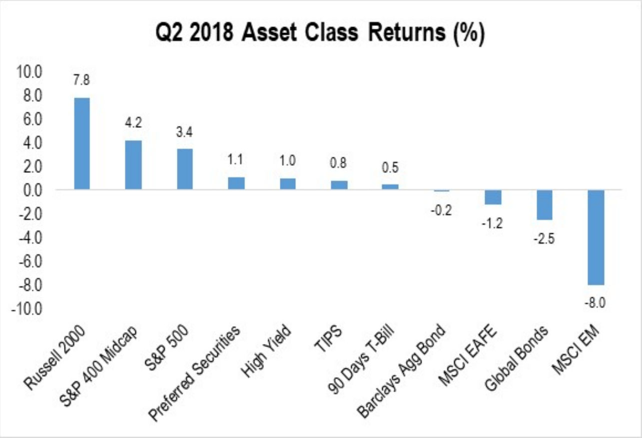
Executive Summary:

- **Tweets, Tariffs and Trade.** The market does not like uncertainty, and overnight tweets announcing new tariffs give investors the uneasy feeling that trade policy is being made up on the fly. There was more dispersion in performance across asset classes in the second quarter in part due to trade issues.
- **Focused on the Fundamentals.** Economic performance across regions has changed with the global synchronous recovery now over. Softness is apparent in the Euro area, Japan, and emerging markets with the U.S. being the exception as economic growth appears to be accelerating.
- **Young for Its Age.** The current economic expansion started in July 2009, which makes it 108 months old as of the end of the second quarter. The second longest expansion on record. Despite the age of the current cycle on paper, it has many of the characteristics of a younger expansion.
- **Current Positioning.** A stronger U.S. dollar and softness in China make the outlook for emerging market equities more uncertain. We favor U.S.-centric businesses, notably small and mid-cap stocks, that should continue to benefit from corporate tax cuts and deregulation. We also favor regional banks for these reasons as well as being beneficiaries of higher interest rates, which we continue to see as the likely direction.

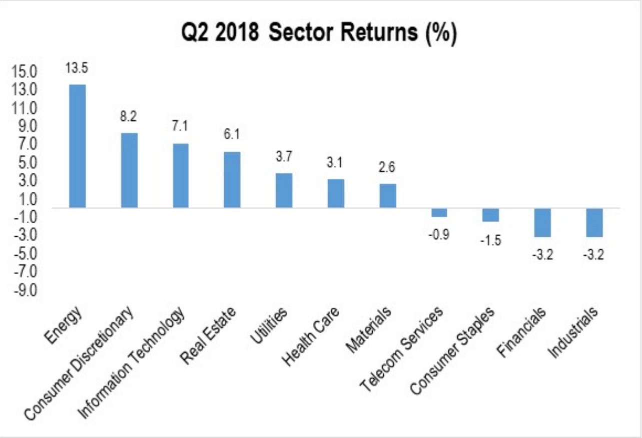
"If you can keep your head when all about you are losing theirs and blaming it on you…" Rudyard Kipling

Tweets, Tariffs and Trade. The market does not like uncertainty. We all know that. Overnight tweets that make it seem trade policy is being made up on the fly adds to uncertainty and is bad for stocks. Defending intellectual property rights against theft and trying to level the playing field may be just and appropriate, but imposing tariffs in a capricious manner against our allies to try and save industries that are likely not salvageable, at least from the perspective of bringing jobs back to America, causes concern. When investors get concerned they tend to take less, not more, risk.

The previous paragraph may sum up some of the push and pull that affected markets in the second quarter as there was an increase in dispersion of returns across asset classes during the quarter. Small cap stocks led the way with a gain of nearly 8% in the quarter. While large cap stocks posted a decent gain with the S&P 500 up 3.4%. In contrast, international markets struggled with developed markets down 1.2% and emerging markets falling 8%. Interest rates started to rise during Q2 with the ten-year yield poking its head above 3.1% before falling back below 3%, where it still resides. The net result was fairly flat performance in fixed income markets during the quarter.



Source: Morningstar



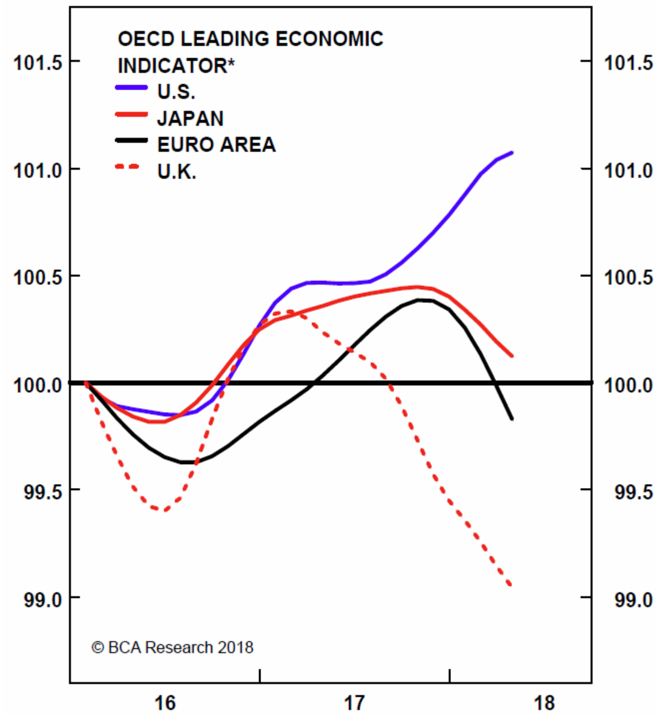
Source: Morningstar

Across sectors of the S&P 500, performance was more varied and perhaps, in this regard, more normal. Technology continued its winning ways with a 7.1% return in Q2, but the energy sector surged over 13% after a prolonged period of underperformance (Energy fell 6% in the first quarter of this year.) We have had a belief that the combination of better-than-expected demand and systemic production problems at some legacy oil producing countries would ultimately drive the price of oil meaningfully higher benefitting energy equities. At the end of the quarter, the price of WTI crude was over $74 per bbl versus $45 per bbl at the same time last year.

Consumer discretionary stocks also performed well in Q2, and this sector has posted the best performance in the S&P 500 on a year-to-date basis. A strong job market and still-high consumer confidence suggests the consumer is back on its feet. One should never count out the American consumer!

As evidence of the negative impact trade concerns are having on stocks, we offer the Industrial sector. Caught in the cross hairs over concerns of a potential trade war, Industrials lost ground in Q2, falling 3.2%, the worst performing sector in the S&P 500 along with Financials.

Focused on the Fundamentals. Divergent performance across asset classes should not be terribly surprising given that economic

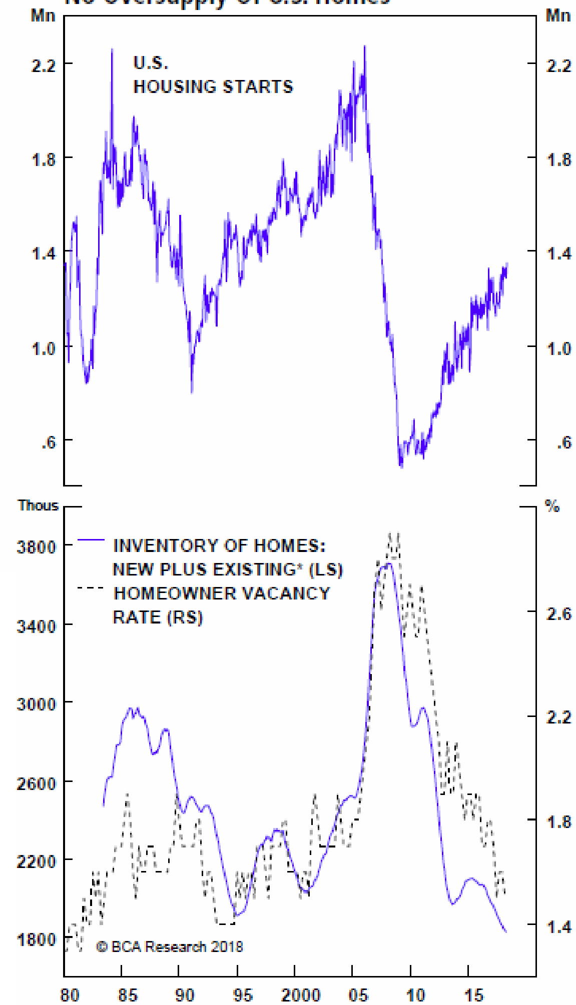


* AMPLITUDE ADJUSTED, REBASED TO JAN. 2016 = 100. SOURCE: OECD.

performance across regions has changed. Global real GDP growth increased from 3.2% to 3.8% last year. Unfortunately, the synchronous global recovery that drove the improvement in growth and asset classes around the world appears to be over. As the chart above shows, global growth is slowing as leading economic indicators in Japan, the Euro area, and especially in the U.K. have rolled over.

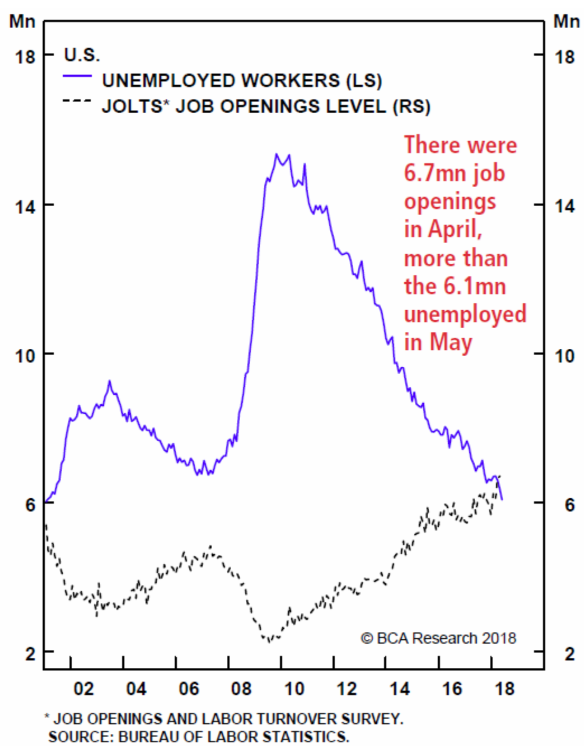
Bucking the trend is the United States, where economic trends appear to be accelerating. Real GDP growth in the second quarter could be in the 4% range according to estimates following a print closer to 2% in the first quarter. There are several issues to consider when evaluating the U.S. economy.

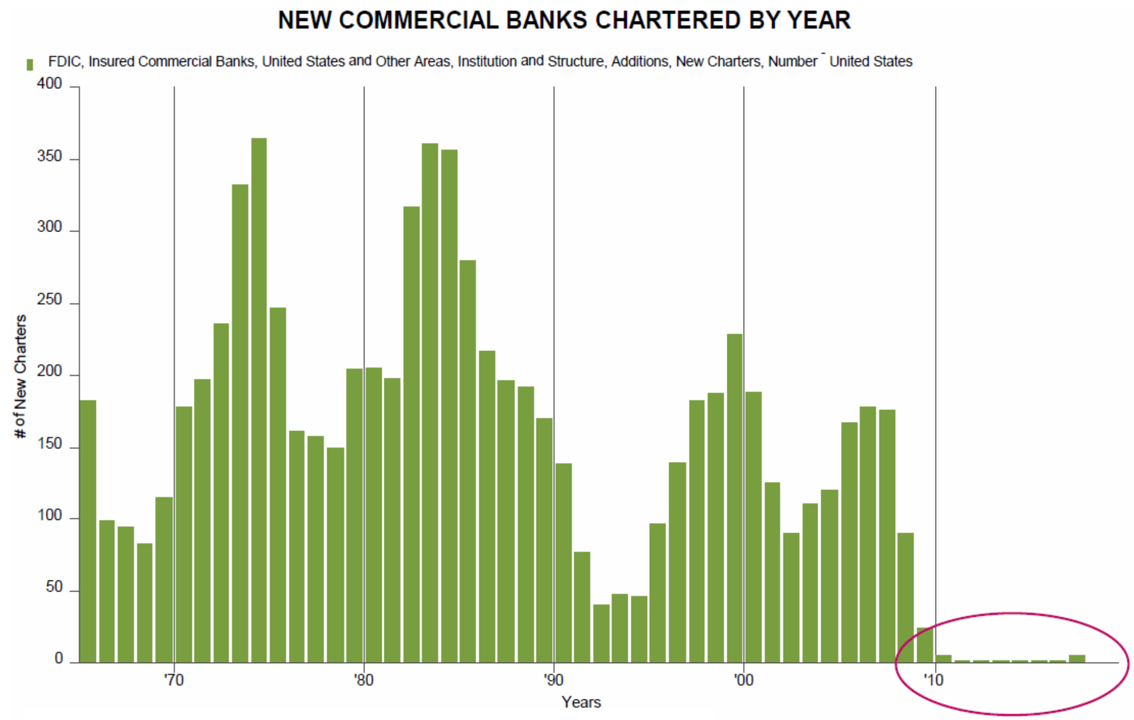
No Oversupply Of U.S. Homes



* SHOWN AS A 12-MONTH MOVING AVERAGE.

First, the fundamentals are quite sound. For example, housing activity is on the rise, but remains below long-term averages. Housing starts are tracking in the 1.3M range annually, and inventories are low suggesting that there is still quite a lot of room to run before housing demand is satiated. The labor market is healthy with unemployment claims at an all-time low, and the unemployment rate near a 50-year low. In fact, there are more job openings than unemployed people. Credit spreads remain tight, and while the yield curve has flattened in recent weeks, it has yet to invert, a sign that many feel would be a harbinger of recession.





Source: Fidelity Investments

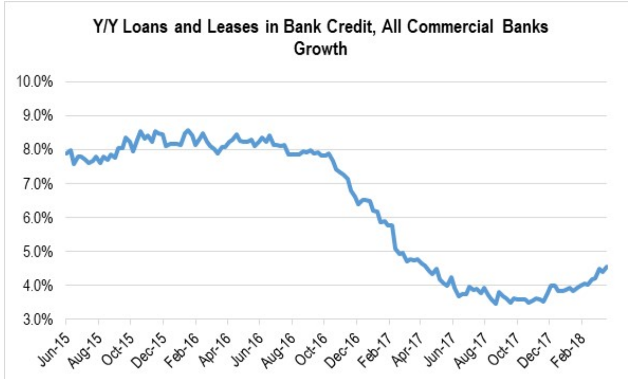
Second, fiscal policy is stimulative given the tax cuts passed late last year as well as ongoing deregulation. The impact of deregulation may seem a bit nebulous, i.e. something that is talked about but difficult to quantify. We ran across the chart above from Fidelity Investments, which depicts the impact Dodd-Frank regulation had on the heavily regulated banking industry. It is startling to us and illustrates the degree to which government intervention can impact an industry. In this case, the formation of new banks came to a screeching halt.

Third, monetary policy in the U.S. has begun to tighten after an extended period of accommodation following the financial crisis. In past cycles, the Federal Reserve has raised interest rates to a point where a recession occurs as they combat rising inflation. This may yet occur, but interest rates had been at zero—so called emergency levels—following the financial crisis. The fact that the Fed feels it can raise rates right now is a sign of the economy's underlying strength, in our opinion. The risk that they may overshoot, however, is omnipresent.

Historically, bear markets in stocks have occurred coincident with recessions. With an improving economy, there are few signs of recession. In contrast, international markets are on a looser footing, and as such we would favor domestic investments to those overseas.

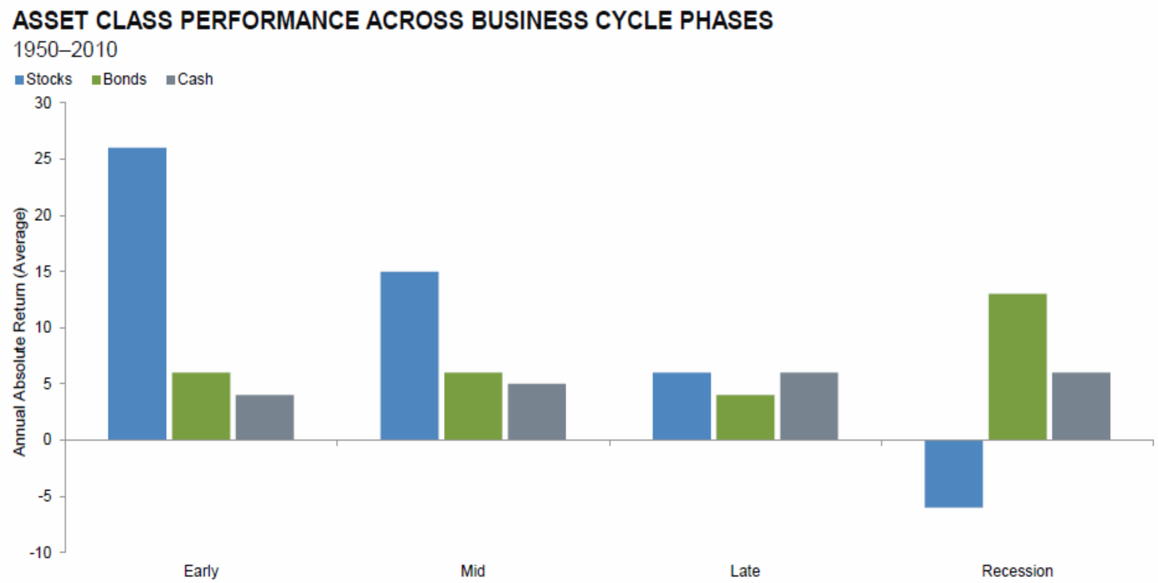
Young for Its Age. For the record, the current economic expansion started in July 2009, which makes it 108 months old as of the end of the second quarter. The second longest expansion on record according to the National Bureau of Economic Research. (The average expansion dating back to 1900 has been 47 months.) The coinciding bull market that started in March 2009 has lasted 111 months with the S&P 500 returning 302% making this bull run also the second longest on record. The longest bull market started in October 1990 and lasted 113 months with the S&P 500 returning 417%.

As to how much longer the current expansion and bull market can last, it is impossible to determine. We will leave efforts to pinpoint the end to market timers, which we are not. That said, with the S&P 500 trading at about 16.4x this year's earnings--in line with its historic average--valuations do not appear extreme. Moreover, earnings growth is accelerating with the



Source: Federal Reserve Bank – St. Louis

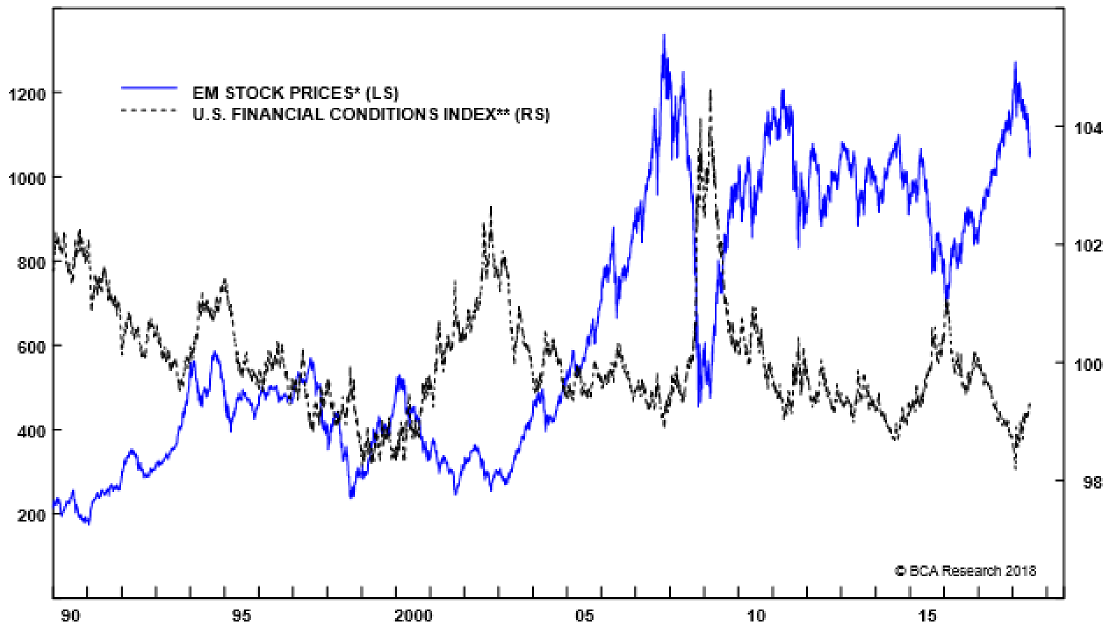
estimates implying nearly 20% growth for S&P 500 earnings in 2018 with another 10% expected



Source: Fidelity Investments

next year. This situation is in stark contrast to the late 90s when the bull market ended under the weight of speculative excess and extreme valuations.

Despite the age of the current cycle on paper, it has many of the characteristics of a younger expansion. Economic activity is still improving; credit growth, which had been lackluster, appears to be growing again; profits are still rising, although this year may be the peak for the rate of growth; and while monetary policy is contractionary, fiscal policy is stimulative.



Typically, characteristics of an older cycle include moderating growth, tighter credit, margin pressure, contractionary policy, and rising inventories with slowing sales. None are present today except for tighter monetary policy. As cycles mature, performance across asset classes shifts. Stocks do better early in a cycle (presumably because they are anticipating better economic growth) and then start to fade as the cycle ages. Once in a recession investors flock to bonds and the safe haven of cash.

Current Positioning. The U.S. dollar rose 5.5% in the second quarter after a period of weakness last year. In recent commentaries, we expressed that dollar weakness was likely due to better relative growth outside the U.S. in both the Eurozone and emerging markets. This dynamic changed during the second quarter.

With the Fed in tightening mode and an accelerating U.S. economy, we continue to believe that interest rates are likely to rise over time. The combination of these factors along with elevated debt levels and slowing economic growth in China give us concern over the outlook for emerging market equities in particular.

History suggests that emerging market equities almost always fall when U.S. financial conditions are tightening, as shown above. EM dollar-based debt has ballooned back to late-1990s levels. A vicious cycle could manifest where a stronger dollar makes it challenging for emerging market borrowers to repay their loans, prompting investors to withdraw their capital from the developing world and leading to an even stronger dollar. To complicate matters, while EM dollar-denominated debt issuance has declined as a percentage of total EM debt issuance, this is because local currency-denominated issuance has grown at a faster pace. If emerging market central banks raise rates to try to prevent their currency from weakening, this could make it difficult for local-currency borrowers to repay their loans. Neither scenario would be favorable for emerging market equities.

A potentially greater concern is slowing economic growth in China. May data on industrial production, retail sales, and fixed asset investment missed consensus estimates. Leading indicators employed by our colleagues at BCA Research point to continued softness in Chinese economic activity. Importantly, a downturn likely would have significant negative consequences for other emerging markets. For example, China accounts for over 50% of metal demand, and Brazil, South Africa, and Chile are three of the largest producers of metals in the world.

When emerging markets last came under pressure in 2015, Chinese officials intervened with major stimulus. While we believe that the Chinese government would provide support in the event of a meaningful downturn, the bar for new stimulus seems higher today than it was in the past. Officials have less flexibility to respond given elevated debt levels and excess capacity in some parts of the industrial complex. Given this set of circumstances, we recently made the decision to exit emerging market equities.

Companies with U.S.-centric businesses have done well this year with the Russell 2000 the best performing asset class through the first half of the year. The benefits of a lower corporate tax rate and improving economic conditions should continue to favor small and midcap companies, in our opinion. As such, we have lowered our overall exposure to international equities within our strategic equity allocation.

Within U.S. equities, we believe the underperformance of the financial sector has a good chance to improve in coming quarters. Specifically, we favor regional banks as these companies were materially impacted by heightened regulation following the financial crisis and should therefore benefit from recent moves to reduce regulation. Moreover, regional banks have more transparent business models than money center banks, help drive the improvement in loan growth we are seeing, and should benefit from higher interest rates, which has been a frustration for investors given the recent flattening of the yield curve.

Risks that may imperil the expansion and bull market in stocks continue to center on the Fed. If inflation accelerates forcing interest rates meaningfully higher, then the yield curve inverts, earnings deteriorate and multiples on stocks compress. Moreover, if bellicose protectionist rhetoric and symbolic tariffs designed as negotiating ploys turn into a trade war then inflation may become even more of a concern. This would likely cause further strength in the dollar and cause trouble for the global economy, particularly emerging markets.

If, however, inflation remains contained through, for example, increased labor participation and thus tempered wage growth allowing the Fed to keep monetary policy on a gradual path, a more bullish scenario unfolds where the benefits of fiscal stimulus, ample available credit, and a healthy consumer drive continued earnings growth and extend the bull market. Such a set of circumstances would likely make this cycle one for the record books.

In closing, we want to reiterate our appreciation for the trust our clients have bestowed upon us. As we move forward, we are committed to retaining your confidence and serving your specific needs.