ECONOMIC & INVESTMENT OUTLOOK
JULY 2018

Investment Perspective

Smaller companies have outperformed as they are primary beneficiaries of tax reform and less likely to be negatively impacted by protectionism

The broader U.S. stock market rebounded during the second quarter after a turbulent start to the year. The S&P 500 increased 3.4% in the second quarter putting the benchmark's six-month return at 2.7% through June 30. However, other investments fared worse with the Dow Jones Industrials, emerging markets, international equities and U.S. bonds producing negative returns. On the flip side, small cap growth stocks have been among the best performers with the Russell 2000 Growth Index up 9.7%. Smaller companies have outperformed as they are primary beneficiaries of tax reform and less likely to be negatively impacted by protectionism. In addition, the acceleration in earnings growth has created a fundamental catalyst that makes the U.S. equity market more attractive. In fact, the valuation of the market has improved over the last nine months as earnings growth outpaced stock market appreciation. The investment environment for equities remains favorable as stable economic growth, low interest rates, moderate inflation and double-digit earnings growth appear sustainable. A summary of index returns for the quarter ending June 30, 2018 is as follows:

Dow Jones Industrials	-0.7%	Russell 2500	+5.5%
MSCI EAFE	-2.8%	S&P 500	+2.7%
NASDAQ Composite	+9.4%	Wilshire 5000	+3.4%

GLOBAL ECONOMY

The overall economic tone has improved the most in the U.S., but other regions are also benefiting

World economic growth (ex. U.S.) is expected to increase 4.1% in 2018 with expectations of similar improvement in 2019. This represents the healthiest period of global growth in recent memory with gains approximating 4% for three consecutive years. The overall economic tone has improved the most in the U.S., but other regions are also benefiting. Europe is growing moderately at 2.1% and Japan is plodding along at a 1.1% pace. China is showing steady growth of 6.5% and several emerging regions are growing about 5%. The massive stimulus measures undertaken by the major central banks have helped improve inflationary expectations and investor confidence. The virtuous cycle of growth continues to strengthen and appears unlikely to be derailed in the short term, unless trade wars disrupt progress.

The U.S. economy is growing faster than previously expected as GDP gains will likely hit 3% in 2018 and 2.6% next year. Growth accelerated to 4% mid-year following 2.0% in the first quarter. Capital expenditures are the largest contributor with non-residential investment spending increasing 6.8%. Consumer spending remains another key factor with 2.7% growth, underpinned by broad-based employment gains. The improvement in aggregate income (wages x jobs) suggests consumer spending will remain healthy for the foreseeable future. Labor force participation rose to the highest levels in four years — a

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good sign. Also, initial jobless claims — a proxy for layoffs — recently fell to its lowest level since December 1969. Supporting these trends, small business hiring plans are the best they have been in 20 years, according to the National Federation of Independent Business (NFIB) surveys. The manufacturing sector remains vibrant with the new orders indices indicating strong growth ahead. The Institute of Supply Management (ISM) manufacturing survey rose to 60.2 in June — one of the highest readings since February 2004. To further highlight the broad-based strength, the ISM non-manufacturing survey of business activity reached a new high for this economic cycle. The domestic economy is firming with accelerating momentum and few visible weaknesses. A positive feedback loop of broad-based growth, moderate inflation and ample confidence is laying the foundation for more progress ahead. The risks reside with possible unexpected shocks or policies and decelerating growth over the next two years.

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FED POLICY & INFLATION

The Federal Reserve is succeeding in its mandate of low inflation and full employment. Recent employment and inflation reports indicate that economic conditions are "just right — not too hot, not too cold." The central bank remains in the process of raising interest rates to unwind the easy money conditions that have prevailed since 2008. In June, the federal funds rate was increased 25 basis points to 2.0% for the seventh time since December 2015. The Fed is likely to raise rates one or two more times this year. Economists suggest real short-term rates of 2% (nominal yield minus core inflation) would be sufficiently high to moderate economic growth. Today, real short-term rates remain negative and accommodative because nominal rates do not exceed inflation. It will take time before real rates are high enough to suppress economic growth. In addition, the rising budget deficit may reach 5% of GDP next year — a record level excluding wars and recessions — but similar to the early Reagan years in the 1980s. Higher deficits may create upward pressure on long-term rates.

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All domestic inflation measures indicate inflation is rising moderately and likely to remain in the 2% range without much risk of acceleration or deceleration. Headline CPI inflation is 2.9% and core inflation (excluding food and energy) is 2.3%. The Fed's preferred inflation gauge, the core personal consumption expenditures price index (core PCE) hit 2.0% for the first time since May 2012. Today, the Fed continues to taper its $4 trillion-plus balance sheet by letting bonds mature without fully reinvesting the proceeds. The pace of tapering will continue to increase over the next few months as the monthly cap on reinvestment rises from $30 billion to $50 billion per month by October 2018. The net effect is that the Federal Reserve will buy fewer bonds and institutional buyers will increasingly influence pricing — an implicit tightening.

PROTECTIONISM

President Trump recently initiated protectionist measures that could ignite a detrimental trade war. To date, only a small number of tariffs have been enacted. However, the U.S. has threatened to impose a wider range of tariffs on imports from China and a new tariff on auto imports. These measures would raise tariffs on approximately 30% of U.S. imports and might invite retaliation from key trading partners, shocking the world economy. This would lower growth and ignite cost push inflation. Looking at financial assets, short-term implications could include more volatile asset prices, tightened financial conditions and a general loss of confidence. The positive feedback loop that has played a central role in lifting the global economy would be at risk if currencies and interest rates responded dramatically to extreme protectionism. For example, the dollar has been strengthening year-to-date on a trade-weighted basis as part of a flight to quality. Most investors view a major trade war as unlikely, but recognize it could be a possible disruptive force. Also, it appears that these polices, if enacted, will unfold gradually.

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INVESTMENT OUTLOOK

The economic and business fundamentals supporting the outlook for equites are positive. Yes, the political rhetoric creates uncertainty, but strong growth and moderate inflation are powering U.S. equities higher, especially small and medium-sized company growth stocks. Strong double-digit earnings growth combined with low inflation is a successful recipe in any era. We are enjoying one of the longest bull markets in history because the fundamentals driving growth are strong and skepticism toward equity investing remains high. As a result, the market is gradually appreciating and its valuation remains reasonable. The S&P 500 is valued at 17x forward earnings compared to its long-term average of 16.6x and 20-21x, respectively, during periods of low inflation and interest rates. Also, it is important to note that the stock market is not the subject of euphoric cocktail party banter. This bull market may last longer than expected because we currently enjoy a favorable combination of forces.

The "core" earnings growth for this year and next may be in the same 9-11% range due to the combination of accelerating revenues, margin improvement and record stock buybacks

Operating earnings after taxes for the S&P 500 are expected to increase 21% in 2018 to $160 per share and possibly 8-10% in 2019. Approximately half of this improvement is related to tax reform with the balance to fundamentals. Tax reform mostly impacts earnings rather than revenues. It is a positive development and one-time boost. Revenue growth is reaccelerating to 5-7% and remains a key reason for the strength in equities. The significant increase in the pace of revenues is a result of an improving business environment, which may be a more sustainable source for future growth. There will likely be a deceleration of earnings growth from the 21% rate this year, but this should not surprise investors. Importantly, the "core" earnings growth for this year and next may be in the same 9-11% range due to the combination of accelerating revenues, margin improvement and record stock buybacks.

From a technical perspective, the secular bull market remains firmly in place and the major indices are consolidating at a high level after the February correction. Momentum has slowed, but most technical indicators are positive. Technology stocks and smaller companies have demonstrated the greatest leadership year-to-date. Positively, the S&P 500 tested its 200-day moving average (DMA) in March/April and has since rallied. Also, the 50 DMA has been above the 200 DMA since April 2016 and both have a positive slope — a favorable indicator. Due to the recent period of consolidation, there are no major signs of buyer exhaustion as 50% of stocks on the NYSE are near their 200-day moving averages. Moreover, the NYSE stocks advance-decline lines scored new highs this month indicating strong breadth and a potential leading indicator for further strength. Volatility has subsided after a turbulent first quarter. The VIX (CBOE Volatility Index) spiked to 50 on February 6 and remained elevated around 20 for several weeks, but has since subsided to 12 in mid-July.

A variety of factors account for the lack of popularity of U.S. equities, but skepticism helps insure that investors are not over-invested in equities today

Time in the stock market is more important than timing the market. We are amidst one of the longest and strongest bull markets since World War II. Ironically, these impressive gains have not been enjoyed by many because the cumulative outflow of U.S. equities since 2008 has been remarkably large. A variety of factors account for the lack of popularity of U.S. equities, but skepticism helps insure that investors are not over-invested in equities today. Related, the duration of this bull market advance is not cause for concern — bull markets do not die of old age. The bull is more at risk during earnings recessions and tight financial conditions. Earnings are advancing strongly after three years (2014-2016) of moving sideways and financial conditions are not tight. The experience over the last 10 years illustrates the importance of maintaining a disciplined investment approach that views market events from a long-term perspective. Investors who react emotionally to short-term movements are at risk of making ill-timed decisions that compromise long-term performance.

We believe the odds favor new highs in the year ahead. The risks primarily relate to politics and trade relations. We remain alert to factors that might contribute to a recession or overheating inflation, but these risks appear low at this time. Other risks include a Chinese hard landing, cyber-attacks, military conflicts and terrorism. Quality small and medium-sized growth companies are poised to succeed in this environment. We favor growth over value with emphasis on the health care and information technology industries.