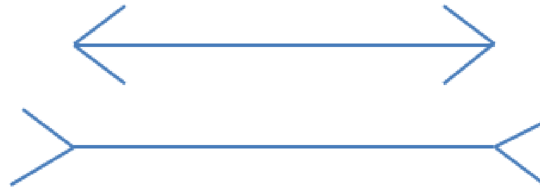
NOTTINGHAM ADVISORS
ASSET MANAGEMENT

Q3 2018 CIO Letter

Should I Stay or Should I Go?

Should I stay or should I go now?
Should I stay or should I go now?
If I go, there will be trouble
And if I stay it will be double
So come on and let me know
-The Clash



Perception is a funny thing. Two people can look at the same object, the above lines for example, and see two different things. Ask yourself, which line is longer? For some the answer is obvious; others not so much. (I'll save the real answer until the end of this missive.) Many wise investors remain bullish on equities; however, the bull itself may be running on fumes after 10 long years galloping at breakneck speed.

Corporate earnings have surged year over year. The stock market is near an all-time high. So too are political tensions in the U.S. The economic landscape appears benign and extra innings to this rally are very possible. Yet, investors everywhere appear to have one foot out the door while tenuously holding on to the belief things can improve from here. What's an investor to do – should we stay or should we go?

I'm afraid Joe Strummer, Mick Jones and the lads from The Clash never got around to figuring that out in their early '80's hit song referenced above. Fortunately for you, we at Nottingham remain at the ready to help you navigate this conundrum.

The questions we're grappling with as we begin the fourth quarter of 2018 are: 1) Is the rally in corporate earnings sustainable or just a "sugar high"?, 2) At what point do rising interest rates choke off business investment?, 3) What will political gridlock mean for the economy and lastly, 4) Do international markets represent value or a value trap? We'll attempt to address each of these issues over the next few pages and present what we think is a plausible case for staying the course – although with an added degree of caution in mind.

Sugar High?
We've mentioned in the past the impact that the 2017 tax reform act has had on corporate earnings. With lower marginal tax rates, an incentive to bring back to the U.S. foreign-sourced profits, and large scale fiscal stimulus courtesy of our elected officials in Washington, it's no wonder we're seeing equity markets test new highs. The question is, once we get beyond the initial impact of the changes, do we have a sustainable pathway to consistently higher earnings? 25% increases year over year are highly unusual and certainly not sustainable in the long run. Our guess is we might be seeing peak earnings, or something close to that, and while 2019 should look pretty good, earnings growth will slow due to rising wages, higher interest rates, a rising US Dollar and the impact of tariffs on raw materials.

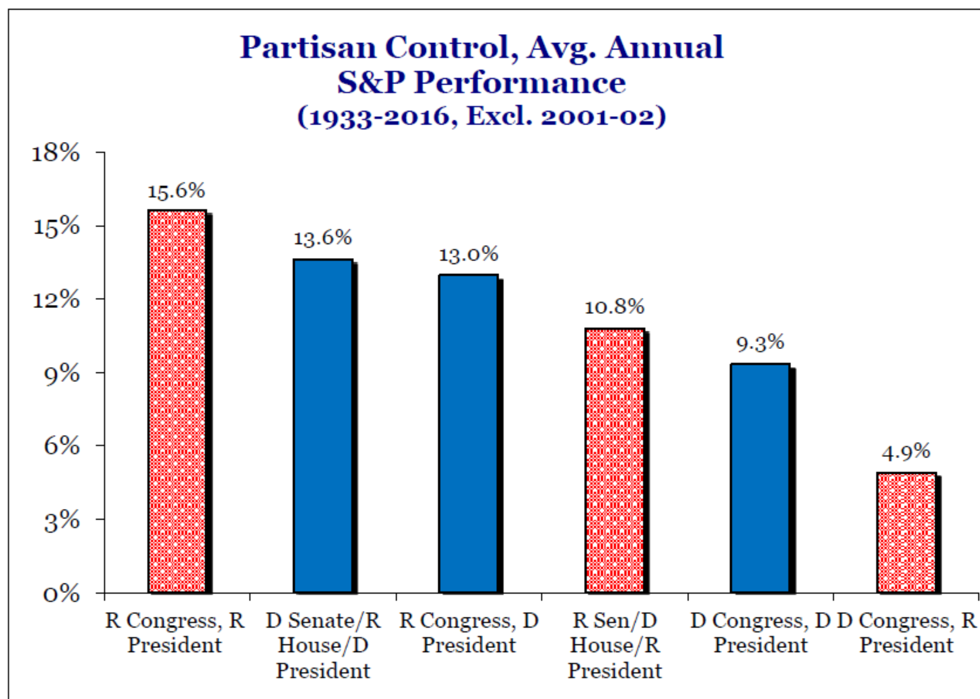
US equities aren't as expensive as they were a year or two ago, however they aren't cheap and by some long-term metrics (CAPE Ratio) they look frighteningly expensive. While we have yet to pare back our domestic exposure to stocks, we have maintained a more defensive posture via the low-volatility factor present in a number of the ETF's we own. We also have maintained a slight value bias in our equity holdings. Value has underperformed growth, but with lower valuations should offer protection in a sell-off. Financials are still attractive while the FAANG names make us uneasy at current levels.

Fear Rising Rates?
The Federal Reserve raised short-term interest rates by .25% in September and indicated that they will likely do the same in December and perhaps 4 more times in 2019. The market has a history of ignoring the Fed, thanks largely due to the Greenspan (and Bernanke and Yellen) "put", or the belief that the Fed will cut interest rates at the first sign of trouble in the stock market. We think Fed Chair Powell is different, and that he won't be afraid to pursue higher interest rates, even if the equity market balks. So, the simple answer is, Yes, we should fear higher interest rates. But, not just yet.

In absolute terms, interest rates are still near the lower end of their 35-year range. Despite the onset of "quantitative tightening", credit is still readily available and the demand for income by yield-starved investors remains robust. All that said, when one is used to paying 1% to 2% interest on a loan, 4% can seem egregious. We do think higher rates will hasten the end of this bull market, and certainly will add to market volatility, but there remains potential for the bull to limp on in 2019 and we don't want to give up quite yet. Increased caution, however, is warranted. Lower quality companies with higher debt loads will struggle with higher interest rates and ultimately we could see defaults spike.

Political Gridlock
November 6th will be a very important day for financial markets (and all Americans for that matter), as Election Day will potentially see a change in control for one, if not both houses of Congress. As the accompanying chart indicates (courtesy of our friends at Strategas Research Partners), the makeup of Congress matter to investors. We do think at this point the House will flip to the Democrats while the Republicans will hold on to the Senate, although it may be 50/50. Anything can happen though.

Regardless of whether you're a Republican, Democrat or Independent, **DON'T FORGET TO VOTE!** The election outcome will likely have a significant impact on equity returns and interest rates over the balance of the next few years. What is important to remember is that it will get pretty noisy over the coming month and investors need to keep in mind their own personal investment objectives. Markets may fall, but they've always recovered. It's been a long time since we had a material correction and we are overdue. It's always best to keep one's head about them when everyone else is losing theirs!



International Equities
International stocks have been a core part of our equity exposure here at Nottingham for the past 15 to 20 years. More recently, and with the exception of 2017, they haven't added a lot of value to our portfolios. Admittedly, they've been frustrating to own. We encourage investors not to lose faith, however. We highlighted in our Q1 '18 CIO Letter the long cycles that domestic and international equities move in. Emerging market stocks especially look cheap to us right now. Many astute investors, including Rob Arnott of Research Affiliates, see EM as potentially the "trade of the decade" looking out the next ten years. But, patience is required (and highly recommended!).

The brewing trade war has taken a toll on Asian markets – especially China. The Shanghai Composite Index was down -12.6% through the first nine months of the year. It's promising to see new trade deals get struck with Mexico and Canada and we remain optimistic that ultimately new rules of trade with China will get written. Both sides have too much to lose should this drag on deep into next year. We believe any hint of a compromise between the US and China should send Asian markets soaring. From a pure valuation perspective, international equities remain compelling and we're optimistic their returns over the next five to ten years should equal or exceed those found domestically.

Summary
Back in our Q1 '17 CIO Letter, we commented on the challenges facing managers and investors alike at the tail end of a bull market. Historical patterns and relationships get skewed and oftentimes come untethered. Recent weeks have seen the announcement by two large and well known hedge funds that they were shutting down and returning investor money. Favorable returns in the "2 and 20" space have been hard to come by in recent years and investor patience for high fees and low performance is wearing thin. Indexing continues to win over new converts, especially in the institutional space.

As I write this letter, the Dow Jones Industrial average is down nearly 800 points on the day. The talking heads on CNBC are working overtime to come up with plausible explanations for today's drop. Most are blaming the Fed, even though the Fed last met on 9/26 and hasn't said anything since. Some

are amazed that a stock as great as Amazon could be off -5% on the day. IT'S UP 51% THIS YEAR! Are you kidding me? Down -5%? As we said at the start of this note, perception is a funny thing.

Despite the concerns we outlined above, we remain sanguine on the prospects for both the global economy and a globally diversified portfolio. Third quarter corporate earnings readings are just being released and they should be strong. US equities are relatively expensive while international equities are relatively cheap. Interest rates are rising – that's good news for savers and fixed income investors. Volatility is sure to pick up as we near the midterm election. Brace for it. Diversification remains cheap and cash is a good hedge right now. Give us a call if you'd like to talk about our strategies or your portfolio. We'd look forward to speaking with you and comparing our perceptions with yours. Oh, and by the way, the two lines shown on page one are of equal length!

As always we appreciate your business,

Larry Whistler, CFA
President/Chief Investment Officer
October 2018

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www.nottinghamadvisors.com

NEW YORK OFFICE : 100 Corporate Parkway : Suite 338 : Amherst, NY 14226 : 716-633-3800 : 716-633-3810 Fax

FLORIDA OFFICE : 3801 PGA Boulevard : Suite 600 : Palm Beach Gardens, FL 33410 : 800-281-8974