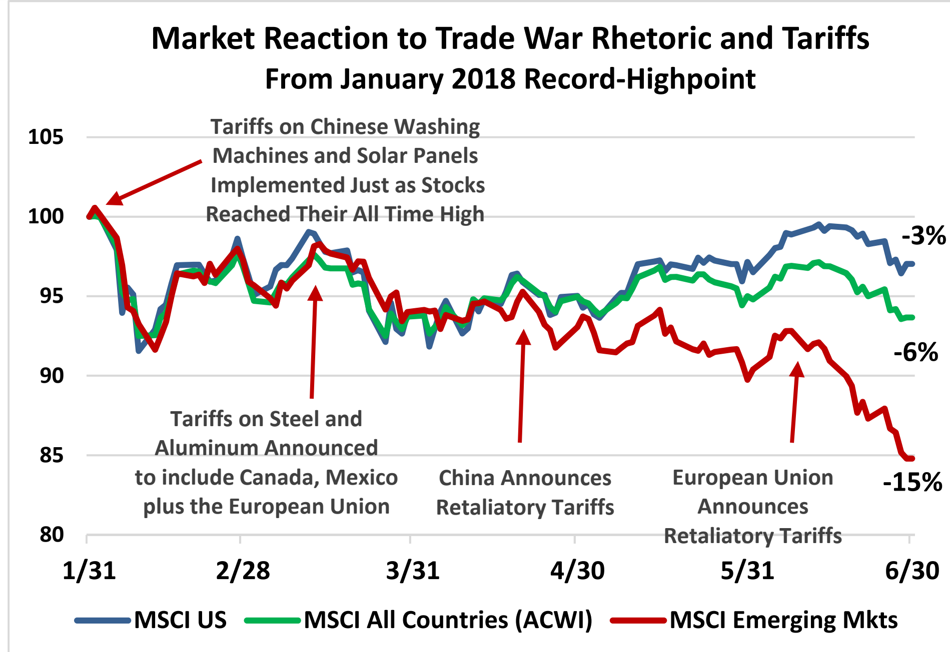
From: Aequitas Investment Advisors

Subject: Maintaining Long-Term Convictions amidst Short-Term Uncertainties

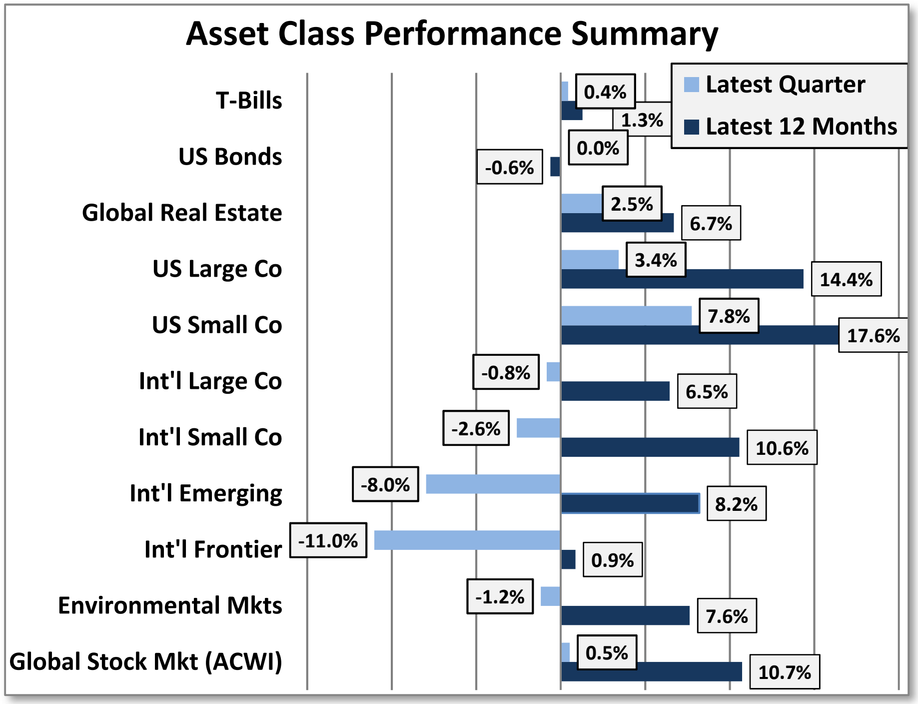


The year 2018 began on a positive note with favorable economic forecasts, strong consumer confidence levels and upbeat corporate earnings estimates. Furthermore, lower tax rates for individuals and corporations combined with a business-friendly regulatory environment were seen as additional stimuli for continued economic growth well into 2019. Having delivered on the promises of lower taxes and deregulation, the administration turned its attention toward the promise to scrap and/or rewrite our nation's trade agreements to deliver a "better deal" for the American economy. Once the administration pulled out of the Trans-Pacific Partnership (TPP) agreement, the administration set its sights on renegotiating NAFTA and placing tariffs on steel and aluminum imported from Europe, Canada and Mexico as well as billions of dollars of Chinese goods. As predicted, our trading partners reciprocated with comparable tariffs of their own on US goods, including Harley-Davidson motorcycles and Kentucky Bourbon (two tariffs with political ramifications in mind). With fear of further trade war escalation and heightened uncertainty, stocks around the globe retreated from record high levels with minimal damage in the US, but greater price weakness in the Emerging Markets. The MSCI All Country World Stock Index (ACWI) has since fallen by about 6% from its January record high.

At this point, investors have likely priced in the economic impact of a *limited* trade war, but have not priced in the impact of a *full-blown* trade war which we believe would be detrimental to all parties and would curtail economic growth around the world. After the trade war rhetoric and tariff actions began heating up in late April, stocks in the US advanced slightly (refer to the graph at the top right of the page), the ACWI Index went sideways, while the Emerging Markets Index shed about 8% of its value. The net result is that US stocks, which were arguably overvalued to begin the year, have become more expensive relative to non-US stocks in general, and relative to Emerging Markets stocks in particular (the latter becoming even more compelling from a long-term investment perspective). We'll delve into the potential impact of trade wars on the markets later in this report following our review of recent performance across the major asset classes.

Asset Class Performance Review

For the trailing twelve months ending June 30th, The MSCI All Country World Index (ACWI) gained 10.7% with the strongest returns in the US. All but one of the major asset classes ended up in positive territory with returns ranging from 0.9% to 17.6%; the one negative return being US Bonds (-0.6%) reflecting the rise in interest rates over the past year which caused bond prices to fall. US T-Bills generated a return of 1.3% which is in contrast to their near zero return not long ago. Buoyed by strong corporate earnings reports, the two best performers were US Small Company stocks (+17.6%) and US Large Company stocks (+14.4%). Next in line were International Small Co's (+10.6%), Emerging Markets stocks (+8.2%), Environmental Markets (+7.6%), Global Real Estate (+6.7%) and International Large Co's (+6.5%). Lastly, despite their compelling long-term potential, the most disappointing performance came from stocks in the Frontier Markets (+0.9%), mainly due to a particularly weak second quarter.

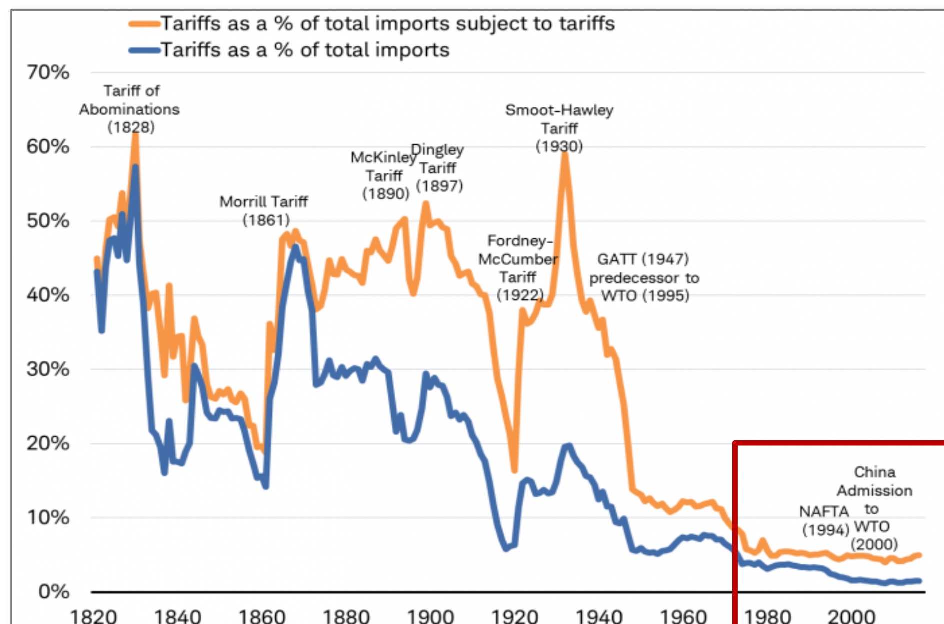


For the latest quarter, we see a sharp contrast between the performance of US and non-US stocks which clearly reflects the detrimental impact of tariffs and trade war fears (more on this topic ahead). Stocks around the globe as measured by the All Country World Index (ACWI) gained a paltry 0.5%. Stocks in the US, however, performed well, especially Small Company stocks (+7.8%) which may be less impacted by trade wars due to their earnings being derived mostly from domestic consumer spending (in contrast to larger global companies which generally derive a significant portion of their earnings from abroad). US Large Co's gained 3.4% followed by Global Real Estate (+2.5%). Within the International asset classes, the regions deemed to be most directly impacted by trade wars suffered the most with Emerging Markets down 8.0% and Frontier Markets down 11.0%. While not included in the graph above, stocks in Emerging Asia performed better, perhaps due to their link to Asia's growing consumer economy (according to the Brookings Institute, 88% of the next one billion people to enter the middle class will be Asian!). Modest losses were posted in the Environmental Markets (-1.2%), Int'l Large Co's (-0.8%) and Int'l Small Co's (-2.6%). T-bills returned 0.4% and US Bonds were flat.

Trade Wars and Our Long-Term Convictions

Just after midnight on Friday, July 6th, President Trump imposed trade tariffs of up to 25% on $34 billion in Chinese goods entering the US including steel and aluminum, automobile parts and medical devices. China immediately retaliated with tariffs on an equal amount of our heartland's exports including pork, corn, soybeans, poultry and cars, a move that President Donald Trump said would compel him to respond with yet another round of duties on up to $500 billion in products – nearly all of China's exports to the US. Given our $375+ billion trade imbalance with China, the initial move could conceivably be an effective way to negotiate for improved trade practices, but the potential for an escalation into a global trade war and the resulting unintended consequences for international trade are now overshadowing the most recent positive reports on an improving labor market and economic activity.

In the broader context of the historical impact of tariffs on global trade, the current trade tariffs are very small relative to imports as a whole, and while they may have dire short-term consequences for specific industries, international trade is a very resilient component of capitalism. Companies will ultimately adapt to these changes and develop relationships with new trading partners, which will broaden and strengthen international commerce over time.



From the chart below, it is clear why the U.S. decided to initiate more tariffs with China. As the most significant contributor to our trade deficit, they appear to be most vulnerable to a trade war, but we are carefully watching for the unintended consequences of this move which are beginning to play out. Here are a few anecdotal events that may be indicative of what else may lie ahead:

- US tariffs on steel and aluminum imports are hurting the US auto industry
- Harley-Davidson is now relocating some production to France
- BMW, whose largest production facility is in Greer, South Carolina, is moving production (and jobs) to China
- US soybean farmers (a $12 billion/year industry) are suffering as China now buys soybeans from Brazil
- Other negotiating levers are appearing: inspections and permitting delays
- The heartland that voted for Trump is taking the brunt of his policies

Biggest U.S. trade deficits, by country

2017 deficit in goods, in billions (services are excluded)

RANK	COUNTRY	2017	2016	CHANGE	BIGGEST IMPORT
1	China	$375.2	$347	+28.2	Consumer electronics
2	Mexico	$71.1	$64.4	+6.7	Autos, electronics
3	Japan	$68.8	$68.8	0	Autos, electronics
4	Germany	$64.3	$64.7	-0.4	Autos, transportation
5	Vietnam	$38.3	$32	+6.3	Rice, crops
6	Ireland	$38.1	$36	+2.1	Chemicals, drugs
7	Italy	$31.6	$28.6	+3	Machinery
8	Malaysia	$24.6	$24.8	-0.2	Consumer electronics
9	Netherlands	$24.5	$23.6	+0.9	Chemicals, machinery
10 (tie)	India	$22.9	$24.4	-1.5	Manufacturing, clothes
10 (tie)	South Korea	$22.9	$27.6	-4.7	Autos, electronics

Source: Bureau of Economic Analysis, U.S. Census

Over the past few decades, the world has become far more interdependent. Today, the sum of exports and imports across nations is more than 50% of global production, while at the turn of the 19th century, this figure was below 10%. Comparative advantage, the concept that allows countries to "do what they do best and import the rest," has resulted in tremendous global efficiency, and when this is disrupted, countries must adapt and go to alternative channels for sourcing and distribution. As a result, this interdependency also requires tremendous flexibility in the face of trade wars.

Looking forward, despite all the trade rhetoric, we remain cautiously optimistic. However, should the current set of tariffs escalate further into a full-blown trade war, the detrimental impact on the global economy might trigger an economic recession sooner than might otherwise be expected (recessions are a normal part of the economic cycle occurring on average about once every six years). Given the heightened level of short-term uncertainty, we believe it is important to focus on two of our core beliefs which are (1) high quality bonds will help to reduce overall portfolio risk and (2) a globally diversified portfolio of stocks will deliver desirable long-term returns. Furthermore, we believe that stocks with lower prices relative to their intrinsic value will outperform stocks with high prices (i.e., the premise of value investing). For this reason, we have been recommending a reduction in the allocation to US stocks, which are arguably overvalued, and an increased allocation to non-US stocks which appear to be more attractively valued with higher *expected* long-term returns. In addition, we are upgrading the credit quality of our recommended bond funds which should serve as a partial buffer against future stock market volatility.

Long-Term Rate of Return Expectations

In 2013, Robert Shiller of Yale University was awarded the Nobel Prize in Economics partly for his work demonstrating that the relationship between stock prices and their trailing 10-year inflation adjusted annual earnings is a meaningful measure to forecast *likely* future returns (Shiller devised the Cyclically Adjusted Price-to-Earnings Ratio, or CAPE Ratio, to measure stock market valuations). According to current CAPE valuations, US stocks are highly priced and, as a result, *likely* to deliver below average returns over the next ten years. Non-US stocks and Emerging Markets stocks, in particular, have significantly lower CAPE valuations suggesting they are *likely* to deliver higher returns over the next ten years. In addition to Shiller's CAPE research, other academic studies have found that higher future returns are also more likely when stock prices are low relative to their book values (book value is essentially the value of a company's assets less outstanding liabilities). Star Capital Research of Germany has analyzed the future rate of return expectations using both the CAPE and Price-to-Book valuation methods. In the table on the next page, note that US stocks have the highest valuations based on both methodologies and the lowest 10-year future return expectations. While on the other hand, non-US stocks have relatively low valuations and higher expected returns. Of course, US stocks have out-performed over the past 10 years which is one reason for their high current valuations. Unfortunately, neither Shiller's CAPE Ratio nor the Price-to-Book Ratio is particularly useful in predicting future short-term performance; however, we believe that by paying close attention to stock market valuations one can improve the odds of a successful long-term investment experience.

Current Valuations and 10 Year Future Expected Returns					
Country or Region	CAPE Ratio	Expected Returns	Price-to-Book Valuation	Expected Returns	Combined Long-Term Expected Returns
United States	30.3	3.0%	3.3	3.2%	3.1%
Developed Europe	18.8	6.4%	1.8	7.2%	6.8%
Developed Markets	25.3	4.3%	2.2	6.0%	5.1%
Emerging Markets	16.2	7.4%	1.6	7.9%	7.6%
World All Countries	23.9	4.6%	2.1	6.3%	5.5%

Source: Star Capital Research data as of 6/30/18

Closing Lesson from Isaac Newton

Paying close attention to stock market valuations and avoiding overpriced stocks was a lesson learned the hard way by Isaac Newton. In 1720, Newton invested in shares of the South Sea Company which was involved in trade between Britain and South America and nearby islands (i.e., the "South Seas"). Newton was an early investor and made the decision to sell his entire position after doubling his money and feeling the stock was overpriced. The stock kept on rising, however, and letting his emotions get the better of him, Newton bought back into the stock near the peak of what ended up being a colossal stock bubble resulting in Newton nearly losing most his life's savings. Allegedly, this brought Newton to lament, "I can calculate the movement of heavenly bodies, but not the madness of men." For today's value-minded investors, Newton's lesson reflects a core principle of our investment process which is to rebalance out of stocks with higher valuations into more attractive stocks with lower valuations. While this approach may seem contrarian at times and might underperform in the short term, we believe that such a program of regular rebalancing will deliver desirable portfolio performance over the long term.

In closing, please feel free to share this report with others. We welcome any comments or questions you might have and hope you have an enjoyable summer.

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