AMB Newsletter
3rd Quarter 2018

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2nd Quarter 2018 Review

The 2018 theme of volatility continued throughout the second quarter. This was driven by headlines out of Washington connected to trade, Federal Reserve (FOMC), rate decisions, and geopolitical tensions. US trade disputes and news on impending tariffs seem to be the main driver of current market swings as these decisions would hit the top and bottom line of companies immediately. This has not been the only market moving news; FOMC policy decisions have driven the yield curve to its tightest spread since 2007 which has brought about recession fears. If that was not enough, the current administration has continued to publicly dispute and criticize other world leaders leading to strong geopolitical tensions. Despite all of this, the second quarter ended with stocks and bonds up for the quarter and relatively flat on the year.

Trade concerns continued to weigh on markets throughout the second quarter. This could be seen in US industrial stocks and other companies with a high correlation to imported input costs (i.e. Steel) and exported sales have lagged the overall market. Even with the weakness shown in the US, foreign emerging markets have taken the hardest hit. For the quarter, Emerging Market (EM) equities were down 3.4%. This was due to a culmination of factors such as a strengthening dollar and trade concerns. As the dollar strengthens, it puts pressure on EM's, especially the ones with the highest current account deficits. An example of this can be seen in the countries of Argentina and Turkey. The outcome of the trade negotiations is unknown; but in our opinion, the longer they drag on, the worse it will be for markets.

The Federal Reserve, which had taken a back seat the past few quarters as impeding legislation and trade talks were dominating headlines, is now firmly back in the spotlight. A strong US economy gave the Feds the confidence to raise rates again in June. The biggest news is that the dot plots are currently signaling two more rate hikes for 2018 and as many as four more for next year. This has sent interest rates on the front of the curve higher which is causing the yield curve to flatten. This flattening can be seen when comparing where rates were just a few years ago. In 2013, the 2/10 year spread stood at 265 bps but currently resides at just 30 bps. This tightening has caused speculation to pick up in regards to a possible recession. We need to remember that just because every recession has been preceded by a yield curve inversion, every inversion does not lead to a recession.

The leadership group in equity markets has not changed. Growth stocks continue to dominate and this has now become an even smaller subset of growth such as with the FAANMG group (Facebook, Amazon, Apple, Netflix, Microsoft, and Google) which currently dictates market movements. With FAANMG market caps continuing to grow and currently standing north of $4 trillion, their market dominance is quite noticeable. Since November 2017, these six stocks alone pushed the S&P 500 up by 2.66 percent. The rest of the market combined was collectively down over the same time period. It is not uncommon for the S&P 500 to be dominated by the largest stocks in the index. This has always been the case, and as a whole, they actually make up a far less percentage than in past years. The considerable difference; however, is they are all in the same industry which can lead to sector diversification issues.

Domestic Fixed income markets were relatively stable in the second quarter of 2018 and finished slightly higher at approximately .01% (measured by the Bloomberg Barclays Intermediate Gov/Credit index). Short-end rates continued to creep higher throughout the quarter which tightened spreads even further. However, the intermediate to longer end of the curve actually came down slightly which lead to the positive second quarter performance. As we mentioned before, spreads are the tightest they have been in eleven years, and we expect that trend to continue and finally lead to an inversion if the Federal Reserve stays on their current tightening cycle. We still believe the intermediate to longer-end is where we need to be positioned as the rates in this range should stay subdued.

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3rd Quarter 2018 Outlook

Economy

The global economy started to show signs of life over the past two years and that trend continued at the beginning of the year. However, over the second quarter, we began to see cracks in the global growth narrative as global trade talks and negotiations escalated – and not in a good way. Along with this move, a strong dollar has come back into play. Both of these issues have caused struggles in EM markets and in developed markets outside the US, but currency fluctuations have obviously affected emerging markets more. If they run fiscal account deficits – which are usually denominated in US dollars – and the dollar strengthens, it takes more of their currency to make payments which would then create a drag on their economy. Tariff talks have hurt economic outlooks for some EU countries as the fear of auto tariffs world put a dent in their exports. Despite these issues, the US has been able to avoid any economic sluggishness.

Despite the worries across the globe, the US economy has continued to move forward. US small business expansion plans continue to improve; and other economic soft survey data, such as consumer confidence, remains elevated. Along with the soft data, hard data has been strong as well. The labor market has continued to strengthen in 2018 which is the real driving force behind the economy. We know that these statistics can be misleading. A 3.8% unemployment rate sounds feasible but this is not a great indicator of actual unemployment. We would rather take a look at the current participation rate and wage growth numbers. In this case, both are improving which is a good sign that the labor market is tightening.

The following excerpt from our last letter summarizes our thoughts on the economy quite well: “How long will this last? Hard to say as we do believe we are nearing the end of this economic cycle in the US; however, putting a time frame on that is impossible. Here are some things the US will have in its favor over the next few years:

- Tighter employment markets could push up wages.
- Higher wages lead to higher consumer spending.
- Corporate profits should remain strong.
- Pro-business policies push up fixed capital investment.
- Easier Fiscal Policy is a positive for the economy in our view.
- Overseas cash being repatriated and used for mergers & acquisitions, dividends and buybacks.

For these reasons, we remain bullish on the overall economy in the US and equity markets.”

Equity Market

Second quarter market action was a continuation of the volatility we witnessed at the end of the first quarter which was caused by a continued and growing list of uncertainties. The new uncertainties that have added to the market angst include trade war fears, rising inflation, curve flattening, and a stronger dollar. Some of these fears are legitimate and other anxieties we believe are overblown. Despite these uncertainties, equity markets measured by the S&P 500, were able to finish out the quarter in positive territory posting a return of 3.44%. This pushed the return for the year back into positive territory.

The leadership group in the equity markets has not changed as growth continues to outperform value. The group of growth stocks driving the market has become smaller and is now predominately being led by the FAANMG stocks (Facebook, Amazon, Apple, Netflix, Microsoft & Google). The contribution from these stocks is approximately 120% of the total return of the market. The other stocks combined are collectively down. We believe this trend will turn with value outpacing growth in the second half of 2018.

Equity Market (Continued)

Going into the third quarter trade war fears will continue to be a major concern. This is a legitimate concern as trade tariffs would put an immediate damper on the top and bottom line of our multinational companies in the US. Trade tariffs, that are being discussed, are currently the largest between the US and China. Disruptions between these two could cause issues for a number of US companies. For example, GM sold more cars in China last year than the company sold in the US. Having additional tariffs or regulations would immediately affect that profitability of companies who have this type of exposure. Overall, trade disputes would negatively impact certain companies but would also be a positive for others which should be a neutral effect on the overall market.

The fear of rising inflation and a continued curve flattening has brought on the fear of stagflation. Throughout history, every recession has been preceded by an inversion of the yield curve; however, every inversion of the yield curve has not led to a recession. This is one reason we believe the fear of a bear market in stocks brought on by a recession may be overblown. GDP, for the second quarter, is currently tracking above 3.8% which is well above the 2.2% we experienced for the first quarter. Fiscal spending is increasing which will be a positive benefit to GDP. We are also witnessing an increase in capital spending and a tightening in the labor market which are all positives for the overall economy. We do not believe a recession will take place within the next year.

The continuation of dollar strength is definitely worth mentioning and could be the biggest detractor to future stock performance. The largest companies in the US are multinationals which just means they do business around the world. As we previously mentioned, some companies such as GM do more business internationally than they do domestically. A stronger dollar will hurt the top and bottom line as exports from the US become less competitive compared to weaker currencies. Translation will also become a negative effect as it will take more foreign currency to purchase a dollar, leading to lower earnings and revenues from foreign subsidiaries. If US growth continues at its current pace and yields on US Treasury continue to trade at premiums, we believe dollar strength could continue and could become a cause for concern for US equity markets.

All in all, we believe the current positives outweigh the negative. AMB believes the stock market should continue to move higher in the second half of the year and a rotation from growth to value will take place. The positive economic backdrop and continued top and bottom line strength of corporate revenues and earnings should be enough to keep this bull market going. We do believe; however, that it will be a bumpy ride as trade concerns along with other economic factors will play on the fear of market participants.

Fixed Income

The second quarter has been a mirror image of the end of the first quarter. The yield curve has continued its flattening pattern even as US growth and employment data improves. This is to be expected as the Federal Reserve continues to tighten financial conditions and for several other reasons we will discuss in the next section. AMB's outlook that intermediate and longer dated interest rates will stay subdued while the shorter term rates move up, has been the case so far. This flattening pattern has the 2/10 interest rate spread at levels not seen since 2007. Overall, it was a tough quarter for fixed income markets across the globe as it finished at -2.78% (measured by the Bloomberg Barclays Global Aggregate).

During the quarter, the Federal Open Market Committee (FOMC) raised the federal funds rate which brought the target rate to 1.75%-2.00%. This was their seventh rate hike during this cycle. The Federal Reserve also updated their dot plot projections which now indicates that there is a possibility of two more hikes this year followed by three more next year. We suspect a fourth hike should the Fed end its current tightening cycle at + or - 3%. For this reason, we maintain that rates on the front end will continue to move higher as the FOMC continues to tighten financial conditions. We still recommend being overweight the intermediate to longer end of the curve.

Fixed Income Continued

As we mentioned earlier, there are several other reasons why we believe the curve will remain flat.

- Wage growth remains absent.
  Consumer spending is the growth engine of the US, and without rising wages, we do not believe inflation will take hold.
- Rates remain at premiums to other developed nations.
  Foreign investors will continue to invest money in US debt as long as rates trade at a discount as that of the rest of the world.
- Increasing amount of debt could strangle growth.
  Corporate and government debt in the US continues to increase. As this happens, future growth potential diminishes.
- US dollar continuing to strengthen.
  A strong dollar hurts corporate earnings growth and will also dampen inflation as import prices decline.

With the FOMC continuing to tighten financial conditions, along with the factors above, we believe rates in the US will remain low.

Investors should remember why we invest in fixed income. It is not the growth engine of portfolios, but fixed income is what brings stability and predictability. When using a buy and hold strategy, interest rate movements are irrelevant as we are investing for a stream of cash flows and the safety of principal (which will be repaid upon maturity as long as the bond is credit worthy). Pundits that speak to fixed income being riskier than the stock market are making a generalized blanket statement that we feel is not accurate. Fixed income provides diversification and stability to an inherently more volatile equity portfolio, and we feel it should play a part in every portfolio in some facet.

Conclusion

Volatility has continued in both equity and fixed income markets and we expect this to continue throughout 2018. Even with the geopolitical turmoil, the markets have fared well in the second quarter returning 3.44%. The trend of growth companies outperforming value has continued over through the second quarter; but as we mentioned, we expect this to change later in the year. Our overall view on the equity market remains positive, but we do believe political uncertainty will cause increased volatility. Fixed income markets have struggled in the first half of the year, and the continued flattening pattern is worrisome when extrapolating to future expectations. However, credit markets have held together which is a positive sign on the overall economy. As always, we appreciate the opportunity to help you achieve your financial goals.

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