Market Update — Second Quarter 2018

Second Quarter 2018 Review

Stocks posted mixed results during the second quarter after moderate losses in the first quarter. US stocks performed well, international stocks were weak, and bonds posted moderate losses. Small cap US stocks were the best performing category during the quarter with a 7.8% gain. The worst performing category, emerging markets stocks, posted a loss of 8.0%. For the year, US stocks are the strongest performers, with losses in international stocks and US bonds.

	Total Return	
Index	**2Q18**	**YTD**
S&P 500 (large cap US stocks)	3.4%	2.7%
Russell Mid Cap	2.8%	2.4%
Russell 2000 (small cap US stocks)	7.8%	7.7%
MSCI EAFE (large cap foreign)	-1.2%	-2.8%
MSCI Emerging Markets	-8.0%	-6.7%
MSCI ACWI All Cap (global stocks)	0.7%	-0.2%
Barclays US Aggregate Bond	-0.2%	-1.6%

Market volatility remains high, but not as high as what we experienced in the first quarter. In the second quarter, there were 13 out of 64 trading days with a +/- 1% return. This compares to the first quarter where there were 23 out of 61 trading days with a +/- 1% return.

Despite the concerns created by prolonged trade disputes, US stocks performed well. If you strip away the noise in the daily media and focus only on economic data and corporate profits, it's no wonder US stocks had a strong return in the second quarter. The strength of the US economy also led to an increase in the value of the US dollar, which negatively impacted foreign currencies. This contributed to the weak performance of international stocks during the quarter.

Economy

After growing a revised 2.2% in the first quarter of 2018, US Gross Domestic Product (GDP) is expected to grow nearly 4% in the second quarter. Corporate tax cuts and deregulation have fostered continued growth in the economy and bolstered consumer spending. Second quarter results will have a limited impact from the recent increase in trade tariffs announced by the US and its trading partners.

While the US economy continues to improve, the same cannot be said for several large international economies. The Eurozone Purchasing Manager's Index, a measure of the European economy, hit an 18-month low in May. While this may be a temporary slowdown as the eurozone economies exhibit modest growth, this deceleration, coupled with an increased risk of a trade war with the US, is worth monitoring.

The Chinese economy grew nearly 7% in the first quarter; however, the trade dispute between the US and China is increasing the risk for a meaningful slowdown in China. The Shanghai Index has tumbled into bear market territory, down over 20% from its highs, over worries about a falling currency, housing curbs and trade relations with the US. Therefore, while the US economy remains strong, global economic weakness from a prolonged trade dispute may spread to the US and derail the positive benefits of corporate tax reform and deregulation.

Geopolitics

In our last quarterly commentary, we reviewed the initial phase of the White House tariff announcements. During the last three months, these trade disputes have only worsened. The Trump administration has announced tariffs that may impact China, the European Union (EU), Canada and Mexico. We highlighted there are issues with our trading relationships that should be addressed long-term. However, we are increasingly concerned the US is nearing trade wars on multiple fronts. It is difficult to predict who, if anyone, wins in this scenario. A further escalation of these disputes may increase input costs for US companies and significantly increase the cost of US products in foreign markets. This has potentially negative implications for the labor market if companies decide to cut costs or move jobs to foreign markets, as Harley-Davidson recently suggested it may do, to meet foreign demand.

On July 2nd, the U.S. Chamber of Commerce launched a campaign to oppose President Trump's trade tariff policies. While normally an ally of the Republican Party, this business group believes that a global trade war will hit the wallets of U.S. consumers. U.S. Chamber President and CEO Thomas J. Donohue commented that "tariffs are simply taxes that raise prices for everyone. Tariffs that beget tariffs that beget more tariffs only lead to a trade war that will cost American jobs and economic growth." He further commented that "we should seek free and fair trade, but this is just not the way to do it. It's time to reverse course and adopt smarter, more effective approaches for addressing trade concerns with commercial partners."

Tariffs tend to reduce growth, increase prices (inflation) and damage confidence. We agree with Liz Ann Sonders', Schwab's chief investment strategist, recent comments that "the risk of a trade war remains one of the most significant risks for U.S. and global stock markets."

The Federal Reserve

Following the Federal Reserve and commenting about their actions quarterly is a lot like watching paint dry. As opposed to the Trump administration, the Federal Reserve takes measured steps and carefully communicates their policies. Make no mistake, though, the Federal Reserve speaks loudly by what they say, and don't say, and can be more influential in the direction of the financial markets than the President.

The Federal Reserve announced the second interest rate hike this year in June by a quarter of a percentage point. This marks the seventh 25 basis point increase in interest rates that began in late 2015. Fed Chair Powell commented that the economy is doing very well, unemployment remains low and inflation is starting to creep higher.

In addition to interest rate policy, the Fed continues to reduce its balance sheet by selling bonds it purchased during the financial crisis. This is another tool the Fed uses to manage liquidity in the financial markets. The plan is for the Fed to reduce its holdings of Treasuries and mortgage-backed securities (MBS) by $40 billion per month in the third quarter, up from $30 billion per month in the second quarter. The Fed has the flexibility to manage the pace of monthly sales depending on the strength of the economy.

U.S. Mid-Term Elections

There will be increasing media attention regarding the upcoming mid-term elections this November. All 435 of the House seats are up for election this November, along with 35 of the 100 Senate seats, as well as many gubernatorial races. Several market strategists have researched history in multiple ways to determine how stocks have performed historically both ahead of the mid-term elections and after mid-term elections. According to the Wells Fargo Investment Institute, the Dow Jones Industrial Average (DJIA) since 1913 has averaged a decline of approximately 20% from the post-President election year high to the midterm election year low. Based on the highs in 2017, if you apply the average decline, there is approximately 20% downside risk in the stock market.

Post-midterm election year trading has historically witnessed a 47% gain from the midterm election lows to the highs the following year. If the averages play out, this suggests approximately 16% upside from current levels. This analysis suggests the market is fairly valued. While this is "nice-to-know" information and interesting for those following politics, the small sample size of the data prevents it from being considered as an investment strategy.

Conclusion

A diversified stock portfolio posted moderate gains overall during the second quarter with bonds exhibiting moderate losses. As was the case after the first quarter, the prospect of strong economic growth from fiscal stimulus may be counterbalanced by rising interest rates and global trade risks. Valuations in the stock market are reasonable and provide an opportunity for solid returns ahead, despite the possibility of continued volatility. We believe the key to solid results from the stock market in the second half of 2018 will rest on the outcome of the trade disputes and Federal Reserve action.

All of us at John D. Dovich & Associates, LLC thank you for the opportunity to serve you and your family. We welcome the occasion to discuss any financial related issues you may have and look forward to speaking with you soon.

Definitions

S&P 500: Standard & Poor's (S&P) 500 Index. The S&P 500 Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad U.S. economy through changes in the aggregate market value of 500 stocks representing all major industries.

Russell Midcap® Index: The Russell Midcap Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the mid-cap segment of the U.S. equity universe.

Russell 2000® Index: The Russell 2000 Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index.

MSCI EAFE Index (Europe, Australasia, Far East): The MSCI EAFE Index is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed international markets, excluding the US & Canada.

MSCI Emerging Markets Index: The MSCI EM Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

MSCI ACWI All Cap Index: The MSCI ACWI All Cap Index is a free float-adjusted index that is designed to measure the equity market performance of the global equity markets representing over 14,000 securities including large, mid, small and micro-cap segments of developed markets together with large, mid and small cap segments of emerging markets.

Barclays Capital U.S. Aggregate Bond Index: The Barclays Capital U.S. Aggregate Bond Index is an unmanaged index consisting of U.S. dollar-denominated, fixed-rate, taxable bonds. The U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS.