July 2018 IN REVIEW

August Update | As of July 31, 2018

ECONOMY:

U.S. GROWTH ACCELERATES

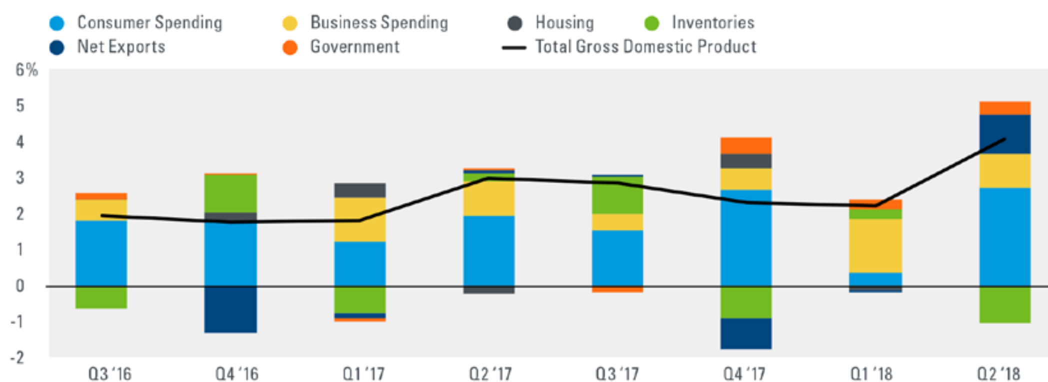
Economic Data

Economic reports released in July 2018, largely reflecting economic activity in June, provided evidence of accelerating U.S. economic growth over the second quarter.

The U.S. economy, measured by gross domestic product (GDP), grew 4.1% in the second quarter, its strongest since the third quarter of 2014 and fifth strongest quarter of the expansion. Despite slightly missing the Bloomberg-surveyed economists' consensus of 4.2%, the details behind the report were generally positive, with strong growth despite a big headwind from shrinking inventories and an upward revision to first quarter growth from 2.0% to 2.2%. Fiscal stimulus had a clear impact, reflected in increased government spending, in addition to a strong rebound in consumer spending from first quarter weakness and solid business investment [Figure 1].

The biggest negative on a forward-looking basis was a big jump in exports ahead of the implementation of previously announced tariffs, which is likely to unwind in upcoming quarters. GDP grew at an annualized rate of 3.1% over the first half of the year, so growth could slow some in the second half and the U.S. economy could still grow near 3% for the calendar year, which would be nicely ahead of the expansion average of 2.3%.

Inflation readings reported in July generally exceeded expectations and showed a modest increase in inflation. The core consumer price index (CPI) excluding food and energy increased 2.3% year over year in June. The Fed's preferred inflation gauge, the core personal consumption expenditures (PCE) deflator, increased 1.9%. The prices paid component of the Institute for Supply Management (ISM) manufacturing survey fell from its May peak at 79.5 to 75.3. Wage growth accelerated slightly but remained within its 2018 range, as average hourly earnings increased 2.7% year over year in June, slightly below May's 2.8% increase.



Labor markets continue to generate steady improvement. The economy added 213,000 jobs in June, above consensus estimates of 195,000. The unemployment rate rose from 3.8% to 4% for the month, but for a good reason as the labor force participation rate increased from 62.7% to 62.9%. Overall, recent jobs data confirm the labor market is still gradually tightening, but the persistent lack of wage growth won't force the Federal Reserve (Fed) to speed up its plan for interest-rate increases.

Consumer demand continued to trend higher in June, continuing a solid rebound from the first quarter slowdown. Retail sales grew for a fifth straight month, rising 0.5% in June to match consensus expectations. Initial figures for May were revised higher, from 0.8% to 1.3%, marking the strongest growth rate since September 2017. Eight of 13 subgroups within retail sales gained month over month, confirming a broad-based pickup in consumer activity. Consistent gains in retail sales indicate a healthy consumer amid a strengthening economy. However, control group sales, which are used to calculate GDP, painted a somewhat less encouraging picture, remaining unchanged month over month and falling short of consensus expectations.

Manufacturing activity remained robust in June despite ongoing global trade tensions. The official ISM Manufacturing Index in the U.S. came in at 60.2 in June, above expectations of 58.5 and near the highs of the expansion. The ISM report added to evidence that, as July began, tariffs and escalating trade tensions were having little impact on U.S. manufacturers. Late in the month, several companies reported some drag on their second quarter earnings from tariffs, but overall results through July were quite strong and reflected minimal impact.

The Conference Board's Leading Economic Index (LEI), an aggregate of ten leading indicators, rose 0.5% month over month in June and 5.8% year over year, above expectations and the prior month. This increase in the LEI is consistent with continued growth in the U.S. economy and low odds of recession in the coming year [Figure 2]. The biggest positive contributor was the ISM New Orders, while building permits detracted most.

Central Banks

The Fed's Beige Book released in July noted economic conditions were steady with employment gains picking up and wage pressures building at the end of the second quarter. Respondents noted that price pressures remained modest; however, rising trade tensions did in fact increase the prices of some key production inputs.

At its August 1 meeting, the Fed was expected to keep interest rates unchanged, and that is indeed what occurred. Ahead of the decision, fed funds futures were pricing in a roughly 60% chance of two additional rate hikes by the end of the year.

The European Central Bank (ECB) announced it would continue its asset-buying program through the end of September and stated it would keep interest rates unchanged "at least through the summer of 2019." Markets moved little on the news.

The Bank of Japan pledged to keep its ultra-easy monetary policy in place for "an extended period of time." While the market largely expected policy to remain in place in the short term, investors were looking for any sign of a more hawkish approach after reports that tweaks to Japan's asset purchase program were being considered.

GLOBAL EQUITIES:
U.S. EQUITIES SHAKE OFF TRADE WORRIES, GAIN ON ECONOMY AND EARNINGS

U.S.

Stocks rose for the fourth straight month in July as the S&P 500 Index returned 3.7%, with market participants focusing on improving economic data and strong earnings while shrugging off headlines from contentious global trade discussions. The Dow fared the best among major composites, rising 4.7%. The Nasdaq Composite Index rose 2.2%, while the Russell 2000 Index increased 1.7%. The S&P 500 returned 6.5% this year through the end of July.

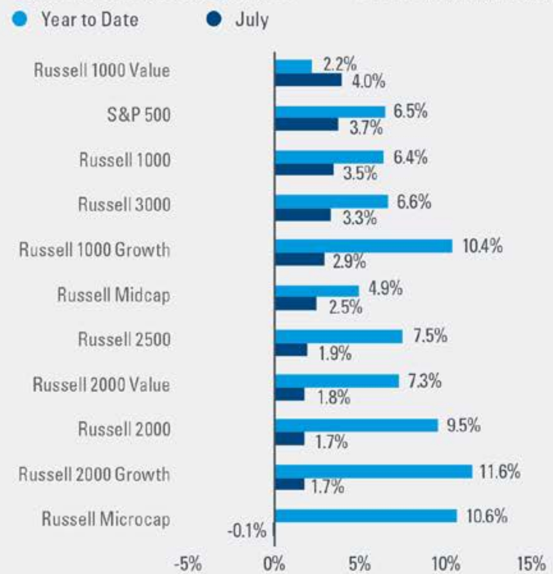
U.S. stocks were resilient even as trade tensions escalated and tariffs on an additional $34 billion in goods took effect. Trade headlines continued to dominate the news as the U.S. and China lobbed additional threats of steep, sizable levies on imported goods. While we think China and the U.S. will reach an eventual agreement and avoid a full-blown trade war, we expect developments on trade to continue injecting periodic volatility into equities.

Strong economic data during the month also helped support the U.S. stock market. Second-quarter GDP grew 4.1%, the fastest quarterly pace since 2014 and the fifth-strongest quarter of the economic expansion. Solid data on the labor market and manufacturing also helped buoy investor sentiment.

Investors also watched earnings reports as the bulk of S&P 500 companies reported during the month. Consensus projections called for corporate profit growth of more than 20% for the second consecutive quarter, boosted by fiscal stimulus and the improving economy. Out of 327 S&P 500 companies that reported second-quarter earnings through the end of July, an impressive 81% beat consensus earnings estimates, producing an upside surprise of about 3%. While trade worries were mentioned in several management commentaries, the impact of tariffs was otherwise not apparent in results.

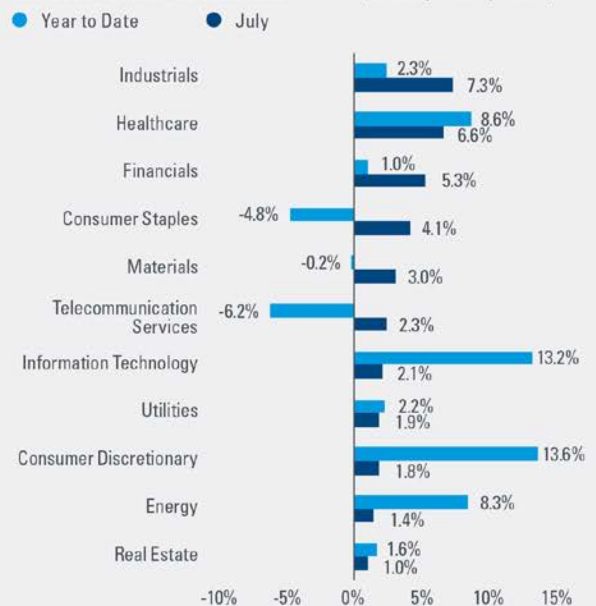
Large-cap stocks outperformed small-cap stocks last month for the first time since February amid encouraging earnings reports from bigger U.S. companies. The small cap Russell 2000 beat the Dow every month from March through June as trade anxieties weighed on large-cap

DOMESTIC INDEX PERFORMANCE (Sorted by Monthly Return)



Source: LPL Research, FactSet 07/31/18

S&P 500 SECTOR PERFORMANCE (Sorted by Monthly Return)



Source: LPL Research, FactSet 07/31/18

Indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

Stock investing involves risk, including loss of principal.

Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

stocks, which typically depend on a larger share of international business for profits. A strong U.S. dollar had also weighed on large caps during the spring months, before that headwind eased as the dollar leveled off in July. Small caps still lead year to date, with the Russell 2000 Index having returned 8.8% in 2018, ahead of the Russell 1000 Index's 5.3% advance.

Value stocks outperformed growth stocks last month by the widest margin in 10 months. The Russell 1000 Value Index returned 4.0% in July, more than 1% greater than the 2.9% gain in the Russell 3000 Growth Index. Most of this outperformance came in the final days of the month, when U.S. large-cap tech stocks sold off sharply on disappointing earnings results. During the last week of July, value stocks staged one of their biggest five-day rallies relative to growth in several years. As is typical when value outperforms, the financials sector's 5.3% return for the month outpaced technology's 2.1% gain. Value still trails growth year to date, with the Russell 1000 Growth Index up 10.4% year to date, versus the Russell 1000 Value Index's return of 2.2% year to date.

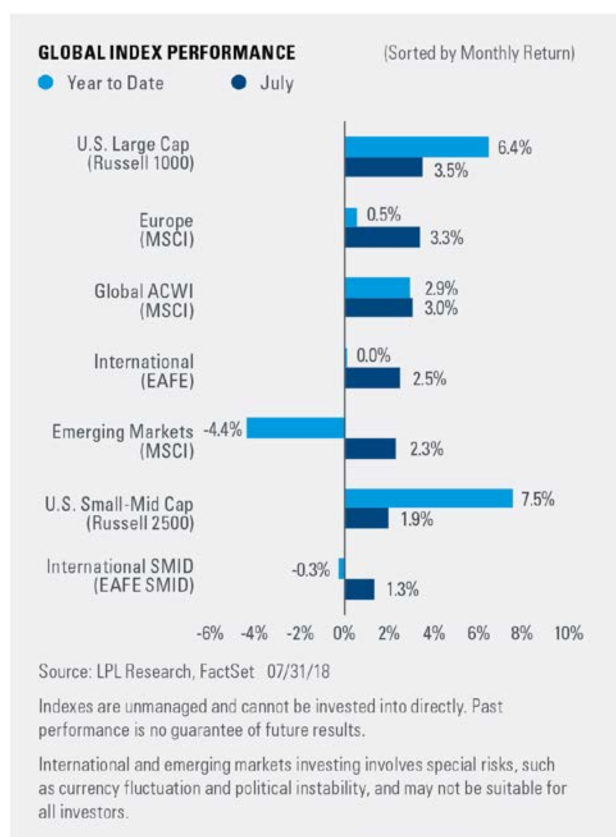
S&P 500 gains were broad based in July, as all 11 S&P 500 sectors within the index rose. Industrial stocks, notably transports, led gains with a 7.3% return, as strong earnings helped offset trade fears. Biotech and pharmaceutical stocks delivered solid gains, propelling the healthcare sector to a 6.6% gain. On the flip side, consumer discretionary, energy, and real estate lagged, as each gained 1-2% during the month.

International

Developed foreign equities tracked in the MSCI EAFE Index returned 2.5% in July, trailing the U.S.* but outperforming emerging-market (EM) equities. Prospects for European trade agreements provided support, particularly for the German equity market, as did a stabilizing U.S. dollar. Year to date, developed international equities are flat, with strength in France and the Netherlands offsetting weakness in Germany and Japan.

EM equities returned 2.3% in July as growth prospects and firming currencies helped overshadow risks from trade tensions. While EM lagged both U.S. and developed international equities, the MSCI Emerging Markets Index posted its first monthly gain since January. EM equities were helped by a strong rebound in Brazil, which posted a double-digit return in July, and solid gains in India and Taiwan; however, the EM Index lagged other major regional equity markets due to losses in Chinese equities on trade fears. Year to date, the MSCI EM index has lost 4.4%, driven mostly by declines in China, South Korea, and South Africa.

*U.S. stocks performance is measured by the S&P 500, which returned 3.72% in July vs. the MSCI Emerging Markets Index, which returned 2.28%.



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International and emerging markets investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

FIXED INCOME:
YIELDS MOVE HIGHER AMID DIVERSE DRIVERS

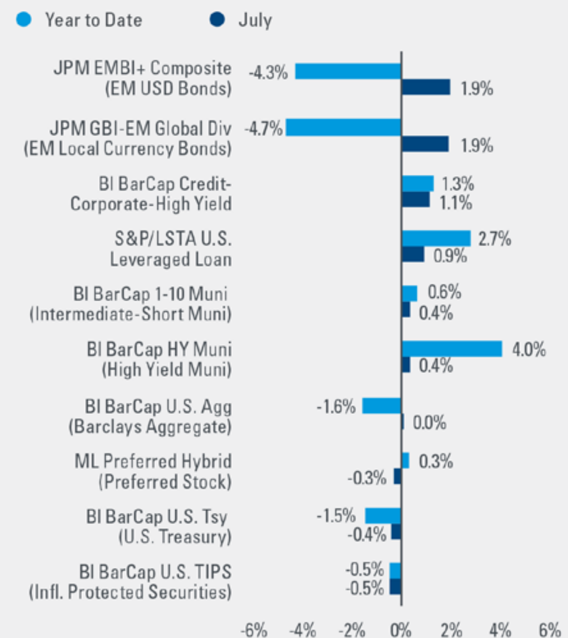
Treasury yields rose across the yield curve during July. Continued economic strength pressured future Fed interest-rate hike expectations modestly higher, increasing short-term yields. Changing expectations from the Bank of Japan regarding its yield targeting program led to higher long-term rates globally. Despite flattening to new lows intra-month, the yield curve ended July with a steepness similar to where it began, stemming the trend of flattening that has persisted since late 2016.

Most segments of high-quality fixed income were hurt by the tide of rising rates, but outperformance by investment-grade corporates* buoyed the broad high-quality market, leading to a flat month overall for the Bloomberg Barclays Aggregate. Investment-grade corporates' outperformance was driven by a recovery after a stretch of weakness due to fears of increased issuance on a potential rise in merger and acquisition activity.

Strong equity market performance during July was a tailwind for lower-quality, more economically sensitive segments of fixed income. High yield returned 1.1% and bank loans 0.9%. Emerging market debt was the standout performer of the month, returning 2.1%, as the asset class recovered from some risk aversion due to trade concerns.** The asset class also benefitted from stabilization in the U.S. dollar relative to other global currencies.

* Investment-grade performance is measured by the Bloomberg Barclays U.S. Credit Total Return Value Unhedged USD, which rose 0.7% in July (vs. a 0.02% return in the Bloomberg Barclays U.S. Agg Total Return Value Unhedged USD).

** Based on the Bloomberg Barclays EM USD Agg Total Return Index (total return was 2/1% in July).



U.S. TREASURY YIELDS

Security	06/30/18	07/31/18	Change in Yield
3 Month	1.93	2.03	0.10
2 Year	2.52	2.67	0.15
5 Year	2.73	2.85	0.12
10 Year	2.85	2.96	0.11
30 Year	2.98	3.08	0.10

AAA MUNICIPAL YIELDS

Security	06/30/18	07/31/18	Change in Yield
2 Year	1.64	1.63	-0.01
5 Year	1.97	1.95	-0.02
10 Year	2.40	2.43	0.03
20 Year	2.84	2.89	0.05
30 Year	2.98	3.03	0.05

Source: LPL Research, Bloomberg, FactSet 07/31/18

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Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

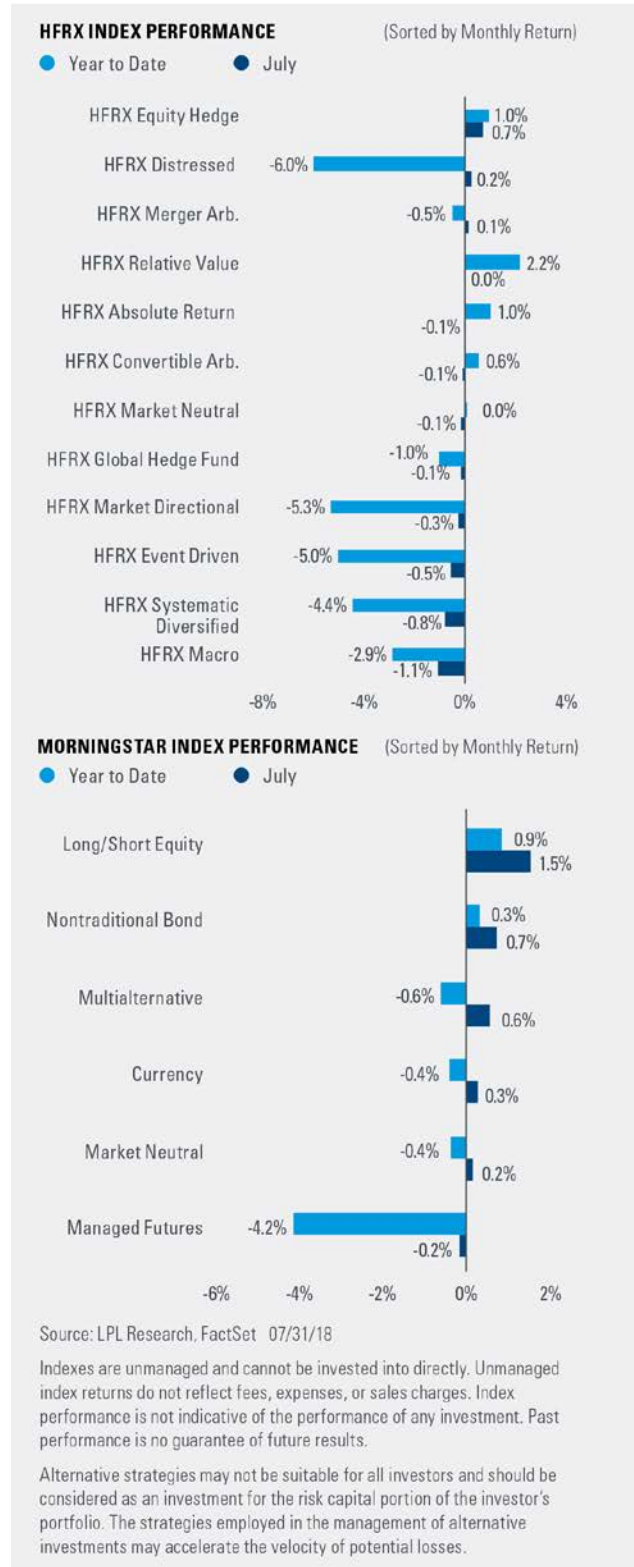
ALTERNATIVES:

TECHNOLOGY WEAKNESS WEIGHS ON LONG/SHORT EQUITY

While equity markets moved broadly higher during the month, hedge fund performance was mixed, with long-biased strategies delivering positive, yet muted gains. The HFRX Equity Hedge Index returned 0.7%, lower than expected given the index's average equity exposure, as the industry's overweight to the information technology sector and select short positioning acted as a headwind. Information Technology underperformed the S&P 500 by 1.6%, while short exposure to defensive sectors detracted from performance. Year to date, long/short strategies have gained only 1.0%, with a beta of roughly 0.4, significantly underperforming the 6.5% gain in the S&P 500 on an absolute and beta-adjusted basis.

In the macro space, the HFRX Macro Index and HFRX Systematic Diversified CTA Index declined 1.1% and 0.8%, respectively. Long Mexican peso and short Canadian dollar positioning detracted in currency trend-following, while long crude oil exposure weighed on both discretionary and systematic trading strategies. To a small extent, long global equity exposure helped offset these losses. The HFRX Systematic Diversified Index remains one of the worst performers for 2018, as the steep losses in February, combined with sideways performance over the past several months, has led to a 4.4% loss on the year.

The HFRX Relative Value Arbitrage Index declined 0.1% during the month, but still leads all other alternative investment subcategories with a year-to-date gain of 2.2%. Returns have been consistent in the convertible arbitrage industry, as well as in less liquid residential mortgage-backed and commercial-backed securities, which continue to benefit from consistent cash flows and a strong fundamental backdrop.



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Alternative strategies may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

REAL ASSETS:

MLPs DELIVERED STRONG GAINS IN JULY

Liquid real asset performance was mostly positive during July, led by a strong 6.6% gain for master limited partnerships (MLP). U.S. and international real estate and infrastructure also rose, while commodities suffered losses for the second straight month.

Master Limited Partnerships

MLPs bounced back from modest losses in June with a 6.6% return in July, despite a more than 7% drop in WTI Crude prices. The group benefited from a favorable tax ruling from the Federal Energy Regulatory Commission (FERC) that partially reversed its action from March 15, 2018. Prospects for additional industry consolidation and continued strong energy production trends also supported the MLP group.

REITs & Global Listed Infrastructure

The S&P Global Infrastructure Index gained 1.8% in July, outperforming U.S. and global real estate but trailing broad global equities. Gains in global industrials provided a tailwind for global infrastructure performance, while gains for the global energy and utilities sectors were slightly behind broad global equities. Year to date, the S&P Global Infrastructure Index has lost 1.3%.

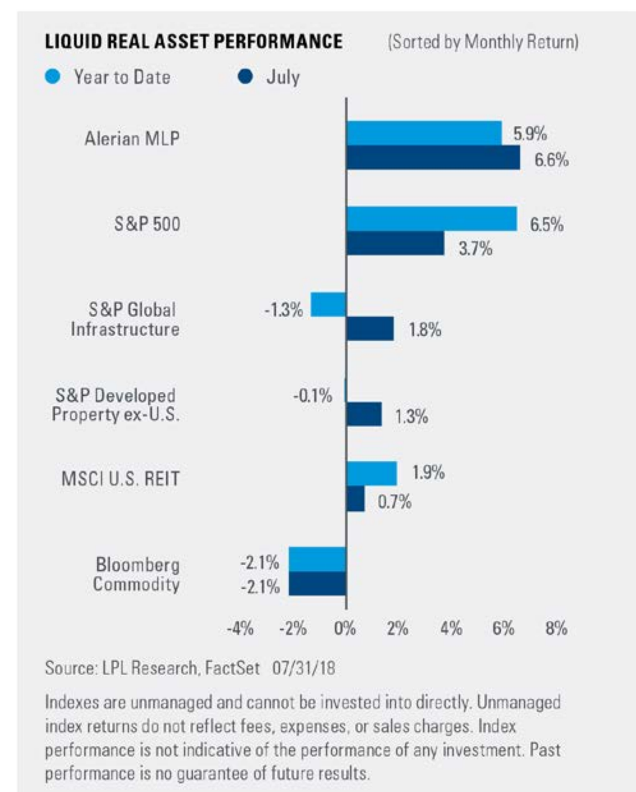
The MSCI U.S. REIT Index trailed the broad U.S. and global equities in July with a 0.7% return.* Data centers rallied for the second straight month after underperforming through the first five months of the year, while self-storage was among the weak spots. Year to date, the broad U.S. REIT index has returned 1.9%. International real estate fared better in July with a 1.3% gain, but was still left with a modest 0.1% loss year to date.

Commodities

Commodities fell for the second straight month, as the Bloomberg Commodity Index lost 2.1% amid ongoing trade tensions. Agriculture commodities, led by grains and cotton, were the best performing category, lifted by hot and dry weather conditions in the U.S. and abroad that impacted production and some bargain hunting following tariff-driven losses in soybeans. Energy was the worst performing commodity category during July, with mid-single-digit declines in oil (both WTI and Brent Crude) and natural gas. Oil prices came under pressure amid Saudi Arabia's plans to boost supply. Metal prices fell broadly amid trade tensions that have sparked concerns about demand from emerging market economies; industrial metal losses were larger than those in precious metals, including copper's 4.5% loss for the month. Year to date, the Bloomberg Commodity Index is down 2.1%.

*Based on the MSCI All Country World Index, which returned 3.1% in July.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.



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