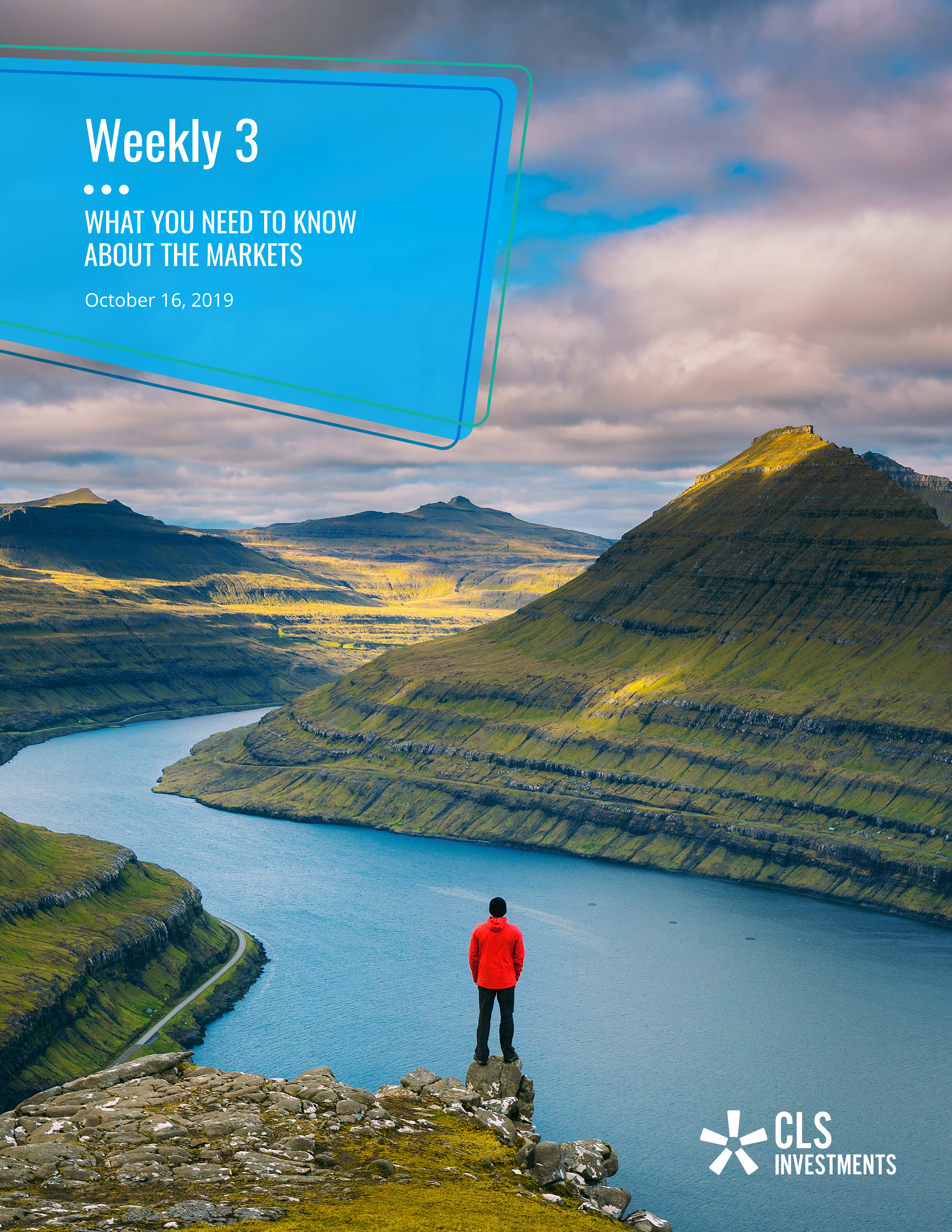
Weekly 3

WHAT YOU NEED TO KNOW
ABOUT THE MARKETS

October 16, 2019



CLS INVESTMENTS

Week in Review

Continued trade tensions with China resulted in a volatile, but positive week for U.S. equity markets. Concerns about escalating trade tensions early last week all but disappeared as the week came to a close amid rumors that a partial resolution had been reached. The S&P 500 Index finished slightly positive, gaining less than 1%.

Despite continued weakness in global economic data, bond yields rose, with two-year treasury and 10-year treasury yields rising by nearly 20 basis points. This proved to be a headwind for interest rate sensitive sectors like utilities and REITs. On the positive side, materials, industrials, and information technology were the best performing sectors for the week. Within domestic equities, value bested growth and small-cap stocks outperformed their large-cap counterparts.

International markets were mixed with developed markets outperforming the U.S. driven by strong returns within Europe. Emerging markets lagged as Turkey dragged on broader indices. Improving oil prices helped buoy the commodity markets, which rose nearly 1% during the week.

1 *Does the latest yield curve inversion mean a recession is imminent? Our advice to investors: don't panic.*

2 *A breakdown of the potential consequences of limiting U.S. investment into China*

3 *We're helping you to understand what is arguably the greatest potential benefit of direct-index investing.*

Market Performance

as of 10/12/2019

FIXED INCOME	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	LAST WEEK
Cash Equivalent[1]	+0.51%	+0.96%	+1.53%	+2.30%	+1.79%	+0.07%	+0.04%
U.S. Investment Grade Bonds[2]	+3.73%	+3.12%	+3.04%	+10.50%	+8.23%	-0.27%	-1.03%
EQUITIES	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Global Equity Market[3]	+8.40%	+7.63%	+10.25%	+8.67%	+16.29%	+0.17%	+1.25%
Total U.S. Market[4]	+13.02%	+11.35%	+13.55%	+10.67%	+20.23%	-0.14%	+0.68%
Domestic Large-Cap Equity[5]	+13.05%	+11.78%	+14.38%	+11.14%	+20.24%	+0.02%	+0.68%
Domestic Small-Cap Equity[6]	+11.45%	+8.59%	+8.40%	+1.73%	+15.47%	-0.39%	+1.06%
International Equity[7]	+4.71%	+4.23%	+7.03%	+6.48%	+12.21%	+0.53%	+1.96%
Developed International Equity[8]	+5.00%	+4.45%	+7.19%	+5.68%	+13.93%	+0.36%	+2.13%
Emerging Market Equity[9]	+3.77%	+3.44%	+6.66%	+9.75%	+7.22%	+1.05%	+1.45%
DIVERSIFIERS	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Diversified Alternatives[10]	+2.85%	+1.02%	+1.82%	+1.82%	+4.61%	-0.16%	+0.29%
Commodity[11]	-4.30%	-6.84%	-1.36%	-6.13%	+4.58%	+1.41%	+1.19%

[1]Morningstar Cash Index [2]Bloomberg Barclay's 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 Gbl xU.S. Large-Mid Index [8]Morningstar DM xUS Large-Mid Index [9]Morningstar EM Large-Mid Index [10]Morningstar Diversified Alternatives Index [11]Bloomberg Commodity Index.

SHANA SISSEL, CAIA
Senior Portfolio Manager

Shana Sissel joined the CLS Portfolio Management Team in 2018. She is responsible for actively supporting the Portfolio Management Team's efforts within a variety of special projects and investment management strategies, as well as writing and speaking on behalf of CLS.

Ms. Sissel has more than two decades of industry experience at leading investment firms, primarily in Boston and Chicago. Most recently, she was a Client Portfolio Manager at Ariel Investments where she represented Ariel's Domestic Research Team. Ms. Sissel also brings a vast background in market research and analysis through various roles held at Fidelity Investments' Strategic Advisor Inc., Mercer Investments, Peak Financial Management, and Russell Investments.

Ms. Sissel earned a Bachelor of Science Degree in Sport Management from the University of Massachusetts at Amherst before receiving her Master of Business Administration Degree from Bentley University's McCallum School of Business. She also holds the Chartered Alternative Investment Analyst® (CAIA) designation.

As a frequent media contributor, Ms. Sissel has appeared on CNBC and other regional news outlets. She has also been quoted extensively in the Wall Street Journal, Smart Money, and Investment News.

Panic! Yield Curve Inversion

1

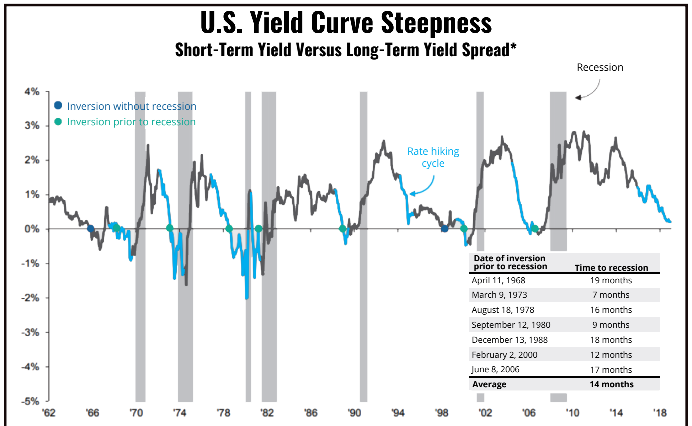
A lot of hoopla surrounded the inversion of the U.S. Treasury yield curve in late August. Last week, Campbell Harvey, the Duke University professor who uncovered the inverted yield curve as a recession signal, said investors should start preparing for a downturn. On the surface, the panic seemed justified. A two-year/10-year inversion is exceedingly rare. It has occurred just nine times in the last 57 years. Over that time, it has occurred prior to every recession. However, it's important to recognize that there have been only seven recessions during that period, which means in two cases, it was a false alarm.

What might the most recent inversion mean? Should we really be preparing for a recession?

I think it's important to recognize two facts.

- We are in the midst of the largest expansion period in modern times. We have not experienced a recession in the U.S. in more than 10 years.
- Historically, the U.S. economy has experienced a recession about every five years.

Given those facts, it's not surprising that investors are nervous that the next recession may be around the corner. It's like we're on the greatest streak ever at a casino, and we are just waiting for our luck to run out. When you also consider that our last recession was extremely painful due to the financial crisis that accompanied it, it's hard not to blame people for being anxious about the next economic downturn.



*Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. *From January 1962 to May 1976 short-term bond is U.S. 1-year bond. Short-dated obnd is 2-year from June 1976. Time to recessino is calculated as the time between the final sustained inversion of the yield curve prior to recession, and the onset of recession. Guide to the Markets - U.S. Data are as of December 31, 2018.*

J.P.Morgan Asset Management

This information is from J.P. Morgan's Guide to the Market 3rd Quarter report. The full report and disclosures may be found here.

It seems cliché to say "this time is different," but consider these reasons that might actually be true today.

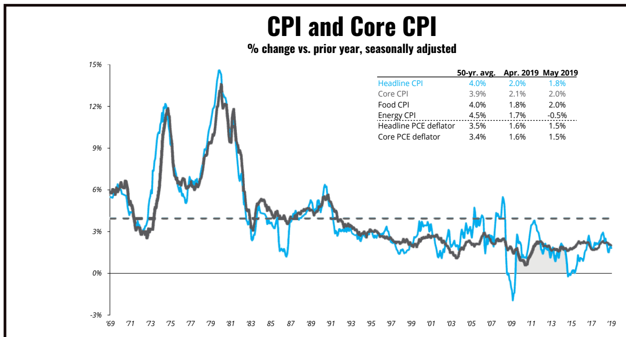
- **In the past, yield curve inversions that signaled a recession occurred during a Federal Reserve (Fed) tightening cycle.** The only other time the Fed was in an easing cycle at the time of the inversion was 1998, and that inversion proved to be a false alarm.

Fed Policy and Previous U.S. Treasury Curve Inversions

Obs.	Inversion Date	Inversion Max Date	Max Inversion (bps)	Last Fed Move	Next Fed Move	Trading Days	S&P Pct. Chg. Inversion to Max
1	12/28/81	2/18/82	-71.0			36	-6.9%
2	12/13/88	3/28/89	-45.0	Hike (10th); 11/22/88	Hike (11th); 12/15/88	71	5.5%
3	5/26/98	6/25/98	-7.0	Hike (1st); 3/25/97	Cut (1st); 9/29/98	22	3.2%
4	2/2/00	4/7/00	-52.0	Hike (4th); 2/2/00	Hike (5th); 3/21/00	56	7.6%
5	12/27/05	11/15/06	-19.5	Hike (13th); 12/13/05	Hike (14th); 1/31/06	224	11.1%
Current	8/14/19	-	-	Cut (1st); 7/31/19	-		
					Averages	79.8	4.12%

Source: Strategas Quantitative Research

- **Rising inflation usually accompanies yield curve inversions.** This is also related to Fed policy decisions. Since 1980, the Fed has been focused on keeping inflation in check. The Fed uses interest-rate policy as a blunt instrument to attack the issue. Cheap money is a sign of a weak economy, and one of the Fed's mandates is to foster an environment of stable prices. If anything, today the concern is that inflation is too low.



Source: BLS, FactSet, J.P. Morgan Asset Management. CPI used is CPI-U and values shown are % change vs. one year ago. Core CPI is defined as CPI excluding food and energy prices. The Personal Consumption Expenditure (PCE) deflator employs an evolving chain-weighted basket of consumer expenditures instead of the fixed-weight basket used in CPI calculations. Guide to the Markets - U.S. Data are as of June 30, 2019.

J.P.Morgan Asset Management

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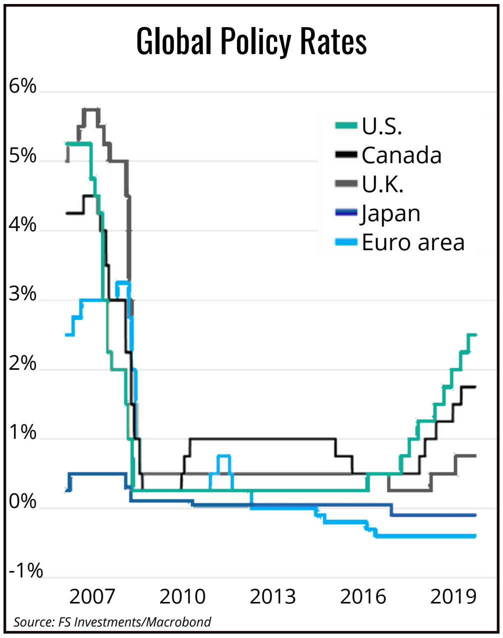
- **Negative interest rates abroad are increasing demand for U.S. Treasury bonds.** This rising demand means higher prices and lower rates.

In summary, it is notable that we've gone a long time without experiencing a recession in the United States. Yes, yield curve inversions have been a consistent signal that a recession is likely to occur. The bottom line is that prior to previous recessions there were other circumstances to consider, not just the inversion. So, while I'm not saying the risk of a recession is zero, I believe the panic is overblown.



1

The Potential Consequences of a China Investment Ban

2

In recent weeks, there have been concerns that President Trump was considering a proposal barring U.S. citizens from investing in Chinese stocks or companies. While the threat clearly appears to have been a negotiation tactic in the trade discussions (which despite the recent "Phase 1" deal will continue as China and the U.S. negotiate a more permanent solution) the concerns are warranted. Over the last two years, the Chinese stock market has gradually seen its weighting in major index providers, such as MSCI, ramp up. Opening the Chinese equity markets and debt to global investors has been a major initiative for Beijing, and China has fought hard to gain inclusion in the benchmarks to attract capital from institutional investors. It remains unclear exactly how a potential ban would be implemented or enforced, but what is clear is that it would have far-reaching implications for U.S. investors. Index providers would struggle to restructure their index products, the investors who use them as benchmarks would be forced to change portfolios and asset allocation models, too. This development brings even greater uncertainty for investors trying to make decisions amid the ongoing trade war.

For investors who have active allocations to emerging market equities, it's a pretty safe bet that China comprises a massive slug of that allocation. Emerging market investing really is China plus the world. The total equity market cap of China is $13.4 trillion, dwarfing the next-largest individual country, India, which totals just $2.6 trillion and is almost double the size of all Latin America ($4.8 trillion) and Africa combined ($2.3 trillion). A quick review of the MSCI Emerging Market Index shows roughly 33% of the index is allocated to China. Pure play emerging market indices wouldn't be the only place China's size might be problematic. Currently, the MSCI All Country World Index maintains China as the fifth-largest country weight, behind the United States, Japan, United Kingdom, and France.

The issue of a potential China investment ban brings to light a bigger issue with pure passive investment strategies. Concentration risk is a major concern. In our increasingly global world, it's important to consider the risks that arise from geopolitical tensions. We believe utilizing active managers or smart beta* options in areas where those risks are highest can often be a preferable way to manage them.

**Smart beta refers to investment strategies that emphasize alternative index construction rules to traditional market capitalization-based indices.*

Direct Indexing's Biggest Edge: Tax Alpha

3

Since launching our direct-index offering on the Orion Portfolio Solutions TAMP Platform in May, the top question we hear from internal colleagues and advisors alike is: "What exactly is tax alpha?" As one of the most obvious benefits of direct indexing, I thought it made sense to highlight what tax alpha is and how it can be maximized through direct-index portfolios.

What is Tax Alpha?

At its most basic level, tax alpha is simply after-tax excess returns minus pre-tax excess returns. In other words, tax alpha means finding ways to reduce a client's tax bill using strategies such as tax-loss harvesting, capital-gains budgeting, and tax-transition management.

Maximizing Tax Alpha

The size of tax alpha depends on two key factors: the direction of the overall equity market and the magnitude of individual stock volatility. A falling market is the most obvious way to realize losses and generate tax alpha, simply because there will be more opportunities. However, market volatility can also play a role, allowing for portfolio managers to harvest losses even in rising markets. This is made possible because volatile markets usually result in above-average return dispersion between stocks.

Tax Alpha Through Tax-Loss Harvesting

This technique involves continuously monitoring a client's portfolio to identify capital losses, which can offset capital gains in other parts of the portfolio. Offsetting capital gains taxes reduces the amount of taxes an investor pays at the end of the year. For our direct-index strategies, we set a minimum-loss threshold of 10% in a share lot to trigger a tax-loss harvesting review. Below is an example of an active account on our direct-index platform illustrating the potential performance benefit a client might achieve by leveraging this approach.

How Does Direct Indexing Create Tax Alpha?

By employing three primary tax-management techniques listed earlier, direct indexing can customize the management of a client's individual account to contribute to a better after-tax experience versus the benchmark.

				Account		Benchmark		Tax Alpha
				Pre-Tax - Net	After Tax	Pre-Tax - Net	After Tax	
	Inception Date	As of	Benchmark	Since Inception	Since Inception	Since Inception	Since Inception	Since Inception
Account A	5/22/2019	8/31/2019	Russell 2000	0.48%	1.67%	-2.87%	-2.80%	1.12%

While our current offering is still limited in what tax-management techniques we can employ, it's easy to see how the simple use of tax-loss harvesting can have a big impact on the client's after-tax returns. By leveraging this tax-efficient approach to client portfolios, advisors can help clients keep more money in their pockets while adding more value to clients as advisors.

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 Morningstar Diversified Alternatives Index allocates among a comprehensive set of alternative underlying ETFs that employ alternative and non-traditional strategies such as long/short, market neutral, managed futures, hedge fund replication, private equity, infrastructure or inflation-related investments. The Russell 3000 Index is an unmanaged index considered representative of the U.S. stock market. The index is composed of the 3,000 largest U.S. stocks. 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.

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