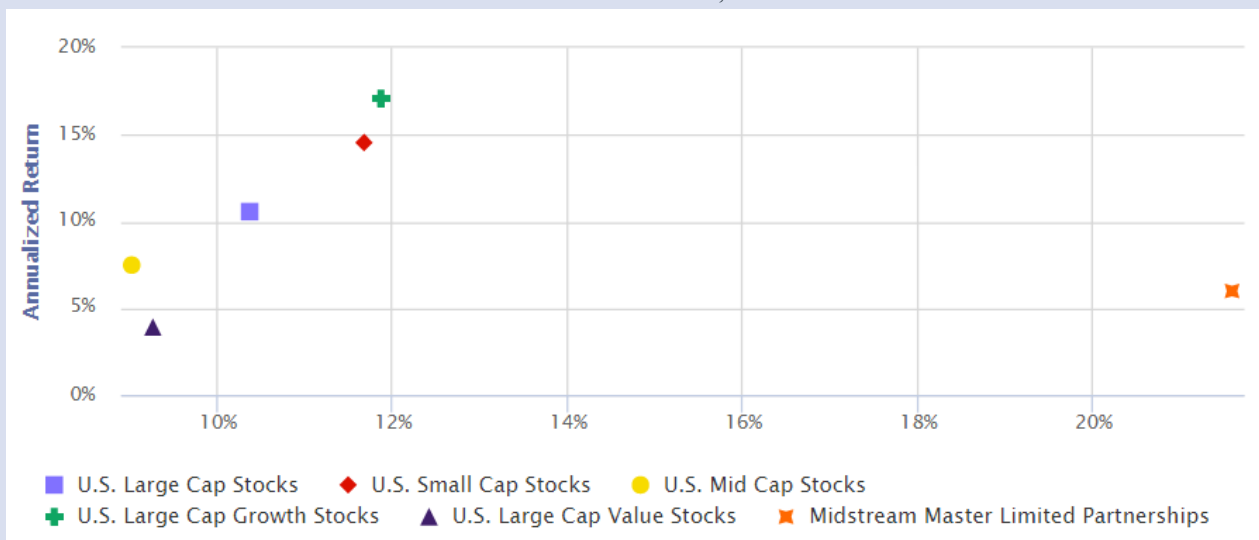
FOREIGN BOND MARKETS [YTD AT SEPTEMBER 30, 2018 (3.03%)]

Foreign government bonds have done well in local currency terms, but poorly when converted to U.S. dollars. Yields are expected to tick slightly higher, as the primary central banks follow the U.S. lead to become less accommodative. However, foreign bonds are susceptible to regional political and economic issues. Notably, we expect the turmoil in Italy, U.K Brexit risk and related Eurozone exposure to continue through year-end.

As for emerging markets debt, we believe similar or better value can be found in the U.S. high yield and floating rate loan markets, without taking on the risks associated with emerging market debt and currencies.

V. U.S. EQUITY MARKETS

RISK & RETURN: YEAR-TO-DATE AT SEPTEMBER 30, 2018¹



U.S. LARGE CAP EQUITY [YTD AT SEPTEMBER 30, 2018 +10.56%]

Our medium-term outlook for U.S. equities is mostly positive. The U.S. economy is fundamentally strong, but risks related to monetary and protectionist trade policies may not be fully reflected in the stock market. The primary monetary risk is that the Federal Reserve will raise interest rates too high and too fast. Trade policy will be a headwind to the U.S. economy as the reality of tariffs and the uncertainty regarding trade policy weighs more on market and corporate sentiment. This headwind has currently been offset by the positive impact from tax cuts and fiscal stimulus on corporate profits.

Looking ahead, despite significant headwinds, U.S. fundamentals remain supportive. Growth is likely to moderate into 2019, but corporate earnings are expected to normalize in the mid to high single in 2019 as the benefit of tax cuts is fully incorporated into comparisons. This level would be positive for equity markets at normal valuations, but we may see valuation regression offsetting some gains.

We do not believe the market is overheated, but we see the economy has strengthened to approximately 3% growth (year-over-year). Our base case is that this growth rate will be maintained through mid-2019, after which it will fade closer to the long-term potential rate of 2% in the second half. Valuations have improved following the market volatility in early October, but they are still somewhat high relative to history, which can expose markets to shifts in sentiment.

We believe U.S. equity market returns will end the year with a positive return amid higher volatility. With investors paying particular attention to Fed policy and rising interest rates, a tight U.S. labor market, midterm elections and protectionist trade policies, a return to higher market volatility is expected. It is important not to let political noise cloud our investment judgement. Since 1945, there has not been a negative 12-month period for the S&P 500 following a mid-term election. With the U.S. economy performing well, we expect that positive record to continue through this election cycle.

MASTER LIMITED PARTNERSHIPS [YTD AT SEPTEMBER 30, 2018 +5.90%]

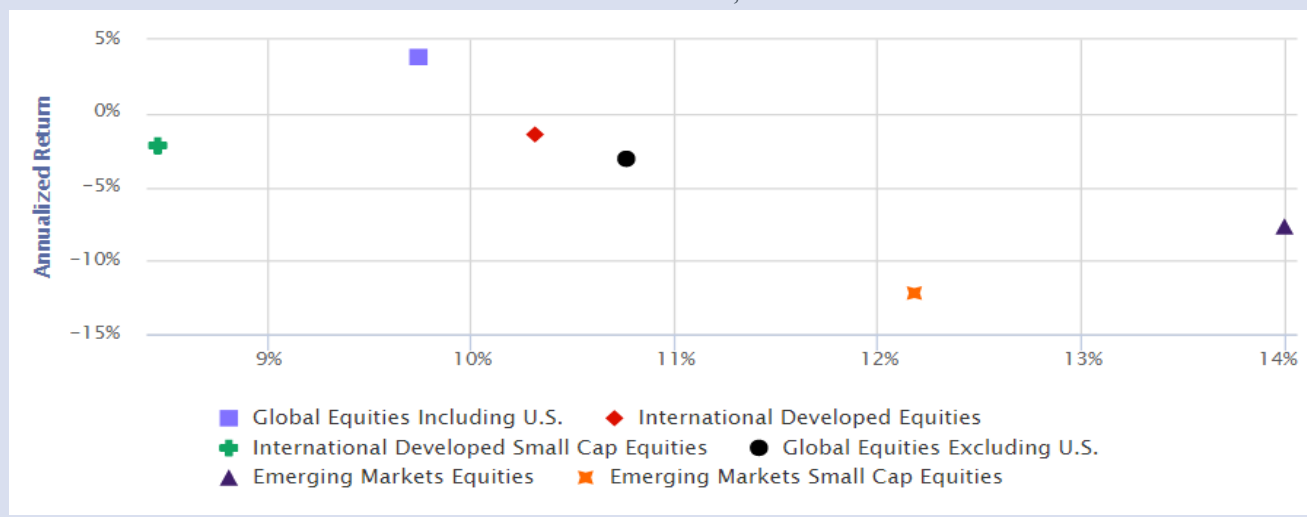
We have a favorable outlook for midstream energy infrastructure (benchmarked to the Alerian Midstream “MLP” index). We believe the sector will continue to benefit from energy price stability, as it has thus far in 2018, and that the high yield and sustained expansion will continue to be a point of differentiation. We believe that, within energy infrastructure, a business’s worth is driven by the value of its cash flows.

Guidance suggests overall asset class distributable cash flow has improved, as have most companies’ debt coverage ratios. Specifically, the Alerian MLP Index offered a yield of 7.9% at quarter-end, along with a 5.0% forecasted growth rate and 1.26x debt coverage ratio.

Many institutional MLP managers construct their portfolios to include companies with slightly lower yields, similar overall debt coverages, but two or three times the distribution growth rate. Speaking with our managers, we understand there has been an effort to diversify outside of “pure” energy master limited partnerships. While this has resulted in underperformance in 2018, this risk reduction should be beneficial in the longer term.

VI. FOREIGN EQUITY MARKETS

RISK & RETURN: YEAR-TO-DATE AT SEPTEMBER 30, 2018¹



INTERNATIONAL DEVELOPED EQUITY [YTD AT SEPTEMBER 30, 2018 (1.43%)]

International developed equities have been impacted by concerns over U.S. and Chinese trade tariffs, and there has been a contagion effect stemming from broad based emerging markets equity risk sentiment. We believe the relatively poor performance of this asset class stems predominately from external risks, but it is also susceptible to local political developments. We are mindful that the new Italian administration’s budget is projected to run a fiscal deficit of 2.4% of gross GDP over the next three-years. Ongoing Brexit negotiations remain an ongoing concern.

While we believe European equity markets will remain subject to a number of headwinds in the coming months, there is evidence to support ongoing improvement in fundamentals and continued positive earnings momentum.

- Corporate earnings have been strengthening with most companies raising or maintaining full-year guidance.
- The euro could provide a tailwind as it has been relatively weak against the U.S. dollar.
- The ECB’s key short-term interest rate remains negative and accommodative.

Outside of Europe, we see positive growth forecasted for Japan amid improving corporate profitability. Many companies have announced plans to hike dividends and increase share buybacks due to improved cash flows. Japan has not been impacted directly, nor via contagion, by the escalating global trade negotiations. Politically, Japan’s Prime Minister Shinzo Abe was reelected for a third term, which is viewed as a positive development.

Valuation metrics favor the Japan over other developed equity markets. The current next twelve-month P/E ended the third quarter at 13.6x, which is significantly lower than the MSCI World and S&P 500, which were 16.0x and 16.8x, respectively.

EMERGING MARKETS EQUITY [YTD AT SEPTEMBER 30, 2018 (7.68%)]

At the end of the third quarter, the MSCI Emerging Markets Index had returned to levels not seen since October 2007. During this period, the Index experienced extreme volatility, including a maximum

drawdown of 62% in 2009 and 33% in 2016, and positive calendar year returns of 78% and 11% during these same years, respectively. We expect this asset class will continue to be pressured by high volatility in the short- and intermediate-terms.

Emerging markets equities have been particularly susceptible to the U.S. dollar. On average, over the past 20-years the MSCI EM Index has risen 22% when the U.S. dollar has weakened 5.8%, and declined 14% when the U.S. dollar has strengthened 6.8%. Valuation metrics favor this asset class over developed markets equities. The current forward twelve-month P/E ended the third quarter at 11.1%, which is far lower than the MSCI World Index and S&P 500 Index, which were at 16.0% and 16.8%, respectively.

Trade protectionism appears to be the greatest risk to the asset class, but guidance suggests the global GDP impact will be relatively constrained over the short-term. The successful renegotiation of NAFTA in late August, now renamed the U.S.-Mexico-Canada Agreement (USMCA), suggests to us that the U.S. may now focus on finalizing a bilateral agreement with China ahead of the November midterm elections.

As it pertains to China, which represents 31% of the MSCI Emerging Markets Index, we see slower growth ahead. China has been growing more slowly and cannot sustain the nearly 10% real GDP growth rate it has maintained for many years. Growth is forecasted to slow to a 6% annual rate, and we expect Chinese policymakers will use all fiscal and monetary tools at their disposal to support the continuation of that growth. In fact, we have already seen the central bank lower the reserve requirements to free up extra capital for banks to lend.

In terms of earnings expectations, growth in 2018 is expected to be in the high single digits or low double digits. However, we hold a more contrarian view than many strategists. As opportunities are present for repositioning, we may move from pure emerging market equity mandates to more global mandates to provide more flexibility to skilled investment managers, enabling them to move in and out of EM markets based on relative risk and return factors.

CLOSING THOUGHTS

In early October, we witnessed a significant market reaction stemming from “risk off” investor sentiment amid worries over rising interest rates and the impact of tariffs and counter sanctions. The global stock market sell-off occurred as investors took profits on outperforming sectors and prior market leaders, generally those with the highest P/E ratios. Investors saw the 2-year U.S. Treasury yield eclipse the dividend yield offered by the S&P 500 Index and the 10-year Treasury to increase 25 bps in just five trading days to over 3.25%. Although rates have since moderated, the trend towards higher rates is clear.

In our opinion, the recent market pull back was an overreaction to a reasonable monetary action. Investors that have maintained a dedicated rebalance schedule were better protected versus those overweight equity. Market pull backs of 5% have historically happened an average of three times per year, with 10% corrections nearly once per year. This pull back has merely normalized market valuations. We do not see this as a signal to sell, but rather a good reminder to rebalance back to long-term targets.

¹ Chart data sourced from eVestment Analytics