REVIEW & OUTLOOK - 3Q2018

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 to you from Sterling Advisors.

Closing Prices 9/30/2018	
DJIA	26,458.31
S&P 500 Index	2,913.98
Barclays Intermediate U.S. Govt.	2,059.46
Russell 1000 Value	1,247.34
NASDAQ	8,046.35
U.S. Treasury Bond	
Current Yield 10-year Bond	3.063%
Current Yield 30-year Bond	3.206%

Source: Bloomberg

The Market Environment

U.S. stocks posted positive returns in the third quarter, further advancing the current bull market, which is setting records for its longevity. Strong corporate earnings and accelerating economic growth were more convincing to investors than risk factors such as less liquidity from the Federal Reserve, trade/tariff impacts and prolonged weakness in emerging markets. Large Cap U.S. stocks, represented by the S&P 500 Index, rose 7.7% in the third quarter, bringing their year-to-date total return to 10.6%.

November will mark one year since the end of the Federal Reserve's near decade-long policy of quantitative easing. The evidence seen in financial asset prices and economic data is pointing to an increasing likelihood our central bank has successfully executed what many thought to be impossible – a soft-landing for the U.S. economy without a disruption of financial markets. With unemployment at its lowest levels since the 1970s and tame inflation, Fed Chairman Jerome Powell has had the economic underpinnings to continue along his predecessor's well-telegraphed interest-rate normalization plan, returning the Fed Funds rate to its highest level since the financial crisis of 2008-2009.

November will also bring the midterm elections, which are likely to occupy the attention of market participants, especially given the high level of political tension in our nation today. This event, along with an escalating trade war with China, is likely to provide a constant flow of headlines for markets to digest as we approach the holiday season. So far, markets have had a muted reaction to the daily headlines out of Washington. Instead, stock prices have been correlated to record corporate earnings and robust economic growth. The market's response to fundamentals over rhetoric is logical but needs to be monitored, as risk factors may garner more attention from financial markets as we move toward year-end.

With respect to the internals of the stock market, sector rotation and low volatility continue to be prominent themes. The smooth ascent of the S&P 500 falls short in illustrating changes happening under the surface. For example, social media stocks have fallen on hard times after years of growth, as data collection policies are under intense scrutiny and may soon be regulated. New leadership groups such as big-pharma, medical devices and industrial companies have emerged to offset weakness in interest-rate sensitive areas including consumer staples, housing, autos and real estate. Information Technology remains the largest S&P 500 sector by weighting and although having risen sharply this year, did underperform several other sectors during the stock market's third quarter advance.

Large Cap Value Strategy

The Large Cap Value Strategy recorded strong relative results in the third quarter, outperforming its benchmark, the Russell 1000 Value Index. The Strategy's year-to-date return is also slightly ahead of the index as of the end of the third quarter, making up for a disappointing first half. Although growth stock returns have outpaced those of value stocks by a wide margin in 2018, the Strategy's sector allocation decisions and quantitative screening process have allowed us to produce positive returns during this challenging period for value investing. Our investment team remains committed to managing risk by regularly reviewing all our holdings for material fundamental changes or full valuation. In the third quarter, for example, we eliminated two holdings in the semiconductor and building-materials spaces, as we felt changes in the economy presented a more difficult path to meeting earnings expectations. At the same time, the aggressive sector-rotation referenced above, has created market conditions that allowed our process to uncover new investment ideas, several of which were added to the Strategy's holdings during the third quarter.

Turning to an analysis of the relative outperformance in the third quarter, the majority of the gains were driven by stock selection decisions. In aggregate, sector allocation decisions did contribute positively but accounted 21% of the total. Health Care and Materials were the two leading sectors from a stock picking standpoint. Within Health Care, the positive performance was broad-based as we saw strong contributions from companies in the Life Sciences, Big-Pharma, Medical Devices and Health Insurance areas. On the other hand, stock selection in the Energy and Information Technology sectors detracted from quarterly results. Within Energy, the main detractor was a leader in the oil service industry, which suffered from a lack of capital expenditure spending among exploration and production companies. With respect to our Technology sector holdings, several very strong performers were offset by weakness in individual holdings exposed to the semiconductor industry. This subsector within the Technology area was impacted by fears oversupply will have an impact on margins in the coming quarters. Finally, our average cash weighting of 7.4% detracted from performance, as will always be the case when holding cash in a rising market. Although the Strategy remains near fully invested at all times, we do choose to hold varying levels of cash based on market volatility and in the interest of having funds to deploy toward new investment opportunities.

We would also like to provide an update on any changes to the prominent investment themes within the Large Cap Value Strategy. The investment team has continued to avoid interest rate sensitive areas, as we expect rates to drift higher over time, pressuring rate-sensitive sectors and high-dividend strategies. This view is expressed by our lack of exposure to the Utilities or Consumer Staples sectors. The Strategy is also not invested in any housing stocks or companies that rely heavily on strong housing demand. We do, however, have holdings in the Real Estate sector, each of which we see as having unique fundamental characteristics that can drive earnings growth in a rising interest-rate environment. Our outlook for value stocks continues to favor the chances of a mean-reversion trade after years of outperformance by growth strategies. We remain confident our screening process, coupled with the expertise of our seasoned managers, will position us well to capitalize in the future.

Large Cap Core Strategy

In the third quarter, investors continued to cheer the benefits of tax reform, the effect on economic growth, tame inflation, high productivity and low unemployment. The fiscal plan pushed forth by the administration is viewed by many investors as the most important influence for stocks this year. We agree. We have seen a large impact on company earnings trends. But they are not the only metrics moving higher. Energy costs, labor costs, trucking and transportation costs, the trade weighted U.S. dollar, and the big one interest rates have all moved higher. We continue to focus on domestic companies, which benefit from higher rates, higher inflation and have pricing power. The biggest sector weights in our portfolios remain the same, Technology, Health Care, Financials and Industrials.

Our team monitors different puzzle pieces of information, data and correlations to create our own investment puzzle that will guide our portfolios as we move forward. In addition to the headwind of higher interest rates, the Federal Reserve is less accommodative, draining liquidity from the financial system. There is also a considerable amount of debt and leverage that will need to be serviced as we move forward. When do these issues begin to matter? Leverage can remain high for years before it presents a problem. Our team is reminded charts show us where we have been, but not where we are going. The investment mosaic is a complicated combination of fundamental, technical and behavioral analysis to determine prudent future valuation. At the present time, investors have access to more information from more sources then they can possibly digest. The greatest investment mistakes as we seen them, are for investors to confuse information with knowledge and insight.

With higher interest rates and the end of financial repression, the differences between winning and losing stocks will widen. Dispersions should increase a favorable backdrop for the nimble investor. A good comparison this year is the weak housing sector compared with the strong technology sector. We continue to focus on risk management to minimize the risk of losing the accumulated capital we have generated over the last several years. We do not want our portfolios subject to the entirety of the next market decline as many passive investments inevitably will. Until we get further confirmation on capital market weakness, we see consumer spending, household incomes, job growth and industrial production all look healthy. It will be interesting to see how companies report year-over-year earnings next year, but for now, we look to manage risk while participating in market advances.

Intermediate Fixed Income Strategy

From a fixed income standpoint, most fixed income categories continued to decline over a course of the last quarter. As expected, FOMC raised Fed Funds by 25 basis points to a range of 2.00% to 2.25% at its September meeting and removed the word "accommodative" from their post-meeting narrative. The latter had led some to believe monetary officials could be moving toward slowing monetary tightening. However, the chairman and other members during numerous post meeting discussions have stated that removal does not signal a change. Our view is inflation will accelerate in 2019, and the Fed will stick to its gradual path unless economic growth weakens more than expected.

For now, growth in the U.S. remains impressive, despite some slowing on a global basis. As a result, our base case remains that yields will continue to grind higher in a rotational range of 2.90% to 3.40%, as represented by the 10-year U.S. Treasury, over the next few months. Any extraneous shock, however, whether resulting from the dollar, election, or trade-related issues, has the potential to push yields higher and prices lower.

Our bias for capital preservation keeps us tactically cautious, even as short end of bond curve is becoming more attractive relative to other risk assets. We continue to diversify fixed income portfolios with a focus on lightening corporate bond exposure, directing proceeds into U.S. Treasury, government-sponsored enterprise issues and for individual high-quality, municipal bonds. Given the advanced stage of economic cycle and the above noted risk, we believe portfolio duration related to the benchmark should be kept short.

Outlook

After spending the first half of 2018 consolidating the gains of the prior year, markets adjusted to a new set of risk factors and posted strong results in the third quarter. Corporate earnings remain robust, but they are becoming increasingly threatened by higher interest rates and economic weakness in other areas of the world. As a result, our outlook is one of cautious optimism. Last year's mantra of synchronized global growth is no longer intact, and emerging markets are experiencing economic weakness that could have a greater impact on some domestic companies. Investment opportunities will continue to present themselves, but we think it's important for investors to temper their expectations with regard to the advance of the major stock indices. Forward stock valuations appear reasonable, but reflect expectations for strong earnings growth in most sectors. Our feeling is market participants will have little tolerance for earnings disappointments in the coming quarters, specifically in areas of the stock market that have elevated expectations for growth. We remain focused on finding investments with proven management, reasonable relative valuation, outstanding balance sheets and dependable dividend growth.

Financial markets have had a sharp focus on strong corporate earnings and positive economic data, barely blinking as trade tensions escalate, interest-rates tick higher and liquidity is steadily removed by the Federal Reserve. We see ourselves as portfolio managers and risk managers, meaning it's our job to keep your portfolio positioned well to participate in gains, while avoiding unnecessary risks by being mindful of where we are in the economic cycle. We will remain focused on identifying the most attractive equity and fixed income investments on your behalf, and we look forward to speaking with you to discuss your investments.

Sources: * Bloomberg and FactSet

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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.