JULY 2018

iCapital

INVESTMENT COMMITTEE MARKET COMMENTARY

IN THIS ISSUE

01

THE MARKETS

Thoughts on the Recent Market Performance

The second quarter of the year can be called a lot of things, but boring isn't one of them. The potential for a trade war between the United States and China heated up in April as China responded to the threat of U.S. tariffs on Chinese imports by warning of the same magnitude of tariffs on American exports. Favorable corporate earnings reports helped calm some of the global economic angst investors may have felt. The indexes listed here ended the month ahead of their March closing values — but only barely. The Global Dow (1.16%) and the Russell 2000 (0.81%) posted the largest monthly gains, followed by marginal upticks in the S&P 500 (0.27%), the Dow (0.25%), and the Nasdaq (0.04%).

Despite expanding trade tensions between the United States, China, Canada, Mexico, and the European Union, equities enjoyed a better month in May, riding surging energy stocks. For most of the month, oil prices hit multi-year highs before falling at the end of May. Robust first-quarter earnings reports also helped push stock markets higher. In fact, each of the indexes listed here posted strong end-of-month gains. The small caps of the Russell 2000 (5.95%) and the tech-heavy Nasdaq (5.32%) enjoyed the largest gains, followed by the S&P 500 (2.16%) and the Dow (1.05%). Of the indexes in this report, only the Global Dow lost value, falling 1.95% by the end of May.

A strong jobs report kicked off the month of June on a mostly positive note. Stocks closed the first full week of June higher, led by the large caps of the S&P 500 and the Dow. However, by the middle of the month, investors were hit with China's threat of increased tariffs on U.S. exports, while Canada pledged to impose retaliatory penalties as well. By the end of the month, the Dow and Global Dow lost some value, while the remaining indexes listed here posted marginal gains.

Overall, the second quarter saw the tech-heavy Nasdaq gain over 6.0%, only to be bested by small caps of the Russell 2000, which grew by almost 7.5%. The S&P 500 also closed the quarter ahead of its first-quarter closing values. The Dow didn't fare as well, finishing the quarter up by less than 1.0%. Prices for 10-year Treasuries rose by the end of the quarter, pulling yields down by 13 basis points. Crude oil prices closed the quarter at about $74.25 per barrel by the end of June, almost $10 per barrel higher than prices at the close of the first quarter. Gold closed the quarter at roughly $1,254.20, noticeably lower than its $1,329.60 price at the end of March. Regular gasoline, which was $2.648 per gallon on March 26, climbed to $2.833 on the 25th of June.

***NOTES:**

The Dow Jones Industrial Average (DJIA) is a price-weighted index composed of 30 widely traded blue-chip U.S. common stocks.

The S&P 500 is a market-cap weighted index composed of the common stocks of 500 leading companies in leading industries of the U.S. economy.

The NASDAQ Composite Index is a market-value weighted index of all common stocks listed on the NASDAQ stock exchange.

The Russell 2000 is a market-cap weighted index composed of 2,000 U.S. small-cap common stocks.

The Global Dow is an equally weighted index of 150 widely traded blue-chip common stocks worldwide. Market indices listed are unmanaged and are not available for direct investment.

Market Performance

Market/Index	2017 Close	As of 6/29	Month Change	Quarter Change	YTD Change
DJIA	24719.22	24271.41	-0.59%	0.70%	-1.81%
NASDAQ	6903.39	7510.30	0.92%	6.33%	8.79%
S&P 500	2673.61	2718.37	0.48%	2.93%	1.67%
Russell 2000	1535.51	1643.07	0.58%	7.43%	7.00%
Global Dow	3085.41	2979.52	-0.75%	-1.56%	-3.43%
Fed. Funds	1.25%-1.50%	1.75%-2.00%	25 bps	25 bps	50 bps
10-year Treasuries	2.41%	2.86%	0 bps	13 bps	45 bps

Chart reflects price changes, not total return. Because it does not include dividends or splits, it should not be used to benchmark performance of specific investments.

02

OUTLOOK

Overview of the Quarterly Economic Perspective and Eye on the Month Ahead

- **Employment:** Total employment rose by 223,000 in May after adding 164,000 new jobs in April. The average monthly gain over the prior 12 months is 191,000. Notable employment gains occurred in professional and technical services (23,000), retail trade (31,000), and health care (29,000). The unemployment rate slipped to 3.8%. The number of unemployed persons declined to 6.1 million. Over the year, the unemployment rate was down by 0.5 percentage point, and the number of unemployed persons declined by 772,000. The labor participation rate was little changed at 62.7% (62.9% in April). The employment-population ratio held at 60.4%. The average workweek was unchanged at 34.5 hours for the month. Average hourly earnings increased by $0.08 to $26.92. Over the last 12 months, average hourly earnings have risen $0.71, or 2.7%.

- **FOMC/interest rates:** The Federal Open Market Committee raised the federal funds target range rate for the second time this year, bumping the range up by 25 basis points following the Committee's June meeting. The target range now sits at 1.75%–2.00%. The Committee cited continued strengthening in the labor market and increased household spending as justifications for the rate hike. Also of note, the Committee forecasts the median funds rate at 2.4% by year's end instead of

2.1% as forecasted in March. This means two more rate hikes could be in the offing before the end of the year.

- **GDP/budget:** The third and final estimate of the first-quarter gross domestic product showed the economy expanded at an annual rate of 2.0%, according to the Bureau of Economic Analysis. The fourth-quarter GDP grew at an annualized rate of 2.9%. According to the report, consumer spending was rather subdued, expanding at a rate of only 0.9%. Corporate profits increased $39.5 billion in the first quarter, in contrast to a decrease of $1.1 billion in the fourth quarter. Fewer exports and more imports during the quarter contributed to slower economic growth. Spending on durable goods, which had increased 13.7% in the fourth quarter, dropped 2.1% in the first quarter. Gross domestic income rose 3.6% in the first quarter — far surpassing the 1.0% growth rate in the fourth quarter. The government budget deficit was $146.8 billion in May following a surplus of $214.3 billion in April. For fiscal 2018 through May, the federal deficit sits at $532.2 billion — up by $99.4 billion, or about 23%, from the deficit over the same period last year.

- **Inflation/consumer spending:** Consumer spending, as measured by personal consumption expenditures, jumped 0.2% in May, after increasing 0.5% in April. Core consumer spending (excluding food and energy) also rose 0.2% in May. Core consumer prices, a tracker of inflationary trends, increased 0.2% in May. But of more importance, core prices have increased 2.0% over the last 12 months — an annual rate that could prompt more interest rate increases during the remainder of 2018.

- The Consumer Price Index rose 0.2% in May, the same increase as in April. Over the last 12 months ended in May, consumer prices are up 2.8%. Core prices, which exclude food and energy, also climbed 0.2% for the month, and are up 2.2% for the year.

The Consumer Price Index rose 0.2% in May, the same increase as in April. Over the last 12 months ended in May, consumer prices are up 2.8%.

- Prices at the wholesale level expanded noticeably in May. The Producer Price Index showed the prices companies receive for goods and services jumped 0.5% after climbing 0.1% in April. Year-over-year, producer prices have increased 3.1%. Prices less food and energy increased 0.3% for May and are up 2.4% over the last 12 months.

- **Housing:** Sales of existing homes continued to slow in May. Total existing-home sales fell 0.4% for May following a 2.5% drop in April. Year-over-year, existing home sales are down 3.0%. The May median price for existing homes was $264,800, which is 4.9% higher than the May 2017 price of $252,500. While inventory for all types of existing homes for sale rose 2.8% in May, it is 6.1% lower than a year ago. New home sales, on the other hand, climbed 6.7% in May after falling 1.5% in April. Falling home prices surely led to the spike in new home sales. The median sales price of new houses sold in May was $313,000 ($318,500 in April). The average sales price was $368,500 ($394,600 in April). Inventory fell slightly to 5.2 months, down from the 5.5-month supply in April.

- **Manufacturing:** Industrial production edged down 0.1% in May after increasing 0.9% in April. Nevertheless, total industrial production is 3.5% higher in May than it was a year earlier. Manufacturing production fell 0.7% in May, largely because truck assemblies were disrupted by a major fire at a parts supplier. Excluding motor vehicles and parts, factory output moved down 0.2%. The index for mining rose 1.8%, its fourth consecutive month of growth; the output of utilities moved up 1.1%. New orders for manufactured durable goods climbed 0.6% in May following two consecutive monthly decreases.

- **Imports and exports:** The advance report on international trade in goods revealed that the trade gap decreased by $2.5 billion in May from April. The deficit for May was $64.8 billion (the April deficit was $67.3 billion). May exports of goods jumped 2.1%, while imports increased 0.2%. On a seasonally adjusted basis, May's total imports ($208,405 billion) far exceeded exports ($143,560 billion). Import and export prices are starting to move higher; both increased 0.6% in May after climbing 0.3% and 0.6%, respectively, in April. Over the last 12 months, import prices have increased 4.3% and export prices are up 4.9%.

- **International markets:** Investors, both at home and abroad, may be concerned that the escalating trade dispute between the United States and several other important trade partners may stunt global economic growth. Despite the negative trade rhetoric, China's economy expanded at a rate of 6.8% in the first quarter, much to the surprise of some investors and economic analysts. On the other hand, potential trade tariffs may have impacted Europe's largest economy. Germany's gross domestic product stalled in the first quarter, growing at a subdued rate of 1.2% after expanding 2.5% in the fourth quarter. Overall, the eurozone GDP also decelerated to a growth rate of 1.7% in the first quarter, down from the 2.7% rate of growth in the fourth quarter.

- **Consumer sentiment:** Consumer confidence, as measured by The Conference Board Consumer Confidence Index®, dipped 2.4% in June following an increase in May. According to the report, consumers' confidence in the present economic conditions remained relatively the same as in May, but expectations for future growth were tempered. This reading may be reflective of the imposition of tariffs and the ongoing trade war.

Moving to the second half of the year, the economy in general and the market in particular will likely react based on the ongoing global economic trade wars. Fewer imports could lead to more domestic sales, which could add to job growth. However, prices could also increase at a rate ahead of wage growth.

03

INVESTMENT INSIGHTS *{as of 6/30/18}*

From iCapital Investment Committee Chief Market Strategist, Dr. Ahmad Etebari

So far, 2018 has been a bumpy year for US stocks. Halfway through the year, most stock indexes have eked out small gains, led by the tech-heavy Nasdaq composite at 8.8% and the small-cap Russell 2000 at 7%. Broader market indexes were mixed, with the S&P 500 posting a gain of +1.7%, while the Dow losing 1.8% in price. Positive catalysts for the market included stellar earnings growth and strong economic conditions, which overcome a wall of worry concerning trade, geopolitics and a faster-moving Federal Reserve. The same narrative of positive indicators against the backdrop of domestic and foreign policy drives the outlook for the second half of 2018.

U.S. Growth Remains Strong

This quarter is shaping up to be one for the books with analysts across Wall Street predicting high growth for Q2 in the range of 5%. Macroeconomic Advisers recently raised its second-quarter GDP forecast to a 5.3% growth rate, up from a previously predicted 4.6% growth rate. This more optimistic outlook was due in part to the shrinking trade deficit.

Economist are predicting that growth will remain robust through 2018. This growth is being driven by the stimulus from recent tax cuts, increased government spending, historically low unemployment, and steady job and wage growth. Across the board growth indicators all look fantastic. Consumer spending did slow last quarter but with consumer sentiment and the ISM manufacturing both at multi-year highs there is little to worry about moving through 2018.

What is Full Employment?

The labor market is currently firing on all cylinders. The Bureau of Labor Statistics reports that there are currently 6.7 million job openings and just 6.4 million available workers to fill them. Additionally, the number of Americans receiving unemployment benefits hit the lowest level since the early 1970s. However, the much-anticipated wage gains and inflationary pressures that typically come with such a tight labor market are still yet to be seen with average hourly earnings up just 2.7% over the past year.

The widely used U-3 unemployment rate shows the U.S economy at 50-year lows for unemployment but if a more granular look is taken then some slack is seen. The U-6, which counts all marginally attached workers plus employed part time for economic reasons, shows that we are at 7.6 percent which breaks the 7.9 percent threshold seen in December 2006, but is still a ways from the most recent bottom of 6.8 percent in October of 2000.

One other factor holding back wage growth in the US is the low mobility rate of the population. Workers are less mobile than ever before, creating situations where employers would pay more for talent but the talent is not readily available to them. This skills gap is leaving many employers frustrated and many workers wondering why they are not seeing wage gains in this strong of a labor market. So while many fear the monster of inflation lurking in the closet at night, the slack still in the labor market and a less mobile population, coupled with a transparent and slow interest rate hike path should keep a lid on inflationary pressures for the near future.

Corporate Earnings Are a Tailwind

U.S. companies continue to report strong earnings, with S&P 500 companies reporting Q1 earnings growth of more than 25%, the highest growth rate since 2010. There have also been unusually large positive revisions to S&P 500 company earnings in each of the past two quarters, with more than 70% of the companies reporting actual earnings that exceeded their analysts' estimates. In total, the latest GDP reports show that on an annualized basis after-tax profits corporate now amount to a record $1.92 trillion, equivalent to about 9.5% of the U.S. GPD.

Analysts expect earnings to remain strong for the rest of the year, growing at about 20% in each of the next two quarters, but then gradually falling to around 7%, as the positive effects of the tax law fade away. At midpoint in the year, year-ahead consensus earnings estimate for the S&P 500 is around $167. This estimate gives a price to forward-earnings ratio of 16.3 for the market — a reasonable price multiple considering historical levels and the current low levels of interest rates.

The Ripple Effects of Raising Rates

The Federal Reserve has two main goals as mandated by Congress, to maximize employment and keep prices stable. However, their decisions have a wide range of consequences not only on the American people and businesses but on the federal government itself. Currently, the federal government owes just over $21 trillion dollars. The obvious but often overlooked point is all that debt needs to be borrowed for and thus subsequently paid interest on. In 2018 the CBO expects the federal government to pay 1.6% of GDP towards debt payments. With the Federal Reserve raising interest rates, it is effectively raising the borrowing cost for the government. Therefore, as the Federal Reserve raises rates, they will raise the borrowing cost.

Under current law, CBO projects that net interest costs will triple over the next 10 years, soaring from $269 billion in 2017 to $818 billion in 2027 and totaling $5.6 trillion over the period. These costs are also income for the investors loaning the government money, thus it takes away sources of capital from the market. A crowding out effect can happen where public investment that could fuel economic growth is hindered. So while it is not a stated goal or care of the federal reserve, their actions to raise rates in an effort to stabilize prices can have a large ripple effect on the government's debt load and the amount of meaningful investment in the market.

Emerging Markets Are a Mixed Bag

Many emerging market countries have had a lot to be happy with at the World Cup, but how does everything look for them back at home? The Argentinian government has been facing hard times with the peso at all-time lows against the US dollar, falling more than 35% since the beginning of 2018. Brazilian fans will not only be going home from the World Cup in poor spirits but may be poorer as well. In 2018 so far, the Brazilian Real has devalued more than 20% against the US dollar.

The pain from growing talk of protectionism in world trade is being felt by many other emerging markets. Asian economies like Taiwan, South Korea, and Singapore are the most exposed to global value chains, which has led to investor sentiment in these markets to turn cautious. Mexico is also likely to be impacted greatly by any aggressive measures, although falling there this year has boosted real wage growth for citizens, softening the potential blow.

Small Cap Stocks Outperform

Small-cap stocks have been outperforming the overall market through the beginning of this year. Small-Caps have been benefited by the recent tax cuts which are poised to improve their profitability and putting them on a more even tax field as larger-cap stocks. This is because small cap companies were paying effectively about 4% more in taxes than S&P 500 companies over the three years ending in December 2017.

Small-Cap Stocks are also poised to benefit in an unstable trade and a rising U.S. dollar environment, as they generally have less international exposure. Rising tensions around geopolitics would also favor small stocks over international stocks. However, it is hard to tell whether or not this information has already been fully baked into the price of small caps, if for nothing else than their recent outperformance. Current valuations aside, over the long run small cap stocks have outperformed large cap stocks. They represent an important asset class for a well-diversified portfolio.

Globalization Will Survive Protectionism

Nationalist and protectionist sentiments have been on the rise worldwide recently. Trade and migration have faced particularly strong attack from nationalist leaders, with both often unjustly blamed for chronic domestic problems. This trend is causing economic policy uncertainly and market volatility as globalization is seen to be increasingly at risk. However, in the long term globalization will reign supreme.

For example, the Brexit vote was motivated by people's dissatisfaction with domestic political, economic and social issues that often had very little to do with EU policy. Many citizens cast their vote to leave without understanding the ramifications. Although officially committed to leaving, the U.K. has realized the challenges a complete exit would create, and is trying hard to mitigate the isolation by striking trade and immigration deals with the EU.

Meanwhile in the U.S., rhetoric about tariffs dominates the news, risking harm to U.S. corporations who depend heavily on foreign markets for their supply chains and the U.S. itself, which depends on foreign investors to fund its surging fiscal deficit. With many pro-Trump industries such as manufacturing and farming prime targets for retaliatory action, these elements of the Trump base will have to choose to sleep in the bed they made or come to terms with their mistake like our friends across the pond have been forced to do.

Bitcoin Meltdown

Bitcoin along with other notable names such as Ethereum, Litecoin and Ripple have tumbled since their peaks last December, driving down the entire crypto market valuation about 70%, from a peak valuation of $830 billion to roughly $250 at the mid-year mark. (Source: CoinMarketCap.com) The primary catalysts for this meltdown have been security and regulatory concerns, as well as concerns about possible price manipulations within the exchanges.

Blockchain is a promising technology of the future, but Bitcoin and other cryptos have had insufficient adoption growth and suffer from extreme price volatility. For these reasons, they cannot serve as reliable mediums of exchange or stores of value. Cryptos backed by hard assets like gold or oil, already available overseas, are likely to gain traction down the road. Without such backings, the coin market's future will remain uncertain.

We are more concerned about the market's fundamentals than Bitcoin and the cypto market. Looking ahead, the outlook for the second half of the year is positive. US growth and corporate earnings are expected to be solid, interest to remain low and inflation to be subdued. The challenge to the market will come from any Governmental chaos and continued tensions about trade and trade-related currency wars. Overall, we remain optimistic about the market.

***NOTES**

Data sources: Economic: Based on data from U.S. Bureau of Labor Statistics (unemployment, inflation); U.S. Department of Commerce (GDP, corporate profits, retail sales, housing); S&P/Case-Shiller 20-City Composite Index (home prices); Institute for Supply Management (manufacturing/services). Performance: Based on data reported in WSJ Market Data Center (indexes); U.S. Treasury (Treasury yields); U.S. Energy Information Administration/Bloomberg.com Market Data (oil spot price, WTI Cushing, OK); www.goldprice.org (spot gold/silver); Oanda/FX Street (currency exchange rates). News items are based on reports from multiple commonly available international news sources (i.e. wire services) and are independently verified when necessary with secondary sources such as government agencies, corporate press releases, or trade organizations. All information is based on sources deemed reliable, but no warranty or guarantee is made as to its accuracy or completeness. Neither the information nor any opinion expressed herein constitutes a solicitation for the purchase or sale of any securities, and should not be relied on as financial advice. Past performance is no guarantee of future results. All investing involves risk, including the potential loss of principal, and there can be no guarantee that any investing strategy will be successful.

The Dow Jones Industrial Average (DJIA) is a price-weighted index composed of 30 widely traded blue-chip U.S. common stocks. The S&P 500 is a market-cap weighted index composed of the common stocks of 500 leading companies in leading industries of the U.S. economy. The NASDAQ Composite Index is a market-value weighted index of all common stocks listed on the NASDAQ stock exchange. The Russell 2000 is a market-cap weighted index composed of 2,000 U.S. small-cap common stocks. The Global Dow is an equally weighted index of 150 widely traded blue-chip common stocks worldwide. The U.S. Dollar Index is a geometrically weighted index of the value of the U.S. dollar relative to six foreign currencies. Market indices listed are unmanaged and are not available for direct investment.

IMPORTANT DISCLOSURES

iCapital, LLC does not provide tax or legal advice. The information presented here is not specific to any individual's personal circumstances. To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances. These materials are provided for general information and educational purposes based upon publicly available information from sources believed to be reliable — we cannot assure the accuracy or completeness of these materials. The information in these materials may change at any time and without notice.

iCapital, LLC | 62 Plympton Street, Boston, MA 02118 | 617.542.8700 | info@icapllc.us