BERMAN CAPITAL ADVISORS

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BCA Q2 Review and Outlook

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Summary Outlook

- The market has been more volatile this year, but the fundamentals remain largely unchanged. Compared to a quarter ago, investor sentiment is worse, but economic growth is strong at home. International growth shows signs of weakening, but not significantly.
- The single greatest market worry are the trade disputes now brewing. Most likely, the back and forth is really just a negotiation in public. The most likely outcome is that they are resolved with face-saving deals. However, there is a risk real damage is done first.
- Based on potentially delayed capital expenditures and international slowing, we think the day of reckoning for interest-rate sensitive bonds has been pushed a bit further out, but the risk/reward tradeoff for high quality bonds is poor.
- Emerging markets have been very poor performers in recent months. We still believe the fundamentals are better than commonly appreciated. On the other hand, EM countries with significant dollar debts (where we have little exposure) will remain under pressure.

Q2 Review

Despite ending on a weak note, the S&P 500 Index rose 2.9% in the second quarter. During the quarter, geopolitical risks held back gains. Issues included uncertainty over OPEC policy, a mini-political crisis in Italy and the continued foundering of Brexit negotiations. Yet the biggest issue during the quarter was the threat to the global trade regime as the Trump administration continued its attempts to force change on allies and competitors alike.

Perhaps ironically, U.S. markets generally outperformed international markets as flight to safety inflows benefitted the U.S. U.S. stocks also enjoyed a tailwind from the confidence boost the tax reform and continued job gains provided. On a local currency basis, most international developed markets performed similarly to the U.S. However, the dollar's unusually strong run meant that international markets were negative for U.S. investors. Gold often moves inversely with the dollar, thus it also fell -5.3% in Q2.

The flip side of U.S. strength was emerging market weakness. EM was clearly the worst equity market, falling over -4% in local currencies and down -8.7% in dollar terms. Emerging markets were generally hurt by Fed interest rate tightening, the strong dollar and continued credit shrinkage in China, despite this last factor being largely by design. Brazilian stocks also fell sharply due to continued political turmoil. Trade war fears disproportionately hit emerging markets as those countries tend to depend more on trade than larger economies with a higher percentage of growth from domestic activities.

Looking under the hood, U.S. market cap and sector performance reflects the macroeconomic environment. The most obvious trends in the second quarter were small-caps over large-caps and Growth over Value. Small caps outperformed because they have greater relative benefit from tax cuts than large caps, and because they have less international revenues that could be hit by trade disputes. The market continues to be very momentum driven, with large cap technology stocks continuing to power ahead. Energy also performed very well. Brent Crude soared an additional 14.2%.

Index	Total Return 2018 YTD	Total Return Q2 2018
S&P 500	2.6%	3.4%
Russell 1000 Growth	7.3%	5.8%
Russell 1000 Value	-1.7%	1.2%
Russell Midcap	2.3%	2.8%
Russell Small Cap	7.7%	7.8%
MSCI EAFE (International)	-2.4%	-0.8%
MSCI Europe	-2.7%	-0.9%
MSCI Emerging Markets	-6.5%	-7.7%
MSCI Japan	-1.8%	-2.1%
US Aggregate Bond	-1.6%	-0.2%
High Yield Bonds	0.2%	1.0%
Gold	-4.2%	-5.5%
Crude Oil	22.7%	14.2%

Source: Factset Research

Note: Int'l market returns reported in U.S. Dollars, not local currency

Relating to Growth versus Value, our earlier thought that later-cycle names would be in gear at this point in the cycle has not yet come to pass. Instead, Growth is at record levels relative to Value, with a huge 9% performance spread during the quarter. The FAANGs have largely been responsible for this, as the table below shows. Valuation factors that work very well in most environments, such as free cash flow yield, had a miserable quarter. At the same time, rising rates didn't help financials (which had a strong 2017) as the flattening yield curve outweighed prospects for better economic growth.

Surprising many, U.S. High Yield outperformed other bond indexes in Q2, gaining over 100 bps. Accelerating U.S. economic growth, relatively less interest rate sensitivity, a lack of issuance, and the continued quest for yield all contributed to high yield's outperformance. The broader investment grade Aggregate Bond Index slipped slightly during the quarter.

Exhibit 3: 10 stocks have contributed more than 100% of S&P 500's YTD return

as of June 28, 2018

Ticker	Company	Cons. 2019E sales growth	Total return	Mkt cap weight	% of SPX Return
AMZN	Amazon.com Inc.	23 %	45 %	2.1 %	**36 %**
MSFT	Microsoft Corp.	10	16	2.9	**18**
AAPL	Apple Inc.	4	10	3.8	**15**
NFLX	Netflix Inc.	24	106	0.4	**15**
FB	Facebook Inc.	27	11	1.9	**8**
GOOGL	Alphabet Inc.	18	7	2.8	**7**
MA	Mastercard Inc.	12	31	0.6	**7**
V	Visa Inc.	11	17	0.9	**6**
ADBE	Adobe Systems Inc.	19	37	0.4	**5**
NVDA	NVIDIA Corp.	14	25	0.5	**5**
Top 10 contributors		**16 %**	**20 %**	**16 %**	**122 %**
S&P 500		**5**	**3**	**100**	**100**

Source: FactSet, Goldman Sachs Global Investment Research

For the quarter, TIPS (inflation protected Treasuries) and floating rate bonds also performed well, gaining 0.77% and 0.73%, respectively. Moreover, floaters were the best performers in the first half of the year, gaining 1.17%. Despite the gradual increase in inflation, it has paid to defend oneself against rising rates, which is a focus of our bond portfolio.

Investment Outlook - Economy

As Q3 begins, recession risk remains minimal. As we've pointed out before, that backdrop is critical to understand since the biggest, most painful drawdowns have historically been accompanied by recession. While current risks are low, we do think the economic cycle is slowly maturing. Clearly, there has been a lot of credit growth in this cycle. Also, while wage growth remains remarkably constrained, the "output gaps" in the developed world are certainly narrowing. Because trade wars are a real threat, the risks to the global outlook are higher now than a quarter ago, but we don't see the risks as high in an absolute sense.

Looking at some data, the OECD Composite Leading Indicator (CLI) for the largest economies, a proxy for future global growth, rose fractionally in April to 100.01, just slightly above its long-term average. This piece of evidence argues for some moderate pick-up in growth over the second half of the year. On the other hand, there is less breadth in the number of countries growing well. Specifically, we've seen a little deterioration in Europe and smaller emerging market countries. China has slowed slightly, but that was partly by design as the government clamped down on shadow bank lending.

There are two major issues on the market's mind right now: trade and the course of interest rates. Starting with the latter, inflation is likely to be driven by wage pressure, and wage pressure remains restrained. Looking at the chart to the right, we can see businesses expect to pay higher wages, but at levels similar to recent months. At that level, wages would be about on track with the long-term trend and far from a rapid, inflationary expansion. The market expects the Fed to move up short term interest rates gradually. The back end of the Treasury yield curve tells us the market is not worried about longer term inflation. We still think the long end of the curve is more likely to move up than down, and reflects too much complacency. Regardless, the near-term picture is benign for inflation and should reduce one market concern.

Trade tensions are a real threat, but we think the right response is to monitor rather than take drastic action to guard against an outcome we still don't think will happen. For now, according to the Dallas Fed, world trade growth remains robust. Measures of container shipments continue to soar. However, surveys show clear signs of rising pessimism. This negative sentiment can have a real impact on orders and can result in delayed or cancelled capital expenditures.

In the U.S., credit formation and household wealth are on the upswing. The ratio of nonfinancial private debt-to-GDP has increased by an average of 1.2 percentage points during the past three years, which is close to its historic trend. If one assumes that every additional dollar of credit boosts domestic demand by 50 cents, today's pace of credit growth is adding 0.6% of GDP to aggregate demand relative to a situation where the ratio of credit to- GDP is stable. In addition, housing and equity wealth have been rising much more quickly than GDP. Household real estate wealth fell from a peak of 182% of GDP in 2006 to 115% of GDP in 2012. It has since clawed its way back to 142% of GDP, equivalent to where it stood in 2002. Equity wealth reached nearly

150% of GDP earlier this year, on par with the prior peak set in 2000. In the near term, these are supports to the economy and markets.

Investment Outlook – Stocks

Some of the underlying pessimism about stocks is due to widespread awareness that P/E ratios, especially the cyclically-adjusted, "CAPE" are high. It's worth noting that high earnings growth and the tax reform have resulted in P/Es that are barely higher than in 2016! (see table to right). The obvious rebuttal is that cost pressures from tightening labor markets or rising goods costs (tariffs) would slow earnings growth. Yet that is not what we are seeing in the data, at least not yet. Earnings growth will slow – the tax reform created a huge one-time bump – but earnings are still predicted to rise from here.

S&P 500 FORWARD AND TRAILING EPS AND P/E RATIOS

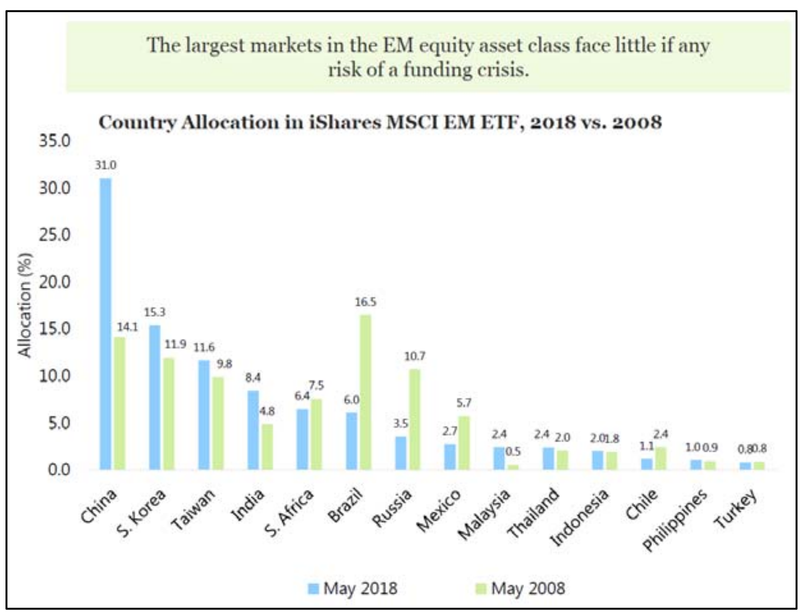
	10/31/16	12/31/17	1/31/18	6/11/18
Price	2126.15	2673.61	2823.81	2782.00
EPS (Trailing)	101.42	124.51	124.51	132.02
P/E (Trailing)	21.0	21.5	22.7	21.1
EPS (Forward)	126.77	142.34	154.9	161.69
P/E (Forward)	16.8	18.8	18.2	17.2

Source: Standard & Poor's. All earnings are operating earnings per share.

We do think there is wisdom in the market saying, "Don't fight the Fed, don't fight the tape." The tape, or market momentum trends, are still positive. However, the market's advance has been largely due to rebounding consumer names and more importantly the big tech growers. It would be good to see broader participation in the market's admittedly choppy advance. The Fed is raising interest rates, so isn't being overweight stocks fighting the Fed? Our answer is that we are still normalizing from ultra-low rates, and that global policy is accommodative overall. The U.S. fiscal budget is set to be highly stimulative in 2019. This probably worsens our long-term problems, but in the near term it is bullish, especially given some concerns on international growth.

We expect continued market volatility, especially as stocks are going through the seasonally weak period through early autumn. Also, mid-term years have tended to be weak, presumably because uncertainty over elections has weighed on the market. Always forward looking, however, the market tends to bottom before the actual elections in November.

There's been a lot of commentary about stress in the emerging markets focused on dollar-denominated debt. The chart on the right shows the constituent weight changes now versus 2008.



Source: Research Affiliates

The takeaway here: the largest weighted countries have very little dollar denominated debt on an absolute basis. Countries like Turkey and the Philippines, where that is not the case, are small and thus unlikely to cause a systemic crisis.

Investment Outlook - Bonds

Our outlook has shifted a bit from the last quarter. The emphasis is on "a bit," because we still think it makes sense to favor credit risk (*Will I get paid?*) over interest rate risk (*Will rising rates reduce the value of my bonds?*). We still think it makes sense to protect the portfolio by owning floating rate securities. What's different is the pace of inflation, which is probably lower than we thought at the end of last year. The factors behind this are the slight slowing in international growth and the potentially dis-inflationary impact of trade disputes. While higher tariffs could trigger inflation on some goods, the slowdown in economic growth would also slow inflation.

We think it's more worthwhile to mention some changes in the investment grade universe that could be a source of opportunity later in the cycle. First, the duration of the major bond indexes is longer than ever. That means if rates come down, there would be strong gains, but on the flip-side, higher rates could hurt more than many expect. For example, the duration of the U.S. Aggregate Bond Index is roughly six years. This is largely due to the duration extension of mortgage-backed securities as refinancings tail off. Increased issuance of long-term corporate debt since the financial crisis has also helped lengthen duration.

The other issue is the lower quality (by rating) of bonds within the investment grade universe. A notable 90% of investment grade U.S. and European corporate credit is rated A or BAA, which are the bottom levels in that category (AA and AAA are the highest). When the credit cycle eventually turns, those bonds represent potential downgrades, some of which will end up as junk. Right now we don't think this is actionable, but when we are closer to hard times, we will likely favor Treasuries over investment grade corporate debt.

Please reach out to us with any questions about our outlook, and thank you again for trusting us with your investments.

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