Q2 Market Commentary

Business Cycle Update

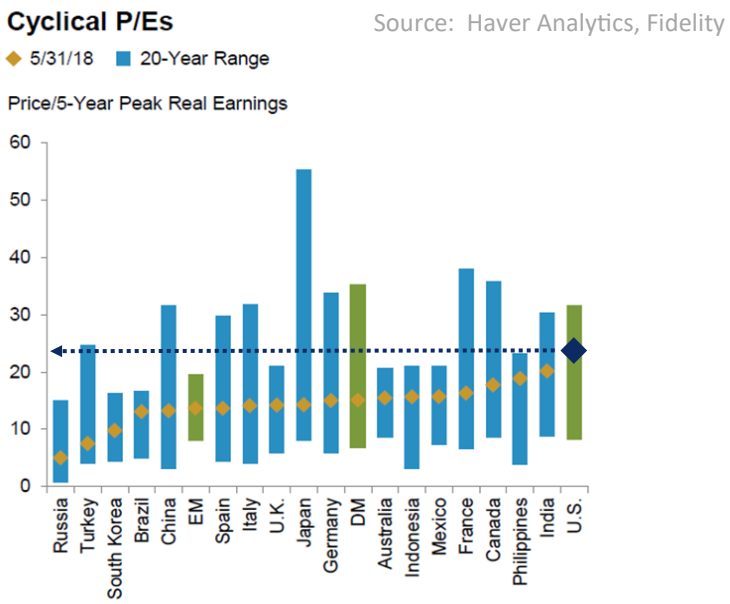
Q2 was a volatile quarter for global assets with a combination cyclical and political forces pushing most assets lower.

The rotation of the business cycle exerts enormous influence on asset class performance. In the US, the current business cycle continues to transition into the late cycle or "*slowdown*" phase. Consistent with this stage of the cycle, asset volatility picks up, inflation pressures build, short-term interest rates rise, and inflation-seeking assets like oil and energy stocks tend to outperform. Q2 was an excellent demonstration of these stereotypical dynamics.

Of course, these normal cyclical forces aren't the only things influencing markets. Political forces, which are far less predictable, have been playing an increasingly dominant role in 2018. For example, Q2 was brimming with trade war rhetoric which applied its own unique market pressure. This political risk had a disproportionate impact on assets that typically benefit from the current cyclical environment. In particular, emerging markets assets and select commodity markets (e.g. major US exports like corn and soybeans) saw what are normally positive cyclical forces overwhelmed by downward pressure from trade war concerns.

Despite the turmoil created by these trade war fears, large US technology companies (e.g. Amazon, Netflix and Facebook) continued to climb, increasingly behaving like "safe haven" assets. The S&P 500 gains in 2018 have been driven entirely by just a handful of stocks (see graph on next page). This performance has extended one of the largest gaps in US vs. global stock valuations in history. ■

US Stock Valuations are now the Highest in the World



Five Things You Should Know about Q2

1. Trade war fears escalate

Trade war rhetoric amplified through June. International stocks and bonds decline along with export focused US sectors like industrials.

2. Tech & oil stocks lead

The technology and energy sectors, which represent 1/3 of the S&P 500, were top performers. They benefitted from positive sentiment, share buybacks and a rally in oil prices.

3. Emerging markets worst performers

Strong fundamentals notwithstanding, emerging market stocks suffered the largest declines in Q2. These stocks now trade at the steepest discount to US stocks in over 16 years.

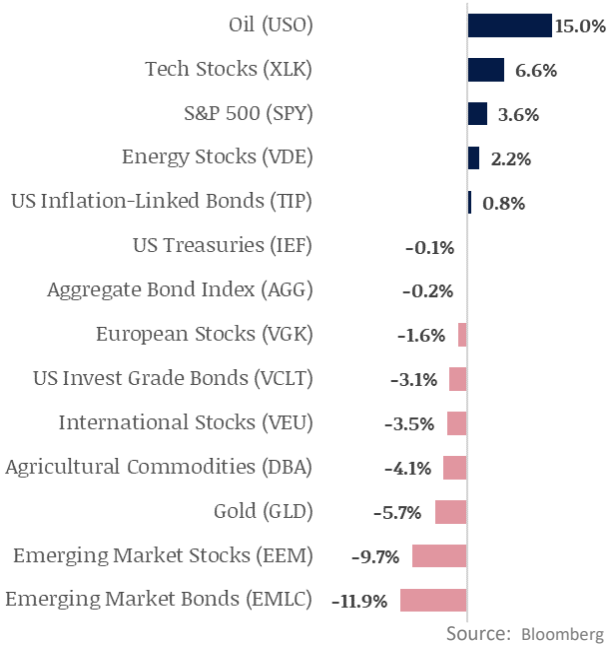
4. Commodities mixed

Oil sharply rebounded in Q2, while agricultural commodities (like soybeans...a major US export) and metals (like gold, copper and aluminum) suffered declines.

5. Growth strong, but drivers are peaking

Q2 economic growth remained strong through the world; however, tailwinds are diminishing. Central bank tightening in the US and preparing to tighten globally. In the US, one-time stimulus from tax cuts and tax amnesty on repatriated overseas corporate cash is set to fade in the second half of 2018.

Asset Class ETF Total Returns: Q2 2018



When Diversification Disappoints

Hudock Capital Group, LLC

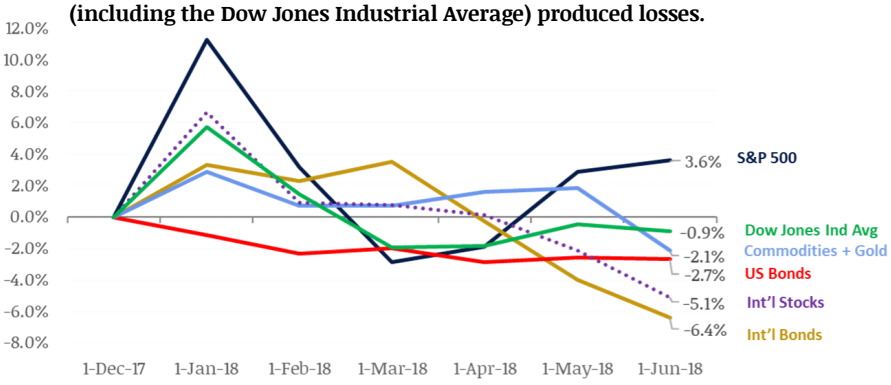
Diversification's Temporary Failure

2018 has been unusually dissatisfying for anyone with a diversified portfolio. While US stock market returns have been volatile, the S&P 500 has managed to grind higher, up +2.5% through June. Meanwhile, most every other asset class and diversifier is lower year-to-date—these include long-term US investment grade bonds (-6.9%), gold (–4.0%), and international stocks (-5.1%).

Squinting at the S&P 500 returns reveals all the performance this year have come from just 10 stocks (mostly large tech companies). As the chart below illustrates, the remaining 490 stocks in the index have generated losses. Both internal and cross-asset class diversification has been more of a hinderance than a help thus far in 2018.

S&P 500 Leads After a Volatile First Half of 2018

After a volatile year for global assets, the S&P 500 managed a YTD gain (driven largely by tech stocks), whereas most every other major asset class (including the Dow Jones Industrial Average) produced losses.



ETF tickers & weights of asset class proxies: S&P500 = 100% SPY; Dow Jones Industrial Avg = 100% DIA; Commodities + Gold = 100% DJP + 50% GLD; US Bonds = 100% SCHX; Int'l Stocks = 50% EEM + 50% EFA; Int'l Bonds = 50% EMLC + 50% BWX.

Source: Bloomberg

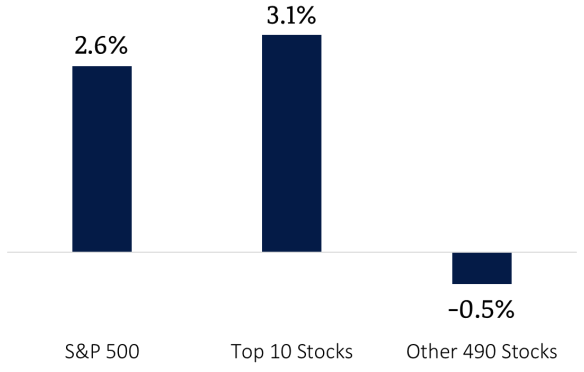
If You Can't Beat Them…Join Them?

If diversification isn't working, why stick with it? The short answer is that, over time, nothing works better. Diversification doesn't produce superior returns 100% of the time. Yet, no other investment technique has consistently offered the average investor the opportunity to improve returns and lower extreme downside risk like diversification.

If investing were as simple as buying what's done well, and selling what hasn't, then the average investor would have above average returns. Unfortunately, they don't. Studies have shown investors who practice this natural human inclination invariably underperformed by a wide margin.

YTD S&P 500 Performance from 10 stocks

S&P Performance Attribution, First Half 2018



Top ten stocks = Amazon, Facebook, Apple, Microsoft, Netflix, Adobe, Cisco, Nvidia, Visa, Mastercard. Source: Bloomberg

What is Diversification Anyway?

For starters, let's simplify what diversification really is: preparing for a range of unknown economic outcomes. We know that the economic environment (whether influenced by cyclical or idiosyncratic forces) drives asset performance. When does a diversified portfolio produce disappointing returns? When a single economic environment persists for a long time. Such has been the case for the past several years, with the US enjoying the longest economic expansion in over a century with little to no headwinds from inflation.

Any decision to abandon diversification in order to chase performance is really just a bet on the current economic environment staying the same. The status quo seems especially unlikely considering the unique circumstances that produced this environment in the first place. Let's review: record amounts of monetary stimulus, near-zero interest rates, record low inflation and, recently, massive one-time stimulus from tax cuts coupled with large government deficit spending. Looking ahead, each of these economic forces are set to reverse. Add to that list the rise of protectionism and it is extremely likely the next few years will look very different from the past decade.

Owning Underperformers

Diversification also includes owning assets that underperform. At times, this places huge demands on investor pa-

tience. As any great value investor would tell you, the best investment opportunities are found in falling markets, not bull markets. Exhibit 3 shows how "bottom feeding" on the worst performing asset classes of the prior year would have outperformed the best performers. A diversified portfolio holds a mix of both, ensuring new sources of growth are in place when performance leadership rotates.

It's important to remember that investing is a forward looking game, not a rear-view mirror exercise. Yes, trends can be powerful drivers of short-term performance, but no trend lasts indefinitely. If you believe change is inevitable, then diversification remains the most reliable and enduring option. ■

Exhibit 3: Performance Chasing & Its Malcontents

Growth of $10,000 invested annually over 20 years
Period ended June 30, 2018

	Total Investment	Portfolio Value	Avg Annual Return
Chasing the winners Investing in last year's two best-performing asset classes	$200,000	$429,082	6.81%
Bottom-feeding Investing in last year's two worst-performing asset classes	$200,000	$480,240	7.76%
BALANCED ALLOCATION Investing consistently across many asset classes in equal proportion each year	**$200,000**	**$483,019**	**7.81%**

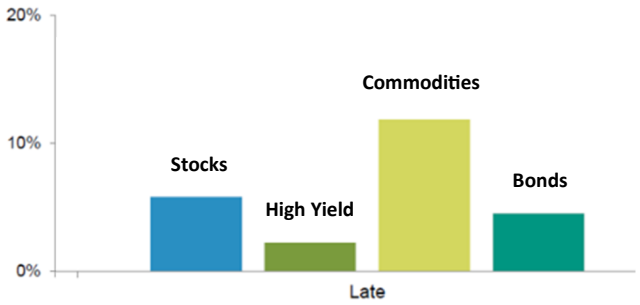
Over 20 years, a portfolio of last year's "losers" would have meaningfully outperformed one with last year's "winners"…while a diversified portfolio would have beaten both.

Source: Morningstar, Franklin Templeton

Commodities Historically Perform Best in the Late-Cycle

Asset Class Performance in Mid- and Late-Cycle Phases (1950–2010)

Source: Fidelity, Morningstar, Bloomberg



Late Cycle: Mixed Asset Class Performance
- Favor inflation-resistant assets
- Gains more muted

Current Tactical Positioning

Our seasonal adjustments are as follows:

1) Overweight commodity exposure
2) Slight overweight energy sector and emerging market stocks
3) Underweight bonds, especially high yield bonds
4) Underweight overall model risk

Opportunities and Risks

The 2018 kerfuffle over tariffs has created unique opportunities in both commodities and emerging markets. Emerging market assets in particular have a combination of excellent long-term underlying fundamentals combined with low valuations from massive outflows.

We are balancing these opportunities with an ongoing gradual reduction in overall portfolio risk as the cyclical pressures of an economic slowdown continue to gather. Downside risks are magnified.

As always, these tactical views are executed in the context of a broadly diversified portfolio that we believe is well positioned for a slowing and more challenging economic environment going forward. ■

Opportunities in Emerging Market Stocks

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