Macro Summary

- In the United States, pro-cyclical tax reform and deregulation continue to offer near-term support for financial markets and the economy.
- Gross Domestic Product (GDP) growth in the US is approaching 3 percent, with Leading Economic Indicators currently telegraphing no recession in sight.
- Inflation is increasing from low levels amid tightening labor markets.
- West Texas Intermediate crude (WTI) August contracts were up nearly 23 percent through the year's midpoint. Brent crude August contracts were up nearly 19 percent YTD through June 30.
- Increasingly aggressive trade policy, if implemented, is a risk, but it is impossible to predict its final form or impact at this time.
- Housing starts were up 10.20 percent in the first 5 months of 2018 versus the prior year and based on population growth and 'scrappage,' housing should have tailwinds. Tight labor markets and the rising cost of materials are potential headwinds.
- Mid-term elections will be a headline and likely source of increased volatility in the financial markets over the next several months.
- Chinese stocks narrowly entered a bear market (a decline greater than 20 percent from high) in the first six months of 2018, the Shanghai Composite declined 13.90 percent through June 30 and China targets modestly lower growth as their government balances growth with needed reforms including 'controlling debt risks.'
- Following the Federal Reserve's lead, the European Central Bank (ECB) is planning initial steps to unwind quantitative easing with bond purchases set to end in September.
- Eurozone debt issues re-emerged with Italy of more prominent concern.

	Q2 RETURN	YTD RETURN
Standard & Poor's 500	2.93%	1.67%
Balanced Portfolio - 60 / 40	1.79%	0.62%
Dow Jones Industrial Average	1.26%	-0.73%
MSCI EAFE	-2.34%	-4.49%
Barclays Aggregate Bond	-0.16%	-1.62%
Barclays Municipal Bond	0.87%	-0.25%

As can be gleaned from the returns noted above, gains have generally been much harder to come by thus far in 2018. Last year by contrast, complete with the near absence of volatility, saw strong returns across many economic sectors, as well as both domestic and international markets. Domestic stocks were out of the gate fast this year, with the Standard & Poor 500 Index (S&P 500) rising more than 7 percent in just the first 18 trading sessions. Permeating investor's minds in the first quarter was a decline that pushed the S&P 500 just low enough to be termed an official 'correction' as defined by a decline of more than 10 percent. From January 26 to February 9 the S&P 500 had declined 10.20 percent, but the recovery was yet again quick, as the S&P 500 ended down a mere 1 percent in the first three months of 2018. This was the first negative quarter for the S&P 500 since third quarter 2015.

International and emerging market stocks have underperformed the US equity markets through the first half of the year. Broad indices of developed international markets, such as the MSCI EAFE indicated above, are negative on the year. Emerging markets have had an even greater struggle, with countries such as Brazil, China, and Turkey among the countries posting the largest losses year-to-date.

Recalling the inverse relationship between interest rates and bond prices, rising interest rates have generally pushed intermediate and long-term bond indices into negative territory with the Bloomberg Barclays US Aggregate Bond Index down 1.62 percent through June 30. Short-term bonds have largely benefited as the Federal Reserve has raised the fed funds rate and are fractionally positive for the year.

After average daily market volatility increased in the February to April time frame, market volatility has fallen to more typical levels again, albeit still elevated from the anomaly that was 2017. The second longest (and seemingly indefatigable) bull market in United States history continues the fight, with the S&P 500 trudging its way back into positive territory at the mid point. We see positives in between the fears that come at us daily in the form of news headlines. We remain favorable on the economy and financial markets, though certainly not without concerns. As the market variably and inevitably moves through challenging periods, we are mindful of the challenge to the investor to step back from the emotional day to day, heeding the greater opportunity for rationality afforded only by taking the longer and wider view.

The Economy

The US economy remains a bright spot, with recent gains in housing starts and new home sales and a rise in Leading Economic Indicators. Cross currents certainly exist, including recent slight declines in existing home sales and consumer confidence. The Bureau of Economic Analysis (BEA) released its final estimate of first quarter real gross domestic product on June 28, revising its earlier estimates downward to a 2 percent annual rate, coming in below consensus expectations of 2.20 percent.

- The Federal Open Market Committee (FOMC) estimated full year real GDP at an approximate 2.8 percent rate, indicating an expected material acceleration of the economy which may have started during the second quarter.

- The Institute for Supply Management (ISM) Manufacturing Index seems to reinforce the prospective acceleration of GDP growth, rising above the Wall Street consensus to 60.2 in June. A level above 50 signals economic expansion while a level below 50 indicates contraction.

- Through the first half of 2018, the ISM Manufacturing Index has averaged 59.2, its best first half since 2004.

- The ISM survey respondents indicate tightening labor markets and a difficulty finding both skilled and unskilled labor to fill open positions pushing average hourly earnings growth to 2.70 percent versus 2017.

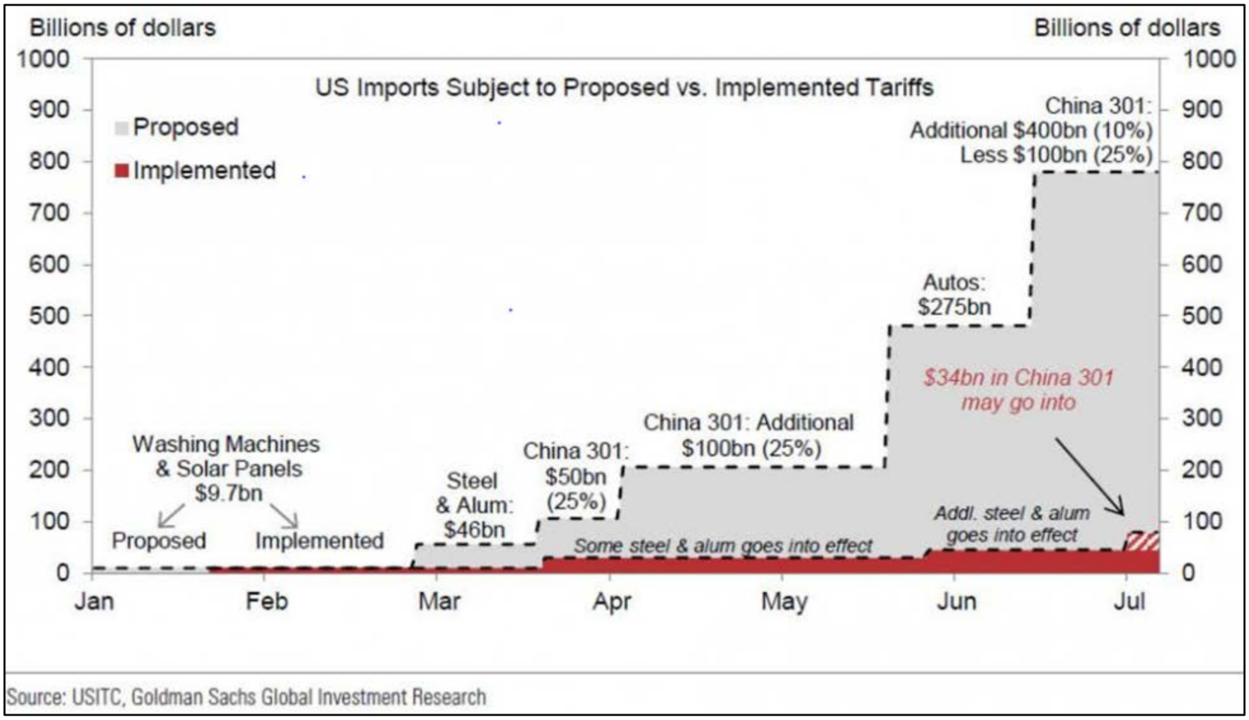
- Other indirectly positive signs for labor markets are declining numbers of people receiving food stamps and Social Security disability benefits.

- Inflation remains contained but moving closer to Federal Reserve Chairman Jerome Powell's target. Personal Consumption Expenditures (PCE) or core prices increased 2 percent over the past year. This is the first time in six years the core index touched 2 percent on a twelve-month basis.

- The broader Consumer Price Index (CPI) over the one year ending May 2018 is up 2.8 percent, largely driven by increasing energy prices.

Tariff Spotlight

Prior to passage in 1913 of the 16th amendment which allowed Congress to implement federal income taxes, tariffs were the primary sources of revenue for the United States, often funding as much as 90 percent of the federal government. By contrast, tariffs now account for approximately 1 percent of federal revenue, likely totaling over $40 billion this fiscal year according to the White House Office of Management and Budget. Tariffs remain a headline and we won't be surprised to see it as a continuing theme from the Trump administration. What began as a volley of threats and rhetoric did finally give way to implementation. However, as the chart below indicates, the disparity between proposed and implemented tariffs is wide.



- The United States Chamber of Commerce estimated that an approximate $75 billion worth of US exports will be subject to retaliatory tariffs from China, the European Union, Mexico, and Canada.

- With respect to China, Goldman Sachs noted that while tariffs certainly pose a risk to market sentiment, the 'potential impact to aggregate S&P 500 earnings per share is limited given exports to China comprise just 1 percent of U.S. GDP.'

Tariffs vary widely, but there is certainly disparate treatment in many industries. By way of one example, the worldwide auto industry needs to navigate the following:

- Vehicles shipped from Europe to the US face a low 2.50 percent tariff. Conversely cars built in the United States face a 10 percent tariff in Europe.

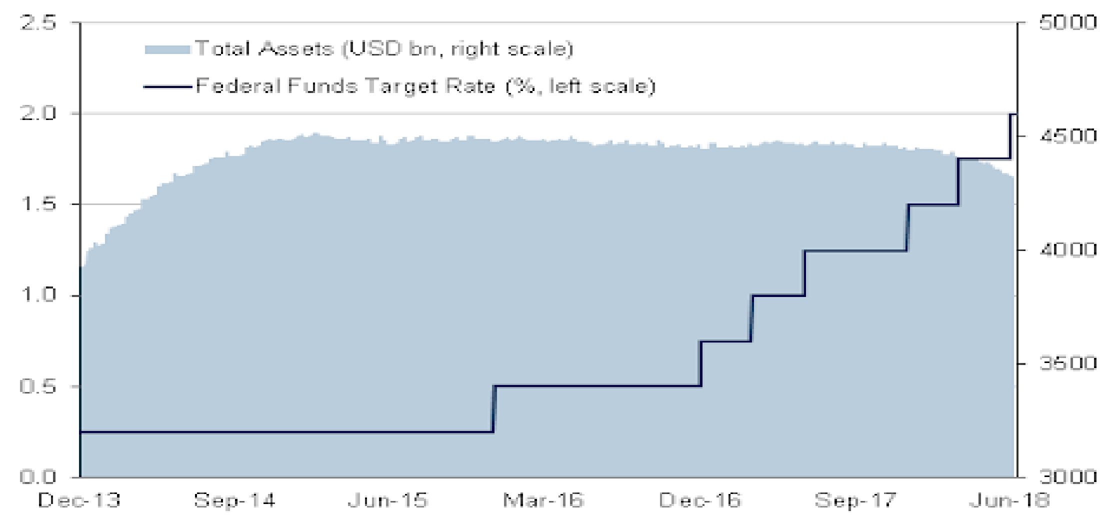
- The United States imposes a 25 percent tariff on imported pickup trucks, while Europe imposes a 10 percent tariff on US pickup trucks.

- In May, the Chinese Finance Ministry announced a cut on import duties on passenger vehicles from 25 to 15 percent.

Tariffs on foreign imports will add cost to the US consumer and new retaliatory tariffs on United States exports will hurt certain businesses. Unless an extended and more encompassing trade war ensues, we believe that, as of yet, any effects are likely to be more muted than headlines would lead one to believe. As always, our team will take the facts as they come.

The Federal Reserve

United States Monetary Policy Chart



Note: Total assets on the balance sheet of the Federal Reserve in USD billion and Federal Funds Target Rate in %. Current rate set at a range of between 1.50% and 1.75%.
Source: Federal Reserve

- The Federal Reserve has raised the federal funds rate twice in Chairman Powell's short tenure, once in March and again in June, to a current level of 1.75 – 2.00 percent. We believe there are two additional rate increases this year.
- Concurrent with the June rate increase, the Fed revised its 2018 GDP growth forecast upward to 2.80 percent from previously 2.50 percent in December.
- Looking ahead, the Fed currently expects three ¼ point rate hikes in 2019. If these hikes come to fruition, the Federal Funds rate will finish 2019 at a range of 3.00-3.25 percent.
- The Federal Reserve will continue reducing its balance sheet at a pace of $30 billion per month, increasing to $40 billion per month in Q3, and $50 billion beginning in Q4. Prior to the financial crisis, the Fed's balance sheet was a comparatively modest $800 billion,

but ballooned to approximately $4.5 trillion through a series of asset purchases designed to support the economy and spur economic growth.

- The Fed's inflation forecast moved higher as well for 2018, to 2.10 percent from 1.90 percent, while the unemployment forecast was lowered from 3.80 to 3.60 percent.

In the financial markets, a 'put' gives the owner protection against market declines below a certain price. While Jerome Powell began his tenure as Chairman of the Federal Reserve in February of this year, our early observations would seem to indicate he may be the first Fed Chair since Paul Volcker (1979-1987) to not have the word 'put' affixed to his name. From the time Alan Greenspan assumed his place as Chairman in 1987, months ahead of the October 1987 crash, followed in 2006 with the appointment of Ben Bernanke just a few years ahead of the Great Financial Crisis, and Janet Yellen in 2014 amidst Quantitative Easing 3 (QE3), each of these Fed Chairs were presumed to be acting at times to attempt to protect investors from market declines via interest rate policy (rate reductions), monetary policy, or both; thus the "Greenspan put," phrase for example.

Many market observers wonder if the Powell-led Federal Reserve, particularly in the face of rising economic growth and inflation, will now have the macro-economic backdrop necessary to continue normalization of interest rate and monetary policy. To us, the outstanding question in the years ahead is whether or not the Fed will be able to navigate to the policy sweet spot without upsetting markets.

The Financial Markets

The first half winners among the indices were the technology dominated Nasdaq, as well as small cap indices such as the Russell 2000. Small companies outperformed as trade fears began to weigh on some large capitalization multi-nationals. Very generally, the rising US dollar in 2018 would be expected to lead to better performance from small companies due to the greater likelihood a larger percentage of their revenue is from domestic sources. This has the effect of insulating a greater percentage of their revenue from the currency translation impact of a strong dollar, which makes our goods more expensive to foreign buyers.

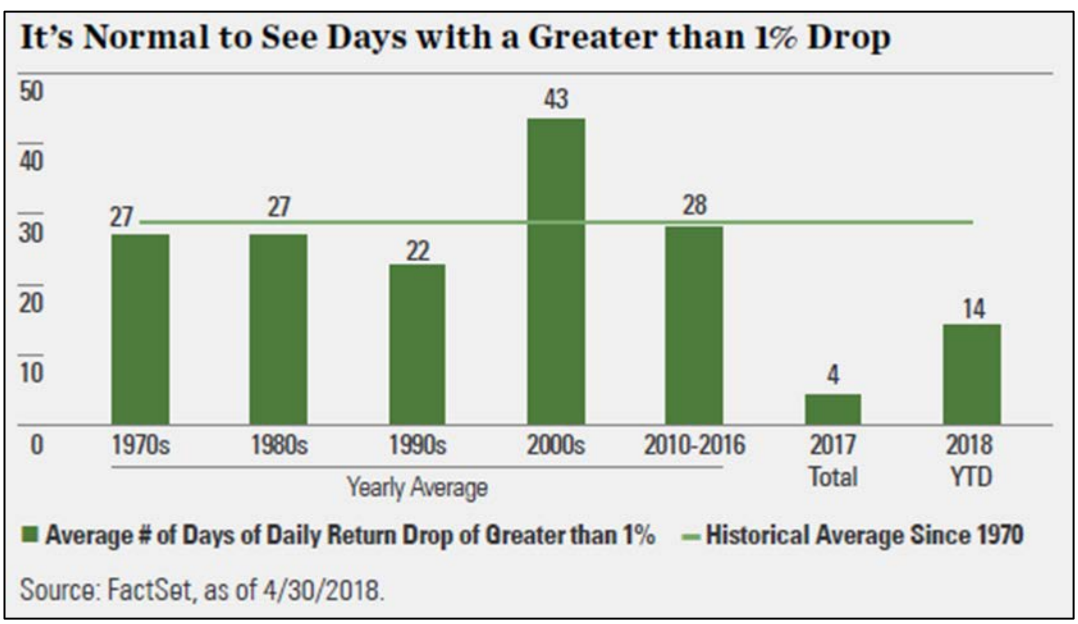
Value stocks have generally underperformed growth stocks for a number of years now, but the disparity seems to be widening through the first six months of 2018. The S&P 500 Growth index increased 8 percent through the second quarter while the S&P 500 Value index is down more than 1 percent.

According to our friends at Bespoke Investment Group, below are the four primary characteristics which likely led to outperformance within the S&P 500 during the first half of 2018:

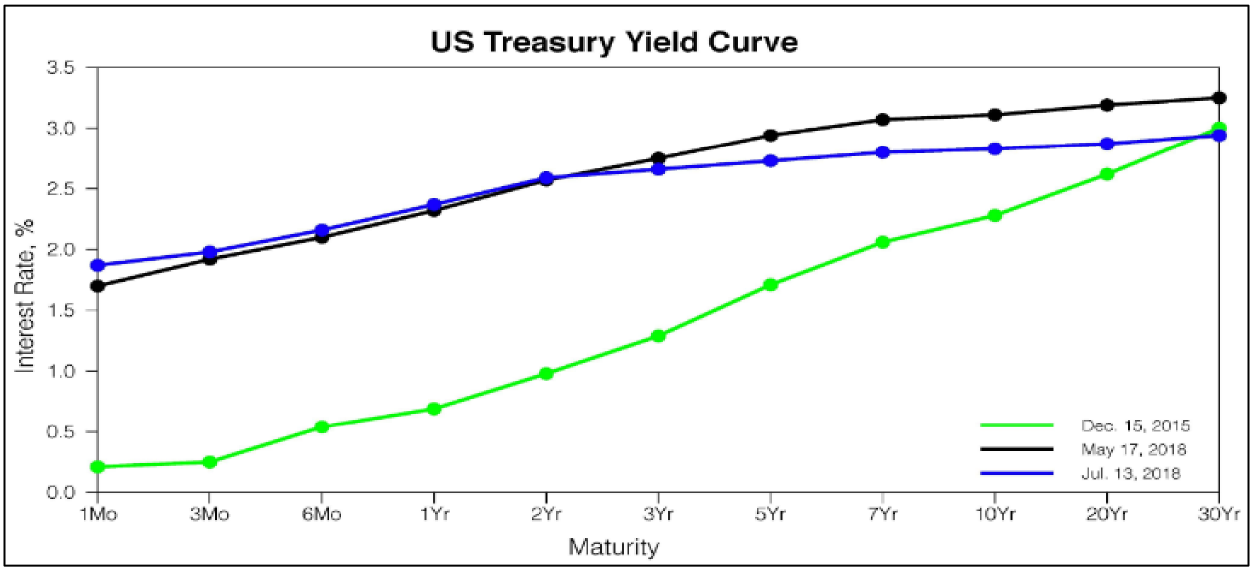
- The smallest stocks have outperformed the largest (the 50 smallest were up 7.43 percent vs. the 50 largest stocks were down 0.65 percent).
- Stocks with the highest P/E ratios increased significantly while the stocks with the lowest P/E ratios are negative.
- Stocks that do not pay a dividend are up 9.88 percent on average while the deciles of stocks with the highest dividends are either flat or negative.
- The 50 stocks in the S&P with the highest short interest levels are up 9.28 percent. The least heavily shorted stocks are generally flat or down.

Technology, Consumer Discretionary, and Energy have been first half bright spots for sector performance with most other sectors in negative territory at the half way point.

The return to greater volatility has no doubt received attention from the media and in general, the investing public. However, looking at volatility as the number of trading days per year with a greater than 1 percent drop, 2018 is setting up thus far merely as a return to normalcy in this regard. After the rare outlier of 2017, which saw a mere four days with a greater than 1 percent drop, it's worth revisiting the long-term.



Moving on to the fixed income markets, in May, the benchmark 10-year Treasury yield pierced the 3.00 percent level, hitting a seven-year high. Yields then fell back, ending the quarter at 2.85 percent. While there are always multiple, diverse factors impacting bond yields on a day-to-day basis, a primary underlying driver is Federal Reserve monetary policy (and the market's expectations regarding). In turn, Fed policy is driven by their assessment of the US economy, and specifically its twin objectives ("dual mandate") of price stability and full employment. To this end, with economic growth above trend and the labor market tight, the Fed continued its gradual path of tightening monetary policy. This has resulted in the yield curve continuing to flatten (i.e. the difference in yields between long-term and short-term Treasury bonds decreasing). Such narrowing is normal at this stage and is a typical characteristic of a tightening cycle as short-term rates respond more quickly to monetary policy changes than long-term rates. As shown in the chart below, this cycle has been no different.



Municipal bonds outperformed both Treasuries and corporate bonds during the first half of 2018 and continue to be an attractive option for investors in higher tax brackets. New issuance continues to be depressed in 2018 as a result of tax reform, down 19 percent year-to-date versus the same period last year and remaining below the five year average. On the whole, municipalities have prudently managed their fiscal balances; however, underfunded pensions will continue to be a burden on certain issuers. From our perspective, a disciplined municipal credit analysis process will continue to be important to take advantage of market inefficiencies in a historically nuanced market. The significant news during the quarter was the Supreme Court ruling that state and local governments can require internet retailers to collect sales taxes, even in states where they have no physical presence. It's too early to tell the full impact; however, it's likely to have a positive credit impact given estimates ranging from $8 to $26 billion of additional annual revenue accruing to state and local governments.

Concluding Thoughts

Second quarter earnings season is upon us and expectations are for an increase of 20 percent from the second quarter of 2017. On the heels of anticipated strong GDP growth and the corporate tax cut tailwind, we expect the strong trend in earnings to continue through year-end. Risks are present, as they always are in the course of human events. Key risks include geopolitical risks, US equity valuations, government and corporate debt levels, and global central bank policy.

As always, as part of our disciplined process, we consistently monitor investments, markets, and the economy. We make purposeful allocations to client strategies for the long-term, adjusting them occasionally, as needs arise. If you would like to have a personal conversation regarding your investments, please call one of our team members at (414) 257-4248.

As the newest member of the Next Generation Wealth team, and on behalf of all of us, please accept our wishes for a wonderful, safe, and healthy rest of your summer.

Respectfully yours,

Jeffrey T. Robbins

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