Quarterly Economic Update 2Q 2018

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The Quarter in Brief. Rising rates, a surge in the U.S. dollar, and mounting trade worries were a major headwind for international stocks, but were not enough to keep U.S. equities from posting solid returns in Q2.

Economic News. According to the final estimate released by the Bureau of Economic Analysis, U.S. Gross Domestic Product (GDP) increased by 2.0 percent in Q1. That was down from the original estimate of 2.3 percent and less than the 2.9 percent posted in Q4 2018. GDP growth is expected to rebound significantly in the second half as the benefits of fiscal stimulus begin to take hold.

The employment picture remained robust. Non-farm payrolls were up 632,000 in Q2 and were up over 2.4 million over the last 12 months. The unemployment rate ended the quarter at 4.0 percent, but hit 3.8 percent in May – the lowest level in 18 years. While wage growth (2.7 percent) remained flat, employers are finding it increasingly difficult to find qualified labor. Job openings are at record levels and now exceed the number of people out of work. A strong job market has kept consumer confidence near 17-year highs.

The June ISM Manufacturing and Non-Manufacturing indices were both hovering near 60.0, well above expansionary levels. The Duke University CFO Confidence Survey hit an all-time high in June. Merger and acquisition activity picked up and business capital expenditures were rising, up 10.5 percent year-over-year in Q1.

The Fed Reserve left rates unchanged in May, but moved the Fed Funds rate .25 percent higher at their June meeting. The official rate is now 1.75 to 2.00 percent, and the Fed's own forecast is for two more hikes in 2018 and three in 2019. That would leave the official Fed Funds rate at 3.00 to 3.25 percent by the end of 2019.

According to the International Monetary Fund (IMF), global growth is still expected to reach 3.9 percent in 2018, but the expansion has become less synchronized. While the U.S. economy continued to be robust, growth projections in the Eurozone and Japan have been revised lower and emerging market economies are slowing. As such, monetary policy is again diverging, with the U.S. tightening and the rest of the world fairly accommodative. Stronger growth, higher interest rates, and the fear of a trade war with China all helped push the U.S. dollar higher in Q2.

Trade tensions escalated throughout the quarter. The U.S. implemented tariffs (primarily on steel, aluminum, solar panels, and appliances) on nearly $50 billion in imports and threatened to impose others. The most recent included a 25 percent tariff on foreign autos and auto parts (roughly $300 billion net), as well as a warning that tariffs on another $200 billion could follow. That would essentially equal the total of all goods imported from China. China threatened to retaliate, dollar-for-dollar, with tariffs of their own, specifically targeting key agricultural products (soybeans, cotton, etc). According to the Tax Foundation, an independent tax-policy nonprofit organization, the tariffs enacted so far by the administration would reduce long-run GDP by 0.06 percent ($15.7 billion). If all tariffs were enacted, U.S. GDP would fall by 0.47 percent ($117.6 billion). While still relatively small for the U.S., an all-out trade war between the two largest economies in the world would have a monumental impact on global growth.

The Markets. S&P 500 operating earnings improved 25 percent in Q1 (reported in Q2) – the highest level of growth since the financial crisis – with over 75 percent of the companies beating their earnings estimates. As a result, the S&P 500 was able to post an impressive return (+3.43 percent) despite the mounting headwinds of higher interest rates, rising oil prices, and growing trade war fears. As trade negotiations got nastier, companies that generate the majority of profits domestically began to outperform. The Russell 2000 small cap index (80 percent of revenue comes from the U.S. according to Factset) posted the best return (+7.75 percent), most of which came in the back half of Q2.

Index Performance	Q1 2018	Q4 2017	YTD
Domestic Equity			
S&P 500	-0.76%	6.64%	-0.76%
Russell Mid Cap	-0.46%	6.07%	-0.46%
Russell 2000	-0.08%	3.34%	-0.08%
International Equity			
MSCI EAFE	-1.53%	4.23%	-1.53%
MSCI Emerging Markets	1.47%	7.50%	1.47%
Fixed Income			
Barclays Aggregate	-1.46%	0.39%	-1.46%

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.

The dollar was up 4.3 percent in Q2 on a trade-weighted basis which posed a significant headwind for international assets. Developed International equities posted positive returns in local currencies (MSCI EAFE was +3.5 percent in local terms) but ended the period with a negative return in dollar terms (-1.24 percent). Weakness in Europe (especially in financials) and Japan also hurt performance in the quarter. Emerging Market (EM) equities were hit especially hard in Q2 (-7.86 percent), as trade war consternation (China is the largest component of EM index) and a rising dollar crushed the asset class.

While the strength in the dollar hurt international stocks (relative to the U.S.), sector make-up had a lot to do with it as well. The U.S. is the leader in the technology industry and, as such, it is the largest sector weight in the S&P 500 at 26.1 percent. That compares to a 6.5 percent weight of the MSCI EAFE Index. With technology stocks (+31.3 percent in the last 12 months) dominating the returns of the market, international equity underperformance may be as much about sector make-up as it is about the performance of a particular region or currency.

The U.S. 10-year Treasury yield reached 3.11 percent in mid-May – a level not seen since 2011, only to drop to 2.85 percent by quarter-end. This rally in bonds was a bit perplexing given the strong data posted on the economic front. The yield curve continued to flatten throughout the quarter, as short-term yields reacted to the Fed rate hike and the long-end of the curve stayed relatively flat. In the end, while volatility increased, bond returns stayed relatively flat, and the Barclays Aggregate Index finished down .16 percent in Q2.

S&P 500 Sector Performance	Q2 2018	Q1 2018	YTD
Consumer Discretionary	8.17%	3.09%	11.52%
Consumer Staples	-1.54%	-7.12%	-8.55%
Energy	13.48%	-5.88%	6.81%
Financials	-3.16%	-0.95%	-4.09%
Healthcare	3.09%	-1.22%	1.83%
Industrials	-3.18%	-1.56%	-4.69%
Information Technology	7.09%	3.53%	10.87%
Materials	2.58%	-5.52%	-3.08%
Real Estate	6.13%	-5.02%	0.81%
Telecommunications	-0.94%	-7.48%	-8.35%
Utilities	3.74%	-3.30%	0.32%

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Total return among sectors varied widely again in Q2. The energy sector (+13.46 percent) was the big winner following a $10 per barrel increase in crude oil during the quarter. Technology (+7.09 percent) and Consumer Discretionary (+8.17 percent) were strong sectors in Q2 and represent the only sectors that have posted double digit returns year-to-date. Real Estate (+6.13 percent) was helped by all of the protectionist rhetoric as most REITS are primarily U.S. based. Other yield-sensitive sectors like Utilities (+3.74 percent) and Telecommunications (-.94 percent) were mixed. Industrials (-3.18 percent) were most affected by the prospects of a trade war. While interest rates have moved higher across the curve, short-term rates have moved higher than long-term rates, making it difficult for financials to improve net interest margin. As a result, the Financial sector (-3.16 percent) was one of the worst sectors in Q2 as well as year-to-date.

Outlook. With an expected growth rate of 3.9 percent for 2018, the world economy is still doing well. However, the recent deviation of growth rates across regions has some investors questioning the durability of this expansion. That doesn't mean the economic outlook is bad, it just might mean that it's not getting appreciably better. Either way, the global expansion remains intact, led by the U.S., and should still be good enough to support investing in risk-assets.

In the U.S., pro-business policies have provided a tailwind for corporate earnings. Earnings for the S&P 500 rose 25 percent year-over-year in Q1 and operating margins are near 12-year highs. Lower tax burdens and access to offshore cash (repatriation) will allow companies to increase capital expenditures, hire more labor, and make acquisitions – not to mention incent companies to return cash to shareholders in the form of higher dividends and stock buy-backs.

It would be a mistake to assume that because the current bull market has been long (nine-plus years and counting) it must be nearing an end. Both domestic and international stock markets seem attractively priced given the outlook. The U.S. has faster growth and tax reform helping an already healthy economy. International economies are earlier in the economic cycle and valuations are cheaper. A case can be made for both. Though the broad market looks constructive, certain asset classes/groups seem extended. Relative performance within style (growth versus value), size (small-cap versus large-cap), and region (U.S. versus international) may be reaching extreme levels and could present investors with opportunities in the future.

All in all, the evidence would suggest that the odds of this bull market coming to an end anytime soon is remote. An overzealous Fed and the threat of a global trade war remain the two major risks to this outlook.