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Spinnaker Trust Third Quarter of 2018 Market Review & Outlook

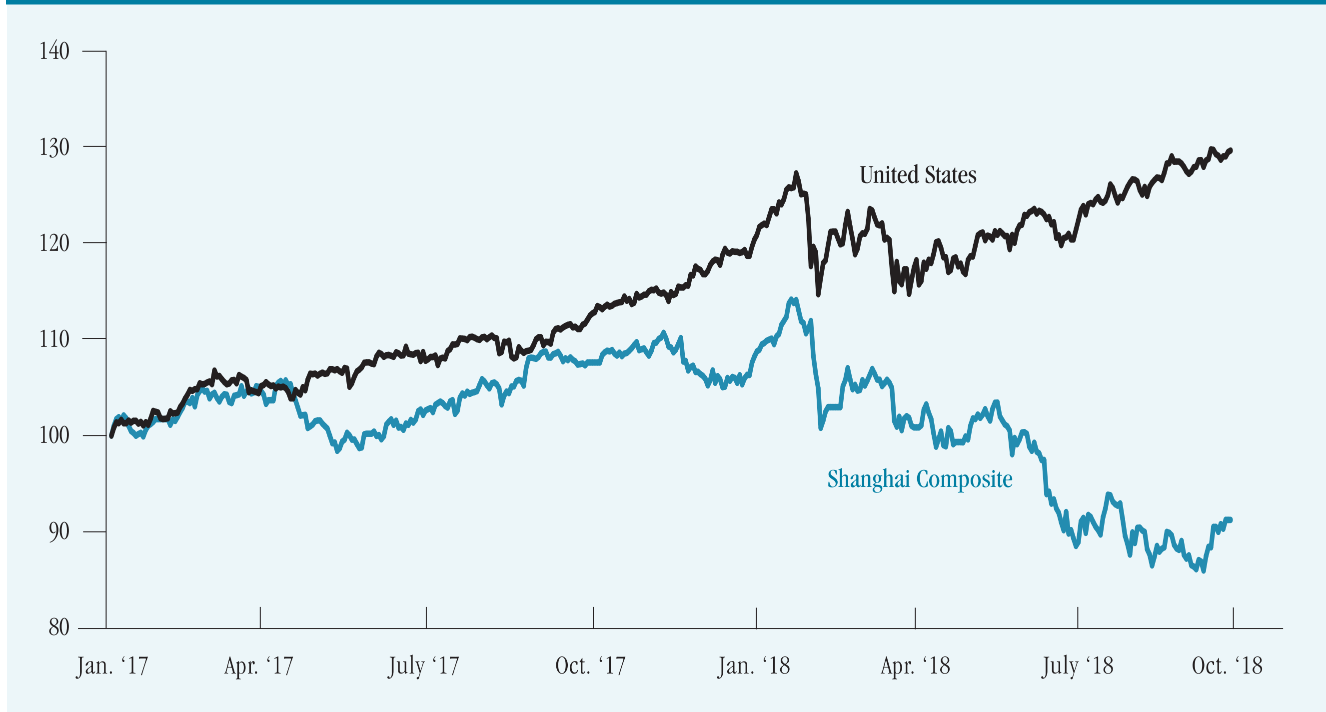
Despite endless reminders of the tenth anniversary of Lehman Brothers' collapse, escalating trade tensions, predictions of an imminent recession and generally expensive equity markets, the U.S. equity market performed strongly in the third quarter. The S&P 500 rose by 7.7% during the third quarter – the largest quarterly gain since the second quarter of 2016 - while international equity markets continued to lag with developed international equity markets up 1.4% and emerging markets down by -1%. In the U.S. market, the Industrial and Health Care sectors led the way, while the Materials and Energy sectors were the worst performers. Small and mid-cap stocks underperformed large-caps for the first time in several quarters.

Energy prices reversed their notable year-to-date gains, falling by -3% during the quarter. The bear market in the non-energy commodity complex continued as soft commodities (agriculture), base metals, and gold prices fell by -6%, -4.4%, and -3% respectively. The widely followed 10-year U.S. Treasury bond yield spiked above 3% toward the end of the quarter as the Federal Reserve raised its benchmark rate to 2.25% while signaling further hikes to come, and the Federal Reserve's balance sheet runoff accelerated to the maximum level of $50bn per month.

Trade Protectionism: The media would have you believe that the U.S. is in a trade war with the rest of the world. At Spinnaker, we characterize the current environment as more of a trade "skirmish" that could escalate into a war in the coming year or two. The Trump administration has focused on the repeal and/or alteration of the NAFTA agreement lately. However, we believe that the White House's true, long-term objective is to limit and/or slow the theft of U.S. intellectual property and the resulting technological advancement by the Chinese. The Trump administration is moving forward with restrictions on Chinese investment in the U.S. and, perhaps purposefully, causing U.S. businesses to pull back from operating in China. While we understand the underlying strategy and recognize that it is addressing an important fundamental problem, we wish that we had more confidence in hardline White House trade and policy advisors Peter Navarro and Robert Lighthizer.

Both the U.S. and China have recently stepped back from some of the most aggressive rhetoric. On September 17th, the Trump administration put 10% tariffs on $200bn worth of goods imported from China after having threatened 25% tariffs. Further, 300 products largely in the smartphone and electronics category were excluded from tariffs altogether (Apple's lobbying budget must be impressive). The Chinese, in turn, have not purposefully devalued their currency, signaling a willingness to negotiate. The Chinese have also suggested that they are willing to lower tariffs for the rest of the world, ex the U.S., which would boost already large trading relationships with Europe and Asia and thus strengthen long-term influence. The Chinese are expected to wait to show their hand until after the mid-term elections to determine if the Trump administration's trade agenda has been strengthened or weakened by the results.

In the early days of de-globalization, the winner in terms of equity market performance has been the U.S., and the loser has certainly been China. In the end, we expect that no one will win. The Trump administration may pay a political price for tariffs in time as the transmission mechanism is higher prices for U.S. consumers. But today, there is little evidence of substantial damage to U.S. companies or equity markets. Longer term, Trump could be voted out of office in 2020 and his trade policies reversed whereas Pre-



Source: Strategas Research Partners

mier Xi Jingping will likely be the Chinese leader for the foreseeable future.

"You Can't Predict. You Can Prepare" – Howard Marks, Co-Chairman of Oaktree Capital

It seems market prognosticators are calling for the end of the current business cycle and an imminent recession on a daily basis, despite strategists' and economists' dismal record of forecasting recessions. Perhaps the doom predictors are simply over-thinking how strong our economy is right now.

The U.S. economy is booming. This year will see $700bn in repatriated corporate profits, $122bn in individual tax savings, $80bn in corporate tax cuts and $100bn in increased government spending. Accelerated depreciation, incorporated in the new tax plan, has spurred businesses to increase capital spending by more than 13% on an annualized basis. More than $1tr in increased government spending will run through the U.S. economy in the coming quarters. As a result, the U.S. economy will likely have back-to-back quarters of 4% GDP growth. Wages are rising by nearly 3% per year. Total wages, which factor in both average hourly earnings as well as the total number of hours worked, are up by 5.1% over the past year. Consumer confidence has not been higher in 30 years. Manufacturing measures are close to all-time peaks. Real interest rates in the U.S. are sitting at basically zero. Productivity measures are finally climbing.

On the other hand, there are legitimate fears about market developments since the end of the financial crisis. The most common are: illiquidity in the bond market, the decline in general volatility levels (and presumptions that these low levels will persist), an escalation in global trade tensions, peak corporate earnings and profit margins, rising levels of corporate and sovereign indebtedness, rising interest rates, a bubble in private market and venture capital valuations, and the topping of the housing and auto markets. All of these are concerns and we are actively positioning client portfolios to reflect these risks. However, we have to date maintained a relatively full equity allocation for our clients. We recognize that the internet, perhaps best personified by Amazon, continues to act like an enormous wrecking ball taking out great swaths of competitive advantage that protected businesses for decades or longer. We have tried to maintain a full exposure for our clients to businesses that are creating new moats and have tried to reduce exposure where businesses are most threatened by this enormous hundred-year storm.

Despite the strength of markets, we sense little investor euphoria at this stage. We

continue to ratchet down risk-levels in equities and monitor the situation closely. We will not predict the end of the current market cycle, but we are preparing and, longer term, we are more cautious.

The Long-Term Is Challenging – Make No Mistake:

Aggressively accommodative monetary policy was necessary in the wake of the global financial crisis in 2008 and 2009 despite the social inequities that it sowed. A member of the Fed board of governors recently said that the decision to implement quantitative easing and prop up the banks was akin to deciding that the French Revolution was preferable to the Great Depression. Quantitative easing bought time for financial institutions to rebuild their capital strength and begin to lend again and for businesses and consumers to repair balance sheets. Ten years later, it seems these policies were effective in avoiding a repeat of the Great Depression, but we have not returned to the economic growth seen in the mid-1990s and have been left with enormous fiscal and societal challenges.

The U.S. budget deficit is set to balloon from 3.5% of GDP last year to an unprecedented 9.5% of GDP by 2048. The annual U.S. federal deficit is currently approaching $1tr. The total U.S. federal government debt burden has surpassed $21.5tr. The social security system is now in structural deficit. Nearly 80% of every tax dollar the U.S. government collects goes to pay for entitlement programs and interest expense on that debt load. The problem is rapidly worsening as the American population ages. The U.S. Treasury is on-track to issue over $1tr in marketable debt this fiscal year. Over the long-term, these massive deficits will likely result in higher interest rates, slower growth or both. Our elected officials are unwilling to take on these issues because they want to be re-elected and deliver to their constituents at home. The funded status of our entitlement programs is set to worsen rapidly as baby boomers retire en-masse. Many of our public pensions are hopelessly underfunded; several states now face unprecedented financial crises and student loan defaults are exploding. At the very time the consequences of our 2009 actions must be faced, our democracy faces a crisis of polarization that we haven't seen since the early part of the 20th century.

Lewis Lapham, the long-time editor of Harper's Weekly and current editor of Lapham's Quarterly, recently observed:

> *Over the past forty years, we've become accustomed to pretending that democracy is a peaceful idea, something civil, orderly, quiet and safe. It isn't. Like capitalism, democracy is rivalry and*

Cyber Security - The Importance of Strong Passwords and Multi-Factor Authentication

Have you ever thought about the underlying process of internet identification and authentication, namely the role of usernames and passwords?

Who are you? (I'm this person). Prove it. (Here's proof, usually a password.) Success! Here's access to your important stuff. Or, if you can't prove who you are? Fail, Try again....

This simple question and answer routine has been around ever since human beings first had reason to password protect something. The amazing part is, that despite the massive technological changes that society has undergone over the years, authentication processes have barely changed. One would think that, given the stakes, proving identity would have evolved by now.

Instead, usernames and passwords still rule as gatekeepers with few alternatives on the horizon. Sure, there have been a variety of complimentary upgrades, like character requirements (symbols, numbers, letters) two-factor authentication, and biometrics (fingerprint scanners, facial recognition, etc.). But most accounts and devices still rely on the static Q&A without any additional rules.

Perhaps future advances in technology will provide an adaptable alternative to the current system. But until then, it's on all of us as individuals to take control of our password habits. Think about what's at stake when you create passwords for email accounts, bank accounts, online retailers, and so on. Inferior passwords make answering the "prove it" part of the equation too simple for criminals. Lock up your important stuff with strong, unique codes, and utilize two-factor authentication wherever possible!

Spinnaker can now make client portals on Spinnaker Connect multi-factor-authentication capable. We would be happy to implement this feature for you. If you need some help creating strong passwords, please email Carolyn Woronoff at cworonoff@spinnakertrust.com for some tips.

feud between time past and time future, the party of the way things are engaged in dubious battle with the party of whoever or whatever comes next. Change induces movement, which produces friction, which disturbs the peace with the age old and permanently ongoing Strife between rich and poor, ruler and ruled, male and female, capital and labor, money and mind. The Strife's a twin, capitalism and democracy both agents of change, but opposed to each other in the nature and direction of their movement. A democratic society places a premium on equality; a capitalist economy does not. Money is property, its movement the competitive pricing of things as they are; democracy is the motion of mind reaching for a change of heart.

Lapham captures our sense that all is not in balance, and that those of us fortunate enough to benefit from the capitalist system need to pay attention to the tensions and cross-currents in our society. We live in a time of unrivaled opportunity and advances in many respects. But the issues cited above and many others need to be addressed, and the process of addressing them is likely to be messy and disruptive. We believe it will be possible to navigate these waters, but we are cautious and note that returns for the decade to come are unlikely to be as robust as the decade we have just completed.

MARKET DATA

Index		*YTD*	*2017*	*2016*	*2015*
S&P 500	*U.S. Large-Capitalization Stocks*	10.56%	21.83%	11.95%	1.37%
S&P 400	*U.S. Mid-Cap Stocks*	7.49%	16.24%	20.73%	-2.18%
S&P 600	*U.S. Small-Cap Stocks*	14.54%	13.23%	26.46%	-2.01%
Russell 1000	*U.S. Large- and Mid-Cap*	10.49%	21.69%	12.04%	0.91%
Russell 1000 Growth	*Growth Stocks broken out*	17.09%	30.21%	7.07%	5.67%
Russell 1000 Value	*Value Stocks broken out*	3.92%	13.66%	17.33%	-3.84%
MSCI EAFE Index	*Established International Markets*	-0.98%	25.62%	1.59%	-0.28%
MSCI Emerging Markets	*Developing International Markets*	-7.39%	37.75%	11.27%	-14.61%
		9/30/18	12/31/17	12/31/16	12/31/15
90 day T-Bill	*Short-Term Interest Rate*	2.19%	1.39%	0.51%	0.17%
10 Year US Treasury Rate	*Longer-Term Interest Rate*	3.05%	2.43%	2.45%	2.28%
VIX Index	*Risk Measurement*	12	11	14	18
Corporate Bond Spread	*Risk Measurement*	106 bps	93 bps	120 bps	165 bps
TIPS Spread	*Inflation expectations*	187 bps	198 bps	197 bps	171 bps