1919 INVESTMENT COUNSEL
Complexity to Clarity

Investment Review and Outlook

July 2018

Introduction

Following a negative start to the year, stocks in the S&P 500 Index regained some ground, rising 3.4% in the second quarter, for a year-to-date return of 2.6%, primarily due to the contribution of a handful of technology stocks. In fact, the narrowness of the markets is further borne out by the performance of the tech-heavy NASDAQ 100 Index which rose 6.3% during the period, once again outperforming the S&P 500 as it has in every quarter since early 2017. For the most part, investors have managed to shake off ongoing trade tensions, tariffs and additional Federal Reserve rate increases. However, the Dow Jones Industrial Average (DJIA), which is composed of multinational companies with greater exposure to revenue from overseas and, therefore, more vulnerable to global trade conflicts, is down 0.7% for the year, off almost 9% from its January high.

The second quarter gain in the S&P 500 was led by energy stocks, as the price of oil rose sharply (the result of economic growth boosting demand at the same time geopolitical issues kept a lid on supply). Technology and consumer discretionary stocks continue to lead for the year. As was the case last quarter, the safe-haven sectors of telecommunications and consumer staples stocks remain the laggards as their dividend focus becomes less competitive when the Fed is raising interest rates. A US dollar rally, higher US interest rates and fears of an escalating trade war hit stocks of international companies, with emerging markets faring the worst, declining 6.5% in the quarter. The bond market, as measured by the Barclay's Aggregate Index, is down 1.6% in 2018, after a minimal decline in this period added to earlier losses.

In all, both bond and stock markets have been remarkably tame given that the headwinds from earlier this year remain intact. In this calm environment, we note that inflation finally has surpassed the Fed's stated target of 2%. Should it persistently run above this level, Fed Chair Jerome Powell has made it clear that the Fed will act to cool things off with additional rate increases. This bears watching following recent oil price increases as well as strong employment numbers, although wage growth remains restrained. Our long-term view of equities remains favorable, relative to other asset classes, but tempered by somewhat rich valuations and narrowness of the market whereby only a small number of stocks are contributing to returns. Our opinion has not changed that the potential returns for fixed income remain low as long as the Fed is tightening policy.

2nd Quarter Review

Performance Summary

Total Returns & Values for Selected Assets as of 6/30/18

	2Q 2018	YTD Return	Price / Value
Dow Jones Industrial Average	1.3%	-0.7%	24,271
S&P 500 Index	3.4	2.6	2,718
Russell 2000 Index	7.8	7.7	1,643
MSCI EAFE Index	-0.8	-2.4	7,942
MSCI EM (Emerging Markets)	-7.7	-6.5	2,358
Barclay's Capital US Aggregate	-0.2	-1.6	100
Barclay's Capital Municipal Bond	0.9	-0.2	107
Gold – Continuous Contract	-5.5	-4.2	$1,255
Light Crude Oil – Continuous Contract	14.2	22.7	$74

Source: Factset

Economy

Domestic economic growth was exceptionally strong in the second quarter, although worries related to trade disputes are becoming more pervasive as we head into the balance of the year. That being said, data from last quarter were exceptional, with strong consumer confidence and healthy labor markets driving broad-based contributions in consumer spending and manufacturing activity. Initial claims for unemployment benefits still reside at the lowest levels since the 1960s, while job creation remained strong during the quarter. The unemployment rate did drift back to 4% at quarter-end after reaching a 48-year low of 3.8% in May. However, this was the result of an increase in the labor force participation rate, as employment opportunities are drawing idle workers back into the work force. The tepid rate of wage growth remains somewhat of a surprise given the seemingly tight labor market. We expect that lower corporate tax rates and the recent optimism of business leaders will translate into productivity-enhancing capital investment, which should be supportive of stronger wage gains and drive the economy late this year and into 2019.

The good news regarding the orderly rise in wage inflation is that it reduces pressure on the Fed to lean into the recovery with steep rate increases, which normally are the cause of a recession. Fed Chair Powell's post-meeting press conference reaffirmed the commitment to raising rates. However, a well-communicated quarter percentage point increase every three months hardly seems inappropriate at this seemingly late stage of the economic cycle and with GDP growth possibly approaching an annual 4% rate. An inversion of the yield curve, with short-term interest rates exceeding long-term yields, normally leads to a recession within eighteen months, on average. While another quarter-point tightening would put us dangerously close to inversion, we think the Fed will adjust course if need be, assuming wage pressures are contained, as are oil and gas prices.

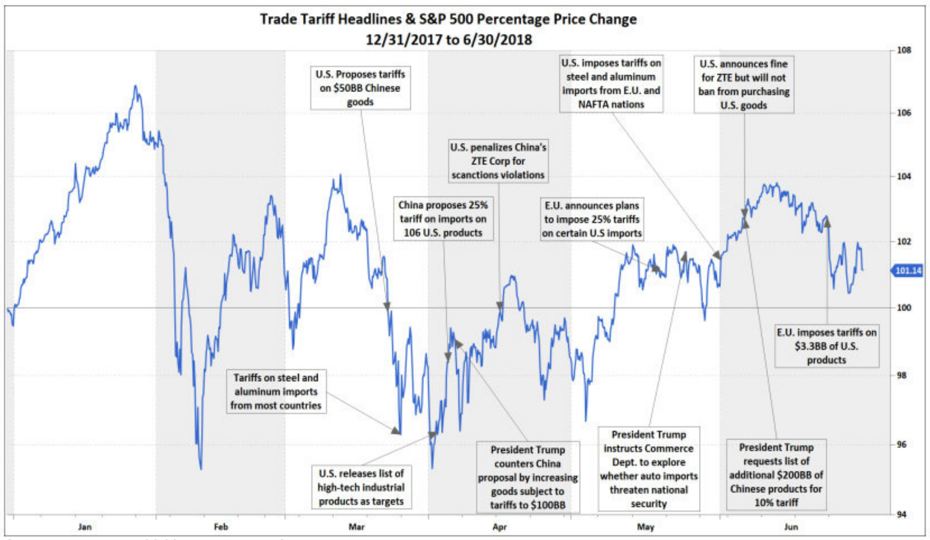
Clearly, the biggest risk to the outlook is trade. While President Trump typically starts negotiations at the extreme and works towards the middle, moves by domestic firms like Harley-Davidson to shift jobs and production overseas could hinder near-term growth before tangible benefits emerge. Much of the strength in this quarter could be the result of firms preparing for this potential conflict. Inventory accumulation, which was revised down in the first quarter, is expected to be a major contributor to the recent quarter's performance, while auto sales surged in June, particularly among SUVs of domestic automakers Ford and GM. Likewise, data on trucking activity show goods are moving briskly as businesses stock up in advance of any potential disruptions to their supply chains. While we expect this activity to steal marginally from future growth, we are cognizant that the United States is a consumption-oriented economy, and the underpinnings for a strong consumer remain in place. While we expected fiscal policy, via infrastructure spending, to be the main driver into next year, instead it seems likely that business investment and capital spending in the pro-business climate will take the lead, which should push any recession concerns into late 2019 at the earliest.

Equities

Stocks moved modestly higher during the second quarter, but market averages remained below the highs made in January. Trade tensions and political uncertainty continued to act as headwinds to investor confidence despite healthy economic growth. While market volatility declined from the first quarter, it sustained levels twice that of the low-water mark established in 2017. US corporate tax reform drove analysts to lift future earnings estimates of S&P 500 companies by 14%, but stock prices have not kept pace with the favorable revisions. Skepticism and concern have added to the "wall of worry" and have driven down the price buyers are willing to pay for future profits.

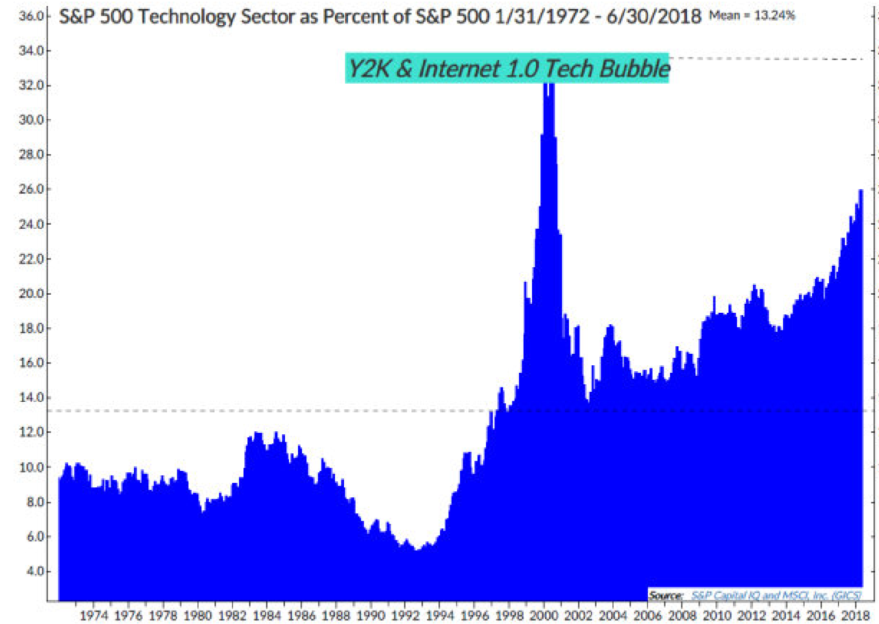
Source: Factset, 1919 Investment Counsel

By mid-April, markets recovered to levels where 2018 began and generally moved slowly higher as investor sentiment peaked by the middle of June. By late June, a ratcheting up of trade war concerns caused equity markets to sell off. The S&P 500 returned 3.4% for the quarter, which pulls it into positive territory for the year, up 2.6%. International developed markets had a similar return when measured in local currencies with the MSCI EAFE Index up 3.5%, but the impact of a stronger US dollar reduced this return to -0.8% in USD terms for the quarter. US dollar strength had a bigger influence on emerging market equities, which returned -7.7% in USD terms. Buyers were attracted to domestically-focused small cap US companies that are less affected by trade policy, resulting in an increase of 7.8% for the period. As interest rates moved up modestly in the quarter, US stocks continued to outperform bonds.



Source: Factset, 1919 Investment Counsel

Across the S&P 500, seven of the eleven economic sectors had positive returns. Buoyed by supply concerns and a double-digit increase in global oil prices, energy stocks led the pack and returned 13.5%. The consumer discretionary sector and the long-outperforming technology sector were the next strongest and still lead all other sectors for the year. As technology stocks have risen, the group's weight in the S&P 500 has expanded. Surging share prices supported by strong sales growth and growing profit margins lifted the sector to 26% of the large cap US market, up from 18% five years ago. This is still well below the peak level reached in the technology bubble of the late 1990s, when the sector grew to represent nearly 34% of the market. Back then, however, it only contributed 16% of the profits of the S&P 500, whereas it currently represents 22%.



Source: Factset, 1919 Investment Counsel

Concurrent with the technology sector's expansion, a very limited number of companies have driven the performance of the market this year, contributing more than 100% of the return for the S&P 500. This concentrated performance may be a warning sign of overly-enthusiastic herd behavior.

Prospectively, strong corporate cash flows, associated share repurchases, and dividend increases will continue to support equity markets. We are enthusiastic about the near-term stimulative effects of tax reform and potential infrastructure spending, but as the business and market cycles mature, we expect valuation pressures to increase and investors to become more discriminating and demanding. This increased scrutiny may limit market advances and result in below-average equity returns and increased volatility. Companies that are able to deliver growth and maintain strong balance sheets will garner attention and capital.

As the impact of tighter monetary policy increases along with trade and tariff tensions, the risk of a policy mistake increases and concerns about the next recession and a market correction rise. At current proposed levels, tariffs are likely to reduce US GDP modestly. However, there is a distinct possibility that investors are underestimating the disruption this will have on the economy and markets. As most of the announced tariffs impact the supply chain of US manufacturers, it is important to understand the role of these companies in the economy and the markets. Manufacturing represents approximately 12% of US GDP but contributes approximately 40% of earnings for S&P 500 companies. Thus, even a modest impact on GDP can be associated with significant consequences for certain industries and the overall equity markets. The outcome of the current trade battle is indeterminate, but when combined with tighter financial conditions and political uncertainty, the risks for equity investors are increasing.

Economic and Market Drivers

Tailwinds	Headwinds
Strong Corporate Cash Flows	Fed Policy – rising rates and balance sheet runoff
Low Interest Rates	Protectionist Trade Policies & Supply Chain Disruption
Fiscal Stimulus Package	Tight U.S. Labor Market – rising labor costs
Improving Real Household Income	Mid Term Election Uncertainty
Low Inflation	Aging Demographics in Developed Markets
Animal Spirits rising - Business Optimism	China Slowdown / Deleveraging
Household Formation Increasing	Political Pressure to Regulate Tech

Bonds

The Bloomberg Barclays Aggregate Index returned -0.2% for the second quarter of the year. Given that interest rates rose along the entire US Treasury curve, the results could certainly have been worse. With all the headlines swirling around Italy, North Korea and US trade, the tone for the period generally can be characterized as risk-off, which should have pressured yields lower. However, with a flood of supply and a withdrawal of foreign buyers, yields went the other way. Ending the quarter only slightly down, amidst the noise and volatility, seems like a tolerable outcome. In addition to the geopolitical and fiscal tensions, the Fed also came back into the spotlight with June's expected rate hike and slightly hawkish tone.

With the 2-year Treasury yield rising twice as fast as the 10-year Treasury yield, the yield curve flattened from already low levels to an even lower 33 bps between the two maturities. This type of move is called a 'bear flattener' and may be signaling a slowing economy. While the curve is getting dangerously close to zero, we are not predicting that the curve will invert, a situation which has been a fairly reliable predictor of past recessions. Given the flatness of the curve, we have been hesitant to buy too far out the maturity spectrum, as investors are not getting compensated for the additional risk. As such, our preference has been to stay invested in bonds with maturities of 5 years and shorter, or in maturities of 7 to 12 years if more duration is necessary. While we do not anticipate a sharp rise in the 10-year Treasury yield, we are forecasting yields to rise to 3.25% by year-end as well as into next year and will continue with our shorter duration stance relative to the benchmark.

Increasing Treasury yields are most often met with tighter credit spreads relative to corporate bonds, but this has not been the case for quite some time. Spreads have widened, making investment grade corporates one of the worst performing sectors year-to-date. A surge in supply due to large M&A deals and less demand also has contributed to the lagging performance. With the European Central Bank (ECB) set to end its bond-buying program later this year, the resulting decreased demand for bonds will certainly have a negative impact on spreads. Despite this somewhat weak backdrop and a flurry of debt-financed activity, investment-grade corporates remain relatively safe.

Muni Bonds

The municipal bond market bounced back nicely in the second quarter from the historically poor start to the year. Buoyed by surprisingly strong mutual fund flows and a dearth of new issuance, the Bloomberg Barclays Municipal Bond Index advanced 0.9% during the period and performance relative to other fixed income was solid, although year-to-date returns remain slightly negative. While the headwinds of rising Treasury yields, Fed tightening and widening corporate credit spreads also negatively impact the tax-free market, a 19.9% drop in new-issue volume year-to-date created a shortage of municipal bonds, which supported pricing, along with mutual fund inflows in the final eight weeks of the quarter. Lack of supply combined with solid credit fundamentals among local governments to create a narrowing of credit spreads on tax-free bonds, contrary to what was seen in the corporate sector. Finally, the Fed's unwinding of its quantitative easing program has had no direct impact on tax-free bonds, since the Fed never had included them on its balance sheet expansion.

Normally, one would expect tax-free bonds to provide poor returns relative to taxable bonds in an environment of lower marginal tax rates. However, the drop in the top marginal rate from 39.6% to 37% was not significant enough to deter demand for tax-free income. Also, the 3.8% surcharge on non-municipal investment income to finance the Affordable Care Act remains intact, further benefitting tax-free bonds. As uncertainty looms regarding new limitations on deducting state and local taxes, as well as property taxes, individuals were not willing to abandon reliable tax shelters that remain intact. We believe the municipal market should continue to deliver decent returns since higher interest rates should continue to boost demand. New issuance likely will remain light, given the disappointing roll-out of the infrastructure spending plan by the Trump Administration, and volatility within equities may create pause for those considering selling well-bought municipals to fund other asset purchases.

That being said, while prevailing after-tax municipal bond returns remain compelling for those in the highest tax brackets, we are cognizant that yields, versus taxable alternatives, are at the low end of the historical range. Therefore, the performance of the Treasury market will become a more significant determinate of future returns. Heavy Treasury issuance to pay for burgeoning fiscal deficits will become increasingly problematic for all fixed income markets.

Conclusion

There are no shortages of risks as we head into the second half of the year: the Fed is signaling additional rate increases; protectionist trade policy concerns are unlikely to wane; and, heading closer to the 2018 midterm elections, we expect domestic politics to be in the headlines. However, we believe that stimulus from corporate tax cuts, good employment numbers, decent GDP growth and still-tame inflation mitigate the risk of a recession in the near-term. With the Fed continuing to tighten monetary policy, we believe the return potential of stocks remains favorable to bonds, although investors should be prepared for increasing market volatility, especially this late in the business cycle.