Main Street Advisors, LLC

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Second Quarter 2018 Key Takeaways

US stocks rose to the top of asset class performance charts with solid returns in the second quarter. Larger-cap US stocks gained 3.4%, but were outdone by smaller-cap stocks, which jumped 7.9%. The smaller-cap outperformance was driven by the market narrative du jour that smaller companies are more domestically focused and therefore not as exposed to a strengthening US dollar or potential trade wars, both of which are assumed to be detrimental to larger-cap (multinational) company profits.

Developed international stocks fell 1.8% and European stocks declined 1.6% for the period, as the US dollar rebounded. Dollar appreciation can be a meaningful headwind to returns for dollar-based investors in foreign securities.

Emerging-market (EM) stocks fared the worst, dropping 9.6% in dollar terms. In addition to the currency effects, EM stocks were buffeted by trade tensions between the United States and nearly all its major trading partners. As we discuss this quarter, we remain confident in our modest overweight to EM stocks in our tactical portfolios, mostly with T. Rowe Price New Asia.

Moving on to the bond markets, in May, the benchmark 10-year Treasury yield pierced the 3% level, hitting a seven-year high before falling back, ending the quarter higher by 11 basis points at 2.85%. The core bond index had a slightly negative return (bond yields move inversely to bond prices). Our lower-quality bond funds performed better, even making money this quarter. For the year, the core bond index is down nearly 2% and our portfolio bond holdings have dropped about half that amount.

With the US economy growing above trend and the labor market tight, the Fed continued its gradual path of tightening monetary policy. It raised interest rates again in June, but also forecasted a slightly accelerated path of hikes over the next two years. Whether the economy can withstand that degree of tightening remains to be seen.

Beyond the strength of the US economy, the global economy remains in pretty good shape, with real GDP growth expected to be above trend again this year. However, last year's highly synchronized growth has decelerated and may have peaked for this cycle.

Recent US dollar strength may continue for a while as currency momentum can take on a life of its own. It is the reason that gold, a hedge against chaos, has weakened in recent months. But there are fundamental reasons to expect the dollar may weaken looking a bit further out: the prospect of a ballooning US federal budget deficit in the coming years, a large US trade deficit, the eventual convergence of central bank monetary policies, and the fact that the Trump administration seems to prefer a weaker dollar.

Regardless, from a portfolio management perspective, we remain tactically agnostic on the dollar—we don't have a high-conviction view relative to the currency markets that we would want to reflect in our portfolios. Instead, we maintain our strategic (long-term) diversified approach of having both dollar and non-dollar exposure—with the latter coming primarily from our foreign stock funds.

Second Quarter 2018 Investment Commentary

Market Recap

As we pause to reflect at the midpoint of the year, it seems so far 2018 has served as yet another reminder to investors that over the short term, markets are driven by innumerable and often random factors that are impossible to consistently predict. In the first quarter, US stocks experienced their first major losses since 2016 and a return to more "normal" market volatility. Many market prognosticators speculated that this could indeed be the end of the nearly decade-long US bull market.

Our client portfolios have been more conservatively positioned than benchmarks for several years. This means positive returns have been muted, however during the recent stock rout earlier this year our portfolios dropped less than one-half the stock market's 11% decline (January 26th to February 9th). We generally added to equities in February.

Fast-forward through three more eventful months and this time around US stocks have been the net beneficiaries, gaining 3.4% on the back of a surging dollar while the rest of the world has slowed. The dollar's 5% appreciation translated into a meaningful return headwind for dollar-based investors in foreign securities as foreign currencies depreciated against the dollar. Developed international stocks fell 1.8% and European stocks declined 1.6% for the quarter. Emerging market stocks fared the worst, dropping 9.6% in dollar terms, while T. Rowe Price New Asia dropped 4.1%.

In bond markets, the benchmark 10-year Treasury yield pierced the 3% level in May, hitting a seven-year high. Yields then fell back, ending the quarter at 2.85%, an 11-basis-point increase from the prior quarter-end. As such, the core investment-grade bond index had a slight loss for the quarter and remains in negative territory for the year to date.

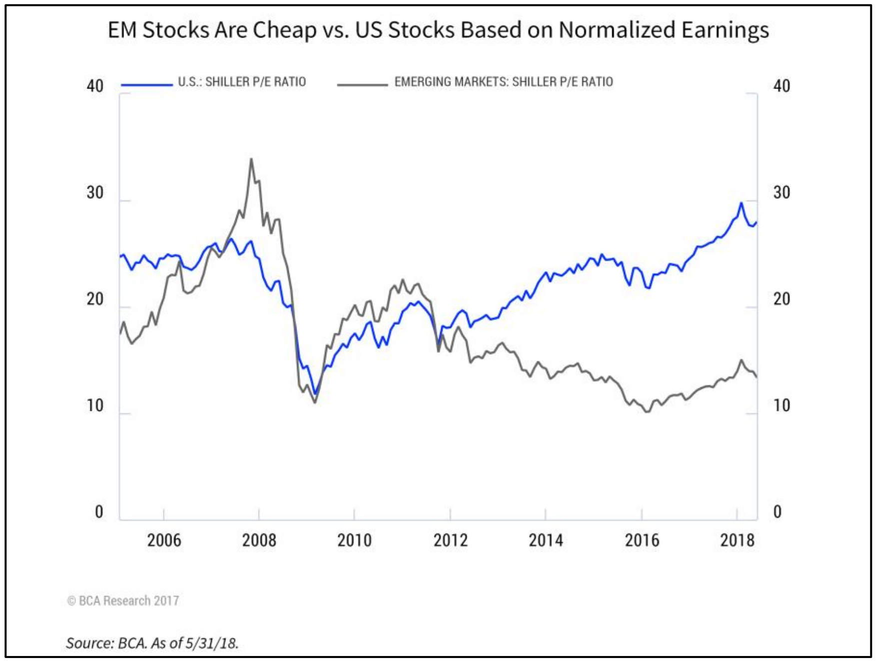
Portfolio Attribution

It was a difficult quarter for our equity holdings given the jittery investment climate outside the United States, particularly in the emerging markets (EM). As a reminder, we primarily own T. Rowe Price New Asia as our emerging markets exposure; China, India and southeast Asia are its domain while it avoids Japan altogether. As the global economy began firing on all cylinders last year, this fund returned 41.3% in 2017 and got off to a roaring start this past January. Since then, however, it has dropped sharply and its return is now in negative territory for the year.

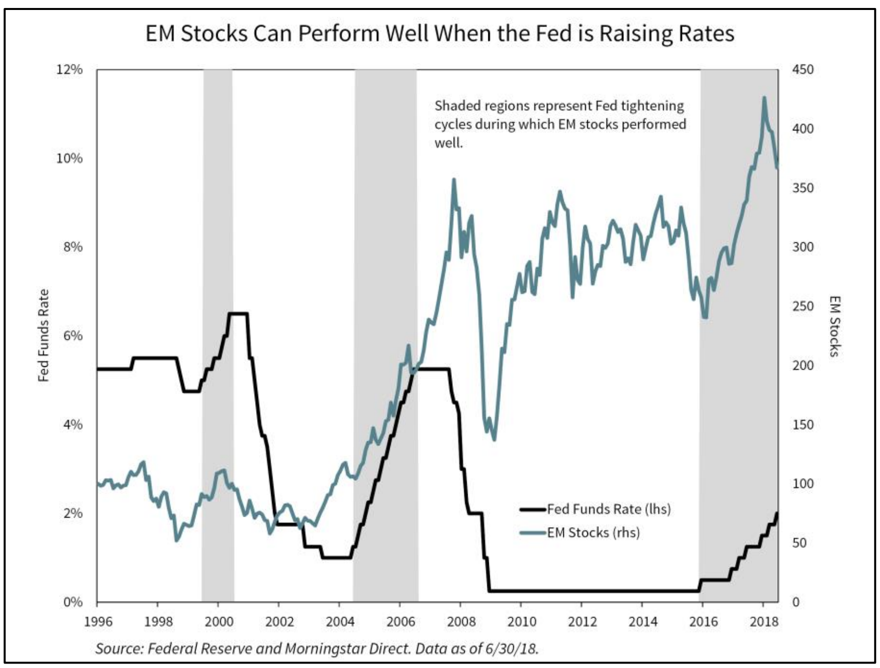
The selloff in EM stocks appears to have been driven by a combination of investor concerns about

- a potential trade war with China (and possibly other global trade partners such as the European Union, Mexico, and Canada);
- how EM economies will manage a deceleration in global growth outside the United States; and
- a stronger US dollar coinciding with rising US interest rates and tightening Fed monetary policy.

These macro developments, in particular the risk of a US trade war with China and the rest of the world, are indeed risks to EM stocks, at least in the shorter term. However, these are not new risks, nor do we believe they overwhelm the attractive fundamentals, valuations, and potential longer-term returns of EM stocks. Based on our analysis, we find that emerging markets are fundamentally better placed today than in past cycles. The sector composition of EM indexes has changed meaningfully over the past decade, from traditional heavy-cyclical industries like materials and energy to more growth-oriented technology and consumer-driven sectors that are less sensitive to shifts in global growth. Evidence also suggests EM stocks do fine when interest rates in the United States are rising as long as global growth is solid (real GDP growth is expected to be above trend again this year). As to the underlying fiscal health of EM economies, emerging markets, in aggregate, have much better debt coverage than in the late 1990s/Asian crisis era. Additionally, most EM countries now have floating rather than dollar-pegged currencies, which should help release pressure in these economies and reduce the likelihood of a currency devaluation–driven crisis.



Source: BCA. As of 5/31/18.



Source: Federal Reserve and Morningstar Direct. Data as of 6/30/18.

On the fixed-income side, our portfolios were helped once again by our large allocation to actively managed flexible bond funds such as Loomis Sayles Bond and Osterweis Strategic Income. In aggregate, these funds contributed positively to quarterly portfolio returns and outperformed the core investment-grade bond index, as has been the case over the past several years.

The performance of our gold bullion and remaining alternative investments was mixed to poor in the second quarter. Our lower-risk arbitrage strategies produced modest gains, outperforming core bonds and foreign stocks but trailing US stocks. Our positions in gold bullion (symbol: GLD) and junior gold mining stocks were negative, and reversed their positive contribution to portfolio returns in the first quarter.

Market and Portfolio Outlook

It is understandable that fears of a global trade war are rattling financial markets. Any resolution of the current trade tensions is a meaningful uncertainty—our relationship with China being the most fraught—with the potential to seriously disrupt the global economy at least over the shorter to medium term. (The potential for a positive surprise seems more limited, but also exists.) President Trump's unconventional negotiating approach adds an additional wildcard dimension. The process is likely prone to several more twists and turns before things become any clearer.

Our view on the matter, however, remains broadly the same. It is in the best interest of both the United States and China to negotiate a resolution and prevent trade skirmishes from becoming an all-out trade war. However, the potential for a severely negative shorter-term shock to the global economy and risk assets (not just emerging markets) can't be dismissed. Even absent an actual trade war, the negative impact on business and consumer confidence from the uncertainty and fear of a trade war is a risk to the remaining longevity and strength of the current economic cycle.

The recent dollar-strength trend may also continue for a while. But there are reasons to expect the dollar may weaken looking further out: the prospect of a ballooning US federal budget deficit in the coming years, a large trade deficit, and the eventual convergence of central bank monetary policies—as other central banks start to raise interest rates, thereby shrinking the yield gap versus the United States.

The second quarter brought strong returns from our energy stock holdings, in double digits for many and bringing their year-to-date returns to a range of 2% to 6%. Additionally, utility stocks bounced back sharply and are now in positive territory for the year. Foreign stocks and bonds continue to be drags on returns, but both of these asset classes are essential to keeping portfolios diversified. In the case of foreign stocks, they are priced at one-half to two-thirds U.S. equities.

We remain confident in the positioning of our globally diversified portfolios, which we believe are structured to perform well over the long term while providing resiliency across a range of potential short-term scenarios. Should the current trade tensions resolve, and the global economic recovery continue, we expect to generate good overall returns, with outperformance from our European and EM stock positions, active equity managers, and flexible bond funds.

Alternatively, should a bear market strike, our portfolios have "dry powder" in the form of lower-risk fixed-income and even bank CD investments that should hold up much better than equities. We'd expect to put this capital to work more aggressively following a market downturn by, for example, reallocating to US equities at lower prices and higher expected returns sufficient to compensate us for their risks.

Thank you for your continued confidence and trust.

—Main Street Advisors, LLC (07/16/2018)