The quarter can be analyzed from the impact of taxes, trade, and Treasuries (Some might add President Trump or Twitter as well). Policy decisions, whether from central banks or politicians, had a significant impact on asset class movements. We saw continuation of trends in the form of growth stocks continuing to outperform value, and a rotation to small caps outperforming international stocks. This is attributable to taxes and trade as U.S. small cap stocks continue to benefit from lower taxes while being less exposed to tariffs and possible trade wars. International developed and emerging markets got hit hard during the quarter as the talk of tariffs and possible trade wars ramped up. China was the primary focus due to their significant trade imbalance with the U.S. as a result of historically pushing the boundary on free trade. President Trump implemented tariffs on steel and aluminum, primarily targeted at China, but also affecting Europe and Canada. The immediate impact was higher input costs for U.S. manufacturers and retaliatory tariffs by China on U.S. agricultural products and some industrial products. With small cap stocks less sensitive to international revenue, we saw a rotation towards small cap stocks during the quarter primarily at the expense of international stocks. The shape of the yield curve (U.S. 10-year Treasury yield less the 2-year Treasury yield) continued to flatten with the spread reaching a low of 33 basis points. The short end of the curve continues to move higher with the Fed’s increase in rates, while the 10-year U.S. Treasury is anchored by low global rates from Quantitative Easing (QE). The Federal Reserve is only a couple of more rate hikes from possibly inverting the yield curve, which has typically been followed by a recession.

**Asset Class Returns, YTD 2018**

- S&P GS Commodity Idx: 10.17%
- HFRI Hedge Fund Idx: 0.79%
- Russell 2000: 7.66%
- MSCI Emerging Mkts: -6.66%
- MSCI EAFE: -2.75%
- Barclays Aggregate: -1.62%
- Barclays LT Treasury: -3.00%
- S&P 500: 2.65%

Source: NDR

Please refer to important disclosures on the last page.
Equities

The quarter saw a larger divergence in returns, with small cap stocks up 7.8% and emerging market stocks down 7.7%. Much of the dramatic swing is attributable to talk of trade wars and a stronger dollar. Both are a drag on emerging market stocks, while small cap stocks who mostly have domestic revenue are less sensitive. Growth continued to significantly outperform value within the large cap space as the Russell 1000 Growth index was up 4.6% more than the Russell 1000 Value index. However, small cap value outperformed growth. Developed international markets were down .8%, as they were affected by trade discussions, but not nearly as much as emerging markets which declined significantly more.

Energy, technology, and consumer discretionary were the leaders during the quarter, while financials, industrials, and consumer staples were the laggards. Active management saw improvement relative to passive, as our managers within small cap and international continued to outperform, while our large cap managers were more mixed. We continue to see opportunity for active management to play a bigger role in equity allocation so we have increased our exposure first in international and are looking at small and emerging markets as the next place to increase. As we have mentioned in previous letters, from a valuation standpoint, international and especially emerging markets look more attractive than the U.S. The issue that remains forefront is how will tariffs and talk of more tariffs play out. In May, as talks of tariffs and possible trade wars flared up, we cut our emerging and frontier market exposure back and added to small cap. This move brought us to slightly overweight international and slightly underweight small cap.

Within equities, the key indicator will be the impact of tariffs. If rhetoric continues to ramp up, then international stocks, and especially emerging markets, will be most vulnerable. With the main reasons being: 1) less exports to the world’s largest economy due to higher prices 2) a stronger dollar. A major risk is that emerging markets can become trapped in a downward spiral as exports decline. Their debt, if issued in dollars, becomes more expensive, and inflation heats up. The good news is that there has been a divergence between financially strong and weak countries. This allows for active management to play an important role rather than investing passively in the indexes (which can be concentrated and contain both strong and weak countries.) From a portfolio construction standpoint, emerging markets and large cap U.S. stocks have both been more sensitive to tariffs and a strong dollar. Small caps, while not cheap, do provide diversification in case more tariffs are introduced and the dollar continues to strengthen.

Fixed Income

U.S. interest rates gradually moved higher over the quarter as the Fed implemented a second hike for the year. Short term rates followed in line with 3-month U.S. Treasury bills, higher by 21 basis points, while 10-year Treasuries were higher by about 15 basis points. The yield curve continued to flatten with the spread between 10-year and 2-year Treasuries at the narrowest level since 2007. Nearly every newsletter is warning about the signal that a flat to inverted yield curve sends. Historically, when the yield curve has inverted (10-year yield below the 2-year yield) a recession has followed. While that has been true, the timing can vary significantly, and we are in a unique period of exiting unprecedented quantitative easing. The range can be anywhere from 6 months to 24 months from when the curve inverts till a recession starts. Currently the curve is flat, but not inverted. Flat yield curves can persist for a long stretch of time, and there is no immediate indication the curve will invert. The Fed is likely to be more aggressive in allowing bonds to roll off their balance sheets, which would put more supply into the market to keep rates on the 10-year Treasury higher. If the Fed raises rates two more times, as they are forecasted to do, then the curve will be flatter but not necessarily inverted. If the curve were to invert, it is possible that because of the quantitative easing period we have been in, a recession may not be predicted as in the past. At the
end of the day, whether the curve inverts or not, the economy has momentum and is not likely to enter a recession this year or the following. Inflation has been a concern with the economy heating up and unemployment back to historical lows. As indicated in the chart below, wage growth should be growing faster based on the low level of unemployment. Historically, based on the current level of unemployment, we should see wages growing more than 3%.

Our defensive stance of being shorter in duration and focusing on quality individual securities continues to play out. During the quarter, longer duration securities suffered while shorter duration bonds rallied slightly. Our non-core fixed income allocations added additional alpha, as mortgage backed securities were up modestly.

Source: Bloomberg

Please refer to important disclosures on the last page.
Going Forward

Tax cuts and the reduction in regulation have started to filter their way into the economy, but should start to slow with the implementation of tariffs. Estimates are from a few basis points to about .35% subtracted from GDP. Liquidity conditions in the U.S., which have been accommodative, are beginning to become tighter as a result of tariffs and increased rates by the Fed. While GDP is expected to be 4% or more in the second quarter, it will likely revert back to 2.5% to 3.5% the rest of the year. The impact of tariffs on China and their response will drive volatility because China will have to deal with declining exports at a time when their economy is slowing. For answers on global growth and when to invest more in emerging markets China is the focus.

Our focus will continue to be on ways to enhance our portfolio allocations as volatility returns to normal. Some ways we are looking to achieve this include switching from more passive to active management within small cap and international equities, finding small and niche private equity managers, and investing in income producing assets such as mezzanine and structured credit. Our private equity vehicle is open and making commitments. While private equity in general is expensive, like everything else, we continue to find opportunities below the radar with disciplined managers.

Source: Bloomberg
Disclosures

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