2018 Second Quarter Review & Outlook

Market Review

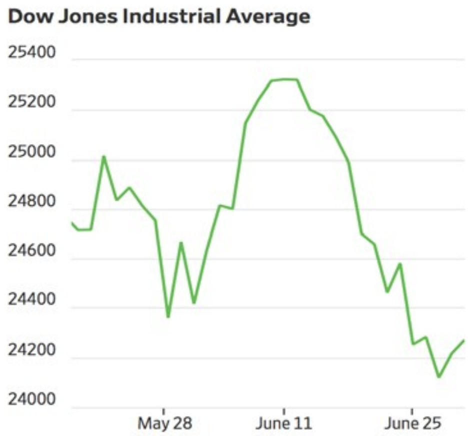
Equities

So far this year market instability has been the overriding theme and has grounded stock returns. U.S. stocks struggled in the past three months over investors' concerns about trade tensions, political uncertainty in the Eurozone and signs of slowing global economic momentum. With tariff wars primarily in focus throughout the quarter stocks made gains nonetheless, assisted by very strong corporate earnings reports. The Dow Jones Industrial Average of 30 stocks added just 0.7%, while the S&P 500 Index rose 2.9% over the second quarter.

Another detractor to U.S. and foreign equity returns last quarter was the solid rebound of the U.S. dollar. The WSJ Dollar Index, which measures the currency against a basket of 16 others, rose 5.1% in the second quarter and stands near its highest level in a year. A strong dollar hurts large multinational companies' future earnings whose goods become more expensive to foreign buyers. And overseas revenue will be worth less when converted back into dollars. To U.S. investors holding foreign stocks, weaker global currencies results in lower returns. This was evident in low international stock performance in the past three months.

Rocky Ride

The Dow Jones Industrial Average stumbled in June as trade tensions intensified.



Source: SIX

Fixed Income

The yield on the benchmark 10-year U.S. Treasury note rose for the fourth straight quarter, briefly topping 3% on strong corporate earnings news before concerns about mounting trade tensions and slower global growth drove investors to the relative safety of government debt. Rising yields means lower bond prices. Toward quarter end the yield on the 10-year U.S. Treasury note dropped below 3%, even after the Federal Reserve proceeded with another interest-rate increase in June. That has led to a flattening yield curve. The "spread" or difference between two-year and 10-year U.S. Treasury notes is at its narrowest level in a decade. The flatter the curve, the less profitable bank lending can be. The movement of the 10-year yield is also important because it affects borrowing costs for consumers, companies and state and local governments.

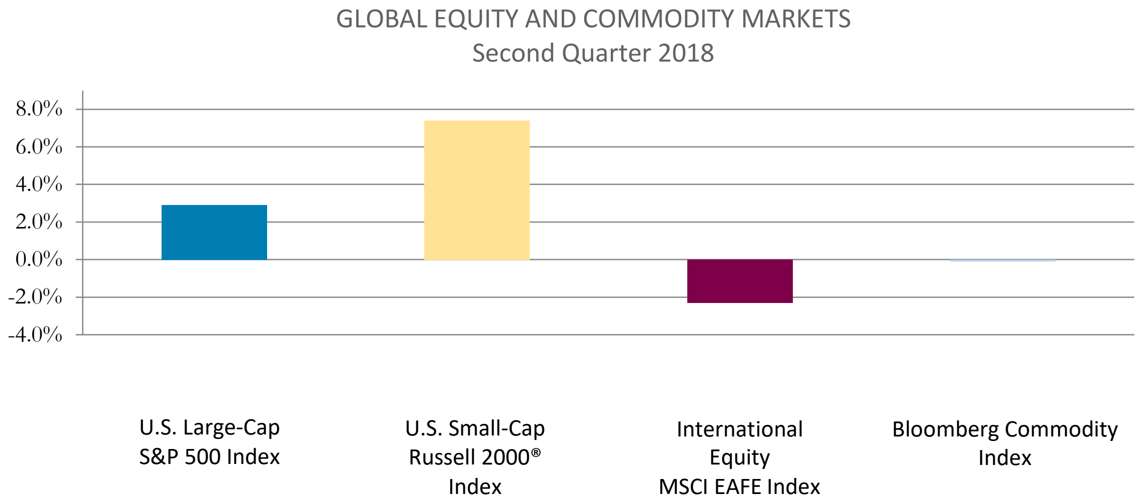
Global Market Performance

The broad-market S&P 500 Index advanced 2.9% for the quarter, resulting in a slight gain for the year. The Nasdaq Composite jumped 6.3% despite much turbulence in the last three months. Other winners in the quarter included small-company stocks (up 7.4%), which domestic-dependent revenues were not affected by foreign trade-war fears. The technology and energy sectors also performed well.

It's not just the United States that was suddenly dealing with increased economic and geopolitical concerns. Stock markets around the world have reacted negatively to the possibility of an escalating trade war. Foreign companies making up the MSCI World Index earn more than half of their sales from international trade. As such, developed international stocks slumped 2.3% in the past three months as measured by the MSCI EAFE Index in U.S. dollars. Japan's Nikkei stock market was slightly down in dollar terms because of a depreciating yen currency.

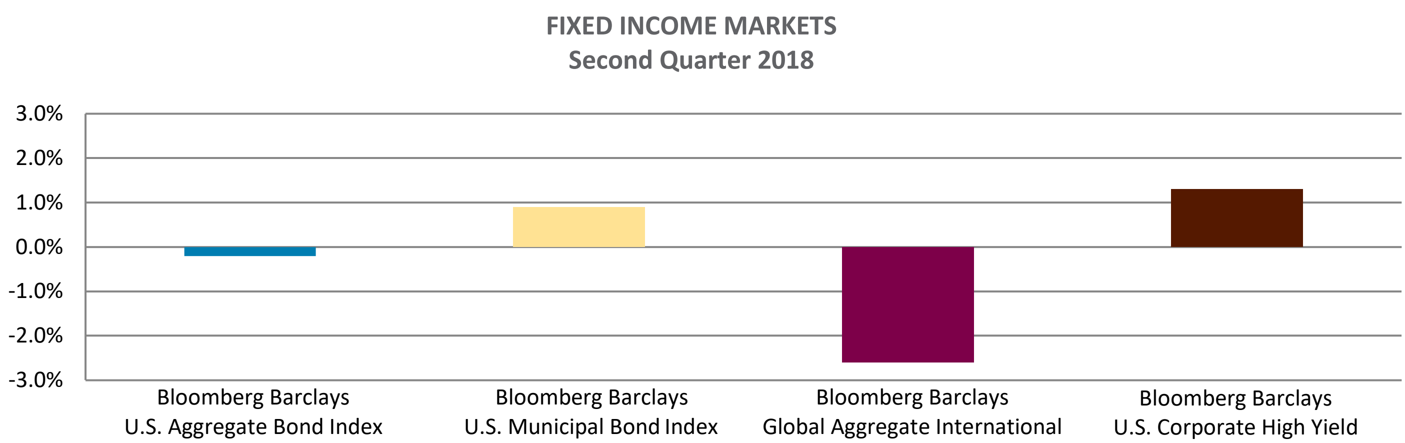
Emerging markets tumbled in the second quarter after a stronger dollar and higher U.S. interest rates led many investors to flee from these riskier investments in the developing world. The MSCI Emerging Markets Index fell 8.5% over the past quarter; the index's worst three-month performance since the third quarter of 2015. Both the Chinese Shanghai Composite and Hong Kong's Hang Seng Index entered into a bear market by the end of June, having declined 20% from this year's highs. Fears that the U.S. and China could escalate trade tariffs have become a nagging concern, along with trade-dependent countries like Russia, South Korea and Brazil.

Natural resources and other commodities were slightly down 0.1% for the quarter as measured by the Bloomberg Commodity Index. An appreciating dollar hurt the commodity index price. Trade barbs between the U.S. and China ratcheted up in the final weeks of the quarter, fueling concerns that protectionist trade policies might spread thus slowing the global economy and choking demand for raw materials. This sent prices of industrial metals including copper, zinc and tin slumping for the quarter, while gold stood near its lowest level since late 2017 after a 5.4% drop. In contrast, oil prices soared as geopolitics weighed on supply, helping to drain bulging inventories and promising continued strength for the crude market in the months to come. The price of Brent crude climbed by 13% during the quarter, temporarily topping $80 a barrel for the first time in over three years.



With lower forecasted global economic growth and inflation along with higher stock market volatility, the second quarter performed better across many segments of "safe" high-quality fixed income securities compared to the first quarter (though ending about flat). Both international developed and emerging market bond returns deteriorated due to trade concerns and a strengthening dollar versus foreign currencies.

For the second quarter, the Bloomberg Barclays U.S. Aggregate Bond Index of high-quality government, mortgage and corporate bonds slipped 0.2%. Non-investment grade or high-yield bonds gained 1.3% as investors were more positive about low credit quality with a strong economy and corporate earnings. State government municipal bonds advanced 0.9% in the second quarter, rebounding after the largest drop of any first quarter in the past 15 years. The Bloomberg Barclays Capital Global Bond Index was down 2.6% for the quarter mainly due to weak foreign currency values versus the U.S. dollar.

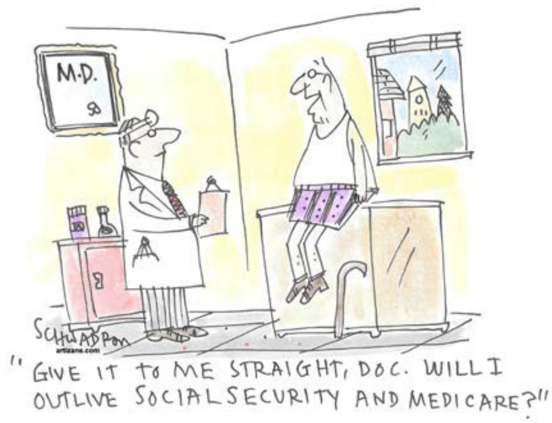


Portfolio Review

Strategic Financial Concepts Tactical Investment Strategies (TIS) model portfolios overall advanced for the quarter and have recorded slim gains for the year. TIS portfolios have outperformed the respective indices and peer benchmarks in 2018. While we are dissatisfied with only slight gains for the first half of 2018, we are pleased that our investment positioning has succeeded in minimizing client account drawdowns—especially during the prominent stock market correction in the first quarter.

Being underweight stocks and bonds versus neutral portfolio targets has helped with performance for 2018. Also, our stock and bond holdings overall have outperformed the respective indices. Thus far, our yearly alternative investments' performance has added value to portfolios in general. More importantly, these holdings have served client accounts well as "stabilizers" when market volatility and losses finally returned in the first quarter after nine quarters of equity-market advances. Core (high-quality) bond holdings and emerging market stock positions detracted from performance for the first half of the year.

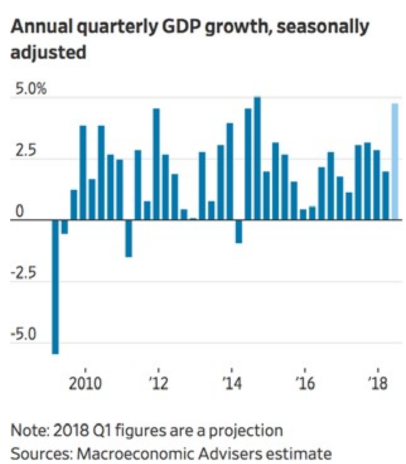
After making minor adjustments to TIS model portfolios during February's stock market drop, no changes were made in the second quarter. While we are concerned about trade wars and a flattening yield curve, being already conservatively positioned with accounts we see no need to further lower portfolio risk. Plus there are still several economic factors that point to equity advances for the rest of 2018, albeit at a slow pace. (These factors are discussed in the following Market Outlook section.)



Market Outlook

> *Investors have this unusual set of dual realities. You have a risk of an escalating, truly global trade war which creates a huge amount of uncertainty. But if you look at the economic data coming out each day most of it is still suggesting robust growth …*
>
> —Rebecca Patterson; Chief Investment Officer, Bessemer Trust

While the stock market has shown bipolar tendencies for the first half of 2018, there are reasons to believe stocks will deliver positive returns for the full year. The U.S. economy has just completed one of its strongest quarters of this long, slow-but-steady expansion. Economists estimate a growth rate of around 4%. Only once, in the 35 quarters since the Great Recession ended, has GDP (gross domestic product) growth exceeded this pace.



Spending by consumers, businesses and the government all appeared solid in the second quarter. The economic expansion enters its 10th year this month, building on what is already the second-longest on record. Faster growth has helped drive the unemployment rate to its lowest level in 18 years, arguably fueled in part by the Trump administration's pro-business policies.

However, there are also potential impediments to this prolonged expansion. For one, the U.S. economy is revving up just as Europe and other major economies are losing steam. This jeopardizes the Goldilocks period in which the world's largest economies have been accelerating in unison and could lower U.S. exports and profits.

Also, fears that an escalating trade wars sparked by the Trump administration could halt domestic growth by increasing the cost of goods for U.S. and foreign consumers alike—sparking hyper-inflation and lowering demand for goods and services. If this scenario plays out, and if an aggressive Federal Reserve raises borrowing rates too quickly to stop inflation, then a recession could follow.

Finally, there are concerns that the U.S. Treasury yield curve "spread"— or difference between 2-year and 10-year Treasury yields (its narrowest since 2007)—has flattened even further. Why is this important? When the 2-year yield rises above longer-term Treasury yields, the yield curve becomes "inverted." An inverted yield curve is the bond market's way of saying the financial system is broken and can usually predict that a recession is looming. So while our view is that an inverted yield curve and impending recession is not imminent, it's an important indicator that we'll be monitoring.

Despite these negative sentiments, the most important indicator of long-term stock market returns is corporate profits. And the numbers so far this year have been excellent. Second quarter earnings reports are just being released, and analysts expect another strong performance nearing a 20% rise from the same period last year. That would mark the third consecutive quarter of double-digit earnings growth for S&P 500 companies, similar to first-quarter growth and perhaps in line with the huge 21% growth in the fourth quarter of last year.

So given all the above factors, what is our outlook for the second half of 2018? Although we expect the stock market to continue its roller coaster ride, we still predict gains for the year. And for our clients, the ride should be made smoother by the use of our low-correlated alternative investments that tend to "zig" when other investments "zag." This strategy has proven effective so far this year and in other periods of volatile market environments.

We appreciate your continued confidence in our services. Your inquiries are welcomed.

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*** For financial advisors, please contact our firm for performance information on SFC's model portfolios**

Sources: 361 Capital, Weekly Research Briefing, July 9, 2018; The Houston Chronicle, A nerve-wracking second quarter was better, but still not easy, for investors, July 1, 2018; JP Morgan Asset Management, Guide to the Markets, Q3 2018; Marketfield Asset Management, The Weekly Speculator, June 28, 2018; State Street Global Advisors, SPDR ETFs Chart Pack, Mid-Year 2018 Edition; USA Today, What are the risks and rewards for the rest of 2018, July 2, 2018; The Wall Street Journal (multiple publications).

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