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Second Quarter 2018 Market Commentary

Index Performance and Analysis

The volatility of the first quarter subsided in the second as markets made a gradual recovery from February's correction. Uncertainty surrounding the President's multiple ongoing trade spats has had a restraining effect on markets as investors who avoided an overwrought sell-off earlier this year have only cautiously resumed their buying. The broad stock index returns reflect this unenthusiastic attitude: the S&P 500 with dividends returned just over 1.7% while the Dow Industrials finished the first half down almost two percent. Growth and technology stocks are having yet another banner year with the Nasdaq index gaining nearly 9% so far for 2018. Small companies that do less international business are thus less likely to be hurt by a trade war and their stocks have risen as a result; the Russell 2000 small cap index gained 6% through the end of June. Bond prices fell again this past quarter as interest rates continue to rise. The Bloomberg Barclays Aggregate Bond Index fell over 1.5% at this year's mid-point.

Gradual Recovery and Indifferent Investors

With the daily barrage of news it is easy to forget that the stock market experienced a correction in February. It had been almost two years to the day that stocks once again retreated just over 10% from their recent highs. In a bout of volatile selling and buying that lasted about three months, investors performed a reappraisal of stock valuations and tapped the brakes on the exuberance ushered in at the election of President Trump. Since that time domestic stocks have slowly, calmly risen off these lows, particularly in the second quarter. The pace of the recovery has been deliberate though it remains only partial. As of the end of June the S&P 500 closed still down 5% from its all-time high and the Dow, though now no longer saddled with perennial under-performer GE, remained in range of correction territory, off nearly 9% from its January high.

That being said, the second quarter that just wrapped up looked very much like the low-volatility year we experienced in 2017. There were some minor aftershocks felt through April but these had all but disappeared by the end of June. April saw eight days when the S&P's price moved at least one percent in either direction; above average movement, yes, though most of it occurred in the first half of the month. Together, both May and June saw only five days of similar one percent swings. Such market behavior confirms our observation that not only does volatility self-perpetuate, it also tends to cluster. Panic selling induces more selling which then brings in the value-hunters to buy up what they think has been oversold. This period of volatility will eventually run its course as markets revert to their former equilibrium. The unknowable variable is the length of such clustered behavior. The past two months brought a welcome lull in market extremes although given that considerable uncertainty (about trade policy and the growing economy) still hangs thick in the air, the relative calm may not persist through the second half.

Investors last year displayed an impressive collective ability to ignore the steady stream of Trump-related bluster and focus on the fundamentals of the economy. And to a certain extent we have seen this behavior predominate this year as well. Recall that February's correction was spurred *not* by fears of a trade war between the world's two superpowers but mainly by above average wage growth for supervisory workers. To be sure the cable news fear-mongering on tariffs has produced some minor volatility—e.g. the Dow experienced eight straight negative days in mid-June—but the volatility has been neither widespread nor sustained. Perhaps once the tangible effects of the tariffs are felt (consumers overwhelmingly bear the brunt of protectionist tariffs) we will begin to see reverberations in securities markets.

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So far investors have mostly ignored them. The United States imposed tariffs on $34 billion worth of Chinese goods at midnight, July 6th and China retaliated immediately in the same amount on American goods. Markets rose almost a percent the day after the tariffs went into effect.

The nonchalance investors have shown toward the potential trade war has carried over to other current events that would, in years past, have caused significant market turmoil. This year alone oil has climbed 20% to over $70 per barrel. The glut that led to oil's dramatic fall four years ago has been exhausted as failing state Venezuela is pumping less and less and the end of the Iran deal has severely limited the Islamic Republic's exports. Aside from bidding up some oil companies set to benefit from the higher prices, investors have remained indifferent to the commodity's rapid rise. The much-hyped Singapore Summit between North Korean dictator Kim Jong-un and President Trump came and went causing barely a ripple in markets. Meanwhile in Europe hard-right nationalist parties are gaining purchase through Germany, Poland, Hungary and Italy and are threatening the common currency Union. Investors, having learned their lesson the past several years from Brexit and the threat of Grexit, are taking these developments in stride with a reasonable wait-and-see approach.

KEY ECONOMIC INDICATORS

Gross Domestic Product

First quarter economic growth was tepid, coming in at 2%, though it was the best first quarter growth we've seen in three years. As is often the case, the first three months of the year will exhibit a seasonal slowdown owing to the weather and post-holiday tightening of personal expenditures. Indeed, consumer spending, along with sentiment (see below), moderated somewhat and led to downward revisions to the final GDP growth rate. Such seasonality and sentiment are not predicted to have persisted through the second quarter.

Inflation has finally picked up to levels last seen in 2012, wage growth is increasing and business capital expenditures—what businesses invest in themselves—are reaching new highs thanks to the Republican tax cut. This increased spending by both consumers and businesses will lead to faster growth in the year ahead. The Federal Reserve Bank of Atlanta estimates 3.9% growth for the second quarter and the New York Fed is estimating 2.8%. The advance reading is available July 27.

Consumer Sentiment

Despite our President going toe-to-toe on tariffs with the international community American consumers have maintained a positive outlook on the economy. Readings of general consumer sentiment and consumer confidence, while still elevated, have fallen of late from their highs. Economists worry that some of the negative effects of tariffs will lead to a reversal of the only-recently rejuvenated "animal spirits." These animal spirits, roughly quantified by imprecise measures of sentiment and confidence, are a crucial element of economic growth. If American consumers become discouraged by more expensive goods and services thanks to the tariffs the spirits will dissipate and growth will suffer thanks to this self-inflicted wound. The implications for markets are obvious so we will keep a close eye on these indicators through the rest of the year.

Labor Market

The number of unemployed Americans is at an 18-year low, a result of our undeniably expanding economy. The last time as many Americans had jobs was at the tail-end of the booming 1990s. And even though the unemployment rate ticked up a bit for June, it only did so because previously sidelined workers decided to reenter the workforce. This tightening of excess labor market slack is welcome news for economists and the Federal Reserve Board of Governors. It means that our labor market can meet the demands of the current expansion without detracting from productivity and curbing our accelerating growth.

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Both African-American and Hispanic joblessness stand at record lows and the labor force participation rate notched up last month. In the face of such robust jobs data the missing ingredient, wage growth, remains the sole outlier. Year-over-year wages grew 2.7%, only slightly more than the rate of inflation. Annual wage growth has not exceeded 3% in nearly a decade. Nevertheless, we expect that continuing positive employment data the rest of this year will begin to nudge employers to start raising wages in order to hire and retain their best talent.

LOOKING FORWARD

Observers attempt to attribute the unflappability of investors to the unusually calm stock markets. But this reasoning is circular in that it is just as true to say that markets are calm because investors have been calm. The relation is not causative but self-reinforcing. We think that investors have shrugged off market-moving news and that markets have been calm because investors are focused on the most important economy in the world, our own. February's correction confirms this. The threat of a trade war didn't budge markets last year and hasn't moved them much this year. What has moved markets? Worries about inflation have been the primary market mover. The investing public believes that as long as the fundamentals of our domestic economy remain sound there is little reason not to expect the nine-year old bull market to charge into its tenth year. Remember, however, that the economy is not the stock market and that corrections and bear markets are inevitable. While we are optimistic about this year's markets this does not mean that we are complacent.

Our portfolio management software ignores all the noise and looks only to price movement. So, regardless of tariff announcements or inflation readings that exceed expectations, our quantitative portfolio management process examines only the market's behavior. In this way we are able to make informed, unbiased and unemotional investment decisions. We have been pleased with the selection made in our price-trend-portfolios in identifying the strongest performing asset classes and in some cases have been able to outperform the S&P index.

The performance of some of our strategic Target Volatility portfolios experienced some lag in the first half. The lag was caused by the portfolios being composed of ETFs instead of active mutual funds. A majority of ETFs strictly track an index (like the S&P 500) and deliver market returns. Moreover, this year's market has proven quite narrow; small company stocks and growth-oriented technology stocks have outperformed all other market sectors. In such a narrow market broad indexes "meld the extremes" so that high-flying stock performance is tempered by the components of the index that are poorly performing and active managers have been able to outperform the indexes. Thus, we see the muted return of passive ETFs that track broad indexes and the resulting lag in our Target Volatility portfolios. Going forward, we have adjusted the portfolios to address the underperformance of ETFs.

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