Investment Update

July 2018 Review and Outlook

Despite ongoing uncertainty from the upcoming Congressional midterm elections, proposed tariffs and gradual change in monetary policy by the Federal Reserve, domestic equity markets rebounded for the month. At the same time, overseas equity investments declined as recent economic data suggested that overseas economic growth was moderating. Domestic equity markets rose in June, with the S&P 500 up 0.62% for the month. Small-cap domestic stocks (Russell 2000 Index) closed up 0.72% in June. International developed equities (as measured by the MSCI EAFE Index) fell 1.19% for the month.

Domestic equity markets continued to experience volatility for the month primarily due to concerns that tariffs proposed by President Trump would ignite a trade war with U.S. trading partners. There is also some concern that rising inflation and interest rates will lead to more aggressive action by the Federal Reserve, which might raise rates more quickly and more often than initially assumed by financial markets.

Fixed-income investments fell slightly during June, losing 0.08% for the month, as measured by Barclays Intermediate Government Credit Index. The yield on 10-year Treasury notes closed at 2.86%, virtually unchanged from 2.85% at the end of May. The yield on the 10-year Treasury note is up 0.45% since year-end, when it yielded 2.41%. Overall, the domestic economy continues to grow moderately. Here is our economic and financial-market perspective:

Volatility – The financial markets continued to be volatile in June as President Trump escalated his rhetoric regarding proposed tariffs. The financial markets continue to be concerned with changing monetary policy by the Federal Reserve (increasing interest rates), geopolitical uncertainty, and the midterm elections in November.

Corporate Profits – Earnings for companies in the S&P 500 are expected to increase by 20% in the second quarter. Profits in the first quarter increased for the sixth consecutive quarter and are expected to increase by 19% for calendar year 2018. Corporations are benefiting from the lower tax rates this year due to the tax-reform bill. Corporate earnings are a key driver of stock prices.

Interest Rates – As we expected, the Federal Reserve raised short-term interest rates by 25 basis points at its June meeting. The Fed expects to increase short-term rates two additional times in 2018, but will base its decisions on the most recent economic data. Interest rates are expected to remain "low for longer," however, when compared to longer term average interest-rate levels.

Consumer Confidence and Spending – Consumer confidence, as measured by the Conference Board, fell in June to 126.4 from 128.8 in May. Higher levels of consumer confidence bode well for the domestic economic outlook. Consumer sentiment, as measured by the University of Michigan, rose in June to 99.3 from 98.0 in May.

Global Central Banks – The Fed and overseas central banks continue to be accommodative by keeping interest rates extremely low by historical standards, furthering the case for equities as an attractive investment for long-term growth.

Economic Growth – U.S. gross domestic product (GDP) growth in the second quarter is expected to be over 3%, higher than the first quarter's 2.2% rate. The second quarter should reflect higher consumer spending and greater corporate profits due to the tax-cuts implemented earlier this year.

Employment – The official unemployment rate rose in June to 4.0% as an additional 601,000 people entered the labor force seeking employment, offsetting higher than expected job growth (213,000). The longer term employment-growth trend has been at healthy levels, reflecting a moderately growing economy.

Housing – Housing starts increased 5% from April levels to an annual rate of 1.35 million starts, according to the U.S. Census Bureau. Sales of existing homes declined in May as mortgage rates increased and the supply of homes for sale continues to be low. Mortgage rates have increased since year-end and bear watching to see if higher lending rates dampen housing activity.

Economic and Financial Market Outlook

Economy – The U.S. economy continues to be in solid shape, and inflation remains at historically low levels. The largest uncertainty is the proposed tariffs and potential for trade wars, which would drive up costs and could dampen consumer and business sentiment. Economic activity has been moderating in Europe, and expectations of synchronized global growth have diminished. In the U.S., the tax-reform bill is likely increasing economic activity in 2018. We continue to expect domestic economic growth to be around 3.0% for 2018.

Financial Markets – We expect markets will continue to be volatile this summer. Volatility has been elevated so far this year as they adjust to greater levels of risk regarding proposed tariffs, the potential for rising inflation, higher interest rates, and changing monetary policy, as well as geopolitical risks. Historically, the stock market has been volatile in years when there is a mid-term election. As we enter summer-vacation season, financial markets tend to be more volatile due to lower trading volumes. We also anticipate increased volatility as mid-term elections draw near. Despite all of the near-term risks and a myriad of uncertainties, the strength of corporate earnings will continue to be a key driver of the stock market. We continue to be bullish over the longer term. The priorities of President Trump and the Republican-led Congress are oriented toward generating higher economic growth in the U.S. that should lead to higher corporate earnings.

Sources: Federated Investors, The Wall Street Journal, CNBC.com, FactSet, MainStreet Advisors, The Conference Board, The University of Michigan, JP Morgan Asset Management.

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