Broadwing Capital Advisors Investment Letter

Second Quarter 2018 *Key Takeaways*

US stocks rose to the top of asset class performance charts with solid returns in the second quarter. Larger-cap US stocks gained 3.4%, but were outdone by smaller-cap stocks, which jumped 7.9%. The smaller-cap outperformance was driven by the market narrative du jour that smaller companies are more domestically focused and therefore not as exposed to a strengthening US dollar or potential trade wars, both of which are assumed to be detrimental to larger-cap (multinational) company profits.

Developed international stocks fell 1.8% and European stocks declined 1.6% for the period, as the US dollar rebounded. Dollar appreciation can be a meaningful headwind to returns for dollar-based investors in foreign securities.

Emerging-market (EM) stocks fared the worst, dropping 9.6% in dollar terms. In addition to the currency effects, EM stocks were buffeted by trade tensions between the United States and nearly all its major trading partners. As I discuss this quarter, I remain confident in our overweight to EM stocks in our portfolios.

Moving on to the bond markets, in May, the benchmark 10-year Treasury yield pierced the 3% level, hitting a seven-year high before falling back, ending the quarter higher by 11 basis points at 2.85%. The core bond index had a slightly negative return (bond yields move inversely to bond prices). For the year, the core bond index is down nearly 2%.

With the US economy growing above trend and the labor market tight, the Fed continued its gradual path of tightening monetary policy. It raised interest rates again in June, but also forecasted a slightly accelerated path of hikes over the next two years. Whether the economy can withstand that degree of tightening remains to be seen.

Beyond the strength of the US economy, the global economy remains in pretty good shape, with real GDP growth expected to be above trend again this year. However, last year's highly synchronized growth has decelerated and may have peaked for this cycle.

Recent US dollar strength may continue for a while as currency momentum can take on a life of its own. But there are fundamental reasons to expect the dollar may weaken looking a bit further out: the prospect of a ballooning US federal budget deficit in the coming years, a large US trade deficit, the eventual convergence of central bank monetary policies, and the fact that the Trump administration seems to prefer a weaker dollar.

Regardless, from a portfolio management perspective, I remain tactically agnostic on the dollar—I don't have a high-conviction view relative to the currency markets that I would want reflected in portfolios. Instead, I maintain a strategic (long-term) diversified approach of having both dollar and non-dollar exposure—with the latter coming primarily from our foreign stock and bond funds.

Second Quarter 2018 Investment Commentary

Market Recap

As we pause to reflect at the midpoint of the year, it seems 2018 has so far served as yet another reminder to investors that over the short term, markets are driven by innumerable and often random factors that are impossible to consistently predict. In the first quarter, U.S. stocks experienced their first major losses since 2016 and a return to more "normal" market volatility. Many market prognosticators speculated that this could indeed be the end of the nearly decade-long US bull market.

Fast-forward through three more eventful months and this time around U.S. stocks have been the net beneficiaries, gaining 3.4% on the back of a surging dollar while the rest of the world has slowed. The dollar's 5% appreciation translated into a meaningful return headwind for dollar-based investors in foreign securities as foreign currencies depreciated against the dollar. Developed international stocks fell 1.8% and European stocks declined 1.6% for the quarter. Emerging Market ("EM") stocks fared the worst, dropping 9.6% in dollar terms.

In bond markets, the benchmark 10-year Treasury yield pierced the 3% level in May, hitting a seven-year high. Yields then fell back, ending the quarter at 2.85%, an 11-basis-point increase from the prior quarter-end. As such, the core investment-grade bond index had a slight loss for the quarter and remains in negative territory for the year to date.

Portfolio Attribution

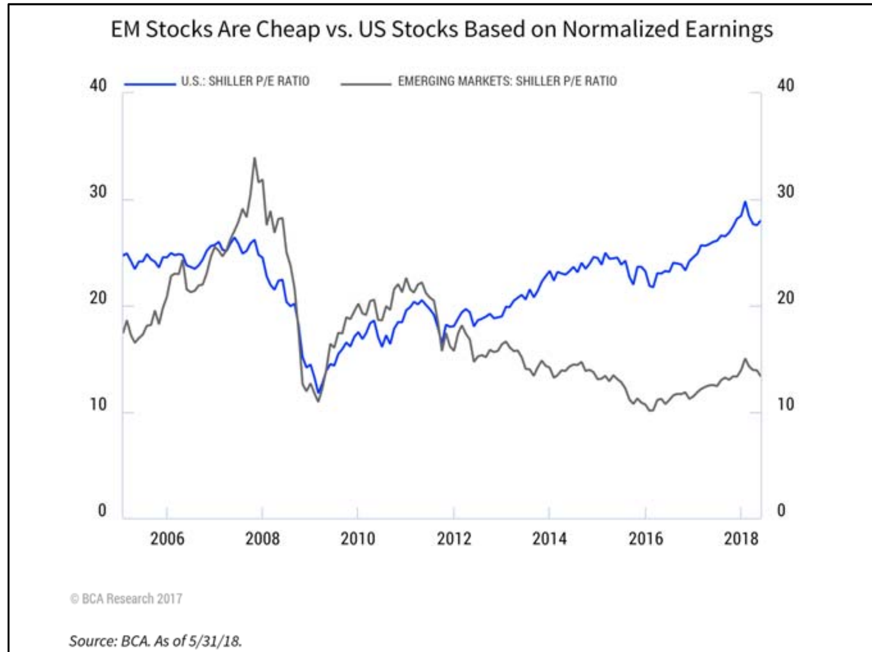
It was a difficult quarter for international portfolio equity holdings given the jittery investment climate outside the United States, particularly in the emerging markets. As a reminder, I maintain an overweight (relative to a benchmark weighting) to emerging market stocks. During 2017 and early 2018, as the global economy began firing on all cylinders for the first time since the financial crisis, my thesis began to play out, with emerging market stocks outperforming for the first time in years. For example, our Oppenheimer Developing Markets fund gained 35.33% in 2017 and 8.13% in January 2018.

Since late January 2018, however, this and other international stock holdings have declined sharply, and returns are now in negative territory for the year.

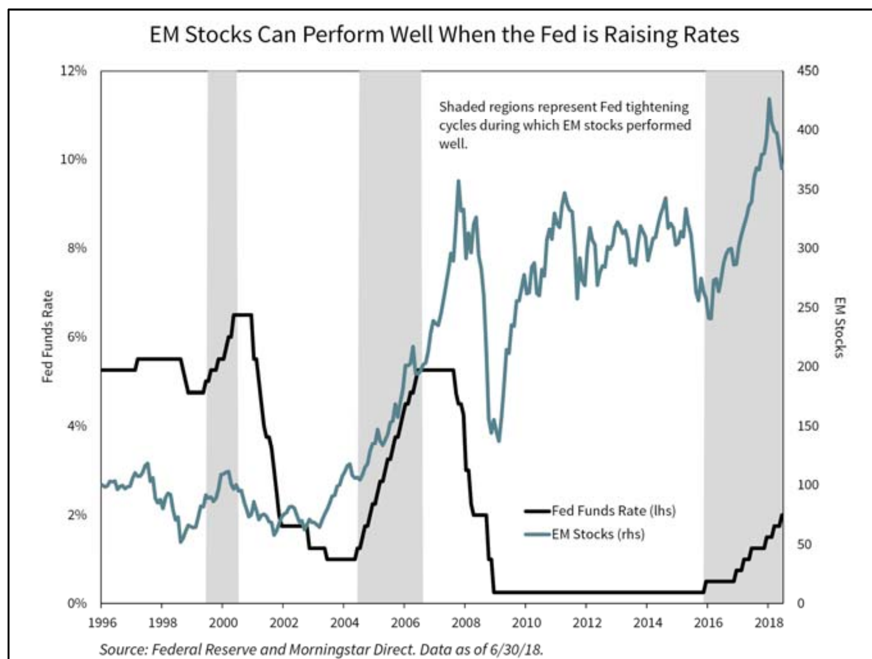
The selloff in emerging markets stocks appears to have been driven by a combination of investor concerns about

- a potential trade war with China (and possibly other global trade partners such as the European Union, Mexico, and Canada);
- how EM economies will manage a deceleration in global growth outside the United States; and
- a stronger U.S. dollar coinciding with rising U.S. interest rates and tightening Fed monetary policy.

These macro developments, in particular the risk of a U.S. trade war with China and the rest of the world, are indeed risks to EM stocks, at least in the short-term. However, these are not new risks, nor do I believe they overwhelm the attractive fundamentals, valuations, and potential longer-term returns of EM stocks. Based on my research, I find that emerging markets are fundamentally better placed today than in past cycles. The sector composition of EM indexes has changed meaningfully over the past decade, from traditional heavy-cyclical industries like materials and energy to more growth-oriented technology and consumer-driven sectors that are less sensitive to shifts in global growth. Evidence also suggests EM stocks do fine when interest rates in the United States are rising as long as global growth is solid (real GDP growth is expected to be above trend again this year). As to the underlying fiscal health of EM economies, emerging markets, in aggregate, have much better debt coverage than in the late 1990s/Asian crisis era. Additionally, most EM countries now have floating rather than dollar-pegged currencies, which should help release pressure in these economies and reduce the likelihood of a currency devaluation–driven crisis.



Source: BCA. As of 5/31/18.



Source: Federal Reserve and Morningstar Direct. Data as of 6/30/18.

As mentioned above, this past quarter rewarded companies whose revenues are more insulated from the potential fall out of a trade war, and from the impact of a strong dollar. Companies whose sales are concentrated domestically, for example, will not only sidestep foreign tariffs, but may benefit from tariffs placed on their foreign competitors selling in the U.S. So some small U.S. companies will likely benefit from a trade war. This likely explains the considerable outperformance of small U.S. companies during Q2. Our Conestoga SMid Cap fund (CCSMX), for example, earned +8.24% for the quarter.

On the other hand, companies will significant overseas revenues may not only be exposed to new tariffs that will negatively impact their revenues (and profits), but will also see those revenues negatively impacted by the strong

dollar. Our portfolios maintain U.S. stock exposure primarily through the Schwab U.S. Dividend Equity fund (SCHD). During 2018 this fund has lost 2.38% while the S&P 500 has earned +2.52%, an almost 5% differential. This performance disparity can be explained by the Schwab fund's concentration of investments in slow-growth companies with significant overseas revenues, the exact companies that will be hurt by a strong dollar and tariffs. Some of the Schwab fund's top holdings include PepsiCo (4.99% of fund assets as of 6/30/18), Proctor & Gamble (4.78% of fund assets), Walmart (4.28% of fund assets), 3M (4.06% of fund assets), Altria Group (3.78% of fund assets). Each of these holding has earned negative returns in 2018, ranging from -4.42% to -15.75%. By contrast, the S&P 500 holdings are more concentrated in fast-growing companies with less potential tariff-exposure and less overseas revenues as a percent of overall revenue (Apple, Microsoft, Amazon, Facebook, Alphabet, Berkshire Hathaway, Bank of America, etc.).

On the fixed-income side, portfolio returns were weighed down in Q2 by a large allocation to our actively managed flexible bond fund, the Blackrock Strategic Income Opportunities fund (BASIX). Over the past several years, this fund has contributed positively to portfolio returns, at least by comparison to its benchmark, but this past quarter it lost 0.87% while its benchmark lost just 0.18%. This hurt performance of our more conservatively-invested portfolios, which contain significant exposure to the Blackrock fund.

Portfolios were also hurt by our allocation to emerging markets bonds through the Invesco Emerging Markets Sovereign Debt fund (PCY), which lost 4.79% for the quarter, a significant decline for a bond fund, owing partly to the general sell off in bonds during the quarter, but primarily due to declines in local currencies relative to the dollar. This fund is denominated in the local currencies of the countries in which it invests in, so it is negatively impacted when the U.S. dollar appreciates relative to the local currency, which was the case for many emerging markets currencies during Q2.

The performance of our liquid alternative investments was mixed in the second quarter. The Litman Gregory Alternative Strategies fund slightly outperforming core bonds. We use the Litman fund, in lieu of bonds, to provide a similar hedge against stocks, but without the interest rate risk of bonds. While the fund outperformed core bonds, it still lost 0.03% for the quarter, thus doing little for portfolio performance. "Alternative investments" offer a third leg to the diversification stool constructed using stock, bonds and alternatives. The intent behind owning alternatives is to hedge against bond risks (rising interest rates, for example), and to hedge against stock risks (stocks can be counted on to intermittently suffer sharp sell offs). Hedges work when they earn an attractive absolute returns while simultaneously providing the desired hedge against stock and bond risks. Hedges offer questionable value when they fail to generate returns meaningfully better than traditional safe investments, such as cash. If the best that one can expect to make on an investment in alternatives is a low single-digit return during a bull market, then one must ask whether the hedge is worth the sacrifice in returns. Might one be better off simply investing the money cash equivalents? Or might one be better off accepting additional market risk in order to potentially earn better than low single-digit returns? At present, I am asking myself this question of alternatives. However, I have yet to witness how alternatives will perform in a serious stock market sell off. I suspect that a serious stock market sell off is where our investment in alternatives will truly pay off (not that I wish that scenario to transpire). For now, I'm comfortable maintaining our position in alternatives, despite their lackluster absolute performance.

Market and Portfolio Outlook

It is understandable that fears of a global trade war are rattling financial markets. Any resolution of the current trade tensions is a meaningful uncertainty—our relationship with China being the most fraught—with the potential to seriously disrupt the global economy, at least over the short to medium term. However, the potential for a positive surprise also exists, though it seems more limited. President Trump's unconventional negotiating approach adds an additional wildcard dimension. The process is likely prone to several more twists and turns before things become any clearer.

My view on the matter, however, remains broadly the same. It is in the best interest of both the United States and China to negotiate a resolution and prevent trade skirmishes from becoming an all-out trade war. However, the potential for a severely negative short-term shock to the global economy and risk assets (not just emerging markets) can't be dismissed. Even absent an actual trade war, the negative impact on business and consumer confidence from

the uncertainty and fear of a trade war is a risk to the remaining longevity and strength of the current economic cycle.

The recent dollar-strength trend may also continue for a while. But there are reasons to expect the dollar may weaken looking further out: the prospect of a ballooning US federal budget deficit in the coming years, a large trade deficit, and the eventual convergence of central bank monetary policies—as other central banks start to raise interest rates, thereby shrinking the yield gap versus the United States.

I remain confident in the positioning of our portfolios, which I believe are structured to perform well over the long term while providing resiliency across a range of potential short-term scenarios. Should the current trade tensions resolve, and the global economic recovery continue, I expect portfolios will generate good overall returns, with outperformance from our European and EM stock positions, active equity managers, and flexible bond funds.

Alternatively, should a bear market strike, our portfolios have "dry powder" in the form of lower-risk fixed-income and alternative investments that should hold up much better than equities. I'd expect to put this capital to work more aggressively following a market downturn by, for example, reallocating to US equities at lower prices and higher expected returns sufficient to compensate us for their risks.

Thank you for your continued confidence and trust.

Best,

Kelly D. Kane, ChFC, CFP

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