Market Commentary
Second Quarter, 2018

Year to date, the pundits and media have had a feast of content to interpret for the public. Volatility picked up in the first quarter, and continued in the second, driven by headlines that boast varying positions on the economy, politics, immigration, global trade and tariffs. Unfortunately, bias is prevalent and facts can be easily misrepresented or omitted to push a narrative instead of objectively presented to illuminate the full picture. In this quarter's client letter, we will attempt to distill the current investing environment down to key points and explain what it means for your portfolio.

The most prominent headline: trade and tariffs.

The US economy, as measured by total GDP is approximately $19.4 trillion. US trade with foreign countries was $5.2 trillion in 2017, $2.3 trillion of exports and $2.9 trillion of imports. Although the figures suggest a trade deficit, it's important to understand the full context of international trade relations, as it can vary considerably by country. Trade, at its simplest, is balanced by definition. It is an exchange of one thing for another. Our trade deficit means that in some cases, instead of trading one good for another, a good is exchanged for financial assets. Approximately $6.3 trillion, or 45% of the US treasury debt held by the public, was owned by foreign investors at the end of last year, including $1.2 trillion by China. Ownership of US financial assets by China and other countries supports the value of the dollar, consumer prices and low interest rates.

In March, we imposed tariffs on steel and aluminum imported from Canada, Mexico and Europe (approximately $51 billion) and on July 6, we imposed tariffs on $34 billion of Chinese goods. Retaliatory tariffs or duties were imposed on the US in both cases. Then on July 10th, President Trump announced intentions to impose a 10% tariff on an additional $200 billion of Chinese goods (nearly half of all Chinese to US imports). China has until August 30th to make a deal, but will likely retaliate in kind to maintain the status quo. In an unlikely worst case scenario, our administration has threatened tariffs of $450 billion on Chinese goods and $275 billion on auto imports. If these threats come to pass, it would impact 27% of total US imports and 4% of GDP.

In terms of pure trade, the US imports significantly more from China than they import from us, suggesting a tariff negotiation quid pro quo would be in our favor. Trade relations are more complicated than that. Looking at China specifically, a significant amount of imports are from US manufacturers that send raw materials to China for low-cost assembly, with the total cost of finished goods included in the trade figures. An iPhone X, for example, has an estimated manufacturing price of $370. It's final destination is China for assembly, where $11-22 of value is added by Chinese labor. Apple purchases the display from Samsung Electronics in South Korea and memory chips from Toshiba in Japan, to name a few, yet the full $370 deficit created by the iPhone is 100% allocated to China. In fact, that product alone requires the cooperation of five countries and nine different companies to reach your local Apple store. This is an extreme example of the global economy's interconnectedness, but nevertheless, reflects the imprecision of foreign trade accounting - not to mention the business risks of trade disruption. Although China cannot match the US tariffs dollar for dollar, they can take other retaliatory measures against us, including imposing limits and regulations on US firms operating in China, weakening its currency to offset the tariffs or threaten to sell its US financial assets.

Free trade policies and globalization have had many positive, long-term effects on our economy - international competition has motivated innovation, productivity, output, and increased the standard of living for Americans. In 1990, shortly after the enactment of the North American Free Trade Agreement (NAFTA), the average American household net worth was approximately $80,000. Today, it is $314,000 - an increase of nearly 400% in less than 30 years, or 5% compounded annually. Indeed there are many contributing factors, but it is indisputable that Americans have prospered. In contrast, tariffs constrict trade, reduce competition and increase costs for businesses and consumers. US business is global, with approximately 40% of S&P 500 revenue coming from consumers abroad. It is challenging to imagine a scenario where increased global trade costs improve corporate earnings at home. We are hopeful that these issues are resolved without any further harm to economies both domestically and abroad.

Next on our minds has been interest rates and the yield curve.

The Federal Open Market Committee (FOMC) increased its target range for the federal funds rate by 0.25% to 1.75 - 2.00% last month. This is the seventh increase since December 2015, and the FOMC is forecasting two additional 0.25% increases this year and three next year, resulting in a projected target range of 3.00 - 3.25%.

When the FOMC increased its target range for the federal funds rate to 0.25 - 0.50% in December 2015, the yield on the ten year treasury bond was 2.30%, or 1.80% above the range. At June 30, 2018 the ten year treasury bond yield was 2.83%, or 0.83% above the target range for the federal funds rate.

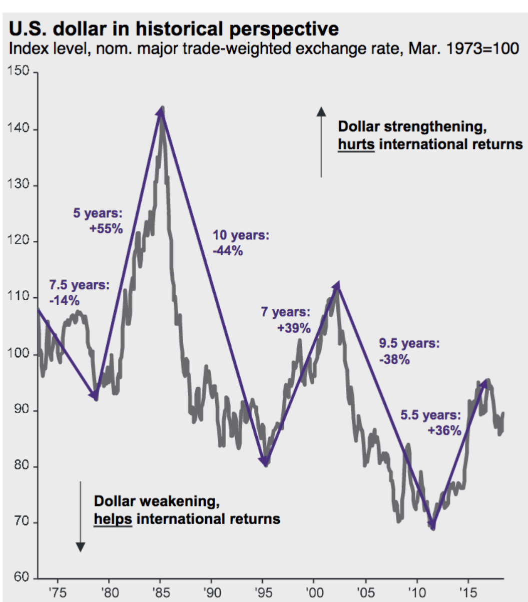
This "flattening" of U.S. treasury interest rate differentials is expected to continue with shorter term interest rates increasing more rapidly than longer term interest rates until there is almost no difference in yields, regardless of maturity. Flat interest rate differentials are a late economic cycle indicator and typically precede a slowing economy and a diminished growth and inflation outlook. That said, the FOMC's dual mandate is for maximum employment, stable prices and moderate long term interest rates. We do not expect them to stray from these objectives, and will only raise short term interest rates as high as necessary to curtail inflation pressures as the economy continues to expand. Absent political and trade risks, we do not see any other meaningful indicators of recession or diminishing inflation and expect long term interest rates to increase modestly, remaining higher than short term interest rates in the near term.

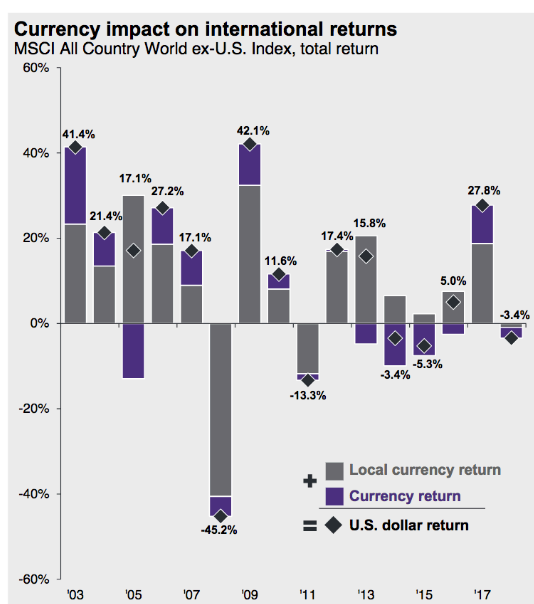
Interest rates, the global economy, and the threat of a trade war have all impacted equity markets domestically and abroad.

The US economic expansion is just two months shy of becoming the longest on record. US optimism continues, driven by consumer spending and business investment that are largely due to tax cuts and fiscal stimulus. Corporate earnings and margins are also at an all time high. GDP growth estimates are 4% for the second quarter and year-over-year growth is 3%. We expect the labor market to continue tightening, which may eventually cause higher inflation and slower economic growth.

Year to date through June 30th, we experienced a reversion from 2017 market results with international equities underperforming domestic equities. Taking a narrower look at domestic markets, small caps outperformed large caps and growth oriented asset classes such as consumer discretionary and technology were top performers. The S&P 500 and Russell 2000 returns were +2.7 and +7.7%, while foreign developed and emerging market equity returns were -2.8% and -6.7%, respectively. In the short term, domestic equity outperformance was primarily due to strengthening economic growth, a strengthening dollar and global trade concerns.

As a result, market valuations in foreign equity markets are about 10% below their 20-year averages while domestically, valuations sit slightly above. In addition to favorable valuations in foreign equities, there is reason to believe the dollar could be in the early stages of a long-run cyclical downtrend, which would further boost real returns from abroad. The charts below provide some historical perspective on the dollars exchange rate and impact on international returns.





Source: FactSet, J.P. Morgan Asset Management; (Left) Federal Reserve; (Right) MSCI.
Currencies in the nominal major trade-weighted U.S. dollar index are: Australian dollar, British pound, Canadian dollar, euro, Japanese yen, Swedish krona and Swiss franc. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of June 30, 2018.

J.P.Morgan Asset Management

Foreign currency risk adds an element of volatility to investing abroad, but also provides a meaningful hedge against a weakening dollar. Currency weakness commonly occurs as an economy slows down and the spread between domestic and foreign interest rates narrows. If our economy loses steam, or interest rates begin to rise in other developed nations relative to the US, we would expect the value of the dollar to decline.

Trade disruptions from tariffs or in-kind economic retaliations are a real risk to markets globally. Ultimately however, the outlook remains positive, and we continue to believe a globally diversified portfolio will be the most effective strategy for long term investors. In the short to intermediate term, however, the scale and scope of our trade conflicts will likely determine whether the global economic machine continues to hum along nicely or begins to sputter.

Thanks again for your trust and confidence. Should you have any questions or would like to discuss your financial goals and investment portfolio, please let us know.

Respectfully,

The JRM Investment Counsel Team

Jack, Phil & Lauren