Quarterly Model Portfolio Update

October 15, 2018

U.S. Economy & Financial Market Observations

In the 3rd quarter, most equity asset classes fared well on the heels of excellent 2nd quarter earnings that came in nearly +20% year-over-year. The S&P 500 leapt 7.7% while smaller and mid-size stock indexes gained between 3-4%. However, in the opening days of October, markets wavered giving most of their Q3 gains back in a matter of just a few trading sessions. As we have noted many times in the last few years, given the record low volatility environment, such choppiness can seem unfamiliar and unnerving. Instead of being unnerved, we accept that the recent volatility could simply be part of a return to normalcy. Following last week's unsteadiness, most domestic markets still sit with respectable gains on a year-to-date basis as of this writing (October, 15th): The S&P 500 now stands +**5.1%** since January first, and the tech heavy Nasdaq Composite leads all major market indices with a **9.5%** YTD return. U.S. small and mid-size companies have fared worse during the last two weeks, surrendering most, if not all, of their YTD gains to now sit **-1.7%** and **-0.4%** respectively. In other areas of global markets, 2018 results have been worse, with the MSCI International Index down **9.1%**, Emerging Markets Indices down **13%** and the MSCI U.S. REIT Index down **4.5%**[1].

Much of the cause of recent market tremors has been attributable to measurably higher interest rates. The interest rate on the U.S. 10-Year Treasury Bond ticked up to a 7-year high of **3.23%** in the early trading days of the month (it started the year at 2.48%, so we should be mindful that the incremental YTD yield gain sits near 30%.) As interest rates on Treasuries rise, stocks can look relatively more-risky and less desirable. For example, the two-year U.S. Government Bond yield has now also climbed to 2.8%, roughly 1% higher than the average yield on U.S. stocks, which cements the attractiveness of bonds for some risk-averse investors, especially those with short term time horizons. Given these fairly dramatic yield changes (albeit from low starting levels) we're encouraged that bond market trading has remained orderly, though bond prices have indeed softened. When interest rate changes truly rattle financial markets, one would see instances of large blocks of bonds being sent to market with simply not enough buyers to absorb them, potentially causing bond prices to lurch even lower. No conditions even close to such stress levels have been evident. YTD the Barclays Aggregate U.S. Bond Index has fallen a modest **2.1%** with the Barclays Municipal Bond Index down **1.6%**[1].

The "easy to win" trade war that the U.S. commenced earlier this year has also been a gnawing concern in the background. It appears, frankly, to be more of an economic version of Viet Nam than a walkover at this point. While China and the U.S. have announced and begun enforcing escalating retaliatory tariffs, there is an important dynamic beyond these nominal trade measures: currency. It's likely more than coincidental that China has simply let their currency devalue over the last several months, making Chinese goods cheaper for U.S. consumers, and effectively nullifying the pricing disadvantage imposed by U.S. tariffs. A swift resolution to this trade quagmire would be mutually beneficial and certainly be a positive for markets going forward.

Looking beyond what we view as the simply modest – yet headline grabbing - turbulence of early October, our outlook for the remainder of the year remains constructive given the big picture data: U.S. unemployment recently touched a 49-year low, U.S. GDP has climbed above 3% and inflation remains at healthy, normal levels around 2%. Consumer spending and optimism – the single largest driver of economic activity – also remain at historically robust levels. While domestic markets have given back about half of their YTD gain in October, we see this revaluation in the face of higher rates as a reasonable reaction, not the development of a major trend change.

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Current Portfolio Stance & Adjustments

In early October, we completed our semi-annual test of asset weightings in our Core Model Portfolios to determine where rebalancing action is warranted. Weightings in U.S. large growth stocks represented by the **Vanguard Growth Index (VUG, +13.8% YTD)** and the **Fidelity MSCI Information Technology Index (FTEC, +15.9 YTD)** were both observed to be beyond our upper weighting limits and stand to be sold back to target weight. International stock indices represented predominantly by the **iShares Core MSCI Index (IEFA, -1.6% YTD)** and **iShares Core MSCI Emerging Markets Index (IEMG, -8.0% YTD)** are being subsequently purchased to meet target portfolio levels. Rebalancing of this nature is always counter-intuitive – yes, we're intentionally culling profits from our strongest holdings and redeploying those dollars in currently out of favor investments. Fundamental valuations of both international stocks and large cap growth stocks continue to indicate the latter remain near all time relative highs, while the former (international indices, that have particularly struggled with trade-war speculation) remain relatively as cheap compared to U.S. stock investments as they have been in the past decade. Most fixed income asset classes remain near their target weighting to cause relatively little if any trading activity in most Core Model Portfolio accounts[2].

In addition to selling profits from U.S. Growth stocks to purchase beaten down international stocks, after several months of evaluation, we are also completing the finalization of a component change to one of our long held international equity holdings: **First Eagle Overseas** (**SGOIX**, *institutional share class*).

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We are committed to empowering our clients to discover and direct action toward their most important financial goals. Our advisors have over 100 years of combined experience and advanced credentials in counseling clients to develop and implement strategies to meet their personal and family financial objectives.

We welcome your feedback!

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The First Eagle Overseas fund has been a component of our models since their inception in 2012. Over the last 5 and 10-year periods, the fund has outperformed both its peers and the international index on an annualized basis by margins of 0.24% and 1.9% respectively. In late 2014, though, there was a significant management change with the departure of long-time co-manager Abhay Despande. In early 2016, Despande launched an actively managed international fund following a similar conservative and value-oriented approach, the **Centerstone International Fund** (**CINTX**, *institutional share class*). After evaluating both funds on a qualitative and quantitative basis, our Investment Direction Committee voted unanimously to make a fund replacement. Here are a few key points of comparison:

- First Eagle's fund size of nearly $15 Billion makes it less nimble than Centerstone's with approximately $200 million of assets.
- Both risk-adjusted and absolute return comparisons over the past nearly three years favor Centerstone.
- Centerstone invests with modestly less gold and cash in its portfolio, which we believe will provide a return advantage, particularly with international valuations depressed.

Our regular readers will likely anticipate our perspective and advice going forward: having patience with a carefully constructed portfolio approach. On balance U.S. financial market conditions, and largely those we observe globally remain supportive of positive future returns, despite October's bumpy start. As always, we encourage you to contact your advisor for information regarding your current portfolio holdings, performance or this most recent update.

NorthLanding Financial Partners, Investment Direction Committee

1. Investment index and NLFP portfolio performance data through 9/30/2018 is provided by Morningstar and believed to be accurate as of the date of this publication, gross of any advisory fees. Other sources include the Wall St. Journal, FactSet Research, and Strategas. All investment strategies including diversified asset allocation have risk. Past performance of our investment approach, and component holdings does not guarantee future results. Advisory services are offered through NorthLanding Financial Partners, LLC, ("NLFP") Registered Investment Advisor. While all data is believed to be from reliable sources, accuracy and completeness are not guaranteed.
2. Model component changes referenced refer to model accounts with a minimum account balance of $100,000. Starter model accounts with lower balances, were also evaluated and rebalanced during this time with slightly different results due to different component holdings.