M|L|L
INVESTMENT ADVISORS

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# INVESTMENT REVIEW AND OUTLOOK

## A Reflective Stock Market

From a geopolitical and economic perspective, the second quarter was marked by several unfavorable developments. The momentum of global economic growth slowed in the quarter and leading economic indicators in Europe, Asia and Latin America all showed signs of deceleration. At the country-specific level, Italian bond yields increased significantly (a sign of credit market stress) following a strong showing by populist candidates in recent elections. Argentina, which has only recently achieved an investment grade credit rating, was the recipient of a $50 billion emergency loan from the International Monetary Fund. Elsewhere, Turkey and Brazil both experienced pronounced currency weakness amid slowing economic growth and rising budget deficits. International trade tensions escalated during the quarter with the implementation of U.S. tariffs on imports from Europe, Canada and Mexico resulting in retaliatory actions by the respective trading partners. Additional tariffs on selected Chinese imports took effect in early July followed shortly thereafter by the implementation of Chinese tariffs on a variety of U.S. goods.

In contrast to developments abroad, the U.S. economy continued to make steady headway, and GDP growth for the second quarter is estimated to be approximately 4%, according to Strategas Research Partners. As has been the case for over a year, the U.S. economy is operating at full employment, and measures of industrial production and consumer confidence are at multi-year highs.

The broad stock market, as measured by the S&P 500, had a total return of 3.4% during the quarter. It is natural to wonder how stocks posted a gain during this time period, given the unsettled economic and geopolitical backdrop. The answer will only be known in the fullness of time. However, there are several considerations to bear in mind. Stocks experienced an approximate 10% correction in January-February. In our view, the dip in stock prices was at least partially discounting the challenges described above. It is also possible that the rebound in stock prices during the quarter is foreshadowing a constructive resolution to trade tensions and the ongoing strength of the U.S. economy. The answer will be revealed in the months ahead.

Similar to the first quarter, a wide divergence in stock returns persisted. Growth stocks again outperformed value stocks with the S&P Growth Index returning 5.2%, while the S&P Value Index returned 1.4%. International stocks trailed the U.S. and the MSCI World Index had a return of 0.4%, while the MSCI Emerging Markets Index had a return of -6.7%. Longer duration bonds generally had a negative return in the quarter with the Bloomberg/Barclays 5-10 Credit Index declining 0.6% for the three months ending June 30th. Away from a handful of growth stocks, equity returns have been lackluster for both quarter and the year to date periods. Similarly, most balanced funds have had modest returns. As one measure, the Lipper Balanced Fund Index returned 1.1% for the quarter and 0.1% for the year to date.

**History Rhymes**

The quote, "History doesn't repeat itself, but it often rhymes." (attributed to Mark Twain) seems particularly appropriate for investors at this moment in time. The current economic and stock market recovery, which dates from 2009, is among the longest on record and many of the characteristics of past cycles are becoming increasingly apparent in the current environment. These include:

- The U.S. economy is operating essentially at full employment with shortages of workers being reported in many segments of the economy.
- A modest acceleration in inflation, as indicated by the Consumer Price Index, which rose 2.9% year-over-year in the month of May according to the Bureau of Labor Statistics.
- A shift towards monetary tightening by the Federal Reserve and foreign central banks. The yield on the U.S. 2-year Treasury note has risen from 1.4% to 2.5% over the last 12 months.
- The U.S. stock market trading at above long-term average valuations on several measures of earnings and cash flow. Stock market leadership has narrowed over the last 4 years with a handful of stocks contributing a significant portion of the index return. For example, Amazon.com's stock, which rose 45% in the first half of 2018, is estimated to have contributed one third of the year to date S&P 500 return of 2.6%.

Labor shortages, rising prices and higher interest rates are just a few of the signs of a maturing economic cycle. In addition, commercial and residential real estate, which was a key factor in the last recession, has fully recovered and many residential markets around the country report a *shortage* of available homes for sale. Likewise, narrow stock market leadership, generous valuations and record high margin debt, along with speculative investor behavior in areas such as Bitcoin and other crypto currencies, are all signals of a maturing stock market cycle.

Thus, the economic and stock market picture is reminiscent of previous eras. To be sure, events rarely repeat themselves, however the broad contours of the current environment suggest a measure of caution is in order. Aside from the familiar cyclical aspects of the current environment, there are risk factors that are unique to 2018. Prominent among these are a significant escalation in trade tensions between the U.S. and our major trading partners and the after-effects of almost a decade of ultra-easy monetary policy.

**Staying on Course**

We have written about many of the above considerations in previous letters and our thinking about future returns for equities and bonds is tempered by the facts as we see them. While we continue to feel stocks represent the best vehicle for long-term growth, our *near-term* expectations are more modest due to the combination of higher interest rates, a maturing economic cycle and above-average valuations. In addition, the recent strength of the U.S. dollar has had a favorable impact on inflationary trends. Should the dollar strength reverse, it is possible that the rate of inflation could accelerate.

Our equity holdings favor companies with modest valuations, organic revenue growth and strong free cash flow generation. In balanced portfolios, we continue to have a neutral equity weighting vs. the benchmark. Excess cash in portfolios has been invested in short-term (1-2 year) U.S. Treasury securities with average yields of 2.4%. For the first time in nearly a decade, investors can earn a competitive return on short-term instruments. Our fixed income holdings continue to be of high quality with average duration of approximately 3.7 years.

In summary, our expectations for future returns are conservative and we have positioned our portfolios accordingly. At the same time, we are continually searching for opportunities both here and abroad. International markets, and emerging markets in Asia specifically, continue to be of interest due to favorable demographic and economic fundamentals and more attractive valuations. We look forward to reporting on opportunities as they develop.

As always, we welcome your comments and questions.