



TILDEN

Capital
Management

An Investment Advising and Financial Planning Firm

Firm Inception 08/03/10

08/03/18

Quarter in Review

The Markets

Tariffs grabbed the majority of the headlines in Q2 of 2018, and the effect they will have on both domestic and foreign economies. Following the solar panel and washing machine tariffs in January, the US imposed a 25% and 10% tariff on imported steel and aluminum respectively. This caused retaliatory tariffs on US goods from NAFTA trading parts and the EU. But the main focus of the tariffs has been and will be China. On March 22nd the US imposed tariffs on \$50 billion of goods from China, which China responded with tariffs on 128 US products from 15 to 25%. In April the U.S Trade representative's office published a list of over 1,300 Chinese goods that it could tariff at a rate of 15 to 25%, the response from the Chinese Customs Tariff commission was a list of an additional 106 items it could tariff up to 25%. After China canceled US soy bean orders, the US responded with another \$34 billion goods facing a 25% tariff starting July 6th and another \$16 billion with a TBD date. At the end of the day the president is looking to reduce the overall trade deficit with China, but more importantly to bring them to the table regarding intellectual property theft that has been going on for years. (Which frankly the WTO and other countries have done little to stop.) Most economists agree that tariffs will not make US consumers and workers better off, and disagree with Peter Navarro's (Director of the National Trade Council) views on the economy. But with Q2 GDP printing a 4.1%, critics will be hard pressed to convince this nationalist direction to change. When the tax law effects vanish and tariffs push the economy into recession then the argument can be made. But I believe the gamble here is that the other sides, China, Mexico, Canada and the EU whose economies are slowing and still benefiting from quantitative easing, will cave first. Thus, the US will gain concessions and remove the tariffs prior to the economy tipping into recession.

In other domestic related news, the New York Fed started the path to replace the dependency on LIBOR with the publishing of the Secured Overnight Financing Rate (SOFR) on April 3rd. SOFR is volume-weighted median rate based on actual overnight lending in tri-party repos where treasuries are used as collateral. The difference being, unlike Libor, the rate is calculated on actual transactions and the range of rates is shown daily. Also, AT&T won its court case and was allowed to merge with Time Warner. Lastly the Fed raised the target fund rate another 25 basis points in its June meeting to a target range of 1.75 – 2.00%.

There was no shortage of international news in the second quarter either. In April, Deutsche Bank replaced its CEO with Christian Sewing (pronounces "saving") reduced its US footprint, confirmed shedding 7000 jobs globally, and



TILDEN

Capital
Management

An Investment Advising and Financial Planning Firm

Firm Inception 08/03/10

failed the qualitative portion of the US Federal reserve's exam at the end of June. Morgan Stanley and Goldman Sachs also failed this portion of the exam but unlike DB were given an *option* to freeze their payouts and would then get a "conditional, non-objection" grade instead of failing. Some animals are just more equal than others... In April the US sanctioned many of the Russian Oligarchs, causing aluminum prices to spike as Oleg Deripaska's United Co. Rusal was targeted. The deadline to sell shares in Rusal was extended at the end of July from August 5th to October 23rd. Also, in early April the US hit Syria with a second missile strike in response to another chemical weapons attack by Assad forces. In the UK, PM May continued to struggle with Brexit negotiations but on 06/29/18, with Royal approval, the Brexit bill became law. But in early July both Brexit Secretary David Davis and Boris Johnson resigned their posts leaving May to personally negotiate with the EU. This is like watching a car crash in slow motion. In the beginning of June, Italy finally formed a government while Spain dissolved one as Rajoy lost a vote of confidence. In early May, the US pulled out of the Iran Nuclear deal, with many US allies calling for them to stay in. Five days later the US inaugurated its embassy in Jerusalem sparking Palestinian protests which ended with the deaths of 57 people. The tension between the US and Iran is palatable, and my thought is that this will not end like the rhetoric between the US and North Korea, but rather previous sanctions and more will be put into effect. Speaking of North Korea, the President and Kim Jong-un sat down for a relatively softball summit on June 12th in Singapore. Sanctions are still in place and missiles are still being built. Lastly in mid-June the ECB stated that it plans to end bond buying program. <http://www.ecb.europa.eu/press/pr/date/2018/html/ecb.mp180614.en.html> They will half it in September and end it in December. But they will not pare down the balance sheet instead they will reinvest the proceeds. But to stave off tightening fears, they stated that they will keep interest rates the same through the summer of 2019

In Markets, the best performing asset segments were real estate and small cap stocks up over 10% and 8% for the quarter respectively. The biggest equity losers were in emerging markets and non-US developed markets down 7.9% and 2.3% respectively. US taxable fixed income was practically flat except for long bonds down over 1.4%. Global bonds though performed much worse, down 4.8% reversing Q1's positive 3.6% and putting it into negative territory for the year. Both High Yield and TIPS were up close to 1% as the equity rally continued and inflation has started to pick up. The other decent performer for the quarter was commodities up over 4% and close to 6% for the year.

Interest Rates

The Federal Reserve increased the target range for the Federal Funds rate by another 25bps in June to 1.75% - 2.00%. The effective rate has been around 1.91% since the meeting except for a few days where it fluctuated a basis point. This quarter however was different than Q1 in that we got a bear flattener, as the difference between the 2-year treasury rate and the 10-year rate went from 47bps to 33bps with the front side moving up over twice the amount as the back side. Historically recessions have often followed the inversion of the yield curve, where



TILDEN

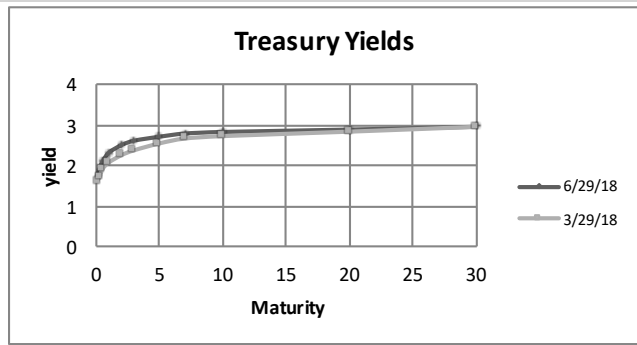
Capital
Management

An Investment Advising and Financial Planning Firm

Firm Inception 08/03/10

short terms rates are above long-term rates. There are market pundits out there touting that this time will be different, citing an immeasurable array of reasons, but since this expansion is already the second longest in recorded history, I will be watching the effects of rising interest rates and tariffs very closely.

Years	6/29/18	3/29/18	Difference
0.08	1.77	1.63	0.14
0.24	1.93	1.73	0.2
0.5	2.11	1.93	0.18
1	2.33	2.09	0.24
2	2.52	2.27	0.25
3	2.63	2.39	0.24
5	2.73	2.56	0.17
7	2.81	2.68	0.13
10	2.85	2.74	0.11
20	2.91	2.85	0.06
30	2.98	2.97	0.01



The Primary Mortgage Market Survey from FHLMC showed the 30-year conforming balance fixed rate mortgage has ticked up over the quarter from 4.14% to 4.55%. 15-year conforming balance moved up more from 3.39% to 4.04%. As this report has taken a little longer than anticipated, the Mortgage Bankers Association information is a little more current than Q2. As of 7/27/18, 30-year conforming balance FRM are 4.84 with .45 points, while jumbos are 4.76 with .37 pts. 15-year conforming balance FRMs are 4.29% with .53 points. With the Fed probably raising rates in September and February look for mortgage rates to get close to or above 5% by year end.

Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) stood at 109.8 for the quarter ending June 2018. Three quarters of the 10 factors contributed positively this month. ISM New Orders contributed the most, followed by the Interest rate spread (10-year treasury bonds less federal funds), and then average consumer expectations for business conditions and stock prices. The largest detractors were building permits, down each month of the quarter. There is a reason that economists watch housing closely as an economic indicator. New houses require construction teams, building materials, durable good purchases. Reductions in permits are a good leading indicator, and should be watched closely. Given the fact that it was the only Leading indicator that was negative and other indicators have moved back in additive territory I will watch the LEIs but am less concerned at this stage.

Jobs

At the time of this write up **nonfarm payrolls** posted an increase of 213,000 jobs for June (consensus was 195k). The Household survey was up 102,000 jobs. The labor force participation rate of 62.9 was exactly the same in Q1



TILDEN

Capital
Management

An Investment Advising and Financial Planning Firm

Firm Inception 08/03/10

and the unemployment rate was down a tenth to 4.0% and up from the 3.8% it printed in May. This was due to more people entering the job market again that had been sitting on the sidelines. The 214,000 average for the first six months of the year is a very good number given where we are in the end of the cycle and that we have a 4% unemployment figure. Just like the first quarter, these numbers are not showing signs of a recession, and help to support the Fed policy of increasing interest rates.

The ISM survey for manufacturing jobs hovered around 56 for the entire quarter, a point below the Q1 average but definitely still in the expansion phase. The average manufacturing employment in the BLS survey was 28k jobs added per month, stronger than the first quarter. Employment is still strong and showing little signs of a correction.

Industrial production

Q2 Industrial production numbers were up 1.22% and there was a revision to Q1 from (1.31% to 0.61%) This is an even greater slow-down from Q4 2017. But the Q2 number was pretty good, and the last twelve months of IP are better than they have been since 2014. Manufacturing was up on 1.9% for the past twelve months, while mining is up almost 13% and utilities is up 5% over the same time period. In general, the total index is up 3.8% for the past twelve months. Capacity utilization is stuck at 78% still off the long run average of 80%.

Last quarter saw inflation outpace the revised IP numbers so it changed to an inflationary period, whereas this period is labeled as growth with IP up 1.22% and CPI up only 0.56% for Q2. As stated above the ISM employment index average for the month was 56 off 1 point from the previous quarters but no flashing red lights here either.

Housing

Single-family new home sales were 631,000 units per year as of June 2018, compared to a Q4 average of 655,000 and a Q1 average of 656,000. **Existing home sales increased to 5,380,000** on an annual basis ending March, showing another slowdown, or possibly shift to early sales in the season. The S&P/Cash Schiller 20 city composite index has risen 6.51% in the twelve months ending May 2018. **The May report had all 20 cities reporting positive growth** (seasonally adjusted). S&P reported that continued price increases, combined with rising mortgage rates are now affecting sales of both new and existing homes. The slowing of the housing market could be a canary in the coal mine, but other strong factors in the economy are not pointing to a deterioration yet.

The Consumers

The **Conference Board's consumer confidence index stood at 127.1 as of June 2018** (March's revised number was 125.6). Although off from February's 130, it was steady through the quarter. Business conditions (a positive



TILDEN

Capital Management

An Investment Advising and Financial Planning Firm

Firm Inception 08/03/10

number in the LEI) was considered the main reason, as were people’s outlook on the labor market. **University of Michigan’s Consumer Sentiment number was 98.2 in June, off from the 101.4 of March.** Concerns about the effects of tariffs have increased in each survey from May on until July, rising from 15% to 35%. Those that mentioned tariffs saw negative impacts to the economy and employment but those impacts would disappear with resolutions to the tariff problem.

Personal income and outlays showed expansion across total, disposable, and consumption all up close to 5% year over year. Real Personal income less transfers is now expanding closer to 3% or its long run average. This is a lagging indicator but still one of the top ones NBER looks at to confirm recession time periods. **The personal savings rate is now closer to 7% for the year than the 6.675% of last year,** but consumer debt still continues to climb at a rate of over 5% annually. Consumer debt has continued to expand at a 4.77% year-over-year rate ending May 2018. Revolving debt passed its pre-crisis levels back in September of 2017 but non-revolving debt (car loans, education loans, etc.) is now 1.8x pre-crisis levels at 2.85 trillion dollars! What impact will increasing defaults have on an already heavily indebted US Government. From February 2009 until January 2017 non-revolving debt expanded at a 6.37% annual rate, from February 2017 until May 2018 it was 4.72%. An even more enlightening group of data points is in the below table of who has and does own the debt over the past nine decades. The source of the data is from (<https://www.federalreserve.gov/releases/G19/default.htm>)

Nonrevolving consumer credit owned and securitized by: (not seasonally adjusted)							
Date	Depository Institutions	Finance Companies	Credit Unions	Federal Government	Nonprofit and educational institutions	Nonfinancial business	Securitized
1943-01	39%	16%	0%	0%	0%	44%	0%
1950-01	45%	23%	1%	0%	0%	32%	0%
1960-01	47%	25%	5%	0%	0%	23%	0%
1970-01	51%	22%	10%	0%	0%	17%	0%
1980-01	59%	19%	16%	1%	0%	5%	0%
1990-01	53%	21%	15%	3%	0%	4%	4%
2000-01	39%	19%	16%	9%	0%	4%	14%
2010-01	33%	27%	12%	14%	5%	1%	8%
2018-05	25%	18%	13%	42%	1%	1%	1%

For those of you that keep track of the money supply that is 1.187 trillion dollars that cannot be directly expanded or reduced by the Federal Reserve. Does a student care what interest rate is on a loan that they won’t start paying for four years, if that? Go ahead and ask your 8, 12 or 16 year old child to explain interest rates to you.



TILDEN

Capital
Management

An Investment Advising and Financial Planning Firm

Firm Inception 08/03/10

Inflation

As of June, CPI was up 2.80% over the past twelve months, and is climbing. PCE was up 2.23% and the GDP Deflator was up 2.47% over the same time period. Welcome back inflation. The seasonally un-adjusted numbers that the BLS reports showed Food up 1.4%, Energy up 12%, Shelter up 3.4%, transportation services up 3.7% and Medical care services up 2.5% over the past twelve months. The main detractor in the energy sector was the Utility (piped gas) down 2.1% over the same period. The Fed seems to be in a sweet spot with inflation rising (justifying interest rate normalization) with low unemployment 4% (justifying normalizing over a longer period of time), while long term interest rates are indeed moderated.

In Closing

We are now **108 months** into an economic expansion with the **average expansion being 42 months** (and the longest being 120 months) for the past 33 cycles. The yield curve has flattened over 60 bps since June 2017, while the Fed hiked another 25 bps in June. Two more hikes are expected for the year but the fed is aptly aware of the effects of the tariffs currently in place and those speculated on. The LEI was up again with three quarters of the indicators contributing positively, albeit four of the ten were adding .00 to .02 to the overall indicator. Industrial production was up 1.22% for the quarter with a starkly lower revision to Q1. Production looks good and consumption looks strong with help from the tax law change, but that is transitory, so let's see how Q3 and Q4 look. Q1 GDP was 2.22% and the first pass at Q2 was 4.06%, and with inflation up and unemployment down the Fed doesn't have many obstacles (except for tweets from oval office) to raising rates two more times this year. Jobs were strong throughout the quarter and temporary services continue to tick up.

I made a couple of changes to security selection in some of the 529s this quarter but since I only have two bullets (can only reallocate twice in one year) I don't feel using the second allowable reallocation was prudent with the tariff talk potentially derailing the economy later in the year. Over-cautious probably, but never too much with a client's education savings for their children. The second quarter was much better than the first, we were up about 1.7% across the portfolios reversing the losses of Q1. The place to be for the quarter was Real Estate, Small Cap Stocks and Commodities. I have shied away from Real Estate in this rising interest rate environment, and am still licking my wounds from commodities. If inflation gets out of the feds controls then I might allocate some to the commodity space then, but only small amounts. The economy is not showing signs of recession and my model only has a 15% chance of it occurring anytime soon. If the effects of tariffs truly start being felt by the economy and interest rates get normalized then there should be a heightened possibility, but I don't think that happens for at least 9 months from now or perhaps longer.