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THE ITALIAN JOB

Market Review **JUNE 2018**

As if there wasn't already enough geopolitical tension in the air for financial markets, another round of dysfunctional politics in Europe's fourth largest economy certainly left an impression. Investors were quick to price-in-expectations when a political and constitutional scare quickly swept through Italy. An uncertain future for the European Union became a highlight of last month in an investment environment already troubled by American trade disputes and North Korea.

Italian bond yields rose swiftly to multi-year new highs when the Italian president refused to swear in a trained economist and Eurosceptic as Italy's next finance minister. The Italian president's decision was met with outrage by political activists and may have given two Italian populist groups a larger political foothold. The Italian populist would like anything but Italian austerity, which existing EU members and financial markets both find destabilizing.

Holders of US treasuries and German bunds were the beneficiaries from Italian bond selling. US and German interest rates that were finally gaining altitude this year broke back down below critical support levels during the Italian debacle.

The move is especially meaningful for global central bank policy. Specifically, US central bank policy is raising short-term interest rates. A problem, however, arises when long-term yields fall on geopolitics and the difference between yields on longer-dated and shorter-dated borrowings narrow. What is known as a flattening yield curve becomes especially dangerous if shorter-term yields push past longer-term yields in magnitude.

Currency markets were not immune to the political juxtaposition in Italy either. A flight to safety ensued in currency markets similar to that of fixed-income markets. Safe haven currencies like the Australian dollar, Japanese yen, and Swiss franc made gains against the US dollar. The US dollar, however, has strengthened against most other trading partners this year. The Canadian dollar, euro, and pound sterling are in losing positions against the US dollar.

No doubt, the US dollar is strong on a better US interest rate environment, but there is more to the story than just yields. That

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includes things like a robust economy and stock market. For example, corporate earnings experienced record performance in the latest quarter. US companies represented in the S&P 500 put up blended revenue and net earnings growth of nearly 9% and 25%, respectively. Performance figures by technology and energy companies were at the forefront, although energy's earnings had a low hurdle to clear after last year's dismal results.

Stocks outside the US, however, are leaning more to the downside. Specifically, emerging market stocks are the most badly bruised. European stocks, on the other hand, are a mixed group. Year-to-date, gains exist in France and Italy, although Italian stocks have given back a majority of their earlier gains. German stocks are down on weaker economic prints, and UK stocks are flat on weaker economic data and BREXIT concerns.

Unlike the US, European corporate revenues and earnings are less impressive. Blended revenues actually contracted and net earnings barely surpassed European inflationary data. That's not exactly the type of data that stock investors desire.

In any event, a lot remains to be seen this year, especially on the political landscape. The global recovery should not be discounted as being over yet, though there are probably plenty of wild cards left unplayed. In the meantime, the investment environment must balance American trade negotiations and the unpredictable episodes of global governments. Expect risk premiums that affect prices to vary in the near-future as the drama unfolds.

Market Movers

The asset trade narrative in May favored domestic equity and bonds. Domestic assets benefited on foreign weakness as too much uncertainty swept into foreign assets last month. The ability of governments and global economies to coalesce will impact the continued success of the foreign asset trade this year. If things are able to improve, May's performance was probably just a short-term blip. One thing remains clear, however. US prosperity is showing up in the data and US small business is making a come-back. The investment team believed this was a likely scenario heading into 2018. Accordingly, we positioned the Core Allocation portfolios to closely track these convictions. Year-to-date, the Core Allocation portfolios of similar risk to the Morningstar World Allocation and Tactical Allocation category averages have shown outperformance.

Asset Categories	*Monthly*	*YTD*
US STOCKS	3.23%	2.37%
FOREIGN STOCKS	-1.84%	-1.65%
US BONDS	0.25%	-0.63%
FOREIGN BONDS	-1.53%	-2.33%
HARD ASSETS	1.40%	1.52%
HYBRIDS	1.52%	1.38%

*DATA USED IS SOURCED FROM MORNINGSTAR®, DATE ENDING MAY 31, 2018.

US STOCKS made a strong come back last month. The category average lifted 3.2% in the month bringing year-to-date gains back up to 2.4%, Boosting the category average on the month and year are Small Cap stocks. Small cap stocks rose roughly 5% in May and are up around 4.5% this year. Additionally, Large Cap stocks have made it back into positive territory this year. Our current allocations have benefited from heightened overall US equity exposure, specifically with a focus on small caps.

FOREIGN STOCKS fell in May. Emerging Market stocks brought down the category average posting an approximate 3% loss last month. For the year, Emerging and Developed market stocks are down. Although we maintain foreign equities in our strategies, the bias toward US markets have added value to our investors.

US BONDS rose last month on a favorable flight to quality trade. US treasuries, inflation-protected, and corporate bonds all gained in the month. Floating-rate bank loans also put up a small gain last month. Last month's only loser in the category was fixed-couponed, high-yield bonds. The category average is down on small losses this year primarily associated with US Corporate bonds. Although, performance of floating-rate bank loans has managed to stay positive this year. Overall, our US Bond mix has added value relative to intermediate and long-term high-quality bonds commonly used by many investors.

FOREIGN BONDS have suffered losses on both the month and full year. Most badly hurt is anything to do with Emerging Markets. Emerging Market bond losses are down around 2.0% for the month and over 3% for the year. Developed Market bonds are down this year, too. We have underweighted this asset category for a variety of reasons which has benefited our allocations.

HARD ASSETS have finally stabilized as a category average this year. This category had a rough end to last year and rough start to this year. Hard Assets have been lifted up primarily on the resurgence of the American energy renaissance. The Energy category rose nearly 2% last month and has a whopping gain for the full year, of over 10%.

HYBRIDS remain robust in 2018 similar to their performance from last year. US Convertible Bonds lifted the category average this month with gains of almost 3%. For the year, Convertible Bonds are up over 4%, which sets the asset apart as a leading asset-class this year. Preferred Stocks made some small gains last month. However, Preferred Stocks are still trying to unbury from their losses earlier in the year.