Outlook Third Quarter 2018

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Currencies Commodities Bonds Stocks

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Highlights:

1. **2nd Quarter Portfolio Produced Hard Earned Gains**
2. **Economic Outlook; With & Without a Trade War**
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2nd Quarter Portfolio Produced Hard Earned Gains

During the second quarter, most client portfolios produced gains despite many political and market challenges that swung the markets up and down. The S&P500 rose by 3.4% while the Barclays Aggregate Bond Index slipped by 0.2%. Due to over-weighting in technology stocks and floating rate bonds, client portfolios may have outpaced the market averages. Investors have preferred innovative companies with strong competitive advantages to prevent competitors from stealing their customers. For example, Amazon, which is the largest holding across all client accounts, is a company that exhibits these characteristics as well other top performing holdings.

After the S&P500 peaked in late January, the stock market has been trading in a range bound choppy manner. Strong corporate earnings helped stocks trade higher but the recent international trade concerns has taken stocks lower in June.

The bond market has traded inversely to the stock market this year. Positive economic data has sparked bond selling while the recent trade tariff fears has led to a rally in bonds as it is viewed as damping economic activity. One of the biggest surprises this year is that the 10-year Treasury yield has held under 3% despite the head winds of higher inflation, growing budget deficits, and tighter monetary conditions.

Financial Market Performance

	2nd Quarter	Year-to-Date
Money Markets	+0.5%	+0.8%
S&P500	+3.4%	+2.6%
U.S Bond Market	-0.2%	-1.6%
Gold	-5.7%	-4.0%
U.S. Dollar Index	+6.2%	+4.8%

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Economic Outlook: With & Without a Trade War

At present, the economy is on track to grow just under 3% in 2018, the best showing in years. Inflation is still moderate at the consumer side, although increasing at a faster pace for manufacturers. The recent tax cuts are leading to a moderate acceleration of economic activity. The Federal Reserve has noticed the economic momentum. At the June committee meeting, they increased the guidance from 3 to 4 interest rate hikes in 2018. Also, the Federal Reserve continues to decrease its quantitative easing programs of purchasing Treasury securities. The economy is improving thus the Federal Reserve is moving towards a "neutral" policy position, which is good.

Now for the "monkey wrench". President Trump appears to desire that all goods should be produced in the U.S. His preferred method is Section 232, by implementing tariffs based on National Security Grounds. It is hard to believe that he would impose tariffs against Canada, the U.S.'s largest trading partner and longtime ally since the war of 1812. Tariffs on Canadian Lumber were one of the first tariffs implemented which has led to a noticeable increase in the costs of building.

There has been plenty of news coverage on the tariffs. China's trade policies warrant attention. For example, several years ago, American Superconductor (a holding in client accounts at that time) lost about half of its' value after a Chinese company stole its technology and refused to pay for products purchased. This is an example of unacceptable action and the Trump administration has rightfully addressed this type of behavior. The case has recently settled with a $57 million award to American Superconductor, a fraction of the lost market value.

What has not been discussed is the impact on corporate profitability. Global trade has allowed countries to produce what they do best and purchase the rest. The US is good at innovation and design, but not so good at repetitive manufacturing of low margin products. Should businesses be forced to produce low margin products due to tariffs, overall profitability will decline. As this relates to our clients' portfolios, lower margins equate to lower stock prices.

This week, the U.S. Chamber of Commerce began launching a campaign to oppose tariffs over the growing concern with the White House's trade policies. It appears that the intention of the Trump Administration is to create barriers to <u>all</u> imports, which is an economic mistake that ultimately will be paid by the U.S. consumer.

Tariffs: A Negotiating Strategy or a Policy of Isolation?

Looking forward, the key question: "Is this the initial round of tariffs it, or just the beginning?" At present, the magnitude of the tariffs is not meaningful to the overall economy, but if you are a soybean farmer or a hog farmer, right now you are not very happy. Or, perhaps is this the beginning of long and protracted trade war? Only time and action will answer this question. Should the tariffs turn out to be a negotiating tactic and soon removed, the impact on the overall economy will be rather limited besides the micro economic sectors that have been targeted by foreign countries. Conversely, if this is just the beginning of a trade war with numerous rounds of retaliation tariffs, the impact on the economy will be lower growth and higher inflation, both not good for stocks and bonds. We speculate that the current anti-trade rhetoric has discounted the SP500 by 5% to 10%.

The next steps by the Trump administration will provide a clue as to the direction of trade policy. The most significant trade decision will be NAFTA (North American Free Trade Agreement). NAFTA allows most goods purchased between the US, Canada, and Mexico to be tariff free. This allows my friend Jim who lives in Buffalo to cross the border to Canada to purchase cases of Canadian beer and then ship them to me in Naples, Florida duty free. Canadian beer does not have the preservatives typically found in US beer; therefore, it tastes better and does not leave you with a morning "hang over". In exchange, Jim receives Kobe steaks from Jimmy P's Butcher Shop- an example of fair trade.

Who is Financing our US Deficit? Yes, China and Japan are the Biggest Foreign US Bond Holders

While the financial media has focused on the potential impact on growth, investors should equally consider the implications on who will fund our large and growing deficit. China is the largest foreign holder of US Treasuries, closely followed by Japan. Given the recent tariff action by the Trump Administration, we will need to closely monitor foreign participation at Treasury bond auctions. In the past, US businesses would purchase foreign goods with US Dollars and the foreign entity would purchase our US Treasury debt. Again, in a full-blown trade war, funding the budget deficit with foreign investors seems unlikely and could be a factor leading to a rise in interest rates.

Financial Market Game Plan – 2nd Half of 2018

Now that we have started the second half of 2018, it is safe to say that the average portfolio manager is tired of hearing and reading the endless news headlines which disrupt what otherwise should be a stable and growing economy. As outlined in economic reviews, the trade policies of the Trump Administration may have significant negative economic impact on the financial markets. As such, we are positioning our clients' portfolios slightly more conservative from their stated asset allocation targets in their customized investment policy statement (IPS).

Below is the outlook for each of the major asset categories:

1. ***Cash: Finally, a positive yield on money market funds***

For the first time since the financial crisis in 2008, the Fidelity Cash Reserves Fund (a standard client money market fund in client accounts) now yields 1.5% (SEC yield), providing a nominal, but positive return. With financial market risks above normal, it is prudent to hold a larger than normal cash balance for the short- term.

2. ***Commodities: Some up and some down, depending on the "Tariff Tweet of the Day"***

Recently, commodities have been a mixed bag after trending higher earlier in the year. With the US Dollar rising, this usually provides a headwind for commodities. This has impacted gold which has fallen about 4% this year. The other important market has been oil. Oil prices are near the highest level since 2015. Prices have risen partly due to rising demand which is good as the economy is improving, but the big factor has been the falling supply worldwide. OPEC countries cut back their production several years ago, but now have been slowly increasing their product as prices are rising. Saudi Arabia is planning an IPO of their government owned oil company, so they would like prices to stay high and stable. Also, on the international front, US sanctions against Iranian oil are reducing the supply to the US and its trading partners. Venezuela production has dropped from 2.4 to 1.5 million barrels a day and possibly falling even more overtime. Back home, bottlenecks are the challenge in getting oil to the refineries. This is most prevalent in the Permian Basin, one of the largest oil and natural gas deposits in the world. As drilling techniques have increased production, the pipeline infrastructure is in a log jam. Now, constructing pipelines just got a lot more expensive due to the 30% rise in steel and aluminum prices. The tight oil market suggests prices will continue to trend higher, which explains why we are over-weighted in energy related stocks.

3. ***Fixed Income: Prepared for higher, lower, or stable interest rates***

The only predictable trend in the bond market is that short-term interest rates will rise. The Federal Reserve has guided for two more ¼ % increases this year, so short-term interest rates will likely rise to 2.0% by year-end.

The outlook for longer-term interest rates (5 to 30 years) is more complicated. US Treasury yields are the base to which all other bonds and financial instruments, such as mortgages, are priced. Some of the factors impacting the Treasury bond market include inflation expectations, the supply of bonds issued to fund the government/deficit, and the demand from investors. So far in 2018, the yield on the 10-year Treasury bond is below 3%, a "line in the sand" that many investors are watching closely. Recent tariff talk has dampened any prospects of growth so yields have trended lower (which rises the cost of bond prices). Given the strength in the US economy, a tightening Federal Reserve policy, and rising inflation, it is surprising that yields have not risen significantly higher than the current 2.9%.

Our strategy for most client accounts is to ladder the bond maturities of quality corporate or municipal bond issues. Also, floating rate bonds and funds are a core part of bond portfolios. Floating rate securities reduce the risk of rising interest rates. For some IRA accounts, we prefer "taxable" municipal bonds that often offer yields higher than corporate issues with similar risk. Investors frequently shy away from this misunderstood segment of the bond market. Also, we are considering adding to preferred stock funds that are yielding over 6%.

4. ***Equities: Tariffs are Ruining the Stock Market Party***

Corporate earnings are increasing at the fastest pace in years. Since earnings growth is usually associated with long-term increases of stock prices, we would have expected a bit more growth than 2.5% increase this year. Concerns over tariffs have naturally unsettled investors both domestically and internationally. As the below table illustrates, the SP500 has increased a nominal 2.5%, but foreign markets have dropped with emerging markets falling the most.

International Stock Performance Trails US in the 1st Six Months of 2018

Index	Change
SP500	2.5%
MSCI Emerging Markets	-8.7%
MSCI Developed EAFE	-3.0%
Source: Black Diamond	

Looking through the clouds which surround the trade questions, the focus remains on selecting holdings that exhibit innovation, have limited debt, and growth of sales and earnings. Our preferred sectors remain technology, utilities, and energy while under weighting financial, consumer staples and healthcare.

Equity Strategy Sector Picks and Pans

Over-weighted	**Under-weighted**
Technology	Financial
Energy	Consumer Staples
Utilities	Healthcare

Updates on Notable Stock Holdings:

Amazon – Amazon is growing on all key points of their business. Whole Foods has seen a pickup in sales since the acquisition about a year ago. AWS (webhosting) is the industry leader. Most recently, AMZN signed a deal to acquire PillPack, an online pharmacy serving primarily customers with limited mobility. The announcement led to a $15 billion reduction in the value of CVS and Walgreen's stock values, leaving many asking the question, "why did they not start their own mail service"?

Visa – Visa reported a strong first quarter with sales growing 13% and earnings up 30% as the operating leverage of their business kicked in. Digital payments are a secular growth story and Visa is a globally recognized name for secure processing.

Palo Alto Networks – the leader in cybersecurity for large corporations grew revenues 31% in the quarter ending April 30th. With so many companies turning to store their data in the cloud, Palo Alto has emerged as the leader in this segment as a result of their partnership with VM-Ware.

Intuitive Surgical – Robotic surgery has become mainstream as evidenced by the 15% growth in robotic procedures in the most recent quarter. With limited competition, Intuitive grew the number of systems in hospitals by 13%. Lung cancer is a new procedure under research which may, although unfortunately, lead to more growth in the near future.

Deere – The good news is that business has been strong for Deere with recent equipment sales of the big green tractors which have jumped 28%. The bad news is that Deere will most likely suffer from the trade wars as China and Japan have placed large tariffs on US Soybeans.

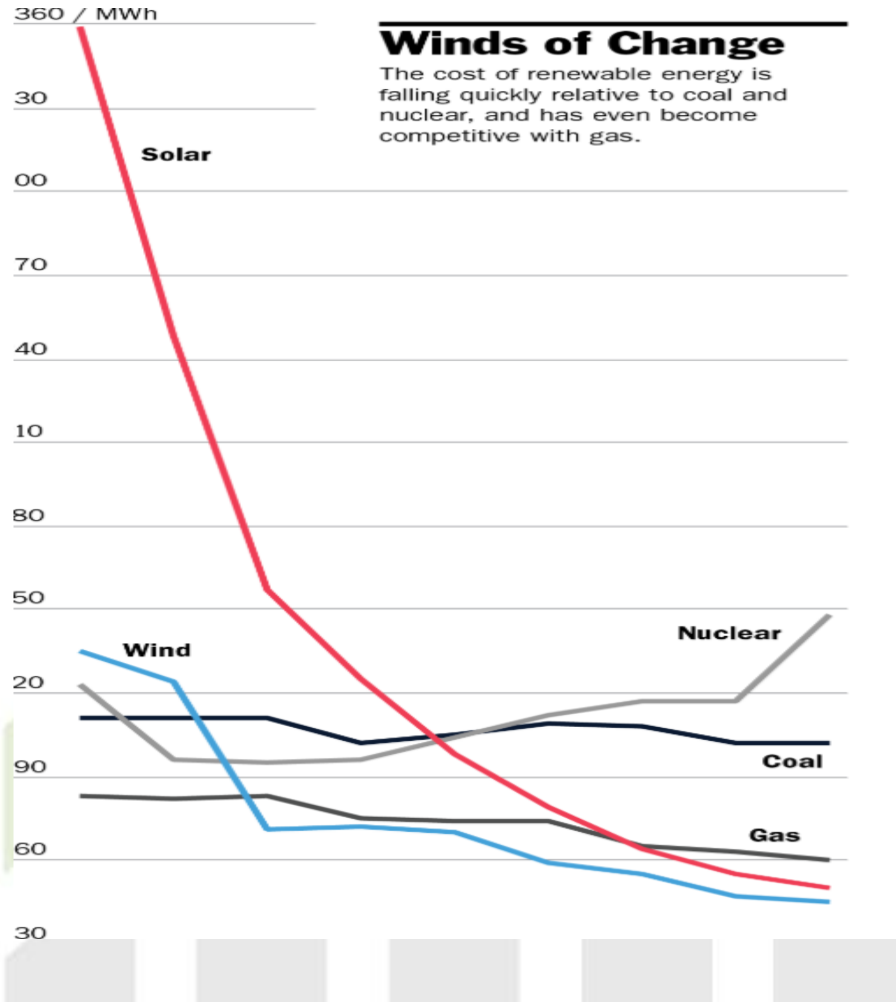
Hexcel – Hexcel is the industry leader in the production of carbon fiber. Given the 30% increase in steel and aluminum costs, Hexcel produces a lighter, stronger and much cooler carbon fiber. The company has an excellent opportunity to increase the amounts that are being used to manufacture airplanes and cars.

Pioneer Natural Resources – Pioneer drills and produces oil and natural gas from the Permian Basin (Texas area) and is considered to be one of the better managed energy companies. By focusing on the Permian Basin, Pioneer is positioned to gain operating leverage as their assets are deployed in a concentrated area. From an ESG point, their CEO's bonus plan includes performance of environmental guidelines, a unique compensation criterion for an industry that is often short on stewardship.

Sun Communities – one of our longest owned holdings. Sun is a Real Estate Investment Trust (REIT) which means if they distribute at least 90% of their "earnings", then no corporate income taxes are paid. Sun owns manufactured home and Recreational Vehicle (RV) parks throughout the US and Canada. Florida is its largest market. Sun has grown by acquiring existing RV and mobile home parks, cleans them up, adds amenities, and markets the properties nationally. Given the negative sentiment against "trailer parks," Sun has a huge competitive advantage in limiting new competition coming into the industry.

NextEra Energy, First Solar, SolarEdge, & SunRun- Renewable Energy Holdings

We are grouping our comments on the renewable energy industry holdings together, since they are closely related. Renewables are coming of age and are expected to grow rapidly in the future. Several converging factors are catching many investors by surprise including the rapidly falling cost of solar panels and batteries. Lower material costs combined with advancements in technology have presented the opportunity to produce wind and solar energy and store energy until needed. According to the Barron's research (see chart below), the cost of wind, solar and natural gas are comparable and less expensive than coal and nuclear. Most of the public, portfolio managers, and certainly many politicians are not aware of the rapid changes in the renewable energy business. Energy could soon be a free commodity if renewables are properly deployed, while the conversion from old utilities could be an economic driver for a decade. Also watch for Hydrogen as the future fuel for vehicles.



So: Barron's

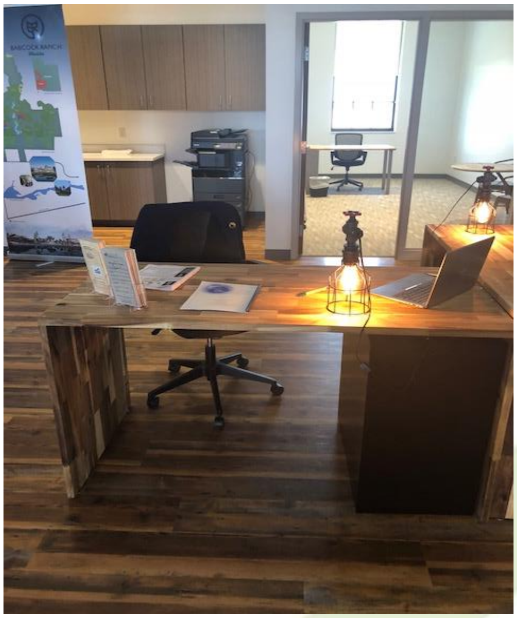
Stocks in the renewable industry tend to be highly correlated with the price of oil, although oil is primarily a transportation fuel, not a power generator. With the price of oil at a three-year high and expected to trend higher, renewables are consistent with our over-weighting in the energy sector.

We have employed a portfolio approach to renewables by investing smaller positions in related companies:

NextEra- The largest owner of wind and solar generation
SolarEdge- Electronics of solar systems
First Solar – Construction of utility scale solar systems
SunRun – Residential solar systems and recently began leasing systems in Florida

ESG (Environmental, Social, & Governance) Update:

AHIA opens Satellite office in Babcock Ranch, Florida!



As of July 1, 2018, our Firm has a "Dedicated Desk" at The Hatchery, an office and co-working space for entrepreneurs at Babcock Ranch, Florida. Since the inception of our Firm in 2010, we have provided clients with customized portfolios which incorporate environmental, social and governance research to mitigate risks and maximize returns over time.

By establishing a presence in America's first solar powered city, our Firm will be positioned to provide sustainable investing strategies for the residents and professionals who live and work at Babcock Ranch. Working in a collaborate environment will allow us to foster new relationships and partnerships to grow our business and inspire new ideas.

Left: Our "Dedicated Desk" at The Hatchery in Babcock Ranch

BlackRock's 2018 Annual Letter to CEO's:

The world's largest publicly traded companies will need to begin embracing social, environmental and governance standards if they want to continue doing business with BlackRock, says Laurence D. Fink, CEO.

This should not come as a surprise to investors, as Mr. Fink has been setting the tone by frequently including words such as "longer-term", "forward looking" and "sustainability" in his annual letters over the past four years. The demand for investing strategies based on ESG factors is being driven by millennials and women, who, by 2025 will make up ¾ of the workforce. BlackRock is a financial giant and for this firm who insists that its clients fully embrace long-term strategy and sustainability is remarkable and gives hope for the future.

Community Spotlight

On May 17, 2018, Andrew Hill Investment Advisors, Inc. co-hosted “Swirl & Sip for CE”, a Certified Public Accountant (CPA) continuing education event with RMC Group at The Moorings Country Club. The educational session provided CPA’s with free continuing education credits on retirement and pension planning, and afterwards a wine presentation which included a variety of hand-picked wines and paired hors oeuvres.

Right: AHIA and the team from RMC at Moorings Country Club in Naples, Florida.

Jennifer Figurelli is now a member of the Speakers Bureau for Catholic Charities of Collier County. In her role, Jennifer will speak before various groups to promote awareness of the new Judy Sullivan Resource Center. The Center provides a Choice Food Pantry, direct assistance for utilities, rent and prescriptions, the Weekend Power Pack Food Program, holiday food and gift distribution and many other services for the working poor in Collier County. The Center is located at the site of the former Social Security building across from the Collier County Government Center and has undergone extensive renovation to provide space to accommodate growth for more effective execution of programs and services.

Above: Rendering of the new Judy Sullivan Resource Center of Catholic Charities of Collier County.

AADMM
American Association of Daily Money Managers

Jennifer Figurelli has been certified as a Professional Daily Money Manager (PDMM) by the American Association of Daily Money Managers. The certification program is based on adherence to Code of Ethics, a documented amount of experience providing services defined as daily money management and testing to assure required level of knowledge and proficiency in providing these services.

Disclosures: *Information sources used to prepare this report include Argus Research, JP Morgan Asset Management, CFRA, Forbes, Zacks, Barron’s, Kiplinger’s, Fidelity, and Decision Economics. Founded in 2010, Andrew Hill Investment Advisors, Inc. is registered as an investment advisor with the state of Florida and only transacts business in states where it is properly registered or is excluded or exempted from registration requirements. Andrew Hill and clients of AHIA hold positions in the investments mentioned in this report. Please contact Andrew Hill Investment Advisors, Inc. if there are any changes in your financial situation or investment objectives, or if you wish to impose, add or modify any reasonable restrictions to the management of your account. Our current disclosure statement is set forth in Part 2 of Form ADV and is available for your review upon request. Tax and estate planning advice is general in nature and the firm is not engaged in the practice of law.*