Market Commentary

Second Quarter 2018

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The second quarter of 2018 was a more normalized period for financial markets. After the extreme levels of volatility in the prior quarter, the recently ended three-month period saw measures of volatility decline to historical levels. The benchmark S&P 500 Index rose by 3.4% during the quarter bringing the six-month return to 2.6%. While volatility was reduced from the prior quarter, there were pockets of significant price movements, particularly at the sector level. Technology, Energy and Consumer Discretionary stocks were very strong during the quarter, while Financials lagged meaningfully. Looking at fixed income, the 10-year Treasury note yielded 2.85% at quarter end, modestly higher than the 2.74% yield at the end of March, and above the 2.41% rate at year-end 2017. Thus far in 2018, most bonds are showing slightly negative returns as yields climb faster than many had expected.

Economic and Market Outlook

After nearly a decade of weak economic growth, the US economy has hit full stride, boosted by both the late 2017 tax cuts along with a significantly improved regulatory environment. Statistics affirming this include the lowest unemployment rate since 2000, robust consumer spending, record government tax receipts, the fastest wage growth in 15 years, sharp declines in federal disability applications, and a recent survey showing 95% of manufacturers are optimistic on their company's outlook (an all-time high). Given all this positive news on the economy, our outlook for the stock market is optimistic. Market downturns are historically caused by recessions and we see no signs of a recession on the horizon. Earnings growth should continue through at least 2019, which reinforces our belief that equity markets can continue to move higher. Inflation is modest, despite worries that higher rates will drive it significantly higher. At the June Federal Reserve meeting, the FOMC moved rates 25 basis points higher and gave indications that they would raise rates two more times during 2018 for an additional 50 basis points. We believe we are closer to the end of the tightening cycle than the beginning and note that rates have already increased by 175 basis points since the tightening began in December 2015. With long-term real GDP growth estimates centered around 2%, and inflation estimates also approximating 2%, It is hard to conceive of a Fed Funds rate meaningfully above 3% without causing damage to the economy. While rates on the 10-year Treasury note have risen this year, the gap between the Fed Funds rate and the 10-year Treasury has narrowed meaningfully. Short-term rates are driven by the Central Bank while long-term rates are market driven. Investors are willing to lock up their money for 10 years to earn about 1% more than they can get from a one-month T-bill. The modest difference in interest rates between the two tell us that inflation fears remain scant. If investors believed higher inflation was coming, they would demand a significantly higher interest rate to lend money for ten years than they do for one month.

The US-North Korea summit meeting along with the concerns over trade policy were the two most significant geopolitical stories that affected markets in the last quarter. The biggest bilateral meeting in some time occurred in mid-June with the Trump-Kim meeting in Singapore. While historic in nature, there were few concrete results, although both sides promised to work towards better relations with the stated goal of a completely nuclear-free Korean peninsula. While efforts to end the North Korean nuclear program will likely take several meetings and many years, any work towards stabilization in that region is a positive for not only the US, but many other nations.

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Looking at trade, we note that policies seem to be changing almost daily. The rhetoric is elevated, but we believe this is merely public negotiating by all sides. Historically these negotiations happened behind the scenes which is what makes the current situation so different. If nobody backs down and the large tariffs that are being mentioned do take hold, global trade will suffer, and we will see economic growth reduced, both in the US and globally. Thus far, there is scant evidence that any of this uncertainty is affecting the US economy with GDP growth expected to surpass 4% in the just completed quarter. There have been some businesses reporting higher costs due to metal tariffs, along with modest supply chain disruptions. We believe this is transient and will resolve itself in the coming months. We have confidence that cooler heads will prevail, although we may need to get to the precipice of the abyss before this happens. As we implied in our last commentary, tariffs are a side show which may spook investors, but think fair trade deals will be the eventual result of this turmoil.

Oil prices continued their upwards move during the quarter, with West Texas Intermediate (WTI) rising to $74.15 at quarter-end, closing in on a four-year high. WTI climbed about 14% during the three-month period and is nearly 55% higher than one year ago. We continue to view higher energy prices as a constraint on consumer spending with more discretionary income being directed towards fuel costs. Using current global GDP growth forecasts, oil prices appear to be near the top end of fair value, with the caveat that geopolitical events – such as the US demand that all Iranian oil exports end under threat of sanctions – could move oil above this level in the short-term.

Portfolio Positioning

We have made very few changes in client portfolios in recent months, maintaining our belief in continued economic growth. There are small pockets of valuation concerns in specific subsectors of the market, but overall valuations remain slightly below fair value for US Equities in our opinion. International markets boast lower P/E multiples, although they also have more risk to their earnings potential than in the US. Based on our economic forecasts, we continue to favor equities to fixed income, although the increase in bond yields over the past 12 months has made fixed income slightly more attractive versus a year ago. Also, for the first time in over a decade, yields on cash equivalents have risen to levels that make them worthy of consideration in portfolios.

Conclusion

We see very few signs of stress in the US economy. Strong employment, relatively low levels of inflation, and strong consumer spending bode well for continued economic growth. Besides the unknown geopolitical risks, the level of interest rates will be the major variable for investors to watch in the coming months. Gradual increases in interest rates are not only warranted, but helpful as the Federal Reserve continues to unwind a decade of monetary stimulus. Earnings growth should remain very strong for the remainder of 2018 with continued benefits from the 2017 tax law changes combining with robust demand growth. Continued mid- to high-single digit earnings growth is likely in 2019. The modest first half returns in equity markets, combined with strong earnings growth has reduced the overall valuation of US equities to slightly below fair value in our opinion. Continued strong economic growth should allow earnings growth to remain strong for several more quarters, reducing overall valuations further.

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