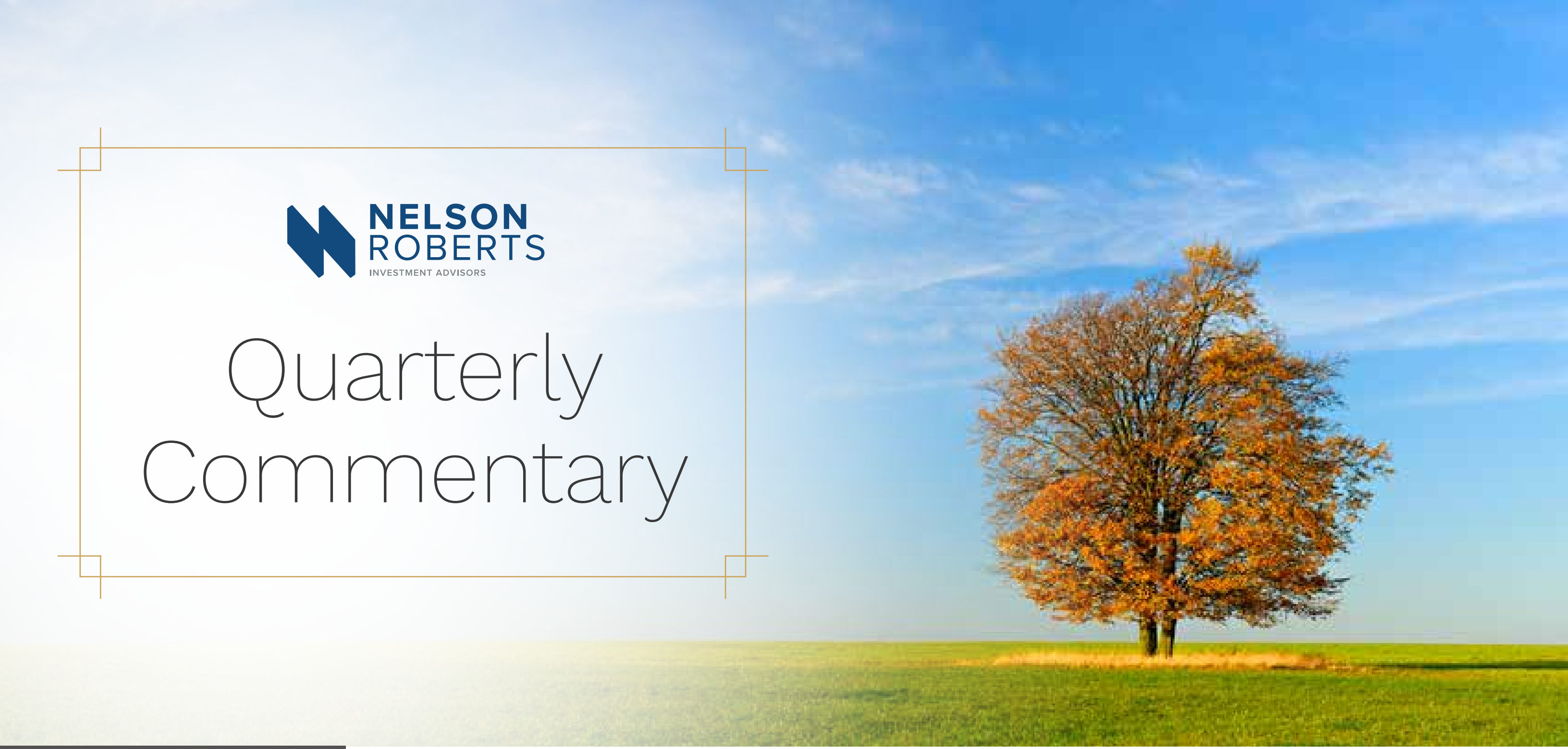

Quarterly Commentary

NELSON ROBERTS
INVESTMENT ADVISORS

2018 | Q3

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ECONOMIC OVERVIEW

Preparing to Pivot

The current economic expansion is now the second longest on record, causing us to pose the question: When will the party end?

Last quarter, we outlined three possible reasons the current bull market might come to an end: valuation, trade wars, and the Federal Reserve overtightening. Since then, both the S&P 500 and the Dow Jones Industrial Average have crept higher, with the S&P 500 hitting a fresh high of 2,913 on September 21. Nevertheless, the forward price-to-earnings valuation multiple has stayed reasonable, primarily because corporate earnings, aided by the 2017 tax cut, have grown significantly. As a result, we have greater confidence that valuation will not be the culprit that ends this market cycle.

Foreign trade, on the other hand, has become increasingly concerning. Earlier this year, tariffs were confined to a few high-profile examples—steel and aluminum—which together make up roughly $50 billion worth of imports. While nothing to sneeze at, a 25% tariff on $50 billion equated to only 0.4% of total U.S. imports, which were about $2.9 trillion in 2017. We believed at the time that fresh rounds of tariff proposals by the administration were likely bluster for more leverage ahead of trade negotiations. However, months have gone by with no significant trade agreements, the U.S.-Mexico trade deal notwithstanding, and instead of scaling back, the administration has increased tariff proposals substantially.

The Trump administration has now threatened or imposed tariffs on nearly $900 billion worth of imports. This includes virtually all $500 billion worth of Chinese imports. Assuming a 25% tariff rate, this would equate to about 7.5% of the value of all imports, about a third the 20% level reached following the enactment of the Smoot-Hawley Tariff Act in the 1930s. Both the administration and its trading partners have inched closer to an actual trade war. While we hope that subsequent trade talks result in some kind of resolution, at this point we must consider the possible economic collateral damage of a trade war.

Emerging markets have already felt the negative effects in the near term. We currently have very low exposure in our portfolios to international stocks, and particularly to emerging markets. We are watching valuations for a turning point that may offer an opportunity to invest.

Index Performance	Q3 '18	YTD
Dow Jones Industrials	9.63%	8.83%
Standard & Poor's 500	7.71%	10.56%
EAFE (international stocks)	1.42%	-0.99%
Russell 2000 (small stocks)	3.57%	11.51%
Barclays Interm. Gov/Credit	0.21%	-0.76%
Barclays Municipal	-0.15%	-0.40%

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

ECONOMIC OVERVIEW

Preparing to Pivot (cont.)

From a domestic perspective, tariffs are fundamentally inflationary. They are effectively a tax on the consumer. Nearly every American company has projected price increases to offset rising costs of imported goods and materials. We also see inflationary pressures in the tight labor market, with unemployment at historic lows and accelerating wage growth. The most recent batch of data from the labor market indicated that wages rose 2.9% from a year ago, the highest level of growth since the end of the financial crisis.

The Federal Reserve is tasked with managing this inflationary pressure. The Fed has telegraphed one more increase in its target rate between now and the end of the year, which would bring the Fed Funds Target Rate to 2.50%. We continue

U.S. Inflation

Source: Bloomberg

to believe that the Fed overtightening is ultimately what will likely bring this bull market to an end. The current inflationary pressures in the market give the Fed room to push forward with its scheduled rate hikes, as it chases inflation higher with no change in real rates.

U.S. Wage Growth

Source: Bloomberg

The political drama in Washington will continue to hog headlines, but we do not believe it will have an impact on the markets. If the November midterm elections produce a Democratic majority in the House or Senate, this should lead to politcal gridlock, which is often a good thing for economic activity. If Republicans maintain their majorities, it is possible that we may see another piece of legislation down the road, perhaps in infrastructure or another attempt at repealing and replacing the Affordable Care Act.

We continue to monitor two particular economic data points very closely. The spread between the 2-year and 10-year U.S. Treasury yields is now at 0.23%. Recall that this spread has turned negative as the yield curve has inverted 6 to 18 months ahead of every recession since WWII. We also track the year-over-year change in nonfarm jobs. When this number dips below 1% alongside an inverted yield curve, we will reduce risk across our client portfolios. If current trends persist, the 2-10 spread will turn negative in early 2019 while the change in nonfarm payrolls likely will stay above 1% until late 2019 or early 2020. For now, we are staying fully invested, adjusting target allocations on a client-by-client basis. Meanwhile, the markets grind higher, climbing the proverbial wall of worry.

ASSET TRANSACTIONS

Technology Sector Additions

We had a quiet third quarter, making only a few small changes within our technology sector. We added a position in Microsoft Corp (tkr: MSFT). Microsoft is the second-largest holding in the S&P 500, making up about 3.4% of the index. Under leadership from CEO Satya Nadella, Microsoft has developed several profitable, fast-growing revenue streams, particularly in the cloud. “Commercial Cloud” revenue, which includes Office 365, Dynamics 365 and Azure, has been growing about 50% each year, and currently is roughly $7 billion. We believe that Microsoft has emerged as a clear winner alongside Amazon in the cloud. As the transition to the cloud continues, Microsoft should continue to benefit from its leadership position. Microsoft cloud revenue is growing much faster than its competitors, as it continues to gain market share.

Furthermore, we like the $7.5 billion acquisition of GitHub that was announced in June of this year. GitHub is a community of 28 million software developers who contribute code to more than 85 million open-source software projects. We think this was a smart acquisition by Microsoft, as it should help fuel Azure growth going forward. Alongside the increasing revenue growth over the past several years, Microsoft’s valuation has risen. We decided to buy a 2% position, smaller than the market weight, given the rise in valuation. If we see this valuation decline or if we recognize further growth potential at the company, we could look to add more.

We added to our position in Qualcomm (tkr: QCOM) ahead of several possible positive catalysts for the company. Qualcomm has been entangled in a mess of regulatory fights, a bitter legal battle with Apple, a failed hostile takeover attempt by Broadcom, and roadblocks in its own acquisition of NXP Semiconductors. However, in the last few months, we have seen resolutions to many of these issues. Most of the regulatory bodies across the globe challenging Qualcomm’s business practices have concluded their investigations and Qualcomm has paid the corresponding fines. The takeover attempt by Broadcom was ultimately blocked by the Trump administration in March. Qualcomm officially abandoned the purchase of NXP Semiconductors in July after Chinese regulators held up approval of the deal as part of the larger trade conflict with the U.S.

Following the termination of the acquisition, Qualcomm announced a $30 billion stock buyback program and mapped out a plan to diversify its revenue beyond the smartphone market. The legal battle with Apple remains an overhang, but there are several upcoming legal events that should steer the two companies toward some kind of resolution. Even if the outcome of a settlement or trial is not 100% a win for Qualcomm/loss for Apple, we think that a conclusion to this fight will overall be a positive for the stock.

> The current economic expansion is now the second longest on record, causing us to pose the question: When will the party end?

FIRM UPDATES

Nelson Roberts is looking forward to hosting our upcoming Fall Presentation at BootUP Ventures, 68 Willow Road in Menlo Park. Please join us either Tuesday, October 16 or Thursday, October 18 at 12pm. RSVP by October 11 to Erin Rodriguez (ERodriguez@nelsonroberts.com or 650-322-4000).

WEALTH MANAGEMENT

Fixed Income Opportunities

For the first time in a decade, short-term bond yields are increasing and offering meaningful income to buyers. When the Federal Reserve cut interest rates in 2007 and 2008 to help avert an economic collapse during the financial crisis, short-term bond yields dropped to near zero and have remained at 50-year lows. However, this trend appears to be changing.

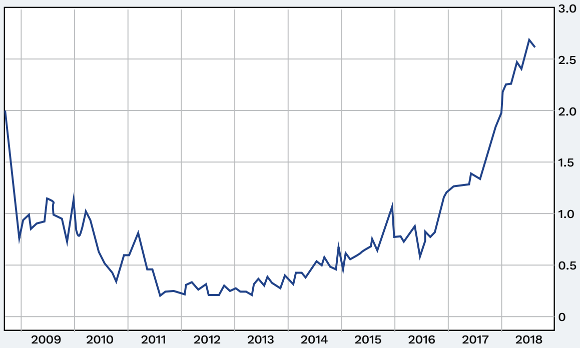
As signs of a tight job market and inflation pick up, the Federal Reserve has reversed course and increased its benchmark interest rate, while at the same time reducing the size of its balance sheet. The Fed first bumped rates higher by 0.25% in December 2015. Since then, the Fed has increased rates by 0.25% seven times. The combination of these actions and the expectation of more rate hikes in the future has pushed the short end of the yield curve higher. The yield on the 2-year U.S. Treasury note crossed above 2.5% for the first time since March of 2008 and closed the quarter yielding 2.81%. This is a significant move—twelve months ago, the 2-year Treasury note was yielding 1.48%.

Flat Yield Curve
Short-term rates are rising faster than longer-term rates, flattening the yield curve. The gap between yields for short and long Treasuries narrowed to an 11-year low, a sign that the bond market is concerned about future economic growth. Longer bonds are influenced more by the expectations for growth and global demand and less by what the Fed does. The difference between the 2-year yield of 2.80% and the 10-year yielding 3.05% narrowed to 0.19%, its lowest point since August 2007.

The relationship between short-term rates and long-term rates is important. If the differential goes negative, meaning the 10-year yield is below the 2-year yield, this is usually an indicator of a slowdown in economic growth. The yield curve has inverted ahead of each recession since 1975.

Outlook
In our view, the short end of the yield curve looks attractive and provides solid opportunities to earn income and stay defensive in a rising interest rate environment. We recommend keeping bond durations short and investing in high-quality bonds such as T-bills, CDs and short Treasury notes. These vehicles provide real returns, low volatility and ample liquidity.

2-Year Treasury Yield



Source: FactSet

TOP 15 HOLDINGS

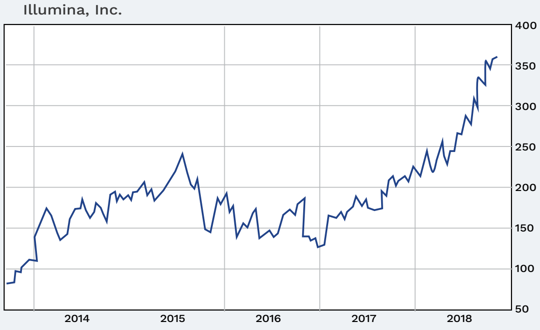
- iSHARES S&P SMALL-CAP ETF
- AMAZON.COM INC.
- VANGUARD DEVELOPED MARKET ETF
- ALPHABET INC.
- UNITEDHEALTH GROUP INC.
- COSTCO WHOLESALE CORP.
- ILLUMINA INC.
- SALESFORCE.COM INC.
- CISCO SYSTEMS INC.
- QUALCOMM INC.
- VANGUARD FTSE EMERGING MARKETS
- VERIZON COMMUNICATIONS INC.
- TJX COMPANIES INC.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

FEATURED EQUITY

Illumina, Inc.

Illumina (tkr: ILMN) is the global leader in DNA sequencing and array-based technologies, serving customers in research, clinical and applied markets. Products are used for applications in an ever-widening number of fields, including life sciences, oncology, reproductive health, and agriculture. The global market for sequencing products and services reached $3.5 billion in 2012, grew to $4.5 billion in 2013 and is projected to reach $11.7 billion in 2018, a compound annual growth rate of 21%. Macquarie and Morningstar forecast that the market this year could actually be nearly twice that size, or about $20 billion.

Illumina is estimated to have 70-80% of the current market and analysts think that 90% of all genomes sequenced so far have been done on Illumina machines. As Illumina's installed base increases, so does its revenue from consumables and services. Illumina has nearly 800 U.S. patents, 402 owned and 383 pending. Although there are several other companies using different technologies



Source: FactSet

for sequencing, thus far they have had little impact in the in the DNA sequencing market. Current sequencing technology is called "next-gen sequencing." The biggest medium-term threat to Illumina is "third generation" sequencing technology, which could be lower-cost, easier to use, and faster. Some of the new technologies being studied would also increase "read length" (the number of base pairs that could be sequenced in one run), which would decrease the need for complicated data management and software to line the sequences up after completing the runs. However, Illumina is pursuing its own research into new sequencing methods and will likely dominate the market with its current technology for the next five years.

Our thesis for owning the company is that as the cost per genome declines from $1,000 to $100 eventually, demand will jump, increasing sales of Illumina's machines and associated consumables. An expanding number of indications for sequencing, most notably in oncology and noninvasive prenatal testing (NIPT), will also drive volume.

Illumina introduced its new high-throughput sequencing instrument, the NovaSeq, in January of 2017. NovaSeq represents a major advance and kicked off an upgrade cycle that will run for three to five years. Sales of NovaSeqs and the associated consumables have exceeded initial projections. Management also noted in the most recent quarter that one-third of NovaSeq purchasers were customers new to Illumina or customers transitioning from much smaller, benchtop units. Many of these new customers reflect growth in the clinical market. In oncology, customers are using Illumina's machines to sequence tumor DNA, which then allows a much more targeted treatment approach. NIPT has largely eliminated the need for previous, much more invasive prenatal testing.

OUR TEAM

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SPECIAL TOPIC

GICS® Sector Changes

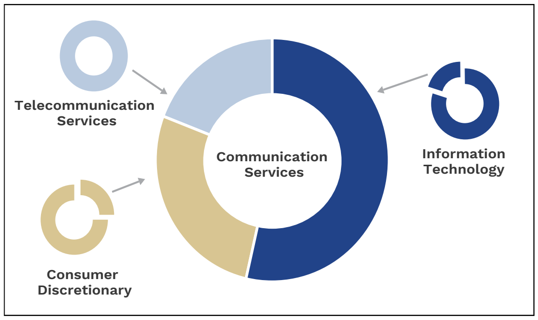
The Global Industry Classification Standards (GICS®) is a categorization structure that catalogues companies by industry across eleven major sectors. GICS® went through a major change at the end of September. The Telecommunication Services Sector, a relatively small sector which has traditionally included telecom companies such as AT&T (tkr: T) and Verizon (tkr: VZ), was broadened and renamed "Communication Services." The Communication Services Sector now includes the existing telecom companies, media companies that were formerly part of the Consumer Discretionary Sector such as Disney (tkr: DIS) and Netflix (tkr: NFLX), and select Information Technology Sector companies, most notably Google parent company Alphabet (tkr: GOOG) and Facebook (tkr: FB).

This is a major change that significantly alters the weightings of the affected sectors. Before the change was made, Telecommunication Services was only 2% of the S&P 500 index. The new Communication Services Sector now makes up 10% of the index, with about 5% coming from the Technology Sector and about 3% coming from the Consumer Discretionary Sector.

GICS® first announced the change in November 2017. The change is designed to reflect the "rapid evolution in the way people communicate, access entertainment content and other information," according to the GICS® website. Media, communication and content have become intertwined over the years through business transitions and company mergers. Communication over search engines, social media and networking platforms has become more prevalent. Consumption of entertainment has evolved, as people regularly consume video and gaming content over the internet. Telecom companies have made acquisitions in the content space, such as AT&T's purchase of Time Warner, to capitalize on this transition.

Although this is a substantial change to the GICS® sectors, there should be minimal—if any—near-term impact on the performance of the individual companies that are changing sector assignment.

New Communication Services Sector



Source: GICS®

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