Sterling Advisors

REVIEW & OUTLOOK - 2Q2018

This Review & Outlook includes commentary on Sterling Advisors' three investment Strategies: Large Cap Value, Large Cap Core and Intermediate Fixed Income. As a valued client, we want you to be aware of and updated on all investment options available to you from Sterling Advisors.

Closing Prices 6/30/2018	
DJIA	24,271.41
S&P 500 Index	2,718.37
Barclays Intermediate U.S. Govt.	2,055.07
Russell 1000 Value	1,187.49
Russell 1000 Growth	1,440.84
NASDAQ	7,510.30
U.S. Treasury Bond	
Current Yield 10-year Bond	2.862%
Current Yield 30-year Bond	2.991%

Source: Bloomberg

The Market Environment

U.S. stock indices posted mixed results in the second quarter, representing a continued pause in the nine-year-old bull market advance. Volatility remained elevated from the calm conditions of a year ago, but did not approach the levels seen during the most recent stock price correction in February. Robust corporate earnings have been offset by concerns over higher short-term interest rates, a notably stronger U.S. dollar, weakness in emerging markets, foreign trade tensions and less liquidity from central bankers. Although the median stock return is negative in 2018, the market-cap weighted S&P 500 Index did post a 3.4% total return for the quarter, resulting in a year-to-date gain of 2.7%.

Policy has been a major influence on financial markets in recent months, specifically the ongoing interest rate normalization goal of the Federal Reserve, and our rapidly changing foreign trade policy. Stock and bond markets have had several years to digest and adjust to the prospect of higher interest rates, with Fed Chairman Powell continuing along the well-telegraphed path laid out by his predecessor. On the other hand, proposed tariffs and intensifying trade tensions with China are recent developments that have caused short-term uncertainties, which financial markets are still in the process of discounting.

The U.S. economy remains on an upward trajectory with strong GDP growth, lower corporate tax rates, tame inflation, full employment, and stable commodity prices. Consumer confidence has rebounded, leading to a recovery in the performance of some retailers. As is often the case, there are parts of the economy that have not participated in the broad-based strength, therefore requiring our attention as potential risks. Housing is a major economic driver that has shown weakness in some regions of the country, likely in response to higher mortgage rates and less affordability. Additionally, the U.S. dollar has emerged from a downtrend, rising sharply in recent months. While this is a positive for those holding or being paid in dollars, it creates headwinds for large-cap multinational companies with significant international operations.

Turning to the internals of the stock market, small-cap stocks outperformed large-cap, and growth bested value in the second quarter. The divergence of returns among domestic stock indices has been attention-grabbing, as evidenced by the tech-heavy Nasdaq Composite's 9.4%, small-cap Russell 2000's 7.7%, and the Dow Jones Industrials' (.7%) year-to date total returns. Regardless of this variance, U.S. stocks have been a standout performer globally, as many international markets have declined, with some emerging markets, including China, sliding into bear market territory. Overall market sentiment has weakened in recent weeks as the mantra of "synchronized global growth" is now being reexamined for validity. This has led to increased levels of more risk-off investor behavior as the U.S. stock market searches for new leadership groups to lead the next leg of the current bull market.

Large Cap Value Strategy

The Large Cap Value Strategy had a challenging second quarter, lagging its benchmark, the Russell 1000 Value Index. The continued outperformance of small-cap stocks and growth over value are two trends that persisted through the second quarter, creating a headwind for our large-cap (over $5 billion market cap) relative value approach. Our idea generation process continues to uncover investment ideas, including new positions within the Technology, REIT, Industrial and Energy sectors during the quarter. The investment team remained committed to our sell discipline, eliminating several holdings based on full valuation or our anticipation of changing industry fundamentals. We have seen increased earnings estimates along with a moderation in equity valuations in most market sectors, which allowed our quantitative screening process to include some previously unattractive equities as new buy candidates.

The majority of the relative underperformance in Q2 stemmed from stock selection. In aggregate, allocation decisions to actively overweight or underweight individual sectors had a neutral impact on the quarterly results. Stock selection within the Financials and Consumer Discretionary areas were the biggest detractors, whereas our holdings in Materials and Technology provided the biggest boost to relative performance. As of the end of June, Technology and Industrials stand as the Strategy's most overweight sectors vs. the benchmark, while Financials and Consumer Staples are areas where we remain most underweight. The average cash level during Q2 was 7.8%, slightly above the Strategy's historical average, based on our expectation of above normal volatility in the months to come. It should be noted that the sector weightings of different stock indices do vary greatly. For example, Technology finished the quarter as a 9.2% constituent of the Russell 1000 Value Index, its fourth largest sector. In comparison, Technology accounted for 25.5% of the S&P 500 Index at the end of the second quarter, its largest sector by a wide margin.

We'd like to provide an update on changes to prominent investment themes that exist within the Large Cap Value Strategy. We have continued to cut back or eliminate portfolio holdings with exposure to the housing market. Although the Strategy does not hold shares of any homebuilding stocks, we have had successful holdings in several suppliers of household appliances, building materials, etc. Individual holdings in these areas, while of the highest quality relative to peers, have been trimmed or sold in recent months based on our expectation of gradually rising interest rates and their impact on affordability. Staying on the interest rate theme, the Strategy made significant additions to holdings in the REIT sector during the quarter. We found opportunity in REITs that suffered sharp share price declines in Q1 as market participants indiscriminately sold higher dividend-yielding securities in reaction to rising interest rates. It is our view that individual REITs with strong business fundamentals and superior dividend growth remain well-positioned while helping to diversify the portfolio. Finally, we have taken on a more optimistic view of the Energy sector, with a tilt toward domestic producers and service companies with high-quality balance sheets. This is an area that typically does well in the later stages of a business cycle, and one that we think will continue to benefit from stable commodity prices and the U.S.'s emergence as a major global producer and exporter of oil and natural gas.

Large Cap Core Strategy

In the second quarter, tax reform and tax cuts took center stage as companies and business owners cheered the recent policy changes. Hundreds of companies announced bonuses or other increases in benefits. As a result, small business and consumer confidence has been surging recently and immediate expensing of capital should prompt companies to invest in their business rather than engage in financial engineering. This increased level of capital expenditures should lead to stronger productivity. The question is, how long will stronger productivity last? Trade tensions have heated up and we see the evidence of the volatility in emerging market currencies, commodity prices and overall investor nervousness. It is difficult for investors to grasp the predictability of future company earnings once tariffs are involved.

The breadth of the market continues to be very narrow with just a few stocks continuing to keep the overall market averages up. Company earnings have been robust, but price to earnings multiples have been compressing in the face of higher interest rates. Investors are questioning it might not be a great backdrop to pay a premium for future earnings growth that might not be all that it is expected to be. We continue to participate in the market advance, but focus on defensive posturing to protect the accumulated gains investors have made since the last bear market low in 2009.

Our team continues to position the largest portion of the portfolio in Technology, Healthcare, Financials and Industrials. These areas should continue to do well with robust economic activity, higher inflation and elevated interest rate levels. We are on the hunt for long term growth themes and how best to invest in them. Examples include U.S. energy production, robotics, faster broadband and data usage, artificial intelligence and efficiency in healthcare. However, we monitor all areas of the market and have been tactically investing in the Utility, Real Estate and Consumer related areas to take advantage of income and growth expectations that we feel are not reflected accurately in current stock price levels for future appreciation. Finally, we have been investing in companies that derive most of their revenue from the United States. These companies tend to perform better when the U.S. dollar is increasing, which benefits in times of uncertainty.

Intermediate Fixed Income Strategy

Turning to the internals of bond markets, most fixed income categories declined over the course of the second quarter as interest rates increased and investment grade corporate credit spreads widened. That combination, generally, restrains bond prices. While the specter of trade wars represents a risk to growth that could cause yields to dip in near term, we continue to believe rates will rise over a 12-month horizon. We believe the present environment of favorable domestic economic growth and inflation will cause the Fed to raise rates more than many think. As such, we think the yield curve will continue to flatten where long-term rates rise less than short-term rates. The Fed has cautioned, however, not to read too much into the fattening and the potential for inversion. We agree with the Fed that the flattening is not denoting nor is it likely a harbinger of a coming recession.

Tactically, however, there are enough risks that loom large enough to justify some degree of caution, and we have begun to slowly lighten up on our corporate bond exposure, directing proceeds into U.S. Treasury & Government Sponsored Enterprise issues. We are also maintaining our neutral to slightly-under-weight duration posture relative to benchmark.

Outlook

Financial markets spent the first half of 2018 digesting the gains of the last few years, while encountering a new set of uncertainties to hurdle. Topping the list are trade tensions with China, a much stronger U.S. dollar, stress in many emerging markets and less evidence of synchronized global growth. Given the aggressive earnings expectations that exist for U.S. corporations, we think it is important that investors temper their expectations and expect to see some market volatility in the months ahead. It is likely that earnings shortfalls will be met with disappointment, leading us to an increased focus on companies with strong earnings consistency and defensive characteristics. Proven management, reasonable valuation, outstanding balance sheets and dependable dividend growth are attributes found in our portfolio holdings. Our outlook is that stocks and interest rates are likely to remain range-bound through the end of 2018, as the market takes a wait and see approach to trade tensions, Fed policy and elevated earnings expectations. Our goal is to remain patient and disciplined, positioning our clients to benefit from sector and style rotation that is likely to occur under the surface, even if major stock indices do not immediately resume their bull market advance.

Although equity valuations remain closer to the high end of their historical range, stock prices, in aggregate, have stopped rising faster than earnings estimates, which has allowed valuation ratios to moderate. In addition, the richly valued Technology sector, accounting for over 25% of the S&P 500, has a dramatic impact on the overall market valuation. In our view, two primary risks to equities are a sharper than expected rise in interest rates, and a shortfall in corporate earnings growth, given the lofty expectations that exist today. We believe that current market internals indicate a high likelihood of a period of mean-reversion, away from growth and momentum strategies and toward fundamentally strong companies displaying value-oriented characteristics. We continue to maintain diversified equity and fixed income portfolios for our clients, with a focus on avoiding areas of elevated risk, while working to provide competitive returns that will build wealth over time. As always, we will monitor the economic environment for material changes and adjust our outlook accordingly.

Sources: Bloomberg

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Dow Jones Industrial Average: The most widely used indicator of the overall condition of the stock market, a price-weighted average of 30 actively traded blue chip stocks, primarily industrials. **NASDAQ Composite Index:** Measures all NASDAQ domestic and international based common type stocks listed on The Nasdaq Stock Market. The NASDAQ Composite is calculated under a market capitalization weighted methodology index. **Standard and Poor's 500 Index:** Capitalization-weighted index of 500 stocks, including the reinvestment of dividends and other distributions, designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. **Russell 1000 Value** Measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.