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Monthly Investment Report

June 2018

<u>SUMMARY</u>: U.S. stocks had positive returns again in May but foreign stocks were mostly negative, largely the result of a stronger dollar, particularly against the euro. Italy's political turmoil hurt bond returns overseas but boosted U.S. Treasuries as investors sought safe havens. The Fed is likely to raise interest rates at its June meeting but now appears less concerned about inflation, which may reduce the likelihood of further rate hikes later this year. The U.S. economy appears on its strongest footing in years, while stocks may be undervalued.

U.S. stocks has positive returns for the second month in a row in May. Tech-heavy NASDAQ continued to have the best performance, returning 5.5% in May to lift its year-to-date return to 8.3%. The S&P 500 rose 2.4%, pushing the index into positive territory for the year, up 2.0%. The Dow gained 1.4% but that wasn't enough to keep it out of the red YTD; the index is still down 0.2% for 2018. Small-cap stocks outshone the big-cap indexes in May, as the S&P 600 small caps jumped 6.5%, boosting their YTD return to 8.2%, just barely behind NASDAQ. The S&P 400 midcaps also did well, rising 4.1% for the month to raise their return to a positive 3.1% for the year.

Not surprisingly, tech was the best performing category in the S&P 500 in May. Tech stocks returned 7.4% last month, raising their market-leading YTD return to 11.3%. Industrials and energy stocks tied for the second-best May returns, rising 3.0%. Telecoms were the worst performers, falling 2.3% to lower their 2018 return to negative 10.5%. Consumer staples remained out of favor, falling another 1.5% in May to lower their 2018 return to minus 12.5%.

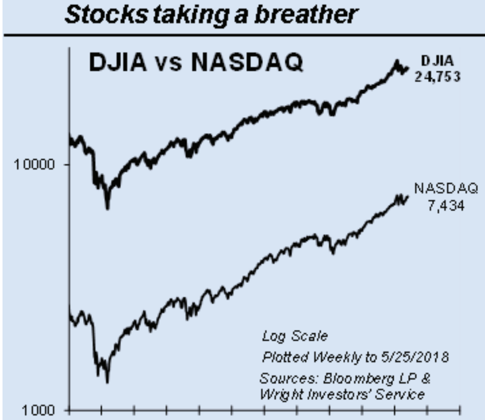
U.S. stocks easily outperformed their foreign counterparts in May, compounded by a strong dollar. Eurozone stocks, as measured by the MSCI Europe ex U.K. index, dropped 4.2% as the dollar jumped 3.3% against the euro, which fell nearly four cents against the greenback. European markets were rattled by a political crisis in Italy, where President Sergio Mattarella refused to allow two antiestablishment parties, the winners of the most recent election, to form a coalition government that many fear wants to pull Italy out of the euro. Japanese stocks lost 1.0% while emerging markets dropped 3.5%.

U.S. Treasury bonds rebounded in May as investors sought safe haven assets against the turmoil in Italy. The Bloomberg Barclays U.S. Aggregate returned a positive 0.7% last month after falling by that much in April, although it's still down 1.5% so far this year. The yield on the benchmark 10-year T-note ended May at 2.86%, down nine basis points for the month after soaring to 3.11% in mid-month. But foreign bonds had negative returns for the second month in a row, as the Bloomberg Barclays Global Aggregate ex U.S. fell 1.9% after losing 2.3% in April; the index is down 0.6% so far this year. U.S. corporate bonds gained 0.5%. In commodities, U.S. crude oil fell 2.2% after climbing 5.6% in April as Saudi Arabia and Russia reached an agreement to increase production.

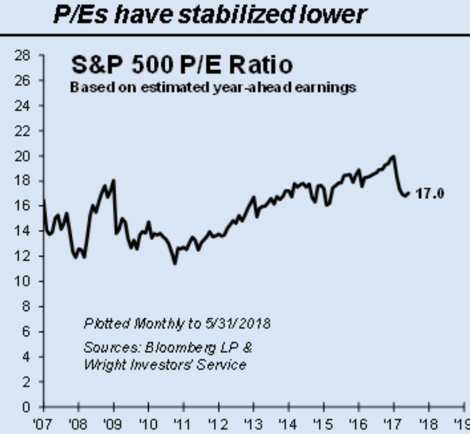
U.S. ECONOMY

The economy appears to be picking up steam as we near the half-way point of 2018. First quarter GDP growth was revised slightly downward to 2.2% annualized from 2.3%, but the second quarter is looking a lot better. The Atlanta Fed's latest GDP Now forecast is calling for 4.8% growth in Q2, while the Federal Reserve's Beige Book covering late April and early May said "out-

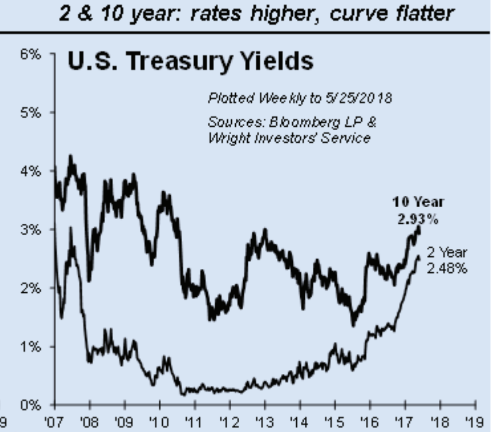
Stocks taking a breather



P/Es have stabilized lower



2 & 10 year: rates higher, curve flatter



looks for near term growth were generally upbeat." Industrial production jumped 0.7% in April for the second straight month while capacity utilization rose to 78%, its highest level in three years. The Conference Board's index of leading indicators rose 0.4% for the second month in a row. "April's increase and continued uptrend suggest solid growth should continue in the second half of 2018," the firm said, although it "is unlikely to strongly accelerate."

May's employment report came in better than expected. Nonfarm payrolls rose by 223,000, 33,000 more than forecast and well ahead of April's revised total of 159,000. The unemployment rate fell to 3.8%, its lowest level since 1969. Average hourly earnings rose 0.3% from the previous month and 2.7% compared to a year earlier. The improved jobs market appears to be raising consumer expectations and spending along with it. Personal consumption expenditures jumped a better-than-expected 0.6% in April, outpacing the 0.3% gain in personal incomes. Retail sales, a smaller category, climbed 0.3% in April following an upwardly revised 0.8% gain in March. The Conference Board's consumer confidence index rebounded in May to 128.0 from April's downwardly revised 125.6 reading. "Overall, confidence levels remain at historically strong levels and should continue to support solid consumer spending in the near-term," the firm said.

But the housing market remains under pressure, facing the double-whammy of higher prices and now rising mortgage rates. Sales of existing homes fell 2.5% in April to an annual rate of 5.46 million, while pending homes sales fell 1.3%. Sales of new homes fell 1.5% while housing starts slipped 3.5%. "The continuing run-up in home prices above the pace of income growth is simply not sustainable," said National Association of Realtors' chief economist Lawrence Yun, noting that home prices have risen 48% over the past six years, well ahead of the 14% increase in incomes. At the same time, the average rate on a 30-year mortgage is now well above 4.5%, up nearly three-quarters of a percent since the beginning of the year.

INVESTMENT OUTLOOK

Last month's political turmoil in Italy reminds us that even problems we thought were in the rearview mirror can pop up again without warning. Many investors probably believed the issue of eurozone stability had been put to rest several years ago during the last Greek crisis. Apparently not. Now the issue involves a much larger country, and possibly more down the road. Trade also remains an international flash point, although here investors need to restrain the urge to overreact to every utterance by government officials, whether here or abroad. So we can probably expect market volatility to continue.

Otherwise, the near-term investment outlook looks positive. The U.S. economy seems to be growing nicely and sustainably. While the Fed is very likely to raise short-term interest rates another quarter point later this month, its latest messages indicate it's not overly concerned about inflation running a little faster than its 2% target, which may mean a less hawkish stance going forward. At the same time, equity valuations have come down recently, indicating that stocks are more reasonably priced than a few months ago. The price-to-earnings ratio on the S&P 500 fell to 17.0 last month, down from 20.0 at the end of last year. Still, as recent events prove, long-term investors always need to be cautious, so a diversified portfolio of high-quality stocks and bonds remains the best strategy.

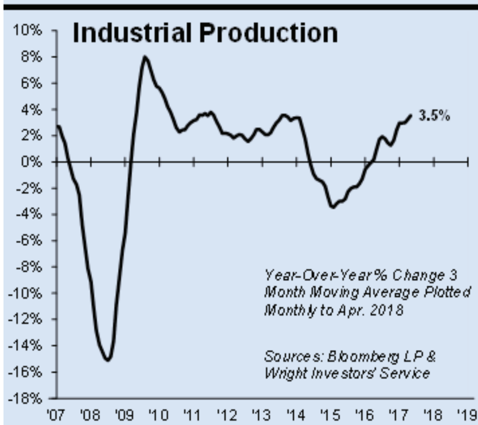
June 2018

Total Investment Returns — 5/31/2018

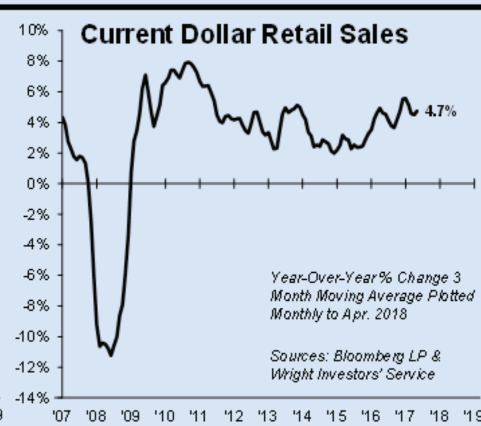
	May	Last 12 Mos.
Dow Jones Industrial Average	1.4%	18.9%
Nasdaq Composite	5.5%	21.3%
S&P 500 Composite	2.4%	14.4%
S&P MidCap 400	4.1%	14.9%
S&P SmallCap 600	6.5%	22.7%
MSCI World ($)	0.6%	11.6%
MSCI World ex U.S. ($)	-1.9%	8.3%
Bloomberg Barclays U.S. Aggregate	0.7%	-0.4%
90-Day Treasury Bills	0.2%	1.3%
Consumer Price Index NSA* (Apr 2018)	0.4%	2.5%

*NSA: Not Seasonally Adjusted

Manufacturing gaining foothold



Consumer spending small increase



Core inflation low but rising