ASSET STRATEGY CONSULTANTS

MARKET REVIEW

Second Quarter 2018

We are pleased to present *Market Review,* featuring a discussion of the Capital Markets during the Second Quarter 2018 and a summary of historical performance for the major asset style passive indices for the period ending June 30, 2018. We hope you find the information useful and helpful in your investment considerations.

We welcome your comments.

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ASSET STRATEGY CONSULTANTS

Founded in 1991, Asset Strategy Consultants provides investment consulting services to institutional clients representing over $9.5 billion under advisement. Headquartered in Baltimore, Asset Strategy Consultants has offices throughout the East Coast.

THE MACROECONOMIC ENVIRONMENT

Summer Doldrums?

Summer months are typically a quiet time for the markets. Recent events, however, may disrupt this tradition. Threats of escalating trade wars have cast a pall over equities, and numerous geopolitical uncertainties continue to push investors toward a more cautious stance.

A desynchronization in global growth as well as a divergence in central banks' monetary policies have contributed to U.S. dollar strength and wreaked havoc on emerging markets. Currencies of emerging market countries with significant external funding requirements came under particular pressure. Oil prices have risen sharply, and the CBOE's VIX Index climbed steadily higher through June, signaling increased investor angst. While economic growth in the U.S. has been robust, signs of deceleration have emerged overseas, especially in Europe, Japan, and China. While the summer months are traditionally a good time to take vacation, it seems the summer of 2018 could take a different course.

The U.S. economy continues to thrive. The unemployment rate dropped to 3.8% in May, the lowest since 2000. Wages have been inching up, showing a year-over-year increase of 2.7% in May. Consumer spending has been robust; retail sales topped forecasts in May, rising 0.8% (6% y/y). Housing starts, which have been hindered by high lumber costs and a shortage of labor, surged to near an 11-year high in May. Business optimism and consumer confidence indices remain elevated. The National Federation of Independent Business reported that its index of small business optimism rose in May to its highest level in more than 30 years. While real U.S. GDP growth in the first quarter was a mere 2.0% (annualized), expectations for second quarter growth are sharply higher. Some are forecasting an annual rate of more than 4%—the Atlanta Fed expects 4.5%—and most project at least 3.5%.

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Inflation is moving up but remains contained. The Producer Price Index jumped 0.5% (3.1% y/y) in May with roughly half the increase attributable to higher oil prices. This marked the highest level since 2012. Consumer prices rose 0.2% (2.8% y/y), also the biggest jump since 2012. Energy prices climbed 11.7% y/y and appear poised to rise further given a sharp drop in supply and President Trump's threats of sanctions on countries that continue

to import from Iran. The Fed's favored inflation measure, the Core Personal Consumption Expenditures Index, hit its stated 2% y/y target in May for the first time since 2012.

Against this backdrop, the Fed raised short-term rates for the second time in 2018, bringing the Fed Funds rate to 1.75% - 2.0%. The Fed expects two more rate hikes this year and three more in 2019. The U.S. dollar appreciated more than 5% over the course of the quarter (versus a basket of currencies) given higher interest rates, the strength of the U.S. economy, and relative weakness in Europe and Japan.

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In the face of all of the good economic news (and perhaps because of it), the White House imposed a 25% tariff on $50 billion of imports from China. While these tariffs are not expected to have a meaningful impact on U.S. GDP (roughly -0.2%), the administration has threatened to apply additional tariffs on at least $200 billion of goods should China retaliate. That move would have a much more significant impact on U.S. GDP as well as add to inflation. Further, the White House announced new tariffs on steel and aluminum from Europe, Mexico, and Canada. In response to President Trump's move, European Union members unanimously backed a plan to impose import duties on €2.8 billion worth of American products. Discussions are ongoing, but the markets have clearly expressed displeasure in recent days around the potential impact of trade wars on the economy.

Conversely and in contrast to 2017, data in Europe suggested slower growth. German factory orders unexpectedly dropped for a fourth month in April. A European Commission Index of consumer sentiment fell to an eight-month low in June. Turmoil in Italy also worried investors. Initial attempts by the Northern League and 5 Star Movement to form an anti-establishment government coalition were rebuffed by the Italian president's veto of the parties' choice of a euro-skeptic finance minister. While a compromise was reached, investors are wary of the new government's fiscal discipline. Italy's national debt is among the highest in the world and growth remains meager; unemployment hovers around 11%, and the new government includes leaders who have talked of leaving the euro. Italian bond yields surged 100 basis points on the news. Finally, Brexit negotiations between Britain and the EU have stalled, raising the threat of a "hard" Brexit come March 2019.

In recognition of these headwinds, euro zone central bankers trimmed their outlook for growth in 2018 to 2.1%, down from the previous forecast of 2.4%. The European Central Bank announced plans to cut in half (€30 billion to €15 billion) its monthly asset purchase program beginning in October 2018, and fully stop purchases by the end of 2019. However, this timing was further out than markets had expected, and reinvestment of principal payments from maturing bonds is expected to remain for "an extended period of time after the end of the net asset purchases," according to the ECB. The Bank also kept rates unchanged during the quarter.

China also showed signs of slowing. Both industrial output and retail sales rose less than expected in May and fixed-asset investment growth has also slowed. Japan's economy contracted for the first time in two years. The world's third-largest economy shrank by 0.2% in the first quarter. Stimulus measures are expected to remain in place in Japan as inflation remains significantly below target. ■

EQUITY MARKETS

The U.S. equity market posted solid returns in the second quarter on the back of strong first quarter earnings as well as record share buybacks fueled by the Trump Administration's $1.5 trillion tax cut. The S&P 500 Index gained 3.4% in the second quarter. Small cap stocks, seen to be relatively immune to global trade

spats, surged nearly 8% (Russell 2000: +7.8%). Large cap growth (Russell 1000 Growth: +5.8%) continued to dominate large cap value (Russell 1000 Value: +1.2%); for the y-t-d period growth (+7.3%) outpaced value (-1.7%) by 9%. Within the S&P 500, rising oil prices fueled the Energy sector (+13.5%), but Consumer Discretionary (+8.2%) and Technology stocks (+7.1%) were not far behind. In spite of a late quarter boost, Financials (-3.2%) were hurt by rising short rates and a flattening yield curve. Industrials (-3.2%) and Consumer Staples (-1.5%) also lost ground during the quarter. The oft-quoted "FANG" stocks plus Apple and Microsoft accounted for over half of the second quarter total returns for both the Russell 1000 Growth and S&P 500 indices. Notably, the y-t-d contribution from these six stocks accounted for over 70% of the Russell 1000 Growth and over 120% of the S&P 500 total returns; Amazon alone accounted for nearly half of the y-t-d total return for the S&P 500 Index.

U.S. stocks outperformed non-U.S. and (in particular) emerging market equities both in local as well as U.S. dollar terms. The U.S. dollar appreciated roughly 5% over the quarter (versus a basket of developed market currencies), benefitting from higher interest rates and a relatively robust economy. The MSCI ACWI ex-US Index lost 2.6%, with most countries posting negative returns. The MSCI Emerging Markets Index sank 8.0%, with many countries posting double-digit declines. Regionally, Emerging Europe and Latin America sank about 15% while Emerging Asia fared better with a 3% drop. ■

FIXED INCOME MARKETS

U.S. rates rose in the second quarter and the yield curve continued its flattening trend. The yield on the 10-year U.S. Treasury note hit an intra-quarter high of 3.11% in May but closed the quarter at 2.85%, only 11 bps higher than March 31. Concerns over mounting trade tensions and slower global growth pushed yields lower going into quarter-end. The 2-year U.S. Treasury note closed at 2.52%, up sharply from 2.27% as of March 31 and its highest level since August 2008. The yield curve continued to flatten and the spread between the 2-year and 10-year ended at its lowest level (33 bps) in more than 10 years. The Fed hiked rates in June, as was widely expected, and expects two more increases in 2018. The Bloomberg Barclays US Aggregate Bond Index fell -0.2%, with investment grade corporates underperforming Treasuries as heavy supply and concerns over heightened M&A activity weighed on the market. High yield corporates (Blomberg Barclays High Yield: +1.0%) outperformed, and leveraged bank loans (S&P LSTA: +0.7%), which carry a floating rate coupon, posted the best returns. Municipals performed relatively well during the quarter; the Bloomberg Barclays Municipal Bond Index was up 0.9%.

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Overseas, changes in interest rates were modest (with the exception of Italy, where yields spiked on political news) and currency fluctuations drove returns for unhedged bonds. The dollar strengthened by 5% versus the euro over the quarter and similarly relative to the yen and U.K. pound. The Bloomberg Barclays Global Aggregate ex-US Bond Index fell 4.8%, largely a result of U.S. dollar strength. Emerging market currencies suffered more as higher interest rates in the U.S. and trade concerns weighed on markets. The JPM EMBI Global Diversified Index was down 3.5% with broad-based weakness. Argentina (-11.5%) and Venezuela (-14.5%) were among the weakest performers. The local currency-denominated JPM GBI-EM Global Diversified Index fared even worse (-10.4%) with several countries posting double digit declines. Argentina (-34%), Turkey (-22%), South Africa (-17%), and Brazil (-16%) were notably poor performers. Countries that rely heavily on external financing were especially hard-hit. ■

REAL ASSETS RESULTS

As a group, real assets performed relatively well in the second quarter, led by Energy stocks (S&P 500 Energy: +13.5%), MLPs (Alerian MLP Index: +11.8%), and equity REITS (FTSE NAREIT: +10.0%). The listed infrastructure sector wasn't to be kept away from the party, as the Dow Jones Brookfield Global Infrastructure Index rose 4.2%, while hard commodities saw dispersed returns and a more modest +0.4% return overall for the Bloomberg Commodity TR Index. Gold slipped 5.5%. Across the hard commodity complex, the biggest gains came from lean hogs (+45%), crude oil (+14%) in both Brent and WTI, and feeder cattle (+14%). The biggest loser was soybeans, which fell by 18% over the quarter. TIPS also performed well, in relative terms, rising 0.8% for the quarter as inflation expectations rose. The 10-year breakeven inflation rate was 2.11% as of quarter-end.

Geopolitics influenced the performance of several hard commodities. The tension between the U.S. and North Korea was somewhat eased by a June 12 summit between President Trump and Kim Jong-Un, while the U.S.-Russia relationship continued to stand at a post-Cold War low. Elsewhere, the continued rhetoric and threat of a trade war between the U.S. and China continued to weigh on several commodity sectors, soybeans chief among them (the U.S. is the largest global exporter and China is the largest buyer of American soybeans). As for oil, robust demand and a spate of global oil supply disruptions in Venezuela, Libya, and even Canada pushed the spot price to a multi-year high of $74/barrel despite efforts by OPEC and others to open the spigot. Recent threats by President Trump to sanction nations importing oil from Iran only exacerbated concerns around this imbalance.

Inflation-sensitive assets traditionally perform well through the later stages of economic growth cycles. However, the Fed expects to hike rates up to five times between now and the end of 2019, leaving us to wonder how long some of these more rate-sensitive real asset categories can maintain this momentum. ■

CLOSING THOUGHTS

As of the end of the quarter, valuations remained full across most asset classes (emerging markets being the notable exception) and numerous storm clouds loomed on the horizon. Could rising interest rates, higher energy prices, U.S. dollar strength, Brexit woes, looming trade wars and/or other geopolitical concerns derail the 108-month-old economic expansion, the second-longest since data were recorded, or will sunny skies prevail? While we cannot predict the future, we continue to suggest that investors temper return expectations, maintain a long-term perspective, and adhere to prudent asset allocation with appropriate levels of diversification. As always, Asset Strategy Consultants encourages investors to maintain a long-term perspective and prudent asset allocation with appropriate levels of diversification. ■

Important Disclosure Information

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PRELIMINARY RETURNS FOR VARIOUS PERIODS: 2Q18

		April	May	June	Last Quarter	Year to Date	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
EQUITY	1 Russell:3000 Index	0.38	2.82	0.65	3.89	3.22	14.78	11.58	13.29	10.23	9.61
	2 Russell:1000 Index	0.34	2.55	0.65	3.57	2.85	14.54	11.64	13.37	10.20	9.54
	3 Russell:1000 Growth	0.35	4.38	0.96	5.76	7.25	22.51	14.98	16.36	11.83	10.30
	4 Russell:1000 Value	0.33	0.59	0.25	1.18	(1.69)	6.77	8.26	10.34	8.49	8.63
	5 Russell:Midcap Index	(0.15)	2.27	0.69	2.82	2.35	12.33	9.58	12.22	10.23	11.17
	6 Russell:Midcap Growth	(0.94)	3.74	0.39	3.16	5.40	18.52	10.73	13.37	10.45	11.07
	7 Russell:Midcap Value	0.50	1.09	0.81	2.41	(0.16)	7.60	8.80	11.27	10.06	11.04
	8 Russell:2500 Index	0.24	4.70	0.72	5.71	5.46	16.24	10.30	12.29	10.74	10.99
	9 Russell:2500 Growth	(0.64)	5.32	0.84	5.53	8.04	21.53	10.86	13.87	11.38	11.46
	10 Russell:2500 Value	1.09	4.11	0.53	5.80	3.00	11.49	9.76	10.78	10.10	10.37
	11 Russell:2000 Index	0.86	6.07	0.72	7.75	7.66	17.57	10.96	12.46	10.60	10.50
	12 Russell:2000 Growth	0.10	6.30	0.78	7.23	9.70	21.86	10.60	13.65	11.24	10.95
	13 Russell:2000 Value	1.73	5.82	0.61	8.30	5.44	13.10	11.22	11.18	9.88	9.93
	14 S&P:500	0.38	2.41	0.62	3.43	2.65	14.37	11.93	13.42	10.17	9.30
	15 S&P:400 Mid Cap	(0.26)	4.13	0.42	4.29	3.49	13.50	10.89	12.69	10.78	11.39
	16 S&P:600 Small Cap	1.03	6.46	1.13	8.77	9.39	20.50	13.84	14.60	12.25	12.03
	17 MSCI:ACWI ex US	1.60	(2.31)	(1.88)	(2.61)	(3.77)	7.28	5.07	5.99	2.54	7.74
	18 MSCI:EAFE	2.28	(2.25)	(1.22)	(1.24)	(2.75)	6.84	4.90	6.44	2.84	7.26
	19 MSCI:EM	(0.44)	(3.54)	(4.15)	(7.96)	(6.66)	8.20	5.60	5.01	2.26	10.70
	20 MSCI:ACWI	0.95	0.12	(0.54)	0.53	(0.43)	10.73	8.19	9.41	5.80	8.19
FIXED INCOME	21 Blmbg:Aggregate	(0.74)	0.71	(0.12)	(0.16)	(1.62)	(0.40)	1.72	2.27	3.72	3.77
	22 Blmbg:Gov/Credit	(0.85)	0.72	(0.19)	(0.33)	(1.90)	(0.63)	1.83	2.29	3.78	3.71
	23 Blmbg:Credit	(0.91)	0.50	(0.47)	(0.88)	(2.99)	(0.65)	2.86	3.37	5.15	4.52
	24 Blmbg:Corporate High Yld	0.65	(0.03)	0.40	1.03	0.16	2.62	5.53	5.51	8.19	7.77
	25 Blmbg:Municipal Bond	(0.36)	1.15	0.09	0.87	(0.25)	1.56	2.85	3.53	4.43	4.13
	26 Blmbg:US TIPS	(0.06)	0.43	0.40	0.77	(0.02)	2.11	1.93	1.68	3.03	4.01
	27 Blmbg:Glob Agg ex USD	(2.27)	(1.87)	(0.70)	(4.76)	(1.31)	2.78	3.23	0.88	1.76	3.58
	28 S&P:LSTA Levg Loan	0.41	0.17	0.12	0.70	2.16	4.37	4.21	4.01	5.18	4.91
	29 ML:US Treasuries 1-3 Yrs	(0.16)	0.36	0.02	0.22	0.09	0.08	0.42	0.58	1.24	1.92
	30 LIBOR - 3 Month	0.19	0.20	0.19	0.58	1.04	1.75	1.07	0.74	0.73	1.69
	31 3 Month T-Bill	0.13	0.15	0.17	0.45	0.81	1.36	0.68	0.42	0.35	1.29
REAL ASSETS	32 Blmbg:Commodity TR Idx	2.58	1.42	(3.50)	0.40	0.00	7.35	(4.54)	(6.40)	(9.04)	(0.63)
	33 GS Commodity Index	5.04	1.45	1.36	8.00	10.36	30.04	(4.37)	(9.41)	(12.36)	(2.33)
	34 MSCI:US REIT Index	1.44	3.94	4.42	10.10	1.19	3.57	8.06	8.26	7.95	9.96
	35 Alerian:MLP Index	8.09	5.05	(1.54)	11.80	(0.63)	(4.58)	(5.93)	(4.09)	6.46	9.07
	36 DJB:Glbl Infrastructure	1.48	(0.02)	2.72	4.22	(1.26)	2.51	4.55	7.15	7.63	11.35
	37 US DOL:CPI All Urban Cons	0.40	0.42	--	--	--	--	--	--	--	--