DANN ASSET ADVISORS, LLC

Second Quarter 2018 Update

July 13, 2018

2Q18 Highlights

- U.S. stocks rise modestly; international stocks fall with emerging markets especially weak
- Trade tensions escalate between the U.S. and nearly all our significant trading partners
- 2Q GDP expected to be particularly strong after a seasonally softer first quarter
- Fed raises rates in June and now expects two more increases by year end

The table below summarizes the performance of some key indices during the second quarter:

Index	Market Performance % Ch. 2Q18
S&P 500	3.4
MSCI Developed Markets (excl US)	-1.1
MSCI Emerging Markets	-7.8
MSCI All Country World	0.6
US Aggregate Bond (1)	-1.6
Liquid High Yield (1)	0.3
US Dollar Emerging Markets Bond (1)	-6.0

(1) Barclays indices

Equities. Despite volatility caused by trade headlines, U.S. stocks (as measured by the large company S&P 500 index) generated a respectable 3.4% return for the quarter. As has been the case since late 2016, growth stocks (especially large technology stocks) did significantly better than value stocks – over the first half of 2018 the Russell 1000 Growth index returned 7.3% vs. a negative 1.7% for the Russell 1000 Value index. Small company stocks did especially well in the second quarter as investors turned to U.S.-focused businesses in an effort to avoid potential negative impacts from tariffs. The Russell 2000 index of smaller companies returned 7.8% in the quarter.

International markets had a much tougher time. Reasons likely include: 1) weaker than expected economic growth; 2) concerns over the long term viability of the eurozone, with the latest issues being immigration and Italian election results; 3) difficult Brexit negotiations; and 4) trade tensions. Speaking generally, we believe many of these concerns already are reflected in international markets valuations, with the developed and emerging markets indices trading at 13.5x and 12.6x multiples of forward earnings according to Morningstar. In comparison, the S&P 500 is trading at 17.2x.

Fixed income. While there was some volatility, fixed income markets were quieter in the second quarter compared with the first. After rising to 3.11% in mid May, the 10 year Treasury yield fell and ended the quarter at 2.85%, up only slightly from 2.74% at March 31. Longer term rates seem to have backed off as investors sought safer investments in response to uncertainty around the Italian elections and international trade. Short term rates as measured by the two year Treasury continued rising, ending the quarter at 2.55%, compared with 2.27% at March 31.

We flagged the narrowing of the spread between 10 and two year Treasury yields in our first quarter update. The spread continued to narrow during the second quarter, ending at 30 basis

points. For reference, the spread had been as high as 78 basis points earlier in 2018 and as high as 130 basis points in 2017. A negative spread – also called an inverted yield curve – is considered a reliable indicator of an impending recession. Data from the St. Louis Federal Reserve indicate that the yield curve inverted before each of the past five recessions. However, the data also show it can take a year or more for the recession to follow.

From our experience, upcoming recessions usually are obvious only with hindsight. We believe there are two key differences between now and past recessions. One is the incredible balance sheet expansion and intervention of central banks in the credit markets. The other is that many developed countries' interest rates are substantially lower than ours, and this likely creates demand for 10 year Treasuries (reduces the 10 year yield) without regard to what's happening in the underlying U.S. economy. However, for further perspective, the current economic expansion already ranks as the second longest for the U.S. according to CNNMoney.

<u>Market sectors</u>. The best performing broad U.S. market sectors during the second quarter were energy, real estate investment trusts (REITs) and consumer discretionary stocks (includes retail, restaurants, entertainment). Energy stocks rose with the price of oil, which increased roughly 15% in the second quarter and 25% through the first half of 2018. We don't have a strong explanation for the increase in REITs other than that the bulk of the ETF's good performance occurred as interest rates fell from their mid-May highs. The consumer discretionary ETF is dominated by a 20% weight in Amazon, which was up 17% in the second quarter following a 24% gain in the first. For the first half of the year, technology, consumer discretionary and energy were the top performers.

The second quarter's weakest sectors were telecommunications, financials and industrials. Telecom was hurt by further declines in AT&T, which has been losing share in several businesses and is a substantial weight in the index. A narrowing spread between long and short term rates is potentially negative for bank earnings, and this may have contributed to the financials' weakness. Given substantial international business exposure, industrials are perceived as one of the most vulnerable sectors to reduced trade and this likely hurt the group in the quarter. Year to date, consumer staples, industrials and materials were the weakest sectors.

Market sector comments have been part of our updates for several years. We want to note that late in 2017, the firms that determine which stocks fall in which sectors decided to make changes for 2018. These changes are being phased in throughout the year. The biggest change is in the telecommunications sector (formerly dominated by AT&T and Verizon); by September this sector will be renamed communications services and include Alphabet, Facebook, cable/broadcasting companies and more. Accordingly, this sector will be much higher growth and potentially more volatile than in the past. The companies coming into the new communications services sector will come from the tech and consumer cyclical sectors, so these sectors, too, likely will have different performance characteristics going forward.

Portfolio Positioning

The only fixed income change made for some clients during the quarter was to add slightly to a high-yield bank loan fund. We continue to believe it more likely that rates rise than decline over time, and thus remain focused on shorter duration fixed income investments. On equities, for many clients we continued to modestly reduce large company, U.S. stocks exposure and increase exposure to smaller cap U.S. and international stocks. Generally speaking, we've seen more value in the latter two sectors.

Economy

U.S. GDP grew 2.0% in the first quarter, in line with expectations but below the roughly 3% level of the prior three quarters. Consumer spending growth slowed to 0.9% from the very strong 4.0% registered in the fourth quarter of 2017. Given tax cuts, increased government spending and near record low unemployment levels, we expect that consumer spending growth will show a rebound when second quarter GDP is reported in the next couple of weeks. According to a Wall Street Journal survey of economists, second quarter GDP is expected to increase in the 3.5% range, with a few estimates significantly higher.

Due to seasonal adjustments to the data, first quarter GDP numbers often understate growth. Based on most data, it seems to us that the U.S. economy is in a strong stretch that could last through year end. Listening to management conference calls during the second quarter, we heard more optimism about business conditions than we have in a long time. The concerns we heard focused on rising cost pressures (compensation, some raw materials and shipping) and uncertainty over government trade policies.

We appreciate the importance of trying to establish more favorable conditions for trading with and doing business in China. And we understand that doing this now rather than 10 years from now probably makes sense. However, we don't understand bullying long time, important allies and threatening to leave NAFTA. We'd like to believe it's there, but we don't see a strategic, cohesive approach to trade coming from the Administration. In our opinion, the longer seemingly chaotic and protectionist rhetoric and actions around trade go on the more likely there will be negative impacts on U.S. businesses and the economy.

Beyond that, while most data don't indicate a significant acceleration in inflation, the low unemployment rate and comments from managements about cost pressures lead us to believe higher inflation is a risk. If inflation were to pick up the Fed likely would accelerate rate increases and potentially cause the economy to slow.

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