Q2 2018

QUARTERLY REVIEW

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Q2 MARKET NOTES

Stock and bond markets around the world delivered decidedly mixed results during the second quarter of 2018. While investors cheered generally strong earnings and economic news in the U.S., they were less impressed by conditions in other regions and countries. They also fretted at various moments about rising inflation and interest rates, geopolitical concerns, and heightened tensions around the possibility of a trade war that could hurt global economic growth.

In aggregate, global stocks as a group were essentially flat for the quarter—with strong U.S. results being largely balanced out by weak returns internationally. For the quarter:

- The S&P 500 index of large-cap U.S. stocks gained 3.43%.
- Broad-based international stocks (as measured by the S&P Global Ex-US BMI Index) returned -2.41%.
- Bonds (as measured by the Bloomberg Barclays US Aggregate Total Return Index) returned -0.16%.

CHART 1: A MIXED BAG FOR GLOBAL ASSETS IN Q2 2018

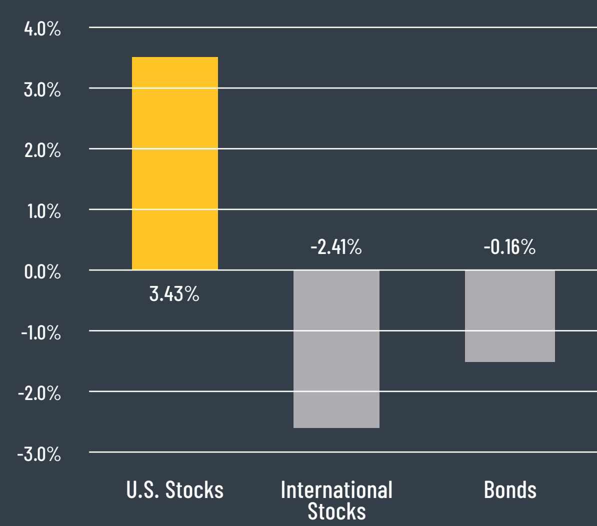

Chart source: Bloomberg

SOLID SHOWING FROM THE U.S. ECONOMY

The U.S. economy posted overall solid results during the quarter. Some of the positive highlights:

- Retail sales in April and May rose sharply and rose by 5.9% over the 12 months through May.
- Spending on consumer goods in April rose sharply for a second straight month.
- The unemployment rate in April fell to a 17-year low. The following month it fell again to touch a low not seen since 1969.
- Manufacturing activity rose, with the Institute for Supply Management's manufacturing index hitting a two-month high in May.
- A key index of consumer confidence remained strong in June, not far below its 18-year high reached earlier this year.

That said, some economic results raised concerns among investors, including:

- Sales of existing U.S. homes unexpectedly fell in May, for the second consecutive month.
- Orders for durable goods fell in April and May. The May result was fueled by the largest decline in new orders for cars and trucks since 2015.
- First quarter GDP growth was lowered—first from 2.3% to 2.2%, and later to 2.0%.

U.S. STOCKS LEAD THE WAY, DRIVEN BY GROWTH AND SMALL-CAPS

Global stocks posted vastly different returns depending on the region and the individual country. A closer look reveals

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that there were relative winners and relative losers within the broader market.

U.S. TOPS INTERNATIONAL

U.S. stocks significantly outperformed broad-based international markets, generating solid gains during the quarter. Domestic equities were driven largely by solid economic fundamentals—such as strong corporate earnings and business activity, reasonable levels of inflation, and high levels of consumer spending.

Foreign equity markets failed to keep pace with the U.S. In fact, the difference in returns between the U.S. and foreign stocks during the quarter was the highest it's been since the fourth quarter of 2014 (see Chart 2).

In Europe, for example, relatively weak economic growth and growth prospects weighed on returns—as did political uncertainty in Italy that caused some investors to fear that an Italian exit from the EU could be possible. The Euro depreciating versus the U.S. dollar (down 2.7% for the quarter) also kept a lid on European stocks. Meanwhile, Japanese markets were hurt by their trade affiliations with China and the weak Chinese stock market, political uncertainty surrounding Prime Minister Abe's re-election, and weak inflation.

Emerging markets experienced particularly sizable losses after several quarters of strong performance—with the MSCI Emerging NTR USD Index index down 7.83%. As seen in Chart 3 on the following page, the return spread between emerging and developed markets during the quarter was its widest since the third quarter of 2015.

One reason: Currencies of many emerging markets in Latin America and elsewhere fell sharply relative to the U.S. dollar, as short-term interest rates in the U.S. rose. For example, the Argentine peso plummeted 30.5% and Brazilian real fell 14.6%. This makes it more difficult for emerging markets to service their debt and tends to make emerging markets less appealing to foreign investors. Loss of investment capital can hurt emerging markets' growth prospects. Additionally, trade war fears hit Chinese stocks hard.

CHART 2: RETURN SPREADS BETWEEN U.S. AND INTERNATIONAL EQUITIES

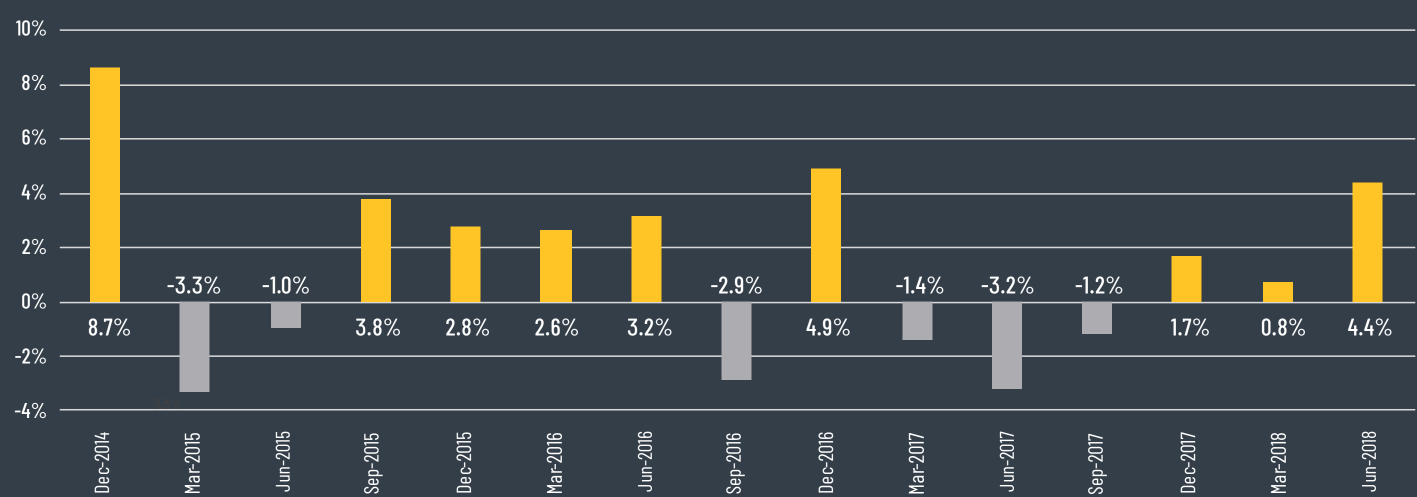

Chart source: Bloomberg

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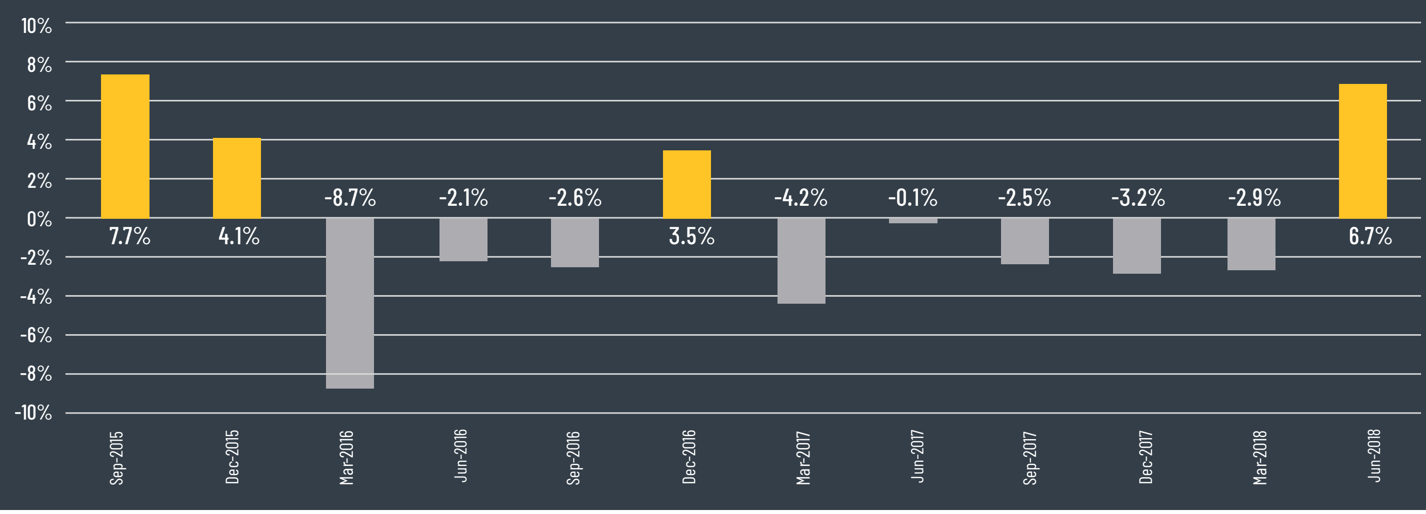
CHART 3: RETURN SPREADS BETWEEN DEVELOPED AND EMERGING INTERNATIONAL EQUITY MARKETS



SMALL-CAPS AND GROWTH LEAD THE PACK

Small-company stocks were a major success story of the quarter—handily outperforming their large-cap peers (see Chart 4). Indeed, small-caps outpaced large caps by 5.34 percentage points—the widest margin since the fourth quarter of 2016, when they outran large-caps by 7.31 percentage points.

Small companies tend to generate less of their revenues from foreign markets, which makes them less vulnerable to tariffs and trade wars that can hurt larger, multinational businesses. In addition, relatively strong economic conditions in the U.S. have helped drive strong revenue and earnings growth among smaller, domestically focused companies.

Additionally, growth stocks in the second quarter once again beat value stocks (see Chart 5)—a trend that has remained solidly in place since the fourth quarter of 2016. Growth's outperformance was driven largely by the relatively strong returns from the technology and consumer discretionary sectors.

SECTOR WINNERS AND LOSERS

Most equity market sectors posted a positive return during the quarter.

Investors favored technology stocks for their growth and their low debt levels, while strong consumer confidence and

SECTOR	Q2 2018 RESULTS
Energy	13.48%
Consumer Discretionary	8.17%
Technology	7.09%
Consumer Staples	-1.54%
Financials	-3.16%
Industrials	-3.18%

CHART 4:
SMALL-CAPS SOAR

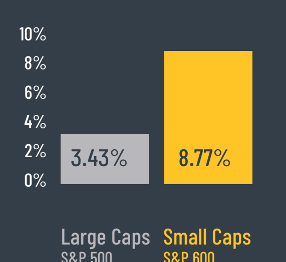
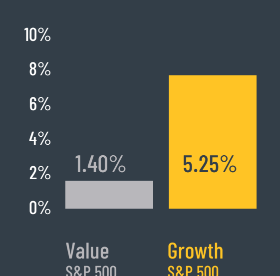


CHART 5:
GROWTH OUTPERFORMS



Charts source: Bloomberg

spending helped push consumer discretionary stocks higher. Both sectors are part of the growth stock universe. That said, value stocks did get a shot in the arm from the energy sector, which soared above 13% due to sharply higher oil prices during the quarter.

In contrast, steel tariffs and fears of a trade war hurt the industrials sector. Consumer staples, a traditionally defensive sector that does well in difficult markets, also lagged. Financials struggled as the yield curve flattened during the quarter, a development that crimps banks' profits.

FIXED INCOME SPUTTERS ALONG AS FED TIGHTENS AND YIELD CURVE FLATTENS

Fixed-income market returns were generally flat for the quarter, despite some volatility along the way brought on by concerns about inflation and how the Federal Reserve Board would alter its monetary policy. For the quarter:

- The Bloomberg Barclays U.S. Aggregate Bond index was down 0.16%.
- The ICE U.S. Treasury 20+ Year Bond Index was up 0.41%.

Overall, yields on short-term bonds rose during the quarter. These yields are influenced mostly by the direction of the Federal Funds Rate (FFR), a key short-term interest rate set by the Fed. The Fed raised the FFR once during the quarter and communicated that future increases were likely. Meanwhile, longer-term bond yields tended to trade in a narrow range for the most part. Demand from foreign investors and from retirees, along with reasonably tame inflation, helped to keep a lid on long-term bond yields.

The result of this dynamic: The yield curve flattened significantly—meaning that the difference in yield between short-term bonds and longer-term bonds shrank. By the end of the quarter, the spread between the two-year Treasury and the 10-year Treasury—as well as between the 2-year Treasury and the 30-year Treasury—were at their lowest levels since the third quarter of 2007.

CHART 7: Q2 2018 BOND MARKET RETURNS

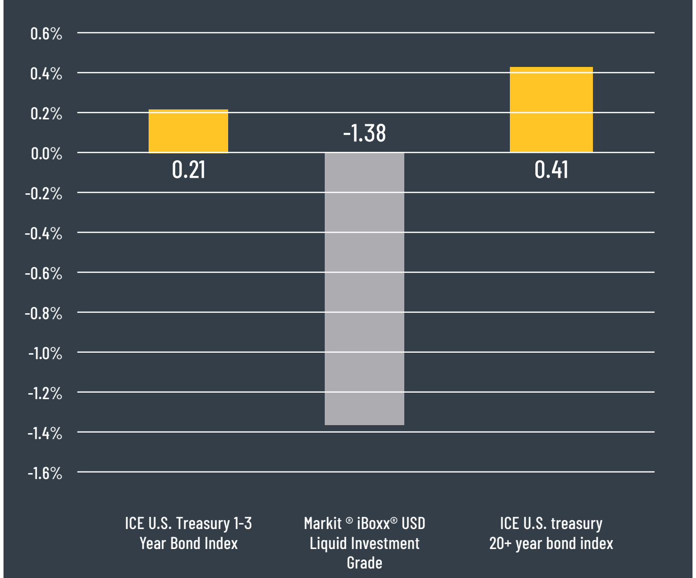


Chart source: Bloomberg

The result: Investors were less incentivized to own intermediate- or longer- term bonds given the relatively small additional yield those bonds offered.

Corporate bonds were mixed. High-yield corporates, which carry relatively low credit ratings, were the top performers in the bond market during the quarter (up 1.38%). The strong economy and stock market helped to support these and other "equity-like" fixed-income securities (such as preferred stock, a hybrid security that was up 1.83% for the quarter). Additionally, master-limited partnerships performed well (driven mainly by higher oil prices) as did REITs.

In contrast, higher-quality investment-grade bonds lagged (down 1.38% for the quarter). One reason: The yield advantage on these bonds over comparable Treasury bonds was not sufficient to attract investors. Emerging markets bonds also suffered losses (down 4.29%) due to currency-related issues such as those noted above.

Ultimately, as seen in Chart 7, the best places to be in bonds this quarter were in very long-term and very short-term Treasury securities. In contrast, intermediate-term investment-grade bonds lagged.

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