# Second Quarter 2018 Commentary

July 13, 2018

Dear Investor,

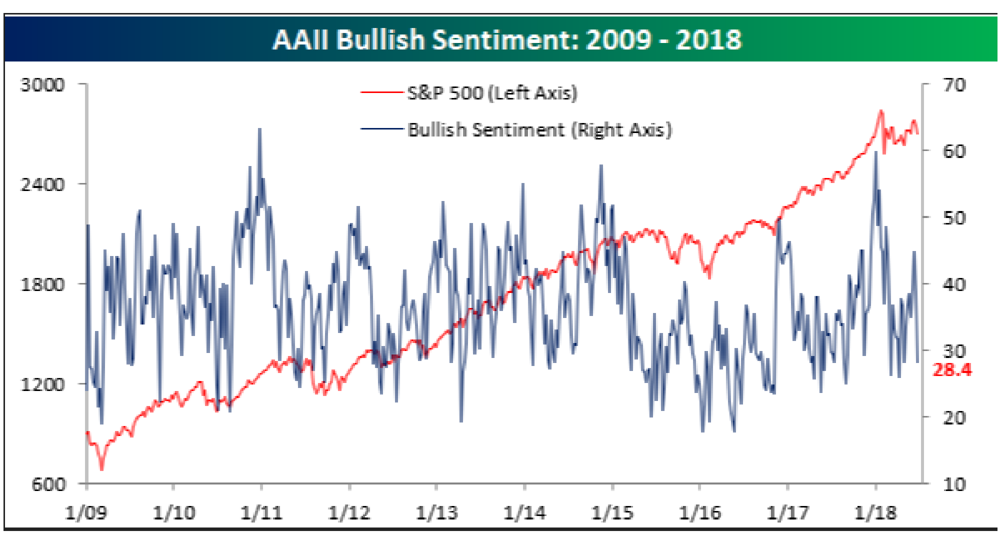
Inflection points are hard enough to identity in normal times, let alone during the longest bull market on record. By the end of the second quarter, however, there was little doubt that the high-octane punch that powered share prices past one record after another was being replaced with the equivalent of algae biofuel, with unmistakable consequences. Investors signaled doubt about the market's staying power as many believe flatter bond yield curve augurs an economic slowdown, if not recession.

Uncertainty intensified as the Trump administration's tough trade talk, originally thought to be a bargaining ploy, mushroomed into a brewing global trade war at a time when emerging markets are in crisis and Europe is dwindling.

Of course, we've stared down what looked like a precipice before only to be swept up in another go-round and we are not ruling out another. See you in September.

# Markets:

For the first time in six months investors flirted with a bear market, according to weekly survey data from *American Association of Individual Investors (AAII), as depicted in the chart below*. Bullish sentiment dropped more than ten percentage points in the last week of June, from 38.7% to 28.4%, the largest one-week decline since early March. As bullish sentiment declined, bearish sentiment surged, from 26.2% to 40.8% in only the second week in the last year where bearish sentiment has been above 40%. It was also the largest one-week increase in negative sentiment since January 2016.



Investors and policy makers watched with trepidation in mid-June as the Treasury yield curve from 5 to 30 years flattened to levels last seen in August 2007. *The New York Times,* citing research from the San Francisco Fed, noted that every recession of the past 60 years has been preceded by an inverted yield curve.

Undaunted, Fed officials committed themselves to four interest rate increases in 2018, up one from their March outlook. Investors took it in stride, scooping up some $14 billion worth of 30-month bonds at a yield of 3.10%. As ZeroHedge put it, "Overall, a quick and relatively painless sale in just 48 hours, to a market which despite rising rates, continues to be quite receptive to all the issuance the U.S. government can throw at it."

According to Bank of America Merrill Lynch however, this may be the calm before the storm. The market, it argued in a note, is still in an orderly "intermediate phase" as interest rates, credit spreads and volatility pivot to reflect a tighter credit environment. "If quantitative easing (QE) created an era of lower interest rates, tighter credit spreads and suppressed volatility, the bank warned, quantitative tightening … will lead to the opposite - i.e. higher interest rates, wider credit spreads and very volatile market conditions." The bank added that global QE has rapidly declined on a year-over-year basis, a trend accelerated by a strong dollar it regards as "destructive to asset values that thrive on liquidity expansion."

| 6/30/2018 | Economic and Market Review | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Overall | Indicator Name | Value | 1 Mo. Ago | | | 3 Mo. Ago | | 1 Yr. Ago | | |
| ▼ | S&P 500 Total Return | 5,351 | 5,354 | ▼ | -0.05% | ▲ | 3.43% | 4,678 | ▲ | 14.37% |
| ▼ | Russell 2000 Total Return | 8,133 | 8,144 | ▼ | -0.14% | ▲ | 7.75% | 6,918 | ▲ | 17.57% |
| ▼ | MSCI EAFE Total Return | 7,942 | 8,019 | ▼ | -0.96% | ▼ | -0.97% | 7,397 | ▲ | 7.37% |
| ▼ | MSCI Emerging Markets Total Return | 2,358 | 2,440 | ▼ | -3.39% | ▼ | -7.86% | 2,171 | ▲ | 8.59% |
| ▲ | 10 Year Treasury Rate | 2.85% | 2.84% | ▲ | 0.35% | ▼ | -3.39% | 2.31% | ▲ | 23.38% |
| ▼ | Barclays US Aggregate Total Return | 2,013 | 2,014 | ▼ | -0.04% | ▼ | -0.16% | 2,021 | ▼ | -0.40% |
| ▲ | AMEX Dollar Index | 94.47 | 94.1 | ▲ | 0.43% | ▲ | 4.93% | 95.64 | ▼ | -1.22% |
| ▲ | Euro to US Dollar Exchange Rate | 1.17 | 1.16 | ▲ | 0.22% | ▼ | -3.49% | 1.14 | ▲ | 2.16% |
| ▲ | US Dollar to Chinese Yuan Exchange Rate | 6.62 | 6.42 | ▲ | 3.11% | ▲ | 5.49% | 6.78 | ▼ | -2.39% |
| ▲ | US Dollar to Japanese Yen Exchange Rate | 110.71 | 109.04 | ▲ | 1.53% | ▲ | 4.25% | 112.40 | ▼ | -1.50% |
| ▼ | Gold Price in US Dollars | 1,250 | 1,301 | ▼ | -3.86% | ▼ | -5.54% | 1,242 | ▲ | 0.66% |
| ▲ | WTI Crude Oil Spot Price | 74.13 | 68.24 | ▲ | 8.63% | ▲ | 8.12% | 46.0 | ▲ | 61.08% |
| ▲ | VIX | 16.09 | 14.94 | ▲ | 7.70% | ▲ | 1.00% | 11.18 | ▲ | 43.92% |

Source: yCharts

Topdown Charts agreed, warning that the epic wind-down of central bank debt stocks may well come at the expense of the S&P 500 - and sooner than expected. "The major QE banks are actually all headed in the same direction," it argued, adding that while Europe and Japan are still expanding their balance sheets they are doing so at a much slower pace. "For now this is providing some offset against Fed QT," according to Topdown, "but the question is for how long.

In a report, S&P Global estimated U.S. corporate debt at a record $6.3 trillion, a troubling factor as Wall Street faces higher borrowing costs. According to the report, speculative-grade borrowers have reached a new record-low cash-to-debt ratio of just 12% in 2017, below the 14% reported in 2008. And while U.S. companies also have a record $2.1 trillion in cash to service that debt, most of it is concentrated in the treasuries of a few large companies, according to S&P's analysis.

In a related story, *The Wall Street Journal* reported that S&P 500 companies have repurchased $150 billion in stock in the quarter, which is on track for the most since data became available in 1998. S&P 500 companies distributed dividends or bought back shares totaling $1 trillion over the past 12 months. The article suggested repurchases have supported the S&P in the face of uncertainty around global trade, interest rate increases, and fund redemptions.

Speaking of liquidity flows, Reuters reported that U.S. equity fund outflows totaled $20 billion for the week ended June 27. The surge represented the fourth straight week of equity fund outflows, the largest since February and the sixth largest since Reuters began tracking the data in 1992. EPFR Global data showed that $29.7 billion exited global equities, the second largest outflow on record.

On a positive note, the estimated earnings growth rate for the S&P 500 is 19.0%, according to FactSet, a forecast that, if validated, would mark the second highest earnings growth since the 19.5% rate posted in the first quarter of 2011.

# US Economy:

The Atlanta Fed cut its estimate for GDP growth in Q2 2018 to 3.8% on June 29, compared with 4.5% on June 27. The write-down came as Bloomberg reported that the strongest U.S. output in four years may be losing steam. In a June 19 report, the wire agency cited such factors as a housing market plagued by supply constraints and soaring property values and a slowing manufacturing sector amid crippling order backlogs and accelerating input prices.

Escalating trade rows between the U.S. and its largest commercial partners also weighed on the economy. Industrial icons Harley-Davidson and General Motors appealed for an end of tit-for-tat tarification as the former announced plans to move some of its production lines abroad to protect itself from tariffs and the latter warning that duties could force job cuts in the U.S. and drive up the price of its vehicles.

A positive view was shared by JPMorgan CEO Jamie Dimon, who implied the fundamentals are strong enough to sustain at least several more years of growth. "We're probably in the sixth inning," Dimon told an investor conference in New York. "It's very possible you're going to see stronger growth in the U.S."

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|---|---|---|---|---|---|---|---|---|---|
| | | Last Reported | 1 Mo. Ago | | | 3 Mo. Ago | 1 Yr. Ago | | |
| Overall | Indicator Name | Date | 1 Mo. Ago | | % Change | % Change | 1 Yr. Ago | | % Change |
| ▲ | US Core Inflation Rate | 5/31/2018 | 2.14% | ▲ | 4.58% | ▲ 21.09% | 1.73% | ▲ | 29.06% |
| ▼ | ADP Change in Nonfarm Payrolls | 6/30/2018 | 189 | ▼ | -6.32% | ▼ -10.72% | 154 | ▲ | 15.37% |
| ▼ | US Unemployment Rate | 5/31/2018 | 3.90% | ▼ | -2.56% | ▼ -7.32% | 4.30% | ▼ | -11.63% |
| ▼ | US Producer Price Index: Savings Institutions | 5/31/2018 | 96 | ▼ | -1.25% | ▲ 1.07% | 93 | ▲ | 1.61% |
| ▲ | ISM Purchasing Managers Index | 6/30/2018 | 59 | ▲ | 2.56% | ▲ 1.52% | 58 | ▲ | 4.15% |
| ▲ | US Housing Starts | 5/31/2018 | 1,286 | ▲ | 4.98% | ▲ 4.65% | 1,122 | ▲ | 20.32% |
| ▼ | US 30 Year Mortgage Rate | 6/28/2018 | 4.56% | ▼ | -0.22% | ▲ 2.48% | 3.88% | ▲ | 17.27% |
| ▲ | US Consumer Price Index | 5/31/2018 | 250.0 | ▲ | 0.21% | ▲ 0.37% | 243.9 | ▲ | 2.72% |

Source: yCharts

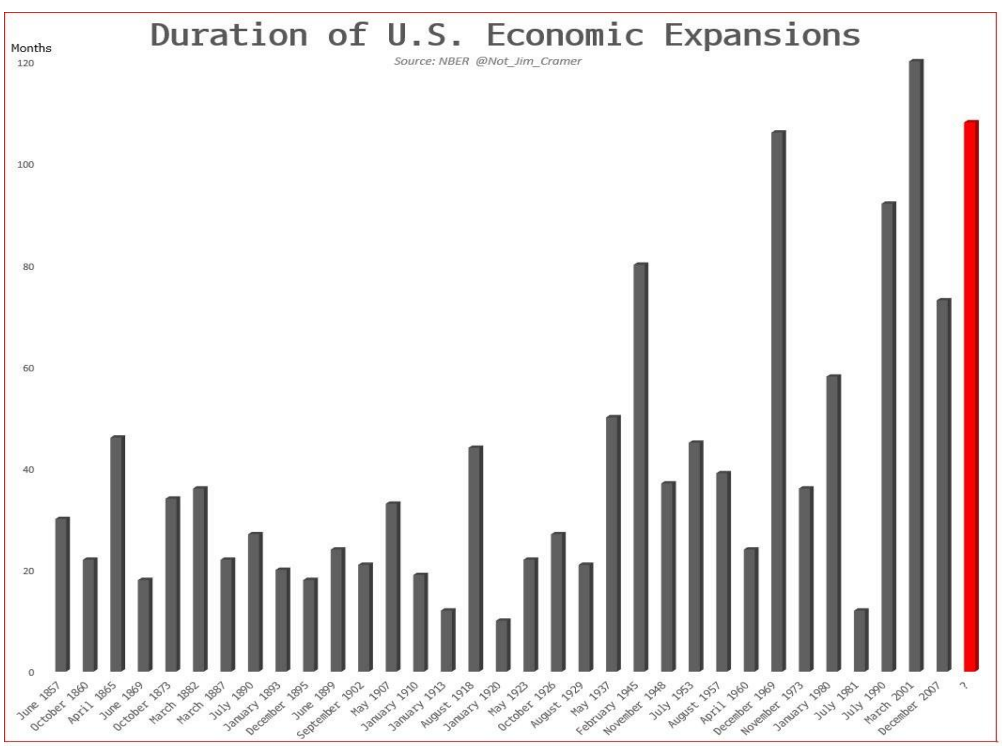
The Labor Department reported that inflation accelerated in May to the fastest pace in more than six years, reinforcing the Fed's outlook for gradual interest-rate hikes while eroding wage gains. The consumer price index rose 0.2% from the previous month and 2.8% from a year earlier. The annual gain was the biggest since February 2012 and followed a 2.5% increase in April.

On the job front, the number of Americans filing applications for new unemployment benefits fell for the fourth straight week in mid-June, signaling continued strength in the labor market. Initial jobless claims, a proxy for layoffs across the U.S., declined by 3,000 to a seasonally adjusted 218,000 in the week ended June 16, according to the Labor Department.

After a sluggish April, retail sales rebounded in May, climbing to 0.8% compared to the previous month, beating expectations of 0.4% and the biggest jump since Sept 2017. Similarly, after slowing in April to 2.6% on a year-on-year basis, The Producer Price Index rose in May by 3.1% compared to a year ago, the biggest price rise since Dec 2011.

In related commentary, Bank of America Corp reported that consumers are ramping up debt at a significant rate. At the same time, Fed data suggests U.S. consumers' financial obligations as a percentage of their disposable personal income has also begun to climb noticeably. "People and clients are definitely levering up and we have to watch that," Dean Athanasia, co-head of the company's consumer and small-business operation, told a banking conference. "If I lend to them and then if four other lenders come behind and lend to them as well, then you have a credit profile that may not be optimal for that client."

Speaking of debt, according to the May Monthly Treasury Statement, the **U.S. collected $217 billion in receipts** as federal spending surged, rising from $328 **billion** last March to $363 **billion** in May. The surge in spending led to a **May budget deficit of $146.8 billion that was** above the consensus estimate of $144 **billion and** a swing from a surplus of $214 billion in April**.**



Surveys were mixed in the second quarter. The PMI Composite Flash suggested reduced factory activity in June, likely related to tariffs as the Philly Fed report slowed to a year-and-a-half low in tandem with a declining manufacturing PMI, falling to a 7-month low at 54.6. The PMI report cited a "clear loss of momentum" with new orders slipping and export sales at a 2-year low. Optimism on the outlook is also sinking, down at year-and-a-half lows.

At the same time, U.S. Services vaulted to a three-year high, according to Markit's PMI survey, though the outlook was clouded by concerns over rising costs and the impact of tariffs. The index settled at 56.8, above the PMI Manufacturing level and beating forecasts as well as April's 54.6 level. This despite the fact that input-cost inflation rose at its fastest rate since October 2013, due largely to higher material cost related to tariffs, rising interest rates and creeping energy and fuel prices. Output charges also increased at a quicker rate, with inflation accelerating to a three-month high.

The Conference Board Leading Economic indicator remained positive, increasing to 109.5, slightly lower than economists anticipated. Consumer Confidence, meanwhile, hovered at a near 17-year high despite the Conference Board Consumer Confidence Index slipping to 126.4 versus forecasts of 128.0. While confidence in the 'Present Situation' fell to its lowest since December 2017, 'Expectations' for the future remains just shy of its highest since March 2001.

# International:

The European Central Bank forecast diminishing growth in 2018 GDP this year, from 2.4% to 2.1%, while 2019 and 2020 were kept unchanged at 1.9% and 1.7%, respectively. Acknowledging that the "soft patch may last longer than forecast," ECB head Mario Draghi also anticipated inflation would remain stable at 1.7% from now to 2020.

At the same time, Eurozone economic sentiment slipped to 112.3 in June, from 112.5 in May, as consumers and managers in the construction sector became downbeat. The sentiment among managers in manufacturing and services was unchanged from May and also above expectations.

The new government in Rome inspired fears among executives that continental Europe's third biggest economy will soon vote to leave the eurozone. According to the latest CNBC Global CFO Council quarterly survey, more than 76% of executives are "somewhat concerned" about Italy leaving the bloc, while almost three out of four respondents said the United Kingdom economy has already been hurt by Brexit.

Signs of global dollar-funding pressures revealed themselves in currency derivatives, Bloomberg reported, making it costlier for international investors to protect against swings in the U.S. currency when buying U.S. debt. Cross-currency basis swaps, which offshore money managers and corporate treasurers use to borrow in dollars, are trading at some of the widest spreads since January. The market, a key indicator of stress during the financial crisis, is attracting the attention of a growing share of analysts.

The Shanghai Composite stock index entered a bear market in late June, having sustained a 20% rout in share prices over the last six-months and wiping out $1.8 trillion in market value. According to Seeking Alpha, investors have ignored government measures to support the market, including a brief bank reserve-ratio cut, as Sino-U.S. trade pressure intensify concerns about Beijing's deleveraging drive and weaker-than-expected economic data.

Staying with China, Cantor Strategy Group reported that its industrial production in April rose by 7.0% compared to year-ago figure, beating estimates, while retail sales growth slowed to its lowest level since late last year while the pace of fixed asset investment fell to the lowest level in nearly 20 years. The data confirmed, according to Seeking Alpha, analysts' long-held suspicions "that the popular narrative of China transitioning to a developed consumption-based economy is mostly fictitious."

In his first interview with international media since becoming Bank Indonesia Governor, Perry Warjiyo echoed appeals from his emerging market counterparts in opposition to Fed Quantitative Tightening. The Reserve Bank of India (RBI) Governor argued for a slow-down of stimulus withdrawal to avoid an emerging market meltdown that could spill over into developed e economies.

# Multi-Asset Portfolios

## Attribution Based on Asset Classes

Multi-Asset portfolios participated pro-rata according to heir allocations to these building block strategies:

Equity:
- Positive Contributors: U.S. Small Cap U.S. Large Caps
- Negative Contributors: Emergining Markets, Non-U.S. Developed

Fixed Income:
- Positive Contributors: Investment Grade, Mortgages
- Negative Contributors: Emerging Markets

Alternatives:
- Positive Contributors: REITS, Private Equity / BDCs
- Negative Contributors: Frontier Markets

## Portfolio Changes for Multi-Asset Portfolios

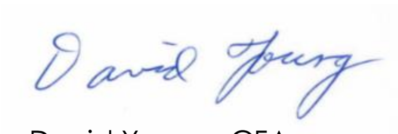
In early June we sold DBEM and CEMB (Emerging Market Equity and Emerging Market Debt positions) using the proceeds to purchase MINT (Enhanced Cash position) for Non-Options based STAR Spectrum accounts. We sold EEM (Emerging Market Equity) and closed corresponding options for VEGA and VEGA Enhanced accounts.

We believe that rising U.S. interest rates, along with the amount of USD denominated debt that Emerging Markets countries currently have, create significant headwinds to investors. Consequences could include:

- The continued weakening of currencies resulting in further rising interest rates
- Dramatic central bank response and the risk of a spill-over into local stock markets
- Slowed growth

All of the above could result in a spiraling contagion effect. In our opinion, these factors are not fully priced in; this situation is much better viewed from the sidelines.

Sincerely,



David Young, CFA
Chief Investment Officer

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