INVESTMENT PERSPECTIVE SEPTEMBER 2018

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MARKET COMMENTARY

US stocks had their best performance of the year in the third quarter. In fact, the S&P 500 had its best quarter since 2013. Large cap stocks in the S&P 500 were up 7.71% in the third quarter bringing their year-to-date return to 10.56%. Small cap stocks in the Russell 2000 had been outperforming their large cap counterparts but slowed this quarter and only gained 3.58%; however, they are still outperforming for the year with a 11.51% year-to-date return. International stocks of developed markets in the MSCI EAFE are still lagging but did gain 1.35% for the quarter yet their year-to-date return is still negative at -1.43%. Emerging market stocks continued to struggle and lost -2.02% in the quarter which resulted in a loss of -9.54% year-to-date. Although bond yields rose again, the Barclays US Aggregate Bond Index had a slight gain of 0.02% for the quarter and a loss of -1.68% year-to-date.

The economy continues to grow. Second quarter GDP growth was 4.2% following first quarter's growth of 2.2%. Third quarter GDP growth could be 3.5% according to The Atlanta Fed GDPNow estimate. David Kelly of JPMorgan expects 3% GDP growth into next year but does expect it to slow to 2% long-term.

Corporate profits also continue to have strong growth. JPMorgan is projecting third quarter earnings growth of 28% which will make it the third quarter in a row with an earnings growth rate in the mid-20's. Next year, earnings growth will likely slow as tax reform benefits will already be factored into year over year comparisons.

President Trump campaigned on a platform to use tariffs to renegotiate trade agreements. Initially some people worried about the tariffs and potential resulting trade wars and stocks floundered along earlier this year. The markets seemed to applaud in June when the US changed strategy to focus on one trade agreement at a time. The US, Mexico and Canada have now reached a trade agreement to replace NAFTA. It will be signed by the leaders in November and voted on by Congress next year. The US and European Union have also begun to make progress on trade negotiations. Talks with China are more difficult and seem stalled at this time, possibly until after the mid-term election. New tariffs on Chinese goods announced and threatened have been met with retaliatory tariffs. Even so, Strategas Research continues to point out how the benefits of tax reform far outweigh the negative effects of the tariffs. However, they do note that if the situation escalates into a full blown trade war, their view would become more negative. They don't expect a trade war at this point. David Kelly at JPMorgan believes that a deal with China will be reached by the end of 2019.

The Federal Reserve again raised rates in September by 0.25%. The Fed didn't change its commentary much except to remove the phrase "the stance of monetary policy remains accommodative". Analysts expect another increase in December and two or three next year. The Fed expects three next year and an additional increase in 2020. The Fed Funds rate is now at 2.0%-2.25% but would be around 3.25%-3.5% by the end of the rate hike cycle. Long-term, the Fed estimates that the Fed Funds rate would settle around 3%.

The 10-year Treasury bond yield resumed its ascent. Its yield went from 2.85% at the end of June to 3.06% at the end of September. Concerns of an inverted yield curve seemed to have abated for now since long-term rates also increased with the move in short-term rates. In addition, Fed Chairman Powell addressed concerns at a Rhode Island conference of business leaders by reiterating that a flattening yield curve was to be expected and that "there's no reason to think that the probability of a recession in the next year or two is at all elevated".

Most analysts continue to favor stocks over bonds for the remainder of the year but also point out that we are moving later into the economic cycle. Late cycle doesn't mean "near recession" but it does mean that you want to understand the risks you are taking in your portfolio. Stock performance may become more varied by security. Next year, bond returns may become positive again as the depreciation in bond prices from yields rising may be counteracted by the increased return being earned with the higher yield. Investors may want to reduce the risk in their portfolios over the next year as bond yields become more attractive.

2018 BENCHMARK RATES OF RETURN

INDEX	THIRD QUARTER	YTD
S&P 500	7.71%	10.56%
DJIA	9.63%	8.83%
NASDAQ	7.14%	16.56%
Russell 2000	3.58%	11.51%
International	1.35%	-1.43%
Fixed Income	0.02%	-1.60%

We value our relationship with you, and we are always available to meet with you in person or by phone. Please do not hesitate to call or email us with any questions that you may have. Also, if your situation has changed, please contact your advisor so we can determine if any changes are needed in your account.

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FINANCIAL PLANNING

Redefining Retirement

How people view retirement is changing. We watched our grandparents or parents retire and it often meant winding down—not setting an alarm because they didn't have to get up to go to work, sitting on the front porch in rocking chairs or in a recliner in front of the tv. Now, people are living longer and they are healthier thanks to advances in medicine. Many retirees are staying more active with hobbies, volunteer activities, grandchildren and other interests so their days are almost as busy as when they were working full-time jobs. Retirement may not mean winding down anymore, it may be more a period of pursuing new opportunities and interests.

Escaping the daily grind may be appealing to some people and they may be counting down the days until they can retire. With proper planning, retirement may come sooner. To start, you need to have a realistic vision of what your retirement will look like. This includes how you plan to spend your time. Then, you need to create a list of expected expenses. This list needs to include any expenses related to new hobbies, travel, entertainment and/or spoiling grandchildren. Then, we'll need to compare it to sources of income. Planning early will help identify if you are saving enough or if savings need to increase.

If savings can't be increased, don't become discouraged. Other adjustments could be made that would help the situation. For example, some people continue to work in retirement. They may work part-time or on a consulting basis. They may even work in a new field or have found a way to turn a hobby into an income. Often, people find they can work later in life and even enjoy it once the day to day job pressures are removed or reduced.

Another option would be to re-examine your expenses to see where reductions could be made. Many people find that they can be just as happy in retirement spending less—they realize that they can reduce their travel budget or the amount of times they eat out in restaurants. They reduce the amount they are giving to kids and grandkids and instead focus on spending time together and creating memories. Some people look for other ways to cut expenses such as downsizing their homes and driving their cars longer before replacing them.

It's never too soon to start planning for retirement. Starting early allows for targeting goals and determining a path to reach your goals. It also makes saving more fun because you know what you are working towards. Your plan doesn't have to be set in stone, it can change as your situation and desires change. We have financial planning software that can help model different retirement scenarios. Talk to your advisor to get started on the process or to check up and see where you stand.

QUESTION: What's a REIT?

ANSWER: A REIT is a Real Estate Investment Trust. It is a company that holds income producing real estate. People invest in REITs for many reasons. First, they can provide diversification benefits as their returns have low correlation to bonds and reduced correlation to other asset classes. Second, they typically provide a higher dividend because REITs must pay out at least 90% of their net income to investors—their yield currently averages around 4.3%. Third, they can provide a hedge against inflation as real estate prices and rents tend to rise with inflation. Fourth, public REITs are more liquid and easier to sell than actual real estate and they don't require a large investment like buying property directly might.

Over the past 15 years, REITs have had an average return of 11.1%. Only emerging market stocks and small cap stocks have outperformed. This good performance didn't come risk-free. REITs also had the second highest volatility during the time period (emerging market stocks were higher).

So far this year, REIT returns are less than half that of US stock returns. Investors have been concerned that higher interest rates will make REITs less enticing to investors who were holding them as an alternative to bonds now that bond yields are more attractive. However, Nareit points out that "share prices of listed equity REITs have more often increased than decreased during periods of rising interest rates". They think this is because higher interest rates are normally accompanied by a growing economy which is resulting in higher earnings.

This may be a good time for investors to increase their REIT exposure. Stock valuations are higher and trading at their 25-year average Price/Earnings ratio. The Price/Free Cash Flow is a comparable valuation measure for REITs and it has not increased like stock valuations; instead it has remained at about the same level since 2010.

One thing to note with REITs is that their dividends are not taxed the same as stock dividends which receive a lower capital gains tax rate. Instead, dividends are allocated and taxed as ordinary income, capital gains and return of capital.

If you would like to learn more about REITs or see how they may fit into your investment plan, please talk to your advisor.

CAMBRIDGE ADVISORS NEWS

We are happy to welcome Andrew Murphy as our new intern for this school year. Andrew is a senior at Creighton University where he is majoring in Finance and Marketing. He is in the Portfolio Practicum Program which manages part of Creighton's endowment fund. Upon graduating, he hopes to return to the Minneapolis area. While he is with us this year, he is preparing the materials for our research meetings and is assisting on some special projects involving investment management, compliance and reporting. Be sure