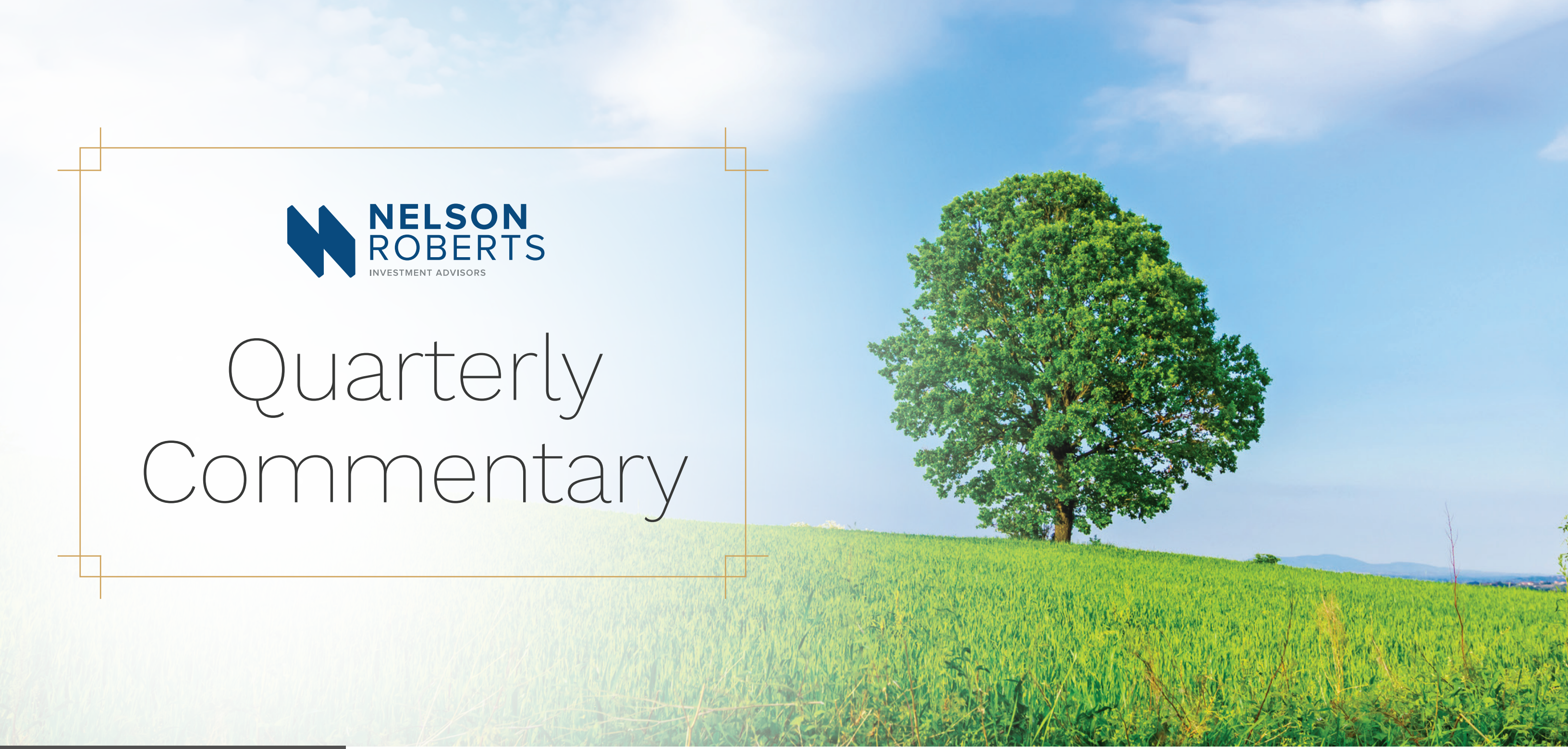


NELSON ROBERTS
INVESTMENT ADVISORS

Quarterly Commentary

2018 | Q2

IN THIS ISSUE:

ECONOMIC OVERVIEW

Not Yet, But Soon

The current economic expansion began in July of 2009. At 108 months long, it is the third-longest expansion in history, and it is more than twice as long as the postwar average of 47 months. Many are asking: should we anticipate this current bull market coming to an end? Although bull markets do not simply die of old age, in the Q1 2018 Commentary, we identified three potential risks to the current bull market run: trade disruptions, overvaluation and the Fed tightening.

Trade

Headlines detailing the latest Trump tariffs often cause jolts to daily market moves, contributing to higher near-term volatility. Most of the tough trade talk has been directed at China, although relations with many of our “friendly” trading partners have also become strained. Although this short-term volatility is uncomfortable, we do not think this will be what ultimately derails the economy. We believe that this trade talk is mostly posturing at this point, particularly in advance of trade negotiations.

Overvaluation

In late January, valuation was a concern. The S&P 500 saw a feverish run at the start of the year, rising over 7% in four weeks and hitting an all-time high on January 26th. At the peak, the forward-looking price-to-earnings (P/E) ratio of the S&P was more than 19 times. Since then, however, the index has declined by 4.55%. The initial shock to the market was due to a higher-than-expected wage growth number, which fueled speculation that inflation might be running out of control. The second jolt to the markets was caused by the first tariff announcement by the Trump administration. The market’s post-January decline, combined with substantial earnings growth fueled by the corporate tax cut, has reduced this forward P/E value to 16.1 times. This level is much closer to the S&P 500’s average valuation over the last 25 years. Therefore, at present, we do not think that overvaluation will be the cause for the end of this bull market. Instead, we believe that the market will continue to follow earnings in the near term, and that earnings will continue to grow, stimulated by the tax cuts.

Index Performance	Q2 '18	YTD
Dow Jones Industrials	1.26%	-0.73%
Standard & Poor’s 500	3.43%	2.65%
EAFE (international stocks)	-1.06%	-2.40%
Russell 2000 (small stocks)	7.75%	7.67%
Barclays Interm. Gov/Credit	0.01%	-0.97%
Barclays Municipal	0.87%	-0.25%

We apply rigorous analysis in asset selection so you can focus on your passion

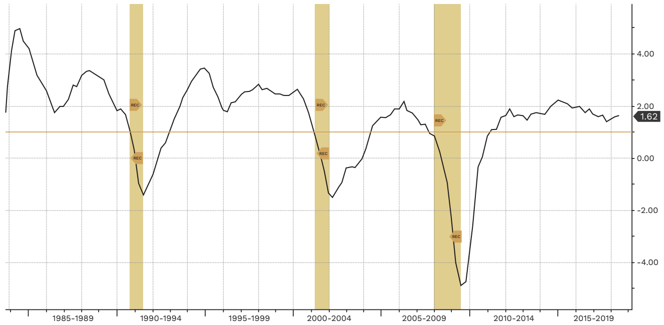
ECONOMIC OVERVIEW

Not Yet, But Soon (cont.)

Fed Tightening

Our principal concern is the Federal Reserve overtightening. The Fed sets its target rate based on signals it watches from jobs and inflation data. As unemployment has fallen and the economy has picked up, many industries have seen labor shortages. As long as company earnings remain on track, we believe that these shortages will continue. We are closely watching one particular piece of jobs data: the yearly change in total number of nonfarm jobs. Before each of the last three recessions, this number has dipped below 1%. The latest value was 1.62%.

Percent Change in Nonfarm Payrolls

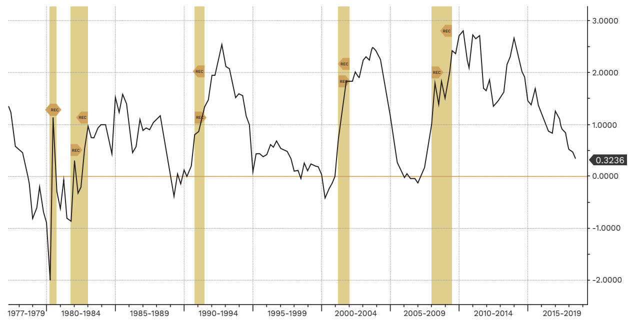


*Shaded area indicates recession

Source: Bloomberg

The Federal Funds Target Rate stands at 2% currently, and we expect two more increases this year, which would put the rate at 2.5% by year-end. The Fed is moving its rate up, following inflation, producing no change in real rates. Furthermore, although short-term rates have moved up with the Fed rate increases, longer-term rates are not reacting to the Fed's actions. Since the Fed first began raising its target rate in December 2015, the two-year Treasury yield has moved from 0.93% to 2.53%. Meanwhile, the 10-year Treasury has only moved from 2.21% to 2.86%. Why? Longer-term U.S. Treasury bond yields have not risen because there is currently no yield anywhere outside the U.S. A United Kingdom 10-year government bond yields 1.28%, a German 10-year yields 0.30% and a Japanese 10-year yields a paltry 0.03%.

10-2 Year Treasury Yield Spread



*Shaded area indicates recession

Source: Bloomberg

The Fed's seven rate increases since 2015 have only affected the short end of the curve, causing the yield curve to flatten. Since 2011, the spread between the 10-year bond and 2-year bond has decreased from 2.89% to 0.33%. We are watching this spread extremely closely. This spread has turned negative as the yield curve has inverted ahead of every postwar recession.

Although we continue to monitor all three of these potential risks to the bull market, we remain focused on our main concern: the Fed overtightening. If the yearly change in nonfarm payrolls dips below 1% and the spread between the 10 and 2-year Treasuries dips below 0%, that will likely be the signal that it is time to reduce risk.

ASSET TRANSACTIONS

Another Busy Quarter

In the second quarter, we made several adjustments across various sectors in our portfolios. In our healthcare sector, we purchased a position in Medtronic (tkr: MDT), a leading medical device company focused on treating diseases affecting the heart and the nervous system, as well as diabetes. The stock had underperformed following the acquisition of Covidien, which was completed in 2015. Covidien's lower-margin products weighed down the combined company's operating margins, although they have begun to trend back up. Meanwhile, Medtronic's valuation remains low and management sees growth opportunities in emerging markets and in value-based contracting, where Medtronic takes on the risk for non-performance of new products that it believes will improve patient outcomes while lowering costs. We think this is an attractive offering that should fare well if we eventually see elevated scrutiny of healthcare costs. We sold our position in Stryker (tkr: SYK), which had performed well but had risen in both price and valuation. Stryker and Medtronic are both medical device companies, so our relative exposure remains the same, but we believe there is more upside opportunity in Medtronic.

In our industrial sector, we bought Stericycle (tkr: SRCL, see Featured Equity). Stericycle had declined precipitously following the challenges related to the integrations of two large acquisitions as well as a pricing-reset period for its smaller customers. These issues caused margins to decline, sending the stock price down along with the valuation. We believe Stericycle's core business is intact and that its multi-year turnaround program should begin to bear fruit. We took the low valuation as an opportunity to initiate a position.

We sold our position in the Utilities Select Sector SPDR® ETF (tkr: XLU). Given that we are seeing a trend of declining per capita electricity use due to adoption of energy-efficient lighting and appliances, we looked at how this might affect utilities stocks. As usage goes down, utilities make less money, although we acknowledged that widespread electric vehicle adoption could offset declines. However, we believe that this adoption is far down the road. Furthermore, the adoption of customer-owned solar electricity may rise, which would put further pressure on utilities. Rising rates will also pressure utility company earnings, since these companies must borrow to build and maintain their infrastructure. All of these factors together led us to sell our exposure to utilities stocks.

We decided to sell our position in Paychex (tkr: PAYX) for a number of reasons. Although we had maintained the position partly because we believed that rising interest rates would boost Paychex's bottom line as they collected interest on funds held for clients, recent clarity from management indicated that this amount would be negligible. Furthermore, Paychex indicated that it was planning to reinvest savings from the tax cut into technology and sales initiatives, guiding margins lower than we had anticipated. Management also highlighted increasing competition in the "mid-market" (20-500 employees) space, probably due to upstart competitors taking market share. Finally, with the U.S. labor market near full employment, we see little opportunity for growth in Paychex's core segment. In recent years, ancillary services have allayed these concerns and augmented growth, but this segment's growth has begun to decelerate in recent quarters.

> "Although we continue to monitor all three of these potential risks to the bull market, we remain focused on our main concern: the Fed overtightening."

FIRM UPDATES

The Nelson Roberts team would like to wish everyone a wonderful summer.

WEALTH MANAGEMENT

Tax Updates

We discussed the Tax Cuts and Jobs Act in our Q4 2017 Commentary, but six months after the bill took effect, there are still parts of the new tax law that need clarification as small businesses, home owners and tax professionals await guidance from the IRS.

1) Pass through Deductions

The general consensus is that the tax changes have been well-received by U.S. corporations as the top corporate tax rate was reduced to 21% from 35%. But for non-corporate businesses known as “pass-throughs”—S-corporations, partnerships, LLC’s or sole proprietorships—the effect is less clear. The new tax law establishes a deduction of up to 20% of qualified business income generally defined as the net amount of qualified items of income, gain, deduction, and loss from any qualified business. Business income does not include investment income, guaranteed payments and reasonable compensation income from the business. Business owners that provide personal services (except engineers and architects) are not eligible for the deduction unless their income is below certain thresholds. A single taxpayer with taxable income of $157,500 or less ($315,000 or less for married couples filing jointly) will be entitled to the full 20% deduction, subject to the taxable income limit.

The pass-through deduction, which expires in 2026, is quite complicated, leaving business owners unclear exactly how to calculate it and wondering how the IRS will police it. There is a growing urgency for the guidance to be issued as soon as possible, so that businesses can plan to take advantage of the deduction.

2) Real estate deductions

The new tax prohibits interest deductions for home equity loans, unless the funds are used for home improvements. In the past, homeowners could borrow up to $100,000 of home equity debt for any purpose, including paying for college, paying down debt, or buying a new car and then deduct the interest on the loan. Those transactions no longer qualify for an interest deduction. As of 2018, the law states that interest on home equity loans is deductible only if the money is used to “buy, build, or substantially improve” one's home. There is no guidance yet from the IRS about what counts as a substantial improvement.

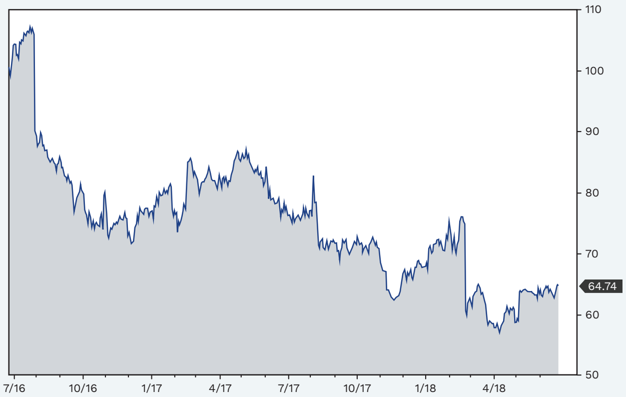
Businesses are still sorting through the impact of the tax law, which is the first major tax reform in the U.S. since 1986. The IRS and U.S. Treasury have issued some guidance already, but more is needed. It is estimated that it could take months or years to understand the full effect of the changes. The outcomes will play a large role in determining just how much business and homeowners can reduce their tax bills.

FEATURED EQUITY

Stericycle

We recently added a position in Stericycle (tkr: SRCL) as part of our industrial sector. Stericycle's primary business is providing regulated medical waste management and ancillary services. The company has an estimated 10% of the global market share in medical waste disposal, which is expected to grow at around 5% annually. Stericycle has a long history of organic growth and healthy profitability, but its operating performance has been plagued by various issues in recent years following two very large acquisitions. In 2014, Stericycle acquired PSC Environmental for $275 million, adding exposure to industrial hazardous waste disposal. In 2015, Stericycle acquired document-shredding company Shred-It for $2.3 billion. These larger acquisitions made the organization more complex, and the costly integration efforts required weighed on margins.

Stericycle, Inc.



Source: FactSet

Additionally, Stericycle has recently been forced to go through a pricing-reset period for its small-quantity medical waste customers. Alongside consolidation of independent healthcare practices into larger hospital groups, these small customers have garnered more bargaining power. In 2017, Stericycle settled a lawsuit with these small-quantity customers for $295 million. The visibility of that lawsuit also sparked pricing concessions among independent doctor and dental practice accounts. Finally, rising inflation is affecting Stericycle's ability to pass through costs, which is negatively affecting margins.

Nevertheless, the company's core medical waste network maintains its competitive advantages due to its route density. Even though the integration of the two large acquisitions has been challenging, both have further boosted this advantage. Moreover, retention rates near 90% indicate that Stericycle is not losing to small regional peers. There are only 15 commercial incinerators remaining in the U.S. (most have been closed due to environmental restrictions) and Stericycle controls 10 of them. Meanwhile, about 15% of waste from hospitals must be incinerated. In November 2017, Stericycle management announced a multiyear turnaround program aimed at creating better internal controls and improved execution.

Following a significant decline in the stock price, we believed that much of the bad news had already been priced in, and that Stericycle maintains attractive core businesses. Roughly 50% of Stericycle's consolidated sales now come from medical waste, with the other half coming from nonmedical hazardous waste management and document destruction, both of which are expected to grow roughly 6% annually.

Furthermore, given that we are likely in the later stages of the current bull market, we saw Stericycle as attractive given the inelastic demand of its end markets. The company is in the early stages of its business transformation, but at a very low valuation of 13.5 times forward earnings, we decided to add a small position.

(The preceding information regarding the featured equity should not be construed as a recommendation to purchase the security. It should not be assumed that future returns will be profitable or will equal the historical performance. Please contact us for a complete list of holdings.)

TOP 15 HOLDINGS

- iSHARES S&P SMALL-CAP ETF
- VANGUARD DEVELOPED MARKET ETF
- AMAZON.COM INC.
- ALPHABET INC.
- UNITEDHEALTH GROUP INC.
- COSTCO WHOLESALE CORP.
- SALESFORCE.COM INC.
- VANGUARD FTSE EMERGING MARKETS
- CISCO SYSTEMS INC.
- ILLUMINA INC.
- VERIZON COMMUNICATIONS INC.
- FIRST REPUBLIC BANK
- ROPER TECHNOLOGIES INC.
- TJX COMPANIES INC.
- CHEVRON CORP.

OUR TEAM

Brooks Nelson, CFA
Brian Roberts, CFA, MBA
Steve Philpott, CFP®, MBA
Ann Oglesby, MD, MBA
Darcy Nelson Smoot, CFA
Evan Nelson, CFP®
Sarah Sinclair
Erin Rodriguez
Chrissy Domingo

SPECIAL TOPIC

Charitable Giving

Nelson Roberts Investment Advisors has been committed to helping our local education system by sponsoring the Schoolhouse Rocks 5k for the fifth year in a row. This event benefits the Menlo Park Atherton Education Foundation (MPAEF). We encourage all of our clients who are philanthropically inclined to give to the charities of their choice and we offer strategies on how to maximize those gifts.

Gifting appreciated securities is one great way to give back to charity while lowering your tax burden. This allows you to recognize a charitable deduction for the full fair market value of the security instead of paying taxes that would have been due on the capital gain, had the security been sold in order to gift cash. Consequently, the benefiting charity receives a gift for the entire value of the security. This strategy can be extremely helpful with low-basis stock. For example, let's say you received stock options which were exercised several years ago at $10/share and the stock is currently trading at $100/share. You can gift 100 shares valued at $10,000 to a charity and avoid paying tax on the $9,000 capital gain.

Clients who give to charity annually should consider the use of donor-advised funds. The new tax code increased the standard deduction to $24,000 for a married couple filing jointly. This, combined with the $10,000 cap on deductions for state and local taxes (including property tax), means that far fewer people will be able to itemize their deductions. Donor-advised funds allow you to contribute stock for several years' worth of donations in one year and recognize the income tax deduction. You can then make the grant to charity at a later date. For example, if you normally give $5,000 to charity per year, you can donate $25,000 worth of stock to your donor-advised fund in one year to take advantage of the tax deduction and then recommend $5,000 grants over the next 5 years.

Grandparents over age 70½ who are interested in giving to charity may consider using qualified charitable distributions (QCDs). Instead of taking a required minimum distribution (RMD) from your IRA and gifting cash to charity, you can directly transfer an IRA balance up to $100,000 to a charity. This transfer avoids the funds from being included in your adjusted gross income (AGI), which can significantly lower your taxes.

If you have any questions about gifting low-basis stock, setting up a donor-advised fund, or making qualified charitable distributions, please contact us. For more information on how to donate to specifically MPAEF, please visit https://mpaef.org/donate.

NELSON ROBERTS
INVESTMENT ADVISORS

545 Middlefield Road, Suite 200 • Menlo Park, CA 94025 • 650.322.4000
www.nelsonroberts.com • invest@nelsonroberts.com