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INVESTMENT MANAGEMENT

Second Quarter 2018 Commentary

Dear Clients,

Please find enclosed your June 30, 2018 Investment Reports.

The global stock market was flat to slightly negative in the second quarter, though US stocks diverged significantly to the upside from their international counterparts. Larger-cap US stocks gained 3.6%, but were outdone by smaller-cap stocks, which jumped 6.2%. The smaller-cap outperformance was driven by the market narrative that smaller companies are more domestically focused and therefore not as exposed to a strengthening US dollar or potential trade wars, both of which are assumed to be detrimental to larger-cap (multinational) company profits.

After surprising the market consensus by dropping roughly 12% over the prior 15 months, the US dollar rebounded 5% against a basket of its peers and ended the second quarter at an 11-month high. The dollar's appreciation translated into a meaningful headwind to returns for dollar-based investors in foreign securities (as foreign currencies depreciated against the dollar). Developed international stocks fell 1.0% and European stocks declined 1.6% for the period. Emerging-market stocks fared the worst, dropping 8.1% in dollar terms. A global stock index, which combines US, international, and emerging stock markets, gained just 0.3% for the quarter and is slightly negative for the year. In addition to the currency effects, emerging market stocks were buffeted by on-again, off-again trade tensions between the United States and Europe, Mexico, Canada, Japan, and China—in other words, all its major trading partners. Fears of a trade war with China and the European Union escalated into quarter-end, with the entities engaged in vigorous trading of threats and counter-threats.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	3.6%	14.9%	13.6%
US Mid Cap Stocks	2.6%	12.1%	12.4%
US Small Cap Stocks	6.2%	16.5%	12.4%
International Developed Stocks	-1.0%	7.7%	7.0%
Emerging Market Stocks	-8.1%	7.7%	5.1%
US Bonds	-0.2%	-0.4%	2.3%
Global Bonds	-4.8%	2.8%	0.9%
US REITs	9.7%	2.2%	6.9%

Data source: Morningstar Direct. Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Market indexes include:

US Large Cap Stocks: CRSP US Mega Cap TR USD
US Mid Cap Stocks: CRSP US Mid Cap TR USD
US Small Cap Stocks: CRSP US Small Cap TR USD
Emerging Market Stocks: FTSE Emerging TR USD
International Developed Stocks: FTSE Developed Ex US TR USD
US Bonds: Barclays US Aggregate Bond TR USD
Global Bonds: Barclays Global Aggregate Ex USD TR USD
US REITs: MSCI US REIT NR USD

Moving on to the bond markets, in May, the benchmark 10-year Treasury yield pierced the 3% level, hitting a seven-year high. Yields then fell back, ending the quarter at 2.85%, an 11-basis-point increase from the prior quarter-end. As such, the core bond index had a slightly negative return (bond yields and bond prices move inversely to each other). For the year, the core bond index is down approximately 2%.

While there are always multiple, diverse factors impacting bond yields on a day-to-day basis, a primary underlying driver is Federal Reserve monetary policy (and the market's *expectations* about such). Fed policy in turn is driven by the Fed's assessment of the US economy, and specifically its twin objectives ("dual mandate") of price stability and full employment. To this end, with the economy growing above trend and the labor market tight—the unemployment rate fell to an 18-year low in May—the Fed continued its gradual path of tightening monetary policy. In June, as expected, it hiked the federal funds policy rate another 25 basis points to a range of 1.75%–2%. It also forecasted a slightly accelerated path of hikes over the next two years, which, if it comes to pass, would bring the fed funds rate to a range of 3%–3.25% by the end of 2019. Whether the economy can withstand that degree of tightening remains to be seen.

Beyond the strength of the US economy, the global economy remains in pretty good shape, with real GDP growth expected to be above trend again this year (the consensus forecast seems to be in the 3.5% –4% range). However, last year's highly synchronized growth has decelerated and may have peaked for this cycle. The US economy's stronger relative growth along with a further widening of the yield gap between US and foreign bonds have been reflected in the rebound in the US dollar, described above. The recent dollar-strength trend may continue for a while as currency momentum can take on a life of its own. But there are fundamental reasons to expect the dollar may weaken looking a bit further out: the prospect of a ballooning US federal budget deficit in the coming years, a large US trade deficit, and the eventual convergence of central bank monetary policies—as other central banks start to raise interest rates, thereby shrinking the yield gap versus the United States. The Trump administration also seems to prefer a weaker dollar.

As for the trade war rhetoric, we are hopeful that cooler heads will prevail and a mutually damaging trade conflict will not ensue. It is in the best interest of both the United States and China to negotiate a resolution and prevent trade skirmishes from becoming an all-out trade war. However, the potential for a negative shorter-term shock to the global economy and risk assets (not just emerging markets) can't be dismissed. Even absent an actual trade war, the negative impact on business and consumer confidence from the uncertainty and fear of a trade war is a risk. The resolution of the current trade tensions is a meaningful uncertainty with the potential to disrupt the global economy at least over the shorter term. The process is likely prone to several more twists and turns before things become any clearer. The bottom line is that nobody knows how it will all play out.

Therefore, we file this under the heading: "There are *always* risks and uncertainties when investing in equities that have the potential to cause significant shorter-term price declines." Whether it is a trade war, a geopolitical event, an unexpected economic shock, a monetary policy mistake, or innumerable other factors, stocks can deliver losses, at least over shorter-term periods. Market corrections and bear markets happen. An investor must be able to withstand these drops, stay the course, and stick to their long-term plan (assuming it was well-designed and aligned with their financial objectives to begin with).

We don't invest based on three-month investment horizons or short-term expected outcomes. To the contrary, we strongly believe that a critical element of our investment process is our discipline to maintain a longer-term perspective while others are over-reacting to short term performance swings, daily news flow and other short-term market "noise". Many investors spend time on issues that don't really matter and can often cause them to act in ways detrimental to their long-term investment goals. We try to focus on the things that do matter most, such as asset allocation, investor behavior and risk tolerance, valuations, and market cycles.

As always, we thank you for your continued confidence and trust.

Timothy S. Healey
Chief Investment Officer

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Chief Operating Officer

Please advise us if you would like copies of our annual Securities & Exchange Commission Disclosure Brochure (Form ADV), a Prospectus for The Government Street Funds or a record of how your proxy statements were voted.