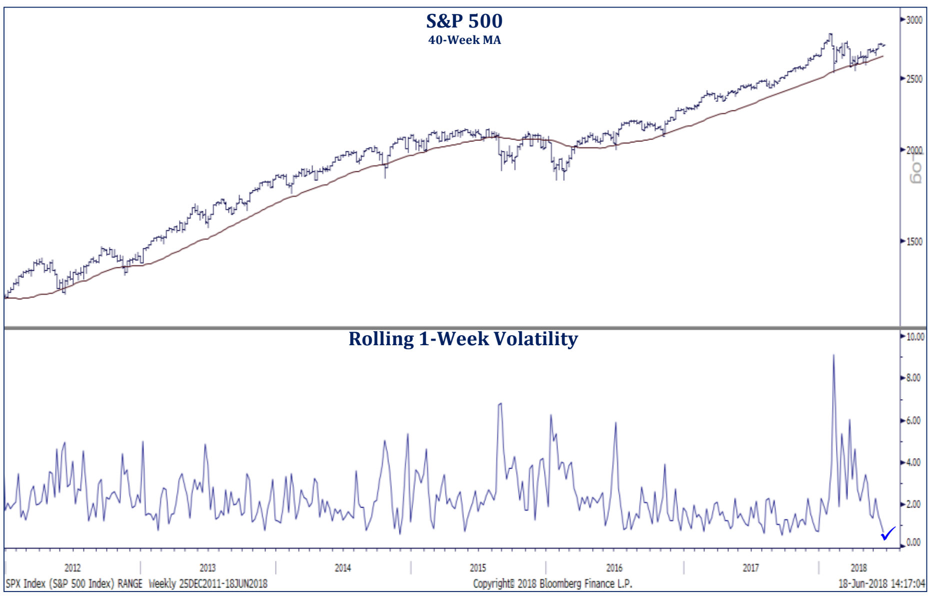
SECOND QUARTER REVIEW:

EQUITY MARKETS CONSOLIDATING

The U.S. equity market remained in a relatively tight trading range during the first half of 2018. This consolidation is normal and healthy as the overall equity market weighs all the different economic and political trends now underway. What is clear is that the corporate and personal tax cuts have been a very positive factor to domestic economic growth.

CHART I

NARROWEST S&P RANGE OF THE YEAR (DESPITE THE HEADLINES)



Source: Strategas

Beneath the broader market trend, significant shifts are underway across many equity sub-sectors. Most large capitalization bank stocks have declined year to date despite the rising interest rate environment. Indeed, the financial sector overall has underperformed the market averages while most analysts and strategists remain over-weighted to the group in most asset allocation models. Industrials, consumer staples, old media and other sectors have not kept up with the market. What is apparent has been the very strong performance in technology equities concurrent with small and midcap stocks in general. It seems that the equity market remains focused on growth and little else.

Within technology, we believe valuations for many equities appears stretched. However, history tells us the group can continue to move higher in the intermediate term. The macro backdrop for the broader trends have varied. They include:

- Many economists believe that gross domestic product (GDP) growth could materially accelerate to as much as 3-4% in the second and third quarters from the 2+% pace that has characterized its growth profile for years.
- Corporate profits are accelerating on the heels of the significant cuts in tax rates this year. Overall corporate profitability could jump 15% or more in 2018.
- Corporate revenue growth is also set to accelerate as business and consumer demand picks up speed.
- Operating margins, already at or near peak historic levels, could move even higher this year.
- Consumer debt has picked up in recent months. This is another sign that the consumer is more optimistic about the future.
- Despite the Federal Reserve's efforts to raise interest rates, the yield curve is flattening as short-term interest rates move up while the 10-year rate remains at or slightly below 3%.
- Despite full employment, wage increases (inflation) have been modest.

On the political front, the "tariff wars" have begun on a modest scale. Tariffs against Canada, our European trading partners and China have been met with similar tariffs on U.S. products in retaliation. Additionally, NAFTA negotiations also seem to have broken down recently. As mentioned earlier, the overall impact of these factors is still modest and does not come close to the sizeable benefits from corporate tax cuts. As we have said in our last quarterly report, a significant trade war could negatively impact our economy and the global economy.

The combination of strong corporate profits, accelerating GDP, a muted rise in inflation and interest rates and a consumer pickup in spending has offset the broader concerns over global growth slowing in subsequent periods. Hence, most strategists are calling for a continuation of the bull market through 2019 at the minimum.

As we enter July, we will get a good look at corporate profit expectations as companies begin to report results. To some extent, we are concerned on a few levels. First, the U.S. dollar has been quite strong, and this has created a headwind for all U.S. based multi-national companies. We may be surprised at the magnitude of the currency impact on corporate profit expectations throughout the balance of the year.

Second, European growth has slowed a bit and this could also be a factor in the outlook for the second half of the year. Third, raw materials and transportation costs have increased to the point where manufacturers will have to include price increases to offset these cost factors. Usually, this creates a short-term pressure on earnings as price increases come 3-6 months after the rise in costs. On the positive side demand seems to be rising for most businesses and revenue growth could be an upside surprise. Concurrent with lower tax rates, earnings growth could still be very strong throughout the balance of the year.

CHART II

S&P 500 P/E Sensitivity Analysis

	Cyclical Trend	Secular Trend	Current TTM P/E		Multiplier		Implied NTM P/E
1	Expansion	Expansion	19.5x	↗	1.17	›	22.9x
2	Expansion	Contraction		→	1.03	›	20.2x
3	Contraction	Expansion		→	0.97	›	18.9x
4	Contraction	Contraction		↘	0.91	›	17.7x

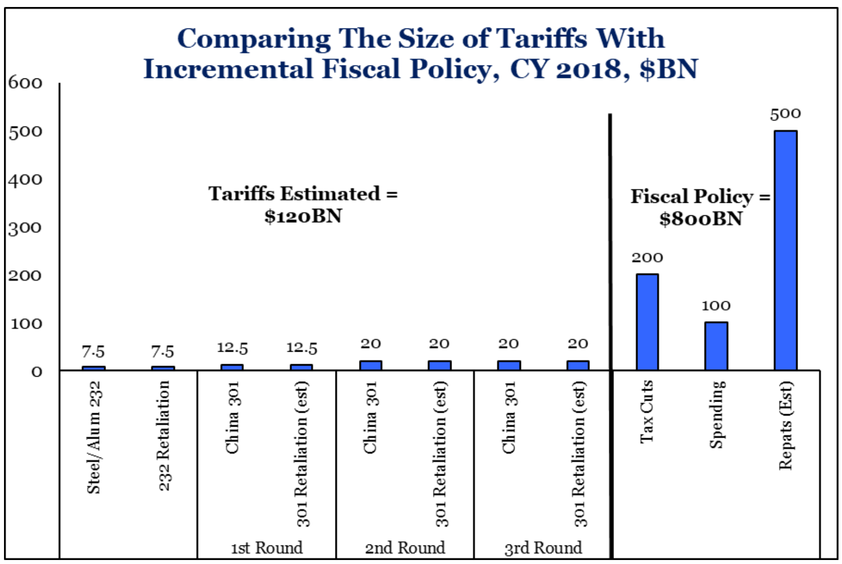
Source: Strategas

At this juncture, we believe that S&P 500 corporate profits are likely to reach $150-160 a share this year. That puts the overall market at about 17-18 times 2018 earnings estimates. As Chart II (above) suggests, the market is fairly valued. However, many growth stocks are selling at 25-30 times earnings. This bifurcated market in valuations should continue for a while longer.

Nevertheless, the overall positive trends in GDP growth, corporate profits, low interest rates and low inflation are a powerful combination that should allow the market to expand as the second half of the year unfolds.

Regardless, macroeconomic trends are beginning to take a backseat to the political winds blowing strongly across the global landscape. While evidence mounts of an accelerating revenue and profit picture in the U.S. and select other markets, the investment community is becoming increasingly nervous around the budding tariff threats that are being announced by various countries trading with the U.S.

CHART III



Source: Strategas

While recently implemented tariffs have created a headwind for our economy, the tax cuts are significantly more impactful (Chart III). This gives the Administration considerable latitude in implementing other trade restrictions without jeopardizing the current expansion now underway.

PORTFOLIO VIEWS

During periods when the Federal Reserve is cutting interest rates, the risk-free premium for equities declines. With interest rates so low, investors were being rewarded for adding risk to their portfolios. Now, interest rates are slowly moving upward toward a more normal level in the next few years. Thus, the risk-free rate begins to rise. As a result, not all equities are likely to benefit from this trend as has been the case in the last 8-9 years.

We have always focused on high quality, category-dominant companies, and we believe that equities with these characteristics should shine in a long-term rising interest rate environment. Thematically, we continue to seek out companies that benefit from the new digital environment. To that end, we plan to add additional exposure in this broad area in the coming months.

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