July 2018

INVESTMENT UPDATE

Executive Summary

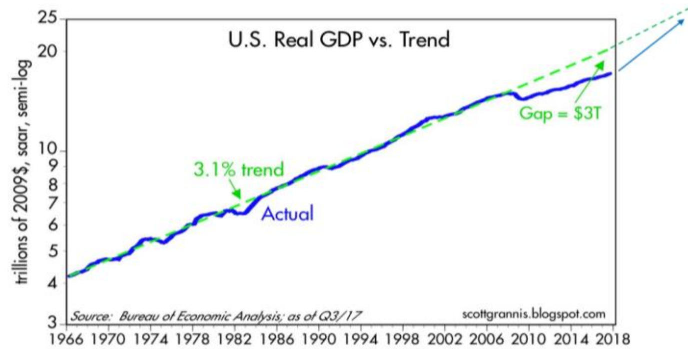
- The U.S. economy is accelerating and looks positioned to experience its first year of greater than +3.0% growth since 2005, aided by improvements in consumer spending and small business investment.
- Trade tensions are acting as an overhang on the stock market as President Trump threatens new tariffs on trading partners in an effort to reduce tariffs around the world.
- Stock market volatility has intensified over the past several months as investors attempt to balance strong economic growth with escalating trade tensions. With the S&P 500 trading at 16.0x forward earnings stocks appear reasonably valued, trading in line with their historical average, and remain attractive for long-term investors.

Stock Market Volatility Continues, but Profit Growth Supports Higher Stock Prices

Since setting an all-time high on January 26th, the stock market has seen a significant increase in volatility, with strong growth in corporate profits being offset by rising trade tensions, and periodic concerns around inflation, rising interest rates, and a strengthening dollar. We expect this volatility to continue throughout the remainder of the year but believe the market will trend higher over that time as strong corporate earnings growth, driven largely by accelerating economic growth, will overcome these fears.

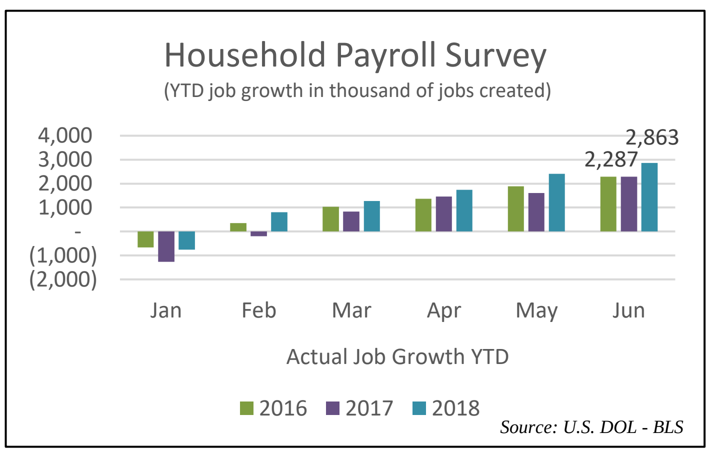
U.S. economic growth, in 2018, is expected to exceed +3.0%, which would be the fastest rate of growth for any year since 2005 and would represent a return to the long-term historical trend rate of +3.1% growth experienced over the 40 years prior to the recession in 2008 (see Graph 1). In fact, the current economic recovery, while the second longest in history, is just the 8th strongest recovery out of the past 11 that have occurred since 1960, indicating that there may still be an opportunity for economic growth to continue for some time. The recent acceleration is being driven by a significant reduction in regulations, a corporate tax cut that has increased incentives for firms to invest and grow domestically, and consumers and businesses finally starting to increase spending at a faster rate.

Graph 1. U.S. Real GDP Growth Returning to Long-term Trend



One encouraging sign pointing to the sustainability of the significant improvement in economic growth is small business optimism, which is currently at the highest level in 40 years. This new optimism is starting to show up in job creation as small businesses have added 2.9 million net new jobs so far this year compared to just 2.3 million at this point in each of the last two years, an increase of 96k net new jobs per month (see Graph 2). This is very encouraging as small businesses are the backbone of the U.S. economy, accounting for around half of all jobs and nearly two-thirds of all jobs created. We expect small business optimism to continue to drive higher levels of job creation and economic growth as they continue to increase investment in their businesses following years of under investment.

Graph 2. Small Businesses are Increasing Hiring



Additionally, consumer confidence is the highest it has been in 18 years aided by the low unemployment rate, record household net worth, the lowest debt payments as a

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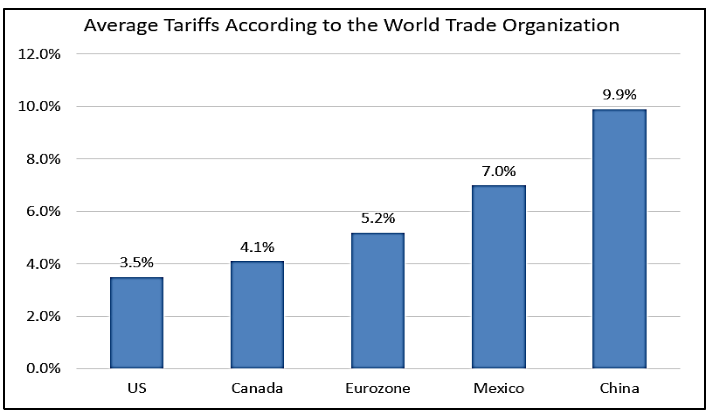
percentage of disposable income in over 30 years, and rising hourly wages. This confidence is starting to be demonstrated in higher retail sales, which grew at a rate of +5.9% in the last year and exceeded the rate of growth in consumer income of +5.0%. We believe continued growth in consumer income and faster growth in spending should support economic growth in excess of +3% over the next couple of years.

While economic growth is positioned to remain strong, there are a few factors that could pose a potential threat to continued improvement. First, President Trump's willingness to threaten new tariffs has resulted in an escalation of trade tensions that could ultimately spark a global trade war. His goal is to reduce tariffs around the world as our primary trading partners have higher average tariffs than the U.S. (see Graph 3). However, this "fight tariffs with tariffs" approach is a major risk as it could significantly reduce global economic growth if it turns into an all-out trade war. At this point, we don't believe this is likely, but it deserves to be watched closely.

Graph 3. President's Goal is to Lower Tariffs Around the World



Another factor that could limit economic growth is a lack of available workers. With the unemployment rate currently at 4%, and job openings at record highs, there is currently less than one unemployed person available for each available job. This is likely to lead to an acceleration in hourly wages as employers will need to pay their employees more to avoid losing them to competitors. While higher wages will lead to faster economic growth in the near-term, the problem with this is that it is inflationary and could cause the Fed to switch from promoting growth through gradually raising interest rates, to fighting inflation through a faster pace of rate increases. So far, wage growth has remained modest at less than +3%, but we believe it could become an issue later in 2019 and 2020.

Lastly, rising interest rates could, over time, begin to limit the pace of economic growth. While interest rates currently remain low relative to historical standards, and the Real Fed Funds Rate currently sits at around 0%, new Fed Chairman Powell appears to be willing to more rapidly increase short-term interest rates to fend off inflation. Eventually, higher interest rates will hurt economic growth, though this tends not to happen until the Real Fed Funds Rate exceeds 3%. With two more rate hikes anticipated this year, and another four expected for 2019, we believe interest rates will remain supportive to economic growth through at least 2019. However, if the Fed continues this pace, interest rates could become neutral to economic growth in 2020 and start to limit growth in 2021. Overall, economic growth should be good for the next few years, but clouds are building that deserve close attention.

Stock Market Returns Reflect Trade Tensions

Through the first six months of the year, there was a significant divergence in performance for the major indexes as investors worked to digest the impact of a strong domestic economy and increasing trade tensions. Small capitalization stocks (Russell 2000) led the way with a total return of +7.7% so far this year, as they benefit the most from a strong domestic economy and have the least amount of exposure to foreign trade. Meanwhile, foreign stocks (EAFE), with a total return of -2.8%, and large capitalization stocks (S&P 500), with a total return of +2.7%, lagged given their larger exposure to foreign trade. Barring a major escalation in trade tensions that significantly reduces economic growth, we would expect the stock market to trend higher throughout the remainder of the year. At 16.0x forward earnings, the S&P 500 valuation is reasonable and should allow stocks to rise along with growing corporate profits. While volatility is likely to persist, we continue to believe that over the long term, investing in high quality consistent growth stocks at reasonable prices is the best way to build wealth for long-term investors.

Bond yields moved higher through the first six months of the year on expectations for faster economic growth and higher inflation, resulting in bonds (Citi Broad Bond Index) generating a negative return of -1.7% so far this year. While the yield curve has flattened modestly since the beginning of the year, we continue to believe that bond yields will move higher across all maturities, aided by continued Fed rate hikes, modestly rising inflation, and bond investors demanding a greater real rate of return on fixed income investments. Therefore, we continue to recommend clients maintain defensive bond portfolios invested in high quality securities with shorter than market average durations.