AZA Capital Management

2018 Q2 Commentary

Summary

- In Q2 2018 stock returns were mixed among U.S. large capitalization (3.43%), international developed (-1.06%), and emerging markets (-7.90%).
- The Barclays U.S. Aggregate Bond Index declined -0.16%, and high yield bonds were up +1.00%.
- The U.S. Dollar ("USD") advanced relative to other major currencies.
- Price and earnings momentum in equities are positive heading into Q3 2018.
- Equity risk premiums are supportive of current valuations while other metrics suggest overvaluation and more potential downside risk. The Federal Reserve has raised the Fed Funds interest rate while also executing quantitative tightening ("QT") at a $40 billion per month pace. The yield curve has flattened significantly but is still upward sloping.
- Economic conditions suggest we are in the middle to later stages of a cycle. The fiscal stimulus from the tax reform could extend the cycle in the near-term but bring headwinds starting in 2020.
- Financial conditions have become less supportive while financial stress indicators remain at low levels.

Review

During the second quarter (Apr-Jun) of 2018 the U.S. diverged from international markets as the USD advanced while political and trade disputes flared. Q2 GDP growth in the U.S. is expected to exceed a +4% annualized real growth rate. Tax cuts and a strong economy are expected to fuel continued earnings growth. U.S. job markets are demonstrating strength without generating significant inflation. Job openings are at record levels while unemployment claims are at historical lows. Low relative wage inflation suggests that there is latent labor supply as well as a favorable regulatory climate for corporations.

With a gargantuan goods trade deficit exceeding $800 billion, the U.S. is expected to benefit from a trade war, though there will be losers from shifts in the underlying economy. The Federal Reserve's path to tightening monetary policy has yet to bite the U.S. economy, but emerging markets such as Turkey and Argentina are experiencing dollar funding issues. The Chinese have allowed the Yuan to devalue significantly, which could offset anticipated tariffs and be deflationary for the global economy.

As oil has risen and excess inventories eliminated, OPEC and Russia have agreed to increase production to stave off harmful oil price spikes. Conflict over the formation of Italy's government highlighted differences within the European Union as European sovereign bond spreads widened and then recovered. Geopolitical risks seem to be declining as tensions with North Korea have been temporarily defused. Stalemates in the Middle East and Eastern Europe provide incentives for diplomatic results as well.

Quantitative Tightening (QT) may be moving monetary policy to a less-than-accommodative stance before the end of the year. With the Fed Funds rate at 2.0% and the annualized pace of QT escalating to $600 billion or circa 0.90% of total credit outstanding, one might impute an effective Fed Funds rate of over 2.9% near average nominal GDP growth—the point where we estimate monetary policy to be restrictive.

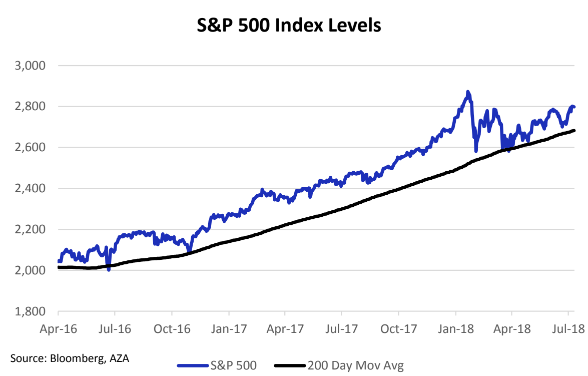
Thus by a rough estimation, the Federal Reserve may be within one or two Fed Funds rate increases from restrictive monetary policy. The Federal Reserve has telegraphed that it will reach this point before the end of 2018. The flattening yield curve is likely approximating policy that is tighter than implied by the Fed Funds rate alone. In fact, the Taylor Rule, a formula that many economists believe should guide Fed Funds rate policy, is currently at 1.93% using the Bloomberg Taylor Rule model (current effective Fed Funds is 1.91%). Adding the imputed effect of QT suggests that the Federal Reserve's monetary policy may be too tight given current conditions.

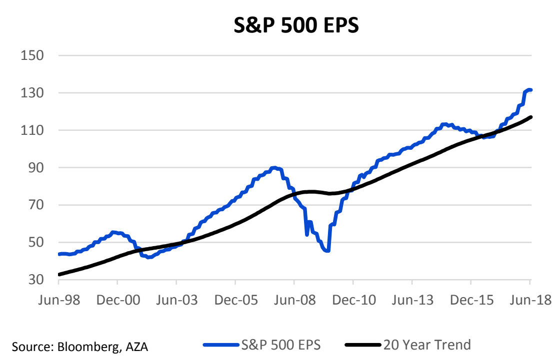
Lag effects on monetary policy can be 18 months to two years. Since fiscal policy stimulus is expected to taper off in 2020 and lag effects might be expected that same year, early forecasts could expect growth to slow in that time frame barring other shocks. Hence, the lower path of rates currently expected by a flatter yield curve.

Market Survey

Momentum

Long-term trends in equity prices remain positive. Corporate earnings growth is strong and supported by corporate tax changes.





Valuation

Valuation measures are not extremely bullish and some are bearish. Market capitalization to GDP and cyclically adjusted ratios suggest caution and low-to-negative real returns. Equity risk premiums and yield based approaches are supportive to equity returns on a forward looking basis and relative to bonds, but do not signal bargains. U.S. Dollar appreciation is now a potential headwind for earnings. A strong underlying economy that could produce 3+% annual real GDP growth is net positive for earnings.

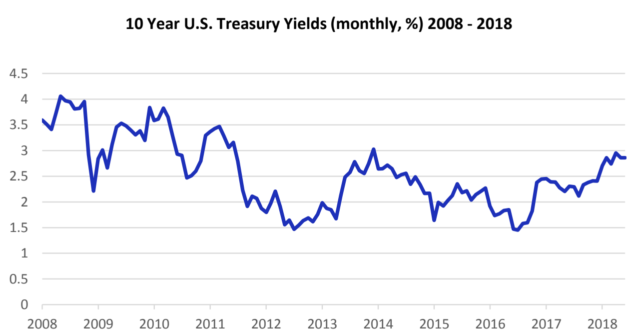
Earnings / Valuation Factors

Factor	*Notes*	*Signal / Result*
GDP / Earnings Growth	Fiscal expansion via tax cuts combined with global growth are key drivers	SUPPORTIVE
Buybacks	Net issuance remains negative as earnings repatriation drives buyback flows	SUPPORTIVE
Margin Expansion	Margins are off all-time highs but elevated - tax cuts are having an impact	NEUTRAL
US Dollar	USD has strengthened and dollar funding issues could provide upward pressure	HEADWIND
Multiple Expansion		HEADWIND
P/E, EV/EBITDA, CAPE	These multiples are in ranges that have historically been correlated with lower returns	HEADWIND
ERP, FCF and Div Yields, Forward P/E	These mutliples appear near longer term averages	SUPPORTIVE
Overall		NEUTRAL

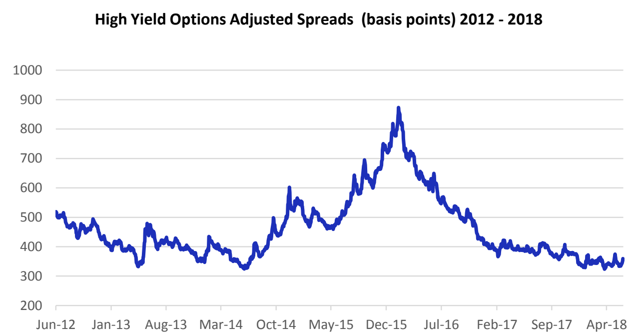
Sources: AZA, Bloomberg

Bond Markets

Bond markets have been resilient given large increases in supply and increasing short term rates. U.S. 10-Year Treasury rates have yet to sustain levels above 3%. Credit spreads remain tight though the yield curve has flattened significantly. Yield curve dynamics suggest that the Fed's tightening path could be curtailed sooner than Federal Reserve dot plots imply. Quantitative Tightening has stepped up to $40 billion per month in estimated Federal Reserve balance sheet reductions or an annualized rate of $480 billion per year. Higher rates have resulted in lower mortgage refinancing, but have yet to materially impact housing starts or existing home sales where first half of 2018 starts are 7.4% above H1 2017.



Source: Bloomberg



Source: Bloomberg

Economic Conditions

Economic conditions in Q2 suggest 4+% rate of real GDP growth. Historically the Federal Reserve has attempted to slow the economy and suppress wage inflation via higher rates to slow housing and other investment. The Fed anticipates job market tightening and has entered a cycle of rate increases that have lag effects on the real economy and financial markets.

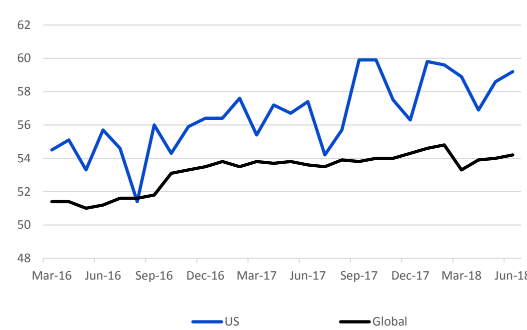
The cycle of Fed tightening is beginning to have yield effects from tighter financial conditions though they are primarily being felt outside of the United States. Certain emerging markets are having issues with their currencies as the USD becomes relatively scarce. China has devalued the Yuan at a rapid pace, which is deflationary for the world as Chinese manufacturing prices impact costs globally. Housing starts are up substantially year-over-year and have a long runway that is dependent on the path of interest rates and housing prices. Auto sales remain at high levels. Energy prices have increased substantially off of lows leading to more domestic U.S. shale production investment. U.S. and Global PMI indexes indicate growth.

We detail key causes of past recessions and evaluate the current status of each in the table below.

Recession Risk

Factor	*Notes*	*Signal / Result*
Tight Money / Credit Contraction	Federal Reserve Tightening including balance sheet reduction program	MEDIUM to MED HIGH
Housing Starts Decline	Risk of higher rates and prices slowing growth, but Millennials and jobs supportive	LOW
Business Capital Expenditures Decline	Policy uncertainty may slow growth	LOW
Military Demobilization	Low intensity conflicts with higher expected defense budgets	LOW
Overall	Emerging markets issues could signal tighter than perceived monetary conditions	LOW to LOW MED

Note: Four key factors AZA tracks that drive recession risks and may explain most major economic contractions



Conclusion

After a strong 2017 for markets, real economic expansion in 2018 is delivering results in terms of jobs, sales, and earnings growth. Political, monetary, and other macro factors have been the primary sources of volatility. Currently, the odds of economic recession are low and the large majority of indicators point to continued growth for the global economy. The Fed's QT program is among the biggest sources of uncertainty and will be in full effect by year end. At some point, QT could lead to lower growth as lag effects gain traction over time.

These outcomes are not certain and the team at AZA will be following events closely.

Strategy Highlights

We are available to discuss your personal investment portfolio in more detail. The following summaries are from select strategies:

DRIV Core
- Guided by our data analysis, this strategy ended the quarter positioned with an allocation of approximately 65% equities and 35% bonds/cash.
- Within the equity portion, we are favoring overweight allocations to large cap value and international developed markets. Growth is still the largest weight on a style basis. Within the bond portion, we maintained a mix of short duration corporates and cash.

Core Equity and Options (CEO)
- We are holding more stock positions while looking to add exposure in energy, tech, and financials.
- Higher rates are increasing the attractiveness of option writing. Currently, we favor put writing over call writing, though we anticipate more call writing in the near to intermediate future.

Enhanced Income
- The strategy is primarily in a “risk off” mode for most yield asset classes. However, we are close to adding risk in various classes and expect more rates exposure in the near term.
- At the end of the quarter, approximately 90% of the portfolio was in a mix of short term and long term U.S. Treasury ETFs, while we estimate an annualized yield of 2.5%.

Global Equity
- We held steady with existing positions. We hold approximately 5% cash to deploy in new opportunities.
- We maintain the belief that global markets may offer more attractive returns as they attempt to close the underperformance gap of earnings and capital efficiency versus the United States.

Global Equity & Income
- We held steady with existing positions. We hold approximately 5% cash to deploy in new opportunities.
- At the end of the quarter, the income portion of the portfolio was in cash equivalents and U.S. Treasury ETFs, while we estimate an annualized yield of 2.5%.

Global Opportunities Hedged
- With cash we added exposures in General Electric after it announced a very credible portfolio plan and seemed to be at or near a trough in the difficult power markets.

Total Return
- We remain broadly allocated across growth and value as well as large and midcap stocks. International developed markets are a significant exposure, while we have maintained low exposure to small caps.
- At the end of the quarter, the income portion of the portfolio was in cash equivalents and U.S. Treasury ETFs, while we estimate an annualized yield of 2.5%.