Investment Insights:

Q2 2018 Capital Markets Review & Outlook

MCF
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Capital Markets Review & Outlook

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OVERVIEW

During the second quarter, volatility was omnipresent as major global stock markets posted mixed returns. US Equities rebounded nicely after a negative first quarter while International Equities (both Developed and Emerging Markets) declined for the quarter. Newly imposed trade tariffs contributed significantly to global stock market volatility throughout the quarter. The US Treasury 10-year yield peaked at 3.11% but ultimately closed the quarter at 2.85%. On June 13th, the Federal Reserve hiked interest rates 0.25% for the second time this year.

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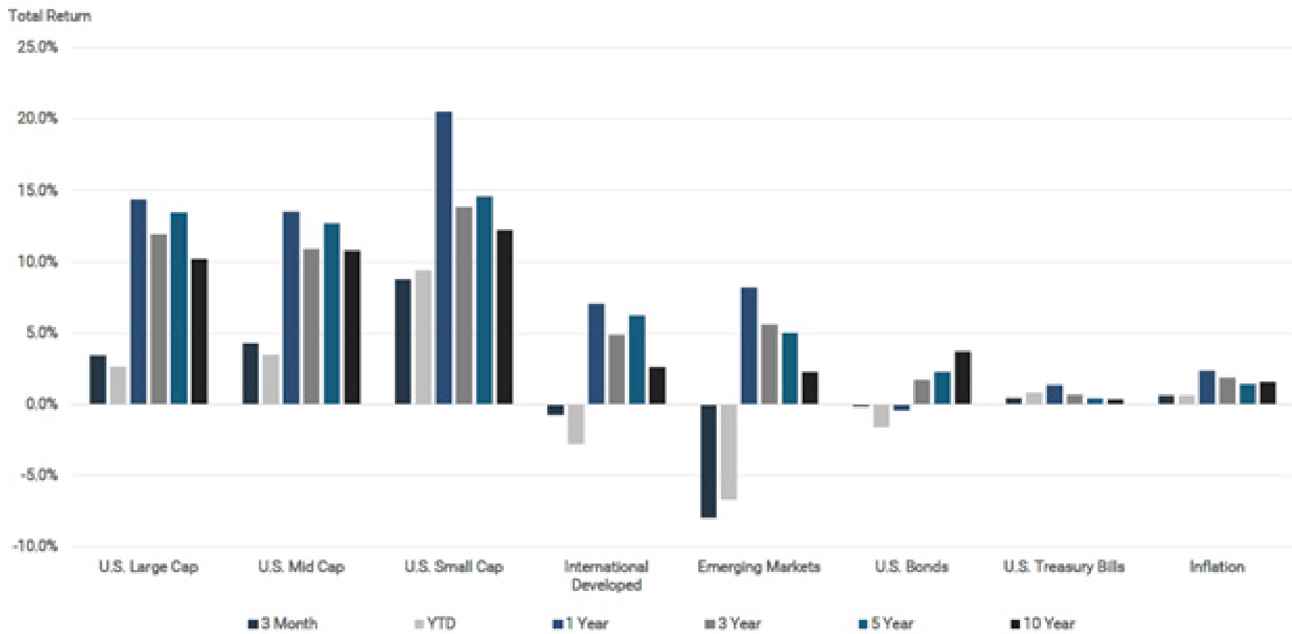
Index Returns as of 06/30/2018



TOTAL RETURNS AS OF 06/30/2018

Asset Class	Index	3 Month	YTD	1 Year	3 Year	5 Year	10 Year
U.S. Large Cap	S&P 500 TR USD	3.4%	2.6%	14.4%	11.9%	13.4%	10.2%
U.S. Mid Cap	S&P MidCap 400 TR	4.3%	3.5%	13.5%	10.9%	12.7%	10.8%
U.S. Small Cap	S&P SmallCap 600 TR USD	8.8%	9.4%	20.5%	13.8%	14.6%	12.2%
International Developed	MSCI World ex USA NR USD	-0.7%	-2.8%	7.0%	4.9%	6.2%	2.6%
Emerging Markets	MSCI EM NR USD	-8.0%	-6.7%	8.2%	5.6%	5.0%	2.3%
U.S. Bonds	BBgBarc US Agg Bond TR USD	-0.2%	-1.6%	-0.4%	1.7%	2.3%	3.7%
U.S. Treasury Bills	ICE BofAML US 3M Trsy Bill TR USD	0.5%	0.8%	1.4%	0.7%	0.4%	0.4%
Inflation	US BLS CPI All Urban SA 1982-1984	0.6%	0.6%	2.4%	1.9%	1.4%	1.6%

Sources: MCF Advisors, Morningstar Direct. See disclosures for index descriptions.

US EQUITIES

US Large Cap stocks (S&P 500 Index) posted a gain of 3.4% for the quarter and are up 2.6% year-to-date. US Mid-Cap stocks (S&P 400 Index) also increased, gaining 4.3% for the quarter and are up 3.5% year-to-date. US Small-Cap stocks (S&P 600) managed impressive returns — the index returned 8.8% for the quarter and is up 9.4% year-to-date. Companies are now reporting second quarter earnings and FactSet estimates an earnings growth rate of 20.0% year-over-year for the S&P 500. If 20% is the actual growth rate, this would be one of the highest growth rates since the financial crisis. International Developed stocks (MSCI World ex-USA Index) declined -0.8% for the quarter and are down -2.8% year-to-date. Emerging Markets stocks struggled significantly as a strengthening dollar, political turmoil, and tariffs all acted as headwinds. The MSCI Emerging Markets Index declined -8.0% for the quarter and is down -6.7% year-to-date.

The strong returns for US equities in 2018 are largely attributed to tax reform, so we expect earnings growth will slow in 2019. The biggest contributor to earnings per share (EPS) growth in the first quarter was improved margins (read as: lower taxes). Above-average revenue growth also contributed, and share buybacks provided a small boost. While the tax cuts have improved certain valuations, such as the Price/Earnings ratio, other metrics are still elevated, such as Price/Book and Price/Sales. All these metrics are dependent on top-line growth (selling more products and services), which is the crux for long-term growth and returns. However, P/E ratios also can be improved by decreasing costs (such as taxes), which is partly why P/E ratios have improved much more than P/B

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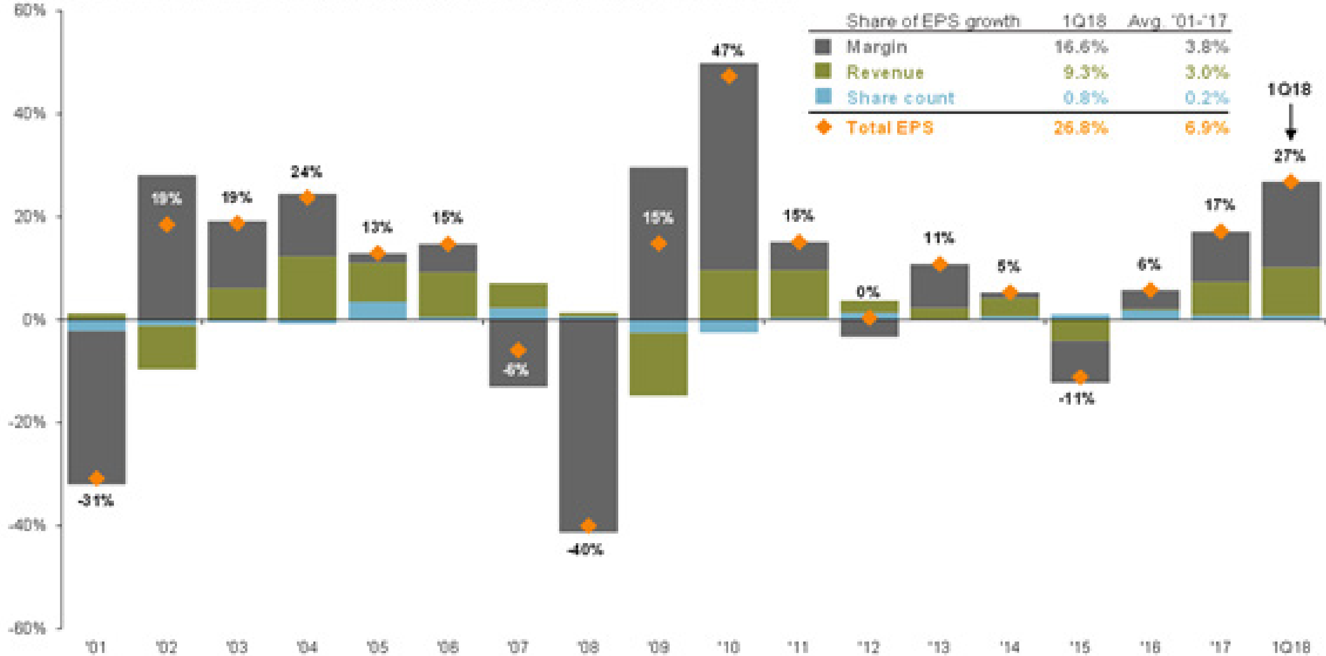
and P/S ratios. Looking forward, there is minimal room for reducing expenses, and costs likely will rise due to rising interest rates, higher inflation and higher wages. Although we saw strong revenue growth in the first quarter, some of this may be consumers buying in advance of potential negative effects from tariffs or a trade war. Before we feel comfortable that consumers are spending more, sales growth needs to be more persistent.



Even after a strong 2017, International Equities remain more attractive from a valuation perspective (both relative to US Equities and relative to their own historical averages). From a technical view, US Equities and International Equities have provided similar returns over time but go through varying cycles of outperformance. Over the last decade, International Equities have nearly 115% of returns to "catch up" relative to the US. We don't expect this to happen in a short amount of time, but forward-looking (5-7 years) expected returns greatly favor International Equities. Our concerns for International Equities are a potential trade war, weakening economic growth in Europe, a much stronger dollar, and the always present geopolitical risks associated with global investing. We believe the potential for higher returns abroad are worth more than the potential risks.

Overall, equities still provide the best potential for long-term growth, and we generally favor a small overweight to International Equities. Emerging Markets have taken the brunt of the pain from fears over a trade war, but given the positive global economic growth story, emerging economies also have the best growth potential given their heavier exposure to commodity-related industries and reliance on exports. We continue to favor equities over bonds, but we are cautious in our allocations.

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REAL ASSETS & DIVERSIFYING STRATEGIES

Allocations to Real Assets contributed positively to performance while Diversifying Strategies detracted for the quarter. Global Macro and Real Return strategies declined while Insurance-linked securities increased slightly and are positive year-to-date. Our positions in Real Assets rebounded after a negative first quarter as both Energy Infrastructure investments and Master Limited Partnerships (MLPs) posted very strong returns.

Our allocations to Real Assets and Diversifying Strategies are higher than our historical average – because these are not average times. Historically, bonds have provided a good source of low-risk diversification from equities. The chart above reflects the currently lopsided risk and return relationship of the Agg Bond Index relative to the historical average yield and duration. We are cautious on equities, and the current characteristics of bonds are very unattractive, so we must look elsewhere for diversification and returns.

Diversification from equities has detracted from performance. This year. Last year. Most years since the Great Recession. But we are in extraordinary times and there are many potential risks lurking around both equity and bond markets. Interest rates rose higher this year (which hurts bond returns) and the Fed likely will raise rates at least one or two more times by the end of the year. If rates rise high enough or too quickly, it could impinge on equity returns as well. There is also uncertainty and no historical precedence for the effects of the Fed's balance sheet reduction, which began at $10B/month in Q4 2017 and will go up to $50B/month starting in Q4 2018. The Fed's balance sheet bloated to $4.5 trillion during Quantitative Easing, five times higher than the $900 billion on the balance sheet just before the Financial Crisis. The Fed's goal is to "normalize" their assets around $2.5-$3.0

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trillion. That's a total of $1.5-2 trillion of bond buying demand leaving the market over 4-6 years. Real Assets and Diversifying Strategies are quite attractive when viewing both equities and bonds through a risk lens.

BONDS

US Intermediate Bonds (Bloomberg Barclays US Aggregate Bond Index) declined -0.2% for the quarter and are down -1.6% year-to-date. Municipal Bonds (Bloomberg Barclays Municipal Index) increased 0.9% and are down -0.3% for the year. Short-Term Bonds (Bloomberg Barclays US Agg 1-3 Year Bond Index) increased 0.3% for the quarter and are up just 0.1% year-to-date. Interest rates (as measured by the US Treasury 10-year yield) increased 0.11% and closed at 2.85%. The Federal Reserve remains committed to raising rates and has indicated that an additional 1-2 rate hikes are likely for the remainder of 2018.

Although it sounds like a broken record, we continue to underweight bonds and keep duration (interest rate risk) shorter than the Barclays Agg Bond Index. Our bond allocation has performed well this year relative to the Agg Bond Index, and we believe portfolios are positioned well for future rate increases.

There are three general scenarios for interest rates: rates go up, rates do not change, or rates go down. Although each of these scenarios has varying effects on bonds based on which part of the yield curve is moving, our bond allocation should outperform the index if rates rise and should hold up to the index of rates do not move. If rates were to fall - the least likely scenario - our bond allocation would likely underperform. We are positioned well for two out of the three scenarios, which both have higher probabilities than rates going down in the near term.

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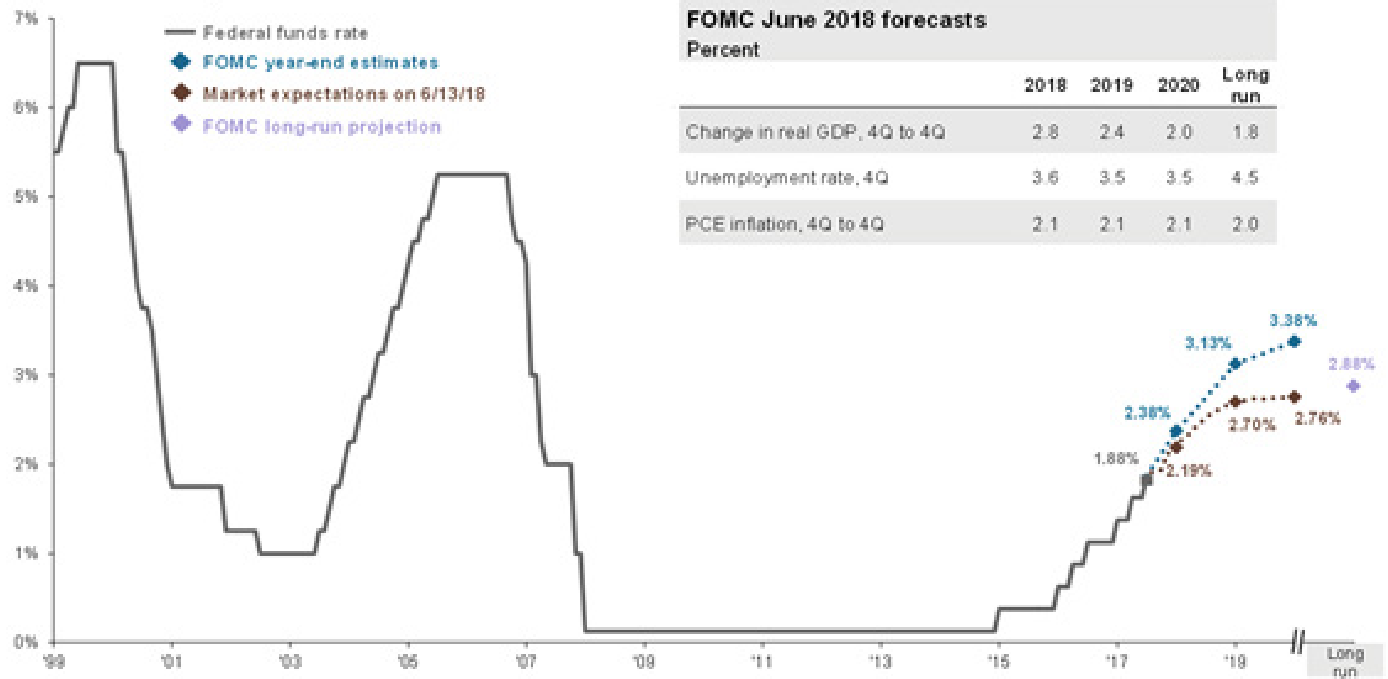

FOMC June 2018 forecasts
Percent

	2018	2019	2020	Long run
Change in real GDP, 4Q to 4Q	2.8	2.4	2.0	1.8
Unemployment rate, 4Q	3.6	3.5	3.5	4.5
PCE inflation, 4Q to 4Q	2.1	2.1	2.1	2.0

Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management.
Market expectations are the federal funds rates priced into the fed futures market as of the date of the June 2018 FOMC meeting.
Guide to the Markets – U.S. Data are as of June 30, 2018.

SUMMARY

Overall the global economy is still growing, but the outlook is not quite as optimistic as it was a year ago. The US economy is finally eclipsing the 3% real GDP growth mark, but the outlook for 2019 and beyond is a little weaker. Foreign developed and emerging economies have very mixed economic growth forecasts, but the picture is generally positive and emerging markets continue to have higher growth expectations than developed markets (including the US).

We expect volatility to persist and likely could see an increase above average levels as global central banks are changing policies from excessively accommodative to "normalizing" policies, eventually leading to monetary tightening if economic conditions continue to strengthen or even surprise on the upside. On the other hand, if economic conditions weaken, volatility could also elevate. As such, we are cautious in our views and have been lowering risk in portfolios from potential equity pullbacks as well as a rising interest rate environment.

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INTEGRITY

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KNOWLEDGE

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