Economic and Market Overview

Second Quarter 2018

IRONWOOD
Investment Counsel, LLC

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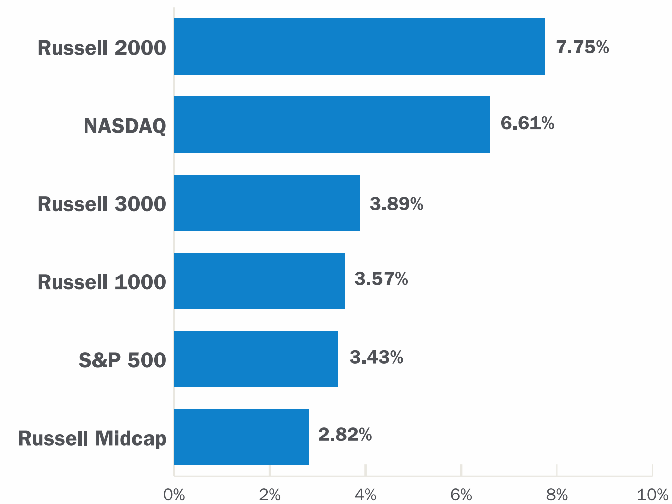
The Economy

The global economic environment is expected to remain on an upward trajectory, benefiting from several drivers, including an expansionary fiscal policy in the US and improving trade and investment in many regions of the world. The Eurozone economy slowed in the first half, following a growth revival in 2017. A decline in exports due to a strong euro was the primary driver of this slowdown. Japan also hit a speedbump in the first part of the year, with GDP actually contracting modestly due to weaker private consumption and lackluster wage growth. Economists expect Japan's GDP growth to slip to 1% in 2018 from 1.7% in the prior year. China bucked the trend, as its economy posted solid gains despite the back-and-forth trade and tariff tiff with the US. The country posted annualized GDP growth of 6.8%, which matched its 2017 rate. Most analysts believe that China's growth will moderate in the coming months as credit controls imposed to prevent overheating in certain economic segments kick in.

Broad Market Index Returns

Second Quarter 2Q18



Source: Morningstar, Inc.

The US economy remained on an uptrend, although growth in the first quarter was the lowest in a year. The Bureau of Economic Analysis reported its third estimate of first quarter 2018 gross domestic product (GDP) of 2.0%, down modestly from the prior estimate, and lower than the fourth quarter's 2.9% reading. The employment situation continued to post gains, with an average of approximately 179,000 jobs added each month. At the same time, the unemployment rate fell to 3.8%. The Federal Open Market Committee (FOMC) modified its interest rate policy by raising the federal funds rate target 25 basis points to a range of 1.75% to 2.00%. Economists expect up to two additional increases in 2018, as economic growth accelerates and inflation and wage pressures increase.

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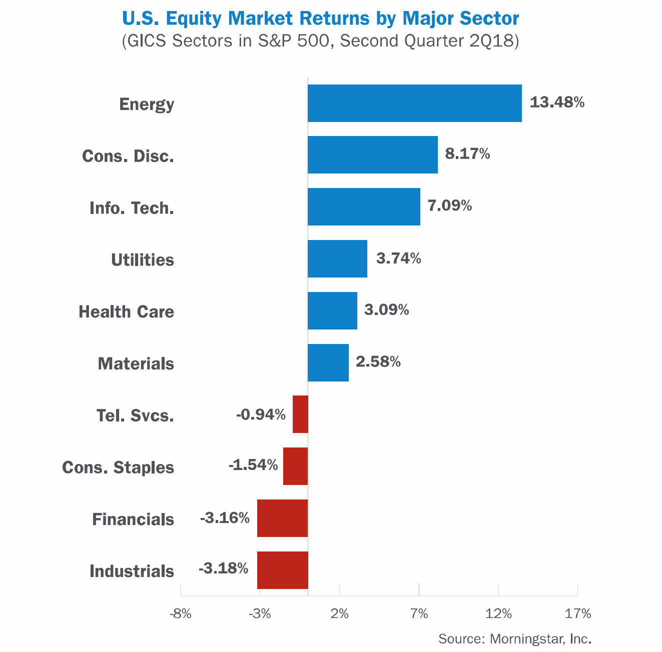
Highlights and Perspectives



GROSS DOMESTIC PRODUCT (GDP)

Analysts and economists are encouraged by the sustained growth over the past several quarters and believe that it should continue, as the full impact of tax cuts and government spending is now starting to flow through the economy. The current expansion recently tied for the second longest in history. Aggressive fiscal stimulus is the key catalyst for the economy's current growth trajectory. Inflation was relatively benign in the quarter, with the personal consumption expenditures (PCE) index of prices rising 2.5%, following a 2.7% advance in the prior quarter. Additionally, corporate profits rose by 1.8% (not annualized) during the quarter.

HOUSING

The housing segment continues to be a positive for the economy, although housing analysts expect that the rise in mortgage rates will eventually put a damper on demand and price increases. Existing home sales for May (the latest monthly data available) grew at an annualized rate of 5.4 million units, a decline of about 0.4% from April, and down about 3% from year-ago levels. The inventory of existing homes was slightly more than four months of supply, up somewhat from the prior year. Existing home prices in May were up 2.6% from April and have increased 5.2% from May 2017. In the new-home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at 68, slightly lower than the previous month, but still at high levels.

EMPLOYMENT

The employment situation improved once again in May. Employers added 223,000 jobs during the month, obliterating the consensus expectations of 185,000 new jobs, and outpacing the prior month's gain of 159,000. Despite May's solid results, the three-month moving average slipped due to lackluster reports for the prior two months, coming in at 179,000. The unemployment rate in May declined to 3.8%, the lowest level in 18 years. Average hourly earnings increased by a greater-than-expected 0.3% in the month, with economists anticipating further increases as the economy gains steam.

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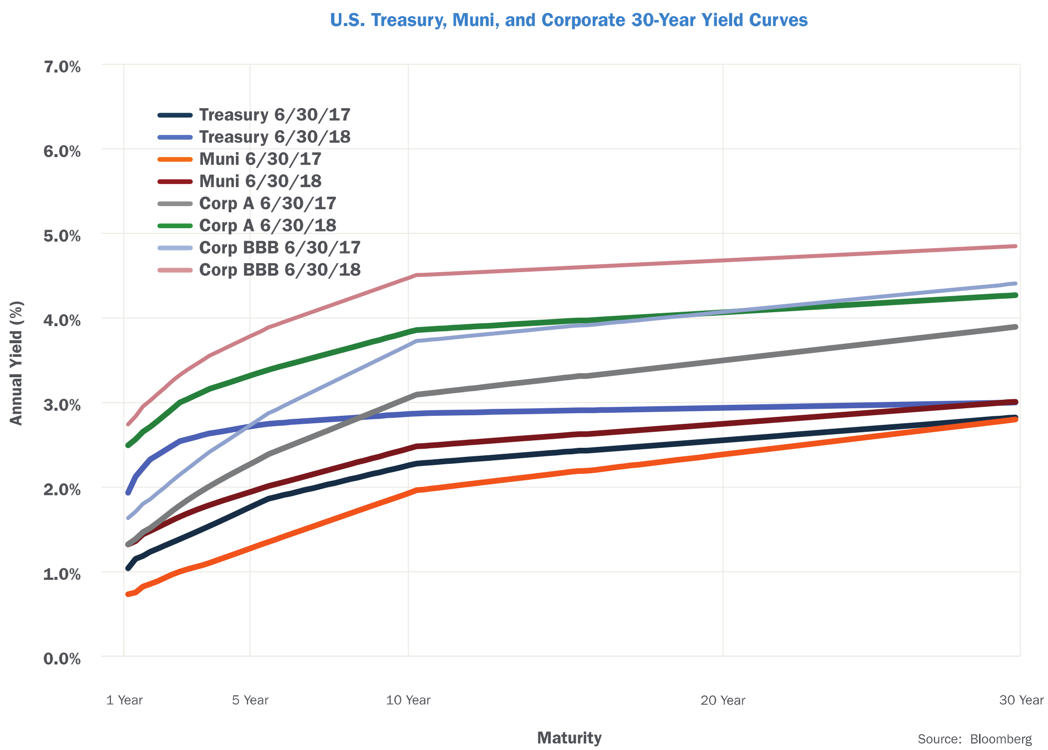
FEDERAL RESERVE POLICY AND INTEREST RATES

The Federal Open Market Committee (FOMC) ended its recent June meeting by announcing an increase of 25 basis points in the federal funds rate target from 1.75% to 2.00%. The rate increase was widely expected, but the big change came in the accompanying statement, in which the FOMC removed its forward guidance, which stated that the federal funds rate was likely to remain below levels expected over the long run. In addition, the FOMC removed language describing inflation expectations as being low.



The shape of the Treasury yield curve again flattened somewhat during the quarter, with yields on short- to intermediate-term maturities climbing more than those for long-term issues. By the end of the quarter, the yield on the benchmark 10-year U.S. Treasury Note was higher, ending the quarter at 2.86%, compared with 2.74% on March 31.

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Interest rates in the quarter continued to be driven by solid economic growth in the US and abroad. With the economy now in the second-longest expansion in history, investors are becoming acclimated to the FOMC's need to normalize interest rates from abnormally low levels. In addition, fixed income markets have been confronted with other issues, such as the imposition of tariffs and heightened rhetoric about trade. The trend in yields was higher during the first half of the quarter and declined for the last several weeks. Yields at the shortest end of the yield curve (up to one year) were generally about 10 to 25 basis points higher than in March, whereas those on the longer end were higher by about 10 basis points. The yield on the 3-month Treasury Bill settled at 1.92% at the end of the quarter, up about 21 basis points from the end of the previous quarter. The yield on the 5-year Treasury Note ended the quarter at 2.74%, compared with 2.56% on March 31, and as mentioned above, the yield on the 10-year Treasury Note rose to 2.86% from 2.74% over the same period. At the same time, the yield on the 30-year Treasury Bond was little changed, ending the period at 2.99%, compared with its beginning level of 2.97%. Inflation expectations rose modestly, with the Federal Reserve's gauge of five-year forward inflation expectations rising to 2.15% from 2.03% on March 31.

FIXED INCOME

Total returns on fixed income securities were generally mixed across the various market segments. The Bloomberg Barclays Treasury 5-7 Yr. Index eased lower by 0.1% for the quarter. The Bloomberg Barclays U.S. Corporate 5-10 Yr. Index fell by 0.6% during the three months. High yield securities, which often follow the performance of equities, delivered a positive return of 1.0%. Municipals also were higher, as the Bloomberg Barclays Municipal Bond Index edged up by 0.9% during the quarter. Prices of non-US fixed income securities were sharply lower in the quarter, as the Bloomberg Barclays Global Aggregate ex-U.S. Index declined 4.8%. Emerging markets bonds also gave up ground, with the JPM EMBI Global Index declining by 3.5%.

EQUITIES

Equity markets lurched modestly higher during the quarter, seeming to take two steps forward and one step back. The volatility appeared to be a result of investor angst over the Trump Administration's trade policy and its insistence on imposing tariffs on certain imported goods. Within this landscape, the S&P 500 Index finished the quarter with a modest gain of 3.4%.

The ten primary economic sectors produced mixed performance results during the quarter. Energy, Consumer Discretionary, and Information Technology were the strongest performers on a relative basis, generating returns of 13.5%, 8.2%, and 7.1%, respectively. The Financials, Industrials, and Consumer Staples sectors were the poorest relative performers, posting returns of -3.2%, -3.2%, and -1.5%, respectively.

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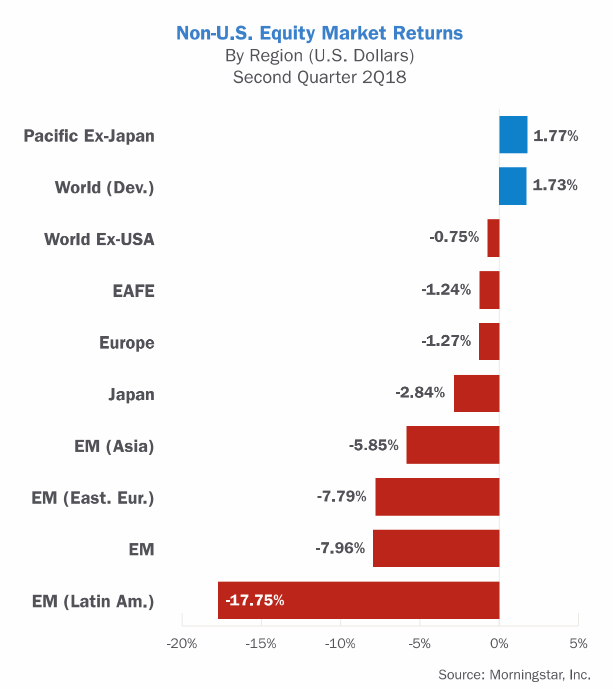
The Russell 1000 Index of large capitalization stocks generated a 3.6% total return. Within the large cap segment, growth stocks once again outperformed value stocks. Small cap stocks, as represented by the Russell 2000 Index, outperformed large caps by a fairly wide margin, finishing the quarter with a total return of 7.8%. Small cap value outperformed small cap growth. The NASDAQ Composite Index, dominated by information technology stocks, finished the quarter with a gain of 6.6%. The Dow Jones Industrial Average of 30 large industrial companies inched higher by 1.3%.



Real Estate Investment Trusts (REITs) posted material gains during the quarter, with the DJ US Select REIT Index surging 10.0%. Commodities were little changed, with the Bloomberg Commodity Index gaining 0.4% for the quarter.

International stocks performed poorly on a relative basis, with almost all markets lagging US equities. Economic growth, although still positive in most regions, cooled in the second quarter. As a result, international stock indices had a difficult time. The MSCI ACWI Ex-USA Index, which measures performance of world markets outside the US, declined 2.6%. The MSCI EAFE Index of developed markets stocks fell by 1.2%. Regional performance was likewise poor for the quarter. The Pacific region ex-Japan was the strongest performer on a relative basis, with a return of 1.8%. No other region delivered positive gains for the three months. Latin America was the poorest performer, declining 17.8%. China also was a poor performer, falling 3.5%. Emerging markets performance was abysmal, as the MSCI Emerging Markets Index shed 8.0%.

Outlook

The US economy remains strong, and although the current expansion is now the second longest in history, the consensus among economists is that the prospects for further growth are solid. Aggressive fiscal stimulus in the form of tax cuts, according to many economists, has the potential to provide the fuel for continued expansion for at least the next several quarters. It is estimated that this factor will accelerate domestic economic growth to 3% over the next couple of years before slowing down at the beginning of the next decade. Not all is bright on the horizon, however. The escalation in trade skirmishes poses a threat to this growth, as investors view tariffs as tax increases, because consumers will spend more on imported goods. If the tariff retaliation were to end with what has already been imposed, leading economic consulting firm Moody's Analytics projects that the overall effect would not be significant, amounting to a decline of only about 0.1% of GDP. However, if the additional tariffs that have been threatened—and their retaliatory responses—are imposed, Moody's estimates the adverse impact on GDP would rise to about 0.4%. For that reason, if the brinksmanship does not subside, there is a possibility of a tariff-induced downturn in the road ahead. But the expectation is that if the equity market continues to have difficulties, as a result of the back-and-forth tariff tiff, the administration may soften their stance, enabling the recent strong growth and employment gains to continue.

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The information, analysis, and opinions expressed herein are for general and educational purposes only. Nothing contained in this quarterly review is intended to constitute legal, tax, accounting, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. All investments carry a certain risk, and there is no assurance that an investment will provide positive performance over any period of time. An investor may experience loss of principal. Investment decisions always should be made based on the investor's specific financial needs and objectives, goals, time horizon, and risk tolerance. The asset classes and/or investment strategies described may not be suitable for all investors, and investors should consult with an investment advisor to determine the appropriate investment strategy. Past performance is not indicative of future results.

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INDEX OVERVIEW

The **Dow or DJIA** (Dow Jones Industrial Average) is an unmanaged index of 30 common stocks comprising 30 actively traded blue chip stocks, primarily industrials, and assumes reinvestment of dividends. The **NASDAQ Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. The **S&P 500 Index** is an unmanaged index comprising 500 widely held securities considered to be representative of the stock market in general. The **DJ U.S. Select REIT Index** is a subset of the Dow Jones Americas Select RESI and includes only REITs and REIT-like securities (The Dow Jones U.S. Select Real Estate Securities Index (RESI) represents equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded in the US). The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks prices of futures contracts on physical commodities on the commodity market and is designed to minimize concentration in any one commodity or sector. The **MSCI EAFE Index** is recognized as the preeminent benchmark in the US to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America: Europe, Australasia, and the Far East. The **MSCI Emerging Markets Index** is a free float-adjusted market-capitalization index that is designed to measure equity market performance in the global emerging markets. The **MSCI ACWI Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indices comprising 23 developed and 23 emerging markets country indices. The **MSCI Emerging Markets (EM) Eastern Europe Index** captures large and mid-cap representation across four emerging markets (the Czech Republic, Hungary, Poland, and Russia) countries in Eastern Europe. With 52 constituents, the Index covers approximately 85% of the free float-adjusted market capitalization in each country. The **MSCI EM (Emerging Markets) Latin America Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of emerging markets in Latin America. The **MSCI ACWI Ex-U.S. Index** is a market-capitalization-weighted index maintained by Morgan Stanley Capital International (MSCI) and designed to provide a broad measure of stock performance throughout the world, with the exception of US-based companies. The **MSCI China Index** captures large and mid-cap representation across China H shares, B shares, Red chips, and P chips covering about 85% of this China equity universe.

The **Bloomberg Barclays Municipal Bond Index** is an unmanaged index comprising investment-grade, fixed-rate municipal securities representative of the tax-exempt bond market in general. The **Bloomberg Barclays Global Aggregate ex-U.S. Index** is a market-capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most US-traded investment- grade bonds are represented. Municipal bonds and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The Index includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in the US. The **Bloomberg Barclays U.S. 5-10 Year Corporate Bond Index** measures the investment return of US dollar-denominated, investment-grade, fixed-rate, taxable securities issued by industrial, utility, and financial companies, with maturities between 5 and 10years. Treasury securities, mortgage-backed securities (MBS), foreign bonds, government agency bonds, and corporate bonds are some of the categories included in the Index. The **Bloomberg Barclays Capital US 5-7 Year Treasury Bond Index** is a market-capitalization-weighted index and includes Treasury bonds issued by the US with a time to maturity of at least 5 years, but no more than 7 years. The **Russell 1000 Index** is a market-capitalization-weighted benchmark index made up of the 1000 largest US companies in the Russell 3000 Index (which comprises the 3000 largest US companies). The **Russell 2000 Index** is an unmanaged index considered representative of small cap stocks. The **Russell 3000 Index** is an unmanaged index considered to be representative of the US stock market and measures the performance of the largest 3,000 US companies representing approximately 98% of the investable US equity market. The **Russell Midcap Index** is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The **Housing Market Index** (HMI) is based on a monthly survey of **NAHB** members designed to take the pulse of the single-family housing market. The survey asks respondents to rate market conditions for the sale of new homes at the present time and in the next six months, as well as the traffic of prospective buyers of new homes. The **JPMorgan Emerging Market Bond Index** (EMBI Global) tracks total returns for traded external debt instruments in the emerging markets and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the EMBI Global includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million. The **CBOE Volatility Index** (VIX) is an up-to-the-minute market estimate of expected volatility that is calculated by using real-time S&P 500 Index option bid/ask quotes. The Index uses nearby and second nearby options with at least eight days left to expiration and then weights them to yield a constant, 30-day measure of the expected volatility of the S&P 500 Index.

DEFINITIONS

The **Federal Open Market Committee** (FOMC) is the monetary policymaking body of the Federal Reserve System. The **federal funds rate** (fed funds) is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **European Central Bank** (ECB) is the central bank for Europe's single currency, the euro. The ECB’s main task is to maintain the euro's purchasing power, and thus price stability, in the euro area. The euro area comprises the 19 European Union countries that have introduced the euro since 1999. The **Gross Domestic Product** (GDP) rate is a measurement of the output of goods and services produced by labor and property located in the United States. The **Bureau of Labor Statistics** (BLS) is a unit of the United States Department of Labor. It is the principal fact-finding agency for the US government in the broad field of labor economics and statistics and serves as a principal agency of the US Federal Statistical System. The **Bureau of Economic Analysis** (BEA) is an agency in the US Department of Commerce that provides important economic statistics, including the gross domestic product of the US. It is a governmental statistical agency that collects, processes, analyzes, and disseminates essential statistical data to the American public, the US Congress, other Federal agencies, state and local governments, business, and labor representatives. The **Personal Consumption Expenditure Index of Prices** (PCE) is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data, including US Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures, and is essentially a measure of goods and services targeted towards and consumed by individuals. Sector performance is represented by the **Global Industry Classification Standard (GICS)** sectors, developed by Standard & Poor’s and MSCI Barra.