

REVIEW & OUTLOOK – 4Q2018

This Review & Outlook includes commentary on Sterling Advisors' three investment Strategies: Large Cap Value, Large Cap Core and Intermediate Fixed Income. As a valued client, we want you to be aware of and updated on all investment options available from Sterling Advisors.

Closing Prices 12/31/2018	
DJIA	23,327.46
S&P 500 Index	2,506.85
Barclays Intermediate U.S. Govt.	2,093.52
Russell 1000 Value	1,314.62
NASDAQ	6,635.28
U.S. Treasury Bond	
Current Yield 10-year Bond	2.684%
Current Yield 30-year Bond	3.014%

Source: Bloomberg

The Market Environment

Heightened volatility was the theme in the fourth quarter, sending stocks firmly into correction territory and erasing yearly gains across all major U.S. indices. Fears of a softening global economy and slowing corporate earnings growth are weighing on investors' minds as we flip the calendar into 2019. Prominent concerns include potential impacts of the Federal Reserve's monetary policy and deteriorating trade relations with China, both of which have pressured, but not officially ended, the decade-long bull market. Large Cap U.S. stocks, represented by the S&P 500 Index, fell 13.5% in the fourth quarter, resulting in a decline of 4.4% for 2018 – the first negative total return for the Index since 2008.

The stock market's tantrum accelerated in earnest on December 19th in response to Fed Chair Jerome Powell's speech, during which he confirmed an expected .25% interest rate increase and stated the Federal Reserve's future monetary policy would remain flexible and data-dependent. Although these comments echoed his previously stated agenda, the market's expectations of meaningful policy moderation had become overly optimistic. This disconnect fueled fears of a Fed policy-induced economic slowdown, causing mild stress in credit markets and a sharp decline in asset prices, as well as dashing hopes of a traditional year-end stock market rally.

The silver lining for investors is there's a growing divergence between stock prices and the underlying fundamentals of the U.S. economy. Despite persistent weakness in cyclical areas, such as housing, autos, commodities and semiconductors, the majority of economic data seen in recent weeks continues to support modest earnings growth and reasonably strong domestic business activity. Additionally, unemployment, inflation and interest-rates remain at benign historical levels, a backdrop we see as supportive to corporate earnings growth, albeit at a far slower clip than the 20% plus advance seen in 2018. Key risks to our optimistic outlook are a further escalation of already strained trade relations with China, continued falling asset prices creating a negative "wealth-effect," or a misjudgment of economic conditions by the Federal Reserve, resulting in a lack of liquidity in financial markets.

The fourth quarter market decline and negative sentiment that permeates today's investment environment have shifted the S&P 500 from a historically average price-to-earnings valuation to one that now stands out as relatively inexpensive. Slowing economic growth and a less accommodative central bank are real headwinds that warrant caution about what price to pay for assets. However, markets are known for overshooting in both directions, often creating opportunities for disciplined investors. It's our view that although stock and commodity prices have rapidly discounted the worst-case scenario, an economic recession in 2019 (two consecutive quarters of declining GDP) remains an unlikely outcome based on past business cycles and the current levels of economic activity.

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Large Cap Value Strategy

The Large Cap Value Strategy had a challenging fourth quarter, underperforming its benchmark, the Russell 1000 Value Index. The Q4 results accounted for all the relative underperformance in 2018, and were mainly the result of sector allocation decisions that impacted relative performance as equity markets quickly turned defensive, amid heightened volatility. Growth stocks outpaced value stocks by a wide margin in 2018, making it difficult for traditional value managers to produce attractive absolute returns. While frustrating in the short-term, our investment team is uncovering more opportunity recently, as previously unattractive stocks fall into our universe for potential purchase, due to the stock market's corrective phase. The fourth quarter was a reminder to investors that investing in equity markets involves risk, and that economic conditions can change quickly. The Sterling Advisors investment team remains committed to managing the Large Cap Value Strategy's risk by regularly reviewing all holdings from a bottom-up and top-down standpoint. Our idea generation process is alive and well, including new positions in six of the eleven market sectors during the quarter – reflecting our ability to adjust to rapidly changing economic and market conditions. We have begun to see declining share prices along with lower earnings estimates, which has reinforced the importance of our quantitative screening process, which is designed to find relative value and eliminate companies with declining fundamentals.

Turning to an analysis of the relative performance in the fourth quarter, selection decisions in several economically cyclical sectors were the culprit for the Strategy's shortfall during the period. The two sectors with the greatest weakness in selection were Financial Services and Industrials. Within Financials, it was our exposure to several asset management and financial advisory issues that had the greatest impact. Our exposure to several regional and large money center banks also acted as a headwind, as these areas saw a sharp downturn in share prices toward year-end. Although the individual Financial Services firms owned by the Strategy continue to execute well, factors such as a flat yield curve, softening economic data and uncertainty regarding the Federal Reserve's policy all trumped the strong underlying fundamentals (i.e., growing dividends, strong balance sheets, and low valuations) in Q4. With respect to the poor relative performance of the Strategy's Industrial holdings, our most cyclical constituents proved costly in the short-term, including ownership of well-known global transportation, machinery and rental equipment companies. Factors such as a strong U.S. Dollar, weakness outside of the U.S. and global growth fears all changed sentiment drastically during the second half of 2018, leading to a performance drag on the portfolio. Looking at the positive side of our stock selection results during Q4, Materials and Real Estate both helped relative performance. Our timely purchase of a leading global chemical company after a 30% share price decline was the standout relative performer in the Materials sector. Overall, Real Estate and Materials, together, accounted for roughly 10.7% of the Strategy at year-end, so our strong picks were not enough to offset the drag of holdings in the much larger Financial Services and Industrial sectors.

Sector allocation decisions helped relative performance in Q4, with the greatest contribution coming from our 8.13% average cash position. As is always the case, holding cash in a declining market benefits investors, and often provides a manager the opportunity to capitalize on opportunities without having to liquidate other holdings – a sound strategy during periods of market volatility. Other notable allocation decisions include the Strategy's underweighting of the Energy sector and the lack of any exposure to the historically counter-cyclical Utilities sector. Crude Oil's plunge from \$76 to \$42 per barrel is pressuring all energy companies' earnings, resulting in sharp share price declines. The Utilities sector shined during Q4, acting as a safe-haven for investors during turbulent markets. As a result of this flight to safety, Energy companies trade at historically depressed levels and Utility stocks have unusually high valuations.

We would also like to provide a brief update of changes that have been made as a result of changing global economic conditions. We have trimmed or eliminated several holdings with high levels of economic sensitivity, particularly those with material business operations in China and emerging markets. The investment team has also put a greater focus on low debt levels as a key attribute, as well as assessing current holdings to ensure debt loads won't become a headwind to earnings or ability to refinance. New positions were added in the more defensive Consumer Staples and Healthcare sectors, which we view as having favorable earnings outlooks on a company specific basis. We continue to believe value stocks will generate better returns in 2019, likely providing new leadership as U.S. stocks emerge from the current corrective phase. Our goal is to keep your portfolio well diversified and positioned to capitalize when that change in leadership occurs.

Large Cap Core Strategy

There are various explanations to explain the decline in the capital markets in the fourth quarter. The adverse effect of a strong U.S. dollar, the slowdown in China and other foreign markets, tariff issues and trade wars, raw material price increases, political uncertainty, diplomatic uncertainty, rising interest rates and profit margin pressures. The recognition that market

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strength during the quarter has been viewed as an opportunity to sell has shaken investor confidence and contributed to selling efforts on the part of investors trying to secure profits made throughout the year in crowded trades before they disappear.

As we have written in this quarterly letter before, our team has been prepared for a market pullback. We have remained in high quality, dividend paying companies with pricing power and excellent balance sheets. Our stocks declined during the quarter, but on a relative basis our portfolios were more conservatively positioned. Healthcare was our largest sector weighting, followed by Financials, Technology and Industrials. Larger domestic capitalization companies performed better than smaller capitalization and international companies. We believe stock selection will become more important in the future to manage risk and find future opportunities.

The Federal Reserve faces a dilemma. Does the Federal Reserve raise interest rates to fight anticipated inflation commensurate with higher wage pressure and the trade tariffs? Selectively, prices of some goods are rising as a result. Or does the Federal Reserve review the tariffs as a temporary shock, ignore them and declare inflation expectations are anchored? Whatever path of monetary policy the Federal Reserve chooses, one thing is clear; the transition away from the sole reliance on monetary policy to spur growth will lead to greater economic and market volatility. We believe the Federal Reserve's policy will become more data dependent as it nears its neutral stance. Given the recent events, the Federal Reserve is further along in its interest rate hike cycle than investors thought several months ago with a pause in hiking rates a possibility. The U.S. is late in the current business cycle, with recent tax reform extending the cycle. If the tax cuts work as intended, companies will use their increased cash flows to invest in productive projects that will lift growth and wages while keeping unit labor costs constrained; a welcome result for the American economy.

We would expect a trade deal in some capacity between China and the U.S. to happen in the beginning of 2019. We see economic data from China, Europe and the Emerging Markets signaling a slowdown. A rising U.S. dollar and international uncertainty has caused more investment capital to flow into the perceived strength of American markets. Even if the U.S. economy slows in 2019, by some accounts, it is still the envy of the world. Unemployment is low, wages are rising, energy prices are lower and consumer spending remains robust. Household finances are in good shape and, for the most part, corporate debt levels appear manageable. Stocks can still do well late in the cycle, but it's the selectiveness of certain industries and companies that will allow us to perform better in the future. We continue to look at sales and earnings growth, pricing power, strong balance sheets and industry leadership positions as our main factors for future equity selections.

Overall, we're watching for potential earnings downgrades and what company management teams say about trade, fiscal and monetary policy for further evidence of market trends. Our team continues to remain prudent and will use any market dislocations to our advantage. There are two types of losses investors can take, a loss of capital or a loss of opportunity. If we preserve capital, there is always another opportunity.

Intermediate Fixed Income Strategy

Turning to bond markets, with exception of U.S. Treasury issues, most fixed income categories declined over the course of 2018 as global growth uncertainty increased and corporate credit spreads widened. As expected, the Fed raised rates by a quarter point in December, to a range of 2.25% -2.50%, and adjusted projections downward to suggest two more potential increases in 2019, with another in 2020. The flat yield curve and slower global growth may complicate those efforts, however, in our opinion. Slowing U.S. data and global headwind make the Fed's stance look overly aggressive. We believe an increased focus on incoming data will replace the Fed's present desire to pursue a stated path and become more data dependent, thereby reducing the predictability of the rate hikes in 2019.

We continue, nevertheless, to hold our view that over the longer term inflation is being underestimated and presents both interest rate and credit risk for fixed income issues. So while yields could dip in near term, we believe rates will rise over the next 12-18 month horizon. Tactically, we will continue to pursue a cautious posture, with a focus on lightening corporate bond exposure in favor of shorter duration U.S. government and government sponsored issues and/or high quality tax-free bonds for individuals, where appropriate.

We expect with less market liquidity, volatility will remain elevated in 2019, offering a compelling case for shorter duration issues. Investors can currently capture over 80% of 30-year yields with a 2-year maturity; and significantly reduce overall portfolio volatility. In fact, 2/5 year slope is slightly inverted as we go to press.

Outlook

Our outlook for the year ahead is one of cautious optimism, and one that weighs the plethora of current risks vs. the benefits of taking a long-term approach. Our greatest area of focus, and perhaps what is most important to the progress of the equity market in 2019, is what the level of corporate earnings will be as a result of the current growth slowdown. The days of synchronized global growth have ended, making it a far more treacherous investment environment, as future returns will rely on which individual companies will continue to produce sustainable, high-quality earnings in an uncertain and changing global economy. Our view is that corporate earnings growth will slow materially in 2019, but stop short of declining from 2018 levels. In this scenario, the U.S. economy should avoid recession and reset at a lower level of GDP growth. Persistent evidence of broad-based economic slowing will likely motivate the Federal Reserve (and may have already) to pause the interest rate normalization policy and/or alter the pace of its balance sheet reduction plan. However, the current picture is not completely clear as weak data from cyclical areas like housing, autos and semiconductors conflicts with more encouraging information, such as December's stellar +312,000 employment report, albeit a lagging indicator. It has been the leading economic indicators, including stock prices, which have shown the sharpest declines in recent months – justifiably drawing the attention of central bank policy makers.

We believe the sharp selloff in December represents most, if not all, of the damage that will be done in stock indices, and that opportunities to invest have increased as market participants have “thrown out the baby with the bathwater,” as is historically done in volatile markets that lead to emotional decision-making. As we look for new investment opportunities to upgrade portfolios and put new money to work on behalf of our clients, we are mindful of the changing economic environment and volatile financial markets, both of which we expect to persist throughout 2019. We will favor consistent businesses that have not overleveraged during the prior decade of record low interest rates and focus on companies that derive most of their revenues from here in the United States. Many of the most successful stocks of the last decade have fueled their stock prices through financial engineering, some even going as far as to borrow money to buy back stock. This is the type of practice that fueled returns over the last decade, but is unlikely to do so over the next ten years, given less accommodative financial conditions.

Relevant risks to the economy include:

- Federal Reserve policy error
- Escalation of trade and tariff tensions with China
- Corporate debt overhang
- U.S. Dollar strength pressures multi-national earnings
- Negative “wealth effect” from falling asset prices
- Weakness in Europe and Emerging Markets

In conclusion, if we see resolution of the foreign trade issues and the Federal Reserve does not commit a policy mistake by misjudging the economy, corporate earnings should be resilient, making 2019 a strong year for investors despite today's gloomy sentiment. We will continue to use weakness in financial markets as a source of opportunity for new investment ideas, while carefully managing risk in your portfolio. As always, your fixed-income investments will be of high credit quality, and our equity selection team continues to scour the markets for reasonably priced companies with outstanding balance sheets, proven management and growing dividends. This quality-first approach is a strategy that can provide competitive returns with less volatility and has characteristics imperative to protecting and growing your wealth in a turbulent market environment.

Sources: * Bloomberg and FactSet



Dow Jones Industrial Average: The most widely used indicator of the overall condition of the stock market, a price-weighted average of 30 actively traded blue chip stocks, primarily industrials. **NASDAQ Composite Index:** Measures all NASDAQ domestic and international based common type stocks listed on The Nasdaq Stock Market. The NASDAQ Composite is calculated under a market capitalization weighted methodology index. **Standard and Poor's 500 Index:** Capitalization-weighted index of 500 stocks, including the reinvestment of dividends and other distributions, designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. **Russell 1000 Value** Measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

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