The Ten Themes of 2Q 2018

U.S. and International stocks diverged in the second quarter of 2018. Advantage U.S. stocks! Over the three months ended June 30, 2018, large cap U.S. stocks, as measured by the S&P 500, gained +2.93% and shares of smaller companies, as measured by the Russell 2000, fared even better rising +7.43%. Outside of the U.S., stock returns were awful. The MSCI Developed International index, which represents mostly Europe and Japan, declined -3.86% and Emerging Market stocks got slammed falling -10.25% during the second quarter of 2018.

Our decision to overweight U.S. stocks, with a greater emphasize on small caps, has been the correct one in 2018. Our research indicates that the performance gap between U.S. stocks and International stocks is likely to grow even wider in the second half of 2018. There are several reasons why U.S. stocks are performing better this year. Perhaps the two biggest reasons are the lowered tax rates, which have provided a short-term boost in cash flows for U.S. corporations and the potential for better trade deals for American companies and workers.

It was not a smooth ride up though during the quarter as the Trump administration followed through with its campaign promises and placed tariffs on imported goods from China and many other countries. China decided to hit back with additional tariffs with the intention of targeting Trump's voter base, farmers. This is a smart move by China. However, financial markets are betting that the U.S. will win in a global trade conflict versus China. What do we mean? Look at the scorecard. Since trade war talks started in late January 2018, Chinese stocks, as measured by the Shanghai composite have declined -20% from their closing highs. Small cap U.S. stocks, on the other hand, have rallied +12% off their 2018 closing lows. Clearly, financial markets are placing the U.S. as the clear-cut favorite to win this fight.

As we enter the second half of the year, we want to stress emotions can drive financial markets in the short term. Because of an escalating fear of additional tariffs adversely impacting global trade, investors could get very nervous if some compromises are not soon reached. Some will even begin to bring up the R word (i.e. recession.)

While fears could run high, the fact is during the first three months of the year, we learned 1Q 2018 earnings among the companies in the S&P 500 index grew at a rate of +25%. This represented the best growth we have measured in any quarter in over eight years. Even better, as companies were reporting their 1Q 2018 results, they guided Wall Street analysts mostly higher for even greater profit growth in 2018. In other words, while fear may grow about a recession, the underlying strength in corporate sales and earnings suggest otherwise.

Stay tuned as we objectively measure and analyze the data for any changes that could alter our opinion(s). In the meantime, **here are the ten themes** that we believe **were the most relevant for financial markets over the past three months.**

1. Trade War(s)
2. U.S. stock outperformance
3. Emerging Market crash
4. More Fed rate hikes
5. Less stimulus abroad
6. Flattening yield curve
7. Commodity prices flat
8. Bricks in the Wall of Worry
9. Rising earnings expectations
10. Global stock market performance

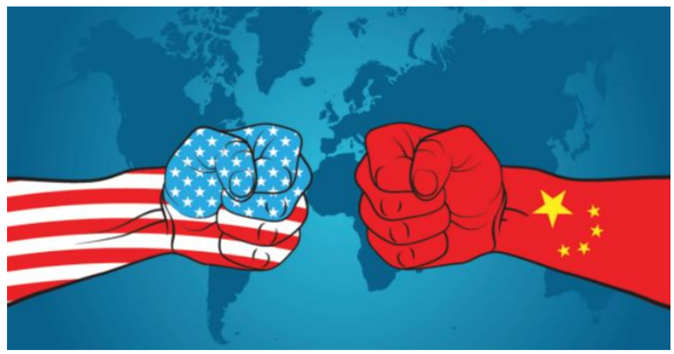
Trade Wars

Earlier this year, the Trump administration proposed a 25% tariff on Chinese Steel and a 10% tariff on Aluminum. This caused investor anxiety as the Chinese government came back with its own additional 25% tariffs on an equal amount of U.S. goods. While other countries such as Canada and Germany are also involved with the U.S, in a tit for tat trade skirmish, let's face it, Trump is targeting China.

Interestingly, the proposed U.S tariffs on Chinese goods and services are more related to technology while China is targeting U.S. farm goods. It is at least in theory smart for China to place additional tariffs on cherries and soybeans and put pressure on Trump's base of voters.

While the threats of an escalating trade war make great headlines, the truth remains that both countries still need each other. Trump is trying to get better deals for U.S. companies and workers. As such, trade war fears are still likely overblown. We say that not because a trade war would not be bad. We say that because we know both sides understand it would be bad and concessions will eventually be made. Therefore, investors are best served not to overreact and hit the sell button on trade talk at this time.

Fear of a China / US trade war is a worry



A trade war is unlikely though because each side needs each other

U.S. stock outperformance

After posting its first quarterly loss in three years during the 1Q of 2018, the S&P 500 index bounced back in the 2Q of 2018 period by gaining +2.93%. In fact, the large cap index only posted gains in April, May and June! That may come as a surprise given the negative headlines in the press on global trade and the Fed set to become more restrictive with its policy.

As we have already noted, small cap U.S. companies fared even better during the 2Q 2018 period, as the Russell 2000 gained +7.43%. It also posted gains each month during the most recent quarter. You might also be surprised to know that U.S. small cap stocks have posted gains in 5 out of the 6 months in 2018.

We continue to favor smaller U.S. companies over larger ones as they will benefit more from last year's corporate tax rate cuts from 35% to 21%. The trade wars will also benefit smaller companies as more fair trade practices will impact their bottom lines disproportionately over large companies, which have more international operations.

Emerging Market Crash

While U.S. stocks have posted gains this year, many of the major stock indices we track in the MSCI Emerging Market index were in crash mode during the 2Q 2018 period. We have been correctly underweight International stocks this year and we are sticking with that recommendation as we enter the 2H of 2018. There are several reasons why Emerging Markets have underperformed and why we do not see those negative factors abating over the next six months. Perhaps the two greatest factors that keep us cautious on overseas markets are the potential for less favorable trade conditions, and the negative impact the rising value of the U.S. dollar will have on developing economies. The graph below illustrates the divergence in returns between domestic and international equity.

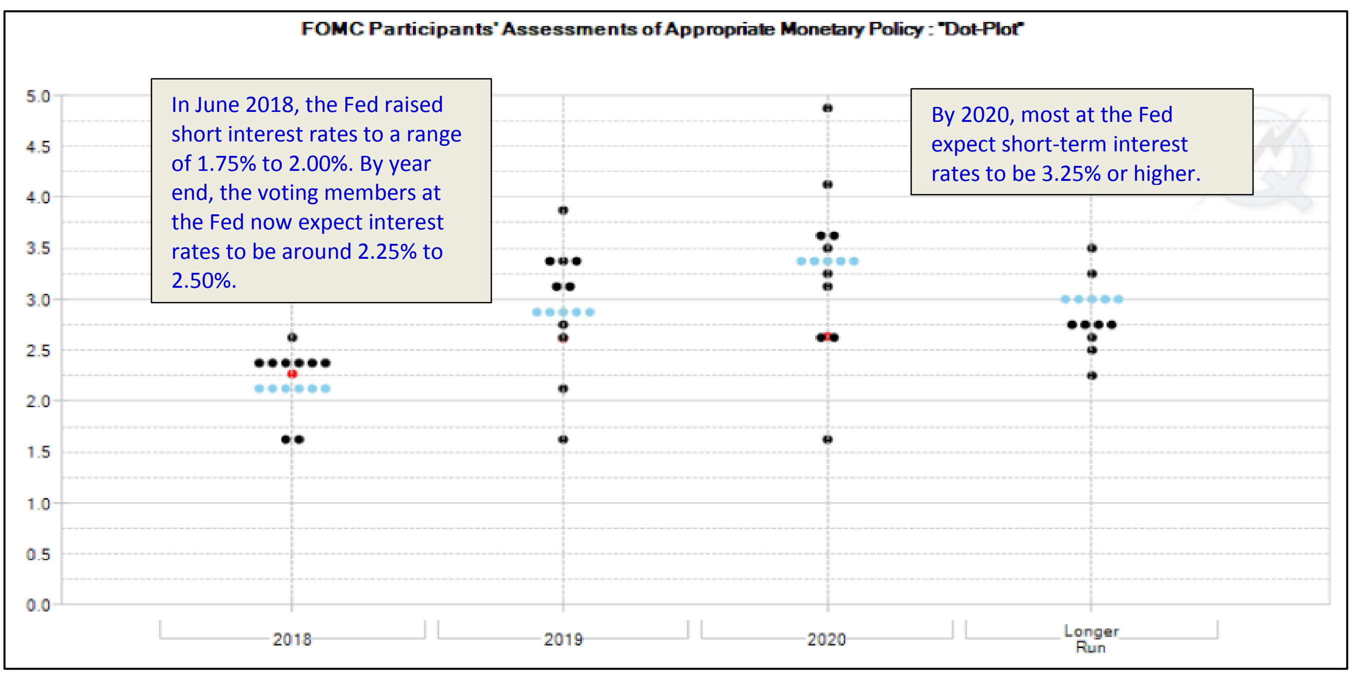
Country	Stock Index	*2Q 2018	*YTD
U.S. Small Cap	Russell 2000	7.43%	7.00%
U.S. Large Cap	S&P 500	2.93%	1.67%
Greece	ASE	-2.94%	-5.58%
Developed International	MSCI Developed International	-3.86%	-4.72%
South Korea	KOSPI	-4.89%	-5.73%
Indonesia	JSE Composite	-6.30%	-8.75%
Philippines	PSEi	-9.85%	-15.95%
China	Shanghai Composite	-10.14%	-13.90%
Thailand	SET Index	-10.17%	-9.02%
Emerging Markets	MSCI Emerging Markets	-10.25%	-8.04%
Brazil	Ibovespa	-14.76%	-4.76%
Turkey	BIST 30	-15.72%	-16.89%

*As of June 29, 2018
Source: Bloomberg

More Fed rate hikes

On June 13, 2018, the Fed hiked its benchmark federal funds rate by +0.25% to a range of 1.75% to 2.00%. The policy setting FOMC (Federal Open Market Committee) envisions two additional rate hikes this year. If that occurs, it would mean a total of four rate hikes in 2018. Back in March 2018, the FOMC was only expecting three rate hikes this year.

By the end of this year, short-term interest rates should be around 2.25% to 2.50%. As the Fed raises rates, expect slightly more from your savings account, but also to pay more in interest on mortgages, auto loans, credit cards, etc. the key for stocks is how will higher interest rates impact corporate profits?



Source: Federal Reserve, The Earnings Scout

Less stimulus abroad

While the U.S Federal Reserve ended its QE bond buying stimulus program two years, and has now embarked on normalizing interest rates by raising them to prior levels, central banks outside of the U.S. have still been pumping stimulus dollars into the economy. Most notably, the European Central Bank extended its QE bond buying program this year, when it was supposed to end it last year. However, the amount of stimulus it has been injecting into the Eurozone economy has been cut in half. It will be cut in half again in September with the goal of ending the program at the end of the year.

Our research on the impact global central bank stimulus has had on improving macroeconomic expectations over the past ten years suggests that less stimulus from the monetary policy makers is having an adverse impact on expected economic growth. This is yet another reason we are more negative on international markets.

You may ask but what about the U.S.? The U.S. Fed is no longer doing QE and is raising interest rates. That should hurt growth and U.S. stocks should be underperforming even more than international stocks. We say do not overlook the help on the fiscal policy side in the U.S. in the form of the Tax Cuts and Jobs Act and less regulation. The easy fiscal policy initatives have helped carry the baton of stimulus in the U.S,, and our research indicates this will extend the current economic cycle longer than the consensus anticipates.

Flattening Yield Curve

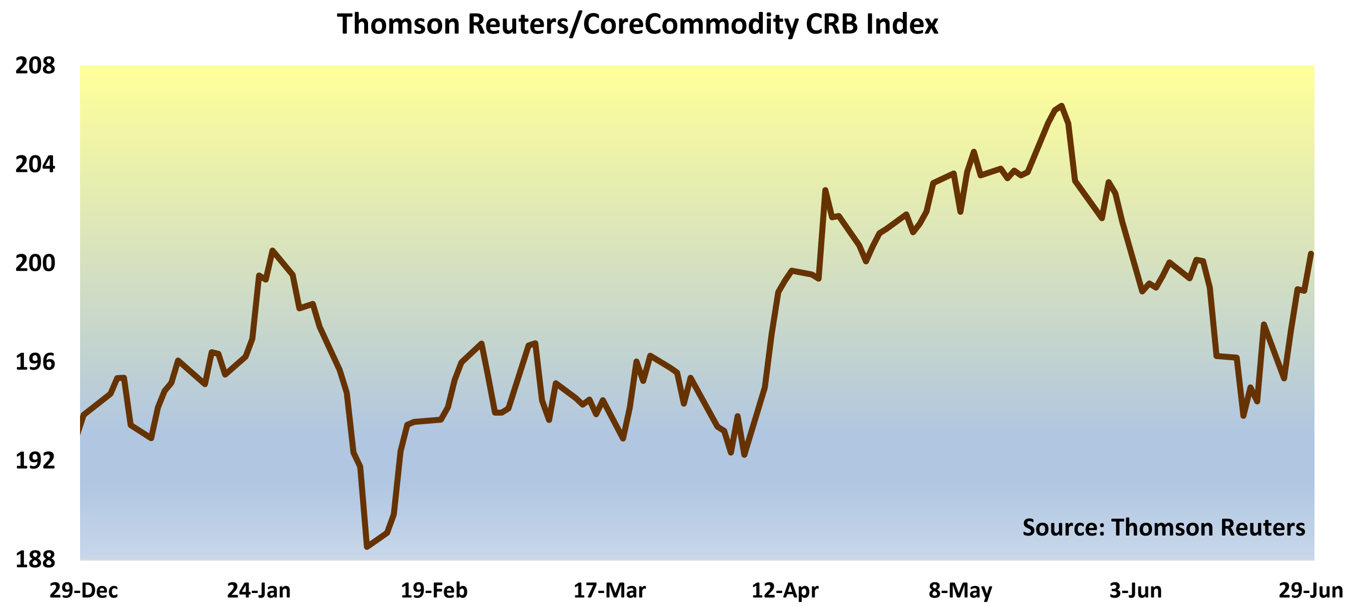
The U.S. yield curve is often referred to as the spread between the rate on a 2-year note and a 10-year U.S. treasury bond. When the spread widens (i.e. steepening yield curve) between the rates on 2 and 10-year notes, it tends to indicate an expanding economy. When the spreads narrows (i.e. flattening yield curve) it typically means less robust economic growth on the horizon. When it inverts (i.e. the rate on a 2-year note becomes higher than that on a 10-year bond), it tends to indicate a pending recession. In the last 20 years, the yield curve has inverted twice. Once in 2000 before the dot.com collapse and again in 2007 before the financial crisis of 2008.

The rate on a 2-year note closed 2017 at 1.89% and the 10-year bond ended the year at 2.40%. Thus, the yield curve was +51 basis points. At the end of the first six months of 2018, the rate on a 2-year note has risen to 2.52% while the 10-year rate jumped to 2.85%. If you take a closer look at those numbers, you will see the rates on the short end of the curve (i.e. the 2-year note) rose more than on the long end (i.e. the 10-year note). As such, the yield curve has narrowed 18 basis points in 2018 to just +33 bps. Ideally, we would like to see this yield curve steepen so it would reflect better economic growth ahead. However, our research shows the bond market remains cautious and market bears keep pointing to the flattening yield curve as a sign of a looming recession.

Commodity prices flat

In addition to the U.S. bond market signaling caution, commodity markets have been somewhat cautious as well in 2018. Specifically, commodity prices, as measured by the Thomson Reuters Core Commodity CRB index, which tracks 19 different commodities, from crude oil to orange juice, rose +2.57% in the 2Q 2018 period but are only up +3.37% in the first half of the year. With some investors worried about inflation rising too fast, we are unlikely to see it any time soon given commodity prices being held in check.

We also want to highlight that falling commodity prices are usually a sign of slowing economic activity. Therefore, with prices rising gradually, commodity markets are indicating a gradually improving economy. Our research on earnings trends paints a similar picture of the economy.



Bricks in the Wall of Worry

In 2017, markets were remarkably calm rising on the hopes of Trump's tax cuts even though uncertainty about its passage was very high. In our opinion, last year was when market volatility should have been excessive. Instead, 2018 has turned out to be a roller coaster ride for stock investors.

On Wall Street, there is an adage that "stocks climb a Wall of Worry." This is actually very true since stock prices reflect future earnings expectations for each company. Therefore, if the market is expecting negative things for a company and those negative factors have been discounted into its stock price, if those negative things do not occur, the stock price will eventually rise "climbing a wall of worry."

In 2018, there have been many negative factors that have arisen that have caused the stock market to sell off. Some of which include rising interest rate fears, inflation fears, threat of global trade, threat of nuclear war, etc. If any of these factors begin to impact corporate earnings expectations, then lower stock prices would be justified. For the time being, we acknowledge these threats as potential negatives; however, we are not yet measuring any deterioration in U.S. earnings expectations. Therefore, they are each bricks in the Wall of Worry that should allow stocks to climb higher in the 2H of 2018 when they are proven as unjustified fears.

Rising Earnings Expectations

Fears have come and gone and then re-arisen during the first six months of the year. This has depressed stock prices. However, the main long-term driver of stock prices, changes in earnings expectations, keep rising. What's more, this was the first time in over seven years that we measured a majority of companies in the S&P 500 raising their earnings expectations after reporting results. We attribute most of those rising earnings expectations to the Tax Cuts and Jobs Act. In fact, in nearly 25 years of compiling earnings data, we have never measured so much growth this late in an economic cycle. The key questions for markets is, "is this as good as it gets? And, can above trend growth persist longer than the market expects?

How S&P 500 EPS growth estimates have changed in 2018: They are going higher!

Date	2Q18E EPS Growth	3Q18E EPS Growth	4Q18E EPS Growth	1Q19E EPS Growth
1/1/2018	9.69%	14.69%	11.60%	9.34%
2/1/2018	15.77%	20.48%	13.19%	10.25%
3/1/2018	17.60%	22.62%	13.70%	10.89%
4/1/2018	18.13%	23.09%	14.41%	10.71%
5/1/2018	17.65%	23.56%	15.28%	8.51%
6/1/2018	18.15%	23.39%	15.18%	6.29%
6/30/2018	18.95%	23.82%	15.44%	7.11%

Source: The Earnings Scout

Global Stock Market Performance Returns

Country	Stock Index	1Q 2018 Return	2Q 2018 Return	2018 YTD
U.S. Small Cap	Russell 2000 Index	-0.40%	7.43%	7.00%
India	SENSEX	-3.20%	7.45%	4.01%
Portugal	PSI	0.32%	2.27%	2.60%
Australia	S&P/ASX 200	-5.10%	7.56%	2.07%
Taiwan	TSE	2.47%	-0.64%	1.82%
U.S. Large Cap	S&P 500	-1.22%	2.93%	1.67%
Canada	TSX Composite	-5.19%	5.92%	0.42%
France	CAC	-2.73%	3.02%	0.21%
U.K.	FTSE	-8.21%	8.22%	-0.66%
Ireland	ISE	-6.32%	5.90%	-0.79%
Italy	MIB	2.55%	-3.50%	-1.04%
Japan	Nikkei 225	-5.76%	3.96%	-2.02%
Hong Kong	Hang Seng	0.58%	-3.78%	-3.22%
Mexico	Bolsa IPC	-6.54%	3.34%	-3.43%
Spain	IBEX	-4.42%	0.23%	-4.19%
Germany	DAX	-6.35%	1.73%	-4.73%
Brazil	Ibovespa	11.73%	-14.76%	-4.76%
Greece	ASE	-2.73%	-2.94%	-5.58%
South Korea	KOSPI	-0.88%	-4.89%	-5.73%
Indonesia	JSE Composite	-2.62%	-6.30%	-8.75%
Thailand	SET Index	1.29%	-10.17%	-9.02%
China	Shanghai Composite	-4.18%	-10.14%	-13.90%
Philippines	PSEi	-6.76%	-9.85%	-15.95%
Turkey	BIST 30	-1.40%	-15.72%	-16.89%

Source: Bloomberg

Conclusion

Last year's global stock rally was built on hope and speculation that easy fiscal policy would lead to increased profits and higher stock prices. Because of the reality of lower U.S. taxes, we are now more optimistic that CEO's will go out and spend those savings on property, plant and equipment. This has already supported further revenue growth for S&P 500 companies in the 1H of 2018. Therefore, we expect more U.S. stock outperformance over

International markets. Our research also indicates more solid performance ahead for small cap U.S. based companies because they stand to benefit more from the tax cuts than large cap companies. Small caps should also benefit more from better trade deals for American companies and workers.

As always, we will be paying close attention to the U.S. Fed in 2018. It has taken steps to raise interest rates and reduce the size of its balance sheet. These moves are the opposite of the stimulus the central bank has provided markets for almost a decade. Additionally, we must closely monitor the impact additional tariffs will have on global economic activity. Will all the bricks in the wall of worry derail the improving economic growth? Maybe, but our research indicates that it is not likely at this point.

While we take great pride in our measurement and understanding of all the economic and earnings data, it is impossible for us to know every major market factor in advance. Because of this we continue to apply our fundamental beliefs that risk and return are related, markets are efficient over time, profitability matters and diversification is key. These fundamental beliefs continue to be the core of our short term and long-term investment approach.

We hope you found this information useful and encourage you to approach us with any questions you may have. We look forward to our next conversation.

Strategic Investment Advisors Investment Committee,

Mark Klopfenstein, AIF® **Nick Raich, CFA®**