MARKET COMMENTARY

3rd Quarter 2018 October 3, 2018

SILVER HAWK PRIVATE WEALTH

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"What is most likely to happen?" -Matthew Berry

The biggest mistake people and professionals make in investing is assuming that because things have been good recently, things will keep being good in the future. As you will read later in the commentary there are an overwhelming number of positive trends in the US Economy, US Corporations, and US Financial Markets.

The Federal Reserve Bank raised rates yet again in September by another 25 basis points, bringing the effective federal funds rate to 1.95%. This has led to higher yields and negative returns to most bond sectors with the exception of High Yield corporates. We remain confident that bond alternatives such as promissory notes, preferred private real estate shares, direct-lending, and certain fixed indexed annuities will outperform bonds over the next 5 years.

Key things we will be watching for this quarter are if Corporate earnings continue to keep pace with their impressive figures the past two quarters, the pending trade decisions that should culminate near the end of the year, and developments in the Eurozone (in particular, political decisions both in Britain and Italy).

US Equities enjoyed their best quarter of the year, up 7.2% (S&P 500).

Sean Puckett, CFA
Chief Investment Strategist

"We continue to be positioned long US Equities but will be increasing our tail-risk hedge positions heading into 2019."

US Equites were led by the Consumer Discretionary, Technology, and Healthcare sectors (gains on the quarter of 7.3%, 8.4%, and 14%, respectively). Easing trade tensions and large demand for risky assets from both institutional and retail investors helped boost US Stock prices to all-time highs during the quarter.

We anticipate another strong quarter for Corporate earnings and US Economic data, supporting higher equity prices into the fourth quarter; however, we are at the point in this bull market where it is necessary to begin thinking about how to prepare for an increasingly probable correction as we move further into this historically long cycle.

International Equities continue to underperform relative to the US. In developed markets, key Italian political developments are going to be an important development over the next quarter. Italian bond yields have already risen materially and this should continue to be a sore the most Developed Market (DM) economies.

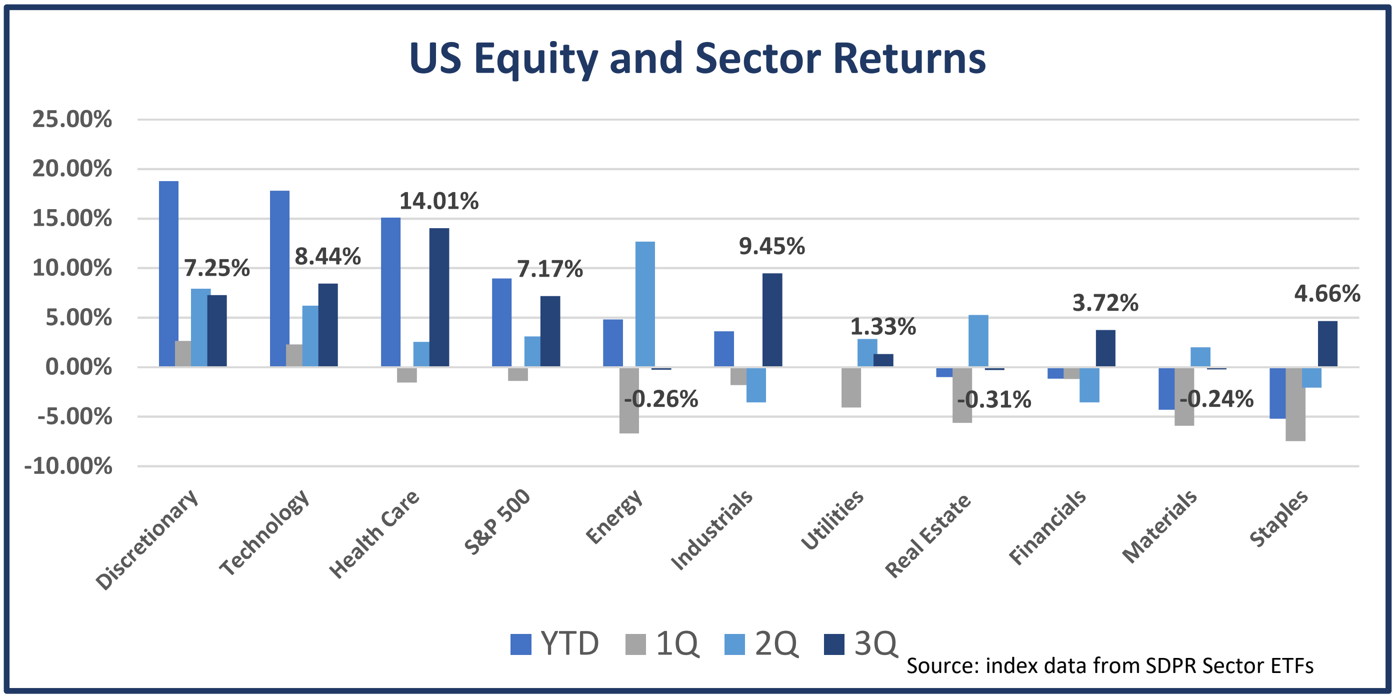
Emerging Markets (EM) returns continue to underperform due to both a material slowdown in Chinese credit and a rising US Treasury yield curve. In general, rising interest rates domestically attract more capital from international investors. This normally leads to a rise in the US dollar, and subsequently more expensive debt repayments and capital outflows for these Economies. We do not see this recent trend changing going into the fourth quarter.

The US Economy continues to march forward with strength and resilience. Consumer confidence reached its highest level since 2000, business owner confidence remains high, wage growth is at its highest since 2009, and the monthly average of initial jobless claims dropped to its lowest level since 1969. To put unemployment and US job growth into perspective, there currently are 0.90 unemployed people for every 1 job opening in the US as of August. By comparison, by the end of the last recession (June 2009), there were 6.1 unemployed people per job opening.

The main risks to Global Financial markets remain centered around potentially increasing trade conflicts, rising interest rates, and late-cycle growing pains.

PUBLIC FINANCIAL MARKETS

DOMESTIC MARKETS



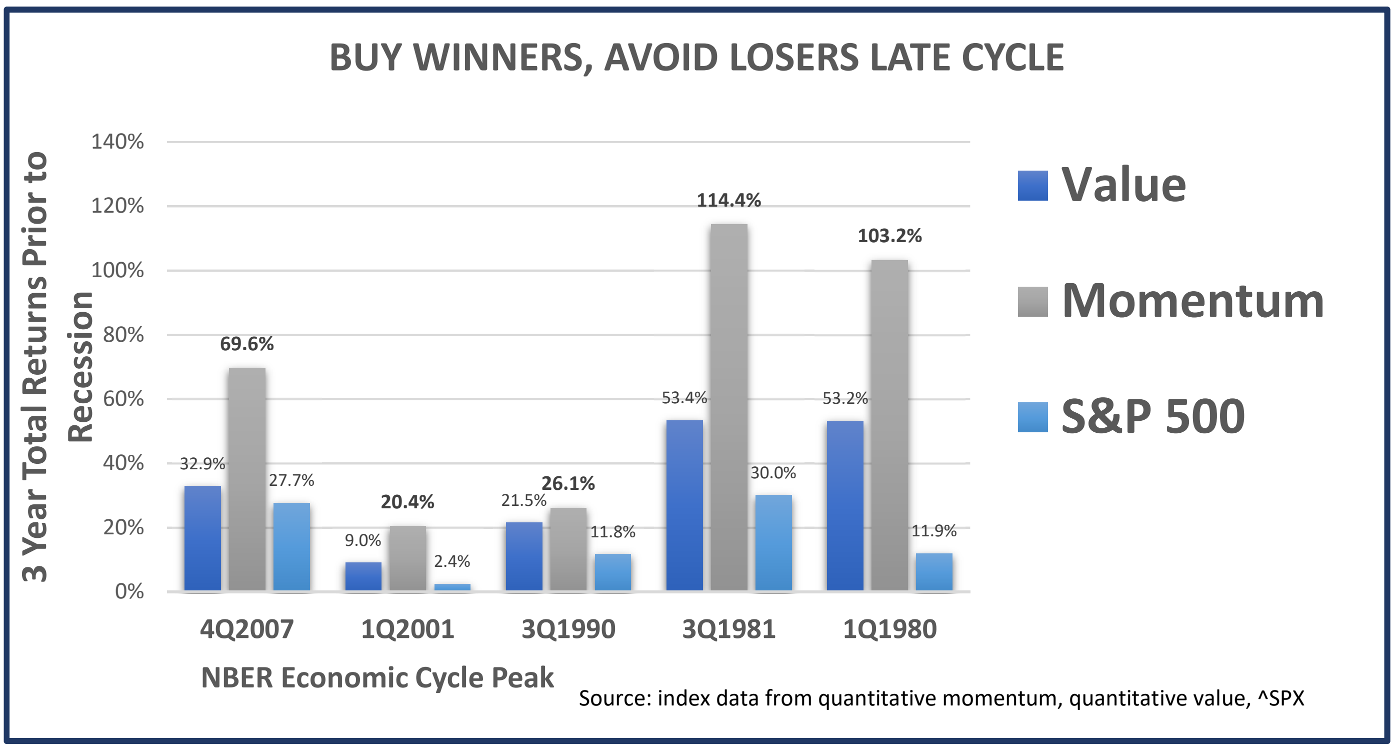
3Q2018: US Equities enjoyed their best quarter of 2018 due to continued strength in Corporate earnings, a booming US Economy, and strong demand from both institutional and retail investors at home and abroad. The strong quarter was also spread across nearly all sectors with only 3 of the 10 showing negative returns on the quarter (Materials, Real Estate, Energy). The strong US Economy has also led to higher Treasury yields as the Fed implemented their third rate hike of the year and Institutional demand on longer-dated treasuries pulled back substantially. As the Economy continues to move through the late stage of the business cycle, we expect yields to continue higher into the end of the year in addition to heightened volatility in the equity markets as investors grapple with a rising yield curve and uncertain trade outcomes when deciding how to position their portfolios heading into 2019.

In our previous commentary, we looked at the current unemployment rate and the GDP output gap compared to historical periods preceding recessions. The conclusion was that we are in a period where the US Economy is producing more than what is sustainable (the potential real GDP), and unemployment is likely at or beyond full employment. Looking back at the five most recent recessions, this GDP output gap has preceded recessions by about 5 quarters, except for the 2001 recession in which output exceeded potential for nearly 4 years from 1997 to 2001 due to one of the largest economic expansions in our modern history. When you combine an economy that is operating at full (or past full) employment and overproduction with Fiscal Stimulus, the likely outcome is an extended business cycle; however, what goes up must eventually come down. That is, by definition, inherent in cycles.

There are many ways to reduce losses during downturns, including selling risky assets and rotating to cash (timing the market), investing in a low-risk portfolio largely held as cash, or portfolio hedging. It is increasingly important that a well-balanced portfolio include some form of portfolio hedging to help curb losses when the downturn and interim corrections eventually do play out. Portfolio hedging prevents the needed sale of the risky assets inside the portfolio, which triggers a taxable event likely with large capital gains if the portfolio had been invested in risky assets.

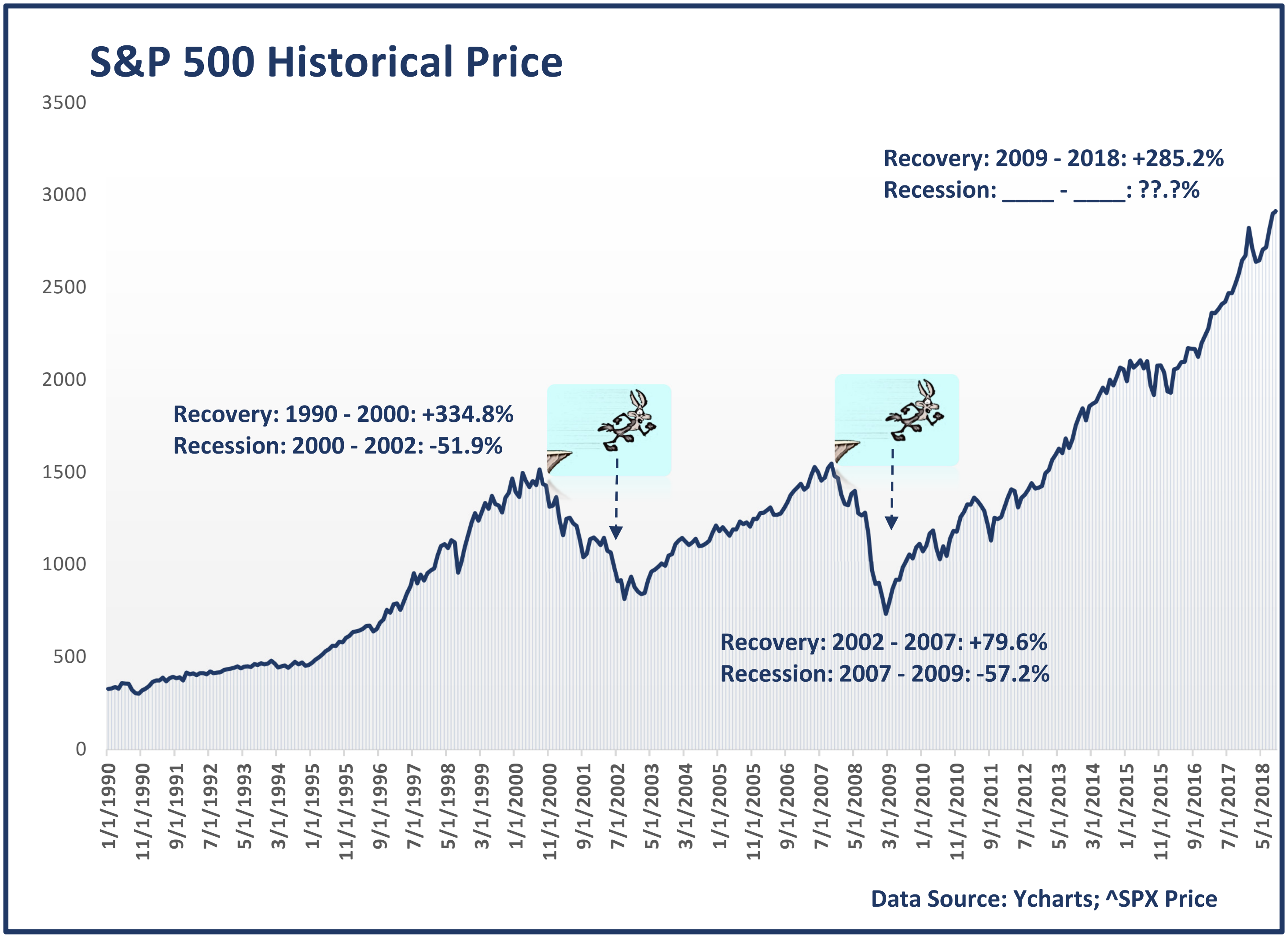
We do not know when it will happen, or the magnitude of the recession, but we can control how we prepare for it. In general, when an investor wants to go buy insurance on their portfolio through option contracts it is when something has already happened, and they are scrambling to go purchase these contracts, not surprisingly at a higher price than when things were calm. It is analogous to purchasing home Insurance when there is no sign of a fire, versus purchasing the insurance when the fire is already at the doorstep. We like to be proactive in this strategy and take some of the gains from this historically long bull market to purchase small amounts of these insurance contracts to begin to build up a position in this insurance.

It is likely that US Equity and risky assets produce lower average returns over the next 5 years than what we've enjoyed the past 5 years (about 11.5% average return on the S&P 500 since 3Q2018); however, markets are largely driven by human behavior which provides the opportunity to improve returns over that average. If we can understand what those behaviors are and how to identify them, it is possible to take advantage of them consistently. It is widely accepted in the Behavioral Finance world (and increasingly the Traditional Finance world) that human emotion and irrational decisions drive markets higher in the late innings of a bull cycle. This is fairly clear if you go back to the past 5 recessions and look at the returns on a strategy attempting to take advantage of this behavior (momentum) compared to 1) holding a passive market index (the S&P 500), and 2) a Value investing strategy for the 3 years preceding that Economic Cycle peak (as defined by the National Bureau of Economic Research (NBER)).



In summary, we continue to be long US Equities but will be increasing our tail-risk hedge positions heading into 2019. For fixed income we are also focusing on the lower-end of the yield curve to reduce interest rate risk as both short and long. By using behavioral biases to our advantage and by sacrificing some returns at the top to hedge the portfolio for catastrophe, it sets up the portfolio to take advantage of two very persistent occurrences in the history of the markets.

Ending Comments



I wanted to show this graph to remind us that markets have cycles. They go up, they come down. People borrow money to spend more, and businesses are the recipients of that spending. The business owns then have more income, and they borrow more to spend more. Eventually, the banks are unwilling to extend additional credit to consumers and businesses, and this marks the ending of the upswing of a business cycle (put quite simply).

Whenever things seem like they'll keep going up, everything seems positive, volatility is low, and confidence is high, it is important to ***begin thinking in an opposite way than the crowd.*** This goes against our basic survival instinct and biology that tells us to stick with the crowd, and our chances of survival will go up. But, when you begin to take action ahead of the crowd, you can find both investments, and portfolio insurance that protects against catastrophic losses much cheaper when things are calm than when volatility is escalating. You can do this without sacrificing much return as the market continues to march higher. The tradeoff is slightly lower returns to cover the cost of insurance, for the potential to reduce portfolio losses in a correction by a material amount. US Equities have risen 285% from the market lows in March 2009. Taking 1-2% a year to prepare for an increasingly probable correction, and subsequent recession is not only logical, it is prudent investing. We know how the story ends with Wiley Coyote chasing the Road Runner. We, as active investors, have the ability to prepare for the inevitable cliff at the end of the road, not by perfectly timing the market, but preparing when signs say we are NEAR the top. As we near the end of the cliff as discussed above by where we are at in the market cycle, it is a good practice to prepare for that cliff while the insurance is cheap. Don't be Wiley Coyote.

Disclosures

Past performance is not a guarantee or reliable indicator of future results. All investments discussed herein contain risk and may lose value. US Treasury bonds are considered risk-free assets under the assumption that the initial principal invested into the bond is secured by the full faith and credit of the United States Government. An investment in Treasury securities may still lose value depending on your time horizon relative to the maturity date of the bond. Equities can decline in value from both perceived and actual market, economic and industry conditions. The views expressed herein are that of the Portfolio Management Division of Silverhawk Financial and do not necessarily represent the views or opinion of Silverhawk Financial as an entity. The discussion herein is broad in scope and its purpose is purely informational in nature. This document does not represent a financial recommendation, proposal, or suggested allocation strategy. The data used in the graphics was derived from reliable sources widely used in the Financial Marketplace but is not guaranteed to be accurate. No part of this material may be referred to in other publications or reproduced in any form without express written permission by Silverhawk.