Q4
2018

QUARTERLY REVIEW

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Q4 MARKET NOTES

The fourth quarter of 2018 was decidedly different in many ways from the previous two quarters. U.S. stocks—which had generated strong performance for much of the year—plummeted during the fourth quarter, regardless of sector, investment style or market capitalization. Non-U.S. equities also were hit hard, but managed to outperform the domestic market. In particular, emerging markets stock held up surprisingly well during a period of significant uncertainty and volatility.

Meanwhile, U.S. government debt—which had struggled throughout most of 2018—generated positive returns as nervous investors flocked to "safe haven" assets in an effort to sidestep sizable losses in equities.

In aggregate, global stocks were down sharply during the fourth quarter:

- The S&P 500 index of large-cap U.S. stocks fell 13.52%.
- Broad-based developed market international stocks (as measured by the S&P Global Ex-US BMI Index) returned -11.78%.

The market's fall during the quarter was historic in at least one way: 2018 marked the first time ever in which the S&P 500 ended the year with a loss after being positive for the first three quarters of the year (see Chart 2).

CHART 1: STOCKS HIT HARD AROUND THE WORLD IN 4Q2018

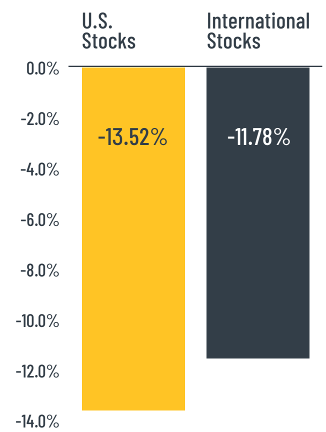


Chart source: Bloomberg

CONCERNS ABOUT TARIFFS, TRADE, INTEREST RATES AND GLOBAL GROWTH PROSPECTS

U.S. stocks followed up their extremely strong performance in the third quarter with their worst quarter since the fourth quarter of 2008. The market's performance in December alone was its worst for that month since the Great Depression. A number of factors drove those historically extreme results, including:

1. **Concerns about global economic growth.** Investors became increasingly worried that signs of slowing global economic growth could possibly lead to a global economic recession. Weak data out of China—the world's second largest economy—was particularly unnerving. In October, for example, China reported its slowest year-over-year gross domestic product growth since 2009. Then in December, the country's manufacturing activity hit a two-year low. Investors also worried that U.S. corporate earnings growth has peaked and will weaken going forward.

2. **Fed fears.** Investors were surprised by Fed Chairman Powell's comment in early October that current interest rates were "a long way from neutral"—which they took as an unwelcome sign that the Fed would raise rates for the foreseeable future. Some investors also questioned the Federal Reserve Board's decision in December to raise a key short-term interest rate given overall low inflation and concerns about the strength of the economy. If interest rates—and borrowing costs—rise too much, the economy could slow too rapidly.

3. **Tariff and trade tensions.** Stocks sold off at various points during the quarter on developments—or lack thereof—surrounding the ongoing trade and tariff dispute between the U.S. and China. In early December, for example, investors expressed concerns and doubt about an agreement between the two countries to hold off on implementing

additional tariffs on each other's exported goods. That led to a nearly 5% drop in the S&P 500 over a one-week period. Additionally, China's soybean imports from the United States plunged to zero in November—the first time since the trade war between the world's two largest economies started that China (the world's largest soybean buyer) has imported no U.S. supplies.

4. **Turmoil in Trumpland.** Adding significant fuel to the fire were developments in the Trump administration, as well as statements made by President Trump that created uncertainty and fear among investors. Taking a break from his usual focus on the media as the "enemy," Trump set his sights during the quarter on Fed Chairman (and Trump appointee) Jerome Powell—calling the Fed "his biggest threat" and "the only problem our economy has."

Additionally, Treasury Secretary Mnuchin surprised investors with an assurance that major U.S. banks have ample liquidity for lending. Mnuchin's move—seen by some as akin to the local fire department calling people out of the blue to assure them it has plenty of water—simply put investors even more on edge.

5. **Institutional-driven selling.** Hedge funds, banks and other types of institutional investors drove much of the selling during the quarter. Overall, there was a lack of participation among retail, individual investors. When institutional investors move in lock-step, selling pressures can increase.

DÉJÀ VU ALL OVER AGAIN?

The fourth quarter of 2018 was similar in some noteworthy ways to the roughly six-month time period of mid-August 2015 to mid-February 2016, when global equities (as measured by the S&P Global BMI index) fell approximately 16%.

For example, in both periods:

1. **Fears about global growth abounded.** Back in the summer and fall of 2015, investors worried that a serious downturn in the global economy was on its way. They pointed to weakness in the Leading Indicator Index, the Current Activity Indicator, retail sales and freight carloads as evidence. Similarly, investors during the fourth quarter of 2018 feared that tariff battles between the U.S. and China could throw the global economy into a tailspin.

CHART 2: S&P 500 PERFORMANCE, 2018

Charts source: Bloomberg

That said, there are signs that the current global economy—the U.S. economy, in particular—remains healthy enough to stave off a near-term recession. Example: Hiring in December 2018 surged by a much-better-than-predicted amount—data suggesting the U.S. economic expansion remains strong. Nevertheless, the narrative of a global slowdown exists.

2. **Central banks made blunders.** In both time periods, decisions made by central banks were key factors in driving stock prices lower.

- In August 2015, China's central bank shocked investors around the world by devaluing China's currency, the yuan. The move helped spark the roughly 16% decline in the S&P Global BMI index over the next six months.
- In October 2018, Fed Chairman Powell's "long way from neutral" comment about interest rate levels kicked off a historically bad quarter for equities. From early October through Christmas Eve, the S&P Global BMI index fell 17.3%.

When central banks create problems, it often takes central banks to fix them. Back in 2016, for example, there may have been a deal between various central banks (known as the Shanghai Accord) that helped stabilize markets. In early January 2019, Fed Chairman Powell revised his tone about interest rates—saying the Fed "will be patient" as it considers future rate hikes. His more cautious statement helped boost markets immediately.

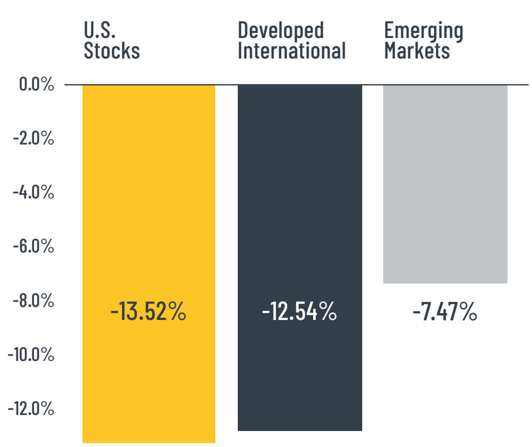
INTERNATIONAL MARKETS HOLD UP RELATIVELY WELL

International equities hardly fared well during the quarter. But, as noted above, they did manage to outperform the U.S. equity market (see Chart 1), which faced significantly greater selling pressure during the quarter.

One key driver of international outperformance was emerging markets equities, which (as a group) fell just 7.47% during the quarter (see Chart 3) —a much better return than those posted by developed equity markets.

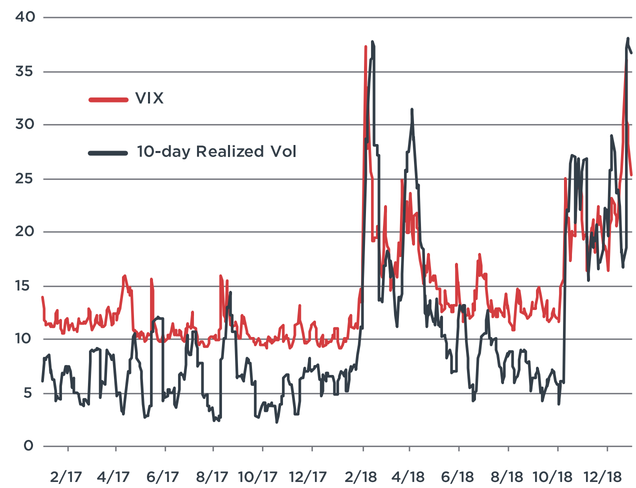
Emerging markets had fallen significantly through the third quarter: The asset class was down 7.68% from January through September, versus the S&P 500's gain of 10.56% during that time. As a result, much of the bad news impacting emerging markets had already been priced in by the start of the fourth quarter. Relatively attractive valuations among emerging markets equities also provided some support for the shares as developed markets stumbled. Additionally, some of the political instability in emerging markets faded during the quarter.

CHART 3: EMERGING MARKETS OUTPERFORM DEVELOPED MARKETS



Charts source: Bloomberg

CHART 4:
VOLATILITY RISES DURING 4Q 2018



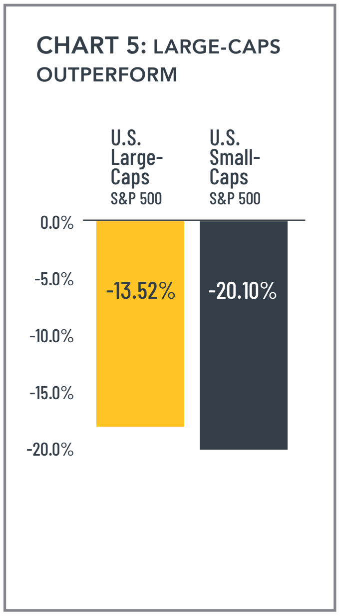
VOLATILITY ON THE RISE

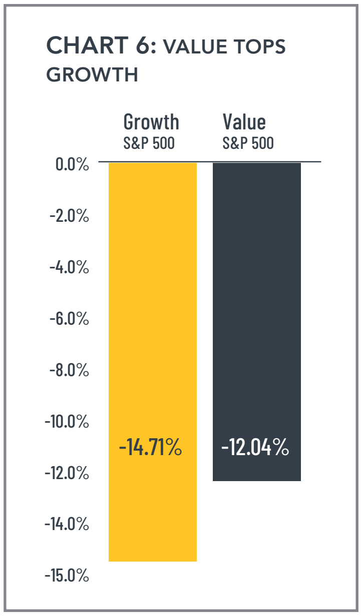
Volatility made a comeback during much of the quarter as investors worried about how the factors noted above might impact corporate profits and equity prices. For example:

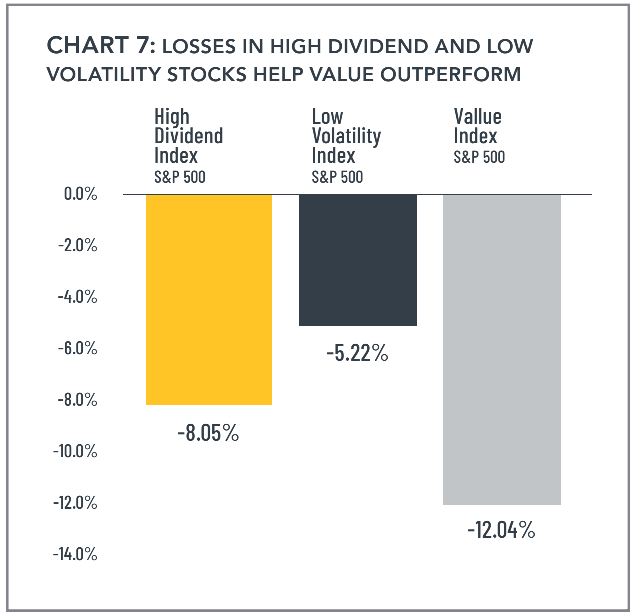
- The CBOE Volatility Index (VIX), which measures expected S&P 500 volatility, rose throughout most of October before moderating in November. It then flared up in December, soaring nearly 120%, from around 16 to 36—much higher than its long-term historical average of around 20.
- Actual (realized) volatility was particularly intense, driven largely by low levels of market liquidity as both buyers and sellers remained on the sidelines. The S&P 500's average 10-day realized volatility during the quarter was 20.7. That compares to an average of 12 during the first three quarters of 2018, and just 6.5 in 2017. (see Chart 4)

LARGE-CAP STOCKS BEST SMALL-CAPS

Large-caps significantly outperformed small-caps during the fourth quarter (see Chart 5). Of course, both market segments were down significantly, but small-caps were hit especially hard. One major reason: Smaller businesses tend to rely more on bank loans and short-term financing than do large firms. As the Fed has raised short-term rates, the cost of capital for small companies has risen—which investors worry could hurt their profits and boost their risk of defaulting. Additionally, the overall "risk-off" environment during the quarter prompted investors to







Charts source: Bloomberg

shun small-caps, which are generally seen as riskier than shares of larger, well-established companies.

VALUE EDGES OUT GROWTH

Both value and growth stocks lost considerable ground during the quarter. That said, as seen in Chart 6, value managed to edge out growth—thanks largely to the fact that the value-stock universe contains many dividend-paying stocks and low-volatility equities, which nervous investors favored during the quarter for their relative stability and/or regular income payments.

To see the impact of dividend-paying stocks and low-volatility stocks on value's outperformance during the quarter, consider Chart 7. The relatively small losses for the two investment styles helped buffer value overall.

In addition, growth stocks were hurt when high-profile technology companies Amazon, Apple and Facebook announced disappointing financial forecasts in November. Trade war fears and a projected decrease in spending on information technology weighed on the sector, dragging growth-style investments lower.

SECTOR WINNERS AND LOSERS

All but one sector of the U.S. equity market—utilities—were negative for the quarter. The performance of the top three and bottom three sectors during the period is summarized in Table 8.

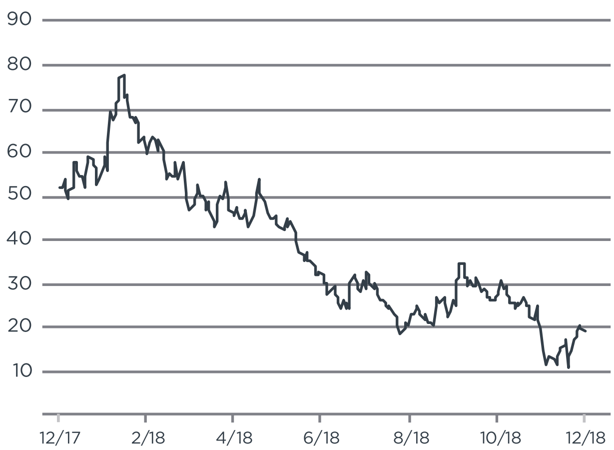
So-called defensive sectors—utilities, real estate and consumer staples—performed the best on a relative basis. Investors favored these sectors for their perceived relative stability and safety during challenging, volatile market environments. Also, utilities and real estate companies tend to pay dividends to shareholders—which, as noted above, can act as a ballast when the broader equity market is falling.

The worst-performing sectors during the quarter were energy, technology and industrials. Energy suffered in large part from the roughly 40% decline in the price of crude oil during the quarter. Tech stocks were hurt by the factors noted above, such as U.S.-China trade-related concerns (many technology firms rely on trade between the two nations). Valuation concerns

TABLE 8

SECTOR	Q4 2018 RESULTS
Utilities	1.36%
Real Estate	-3.83%
Consumer Staples	-5.21%
Industrials	-17.29%
Information Technology	-17.34%
Energy	-23.78%

CHART 9: YIELD SPREAD BETWEEN 2-YEAR AND 10-YEAR TREASURIES



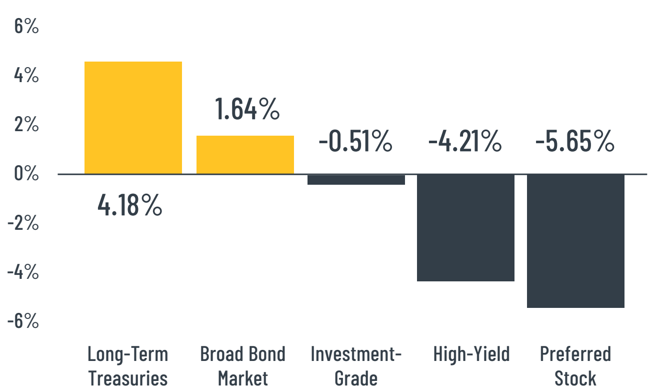
also drove tech stock selling as investors shifted out of high-flying growth sectors into more defensive areas of the market. Like tech, industrials were hurt by fears of a growing U.S.-China trade war that could hurt global economic growth.

BONDS SHOW SIGNS OF LIFE

After three consecutive quarters of flat to negative returns overall, the fixed-income market rallied in the fourth quarter. That said, not all segments of the bond market saw positive results.

Specifically, U.S. government bond prices were up across all maturities. Uncertainty about the global economy,

CHART 10: BOND MARKET SECTOR RETURNS



Charts source: Bloomberg

along with significant stock market volatility, created a flight to quality as investors favored assets with a high degree of perceived safety—such as U.S. Treasury notes, bills and bonds. For example:

- The ICE U.S. Treasury 1-3 Year Bond Index gained 1.32%.
- The ICE U.S. Treasury 7-10 Year Bond Index was up 3.75%.
- The ICE U.S. Treasury 20+ Year Bond Index (which measures the performance of long-term Treasuries) returned 4.18%.

Bond yields finished the quarter lower than where they began it. In particular, intermediate-term bond yields fell significantly: The yield on the 10-year U.S. Treasury note started the quarter at 3.062% and peaked at 3.237% on November 8th before plummeting to 2.684% by the end of December. Falling yields boost bond prices, and the prices of longer-term issues are especially sensitive to changes in rates.

During the quarter, the difference in yields—or spread—between certain types of Treasury securities narrowed to historically low levels (see Chart 9). Example: The spread between the 2-year U.S. Treasury note and the 10-year Treasury note in early December was just 0.11 percentage points—its flattest level since July 2007.

Why does that matter? The spread between these two fixed-income securities is closely watched by investors because it is a popular gauge of future economic growth. If the 10-year yield falls below the 2-year yield, it is often seen as a sign that a recession could be on the horizon.

In stark contrast, non-government bonds—such as those issues by corporations—posted losses for the quarter (see Chart 10). Equity-market risk carried over into corporate bonds and fixed-income securities that have equity-like traits—hurting investment-grade corporates, high-yield bonds and preferred stock. Investors' aversion to bonds perceived as risky hurt corporate bond indices as well as broad-based bond indices with significant percentages of corporate bond exposure.

Our Strategies

STAGE: GAIN

Seek capital gains through active asset allocation

Features:

- Global diversification
- Tilts between international and domestic
- Designed to deliver a Beta range between 0.80 and 1.20 to global equity markets

Sunny Expectation: Opportunistic weightings among the S&P and global markets

Storm expectations: Will seek less volatile holdings for perceived long-term market dislocations, while shorter shocks may either be weathered with current positioning or may be repositioned to take advantage of the "normalization".

The GAIN portfolios maintained their overweight to the U.S. equity market during the quarter. Early on, however, we began adding to our developed international and emerging markets positions. Both asset classes had slumped for much of the year, and offered relative stability and attractive valuations. We eliminated positions in factor-based investments to implement the portfolio reallocation. We also shifted from a growth stock overweight to a neutral stance between growth and value. Such decisions helped the portfolios avoid the worst of the losses seen during the quarter, as international equities outperformed the U.S. market and as value beat growth.

In early November, we added more to our emerging markets allocation—including dividend-focused emerging markets investments, which offered an additional degree of stability.

The worst-performing allocation was small-cap stocks, which underperformed U.S. large caps, as well as developed and emerging markets international equities.

In the fixed-income portion of the portfolios, we maintained a slightly shorter-than-average duration profile. That positioning was detrimental, as longer-term Treasuries outperformed in the falling-yield environment. Corporate credit holdings also dampened performance, as investors sold corporate bonds due to concerns about the equity market, the economy and corporate earnings. That said, equity market stabilization should help corporate bonds. As with stocks, institutional investors played a large role and were hesitant to buy late in the year. We expect to see more liquidity and activity in 2019.

active asset allocation

GLOBAL

The ability to target more opportunities in various segments of equity markets

FLEXIBLE

The ability to make portfolio adjustments in order to adapt to market changes

BALANCED

We screen opportunities through a balanced set of quantitative and qualitative perspectives

Global Market Indicators

		Q4 2018	10 Year Annualized
GROWTH	CPI	**1.90%**	**1.56%**
	World GDP	**3.64%**	**3.37%**
	US GDP	**3.00%**	**1.63%**
	10 Yr Yield	**2.68%**	**2.48%**
	VIX	**25.42**	**18.74**
RETURNS	S&P	**-13.52%**	**13.12%**
	DJIA	**-11.31%**	**13.16%**
	Russell 2000	**-20.20%**	**11.97%**
	ACWI	**-12.65%**	**10.05%**
	EAFE	**-12.50%**	**6.81%**
	Emerging Markets	**-7.40%**	**8.39%**
	Gold	**7.54%**	**3.81%**
	Oil	**-38.01%**	**0.18%**

Inflation Data as of	12/31/18
Global GDP Data as of	6/29/18
US GDP Data as of	9/30/18
All Other Data as of	12/31/18

10 Yr Yield is yield as of most recent quarter end
VIX Data is index level as of most recent quarter end
10 Year data points for CPI, World GDP, US GDP, 10 Yr Yield, and VIX are averages of last 10 years of data

Source: Bloomberg and World Bank

STAGE: **PROTECT**

Seek capital preservation during catastrophic markets

risk assist®

Objectives:

- Globally diversified
- Defaults to invested rather than de-risked
- De-risking begins to take effect as drawdown approaches 8%

Sunny Expectations:

Seeks the expectations of our Gain products with defined downside tolerance and potential for drag exists.

Storm Expectations:

Will react similarly to our Gain products for the first 8-10% of drawdown in global equity markets. Thereafter, de-risking actions are taken to help limit investor exposure to additional declines in global equity markets. These strategies use Horizon's volatility forecasting expertise to help guide de-risking speed and magnitude. Seeks to return to fully invested status as market conditions allow.

The Risk Assist portfolios began the quarter fully invested in equities. However, as stock market losses increased, we began to de-risk the portfolios. De-risking occurred first in October and then later in December—with the result that all Risk Assist models were partially de-risked by the end of the quarter.

Other strategies also helped the portfolios mitigate losses somewhat. For example, we began adding to our developed international and emerging markets positions in October. In early November, we increased our emerging markets allocation. In addition, we reduced our growth stock overweight to achieve a neutral balance between growth and value. These decisions were beneficial, as value beat growth and international outperformed the U.S. for the quarter.

Small-cap stocks were the worst performers in the portfolios; they lagged not only U.S. large caps but also developed and emerging markets international equities. That said, our benchmark-weighting to small-caps helped us sidestep some of the losses we would have suffered if we had overweighted the asset class in the portfolios.

We maintained a slightly shorter-than-average duration profile in the fixed-income portion of the portfolios. That positioning hurt returns because longer-term Treasuries outperformed as bond yields fell. Corporate fixed-income holdings also weighed on performance. Investors—worried about the prospects for the stock market, the economy and earnings—sold corporate credits.

STAGE: SPEND

Seek longevity for retirement income

REAL SPEND®

Features:

- Globally diversified
- Embedded liquidity feature
- Embedded risk mitigation feature

Sunny Expectations: Regular distributions, adjusted annually for inflation.

Storm Expectations: More conservative allocation due to bucket strategy, but still has global equity exposure to manage longevity and inflation risks. Can experience drawdown, but dual risk management features of bucket implementation and Protect feature guard against catastrophic risk.

Global stocks suffered significant losses during the quarter, while Treasury bonds gained ground and acted as a buffer in the volatility environment for financial markets.

The Real Spend portfolios during the quarter maintained their overweight to equity markets, as well as their overweight to U.S. stocks. That positioning hurt returns during the quarter, as stocks fell and as U.S. equities underperformed foreign stock markets. That said, we emphasized many defensive areas of the market within the equity portion of the portfolios. Defensive sectors were our best-performing equity holdings, as investors favored more conservative investments with higher perceived levels of safety and stability. Our poorest-performing equity holdings were international and growth assets. Meanwhile, our top bond holdings were Treasuries, and our worst-performing fixed-income allocations were preferred stock and high-yield bonds.

We partially de-risked all of the model portfolios by activating the Risk Assist overlay, which is designed to help guard against catastrophic losses. We also harvested losses by engaging in trades that may have proved tax efficient for some accounts—swapping some existing international and investment-grade bond holdings with similar investments.

In the spending reserve, we maintained our positions in short-duration fixed-income securities to provide portfolio stability in the event of short-term market volatility. Because of the financial markets' negative returns, Real Spend rebalanced the spending reserves to 11 quarters' worth of spending—approximately 2.75 years—in an effort to provide a liquidity cushion and minimize selling securities during down markets in order to generate income.

Looking back at 2018's finish, it's worth noting that the trailing 12-month P/E ratio for the S&P 500 is at its lowest since 2014. In addition, the S&P 500's earnings yield—another valuation metric—is at a historically high level of around 6%. When that yield is compared against the 2.8% yield on the 10-year U.S. Treasury note, a case can be made that U.S. stocks offer relatively attractive valuations in the current environment.

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