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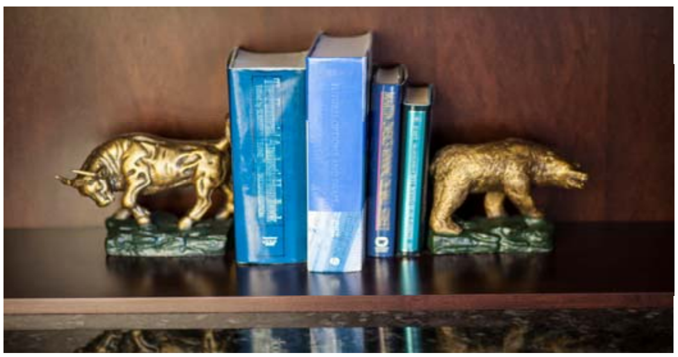
Quarterly Newsletter

2018: Second Quarter | **118th Edition**



"As I think back over the years, I have been guided by four principles for decision making. First, the only certainty is that there is no certainty. Second, every decision, as a consequence, is a matter of weighing probabilities. Third, despite uncertainty we must decide and we must act. And lastly, we need to judge decisions not only on the results, but on how they were made."

~ Robert Rubin, Former United States Secretary of the Treasury

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CAPITAL MARKETS SCOREBOARD

Equities					
Indices	**2Q18 Total Return (%)**	**2018 Total Return (%)**	**Index Characteristics**		
Domestic			**NTM P/E**	**P/B**	**Div. Yld. (%)**
S&P 500	3.4	2.6	16.1	3.2	1.95
DJIA	1.3	-0.7	15.1	3.9	2.14
NASDAQ	6.6	9.4	21.6	4.4	1.01
Russell 1000 Growth	5.8	7.3	20.3	6.8	1.24
Russell 1000 Value	1.2	-1.7	13.8	2.0	2.53
Russell 2000	7.8	7.7	21.9	2.1	1.30
International*					
MSCI EAFE	-0.8	-2.4	13.6	1.6	3.17
MSCI Emerging Markets	-7.7	-6.5	11.3	1.7	2.58
MSCI United Kingdom	3.0	-1.0	13.3	1.8	4.02
MSCI France	0.3	0.7	13.9	1.6	3.16
MSCI Germany	-3.4	-6.8	12.4	1.7	2.93
MSCI Japan	-2.1	-1.9	13.2	1.4	2.11

Fixed Income		
Indices**	**2Q18 Total Return (%)**	**2018 Total Return (%)**
Domestic		
U.S. Corp - Gov (1-3 Years)	0.3	0.1
U.S. Corp - Gov (3-5 Years)	0.0	-0.9
U.S. Corp - Gov (10+ Years)	-1.2	-4.7
U.S. Treasuries Master	0.1	-1.1
U.S. Corporates Master	-0.9	-3.1
U.S. Municipals Master	0.9	-0.3
U.S. High Yield Master	1.0	0.1
International*		
Developed Markets Sov Bond	-3.2	-0.6

Commodities		
Resource	**2Q18 Total Return (%)**	**2018 Total Return (%)**
Precious Metals		
Gold	-5.4	-4.2
Silver	-1.5	-5.0
Industrial Metals		
Copper	-2.3	-10.1
Aluminum	9.3	-2.6
Energy		
Brent Crude Oil	12.2	16.0
WTI Crude Oil	14.3	22.6
Natural Gas	7.0	-1.0

Key Rates				
Rates	**6/30/2018**	**3/31/2018**	**12/31/2017**	**12/31/2016**
U.S. Target Fed Funds Rate	1.88	1.63	1.38	0.68
2-Year U.S. Treasury	2.52	2.27	1.89	1.20
10-Year U.S. Treasury	2.85	2.74	2.40	2.45
30-Year U.S. Treasury	2.98	2.97	2.74	3.06
10-Year German Bund	0.30	0.50	0.43	0.21
10-Year Japanese Bond	0.03	0.04	0.05	0.03
30-Year Fixed Mortgage	4.84	4.69	4.25	4.39

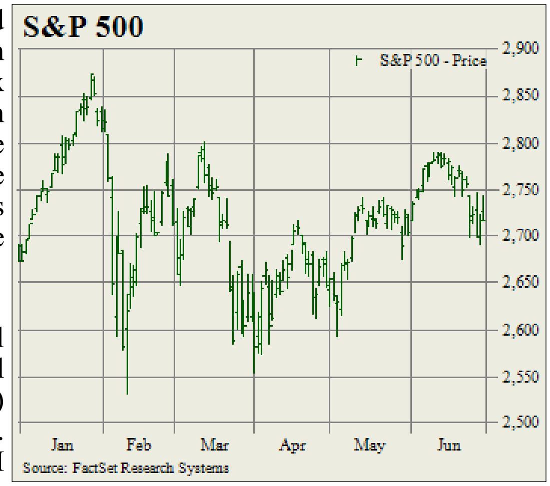
Currencies				
Indices/ Exchange Rates	**6/30/2018**	**3/31/2018**	**12/31/2017**	**12/31/2016**
ICE U.S. Dollar Index	94.64	90.15	92.12	102.21
USD per EUR	1.17	1.23	1.20	1.05
USD per GBP	1.32	1.40	1.35	1.23
JPY per USD	110.75	106.30	112.71	116.90
CAD per USD	1.31	1.29	1.26	1.34

*Returns denominated in U.S. dollars

**ICE Bank of America Merrill Lynch (BofA-ML) indices

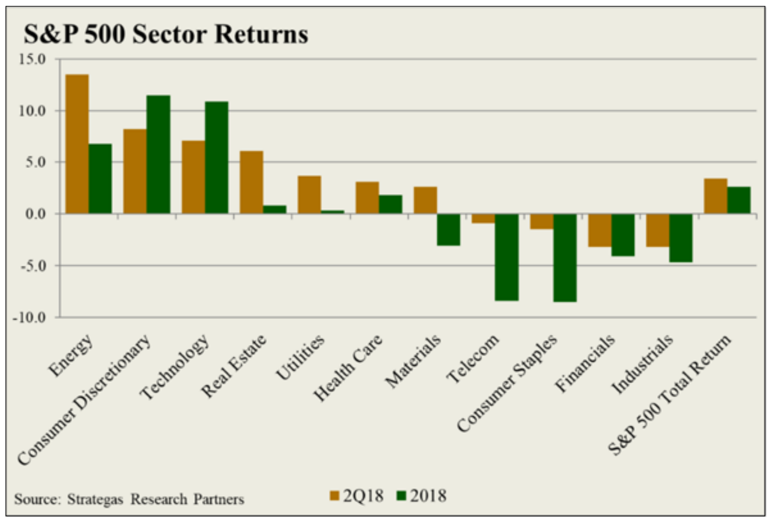
EQUITIES

- The Standard & Poor's 500 (S&P 500) index rebounded during the second quarter, generating a positive total return (price appreciation plus dividends) of 3.4%. The index closed at a record high of 2,872.87 on January 26, but then entered correction territory (traditionally defined as a decline of 10-19.9%) on February 8; the fifth such correction since the current bull market began in March 2009. With this rebound in the second quarter, the S&P 500 closed the quarter slightly more than 5% below its record high.



- Small cap stocks outperformed larger stocks as the Russell 2000 Index returned 7.8% in the second quarter. On a global basis, the MSCI Europe, Australasia, and Far East (EAFE) Index generated a total return of -1.0% when priced in U.S. dollars, or 3.8% priced in local currencies. The MSCI Emerging Markets Index produced total returns of -7.8% in U.S. dollar terms and -3.4% in local currency. The Chinese stock market had a significant impact due to the -13.3% total return in Shenzhen A Shares when denominated in U.S. dollars. This index has now declined over 50% since the all-time high set on June 15, 2015.

- For the quarter, the S&P 500 Growth Index returned 5.2% versus 1.4% for the S&P 500 Value Index. This represents the sixth consecutive quarter in which growth stocks have outperformed value stocks. The Energy Sector, which benefited from higher oil prices, was the best-performing sector as it returned 13.5%. The Consumer Discretionary Sector and the Technology Sector were the second- and third-best performers, generating returns of 8.2% and 7.1%, respectively. Due to concerns about higher input costs and a potential trade war, the Industrials Sector produced a total return of -3.1%. Other sectors with negative performance for the second quarter included Financials (-3.2%), Consumer Staples (-1.5%), and Telecommunications (-0.9%).

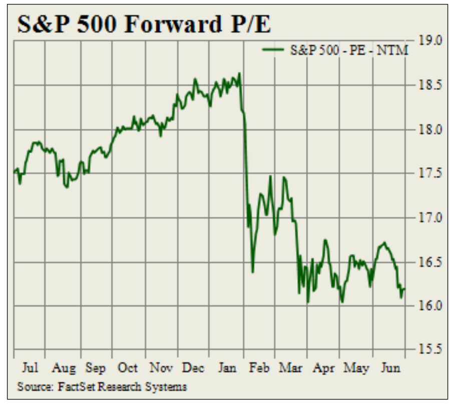


- First quarter earnings growth for companies in the S&P 500 was 24.9%, exhibiting the fastest rate of growth since the third quarter of 2010. A material portion of this earnings growth stemmed from a decline in companies' effective tax rates. Still, top-line revenue growth registered in at a healthy 8.6%, the strongest since the fourth quarter of 2011. Of the companies in the S&P 500, more than 75% reported revenue and earnings results that exceeded analyst expectations, well above the long-term averages of 60% and 64%, respectively. As of June 30, growth in second quarter earnings was projected at 20.4%, below first quarter growth but higher than the 19.1% growth rate expected at the start of the quarter.

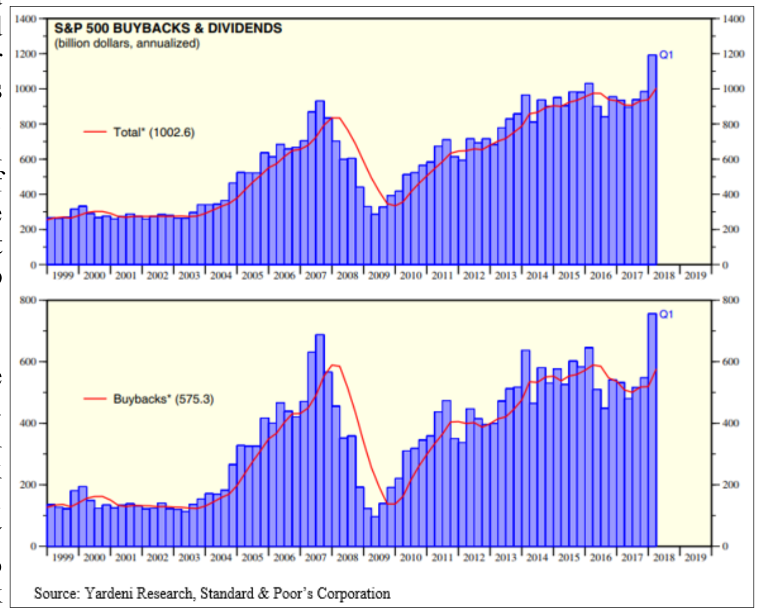
- While Wall Street analysts are projecting strong earnings growth, the U.S. Commerce Department's measure of corporate profits provides a different view. For the first quarter, the department's earnings growth measure was a mere 0.1% year-over-year. The difference is primarily attributable to the exclusion of companies' overseas operations and inclusion of one-time, non-recurring charges that lower earnings. Additionally, the government focuses on operating income while analysts and investors focus on earnings per share growth, the latter of which benefits from stock buybacks that reduce shares outstanding.

- Gross margins for S&P 500 companies have increased on a year-over-year basis for 15 consecutive quarters, boosting earnings growth. However, in recent quarters, a growing percentage of companies have begun to report lower gross margins year-over-year due to the rising costs of labor, transportation, and raw materials. If this trend continues, it will put more of a premium on revenue growth for stock prices to advance.

- A common stock valuation measure followed by investors, the price-to-earnings (P/E) ratio, has become more favorable recently due to the fact that earnings have increased while stock prices remain below their January peak. On June 30, the S&P 500 closed the second quarter trading at 16.2x next twelve months earnings versus its 20-year average of 15.7x, according to FactSet. This is a sharp drop from January 26, 2018, when the S&P 500 was trading at a 16-year high of 18.6x next twelve months earnings.

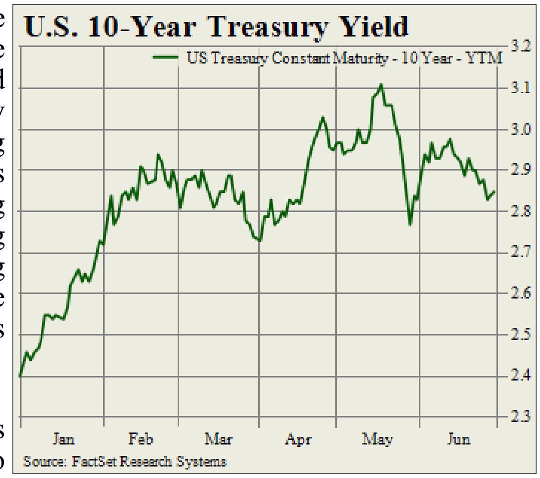


- U.S. companies announced record capital returns (share buybacks and dividends) exceeding $1 trillion on an annualized basis during the first and second quarter. This was due in part to the U.S. tax overhaul, which lowered corporate tax rates and enabled corporations to invest more in their operations and/or increase their returns of excess capital to shareholders. Interestingly, while the volume of total share buybacks surged, the number of buyback announcements was in line with the average for the previous eight earnings seasons according to TrimTabs Investment Research.



- The Dow Jones Industrial Average (DJIA) began on May 26, 1896. General Electric, the last original member, was dropped from the index after the company fell on hard times. The index committee at S&P Dow Jones Indices suggested that the 54% decline in General Electric's stock price over the past year contributed to its removal. Since the index is price-weighted, General Electric had the lowest weighting in the index, representing less than one-half of one percentage point. Additionally, by removing General Electric and replacing it with Walgreens Boots Alliance, "the Dow Jones Industrial Average will be more representative of the consumer and health care sectors of the U.S. economy," according to the committee.

FIXED INCOME



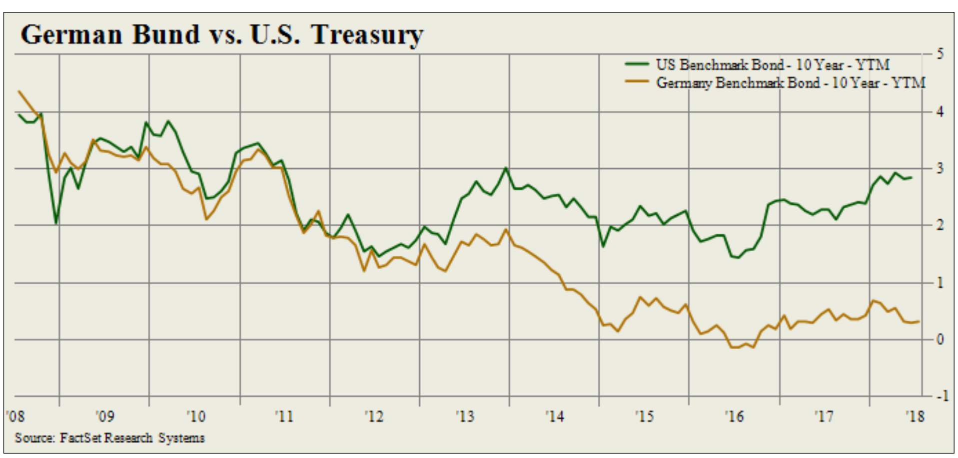
- Interest rates in the U.S. generally increased during the second quarter, creating headwinds for fixed income performance. In April, the 10-year U.S. Treasury (UST) yield surpassed 3.00% for the first time since 2014. It eventually reached 3.11%, its highest level since 2011, before finishing the quarter at 2.85%. As measured by BofA-ML indices, less interest rate sensitive short-term U.S. bonds maturing between one and three years provided some shelter, returning 0.3% for the quarter. Bonds of similar quality maturing between three and five years were effectively flat for the quarter, while long-term bonds with maturities over ten years lost 1.2%.

- From a credit perspective, investment-grade corporate bonds had their worst first half of a year since 2013 compared to U.S. Treasury bonds. Credit spreads (the yield differential between corporate and government bonds) widened as investors sought higher safety due to concerns about tariffs and their potential impact on the economy. Even so, low credit, high-yield (junk) bond spreads remained relatively stable, partially due to their lower interest rate sensitivity. As a result, junk bonds outperformed most segments of the fixed income markets, returning 1.0% for the quarter.

- In June, the Federal Open Market Committee (FOMC) announced they would move forward with an additional increase in the federal funds rate. At the end of the quarter, expectations were that two additional rate increases would occur in 2018. If both increases are implemented, they will move the federal funds rate to near 2.50%.

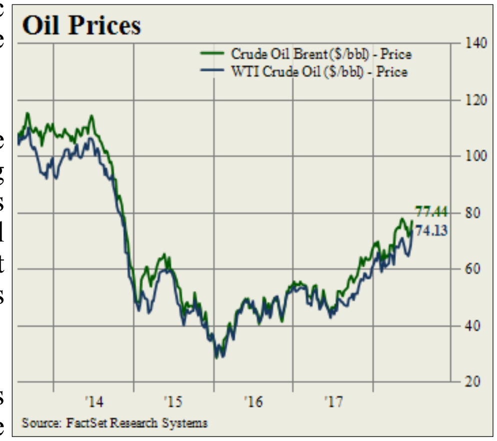
- Investors are particularly concerned about the FOMC continuing to increase rates due to an ongoing flattening of the yield curve, the maturity spectrum of UST yields. The curve is normally upward-sloping, as investors require a higher rate of return for the increased uncertainty of a longer-term investment. An inverted yield curve, when longer-term bonds are offering a lower yield than shorter-term bonds, is widely considered a negative sign for equity markets and the broad economy. The spread between yields on 2-year USTs and 10-year USTs in late June was at its lowest level since 2007, a signal that investors differ from the FOMC in their outlook for economic growth.

- One factor impacting UST yields is the sluggishness of foreign interest rates. The spread between 10-year USTs and 10-year German bunds continued to widen, reaching 2.55% to end the second quarter. This marked the highest spread since the 1980s. The 10-year bund has not offered a higher yield than the 10-year UST since 2011. As the spread has widened and UST yields have become more attractive, demand (particularly from foreign investors) has increased, serving to hold back interest rates domestically.



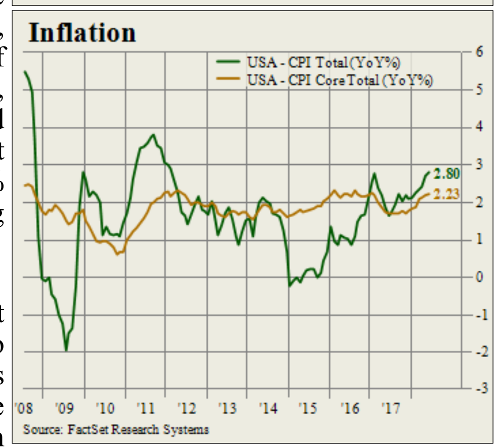
ECONOMICS

- On June 28, the Commerce Department released its third estimate of U.S. economic growth for the first quarter of the year. Gross Domestic Product (GDP) was revised down to an annualized rate of 2.0% from the 2.3% and 2.2% prior estimates. For the second quarter, GDP growth is expected to increase due to much higher consumer and business spending and exports; estimates run from 3.0% (NY Fed) to 4.0% (Atlanta Fed). During the second quarter, the current economic expansion, which started in June 2009, officially became the second-longest in U.S. history.



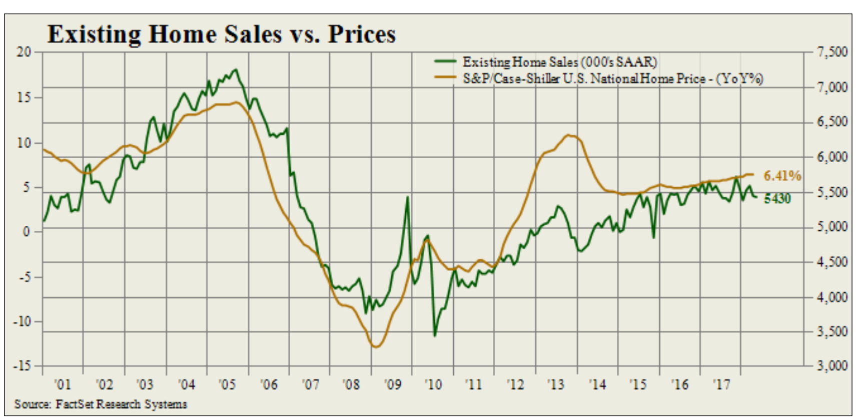
- The U.S. economy appears to be gaining steam just as the economies in Europe, Asia, and developing countries are losing momentum, and the global synchronized growth of 2017 has stalled. The stronger dollar (up 6% since February) and rising oil prices (at their highest level since 2014 and up 67% in the last year) have impacted economic growth for oil-importing countries and developing economies.

- The Consumer Price Index (CPI) hit a six-year high in May as the headline CPI was up to an annual rate of 2.7%. Core inflation, which excludes food and energy, was up 2.2%, exceeding the Fed's 2.0% target. The Fed's preferred measure of inflation, the personal consumption expenditures (PCE) index, increased an annualized 2.5% in May; 2.0% excluding food and energy. This marks the first time since 2012 that the Fed has hit its inflation target. The Producer Price Index (PPI) was up 3.1% in the last 12 months, indicating businesses are also experiencing higher inflation.



- The U.S. economy continued to add jobs in the second quarter at an average of 211,000 per month. The unemployment rate fell to an 18-year low of 3.8% in May but increased to 4.0% in June as 601,000 new jobseekers entered the workforce. For the first time since recordkeeping began in 2000, job openings of 6.7 million exceeded the 6.3 million unemployed, and jobless claims are now at 50-year lows. Average hourly earnings increased 2.7% in May and June compared to those same periods last year.

- The housing market remained in slow motion as existing home sales declined to an annual rate of 5.45 million in April and 5.43 million in May. Sales have fallen year-over-year for three straight months and are 3.0% below year ago levels. Despite a strong jobs market and a solid economy, supply and affordability are challenging the housing market. There is a four-month supply of existing homes for sale, a record low, and new single-family home construction is below trend. Housing affordability is at its worst in nearly a decade; the S&P Case-Shiller National Home Price Index is up over 6% in the last year and the 30-year fixed-rate mortgage rate hit a seven-year high of 4.66% in May, up from a 2017 low of 3.78% in September.



Economic Momentum Amid Rising Uncertainty

All indications are that the U.S. economy has a lot of momentum even after nine years of economic expansion. When the final results are tallied, economic growth will have improved in the second quarter from the 2.0% level posted in January through March of this year, based upon higher consumer spending, business investment, and a surge in exports. Consumers have benefitted from job growth, low unemployment, minimum-wage increases, tax cuts, and government spending. Still, they are somewhat cautious even ten years after the financial crisis.

The Fed is being vigilant about the inflationary impact of the 18-year low in the unemployment rate. Their concern is that a tight job market and the possibility of wage inflation will set off overall inflation. The Fed originally targeted full employment at a 4.5% unemployment rate but it may reach 3.5% by the end of 2018. It appears the job market has not been as tight as the Fed originally thought. The worker participation rate reached 62.9%, significantly below the 67.3% that prevailed in 2000, the last time the unemployment rate was this low. Retiring baby boomers have accounted for much, but not all, of the decline in the participation rate. Increasing the rate by 1.5% would result in 4 million new workers. As a result, wage growth has not increased as much as expected with the strength in the job market. Recently, average hourly earnings have grown at the same rate or slightly below the Consumer Price Index (CPI) leading to stagnant "real" wages. Should this continue, it will present a headwind for U.S. economic growth.

Trade tensions elevate risks to the global economy, and while their impact has been minimal thus far, that could change quickly. Global trade growth had already waned prior to the tariffs and the same could be said for synchronized global economic growth. Europe, Japan, Canada, and China have all recently experienced slower growth. In China, retail sales and fixed-asset investments have declined in recent months, the stock market is in bear market territory, and the Chinese yuan hit a six-month low relative to the dollar in June. Other major world currencies were also lower relative to the dollar in the second quarter.

The prospect of a trade war is beginning to weigh on consumer and business confidence in the U.S. While the economy had a lot of momentum in the second quarter, consumer confidence fell slightly in May and June from the 17-year high set in February, and durable goods orders declined in those same two months. The Trump Administration has already imposed tariffs on steel (25%), solar panels (30%), lumber (20%), aluminum (10%), and washing machines (20%). As the quarter closed, there was a forthcoming 25% tariff on 818 Chinese exports worth $34 billion and more forthcoming if China retaliates, which it typically does. Commerce Secretary Wilbur Ross has ordered an investigation on whether imports of foreign-made cars, SUVs, vans, and light trucks threaten national security. The importation of these cars and car parts cost a total of $324 billion in 2017. A 25% tariff would especially hurt Germany, Mexico, Japan, and Canada as it would add about $5,000 to the cost of a new imported car. Canada, China, Mexico, and the Eurozone have also imposed tariffs on U.S. exports.

The uncertainty related to the tariffs is extremely high. All sides could scale back, choose to maintain the status quo, or escalate. Escalation would certainly hurt the American consumer as a tariff ends up being a tax on consumers. This could negate the personal tax cuts which the Joint Committee on Taxation has estimated at $75 billion in 2018 and $189 billion in 2019. Tariffs already implemented amount to $23 billion of higher import costs, and pending tariffs could add another $125 billion, all borne by household budgets. Due to the tariffs on Canadian lumber, newsprint prices are up 30% and lumber prices hit a record high in May, adding approximately $9,000 on average to the price of a new home. Steel prices are up 35%. Meanwhile, soybean prices have fallen to a 10-year low; soybeans are the biggest U.S. export to China and are now subject to tariffs. These are direct costs and do not include second-order effects such as interruptions of complex global supply chains, job losses, loss of confidence, and less consumption and investment. The true cost of tariffs is impossible to assess. Measuring the benefits of tariffs, such as protecting industries, saving jobs, and ensuring an equal playing field, is no simpler.

Markets do not like uncertainty, and this has been reflected recently in global stock markets. The first half of 2018 has been a rollercoaster ride for the U.S. stock market. The S&P 500 peaked in January, fell more than 10% in the next two weeks, and has yet to fully recover. The main worries have been uncertainties related to rising interest rates, slowing global economic activity, trade tensions, European politics, and the return of volatility. Offsetting the increased risks has been the surge in corporate earnings, up nearly 25% in the first quarter with expectations of a 20.4% increase in the second quarter. Some of the blockbuster earnings are due to the recent corporate tax cuts, but organic earnings growth would have still been strong (in the 13-15% range) without them. First-quarter earnings growth may be the peak for this cycle, but earnings and revenues for all of 2018 are expected to increase roughly 20% and 9% respectively. Normally, this type of growth would result in advancing stock prices. Now, though, the battle between rising earnings and lower valuations will likely continue until some of the increased uncertainty investors have been facing recently is resolved. It is unlikely to come from reduced trade tensions as those are not expected to be resolved until 2019 or thereafter.

International economies experienced faster growth than the U.S. in 2017, leading to the MSCI EAFE index outperforming the S&P 500 on an annual basis for the first time since 2012. When the new year began, global equities markets were expected to continue outperforming the U.S. market, primarily due to lower valuations and synchronized global economic growth. The consensus was that foreign economies would accelerate in 2018 while the U.S. economy had already reached its peak and would decelerate, or at least not strengthen. The consensus was wrong – instead, U.S. economic growth accelerated in the first six months of the year while international growth lagged, and U.S. equities outperformed the MSCI EAFE index as a result. Tariff-fueled concerns of a trade war have also had a major impact on foreign equities due to those economies' heavier reliance on trade. As an example, exports represent 43% of Germany's economy versus 12% for the U.S.

The U.S. economy is now in its tenth year of expansion, one year away from setting a record as the longest in history. Over the first nine years, economic growth averaged 2.2% and inflation was contained. Economic growth picked up starting in the second quarter of 2017, inflation has been rising since the start of this year, and the economy appears to be running up against capacity constraints for workers, logistics, and other sectors. The Fed's focus has shifted to preventing the economy from overheating because of the tight labor market and inflation above its 2.0% target. As former Fed Chair William McChesney Martin said, "It's the Fed's job to take away the punch bowl just as the party gets going." The Fed has followed that course, raising short-term interest rates seven times since December 2015, including twice thus far in 2018. Fed plans include the potential for five more rate hikes by the end of 2019. While the Fed can control interest rates out to two years' maturity, longer-term interest rates are driven largely by investor demand, both domestic and foreign. Longer-term interest rates have risen, but less than expected, indicating economic growth will slow and inflation will be contained. The Fed does not have a good record of managing soft landings for the economy, and more times than not, has raised short-term rates too much, causing a recession. If the Fed continues raising rates and the 10-year UST yield cannot surpass its 3.11% peak, the yield curve could invert – a signal that the economy probably will likely not grow at more than a 3.0% rate long-term and inflation will be subdued. The uncertainty this time around involving trade and tariffs makes the Fed's job even more complicated. Time will tell who is correct, the Fed or longer-term interest rates. Investors will be well-served to watch this issue closely as it could have significant ramifications within both equity and fixed income portfolios.

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