2018 SUMMER INVESTMENT OUTLOOK

Stock markets have historically been discounting mechanisms of future expectations and 2018 thus far is a case in point. The passage of significant tax cuts in mid-December and recent acceleration of global GDP growth are already old news. Stock price volatility has risen this year and investor sentiment has shifted towards a more cautious stance as the close of the second quarter nears despite first half earnings growth of more than 20%. While technology shares and small caps have risen by double digit percentages, the broader market as measured by the S&P 500 is up a mere 3.5% in price thus far in 2018 and still trades modestly below its late January peak when the most recent correction commenced. International equities have fared much worse and are in the red for the year. Emerging markets, in particular, are down 5.6% YTD but are off 14.1% since late January. The Shanghai Composite Index (China) is down more than 19% since its January peak. The 65% decline in the price of the cryptocurrency bitcoin since its mid-December peak perhaps offers the sharpest contrast in risk-taking behavior in 2018 relative to the previous few years.

The U.S. dollar has been surprisingly strong, appreciating more than 8% since mid-February and catching many forecasters off guard. Such strength could be attributed to several factors. Interest rate differentials between the U.S. and other developed markets remain extraordinarily wide. The 5-year U.S. Treasury note offers a more than 300 bps yield advantage over a 5-year German Bund, the widest margin since the fall of the Berlin Wall in the late 1980s. Such advantage is being driven by a divergence in central bank policies. While the Federal Reserve is currently telegraphing two additional 25 bps rate hikes this year (for a total of four rate hikes in 2018), the European Central Bank (ECB) is hoping just to exit its bond buying program in December and is not expected to raise interest rates until next summer at the earliest. The ECB's exit from its own QE program could be complicated by an unexpected slowdown in growth in that geography since year-end. U.S. economic momentum picked up during the spring months but Euro Area activity slowed, leading to a divergence in economic surprises.

The backup in U.S. interest rates over the past 16 months combined with the recent spike in the U.S. dollar has also complicated life for policymakers in emerging markets. Countries such as Argentina and Turkey have significant dollar-based debt outstanding, which becomes an even greater burden when their local currencies depreciate. The JPMorgan Emerging Market Currency Index is down about 10% since its first quarter peak and the local currency depreciation in many emerging economies has also caused inflation to spike, leading central bankers to significantly raise interest rates or no longer pursue accommodative policies in some cases. Credit spreads in these markets have also widened. Such tightening of financial conditions could lead to weaker growth in the back half of the year in many of these economies. Brazil, for example, has already seen its 2018 GDP growth expectations slashed to 1.8% compared to a forecast of 2.8% earlier in the year.

Despite the current lull in most equity markets, stocks remain expensive by many traditional measures. The rise in interest rates and the widening of investment grade credit spreads during the first half of 2018 only add to the valuation headwinds as bond yields are beginning to offer a competitive return relative to stocks for the first time in many years. While underlying earnings growth on a year-over-year basis should continue at a high teens rate in the back half of 2018 thanks to the corporate tax cuts, the first quarter of the year was likely the peak in terms of growth and additional progress beyond this year will likely normalize at a much lower single digit level should the expansion continue. Furthermore, the synchronous global growth that existed at the end of 2017 (when the largest global economies saw their expansions shift into a higher gear all at once) seems to have disappeared with the passing of spring and even before the most recent tariff spat, which adds an element of risk itself to the back half of the year.

2018 YTD Total Returns

	6/20/18	% Change
Dow 30 Industrials	24,658	+0.9%
S&P 500	2,767	+4.5%
NASDAQ Composite	7,782	+13.3%
MSCI All Country World Index ex-USA	292	-2.7%

Outlook

The U.S. economy has experienced an uptick in activity throughout the spring months, underpinned by the significant fiscal stimulus that was passed late last year. Such accommodation should continue to support the expansion in the back half of 2018 and enable the economy to realize above trend growth of 3% or so for the full year. Core retail sales grew at a 6.6% annualized rate the past three months, well-above the 3.6% trend since the ’09 bottom, and measures of both consumer and business confidence remain near cycle highs. Monthly measures of manufacturing and service sector activity are also at levels suggestive of sustained economic growth.

There are also signs of growing pains of a strong economy as capacity looks increasingly constrained in the non-manufacturing sector with order backlogs rising at the fastest pace in the 20+ year history of the ISM survey. Additionally, there are now more job openings (6.7 million) in the U.S. economy than unemployed individuals (6.3 million) for the first time since such record-keeping began in 2000. Such momentum has raised second quarter GDP growth estimates to 3.6% (WSJ survey) with the Atlanta Fed GDPNow model offering an even higher forecast of 4.7%, providing a strong impetus for the Federal Reserve to continue raising its fed funds rate.

While additional interest rate hikes are on the way, there are also several developments that could see the tightening cycle end sooner. The yield curve continues to flatten, a hint from the bond market that central bank policy is becoming too tight. The 7-year Treasury note is essentially yielding the same as the 10-year note. The Federal Reserve can probably raise rates by 25 bps an additional 2-4 times before inverting the curve between the 10-year note and every shorter maturity (assuming longer maturities continue to trade at the same yield). An inverted yield curve has typically led recessions by 1-2 years. This timeframe generally aligns with a slowdown around 2020, consistent with two-thirds of economists’ expectations in the latest WSJ economic survey.

In addition to the flat yield curve potentially ending the tightening cycle, inflation and wage growth have yet to breakout to the same degree as previous cycles. When excluding the impact of oil prices and housing from the headline CPI, the inflation trend doesn't seem to be responding as expected to global economic improvement. Furthermore, interest rates are likely to normalize at lower levels than in previous cycles due to demographic factors and high debt levels. Working age population growth is slowing, limiting the growth potential of the economy. Historical fed funds rates in the mid-to-high single digit percentage range operating on an economy with less than historical growth potential and too much debt would be too disinflationary and may even cause a recession. Additionally, savings will need to be solid to support increasing longevity and later retirement ages. Government debt sustainability will also need to be taken into account when setting monetary policy, tying the hands of central bankers. The increased desire to save to address both retirement and high debt levels pushes down on interest rates.

Corporate credit markets are displaying many late stage characteristics and could eventually become a detriment to equity returns. Investment grade credit spreads have widened by 30 bps since late January. There has been a surge in both announced and closed M&A deals following the passage of tax reform. Much of this activity has been driven by large multinational corporations making transformative acquisitions and funding them with a significant amount of debt. Excess cash flow in many cases will now be allocated towards balance sheet repair in the coming years instead of incremental shareholder remuneration. This trend is historically associated with below average stock returns.

The percentage of investment grade bonds rated BBB (one level above a high yield/junk rating) has risen to 49% of the total universe from just 32% at the beginning of 2009, putting many more issues at risk of a downgrade to a junk rating should a recession occur before balance sheet improvement takes place. Junk bonds themselves have outperformed investment grade credit year-to-date with spreads remaining abnormally tight despite the high levels of corporate debt that exist in the economy, a risk that bears watching since credit spreads have historically been a leading indicator of stock prices.

Perhaps the biggest impact on global fundamentals aside from the U.S. economy and the Federal Reserve emanates from China, where various measures of credit growth have been slowing since late last year. Following the completion of the 19th Communist Party Congress last October, Chinese authorities stepped-up their deleveraging campaign to address the country's debt issues. So-called shadow banking channels have been significantly curtailed, bank funding has been tightened, and authorities are allowing more defaults to occur in the public bond market. Such policies have stifled financing to the private sector in China and pushed overall credit flows lower, growing at just 11.5% in May, the slowest pace in more than a decade. Thus, it's not surprising that consumption and investment in the country have slowed throughout the first half of 2018.

It will be interesting to see if the current debt clampdown in China continues in the event that the latest trade spat with the U.S. turns into a more prolonged showdown. The U.S. has imposed $50 billion worth of tariffs that go into effect on July 6th mainly on steel and metals coming from China. The Chinese retaliated with a similar amount on predominantly U.S. agricultural products. The White House then retaliated further, threatening 10% tariffs on $200 billion of additional Chinese goods, which would probably take until fall to impose. The U.S. has also exchanged tariff impositions with its European and North American trading partners.

The ultimate goal of the Trump administration is more fairness in trade. Officials are most concerned with Chinese theft of intellectual property and technology from U.S. subsidiaries operating in China as well as outdated World Trade Organization (WTO) rules that significantly favor exporters like China, which heavily subsidizes local industries and does not yet operate a pure market-based economy (the WTO trade regime has not been upgraded in comprehensive fashion in nearly a quarter century). U.S. officials also point to the inequity in tariff rates among our four largest trading partners, which impose a weighted average tariff of about 6% compared to the U.S.'s 3.5%. Nobody wins in a trade war and the most recent tactics are likely posturing to force more serious negotiations. Nonetheless, the disputes increase the downside risks to global growth in the back half of the year and into 2019 if comprises are not eventually reached.

Prior to the current tensions, global trade had already been slowing on the heels of the decline in China's credit impulse. This has particularly impacted Euro Area growth during the first half of the year since that geography is quite dependent on external demand and equipment exports into China. In particular, German factory orders have fallen through the first four months of 2018 and monthly activity indices point to a much slower rate of GDP growth for the region than most economists expected. The recent weakness can also be attributed to the strong appreciation of the euro currency throughout 2017 (which rose more than 14% against the dollar and 7.5% on a trade-weighted basis).

Some economists believe that the solid economic performance of the Euro Area over the past couple of years has been inflated by ECB action to a greater extent than is appreciated by most. Thus, it isn't a surprise that ECB officials rolled out a more dovish policy in their latest meeting. It is doubtful this particular central bank will be able to fully step away from its extraordinary measures to the same degree as our own Federal Reserve, for both fundamental and political reasons.

Investment Conclusion

Our firm's investment strategy continues to emphasize capital preservation. Companies that are generating above average sales and profit growth are currently being valued at a substantial premium by the stock market. On the other hand, defensive/non-cyclical stocks comprise the lowest percentage of the S&P 500's total market cap of the last three decades. Thus, we are finding value in some select consumer staple and healthcare names with strong distinctive competences and whose dividend yields are nearing 4% in some cases.

In fixed income, short maturity Treasuries are offering positive real returns above the economy's broad inflation measure. The rise in interest rates along with some spread widening has also made some BBB corporates in less cyclical industries appealing with yields over 3% for shorter maturities. We are also finding value in some select municipals. Portfolio income should also continue to grow as cash money market rates move higher along with the Fed rate hikes.

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We are pleased to announce the addition of Sweta Singh to our investment team. Sweta arrived at the firm on May 1st as our new fixed income portfolio manager. She is a graduate of the University of Massachusetts where she majored in economics and political science. Sweta earned a Master of Public Affairs from the University of Texas and an MBA from State University of New York. Her previous experience includes trading and portfolio management at Thornburg Investment Management and research positions at Breckinridge Capital Advisors, Income Research & Management, and Wellington Management.