JOHN G. ULLMAN & ASSOCIATES, INC.

COMPREHENSIVE FINANCIAL MANAGEMENT SERVICES

TO:	UNITED METHODIST FRONTIER FOUNDATION
	COMMITTEE ON INVESTMENTS
FROM:	CHIAO NI WANG, PORTFOLIO MANAGER & SR. RESEARCH ANALYST
SUBJECT:	QUARTERLY INVESTMENT MANAGER REPORT
DATE:	07/13/2018
CC:	SUSAN EZRATI, ELLEN KNUDSEN

OVERVIEW

The equity market recouped its losses in the aftermath of cross asset volatility routs, trade conflicts, and concerns over slower growth and higher inflation, but was not able to surpass its previous highs in January due to renewed escalation of trade tensions in late June. In the second quarter this year, the S&P 500 managed to gain 3.48%, while the NASDAQ composite and the Russell 3000 index were up 6.61% and 3.89% respectively. The Russell 2000 Index, the proxy for small capitalization equities, beat the S&P 500 by a sizable 427 basis point margin as the small cap index gained 7.75% with its underlying companies more reliant on domestic markets and thereby less vulnerable from global trade war risks.

MACRO ECONOMY

As the global economy has phased out of a synchronized Goldilocks scenario (of not too hot inflation and not too cold unemployment) during the first half of 2018, its growth trajectory has become less vigorous and less coordinated going into the second half of 2018. According to JPMorgan, the U.S. is the only major economy where growth expectations continue to be revised upward. The outlook in Europe has stabilized in the late second quarter after a temporary deceleration earlier this year. While China is expected to remain stable for the rest of this year, the Emerging Market economies are seeing their growth forecasts continue to deteriorate.

In the U.S., the Federal Reserve hiked rates for the second consecutive policy meeting this year and signaled a more hawkish tone than it did previously as it raised its economic outlook for this year and next, and now expects a total of four rate hikes this year, instead of three. In Europe, the European Central Bank's (ECB's) decision to end its Quantitative Easing program by the end of 2018 came with a dovish spin as the ECB pledged to maintain record low rates at least through the end of summer 2019. In contrast to the U.S. Fed's upbeat economic outlook, the ECB revised down its economic growth forecasts for 2018. Temporary factors such as strikes and bad weather have led to a deceleration of growth prospects as indicated by weaker than expected German business surveys and industrial data.

The diversion of policy signals between the two sides of the Atlantic echoes the economic data suggesting strong growth momentum in the U.S. in contrast to a soft growth patch in Europe. Compared to Europe, which is mute of expansive fiscal policies, the U.S. is seeing its major growth engines simultaneously at work: solid consumption backed by a strong labor market; robust business investment supported by tax cuts; strong housing markets; and expansionary government spending further fueling domestic demands. Multiple transportation industry data have also pointed to accelerated growth in consumption and manufacturing activities in the U.S. through this year.

Despite profound diversion in the stages of policy cycles among the U.S., Japanese, and European central banks, their leaders have all shared a common concern of low wage growth and mild core inflation. The Fed kept its inflation forecast unchanged, yet there are already signs showing decelerated inflation. In addition to declining commodity prices, a stronger U.S. Dollar, and falling expectations for pay raises, expectations for inflation as indicated by the ten-year breakeven inflation rate (the difference between the nominal yield of a ten-year treasury and ten-year Treasury Inflation-Protected Securities) has moderated towards the end of the second quarter. Meanwhile, the ECB revised up its inflation forecasts. However, the upside is primarily driven by higher oil prices despite rising Purchasing Manager Index (PMI) pricing sub index, persistent wage growth and strong German wage settlements. These economic indicators imply that EU core inflation has remained benign and is expected to increase only gradually as wage growth has been trailing the trend of a diminishing output gap. At this point, we continue to see wage growth remain normal since the global economy has yet to run its course of the current expansionary cycle while structural factors have strengthened employers' bargaining power in the labor market.

China's economy has managed smooth sailing through waves of reform initiatives as China has become more advanced with managing its financial stability. With an establishment of a super financial regulatory body and some subtle handholding of the Peoples Bank of China (PBOC) through a liquidity bump, these initiatives have started to take effect without substantial downside in economic growth so far. Dollar leverage among Chinese companies has been reduced while industrial production beat expectations during the second quarter with the strongest growth since last September. Various PMI data have remained in expansionary territory, in line with factory activity readings based on data collected by satellites. Unemployment indicators continued to trend lower, reflecting China's continuous transition from an old economy built on excessive investment in industrial manufacturing capacities to the new economy driven by innovation and consumption.

MARKETS

Through the first half of 2018, the stock markets have been convoluting in a directionless mode amid continuous trade war jitters. Eclipsing corporate earnings outlooks, political headline noises and White House tweets have been driving investors' actions, yet resulting outcomes are still highly uncertain. Escalating trade war rhetoric has kept hitting headlines, but then subsequently followed by details showing less drastic actions, leading investors to "Sell-on-the Rumor and Buy-on the-Fact" as stock markets flip-flop between uptick and downtick on a second-to-second basis.

We maintain our view that the odds of a full blown worldwide trade war remain low. Trade war rhetoric from the Trump administration have so far barked more than they have bitten. The headlines about the upcoming decision of the Trump administration, such as blocking China's investments in U.S. technology out of security risk concerns, withdrawing from the World Trade Organization (WTO), and imposing automobile import tariffs all ended up with much watered down scenarios. President Trump has declined to take actions on leaving the WTO, and decided to use the Committee on Foreign Investment in the U.S. (CFIUS) instead of invoking the national emergency law on China’s investments in the U.S. Recently, U.S. officials also indicated proposals of zero duty on cars imported from Europe if the bloc makes concessions on U.S. made cars tariffs. The Trump administration may have appeared to play a game of chicken by exerting trade threats in an ever aggressive fashion. In practice however, a stronger U.S. economy has helped the Trump administration to extend the trade war with China in a way that can lead to a favorable deal.

In our last quarterly investment management report, we warned against overly discounting downside risks in economic growth out of trade war worries. Indeed, rather than further deteriorating to stagnation from a soft patch earlier this year, growth trajectory in Europe, Japan, and China have shown signs of stabilization towards the end of the second quarter based on leading economic indicators. In the second quarter when trade tensions escalated further, the U.S. stock market managed to recover more than its losses during the first quarter amid buoyant economic prospects and a strong earnings season. Indicators of volatility for both U.S. equity and foreign exchange rates are also reflecting the calm of the markets, and the fact that trade conflicts have so far spared “Main Street” despite being the major catalysts for Wall Street this year. With major demand drivers, including fiscal spending, investments, and consumption, firing on all cylinders, U.S. real GDP growth is expected to accelerate in the next few quarters, supporting strong earnings growth for the rest of the year. Small-cap's relative strength to the market also reflects the strength of domestic demand in the U.S. Yet analyst projections for 20%+ YoY profit growth in the second quarter is relatively tame despite a faster growing U.S. economy which continues to underpin bottom line growth. Domestic corporate earnings are very likely to deliver another strong quarter for the second quarter, after earnings for the first quarter grew by 26.6% YoY vs the expectation of 18.5%. A survey by Bloomberg shows that strategists expect the second half of 2018 to be one of the strongest of the nine-year bull market run.

However, not all markets demonstrated the same resilience as those in developed countries. During the second quarter, China’s equity market plunged into bear market territory. Over the past year, China’s campaign to curb financial leverage and to reform onshore bond markets have led to increased defaults and rising yields in the local corporate bond markets, which eventually triggered sell-offs in the equity market where 13% of value was pledged as collateral for company debts. The Latin American region has not fared better with Brazil and Argentina both experiencing bearish markets as well. Amid a broad-based correction, Emerging Market equities as a whole saw its worst decline since 2015 in the second quarter, or the 25th largest decline among 46 down quarters since MSCI's Emerging Market benchmark was launched in 1988, according to Bloomberg. The Emerging Market debt market also saw its worst first half in history.

While it’s easy to blame trade risks for the market turmoil, we think the escalating trade war rhetoric are just scapegoats to those markets in turmoil. With global central banks on a broad-based wave of tightening actions albeit at different stages of their cycles, the underlying risks for financial markets are boiling under the combination of uneven economic growth trajectories in various economies and concurrent liquidity tightening. After years of easing, central banks' stimulus is now reversing. Major global center banks in the U.S., Europe, and Japan are either raising rates or reducing the size of their balance sheets. The ECB is tapering its bond purchases, and the Bank of Japan is mulling over a gradual retreat from buying bonds. Yet, despite the turmoil in Emerging Markets as developed countries reverse their easy-money policies, Emerging Market central banks are expected to raise their interest rates at the fastest pace since 2011 to respond to higher U.S. interest rate and USD appreciation that exposed their dependence on foreign borrowings. China has also recently expanded credit to small businesses and accelerated debt-to-equity swaps for state owned enterprises in response to piling stresses in capital markets. But this should be regarded as fine tuning rather than a signal for a change in plan. In the backdrops of global tightening, the rising political risks in major emerging economies has also further dampened their economic outlooks.

At this point, all major accumulative changes of various economic indicators in this current cycle are pointing to further transition from mid cycle to late cycle. As we have indicated before, the yield curve in both the short end and long end of the U.S. treasury market persisted in its downward trend but has not yet inverted, signaling aging of the current business cycle instead of recession. History has shown that equity markets can still pull off smaller gains albeit with higher volatility during the late part of the cycle. Some signs in the credit markets are also sending a more profound late cycle signal than the macro fundamentals: re-leveraging among investment grade debt issuers driven by mergers and acquisition and share buybacks, weaker borrowers retreating to floating-rate credit available in the leveraged loan and Collateralized Loan Obligation (CLO) markets, moderation in credit growth shown by recent senior loan officer surveys, and potential peaking in CLO markets indicated by retail investors' enthusiasm for closed end funds holding the riskiest tranches of the CLO structure. The popularity of those closed end funds among retail investors warrants some caution as the CLOs have become a borrowers' market where creditor protections get weaker in the underlying loans. Additionally, a lack of standardized market structure makes the CLO markets prone to shocks from misallocation and potentially could trigger similar market events as the volatility rout that took place in February this year.

BONDS

Investment Grade Bond, High Yield Bond, and Emerging Debt markets all saw their credit spread expanded during the second quarter amid the global tightening cycle. At the same time, ten-year treasury yields increased further from 2.74% to 2.86%, with half of the move attributed to higher expectation in inflation, and the rest due to impacts from an increased supply of Treasury bills, partially offset by a slight flattening of the yield curve.

We continue to anticipate a flattening yield curve as the Fed proceeds with its current rate hike cycle although rising money-market rates have made it harder for the Fed to maintain control over their key policy benchmark. The surge in supply of Treasury Bills has pushed key overnight rates higher, making short-term assets more attractive alternatives than lending reserves to other banks. In light of less supply in the interbank borrowing market, demands on reserves in the interbank market has increased as most U.S. banks do not have excess reserves. Consequently, if the Treasury Bills issuance continues to ramp up and drive overnight rates higher, the upward pressures on the Fed's policy rate may trigger the Fed to tweak its current tapering schedule.

THE FUNDS

The equity portfolios' underperformance to the benchmark YTD is caused mostly by the effects of negative stock selection in the Consumer Discretionary and Information Technology sector. This is predominately due to avoiding the FAANG stocks which contributed to a big chunk of market upside this quarter, combined with "risk on" buying reemerging in the markets. The positives from the portfolio's overweight in quality, profitability was not enough to offset the negatives from underweight in stocks with high trading turnover, which has been the strongest factor year-to-date as stocks with the highest short interest score led the market by the biggest margin compared to other characteristics. Value stocks also further lagged the broad market, causing the portfolio to be further behind the market rally. Meanwhile, factor based quantitative funds also suffered from their worst performance in eight years as factors that used to move in the opposite directions dropped altogether in June. Popular factors such as growth and momentum experienced drawdowns along with value factors during June, causing one of the largest factor based quantitative shops, AQR Capital Management, to have its market-neutral value fund perform the worst since 2011 over a three month period.

During the quarter, we outperformed the benchmark in the Industrial, Consumer Staple, and Utilities Sectors, while underperforming in the Information Technology, Healthcare, Consumer Discretionary, and Energy Sectors. Our sector allocation largely remained the same with a notable overweight position in Healthcare and Utilities and an underweight position in Financials, Consumer Discretionary, and Information Technology. We have added two new holdings that are positioned to grow with the trend of increasing electrification and automation in automobiles. In addition we removed our holding in the aftermarket automobile parts retail industry.

PERFORMANCE

The Diversified Equity Fund returned 0.47% for the quarter and 7.97% for the last 12 months, while its benchmark returned 3.89% for the quarter and 14.77% for the last 12 months.

The Balanced Income Fund returned 0.41% for the quarter and 2.99% for the last 12 months, while its benchmark returned 1.27% for the quarter and 4.27% for the last 12 months. The duration of the Balanced Income Fund is 2.5 years, the same with that of the previous quarter's 2.5 years.

The Growth and Income Fund returned 0.28% for the quarter and 3.97 % for the last 12 months, while its benchmark returned 1.95% for the quarter and 7.03% for the last 12 months. The duration of the Growth and Income Fund is 2.6 years, slightly lower than the previous quarter's 2.7 years.

The Bond Fund returned 0.33% for the quarter and 0.34% for the last 12 months, while its benchmark returned 0.15% for the quarter and -0.22% for the last 12 months. The duration of the Bond Fund is 2.1 years, slightly higher than the previous quarter's 2.1 years.

The Annuity Fund returned 1.6% for the quarter and 4.93% for the last 12 months. The Annuity Fund does not have a specified benchmark.

Please refer to the UMFF Fund Summary pages, provided separately, for additional portfolio characteristics