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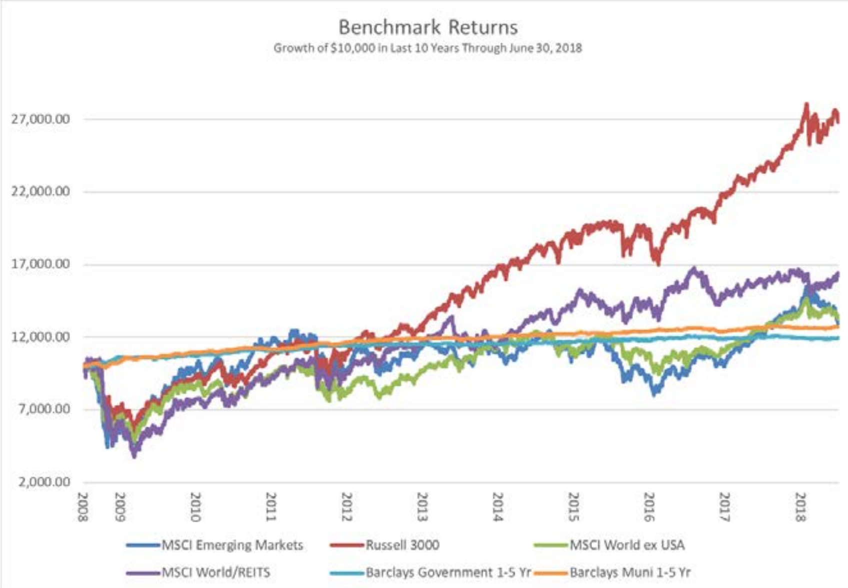
Investment Briefing

Second Quarter 2018

Introduction

While economies generally kept humming, investment market performance was mixed in the second quarter. Increasing interest rates, a strong dollar, and threatened tariffs weighed heavily on emerging markets, especially China. Both U.S. stocks (led by small caps) and Real Estate came back from their weak standings in the first quarter. Bonds were mostly flat. Longer term, U.S. stocks are still the clear winners with Real Estate in a distant second place.

Asset Class[1]	**2nd Quarter**	**12 Months**	**5 Years (annualized)**	**10 Years (annualized)**
U.S. Stocks (Russell 3000)	3.89%	14.78%	13.29%	10.23%
International Developed (MSCI World ex U.S.)	-0.75%	7.04%	6.23%	2.63%
Emerging Markets (MSCI EM)	-7.96%	8.20%	5.01%	2.26%
Real Estate Investment Trusts (MSCI World REITs)	4.94%	4.24%	6.84%	4.92%
Taxable Bonds (Barclays 1-5 Yr Gov)	0.12%	-0.38%	0.79%	1.81%
Municipal Bonds (Barclays Muni 1-5 Yr)	0.71%	0.54%	1.42%	2.47%

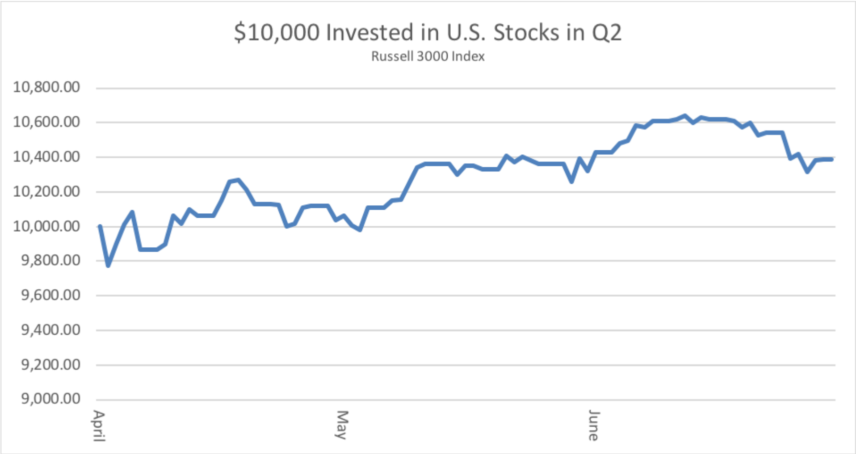


References

1. Return data and charts are from Morningstar Direct.

U.S. Stocks: Talking Trade

As the chart shows, stocks in the United States began Q2 with an extension of Q1's volatility and then started a mostly steady climb up until some serious talks about new tariffs brought worries about a trade war.



We will have to wait and see whether the words were just a brash threat or will lead to serious action. In the meantime, our economy continues its strong pace.

Positive news was plentiful, with crude oil returning to $70 a barrel and housing starts hitting their highest level since 2007. Unemployment in the U.S. dropped to 3.8%, its lowest rate since 2000 and a survey by the New York Fed found that the public expects inflation to be 3% one year from now. The Federal Reserve reacted to all of this news by increasing interest rates and upping their projections for the rest of the year (more about this in

our bond discussion). Corporate earnings were also robust as companies announced record levels of stock buybacks.

But, also as the chart shows, the bright lights of great performance began to dim at the end of June as President Trump increased his tariff threats. As a result, large U.S. companies with lots of business abroad began to lose some value. Meanwhile, smaller companies whose sales are mostly domestic, had one of their best quarters ever. The Russell 2000 Index, which represents the performance of smaller U.S. companies, hit all-time highs and returned 7.75% in Q2. For perspective, the Russell 1000 Index, which represents larger companies in the U.S. returned 3.57% in Q2.

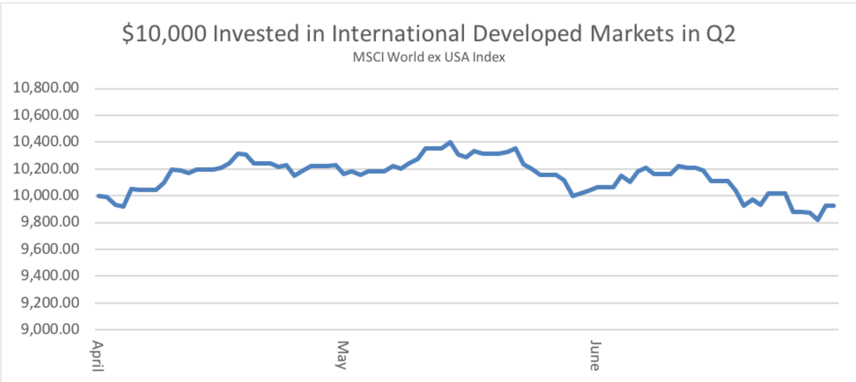
A high point for U.S. equities was also the performance Real Estate Investment Trusts, returning almost 10% for the quarter. This was quite a change from the prior twelve month's return of less than 2%. This supports our view that REITs are an important diversifier in portfolios, although their challenges continue in the short-term as interest rates increase.

As we look forward, the big question on the market's mind is where the talk about tariffs will finally settle. The financial press is generally biased toward free trade because of the economic argument that countries who produce the best goods at the best price should be able to do so. Those goods tend to raise the standard of living around the globe (if iPhones were manufactured where it is more expensive to do so, fewer consumers would be able to afford them).

The other side of the trade coin is that producing goods in other countries displaces workers. The tariff battle is a classic economic conflict pitting consumers against workers. The long-term trend tends to favor the fact that there are more consumers than there are workers, but we will have to wait and see what develops in the short-term.

International Developed Stocks: Trading Trials

The stocks of international developed countries were mostly flat to slightly negative in Q2.



This was not due to a lack of economic news:

- France's President Macron continued to embrace reforms as France's four main railways went on strike against them.
- Wages in Germany increased more than usual with public sector workers being promised 3% per year for the next two years and metalworkers getting a 4.3% increase this year.
- Italy, Europe's third largest economy, had a difficult time forming a government as populist factions gained more ground. There was some talk, later squelched, that Italy could leave the EU.
- A 6.1 magnitude earthquake rocked an industrial area in Japan, interrupting production at a number of plants.

- Germany's Merkel met with France's Macron and agreed to have a common Eurozone budget by 2021.

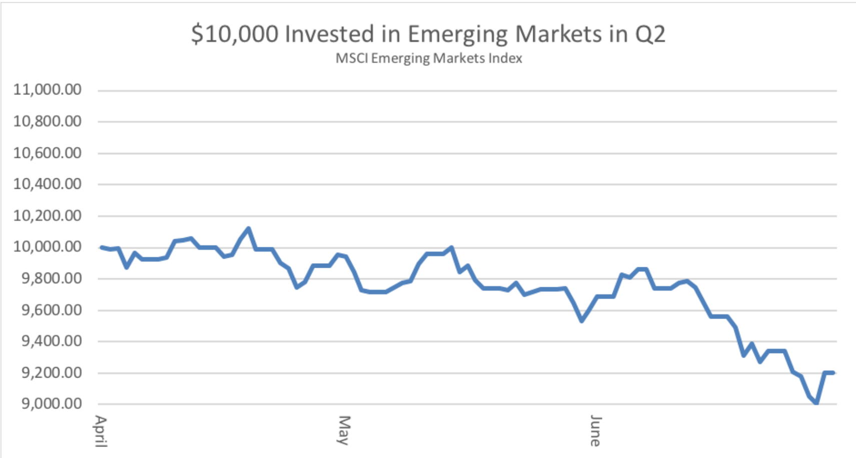
The mixed news led to mixed market results, although international developed economies also generally continued their upward trajectories. (Note that most of these markets were up in local currency terms, but our returns in them suffered from a very strong U.S. dollar.) The European Community Bank (ECB) announced that Europe was doing well enough that it would reduce bond purchases in October and stop them completely at the end of the year. However, Europe was not doing well enough to meet its target inflation rate of 2%, coming in at only 1.2% in April. The ECB also said that they would hold their current low-interest rate regime through at least the summer of 2019.

For the quarter, International Developed markets did slightly better than in Q1 (when they were down about 2% compared with Q2's down of 0.75%). It is important to keep the recent performance in perspective, comparing it to last year when these markets were up 25%. Also, as tariffs and trade continue to dominate much of the financial news, it may be necessary to keep in perspective the U.S. relationship with its developed market counterparts.

At the beginning of the quarter when President Trump's trade rhetoric began to increase, he met with European leaders and then decided to delay his decisions about new tariffs with them. In 2016 (the latest year with reliable data), the U.S. exported about $270 billion of goods to Europe who is our largest trading partner (followed closely by Canada, to whom we exported $266 billion of goods in 2016). As we mentioned last quarter, our President likes to open negotiations with bluster. Where that bluster leads is most likely going to be tempered by the harsh reality of a world that continually competes across borders in a complex web of traded goods and services.

Emerging Markets: Trading Tantrums

Emerging Markets, most notably China, felt the brunt of the talks about tariffs in Q2, as well as our increasing interest rates.



China's stock market was down 3.25% and her currency (the yuan) dropped 5.04% against the dollar, for a combined loss of over 8% for U.S. investors. While other emerging markets were also down, the relative size of China's market tended to drive returns for the quarter. An important aspect is the fact that the U.S. dollar had one of its strongest quarters, appreciating against nearly all major foreign currencies, both developed and emerging. There are many reasons for currency fluctuations, but in the short-term they are often driven by interest rate differentials and the increases in U.S. interest rates also took their toll on emerging market currencies.

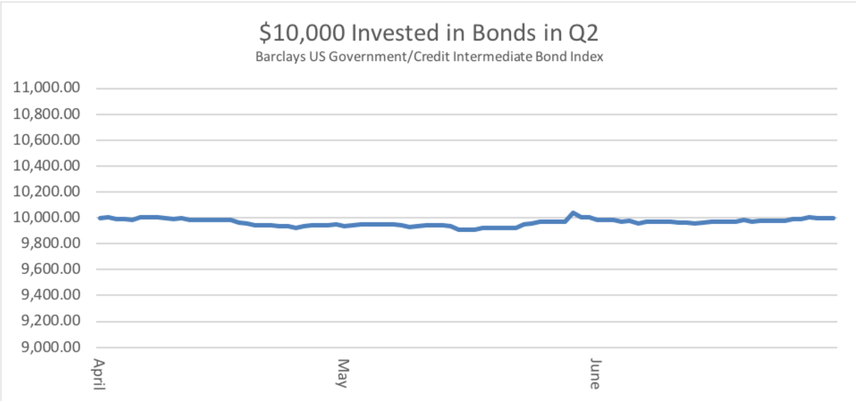
The performance of China's stock market did not reflect the country's mostly positive news, including continued

strong productivity and expected economic growth. Other news items from emerging markets included:

- India’s raising key interest rates for the first time in four years to help control growth,
- Saudi Arabia and Argentina being reclassified from frontier markets to Emerging Markets due to their improving growth and stability, and
- Mexico electing a populist President, Andres Manuel Lopez Obrador (referred to as AMLO), who promised to control corruption and to re-write the North American Free Trade Agreement (NAFTA).

You may recall that Emerging Markets had also been performing well prior to this quarter, with returns much better than in other markets. Thinking long-term, the growth story here is still very compelling, whether it be from more efficient manufacturing, higher global demand for commodities, or the growth of each of these countries’ middle class and the rewards that growth brings.

Bonds: Trading Coupons



Bond returns were up slightly, despite the fact that the Federal Reserve believes the economy is doing well. Our projected economic growth rate caused the Fed's members to decide there may be four, rather than three, interest rate increases this year. This occurred at the same time they increased their Fed Funds target rate by 0.25%, to the range of 1.75% to 2.00%. This overall positive performance points to the fact that most of the returns from bonds in the long-term come from the interest they earn, rather than moves in interest rates. With the U.S. benchmark 10-year bond near 3% for most of the quarter, the interest income of bonds in general exceeded the effects of expected rises in interest rates.

This quarter’s performance continues to enforce our view that the market has already priced in many of the anticipated interest rate increases as the economy continues to grow. On the negative side the yield curve, which is graphic illustration of rates compared to maturities, has become flatter. Whenever this curve

flattens, some investors become concerned that the curve may invert (meaning that short-term rates are higher than long-term rates), which has sometimes been an indicator that the economy is in a recession (this is because more short-term investments and cash are necessary to keep companies operating when the economy slows down, similar to a household saving more in anticipation of less income due to a job loss, etc.).

Overall, however, this quarter did demonstrate the importance of holding bonds. As stock market volatility and losses in most markets other than the U.S. took place, bonds continued to be the mostly stable rock in a windstorm.

Summary: Trouble Triangulating Trading and Tariffs

You may recall that Q1 was very volatile and mostly negative for investment returns. That volatility lessened in Q2 and we saw mixed investment results as markets adjusted to trade talks and the usual complex mix of variables that are our global economy. While the short-term moves are interesting, we should always keep the long-term path in mind. These short-term issues shouldn't cause us to sway from investing for your long-term goals.

As always, we look forward to any questions you may have. Thank you for your trust in Vista.

Your Vista Wealth Management Team

Source of all charts and data: Morningstar Direct
Economic data is from BCA Research, Dow Jones, and The Economist Newspaper Limited.

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