

ACCESS FINANCIAL SERVICES, INC.

Quarterly Review and Outlook

Second Quarter, 2018

Benchmark Returns as of June 30, 2018

INDEX	Last 3 Mo.	Last 6 Mo.	Last 12 Mo.
US STOCKS			
S&P 500 Index (large-cap stocks)	3.43	2.65	14.37
Russell 2000 Index (small-cap stocks)	7.75	7.66	17.57
FOREIGN STOCKS			
MSCI EAFE Net Total Return Index (US\$)	(1.24)	(2.75)	6.84
S&P Europe 350 Index Net Total Return Index (US\$)	(1.17)	(3.34)	5.22
MSCI Japan Net Total Return Index (US\$)	(2.84)	(2.03)	10.51
MSCI Emerging Markets Net Total Return Index (US\$)	(7.96)	(6.66)	8.20
COMMODITIES			
US Dollar Index (DXY)	4.91	2.41	(1.21)
Euro	(5.02)	(2.73)	2.26
Gold	(5.50)	(3.85)	0.89
Oil (West Texas Intermediate)	14.18	22.72	61.06
Bitcoin	(13.91)	(58.78)	135.75
BONDS			
BloomBar* US Aggregate Bond (investment-grade bonds)	(0.16)	(1.62)	(0.40)
ICE US Treasury 20+ Year TR Index	0.35	(3.02)	0.03
BloomBar* US Treas. Inflation Protected Securities (TIPS)	0.77	(0.02)	2.11
Bloomberg Barclays Municipal Bond Index	0.87	(0.25)	1.56
BBG* US Corporate Total Return (corporate bonds)	(0.98)	(3.27)	(0.83)
BloomBar* US Corp. High Yield Tot. Rtn. (high yield bonds)	1.03	0.16	2.62
BloomBar* Global Aggregate Treasuries Total Return	(3.52)	(0.73)	1.93

*Bloomberg Barclays; Source: Bloomberg Finance LP

"We're going to win so much, you're going to be so sick and tired of winning"

Candidate Donald Trump, May 26, 2016

President Trump was elected with the mandate of changing the trajectory of American power and getting the country back on a "winning" path. Most of the moves by the administration – from protectionist actions against China and traditional allies, to applying maximum pressure policies against North Korea and Iran – are all part of his fight against the decline of US power.

Trump's economic populism is boosting sentiment and mitigating the negative consequences - real or imagined - of his protectionism. At the same time, the threat of tariffs is straining our relationships abroad.

This policy mix is causing US assets to outperform. As shown in the table above and in Chart 1, US stocks meaningfully outperformed their foreign counterparts during the quarter and year-to-date. US small company stocks have significantly outpaced large companies due to the greater impact of tax cuts on their earnings and the relatively low direct impact of foreign policy.

The US dollar's 5% rise in the second quarter is putting growing pressure on emerging markets (EMs) assets in particular. 80% of EM foreign-currency debt is denominated in US dollars. Outside of China, EM dollar

debt is now back to late-1990s levels both as a share of GDP (Chart 2) and as a percent of exports. Just like in that era, a vicious cycle could unfold where a stronger dollar makes it difficult for EM borrowers to pay back their loans leading to capital outflows from EMs and an even stronger dollar.

Chart 1: US, Developed Foreign & Emerging Market Stocks Year-to-Date

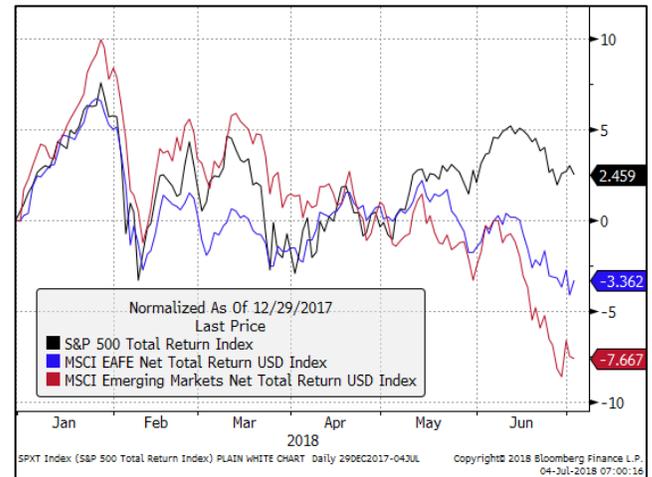


Chart Source: Bloomberg Finance LP

Chart 2: EM US Dollar Debt Relative to GDP

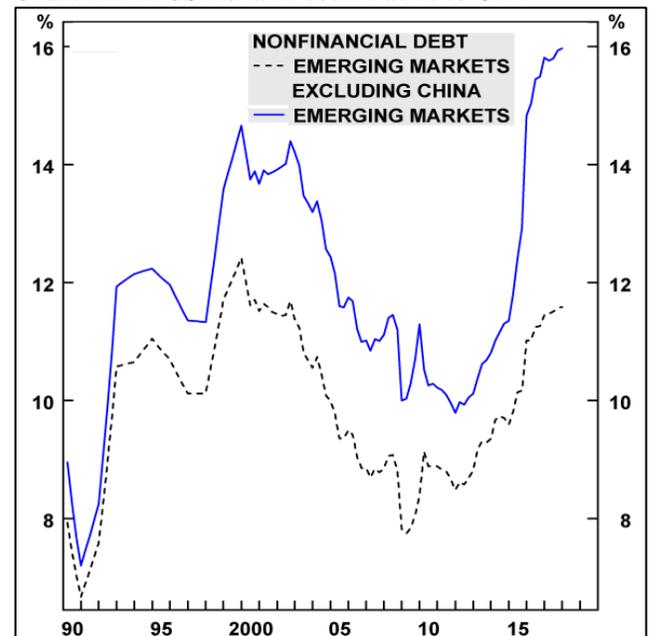


Chart Source: BCA Research

This is obviously not the first time that an American president has employed both an aggressive trade policy and an aggressive foreign policy. The difference now is

that the world is “multipolar”¹. A characteristic of multipolarity is that it is less predictable and more likely to produce conflict. As more countries matter geopolitically, economically and financially, the number of "veto players" rises, making stability more difficult to achieve. This time around, bullying as a negotiating tactic that worked in the past may not work going forward.

There is a clear logic behind President Trump's foreign and trade policy: he is trying to reverse a decline in US leadership and dominance. However, the problem is that his policy decisions are unlikely to address the structural causes of America's decline. What is more likely is that his policy will cause the rest of the world to react in unpredictable ways. The US may benefit, but that is far from a foregone conclusion.

After months of posturing, Trump's trade war is heating up. The US imposed tariffs of 25% on \$34 billion of Chinese goods on July 6. Tariffs on another \$16 billion of goods are set to go in effect on July 20th. China has stated that it will retaliate in kind.

On July 10, Trump further upped the ante, announcing that he will levy a 10% tariff on an additional \$200 billion of Chinese imports by August 31. He also threatened tariffs on another \$300 billion on top of that if China still refuses to back down. That would add up to \$550 billion in Chinese goods and services that could be subject to tariffs, more than what China exported to the US last year.

China is not the only country in Trump's crosshairs. The Trump administration levied tariffs of up to 25% on steel and aluminum from the European Union (EU), Canada, Mexico, and other US allies on June 1, 2018. The affected regions have retaliated with their own tariffs.

The first \$50 billion targets goods that will not affect most Americans. However, the next \$200 billion will affect everyone either directly or because of the impact on the costs of manufacturing.

The majority of trade today is in the exchange of intermediate goods within complex global supply chains. US firms are particularly vulnerable to supply chain disruptions because the Trump administration has chosen to impose tariffs mainly on intermediate and capital goods (Chart 3). In contrast, China and the EU, which have raised tariffs mainly on final goods in a politically strategic manner such as agricultural products in Trump-supporting rural areas and Harley Davidson motorcycles, which are manufactured in Paul Ryan's home district in Wisconsin.

There is little reason to think that trade tensions will ease over the coming months. Protectionism is popular with the American public. Trump ran on a protectionist platform

and now he is trying to fulfill his campaign promises. It doesn't help that Trump is accusing foreign governments of doing things they are not doing. Chart 4 shows that US tariffs are actually higher than in most other G7 economies.

Chart 3

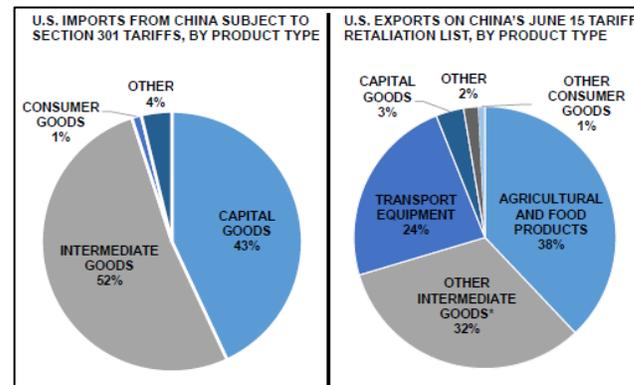
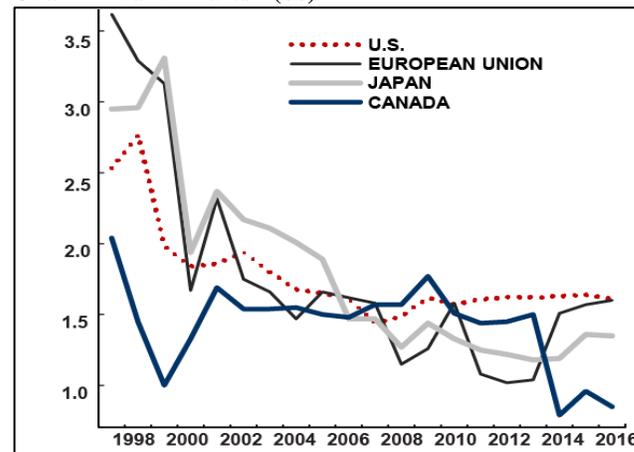


Chart Source: BCA Research

Chart 4: Tariff Rates* (%)



*Tariff rate, applied, weighted mean, all products. Latest data is for 2016. Data source: World Bank. Chart Source: BCA Research

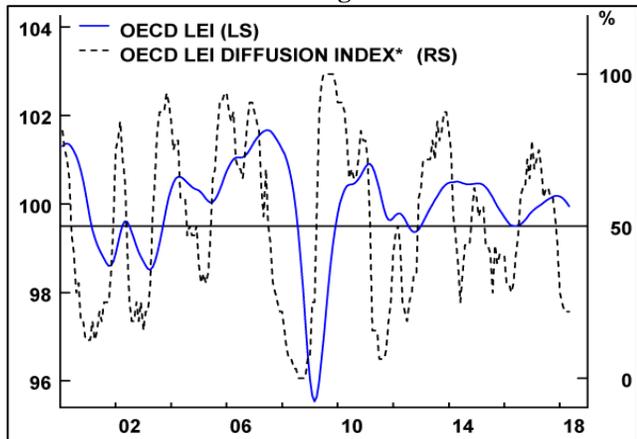
The question as to how much damage a trade war could do to the global economy is a difficult one to answer and economic theory doesn't add much that's usable in the real-world. Our sense is that the true cost of a trade war would be much greater than simple economic models suggest.

From an economic growth perspective, the global economy experienced a synchronized expansion in 2017. For the first time since 2007, all 46 countries tracked by the Organization for Economic Cooperation and Development (OECD) experienced positive GDP growth. Global real GDP growth accelerated to 3.8% from 3.2% in 2016 with the euro area, Japan, and most emerging markets moving from trailers to leaders in global growth.

¹ Multipolarity is a term that describes a situation when the number of states powerful enough to pursue an independent and globally relevant foreign policy is greater than one or two.

The opposite has developed this year. Global growth has slowed, and this trend that is likely to continue over the next few quarters judging by a variety of leading economic indicators (LEIs) (Chart 5).

Chart 5: OECD Total Leading Economic Indicator



*Number of countries with rising LEIs as a percentage of total. Based on 32 OECD countries. Chart Source: BCA Research

The US, on the other hand, has once again moved into the lead. It is the only major economy where the LEI is still rising (Chart 6). The NY Fed’s Nowcast model is pointing to 2.8% annualized real GDP growth in the second quarter while the Atlanta Fed’s GDP forecast (its GDPNow model) suggests that US real GDP growth could reach 4% (first quarter GDP was 2%), more than double most estimates of trend growth.

Chart 6: OECD LEIs (US, euro area, Japan & UK)

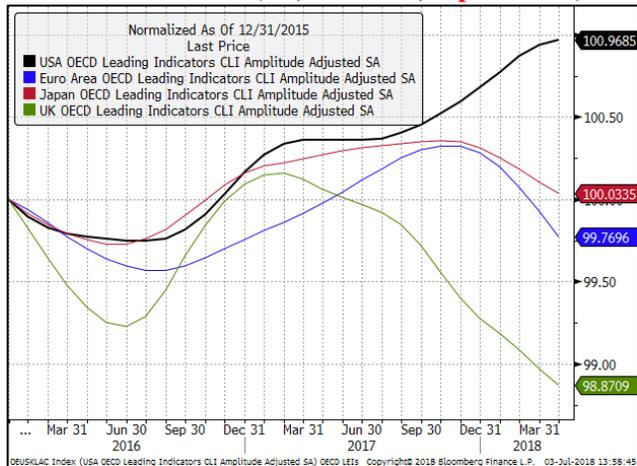


Chart Source: Bloomberg Finance LP

For the first time in over a decade, the US economy has reached full employment. The unemployment rate stood at a 48-year low of 3.75% as of May 31. The number of people outside the labor force who want a job, as a percentage of the total working age population, is back to pre-recession lows. And, for the first time in the history of

the Bureau of Labor Statistics' Job Openings and Labor Turnover Survey, there are more job vacancies than unemployed workers.

Continuing unemployment claims have closely tracked the unemployment rate over time (Chart 7). The fact that continuing claims have dropped by 9% since the end of January, while the unemployment rate has come down by only 0.1 percentage points, suggests that the unemployment rate will fall further over the coming months.

Chart 7: Number of People Receiving Unemployment Insurance (Thousands) & Unemployment Rate

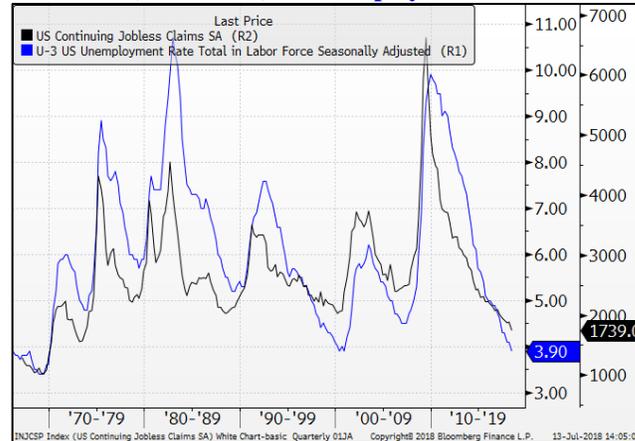


Chart Source: Bloomberg Finance LP

As the labor markets tighten, wages should accelerate further. Average hourly earnings surprised to the upside in May. The Employment Cost Index for private sector workers - one of the cleanest and most reliable measures of wage growth - rose at a 4% annualized pace in the first quarter. The US labor market finally appears to have moved onto the steep side of the Phillips curve² (Chart 8).

Chart 8: Phillips Curve

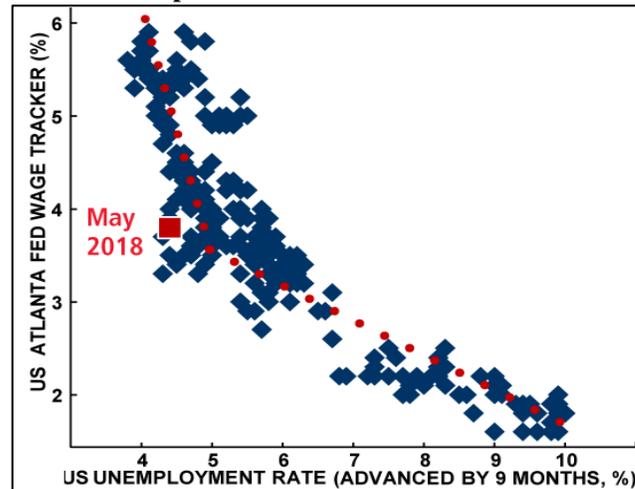


Chart Source: BCA Research

² The Phillips curve depicts the relationship between employment and inflation. It tends to steepen at an increasing rate as unemployment falls to very low levels.

Rising wages lead to increased spending. As demand increases beyond the economy's productive capacity, inflation will rise. The New York Fed's Underlying Inflation Gauge, which leads core CPI inflation by around 18 months, has now advanced to 3.27% (Chart 9). The prices paid components of the Institute for Supply Management surveys, regional Fed purchasing manager surveys, and National Federation of Independent Business percent of firms raising selling prices have also surged.

Chart 9: NY Fed Underlying Inflation Gauge (advanced by 18-months) & Core Inflation (CPI)

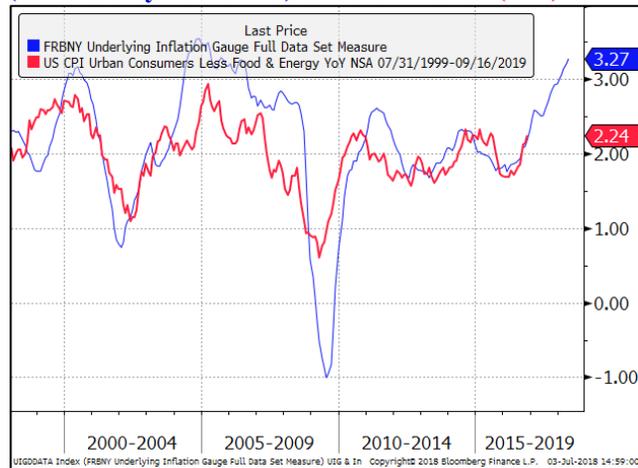
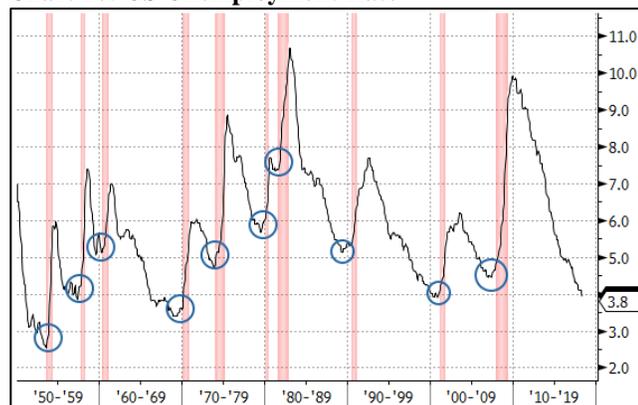


Chart Source: Bloomberg Finance LP

The fact that the unemployment rate has fallen to 0.7% below the Fed's estimate of full employment naturally seems positive. However, as we've pointed out in the past, the situation has a bit of a dark side. There has never been a case in the post-WWII era where the unemployment rate has risen by more than one-third of a percentage point without this coinciding with a recession (Chart 10).

Chart 10: US Unemployment Rate*



*Shown as 3-month moving average; Red shaded areas denote recessions; Circles denote times when 3-month moving average increased more than 1/3%; Chart source: Bloomberg Finance LP

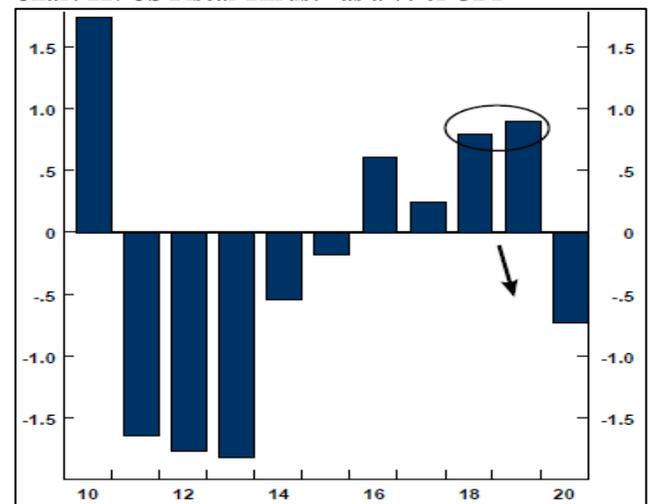
The Fed wants to avoid a situation where the unemployment rate has fallen so much that it has nowhere to go but up. Therefore, we think the bar for the Fed to abandon its once-per-quarter pace of interest rate increases is rising. If anything, the risk is that the Fed accelerates

monetary tightening. Fed Chairman Powell's recent announcement that he will hold a press conference at the conclusion of every Fed meeting could even be opening the door for the Fed to move back to its historic pattern of hiking rates once every six weeks.

While mainstream economic theory says that governments should tighten fiscal policy as the economy begins to overheat in order to accumulate a war chest for the next downturn, the Trump administration is doing the opposite. The budget deficit is set to widen to 4.6% (currently 3.5%) of GDP next year on the back of tax cuts and increases in government spending.

This creates a strong "fiscal impulse" (the *change* in the rate of change of fiscal policy) during 2018 and 2019, but is set to fall in 2020 as the full effects of the tax cuts and spending hikes make their way through the system (Chart 11). This is not to say that fiscal policy will be tightening in 2020. Rather, that the *rate of change* in the fiscal impulse will no longer be a positive tailwind for economic growth and GDP will start to decline.

Chart 11: US Fiscal Thrust* as a % of GDP



*Change in cyclically-adjusted primary budget balance
Source: BCA Research and IMF Fiscal Monitor

We believe that the overall macroeconomic and geopolitical context is negative for global risk assets and that investors should be prepared for a period of uncertainty and increased volatility for the rest of the year as the world responds to a US administration focused on "winning".

Markets have grown accustomed to the notion that central banks will come to the rescue when there is significant weakness in the financial markets. This is known as the "Fed put". While financial market turbulence always has the potential to influence monetary policy, we think the "strike price" (the level asset prices need to drop to before the Fed will step in) has been marked down to a lower level now that unemployment is so low and inflation is showing signs of increasing.

Similarly, worries about growing financial and economic imbalances will limit the effectiveness of the "China stimulus put" - the tendency for the Chinese government to ease fiscal and credit policy at the first hint of slower growth. The same goes for the "Draghi put" as the European Central Bank is hoping to wind down its asset purchase program later this year.

While the geopolitical, monetary and fiscal policy environments signal risks are to the downside, US stocks have been remarkably resilient. In fact, since the 10.2% market setback between January 26 and February 8, the S&P 500 is closely tracking its average path following market corrections since 2010 (Chart 12). This is likely due to continued strong current and expected corporate earnings growth in the US (Chart 13) and the uncertainty about the impact of a trade war.

Chart 12

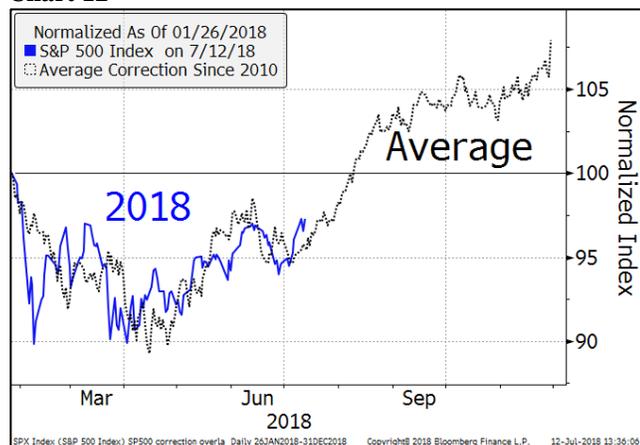
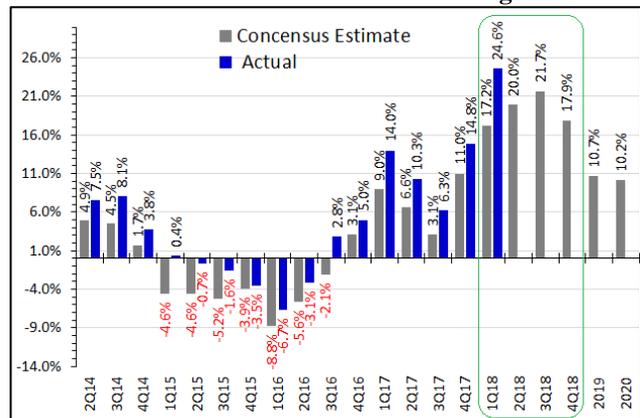


Chart Source: Bloomberg Finance LP

Chart 13: S&P 500 Year Over Year Earnings Growth



Source: Factset

US corporate earnings expectations are also benefiting from a surge in stock buyback announcements as a result of the Tax Cut and Jobs act of 2017 (Chart 14).

Also, low unemployment, increasing wages and the positive impact of tax cuts mean that the additional 10% tariffs on \$200 billion of Chinese imports will take some time to impact the US economy.

Chart 14: S&P 500 Stock Buyback Announcements

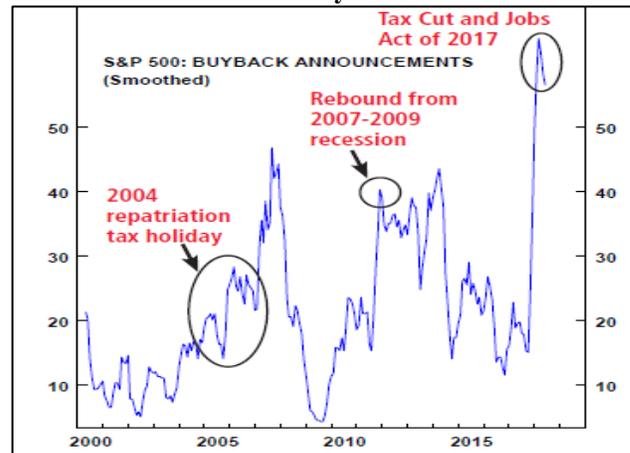


Chart Source: BCA Research

Nevertheless, we think the markets are underestimating the risks of a trade war and therefore have a cautious outlook.

As bad as a trade war would be for Main Street, it would be even worse for Wall Street. The mega-cap companies that comprise the S&P 500 have a lot more exposure to foreign markets and global supply chains than the broader US economy.

Our view is that a trade war would lead to lower stock prices and wider credit spreads (the margin above US Treasury interest rates that corporations borrow at). This, in combination with the effects of rising US interest rates, a strengthening US dollar and higher oil prices translates into tighter overall financial conditions.

Tighter financial conditions will likely be felt first and to the largest degree in EMs. As shown in Chart 15, EM stocks almost always fall when US financial conditions are tightening. This dynamic appears to be playing out as EM stocks have significantly underperformed US stocks since the end of March (Chart 16).

Chart 15: EM Stock Prices & US Financial Conditions

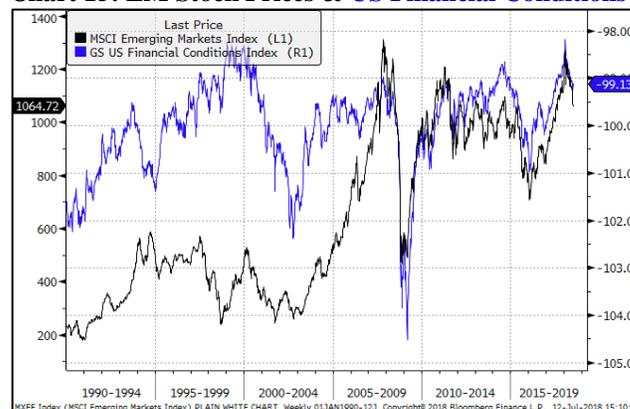


Chart Source: Bloomberg Finance LP

Foreign economies – EMs in particular – are more dependent on Chinese growth than the US. And, while the US is engaged in stimulative fiscal policy, and monetary

policy is not yet restrictive, China is focused on economic and social reform. The combined impact of reduced trade with the US and China's commitment to the "Three Battles" of systemic financial risk, pollution and poverty (the first two requiring tighter policy) will work against economic growth. Also, the Chinese authorities will feel less pressure to stimulate because Trump is giving China some "cover" in that the blame for any economic weakness can be placed on US trade policy.

Chart 16: MSCI EM Index, S&P 500 Index & EM relative to S&P 500

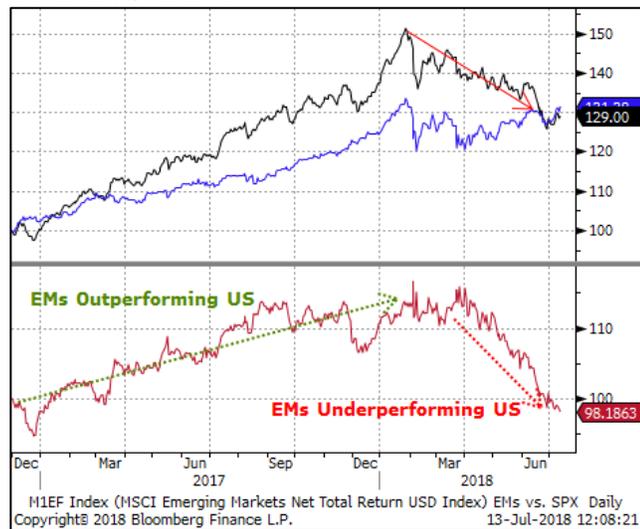


Chart Source: Bloomberg Finance LP

President Trump is a very US centric president. He will not pursue global issues that will hurt him domestically. Not only does he have the support of the median voter, but Congress also supports his views on China. And, contrary to popular belief, he doesn't care about the stock market. He cares about his popularity, which he has figured out is actually inversely correlated with stocks (Chart 17).

Chart 17

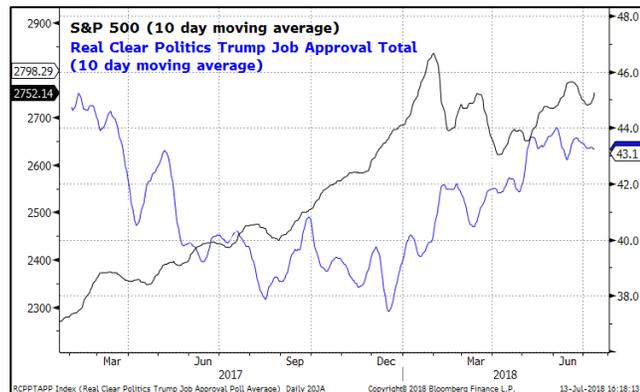


Chart Source: Bloomberg Finance LP

We would like to believe the rest of 2018 will play out according to the path shown earlier in Chart 12, and we hope it does. What we actually believe is that the combined effects of tightening financial conditions and

escalating trade tensions will result in higher volatility and much more limited upside for risk assets.

In this environment:

- US stocks should continue outperforming foreign stocks
- The US dollar should continue strengthening due to
 - Stronger US economic growth
 - Higher US interest rates
 - A weakening Chinese yuan

In almost all cases, our clients' portfolios are underweight stocks overall and foreign stocks in particular.

While a less constructive outlook for stocks would normally imply a more favorable view of bonds, that's not the case today. We think the most likely path for interest rates for the rest of the year are higher. If this plays out, bond prices will decline.

Short term interest rates have risen significantly since late 2015, while longer term interest rates have risen to a much less degree (Chart 18). In fact, the difference in interest rates between 10-year US Treasuries (2.83%) and 2-year US Treasuries (2.58%) is only 0.25%. Therefore, short term bonds and money market funds are an increasingly attractive alternative to longer term bonds because of their relative price stability.

Chart 18: Treasury Yields 12/31/15 & 07/13/18

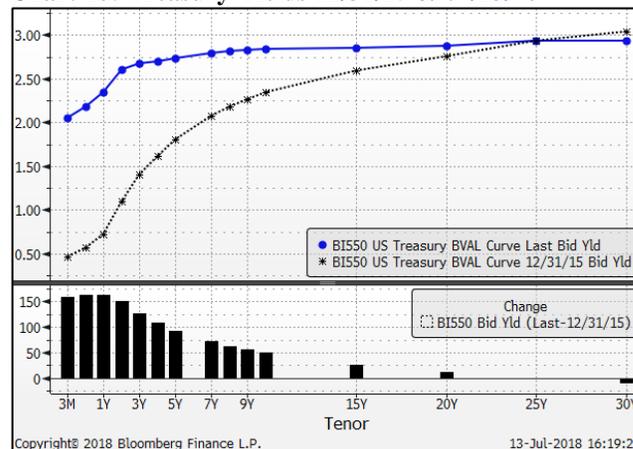


Chart Source: Bloomberg Finance LP

We also continue to emphasize floating rate securities within our clients' fixed income allocations.

-Brant Kairies
952-885-2732

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