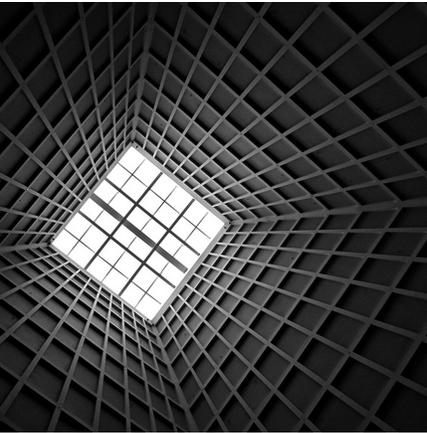




JULY 2018



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U.S. equities moved solidly higher across the board during the quarter. Small-cap stocks posted a sizable advantage over large-cap stocks, with investors likely rotating due to both decent relative valuation and the threat of increased trade barriers harming larger companies. While U.S. equity markets gained in the quarter, many foreign markets declined, with many emerging markets losing 15% or more.

Markets hate uncertainty, and the recently imposed tariffs provided investors with much to hate in the quarter. The U.S. Dollar gained more than 5% in the quarter, at the expense of just about every other major currency – the Euro, Japanese Yen, Chinese Yuan, and British Pound all lost more than 4%. Most commodities (with the notable exception of oil) also declined, as the threat of tariffs on agricultural products and industrial metals drove prices lower.

Crude oil prices rose by more than 14% in the quarter on the back of strong demand and political uncertainty. The United States' withdrawal from the Iran nuclear deal and threat to end Iranian oil imports has heightened tension in the region, putting upward pressure on prices.

Interest rates rose early in the quarter, with the yield on the 10-year Treasury note breaching the psychologically important 3% level in April and May before backing off in June, closing the quarter at 2.85%. The Federal Reserve continued on its path of raising the Federal Funds Rate, moving it up one-quarter of a point to 2% in June, and signaled two more such hikes before year-end. The yield curve, however, flattened, perhaps suggesting a more challenging economic environment ahead.

Market Outlook

Last year we described the investment climate created by global monetary policy of the last 10 years, and how it has forced investors to “pay up” for shares of companies that promise high growth in the future. One year ago in our comments we wrote *“These companies might be able to show well-above average revenue growth, but are likely to have difficulty (or find it impossible) to translate that revenue growth into sustained profitability and free cash flow.”*

Earnings growth still remains elusive for many companies and industries if we factor out the one-time impact of tax cuts, and equity investors continue to chase “growth” companies, almost regardless of valuation or their ability to ever generate income. We discuss this in more detail in our June piece “Reports of Value Investing’s Death are Greatly Exaggerated”. “Growth” indices continue to vastly outperform their “Value” counterparts; the Russell 2000 Value Index, for example, is 2000 basis points (20 percentage points) behind Growth in the last 18 months. As we wrote, *“[t]his has understandably left Value investors frustrated and angry, and indeed many do wonder if ‘this time it is different’”* (spoiler alert: we do not think that it is).

Recent political and economic developments may be leading even more liquidity created by central banks into U.S. assets. The United States’ recent imposition of certain tariffs on imports has led to a strengthening of the U.S. dollar against virtually every major currency. Foreign equities, especially those of emerging economies, sold off hard in the second quarter as a result, making investors in emerging markets nervous and leading some to focus more on investing in U.S. equities. Of course, U.S. stocks were not immune to the impact tariffs may have, as many larger capitalization industrial companies sold off on fears that tariffs might negatively impact their businesses.

It appears U.S. fixed income investors are finding longer term bonds more attractive as the Federal Reserve continues to push short term rates higher. Recent reports suggest domestic investors have replaced foreign buyers as the source of demand for recent Treasury auctions. Hopefully this will continue, as Trump’s fiscal programs suggest the U.S. will run budget deficits exceeding \$1 trillion as soon as next year. It is hard to fathom that this can continue for long, and poses a substantial risk to U.S. economic growth if one takes a longer term view.

In this environment one might feel especially uneasy looking for investment opportunities in the short run. We cannot forecast short-term market moves, but we do believe that the global investment environment has become more volatile. There will be clear winners and losers, and part of our job is to forecast the impact that these policies may have on the **long-term** value of the businesses in which we invest. As always, our style of investing continues to place value on high returns on invested capital, goal congruence with management, prudent capital structures, and abundant free cash flow. We believe this approach will continue to be attractive for our clients' portfolios in the future, and appreciate your support and confidence.

This manager commentary represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice. No mention of particular securities should be construed as a recommendation or considered an offer to sell or a solicitation to buy any securities.

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