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MARKET COMMENTARY

US stocks were up in the second quarter bringing most domestic indices into positive territory on a year-to-date basis. Large cap stocks in the S&P 500 were up 3.43% in the second quarter resulting in a year-to-date return of 2.65%. Small cap stocks in the Russell 2000 outperformed their large cap counterparts and gained 7.75% for the quarter and 7.66% for the year so far. International stocks of developed markets in the MSCI EAFE did not fare as well and were down -1.24% for the quarter bringing their year-to-date loss to -2.75%. Emerging market stocks had an even tougher time and lost -8.66% in the quarter wiping out their first quarter gain and resulting in a loss of -7.68% year-to-date. Bond yields rose again so the Barclays US Aggregate Bond Index added to its prior loss with a -0.16% return for the quarter and a -1.62% return year-to-date.

The economy is on firm footing. Inflation is near the Fed's 2% target, small business and consumer confidence is strong, and unemployment is the lowest it has been since 1969 at 3.75%. GDP growth for the first quarter was 2.0% which was better than expected. Strategas Research is projecting second quarter GDP growth of 4% or higher and JPMorgan strategist David Kelly believes it could be as high as 5%. Both expect it to slow in subsequent quarters. JPMorgan believes that slower GDP growth is inevitable because unemployment is below 4% and can't go much lower so the economy will naturally slow because there won't be enough workers to support high growth rates.

Corporate profits are also surging. First quarter earnings for the S&P 500 grew 24.6% which was the highest growth in nearly seven years. The growth is expected to continue in 2018 with Zack's projecting second quarter earnings to be up 18.5%. Some analysts have been concerned that earnings growth peaked in the first quarter, but with earnings growth still expected to be positive through year end, earnings are projected to reach new highs at year-end.

Higher earnings have been partly attributed to the tax law changes. Lower corporate tax rates have benefited both large and small companies but smaller companies tend to benefit more hence their stock return outperformance. They also benefit disproportionately from easing regulations and less exposure to trade wars so this outperformance may continue.

Strategas believes the market may be under appreciating the benefits of tax reform and easing regulations and instead focusing too much on a possible trade war. They point out that the negative impact of the potential tariffs is $120 billion compared to the $800 billion positive impact from fiscal policy. They believe the benefits of fiscal policy actions are just beginning to filter into the economy. They expect capital equipment spending will pick up as companies have more cash available from lower taxes and repatriation along with the ability to fully expense these purchases. They also see increased infrastructure spending which will come from budget appropriations that have already been approved. If they are right, the economy could be closer to the middle of the business cycle rather than near the end. JPMorgan believes the soonest possibility of recession would be in the second half of 2019 and that it, and any resulting bear market, would be mild compared to 2000 and 2008.

The tariffs and trade war talk along with a stronger dollar and weaker Chinese yuan have hurt emerging market stock indices. While Russia and India have positive year-to-date returns, South Korea, Hong Kong and Brazil are negative and Chinese stocks are now in bear market territory from their 52 week highs. Developed markets are more mixed with Japan seen as strong but Europe experiencing a soft patch. International stocks are selling at more attractive valuations than US stocks and may offer longer-term opportunities for growth in addition to diversification benefits. Longer-term, the dollar is expected to weaken and when this happens, international and emerging markets are expected to perform better than recent months.

As expected, the Federal Reserve raised rates again in the second quarter. Two additional increases are possible in the second half of 2018. The 10-year Treasury yield continued to climb higher but at a slower pace as its yield went from 2.74% at the end of March to 2.85% at the end of June. The yield curve has been flattening as short-term rates have increased more than long-term rates. Analysts are watching to see if the yield curve inverts as that has been a negative indicator and a precursor to recession. David Kelly of JPMorgan notes that an inverted yield curve may not be a reliable indicator right now and describes it as more of a "broken barometer" because of the extraordinary intervention of the Fed.

Although fears of recession and trade war make their way into the headlines often, stocks have been mostly resilient. Most analysts continue to favor stocks over bonds for the remainder

2018 BENCHMARK RATES OF RETURN

INDEX	SECOND QUARTER	YTD
S&P 500	3.43%	2.65%
DJIA	1.26%	-0.73%
NASDAQ	6.31%	8.79%
Russell 2000	7.75%	7.66%
International	-1.24%	-2.75%
Fixed Income	-0.16%	-1.62%

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of the year. Fixed income faces a difficult time as yields rise because of the resulting depreciation in existing bond prices. When the depreciation is greater than the income generated, negative total returns can occur which can be surprising and frustrating to investors who hold bonds for safety and income. Longer-term, the increase in yields results in more income generated for bond investors so any short-term pain from rising yields is rewarded. In addition, a bad year in bonds is never as negative as a bad year in stocks so bonds play an important role in reducing risk.

FINANCIAL PLANNING

Risk Tolerance

When managing investment portfolios, it is important for advisors to understand their clients' risk tolerance or how much risk they are comfortable with in their accounts. Some advisors have standard questionnaires they ask clients to fill out at the start of a relationship. The pitfalls to this approach is that the questions can be ambiguous or confusing leading to answers that aren't truly reflective. Also, recent market conditions can influence responses; during prolonged up-market trends people become more optimistic regarding their risk tolerance and during market corrections they often are more pessimistic regarding their risk tolerance.

Having an appropriate strategy for your risk tolerance helps remove emotional reactions from the investment management process so you can stick to the strategy to reach your goals regardless of market conditions. At Cambridge Advisors, we measure risk tolerance in multiple ways and multiple times as risk tolerances often change as your circumstances change. Many times we are measuring your risk tolerance without you even knowing it through the conversations we have about market conditions and monitoring your reactions to market movements.

Over the past few months, we have been testing an additional tool to help us measure your risk tolerance. Riskalyze software is an interactive questionnaire approach that objectively quantifies your risk tolerance and assigns a "risk number". This risk number can then be compared to your current portfolio to see if the two align or if adjustments need to be made. The Riskalyze software also analyzes each investment individually to help identify where additional risks lie.

We will be rolling out Riskalyze more widely over the next year. A link will be emailed to you where you'll be able to go through the questions at your convenience. Because it is interactive and based on how you answer each preceding question, it fine tunes the results into a more meaningful measure. When we meet, we'll be able to discuss the results and make sure that the risk number is appropriate and talk about how it relates to your investments. Periodically, we will email the link again to see if changes are needed in your investments.

CAMBRIDGE ADVISORS NEWS

We are happy to welcome back Matt Bridgman as he interns for us again this summer. Matt is the son of our Vice President, Mike Bridgman. He will be a junior at Notre Dame this year where he has decided to major in accounting. In the fall he will study abroad in Dublin, Ireland. While he is with us this summer, he is preparing the materials for our research meetings and is assisting on some special projects involving investment management, compliance and reporting.

QUESTION: What is cryptocurrency?

ANSWER: Although it is becoming more prominent, many people still do not know or understand what cryptocurrency is. Bitcoin may be the best known cryptocurrency name but there are others like Litecoin, Ripple, Ethereum and new ones being created each day. Basically, cryptocurrency is a digital or "virtual" currency that can be used just like physical money to buy or sell goods. You can think of it as electronic money.

Unlike cash, it is not associated with any country's government or central bank - it is completely independent. In its simplest form, it is a decentralized payment network with accounts, balances, and transactions where there is absolute consensus among every peer in the network because entries in the database can not be changed without fulfilling specific conditions. Each transaction is broadcast to every peer in the network through cryptography (complex protocols based on advanced mathematics and computer engineering principles) and is verified and combined with other transactions to create a "block" of data that is added to the existing "blockchain" which is permanent and cannot be changed.

It has no physical form - it is created and stored electronically in the blockchain network. It also has no intrinsic value because it is not redeemable for some other commodity like gold. It has value because someone else believes it has value. Through cryptocurrency exchanges, it can be converted into dollars, or pounds, or euros, or yen.

The cryptography protocols are virtually impossible to break thereby protecting cryptocurrencies from duplication or counterfeiting. It also hides the identity of users which makes it difficult to track fund flows to specific groups or individuals.

Cryptocurrencies have a finite supply that is determined by their source codes. Computers are used to "mine" the currency but at some point the limit will be reached. This finite supply makes them like gold rather than a currency that can be "printed" by a central bank.

Some people consider cryptocurrency to be an investment and CNBC reports much of the hype, but most serious financial professionals see them a speculative and not suitable for most investors at this time. When using cryptocurrency as money, it is important to guard your digital wallet closely. They can be vulnerable to hacking but the larger risk may be in losing access to the funds because the user has forgotten their "key" or the user dies and because of the anonymity of ownership, the value doesn't get recognized or transferred to heirs.

"Stay away from it. It's a mirage, basically" - Warren Buffet

"The future of money is digital currency." - Bill Gates

"I think the internet is going to be one of the major forces for reducing the role of government. The one thing that's missing but that will soon be developed, is a reliable e-cash." - Professor Milton Friedman

"We don't really know how this coin is created. You can't have a functional money without a basic transparency. Unless you are addicted to volatile trading for the sake of trading, stay away from the Bitcoin." - Steve Forbes