Towerpoint Wealth
Monthly Market Commentary

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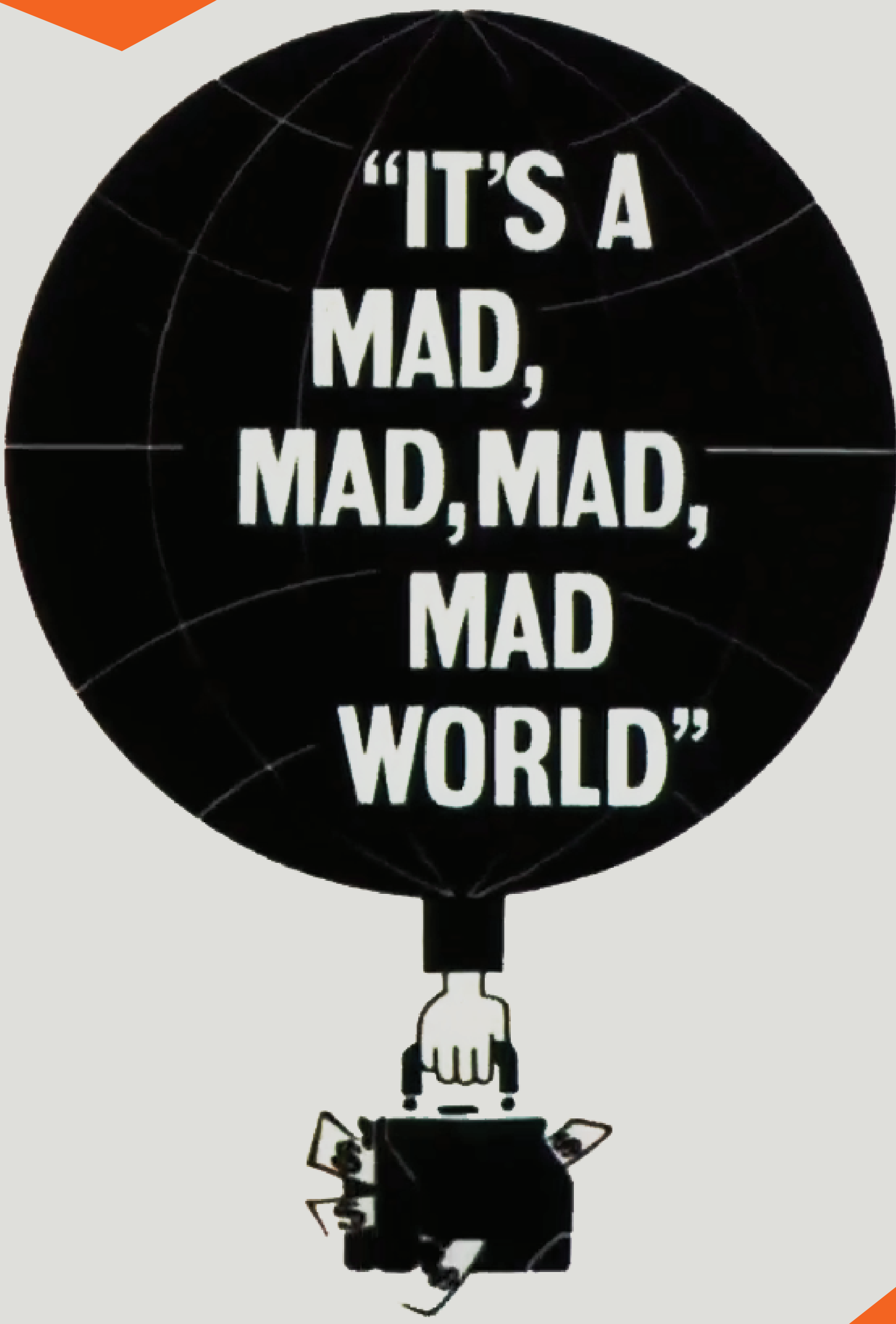
It's A Mad, Mad, Mad, Mad World

June 2018



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"An Investment in Knowledge Pays the Best Interest"
(Ben Franklin)

It's a Mad Mad Mad Mad World…

Benjy Benjamin *(Buddy Hackett): Look! We've figured it out seventeen different ways, and every time we figure it, it was no good, because no matter how we figured it, somebody don't like the way we figured it! So now, there's only one way to figure it. And that is, every man, including the old bag, for himself!*

Ding Bell *(Mickey Rooney): So good luck, and may the best man win!*

Benjy Benjamin *[to Mrs. Marcus (Ethel Merman)]: Except you, lady. May you just drop dead!*

(From "It's a Mad Mad Mad Mad World", 1963)

No sooner had the market recovered from the Italian political crisis than increasing trade tensions between the US and its primary trade partners spooked the market yet again. As we head into the end of June, the uncertainty over the direction of these trade talks resulted in sharp drop-offs in most global equity markets.

We suspect this is what investors should expect over the rest of this year. The underlying fundamentals remain generally positive – the US economy is accelerating, the non-US economies remain positive (with signs of deceleration), global inflation remains in check, global interest rates remain under control, and earnings remain positive (though, again, with signs of deceleration).

But, just like the summer months frequently bring violent weather and thunder storms, geopolitical issues seem determined to drive increased volatility into the markets. First, we had the on-again / off-again / on-again summit between the US and North Korea – of which the ultimate outcome remains unknown. Then we had the Italian political crisis, which appears to have settled down (or at least as settled down as it ever gets with Italian politics, which means *for now*) and, then, over the course of mid- to late-June, the markets turned increasingly nervous as the Trump administration announced additional trade tariffs on China (to which, of course, the Chinese retaliated). The negative effects of the tariffs battle are already being felt, as companies such as Harley Davidson announced that increased raw material and production costs, combined with retaliatory import tariffs in Europe and Asia, are forcing the company to move more production overseas – the exact opposite of what the Trump administration desires.

There are three market phenomena becoming increasingly clear, all of which will make for interesting times as we head into the typically slow summer months. First is the desynchronization of the global economy. The US is accelerating as the full effects of the regulatory roll backs of the Trump administration and the early-year tax reforms are working their way through the economy. Meanwhile, Europe, Japan, and China, though still posting positive economic growth, show distinct signs of deceleration, specifically in manufacturing.

Second, the US dollar is on a tear. The "uncoupling" of global central bank policy (as the US tightens while the rest of the world remains largely accommodative), combined with accelerating US economic growth and inflation, have resulted in the dollar rising steadily since the end of the first quarter. This actually is what we

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forecasted at the beginning of the year, but we were wrong through the first quarter. We now believe the dollar may begin to stabilize but will generally grind higher as we move through the year.

This has several knock-on economic and investment effects: (1) it will negatively affect US exports (which may be a contributing factor to the dramatic outperformance of small cap stocks so far this year, as they generally tend to be more domestically focused companies); (2) it will help Japanese and European exports, as their goods become more competitively priced on the global stage. At the same time, a weakening euro will hamper ECB President Mario Draghi's plan to begin tapering quantitative easing in Europe later this year; and (3) it will continue to put headwinds into non-US investments. Investor outflows and weakening currencies have dragged down EAFE and EM investments for US investors, and this may continue.

Third, we definitely have entered a new market regime, with dramatic differences in the performance of different equity markets. Large cap US stocks are slogging along (despite strong earnings), while small cap stocks are thriving as the full effect of policy changes in the US work through the markets. At the same time, decelerating economic growth and the strengthening dollar have pushed non-US markets into negative territories for the year (in US terms).

We believe investors should expect more of the same over the next several months, with increased volatility and periodic (but probably short-lived) panic attacks as whatever the *next* geopolitical crisis is spooks investors. The silver lining is that this should present better opportunities for both active and non-traditional managers.

With that as a backdrop, looking out over the current economic and investment landscapes, here is what we see.

The Current Economic Landscape

The word for the current state of affairs is *desynchronization*:

- The consensus estimate for Q2 GDP growth in the US is a sizzling 3.6%. GDP growth is expected to remain strong but decelerate through Q3 (3.0%) and Q4 (2.9%); (source: *The Wall Street Journal*);
- There remains some uncertainty regarding this forecast, however, as the outcome of ongoing trade negotiations could change the economic outlook for the US over the remainder of the year. Specifically, current trade negotiations seem to be taking a protectionist-leaning turn for the worst, which has already resulted in retaliation policies that will affect both inflation and global growth. Of specific concern are agricultural products, including soy beans, which are a major source of exports to China. Politically, these policies affect many of the voters who helped propel Donald Trump into office. We can expect that Congress people and Senators from states most affected by increased tariffs will increasingly speak out against current policy;
- Both the US manufacturing and services sectors remain well in expansionary mode (58.7 and 58.6 in May, respectively; any reading above 50 is considered expansionary), and after several month-over-month declines seem to be accelerating again. The manufacturing index has been in expansionary territory for 109 consecutive months, while the non-manufacturing index notched its 100th consecutive expansionary month (source: *Institute for Supply Management*);
- Inflation (as measured by CPI) rose 2.8% year-over-year in May, slightly above market expectations, driven largely by increases in gasoline and housing costs. The Personal Consumption Expenditure

(PCE) index – which is the Fed's preferred measure of overall inflation, increased 2% year-over-year in May, in line with the Fed target rate (source: *TradingEconomics*).

- We continue to believe that inflation will tick up over the rest of this year, but that it does not *yet* constitute a primary risk to economic growth. Further, we continue to believe the Fed will allow inflation to run slightly "hot" before stepping in more aggressively;
- After raising rates (as expected) in mid-June, the consensus estimates are that the Fed will raise rates at least two more times in 2018. This may change depending on what unfolds with the outcome of current trade negotiations – a negative turn of events may slow down the planned steady tightening initiatives;
- After a sharp decline in yields in late May due to the Italian political crisis, interest rates continued their "grind higher" path through most of June, before dropping yet again toward month-end as trade war fears swept the market. The 10-year Treasury yield is once again below the mental barrier level of 3%, currently trading at approximately 2.9%. We maintain our outlook that rates in the US generally will inch steadily higher, with periodic reversals during market disruptions;
- The yield curve remains very flat as the Fed raises rates on the short-end but the long end remains "tamped down" by high demand, lack of inflation fears, and periodic "flights to quality". As of this writing there is less than 40 basis points difference between the yield on the 2-year and 10-year Treasury. We do not anticipate (or fear) an inverted yield curve – should one occur, we believe it will be because of investment flows and Fed actions, not a harbinger of an imminent recession;
- The US dollar continues its second quarter strengthening momentum, rising steadily against the euro, yen, and British pound. We believe the dollar will continue to strengthen through 2018, as the US economy, interest rates, investment flows, and inflation all pick up steam. This may have negative effects on US large cap export-driven companies (source: *YCharts*);
- As we head into the end of Q2 in the US, earnings are expected to increase 18.3% on 8% higher revenues. While this represents solid expansion, it also signals the beginning of a forecasted deceleration in US earnings growth as we head through the rest of the year (source: *Zachs Earnings Report*);
- Manufacturing all across the Eurozone remains expansionary, with the Markit Manufacturing index falling slightly from 55.5 in May to 55.0 in June, continuing a slow month-over-month deceleration in manufacturing growth in Europe. Contrarily, the Services index rose to 55.0 in June from 53.8 in May. (source: *TradingEconomics*);
- Eurozone unemployment fell slightly to 8.5% in April, the lowest level since 2008, and annualized inflation went up 1.9% in May, with most of the increase coming from rising oil prices. Expected inflation for Q2 is 1.7%, and remains under 2.0% for all of 2018, another reason we simply do not see a major inflation spike in 2018 (despite market fears) (source: *TradingEconomics*);
- Now that the Italian political crisis has abated (at least, for now), ECB President Mario Draghi has announced his "tapering" program. He recently indicated that the ongoing bond buying program will begin to decline starting in September, but he also said he would not move to increase interest rates until well into 2019. This was viewed as a largely "dovish" move and the euro weakened as a result;
- Japan's GDP contracted 0.6% (annualized) in Q1, after expanding 1.6% in 2017, its first contraction after eight consecutive quarters of growth. The consensus estimate for 2018 GDP growth is 2.2% (source: *TradingEconomics*);

- China's (official) GDP growth in Q1 was 6.8% (annualized), after growing at 6.9% in 2017, and (official) estimates for 2018 suggest a slight slowing to 6.5% -- 6.6% (source: *TradingEconomics*).

The Towerpoint Wealth & Market Outlook:

- ***The global economy continues to expand, though there is a "desynchronization" of growth. The US economy appears to be accelerating as the full effects of regulatory and tax reform work their way through the system. At the same time, the rest of the world appears to be decelerating – still expansionary, but slowing down;***
- ***Over the past several months, we continue to see a downward trend in the Citigroup Economic Surprise Indicators, both in the US and in the G-10 countries, though the US may be at a reversal point back toward an upward trend. A downward trend in this index means that actual economic data are coming in at worse levels than estimated;***
- ***We believe going forward that an expanding US economy, rising inflation rates, continued tightening of Fed policy, and strong investment flows will further strengthen the dollar;***
- ***Inflation is trending higher, but we maintain our belief that it (as of yet) does not represent a problem for continued economic expansion. Wages finally are starting to increase, though slowly, as there currently are more job openings in the US than qualified workers to fill them. Outside the US, inflation simply is not a problem, despite rising oil prices. We also maintain our belief that the Fed is inclined to let inflation "run hot" before stepping in;***
- ***In the US, tax and regulatory reform currently are trumping (pun fully intended) monetary tightening. Adding stimulatory fat to an already raging economic fire remains an unknown with respect to the longer term impact on deficits and inflation. We continue to believe this is at least a contributing factor to ongoing market uncertainty and volatility;***
- ***Solid US GDP growth, and solid earnings and revenue growth, make for a generally positive market environment, and we still think stocks will end the year higher than where they began. However, decelerating earnings growth and rising interest rates will most likely combine to push valuations down and volatility up;***
- ***Market volatility will also be affected by what seems to be a continuing series of geopolitical events. The most current (and probably the most feared) is the ongoing trade tensions. The Trump administration is (in our opinion) wrong on the issues, but seems increasingly determined to bend the rest of the world to its "trade will". If this trend continues, we do not see a positive outcome, and this represents by far the largest threat to the current "Goldilocks" economic regime;***
- ***EM and EAFE markets continue to be hurt by the strengthening US dollar and a "risk off" mentality driving significant investment outflow. We still like EM and EAFE as longer-term positions, but investors almost certainly are headed into increased volatility;***
- ***The US yield curve remains flat (there is currently less than a 40 bps difference between the 2-year and 10-year yields), as lower longer-term expected growth rates and technical investment flows combine with only modest inflation expectations on the long-end of the curve, but we believe the risk of inversion is low. We maintain our view that rates will "grind higher" over the course of 2018, with periodic market corrections and a corresponding "flight to quality" response from investors;***

- ***At these rates and credit spreads, the public credit markets still look very expensive to us. Further, we are concerned about high yield liquidity and refinancing risk and the growing level of "covenant lite" bank loans. We are nearing the end of the current credit cycle and risks are increasing;***
- ***As was true in 2017, we believe 2018 should continue to be constructive for alternative investments, especially if interest rates continue to rise and market volatility remains elevated – these are the conditions when alternative investments historically performed best and/or played an important diversification role in client portfolios. We continue to believe that hedge funds generally will deliver superior performance than their liquid alternative brethren, because of less liquidity and leverage constraints;***
- ***We remain constructive on real assets and commodities, as both inflation and demand increase, though we believe oil prices may soon begin to stabilize after their recent rally;***
- ***While we generally are constructive on the global economy and overall market performance, the public markets still are not cheap. We see little reason (barring exogenous geopolitical events) why the market cannot move higher over the rest of the year, with increased volatility. We also believe, however, that clients need to have their expectations managed as to what a globally diversified portfolio can deliver over a full market cycle.***

The days are long and people's thoughts naturally move to the mountains, lakes, and beaches. But these coming summer days may not be so "dog-like" as we normally anticipate.