Economic & Market Quarterly

Summer 2018

This summary is provided by BMT Wealth Management.

Global Economic Growth Divergence

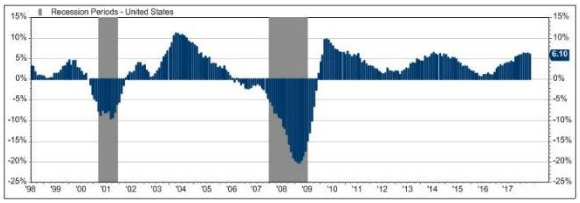
Economic growth is showing no visible signs of abating in the United States. This is in spite of all the negative headlines surrounding tariff impositions and the threats of a global trade war between some of America's largest trading partners.

In fact, a case could be made that U.S. economic growth is accelerating, which is almost unfathomable, given that it has been roughly nine years since the end of the last recession.

Consensus forecasts for Real GDP in the second quarter of 2018 stand at 3.2%, and some economists are expecting a figure closer to 4.0%.

The case for growth acceleration has been further substantiated by the advancement in The Conference Board Leading Economic Index® for the United States, which is designed to forecast future business activity. As the chart below illustrates, this indicator has marched steadily higher over the past two years.

The Conference Board Leading Economic Index®
For the United States (YoY%):
20 Years Ending 5/31/2018



Source: FactSet, Inc.

While the U.S. economy seems to be humming along, economic conditions internationally have weakened somewhat since the beginning of 2018.

As displayed in the table below, the Purchasing Managers' Index® (PMI), a gauge of economic health for the manufacturing and service sectors, reflects that readings for manufacturing have declined recently, even though a reading above 50 is still indicative of an economic expansion for most countries.

Purchasing Managers' Index® for Manufacturing:
Monthly Readings

Global Manufacturing Summary					
	Most Recent Data			Current Reading vs.	
Country	Period	Current Reading	Prior Reading	6 Mo. Avg.	12 Mo Avg.
Brazil	May-18	50.7	52.3	-1.5	-1.0
Canada	May-18	56.2	55.5	0.6	1.0
China (Caixin)	May-18	51.1	51.1	-0.2	0.0
France	May-18	54.4	53.8	-1.4	-1.5
Germany	May-18	56.9	58.1	-2.8	-3.0
Japan	May-18	52.8	53.8	-0.9	-0.4
Korea	May-18	48.9	48.4	-0.6	-0.9
Mexico	May-18	51.0	51.6	-0.8	-0.8
United Kingdom	May-18	54.4	53.9	-0.5	-1.1
United States	May-18	58.7	57.3	-0.4	0.0

Source: Strategas Securities, LLC

Concerns over a more hawkish Federal Reserve (Fed), a strengthening U.S. dollar, and potentially excessive optimism spurred by two years of synchronous growth could potentially explain the recent deceleration in economic growth in the international developed and emerging market economies.

However, negative sentiment surrounding global trade has clearly played a role. For example, the new-exports portion of JP Morgan's Global Manufacturing PMI fell to 50.5 in June, which is its weakest figure in nearly two years.

While global trade disruption is a valid concern and worthy of our attention going forward, corporate earnings in 2018 are expected to grow 15.9% within the MSCI Emerging Markets Index and 7.0% within the MSCI EAFE (developed international markets) Index, according to Thomson Reuters I/B/E/S estimates as of June 27, 2018.

Therefore, the recent volatility in international markets seems to be discounting a material weakening in business fundamentals, which is not being reflected in the outlook for corporate profits.

There Is No Place Like Home – At Least This Decade

The S&P 500 entered the second quarter with a modest year-to-date loss, but returned +3.43% during the quarter, to bring its year-to-date tally to +2.65%.

Small-cap stocks, as represented by the Russell 2000 Index, also entered the quarter in the red, but advanced a strong +7.75% during the quarter and now show a year-to-date return of 7.66%.

The relative outperformance of smaller-cap stocks in 2018 can be attributed to many factors. At the top of the list is the fact that smaller-cap companies, in general, derive a larger percentage of revenues from U.S. business activity, which has been robust, and the belief that they will see a greater benefit (relative to larger companies) from the passage of the Tax Cuts and Jobs Act of 2017.

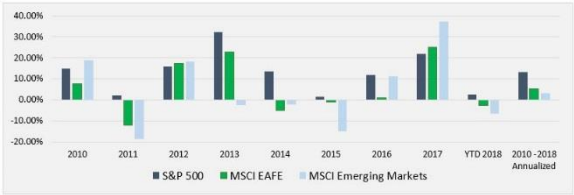
When we reviewed the final figures for 2017, we noted it was the first year since 2012 that the S&P 500 underperformed both the developed international markets (MSCI EAFE Index) and the emerging markets (MSCI Emerging Markets Index). The trend was short lived.

Thus far in 2018, the winds have once again shifted to favor domestic stocks. As noted above, the S&P 500 has generated a positive return of +2.65% for the six-month period. Conversely, the MSCI EAFE Index has declined by -2.75%, while the MSCI Emerging Markets Index has suffered a more sizable drawdown of -6.66%.

Looking longer term, the outperformance of domestic stocks has been rather consistent for much of the current decade. In fact, since the year 2010, the S&P 500 has been the best-performing index of the three in six of the nine years (including 2018).

The annual returns for the three indices – S&P 500 (navy bar), MSCI EAFE (green bar), and MSCI Emerging Markets (light blue bar) – are set forth in the table below, along with the cumulative average annualized returns for the period.

Total Returns by Geography: 2010 – 2018



Source: Morningstar, Inc.

Since the outset of 2010, the average annual return of +13.40% posted by the S&P 500 is more than twice the return earned on international stocks and essentially fourfold the return earned in emerging markets.

So, at least for this decade, for a U.S. investor, there has been no place like home.

It is worth noting, however, that from 2000 through 2009, the returns posted on both non-U.S. indices were greater than the return earned on the S&P 500, with a particularly large advantage for emerging markets equities.

Fixed Income

U.S. Treasury yields continued to increase across the yield curve during the second quarter of 2018, as the two-year and 10-year U.S. Treasury

notes increased 26 basis points (0.26%) and 12 basis points (0.12%), respectively. The yield curve flattened by 14 basis points (0.14%) and ended the quarter at 33 basis points (0.33%), its tightest level since 2007.

The Fed contributed to the jump in short-term yields in the quarter by raising the federal funds target range 25 basis points (0.25%) at the June meeting of the FOMC.

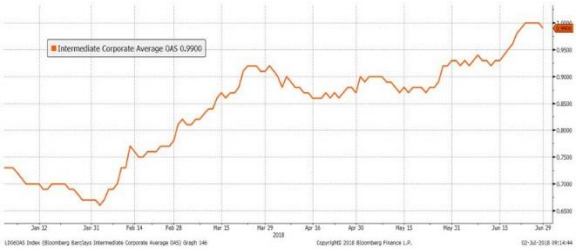
The Fed also indicated that, given robust U.S. economic growth, an additional two rate hikes, at 25 basis points (0.25%) each, may be needed this year to keep the U.S. economy from overheating.

Based on economic data received to date for the second quarter, annualized economic growth is expected to surpass the roughly 2.0% annualized growth rate the U.S. economy has experienced since June 2009. Company earnings and revenues have benefitted, which has led to healthier company fundamentals.

Despite the favorable environment for corporate issuers, investors favored U.S. government bonds over investment-grade corporate issuers during the quarter, leading to widening credit spreads, a common occurrence this year.

This is illustrated in the graph below, which reflects that, through the first six months of the year, the Bloomberg Barclays Intermediate Corporate Average option-adjusted spread (OAS) increased 26 basis points.

Bloomberg Barclays Intermediate Corporate Average OAS: 1/2/2018 – 6/29/2018



Source: Bloomberg Finance L.P.

In the quarter, intermediate U.S. government bonds returned six basis points (0.06%), compared to intermediate U.S. corporate issuers, which were down 10 basis points (-0.10%). Overall, the Bloomberg Barclays U.S. Intermediate Government Credit Index finished the quarter mostly unchanged, up a very modest one basis point (0.01%).

Widening credit spreads were partly due to ongoing trade war rhetoric and rising tensions among U.S. trading partners. The potential negative impact to economic growth led to increased risk aversion and demand for U.S. government securities.

Also worth noting, given higher levels of corporate debt after many years of low borrowing costs, investors are looking closely for indications that corporate credit metrics are deteriorating.

The jump in bond yields so far in 2018, coinciding with a flatter yield curve, has reduced the incentive to extend too far out on the yield curve. We continue to believe the short to intermediate part of the yield curve provides the most favorable risk/return trade-offs. Corporate fundamentals remain stable, and we continue to favor high-grade issuers, given the additional yield pickup over U.S. government securities.

Looking Ahead

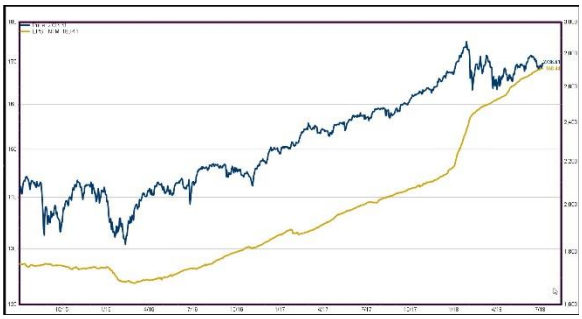
We remain optimistic about the trajectory of economic growth and corporate profitability over the near term. In the first calendar quarter of 2018, quarter-over-quarter earnings growth came in at a strong 25%, driven by solid top-line (sales) growth of 8.5%. Expectations are for a good second-quarter earnings reporting season.

The graph below tracks the price of the equity market, as measured by the S&P 500 Index (blue line), and the growth in projected earnings per share (gold line). We have been watchful of the "gap" between stock price growth and underlying earnings, and have held the view that

further gains in stocks would need to be supported by earnings, not expansion of valuation.

Since the beginning of the year, earnings growth has accelerated faster than price. This confluence of events has caused the forward price/earnings ratio (P/E) of the S&P 500 to decline from over 18 times to a current 16.1 times forward earnings.

S&P 500 Price vs. Next-12-Month Earnings Per Share: Three Years Ending 6/30/2018



Source: FactSet, Inc.

At this juncture, we are in an extended period of economic expansion and positive equity market returns. The risks of policy errors (faster monetary tightening) or overheating demand (commodity and/or wage inflation) can more easily tip the scales at this stage of the cycle.

We affirm the importance of diversified equity and shorter-duration fixed income portfolios, and we see the potential for incremental returns in a more risk-sensitive environment.

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