MARKET REVIEW
AUGUST 2018

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MARKET BRIEF

A SECOND WIND?

Long known to distance and marathon runners, a "second wind" occurs near the end of a race when the athlete seems to discover another source of energy and with that energy finishes up the race in a surprising burst of speed. *Surprising* can be a key term here, as the second wind sometimes hits as the runner thinks they have nothing left. What about the economy and markets? Is the recent acceleration in the growth of U.S. gross domestic product (GDP) the happy beneficiary of a second wind? Or could it be something else?

RE-ACCELERATION

The chart on the top of page three (left) shows the real GDP since 1950. While we can see a steady trend of growth over multiple generations disrupted by decelerations in the 1970s, early 1990s and 2007-2009, it is difficult to see any renewed acceleration in recent quarters. However, momentum in economic growth can be observed in a variety of economic statistics, many of which are reviewed in this publication. In addition to these, there are other examples indicating the U.S. economy has found renewed strength. The impact of this year's tax cuts have yet to be fully felt in the economy, but a declining corporate tax rate from 35% to 21% is certainly a boon to the economy. Immediate expensing of certain capital goods investments has allowed business investment[1] to grow from $960 billion in the first half of 2017 to $1.183 trillion in the first half of 2018 – an increase of $223 billion or roughly 23%.

We believe U.S. consumers are now feeling the effects of a strong domestic job market, a wealth effect from rising home values, and a further positive sentiment from growing values in 401(k) and other retirement accounts.

With more people working and more people feeling wealthier, it should not come as a surprise that retail spending has risen strongly. Annual growth in retail sales[2] has been rising since a paltry year-over-year growth rate of 1.5% in late 2015. In the twelve months ending June 2018, retail sales have increased nearly 6.3%.

We believe it is tough to argue that the economy is doing poorly in the face of such evidence. It is even more difficult to argue that the economy has suddenly taken off as a result of new policies as business owners had been delaying necessary investments in property, plant and equipment for many years *and* the unemployment rate has been falling for more than just the past twelve months.

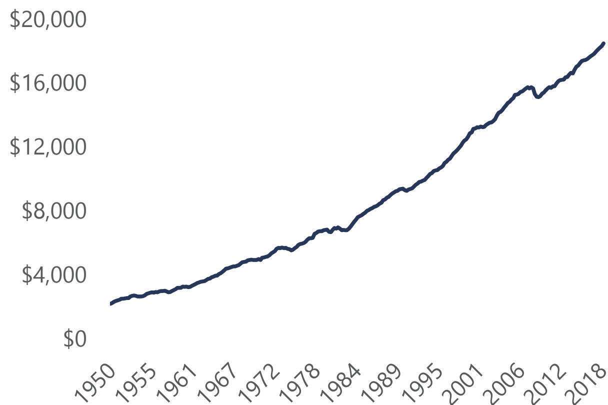
DID WE MISS SOMETHING?

While there is evidence for a resurgence of business and consumer spending, it is not perfectly clear that those alone are responsible for lifting GDP growth to an impressive 4.1% rate for the second quarter of 2018. Pent up business demand, strong jobs and rising wealth levels might not be a sufficient explanation. Could the markets have missed something? Don't businesses invest more strongly at the beginning of a business cycle than towards the end?

Wouldn't it make more sense for business owners to expand factories, upgrade computers and hire people when the economy was just beginning a new expansionary phase, rather than at the end of nearly nine years of growth?

U.S. REAL GDP ($TRILLIONS)

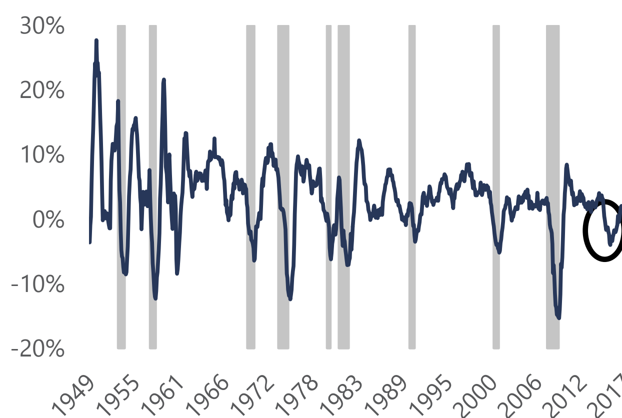
1950 THROUGH 1H2018



Source: Bloomberg. Past performance does not guarantee future results.

U.S. INDUSTRIAL PRODUCTION: ANNUAL CHANGE

1949 THROUGH 2017



Source: Bloomberg. Past performance does not guarantee future results.

Perhaps the answer is as simple as the market missed a recession. Perhaps the Federal Reserve's ultra-low interest rates and quantitative easing efforts to save the economy from a second great depression were so low for so long that they inadvertently masked a recession. Simply put, perhaps an unintended consequence of the Fed's efforts was to mask the recognition of a recession.

There are a variety of economic indicators that closely follow the business cycle. The chart above (right) shows the annual rate of change of industrial production[3] with shading to indicate recessions. According to this data, when industrial production rapidly slows, or even shrinks, in most cases a recession follows. Why, then, was the latest contraction of industrial production for most of 2015 and 2016 (circled in black) not deemed a recession when its pattern resembles the recessions in 2000-2001 and 1988-1989? If, in fact, there was even a shallow recession nearly one year ago, would investors be so anxious about the markets today?

CONCLUSIONS AND INVESTMENT IMPLICATIONS

Investors can be tempted to time the market based on signals indicating economic growth may be weakening or strengthening. Economist John Maynard Keynes' quote "the markets can remain irrational longer than you can remain solvent" is good advice for would-be market timers. Still, investors are people, and people can be subject to the emotional throes that can accompany changes in economic activity despite their insistence to be "long-term" investors. Rather than timing asset allocation decisions based on arbitrary assessments of the phase of the business cycle (notwithstanding how difficult this may be) investors should instead have confidence in the expected returns and volatility as determined by their overall asset allocation and investment goals. Instead of getting in or out of equities when the economy is growing or slowing, maintaining exposure set around a central target with defined ranges above and below that target can be a very effective technique to control risk and enhance returns over a full market cycle.

[1] U.S. Bureau of Economic Analysis, Net domestic investment: Private: Domestic business, 2nd Quarter 2018

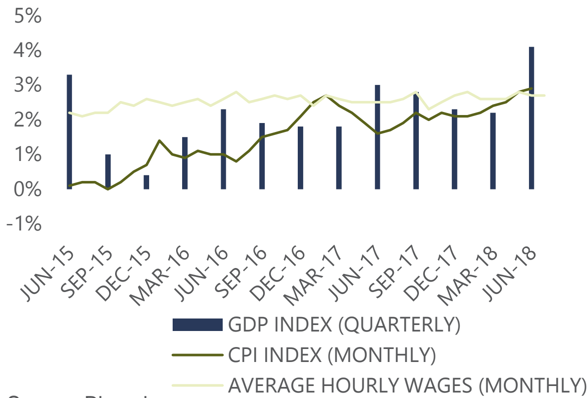
[2] U.S. Bureau of the Census, Advance Retail Sales: Retail and Food Services Excluding Motor Vehicles and Parts Dealer

[3] Board of Governors of the Federal Reserve System (US), Industrial Production Index

ECONOMY

GDP, CONSUMER PRICES AND WAGE INFLATION

JUNE 2015 THROUGH JULY 2018

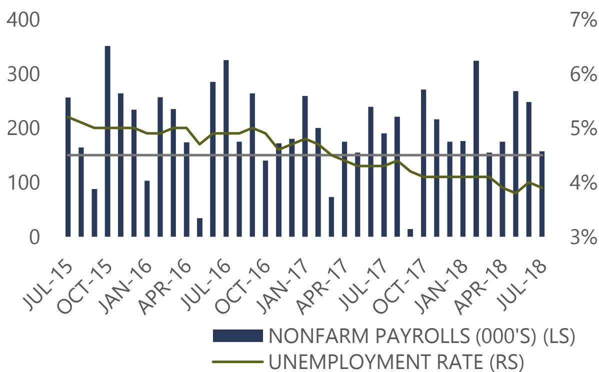


Source: Bloomberg

- Second quarter U.S. GDP grew at a robust 4.1% annualized pace, the strongest growth rate since 2014. Strong consumer and business spending, as well as a boost in exports ahead of planned Chinese tariffs, helped drive GDP growth.
- The Core Personal Consumption Expenditure (PCE) price index, the Fed's preferred inflation measure, increased in June by 0.1%, driven by strong consumer spending. The year-over-year reading for Core PCE remained at 1.9%.
- Core Consumer Price Index (CPI), which excludes volatile food and energy costs, rose 0.2% in June. The year-over-year number for Core CPI rose to 2.3%.

LABOR MARKET

JULY 2015 THROUGH JULY 2018

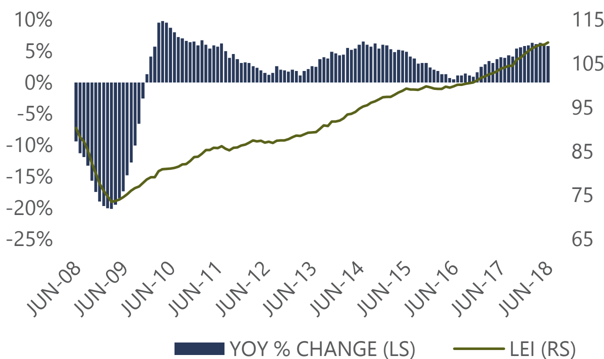


Source: Bloomberg

- U.S. nonfarm payroll employment increased by a seasonally adjusted 157,000 in July, below the 190,000 consensus forecast. Commentators have pointed to 33,000 job losses from the Toys "R" Us closing as a potential driver of the weaker-than-expected numbers.
- The unemployment rate ticked down a tenth of a percentage point to 3.9%, in June remaining near its lowest level in approximately 50 years.
- Average hourly earnings increased 2.7% year over year. The Federal Reserve continues to monitor the wages component as it seeks to meet its 2.0% inflation target.

LEADING ECONOMIC INDICATORS

JUNE 2008 THROUGH JUNE 2018



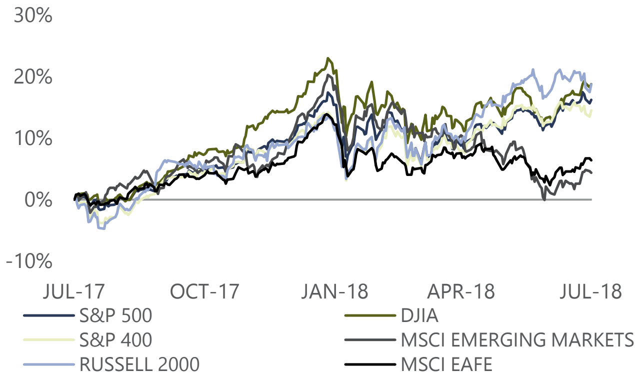
Source: Bloomberg

- The Conference Board LEI Index is comprised of ten economic components, and is considered a helpful gauge for estimating economic activity for the subsequent three to six months. The LEI Index increased 0.5% in June to 109.8, following no change in May.
- The increase in the LEI cited positive contributions from new orders, financial components and consumer expectations which offset a negative contribution from housing permits.
- The six-month growth rate of the LEI remains lower than the second half growth of 2017, suggesting that a strong upside breakout in growth may be unlikely.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, JULY 2017 THROUGH JULY 2018

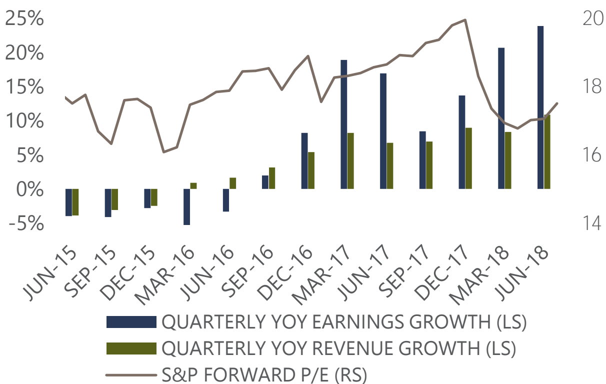


Source: Bloomberg

- The S&P 500 index rose 3.7% last month as better-than-expected second quarter earnings results and strong economic data overshadowed ongoing concerns about the trade conflict with China and, to a lesser extent, the European Union.
- Foreign equities were slightly weaker than U.S. equities with the MSCI EAFE and MSCI Emerging Market indexes gaining 2.5% and 2.3%, respectively.
- Foreign developed equities were led by European car manufacturers which gained over 5.0%. European car manufacturers rallied after President Trump and the European Union President agreed to hold off on imposing additional tariffs while they discuss a trade deal.

S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, JUNE 2015 THROUGH JULY 2018

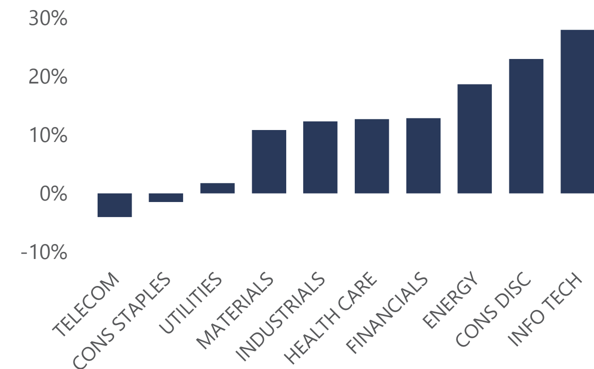


Source: Bloomberg

- Almost two thirds of S&P 500 companies have reported second quarter earnings with year-over-year earnings growth on pace for 24.8%. This would be the first time the S&P 500 experienced two consecutive quarters of earnings growth above 20% since 2011.
- Similar to the first quarter, the strong results are broad based with all sectors except real estate on pace for double-digit earnings growth. This is the first time since 2010 that six sectors are simultaneously experiencing earnings growth above 20%.
- S&P 500 sales growth is on pace for 8.6%. Strength here is also broad based with six sectors simultaneously experiencing sales growth above 10.0% for the first time since 2008.

S&P 500 SECTORS 12-MONTH RETURNS (PRICE)

JULY 2017 THROUGH JULY 2018



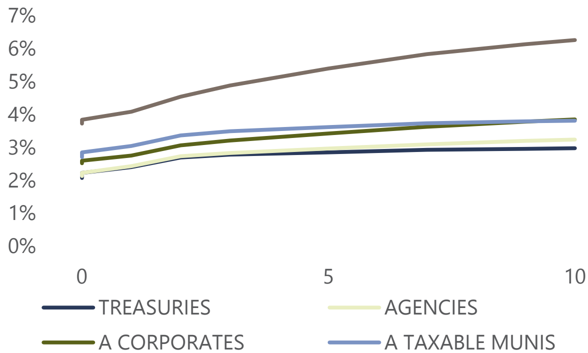
Source: Bloomberg

- The industrials sector rebounded 7.3% last month after declining 3.3% in June partly due to concerns about exposure to tariffs.
- Investors appeared to find some relief in second quarter earnings conference calls where management of several industrial companies said they experienced little impact from tariffs and anticipate little impact in the future.
- The consumer staples sector reversed course to become the best performing sector over the last two months after starting the year off as the worst sector through May. Double-digit earnings growth is helping alleviate concerns about consumer goods companies' business model disruption from private label brands, e-commerce, and shifting consumer preferences.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF JULY 2018

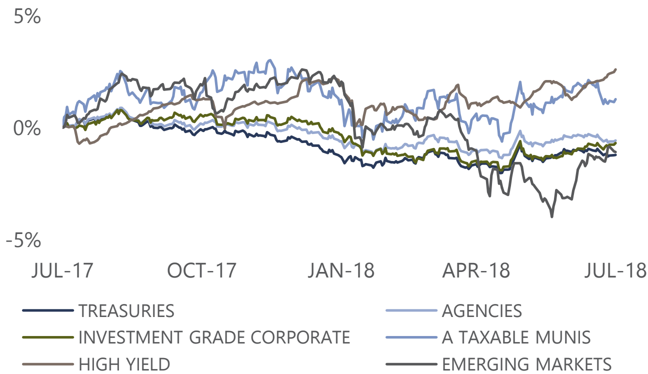


Source: Bloomberg

- The U.S. Treasury yield curve flattened by 0.04% in July, as it spent the first half of the month narrowing, reaching a low point on July 17 after Fed Chairman Jerome Powell reiterated the Fed's plan to hike rates two additional times in 2018.
- The curve flattened to a point where the 10-year Treasury yield was only 24 basis points higher than the 2-year Treasury yield, the narrowest it has been since August 2007.
- Lower market-based inflation expectations looking out several years, along with a stronger dollar, likely helped keep 10-year yields suppressed while the 2-year yield rose 0.14% in July.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

JULY 2017 THROUGH JULY 2018

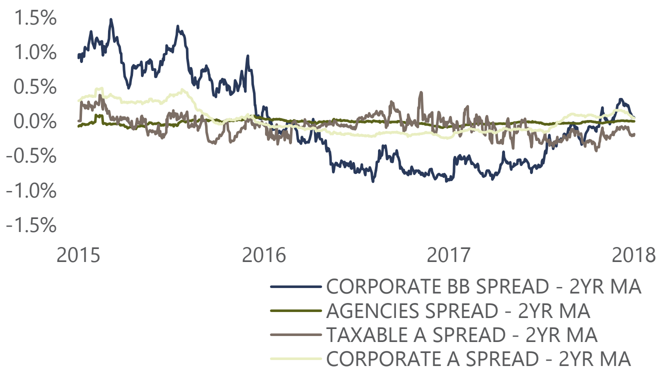


Source: Bloomberg

- High yield corporate bonds and taxable municipal bonds continue to display strength over the rest of the market. In July, high yield corporate bonds substantially separated themselves from taxable municipal bonds as the best performing bond class over the past year with a trailing twelve-month yield of 2.6% compared to taxable municipal bonds at 1.28%.
- U.S. Treasuries, Agencies, Investment Grade corporate bonds and emerging market bonds all have posted negative total returns over the past twelve-month period.
- Emerging market bonds recovered significantly in July. They began the month with a trailing twelve-month total return of -3.19%, but climbed to end July with a -1.09% trailing twelve-month total return.

SPREAD VS. TREASURY LESS 2-YR MOVING AVG

JULY 2015 THROUGH JULY 2018

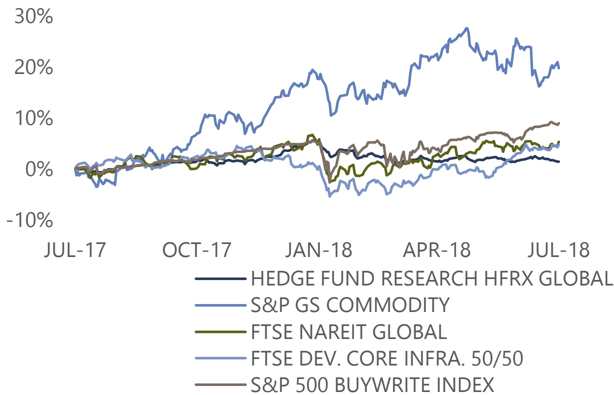


Source: Bloomberg

- Spreads across corporates declined in July as high yield spreads fell 29 basis points and A-rated corporates saw their spreads tighten 11 basis points. While not as snug as the beginning of the year, corporate spreads leave little room for investors to benefit from further compression.
- After hitting their highest levels in a year in the beginning of the month, high yield spreads tightened for the remainder of the month and quickly eliminated whatever modest buying opportunity existed.
- After hitting their widest levels in a year on July 5, spreads on agencies also compressed during the month.

ALTERNATIVES

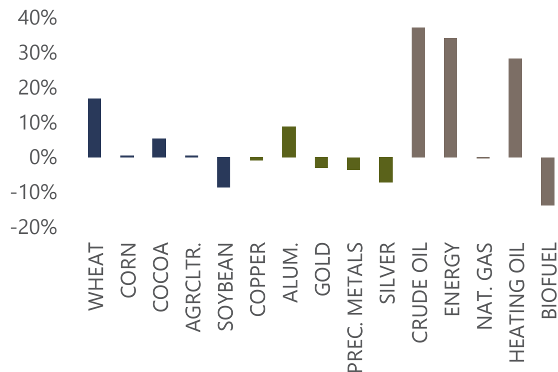
ALTERNATIVES, 12-MONTH RETURNS
JULY 2017 THROUGH JULY 2018



Source: Bloomberg

- Among the five alternative strategy indexes tracked in the chart at left, the broad commodities asset class has been the clear performance leader over the trailing twelve months. Over this period, U.S. crude oil futures prices climbed from roughly $50 per barrel to nearly $70 per barrel.
- Recent weakness in both gold and oil prices led the S&P GSCI Index to suffer a 9.0% drop over a roughly seven-week period from late May to mid-July.
- All five alternative asset class indexes tracked in the chart at left would have provided some benefit to fixed income portfolios in 2018. All five outpaced the Bloomberg Barclays Aggregate Bond Index's -1.6% year-to-date total return through July 31.

COMMODITIES, 12-MONTH SPOT RETURNS
JULY 2017 THROUGH JULY 2018



Source: Bloomberg

- Gold prices have declined nearly 10% since the first half of April against a backdrop of gradual U.S. Federal Reserve interest rate hikes and a strengthening U.S. dollar. Because gold is bought and sold in U.S. dollars, its price typically declines when the greenback strengthens.
- From January 25 to July 31, gold has declined from $1,368 per troy ounce to $1,235. Over this same period, an index that tracks the trade-weighted dollar advanced 5.8% according to Bloomberg.
- On July 25, the Trump administration announced $12 billion of emergency aid to U.S. farmers hurt by European and Chinese tariffs. These farmers include soybean producers, who have been rattled by a 15% decline in soybean prices during June.

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