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Second Quarter 2018 Newsletter

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Fig. 1 – S&P 500

Fig. 2 – U.S. 10-Year Treasury Yield

U.S. stocks rose in the second quarter of 2018, recovering from the first quarter's losses. The large cap S&P 500 index (**Figure 1**) posted a total return of +3.4% and is now +2.7% year-to-date. Smaller company stocks were market leaders. The Russell 2000 Small Cap index rose 7.8%. In contrast, the Dow Jones 30 Industrials gained just 1.3%. Outside the U.S., indices generally fell. Foreign developed country stocks dropped -1.2%, while emerging markets fell sharply, -8.7%.

S&P 500 first quarter earnings grew strongly, +24.5% after the prior quarter's +13.5% rise. Analysts at the beginning of the quarter had expected growth of +18%. Revenue growth of +8.7% for reporting companies was also solid. According to research service Zacks, 77% of companies beat analyst earnings projections, and 75% topped revenue expectations, roughly in line with recent trends. This pattern of outperformance suggests a steadily strengthening economy and helped stocks to rise in the past three months.

Second quarter S&P 500 earnings are forecast to rise +19.0%, led by the most economically sensitive sectors including energy and basic materials. Excluding the energy sector, expected aggregate earnings growth is +15.6%, an improvement over last quarter's early expectation of +14.3%. Again, almost all major sectors are expected to grow. However, the strong growth in earnings has brought new worries to the market: have earnings peaked? Investors will be watching company guidance for signs of continued strength in the back half of the year.

The economy continued to grow in the past three months. Second quarter gross domestic product is expected to grow +3.8% following +2% in the first quarter. Purchasing manager surveys were steady, with new order strength. May's jobs report was particularly strong, with 223,000 jobs created and an unemployment rate of 3.8%, the lowest since 2000. Home sales slowed, as mortgage rates hit 7-year highs. However, housing prices have risen and the supply of homes for sale remains very low.

Index returns taken from Morningstar.com

Although U.S. stocks fared well in the quarter, the gains were not evenly shared. New tariff announcements by the Trump administration weighed on large U.S. industrials, who rely on overseas sales for most of their growth. These companies are now facing the threat of retaliatory tariffs from other countries. In addition, U.S. companies that use imported steel and aluminum are seeing higher costs from tariffs, which could reduce their profits in the coming quarters. Smaller U.S. companies, which tend to earn a lower share from exports, may see less impact from tariffs. (**Figure 3 – Russell 2000 Small Cap Index**). After lagging in 2017, small cap stocks have led the market higher this year.

Trade war fears were particularly painful for foreign markets, especially the emerging economies. Many of these countries, especially China, rely heavily on exports to fuel their growth, and thus are very sensitive to additional tariffs on their products. European shares also lagged in the quarter, as those economies appeared to slow. International stocks were further hurt by the strengthening U.S. dollar (**Figure 4**), which gained +5% in the quarter. A stronger U.S. dollar tends to make our own exports more expensive overseas. This may help foreign stocks bounce back, as their companies find it easier to compete with the U.S.

Fig. 3 – Russell 2000 Small Cap Index

Fig. 4 – U.S. Dollar Index

Fixed income investors fared a bit better in the second quarter, after broad losses in the first three months. Interest rates pulled back (**Figure 2 – U.S. 10-Year Treasury**), giving bond prices a small boost. While the Federal Reserve is likely to raise interest rates again this year, this appears to be priced in to bonds. Inflation has finally hit the Fed's target of 2%. If inflation increases from here are modest, bonds should resume positive returns.

In other noteworthy market news, General Electric (GE) was removed recently from the Dow Jones 30 Industrials. GE was a founding member and had been a component of the index since 1907. The company, a long-time bellwether of the economy and core holding in many portfolios, has now fallen on hard times and disappointed investors. This highlights the need for diversification and regular review and rebalancing of holdings.

If you have any questions about your holdings, we encourage you to contact us anytime. We hope your summer is going well. Stay cool!

Sincerely,

Kenneth M. Bernard

Kenneth M. Bernard, CFA