



In this month's *Insight*

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**Better to be an Hour Too Early
Than a Minute Too Late**

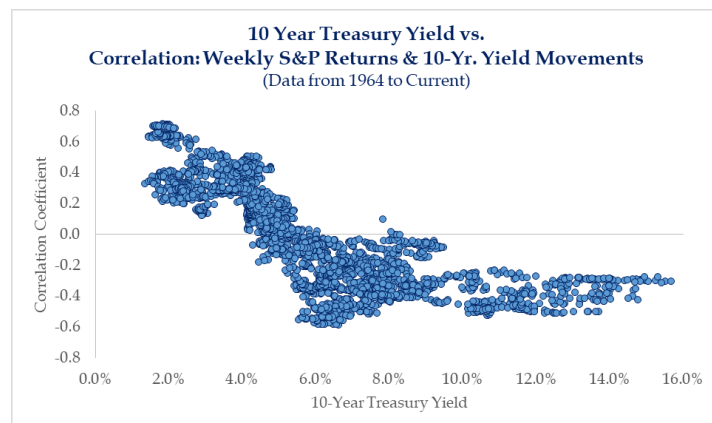
Well, that escalated quickly. The sleepy dog days of summer have given way to a bit of autumn drama in the bond market. US yields have gapped a full 20 basis points higher in the three weeks ending October 9 to take the prevailing rate on the 10-year Treasury to near 3.20% for the first time since 2011. Despite this, in a historical context, yields are far from demonstrably punitive levels. It is likely that the greater cause for investors' concern rests in how yields notched up to current levels—quickly—and, given the Federal Reserve's (the Fed) proclivity to normalize the cost of capital, the likelihood that rates will become less supportive sooner than anticipated. In a

survey of the attendees at Strategas' fifth annual invitation-only Investment Forum at Tucker's Point, Bermuda over the Columbus Day weekend, the assembled investors predicted rates will climb a further 30 basis points to 3.55% over the next 12 months. That would seem tough to achieve without putting a serious stich in the stock market's stride.

In that light, it is worth considering the current move in rates in context with the equity market's response. In fact, as of the close last Tuesday, October 9, the S&P 500 Index had 74 consecutive trading sessions since it last notched a move of more than 1%, up or down. This time around, equity markets remained relatively nonplussed to begin with. Although the market opened October on a moderately softer note, it was not until last Wednesday, October 10, that equities began to unpack the extent of the change in tone underpinning the market. And it did so in dramatic fashion, with the Dow plummeting 831 points, a decline of more than 3%, and the NASDAQ off more than 4%. This dramatic price action stands in sharp contrast to the move in equities last February, when yields on the 10-year Treasury Note backed up roughly 40 basis points, and stocks plummeted by 10% almost immediately

from levels to which they did not recover until late-summer (August 24). The dichotomy in the equity market's reaction to volatility in the bond market underscores two important considerations for investors going forward that did not appear to exist last spring.

1. The economy is on strong footing and remains primed to “outperform” the equity market, but investors’ attention is adjusting to the nominal contours of growth and prices. This supports the case for active management and highlights the beginning of a shift from an environment favoring growth stocks to one which should favor value; and,
2. The impact of continued uncertainty on the policy front:
 - 1) **Trade** tensions have eased in North America with the passage of the USMCA (the “new” NAFTA) and with Europe, where Trump Administration officials are now engaged in broad discussion, but continue to escalate with China;
 - 2) Fed Chair Jay Powell has reiterated a pragmatic approach to **monetary policy**, suggesting policy remains significantly enough below neutral as to introduce an element of risk in owning long-duration assets; and



- 3) Ratcheting political tensions have further energized Democrat and Republican voters, drawing the midterm election outcome into a coin-flip and, in turn, placing a question mark on **tax and regulatory policy**—seemingly settled by the 2016 election.

October is often associated with choppiness in the markets, and 2018's October is certainly holding true to form. It can be difficult to keep the longer-term objectives of investing in mind when the market is providing sufficient daily distraction, but it is all the more important to do so. The US and global economies remain on firm footing and likely are shifting toward the stronger nominal growth regime typically associated with the slowing expansion phase of the business cycle. The presentation of full employment, modestly higher inflation, and strength in corporate profits has provided sufficient

cover for the Fed to push forward with its plans to normalize interest rate policy over the intermediate term (next 12 months). That is OK. There is little to support the case that the economy requires a continuation of accommodative monetary policy. Although a moderate tightening of financial conditions runs counter to the Fed's longstanding post-financial crisis policy position (and will clearly require market participants to adjust), a full reckoning is unlikely to occur overnight. Indeed, it is difficult to qualify current monetary policy as restrictive—yet. But, given the contours of a changing market risk profile, investors would do well to recognize the opportunity to reallocate portfolios to take advantage of a late-cycle growth framework.

Whereas Chairman Powell's press conference following the September Federal Open Market Committee (FOMC) meeting was likely the first substantive nonbullish data point the market has had to digest (suggesting the business cycle is shifting into its later stages), the next batch of substantive data may not be met with as much blowback. By all lights, corporate results for Q3 2018 and guidance for Q4 2018 underscore not just the current strength in the economy, but the C-suite's outlook

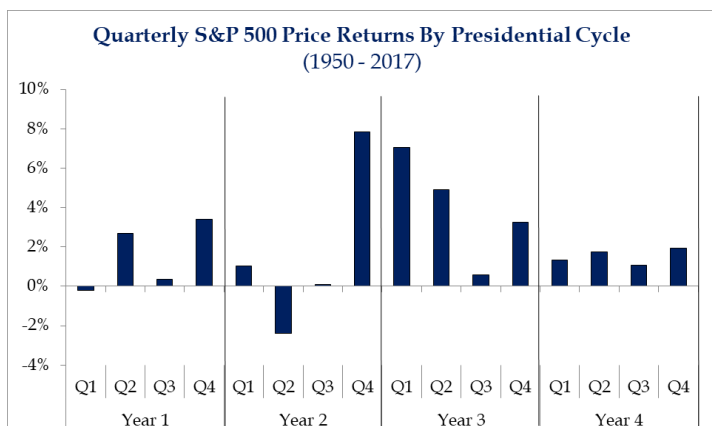
for continued strength. This outlook is echoed in several recent robust business confidence survey readings. We are mindful—as we wrote last month—of the negative anniversary effect awaiting current year 2019 year-over-year earnings growth calculus. But the pace of growth in corporate sales and earnings before interest and taxes (EBIT) continues to exceed the pace of nominal gross domestic product (GDP) growth. If we must watch only one data set in the aggregate, we would focus on profit margin to reveal the impact of higher operating costs on the bottom line.

As Q3 earnings season draws to a close in November, the market also will see resolution on the direction of US politics for the two-year term beginning in January. Strategas' Washington team, led by Dan Clifton, believes investors are underpricing the possibility of an election sweep: The possibility of Republicans maintaining majorities in both the House and Senate is becoming as likely as Democrats wresting control of both chambers. Both of these are out-of-consensus outcomes. As it stands now, the equity market is pricing in political gridlock, with the highest probability assigned to the GOP retaining power in the Senate and Democrats picking up the necessary seats to take over the House of Representatives. But the outlook is shifting. Irrespective of one's political

views, the Kavanaugh confirmation hearings have galvanized the political right and left. Somewhat interestingly, Democrats' support among woman voters has fallen notably in recent polls (a Quinnipiac survey of Democrats' net lead to Republicans with "white woman voters" has fallen from 14% in July to 5% in September to 1% in October; and a Marist poll of Democrats' lead with "suburban woman" has fallen from 35 in early September to 14 in prove temporary? We will not have to wait long: Election Day is November 6. Also worth highlighting, the midterm election historically has been an important inflection point for the equity market. In fact, since 1946, the S&P 500 Index has not fallen in the 12 months following a midterm election—17 consecutive election cycles. This includes 1986, in which 11-½ months after Election Day the S&P 500 Index fell more than 20% in a single day, on October 19, 1987.

Further, stocks have historically been down 2.3% in the April-September period during the second year of a presidential term, but subsequently have rallied 15% on average in the six months beginning in October of that year.

Advisor Takeaway: We are in the early innings of a shift from a liquidity-driven to a fundamental driven market. Ongoing trade tensions, coupled with monetary policy and the implications of the midterm elections on tax and regulatory policy, have added uncertainty. However, advisors can remind clients that the US and global economies are on firm footing, and market dislocations are the natural progression of a slowing expansion phase of the business cycle. It is worth revisiting clients' allocation across assets and consider repositioning to take advantage of the late-cycle growth framework. The strong economy bolsters the case for active management and a switch from growth to value equities. Always better to be among the responsible few continuously challenging their assumptions than to be caught offside and looking to make up ground.



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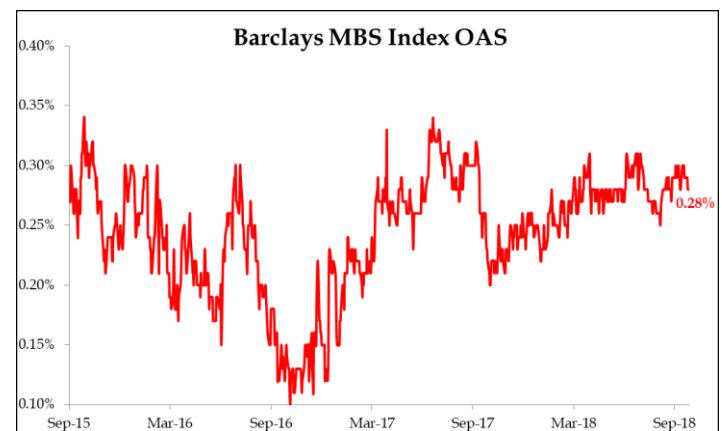
Nicholas Bohnsack is the President & Chief Executive Officer of Strategas Asset Management and a Managing Director of Baird.

Positioning For Risk-Off In Bonds Becomes Even More Difficult In A Rising Rate Environment

As we began the 4th quarter, our model portfolios reflected a slightly more credit risk averse positioning; we've trimmed HY exposure by about 1% in Go Anywhere and trimmed bank loans and convertibles 1% in both Core and Go Anywhere. In all cases, we've moved up in credit quality to agencies and/or IG corps, as we believe valuations in extended credit sectors are likely to continue to adjust cheaper as this cycle matures. The difficulty with positioning for even a modest risk off in such a rising rate environment is that "safe havens" are also not so safe. Specifically, Treasuries and MBS have seen some of the worst of the bond market's pain in the last month, as duration AND negative convexity (MBS) have hit. In contrast, agencies, which tend to be neutral convexity, but similar spread as MBS, are likely to offer some reprieve this quarter, and this is why we've moved to a small overweight to this sector.

We've estimated that the pace of MBS spread widening from balance sheet unwind should be about 2-3 bps a

quarter, but this assumes no other changes in demand vs supply. In reality, mortgage supply has run weaker than consensus in 2018, while slow curve flattening has helped to keep vol suppressed, and keep USD fixed income in general well bid. Now normally, this would be a catalyst for a mortgage supply increase, and although we don't necessarily believe that this is imminent, we do believe that the risks have risen for either a rise in supply or a rise in borrowing costs that could gap MBS spreads out enough to underperform IG corps and agencies in Q4.

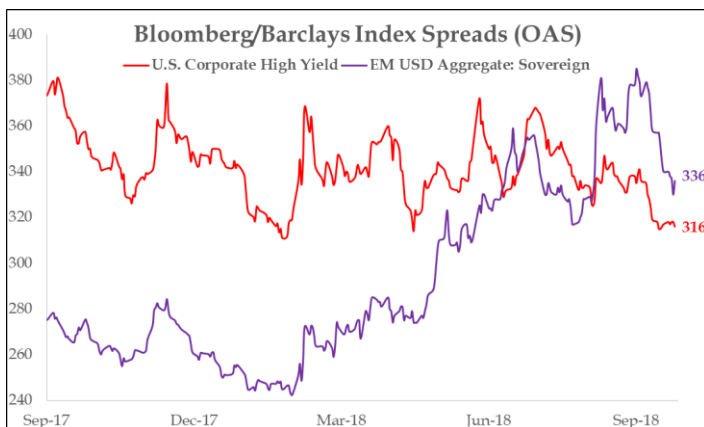


Advisor Takeaway: Q2 and Q3 saw a pause in the 2-3 bps a quarter pace of widening for MBS. By our measures, this puts broad MBS about 5 to 7 bps too tight right now, or about the difference between outperforming the Agg on average over a quarter to underperforming.

We'd classify our bullishness on USD sovereign EMD as more of a relative value argument; it's hard to argue that any scenario that threatens another flare up in hard currency EM won't eventually engulf HY and even IG corps. So we'd rather shift our high beta exposure to USD EMD and away from lower yielding USD HY, or just move up in credit quality, or do both. And that's just what we did. Last quarter, we shifted to EMD. This quarter, we began moving up into agencies (in Core) and agencies and IG (Go Anywhere).

spreads and only slightly lower USD EMD spreads.

Tom Tzitzouris is the Head of Fixed Income Research at Strategas.



Advisor Takeaway: Normally, USD sovereign EMD spreads would be about 100 bps **BELOW** high yield. This inversion is very rare, and usually reverses quickly. We believe that this reversion began in Q3 and will likely continue in Q4, more likely on the back of both higher HY

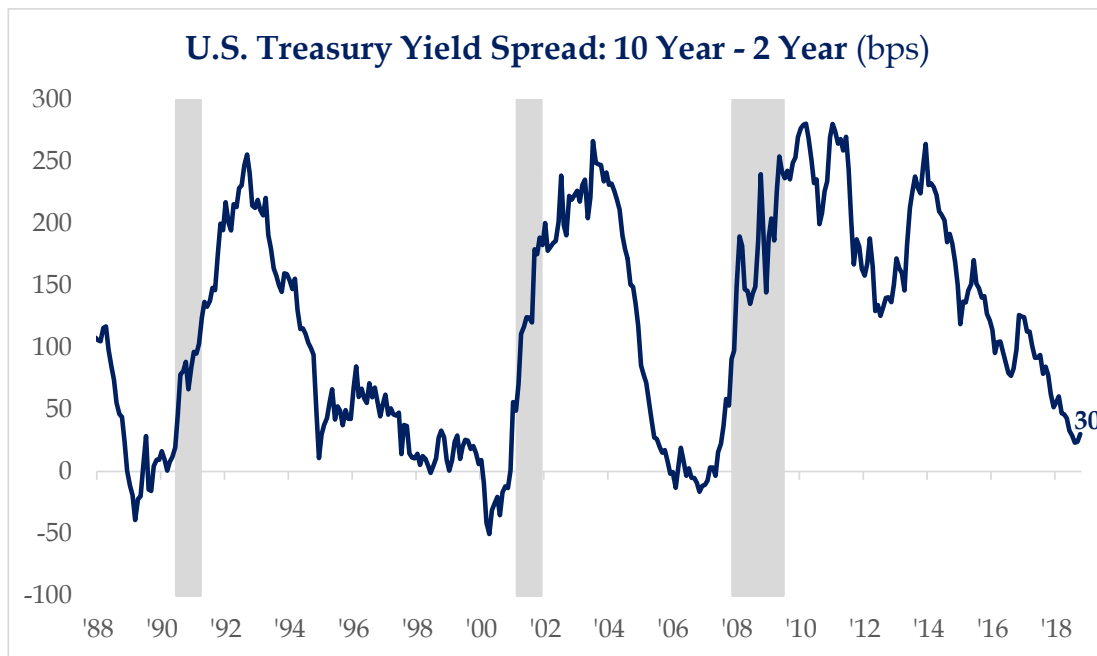
October Recommended Asset Allocation

Strategas Recommended Asset Allocation					
Equities			Bonds		Cash
70%			27%		3%
B'mark	MSCI AC World Index	60%	Barclays Global Aggregate	38%	2%
Domestic		42%	Core Credit	23%	
International		28%	Extended Credit	4%	
Bullish	Dev AC Core	21%	Corporates	9%	
	US LC Value	12%	Local Currency EMD	2%	
	EM AC Core	7%	US Dollar EMD	1%	
	US MC Value	5%			
	US MC Growth	3%			
	US MC Core	3%			
	US SC Core	2%			
Neutral	US LC Growth	10%	Agencies	1%	
	US LC Core	7%	US High Yield	1%	
Bearish			US MBS	8%	
			U.S. Treasuries	5%	
			AMBS/CMBS	0%	
			Convertibles	0%	
			Bank Loans	0%	

Bullet-Point Outlook

- Global rotation: U.S. up, Europe+Japan+China slower.
- U.S. economy performing well in a mid-term election year.
- Regulating “FANG” & Tech and Tariffs near term risks.
- Heading for 3%+ U.S. real GDP in 2018. 2Q/3Q expected ~4%+ q/q A.R.
 - Tough to find the weak spot in the C+I+G+NX equation.
 - Importantly for the U.S. business cycle, there has never been a U.S. economic recession with corporate profits staying buoyant.
 - Tax bill more than offsetting higher oil prices short-term. Spending (G) helps 2019.
 - Capex & labor saving technology (I) could be boosted by accelerated depreciation/tax legislation.
 - Productivity should move toward 2% near-term.
 - Deregulation is non-legislative, and should help money velocity.
 - Autos were a weak spot in the U.S., but previous hurricanes removed some excess.
 - Housing taking 2 steps forward & 1 back. Household formation (buyers + renters) has been weak (ie, not just weak homeownership). A very asymmetric recovery.
- Inflation is rising, but slowly & manageable (reflation before inflation problem).
 - Average hourly earnings typically 4%+ before major margin pressure. Not there.
 - But Phillips Curve not completely dead.
- Monetary policy offset by 2020?
 - Fed “dots” ok for 2018, become more concerning in 2019/20 if yield curve inverts.
 - Markets like to test a new Fed Chair.
 - ECB Taper & rate rise slow. BoJ still ultra-easy. 2019 exit discussion? VAT tax in Japan in 2019?
 - China tightening & easing at the same time.

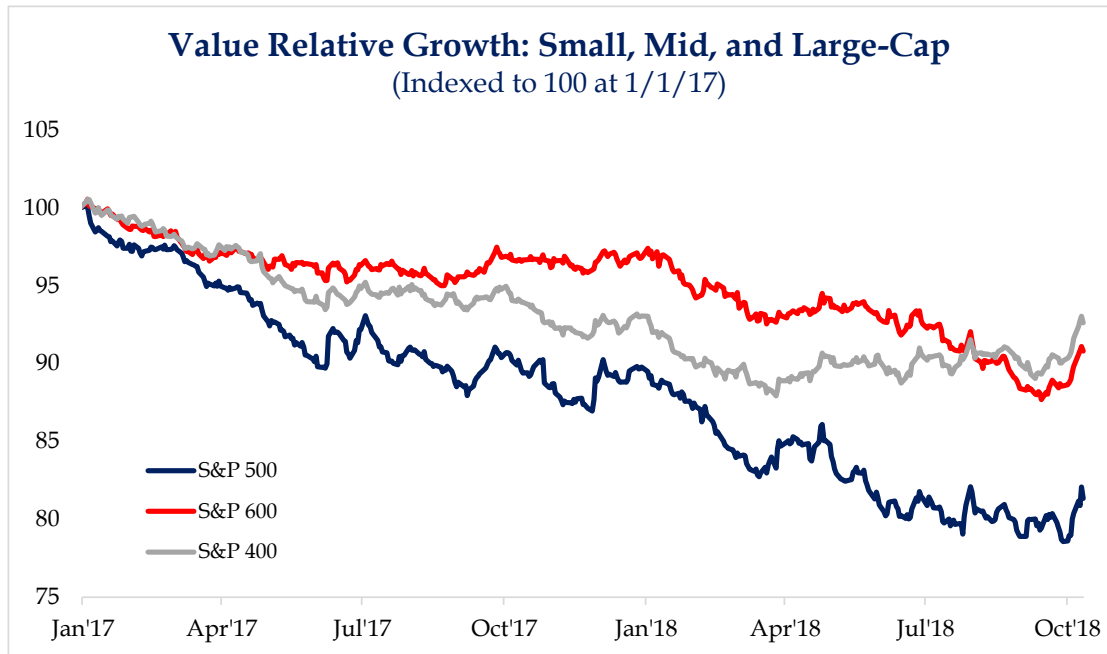
The Yield Curve Remains an Important Barometer – Inverted is Not Good



Stocks Susceptible to Trade Tensions, Fed Overreach, and Softer Earnings Growth

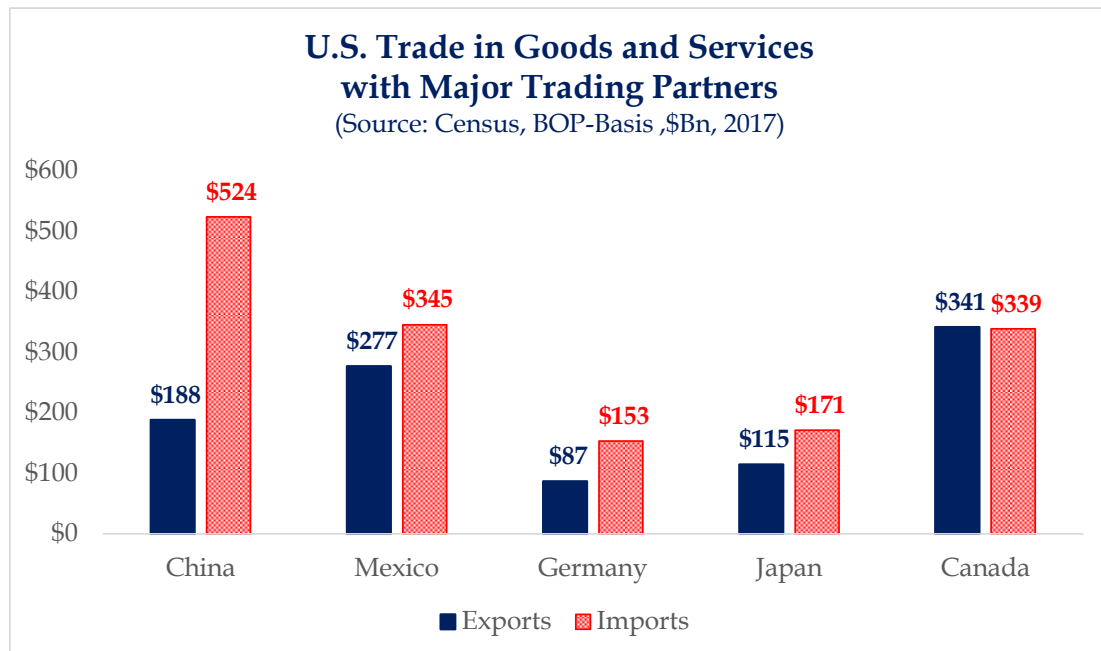


Value Managers Take Note: Finally!

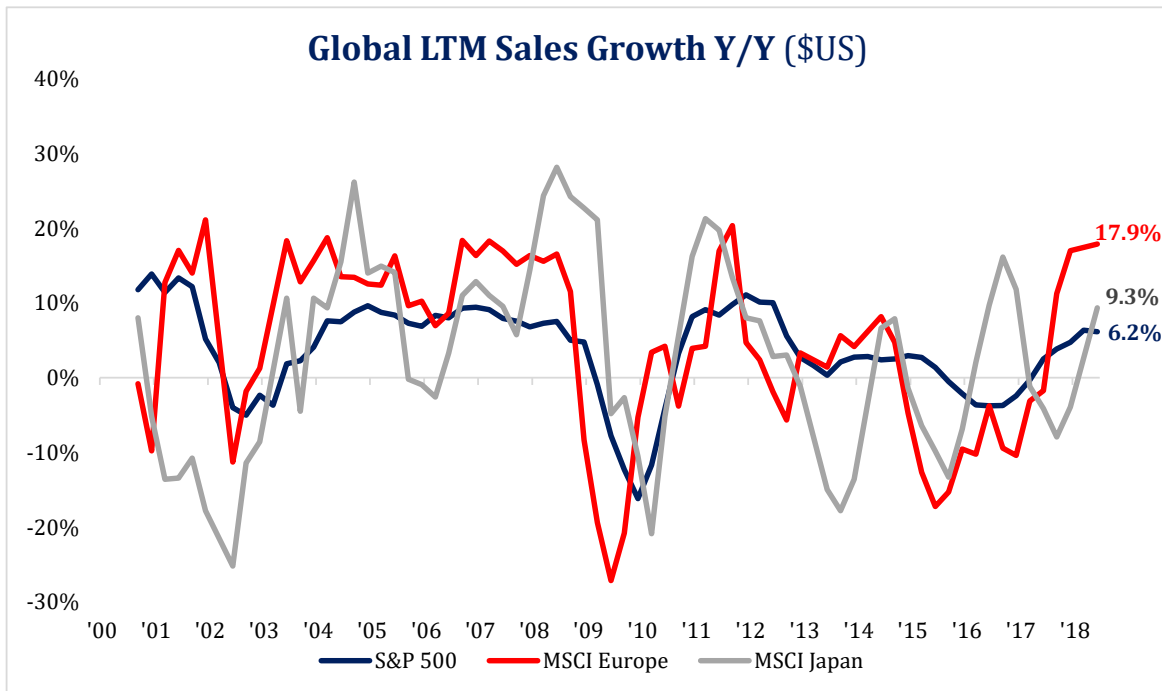


A Little Clarity with Our Major Trading Partners

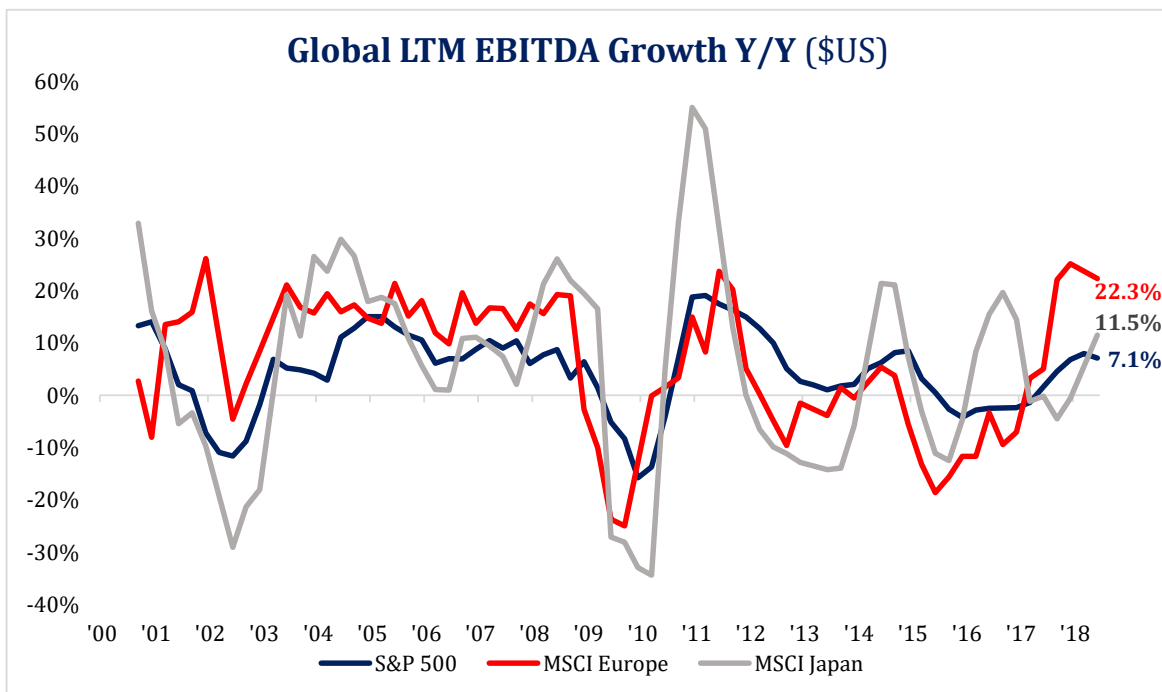
Despite ratcheting tensions with China, agreement on the USMCA (the new “NAFTA”) and progress with Europe on Autos have cooled important trade pockets that had boosted small and mid-cap shares earlier this year.



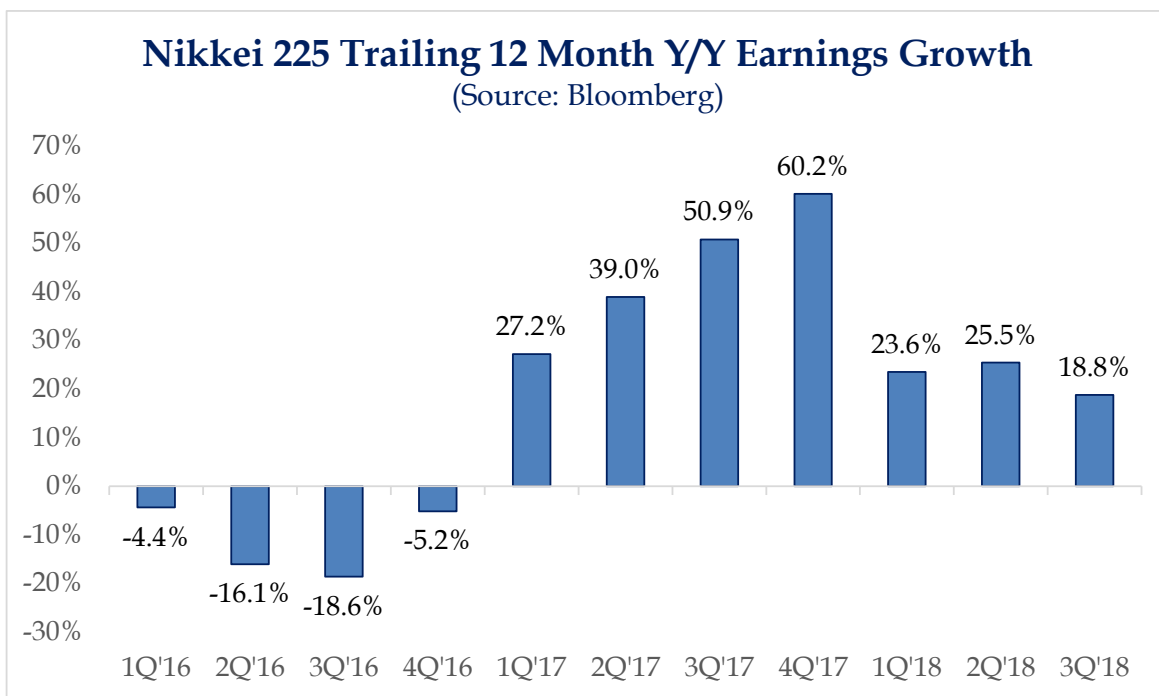
Tax Cuts Continue to Push Through Economy: Sales Growth Has Been Accelerating...



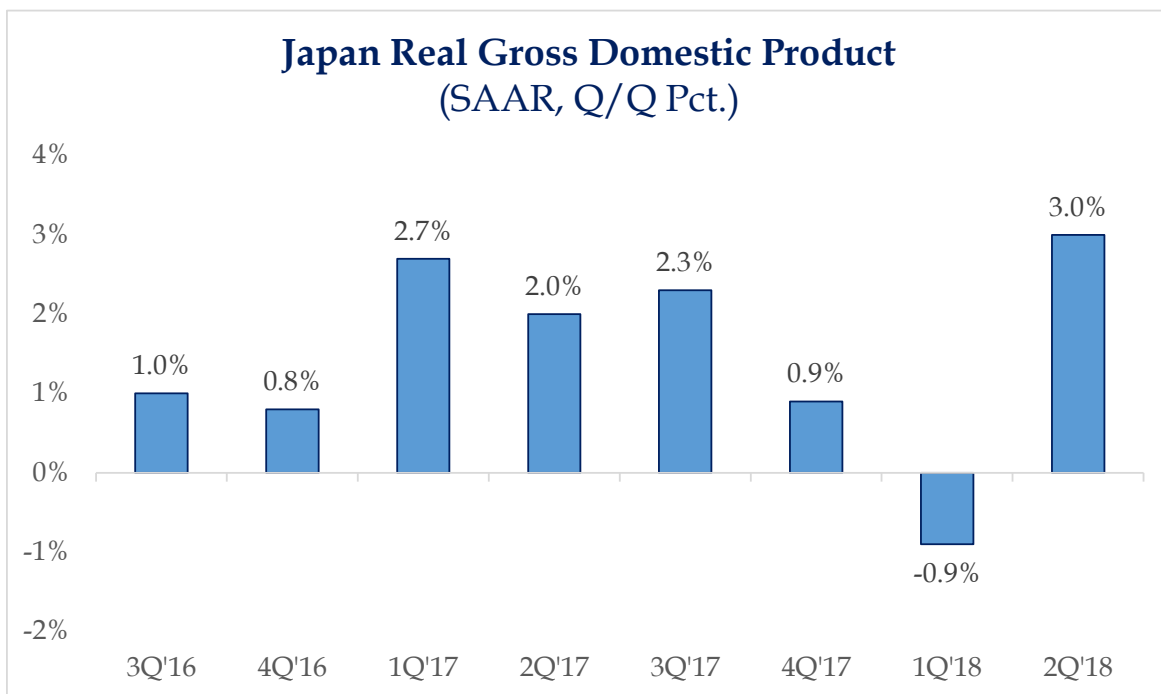
...and, Synchronized Global Upswing Also Evident in EBITDA Growth



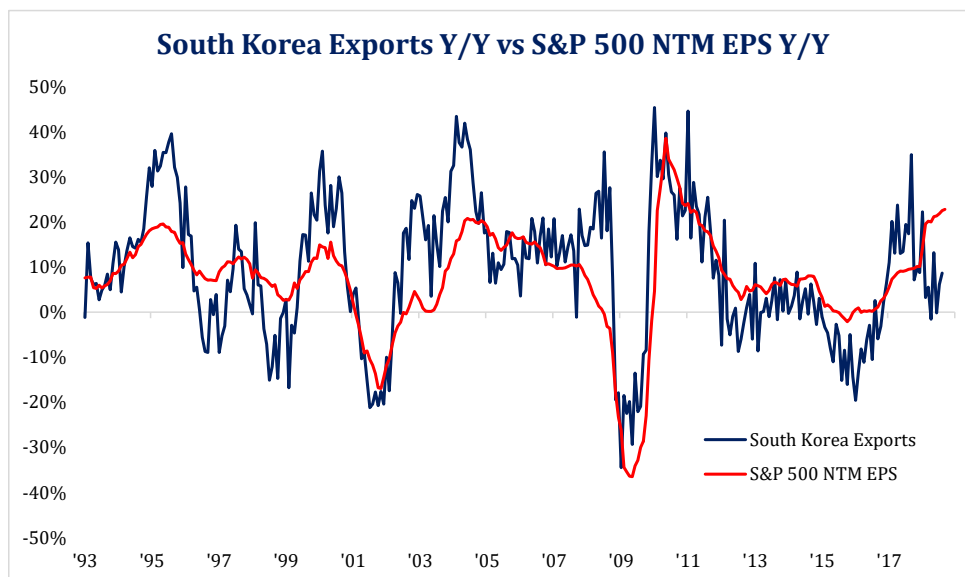
Earnings in Japan Remain Steady...



...While Japan GDP Bounced Back in 2Q'18



South Korea Flashing U.S. Profit Growth Warning



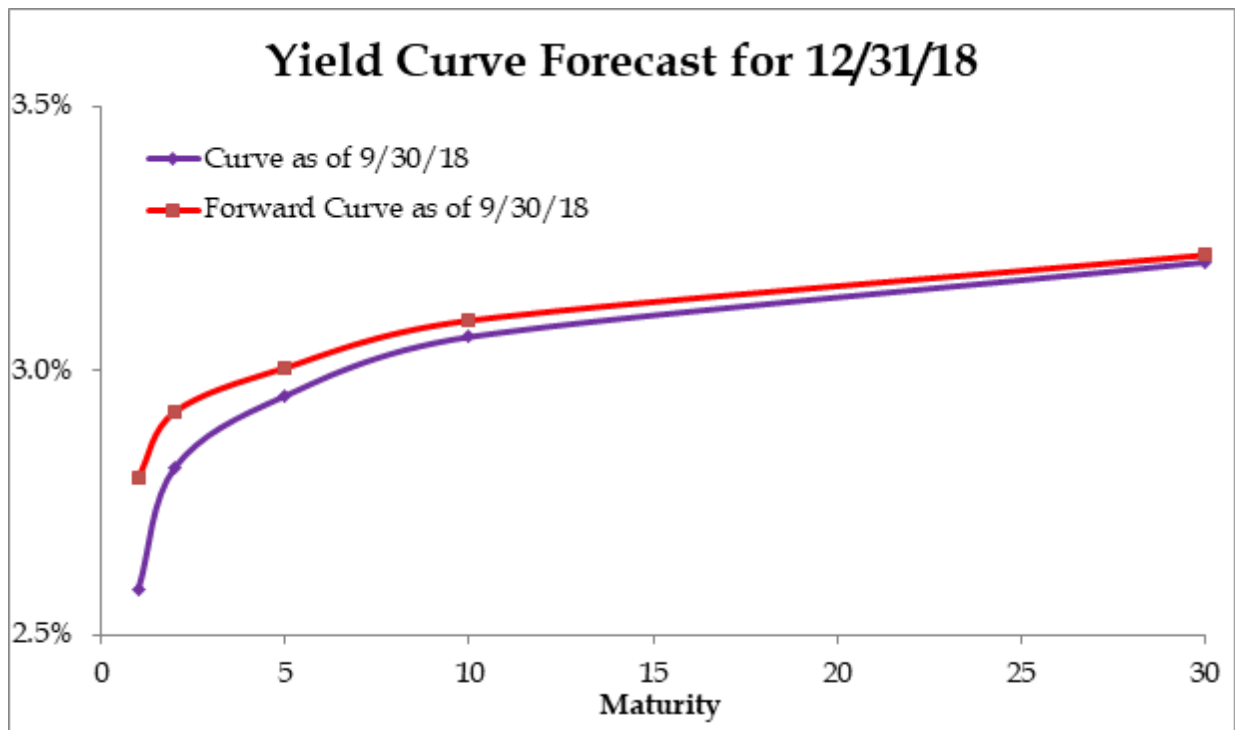
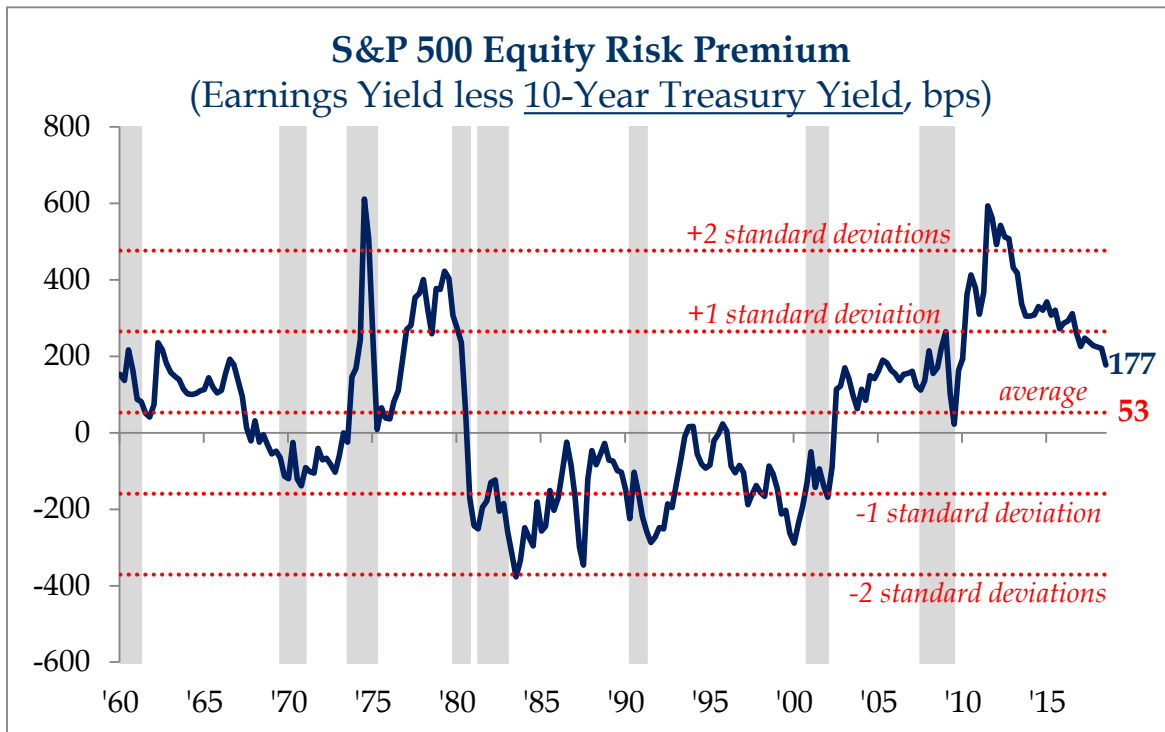
Global Earnings Dashboard

EPS Data				Growth Rates		
	<i>CY 2017 EPS</i>	<i>2018 Est. at Start of Year</i>	<i>Current 2018 Est</i>	<i>First 2018 Est. Growth</i>	<i>Current 2018 Est. Growth</i>	<i>Change (bps)</i>
Americas						
Canada	124.1	56.2	55.5	6.9%	14%	685
United States	133.5	147.4	161.7	10.5%	21.1%	1067
Europe						
Austria	13.9	13.7	14.8	-1.6%	6.4%	800
Denmark	420.2	464.7	438.0	10.6%	4.2%	-636
France	9.7	10.3	10.6	6.3%	9.3%	303
Germany	10.7	11.7	11.1	8.9%	3.5%	-545
Ireland	2.7	3.0	3.0	9.9%	9.9%	1
Italy	4.4	4.8	5.1	9.6%	16.4%	677
Netherlands	8.5	9.0	8.8	5.5%	3.0%	-254
Norway	178.1	194.7	205.8	9.3%	15.6%	627
Spain	8.8	9.3	9.3	5.7%	5.2%	-49
Switzerland	54.8	71.8	71.9	31.1%	31.3%	27
United Kingdom	144.7	150.9	161.2	4.3%	11.4%	709
Pacific						
Australia	72.2	76.1	78.7	5.3%	9.0%	365
Hong Kong	953.0	960.2	943.4	0.8%	-1.0%	-176
Japan	71.0	72.8	78.2	2.6%	10.1%	752
New Zealand	4.6	5.8	4.7	26.1%	2.8%	-2335
Singapore	119.6	132.4	137.4	10.7%	14.9%	417

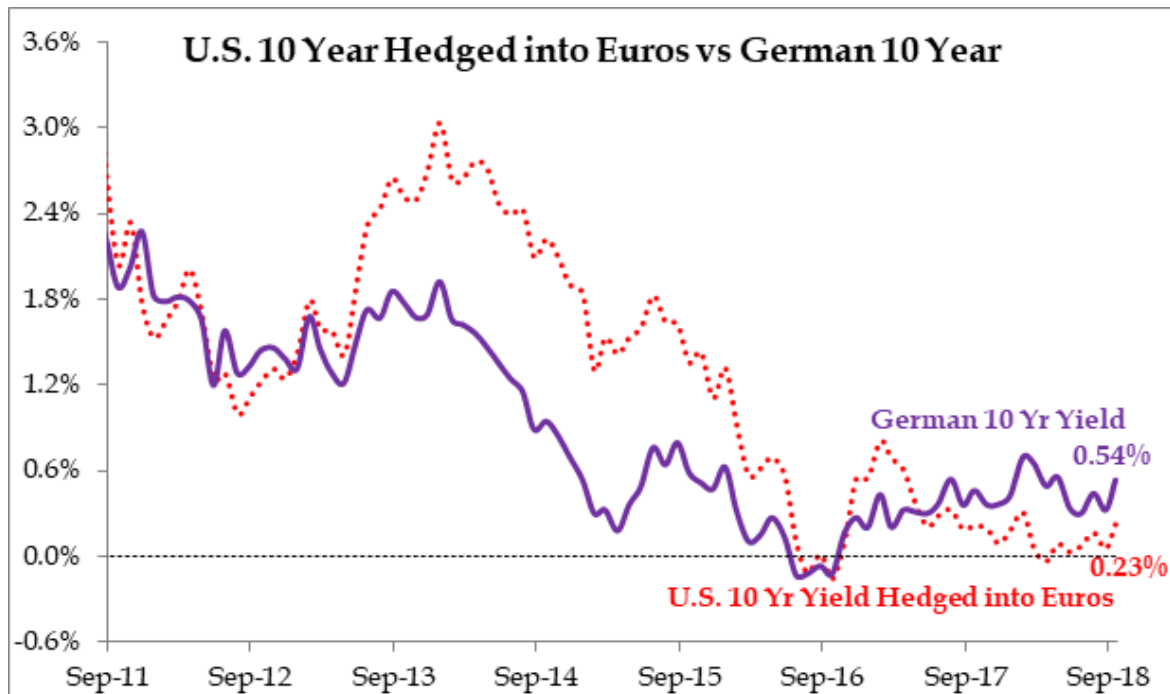
Developed Markets Dominate Loftier Valuations

International Equity Valuations - Absolute & Relative to the U.S.						
	Forward P/E	10-Year Average	Ratio	Discount/Premium to S&P 500	10-Year Average	Ratio (Sorted)
MSCI New Zealand	24.2	16.8	1.44	1.44	1.13	1.27
MSCI Czech Republic	14.7	12.0	1.23	0.87	0.81	1.08
MSCI Thailand	14.7	12.1	1.21	0.87	0.82	1.06
MSCI India	18.7	15.6	1.20	1.11	1.06	1.05
MSCI Netherlands	15.1	12.9	1.17	0.90	0.87	1.03
MSCI Norway	13.2	11.4	1.16	0.78	0.77	1.02
S&P 500	16.9	14.7	1.15	1.00	1.00	1.00
MSCI Portugal	15.6	13.8	1.13	0.92	0.94	0.98
MSCI Switzerland	16.2	14.5	1.11	0.96	0.99	0.97
MSCI Finland	16.5	14.8	1.11	0.98	1.01	0.97
MSCI France	13.6	12.3	1.10	0.80	0.83	0.97
MSCI World	15.4	14.0	1.10	0.92	0.95	0.96
MSCI Greece	12.7	11.6	1.09	0.75	0.78	0.96
MSCI Australia	15.1	13.8	1.09	0.89	0.94	0.95
MSCI Denmark	17.8	16.2	1.09	1.05	1.11	0.95
MSCI Belgium	15.9	14.8	1.07	0.94	0.99	0.95
MSCI Europe	13.4	12.6	1.06	0.79	0.85	0.93
MSCI Peru	13.3	12.3	1.07	0.79	0.84	0.93
MSCI Germany	12.4	11.8	1.05	0.73	0.80	0.91
MSCI South Africa	13.2	12.9	1.02	0.78	0.87	0.90
MSCI EAFE	13.4	13.0	1.03	0.79	0.89	0.90
MSCI United Kingdom	12.4	12.2	1.02	0.74	0.83	0.89
MSCI Chile	15.9	15.6	1.02	0.94	1.07	0.88
MSCI China	10.7	10.7	1.00	0.63	0.74	0.86
MSCI EM	10.9	11.0	0.99	0.65	0.76	0.86
MSCI Mexico	15.5	15.7	0.98	0.92	1.08	0.85
MSCI Indonesia	13.5	13.8	0.98	0.80	0.94	0.85
MSCI Italy	10.8	11.2	0.96	0.64	0.76	0.85
MSCI Canada	13.6	14.1	0.97	0.81	0.96	0.84
MSCI Hungary	9.1	9.5	0.96	0.54	0.64	0.84
MSCI Brazil	10.1	10.6	0.96	0.60	0.72	0.83
MSCI Philippines	15.8	16.5	0.96	0.93	1.13	0.83
MSCI Poland	11.1	11.7	0.95	0.66	0.80	0.82
MSCI Austria	9.6	10.2	0.93	0.57	0.69	0.82
MSCI Hong Kong	14.0	14.9	0.94	0.83	1.03	0.81
MSCI Taiwan	13.5	14.3	0.95	0.80	1.00	0.80
MSCI Russia	5.1	5.5	0.93	0.30	0.38	0.80
MSCI Singapore	11.8	13.2	0.90	0.70	0.91	0.77
MSCI Japan	12.9	14.6	0.88	0.76	1.01	0.75
MSCI Korea	8.1	9.4	0.86	0.48	0.65	0.73
MSCI Colombia	11.0	14.3	0.77	0.65	1.00	0.66

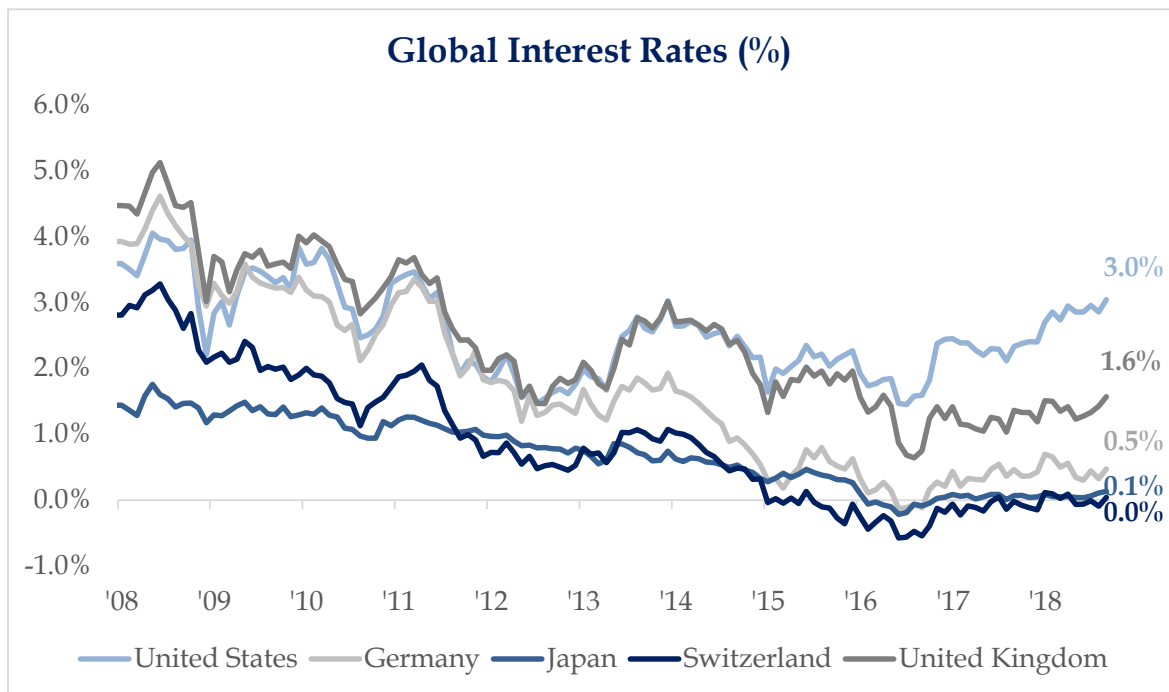
The “TINA” Trade is Over, but Equities Remain More Attractive than Bonds



Expect Volatility in the Credit Markets



Tough to Fade the Dollar When Interest Rate Differentials Remain Wide



APPENDIX – IMPORTANT DISCLOSURES

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