Second Quarter Market Review

July 5, 2018

With a Trade War Brewing, Returns Remain Difficult to Come By

Markets remained volatile in the second quarter with the topic of trade taking center stage. The protectionist rhetoric surrounding tariffs has left investors concerned about an escalating trade war and its potential impact on both the U.S. and the global economy.

Growth in both the short- and long-term is highly dependent on free trade given that some actions could disrupt production and increase costs for businesses and consumers alike. According to JPMorgan, the tariffs that have been imposed so far account for $54 billion of U.S. imports, and our trading partners have implemented tariffs on $22 billion of U.S. exports. This is equivalent to 2% of imports and 1% of exports. Because the tariffs enacted have been limited in scope, they should not materially alter the trajectory of U.S. growth and inflation.

While this is encouraging, the real risk is the unknown. There have been discussions of additional tariffs that have not yet been implemented - the next set of which is expected to be activated against China on July 6th. The potential impact of more tariffs and/or a further escalation of the situation, is fraught with downside risks to growth and remains a source of volatility for the global economy. For example, if the government were to impose the $275 billion in tariffs on autos and auto parts, as has been suggested, this would be equivalent to approximately 4% of U.S. gross domestic product (GDP) and would have a large, negative impact on the economy. However, it is difficult to predict what actions, if any, the Trump Administration will actually take on this front. What we do know is that trade-related headlines are unlikely to subside, so investors should remain ready for a bumpy ride and avoid overreaching for yield or return while we wait for clarity on this front.

A RISING DOLLAR CREATES HEADWINDS EX-U.S.

Beyond trade tensions, the other major theme during the second quarter was the rising dollar versus both developed market and emerging market currencies. The dollar rose on disappointing global growth, escalating trade tensions, and rising interest rates. The MSCI EAFE Index lost 1.24% for the quarter, while the MSCI Emerging Markets Index was down 7.96%. Emerging market economies tend to be highly levered to global growth and trade - especially in Asia, which represents about 75% of the Index. While it is not our base case scenario, the possibility of a significantly escalated global trade war could inflict more damage on emerging markets in the coming months. We are watching this situation closely and will make changes to our LightPoint™ portfolios as warranted.

The S&P 500 Index, a measure of the performance of large cap domestic stocks, rose 3.43% for the quarter. Small caps, which are not as sensitive to movements in the dollar as their large cap counterparts given that more of their revenue is generated domestically, returned 7.75% for the quarter. Despite a pullback in tech stocks, growth stocks continued to outpace value stocks with growth outperforming value by more than 8% year-to-date.

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BEACON WEALTH

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RISING RATES HURT FIXED INCOME

Over the last few years, companies have increasingly issued debt at longer maturities to take advantage of persistently low interest rates, while the credit rating of the U.S. investment grade universe has deteriorated. Combined, these factors have resulted in the fixed income asset class becoming riskier over time. As of June, the duration of the Bloomberg Barclays Aggregate Bond Index stood at 6.0 years - one of the highest readings on record. As such, it should come as no surprise that a record high duration combined with a backdrop of rising interest rates has resulted in losses for bonds over the last few months. The benchmark Bloomberg Barclays Aggregate Bond Index is down 1.62% on a total return basis so far this year while the Bloomberg Barclays Aggregate Global Bond Index is down 1.46%. Unfortunately, fixed income investors should expect further headwinds given that the Federal Reserve is likely to hike rates at least two more times this year.

Duration is a measurement of how long, in years, it takes for the price of a bond to be repaid by its internal cash flows. Bonds with higher durations carry more price volatility than those with lower durations.

COMPRESSED RETURNS CONTINUE TO FRUSTRATE INVESTORS

Overall, the first half of 2018 has been a frustrating one for investors. Through the end of the second quarter, the average balanced portfolio (as measured by the Morningstar® Moderate Target Risk Total Return Index) is down -0.31% before advisory fees are taken into consideration. This is quite a change from what investors have become accustomed to receiving over the last few years. Historically, the difference in returns between the top-performing major asset class and the bottom one often ranges between 35% and 60%. In 2018, the difference has only been about 14%. During periods of compressed asset class returns such as this, it is difficult to generate meaningful outperformance, and it may appear as if diversification is not working. What an investor gains in one asset class is easily offset by what he or she loses in another.

However, it's important to remember that **diversification does not mean that you will have solid, absolute returns year-in and year-out.** It means that over longer periods of time, diversification allows investors to achieve similar returns *with reduced volatility*, which ultimately can help investors stay the course in the face of uncertainty.

Also, while stocks tend to generate returns of 8% per year, this number is *averaged.* In reality, stock market returns are very lumpy. Investors can experience a few years of low returns or even negative returns. Double-digit returns tend to come in spurts, and those double digit years make up for the low return years. Muted returns happen every so often in the market (with notable occurrences in 2005 and 2011 as well) and should be expected. For those who have been invested in the market for a long time, you've likely made progress in recent years, so stay focused on your long-term goals. This period of low returns will eventually pass.

Thank you for your continued confidence. As always, please reach out to us with any questions you may have.

-Hillary Sunderland, CFA®, CKA®
Chief Investment Officer

4 RISKS TO THE RALLY

1) CREDIT SPREADS

The limited spread-tightening potential of corporate bonds combined with interest rates near historic lows could lead to increased volatility in the bond market as the Federal Reserve tightens rates. Leverage in credit has increased, and the economic cycle is approaching the point when credit spreads have historically started to turn.

2) FISCAL STIMULUS

Excessive fiscal stimulus in a full employment economy could lead to overheating.

3) TRADE TENSIONS

Continued trade tensions with China could disrupt supply chains for domestic companies and lead to accelerating inflation in the U.S. Higher inflation could encourage the Federal Reserve to raise interest rates more quickly than anticipated, which would likely slow the U.S. economy.

4) WAGE INFLATION

Tight labor markets could lead to wage inflation and cause the Fed to increase interest rates at a faster rate than anticipated.

Economic Backdrop

GROWTH

For the first quarter of 2018, economic growth came in slightly below consensus at 2.0%. However, monthly data on retail sales, homebuilding, durable goods, and inventories point to a rebound of about 4.1% annualized for the second quarter, which would boost year-over-year real GDP growth to approximately 3%.

EMPLOYMENT

The labor market continues to tighten. In May, the unemployment rate fell to 3.8%, while the labor force participation rate (the number of people who are employed or who are actively looking for work) registered a reading of 62.7%. Private payrolls grew at a disappointing rate in June as businesses struggled to find enough qualified workers for a record 6.7 million job openings. According to the Bureau of Labor Statistics, for the first time, there are more job openings than there are eligible workers to fill them. Economists expect that employers are going to have to do more to entice workers - likely through pay raises or other incentives. The upward pressure on wages could generate an inflation spike that would force the Federal Reserve to raise interest rates at a faster pace than anticipated.

INFLATION & INTEREST RATES

In May, inflation continued its gradual rise, which was in line with expectations. The headline consumer price index (CPI) rose to 2.8% year-over-year, while core inflation (which excludes food and energy prices) rose to 2.2% year-over-year.

At its June meeting, the Fed raised its target for the federal funds rate to a range of 1.75%-2.00%. In addition, they acknowledged gradually firming inflation and increased their inflation outlook for 2018 and 2019. Bond traders are currently pricing in two additional quarter-point rate hikes by year-end. With interest rates set to continue rising, bonds are likely to face continued headwinds.

Index Returns

	Year to Date	1 Year	3 Year Annlzd	5 Year Annlzd
Bloomberg Barclays Aggregate Bond Index	-1.62%	-0.40%	1.72%	2.27%
Bloomberg Barclays Aggregate Global Bond Index	-1.46%	1.36%	2.58%	1.50%
Russell 3000 Index	3.22%	14.78%	11.58%	13.29%
MSCI ACWI ex-US Index	-3.77%	7.28%	5.07%	5.99%
Bloomberg Commodity Index	0.00%	7.35%	-4.54%	-6.40%

Source: Morningstar® as of June 30, 2018

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