Ginsburg Financial Advisors, Inc.
Personal Financial Planning & Investment Management
Larry P. Ginsburg, CFP®

phone: **(510) 339-3933**
fax: (510) 339-1611
LGinsburg@GinsburgAdvisors.com

SECOND QUARTER 2018 MARKET RECAP

Can't We All Just Get Along?

U.S.-China Trade War Concerns Intensify Roiling Foreign Markets

The rhetoric between the U.S. and China over the imposition of trade tariffs intensified over the course of second quarter 2018. The Trump administration stood firm on its promise to levy tariffs on $50 billion of Chinese goods imported into the Unites States while Chinese officials vowed to take (tariff) measures of the "same scale and intensity." The administration also allowed tariffs on steel and aluminum imports to take effect, much to the consternation of our neighbors to the north and south, which sent a signal to the markets that the president was not simply chest pounding. Meanwhile, the U.S. economic expansion kept humming along, boosted by the recent tax cuts, and the economic recovery in foreign markets moderated. The U.S. dollar experienced a boost in value driven by positive domestic economic trends and higher U.S. interest rates. The rising U.S. dollar combined with a "soft-patch" in economic activity overseas and concerns over the impact a U.S.-China trade war will have on global supply chains, roiled foreign markets resulting in most international stock and bond assets to underperform U.S. markets.

We appreciate the risk of escalating trade tensions between the U.S. and China, but we expect both countries will ultimately negotiate a new trade deal. While it is likely this situation will worsen before it gets better, the underlying strength in both the U.S. and the global economy continues to support corporate profit growth, which ultimately will drive stock returns. We continue to favor foreign stocks (both developed and emerging markets) given their lower valuations and potential to outpace U.S. stocks over the next decade. Within fixed income, we continue to advocate owning a diversified mix of predominately investment grade bonds as a means to lower overall portfolio volatility and to provide stability during tenuous market environments.

U.S. Equity Recap

The S&P 500 Index ("S&P 500") was up 3.4% during second quarter 2018 and +2.7% for the first half of 2018. These results followed a record high in January and an 11.8% correction in February. Strong corporate earnings and a continuous flow of mostly solid economic data during 2Q 2018 more than offset the negative sentiment associated with rising interest rates and an escalation in tariff activity between the U.S. and its trading partners. Within the S&P 500, Energy (+13.5%), Consumer Discretionary (+8.2%), and Technology (+7.1%) led all sectors over the second quarter while Industrials (-3.2%), Financials (-3.2%), and Consumer Staples (-1.5%) were the worst performing sectors. Year-to-date (through June 30), Consumer Discretionary (+11.5%), Technology (+10.9%), and Energy (+6.8%) were the top performing sectors while Consumer Staples (-8.6%), Telecom (-8.4%), and Industrials (-4.7%) were the bottom performers. Growth oriented stocks, which tend to represent shares of more economically-sensitive companies, continued to outperform the overall market posting gains of +5.3% for 2Q 2018 and +7.3% during the first half of 2018 versus +1.4% and -2.2%, respectively for defensive-oriented, value stocks.

Foreign Equity Recap

The MSCI EAFE Index ("Europe, Australia-Asia, and Far East"), which measures the U.S. dollar-denominated return of large cap stocks in developed, foreign markets outside of the U.S. and Canada, was down 1.2% during the second quarter and -2.8% year-to-date. Developed market stocks were negatively impacted by sluggish economic activity, increasing global trade frictions (e.g. U.S. tariffs on steel/aluminum imports), and relatively weak corporate profit growth as compared to U.S. companies. The rise in the value of the U.S. dollar year-to-date, particularly the 5.0% rise in 2Q 2018, presented a meaningful headwind to performance of the MSCI EAFE Index (a rising U.S. dollar decreases the value of local currency assets since the value of these assets are translated into dollars at a lower exchange rate). Populist-related, political events in Italy, Germany, Poland, and Spain also renewed awareness of the risk of "European fragmentation," although the rhetoric was nowhere near the levels experienced in 2016/2017.

The MSCI Emerging Markets Index fell 8.0% on a U.S. dollar basis in the second quarter, its largest quarterly slump since 2015, and was down 6.7% during the first half of 2018. The weakness in emerging market stocks year-to-date was primarily driven by China, which accounts for roughly 33% of the index. The MSCI China Index declined 10.8% and 10.9% for the second quarter and first half of 2018 respectively as China investors felt the sting of tariffs more acutely than U.S. investors. Policy-related setbacks in other key emerging market economies, namely Brazil and Turkey, and rising oil prices, which benefits large oil exporters at the expense of net oil importers (e.g. China and Korea) further increased investor uncertainty within emerging markets.

Expectation for Equities Going Forward

The U.S. economy remains on solid footing, but in the later stages of its current business cycle. This means that the U.S. is closer to the end of an economic expansion than a beginning. The strategists we speak with, however, view the near-term risk of a recession, or the end or a business cycle, as low given continued robust trends in employment, consumer spending, manufacturing, and service sector activity. Inflation readings also remain relatively tame, providing an opportunity for the U.S. Federal Reserve ("Fed") to continue raising its target for short-term interest rates without meaningfully impacting economic activity (higher market rates increases the cost of capital and reduces investment spending). The Fed is currently more inclined to raise rates not because inflationary pressures are high but to get its target rate up to an adequate level from which it can once again steer market rates lower when economic activity begins to contract.

The U.S. stock market is neither cheap nor expensive, and the S&P 500 currently trades at around its long-term historical average on multiple valuation measures. Put another way, U.S. stock valuations do not fully reflect the upside associated with the current positive economic backdrop nor the potential for a meaningful increase in shareholder-friendly capital deployment (e.g. stock buybacks, dividend increases) by U.S.-based corporations as a consequence of the recently enacted Tax Cuts and Jobs Act of 2017. Conversely, U.S. stocks do not fully reflect the downside associated with a precipitous slowdown in U.S. economic activity as a result of an all-out trade war with China or a faster-than-anticipated rise in the Fed's short-term target rate to combat an unanticipated rise in inflation expectations.

U.S. stock prices will likely remain range bound over the coming months, reflecting a balance of upside potential and downside risk, until investors get better visibility into the direction of the U.S.-China trade dispute. We also expect the volatility experienced within the financial markets year-to-date to continue given this uncertainty and ahead of midterm elections in November. (Higher volatility means an increase in the frequency and breadth of asset price changes.) Whatever party wins the House, the margin of victory will likely be narrow resulting in increased political gridlock. While the financial markets prefer legislative impasse, due to a lower probability of partisan-driven legislation disturbing the status quo, President Trump may feel compelled to act unilaterally, via executive order, to push through his agenda, which thus far has focused on deregulation, immigration, and, most importantly, international trade. Such a situation means U.S. politics will likely continue to serve as a source of uncertainty, thus volatility, beyond the midterm elections.

Increasing trepidation over timing of the next U.S. recession, escalating tariff activity, and political uncertainty, will likely continue to weigh on investor sentiment and prevent any meaningful expansion in S&P 500's valuation ratios beyond current levels. This means the pace of corporate earnings growth (or the "E" in the S&P 500's "P/E" or price/earnings ratio) will be the key driver of U.S. stock market returns. The consensus average annual growth estimate for

S&P 500 earnings growth beyond 2018 is 6.0%. Adding this expected growth rate to the current S&P 500 dividend yield of 1.9% infers an average annual total return for U.S. stocks of 8% going forward.

We have generally reduced exposure to U.S. stocks over the past year and a half in favor of a greater allocation to foreign stocks (both developed international and emerging markets), which are not only cheaper compared to U.S. stocks but tend to be earlier in their economic cycles. This provides the opportunity to compound portfolio returns at a higher rate over a longer period of time as compared to investing exclusively in U.S. stocks. We continue to expect the U.S. and China will ultimately come to a compromise on trade, but over the near-term, concerns over an escalation in tariff activity will weigh on investor sentiment given the potential negative impact to the global supply chain activity (reduced demand from China and the U.S. for intermediate-stage products sold by other manufacturing-based, export-oriented countries). To put the current tariff regime into perspective, $50 billion worth of Chinese goods subject to a U.S. 25% import tax represents only 0.28% of total goods produced by China. While China is retaliating with tariffs commiserate in scope to the Trump administration's scheme (i.e. applying a 25% import tax on $50 billion of U.S. exports into China), the impact to U.S. aggregate exports is also trivial considering China represents only 0.75% of total U.S. exports.

Global real estate and infrastructure-related assets continue to provide a viable proxy to owning bonds given positive underlying fundamentals within these "real asset" categories. These assets also provide a hedge to an unanticipated rise in inflation expectations and help to stabilize returns without meaningfully increasing portfolio exposure to primary bond risks, namely duration and credit spreads. (Duration is a measure of a bond's sensitivity rising interest rates. The longer the duration, the higher the fluctuation of a bond's price to interest rate changes. Bonds with higher interest payments and/or shorter maturities tend to have lower durations). (A credit spread reflects the yield differential between a non-government bond and an equivalent maturity U.S. Treasury bond. Widening spreads reflect investors' desire for higher yielding non-government bonds to compensate for perceived higher levels of default risk).

We generally recommend tactical investments in technology, healthcare, and financial sector stocks as we expect these sectors to outperform the broader U.S. stock market. We also expect robust operating results among U.S. midstream energy sector multi-limited partnerships ("MLPs") and "C" corporations will continue to drive renewed investor interest in these assets. Alternative assets and strategies remain an important means by which to reduce overall portfolio volatility given their lower correlation (i.e. relationship) to traditional stocks and bonds. Owning lower-correlated assets and strategies helps to increase the efficiency of portfolios by reducing absolute declines in the value of a portfolio and enabling more stable compounding of returns.

Fixed Income Recap

Fixed income or bond markets were broadly lower throughout the second quarter, largely driven by expectations for a continued rise in the Fed's target for short-term interest rates. Bond price fluctuations have also become more volatile due to continued Fed monetary policy “tightening,” expanding credit spreads, and a rising U.S. dollar. U.S. Treasuries, as measured by the Bloomberg Barclays U.S. Government Bond Index, rose 0.10% in second quarter 2018, trimming their year-to-date loss to -1.1%. The yield on the 10-year Treasury bond ended 2Q 2018 at 2.85%, or 45 basis points above the prevailing yield on 12/31/17, almost matching the 50 basis point rise in the Fed’s target for short-term interest rates over the same period. The Bloomberg Barclays U.S. Aggregate Bond Index, a composite of investment grade bonds of all types, trailed safe-haven U.S. government bonds declining 0.2% and 1.6% in the second quarter and first half of 2018 respectively, driven primarily by weakness in investment grade corporate bonds. Widening U.S. investment grade corporate bond spreads throughout the course of the first half of 2018 was not the result of deteriorating corporate fundamentals but rather reduced demand for these assets as the yields for less risky bond assets, namely U.S. Treasuries and mortgage backed securities (“MBS”), have become more competitive.

The Bloomberg Barclays Global Aggregate Bond Index, which measures the U.S. dollar denominated performance of global investment grade bonds of all types, nominally outperformed the Bloomberg Barclays U.S. Aggregate Bond Index year-to-date, down 1.5%, but lost 2.8% in the second quarter primarily due to the 5.0% rise in the U.S. dollar. Emerging market bonds were particularly weak. The Bloomberg Barclays ex-US Emerging Market Bond Index declined 4.6% during 2Q 2018 and -5.4% year-to-date. The primary driver of weakness in emerging market bonds was the increase in yields (thus rising spreads relative to U.S. Treasuries) for bonds associated with weaker emerging market economies. Depreciating local currencies also played a role in the decline in emerging market bond prices since roughly 14% of emerging market bonds are issued in non-local currencies. (Borrowing costs rise when currencies depreciate because rising foreign currency-denominated interest expense is being paid with cheaper local currencies).

Fixed Income Positioning Going Forward

The Fed is expected to continue to raise its target for short-term rates by another 50 basis points from a current range of 1.75%-2.00% to 2.25%-2.50% by the end of 2018. In addition, the Fed continues to “unwind” its holdings of U.S. government securities thereby increasing the supply of these bonds. Both of these monetary policy-tightening measures will pressure market bond rates higher and bond prices lower (bond prices and bond yields move inversely with each other). Even though interest rates continue to rise, bond market yields remain relatively low compared to historical levels. In the current market environment, fixed income, particularly investment grade bonds, serve as a ballast to client portfolios, especially during periods of extreme market volatility. Owning a diversified mix of domestic and international, low duration, investment grade bonds further stabilizes returns by balancing credit exposures and reducing a portfolio’s sensitivity to U.S. interest rate rises.

Over the course of the first half of 2018, we began shifting allocations from investment grade corporate bonds to emerging market bonds for many of our clients. The fundamental backdrop for corporate bonds remains healthy, as evidenced by historically low default rates, but we see better value in emerging market bonds over the intermediate-to-long term. Yet it is important to note that not all emerging market economies are created equal, and the structural issues in a few economies are not reflective of the underlying positive secular trends benefitting the majority of emerging markets, namely the wealth effect and the expansion of the middle class. In fact, 90% of emerging market countries are experiencing positive gross domestic product ("GDP") growth momentum and corporate profits across a range of emerging market economies are steadily rising. The underlying managers we use to access this asset class have proven track records of consistently selecting bonds of fundamentally healthy government and non-government issuers.

"De-Risking" Portfolios as Trade Tensions Persist

While the trade dispute between the U.S. and China has increased uncertainty within the financial markets, the notional value of goods currently subject to tariffs is nominal relative to the total value of products and services exported by either country. We also anticipate the U.S. and China will ultimately reach a compromise on trade. With that said, we have taken steps to "de-risk" many client portfolios should this dispute escalate into a full blown trade war, including diversifying portfolio investments among a broad set of asset classes both domestically and abroad, owning predominately high quality investment grade bonds, increasing exposures to lower correlated alternative assets and strategies, and tactically emphasizing assets that have strong, long-term growth tailwinds.

As always, please contact us if you have any questions or concerns about your investment portfolio. We welcome the opportunity to discuss your goals and the most appropriate strategy to attain them. We are also honored to speak to any of your friends, associates, or relatives should they have an interest in our financial planning or investment management services.