Investment Commentary

July 10, 2018

2nd Quarter Recap

Domestic stocks generated positive returns for the 2nd quarter with the Vanguard Total Stock Market Index providing a return of 3.91%. Small company stocks outperformed large company stocks and the "growth" style continued to outperform the "value" style. International stocks did not fare well with the Vanguard Total International Stock Index showing a loss of -3.30%. Emerging market stocks were a drag on the index performance with a loss of -9.60%.

Investment grade bond funds were essentially flat with a loss of -.16% for the Barclay's Aggregate Bond Index. The Federal Reserve raised short term rates .25% during the quarter.

Tariffs and trade wars were in the spotlight during the quarter creating uncertainty for the financial markets. At this juncture the effect of tariffs on the global economy are not significant.

Global Economy

The U.S. economy is still performing quite well and the rate of unemployment is currently at a low of 4.0%. The corporate profit picture continues to look good and lower tax rates will provide a boost to profits. We will get a better picture of corporate profits in July as companies report 2nd quarter earnings.

While the economy should continue to perform well into next year we are getting close to the peak. The global economy is in the 9th consecutive year of expansion and appears to be getting close to the end. And the Federal Reserve is continuing to raise short term rates. Some highly respected investment firms are calling the end of the current cycle in 2020. While this appears to be reasonable to me it is difficult to predict what will eventually happen.

For some time there has been a period of global economic growth which is now threatened by the prospect of tariffs and trade wars. Escalation of trade tensions will certainly result in increasing volatility and a move down in stocks. Some industries and some stocks are more vulnerable to the implications of a trade war but overall global economic growth will suffer.

Review of Asset Classes

Domestic Stocks

Domestic stocks reflect modestly positive returns so far this year. In the near term they are likely to move sideways as long as there are trade tensions and as the Federal Reserve continues to raise rates. Growth stocks continue to perform well.

Value style stocks, which are more sensitive to the economic cycle, have not performed well for many years and are likely to continue their underperformance.

Due to the current trade issues the high quality, large company stocks have underperformed the overall market. Small cap stocks have outperformed large cap stocks recently since they have less exposure to the current trade issues and also received a bigger boost from the reduction in corporate tax.

But we are still a long way from a trade war. For example the 10% tariffs on $200M of Chinese goods amounts to 0.1% of U.S. gross domestic product (GDP). This does not have a material impact on growth.

International Stocks
International stocks, especially emerging markets, have underperformed U.S. stocks this year due to a variety of issues. Trade tensions appear to have a greater impact on international stocks. And the U.S. dollar is showing strength as a result of higher interest rates. This reduces the investment return of international stocks for U.S. investors.

Investment Grade Bonds
With a strong economy and a rising interest rate environment, investment grade bonds are not likely to produce much in the way of investment returns over the next several months. The yield of the 10 year U.S. Treasury Note is currently 2.88%. This yield is likely to move up over the next few months which has the effect of depressing the overall investment returns for investment grade bonds.

We are currently at an inflection point where the investment returns of short term, intermediate term and money market funds are similar. In the near term this rate of return is about 2.0% or so.

Non-Conventional Bonds
Returns for non-conventional bond funds including floating rate funds year to date are just barely positive. But they are slightly higher than conventional investment grade bond funds. In this rising interest rate environment they will continue to outperform conventional investment grade bond funds. But the returns will be very modest compared to the past few years.

REITs
The Vanguard REIT Index ETF returned 8.92% for the 2nd quarter but is at breakeven year to date. This asset class is not likely to perform well in a rising

interest rate environment. And the continuing implosion in the retail industry will result in a large supply of empty retail space.

Commodities

With the global economy currently at or near a peak, the outlook is not good for most commodities. However, the outlook for oil may be more positive in the near term. The oil producing countries have recently agreed to increase output which will reduce prices. But it is unlikely they will be able to meet their goal so prices could remain higher.

Oil prices are notoriously volatile but in the current environment the profits of oil companies may show a dramatic improvement over the past few years.

Going Forward

Overall investment returns could continue to be positive over the next several months unless there is an escalation of trade tensions. And next year the Federal Reserve may continue to raise interest rates potentially slowing economic growth.