Investment Review and Outlook
June 30, 2018

***"It's hard to see the benefit of staying calm when your cockpit is filled with smoke and everything around you is shaking"* Chuck Yeager (1923 – Present), Air Force Brigadier General**

Although not as harrowing as General Yeager's experiences as a test pilot, investors encountered significant market turbulence in the second quarter. Investors battled economic headwinds and political headlines as trade tensions escalated, Eurozone instability resurfaced, and the synchronized global growth narrative began to unwind. The administration, policymakers and the media all did their part to rattle the markets, as immigration, the North Korean summit, civil unrest, and never-ending Washington investigations escalated.

Despite the abundance of events that could have easily triggered a market convulsion, most markets experienced modest second quarter gains. Earnings' reports and managements' economic guidance received a powerful boost from year-end tax cuts. First quarter year-over-year corporate profits reported in April jumped 25.3%. The rise in profits marked the seventh consecutive increase in corporate earnings and the largest quarterly jump in nearly a decade.

In addition, markets received a boost from strong economic news, especially as unemployment rates for most demographics hit record lows. A well-choreographed interest rate bump by the Fed in June and a Supreme Court ruling allowing AT&T's acquisition of Time Warner to proceed gave markets confidence that the pro-business mood was intact. U.S equity markets responded as the S&P 500 rose 3.43% for the quarter, pushing year-to-date results up 2.65%. Small caps delivered the strongest gains in the quarter with the Russell 2000 posting a 7.75% jump, lifting first half results by 7.67%.

U.S. equity markets were led higher by a strong rally in energy-related stocks, as the price of oil rose by over 14%. Gains in the first half of the year were extremely narrow as only three of the S&P 500's eleven sectors outperformed the index. Consumer discretionary and technology were the only other sectors to outperform. Although the S&P 500 ended the quarter 5.4% off its January record highs, over half of the stocks in the index were actually down more than 10%. In fact, by excluding only four stocks from the index - Amazon, Netflix, Microsoft, and Apple – the S&P 500 would have actually finished in negative territory through mid-year. This incredibly narrow market created a wide gap between index returns and results experienced by individual investors.

International markets suffered a major setback in the second quarter. Fears of slowing growth and uncertainty over the impact of looming tariffs helped drive the developed markets of Europe, the Far East, and Australia (EAFE Index) down 1.24% in the quarter, pushing the index lower by 2.75% for the year. However, the brunt of escalating trade tensions landed in the emerging markets. The export-oriented economies of Brazil, China, and India all tumbled lower. The MSCI Emerging Markets Index declined 8.0% for the quarter, forcing the index down 6.7% for the year.

The bond markets delivered mixed results. The Bloomberg-Barclays Global (BBG) Intermediate Credit Index fell 0.08%, and the Government-Corporate Index was flat. The BBG 1-10 year Municipal Index fared much better, gaining 0.81% on limited bond supply. Although bond returns seemed relatively tranquil, interest rates experienced significant movement.

The Fed initiated an expected quarter point increase in the fed funds rate at its June meeting, marking the sixth rate increase since the Fed began raising rates in December, 2015. In addition, yields widened between corporate and Treasury bonds, as the spread pushed from 126 basis points in early April to 149 at the end of June. However, investor focus continues to be on the shape of the yield curve. Throughout the quarter the curve continued to flatten with the spread between the 10-year and 2-year Treasury bond narrowing to 32 basis points from 50 in late March. The potential that the yield curve inverts with short term yields trading above long rates has investors worried that a recession is on the horizon.

The first half of 2018 has been an extremely difficult period for investors. The narrowness of the markets, compounded by an abrupt increase in volatility has caused a dislocation between underlying benchmarks and portfolio performance. When markets confront a barrage of conflicting information in a compressed period of time, as in the second quarter, we expect portfolios to go through a period where returns disconnect from the long-term fundamentals of the market. As a result, during the first half of the year several strategies within our diversified portfolios have experienced performance below their benchmark.

Our approach focuses on achieving our clients' investment objectives over the long term. Although performance has lagged underlying benchmarks in specific portfolio segments this year, we re-iterate our strong belief that investment success comes to those that maintain a focus on long-term fundamentals, and avoid the temptation to overly emphasize short term results. We have confidence in our view of the markets going forward, and believe attractive opportunities are developing from the current market turmoil.

Economics Outlook: *Slow Down Ahead, But Still Moving Forward*

"If everything is under control, you're just not going fast enough" **Mario Andretti (1940 – Present), International Racing Legend.**

Mario Andretti became a racing legend by driving at speeds exceeding the limits of his race car. Similarly, the current economy is growing at a rate we've not experienced in nearly a decade. Recent economic data confirms tightening labor markets, high consumer confidence, rising homes prices, and escalating capital spending. The economy is "firing on all cylinders". In fact, the closely watched Atlanta Fed recently released its quarterly economic report that highlighted an eye-popping 4.8% estimated expansion in GDP during the second quarter.

Our view is that the current pace of economic growth is unsustainable; as a result we see a deceleration coming in the second half of the year. We expect consumer spending to flatten and global demand to moderate. Synchronized global growth is weakening as European growth levels off and Chinese expansion begins to slow due to trade concerns. A sputtering China will have a ripple effect on other Asian economies, and is likely to take some of the steam out of industrial commodity prices that have drifted higher over the past two years.
Although we are calling for a slowdown, it is important to emphasize that we are not anticipating a recession in the foreseeable future. There continues to be strong economic momentum from tax cuts, reduced regulation, and stable monetary policy. Strong growth in the first half gives us confidence that full year GDP growth will achieve 3%, making it the strongest full year expansion since before the financial crisis. However, we are fully aware that the second half of the year will bring significant challenges.

Investors will continue to focus on the direction of the yield curve. The curve's flattening trajectory towards possible inversion will attract loud cries of concern from investors, pundits, and the financial media. In addition, elections in the U.S. and key Eurozone nations such as Italy will provide abundant drama later in the year. However, a larger economic force is looming. The most significant driver of our economic fortunes over the reminder of the year, and beyond, will be what transpires with global trade.

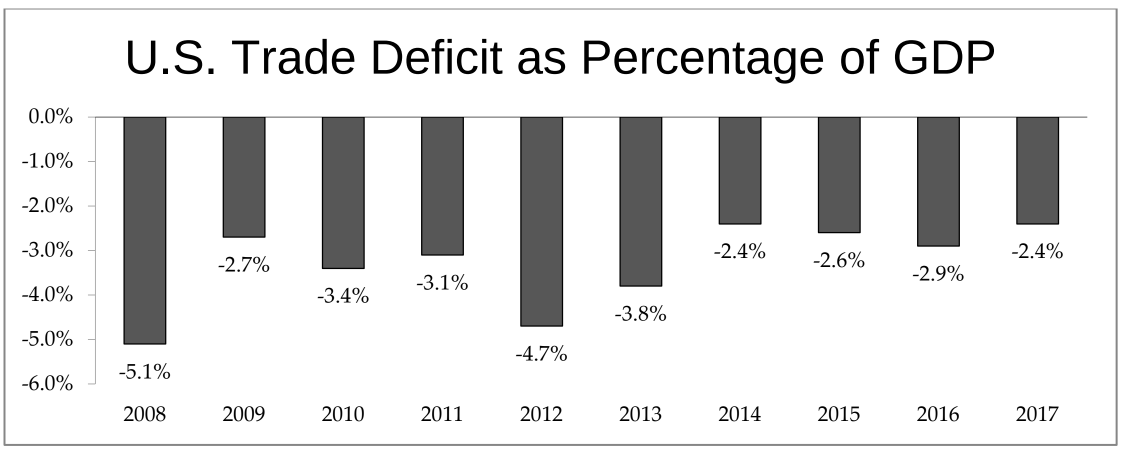
Global Trade: *A Significant Challenge is Looming*

***"The propensity to barter and trade one thing for another is common in all of us, and not to be found in any other of God's creatures"* Adam Smith (1723-1790), economist and author of The Wealth of Nations.**

The Economics of Trade
In 2017 the U.S. imported $2.89 trillion in goods and services versus total exports of $2.32 trillion, creating a $566 billion trade deficit. This net outflow of capital represented 2.4% of GDP, giving the U.S. the distinction of having the largest trade deficit of any economy in the world.

Although this economic equation is simple, the global reality of trade is extremely complicated. It's not surprising that over many years policymakers have tried to address the net outflow of dollars that occurs with a trade deficit. However, additional perspective is required before declaring that all trade deficits are bad for a nation's economy.

It is important to understand that the U.S. has carried the world's largest trade deficit since 1975. In addition, the current 2.4% trade deficit is low relative to history. As the chart below shows, over the past decade the U.S. trade deficit has ranged from 2.2% to 5.1% of total GDP.



Actually, running trade deficits makes economic sense for the U.S. Large mature economies including the Eurozone, Japan, and the U.S. draw from smaller, less developed nations for its labor and low priced commodities. The U.S. is fortunate that it can produce most everything it needs. However, it is more productive to import goods and services at lower prices, thereby allowing the savings to be reinvested in other areas of the economy. In economic circles this rational capital flow between trade and capital investment is referred to as "comparative advantage". Consistent with the laws of comparative advantage, the top U.S. exports include autos, commercial aircraft, and food – while our largest imports are concentrated in automotive parts, petroleum, and electronics.

Despite the economic benefits of unimpeded commerce between nations, global trade is inextricably rooted in politics. For centuries trade practices have been used to control vital resources, bolster national wealth, and achieve territorial ambitions. From 16th century merchant trading to today's North American Free Trade Agreement (NAFTA) political objectives have influenced trading behavior.

Further complicating the global exchange of goods and services is the difference in trade philosophies around the world. For instance, China has adopted a "mercantilist" system of maintaining a trade surplus at all cost, while Russia has built its trading approach around "protectionism". The U.S. has long considered itself "free traders" with significant policy debates centered on fairness. Differences in trade philosophies, and the influences of political motives, make free and fair trade almost unattainable.

Our Current Trade Dilemma

Over the past several decades investors and global markets have tolerated the "organized chaos" of global trade. In the U.S., individual constituencies within the agriculture, industrial, energy, and various service sectors influenced policy through their elected officials, without significant coordination across interest groups. However, in the second quarter a much larger, more comprehensive trade weapon appeared on the global economic stage. In late March, the Trump administration began wielding the threat of trade tariffs. Details around the administration's use of tariffs are vague in scope and magnitude. Targeted tariffs on imported lumber, milk, steel, and aluminum have been met with retaliatory threats of foreign tariffs on U.S. exports such as soybeans, beef, and auto parts. These threats sent investors, politicians, and the media into a frenzy that can only be described as a "tariff tantrum". Although this collision of social, political, and economic forces makes for great drama, we believe it is best to stay focused on the underlying fundamentals.

Our view is that additional restrictions on trade in the form of tariffs will be negative for U.S. and global growth, as well as for the financial markets. The interdependencies across national borders between suppliers, manufacturers, and consumers are intertwined, making tariffs extremely difficult to implement and enforce. Uncertainty is rising, and in the current politically-charged environment it is unclear where the tariff talks are headed. As expected, global equity markets have been extremely volatile. However, they have held up relatively well under the threat of an impending "trade war". The S&P 500 has bounced off its correction lows, and is only off 5.4% from January's record levels. The Emerging Markets Index is understandably down 12% from its highs, and EAFE has fallen only 8% from a record close in mid-February. It is clear that investors are skeptical of a trade doomsday scenario. If investors believed a full on trade war was approaching we would expect much sharper declines than the market has experienced.

Our view is that there is a path out of this trade war fun house. The "prize" for the U.S. in the current trade rumble is to achieve a more open and fair trading relationship with China. The Chinese accounted for $375 billion of the U.S.'s $566 billion trade deficit in 2017 – representing 65% of the total deficit. In addition, the administration is targeting Intellectual Property (IP) theft that has grown significantly over the past decade. The U.S. Commerce Department estimates that Chinese theft of American IP costs $250 - $400 billion annually.
Trade negotiations with China are further complicated by their significant ownership of U.S. Treasury debt. As of May, China held $1.18 trillion of Treasury bonds, representing 20% of all Treasuries held outside of the U.S. Some fear that China could 'weaponize' its Treasury holdings by dumping them in the open market, causing havoc for interest rates. Given that this action would have mutually destructive economic consequences, we agree with most economists that this is not an option for the Chinese.

We expect the tone of trade talks to stay heated well into the second half of the year. Although much of the administration's bluster has been aimed at U.S. trade allies such as Canada, we believe the primary target in the current war of words is China. Although we expect threats from both sides to continue, our mutually dependent economic objectives should motivate an agreement. Despite shared economic objectives we do not anticipate large scale trade reform with China. However, the smallest levels of progress will likely prompt investor enthusiasm, and allow the administration to declare victory. Until we see more significant risk in U.S./China trade relations we are staying with the optimistic view that a trade meltdown will not occur. However, we are fully aware that political motives could overwhelm sound trade policy, resulting in unintended consequences that prove negative for global economies. This is a risk we do not anticipate, but we are closely monitoring.

In the end, Adam Smith will be proven right in his belief that we all have the "propensity to barter and trade one thing for another". This gives us further confidence that the benefits of global trade will ultimately be realized.

Investment Strategy: *Stay Focused on What Matters Most*

***"The best thinking is done in solitude. The worst thinking is done in turmoil"* Thomas Edison (1847 – 1931), Inventor and Businessman**

In times like this investors need to separate from the chaos of the daily news cycle and stay focused on long term objectives. We're not minimizing the significance of what is transpiring in our current political, economic, and social environment; however, we do appreciate the benefits of being thoughtful and deliberate in our investment actions.

U.S. Equity Markets

Despite a dramatic increase in market volatility and a rise in economic uncertainty we are maintaining our positive view towards equities, with a bias towards U.S. versus international markets. We expect returns to be positive, but modest over the next several quarters as returns are driven by profit growth versus P/E expansion. During the last five years coming into 2018 U.S. equity markets enjoyed the combined benefit of rising earnings growth and expanding multiples on those profits. As interest rates have risen multiples have contracted to more reasonable levels. This is to be expected during times of rapid economic growth.

In this environment it is best to keep return expectations modest. Our view is that capturing market returns and controlling risk is best managed through diversification. Our approach is to have broad exposure to all sub-classes of the equity market. Although we emphasize exposure across the capitalization spectrum, we find small and mid-cap stocks particularly attractive in the current environment. Small and mid-sized companies should benefit the most from corporate tax reform and reduced regulation. In addition, small and mid-sized companies are more domestically-oriented, and have substantially less direct exposure to global trade disruptions.

International Markets

When talk of a potential trade war surfaced in the first quarter international markets suffered disproportionately relative to the U.S. Despite the significant growth in international economies over the past two decades the U.S. remains the world's dominant economic power. Disruptions in trade relations with the U.S. have serious economic consequences for the global economy. As investors anxiously wait and speculate on how current trade tensions will play out we expect increased volatility in an already highly volatile market.

In times of uncertainty we prefer to focus on long term fundamentals. We are certain that concerns over trade disruptions will escalate volatility; however, positive fundamentals are expected to be realized over the long-term as global consumer demand and infrastructure spending grows in the U.S and abroad. To manage portfolio risk we maintain a high level of diversification across all global regions in order to reduce country-specific risk. We believe exposure to both developed and emerging markets will ultimately prove additive to portfolios. We currently favor developed markets over export-oriented emerging markets. Our exposure to developed markets includes small cap companies for many of the same reasons we favor this segment in the U.S. Small companies have less direct trade exposure, and are more consumer-oriented.

Fixed Income:

Interest rates rose across the maturity spectrum in the second quarter. We believe upward pressure on rates will persist as the improving U.S. economy, tightening labor markets, and looming inflation keep the long end of the yield curve elevated. In addition, continued economic growth will give the Fed ample justification to continue raising short term rates at least two more times this year.

Managing fixed income portfolios in this environment is difficult as the headwind of rising rates negatively impacts underlying bond prices. This environment makes portfolio decisions regarding duration, credit selection, and yield curve positioning extremely important when considering the total return potential of bond portfolios. Our current strategy emphasizes corporate securities over Treasury and agency bonds in taxable portfolios. We remain positive on high quality municipal bonds, and believe current yields relative to taxable bonds are attractive.

We are positioning portfolios short of their benchmark duration in order to reduce negative price pressure and allow for reinvestment as rates rise. Despite the impact on current bond prices ultimately higher yields will result in increased income generation, something investors have not experienced in many years. We believe our current fixed income strategy is positioned well to effectively navigate through the current rising interest rate environment.

The second half of 2018 is bound to deliver plenty of new challenges for investors. Although it will be tempting to react to the latest event, our view is that staying focused on the long term, while managing risk through asset class diversification, will allow investment objectives to be achieved.