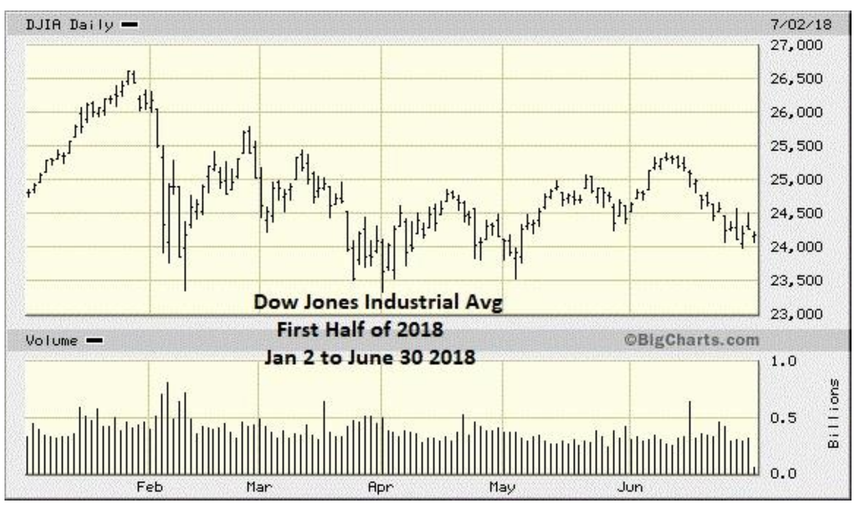
Shifting Sands

It's that time of year when, hopefully, you feel cool sand slipping between your toes as well as notice the massive on-going shifting sands of our great beaches. Similar to our coastal landscape, the market and economy have been experiencing a changing environment in 2018—some is just tiny slippage but there are some major changes occurring as well.

One of the small changes, although the one which gets the most attention, is that ***the stock market has generated little net change year-to-date***. After a torrid start, the S&P 500 plunged to its first correction since 2015 in early February and then spent the next four months struggling to recover. The broad S&P 500 benchmark index produced a small 1.7% gain in the first half while the Dow jones Industrial Average was negative by 1.8%. The *"change"* in those numbers is that the first half of ***2018 was the weakest half-year for the S&P 500 since 2015*** when the index inched up just 0.2% as of 6/30/15. The S&P finished 2015 just one point below where it opened. Another weak first half followed in 2016, when the index was up 2.7% at the midway mark but delivered a gain 9.5% for the full year.



All wasn't tranquil in ***market indices for the half.*** The technology dominated NASDAQ (heavily influenced by the ***"FANG"*** stocks of Facebook, Apple, Netflix and Google) rose by 10.1% and the Russell 2000, an index of smaller, more domestically focused companies (i.e. not affected by trade war talk), rose 7.0%. Looking at the minutiae of the Russell 2000 tells an interesting story: Those stocks considered the Russell 2000 **GROWTH** Index gained 6.5% while the Russell 2000 **Value** Index produced a negative 2.9% return. Weighing down returns in the S&P 500 were the financial and industrial sectors, which declined about 5%, while Telecom stocks slipped by 10.8%.

Returns in U.S. markets may have been merger but ***the U.S. was the place to be.*** Global economies and markets were in the early stages of an immaculate recovery in late 2017 and early 2018—then the tide turned. Pressured by higher interest rates, a strong U.S. Dollar, geopolitical turmoil—with immigration issues the underlying theme and, most of all, tariff and trade war worries, growth stumbled and global markets plunged. The exchange traded fund representing developed, mostly European, markets **(EFA)** declined by 4.7% while an ETF corresponding to investment results in "developing" or "emerging" economies **(EEM)** plunged 7.9—and most of that decline came in June.

Looking forward to the last half of the year, if the economy and markets could function in a vacuum, the outlook would be very promising. The economy continues to show amazing strength even if some recent economic measures have slipped. GDP grew by 2.0% in the first quarter and estimates are for 3% or higher growth for the last three quarters of the year. Record earnings of the last few quarters, along with flat to lower stock prices, has helped the market grow back into an attractive valuation range—the S&P 500 is now trading at about 16 times projected earnings for the next twelve months, according to J.P Morgan. Earnings growth will slow from the unsustainable high rate of last quarter but earnings still look promising and could easily support higher stock prices.

There are two big caveats which could extend the frustrating churning of recent months or even put downward pressure on the overall market. First, paradoxically, is the ***strong economy, especially the employment picture.*** With unemployment an exceedingly low 3.9% and endless stories of companies struggling to find competent employees, there is concern that wage inflation may suddenly explode. Increased inflation is normal in an expanding economy but a big uptick in wages will motivate the Federal Reserve to move more aggressively to raise interest rates while higher wages will also impact profit margins. It has been many many years since the market had to deal with the effects of higher inflation and interest rates and the outcome may not be pretty.

A much greater, and more dangerous uncertainty for the market is the ever-escalating tit-for-tat ***tariff and trade war issue.*** While the U.S. initiated the tariff threats and was first to impose "protective" tariffs, the major global economies have shown they are not about to kneel over and say "uncle." Tariffs and counter tariffs are already having an impact in certain sectors of our economy and they are causing major disruption in many countries. The U.S. and the world are already seeing unintended consequences of this still nascent trade war. The financial impact in the U.S. has been minimal—so far. The impact the psychological uncertainty has had on global business confidence is already major and could become a destructive force in the fragile global economy. Markets hate this type of uncertainty and will react negatively if the trade wars continue to escalate.

All-in-all, we have a lot to keep our eyes on as the second half of 2018 begins. We will do our job so you, hopefully, can enjoy cool sands and rising tides through the hot summer months. Please don't hesitate to contact us if you have questions or concerns.

Best regards,

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Questions or comments?

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