



OUR VIEW



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Second Quarter Review

Markets during the second quarter were seemingly caught in a “tug of war” between optimism and pessimism, as global equities struggled to break out of a trading range. Enthusiasm about economic momentum and strong U.S. earnings results was offset by worries about escalating trade tensions. Optimistic investors are expecting President Donald Trump to “declare victory” on trade before mid-term elections, clearing the way for equities to advance to new highs. Pessimistic investors are worried that escalating trade tensions will lead to economic and earnings disappointments, causing a selloff in equities.

For the second quarter just ended, global equities, as represented by the MSCI All Country World Index, rose 0.7%. U.S. equities were the “safe haven,” as international markets were hurt by trade tensions, the resurgence of the dollar, and slowing Chinese growth. U.S. small company stocks gained nearly 8%, benefiting from tax cuts and domestically-focused business models. U.S. large company stocks also did well, as the S&P 500 gained 3.4%. Frontier markets equities declined by more than 15%, hurt in particular by economic woes in Argentina. Emerging markets equities lost nearly 8%. The strength of the U.S. dollar was a major factor in the relative underperformance of non-U.S. equities, as the dollar rose 4.2% relative to a trade-weighted basket of currencies. The dollar surge was largely attributable to accelerating U.S. economic growth relative to the rest of the world, widening interest-rate differentials, and a flight to the perceived safety of the dollar in response to trade tensions. Value stocks trailed growth stocks in much of the world, with U.S. small company value stocks a notable exception. Short-term bonds provided slightly positive returns during the quarter, despite Fed rate hikes.

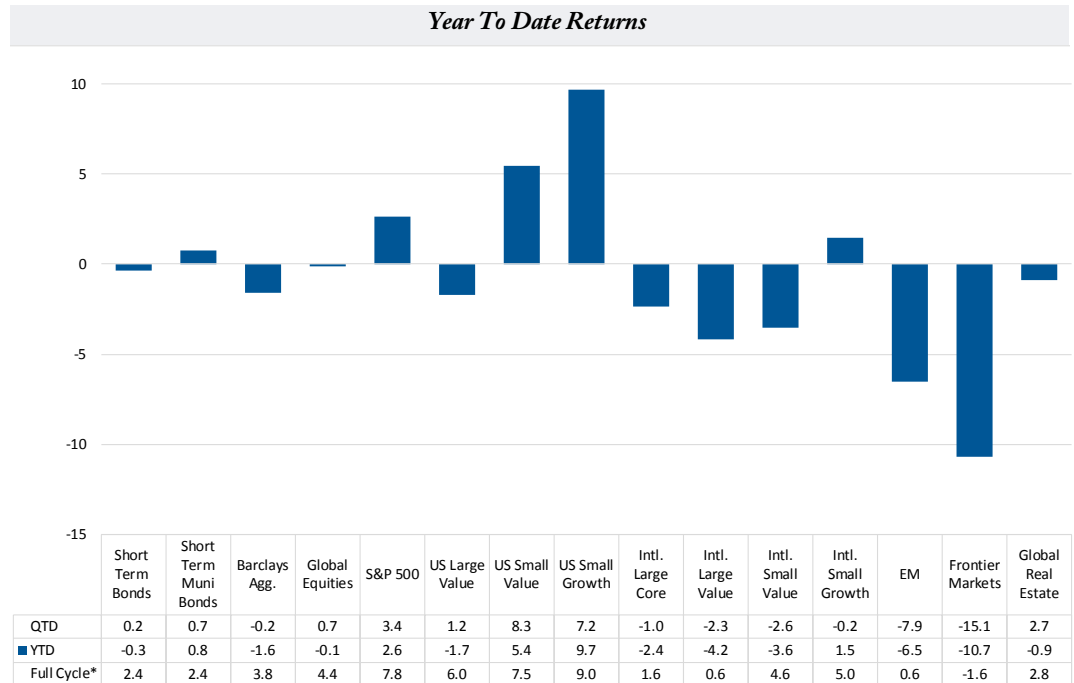
Year-to-date through June 30, global equities, as represented by the MSCI All Country World Index, declined 0.1%. U.S. small company stocks have risen more than 7% year-to-date and the S&P 500 2.6%. Emerging markets and frontier markets equities are in negative territory for 2018, after a stellar 2017 in which emerging markets gained more than 37%. Value stocks are currently trailing growth stocks. Short-term bonds provided slightly negative returns year-to-date, though short-term municipal bonds remain in positive territory.

Technology stocks are continuing their strong run of performance, despite worries about increased regulatory scrutiny of U.S. companies such as Facebook and Google and the increasing involvement of the Communist Party in the governance of Chinese technology companies. Energy stocks staged a comeback during the second quarter, as rising oil prices brought the sector into positive territory for the year.

Volatility has returned to normal levels, a painful adjustment for investors spoiled by the relative calm experienced in 2017. The S&P 500 Index moved by 1% or more on 16 days during the first half of 2018, in line with long-term averages but far above last year's levels.



TFC client portfolios net of fees lagged our benchmark slightly for the second quarter and for the year-to-date period, largely because of the underperformance of U.S. value stocks relative to growth stocks.



* Full Cycle is the annualized return from October 2007 peak to present.

TFC client portfolios declined slightly for the quarter, as negative returns from emerging and frontier markets equity holdings offset the positive performance from U.S. equity holdings. The Harding Loevner Frontier Emerging Markets Fund and Matthews Asia Small Companies Fund both declined during the quarter, but delivered better performance than their respective benchmarks.

TFC client portfolios net of fees lagged our benchmark slightly for the second quarter and for the year-to-date period, largely because of the underperformance of U.S. value stocks relative to growth stocks. Our equity portfolios are tilted towards value. Value underperformance has been notable in recent years, however, over longer periods of time value stocks have outperformed relative to growth stocks. Market leadership rotates unpredictably, and we realize it isn't always easy to patiently wait for our investment style to return to favor. The valuation disparity between growth and value is at a high level today, leading us to be confident that value will ultimately return to favor.

We believe our client portfolios are well diversified globally, by company size (large, mid and small cap), investment style (value and growth) and across industry sectors to weather continued volatility and capture the potential upside ahead of us.

Insights from Hong Kong and Chicago

In May, I attended the CFA Institute Annual Conference in Hong Kong and the J.P. Morgan Wealth Symposium in Chicago. The CFA Conference agenda was Asia-focused, but also included Steve Eisman (made famous by the book and movie *The Big Short*) and Nobel Laureate Daniel Kahneman. The CFA Conference was content-rich, and provided ample opportunities for less formal conversations with local investors. While in Hong Kong, I also met with investment professionals from two of the firms that manage money for TFC clients. The J.P. Morgan event was more policy focused, as they assembled a who's who of prominent former U.S. government officials for their intimate symposium, including Condoleezza Rice, Hank Paulson, David Axelrod and former Ambassadors to Russia and North Korea.



I'd like to share some highlights from both trips:

China update

The timing of my trip to Hong Kong was ideal, given concerns about the potential for slowing growth in China and trade tensions between China and the U.S. China represents more than one-quarter of expected global growth for 2018, consequently a significant slowdown in Chinese growth would have ripple effects for the rest of the world.

I came away with reasonably positive feedback about investment trends and economic momentum in Asia. There was particular optimism about companies that are using or providing technology to improve productivity, with digitization characterized as a theme that would provide opportunities throughout the Asian investment universe. The evolution of Chinese companies was also a hot topic -- in the words of one investor, the Chinese economy is migrating from "copied in China" to "innovated in China." The "Made in China 2025" strategic plan is the aspiration to make "created in China" central to the global economy. The Made in China 2025 plan represents a threat to American supremacy in technology, biotechnology and robotics, and is a major factor in today's trade tensions.

Many recent policy moves by the Chinese government were viewed in positive terms, such as tightening "shadow" banking, addressing pollution issues and cutting some industrial capacity. Some of the policy moves are likely to create more distinction between "winning and losing" companies, providing opportunities for active managers to invest in companies more likely to succeed in a competitive economic environment. One less positive observation from the trip: Investors at the conference were hesitant to share their opinions about the growing role of the Chinese government and Communist Party in corporate governance.

Perspectives on the Global Financial Crisis

The Global Financial Crisis was a focus of conference sessions at both events and a frequent topic of "sidebar" conversations, understandable as we near the ten-year anniversary of the fall of Lehman Brothers. Conference speakers, including the notoriously gloomy Eisman, characterized the financial system as having a relatively low level of systemic risk today. The U.S. real estate market is thought to be in far better shape today than in 2008, with real estate investment remaining far below the levels reached before the crisis, and credit standards much tighter. Multiple commentators pointed out the degree to which banks have deleveraged, and the improved transparency of derivatives exposure and credit risk. In Eisman's words, when Citigroup was leveraged 35 to 1, all it took was a "stiff breeze" to jeopardize the bank's solvency. Today, leveraged at 10 to 1, it may "take a meteor." Eisman had some scathing comments about the causes of the crisis, observing that there was a generation of Wall Street executives "who mistook leverage for genius." He also shared his opinion that a major factor in the crisis was that "incentives trump ethics every time." Kahneman also discussed the influence of incentives, calling the crisis a "combination of overconfidence and perverse incentives."

Geopolitics

Encouraging news about the geopolitical environment was hard to find, though Rice and others were optimistic about the resilience of the U.S. political system. Attendees were told to get used to the presence of Vladimir Putin, with one former official speculating that he plans to remain in power until 2030. Putin's antagonism toward the U.S. was attributed to his blaming the U.S. for the "Arab Spring" and for Moscow protests in 2011 that were the largest since the fall of the Soviet Union. Putin's "zero sum" world view makes continued friction likely. Tensions with China over North Korea, the trade deficit and industrial policy will likely continue, without an easy solution in

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sight. North Korea is also likely to remain a geopolitical risk, with commentators of the belief that Kim Jong Un is following the playbook of his father and grandfather and will fight to retain his nuclear program.

Speakers were pessimistic about the potential for bipartisan solutions on major issues, fearing that only a crisis will bring Democrats and Republicans together. Three numbers illustrate the obstacles for bipartisan cooperation: President Donald Trump has a 90% approval rating among Republicans, but only a 5% approval rating among Democrats. At the Congressional level, gerrymandering created a map in which 80% of Congressional districts are safe for one party.

A few speakers at the CFA conference offered insights beyond the investment realm. Kahneman characterized regret as the greatest enemy of good decision making. He also talked about how people do not like “slow” thinkers as leaders, preferring the style of people who make decisions quickly. Zhang Lei, CEO of Hillhouse Capital Management, discussed the importance to his firm of empathy, humility and sportsmanship. Zhang also talked about the importance of having “empathy for people who are different from you.”

Closing Thoughts

In our view, the key question for investors is about trade policy. Absent a major trade war, we expect equity markets to grind higher during the second half of 2018. The consensus earlier this year was that tariff threats were part of Trump’s “Art of the Deal” approach to governing, and that after some harsh rhetoric and extreme demands he would agree to a set of compromises on trade. The market is less convinced about that consensus today, given mixed signals from Washington and the ascendancy of trade hawks in the Administration. Insight may ultimately come from different numbers than approval ratings or “safe” seats in Congress. Trump often cites rising employment numbers and stock market gains as evidence that his policies are “winning.” A slowdown in employment gains or decline in the stock market would be likely to curb his enthusiasm for a trade war.

Although we expect the heated rhetoric on trade to continue, we are optimistic that a trade war will be averted, easing the path for U.S. equities to stage a final, late-stage rally before a recession in 2020 or 2021. Given heightened volatility, however, TFC has raised cash for many clients who anticipate having near-term liquidity needs. We continue to monitor the risks outlined above and will incrementally adjust the portfolio based on new information. As always, we welcome your comments and questions.

Sincerely,

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