HEFREN-TILLOTSON
QUARTERLY MARKET REPORT

January 2, 2019 • Brian J. Koble, CFA • Jonathan Bernstein, CFA, CFP® • Eric Mozur, CFA • James Morgan • Nicholas Navari

What's Inside

Outlook 2019:

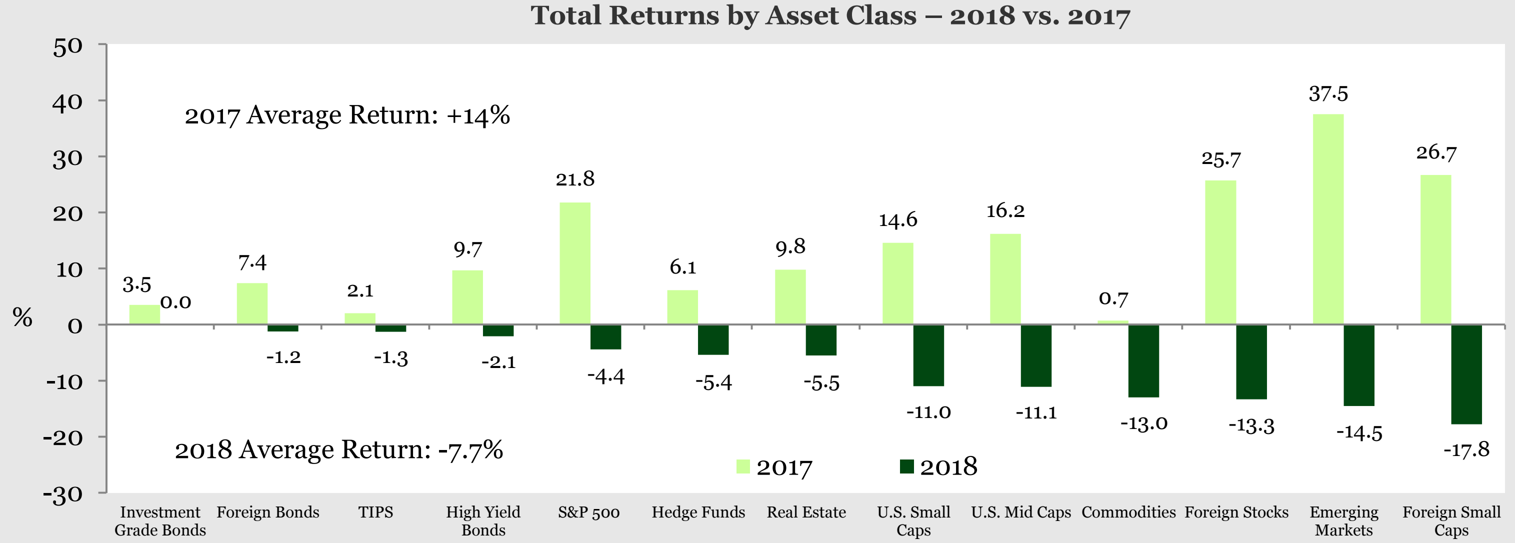
Markets and the Economy Reconnect

Financial markets suffered a sharp sell-off in the fourth quarter. The S&P 500 fell 13.5% over the final three months of the year – and 9% in December alone – finishing 2018 down 4.4%. The average stock in the index finished 25% below its 2018 high. The losses cap a challenging year for investors, with virtually every major asset class losing money. In only two of the last fifty years did markets approach similar across-the-board losses -- 2008 and 1973, which were two of the worst periods for the economy in the post-war era.

Despite market losses, the U.S. economy showed continued strength (as outlined on page 2). This kind of divergence between economic and financial market performance is highly unusual. It is rare for a bear market in stocks to occur outside of a recession – which raises the question of why financial markets have struggled. We see two key, intertwined reasons: political uncertainty over the Federal Reserve and the trade war with China. For stocks to stabilize and rebound, we may need to see more positive developments in these areas, which would allow investors to shift their focus away from Washington and allow stock prices to reconnect with solid corporate and economic fundamentals.

Last year's losses follow one of the best years in memory for investors. In 2017, virtually every type of investment generated positive results, including strong returns for equities (chart). In this context, 2018's losses appear to be part of the "ebb and flow" of the markets. Indeed, years when most asset classes lost value typically were followed by a good year for investors. We expect the same in 2019, with the main risks to the outlook being policy-related.

Total Returns by Asset Class – 2018 vs. 2017



Data as of 12/31/18; Source: Hefren-Tillotson, Bloomberg; PAST PERFORMANCE DOES NOT PREDICT FUTURE RESULTS; See Page 8 for further disclosures

Asset Class Returns as of 12/31/2018

		Latest Quarter	Year-to-Date	1 Year	Annualized Return			Current Yield	P/E Ratio
					3 Year	5 Year	10 Year		
Fixed Income	**Domestic Taxable**								
	Barclays Capital US Treasury Index	4.2	(1.8)	(1.8)	2.6	5.9	4.1	3.0	
	Barclays Capital US Aggregate	1.6	0.0	0.0	2.1	2.5	3.5	3.3	
	Barclays Capital Corporate	(0.2)	(2.5)	(2.5)	3.3	3.3	5.9	4.2	
	Barclays Capital High Yield	(4.5)	(2.1)	(2.1)	7.2	3.8	11.1	8.0	
	Domestic Tax Exempt								
	Barclays Municipal Bond Index	1.7	1.3	1.3	2.3	3.8	4.8	2.7	
	BarCap Muni High Yield	0.3	4.8	4.8	5.8	6.5	9.1	5.0	
	International/Global								
	Barclays Capital Global Aggregate	1.2	(1.2)	(1.2)	2.7	1.1	2.5	2.0	
	Barclays Capital Emerging Market Bond	(0.5)	(3.0)	(3.0)	5.0	3.6	8.1	5.6	
Equity	**Domestic Equities**								
	S&P 500 Index	(13.5)	(4.4)	(4.4)	9.2	8.5	13.1	2.1	15.4
	Dow Jones Industrial Average	(11.3)	(3.5)	(3.5)	12.9	9.7	13.2	2.4	14.7
	S&P Mid Cap Index	(17.3)	(11.1)	(11.1)	7.6	6.0	13.7	1.9	14.9
	Russell 2000	(20.2)	(11.0)	(11.0)	7.3	4.4	12.0	1.7	22.6
	Investment Styles								
	S&P 500 Value	(12.1)	(9.0)	(9.0)	7.2	6.0	11.2	2.7	12.6
	S&P 500 Growth	(14.7)	(0.0)	(0.0)	10.8	10.5	14.8	1.6	19.4
	Foreign Equities								
	MSCI World	(13.3)	(8.2)	(8.2)	6.9	5.2	10.3	2.7	14.3
	MSCI EAFE	(12.5)	(13.3)	(13.3)	3.4	1.1	6.9	3.7	12.7
	MSCI Emerging Markets	(7.6)	(14.5)	(14.5)	9.6	2.0	8.4	3.0	11.3
Other	**Other Assets**								
	Bloomberg Commodity Index	(10.0)	(13.0)	(13.0)	(0.8)	(9.4)	(6.6)	0.0	
	Dow Jones Global Real Estate Index	(5.9)	(5.5)	(5.5)	2.4	5.5	6.4	3.9	21.0
	Gold	7.5	(1.9)	(1.9)	6.1	0.9	3.4	0.0	

Source: Hefren-Tillotson, Bloomberg

Economic Trends & Expectations

Data as of 12/31/18

	Current	1 Yr Ago	Change	Expectations
Fed Funds Rate	2.50%	1.5%	↑	The Federal Reserve raised rates in 2018 for the ninth time in three years. Two more rate increases are forecast for 2019.
Prime Rate	5.50%	4.50%	↑	
10 Year US Treasury	2.70%	2.42%	↑	Interest rates rose on the back of strong economic growth and as the Federal Reserve raised rates
30yr PA Mortgage	4.5%	3.8%	↑	
GDP Growth %	3.0%	2.3%	↑	2018 was likely the first year on record that the U.S. economy grew by more than $1 trillion
Industrial Production	3.9%	3.4%	↑	
Retail Sales	4.2%	6.2%	↑	Consumer spending was strong in 2018, boosted by tax cuts and strong consumer sentiment
Consumer Sentiment	98.3	95.9	↑	
Consumer Price Index	2.2%	2.2%	→	Inflation remained low despite continued low unemployment
Unemployment Rate	3.7%	4.1%	↓	
Non-Financial Debt/GDP	248%	248%	→	Debt levels high but steady
Corporate Default Rate	3.1%	1.7%	↑	Defaults have been low amid recent market volatility
U.S. Dollar Index	96.1	92.1	↑	The Dollar strengthened on the back of Fed Rate hikes
Gold	$1,281	$1,303	↓	Gold was lower in 2018, despite political turbulence
Oil Prices	$45	$60	↓	Oil prices fell due to surprisingly high Iranian exports
Home Prices Index	5.0%	6.3%	↑	Home prices were up, but slowed in the fourth quarter

Review of Market Performance

Not since the global financial crisis of 2008 has politics had such an outsized impact on financial markets. This fact alone helps to explain why markets diverged from the economy in 2018 (top chart).

Some political developments were helpful to the economy. De-regulation and corporate tax cuts boosted business confidence and profitability. These positives were overwhelmed, however, by the combined effect of Federal Reserve rate hikes and the trade war with China.

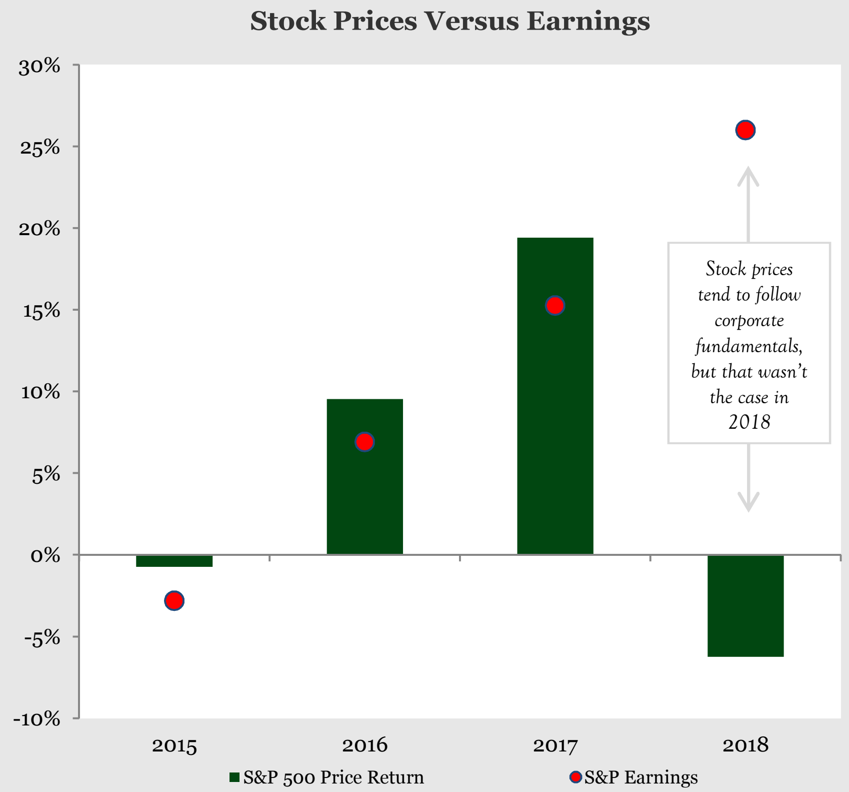
In December, the Federal Reserve raised its benchmark interest rate for the ninth time in three years -- a show of confidence in the outlook. However, the Fed also dismissed the impact of the trade war. Meanwhile, the White House has given little indication of backing down on trade policy, and has blamed the Fed for the stock market's decline. This failure of the Fed and White House to soften their policies in response to each other was at the heart of the fourth quarter sell-off.

Policy developments also help to explain losses in the bonds and overseas markets. Fed rate increases caused interest rates to rise, leading to losses across most parts of the U.S. bond market. At the same time, higher interest rates have attracted money to the U.S. and caused the dollar to rise, which together with trade worries led to losses in foreign stocks (-13.3%) and bonds (-1.2%) in 2018.

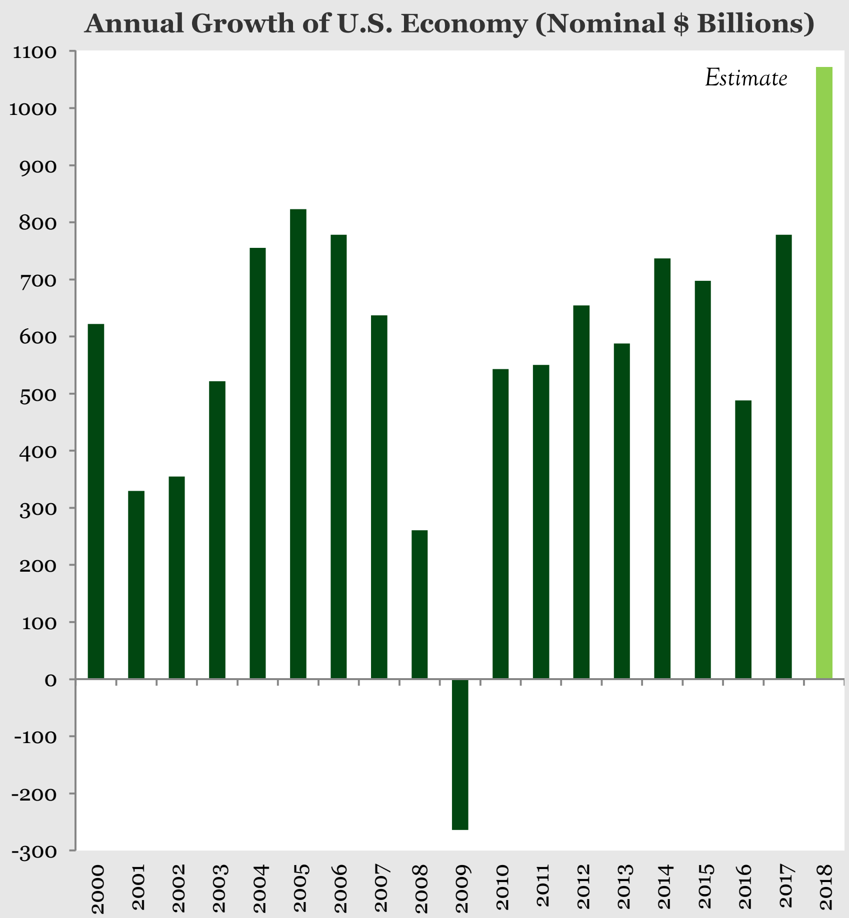
Although markets were weak in 2018, the economy remained strong. Consider the following:

- 2018 was likely the first year in history that the U.S. economy grew by more than $1 trillion (chart).
- Earnings for S&P 500 companies grew 26% in the third quarter.
- Unemployment remained near a 50 year low at 3.7%.
- Wages rose 3.1% on average, the highest rate in more than a decade.
- Small Business Optimism remained near a 50 year high, according to the National Federation of Independent Businesses.
- The Leading Economic Indicators index, which is made up of ten components such as manufacturing orders and building permits, rose 5% in November.
- Inflation stayed low at 2.2%.

In short, U.S. stocks fell in 2018 despite the economy, not because of it – an unusual development that we don't expect to be repeated in 2019.



Data as of 12/31/2018 Source: Hefren-Tillotson, Bloomberg



Data as of 12/31/2018 Source: Hefren-Tillotson, Atlanta Federal Reserve

Market Volatility – What Not to Do

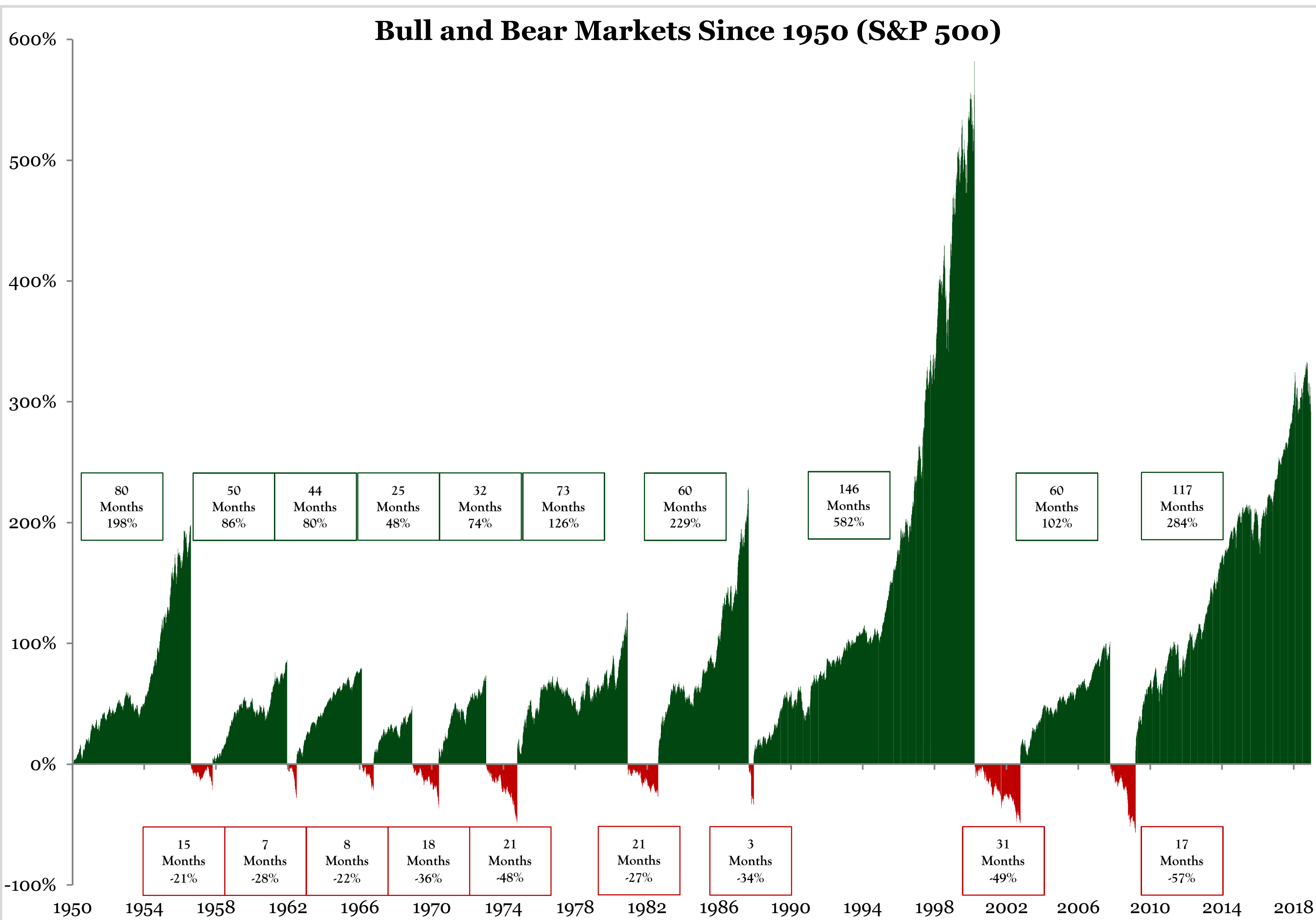
It takes only one or two large mistakes to put your financial goals at risk. In our experience, periods of market volatility are when investors are most susceptible to such mistakes. Perhaps the most common mistake when the market is down is for investors to sell their stocks and move their portfolio to cash. We caution investors against this course of action for several reasons.

First, the odds are stacked against investors who try to cash out their portfolios and reinvest at lower prices. The stock market has spent the great majority of time going up. Bear markets have been relatively brief (see chart below).

Second, the psychology of going to cash is harder than most investors realize. It requires making two correct decisions –when to get out of the market, and when to get back in. While getting out of the market can feel like an easy decision, getting back in can be difficult. If an investor feels uncomfortable in stocks today, he or she is unlikely to have the confidence to reinvest when markets are even lower and news headlines are even more worrisome. By the time an investor feels better, markets may have recovered above the level when the investor went to cash.

In short, investors should respond to market volatility by staying the course. Legendary investor Warren Buffett offered similar advice in a letter to Berkshire Hathaway shareholders in 2013:

> *"American business will do fine over time. And stocks will do well just as certainly, since their fate is tied to business performance. Periodic setbacks will occur, yes, but investors and managers are in a game that is heavily stacked in their favor. (The Dow Jones Industrials advanced from 66 to 11,497 in the 20th Century, a staggering 17,320% increase that materialized despite four costly wars, a Great Depression and many recessions. And don't forget that shareholders received substantial dividends throughout the century as well.) Since the basic game is so favorable... I believe it's a terrible mistake to try to dance in and out of it based upon the turn of tarot cards, the predictions of "experts," or the ebb and flow of business activity. The risks of being out of the game are huge compared to the risks of being in it."*



Source: Hefren-Tillotson, Bloomberg; Data as of 10/31/2018; PAST PERFORMANCE DOES NOT PREDICT FUTURE RESULTS

A Better Approach to Market Turbulence

Rather than try to avoid bear markets, investors should have a plan in place to navigate turbulent periods. Our recommendations are as follows:

- Stick with your long-term financial plan, which provides a roadmap to meeting your goals. That plan -- not short-term market volatility -- should drive how decisions about your financial situation are made.

- Ensure sufficient cash is available to meet your upcoming spending needs. This will limit the need to sell stocks when they are down.

- Stay diversified. By spreading your money across many types of investments, you can reduce the impact of sharp losses in any one part of your portfolio (chart).

- Remember that stocks, which are the hardest hit part of a portfolio during a bear market, are owned to meet spending needs that are further in the future. Cash and bonds can be used to meet near-term spending needs.

- Focus on quality investments with attractive underlying investment merits. Large cap value stocks are a good example today. The nearby table lists the top ten holdings of the Russell 1000 Value index, and represents the types of businesses owned by large cap value mutual funds recommended by Hefren-Tillotson. These companies generally offer, in our opinion, industry leadership, attractive valuations, solid dividends, and strong balance sheets. While stocks like these will fall during a bear market, investors should be confident that they will ultimately rebound.

- Avoid overvalued areas of the markets. Highly priced securities often fall the most during a bear market, and may take longer to bounce back (remember that a 50% decline requires a 100% gain to break even). Indeed, expensive areas of the market like aggressive growth stocks were hit hardest during the recent sell-off.

- If you are still saving, be opportunistic and consider using market pullbacks as a buying opportunity.

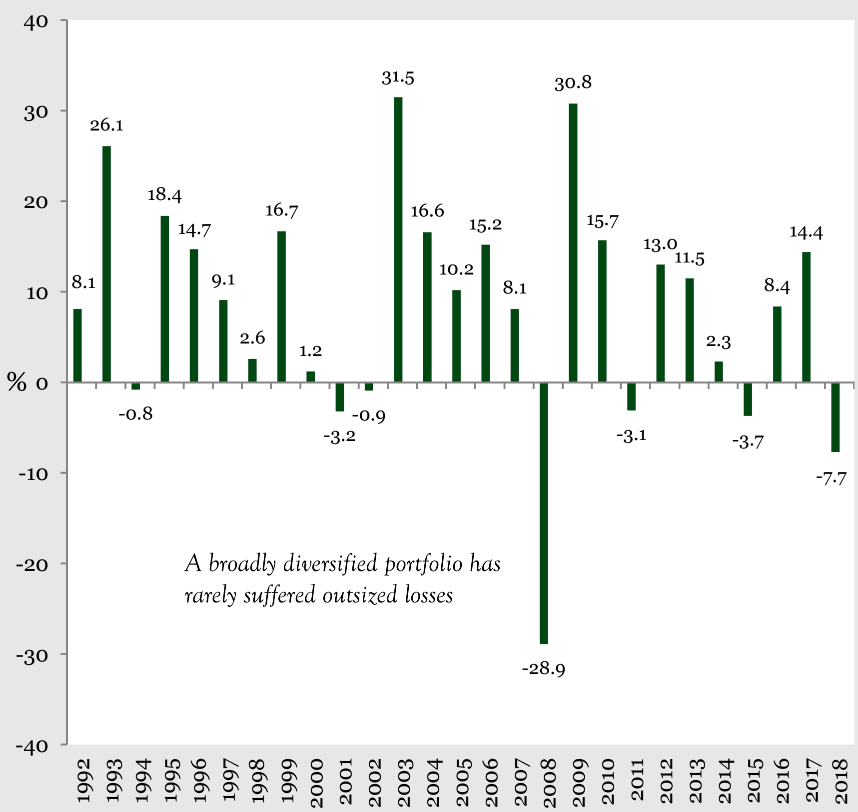
- Finally, remember that what you are ultimately counting on with stocks is the ability of businesses to find ways to make money. As Buffett states, there are bound to be periodic setbacks in the economy, but in the end companies will find ways to adapt and grow.

10 Largest Holdings in Russell 1000 Value Index

	Price/Earnings Ratio	Dividend Yield	Credit Rating
Berkshire Hathaway Inc B	7.9	0.0%	AA
JPMorgan Chase & Co	11.9	2.6%	A
Exxon Mobil Corp	12.6	4.7%	AA+
Johnson & Johnson	19.4	2.8%	AAA
Pfizer Inc	10.7	3.2%	AA-
Verizon	6.9	4.4%	BBB+
Procter & Gamble Co	22.7	3.2%	AA-
Bank of America	10.0	2.2%	A-
Intel Corp	14.3	2.6%	A+
Chevron Corp	14.5	4.2%	AA
Average of Top 10	**13.1**	**3.0%**	**AA-**
S&P 500 5 Year Average	**19.5**	**2.0%**	**BBB+**

Data as of 12/31/2018 Source: Hefren-Tillotson, Blackrock

Annual Return for a Hypothetical Diversified Portfolio



Hypothetical portfolio equal-weighted across U.S. Bonds, TIPs, High Yield Bonds, Foreign Bonds, U.S. Stocks, Mid Cap Stocks, Small Cap Stocks, Foreign Stocks, Foreign Small Caps, Emerging Market Stocks, Hedge Funds, Real Estate, Commodities

PAST PERFORMANCE DOES NOT PREDICT FUTURE RESULTS. Ignores Taxes, Fees, and Other costs of Investing. Data as of 12/31/2018. Sources: Hefren-Tillotson, Bloomberg; See page 8 for additional disclosures.

Outlook for 2019

Our expectation for 2019 is that markets will reconnect with the economy. Because we do not believe that a recession is imminent, this means financial markets should perform better in 2019.

For this to happen, however, we likely need better news on the policy front. Markets likely can withstand either assertive trade policy or an assertive Fed, but are struggling with both at the same time. Fortunately, there is room for both the White House and the Fed to adjust course. The White House has no incentive to push the trade issue to the point that it causes lasting damage to the economy and markets. Likewise, continued low inflation means the Fed has room to postpone rate hikes. Accordingly, we expect either the administration or the Fed will back down from their present stance, which should stabilize markets and refocus investors on strong corporate fundamentals.

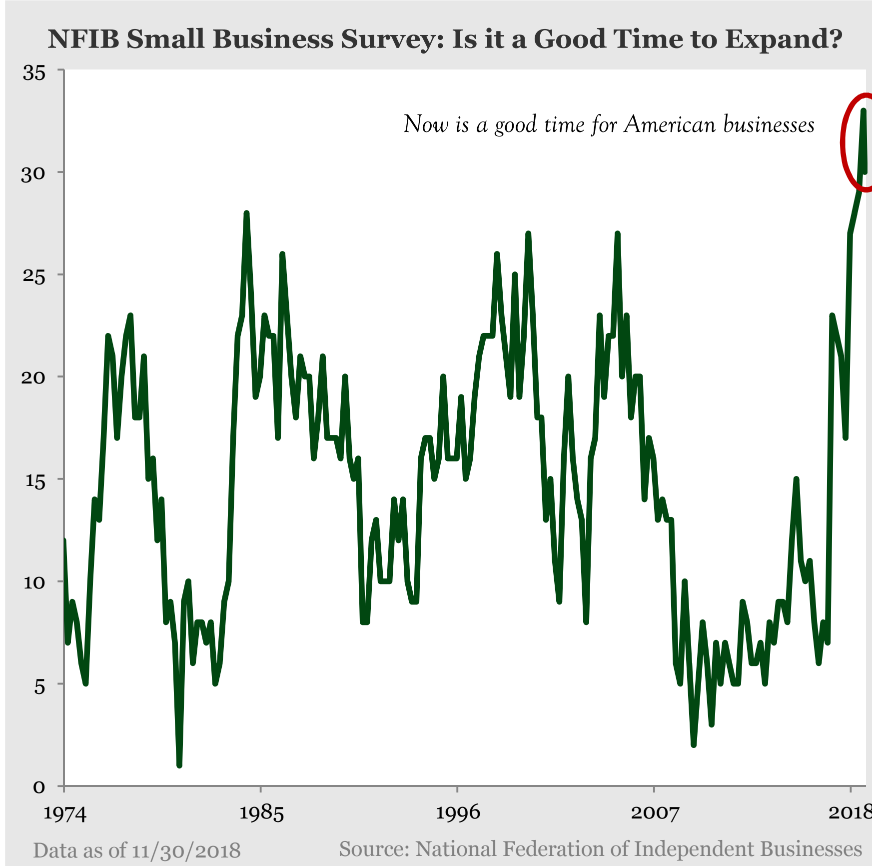
Indeed, absent policy uncertainty, there are many reasons to be upbeat on the outlook – including the strong economy, record-high corporate profitability, and massive corporate stock buybacks. It is a good time for businesses in America (chart), which should translate to it being a good time to be an investor.

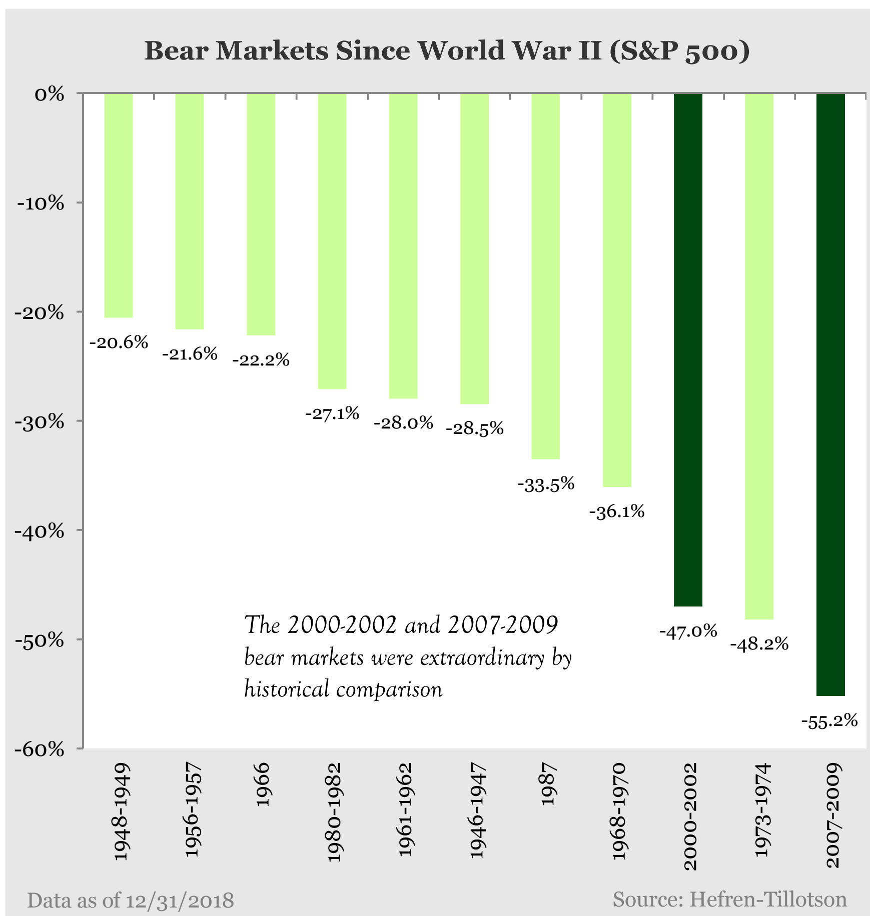
That said, the risks of a policy error are high. If trade tensions worsen and the Fed does not modify its plans to raise rates, markets could continue to struggle in 2019. Instead of stock prices following the economy higher, the economy could follow the stock market lower if declining markets cause business and consumer confidence to suffer.

What if markets continue to decline? The S&P 500 fell in December as much as 19% from its September 20th high, nearly qualifying as a "bear market," which traditionally is defined as a 20% decline. If "bear market" headlines become more prominent in the financial news, we would caution investors not to anchor to the results of the last two bear markets (2000-2002) and (2007-2009). These two periods were extraordinarily painful by historical standards (chart), but bear markets in the range of 20-30% are more typical. Accordingly, if markets do fall further, we believe it could represent a buying opportunity.

Areas of the markets that could present buying opportunities in a further sell-off include:

- Small and mid-cap stocks, which often are down the most during a sell-off and typically enjoy a strong rebound. Small caps fell 20% in the fourth quarter.
- High yield corporate bonds. Yields for these bonds rose in the fourth quarter, but are not yet at bargain levels.
- Opportunistic mutual funds with good upside return potential.





Recommended Portfolio Positioning

Given our outlook, we recommend the following positioning in portfolios:

The mix of stocks and bonds (i.e. offense and defense) in portfolios should be near the long-term targets appropriate to an investor's situation. Portfolios should be positioned to participate on the upside should the bull market resume. At the same time, given present policy uncertainty and the fact that the economic expansion is nearly ten years old, investors should hold the appropriate amount of defense.

Within equity portfolios, investors should take the following steps:

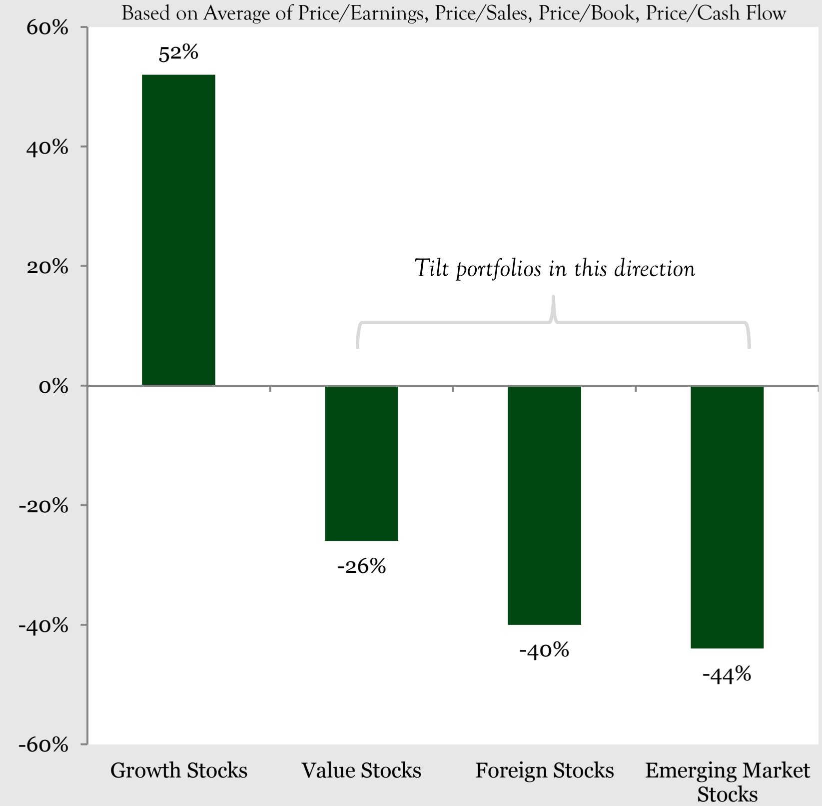
- Stay broadly diversified in terms of region, market capitalization, and style (growth and value stocks).
- Tilt portfolios toward areas of the markets that are cheaper and therefore, in our opinion, offer better long-term return potential. Today that means emphasizing foreign stocks and particularly emerging markets. De-emphasize aggressive growth mutual funds that have performed so well over the last decade, but have expensive valuations today.
- Investors should also emphasize mutual funds whose managers own quality companies with solid finances and good business characteristics. This emphasis should give investors the confidence to stay invested if market turbulence continues (see page 3).

Our recommendation for bond investors is to play it safe.

- Short term interest rates today are at a similar level to long term interest rates. This means there is not an incentive to reach for yield by buying very long maturity bonds or bond funds.
- Likewise, despite the recent sell-off, high yield bonds do not offer an especially high level of yield today. They should not be over-emphasized in portfolios.
- Municipal bond investors should be selective and patient when buying bonds. Generally 12-15 year maturities offer the best combination of risk and reward today. Revenue bonds offer good opportunities, but are not as plentiful today as in years past.
- Finally, Treasury Inflation Protected Securities (TIPS) and foreign bonds offer good diversification benefits, as well as attractive valuations in the case of emerging market bonds.

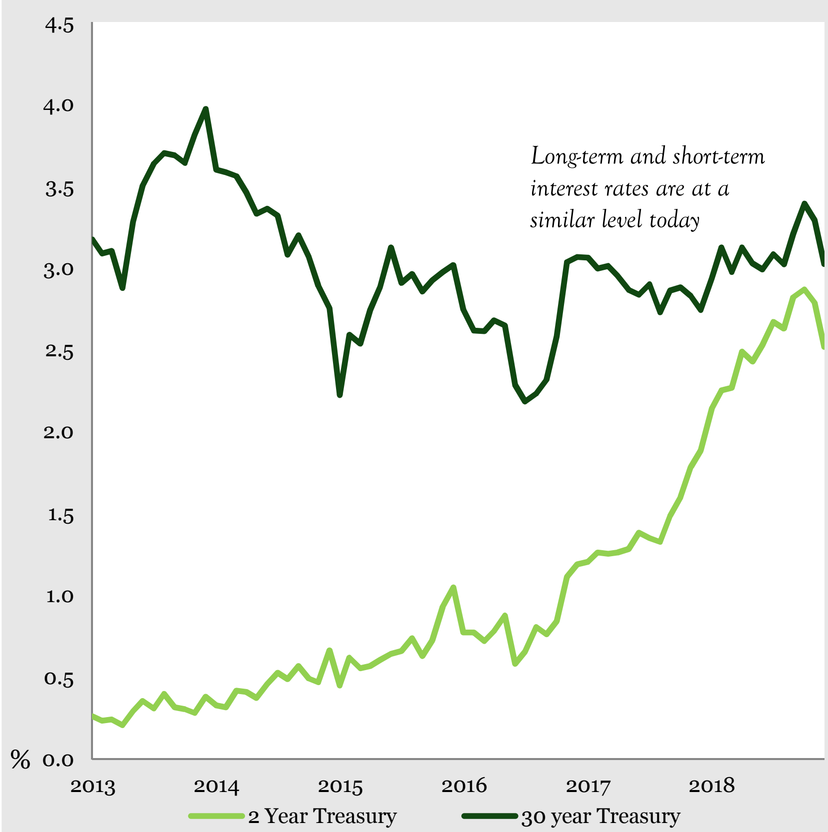
Valuation Comparison to the S&P 500

Based on Average of Price/Earnings, Price/Sales, Price/Book, Price/Cash Flow



Data as of 12/31/18 Sources: Hefren-Tillotson, Morningstar; Additional Disclosures on page 8

Long-Term vs. Short-Term Interest Rates



Data as of 12/31/2018

Source: Hefren-Tillotson, Bloomberg

Investment Strategy Summary

Outlook and Strategy Overview

- After diverging in 2018, markets and the economy should reconnect in 2019. Because we don't expect that a recession is imminent, financial markets should perform better.
- For this to happen, however, we may need to see a more constructive policy environment, especially with respect to trade and the Federal Reserve.
- The main risk in 2019 is that the policy environment continues to deteriorate. Further sustained weakness in financial markets could hurt consumer and business confidence, and threaten the economic expansion.
- Stock and bond exposure should be close to long-term targets.
- Maintaining a healthy amount of stock exposure should allow portfolios to participate should the bull market resume in 2019.
- However, given that the economic cycle has continued uninterrupted for nearly ten years, investors should maintain adequate defense in portfolios in case of a downturn.
- By emphasizing mutual funds that own high quality companies, investors should have the confidence to ride out further volatility in the stock market.
- Continue to de-emphasize aggressive growth mutual funds where high valuations mean more downside risk and lower long-term return potential, in our view.
- International and emerging market equities should rebound in 2019 if there are positive developments relating to trade and the Federal Reserve. In the meantime, attractive valuations and cheap currencies make for a good long-term opportunity, in our opinion.
- Further declines in the equity market could present a buying opportunity. Potential areas of interest include small and mid-cap stocks.

Fixed Dollar Assets

- Short-term investments are becoming more attractive as the Fed raises rates. Ensure adequate liquidity for upcoming spending needs.

Fixed Income Strategy

- Play it safe in bond portfolios by limiting interest rate and credit risk.
- Emphasize short-term bond funds, which are a good source of income today relative to the amount of risk entailed.
- Utilize inflation-linked bonds to hedge against a potential rise in inflation.
- Some foreign bond markets, particularly emerging markets, offer attractive valuations and solid return potential, in our opinion.

Equity Strategy

- Despite persistent Growth style leadership since 2007, we expect better relative performance from Value styles in the years ahead.
- Emphasize mutual funds that own companies with quality business characteristics and reasonable valuations.
- Overweight international stocks and particularly emerging markets given attractive valuations and the potential for higher long-term returns.
- Emphasize large caps over small caps longer term.

Other Assets

- We do not see outsized opportunities today in commodities, real estate, or other mainstream diversifying asset classes.

Indices used in exhibits: U.S. Large Cap Stocks = S&P 500 Index. U.S. Mid Cap Stocks = S&P 400 Mid Cap Index; U.S. Small Cap Stocks = Russell 2000 Index; Foreign Stocks = MSCI EAFE Index. Emerging Market Stocks = MSCI EM Index; Foreign Small Caps = MSCI EAFE Small Cap Index; Investment Grade Bonds = Barclays US Aggregate Bond Index; TIPS = Barclays U.S. Treasury Inflation Protected Bond Index: High Yield Bonds= Barclays High Yield Corporate Index; Foreign Bonds = Barclays Global Aggregate Bond Index; Hedge Funds = CS All Hedge Index; Real Estate = DJ Global Real Estate Index; Commodities = Bloomberg Commodity Index; Ignores taxes, fees, and other costs of investing. Past performance doesn't predict future results.