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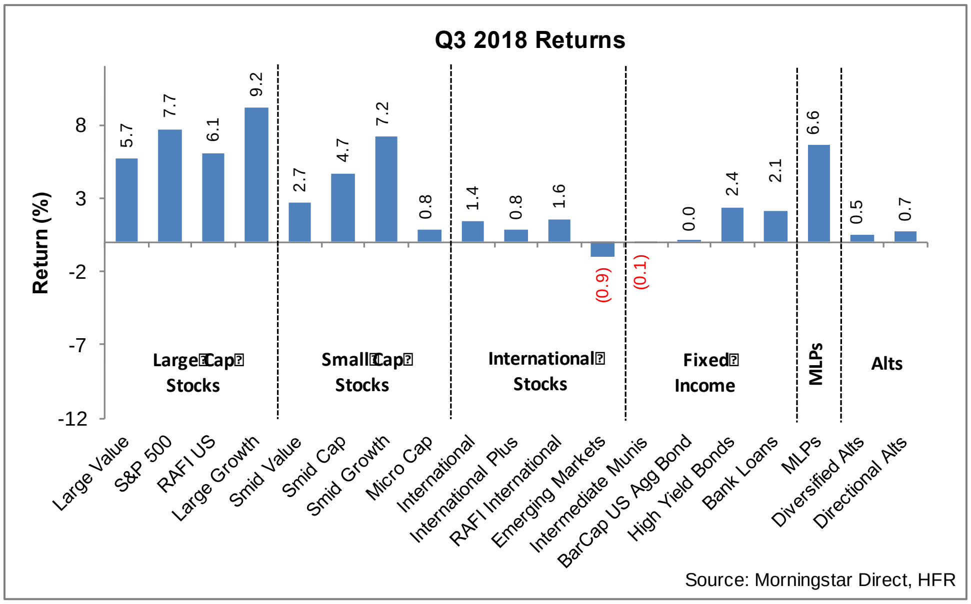
Third Quarter 2018 Investment Review & Outlook



EXECUTIVE SUMMARY

Q3 2018 Recap:

- Despite modest rebound, difficult year for investments continues outside of growth stocks
- FAANG continued to dominate market performance; other market sectors such as value, international, and small cap lag large cap growth
- Traditional fixed income continued to struggle amid rising interest rates, now down 1.6% for the year

NEXT Outlook:

- A strong fundamental backdrop is supportive of the equity markets, but volatility is likely here to stay amid increased geopolitical risks and an aging market cycle
- Corporate earnings and economic data will need to sustain itself beyond the initial impact of last year's tax bill to carry the bull market forward
- Risk remains to the upside for interest rates given strong economic data and continued withdrawal of Fed monetary policy
- Trade tensions with China and mid-term elections remain sources of potential volatility entering the fourth quarter

To Our Clients and Friends,

Despite a wave of strong economic data, corporate earnings, and robust sentiment, 2018 has proven to be a difficult year for investors. After tremendous gains in 2017 – perhaps bolstered by the anticipation of this fundamental performance – the vast majority of the global market displays relatively meager performance year-to-date. Through September 30th, the global stock market was up approximately 4% while the US fixed income market had declined 1.6%. Although the third quarter brought slightly improved performance compared to the first half of the year, resurgent volatility in the first two weeks of the fourth quarter has pushed many indices back into negative territory.

Casual observers may be surprised by this assessment, given better performance of the S&P 500 index. Unlike the other major asset classes – bonds, foreign stocks, hedge funds, etc. – US large cap stocks were up just over 10% during the first nine months of the year (although, more than half of that gain has been given back in the first two weeks of the fourth quarter). It has been one of the few sources of return in what has been a difficult year of performance. While this would not be so much of an issue if this was a more niche market – say emerging markets that led market performance in 2017 – we understand that the S&P has a more prominent place in the financial media and thus our clients' psyches.

To that end, we would re-emphasize that an institutionalized approach to investment management is to invest on a global basis. While US markets take on the largest single component of our equity portfolios, we believe a properly diversified approach includes other markets such as Europe, Japan, and China (regardless of their year-to-year oscillations). Next Capital emulates the long-term investment philosophy of endowments and foundations which maintain a similar approach.

The rationale for this approach is well illustrated by a graphic created by J.P. Morgan that we call the "Quilt Chart" (see below). Each column represents a calendar year and the relative rankings of several major asset classes in that year. While we have been in a remarkable period of US large cap outperformance during the past six years (green box labeled "Large Cap"), you will note that there was a similar stretch of developed international (grey box labeled "DM Equity") and emerging market (purple box labeled EM Equity") outperformance relative to the US in the mid-2000s. If we were to stretch this concept back longer than 15 years, similarly alternating periods of relative performance can be observed. By avoiding making a singular bet on any single market, we believe investors achieve a more robust return over time.

																2003 - 2017	
2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	Ann.	Vol.
EM Equity 56.3%	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%	Small Cap 11.5%	EM Equity 12.7%	EM Equity 23.0%
Small Cap 47.3%	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%	Large Cap 10.6%	Small Cap 11.2%	REITs 22.3%
DM Equity 39.2%	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%	Asset Alloc. 2.9%	REITs 11.1%	Small Cap 18.8%
REITs 37.1%	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%	REITs 1.8%	Large Cap 9.9%	Comdty. 18.8%
High Yield 32.4%	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%	Cash 1.3%	High Yield 9.6%	DM Equity 18.4%
Large Cap 28.7%	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%	High Yield -0.6%	DM Equity 8.6%	Large Cap 14.5%
Asset Alloc. 26.3%	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%	DM Equity -1.0%	Asset Alloc. 8.3%	High Yield 11.3%
Comdty. 23.9%	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%	Fixed Income -1.6%	Fixed Income 4.1%	Asset Alloc. 11.0%
Fixed Income 4.1%	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%	Comdty. -2.0%	Cash 1.2%	Fixed Income 3.3%
Cash 1.0%	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 -7.4%	Comdty. -0.3%	Cash 0.8%

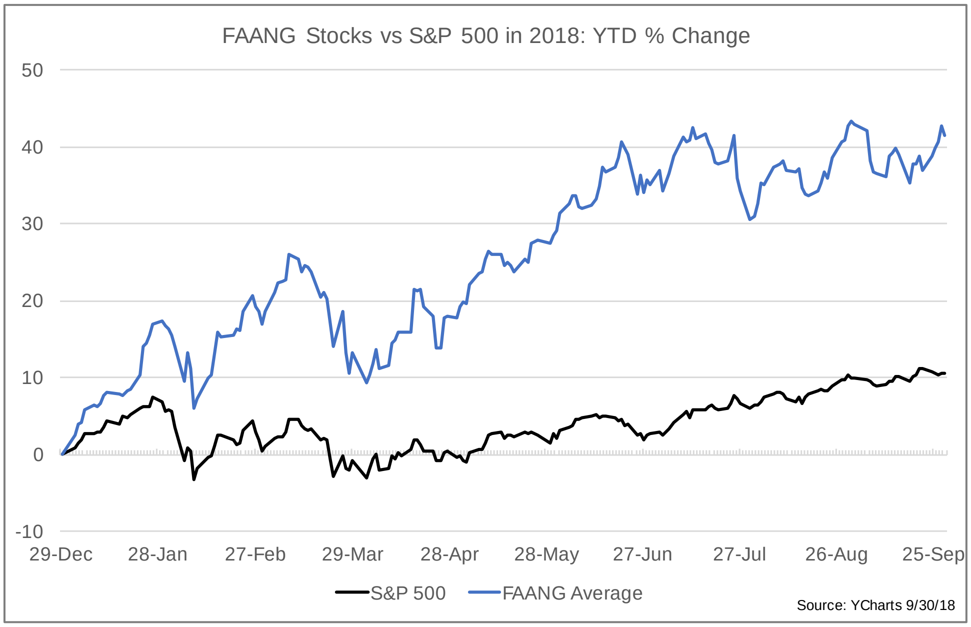
Source: Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management.
Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Bloomberg Barclays Global HY Index, Fixed Income: Bloomberg Barclays US Aggregate, REITs: NAREIT Equity REIT Index. 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 12/31/02 – 12/31/17. 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 September 30, 2018.

J.P.Morgan Asset Management

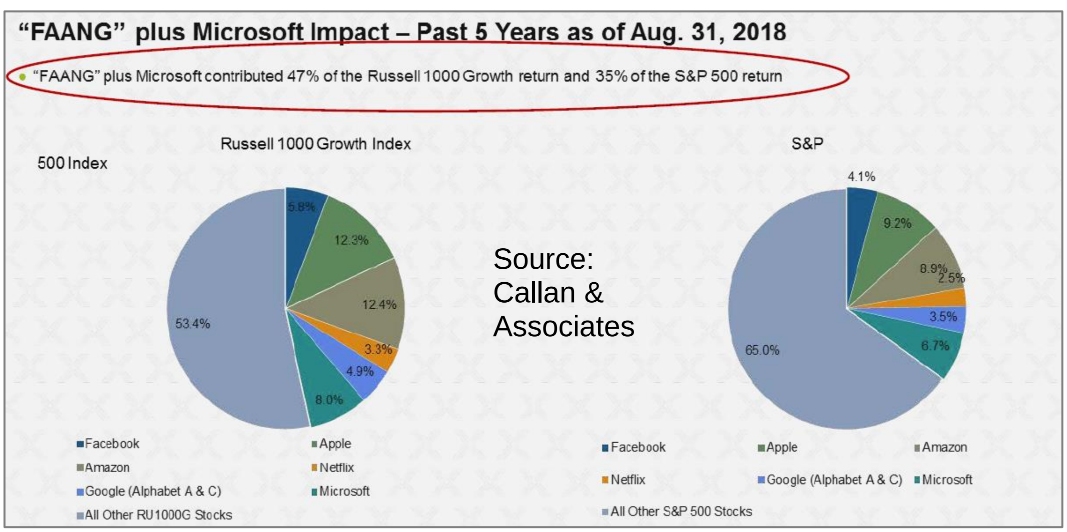
International markets have been beset by a few factors this year, the most notable of which has been President Trump's intensely negative rhetoric around trade. In combination with a stronger US dollar, these forces have presented a sharp headwind for foreign markets – particularly emerging markets, which have been very volatile in 2018. These types of issues have historically been more transient in nature, although it may be more difficult to handicap President Trump given his less conventional approach to foreign policy.

FAANG Impact

Of course, the other factor at play in 2018 performance is the continued dominance of technology and other high growth momentum stocks. In particular, the so-called FAANG stocks (Facebook, Amazon, Apple, Netflix, and Google/Alphabet) have been uniquely responsible for the performance of the S&P 500 in 2018. On an equal weighted basis, the FAANG contingent is up 41.4% on the year and accounts for a third of the S&P's 2018 gain. As recently as three months ago, the entire S&P 500 was actually negative if you excluded the performance of these five companies.



We have written ad nauseum here before about how the incredible performance of these companies has created substantial divergence between markets in recent years. Foreign markets, for example, where technology makes up just 7% of their market cap, have struggled to keep pace. Likewise, value indices in the US and even small cap stocks – the latter of which should traditionally outperform large caps in a bull market environment – have seen their returns lag large cap growth due to much smaller exposure towards these types of companies. This has not been a short-term phenomenon: analysis by the consulting firm Callan & Associates shows that 35% of the S&P 500's return over the past five years is attributable to the five FAANG stocks plus Microsoft; nearly 50% of the Russell 1000 Growth (the index proxy for large cap growth stocks) five year return is attributable to those six stocks.



One of the key questions for equity investors today is whether the incredible dominance of disruptive names like FAANG will persist. While many professional investors have de-emphasized these holdings for valuation reasons, their astronomical performance has continued (for the most part). Others have argued that the unique transcendence of these companies across industries and sustainable growth characteristics demand a different valuation methodology.

We believe that, unlike the technology bubble in the late 1990s, many of the FAANG's are real companies with real earnings and fundamentals. While we might quibble about the individual names, we do accept the concept that a new digital economy has emerged in which traditional players are being disrupted. And although the FAANG's have been the representation of this shift, there are certainly a number of companies that have are participating in this new regime of disruption and innovation.

With that said, we believe investors should exercise caution around abandoning their allocations and significantly overweighting large cap growth stocks. We would point out that the first few cracks in the armor of the FAANG mystique have emerged. The increasing size and dominance of these companies has invited fresh regulatory scrutiny, particularly surrounding anti-trust issues and data privacy concerns that have the potential to disrupt their incredible momentum (Facebook being the most obvious example). As long as these companies continue to grow and perform, they will justify their valuations. If those dynamics change, they have the potential to be punished more harshly than their peers. We saw a bit of that unfold late last week, as signs of a crowded trade unwinding – at least a for a couple days – seemingly took hold.

Outlook

While we have dominated our earlier discussion with talk of international stocks and FAANG, the first few weeks of Q4 have made clear that interest rates are now the driving force for financial markets. A spike higher in early October has left the yield on the 10-year Treasury bond at 3.20%, the highest level since 2011. It was just two years ago that the 10-year yield was at an all-time low of 1.37%.

There is immense pressure on interest rates to rise, whether it be a tight labor market (unemployment rate is now 3.7%, the lowest since the 1960s), a Federal Reserve that is both raising short-term rates and unwinding its balance sheet of longer dated Treasuries, or an economy that is expanding at its fastest pace in years. While rates have thus far been able to remain relatively contained, they are still historically low and there is a strong chance that they continue to move higher.

This has a few implications for investors. For starters, traditional bond portfolios – which are the most sensitive asset class to interest rates – will likely continue to struggle. As noted here before, we have positioned client portfolios to avoid this risk by focusing on shorter duration, more credit centric strategies. A sharp enough move in rates, however, could prove disruptive to the financial markets more broadly.

Something similar could happen economically. Higher interest rates could eventually become a headwind to growth as financing costs go up for everything from corporate debt to mortgages. While we do not seem to be there just yet – indeed, real interest rates only recently became positive and historically rates remain very low – these are factors that bear watching for investors.

In the near-term, fortunately, fundamentals remain strong enough to overcome higher rates. Corporate earnings are once again expected to top double-digit levels, with current estimates calling for 19.2% year-over-year growth in the third quarter, according to data from FactSet. From an economic perspective, second quarter GDP hit the highest level in four years – a 4.2% annual rate – and third quarter growth is expected to top 3%. These are robust levels that underscore an economy firing on all cylinders.

Whether this growth cycle will sustain itself beyond the initial effects of last December's Tax Cut & Jobs Act, however, is another question. There is no doubt that the new tax law has helped boost economic and corporate performance. Advocates suggest that the combination of higher confidence and incentives the law has inspired will drive lasting effects for the economy. Cynics argue that TCJA has done little more than pull future growth forward, lifting near term numbers at the expense of 2019's or 2020's. Like many things in life, the truth is probably somewhere in the middle. In general, though, lower taxes and a less restrictive regulatory environment will perpetuate a more friendly corporate environment going forward.

As the early weeks of October have shown, the markets are aware of these issues and we have re-entered a more "normal" environment of market volatility. While it may not feel that way, the extremely low volatility of 2016-2017 was amongst the lowest on record and therefore decidedly abnormal. We should all be prepared to deal with more periodic declines in the stock market – whether it be induced by Trump's trade comments, next month's elections, or otherwise. We remind clients, however, that we build diversified portfolios expressly for this reason. When the stock market is booming the inclusion of diversifiers like fixed income and alternative investments may not feel productive. Ultimately, though, they help cushion the magnitude of declines when times are not so good and lead to a better full-cycle experience.

As always, if you feel your personal financial situation has changed or you would like to revisit your asset allocation, please do not hesitate to call or visit our offices.

Kindest regards,
Your Investment Team
10/15/2018

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