Walking the Tightrope - Don't Look Down

Compared to the wild ride we experienced early in the first quarter, market volatility and high valuations settled into a more comfortable range during the second quarter. But, even though most economic indicators point to continued growth in the markets, investor emotions remain on edge, swinging between optimism and pessimism as forces that support global growth are offset by competing forces that deter growth. This balancing act causes many of us to worry, "How long *will* this bull market last and what could derail it?"

Economic Updrafts and Downdrafts

Providing some lift to markets, domestic and international interest rates remain historically low. As well, the European and Japanese Central Banks are still stimulating their economies. However, the U.S. Fed expects to hike rates five more times before the end of 2019. While higher U.S. interest rates tend to strengthen the U.S. dollar and make imports cheaper, a strong U.S. dollar can burden domestic exporters whose products become more expensive overseas. Also, oil prices which rose 19% this quarter could remain high, making the myriad of related products and services cost more and once again spurring fears of inflation.

Even with the specter of inflation looming over us, the current news about corporate earnings is upbeat. U.S. corporations have shown 27.3% year-over-year growth and we have witnessed strong earnings internationally. Profit margins of the S&P 500 are the highest they have been for over 18 years (11.3%). Nonetheless, when U.S. unemployment hit its lowest point since the 1960s at 3.8% and it was announced that there are 670,000 more jobs in the U.S. than people available to fill them, those pesky inflation concerns trickled back into the markets and the S&P 500 eked out only a modest increase of 2.9% as of mid-year.

To some extent, earnings growth and profit margins in the U.S. have been boosted by the repatriation of overseas earnings and the fiscal stimulus Congress enacted last year. Unfortunately, this lift is only temporary, and it will dramatically increase U.S. government debt. It is yet to be seen if corporate tax cuts will translate into greater capital investment instead of share buybacks and onetime special dividends. Also, it is unclear if imposed tariffs will set off a global trade war which could negate corporate gains earned under the new tax laws.

There are also concerns that there is not enough long-term capital investment to help buoy companies through weaker economic times. This fear, however, has not deterred most purchasing managers from forecasting updrafts for international economies. In fact, China, the second largest economy in the world after the U.S., is expected to grow strongly at 6.8% as it continues to manage its transition from a manufacturing to a service-based economy. How tariff and geopolitical disputes with the U.S. and other countries will impact China's growth is yet unknown, but the implications for the world could be dire should China's economy falter.

Finding Balance

The ups and downs of the markets tugged at different parts of investor portfolios at different times during the first six months of the year. Diverse portfolios holding a balance of U.S. and international equities as well as a broad array of fixed income and alternative investments likely experienced flat returns. Whereas, portfolios more heavily weighted with equities saw a modest rebound in the second quarter. In particular, small cap stocks strongly outperformed other equity categories at 7.8%. And while growth stocks have been dominating the performance race since the beginning of 2017, value stocks have shown some signs of breaking that trend. In contrast to the U.S. equity markets, international developed markets equities returned -0.97% and emerging

markets lost 7.86%, a stark difference from the 6.38% gain seen in the Q2 2017. As expected with rising rates, bond markets continue to show weak performance with the US Aggregate Bond Index losing 0.16%, 2-year Treasuries down 0.43% and 10-year Treasuries down 0.75% for the quarter.

Shifting Winds

As competing forces continue to impact portfolios, what risks do we see going forward that could upset the current equilibrium? In the U.S., the fiscal stimulus should continue to boost the economy in the near term, but recently imposed trade tariffs could blunt its effect, particularly if an increase in wage inflation kicks in stronger than expected and labor markets continue to tighten. The Fed has been diligent in telegraphing its moves, but may feel compelled to accelerate interest rate hikes, particularly if it sees spikes in inflation. Geopolitical events could also exacerbate the ability to manage trade relationships with the U.S. mid-term elections potentially upending the balance of power in Washington and nationalistic parties strengthening in Europe and Mexico. It is also imperative not to understate the importance of the Chinese economy on the economies of their trading partners in emerging Asia and Europe.

Where is Our Safety Net?

As long as no opposing forces get too out of sync, we believe that strength in corporate earnings should continue to support the bull market in the near term and U.S. equity valuations will likely remain within range of historic averages. International developed market equities should also remain strong if the strengthening dollar and political events don't spook investors. And even though U.S. Treasuries will face headwinds as the Fed continues to raise interest rates, we believe that short term fixed income yields have risen to the point where they are becoming attractive again as a tool to preserve wealth.

While we see no major downturns in the market on the horizon and certainly no indications of impending recession, we feel it is important to prepare for these possibilities. Investors should bolster themselves for periods of volatility which may feel scary but in reality are normal. As always, we recommend that the best way to grow and protect wealth over the long term is to build diversified, high quality portfolios and select savvy active managers who know how to avoid pitfalls and take advantage of opportunities in the markets.