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Quarterly Market Review
Second Quarter 2018

TECHNOLOGY SHARES AND SMALL-CAPS OUTPERFORM AS MARKET RECORDS MODEST OVERALL GAINS
Stocks recorded decent gains in the second quarter, although the performance of the major benchmarks varied considerably. The technology-focused Nasdaq Composite Index outpaced the large-cap benchmarks and reached new highs, helped by the continued strong performance of many "mega-cap" technology firms. The smaller-cap indexes also outperformed and set new records late in the quarter. The narrowly focused Dow Jones Industrial Average lagged as escalating trade tensions weighed especially on several of its export-focused components. Growth shares continued to outpace their value counterparts, except in the small-cap space. Volatility, as measured by the Cboe Volatility Index, subsided a bit from the multiyear peaks reached early in the previous quarter, but the market continued to see larger price swings relative to 2017's remarkably steady climb upward. Within the S&P 500 Index, energy shares performed best as oil prices climbed to four-year highs, while industrials and business services, financials, and consumer staples shares endured losses.

Investment Performance	2012	2013	2014	2015	2016	2017	2018 YTD
Growth & Value Strategy (NET of all fees & commissions)	17.95%	43.51%	6.59%	3.27%	1.98%	16.68%	4.68%
Balanced Fund Index (including all dividends)	13.95%	19.25%	5.97%	0.65%	5.92%	18.01%	1.42%
S&P 500 (including all dividends)	13.40%	32.39%	11.35%	1.38%	11.96%	21.83%	-0.77%
NASDAQ (dividends not included)	15.91%	38.32%	13.17%	5.73%	7.50%	28.24%	2.32%

TAX CUTS AND GLOBAL GROWTH SPUR BEST PROFIT GAINS IN NEARLY A DECADE
Generally, the second quarter seemed characterized by a tug of war between positive corporate fundamentals and a negative political backdrop. April and May brought evidence that corporate earnings had accelerated even more than expected following the December 2017 tax cut and further stimulus provided by federal spending increases in March. According to data and analytics firm FactSet, earnings for the S&P 500 as a whole rose by 24.6% in the first quarter relative to a year earlier, marking the best increase since profits rebounded following the Great Recession nearly a decade ago. Steep cuts in the corporate tax rate deserved part of the credit, but top-line revenue growth also surprised on the upside. Indeed, more than three-quarters of firms reported higher-than-expected increases in both earnings and revenues.

Economic signals were less impressive overall but still encouraging. The quarter started on a down note, with the S&P 500 recording its biggest daily drop of the period on April 6, after March payroll gains came in substantially below expectations. U.S. Economists noted that the solid employment growth trend appeared intact, however—an outlook that later proved justified as payroll gains rebounded in April and May and brought the unemployment rate down to 3.8% in May, its lowest level in 18 years. Gauges of manufacturing and service sector activity remained elevated, if down a bit from multiyear peaks reached early in the year.

Housing data were a bit more mixed. Home prices and existing home sales continued to increase at a healthy clip, but home construction lagged as builders appeared to focus on the higher end of the market.

FED LIKELY TO REMAIN PATIENT

Throughout the quarter, investors kept a close eye on whether the tightening labor market—with the unemployment rate already well below a level indicating full employment, according to most measures—would prompt the Federal Reserve to pick up its pace of interest rate increases. After keeping rates steady in May, the Fed raised rates by another quarter point at its June meeting, as was widely expected. Investors seemed to have modestly negative reactions to the Fed's accompanying statement, however, which indicated that a majority of policymakers now expected four interest rate increases in 2018, versus three—suggesting two more hikes were likely to come in the second half of the year.

TRADE WORRIES APPEAR TO KEEP A LID ON GAINS

Trade tensions clearly deserved much of the blame for stock prices being unable to follow profits higher. Market indexes recorded sharp intraday declines on several occasions in the quarter following the announcement of new tariff threats from the Trump administration, as well as vows of reprisals from U.S. trading partners. The growing trade conflict between the world's two largest economies—the U.S. and China—garnered the most attention. Over the quarter, the Trump administration announced a steady escalation in possible tariffs on Chinese goods, eventually reaching $200 billion on a range of goods by late June. In late May, the U.S. also extended the metals tariffs to Canada, Mexico, and the European Union (EU), while the Department of Commerce announced that it was considering raising tariffs on auto imports on national security grounds.

Whether the mounting threats were merely negotiating tactics on all sides remained unclear, but markets appeared to waver late the in the quarter as evidence emerged that the prospect of tariffs was already impacting corporate strategy and profit outlooks. Stocks slumped in particular on June 21, after German automaker Daimler lowered its profit outlook due to prospective higher tariffs on SUVs it manufactures in the U.S. and sells in China. A few days later, Harley-Davidson revealed in an SEC filing that it was planning to move some of its motorcycle production overseas to avoid retaliatory tariffs recently announced by the EU. Shares of Boeing, Caterpillar, and other U.S. industrial firms also fell sharply late in the quarter as concerns grew about their export markets. Signs of slowing growth in Europe and China, even in advance of an all-out trade war, also weighed on sentiment toward exporters.

EARNINGS CONTINUING TO RISE FASTER THAN STOCK PRICES WOULD MAKE VALUATIONS MORE COMPELLING

Investment officers observe that earnings growth will likely slow from its rapid first-quarter pace over the rest of the year, but only moderately. Nevertheless, they caution that investors should expect lower returns relative to the last couple of years. On balance, U.S. large-cap valuations, as measured by the S&P 500 Index, still appear moderately expensive—off recent peaks but still far from compelling. A relatively painless path to more attractive broad valuations, they observe, would be if earnings continued to rise at a faster pace than equity prices over the balance of 2018 and into 2019.

If you have any questions, please feel free to contact me at 513-257-5949.

Sincerely,

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