U.S. large-cap stocks outperformed most other asset classes in the third quarter and over the past year. More generally, equity investments performed better than fixed income, as the chart shows, and in line with the usual trade-off between risk and return. As a result, portfolios that included bonds as well as stocks didn’t gain as much as the S&P 500 because they are designed to be less risky and less volatile over time. In addition, international equity investments underperformed the S&P 500 due partly to the stronger dollar and slower-than-expected economic growth in the rest of the world.

Global bull market continues – The outlook for solid U.S. economic growth and strong earnings growth supports rising stock prices over time. And while not as strong, the international equity outlook is also positive, with more attractive equity valuations. In early September, emerging-market stocks were down 20% from their January 2018 high, dipping into bear market territory. Despite the potential disruptions from slower trade and higher tariffs, we think the underlying fundamentals will keep the global bull market on track.

Supportive monetary policy – Inflation has remained near the Federal Reserve’s 2% target, allowing it to continue to increase short-term interest rates slowly and keep U.S. monetary policy accommodative rather than restrictive. In addition, foreign central banks continue to provide stimulus. Supportive monetary policies can help extend the market and economic cycle.

Still-high market volatility – Although daily stock market moves calmed compared to early in the year, volatility has remained high in currencies and commodities, as well as across market sectors. We expect volatility to continue as the Fed continues to raise short-term interest rates, earnings growth slows below 20% and the ongoing impacts of higher tariffs and higher oil prices are felt.

Action for Investors

Set realistic expectations for your investment portfolio’s returns, realizing that well-diversified portfolios aren’t designed to outperform the S&P 500. After several years of above-average performance, we expect lower returns over the next decade. If you haven’t rebalanced recently, you may need to return to the right mix of equities and fixed income for your situation and risk tolerance, with a wide variety of asset classes in each to help improve portfolio resilience and performance over time.

Diversification does not ensure a profit or protect against loss in a declining market.
Moderate economic growth ahead positions this expansion to become the longest since World War II. We believe most signs – including the positive but flatter yield curve, rising index of leading indicators and the PMI showing strong manufacturing growth – point to solid growth. Those and other indicators suggest predictions of a recession looming in 2020 are premature without an unexpected shock.

Slightly slower growth – The economy continues to be powered by consumer spending, aided by still-strong job growth. Although the unemployment rate is below 4%, still-modest wage increases suggest further job growth ahead. We expect optimistic consumer spending continues to keep the economy growing around 3% through the second half of 2018, as the chart shows. In 2019, quarterly economic growth slows slightly as some effects of the fiscal stimulus from the tax cut and budget agreement fade and higher tariffs bite. We continue to believe negotiations will avoid an escalating trade war, but the risk remains.

Higher inflation ahead – As economic growth continues at a faster pace, shortages in various industries are likely to spread, leading to rising wages and costs. Higher tariffs are also raising prices for some products. And supply disruptions from sanctions on Iran and turmoil in Venezuela could push oil prices higher, too. But we think fierce competition and cost-cutting are likely to keep inflation near current levels, which are within the Federal Reserve’s comfort zone near 2%.

Action for Investors

The economy is expected to continue to grow faster than its 2.2% average without prompting sharply higher inflation. Those are favorable conditions for both stocks and bonds. Investing in the right mix of equities and fixed income based on your situation, time frame, goals and comfort with risk can help you stay on track through all parts of the economic cycle.
After more than nine years without a bear market or recession, we think U.S. stocks are moving into the later part of the market cycle but aren’t nearing a downturn. Instead, stocks appear well-positioned to continue to rise, based on our outlook for modest U.S. economic growth and strong earnings growth through the end of next year. Stay prepared for higher volatility to continue as earnings growth slows and interest rates rise slowly. In addition, valuations are above-average, and high valuations have been followed by below-average long-term returns in the past.

**Double-digit earnings growth** – FactSet projects S&P 500 earnings growth continues above 20% in the third and fourth quarters and then slows to slightly less than 10% in 2019 – still above-average and thus positive for stocks. U.S. tax cuts have been a reason for stronger earnings growth, and revenue growth has also been above-average, suggesting companies have the flexibility to continue to grow earnings.

**Smaller companies attractive** – Large-cap valuations are above their long-term average, as the price-to-earnings ratio in the chart shows. Historically, slightly above-average valuations have been followed by slightly below-average returns for the S&P 500, and they could be less than half of the 14% average annual return over the past five years. Small- and mid-cap U.S. stocks appear to be more attractively valued and should continue to benefit from the tax cuts and solid domestic economic growth. They are also likely to be less affected by higher tariffs or trade disruptions.

**Action for Investors**

Higher valuations for equity investments have led to lower long-term returns in the past, so make sure your expectations for future returns and stock market volatility are realistic. As the market environment changes, consider taking advantage of opportunities to improve the diversification of your equity portfolio in better-valued investments such as small- and mid-cap U.S. stocks if appropriate.
Our outlook for fixed income is based on stable economic growth and a moderate pickup in inflation. Both trends suggest the Federal Reserve will continue gradually increasing short-term interest rates.

**Interest rates drift upward** – Gradual rate hikes are expected as long as there is solid economic growth and inflation remains near the Fed’s target of 2%. Though still low, U.S. rates are higher than most international developed economies. Hence, U.S. bonds are attractive to foreign investors seeking both higher returns and a safe haven from global market volatility. This demand is likely to keep long-term interest rates below their historical averages.

**Flatter yield curve** – As short-term rates rise and long-term rates stay low, the gap between the two has narrowed. This gap, known as the yield curve, is the smallest it’s been since 2007. The flatness of today’s yield curve signals expectations for continued modest economic growth, moderate inflation and a gradual withdrawal of Fed stimulus.

An inverted yield curve, in which short-term rates rise above long-term rates, has occurred when the Fed hiked rates aggressively to calm an overheated economy. As the chart shows, an inverted yield curve is a leading indicator of a recession, though not immediately. The time between when the yield curve inverts and the start of an economic downturn has ranged from six months to nearly three years. Inverted yield curves are rare and, in our view, unlikely in the near term.

**Fixed-income opportunities** – When the yield curve flattens, short-term bonds provide a rate that is close to long-term bonds without the additional interest rate risk. We recommend adding CDs to take advantage of the increase in short-term rates. Additionally, since it’s impossible to predict future interest rates, holding a mix of long-, intermediate- and short-term bonds helps cushion market swings whether rates move up or down.

**Action for Investors**
Slowly rising rates and policy uncertainties are likely to bring a return to normal market volatility with bigger price movements, both up and down. Make sure you have the right mix of stocks and bonds that matches your comfort with risk. An appropriate allocation to bonds as well as diversification across maturities, sectors and issuers can help provide portfolio protection against future stock market fluctuations and pullbacks.

*Certificates of deposit (CDs) are federally insured up to $250,000 (principal and interest accrued but not yet paid) per issuing institution. Please visit fdic.gov or contact your financial advisor for additional information. CD values are subject to interest rate risk such that when interest rates rise, the prices of CDs can decrease. If CDs are sold prior to maturity, the investor can lose principal value. FDIC insurance does not cover losses in market value.*
International equities have lagged this year amid stalled economic momentum in Europe, emerging-market turbulence and a rising U.S. dollar. Trade and geopolitical uncertainties pose headwinds, but an extended global expansion, ongoing central bank stimulus and discounted valuations support international portfolio allocations.

**Global expansion isn’t exhausted** – Upward momentum in the global economy stalled recently, with U.S. strength offset by a soft patch in Europe and China. Rebounds followed similar soft patches in 2012 and 2016, and positively, recent data are signaling some stabilization. Though we don’t anticipate a rebound as synchronized as in 2017, we think global growth remains supportive to international markets ahead.

**Emerging markets fall, tariffs rise** – Although the proposed trade agreement for Canada, Mexico and the U.S. has resolved some issues, we expect escalating trade tensions, dollar headwinds and emerging-market turmoil to continue to stoke bouts of volatility. We still don’t believe an all-out trade war will ensue, but recent global trade activity suggests tariff threats are taking a modest toll, and more retaliatory rhetoric and risks are likely before a compromise is reached. Headwinds remain, but a rebound in China’s growth or a lower U.S. dollar could be a catalyst for a rebound in emerging-market equities, which are more attractively valued after this year’s underperformance.

**Still a compelling case for international exposure** – While global risks remain, we believe many are already reflected in international equity markets. Developed-market stocks are trading at a 20% discount to the U.S., while emerging-market equities are at a 29% discount.* Lower valuations, along with fundamental help from still-stimulative global central bank policies and less mature economic and profit cycles, make international equity investments attractive, in our view.

**Action for Investors**

U.S. small- and mid-cap equities should continue to benefit from the relative strength of the domestic economy and less sensitivity to global trade and currency headwinds. We also recommend maintaining appropriate allocations to international developed-market large-caps and emerging-market equities.

*Sources: FactSet, forward P/E for the MSCI EAFE, MSCI Emerging Market and S&P 500 indexes.

Investing in equities involves risks. The value of your shares will fluctuate, and you may lose principal. Small- and mid-cap stocks tend to be more volatile than large company stocks. Special risks are inherent to international investing, including those related to currency fluctuations and foreign political and economic events.
A bear market in emerging-market stocks started in September when they dropped 20% from their January peak due to the impacts of the stronger U.S. dollar, declines in Chinese stocks and concerns about higher tariffs. Emerging markets appear attractively valued, and the fundamentals look solid in most of the larger countries. Although increased trade tensions, rising U.S. interest rates, higher oil prices and a stronger dollar remain risks, we believe emerging-market equity investments represent an opportunity for long-term investors.

China is the largest emerging market – Chinese stocks are the largest holdings – about 30% – of the benchmark MSCI emerging-market equity index, as the chart shows. Seven of the 10 largest companies are Chinese. In 2018, as China’s economic growth slowed to near 6% and tariff threats escalated, China’s stock market dropped 26%, pulling down broad-based emerging-market equity investments as well. Despite ongoing concerns about higher tariffs, we think trade disputes are likely to be resolved by negotiations. In addition, China’s government continues to have many tools to maintain growth and address high levels of domestic debt.

Risks from tariffs, a stronger dollar and rising U.S. interest rates – Historically, emerging markets have faltered when U.S. interest rates rose and the dollar strengthened, and headlines have emphasized the sharp drops in some emerging currencies such as Turkey and Argentina. But their combined impact is less than 2% of the benchmark, and technology, not commodities, has become the largest sector. Higher tariffs and trade disruptions could continue to dampen the short-term outlook, since many emerging economies are closely tied to global trade. While risks remain and further fears could prompt additional short-term price drops, we think many of these risks are already reflected in attractive valuations and positive fundamental conditions in the largest countries.

**Action for Investors**
We recommend investors diversify portfolios with international equity investments, including emerging markets. Although challenges remain and emerging markets can be volatile, we think using the pullback presents an opportunity to add broad-based emerging-market investments if appropriate.

Equity investing involves risks. The value of your shares will fluctuate, and you may lose principal. Special risks are inherent to international and emerging-market investing, including those related to currency fluctuations and foreign political and economic events.
QUARTERLY MARKET OUTLOOK: FOURTH QUARTER 2018

Asset Class Outlook

Equity versus Fixed Income (Target = Middle) – We think the bull market in stocks can run further, supported by stronger economic growth and double-digit increases in corporate profits, helped by the tax cuts. Interest rates remain low but are likely to continue to rise slowly. A laddered bond portfolio and an above-average amount in cash may help provide downside protection for portfolios as volatility picks up.

Domestic versus International (Target = Middle) – We recommend overweighting international equities and underweighting international fixed income as global growth remains solid.

Asset Class Diversification

Aggressive (Target = Middle): We remain cautious on commodity investments despite the sharp rise in oil prices. The drop in emerging-market equities reflects the stronger dollar and worries about possible trade disruptions. We think the pullback is an opportunity and recommend a small allocation.

Growth (Target = Middle): U.S. small- and mid-cap stocks are attractive because they appear well-positioned to benefit from lower corporate tax rates and accelerating economic growth. Opportunities and risks appear balanced for international small-cap stocks.

Growth & Income (Target = Middle): We think risks and opportunities are balanced for real estate investments. Above-average valuations for large-cap U.S. stocks already reflect our expectations for improving economic growth and rising earnings, reducing our long-term return expectations. We recommend overweighting international developed-market large-cap equities because expectations are low, dividend yields are attractive, and we expect solid earnings and economic growth to continue.

Income (Target = Low): Long-term interest rates tend to move with inflation, which should rise slightly as growth improves. Higher short-term interest rates make them attractive. But rates on high-yield bonds have fallen despite their additional risk, so the aggressive-income target is low. We think international fixed income looks relatively unattractive due to low foreign interest rates that also have started to rise slowly.

Cash (Target = High): We recommend overweighting cash, having enough to cover short-term expenses and investing during pullbacks.

Investors should understand the risks involved in owning investments, including interest rate risk, credit risk and market risk. The value of investments fluctuates, and investors can lose some or all of their principal. The prices of small-cap, mid-cap and emerging-market stocks are generally more volatile than those of large company stocks. Special risks are inherent to international investing, including those related to currency fluctuations and foreign political and economic events.

1 Alternative investments and Stocks trading less than $4 align with the aggressive investment category, but they are not recommended.
2 Large-cap stocks that do not pay a dividend are in the Growth investment category.

Asset classes we don’t recommend separately include alternative investments, micro-cap equities and international high-yield bonds.
It’s natural to compare your portfolio’s performance to market performance benchmarks, but it’s important to put this information in the right context and understand the mix of investments you own. Talk with your financial advisor about any next steps for your portfolio to help you stay on track toward your long-term goals.

As of September 30, 2018

The U.S. Equity Sector Performance table to the left incorporates recent changes in the S&P/MSCI Global Industry Classification System (GICS). The Telecommunications sector now includes media and internet companies under a new label called Communication Services. GICS also revised its historical data to reflect the new allocations.

Source: Morningstar Direct, 9/30/2018. U.S. large-cap stocks represented by the S&P 500 Index. U.S. mid-cap stocks represented by the Russell Mid-cap Index. U.S. small-cap stocks represented by the Russell 2000 Index. International large-cap stocks represented by the MSCI EAFE Index. U.S. bonds represented by the Barclays U.S. Aggregate Bond Index. Cash represented by the Barclays U.S. Treasury Bellwethers 3Mon Index. High-yield bonds represented by the Barclays U.S. HY 2% Issuer Cap Index. Commodities represented by the S&P GSCI Index. Emerging-market stocks represented by the MSCI EM Index. International bonds represented by the Barclays Global Aggregate Ex U.S. Index. International small-cap stocks represented by the MSCI EAFE Small-cap Index. Real Estate represented by the FTSE NAREIT All Equity REITs Index. All performance data reported as total return. An index is unmanaged and is not available for direct investment. Performance does not include payment of any expenses, fees or sales charges, which would lower the performance results. The value of investments fluctuates, and investors can lose some or all of their principal. Past performance does not guarantee future results.

Sector Changes

Source: Morningstar Direct, 9/30/2018. U.S. large-cap stocks represented by the S&P 500 Index. U.S. mid-cap stocks represented by the Russell Mid-cap Index. U.S. small-cap stocks represented by the Russell 2000 Index. International large-cap stocks represented by the MSCI EAFE Index. U.S. bonds represented by the Barclays U.S. Aggregate Bond Index. Cash represented by the Barclays U.S. Treasury Bellwethers 3Mon Index. High-yield bonds represented by the Barclays U.S. HY 2% Issuer Cap Index. Commodities represented by the S&P GSCI Index. Emerging-market stocks represented by the MSCI EM Index. International bonds represented by the Barclays Global Aggregate Ex U.S. Index. International small-cap stocks represented by the MSCI EAFE Small-cap Index. Real Estate represented by the FTSE NAREIT All Equity REITs Index. All performance data reported as total return. An index is unmanaged and is not available for direct investment. Performance does not include payment of any expenses, fees or sales charges, which would lower the performance results. The value of investments fluctuates, and investors can lose some or all of their principal. Past performance does not guarantee future results.