ACCESS FINANCIAL SERVICES, INC.

Quarterly Review and Outlook — Third Quarter, 2018

Benchmark Returns as of September 30, 2018

INDEX	Last 3 Mo.	Last 6 Mo.	Last 12 Mo.
US STOCKS			
S&P 500 Index (large-cap stocks)	7.71	11.41	17.91
Russell 2000 Index (small-cap stocks)	3.58	11.61	15.24
FOREIGN STOCKS			
MSCI EAFE Net Total Return Index (US$)	1.35	0.27	2.74
S&P Europe 350 Index Net Total Return Index (US$)	2.19	5.94	0.93
MSCI Japan Net Total Return Index (US$)	5.72	1.08	10.41
MSCI Emerging Markets Net Total Return Index (US$)	(0.15)	(8.86)	(0.93)
COMMODITIES			
US Dollar Index (DXY)	0.28	5.64	1.68
Euro	(0.30)	(5.67)	(1.10)
Gold	(4.12)	(11.21)	(6.31)
Oil (West Texas Intermediate)	(0.93)	16.25	44.82
Bitcoin	0.35	(4.24)	51.28
BONDS			
BloomBar* US Aggregate Bond (investment-grade bonds)	0.02	(0.14)	(1.22)
ICE US Treasury 20+ Year TR Index	(2.88)	(2.69)	(3.43)
BloomBar* US Treas. Inflation Protected Securities (TIPS)	(0.93)	(0.10)	0.55
Bloomberg Barclays Municipal Bond Index	(0.18)	0.62	0.35
BBG* US Corporate Total Return (corporate bonds)	1.03	(0.08)	(1.23)
BloomBar* US Corp. High Yield Tot. Rtn. (high yield bonds)	2.64	3.55	3.02
BloomBar* Global Aggregate Treasuries Total Return	(1.53)	(5.29)	(1.04)

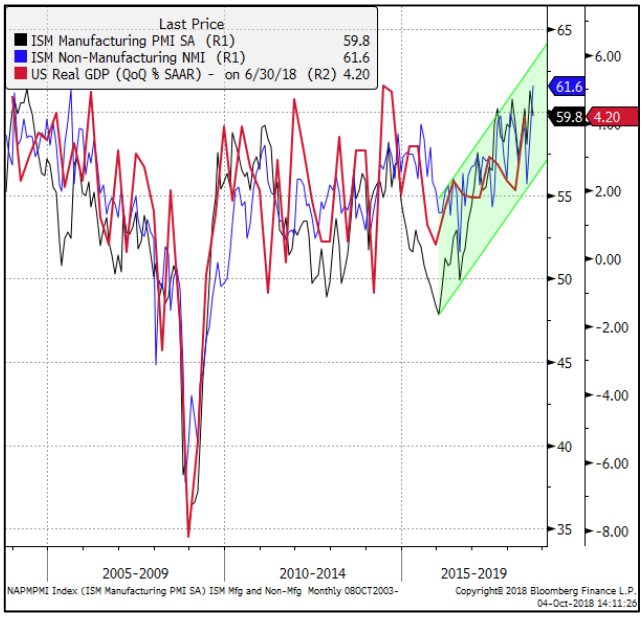
**Bloomberg Barclays; Source: Bloomberg Finance LP*

US stocks once again generated strong returns during the third-quarter with many indices finishing September at or near all-time highs. The S&P 500 Index jumped 7.7%, its best quarter since the fourth-quarter, 2013 and its third best quarter since 2010.

The current US economic expansion will become the longest on record if it makes it to July 2019. Investors are focusing on the strong US economic backdrop as incoming data continue sending signals which are supportive of strong US economic growth and ongoing strength in the financial markets:

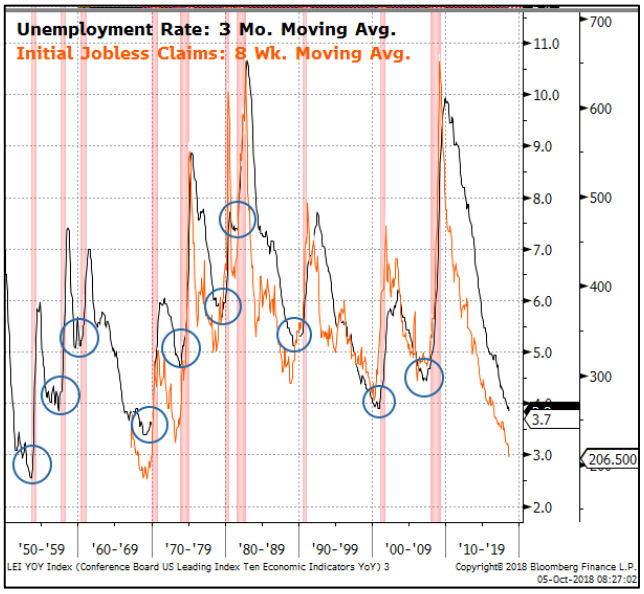
- Overall economic growth is strong (chart 1)
- Unemployment rates are low (fell to a 48-yr. low of 3.7% as of October 5 – lowest since 1969) (chart 2)
- Corporate earnings are strong (chart 3)
- Inflation remains in check (chart 4)
- Interest rates and liquidity are supportive (chart 5)
- Consumer and small business confidence is high (chart 6)
- Household spending is well supported by accelerating wage growth (chart 7) and a savings rate that has room to fall from current levels (chart 8)

Chart 1: Manufacturing Index, Services Index, Real Gross Domestic Product



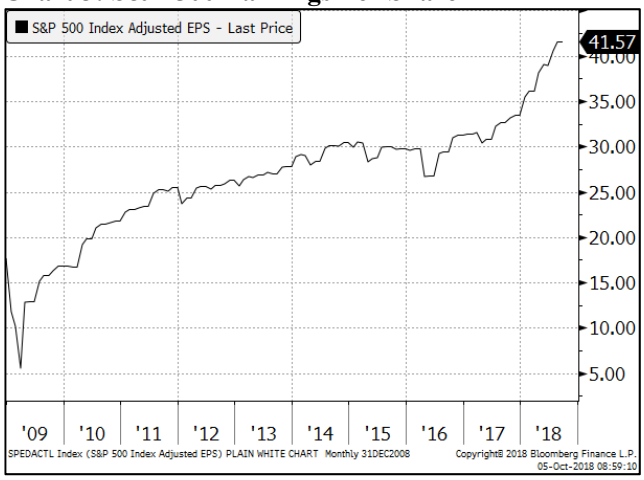
Source: Bloomberg Finance LP

Chart 2: US Unemployment Rate & Initial Jobless Claims



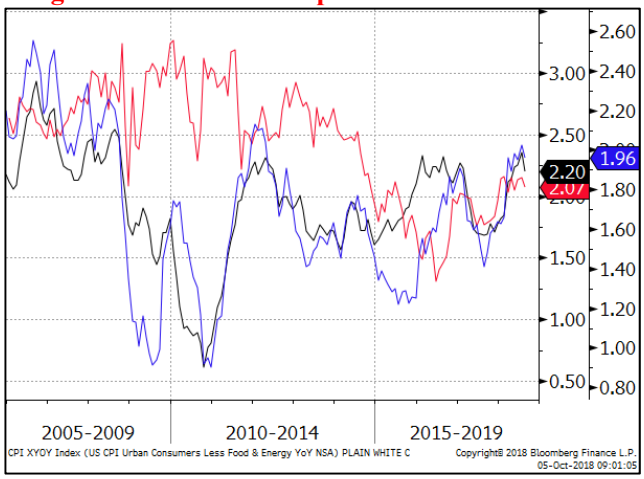
Shown as 3-month moving averages; Red shaded areas denote recessions; Circles denote times when 3-month moving average increased more than 1/3%; Chart source: Bloomberg Finance LP

Chart 3: S&P 500 Earnings Per Share



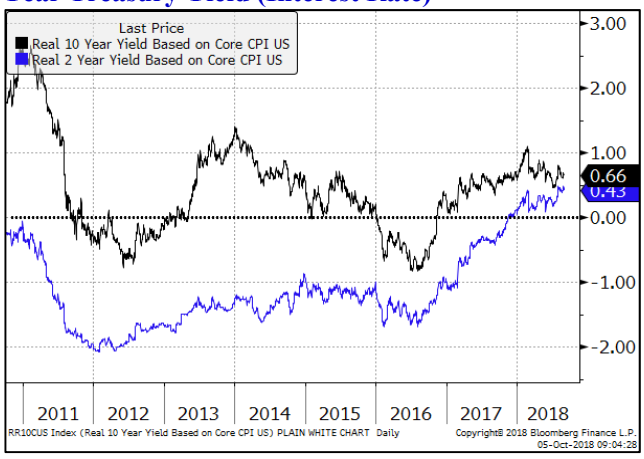
Source: Bloomberg Finance LP

Chart 4: Inflation (Core CPI), Inflation (Core PCE), Longer-Term Inflation Expectations



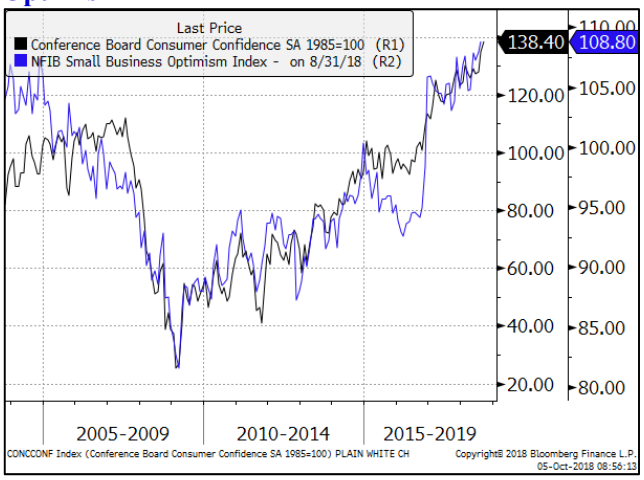
Source: Bloomberg Finance LP

Chart 5: Real (Inflation Adjusted) 10-Year Treasury Yield (Interest Rate), Real (Inflation Adjusted) 2-Year Treasury Yield (Interest Rate)



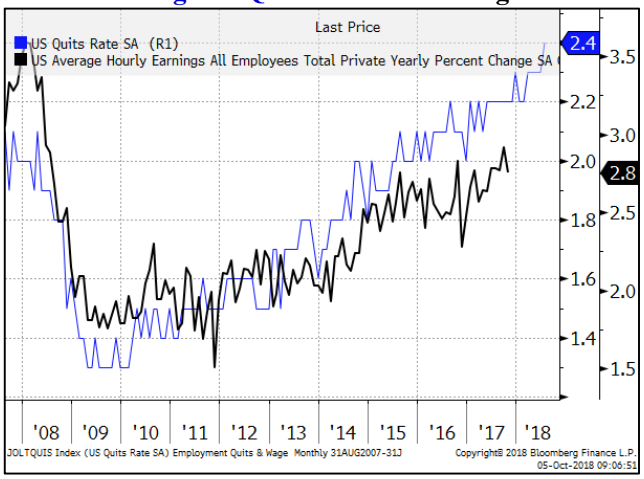
Source: Bloomberg Finance LP

Chart 6: Consumer Confidence, Small Business Optimism



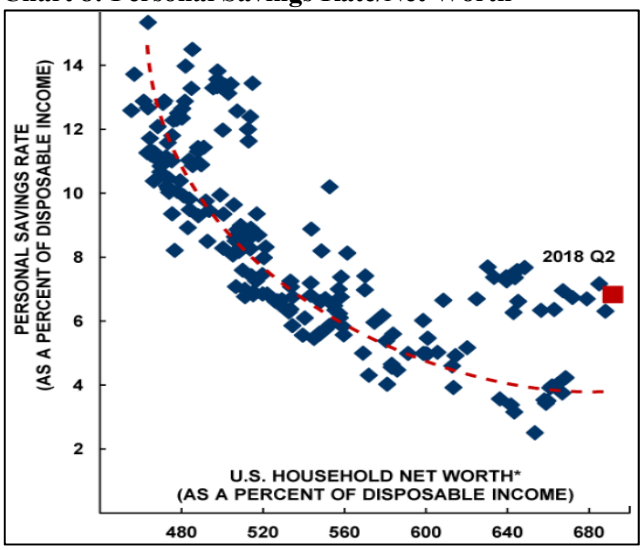
Source: Bloomberg Finance LP

Chart 7: Rising Job Quits Rate Leads Wage Growth



Source: Bloomberg Finance LP

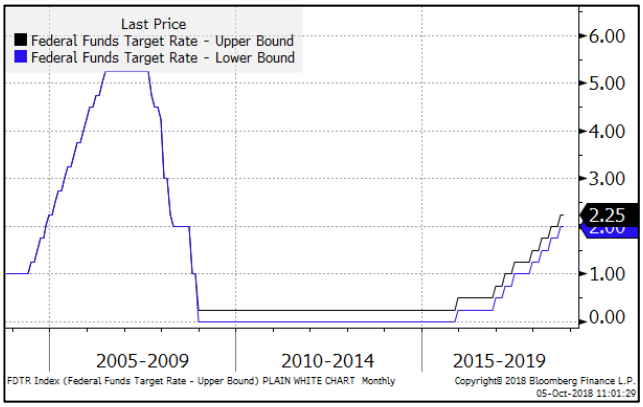
Chart 8: Personal Savings Rate/Net Worth



Source: BCA Research

As noted in last quarter's letter, 2017 was a year of synchronized global growth, while 2018 has turned out to be a year where desynchronization is once again the name of the game. The US economy continues to fire on all cylinders, while much of the rest of the world is struggling to stay afloat. The divergence in economic outcomes is being reflected in central bank monetary policy around the world with the US Fed now hiking short-term interest rates on a once per quarter basis (chart 9) whereas most other major central banks are yet to move.

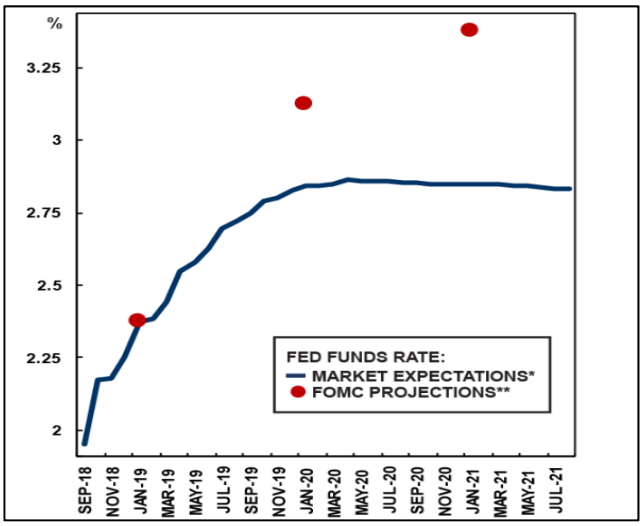
Chart 9: Fed Funds Target Rate Upper Bound & Lower Bound



Source: Bloomberg Finance LP

How high can US rates go? The answer is probably a lot higher than investors anticipate. Market participants currently expect the Fed funds rate to rise to 2.37% by the end of this year and 2.84% by the end of 2019. No rate hikes are priced in for 2020 and beyond. The Fed's median expectation for rates are materially higher than that (chart 10).

Chart 10: Fed Funds Rate – Market Expectations Vs. Fed's Median Estimates



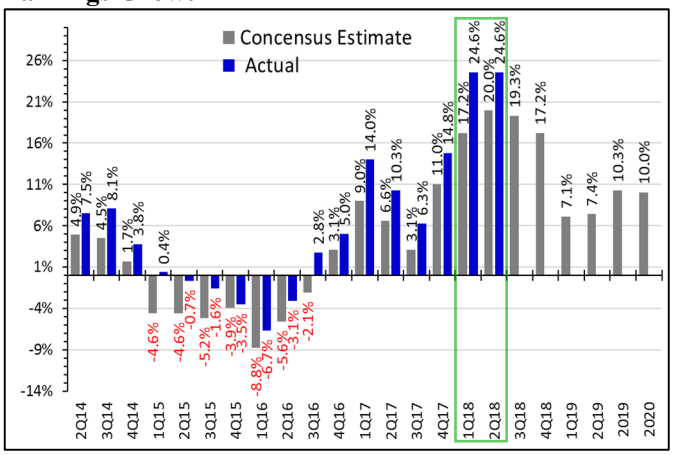
**As discounted by the Fed funds futures market; **FOMC projections as of September 2018. Source BCA Research*

Stock markets are influenced by many variables, but in the end, what matters most is corporate earnings growth. Thanks to the strong economic expansion and an easier tax burden after last year's reform package, both realized and expected earnings for US companies have surged higher.

The US has outperformed most major stock markets during the past few years largely because US corporate earnings have increased more rapidly than earnings abroad. Stronger earnings growth, in turn, has caused investors to assign higher valuations to US stocks in comparison to other regions. This has given US stocks a further lift.

Differences in sector weights have also added to overall US earnings to some extent. Globally, earnings in the technology and health care sectors have grown much more quickly than earnings in the financials and materials sectors. The former sectors have large weights in US indices, while the latter are overrepresented in overseas indices. Nevertheless, most of the outperformance of US firms can be explained by their superior earnings growth even within the common sectors.

Chart 11: S&P 500 Quarterly Year-Over-Year Earnings Growth



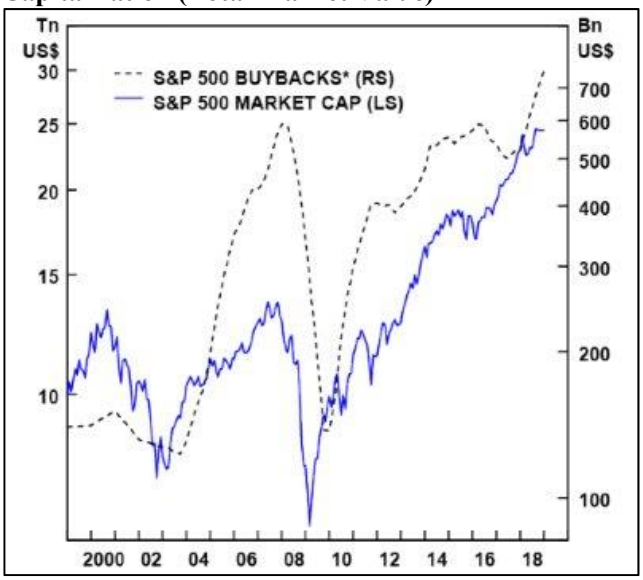
Source: FactSet

As shown in chart 11 above, year-over-year corporate earnings growth for the S&P 500 have been incredibly strong at just under 25% for the first- and second-quarters of 2018. Third- and fourth-quarter earnings are also expected to be strong at 19.3% and 17.2%, respectively.

Adding near-term support to stock prices, US companies are on track to spend a record amount of money buying back their own shares in 2018 (chart 12), with companies in the technology sector accounting for about 40% of all shares repurchased. While this is generally considered bullish for stock prices as it creates

additional demand for, and reduces the number of shares being traded, we should keep in mind that the prior peak in share buybacks occurred in 2007 showing that companies are not particularly skilled at timing the stock market, even when it is their own shares they are purchasing.

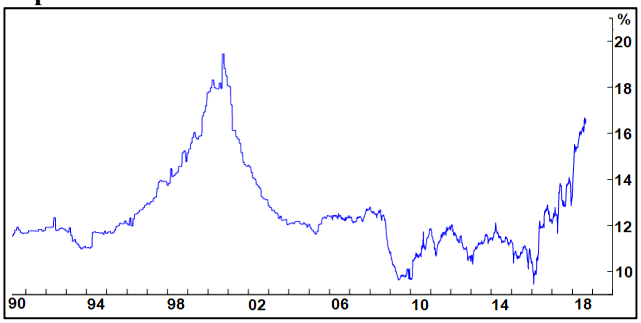
Chart 12: S&P 500 Buybacks & Market Capitalization (Total Market Value)



**Shown as 4-quarter moving total. Source: BCA Research*

An associated point is that buybacks, by their very nature, leave companies with less cash to invest in future growth. This issue is important in the current environment because analysts today expect the average S&P 500 company to grow earnings at an annual rate of almost 17% (chart 13) over the next three- to five-years (which seems very optimistic). That is six percentage points higher than what was expected just three years ago and has only been topped during the runup to the market peak in 2000 after which the S&P 500 declined significantly (almost 50%) between August 2000 and October 2002. The increasingly optimistic outlook for earnings growth raises the risk that we will see earnings disappointments weigh on the stock market.

Chart 13: US Long-Term Earnings Growth Expectations*



**Market cap weighted average of the median analyst long-term (forecast period between three and five years) EPS growth forecast. Source: BCA Research and IBES.*

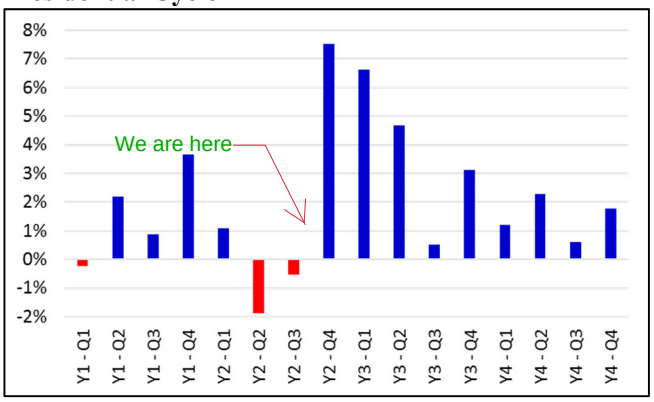
From our perspective, there are at least four reasons why US earnings growth should be expected to decelerate in 2019 and beyond:

- Wage growth is likely to continue picking up. Average hourly earnings surprised to the upside in August, with the year-over-year change rising to a cycle high of 2.9%. There is an almost perfect correlation between profit margins and the ratio of selling prices-to-unit labor costs. A variety of surveys suggest that US firms are struggling to find qualified workers. This is confirmed both by the most recent Fed Beige Book report and earnings conference calls.
- A stronger US dollar is a headwind to earnings. A general rule of thumb is that every 5% appreciation in the broad trade-weighted dollar reduces S&P 500 earnings by 1% over the course of the next 12- to 18-months. The broad trade-weighted dollar has risen 6.2% so far this year and we expect further strength in the months ahead.
- The policy environment will become more challenging. Corporate tax cuts helped boost earnings earlier this year. However, the regulatory landscape is likely to turn less friendly over the next few years. The technology sector in particular is facing increased scrutiny. New European Union privacy rules came into effect in May, which will limit the ability of internet companies to harvest personal data. The Trump Administration is also increasingly targeting social media companies for allegedly suppressing conservative voices. US-China trade tensions are likely to remain elevated, with the US threatening to impose tariffs on an additional $200 billion worth of Chinese imports.
- Rising interest rates will increase debt service costs negatively impacting earnings.

As the midterm elections grow closer, the topic of their impact on financial markets becomes increasingly popular. While we don't put much value on "seasonal" analysis, the presidential cycle is actually transitioning from its worst two quarters to its two best, historically (Chart 14 and 15). Additionally, in the eight previous cases when the S&P 500 gained more than 5% in the third-quarter of a midterm election year, the index posted strong gains in the forth-quarter (median return: 9.8%).

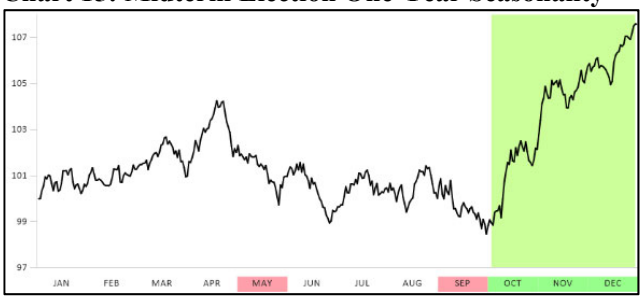
Our view is that the midterm elections themselves will have little financial market relevance. History actually suggests that they tend to be a bullish catalyst for the stock market (Chart 16).

Chart 14: Average S&P 500 Change by Quarter of Presidential Cycle



Source: Ned Davis Research

Chart 15: Midterm Election One-Year Seasonality



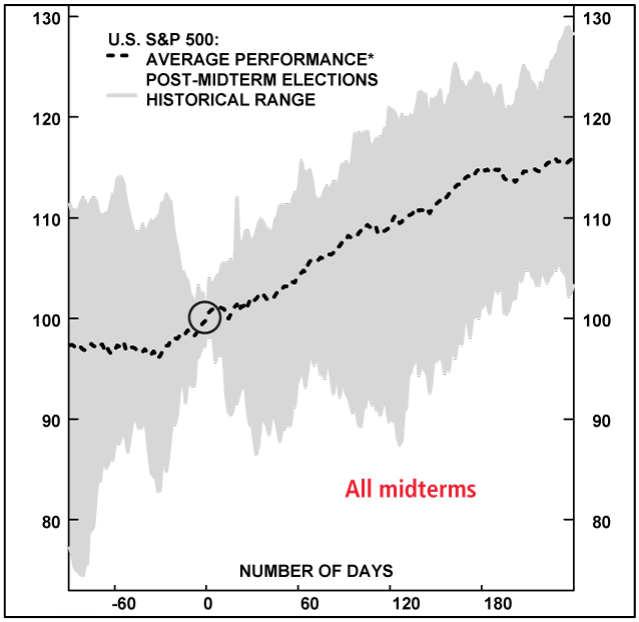
Source: Nautilus Investment Research

We think the results of this year's elections in November will result in a gridlocked Congress. In this case, Democrats would not be able to change the president's agenda or reverse his policies. Trump's deregulation will continue, given that regulatory affairs are the prerogative of the executive branch. Tax cuts will not be reversed, given that Democrats have no chance of gaining a 60-seat majority in the Senate, and would not have a two-thirds majority in each chamber to override Trump's veto. As for fiscal stimulus, we see no chance of the Democratic Party becoming the party of fiscal discipline ahead of the 2020 election.

Putting it all together, while this year's midterm elections will likely dominate the news flow, they are less investment relevant than is assumed. President Trump has already initiated aggressive foreign and trade policy. We expect the White House to intensify the pressure on Iran and China regardless of the outcome of the midterm election. We also expect the Democratic Party to be unable to stop President Trump on either front, should it gain a majority in the House of Representatives.

What's more interesting from our perspective is that the US embargo on Iranian oil exports will officially begin on November 4, just two days before the midterm election date. This is hardly a coincidence. We expect President Trump to apply increasing pressure on Iranian exports going forward. Given the potential impact on domestic gasoline prices, the White House has decided to time the pressure on Iran with the end of the election season.

Chart 16: Midterm Elections Tend to be Bullish



Source: BCA Research

Once the midterms are out of the way, President Trump will likely refocus on his "maximum pressure" tactics. Unfortunately for the markets, we do not expect that this will work as smoothly with Iran and China as it has with others.

Iran is an important risk. If President Trump applies maximum pressure, then a reduction in oil exports from Iran, the possibility of Iranian retaliation in Iraq, and the loss of Venezuelan supplies combined with rising interest rates and a mounting trade war with China could combine to materially increase the likelihood of US recession as soon as next year.

Since no sitting president has gotten reelected during a recession, it seems reasonable that Trump will back down from his maximum pressure tactics if faced with the prospect a recession. However, it is a mistake to assume that policymakers are totally rational or even fully informed. American presidents are some of the most unconstrained policymakers in the world, given both the hard power of the US and the lack of constraints on the president when it comes to national security and foreign policy. Trump may believe that the 660 million barrels of oil in America's Strategic Petroleum Reserve can offset the impact of sanctions against Iran. Or, he may believe that he can force OPEC to supply enough oil to offset the Iranian losses.

The Iranians understand that the best way to reduce American pressure is to create an oil price spike during 2019 that hurts President Trump's reelection chances, forcing him to back off. An oil price spike would serve as a negotiating tool against the US, and the additional revenue would help replace what Iran loses due to the embargo.

Tehran and Washington will therefore most likely play a game of chicken throughout 2019, and there is a fair probability that neither side will swerve.

In the months ahead, we see the following as being the major near-term risks to the financial markets:

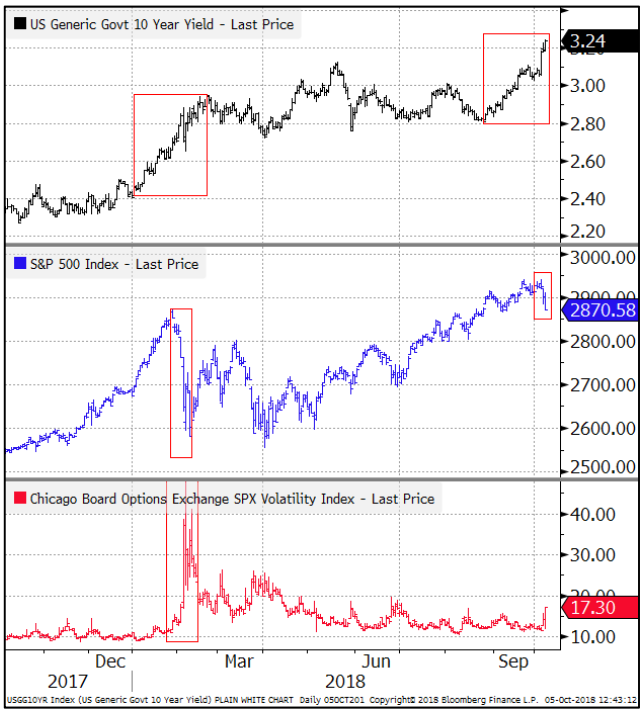
A full-blown trade war with China: Trump's procyclical fiscal policy is causing the current account deficit to widen. Since Trump is unlikely to blame his own policies for a rising trade deficit, he will have to find a scapegoat. He cannot blame Canada or Mexico anymore since he just negotiated a "tremendous" new agreement with them, which corrects all the injustices of the prior trade deal. Japan and the EU will also get a break because they are still needed as geopolitical allies. This leaves China as the primary target. The risk is that the Chinese government not only raises tariffs on US exports, but also retaliates against US firms with operations in China. While unlikely at this point, a trade war with China could also escalate into an outright military conflict.

A spike in oil prices: Tight supply conditions, made worse by sanctions against Iranian oil exports, could cause the price of crude to rise significantly by early next year. A spike in oil prices has preceded 10 of the last 11 recessions in the US since 1945. While not all spikes were followed by recession, the combination of an oil price spike and Fed rate hikes has been associated with a recession 8 out of 9 times. While there are reasons to believe that an oil price shock would be less damaging than in the past, a big enough oil spike, if combined with other adverse shocks, *could* create the conditions for another recession. Higher oil prices will also hurt growth in the rest of the world where many economies are already struggling with weak economic growth.

Emerging market (EM) meltdown: The combination of a stronger dollar, slowing global trade, high EM debt levels, and the Chinese government's reluctance to pursue significant stimulus program because of concerns about financial stability, all spell trouble for EMs. It is doubtful that an EM crisis would bring down the US economy, but it could worsen a preexisting slowdown, especially if the spillovers from EMs lead to a tightening in US financial conditions via a sharp appreciation of the dollar, wider credit spreads (higher interest rates on corporate bonds relative to US Treasuries), and a selloff in US stocks. Already, EM stocks as measured by the MSCI EAFE Emerging Markets Index have declined 21% since January 26 (as of October 4).

Longer-term interest rates moved solidly higher from 2.80% to 3.05% during September. As the fourth-quarter kicks off, rates have surged to 3.25%. This appears to be pressuring stocks and driving volatility higher as it did during January (chart 17).

Chart 17: 10-Yr. Treasury Yield, S&P 500, Volatility Index



Source: Bloomberg Finance LP

Assuming longer-term interest rates settle into a new and slightly higher range and that the geopolitical issues discussed earlier don't flare up, the solid earnings and economic data should keep stocks well supported over the near-term. With that said, this "goldilocks" environment for US risk assets is increasingly vulnerable to disappointments as expectations that the current exceptionally strong environment will persist for the foreseeable future.

-Brant Kairies
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