HIGHTOWER
VWG WEALTH MANAGEMENT

2nd Quarter 2018 Review

Coming off its first losing quarter in the previous 10, the S&P 500 Index got back on the winning track in the 2nd Quarter, gaining +3.6%. Year-to-date, this benchmark for large U.S. stocks is positive +2.5%. Other U.S. large stock indices were mixed. The Dow Jones Industrial Average increased +1.0%, but is still posting a -0.9% loss for the year. The technology-heavy NASDAQ 100 Index rose +7.4% in the quarter and is up to +10.6% this year. Stocks of small U.S. companies outperformed in the quarter, as domestically-focused businesses were perceived to be more insulated from trade skirmishes. The benchmark Russell 2000 Index gained +7.7%. It has returned +7.7% year-to-date.

International stocks fared worse in the 2nd quarter, as European economic conditions softened somewhat after a strong 2017. The MSCI EAFE Index lost -2.0% and is down -2.8% year-to-date. Fears of protectionist tariffs derailed the past year's strength in emerging markets equities. The MSCI Emerging Markets lost -9.7% in the quarter. It is not down -7.4% this year. China fared worse. The Shanghai Stock Exchange Composite Index fell -10.1% for the quarter and has lost -13.9% this year.

On June 13, the Federal Reserve increased the target short-term borrowing rate (Fed Funds Rate) by 0.25%. This followed March's similar increase and was accompanied by the Fed's evaluation of "continuing strength and economic activity" which could lead to 2 more rate increases this year. Accordingly, yields of other short maturity bonds also rose. Surprisingly, the yield of the 10-year U.S. Treasury Note did not move higher, even after flirting with the 3.0% level. The Barclays Aggregate Bond Index fell -0.2% for the quarter, and has lost -1.6% this year. Tax-exempt bonds did slightly better, with the S&P National Municipal Bond Index rising +0.7%. The Bloomberg Barclays High Yield Bond Index nudged higher by +0.3% in the quarter. It is down -1.2% this year.

Crude oil's strength continued, as Venezuela's production fell further and as global markets feared possible sanctions on Iranian oil exports. Most other commodities softened in the 2nd quarter. The NYMEX High Grade Copper continuous futures contract slipped -2.0%. The NYMEX Gold continuous futures contract dropped -5.5% in the quarter, and is down -4.4% for the year.

Securities offered through HighTower Securities, LLC | Member FINRA and SIPC | HighTower Advisors, LLC is a SEC registered investment adviser

HIGHTOWER
VWG WEALTH MANAGEMENT

Trouble With the Curve

In response to improving U.S. economic conditions and to the Federal Reserve's signals to markets that they will continue to increase the Federal Funds (short term borrowing) rate if these conditions persist, the yield of the 2-year U.S. Treasury Note has almost doubled over the past 12 months. It has risen from 1.37% to 2.52%. Casual observers should find this an encouraging sign for optimism, after years of Central Bank quantitative easing (QE) that distorted interest rates, and the resulting "financial repression" that purportedly punished savers.

Unfortunately, a number of market observers don't see it this way. That's because during this same period, the yield of the 10-year U.S. Treasury Note has risen from 2.27% to the current 2.85%. The yield of the 2-year Treasury has increased more rapidly than that of the 10-year, and thus the yield curve (a graphic plot of bond yields versus their maturities) has flattened. These worrywart strategists fear that further increases in the Federal Funds rate, in the face of long0bonds remaining stable, will eventually lead to the curve inverting, where short-term rates are higher than long-term rates. In cinematic terms, why do these pundits share Gus Lobel's (character played by Clint Eastwood) "Trouble With the Curve?". Should we share these concerns?

Bespoke Investment Group explains the yield curve as an economic signal:

> "Of all the different tools used by economists to forecast recessions, on of, if not the, most reliable signals is the yield curve. Even the New York Fed has cited its utility as being a good predictor of recessions, specifically when the curve inverts."

Julian Birgden of MI2 Partners elaborates:

> "Concerns have some justification because in the post-war period, once the Treasury curve turns negative, a recession has usually followed, albeit with a lag of approximately 15 months. Worry may be justified because on the current trajectory, the curve could be negative by the end of the year, suggesting a recession in 2020."

Tan Kai Xian of Gavekal Economics explains the economic rationale behind this signal:

> As the yield curve flattens further and approaches inversion, the probability of a U.S. recession increases substantially. The reason is that short rates act as a proxy for market borrowing costs, while long rates are a proxy for the structural economic growth rate, which in turn is a proxy for corporate profit growth. Therefore, an inverted yield curve implies that the cost of capital has

HIGHTOWER
VWG WEALTH MANAGEMENT

exceeded the structural growth rate of earnings - at which point recession becomes inevitable."

*(Plot of the 2-**10's** Yield Spread, with Red Bands Depicting Periods of Past U.S. Economic Recession – Bloomberg Finance L.P.)*

Should investors hunker down into their foxholes, or head for the hills? We recommend taking a step back and taking a more critical and measured look. There are some strong counterarguments to consider:

- First, we must be reminded of the wisdom of Yogi Berra who said, "You can observe a lot just by watching." Be careful of projecting present conditions into future trajectories and predictions. The yield curve is not presently inverted. Although the spread between the 2- and the 10-year Treasury is now at its lowest since August 2007, narrowing in and of itself doesn't predict inversion.

- Bespoke Investment Group points out that "flat yield curves by themselves are not a reliable predictor of recessions. In order for the "recession countdown" to start, the curve really has to invert."

- Much of Bespoke's research on the yield curve as an economic indicator uses the 3-month Treasury bill rate (which trades much tighter to the Fed Funds Rate) for its measure of short-term yield. Their findings show that the performance of the S&P 500 has been surprisingly positive following periods of yield curve flattening. They show that when the 3-month T-Bill/10-Year T-Note spread has flattened below a spread of 100 bps, the S&P 500's 12- month forward return has been positive 89% of the time. The quarter's end measurement of this spread is 94bps. When it has flattened below a spread of 50 bps, the S&P 500's 12-month

Securities offered through HighTower Securities, LLC | Member FINRA and SIPC | HighTower Advisors, LLC is a SEC registered investment adviser

forward return has been positive in 65% of observations, averaging a +5.0% positive return.

- Some counter arguments are more vehement, claiming that global central bank qualitative easing (QE) programs have impaired bond yields' abilities to act as accurate economic barometers. The Bank for International Settlements (BIG) states, "long-dated yields may be overrated as a forward indicator of economic conditions." Julian Brigden says that "ECB and BoJ policy has suppressed yields by creating a Tsunami of inflow, which has distorted 'fair value'". His models show that "absent these distortions, fair value of the 10-year Treasury is over 4%." Using this figure, "'fair value' measurement of the 2- 10's curve would not be 50bps but closer to 150bps. At which point, any debate about inversion and imminent recession risk would be moot."

This "curve" argument quickly becomes very confusing. VWG Wealth Management relishes simplicity in response to dealing with complex adaptive systems. However, much more is required beyond looking at one simple indicator when evaluating the strength of an economy, and in predicting its next meaningful downturn.

A number of economists and strategists we greatly respect feel very positive about the currently strong US economy, and its potential to persist going forward. Strategas Research Partners' Chief Economist Don Rissmiller is "long-term bullish on the economy and markets, and is not too worried about a recession." The revered Byron Wien, currently Vice Chairman of Blackstone Advisory Partners, was recently quoted on CNBC as being long-term positive, and he "sees no signs of a U.S. recession until at least 2021."

First Trust's Chief Economist Brian Wesbury paints his picture with a blunter brush:

> "Now we agree that a recession is coming – someday. Recessions are a fact of life, like death and taxes. But predicting one in 2020 – and being right about it – is like reading tea leaves, it's pure chance. No one, and we mean no one, can honestly see that far in the future – not with the clarity expressed by these dated forecasts. No one knows exactly what the Fed will do, not even the Fed. Let's say they follow their forecasts, raising fed funds to 3.5% in 2019. That alone doesn't tell us if policy is "tight."
>
> The U.S. is not facing an imminent threat. That's why doom and gloomers have shifted to forecasting future recessions, not looming crises. But we think it's not going to be the economy that gets an anvil on its head in 2020. More likely, it'll be investors who believe in the recession forecast."

Securities offered through HighTower Securities, LLC | Member FINRA and SIPC | HighTower Advisors, LLC is a SEC registered investment adviser

HIGHTOWER
VWG WEALTH MANAGEMENT

Portfolio Strategy and Asset Positioning

VWG Wealth Management continues steadfast vigilance on the markets, seeking opportunities, and looking for obvious and not-so-apparent risks. We endlessly seek investment education and awareness from a multitude of sources. Much work is spent attempting to gain focus on the longer term, and to filter out the shorter-term noise. It is a challenging task that never ceases to engage and energize.

Today's world presents quite a number of different macroeconomic and political crosscurrents, and potentials risks. U.S. equity markets certainly have the potential to pullback, or meander aimlessly, in the summer months leading up to the mid-term

election. Trade war fears, the flattening yield curve, and financial stocks' 2018 underperformance – all have our attention. International equities add further concern. Europe is showing a bit of softness in consumer confidence, and in purchasing managers indices (PMIs). China's retail sales and industrial output have slowed (but are still growing), and the Chinese Yuan has weakened notably. The extremely low volatility enjoyed by the global equity markets in 2017 is long gone.

Yet, we are not altering our modestly positive stance. U.S. employment, retail sales, manufacturing output, and corporate profits and forward guidance are very solid. The global economy is growing. More importantly and counterintuitively, investor sentiment is far from frothy. TrimTabs Investment Research saw global mutual fund and ETF outflows of $12.4 billion through June 26, which could lead to June's outflows being the fourth largest month on record. The negative equity flows have not been accompanied by inflows into traditional safe havens of bonds and gold.

Patience, discipline and diversification is required. We continue to recommend allocating some cash and stable short-term bonds as protective ballast and "dry powder" for future potential opportunities. Investors who have been overweight equities, can tactically trim or reallocate a portion into partially hedged strategies and risk-defined structured notes. Allocations to bonds will be increased slightly should intermediate term interest rates rise. VWG Wealth Management continues to devote great time to evaluating niche private real estate, and other boutique private strategies and managers. When suitably placed and appropriately sized, these have the potential of providing stability and differentiated returns.

VWG Wealth Management | 1919 Gallows Road, Suite 330 | Vienna, VA 22182 | www.hightoweradvisors.com/VWG
Securities offered through HighTower Securities, LLC | Member FINRA and SIPC | HighTower Advisors, LLC is a SEC registered investment adviser

HIGHTOWER
VWG WEALTH MANAGEMENT

Best wishes for a fun-filled and relaxing summer!

Regards,

VWG Wealth Management
Suzanne, Ashley, Rashmi, Lynette, Michelle, Christina, Justin, Amanda, Sarah, Patricia, John, Rick & Jeff

---

** Index Data Sourced from FactSet Research and Morningstar*

VWG Wealth Management is a team of investment professionals registered with HighTower Securities, LLC, member FINRA and SIPC, and with HighTower Advisors, LLC, a registered investment advisor with the SEC. Securities are offered through HighTower Securities, LLC; advisory services are offered through HighTower Advisors, LLC.

The information provided has been obtained from sources not associated with HighTower or its associates. All data and other information referenced herein are from sources believed to be reliable, although its accuracy or completeness cannot be guaranteed. Any opinions, news, research, analyses, prices, or other information contained in this report is provided as general market commentary, it does not constitute investment advice. VWG Wealth Management and HighTower shall not in any way be liable for claims, and make no expressed or implied representations or warranties as to the accuracy or completeness of the data and other information, or for statements or errors contained in or omissions from the obtained data and information referenced herein. The data and information are provided as of the date referenced. Such data and information are subject to change without notice.

This is not an offer to buy or sell securities. No investment process is free of risk, and there is no guarantee that the investment process or the investment opportunities referenced herein will be profitable. Past performance is not indicative of current or future performance and is not a guarantee. The investment opportunities referenced herein may not be suitable for all investors.

This document was created for informational purposes only; the opinions expressed are solely those of VWG Wealth Management, and do not represent those of HighTower Advisors, LLC, or any of its affiliates.

VWG Wealth Management | 1919 Gallows Road, Suite 330 | Vienna, VA 22182 | www.hightoweradvisors.com/VWG
Securities offered through HighTower Securities, LLC | Member FINRA and SIPC | HighTower Advisors, LLC is a SEC registered investment adviser