



PRIVATE CAPITAL MANAGEMENT
A Subsidiary of GUARANTY BANK AND TRUST

P: 303.370.0055

F: 303.370.0066

pcm-inc.com

Second Quarter 2018

"No nation was ever ruined by trade, even seemingly the most disadvantageous."

- Benjamin Franklin

The second quarter was a period of haves and have-nots for many major asset classes. Among the best performers were U.S. small cap stocks, global energy, and the dollar. Among the worst performers were emerging market stocks and gold. The table below summarizes select asset class returns for the second quarter and YTD periods.

Name	Category	Q218 (%)	YTD (%)
Dow Jones Industrial Average	US Large Cap Stocks	1.22	-0.82
Russell 2000	U.S. Small Cap Stocks	7.74	7.65
MSCI EAFE	Foreign Developed Stocks	-1.01	-2.71
MSCI Emerging Markets	Emerging Market Stocks	-7.99	-6.93
S&P Global REIT	Global Real Estate	5.43	0.13
DJ Global Oil & Gas	Global Energy	10.15	6.11
SPDR Gold Shares	Gold	-5.64	-3.75
Barclays Aggregate Bond	U.S. Core Bonds	-0.16	-1.66
Invesco U.S. Dollar Index Bullish	U.S. Dollar	5.69	4.05

Source: Morningstar; all indices represented by investable ETFs

Many of the same themes that drove markets earlier in the year continue to play out. Investors remain anxious regarding the path of interest rates and inflation, and have become even more sensitive to the potential impact of a trade war on global growth and equity markets. These concerns have been offset in the U.S. to some degree by solid economic data and record corporate earnings growth. The result has been a tug-of-war between risk-on and risk-off sentiment during the past few months. U.S. stocks have generally grinded higher, while core bonds continue to net minor losses due to gradually rising rates.

The Federal Reserve has now raised short term rates twice in 2018. At their recent meeting they signaled that an additional two rate hikes are likely in store for the second half of the year, with three more expected to follow in 2019. The Fed noted solid economic conditions and the potential for a pickup in growth for the rest of 2018 as fiscal stimulus and tax reform take hold. As a result, the Fed upgraded its outlook to reflect higher growth, higher inflation, and lower unemployment for this year and next. Importantly, Fed policy remains accommodative, meaning that the current low absolute level of rates should continue to support

economic growth before reaching a more neutral level sometime next year. This type of rate environment should not yet pose a threat to stocks, although likely comes with greater volatility. Bonds, however, will likely face a moderate headwind, as bond prices move opposite to rates.

The Fed action described above has led to higher interest rates across the yield curve, but with a disproportionate impact on the short end. The result has been a positive but flattening curve that has many worried about increased odds of a recession in the near term. Historically, an inverted yield curve— defined as a period when short term rates exceed long term rates— has been among the most reliable indicators of the business cycle and has correctly forecasted almost all recessions in the post-WWII era. So how concerned should we be with the current shape of the yield curve? Most analysis supports the idea that a flattening curve that is primarily caused by short rates rising (as opposed to long rates falling) has historically been a decent environment for both economic growth and stock market performance. Further data indicates that a flattening curve is consistent with tightening monetary policy and does not really matter until and unless it inverts. The period between December 1994 and January 2000 offers an example of the yield curve hovering just above the zero line for 5 years before turning negative. Like today, this was a period in which the Fed was raising rates.

Yield Curve Flattening: 10 Year Treasury minus 2 Year Treasury



Source: Federal Reserve Economic Data; gray bars indicate recession, negative values = inversion

Turning to trade, we have seen tariff rhetoric ebb and flow during the quarter with an escalation during the month of June. It is somewhat difficult to keep up with the sheer volume of announcements, but so far we know that tariffs have been imposed on approximately \$54B of U.S. imports. These include steel and aluminum, lumber, washing machines, and solar cells. How significant is \$54B of U.S. imports? In total, these items currently account for about 2% of total imports and less than 1% of GDP. These are levels that are mostly symbolic and that should not materially impact U.S. growth or inflation. China, the primary target of these actions, has responded with tariffs on \$22B of U.S. exports, a figure that has even less significance for the broad economy.

While significant additional tariff proposals have recently been announced by the Trump administration, it remains to be seen what will actually be enacted and what the potential impact could be. The current worst-case scenario would include tariffs on over \$400B of Chinese imports and \$360B on autos and auto parts. This would affect about 26% of U.S. imports, or approximately 4% of GDP. Notably, this figure does not include any retaliatory impact on U.S. exports, or the related impact on inflation. Other likely fallout would include supply chain disruptions, lower earnings for affected industries, and lower consumer and business confidence. In aggregate, these factors could negatively impact both economic growth and stock prices.

Status	Tariff/quota	Import value targeted	Amount of U.S. imports	Date effective	Primary countries
Implemented	Sec 201 - solar panels and washers	\$8.5 billion solar \$1.8 billion washers	0.3% 0.1%	January 2018.	China, South Korea
Implemented	Sec. 232 – steel & aluminum	\$29 billion	1.0%	March-June 2018. Specific retaliatory tariffs being drafted	NAFTA, South Korea, Brazil, EU
Announced	Sec. 301 – China IP theft	\$34 billion \$16 billion Add'l \$100 billion considered	1.2% 0.6% 3.4%	July 6 on \$34 billion. Investment restrictions June 30.	China
Announced	TBD	\$200 billion	6.8%	TBD	China
Announced	Sec. 232 - autos	\$360 billion	12.4%	Commerce dept. report due Feb 2019.	NAFTA, Japan, EU, South Korea

Source: Charles Schwab & Company; U.S. commerce Department; sample list is not exhaustive

On the surface, these events are not encouraging. We remain hopeful, however, that tough talk and tariff threats are more of a negotiating tactic than anything else, and that all parties would benefit from freer and fairer trade. This is not entirely wishful thinking. Negotiations with South Korea offer a good recent example. After calling the current South Korean trade deal “horrible” and “a one-way street,” President Trump agreed to changes that don’t drastically alter the trade relationship between the two countries. This type of favorable outcome is not inevitable, but may in fact be what the U.S. is targeting and what other countries may be willing to concede. Trade tensions represent a downside risk that we will continue to watch closely.

Rising rates and tightening monetary conditions generally make the world more vulnerable to shocks. Those conditions, along with a flattening yield curve, are also prominent reminders that we are closer to the end of the current economic cycle than the beginning. How close, however, is hard to say. We remain constructive on the outlook for stocks relative to bonds, while acknowledging downside risks. At some point, higher rates will justify a greater allocation to bonds, but we are not there yet.

Finally, we are pleased to welcome Jessica Hannon to Private Capital Management as a Senior Client Service Associate. Jesse has over four years of client service experience in the wealth management industry. She will be working closely with our advisors to help take care of client needs. Welcome aboard, Jesse!

Sincerely,

The Private Capital Management Team

By the numbers...

Index	Close	2 nd Quarter	Year-to-Date
S&P 500	2718	+3.4%	+2.6%
Dow Jones Industrial Average	24,271	+1.3%	-0.7%
Russell 2000	4083	+7.7%	+7.7%
MSCI EAFE	1958	-1.2%	-2.7%
MSCI Emerging Markets	1069	-8.0%	-6.7%
Barclay’s US Aggregate Bond	-	-0.2%	-1.6%
Bloomberg Commodity	87	+0.4%	0.0%

Domestic total return and international net return data provided by Morningstar as of 6/30/2018

Disclosures: Investment Products: Not FDIC Insured – No Bank Guarantee – May Lose Value - Not insured by any federal government agency

Private Capital Management, LLC (PCM) is a wholly owned subsidiary of Guaranty Bank and Trust. Opinions and information presented have been obtained or derived from sources we believe to be reliable, but we cannot guarantee their completeness or accuracy. Opinions represent PCM's judgment as of the date of the report and are subject to change without notice. This material is for general information only and is not suitable for all investors. It is not soliciting any action from any particular investor. This presentation is not an offer to buy or sell, or a solicitation of an offer to buy or sell the securities mentioned. The investments discussed or recommended in this presentation may be unsuitable for some investors depending on their specific financial position and investment objectives. Private Capital Management and/or its personnel may trade for their own accounts, be on the opposite side of customer orders, and have positions in securities related to issues mentioned in this presentation. Investing in foreign securities presents certain risk that may not be present in domestic securities. Fixed income securities are subject to availability and market fluctuation. These securities may be worth less than the original cost upon redemption. Past performance does not indicate future results. The value or income associated with a security may fluctuate. There is always the potential for loss as well as gain. Asset allocation does not assure or guarantee better performance and cannot eliminate the risk of investment losses. PCM does not provide tax or legal advice. Please consult appropriate tax or legal advisors to determine how this information may apply to your own situation. The indices and benchmarks mentioned for comparison purposes are unmanaged. You cannot purchase an index. Index returns do not reflect any fees an investor may incur to purchase the securities underlying the index or an index fund. S&P 500 Index is an unmanaged capitalization weighted index of 500 stocks. The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ. The Russell 2000 Index is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. The Russell 1000 Index is a large-cap stock market index of the largest 1,000 stocks in the Russell 3000 Index. The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets consisting of 21 emerging market country indices. The Barclay's U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The Bloomberg Commodity Index is an index composed of the futures contracts on 19 physical commodities. Additional information is available upon request. Dated: 7/9/2018