MARBLE TRAIL ADVISORS

Financial Planning & Wealth Management

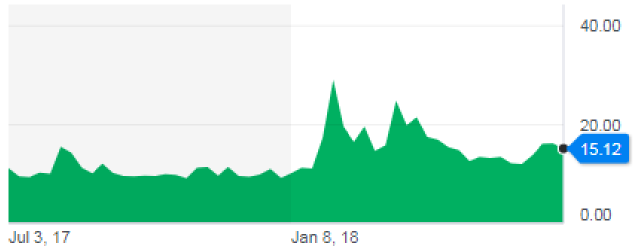
Market Update

2nd Quarter 2018

Global Stock Market Highlights

- Trade tension was the dominant theme of the quarter and moved investors to dial back on equity risk, leading to small average gains in the US and large losses in emerging markets.
- Chinese stocks entered a bear market and other exporting countries like Korea and Singapore also suffered.
- A search for safe havens sent the US dollar higher. This contributed to small losses for US investors in developed foreign markets, even as European and Japanese markets advanced in local currency terms.
- The UK market recouped losses from a miserable 1st quarter. There was less to the recovery than meets the eye, however, as gains were concentrated in oil producers and miners, driven more by global demand for commodities than any positive assessment of the British situation. The government remains divided about how to approach Brexit negotiations and no one has put forth a credible plan.
- Outside the US, profit growth moderated slightly, but valuations are generally lower than a year ago and far more reasonable than the still high US market.

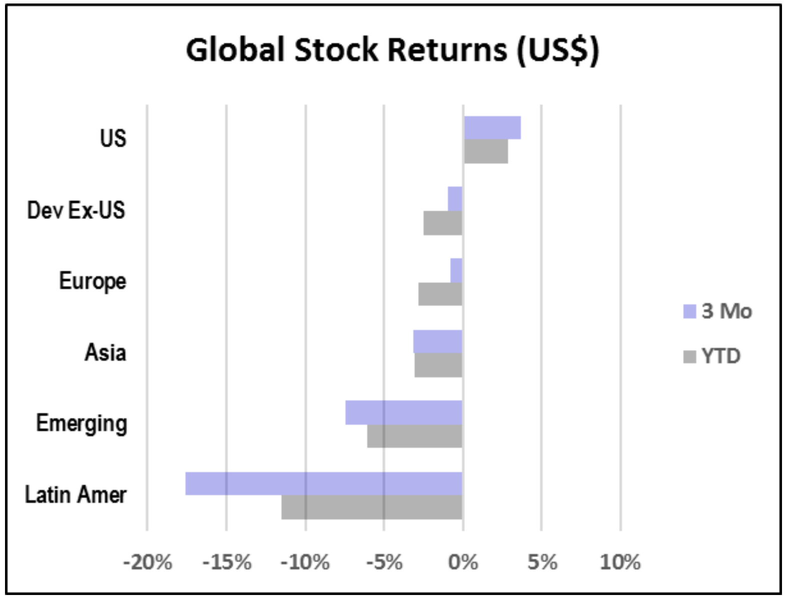
Vix Volatility Index



Source: Yahoo Finance

P/E Ratios	Current	1 Yr Ago	3 Years Ago
S&P 500	20.4	21.4	19.0
Russell 2000 (Small)	18.3	21.1	20.6
Europe	15.2	20.0	19.2
Emerging Markets	14.0	14.3	14.6

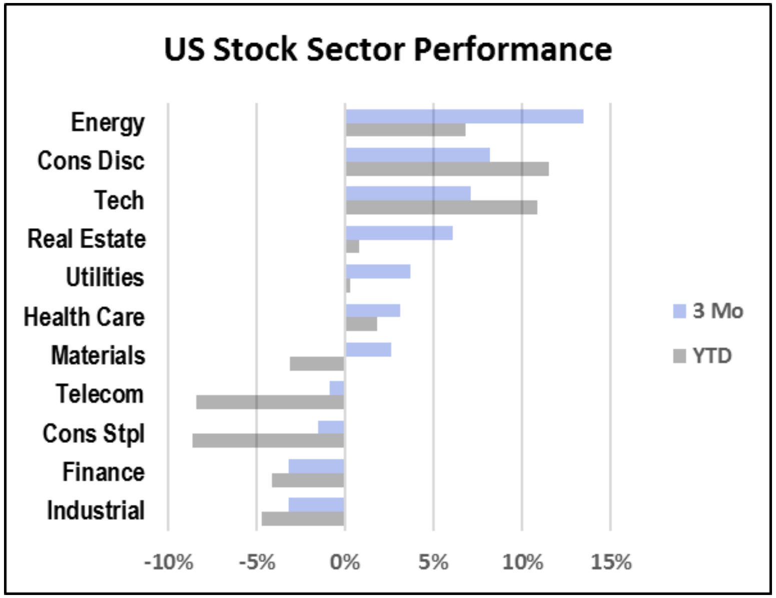
Source: Morningstar



Source: S&P Dow Jones

Stock Sector Highlights

- Despite a gain in the major indexes, US stock performance was decidedly mixed.
- Higher oil prices helped energy to double-digit gains, while consumer discretionary and technology stocks continued their strong run.
- At the other end of the spectrum, threatened retaliatory tariffs hammered industrial companies like Boeing and Caterpillar that rely heavily on exports.
- Corporate earnings remain strong and, with the S&P 500 up less than 3% year-to-date, P/E ratios are 11% lower than in January. On the other hand, it is difficult to assess the likely hit to profits that would result from a trade war, so little comfort can be taken in the market's current position.



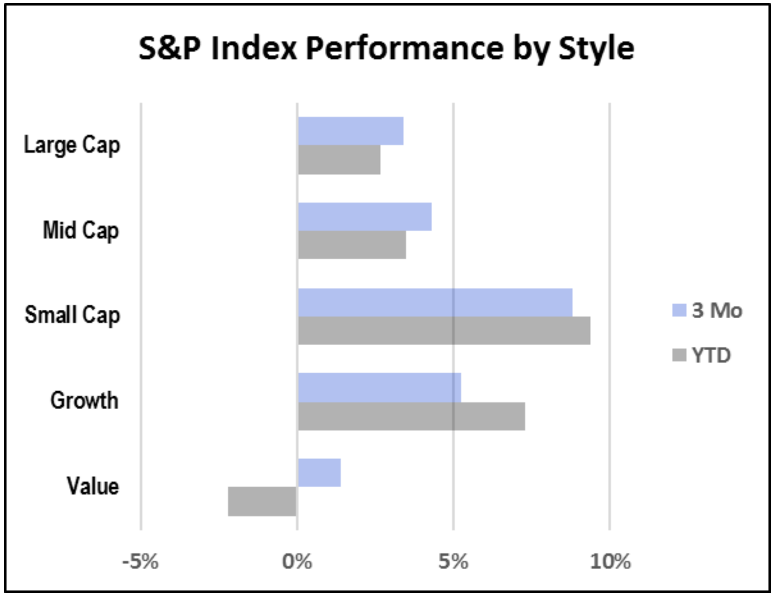
Source: S&P Dow Jones

	P/E Ratios			Yields	
Sector	Current	1 Yr Ago	3 Years Ago	Current	3 Years Ago
Consumer Discretionary	20.5	21.7	20.7	1.1%	1.3%
Consumer Staples	20.5	21.6	20.2	2.8%	2.6%
Energy	19.2	32.1	16.4	3.0%	2.7%
Financials	14.4	15.9	15.5	1.7%	1.7%
Health Care	26.4	23.5	23.7	1.5%	1.3%
Industrials	19.1	21.9	18.3	1.9%	2.1%
Technology	22.4	22.2	17.6	1.3%	1.8%
Utilities	17.2	20.2	19.8	3.4%	3.7%
S&P 500	*20.4*	*21.3*	*19.1*	*1.9%*	*2.0%*

Source: Morningstar

Stock Market Performance by Style

- Investors seem convinced that the future belongs to Amazon, Facebook, Google and Netflix. Their stocks continue to soar and the performance gap between growth and value stocks has widened. Investors appear unfazed by the tail risks[1] these companies face, especially from the potential for heightened regulation.
- Small companies again outperformed as investors appreciate that they are less reliant on trade and, therefore, more insulated from the effects of a potential trade war.
- Very few areas of the market appear attractively valued. A long-awaited surge in the profitability of banks and oil companies drove the European P/E ratio down to 15.2. The narrowness of the market makes this a bit deceptive, in our opinion. Emerging markets are also cheap on paper, but the escalation of trade rhetoric has dominated fundamentals, turning last year's most-loved investment into this year's most-hated.



Source: S&P Dow Jones

Style Box Valuation

	Value	Blend	Growth
Large	17.2	20.5	25.6
Mid	16.4	20.6	28.1
Small	16.2	19.2	25.1

Source: Morningstar, Vanguard

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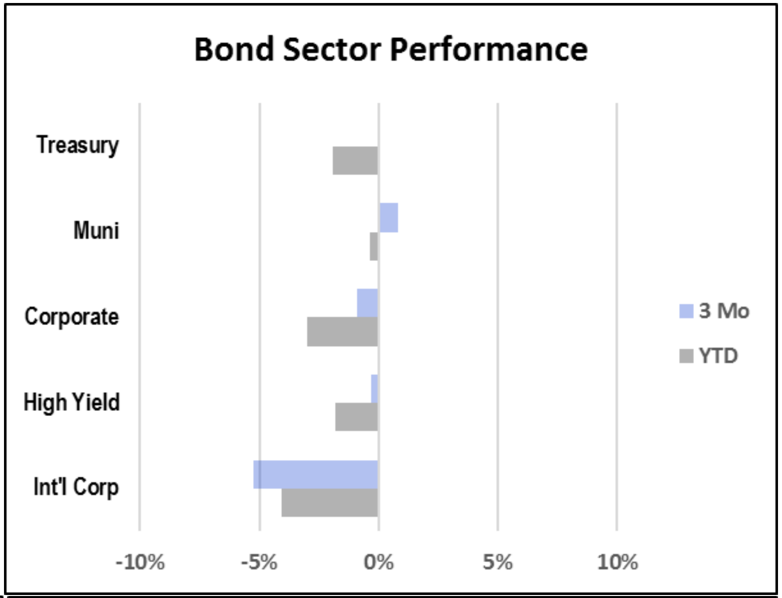
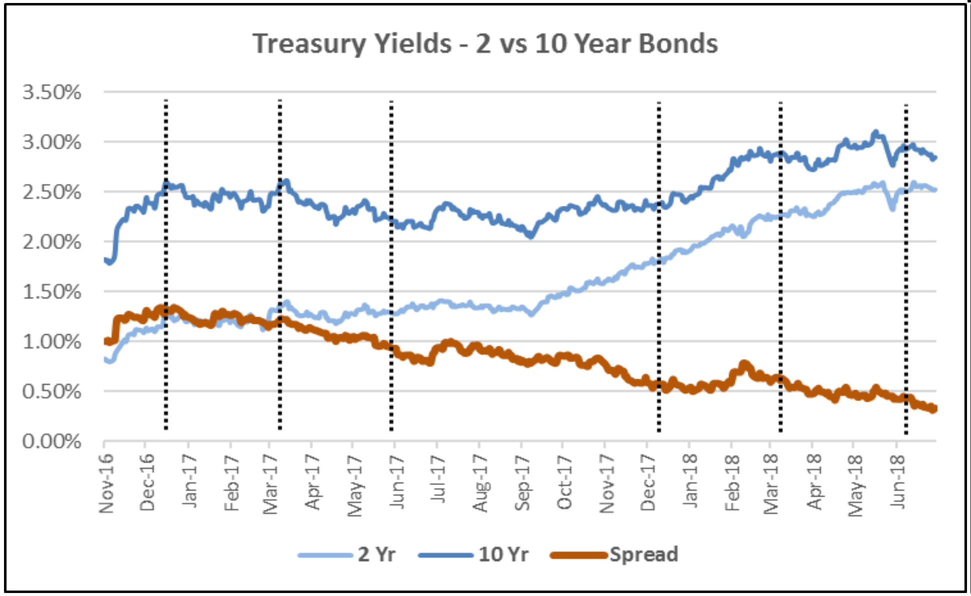
Source: Morningstar

1 An improbable event which, if it occurred, would prove highly destructive of value. For example, prior to the 2008-2009 financial crisis, a cross-country wave of mortgage defaults was considered to be a low-probability tail risk for banks.

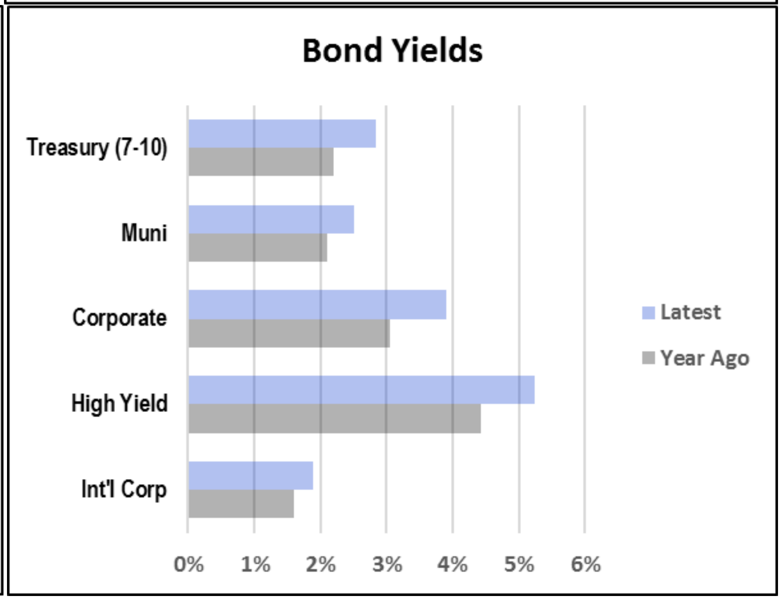
Bond Market Highlights

- Global interest rates climbed in April before retreating because of – you guessed it – escalating trade threats.
- In general, government bond yields were unchanged from a quarter ago, while corporate bonds yields increased slightly alongside economic/trade concerns.
- US investors in foreign bonds lost money due to a strengthening of the dollar.
- The spread between high yield and investment grade corporate bonds remains narrow, suggesting that the market considers the risk of recession to be quite low. On the other hand, short-term rates have climbed faster than long-term rates, suggesting the market thinks the long-term outlook is less favorable.





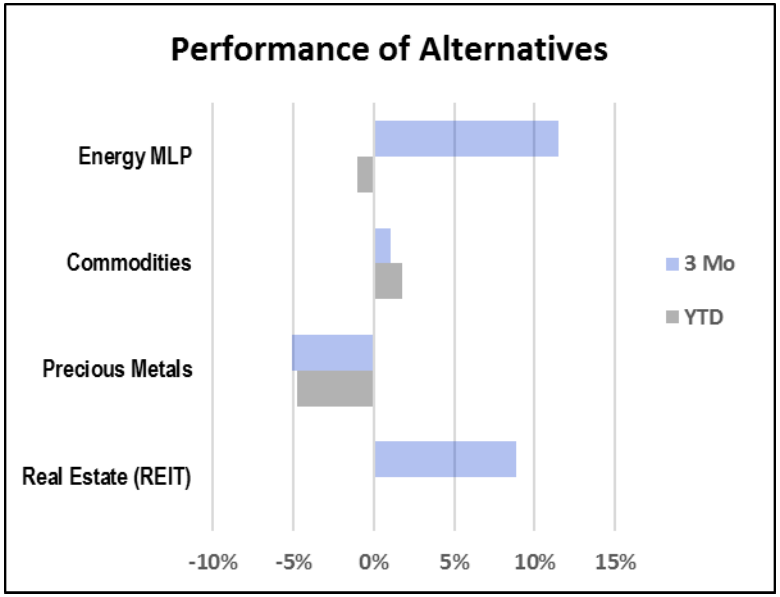
Source: St. Louis Fed



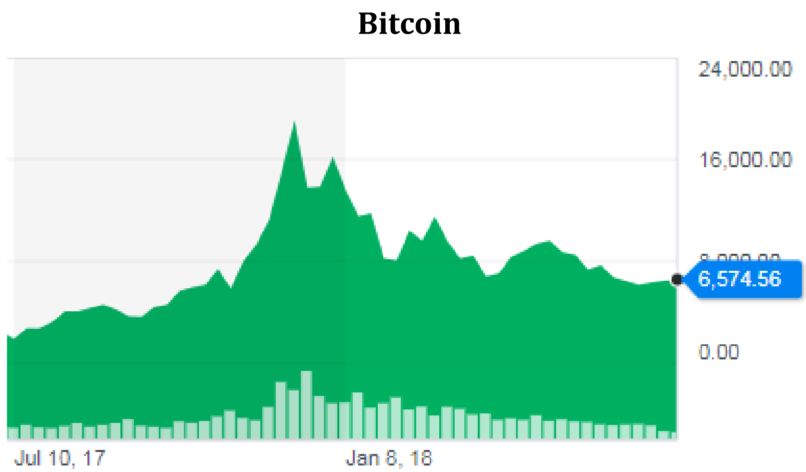
Source: S&P Dow Jones

Alternative Investments

- The oil prices rally extended into the 2nd quarter with WTI crude finishing at $74 / barrel, up 14%. The benefits finally filtered down to energy MLPs, helping them to a double-digit gain for the quarter and near break-even for the year.
- A similar performance was turned in by REITs, which benefited from moderating long-term interest rates.
- Gold failed to live up to its reputation as a safe haven, with most of the quarter's 5% price drop occurring after the tumultuous G7 meeting in mid-June that accelerated the deterioration in US trade relations.
- Enthusiasm for Bitcoin has faded with prices down a further 13% in Q2 amid lower trading volume and volatility.



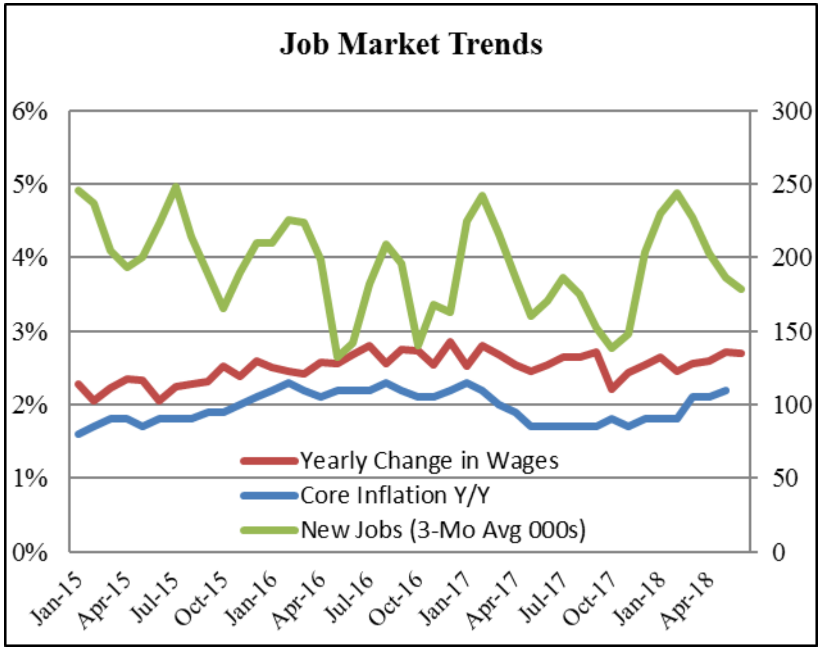
Source: S&P Dow Jones, Morningstar

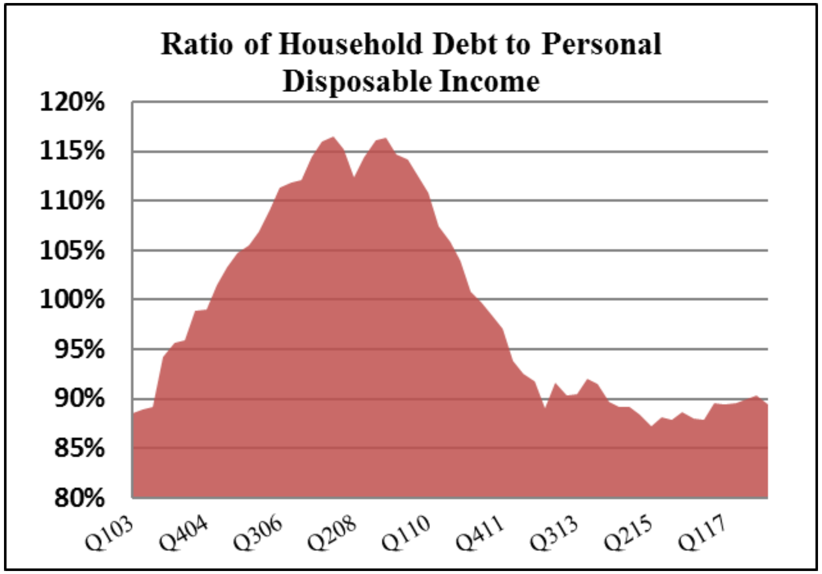


Source: Yahoo Finance

Economy

- Jobs grew at a somewhat less robust pace while the unemployment rate ticked down to 4.0%. Economists seem more uncertain than ever as to what level constitutes "full employment" and look to rising wages and inflation to give them the answer.
- Denying any clear signal, annual wage growth has bounced around 2.7% for nearly two years, while core inflation has edged up to 2.1%, slightly above the Fed's target, but also about where it was two years ago.
- Nonetheless, the Fed "dot plot" was updated in June to suggest four total rate hikes in 2018, rather than three.
- Newly imposed tariffs now add further price pressure on top of fiscal stimulus, but with the prospect of destroying rather than creating jobs. The Fed's dual employment/inflation mandate gets harder to fulfill by the day.
- Consumer debt has steadily increased throughout the expansion, but newly enabled tax cuts have increased disposable income and made this slightly less burdensome, helping to offset the effects of higher interest rates.
- The most imminent threat to this nine-year expansion is not a gradual build-up of excess, but rather an external shock to the system. A trade war might be just that threat.





Sources: ADP, US Depts. of Labor and Commerce, & the New York Fed

Our Macro View

Region	Current Conditions	Long-term Outlook	Investment Implications
USA	Accelerating growth; labor market near full-employment; early signs of excesses that typically precede recession, all clouded by trade policy.	<u>Base</u>: Trump backs down on trade war as effects become unpopular. Stimulus increases spending & business investment in short run; rising debt and interest rates lead to next recession (2-4 years). <u>Downside</u>: Trade war triggers stagflation – higher inflation with lower growth, corporate profits suffer. <u>Upside</u>: Trade war averted, increased investment leads to permanent rise in growth & productivity.	Tax cuts are more fully priced into market than a trade war, which leaves the market fully priced with more downside risk than upside opportunity. A marginally defensive posture is prudent.
Europe	Slowly improving with gains in hiring and inflation; South now improving, but facing political challenges.	<u>Base</u>: Irreconcilable differences lead to slow dissolution of the EU in its current form. <u>Downside</u>: Nationalist sentiment hastens the process beyond the point of prudence. <u>Upside</u>: Germany takes more enlightened view toward providing fiscal stimulus in South.	Market consensus not entirely in line with our base case. Brexit and Euro zone now equally in focus. Slightly lower than normal weightings with moderate currency hedges.
Japan	Marginal gains in growth and inflation are fading; trade weighing on outlook; massive public debt.	<u>Base/Downside</u>: More of same until debt burden breaks view of Yen as safe haven asset, at which point inflation returns by way of devaluation. <u>Upside</u>: Nation implements structural reforms and immigration policy to inject dynamism.	Slightly below normal weightings with hedging of currency exposure.
China	Slower growth than official figures; heavy industry, interior struggling; consumer strong; public & private debt growing.	<u>Base</u>: Slowing of economy creates domestic issues absorbing central government resources, pressuring the currency. <u>Downside</u>: Either government missteps or a trade war lead to rising unemployment & unrest. <u>Upside</u>: Consumer economy grows fast enough to outweigh other problems.	Chinese stocks in bear market due to trade worries. Potentially more near-term upside than downside, but range of possible outcomes extremely wide. Selectivity remains key; avoid state-owned enterprises, heavy industry; favor consumer and smaller companies.

Our Fundamental View

Fundamental	Medium- to Long-term Outlook	Investment Implications
Stock Market Valuation	Virtually all assets are expensive relative to historical averages, which suggests that investment returns for everything from stocks to bonds and real estate will be below long-term averages. Tax cuts justify some of the appreciation since Nov 2016, but companies will have to deliver in 2018, which they started to do prior to the trade battles. Higher valuations mean more vulnerability to shocks, with North Korea and Trump's trade agenda still being the most proximate risks.	Achieving 5-7% annual returns over the next 5-10 years will require embracing stock market volatility to the extent afforded by your risk tolerance and portfolio withdrawal rate. Diversification will remain key to generating decent returns while managing risk.
Interest Rates	The era of policy divergence has moved to the middle stages with the US tightening and most of the world still accommodative. Powell unlikely to push major policy changes at Fed. Europe, Japan and China, awash in money, have helped contain long-term interest rates in U.S., but debt will rise substantially in coming years. Europe is around two years behind the U.S. in policy, which suggests tightening starts in 2019; disparate North-South conditions – and the potential for trade to cause a global slowdown – add uncertainty to that outlook. Draghi's successor in 2019 may be German and less supportive of easy money policies.	Continue to employ reasonable hedges against rising rates, including laddered bond portfolios, floating rate notes and cash. With short-term rates high relative to long-term, focus on the near-end of the yield curve for now.