2018 Second Quarter Review of the Markets

Index	2nd Qtr Return	YTD Return
S&P 500	3.43%	2.65%
MSCI ACWI Ex USA	-2.61%	-3.77%
Barclay's Bond Index	-0.16%	-1.62%
Consumer Price Index	0.56%	1.19%

Investment Commentary

The second quarter of 2018 saw mixed returns across asset classes. The S&P 500 returned 3.4%. Within the US equity market, small companies outperformed larger companies with the Russell 2000 returning 7.7% for the quarter. Looking abroad, developed market stocks increased by 3.5% in their local currencies. However, in U.S. dollar terms, those same stocks declined 1.2%, meaning U.S. investors generally experienced negative returns on foreign stocks. Emerging market equity was the worst performing major asset class this quarter and declined in both local currency and dollar terms.

The Bloomberg Barclays Aggregate Bond Index declined 0.2% for the quarter. The yield on the 10 year U.S. Treasury note increased slightly to 2.85%, which is notably lower than the 3.11% yield reached in May. More dramatic moves were seen in shorter maturities, as the yield on the 2 year U.S. treasury increased 0.27% to finish the quarter at 2.52%. This increase in short term rates was largely due to the Federal Reserve increasing the Federal Funds Target Rate (as expected), in June.

While the Bloomberg Commodity index was little changed for the quarter, West Texas Intermediate crude oil increased 14%.

Economic Outlook

Fears of a trade war were largely responsible for volatility during the quarter, especially in non-U.S. stocks and U.S. interest rates. The impact of trade talks, trade rhetoric, and/or trade wars hinges on how long nations remain in their respective protectionist postures. It should not be assumed that this will pass quickly. Domestically, there is a great deal of political support for protectionism and in a mid-term election year that can be quite valuable. Trading partners recognize this and have targeted retaliatory tariffs to impact regions that have traditionally supported protectionism, such as farmers in the Midwest. Full blown trade wars are generally rare, but large tariff increases in the 1930s and late 1980s each saw the stock markets lower one year later. A myriad of crosscurrents make it difficult to predict the impact of changes in trade policy on asset prices, but it is unlikely that prolonged tariffs in and of themselves will be positive for the stock markets of the nations involved.

In the fixed income realm, tariffs should increase the price of goods for consumers, leading to increased inflation and higher bond yields. However, bond yields pushed lower after the 10 year U.S. Treasury note hit its highest level since mid-2011 in May, presumably because the market perceives that the decrease in economic growth will be more pronounced than the increase in prices. If tariffs do last long enough for increased prices to become persistent in official inflation data, this could give the Fed continued cause to increase the Federal Funds rate. The incremental rate hikes that may occur as a result of tariff-induced inflation may be the straw that breaks the economic recovery's back.

With all of the recent tariff talks, one could be forgiven for forgetting that in June, President Trump and Kim Jong-un met in Singapore to open a diplomatic dialogue between the U.S. and North Korea. Any discernable resolution will take considerable time, if one comes about at all. Regulated trade with North Korea is unlikely to add any meaningful level of economic activity that could boost asset prices. However, watching the threat of military action stabilize or decrease is positive for global risk assets.

We often write about unemployment and its impact on our outlook for the future. When June unemployment data was released in early July, we saw a minor increase in the unemployment rate from 3.8% to 4%. This is not yet alarming, but it is worth noting that the increase came in two categories: reentrants who did not find jobs right away, and people who lost their jobs or completed temporary jobs (as opposed to new entrants or people who left their jobs).

Investment Strategy

Last quarter we wrote about potentially removing our overweight to stocks with growth characteristics versus stocks with more value-oriented characteristics. We went through with this change in the second quarter. Growth stocks have generally continued their outperformance over this time, but the change was not made with a short time horizon in mind. We believe that returning equity portfolios to a neutral growth versus value position will provide a better risk/reward experience going forward from these valuation levels.

Another smaller shift in the portfolio came from the impact of tax reform on midstream energy (i.e. transportation, pipeline and storage) companies. Historically, these companies have enjoyed large tax benefits from organizing themselves as Master Limited Partnerships (MLPs). The magnitude of those tax breaks was diminished as corporate tax rates decreased earlier this year. This has already brought about some restructuring in the industry, and we believe this is likely to continue to some degree. For this reason, we've shifted investment vehicle we use for our midstream energy allocation to a fund that allows for the purchase of midstream companies not organized as MLPs.

Valuations on large U.S. stocks ended the quarter in line with their 25 year average at 16.1 times next twelve months earnings. S&P 500 earnings in the first quarter increased by more than 20% from the year prior. This strong earnings data supported our notion that current valuations are justified by sound corporate fundamentals. For this reason, we are still comfortable with our neutral allocation to equity across risk profiles. In addition to unemployment, we continue to monitor developments in trade negotiations for signs that the aggregated deleterious impact of tariffs may last longer than markets anticipate.

As the economic expansion continues, we remain available to discuss the impact of clients' allocations and market levels on their financial independence.