Towerpoint Wealth
Monthly Market Commentary

Author: Joseph Eschleman, CIMA®, President

Staying Focused in the Age of "The Donald"

July 2018

info@towerpointwealth.com
Twitter: @twrpointwealth

TOWERPOINT WEALTH
500 Capitol Mall, Suite 1060
Sacramento, California, 95814

1.916.405.9140

JULY 2018 MARKET COMMENTARY

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

Staying Focused in the Age of "The Donald"

George Costanza:	*Hey, I just found twenty dollars! I tell you this, something is happening in my life. I did this opposite thing last night. Up was down, black was white, good was -*
Jerry Seinfeld:	*Bad.*
George:	*Day was -*
Elaine Benes:	*Night.*
George:	*Yes!*
Jerry:	*So you just did the opposite of everything?*
George:	*Yes. And listen to this, listen to this; her uncle works for the Yankees and he's gonna get me a job interview. A front office kind of thing. Assistant to the travelling secretary. A job with the New York Yankees! This has been the dream of my life ever since I was a child, and it's all happening because I'm completely ignoring every urge towards common sense and good judgment I've ever had. This is no longer just some crazy notion. Jerry, this is my religion.*

(From "Seinfeld", Season 5, Episode 21, 1994)

Geopolitics dominates the news these days, over-shadowing what remains a fundamentally solid global economy. As always, Donald Trump is at the center of most of the "noise", whether it is his hard line on global trade negotiations, his seemingly soft line on Vladimir Putin, or the increasingly partisan obsession with "meddling" in the 2016 election. If you *do* believe there was meddling, your opinion as to who is to blame depends on which side of the political spectrum you occupy (and which news channel you watch).

House Republicans announced legislation aimed at further tax cuts plus retirement planning reform, but in the current rancorous and "swamp-like" environment in Washington, DC, passage of *any* meaningful legislation before the mid-term elections in November is *highly* unlikely.

Of most concern to the markets, for good reason, are the continuing trade tensions between the US and its major trading partners and the somewhat-associated continued strengthening of the US dollar. Of secondary concern is the flatness of the US yield curve, though we maintain our belief that the risk of inversion is low and, should it occur, it does not necessarily represent a harbinger of impending recession.

Tariffs are already affecting a variety of industries, including agriculture and the automobile supply chain. An escalation of imposed tariffs and other trade restrictions is the primary threat to the global economy. We continue to believe that all sides will come to a reasonable outcome, since the historical catastrophic repercussions of "trade wars" are well-known to all parties – no one wins, and "beggar thy neighbor" currency and trade policies tend to work only temporarily before underlying market forces take back over.

So, while we remain generally optimistic for a reasonable outcome, we suspect the brinksmanship, reciprocal threats, and "poking around the edges" with escalating tariff threats and actions will continue, probably through the summer. Look for volatility to increase as the rhetoric heats up and we work our way through the typically slow summer trading months. As has been the case for the past several years, September and October look to be much more "interesting", and it is not too early to start thinking about how to allocate your portfolios accordingly.

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 remains *desynchronization*:

- The consensus estimate for Q2 GDP growth in the US is now a sizzling 4.1%. GDP growth is expected to remain strong but decelerate through Q3 (3.0%) and Q4 (2.9%), bringing overall 2018 GDP expectations to a solid 3.0%; (source: *The Wall Street Journal*);
- As discussed, however, there remains some uncertainty regarding this forecast, as the outcome of ongoing trade negotiations could change the global economic outlook over the remainder of the year;
- Both the US manufacturing and services sectors showed continued expansion, with the PMI (manufacturing index) coming in at 60.1 in June versus 58.7 in May, and the NMI (non-manufacturing index) coming in at 59.1 versus 58.6 in May. The manufacturing index has now been in expansionary territory for 110 consecutive months, while the non-manufacturing index notched its 101st consecutive expansionary month (source: *Institute for Supply Management*);
- Inflation (as measured by CPI) rose 2.9% year-over-year in June, its highest rate since February of 2012. Rising oil and gas prices were the primary culprits to the increase (though oil prices stabilized and even fell slightly as we moved through July). The Personal Consumption Expenditure (PCE) index – which is the Fed's preferred measure of overall inflation, increased 2% year-over-year in May (the most recent reading), in line with the Fed target rate (source: *TradingEconomics*).
- We continue to believe that inflation will increase steadily 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 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.
- In addition, President Trump is now on record publicly as being against further rate hikes. This puts the Fed in an awkward situation. If it maintains its slow but steady rate hike plan, it may come under withering attack from President Trump, who sees the hikes as a potential threat to continued economic expansion, but if the Fed slows down its rate hike program (for whatever reason), it will be seen as having been "politicized" by the President;
- US interest rates inched higher through most of July, though the 10-year rate currently remains under 3%. We maintain our outlook that rates in the US generally will increase 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, periodic "flights to quality", and Treasury actions (i.e., its bond buying program);
- As of this writing there is less than 30 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 continued its second quarter strengthening momentum, rising steadily against the euro, yen, and British pound throughout July. Perhaps in anticipation of (or in response to) the trade tensions between the US and China, the Chinese have allowed a steady and fairly dramatic weakening of the yuan versus the dollar (thereby making Chinese exports to the US more attractively priced and US exports to China more expensive);
- It is unrealistic for the US to believe it can unilaterally dictate trade policies – other countries *can* and *will* retaliate. 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 be one explanation for the dramatic outperformance of small cap versus large cap US stocks so far in 2018, as small cap stocks tend to be less influenced by movements in the dollar (source: *YCharts*);
- The Q2 earnings season is underway, and expectations are for another very strong quarter. Although only ~50-60 companies have reported so far, those companies posted a 23% increase in earnings on 10% higher revenues. Overall Q2 S&P 500 earnings are expected to increase 20.4% on 8.3% higher revenues. Earnings are expected to remain strong (though decelerate) as we move through the rest of the year (source: *Zachs Earnings Report*);
- Manufacturing across the Eurozone remains expansionary, with the Markit Manufacturing index rising slightly to 55.1 in July from 55.0 in June. Contrarily, the Services index fell to 54.2, down from 55.2 in June (source: *TradingEconomics*);
- Eurozone unemployment remained at 8.4% in May, unchanged from the April reading, and down from 9.2% a year ago. It remains at the lowest level since 2008. Annualized inflation went up 2.0% in June, a 16-month high (source: *TradingEconomics*);
- 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 Q2 was 6.7% (annualized), after growing at 6.9% in 2017, and (official) estimates for all of 2018 suggest a slight slowing to 6.5% (sources: *Reuters and TradingEconomics*).

The Towerpoint Wealth Economic & Market Outlook:

- ***The global economy continues to expand, though there remains a "desynchronization" of growth. The US economy appears to be accelerating as the full effects of fiscal stimulus and 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;***
- ***We believe going forward that an expanding US economy, rising inflation rates, continued tightening of Fed policy, ongoing trade tensions, 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 in the US are increasing, but oil prices may be stabilizing from their recently elevated levels. We also maintain our belief that the Fed is inclined to let inflation "run hot" before stepping in. Outside the US, inflation simply is not a problem, despite the recent rise in oil prices;***
- ***In the US, tax and regulatory reform and fiscal stimulus are winning the economic tug-of-war against monetary tightening. At some point, the markets will be concerned again about massively increasing deficits and debt, but right now those issues appear to be non-events for most market participants;***
- ***Solid US GDP growth, as well as 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, decelerating economic growth, and generally 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 most feared) are the ongoing trade battles. 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 remains 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 and perhaps negative performances for the year (in US terms);***
- ***At these rates and credit spreads, the public credit markets continue to 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;***
- ***Many investors increasingly are turning to shorter-duration bond strategies and even cash solutions, which finally have a positive real yield again due to the Fed rate hikes. The curve is so flat that investors simply are not being sufficiently compensated to take on term or duration risk;***
- ***We expected that rising rates, increased volatility, and greater security price dispersion would create a more positive environment for alternative investments.***
- ***With most public markets viewed as at least fully valued, many investors are revisiting the use of alternative investments within their portfolios, both for diversification purposes and as a means of accessing lower-correlated sources of potential return.***
- ***We remain constructive on real assets and the commodity complex, as both inflation and demand increase, though, as we expected, oil prices may have begun to stabilize after their recent rally, and the overall space has been hurt by the strengthening dollar;***
- ***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 summer months often bring lower market trading volumes (which has the ironic effect of sometimes magnifying perceived market reaction to breaking news). The global economy is in good shape, corporate earnings are solid, and inflation remains under control. But there is never a dull day on the geopolitical front.

Perhaps the most important lesson investors can learn in the age of "The Donald" is to not let short-term noise interfere with longer-horizon investment plans.

Disclosures: Towerpoint Wealth is a Registered Investment Advisor. This platform is solely for informational purposes. Advisory services are only offered to clients or prospective clients where Towerpoint Wealth and its representatives are properly licensed or exempt from licensure. Past performance is no guarantee of future returns. Investing involves risk and possible loss of principal capital. No advice may be rendered by Towerpoint Wealth unless a client service agreement is in place. No portion of any content within this commentary is to be interpreted as a testimonial or endorsement of Towerpoint Wealth investment advisory services and it is not known whether any clients referenced herein approve of Towerpoint Wealth or its services; nor should it be assumed that any references to our clients are representative of all our clients' experiences.