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Market Commentary
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Introduction

Market volatility has spilled over into the second quarter of 2018. Investors have been surprised to the downside, with U.S. equities only modestly higher, foreign equities in negative territory and fixed income on track to posting its first negative calendar year return since 2013. Despite this relatively unpredictable market compared to 2017, the U.S. continues with strong economic data. The labor market continued to strengthen with the unemployment rate falling to 3.8% in May, an eighteen-year low, first quarter GDP increasing at a moderate 2.0% annual rate and expected to strengthen in the second quarter, and inflation ticking up with CPI up 2.8% year over year. The Fed raised the federal funds rate by 0.25% in their June meeting to keep the economy from overheating and is expected to raise rates two more times this year. Although there are risks, as evidenced by geopolitical headlines regarding trade and election cycles and concerns surrounding the length of the current bull market, we still find equities attractive due to a solid economic backdrop and pro-growth policies, like tax cuts, taking effect. However, we do not dismiss the threats currently looming over the market and instead stand ready to alter our portfolios to a more defensive posture in the face of uncertainty.

Domestic Equities

U.S. stocks continued to be relatively volatile, but still showed signs of resilience with positive performance on the year. This is despite a heightening trade war between the U.S. and its four largest trading partners. In total, the S&P 500 is up 2.65% year to date, and 3.43% for the past three months. Second quarter earnings and sales are expected to come in strong. The full extent of the most recent tax cuts is expected be realized in the upcoming quarters, which should result in continued positive results for the remainder of the year and into 2019. Due to this and a healthy economic environment, we believe U.S. equities should continue to grind higher, albeit with some short-term resistance due to geopolitical uncertainty related to tariffs. These geopolitical uncertainties coupled with significant currency movements make smaller sized stocks an attractive opportunity as they tend to be more isolated than larger sized stocks from these global risks because of their more U.S focused business models. With all this in mind, we remain modestly overweight domestic equities.

International Equities

The global markets have seen a recent slowdown in growth, with the MSCI EAFE, returning -2.75% year to date and -1.24% quarter to date. The European Central Bank (ECB) has declared it will stop buying bonds in December and will start raising interest rates no earlier than the summer of 2019. The ECB plans to raise their rates gradually in response to a weakening Euro, but there is concern that the Eurozone will continue to miss its GDP annualized goal of 2% growth by raising rates too soon. Unlike in the U.S. and Europe, the Bank of Japan plans on keeping rates steady due to a downgraded view on inflation, which is moving at around 1%. The negative returns in international equities can be attributed to political risks from Europe, trade tensions, as well as a rising dollar due to Fed rate hikes and solid U.S. economic data. The MSCI Emerging Markets index (EM), with a return of -6.66% year to date and -7.96% quarter to date, has underperformed both the S&P 500 and the MSCI EAFE in 2018, with most of its decline occurring in the last month due to a few reasons. First, many of the countries face political uncertainty, which has negatively impacted their local currencies. In addition, as the dollar strengthens, it becomes more difficult for EM countries to pay off their dollar denominated debt. The hit from a stronger dollar can be magnified for commodity-oriented EM economies since the demand for commodities should decrease as their prices increase in line with the increasing dollar. Finally, poor trade relations between China and the U.S. have caused global concerns as the two represent the world's two largest economies. Escalated trade tensions may also impact consumer sentiment and the global supply chain, the consequence of which could be difficult to estimate. International equities have taken a sizable hit recently, but due to a world economy that is still showing signs of strength, oil production set to increase, and President Trump starting to ease up on Chinese-U.S. investment relations, international as well as emerging market equities should bounce back.

Fixed Income

Through the first half of 2018, the fixed income market is showing negative returns. The 10-year Treasury yield has steadied around 2.9% whereas the 2-year Treasury yield has climbed to 2.5%. If the two-year yield surpasses the 10-year yield, it has historically been an indicator of a fast approaching recession, but we are not there yet. Federal Reserve Chair Jerome Powell continues to take a hawkish outlook on interest rates moving into 2019. With the second interest rate hike of the year up another 25 basis points, the Fed maintained their forecast of two additional rate hikes in 2018. The Fed anticipates 2.7% growth in GDP this year, up from 2.5%, noting that their economic outlook has strengthened. Fixed income securities will continue to face headwinds with rising interest rates, but a diversified fixed income bucket should be resilient on its own and help diversify the overall portfolio as the equity markets experience increased volatility.

Alternatives

Oil prices have picked up since their February low. Brent crude, the global benchmark is up 13% in the second quarter after major crude producers agreed to a slight increase in output – 600,000 barrels per day – which in turn calmed investor fears of an oversaturated market. The U.S. continues to increase production and be a large contributor of oil, with plans to produce 11 million barrels a day by October. However, the broad commodities space, as measured by the Bloomberg Commodity Index, was relatively flat this quarter as the stronger dollar continues to be a headwind.

Real Estate

Real estate has begun to slow down, with growth on both the commercial and residential side lagging in comparison to 2017. Leading the housing market are first time home buyers, who make up 34% of the population purchasing homes. There are many difficulties that are pressing this year, but some of the largest are the supply of homes on the market as well as rising mortgage rates. The US Home Mortgage 30-year fixed rate posted by bankrate.com is up 0.13% on the quarter and nearly 0.55% from the same time last year. With rates continuing to rise and supply at historically low levels, we believe there is a chance for moderate growth, but there is limited opportunity in the sector at this stage of the business cycle.

Conclusion

Stocks and bonds have been positive in the last 4 calendar years, however, this year has not followed trend, as U.S. stocks are modestly up and bonds are down. Overall, we expect the market to grind higher but do not expect to see performance like 2017, as geopolitical issues such as tariffs, a flattening yield curve, and questions surrounding the effectiveness of the fiscal stimulus so late into a market bull run remain on the forefront of investors' minds. Although limited, 2018 should be a positive year, as the economy remains on solid footing with a constructive outlook into 2019. As a result, we are cautiously optimistic that global markets will continue to rise.