Q4 2018

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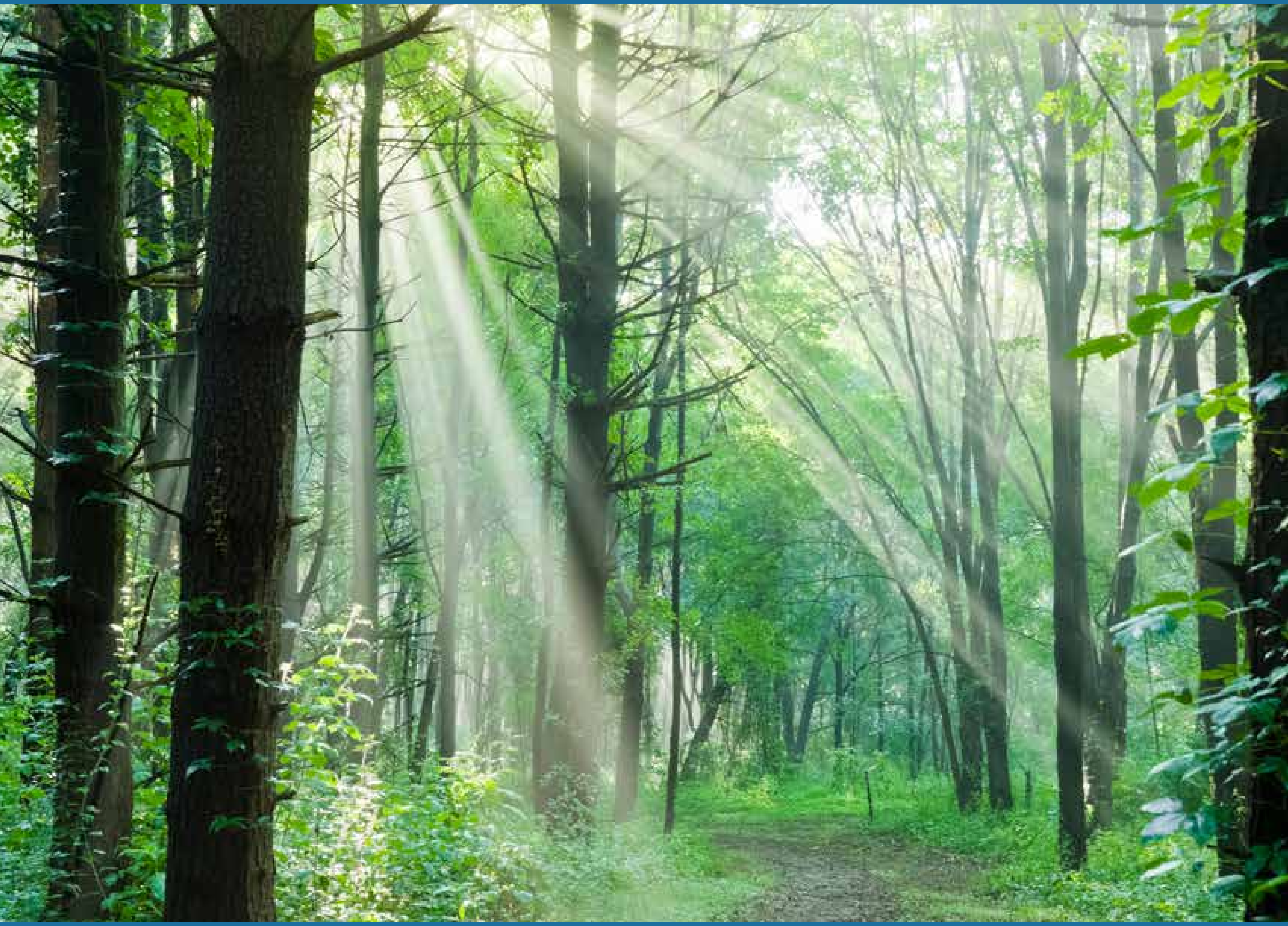

Personalized Wealth Management

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Mitch's Outlook

Explaining Volatility and Focusing on the Year Ahead

Let's not beat around the bush – Q4 2018 was a challenging, if not ruthless, quarter for equity investors. The S&P 500 peaked in September, then sudden and sharp equity price declines extended through Christmas Eve. The S&P 500 fell -13.5%[1] (total return) for the quarter and finished 2018 down -4.4%. Considering that U.S. GDP is expected to have grown over 3% in 2018, with corporate earnings growth between 15% and 20%, it isn't the result one would expect.

So, what happened? In just a couple of months, investors shifted from being optimistic about corporate earnings and economic growth to being convinced the U.S. was headed for a recession. In my view, the onset of downside volatility reflected this shift in sentiment, but it's important not to conflate this with a shift in underlying economic fundamentals.

That's how corrections happen – assets get re-priced downward once investors assume the worst-case scenario, then equities rally when the economy doesn't enter a recession and earnings growth proves stable. Today, let's ask ourselves the same question we ask each time the market corrects: will the worst-case scenarios come to fruition or will outcomes be better, or less worse, than expected?

There are four factors we believe drove recent downside volatility. Here, we'll review whether those factors (fears) are substantial enough to cause a recession/bear market.

U.S. Economic Growth

There is little doubt the U.S. economy is likely to slow in 2019. Still, the unemployment rate is near a 50-year low (3.7%), while wages are rising at ~3.1% and core inflation is at 2.2%. As much attention was focused on Apple's rare downward earnings revision on January 3, few noticed the economy added 312,000 jobs in December. This significantly outpaced the 180,000 jobs that economists were expecting. In all, the U.S. is expected to grow over 2% in 2019.[3]

Corporate earnings also do not suggest a recession is nigh. S&P 500 Operating Margin (a measure of corporate profitability) has been ticking solidly higher since the end of 2015. In the past two cycles, we've seen operating margin growth peak and then turn negative before a recession took hold.[4] Operating margins may well have peaked in 2018, but we think we're at least a year away from seeing them turn negative.

Global Economic Growth

The wild card for global economic growth, in our view, is China. The concern is whether the world's second largest economy is in worse shape than most believe. Economic metrics from retail and property sales to consumption tax revenue are down in China.[5] When Apple revised earnings downward on January 3, it was due mostly to concern over sluggish iPhone sales in "Greater China;" a concern made worse by trade disputes with the U.S.

Given China's growth concerns, and global market volatility as a backdrop for these negotiations, it appears the United States has some leverage to force China into a deal. At the same time, China has the advantage of a government that faces little to no political pressure from their citizens.

In our view, no one wins from a trade war between the U.S. and China; both sides are incentivized to arrive at a deal. To be fair, this leaves the door open for both a positive or negative surprise for the markets, though we tend to believe a positive surprise could be in the offing.

Interest Rates

The Federal Reserve's deleveraging policies through U.S. interest rate increases and balance sheet reductions are reducing liquidity in financial markets. "Removing the punchbowl" has arguably created a negative response for risky assets. Case in point: recent market volatility began in September 2018 with the FOMC removing the word "accommodative" in describing its policy to become more data dependent. The fact remains that the U.S. Real Fed Funds Rate, which accounts for inflation, is still close to zero.[6] We think this means that 'error territory' for the Fed is still a couple of rate increases away.

The question at the end of Q4 2018 was whether Fed Chairman, Jerome Powell, would make a shift if equity market volatility continued, particularly if economic data remained solid. Almost like clockwork, on January 4, Chairman Powell noted that the Fed was ready to "shift policy quickly and flexibly" should downside risks become more pronounced. He added that the Fed would be "patient" to see how the economy evolves in 2019; equity markets jumped on the news.[7]

Time will tell how Fed policy shapes up in 2019 given the economy is expected to continue growing (meaning another rate increase may be warranted). But, in our view, the Fed seems poised to "pause" interest rate increases perhaps by mid-year (if rates are increased at all), which should help put the market at ease.

Programmatic Trading

There has been ongoing research regarding automated trading and what triggers it, particularly at the institutional level. One key finding is that large institutional portfolio managers sold during market corrections because stock prices were falling. Investors were reacting to price movements versus changing fundamentals. So, selling has 'snowballed' because large institutional investors sold stocks because other large institutional investors were selling stocks.

The problem is that this lemming-like behavior is becoming a self-fulfilling prophecy given algorithmic trading. If we look at a sample of three of the largest multi-strategy hedge-funds, they might collectively manage only $100 billion dollars in assets. However, through leverage, they can deploy half a trillion dollars. Additionally, most of these firms are focused on using leverage to generate returns on a very short-term time horizon.

Essentially, by independently analyzing past price movements, multiple firms have come to the same conclusion as psychologists – during large negative market movements selling accelerates.

This bias is ingrained in multiple trading strategies all of which basically start firing at the same time under the same conditions. As a result, mild selling has the capacity to snowball much more quickly in today's market than it has historically.

A key concern is that programmatic trading may prevent markets from functioning normally since large amounts of capital are deployed in response to price changes instead of fundamental changes. While I share this concern, my belief today is that the total return produced by stocks over the long-term will not be affected. Since stocks measure value created over time by corporations in the global economy, I'm not convinced that algorithms can fundamentally change the arc of that value creation and how it is priced.

Bottom Line for Investors

If economic uncertainty is a catalyst for downside market volatility (we believe it is), it should also follow that subsiding uncertainty can be a catalyst for market recovery. It is far from certain that the fears reviewed here will be resolved (and subside) in a timely and effective manner. But, we do think they will be resolved, with worst-case scenarios avoided.

The market environment today, where uncertainty seems to rule, brings to mind an underappreciated market principle: when expectations drift too far from reality, assets get mispriced. The phenomenon works both ways. In 2000, when investors poured money into Dotcoms with little concern for risk or earnings, there was an expectation that paying an exorbitant premium for a company was worth it—after all, it was sure to be the 'next big thing!'

Today, it may be similar to wonder if the increasingly negative expectation of economic slowing/decline is perhaps too far disconnected from the reality of current economic fundamentals. This is not to say that the global economy is humming along—it isn't. But, is a recession really as imminent as the downside volatility suggests?

Over time, asset prices have a way of finding the balance between expectations and reality—that's why they have always rewarded investors with fairly consistent long-term annualized returns. As the global economy grows from decade to decade, broad global indices appreciate too. Lots of crazy things happen along the way, but ultimately the stock market is a weighing machine of economic progress, and as long as progress happens (it always has), investors get rewarded for sticking with it.

Mitch

1 Strategas Research

2 Zacks Investment Research

3 Strategas Research

4 Strategas Research

5 The Wall Street Journal

6 The Federal Reserve

7 The Wall Street Journal

All-Cap Core Strategy

For the quarter ending December 31, 2018, the Zacks All-Cap Core Strategy returned -12.64% gross and -13.04% net, exceeding the -14.30% return from the Russell 3000 Index, the strategy's benchmark. For 2018, the All-Cap Core Strategy returned -4.04% gross and -5.72% net, while the Russell 3000 Index was down by -5.24% over the same period. Since inception, the Zacks All-Cap Core Strategy ranks in the top 4% of 614 managers in the Morningstar All Domestic Equity Managers universe.

In terms of style and size, defensive stocks broadly outperformed cyclicals, growth outperformed value stocks, and large-caps outperformed small-cap stocks. Defensive stocks outperformed cyclical stocks across all capitalization categories. While Russell 1000 defensive stocks were essentially flat (down 4 basis points), Russell 1000 cyclical stocks fell by a wide margin, down -9.48%. Similarly, Russell 2000 defensive stocks, although down by -8%, significantly outperformed Russell 2000 cyclical stocks which fell by -14.13%.

Although growth stocks trailed value stocks in Q4, in 2018 growth stocks outperformed value stocks across all capitalization categories. The Russell 1000 Growth index (large-cap growth) fell by a modest -1.51% while the Russell 1000 Value Index (large cap value) fell significantly by -8.27%. Similarly, the Russell Midcap Growth Index (down -4.75%) outperformed the Russell Midcap Value Index (down by -12.29%). In terms of size, performance played in near linear fashion – the larger the size, the better the performance. Mega-cap stocks (Russell 200 Index) were down 52 basis points over the quarter, while the next group, the Russell 1000 Index, was down -4.78%. Moving down the line, the Russell Mid-Cap Index fell -9.06% and the smallest category of stocks (Russell 2000 Index) were down -11%.

For the year ending December 31, the All-Cap Core strategy's sector allocation contributed positively to performance (40 basis points) as did stock selection (80 basis points). The strategy added significant value in the Health Care, Utility, Technology, and Energy sectors. In the Health Care sector, stock selection added over 95 basis points while allocation added 10 basis points. The Health Care sector's returns (+5.63%) far exceeded those of the Russell 3000 Index (-5.24%), and several health care stocks such as Merck (+38.84%), Pfizer (+24.10%), United Healthcare (+14.48%), Amedisys (+115.33%) and Edwards Life Sciences (+35.53%) stood out. Similarly, in the Utilities sector, several strategy selections, such as American Electric Power (+5.39%) and American States Water (+17.85%), added value. The All-Cap Core strategy benefited from being overweight to the Health Care sector in Q4.

Despite the severe correction in several technology stocks, All-Cap Core was exposed to stocks and sub-sectors in Technology that performed well. Combining the impact of allocation and stock selection decisions, the strategy added over 90 basis points of return over the benchmark in its Technology positioning. The Security Software company, Fortinet (+61.21%), the Communications Equipment company CIENA (+58.31%), and the software behemoth Microsoft (+20.59%) were notable contributors.

The All-Cap Core strategy benefited from being underweight the Energy sector (-19.68%), the worst performing sector in the Index. Even within this sector, however, the strategy held mostly integrated Oil and Gas companies, which performed far better than Oil Services stocks. Stock selection added 32 basis points of value while allocation added 17 basis points in the Energy sector.

The strategy's results, we believe, are a product of a disciplined investment management process combined with a strong risk management approach. Some factors to look out for in the coming months and quarters are potential Fed actions, trade conflicts, and deceleration in global growth. At the end of the day, we follow our model and continually refine it while managing risk on your behalf. This is the team's approach and we encourage investors to remain focused on long-term results.

Dividend Strategy

In Q4 2018, the Zacks Dividend Strategy returned -8.94% gross and -9.35% net, outperforming its benchmark, the Russell 1000 Value Index, which declined -11.72% during the period. The dividend yield on the strategy was 3.65% at the end of Q4 2018, which is higher than the 2.87% yield on the Russell 1000 Value Index. Since inception, the Zacks Dividend Strategy ranks in the top 2% out of 756 managers in the Morningstar Large Cap Value Universe.

The final three months of 2018 were notable for the sudden, heightened volatility and steep drop in prices across all asset classes. Investors seemed focused on early signs of a slowdown in U.S. economic growth, trade tensions with China, and continuing global economic weakness outside the U.S.

Oil and materials prices dropped sharply reflecting weaker global demand. Additionally, the Federal Reserve cited strong U.S. employment gains and sustained economic growth as rationale for raising interest rates and maintaining tighter monetary policy. Investor mind-sets swung from focusing on current fundamentals to anticipating sooner-than-expected economic growth slowdown and corporate profit reduction. This resulted in asset prices and valuations moving sharply lower. Additionally, investors favored defensive companies and sectors.

In the 'large value' space, Utilities, Health Care, and Consumer Staples outperformed over the quarter. Energy, Industrials, and Materials underperformed. The strategy's overweight to the Health Care and Consumer Staples sectors, and underweight to Energy, supported relative performance. The strategy's underweight to the Utility sector hampered relative performance.

We believe the U.S. economy has unique opportunities for 'positive surprises.' If retaliatory global trade actions do not spread widely, if the U.S. and China can strike a trade deal, and if the Federal Reserve pauses monetary tightening (all of which we see as distinct and likely possibilities) then equities are likely to respond positively. Dividend stocks would be no exception.

Finally, due to the tax-advantaged nature of dividend payments, as well as a more attractive yield of 3.65% net in Q4 2018 versus the 10-Year US Treasury yield of 2.69%, we believe the strategy remains well-suited for investors seeking moderate growth and income.

Focus Growth Strategy

In Q4 2018, the Zacks Focus Growth Strategy returned -15.55% gross and -15.94% net. The strategy's benchmark, the Russell 1000 Growth Index, returned -15.89% during the same period. Since inception, the Zacks Focus Growth Strategy ranks in the top 7% of 937 managers in the Morningstar Large Cap Growth universe.

Equity market volatility reared its head in September, as the Federal Reserve removed the word "accommodative" from its policy statements and following a quarter point interest rate increase. Though the economy was strong and corporate earnings continued to grow firmly, the market seemed to believe the era of easy money was coming to an end. When the Fed made it clear that further interest rate increases were likely in 2019, if the economy continued to expand, equities entered a volatile patch that led to sharp and sudden declines. The possibility of a recession in 2019 cast a cloud over the market.

Beneficially, in Q4 2018, Focus Growth was overweight to the Health Care, Transportation, Basic Materials, and Business Services sectors which supported relative returns as each sector outperformed the benchmark. The strategy's underweight to Financials and Retail-Wholesale also supported relative returns as those sectors underperformed the benchmark. However, Focus Growth performance was hampered by the strategy's weightings to the Industrial, Energy and Technology sectors. Utilities and REITs rendered neutral performance relative to the benchmark.

Looking back at 2018, the Zacks Focus Growth strategy outperformed its benchmark, returning -1.33% net, versus the Russell 1000 Growth Index, which returned -1.51%. Looking forward to 2019, we remain cautiously optimistic that the equity market is due for a recovery and believe the strategy is positioned to continue outperforming on the upside.

International Strategy

In Q4 2018, the Zacks International Strategy returned -11.71% gross and -12.11% net. The strategy's benchmark, the MSCI EAFE declined -12.50% over the same period.

During the quarter, political turmoil, central bank actions, and the on-going U.S./China trade war drove negative market sentiment higher. As China attempts to balance several economic objectives, such as controlling property prices, reducing excess leverage, reducing emissions, and maintaining stable employment, a soft landing for the Chinese economy appears further out of reach. A trade breakthrough with the United States, while far from assured, would be a boon for China.

The weakening Chinese economy has also affected Europe, as evidenced in the European auto and auto-components industries. Several European sectors, such as Financials, have seen valuations marked-down significantly even while underlying businesses continue to perform relatively well. Of course, not all of Europe's problems can be blamed on China and trade issues – some are of Europe's own making. The fear of a disorderly Brexit is undercutting future economic growth as businesses hold off on new investment until there is more clarity on the situation. After several years of QE, and trillions spent by the ECB (European Central Bank), European GDP growth and inflation are still uninspiring. QE has failed to achieve anything meaningful in Europe and has, arguably, led to populist uprisings in countries like Italy.

The stock markets of nearly every major developed economy fell last year. The best performing developed economy was New Zealand, but it only rose by 35 basis points. Among all major economies, other than New Zealand, only Brazil (-2.57%), Russia (-7.10%) and Norway (-7.99%) stood out. Beneficially, new positions were initiated in the International Strategy at 2.73% for Russia and 2.44% for Norway while the strategy's weight to Brazil was increased 1.5% in the last rebalance of 2018.

On a relative basis, the International Strategy's models resulted in several supportive calls. Allocation to Singapore (EWS), Australia (EWA), Hong Kong (EWH), and Thailand (THD) added material value to total return. Each country fell by less than the benchmark supporting relative outperformance. Similarly, among major calls to reduce or remove a country, reducing South Korea's weight and removing Belgium added value to the strategy as Korea (EWY) was down -20.38% and Belgium (EWK) was down -20.39%; both significantly underperformed the broad EAFE index.

Ultimately, global equity markets are inherently volatile and issues such as trade, geopolitics, wars, and political uprisings will likely never fully dissipate. And, while these factors matter, what matters most is whether or not there is growth. Investors should ask, is new value being created in the global economy by global corporations? If the answer is ‘yes’ (it almost always is), then we believe it makes sense to have a globally diversified equity portfolio for those seeking growth over the long term. Attempting to trade in and out of the market during patches of volatility will only increase the chances of being left on the sidelines when the market undergoes a sustained rally. In our view, global growth is still expected to finish in positive territory in 2019, with low risk of global recession. From a U.S. investor’s perspective, having international allocation offers the potential to reduce risk and increase long-term expected return. The events of the past few quarters haven’t destroyed the basic tenets of investment rules. The team continues to follow the strategy’s models and prudently manage risk.

Market Neutral Strategy

While the Zacks Market Neutral Strategy saw its NAV down slightly in Q4 2018, this stood in stark contrast to the S&P 500 which was down a steep -13.52% during the same period.

The Market Neutral strategy fell slightly due to the strategy's small-cap stocks risk exposure. Small-caps, a major portion of the portfolio, exhibited greater downside volatility than large-caps during the quarter as investors pivoted to safety. Growth stocks, particularly within the large-cap space, outperformed their value counterparts. The strategy's short exposure to large-cap growth positions hampered returns relative to the strategy's better performing long positions.

From a sector perspective, performance in Retail, REITs and Financials were relatively neutral. Additionally, while the strategy's short positions performed as expected in Technology, long positions did not fare as well with several concentrated positions underperforming. In the Capital Goods sector, both the long and short positions generated losses relative to their peers in the sector. A majority of the long holdings underperformed versus their short counterparts within this sector. Consumer Staples, Health Care and Consumer Cyclical sectors also underperformed.

As the market rallied in the first half of 2018, and investors chased a few winners in the large-cap growth space, the Market Neutral strategy experienced challenges. However, investors started to realize the risks of high correlations for those few stocks, leaving more divergence from the rest of the market. As such, we believe the strategy has a strong opportunity to perform better in 2019.

Mid-Cap Core Strategy

In Q4 2018, the Zacks Mid-Cap Core Strategy returned -17.37% gross -17.75% net. The Russell Midcap Index returned -15.37% over the same period. Since inception, Zacks Mid-Cap Core Strategy ranks in the top 1% of 317 managers in the Morningstar Mid-Cap Blend universe.

As an asset class, mid-cap stocks underperformed large-caps but outperformed small-cap stocks over the quarter. A confluence of concerns hit the market during the period, which led to elevated levels of volatility throughout.

Early signs of slowing U.S. economic growth, increased trade tensions with China, and continuing global economic weakness (outside the U.S.) contributed to the downside. When the Federal Reserve increased interest rates a quarter percentage point, and removed the word "accommodative" from their policy statement, the market immediately postured for an increased chance of recession in 2019. This drove valuations and equity prices sharply lower. On Christmas Eve, the S&P 500 touched bear market territory with a decline of -20%, but it only lasted a day and the market rallied afterward. Our view remains that economic fundamentals in the U.S. and abroad, while weakening, remain firmly in growth territory with corporate earnings in the U.S. set to grow in the high single digits in 2019. We maintain a constructive view on stocks as a result, and see the downside pressure as a classic market correction, not a prolonged downturn.

In the mid-cap space, the Utilities and Consumer Staples sectors outperformed while Energy, Financials, and Technology underperformed. The strategy's overweight to Utilities supported relative performance, while the strategy's underweight to the outperforming Consumer Staples sector hampered relative performance.

We believe the U.S. economy has unique opportunities for 'positive surprises.' If retaliatory global trade actions do not spread widely, if the U.S. and China can strike a trade deal, and if the Federal Reserve pauses monetary tightening (all of which we see all as distinct and likely possibilities), then growth-sensitive mid-cap stocks could see strong gains. Mid-cap stocks, in particular, could benefit from investors deflecting risks associated with small-caps who wish to pursue higher growth potential than might be seen in large-cap stocks.

Quantitative Strategy

In Q4 2018, the Zacks Quantitative Strategy returned -18.76% gross and –19.15% as the strategy's benchmark, the S&P 500, returned -13.52% over the period.

During the quarter, the strategy maintained an overweight to small and mid-cap stocks, though neither category outperformed large-caps across most sectors. Large-cap growth stocks were the better 'defensive' stocks during the recent downside volatility, perhaps as investors viewed traditional smaller-caps as more vulnerable to interest rate risk. It follows that small-cap stocks, which performed impressively earlier in the year, experienced a great deal of profit-taking during the market rout. We maintained a constructive outlook on equities throughout most of the year, and do today, as the strategy maintains its positioning; we believe a recovery in prices could benefit areas of the market hurt the most on the downside.

From a sector perspective, the Quantitative Strategy was overweight to the Consumer Discretionary, Industrial Products, and Financials sectors. However, these sectors took hard hits in Q4, particularly in December. The strategy was underweight to the Technology, Health Care, and Consumer Staples sectors, and stock selection within these sectors did not contribute as expected. The strategy's weightings to the Energy, Transportation, Materials, and Utility sectors were neutral.

Looking back on 2018, growth stocks outperformed value stocks across the board. The underlying forces for this, in our view, included both the strong economy and the tax cuts. The trend was disrupted, however, by the late-year uncertainty tied to the U.S./China trade war coupled with tightening Fed monetary policy. Because we believe the uncertainties have potential for positive outcomes (i.e., a trade deal with China and a Fed rate hike "pause") we believe equity markets can and should recover in full. In 2019, we believe earnings consistency will become a major factor in valuations and that earnings should moderate but remain strong.

Small-Cap Core Strategy

In Q4 2018, the Zacks Small-Cap Core Strategy returned -22.06% gross and -22.43% net. The strategy's benchmark, the Russell 2000 index, returned -20.20% during the same period. Since inception, the Zacks Small-Cap Core Strategy ranks in the top 2% out of 544 managers in the Morningstar Small Blend universe.

Early signs of slowing U.S. economic growth, increased trade tensions with China, and continuing global economic weakness contributed to the downside. When the Federal Reserve hiked interest rates a quarter percentage point amidst these concerns, and removed the word "accommodative" from their policy statement, the market postured for an increased chance of a recession in 2019; this drove valuations and equity prices sharply lower. Small-cap stocks were particularly hurt by the sudden shift in investor sentiment, we believe, for two reasons: small-caps outperformed earlier in the year (and were more vulnerable to profit-taking), and as small-cap fortunes are more closely tied to U.S. economic growth and attractive interest rates.

On Christmas Eve, the S&P 500 touched bear market territory with a decline of -20%, but it only lasted a day with the market rallying soon after. Our view remains that economic fundamentals in the U.S. and abroad, while weakening, remain firmly in growth territory with corporate earnings in the U.S. set to grow in the high single digits in 2019. We maintain a constructive view on stocks as a result, and see the downside pressure as a classic market correction and not a prolonged downturn.

The Zacks Small-Cap Core Strategy was underweight to the outperforming Utilities, Consumer Staples, and Financials sectors and overweight to the underperforming Industrial sector – all of which hampered the strategy's relative performance. By contrast, the strategy's underweight to the underperforming Energy and Health Care sectors supported relative performance. During the quarter, there was a sudden shift in investor positioning to favor defensive companies and sectors. The Small-Cap Core portfolio is positioned for longer-term marketplace trends, not short-term swings, so the impact was felt more in Q4. By the same line of thinking, a recovery could also benefit the strategy disproportionately on the way up.

We believe the United States economy has unique opportunities for 'positive surprises.' If retaliatory global trade actions do not spread widely, if the U.S. and China can strike a trade deal, and if the Federal Reserve pauses monetary tightening mid-year (all of which we see as distinct and likely possibilities), then growth-sensitive small-cap stocks could continue to see strong relative returns looking forward.

Fixed Income Strategy

Bond yields decreased sharply at the tail-end of the year as investors sought a safe-haven from the precipitously declining equity market. Although there was no single catalyst for the sudden selling pressure, investor sentiment went from bullish to extremely bearish quickly. Geopolitical concerns, trade tensions, a slowing housing market, President Trump's disapproval of the Fed Chair, and concerns regarding future economic growth rates contributed to an increasingly volatile market. Treasuries and municipal bonds outperformed corporate bonds and, within the corporate bond sector, investment grade bonds vastly outperformed high-yield bonds during Q4.

As expected, the Federal Reserve raised the fed funds rate by 25 basis points in December citing the strengthening labor market, strong household spending, and solid economic activity as rationale. The decision came as no surprise to market watchers as attention was more focused on the fireworks surrounding the meeting. President Trump has put an increasing amount of public pressure on the Fed to cease raising rates, and there were news stories swirling as to whether he would somehow replace Fed Chair, Jerome "Jay" Powell. Perhaps, not surprisingly, the equity markets started to drop sharply at around the same time.

We believe a combination of political and market pressures effectively 'boxed-in' the Fed and, to show independence from political pressure, the Fed was almost forced to increase the rate. If this didn't occur, it would have degraded the Fed's credibility and weakened their control over monetary policy. While the Fed was going to raise the rate, we also believe their goal was to do their best to calm markets. The Fed December meeting statement was dovish and since then Fed officials have conveyed desire to be patient with future rate hikes. In other words, the Fed is signaling some likelihood that rates will not be raised in the near future. As this piece is being written, predominant 'chatter' is evolving from how many rate increases will occur in 2019 to whether rate increases will happen at all.

Bond yields peaked in early November before declining sharply as equity markets declined. The 2-Year U.S. Treasury bond ended Q4 with a yield of +2.49%, down from +2.81% at the beginning of the quarter but up from +1.88% at the start of the year. The 10-Year U.S. Treasury bond ended Q4 with a yield of +2.68%, down from +3.06% at the beginning of the quarter.

While we expect the yield on short-term bonds to be dictated by Fed policy, yields on intermediate to long-term bonds will be affected by two variables. On one hand, the rising federal budget deficit could cause the U.S. Treasury to issue more debt, which will put upward pressure on yields. On the other hand, if equity markets continue to come under pressure, or an economic slowdown occurs, then yields should remain contained. Overall, investors are finally able to see a meaningful yield return from bond holdings without sacrificing safety.

The yield curve continued to flatten throughout the quarter. The yield spread, as measured by the difference between 2-Year and 10-Year Treasury bonds, was +0.19% at the end of September; down from +0.24% and at the tightest level seen since 2007. While a flattening yield curve is often associated with a slowing economy, or an impending recessionary phase, this thinking is at odds with estimated U.S. economic growth of 2%+ and an unemployment rate that remains at historically low levels.

Credit spreads blew out during Q4 as risk aversion came to the forefront. The difference in yields between corporate bonds and Treasuries reached levels not seen since mid-2016. Concerns over earnings growth, and a realization that U.S. corporations used most tax cut savings for buybacks and dividends rather than strengthening balance sheets, were drivers of higher credit spreads. Lower-rated bonds underperformed higher rated bonds during the quarter.

Municipal bonds rallied as interest rates declined throughout the quarter. Demand remains strong from high tax bracket investors as municipals continue to provide good value on a tax-equivalent basis. Additionally, a reduced supply of new issues helped municipal bond holders as demand outpaced supply. The muni market yield curve is steeper than the Treasury and corporate yield curves, providing attractive yields for investors willing to extend the duration of their portfolio.

Fixed income investments remain an important risk management component for portfolios by providing diversification and stability (as seen during the recent market turmoil). We continue to favor corporate and municipal bonds for investors seeking income and diversification and, as always, credit quality remains foremost in our selection method.

DISCLOSURE Past performance is no guarantee of future results. Results for Strategies are shown gross and net of fees. Results for the Strategy reflect the reinvestment of dividends and other earnings. The results portrayed is the performance history of a composite of all discretionary accounts with no material investment restrictions, which are not restrained by investment style, type of security, industry/sector, location, size or market cap; it invests primarily in U.S. common stocks.

Prospective clients and clients should not assume identical performance results to those shown would have been achieved for their account if it was invested in the Strategy during the period. Clients of the firm may receive different performance than the composite. Client performance may differ due to factors such as timing of investment(s), timing of withdrawal(s), and client-mandated investment restrictions. Wholesale, retail and institutional clients of the firm may have differing performance due to timing of trades.

Investments in the Strategy are not deposits of any bank, are not guaranteed by any bank, are not insured by FDIC or any other agency, and involve investment risks, including possible loss of the principal amount invested. Net of fees performance is based on the maximum fee of 1.75% for a $500,000 account. Lower fees may apply to larger accounts; higher fees may apply to smaller accounts. Separately managed account minimums apply. Inherent in any investment is the potential for loss. Standard management fees are available on request and are described in Part 2A of Form ADV.

The sample portfolio holdings provided represents the top 10 largest equity positions in the Strategy as of 12/31/18 based on the aggregate dollar value for a representative account. The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for the Strategy, and the reader should not assume that investments in the securities identified and discussed were or will be profitable. All information is provided for informational purposes only and should not be deemed as a recommendation to buy the securities mentioned.

Morningstar Rank:

The Morningstar Universes used for comparative analysis are constructed by Morningstar (median performance) and data is provided to Zacks by Zephyr Style Advisor. The percentile ranking for each Zacks Strategy is based on the gross comparison for Zacks Strategies vs. the indicated universe rounded up to the nearest whole percentile as of 12/31/18. Other managers included in universe by Morningstar may exhibit style drift when compared to Zacks Investment Management portfolio. Neither Zacks Investment Management nor Zacks Investment Research has any affiliation with Morningstar. Neither Zacks Investment Management nor Zacks Investment Research had any influence of the process Morningstar used to determine this ranking.

[1] WE CALL IT PURE INVESTING™

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At Zacks, we believe the "truth in investing" is ...the more of your investable assets allocated to stocks and bonds, the greater your net worth will grow. We call this Pure Investing™

Our competitors want to allocate an ever increasing % of your money to alternatives; hedge funds, fund of funds, commodity funds, options, futures or the hot trend or theme at the time, from tulip bulbs to mortgage backed securities.

These "alternatives" amount to gambling with your money, "mostly for the benefit of others". They do not create long-term value. These are simply zero-sum games with short- term winners and losers.

Why chase alternatives, when you can invest in the real thing? We believe there is a Better Way, benefit from Pure Investing™ at Zacks.

Indexes Presented:

The S&P 500 Index is a well-known, unmanaged index of the prices of 500 large company common stocks, mainly blue-chip stocks, selected by Standard & Poor's. The S&P 500 Index assumes reinvestment of dividends but does not reflect advisory fees or other expenses. An investor cannot invest directly in this Index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell 2000 Index is a well-known, unmanaged index of the prices of 2000 small-cap company common stocks, selected by Russell. The Russell 2000 Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell Mid Cap Index is a well-known, unmanaged index of the prices of approximately 800 mid-cap company common stocks, selected by Russell. The Russell Mid Cap Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell 1000 Growth Index is a well-known, unmanaged index of the prices of 1000 large-company growth common stocks selected by Russell. The Russell 1000 Growth Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell 1000 Value Index is a well-known, unmanaged index of the price of 1000 large-company growth common stocks selected by Russell. The Russell 1000 Growth Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot directly invest in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell 3000 Index is a well-known, unmanaged index of the prices of 3000 broad U.S. equity company common stocks, selected by Russell. The Russell 3000 Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The MSCI EAFE is an index from Morgan Stanley Capital International. The MSCI EAFE is a well-known, unmanaged index representing developed nation countries around the world. The MSCI EAFE Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

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