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The evolution of investment

Second Quarter 2018

The first quarter's market volatility persisted throughout the second, driven by apprehension around global trade and an expectation that corporate profits may have recently peaked. The mid-spring reporting cycle saw 23% earnings growth for aggregated S&P 500 companies, just eclipsing the 22% growth projected for mid-fall. Corporate margins are near post-financial crisis highs and the market's valuation now sits at its long-term average.

While volatility remains relatively new to 2018, market narrowness has intensified. In 2016 the top ten largest contributors to the S&P 500 accounted for more than one quarter of the market's return; in 2017 that increased to one third. By the end of this past March, half. Of those top ten companies, technology behemoths Amazon, Apple, Microsoft, Alphabet (Google's parent) and Facebook led the charge. To contextualize their influence, the collective market capitalization of the former three is greater than the annual GDP of Africa (all 54 countries). This comparison is not like for like; GDP is a backward looking snapshot when market capitalization depends on estimated future cash flows, but the magnitude resonates. Technology not only dominates our daily lives, it dominates market returns and in so doing, our financial health.

Information technology currently composes 25% of the U.S. market; including Amazon (still classified as consumer discretionary), it rises to nearly 30% and with biotech, more than one third. By contrast, the European market is just 5% technology, reflecting a mere two companies, while the sector represents more than 40% of the Chinese market. China now matches the U.S. in production of high tech manufacturers and outspends the U.S. in sector-related capital expenditures by 80%. Compare that to thirteen years ago when China's tech investments were a fraction of the U.S.' and trade war rhetoric becomes all the more tenuous.

Whether tariffs influence the market remains uncertain; in 2002 President Bush imposed a twenty-one month steel tariff that seemingly coincided with a 34% drop in the stock market; recall Enron, WorldCom and a search for "weapons of mass destruction" also plagued the market at that time. Direct market influence aside, tit-for-tat antics between the U.S. and China have certainly strained global trade relations and contributed to reservations around product pricing and supply chain management.

For all the media attention to the topic, tariffs have yet to dim business optimism. Executives remain upbeat even as the U.S. economic expansion moves through the middle of its ninth year (tied for the third longest on record). Though investment in traditional capital expenditures remains soft, spending on technology is now at multi-year highs; in aggregate, U.S. tech spending could potentially reach nearly $4 trillion by year end as companies across all sectors upgrade software, services and cloud capabilities.

Tariff talk has likewise done little to hinder the American consumer. With less than 10% of mortgages subject to variable rates, household balance sheets are healthy, supported by growing disposable income and an

BALDWIN BROTHERS, INC. 204 SPRING ST. MARION, MA 02738
PHONE (508) 748-0800 FACSIMILE (508) 748-0806

WWW.BALDWINBROTHERSINC.COM

unemployment rate now more than half a percent below its natural level (and on track to reach the lowest rate recorded in fifty years). In part a response to tax reform and its elimination of state and local tax (SALT) deductions, upper income households have cooled spending; on the lower end, credit quality has begun to deteriorate as card delinquencies move higher.

Rising energy prices could further hamper both corporate and consumer sentiment. Brent has increased nearly 50% year-over-year, translating into rising material, freight and logistics costs for businesses and higher prices at the pump for consumers. By mid-May, the average national price of gasoline had risen 44 cents since the year prior; if sustained, high gas prices could potentially eliminate one-third of tax reform's paycheck benefit. Though they have yet to do so, companies passing fuel-related increases onto the consumer via higher prices will likewise further reduce discretionary spending and erode confidence.

Investor confidence in markets outside the U.S. has already started to fade. The first quarter's optimism around Japan has all but evaporated, despite the Bank of Japan's accommodative monetary policy. The European Central Bank will similarly maintain its loose policy through at least next summer, despite mounting continental populism, most notably in Italy and Spain. On June 1st, the former swore in its first populist government since World War II, while the latter removed its prime minister by a vote of no confidence, the first such removal in Spain's democratic era. Populist sentiment strengthens in Mexico, fueled in part by NAFTA uncertainty, as the country moves toward its July 1st presidential election. A May 18th truckers' strike challenges Brazil; Argentina struggles to curb the peso's depreciation; and populist rhetoric may lead Turkey to lessen central bank independence.

Back in the U.S. recession chatter percolates, though most economists argue it at least eighteen months to three years away. Reaffirming confidence in the country's economic health, the Fed raised interest rates again in June and signaled the possibility of two more increases before year end; while the media fuels anxiety around rising rates, a cessation or reversal to such hikes would prove more worrisome. The Fed historically cuts rates to stave off recession and hikes in prosperity. That said, higher rates increase the debt service owed on the growing national deficit. Inflation meanwhile remains in-check, sitting comfortably at the Fed's 2% target.

A change of political power in November, pervading protectionist agendas and geopolitical risks could all momentarily disrupt the global markets, but increased regulation of technology could prove structurally transformative. Recall the influence the top technology companies currently exert over the S&P 500. Burgeoning governmental measures to counter their influence, such as Europe's sweeping General Data Protection Regulation (GDPR), could pose near-term challenges while over a longer period, the sector's monopolistic tendencies could come under renewed scrutiny. At the turn of the last century, Standard Oil controlled more than 90% of oil production in the U.S. and 85% of sales; it took another eleven years before the passage of the Sherman Antitrust Act to curb the company's power, breaking it into the many energy companies we know today.

With our goals to preserve and grow your capital, we heed recent market turbulence and its pending challenges. We pay particular attention to asset allocation, making sure non-equity exposure, the ballast of your portfolio, reflects your long-term needs. We likewise remain mindful of our concentration in technology, right-sizing those market leaders for further risk mitigation (after all, those names that lift the market to new highs can also lead it downward). Most importantly, we keep our eye toward a long horizon, seeking thoughtful transparency from the companies in whose stocks we invest or vehicles we utilize. Transparency around financial, environmental, social and governance criteria lend confidence that these investments will adequately address near-term challenges and continue to shape our tomorrow.

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