QUARTERLY
Market
TALK

3RD QUARTER - 2018

We at Sterling Capital Management are engaged in three key support areas: providing custom asset allocation frameworks, selecting high quality investment managers, and constructing well diversified portfolios. Importantly, of course, we remain engaged every day in the ongoing monitoring and periodic rebalancing of those portfolios over time.

Today, we are pleased to provide a review of global financial markets during the third quarter of 2018, to reflect on changes we made to our portfolios during the quarter, and to update our current positioning and outlook.

EQUITY MARKET REVIEW

Beginning with equity markets, global equities, as defined by the MSCI All country world investable market index, gained 3.9% in the third quarter. U.S. equities continued to outpace international equities by a wide margin and while international developed markets managed to post modest gains, emerging market equities followed up a difficult second quarter with additional weakness in Q3. Global large-cap stocks outperformed small-caps and global growth equities continued to significantly outperform their value counterparts as they have done now in each of the last seven quarters.

Year-to-date through September 30, global equities have generated a positive 3.7% return though there have been significant divergences in geographic, sector and style relative performance. U.S. equities have posted double digit gains year to date through Q3 while international equities have fallen over 3%. Strong U.S. earnings and economic growth relative to most of the world, a strengthening U.S. dollar, and the impact of trade policy uncertainty on a number of international markets have all played a role in creating U.S. equity outperformance. The magnitude of outperformance has been so substantial that the SandP 500® Index was trading at a 12% premium to the MSCI all country world ex US Index at the end of the third quarter on a forward price-to-earnings basis, which represented the highest premium since 2009. In addition, growth equities have outpaced their value counterparts by over 7½% year-to-date. And the technology and health care sectors have produced double digit returns year-to-date, while financials, consumer staples and real estate have declined and are among the worst-performing sectors.

In the U.S., the Russell 3000 broad market index rose sharply during the third quarter, returning 7.1%. In fact, U.S. equities posted their highest quarterly return in almost five years and the U.S. equity bull market became the longest in history in late August. Strong earnings growth, favorable economic data and robust share buyback activity all played a role in pushing several U.S. equity indexes to all-time highs during the quarter despite ongoing global trade tensions. According to FactSet, third quarter SandP 500® earnings per share rose 25% year-over-year, coming in well ahead of consensus estimates of approximately 21% and SandP 500® revenue growth was approximately 10% in the second quarter, which was the strongest growth rate in nearly seven years. Second quarter GDP growth of 4.2% was the highest in roughly four years, and was driven by strong consumer and business spending.

On a sector, style, and size basis, U.S. equity market leadership trends remained largely intact during the quarter, as growth and "FAANG" outperformance continued. However, FAANG return dispersion widened, with relative strength in Amazon and Apple being offset by weakness in Facebook and Netflix. Health care was among the top-performing sectors, driven by pharmaceutical and biotechnology gains. Value-oriented cyclical sectors such as energy, materials and financials underperformed the broader market, as did defensive and/or income-focused segments such as utilities, consumer staples and real estate. Large-cap stocks outperformed both small-caps and mid-caps.

It is worth noting that the persistently narrow market leadership throughout 2018 has created challenges for many U.S. actively-managed strategies. These headwinds have perhaps been the most severe in the U.S. large-cap segments (especially large-cap growth), where FAANG stocks have accounted for an outsized portion of year-to-date returns. In fact, just 3 stocks – Amazon, Apple and Microsoft – accounted for one third of the Russell 1000 Index's year-to-date return through September 30th.

Moving now outside the U.S., International equities, as defined by the MSCI All country world ex US investable market index, managed to generate a 0.4% return during the quarter despite continued emerging markets volatility. Emerging markets fell 1 ½%, with relative weakness in China accounting for a significant portion of the decline. Escalating trade tensions with the U.S. led to Chinese equities falling over 7.50% in Q3, which represented the largest quarterly decline in three years. In addition, the Shanghai Composite Index was entrenched in bear market territory throughout much of the quarter. International developed markets increased 1%, led by strong results in Japan. European equities experienced modest gains, but Italian budget concerns, Brexit uncertainty and volatility in European banks with exposure to Turkey, which experienced significant currency weakness during the quarter as a result of U.S. trade sanctions, soaring inflation and high levels of private sector debt, were headwinds. In contrast to the U.S., value outperformed growth in international markets, although this outperformance was largely attributed to material underperformance from emerging markets growth equities. The health care and energy sectors were standouts in Q3, while real estate and consumer discretionary lagged the broader international market.

PORTFOLIO POSITIONING

In terms of portfolio positioning, we made multiple changes to the equity portion of portfolios during the early part of the third quarter. Most notably, we increased the portfolio's overweight to U.S. equities due to an improved expected return outlook relative to international developed markets. We also increased the portfolio's emerging markets exposure to a neutral market weight versus our benchmark as valuations became more attractive following significant weakness in the second quarter. With improved relative outlooks for U.S. and emerging market equities, we reduced the portfolio's exposure to international developed markets to an underweight, with the underweight concentrated in the international developed markets large-cap growth segment. Overall, the portfolio continued to maintain an overweight to value over growth, with the value overweight concentrated in the U.S. large-cap value and U.S. small-cap value segments.

We also made a manager change in the US mid cap growth space during Q3, replacing the Goldman Sachs Growth Opportunities Fund with the Touchstone Mid Cap Growth Fund. Multiple changes to the Goldman Sachs investment team in recent years and relative performance that has consistently been below expectations were the primary reasons for making this change. The Touchstone Mid Cap Growth Fund is sub-advised by Westfield Capital Management, a Boston-based investment manager focused exclusively on growth equity investing. The firm's investment committee utilizes a growth-at-a-reasonable-price and risk-focused approach to investing that has been successful in generating consistent long-term risk-adjusted outperformance over time.

BOND MARKETS

Now, turning to bond markets, the Bloomberg Barclays Aggregate Bond Index, a proxy for overall fixed income performance, was nearly flat for the third quarter, returning 0.02% and -1.60% year-to-date.

Looking at different segments of fixed income markets, corporate bonds were the top performers within the aggregate bond index over the quarter, with investment grade bonds returning 0.89%. From a fundamental perspective, despite global trade tensions and the Federal Reserve raising interest rates, solid economic growth and healthy corporate earnings gave investors a boost to overall confidence.

Within the structured space, Agency mortgage-backed securities again outpaced duration-matched Treasuries for the quarter despite the Fed's continued exit putting pressure on the market. Non-agency mortgage-backed securities also continued to perform well as improved housing fundamentals, strong borrower credit performance, and negative net supply produced positive returns during the quarter.

In a fully-expected and unanimous decision, the Federal Reserve raised its target rate by 25 basis points during its September meeting. This marked the eighth time the Fed has raised rates this cycle, moving to a range of 2.00%-2.25%.

As for the path of future rate hikes, we look to the Fed's "dot plot" and see 75% of Fed officials (and the market) pricing in one more rate hike in December. The Fed also maintained their expectations for 2019, estimating three rate hikes (and a slight increase in its economic growth forecast).

During the third quarter, no changes were made to our Core Fixed Income portfolio and positioning remains similar to last quarter. Our taxable core fixed income portfolio remains short duration relative to its benchmark. It also maintains an overweight to structured credit and an underweight to government related securities, specifically Treasuries. Yield curve positioning remains a focus.

Our Municipal Bond portfolio also remains slightly short duration and maintains an overweight to essential service revenue bonds and an underweight to general obligation bonds.

THIRD-QUARTER REVIEW

For the third quarter overall, our balanced portfolio gained 2 ½%. Manager selection decisions detracted from benchmark relative returns in Q3 while asset allocation decisions contributed positively. The portfolio finished slightly behind its benchmark in Q3 but has delivered strong positive absolute returns and positive relative returns ahead of both benchmark and peers since inception.

Leading contributors on the equity side for Q3 included our underweight to international developed market equities which trailed US markets by a wide margin. Also, our small cap US equity managers delivered strong performance. On the fixed income side, the largest contributor came from our unconstrained bond manager, which produced a positive return of 1.4% for the quarter while the benchmark aggregate bond index was flat.

Overall, we're pleased with Q3 and longer-term results and the way our portfolios have weathered the increased volatility in both equity and fixed income markets thus far in 2018. We remain confident that we're well positioned for markets ahead.

Thank you very much as always for your interest, trust and support and we look forward to a continued strong and successful partnership.