As Good As It Gets

By Theresa Gusman

Following a brief first quarter hiatus, the US equity market resumed climbing a wall of worry in the second quarter. International markets did not follow suit, with significant losses in emerging markets. As we look toward the second half and 2019, the outlook for global equities is clouded by decelerating economic and earnings growth, rising inflation and interest rates, higher oil prices, and trade headwinds.

Building on the gains of the past few years, the S&P 500 advanced by 3.43% in the second quarter, offsetting the first quarter loss and boosting year-to-date returns to 2.65%. Growth continued to outperform value, and small cap stocks significantly outperformed their large cap peers. Energy was the top performing sector, as oil prices (NYMEX light futures) surged 14.18%, bringing the year-to-date gain to 22.72%. Real estate, healthcare, consumer cyclicals, and technology also performed well in the second quarter, as consumers continued to rev up spending. Not surprisingly, with trade clouds brewing, industrials were the worst performing sector during the quarter.

Continuing the pattern of US excess performance, international equities did not fare as well as domestic stocks in the second quarter. The MSCI All Country World (ACWI), Ex US index fell 2.61%, as the MSCI Emerging Markets index dropped 7.96%. Latin American equities plunged 22% in the quarter. The decline was fueled by general fears the growth-dampening effects of a trade war, combined with the specific threats of US tariffs on automotive-related imports from Latin America and contagion from Argentina, where the central bank raised a key interest rate to 40% in May to support the currency and tame inflation.

Quarterly Performance Benchmarks

Passive Benchmarks*	Q2-2018	YTD	1 Year	3 Year**	5 Year**
S&P 500 Index	3.43	2.65	14.37	11.93	13.42
MSCI KLD 400 Social Index	3.70	3.48	14.61	11.40	12.30
DJIA (reinvested dividends)	1.26	-0.73	16.31	14.07	12.96
S&P MidCap 400	4.29	3.49	13.50	10.89	12.69
Russell 2000 (Small Cap)	7.75	7.66	17.57	10.96	12.46
MSCI EAFE (Europe, Australasia, Far East)	-1.24	-2.75	6.84	4.90	6.44
MSCI Emerging Markets	-7.96	-6.66	8.20	5.60	5.01
Bloomberg Barclays Aggregate Bond	-0.16	-1.62	-0.40	1.72	2.27
Morningstar Mutual Fund Benchmarks					
U.S. Large Cap Growth	7.01	12.34	27.24	15.21	17.72
U.S. Large Cap Value	0.47	-2.68	8.76	9.68	10.04
U.S. Mid Cap Growth	4.98	8.50	20.54	10.70	13.41
U.S. Mid Cap Value	2.56	0.90	10.23	11.50	12.85
U.S. Small Cap Blend	7.02	5.33	15.52	10.19	12.11
Foreign Large Blend	-2.17	-3.08	6.06	4.58	5.95
U.S. Real Estate	9.25	1.98	4.43	8.00	8.30
Intermediate-term Bond	-0.24	-1.55	-0.36	1.69	2.22

* Sources: Morningstar

**3-Year and 5-Year returns are average annual returns for that benchmark.

Performance data presented reflects past performance. Past performance is no guarantee of future results. Investing involves risk, including loss of principal. Passive benchmarks are unmanaged groups of stocks and are not directly available for investment. Information has been obtained from a source considered to be reliable; however, neither First Affirmative nor its agents can guarantee the accuracy of the numbers reported.

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For the time being, US economic and earnings growth remain strong, the equity markets are well-supported, unemployment is at historic lows, and inflation is within the Fed's parameters. However, this may be as good as it gets. The beneficial effects of this year's tax cuts have been incorporated into corporate and individual expectations, international growth is slowing, particularly in emerging markets, interest rates are rising globally, the dollar is strengthening, and oil prices have increased – none of which bode well for economic or corporate earnings growth. Furthermore, the detrimental consequences of US tariffs are already being felt internationally and by US companies, including Harley Davidson, Whirlpool, and other corporations that use foreign steel and parts. In the end, nobody wins a trade war.

As we look toward the second half and 2019, positive and negative factors are well-balanced, suggesting increased volatility amid decelerating equity market increases. Given current valuations, with US economic activity strong relative to the rest of the world, the dollar strong and well-supported by rising interest rates, and trade tensions continuing to escalate, we believe US equities may continue to outperform international stocks over the next several months. In the long term, we remain convinced by that well-structured, highly diversified portfolios – across the geographic, market capitalization, and growth-value style spectrums – will continue to enable our clients to achieve their financial and impact objectives.

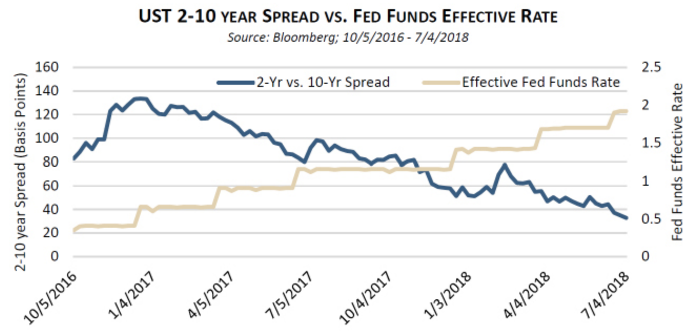
The Smartest Guys in the Room

By Wasmer, Schroeder & Company

To be honest, the second quarter was not very exciting. There were pockets of action, notably centered around either Central Bank meetings and pronouncements or political events such as Italy's parliamentary elections, but overall, there was nothing earth shattering. The U.S. economy continued to show relative strength. Estimates for 2Q18 domestic GDP skewed above 3.00% on an annualized basis during the period, despite the first quarter's recently finalized 2.00% estimate. U.S. unemployment remained low, with only slight increases in inflation—a backdrop that the U.S. Federal Reserve has used to maintain its commitment to firming monetary policy and shrinking its balance sheet. All of this was expected.

Economies in the rest of the developed world haven't been as robust as ours has been in the U.S. As a result, central banks in Europe and Asia have been more tentative in their policy actions—but this has largely been as telegraphed, as well. All and all, it has felt like the quiet trading days of summer have already been here for some time.

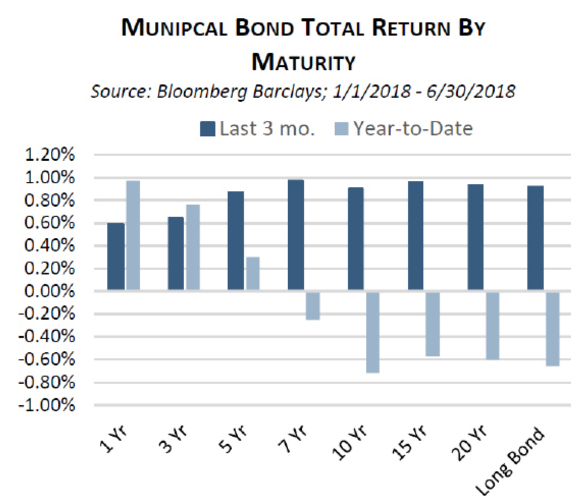
For the most part, the financial markets took all of this news in stride and reacted accordingly. Treasury yields bounced around, but ended the quarter slightly higher (gratuitous plug alert: back at its March meeting, WSC's Investment Committee had foreseen a 2.83% 10-year yield at quarter end—2.86% was pretty close). The Fed's rate hike and slightly hawkish tone led to ongoing flattening in the yield curve. The yield on 2-year notes rose 26 basis points (bps), while 10-year Treasury yields were only 12 bps higher. Risk assets had another decent quarter, despite some bouts of volatility; broad stock indexes were up several percentage points, and technology stocks led the Nasdaq Composite Index to a gain of over 6.00%. Municipal bonds,



buoyed by strong credit fundamentals and favorable supply/demand dynamics, also enjoyed solid performance as well despite the drop in Treasury prices.

One fly in the proverbial ointment, however, was the relative performance of domestic corporate bonds. While stock market participants were happy to propel equity prices and valuations to levels near all-time highs, credit spreads in the corporate market continued to widen at essentially the same pace that was observed during the first quarter. The first half of the year ended with the option-adjusted spread (OAS) of broad corporate indexes actually sitting at wider levels than they were just after the 2016 Presidential election. At that time, risk assets in all categories began their strong performance run. While this fact is not necessarily troubling—and may have more to do with corporate bond market money flows and technical factors, such as quarter-end positioning by both investors and market makers—it seems clear that risk traders in the bond markets have a slightly different view of the current situation than their stock-investing colleagues.

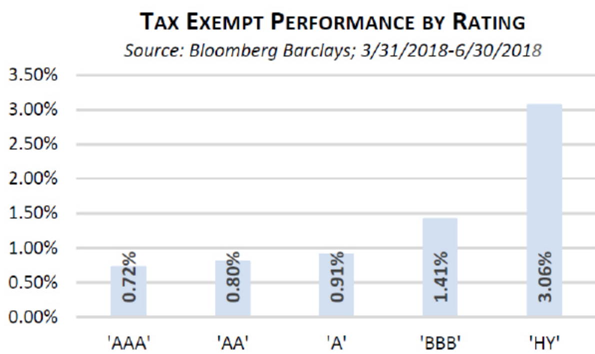
Only one of these views can be correct in the long run, of course. I'll admit my bias toward one side's ability to foresee these market turns and will say only that, in my experience, those of us in the bond markets have been better at predicting changes through our collective trading actions. As our Investment Committee sees slightly higher U.S. Treasury 10-year yields of just more than 3.00% in the third quarter (and a still marginally-flatter yield curve), it is clear that we don't see any major, "risk off" or "flight-to-quality" bouts on the horizon. That said, we will be watching carefully for any indications that these market moves were, in fact, prescient, and that we need to rethink our base-case scenarios.



Tax Exempt Market

DURATION/STRUCTURE

Although we saw U.S. Treasury yields move higher during the quarter, especially on the short end, municipal yields moved very little and ended the quarter very close to where they began the period. Performance was positive, up and down the yield curve, with the best performance in 7-15 year maturities. The 0.87% second-quarter return posted by the Bloomberg Barclays Municipal Bond Index helped to offset the -1.11% that we saw at the end of the year's first quarter. This brought the Index's year-to-date performance back to -0.25% at the close of the year's first half, a big improvement from where we sat three months ago.



From a maturity structure perspective, the short end of the yield curve provided the weakest area of performance during the second quarter of 2018, with 1- and 3-year munis posting gains of 0.59% and 0.64%, respectively. By contrast, the best area of performance came from 7-year maturities, followed closely by the 15-year area. Returns were 0.97%, and 0.96%, respectively. The bear-flattening move we saw in the U.S. Treasury curve did not spill over to the municipal market, as short muni yields remained stubbornly low despite the move higher in Treasuries. From a yield standpoint, 2-, 10- and 30-year tax exempt bonds decreased by 3, 1 and 1 point(s) respectively. For comparative purposes, Treasuries with comparable maturities moved higher by 26, 12 and 2 bps, respectively.

Sector allocations provided little in the way of performance differentiation on a duration-neutral basis. General obligation (GO) and revenue bonds performed within three basis points of each other with the Bond Buyer Revenue Bond Index returning 0.90% vs. 0.87% for GOs. The Healthcare (1.11%) and Tobacco (1.36%) sectors were outperformers, as investors continued to seek out sources of additional spread.

Along those same lines, we saw lower-rated credits continue to outperform higher-rated credits, during the quarter, as has been the case all year. In particular, BBB-rated bonds, returning 1.41%, continued to dominate AAA-rated bonds, with results of 0.72% in the performance category. Credit spreads in the municipal market have continued to hold up very well, despite the volatility that we have seen recently in corporate bond credit spreads. Tax exempt spreads have become especially tight in shorter maturities, where the majority of demand has been congregating.

SUPPLY/DEMAND

Second-quarter muni market performance was primarily driven by low supply and strong demand. The period's $96 billion in new issuance dropped 11% from the $108 billion in new issuance in the second quarter of 2017. On a year-to-date basis, supply was down 20% versus the first half of last year. Although we did continue to see increased secondary selling from banks and insurance companies during the quarter, the selling was orderly and it was easily absorbed by the market. Going forward, we do not expect to see a large increase in supply, and we still anticipate that this year's total new issuance will finish under $300 billion. That total would equate to around a 30% decline versus last year.

After experiencing outflows throughout most of April—which were most likely tax-related—the course reversed, and municipal bond funds saw net inflows in every week of the last eight weeks, with the average inflow over the final eight weeks of the quarter coming in at $298 million. This demonstrates continued strong demand from retail investors, despite the negative performance that the market experienced during the first quarter. During June, we were able to see updated data regarding municipal ownership patterns after the Fed released their Flow of Funds report. The report revealed a slight decrease in ownership from institutional buyers, which was anticipated due to lower corporate tax rates. Retail ownership continues to remain strong, with households owning approximately 67% of all munis.

As can be expected when Treasury yields move higher while muni yields remain largely unchanged, muni-to-Treasury yield ratios fell during the quarter, most notably on the short end. Specifically, 2-year muni-to-Treasury ratios dropped from 74% from March 31, 2018 to 65% on June 30, 2018. The ratio in 5-year maturities closed the quarter around 73%, down from 80% at the beginning of the period. Ten-year muni-to-Treasury ratios fell from 90% during the quarter to close at 86%, while three months later, and 30-year muni-to-Treasury ratios hovered right around 100% throughout the period. The steepening in the ratio curve is a strong illustration of the demand patterns that are present in the muni market at this time. While retail investors' preference for short maturities remains strong, we continue to see decreased demand for longer maturities from institutional buyers who are still adjusting to lower corporate tax rates. Because of these dynamics, longer maturities appear to be attractive versus Treasuries at this time, while shorter maturities appear to be fully valued.

CREDIT QUALITY

Credit quality trends remained stable during the second quarter. The market continued to be defined by a stable-to-improving credit landscape, with strong state and local tax receipts. We believe that the combination of a relatively smooth budget season, recent state gambling initiatives and the Wayfair Supreme Court ruling could also create marginal tailwinds for credit. We continue to watch for non-systemic risks on a credit-by-credit basis and continue to be on the lookout for state and local governments who are unprepared for unexpected periods of economic weakness.

LOOKING FORWARD

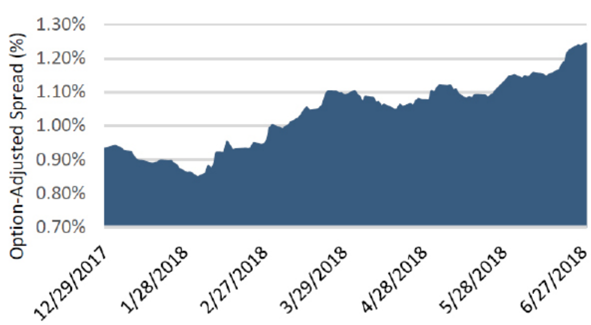
In the coming quarter, we think that the positive technical environment will remain in place, with low supply and steady demand, particularly on the short end of the curve. We believe that ratios on short and intermediate maturities will continue to be supported in the near term. We also anticipate that longer-term ratios will persist at higher levels given the decreased appetite from institutional buyers. Overall credit quality should remain stable and credit spreads should continue to reflect strong demand for A-rated and BBB-rated bonds. We also expect that yields on specialty state bonds, particularly those in California and New York, will still be exceedingly low, suggesting that clients who are not in the highest tax brackets in those states would benefit from an allocation to out-of-state bonds to enhance after-tax yield.

Taxable Market

The continued uncertainty and increased rhetoric surrounding trade disputes between the U.S. and its global trading partners weighed on corporate spreads during the second quarter. Investors struggled with the scope and scale of the potential tariff impact and therefore required a higher risk premium. The increased volatility didn't stop corporate CFO's from tapping the market, though. The pickup in merger and acquisition (M&A) activity affected certain sub-sectors, such as Telecom/media, and put pressure on the overall market with new supply. The two largest deals of the quarter were both used to finance acquisitions. The first deal came from Walmart (a $16 billion bond deal for Flipkart), and the second largest deal came from Bayer (a $15 billion bond deal for Monsanto). Overall, issuance was approximately 5% above the second quarter of last year and spreads, as measured by the Bloomberg Barclays U.S. Corporate Index, moved 15 bps wider, from 109 bps at the end of March 2018 to 124 bps at the end of June 2018.

BLOOMBERG BARCLAYS US CORPORATE AVERAGE OAS

Source: Bloomberg; 12/29/2017 - 6/30/2018



Like they did last quarter, credit spreads in the taxable municipal market bucked the widening trend seen across other credit markets. The inherent higher-quality bias and U.S.-focused nature of the sector helped spreads remain firm in a widening environment. The continued growth of the economy has helped support increased tax receipts, leading to strong underlying fundamentals in the sector. The drop in new issue supply was another contributor to performance as limited availability kept the secondary market well bid and new deals were generally oversubscribed. New financings were of particular interest to investors during the quarter. California priced more than $2 billion of GOs in two separate series and Georgia also priced just under $500 million of GOs in two tranches. Both deals saw very strong investor demand, not only from the traditional municipal market but from credit cross-over buyers, as well.

Mortgage-backed securities (MBS) were some of the better fixed-income performers in the second quarter. Yields rose during the period; however, the move was slow, which allowed the mortgage basis to weather the drop in price. This change contrasted sharply with the rapid speed and magnitude of both the rise in interest rates and flattening yield curve in January, which hurt the mortgage basis during the first quarter. The outcome can be seen in The Bloomberg Barclays U.S. Mortgage Index. While the Index had a negative price performance of 58 bps, the carry from coupon payments produced a positive 86 bps. This resulted in an overall positive return of 24 bps, which included 15 bps of excess return.

The last quarter can be counted as a win for the Fed, as their asset-reduction plan entered the third-consecutive quarter of Agency MBS roll-off and the mortgage basis was able to outperform. Going forward, the asset reduction plan for Agency MBS is scheduled to rise to $16 billion of roll-off in the year's third quarter and then reach its terminal cap of $20 billion in the fourth quarter of 2018. We do not see these increases as significant headwinds for the sector, as prepayments have slowed due to higher mortgage rates. This resulted in lower-than-expected runoff from the Fed's portfolio, which came in below the $12 billion cap in each month of the second quarter. The high coupon, low duration, seasoned Agency MBS pools used across our various taxable strategies provided a positive return, despite the backup in short-rates, due to the previously mentioned strong carry dynamics.

A small, but noteworthy component of the market struggled in the face of a rising dollar. The tighter monetary policy and strong economic backdrop here in the U.S. caused the dollar to rally against its global peers. Sovereign issuers felt the pain, as the cost to repay their dollar-denominated debt significantly increased, resulting in wider spreads. The group was largely made up of South American countries, which included but were not limited to, Peru, Panama, Mexico, Chile, and Colombia.

CARRY THE YEAR

Looking ahead to the next quarter and to the remainder of 2018, we expect the markets to benefit from the backup in both Treasury yields and credit spreads. While we believe that the Fed does intend to hike interest rates two more times this year, yields in the front end of the curve are starting the quarter significantly higher than where they were at the beginning of the year. The same dynamic holds true in the corporate market. Corporate credit spreads are in a widening trend but are also starting the quarter at increased yields. The additional carry from the combination of the two previously mentioned factors can help offset a potential rise in rates or credit widening. Supply/demand dynamics should also benefit the credit markets in the second half of 2018, with a constrained new issue taxable municipal market calendar and most M&A financings having already been completed in the corporate market (with the exception of the FOX/Disney/Comcast bidding war and UTX buying Rockwell Collins.) With that as a backdrop, we believe that the taxable market is set up well to provide positive overall returns in the second half of 2018.

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