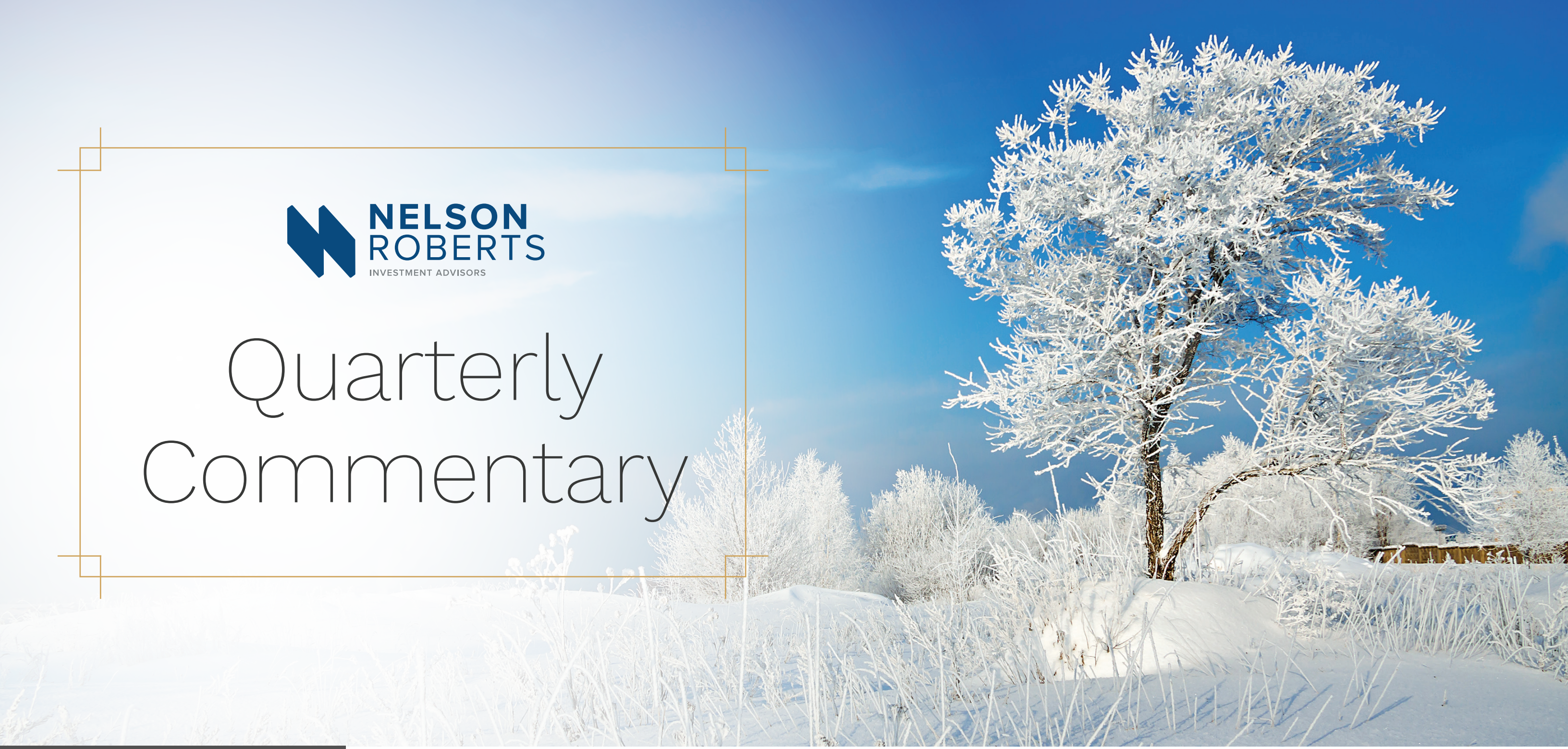

NELSON ROBERTS
INVESTMENT ADVISORS

Quarterly Commentary

2018 | Q4

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Waves of Volatility

Volatility reignited in the fall, following a relatively quiet spring and summer. In the fourth quarter, the index moved more than 1% on 28 out of 63 total trading days, compared to zero days over 1% in the third quarter. Most of these moves were to the downside, as the S&P 500 fell 13.5% from the end of September, erasing all gains that the index had seen up to that point, and bringing the year-to-date decline to 4.4%. Markets tend to hate uncertainty, and there was plenty of it in the last few months of the year. The trade conflict with China, the breakdown in Brexit negotiations, the government shutdown, the Mueller investigation, oil prices in freefall, geopolitical concerns over the withdrawal from Syria, high-profile Trump administration departures, and shrinking global growth forecasts were all sources of anxiety.

Meanwhile, economic data exhibited a robust labor market, with low unemployment and rising wages, while corporate earnings achieved their 20% growth forecast for the year. The S&P 500's drop in 2018 alongside the significant increase in earnings translated to a considerable valuation decline. Indeed, the S&P 500 trailing price-to-earnings ratio fell 22%, from 21.9 at the start of the year to 17.1 at the end.

Of all the tea leaves, perhaps none were more carefully studied than those from the Federal Reserve. At its final meeting of the year, the Fed raised its benchmark Federal Funds Target rate to 2.5%, as was widely expected. It also signaled that it will slow its rate hike program in 2019, with only two rate hikes planned, following four in 2018. Furthermore, the Fed maintained that it will remain "data dependent," meaning that it will react accordingly if it sees signs of a slowdown in the economy. Nevertheless, the Fed anticipates that the tight labor market will ultimately cause inflationary pressure, which is why it decided not to take a dramatic pause in its interest rate hikes or to disrupt the current pace of unwinding its balance sheet.

Inflation has thus far remained benign in the current bull market. The Fed measures inflation primarily with the Personal Consumption Expenditures (PCE) price index. Rising wages, increasing freight costs and higher input prices have helped firm inflation, while falling oil, global growth concerns and a softening housing market are acting as buffers, keeping inflation from running away.

David Brancaccio, host of American Public Media's "Marketplace," analogized that if the U.S. economy is the ocean, then the Federal Reserve might be the

Index Performance	Q4 '18	YTD
Dow Jones Industrials	-11.31%	-3.48%
Standard & Poor's 500	-13.52%	-4.39%
EAFE (international stocks)	-12.49%	-13.32%
Russell 2000 (small stocks)	-20.21%	-11.03%
Barclays Interm. Gov/Credit	1.65%	0.88%
Barclays Municipal	1.69%	1.28%

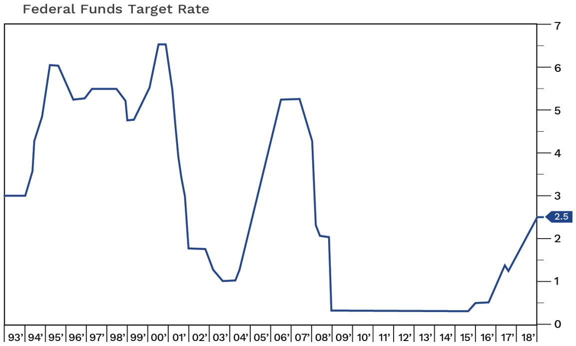
We apply rigorous analysis in asset selection so you can focus on your passion

ECONOMIC OVERVIEW

Waves of Volatility (cont.)

moon. The Fed's monetary policy controls the economic "tides." The Fed's four rate increases this year have led to higher short-term interest rates and an even flatter yield curve. Much ado has been made in the headlines about the traditional recession harbinger, the yield curve "inversion," that occurred near the end of the year. The 2-year yield did indeed trade higher than the 5-year yield—by 0.02%. But this inversion is miniscule compared to the one that occurred at the end of 2006, when the entire curve was inverted and the 2-year Treasury was yielding nearly 20 basis points more than the 5-year Treasury. Even then, it took a full 18 months after that for a recession to materialize. We do predict that we will see a more genuine yield curve inversion in 2019, and if this is coupled with a slowdown in payrolls, we think the next recession will follow 6 to 18

Federal Funds Target Rate

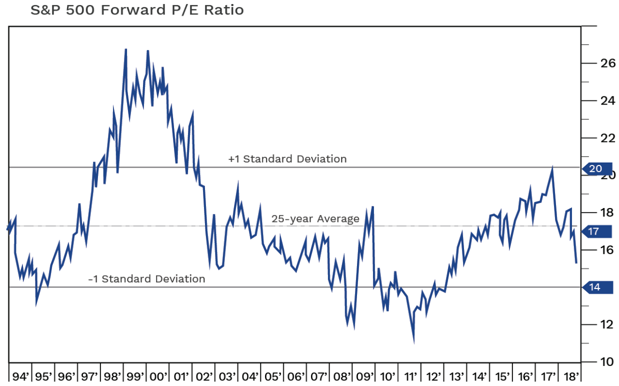


Source: Bloomberg

months later, as it usually does. We continue to monitor the spread between the 2- and 10-year Treasury yields as well as the year-over-year job growth rate.

We maintain our belief that the next recession will be caused by the Fed overtightening, or raising rates to a point where economic growth is impacted. However, we are surprised at the strong negative reaction in the market given a low 2.5% benchmark

S&P 500 Forward P/E Ratio



Source: Bloomberg

rate and the measured, cautious approach the Fed demonstrated at its last meeting. But just as the ocean has its own currents and waves that act independent of the tides, the markets have their own idiosyncrasies that cause near-term volatility.

While we remain fully invested at this time, we have begun to pivot toward defensive stocks that should hold up well in a recession. These include companies whose revenue is less dependent on robust macroeconomic growth as well as value stocks that have low valuations and high dividend yields. We have also added more 2-year Treasury notes and money market funds, including the Schwab Value Advantage Money Fund (tkr: SWVXX), to our client portfolios. Nevertheless, we still remain overweighted in equities relative to fixed income. Currently, our client portfolios are roughly 75% equities and 25% fixed income. By comparison, in 2004 that split was closer to 50/50.

The next step in our pivot will be to increase our fixed income exposure and decrease our equity exposure. Eventually, we will look to add more to our international equity weighting, but we see too much risk and uncertainty in international markets to warrant a heavier weighting at this time.

ASSET TRANSACTIONS

End-of-Year Positioning

In our healthcare sector, we bought Zoetis (tkr: ZTS, see Featured Equity). Zoetis is the world's largest standalone producer of medicine and vaccines for animals. Zoetis was originally the animal health division of Pfizer (tkr: PFE), but it was spun out as its own company in 2013. Zoetis produces pharmaceuticals for both livestock and companion animals, but we are particularly excited about the growth opportunities for the latter. As more people decide to keep household pets, and more pet owners are willing to spend money to keep their pets healthy, Zoetis will benefit. Remarkably, spending on pets has increased even during recession years, so if we do hit a recession in the next few years, Zoetis should be relatively insulated. We kept our overall exposure to healthcare about the same, as we also decided to trim our large position in UnitedHealth Group (tkr: UNH). We still maintain an overweight position in UnitedHealth, but we took advantage of an increase in price and valuation to reduce our exposure slightly.

In our finance sector, we sold Invesco (tkr: IVZ). We had held the stock based on the thesis that management could drive margin expansion to levels more in line with its peer group. However, the margin expansion story was taking much longer than expected to materialize, and in the meantime, organic growth remained challenged, while fee compression in the exchange-traded fund (ETF) space battered the stock. We decided to realize a loss for most of our clients in order to offset capital gains taken throughout the year. We purchased a small position in Charles Schwab (tkr: SCHW). The recent downturn brought Schwab's valuation down to levels not seen since 2011. Although asset management fees are down, net interest revenue and trading revenue have been strong as the company continues to attract assets. We took this as an opportunity to gain a position in this premier asset gatherer.

In our consumer discretionary sector, we sold the Invesco S&P 500 Equal Weight Consumer Discretionary ETF (tkr: RCD) and added to our position in TJX Companies (tkr: TJX). RCD, as an equal-weighted sector ETF, had allowed us to gain sector exposure without adding meaningfully to Amazon (tkr: AMZN), which is already represented heavily in our client portfolios. However, we sold the position in RCD because we believe there is better upside opportunity in TJX Companies, the parent company of TJ Maxx, HomeGoods, Marshalls, and other off-price clothing and home stores. TJX continues to demonstrate that it is "Amazon-proof," driving increasing same-store sales growth consistently even as other retailers feel the sting of competition by Amazon.

In the new communication services sector, we added to our position in Disney (tkr: DIS). Disney's stock price has traded sideways over the past few years due to ESPN subscriber declines amidst a transition toward over-the-top (OTT) content consumption. However, subscriber declines have slowed recently, and are likely close to hitting an equilibrium level. Furthermore, Disney acquired valuable content assets from Fox (tkr: FOXA) and outlined its own OTT streaming strategy, including ESPN+, a majority stake in Hulu, and Disney+. This visibility, and the fact that we believe the ESPN subscriber declines are subsiding, led us to add to our position in Disney, taking advantage of a very low stock valuation.

Finally, there were two corporate actions to note. TJX Companies split 2-for-1 during the quarter. Praxair (tkr: PX) was renamed to Linde (tkr: LIN) following the merger of the two industrial gas companies.

> But just as the ocean has its own currents and waves that act independent of the tides, the markets have their own idiosyncrasies that cause near-term volatility.

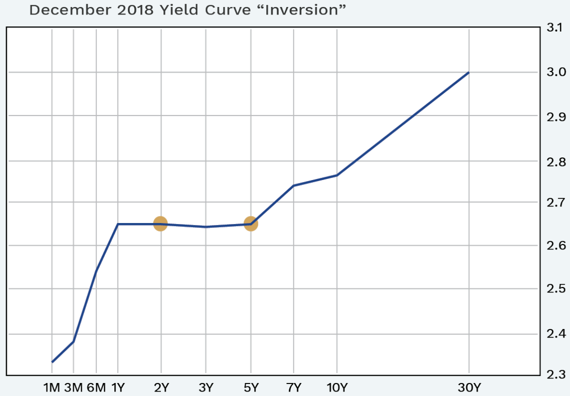
The team at Nelson Roberts would like to wish everyone a happy and healthy new year.

WEALTH MANAGEMENT

The Yield Curve “Inversion”

The yield curve has been a popular topic of discussion in the media in recent months. During the first week of December, many headlines declared that the yield curve had inverted. Inverted yield curves have generally been reliable indicators of past recessions, so this “inversion” gained a lot of attention. Does this mean we are headed for a recession? The short answer is that the media is focused on the wrong part of the curve and although the yield curve is flattening, we have not seen a true inversion yet. In normal economic periods, the yield curve slopes upward as longer bonds yield more than shorter bonds. Currently, short-term rates, which are controlled by the Federal Reserve, are rising faster than longer-term rates, creating a flat yield curve. In early December, the yield on the 2-year Treasury was about 0.02% higher than the yield on the 5-year Treasury. The media highlighted this relationship as an inversion, but not only was the differential very small, it was likely a short-term trading aberration. The 2-year and 5-year also “inverted” in 1998, but this inversion was not followed by a recession. Generally, the relationship between the 2- and 10-year yields is a better indicator of a recession. At a spread of 0.18 percentage points, the 2-year and 10-year are close, but still in positive slope.

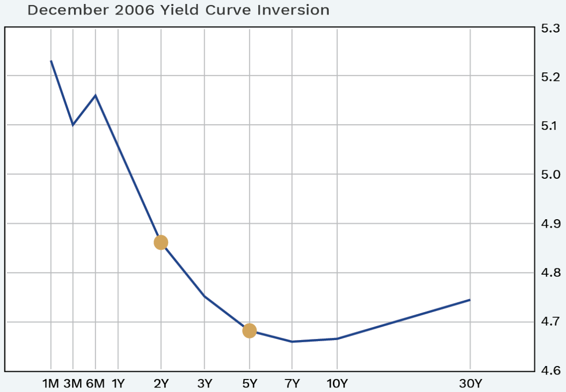
December 2018 Yield Curve “Inversion”



Source: FactSet

Historically, the probability of a recession doesn’t increase until the yield curve becomes substantially more inverted than a few basis points. The case for focusing on yield curves in the U.S. is based on the fact that they have made few false recession signals and many correct warnings. Still, it is unclear why the curve should matter, or which gap matters most.

December 2006 Yield Curve Inversion

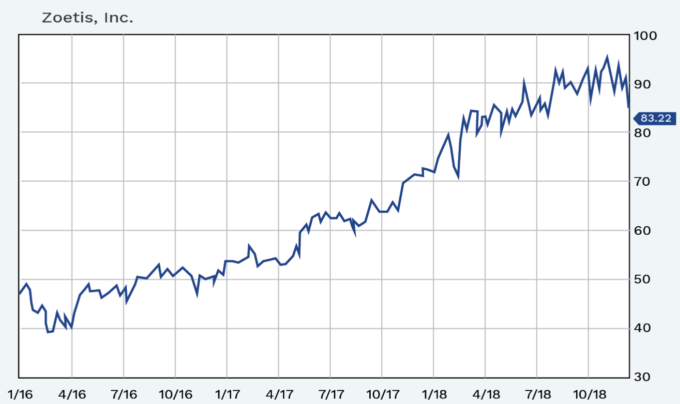


Source: FactSet

FEATURED EQUITY

Zoetis

Zoetis is the world's largest standalone manufacturer of pharmaceutical products for animals. Most of Zoetis' competitors are the animal health units of big pharmaceutical companies. Merck and Boehringer Ingelheim both have animal health units and Eli Lilly just recently spun out its animal health unit, which is now called Elanco (tkr: ELAN). Zoetis itself was spun off from Pfizer in 2013. Since then, the company has built a strong global infrastructure, which gives it a substantial cost advantage, and it also boasts the broadest product portfolio. Zoetis has its own salesforce, which allows it to bypass distributors and market directly to veterinarians and livestock producers. The size of the global animal pharmaceutical market is estimated to be approximately $30 billion and Zoetis has about 18% of that market, with revenues of $5.3 billion in 2017. This niche has historically been somewhat "recession-proof," given that even during recession years, pet spending has increased.



Source: FactSet

We own Zoetis based on two main investment themes. First is the increasing "humanization of pets," as pet owners are becoming much more willing to invest substantial resources to keep their pets healthy, and treat them when they become ill or injured. In the U.S., 68% of households have pets (about 184 million companion animals), while international pet ownership is also on the rise. Second, we believe there will be greater demand for "production animals" for food in developing countries as income rises. Zoetis' revenues are divided equally between its U.S. and international businesses. Major product categories include anti-infectives ($1.25 billion of revenue), vaccines ($1.37 billion), parasiticides ($763 million), medicated feed additives ($475 million) and other pharmaceuticals ($1.18 billion).

We had initially looked at Zoetis four years ago. The main reason we decided not to buy the stock was concern over how increasing regulation of the use of antibiotics in livestock feed might affect revenues. Since then, the FDA has issued stricter guidance on such use and the impact on Zoetis' revenues has been modest. In the meantime, Zoetis revenues overall have continued to grow, with a smaller percentage coming from antibiotics in feed. Management has successfully introduced new products to replace these lost revenues, including important new vaccines, parasiticides and medication to treat allergies in companion animals.

(The preceding information regarding the featured equity should not be construed as a recommendation to purchase the security. It should not be assumed that future returns will be profitable or will equal the historical performance. Please contact us for a complete list of holdings.)

TOP 15 HOLDINGS

- iSHARES S&P SMALL-CAP ETF
- VANGUARD DEVELOPED MARKET ETF
- AMAZON.COM INC.
- ALPHABET INC.
- COSTCO WHOLESALE CORP.
- SALESFORCE.COM INC.
- TXJ COMPANIES INC.
- VERIZON COMMUNICATIONS INC.
- ILLUMINA INC.
- UNITEDHEALTH GROUP INC.
- CISCO SYSTEMS INC.
- VANGUARD EMERGING MARKET ETF
- QUALCOMM INC.
- ROPER TECHNOLOGIES INC.
- FIRST REPUBLIC BANK

OUR TEAM

Brooks Nelson, CFA
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Darcy Nelson Smoot, CFA
Evan Nelson, CFP®
Sarah Sinclair
Erin Rodriguez
Chrissy Domingo

SPECIAL TOPIC

Vacation Destinations

With the New Year upon us, many set a resolution to spend less time at work and more time with family. Family vacations can be made more enjoyable with a great location and in a fabulous home. Whether the destination is the beach or mountains, domestic or international, there are many different ways to secure access to a great location. Options range from full ownership to timeshare models. Here are some attributes of a few different options.

Direct ownership of a second home: By directly purchasing a second home, the owner has unlimited access to enjoy the location. The owner also benefits from 100% of the upside (or suffers 100% of the downside) of the value of the investment in the property. However, full ownership also comes with the responsibilities of maintenance and property taxes. Furthermore, the entry price point can be prohibitive when buying an entire property. Unless an owner is able to spend significant time in the second home, the cost per usage day can be very high, and owners are essentially tied to the location of their second home.

Buying a Timeshare: Usage rights for a timeshare can be defined in many different ways: fixed week, floating, right-to-use, and even points-related usage. The biggest benefit to a timeshare is the relatively low price point, since you are only paying for the time you use. A timeshare can provide access to a single home or to a group of vacation properties. The annual maintenance fees are generally a fraction of the cost relative to direct ownership. However, access to timeshare properties is limited by the outlined usage rights and liquidity is often poor, as the resale value can be dramatically lower than the entry price. If you are considering a timeshare, consider it a lifestyle expense rather than an investment.

Fractional Ownership (aka Private Residence Clubs): With this option, owners buy a fraction of a specific luxury property. Their usage opportunity is proportional to their ownership percentage. Owners share the costs of maintenance and upkeep, and pay a manager to administer usage. There is frequently an emphasis on privacy and exclusivity, as fractional ownership can include access to private golf courses, beaches and ski runs. However, resale value and liquidity are top concerns, particularly with aging properties.

Luxury Residence Fund: With a luxury residence fund, owners buy an interest in a real estate partnership that owns multiple luxury properties. The owner's ability to utilize the properties is defined by the capital contribution plus an annual fee that is used for maintenance and upkeep. The annual usage fees are slightly lower compared to renting a similar property on a nightly basis, and the owner can benefit from any increased value of the property portfolio. Similar to private residence clubs, there is an emphasis is on privacy and exclusivity, but with luxury residence funds, owners have access to the entire range of the fund's properties at multiple locations. The ability to sell an ownership stake is limited, but many funds have a terminal point that provides a liquidity event for the fund's owners.

These options range from a true investment to a lifestyle expense, and there is not a one-size-fits-all solution. Please reach out to us to discuss these options further, or to find out which option would fit best for you. Regardless of the option that fits best, we encourage the resolution to spend more time away from work and with family.

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