an excerpt from

the 9:05

Bailard Wealth Management
Quarterly Review of Economic and Market Developments*

Q1 2018

Inside Q1 2018:

**Please see page 12 for important disclosures.*

Q & A

WITH BAILARD'S SVP OF INTERNATIONAL EQUITIES

U.S./China Trade: Tiff, Stand-off or War?

Anthony Craddock, Senior Vice President, examines the state of trade relations between the U.S. and China.

Where do the U.S. and China stand and how did we get here?

Renegotiating trade deals and overhauling U.S. policy in order to protect American workers and industry was a central promise of Donald Trump's presidential campaign. In its first year, the Trump Administration was fairly quiet on this front before announcing tariffs early in the first quarter on imported solar panels, which mostly affects China. This was followed in March by hefty new tariffs on steel and aluminum imports, where temporary exemptions granted for most countries left the focus of this action also primarily on China. Early April brought a rapid acceleration of tensions, with competing announcements separated by hours rather than days. In response to the steel tariffs, China imposed tariffs on around $3 billion of U.S. imports, including pork and fruit products. The U.S. then targeted about $50 billion in Chinese electronics and machinery, a move designed to penalize China for its cavalier treatment of intellectual property. China immediately matched this with levies on roughly $50 billion of U.S. soybeans, autos and airplanes. The latest salvo was a presidential order to consider an additional $100 billion of Chinese products for possible tariffs.

So this is a trade war, right?

Events have been moving quickly but, for now, there are reasons to hope that the escalating "tit-for-tat" tariff announcements will end up sounding like the opening fanfare for a round of bilateral trade negotiations. The $50 billion in tariffs proposed by the U.S. came with a comment period before they go into effect; statements from the U.S. Commerce Secretary and others have suggested the Trump Administration is willing to deal.

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China's selection of products—intentionally targeting soybeans and other goods from predominantly Republican states—may increase the momentum for negotiation, rather than war, in the run-up to U.S. midterm elections.

What's our problem with China anyway?

The U.S. does have several legitimate grievances. American firms wanting to operate in China are often required to share proprietary technology with Chinese partners. The relatively lax enforcement of intellectual property rights law makes it easy for the technology to then be used or copied outside of the original partnership. China could also do more to lower its tariffs on imports from the U.S. and relax non-tariff barriers, including financial sector regulations that make it difficult for foreign banks and insurers to establish themselves in China. Additionally, the U.S. trade deficit with China is an eye-popping number: $375 billion in 2017, the highest level on record. Free trade skeptics in the Administration consider the large, persistent deficit to be clear evidence of unfair Chinese trade practices and an illustration of the damage done by globalization to American manufacturing prowess.

Benefitting from trade is ... not mutually exclusive and both the net exporter and the net importer can be better off.

What's wrong with fighting back then?

Tariffs are the bluntest of blunt instruments when it comes to addressing a trade imbalance or "leveling the playing field." If tariffs succeed in causing a drop in imports from China, reciprocal tariffs will likely make U.S. exports to China fall as well. A series of tariff impositions can therefore leave the trade balance largely unaffected while managing only to reduce overall trade flows. Further, a reduction in imports from China would do collateral damage to other countries, such as Japan and Taiwan (not to mention the U.S.), that manufacture components for products ultimately assembled in China and exported from there.

Meanwhile, costlier imports reduce the purchasing power of American consumers and the profitability of businesses that use those products. Raising the price of imported solar panels might give relief to domestic

If this is a chronic illness, it is taking a long time for the patient to die.

manufacturers but it will also hurt the many American installers. The negative impact of one particular action may be considered minor in terms of incremental cost relative to GDP, but successive escalations create heightened uncertainty for business decision-making and add extra volatility to the financial markets.

But didn't I hear somewhere that trade wars are good and easy to win?

We believe a full-blown trade war with China would impair growth in the world's two largest economies, disrupt global supply and distribution chains and raise prices for consumers worldwide. Tariffs declared in the midst of heated battle could influence investment and employment decisions, with impacts stretching over years and decades. It's true that the U.S. is more geared to domestic demand and less dependent on trade than many nations including China, so the Chinese could indeed have "more to lose" in a trade war than the U.S. On the other hand, the lack of any lines of accountability from the Chinese government to its people means that China can probably tolerate greater economic pain in the service of its strategic trade goals. Ultimately, the fact that "winning" a trade war means, at best, causing less harm to your own country than to another tells you that it's better not to fight in this way at all than to win.

Stopping short of a war, how do we fix the trade deficit?

First of all, it's unhelpful to view exporting more than you import as "winning" in trade and the reverse as "losing." Benefitting from trade is not really a matter of selling more to your trading partners than they sell to you. Rather, the gains from trade are the production efficiencies and lower prices that come from specialization. It is not mutually exclusive and both the net exporter and the net importer can be better off. Globally-competitive exports are nice to have, of course, but the production side is only one half of the economic story. A country in surplus—providing goods and services in high demand by other nations—might also be one whose citizens are too eager to save and too reluctant to spend, where domestic demand is insufficient to utilize the country's full productive capacity. A country in deficit, conversely, might be one where aggregate demand outstrips the country's capacity to efficiently supply it through domestic means alone, whose citizens are borrowing rather than saving, spending freely and enjoying well-priced, competitive goods from abroad.

So, forget the trade deficit?

There are good reasons to pursue a fresh set of trade negotiations with China (if that's what we're doing) as well as remedies through the World Trade Organization (which we are definitely doing), but to fixate on the trade deficit seems a bit masochistic. The U.S. has run a deficit with the rest of the world in every year since 1976, through expansions and recessions, through Democratic and Republican administrations, cumulatively totaling well over $10 trillion. If this is a chronic illness, it is taking a long time for the patient to die.

Balance of payments arithmetic ensures that the extra dollars sent abroad for all those imports eventually get recycled back into the U.S. as investments: in property, factories and financial assets including, crucially, Treasury bills. In the case of China, there is a fear that the country will someday decide to curtail its purchases of U.S. government debt. Since U.S. Treasuries represent both the safest possible investment vehicle for China's excess dollars and the mechanism by which China helps us finance the purchase of their exports in the first place, it's not clear what they would choose as a large-scale, long-term substitute. The past 30 years have seen the economic ties of the two countries evolve into a state of deep inter-dependency, which brings benefits to both and which will almost certainly outlast the current kerfuffle.

After all, trade may be managed but it is not coerced. Aggregate flows are the result of individual, self-interested buyers (more American than Chinese) and sellers (more Chinese than American) who have all spotted what they believe to be a good deal. America first, sure... but we're all in this together.

America first, sure... but we're all in this together.

U.S. ECONOMY

Although Edging Upwards, Slow Growth Continues

Final GDP for the fourth quarter was revised higher to 2.9% (annualized) from the earlier 2.5% estimate; further, the year-over-year pace increased to 2.6%. This third consecutive quarter of growth around 3% represents the upper end of the slow growth range. Historically, growth between 3% to 4% is deemed moderate, with growth exceeding 4% considered boom times. As reflected in the chart below, GDP growth has been muted, averaging only 1.9% since 2000. This is in contrast to, and well below, the long-term post-WWII average rate of 3.8%. The secular trend in slow growth is likely to continue to be driven by excessive debt that has borrowed demand from the future (and eventually will have to be repaid), an aging population in the developed world and slow growth in productivity.

Changing Economic Drivers

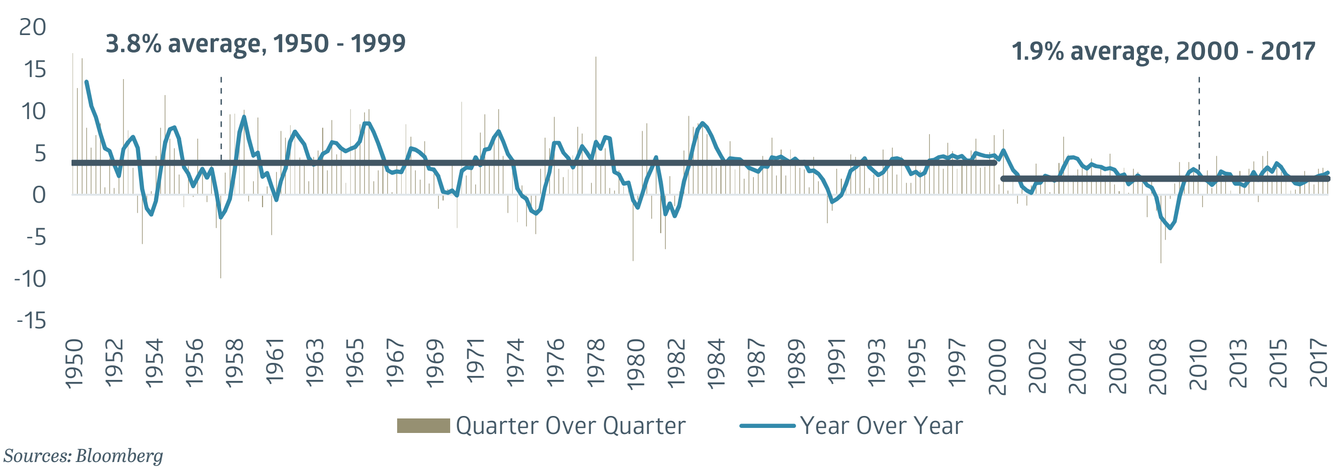
The post-hurricane rebuild supported residential housing in the fourth quarter, which had declined in the previous two quarters. Further distortions included auto sales boosted by replacement demand and increased government spending related to the rebuild. These impacts from the 2017 hurricanes are largely behind us. Tax cuts could give the economy a one-time boost in the short term but rising interest rates might serve as an offset, and the underlying income growth suggests continued slow growth.

So far in the first quarter of 2018, we have seen two small declines in retail sales but industrial production was up a nominal 3% (annualized). With production rising faster than sales, inventories increased and will add to growth for the first quarter. However, inventories that are rising relative to sales indicates they will likely need to be reduced in future quarters. Auto sales fell in January and February, home sales trended lower as mortgage rates increased, and the trade deficit continued to deteriorate early in the quarter. According to the Atlanta Fed GDPNow Model and the Bloomberg consensus of economists, growth is expected to be up by 2.0% to 2.5% for the first quarter of 2018.

More Spending, Less Saving

Real personal income growth increased 2.1% over the last year, setting the base for real personal consumption growth of 3.1% (year over year, ending February 28, 2018). The difference between spending and income was driven by a sharp decline in the savings rate and a jump in credit card debt, meaning consumers are supplementing income by taking on more debt and saving less. This is unsustainable, particularly if the Federal Reserve (the "Fed") continues to increase rates as expected. However, if financial markets continue to deteriorate or if economic data confirms a deceleration in first quarter growth, the Fed could provide relief by delaying the rate hikes or even cutting rates. We are not there yet but as the year progresses—and if the first quarter slowdown is confirmed and extended—the Fed could reverse its planned course.

Real Economic Growth (RGDP, %), 1950 - 2017



Sources: Bloomberg

INTERNATIONAL ECONOMIES

Generally Healthy Slow Growth and No Lack of Political Intrigue

CHINA

In the fourth quarter of 2017, China's GDP growth slowed more than expected to 6.4%, below the year-over-year increase of 6.8%. Since 2012, China has been in an "L-Shaped" recovery, exhibiting growth just below 7%. China's growth had surged above 7% ahead of last October's 19th Party Congress, but with the Congress behind it, growth has slipped back. Bank lending and credit flows in China are trending lower, suggesting continued but moderate deceleration.

Chinese Government Policies

During the quarter, the Chinese government announced its 2018 economic growth target of 6.5%, ramping up efforts to reduce risks in the financial system and closing down inefficient, polluting factories. In addition, China has announced plans to shrink its budget deficit to 2.6% of GDP, down from 3.0% in 2017. The lower target will have to be achieved through reduced spending, given that tax cuts were also declared this year. This greater restraint in government spending is one reason to expect slower growth.

Additionally, after years of heavily investing in infrastructure, China appears to be curtailing expansion in order to focus on growing into its prior investments. The old way of boosting local GDP by building unneeded projects appears to have come to an end.

Military spending is one area where China intends to increase spending. The sector is forecast to rise 8.1% in 2018, faster than last year's 7.0% increase.

> The lower growth target will have to be achieved through reduced spending, given that tax cuts were also declared this year.

Trade Between China & the U.S.

President Trump's imposition of tariffs on steel and aluminum, among other things, has increased fears about a trade war, which could hurt China's export machine. The danger for growth comes from retaliatory trade measures and the disruption of complex supply chains that could impact global trade more widely. For further discussion of the state of trade relations with China, please see the Q&A feature on page 1.

JAPAN

In contrast to much of the world anticipating stronger growth and higher inflation, Japan is sinking back into disinflation and renewed slow growth. In February, Japanese headline inflation fell back to 1.0%, with most of the increase due to rising energy costs. Underlying inflation in Japan has been well contained. The Core Consumer Price Index—which excludes both food and energy—was up 0.3% year-over-year.

Japan's real household income fell 1.7% year-over-year in January and real household spending increased 2.0% for the same time period. Japan, like most other developed countries, is maintaining spending levels by saving less and taking on more debt. Even with higher debt and lower saving—as well as a surge in public work spending in the latter half of 2017—growth is relatively slow. Underlying organic growth remains sluggish.

The deterioration in the trade balance from surplus to deficit is likely adding to the first quarter's weakness, as imports increased (oil) and export growth slowed to 1.8% year-over-year, ending February 28, 2018. The Japanese yen has continued to strengthen in 2018 and a stronger yen is likely to work against the trade balance. Inventories in Japan are climbing again: production is running well ahead of retail sales and the inventory-to-sales ratio is rising. This could be another drag on growth as corporations endeavor to bring down inventories in coming quarters.

Growth in Japanese lending and M3 (a measure of money supply) has also been slowing. However, the Bank of Japan (BOJ) continues to expand its balance sheet, albeit at a slower pace. The BOJ also continues to purchase stocks, providing artificial support to the market.

EUROPE

The Eurozone economy grew at a healthy 2.4% pace in the fourth quarter of 2017 and 2.7% year-over-year. The expansion has been broad-based, boosted by manufacturing, construction, capital spending and trade, as well as modest gains in household consumption. This was the strongest growth rate in over a decade and the European Central Bank (ECB) is predicting 2.3% growth in 2018.

Quantitative Easing Coming to an End

The region continues to garner support from the still extremely accommodative ECB. During the quarter, the ECB trimmed its asset purchase program from €60 billion per month to €30 billion per month. This September, the ECB is planning to end the program—and its quantitative easing—entirely. At that point, with the central bank intervention ending in Europe, interest rates are likely to rise.

Europe, like the rest of the developed world, has been growing on the back of massive debt creation and state-sponsored asset purchases. This type of growth is unsustainable when it is increasing faster than GDP and/or as interest rates rise. Debt-driven growth is effectively borrowed from the future; as it is repaid, there will be less income for other spending.

This September, the ECB is planning to end its quantitative easing program entirely.

Considerations on the Political Front

There have been plenty of surprises in European politics in recent years, beginning with the Brexit referendum in June of 2016, calling for the U.K. to leave the European Union (EU) and the subsequent invocation of Article 50 of the Treaty of Europe the following March. The Brexit negotiations have sputtered along, with progress being heralded as a positive for asset prices, and any setbacks as a negative.

There have also been a number of elections in Europe where the *status quo* has been maintained, even as populist anti-government and anti-euro forces garner more support. However, Italy's election in early March was one exception. The populist, anti-euro Five Star Movement emerged as the largest single party with 32% of the vote, while the right-leaning alliance of the Northern League and Berlusconi's Forza Italia claimed 37% of the vote. It is still uncertain who will be asked to form the next government: the Five Star Movement or the right-leaning alliance. The Five Star Movement previously said it would not join any coalition but now seems to have changed its mind; Luigi Di Maio, said the party is willing to form a coalition with either the Democrat Party (PD) or the Northern League. The center-Left PD Party, which won only 19% of the vote, seems determined to be an opposition party but could emerge as the kingmaker. The Five Star Movement has ruled out any association with Berlusconi's Forza Italia given his conviction on tax fraud and government corruption.

FIXED INCOME

Higher Interest Rates and Increased Volatility

Interest rates increased significantly over the first quarter as did bond market volatility. Ten-year U.S. Treasury yields rose to a high of 2.95% before backing down and ending the quarter at 2.75%—0.34% higher than the previous quarter. Solid global economic growth combined with the ECB's reduction of its bond purchase program, Trump's tax cuts and the Fed's unwinding of its massive balance sheet all contributed to higher interest rates. Inflationary fears in the U.S. returned as a strong employment report showed moderate wage gains. Higher inflation expectations—coupled with a heavy anticipated Treasury supply—drove rates higher across the Treasury yield curve. The yield curve remained the flattest it has been in ten years.

Rates might have risen more had foreign buyers not increased their demand for Treasuries. As of quarter end, foreign buyers bought slightly over 20% of Treasuries at auctions, the highest participation rate since 2011. Some emerging market central banks have been buying Treasuries to help slow the appreciation of the dollar relative to their currencies, which would hurt their exports. Relatively slow economic growth and still-low inflation also restrained the level of interest rates. The Barclay's U.S. Aggregate Bond index (a broadly-diversified index that includes Treasuries, agencies, corporates and mortgage-backed securities) decreased 1.5% over the quarter. The BofA Merrill Lynch 1-10 Year U.S. Corporate index lost 1.5%, and the Barclay's 1-15 Year Municipal Blend index was down 0.9% for the same time period.

Federal Reserve Monetary Policy

Jerome Powell was sworn in as Fed Chairman in February. In his first Federal Open Market Committee (FOMC) meeting, the Fed raised rates a much-anticipated 0.25%. The market continues to expect two more rate hikes in 2018 and the Fed stated it plans to raise rates another three times in 2019. The Fed is continuing its program to "re-normalize" its massive $4.5 trillion balance sheet of Treasuries and mortgage-backed securities (MBS) by allowing more securities to roll off each month without reinvesting the principal. The maximum to be rolled off each quarter is $30 billion in Treasuries and $20 billion in MBS.

Bond Market Recap

The larger Western central banks—including the Fed, ECB, the Bank of England and the Bank of Canada—continue their tightening, or at least less easing, monetary paths. The impacts of Trump's late-cycle fiscal stimulus (tax cuts) are still to be determined. With the Fed raising short-term interest rates, both the London interbank offered rate (LIBOR) and Treasury bills are at levels not seen since 2008. This has affected rates for commercial paper as banks compete to attract investors. The LIBOR spread above the overnight index swap rate (LIBOR-OIS) has widened to levels not seen since the 2008/2009 financial crisis. This spread is often seen as a gauge of the credit risk within the banking sector. However, rather than being an indicator of systemic risk in the financial system (as it was in 2008/2009), its high level is now more a reflection of heavy Treasury issuance and the change to the U.S. tax system. The tax law change makes it easier for firms to repatriate cash back to the U.S., and the Base-Erosion and Anti-Abuse (or BEAT) tax makes interest paid by U.S. affiliates on money received from their foreign-domiciled headquarters no longer tax deductible in the U.S. Therefore, those flows from foreign-domiciled headquarters are decreasing and being offset by more commercial paper lending in the U.S.

In connection with a January deadline, lawmakers suspended the debt limit yet again, this time through March 1, 2019. Once the suspension ends, the amount borrowed during the suspension period will be added to the legal debt limit. The Committee for a Responsible Federal Budget estimates that by March of 2019 the new debt limit could be reset as high as $22 trillion, or $1.5 trillion higher than today. Since 2013, Congress has passed five debt limit suspensions.

Bond Market Outlook

The economy should grow marginally faster under the new tax law. We expect growth and inflation to remain constrained, with real GDP under 3% and inflation lower than the Fed's 2% target. As such, we believe the economy is not strong enough for rates to spike dramatically higher from their current levels. With so many foreign sovereign bonds trading at negative yield levels, demand for U.S. bonds should remain high. However, as central banks around the world move to more normal monetary policy from current simulative policies, rates may come under some pressure and move moderately higher.

DOMESTIC EQUITIES

Perceived and Actual Risks in Stock Market Corrections

In the U.S., 2018 started off markedly similar to 2017 and the several years preceding it. Domestic stocks initially moved smoothly higher, but the similarities quickly began to fade toward the end of January. A 10% correction—the largest drop in the S&P 500 index seen since September of 2011—and the substantial volatility through quarter end caught the attention of even the previously most blasé investor. In spite of all that action, for the full quarter, the S&P 500 was down less than one percent (0.8%). Technology stocks and small cap value stocks both followed a similar course in the first quarter, though a stronger start and vigorous rebound left tech stocks (as measured by the S&P NA Tech Index) up 6.7%. In contrast, a slower start and more tepid rebound left small value stocks (as represented by the CRSP Small Cap Value Index) down 2.1%.

Perceived vs. Actual Risk

With recent stock market volatility increasing investors' perception of risk, it is a good time to review the concepts of perceived risk versus actual risk. A non-investment related, but hopefully familiar, example may help to clarify the differences between the two.

Observant motorists may know that when a police car is spotted on the side of the road, drivers tend to slow down and remain at a lower rate of speed for miles after the encounter. Many police departments take advantage of this phenomenon by temporarily parking an empty patrol car in areas plagued by excessive speeding.

Perhaps counterintuitively, seeing an occupied police car on the roadside increases the perceived risk of receiving a speeding ticket, but it lowers the actual risk of receiving a citation. How can this be? There are a limited number of patrol vehicles on duty in any given jurisdiction. Before seeing a police car, you don't know where any of them are located. Once you spot a police car, you now know where enforcement is occurring at that time. The odds of encountering another patrol car anywhere near the one you just passed are very low (though not zero, as a very few officers may engage in second-level thinking). Therefore, if you were inclined to speed (which this newsletter neither recommends nor condones), your risk for a speeding ticket after passing a parked police car is lower than if you were speeding prior to seeing it. Spotting a police car increases your perceived risk of receiving a ticket, but actually lowers your risk once safely past the officer.

> Few believed it but, at that time, the actual risk to stocks was quite low.

How does all this apply to stock market investing? The S&P 500 index's first 10% correction in over six years has boosted investors' perception of risk. Long-time investors will remember January and February of 2009, the depths of the great recession. The stock market had plunged downward 40% over the previous six months and a sense of overwhelming risk seemingly permeated every thought and discussion. Few believed it but, at that time, the actual risk to stocks was quite low. The market began its recovery just a few days into March of 2009 and has since remained on an unparalleled nine-plus year bull market run.

In hindsight, it is of course easier to see the disconnect between perceived risk and actual risk. Just remember that stocks have historically been the highest returning liquid asset class and that any market correction—no matter how painful it is perceived at the time—is likely to be reducing actual future risk and potentially setting up opportunities for future outperformance.

INTERNATIONAL EQUITIES & FOREIGN EXCHANGE*

Middling Returns Amidst Higher Volatility

January's spectacular bull market for global equities turned around dramatically in the quarter's final two months, leaving returns for the major indices generally uninspiring. Volatility—long dormant and, for some reason perceived as a measure of the markets' ill-health—came back with a vengeance. Non-U.S. equities didn't gyrate at the level of domestic stocks, but a combination of strong earnings and tepid equity returns took some froth out of their valuations. Concern over Apple's earnings began the markets' sell-off in late January. The pressure on prices was maintained by underlying concerns including anxiety over rising interest rates and inflation, prospects of increasing global trade barriers and, as the quarter ended, a range of issues in the technology sector.

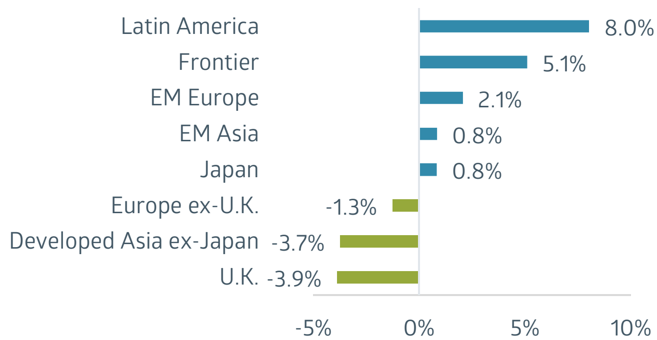
Quarterly Performance

The MSCI EAFE index, a measure of developed markets' performance, declined 1.5%, while MSCI's Emerging Market index rose 1.4% during the quarter; U.S. equity returns fell in between. The U.S. dollar provided a tailwind to both developed and emerging market stocks. As the chart at right indicates, all emerging market regions turned in gains for the first quarter. Most developed regions declined, with the largest decreases in Asia (ex-Japan) and the U.K. at -3.7% and -3.9%, respectively.

Market Overview

The list of upside risks to global equities was probably matched—and potentially exceeded—by downside risks. The positive factors included prospects for another good quarter of global earnings and economic growth in Europe, which is now higher than at any time since 2007. Additionally, valuations on stocks outside the U.S. remained dramatically undervalued compared to U.S. peers (even if they aren't cheap relative to their long-term histories). The range of anxieties was likely led by the specter of protectionism, an ambiguous range of outcomes for multiple elections around the globe and the continuing incremental shift of global leadership from the U.S. to China. Somewhere in the ambiguous middle was the prospect of a return to normalcy by many developed market central banks, with at least six of the ten major central banks likely to hike rates during 2018.

Total Returns for Selected MSCI International Stock Indices, First Quarter 2018



Source: Bloomberg. ***Past performance is no indication of future results.*** *All investments have the risk of loss.*

Depending on an investor's viewpoint this shift in monetary policy is either a statement of strong underlying economic health or central bankers reacting too quickly to nascent inflation that could push the world's modest but accelerating growth into reverse. Bearish investors increasingly fear that we may be at the cusp of a "Minsky Moment": a sudden collapse of asset values after a long period of growth, sparked by debt or currency pressures. More specifically, it describes the endpoint of an economic cycle when extended speculation leads to overvaluations, where returns and/or income on leveraged assets become insufficient to pay the debt used to purchase them. Even with a desire to sell, likely buyers are in a similarly distressed situation, which leads to exacerbated downward pressure on prices, as sellers search for the buyer willing to buy the falling knife.

The performance of non-U.S. companies continued to be underappreciated by global investors. A year ago investors were willing to pay $14.90 for one dollar of emerging market companies' earnings. As of quarter end, they were paying a bit less: $14.70 or 14.7x. Among EAFE markets, this trend was even starker: the ratio one year ago was 19.6x, compared to 15.9x at quarter end. This is in spite of the fact that earnings have been very impressive, growing 24% over the past year in emerging markets and 38% in EAFE markets. Austria exemplifies this effect, with earnings that grew 57% over the past year, but investors only accorded the market a P/E ratio of 11.7x at quarter end. By way of comparison, U.S. earnings growth over this same period was 15%.

Developed Markets

Developed market leaders in the first quarter were generally found on the Continent (in fact six of the top seven performers among the 23 developed markets were European). The only interloper into this top tier was Singapore, which advanced almost 3% for the quarter. At the other end of the spectrum were Canada and Australia, down 7.4% and 6.2%, respectively.

Europe continued to produce solid earnings in an environment that gives some investors pause. Negotiations between the EU and the U.K. over Brexit are moving haltingly forward. As critical dates and decisions get pushed farther out, investors have been less reactive to Brexit-related news flow. The pound has retraced much of the value lost in the wake of the referendum, ending the first quarter of 2018 above where the dollar-pound exchange rate sat just after the vote on June 23, 2016.

The Italian parliamentary election followed the trope of many recent European elections: the party in power fared poorly, no party got a majority and forming a coalition government is proving testy. The two top vote-getting parties—the Five Star Movement and the Northern League—share antipathy toward the EU, but have little in common domestically. The Northern League represents the interests of the wealthy North and is eager for a flat tax, while the Five Star Movement gets power from the poorer South and is pushing for universal income. Italy is the Continent's third largest economy; a government led by either party will represent a powerful voice against the EU.

Emerging Markets

Emerging markets eked out a positive return for the quarter, as typical risks were offset by positive economic, financial and policy prospects. Leading the pack was Brazil, which posted a 12.4% return for the quarter. Other top markets included Egypt, up 10.9% after a challenging 2017. Laggards were mostly to be found in Asia with Indonesia, India and the Philippines all dropping 7.0% or more.

At the same time the U.S. is challenging free trade, the rest of the world made strides in the opposite direction. The trade deal previously known as the Trans-Pacific Partnership was finalized in February, under its new moniker: the Comprehensive and Progressive Trans-Pacific Partnership. The agreement has eleven members representing 27% of global trade but is notably absent the U.S. as it waits for a better deal. China National Petroleum established China's first long-term contract to import liquefied natural gas from the U.S. At 1.2 million tons annually for the next 25 years, the deal is meaningful but puts only a small dent in China's trade balance with us.

The world's hope that Brazilian ex-President Lula da Silva's administration represented a reformation of corruption-ridden Brazilian politics has taken another hit. Instead of being a candidate for his country's presidency, he will likely watch its outcome from jail after his conviction for money laundering was upheld by Brazil's highest court in January. Current officeholder Michel Temer's nearly non-existent popular support makes the outcome of the coming Fall election completely unpredictable. Still, the economic data from the nation is encouraging. Industrial output is strong and inflation has fallen from double digits in December of 2015 to under 3% as of quarter end, allowing the central bank to lower rates from 14.25% to 6.75% over the same period.

In Mexico, Andrés Manuel López Obrador is the surprise favorite in the country's upcoming July 1 presidential election. His win would be the first for his left-leaning coalition, the National Regeneration Movement, a spin-off from the all-powerful PRI. Obrador is an old-style Latin American leader, having a broader distrust of market forces including the recent privatization of the oil industry.

Finally, while headlines may belie this reality, Saudi Arabia is becoming more integrated in the world's financial markets. FTSE, a major arbiter of global equities indexes, announced during the quarter that the Saudi Arabian stock market has satisfied the criteria for inclusion in its emerging markets equity index. MSCI, another major index creator, is reviewing the same issue this June. While the market is barely known by most Western investors, it is highly liquid and offers stocks covering ten of eleven of the major economic sectors.

FOREIGN EXCHANGE

Even with the Federal Funds rate hike by the FOMC in March (bringing the total to six in this tightening regime that began in December, 2015), the tone of the U.S. dollar remained generally weak in the first quarter. Among developed market currencies, the Japanese yen appreciated almost 6% for the period; the Norwegian krone, euro and British pound all advanced more than 2%. The weakest developed market currencies were Canadian and Australian.

In general, the emerging market currencies—often most negatively impacted by rising U.S. interest rates—have performed well. Mexico's peso was pummeled in the latter half of 2017 as the rhetoric around renegotiating NAFTA increased. The currency had a sharp turnaround in the first quarter, rising 7.2%. Some of the Asian currencies declined during the period, but overall fourteen of the 24 emerging market currencies advanced during the quarter.

** Unless otherwise indicated, the equity returns cited in this section of the 9:05 are based on their respective MSCI region or country indices. The returns of these indices along with those of the MSCI EAFE and the MSCI Emerging Markets indices are presented in U.S. dollar terms on a total return basis (with net dividends reinvested).*

3/31/18

MARKET PERFORMANCE

U.S. Interest Rates	6/30/2017	9/30/2017	12/31/2017	3/31/2018
Cash Equivalents				
90-Day Treasury Bills	1.01%	1.05%	1.38%	1.71%
Federal Funds Target	1.25%	1.25%	1.50%	1.75%
Bank Prime Rate	4.25%	4.25%	4.50%	4.75%
Money Market Funds	1.07%	1.12%	1.36%	1.68%
Bonds				
30-Year U.S. Treasury	2.84%	2.86%	2.74%	2.97%
20-Year AA Municipal	3.21%	3.09%	3.17%	3.47%

Source: Bloomberg, L.P.

Global Bond Market Total Returns (US$) through 3/31/18	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
U.S. Bonds				
BofA Merrill Lynch U.S. Treasury Index	-1.21%	-1.09%	-1.21%	0.51%
BofA Merrill Lynch Agency Index	-0.53%	-0.53%	-0.53%	0.85%
BofA Merrill Lynch Corporate Index	-2.20%	-1.10%	-2.20%	2.68%
BofA Merrill Lynch Municipal Index	-1.15%	-0.40%	-1.15%	2.78%
International Bonds				
Citigroup non-US$ World Government Bond Index, fully hedged	1.50%	2.62%	1.50%	3.95%

Sources: Bloomberg, L.P. and Morningstar Direct

Global Stock Market Total Returns (US$) through 3/31/18	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
U.S. Stocks				
Dow Jones Industrial Average Index	-1.97%	8.76%	-1.97%	19.36%
S&P 500 Index	-0.76%	5.84%	-0.76%	13.99%
NASDAQ 100 Index	3.15%	10.63%	3.15%	22.36%
Morningstar Small Value Index	-5.18%	-1.37%	-5.18%	1.30%
International Stocks				
MSCI Japan Index, net dividends	0.83%	9.39%	0.83%	19.64%
MSCI Europe Index (includes UK), net dividends	-1.98%	0.18%	-1.98%	14.49%
MSCI EAFE (Europe, Australasia, Far East) Index, net dividends	-1.53%	2.63%	-1.53%	14.80%

Sources: Bloomberg, L.P. and Morningstar Direct

Real Estate Total Returns (US$) through 3/31/18 (estimated)	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
NFI-ODCE Index*	2.07%	4.18%	2.07%	7.94%

Source: The National Council of Real Estate Investment Fiduciaries

**Since the first quarter 2018 NFI-ODCE index return is not yet available, we have estimated it by using the previous quarter's return. This estimate is used for all time periods presented.*

Past performance is no indication of future results. All investments have the risk of loss.

DISCLOSURES

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ABOUT *THE 9:05*

Since 1978, we've held a weekly company wide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as "the 9:05." Just as the 9:05 enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

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