Market & Economic Commentary: Hottest Summer Ever!

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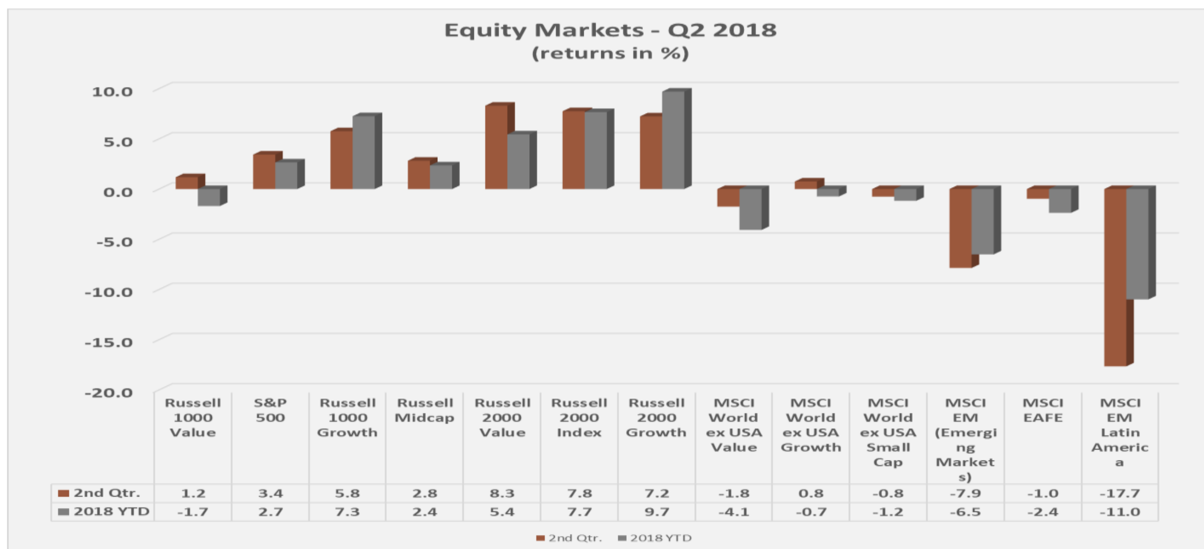
Hottest Summer Ever!

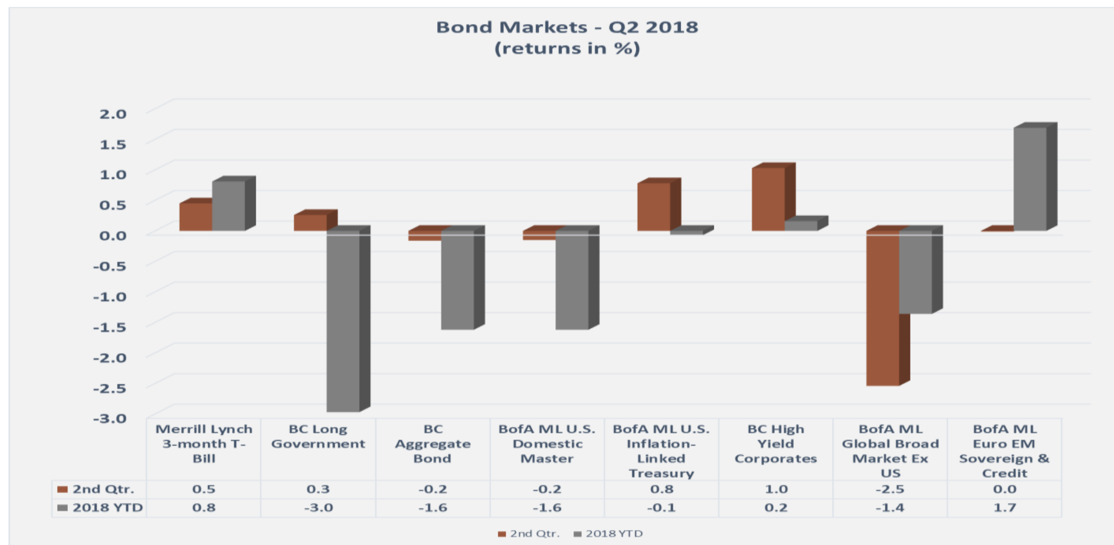
Sure the temperatures might be soaring across most of the U.S., but it's the economy that's really on fire. Every indicator we follow is showing ideal conditions. Jobs are abundant, wages are improving, business is booming, and so far, global trade is steady. Politically, the globe is peaceful - despite the usual rancor in Washington D.C. These rosy conditions led to advances in the U.S. stock markets in Q2, turning indexes positive for 2018. Strength in the U.S. economy also led to a 5% rise in the value of the dollar. This caused most global markets to show declines when measured in dollar-terms. A strong dollar may help buying power for consumers, but in the end, it makes our products more expensive overseas and can have a cooling effect on exports. For now, however, there is no ebb in sight.

How the Markets Fared

After the return to volatility that we experienced in January, trading normalized in the second quarter. Yes, the markets had their ups and downs, but in a narrow range of less than 5%, high to low. The S&P 500 advanced a few points, led again by growth stocks. However, it was U.S. small companies that enjoyed the biggest surge in Q2 with the Russell 2000 better than doubling the performance of the large caps. Here, value sectors edged out growth. The consensus was that smaller capitalization companies would not be as vulnerable to the impacts from trade tariffs and subsequent retaliation as larger, multinational firms. However, these smaller companies surely would benefit from the newly enacted 20% corporate tax rate. Internationally, the story was not as upbeat. With the dollar's advance, most non-U.S. currencies lost ground. Therefore, assets such as international stocks, that are priced in Euros, Yens, and Pounds, etc. appeared to have lost ground from the perspective of a U.S. investor, while developed international markets were virtually unchanged, despite advancing in their own home markets. Emerging markets did not fare as well. With the drums of trade wars beating, Latin America stock markets sold off, as did their currencies, creating a double whammy of double digit losses. Mexico and Argentina both led Latin American stocks down over 17%, completely reversing an outstanding prior year of performance.



	Russell 1000 Value	S&P 500	Russell 1000 Growth	Russell Midcap	Russell 2000 Value	Russell 2000 Index	Russell 2000 Growth	MSCI World ex USA Value	MSCI World ex USA Growth	MSCI World ex USA Small Cap	MSCI EM (Emerging Markets)	MSCI EAFE	MSCI EM Latin America
2nd Qtr.	1.2	3.4	5.8	2.8	8.3	7.8	7.2	-1.8	0.8	-0.8	-7.9	-1.0	-17.7
2018 YTD	-1.7	2.7	7.3	2.4	5.4	7.7	9.7	-4.1	-0.7	-1.2	-6.5	-2.4	-11.0



The fixed income markets were relatively calm during the quarter despite the Federal Reserve raising short-term lending rates another quarter of a percent in June. The yield on the bellwether, 10-year Treasury rose a modest one-tenth of one percent in Q2. Most high quality bonds were virtually unchanged for the quarter. With the continued strength of the economy, credit spreads stayed tight, leading high yield bonds to essentially earn only their coupons. The only real movement in fixed income came from the international debt space. Again, if your asset wasn't priced in dollars, you likely lost money during the second quarter. Developed market debt saw modest declines, emerging markets debt fared even worse for similar reasons to that of EM stocks, with Latin markets seeing the largest erosion of value.

Strong Planks

Strong Planks	*Weak Planks*
Business to Business Activity (ISM)	Labor Costs Rising (Compensation + 2.8% y/y)
Low Unemployment (4%)	Producer Costs Rising (PPI final demand +3.4% y/y)
Wage Growth (nearing 3% / year)	
Advancing Home Prices (+5.25-6.5% w/ tight inventory)	
Consumer Confidence (25 year highs)	
Strong Retail Sales (up 6.2% y/y)	
GDP + 4.1% in Second Quarter	

PIER*ing* Ahead

It doesn't appear that the economic heat of the summer is looking to cool-off much as we head to the fall, at least here in the United State. Earnings for U.S. companies is stronger than ever, with over 80% of S&P 500 companies beating their already higher-revised estimates. Not only are earnings swelling from higher profitability, but top-line revenues are accelerating too, at their highest levels in 7 years. This has helped Price to Earnings Ratios to come back near longer-term averages (16.5 times forward 12-month earnings vs. 16.1 for long-term norms.) We have successfully digested higher short-term interest rates as well as higher mortgage costs without dampening the economy or housing markets. It is hard to imagine a non-geopolitical cause upsetting this momentum any time soon. Internationally, we don't see an early winter for developed market economies either, as business and consumer conditions there continue to be quite favorable. So, if the U.S. is booming and Europe and Japan are expanding, then it is highly unlikely that emerging market economies are going to head into a tailspin (as one might have thought after Q2's selloff). What is likely is that the more dramatic headlines are about tariffs, the more volatility we will see in stock markets and currencies around the globe.

Eventually, either an all-out trade war will end the party (which would be well telegraphed); or, far more likely, a *new-normal* trade environment will be hatched, and the global boom will continue, with all players enjoying the advance. If the latter occurs, it is very difficult for me to see how longer-term interest rates, which are seemingly frozen around 3%, will keep from rising back closer to their historic norms of 4%-5% or more. Baby boomers and terminating pension funds will all be selling their longer-term bonds at the same time, leading to further upward pressure on interest rates. It will be higher rates, and not trade wars, that will likely cause the next recession. But that's just what we can see… Pier*ing* ahead from here.