



## QUARTERLY UPDATE & ECONOMIC COMMENTARY—JUNE 30, 2018

### QUARTER IN REVIEW

The broad domestic markets had a good second quarter. Most broad U.S. indices finished the quarter in positive territory and are now positive year-to-date. The S&P 500 returned 3.43 percent during the quarter but was outdone by the smaller capitalization stocks; the S&P Small-Cap 600 returned a whopping 9.39 percent. The energy sector was the top performing S&P 500 sector, returning 13.48 percent during the quarter, followed by Consumer Discretionary (8.17 percent) and Information Technology (7.09 percent). The biggest detractors were Industrials (-3.18 percent) and Financials (-3.16 percent). International markets did not fare as well. The large cap developed markets index lost 1.24 percent

and the emerging market index lost 7.96 percent; both indexes are negative year-to-date. International developed leaders for the quarter were Norway, returning 5.99 percent, and Israel which gained 5.75 percent; the biggest laggards came from Austria, down 8.43 percent, Singapore, down 7.46 percent and Italy which fell by 6.85 percent. It was much harder to find winners in the emerging markets, Qatar gained 4.25 percent and Columbia gained 1.95 percent. Brazil and Turkey both fell by over 25 percent and Thailand lost 14.98 percent.

Intermediate and long-term bonds traded slightly lower during the quarter, while some shorter duration bonds managed a modest increase. Bond performance was hindered by the increase in interest rates. Lower quality bonds had

a good quarter, finishing positive by 1.03 percent. The second quarter saw the U.S. dollar strengthen against most other foreign currencies. The move in the dollar caused a decline in many international bonds that were being held in local currency.

The price of oil was a big mover in the commodity markets. Oil prices jumped over 14 percent. Another big mover was wheat, which increased by 11.14 percent. Commodities that moved lower include, Soybeans (-15.77 percent), Corn (-7.29 percent) and Gold (-5.48 percent). Some of the big movers in commodities were a result of the trade discussions between the U.S. and many other foreign countries.

In terms of equity fundamentals, the second quarter started off well with a stellar earnings

season. According to FactSet, the first quarter earnings growth rate for the S&P 500 was 24.8 percent, which represented the largest increase since Q3 2010. The earnings growth rate has been in the double-digits for the last three quarters. The biggest contributor to the exceptional earnings growth was the new tax reform that went into effect on January 1st, 2018. In addition to the tax benefits, the strong economy contributed to earnings, with revenues for companies in the S&P 500 growing at a rate of 8.5 percent.

There are also a number of encouraging signs from consumers as well. The unemployment rate has fallen to 3.8 percent. Wage growth is still not growing at levels that are consistent with a 3.8 percent unemployment rate, but wages are trending upward. The household net worth index is at all-time highs, mortgage rates remain relatively low and the household debt service ratio remains low compared to the historical standard.

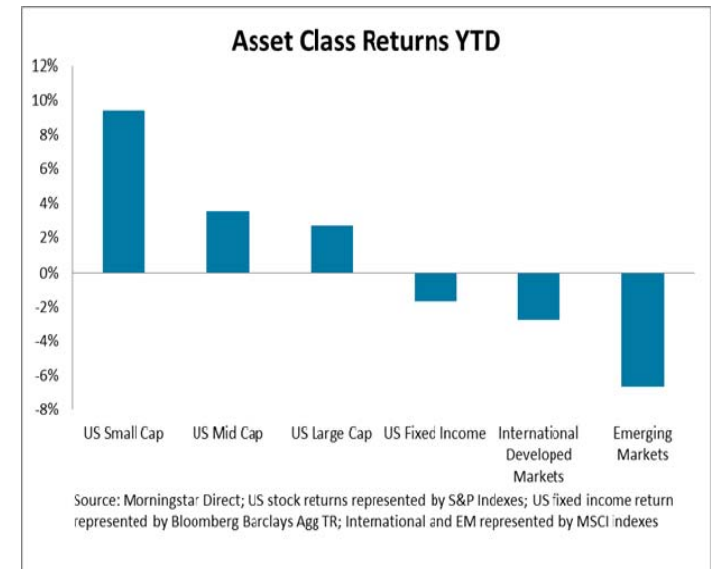
Typical drivers of interest rate movements include the Federal Reserve, inflation indicators and prospects for economic growth. With the Federal Reserve raising interest rates, inflation measures rising and economic growth steadily above two percent, you would expect to see interest rates moving higher. However, another factor, the Italian election and concern over Italy trying to leave the Euro, caused a flight to safety and kept longer term rates stable. As the Fed increased rates again in June, the short-end of the yield curve (two-year treasury) moved higher by 25 basis points while longer maturity bonds (ten-year

treasury) only increased by 11 basis points resulting in a flatter yield curve. The often watched 2/10 spread between both yields tightened to about 32 basis points. An inverted yield curve is often looked at as an early indicator of an upcoming recession.

Despite such a strong fundamental backdrop, the return of risk assets like stocks was relatively mundane. A main contributor to the performance was the growing risk of a trade war that President Trump initiated with just about every country with whom we have a strong trade relationship. The countries include Canada, Mexico, the European Union and China. The President wants more and better paying jobs for Americans, which may be good for wages but bad for the price of goods. Any tariff threats the President made were followed by retaliation from impacted countries. Neither side seems like they want to back down from the topic but given the high stakes, we do not expect this issue to turn into a full-fledged trade war. A full blown trade war would not be good—costs would increase at a faster pace than wages, resulting in less consumer purchasing power. Given the low unemployment rate and the good jobs that can't be filled because of lack of skill, we are not even sure if any jobs are brought back to the U.S. that they can be filled any time soon.

Another anti-establishment political confrontation, this time in Italy, caused a market sell-off in May. Concerns in Italy, which had been

struggling for months to form a new government, grew when Italy's President refused to allow the appointment of a euro-skeptic to head the finance ministry. Should the already fragile agreement have fallen through, an election would most likely have been scheduled for later this year and looked at as a de facto referendum on whether Italy should leave the European Union. Fortunately an agreement was reached for now but the fragility of the government remains. Even without the concerns in Italy, Europe's economy is showing signs of slowing and the European Central Bank is preparing to end their version of quantitative easing and begin hiking interest rates in 2019.



Overall, Emerging Markets had the most difficult quarter. The concerns around trade have had a negative impact on the emerging markets. Additionally, the stronger U.S. dollar has hurt

those countries that have external funding needs and have debt denominated in U.S. dollars.

The Organization of Petroleum Exporting Countries (OPEC) held a meeting in June and agreed to marginally increase production. As oil prices have increased throughout the year, driven by falling inventories, President Trump has called for more production to lower prices. OPEC's announcement did not appear to go far enough and oil prices moved higher since the decision.

## A LOOK AT THE NUMBERS

Name	Second Quarter Performance (%)	YTD Performance (%)
DJ Industrial Average TR USD	1.26	-0.73
S&P 500 TR USD	3.43	2.65
S&P MidCap 400 TR	4.29	3.49
S&P SmallCap 600 TR USD	8.77	9.39
NASDAQ Composite TR USD	6.61	9.37
MSCI EAFE NR USD	-1.24	-2.75
BBgBarc US Agg Bond TR USD	-0.16	-1.62
Wilshire US REIT TR USD	9.73	1.52
IA SBBI US 30 Day TBill TR USD	0.42	0.76

## FORECAST IN BRIEF

With some of the tariffs expected to go into effect in July, we should gain some clarity on whether or not President Trump or leaders of other countries will negotiate or adhere to their trade threats. This uncertainty is one of the biggest

contributors to the lackluster market performance through the first half of the year and is a threat to U.S. and global economic growth. Nobody likes or wants trade wars but the economic impact may be a little exaggerated. The trade issue creates a change from the status quo and creates uncertainty, which is bad for the markets. The talking heads on television are incentivized to create concern so people will tune in to watch. Undoubtedly, certain sectors like manufacturing and some multinational companies will be impacted significantly but some other areas of the market may benefit. It is also important to remember that many of the impacted companies received a major tax cut earlier this year; the trade war may reduce the overall benefit of the tax cuts, but not so much that the net effect of tariffs and tax cuts is negative.

We expect to see very good corporate earnings this quarter. FactSet estimates earnings growth for the S&P 500 to be 20 percent, which would mark the second highest quarter (only to Q1 2018) since Q3 2010. In another bullish sign, earnings for the second quarter have been revised upward through the quarter; the normal pattern is a decrease in earnings estimates. In addition to strong earnings, FactSet also reports that expected revenue growth will be 8.8 percent. Through the rest of the year, analysts predict double digit growth, 21.7 percent for Q3 and 17.8 percent for Q4. Earnings growth for the entire 2018 calendar year is expected to be 20 percent.

The U.S. economy is expected to have had strong economic growth for the second

quarter. As of July 2, the Atlanta Fed estimates GDP growth of 4.1 percent; the Atlanta Fed historical estimates are high, but Wall Street analysts expect around 3.8 percent GDP growth. In addition to strong economic growth, we also expect to see a strong employment picture. It would not be surprising to see business indicators like inventory orders and sentiment to be light as a result of uncertainty from trade discussions.

The Fed will meet twice during the third quarter plus the Jackson Hole Symposium in late August. The Fed is expected to announce another rate hike during the September meeting. We believe it will be important to watch the minutes that are released as well as any press conferences or speeches given by committee members. There are growing expectations for an additional hike in December, which would be four rate hikes for 2018. With the Fed pushing the short-end of the yield curve higher but the 10-year and beyond not moving as much, the concerns of the Fed inducing an inverted yield curve are growing. Previous statements have not shown a concern of the inverted yield curve but as it becomes tighter we will want to see if the strategy or talking points change. The Fed seems to believe "run-away" inflation is a bigger risk than an inverted yield curve. An inverted yield curve does not equate to an immediate recession but it is an indicator worth monitoring.

Fixed income markets will continue to see headwinds if interest rates increase. The Bloomberg Barclays Agg will likely not finish 2018 in positive territory. Even though the index's inter-

est payments will contribute about 1.5 percent through the second half of the year, the index is already down 1.62 percent year-to-date. Bond math suggests that unless interest rates come down a bit between now and December 31, the income won't be enough to erase the price decline. Shorter duration bonds have a better chance of finishing the year positive, but not by much.

**T**he strong dollar was a big story during the second quarter. Over the short-term, we expect to see a continued stronger dollar. Relative to other developed economies, the U.S. has one of the strongest economies, the highest interest rates and strong future prospects, all bullish indicators for the dollar to stay strong. Some factors that might cause the dollar to weaken could include isolationist-related headlines like tariffs that would reduce the demand for dollars or dovish talk by the Federal Reserve.

**T**he sell-off in emerging markets during the second quarter resulted in potential opportunities. The biggest threat is probably a much stronger dollar which is possible but we don't expect to see a significant move stronger in the short-term. Another sector of the market that suffered during the second quarter but we believe could be an opportunity is the financial sector. The flattening yield curve during the quarter put pressure on bank stocks. Despite the move in the yield curve, banks are healthy with many increasing shareholder returns, either through buybacks or dividends, and consumers are healthy and have a need for lending. If the yield curve continues to flatten it

will not be good for financials, but any stability or growth in longer term rates could result in good returns for financials and bank, in particular.

**M**any of the same themes that have caused volatility during the first half of 2018 will continue to do so during the second half. While concerns around interest rates, trade wars and political drama are important issues that warrant your attention, it's important to maintain a measured view of developments against the daily crescendo put in front of the public by the media, financial and otherwise. As we enter the second half of the year, as always, reflect on the amount of risk in your portfolio and whether it is appropriate in light of your goals.

**I**f anything has changed with your financial picture that may affect your investment strategy, please let us know so we can make any necessary changes.

**— Robert Moyer, CFA, CFP®, CAIA  
Director of Research**

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