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MARKET SENSE: THE GOOD, THE BAD & THE UGLY

In our last quarterly newsletter, we highlighted the dramatic moves in global markets. Building on the gains of 2017, a period of strong gains preceded a burst of volatility, followed by a reversal of the earlier gains. Most asset classes moved consistently and logically. The second quarter was much different.

"Messy" is the word we might choose to describe the current market. Some risk-on asset categories like U.S. small-cap, energy and technology stocks were up close to double-digits, while others like emerging markets, industrial and financial stocks were down nearly 10%. Adding to the confusion, traditional safe-haven equities like consumer staples and telecom were down, while gold failed to rally despite the economic and political uncertainties.

At present, we believe that confusion and market volatility will continue through the November midterm elections, followed by a strong fourth quarter finish that will carry over into early next year. In this newsletter, we will address the current environment, our view on the fundamentals and how we have portfolios positioned for our base-case scenario. However, we will also address alternative scenarios. Though we continue to fall on the optimistic side, the performance of the markets in the past three months and the incoming global economic data have slightly weakened since our spring update. Before shifting gears to a more detailed analysis, we will take a look at the recent broad market performance. The table shows quarterly and 12-month performance. Note that U.S. equities held up the best, driven by smaller companies, technology and energy. Broad international indexes were down slightly while emerging market indexes were off close to 8%. The rapid pace of yield increases witnessed in the first quarter eased, but bonds largely failed to help diversified investors, with treasuries generally flat and corporate bonds down slightly.

	2nd Quarter	52 Weeks
S&P 500	3.43	14.37
Dow Jones Industrial Average	1.26	16.31
MSCI EAFE (Developed International)	-1.24	6.84
MSCI EM (Emerging Markets)	-7.96	8.20
Bloomberg Commodity Index	0.40	7.35
Barclays Global Aggregate Bond Index (Global Bonds)	-2.78	1.36
Barclays U.S. Aggregate Bond Index (Taxable Bonds)	-0.16	-0.40
Barclays Municipal 5 Yr Index (Tax-Free Bonds)	0.87	0.27
HFRI Fund of Funds Composite Index	0.41	5.62

HFRI Index updated through May. Second quarter returns represent March through May 2018 and 52-week returns represent June 1, 2017, to May 31, 2018.

MARKET OVERVIEW AND OUTLOOK

Corresponding with a messy market, there are widely divergent interpretations of recent market and economic signals. Pundits provide an ever-growing list of explanations for the recent moves — trade wars and political risks, a flattening yield curve in the U.S., the rising dollar, concerns over inflation, concerns about global debt levels and worries about the Federal Reserve interest rate increases. In our view, the most important on the list is the concern about the Fed. Thus far, it appears that the Fed is unwavering in its goal of both raising interest rates and continuing to shrink its balance sheet in the face of growing pressures overseas. The adage that "bull markets don't die of old age but are killed by the Fed" has some merit in this case. Below, we try to classify recent messy data and market action in the following categories: The Good, The Bad and The Ugly.

THE GOOD: The synchronized global expansion that started in early 2016 has shifted recently in favor of the U.S. as domestic economic data surged in the second quarter. The Atlanta Fed GDPNow estimate and the Blue-Chip consensus of top economists are converging to a second quarter real GDP around 3.5-4%. The forward-looking data seems to point to continued robust growth in the second half with confidence indexes remaining at multi-decade highs, employment growth running ahead of trend and indications of capital spending coming in strong. The robust backdrop is providing a boost to corporate sales and profits. Both are important, but the former is the fuel for sustainable gains. After bottoming in early 2016 at an annualized decline of 5%, current year-over-year sales growth is at a five year high of 6.4%.

UNLESS WORST-CASE TRADE WAR SCENARIOS START TO MATERIALIZE, THE CONSTANT CHATTER ABOUT TRADE SHOULD BE MANAGEABLE.

Certainly, the talk of tariffs can impact the market. The risk that a policy mistake leads to a full-blown trade war also creates a cloud of worry that puts pressure on markets. However, the scale of stimulus provided by the U.S. tax cut and repatriation of foreign cash from U.S. companies dwarf the economic drag from the announced tariffs. Currently, the size differential of fiscal and tax stimulus over trade drag is about 10x. This should mean that unless worst-case trade war scenarios start to materialize, the constant chatter about trade should be manageable for the economy.

THE BAD: In the bad category, we would place much of the rest of the developed economic world. European markets performed well in 2017 as growth surged to levels unseen in more than five years. However, there has been a measured deterioration in the pace of growth so far in 2018. Germany is the leading economy in Europe, and there has been a clear easing of growth rates since the end of last year. Political challenges also compound the evidence of slowing growth in Europe, especially in Italy, but also as it relates to German Chancellor Angela Merkel and her coalition battles regarding migration policies.

Outside of Europe, the Japanese domestic economy remains on a much better trajectory than it has seen in years, but exposure to Asian trade and worries over trade disputes between China and the U.S. has held back the equity markets in Japan.

We would also add the slight deterioration in credit conditions to the bad list. We actively monitor the credit markets because they tend to lead both economic data and equity markets. We are far from a panic in credit markets, but there have been modest increases in the cost of financing corporate activities. Interestingly, this has been less pronounced in the so-called "junk" bond space, which includes lower-rated companies, than within the higher-quality, investment-grade sector. Thus far, the rising cost of credit is the only tracked indicator that has started to signal a shift away from a favorable outlook for stocks over bonds.

THE UGLY: The recent performance of many emerging markets qualifies as ugly. Certainly, unique circumstances would seem to explain the poor performance of Turkey, South Africa and Argentina. But as the number of countries with unique challenges grows, it starts to look less peculiar and more systemic. In recent weeks, Chinese stock markets dipped into bear market territory (down 22.6% from 52-week highs), while Brazil, Hong Kong and South Korea all are off double digits from their recent highs. The common thread in the concerns over emerging markets is the recent rise of the dollar vs. most other currencies. This is a reversal of the environment that existed for much of 2017, and we will elaborate on its implications further in this letter.

To be fair, the fundamentals have not deteriorated significantly, which could leave the market pull-back as a buying opportunity. Thus far, the trade dispute has been mostly noise, and global trade trends remain largely in place. The economic data in China has deteriorated slightly in recent months but is nowhere near what we would consider overtly negative. One way we gauge the status of global trade and its impact on emerging economies is through commodity prices. Copper has recently deteriorated but remains within its price range of the past year. We also watch the broader BLS Raw Industrials Index. This index covers more than 20 commodities used primarily in basic manufacturing industries. Many of the components also do not have financial trading markets, which reduces noise from money flows and gives a better indication of real supply and demand. This index also remains within a range that has been in place for more than a year and well above levels reached in early 2016.

IMPACT OF FEDERAL RESERVE POLICY AND THE RISING DOLLAR

If we sift through all the above analysis, the critical item that we think the markets are focused on is the quickening pace of Federal Reserve tightening, even in the face of growing pressures on global economies and the currency markets. The fears that the Fed will "keep tightening until something breaks," in our opinion, are the most relevant right now. Recent projections by the Fed show an anticipation that short rates will rise to 3.375% by 2020, which would represent an additional seven 25-BPS increases, or approximately one per quarter. This pace of rate increases would continue as the rate of quantitative tightening (selling down the Fed's bond holdings) increases in the fourth quarter to a scheduled maximum of $50 billion per month. To put that in perspective, the Fed currently holds over $4 trillion in treasuries, mortgage-backed securities and a relatively small amount in agencies.

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There are multiple factors that are putting pressure on many emerging markets via a strengthening greenback: the Fed policies; the impact of the fiscal stimulus and tax bill, which have increased the deficit financing needs of the U.S.; and some pressure to repatriate corporate profits back into dollars. (Much of the foreign cash was already converted to dollars but some unknown amount is likely being converted as it is repatriated, putting additional upward pressure on the dollar.) As described above, it is the weakest economies that have suffered thus far, but concerns about widening stress are growing. In our view, the rationale for the dollar rise to abate and the 2017 trend of a weakening dollar to reintroduce itself is strong, but we recognize that a rising dollar can eventually create its own vicious cycle.

Because the dollar is the world's reserve currency, upwards of 80% of emerging market external debt is financed in dollars. Thus, a rising dollar increases their financing costs and drains resources from other productive uses. This can turn into a vicious cycle were a dollar shortage turns into a scramble for access, thus pushing prices even higher and increasing the need to gain access to dollars. This was the base cause of the emerging markets crisis of the late 1990s.

In our opinion, the 1990's crisis taught the Fed that it needs to be more aware of the global implications of its policies, as evidenced in 2015/16 when the Fed moderated its tone in the face of weakness in other global economies. Of course, we now have a new Fed chair, and inflation has reached the target of 2%. (In 2015/16, it was still below the target.) Today, the Fed is confronted with a more challenging decision. However, a moderation in the rate increase outlook and favorable resolution of the trade dispute with China could coincide with midterm elections and would be the catalyst for a stabilizing dollar, renewed synchronized global growth and a push to new record highs for equity markets in the fourth quarter.

PORTFOLIO POSITIONING AND CONCLUSION

With fundamentals in the U.S. booming and China gaining stability, we are hard-pressed to see how the world economy can soon fall into economic recession. We are reluctant to make dramatic changes to portfolios or our outlook during the seasonally slow summer, especially in a mid-term election year where the current market action is in line with history. If this history plays out, a year-end rally and solid gains in early 2019 remain the most likely scenario. We made slight adjustments to the portfolio during the second quarter, with a reduction in our Eurozone holdings in favor of Asian exposures. These changes also slightly added to the U.S. exposure, specifically, modest increases in tech and financials are closer to benchmark weights for the two biggest sectors.

Compared to our global benchmarks, we remain roughly neutral between U.S. stocks vs. international, with a slight bias toward emerging markets and Asia. Compared to the index, we are overweight to small and mid-cap stocks and value over growth. On a sector basis, portfolios are overweight industrials, energy — mostly through pipeline stocks — as well as healthcare and underweight consumer staples as well as utilities.

As we monitor relevant data, we still believe the weight of the evidence leans positive. That said, the growing divergences between the U.S. and international economies are worth monitoring. In addition, the market deterioration on the back of the rising dollar has started to impact a few of our indicators. We are monitoring closely for any further deterioration in the high-level stocks vs. bonds relative trends, as well as the erosion in support for emerging markets. We will provide additional details if any of these moves prompt further portfolio shifts before the next quarterly newsletter.

During market environments where we find divergent tensions such as these, we rely on our investment process and operating principles as a guide to assess change quickly and to rigorously separate distractions from our core focus of building wealth. It's important to separate economics from market fundamentals and price. It's why we seek outside evaluation and stress-test our portfolio construction on a regular basis and invest in several independent third-party research providers for a broad spectrum of insightful perspectives.

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