SPINNAKER

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SECOND QUARTER 2018: MARKET REVIEW & OUTLOOK

The second quarter of 2018 is in the books, and the third longest business cycle in recorded history rolls on despite many political and rhetorical challenges. During the quarter, the S&P 500 rose by 4.3% while International equity markets performed poorly with developed and emerging markets falling by -3.3% and –10.0% respectively. U.S. small caps handily outperformed large-caps during the quarter, as small companies are less exposed to trouble overseas, trade issues and a strengthening U.S. dollar. Investors received the best global earnings season in recent memory, but markets largely ignored the good news as market multiples continued to contract.

In terms of U.S. sectors, the outperformers from 2017 and early 2018 continued their run. The Technology and Consumer Discretionary sectors continued to pull away from the pack as their business models are considered secular growers. However, Financials, which appeared poised to benefit from rising interest rates and a more benign regulatory climate, stalled as concerns increased that global growth may have peaked and 10-year U.S. Treasury rates failed to hold above 3.0%. The worst performing sectors were those seen as being most impacted by a potential trade war, namely the Industrials and Materials sectors.

We saw an abrupt turn in the Energy sector, as stock prices finally started to catch up with the performance seen from the price of crude oil. In a bizarre twist, OPEC met and decided to expand production levels for the first time since 2016, and energy prices promptly responded by moving decidedly higher. Production from OPEC member Venezuela has functionally halted, and the embargo means that Iran will have difficulty selling its oil to former trade partners. Brent crude prices rose by 8.3% during the quarter, and the spread between Brent and WTI prices (relevant to oil produced in the U.S.) continued to widen.

Interest rates continued to rise during the second quarter but in a volatile fashion. The yield on 10-year U.S. Treasury bonds began the quarter at 2.73%, topped out at 3.11% and ended at 2.88%. Accordingly, the Barclays Aggregate Bond Index fell by -1%. Investors believed that once the 10-year yield exceeded the important psychological level of 3%, it would shoot straight up. Once again, the market fooled nearly everyone as rates immediately retreated lower.

Another widely followed indicator is the path of the U.S. dollar versus a basket of global currencies (the DXY). The DXY rose by 7% during the quarter, a meaningful move for a currency, thanks to a resurgence in growth in the U.S. and an abrupt turn lower in growth internationally. A stronger U.S. dollar is another reflection of tightening financial conditions. Gold continued its inverse trading relationship with the DXY, falling by -6.4%.

OUR FRAMEWORK FOR THINKING ABOUT THE BUSINESS CYCLE:

Earnings are still positive, monetary policy is tightening only slowly, and interest rates and inflation are below historical averages. On the flipside, coordinated global growth (perhaps the most overused phrase of 2017) is probably behind us. Where do we stand?

As mentioned above, we are in year nine of the current business cycle. Our investment committee has dedicated a lot of time over the last few years thinking about how and when this cycle might end. We do not believe that the end is imminent; however, we are managing portfolios under the framework that the "peak" has been reached for many important economic indicators. While we expect that corporate earnings will remain robust, we believe that the first quarter registered the fastest year-on-year growth rate for earnings. While manufacturing indicators like the U.S. PMI and/or ISM remain very strong, we believe that they likely peaked for the cycle in February of this year. The NFIB Small Business Optimism Index reached its highest level since 1983 in May of this year. While we believe that business optimism will remain very high, we believe that it will not go any higher.

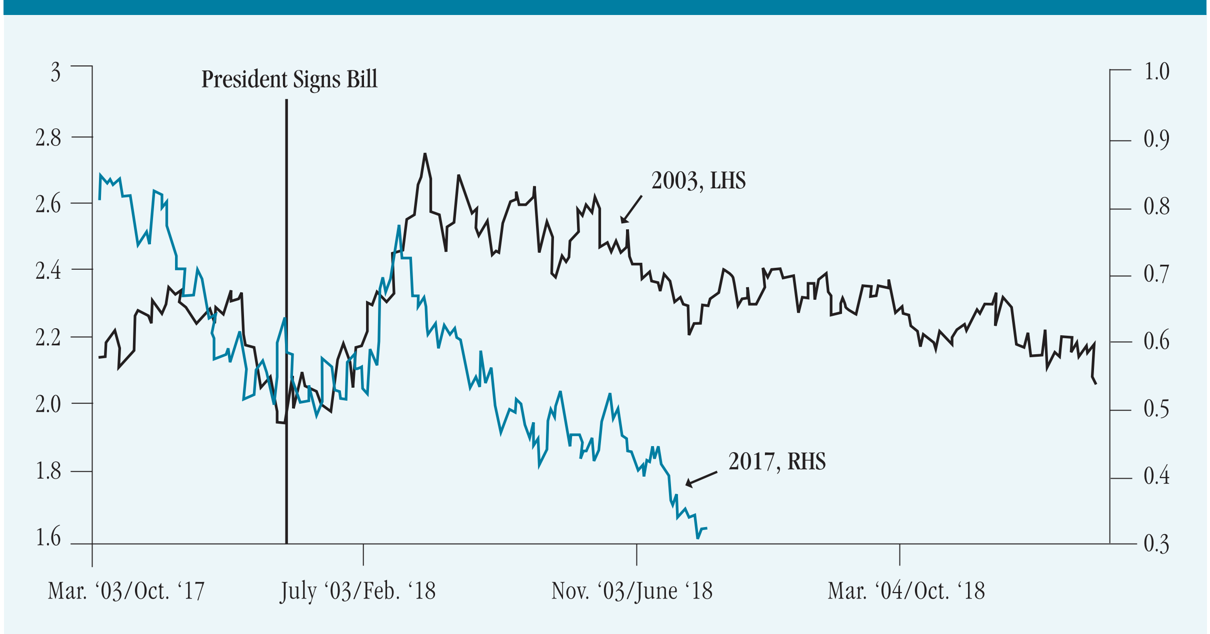
However, there are many indicators that should continue to improve. For instance, we believe that the U.S. unemployment rate will fall even lower than its current level of 3.8% before the end of this year. According to the most recent Job Openings and Labor Turnover survey from the Labor Department, the number of job openings in our country exceeds the number of unemployed workers. The 2017 Tax Act allowed for the repatriation of foreign-held cash back to the U.S. at favorable tax rates. We believe that companies are only about 25% through their repatriation, which means that there should be a lot more money in the months ahead for mergers & acquisitions, share buy-backs, dividend increases, and capital expenditures.

THE YIELD CURVE:
We are also watching the trajectory of the yield curve. The yield curve is an often-used economic indicator and it has been flattening since the Federal Reserve began to raise interest rates and pare back its balance sheet more than two years ago. Logically, the rates on long-term interest rates should be notably higher than those on short rates as investors should be paid more to lend money for longer periods of time. However, this cycle is a bit unusual because long interest rates are still well-below historical levels, resulting in a flatter yield curve. The Federal Reserve has little influence on long-term rates, as yields on longer maturity bonds are driven largely by growth and inflation expectations. The Fed has substantial control over short-term interest rates and has raised rates by a quarter point seven times since the end of 2015. Economic lore suggests that the current yield on the two-year U.S. Treasury represents the terminal Fed Funds rate in that given business cycle. Today, the yield on the U.S. two-year Treasury is 2.51% versus the current Fed funds rate of 2%. This is telling as it would appear markets are less optimistic about future growth relative to the Federal Reserve. If the Fed continues to raise rates, it could upset a fragile economy.

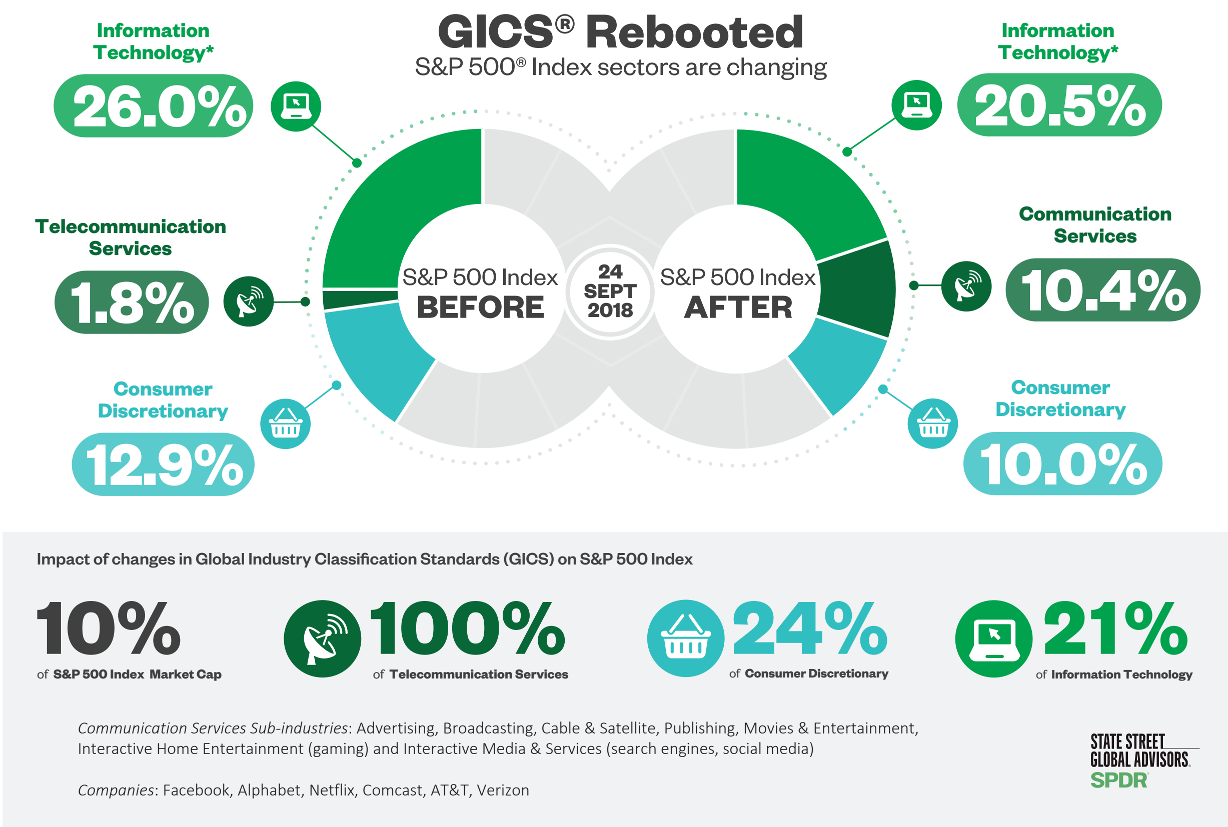
TRADE "WARS" & CHINA:
Market-friendly aspects of the Trump agenda were delivered in 2017 and equity returns were incredible. This year, investors must deal with the opposite. We believe that President Trump is very serious about his stance on trade and will continue to press on our trading partners and challenge relationships with uncomfortable allies.

Most important to this administration is limiting the extent to which China takes advantage of U.S. intellectual property on an ongoing basis after a decade of allegedly "stealing" it by forcing multi-national companies to form joint ventures with Chinese government companies to enter the market. We believe that our government will announce restrictions on Chinese investment in American companies in the coming months. The Chinese yuan has started to weaken again, particularly against the U.S. dollar.

The Yield Curve: 2003 & 2017 Tax Cuts



Source: Strategas Research Partners



Source: State Street Global Advisors

An extra 25% tariff on all imports from China would cost consumers $135 billion, assuming no change in purchasing patterns. That equates to 0.7% of GDP - not good for the U.S. economy - but unlikely, on its own, to cause a recession. Of greater concern is that a true trade war could harm the global supply chain and disrupt the efficient allocation of corporate capital around the world. This could put some companies that depend on Chinese affiliation in financial danger, possibly enough to strain the financial institutions that support them.

Some worry that fewer Chinese exports to America would reduce dollar flows to China, reducing its ability to buy U.S. Treasuries, or force a significant reduction in China's $1.2 trillion of Treasury holdings. China has increased its stock of Treasuries by about $90 billion in the past year, and bond yields have fallen recently as trade tensions have grown. The bond market doesn't seem particularly worried.

COMMUNICATION SERVICES SECTOR:

Our investment committee spends a lot of time evaluating the prospects for the sectors of the U.S. economy, so upcoming categorization changes will be important. In September, a new Communications Services sector will replace the Telecommunications sector as part of a shakeup to the GICS classification which was established in 1999. The motivation for creating this new classification is to better align "consumer-facing" Technology companies and separate them from more enterprise-facing, software-oriented Technology names like Microsoft, Intel and Cisco. Among the new additions to the sector will be Facebook, Netflix, Alphabet (Google), Disney, and Comcast. The new sector will likely comprise about 10% of the S&P 500. Importantly, this change also reduces the weight of the Technology sector from about 26% to approximately 20%.

IN CONCLUSION:

We believe that the economy transitioned from "mid-cycle" to the beginning of "late cycle" at the turn of the year. Historically, the "late cycle" period can continue for multiple years. We find valuations overall to be quite reasonable, especially relative to levels seen at the end of 2017. We believe that the U.S. is in the early innings of a powerful investment cycle thanks to the recent passage of the Tax Act, specifically lower corporate tax rates and the ability to repatriate foreign cash. We believe that the U.S. consumer is in great shape and should continue to spend. Overall, we are starting to tilt our portfolios toward a more cautious stance, but believe that investors should remain fully invested.

SPINNAKER CONNECT

As part of our ongoing Spinnaker Connect initiative, we are pleased to announce that a Spinnaker Connect app for your smartphone and/or tablet will be available on both the Apple iOS and Android operating systems in a week or two. We will announce the app rollout on our website. You will be able to check your account allocation and balance as of the previous business day's market closing prices. Please contact your client advisor should you have additional questions.

MARKET DATA

Index		*YTD*	*2017*	*2016*	*2015*
S&P 500	*U.S. Large-Capitalization Stocks*	2.65%	21.83%	11.95%	1.37%
S&P 400	*U.S. Mid-Cap Stocks*	3.49%	16.24%	20.73%	-2.18%
S&P 600	*U.S. Small-Cap Stocks*	9.39%	13.23%	26.46%	-2.01%
Russell 1000	*U.S. Large- and Mid-Cap*	2.85%	21.69%	12.04%	0.91%
Russell 1000 Growth	*Growth Stocks broken out*	7.25%	30.21%	7.07%	5.67%
Russell 1000 Value	*Value Stocks broken out*	-1.69%	13.66%	17.33%	-3.84%
MSCI EAFE Index	*Established International Markets*	-2.37%	25.62%	1.59%	-0.28%
MSCI Emerging Markets	*Developing International Markets*	-6.51%	37.75%	11.27%	-14.61%
		6/30/18	12/31/17	12/31/16	12/31/15
90 day T-Bill	*Short-Term Interest Rate*	1.91%	1.39%	0.51%	0.17%
10 Year US Treasury Rate	*Longer-Term Interest Rate*	2.85%	2.43%	2.45%	2.28%
VIX Index	*Risk Measurement*	16	11	14	18
Corporate Bond Spread	*Risk Measurement*	123 bps	93 bps	120 bps	165 bps
TIPS Spread	*Inflation expectations*	175 bps	198 bps	197 bps	171 bps

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