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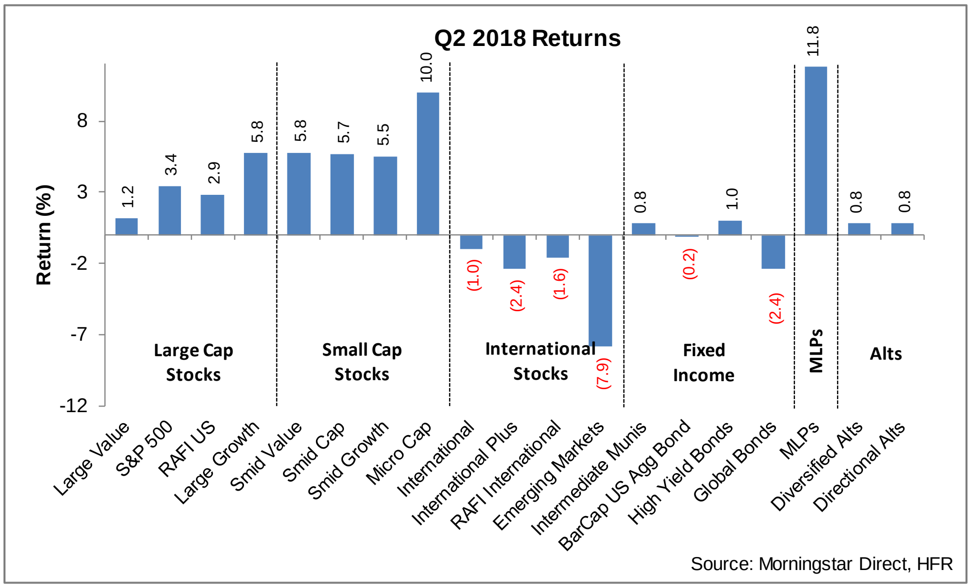
Second Quarter 2018 Investment Review & Outlook



EXECUTIVE SUMMARY

Q2 2018 Recap:

- Volatility continued in Q2, as protectionist trade rhetoric from the President overwhelmed strong economic and earnings data
- Small cap stocks surged on perceived tax cut benefits and insulation from trade issues
- International markets underperformed the US, almost entirely due to currency movements
- Fixed income markets lost money for the second straight quarter amid fears of higher interest rates and a more hawkish Federal Reserve

NEXT Outlook:

- A strong fundamental backdrop and a reset in valuations are supportive of the equity markets, but volatility is likely here to stay amid increased geopolitical "noise" and an aging market cycle
- With little else in the way of legislative help for the markets likely coming from this administration (and, indeed, seemingly the opposite), corporate results and economic data will need to take on greater prominence to carry the bull market forward
- Risk remains to the upside for interest rates given strong economic data and continued withdrawal of Fed monetary policy
- Trump's trade war will likely remain an overhang, but we do not advocate trading around the situation due to its unpredictability

To Our Clients and Friends,

At the year's halfway point, market behavior has clearly changed from the easy, care-free gains of 2017. After a near-uninterrupted climb higher last year – one in which the S&P 500 did not experience a 3% decline during the entire year – financial market volatility increased substantially. Markets suffered their first 10% decline in two years in the first quarter, while the second quarter offered little more than choppy up-and-down trading. Both stocks and bonds have struggled to generate any meaningful returns in this environment: for the year, global markets[1] are down (0.1%) while the broad US bond market[2] has lost (1.6%).

That markets would need some time to digest the large gains from 2017 is perhaps not all that surprising. However, this volatility occurred despite tremendous levels of economic and corporate growth in the US. Unemployment stands at its lowest level in decades, GDP has surged to above 3%, and corporate earnings growth is expected to top 20% this year. December's Tax Cut & Jobs Act (TCJA), the most substantive tax reduction since the Reagan administration, is only helping fuel this expansion.

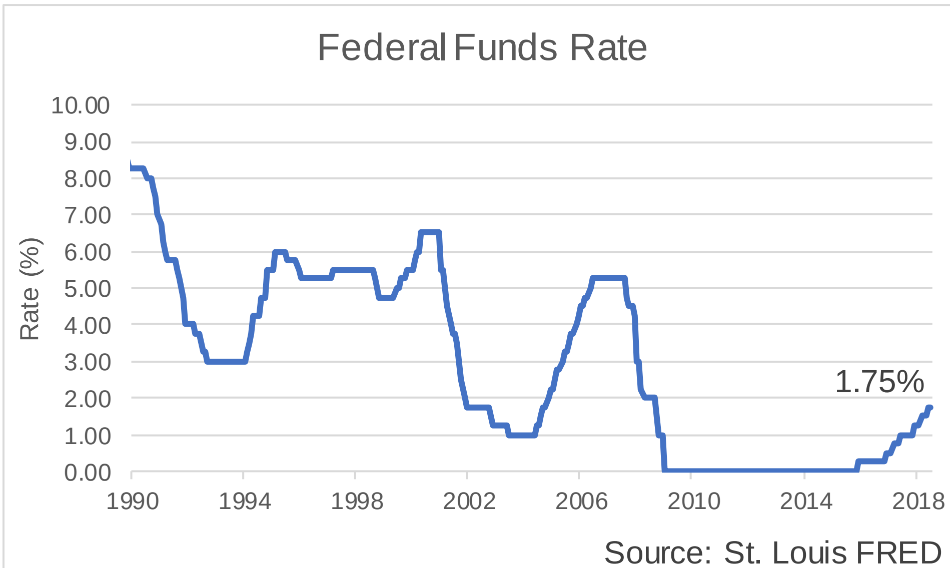
Unfortunately, President Trump's aggressive anti-trade rhetoric has been disruptive to these positive market forces. His announcement of tariffs on goods from China, Europe, and other trading partners has stoked fears of a protracted trade war, one in which consumer prices rise and trade volumes sink. Regardless of your views on Trump or the merits of his argument in this case, there is no question that global growth will be negatively impacted if Trump's tariffs (and whatever retaliatory measures are enacted by our trading partners) persist.

We noted last quarter that President Trump typically stakes out an extreme initial stance as a negotiating tactic. While we are skeptical that Trump has much appetite to undermine the positive economic and market momentum that has marked his presidency thus far – particularly ahead of mid-term elections – it remains to be seen how long and to what extent he will dig his heels in on this issue. Many of his initial tariff announcements have lacked the same bite upon implementation. With that said, there are many

[1] Represented by the MSCI All Country World Index
[2] Represented by the Barclays US Aggregate Bond Index

potential ripple effects from Trump's actions that could have unintended consequences he cannot easily reverse.

We must also recognize that the Federal Reserve's support of financial markets is diminishing. Following years of highly accommodative policies – including ultra-low interest rates and voracious buying of bonds in the open market – the US central bank has significantly advanced in its objective to "normalize" policy. In the second quarter, the Fed hiked short-term interest rates for the second of what is expected to be four times in 2018. The Federal Funds target rate – the benchmark level for which lending rates are set in the US – now sits at 1.75% after seven 0.25% rate hikes since the end of 2015.

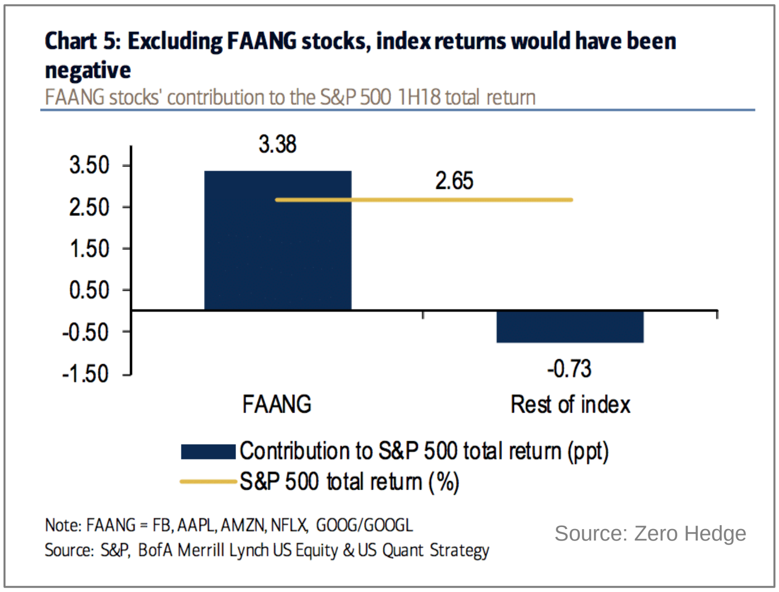


That short-term interest rates are now 1.75% should not be ignored by investors. Assuming the Fed continues as planned, the target Federal Funds rate should reach 2.25% by year end. One of the original premises for "ZIRP" – zero interest rate policy – was to encourage risk-taking: those unsatisfied by earning 0% on their cash were expected to move out on the risk spectrum and buy assets like junk bonds and equities. This did, in fact, happen, bringing stability to those asset classes. Now that more meaningful yields can be had with lower risk, it is inevitable that some level of re-allocation will occur and volatility will increase. Even we here at Next Capital have recently begun exploring ultra-short, cash-type solutions based on the attractiveness of those yields.

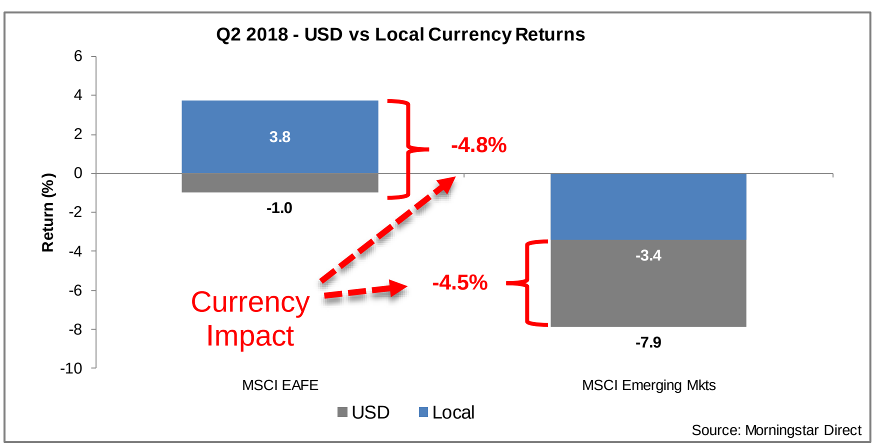
Market Recap

Global stock markets were mixed in the second quarter, as US stocks posted gains and foreign securities sank under the weight of Trump's trade rhetoric and a stronger dollar. Within the US, small caps sharply outperformed large caps, rising nearly 8% compared to the S&P 500's 3.5% increase. Small cap companies are perceived to be greater beneficiaries of December's tax cut than larger stocks, largely because they have less of an ability to reduce taxes through multi-national structures. The market also appears to believe that small caps are more insulated from foreign trade issues, though the reality of that view remains to be seen (e.g., plenty of small companies would suffer from increased prices on imported components should a protracted trade war occur).

From a style perspective, growth stocks once again outperformed value – and dramatically so. For the third time in four years, growth stocks maintain a double-digit advantage versus their value peers. This was once again a story of a few stocks driving performance: the so-called FAANG stocks (Facebook, Apple, Amazon, Netflix, Google) were up more than 35% through the first six months of the year on an equal-weighted basis. While valuations appear to be elevated for many of these high-profile names, the market continues to reward their transcendent growth potential. In fact, the five FAANG names are alone responsible for the S&P 500's positive return year-to-date.



Turning abroad, many may be surprised that developed international markets in Europe and Japan actually outperformed the US on a local currency basis. Despite no FAANG-type constituency, those markets generated a positive 3.8% return in their native currencies – underscoring the rebounding nature of those economies after many years of anemic growth. However, the depreciation of those denominations against the greenback resulted in a return nearly 5% lower for US investors. Currency swings are unfortunately a part of being a global investor; over time, currency effects tend to wash out, but we recognize that in the short-term they can create unwanted volatility.

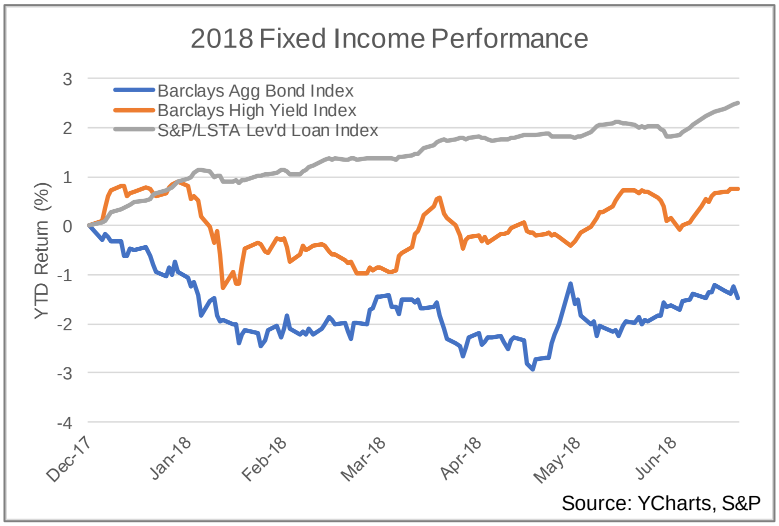


Emerging markets were a more disappointing story in the quarter, as they suffered deep losses following an initial 8% increase in January. As illustrated in the peak-to-trough decline chart below, the emerging markets index is nearly 14% off of its highs and was down 8% for the second quarter. Like developed international markets, currency was a significant factor. While one might assume China was also a major loser in the quarter – owing to Trump's ongoing trade spat with the country – the reality is that the MSCI China index was down just 3.4%. A 40% tech weighting and a more stable currency helped insulate the Chinese markets from the same levels of decline.

Fixed income markets offered little reprieve from the second quarter's volatility, as the broadest measure of fixed income (the Barclays US Aggregate Bond Index) declined for a second consecutive quarter. As we noted earlier, that index is now down (1.6%) on the year, its worst start to a year since the Taper Tantrum in 2013.

"Traditional" fixed income such as investment grade corporates and municipal bonds have struggled to overcome their sensitivity to interest rates, as sharp increases in Treasury yields early in the year caused declines in both sectors. We believe the risk remains to the upside for interest rates, based on continued economic expansion and Federal Reserve tightening. The yield on the 10-year Treasury – often used as the barometer for interest rates in the US – now sits more than 0.50% higher than the end of last year after reaching as much as 0.70% higher intra-quarter. This is a significant move and underscores how quickly rates can shift.

Non-investment grade fixed income offered better performance than their traditional counterparts in the quarter, amid robust corporate financial health and an exceptionally low default environment. Floating rate bonds, which inherently do not have interest rate sensitivity, were particularly effective in avoiding the losses experienced by traditional bond sectors in 2018. This continues a phenomenon of strong credit performance since the minor market selloff in late 2015/early 2016.



Finally, the energy complex – including infrastructure MLPs – saw a strong rebound in the quarter. The Alerian MLP index climbed nearly 12% in the quarter on improved sentiment. Since the quarter ended, those gains have continued on the heels of a revised regulatory ruling that benefits the asset class, reversing an adverse ruling from earlier this year. While the actual impact of the ruling is debatable, it had been a headwind for performance in the first quarter.

Outlook

Since the start of July, markets seem to have turned their attention back to fundamentals. Another strong slate of corporate earnings has boosted the S&P 500 by 3% thus far, as companies are surpassing expectations at a historic rate. Approximately 87% of companies have beat analyst expectations, while companies are also reporting record high profit margins for the second straight quarter.

The market continues to be supported by several factors: economic growth is rebounding, business and consumer confidence are at their highest levels since the recession 10 years ago, and corporate America is unusually healthy. The impact of December's corporate tax is providing a massive level of fiscal stimulus to the economy that should accelerate momentum into the coming quarters. Moreover, stock market valuations appear quite reasonable as they currently trade at long-term averages.

The evolution of Trump's trade war will likely remain an overhang to this positive backdrop, but ultimately we do not advocate trading around the issue. Geopolitical factors tend to be unpredictable and subject to the whims of a few individuals, making them extremely difficult to forecast. We place greater faith in the role of a diversified asset allocation mix to absorb such volatility rather than our ability to predict an outcome – let alone the market response to that outcome (read: "Donald Trump, 2016 election" for a perfect case study on that point). At this stage, staying disciplined and long-term with your investment strategy is the best course of action, in our opinion.

With regards to the Federal Reserve, we fully expect Jerome Powell and company to hike rates two more times this year. There will likely be repercussions for the market as short-term rates will become more attractive to investors. We believe this will primarily translate to greater volatility in the bond markets rather than equity markets given the current momentum in earnings and economic growth. We continue to be focused on bond portfolios that mitigate interest rate risk in this environment.

As always, if you feel your personal financial situation has changed or you would like to revisit your asset allocation, please do not hesitate to call or visit our offices.

Kindest regards,
Your Investment Team
7/25/2018