Investors Trust
Investment and Trust Services

Your Goals. Our Knowledge.

Second Quarter 2018

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Index	6/30/2018	3/31/2018	12/31/2017	Total Return 2018 YTD	Total Return Q2 2018
Dow Jones	24,271.41	24,103.11	24,719.22	-1.8%	0.7%
S&P 500	2,718.37	2,640.87	2,673.61	2.6%	3.4%
Nasdaq	7,510.30	7,063.44	6,903.39	9.4%	6.6%
S&P 400 Midcap	1,951.67	1,878.77	1,900.57	3.5%	4.3%
Russell 2000	1,643.07	1,529.43	1,535.51	7.7%	7.8%
Yield on 10-Year Bond	2.86%	2.74%	2.41%		

Source :FactSet

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Investment Summary

The market activity in the second quarter of 2018 can largely be summed up with one word: trade. When trade tensions appeared to increase, equity markets both in the US and globally typically went down, and when reports of a potential easing in trade tensions surfaced, equity markets typically went up. Ultimately, the S&P 500 posted a modest 3.4% return for the quarter to bring returns for the year back into positive territory, up 2.6%. There is an ongoing debate among investors on whether the current “tough” stance taken by President Trump on trade is merely a negotiating tactic designed to maximize a positive deal for the US with its trading partners, or whether it is a more substantive position that could lead to a decline in trade with an ensuing negative impact on the US economy. Our view favors the former position that it is likely a negotiating tactic, though we acknowledge how unsettling some of the trade rhetoric can be. As a result, we remain constructive on the outlook for the equity markets, noting that corporate earnings growth this year will likely exceed 20% and current expectations for 2019 suggest corporate earnings growth of about 10%. If we see anything close to that growth, then we believe that equity markets should perform well. We also note that equity returns in years with US mid-term elections have historically done very little leading up to the election, then rallied nicely subsequently. There is no guarantee that history repeats itself this year, but given the earnings growth backdrop, we remain optimistic.

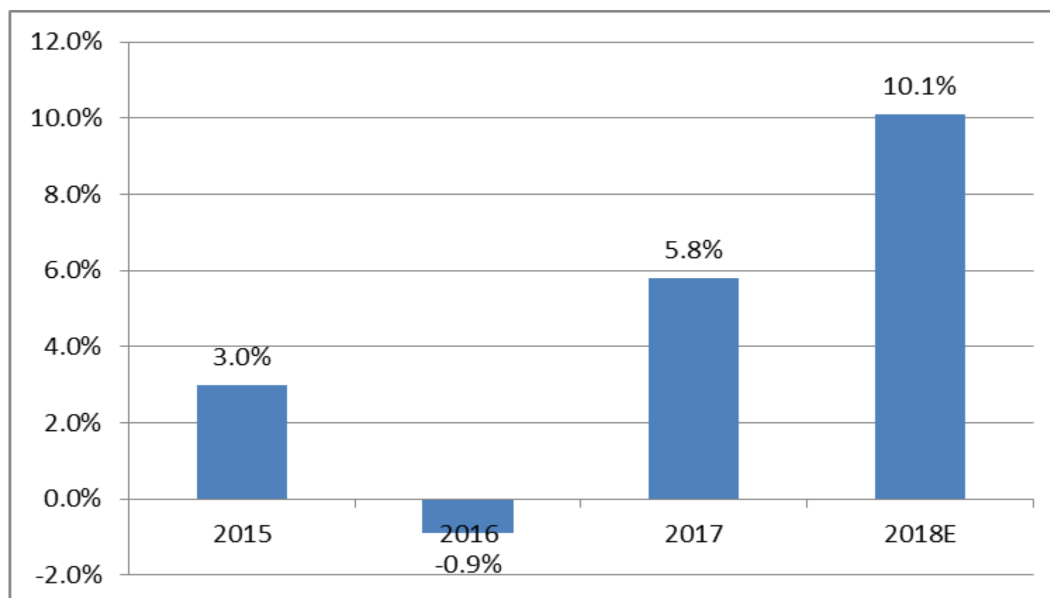
As for the quarter itself, trade issues impacted returns across virtually all asset classes both in the US and abroad. In the US, large-cap stocks (S&P 500) posted relatively modest returns in the quarter despite strong earnings reports, while US small-cap stocks (Russell 2000), which are less impacted by the trade tensions than larger firms, hit all-time highs in the quarter, posting robust returns of almost 8%. Globally, European markets dropped slightly in the quarter, while Asian markets, especially in China, sold off sharply. Emerging markets also came under notable pressure thanks to rising trade concerns.

As for the fixed income markets, interest rates continued to increase in the second quarter, actually hitting the highest levels since 2011 before falling back amid the trade tensions. As expected, the Fed raised the Fed Funds rate by another 0.25% in June due to the strengthening US economy, and the Fed increased its expectation of rate hikes in 2018 to four times from three times. It is possible that the current trade rhetoric could cause the Fed to refrain from a fourth rate hike later this year, especially if it would occur around the mid-term elections. But we continue to expect upward pressure on rates. Our outlook for rates for 2018 remains unchanged, with the yield on the US 10-Year Treasury likely rising to the 3.0 to 3.25% range by yearend.

Economy

Despite the unsettling headlines around trade, the US economy has been accelerating with numerous data points suggesting that strength should continue. Consumer Confidence continues to hover near 20-year highs, both Auto and Home sales remain robust, and the Unemployment Rate sits at a very low 4.0%. US manufacturing activity remains at roughly 14-year highs, while business confidence as measured by the National Federation of Independent Business (NFIB) hit its second highest level in 45 years in May 2018. Encouragingly, corporate capital expenditures (capex), which historically have been a notable indicator of future economic growth, are poised to increase sharply in 2018. That is important, as capex projects are typically long-term in nature that yield long-term results for organizations with many positive domino effects for the economy. Once committed, such spending typically is not cancelled. As seen in Chart 1 below, after a couple of years of relative stagnation, US capex increased by roughly 6% in 2017 and is projected to rise by a strong 10%+ in 2018. In addition, surveys show that corporate plans to accelerate spending on capex have been increasing this year. This should provide a favorable backdrop for US economic growth well into 2019.

Chart 1: US Corporate Capital Expenditures, 2015-2018E



Source: Strategas, Bureau of Economic Analysis

Will the recent trade tensions derail the current favorable economic landscape? We do not believe so, in large part due to the significant fiscal stimulus that has already been set in motion. As of early July, the proposed tariffs are estimated to have a negative impact of approximately $120 billion on the US economy, yet that is overshadowed significantly by the fiscal stimulus of tax cuts (estimated $200 billion positive), increased government spending (estimated $100 billion positive), and corporate repatriation of overseas profits (estimated at $500 billion). The net impact of fiscal stimulus less the tariffs is a net positive of roughly $680 billion. Admittedly, we would prefer that the tariffs were not hurting the fiscal stimulus, but on balance, the positives from fiscal policies are outweighing the negatives from the tariffs.

Equities

After a slight decline in the first quarter, the US equity markets posted modest 3.4% gains in the second quarter, with the S&P 500 now up roughly 2.6% through June. Trade rhetoric from President Trump, our allies, and China escalated in the quarter, with proposals for the imposition of tariffs by the US on selected foreign goods and a commensurate retaliation response from other nations. Importantly, while much has been "proposed," only about $34 billion in actual tariffs have been implemented, which is relatively immaterial to US trade. No matter, the fear of a broader trade war between the US and its trading partners heavily influenced equity market returns in the quarter both in the US and globally. Specifically, areas and asset classes less impacted by trade concerns generally performed the best while those areas and asset classes most impacted by trade concerns generally performed the worst. As shown in Chart 2 below, China was among the worst performing areas in the second quarter, as China exports roughly 5x more to the US than the US exports to China and, therefore, would likely be hurt worse. At the same time, US small-cap stocks performed exceptionally well in the quarter, as this asset class is more US domestically focused and generally less exposed to trade issues.

Chart 2: Selected Equity Asset Class Returns (based on common indices)

	Total Returns	
Asset Class	**Q2 2018**	**Year-to-Date**
US Large Cap	3.4%	2.6%
US Small Cap	7.8%	7.7%
Europe	-1.2%	-1.9%
China	-15.7%	-15.7%
Hong Kong	-4.2%	-2.8%
Emerging Markets	-7.9%	-6.5%

Source: Greenhill, FactSet

With so much media attention and short-term market focus on the trade issues, it is easy to lose sight of the ultimate driver of stock prices – corporate earnings growth. The outlook for corporate earnings has actually improved following the strength of first quarter results, with growth expectations for 2018 now exceeding 21%. At the same time, current expectations for 2019 earnings growth sit at roughly 10%. While the recent reduction in the corporate tax rate has certainly elevated 2018's growth prospects, revenue growth expectations have also accelerated (now forecast to be up about 7.5%) to the best levels since 2011. This suggests an underlying strength for companies as demand for their products and services has picked up.

In light of this backdrop, we remain optimistic about returns for US equity markets for the balance of the year. As we have noted in the past, there are always several headline-grabbing issues that could impact market returns over a relatively short period of time. In addition to the trade issues, there are mid-term elections in the US in November, interest rates have been increasing, and there remains risk of an unexpected inflation spike. Despite these issues, we encourage investors to remain focused on the outlook for corporate earnings growth.

Fixed Income

Interest rates continued to move higher in the second quarter, with the yield on the US 10-Year Treasury closing the quarter at 2.86% compared to 2.74% at the end of the first quarter and 2.41% to start the year. In fact, the improving US economy combined with growing concerns about potential inflation led to the highest level of interest rates in the quarter since 2011, with the US 10-Year Treasury topping 3.1% before falling as the trade rhetoric between the US and its allies grew louder. As Chart 3 below depicts, interest rates have been on a slow-and-steady move higher over the past two years, and we continue to expect upward pressure thanks to the strength of the US economy. Indeed, the Federal Reserve raised the Fed Funds rate by another 0.25% in June (expected) and increased its expectations of raising rates to a total of four times in 2018, up from prior expectations of three times.

There is growing discussion in the market about the potential negative implications for "an inverted yield curve." An inverted yield curve occurs when rates on 2-year bonds are higher than rates on 10-year bonds. While rates on 10-year bonds have been increasing, the rates on 2-year bonds have risen at a faster pace. The "concern" is that every US recession has been preceded by an inverted yield curve, so if the yield curve does indeed invert, will that suggest a pending US recession? We do not believe so based on the ongoing strength in economic data. There have been many inverted yield curves in which a recession did not follow, and there are currently no signs of recession in the economic data.

Based on the underlying strength in the US economy, our expectation remains that the yield on the US 10-Year Treasury should close the year between 3.0% and 3.25%. Admittedly, any meaningful escalation in trade tensions could result in a ceiling, if not outright downward pressure, on interest rates. In addition, there is a practical issue around the timing of the fourth Fed rate hike, which could occur around the time of the US mid-term elections. Historically, the Fed has chosen to avoid moves in rates around election periods so as not to appear to be influencing the election outcome. We'll see how this unfolds. Longer-term, we continue to believe rates should trend higher, so we continue to position bond portfolios with relatively short durations, where possible.

Chart 3: Yields on US 10-Year Treasuries, July 1, 2016 – June 30, 2018

Source: FactSet