Market Review and Outlook
March 30, 2018

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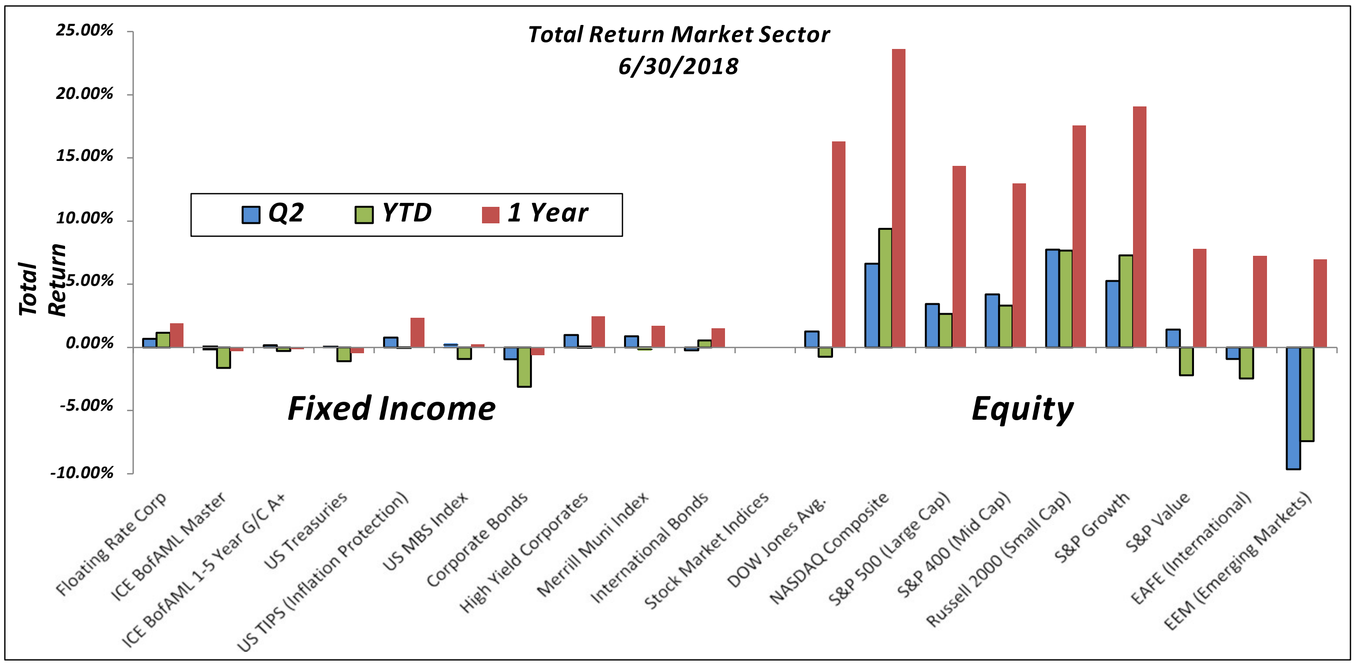
Market Summary

June 2018

- The US Equity market rebounded in Q2 from the Q1 correction, led by growth-oriented stocks. The more growth and small-cap-oriented the stock, the better the performance. This has been a consistent pattern over the past year.
- Bonds were generally flat in Q2 with higher income offsetting price declines. Year to date, almost all bond sectors are down with the exception of floating rate notes, which were protected from the rise in rates.



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Market Environment Summary

June 2018

- Rising interest rates generated negative returns across the bond market with the exception of floating rate securities. Equity markets rose, but with high volatility and significant dispersion across sectors.
- All key inflation measures have topped the Feds 2% target rate.
- The broad-based strong economic foundation and lower tax rates should sustain growth and investment, while providing support to credit quality and equity markets even in a higher rate environment.
- The Fed hiked rates again in Q2, and declared a high probability of 4 rather than 3 hikes in all for 2018 to remove stimulus, citing the strength of employment, wages, and inflation that is likely to be sustained.
- The bond market continues to price in a lower rate environment than the Fed has indicated, however the equity markets seem to be taking note, evident in higher volatility and sector performance.
- The synchronized global economic growth environment remains in place, but has become less consistent overseas with increased political uncertainty and pending trade negotiations.
- The higher US rate environment and a stronger US dollar has negatively impacted emerging markets.
- Yields on 2 year notes continued to rise in Q2 to their highest level since 2008, and longer term rates have finally begun to rise as well, but not as quickly, flattening the yield curve.
- Oil prices continued to climb into the mid $70's as global demand and OPEC production cuts have offset increased production in the US.

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Market Environment Summary

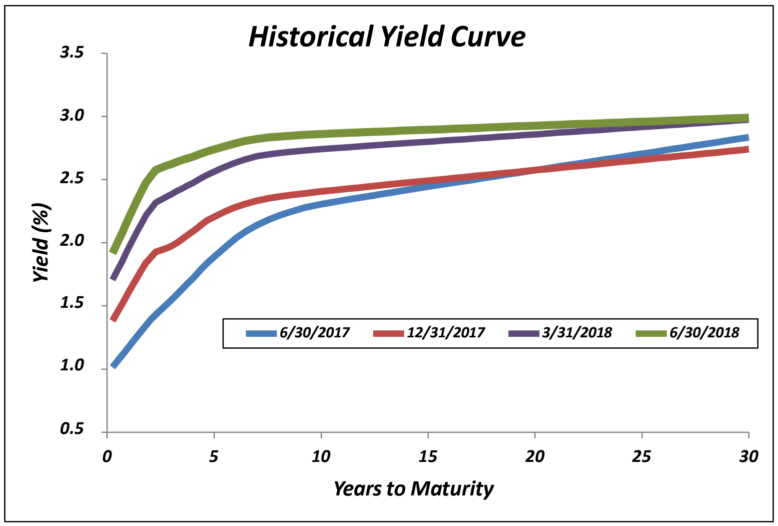
June 2018

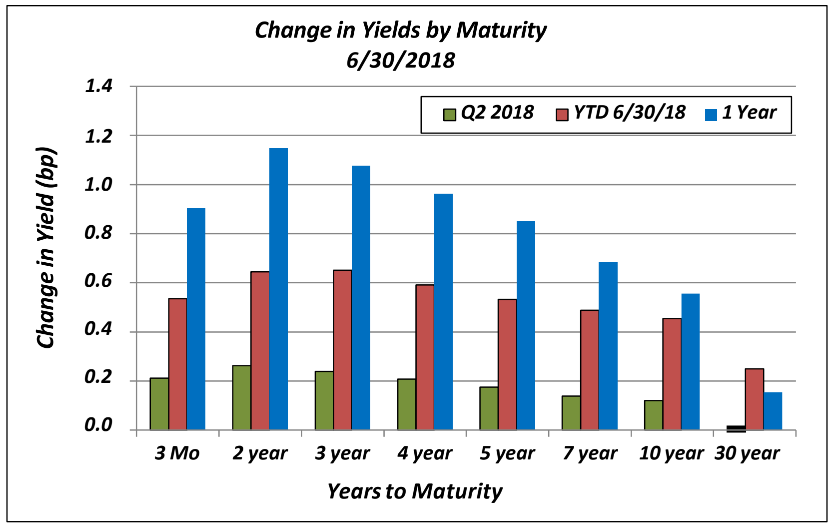
- Our outlook for rising interest rates remains in place, with economic fundamentals including employment, consumption, manufacturing, and investment continuing along a steady upward path.
- We expect rates to continue to move higher, with 4 rate hikes in 2018 along with continued removal of accommodative policy. We still believe that long rates will move higher with the 10-year Treasury note reaching 3 –3.5% in 2018. The market continues to under appreciate this risk.
- The broad-based economic growth and employment provides a more self-sustaining level of activity (less dependent on low rates for stimulus, and able to withstand a higher rate environment).
- The equity market may be able to withstand 50 –100 basis points higher interest rate environment but will likely experience increased volatility along the way to new highs, driven by earnings growth.
- Growth stocks may still benefit from the environment, while dividend paying stocks such as utilities and REITS may still be challenged by the higher market levels of interest rates.
- Corporate tax cuts will benefit many companies, enhancing investment, dividends and stock buybacks and acquisitions, while also maintaining strong credit quality.
- Housing and consumption has remained strong while investment continues to drive economic activity.
- We see the biggest risk to corporate earnings is increased input costs such as energy, labor, and transportation (trucker shortage) that may pressure margins despite strong top line growth.
- Trade talks will preoccupy markets and generate volatility.

Market Review

Yield Curve – June 2018

- Interest rates rose across all maturities in Q2, YTD, and the past year reflecting actual Fed rate hikes and expectations for more going forward.
- Short rates rose by over a percentage point over the past year to the highest level since 2008.
- As the Fed continues tightening in 2018, short rates will rise, and long term rates will also rise, driven by higher inflation and government debt issuance.

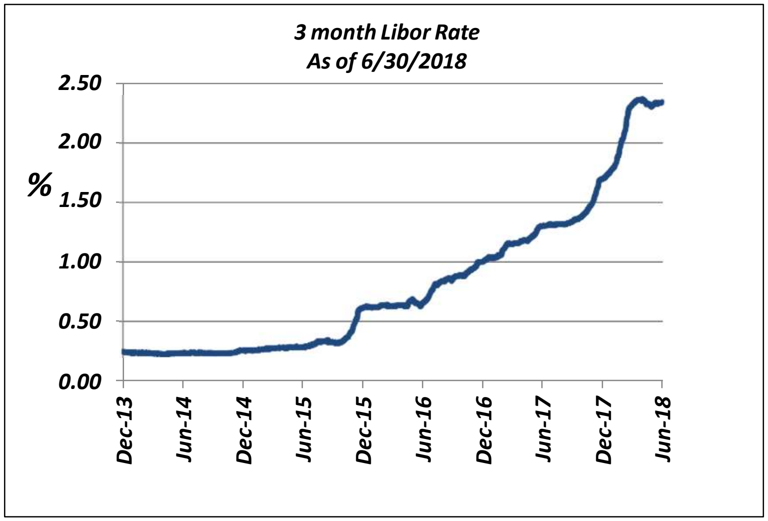


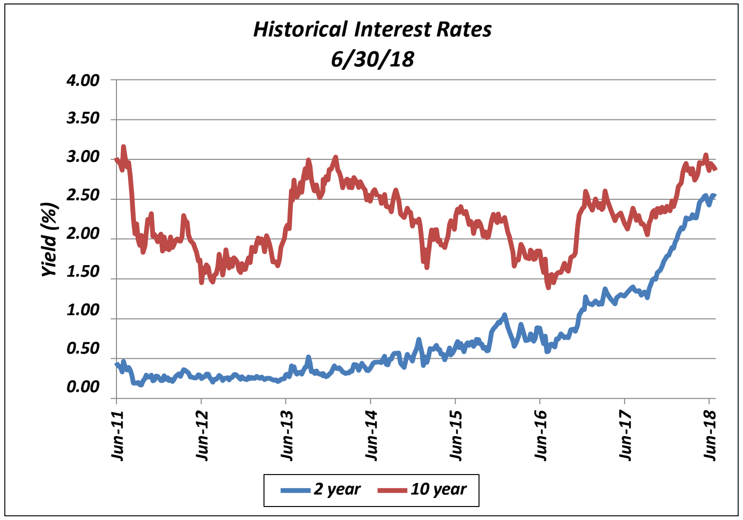


Market Review

Yield Curve – June 2018

- The 3-month Libor has risen significantly. Most floating rate notes are benchmarked off of Libor, providing increasing coupons with stable prices.
- The flattening of the yield curve (the yield spread between 2 and 10 year rates) has gained attention since "inversions" have been associated with recessions. Correlation is not causation, and technical factors are at work keeping long rates artificially low.
- With economic growth, rising inflation, and increased net issuance, longer rates are likely to rise as well.





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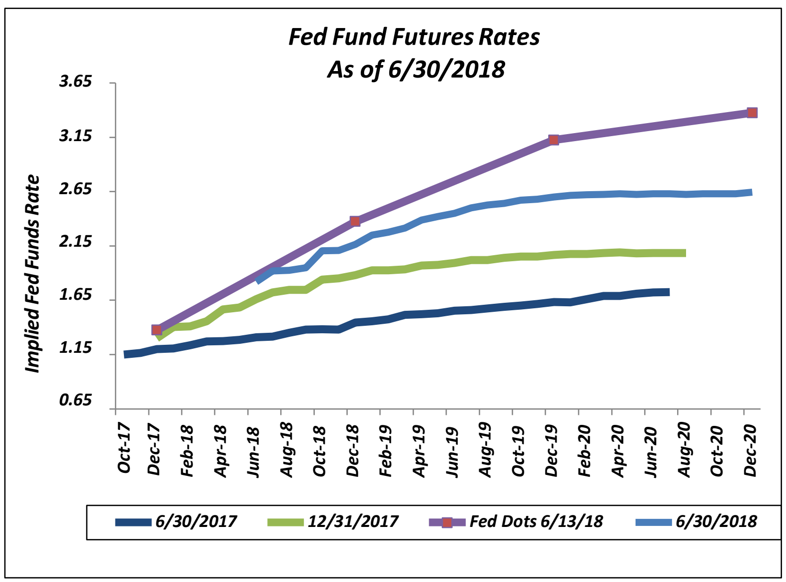
Market Review

Monetary Policy – June 2018

- The "dot plot", or the Fed's own expectations of future rates, shifted up 25 basis points at their June meeting, significantly upgrading their outlook for unemployment and inflation.
- Current GDP is on pace to grow a bit faster than the Fed's current projections.
- The markets have made an adjustment towards the Fed targets, however continue to price in a lower future Fed Funds rate with only a 47% probability of 2 more hikes in 2018.



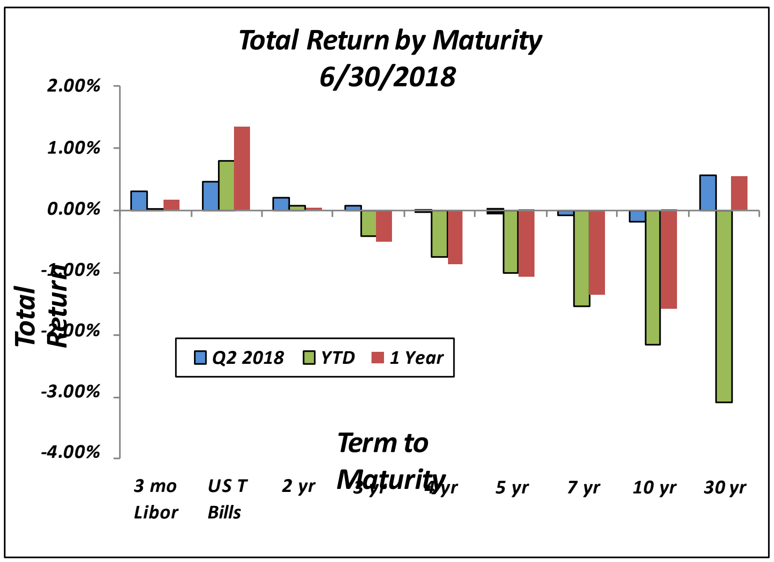
Federal Reserve Median Economic Projections
As of 6/30/2018

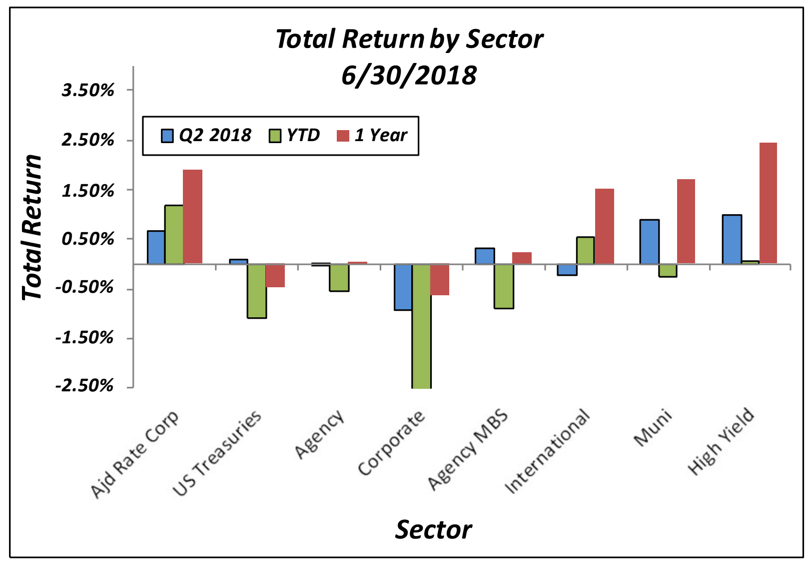
		2018	2019	2020	Longer Run
Change in GDP					
June 2018 Projection		2.5	2.4	2.0	1.8
March 2018 Projection		2.7	2.4	2.0	1.8
Actual Q1 2018	**2.8%**				
Unemployment Rate					
June 2018 Projection		3.6	3.5	3.5	4.5
March 2018 Projection		3.8	3.6	3.6	4.5
Actual Q4 2017	**4.0%**				
PCE Inflation					
June 2018 Projection		2.1	2.1	2.1	2.0
March 2018 Projection		1.9	2.0	2.1	2.0
Actual May 2018	**2.3%**				
Core PCE Inflation					
June 2018 Projection		2.0	2.1	2.1	
March 2018 Projection		1.9	2.1	2.1	
Actual May 2018	**2.0%**				
Projected Policy Path- Fed Funds					
June 2018 Projection		2.4	3.1	3.4	2.9
March 2018 Projection		2.1	2.9	3.4	2.9

Market Review

Yield Curve and Sector Returns – June 2018

- Total returns across the maturity spectrum were generally flat in Q2 as income offset price declines; however, total returns are significantly negative in longer maturities year to date.
- Fixed rate corporate bonds have been negative due to longer durations and widening yield spreads. High Yield corporates continue to perform well due to the significantly higher income and stable credit.
- Floating rate corporates have performed well due to stable prices and upward adjusting coupons.

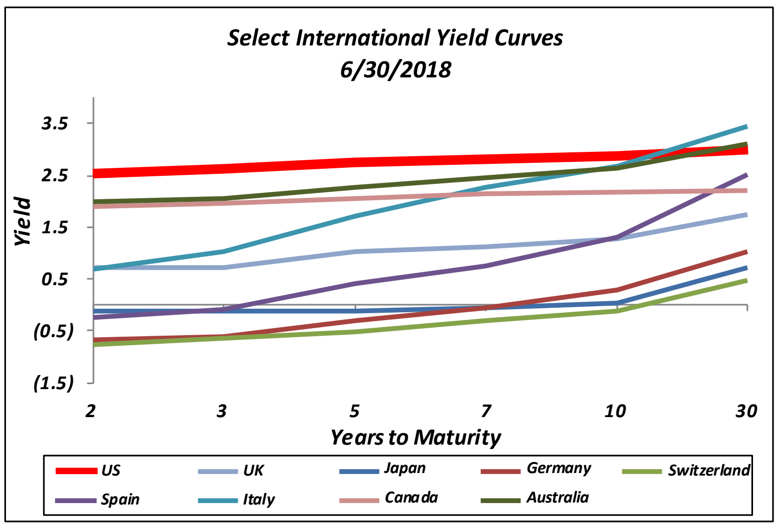


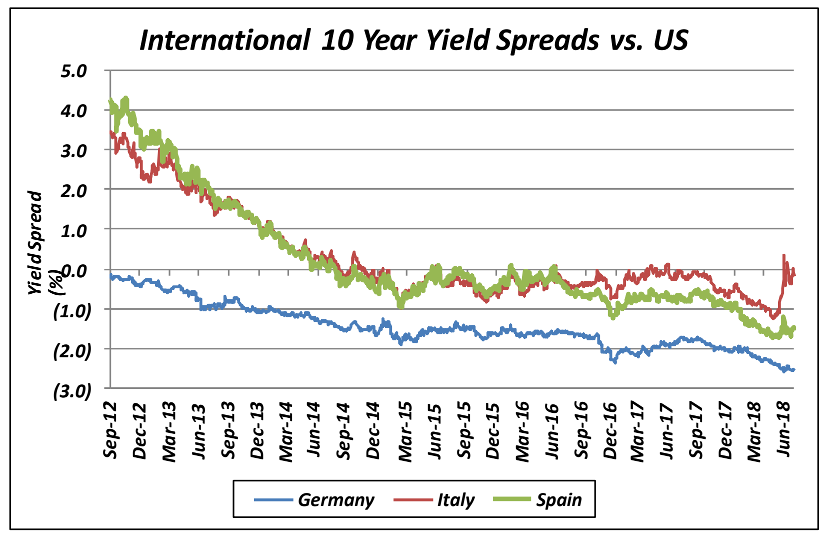


Market Review

International Yield Curves – June 2018

- The US remains one of the highest yielding developed countries and the yield spread over Europe continued widening in Q2 as US rates rose.
- The European Central Bank and Bank of Japan continue with aggressive easy monetary policy.
- Political events in Italy sent Italian yields higher and drove investors to Germany and the US in a flight to quality.

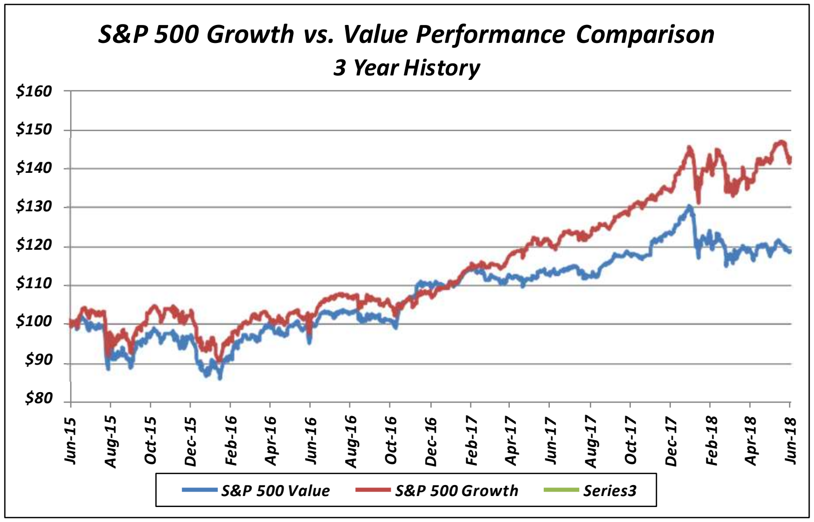


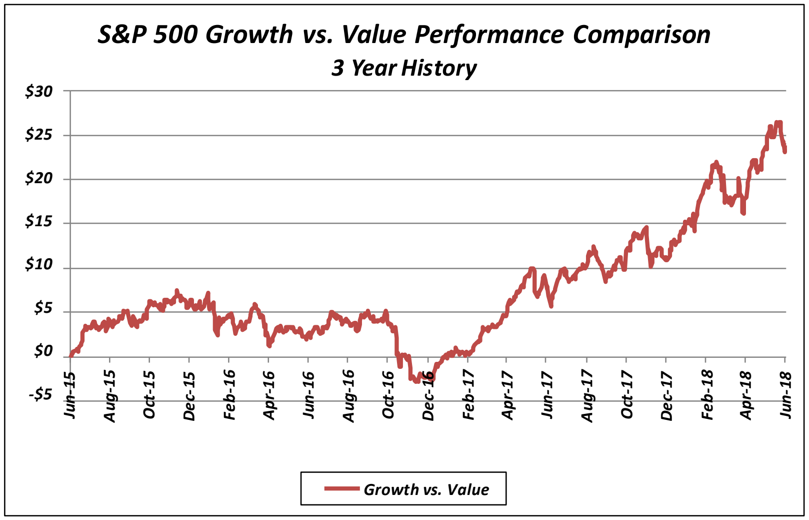


Market Review

Equity Market Returns - June 2018

- Growth has outpaced value reflecting innovation and expectations of business investment going forward. It is also reflective of the improving economic environment.
- The recent volatility has been evident in growth stocks, while value has remained a bit more stable.
- Dividend paying value stocks have been challenged by higher interest rates.

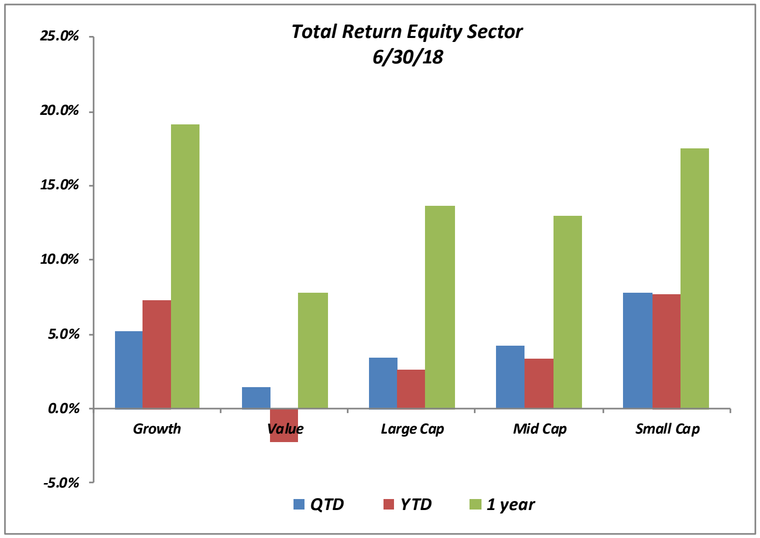


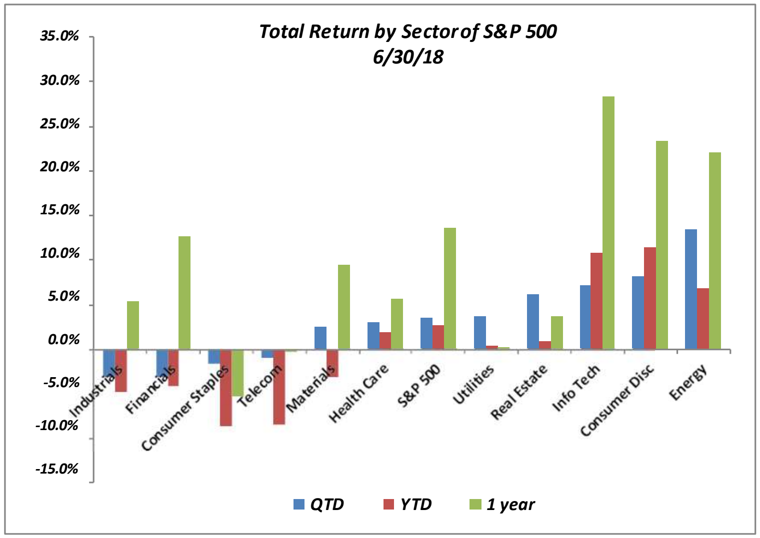


Market Review

Equity Market Returns - June 2018

- Equity gains have been led by technology and consumer discretionary due to investment and broad-based economic growth, while energy has made a strong comeback reflecting the recovery in oil.
- REITs and utilities recently recovered as rates were more stable in Q2. This has given financials a pause from strong performance over the past year.
- Industrial and manufacturing stocks have been strong due to global economic strength but have recently paused amid global trade tensions.

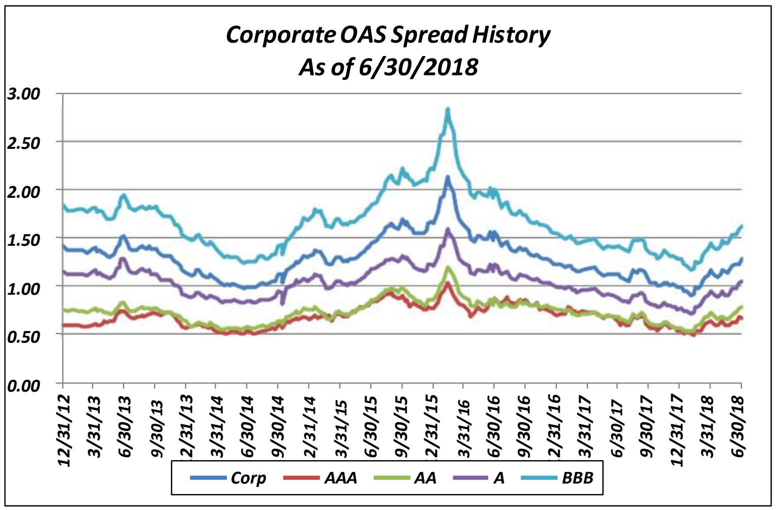


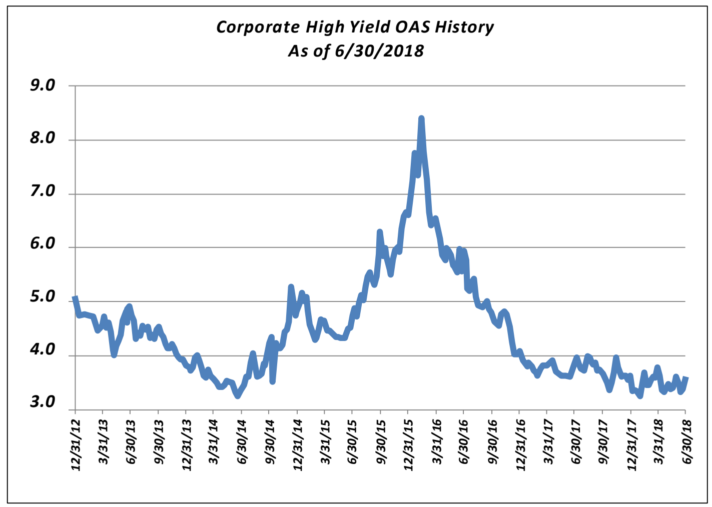


Market Review

Corporate Yield Spreads – June 2018

- Corporate yield spreads widened from historically tight levels, particularly in lower rated BBB amid the stock market correction and increased volatility, .
- Spread widening was a function of market volatility rather than increased credit risk as fundamentals continue to support current levels. High Yield spreads remained relatively steady.
- Increased merger and acquisition activity may put pressure on higher quality corporate bonds.

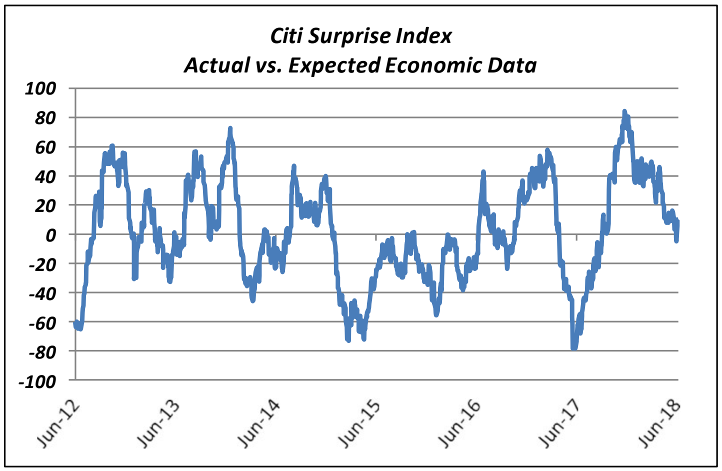




Economic Environment

June 2018

- The Citi Surprise index, which measures actual economic data relative to economist and market expectations, has shown the US economy has performing better than expectations despite a slight moderation in Q1. creased
- Economic expectations have in, and Q2 economic data has been strong, meeting expectations. Economic growth has been broad-based, indicating it is becoming self-sustaining.
- Despite new moderation in some countries, synchronized global economic growth remains in place. Recent political events, trade tensions, and volatility in emerging countries have produced some concern.



GDP YoY % Change			
	Current (Q1)	One Year Ago	Change
US	2.80	2.00	0.80
Eurozone	2.50	2.10	0.40
Germany	2.30	2.10	0.20
France	2.20	1.40	0.80
Italy	1.38	1.32	0.05
UK	1.20	1.80	(0.60)
Canada	2.90	2.80	0.10
Mexico	1.30	3.25	(1.95)
Australia	3.10	1.80	1.30
Japan	1.10	1.40	(0.30)
China	6.80	6.90	(0.10)
Russia	1.30	0.60	0.70
Brazil	1.21	(0.01)	1.22

Inflation YoY % Change			
	Current	One Year Ago	Change
US	2.80	1.90	0.90
Eurozone	2.00	1.30	0.70
Germany	2.10	1.60	0.50
France	2.10	0.70	1.40
Italy	1.40	1.20	0.20
UK	2.40	2.90	(0.50)
Canada	2.20	1.30	0.90
Mexico	4.51	6.16	(1.65)
Australia	1.90	2.10	(0.20)
Japan	0.70	0.40	0.30
China	1.80	1.50	0.30
Russia	2.40	4.10	(1.70)
Brazil	4.39	3.00	1.39

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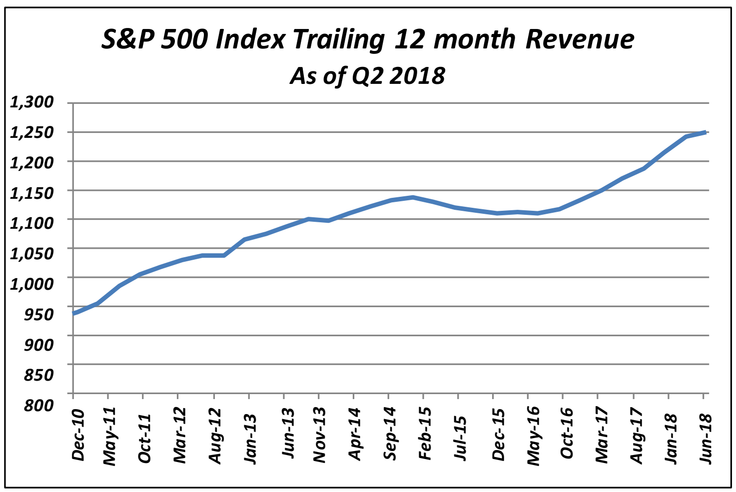
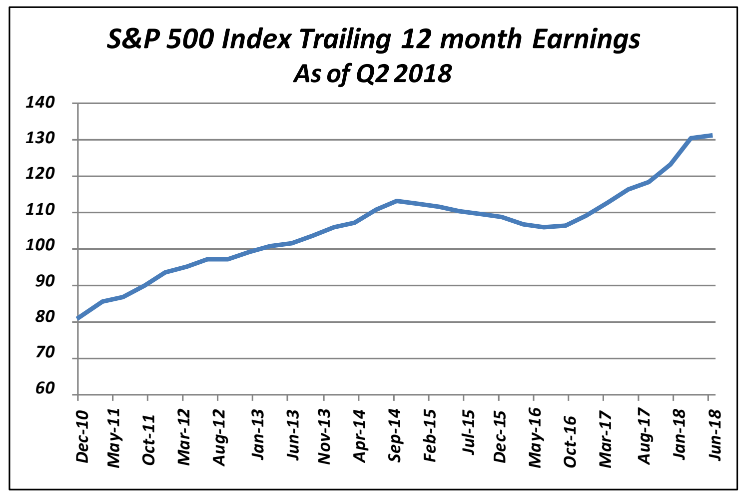
Economic Environment

June 2018

- Top line revenue growth has been strong, flowing through to earnings, particularly on the heels of the recent tax package.
- The negative impact of the energy sector on overall earnings from 2015/16 has recovered and normalized due to the recovery in oil prices.
- Top line revenues may continue to grow given the economic backdrop. However, cost pressures from energy, labor, and transportation (including truck driver shortages) may pressure margins.
- The stronger dollar and trade tensions may pressure multinationals due to more expensive exports and currency conversions back to the US Dollar.

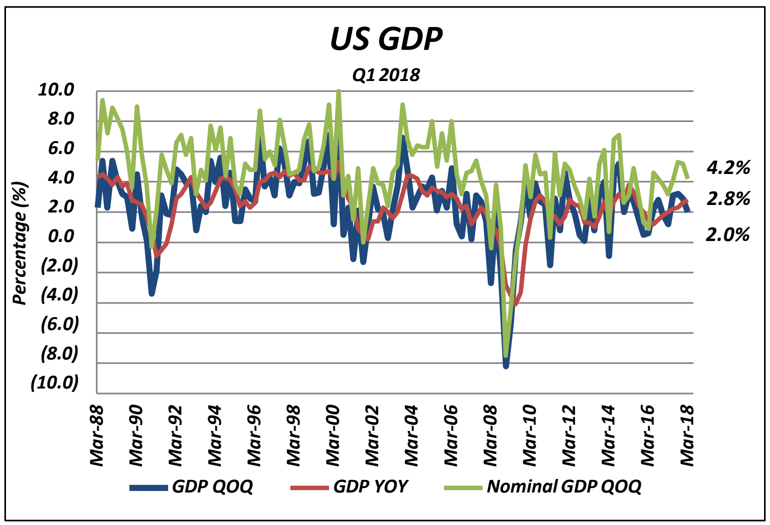


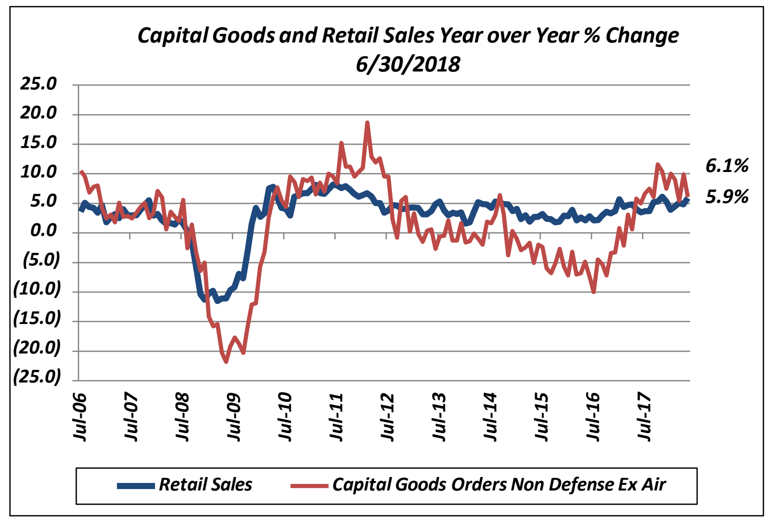


Economic Environment

June 2018

- Economic growth has been strong, with 2.0% in the first quarter and 2.8% Year over Year.
- Nominal GDP has reached 5% and is maintaining levels of over 4% with rising inflation.
- Q2 GDP is expected to rise 4-5%, driven by continued strength in consumption and investment.





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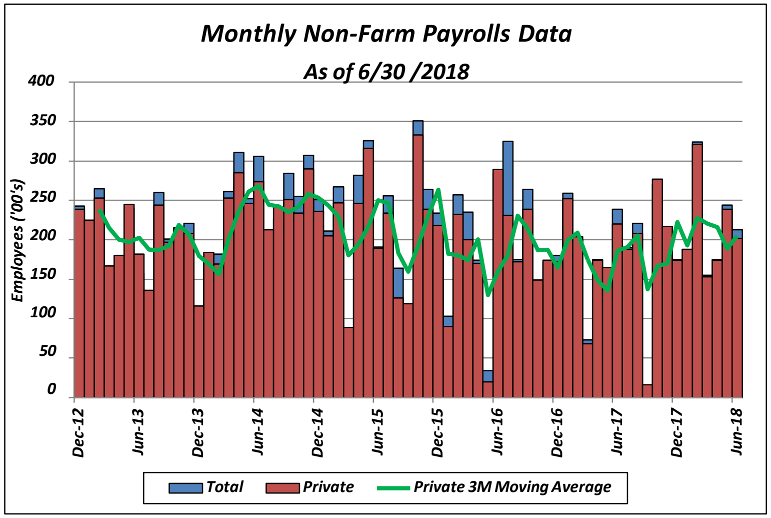
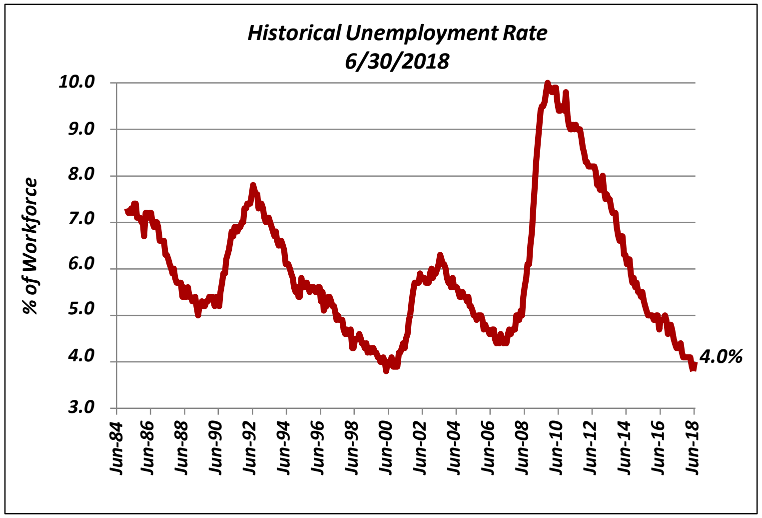
Economic Environment

Employment – Monthly Payrolls – June 2018

- Non-farm payrolls are maintaining a healthy pace. Virtually all payroll gains have been in the private sector.
- The labor participation rate has continued to improve, with as many people entering the workforce as people getting hired. In Q2, there were more jobs available than job seekers.
- Weekly initial unemployment claims have been running below 220,000, the lowest numbers since the 70's.
- The unemployment rate dipped returned to 4% due to significant new entrants to the labor force.

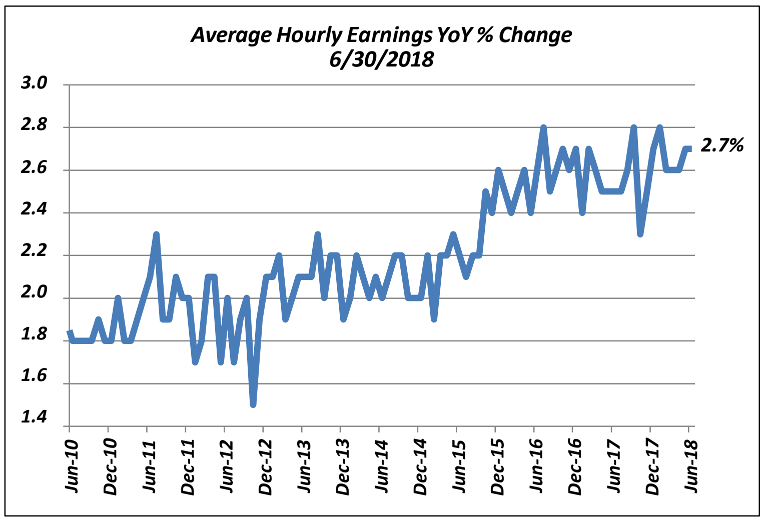


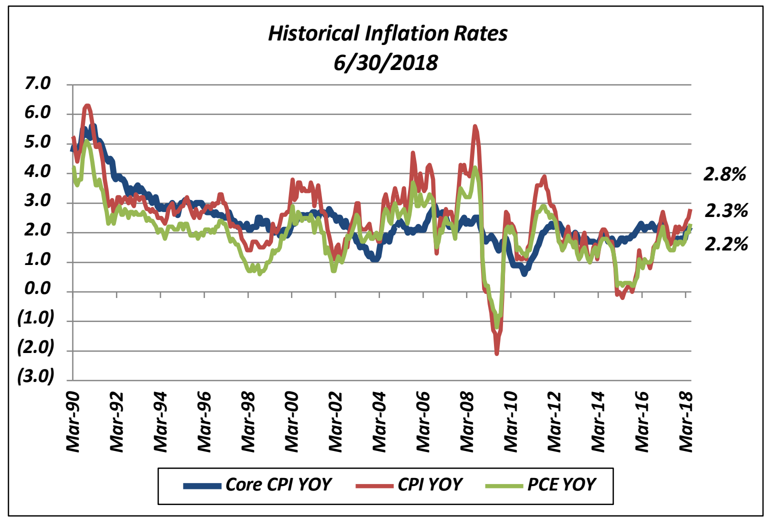


Economic Environment

Employment and Inflation – June 2018

- Average hourly earnings have been volatile recently, but have maintained a higher level, indicating possible wage pressures at long last. Corporate announcements of wage hikes will contribute.
- Key inflation measures have exceeded the 2% level, including core measures that exclude food and energy.
- The YOY Personal Consumption Expenditure Index (PCE), the Fed's favored inflation gauge, has also moved above their target level of 2%.

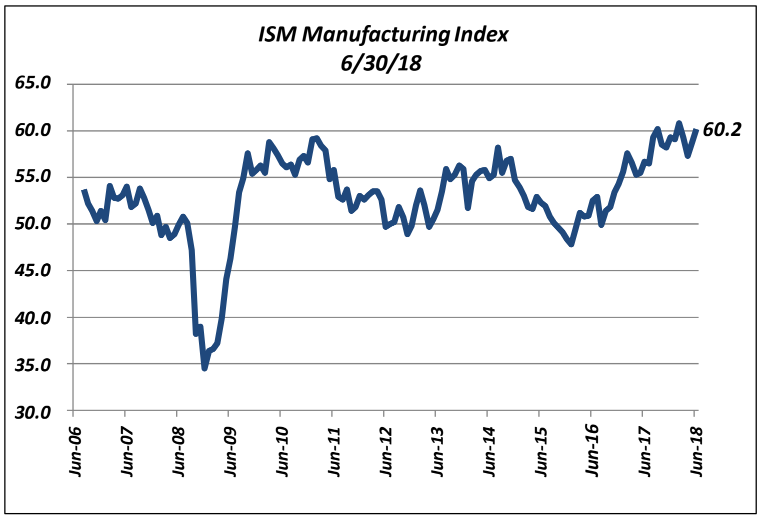


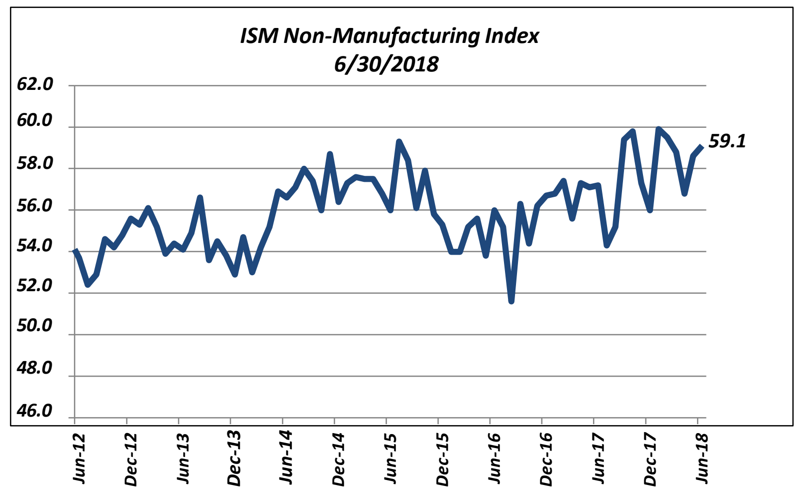


Economic Environment

Investment – June 2018

- Consumption, services, and manufacturing activity have been running at a high rate.
- The manufacturing sector, as measured by the manufacturing purchasing manager index has maintained a high level of activity including orders, employment, and pricing.
- The Non Manufacturing index has also remained at a strong level.
- The 50 level that divides expansion/contraction.





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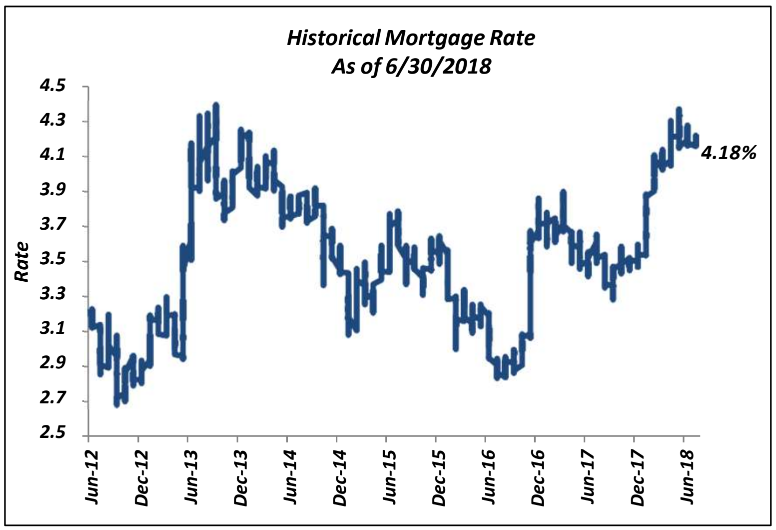
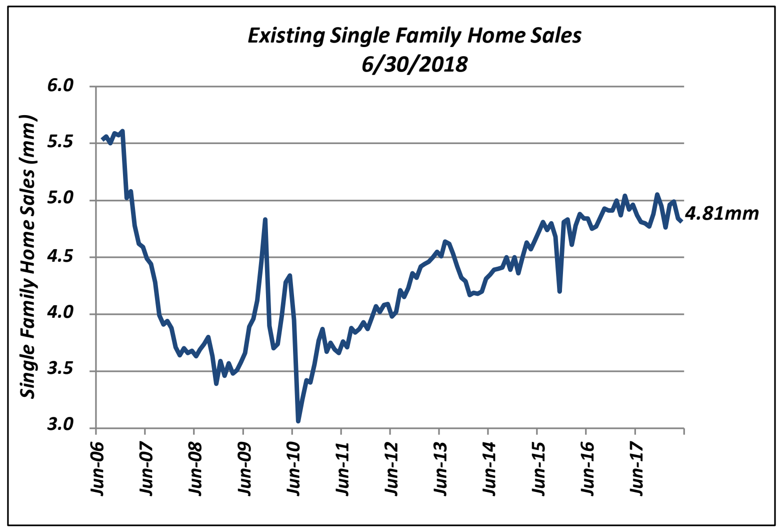
Economic Environment

Mortgage Rates and Housing – June 2018

- The Mortgage commitment interest rate has risen above 4%. A significant majority of the mortgage universe is now out of the refinance window.
- Despite the higher level of mortgage rates, home purchase activity has remained solid.
- The broad-based employment gains and overall income growth has supported the housing market and may continue to level out as rates rise.

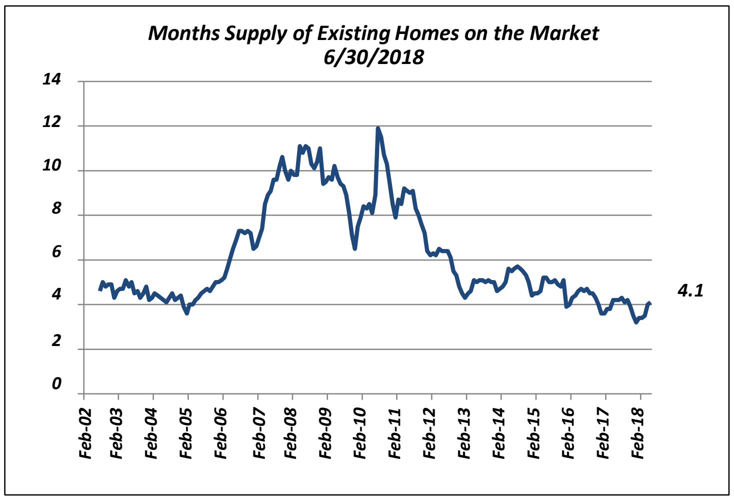


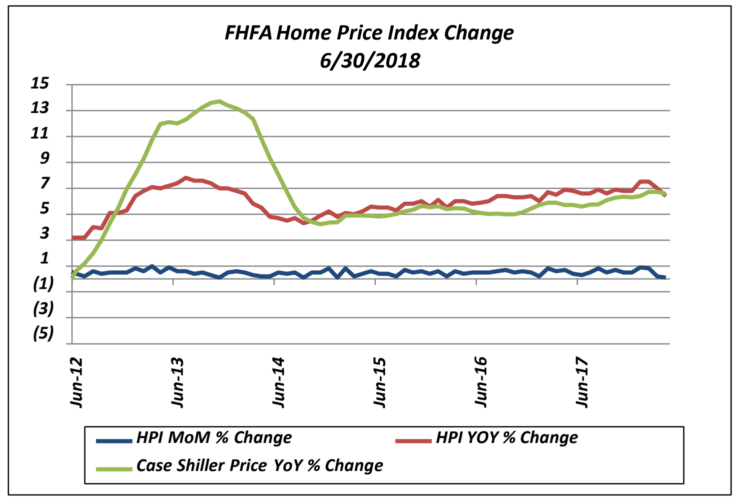


Economic Environment

Mortgage Rates and Housing – June 2018

- ➢ The healthy pace of housing activity has significantly reduced the number of homes for sale on the market.
- ➢ The Home Price Index has increased due to demand with low rates, bringing home prices back to high levels. Home prices may continue to rise per the AD&Co HPI home price model, but at a moderate pace.
- ➢ The growth in employment translates into more household formation and home sales, outweighing the higher level of rates this year.
- ➢ The increase in housing activity seems to be rippling through to higher overall consumer demand and economic growth. (see Home Depot)

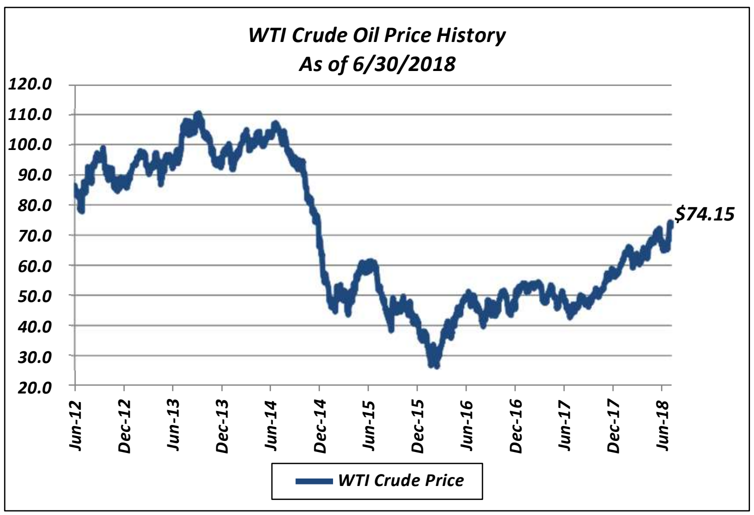


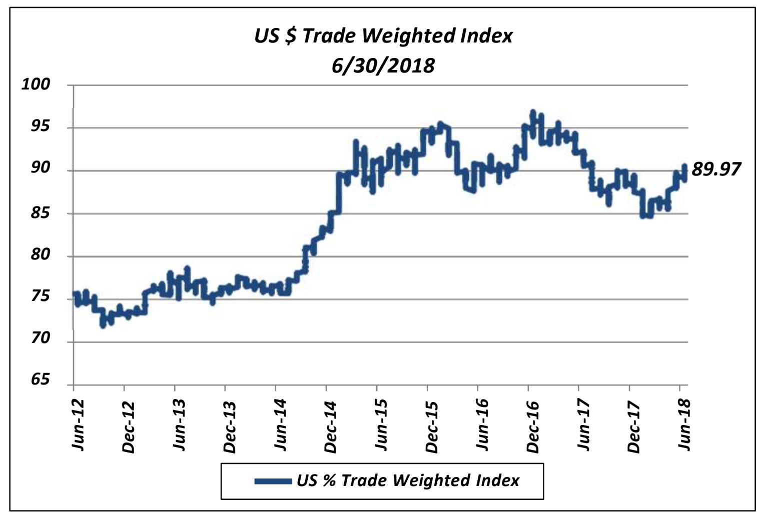


Economic Environment

June 2018

- Two recent significant issues continue to be the price of oil and the value of the dollar.
- Oil has resumed its rebound despite US increased production, due to global demand, OPEC production cuts and other outages.
- The dollar has reversed recent declines and has appreciated recently as US rates rose significantly this year with strong growth, while other central banks have maintained lower rates.





Market Environment Summary

June 2018

- Risk is being rewarded again in 2018 after markets shook off the Q1 rate rise that caused a market correction, pushing stocks down 10%. Some markets have achieved new record highs in Q2.
- Fed policy has become more clear about removing the still accommodative policy through slow but regular hikes in the Fed Funds rate, and reducing Fed Treasury and MBS holdings.
- Strong employment and income combined with lower taxes, corporate investment and increased earnings may enable the economy and equity markets to withstand a higher interest rate environment.
- Many international rates remain in deep negative territory as central banks are extremely stimulative, providing support to global growth.
- US and Global economic activity is on a synchronized growth path, with inflation finally accelerating.
- Oil prices have taken another leg up to around $75 due to growth expectations and OPEC supply cuts.
- Credit premiums have widened from historically tight levels, but may be supported by fundamentals.
- Equity markets continue to make new record highs, with growth stocks leading the way.
- Earnings may be challenged due to higher input costs (cost push inflation), depending on how much can be passed through to consumers.
- Higher interest rates, trade agreements, and geopolitical risks may increase market volatility.

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