CLS's

WEEKLY 3

What You Need to Know About the Markets

AUGUST 20, 2019

1 **As the U.S.-China trade war continues to concern investors, find out what we expect going forward.**

2 **Yield curve inversions have historically indicated recessions, but that might not be the case this time.**

3 **The coexistence of direct indexing and ETFs can lead to better investment solutions.**

Week in Review

Stocks took a hit last week, as global economic growth and the ongoing U.S.-China trade war weighed heavy on investors. U.S. stocks fell by more than 1%, with large-caps faring better than small-caps.

Overseas, international developed stocks fell by more than 1% while emerging market stocks dropped 1%. Bonds rallied higher as investors sought safety, and the yield on the 10-year U.S. Treasury fell by 19 basis points to yield 1.55%.

Joe Smith, CFA

Deputy Chief Investment Officer

Joe Smith specializes in quantitative research, risk management, and ETF due diligence. He serves as Senior Market Strategist for the CLS AdvisorOne International Equity Fund, CLS's Thematic Growth Strategy, and CLS's Core Plus ETF Strategy.

Prior to joining CLS in 2015, Mr. Smith worked at Russell Investments where he served as an Analyst responsible for asset allocation research, portfolio construction, optimization design, and risk management research. He later joined Russell ETFs as Manager of ETF Product Development and Research, a role in which he developed quantitative indexing strategies implemented as ETFs. Mr. Smith also worked for Charles Schwab Investment Management as a Senior Product Specialist supporting product management activities for the Schwab ETFs fund family. In addition, he worked for CLS during the summer of 2014 as an Investment Analyst.

Mr. Smith received his Bachelor of Science degree in Economics from the University of Washington. He later received his Master of Business Administration from the Tepper School of Business at Carnegie Mellon University.

Mr. Smith holds the Chartered Financial Analyst (CFA®) designation and is a member of the CFA Society of San Francisco, Pittsburgh, and Nebraska. He is also a member of the Society of Quantitative Analysts and the Quantitative Work Alliance for Applied Finance, Education, and Wisdom.

Did you know? In grad school, Joe spent 40 days in nine countries.

Market Performance *(as of 8/17/2019)*

Fixed Income	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	LAST WEEK
Cash Equivalent[1]	+0.48%	+0.90%	+1.44%	+2.30%	+1.48%	+0.28%	+0.04%
U.S. Investment Grade Bonds[2]	+3.96%	+3.31%	+3.07%	+10.02%	+8.78%	+2.51%	+0.95%
Equities	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Global Equity Market[3]	+8.83%	+5.67%	+8.34%	+0.45%	+12.00%	-3.53%	-1.20%
Total U.S. Market[4]	+13.51%	+10.05%	+11.92%	+3.01%	+16.89%	-1.67%	-1.03%
Domestic Large-Cap Equity[5]	+13.43%	+10.65%	+12.67%	+4.11%	+16.60%	-1.25%	-0.89%
Domestic Small-Cap Equity[6]	+12.31%	+6.64%	+7.29%	-8.03%	+13.31%	-4.01%	-1.03%
International Equity[7]	+5.07%	+1.56%	+4.84%	-2.62%	+6.85%	-5.75%	-1.40%
Developed International Equity[8]	+5.27%	+1.73%	+4.94%	-2.87%	+8.41%	-5.21%	-1.54%
Emerging Market Equity[9]	+4.45%	+0.93%	+4.63%	-1.39%	+2.28%	-7.39%	-0.98%
Diversifiers	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Diversified Alternatives[10]	+3.30%	+0.24%	+1.25%	-0.07%	+3.34%	-0.45%	-0.20%
Commodity[11]	-4.45%	-8.52%	-2.14%	-5.34%	+1.55%	-3.34%	-0.80%

[1]Morningstar Cash Index [2]Barclays Capital U.S. Aggregate Bond Index [3]Morningstar Global Market Large-Mid Index [4]Morningstar U.S. Market Index [5]Morningstar U.S. Large Cap Index [6]Morningstar U.S. Small Cap Index [7]Morningstar Global ex-U.S. Large-Mid Index [8]Morningstar DM ex-US Large-Mid Index [9]Morningstar EM Large-Mid Index [10]Morningstar Diversd Alt Index [11]Bloomberg Commodity Index.

1 U.S.-China Trade War – What Now?

Markets were choppy last week as uncertainty over economic growth and the impact of the ongoing trade war between the U.S. and China weighed heavily on investors. Leading up to the week, market pundits and experts had been debating how the latest round of proposed tariffs, to begin in September, could negatively impact revenues for U.S. companies, including technology companies, such as Apple and Cisco.

By mid-week, some of those concerns had been alleviated as the U.S. announced it would hold off on additional tariffs until December. Sentiment was again impacted as China responded harshly to the U.S.'s latest moves, but China later agreed to meet the U.S. halfway on future trade negotiations. With so much jawboning on trade between both parties, the long-term impact of a deal, if one ever goes through, remains unclear.

At CLS, we see a resolution to the trade war as being positive for markets. We also believe (as do a few others out there) that emerging market (EM) stocks will be much bigger winners than U.S. stocks from an expected return standpoint over the next 10 years. When considering factors such as relative valuations and interest rate differentials around the world, we believe EM stocks overall are poised to produce annual returns 6% to 8% higher than those of the U.S. A resolution on trade will be a net positive for your bottom line, but even more so if you are a global investor.

Capital Market Assumptions
(Long-term return expectations)

	CLS	RAFI
U.S. Stocks	**2.36%**	**2.56%**
International Stocks	4.04%	7.35%
Emerging Markets	**9.00%**	**9.07%**
Bonds	2.30%	1.99%
As of Date	7/31/2019	7/31/2019
Outlook (Years)	10	10

Sources: CLS Investments, Research Affiliates.

2 Reading into an Inverted Yield Curve

Yields and interest rate policy were front and center last week as U.S. Treasury yields ground to some of their lowest levels in 2019. Bonds have largely been in rally mode on concerns over the U.S.-China trade war and the future of U.S. and global economic growth. This has resulted in a relatively flat yield curve – yields between two-year and 10-year Treasuries have inverted, and 30-year Treasury yields hit their lowest levels ever.

Although inverted yield curves have historically been precursors to slowdowns or recessions, there are multiple indicators to suggest that may not be the case just yet. First, on the inflation front, the latest reading in the core Consumer Price Index (CPI) was just above 2.2%, suggesting inflation may be running near or at the Fed's desired target. Second, manufacturing and service PMIs are still reading above 50, levels that suggest continued expansion. Third, consumer confidence remains at its highest level of 2019.

If the data is so good, then what does the bond market picture mean for CLS portfolios? Variability in interest rates is a primary reason that we manage fixed income assets using active fund options, per our Be Active investment theme. Active managers generally have greater flexibility in bond portfolios, and they are in the best position to carefully navigate interest rates as they continue to evolve in real time. In addition to this, the CLS Portfolio Management Team largely supports maintaining a shorter-duration profile in CLS portfolios to limit the influence of interest rate swings.

Although the U.S. Federal Reserve may be enticed to further reduce short-term interest rates, we believe investors should not necessarily read the latest movements on the bond markets as signals that an economic recession is imminent.

3 Why Direct Indexing and ETFs are Better Together

Direct indexing is the latest disruption in the financial advising industry. Not just about tracking stocks held in an index within a given risk band, direct indexing represents opportunities for advisors to deliver personalized portfolios for each client, including portfolios that are uniquely tax-managed.

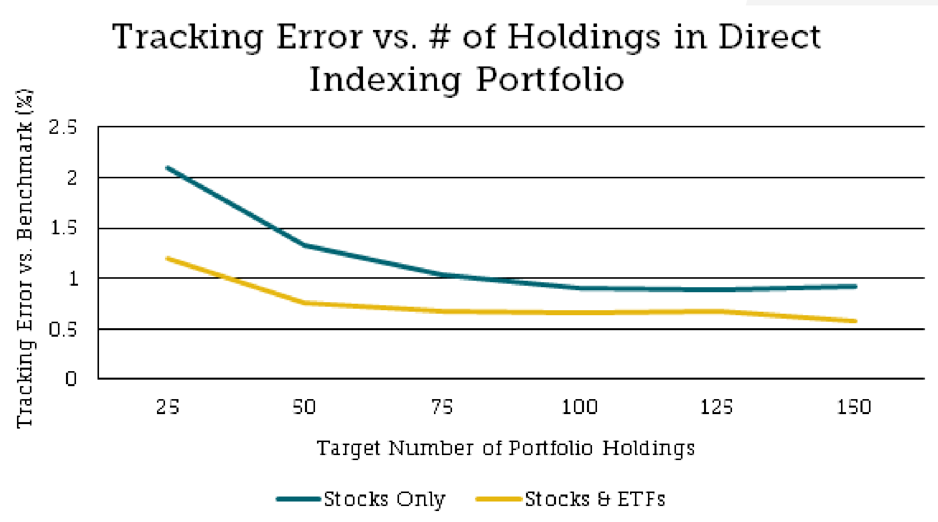
Earlier this year, at the annual Inside ETFs conference in Florida, Inside ETFs Chair Matt Hougan described direct indexing as, potentially, "the next $100 billion opportunity for advisors" that could disrupt and upend the ETF industry. ETFs are widely considered an effective implementation of passive investing with improved tax efficiency (achieved by limiting taxable events inside the fund). However, many believe direct indexing could produce outcomes that are more unique to each client and more consistent with the financial plans that have been created for them.

There is a strong case for direct indexing and ETFs to coexist in order to deliver even better investment solutions. Many direct-indexing offerings currently available are reserved for clients with sizable investable assets. That's because of implementation challenges that can make direct indexing hard to scale and efficiently manage through time. However, direct indexing can be made more widely available by bringing ETFs into the mix.

To demonstrate this, we evaluated the implementation of a hypothetical $100,000 direct-indexing portfolio benchmarked to the holdings of a U.S. large-cap ETF (the iShares Russell 1000 ETF). We then assessed how much incorporating sector and smart beta ETFs can improve risk-management and found that including ETFs in smaller accounts, as opposed to owning individual stocks, can make risk-management easier.

As illustrated in the chart below, the results clearly highlight how much risk is reduced by including ETFs in the implementation of a direct-indexing portfolio. There is about a 35% reduction in risk relative to the market benchmark intended to be tracked. This result means that direct indexing as a value-add solution is within the grasp of a much wider population of investors – not just those with sizable account balances.

We believe that direct indexing has a bright future, and it is even brighter with ETFs. Combining ETFs with direct-indexing solutions creates greater opportunities for advisors to deliver more customized, tax-sensitive options to their clients without having to stick to a more generic answer in their portfolios. Our use of ETFs in direct-indexing portfolios at CLS is consistent with how we believe investors should approach any investment problem – by taking a risk-first approach to ensure long-term success.



Sources for analysis: iShares.com, Northfield's Managed Account Rebalancing Service (MARS), and Orion's Advisor Strategy and Tax Return Optimization (ASTRO) tool. Benchmark in analysis is defined as holdings for iShares Russell 1000 ETF. Risk model and expected tracking error analysis based on Northfield's multi-asset Everything-Everywhere (EE) Model. As of August 15, 2019.

The Morningstar Global Market Large-Mid Index is an index that measures the performance of the global market's equity markets targeting the top 90% of stocks by market capitalization. The Morningstar U.S. Market Index is an index that measures the performance of U.S. securities and targets 97% market capitalization coverage of the investable universe. It is a diversified broad market index. The Morningstar U.S. Large Cap Index is an index that measures the performance of U.S. large-cap stocks. These stocks represent the largest 70% capitalization of the investable universe. The Morningstar U.S. Small Cap Index is an index that measures the performance of U.S. small-cap stocks. These stocks fall between the 90th and 97th percentile in market capitalization of the investable universe. In aggregate, the Small Cap Index represents 7% of the investable universe. Morningstar Global ex U.S. Large-Mid Index is an index that measures the performance of Global Markets (ex-U.S.) equity markets targeting the top 90% of stocks by market capitalization. The Morningstar DM ex U.S. Large-Mid Index is an index that measures the performance of developed markets ex-U.S. equity markets targeting the top 90% of stocks by market capitalization. The Morningstar EM Large-Mid Index is an index that measures the performance of emerging markets targeting the top 90% of stocks by market capitalization. The Barclay's Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. The Morningstar Cash Index is an index that measures the performance of a Treasury Bill with six to eight weeks until maturity in the U.S. market. The Bloomberg Commodity Index is made up of exchange-traded futures on physical commodities and represents commodities that are weighted to account for economic significant and market liquidity. This index provides investors with a means of understanding the performance of commodity futures markets and serves as a benchmark for investment performance of commodities as an asset class. The volatility of the indexes may be materially different from the individual performance attained by a specific investor. In addition, portfolio holdings of investors may differ significantly from the securities that comprise the indexes. You cannot invest directly in an index.

The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000 Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. An index is an unmanaged group of stocks considered to be representative of different segments of the stock market in general. You cannot invest directly in an index.

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