Market Recap

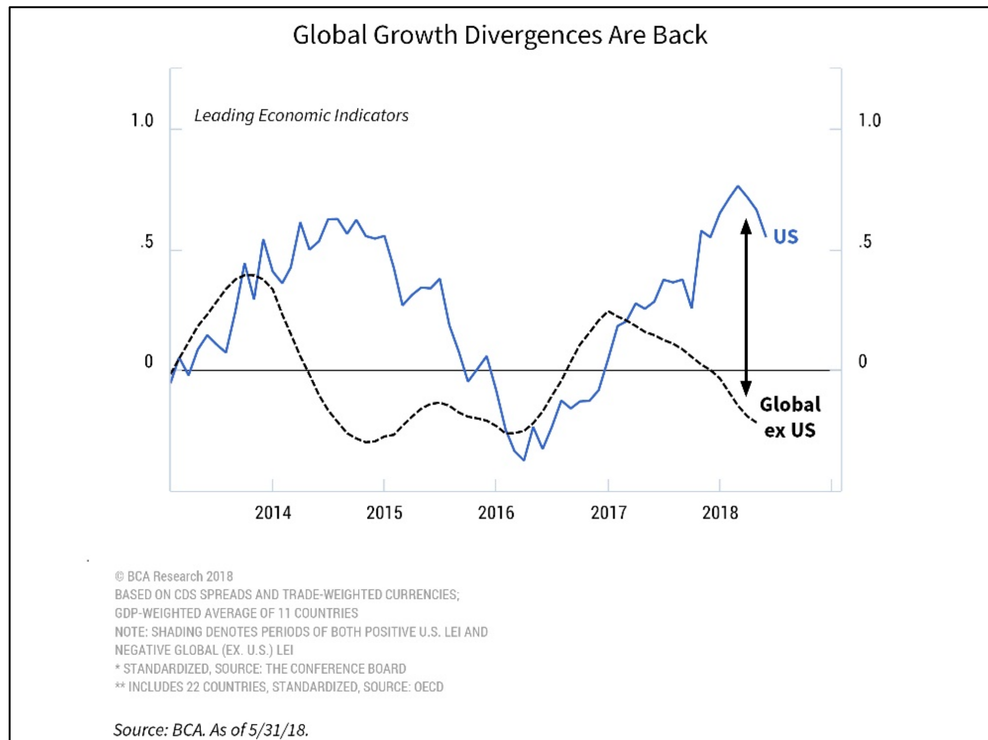
June Benchmark Returns	MTD	QTD	YTD
EQUITY BENCHMARKS			
Vanguard 500 Index	0.6%	3.4%	2.6%
iShares Russell 1000 ETF	0.6%	3.5%	2.7%
iShares Russell 1000 Value ETF	0.3%	1.2%	-1.8%
iShares Russell 1000 Growth ETF	1.0%	5.7%	7.1%
iShares Russell 2000 ETF	0.6%	7.9%	7.7%
Vanguard REIT	4.1%	8.8%	-0.1%
iShares MSCI ACWI ETF	-0.6%	0.3%	-0.3%
Vanguard FTSE Developed Markets ETF	-1.7%	-1.8%	-2.8%
Vanguard FTSE Europe ETF	-1.3%	-1.6%	-2.8%
Vanguard FTSE Emerging Markets ETF	-4.8%	-9.6%	-7.3%
FIXED-INCOME BENCHMARKS			
Vanguard Total Bond Market Index	0.0%	-0.2%	-1.7%
Vanguard Intermediate-Term Tax-Exempt	0.1%	0.8%	-0.3%
iShares TIPS Bond ETF	0.7%	0.9%	-0.0%
ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index	0.4%	1.0%	0.1%
S&P/LSTA Leveraged Loan Index	0.1%	0.7%	2.2%
ALTERNATIVE BENCHMARKS			
HFRX Global Hedge Fund Index	-0.2%	0.2%	-0.9%
Bloomberg Commodity Index	-3.5%	0.4%	0.0%
SG Trend Index	1.1%	-1.3%	-5.2%
3-Month LIBOR	0.2%	0.6%	0.9%

U.S. stocks rose to the top of asset class performance charts with solid returns in the second quarter. Larger-cap U.S. stocks (Vanguard 500 Index) gained 3.4%, but were outdone by smaller-cap stocks (iShares Russell 2000 ETF), which jumped 7.9%. The smaller-cap outperformance was driven by the market narrative that smaller companies are more domestically focused and therefore not as exposed to a strengthening U.S. dollar or potential trade wars, both of which are assumed to be detrimental to larger-cap (multinational) company profits.

After surprising the market consensus by dropping roughly 12% over the prior 15 months, the U.S. dollar (DXY Index) rebounded 5% against a basket of its peers and ended the second quarter at an 11-month high. The dollar's appreciation translated into a meaningful headwind to returns for dollar-based investors in foreign securities (as foreign currencies depreciated against the dollar). Developed international stocks (Vanguard FTSE Developed Markets ETF) fell 1.8% and European stocks (Vanguard FTSE Europe ETF) declined 1.6% for the period. Emerging-market (EM) stocks fared the worst, dropping 9.6% in dollar terms (Vanguard FTSE Emerging Markets ETF). The global stock index (iShares MSCI ACWI ETF), which combines U.S., international, and emerging stock markets, gained just 0.3% for the quarter and is slightly negative for the year.

In addition to the currency effects, emerging market stocks were buffeted by on-again, off-again (and back on-again) trade tensions between the United States and Europe, Mexico, Canada, Japan, and China—in other words, all our major trading partners. Fears of a trade war with China and the European Union escalated into quarter-end, with the entities engaged in vigorous trading of threats and counter-threats. In light of the trade tensions, we'll also address the global trade threat below and how we incorporate such macro uncertainties into our overall portfolio management approach.

Moving on to the bond markets, in May, the benchmark 10-year Treasury yield pierced the 3% level, 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 bond index (Vanguard Total Bond Market Index) had a slightly negative return (bond yields and bond prices move inversely to each other) for the quarter and is down nearly 2% for the year.



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

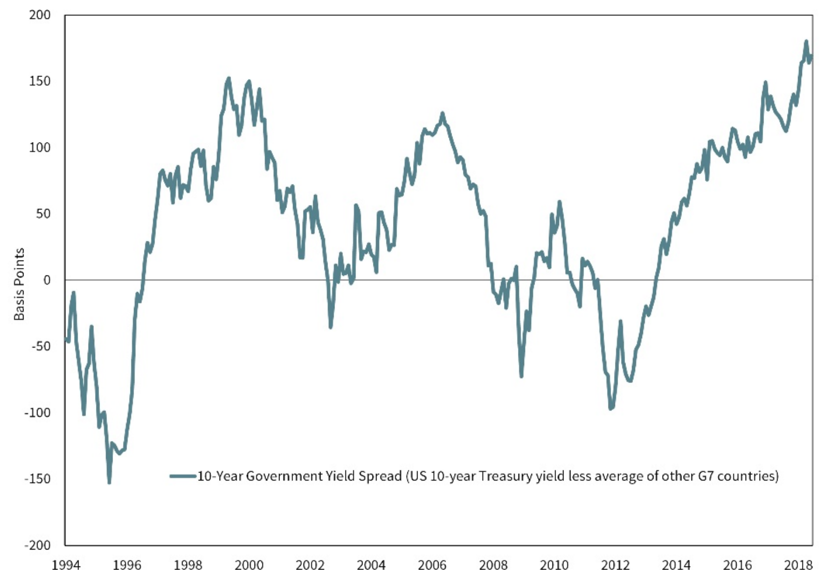
While there are always multiple, diverse factors impacting bond yields on a day-to-day basis, a primary underlying driver is Federal Reserve monetary policy (and the market's *expectations* about such). Fed policy in turn is driven by the Fed's assessment of the U.S. economy, and specifically its twin objectives ("dual mandate") of price stability and full employment. To this end, with the economy growing above trend and the labor market tight (the unemployment rate fell to an 18-year low in May), the Fed continued its gradual path of tightening monetary policy. In June, as expected, it hiked the federal funds policy rate another 25 basis points to a range of 1.75%–2%. It also forecasted a slightly accelerated path of hikes over the next two years, which, if it comes to pass, would bring the fed funds rate to a range of 3%–3.25% by the end of 2019. Whether the economy can withstand that degree of tightening remains to be seen.

In other central bank news, the European Central Bank said it would conclude its quantitative easing/asset-purchasing program by the end of this year. However, the ECB also sent a more dovish message, saying it doesn't plan to begin raising its benchmark refinancing rate (currently sitting at 0%) until at least September 2019. The ECB also has no plans to start shrinking its balance sheet any time soon, unlike the Fed, which is in the process of allowing up to $50 billion per month of its QE assets to mature without reinvesting the proceeds.

Beyond the strength of the U.S. economy, the global economy remains in fairly good shape, with real GDP growth expected to be above trend again this year (the consensus forecast seems to be in the 3.5%–4% range). However, last year's highly synchronized growth has decelerated and may have peaked for this cycle. BCA's chart of leading economic indicators highlights the divergence in global growth. The U.S. economy's stronger relative growth along with a further widening of the yield gap between U.S. and foreign bonds (i.e., diverging central bank policies) have been reflected in the rebound in the U.S. dollar, described above.

The recent dollar-strength trend may continue for a while as currency momentum can take on a life of its own. However, 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, 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 Trump administration also seems to prefer a weaker dollar.



Source: Bloomberg. Data as of 6/30/18.

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 owning both domestic and foreign stocks.

Quarterly Portfolio Performance, Key Drivers, and Positioning Recap

Our clients know we don't invest based on three-month time horizons or short-term expected outcomes. To the contrary, we strongly believe that a critical element of our investment process and edge is our discipline to maintain a longer-term (multi-year) perspective while other market participants over-react to short-term performance swings, daily news flow, and other emotional/behavioral triggers. We try to minimize the harmful impact of "myopic loss aversion" on our investment decision-making that can come from paying too much attention to short-term results. Yet, many clients are also naturally curious to know "what worked and what didn't" in any given period. So, with that in mind, we provide the following update on the key drivers of our portfolios' recent quarterly performance.

Equities

All our globally diversified portfolios have meaningful strategic allocations to developed international stocks. Our active portfolios also currently have a tactical overweight to European stocks and are underweight to U.S. stocks. This positioning was beneficial in 2017, as foreign markets outperformed U.S. markets. However, it has been a drag on returns this year, driven by the sharp performance divergence among these markets in the second quarter.

We provide a more detailed update of our outlook below. In a nutshell, our key equity market views and positioning remain unchanged. On a tactical (five-year) basis, U.S. stocks are overvalued driven primarily by growth/momentum issues (i.e. FANG – Facebook, Amazon, Netflix and Google) and offer very low expected returns across the macro scenarios we think are most likely. Put differently, at current prices and valuations for broader U.S. market indices, we don't believe we are being sufficiently compensated for U.S. stocks' downside risk – which is another reason to stick with our value-based, dividend-focused investment approach which avoids overpriced issues. European and foreign stocks currently offer a meaningful expected return premium over U.S. stocks across most scenarios, and at least sufficient (although not table-pounding) absolute returns to compensate us for their shorter-term risks.

Overall, on a global basis, our portfolios are tactically underweight to stocks for our balanced portfolios. We are waiting patiently for expected equity returns to materially improve before increasing our U.S. equity exposure back toward our strategic portfolio targets. At this point in the cycle, it will most likely take a large market decline (a bear market) for equity returns to become attractive. A bear market will likely unfold in advance of an economic recession, which is likely to be caused by central bank policy tightening or some unexpected macro or policy shock.

Fixed-Income

Our balanced portfolios have an overweight allocation to our unconstrained fixed income strategy which consists of an actively managed, opportunistic process consisting primarily of high yield (junk) bonds. Our strategy contributed positively to quarterly portfolio returns and strongly outperformed the core investment-grade bond index, as has been the case over the past several years. We continue to expect these positions to outperform over the next several years, particularly if interest rates continue to rise.

Reiterating our Foreign Stock Thesis and Outlook

Our research continues to suggest attractive return potential for foreign stocks relative to U.S. stocks over our five-year tactical investment time horizon. We believe international companies in aggregate are under-earning relative to their normalized potential, and this is not fully priced into their stock prices. U.S. stocks, on the other hand, are over-earning and are expensive, implying very low five-year expected returns.

This year's selloff in foreign stocks appears to have been driven by a combination of investor concerns about:

- a potential trade war with China and other global trade partners such as the EU, Mexico, and Canada;
- deceleration in global growth outside the United States as foreign stocks tend to be perceived as more sensitive to shifts in overall economic growth; and
- a stronger U.S. dollar coinciding with rising U.S. interest rates and tightening Fed monetary policy—although evidence suggests international stocks do fine when interest rates in the United States are rising as long as global growth is solid.

These macro developments, in particular the risk of a US trade war with China and the rest of the world, are indeed risks to foreign stocks, at least in the shorter term. We also know that investor perceptions and over-reactions can create a self-fulfilling market reality for some period of time (i.e. financial market outflows causing lower asset prices and depreciating currencies, causing more investor fear, causing more outflows, and so on). However, these are not new risks to international markets.

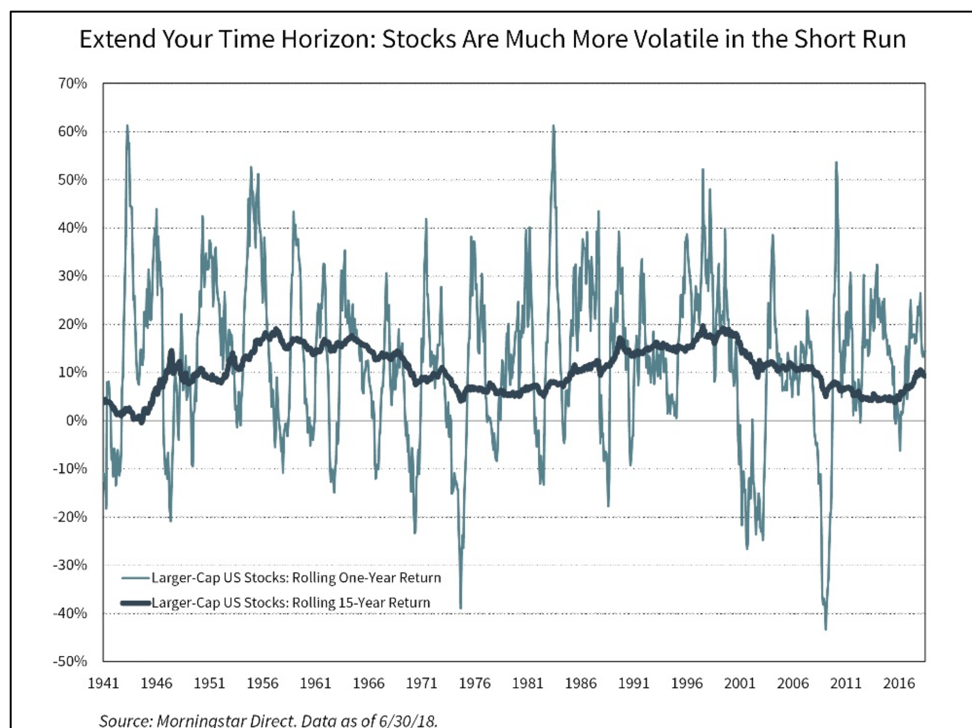
President Trump campaigned on a promise of trade protectionism. At the time, we acknowledged that while protectionism would be a negative for markets, there was great uncertainty as to what, if any, trade policies would actually be implemented. We also believed in the event of trade restrictions, it was not obvious which foreign companies would necessarily be worse off than U.S. companies, given how much U.S. businesses (and profits) have benefited from free trade and the globalization of labor markets and supply chains.

Ultimately, we thought it likely that cooler heads would prevail and a mutually damaging trade conflict would not ensue. As it happened, the market's concerns about protectionism receded and stocks performed well. Tariff concerns have now re-emerged, and with more concrete threats and reprisals on the table. Our view, however, remains broadly the same. It is in the best interest of both the United States and its trading partners 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 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.

Concluding Comments

It is understandable that fears of a global trade war are rattling financial markets. The resolution of the current trade tensions is a meaningful uncertainty 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. For a recent example: how many experts predicted the 180-degree flip this year in the relationship between President Trump and North Korea's dictator—from name-calling and nuclear threats to grinning BFFs? The bottom line is that nobody knows how it will all play out.

Therefore, we file this under the heading: "There are *always* risks and uncertainties when investing in equities that have the potential to cause significant shorter-term price declines." Whether it is a trade war, a geopolitical event, an unexpected economic shock, a monetary policy mistake, or innumerable other factors, stocks can deliver big losses, at least over shorter-term (one- to three-year) periods. Market corrections and bear markets happen. An investor must be able to withstand these drops, stay the course, and stick to their long-term plan - assuming it was well-designed and aligned with their financial objectives to begin with.



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

No one can consistently and accurately predict the timing, outcome, and market reactions of these types of macro/geopolitical uncertainties. A corollary, therefore, is that people who try to do so are very likely to detract more value than they add over time. They're more likely to get whipsawed by the daily news headlines and changing "expert" opinions

amid market ups and downs. While they may feel better in the moment of their action, they end up with a worse outcome than if they had remained disciplined in their investment approach. We believe it is far better to stick with one's long-term strategic asset allocation applying disciplined rebalancing and to only make portfolio changes away from your strategic allocation when you have high confidence (based on strong evidence and analysis) that you have an edge. This is possible if you understand what the market is discounting in current prices, why you think the market is wrong, and why the odds are stacked in your favor that you are likely to ultimately be proven right. Even then, of course, there is no guarantee you will be right every time. In fact, it is guaranteed you *won't* be right every time. That's why portfolio diversification, scenario analysis, and risk management are also critical elements.

As mentioned earlier, one of the key elements of the edge we think Altrius has is "time arbitrage"—our willingness and ability to take a longer-term analytical view and maintain a longer-term investment horizon than other market participants. We don't have to respond to all the short-term market noise, and we don't play the short-term trading (guessing) game.

Our globally diversified portfolios are positioned to perform well over the long term and to be resilient across a range of potential scenarios. Should the current trade tensions resolve, and the global economic recovery continue, we expect to generate solid overall returns, with outperformance from our value-based, dividend focused foreign and domestic stocks and our unconstrained fixed income process. Alternatively, should a bear market strike, our portfolios which are underweight stocks, should hold up much better than those tilted strongly toward equities. We'd then expect to put capital to work more aggressively by, for example, reallocating to US equities at lower prices and higher expected returns sufficient to compensate us for their risks.

As always, we thank you for your continued confidence and trust.

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