NELSON ROBERTS
INVESTMENT ADVISORS

Quarterly Commentary

2019 | Q1

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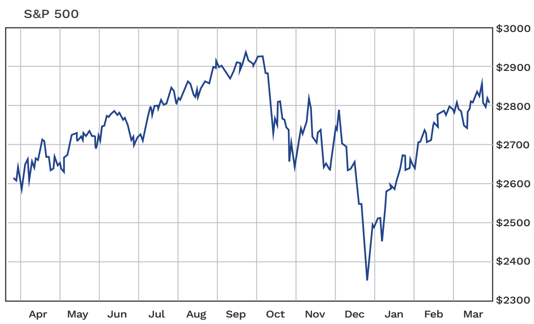
Market Bounces Back

The clouds of uncertainty that dragged equity markets down in the fourth quarter began to part at the beginning of 2019. Between October 1 and Christmas Eve, the S&P 500 fell 19.2%, narrowly missing the 20% threshold that would qualify the downturn as a bear market. However, starting December 26, market sentiment generally began to turn cautiously optimistic as retailers such as Amazon reported a record-breaking holiday season.



On January 4, the December jobs report provided more good news, revealing that a whopping 312,000 jobs were added during the month, while the prior month's number was revised higher. More uncertainty was removed when the government shutdown that began three days before Christmas finally came to an end on January 25.

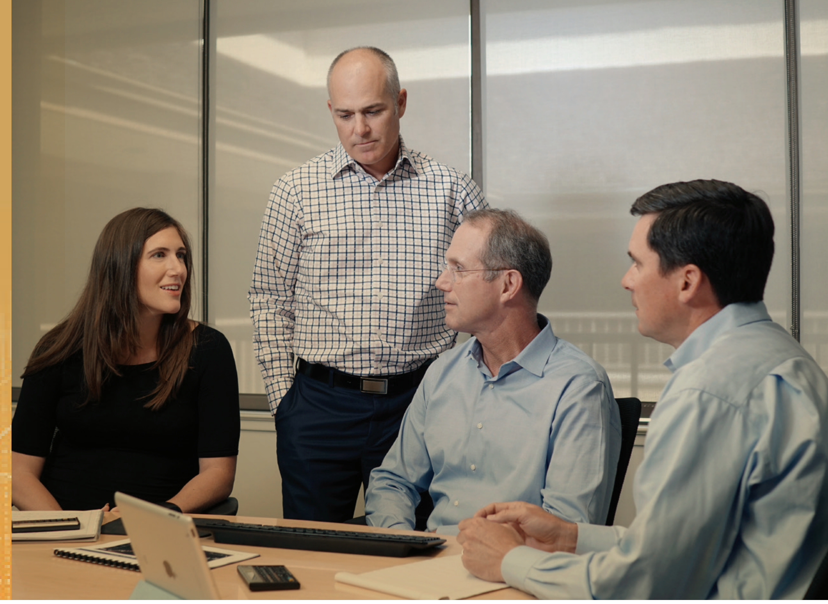
The tough trade talk that had brewed skepticism over the ongoing trade war began to turn more positive, as officials expressed optimism that the U.S. and China might actually reach a deal. On February 24, President Trump announced that the tariff increases that had been planned for March 1 would be delayed, citing progress in trade negotiations.

The equity markets continued to march higher as companies began reporting earnings that were generally better than expected. Overall, fourth quarter S&P 500 company earnings rose 12%, capping off a full year of stellar earnings growth fueled by the Tax Cut and Jobs Act.

Meanwhile, the Federal Reserve telegraphed that it would take a pause in its rate hike program this year following the four increases to its target rate in 2018. Against a backdrop of tame inflation, low commodity prices and global growth concerns, the Fed reiterated that it plans to remain patient and take a "wait-and-see" approach to any future rate increases.

Index Performance	Q1 '19	YTD
Dow Jones Industrials	11.81%	11.81%
Standard & Poor's 500	13.65%	13.65%
EAFE (international stocks)	10.15%	10.15%
Russell 2000 (small stocks)	14.57%	14.57%
Barclays Interm. Gov/Credit	2.32%	2.32%
Barclays Municipal	2.90%	2.90%

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



ECONOMIC OVERVIEW

Market Bounces Back (cont.)

By the end of the first quarter, the equity markets had nearly recovered from the sharp correction at the end of last year. The S&P 500 rose 13.6%, bringing it to 2,895, just shy of the September 20th all-time high of 2,930. The volatility that was a hallmark of the fourth quarter of 2018 has been largely absent thus far in 2019.

Internationally, growth remains challenged. The International Monetary Fund revised down its estimates for global growth, the second downward revision in three months. The undeniable slowdown in the Chinese economy, coupled with the yet-to-be-resolved trade war between the U.S. and China, was part of the reasoning behind the downward revision. Furthermore, the confusion surrounding how the Brexit will actually occur and what the impact will be remains a question mark that complicates global growth estimates. Nearly three years after the British people voted to exit the European Union, no official plan has been agreed upon. The European Central Bank, which had three months ago decided to end its stimulative bond-buying program, reversed course and began adding stimulus measures back in following cuts to its forecasts for euro-area growth and inflation.

At home, the U.S. labor market continued its powerful streak. In December and January, the U.S. added an average of ~270,000 per month. However, the most recent report showed that the labor market only added 20,000 jobs in February, far below the estimated 180,000 jobs economists were expecting. We continue to track the year-over-year job growth rate, which tends to fall below 1% ahead of major recessions. But one mediocre jobs report is not a reason for heightened concern. The rapid pace of job increases over the last several months means that we likely do not have to worry about year-over-year job growth falling below 1% until the end of this year at the earliest. In this tight labor market, wages also continued their steady march higher, with average hourly earnings rising 3.4%.

In spite of rising wages and increasing labor costs, inflation remains elusive. Low commodity prices, stubbornly low rates abroad, economic weakness internationally, and a strong dollar appear to be outweighing the inflationary impact of the rising cost of labor. The German 10-year bond yield recently turned negative, and is currently 270 bps less than the U.S. 10-year Treasury yield. The U.S. Treasury yield curve remains technically inverted, with the 10-year bond yielding less than the 3-month note, although the more recognizable 2-year/10-year spread is still positive, hovering around 15 basis points, which is where it has been since early December. We continue to monitor the 2-year/10-year spread, as this tends to turn negative about 6 to 30 months ahead of a recession.

Recently, we began pivoting toward defensive stocks that should hold up well in a recession. We continue to be thoughtful about our equity selection, recognizing that we are in the later stages of the current economic cycle. If we see a resolution to the trade war with China and if the Federal Reserve remains committed to keeping rates low, we think the bull market may get a second wind. We do not recommend trying to time the market, but we are advising a thoughtful assessment of equity market exposure. The recovery from the fourth quarter dip provides an opportunity for us to reassess individual client asset allocations.

A Very Busy Quarter

We made several adjustments and changes in our portfolios this quarter. First, we sold Mindbody (tkr: MB) following the December 24th announcement that it would be taken private by Vista Equity Partners. The stock rose about 65% on the announcement and we decided to lock in gains early this year, given that we felt it was unlikely that there would be a competing offer. We added to our position in AT&T (tkr: T). AT&T has a 6.5% dividend yield and a P/E of 8.7x. It is a deep value stock that should hold up well in an economic recession given its stable, relatively noncyclical exposure.

In our healthcare sector, we sold Bristol-Meyers Squibb (BMY) following the announcement that the company planned to buy Celgene (tkr: CELG). The deal adds a substantial amount of debt to Bristol-Meyers' balance sheet and we thought the company's synergy projections seemed overly optimistic. We added to our position in medical device company Medtronic (tkr: MDT). We believe Medtronic is relatively undervalued given its strong and innovative product portfolio. Furthermore, we like the "value-based" pricing method, where Medtronic takes the risk for non-performance of some new products, as it demonstrates the confidence that the company has in its products' ability to improve patient outcomes and lower costs.

In our consumer discretionary sector, we sold Capri Holdings (tkr: CPRI), formerly known as Michael Kors. The company was renamed following the $2.1 billion acquisition of Versace. Although we liked the company's previous acquisition of Jimmy Choo, the Versace acquisition is nearly twice the size and the growth trajectory of this luxury brand is unclear. We purchased a position in Home Depot (tkr: HD, see Featured Equity) given its reliable dividend, its new focus on the maintenance, repair and operations (MRO) business, and the fact that it is relatively insulated from online competitors such as Amazon (tkr: AMZN).

We trimmed our position in Qualcomm (tkr: QCOM) following the conclusion of its trial against the FTC. Although the judge has yet to make an official ruling in the case, early indications hinted that Qualcomm was not in a favorable stance to win the case. Although we believe a resolution to this trial will remove one overhang, we trimmed our position back given the downside risk of an unfavorable ruling, which could have implications for Qualcomm's more important upcoming legal battle with Apple.

We trimmed our position in Amazon (tkr: AMZN). Although we still maintain an overweight position, given the outperformance of the stock, the high P/E ratio and the recent uncertainty over its expansion in India, we decided to reduce our exposure slightly.

We purchased a position in Royal Dutch Shell (tkr: RDS/B) and sold our position in Chevron (tkr: CVX). We believe Shell is well-positioned to capitalize on an increase in demand for natural gas, whereas Chevron has less exposure to the cleaner-burning resource.

In our consumer staples sector, we sold Constellation Brands (tkr: STZ) and added to Proctor & Gamble (tkr: PG). We have concerns over the amount of debt Constellation took on to fund its acquisition of a stake in the Canadian-based cannabis company, Canopy. The pace of legalization in the U.S. is uncertain and beer demand has been weakening, raising questions about Constellation Brands' ability to service its significant debt. We are happy with the turnaround at Proctor & Gamble and we also felt it was prudent to add to this low P/E, high dividend stock given our pivot toward more value-oriented companies.

Finally, we added a position in Visa (tkr: V). Visa is the largest global payment network, accounting for roughly half of all credit card transactions and an even higher percentage of debit card transactions. Visa will benefit from the ongoing conversion of check and cash payments to transaction-based payments. Visa has also demonstrated its ability to stave off competition from large technology disruptors, evidenced by its partnerships with alternative payment methods such as Google Pay, Apple Pay, and PayPal.

> "If we see a resolution to the trade war with China and if the Federal Reserve remains committed to keeping rates low, we think the bull market may get a second wind."

FIRM UPDATES

Nelson Roberts is proud to sponsor the Menlo Park School District's Schoolhouse Rocks 5k run for the fifth year in a row. The event will be held on Sunday, May 19, 2019 at 9:00 am at Hillview Middle School.

Nelson Roberts is pleased to welcome Marissa Wisniewski to the team. Marissa joined the firm April 1st and was formerly a National Accounts Regional Marketing Manager at Amgen Pharm, PNW Boeing Co and Hewlett-Packard Inc. Marissa moved to California from the Midwest, and she enjoys hiking, cooking, video games, and concerts. She is also a volunteer for the National Multiple Sclerosis Society.

WEALTH MANAGEMENT

Time to Review Your Asset Allocation

For several quarters we have been writing about metrics that will portend the eventual economic contraction marking the end of the current expansion, which is a few months shy of becoming the longest in history. Those metrics include 1) the narrowing of the spread between long and shorter term interest rates and 2) the year-over-year growth rate in U.S. non-farm jobs. As Darcy Nelson Smoot said in our recent video, "End of the Bull Market?" (available in the Knowledge Center at www.nelsonroberts.com), trying to predict an economic downturn and its associated bear market is a bit like trying to predict when an earthquake will happen. We know one is coming, we just do not know exactly when.

Knowing that the ground in California will eventually shake, we prepare by strapping down water heaters, bolting foundation framing, supporting shear walls and making other structural engineering improvements. In a portfolio, the analogous change one should make is to immunize it against the need to make capital withdrawals over the period of time that it typically takes the markets to recover, which is about four years on average.

The near 20% decline in the fourth quarter of last year was a reminder that it is important that we do this now, especially considering the high equity allocations in many of our portfolios.

After the prolonged bear markets and high inflation of the 1970s, most of our clients had less than half of their assets in stocks during the 1980s. With real rates at historically high values at the time, most of our clients made as much or more money in the bond market during that decade. From 1980 to 1993, bond yields declined steadily. By 1995, most of our client portfolios were allocated to equities at 60% or more. From 1995 to 2000, with stocks—particularly growth stocks—roaring, average allocations rose with the market to 80%+/-. We reduced average equity allocations to the mid-70% range by the time the dot-com bubble burst.

Equity allocations averaged 60% to 65% in the years between the end of the dot-com bubble and the beginning of the financial crisis. The Fed lowered rates during the financial crisis of 2008-2009, and for the last decade, fixed income assets have barely offset inflation. In fact, equity dividend income has exceeded fixed income yields for most of the last decade. Consequently, many of our clients have equity allocations between 80% and 90%. For most of us, this is too high, and needs to be corrected, first to immunize against capital needs as described above, and then to adjust the remaining assets to one's risk tolerance. With money fund and bond yields back at or above inflation and stock yields, we can reduce equity allocations without detracting from income production.

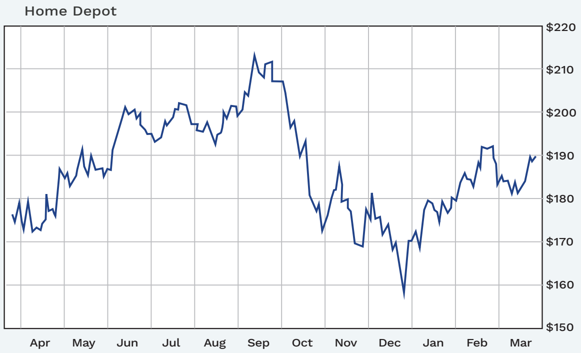
TOP 15 HOLDINGS

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

FEATURED EQUITY

Home Depot

Home Depot (tkr: HD), with a market cap of $215 billion and 2018 revenues of over $100 billion, is the world's largest home improvement retailer. Offerings include building materials, home improvement products, lawn and garden products and home décor items. Home Depot also provides a number of services, including home improvement installation services and tool and equipment rental. Its warehouse format stores stock over 35,000 products, while one million products are available online. The company's nearly 2,300 stores are in the U.S. (almost 2,000), Canada (just under 200) and Mexico (about 125), for a total of 13% outside the U.S. The company employs over 400,000 people, 93% of whom earn hourly wages.



Home Depot has two customer segments: professional and do-it-yourself (DIY). The acquisition of Interline in 2015 allowed Home Depot to enter the MRO market (maintenance, repair and operations, delivering supplies and services needed to maintain and upgrade multi-family, hospitality, healthcare and institutional facilities). One additional and growing market is the "do-it-for-me" (DIFM) customer, typically a homeowner who purchases materials at Home Depot and then hires a "Pro" to complete the project or installation. Alongside the aging of the baby boomer generation, there has been a transition from "DIY" to "DIFM," a trend which Home Depot is well-positioned to capitalize on.

While Home Depot faces some risk from slowing in the housing market, the company has considerable opportunities to expand into adjacent businesses, take market share (for example, appliances from Sears) and drive its online presence. Stronger penetration of the Pro business, particularly MRO, is also an opportunity. Home Depot has knowledgeable, helpful employees and does a lot of "culture" training. Since the domestic home improvement market is relatively mature, management plans to focus on the growth opportunities listed above, as well as on driving margins, including improvements in speed and efficiency in the supply chain.

Lowe's is Home Depot's largest and most similar competitor. Although Amazon is always a threat, the specialized nature of many of Home Depot's products, the need for expert purchasing advice in real-time, and the high weight-to-size ratio of many items offer significant protection from online competition.

We bought Home Depot as part of our pivot toward more value-oriented stocks. Home Depot is an appropriate "pivot" holding because it is large, primarily U.S.-based, well-managed, pays a reliable dividend and offers products to the vast middle of the market, rather than focusing on luxury/upscale customers.

(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.)

OUR TEAM

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Chrissy Domingo

SPECIAL TOPIC

Opportunity Zones

Part of the Tax Cuts and Jobs Act included the U.S. Investing in Opportunities Act which established the Opportunity Zone program. This program was created to encourage investments and job creation in economically distressed areas.

Opportunity Zones are census tracts nominated by the states and certified by the Internal Revenue System (IRS) and the U.S. Treasury. To date, there have been over 8,700 Opportunity Zones certified in all 50 states and five U.S. territories. These communities have a median family income 37% below the state average and unemployment 1.6 times higher than the national average.

To spur investments in Opportunity Zones, investors are given a capital gains tax incentive. Typically, when an investor sells an appreciated asset, they are required to pay capital gains tax on the appreciation. The Opportunity Zone program allows an investor to defer this capital gain by reinvesting the proceeds into a Qualified Opportunity Fund within 180 days of realizing the gain. A Qualified Opportunity Fund is an investment vehicle set up as a corporation or partnership that invests at least 90% of the assets in Opportunity Zones. Investors cannot invest in properties directly and must utilize Qualified Opportunity Funds.

Investments rolled into Qualified Opportunity Funds and held for five years will receive a 10% step up in basis. If the investment is held for seven years, there will be an additional 5% increase in basis. On December 31, 2026, investors must realize capital gains on their initial investment. Therefore, in order to benefit from the 15% increase in cost basis, investments must be made in Qualified Opportunity Funds by December 31, 2019.

If the investment is held for 10 years, there will be no federal capital gains tax on any appreciation in the Opportunity Fund Investment.

For example, in April 2019 an investor sells a $1 million investment with zero-basis and reinvests the capital into a Qualified Opportunity Fund within 180 days. This allows them to avoid paying $200,000 in capital gains tax in 2019 (assuming the top 20% long-term capital gain rate). If they hold this investment until December 31, 2026, they will only be required to pay tax on $850,000 of the initial $1,000,000 investment. At the current capital gains rates, they would avoid $30,000 in taxes due to the 15% increase in their cost basis. If they hold the investment until April 2029, any appreciation in the Qualified Opportunity Fund will be free of tax.

This program has the potential to drastically improve many impoverished areas while creating tax benefits for investors. But it should be noted that Qualified Opportunity Funds charge fees which can be quite high, often in excess of 1% annually. Furthermore, the rush to get invested in the short time window to maximize tax benefits may create some frothiness in the Opportunity Zone market. Similarly, investors forced to realize gains simultaneously in 2026 could depress fund prices at that time.

Investing in Opportunity Zones may be worthwhile for investors who have assets with very low basis. If you think investing in a Qualified Opportunity Fund makes sense for you, please contact us.

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