Q3 2018
ECONOMIC OUTLOOK

By the LNWM Investment Strategy & Research Group

Summary

- **Trade and political tensions are likely to drive volatility higher.** The magnitude of the tariffs imposed so far has been small. However, the possibility that trade tensions will escalate continues to be a growing threat to global growth and a source of increased capital market volatility, here and abroad.
- **Fundamentals remain strong.** Globally, economic growth and corporate earnings remain very positive, although this good news has been overshadowed by tariffs and politics. After a very strong January, US equities have fallen about 5% while China's equity market gauge (the CSI 300) plummeted by 20%. While this has brought valuations to attractive levels relative to this time last year, we don't see much upside until the trade conflicts settle.
- **We expect dollar strength to subside.** We think currency volatility is yet another consequence of rising trade tensions. The Chinese yuan has depreciated 5% vs. the US dollar in the past quarter and the dollar has continued to strengthen relative to other currencies. In the 2nd quarter, returns were negative particularly in Emerging Markets in part due to a stronger dollar.
- **We are not making changes to LNWM asset allocations at this time**. We remain optimistic at least through 2018 due to fundamentals (economic growth, earnings) plus the prospect that reason will prevail to keep trade disputes from escalating into full-blown trade wars. However, this is a volatile situation and we are prepared to make significant changes to allocations should tensions increase.

> "Volatility is not synonymous of risk but –
> for those who truly understand it – of wealth."
>
> – Francois Rochon

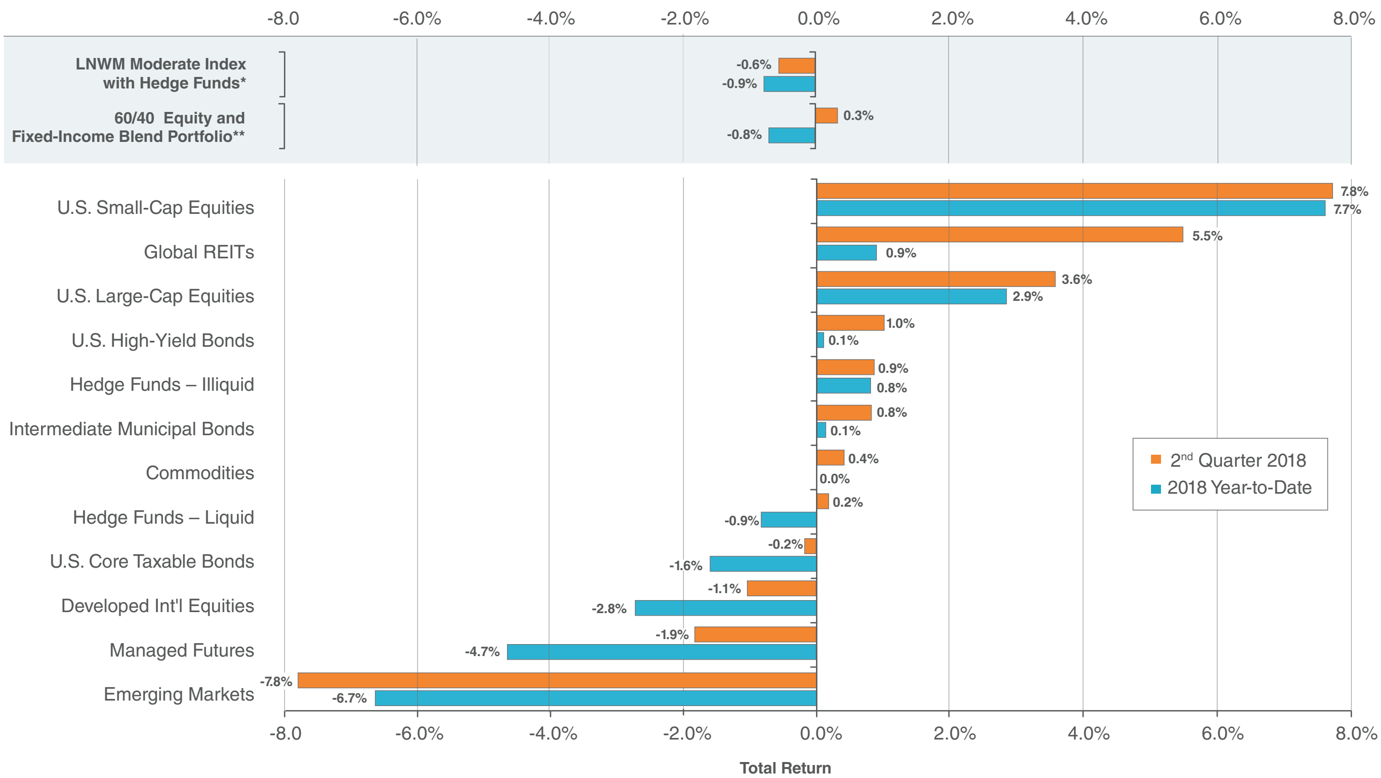
OF TARIFFS AND TRADE WARS

First the good news: The 2nd quarter came with a spike in volatility, but the equity markets proved resilient, ending the quarter up more than 3% and bringing performance back into positive territory for the year. The bad news: The worst-performing asset class in Q2 was emerging market equities, which were down almost 8% in US dollar terms, having been hit by a perfect storm of a stronger dollar, higher commodity prices and the threat of trade war disrupting their export markets (more on that later).

While the US relationship with China has been at the forefront, many of China's exports to the US are sourced from Malaysia, South Korea, and Thailand (through China); hence, negotiations with China impact many other emerging economies. We are maintaining our allocation to emerging markets (EM) despite recent challenges for two reasons: (1) we think foreign currencies will not continue to weaken relative to the US dollar; and (2) EM economies are the world's fastest-growing, with market valuations now more attractive than they have been in a long time.

In Q2 2018, the LNWM Moderate Portfolio with Hedge Funds underperformed a 60/40 benchmark (60% global stocks; 40% US bonds), although it is on par with benchmark results year-to-date. Performance of our liquid alternatives holdings was disappointing, particularly the AQR Style Premia Fund, which was down 8% for the quarter. Much of the drop in AQR came in May (-4.4%) as value stocks significantly underperformed growth. Dramatic price swings (up or down) prompt us to immediately review our original investment thesis, as well as ask ourselves, "Does the observed return fall within the distribution of expected returns?" In this instance, the answer to both questions is yes: the size of the recent drop in AQR is within expectations. Although relatively rare, such a drop is nonetheless concerning. We are keeping AQR in the portfolio because it provides a source of returns not available through traditional investments.

Performance of Asset Classes
2nd Quarter 2018 and Year-to-Date (As of June 30, 2018)



*Net of manager fees, gross of LNWM fees | **Assumes no manager fees

SOURCE OF DATA: Morningstar, Bloomberg, Hedge Fund Research. Please see the disclosure and definitions.

A Different Kind of Year

This year is dramatically different from 2017. Last year, investors – including us – were pleasantly surprised by globally synchronized growth, low market volatility, low inflation. This was often referred to as a Goldilocks economy. In 2018, the US is maintaining its growth trajectory, while many foreign economies are not, resulting in a decoupling. In the US, we are still enjoying the fiscal stimulus provided by the 2017 tax cuts, and the Federal Reserve is raising interest rates to keep inflation in check and avoid an overheating economy. Meanwhile, growth prospects abroad have started to weaken somewhat. Add to this the increasing threat of trade wars and you can see why the dispersion of possible macroeconomic outcomes (aka risk) has increased significantly. Still, the fundamentals remain sound.

The wild card in all this is the trade issue, and the resulting impact on the US dollar. Trade tensions (along with rising US interest rates) have boosted the dollar, which is seen as a currency of last resort. Continued gains in the greenback could cause more pain for countries that rely on imports priced in US dollars (such as oil) as well as US dollar funding. However, we think the momentum of dollar strength is limited, given that the US has large budget and trade deficits, as well as the underpinnings for rising inflation. Still, if we see a further escalation in tariffs and the dollar gaining more ground, we are likely to consider changing our allocations to foreign markets.

Update on Key Economic Drivers

Inflation – While higher than in 2017, US inflation has remained subdued as growth across the globe has not kept up with that in the US. Wages in the US have begun to move higher, which is a precursor for rising inflation. While full blown trade wars would further boost inflation, we believe they remain a low probability.

Geopolitical Disruption – Since the US and North Korea summit, geopolitics has gotten less attention, although this can change quickly. We think the recent spike in oil prices is due to global supply/demand imbalances, not geopolitical concerns.

Corporate earnings – Earnings at S&P 500 companies are expected to rise nearly 21% in Q2 2018 vs. a year ago. This is after a 27% jump in Q1 2018 over Q1 2017, which was the highest quarterly earnings growth since Q1 2011 (+20%). Since most of the increase is coming from tax cuts, the level of earnings growth will drop dramatically in 2019 as year-over-year comparisons become more difficult.

Shift in Monetary Policy – Financial conditions in the US continue to tighten as the Fed sticks to its goal of raising US interest rates incrementally. Short-term bond yields have risen much faster than longer-term ones due to an uncertain outlook for economic growth and inflation, plus ongoing demand for longer-term US debt from an aging US population and foreigners.

Longer-term benefits and costs of tax policy changes – Equity markets are indicating that tax cuts alone will not move stock prices higher, as investors continue to focus on fundamentals. Longer-dated US Treasury yields have remained stubbornly low despite the projected big increase in the US budget deficit. We continue to monitor this and may consider reducing our allocation to short-duration fixed income.

The Trade Juggernaut

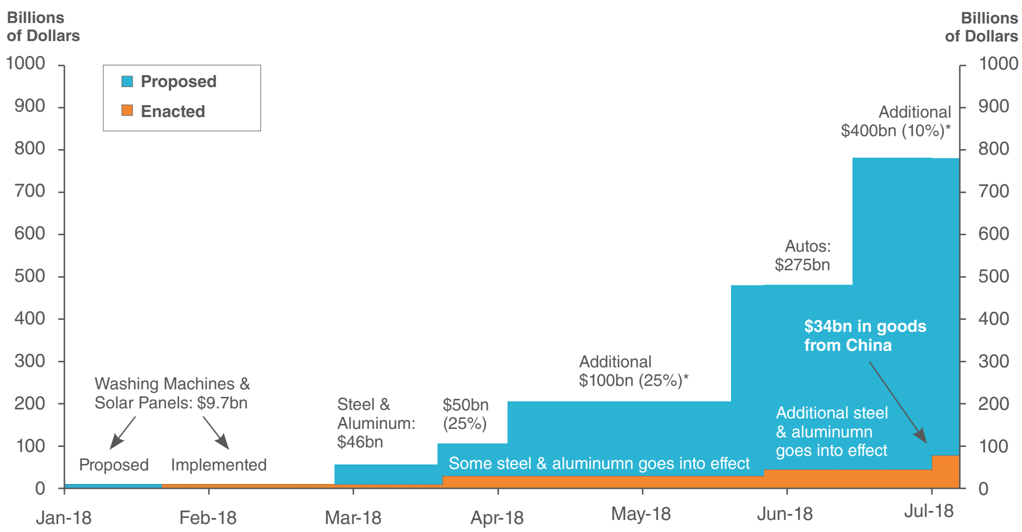
At the beginning of 2018, we highlighted our concern regarding trade wars. Our concern then, as now, is the fact that tariffs and trade wars have historically been inflationary and generally bad for economic growth. There is no shortage of opinion regarding our current trade situation – some say our major trading partners have levied unfair tariffs and other restrictions on US goods, while others think our current trade agreements are mutually beneficial over all.

It is not obvious what the Trump administration's goal (and tactics) is on trade negotiations, let alone what constitutes a successful outcome. According to World Trade Organization (WTO) data, the level of trade tariffs levied by the US is lower *on average* — 3.5% for the US vs. 5% for the Eurozone, 7% for Mexico and 9.9% for China. However, trade is complicated and any judgment requires detailed analysis, by product category and overall economic impact. We, like the WTO, believe in open, fair trade.

Magnitude of the Threat

For now, we can assess the current tariffs imposed by the US and the retaliatory tariffs by our trading partners. In early July, the White House imposed a 25% tariff on approximately $34 billion worth of goods imported from China (China responded with tariffs on approximately the same amount). A second round of additional tariffs has been threatened on $200 billion in goods, although how the second round is implemented remains uncertain. Leading up to this, markets reacted as expected given the uncertainty; US equities have sold off a bit while emerging markets (led by China) have fared much worse.

New US Tariffs on Imports from China: Enacted and Proposed



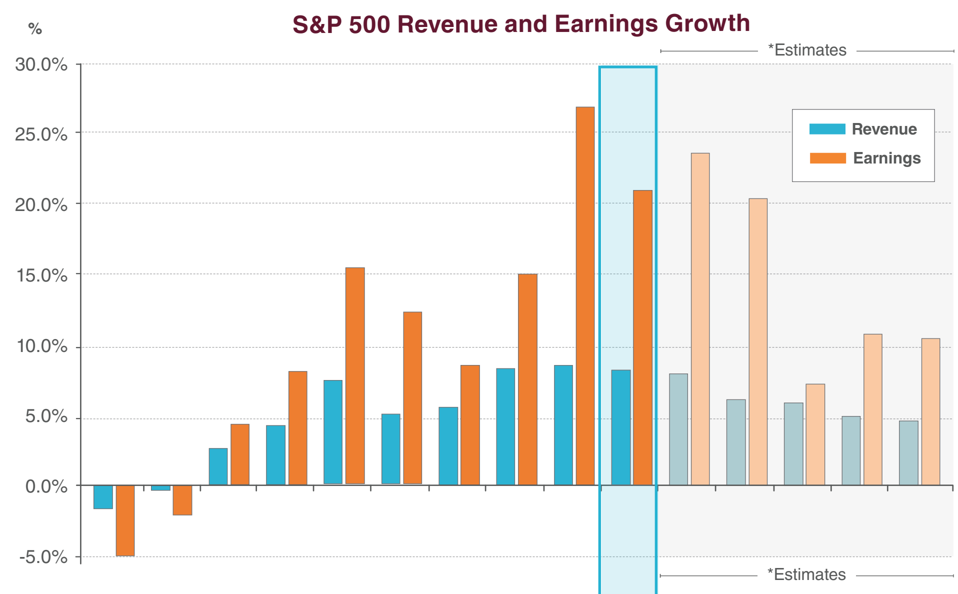
*On June 18, proposed retaliation increased to additional $400bn at 10% in place of $100bn at 25%.

SOURCE OF DATA: USITC, Goldman Sachs Global Investment Research.

The subsequent strengthening of the US dollar has put pressure on LNWM's portfolio allocation to emerging market equities, which were among the worst performing asset classes for June and Q2. The direct effects of the initial tariffs will be small, mostly driving up prices on specific goods and marginally lowering growth expectations. The size of the second round – and uncertainty regarding implementation and duration – will continue to drive market volatility for now. Much of the focus thus far has been on tensions with China but any additional tariffs will have significant impacts on our European relationships as well.

What's next? A large list of products targeted for additional tariffs was published by the US on June 15. If implemented, the additional tariffs are likely to be followed by equal retaliation from China. Most, including LNWM, hope that the US, China and Europe can reach agreements to avoid further tariffs. History demonstrates that protectionism is not in anyone's best interest in the long run. Knowing this, there is good reason to believe countries will eventually come to terms and stop major escalation before it starts. This is the most likely outcome, in our view. Hence, while Q2 performance in several asset classes was concerning, for the time being we are maintaining our global asset allocations.

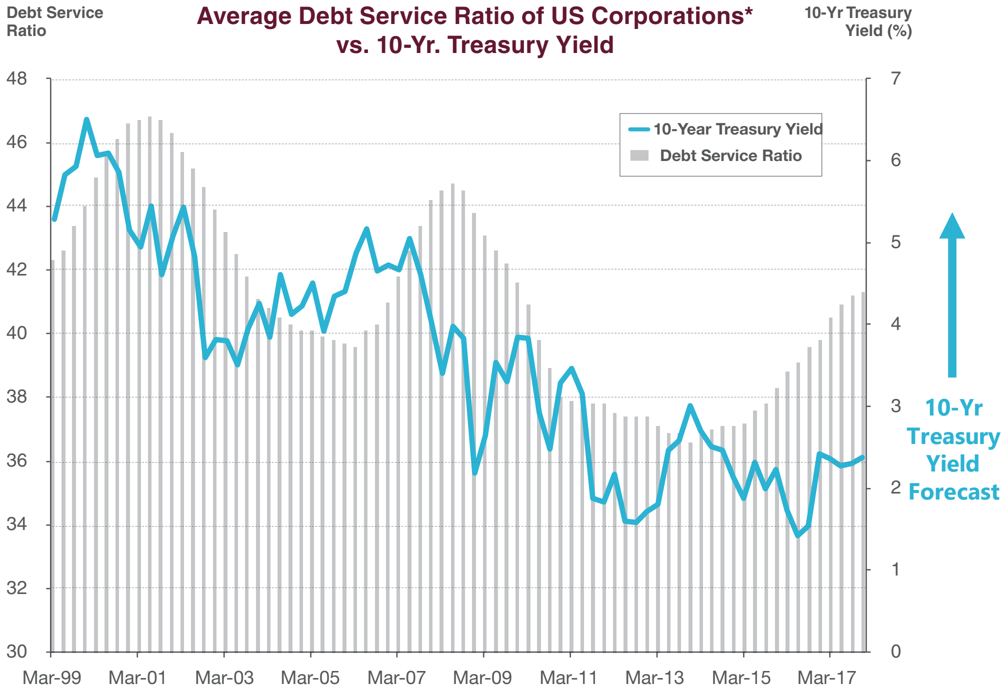
A CLOSER LOOK



	Q1-16	Q2	Q3	Q4	Q1-17	Q2	Q3	Q4	Q1-18	Q2	Q3	Q4	Q1-19	Q2	Q3
Revenue	-1.7%	-0.4%	2.6%	4.2%	7.3%	5.0%	5.5%	8.3%	8.4%	8.1%	7.9%	6.0%	5.9%	4.8%	4.6%
Earnings	-5.0%	-2.1%	4.3%	8.0%	15.3%	12.3%	8.5%	14.8%	26.6%	20.7%	23.3%	20.2%	7.2%	10.6%	10.4%

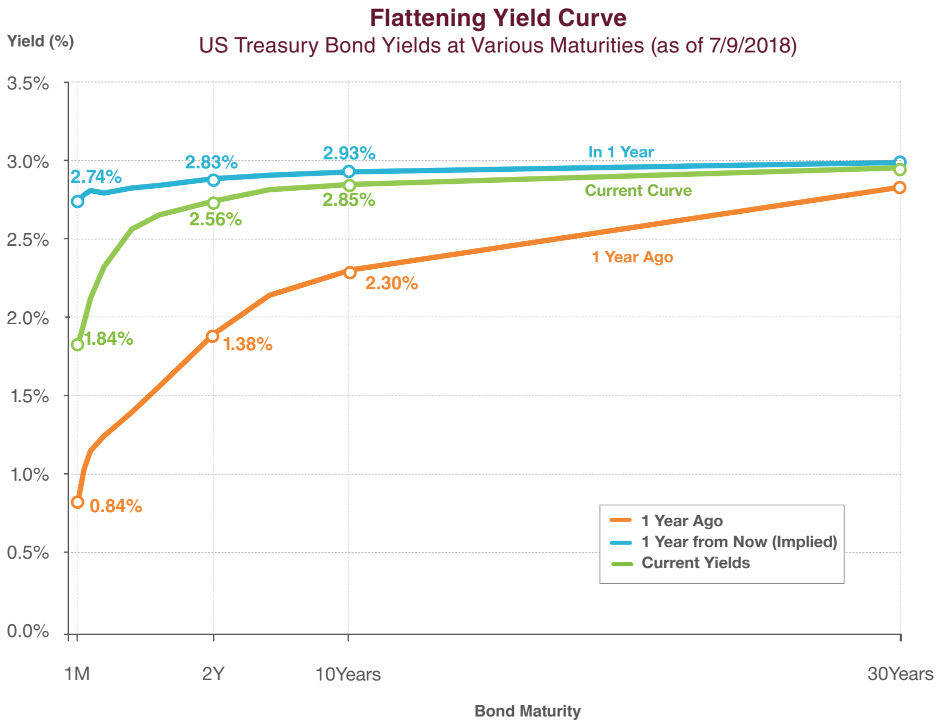
SOURCE OF DATA: Thomson Reuters I/B/E/S, Thomson Reuters Proprietary Research.

For Q2 2018, S&P 500 companies are expected to post a 20.7% increase in earnings per share vs. the same period last year. This is after a very strong showing of 26.6% earnings growth in Q1 2018 over Q1 2017, which was also the highest quarterly earnings growth since Q1 2011 (+19.5%). Cyclical sectors, such as energy and materials, are expected to show the greatest growth in Q2 earnings year-over-year at 141.5% and 33.5%, respectively. As shown in the chart, earnings are expected to be strong through Q4 2018 and then taper off substantially as the benefit of tax cuts becomes fully incorporated into comparisons. We expect strong 2018 earnings increases to support US equity prices, barring an escalating trade war and/or geopolitical tensions.



*Excluding banks and other financials.
SOURCE OF DATA: Bank for International Settlements.

US corporate balance sheets are generally healthy. However, because of the large amount of debt that companies issued to take advantage of low interest rates, some measures of solvency have declined overall. One of these: the debt-service ratio, or the relative amount of cash flow used to make interest payments (see chart at left). Looking forward, any rise in US interest rates — the 10-year Treasury yield in particular — will mean a continued rise in debt service ratios, which will be a headwind for profitability.



SOURCE OF DATA: Bloomberg.

US bond yields have risen substantially in the last year but unevenly. Shorter-term yields have risen as the Fed has increased its target interest rate, but long-term rates not nearly as much, as investors remain cautious about longer-term economic growth and inflation.

We anticipate the US yield curve will continue to "flatten" as the Fed increases rates at the short end while demand for long-term bonds stays strong due to an aging US population, foreign investor demand and modest inflation, keeping a lid on long-term yields.

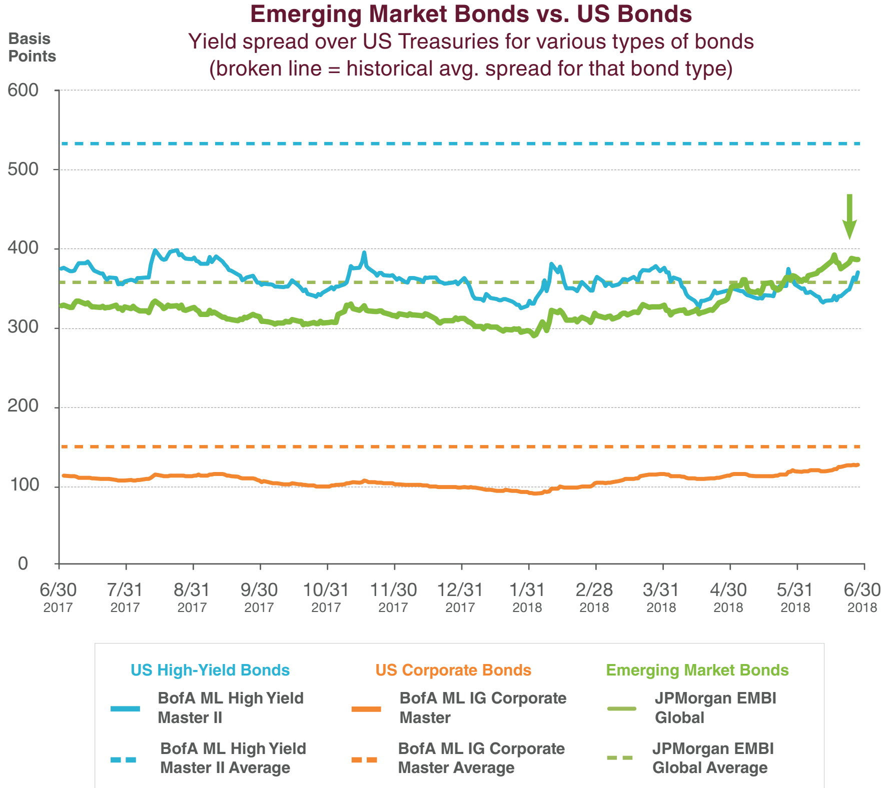
Fixed-income managers with flexible mandates should have an advantage in this type of environment.

Municipal Bond Outperformance
12/31/2017 - 06/30/2018

SOURCE OF DATA: Bloomberg.

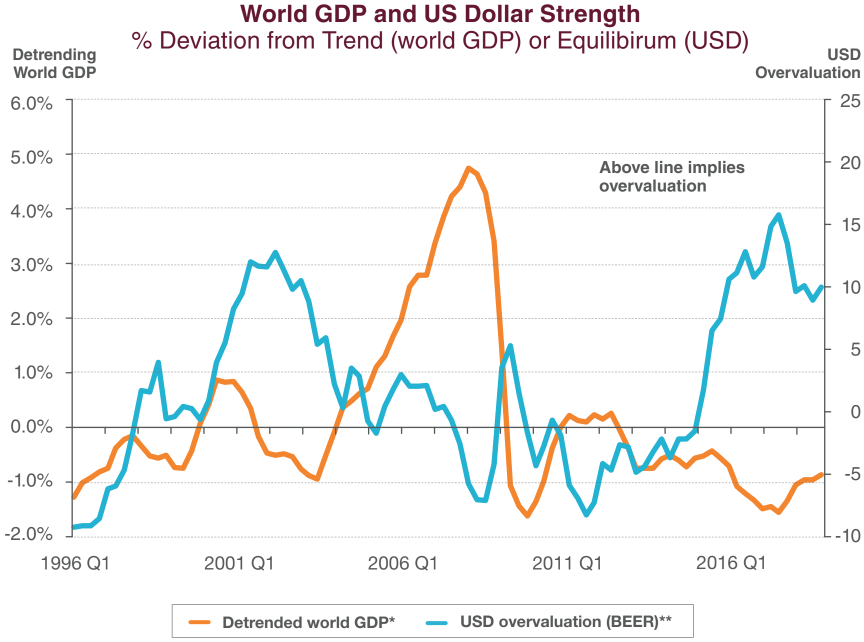
It's been a difficult environment for bonds in 2018 in the face of rising US interest rates. Our preference for tax-exempt US municipal bonds has added value as lower muni bond issuance and steady demand from investors have provided support for municipal bond pricing. We continue to favor municipal bonds for their relatively attractive valuations and defensive characteristics.

Emerging Market Bonds vs. US Bonds
Yield spread over US Treasuries for various types of bonds
(broken line = historical avg. spread for that bond type)



SOURCE OF DATA: Bloomberg. Historical averages are the median values since 2000 through June 2018.

Emerging market (EM) bonds have performed poorly alongside other foreign investments year-to-date. We believe stronger economic growth, continued improvements in creditworthiness and the potential for currency appreciation all support a strategic allocation to EM debt. From a valuation perspective (left), the yield spread on EM bonds relative to US Treasuries is higher than it has been historically. That is not the case for US high-yield and investment-grade corporate bonds.



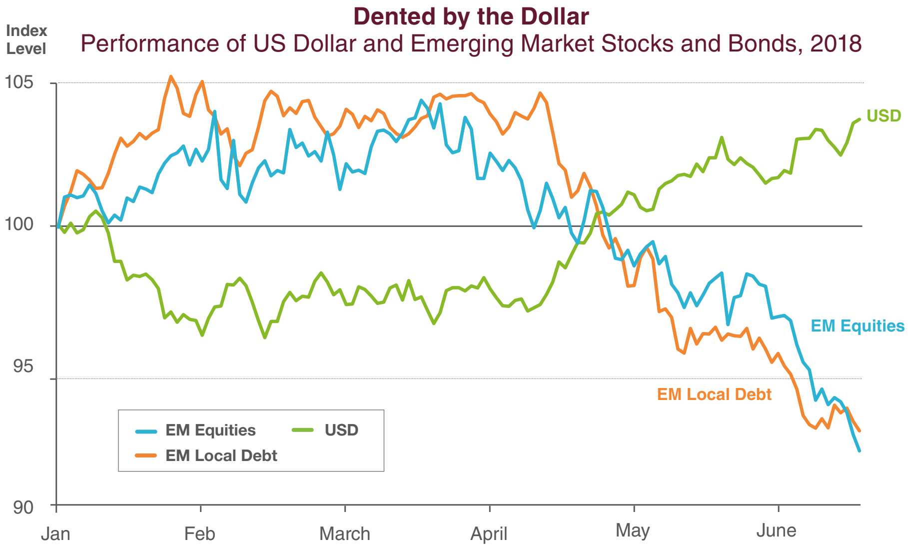
* World GDP relative to exponential time trend.
** US real effective exchange rate relative to BEER (behavioural equilibrium exchange rate)

SOURCE OF DATA: Oxford Economics/BIS/Haver Analytics.

When the US dollar gains in value, global economic growth tends to weaken, and vice versa.

The dollar appears to be overvalued now, based on key factors that determine the value of currencies -- trade patterns, global money flows and central bank currency reserves, etc.

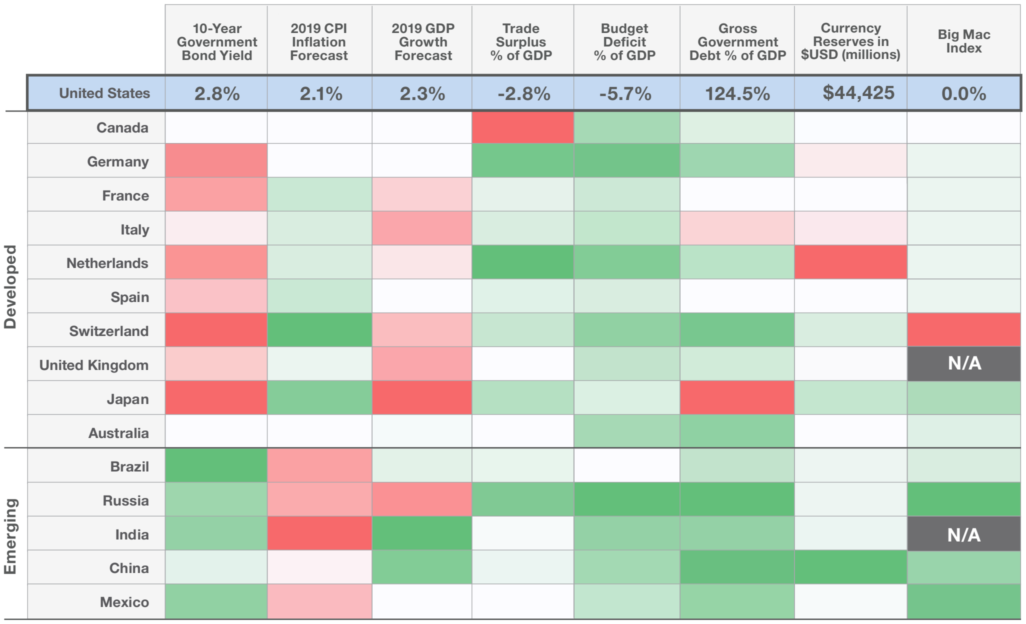
Therefore, we believe recent strength in the dollar is not likely to last and could reverse.



SOURCE OF DATA: BlackRock Investment Institute, with data from Thomson Reuters, July 2018.

US dollar strength has had a significant negative impact on both emerging market equities and debt. For EM economies, a stronger dollar increases the interest payments on debt issued in US dollars; and it makes production more expensive since some key commodities such as oil are priced in dollars. LNWM believes the US dollar is expensive, especially when considering the mounting US debt levels. That said, it could maintain support if geopolitical risks (i.e. trade wars, nuclear escalation) increase and yields continue to widen between the US and other economies.

Economic Fundamentals Stronger in Many Foreign Markets



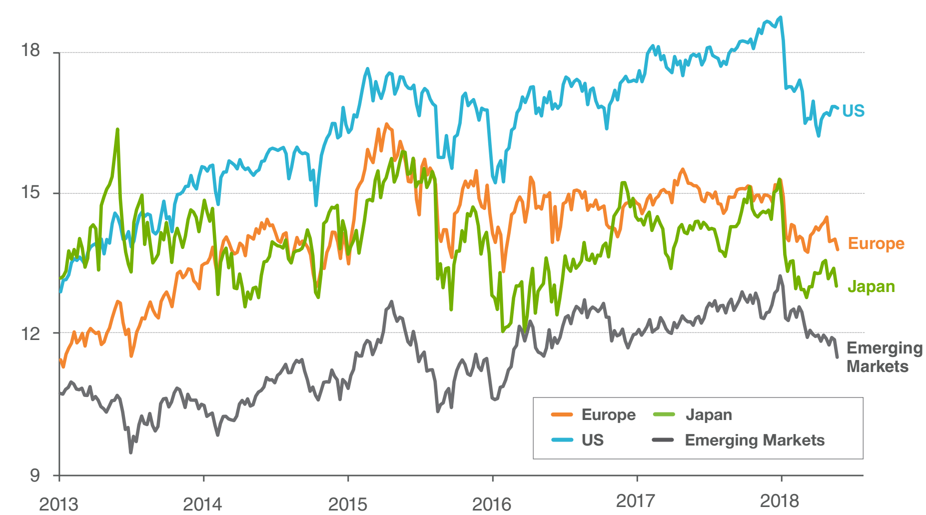
SOURCE OF DATA: Bloomberg.

More attractive relative to the US — Less attractive relative to the US

Since January 2018, the roughly 6% appreciation in the US dollar has been a significant drag on the returns of foreign investments and commodities. We think continued gains in the dollar are not sustainable, and are being mostly driven by concerns about a global trade war. More importantly, economic fundamentals are stronger in many foreign countries relative to those in the US (see "heat map" at left). We think this will limit further appreciation in the dollar and is more likely to lead to weakness ahead.

Emerging Markets Are Attractively Priced

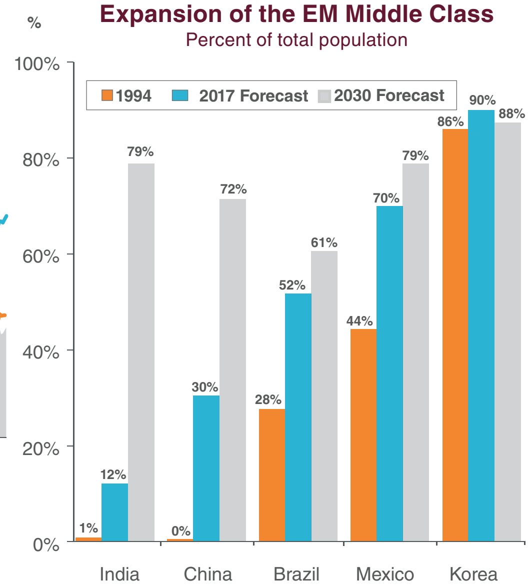
Equity market average price-to-earnings ratios*, 2013–2018



*Based on earnings estimates for next 12 months.
SOURCE OF DATA: Source: BlackRock Investment Institute, with data from Thomson Reuters, July 2018.

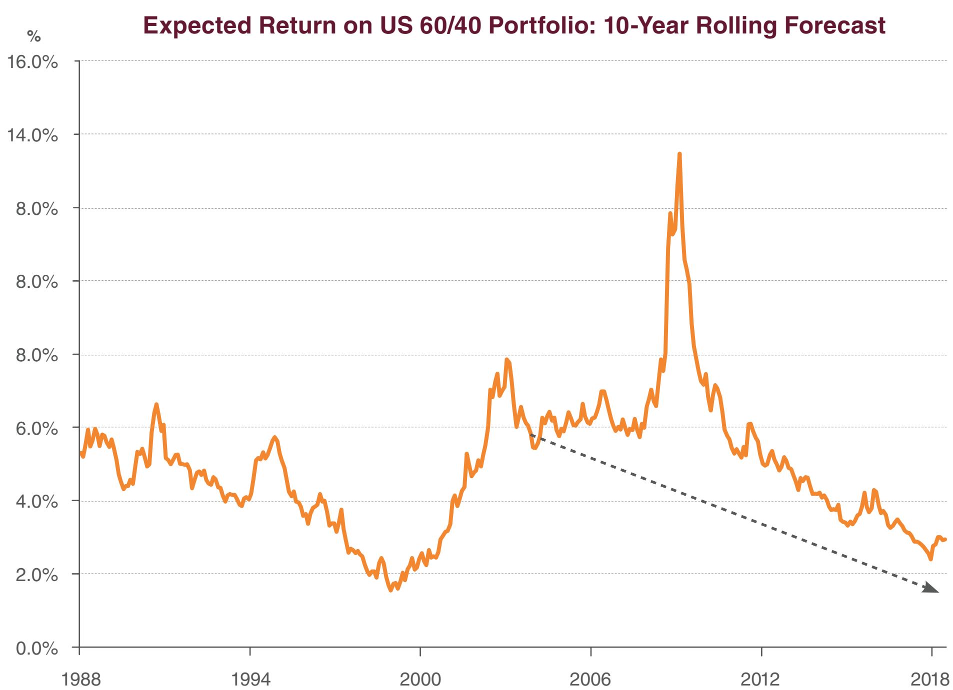
Price-to-earnings ratios and other valuation measures for emerging market equities continue to be compelling versus all other global stock markets, both on an absolute basis as well as the 25-year average. As this chart indicates, emerging market stocks are priced at about 11.5 times earnings estimates vs. 16 times in the US.

SOURCE OF DATA: J.P. Morgan Asset Management; Consensus Economics



SOURCE OF DATA: J.P. Morgan Asset Management; Brookings Institute.

Emerging markets (EM) offer strong economic growth and promising demographics. In the next 12 months, GDP growth in emerging markets is expected to average 4.5% versus 2.5% in developed markets. As many of these EM countries continue to develop, the middle class in each is expected to expand dramatically. By one estimate, the percentage of EM population with annual income above US $15,000 will rise eightfold — from 2% currently to 16% by 2030. (Comgest/EY/World Bank).



SOURCE OF DATA: Bloomberg, Robert Shiller website.

Expected return on a 60/40 US-centric portfolio (60% S&P 500 stocks; 40% US Treasury bonds) has been decreasing since the early 2000s, based on the level of price-earnings ratios (cyclically adjusted) and real interest rates (inflation-adjusted). We think lower expected returns reflect current heady valuations in traditional asset classes, geopolitical uncertainty and a global decoupling of monetary policy. Such an environment we think will present an attractive opportunity for alternative asset classes, such as hedge funds and private equity.

ABOUT THE AUTHOR

Gino Perrina, Ph.D., CFA is the Chief Investment Officer at Laird Norton Wealth Management and has more than 15 years of experience in investment analysis, strategy and risk management. Prior to joining LNWM in November 2015, Gino was a Managing Director at BlackRock Inc. in New York City, responsible for managing risk in the firm's alternative asset portfolios (+$100 billion in total investment). He was also Managing Director of Research and Risk Management at BlackRock Alternative Advisors (2006 to 2010), Head of Fixed Income Research at Russell Investments (2010 to 2012) and a fixed income analyst and portfolio manager at Microsoft and IAC/InterActive Corp.

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With nearly $5 billion in assets under advisement, Laird Norton Wealth Management is the Northwest's premier wealth management company. Founded in 1967 to serve the financial management needs of the Laird and Norton families, the firm now provides integrated wealth management solutions to more than 600 individuals, families, business leaders, private foundations and nonprofit organizations.

LNWM ASSET CLASS RETURNS CHART INDEX DEFINITIONS

Intermediate Municipal Bonds: Barclays Municipal Bond 1-10 Year Blend Index that measures the performance of municipal bonds with maturities between one and 10 years.

U.S. High-Yield Bonds: ICE BofAML US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

U.S. Core Taxable Bonds: The Barclays Capital U.S. Aggregate Bond Index covers the USD denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS, ABS, and CMBS sectors.

U.S. Large-Cap Equities: The Russell 1000 Index is an index of approximately 1,000 of the largest companies in the U.S. equity market.

U.S. Small-Cap Equities: Russell 2000 Index, a measure of the performance of the 2,000 smallest companies in the Russell 3000 Index, representative of the U.S. small capitalization securities market.

Developed International Equities: MSCI EAFE Index, a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada. As of June 2014, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

Emerging Markets: MSCI Emerging Markets Index, a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of June 2014, MSCI Emerging Markets Index consisted of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

Commodities: The Bloomberg Commodity Index is made up of 22 exchange-traded futures on physical commodities. The commodities are weighted to account for economic significance and market liquidity and weighting restrictions on individual commodities and commodity groups promote diversification.

Global REITs: FTSE EPRA/NAREIT Global Equity REIT Index, a measure that tracks the performance of listed real estate companies and REITs worldwide.

Managed Futures: The SG CTA Index provides the market with a reliable daily performance benchmark of major commodity trading advisors (CTAs). The SG CTA Index calculates the daily rate of return for a pool of CTAs selected from the larger managers that are open to new investment.

Hedge Funds – Liquid: HFRX Global Hedge Fund Index – A daily-valued index designed to be representative of the overall liquid hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry. For

Hedge Funds – Illiquid: HFRI Fund Weighted Composite Index – A global, monthly-valued, equal-weighted index of over 2,000 single-manager funds that is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies. Constituent funds report monthly net of all fees performance in U.S. dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

BENCHMARK 60/40 BLEND PORTFOLIO

The 60/40 Equity & Fixed-Income Blend Portfolio: Annually rebalanced blend of the Barclays Capital US Aggregate Bond Index and the MSCI All-Country World Index (ACWI). The blend is intended to reflect a typical moderate asset allocation without active management or manager fees for comparison.

DISCLOSURE

All investments involve a level of risk, and past performance is not a guarantee of future investment results. The value of investments and the income derived from them can go down as well as up. Future returns are not guaranteed and a loss of principal may occur. All investment performance can be affected by general economic conditions and the extent and timing of investor participation in both the equity and fixed income markets. Fees charged by LNWM will reduce the net performance of the investment portfolio.

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A benchmark is an unmanaged index, and its performance does not include any advisory fees, transaction costs or other charges that may be incurred in connection with your investments. Indices are statistical composites and are shown for informational purposes only. It is not possible to invest directly in an index. Indices are unmanaged and are not subject to management fees. Any benchmark whose return is shown for comparison purposes may include different holdings, a different number of holdings, and a different degree of investment in individual securities, industries or economic sectors than the investments and/or investment accounts to which it is compared. Comparisons of individual account or portfolio performance to an index or benchmark composed of indices are unreliable as indicators of future performance of an actual account or portfolio. Actual performance presented represents past performance net of investment management fees unless otherwise noted. Other fees, such as custodial fees or transaction related fees may not be reflected in the actual performance results shown.

The LNWM Moderate Model Portfolio with Hedge Funds performance shown is comprised of a hypothetical combination of actual investment returns generated by investment managers and funds recommended by LNWM during the time period indicated. Past performance is no guarantee of future results. The model portfolio allocation ranged from 20%-33% fixed income, 36%-67% equity, 10%-33% hedge funds and 0-5% cash. The actual allocations at any given time are available upon request. Within equities there is a mix of active and passive strategies, value and growth, various capitalizations and international stocks. The Model reflects all changes in LNWM's recommended managers during the period. The investment results include the reinvestment of dividends and other earnings. The Model Portfolio is net of mutual fund fees and gross of LNWM management fees.

The Moderate Model Portfolio with Hedge Funds is not an actual portfolio and it is not possible to invest in the Model directly. Neither is it possible to invest directly in any index used in the comparative asset allocation blends shown. The Model investment performance does not represent the actual performance experienced by any client or group of client accounts. Actual performance results in client accounts will have varied substantially from the performance shown as a result of the inception of the investment, the timing and expenses of trades in the portfolio, the addition or withdrawal of cash, funds or securities, the imposition of taxes, expenses of custody and other variables not accounted for in the Model Portfolio.

Fees charged by Laird Norton Wealth Management will reduce the net performance of your investment portfolio. For example, a $3,000,000 investment for the 10-year period ending December 31, 2016, allocated in line with a Moderate Portfolio Model, would have a value of approximately $4,863,109 at the end of the period. A 1% annual fee, collected monthly in arrears, would reduce the ending balance to approximately $4,403,809. The Laird Norton Tyee Asset Strategies, LLC standard schedule of fees is set forth in our Form ADV Part 2A and is available upon request. Fees for accounts managed by Laird Norton Trust Company are based on the trust company's standard fee schedule and may include fiduciary fees and related expenses in addition to investment management fees.

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