

Second Quarter 2018

Courtesy of Miles Capital, Inc.

Economic Commentary

Financial market volatility still remains in play as the markets continue to decipher the long-term effects of tax stimulus, trade concerns and related rhetoric, possible wage pressures, and the strength of the consumer. However, the economy is showing strong resilience.

Consumer activity, which represents approximately two-thirds of the U.S. Gross Domestic Product (GDP), has displayed confidence and strength in this economy. Consumer spending and home buying have remained strong, and the housing supply remains tight. However, consumer saving is a relatively low rate of 3 percent, which suggests people are spending their income. Labor markets are strong with approximately 3.8 percent unemployment, and we are starting to see the potential foundation for wage growth. First quarter corporate earnings were up nearly 25 percent and revenues were up 8 percent, which is high relative to an average earnings increase of 6 percent for the period of 2010-2017.

The Federal Reserve (Fed) raised rates again in June and is continued to be expected to do so one to two more times in 2018, which has an effect on the tone of the markets and valuation expectations. The Fed has so far maintained a moderate approach to raising rates, including an increase of $\frac{1}{4}$ percent during the second quarter to 2 percent. Market participants are closely watching for signs that the Federal Reserve may raise rates at a different pace than anticipated due to changes in the economy or inflation.

There are several risks to the economy, including trade concerns, unexpected inflation, diminishing global growth, yield curve flattening, and possible recessionary indicators. While risks abound as always, we remain optimistic for the economy for the remainder of the year. However, this does not necessarily mean the markets will follow suit. As has been demonstrated this year, market volatility can occur for many reasons beyond economic performance.

Fixed Income Commentary

Fixed income investors had plenty to digest during the second quarter which resulted in elevated market volatility. However, the fixed income markets ended the quarter with only a modest change in value given a host of competing drivers of performance. While macro events such as trade discussions and Federal Reserve (Fed) activity will continue to add uncertainty, the fundamental backdrop of the U.S. economy continues to provide positive signals.

The Fed, observing the same economic indicators, increased rates a quarter of a percent at their June meeting and indicated a potential for two more hikes this year. These moves are pushing up short term interest rates while longer term rates have been more sluggish to move higher. The difference between short term and long-term rates has narrowed to levels not seen in nearly a decade and is driving more investors to shorter-term securities. We believe this flattening of the yield curve is likely to slow in the coming quarters.

Interest rates, as measured by the 10-year U.S Treasury note, reached as high at 3.11 percent intra-quarter but ended the period only modestly higher at 2.86 percent. Shorter-term rates, as measured by the 2-year U.S Treasury note, rose considerably and ended the quarter at 2.53 percent, a ten year high.

Sector performance within the fixed income markets varied during the second quarter in response to the competing macro, fundamental, and interest rate dynamics. The Bloomberg Barclay's Aggregate index, a broad measure of the investment grade U.S. bond market, lost 0.16 percent for the quarter and

1.62 percent year to date. Most major spread sectors including corporate, municipal, and agency bonds underperformed similar duration U.S. Treasury securities for the quarter. Mortgage and asset backed sectors realized slight outperformance relative to similar duration Treasuries. Within the investment grade sectors, lower quality assets underperformed higher quality and longer duration underperformed shorter duration securities. Inflation linked securities experienced limited outperformance with the slight uptick in inflation expectations over the quarter.

We expect that macro news and events will continue to create uncertainty and volatility for the markets but that the solid fundamental backdrop will ultimately drive longer term sector performance and push interest rates higher. If the Fed becomes overly aggressive and raises rates too fast, that could be a risk to the economy and markets. But we believe the Fed will continue to be moderate in their approach. Our expectation of modestly rising rates likely means lower absolute fixed income returns ahead for investors, but we believe there are still opportunities to outperform through appropriate sector and security selection allocations.

Equity Commentary

Trade dominated headlines throughout the second quarter, contributing to market volatility in both directions. There is skepticism that heightened trade tensions will result in a trade war, but attention to and analysis of the U.S.'s largest trading partners' reactions remain a top concern.

While China is the largest overall trading partner and garners the most news attention, Canada and Mexico are both nearly as large and receive more U.S. exports. For this reason, discussions around NAFTA are important and impactful to U.S. markets. Retaliation plans from the U.S.'s larger trading partners have begun or are in implementation stages. Canada's retaliatory tariffs were effective July 1 and Mexico is discussing adding duties to pork. Meanwhile, China is expected to impose a new 25 percent tax on soybeans in July. The overall magnitude of the tariffs announced is very small relative to the overall U.S. economy. The potential risk is that further retaliatory tariffs and other barriers to commerce may be put into place which may have far wider implications.

U.S. equities bounced back after a negative first quarter, and the S&P 500 returned 3.43 percent in the second quarter. Corporate earnings growth was strong at 25 percent in the first quarter (for S&P 500 companies) and is expected to increase 20 percent in second quarter. Energy was the top performing sector due to a 14 percent increase in crude oil. Once again, small cap stocks outperformed large caps. The Russell 2000 returned 7.75 percent driven by the strong U.S. dollar and lower exposure to tariff implications. International stocks trailed all domestic stocks; the MSCI EAFE index lost 1.24 percent during the quarter.

Positive U.S. fundamentals continue to provide a cushion. Earnings growth is expected to continue at double-digit levels for the rest of 2018. M&A was a large theme in the second quarter, highlighted by the acquisition of Time Warner by AT&T. JPMorgan noted that buyback activity greatly increased in the second quarter; the share count reduction across large cap stocks was three times higher than in first quarter.

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