Markets Review and Economic Commentary Q2 2018

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Overview

Global trade tensions dominated market news in the second quarter of 2018 and the ongoing trade war between the United States and the rest of the world drove global market performance. Tensions escalated steadily throughout the quarter with the U.S. enacting tariffs in June on Chinese, European and other trading partner imports and those countries retaliating in an immediate, though measured fashion. The U.S. contends that its export industries are unfairly treated by policies and tariffs that inhibit access to trading partners' markets or don't provide sufficient protection for intellectual property.

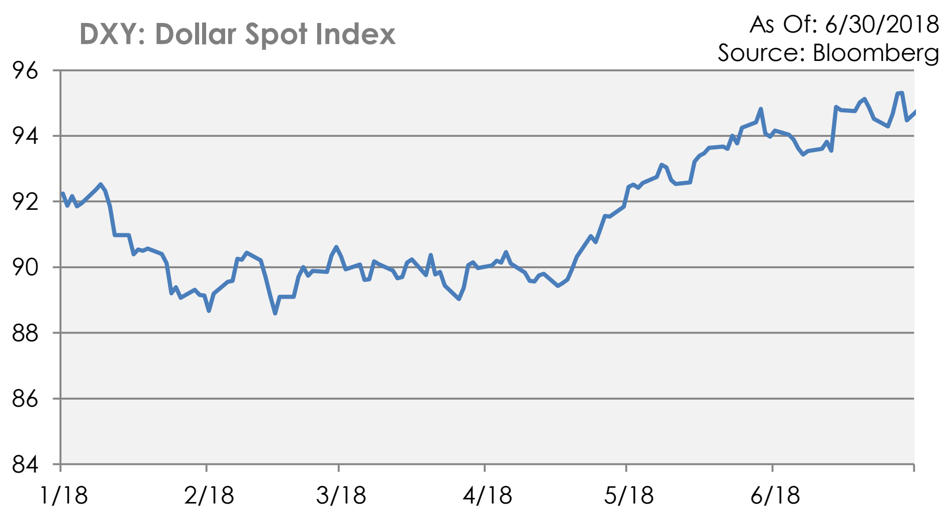
Global stock markets had mixed results for the quarter with U.S. small cap stocks and U.S. growth stocks benefiting from the newly imposed tariffs and emerging market stocks being viewed as the loser.

Global stock markets were up slightly for the quarter, though there were clear winners and losers in the ongoing trade war. U.S small cap stocks and U.S. growth stock were clear winners. New tariffs are expected to reduce U.S. imports, which should benefit U.S. small cap stocks, and to temper global growth, which should benefit U.S. growth stocks. Emerging market stocks were the clear losers, as investors viewed a trade war as hampering emerging market growth and profit margins. The U.S. dollar appreciated strongly during the quarter, as investors viewed the currency to be better positioned in a trade war.

The yield on the 10-year U.S. Treasury bond hit 3.11% in mid-May before falling back to 2.85% by the end of the quarter. The Federal Open Market Committee's (FOMC) rate hike and generally positive economic news was tempered by concerns that an escalating trade war could stifle U.S. economic growth.

U.S. companies reported strong earnings growth for the first quarter of 2018. More than three quarters of companies in the S&P 500® beat their earnings estimates and their revenue estimates. Actual earnings growth averaged an incredible 24.7% for the quarter and revenue growth averaged 8.5%. Recent tax cuts and optimism around growth helped push up second quarter 2018 earnings growth estimates to 19.0%. (source: Factset)

The U.S. dollar appreciated strongly during the quarter as investors interpreted new tariffs as having a greater impact on more export-sensitive international and emerging market economies.



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The U.S. Economy

The U.S. gross domestic product (GDP) grew by 2.0% in the first quarter of 2018, declining from its 2.9% pace in the fourth quarter of 2017 and trailing expectations of 2.2% for the quarter. Lower than expected personal consumption and weaker trade dragged on economic growth. Even so, the second quarter GDP consensus estimate is very strong. The current analyst estimate reads 3.8%. (source: Atlanta Fed)

The June employment report surprised to the upside adding 213,000 to nonfarm payrolls in June. The number of unemployed workers actively looking for a job rose meaningfully by 500,000 driving the unemployment rate 0.2% higher to 4.0%. Wage growth remained tepid, despite shortages of truck drivers and an increase in the hiring of outside contractors. Average hourly earnings rose just 0.2% for June, up 2.7% for the year.

Retail sales rebounded in May. April retail sales metrics also revised upward as consumers with new jobs decided to spend more of their hard earned paycheck.

Strong retail sales surprised in May, rising 0.8% despite weakness in auto sales. Sales in building materials, department stores, and restaurants came in very strong. April retail sales also revised upward to show a 0.4% gain.

U.S. manufacturing showed signs of slowing down with the U.S. manufacturing PMI dropping two points from 56.6 in May to 54.6 for June. While production levels remained high, new orders and export sales slipped under the impact of tariffs. The PMI report also indicated that manufacturing input costs are at a 5-year high led by rising fuel prices and wages, and exasperated by a shortage of truck drivers.

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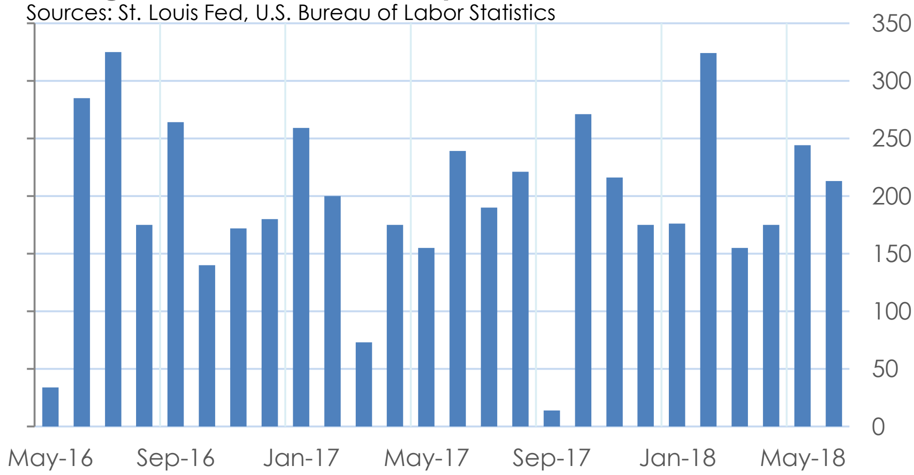
Housing starts jumped up 5.0% in May to an annualized rate of 1.35 million and are expected to contribute positively to the residential investment component of second-quarter GDP. Housing completions also rose 1.9% to a rate of 1.29 million, which will help feed a housing market that is already low on supply.

Employment was solid for the quarter. The risk of significant wage inflation remains just a threat as more non-workers are searching for jobs in response to companies relaxing their hiring standards.

Change in Total Non-Farm Payrolls As of: June 2018

Sources: St. Louis Fed, U.S. Bureau of Labor Statistics



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Inflation & Monetary Policy

The Fed, under new Chair Jerome Powell, is forecasting two more rate hikes in 2018 and additional rate hikes in 2019. Inflation is hitting the Fed's 2.0% target, with few signs of runaway inflation.

The headline Consumer Price Index (CPI) rose by 2.8% year-over-year for May remaining above 2% since last fall. The Federal Reserve Board's (Fed) primary inflation indicator is the Core Personal Consumption Expenditures (PCE) deflator, which rose 2.0% on the year and hit the FOMC's target for the first time in six years. The FOMC raised the federal funds rate by another 0.25% at June meeting. (The federal funds rate is the interest rate that banks and financial institutions charge each other for borrowing funds overnight.) Their statement noted the strength of the U.S. economy and set guidance for two more rate hikes in the second half of 2018.

The Global Economy

Global economic growth may be slowing from its elevated levels, but most indicators suggested that activity remained strong. The new tariffs will be disruptive, but weaker currencies and the ability for companies to reroute supply chains should help temper the shock.

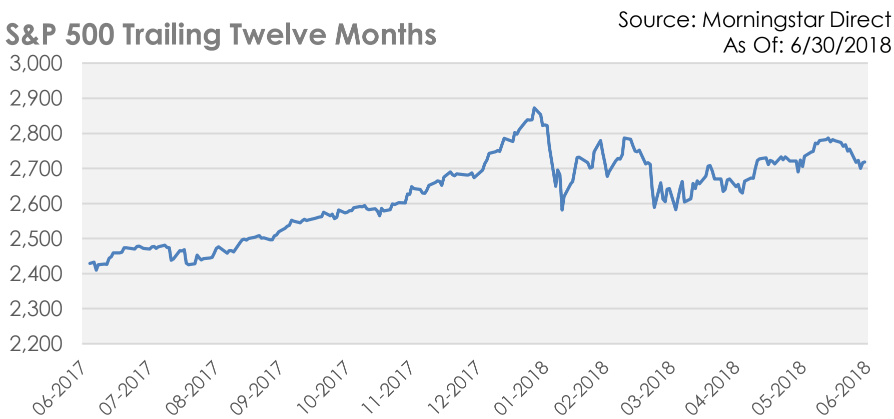
Global economic growth momentum slowed somewhat in the first quarter. Second quarter figures showed the Eurozone economy growing at a 2.5% annualized rate for the quarter. The March Eurozone PMI Composite released in June came at 54.9, off from its January high of 58.8, but above 50 suggesting some expansion. Japan's economy slowed sharply, expanding at only 1.1% annually in the first quarter, down from 1.9% for the prior quarter.

The European Union faced significant political challenges in the quarter. German Chancellor Angela Merkel fought to maintain her 14-year grip on power, and potentially a very disruptive change in leadership, by achieving a last-ditch agreement to end the dispute between her conservative Christian Democrats (CDU) and their Bavarian sister party, the Christian Social Union (CSU). Italy struggled to form a coalition government in May, raising concerns that its troubles could eventually lead to the much larger issue of Italy leaving the European Union.

Domestic Stocks

U.S. stock prices climbed back into positive territory as the S&P 500 index ended up 2.65% year-to-date. Continued positive economic news and strong corporate earnings growth helped to overcome the impact of new tariffs on global economic growth.

U.S. equity investor optimism surged in the quarter, buoyed by positive economic news and corporate earnings growth, a revitalized energy sector, and the belief that new tariffs could be broadly beneficial to U.S companies, especially those with primarily domestic revenue and higher growth.



U.S. small cap stocks outpaced the broad market benefiting the most from the new tariffs. Growth stocks continued to outpace value stocks. Investors downgraded global economic growth forecasts as new tariffs moved from being a threat to the new normal.

Market Capitalization & Style

U.S. small-cap and growth stocks outpaced the S&P 500 Index for the quarter benefiting from new tariffs, which are expected to reduce U.S. imports and temper global growth.

Asset Class	MTD (%)	QTD (%)	YTD (%)	1 Year (%)	Benchmark
U.S. Large Cap Stocks	0.62	3.43	2.65	14.37	*S&P 500 Composite*
U.S. Mid Cap Stocks	0.69	2.82	2.35	12.33	*Russell Mid Cap*
U.S. Small Cap Stocks	0.72	7.75	7.66	17.57	*Russell 2000*
U.S. Value Stocks	0.28	1.71	-1.16	7.25	*Russell 3000 Value*
U.S. Growth Stocks	0.95	5.87	7.44	22.47	*Russell 3000 Growth*

Source: Morningstar Direct℠ as of 6/30/2018

Past performance does not guaranteed future results.

Energy sector stocks rallied as oil prices rose by double digits in quarter. Industrial sector stocks largely underperformed on concerns about new tariffs tempering global economic growth.

Sector

Energy sector companies led the market with double-digit gains in response to rising oil prices caused by falling inventories and concerns about whether supply could keep pace with rising demand. Losses in large sectors, notably financials and industrials, weighed on index returns.

S&P 500 Index Sectors	Weights (%)	Returns (%)
Consumer Discretionary	12.89	8.11
Consumer Staples	6.89	-2.23
Energy	6.14	13.59
Financials	14.44	-3.17
Health Care	13.97	3.33
Industrials	9.94	-3.21
Information Technology	25.51	7.01
Materials	2.87	2.58
Real Estate	2.73	6.14
Telecommunication Services	1.84	-0.77
Utilities	2.78	3.77
Total		**3.40**

Source: Morningstar Direct℠ as of 6/30/2018

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International stocks underperformed for the quarter. New tariffs downgraded economic growth forecasts outside the U.S. and led to a strengthening of the U.S. dollar.

International Stocks

International stock markets underperformed for the quarter as concerns of a global trade war downgraded economic growth expectations for international economies – especially emerging economies – and causing the U.S. dollar to strengthen significantly.

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The U.S. Treasury yield curve flattened during the quarter as the Federal Reserve funds rate hike moved short-term interest rates up while the start of global a trade war put a damper on global economic growth prospects and kept the long end of the yield curve in check. Historically, yield curve flattening occurs near economic slowdowns.

Emerging market economies underperformed significantly as new tariffs reduced expectations for capital investment and commodity demand, resulting in lower economic growth expectations and weaker currencies. Developed market economies faired better due to lower dependency on exports.

Asset Class	MTD (%)	QTD (%)	YTD (%)	1 Year (%)	Benchmark
Developed Market Stocks (USD)	-1.22	-1.24	-2.75	6.84	*MSCI EAFE (net)*
Emerging Market Stocks (USD)	-4.15	-7.96	-6.66	8.20	*MSCI EM (net)*
European Stocks (USD)	-0.67	-1.27	-3.23	5.28	*MSCI Europe (net)*
Japanese Stocks (USD)	-2.52	-2.84	-2.03	10.51	*MSCI Japan (net)*
Pacific Country Stocks (USD)	-1.63	1.77	-2.02	8.68	*MSCI Pacific Ex Japan (net)*

Source: Morningstar Direct℠ as of 6/30/18
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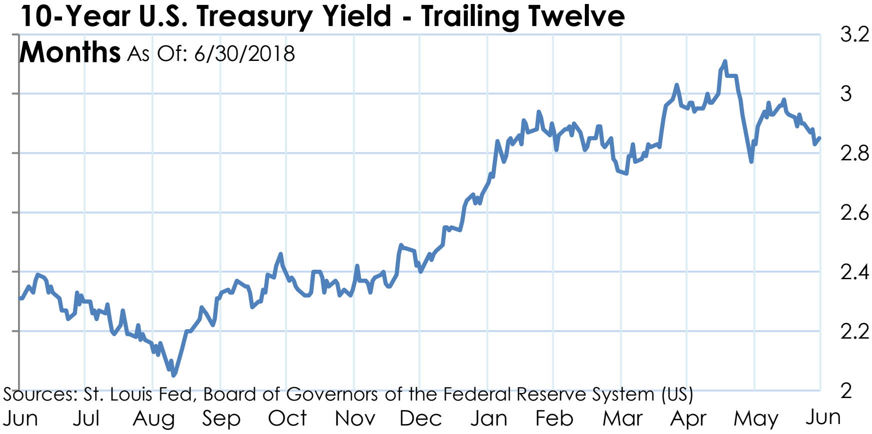
Fixed Income

The 10-year U.S. Treasury bond yield reached 3.11% in mid-May before falling back to 2.85% by quarter end. Concerns that an escalating trade war could stifle global economic growth tempered the Fed's rate hike and generally positive economic news. The U.S. Treasury yield curve flattened as the 30-year treasury yield was up only 0.02% for the quarter while the 2-year yield rose by 0.30% in response to a higher federal funds rate. The spread between 2-year and 10-year Treasury bonds tightened to 0.33% compared to 0.93% a year ago.

This was the seventh time the Fed raised the federal funds rate since its first post-recession move in December 2016. The target rate now sits at 1.75 -2.00%. Fed projections suggest two more rate hikes in 2018 and further moves in 2019. Rising federal funds rates will make fixed income investing more challenging and increase the risk of negative returns for bond investors.

10-Year U.S. Treasury Yield - Trailing Twelve Months As Of: 6/30/2018



Sources: St. Louis Fed, Board of Governors of the Federal Reserve System (US)

U.S. currency effects drove returns on developed and emerging market bonds down sharply for the quarter.

Regions

U.S. dollar strength in the quarter drove developed and emerging market bond prices down sharply. Concerns over economic growth in international markets, and especially emerging markets, increased in step with concerns about a potential trade war.

Credit

U.S. high-yield bonds delivered solid gains in the quarter, as higher oil prices drove energy sector credit spreads tighter and offset the effect of widening spreads in other sectors. U.S. corporate bond indexes did not fare as well, given increasing concerns over global economic growth and a smaller exposure to energy.

Duration

A flattening U.S. Treasury yield curve kept the 30-year yield stable and allowed U.S. Long Duration Treasuries to deliver a positive return for the quarter.

Asset Class	MTD (%)	QTD (%)	YTD (%)	1 Year (%)	Benchmark
U.S. Bonds	-0.12	-0.16	-1.62	-0.40	*Barclays US Agg Bond*
Developed Market Bonds	-0.70	-4.76	-1.31	2.78	*Barclays Gbl Agg Ex US*
Emerging Market Bonds	-1.00	-3.51	-5.23	-2.45	*JPM EMBI Global*
U.S. Corporate Bonds	-0.58	-0.98	-3.27	-0.83	*Barclays US Corp*
U.S. High Yield Corporate Bonds	0.40	1.03	0.16	2.62	*Barclays US Corp High Yield*
U.S. TIPS	0.40	0.77	-0.02	2.11	*Barclays US Treasury US TIPS*
U.S. Long Duration Treasuries	0.19	0.35	-3.02	0.03	*Barclays US Treasury 20+ Yr*

Source: Morningstar Direct℠ as of 6/30/18

Past performance does not guaranteed future results.

Real Estate Investment Trusts (REITS) prices rebounded sharply as interest rates stabilized and U.S. economic growth continues to be strong.

Real Estate & Commodities

U.S. Real Estate Investment Trusts (REITs) delivered a strong quarter as more stable interest rates, the pro-U.S. trade rhetoric, and relatively cheap valuations convinced investors to invest in REITs. Commodity prices ended the quarter roughly where they started, as sharply rising oil prices proved enough to offset U.S. dollar strength. West Texas Intermediate oil prices ended the quarter at $74.31, up $13.85 from the end of 2017.

Asset Class	MTD (%)	QTD (%)	YTD (%)	1 Year (%)	Benchmark
U.S. Real Estate	4.07	7.78	1.41	5.19	*DJ US Real Estate*
Commodities	-3.50	0.40	0.00	7.35	*Bloomberg Commodity*
Gold	-3.70	-5.49	-4.59	0.20	*Bloomberg Sub Gold*

Source: Morningstar Direct℠ as of 6/30/18

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Conclusion

Global trade policy drove tepid global market performance as the U.S. enacted import tariffs on global trading partner imports in an attempt to get fair treatment and market access for U.S exporters. Trading partners retaliated, but in a measured manner. Strong corporate earnings and revenue growth and generally positive economy reports supported the quarter's market performance, which could have been considerably worse.

While global stocks market were up slightly in the quarter, there were clear winners and loser. U.S small cap stocks put up very strong returns on the expectations that fewer imports would result in greater domestic production and profits. U.S. growth stocks also delivered strong returns on expectations that new tariffs would impair global growth making U.S. growth stocks more valuable. Emerging market stocks floundered as reduced U.S. imports may dampen profits. Sharp declines in emerging market currencies relative to the U.S. dollar also dragged.

Trump-era trade wars are a "new normal" for now. We expect increased market volatility until tensions resolve. Renewed volatility and divergence in market performance may create opportunities for managers of active funds to deliver benchmark beating results. It also serves to reinforce the general investment of establishing a long term strategy, diversifying assets across asset classes, investment styles, and global regions, and staying disciplined in the face of shifting market trends and global affairs.