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MARKET SUMMARY

Equities

S&P 500 2,718
Price / Earnings 20.7x
Dividend Yield 1.9%

MSCI AC World 505.2
Price / Earnings 17.9x
Dividend Yield 2.4%

US Treasury

2 Year Yield 2.5%
10 Year Yield 2.9%
30 Year Yield 3.0%

US Corporate Spreads

Investment Grade 1.1%
High Yield 4.1%

Equity Volatility

CBOE Market Volatility 16.1

US Economic Figures

GDP Growth 1Q18 2.0%
Unemployment 4.0%
Inflation 2.3%
Fed Funds Rate 2.0%
3 Month LIBOR 2.3%

Commodities

Oil (Brent) \$79.44
Natural Gas \$2.92
Copper (\$/lb.) \$2.95
Gold (\$/oz.) \$1,253

Foreign Exchange

Euro \$/€ 1.17
Japanese Yen ¥/\$ 111
Chinese Yuan 元/\$ 6.62

Market summary data as of:
June 29, 2018

A Shot Out of the Blue?



The most important contest for the most popular sport in the world is well underway. Viewed by over three billion people, the FIFA World Cup is a quadrennial global obsession. Some countries see labor unions conveniently strike on days that their national team is playing. The European Central Bank has observed stock market trading volumes fall by over half during games.

Despite its global popularity, America sees soccer as a fringe sport with viewership dwarfed by that of football, baseball, basketball, and hockey. We think the prominent role of randomness in the game explains the lack of interest. Compared with the “big four” where the team that plays better almost always wins, soccer matches can more often be won by a weaker team by a fluke.

An economist would describe soccer matches as having a “fat tail” in the range of their results – the predictable outcome (better team wins) happens most of the time, but there are more unexpected outcomes. The same could be said of today’s market and macroeconomic environment. The fundamental picture is tracking as we’ve expected – continued growth with a supportive environment for corporate earnings, employment, investment and

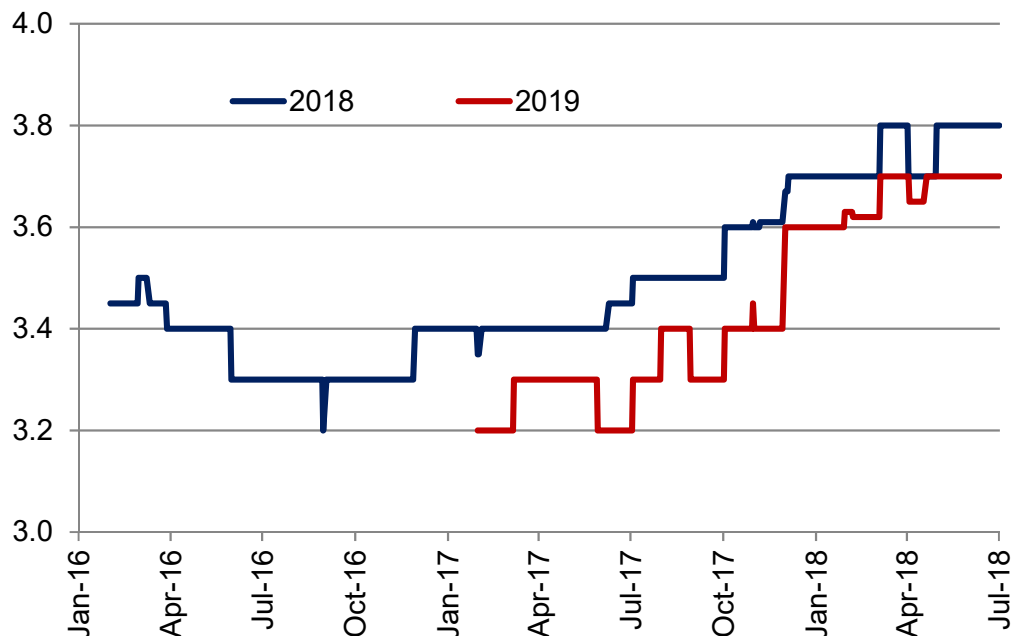
consumption. However, there's potential for exogenous events that could rapidly affect the outcome.

The Cycle and Its Signs

The economic and market cycle is mature with the current expansion and bull market for risk assets over nine years old. As such, monitoring for evidence that "late cycle" conditions are turning toward "end of cycle" conditions is an important part of managing risk in investment portfolios.

The favorable economic and earnings backdrop we discussed in recent letters remains in place. Consensus expectations for global economic growth and earnings are largely unchanged since our last letter following substantial improvements over the prior 18 months. As such, the underpinnings of the stock and credit markets still appear solid (see exhibit 1).

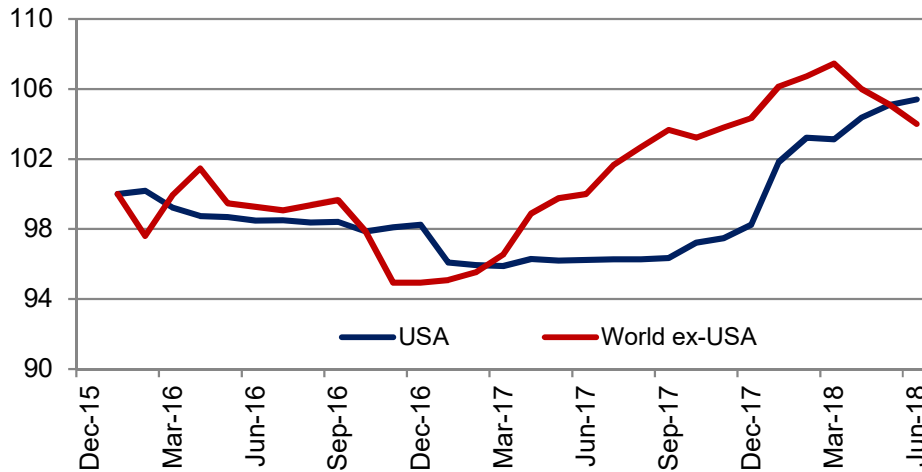
Exhibit 1: 2018 & 2019 Global Economic Growth Forecast %



Beneath the surface however, we've witnessed signs that historically have indicated potential softening in the fundamental backdrop.

The economic and earnings dynamic in the US has strengthened in recent months, while international conditions have weakened – a separation caused by fiscal stimulus from lower taxes in the US, tighter financial conditions in China, and a period of weaker than expected activity in Europe (see Exhibit 2). The regional divergence in growth from what appeared to be a synchronously growing global economy has raised concerns. Could weaker conditions in Europe and China drive a global deceleration? We expect this divergence to be temporary, given earlier-cycle characteristics of Europe's expansion and China's ability to tactically reverse financial tightening measures that have affected its economy in recent months.

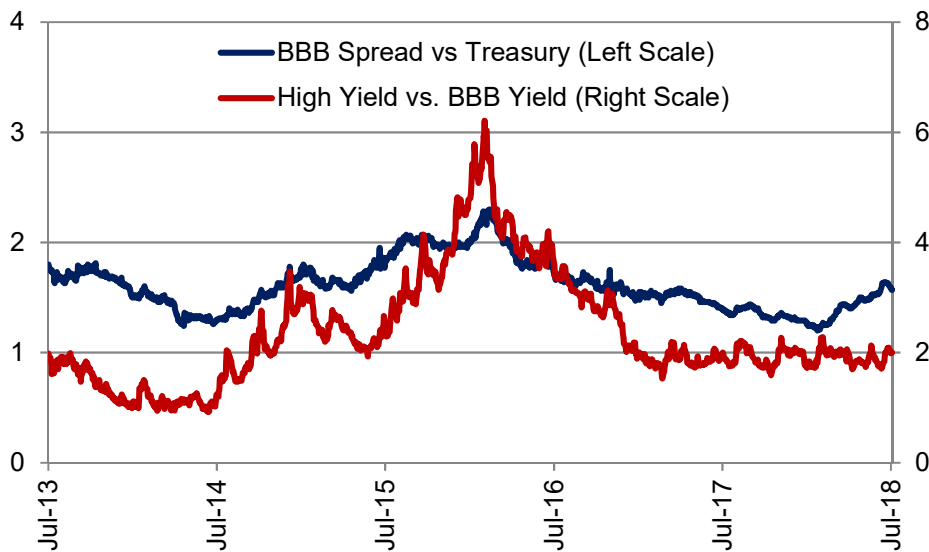
Exhibit 2: US & World ex-US 2018 Earnings Estimate Revision Ratios



Meanwhile, US investment grade credit spreads, the additional yield offered by corporate bonds over the equivalent maturity government bond, have widened since early February (see Exhibit 3). Higher corporate credit spreads have historically predicted turns in the economic cycle.

Increased indebtedness among corporations and the late-cycle nature of the US expansion should limit spread tightening. However, the recent widening may have more to do with fund flows than deterioration in the economic cycle and debt service ability. These flows stem from liquidation of bond holdings held offshore by US corporations who can now repatriate foreign profit at a lower tax rate. High yield (also known as junk) spreads, which have not widened, corroborate this view, since lower quality bonds are more sensitive to deterioration in the economy and are not used to warehouse foreign profits to the extent that investment grade bonds are.

Exhibit 3: BBB Corporate Yield Spread vs. Treasury & High Yield vs. BBB Yield %



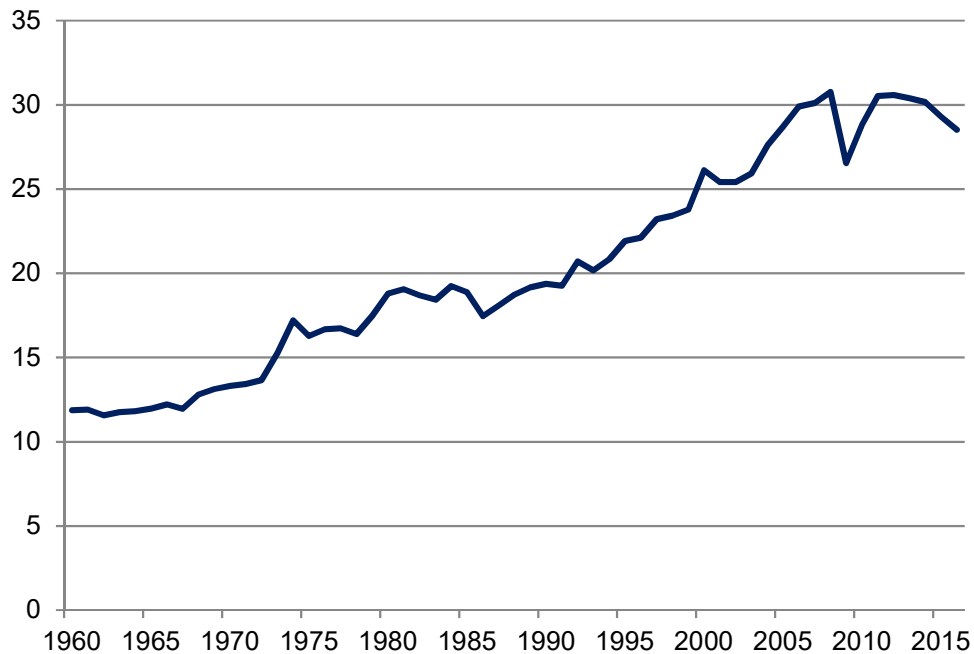
Recent variance in regional growth and earnings expectations and rising risk premia demanded in the corporate debt market have raised some concerns regarding the aging economic cycle. However, when seen in context as part of the normally irregular ebb and flow of growth and, in the case of bonds, market distortions from fund flows related to tax, monetary, and fiscal policy change, these signs appear insufficient to tip our call from “late cycle” to “end of cycle” when seen amidst the broad array of data that continues to point toward growth (see Charts 6-9 on the letter’s final page).

Something Out of the Blue

We discussed briefly in our letter last quarter the threat of protectionist trade policy as perhaps the most relevant risk to the outlook. The recent levy of tariffs on up to \$50 billion of Chinese imports by the US and China’s immediate and proportionate response have raised concerns that an expansive “trade war” may be at hand.

According to the World Bank, international trade has become an essential portion of the global economy that now accounts for almost a third of all activity (see Exhibit 4). Should an expansive and protracted retrenchment in trade develop, we would expect a global, inflationary recession to ensue.

Exhibit 4: Trade & Exports % of the World Economy

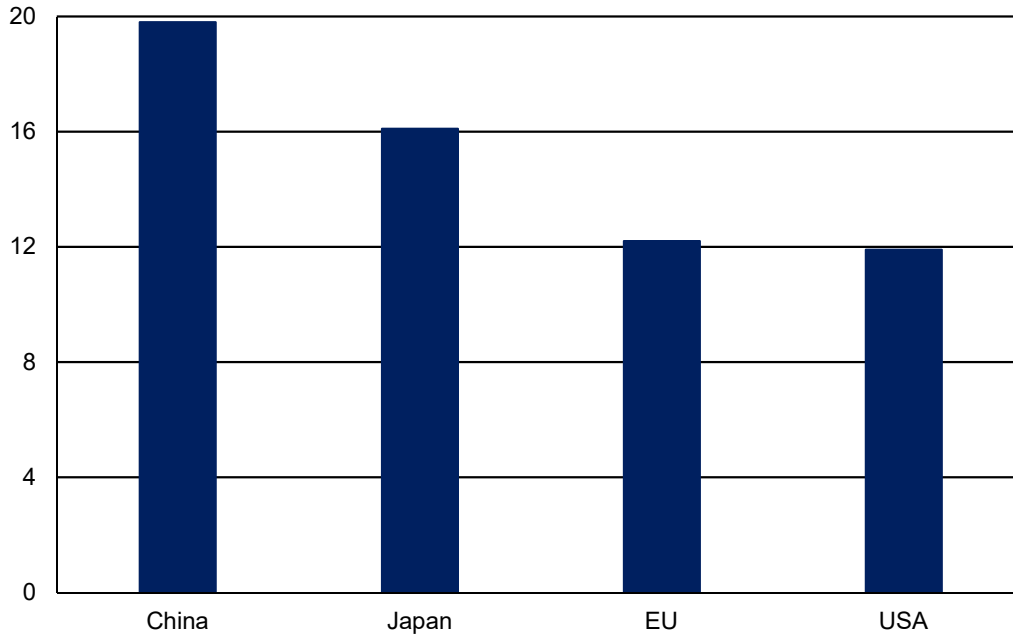


Despite the risk of escalation reflected in president Trump’s further indication to expand tariffs to \$200 billion (or even \$500 billion depending on the tweet) of Chinese imports, we expect moderate behavior to ultimately prevail. Both governments understand the downside risk to a long, all-out trade war from both an economic and political perspective. A trade-induced recession would tilt the 2020 US elections heavily against incumbents, and

continued robust growth has long been one of the reasons the Chinese Communist Party has remained in power.

Trade related concerns may very well worsen before ultimately improving, since the stakes in these discussions include geopolitical considerations. The duration and extent to which trade concerns affect the economy and markets depends on the path toward de-escalation and agreement. The US electoral cycle provides an incentive for the US and a much higher dependence on exports provides an incentive for China (see Exhibit 5).

Exhibit 5: Exports % of Major Economies



Outlook & Strategy

All said, we see the economic and market environment as supportive of continued earnings growth and the allocation stance of our client portfolios – higher equity allocations than historically “normal” proportions that client-specific risk budgets would suggest and a preference for credit premia versus term premia in fixed income strategies.

The recent divergence in global growth, unusual demand for US dollars, and trade tensions have driven a sharp rally in the dollar versus other currencies, outperformance of US versus international stocks, and a crowding into sectors seen as relatively immune to the cycle and its risks (growth, and in particular internet, stocks). A balanced portfolio that includes global exposure and value stocks appears prudent given the economic and market backdrop.

We will continue to watch out for the risk of a trade policy induced recession that would suggest a change in asset allocation between stocks and bonds and modifications to portfolios within each asset class. For now, it’s not the central case in our forecast. But like a soccer game that can turn unexpectedly by a shot out of the blue from mid field, such an outcome and turn in the economy and earnings can happen and must be monitored.

We appreciate your trust in our management of your capital and would welcome further discussion of our outlook and the strategy reflected in your portfolio. Please contact us with any questions. We welcome your call or email.

With best regards,



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Chart 1: S&P 500 Index



Chart 6: US Unemployment Rate %

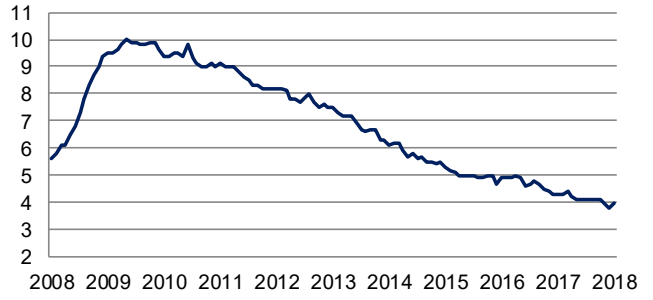


Chart 2: US Treasury 10 Year Yield %



Chart 7: US Consumer Confidence Index

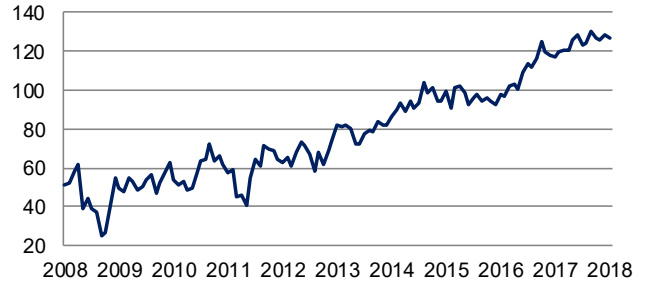


Chart 3: US Annualized GDP Growth %

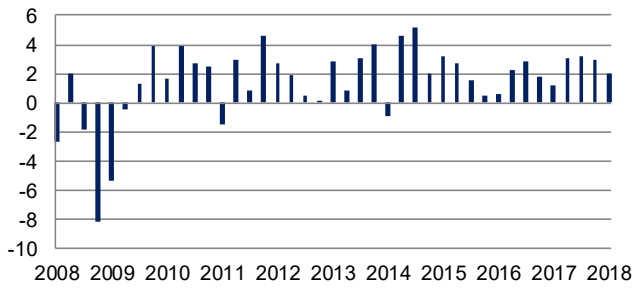


Chart 8: US Retail Sales Growth %

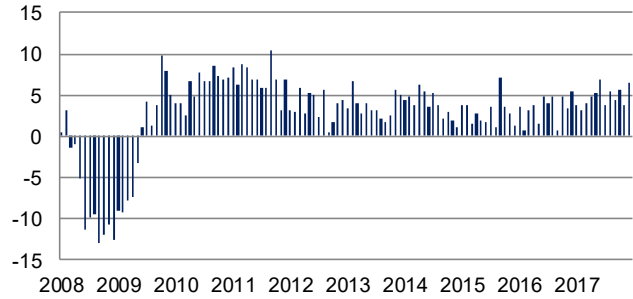


Chart 4: US Core Consumer Price Index %

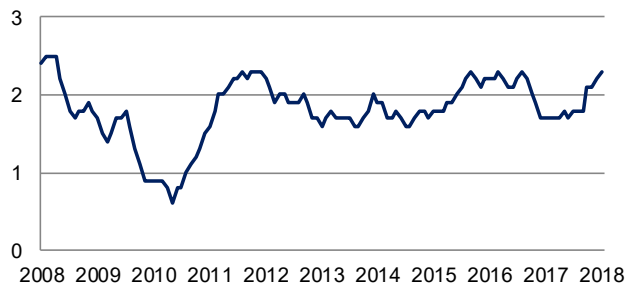


Chart 9: US ISM Manufacturing Index

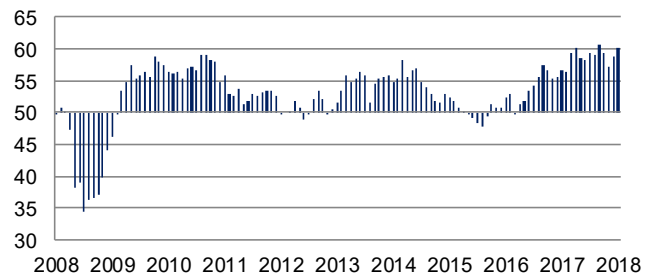


Chart 5: Trade-Weighted US Dollar Index



Chart 10: Conference Board Leading Index

