Investment Tally & Perspective

Second Quarter 2018 Review

MAJOR ASSET CLASS RETURNS	2nd Qtr. 2018	1-Year	3-Year	5-Year
Equities				
S&P 500	3.4%	14.4%	11.9%	13.4%
MSCI EAFE	-1.2%	6.8%	4.9%	6.4%
MSCI Emerging Markets	-8.0%	8.2%	5.6%	5.0%
Fixed Income				
Barclays Capital US Aggregate	-0.2%	-0.4%	1.7%	2.3%
Barclays Capital US Corp. Inv. Grade	-1.0%	-0.8%	3.1%	3.5%
Barclays Capital Emerging Market	-2.4%	-1.0%	4.1%	4.5%
Other Assets				
MSCI US Reit Index	10.1%	3.6%	8.1%	8.3%
S&P GSCI	8.0%	30.0%	-4.4%	-9.4%
ICE WTI Crude Oil	14.2%	61.1%	7.6%	-5.1%
Comex Gold	-5.5%	1.0%	2.3%	0.5%

Source: Capital IQ — All returns greater than one year are annualized

Market Activity-

Global stocks posted mixed results in the second quarter. The S&P 500 (SPX) saw respectable returns, posting a gain of 3.4%. Small cap U.S. stocks posted very strong returns in the quarter, with the Russell 2000 up 7.8%. Taking a deeper look at the S&P 500 - in the first half of 2018 the total return for the SPX was 2.65% and just five stocks generated 90% of the 2.65% return: Amazon (AMZN), Microsoft (MSFT), Apple (AAPL), Netflix (NFLX), and Facebook (FB); Amazon alone accounted for 33.9% of the first half return.

Emerging markets had a rough quarter with the MSCI Emerging Markets Index declining 8%. Major pain points in developing markets were Turkey and Argentina. In addition to a weakening currency, Turkey held Presidential Elections, while Argentina requested a credit line from the IMF in the quarter. Developed international markets fared better, with only a slightly negative return, which was driven entirely by the rising U.S. dollar.

U.S. fixed income posted another quarter of negative returns, bringing year-to-date results for the Barclays Aggregate Bond Index to -1.6%. Corporate credit has underperformed the Aggregate index, but high yield corporates have outperformed higher grade corporates. Given the rates and spreads available today we continue to favor shorter duration and higher quality bonds.

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The U.S. Treasury yield curve has seen significant moves in the past year, as illustrated in the diagram below. The most significant moves higher have been in the shorter maturities, while longer duration securities haven't moved as much. Other bond rates (government agency, municipal, corporate) rose in a similar manner, as have mortgage and lending rates.

Change In U.S. Treasury Rates				
	1 Year	5 Year	10 Year	30 Year
6/28/2017	1.20%	1.82%	2.23%	2.78%
6/27/2018	2.37%	2.70%	2.83%	2.97%
Change	1.17%	0.88%	0.60%	0.19%
% Change	98%	48%	27%	7%

With the exception of gold, other assets posted strong returns. Crude continued to rebound. Though OPEC and Non-OPEC countries agreed to boost output from their previously set level, this is being offset by solid demand, plummeting output in Venezuela, and upcoming Iranian sanctions.

Economic Developments-

Last quarter we spoke to the decelerating growth indicators in Europe and these trends have largely persisted as we close out the second quarter and look into the second half. Eurozone PMI has stabilized, and unemployment is working its way lower. Italian politics created some mid-quarter drama, and although the market has mostly digested these developments, the unconventional coalition may be back in the headlines soon. China is an area to watch as economic growth appears to be slowing moderately, and the Yuan has shown weakness against the U.S. Dollar and other global currencies.

While the rest of the world has downshifted, the U.S. has maintained its momentum from 2017. Job growth, inflation, corporate profits, are all moving in the right direction. We continue to march towards record expansion levels (picture courtesy of JP Morgan):

Length of past US expansions, since WW2		
Start of Expansion	**End of Expansion**	**# Months**
Nov. 45	Nov. 48	36
Nov. 49	Jul. 53	44
Jun. 54	Aug. 57	38
May 58	Apr. 60	23
Mar. 61	Dec. 69	105
Dec. 70	Nov. 73	35
Apr. 75	Dec. 79	56
Aug. 80	Jun. 81	10
Dec. 82	Jun. 90	90
Apr. 91	Feb. 01	118
Dec. 01	Nov. 07	71
Jul. 09	Current	108
Average		61
Max		118
Min		10

Source: NBER

Monetary Developments-
In sync with the above economic backdrop, central banks are generally following expected paths. The Federal Reserve will likely implement two more increases in the Fed Funds rate in 2018, and FOMC members expect three more next year, followed by one in 2020. At this pace, expectations are for short-term rates to reach 3.00 – 3.25% by the end of next year. The ECB, which still has negative interest rates on overnight deposits, signaled it will be removing its asset purchase program by the end of the year. The Bank of Canada and Bank of England are moving rates higher, while the Bank of Japan and Australia are maintaining the status quo.

Valuation & Investor Sentiment-
Investor sentiment has reset dramatically from the extreme bullishness seen at the start of the year. This is true for both individual investors and professionals. Hedge Funds have gone from overly exposed to the market at the start of the year, to in line with historical positioning. Despite this, flows into equity products have turned positive, while money has not been rushing into defensives. The latter point is interesting considering the consensus view that we are in the late innings of this bull market.

Valuations have become more compelling as the year has progressed. Stocks have moved sideways since January, while earnings have been growing throughout this period. Although 2018 EPS received a one-time boost from tax cuts, prospects for 2019 EPS growth appears solid.

Investment Outlook & Strategy

A summary view of the investment backdrop:

- The U.S. economy is strong with growth in the second quarter estimated to be double the rate of the first quarter (2% 1Q18 versus 4% 2Q18) even with a wide shortage of qualified workers
- Corporate profit growth, expected to exceed 20% this year, has momentum into 2019
- The fate of the European Union is uncertain as it deals with major issues like Brexit and Italy
- Emerging Markets are being negatively impacted by the rising dollar
- The Chinese economy has global impact; notable signs of economic softening require monitoring
- The Fed is expected to stay on its path to normalize interest rates unless incoming data pressure them to change

The sideways stock trading in the past five months or so combined with sharply higher earnings have improved valuations and, barring an unexpected shock to the global economies, are setting the stage for a rally that may take stock indices to new high levels. While we have accounts positioned to participate, there are increasing signs of excess and imbalances that are largely being masked or ignored which give us pause and concern. If wage pressures continue with the Fed staying on the path of normalizing interest rates, then the odds of a recession in 2019-2020 will rise considerably. In sum, this remains a high-risk environment that warrants prudence and increasing emphasis on capital preservation. While we maintain a neutral investment strategy, we are taking gradual steps in defensive directions through a combination of changes in overall asset allocation, and at the asset class, sector and individual security levels.

Retiring Your Mortgage Early

The question "Is it advisable to pay off your mortgage or home loan?" is a common and appropriate question for those near or approaching retirement. While the idea of retiring with no debt is enticing, related questions are, "Should you increase your mortgage payments to reduce the amount owed and avoid paying the lender additional interest", or "Should you maintain your liabilities and invest your funds with expectations of receiving a better return?" The truth is there is no right answer that fits everyone, as it depends on each individual situation. Further, the emotional aspect of this decision is just as important as the financial.

You've likely heard that if your mortgage rate is high, you should choose to pay off your mortgage early. This can be true, but there are other factors to consider. If you aren't already contributing the maximum to your retirement plan, this should be your first step. Contributions to these plans can reduce your taxable income while having the ability to grow earnings tax-free until they are withdrawn. Also, if you have higher interest debt, such as credit card balances or student loans, those should be the first to go. As financial planners, we also consider having a cash reserve of at least 3-6 months in case of an emergency as more important than paying off your mortgage.

If after considering the above you want to evaluate paying off your mortgage early, the logical process is to compare your after-tax cost of debt obligations to the expected after-tax return on funds. However, it's important to be conservative when doing the comparison. So, we suggest the comparison of the after-tax cost of debt to that of an after-tax, lower-risk investment, such as a high quality municipal bond.

If interest rates continue to rise higher, new home owners may feel that it is prudent to work towards paying off their mortgage balances instead of saving and investing excess funds. A related factor is the increase in the standard deduction to $12,000 for an individual ($24,000 per couple) which may decrease the appeal of paying mortgage interest as more taxpayers will no longer itemize their tax returns. When clients ask for assistance with this question, we provide mathematical calculations to guide their decisions. As noted earlier, while calculations are helpful, the emotional or psychological aspect is just as important, if not more. For those who want to have peace of mind, retiring debt early can be a great relief.

As always, please view us a resource for related information and contact us if we can be of assistance.
