ST. JOHN & ASSOCIATES
INTEGRATED FINANCIAL SERVICES

2018 3rd Quarter Financial & Investment General Commentary

This General Commentary covers information of general interest on the Firm, Financial Planning, Financial Services, Market Results, Economic & Market Conditions, Economic & Market Outlooks and Portfolio Investment Management. The last page provides a list of indexes returns for each of the market's major categories.

Our sources of information are diverse and vary from period to period. For this period, sources referred to include Greenrock Research, the Wall Street Journal, Investment News, Morningstar, Fidelity Investments, and others.

INFORMATION OF GENERAL INTEREST

We continue to work on processing and converting clients' portfolios to our new portfolio design asset allocation. This work is being done carefully on an individual and account by account basis as there are both tax and cash flow issues as well as investment issues to work through, client documents to prepare for signature and client meetings to be held. We have a schedule to follow and we will be in contact with you when we are prepared to meet. This new portfolio was designed to deal with the market's current view of equities and bonds.

Much has happened since our 2nd quarter reporting and even since the end of this 3rd quarter reporting. In our Market Reporting we have drilled down into more depth than usual because we believe we are at or near a tipping point in the market. For those of you who are not inclined to read this Market Report in depth or even if you are, it would be helpful for your understanding to read the Conclusion first for a brief overview.

FINANCIAL PLANNING & SERVICES

With the end of the year fast approaching, client and advisor both need to focus on activities that need to be completed by 12/31/18.

This list of activities may include completing the withdrawal of your required minimum distribution (RMD) from your IRA accounts, or your qualified charitable distribution (QCD) on a tax-free basis from your IRA accounts if you are 70 ½ or older. It is also timely to determine if you are eligible and if it is advisable to either make an annual contribution to your IRA or Roth accounts, or possibly do a conversion from your IRA to your Roth account.

It is also not too late for tax planning. One of the opportunities is to consider tax harvesting of losses from your taxable accounts to offset any realized capital gains incurred during 2018.

Year-End Financial Planning Checklist.
Each year around this time we make available our "Last Chance" **financial planning checklist** to all our clients. We call this checklist "Last Chance" because it reminds you to take a look at some areas – like taxes, investments, health care, insurance, and retirement – that might need your attention before the end of the year. Please contact Debbie and she will see that you receive a copy.

Here is the year-end deadline for your planning.
December 31 – Last day to:

- Establish Keogh, Solo 401(k)
- Make contributions to 401(k)
- Sell stock to realize gains/losses
- Take RMDs
- Pay expenses for itemized deductions
- Make tax-deductible charitable contributions
- Make annual tax-free gifts

Medicare Enrollment

This year's open enrollment period for changing your Medicare drug coverage is from 10/15/17 to 12/7/17. For other Medicare options, November 1st to December 31. For these services we have continued to engage the firm Affordable Medical Solutions for their professional advice and assistance, paid for by us and provided to you on a courtesy basis. If you utilized their service last year and have not received notice from them yet, or if you are new to Medicare for 2019 and have questions about the process, please call Lisa in our office.

Social Security Benefits to Increase in 2019

The Social Security Administration has announced a 2.8% increase in the annual cost-of-living adjustment (COLA), for the Social Security and Supplemental Security Income (SSI) benefit amount people will receive each month beginning in January 2019. Federal benefit rates increase when the cost of living rises, as measured by the Department of Labor's Consumer Price Index (CPI-W).

College Planning.

October 1 is the first day the 2019-2020 Free Application for Federal Student Aid or **FAFSA** is available. **This does not mean** that you must file on that first day. Far from it. Each college and university has their own schedule of deadlines. Some are for Early Action and Early Decision, Regular Decision, some are for returning students and some are for transfer students. Follow the college's deadlines and file a week or two before the earliest one if possible.

Tax Planning

We are exploring a program included in the new tax legislation that allows a taxpayer who has large unrealized capital gains – think stocks, real estate, and even cryptocurrencies –to sell your appreciated assets, defer the capital gains tax, and invest the proceeds into one of 9,000 designated distressed communities across America called **Opportunity Zones**. Individuals must invest in Opportunity Zones through Opportunity Funds. There are three main benefits in using this program…Benefit 1. Deferral of the original capital gains tax obligations. Benefit 2. Discount of 10% or 15% on the taxable amount of your original capital gains. Benefit 3. Elimination of capital gains tax on your Opportunity Zone investment. We're staying on this topic, the Internal Revenue Service (IRS) has promised to implement further guidance and clarifications by the end of 2018.

MARKET RESULTS

It was an interesting quarter in that there were lots of danger zones, but very little damage to the market. Potential trade wars, talk of tariffs, leaving NAFTA and sanctions for Iran were only a handful of major issues on the world stage for the U.S. Events going on within the U.S. were rising interest rates, Supreme

Court hearings, continued special council investigations and a ramping up to the November election, not to mention major hurricanes.

Short of a small glimpse of volatility which perked up in July, the VIX, an index of volatility, remained near a 10-year low. Through all the events going on, the market seemed to be more concerned about a strong economy, increasing wages, decreasing unemployment, lower taxes and strong corporate earnings. While this may seem uncharacteristic that the market ignored the political activity, it is actually quite normal. The smooth water, however, can change violently as we begin to see the economic factors change.

We would like to think that investors have begun to finally embrace the mentality of long-term investing and this low volatility is the new norm, but the naïve thought of this has a way of creating a sense of calm and passivity that can be a shock to investors when they find this feeling is only temporary in sometimes a violent correction.

Recently we hit the statistical point where we are now having the longest bull market run in history. While it is easy to say this will continue, there is no telling when the wind will change and bring in a storm. All we can do is enjoy the sun while it is shining but always be prepared a storm could be just around the corner. (We could be seeing this now in October.)

While we do not fear the storms as they are part of a healthy cycle and they will pass, we know we must prepare for the change of seasons. October has a historical preponderance to announce winter is coming.

It is easy to think of investments based on our economy or track things related to U.S. index like the DOW, NASDAQ or S&P 500, but we are also connected to other economies throughout the world and all investments do not track with those indexes unless they have only domestic limited diversity. The U.S. market has been the main stability within the equity markets as international companies continue to try to recover from recessions as well as Europe still dealing with Brexit. The Brexit issue will remain a point of volatility at least until April of 2019.

In the U.S. and elsewhere earlier in the year, we saw a significant outperformance by the growth stock, especially in technology, with the more value-oriented dividend stock lagging well behind. During the 3rd quarter, we have started to see a possible rotation as returns were closer to even, although growth is still slightly outperforming value. It is too early to make that call, but we are looking ahead and are concerned about how high it is possible for some of the tech companies to grow.

Although the U.S. stock market returns were lower in the 3rd quarter than in previous quarters, it remained slightly negative; international equity was worse. Emerging markets being a driving force last year have seen double digit losses this year with no expectation of improving in the near future.

Bonds continue to straddle a breakeven and while remaining relatively stable, are not adding much in the way of returns to the portfolios. With no substantial increase in interest rates for long term bonds over short, in an environment of rising rates, the trend has been to stay short. Additionally, in reaching for higher rates, there is a tendency to go to more risky higher yield bonds. This creates problems in that everyone is fighting over the same bonds.

ECONOMIC & MARKET OUTLOOK

While we don't have a firm outlook on when the market will end the bull run we have all enjoyed, we do know the beginning of the next cycle gets closer every day. We see others preparing and this is one of the reasons the FED is raising interest rates. They are preparing in the event we have another economic downturn.

Reducing interest rates is a weapon the FED uses to create what they like to call a "soft landing". With rates down near zero, they did not have the ability to further lower rates should the economy turn negative, so they are raising rates to create that capacity to later reduce them, but this comes at a cost. Raising interest rates are a negative for an economy and a country. The already huge debt we have as a nation gets bigger as we are facing higher interest rates on that debt. It also forces companies to borrow or refinance at higher levels to pay for new projects and products. As interest rates trickle through to consumer levels, credit card and mortgage interest rates rise.

U.S. Federal Reserve raised its target benchmark rate by 0.25% for the third time in 2018, while simultaneously providing an upbeat assessment of the U.S. economy. This was widely expected and lends further support to another expected hike in December, and potentially three more in 2019.

Bonds

Normally we would discuss equites as a top priority of the portfolio, but interest rates are really becoming the bigger issue. For most of us, interest rates have become a non-issue over the years. Many can still remember the high interest rates of the 70s when they were a big deal, but over the years since then they have been falling. More people typically think of the big dollars interest rates effect on the debt side like credit cards, mortgages and car loans, more so than they do on savings and investing, so they think reducing interest rates are not a bad thing. It is harder for most of us to think back to a time of rising interest rates as with what happened after the great depression up to the 1970s. It was a time most have not experienced as investors. However, to understand what is coming, we must understand how this affected the market then and how we believe it will affect the market in the future.

To understand the risk that rising interest rates bring, we need to look into the modeling of asset allocation. Asset allocation was the work of Harry Markowitz. In 1952, he published a study that became the standard for asset allocation, and he showed the best allocations on what he called the efficient frontier. He used two variables, stocks and bonds, and demonstrated how they had very low correlation and offered different characteristics to a total asset allocation. Stocks offered higher returns than bonds, but also came with higher volatility (risk). Bonds had expected returns that were reasonable yet lower than stocks, but they also had much lower volatility (risk). In a perfect world, bonds would be the anchor to windward when stocks declined. Sticking with only a stock portfolio over the long run would provide higher returns and risk. Interestingly, he came up with this theory by applying mathematics to the study of investment portfolios.

Dr. Markowitz talked about optimal portfolios which contained a precise mix of stocks and bonds in order to produce a desired level of volatility. One of his key assumptions was that risk or volatility was the ultimate measure of return. The more risk one took, the higher their future expected return would be. Conversely, investors who could not withstand risk could expect much lower returns. He drew the efficient frontier which outlined the return expectations one could expect based on the risk one was willing to absorb. Markowitz argued that all one needed to do was to calculate their acceptable level of risk and the efficient frontier would provide them with the perfect portfolio. There are some significant assumptions in Markowitz's theory. The two that are important as we think about his theory today are normal distributions and rational behavior by investors.

NORMAL DISTRIBUTIONS AND RATIONAL BEHAVIOR

Distributions is the study of statistics to observe patterns. If one looked at the weather pattern in Chicago, it would be easy to suggest we are more likely to have warmer weather in July than in January. The average temperature in January is 32 degrees while it is 84 degrees in July. If people dressed just based on the average temperature, they would certainly have surprises. These surprises are referred to as long tails in statistics. Long tails suggest that averages can be determined, but there will be ranges of normal. So, while 32 degrees is the average temperature in January, that does not mean 32 degrees will be the temperature every day. There will be a range around normal. The record high in January is 67 and the record low in July is 51. So, using normal distributions as your method of determining what you wear would leave you awfully cold on some days and well over dressed on other days. Markowitz was using these statistical principles to study investment portfolios. He based his work on normal distributions, and in reality, he had no other choice. He needed to study long-term data and he needed to do so in such a way that he could advise people on portfolio allocations during normal times.

He also based his work on the premise that rational behavior would be how investors would react to market movements. The idea was that individuals would be thoughtful about their portfolios and understand that the stock market will experience years of negative returns. When investors experienced a negative return year, they would have perspective and understand this was normal. They would also understand that two negative years in a row were highly unusual, so reallocating to their stock portfolio would be the rational thing to do. Just like he had no choice but to study normal distributions, he had no choice but to believe that everyone would act rationally when stress points came.

The reality of investing is that normal distributions have exceptions and irrational fears arise out of times when markets decline. Markowitz knew this in 1952 when he developed his asset allocation theory. Today we are living in exceptional times and expecting a normal distribution of returns for the next decade will lead to disappointment.

WHAT IS NOT NORMAL TODAY?

The quick answer is bonds, but stocks have their issues as well. We will start with the bond market. The annualized return of the 10-Year U.S. Treasury from 1910 to September 30, 2018 was 4.7%. We use the 10-Year U.S. Treasury as our proxy because it has the longest history of bonds. We are aware that active bond management has achieved higher returns, so you can add whatever additional return you like to approximate the returns you might have received during this time frame. Bond returns include both price movements and yield (or interest payment received). This is the data, obviously with a different time frame, that Markowitz was using to develop his allocations. His thesis was that bonds would provide reasonable returns and simultaneously they would provide volatility reduction.

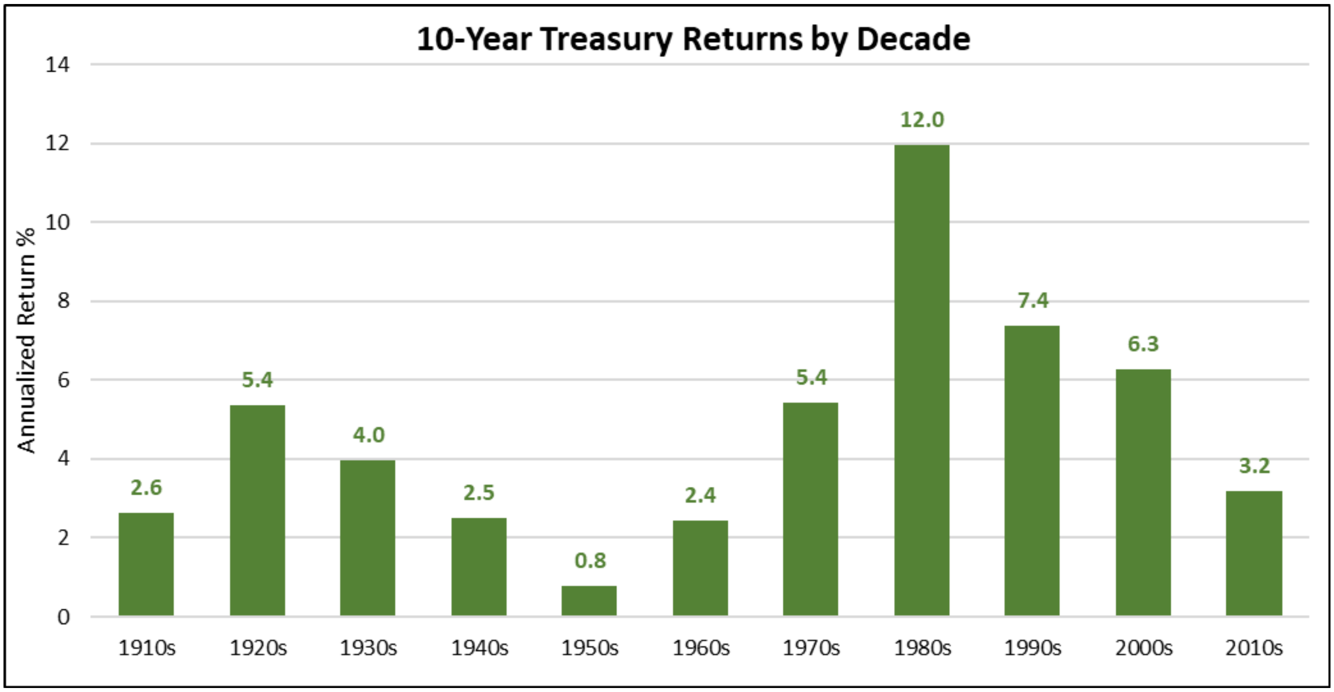
So, if the long-term returns of the 10-Year have been 4.7%, can we expect that today? Charts 1 and 2 will give us some insights into the answer to that question. Chart 1 shows the yield of the 10 Year as of the beginning of each year and Chart 2 shows the total return of the 10-Year for each decade.

Chart 1

Source: St. Louis Federal Reserve (FRED)

Chart 2 shows the returns of the 10-Year for each calendar decade.

Chart 2



You will note that when rates are declining, returns are terrific. The 1980s, 1990s and 2000s saw fabulous returns from bonds. But, when rates are rising like the 1940s, 1950s and 1960s, returns were negligible. The period of 1940-1960 was like having a series of 67-degree days in January in Chicago or 51-degree days in July. Normal distributions in fixed income comes in decades not in days like weather patterns.

SO, WHAT ABOUT THE PRINCIPLE OF LONG-TERM INVESTING?

Long-term investing should not be oblivious to the current reality of price. This is true for any asset class, but especially true of fixed income because of the slow and long-term changes in interest rates. Unlike our examples of normal distribution in weather patterns, equities and fixed income will be measured in much longer periods than the odd day in January of 67 degrees. Equities can go from over-priced to fairly-priced in one year; however, when interest rates are low it takes decades to correct. In addition, fixed income returns are a simple arithmetic problem. You calculate total return by determining the current yield and adding or subtracting the gain or loss based on whether rates fall or rise. A bull market started in bonds in the 1980s because rates were high and beginning to fall. Fixed income investors had both high coupons and declining interest rates, so returns were fabulous. The problem we have today is we have low coupons and rising interest rates.

So, it will be years or even decades before you can assume reasonable returns from bonds. They will reduce your volatility, but they will not allow you to achieve your investment return needs. The coupon is simply too low. You will need to reflect on the decades of the 1940s, 1950s and 1960s to understand the near-term future of bond returns. During these decades the 10-Year annualized 1.9% for 30 years. You can add to that whatever excess you believe you can get above the 10-Year return by investing in corporate or mortgage fixed income securities. Even if you add 2%, which we believe is highly suspect, you will still only be at a projected return of 3.9%. That return is before fee.

TWO POSSIBLE OUTCOMES

There are two schools of thought on what will happen to interest rates as we look out the next five or ten years. Jeff Gundlach of Double Line Capital believes interest rates will rise quickly and precipitously. He believes the 10-Year will be 6% in two years. He made this prediction two years ago and it has been widely criticized. Others believe there will be a much more moderate rise in rates. So, let’s look at fixed income returns if rates rise quickly or slowly.

If over the next two years, the 10-Year went from 3.05% to 6% the principle loss would be 23.4%. This is the loss before earning any income. If the increase were linear monthly, which it almost certainly would not be, the income would be 9.2%. That would mean the total return for the 10-Year over the next two years would be negative 14.2%.

If rates rise more slowly, the loss from 3.05% to 6% would be the same, but the income would be greater because it would cover a longer time frame. We will not speculate on what a slower rise might look like, and it is anyone’s guess as to what it might look like. You can do your own stress tests to determine that for yourself.

Both scenarios are concerning and will be really bad for investors. Couple this with the fact that from the beginning of 2013 the Barclays Aggregate Bond Index has compounded at 1.5% annually, we are experiencing an enormously difficult time for bonds.

PURPOSE OF BONDS IN ASSET ALLOCATION
There are four generally accepted roles for bonds in client portfolios. They are as follows:

1. Diversify from equities
2. Preserve capital
3. Protect against inflation
4. Produce income

We believe bonds do diversify portfolios away from equities. Bonds will provide a different and lower volatile portfolio.

We believe they do preserve capital, but not if rates rise; a negative 14.2% return from the 10-Year feels like an equity return.

Bonds have not, over the last 5 years and 9 months, provided inflation protection with an annualized return of 1.5%. Whether rates rise slowly or quickly, they will not provide inflation protection in the future.

We believe bonds do provide income, just not at the level that can solve the income need.

So, all of this leads us to suggest if you are using bonds, we need to lighten their weighting in your portfolios. Other than diversifying from equities, bonds fail their accepted roles in portfolios.

Now it needs to be stated that there is a third possible outcome, interest rates fall over the next few years. Theoretically, it is possible that the 10-Year could go from 3.05% to 1.49%, which is the low on the 10-Year during this cycle. While possible, there are signs that suggest this is highly unlikely. First, the Fed has targeted a 2% inflation rate going forward, and second, GDP growth this year will be 3%. So, when you factor in inflation and GDP growth, one would question if it is possible for rates to fall.

If we were surprised and rates did fall back to the 2016 low, this would be a signal of no growth and no inflation, perhaps even deflation. This would be very bad news for our stock market; it would signal a very large correction. Bonds would have positive returns, but coupons would again be below 2%. This would make conditions even worse for the future returns of bonds.

Stocks
Following a huge run up in technology stocks, we have to continue to wonder how big and thus how valuable a company can grow its earnings. Companies are somewhat limited in how much product they can sell as there are only so many customers to sell to and once everyone has one it becomes harder to sell more. Think of this when you consider how many more people there are that do not have an apple phone or do not subscribe to Netflix already. How many people are not already shopping through Amazon or posting on Facebook or Instagram. In these times, a company does not get rewarded for keeping customers, but adding to them. Remaining the same is seen as not good enough, so you can see the pressure building in figuring out how to continue to grow revenues and earnings.

This gives an opportunity for interest sensitive value-oriented stocks like financials and energy to finally have their day. The value-oriented stocks are traditionally backed with dividends. This gives them a better ability to outperform should the equity market begin to slow. Nothing is a buffer to a correction as those tend to take all stocks down together, but it helps in times of longer flat markets which we see within the foreseeable future.

Still this only covers the domestic stocks and speaks nothing of the international stocks which are also being strained with political unrest, worldwide tariff discussions, oil prices and of course Brexit. Europe is also still fighting their way out of a recession. While the growth potential is there for many international companies, the international markets remain very unsettled.

CONCLUSION

As we approach November, the U.S. midterm elections are likely to capture an increasing share of the spotlight, with many expecting Democrats to take control of the House. A divided Congress would likely mean more noise and investigations, but less action. This may be a positive for stocks, which tend to enjoy a softer legislative agenda. Moreover, the calendar year following midterm elections has historically been very strong, posting an average annual return of approximately 17.9% since 1927.

Our new portfolio is designed to address both the issues of the equity and bond portions of your portfolio. In lieu of holding various classes of bonds funds and a mixture of growth and value oriented domestic and international mutual funds, we are refocusing the portfolio to invest in individual equities and bond alternatives to improve portfolio stability, avoid some market's risk and potentially improve portfolio performance. This will reduce some of the risk of the equity part of the portfolio by investing in dividend paying stocks only and supplementing bonds with a range of selective and timely alternative ETF investments. While adding a small amount of additional risk to the bond side, and less risk on the equity side, we do so to set up the opportunity to outperform the traditional bond market returns.

We believe a move from a growth-based portfolio to a growing dividend equity portfolio is the prudent move over the next 10 years, but periods like the last 12 and 18 months make it difficult to make that case. We get that. It may not be intuitive to all clients that avoiding overpriced stocks even when they are achieving great returns is an integral part of a thoughtful long-term investment strategy, but we feel that time will prove us right.

Additionally, we feel that history is also on our side with regards to the bond side of the portfolio as we must look for alternative solutions to gain opportunities to outperform historical bond returns in times of rising rates.

St John & Associates

Below are the returns for mutual fund categories making up our clients' portfolios and the major stock market averages. Morningstar sourced these mutual fund returns. Returns beyond one year are annualized.

	3rd Qtr. 2018	1 Year Average	5 Year Average	10 Year Average
Large-Cap Growth	7.54	23.18	1.02	12.60
Large-Cap Value	5.49	10.84	10.19	9.69
Mid-Cap Growth	6.48	20.31	11.68	11.97
Mid-Cap Value	3.05	8.93	9.33	10.41
Small-Cap Growth	7.00	24.44	11.75	12.57
Small-Cap Value	1.03	8.41	8.36	10.03
DJIA	9.63	20.76	14.57	12.22
S&P 500	7.71	17.91	13.95	11.97
S&P Mid-Cap 400	3.86	14.21	11.91	12.49
Russell 2000	3.58	15.24	11.07	11.11
Russell 3000	7.12	17.58	13.46	12.01
Health	10.56	19.89	14.62	14.98
Commodities	-1.80	5.62	-6.76	-6.81
Real Estate	0.58	3.39	8.56	7.13
Technology	5.62	24.23	18.14	15.73
Emerging Markets	-2.47	-3.63	2.54	4.91
Intl Large Growth	0.21	4.08	5.74	6.41
Intl Large Value	0.94	-0.23	3.02	4.41
Intl Small/Mid Growth	-1.30	5.37	7.59	9.88
Intl Small/Mid Value	-1.60	-1.55	4.83	6.49
MSCI EAFE	1.35	2.74	4.42	5.38
MSCI Emerging Mkt	-1.09	0.81	3.61	5.40
MSCI World	4.98	11.24	9.28	8.56
Inflation Protected	-0.63	0.42	0.97	2.89
Intermediate Term	0.20	-1.06	2.14	4.21
Short Term Bonds	0.50	0.43	1.24	2.52
Multi Sector Bonds	0.89	0.59	3.15	5.73
Barclays Agg Bond	0.02	-1.22	2.16	3.77
High Yield Bonds	2.02	2.36	4.31	7.62
High Yield Muni	0.30	3.05	5.73	5.55
World Bonds	-0.25	-1.23	1.05	3.52
Fidelity Cash Reserve	0.47	1.50	0.50	0.38