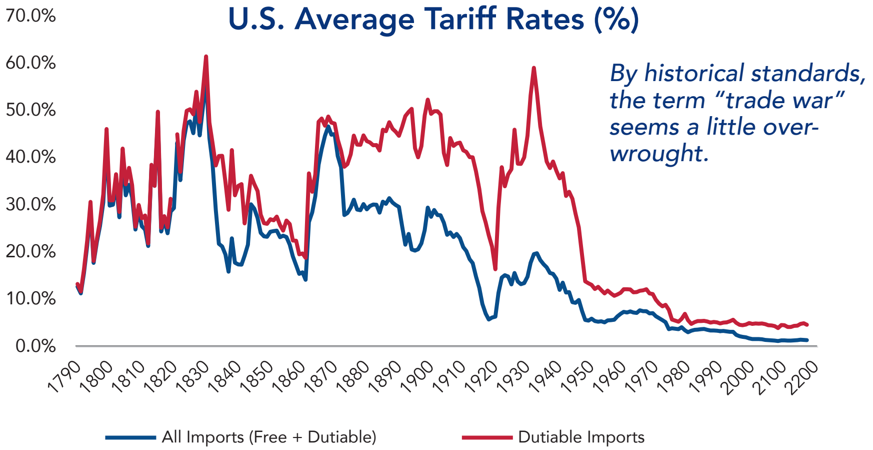
Review & Outlook – 2Q 2018

Fears of tariffs continued to dominate headlines even as U.S. equity markets turned positive in the quarter and year-to-date. All market capitalizations were positive, with small caps leading the way returning 7.8% in the second quarter and 7.7% so far in 2018. Large caps also gained, with the S&P 500 rising 3.4% for the quarter and now up 2.6% for the year. Tariffs may dominate the conversation, and at times cause short-term equity market volatility, but the underlying economic fundamentals remain strong.

We are not dismissing the impacts of the already announced tariffs and retaliations, or the possibility of future escalations, but are keeping them in perspective as long-term investors viewing short-term volatility and fear driven trading as buying opportunities. The 1Q Review & Outlook included a chart estimating the cost of the tariffs at $36.5 billion. Two additional rounds of announcements and retaliations places the new estimated cost at $120 billion, significantly higher but still small compared to the nearly $800 billion stimulus from tax cuts, an increase in government spending and estimated corporate repatriations. Tariffs are being raised from a very low level, since the end of World War II, U.S. tariff rates have steadily fallen. The increases from these low rates and relatively small cost, at least presently, do not yet justify the fears of a "trade war" but bear watching over the coming quarters.



Source: USITC, Statistical Abstracts of U.S. 1971-88, Historical Statistics of the U.S. Colonial Times to 1970, Douglas Irwin's New Estimates of the Average Tariff of the U.S. 1790-1820

As we have written previously, the U.S. economic fundamentals remain very strong. Unemployment is drifting lower, real GDP grew at 2.7% in 2017 and is on pace to grow between 3-4% in 2018. Fiscal stimulus in the form of tax cuts and government spending, and deregulatory effects are now just starting to take hold. S&P 500 earnings, an underreported story last year when they turned positive, continue to grow at a healthy rate including a 23% expansion in the first quarter. The U.S. **has never** experienced a recession while S&P 500 earnings were growing. The strong earnings growth coupled with a relatively flat market has resulted in multiple compression across sectors and left the market trading at very reasonable valuations.

The other great worry facing U.S. investors is the potential for a policy error by the Federal Reserve. The Fed raised rates twice this year to between 1.75-2% and may raise them once more in 2018 and three more times in 2019. As short-term rates have risen, long-term rates have not kept pace, leading to a narrowing of the difference between 2-year and 10-year Treasury yields and a flatter yield curve. The concern is additional rate increases could invert the yield curve, typically a harbinger of recession.

It's important to note that interest rates are not high, they are rising from a historically low base, an indication the economic crisis is over and monetary policy is normalizing. Even if the curve were to invert, markets may still perform well for some time, as in 1989 and 2006 and a recession may be 1.5 to 2 years away.

As the U.S. weighed tariffs and monetary policy changes, the rest of the world weakened slightly in the second quarter. Economic data disappointed in Europe and Japan, after strong readings in 2017, and markets reacted accordingly. The MSCI EAFE index fell .9% in the quarter and is down 2.4% for the year. Emerging markets, squeezed by tighter monetary conditions due to rising U.S. interest rates and higher oil prices fell 7.8% in the quarter and 6.5% year-to-date. China may be starting to feel those effects with the Yuan weakening against the dollar and liquidity injections through open market operations and lower reserve requirements. The long-term outlook internationally still looks promising, though a bit behind the U.S. in terms of growth and normalization of monetary policy.

U.S. equity market returns are now positive for the year with encouraging earnings and economic growth. Heading into the mid-term elections, which historically have caused some market volatility, any news on additional tariffs and long-term interest rates are two areas to continue monitoring along with the campaigns. As patient long-term investors we are more focused on the expanding earnings in the U.S. and less captivated by ephemeral headlines, seeing opportunity in short-term volatility.