2018 Capital Markets Review

July 2018
James W. Underwood, CFA - Chief Portfolio Strategist
junderwood@welchhornsby.com

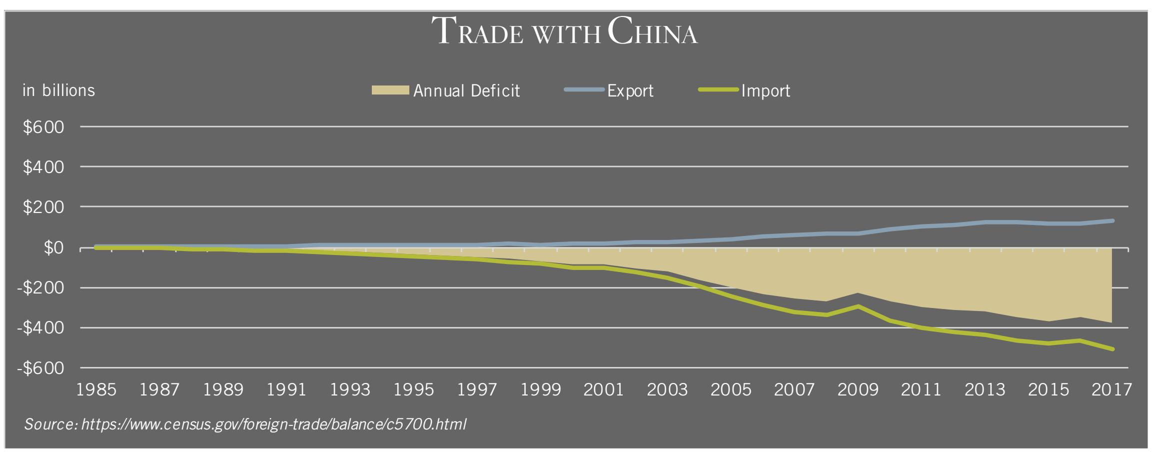
WELCH HORNSBY
INVESTMENT ADVISORS

QTR. 2

Tariff Threat

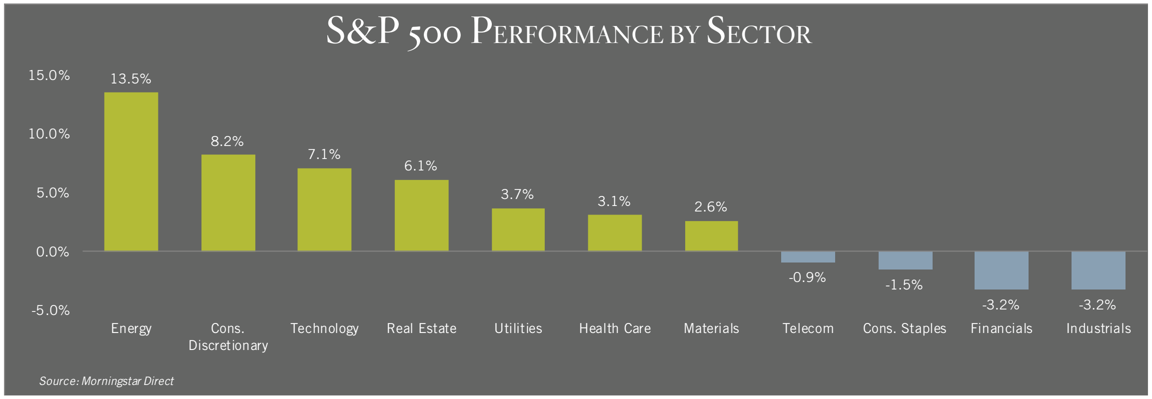
Free trade, driven by the law of comparative advantage, works perfectly in theory, but misplaced workers are the practical complication to a theoretical win-win solution. Consequently, countries have historically used various forms of trade restrictions to protect select industries, employment or longer-term objectives deemed important to future prosperity/security. Despite the practical shortcomings, trade over the last generation has been less restrictive and the global economy has been the beneficiary.

Since his election, President Trump has been aggressively reviewing the United States' trade policies, serving as the defining global economic development over the first half of 2018. The market easily digested new tariffs imposed on washing machines and solar panels to begin the year. The new tariffs on steel, aluminum and newsprint created more headlines, but investor anxiety remained generally contained. However, investors' dismissive reaction abruptly changed in mid-March when President Trump threatened China with additional tariffs and China countered with similar threats. Investors fear this tit for tat trade spat between two economic superpowers could escalate, sending shockwaves across the entire economic landscape.



President Trump highlighted unfair trading practices and theft of intellectual property when he announced these proposed tariffs on China. Many have asked--why now? The U.S. has maintained a sizeable and growing trade imbalance with China for decades and concerns about the security of intellectual property are certainly not new.

In mid-2015, with very little fanfare, China announced its Made in China 2025 policy. This 10-year strategic plan provided a blueprint for transforming China from a labor-intensive economy specializing in low tech manufacturing to a dominant leader in manufacturing high-quality and high-technology products focused on ten priority sectors: (1) Next-generation technology; (2) High-end numerical control machinery and robotics; (3) Aerospace and aviation equipment; (4) Maritime engineering equipment and high-tech maritime vessel manufacturing; (5) Advanced rail equipment; (6) Energy-saving and new energy vehicles; (7) Electrical equipment; (8) New materials; (9) Biomedicine and high-performance medical devices; and (10) Agricultural machinery and equipment.



Many people point to this policy and China's state-sponsored subsidies to build leadership within these ten primary sectors as the catalyst for Trump's tariffs. It's one thing to have a massive trade deficit with China that is concentrated in labor-intensive low-tech manufacturing, but something dramatically different to potentially contribute funding (trade deficit) that puts at risk one of our primary assets - our technological competitive advantage.

Regardless of the reason, this is not the first time investors have fretted over a U.S. trade dispute with China, nor do I anticipate it will be the last. Despite the cyclical rhetoric, the net effect of trade between China and the U.S. has been a win-win relationship. While the connections have softened, the two global economic engines remain intricately linked making a meaningful separation essentially impossible over the foreseeable future. Consequently, headlines and tweets will continue to contribute to near-term investor anxiety, while both sides negotiate and position themselves for the next phase of this trade relationship.

Against this backdrop, a closer look at the second quarter capital market environment follows.

Developed Equity Market Review

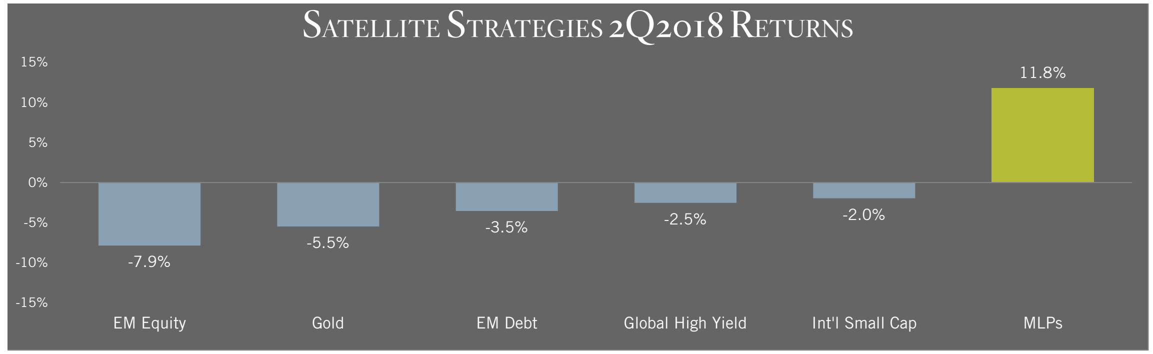
Equity investors across developed markets attempted to balance the elevated risks associated with a potential disruption in global trade against continued strength in corporate earnings. During the second quarter, earnings strength was the victor as most developed equity markets ended the period higher.

Reviewing the U.S. markets, the S&P 500 ended the second quarter up 3.4%. The quarterly gains fully offset the losses over the first three months of the year, resulting in a modest 2.6% mid-year return. For the quarter, soaring oil prices provided the fuel to propel the Energy sector to the lead, posting a robust 13.5% return for the period. Other notable second quarter outperformers were the Consumer Discretionary (Amazon) and Technology sectors, bringing their year-to-date gains into double-digits. On the opposite end of the spectrum, four sectors have experienced back-to-back negative quarters with the Financials and Industrial sectors experiencing the largest declines during the second quarter.

Evaluating the U.S. market by style and capitalization, the growth style continued its dominance within large cap as market leaders Amazon, Microsoft, Apple, Netflix, Facebook and Alphabet have accounted for the majority of the market's 2018 return. Reviewing performance by capitalization, smaller-cap companies generally outpaced their larger-cap counterparts during the quarter, partially insulated from the headwinds associated with the strengthening U.S. dollar.

Developed Market 2Q2018 Performance Contribution	Local Currency Return	Currency Impact	U.S. Dollar-Based Return
MSCI Europe Index	4.5%	-5.4%	-0.9%
MSCI Japan Index	1.2%	-4.0%	-2.8%
MSCI EAFE Index	3.8%	-4.6%	-0.9%
Source: Morningstar Direct, Welch Hornsby, Inc.			

Outside the U.S., most developed equity markets ended the quarter in positive territory, but rising U.S. interest rates and the possibility of a smaller U.S. trade deficit going forward sent the dollar sharply higher, offsetting all of the foreign equity market gains for U.S. dollar-based investors.

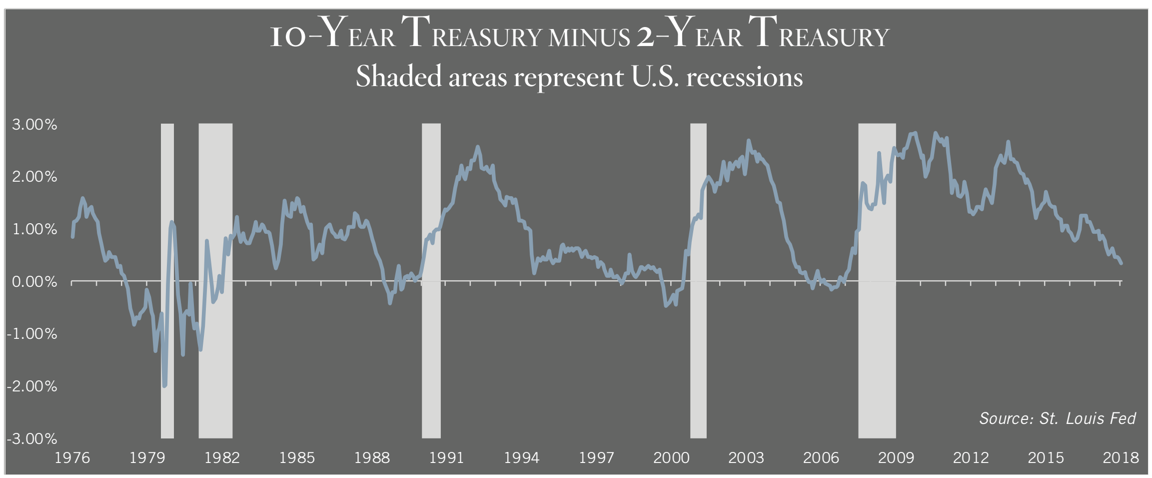


Source: Morningstar Direct, Welch Hornsby, Inc. - Emerging Mkt Equity: MSCI EM Index ($); Global High Yield: Barclays Global High Yield TR ($); MLPs - Alerian MLP TR ($); Emerging Market Debt - JPM EMBI Global Diversified TR ($); Int'l Small Cap: S&P Developed Ex US Small TR ($); Gold - S&P GSCI Gold ($)

Fixed Income Review

The Federal Reserve continued their rate normalization process by increasing the Fed Funds target 0.25% in June. Longer-term yields also advanced in April and early May, but retreated over the second half of the quarter as risk aversion climbed higher. The result was further flattening by the yield curve with the spread between 10-year Treasuries and 2-year Treasuries ending the quarter at 0.33%, a level last seen in 2007. This flattening by the yield curve presents challenges to the Federal Reserve's plan to continue raising the Fed Funds target. The question is will the Fed purposely invert the yield curve with policy decisions, knowing that an inverted yield curve has historically preceded economic slowdowns?

Within this fluid yield environment, U.S. Treasuries inched higher while corporate bonds posted modest losses. The net effect was a -0.2% decline by the Bloomberg Barclays U.S. Aggregate Bond Index.



Satellite Strategies

In an investing world where most risk assets are valued above their historical averages, select satellite asset classes are the exception, priced below historical norms. Despite this valuation advantage, the combination of rising trade anxiety and a strengthening U.S. dollar resulted in significant losses across certain areas. Hardest hit were emerging market equities, which declined 7.9% during the quarter, as measured by the MSCI EM ($) Index. Gold was another weak performer, as the historical dollar hedge declined with the dollar's upside move. The lone exception to an otherwise terrible quarter were master-limited-partnership, which saw their prices rally 11.8%, but remain in negative territory year-to-date.

WELCH HORNSBY
INVESTMENT ADVISORS
WWW.WELCHHORNSBY.COM