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Third Quarter Market Commentary 2018

Although there has been an increase in volatility for the first half of 2018, the major market benchmarks are generally unchanged while interest rate sensitive securities are generally down. Moreover, this is not unusual market behavior given a rising interest rate environment and the strong market performance of 2017. The exception has been technology stocks which have continued to perform well riding a wave of increased capital spending by corporate customers. In this market commentary**,** we will comment on the improving economy as well as talk about the current headwinds facing the market including the potential for Federal Reserve miss-calculations, tariffs, and uncertainty around the midterm elections.

Driven by personal and corporate tax cuts, consumer sentiment and corporate earnings have both improved this year. How long this stimulus will last remains a question mark. For now, Fact Set reports that earnings for the 500 largest firms in America grew by 20.7% last quarter, with an equally impressive 8.1% revenue gain. Rebounding energy prices and lower taxes accounted for a bulk of the gains.

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The improving economy has also caused unemployment to drop to near record lows and has caused consumer sentiment to pick up.

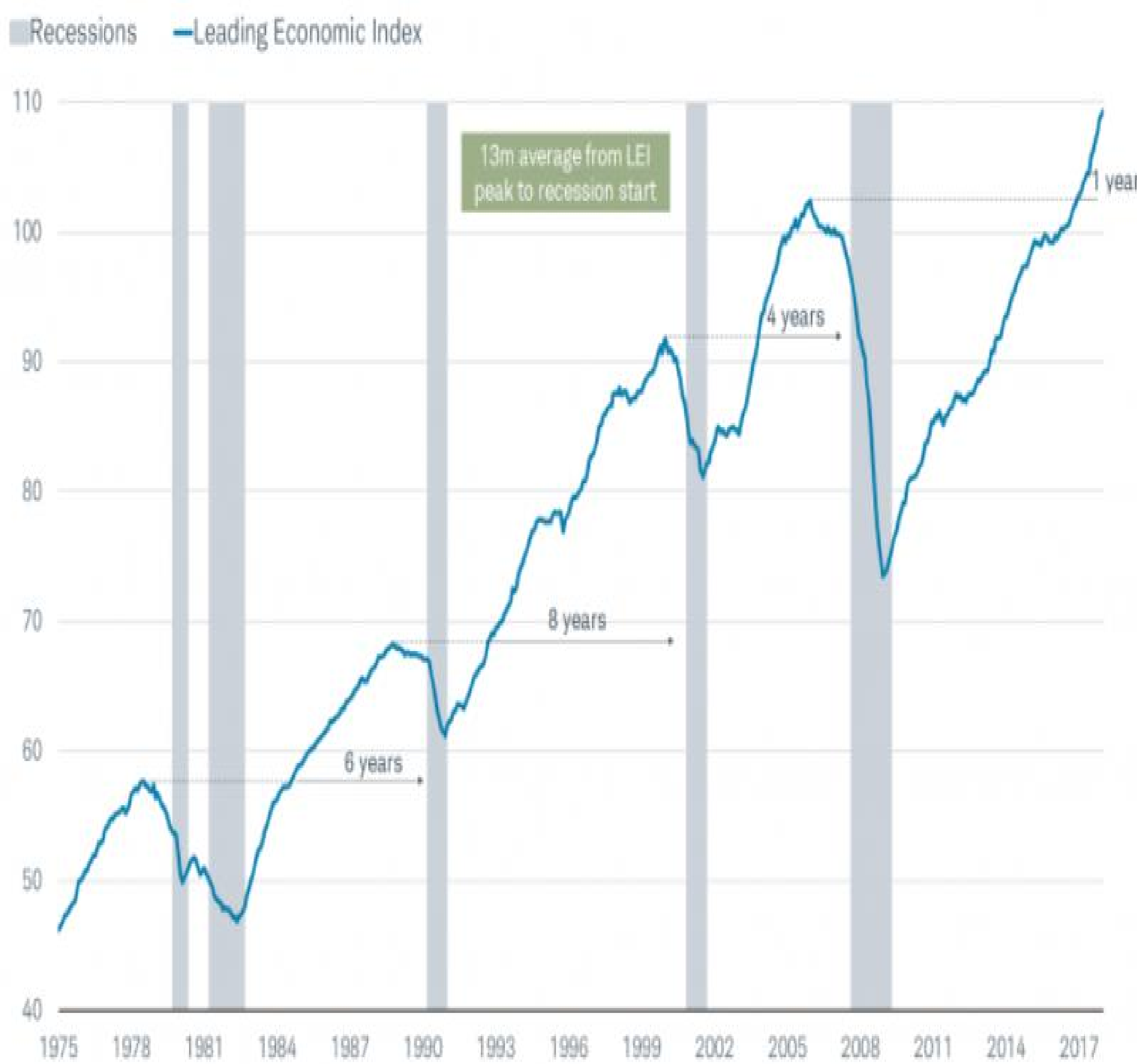
A healthy consumer often points to a healthy economy

Source: Factset. As of June 2018.

What does drive the US economy is the consumer, as consumption makes up about 70% of GDP.[3] Consumer confidence is a key indicator for the health of equity markets; there is a 0.97 correlation between consumer confidence and performance of the S&P 500 Index. Consumer confidence continues to remain solid in the US.

The stronger economic momentum looks like it will continue at least for the near term if history is any guide. The index of Leading Economic Indicators has just hit another new high, and a recession usually does not start until 13 months after the index begins to turn down (see chart below). Moreover, the index only reclaimed its prior highs from before the financial crisis within the last year. This also suggests that the next recession is not imminent.

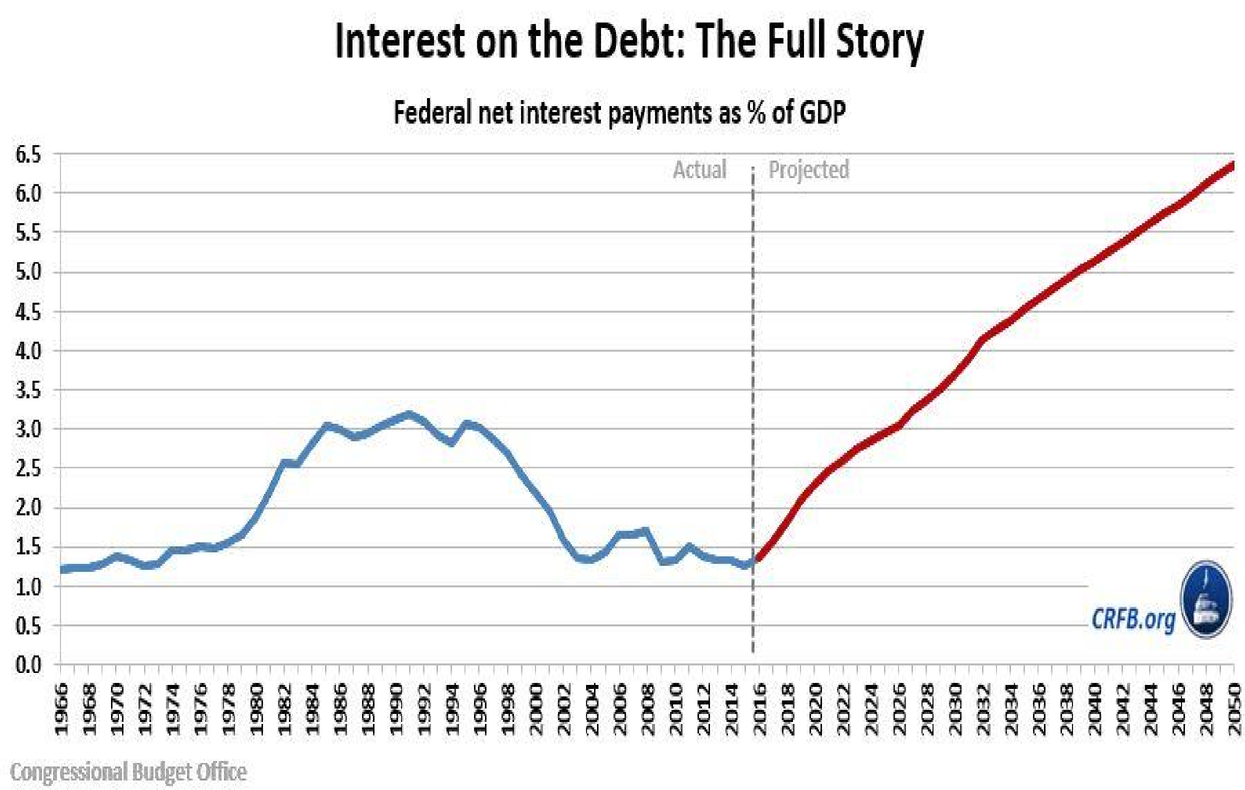
Index of Leading Indicators



Source: Charles Schwab, FactSet, The Conference Board, as of April 30, 2018.

Headwinds- Federal Reserve

Federal Reserve miscalculation remains our biggest concern for the improvement in the U.S. economy. The Federal Reserve has raised rates seven times in the last three years and is projected to raise rates two more times this year. There is no doubt the Fed has a tough job to balance growth while controlling inflation. Since the financial crisis, the Fed has been very dovish in keeping rates low and pumping money into the economy through quantitative easing (expansion of the Fed balance sheet). We believe this was a primary driver of the market rally since the financial crisis. However, the Fed has now changed course and is unwinding their balance sheet- in effect quantitative tightening. The Fed has indicated they are now unwinding their four trillion dollar balance sheet by the rate of sixty billion per month. Moreover, by pushing the short-term interest rates up, the Fed has raised the cost to service the U.S. debt. The U.S. Treasury reports twenty one trillion of U.S. government debt at an average duration of sixty eight months. Since January of 2016, the five year government yield has jumped from 1% to 2.8%. This may not sound like much, but it will add $378 billion in additional interest cost to the U.S. budget deficit. In addition, when this increased interest cost sum is added to the $720 billion run rate the Fed is unwinding from their balance sheet, we believe the biggest risk to the market is the Fed mis-calculating the strength of the U.S. economy and tightening too far too fast.



Headwinds- Tariffs

Another headwind facing the market are tariffs. Most Wall Street analysts are against tariffs and the market has sold off every time a new round of tariffs gets proposed. The question becomes how long and deep will trade wars go, and who is in the best position to win concessions on trade? We believe that the Trump administration will not let up on tariffs until at least after the midterm elections because the U.S. economy is currently strong (thus better able to handle the side effects of tariffs) and because the use of tariffs is polling well in politically important swing states. Moreover, given the large size of the U.S. trade deficit, the current relative economic weakness of our biggest trade partners, and the importance of the U.S. market to the rest of the world, it seems likely that the U.S. will win some concessions on trade.

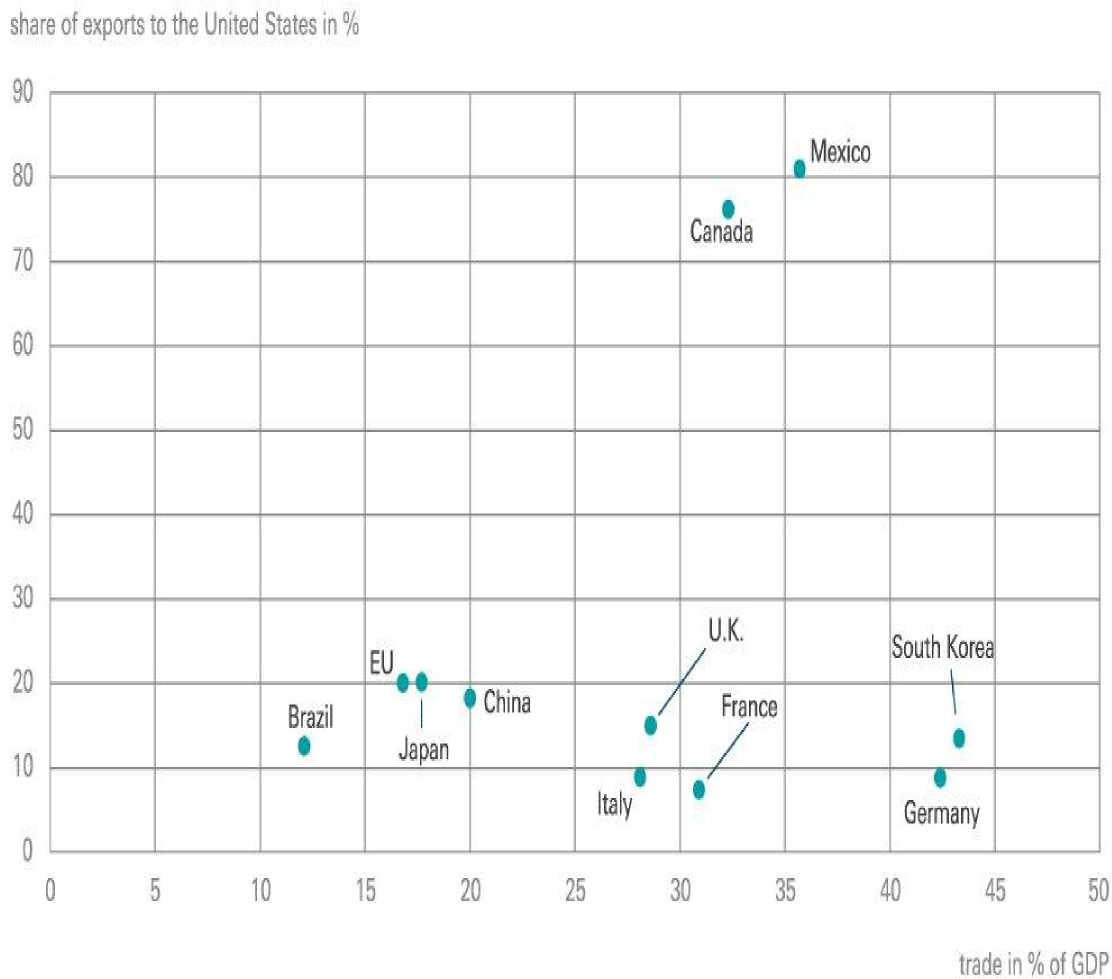
Europe is the largest trading partner of the U.S. with a 65 billion dollar trade deficit with Germany alone. However, Europe is still struggling to recover from the financial crisis and is in a bad position to wage a trade war. According Thompson Reuters, the 12 month earnings per share of U.S. companies is over 50% higher than it was from the 2008 financial crisis while the MSCI European index (a benchmark of the 15 developed European economies) is still almost -15% below where those earnings stood from the 2008 financial crisis. However, some progress is being made. According to the Wall Street Journal, Germanyȏs leading auto makers have thrown their support behind the abolition of all import tariffs for cars between the European Union and the U.S. in an effort to find a peaceful solution to the brewing trade war.

The U.S. currently has a 347 billion dollar trade deficit with China. The Chinese market has fallen into bear market territory (-20% correction) since the announcement of tariffs by the U.S. In fact, the Chinese Central Bank has issued emergency measures to help counter tariffs by the U.S. The U.S. accounts for almost 20% of all Chinese exports and the Chinese have sought to quickly end the dispute by not only offering to buy an additional $60 billion of U.S. made goods, but also by lowering tariffs on U.S. made goods until the dispute is over. The Trump administration has said that this is not enough and is pushing for China to make deeper concessions. Some economists worry that China could dump their vast holdings of U.S. Treasuries (China holds over 1 trillion dollars of U.S. government debt) if a trade war with China gets too serious. We think this is unlikely for several reasons. First, dumping U.S. Treasuries would hurt the monetary value the Chinese have made in buying those Treasuries. Second, dumping U.S. treasuries would cause the value of the dollar to fall (helping U.S. exports) and the value of the Yuan to rise (hurting Chinese exports). Lastly, the Wall Street Journal reported that during the 2008 financial crisis, China did stop buying U.S. Treasuries. According to the Journalôs crunching of the numbers, dollar assets comprised 54% of Beijingôs $3 trillion-plus reserves as of June 30, 2012, down from 74% from the end 2006. During this time, the U.S. Federal Reserve stepped in and became the largest buyer of U.S. debt. So, if China did dump Treasury bills the Federal Reserve could counter their selling by printing money like they did during the financial crisis.

Mexico and Canada have perhaps the most to lose in a trade war. Canada sends over 70% while Mexico sends over 80% of all their exports to the U.S. While Canada has only a small trade surplus with the U.S., Mexico has the most to lose because they have over a 71 billion dollar trade surplus with the U.S. Furthermore, most of the goods made in Mexico are solely for the U.S. market and they would have a tough time selling these products elsewhere. Big changes in U.S. / Mexico trade seem likely given that both Trump and Mexicoôs new president Lopez Obrador believe the North American Free Trade Agreement needs to be rewritten.

Japan also has a big trade surplus with the U.S. The U.S. Commerce Department has launched an investigation into Japanese imported cars and auto parts, the biggest source of friction between the two countries. Our view is that progress will be made with all of our trading partners, but that it will be messy and take longer than the Trump administration expects.

Biggest U.S. Trade Partners and their share of Exports to the U.S.



Source: Deutsche Bank

Headwinds- Midterm Elections

Midterm elections are another head wind we see facing the market. Midterm elections are important because policies could change on taxes, immigration, and regulations. So, many investors are in a wait and see mode. This has created more volatility in the market this year as investors are reluctant to bid prices of companies up to new highs if they are unsure of future policies out of Washington.

Historically, the party in power loses seats at the midterm elections. Even though President Trump's current approval ratings are not as weak as they were in the fall, they are still at a historically low level. Democrats are using this to try to build momentum to retake Congress. Their best chances for doing so are in the House of Representatives, and in especially turning over Republican districts in California.

Republicans hold 14 house districts in California. In seven of those districts Hilary Clinton won the election tally in the last election. So Democrats are hoping to turn those districts in their drive to retake the House of Representatives. However, in the primaries, Republican voter turnout was greater than Democratic turnout in 6 of the 7 contested districts, which suggest that the Democrats may not pick up as many seats as they hope. (Wall Street Journal 6-7-18) Democrats may also have success in former strongholds like Michigan and Wisconsin, which voted for Trump in the last election, but have usually voted Democratic. Michigan has fourteen seats that are up for election, and nine of them are held by Republicans, Wisconsin has eight seats up for election, of which five are currently held by Republicans.

In the Senate, things are different. The politics of the states where senators are up for re-election make these Senate races among the more lopsided in modern history, favoring Republicans. The U.S. Senate has 51 Republicans and 49 Democrats (including two independents). The 2018 Senate election takes place on November 6, 2018. There are 35 seats up in 2018, of which 26 are held by Democrats and nine Republicans. The Democratic Party will need to gain 2 seats to take control and maintain its current holdings.

However, handicappers have pointed out that 10 Democratic Senate incumbents from states carried by Donald Trump would be on the ballot in 2018. That count is accurate, but most Republicans are acknowledging that the list of serious targets is shrinking to five or six states. Indiana, Missouri, West Virginia (think coal miners), North Dakota and Florida are certainly in play (Political ï Roll Call).

So, it seems unlikely the Democrats will retake the Senate, although the House of Representatives is certainly in play. Indeed, on June 18th Goldman Sachs came out with a research report in which they stated that the Republicans had a 75% chance of maintaining control of the Senate, but only a 44% chance of maintaining the House.

Financial markets hate uncertainty. Historically, either way, the stock market tends to rally after midterms, once the uncertainty is gone. According to Strategas Research Partners, the S&P 500 has never declined in the 12 months following midterm elections since 1946. Even better, Strategas observes that the average S&P 500 price return in the 12-month period following midterm elections from 1950 through 2014 has been 15.3%. (Full disclosure: the 12-month returns following the 2010 and 2014 midterm elections averaged about 4%).

In conclusion, we think the markets are in a sideways pattern consolidating their gains from last year. Furthermore, we believe that Federal Reserve monetary policies are the biggest risk in the current market and the Fedôs current level of quantitative tightening and interest rate increases are largely off-setting the positive effects of lower taxes and corporate buy backs. Moreover, investors remain concerned about potential trade wars and the uncertainty of midterm elections. We believe that our trading partners will give into some concessions on trade, but it will not be as quick or easy as the Trump administration expects. Furthermore, we believe the markets will remain range bound until there is greater consensus at what level the Fed will slow or stop their current round of tightening and greater clarity on the outcome of the midterm elections.

As always, we thank you for your continued support. Have a great summer.

Sincerely,

Bill

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