SECOND QUARTER 2018

Matt's Market Update

IN THIS REPORT

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Market Review

Location, location, location. The mantra of real estate investing also applied to stocks in Q2 as the recent trend for global equities rising or falling in unison was broken. While U.S. stocks, particularly growth companies and small-caps shined, foreign markets diverged considerably with losses of at least 2% across the board depending on the category. The MSCI ACWI ex USA index of foreign large-caps declined -2.61% for the quarter as investors expressed concerns over potential trade wars and the impact of a strengthening U.S. dollar. Emerging markets (one of the best performing asset classes in 2017) were particularly weak with a quarterly loss of -8.87% for the average fund in the Morningstar peer group. To put an exclamation point on the weakness in emerging markets (and the risk of investing in sector funds as opposed to diversified strategies), the Latin America fund category posted a whopping -22.37% decline in Q2. In contrast, U.S. markets rallied in Q2 with the S&P 500 gaining +3.43% while the Russell 2000 and NASDAQ indices led the way with gains of +7.75% and 6.31% respectively. The trend of Growth outperforming Value remained firmly in place.

Most fixed-income categories followed the declines in Q1 with very modest gains or losses in Q2. The yield on the benchmark 10-year U.S. Treasury rose modestly from 2.74% at the start of the quarter to 2.85% at quarter-end, but yields did briefly rise above 3% before settling back. The Fed once again raised short-term interest rates by 25 basis points in June, continuing their program of monetary tightening that commenced in June 2016. Most market observers feel that two more rate hikes are in store by year-end. We continue to believe that Fed policy is the key to equity market performance going forward. If you believe (as we do) that the Fed's QE (Quantitative Easing, aka money printing) policies since 2009 were a key factor in moving stock markets higher, then you have to believe that QT (Quantitative Tightening, a.k.a. removing liquidity from the markets) will have a negative influence on stock prices going forward. In fact, the Fed's QT policy has been ramping up rapidly this year. To put some real numbers on this issue, consider that the Fed's current campaign to raise interest rates and shrink their balance sheet (QT) amounted to $30 billion per month in Q2. This progresses to $40 billion per month during Q3 and $50 billion per month in Q4. According to the investment firm Gluskin Sheff, the Fed's balance sheet will shrink by $900 billion by the end of next year as the process of removing QE continues. It's amazing that there is not more discussion of this in the general financial press, but this process will be very impactful to stock prices going forward. In our view, caution and lowered expectations regarding the outlook for equities is warranted.

Trade Tensions

Increasing trade tensions between the U.S. and its global trading partners (most notably China)

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ramped up considerably in Q2. While it still may be too early to use the phrase "trade war", we certainly seem to be moving in that direction. Even if the proposed tariffs and other restrictions don't go into effect, the higher level of uncertainty as negotiations progress could have a measurable impact on global economic growth. Most business planning is done with longer-term time horizons in mind so the overhang of potential trade restrictions will only serve to add caution on spending plans, which hinders growth. Even Federal Reserve policy makers have stated that uncertainty and risks from trade policy have "intensified", according to the minutes of the Fed's recent meeting in June. As of early July, the U.S. had threatened 10% duties on $200 billion of Chinese exports to the U.S. unless a deal is in place by August 30th. This is in addition to the $50 billion of tariffs against China already imposed. How China will respond is the question. Certainly more tariffs from their side could be on the way. In addition, both countries can impose other regulatory burdens that simply make it harder to do business in each country. Finally, while the U.S. vs China issue seems to get the bulk of the media coverage, there are ongoing negotiations regarding the NAFTA agreement with Canada and Mexico as well as talks with the European Union.

In spite of the increased rhetoric surrounding trade policy, U.S. equity markets have taken the news in stride without the negative reaction, at least so far, that may have been expected. The market friendly forces of the recent corporate tax cuts, strong year-over-year earnings growth and ongoing stock buybacks have been able to counter the negatives of a potentially prolonged trade battle. As the year progresses, we'll hear much more from Corporate America on the trade topic and its potential impact for earnings and growth. With the U.S. mid-term elections coming in November, the state of company forecasts and impact to U.S. economic growth from higher trade costs will be important. As it pertains to China, they can play the long game in terms of trade as they don't have to answer to the will of the voters. Clearly this isn't the case in America. While the economy is performing well with low unemployment at the moment, the progress on resolutions to the various ongoing trade disputes will be a big focus in the second half of the year.

Technology Stocks Driving the Market

Per research from Goldman Sachs, one stock alone was responsible for more than a third of the YTD gain in the S&P 500. That stock was Amazon with a gain of 45%, contributing 36% of the index gain in 2018. Goldman also analyzed the return of the top 10 S&P performers this year and the conclusion is simple: technology stocks alone are responsible for the S&P gains so far in 2018. As you can see from the chart on this page, the top 10 peformers accounted for 122% of the S&P total return this year. Put another way, technology is driving the market gains while the non-technology sectors have been a net drag on the index.

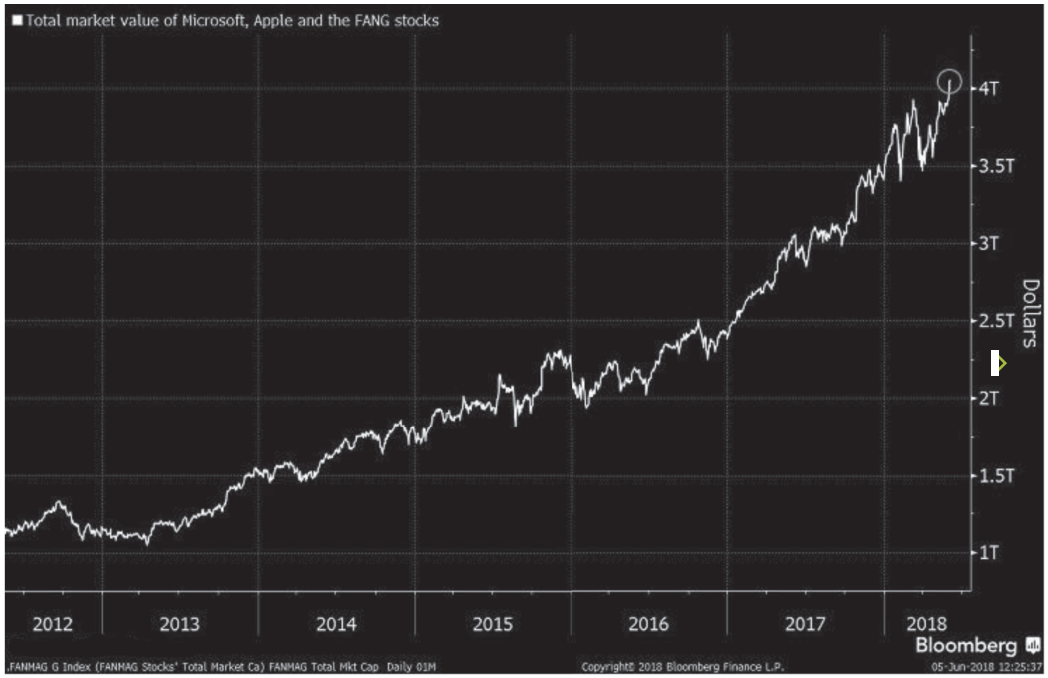
Looking closer at the chart, we can see that the top four stocks, Amazon, Microsoft, Apple and Netflix have been responsible for 84% of the S&P upside in 2018. According to Bloomberg, the top six stocks on this chart, when you consider Facebook and Google, recently passed the $4 trillion mark for combined market value. As the next chart shows, the combined value of the six stocks has doubled in the past two years. Judging individual large-cap fund manager performance in 2018 must be done with an eye towards technology sector performance. Those managers who haven't had some exposure to this very small group of winning stocks have probably lagged the benchmarks thus far.

10 STOCKS CONTRIBUTED MORE THAN 100% OF S&P 500'S YTD RETURN
As of June 28, 2018

Ticker	Company	Cons. 2019E sales growth	Total return	Mkt cap weight	% of SPX Return
AMZN	Amazon.com Inc.	23 %	45 %	2.1 %	**36 %**
MSFT	Microsoft Corp.	10	16	2.9	**18**
AAPL	Apple Inc.	4	10	3.8	**15**
NFLX	Netflix Inc.	24	106	0.4	**15**
FB	Facebook Inc.	27	11	1.9	**8**
GOOGL	Alphabet Inc.	18	7	2.8	**7**
MA	Mastercard Inc.	12	31	0.6	**7**
V	Visa Inc.	11	17	0.9	**6**
ADBE	Adobe Systems Inc.	19	37	0.4	**5**
NVDA	NVIDIA Corp.	14	25	0.5	**5**
Top 10 contributors		**16 %**	**20 %**	**16 %**	**122 %**
S&P 500		**5**	**3**	**100**	**100**

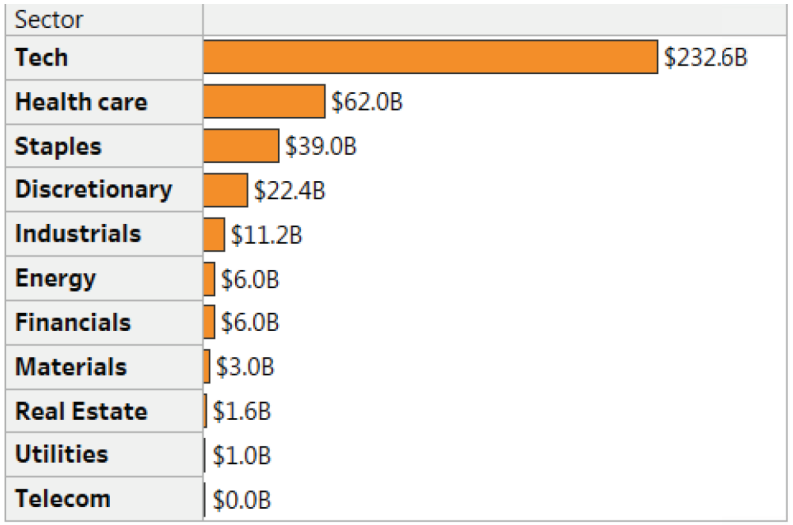
Source: FactSet, Goldman Sachs Global Investment Research

ADDING TEETH TO FANG
Throw in Microsoft & Apple, and market value exceeds $4 trillion



Source: Bloomberg

STOCK BUYBACKS
By sector, YTD



Source: CompuStat, FactSet, Bloomberg, UBS

Stock Buybacks Surging

One of the key reasons for the strong performance of technology stocks in 2018 is the ongoing surge in stock buyback activity. As we've mentioned previously, S&P 500 companies have spent trillions of dollars since the market bottom in 2009 repurchasing stock with their corporate cash. This activity, along with the easy money policies of the Federal Reserve, has been highly influential in powering the stock market gains post-crises. With the additional cash now available from the recently passed tax reform, corporations are flush with new capital to allocate and much of it is going towards a variety of shareholder friendly activities. According to UBS estimates, companies are expected to spend $2.5 trillion combined on share repurchases ($700 billion), dividends ($500 billion) and mergers & acquisitions activity ($1.3 trillion) this year.

As you'll note from the chart on this page, technology companies have seen the majority of the benefit of stock buybacks so far this year. Through the end of May, stock buybacks are up 83% over the prior year, while dividend increases are up only 9%, with M&A activity involving U.S. companies up 130% according to UBS. In terms of company buyback announcements (stating their intention to repurchase set amounts of stock), 2018 has also been a record year. Apple has led the way with their announced intention to repurchase $100 billion of stock. This combined with other company announcements amounted to $160 billion through May, an increase of more than 200% from 2017. It should be noted that company announcements to repurchase shares are different from the actual act of open market purchases. They are not bound to follow through on these announcements, but to the extent that these repurchase are carried out, it will continue

to be very supportive to the market as a whole. It should also be noted that while the amount spent on buybacks is supportive to individual stock and sector performance, it's clear there's not a short-term proportional benefit (aka the more you spend on buybacks the greater the sector performance). In returning to the chart we'll note that the Consumer Staples sector was the third largest in terms of stock buyback activity, but the returns for the S&P Consumer Staples index YTD through the second quarter was -8.5%. This performance severely lagged the S&P 500 Index (+2.65%) and ranked dead last out of the 11 industry sectors that make up the S&P 500. The Consumer Discretionary sector, which ranked 4th in buybacks, was the best performing sector as of Q2 with a 11.5% return, slightly better than the 10.9% return for the S&P Technology sector. Needless to say, there are many factors that drive stock and sector performance, including buyback activity, but spending billions on buybacks doesn't guarantee higher stock prices.

Wealth Management Corner

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Senior Investment Officer

When it comes down to it, saving for retirement is a lifelong commitment. There are no shortcuts for most of us. Most individuals approach retirement savings by saving directly through their company retirement plans, as this path tends to be the easiest and most efficient way to save. People without access to work retirement plans tend to save through Individual Retirement Accounts, also known as IRAs. Some may actually contribute to both within certain restrictions.

Contributing to an IRA is where it might get a bit more complicated. To start, there are essentially two types of IRAs: the traditional IRA and the Roth IRA. They each have an annual contribution limit yet are treated differently from a tax standpoint. The easiest way to think about the difference between the two types is that the traditional IRA is usually tax-deferred with a current tax benefit, while the Roth IRA is a tax-free vehicle funded with after-tax money, i.e., no current tax benefit. Distributions are taxed differently too. In retirement (over 59.5 years old), contributions and earnings are usually taxed upon withdrawal from traditional IRAs, while all distributions are generally tax free from Roth IRAs. Another feature of Roth IRAs is that the vehicle could also be used as an effective health & wealth tool. Distributions are not counted toward Medicare means testing in retirement and could lower your healthcare costs in retirement if your Roth IRA balance is utilized. This is one of the little known features of the Roth IRA in comparison to a traditional IRA.

The type of IRA that's right for you usually relies on a few important factors: First of all, limits focus on an individual's modified-adjusted gross income (MAGI). We won't go over the specific amounts and limitations here, yet if you are a high income earner, you may not be able to contribute to an IRA or deduct your contribution. Second, if you contribute to a company-sponsored retirement plan, i.e., 401(K), 403(b), SIMPLE IRA, etc, the ability to deduct IRA contributions may be limited. In this case, you usually can't deduct your traditional IRA contribution. In fact, you may not qualify for one at all given certain conditions. Lastly, your effective personal tax rate is important. It's important because Roth IRA contributions tend to favor people that are currently in lower tax brackets since they wouldn't earn much of a tax break on traditional deductible IRA contributions. If the individual is in one of the higher tax brackets, it may make more sense to make contributions to either a 401(k) or traditional IRAs to take advantage of a tax deduction in the current year.

This is a simplification of the benefits available and rules for IRA owners. As always, please don't hesitate to discuss this important decision with your individual Sentinel advisor. You can also refer to www.irs.gov for exact amounts and further details. Whichever way you decide to build your nest egg, saving for your retirement is an important step toward your own financial security.

Our Portfolio Strategy & Allocation Outlook

We made no changes within our individual client strategies this quarter. While U.S. equity markets recovered into positive territory after a weak Q1, this wasn't the case for foreign equity markets. In addition, fixed-income markets remain extremely challenging due to the Fed's ongoing campaign to raise short-term interest rates. Alternative

strategies that attempt to hedge equity risks by shorting stocks also struggled with the strong upward moves in U.S. equities. This has left a great number of diversified portfolio strategies we track (including our own) with very small positive or negative returns YTD. In other words, small changes in returns that mask the amount of volatility we've witnessed in the market so far in 2018.

Within fixed-income, the most interesting development has been the rapid increase in short-term interest rates and the potential impact in both the economy and markets. According to Gluskin Sheff research, for the first time since June of 2008, the yield on the three-month Treasury bill has moved above 2%. This is up sharply from the 1.39% yield it displayed at the end of 2017 and up nearly 1% from one year ago. The current yield is now greater than the dividend yield of the S&P 500 for the first time in the last decade as well. Yields at this level now represent real competition to equities for risk-averse investors. They can now get a yield that tops what is available in the stock market without the principal and duration risk. We took action earlier this year to introduce a floating rate component to our bond holdings. This bond holding holds high quality, short-term securities which have a rate re-set feature that allows them to capitalize on a rising rate environment. Going forward, we would expect our fixed-income holdings to become even more short-term oriented in terms of duration and floating rate exposure as the Fed has given no indications (yet) of slowing down plans to hike short-term interest rates.

Within the global equity markets, high valuations continue to be a challenge. Based on forward earnings expectations, various segments of the U.S. markets are best described as moderately to excessively overvalued. The situation overseas is no better with foreign developed and emerging market indexes displaying various degrees of excessive valuations in comparison to the past ten years. At the same time, we must consider a Federal Reserve that is removing liquidity from the markets, a U.S. dollar that is rallying against other currencies and growing fears over potential global trade wars. In short, a great recipe for potential equity market volatility. While we intend to maintain core exposure to low-cost index strategies, we're constantly looking for ways to add more active management exposure in our client portfolios. Slowly, but surely, we believe the markets are transitioning away from a "rising tide lifts all boats" type of environment to one where there will be more pronounced winners and losers depending on the business, sector and geography of individual companies. In this type of environment, skilled active managers should have a better time in producing index-beating returns.

Please let us know if you'd like to discuss your personal investing and financial planning needs.

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Market Scoreboard

Index Returns (%)	Q2 2018	YTD	1 Year	3 Year	5 Year	10 Year
S&P 500	3.43	2.65	14.37	11.93	13.42	10.17
DJIA	1.26	-0.73	16.31	14.07	12.96	10.78
NASDAQ	6.31	8.79	22.31	14.62	17.16	12.60
Russell 2000	7.75	7.66	17.57	10.96	12.46	10.60
MSCI ACWI Ex USA	-2.61	-3.77	7.28	5.07	6.00	2.54
Barclays Aggregate Bond	-0.16	-1.62	-0.40	1.72	2.27	3.72
Bloomberg Commodity TR	0.40	0.00	7.35	-4.53	-6.40	-9.05

Source: Morningstar

S&P 500 TR: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the large-cap segment of stock market.

Russell 2000 TR: Consists of the smallest 2000 companies in the Russell 3000 Index, representing approximately 7% of the Russell 3000 total market capitalization often used as a proxy for the small-cap segment of the stock market.

Barcap Aggregate Bond TR: The Barclays Capital Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most U.S. traded investment grade bonds are represented. The index includes Treasury securities, Government agency bonds, Mortgage-backed bonds, Corporate bonds, and a small amount of foreign bonds traded in U.S.

MSCI EAFE NR USD: Widely accepted as a benchmark for international stock performance, the EAFE Index is an aggregate of 21 individual country indexes that collectively represent many of the major markets of the world.

DJ US Industrials TR USD: Computed by summing the prices of the stocks of 30 U.S. companies and then dividing that total by an adjusted value--one which has been adjusted over the years to account for the effects of stock splits on the prices of the 30 companies.

NASDAQ: Measures the performance of all issues listed in the Nasdaq Stock Market and is often used as a proxy for the large-cap technology segment of the U.S. stock market.

DJ/UBS Commodity: The DJ-UBSCI is composed of futures contracts on physical commodities and is often used as a proxy for broad-based exposure to the commodity markets.

Date of First Use: 7/25/2018 | QMR-045-07252018

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