THIRD QUARTER 2018 REVIEW AND COMMENTARY

Market Review: A strong rally in August and September pushed the Standard and Poor's 500 Stock Index to a gain of 7.7% in the quarter and 10.6% year-to-date. The Russell 2000 Small Cap Index returned 3.3% and is up 11.5% in 2018. International markets lagged as the MSCI All World ex-U.S Index rose only 0.7% in the quarter and has declined 3.1% year-to-date due to the 7.5% drop of the emerging markets component. The Barclay's Aggregate Bond Index was flat for the quarter and has declined 1.6% year-to-date. Gold fell 5.0% in the quarter and 9.9% for the year. Virtually any portfolio diversification away from U.S. equities, and more specifically from large cap growth, has pulled returns lower.

Economic Divergence: Boosted by fiscal policy, the U.S. is leading the global economy. Second quarter real GDP was 4.2%, the unemployment rate is down to 3.7%, small business optimism is at an all-time high and the leading and coincident indicators are strong. Corporate revenue and earnings are growing, and there is very little indication of a recession over the next twelve months. Nevertheless, the market's tone deteriorated quickly in early October. The 6.6% decline in six trading days moved the S&P 500 below its 200-day moving average for the first time since June 2016, ending the longest run in history. One potential culprit was a spike in long-term interest rates as the 10-Year Treasury yield spiked from 3.06% to 3.25% at the start of the market decline. Other issues include the intensifying conflict with China that has spread from trade to national security, and the uncertainty around the upcoming mid-term elections. Of note, this weakness occurred just prior to earnings season and at a time when companies are blocked from buying their shares in the market. The absence of this "corporate bid" surely was felt considering S&P 500 companies repurchased a record $190 billion of stock in the second quarter alone, which was up 59% versus the second quarter of 2017.

More on Interest Rates: Interest rates have been moving higher in response to faster growth and the continued withdrawal of monetary accommodation. This is significant from a number of perspectives with regard to equities. The median price to earnings ratio within the 500 stocks in the S&P 500 Index at quarter end was over 24 versus the historical median of 17. As we put the zero percent interest rate environment in the rear view mirror, valuing future earnings at higher discount rates makes high PE's a bit more challenging. Additionally, dividend-paying equities for years were quite attractive versus the income paid by bonds, but today the 1.9% dividend yield on the S&P 500 Index trails the 2.9% yield derived from safe short-term Treasuries. Emerging markets, particularly those that borrow extensively in U.S. dollars, are under extreme pressure from the stronger dollar strength and higher U.S. rates. Upward pressure at both the short and long ends of the yield curve should continue. The Federal Reserve hiked the Fed Funds rate 0.25% in September to 2.25% and Chairman Powell recently made clear that the plan calls for a hike per quarter through the end of 2019. Additionally, the Fed is unwinding its Treasury and mortgage bond holdings by $50 billion per month just as Treasury auction sizes are set to grow to fund $1 trillion annual budget deficits over the next ten years.

Looking forward: We expect that more volatility is in the offing due to the length of this economic cycle and the increasingly restrictive monetary environment. And if early October is an indication, intra-day volatility is also becoming the norm, especially into the last half hour of trading. Given the wide use of exchange-traded funds that promise immediate liquidity and the prevalence of algorithmic trading, navigating sudden zigs and zags will be a priority. Fortunately, as long-term investors who constantly track the market, we use short-term gyrations as trading opportunities to adjust positions. To quote legendary investor Benjamin Graham, "In the short run, the market is a voting machine but in the long run, it is a weighing machine." We do not expect the performance divergences between categories, Growth versus Value, U.S. versus International, to persist indefinitely and we are managing to relative value.

We thank you for your continued trust and welcome the opportunity to discuss your portfolio in detail.

THE STALEY CAPITAL INVESTMENT TEAM