TRAPHAGEN FINANCIAL GROUP

2018 Market Review & 2019 Outlook

2018 Economic & Market Review/Comments

Global stock, bond, commodity, and real estate markets all had a poor year in 2018. **This was one of only 4 years since the great depression that all broad traditional asset classes had negative/flat returns.** The last time this occurred was 1969. Although 2018 was not even close to 2008 in terms of panic, economic conditions, or financial market losses, the lack of returns across all assets was unique. **The US stock market was down 4.4%, while the broad global stock market benchmark (ACWI), was down 9.2%.** The overall bond market was essentially flat on the year.

Select 2018 Asset Class Returns (Grey = TFG Private/Alternatives)	
*Private Equity (GPB Capital)	+ 8.7%
*Private Real Estate Credit (Mosaic)	+ 8.6%
Alternative Lending (LENDX/RMPLX)	+ 4.5%
Mid/Long Treasury Bonds	+ 0.8%
Private Real Assets (VCRRX)	+ 0.6%
Insurance Linked Securities (SRRIX/XILSX)	- 3.1%
Investment Grade Bonds	- 3.8%
Public Real Estate	- 4.4%
US Large Cap Stocks (SP500)	- 4.4%
US Small Cap Stocks	- 8.4%
Commodities (Pipeline Companies)	- 10.9%
Option Selling Strategy (AVRPX)	- 12.1%
Foreign Developed Stocks	- 13.8%
Emerging Market Stocks	- 15.0%

** Private Equity & Private RE Credit available to accredited investors only*

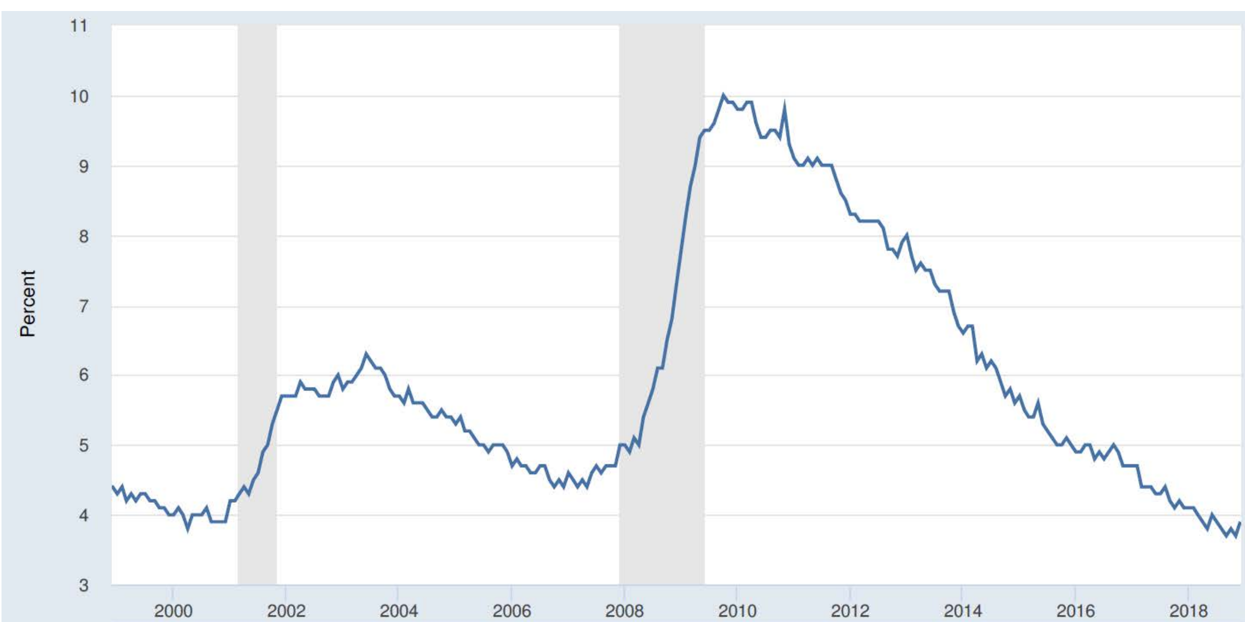
Traphagen believes the negative returns experienced in 2018 were largely caused by the **increase in interest rates, reduction of balance sheet assets, and trade/tariff policy concerns.** This was a 'shock to the system' after a full decade of 0% rates and 'free money'. **We ultimately think this transition to a more 'normalized' interest rate regime is helpful to the health and sustainability of the US economy**. Getting 2%-3% on cash/short term bonds, having some 'cost of money' (which forces discipline in corporate governance), and introducing 'normal' volatility all contribute to a more natural/stable market over the long term.

An additional positive development early in 2019 was clarification by the FED of their likely path forward. ***Below you will find a graphic with some major points.***

Major FED/Interest Rate Takeaways
1- FED is paying close attention to market signals/action
2- 2019 will likely feature 0 to 2 additional hikes
3- Majority of interest rate increases are behind us
4- FED is willing to change balance sheet policy if needed
5- FED seems more pragmatic/'real world' orientated
6- 2.7% 10 Year indicates short term rates are near a high

US Corporate earnings (S&P500) were up 27% in 2018 ($140) vs. 2017 ($110), which is the biggest increase since 2010.

US GDP growth will come in at about 3%, which would also be the highest level of growth we have seen in a decade.



Above: ***Unemployment Rate over the past 20 years***

Employment is another positive note. Arguably, the latest job report was one of the most ‘robust’ and encouraging in years. Along with well above expected job growth (more than 300,000 new jobs), it also showed growth in areas that have been weak over the past 5-10 years including manufacturing. As an added bonus, wage growth (especially for lower earners) finally breached 3% and the employment participation rate increased 0.4% during 2018.

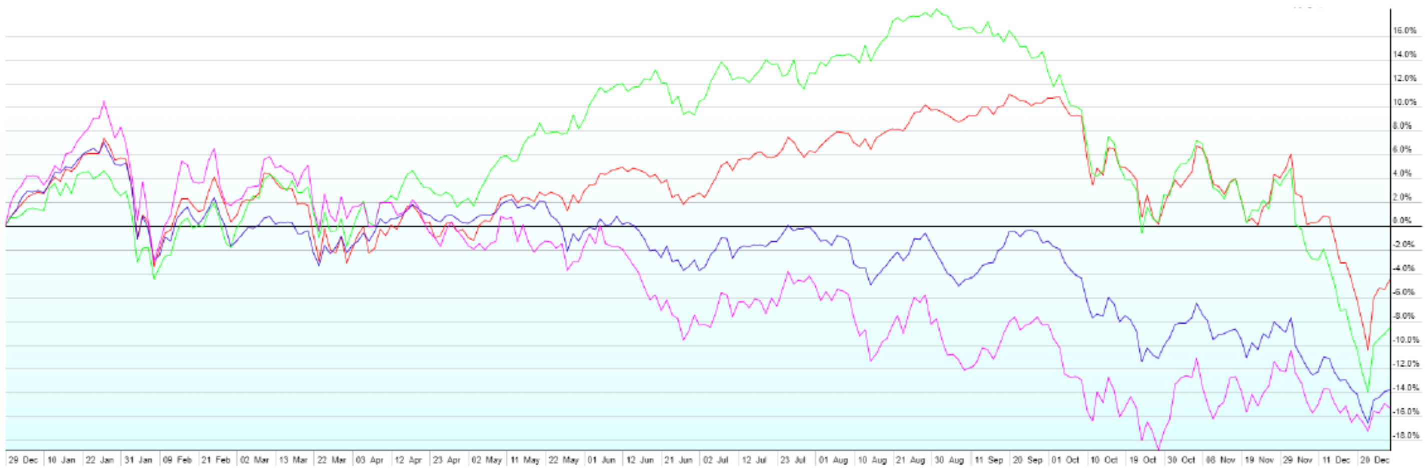
Bonds had a near flat year, with the highest quality (Treasuries/Municipals) the better performers. The 10-year Treasury note had a very volatile year, with a January 2.4% rate increasing to 3.25% in early November, before collapsing back to the 2.7% level at the end of the year. High yield, investment grade, and TIP bonds all closed the year with losses of between 1% and 4%.

Our alternative/private suite had a generally good year with one major exception. Alternative lending returned +4.5% with the help of a very healthy US consumer. The private real assets fund (VCRRX) was up slightly (+0.6%) for the year (although down about 1% since we entered the position in July). ILS was on pace for a good year with returns of about 5% through October, despite two major US hurricanes. The California wildfires had a far bigger impact than originally predicted, contributing to the -3.1% return on the year. The major laggard was our option selling strategy (AVRPX), which was down 12.1% as ever-increasing volatility on many global assets took its toll.

We allocated to our two private investments late in 2017 (private equity and private real estate credit) with the goal of decreasing portfolio volatility, increasing cash flow, and increasing overall returns. These investments did not disappoint in 2018 when we needed them the most. **Both investments returned between 15% and 20% better than their public market counterparts**, with both distributing about 8.5% in dividends/interest during the year. In addition, they exhibited essentially no volatility.

US and global stocks had their worst year since 2008. Foreign stocks had a very bad year with returns of around -15.0%. This was caused by a combination of rising interest rates, a higher US Dollar, a pronounced slowdown in most foreign economies, and trade fears. For much of the year, the US market defied gravity while retaining moderate gains through November. The worst December for US stocks in over 70 years, however, brought even the US markets into negative territory.

Below: Chart of SP500 (Red), US Small Cap Stocks (Green), Foreign Developed Stocks (Purple), and Emerging Market Stocks (Pink) in 2018.



The major factors which affected markets in 2018 are highlighted below:

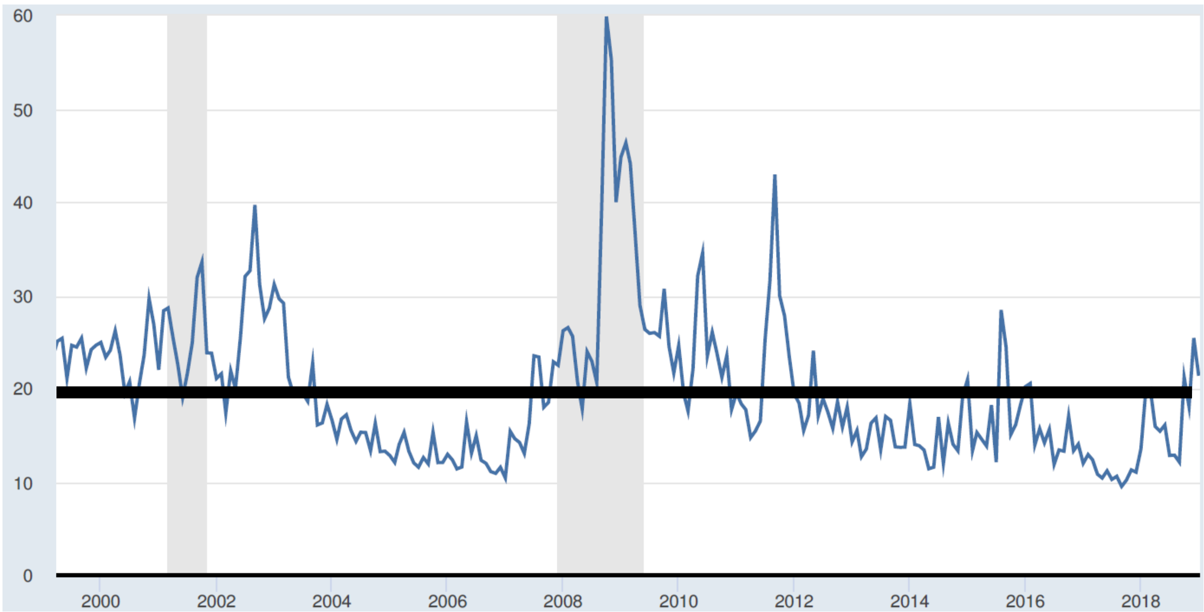
- **FED Rate Hiking/Balance Sheet Reduction:** After a full decade of nearly "free money" and 0% interest rates on short term bonds/cash, by the end of 2018, these instruments were yielding 2% to 3%. Even though these levels are still low in absolute terms, on a relative basis this increase will have large impacts on corporate borrowings, corporate profit margins, market volatility, and asset allocation decisions. Again, we think a normalization of interest rates (assuming done thoughtfully and gradually), is healthy for the US economy in the longer term.

- **"Aggressive Trade Policy" & Tariffs:** Beginning in the early spring, President Trump and the administration have been pursuing broad based and ambitious trade deals with many countries around the world. The style has been aggressive and non-traditional, with tariff action/threats and 'hard-nosed' negotiating tactics commonly used with allies and foes. We have seen significant progress made with Europe, Japan, Canada, Mexico, and Korea over the past 3-5 months, while China remains the biggest risk. The China - US trade relationship is one of the most important in the world and over the next couple of months, the outcome of the ongoing negotiations will likely have a significant impact on global economies and investor sentiment.

- **Much Higher Volatility & 2 Major Stock Corrections:** As mentioned above, the increase in interest rates, uncertainty surrounding future FED hikes, slowing foreign economies, and aggressive trade policy has caused much higher volatility and two major stock corrections. The US market corrected 11% in late January 2018, then recovered to new highs in

September, before dropping 20% through December. After 2017, which was the least volatile year ever, this certainly was a shock to the system, **but was about normal for the past 20 years.** It is important to note that this is not necessarily a bad thing for our clients. Volatility is a chance to rebalance between different asset classes and invest in temporarily depressed assets at cheaper valuations. **It is at times like this where the greatest opportunity exists.**

Below: VIX (SP500 Volatility levels over past 20 years)



- **Very Strong US Economy & Corporate Earnings:** Despite two major corrections, much higher volatility, and the first negative return year since 2008, the US economy itself was on fire in 2018. Overall, this was the best year for the domestic economy in terms of unemployment, wage growth, GDP growth, and corporate earnings. Unemployment hit the lowest levels since 1969 (3.7%), wage growth topped 3%, US GDP growth should be around + 3%, and corporate earnings will be up more than 25%. The robust economy is the reason the FED hiked rates 4 times during the year. We are hopeful the FED will not 'over hike' and put the brakes on the expansion.

Traphagen 2018 Portfolio Comments & 2019 Changes

Overall, in absolute terms this was a tough year for most portfolios with returns ranging from near breakeven to down around 8%, with the more conservative portfolios performing better. Generally, the more private/alternative investments and bonds held within a portfolio the better it performed during 2018 as stocks suffered.

Despite disappointing absolute returns, negative years will of course occur, and on a relative basis we met or beat our benchmarks in terms of risk and return. Our 'aggressive growth' portfolios should return roughly 1 for 1 with the global stock market, but with the benchmark down 9.2%, these portfolios were down 6.5% to 8% (due to strongly positive returns on private/alternative investment allocation). The more conservative portfolios were down roughly in line with our long term projections.

You will find a summary of major changes we made to portfolios during 2018 and our comments on each investment.

- **Allocation to Private Real Asset Fund (VCRRX):** In July, we allocated to this fund which invests largely in private farmland, timberland, and infrastructure. Since our entry, most clients are near breakeven in the fund vs. the public stock markets which are down close to 9%. It is early, but so far we are pleased with the investment with a 4% cash flow yield, much lower volatility than the public markets, and little correlation to other investments within the portfolio.

- **Allocation to Private Equity (GPB Capital) & Private RE Credit (Mosaic):** We were very pleased during 2018 with both these holdings as they both provided the highest returns of any assets (+8.5% in the form of cash flow) along with essentially no volatility or correlation to any other asset. Updates on each are presented below: ***(accredited investors only)***

    - **GPB Capital:** The firm has grown significantly over the past 1-2 years (now managing more than $1.5B), and along with that growth comes challenges. In addition to transitioning to 'public accounting'; which should be completed within several months, they are now in the process of merging many of their portfolio companies. In order to fund company growth they are transitioning from a fixed monthly pay out to a variable quarterly payout based on free cash flow earned (similar to Mosaic). Because of general auto industry weakness and some specific issues related to their Prime Auto Group acquisition we expect a lower return in 2019. Over the long term, we do agree with their decision to use free cash flow first to support underlying company growth, with the excess used to payout current dividends. This should help maximize total return on the investment over the next several years.

    - **Mosaic:** This fund has also grown nicely in 2018 and now they manage close to $500M. We are happy with the 8.6% or so net return achieved in 2018. Overall, they continue to execute at a high level and expand their loan base, with now around 20 different high interest development loans from around the country. The drags on the portfolio have been loans on two Manhattan condo properties. In 2018, the fund took control of the actual real estate and sold the larger property in Q3 2018 with a near breakeven return but a drag on yield. The other property remains in the portfolio and on the market, with a likely sale price above cost basis. At this time we expect a similar return in 2019.

- **Reduction in Foreign Stock Investments:** After significant research and discussion, we have decided to reduce our average target allocation to foreign stocks vs. domestic stocks. It appears to us that over very long periods of time foreign stocks return about the same (or in some cases somewhat less) than US stocks but exhibit higher risk/volatility. Despite this, at times foreign stocks will outperform depending on the US Dollar, marginal changes in policies, interest rates, and growth. We will continue to alter exposure to foreign stocks around a lower average level to take advantage of these cycles.

2019 Portfolio & Economic Commentary

For the first time in a decade in moderate and conservative portfolios, we will hold cash and short-term bonds. With near risk free or very 'low risk' investments yielding 2% - 3% we see an opportunity to trim some commodity, option selling, and longer term bond exposure and move into this space.

2019 Portfolio Changes
Addition of Short Term High Quality Bonds/Cash
Addition of high yield private municipal bonds (~ 6% yield)
Allocation to Private Real Estate Equity
Allocation to low volatility US Stocks (USMV)
Gradual Elimination of Option Selling Fund (AVRPX)
Concentration to Healthcare & Technology in US Stocks

The three main themes regarding the above 2018 portfolio changes are:

1- Taking advantage of higher yields in cash/short term bonds

2- Allocating to two new alternatives/private investments (Private Real Estate Equity & Private Municipal Bonds) which should offer lower volatility and good cash flows

3- Employing a 'Barbell' strategy within US stocks. We are allocating to higher growth areas (healthcare & technology) along with an allocation to low volatility equities (utilities & consumer staples)

When looking at the short to intermediate term outlook for the US and global economy there is a mixed picture. US unemployment is historically low, wages are rising, GDP growth is solid, and corporate earnings are growing. On the other side of the coin, most foreign economies look weaker, trade policy risk looms, interest rates are higher than they have been in 10 years, and volatility is high.

All the above factors point to lower (but positive) US economic growth and lower (but likely still positive) corporate earnings growth. **If we get this type of environment in addition to a more stable interest rate regime, we see a constructive 2019 for most financial markets.**

In addition, as opposed to last year, we now see better valuations in many global stock markets, sectors, and individual companies.

Below we have highlighted what we feel are the major risks for the markets in 2019

2019 Stock Market/Economic Risks
Overly Aggressive / 'Stubborn' FED Policy
Significantly higher interest rates
Poor US/China relationship & negative trade policy outcome
US Corporate profits slowing more than expected
Negative Political Developments

Our Traphagen Recession Index (TRI) is signaling a ~ 37% change of recession over the next 12 months, which is higher than normal (normal is roughly 15% - 20%), but still lower than 'red flag' levels. **Again, if we see this creep above 45% - 50%, we will take more defensive portfolio action.**

We expect continued higher volatility than we saw between 2012- 2017; but hopefully no higher than last year as the market might have finally found peace with a slowing, but still positive, US economy and FED policy.

We wish you and your family a healthy, happy, and prosperous 2019. As always, remember that your Traphagen advisors are monitoring your portfolios and are confident **they are positioned for both asset protection and good long term returns**. **We continue to appreciate the continued confidence and trust you have placed with us.**

Best regards,

Your Traphagen Investment Team