July 17, 2018

Dear Valued Client:

Trade and geopolitical issues dominated the headlines this past quarter. Tariffs have been the modus operandi used to address trade imbalances and so far this renegotiation of trade agreements has created uncertainty that does not seem poised to abate. Nevertheless, markets are for now focused on fundamentals and that story remains intact, at least in the U.S.

The U.S. was buoyed by solid earnings reports in Q1, high expectations in Q2, and continued strength among the leading indices. The strength of the U.S. economy has kept the Federal Reserve's rate hike plan on pace and has helped to boost the dollar (up 5.1% in Q2 vs a basket of 16 other currencies) following last year's decline.

As a result, money flow to the U.S. from overseas took place in earnest towards the second half of the quarter with the Wall Street Journal reporting U.S.-focused firms attracting $3.2 billion of inflows in the second quarter, compared with $25 billion in outflows for European-focused funds.

On the plus side, if you are planning a trip abroad, that strong dollar should work in your favor!

Second Quarter Market Review

Global equity markets recorded a modest 0.7% gain for the second quarter of 2018, as measured by the MSCI ACWI Index, while the Bloomberg Barclays Global Aggregate Bond Index declined 2.8%.[i] As noted above, the US outperformed international markets amid a divergence in economic data, escalating trade tensions, and a strengthening US dollar. Despite the performance gains in technology-related stocks, the first half of 2018 saw flat-to-negative results across many asset classes, as global stocks declined 0.1% and global bonds were down 1.5%.

The S&P 500® Index of large-cap US stocks rose 3.4% during the second quarter, supported by improved economic growth. Small caps outperformed larger multinational companies, which were weighed down by the threat of a trade war and an appreciating US dollar. Among sectors, energy stocks rebounded with a 13.5% gain as lower global inventories drove higher oil prices. Growth-oriented sectors such as technology (+7.1%) and consumer discretionary stocks (+8.2%) continued their strong run, while defensive and higher-dividend sectors such as consumer staples (-1.5%) and telecoms (-0.9%) lagged.

The MSCI ACWI ex-US Index of international stocks declined 2.4% during the quarter, as the depreciation in foreign currencies versus the US dollar detracted from returns. Broader Europe (-0.9%) was weighed down by weaker economic data and concerns over protectionist trade policies. In the Asian region, Japan (-2.8%) was hurt as its economy contracted 0.6% in the first quarter and inflation remained far short of the central bank's 2% target. Emerging markets (-7.9%) felt the larger impact of US-China trade tensions, with Brazil (-26.4%) hit hard by economic uncertainty and the depreciation of its currency.

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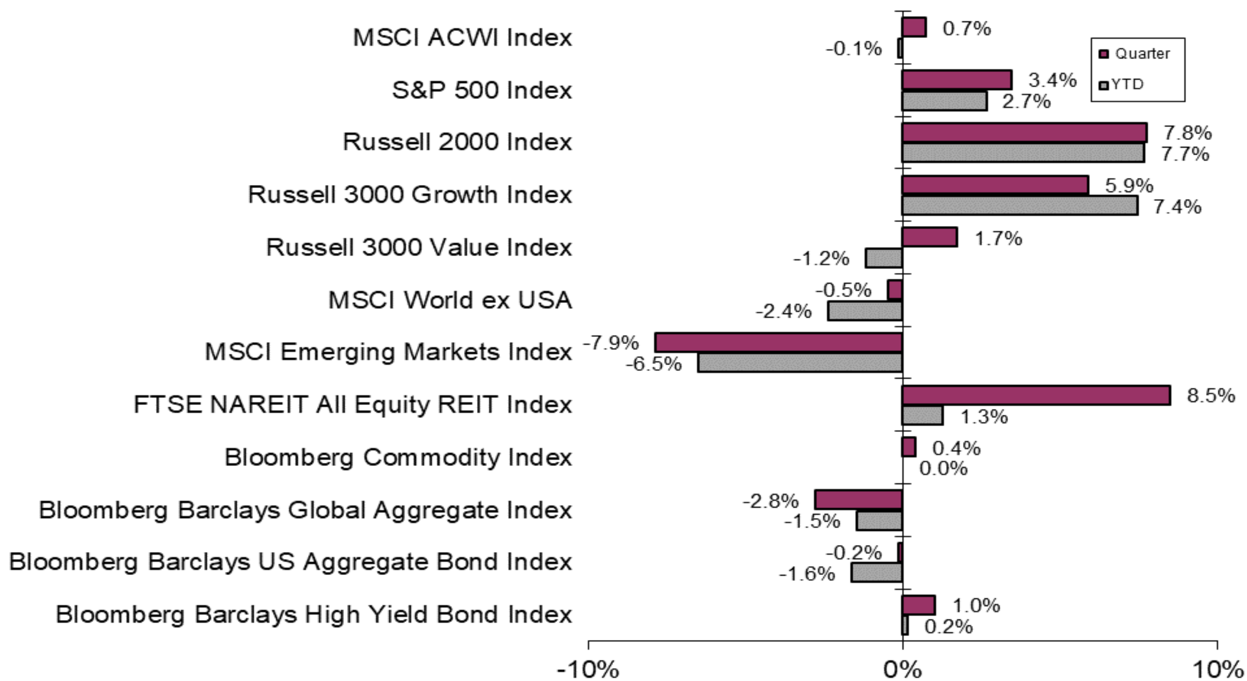
In fixed income, the Bloomberg Barclays US Aggregate Bond Index was down 0.2% for the quarter, as bond yields rose and the Treasury yield curve flattened. Intermediate-term bonds tended to lag shorter and longer maturity issues. Government bonds (+0.1%) outperformed investment grade corporate bonds (-1.0%) with the widening in credit spreads. High yield bonds (+1.0%) benefited from their higher coupons and underlying strength in the US economy. International bonds (-4.8%) were weighed down by the strength in the US dollar, including emerging market issues (-2.4%).



An index is a portfolio of specific securities, the performance of which is often used as a benchmark in judging the relative performance of certain asset classes. Indices are unmanaged, with no associated expenses, and investors cannot invest directly in an index. All index returns shown in the table represent total return figures in US dollars, with dividends reinvested, which means the returns include not only the change in prices for the securities in the index, but any income generated by those securities.
Sources: Bloomberg, Barclays, Dow Jones, Morningstar, MSCI Barra, Russell, Zephyr Associates.

Economic Highlights

US economic growth was 2.0% for the first quarter of 2018, down from the 2.9% reading in the fourth quarter. This reflected a slowdown in consumer spending and residential investment, but data suggests that growth rebounded in recent months. The Federal Reserve Bank of Atlanta forecast that GDP rose 3.8% in the second quarter, with consumer spending up 2.7% versus 0.9% for the first quarter. [ii] Analysts expect earnings for S&P 500 companies to increase 20% for Q2 2018 (versus the prior year), led by a rebound in the energy sector. Earnings for all of 2018 are also projected to grow 20% compared to 2017.[iii]

The Federal Reserve (Fed) increased short-term interest rates by 0.25% at the June FOMC meeting, raising the new target range for federal funds to 1.75%-2.00%. Employment conditions continued to be strong with the unemployment rate at 4.0% in June. Prices moved higher with the Consumer Price Index inflation rate up 2.8% for the 12-month period through May, lifted by higher energy prices. Core inflation (excluding food and energy) increased 2.2% over the same period.[iv] Positive readings on economic growth, employment, and inflation suggest that the Fed could raise rates twice more in 2018.

Tariffs

As noted above, the second quarter of 2018 was full of headlines relating to tariffs. President Trump has made it very clear that unless global trade policies are revised, they are going to be a large part of his agenda.

So what is a tariff? The goal of a tariff is to add to the cost of imported goods in the form of a tax commonly seen as either Specific or Ad Valorem. Specific tariffs place a set fee on each type of imported good. For example, a country may decide to place a fee of $50 per television imported, but place a fee of $2,000 per car imported. President Trump and his administration have centered their policies around the Ad Valorem tariff, which translates to "according to value." Instead of a flat rate, this tariff taxes a type of good based on a percentage of price. For example, a computer that costs $1,000 will have a higher fee placed on it than a computer that costs $500.

The history of the United States and tariffs has not been great. The last big set of tariffs came through the Smoot-Hawley Tariff of 1930. The legislation raised U.S. tariffs on more than 20,000 imported goods at a time when the Great Depression was in its infancy. More than 1,000 economists signed a petition to try and persuade President Hoover not to pass the bill. The petition stated that the tariffs would raise the cost of living, limit our exports due to retaliation by other countries, injure investors, and damage foreign relations. They were right. In fact, many economists argue that this act led to a lengthening of the Great Depression while others argue that the act itself created the worldwide disaster.

Like President Hoover, President Trump has had his share of opposition to his strategy. What is he trying to accomplish? The first issue he is trying to address is trade deficits. The largest trade deficit he is currently going after is China at $375 billion (2017). President Trump has also eyed deficits from NAFTA partners Canada and Mexico as well as the European Union (EU). President Trump's goal is to reduce our trade deficit as much as possible by attempting to persuade nations to remove their tariffs and tear down their trade barriers. During the G7 Summit, Trump stated "Ultimately, that's what you want. You want tariff free, no barriers, and you want no subsidies."

The second issue President Trump is targeting is intellectual property theft. China has an active business policy that prohibits foreign companies from going to market unless they technology transfer. The technology transfer comes down to trading trade secrets and company specific know-how in exchange for access to Chinese markets. President Trump views this as a huge problem as China can take the intellectual property they have forcibly taken, share it with Chinese companies that produce cheaper knockoffs that ultimately cut into the sales of the original designer. Trump sees this as an incredibly unfair trade barrier to gain access to the world's second biggest economy.

The tariffs implemented so far have been on four key goods: a 25% tariff on steel, 10% on aluminum, 30% on solar panels, and 20% on the first 1.2 million washing machines. There is also a 25% tariff on $34 billion of goods strictly imported from China that became active July 6th. Many countries affected by these tariffs, including our closest allies, have either announced or are strongly considering retaliation against the United States. In response, President Trump stated that he would enact even more tariffs.

To date, the impact of tariffs on the economy has been fairly benign. Economists have suggested that the overt impact to the $20 trillion U.S. economy should be minimal. However, outside of the hard numbers, the uncertainty of the trade situation may impact both sentiment and business planning- both of which may show up in earnings numbers down the road. As an example, the Boston area real estate market is feeling the pinch of tariffs on steel, lumber, and aluminum. The increasing cost of construction will likely have a reverberating effect for both the public and private sector. Globally, the U.S. is resetting trade with allies and non-allies alike, including renegotiation of trade agreements like NAFTA. We continue to monitor these events closely as the outcome of this situation is difficult to predict.

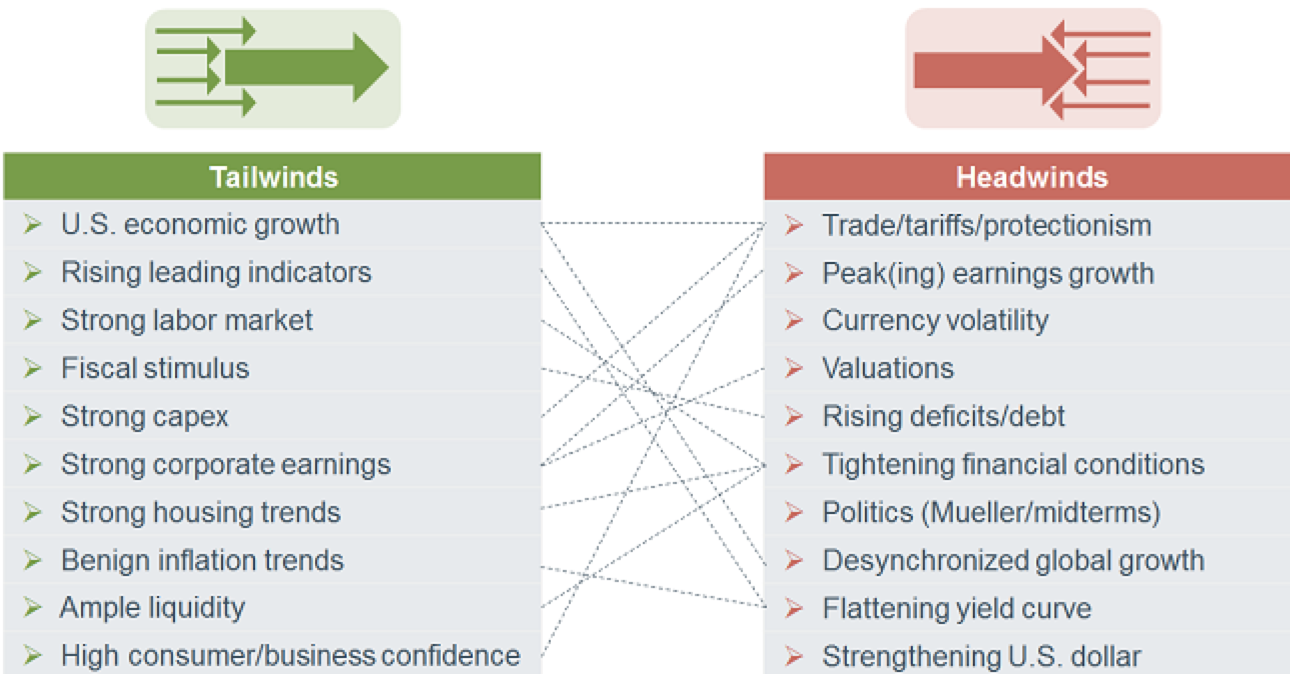
Outlook

The current rally in the US stock market is now in its 9th year and appears to be on track to become the longest in history. Since its official start on March 9, 2009, the current US stock rally has returned a whopping 302% from the market's low at the end of the Great Financial Crisis.[v] Since then it has grown, uninterrupted by a decline of 20% or more (i.e., the definition of a bear market). The prospect of breaking the longevity record is a double-edged sword for investors who are grateful for the rewards provided, but anxious about what they can look forward to in such an old rally.

While there is no question this rally is old, it seems in surprisingly good health. Economic growth appears to be strong (Atlanta Fed forecasted 3.8% GDP growth for Q2), corporate earnings continue to grow and even though interest rates have been rising, credit availability is still easy. The longevity of the current economic expansion may be explained by its slow rate of growth relative to other periods of economic expansion. More importantly, tax cuts, increased federal spending, and accommodative monetary policy have helped sustain the current cycle, which means this rally will not necessarily act its age.

Inflation appears to be on the rise. The Fed's preferred measure of inflation (which excludes energy and food) finally hit its 2% target for the first time in almost 6 years, and rising prices here and abroad have central banks either in tightening mode (U.S.) or non-easing mode (Europe).[vi] Given the positive earnings surprises, it would be fair to wonder why the market results have not been stronger for 2018. One answer may be that the focus of analysts and investors recently has been on trade policy and the potential impact of tariffs on the global economy.

Uncertainty over trade is likely to remain a major global theme. Liz Ann Sonders, Chief Investment Strategist at Charles Schwab, summarized the current state of potential market tailwinds and headwinds in the charts below.



Source: Schwab

In the U.S., where labor markets are strong, inflation still reasonable, and earnings still getting a boost from tax cuts, the story is relatively positive. As such, fund flows to the U.S. remain strong and supportive. We remain constructive on US Equities but tempering our return expectations.

As noted, the growth in the U.S. stock market has been driven by technology and consumer discretionary stocks. We have been positioned with an overweight position to technology for the past two years and continue to believe that this overweight is warranted. Russ Koesterich at BlackRock Inc.'s global allocation team recently noted that the price-earnings ratio (P/E) for the S&P 500 Information Technology Index has been no more than 13 percent higher than the S&P 500's P/E in 2018. Compared to the March 2000 peak of 166%, the sector does not appear to be in bubble territory.

Nevertheless, changes are coming to the tech sector categorization as a new communications sector is set to roll out in September. Facebook and Google parent Alphabet will be among the companies joining the new sector, which will also include Netflix and Comcast. The new sector will make up more than 10% of the broad S&P 500 index (WSJ 7-2-18). The impact of this change to the technology sector and the broader markets is not totally clear. We opted this quarter to reduce our dedicated technology exposure and take the profits to reinvest in the innovation fund we have discussed in prior communications.

We continue to do our due diligence on several new managers and will be adding a new hedged manager to our lineup. The new manager should complement our existing manager and provide further diversification to portfolios. In addition, we are reducing our direct emerging markets exposure. Emerging markets were quite accretive for the 5 quarters ending 3/31/18 but have been the victim of both disappointing growth versus estimates and the stronger dollar. We believe that these headwinds will be in place for the near term and are therefore shifting, on the margin, to better potential opportunities. We will be rebalancing portfolios this quarter.

PRW Wealth Management News

We are pleased to introduce Jared Sweeney, the newest addition to our growing team. Jared joins us with over 12 years of banking, lending, investment management, and financial planning experience. Jared received his B.S. in Economics from Rensselaer Polytechnic Institute and is currently pursuing his Certified Financial Planner designation. He and his young family live in Walpole where Jared is active in the community. We look forward to having you meet him.

In early April, Elliot shared some thoughts on lifestyle habits of millionaires that everyone should adopt https://www.thestreet.com/lifestyle/lifestyle-habits-of-millionaires-that-everyone-should-adopt-14547729.

Chris Stone was named Chair of the Membership Committee for the Boston Estate Planning Council while Janice Forgays joined the Education Committee. Chris also attended a conference on Financial Planning for Public Company Executives & Directors while Janice attended a Restricted Stock and Equity Options Planning seminar. **We continue to engage clients with these types of issues and encourage you to let us know if we can be of help to you or anyone who might benefit from our advice on these or any wealth management related planning.**

As always, please contact us if there have been any changes to your financial situation, your investment objectives, or your instructions concerning your account(s).

We look forward to seeing and working with you in the months ahead. Thank you.

Sincerely,

William A. Payne   Richard A. Renwick   Elliot B. Herman

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Index Definitions

MSCI ACWI (All Country World Index): A free float-adjusted capitalization weighted index that is designed to measure the equity performance of countries considered to represent both developed and emerging markets.

S&P 500®: An unmanaged index that is generally considered representative of the US equity market, consisting of 500 leading companies in leading industries of the US economy (typically large cap companies) representing approximately 75% of the investable US equity market.

Russell 2000: An unmanaged index that measures the performance of the small cap segment of the US equity universe. It is a subset of the Russell 3000 Index based on market capitalization.

Russell 3000 Growth: An index that measures the performance of the growth segment of the US equity universe. It includes those Russell 3000 companies with higher price-to-book ratios and higher forecasted growth rates.

Russell 3000 Value: An index that measures the performance of the value segment of the US equity universe. It includes those Russell 3000 companies with lower price-to-book ratios and lower expected growth rates.

MSCI World ex USA: An index that captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries – excluding the United States. With 1,020 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI Emerging Markets: A free float-adjusted, market capitalization index that is designed to measure the equity market performance of countries considered to represent emerging markets.

FTSE NAREIT All Equity REIT: A broad measure of the performance of publicly traded real estate securities, such as real estate investment trusts (REITs) and real estate operating companies.

Bloomberg Barclays Global Aggregate: An index of global investment grade debt from twenty-four local currency markets including treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. The index also includes Eurodollar, Euro-Yen, and 144A Index-eligible securities, and debt from five local currency markets.

Bloomberg Barclays High Yield Bond: An index measuring the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes emerging market debt.

Bloomberg Barclays US Aggregate Bond: An index covering the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS sectors. US Agency Hybrid Adjustable Rate Mortgage (ARM) securities were added to this index on April 1, 2007.

Bloomberg Commodity: A broadly diversified index that allows investors to track futures contracts of physical commodities traded on US exchanges. The component weightings are determined by several rules designed to ensure diversified commodity exposure.

[i] Unless otherwise indicated, all index returns are from FactSet
[ii] Source: Bureau of Economic Analysis (Federal Reserve Bank of Atlanta GDP forecast as of 7/6/18)
[iii] Source: FactSet
[iv] Source: Bureau of Labor Statistics
[v] Source: FactSet; reflects cumulative price return for S&P 500 index (total return is 389%, including dividends)
[vi] Source: Bureau of Economic Analysis (Federal Reserve Bank of St. Louis, FRED database)

Tariff Section Sourcing:

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