Polaris Greystone FINANCIAL GROUP, LLC

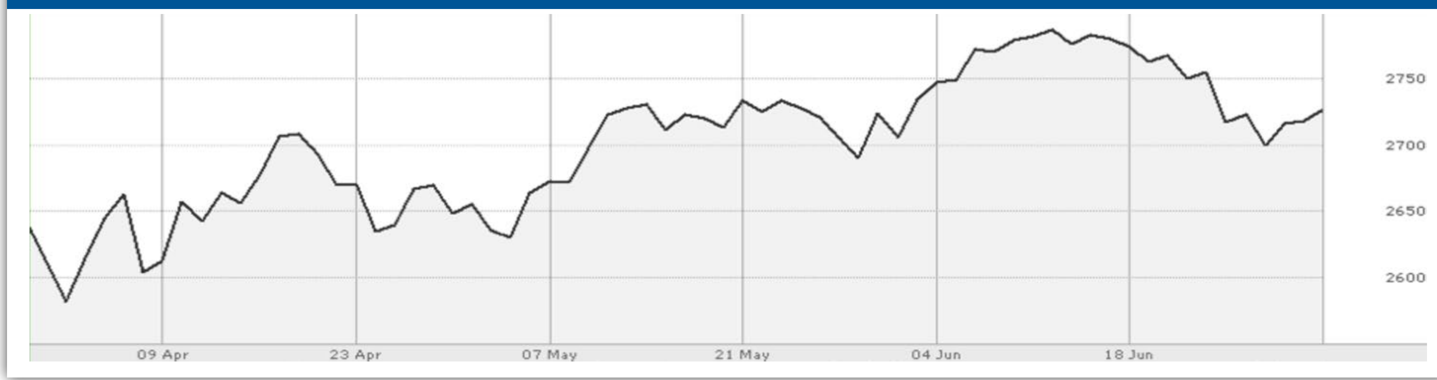
Polaris Greystone Educational Series

For more information or to schedule an introductory consultation contact us at: info@polarisgreystone.com I (800) 268-9046 I www.polarisgreystone.com

2nd Quarter 2018 Market Review

The S&P 500 finished the quarter up 2.93%, fighting headwinds of threats of trade wars. While 2.93% is a slightly above average quarterly return, it was surprising that the markets didn't react more positively given the record earnings reported during the quarter.

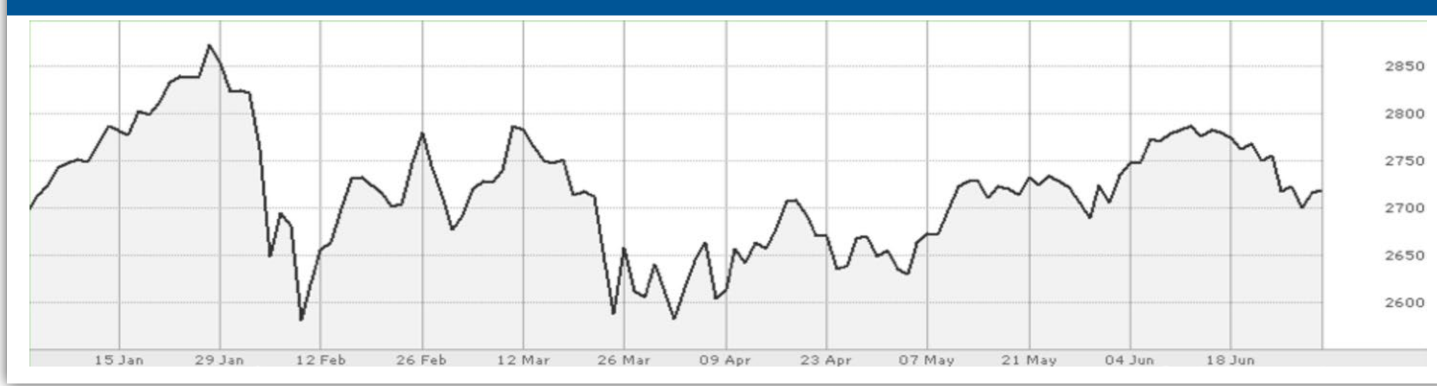
S&P 500 Index – Second Quarter 2018



Source: TD Ameritrade, Polaris Greystone Financial Group

The S&P 500's second quarter performance erased the negative performance found in the first quarter, pushing performance into positive territory. Even though all three months of second quarter were positive, the S&P 500 price return index finished the first half of the year up a meager 1.67%.

S&P 500 – Year-to-Date 2018



Source: TD Ameritrade, Polaris Greystone Financial Group

Polaris Greystone FINANCIAL GROUP, LLC

Polaris Greystone Educational Series

For more information or to schedule an introductory consultation contact us at: info@polarisgreystone.com I (800) 268-9046 I www.polarisgreystone.com

Second Quarter Highlights

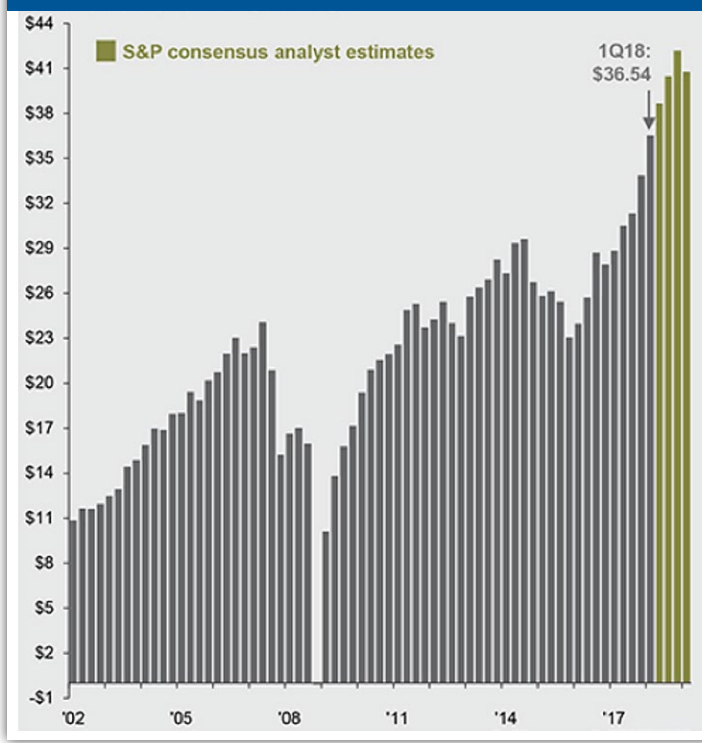
- The U.S. outperformed the MSCI All-Countries World Index and the MSCI Emerging Markets Index for the quarter and the year.
- The U.S. Dollar Index increased 4.9% for the quarter, as repatriation of overseas cash and foreign investors seeing better growth prospects for their money in U.S. markets.
- Gold was the worst performing asset class, down 5.32% for the quarter.
- Stocks outperformed bonds, with the S&P 500 TR index outperforming the Barclays U.S. Aggregate Bond Index by over 3.5% for the quarter and 4.25% for the year.
- Stocks with higher percentages of income from overseas trailed stocks with a lower percentage of overseas income by over 1.5% in the second quarter.
- Small companies outperformed large companies (small companies have a smaller percentage of their revenue from foreign sources), with their best relative return vs. large companies since 2010.
- Emerging Markets was the worst performing stock index, down 3.51% for the quarter. Countries like China and Korea pulled down the index, suffering from the fear of a trade war and a strong dollar due to a tightening Fed cycle.
- The best performing sectors of the S&P 500 were Energy, Consumer Discretionary, and Information Technology, up 12.69%, 7.84% and 6.75% respectively.
- The worst performing sectors were Industrials, Financials, and Consumer Staples, down 3.66%, 3.58%, and 2.34% respectively.

What PGFG Like About the Markets

Record Earnings

S&P 500 companies reported record earnings for the 1st quarter of 2018, reporting almost 25% quarter over quarter growth. As you can see from the estimates chart, 2nd quarter earnings are expected to be even higher, as are the subsequent quarters in 2018.

S&P 500 Earnings Per Share
Index Quarterly Operating Earnings



Source: Standard & Poors

Polaris Greystone Educational Series

Polaris Greystone FINANCIAL GROUP, LLC

For more information or to schedule an introductory consultation contact us at: info@polarisgreystone.com I (800) 268-9046 I www.polarisgreystone.com

Market Valuations

There are many ways to evaluate market valuations. The forward P/E ratio is probably the most popular way of evaluating the markets (the other common ways are found in the enclosed graph). As we discussed in our 2018 market outlook webinar (provide link), we were concerned that the S&P 500 was overvalued. A market correction (lowering the "P" of the P/E ratio) and record earnings (increasing the "E" of the P/E ratio) has brought this popular evaluation tool back to 25-year norms.

S&P 500 Index: Forward P/E Ratio

Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	16.1x	16.1x	0.0
CAPE	Shiller's P/E	32.1	26.6	0.9
Div. Yield	Dividend yield	2.1%	2.0%	-0.2
P/B	Price to book	3.0	2.9	0.1
P/CF	Price to cash flow	12.0	10.7	0.7
EY Spread	EY minus Baa yield	1.4%	-0.2%	-0.8

Source: FactSet, Federal Reserve Bank, Standard & Poors, Thomson Reuters, JP Morgan

Record Profit Margins

The S&P 500 reported the highest profit margins they have experienced in over 20 years (see to the right). This can be viewed in a glass half empty or a glass half full. One could argue that with such high profit margins, they are sure to come down. I would argue that S&P 500 companies are being well run and should be rewarded for their excellent profit margins.

S&P 500 Profit Margins

Source: Standard & Poors

Record Dividends and Near Record Share Buybacks

S&P 500 companies rewarded investors with the highest dividend payments ever paid to investors and near record share buybacks. The combination returned almost $1 trillion to investors over the past four quarters.

Cash Returned to Shareholders

Source: Bloomberg, Compustat, FactSet, and Standard & Poors

Polaris Greystone FINANCIAL GROUP, LLC

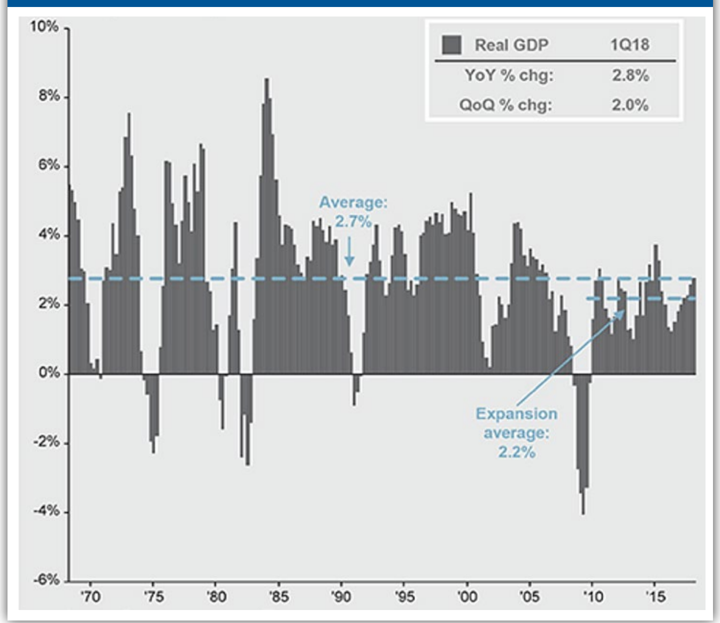
Polaris Greystone Educational Series

For more information or to schedule an introductory consultation contact us at: info@polarisgreystone.com I (800) 268-9046 I www.polarisgreystone.com

Strong GDP Growth

The U.S. economy is currently growing at a 2.8% year-over-year pace. This is substantially higher that the 2.2% average growth since the end of the financial crisis, and it is slightly higher than the 2.7% average growth pattern over the past 40 years.

Real GDP
Year-Over-Year % Change



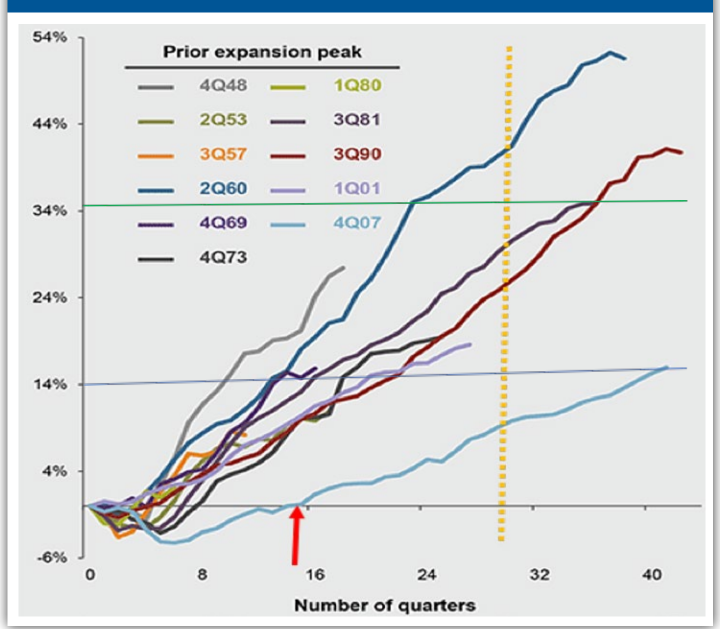
Source: BEA, FactSet, JP Morgan

Economic Expansion

Many news agencies and analysts are expressing concern over the length of time that our economy has been expanding. Our economic expansion is the second longest expansion on record. Some would challenge that this means a recession is just around the corner. I would argue that this economic expansion is very different from all other expansions since World War II.

Economic expansions are measured from the prior economic high, the length of the recession, the recovery back to break even, and then the expansion that happened afterwards. As you can see from the chart, the red arrow indicates that it took the United States 15 quarters to recover from our prior recession. This was almost twice as long as any prior post-WWII recovery time. In addition, we had extreme government intervention to stabilize our economy. Quantitative easing didn't stop until 2014 (marked by the orange line). While we have seen our economy expand, it has been anemic compared to prior economic expansions that have last as long. Our economy has only growth 14% bigger than where it was in 2007 (blue horizontal line). Prior expansions of this length produced two to three times more growth (horizontal green line) over the same number of quarters during their expansion. I believe that we will see our economy continue to grow for the foreseeable future.

Strength of Economic Expansions
Cumulative Real GDP Growth Since Prior Peak, Percent



Source: Bureau of Economic Analysis, National Bureau of Economic Research, JP Morgan

Polaris Greystone FINANCIAL GROUP, LLC

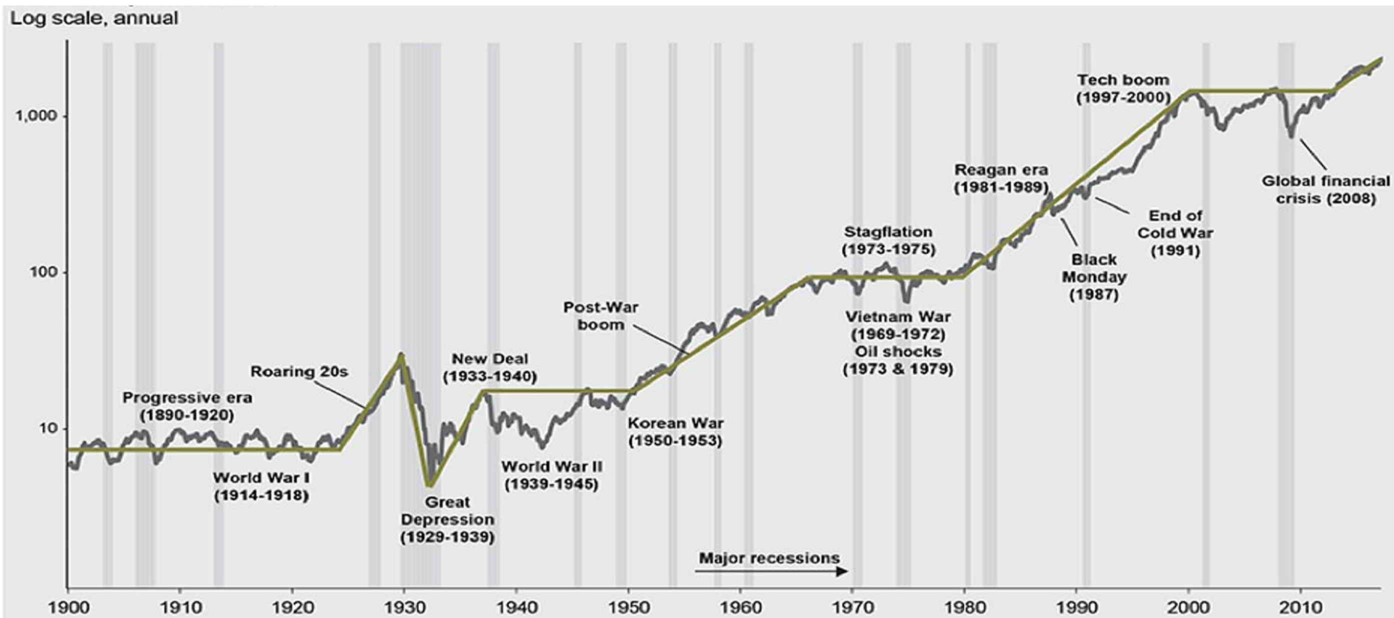
Polaris Greystone Educational Series

For more information or to schedule an introductory consultation contact us at: info@polarisgreystone.com I (800) 268-9046 I www.polarisgreystone.com

Market Trend is Still Intact

No market goes straight up or straight down. The S&P 500's overall trend is still strong and pointing in the right direction.

S&P Composite Index



Source: FactSet, National Bureau of Economic Research, JP Morgan

Concern Points!

Continued Fed Action

The Federal Reserve kept their promise, raising rates a second time this year on June 14th. This is the second rate hike this year. Even though rates are rising, they are still historically low (as seen to the right).

Historical Fed Fund Rates

Source: Macrotrends.com, Federal Reserve Bank

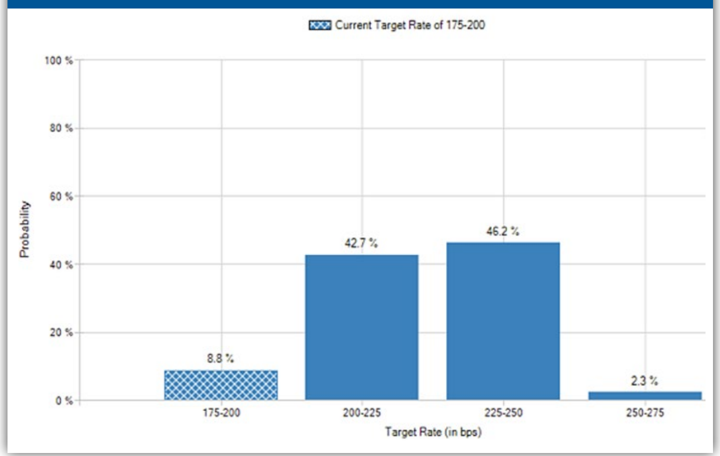
Polaris Greystone FINANCIAL GROUP, LLC

Polaris Greystone Educational Series

For more information or to schedule an introductory consultation contact us at: info@polarisgreystone.com I (800) 268-9046 I www.polarisgreystone.com

Even with these two hikes, the December Fed Futures indicate that it is very likely that we will one or two more hikes this year (see to the right). This will continue to place downward pressure on bond prices.

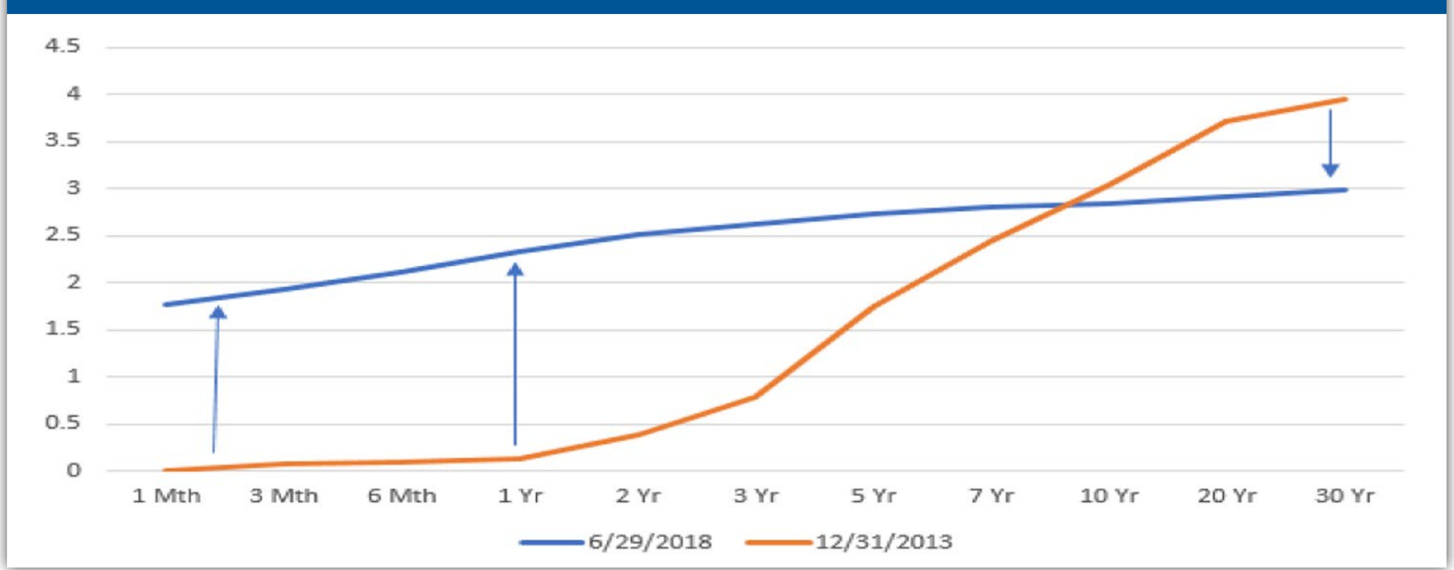
Fed Fund Rate Probabilities for December 19, 2018 Fed Meeting



Source: CME Group

Fed actions are already having an impact on bond prices, as we've seen short and intermediate bond yield rise by nearing two percent. This should not be surprising because the Federal Reserve has raised rates by the same amount. The surprise is the flattening of the yield curve. As you can see from the chart, short-term bond yields have moved up substantially, while yields have dropped for bonds with a ten-year duration or longer.

U.S. Treasury Yield Curve



Source: U.S. Treasury Department, Polaris Greystone

Polaris Greystone FINANCIAL GROUP, LLC

Polaris Greystone Educational Series

For more information or to schedule an introductory consultation contact us at: info@polarisgreystone.com I (800) 268-9046 I www.polarisgreystone.com

Why is this Happening?

According to Bloomberg News, there is $8.1 trillion (yes with a T) in negative yield global debt. For example, a 2-year German bund is yielding -0.65% per year. Yes, that is correct. If you are German, buy your country's 2-year debt, you will lose 1.3% over that two-year time period. Guaranteed!!! Who signs up for such an investment? These investors are looking for a safe investment. They've been flocking to long-term U.S. Treasuries. More buyers mean more demand. More demand means higher prices. And if you remember, there is an inverted relationship between prices and yield. As prices go up, yields drop. That is why we are seeing a very unusual shift in our yield curve.

Why does this matter?

Many companies in the S&P 500 use short-term debt to help them leverage their earnings. Higher short-term rates mean lower margins. Sectors that are more exposed to short-term debt are Consumer Staples, Real Estate, Utilities, and Telecommunication. Typically, higher short-term rates would have a positive impact on the Financial sector. Right now, the financial sector is suffering because of the flattening yield curve. Banks, for example, borrow short-term and lend long-term. The flattening yield curve is compressing their profit margins.

Tariffs Begin…

But does this mean a trade war has begun? I don't think so. As I have mentioned many times before in our educational pieces, you can't renegotiate trade deals by saying "please." You must take a very tough stance and you must be willing to follow up your threats with actual consequences. It's kind of like disciplining a child. If you tell your child that if they continue to do what they are doing that they are going to be grounded for a week, then you need to ground them for a week if they cross the line that you set. If you then turn around and let them go out and play the next day, the child learns that there are no consequences to misbehaving. While the parent might feel like they are suffering alongside the child who is obviously unhappy being grounded, that child will not misbehave if you stay firm and keep them in the house for the entire week.

China will continue their unfair trade practices until they are forced to do otherwise. The United States only exports $130 billion worth of goods to China. China, on the other hand, export $506 billion worth of goods to the United States. There have been multiple salvos shot across each country's bow, warning each other that they won't back down from each other's threats on tariffs. But China has far more to lose in this game of chicken than the United States due to the trade imbalance.

On Tuesday (July 11th) President Trump announced a $200 billion tariff as a direct punishment for China's intellectual property theft, sighting "China apparently has no intention of changing its unfair practice related to the acquisition of American intellectual property and technology." China has promised to "strike back hard, and launch comprehensive measures that match the US move in quantity and quality." The question is, "how?" They only export $130 billion of goods to the United States. They can't directly match the tariffs imposed on them by the United States.

As of July 11th, the Shanghai Stock Exchange Composite Index was down 16.36% for the year. This is obviously having an impact of the Chinese markets.

Polaris Greystone Educational Series

For more information or to schedule an introductory consultation contact us at: info@polarisgreystone.com I (800) 268-9046 I www.polarisgreystone.com

Conclusion

Uncertainty often weighs on the performance of the stock market. By far, the number one thing keeping this market from being up significantly is negative sentiment. People are investing by their gut, not their head. They aren't being clinical with their decisions but rather reacting with fear.

There are many cultural differences between the United States and China. Trump's tough stance will probably bring the Chinese back to the negotiating table, and when a new trade deal is struck, expect both sides to declare victory as a means of "saving face." Don't be surprised if you see this deal to be finalized in time for the mid-term elections in the fall.

Domestically things look very good. We had record earnings. Earnings growth was over 24% quarter-over-quarter and companies in the S&P 500 are expected to report even higher earnings. GDP is strong. Inflation is under control. Unemployment is non-existent (at 3.8%). Wages are increasing (putting more money into the average American's hands). Companies are rewarding their investors by paying record dividends and buying near record amounts of their company shares back. What's not to like?

While we are currently bullish on the outlook of the markets, we are not married to this belief. The power of tactical portfolio management is the flexibility and the adaptiveness. Our investment team is constantly reevaluating the risk in the market. If we see the need, we will take all of our strategies to a more defensive allocation.

As always, please feel free to call or write your wealth advisor if you have any questions or comment.

Sincerely,

Jeffrey J. Powell
Managing Partner

Polaris Greystone FINANCIAL GROUP, LLC

Polaris Greystone Educational Series

For more information or to schedule an introductory consultation contact us at: info@polarisgreystone.com I (800) 268-9046 I www.polarisgreystone.com

Privacy Policy

Maintaining the confidentiality of client personal financial information is very important to us. To provide clients with superior service, we collect several types of nonpublic personal information about our clients, including:

- **Information from forms that clients fill out and send to us in connection with a new account application (such as name, address, and social security number).**
- **Information a client gives to us orally.**
- **Information about the amount clients have invested (such as initial investment and any additions to and withdrawals from a capital account).**
- **Information about any bank accounts clients use for transfers between accounts.**

Polaris Greystone does not sell or disclose client personal information to anyone except as permitted or required by law. We share this information with our legal counsel as we deem appropriate, with our custodians in the course of servicing a client's accounts, and with our regulators. Finally, we may disclose information about a client at the client's request or with the client's permission (for example, by sending duplicate account statements to someone designated by the client), or as otherwise permitted or required by law.

Access to information about clients is restricted to those employees who need to know the information to service client accounts. Our employees are trained to follow our procedures to protect client privacy and are instructed to access information about clients only when they have a business reason to obtain it. We maintain physical, electronic and procedural safeguards to guard your nonpublic personal information.

If you have any questions concerning our privacy policies and procedures, please feel free to contact James Mason, Chief Compliance Officer, at jmason@polarisgreystone.com or by calling Mr. Mason at (248) 267-1270.