2018 Mid-Year Market Update

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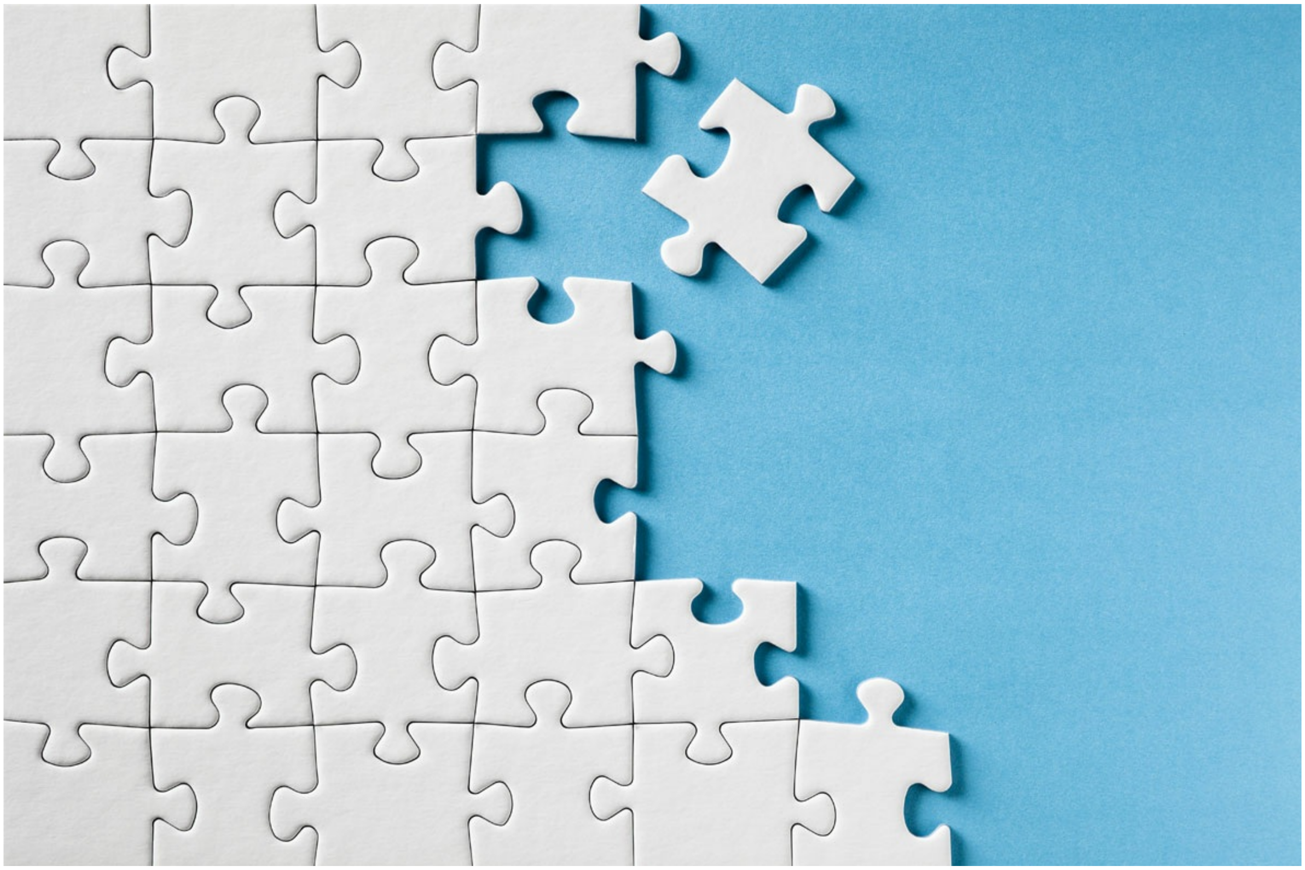

It's July 1, Do You Know Where Your Investments Are?

We are now halfway through 2018, and my how time flies! After an active six months for the global financial markets, we wanted to update our valued clients on what has transpired, what happened that actually matters and where we stand headed into the second half of the year.

You Are Here

The S&P 500 closed on June 30 at 2,719.00, which is a gain of **2.7 percent** year to date. S&P 500 street earnings estimates are about $160 a share, so the index trades at **17.0x** 2018 eps. The 10-year T-bond yields **2.86 percent**, up from 2.40 percent at year end. The Fed Funds rate is in the 1.75 percent to 2.0 percent range, and the range will be raised again at the September Fed meeting. Energy prices have risen this year, with crude closing June at **$74** a barrel, up from $60 at year end 2017. Inflation finished June at a 2.0 percent annual rate. Under the surface of the market, there has been a pronounced difference between performance in growth stocks vs. value stocks. Large value stocks are down one percent for the year, while large growth stocks are up 8.0 percent. Smallcaps are outperforming vs. largecaps, at up 8.2 percent vs. 3.6 percent.

There has been a wide divergence in the performance of S&P 500 sectors, with Growth sectors such as Consumer Cyclical (up 12.1 percent year to date), Technology (up 10.0 percent) and Energy (up 7.0 percent), the only three sectors that have outperformed the S&P 500 index itself. Sharp weakness in value and yield-focused sectors, such as Consumer Staples (-7.8 percent) and Basic Materials (-2.5 percent), have heavily weighed down the overall index.

The yield curve: With 2-year bonds yielding 2.53 percent, the spread between the 2- and 10-year bond yields is now only 33 basis points. Although we are in a period of strong economic growth, the yield curve has flattened meaningfully since the end of 2017. However, there may be valid reasons for that flattening, so we cannot ring an alarm of worry just yet. The Fed has been gradually raising rates at the short end of the curve, after a historically long period of low interest rates. Moving back to a more neutral level of interest rates, relative to inflation, is a positive and gives the Fed room to maneuver in the future. And on the long end of the curve, yields have remained stubbornly low, possibly due to the weakening of developed and emerging market economies since the start of the year. Global bond flows toward the safe haven of U.S. government bonds may be keeping long-end yields lower than they should otherwise be. Whatever the reasons for the yield curve flattening are, a flat curve is not the same thing as an inverted curve, and does not mean that a sharp economic slowdown leading to a recession is near. For example, the yield curve was flat throughout 1994-98, which was a very strong period of economic growth.

The Most Important Theme for the Second Half of 2018

While there continues to be a drumbeat of headlines affecting the financial markets on a daily basis that can either cheer or worry investors, we need to keep our eye on what matters most. The most important and enduring economic focus for us at Westwood is the **profit cycle** that is unfolding, and its effect on lasting **corporate earnings.** Everything else is just daily noise. And as of July 1, the economy is performing *really* well. We anticipate that the long economic expansion we have enjoyed since 2009 will see faster and broader growth in 2018 than in recent years, due to the large package of fiscal stimulus that is the tax reform bill. Corporate earnings overall should rise about 20 percent in 2018, which is a very strong rate of growth. Driven by a combination of accelerating business investment and increased consumer spending, GDP should pick up the pace to notch a 5 percent growth rate for the second quarter, and a 3 percent growth rate for 2018.

Lower consumer and corporate tax rates will spur spending in both groups, and repatriated cash will spur share buybacks, M&A, wage growth and capital spending. The effects of the tax cuts are just now flowing through corporate and personal balance sheets, so the upcoming quarterly earnings report periods should display the effect of the tax changes, whether larger than expected or more muted. The strength of corporate profit growth over the next 12 months will have the greatest influence on the strength of the equity markets and investor sentiment. Will the stock market perform as well as the economy in the second half? That is uncertain, as the correlation between economic growth and equity market gains is low in the short term. But take heed, the link between strong corporate profits and stock market strength is far higher in the medium to long term.

3 Very Positive Factors Seen in the First Half of 2018

1. Both business and consumer confidence numbers hit all-time highs

Due to lower tax rates from tax reform, both consumers and businesses are flush with cash, and are spending and expanding at high rates. Small business owner confidence is especially high, with the percentage of businesses planning to expand in the next year at an all-time high.

2. A sharp rise in earnings growth and increases in S&P 500 estimates

Reported earnings in 1Q18 rose a very robust 23 percent, and even grew 21 percent excluding the sharp rise in energy prices. Estimates for full year S&P 500 earnings have risen to $160 a share, from $148 at the beginning of the year. Lower corporate tax rates have surely aided earnings growth, but a very strong economy also has been an aid to corporate prosperity. Estimates have only begun being bumped up by the flow-through of lower corporate tax rates and higher capital spending spurred by new tax laws, so estimates in the back half of the year could continue to rise with new information from second quarter conference calls.

3. Very low unemployment

The unemployment rate is near a 40-year low, with wage growth starting to expand. At 3.8 percent, unemployment is very close to full employment, where wages and employee bargaining power really gain strength. Most companies are struggling to fill empty positions, and have had to increase wages, benefits and give signing bonuses. It may cause a very welcome rise in wages for the average worker.

4 Things the Market Worried About in the First Half of 2018

1. The return of market volatility

The first half of the year was very eventful, and much more volatile than all of 2017. In 2017, the S&P 500 index had only eight days where the market index moved up or down more than 1 percent, and the first half of this year has already had 38 such days. However, 2018 is more of a normal market volatility year and it is not an outlier; it was the calm and tranquil period of 2017 that was far out of the norm.

2. Oil prices

Energy prices have rallied this year, ending June at $74 a barrel. The combination of a strong economy and bottlenecks in the domestic and global supply chain have caused oil prices to spike 23 percent in 2018. Historically large drilling in the Permian Basin, without a commensurate transport system to get the crude to market, left many drillers with a price that is far less than on the world market. Anyone with an oil tanker truck could buy crude in Midland at $62 a barrel and sell it in Houston for $72. New pipelines are being constructed but they will not be fully operational for more than a year, so the transportation situation will continue.

3. The looming threat of a global trade war

The Trump administration has slowly ratcheted up ever-increasing plans for tariffs on foreign goods, with commensurate retaliation from China and Europe. Tariff plans by the U.S., and the retaliatory tariffs announced by our trading partners, increased in severity as the year has unfolded, and the rhetoric has enveloped more and more industries and products.

4. Threat of higher inflation

Although the Fed is laser-focused on its goal of price stability in a 2 percent a year inflation rate, the market fretted each tick up, even though it finished June at a 1.9 percent rate. The Fed has a superb track record of focusing on full employment with a stable price level for the past 38 years, since this “dual mandate” was adopted, and we anticipate that the Fed will stay on top of any inflation in the system and adjust monetary policy accordingly.

However, we must remember that the market’s short-term headlines usually do not have much influence over the long-term performance of the equity market. Do you remember these ominous headlines from recent years?

2016: An impending slowdown in the Chinese economy caused the U.S. market to correct 10 percent down in the first two weeks of the year. The **Brexit vote** caused a two-day decline in the S&P 500 of 7 percent. President Trump was elected and the market dropped sharply the next day. Oil prices plunged from $100 a barrel to $30 at mid-year, and investors worried about the low price of oil. For all of 2016’s ups and downs, the S&P 500 rose 12 percent for the full year.

2017: Bitcoin grew and became the rage for speculators young and old. The price peaked in November at $19,500, and now sits at $5,800 a coin. Amazon bought Whole Foods, signaling the end of the traditional grocery chains, which have somehow survived since, as Kroger stock has risen 33 percent over the past year and Wal-Mart is up 12 percent. The tax reform bill was debated most of the year and was finally signed in December, causing a strong year-end upward move in equities. The S&P 500 finished 2017 with a 22 percent gain.

5 Things the Market Will Worry About in the Second Half of 2018

1. Midterm Elections

Since 1930 there have been 22 midterm election years, and typically midterm years display more market volatility than normal, but usually end well. Increased equity market volatility this year is a reminder that midterm election years tend to have larger corrections compared to the other three years in a four-year presidential cycle. On average, the S&P 500 usually suffers an 18 percent correction in a midterm election year. Midterm elections are usually change elections, which tend to shift some power to the competing party. In fact, the last four midterm elections and five of the past six midterm elections have led to at least one Congressional chamber changing political parties. But historically, midterm election sell-offs tend to be great buying opportunities with stocks up one year later every time since 1962 and by an average of 36 percent. The S&P 500 has not declined in the 12 months following a midterm election since 1946. Performance by month in midterm election years is typically very choppy in the first nine months, and then rebounds in the fourth quarter as the outcome of the elections become clear. The outcome of the election is not important for a stock market rebound, it is merely the uncertainty of that outcome that holds the market back earlier in midterm election years.

2. Synchronized Global Growth

The period of "synchronized global growth" that world economies enjoyed in 2017 may be ending. The obvious strength in the U.S. economy this year may be starting to diverge from other large developed areas such as Europe and China, who are much more cautious in their economic growth outlooks. The U.S. economy is revving up just as Europe and other major economies lose steam. The European Central Bank said they would hold interest rates steady through summer next year, a sign that they felt the eurozone economy remains fragile. Many investors thought a revitalized Europe would see strong growth in 2018, but recent labor strikes in France, political turmoil in Italy and softer economic data are causing investors to reign in those hopes. In China, new data showed business activity, including investment and retail sales, slowed in May, suggesting China is facing growing headwinds.

3. Tariffs and Trade

With such a strong economy and soaring business and consumer confidence, many investors question the wisdom of threatening a trade war with both our trade friends and foes. The exact financial effects of the unfolding trade war on economic growth cannot be known yet, as the narrative continues to evolve by the day. But historically, using trade barriers to increase economic growth is akin to taking out an appendix using only a mallet. Things will get messy, and usually neither side is better off afterwards.

4. Inflation

There is still a great fear of inflation in the market, even though inflation has averaged a very benign level of 2.9 percent over the last 38 years and has averaged 3.1 percent over the last 90 years. Older market participants still remember the period of 1968-1981, when inflation raged, and peaked at 13.3 percent in 1981. Runaway inflation in that era caused long periods of sluggish economic growth and high unemployment. The lost decade only started to improve after the passage of the Humphrey Hawkins Act in 1978, that instituted the Fed's "dual mandate" of a laser focus on full employment with price stability, that has been followed ever since. For 40 years, this focus on a low and stable inflation rate has generated steady and impressive results. Although many investors and economists will continue to fear inflation's return, inflation is currently like a toddler in a kiddie pool, with 14 lifeguards on duty watching and analyzing its every move. With that much focus and attention on the goal of a steady inflation rate, we are probably in good hands.

5. Energy

U.S. crude oil production in March jumped 215,000 barrels per day, to 10.5 million barrels per day, the highest on record. Oil production in the U.S. could soar to 11 million barrels per day by the end of 2018, and the U.S. could be energy independent by 2020. U.S. crude output, which has shown no sign of slowing, has surged more than 27 percent in the past two years, inching closer to Russia's 11 million barrels per day. Russia is the top oil producer in the world, followed by Saudi Arabia and the U.S. However, an inadequate delivery network could limit crude supplies coming to market for the next year, so the bias to oil prices may be upward.

What You Should Worry About in the Second Half of 2018

It is a safe bet that there will be a steady drumbeat of financial and political news headlines on a daily basis that will attempt to unnerve the average investor. However, these news stories will all be short-term noise that should not affect an investor's long-term wealth plan. We should only focus our angst and attention on things that we can control, and that matter in the long term. These include retirement planning, estate planning, controlling our own investor behavior, continuing to save for retirement and legacy planning. Long-term thinking and planning will always bring more rewards to a long-term investor than worrying about short-term market events.

And finally, although daily stock market movements may seem volatile and scary in the short run, the odds are squarely in the investor's favor in the long run. Long-term investing is not a *Hunger Games*-like contest, where the host wishes that "the odds are in your favor," but tragedy usually befalls most players in the end. In equity investing in the U.S. over the long term, the odds are decidedly in *your* favor. Over the last 90 years, the S&P 500 showed positive returns in 73 percent of those years, and 80 percent of the time, the S&P 500 has bested the inflation rate for that year. Over the last 100 years of stock market trading days, 53 percent of those days saw the market close with a gain, and 47 percent of those days closed with a loss. Over the past 200 years, the U.S. economy has continued to grow at a steady pace due to population growth, productivity growth and technological advancements, with only a few very short recessions during that long-term growth. With a real return on stocks of 6.8 percent a year over that 200 years, those gains came from holding stocks on all days, and picking up the small amount of gain that a 53 percent/47 percent odds advantage gave you over time. That 53 percent/47 percent historical advantage may seem small, but it is actually quite large, and far larger than casino house odds. By the principles of game theory, if the odds are in your favor, you should "play every hand" and be invested in the U.S. economy on every day possible. The only mistake an investor can make is to choose which "hands" to play based on gut feel, and which not to. With these favorable odds, the risks of being out of the market are high, compared to the risks of being in it.

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