

Market Outlook

Mid Year 2018

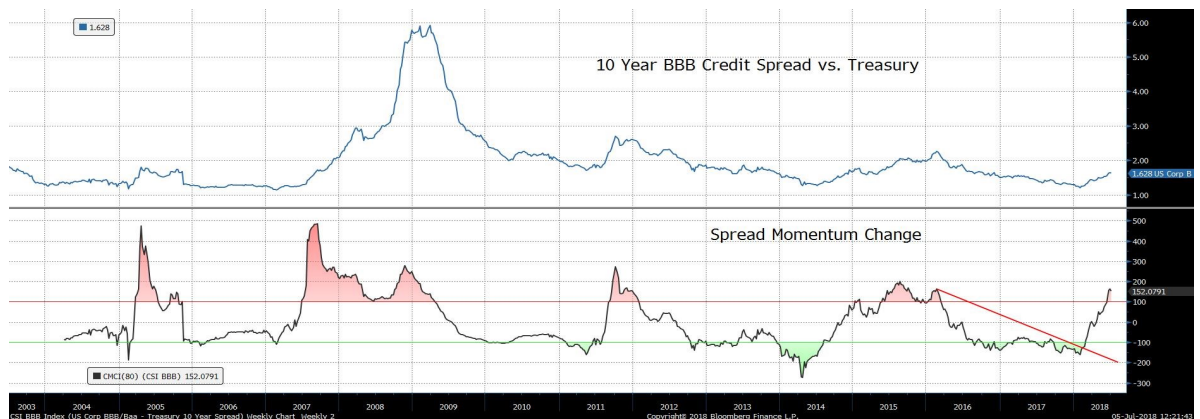
A Classic Late Cycle Cocktail with a Twist of Trump

While the stock market has staged a modest recovery from the levels reached at the height of the first quarter correction, it has been for the most part a lackluster first half with the S&P 500 rising a mere +2.65%. The result is a little surprising given that corporate earnings have remained strong, investors have cheered corporate tax reform and unemployment has reached its lowest levels since before the 2007-09 financial crisis. There have been pockets of opportunity most notably in large cap tech stocks with the NASDAQ 100 Index up +10.65% year to date, yet one would expect performance to be more inclusive based on the strength of the economic data we have seen. It has been a market where leadership has narrowed as investors have focused not so much on the current state of affairs, but rather on the increasing risks to future earnings presented by the Fed increasing short term interest rates and the Trump tariffs. Both of these factors are working to bolster the dollar leaving investors to worry about the pace of exports and their impact on earnings.



Our take on the year so far is that it has looked like a fairly typical late cycle bull market with the economy strong, the Fed raising rates to negate inflation and a market full of investors who are looking to lock in some profits but are reluctant to leave the party all together. A perfect mix for a return to more normal volatility levels following a year where there wasn't even a correction of more than 5% in the major averages. The Trump tariffs have introduced an element of uncertainty for investors along with mid term elections heating up over the next few months. Though we are only days away from second quarter earnings reports, the near term focus for investors is likely to be on the political front at least until the trade rhetoric settles down and there is more clarity with regard to the election. It is too early to declare the bull dead because there is life left in the economy though the market has become more selective with strong earnings growth held ever dearer as rates have ticked up a bit. The question is whether the economy will maintain its resiliency in the face of further Fed action and the tariffs as we go through the second half of the year.

The evidence continues to lean bullish based on the economic data though risks have risen and the upside potential for stocks may not measure up to the bullish optimism that permeated the start of the year. We need only to look at the uneven nature of the rebound from the February correction which has not been broad based. The NASDAQ has rallied strongly, the S&P 500 has bounced some, but the Dow Jones Industrial and Transportation Indexes have barely moved off the bottom. This is a concern because it suggests that the Main Street economy may not be as strong as some of the major averages would lead us to believe. One of the cornerstones of Dow Theory is that major market averages should confirm each other in the direction of the primary trend. For the moment, we are getting mixed messages along these lines which suggest that we could be getting closer to a turning point. Credit markets are another place where we have seen some signs of potential risk as the yield for lower quality corporate bonds has moved higher in comparison to benchmark U.S. Treasury bonds. This suggests that investors are not as confident about the economy moving forward as they were at the beginning of the year and heightens our antennae with regard to the asset allocation in client portfolios.



In light of some of the risks that have begun to creep into the market, we are continuing the process that we began in January to move from an overweight position in stocks to something that is much closer to neutral depending on client objectives. This is based on our view that the Fed is getting tighter compared to most global central banks, and that the tariffs are forcing investors to reassess their risk appetites. We are not taking a defensive posture because the economy is still strong which leaves some upside potential in the market as earnings move higher over the remainder of the year. Rather, we are seeking to be careful to lock in some profits from the strong markets we have seen in the last couple of years which is consistent with our disciplined investment process.

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