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Q2 2018 Market Review

U.S. equity markets saw solid returns in the 2nd quarter of 2018, increasing almost 4%. While the markets sailed through April and May, trade tensions between the U.S. and its trading partners caused volatility to return in June. Fixed income markets were mostly negative as the Federal Reserve continued to implement its interest rate tightening policy. That said, the U.S. was the place to be as an investor in this past quarter.

Economic Review

Q2 2018 By The Numbers[1]	Q2 2018	Q1 2018
GDP Est.	3.3%	2.5%
Inflation (CPI)	2.0%	3.5%
S&P 500	3.4%	-0.8%
Bloomberg Barclays U.S. Aggregate Bond Index	-0.2%	-1.5%
Bloomberg Commodity Index	0.0%	-0.4%

The U.S. economy continued to plow forward in the quarter with most economic indicators showing continued growth. Indices for manufacturing (ISM), leading economic indicators (LEI), housing starts, and retail sales all showed continued growth. The employment picture continues to look strong with unemployment at 3.8% in May with an average of 179,000 jobs created every month this year. All this leads to a quarterly GDP print that could be one the best of this cycle. Estimates are for a GDP growth of 3.3% in Q2 and 2.8% for the year. Inflation remains well under control and actually just hit the Fed's 2.0% target in June. While cyclical forces are moving prices slightly higher, we don't think inflation is breaking out to the upside anytime soon. The continued strength in economic growth and on-target inflation leads us to think the Federal Reserve is on track for an additional rate hike this year (September) and maybe a second at year-end. The Fed has taken a slow and gradual approach to increasing rates and we see no reason for this to change in the near term.

Outside the U.S. the picture is very different. While 2017 was all about synchronized global growth, 2018 has been a challenge for most but especially for emerging economies. The Federal Reserve monetary tightening cycle has presented a challenge for emerging market growth this year. As we have seen in past Fed tightening cycles, as the Fed raises rates and the U.S dollar strengthens, emerging economies struggle to maintain their growth rates. Add in concerns around trade, and economic growth outside the U.S looks to be volatile for the rest of the year.

Equity Markets

The equity markets were up nicely in the quarter following a stock market correction during Q1. The S&P 500 finished the quarter up 3.4%. Volatility picked up toward the end of the quarter as trade tensions caused some investors to take a risk-off approach. Those tensions benefited small company stocks as the Russell 2000, a small company benchmark, was up 7.8% in the quarter. Smaller companies are seen as beneficiaries as they, on average, drive a smaller percentage of their revenues from outside the U.S. relative to their large, multinational peers.

U.S. S&P 500 Sector[3]	Q2 2018 Returns	Q1 2018 Returns
Energy	12.7	-5.9
Consumer Discretionary	7.9	3.1
Real Estate	6.8	-5.3
Information Technology	6.2	3.5
Utilities	2.8	-3.3
Health Care	2.5	-1.2
Materials	2.0	-5.5
Telecommunication Services	1.5	-7.5
Consumer Staples	-2.1	-7.1
Financials	-3.6	-1.0
Industrials	-3.6	-1.6

Earnings continue to provide a tailwind for U.S. stocks as current analyst estimates continue to show earnings growing over 20% for S&P 500 companies in 2018. The tax cuts from last year are a main driver. Whether trade tensions will dent earnings growth remains to be seen. According to J.P. Morgan, U.S. goods exports drive only 8% of the U.S GDP vs. 20% or more for some economies in Asia. We continue to see strong earnings trends for 2018 but are watching closely to see if growth can follow through into 2019 or if will it fade and become a headwind for equities.

U.S. stock valuations are sitting right on long-term averages at 16.0x earnings for the S&P 500. This tells us that U.S stocks, while not cheap by any stretch, are not overly expensive either. Valuation across company size and profile are wider than the average would indicate. Growth stocks are selling for higher multiples than the S&P 500 average. Small companies, as a result of this year's outperformance, now sell for higher multiples than their large company peers.

Country - Index (USD)[4]	Q2 2018	Q1 2018
America - S&P 500	3.4	0.8
UK - FTSE 100	2.5	-2.99
France - CAC 40	-0.7	0.58
India - Sensex	-2.3	-5.37
Europe - Stoxx 50	-2.6	-0.89
Hong Kong - Hang Seng	-2.8	-0.43
Europe - Stoxx 600	-3.0	-0.07
Japan - Nikkei 225	-3.8	1.25
Germany - DAX	-4.1	-2.98
China - Shanghai	-5.3	3.05
Emerging Markets - MSCI EM	-9.7	2.46
Brazil - Bovespa	-27.4	10.95

Emerging markets bore the brunt of the markets selloff with the MSCI Emerging market index off 9.7% in the quarter and they are now off over 7% for the year. A good deal of the selloff was concentrated in Chinese equities (down 5.3%). The U.S. seems very much focused on trade imbalances with China. As a result, some China technology related stocks saw some of the biggest corrections at the end of the quarter. Developed country non-U.S. equities were also negative in the quarter down 3.3%. We expect, in the short-term, developed international and emerging market stocks will continue to face headwinds. The strong U.S. dollar is hard on emerging markets and we don't see the dollar changing dramatically in the near term. However, valuations are starting to look interesting. Emerging market forward Price to Earnings ratios (PE's)* are hovering around 11.5x this year's earnings estimates. That is down almost three points from late February. Headwinds could persist in the near-term for the emerging markets and we are closely monitoring this situation vis-a-vis adding to our positions in the portfolios.

Fixed Income Markets

The bond market was slightly negative overall in the 2nd quarter, as the Barclays Aggregate Index was down 0.16%. Yield on the 10-year Treasury bond was essentially unchanged in the quarter while the shorter-term 2-year bond saw a yield increase of nine basis points**. The Federal Reserve raised the Feds Funds rate by 25 basis points in June for the second time this year. The yield curve continued to flatten with the 10-year/2year spread narrowing to 32 basis points by the end of the quarter. We closely monitor the yield curve, as in the past it has been an important indicator of future economic activity per our recent paper, *Our Thoughts on the Flattening Yield Curve*. The current spread is still positive and we do not see an inversion this year. Also, the Fed Fund Rate/30-year Treasury spread is almost 100 basis points today. That spread also has inverted in past Fed tightening cycles. Thus the flattening and maybe inverting Treasury curve seems like more of a 2019 issue.

With that being said, the Federal Reserve could continue to tighten monetary policy this year with at least one or two additional rate hikes. As a result, we prefer being below the benchmark from a duration standpoint, as we look to minimize the impact rising rates will have on the portfolios. We have also avoided taking much credit risk, as the credit spreads are not wide enough for us to feel comfortable that we are getting paid for the risk inherent at this point in the economic cycle.

Summary: Our focus for the rest of the year

In summary, we are domestically focused in our equity allocation today while watching for the right opportunity to increase allocations to the international markets. We are underweight bonds, as the Federal Reserves tightening cycle will continue to weigh on overall returns. We favor shorter duration, higher quality credit investments where we are paid adequately for risk. Trade tensions are rising and we are laser-focused on the risks these tensions present. The central tenet of our investment philosophy is to manage risk in our clients' portfolios while we work with them toward achieving their goals. We pride ourselves on being adaptive investors and will continue to monitor the investing landscape for changes that might present interesting return/risk dynamics for our clients.

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[1] Source Factset
[2] Source Factset
[3] Source Factset
[4] Source Factset
* Forward Price to Earnings is price divided by consensus analyst estimates of earnings per share for the next 12-months
** A basis point is commonly used to express differences in expenses or interest rates. 1bp=0.01%

Bloomberg Barclays U.S. aggregate bond: The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.
S&P 500: The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.
The Bloomberg Commodity Index (BCOM) is a broadly diversified commodity price index.