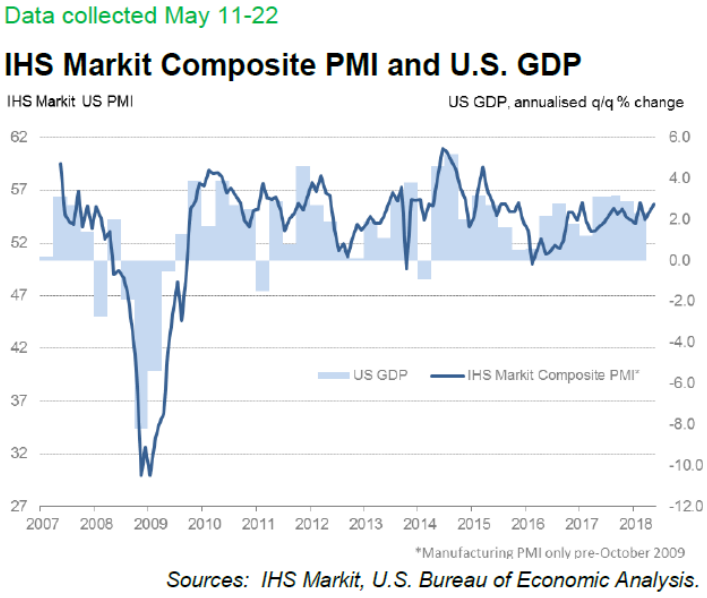
May, 2018

I closed the summary of economic data in last month's newsletter with the following comment;

"Overall, Growth remains the story in both the US & Global economies, but it is Slowing Growth pretty much everywhere. April & May's numbers will be important to see if this is a turning point into a real economic Slowdown or simply a moderating from elevated economic numbers."

Well, the US numbers came in showing a reversal of the slowdown with growth rebounding in April up to 54.9 in April and 55.7 in May;



(readings over 50 = growth while readings below 50 = contraction)

So the top-line number is moving in the right direction, buttressed by better growth in both the Manufacturing and Service sectors of the economy. Job gains continue and salaries are expected to rise by 3% in 2018, matching last year's rise. One potential "fly in the ointment" is that Input Costs (an inflation indicator) have risen at the fastest pace in 5 years while Supplier Delivery Delays (key forward indicator on inflation pressures) has risen to the highest level in 11 years. In many ways this should not be a concern – the Federal Reserve has been trying to artificially create inflation since 2008 because the level of inflation being created by the economy itself was, in their opinion, dangerously low (deflation can be just as destructive to

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an economy as hyper-inflation). Seeing real honest-to-goodness inflation being caused by robust economic activity ought to be viewed as a breath of fresh-air after nearly a decade of stifling quantitative easing! In my opinion this is a long-overdue return to normalcy, not a cause for concern. Now, it would become concerning if inflation takes off without restraint and I will be keeping a close eye on inflation pressures, but I am nowhere near viewing this good news as a sign of the inflation-monster being ready to pounce.

In the US, **1st quarter earnings were terrific** while the market itself went down as volatility returned with a vengeance. There are multiple reasons for the market's poor performance despite great earnings news. One of these is that the earnings were already priced into the market – the tax reform effects were a known quantity and everyone knew it would benefit the bottom line. While this is true, it is also true that most companies reported higher revenues than anticipated and revenues are not directly linked to tax reform, they are a direct result of higher sales. A second reason for the market decline may be that too many investors are being distracted by political news, both foreign and domestic. The Mueller investigation, trade war possibilities with China, a N. Korean summit, pulling out of the "Iran Deal", renegotiating the NAFTA trade agreement, selective tariffs, renewed violence in the Middle East – these are all storylines that greet us on a daily basis in the 24-hour-over-hyped-news-cycle. Every story is presented as THE story that will make or break our world. In fact, none of them are nearly as important to the investing public as the talking heads pretend. Now I am certainly not saying that these news stories are not worth following, but rather, that investing based on headlines, without taking into account the underlying fundamentals is not a sound strategy. Politics is not economics.

I would like to also address some market history to put our YTD volatility in perspective. Sometimes knowing market history can help reduce our own investor-emotion-volatility that naturally coincides with market volatility. This data set from Factset Research Systems compares the largest peak-to-trough corrections in each year with the total return of the S&P500 for that year going back to 1978.

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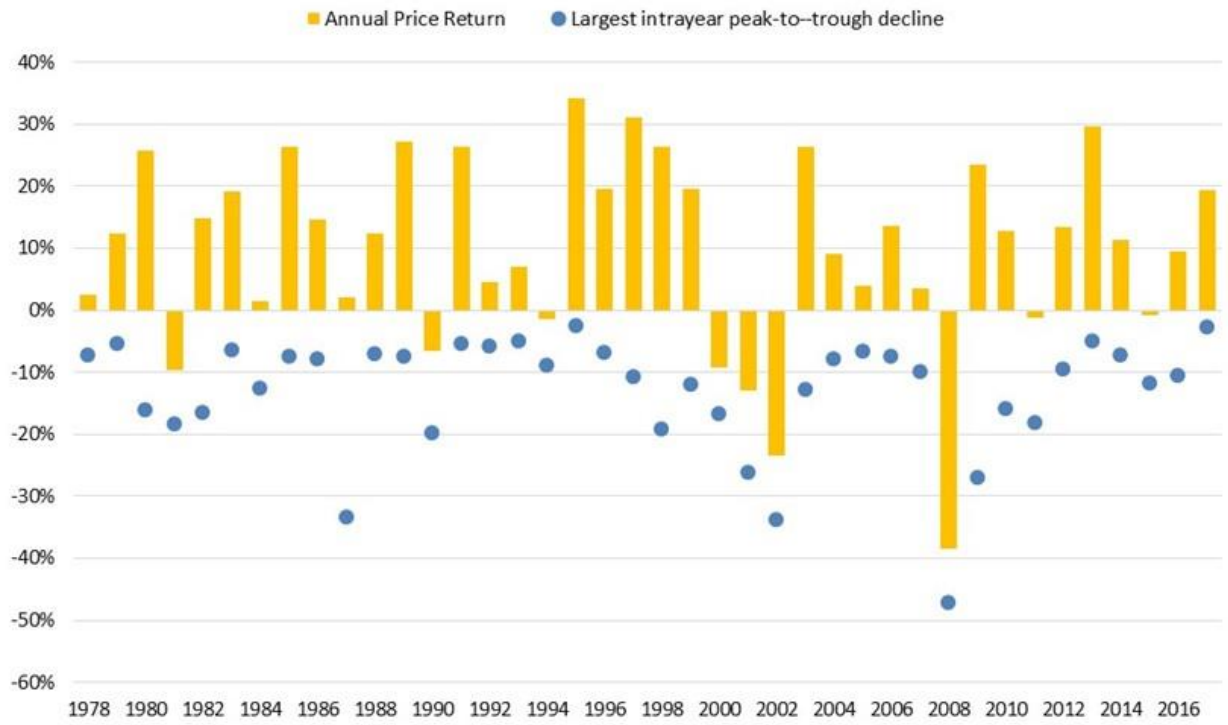

What this data set reveals is that 10% or larger corrections are very common – they occurred in 20 of the 38 years in the data set. However, if you look at the returns for those years you see that in 13 out of 20 of them the S&P500 closed the year with positive returns. Of the 7 years that did end with a negative return, 5 of them were followed by double-digit positive returns the very next year. The take away here is that corrections are commonplace and that most of the time positive returns are still extracted from the market in years that suffer corrections. Now perhaps 2018 is one of those years that ends with a negative return, but we can't simply look at elevated volatility and the on-going correction as a definite indicator that 2018 will end negatively. In other words, don't let volatility alone scare you out of the markets. One ought to have a much more fundamentally based rationale to pull out of the markets than something as commonplace as a market correction.

Eurozone – Slower Growth Continues

Across the pond the April & May numbers did not show a return to faster growth but rather continued the decline begun in March (still growth, but slower growth). Important to note is that breaking the Eurozone down by Country actually shows that Germany & France account for the entire slowdown, while across the rest of the region, growth accelerated to a 3-month high. On the plus side, job creation and business outlook continue to trend above the EZ's long-run average. However,

Germany & France are in the driver seat and the rest of the EZ will eventually follow their lead and May's numbers are flat-out disappointing. Furthermore, while it is the case that economic numbers do point to what is a solid GDP number for the EZ, if the June numbers continue a declining trend it might be time to fret a bit about the Eurozone economy in earnest.

Another potential worry point in the Eurozone is the new government being formed in Italy – it is VERY anti-European Union and intends to challenge the technocratic EU leadership housed in Brussels on numerous fronts, from immigration to honoring its fiscal commitments to a budget-busting universal income proposal. The acrimony is palpable, with some in EU circles already referring to the new Prime Minister as a "perfect Mr. Nobody, a perfect useful idiot". Often these newly formed governments talk like hardliners but moderate once actually in power. Whether this group does so remains to be seen and we should get a hint based on whom the PM appoints as cabinet ministers fairly soon. Should the new government act in accord with its stated plans we could see another bond crisis roil the Eurozone, which would likely bleed into global markets. Italian bond rates are already shooting up.

The overall **Global numbers** are not yet out for May, but the April numbers did show a return to a faster pace of growth in both the Manufacturing and Service sectors of the Global economy. Though the Global numbers show improvement, the particular economies that are showing softer growth are some of the global stalwarts and for this reason I am not as comfortable saying that the Global economic expansion remains strong, even though it is continuing. The United States appears to be on solid fundamental footing.

Thanks for Reading & Please Share with Friends,

Tom Ellis

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