Davenport Asset Management
Quarterly Update | Q3 2018

September 30, 2018

Equity markets enjoyed surprisingly strong returns in the third quarter. The S&P 500 Index gained 7.7% and posted its best quarter in nearly five years. Year-to-date the S&P 500 Index finished the quarter up 10.6%. On another bullish note, the Nasdaq Composite Index gained 7.4% and was up for the ninth consecutive quarter.

Market Returns	Q3 2018	YTD
U.S. Large Caps	7.7	10.6
U.S. Mid Caps	5.0	7.5
U.S. Small Caps	3.6	11.5
International Developed Markets	1.4	-1.4
Emerging Markets	-1.1	-7.7
Intermediate Term Bonds	0.2	-0.8

Source: Morningstar Direct.
Please see last page for index definitions.

Such impressive results flew in the face of many negative headlines. Indeed, there was plenty to worry investors in the third quarter. Trade war fears lingered alongside President Trump's protectionist talk. Monetary policy continued to tighten as the Fed again raised interest rates. And, areas of the economy such as autos and housing showed evidence of slowing. Next up, we will have to contend with a midterm election cycle that is sure to be contentious and may result in the balance of power shifting in Congress.

Still, equities once again managed to climb the proverbial "wall of worry". So what gives? Perhaps most perceive Trump's trade barbs with China as bombast meant to secure a more favorable negotiating position. Recent agreements with Mexico and Canada do indeed suggest a resolution with China is more possible than headlines portray. Maybe rising interest rates are manageable given they remain low by historical standards and increases are accompanied by strong economic growth. And, maybe once the elections are over we will see the chicanery of partisan politics cool a bit (this one is doubtful but who knows). Interestingly, Barron's recently noted the S&P 500 Index has not declined in the 12 months following midterm elections since 1946.

Above and beyond these considerations, however, is the health of the U.S. economy. GDP growth seems poised to reach almost 3% for 2018 versus 2.2% last year and only 1.6% in 2016. Meanwhile, unemployment sits near a record low at 3.9%, wage growth is strong and consumer confidence surged to nearly an 18-year high in August. This should bode well for consumer spending and make for robust holiday retail sales. One can certainly argue this economic expansion is long in the tooth and certain industries are showing signs of weakening. However, the consumer certainly appears healthy enough to power further gains.

We came into the year expecting more modest returns than what we witnessed from 2013-2017. Thus far, we have been pleasantly surprised by the market's ongoing momentum. At 17.3x forward earnings estimates for the S&P 500 Index (just slightly above the 25 year average of 16.5x), we would continue to characterize the market as being fairly valued (i.e. not overvalued or undervalued). Robust economic growth is a plus, but offset in part by the specter of rising interest rates. We continue to find attractive investment opportunities in our Portfolios, but still encourage investors to expect more moderate returns in coming years. Thank you for your trust and read on for a discussion of Portfolio themes and ideas.

Bond Market Update

Economic data released during the quarter were strong and support the Federal Reserve's migration to a less accommodative policy. Second quarter GDP came in at 4.2% and most economists expect a rate for the third quarter close to 4%. Signs of a strong economic backdrop were also supported by the Institute of Supply Management, which hit levels last seen during the 2000-2004 and 1985-1989 expansions. While inflation has consistently been low, signs that it is increasing are apparent and the implementation of tariffs by the current administration have potentially negative price impacts for a widening group of industries. The CPI came in at a 2.7% rate of inflation for August and the Personal Consumption Rate, the inflation metric important to the Fed, was 2%. Additionally, the number of job openings is at an 18 year high but the availability of qualified candidates continues to be a major issue for employers. This shortage has the potential of increasing wage inflation as companies compete for skilled labor. It is noteworthy that wage inflation continues to be moderate.

2018 Yield Curve Change

Security	9/30/18	12/31/18	Change
3 Mo. LIBOR	2.40	1.69	0.70
2 Year Treasury	2.82	1.89	0.94
5 Year Treasury	2.95	2.21	0.75
10 Year Treasury	3.06	2.41	0.66
30 Year Treasury	3.21	2.74	0.47

Source: Morningstar Direct.
Please see last page for index definitions.

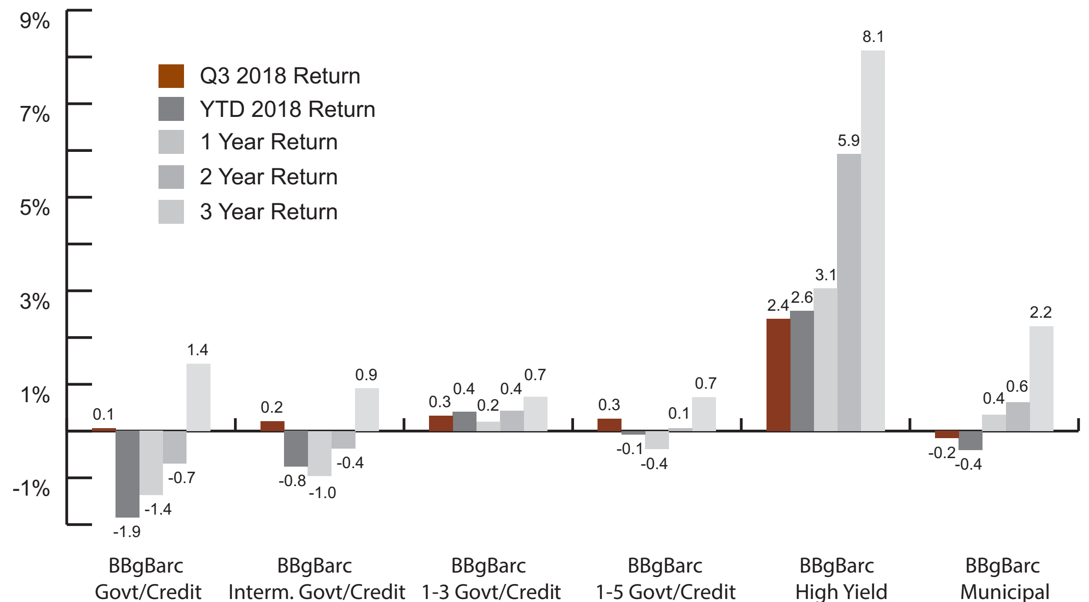
Treasury rates for the quarter reflected market concerns over strong economic data and the expectation of a 25 basis point move by the Fed at their September 26th announcement. For the most part rates were higher by 25 basis points at the end of the quarter across all maturities. These changes left the 2 year at 2.82%, the 5 year at 2.95%, the ten year at 3.06%, and the thirty year at 3.21%. The impact of these changes has caused the yield curve, the yield difference between the 2-year Treasury and the 10-year Treasury, to become flatter by approximately 25 basis points from the end of 2017. A yield curve that has become inverted has historically been an indicator that a recession is eminent. The Federal Reserve is acutely aware of this potential and has stated they do not expect this to happen this cycle.

Bond Market Update Continued

We have maintained our defensive structure in anticipation of continued rate increases. Our allocation to “Floating Rate Notes”, securities that have their rates change on a quarterly basis, have been our best performing allocation as fixed rate securities have suffered as rates have risen. The Federal Reserve has stated their “neutral “ rate is around 3% with expectations that they will raise rates one more time this year and potentially 4 times in 2019.

Bond Index Returns

Source: Bloomberg Barclays. Please see last page for index definitions.



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Performance shown is historical and is no guarantee of future results. Investing in securities carries risk including the possible loss of principal.

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Index Definitions: U.S. Large Caps represented by the **S&P 500 Index**. U.S. Mid Caps represented by the **Russell Midcap Index**. U.S. Small Caps represented by the **Russell 2000 Index**. International Developed Markets represented by the **MSCI EAFE Index**. Emerging Markets represented by the **MSCI EM Index**. Intermediate Term Bonds represented by the **Bloomberg Barclays Intermediate Government/Credit Index**.

The **S&P 500 Index** is comprised of 500 U.S. stocks and is an indicator of the performance of the overall U.S. stock market. The **Russell 2000® Index** measures the performance of the 2000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market. The **Russell Midcap® Index** measures the performance of the 800 smallest companies in the Russell 1000, which represent approximately 25% of the total market capitalization of the Russell 1000. The Russell 2000® Index and Russell Midcap® Index are trademark/service marks of the Frank Russell Co. Russell® is a trademark of the Frank Russell Co. The **NASDAQ Composite Index** is a broad-based capitalization-weighted index of all common stocks listed on the Nasdaq. The **Morgan Stanley Capital International Europe, Australia and Far East (MSCI EAFE) Index** is an unmanaged index composed of the stocks of approximately 1,000 companies traded on 20 stock exchanges from around the world, excluding the U.S., Canada, and Latin America. The **Morgan Stanley Capital International Emerging Markets (MSCI EM) Index** is a capitalization-weighted index of stocks from 26 emerging markets that only includes issues that may be traded by foreign investors. The reported returns reflect equities priced in US dollars and do not include the effects of reinvested dividends. The **Bloomberg Barclays U.S. Corporate High Yield Index** measures the U.S. dollar-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody’s, Fitch and S&P is Ba1/BB+/BB+ or below. The **Bloomberg Barclays Intermediate Government/Credit Index** is an unmanaged index composed of debt securities with maturities from one to ten years issued or guaranteed by the U.S. Treasury, U.S. Government agencies, quasi-federal corporations and fixed rate dollar denominated SEC-registered corporate debt that are rated investment grade or higher by Moody’s Investors Service and Standard and Poor’s Corporation or Fitch Investor’s Service, in that order. The **Bloomberg Barclays Municipal Index** covers the U.S. dollar-denominated long-term tax exempt bond market. The **Bloomberg Barclays U.S. Government/Credit Bond Index** measures the non-securitized component of the U.S. Aggregate Index. It includes investment grade, U.S. dollar-denominated, fixed-rate Treasuries, government-related and corporate securities. The **Bloomberg Barclays U.S. 1-3 Year Government/Credit Index** includes all medium and larger issues of U.S. government, investment-grade corporate, and investment-grade international dollar-denominated bonds that have maturities of between 1 and 3 years and are publicly issued. The **Bloomberg Barclays U.S. 1-5 Year Government/Credit Index** measures the performance of U.S. dollar-denominated U.S. Treasury bonds, government related bonds (i.e., U.S. and non-U.S. agencies, sovereign, quasi-sovereign, supranational and local authority debt) and investment grade U.S. corporate bonds that have a remaining maturity of greater than or equal to one year and less than five years. **The Bloomberg Barclays Intermediate Corporate Index** The Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.
An investor cannot invest in these indices and their returns are not indicative of the performance of any specific investment.