Market Commentary
Third Quarter, 2018

The economic expansion has accelerated this year, largely due to economic stimulus from tax reform, and will likely remain strong going into 2019. The impact of tax reform will fade eventually, and continued economic growth above 3% will require stronger capital investment, a more favorable trade environment and higher productivity. Longer term, we expect normalized economic growth of 2% or less due to numerous headwinds, including weak productivity growth, unfavorable labor force dynamics, and increasing debt levels.

Although we do not see any indication of recession in the near term, we know how business cycles work and eventually there will be another recession. No one, including the Federal Reserve Bank with all of its resources, is able to predict when the next recession will occur. For perspective, here are a couple of infamous quotes from past Chairmen:

> *"We don't have the capability of reliably forecasting a recession", Alan Greenspan, December, 2000*. That economic cycle peaked March, 2001 with the subsequent recession lasting until November, 2001.
>
> *"The Federal Reserve is not currently forecasting a recession", Ben Bernanke, January, 2008*. That economic cycle actually peaked December, 2007, a month before his quote, with that recession lasting until December, 2008.

And a recent quote from the current Chairman, Jerome Powell:

> *"There's no reason to think that the probability of a recession in the next year or two is at all elevated", Jerome Powell, October, 2018*.

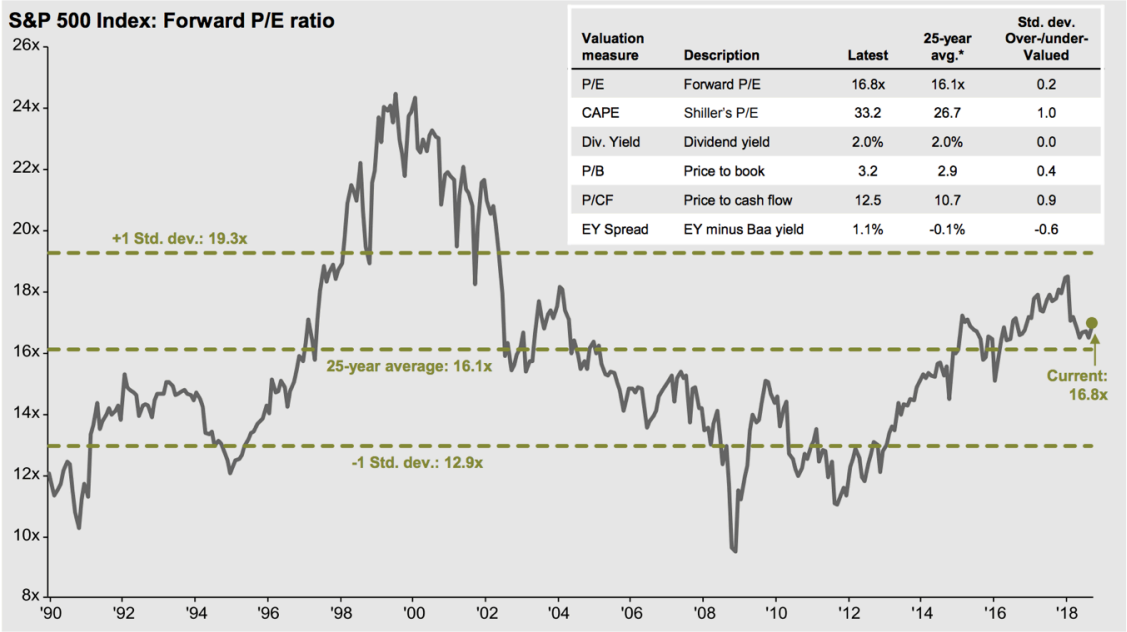
Only time will tell if this becomes another infamous quote from a Federal Reserve Bank Chairman.

We are sharing these quotes ***not*** because we think a recession is likely soon, but rather to reinforce the folly of making predictions. There is another long list of infamous quotes from other respected experts who have been predicting recessions and market corrections for the last eight years. The key point is that recessions and market cycles are impossible to predict. The better approach is to prepare for a wide range of possibilities with a diversified portfolio consistent with your investment objectives and risk tolerance.

Equity Markets

Corporate profits have been very strong in 2018, up 27% thanks to corporate tax cuts, low inflation and low interest rates. Higher corporate earnings have supported record high prices for U.S. stocks. As these favorable factors fade, we expect earnings growth to return to a historical mid-single digit growth rate.

The first table on the following page compares the S&P 500 Index with the 25-year average of six different valuation metrics. With the exception of dividend yield, each measure exceeds its average, but not by a significant amount.

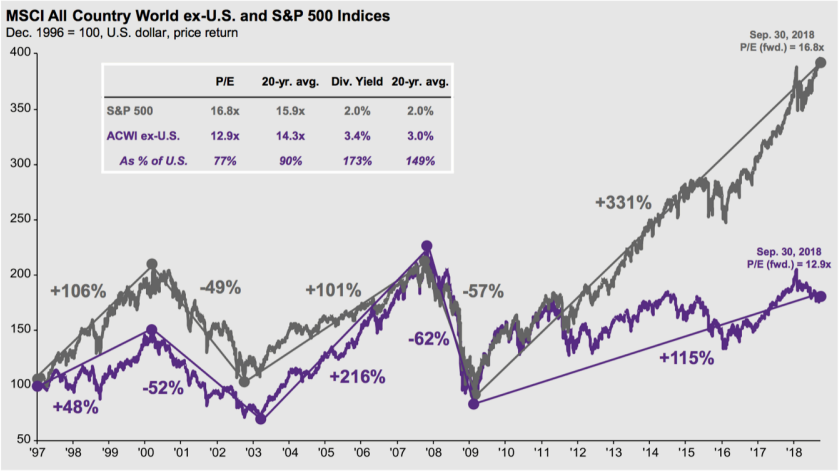


Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	16.8x	16.1x	0.2
CAPE	Shiller's P/E	33.2	26.7	1.0
Div. Yield	Dividend yield	2.0%	2.0%	0.0
P/B	Price to book	3.2	2.9	0.4
P/CF	Price to cash flow	12.5	10.7	0.9
EY Spread	EY minus Baa yield	1.1%	-0.1%	-0.6

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since December 1989, and FactSet for September 30, 2018. Average P/E and standard deviations are calculated using 25 years of FactSet history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price. Price to book ratio is the price divided by book value per share. Price to cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure.
*P/CF is a 20-year average due to cash flow data availability.
Guide to the Markets – U.S. Data are as of September 30, 2018.

J.P.Morgan Asset Management

We continue to believe international stocks may offer better opportunities than domestic. International stocks are attractive over the long run thanks to strong economic growth and the likely downward trajectory of the U.S. dollar relative to other currencies. Further, as noted in the chart below, valuation measures suggest that international stocks are less expensive relative to both the U.S. and their long-term averages.



	P/E	20-yr. avg.	Div. Yield	20-yr. avg.
S&P 500	16.8x	15.9x	2.0%	2.0%
ACWI ex-U.S.	12.9x	14.3x	3.4%	3.0%
As % of U.S.	*77%*	*90%*	*173%*	*149%*

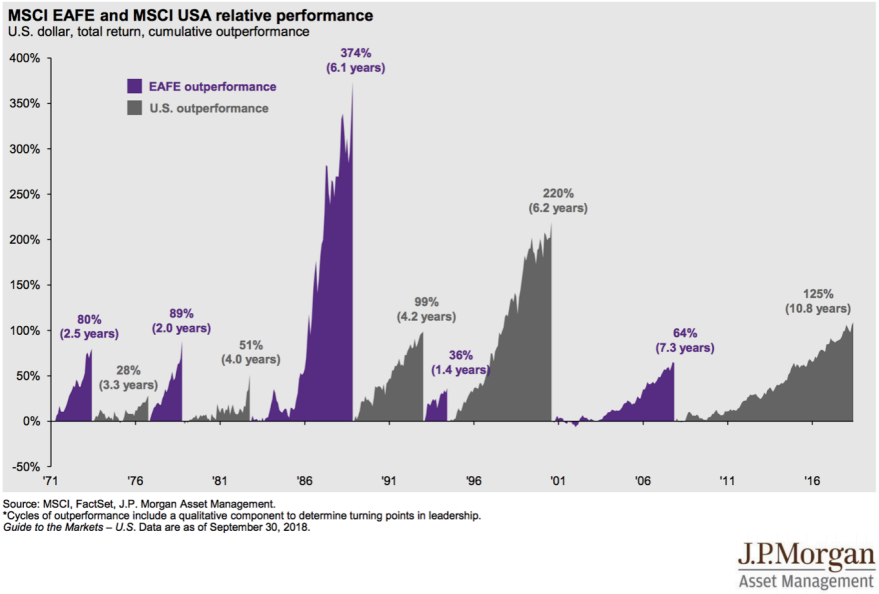
Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Forward price to earnings ratio is a bottom-up calculation based on the most recent index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on price movement only, and do not include the reinvestment of dividends. Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by FactSet Market Aggregates. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of September 30, 2018.

J.P.Morgan Asset Management

We have commented about this valuation gap previously and since then the valuation gap has widened further. The P/E of international stocks is 73% of the S&P 500, significantly below its 20-year average of 90%, and the dividend yield is 3.4%, 73% greater than the S&P 500 and much higher than its 20-year average. We expect the valuations between domestic and international stocks to converge, either with

domestic coming down, international going up, or a combination of the two.

Further, as noted on the chart to the right, there are long cycles of relative outperformance between domestic and international stocks.



Source: MSCI, FactSet, J.P. Morgan Asset Management.
*Cycles of outperformance include a qualitative component to determine turning points in leadership.
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J.P.Morgan
Asset Management

Fixed Income Markets

There has been a significant sell-off in the fixed income market, with the benchmark 10-year treasury yield reaching 3.23% last week, the highest since 2011 and up from 2.01% as recently as September 2017. There is upward pressure on yields due to the strong economy, rising inflation, and the Federal Open Market Committee's (FOMC) continued efforts to normalize monetary policy.

The FOMC increased its target range for the federal funds rate by another 0.25% in September, the eighth increase since December 2015, and is projecting one more 0.25% increase this year with three more in 2019. In addition, the Federal Reserve Bank is reducing its $4 trillion balance sheet by $50 billion monthly, which is another form of monetary policy tightening and may add upward pressure on interest rates.

For the last ten years, the FOMC and the world's other central bankers have suppressed interest rates to counteract the negative impact of the financial crisis. During this period of easy money, debt levels have increased significantly, with the ratio of global debt (public and private) to GDP rising from 179% to 217%, according to the Bank for International Settlements. Further, there has been a significant increase in the amount of debt owed by lower quality borrowers, with the proportion of highly leveraged global companies rising to 37% last year compared with 32% in 2007, the year prior to the financial crisis. Total leveraged debt (high yield bonds and leveraged loans) is now $2.5 trillion, double the level in 2007. In addition, BBB rated bonds, the lowest investment grade category, total $1.4 trillion in the U.S. and represent 47% of all investment grade bonds. The next recession will likely cause considerable stress and higher defaults by these borrowers.

Interest payments on the Federal debt jumped to a record $523 billion in fiscal 2018, up 45% from fiscal 2012, despite borrowing costs (2.1%) that remain far below their long-term average. With the White House's Office of Budget and Management forecasting a $1.085 trillion dollar

deficit in 2019, and very high annual deficits for many years to come, interest expense on our federal debt eventually will have a growing adverse impact on the budget and our economy. Since the average weighted maturity of our debt is just under 70 months, it will take some time for rising rates to have a full impact on interest expense. Based on the current amount of federal debt held by the public, a 1% increase in borrowing costs would increase annual interest expense $164 billion.

Historically, fiscal deficits declined while the economy was expanding, as it is now, and rose during the subsequent economic contraction as tax revenues fell and spending on counter-cyclical programs increased. It is very unusual to have tax cuts and deficits of this magnitude so late in an economic cycle. Counteracting the impact of a normal recession, which will occur eventually, will be more difficult due to current debt levels and fiscal and monetary policies.

When the next recession occurs, we suspect the first signs of stress will be in the credit markets, and would not be surprised if it spills over to other markets. If weakness materializes in the economy or credit markets, we expect the FOMC to again respond with additional stimulus, either by lowering interest rates, suspending the planned reduction in its balance sheet, or both.

Market Timing

Recently several people have asked if it is time to *"get out of the stock market"* due to record high prices. Our answer remains *"NO"* for several reasons.

First, it is impossible to predict when the market will peak, and returns leading up to a peak are historically much better than most realize. For example, the average return for domestic stocks during the six months prior to every bear market since 1945 was +15%. Volatility, including Wednesday's 3% decline in the S&P 500 index, is normal. In fact, the average equity market decline from intra-year peak since 1980 has been 13.8%. If the market continues to decline in the near term, it is likely to be a typical double digit correction from its peak, not a market crash similar to 2008-09, with recovery occurring within a year or so. Despite these average intra-year drops, the S&P 500 had annual positive returns in 29 of the last 38 years.

Second, cash is still earning close to nothing and inflation erodes its purchasing power.

Third, with reasonable stock valuations and economic growth occurring in most of the world, it is sensible for long term investors to allocate a portion of their investments to equities consistent with their risk tolerance and financial goals and objectives. Having said this, it should be noted that many asset prices are higher than they were a year ago and therefore future returns may be lower than in recent years.

There is a saying that is quite appropriate, *"It is not market timing, but time in the market that counts."* We have established asset allocation targets for your investment portfolio based on your risk tolerance, liquidity needs, investment time horizon and financial goals and objectives. Investing for the long term with a diversified portfolio reduces volatility and enables your portfolio to withstand a wide range of future possibilities and market conditions. It is important to stay invested and remain patient when markets are volatile. As market values change, or if

your personal circumstances change, we will re-balance your portfolio to the appropriate asset allocation targets.

We are grateful for your trust and confidence. If your circumstances have changed or you would like to review and discuss your portfolio with us, please let us know.

Respectfully,

The JRM Investment Counsel Team

Jack, Phil & Lauren