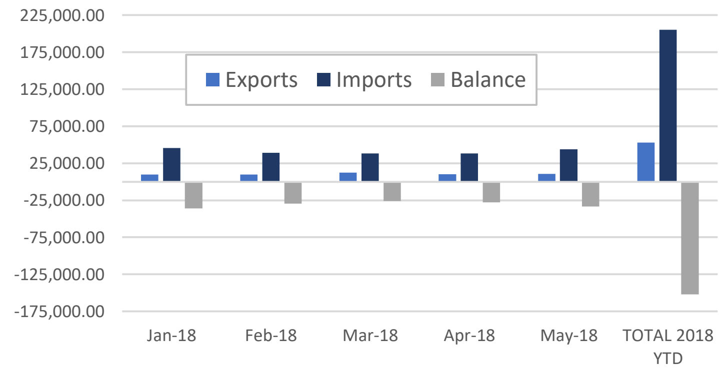
INSIGHTS & OBSERVATIONS

ECONOMIC, PUBLIC POLICY, AND FED DEVELOPMENTS

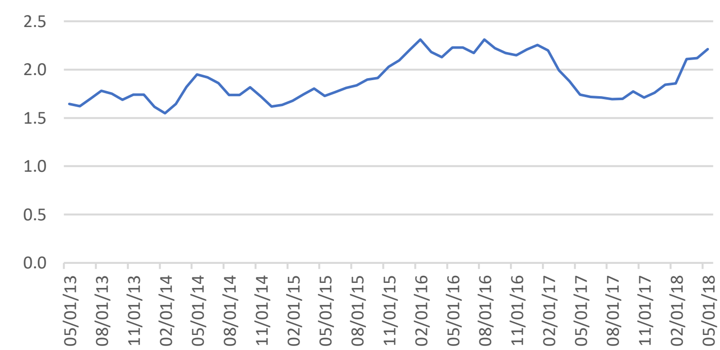
- Favorable US economic conditions were once again unsettled in June by a resurgence of long-simmering trade tensions and the growing risk of a full-blown trade war. After steel and aluminum tariffs went into effect on June 1st, President Trump announced $50 billion in additional Chinese tariffs. A wave of retaliatory tariffs followed from both sides, and progress towards a trade deal appears to have ceased. Canada, Mexico, and the EU also announced proportional retaliatory action. While the market remains hopeful that these are merely aggressive negotiation tactics, proposed tariffs are now rapidly becoming real ones. ***A protracted trade war would likely weigh on long-term inflationary expectations through depressed global economic demand despite tariff-driven import price increases, thereby complicating Fed policy direction.***
- Ironically, price and wage inflation was only just beginning to reach the Fed's long-term target range. May's core inflation increased to 2.4%, as measured by PPI and 2.2% by CPI. However, while wage growth increased from 2.6% to 2.7%, this was slower than the energy influenced headline inflation. ***The Fed Funds futures market was little moved by these developments and the most acute inflation risks increasingly appear to be on the downside.***
- Similarly, there were few surprises from June's Fed meeting. The most noteworthy changes were procedural; the Fed dropped their practice, dating to the Bernanke era, of providing forward rate target guidance, and beginning in January will move to a news conference after every Fed meeting. The latter is notable in that by convention the Fed only hikes rates on meetings with accompanying press conferences. These moves should give Chairman Powell a somewhat less transparent, but more flexible platform from which to manage monetary policy.
- Finally, the third revision to Q1 GDP resulted in the growth rate being lowered from 2.2% to 2.0%. This was largely attributable to a decline in consumer spending and a larger than expected reduction in inventories. Meanwhile, PMI data released on July 2nd shows some softening, but remains consistent with healthy economic growth. We had previously expressed concern about a buildup in inventories in the initial release; subsequent revisions have put that worry to rest. ***Coupled with a highly favorable early July jobs report and strong purchasing manager demand, the potential for a healthy second half remains in place, provided global trade tensions don't upset the proverbial apple cart.***

US-China Trade (millions of U.S. dollars)



Source: U.S. Census Bureau

Consumer Price Index



Source: U.S. Bureau of Labor Statistics, www.stlouisfed.org

Fed Funds Rate Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents – as of June 2018

	2018	2019	2020	Longer Run
	Median[1]			
June	2.4%	3.1%	3.4%	2.9%
March	2.1	2.9	3.4	2.9
	Central Tendency[2]			
June	2.1 – 2.4	2.9 – 3.4	3.1 – 3.6	2.8 – 3.0
March	2.1 – 2.4	2.8 – 3.4	3.1 – 3.6	2.8 – 3.0
	Range[3]			
June	1.9 – 2.6	1.9 – 3.6	1.9 – 4.1	2.3 – 3.5
March	1.6 – 2.6	1.6 – 3.9	1.6 – 4.9	2.3 – 3.5

1. For each period, the median is the middle projection when the projections are arranged from lowest to highest. When the number of projections is even, the median is the average of the two middle projections.
2. The central tendency excludes the three highest and three lowest projections for each variable in each year.
3. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.

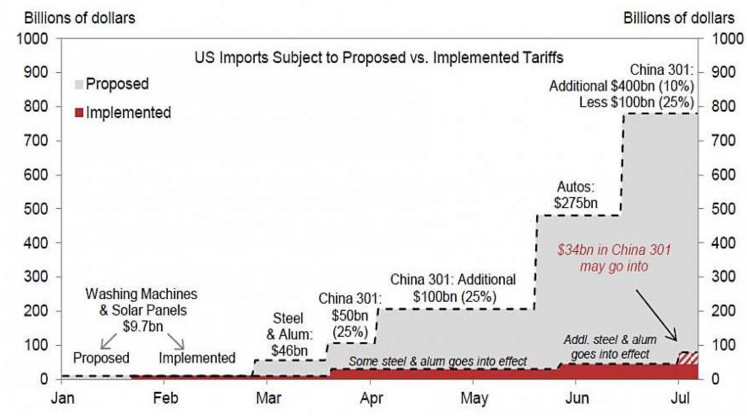
Source: www.federalreserve.gov/monetarypolicy/files

EQUITY NEWS AND NOTES

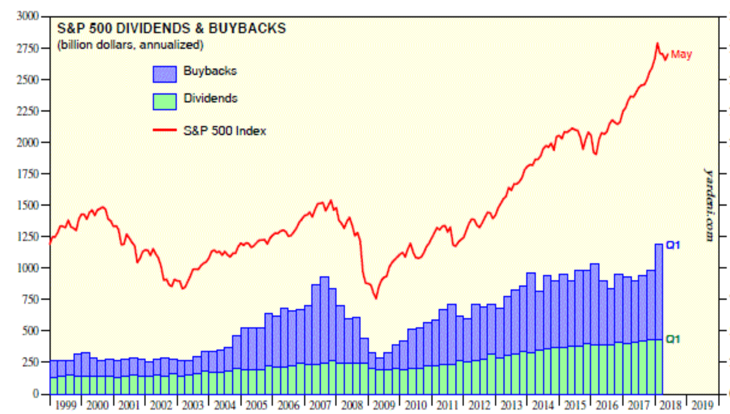
A TRADE WALL OF WORRY THREATENS A RESILIENT BULL MARKET

- ***Trade war fears remain the most visible risk to stocks.*** Retaliatory headlines dominated the news cycle creating a risk-off environment for investors in the second half of June. ***It is important to note that the rhetoric to date has been worse than the reality, as threats and intentions far outweigh actual implementation although this dynamic could change.*** According to multiple sources, the annualized impact of all the proposed tariffs on US GDP would likely fall in a very modest range of 0.1 - 0.4%. While this may seem minimal, tariffs could have a much bigger effect on confidence, an important growth driver. Consumer confidence has boosted retail sales and CEO confidence has led to a resurgence in capital spending, both of which have fueled the economy and stock valuations. Unfortunately, as we move deeper into Q3, the tug of war between positive US economic momentum and troubling tariff headwinds persists.
- One trend fueling equity performance has been the large amounts of cash being returned to shareholders. ***According to UBS, companies are expected to inject $2.5+ trillion this year via buybacks, dividends, and mergers & acquisitions (M&A).*** As demonstrated in the chart to the right, a record amount was returned to investors via dividends and buybacks in the first quarter, largely spurred by the corporate tax reform bill passed in late 2017. The Technology sector alone accounted for over 60% of all S&P 500 buybacks, a reason we continue to favor the sector. M&A activity is also on a record breaking pace, with a total of $4.8 trillion of global deals expected in 2018 according to Dealogic. ***We will be attuned to updates from management teams, as tariff policy and other factors can prompt meaningful changes in risk appetite and capital allocation decisions.***
- We are also closely monitoring the slope of the yield curve. The spread between 2Yr and 10Yr Treasuries dropped to just over 0.31% at the end of June, a widely reported development. ***While the yield curve is the flattest it has been since 2007, a period followed by the Financial Crisis, at that time the spread was spiking to the upside, not contracting.*** When the spread was last at today's level and declining in mid-2015, the S&P 500 gained almost 35% over the subsequent two years. We are not predicting any such equity gains, rather calling attention to the point that yield curve flattening may not be as big a concern as some make it out to be. ***Historically, markets peak roughly 18 months following an inversion, although this is a scenario we do not feel is particularly likely.***

Exhibit 1: Far Fewer Tariffs Implemented Than Proposed

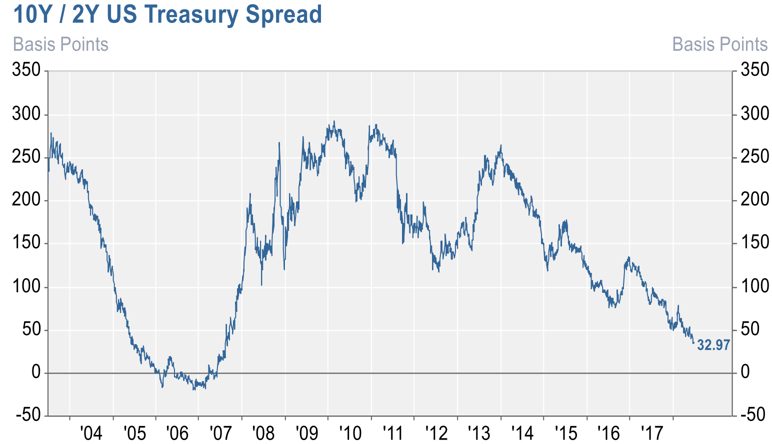


Source: USITC, Goldman Sachs Global Investment Research



Source: Standard & Poor's.

10Y / 2Y US Treasury Spread



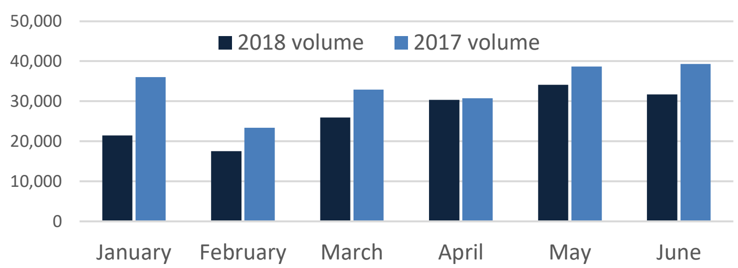
Source: FactSet Research Systems

FROM THE TRADING DESK

MUNICIPAL MARKETS

- ***Municipal supply has continued to underwhelm at just $161.05 billion YTD, about 20% behind the same period of 2017.*** Investors had been looking for a federal infrastructure plan to increase issuance, but that has received little support and appears to be off the table for now. Although new money debt issuance is up 22% year-to-date, it has not been enough to offset the loss of advanced refundings.

Municipal Issuance ($billions): 2018 vs. 2017



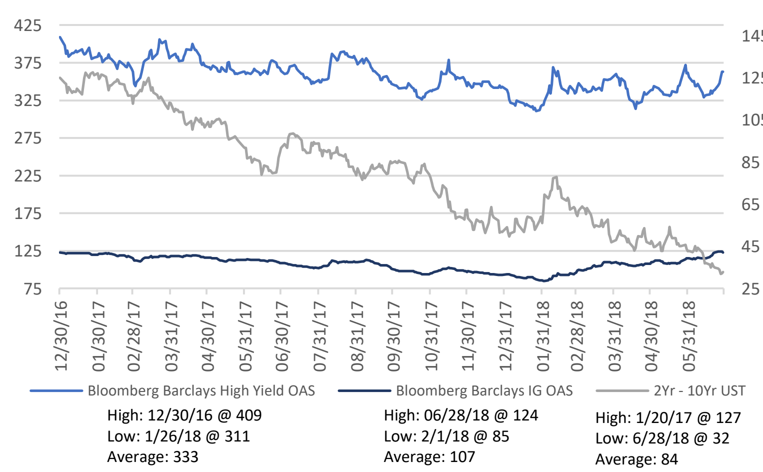
Source: Bond Buyer

- ***Investor appetite for munis remains healthy, creating strong technical support.*** Municipal mutual funds added over $7 billion in net new cash over the first half of the year. In the near term, demand should remain robust due to cash coming from July municipal interest payments and maturities. Recent offerings have typically been significantly oversubscribed. Although banks have reduced their municipal holdings, in large part due to regulatory concerns relating to liquidity risk management, a technical supply/demand imbalance remains intact and is supportive of secondary market pricing.
- ***Although the 10-year AAA Muni/Treasury Ratio fell 2% points from March 31st, the ratio ended the quarter at an attractive level of 86.3%.***

TAXABLE MARKETS

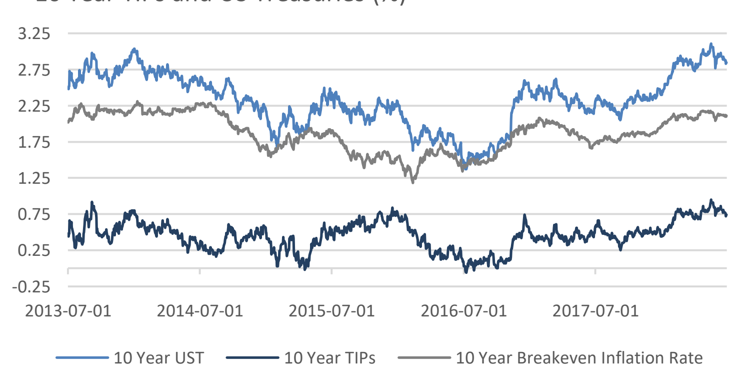
- ***Amid a long cycle of positive economic fundamentals and tight credit spreads, investment grade corporate debt is facing some modest headwinds.*** A surge in late cycle M&A deals has fueled otherwise lukewarm supply, contributing to modest spread widening. With $90 billion of new M&A-related Investment Grade corporate debt hitting the market year-to-date, the largest of which was the $40 billion CVS deal to fund its acquisition of Aetna, short-sellers have taken aim. According to HIS Markit, Investment Grade notional credit shorts of $55 billion now represent a post-crisis peak. Additionally, rising interest rates are slowly increasing the cost of financing at a time when gross investment grade corporate leverage is close to all-time highs. ***Nonetheless, we feel these concerns are case specific and see positive fundamentals in the names we own. Strong balance sheets and still favorable economic conditions continue to backstop credit standing.***
- ***The rally in Treasury Inflation Protection Securities (TIPS) towards the end of 2017 and into 2018 has cooled*** as we closed the second quarter. Inflationary expectations going into this year had risen, with the Fed's 2% target seen by many traders as likely to be met or exceeded. However, despite a US economy that remains on strong footing, it is hard to find evidence of a troubling acceleration of inflation, particularly as global economic conditions slow. The recent rally in US Treasuries may be a signal that we have seen a temporary top of rates and waning inflationary pressures.

The Appetite for Risk is High Even as the Curve Flattens



Source: Bloomberg

Have Yield Increases Stalled?
10 Year TIPs and US Treasuries (%)



Source: Federal Reserve Bank of St. Louis

FINANCIAL PLANNING PERSPECTIVES

529 PLANS: A LINCHPIN OF EDUCATIONAL PLANNING

With the school year having only recently concluded, thinking ahead to next Fall may not be top of mind for many parents, let alone future college years. ***While funding a college education may seem daunting, adding 529 Plans into your planning process can prove valuable.***

Since their introduction in 1996, 529 Plans, which are offered by a state or state higher educational authority, have become the most popular and arguably the easiest and most tax-efficient way to save for college. According to the College Savings Plans Network, 529 Plan assets grew by 16% in 2017 to a record $319.1 billion. At last report, 13.3 million accounts were in place.

While hardly the only educational savings option***, we emphasize the value of 529s for several reasons:***

- Earnings are income tax free if used for qualified educational purposes;
- High funding limits and no income restrictions on funding;
- Plans can be front loaded with 5 years of annual gifts;
- Account owners remain in control of 529 Plan assets, not the beneficiaries;
- Easy to establish and manage (on-line set up, statements and account access); and
- Many offer a state income tax advantage when participating in your state sponsored plan.

Starting early and regularly contributing to a 529 Plan can be highly beneficial given the power of time coupled with potential tax-free asset growth. Furthermore, passage of the 2017 Tax Cuts & Jobs Act now enables the use of up to $10,000 annually of 529 Plan assets per beneficiary for secondary or elementary private, public or religious schools.

Other attributes of 529 Plans include:

- Ability to change beneficiaries;
- Reduced estate tax exposure through shifting assets to a 529 Plan(s);
- Range of plan specific investment options, including many glide path age-based strategies
- Trusts can be named as account owners;
- 529 Plan account assets can be withdrawn at any time for any reason (subject to tax and/or penalties on earnings)

Despite the flexibility and related benefits of 529 Plans, a recent article by The Motley Fool indicated that ***"nearly 75% of parents are housing their college money in a regular savings account."*** Doing so forgoes many valuable benefits and we highly encourage a dialogue concerning 529 Plans or other educational savings strategies.

Additional resources:
www.savingforcollege.com
https://www.irs.gov/pub/irs-pdf/p970.pdf
https://www.irs.gov/newsroom/529-plans-questions-and-answers
http://www.collegesavings.org/

Have you designated a trusted contact for your account?

Help us protect your personal well-being and financial interests by naming an individual to serve as an additional resource on your account. Trusted contacts can either be given an ability to share and discuss financial details of the relationship, or solely authorized to discuss your whereabouts and well-being. Either option provides valuable security and protection.

For questions concerning our financial planning or wealth management services, please contact
Jim O'Neil, Managing Director, 617-338-0700 x775, joneil@appletonpartners.com

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