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Firm Inception 08/03/10

11/07/18

Quarter in Review

The Markets

Tariffs continued to grab the headlines this quarter, with US targeting \$34 billion Chinese products in the beginning in July and another \$16 billion two weeks afterwards. In August the President considered raising the tariffs on \$200 billion Chinese goods from 10% to 25%. In late September the administration did announce a 10% tariff on 5,000 Chinese products. This tariff would be raised to 25% at the beginning of 2019. Barclays took a look at the GDP implications for both countries in their *US Outlook* piece. It stated that if a 20% tariff was put in place bilaterally, it would probably reduce U.S. GDP by something close to 0.2% and 0.4% for China. Thus, the cost of protectionism isn't that great, and mainly because it is only between these two countries. I think that the cost to reshuffle companies' supply chains could be substantial though and we probably won't see its direct affect to GDP compared to the inflationary pressures to the consumer.

In other domestic news, the supreme court nomination to fill Anthony Kennedy's position divided our nation once again with accusations of sexual misconduct. The travesty of this situation is there weren't any winners, or justice done, and both Mrs. Ford and Mr. Kavanaugh look like they were used by the political engine of both parties to increase voter turnout in November. In late July Facebook reported rather disappointing results triggering an after-hours sell off of 24%. Facebook shares were down 23% for the third quarter 2018. Like the President, twitter seems to be Achilles' heel of most CEOs. Elon Musk, tired of analyst questions on profitability, resorted to twitter to espouse his desire to take the company private at a price of \$420 a share on 08/08/18. The stock price rose 11% on the day of the announcement. Investigations ensued by the SEC and eventually he settled for \$40 million and the loss of his chairmanship of Tesla. Coke and Pepsi also made news this quarter diversifying their product lines with the purchase of Costa Coffee and Sodastream. Hurricane Florence, a category 1 on landfall, caused most of its damage to the lower east coast because of its slow movement and large amounts of rain in early September. About \$14 billion in property damage was assessed with only a quarter of that insured. The effect on jobs though seemed muted looking at initial claims data for the time period directly after. With only four of the seven Federal Reserve board members occupied, the president nominated Nellie Liang, a senior fellow at the Brookings institute, on September 20th. With Michelle Bowman and Marvin Goodfriend already nominated for positions five and six, it could be months before her confirmation hearing happens. The senate needs to move on these as the current board members are stretched very thin. For example, Lael Brainard now serves on five of the seven committees and chairs four. Lastly the Fed raised interest rates another 25bps in September to a range of 2% to 2.25%. The effective rate is closer to the higher end of this range at 2.18%



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Internationally the quarter began with the President traveling to Europe to once again demand members of NATO comply with the 2014 agreement that countries spend 2% of the annual GDP on defense spending. From a *Forbes* article entitled “Defense Expenditures of NATO Members visualized” on 07/10/2018, there are only 5 nations meeting the 2% requirement. As of 2017 the US spends roughly 3.6% of GDP or 685 Billion dollars. The UK, which spends \$55 billion or 2.1% of their GDP, is second. Why push this? If NATO nations spend more on defense it probably will be with domestic or European contractors and not US. But Russia’s annexation of Crimea was a very good example of what a reduced European military spend and readiness could cost those countries in the future. In August the US imposed new sanctions on IRAN stopping them from buying us banknotes, and curtailing their auto industry and the US import of Persian rugs and Pistachios. Nationalism and populism seem to be gaining ground politically. Following the Italian election in March, the Sweden Democrats garnered 12.9% of the vote, with such issues as immigration, healthcare and integration on the top of voters’ minds. As of the writing of this review, Angela Merkel, the Chancellor of Germany and leader of the CDU since 2000 said she will not seek reelection to the head of the party in December 2018 or Chancellor in 2021. With CDU losses of over 10% in the Bavarian and Hessian state elections, and rise of the AfD (a right-wing party) on the immigration issue has become front and center not only in Germany but across European.

In corporate news Google was fined \$5 billion dollars in an Android antitrust case by the European Union in July. This didn’t help the possibility of the US placing tariffs on EU car companies, but that hasn’t come to fruition. In the end of September Comcast finally out bid Fox for Sky PLC in an over the weekend three round secret auction \$22.58 vs. \$20.47 a share, ending a ten-month bidding war. Saudi Arabia also formally put on hold their initial public offering of Aramco at the end of August, instead settling for the purchase of the petrochemical company Sabic.

Q3 2018 saw multiple currencies depreciate. The Venezuela Bolivar is essentially worthless as the country continues to struggle with hyperinflation, power cuts and food and medicine shortages. The situation is quite dire and over 2.3 million Venezuelans (almost 7.5% of the total population) have left the country with almost equal amounts of immigration between the US, Spain and other Latin American countries. The Argentinian Peso fell over 30% to the dollar in the third quarter, even after the agreement from the IMF to receive \$50 billion in funding. With new austerity measures being put in place at the time of this write up, riot police have fired rubber bullets in to crowds of antigovernment protestors outside of congress. The third worst performing currency this quarter was the Turkish Lira, down over 24%. With a high current account deficit and external debt service of close to 30% of their GDP, coupled with inflation greater than 15% per annum, and the changing of central bank law in mid-July, the Lira experienced a substantial sell off. Economist don’t see a major rebound unless structural changes are put in place.



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In Markets, large cap growth remained the best performing area for the quarter up over 9%, and over 17% for the year. In fact, growth in general this year has outperformed value by three to four times. It has been rough sledding for us value guys. In the fixed income space, as expected shorter duration assets outperformed longer ones as the Fed increases interest rates. Even though the curve is flattening, the rise in the back end is enough to have the Barclays Long Government Corporate index down 0.46% for the quarter and 5.41% YTD. High Yield and short T-Bills are the only sector in positive territory, up 2.57% and 0.48% for the quarter. Alternatives, Real Estate and Commodities were up 1.1% and 1.18% for the quarter respectively and 6.6% and 7.23% for the year. The sectors that have taken the most pain outside of long bonds have been foreign stocks, developed and emerging sectors were up 1.27% and down 0.71% for the quarter but down 2.95% and 7.29% for the year.

Interest Rates

The Federal Reserve increased the target range for the Federal Funds rate by another 25bps in September to 2.00% - 2.25%. The effective rate has averaged 2.19% since the increase, closer to the higher bound. The quarter was different than Q2 in that we got an almost perfect parallel shift in the amount of the Fed's increase. The curve did in fact flatten though, the difference between the 2-year treasury rate and the 10-year rate went from 33bps to 24bps. In looking at the past five recessions, the curve inverted one to two years prior to the recession. So yes, it is a good leading indicator but not necessarily *the* reason to dump risk assets when it happens. We also need to remember that treasury is reducing its balance sheet. From November of 2017 until now the balance sheet has shrunk by about \$300 Billion dollars or 7%. The plan, which started in Q4 2017, was to reduce the balance sheet by \$10 billion a month, growing to \$50 billion a month. With different bonds maturing at different times this hasn't been as smooth at \$10 billion a month. The variability has ranged from adding \$11 billion in December 2017 to reducing it by \$63 billion in August of this year, with the average being a reduction of \$25 billion per month. To get to the target of \$2.5 Trillion on balance sheet with a \$600 Billion per year (\$50 billion per month average) it will reach its target sometime in the summer of 2021... The reason this is somewhat problematic is that the Fed will probably have stopped raising the funds rate sometime at the end of next year, targeting 3.125% neutral rate. But the balance sheet will continue to unwind, tightening monetary conditions more at the exact same time we could be entering a recession. Now my belief is that if a recession were to hit, the Fed would suspend the bond selling program, and if we were to enter into a severe recession they would once again purchase.



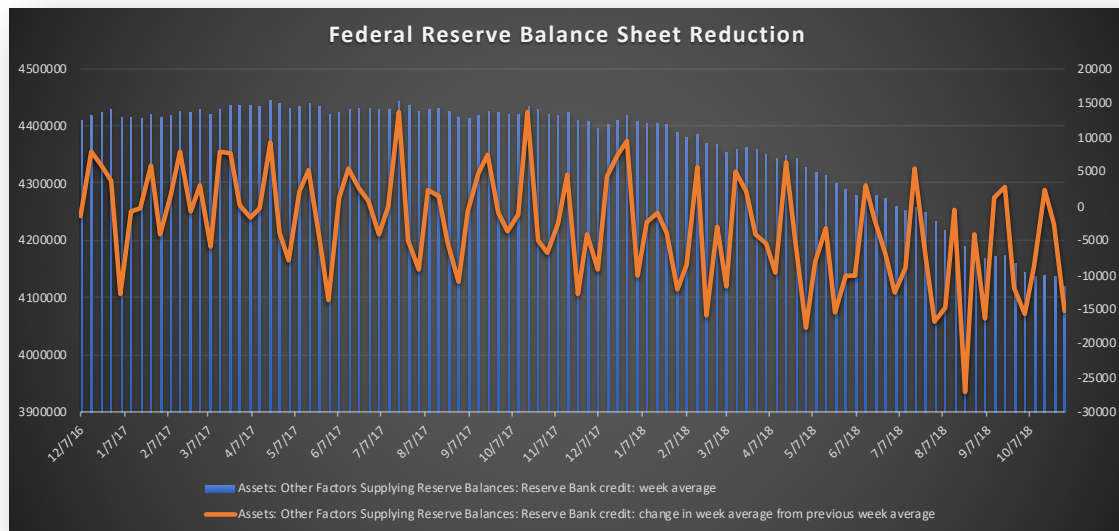
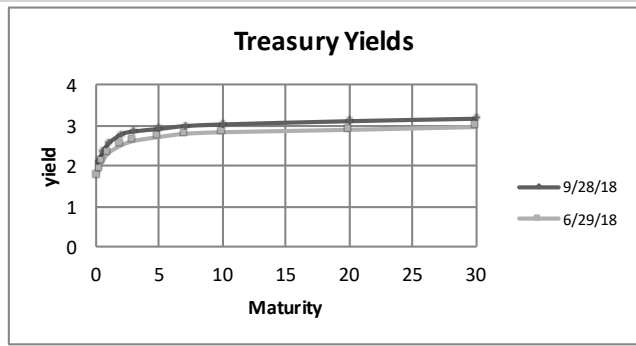
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Years	9/28/18	6/29/18	Difference
0.08	2.12	1.77	0.35
0.24	2.19	1.93	0.26
0.5	2.36	2.11	0.25
1	2.59	2.33	0.26
2	2.81	2.52	0.29
3	2.88	2.63	0.25
5	2.94	2.73	0.21
7	3.01	2.81	0.2
10	3.05	2.85	0.2
20	3.13	2.91	0.22
30	3.19	2.98	0.21



The Primary Mortgage Market Survey from FHLMC showed the 30-year conforming balance fixed rate mortgage has ticked up over the quarter from 4.55% to 4.72%. 15-year conforming balance moved up more from 4.04% to 4.16%. As this report has taken a little longer than anticipated, the Mortgage Bankers Association information is a little more current than Q2. As of 10/31/18, 30-year conforming balance FRM are 5.11 with .50 points, while jumbos are 4.94 with .28 pts. 15-year conforming balance FRMs are 4.55% with .51 points. With the Fed probably raising rates one more time in December look for mortgage rates to be closer to 5.25% by year end.



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Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) stood at 111.8 for the quarter ending September 2018. 80% of the factors positively contributed to indicator. This time Average Consumer Expectations for Business contributed the most followed by ISM New Orders again. The leading credit index wasn't far behind. Building permits were the only detractor, as it has been reported of a slowdown in housing construction. These are good numbers and not showing signs of a recession around the corner.

Last quarter I wrote about how housing was watched closely by economists, but this needs a bit of clarification. As reported by the National Association of Homebuilders, Residential investment (construction of new single-family and multifamily structures, residential remodeling, production of manufactured homes, and brokers' fees) averages about 3% to 5% of overall GDP. But Consumption spending on housing services (includes gross rents and utilities paid by renters, as well as owners' imputed rents and utility payments) makes up much more, 12-13% of GDP. So as new construction slows this won't affect the economy as much as decreased in real and imputed rents. Imputed rents are a discussion topic for another time, but not something that is actually received, instead estimated as the difference between home ownership costs and the rent that would have been received if the owner was renting the home.

Jobs

At the time of this write up, **nonfarm payrolls** posted an increase of 250,000 jobs for October (consensus was 193k). I know that isn't in the third quarter. In fact, Q3 had an average add of 190k jobs, compared with 217k and 218k for Q2 and Q1 respectively. Down, but definitely in-line with consensus expectation. The Household survey was up 600k for October (420k for September) and enough to keep the unemployment rate at 3.7% which was what it was in September, down two tenths of a percent. We haven't seen unemployment numbers like this since 1969... most of you reading this weren't born yet. The labor force participation rate was 62.7 in September, the average for the year. The median duration of unemployment is below 10 months and has been since October of last year. The long-term average is about 9 months. Aggregate weekly hours work index is the highest it's been since the first recording in March 2006 before the recession. Temporary help services also continue to expand, this is one of the first red lights when it starts to contract.

The ISM survey for manufacturing jobs hovered around 58 for the entire quarter, a couple points above the Q2 average, still in the expansion phase. The average manufacturing employment in the BLS survey was 17k jobs added per month, weaker than Q2 but still expanding. The jobs reports and its numbers show a good economy expanding.



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Industrial production

Q3 Industrial production numbers were up 0.95% and there was a revision to Q2 from (1.22% to 0.95%) These aren't terrible revisions but definitely substantial from quarter to quarter. Over the past 12 months though IP grew at a rate of 5.1%. Now the bulk of this coming in Q4 2017, so unless we get a large Q4 number this time around expect it to slow to something closer to the mid 3% area. Mining has been the biggest gainer advancing about 24% since 2016 supported by gains in oil and gas. But capacity here is at 92.1%, unlike manufacturing which stayed near 76% since April of this year.

With the revisions each quarter this year has been a growth quarter, as IP has outperformed inflation. Hurricane Florence hurt September's numbers by only 0.1%, and Hurricane Michael will probably do so as well as 40% of the Gulf oil production shut down. All in all, these are still good numbers.

Housing

Single-family new home sales were 553,000 units per year as of September 2018, compared to a Q3 2017 average of 583,000 and a Q2 2018 average of 632,000. This slowdown is somewhat to be expected as the rise in mortgage rates coupled with the affordability issues are not boding well for home sales. **Existing home sales declined to 5,150,000** on an annual basis ending September, showing another slowdown. The S&P/Cash Schiller 20 city composite index has risen 5.49% in the twelve months ending Aug 2018. This is almost a full percentage point below the May number. **Westcoast cities like Portland, San Diego, San Francisco, and Seattle showed negative month over month price changes.** As state above the housing slowdown is not great but shouldn't have the same effect on the economy as it did during the last recession.

The Consumers

The **Conference Board's consumer confidence index stood at 135.3 as of September 2018.** These are the highest numbers seen since the fall of 2000. Those surveyed said current business and labor conditions improved, as well as the future business conditions. **University of Michigan's Consumer Sentiment number was 100.1 in September, off from the 101.4 of March, but the highest print since then.** Anyone that reads the report has noticed a distinct tilt or reporting of the surveyed to encompass political affiliation and the bias it seems to be correlated with. An interesting report was written about this by Richard Curtin (http://www.sca.isr.umich.edu/files/ciret2018_curtin.pdf), delving into the question of the efficacy of the survey because of it. Unfortunately, the survey hasn't consistently recorded political affiliation over its life. Enough to take a look at in the papers over multiple presidencies, but not enough to come to a conclusion. Both the



Conference board's and the University of Michigan sentiment statistics have long been taken with a grain of salt by the investing community. As has been observed from recent political polls, surveys and their statistical reliability as a leading indicator is not relied upon as much as it once was.

Personal income and outlays continued to expand at an annual rate close to 5% across multiple categories. **Real Personal Income less transfers expanded at a 2.41%** year over year ending September. The savings rate continues to fall and currently stands at 6.2%. Consumer debt continues to expand at a 4.68% rate in September with both revolving and nonrevolving expanding at similar paces. The consumer now has more credit card debt than they did prior to the recession, and most of them have large student loan debt as well. But taking a look at the FRBs Household Debt Service and Financial obligations Ratios page reveals a picture much better than before the recession. It shows household debt service payments and financial obligations as a percentage of disposable personal income. **For example: in Q4 of 2017 the total debt service ratio was 13.23% (7.22% for mortgages, and 6.01% for consumer debt). As of Q2 2018 the total is 9.84% (4.24% for mortgages and 5.60% for consumer debt).** The issue with this is that the data set has limitations, like assuming required minimum payments of 2.5% for revolving debt. Also closed end debt, like auto loans or school debt is calculated based on average interest rates for each major category. Problematic in that it isn't a perfect representation of the credit quality of the underlying assets. However, in the Q2 2018 case the quality of the assets in general are better, loans and credit cards made to high quality borrowers than in the past. Meaning that the Q4 2007 numbers may have been somewhat understated, whereas the Q2 2018 may be somewhat overstated. In general, the consumer looks less burdened by housing debt, which in an economic downturn means the population is more flexible in their housing choices. A good thing for both the overall economy and the housing market. The consumer doesn't look under undue stress here.

Inflation

As of September, CPI was up 2.27% over the past twelve months, and is climbing. PCE was up 1.99% and the GDP Deflator was up 2.36% over the same time period. Definitely cooler than Q2, but still right near the Fed's target.

The seasonally un-adjusted numbers that the BLS reports showed Food up 1.4%, Energy up 4.8%, Shelter up 3.3%, transportation services up 4.0% and Medical care services up 2.0% over the past twelve months. The main detractors were in the Energy Services (-1.2%) and Used Cars (1.5%). Used car prices however were down mainly due to a change in the methodology at the BLS, while looking at Manheim and NADA data showed much more solid numbers. Thus, the dip in CPI could reverse in October, but inflation doesn't look out of control as wage pressures are pretty subdued as well.



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In Closing

We are now **111 months** into an economic expansion with the **average expansion being 42 months** (and the longest being 120 months) for the past 33 cycles.

The yield curve flattened slightly but for the most part made a 20 to 25bps parallel shift upwards during the third quarter of this year. One more hike is expected this year and then another three next year, with an eventual target neutral rate somewhere above 3%. The LEI was up again and eight out of ten segments reported positively. Industrial production was revised for Q2 and was up 0.95% in both Q2 and Q3 of 2018, but is still in good territory. The one dark, say slighting grey spot, in the report is housing. It seems to be slowing both in production and price appreciation. The effect on the overall economy, like tariffs with China will be a drag but not something that should derail the expansion. The consumer has surpassed their prerecession debt levels, but as a percentage of income the ratio is far from pre-crisis levels. Wages seem to be rising, albeit slowly, and inflationary pressure exists but seems managed.

I adjusted the security selection in some of the 401-Ks and 529 plans (using the second and final bullet for the year) in Q3. Seeing the limited effect the tariffs have had on the economy I felt it was ok to go ahead and change the allocation with only two months left in the year. Performance was exactly the same for Q2 and Q3 up 1.7% across all the portfolios. We are trailing the portfolios' targets in the majority of the portfolios as the small and mid-cap value allocation hasn't produced the type of returns its growth counterparts have. Large Cap and/or Growth Sectors of the US equity market were the better place to be in the third quarter, while staying away from emerging market equities and global bonds was also smart. The economy is not showing signs of recession, and my model is only showing a 16% chance for it. I am still sticking with my view that we are 9 months or more away from a recession. Let's hope history repeats itself and the third year of a presidential term is a great year for equities.