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Outlook 2018
Mid Year Update

Presented by the Investment Policy Committee
of Clearwater Capital Partners

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Introduction . . .

The base case presented in our ***Outlook 2018*** report, published last January, focused on the policies of the new Trump presidency and an acceleration of economic activity connected to these pro-growth initiatives. We believed then, as we do now, that **the economic uptick from tax reform and further deregulation will be the big story in 2018.**

While the first half of 2018 has proven to be more volatile than calendar year 2017, the positive underlying fundamentals remain intact. Our constructive view for the year presented in ***Outlook 2018*** was grounded on the view that better government policies regarding corporate taxes and regulation would serve as an important tailwind for stronger economic growth. This growth would translate into a surge in corporate profits and propel the global bull market forward in 2018, and likely into 2019.

So far, the economy has produced the strong corporate earnings we had expected, however these gains have yet to produce significantly higher equity prices.

Our ***Mid Year Update*** reaffirms our optimistic point of view of the U.S. economy. We recognize however, that the current economic cycle is developing certain "late stage" characteristics. While our forecast for strong economic growth has been correct, we must remember that economic data historically looks very good at market tops and really bad at market bottoms.

Financial conditions are tightening and liquidity is receding. The prospects for rising inflation and prolonged trade tensions have elevated risks. Until the U.S. equity market is able to rise above the January highs, it is still technically in correction mode. The longer the market is in this mode, the higher the odds become that the correction will take stock prices lower before new highs are achieved.

It is important to note that we are **not** abandoning our view that the bull market has further to run. We are simply becoming more sensitive to the background of shifting risks. The many positives that have propelled the economy forward over the past year could be deflated if business and consumer confidence begins to reverse.

The Key Elements of *Outlook 2018* . . .

Longtime readers of our commentary are familiar with our goal for maintaining a working model of the global economy that instructs our expectations and investment strategies. As we have often said, **decisions must be born of purpose, predicated on fundamentals, and executed with discipline**.

Our economic thesis for 2018 calls for an acceleration of global economic growth and marginally higher interest rates. Below are a few excerpts from our ***Outlook 2018*** report:

- ✓ **The Tax Cuts and Jobs Act represents a substantial positive development for the U.S. economy. The pace of economic growth and higher corporate profits will exceed current expectations and serve to drive equity prices, the rate of inflation, and interest rates all higher in 2018.**

- ✓ **The pace of economic growth will continue to accelerate from the 2.5% - 3.0% pace of 2017. We believe the combination of a more competitive tax code, the repatriation of foreign profits, higher consumption and capital spending will add between 0.25% - 0.75% in economic growth. Our expectation is for the U.S. economy to expand at a rate of 3.0% early in the year; rising to 4% later in the year as the positive impact of tax reform more fully develops.**

- ✓ **Given the various positive factors outlined in this report, our forecast for corporate earnings on the S&P 500 comes to $149 - $154 per share. Within this range, our target number is $151. This number includes the year's originally expected year-over-year growth, the tax savings from the new tax plan, and the anticipated incremental growth related to the new tax plan.**

- ✓ **We believe that the potential exists for U.S. equities to gain 12% to 16% in the coming year. This suggests levels above 3,000 for the S&P 500 and 27,500 for the Dow Jones Industrial Average. Clearwater Capital's official target for the S&P 500 for the end of 2018 is 3,115.**

- ✓ **We expect the rate of inflation will increase to a level of 2.5% in 2018 as measured by the Consumer Price Index (CPI). Over the past three months the CPI is up at a 2.6% annual rate, signaling that inflation is accelerating further above the Fed's 2% target.**

- ✓ **We expect the Fed will raise interest rates three or four times in 2018. Given the strength of the labor market, with unemployment at the lowest level in more than a decade and headed lower, a fourth hike is looking increasingly likely. We also expect the 10-year Treasury yield will rise to a range of 2.75% to 3.25% in 2018.**

- ✓ **Equities in the Eurozone, Japan, and emerging markets continued a cycle of outperformance relative to U.S. equities in 2017. We project that this outperformance will persist in 2018 and believe these regions should be over-weighted in portfolio strategies.**

- ✓ **The period of exceptionally low volatility will likely come to an end in 2018 with the return of the occasional market correction. Because of the extended time since the last 3% correction, the return of volatility will be particularly difficult for certain investors who might be tempted to sell every drawdown.**

- ✓ **We are forecasting another record year for corporate dividends and share buybacks.**

These expectations have proven to be mostly accurate and remain largely intact as we begin the second half of the year. Here is a quick summary of where things stand:

Corporate tax reform and less government regulation are providing a nice tailwind for the economy. Economic growth has accelerated and interest rates are rising. Market volatility has turned higher and S&P 500 companies are on track to repurchase as much as $800 billion in stock this year, a record that would eclipse 2007's buyback spree (source: The Wall Street Journal).

In June the Federal Open Market Committee (FOMC) raised the target range for the federal funds rate by 25 basis points to 2% (from 1.75%). This marked the second rate hike this year and the seventh since the tightening cycle began in December 2015. The central bank now points to two more hikes, which would bring the 2018 total to four increases in all – meeting our original forecast.

In the midst of the strong economic fundamentals we are reminded that the economy is not the market and the market is not the economy. In other words, over the short run the two do not always move in tandem.

Accordingly, **we are modestly adjusting our 2018 targets for U.S. equity markets** (see below), and only our forecast for stronger relative performance in 2018 from foreign equity markets appears to be unlikely at this point in time.

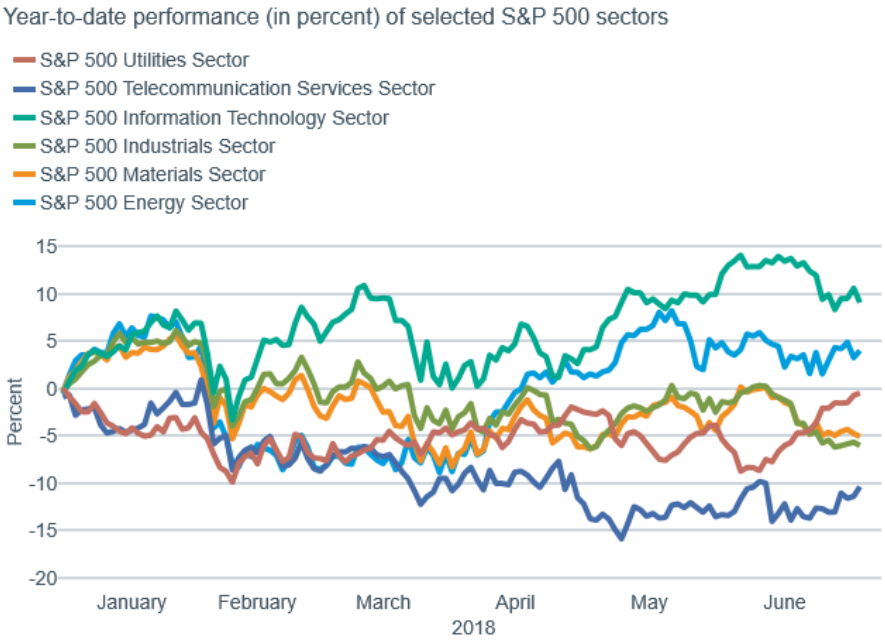
Equity Markets Stuck in Neutral As Valuations Improve . . .

Equity markets around the world have generally taken a breather thus far in 2018 after banner years in 2017. **We are hopeful that the first half ends up being little more than simple mean-reversion**. Since the S&P's peak on January 26th, we've generally seen downward or sideways action.

For what it's worth, only the 1994-1995 correction went longer without turning into a bear market of a 20% decline or more (source: Charles Schwab). This means the S&P is still considered to be in a bull market until it experiences a pullback of 20%. This is now the second longest bull market on record. With the S&P's gain of over 324% in price, the current bull is also the second strongest on record.

Looking at the major indices' performance for the first half of the year we see the S&P gaining just shy of 2%. In spite of the modest gains, the first half was anything but boring. The energy sector started to outperform after a long stretch of underperformance. Technology ran into obstacles recently, while still outperforming during the past year.

Meanwhile, concerns about an escalating trade battle have ramped up, hurting those areas that have more foreign exposure, such as industrials, materials and tech, while benefiting the more domestically oriented groups such as utilities and telecom.



Source: Charles Schwab, Macrobond, Standard & Poor's as of 7/5/2018
Past performance is not indicative of future results.

In terms of market cap, **the smallest stocks in the S&P have significantly outperformed the largest stocks**, which is in-line with the broader theme of outperformance from small caps vs. large caps that we've seen. The average 2018 percentage change of the 50 smallest stocks in the S&P currently stands at +7.43%, while the 50 largest stocks in the S&P are actually down an average of 0.65% YTD.

It is important to note that sectors will be changing at the end of September. S&P has announced that the telecom sector will become the communications sector, and that there is going to be a fairly substantial

movement of stocks from one sector to another. Some major drivers of sector performance, such as Google and Facebook, are moving out of one sector, technology, to another, communications.

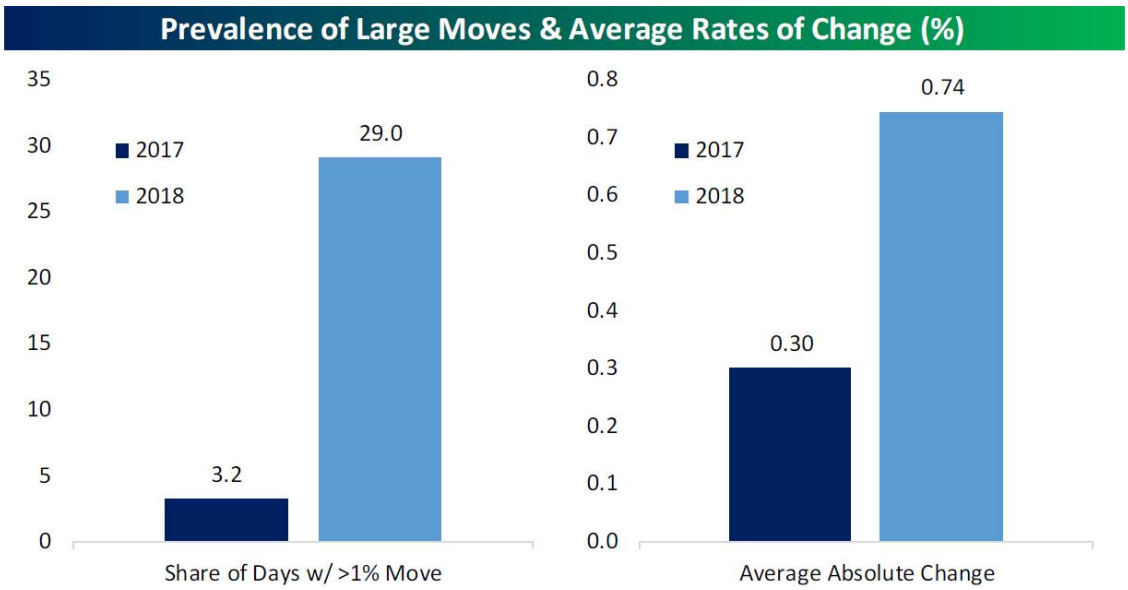
Due to strong earnings growth amid a sideways trending stock market, we've seen quite a bit of contraction in valuations so far in 2018. Whereas 2017 was marked by P/E expansion, the S&P 500 and nine of eleven sectors have seen their trailing 12-month P/E ratios drop in 2018. The forward 12-month P/E ratio for the S&P 500 is now 16.2 and is equal to the 5-year average.

On balance, we perceive this as a positive development and should earnings continue to grow over the next 12 to 18 months, we would regard current equity prices to be attractive from a long-term perspective.

Volatility Is Back . . .

After an extremely quiet 2017, 2018 has seen much more frequent large movements. The S&P 500 had experienced a record stretch without at least a 5% drawdown until the equity sell-off hit in late January. **The sell-off was in line with our view that we were likely to see more volatility in 2018**.

Only 3.2% of days in 2017 had moves greater than 1% in either direction versus 29% in the first half of 2018. Further, the average absolute change in the first half of this year was 74 basis points, more than double the 30 basis points average from 2017.



Volatility is also higher this year in terms of the VIX. The mean level of the VIX has been 5.2 points higher in the first half of 2018 than in all of 2017. The median has been similarly elevated, while the most frequent reading for the VIX has been two points lower (Source: Bespoke).

By any measure, volatility has been much higher in 2018 so far than it was in 2017. We believe this higher volatility is typical of the latter stages of an economic cycle, however we believe the drawdowns will continue to be temporary in nature for the foreseeable future.

JOBS, JOBS, JOBS . . .

The jobs machine continues to chug along, with YTD 2018 payrolls gains per month actually higher than what was seen in 2017. **There are now more open jobs than there are unemployed people in the U.S.**

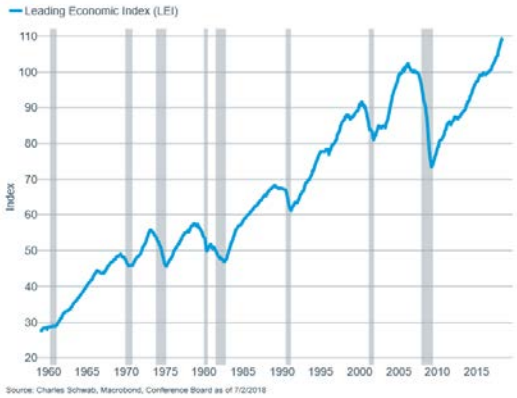
Nonfarm payrolls increased by 213,000 in June, well above the consensus forecast of 195,000. Additionally, the prior two months were revised up by a total of 37,000 bringing the average job growth in the second quarter to a very respectable 211,000 per month. Average hourly earnings in June rose by 0.2% keeping the year over year change at 2.7%.

The unemployment rate rose to 4 percent, but this was one of those months where that was a good thing, as more potential workers came in from the sidelines and added to the total labor force. Though the number can vary widely by month, the 601,000 entrants to the labor force provided a positive sign that discouraged workers are back out looking for jobs.

The persistently strong labor market will encourage the Fed to continue along its path of gradual rate hikes and normalizing monetary policy. **A September rate hike now looks fairly certain and December's odds for a rate hike are trending higher at this point**.

No Recession In Sight . . .

The current expansion remains very broad-based. The economy continues to grow, illustrated by the continued upward trend in the Index of Leading Economic Indicators (LEI), see chart. The headwinds from tighter financial conditions have yet to materialize, despite central bank tightening.



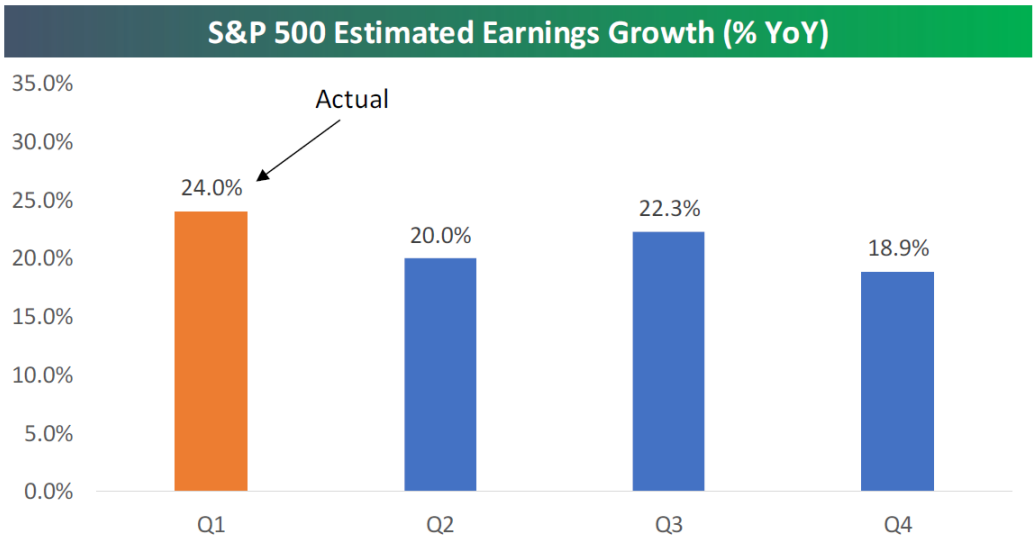
The February budget agreement significantly increased tailwinds to growth from what was already a positive fiscal impulse and the Atlanta Fed is now currently forecasting a Q2 annualized growth rate reaching 4%.

Lastly, the financial press has recently focused much attention on the yield curve and its value in predicting recessions. Every recession since the 1950s has been preceded by a curve inversion. While the lag between inversion and recession has varied between six months and two years, the one has always followed the other, with only one exception in the mid-1960s.

In the current cycle one can easily observe that the narrowing of the spread has been more a function of a rising rate on the 2-year Treasury, versus a precipitous decline in the 10-year yield. While the spread has narrowed, it remains positive and the curve has certainly not inverted. Accordingly, it is important to note that **a flattening yield curve is not a recession signal**. The curve can flatten steadily for years before approaching recession. Our interpretation of this indicator is that at least 2 years of expansion remain.

Record Corporate Profits . . .

Our forecast for stronger corporate earnings in 2018 is fully on track. After surging by a hugely positive 24% in the first quarter, expectations are still for growth near 20% for the remainder of the year.



(source: Bespoke)

Earnings and forward guidance, ultimately the things that impact individual stock price movements the most, have been quite strong in 2018. The Bespoke "guidance spread" measures the percentage of stocks raising guidance minus the percentage lowering guidance on a quarterly basis. After years of negative guidance spreads, this reading turned positive at the start of 2017 as companies finally turned more bullish on their futures. The positive guidance has continued right into 2018 so far as we've seen stronger readings sequentially for the two earnings seasons that we've had already this year.

In ***Outlook 2018*** we indicated that corporate tax reform (along with regulatory reform) would be **THE** major story of 2018. The reduction in corporate income taxes translated into a 20% one-time boost to the after-tax profits of U.S. companies.

According to the revised GDP statistics for the first quarter, after-tax corporate profits reached record levels; approaching over 9.6% of GDP (source: Scott Grannis). **This level of profitability has been exceeded in only 4 quarters in our nation's recorded history. After-tax profits are likely to move higher still, once the full impact of lower corporate income tax rates filters through to the data as the year advances**.

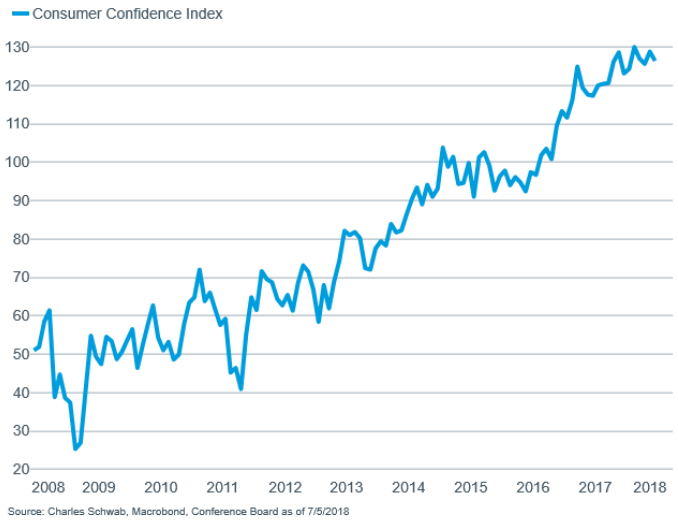
Trade Wars and Other Worries . . .

While economic fundamentals in the U.S. are quite strong, there are other factors at play that have the potential to materially change the positive trajectory we would appear to be on. **Trade concerns continue to dominate the headlines; but tighter monetary policy and financial conditions, alongside higher inflation, are also keeping stocks from making headway out of the range they've been in since February**.

As of this writing, the $34 billion in tariffs that the United States is putting on Chinese goods is a literal drop in the bucket for a nearly $20 trillion economy, however a number of negative aftershocks could become quite serious. If the confidence of consumers or businesses is shaken, the potential for spending and capital investment to level off or decline grows, which could lead to a short-circuiting of the economic expansion and bull market.

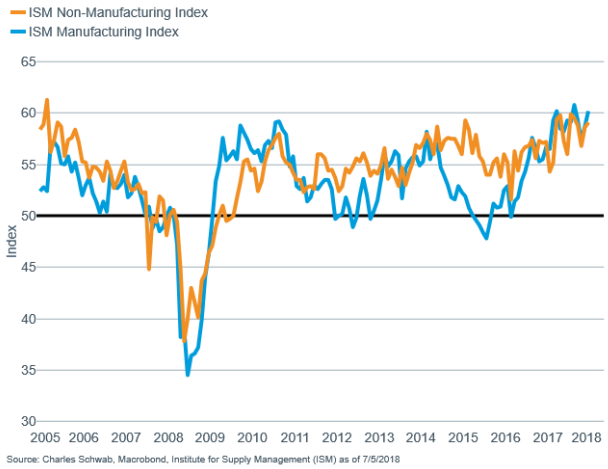
While these are legitimate concerns, **it is important to note that these are only concerns at this point**.

The Conference Board's Consumer Confidence Index slipped 2.4 points in June and is now down in three of the past four months. Despite the deterioration, **confidence is still hovering around its highest level since Q4 2000, and historically consistent with above-trend growth**.



The first half of 2018 saw the ISM nonmanufacturing Index (the service sector) off to its second-best start to a year (behind just 2004, which also followed tax cuts) since reporting began in late 1997. The ISM Manufacturing Index shot up to 60.2 in June, contrary to the consensus expectation for a decline. It matched **the second highest reading since June 2004**, as factory activity

strengthened, consistent with above-trend economic expansion. While trade battles could weigh on manufacturing down the road, the negative impact is not yet evident in the data. Still, survey respondents remained overwhelmingly concerned about the potential impact of tariffs on their business.



While an escalating trade war has the potential to cause a great deal of damage, we would observe that a full blown trade war has not yet developed, and probably won't. **Last year the U.S. imported roughly $500 billion of goods from China, yet China only bought $130 billion worth of U.S. goods. Given this mismatch, China is very limited in how much in kind retaliation it can bring**, because it simply just doesn't buy enough goods from the U.S.

How the ongoing trade conflict plays out will likely be the main risk markets focus on in the second half of the year. So far, investors have been seeing the tariffs implemented as relatively small, tame and unlikely to end growth. The danger is that these steps could escalate further into bigger and substantially more damaging moves in the coming months. We will continue to watch trade policy as it develops, but **for now our assessment is that tariffs are a temporary disruptive factor that are necessary to achieve a long-term reduction in overall trade barriers**.

Lastly, trade isn't the only cause for concern as we move into the second half of the year. A rising dollar, slowing global economic growth and the possibility of a central bank mistake all appear to be impacting sentiment. We've seen stocks with greater international exposure, such as those in the technology and industrial sectors, weaken in the second quarter.

Mid Term Election and Politics . . .

Some investors believe there will be a significant shift in the political environment resulting from the mid-term election in November. They see a "Blue Wave" with the Democratics regaining control of the House of Representatives, and possibly the Senate. Such a shift would represent a tougher legislative environment for the current administration and possibly slow the deregulatory agenda going forward.

Regular readers of our commentary know our discipline of keeping our politics and finances separate. Still we are skeptical of a "Blue Wave" come November. First, the President's job approval rating has improved from 37% last December to about 43% currently. Second, the Democrats edge in the "generic ballot" (the poll that asks which party you'd rather control the House) is currently about half what it was in 2006 when their party last won control of the House from the Republicans. And lastly, of the 35 Senate seats contested in November, the Democrats already occupy 26, while Republicans have only 9 to defend. The math here suggests a tough uphill battle for the Democrats considering that five of their incumbant seats are in states Trump easily won by double-digit margins.

Predicting political elections falls well outside of our area of expertise. Still, **we think it is unlikely that the mid-term elections will produce any type of disruptive "wave" that would materially challenge the policies that have energized the U.S. economy**.

Adjusting Our 2018 Targets for S&P 500 and Dow Jones Industrials . . .

We believe corporate earnings will continue to be strong throughout 2018, and will ultimately drive equity prices higher. In fact, we are **raising** our target for S&P 500 earnings to $158 per share. Investor sentiment, however will be the key to where stock prices end the year. Higher interest rates will make bonds more attractive to stocks on a relative basis and "end-of-cycle" fears will likely moderate risk appetites.

Accordingly, we are moderately adjusting our year-end target for the S&P 500 to 3,025 (from 3,115). This reflects our current forecast for S&P earnings of approximately $158 per share with an implied trailing price earnings multiple of about 19.1x. This target suggests price gains of 11% are possible in the second half of the year, bringing the full year targeted gain to 13%.

Whether we reach our higher targets by the end of the year is of much less importance compared to appreciating the directional nature of our forecasts. We believe the S&P 500 will eventually reach our original target of 3,115 – probably in early 2019. **Our adjustment to the 2018 price target merely reflects our sensitivity to elevated global trade risks and the possible subsiding of investor sentiment**. Should trade tensions quickly give way to bilateral trade agreements and freer trade worldwide, investor sentiment would soar and we could easily see the S&P achieve our original 3,115 target.

Stocks today have an earnings yield of 4.8%, which is substantially higher than the 2.8% yield on 10-yr Treasuries. The P/E ratio of a 10-yr Treasury bond is currently 35x (compared to equities at only 16.2x)! Equities provide a much better yield than risk-free Treasuries, plus plenty of upside should the economy continue to exceed growth expectations.

Based on current analyst expectations of $177 in S&P 500 earnings for 2019, we still have conviction that equity markets will be heading higher over the next 12 to 18 months.

Conclusion . . .

In our ***Outlook 2018*** report published in January we stated:

> **"Our base case is that global growth will accelerate in 2018. Most importantly, we expect a significant boost in corporate earnings coming from lower tax rates and the additional economic activity we believe will be the logical consequence of less regulation and increased business investment. Sustained above-trend economic growth has helped companies deliver strong earnings growth and strong equity returns for over a year now; and both should persist in 2018.**
>
> **The major theme of this *Outlook 2018* report is that meaningful tax reform and a continuing transformation of regulatory burdens will likely provide a significant boost to economic activity and earnings in 2018. With no obvious signs of excess or imbalances, we believe the U.S. expansion has a long way to go."**

We continue to have a positive view on the direction of the global economy. Most leading indicators remain healthy and earnings growth should remain very strong over the next several quarters. Business and consumer confidence remains relatively high and trends in business spending have been encouraging.

The current economic expansion is now officially the second-longest in the post-WWII era. While we believe that the U.S. has entered a late stage of this long business cycle, we don't see a recession on the horizon any time soon.

Policy uncertainty, particularly as it relates to international trade, is likely to blame for the current "disconnect" between a healthy economy and equity markets that have been churning sideways. Accordingly, greater policy clarity may help unleash "animal spirits" and spur the markets higher.

The bottom line is that the economy keeps growing and businesses continue to innovate. We believe success will be found in staying diversified and embracing differentiated sources of return. The ability to form a good plan and stick to it, with judicious adaptation to the market environment, is the time-tested foundation of continued progress toward financial goals.

Thank You . . .

Proper wealth management demands a sound framework for decision making. As new information becomes available our expectations will most certainly be adjusted. There is no substitute for hard work, insight, planning, and action in pursuit of clear goals. By establishing a working thesis for the economy and markets, we have confidence that we will be better equipped to respond to the various twists and turns coming our way.

We take nothing for granted, and we strive to construct judgments that are supported by data and logic. Given the diligence with which we approach this challenge, we have genuine confidence the conclusions presented in this year's ***Outlook 2018 – Mid Year Update*** will again prove helpful.

Thank you for taking the time to review our perspectives and forecasts. We look forward to a prosperous conclusion to 2018 and are deeply grateful for the many relationships of trust and commitment we share with our clients.

John E. Chapman
Chief Executive Officer
Chief Investment Strategist
July 2018

About John Chapman

John Chapman is the Chief Executive Officer of Clearwater Capital Partners. With thirty six years of Wall Street experience, John directs all wealth management and advisory services for the firm, is the firm's Chief Investment Strategist, and chairman of the firm's Investment Policy Committee.

John has a Bachelor of Science degree in Finance from the University of Illinois, Urbana-Champaign. He is a graduate of the Certified Investment Management Analyst program, sponsored by IMCA, in association with the Wharton School at the University of Pennsylvania. In 1998, he became a graduate of the Securities Industry Institute and the Securities Industry Association's Branch Management Leadership Institute at Wharton. He also completed Executive Leadership and Strategy programs at the University of Chicago's Graduate School of Business.

In 2008, John earned the Accredited Investment Fiduciary® designation through the Center for Fiduciary Studies, in association with the University of Pittsburgh Joseph M. Katz Graduate School of Business. In 2012, John completed the Retirement Management program at Boston University's Center for Professional Education and in 2013, received a certificate in Advanced Investment Strategy from IMCA.

He is a member of Advocate Sherman Hospital's Board of Directors, where he chairs the Development Council and serves on the Finance Committee. He is also a board member of the Advocate Charitable Foundation. John is a former president of the Westminster Christian School's Encore Society and is currently the Executive Director of the Clearwater Capital Charitable Foundation.

About Clearwater Capital Partners

Clearwater Capital Partners is an independent Registered Investment Advisor registered with the Securities and Exchange Commission (SEC). The firm was founded in 2006, by John Chapman, as a locally owned, privately held independent advisor. The firm provides comprehensive wealth management services to successful individuals and families through its Private Client Practice. The firm's Institutional Advisory Group offers a suite of professional services to businesses, non-profit organizations, foundations, and ERISA governed retirement plans.

Our services are designed to help simplify the increasing demands and complexities related to making sound financial decisions. As an independent advisory firm, we embrace the fiduciary responsibilities we have for our clients and are at liberty to deliver solutions we believe best reflect their unique needs. Our professional services are provided in accordance with our core beliefs and always with the utmost discretion and confidentiality.

Wealth management is a process; one that takes place over long spans of time, and one that is best served through dedicated expertise, meticulous evaluations, and disciplined judgment. Our process adheres to these precepts and seeks to create an intelligent framework for consistent and rational decision making.

Our process sets forth a course of deliberate action reflecting each client's most critical objectives. Our methods are designed to prioritize critical goals and to achieve congruity between action and values.

Wealth management firms vary widely in their philosophies and in the services they offer. Clearwater Capital is dedicated to a well-organized process that places the client at the center of our business model. We are uniquely qualified in the disciplines of wealth management, and our clients have entrusted us with the care of their most cherished ambitions. In return, we endeavor to meet this privilege with diligence and accountability.

IMPORTANT DISCLOSURES

The opinions presented are those of Clearwater Capital Partners and John Chapman, Chief Executive Officer and Chief Investment Strategist, as of July 2018 and may change, without notice, as subsequent economic and market conditions vary.

This material is presented as opinion and commentary. It is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. It is strictly intended for educational purposes only.

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International investing involves additional risks, including risks related to foreign currency, limited liquidity, less government regulation and the possibility of substantial volatility due to adverse political, economic or other developments.

The two main risks related to fixed-income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments.

Index performance is referenced for illustrative purposes only. You cannot invest directly in an index. S&P 500 is a registered trademark of Standard & Poor's Financial Services LLC, a division of S&P Global ("S&P"). Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Municipal bonds are subject to availability and change in price. They are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply.

Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

The payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time.

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