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Disciplina Capital Management
June 2018 Quarterly Update

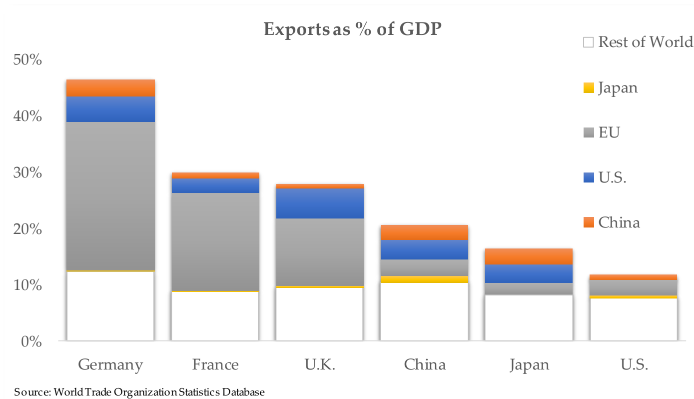
"No nation was ever ruined by trade." – Benjamin Franklin

Second Quarter 2018 Update

As we can see from the statement above from one of the founding fathers of the United States, trade has been a hotly debated issue for quite some time. We would argue the dialogue was probably a bit more constructive in an era without a 24-hour news cycle and social media. Is there anyone on Twitter who's not angry? At Disciplina, we always encourage our partners to sift through the noise and seek out the key topics that are going to drive valuations in the months and years to come. The challenge with the issue of trade and the actors involved is there is an incredible amount of noise to sift through. This quarter, we will attempt to give you our take on the implications of the recent "trade wars" for the economy, markets and our thoughts on asset allocation in the latter part of 2018.

Geopolitical Trade Wars

In an April 2016 speech on foreign policy, Donald Trump stated that "we have to be unpredictable". As it relates to trade policy, we can safely say, mission accomplished! The U.S. is doing some serious multi-tasking as the President has opened up a three-front trade "war" with China, Europe and our neighbors in North America.



Since the U.S. produces and consumes many input parts and raw materials domestically, it is partially shielded from declines in global trade. Therefore, China will ultimately have the greatest impact on markets due to the size of its economy and the fact that an aggressive stance towards China appears to have the most support in the U.S. electorate relative to our battles with Europe and NAFTA counterparties. While imposing a tariff on $200 billion worth of Chinese goods sounds like a very large number, the direct impact appears to be manageable. According to Credit Suisse, their economists estimate that if the U.S. does scale up to the full tariffs it has discussed, the net impact would be a hit to Chinese GDP of about 0.2% in the fourth quarter of this year. This is in line with other estimates we have seen. However, most economists estimate that China has the reserves necessary to still hit its 2018 target of 6.5% GDP growth.

While economist's estimates are somewhat insightful, markets tend to price this news well in advance. While we agree with the basic premise that you cannot "win" a trade war, equity markets would tell you that the U.S. is holding up much better thus far. Year to date, as of the end of June, the S&P 500 has gained 2.7% while MSCI China fell -1.8%, MSCI Europe fell -3.2%, Canada fell -3.0% and Mexico fell -2.7%.

The timing here is fortuitous, if not intentional, for a trade spat with China. Chinese leaders have been attempting to reign in the tremendous credit growth the country has seen over the last several years, which has propelled their property and equity markets higher. While Chinese officials have the tools needed to stimulate the economy and equity markets, it appears their preference for reducing medium-term financial risks is taking priority. We must also keep in mind that the current administration often uses the U.S. equity markets as a benchmark of whether its policies are working or not. While not prudent in our view, we

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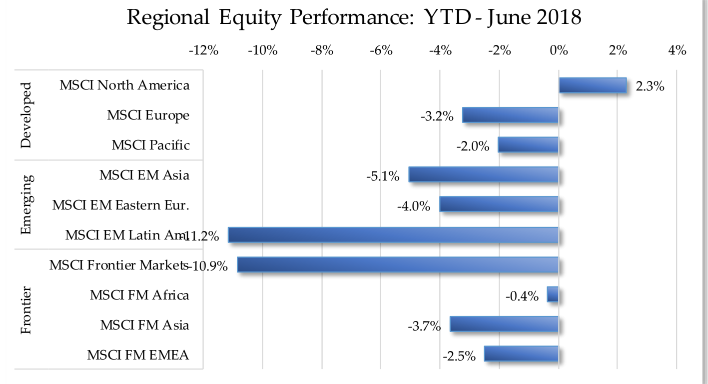
believe that the President is likely to keep pushing ahead on the trade front if equity investors allow it.

Admittedly, this analysis does not account for the additional "knock off" effects that are very difficult to quantify, but rest assured that there will be many if tensions continue to escalate. This includes multinational corporations who may shift production (jobs) to other countries, countries and regions creating new trade agreements that exclude the U.S., supply chain disruptions, and general uncertainty that may stifle corporate planning all during a period of rising interest rates and inflation. Although uncertain how things will ultimately play out, we have heightened our conviction to active management within global equities to ensure flexibility given the uncertainty and ancillary implications of the trade discussion. We also remain underweight fixed income since rate hikes are expected to continue and trade wars and tariffs typically provide a tailwind for inflation. Finally, we are overweight to diversifying strategies such as hedge funds and inflation protection assets, which includes real estate and a diversified exposure to commodities.

Market Update

Domestic equity markets had a strong second quarter following data that confirmed the first-quarter weakness in U.S. consumption was a brief blip. U.S. retail sales grew by over 6.6% year-on-year through June and unemployment hit 3.8% in May before ending the quarter at 4.0%. The 3.8% unemployment rate was the lowest level measured since 1969. The S&P 500 gained 3.4% and the Russell 2000 gained 7.8% in the second quarter. Year-to-date, both indices are in positive territory, gaining 2.7% and 7.7%, respectively.

Internationally, both developed and emerging market equity indices posted losses. The MSCI EAFE index was down -2.8% year to date. Trade concerns have had a compounded effect on vulnerable emerging markets with large account deficits for countries like Turkey and Brazil. Emerging market equities recorded their fifth consecutive monthly loss in June. The MSCI Emerging Markets index is down -6.7% for the year to date period.



Strong U.S. economic data gave the Federal Reserve confidence to raise interest rates again in June and signaled that two more rate hikes are likely this year, followed by three more next year. The Bloomberg Barclays U.S. Aggregate Bond Index lost -0.2% for the quarter and is down -1.6% year-to-date. Long-term Treasuries gained 0.3% for the quarter, but are down -3.0% year-to-date. High-yield bonds, which are less affected by interest rate movements, outperformed investment grade bonds. For the quarter, high yield credit gained +1.0% and was up +0.2% year-to-date.

U.S. REITs performed particularly well during the second quarter, gaining 10.1%. The asset class suffered a sharp correction in the first two months of the year, but since March, U.S. REITs have rebounded. In three of the past four months, the index has been the top performer amongst major asset classes. Commodities were mixed during the quarter and are flat year-to-date.

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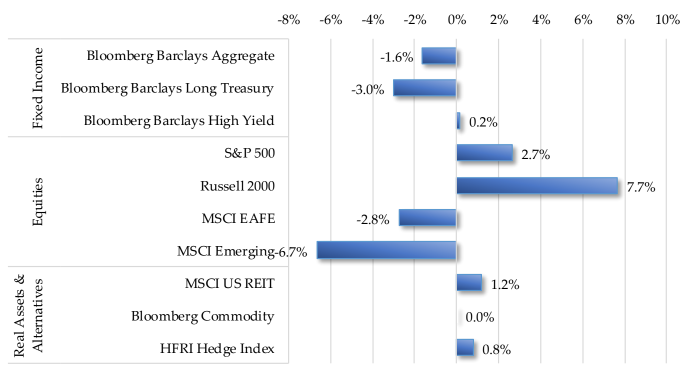

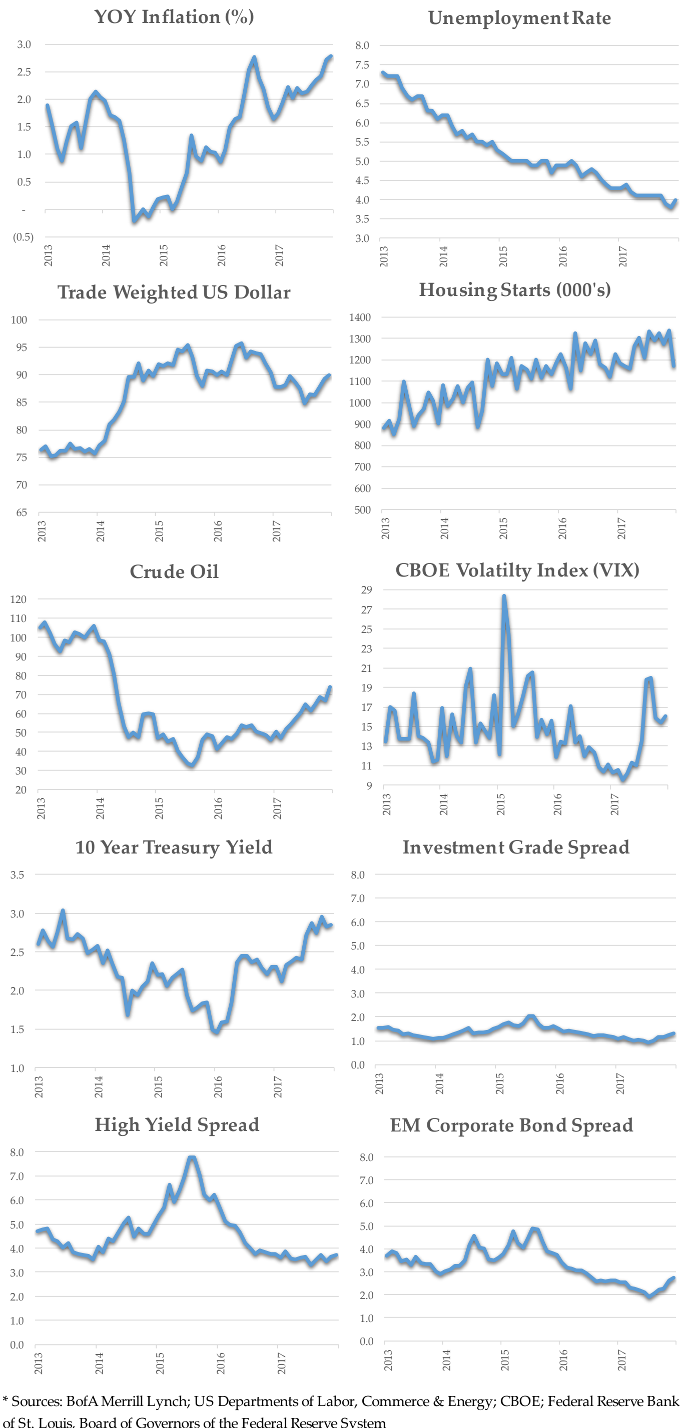

Firm Update

Despite the see-saw performance by financial markets in the first half of 2018, Disciplina posted slightly positive returns, on a net of fee basis, for our clients allocated to our Endowment[2] and Cash Plus[3] investment strategies for the six months ending June 30, 2018. Both strategies have also outperformed their respective benchmarks on a net of fee basis.

While our team remains focused on managing our client portfolios and advancing their respective missions, we thought it worthwhile to note that Disciplina was awarded a sizeable mandate from a not-for-profit institution located in the Southeastern U.S. We are grateful for the opportunity to expand our business and partnership with not-for-profits located throughout the U.S.

Performance Note: Performance refers to Disciplina's track record of managing:

[2] Fully invested discretionary client capital at Disciplina Capital Management for university endowments engaged in similar endowment-style investment strategies.

[3] Fully invested discretionary client capital at Disciplina Capital Management for all clients engaged in Cash-Plus investment strategies.

Fully invested accounts are those with cash allocations within 5% of their cash target allocations. All composites are asset-weighted and net of all underlying manager fees and expenses, including any advisory fees charged by Disciplina Capital Management. For all periods, there can be no assurance that these, or comparable results, will be achieved. Past performance is not indicative of future results.

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