Observations and Outlook

July 5, 2018

Selected Index Returns Year to Date/ 2nd Quarter Returns

Dow Jones Industrials -.73%/1.26% S&P 500 2.65/%/3.43% MSCI Europe -3.23%/-1.27%

Small Cap (Russell 2000) 7.66%/7.75% Emerging Mkts -7.68%/-8.66% High Yld Bonds .08%/1.0%

US Aggregate Bond -1.7%/-.17% US Treasury 20+Yr -2.66%/.07% Commodity (S&P GSCI) 5.47%/4.09%

The second quarter ended with a sharp decline from the mid-June highs, with US stock indexes retreating about 4.5% and ex-U. S markets losing upwards of 6%. This pulled year-to-date returns back close to zero in the broad stock market indexes. The only areas doing well on a year to date basis are US small cap and the technology sector. Equity **markets outside the US are in the red** year to date languishing under the burden of a **strengthening US Dollar** and the constant threat of a tit-for-tat **Trade War**. Areas of the market with exposure to global trade (US large cap, emerging markets, eurozone stocks) have had marginal performances while areas perceived to be somewhat immune to concerns about a Trade War have fared better.

Additionally, the bond market **has only recently seen a slight reprieve** as interest rates have eased as economic data has consistently come in below expectations—still expanding, but not expanding more rapidly. Job creation, wage growth, and GDP growth all continue to expand but only at a similar pace that we have seen over the past several years. The stronger US Dollar has wreaked havoc on emerging market bond indexes have fallen by more than 12% year to date. And in the U.S., investment grade bond prices have fallen by more than 5% year to date, hit by a double whammy of higher interest rates and a widening credit spread (risk of default vs. US treasuries) has edged up.

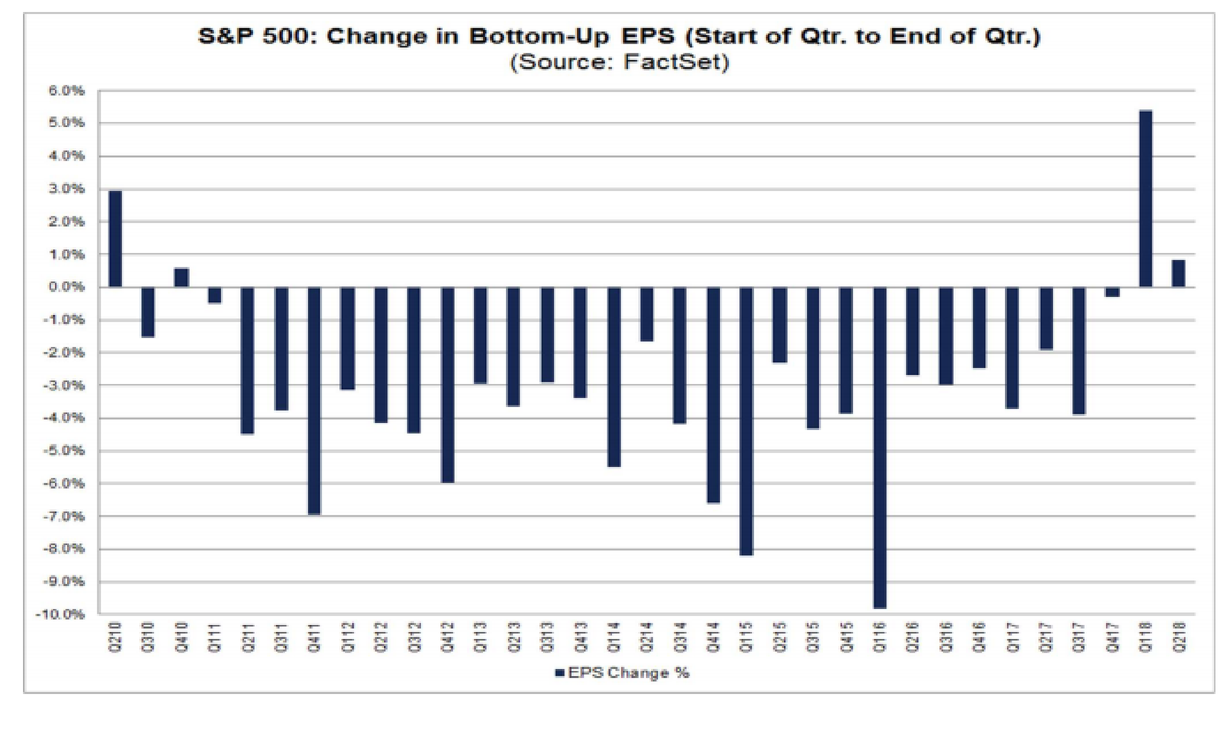
On the bright side, per share earnings continue to **grow more than 20%,** with second quarter earnings expected to climb more than 20%, thanks in large part to the Tax Reform passed late in 2017. As earnings have climbed and prices remain subdued, the market Price to Earnings ratio (P/E) has fallen making **the market appear relatively less expensive** and sentiment as measured by the AAII (American Assoc. of Individual Investors) has fallen from near 60% bullish on January 4th to 28% on June 28th, a level equal to the May 3 reading when the February-April correction ended. The Dow is approximately 800 points higher than the May 3 intraday low.

With reduced bullishness, increasing earnings, and expanding (albeit slow) GDP growth, there is room for equities to move up. Bonds too have a chance for gains. The meme of Global Synchronized Growth which justified the November-January run in stock prices and interest rates has all but died, given Europe's frequent economic data misses and Japan's negative GDP print in the first quarter. This has taken pressure off interest rates and allowed the US 10-year Treasury yield to fall from a high of 3.11% on May 15 to 2.85% at quarter end. I would not be surprised to see the 10-year yield fall further in the coming weeks**. Muted economic data with solid earnings growth would be beneficial to bonds and stocks respectively.**

In my January Outlook I mentioned how the rise in ex-US stock markets followed closely the decline in the US Dollar. The Dollar bottomed in late February and has gained dramatically since April. This has been a weight around European and emerging market share prices and has been at the core of the emerging market debt problems mentioned above. Fortunately, the Dollar's climb has lost momentum and appears ready to pull back, likely offering a reprieve to shares priced in currencies other than the US Dollar. It may also aid in US company earnings. So, while global economic and market conditions have changed since January, hindering prices of most assets, I believe we will see an echo of the 2016-2018 conditions that supported financial asset prices globally. A declining dollar, muted investor bullishness, slowing global growth all should conspire to allow stock, bond and even precious metal prices to rise over the coming weeks, at least until investor bullishness gets **well above average** and the **expectation** of new lows for the US Dollar become entrenched again.

Looking Ahead

As second quarter earnings begin in earnest in mid-July, expectations are for approximately 20% climb in earnings. A large portion is estimated to be due to tax reform passed late in 2017. With market prices subdued and earnings climbing, the market's valuation (Price to Earnings ratio) **is looking more attractive**. While not cheap by any metric, this should give investors a reason to put money to work. In the first quarter, analysts underestimated profits and had raised estimates all the way into the start of earnings season. **This is very rare.** The chart below shows us that generally analysts' estimates *decline* going into earnings season. Estimates start off high and then get lowered multiple times usually. Second quarter of 2018 is setting up to be another rare event where we see **again earnings estimates being raised** into reporting season.



The downside to the effect tax reform is having on earnings will be seen in 2019. When comparisons to 2018 and 2019 quarterly earnings start to come out (in late 2018) the impact of lower taxes on the *change* in earnings will be gone. In 2019 we will only see the change in earnings without the impact of tax reform. Earnings growth will likely come down to the upper single digits. How investors feel about this dramatic slowing in 2019 will dictate the path of stock prices.

Quantitative Tightening (QT) will dominate the headlines towards the end of the year. Over the past 9 years central banks have pumped more than $12 trillion in liquidity into financial markets. The US Fed stopped adding liquidity and has begun to let its balance sheet shrink, removing liquidity from financial markets. During 2017 and 2018 the European Central bank and Bank of Japan more than made up for the US absence. Europe and Japan are scheduled to reduce and eventually cease all new liquidity injections during 2019. Combined with the Fed's liquidity reductions, global financial markets will see a net reduction in liquidity. This will have an impact on markets. It is argued whether this will cause bond prices to fall (rates to rise) or it will have an impact on equity markets. I believe it is likely this will impact both areas and the likelihood of falling bond and stock prices at the same time is significant.

US Dollar liquidity is another topic just starting to show up in the press. The rise in 2018 of the US Dollar after a long decline has taken many market participants by surprise. The "short US Dollar" and "short Treasury" trades were the most popular at the beginning of the year and have been upended. It is often that once 'everyone' knows something, like that the US Dollar will continue to weaken, its about the time that area reverses and goes against how most are positioned. The mystery really was given rising interest rates in the US and a stronger economy, why was the US Dollar weak to begin with? Now the causes of a stronger Dollar are the weakness in Eurozone and Emerging market growth. But which came first, the stronger Dollar or the weaker economies?

Below we can see the relationship of the US Dollar (UUP) and the TED Spread which is the difference in short term rates in the US and Europe. The recent spike in funding costs (rates) parallels the rise in the Dollar index. The rapid Dollar rise in 2014 was partly responsible for the Earnings Recession we saw in 2015. There's about 6 months to a year lag from when the Dollar strengthens to its impact on earnings.

Ironically, part of the Tax Reform passed is a cause of poor Dollar liquidity (higher short-term rates result) and the strengthening Dollar. The ability for US firms to repatriate earnings from abroad at a lower tax rate is causing Dollars to move from Eurozone back to the US. Additionally, the $1 trillion plus budget deficit the US will run in 2018 and on into the future is also soaking up liquidity. Repatriation, US deficits, and Fed tightening are all pushing the US Dollar up, and will likely see the Dollar stronger in 2019, which may impact US earnings in 2019.

Finally, there is China. China is the largest consumer of raw materials. Besides US PMI, the China Credit Impulse impacts base metals and other raw materials that other emerging market economies export. When China is creating more, new credit we can see a rise in prices and in the growth of raw material exporting countries and a rise in US PMI with about a 12-month lag. The chart below indicates that beyond the first half of 2018 the impact from the past China impulse will be fading. This fade is happening at the same time global Central banks will be withdrawing liquidity and the US Dollar likely strengthening. This scenario doesn't bode well for risk assets in 2019.

Adam Waszkowski, CFA
awaszkowski@namcoa.com
239.410.6555