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BCA 4Q 2018 Review and 2019 Outlook

Russ Allen, CIO

Summary Outlook

- Markets in 2019 will be choppy with volatility more like this past year than the placid trading of 2017.
- The Fed is very likely to back off the pace of tightening, perhaps only raising rates once this year. Wage inflation remains gradual despite low unemployment.
- The global economy is growingly more slowly, but is not in recession, a critical distinction. In the near-term equities seem to have overreacted.
- As relative U.S. growth slows and the Fed pauses rate hikes, the US dollar may weaken, boosting international markets and perhaps commodities.
- Technology companies will be subject to increasing regulation and thus costs. Combined with higher real rates, this may slow or reverse the outperformance of growth versus value.
- Long term stock and bond return expectations should be modest due to starting valuations and less monetary support in coming years; quantitative tightening rather than easing. There will likely be more opportunities for active management, especially distressed / complex investments.
- The most significant risks are waning fiscal stimulus this year and ongoing trade frictions, which could push a modest economic slowdown into an outright contraction. This is not our base case.

2018 in Review

In 2017, investors enjoyed a low-volatility rise in stocks, bonds and commodities. 2018 proved to be just the opposite. The S&P 500 Index went all of 2017 without a single 3% decline; at the end of December 2018 the Index was a fraction from a 20% decline. December's 9.2% drop was the second-worst December on record (after 1931) amidst a miserable quarter. Crude oil rose in 2016 and 2017 but fell 23.4% in 2018. Gold was down for the year. The Aggregate Bond Index finished higher, but only by 0.01%. For the first time in many years, cash was the place to be in 2018.

Benchmark Index	2018 YTD	Q4 QTD
S&P 500	-4.4%	-13.5%
Russell 1000 Growth	-1.5%	-15.9%
Russell 1000 Value	-8.3%	-11.7%
Russell Midcap	-9.1%	-15.4%
Russell Small Cap	-11.0%	-20.2%
MSCI EAFE (International)	-13.4%	-12.5%
MSCI Europe	-14.3%	-12.7%
MSCI Emerging Markets	-14.2%	-7.4%
MSCI Japan	-12.6%	-14.2%
US Aggregate Bond	0.0%	1.6%
Long Term Treasury Bonds	-2.0%	4.2%
High Yield Bonds	-2.1%	-4.5%
Leveraged Loans	-0.6%	-4.4%
Crude Oil	-6.2%	-14.0%

Source: Factset Research

Note: Int'l market returns reported in U.S. Dollars, not local currency

Technology stocks led the stock market on the way up, and while hit hard in the fourth quarter, they finished the year a bit better than the broad market. International markets underperformed the S&P by about 4% on a local currency basis, but the dollar's strength made returns to U.S. investors much worse. Going into the fourth quarter, small cap stock returns were nearly identical to large cap, yet the sharp correction hit small caps much harder. In summary, investments perceived as quality or lower risk outperformed, but no major equity benchmark was spared.

Within bonds, both credit risk and interest rate (a.k.a. duration) risk hurt investors. Longer maturity bonds were hit earlier in the year, while credit worries push down tradable loans and high yield bonds in the fourth quarter. Credit spreads widened as the equity market sold off, but actual defaults remain very low. As noted above, oversupply fears again hit crude oil prices, while other commodities fell to a lesser extent.

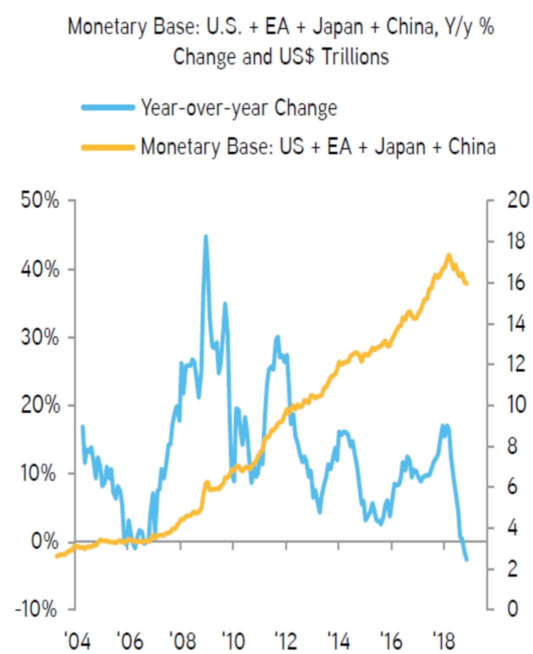
Major Issues for 2019

The Fed and Rates:

Markets have been very concerned that the Fed is wrong about the strength of the economy, and thus is "too tight." The (briefly) inverted yield curve sparked a great deal of conversation about whether it signaled recession ahead. We think a lot of nuance was lost amidst the headlines, and that the inversion wasn't signaling a recession. Perhaps more importantly, as a market timing tool, the inverted curve is fairly useless. It's important to remember that rates are still low and the economy fairly strong, at least at present.

Recently, the Fed has performed an about-face with its commentary and is now signaling a pause. This flexibility is appropriate in our opinion and is likely to remove one of the major bear concerns in the markets. With that said, the Fed still would like to gradually unwind the significant assets it built up during quantitative easing. This will be a contributor to more volatile markets in the coming years.

Chart: While the Fed has begun reducing its Treasury Bond holdings; the monetary base is still high, providing monetary stimulus.



Data as at December 20, 2018. Source: Federal Reserve Board, European Central Bank, Bank of Japan, People's Bank of China, Haver Analytics.

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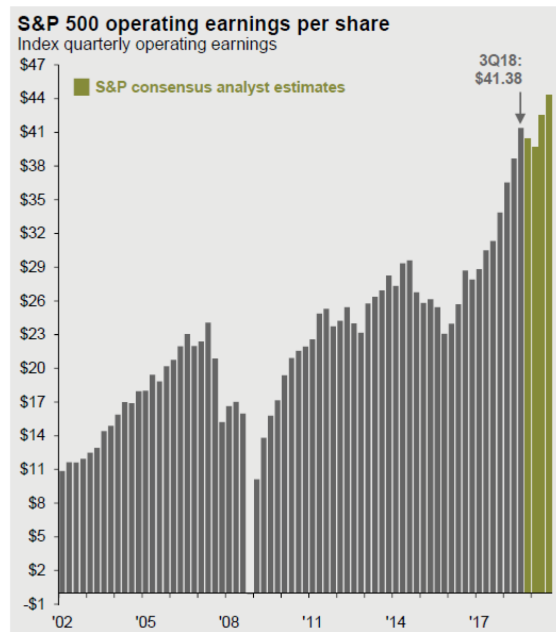
U.S. - China Trade Conflict:
The trade conflict remains a risk that's difficult to predict. The real importance of the current dispute is the effect on consumer, corporate and investor confidence. At present (mid-January) there are signs of a thaw. Perhaps due to some pain now being felt on both sides, negotiations have resumed. As this is a negotiation in public, we would expect some unsettling headlines along the way, however. We think the likely outcome is at least a resolution that papers over problems temporarily, but the issues and politics are complex. We think the best course is to wait to see how it evolves versus making an allocation decision in the face of uncertainty.

U.S. Corporate Earnings Growth:
Profit growth was extremely strong in 2018, with the operating earnings per share of S&P 500 companies rising by over 30% year-over-year in the third quarter (Q4 results not available yet). Revenues have been boosted by a surge in oil prices and above-trend GDP growth. Margins have also risen thanks to corporate tax cuts and persistently low inflation and interest rates. Share buybacks, a product of excess cash, have also modestly boosted earnings per share.
In 2019 and beyond, however, many of these factors will fade. As a result, earnings growth should return to a mid-single-digit pace, not a bad result. The combination of healthy profits and a correction in stock prices have brought equity valuations down to near their long-term averages.

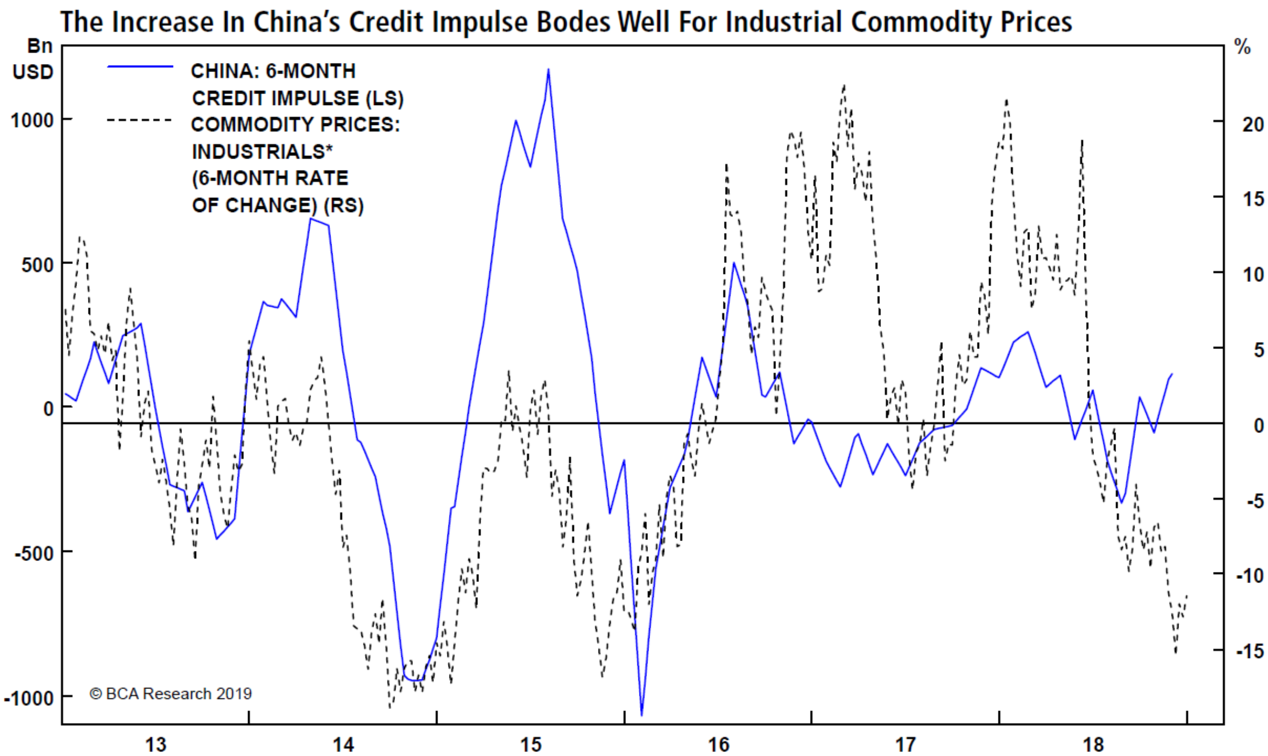


Source: JP Morgan

International Growth:
The Q4 selloff coincided with weaker economic data from overseas economies. While strong in 2017, Eurozone growth slowed markedly in 2018. Some of the European headwinds are temporary, for example weather, strikes in France and new auto emission standards delaying production, which impacted Germany. But unresolved trade tensions with the US, Brexit uncertainty and the rise of populist governments may continue to be a headwind. Overall, Eurozone fundamentals are adequate, with economists expecting about 1.5% growth. European consumer spending, 60% of Eurozone GDP, should be supported by employment and wage growth, as well as lower inflation.

While lower than the U.S., analysts project EAFE (broad developed international) earnings to grow 4% in 2019, on slower but above-trend global growth. Modest multiple expansion in EAFE equities should be possible in 2019, off depressed levels driven by current market fears. Combined with a 3.8% dividend yield, that could provide a high-single digit total return for 2019.

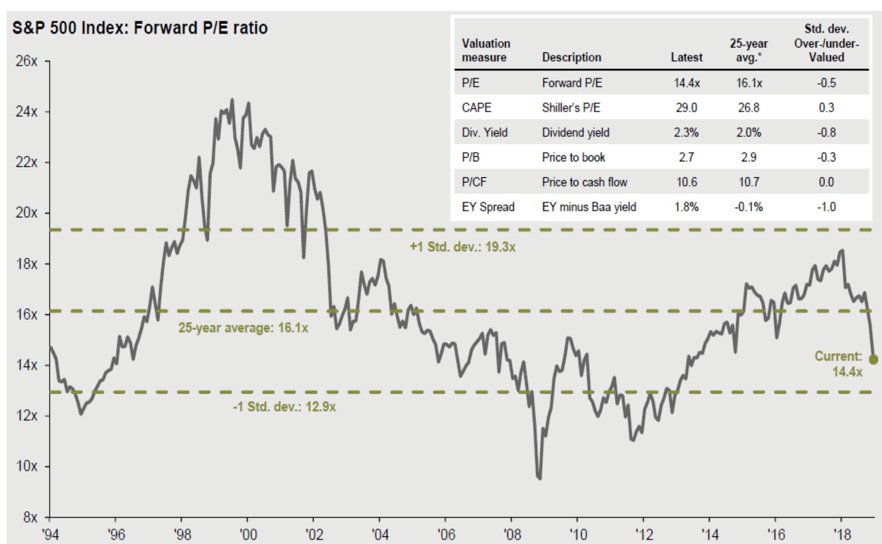
While there will be significant divergence within emerging markets, we are positive on the group due to valuation and long term structural advantages. We are hopeful that rising confidence in Brazil and India can offset some of the slower, but still positive, growth in China. The Chinese government has recently begun pushing harder to offset drags on their economy, such as targeted tax cuts and a reduction in the reserve rate banks are required to hold. These should support improvements in the "credit impulse," which is also tied to global production growth as shown in the below chart.



* EQUAL-WEIGHT CONTINUOUS COMMODITY INDEX. SOURCE: THOMSON REUTERS.

U.S. Equity Valuation:

Market volatility in the fourth quarter of 2018 brought equity valuations closer to their long-run P/E averages, which should reduce fear that the equity market is overvalued. This was not only due to market corrections, but also to extremely healthy profits. The earnings yield on stocks is still higher than the yield on BAA corporate bonds, making stocks cheap relative to bonds at present.



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	14.4x	16.1x	-0.5
CAPE	Shiller's P/E	29.0	26.8	0.3
Div. Yield	Dividend yield	2.3%	2.0%	-0.8
P/B	Price to book	2.7	2.9	-0.3
P/CF	Price to cash flow	10.6	10.7	0.0
EY Spread	EY minus Baa yield	1.8%	-0.1%	-1.0

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

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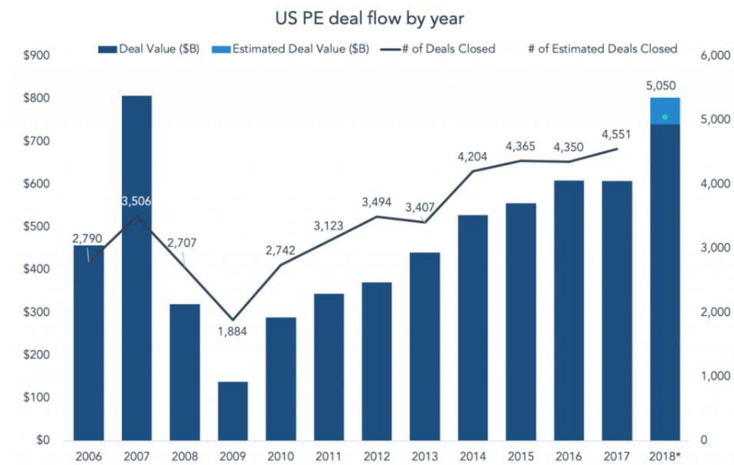
Private Equity

Due to historically strong results, many investors continue to increase their exposure to private equity. We agree there are opportunities and we have been significant investors in private debt and equity since the firm's founding in 2010. However, significant fundraising and the need to deploy that capital makes it a tricky time to commit new funds. Our answer is to focus on the manager selection aspect of private investing and to seek niche opportunities, rather than large funds in the major categories such as buyout.

At the margin, we are finding more opportunity in real estate strategies and somewhat less in the corporate space, which continues to have high levels of debt (but also significant capacity to pay). The opportunity set could be fairly dynamic, but we are most excited about the prospect of distressed funds. Distressed funds raising in 2019 may have the opportunity to invest during the next downturn, which is usually a strong driver of returns.



Source: Churchill Asset Management

Berman Capital appreciates the opportunity to act as your advisor and to invest on your behalf. If you have any questions, please do not hesitate to contact us.

Best Wishes for 2019!