SECOND QUARTER REVIEW AND COMMENTARY

Market Review: While markets around the globe struggled in the second quarter, the U.S. was a magnet for investment as indicated by the 5.4% rally in the trade-weighted U.S. Dollar Index. The Standard and Poor's 500 stock index gained 3.4% and the U.S. centric Russell 2000 Small Cap Index gained 7.2%. The rest of the world, as defined by the MSCI All Country ex-U.S. Index, declined 2.5%. The Barclay's Aggregate Bond Index lost 0.2% and has a negative total return over the past two years. However, the two year Treasury now yields 2.6%, which is quite competitive versus the 1.9% dividend yield of the S&P 500.

The U.S. economy remains on solid footing and forthcoming earnings releases are anticipated to show a second consecutive quarter of 20% year-over-year profit growth. Revenues have been accelerating and corporate tax cuts have provided an added boost. These solid fundamentals have been somewhat offset by tariff rhetoric and Federal Reserve tightening. As a result, the S&P 500 has zigzagged in a five month range bounded by the late January highs and the 10% correction lows in early February. Though market volatility may feel elevated in comparison to the unusual calm of 2017, the CBOE Volatility Index (VIX) reveals that 2018 has been less volatile than the long-term average.

There was substantial return dispersion across S&P 500 sectors in the quarter, however. Energy gained 12.7% as oil continued to rally, Consumer Discretionary gained 7.8% and Technology had the largest impact on the S&P when combining its 6.8% return and 25% index weight. On the other end of the spectrum, Industrials, likely impacted by tariff concerns, and Financials, negatively influenced by the flattening yield curve, each lost 3.6%. Correspondingly, Large Cap Growth trounced Large Cap Value with the iShares Russell 1000 Growth ETF gaining 5.7% and the DFA Large Cap Value Fund gaining 0.4%. As mentioned above, small cap stocks had a strong run in the quarter, with likely factors being direct exposure to the U.S. economy, the full benefit of lower corporate tax rates, and no earnings headwinds resulting from dollar strength. These influences are somewhat transitory and small caps have not offered compelling value for some time so we are not altering our neutral view on the category in diversified portfolios. We have sufficient technology exposure and remain interested in a reversion to value in both U.S. and International funds as well as companies in the industrial and financial sectors.

Trade Wars: The White House is seeking to upend current trade arrangements with our NAFTA partners, the E.U. and China with each counterparty threatening retaliation. "Pricing in" a trade war is extremely challenging given the posturing by the parties involved and the complex global supply chain that intertwines countries and components in nuanced ways. The uncertainty for companies regarding the availability and price of parts and the access to end markets is a clear drag on growth. Commodity exporting countries are experiencing the pressures of both trade disruptions and dollar strength. The EAFE Emerging Markets Index declined 7.9% in the second quarter.

The Fed is Draining Liquidity: The Federal Reserve Board has made it clear that it will gradually normalize interest rates, with expectations of four rate hikes to roughly 3% by the end of 2019. Inflation will drive the pace, and in May, the core CPI hit 2% for the first time since the Fed set that level as their explicit target in 2012. As short rates have marched higher in tune with the Fed, longer term rates have held steady in 2018. This likely reflects strong overseas demand where the yields on bonds are much lower. Separately, the Fed is slowly shrinking its balance sheet, and has withdrawn $115 billion since September by allowing securities they hold to mature without reinvesting. The impact thus far has been minimal, and as long as the market perceives that they are ahead of inflation expectations, calm should prevail. However, just as easy money has been a major catalyst for stock market strength, the turning off of the spigots should be monitored for the reverse effect.

We thank you for your continued trust and encourage you to contact us for a specific discussion of your portfolio.

THE STALEY CAPITAL INVESTMENT TEAM