



FIRST REPUBLIC PRIVATE WEALTH MANAGEMENT

QUARTERLY UPDATE

Third Quarter / 2018

HIGHLIGHTS

- **U.S. equities rallied to record highs while currency devaluations and trade risks continued to punish emerging market equities**
- **Contained inflation and low unemployment in the U.S. economy led the Federal Reserve to continue raising interest rates**
- **We see an inflation surprise or policy blunder as two key risks**

OVERVIEW

Trade policy took center stage during the third quarter of 2018, as escalating tensions between the U.S. and China led to a divergence in results across financial markets. Domestic equities weathered trade uncertainties well, with the S&P 500 returning 7.7% during the quarter and 10.6% year-to-date.¹ The rally was driven by positive U.S. economic data; in particular, healthy gains in consumer spending and historically low levels of unemployment. These, plus ahead-of-forecast earnings growth, helped lift the S&P 500 to new all-time highs, setting the record for the longest bull market run in history.

The constructive U.S. macroeconomic environment also helped the Federal Reserve (the Fed) reaffirm its plan to continue raising interest rates to more normal levels. The Fed increased the federal funds rate for a third time this year, to 2.25%. The Fed's progressively hawkish stance, in turn, helped drive U.S. Treasury yields higher. As a result, returns across most fixed income markets were reduced, as bond prices fall when yields rise.

The high levels of dollar-denominated debt in some emerging market countries remained a headwind as the U.S. dollar appreciated against most currencies, making debt service payments more burdensome for borrowers abroad. The combination of threatening tariffs and the rising U.S. dollar led the MSCI Emerging Markets Index to fall by 1.1% for the quarter and decline 7.7% year-to-date.

FIXED INCOME DECLINES AS FED DELIVERS THIRD RATE HIKE OF 2018

Reinforced by robust U.S. economic data — real GDP at 4.2%², contained inflation readings and the labor force near full-employment — the Fed lifted the benchmark lending rate and projected an additional hike in December and three more in 2019. As a result, short-term fixed income was mildly positive, as evidenced by the Barclays U.S. Treasury 1-3-Year Index, while most long-term markets faced resistance during the quarter. The 10-year U.S. Treasury yield crossed the 3% mark, nearing its highest level since May.

¹ In U.S. dollar terms, net

² Seasonally adjusted annual rate



Within fixed income markets, high-yield bonds showed the best returns for the quarter and year-to-date. This doesn't surprise us since in general, the high yield sector is more correlated to the economic cycle, akin to equities, than to changes in interest rates.

U.S. EQUITIES MARK RECORD HIGHS, FUELED BY CORPORATE EARNINGS

Backed by domestic economic strength and solid corporate earnings, U.S. equities posted gains during the third quarter and displayed resiliency to trade dispute escalations. The S&P 500 reported second-quarter earnings per share growth of more than 20% from a year earlier and analysts are estimating third quarter readings in the double digits again. Meanwhile, U.S. small-caps outperformed large-cap indexes, as sustained growth in the economy boosted smaller companies with relatively lower exposure to international trade risk than larger companies.

DEVELOPED MARKETS WITHSTAND TRADE AND POLITICAL UNCERTAINTIES

Developed overseas equity markets fared better than their emerging market counterparts. The MSCI EAFE Index closed the quarter up 1.4%, compared to 1.1% lower for the MSCI Emerging Market Index. On the positive side, developed market countries tend to have more diversified economies and more local currency debt relative to emerging market countries. On the negative side, developed market economies face unique regional difficulties. For example, the U.K and the European Union reached an impasse in Brexit discussions, depressing appetite for European equities as fears of a "no-deal" Brexit grew.

Additionally, underlying price pressures came softer than expected in the eurozone's 19 countries, as the core rate of inflation fell month-over-month from 1.0% in August to 0.9% in September. The lower than expected reading showed that despite improving economic conditions, a recent pickup in employment and wages hasn't translated to inflationary pressures.

EMERGING MARKETS CONTINUE FACING HEADWINDS

Emerging markets faced several headwinds during the quarter as a mix of international tensions, rising U.S. interest rates and a stronger U.S. dollar drove the MSCI Emerging Market Index down 1.1% loss during the quarter and 7.7% year-to-date. Chinese equities were further pressured as the U.S. and China implemented new tariffs which dampened investor confidence in the global economy. The Shanghai Composite continued its downward trajectory, falling to its lowest close in nearly four years.

Additionally, emerging market equities fell due to crises in Turkey and Argentina. While each country's woes were the result of domestic issues, their problems highlighted the vulnerability of emerging countries to the rising U.S. dollar. Thankfully, Turkey's dilemma did not spread to other emerging nations. Towards the end of the quarter, each country found some relief.

CONCLUSION

Trade and political developments remained under the lime light during the third quarter of the year. Domestic equities outperformed emerging markets as positive economic data continued displaying signs of momentum in the U.S., while corporate profits remained above 20% during the second quarter. Currency devaluations and economic crises plagued emerging markets, supporting our Research team's views of underweighting emerging markets earlier this year. As the Fed continues on its path of rate normalization, we continue to expect changes in interest rates and developments in international relations to weigh on investor risk appetite.



FINANCIAL MARKET RETURNS

U.S. Equity	Q3 2018	YTD*	1 Year*	ANNUALIZED		
				3 Year*	5 Year*	10 Year*
DJ Industrial Average	9.6%	8.8%	20.8%	20.5%	14.6%	12.2%
NASDAQ Composite	7.4%	17.5%	25.2%	21.7%	17.7%	15.7%
S&P 500 TR Index	7.7%	10.6%	17.9%	17.3%	13.9%	12.0%
Russell 1000 Index	7.4%	10.5%	17.8%	17.1%	13.7%	12.1%
Russell 1000 Growth Index	9.2%	17.1%	26.3%	20.6%	16.6%	14.3%
Russell 1000 Value Index	5.7%	3.9%	9.5%	13.6%	10.7%	9.8%
Russell Mid Cap Index	5.0%	7.5%	14.0%	14.5%	11.7%	12.3%
Russell Mid Cap Growth Index	7.6%	13.4%	21.1%	16.6%	13.0%	13.5%
Russell Mid Cap Value Index	3.3%	3.1%	8.8%	13.1%	10.7%	11.3%
Russell 2000 Index	3.6%	11.5%	15.2%	17.1%	11.1%	11.1%
Russell 2000 Growth Index	5.5%	15.8%	21.1%	18.0%	12.1%	12.7%
Russell 2000 Value Index	1.6%	7.1%	9.3%	16.1%	9.9%	9.5%

International Equity	Q3 2018	YTD*	1 Year*	ANNUALIZED		
				3 Year*	5 Year*	10 Year*
MSCI EAFE Index (\$USD, net)	1.4%	-1.4%	2.7%	9.2%	4.4%	5.4%
MSCI AC World Index (\$USD, net)	4.3%	3.8%	9.8%	13.4%	8.7%	8.2%
MSCI AC World Ex US Index (\$USD, net)	0.7%	-3.1%	1.8%	10.0%	4.1%	5.2%
MSCI Emerging Markets Index (\$USD, net)	-1.1%	-7.7%	-0.8%	12.4%	3.6%	5.4%
MSCI BRIC Index (\$USD, net)	-4.1%	-8.6%	-2.5%	13.8%	4.4%	4.4%

Fixed Income	Q3 2018	YTD*	1 Year*	ANNUALIZED		
				3 Year*	5 Year*	10 Year*
Bloomberg Barclays US Treasury 1-3 Year Index	0.2%	0.2%	0.0%	0.4%	0.6%	1.1%
Bloomberg Barclays US Treasury 5-10 Year Index	-0.5%	-2.1%	-2.5%	0.0%	1.5%	3.5%
Bloomberg Barclays US Long Treasury Index	-2.9%	-5.8%	-3.6%	0.7%	4.4%	5.5%
Bloomberg Barclays US Treasury US TIPS Index	-0.8%	-0.8%	0.4%	2.0%	1.4%	3.3%
Bloomberg Barclays US Govt/Credit Intermediate Index	0.2%	-0.8%	-1.0%	0.9%	1.5%	3.2%
ICE BofAML Municipals 1-10 Year A-AAA Index	-0.1%	0.1%	-0.4%	1.1%	1.7%	3.1%
Bloomberg Barclays US Corporate High Yield Index	2.4%	2.6%	3.0%	8.1%	5.5%	9.5%
ICE BofAML Preferred Stock Fixed Rate Index	0.2%	0.2%	0.7%	5.5%	7.1%	9.2%
JPMorgan GBI EM Global Diversified Index	-1.8%	-8.1%	-7.4%	5.2%	-1.7%	2.7%

* All returns for the period ending on September 30, 2018.

Source: Bloomberg, Morgan Stanley Capital International, Russell®, Standard and Poor's and Barclays.



INDEX DEFINITIONS

U.S. EQUITY

Dow Jones Industrial Average: is a price-weighted average of 30 actively traded blue-chip U.S. stocks

NASDAQ Composite Index: is a market capitalization index of approximately 3,000 common equities listed on the NASDAQ exchange

S&P 500 TR Index: is a type of equity index that tracks both the capital gains of the equities in the S&P 500 and assumes any cash distributions (dividends) are reinvested back into the index

Russell 1000 Index®: measures the performance of the 1,000 largest companies in the Russell 3000

Russell 1000 Growth Index®: measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values

Russell 1000 Value Index®: measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values

Russell Mid Cap Index®: measures the performance of the 800 smallest companies in the Russell 1000 index

Russell Mid Cap Growth Index®: measures the performance of those Russell Midcap companies with higher price-to-book ratios and higher forecasted growth values. The stocks are also members of the Russell 1000 Growth index

Russell Mid Cap Value Index®: measures the performance of those Russell Midcap companies with lower price-to-book and lower forecasted growth values. The stocks are also members of the Russell 1000 Value index

Russell 2000 Index®: measures the performance of the 2,000 smallest companies in the Russell 3000 index

Russell 2000 Growth Index®: measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values

Russell 2000 Value Index®: measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values

INTERNATIONAL EQUITY

MSCI EAFE Index: is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada

MSCI AC World Index: is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets

MSCI AC World Ex US Index: captures large and midcap representation across 22 of 23 developed marketing countries (excluding the US) and 23 Emerging Markets countries

MSCI Emerging Markets Index: is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets

MSCI BRIC Index: is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance across the following 4 emerging market country indexes: Brazil, Russia, India and China

**FIXED INCOME****Bloomberg Barclays US Treasury 1–3 Year Index:**

measures the performance of U.S. Treasury securities that have a remaining maturity of at least one year and less than three years

Bloomberg Barclays US Treasury 5–10 Year Index:

measures the performance of U.S. Treasury securities that have a remaining maturing of at least five years and less than 10 years

Bloomberg Barclays US Long Treasury Index: includes all publicly issued, U.S. Treasury securities that have a remaining maturity of 10 or more years, are rated investment grade, and have \$250 million or more of outstanding face value

Bloomberg Barclays US Treasury US TIPS Index: the index includes all publicly issued U.S. Treasury inflation-protected securities that have at least one year remaining to maturity, are rated investment grade, and have \$250 million or more of outstanding face value

Bloomberg Barclays US Govt/Credit Intermediate Index: the index measures the performance of the USD-denominated U.S. Treasuries, government-related and investment grade U.S. corporate securities that have a remaining maturity of greater than one year and less than ten years

Bloomberg Barclays US Corporate High Yield Index:

measures the USD-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. Bonds from issues with an emerging markets country of risk, based on Barclay's EM country definition, are excluded

ICE BofAML 1–10 Year AAA–A Municipal Securities Index:

is a subset of the BofAML U.S. Municipal Securities Index and includes all securities with a remaining term to final maturity less than 10 years and rated AAA through A3, inclusive.

ICE BofAML Preferred Stock Fixed Rate Index:

this index is designed to replicate the total return of a diversified group of investment-grade preferred securities

JPMorgan GBI EM Global Diversified Index:

is an investable benchmark that includes only those countries that are directly accessible by most of the international investor base. This index exclude countries with explicit capital controls, but does not factor in regulatory / tax hurdles in assessing eligibility

**DISCLOSURE**

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