JOHN D. DOVICH & ASSOCIATES, LLC

Market Update — Third Quarter 2018

Third Quarter 2018 Review

U.S. stocks posted strong results during the third quarter after a sluggish first half of the year. International stocks were mixed while bond returns were flat for the quarter. Large cap U.S. stocks, as represented by the S&P 500, were the best performing category during the quarter with a 7.7% gain. The worst performing category, emerging markets stocks, posted a loss of 1.1%. For the year, U.S. stocks are the strongest performers, with losses in international stocks and U.S. bonds.

Index	Total Return 3Q18	YTD
S&P 500 (large cap US stocks)	7.7%	10.6%
Russell Mid Cap	5.0%	7.5%
Russell 2000 (small cap US stocks)	3.6%	11.5%
MSCI EAFE (large cap foreign)	1.4%	-1.4%
MSCI Emerging Markets	-1.1%	-7.7%
MSCI ACWI All Cap (global stocks)	3.8%	3.7%
Barclays US Aggregate Bond	0.0%	-1.6%

The U.S. economy remains one of the strongest major world economies and stock investors continue to push U.S. stocks higher. Foreign stock markets have not participated in the market rally due to the strength of the U.S. dollar this year, less ebullient economies and Trump tariff threats. While international stocks remain attractive for long-term investment, these factors will affect how international stocks perform in the short-term. Rising interest rates dampened bond returns. 10-year Treasury yields rose to their highest level since 2011, ending the quarter at a yield of 3.05%. As a result, bond yields are beginning to look more attractive for bond investors.

Economy

On September 28th, the U.S. Bureau of Economic Analysis (BEA) released second quarter Gross Domestic Product (GDP) which increased at a 4.2% annual rate. The economy remains strong as corporations continue to benefit from lower tax rates and less regulation. The recent trade agreement between the U.S., Mexico and Canada, which replaces the North American Free Trade Agreement (NAFTA), diminishes some of the trade risks that concerned investors this year.

While the overall U.S. economy remains strong, existing home sales peaked in November 2017 and have been stagnant since. Rising interest rates and higher home prices are a few reasons for this sluggishness. In addition, housing affordability is deteriorating, as housing prices are climbing faster than wages. These trends are worth monitoring since they may have a negative impact on the overall economy. From an economic perspective, it's not too early to think about expectations for the holiday shopping season. As of quarter end, there are 86 days until Christmas and 63 days until the first day of Hanukkah. Investors will watch retail sales trends closely for any sign of weakness in consumer spending.

Geopolitics

In our last quarter's commentary, we detailed the risks on numerous fronts for increasing trade disputes. With the announcement of a new NAFTA, the trade dispute with China remains the biggest threat. While both sides are currently far apart in their demands, a continued trade dispute may negatively impact both U.S. and Chinese economies if not resolved. While China seems to have the most to lose in a continued trade disagreement, they also have the most politically patient perspective since President Xi Jinping can stay in office indefinitely. Therefore, he does not have the same political pressures as U.S. politicians. Whether President Trump and his team will be able to barter a trade deal with China remains a big risk factor for global economies.

U.S. Mid-Term Elections

The U.S. mid-term elections are five weeks away as of quarter end. Many races are tightening up and the Brett Kavanaugh Supreme Court hearing and testimony are only magnifying the importance of these elections. The Democrats look to garner enough seats in the Senate to block Supreme Court appointments by the Trump administration. The Republicans are attempting to push through Judge Kavanaugh's nomination before these elections. Besides appointing a conservative judge to the Supreme Court, the Trump agenda for the next two years is at stake. The Republicans have been in control of both the House and Senate. As we all know from the 2016 elections, polling numbers have been inaccurate in predicting a winner. It is anybody's guess as to the outcome of this November's elections. However, the outcome may have significant implications for the financial markets. We will monitor these developments closely to prepare for any potential volatility that may occur because of the elections.

The Federal Reserve

In September, the Federal Reserve announced its third interest rate hike of 25 basis points this year. This led U.S. commercial banks to increase their prime lending rate to 5.25%. This marks the eighth 25 basis point increase in interest rates since late 2015. Fed Chair Powell commented the economy is doing very well, unemployment remains low and inflation is low and stable. Currently, the Fed is expected to raise interest rates another 25 basis points this year, another three 25 basis point increases in 2019 and another 25 basis points in 2020. It has been 10 years since the depth of the 2008 financial crisis. In recent remarks about the economy, Chairman Powell stated "the Fed has been gradually returning interest rates closer to the levels that are normal in a healthy economy. These rates remain low, and my colleagues and I believe that this gradual return to normal is helping to sustain this strong economy for the longer-run benefit of all Americans." We believe this is a proper course of action for interest rates, but we continue to monitor how Fed action impacts the economy and financial markets.

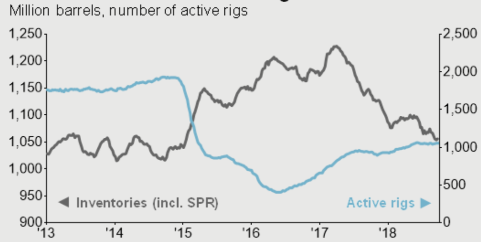
Rising Oil Prices

From time to time, we like to address topics that are not grabbing the daily headlines but may influence financial markets. This quarter, we want to address oil prices. The price of West Texas Intermediate (WTI) has increased over 26% year-to-date and over 50% over the past year. A few reasons for this rally in oil prices is that consumption has been steadily rising while Venezuelan production collapses and sanctions on Iran go into effect in early November. OPEC is not anxious to increase production to lower prices either despite chiding from President Trump. In addition, U.S. pipeline infrastructure limitations have prevented shale producers from bringing more supply on line. As you will see in the following chart, consumption outpaced production, alleviating the glut of inventory following the collapse of oil prices in 2015. With inventory back at "normal" levels, the higher demand for oil has forced prices higher. These trends bear watching as continued strength in oil prices may lead to a slowdown in consumer spending and/or inflationary pressures.

Change in production and consumption of liquid fuels
Production, consumption and inventories, millions of barrels per day

Production	2015	2016	2017	2018*	2019*	Growth since '15
U.S.	15.1	14.8	15.7	17.5	18.8	24.2%
OPEC	38.4	39.4	39.3	39.0	39.0	1.5%
Russia	11.0	11.2	11.2	11.3	11.4	3.6%
Global	**96.6**	**97.0**	**97.7**	**99.7**	**101.6**	**5.2%**
Consumption						
U.S.	19.5	19.7	20.0	20.4	20.7	5.9%
China	12.4	12.8	13.3	13.7	14.2	14.8%
Global	**95.5**	**97.0**	**98.5**	**100.1**	**101.6**	**6.4%**
Inventory Change	1.1	0.0	-0.8	-0.4	0.1	

U.S. crude oil inventories and rig count**
Million barrels, number of active rigs



Price of oil
WTI crude, nominal prices, USD/barrel

Source: J.P. Morgan Asset Management; (Top and bottom left) EIA; (Right) FactSet; (Bottom left) Baker Hughes.
*Forecasts are from the September 2018 EIA Short-Term Energy Outlook and start in 2018. **U.S. crude oil inventories include the Strategic Petroleum Reserve (SPR). Active rig count includes both natural gas and oil rigs. WTI crude prices are monthly averages in USD using continuous contract NYM prices.

Conclusion

A diversified stock portfolio posted solid gains overall during the third quarter with bonds providing flat returns. As was the case after the first half of the year, the prospect of strong economic growth from fiscal stimulus may be counterbalanced by rising interest rates and global trade risks. The outcome of the mid-term elections may also play an important role in the direction of the financial markets through the end of the year. We continue to believe the economy remains strong but believe that volatility may pick up again if some of the concerns we reviewed develop. A balanced approach to investing that considers your withdrawal needs over the next year remains appropriate in today's market environment.

All of us at John D. Dovich & Associates, LLC thank you for the opportunity to serve you and your family. We welcome the occasion to discuss any financial related issues you may have and look forward to speaking with you soon.

Definitions

S&P 500: Standard & Poor's (S&P) 500 Index. The S&P 500 Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad U.S. economy through changes in the aggregate market value of 500 stocks representing all major industries.

Russell Midcap® Index: The Russell Midcap Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the mid-cap segment of the U.S. equity universe.

Russell 2000® Index: The Russell 2000 Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index.

MSCI EAFE Index (Europe, Australasia, Far East): The MSCI EAFE Index is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed international markets, excluding the US & Canada.

MSCI Emerging Markets Index: The MSCI EM Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

MSCI ACWI All Cap Index: The MSCI ACWI All Cap Index is a free float-adjusted index that is designed to measure the equity market performance of the global equity markets representing over 14,000 securities including large, mid, small and micro-cap segments of developed markets together with large, mid and small cap segments of emerging markets.

Barclays Capital U.S. Aggregate Bond Index: The Barclays Capital U.S. Aggregate Bond Index is an unmanaged index consisting of U.S. dollar-denominated, fixed-rate, taxable bonds. The U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS.

DISCLOSURES

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Index and sector performance information in the Market Commentary sourced from Morningstar.

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Neither Asset Allocation nor Diversification guarantee a profit or protect against a loss in a declining market. They are methods used to help manage investment risk.