TRIVANT

CUSTOM PORTFOLIO GROUP, LLC

April 2018

Quarterly Insights

First Quarter 2018

In This Issue

EXECUTIVE SUMMARY

Stocks And Bonds Were Mediocre In Q1

In the First Quarter, the domestic S&P 500 Index was down 0.76%. European and Japanese stocks did not fare much better. Emerging Markets was slightly positive (+1.28% in Q1), led by China (+1.82%) and Brazil (+12.36%). Technology (+3.20%) and Consumer Discretionary (+2.76%) were the only positive sectors. The Bloomberg Barclay's US Aggregate Bond Index fell 1.46% in Q1. We continue to rotate the portfolio to higher quality (defensive) stocks and medium duration bonds.

What's All The Buzz About Tariffs?

A tariff is a government-imposed tax on imported goods and services. During March, the Administration announced tariffs for steel (25%), aluminum (10%), and the People's Republic of China (up to $60 billion). These tariffs were targeted to China in response to China (allegedly) dumping steel on global markets (pushing down prices, forcing rivals out of business and killing thousands of jobs) and stealing US trade secrets (intellectual property). China has demonstrated it will respond in kind to any US tariffs/sanctions by imposing a $3 billion tariff on 128 US exports in response to the US steel tariff. Are we on the verge of a trade war that would be in no one's best interests?

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Tariffs Announced In March For Steel, Aluminum and The People's Republic of China

On March 1, President Trump announced tariffs of 25% for foreign-made steel and 10% for aluminum. That day the stock market fell 2%. On March 22, the Administration targeted specific tariffs for China - up to $60 billion (annual) for Chinese imports due to intellectual property theft. The stock market fell 4% the next two days. President Trump also signaled further tariffs. On Sunday March 25, Treasury Secretary Steven Mnuchin stated "we are simultaneously having negotiations with the Chinese to see if we can reach an agreement". The market surged on the possibility the announced tariffs could be reduced or avoided altogether. On the following day (March 27), the Administration threatened a crackdown on Chinese investments in technologies the US considers sensitive - and the market fell. It is readily apparent that the market does not welcome the prospect of tariffs or restrictions. Should we be worried going forward?

What Is A Tariff?

A tariff is a government-imposed tax on imported goods and services. There are arguments for and against tariffs, so a given tariff decision should be carefully weighed before being implemented.

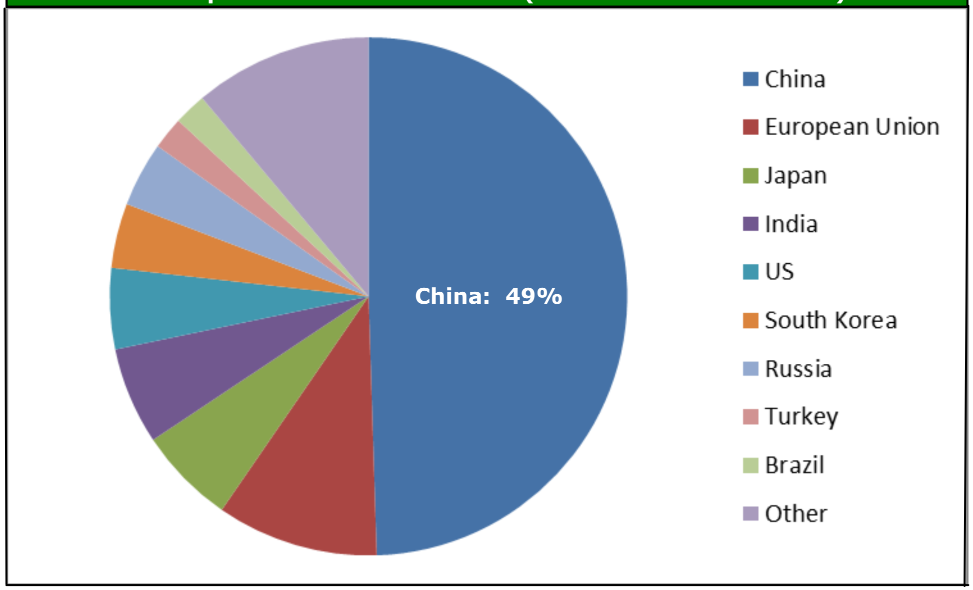
Have Tariffs Worked Well In The Past?

While many countries routinely impose thousands of "small tariffs" (tariffs that average 5%) without incident,, history shows that large tariffs are destructive. Let's look at two instances of tariffs imposed by the US that went terribly wrong. In June 1930, the Smoot-Hawley Tariff raised already-high tariffs on agricultural imports in order to protect US farmers who were decimated by an environmental catastrophe (the Dust Bowl). The resulting high food prices not only hurt Americans who were suffering from the Great Depression, but also compelled other countries to retaliate with their own protectionist measures. As a result of the trade war, world trade dropped 65%. On March 5, 2002, President George W. Bush placed 8%-30% tariffs on US steel. There was widespread belief that politics played a role - the steel-producing swing states (Pennsylvania, Ohio, West Virginia) would benefit. However, steel-using states such as Tennessee and Michigan were hurt. Over 200,000 Americans lost their jobs to higher steel prices in 2002. When the European Union threatened to counter with tariffs of its own on products ranging from Florida oranges to cars produced in Michigan (key swing states), the US backed down and withdrew the tariffs on December 4, 2003. From a historical perspective, neither the Smoot-Hawley or Bush tariffs are viewed as an economic success.

Steel Tariffs - A Closer Look (Less Concerning)

The US is the world's largest steel importer ($29 billion in 2017; source: Worldsteel). Subsequent to the broad 25% steel tariff announcement on March 1, the US has exempted nearly all steel producers - except China, which produces roughly half of the world's steel. Initially the Administration cited "national security" as the rationale for the tariffs, stating they do not want dependence on outsiders to meet military machinery steel needs. However, the US accounts for 5% of world steel production, which more than meets its military needs. The reason for specifically targeting China is that China has been accused of dumping steel on other markets, pushing down prices, forcing rivals out of business and killing thousands of jobs. Thus far, China responded to the steel tariff with a broad $3 billion tariff against the US (128 US exports). Even if both countries follow through on these tariffs, we do not view steel tariffs in isolation as very concerning. Given a $375 billion US goods trade deficit in 2017 with China (source: Commerce Department), steel trade itself is relatively minor.

The Top Steel Producers in 2017 (source: Worldsteel 2017)



The Math ($ Billions): How China Derived A $3B Tariff Response To The US 25% Steel Tariff

US Steel Imports:	$29.0
% Steel From China	49%
$ Steel From China	$14.2
25% Tariff to China	**$3.6**
Tariff Response to US	**$3.0**

China Tariffs And Restrictions - A Closer Look (More Concerning)

On March 22, the Administration announced a plan to hit China with up to $60 billion of annual tariffs for more than 100 products. Why? These products were (allegedly) developed using trade secrets (intellectual property) from US companies that China either stole or forced US companies to give up in exchange for Chinese market access. It is estimated that Chinese theft of American intellectual property annually costs between $180 billion to $540 billion (source: Commission On The Theft Of American Intellectual Property).

If we take Treasury Secretary Steven Mnuchin's comments at face value (see page 2), there is a reasonable chance that the tariff threat (and the potential crackdown on Chinese investment in US technologies) is meant to initiate negotiations with China versus being implemented. The US wants specific concessions from China.

What The US Wants From China

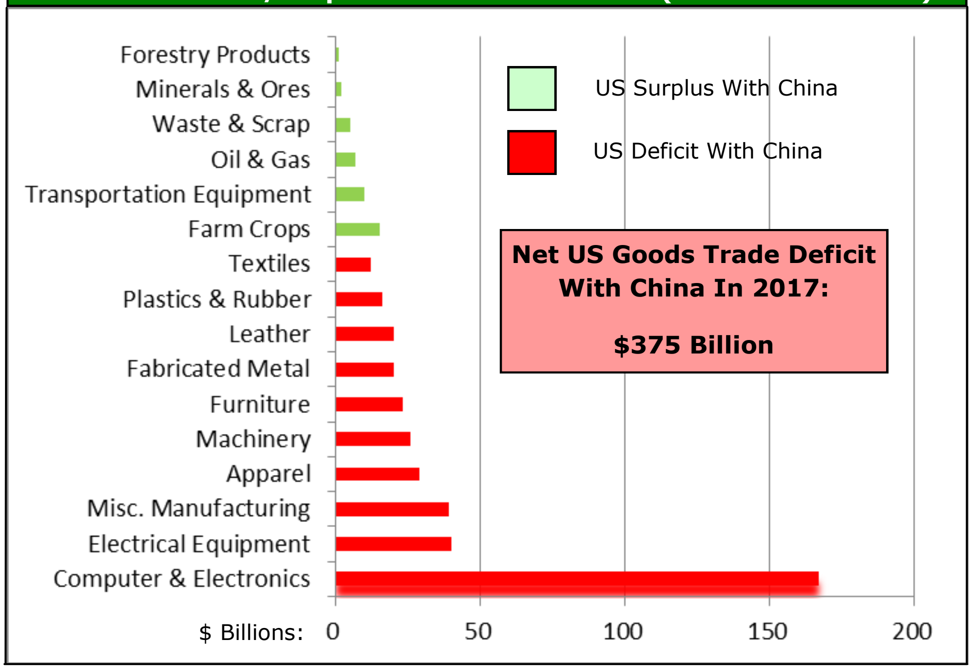
- Lower the goods trade deficit ($375 billion) by $100 billion
- More access to China's vast economy
- Eliminate rules that require joint ventures for China entry
- Stop forced handover of intellectual property for China entry

The big question is whether the US can get what it wants. Will we have prosperous trade or start a trade war?

Successful Negotiations Or The Start Of A Trade War? It Is Tough To Predict

It is tough to predict whether the world's two largest economies (the US and China) will have successful trade negotiations (a good thing) or start a trade war (a bad thing). China has stated "there are no winners in a trade war" yet is also determined to respond to any US tariffs/sanctions in kind. It just matched a $50 billion US tariff (April 3) with its own $50 billion tariff (April 4). Fortunately the actions initiated by the US so far, if implemented, would have relatively little impact. New US tariffs will cause US GDP to decline by only 0.08% and China's GDP to decline by only 0.10% (source: Capital Economics). The bigger threat to economic expansion would be a trade war that spirals. Hopefully that will not happen. We view the best outcome to be a negotiated trade agreement that is satisfactory to both sides. Tariffs force a tradeoff between workers and consumers. The fact that both the US and China have indicated a willingness to negotiate is a good sign.

US Goods Deficit/Surplus With China In 2017 (source: US Census)



Comparative Advantage

David Ricardo (1772-1828) was an influential British economist who championed the theory of "Comparative Advantage". If one country is better at producing one product, while another country is better at producing another, each should devote its resources to the activity at which it excels. They should trade with each other, rather than erecting barriers (such as tariffs) that force them to divert their respective resources towards activities they do not perform well. **For example, China can produce products in the category of "Computer & Electronics" much more efficiently than the US - and US consumers benefit from this comparative advantage. Given this scenario, a US tariff for Chinese products would be a drag on US economic growth.**

Portfolio Strategy Considerations Amidst Tariff Uncertainty

Here is the portfolio strategy we set at the beginning of the year (Quarterly Insights, January 2018, page 4):

Observation Under Restrictive Conditions	Portfolio Action
S&P 500 Index Performs Below Baseline Average	Rotate to higher quality (defensive) stocks Increase: Staples & Health Care Decrease: Discretionary, Energy, Technology
Emerging Markets Out-Perform S&P 500 Index	Increase Emerging Markets
EAFE Index Does Not Out-Perform S&P 500 Index	Maintain or Reduce European Exposure
Corporate Bonds Under-Perform Other Bonds	Reduce Corporate Bonds, Increase Treasurys
Higher Inflation	Maintain TIPS (Inflation-Protected Bonds)

Even assuming a worst-case scenario with US/China trade (tariffs instigate a trade war), our anticipated strategy does not change. If anything, it would be reinforced. Any detrimental effects to the economy due to tariffs/restrictions would further justify a move to defensive stocks. Any consumer price increases would hurt discretionary stocks. Higher steel costs would raise pipeline costs, which would hurt Energy. An investment crackdown on China would hurt Technology. Tariffs are inflationary, which would justify maintaining TIPS.

Stocks Flat In All Major Regions In Q1

In the First Quarter, the domestic S&P 500 Index was down 0.76%. European and Japanese stocks did not fair much better. Emerging Markets was slightly positive (+1.28% in Q1), led by China (+1.82%) and Brazil (+12.36%). All in all, there were no regional performance standouts in Q1.

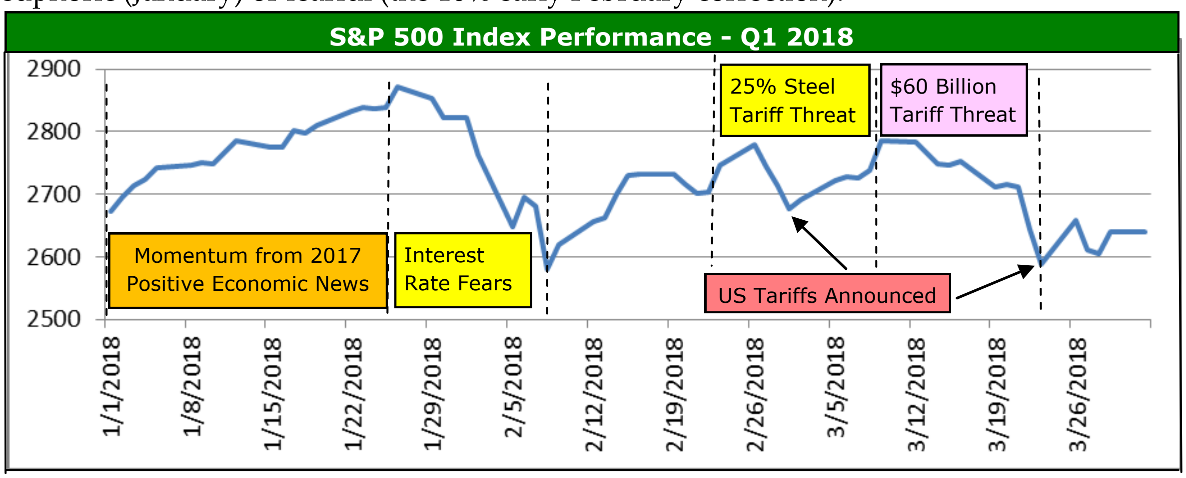
Equity Index Performance

Index	Q1 2018
S&P 500 (Domestic)	**(0.76%)**
MSCI EAFE (Foreign) *	**(1.70%)**
MSCI Emerging Markets	**1.28%**
MSCI EMU (European Monetary Union)	**(0.46%)**
MSCI Japan	**0.13%**

* Europe, Australia and the Far East

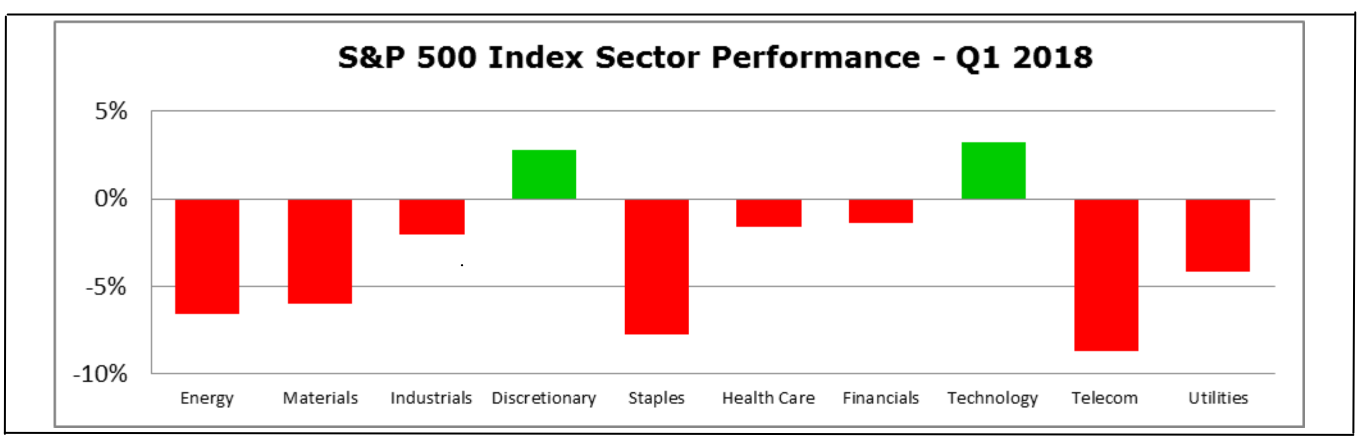
While The S&P 500 Index Ended Flat For The Quarter, It Was A Wild Ride

While the quarter ended flat, the market moved up and down quite dramatically. For many, it was easy to be overly euphoric (January) or fearful (the 10% early February correction).



Technology And Discretionary Were The Only Positive Sectors In Q1

As was the case with global regions, there were no sector performance standouts in Q1. Technology (+3.20%) and Discretionary (+2.76%) were the only positive sectors.

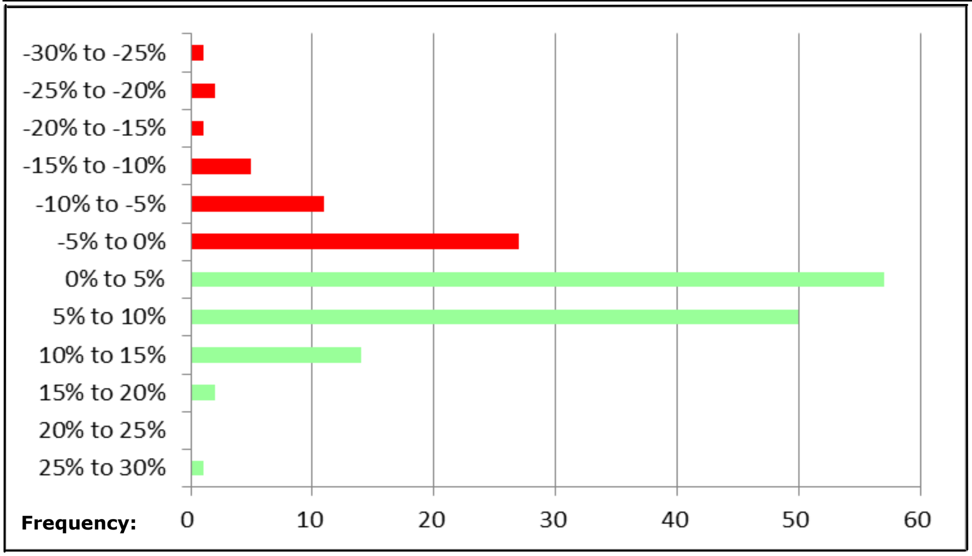


Negative Bond And Stock Returns Have An Identical Frequency Of Occurrence

On March 21, the Federal Reserve raised its benchmark interest rate by 0.25% to a range of 1.50% to 1.75%. The Fed still expects two more rate hikes in 2018 and perhaps a third. As interest rates rise, bond prices fall. The Bloomberg Barclay's US Aggregate Bond Index fell 1.46% in the First Quarter, as the Treasury yield curve continued its flattening in a rising rate environment.

In Q1, we saw both bonds and stocks fall (the S&P 500 Index was down 0.76%). Many investors intuitively expect that bonds do not go down and are alarmed when they see it happen - after all, bonds are supposed to be the "safe component" of their portfolio. It may surprise you that the frequency of bonds falling in rolling three-month time frames is literally identical to that of stocks.

S&P 500 Index Rolling Three-Month Stock Returns (July 2003 Through December 2017

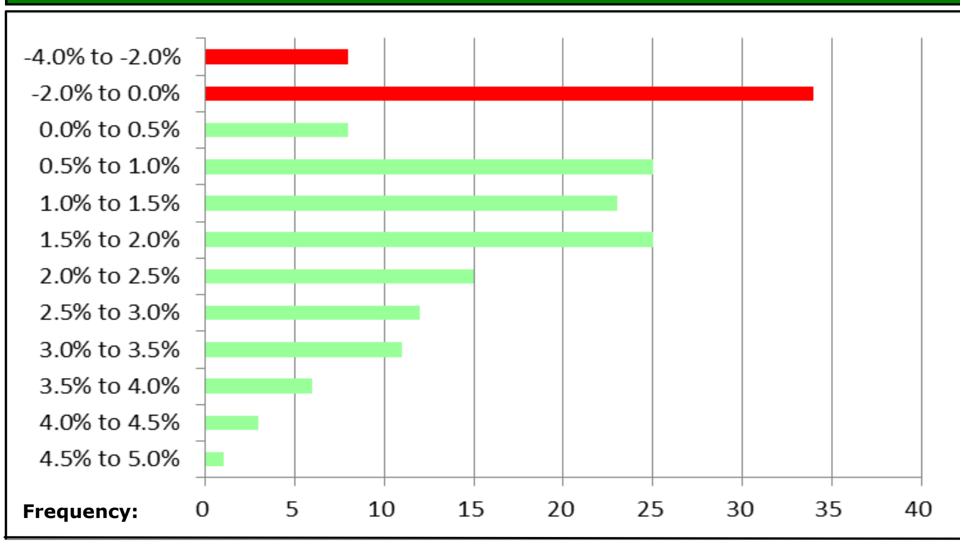


The average three-month stock return was 2.51%.

The standard deviation of these returns was 7.14%.

Out of 171 observations, the returns were positive 124 times and negative 47 times. Put another way, the returns were positive three-quarters of the time.

Rolling Three-Month Bond Returns (July 2003 Through December 2017)



The average three-month bond return was 1.09%.

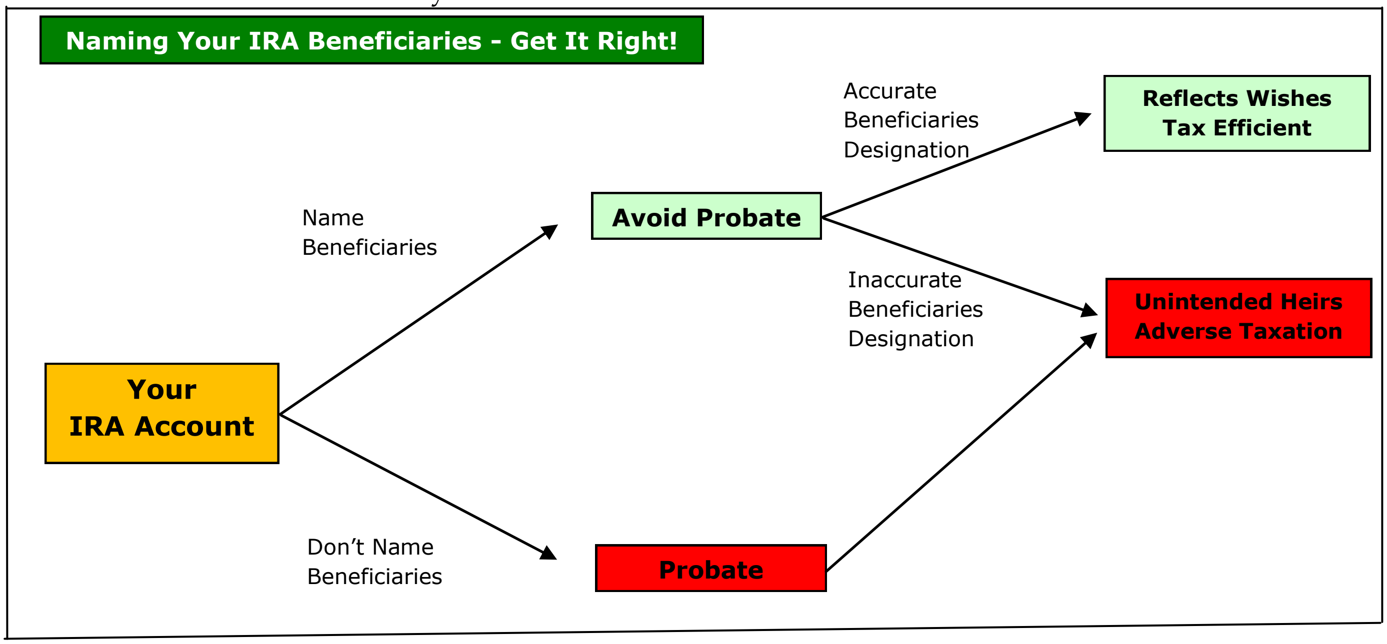
The standard deviation of these returns was 1.61%.

Out of 171 observations, the returns were positive 129 times and negative 42 times. Put another way, the returns were positive three-quarters of the time.

While bonds and stocks had negative three-month returns one-quarter of the time, bonds had relatively lower average returns and standard deviation of returns. This is why bonds form the "conservative component" of your target asset allocation. As we saw in Q1, bonds can perform "more negatively" than stocks in a given three-month time frame. When this happens, maintain disciplined asset allocation.

Make Sure Your IRA Beneficiary Information Is Accurate

It is very important that you designate primary and contingent beneficiaries for your IRA account. By doing so, you will ensure that your assets go where you desire. Additionally, you will avoid probate, a legal process for distributing your assets after your death that is both time-consuming and expensive for your heirs. Once retirement assets go through probate, they have to be distributed either immediately or within five years, leaving your heirs without the ability to stretch the length of time for withdrawals. This will most likely be tax-inefficient.



CASE STUDY - AN IRA BENEFICIARY SITUATION GONE WRONG

Jack and Louise Johnson got married in 1980 and divorced in 2010. At the beginning of their marriage, Jack listed Louise as his 100% primary beneficiary on his IRA account. Jack remarried Annette in 2015, but had neglected to update his IRA beneficiary information subsequent to his divorce or upon his new marriage. Unfortunately, Jack passed away in 2017. His former wife (Louise), not his current spouse (Annette), inherited his IRA. This was not what Jack had intended.

Action Plan

We suggest the following steps to ensure your IRA beneficiary information is accurate:

1. Review your primary and contingent beneficiary information on a regular basis (every three or four years) to ensure accuracy.

2. Check your beneficiary information anytime you have a significant life event such as a divorce.

3. When a revision to your beneficiary information is warranted, do not procrastinate - do it right away.

We are happy to assist you in checking and revising your IRA beneficiary information. Please contact us.

We made a few portfolio adjustments in Q1. The rationale for these moves included a desire to increase Health Care, reduce Technology, and continue our style rotation towards higher quality (defensive) stocks.

We bought Merck (symbol: MRK), a large-cap ($144 billion market cap) pharmaceutical company that boasts a vast lineup of high margin drugs (including its blockbuster drug Keytruda, which treats cancer) and has many new drugs in its pipeline. We also bought Medtronic PLC (symbol: MDT), a large-cap ($105 billion market cap) medical device company. Headquartered in Ireland, MDT has four divisions: Cardiac & Vascular (35%), Minimally Invasive (33%), Therapies (25%), and Diabetes (7%). MDT is a supplier for every hospital.

We sold Fiserv (symbol: FISV), a mid-cap ($29 billion market cap) payment processor for US banks and credit unions. FISV was a tremendous performer over the five years we owned the stock, but sales growth has slowed considerably. We also sold PulteGroup Inc. (symbol: PHM), a mid-cap ($8 billion market cap) US homebuilder. Reasons to sell PHM included rising interest rates (rising rates have already started to be reflected in lower housing sales), higher input material costs (such as steel, aluminum and lumber), and higher-than-ever levels of millennial student loan debt (which is delaying home purchase decisions).

REMINDER
We want to remind you that we have a new downtown office location. Please visit us at One America Plaza (600 West Broadway, Suite 225, San Diego, CA, 92101). Our phone and fax numbers remain the same.

We will continue to closely monitor the market and adjust your portfolio as needed. Please feel free to contact us anytime to discuss questions or comments you may have. We will keep you informed of portfolio progress.

Respectfully submitted,

TRIVANT

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