CORDASCO
FINANCIAL NETWORK

5-Themes Mid-Year Update

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Mounting Pressure

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- Each of our 5-themes remain intact with two modifications. First, continued economic growth is facing headwinds as tightening U.S. monetary policy and a strong dollar begin to restrict economic activity. Second, diverging global monetary policy is likely to moderate, which impacts fixed income opportunities across regions.

- Our capital market updates are not materially different enough at this time to warrant a rebalance. However, we recommend caution broadly in markets today. While no imminent concerns exist, we do not recommend investors reach for risk at this time based on the potential for slower growth, full valuations and macro uncertainty.

- We have also introduced two scenarios that may impact the short-term realization of our themes: the strength of the U.S. dollar and the results of trade negotiations. We believe these are the two most likely scenarios to impact our themes in the short-term and have provided context around each below.

At the beginning of 2018 we published our long-term capital markets outlook along with relevant long-term themes we deem important to frame our expectations. As we round the corner into the second half of 2018 we provided a mid-year update and insight into how our thoughts are evolving.

Additionally, we are often asked how certain market events may impact our themes. While these scenarios are unlikely to alter our long-term perspectives, these short-term scenarios may alter the path over which we expect our themes to be realized. Today we believe the two scenarios most likely to impact our themes are the direction of the U.S. dollar and the outcome from trade negotiations. Below we summarized our 2018 themes, any mid-year updates and the potential impact on a theme as a result of these scenarios. We have no short-term view on the direction of the U.S. dollar or the political whims of trade negotiations. Moreover, we believe trying to time such impacts is more likely to be detrimental than helpful. However, we do recognize that in the short-term the influence from these scenarios can be meaningful and therefore have highlighted their potential impact below. Throughout the rest of the paper we will briefly delve into each theme discussing how new information in 2018 has influenced our current thinking.

2018 Theme	Mid-Year Update	Scenarios			
		U.S. Dollar		Trade Sanctions	
		Stronger	Weaker	Increase	Abate
Continued Focus on Growth	Growth headwinds are mounting	Reduce	Support	Reduce	Support
Keep an eye on inflation	Inflation is taking hold…slowly	Reduce	Support	Support	Reduce
Expect the unexpected	Headlines are not likely to slow	Neutral	Neutral	Neutral	Neutral
Policy Divergence Ahead	Policy divergence is likely to moderate	Reduce	Support	Reduce	Support
International & Emerging Markets	Opportunities still persist	Reduce	Support	Reduce	Support

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Continued Focus on Growth

Key Takeaway Beginning 2018 – Tax reform, capital expenditures, White House support and accommodative monetary policy all set the stage for additional economic growth. Keen interest and ripe conditions for growth are likely to continue from 2017 into 2018.

Mid-Year 2018 Update – Growth has continued into 2018. Following ~3% real GDP growth in the fourth quarter, U.S. real GDP grew at 2.2% in the first quarter of 2018. As the $1.5 trillion dollars in income tax cuts work their way into personal and business spending, this growth trend is likely to persist. However, despite the positive backdrop we see two primary headwinds mounting:

1) Stronger Dollar – A strong U.S. dollar is both a symptom of tighter monetary policy and a tax around the world for goods priced in dollars, such as oil. The dollar's strength leads to tighter financial conditions which can negatively impact economic growth.

2) Tighter Monetary Policy – The Federal Reserve raising the policy rate twice this year and reducing the size of its balance sheet is less accommodative to the markets. Higher rates lead to increased lending costs and may reduce business activity.

Tighter financial conditions alone will not stop growth. However, these conditions can slow the pace.

Scenario Impact – A stronger U.S. dollar creates tighter financial conditions and would be a headwind to future growth. Additionally, if trade sanctions continue to rise we believe they could negatively impact the prospects for future economic growth in the U.S. The opposite conditions hold true for both a falling dollar and reduced trade restrictions. These conditions would at least reduce headwinds to future growth and at best enhance future growth prospects.

Portfolio Impact – The potential for slower economic growth coupled with full valuations and macro uncertainty increases the likelihood of an equity market pullback. We believe equities still play a meaningful role in the portfolio, but we do not advocate reaching for additional risk at this time.

Keep an Eye on Inflation

Key Takeaway Beginning 2018 – Tighter labor markets in the U.S. and other advanced economies are likely to lift wage growth and translate to a gradual inflation uplift.

Mid-Year 2018 Update – Fueled by stronger labor market conditions and rising energy prices, U.S. inflation is in fact rising and now tracking at the top end of a range observed since the financial crisis. Core consumer prices (core PCE, which excludes the prices of food and energy) rose 2.0% through May largely on higher nonfuel imports and industrial metal costs. While tight labor markets continue to push wages forward, higher U.S. interest rates and U.S. Dollar strength year-to-date are counterbalancing this risk. Therefore "gradual" remains a key element to this 2018 theme.

Scenario Impact – If the U.S. dollar were to strengthen, that would diminish short-term concerns for inflation. The purchasing power for U.S. consumers would be higher as they consume goods manufactured outside of the United States. However, an offsetting element is trade sanctions. Sanctions can be thought of as a backdoor tax on the consumer and often force prices higher. Therefore, higher and broader sanctions can be a direct form of price inflation for U.S. consumers.

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Portfolio Impact – Minimal. Our portfolios today are built to accommodate moderate to rising inflation. The strategic utilization of real assets broadly in a portfolio help protect investors should inflation manifest itself in a more material way. However should inflation remain benign, real assets offer opportunity for return even without inflation and also the potential risk reduction due to their diversifying properties.

Expect the Unexpected

Key Takeaway Beginning 2018 – Headlines can drive investors to react, at times irrationally, when they are caught unaware. While every year has the opportunity for surprise events, 2018 has significant opportunity for such events. Be vigilant to not over react.

Mid-Year 2018 Update – 2018 has not disappointed. The Federal Government shutdown, spike in the volatility index, Federal Energy Regulatory Commission (FERC) surprise announcement regarding MLPs, trade wars and uncertainty in Italian markets after political disagreements are just a few headlines that have moved markets. We believe the majority of these events are transitory and are not likely to have a lasting effect on the market. However, they nonetheless create investor angst. We continue to comb through these events to identify elements that may change our forward outlook. As of this update, we see none to date.

Scenario Impact – The direction of the dollar and trade sanctions are two primary examples of a risk to consider when expecting the unexpected. The probability of these scenarios in the news and investor temptation to react is the exact risk we're highlighting. We believe knowledge, thoughtful diversification and a prudent approach to rebalancing and monitoring are key elements to avoiding this common pitfall.

Portfolio Impact – Minimal. We do not expect headlines to slow so the risk of emotional reactions remain high. We would highlight the following as potential newsworthy events likely to come in the second half of 2018: BREXIT negotiations, Italian politics, trade tensions, Brazil elections and North Korea's denuclearization. However, these are just a few of the known *unknowns*. Without fail there will be unknown *unknowns* that will likely move markets in the short-term. We believe investors will continue to be served by not focusing on these events.

Policy Divergence Ahead

Key Takeaway Beginning 2018 – After a decade of unprecedented monetary stimulus and coordinated easing from central banks globally, the U.S. is expected to break ranks and begin tightening monetary policies. This divergence is likely to lead to potential volatility and opportunities across fixed income markets.

Mid-Year 2018 Update – Monetary policy among developed nations has diverged led by tighter monetary policy in the U.S. The Federal Reserve raised short-term interest rates and began reducing its balance sheet. By contrast the European Central Bank (ECB) and Bank of Japan (BOJ) have maintained accommodative monetary policies. The ECB signaled it is prepared to reduce the level of accommodation beginning in October of this year while the BOJ has not set a timeline for exiting its monetary stimulus program. In spite of forward guidance for tighter monetary policy in the U.S. for 2018, we believe the continuation and trajectory of policy divergence beyond 2018 is suspect. Eventually global growth will necessitate that central banks outside the U.S. begin to tighten or a slowdown would likely cause the U.S. to pause or reverse course. The potential for volatility remains as effects of policy divergence among developed countries takes time to flow through global economic channels, but opportunity has already emerged with higher real fixed income returns in the U.S. compared to other developed markets.

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Scenario Impact – A stronger U.S. dollar leads to tighter financial conditions. If the U.S. continues to tighten its monetary policy and diverge from other global central banks this would support the strength of the U.S. dollar all else equal. If that is the case, the ability or willingness for the U.S. to continue to tighten would begin to wane. Additionally, should trade sanctions increase, economic growth is more likely to slow further reducing interest to continue with divergence. Conversely, a weaker U.S. dollar and lower sanctions give more room for the U.S. to diverge its monetary stance from other countries.

Portfolio Impact – Slowing monetary policy divergence can manifest in two different ways; global central banks begin to tighten in-line with the U.S. or the U.S. slows its path to tighter economic policies. Regardless of the path, both conditions make U.S. fixed income more attractive compared to its international peers.

International & Emerging Markets

Key Takeaway Beginning 2018 – Continued signs of growth and lower valuations outside of the U.S. provide an attractive opportunity.

Mid-Year 2018 Update – International markets have lagged their U.S. counterparts thus far in 2018. Much of the difference in return can be explained by the recent rally in the U.S. dollar. In the second quarter alone, the U.S. dollar rallied 5% serving as a headwind for international assets. Additionally, investors have voted with their feet regarding trade tensions and some have exited international positions. Despite these near-term events, we maintain our preference for these assets for two primary reasons; growth and valuations. GDP growth in emerging markets continues to outpace developed markets by a substantial margin. Forward expectations show emerging countries growing at 2.1% more over the next 12 months than their developed counterparts. Additionally, valuations in international and emerging markets are more attractive than U.S. valuations. Current cyclically adjusted price to earnings (CAPE) in emerging markets is 13.2 and 25 in the U.S. implying a nearly 3.5% higher future return expectation for emerging markets relative to U.S. equities over the next ten years.

Scenario Impact – A strong U.S. dollar is a negative for both international and emerging markets. Assets held in foreign currencies are worth less if over the period of ownership the U.S. dollar strengths. Additionally, the potential for escalating trade sanctions can have a negative impact on these markets and create investor angst for owning assets outside of the U.S. Conversely a weaker U.S. dollar and lower sanctions would be positive for assets outside of the U.S. and a tailwind for returns.

Portfolio Impact – Based on the potential for growth and relative valuations, portfolio allocations are already overweight to assets outside of the United States and positioned to take advantage of our higher return expectations in these markets. However, we do not recommend increasing allocations at this time. Potential continuation of U.S. dollar strength and trade tensions may lead to additional short-term volatility in these markets.

For more information and assistance, please contact Cordasco Financial Network, L.L.C.

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About the Author:

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Brad joined DiMeo Schneider & Associates, L.L.C. in 2012. As Principal and Research Director, he directs the firm's Global Public Markets team, overseeing investment research across global equity, global fixed income and global real assets. He is a member of the firm's Investment Committee, Discretionary Committee and all Research Teams. Additionally, Brad leads the firm's efforts in mission-aligned investing across both public and private markets as well as chairs the firm's Target Date Committee. Prior to joining the firm, Brad worked in various research capacities at Citigroup and Wells Fargo in New York. He received a BA in Finance and Minor in Economics from The University of Colorado and is a CFA® charterholder and member of the CFA Society of Chicago and CFA Institute. Additionally, he is active with Greenhouse Scholars, a nonprofit providing financial and personal support to under-resourced college students. In his free time, Brad loves cooking and spending time with his wife and young sons.

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Steve provides investment consulting services to institutional clients and nonprofit organizations. He services clients by providing advice and expertise on asset allocation, portfolio design, investment policy statements, manager search process, fiduciary stewardship, and overall investment management. Prior to joining the firm in 2017, Steve was an Associate Client Investment Officer with Northern Trust Asset Management where he provided comprehensive investment management services to discretionary institutional client portfolios. Steve earned a BA in Economics and Finance from the University of Illinois Urbana-Champaign and earned a Masters of Analytics from the University of Chicago in June 2018. He is a CFA® Charterholder and a member of the CFA Institute, CFA Society of Chicago, and The Chicago Council on Global Affairs. Steve enjoys outdoor activities and spending time with family.

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