Second Quarter - 2018

Market Commentary

The theme of the return of volatility carried over from the first quarter into the second as geopolitical and economic events grabbed the headlines. The Fed continued its slow but steady push toward higher rates as the economy continued to show strength especially in the labor pool. Though the summer months at one point may have been a time for markets to catch their collective breath, it seems unlikely that 2018 will fit that narrative as investors attempt to further gains or minimize exposure to whatever hazards lie ahead.

Economic & Political Overview

The Federal Reserve met last month and raised its benchmark interest rate for the second time this year. It also communicated that it foresees four rate hikes this year, up from the three it had previously forecast. Culling from the dot plot, the central bank's new median forecast projects the benchmark rate at 3.1% by the end of 2019. That is up from 2.9% relayed in the previous forecast released in March. For 2020, the Fed median is likely to be 3.4%.

These predictions are based on a belief that the U.S. economy will be stronger this year—2.8% growth vs. the 2.7% predicted at the end of the first quarter. Fueling this growth is a national unemployment rate that is anticipated to be 3.6% by the end of this year. In May, the unemployment rate fell to an 18-year low of 3.8% so the Fed believes this momentum will continue. If they are correct, that number will drop to 3.5% by the end of next year—a number not seen in the last 49 years. The current expansion is the second-longest ever. If national gross domestic product continues to grow past June 2019, it would surpass the record set from March 1991-March 2001.

This thrust is why the Fed has been moving its rate higher and might shift it into a higher gear. It only raised rates once in 2015 and 2016 before doing it three times last year. It could break 2017's mark if it does it twice more before December of this year. With a potential record-setting expansion in place and a federal funds rate over 3% by 2020, the question focuses back on the dual mandate. Since 1977, the Fed has operated under a decree from Congress to "promote effectively the goals of maximum employment, stable prices, and moderate long term interest rates" as dictated in the Federal Reserve Reform Act which modified the original Act passed in 1913 and made explicit its objectives. Thus, the "dual mandate" is actually three but the long-term interest rate objective is often not discussed or focused upon. Much debate and discussion has focused upon what is the threshold for meeting these aims.

After the latest Federal Open Market Committee meeting, Federal Reserve Chairman Jerome Powell stated: "No one really knows with certainty what the level of the natural rate of unemployment is." Though not exactly a shocking statement given its historical uncertainty, it is attention-getting nonetheless. It is a crucial input because the Fed has little to no control over it. Congress can pump funds into various states and cities via fiscal policy. Governors and mayors can start job drives or influence pay via the minimum wage. In these cases and more, the Fed is in reaction mode. And its response to how the job market is doing determines how much inflation is likely to occur. That helps determine monetary policy where the Fed can set any target, currently 2%, as its bullseye and implement tools, policy or jawboning to reach it.

Soon Powell & Co. will reach the neutral level of rates—the level that neither fuels nor slows growth. Move past it and the job market could get choked off if the labor market is not overheating. On the other hand, if the economy is well past full employment, a too slow pace will risk inflation spiraling. That is why Powell added: "The fact that we live in that uncertainty is why we've been gradually raising rates. We're not waiting for inflation to show up, we're going ahead and moving gradually and trying to navigate between two risks really."

With the longer-run natural rate of unemployment at 4.5% according to the Fed's official estimate, we seem to be running on the hotter side. Even before Powell's term, previous heads of the Fed said that they were willing to let inflation go past the 2% level—a type of balanced policy where close is ok as long as it is not too far away from target. The latest forecast has inflation rising but not climbing above 2.1% over the next three years according to median estimates. What the Fed wants to avoid at all cost is raising interest rates to actually create unemployment. Theoretically, that is one way to accomplish their dual mandate—by bringing up the current level. Or they could lower their longer-run natural rate assumption. But that is tricky because as Powell states, "It's not one of those variables that moves around a lot," because it is influenced by factors like educational advancement, occupational mobility and the participation rate of certain groups in the labor force. The bottom line is that the Fed's job, even in a strong economy, has not become any easier, and an argument can be made that now is the time when its decisions have the most bearing on future outcomes.

How will the latest trade tariff tiffs affect this thinking? It cannot be a good thing when the globe's two largest economies ratchet up tit-for-tat trade war rhetoric. It was only three months ago in which we wrote: "Deficits are, by and large, not a function of trade policy. Trade deficits exists because foreign countries create and export things the U.S. wants and makes them at a cost that is more efficient than what can be done domestically. A tariff does nothing but raise the cost for everyone in the form of a tax that eventually hits innocent bystanders because companies need to make a profit." Yet, in that time period things have only become worse with $50 billion of U.S. tariffs issued last month against Chinese goods with China retaliating with $50 billion tariffs of their own. President Trump promised another 10% round of levies on $200 billion of goods with an option to add a further $200 billion on top of that.

Let's try to get to the bottom of the tit-for-tat with hard numbers. In 2017, the U.S. imported $505 billion of Chinese goods and exported $130 billion. Thus, the U.S. can go much deeper in terms of tolls than can China. However, the majority of that $505 billion is made up of consumer goods. Much of the 1,102 items on the U.S. tariff list, conversely, are raw and intermediate goods like lubricating oils, vapor turbines and electromechanical tools. Not sure if too many Americans are going to know if the price of pulley tackles have risen. Yet, today's shopper at Wal-Mart and Costco and Sears will certainly know if footwear, toys, furniture, computers and mobile phone prices start heading higher. Trump cannot get another $200 billion, let alone $400 billion in total, from backhoes and metal-rolling mills. How many members of Congress want to head to the polls in November with a rise in the cost of living and decline in farm exports facing their electorates square in the face? We would guess none. Job numbers are rising for sure, but rising interest rates coupled with a higher price for a pair of Nikes means that, at some point, somebody blinks.

We compare it to the Soviet premier Nikita Khrushchev "We will bury you" moment. Definitely scary when he said it just a little over a decade removed from World War II. Yet, the backward logic of mutual assured destruction dominated Cold War politics for decades before communism imploded. There are sure to be "casualties" during this potential trade war, but we do not believe that a doomsday scenario is in order simply

because nobody wins on this path. In fact, we are more concerned with our relationship with current allies. The latest G-7 summit in Canada ended with Trump leaving early calling Canadian Prime Minister Justin Trudeau "very dishonest & weak." He also called for inviting Russia back to the coalition after they were expelled due to actions in Crimea. The fear is that allies, at some point fed up with hostile treatment from so-called friends, will no longer look to the U.S. for partnerships and protection—both politically and militarily. America has been front and center at building and maintaining post-World War II coalitions in order to prevent another global catastrophe and also export American interests and influence around the world. A major reorientation of allies would be extremely negative for U.S. business. We are hoping that the current administration realizes, before it's too late, that short-term pain for long-term gain is preferable. Stay tuned.

Market Review & Outlook

Even with all the volatility during the quarter, the tech-heavy Nasdaq composite index was able to achieve all-time records during the month. The S&P 500 and Dow Jones Industrial Average were not so fortunate, however, with each of their respective all-time closing highs reached in January. For the quarter, the S&P 500 returned 2.9%, the Dow nudged higher by 0.7%. The Nasdaq's return was 6.3% fueled by gains in high momentum stocks like Netflix, Amazon and Facebook.

After a bright start, the wind has come out of the sails of international bourses. In local currency terms, year-to-date the German DAX and Spain's IBEX are both lower while France's CAC 40 has moved only modestly into the positive camp. Further east, investors are also finding challenging conditions. Japan's Nikkei and China's CSI 300 indices are both lower. Clearly the talk of trade tariffs has put a pall on trading since the start of the year. In addition, talk of central banks removing the accommodative monetary policy environment is giving pause to investing long term.

After witnessing the first quarterly equity loss as measured by the S&P 500 in over two years at the end of March, investors should be somewhat encouraged by how the second quarter fared even with the negative idiom. The full effect of the tax cuts are now being seen in company reports and starting to get incorporated into earnings guidance. Top line sales figures remain solid as the feedback loop of stronger employment leading to higher confidence leading to higher spending begins to take hold. First quarter gross domestic product was 2.8%. Expectations for second quarter growth are close to 4% according to the latest GDPNow report conducted by the Federal Reserve Bank of Atlanta which would be the strongest data point since the fourth quarter of 2003.

These facts have supported the markets, though the climate around equities is not the jubilant milieu that existed at the end of last year. Investors are increasingly worried about when and how this run ends. The yield curve has been an accurate predictor of economic activity and stock market direction. As the curve flattens, that is, as yields on short-term and long-term rates get closer together, the interpretation is that future growth is not likely to be as strong. This is no guarantee, but every recession since 1950 has been proceeded by an inversion in the curve whereby short-term rates actually exceed long-term yields. We are not at that point yet but the difference between the 10-year Treasury bond and 2-year Treasury note has fallen from around 78 basis points (0.78%) in

February to about 35 basis points currently. If the Fed keeps raising rates, it is possible such an inversion could occur by sometime next year.

It should be emphasized that this does not mean that stocks will suffer the type of sharp, painful declines we saw in the six months after the Lehman Brothers failure in 2008. That memory still remains fresh in the minds of investors, but the entire financial crisis of that period is more likely a once-in-a-generation event. What made that time so pernicious was that neither central bankers, nor Congress nor Wall Street had seen such a confluence of events—overleveraged companies and individuals coupled with the disappearance of longstanding financial institutions. That toxic mix was melded with elected representatives who bungled their fiscal responsibilities and were unable or unwilling to forge an acceptable solution quickly. Thus, the next recession and bear market are never going to be welcomed with open arms, but it is unlikely they will be to such a degree that they will call into question the very foundation of our financial institutions.

Our emphasis on balanced portfolios enable us to not only weather volatility but also generate steady streams of income through a variety of markets. Our portfolio dividend yield exceeds that of the S&P 500 and each quarter we receive a stream of income from our various companies that is a real return on our investment. Though they are not a legal obligation to pay like bonds, companies are loath to reduce or eliminate a dividend because it sends a highly negative signal to investors about future cash flows. Fixed income securities oftentimes gain in value on those days when stocks decline as investors seek the safety of a bi-annual payment versus the uncertainty of net income streams. The key is investing in high credit quality names where we can count on getting paid once the obligation matures. And should corporate balance sheets deteriorate, bondholders are the first in line to receive funds. For municipal borrowers, we can rely upon the full taxing authority of the issuer as many of our investments are classified as general obligation securities. Though bond prices do move in the opposite direction of interest rates, if the bond is not sold before maturity, its yield is locked in at the time of purchase rendering subsequent rate moves basically moot. Plus, when the maturity date does arrive, as rates increase, that gives us the ability to reinvest and lock-in higher yields.

We believe our two latest investments in Visa Inc. and Walgreens Boots were timely purchases that will result in an attractive return versus comparably risky investments over our holding period. Client portfolios will have more exposure to the consumer staples and consumer financials sectors as a result and less toward health care and technology due to SGK Core divestitures. Our investment process is based on bottom-up analysis so at any given time we may be over- or underweight a particular sector. The goal is long-term outperformance and meeting client objectives rather than beating a particular benchmark over one short-term time period. We understand that investing involves risks and we try to insulate portfolios as much as we can. As we have said before and will say again, it is impossible to be right all the time, but our goal is aim for value-enhancement over time. We relish the opportunity to be a guardian of client assets through the second half of 2018 and beyond.

If you would like to schedule a meeting with SGK, please contact Lisa Martin at 703-777-8826 or lisa@sgkwealthadvisors.com

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