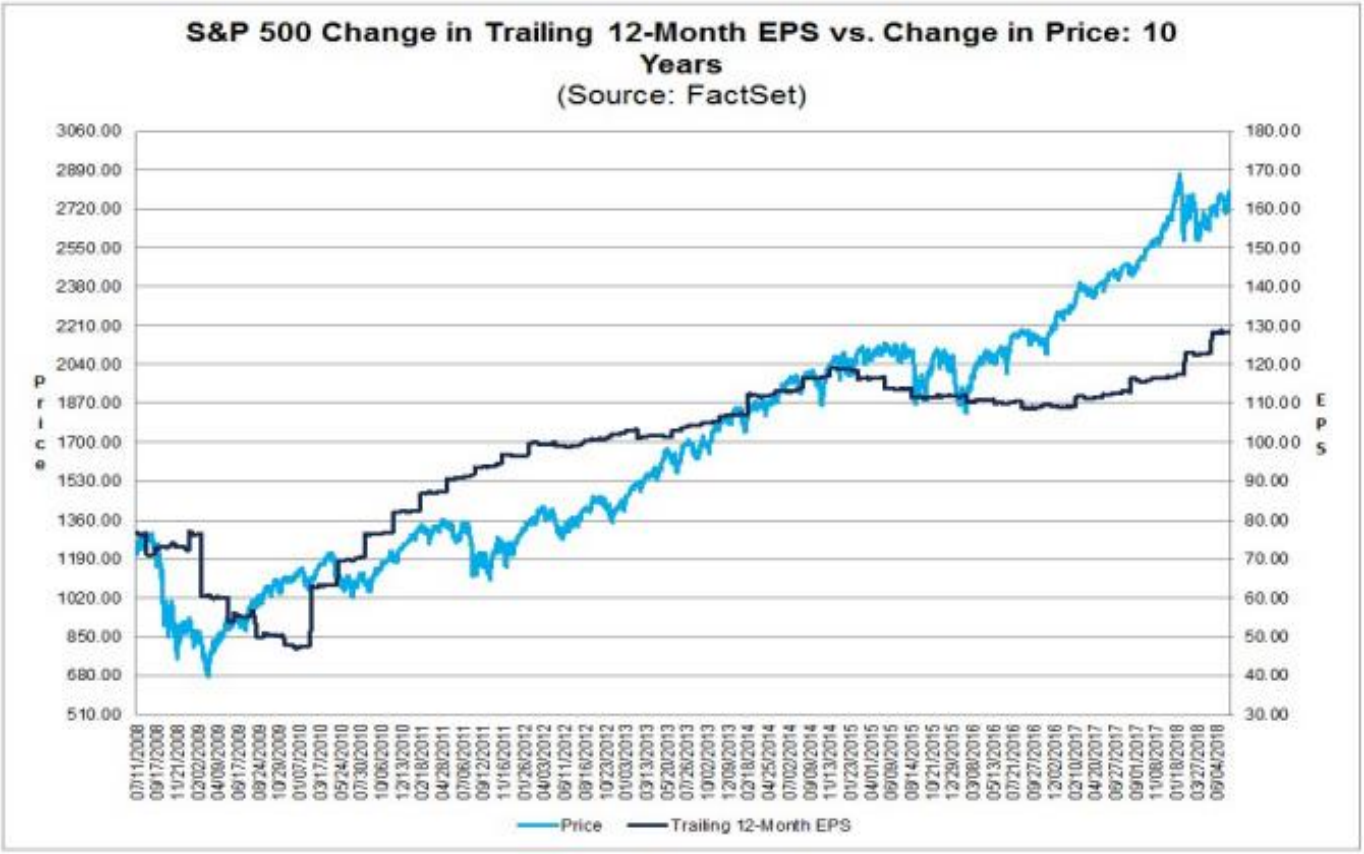
Market Insights for Week Ending July 13, 2018

Great Expectations

Even though only 5% of companies in the S&P 500 have reported actual results for Q2 2018, the expectations for all companies from the market are clear: growth….and a lot of it. According to FactSet Earnings Insight report, analysts are expecting year-over-year earnings growth of 20% for 2Q 2018. If that number holds, it would be the highest earnings growth rate since 3Q 2010 (34.1%). For some historical comparison, 2010 was up against numbers from the depths of the great recession in 2009, so even small increases in earnings performance resulted in very large percentage gains. We are currently at a very different point in the economic cycle, so projecting earnings growth of around 20%, while not impossible, is certainly setting the bar at an extremely high level.



The chart above shows the relationship between the price level of the S&P 500(light blue line) and the aggregate earnings of the companies in the S&P 500(dark blue line) going back 10 years. The gap created on the upper right side of the chart will need to be reconciled at some point. Even with the potential of 20% earnings growth this quarter, we would still require prices to come down somewhat to see the two lines converge. We aren't implying this needs to happen overnight, but even over a longer time frame, the next year or so, it is going to require consistently strong earnings over several quarters to avoid a negative effect on prices. Could it happen? Of course, anything is possible. But with tariff concerns heating up and the strong dollar having a negative impact on sales outside the US, the setup for strong absolute earnings becoming a relative disappointment has emerged.

Why Do We Care?

When HCM considers where to allocate capital in portfolios, we try to be mindful of the future with consideration given to what has already happened. Even though we expect relatively strong earnings growth going forward, we are concerned that the bar has been set high and the chances for disappointment have increased. For this reason, and others we will touch on below, we have made the decision to reduce the equity exposure in our portfolios to neutral from overweight. In addition, we have decided to reduce our international exposure to neutral, relative to the US.

A major consideration for this change is our belief that expectations for growth going forward are simply too high. Even with the tailwind of reduced corporate taxes, uncertainty created by the threat of tariffs has already led to reduced growth forecasts. While most of the reduction has been seen outside the US, all economies could be affected. The negative effect of a strong dollar will also weigh on the earnings of US based, multi-national companies that generate significant sales overseas. Lastly, as inflation continues to slowly increase, there will be cost pressures on companies which could ultimately affect their bottom line if those costs can't be passed on to consumers.

Another factor that led to our decision is seasonality. According to Ned Davis Research, August and September have historically been the worst months of the year for equity returns. In addition, when looking at the 4-year Presidential cycle, mid-term years tend to be the weakest for equity returns as well. Taken alone, these factors may not be enough to drive a risk-reduction decision. But taken together, the factors listed above support the case for risk to be reduced.

Ultimately, we aren't saying this is the beginning of the next big bear market. What we are saying is the balance of risk factors has reached a meaningful level and the prospects for above-average equity growth over the short-to-intermediate term no longer justify an overweight equity allocation.

As we implement this decision, you may be seeing several trade confirmations.

Weekly Focus – Think About It

"A day wasted on others is not wasted"

-Charles Dickens

Market Activity

Performance last week for the four major asset classes were:

- U.S. Stocks – Russell 3000 (IWV) – Gain of 1.33%
- Developed Foreign Markets (EFA) – Gain of .31%
- Emerging Markets (EEM) – Gain of 1.01%
- Fixed Income (AGG) – Gain of .08%

(Note: performance is based on the change in net asset value)

Last Week's Headlines

-Equities rose despite ongoing trade tensions. The US initiated a process that could lead up to an additional $200 billion on Chinese imports by the end of August.

-Commodities were affected by the trade disputes, with metal and oil prices falling sharply.

-Chinese inflation surprised to the upside for the first time this year, with both CPI and PPI accelerating.

Eye on the Week Ahead

-Approximately 20% of the S&P 500 market cap and 11% of the STOXX 600(Europe) market cap are scheduled to report second-quarter earnings. Consensus is for growth of 20% from the prior year period.

If you have questions about our recent portfolio changes, please contact a member of HCM's Wealth Advisory Team:

Mike Hengehold (Mike@HengeholdCapital.com)

Casey Boland (Casey@HengeholdCapital.com)

Jake Butcher (Jake@HengeholdCapital.com)

Jim Eutsler (Jim@HengeholdCapital.com)

Greg Middendorf (Greg@HengeholdCapital.com)

Steve Hengehold (Steve@HengeholdCapital.com)

Doug Johnson (Doug@HengeholdCapital.com)

Additional Notes:

- The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.
- Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.
- Past performance does not guarantee future results.
- You cannot invest directly in an index.
- Consult your financial professional before making any investment decisions.

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