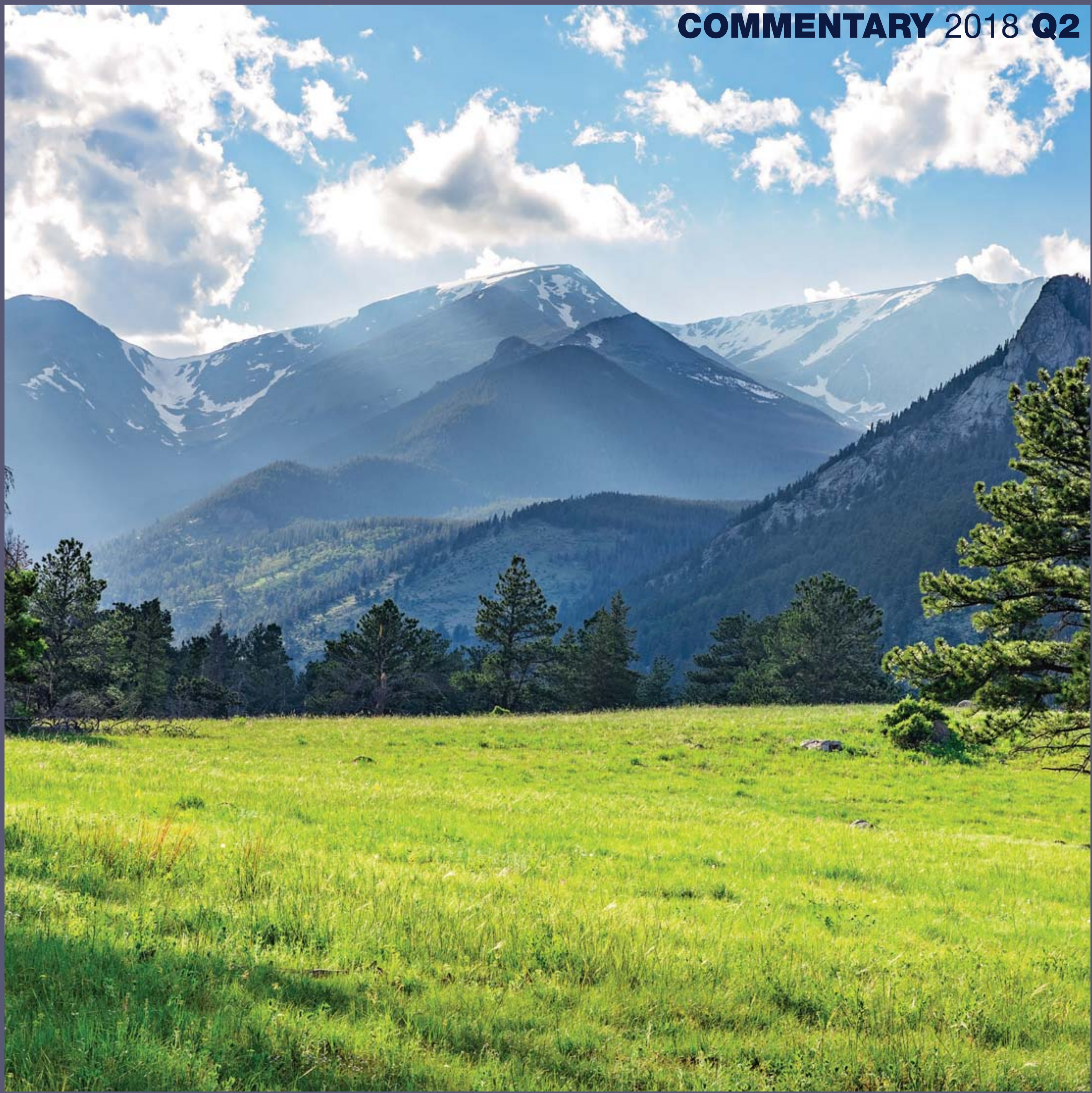
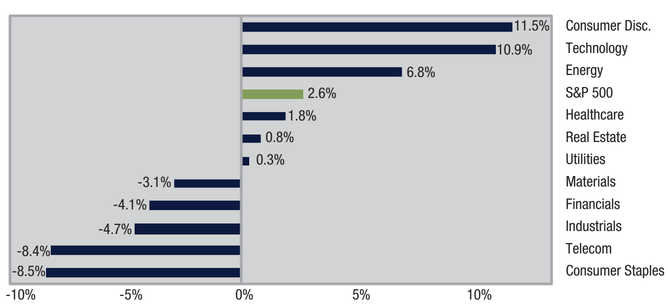


Inverness
Counsel

During the quarter, equity markets traded in a narrow range with less volatility than was seen earlier in the year. The S&P 500 experienced a modest recovery and ended the quarter at 2,736—a positive return for the period but still 5% below the high reached in early January. The synchronized global economic expansion continued, with revenue and earnings for the S&P 500 once again significantly exceeding forecasts. Many domestic economic indicators are at or near record levels. With stronger growth, inflation pressure is building in certain areas. Central banks around the world are migrating back towards a normalized interest rate policy, and the Fed increased the number of expected rate hikes this year. Portfolios remain positioned for faster growth, although with a degree of caution, given the price volatility experienced so far this year and the chance that the Fed will raise rates too aggressively.

The S&P 500 Index increased 3.4% on a total return basis for the quarter, with sector results ranging widely. The Energy and Technology sectors experienced relative strength this quarter, and these two sectors, along with Consumer Discretionary, have been the leaders for the year (see Figure 1). The Consumer Staples, Telecommunications, Industrials, and Financials sectors remain the laggards for the year.

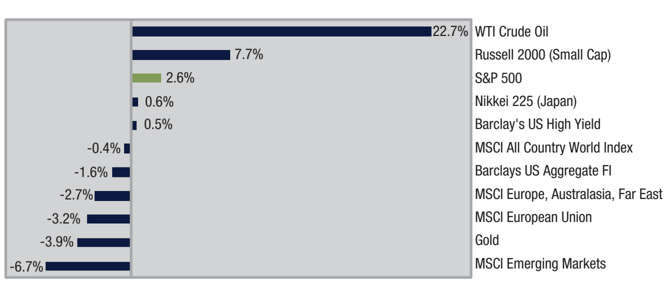
Figure 1: 2018 Performance by Economic Sector



Source: Bloomberg. Data as of 06/30/2018.

From a broader perspective, the strong dollar and healthy fundamentals led U.S. equities to outperform most foreign equity markets for the quarter and the year (see Figure 2). Smaller market capitalization stocks, with less global businesses and higher exposure to domestic tax cuts, performed better than the large-cap S&P 500. Oil extended its rally for the year—further stoking inflation fears.

Figure 2: 2018 Performance by Category



Source: Bloomberg. Data as of 06/30/2018. All returns in U.S. dollars.

The Current Economic Expansion Is the Second Longest in History

U.S. economic growth, as defined by Gross Domestic Product (GDP), remains strong at 2.9% year over year—up from the modest pace of 2% that we have seen in recent years. Residential investment and consumer spending are the main sources of strength. If the current expansion continues into next summer, this economic growth period will become the longest in history, surpassing the boom of the 1990s.

Many economic indicators and sentiment surveys are at or near record levels:

- The Conference Board Consumer Confidence Index stands at its highest level in 15 years.
- The NFIB Small Business Optimism Index is at its highest level ever in its 45-year history.
- National home prices are at all-time highs.
- Unemployment has declined to 3.8%—a level last seen in the late 1960s.

We have positioned portfolios for accelerating growth. A healthy economic backdrop has allowed corporate America to gain considerable strength. Earnings for the S&P 500 are expected to grow around 20% for all of 2018 as a result of strong revenue growth and tax reform. The outlook for 2019 also appears favorable.

Tariffs imposed by the U.S. have caused the threat of trade wars to erupt across the globe. The main focus for the U.S. seems to be the protection of intellectual property rights, such as patents and copyrights, particularly in China, although the issue of global price equalization for some specific goods is also involved. Several governments have drawn lines in the sand with counter threats. We continue to analyze the effect of trade barriers on our investments. As threats turn into actions, this process could take on a life of its own. For now, the market believes negotiations will occur.

Inflation Expectations

Stronger growth across the overall domestic economy has the Federal Reserve concerned about the potential for accelerating inflation. Unemployment has dropped to record lows. Employment gains have been broad-based, and average hourly earnings have increased 2.7% year over year. Many commodity prices, including oil, have also moved higher, stirring inflation concerns. In response to this strength, the 10-year U.S. Treasury bond yield broke through the 3.0% level, which it last reached in early 2015.

In our 2014 year-end commentary, we introduced a number of indicators that have provided early warning signals of markets becoming overheated in the past (see Figure 3). At the time, most of the indicators were benign. Valuations were reasonable, interest rates were at 0%, and wage growth pressure was well below previous cycle highs. Over the last few years, many of the indicators have been downgraded from the positive category. We noted that wage growth was the key statistic; we just weren't seeing it.

At the end of each of the last two economic cycles, peak hourly wage growth was in excess of 4%, and the Fed responded by raising rates aggressively. The Fed has now raised rates seven times since 2015, with two more increases expected this year. The Fed inflation target (core PCE) hit 2% in May, and officials have indicated that after years of below-target price gains, a modest overshoot would not necessarily warrant faster interest rate hikes. Efficiencies created by technology and the hiring of part-time workers should keep inflation at subdued levels, but we are watching closely for any sign that we need to adjust our positive stance.

Figure 3: Indicators vs. Prior Bull Markets

Indicators	Reference Data	Current	2007	1999
Economic Growth (GDP)	Expansion from Prev. Peak	20.8%	15.3%	38.8%
Corporate Balance Sheets	Ratio Debt/Equity	1.1X	2.1X	1.9X
Valuation	S&P Forward P/E Ratio	16.2X	18X	27X
Inflation	PCE Price Index	2.0%	2.5%	1.4%
Wage Growth Pressure	Hourly Wage Growth	2.7%	4.2%	4.4%
Initial Public Offerings (IPOs)	Total Deal Count	276*	240	544
S&P 500 Total Return During Cycle	Return - Bottom to Peak	384%	121%	546%
Duration of Economic Expansion	Quarters of Expansion	37	21	41
Interest Rates / Trajectory	Fed Funds Rate	1.75%	4.25%	5.50%
Mergers & Acquisitions	Total U.S. Transaction Value	$2.3T*	$1.3T	$1.2T

Source: Bloomberg. Data as of 06/30/2018. All returns in U.S. dollars.
**High for economic cycle.*

The Inverness Investment Process

Historically, at this point in the economic cycle, the equity and fixed-income markets have favored active, individual security selection. Inverness actively manages $3.1 billion in client assets, ranking the firm among the largest independent registered investment advisors (RIAs) in the United States. Our approach is to invest in a core group of companies that we believe will create long-term value for shareholders while favoring the preservation of capital. The goal is to own good companies, not to rent stocks. We continue to believe this approach is the best way to manage our clients' wealth.

Our dedicated internal research team uses a "bottom-up" selection process that focuses on cash flow stability, balance sheet strength, and a reasonable price for expected growth. For industries where traditional measures of valuation may not be relevant, we have the flexibility to use other methods to assess valuation relative to future growth. We believe our disciplined process leads to better relative performance over an investment cycle, since attractively valued companies with high-quality characteristics tend to perform better in difficult markets.

Our research at the company level often leads us to investment themes that we think offer compelling long-term growth opportunities. Over the last few years, we have written thought leadership pieces on several of these topics. We often focus on companies that are disrupting the traditional ways of doing business, because such companies take market share, enter new businesses, and appear to have the ability to generate strong long-term growth.

Our Newest Theme: The Sport of the Future (eSports)

Electronic sports, or eSports, are video gaming competitions, where teams of highly skilled gamers compete on a professional level. This booming global phenomenon involves major events with thousands of spectators, millions of broadcast viewers, and millions of dollars in prize money. In some markets, the gamers, or "cyber athletes," are even treated as celebrities.

Current trends indicate that in a few years, competitive video gaming will be acknowledged globally as a "real" sport. The International Olympic Committee (IOC) has even discussed eSports as a possible addition to the Olympic program. The millions of online viewers that eSports attracts create the potential for competitive gaming to evolve into a multibillion-dollar industry with leagues and teams as well recognized and well funded as the NBA and NFL.

The eSports industry is expected to realize $900 million in revenues in 2018 and annual growth rates of 27%–38% over the next three years. Furthermore, the industry attracts an audience of more than 380 million viewers annually, with that number growing by around 14% per year. By 2021, eSports are expected to be a $1.65 billion industry with more than 550 million viewers (see Figure 4).

Figure 4: eSports Industry Growth

Source: Statista. Latest data available as of 6/30/2018

From an investment perspective, eSports represents an industry that will benefit various types of corporations: video game developers, streaming platforms, betting sites, and gaming equipment manufacturers. At Inverness, we already have investments in a handful of the major players and will follow with interest in the development of this new industry and its influence on financial markets.

Course of Action

During the quarter, we increased our already meaningful portfolio weightings in the Technology and Healthcare sectors. Trends in both of these segments are driving strong long-term growth. A strong global economy and the need to rebuild deteriorating infrastructure should benefit industrial companies, to which we also have significant exposure.

We have less enthusiasm for the Financials sector, since the impact of higher interest rates, lower taxes, and less regulation is being muted by sluggish loan growth. Our exposure to consumer-focused sectors remains guarded, as Amazon in particular and online retailing in general are causing disruption for many companies.

Portfolios remain underweight the higher-dividend-yielding sectors—Utilities, Telecommunications, and Real Estate. This group of stocks has underperformed, and valuations have adjusted lower. Along with other mature, higher-dividend-yielding names in other industries, these sectors will be a focus for the research team in the third quarter.

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