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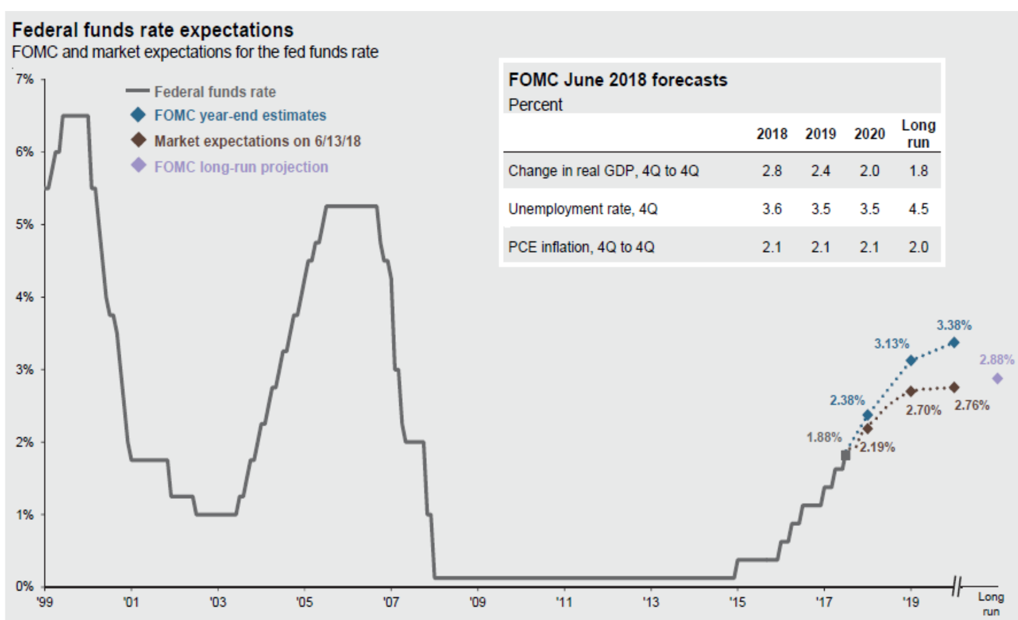
Recap of Q2 2018 Markets and Economy

Volatility subsided in the second quarter despite renewed fears over a looming trade war with China as well as ongoing concerns over the Fed's interest rate policy. U.S. equity markets managed to erase the losses of the prior quarter and posted nominal gains for the year keeping the existing bull market trend intact. While investors have already experienced a correction this year, it is important to remember that "bull markets don't die of old age."

U.S. Economy and The Federal Reserve

Global economic growth continued at a steady rate. U.S. GDP came in at 2.0% annualized for Q1 and is expected to exceed 4% annualized for Q2. The U.S. economy is now in its 9th year of expansion, the 3rd longest on record. The employment picture for Q1was strong with unemployment at a cyclical low of 4.1%. Q2 unemployment is expected to remain at a similar level. The housing market was mixed as year over year home prices were up even though home sales over the same period were flat to only slightly positive. Inflation remained close to the Fed's long-run target of 2%. This collective positive data supported the Fed's decision to raise the federal funds rate target by 0.25% in June to a range of 1.75% -2.00%. Market expectations are still calling for an additional 1-2 increases in 2018.



Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management.
Market expectations are the federal funds rates priced into the fed futures market as of the date of the June 2018 FOMC meeting.
Guide to the Markets – U.S. Data are as of June 30, 2018.

Tariffs

The Fed's policy took a backseat to the Trump Administration's recently imposed tariffs on Mexico, Canada, the EU and most notably China. In general, tariffs have been viewed as an impediment to global economic growth. However, the initial scope of proposed tariffs does not seem as daunting to the prospects of

31 State Route 12, Flemington, NJ 08822 | 908-782-0001 | FAX 908-782-4168
Schoolhouse Plaza, 374 Millburn Avenue, Millburn, NJ 07041 | 973-532-6770 | FAX 973-218-1452
800-743-4768 | pwm@prestigewmg.com | www.prestigewmg.com

the U.S. economy since tax reform and higher government spending should be able to offset most of the negative effects produced by these tariffs. Also, the relative strength of the U.S. dollar and strategic weakening of the Chinese currency should hinder rising costs with many of the affected trade partners. Although the uncertainty surrounding trade negotiations has unnerved many investors, it is critical to keep in mind that very little has been finalized with many of our key trade partners. Also, stronger global growth and above average earnings growth driven by tax reform should provide some insulation to the U.S. economy against the imposition of further measures.

Equity Markets

Global equities have exhibited greater volatility for the first half of the year compared to 2017. After posting negative returns in Q1, broad U.S. markets managed to recover in Q2. Much of this recovery can be attributed to the earnings season confirmation of double digit earnings growth (compared to the same period last year) for most of the S&P 500 sectors. It was the highest earnings growth rate for the S&P in seven years. Unlike prior years, large-cap stocks underperformed their small-cap counterparts for the quarter. However, growth continued to outperform value across the entire market cap spectrum maintaining last year’s trend. When assessing the performance attribution of the S&P 500 for the year, it is remarkable to see that the returns so far have only been represented by a handful of Tech and Consumer Discretionary companies.

International Developed and Emerging Markets were weak for the quarter. Tariff talks as well as broad Emerging Market currency weakness (due to a strengthened U.S. dollar) were the primary contributors of this. While a weaker currency can be viewed positively by an exporting Emerging Market country from the perspective of more competitive trade, it does make the U.S. dollar denominated debts of heavily indebted countries more difficult to service putting more strain on these markets. After being modestly positive for the first quarter, Emerging Markets stocks posted low double-digit losses in Q2. International Developed Markets posted small losses for the quarter as well.

Fixed Income Markets

U.S. bond rates continued to tick higher with the Fed raising rates in June. It is important to note that even though the Fed is raising rates, the pace of increases continues to remain slow and rates are still low by historical standards. Short-term U.S. Treasury rates for the second three months of 2018 rose in concert with the Fed’s second-rate hike. However, the rate on the 10-year U.S. treasury barely moved from its close of the prior quarter. The narrow difference between longer-term bonds and shorter-term bonds (otherwise known as “flattening of the yield curve”) created some concern as well as opportunity for bond investors. Certain financial media outlets have prematurely labeled the recent flatness of the U.S. Treasury curve as an immediate prelude to an inverted yield curve (short term rates being higher than long-term rates). Historically, an inverted yield curve has been a reliable indicator of recessions when used with other dependable leading economic indicators. When viewed alone, this metric has provided many false signals. In our opinion, the U.S. economy remains resilient and we do not believe that the recent movement in short and longer-term rates is an immediate cause for concern.

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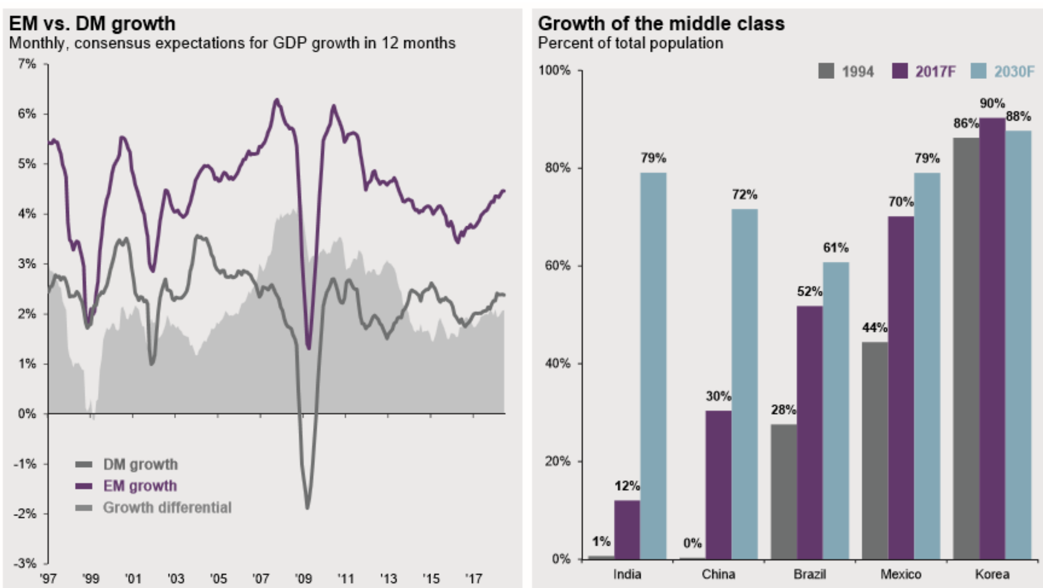
Therefore, we used the recent move in short-term rates (and lack of movement in long-term rates) as an opportunity to further reduce the interest rate risk in our bond allocations by purchasing shorter-term bonds and substantially reducing exposure to longer-term bonds as we did not feel that investors are being properly compensated for the interest rate risk of most longer-term debt. Interest rate risk being the potential for a bond's value to decline as interest rates rise.

Outlook for Q3 2018 and Beyond

Compared to the start of the year when the S&P 500 traded above 18 times forward earnings, valuations now seem more grounded with forward earnings catching up to the previous steeper price levels exhibited in January. The index now trades at approximately 16.4 times forward (next 12 months) earnings which is close to the 25-year average. When factoring in the high single digit revenue growth and high expected earnings yields for the remainder of 2018, one could argue that stocks are attractively priced. . This environment is certainly supportive of earnings multiple expansion and higher equity prices. However, we are cognizant of the potential impact that further trade talks or a stronger U.S. dollar could have on limiting the upside potential for equity prices.



Source: J.P. Morgan Asset Management; (Left) Consensus Economics; (Right) Brookings Institute.
"Growth differential" is consensus estimates for EM growth in the next 12 months minus consensus estimates for DM growth in the next 12 months, provided by Consensus Economics. Middle class is defined as $3,600-$36,000 annual per capita income in purchasing power parity terms. Historical and forecast figures come from the Brookings Development, Aid and Governance Indicators.

Relative values remain attractive for International Developed and Emerging Markets stocks despite the recent underperformance. Compared to U.S stocks, the price/earnings multiples have lagged for most of the current business cycle. Granted, the delayed monetary expansion for some of these economies as well as various geopolitical headwinds abroad have contributed to this gap. Nonetheless, many economic and valuation metrics (i.e. dividend yield and earnings yield) compel us to own these asset classes for the long-term. This is especially true when assessing the merit of emerging markets as a part of one's diversified international stock exposure. Many attributes of developing economies are supportive of above average growth potential when compared to mature economies like the U.S. The expansion of the middle class has been a leading factor for these developing economies to deliver consistently higher GDP growth which has been over twice the rate of almost all developed nations.

The investment policy committee at Prestige remains diligent in constantly monitoring your portfolio and the capital markets. Regardless of the uncertainties that could arise because of future trade negotiations, geopolitical tensions or unexpected changes in economic conditions, we firmly believe that that maintaining a well-diversified and disciplined investment process are critical to investors' long-term success.

Our focus is on helping you meet your personalized goals through customized financial planning and diversified professional investment management. We can discuss your situation at your next review meeting or you can call to schedule an appointment. As always, we appreciate the opportunity to assist you in addressing your financial matters.

Roy Williams, ChFC John DeAngelo, CFP® Alyssa McMahon, MBA, CFP®, CFA Paul R. Esposito, CFP®, CFA

Sources for graphs: *JP Morgan Market Insights.*