SECOND QUARTER REVIEW

After a choppy start to the year, financial markets exhibited a bit more stability in the second quarter. While we experienced day-to-day volatility, it was less than in the first quarter. Corporate earnings reports, released during the quarter, showed a significant increase in corporate profits. This helped to offset some of the negative headlines. The S&P 500 ended the quarter up 3.4%, bringing the return for the first half up to 2.6%. Consumer discretionary and technology related stocks continue to show strength, but energy stocks, bolstered by higher oil prices were the best performing sector. Interest rate sensitive sectors such as Utilities, recovered somewhat from the first quarter, but still lag the S&P 500 for the year. The Federal Reserve (Fed), as was widely expected, raised the Federal Funds rate by 0.25% to a range of 1.75% to 2.0%. Shorter-term interest rates continued to move higher along with the Fed action, while longer-term interest rates were only marginally higher. The yield of the 10-year Treasury ended the quarter at 2.86%, up from 2.74% at the end of the first quarter. Oil prices rose 14.2% during the quarter despite announced production increases by OPEC. Oil ended the quarter at $74.15 a barrel, the highest level since November of 2014.

NEGATIVE HEADLINES OBSCURED THE FUNDAMENTAL STRENGTH OF THE ECONOMY

The economy has shown clear signs of an acceleration from the 2.0% growth in the first quarter, and is on track for growth around 4% in the second quarter. This would mark the fastest pace of growth in nearly four years. We are starting to see tangible signs that increased consumer and business confidence is translating to increased activity. Economic activity has been boosted by a strong labor market, rising wages, increased take-home pay and the favorable business investment environment. Increases in short-term interest rates have been driven by the actions of the Federal Reserve, while longer-term rate changes have been more muted. We saw a sharp rebound in corporate earnings in the first quarter and double-digit earnings gains are expected to continue through at least 2019. From a fundamental standpoint, the news was largely positive during the quarter. However, investors remained reticent due to concerns about the impact of potential trade disputes, concerns about rising interest rates, on-going geopolitical tensions and the increased polarization and rhetoric as the mid-term election season hits full stride. While these concerns are important, they do not offset the positive momentum of the economy and the overall solid fundamental outlook.

Consumer Sentiment Remains Near Record Levels.

The healthy consumer remains a key foundation to the economic growth engine. Even as consumers expressed some concerns about rising trade tensions, they continued to express positive sentiment on the outlook for the economy over the near-term and the remainder of the year. This outlook is bolstered by the continued strength of the labor market. An average of 215,000 jobs a month have been added this year and in total 1.28 million new jobs have been added in the first half. For the first time, the number of job openings is greater than the number of people searching for jobs and discouraged workers have started to come back into the labor market. The positive sentiment is also driven by modest gains in wages and increased take-home pay as a result of the tax cuts. This is all reflected in the ongoing strength in consumer spending. Spending was up a more modest 0.9% in the first quarter but has gained momentum throughout the second quarter. Retail sales rose in May by the largest amount in six months with broad-based gains seen across most retail categories.

Elevated Business Sentiment Has Led to Increased Activity.

The elevated level of business confidence we have seen over the last few quarters is now showing up in measures of business activity. Even during the slower first quarter, business spending on equipment, structures and intellectual property was up 10.4%. Activity in the manufacturing sector rose throughout the quarter, and in June reached the highest level since 2004. Manufacturing jobs increased by 36,000 in June and have averaged 24,000 a month for the last twelve months. This shows that, despite concerns about trade and tariffs, the U.S. manufacturing sector remains strong. The service sector also showed a solid expansion, as new orders and overall activity remain high. Since the passage of the tax cuts, multi-national corporations have repatriated $300B in foreign sourced profits. A sizable portion of this money has been used for purposes that support future economic growth. In the first quarter, capital spending topped $167 billion, the highest level in seven years. In addition, companies have earmarked repatriated funds and tax savings to debt reduction, wage increases and bonuses for employees, contributions to pensions plans, and increases in dividend payments to shareholders. These actions have the benefit of improving corporations' financial flexibility, adding to future growth opportunities and supporting the economy.

Fiscal Stimulus Outweighs the Negative Impact of Tariffs.

Rising concerns about tariffs and a potential trade war have negatively impacted investor sentiment this year. While the currently imposed and proposed tariffs can have a negative impact on the sectors and companies targeted, the impact to the overall economy is not as large. To-date the U.S. has imposed tariffs of $7.5B on steel and aluminum and an additional $12.5B on targeted Chinese goods. Retaliatory tariffs of equal amount have been imposed on U.S. goods by affected countries. An additional $40B in potential tariffs have been announced on Chinese products with an equal amount applied by the Chinese to U.S. products. In total, if these are implemented the fiscal impact would be $120B globally. By contrast, fiscal policy is expected to add $800B to the economy this year. That comes from a $200B positive impact from the tax cuts, $100B from additional government spending and an expected $500B of repatriated foreign profits. At this point, the fiscal stimulus far exceeds the impact of the tariffs. This is not to say that trade policy does not have the potential to impact economic growth, but it is important to separate what has occurred from the speculation of what may happen.

The Fed Drives Short Term Interest Rates, While Moderate Inflation Impacts Long-Term Yields.

The Fed remains on its path to normalize interest rates and reduce the size of its balance sheet. So far, this year, the Fed has increased the funds rate twice to the current range of 1.75% to 2.00%. Expectations are that they will raise rates one or two more times this year, taking the funds rate over 2.0% for the first time since early 2008. While Fed activity has led to increased interest rates in shorter maturity bonds, we have not seen as much movement in longer-term bonds. Rates on longer maturity bonds (10-years and longer) tend to be impacted more by the outlook for inflation that any Fed actions. Despite the tightening labor market and rising commodity prices, inflation has remained relatively stable and in line with the Fed's target. Market expectations are for inflation to remain average around 2.0% over the next 10-years. In addition to the stable inflation environment, global demand for yield and concerns about the impact of trade tensions, are pushing foreign investors to increase their purchases of higher yielding and relatively safer U.S. Treasury debt. This has led to a flattening of the yield curve, or a narrowing of the yield difference between short-term bonds and long-term bonds. While a flatter yield can be a sign of slower growth, it is not always the case. In this instance, we believe that the global demand for yield is the cause of this flattening, not economic concerns.

The Fundamentals of the Market are Solid and Valuations are Attractive.

Fundamentals remain the key driver over the long-term. In the first quarter, earnings for S&P 500 companies grew 24% versus the first quarter of last year. Corporate earnings are expected to increase by double-digits for the full-year and for 2019. Unlike earlier in the recovery, earnings are being driven by strong revenue growth and not just cost-cutting by companies. Positive revenue growth is being generated by the increase in consumer and business spending. With earnings improving and price changes more muted, the valuation of the equity market has improved from the beginning of the year and is currently near its long-term average. We expect that we will see bouts of volatility throughout the remainder of the year, especially during the mid-term election season. However, as the election outcome becomes more certain, the combination of attractive valuation, a strong economy, and rising corporate profits gives us optimism about the markets going forward.

IMPACT ON YOUR INVESTMENTS

Given the positive outlook on the economy and financial markets, we have made some changes to the composition of the portfolios. In the Income Equity allocation, we reduced exposure to slower growing, more interest rate sensitive companies, in favor of companies that are more economically sensitive. The new companies provide an attractive dividend, but also benefit more from stronger economic growth. This should be reflected in stronger earnings prospects that will translate into faster dividend growth. In response to higher short-term interest rates, we have increased the pace of the transition out of mutual funds and into individual bonds in the Fixed Income allocation. For the last 10-years, we have used dividend paying stocks in lieu of traditional fixed income in certain client accounts, but now that the gap between dividend yield and corporate bond yields has narrowed, we have moved that allocation into short-maturity corporate bonds. These changes will allow portfolios to participate from improved corporate profits, while generating current income in a less risky manner. Our Growth Equity portfolio remains focused on companies and sectors that are positioned to benefit from stronger economic growth. We will continue to monitor the fundamentals of the economy and evaluate any potential roadblocks to the recovery. We remain optimistic and believe that the portfolios are well-positioned for the current environment.

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