Investment Letter

Wiggin Financial Services **Second Quarter 2019**

Second Quarter 2019 *Key Takeaways*

The first half of 2019 saw robust gains across most asset classes, but it certainly wasn't a smooth ride. Global stock markets got a jump start on the year thanks to progress in US-China trade negotiations and a newly "patient" Fed, but an abrupt breakdown in the trade talks (announced via Presidential tweet) spurred a sharp market sell-off in May. Stock markets subsequently shook off their swoon in June, rebounding on expectations of Fed rate cuts later in the year and (tentative) signs of re-engagement on the US-China trade front.

The S&P 500 hit a new high near the end of June. Large-cap U.S. stocks shot up 7.0% for the month – their best June since 1955. They were up 4.3% for the second quarter, and a remarkable 18.5% for the first six months of the year—their best first half since 1997.

Foreign stocks also notched double-digit gains through the first half of the year. Developed international stocks gained 5.9% in June, 3.2% for the second quarter, and 14.2% for the year to date. European stocks have done a bit better, gaining 15.6% on the year so far. In April, the "Brexit can" was kicked down the road at least until October 31, but the risk of a disruptive "no-deal" exit remains. Emerging-market stocks also rebounded in June, gaining 5.4%. Although emerging-market stocks were only up 0.8% for the second quarter, their first-half gains stand at 12.6%.

Moving on to the fixed-income markets, the 10-year Treasury yield continued to plunge from its multi-year high of 3.2% last October, dipping below 2% following the Federal Reserve's June meeting. This was a near three-year low, and among its lowest levels ever. The 10-year yield ended the month at 2.0%. Bond prices rise as yields fall, driving the core bond index to a 3.0% gain for the quarter and an impressive 6.1% return so far this year. Floating-rate loans gained 1.7% for the quarter and are up 5.7% for the year.

Looking ahead, we still see a high degree of uncertainty and a wide range of plausible outcomes looking out over the next 12 months (and beyond). But *at the margin* we think the macro risks have increased. Trade uncertainty has damaged global business confidence in what by many measures is an already weak global economy. While this is for now being offset by easier monetary conditions, the inevitable impact of any additional central bank rate easing is certainly muted.

We believe our portfolios are positioned to both generate attractive returns over the next five to 10 years, and to be resilient across this wide range of potential shorter-term risk scenarios. If central banks are successful with their renewed stimulus efforts, our analysis indicates that will favor our positions in global equities, flexible income funds, and floating-rate loan funds.

On the other hand, should markets turn south, our portfolios will benefit from our "ballast" positions in core bonds, lower-risk hybrid and low correlated asset classes. These lower-risk, "insurance" positions benefit us during the occasional market corrections, including in last year's fourth quarter. They also present us with potential capital to re-allocate back into U.S. stocks at lower prices and much higher expected returns if and when the opportunity should arise.

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Market and Portfolio Recap

Wiggin Financial Services Newsletter

In our year-end 2018 commentary, we emphasized the wide range of plausible macroeconomic scenarios and financial market outcomes for the year ahead with the potential for either a positive or negative shorter-term path. Through the first half of 2019 we've gotten a little bit of everything—signs of *both* scenarios, though so far the ups have outpaced the downs.

The first half of 2019 saw robust gains across nearly every asset class—including both core bonds *and* equities—but it certainly wasn't a smooth ride. Among the primary drivers of the market sell-offs and their subsequent rebounds were on-again/off-again U.S.-China trade negotiations and *two* major shifts in central bank policy.

Large-cap U.S. stocks gained 4.3% for the second quarter, and a remarkable 18.5% for the first six months of the year—largely earning back what was lost in the fourth quarter of 2018. Developed international stocks also experienced a healthy rebound from 2018's losses, up 3.2% for the second quarter, and 14.2% for the year to date. European stocks have done a bit better, gaining 15.6% on the year so far. In April, the "Brexit can" was kicked down the road at least until October 31, but the risk of a disruptive "no-deal" exit remains.

Emerging-market stocks, up just 0.8% for the second quarter, absorbed more of the uncertainty surrounding global trade tensions. But for the year so far, they have gained 12.6%.

June Benchmark Returns

	MTD	QTD	YTD
EQUITY BENCHMARKS			
Vanguard 500 Index	7.0%	4.3%	18.5%
iShares Russell 1000 ETF	6.9%	4.0%	18.5%
iShares Russell 1000 Value ETF	7.0%	3.6%	15.8%
iShares Russell 1000 Growth ETF	6.5%	4.2%	20.9%
iShares Russell 2000 ETF	7.0%	1.9%	16.9%
Vanguard REIT	1.7%	1.7%	19.2%
iShares MSCI ACWI ETF	6.5%	3.5%	16.3%
Vanguard FTSE Developed Markets ETF	5.9%	3.2%	14.2%
Vanguard FTSE Europe ETF	6.4%	4.3%	15.6%
Vanguard FTSE Emerging Markets ETF	5.4%	0.8%	12.6%
FIXED-INCOME BENCHMARKS			
Vanguard Total Bond Market Index	1.2%	3.1%	6.1%
Vanguard Intermediate-Term Tax-Exempt	0.4%	2.0%	4.7%
iShares TIPS Bond ETF	0.8%	2.7%	6.1%
ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index	2.5%	2.6%	10.2%
S&P/LSTA Leveraged Loan Index	0.2%	1.7%	5.7%
ALTERNATIVE BENCHMARKS			
HFRX Global Hedge Fund Index	1.6%	1.6%	4.2%
Bloomberg Commodity Index	2.7%	-1.2%	5.1%
SG Trend Index	2.7%	4.4%	7.4%
3-Month LIBOR	0.2%	0.7%	1.4%

In fixed-income markets, the 10-year Treasury yield dipped below 2% following the Federal Reserve's June meeting. This was a near three-year low, and among its lowest levels ever, reflecting promises of further easing later this year. These falling yields drove the core bond index to a 3.1% gain for the quarter and an impressive 6.1% return so far this year. Floating-rate loans gained 1.7% for the quarter and are up 5.7% for the year.

Market and Portfolio Outlook

Not surprisingly, we still see a high degree of uncertainty and a wide range of plausible outcomes looking out over the next 12 months (and beyond). But *at the margin* we think the macro risks have increased. Trade uncertainty has damaged global business confidence in what by many measures is an already weak global economy. While this is for now being offset by easier monetary conditions, the inevitable impact of any additional central bank rate easing is certainly muted.

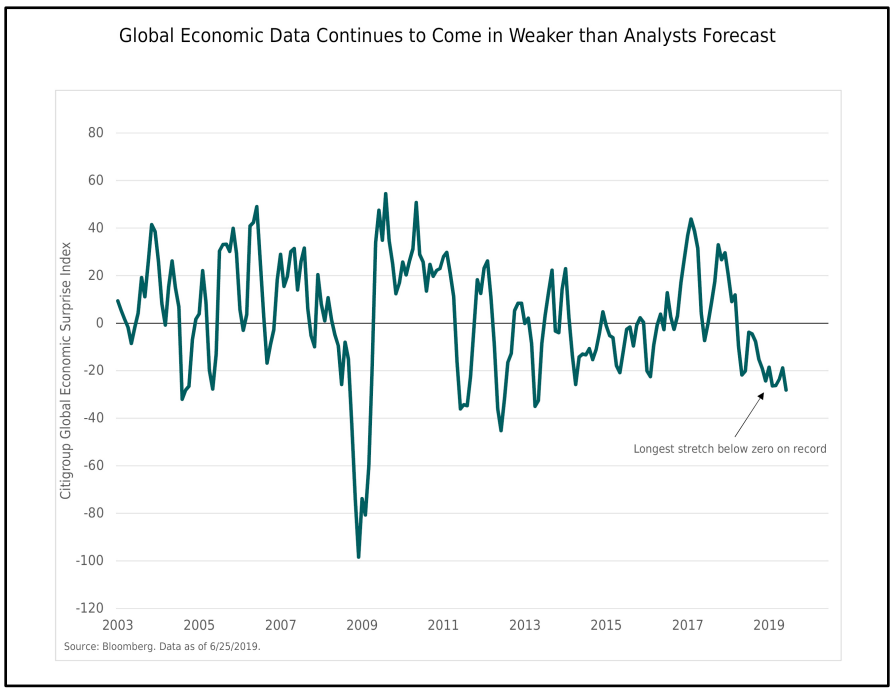
The risk of a geopolitical shock on financial markets is also ever-present. Most recently, there is heightened potential for a military conflict with Iran. But there are many other potential geopolitical flashpoints and unknowns: Brexit remains unresolved. The tug of war between democracy, populism, nationalism, and

autocracy continues around the globe. The U.S. presidential election next year will likely create additional market uncertainty. China's rise and challenge of the United States as a global superpower goes well beyond just the current trade conflict. The Middle East (beyond Iran) remains a potential flashpoint, as does North Korea.

To what extent stock markets are already pricing in these fears and risks is also an unknown. On the heels of yet another strong quarter for U.S. stocks, their valuations are looking more stretched than ever. Our analysis of U.S. stock market valuations and expected returns implies the market consensus is discounting an overly optimistic outlook. And it can certainly be said that any investors chasing stocks higher simply because of the tailwind of more monetary stimulus face potential dangers. Our analysis—informed by history and applying forward-looking judgment—leads us to a base-case scenario where the expected annualized return from U.S. stocks over the next 5 to 10 years is in the very low single digits. This is well below the upper single-digit expected return we require to compensate for the full risk of owning stocks. As such, we remain underweight to U.S. stocks across our portfolios until the risk/reward trade-off improves.

On the other hand, we continue to have modestly overweight positions to European and emerging-market stocks. Our analysis indicates their valuations are very attractive relative to the U.S. In our assessment, these markets are implicitly discounting a lot of bad macro news and poor sustained corporate earnings growth. Our base case generates high single-digit expected returns for European and emerging-market stocks over the medium-term horizon.

Over the shorter-term, if the global economy starts recovering from current depressed levels—with China's fiscal and monetary stimulus being a key to that outcome—and the United States avoids recession, we would not be surprised to see strong absolute returns from stocks, with outperformance from foreign stocks versus U.S. stocks. Further, if the growth differential between the United States and the rest of the world narrows, the U.S. dollar will likely depreciate, providing an additional tailwind to foreign stock returns for dollar-based investors.



A solid global economy would also be beneficial for our flexible fixed-income and floating-rate loan investments relative to core investment-grade bonds, which have much lower yields and would be hurt by rising interest rates.

On the other hand, if the global economy continues to weaken and the United States falls into a recession and bear market, our balanced (stock/bond) portfolios have "ballast" in the form of core bonds as well as lower-risk fixed income and alternative strategies that should hold up much better than stocks on the downside. These lower-risk, alternative positions have been a drag on our overall returns over the past several years as U.S.