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RDM FINANCIAL GROUP

Market Update
June 27, 2018

Unlike The first half of the year has been a tug of war between positive U.S. economic fundamentals and rising corporate profits on the one hand, and additional rate hikes by the Federal Reserve Bank, fears of geopolitical events and a threat of rising tariffs on the other hand. Equity markets started off the year on a positive note in January. However, after advancing for 15 straight months, stock prices peaked in late January. From there, equity markets entered their first correction in several quarters. As a reminder, pullbacks and corrections are a normal part of investing and something that investors should expect to occur from time to time.

Despite a number of punches being thrown at the market over the past few months, equity markets have so far proven to be quite resilient. In terms of the broad markets, returns have been mixed so far this year when comparing various U.S. indices as well as comparing U.S. versus foreign markets. For reference, on a year-to-date basis, the NASDAQ Composite Index, Russell 2000 Small Cap Index and S & P 500 Indices are all posting modest gains so far this year while the Dow Jones Industrial Average along with overseas markets are posting modest declines. Overseas, markets have lagged a bit behind U.S. markets so far this year after a solid performance last year.

Initially, talk of tariffs seemed like political posturing aimed at our trading partners and President Trump's political base. Widespread trade wars are in no one's best interest. They act like a tax on consumers and can have a negative impact on global economic growth. Our current thinking remains that ultimately, calmer heads should prevail and that negotiations will likely lead to a more stable, positive outcome. Unfortunately, it appears that financial markets may be buffeted by daily news tariff headlines out of Washington for the next several weeks or months.

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The following statistics help put things in perspective. Overall the U.S. economy has a GDP of $19.4 trillion dollars (based on 2017 data). Exports to China represent $130 billion or 0.7% of GDP while imports from China represent $506 billion or 2.6% of GDP. According to a recent report from Bernstein Research, the first round of Trump tariffs have affected $120 billion or 5% of total U.S. imports. When you include recently proposed tariff additions on Chinese goods and potential restrictions on European autos, the estimate rises to $520 billion or approximately 21% of U.S. imported goods. A growing concern is that if the U.S. and other countries get involved in an all-out protracted trade war, this could start to offset the positive tailwinds generated from recent tax cuts and increased fiscal spending. In addition, if corporate executives turn more cautious due to a rise in global protectionism, this could lead to a slowdown in growth and impact economic data over the next several quarters.

When we evaluate the list of positives including solid labor market growth, positive consumer and business confidence levels, growing corporate profits, historically low interest rates, healthy credit spreads and signs of a pickup in manufacturing activity, we remain relatively constructive looking out over the next few quarters.

For reference, the NFIB Small Business Optimism Index current stands at the highest reading since 1983 and the second highest level in the survey's 45-year history. Turning to monetary policy, while The Federal Reserve Bank has raised rates seven times so far this cycle (by a quarter point each time), financial conditions remain accommodative. For example, with the core CPI inflation rate slightly above 2% and the Fed Funds rate (controlled by the central bank) now in a range of 1.75% to 2%, the real i.e. inflation adjust Fed Funds rate remains negative (i.e. below 0%). At least historically, short term rates have averaged 1.3% or 130 basis points above the rate of inflation (source: S and P).

Yes, this is the second longest economic expansion in the post WWII period and the Federal Reserve Bank is 2 1/2 years into its current rate hiking cycle. However, right now we do not currently see a recession ahead and believe that the U.S. economy appears to be on relatively solid footing. According to the most recent update from Factset (as of June 22, 2018) earnings per share for the S & P 500 are currently forecast to rise 20.5% this year (compared with an estimate of 17.9% y/y growth on March 31, 2018) and 9.9% next year (compared with an estimate of 8.1% y/y growth on March 31, 2018). The year over year growth rate for corporate profits is bound to slow from current

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levels over the next year or two. Looking ahead, we believe it's important to distinguish between a continued moderate rise in corporate profits over the next year or two (which appears most likely right now) versus an outright decline in corporate profits (which is typically associated with an economic downturn or recession).

If interest rates, wages and commodity costs continue to rise somewhat, that will likely be a drag on the growth rate of corporate profits over the next several quarters. Taking a longer-term time frame, corporate profits tend to follow the direction of nominal GDP (i.e. real GDP plus inflation) over time. If inflation registers around 2.5% and real GDP comes in around 2.5%, corporate profits could rise around 5% per year. If productivity levels rise and GDP growth increases over the next several years (what Republicans in Congress hope to achieve), that should help boost the level of corporate profits. However, if real GDP slows (due to weaker productivity levels, a lack of workers or a down turn in the economy), that could reduce the growth rate of corporate profits down the road.

As we head into the summer months, the wall of worry remains considerable. Headwinds include geo-political risks, the potential for more serious trade wars, further rate hikes by the Federal Reserve Bank (likely two more times this year) along with uncertainty from upcoming elections this Fall. According to the research firm CFRA (formerly S and P), since 1945 the political party in power has historically lost 22 seats in the House of Representative and 4 seats in the Senate (which could threaten Republican's control of Congress). In May, anxiety levels rose somewhat after interest rates spiked in Italy due to rising political tension in that country. Because of some of the issues highlighted above, we could experience more bumps in the road as we head through the summer months. Lastly, rising debt levels (both globally as well as here at home) represent longer-term concerns for financial markets and the economy.

Looking under the hood, market internals remain mixed. This month the advance decline line for both the S & P 500 and the NYSE both registered new all-time highs. While this does not provide an all clear signal, we believe it represents an encouraging sign. At least historically, equity markets have tended to peak after the market's advance decline line starts to weaken for a period of time. On the other hand, the median sector return for the S & P 500 (meaning half are higher and half are lower) has registered -0.7% as of June 22, 2018. Thus, the first half of the year has been a challenging time for

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financial markets and investment returns. With a majority of the world population, GDP and companies located outside the United States (along with the fact that overseas markets remain cheaper than U.S. equity markets and monetary policy is more stimulative), we think it's important for investors to think globally and have at least some foreign exposure when constructing investment portfolios.

At RDM, we currently have approximately 15% exposure in foreign markets. Earlier this year, we considered raising that allocation somewhat. However, as a result of a pick-up in the U.S. economy (due to recent tax cuts and increased fiscal spending), we decided to keep our foreign exposure unchanged. While a number of our equity portfolios are trailing the returns of U.S. markets modestly on a year-to-date basis, a majority of our portfolios are outperforming the MSCI All Country World Index (ACWI) which includes the U.S., developed and emerging markets overseas.

The end of bull markets has historically been marked by a period of extreme optimism when retail money flows into equities. However, according to the research firm Morningstar, over the past 2.5 years (since 12/31/16) $707 billion of money has flowed into fixed income mutual funds and ETF's while just $34 billion has flowed into equity-based ETF's and mutual funds. While this is only one consideration, to us, this is not a sign of the kind of euphoria that typically represents equity market peaks.

In summary, the summer months could bring additional volatility. However, based on currently available information, we believe it is too early to call an end to the current multi-year expansion and bull market just yet. Right now, consumer and business confidence levels remain healthy, employment levels are at multi-decade highs, manufacturing activity is starting to improve and corporate profits are rising at a solid rate. Looking ahead, economic growth in the U.S. could very well pick up somewhat over the next 2-3 quarters after a sluggish start to the year (before slowing down again somewhat next year). While we still think investors should have some exposure overseas, it looks like the U.S. is back in the driver's seat once again (for now).

When all is said and done, this could very well turn into the longest expansion in the post WWII period. As we look further down the road into 2019 and beyond, the headwinds cited above could lead to growing financial strains that may have a more

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significant impact on the outlook for U.S. and global financial markets. Much can change in the period ahead so stay tuned. We will provide a more detailed market update following the end of the second quarter.

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S & P 500 - The S&P 500 is a gauge that tracks the performance of large-cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available U.S. market capitalization.

MSCI ACWI Index – The MSCI ACWI Indexes tracks the returns of 23 developed and 24 emerging markets around the world.

Russell 2000 Index – The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index.

Nasdaq Composite Index - The Nasdaq Composite Index is the market capitalization-weighted index of over 3,300 common equities listed on the Nasdaq stock exchange.

NFIX Small Business Optimism Index - The small business optimism index is compiled from a survey that is conducted each month by the National Federation of Independent Business (NFIB) of its members. The index is a composite of 10 seasonally adjusted components based on the following questions: plans to increase employment, plans to make capital outlays, plans to increase inventories, expect economy to improve, expect real sales higher, current inventory, current job openings, expected credit conditions, now a good time to expand, and earnings trend.

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