Redhawk Quarterly Commentary

September 30, 2018

Each quarter, Redhawk's Investment Committee provides a Quarterly Commentary. We look at what's going on in the investment landscape and provide our perspective on a variety of topics. These aren't predictions and it represents our perspective on important market and economic topics designed to help make decisions affecting your long-term financial strategy.

Market Commentary

U.S. Market

U.S. equities advanced in Q3 to significantly outperform other major regions. Economic growth and earnings data remained robust, and this ultimately outweighed concerns over the escalating China trade war. The U.S. initially targeted $34 billion of Chinese products with a 25% tariff in early July. Tariffs on another $16 billion began in late August, before a 10% tariff was implemented on a further $200 billion of Chinese goods in September (set to rise to 25% in January). Despite these measures, the U.S. equity bull market became the longest in history on August 22.

Stability in growth and employment figures allowed the Federal Reserve ("Fed") to increase the federal funds rate by 25 basis points. The committee dropped its long-standing description of monetary policy as "accommodative" and reaffirmed its outlook for further gradual hikes into 2019. Data released in September showed wages to be growing at the fastest rate since 2009, while additions to non-farm payrolls remain above 185,000 on a three-month average. Yet, industrial activity indicators show little impact from the trade wars.

Over the quarter, the information technology and healthcare sectors were boosted by several significant earnings reports. The energy sector was weaker, with U.S. oil companies negatively impacted by uncertainty surrounding China's inclusion of U.S. crude oil in its tariff-targeted products. Materials companies struggled with potentially weaker demand associated with the trade war and some company-specific developments.

A booming U.S. economy has driven U.S. stocks and Treasury yields higher this quarter, leaving U.S. equities ahead of the pack over the year. In September, U.S. consumer confidence hit its highest level since 2000, while the monthly average of initial jobless claims fell to the lowest level since 1969. Wage growth rose to the highest level since 2009, supporting retail sales growth of over 7% year-over-year. Also, the National Federation of Independent Business's survey showed that small businesses were the most optimistic they've been since the survey began in 1974.

At the start of the year the market thought there was only a 20% probability that the Fed would have already raised rates three times this year. Even at the start of July, markets thought there was a 40% chance that the Fed wouldn't increase rates again in the third quarter. However, by the time the Fed raised rates last week, bond markets had already fully priced in the increase, with Treasury yields drifting higher over the quarter.

While diversification helped during the financial crisis, it has not helped over the last nine and a half years, as the S&P 500 has been the dominant contributor to portfolio returns. Furthermore, performance has been concentrated in growth stocks and growth sectors, with technology stocks outperforming the S&P 500 by over 4% annually.

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	Trailing Returns (%)						5-Year Risk Stats		Other Metrics			Representative Benchmark
	Last Qtr	YTD	1-Year	3-Year	5-Year	10-Year	Std. Dev.	Max. Loss	P/E	EPS Gr.	Div. Yld.	
Bellwethers												
S&P 500	7.7	10.6	17.9	17.3	13.9	12.0	9.8	(8.4)	18.0	12.3	1.9	*S&P 500*
Russell 1000	7.4	10.5	17.8	17.1	13.7	12.1	9.6	(8.6)	18.1	12.3	1.8	*Russell 1000*
DJIA	9.6	8.8	20.8	20.5	14.6	12.2	10.6	(9.0)	16.6	13.3	2.2	*Dow Jones Industrial Avg.*
Market Cap												
Mega	9.3	11.7	19.8	18.3	14.5	11.4	10.1	(8.4)	19.1	12.0	1.9	*Russell Top 50*
Large	8.4	11.7	19.3	18.1	14.5	12.0	9.7	(8.6)	18.1	12.1	1.9	*Russell Top 200*
Mid	5.0	7.5	14.0	14.5	11.7	12.3	9.9	(12.8)	18.2	12.6	1.6	*Russell Midcap*
Small	3.6	11.5	15.2	17.1	11.1	11.1	13.5	(16.8)	17.9	12.8	1.3	*Russell 2000*
Micro	0.8	11.6	13.6	16.4	10.5	10.8	14.8	(21.0)	16.6	13.3	1.1	*Russell Micro Cap*
Style												
Value	5.4	4.2	9.5	13.7	10.6	9.8	9.7	(10.4)	15.0	11.1	2.4	*Russell 3000 Value*
Core	7.1	10.6	17.6	17.1	13.5	12.0	9.7	(8.8)	18.1	12.3	1.8	*Russell 3000*
Growth	8.9	17.0	25.9	20.4	16.2	14.2	10.4	(8.8)	22.9	14.4	1.1	*Russell 3000 Growth*
S&P 500 Sectors												
Consumer Discretionary	8.2	20.6	32.5	18.5	16.1	17.4	12.2	(8.0)	23.6	14.8	1.2	*S&P 500/Cons. Disc.*
Consumer Staples	5.7	(3.3)	2.9	7.6	9.2	10.0	11.0	(13.9)	16.7	9.8	3.0	*S&P 500/Cons. Staples*
Energy	0.6	7.5	13.9	10.7	1.3	3.9	17.6	(38.7)	18.9	28.0	2.7	*S&P 500/Energy*
Financials	4.4	0.1	8.7	16.7	13.5	7.4	13.7	(15.2)	13.4	11.0	1.9	*S&P 500/Financials*
Health Care	14.5	16.6	18.3	14.8	15.4	14.2	11.9	(13.1)	17.0	11.0	1.6	*S&P 500/Health Care*
Industrials	10.0	4.8	11.2	17.7	12.9	11.7	11.7	(11.3)	17.6	12.2	2.0	*S&P 500/Industrials*
Information Technology	8.8	20.6	31.5	27.7	22.4	17.1	13.1	(8.2)	20.8	13.0	1.1	*S&P 500/Info. Tech.*
Materials	0.4	(2.7)	4.0	15.5	8.8	8.5	14.5	(22.7)	16.1	12.5	2.1	*S&P 500/Materials*
Telecom	9.9	0.8	4.4	9.8	6.7	8.9	14.2	(13.8)	10.4	4.7	5.6	*S&P 500/Telecom*

Source: Morningstar Direct. Performance greater than one year is annualized. Performance is represented by the benchmark listed in the "representative benchmark" column. See important disclosures and definitions included with this publication.

Domestic equity markets were positive across market capitalizations, styles, and sectors in the third quarter. The S&P 500 rallied 7.7% in Q3, bringing the YTD return to 10.6%. Growth continued to dominate value this quarter, as the Russell 3000 Growth Index rallied 9% while the Russell 3000 Value Index returned 5% QTD. On the year, value lags growth by almost 13%. Among market capitalization leadership, a decided shift took place, as large-cap outperformed small-cap on the quarter and the year. Thanks to strong earnings, the mega-cap stocks of Amazon, Apple, and Microsoft posted double-digit returns and drove the Russell Top 50 Index up 9.3%, while the Russell 2000 Index rose just 3.6%.

Every sector was positive this quarter, with the best performers, Health Care (+14.5%), Industrials (+10%), and Telecom (+9.9%) leading the way, while Consumer Staples (-3.3%), Materials (-2.7%), and Financials (+0.1%) lagged.

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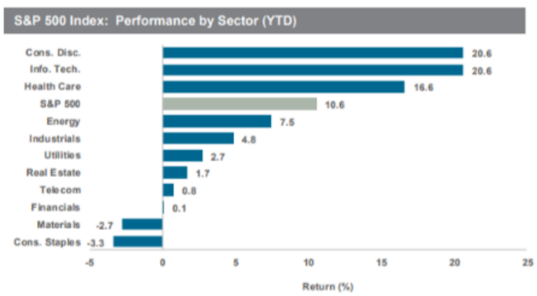

S&P 500 Sector Statistics

	P/E Ratio (TTM)	P/E Ratio (NTM)	Dividend Yield (%)	EPS Growth (%)
S&P 500 Index	20.7	18.0	1.9	12.3
Consumer Discretionary	21.1	23.6	1.2	14.8
Consumer Staples	20.5	16.7	3.0	9.8
Energy	17.4	18.9	2.7	28.0
Financials	14.3	13.4	1.9	11.0
Health Care	29.1	17.0	1.6	11.0
Industrials	19.4	17.6	2.0	12.2
Info. Tech.	28.4	20.8	1.1	13.0
Materials	20.4	16.1	2.1	12.5
Real Estate	37.2	41.5	3.4	7.6
Telecom	6.8	10.4	5.6	4.7
Utilities	16.5	17.1	3.6	5.8

Source: Morningstar Direct. Performance greater than one year is annualized. Performance is represented by the benchmark listed in the "representative benchmark" column. See important disclosures and definitions included with this publication.

International Markets

Emerging market (EM) equities have been weighed down by a slowdown in the pace of Chinese credit growth, fears that some economies are vulnerable to a tighter U.S. monetary policy, and concerns about the potential impact of global trade tensions. China has successfully slowed the pace of non-bank credit growth but is having to implement an easing policy to support growth with headwind of U.S. tariffs. This should

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Asset Class/Region	Trailing Returns (%) Last Qtr	YTD	1-Year	3-Year	5-Year	10-Year	Annual Returns (%) 2017	2016	2015	Benchmark
Broad Developed Markets										
Developed Markets (USD)	1.4	(1.4)	2.7	9.2	4.4	5.4	25.0	1.0	(0.8)	*MSCI EAFE (Net) USD*
Developed Markets (Local Currency)	2.4	1.4	5.1	9.4	7.9	6.7	15.2	5.3	5.3	*MSCI EAFE (Net) Local*
Currency Effect (USD - Local Returns)	(1.0)	*(2.8)*	*(2.4)*	*(0.1)*	*(3.5)*	*(1.3)*	*9.8*	*(4.3)*	*(6.1)*	
Broad Emerging Markets										
Emerging Markets	(1.1)	(7.7)	(0.8)	12.4	3.6	5.4	37.3	11.2	(14.9)	*MSCI Emerging Markets (Net)*
Emerging Markets (Local Currency	(0.0)	(2.9)	2.7	12.2	7.3	7.7	30.6	9.7	(5.8)	*MSCI Emerging Markets (Net) Local*
Currency Effect (USD - Local Returns)	*(1.1)*	*(4.8)*	*(3.5)*	*0.2*	*(3.6)*	*(2.3)*	*6.7*	*1.5*	*(9.2)*	
Returns by Style										
Value	1.2	(3.5)	(0.4)	8.1	3.1	4.5	21.4	5.0	(5.7)	*MSCI EAFE Value*
Growth	1.5	0.6	5.8	10.3	5.6	6.2	28.9	(3.0)	4.1	*MSCI EAFE Growth*
Large Cap	1.5	(1.5)	2.4	8.9	3.9	5.0	24.0	1.1	(2.1)	*MSCI EAFE Large Cap*
Mid Cap	1.0	(1.3)	3.9	10.7	6.6	7.2	29.0	0.7	4.4	*MSCI EAFE Mid Cap*
Small Cap	(0.9)	(2.2)	3.7	12.4	8.0	9.7	33.0	2.2	9.6	*MSCI EAFE Small Cap*
Returns by Region										
Europe	0.8	(1.9)	0.3	8.4	4.3	5.5	26.2	0.2	(2.3)	*MSCI Europe*
Japan	3.8	1.9	10.6	12.5	7.1	6.2	24.4	2.7	9.9	*MSCI Japan*

Source: Morningstar Direct; MSCI benchmarks. Performance greater than one year is annualized. Performance is represented by the benchmark listed in the "representative benchmark" column. See important disclosures and definitions included with this publication.

provide some support for those EM countries that depend on Chinese demand.

On the other hand, the EM economies that are most reliant on external funding are finding the tightening in U.S. monetary policy challenging. As the Fed continues to raise rates and unwind its balance sheet, EM countries with large dollar-denominated debts and significant fiscal deficits will continue to struggle. Higher oil prices are not helpful in this context for those EM economies that are large oil importers, particularly those whose currencies have fallen sharply, further increasing the cost of imports in local currency terms. The tightening in interest rates that some economies have been forced into to defend their currencies and control inflation will prove a drag on growth.

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Source: Standards & Poor's (S&P 500); MSCI benchmarks (country returns). All performance is measured in USD. See important disclosures and definitions included with this publication.

The divergence between U.S. and international equity market performance continued in Q3. Developed international markets, as measured by the MSCI EAFE Index rose 1.4% in Q3, while emerging markets, as measured by the MSCI EM Index fell 1.1%.

For the year, developed international and emerging market equities now lag the U.S. market by 12% and 18% respectively. The lag in returns can be explained in part by the relative attractiveness of the U.S. economy, the strong U.S. dollar reducing international balance sheets and equity returns, and the heightened trade tensions between the U.S. and China. After an impressive first half of the year, the MSCI China Index slumped nearly 8% this quarter. It hasn't been all bad as equity markets rose in Russia by 9.8%, France by 3.6%, and Mexico by 4.2% in Q3.

Fixed Income Markets

The broad U.S. bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, was flat on the quarter, returning 0.02% to investors. Fixed income investors struggled to keep pace with rates trending higher. The upward pressure was largely driven by strong economic data led by wage inflation. Wage data released in September showed an increase of 2.9% year-over-year, fearing further tightening by the Fed.

Emerging markets left a sour taste in the mouths of investors hoping to see a turnaround. Despite the uncertainty emerging market investors felt coming into the quarter, Argentina and Turkey's geopolitical and fiscal uncertainty was somewhat contained in Q3. Broad emerging market exposure, as measured by the Bloomberg Barclays EM USD Aggregate, rewarded investors' patience and delivered positive returns of 1.6% in Q3.

Global developed market investors suffered in Q3 as Europe (-1.9%) and Japan (1.9%) felt the headwinds of tighter monetary policy. U.S. fixed income investors came out of 3Q unscathed, with high yield and bank loans returning 2.4% and 1.8% respectively.

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	Sector Statistics			Returns		
Bond Sector	Avg. Maturity	Avg. Yield	Credit Quality	YTD	1-Year	Benchmark
U.S. Treasuries						
Short-Term	2.8	2.9	AA+	-0.23%	-0.23%	BBgBarc US Treasury 1-5 Yr
Intermediate-Term	7.0	3.0	AA+	-2.11%	-2.52%	BBgBarc US Treasury 5-10 Yr
Long-Term	14.8	3.1	AA+	-4.14%	-3.79%	BBgBarc US Treasury 10-20 Yr
TIPS	8.2	3.2	AA+	-0.84%	0.41%	BBgBarc US Treasury US TIPS
Broad Market						
Aggregate Bond	8.4	3.5	AA	-1.60%	-1.22%	BBgBarc U.S. Aggregate Bond
IG Corporates	10.8	4.1	AA+	-2.33%	-1.19%	BBgBarc U.S. Corporate IG
HY Corporates	6.0	6.5	B	2.57%	3.05%	BBgBarc U.S. High Yield - 2% Issuer Cap
Floating Rates	2.5	2.8	A+	1.99%	2.55%	BBgBarc U.S. Floating Rate Notes
MBS	7.8	3.6	AAA	-1.07%	-0.92%	BBgBarc U.S. Mortgage Backed Securities
ABS	2.3	3.2	AA+	0.52%	0.51%	BBgBarc Asset-Backed Securities

Source: Barclays, Baird Analysis. Sector yields reflect yield to worst. Change in bond price is calculated using both duration and convexity according to the following formula: New Price = (Price + (Price * -Duration * Change in Interest Rates)) + (0.5 * Price * Convexity * (Change in Interest Rates)^2). Chart is for illustrative purposes only. Past performance is not indicative of future results.

During the quarter, U.S. Treasuries and Treasury Inflation Protected Securities felt most of the pain from rates moving higher, falling 0.6% and 0.8%, respectively. Municipal bonds fell short of their taxable peers, falling 0.15% in Q3 due to more than expected supply coming to the secondary market. Rates trending higher and a significant cut in corporate tax rate have caused a rotation out of municipal bonds.

Economic Outlook

U.S. Equity Markets

Last quarter the economy and corporate earnings were humming along because of the fiscal stimulus program approved by Congress. The U.S. economy and corporate earnings are likely to remain healthy over the next six to twelve months. The Fed is responding to U.S. macroeconomic strength with a steady program of quarterly rate hikes.

We expect U.S. fundamentals to remain strong enough to justify another rate increase at the December meeting, but this decision is less certain. The trade war between the U.S. and China doesn't pose as big of a threat as most people think, as the U.S. is a relatively closed economy and should be more insulated than other international markets from trade risks. There is little evidence that suggest trade concerns have chipped away at business confidence, hiring, or capital expenditures. Barring a major trade policy mistake, we expect the Fed to deliver another two to three rate hikes in 2019.

International Markets

The U.S. economy will continue to lead global growth for the remainder of 2018 and into 2019. The main macro uncertainty is being driven by the fear of the Fed raising rates too fast and the trade conflict between the U.S. and other global countries. Trade tensions show few signs of being resolved and tariffs have the potential to disrupt corporate supply chains and erode business confidence.

Gradually increasing U.S. interest rates are tightening financial conditions globally. A stronger dollar exacerbated the troubles of the most vulnerable EM economies. Higher U.S. rates also add to EM stress by creating competition for capital. Investors can now receive decent returns in U.S. short-term bonds without having to take major credit and duration risk. As a result, investors have reset their return expectations for riskier assets, especially EM assets, and global equities.

This year's EM troubles stem from several negatives and EM currencies have taken the brunt of the recent selloff. Currencies of EM economies with the largest current account deficits and highest external debt burdens have taken the biggest hit. Volatility in EM currencies has spiked to higher levels than during the 2013 "taper tantrum" when then Fed Chair Ben Bernanke signaled the beginning of the end of new asset purchases. Yet there has been no visible contagion to other global asset classes.

Fixed Income Markets

The 10-year U.S. Treasury yield stands at 3% at the end of the third quarter. Upside risk to U.S. yields from inflationary pressures and Fed rate hikes are offset by downside risk to yields from an extreme speculative short position which makes U.S. Treasury yields vulnerable to a sharp rally if the economic picture deteriorates.

The spread between the 10-year and 2-year Treasury yield has flattened to around 20 basis points and continued flattening trends suggest an inversion in the yield curve is possible around the turn of the year. Inversions have historically served as a reliable early warning sign that a recession could occur over the next nine to 18 months. In the current context, this means recession risks may be elevated around late 2019 or 2020.

Summary

GDP grew at the fastest pace in 4 years, corporate profits increased over 20% thus far in 2018, and unemployment is near an 18-year low. The U.S. stock market, as measured by the S&P 500, rallied 8% in Q3. Bond yields also climbed with the 10-year yield above 3%.

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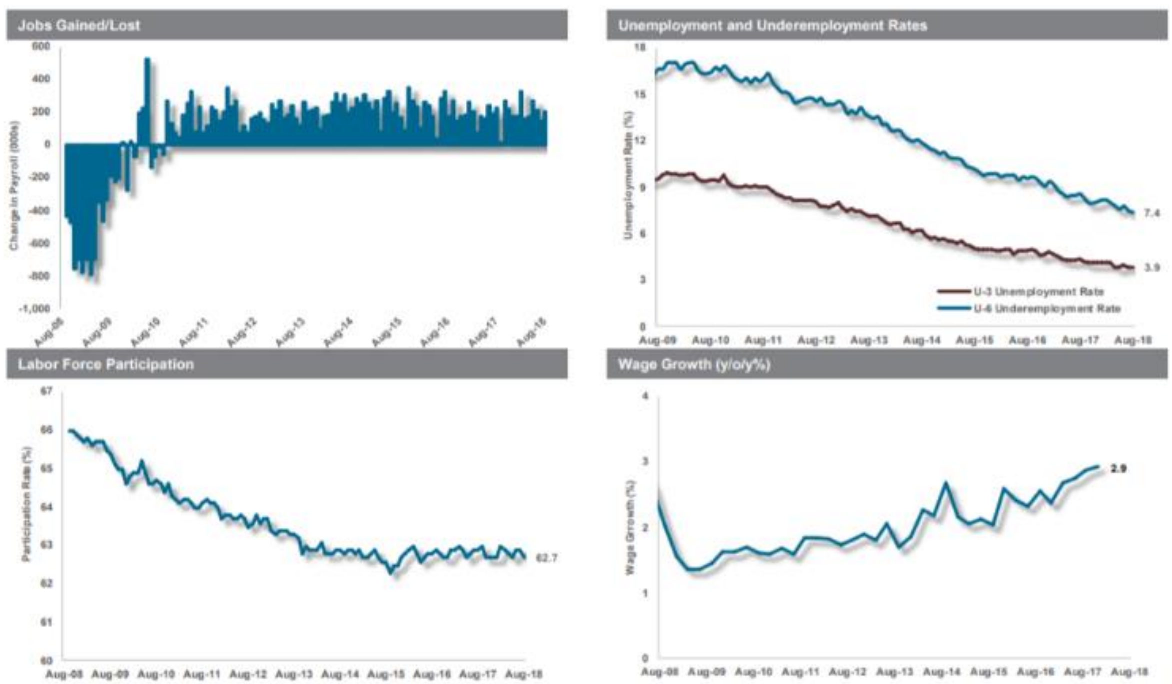

Source: US Department of Labor: Bureau of Labor Statistics. Data will lag one month and is subject to revision. Wage growth is calculated quarterly and will lag one quarter.

The labor market continues to be strong as the average job gains for the past 3 months stands at 185,000, wages grew 2.9% year-over-year, and unemployment remains at 3.9%. Inflation remains manageable, as headline CPI rose 2.7% and core CPI (excluding food and energy) rose 2.2%. As expected, the Fed raised the federal funds rate by a quarter point to a target range of

2.00-2.25% in September. With three rate hikes from the Fed thus far this year, the Fed expects one more rate increase in 2018 and three more in 2019. Noting the strength of the U.S. economy and inflation near the 2% target, the Fed removed language that interest rate policy would remain "accommodative."

Major risks to the economy, over the near-term, include:

1. A surprise in the mid-term elections.
2. An overtightening monetary policy by the Fed.
3. An increase in the tensions between U.S. and China.

It's not enough to own a portfolio personalized for your situation, based on your comfort with risk and long-term financial goals. You must be patient and disciplined, too. With our risk management process, our investment committee is reviewing the market conditions and underlying investments on a weekly basis. Please contact your Redhawk advisor to learn more.