Equity Market Update

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The first half of 2018 for the stock market can be summarized in a single word—volatile. Tax cut benefits are being chipped away by escalating trade war rhetoric, higher energy prices, political instability in Europe, and increases in interest rates. These factors have caused global growth to decelerate. Investors around the world have piled into the US dollar, tech stocks and small cap companies. Performance has been lackluster outside of these investments.

The S&P 500 gained 3.43% in the 2nd quarter, and it is up 2.65% in 2018. The index peaked on January 26th but faded as inflation and trade fears took hold. Currently, the S&P 500 is 5.39% below the January high. A handful of names account for almost all the positive year-to-date performance.

The results are worse for the Dow Jones Industrial Average. It increased 1.26% for the quarter, and it is down 0.73% this year. Large weights in Boeing, 3M and Caterpillar have hurt the index as political spats over trade escalate.

The NASDAQ surged 6.61% in the 2nd quarter. It has outperformed both the S&P 500 and the Dow Jones Industrials for six consecutive quarters. Year-to-date, it remains the best performing large cap domestic index advancing 9.38%. Sharp gains in ecommerce and internet software have enabled the NASDAQ to outperform the S&P 500 and Dow. However, like the S&P 500, the NASDAQ continues to get the lion share of its gains from only a few companies.

Investor crowding into technology has become a topic of concern for the market. Many companies within the tech sector have advanced by large sums in just six months. A recent report from Bernstein showed tech stocks are as crowded of a trade since their previous peak in 2000. Jim Paulsen at Leuthold Group stated that technology is accounting for 99.4% of the S&P 500's entire return this year! Even more astounding was a research piece from Morgan Stanley that showed all the performance is coming from only six tech companies—Amazon (+45.35% in 2018), Netflix (+103.91%), Apple (+10.25%), Microsoft (+16.31%), Facebook (+10.12%) and NVDIA (+22.58%).

President Trump's steel and aluminum tariffs on Canada, Mexico and the European Union have resulted in retaliatory responses. The President is now considering new tariffs on imported cars and auto parts. He has also sharpened the tools used by CFIUS (Committee on Foreign Investment in the US) to block Chinese investment into US technology. Investors are worried that the potential for a global trade war has increased. This has led to a sharp rally in mid and small sized companies which are largely immune from trade spats and movement in the US dollar. The S&P 400 Mid-Cap Index jumped 4.29% in the quarter, while the S&P 600 Small Cap Index gained 8.77%. Thus far in 2018, mid-cap stocks are up 3.49%, and small-cap stocks have increased 9.37%. Earnings growth, along with their underperformance versus large cap in 2017, makes midcap and small-cap stocks very attractive, especially since the tax cuts will lead to dramatically higher profits for these types of businesses.

Trade tension, a rising US dollar, and political instability in Europe have negatively impacted international markets. The MSCI EAFE index fell 0.89% in the quarter and is now down 2.40% for the year. Emerging markets have fared even worse. The MSCI Emerging Markets index fell 7.78% in the 2nd quarter, and the index is now down 6.60% in 2018.

All last year, we wrote about the remarkable rally in growth stocks. For 2017, growth outperformed value by an astounding 1,657 basis points per Russell. This marked the widest performance disparity between growth and value since 1999. Conditions have not let up in 2018 with growth beating value yet again by 894 basis points.

The economic picture continues to improve in the US. Second quarter GDP growth is estimated to be around 4%, mainly due to a jump in exports as companies try to ship items ahead of retaliatory tariffs. The labor market remains robust. Unemployment fell to

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3.8%, the lowest since April 2000. The economy has added jobs for 92 straight months, the longest stretch in history. Wage growth, along with extra income from the tax cuts, has led to a rebound in consumer spending. The savings rate is still low at 3.2%, but the financial state of the consumer remains strong. The overall US economy has been in expansion for 108 months. This makes the current cycle the second longest in history behind the late 1990s. Finally, the Citigroup Economic Surprise Index has moderated from its year-end highs as analysts have boosted their economic forecasts. Unfortunately, the economic gains in the US have not continued overseas as trade disputes and a rising US dollar have led to decelerating growth in Europe and the emerging markets.

Economic success in the US opens the door for the Fed to remove monetary stimulus. They raised rates by another 0.25% in June, and Chairman Powell indicated the FOMC is considering four rate hikes this year in response to rising inflation and low unemployment. The Fed is also shrinking their balance sheet by $30 billion per month.

In our opinion, the words and actions from the major central banks, especially the Fed, will be an oversized factor in determining stock returns in 2018. Investors cling to these bankers' every word since we are living in unprecedented economic times. At no other point in recent history have we seen central banks signal monetary tightening through interest rate hikes and balance sheet reduction, while fiscal policy is signaling looser conditions with tax cuts and deficit spending. Only time will tell if these competing views cancel each other out, or if one side wins over the other. Until then, this will likely create volatility in the capital markets. This means it is important to look at the levels in interest rates and the shape of the yield curve.

Earnings are another major factor influencing stock returns. In the 1st quarter, S&P 500 companies produced year-over-year earnings growth of over 25%. The reduction in corporate tax rates accounted for a large amount of the growth, but pre-tax earnings growth of 12.1% was still very strong. As we enter the next earnings season, we expect earnings growth to remain robust, especially for energy and technology companies.

A large jump in earnings, along with a market that is little changed for the year, has dramatically improved the valuation picture. For three years, we have written about the high valuations in the stock market. Currently, the S&P 500 trades at 16.13x EPS estimates for the next 12 months. This is slightly above the long-term historical average of 15.75x.

With interest rates still low compared to historical standards, stocks are attractive on a relative valuation basis. Despite the insistence from central bankers that they will move at a slow and measured pace, it is fair to say that further tightening will serve as a headwind for stock PE multiples. This puts additional gains from here on the shoulders of continued earnings growth and improving economic conditions.

Currently, economic data does not indicate a recession in the next 12 months; however, many red flags indicate a transition from the mid-cycle to the late cycle. This means the potential exists for higher levels of volatility; therefore, we expect stock returns to be more modest in 2018 when compared to the previous year.

We are overweight financials and energy paired with an underweight in materials. In defensive sectors, we are overweight healthcare paired with underweights to consumer staples, utilities, telecom and REITs.

On the global scale, we are overweight US stocks and underweight developed international. Within the US, we remain overweight mid and small-sized companies since they stand to benefit the most from corporate tax cuts and the reduction of regulations from President Trump. Finally, we have an inline weight to emerging markets.

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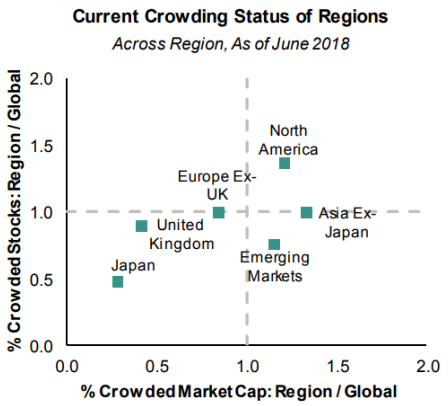
General Market Observations

On June 29th, Bernstein issued its most recent Crowding report. The report shows the US is still the most crowded region in the world. China is the most crowded in emerging markets.

EXHIBIT 12: **Investors currently favor the U.S. over other regions**



Globally, tech is still the most crowded sector, followed by Consumer Discretionary. Technology is at its most crowded point since 2000, with software the most crowded. Consumer Discretionary's crowding is almost entirely comprised by Amazon and Nike.

EXHIBIT 16: **Global Sector Crowding Status: Current**

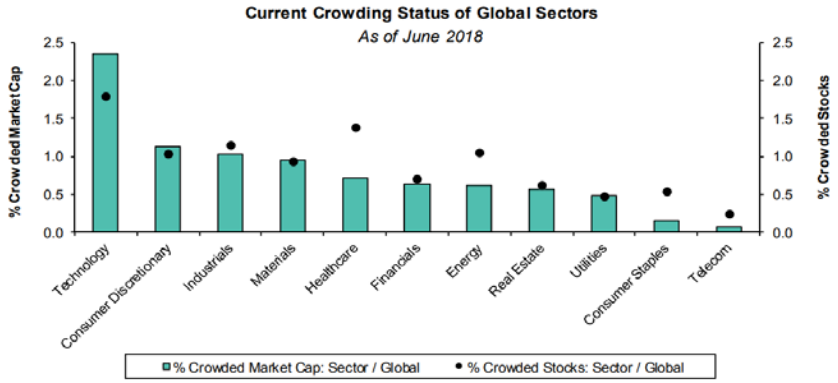
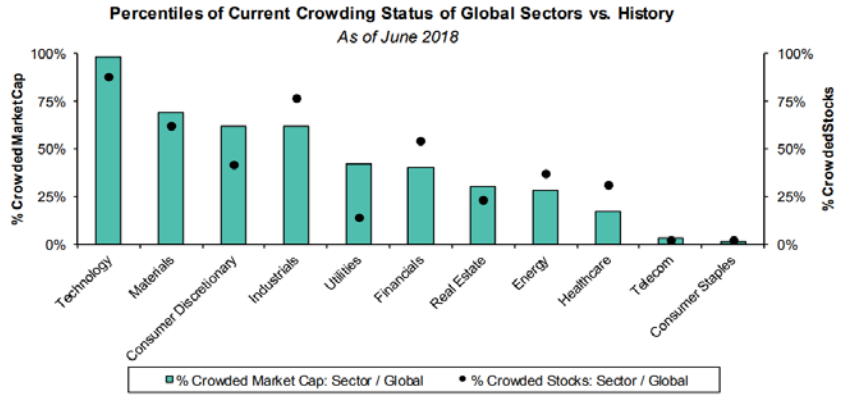
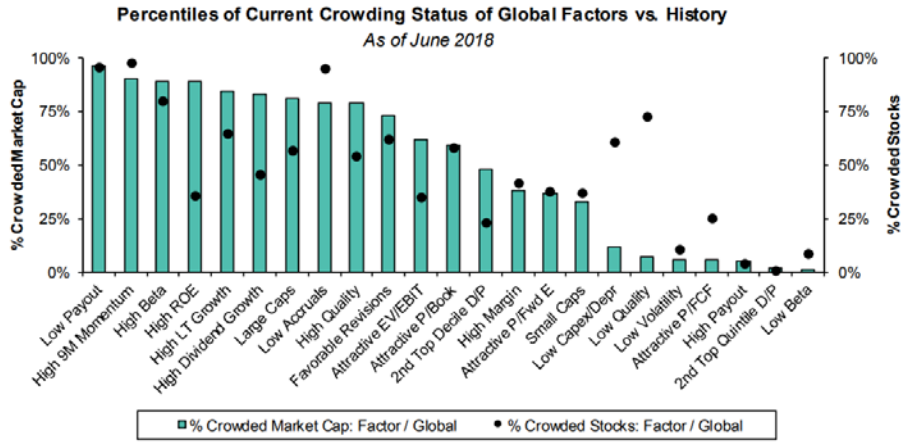


EXHIBIT 17: **Global Sector Crowding Status: Percentiles vs. History (2000-2018). 100%=Most Crowded.**



Globally, low payout and high momentum, followed by high beta are at their most crowded state since 2000. On the flip side, low beta, 2nd quintile dividend payers (big equity income constituents), and attractive price-to-cash flow are near 20 lows.

EXHIBIT 19: **Global Factor Crowding Status: Percentiles vs. History (2000-2018). 100%=Most Crowded.**



The global data is being skewed by the overcrowding in US tech and consumer discretionary. Like the above global chart on factors, the US is experiencing the most crowding in high momentum, high ROE and low payout since 2000.

EXHIBIT 23: **North America Sector Crowding Status: Current**

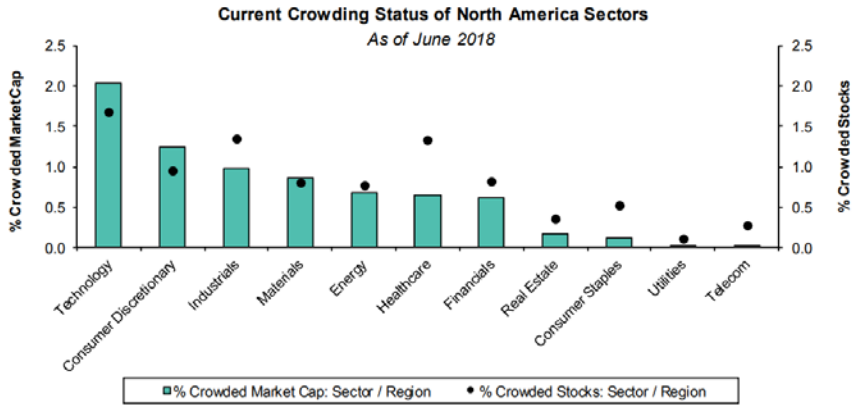


EXHIBIT 24: **North America Sector Crowding Status: Percentiles vs. History (2000-2018). 100%=Most Crowded.**

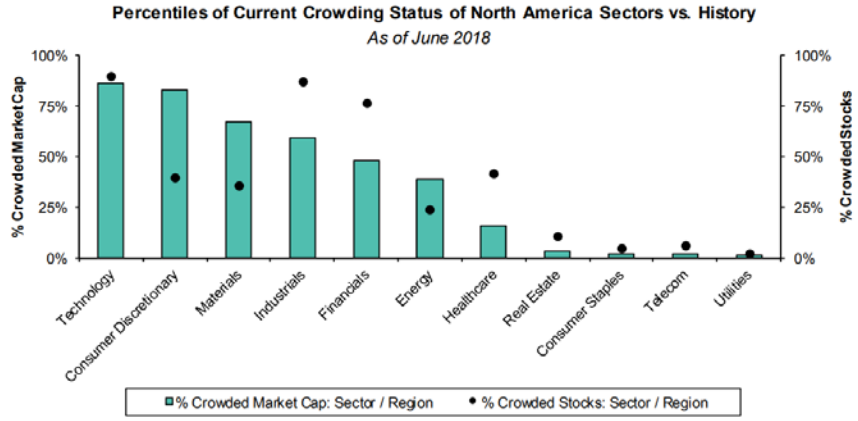
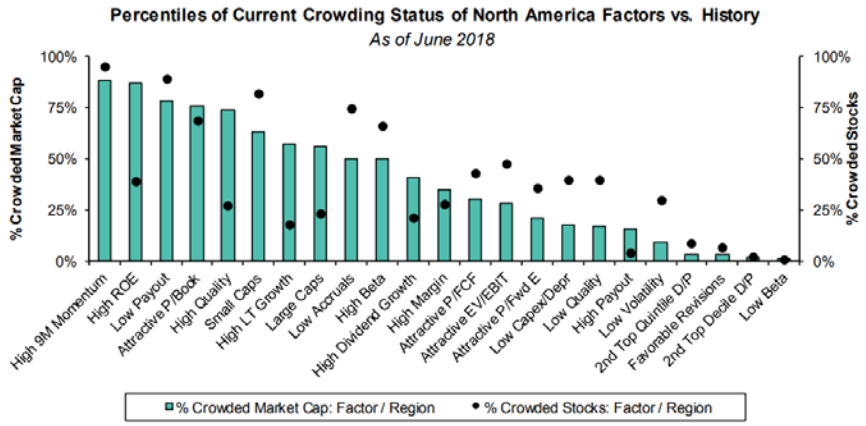


EXHIBIT 26: **North America Factor Crowding Status: Percentiles vs. History (2000-2018). 100%=Most Crowded.**



While technology and consumer discretionary are at their most crowded point since 2000, many other sectors are near the lowest point for crowding.

EXHIBIT 31: **North America: Consumer Staples**

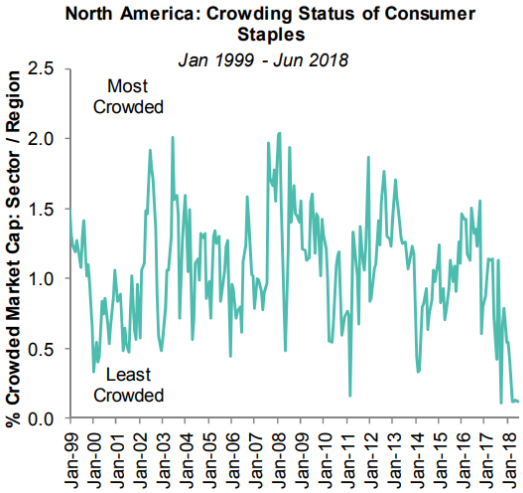


EXHIBIT 32: **North America: Energy**

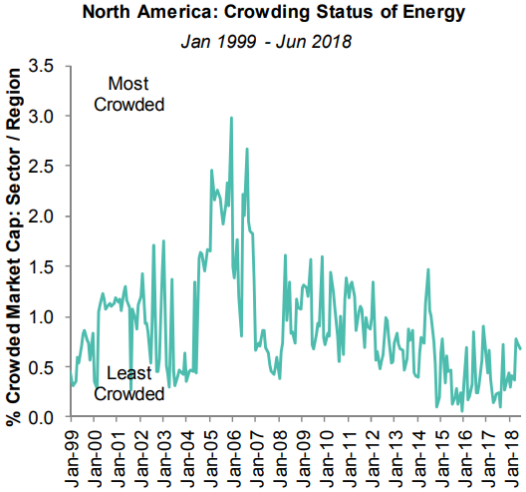


EXHIBIT 34: **North America: Health Care**

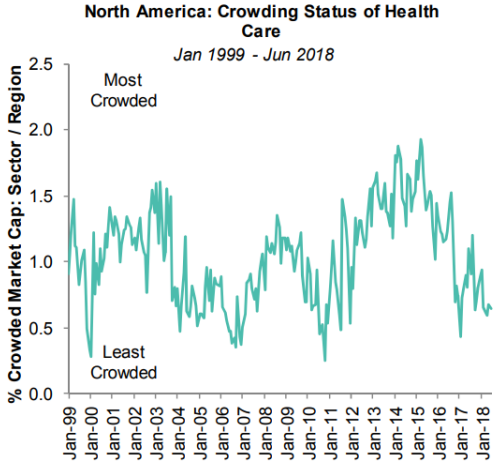


EXHIBIT 37: **North America: Real Estate**

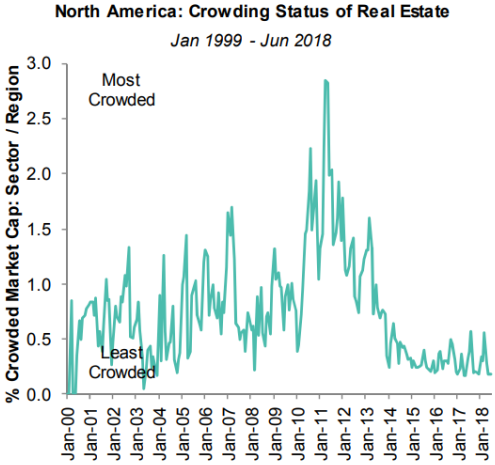


EXHIBIT 39: **North America: Telecom**

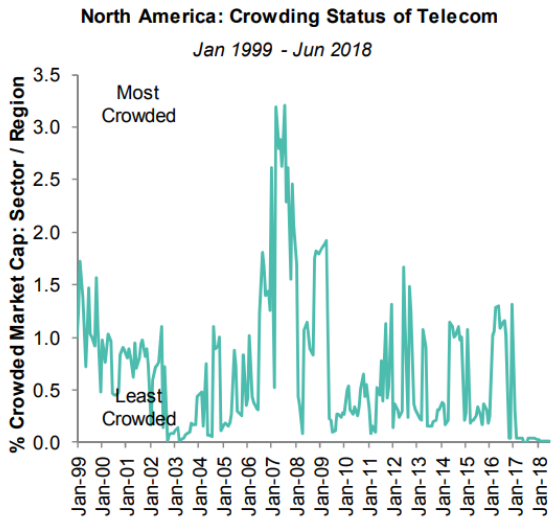


EXHIBIT 40: **North America: Utilities**