Market Commentary
Fourth Quarter, 2018

The current economic expansion is now in its tenth year, is the second longest since the beginning of the 20th century and the slowest growing since WW II. The economy is strong and we expect it to continue growing, but at a much slower rate in 2019, with gradual declines in consumer spending and business investment.

The Index of Leading Economic Indicators is mostly pointing to continued strength during the first half of the year, but the data has started to change, most notably with weakness in housing and a flattening yield curve.

Supporting continued economic expansion during the first half of the year is strength in retail spending (all-time high in November), employment (312,000 new jobs last month), rising wages (3.2% year over year last month), and low inflation (1.8%).

Recent recessions and bear markets occurred in conjunction with extreme spikes in commodity prices (2001 and 2008), an overly aggressive Fed monetary policy (2008) or extreme valuations (technology in 2001 and housing in 2008). The economic data was very strong just prior to the beginning of each of these recessions, similar to today. A recession will eventually occur, but the preponderance of data indicates it is not likely in the near term barring an unforeseen catalyst. Knowing it will end and knowing when it will end are not the same. We will only know with the benefit of hindsight.

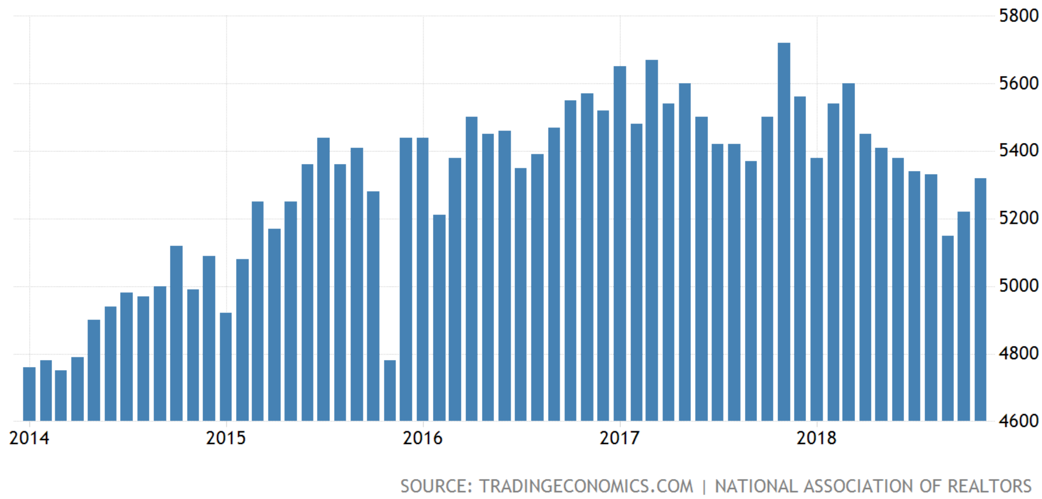
Housing

Housing and all of the ancillary spending associated with purchasing a home represents about one sixth of our economy. It is often the biggest investment people make in their lifetime and a broad reflection of consumer confidence. Historically, housing has been a very reliable leading indicator for the economy.

According to the Fannie Mae Home Purchase Sentiment Index, only 11% of Americans believe now is a good time to buy a home, a measure that dropped sharply in December. This isn't surprising as home ownership affordability has declined. During the last five years, home prices as measured by the National Home Price Index have increased by 29%, while personal income, as measured by the change in average hourly earnings, has increased by only 12%.

Mortgage rates are higher, with the 30 year fixed rate increasing from 3.4% in 2016 to 4.55% at year end. In addition, the 2018 Tax Cuts and Jobs Act caps deductions for interest and state and local taxes, reducing the tax benefits of home ownership.

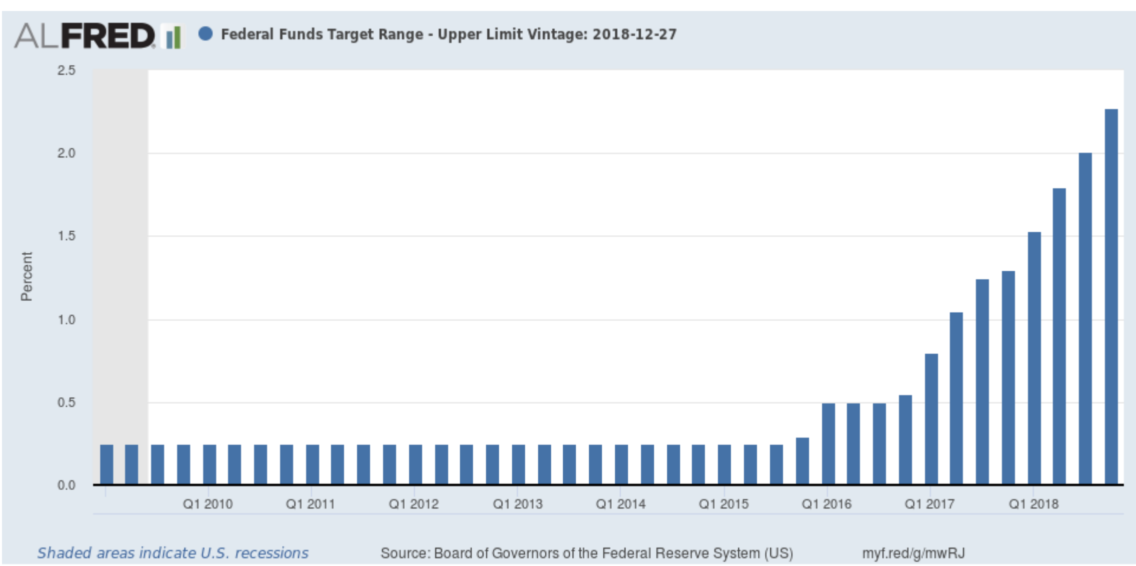
So what is the state of the housing market? Although sales of previously owned houses in the U.S. rose 1.9% in November 2018, the year-on-year sales dropped 7%, the sharpest decline since May of 2011. As noted in the following graph of existing home sales, the trend is down during the last two years.



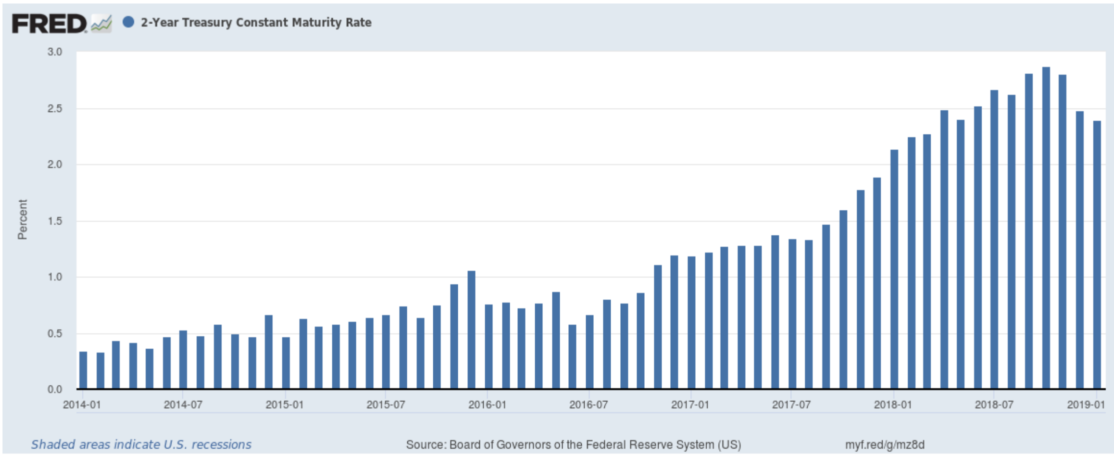
Other weak housing indicators include new single family home sales (-12% in October) and single family housing starts (-13% in November). Housing is the most significant of the few economic indicators warning of weakness and has the longest lead time for predicting recession, about two years.

Interest Rates

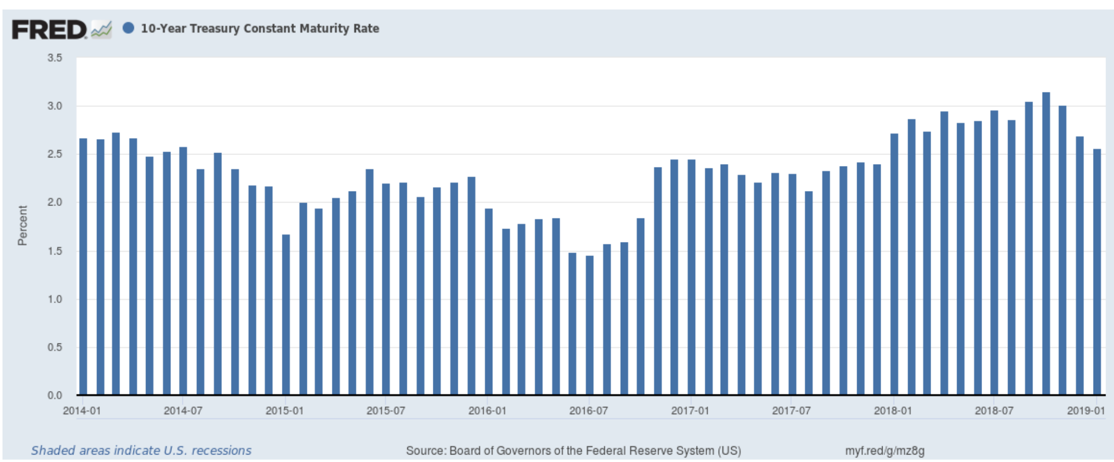
In spite of President Trump's public ire with Chairman Powell, the Federal Reserve Open Market Committee (FOMC) raised its short-term interest rate target last month by 0.25% to a range of 2.25-2.50%. It was the third increase in 2018 and ninth since 2015. In addition, the FOMC is projecting two 0.25% increases in 2019. The chart below illustrates both the long period of near zero interest rates and the steady march higher during the last two years.



The two year treasury yield moved higher in lockstep with the FOMC until early November when its yield peaked at 2.98%. Since then, the yield has declined to 2.39%.



There are very small differences in interest rates regardless of maturity. Yields on short term maturities reflect what the market thinks the FOMC will do regarding monetary policy, and when there are small differences regardless of maturity, it means there is a very low expectation for additional FOMC rate increases.



Yields on longer maturities reflect what the market thinks about economic growth and inflation expectations. The ten year treasury yield peaked at 3.23% in November and subsequently declined to 2.56%, reflecting market expectations for slowing economic growth and low inflation.

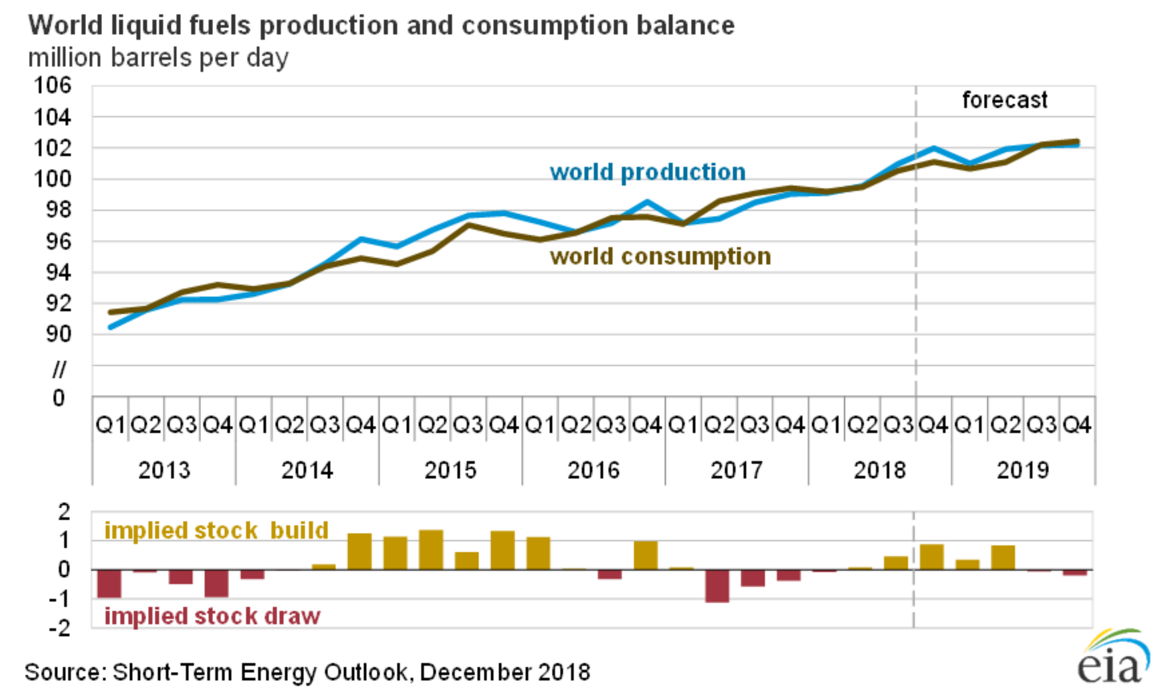
Although the one year treasury bond yield is fractionally higher than the yield on two, three and five year treasury bonds, it is not inverted enough to have predictive value at this time. A flat yield curve has preceded every recession, but not every flat yield curve has been followed by a recession. When recessions have occurred, it is usually about 14 months after the yield curve inverts.

Oil and MLPs and Energy Infrastructure

The United States surpassed Russia and Saudi Arabia in 2018 to become the largest crude oil producer in the world. Crude oil production in the U.S. was 10.9 million barrels per day, surpassing the previous high of 9.6 million set in 1970. U.S. crude oil exports were 1.9 million barrels per day, double the amount exported in 2017.

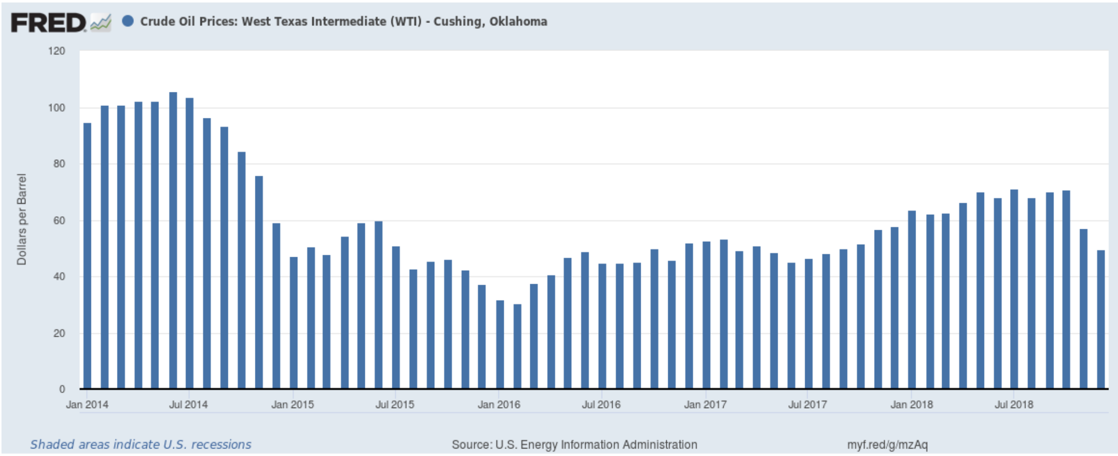
Global production and consumption are in close balance at about 101 million barrels per day. Based on U.S. Energy Information Administration (EIA) forecasts, production and consumption will increase next year, with a slight increase in inventories early in 2019. Production growth in the U.S. is expected to increase by 2.3 million barrels per day and to be offset by a decrease of 900,000 barrels per day in other parts of the world.

Oil prices respond quickly to changes between global supply and production. West Texas Intermediate (WTI) averaged $65 per barrel during 2018, but ended the year at $45. It was the first time since 2015 that oil prices ended the year lower than at the beginning.



To illustrate how sensitive prices are to supply and demand, compare the graph of implied oil stock build and stock draw above with the graph of oil prices below. Prices moved steadily higher from Q2 2017 until Q3 2018 when inventories were declining, and dropped sharply in Q4 2018 when inventories increased, Iran oil sanction waivers were granted, and doubt rose about OPEC's influence on production quotas.

When oil prices are volatile, the correlation between energy master limited partnerships (MLPs) and energy prices increases, despite the MLPs' modest commodity exposure. Investments in MLPs and energy infrastructure declined significantly during the fourth quarter, with the benchmark Alerian MLP Index return of -17%.



The EIA expects WTI prices to average $54 per barrel in 2019, 20% higher than the year end price. The energy pipeline industry is in a very good position, thanks to rising domestic energy production, increasing cash flows, improving debt ratios and better governance. We are optimistic about our investments in energy infrastructure.

Equity Markets

For many years the domestic equity market was calm and investors complacent. The market peaked on September 20, 2018, then declined 20% before rallying the last week of December to end the year with a total return of -4.4%, including dividends. It was the largest intra-year drawdown since 2009, and the worst December performance since 1931. It was a December to ~~remember~~ forget.

There is no shortage of explanations for the sudden increase in market volatility or price decline. Included on the short list are FOMC policy tightening, fading impact of the 2018 tax cuts, slowing economic growth, and trade tensions. The correct answer is there are many reasons as markets are made by millions of investors with different time horizons, strategies, and temperaments. Short term price changes are often more about emotional than fundamental reasons.

The equity markets generally respond negatively to uncertainty, and the rhetoric and actions from the Trump administration on many important foreign and domestic policies are a contributing factor to the recent market decline. Trade and tariffs may be the most important policy issue, as China and the United States combined represent 40% of global trade. Failure to reach an agreement will have a significant adverse affect on the global economy, both sides know it, and consequently we expect resolution of these issues soon.

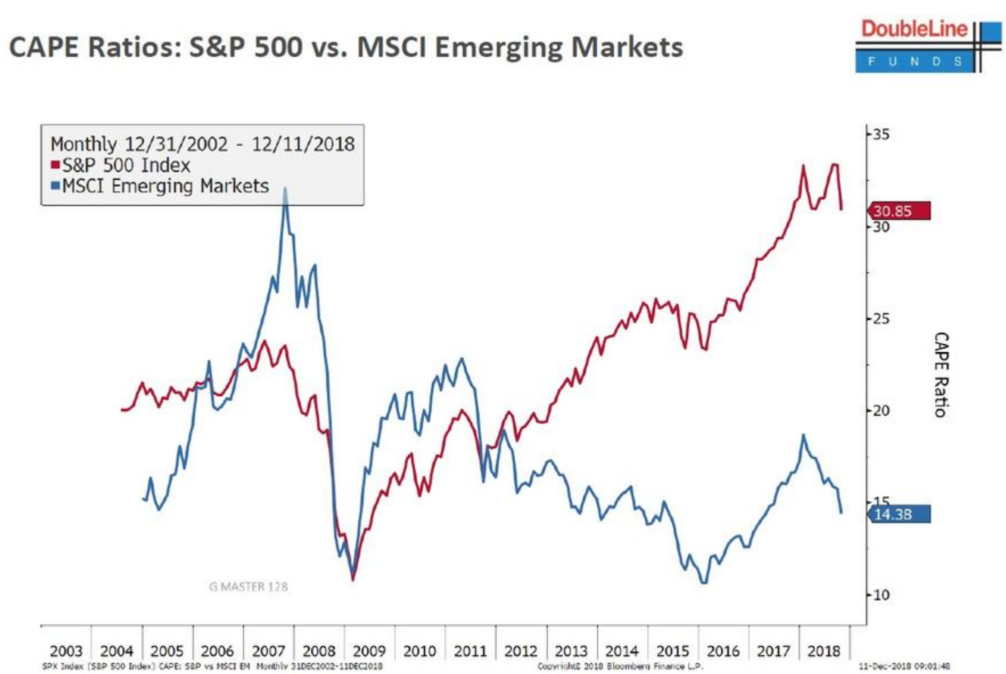
Uncertainty may increase further if the Democratic House of Representatives adopts a more hostile posture towards Trump with its subpoena powers, the government shut-down continues for an extended time, or when the final Mueller report is issued.

Market imbalances often build slowly and correct rapidly, and the recent correction is no exception. To a certain degree, downside volatility is normal. What is unusual is the shallow drawdowns during recent years and positive returns for nine consecutive years. Calendar year results for the last ten years are below for perspective.

Year	S&P 500 Total Return	Maximum Drawdown
2018	-4.4%	-20%
2017	21.8%	-3%
2016	12.0%	-11%
2015	1.4%	-12%
2014	13.7%	-7%
2013	32.4%	-6%
2012	16.0%	-10%
2011	2.1%	-19%
2010	15.1%	-16%
2009	26.5%	-28%

It was not just the U.S. equity market that declined last year. Developed international and emerging markets equities declined by 13.8% and 14.6%, respectively.

As measured by the cyclically adjusted price-earnings (CAPE) ratio, the S&P 500 is twice as expensive as emerging market stocks. The chart below reflects the strong divergence in valuations, and we expect this gap to close. Future returns are generally correlated with current valuations, and with that perspective, we expect emerging market equities to outperform domestic equities over the long-term, but with higher price volatility.



Asset Allocation and Portfolio Diversification

As mentioned in previous letters, we believe strongly in the merits of a diversified investment portfolio. In any given year, there are usually some asset classes with positive returns and others with negative returns. Often asset classes that outperform in a single year lag the following and vice versa. It is very difficult to predict the best or worst performer in any given year.

For the first time in recent history, cash was the best performing asset class in 2018. Domestic and foreign equities, REITs and commodities all declined last year. By contrast, in 2016 and 2017 every major asset class had positive returns. Returns by asset class since 2004 are below.

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2004 - 2018 Ann.	2004 - 2018 Vol.
REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	Cash 1.8%	REITs 8.5%	REITs 22.4%
EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Fixed Income 0.0%	EM Equity 8.3%	EM Equity 22.1%
DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	REITs -4.0%	Large Cap 7.8%	Small Cap 18.6%
Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 14.6%	High Yield -4.1%	Small Cap 7.5%	Comdty. 18.6%
High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 14.6%	Large Cap -4.4%	High Yield 7.3%	DM Equity 17.6%
Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	Asset Alloc. -5.8%	Asset Alloc. 6.2%	Large Cap 14.5%
Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	Small Cap -11.0%	DM Equity 5.2%	High Yield 11.0%
Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Comdty. -11.2%	Fixed Income 3.9%	Asset Alloc. 10.3%
Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty. 1.7%	DM Equity -13.4%	Cash 1.3%	Fixed Income 3.3%
Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Cash 0.8%	EM Equity -14.2%	Comdty. -2.5%	Cash 0.8%

Source: Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management.
Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Bloomberg Barclays Global HY Index, Fixed Income: Bloomberg Barclays US Aggregate, REITs: NAREIT Equity REIT Index, Cash: Bloomberg Barclays 1-3m Treasury. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Bloomberg Barclays US Aggregate, 5% in the Bloomberg Barclays 1-3m Treasury, 5% in the Bloomberg Barclays Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period of 12/31/03 – 12/31/18. Please see disclosure page at end for index definitions. All data represents total return for stated period. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of December 31, 2018.

J.P.Morgan Asset Management

The light grey boxes connected with the line chart represent hypothetical returns from a globally diversified portfolio composed of these asset classes. The diversified portfolio will never yield the best or worst results, but is a useful and consistent method to manage risk and market volatility. Its purpose is to mitigate some of the downside risk and capture meaningful upside return.

Occasionally we will over-weight asset classes with lower valuations and higher expected returns and under-weight other asset classes with higher valuations and lower expected returns, consistent with the investment objectives and risk tolerance of each client.

We are adopting a slightly more defensive posture with asset allocation, security selection and portfolio diversification based on current market conditions, valuations, and expected returns. Our view is returns from all asset classes will be modest during the next few years. We remain committed to an objective goals oriented process and know that investment portfolios will compound long term. During this time of uncertainty and the inevitability of the end of the economic cycle, we think this is a prudent action.

Thanks again for your trust and confidence. Should you have any questions or would like to discuss your financial goals and investment portfolio please let us know.

Respectfully,

The JRM Investment Counsel Team
Jack, Phil and Lauren