

FUNDAMENTAL EQUITY SMALL CAP



GREAT LAKES ADVISORS

A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY

Third Quarter 2018

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MARKET REVIEW

The Russell 2000 Index gained 3.6% in the quarter ending September 30, extending its first half gains, now standing 11.5% higher than year-end 2017. The broader market, represented by the S&P 500, hit an all-time high in September and rose 7.7% for the quarter, putting its year-to-date gain at 10.6%.

U.S. equities fared much better than most international markets. Trade tensions and the threat of U.S. tariffs pushed both emerging market equities and currencies lower; emerging markets lost about 1%, and are now off almost 10% for the full year. The Turkish market declined more than 21% in the quarter, and has been cut nearly in half in 2018, as that country continues to be plagued by both debt and currency problems. Greece has declined by almost 20% in the first nine months of the year, Brazil is off 17%, and Germany, Italy, and Spain are each down almost 10%. Lastly, the Chinese equity market has declined more than 7%, while its currency (the yuan) has lost 2.5% in value. The U.S. dollar has strengthened by more than 5% thus far against a basket of global currencies, making U.S. exports more expensive to much of the rest of the world. It is now clear that the synchronous global economic recovery has been interrupted, with the U.S. economy (at least for now) outpacing the rest of the world.

Oil prices fell 12% to a low of \$65/barrel in August, but bounced back to finish the quarter virtually unchanged at \$73.25/bbl. The yield on 10-year U.S. Treasury Notes rose by 20 basis points to 3.05% at the end of the quarter, reflecting continued strong economic growth in the U.S. as well as consistent messaging from the Federal Reserve. As widely expected, the FOMC raised the Federal Funds rate to a target range of 2% to 2.25% on September 26, drawing criticism from the President in the process. Markets continue to price in one more 25 basis point increase in December, with the outlook for 2019 calling for one to three additional hikes.

The Great Lakes Advisors Small Cap model portfolio grew 5.4% in value in the third quarter, about 180 basis points better than the Russell 2000 Index. Thus far in 2018 this portfolio has gained 9.7%, trailing the benchmark by about 175 basis points.

THIRD QUARTER ATTRIBUTION

SECTOR	GLA WEIGHTING	GLA RETURN	R2000 WEIGHTING	R2000 RETURN	ACTIVE CONTRIBUTION
Financials	15.5	-0.7	21.7	0.9	-0.1
Health Care	4.1	10.6	15.6	7.6	-0.3
Industrials	28.2	12.9	15.0	5.9	2.2
Technology	16.4	-0.4	14.2	5.2	-0.9
Consumer Disc.	16.8	12.4	13.8	3.4	1.4
Materials	3.9	-4.6	4.4	1.0	-0.2
Energy	1.3	1.7	4.3	-1.9	0.2
Real Estate	1.7	-13.1	3.8	-1.1	-0.1
Utilities	0.0	0.0	3.2	2.9	0.0
Consumer Staples	2.4	-3.4	2.5	-1.8	0.0
Comm. Services	3.8	-5.0	1.6	9.2	-0.2
Cash	5.8	0.4	0.0	0.0	-0.2
TOTAL	100.0	5.4	100.0	3.6	1.8

■ Significant underweight position relative to benchmark

■ Significant overweight position relative to benchmark

Source: GLA, FactSet. Percentages may not add to 100% due to rounding. Performance numbers are gross of fees.

It is now clear that the synchronous global economic recovery has been interrupted, with the U.S. economy (at least for now) outpacing the rest of the world.

MARKET OUTLOOK

We live in “extraordinary times.” So concluded Federal Reserve Chairman Jay Powell on October 2, addressing the 60th annual meeting of the National Association for Business Economics.

“*I am glad to be able to stand here and say that the economy is strong, unemployment is near 50-year lows, and inflation is roughly at our 2 percent objective. The baseline outlook of forecasters inside and outside the Fed is for more of the same. This historically rare pairing of steady, low inflation and very low unemployment is testament to the fact that we remain in extraordinary times.*”¹

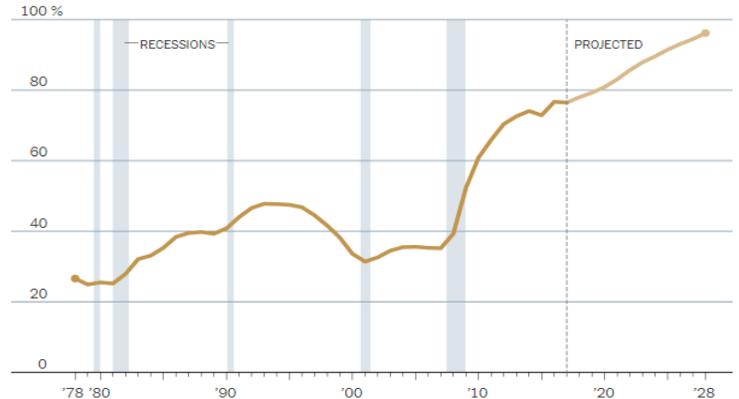
The value of the S&P 500 Stock Index has more than quadrupled since March, 2009, generating an 18.8% annual compound return for those investors brave enough to remain invested (or reinvest) at the end of the 2008-2009 financial crisis; its small cap counterpart, the Russell 2000, has compounded at almost 20%. Extraordinary times indeed.

Mr. Powell went on to say that the Fed’s “ongoing policy of gradual interest rate normalization reflects our efforts **to balance the inevitable risks that come with extraordinary times...**” (emphasis added). As stewards of our client’s capital, we constantly focus on protecting our portfolios from downside exposure. As such, there are two risks we have identified that merit discussion.

The first is trade tariffs. We are of the camp (as are a vast majority of economists²) that global free trade, while certainly disruptive and difficult at times, has made the world on balance a wealthier place. The Trump Administration’s position on global trade is at odds with conventional U.S. trade policy of the last several decades, and threatens to disrupt the benefits of free and fair trade enjoyed by most countries and their citizens. While the administration’s recent agreements with Mexico and Canada, and on-again, off-again discussions with other trading partners, may lead some to conclude this disruption will be temporary, extended discord between the U.S., China, and our other trade partners could have a significant negative effect on the U.S. and global economies.

Recently, JPMorgan concluded that “there is no clear sign of mitigating confrontation between China and the U.S. in the near-term”, and now expects we will see a “full-blown trade war” in 2019, resulting in U.S. tariffs of 25% on more than \$500 billion of imports from China.³ Should JPMorgan’s forecast come to fruition, we are likely to see further weakening of the Chinese (and other emerging market’s) currency, a stronger U.S. dollar, and continuing downward pressure on global equity and credit markets as economic growth slows around the world in response to the imposition of these taxes. The longer lasting impacts of such pressures are not factored into many investors’ corporate earnings expectations, in our opinion.

Public debt as a share of gross domestic product



Source: Congressional Budget Office

Our second concern is growing U.S. budget deficits, and the more than \$1 trillion in U.S. Treasury annual debt issuance required to finance them. Recent tax cuts, while providing at least a small boost to U.S. economic growth, have led to White House forecasts of budget deficits exceeding \$1 trillion starting next year and into the foreseeable future. The Congressional Budget Office estimates that in five years the United States may pay more in interest payments on its debt than it spends on military programs.

We will not fill this space with a litany of reasons why excessive government deficits might harm longer-term economic growth. Suffice it to say that we believe we should be reducing debt, not growing it, during a period of “extraordinarily” good economic fortune. We are bewildered that the Trump Administration is using loose fiscal policy to stimulate the economy at the same time as the Federal Reserve is tightening monetary policy. We think it’s more prudent that the Treasury reduce government debt during times of prosperity, replenishing borrowing capacity for a time in the future when it might once again be needed to help restore economic prosperity. We may be witnessing a rise in longer-term interest rates (the 10-year Treasury note yield hit 3.24% on October 5) in part because fixed-income investors are growing concerned with the huge slate of government borrowing coming in 2019.

Equity markets appear benign today, and most U.S. equity indices are at or near all-time highs. Investors are bullish on growth, and (as Mr. Powell noted) are embedding similar expectations in asset prices in the current environment. We would hope our style of investing, placing value on high returns on invested capital, prudent capital structures, abundant free cash flow, and goal congruence with management, would weather any economic dislocation relatively well. We find this approach to be both wise and attractive, and appreciate your continued confidence in Great Lakes Advisors.

For more information, please contact us at:
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1. *Monetary Policy and Risk Management at a Time of Low Inflation and Low Unemployment*, October 2, 2018 speech by Federal Reserve Chairman Jerome H. Powell at the "Revolution or Evolution? Reexamining Economic Paradigms" 60th Annual meeting of the National Association for Business Economics, Boston, Massachusetts.
2. See, for example, responses to a 2012 survey conducted by The Initiative on Global Markets at the University of Chicago Booth School of Business <http://www.igmchicago.org/surveys/free-trade>
3. JPMorgan note (Pedro Martins Jr, Rajiv Batra and Sanaya Tavaría) to clients October 3, 2018.

The data in the attribution table represent the returns for each sector and the gross returns for a representative composite account for one quarter ending the current calendar quarter. Individual account returns may vary.

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