UNION

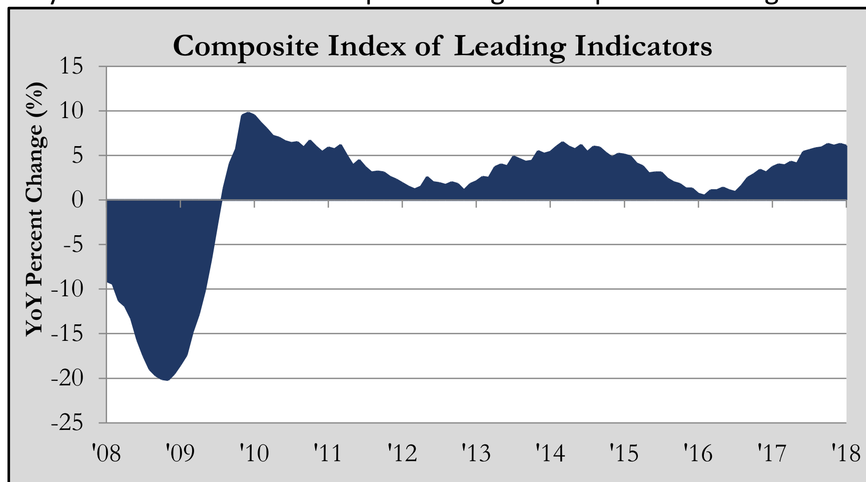
Q2 2018 ECONOMIC AND CAPITAL MARKET COMMENTARY

Recap: The U.S. economy has been firing on all cylinders. Growth in the second quarter tracked a 4.0% annualized pace, helped along by a strong rebound in household spending, business investment, and surprising strength in net exports. What's more, growth is expected to continue at a 3.0% annualized pace on average for the remainder of 2018, with fiscal stimulus contributing about half a point.

In the U.S., unemployment continued to fall, wages rose, and home values and stocks remained high. Those factors have lifted Americans' spirits, along with a tax cut that has put more money in their pockets. Lower taxes, better job prospects, elevated levels of consumer optimism, and increasing household net worth have been helping many Americans to spend more.

Strong economic activity has been absorbing remaining spare capacity. The unemployment rate has stood at an eighteen year low, and as of June there were more job openings than there were job seekers. Wage growth has been healthy by historical standards but should move even higher as skilled labor becomes scarce.

Consumer price inflation finished Q2 above 2.0%, a sign that the U.S. economy is bumping up against capacity constraints. Add higher fuel prices, higher import prices due to increased tariffs, and stronger wage growth, and it's only a matter of time before profit margins are pinched enough for firms to pass on rising costs to consumers.



The Federal Reserve, pointing to this momentum and firming inflation, raised its benchmark interest rates for the second time this year and penciled in two more increases by year end to keep the economy from overheating.

Gross Domestic Product and Income: Economic growth was slower at the beginning of this year than previously reported, as consumers pulled back on spending and the housing market weighed down output. Real GDP expanded at an annual rate of 2% in the first quarter, weaker than an earlier estimate of 2.2% growth. Growth picked up in the second quarter and is expected to grow around 4% in the second quarter. A strong labor market and tax cuts should remain supportive of GDP growth in the quarters ahead.

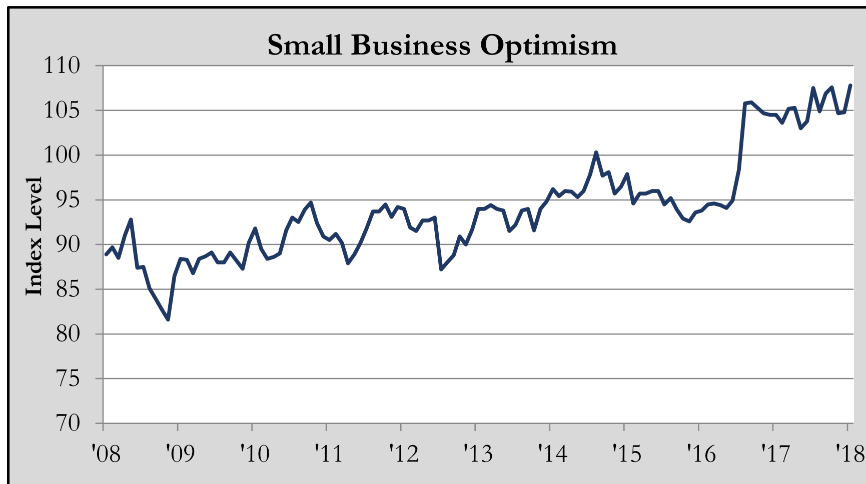
Consumer Confidence: The Conference Board's Consumer Confidence Index declined 2.4 points to 126.4 in June, following May's upwardly-revised gains. The dip in expectations might be tied to concerns over the Trump administration's trade battles with other countries and perhaps could suggest that consumers do not foresee the economy gaining much momentum in the coming months.

Despite the dip, however, consumer confidence has remained at a fairly high level, consistent with solid gains in consumer spending. Consumers have remained upbeat about their employment and income prospects.

Retail Sales: Retail sales surged by 0.8% in May while April's data was revised up. After a weak start to the year, with no gains during the first two months of 2018, consumers have been on a three-month tear, rising by about 2% since. The persistence of the gains suggests that American consumers are, in fact, increasing

consumption gained from income growth, the wealth created from higher stock and home prices, as well as the windfall from the tax breaks implemented at the start of the year.

Small Business: The NFIB's small business optimism index increased by 3 points to 107.8 in May, the second highest reading in the survey's history. Most of the main subcomponents moved up in the month, apart from a slight decline in job openings. The difficulty of finding qualified workers has remained the single most important business problem.



The increase in this sentiment measure has been a strong signal that, following tax and regulatory changes, conditions on the ground have remained quite favorable, which should enable and encourage small businesses to take the necessary steps to expand.

Concerns on the trade front bear close watching in the months ahead. As trade talk begins, some small businesses will undoubtedly be caught in the crossfire, which could weigh on the sentiment measure and expansion plans.

Housing: Home sales and new home construction improved during the first half of 2018, but the pace of improvement has remained disappointing. While nearly all key indicators have headed in the right direction, more improvement was hoped for given the acceleration in nonfarm employment growth and ramp up in real GDP growth.

Housing turnover has remained incredibly low. A larger proportion of homeowners are opting to remain in place rather than trade up or downsize. The lack of willing sellers has contributed to the prolonged slide in existing home inventories.

Moreover, a significant proportion of homes have been taken off the market and shifted to rentals, either directly by institutional investors or indirectly by homeowners keeping their home and renting it out. As a result, existing home sales expectations have been lowered.

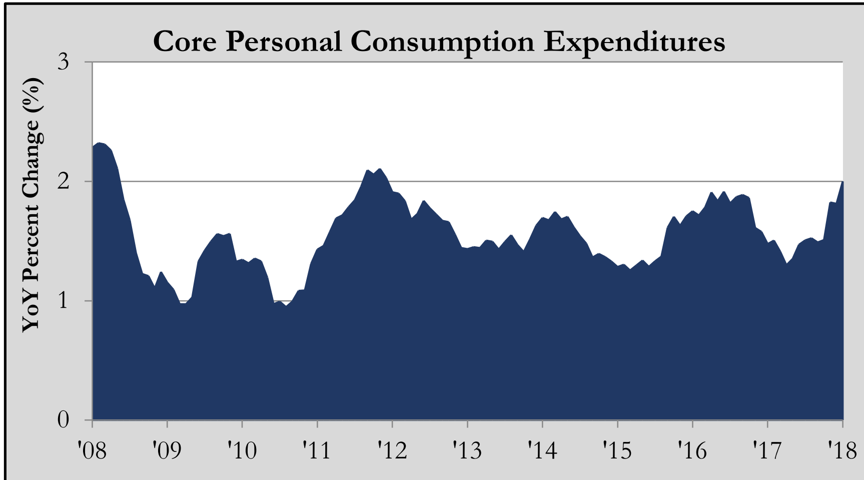
With existing home inventories tight, and likely to remain that way for quite some time, more buyers have shifted to the new home market. New home construction has increased in line with expectations. Solid gains are expected in new home sales and construction in the near term. Apartment developments have also picked up this year.

Tariffs on steel and escalating trade tensions have posed headwinds to homebuilding activity. Rapidly increasing input costs will eventually weigh on home builders' margins and lead to higher prices for perspective home buyers, straining affordability at a time when rising mortgage rates and relatively high property prices have already made home ownership less accessible.

Inflation: Inflation in the U.S. is back after more than half a decade of falling short of desired levels. The price index for core personal-consumption expenditures (PCE), closely watched by the Federal Reserve, rose 2% in May from a year earlier. The price measure hit the central bank's target after running below it every month for six years.

Factors like weak economic demand, a strong dollar and a slowly recovering labor market have been responsible for

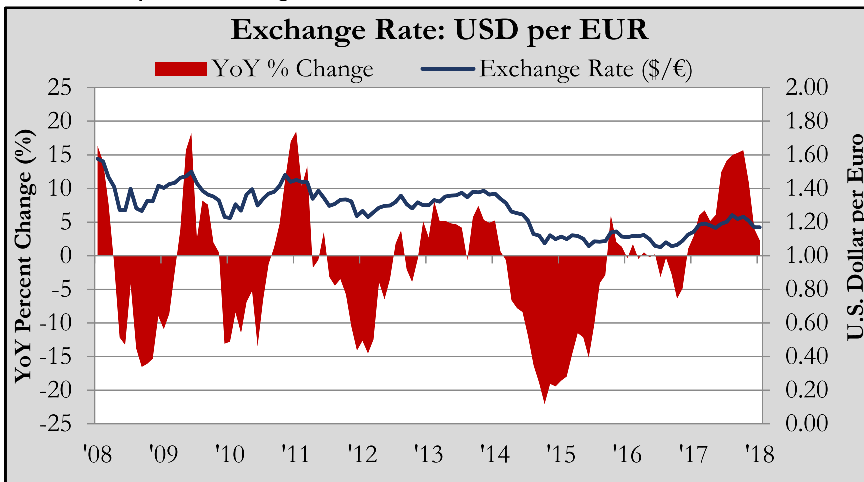
low inflation in recent years. Structural factors have also played a role, like an aging population spending less, cheap imports due to globalization and consumers spending less on goods online.



But demand has been picking up as unemployment has fallen. In recent months, businesses have seen their own costs rise, in part because of higher energy prices and labor shortages which has put some mild upward pressure on wages. Trade tariffs could push the inflation picture further as companies try to pass the resulting higher costs on to consumers.

Tariffs: Trade spats with important trading partners could risk siphoning away much of the economic boost from fiscal stimulus by way of higher consumer prices, reduced exports, supply chain disruptions, and denting consumer and business confidence. Under the presumption that the tougher trade rhetoric is simply a negotiating tactic, there is still hope that cooler heads will prevail, and tensions will de-escalate. The risk, however, is that once the wheels have been set in motion, tensions could quickly escalate to a trade war. Canada, China, Mexico and the EU have already retaliated to some degree. The U.S. may up the ante, further reinforcing the negative feedback loop.

Eurozone: Recent political crises in Italy and Spain revived simmering concerns about the future of the Euro in an era of populist politicians, rising euro skepticism and diverging economies. A fracturing of the common currency, though still unlikely at this stage, would be a calamitous event for financial markets.



If one country exits the currency area, others might follow as levels of euro-skepticism have risen on the continent in the past decade. Widespread capital controls would be needed to prevent destabilizing rushes of money from countries deemed likely to have a weak post-euro currency, to those expected to have a strong one. Huge swaths of financial integration, including derivatives markets and common banking systems, would need to be dismantled.

The fear that chaos could ensue if even one country left the Eurozone, has proven to be a powerful glue holding the region together. Since then, there has been a flurry of changes meant to bind it still tighter, most notably, closer and more consistent supervision of banks and tougher fiscal rules, though these have remained unfinished projects.

Emerging Markets: A surging dollar has been pressuring emerging market countries to support their currencies by halting interest rate cuts or even tightening monetary policy, adding to investor concerns about growing stresses on their economies.

Argentina, Brazil, Indonesia, South Africa and Turkey have recently either increased rates or left rates unchanged, citing concerns about global economic turbulence, rising inflation and weakening local currency.

Low oil prices and last year's weakness in the dollar had allowed many developing countries to cut rates and boost growth without having to worry about sparking higher inflation—often a consequence of loose monetary policy. Now, a rally in the value of dollar, increasing U.S. government bond yields and a rise in oil prices this year have forced central banks to rethink that strategy

A combination of higher commodity prices, slowing expansion around the world and a stronger dollar has tested emerging economies that were either highly dependent on external financing or commodity imports. At this time there has been little indication that financial distress is spreading beyond their borders, and contagion to advanced economies is expected to remain muted. Perhaps the bigger near-term risks to EM growth prospects is collateral damage from escalating trade wars and reduced investor risk appetite. However, barring a worsening in global political tensions, better longer-term growth outlooks for emerging market economies should dominate near-term risks, putting an end to the recent bout of capital outflows later in 2018.

Oil Price: The sudden rise in oil prices is yet another risk to be factored. The price increase has been fueled by a combination of tighter supply/demand and the U.S. administration's decision to pull out of the Iran nuclear deal and re-impose sanctions. West Texas Intermediate (WTI) is up nearly 40% since last year, and prices at the pump have started to pinch consumers' wallets. Though oil prices have not reached levels that would seriously hinder spending, a significant reprieve is unlikely. Demand is expected to outpace supply over the next year, and with the potential for the geopolitical risk premium to oil to remain elevated, prices are likely to remain relatively high. A further increase in oil prices could curb spending and increase market volatility, which would certainly draw the attention of the Federal Reserve.

Economic Outlook: In the current quarter, the United States is leading the charge among developed economies experiencing a reacceleration after a slow Q1. Q2 economic growth in the United States should be around a 4.0% annualized rate. If realized, this would be the fastest pace of growth since Q3-2014. Encouragingly, economic growth appears broadly based, with sizable contributions expected from consumption, business fixed investment and trade.

The U.S. economy is not expected to sustain a 4% plus pace of growth indefinitely. For the year as a whole 3% real GDP growth is expected, which if realized would be the fastest pace of growth in the United States since 2005.

One development worth watching closely is the potential fallout from the Trump administration's recent string of tariff announcements. In particular trading partners have signaled their intent to match, and in some cases expand upon the types of goods subject to import tariffs. The net result might create some downside risk to export growth down the road once these tariffs start taking hold. The possibility also exists that such tariffs could create global inflationary pressures, particularly for intermediate goods in the production process.

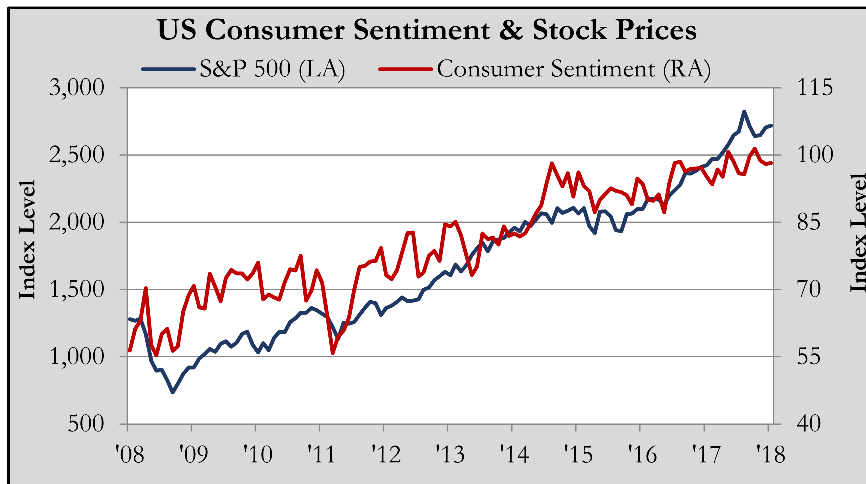
Market Commentary

Recap: Following a first quarter during which broad developed domestic and international equity indexes were generally negative, the second quarter produced mixed results. U.S. equity indexes posted positive returns while international indexes were negative. The S&P 500 generated a 3.4% return for the quarter while the MSCI EAFE index was down 1.2%. The S&P 600 small cap index reached all-time highs. Emerging markets suffered through a difficult quarter, falling nearly 8%. Fixed income markets were broadly negative as the Barclays U.S. Aggregate Bond index fell 0.2% and the Barclays Global Aggregate Ex-USD index slid 4.8%.

Macro factors provided a tailwind in the U.S. as the economic expansion became the second longest in history. Following June's FOMC policy meeting, Fed Chairman Jerome Powell noted, "the economy is doing very well…the overall outlook for growth remains favorable." This confidence led the Fed to raise interest rates 25 bps in June and signal the possibility of two additional hikes by year end. In contrast, and on the heels of some disappointing data, the European Central Bank

(ECB) announced there would be no rate hikes until at least the fall of 2019. The ECB also announced a plan to halt its bond purchasing program by the close of 2018.

Domestic Equities: An important post-recession market theme has been the dominance of U.S. equities over international equities. Since 2010, the S&P 500 has generated a cumulative return of 183% while the MSCI All-Country World Index ex U.S. has only gained 83%. Last year, it appeared the tide was turning as international stocks generally outperformed their U.S. counterparts. Thus far in 2018, the old paradigm of U.S. relative outperformance has returned driven by strong corporate profits, solid economic growth, and business friendly policymaking.



Leading the charge has been corporate earnings. Year-over-year, the S&P 500 earnings growth rate was 25% in the first quarter. This represents the highest earnings growth rate since the third quarter of 2010. Year-over-year sales growth exceeded 8%, and nearly 80% of S&P 500 companies reported a positive earnings surprise, the highest percentage since FactSet began tracking this metric in 2008. Earnings growth has been supported by solid economic growth as the labor market remains strong, consumers are confident and have been spending freely, while businesses have been investing more. Finally, substantive policies out of Washington, including regulatory reform and the Tax Cuts and Jobs Act, have contributed to U.S. equity market gains. Of course, commentary on Washington would be incomplete without noting the market volatility and potential risks driven by uncertainty surrounding the Trump Administration's trade policies, North Korea, and Iran.

International Equities: Trade concerns continue to weigh on international equity markets. Fears of a trade war, a strengthening dollar, and rising U.S. interest rates have had an especially negative impact on Chinese and other emerging market stocks. The Shanghai Composite index is officially in bear market territory, having fallen more than 20% since its January 24th high. Country-specific developments also played a role in some emerging markets. Labor unrest, anemic economic growth, and political uncertainties, for example, contributed to the MSCI Brazil index's quarterly slide of more than 26%.

In developed international markets, political uncertainty has produced volatility as European investors fear a stronger mandate for anti-establishment, eurosceptic politicians and face uncertainty about Italy's future in the Eurozone. And in Asia, the Japanese economy shrank in the first quarter at an annualized rate of 0.6%. This decline marked the end of eight straight quarters of economic expansion for the world's third largest economy, the longest streak since a 12-quarter run between 1986 and 1989. A rebound is expected when second quarter results are reported.

Fixed Income: The first half of 2018 was characterized by rising Treasury yields, a flattening yield curve and widening credit spreads. Volatility increased, particularly in emerging markets. Given this backdrop, money market, high yield, and short-term bonds have performed relatively well, while emerging market debt, investment grade corporates and U.S. Treasuries have lagged.

In the municipal market, high grade issues have produced slightly negative year-to-date returns, primarily driven by higher interest rates. High yield municipals have outperformed. Municipal-to-Treasury ratios have increased for longer term issues and fallen for shorter maturities. Therefore, longer term municipals are relatively inexpensive and appear more attractive. The supply of new issues is down following the record number of new issues in December

2017.

Outlook: Our economic and market outlook remains generally positive for the remainder of 2018 and into 2019. We remain sensitive to signs of late-cycle dynamics in the U.S., including higher inflation and interest rates which could put pressure on stock prices. The macro environment remains supportive for global equity markets.

Strong earnings growth and improving capital investment should support the stock market. As it stands now, wage growth appears manageable, slow moving and shouldn't drive interest rates or inflation to the point where the equity bull market rides off the rails. Geographically, our short-term view favors U.S. equities with all the caveats listed above and, despite recent weakness, we remain upbeat on emerging markets. Further strengthening of the dollar, however, could be a drag on emerging markets despite attractive fundamentals and valuations. Risks to equity returns include geopolitical concerns and potential trade issues. An escalation of current bickering into an actual trade war would hurt stock returns.

Further Fed tightening could act as a drag on taxable fixed income results. Given the expectation of rising interest rates, we like credit and spread sectors rather than pure government bonds and prefer to be short duration. We also like non-traditional investments like bank loans. These preferences of course could change as the market unfolds in the months and quarters ahead.

Municipals face both headwinds and tailwinds. Positives include improving credit, narrowing spreads, higher demand, and lower supply. Fundamental are solid as state and local governments continue to benefit from an improving economy. Defaults remain low and credit upgrades exceed downgrades. Somewhat offsetting these positives are rising interest rates, slightly higher inflation, and a somewhat hawkish Fed. Overall, we are optimistic on municipals as the positives appear to outweigh the negatives.

Index Performance as of: 6/30/2018

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
3000 Value	-1.11	0.28	1.71	1.71	-1.16	7.25	8.47	10.40
3000	-1.45	0.65	3.89	3.89	3.22	14.78	11.58	13.30
3000 Growth	-1.80	0.95	5.87	5.87	7.44	22.47	14.63	16.15
1000 Value	-1.02	0.25	1.18	1.18	-1.69	6.77	8.26	10.35
1000	-1.37	0.65	3.57	3.57	2.85	14.54	11.64	13.37
1000 Growth	-1.72	0.96	5.76	5.76	7.25	22.51	14.97	16.36
Mid Cap Value	-1.04	0.81	2.41	2.41	-0.16	7.60	8.79	11.27
Mid Cap	-1.59	0.69	2.82	2.82	2.35	12.33	9.57	12.22
Mid Cap Growth	-2.41	0.39	3.16	3.16	5.40	18.52	10.72	13.37
2000 Value	-2.13	0.61	8.30	8.30	5.44	13.10	11.21	11.18
2000	-2.46	0.72	7.75	7.75	7.66	17.57	10.96	12.46
2000 Growth	-2.79	0.78	7.23	7.23	9.70	21.86	10.60	13.65
S&P 500	-1.31	0.62	3.43	3.43	2.65	14.37	11.93	13.42
Consumer Disc	-1.87	3.61	8.17	8.17	11.52	23.55	14.44	15.97
Consumer Staples	-0.23	4.50	-1.54	-1.54	-8.55	-3.93	5.52	8.17
Energy	1.03	0.71	13.48	13.48	6.81	20.99	3.67	2.22
Financials	-1.91	-1.92	-3.16	-3.16	-4.09	9.65	12.46	13.13
Health Care	-1.77	1.63	3.09	3.09	1.83	7.11	5.68	13.78
Industrials	-1.32	-3.31	-3.18	-3.18	-4.69	5.34	11.29	12.66
Information Technology	-2.19	-0.35	7.09	7.09	10.87	31.30	22.58	21.91
Materials	-0.74	0.34	2.58	2.58	-3.08	9.90	8.48	10.86
Real Estate	1.23	4.44	6.13	6.13	0.81	5.02	8.69	8.97
Telecom Services	1.18	2.37	-0.94	-0.94	-8.35	1.39	3.86	3.71
Utilities	2.32	2.77	3.74	3.74	0.32	3.41	11.68	10.58
Dow Jones Industrial Avg.	-1.26	-0.49	1.26	1.26	-0.73	16.31	14.07	12.96
Wilshire 5000 (Full Cap)	-1.47	0.73	4.11	4.11	3.38	14.92	11.49	13.11
MSCI EAFE	-1.04	-1.22	-1.24	-1.24	-2.75	6.84	4.90	6.44
MSCI EM	-1.46	-4.15	-7.96	-7.96	-6.66	8.20	5.60	5.01
MSCI Frontier Markets	-3.50	-3.54	-15.19	-15.19	-10.86	1.69	2.15	4.55
MSCI ACWI	-1.21	-0.54	0.53	0.53	-0.43	10.73	8.18	9.41
MSCI ACWI Ex USA	-1.04	-1.88	-2.61	-2.61	-3.77	7.28	5.07	6.00
MSCI AC Asia Ex Japan	-2.17	-4.79	-5.39	-5.39	-4.76	9.90	7.02	8.18

Index Performance as of: 6/30/2018

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
MSCI EM Latin America	1.60	-3.06	-17.75	-17.75	-11.15	-0.16	2.00	-2.39
MSCI Russia	3.90	0.37	-6.04	-6.04	2.76	25.97	10.98	1.33
Barclays U.S. Aggregate	0.34	-0.12	-0.16	-0.16	-1.62	-0.40	1.72	2.27
ICE BofAML US 3M Trsy Bill	0.04	0.17	0.45	0.45	0.81	1.36	0.68	0.42
Barclays U.S. Gov't	0.35	0.02	0.10	0.10	-1.05	-0.63	1.02	1.48
Barclays U.S. Credit	0.35	-0.47	-0.88	-0.88	-2.99	-0.65	2.86	3.37
Barclays High Yield Corp.	-0.53	0.40	1.03	1.03	0.16	2.62	5.53	5.51
Barclays Municipal	0.13	0.09	0.87	0.87	-0.25	1.56	2.85	3.53
Barclays TIPS	0.42	0.40	0.77	0.77	-0.02	2.11	1.93	1.68
Barclays Gbl Agg Ex USD	0.01	-0.70	-4.76	-4.76	-1.31	2.78	3.22	0.88
Barclays Global Aggregate	0.15	-0.44	-2.78	-2.78	-1.46	1.36	2.58	1.50
JPM EMBI Global Div	-0.39	-1.19	-3.54	-3.54	-5.23	-1.60	4.63	5.15
Alerian MLP	-1.38	-1.54	11.80	11.80	-0.63	-4.58	-5.93	-4.09
Bloomberg Commodity	0.14	-3.50	0.40	0.40	-0.00	7.35	-4.53	-6.40
FTSE NAREIT Equity REIT	0.72	4.36	10.04	10.04	1.02	3.50	8.06	8.31
S&P Global Natural Res.	0.15	-1.03	5.44	5.44	3.70	24.75	9.46	5.64
S&P N. Amer Natural Res.	1.28	0.87	12.05	12.05	5.29	19.80	3.28	1.74

Sources: Department of Labor, Department of Commerce, Institute for Supply Management, the Conference Board, Federal Reserve, National Federation of Independent Business, Factset

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