The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets July 2018

From: *Philadelphia* Investment Management Group

OVERVIEW

- *Economic Fundamentals Remain Strong Within the U.S. Economy*
- *Geopolitical Concerns and the Federal Reserve Have Been Headwinds for the Financial Markets*
- *Equity Valuations are Reasonable, Giving Support to Equity Markets*
- *The Anticipated Move in Interest Rates Was and Will Continue to Be a Concern for Fixed Income Markets*

THE ECONOMY

The U.S. economy has just completed one of its strongest quarters of this expansion, bouncing back from a modest first quarter as the rest of the world seemed to have stumbled. Models that track economic output point to the fastest growth since the third quarter of 2014, when the economy expanded at a 5.2% annualized rate.

Spending by consumers, businesses and government appeared solid in the quarter. Early data suggest output was further boosted by inventory investment and a surge in exports. Faster growth has helped drive the unemployment rate to its lowest level in 18 years, fueled by corporate profit growth. Thus, this expansion enters its tenth year this month, building on what is already the second longest expansion on record. A generation of investors has not experienced any persistent rise in inflation. Since 1995, the core Consumer Price Index, which excludes food and energy, has not exceeded 2.5% annually by much for long.

So far, however, 2018 has been a year of contradictions. Corporate earnings growth has been stellar, yet stock prices have been stuck in a one-step-back mode. Economic growth in the U.S. is accelerating and inflation is rising, yet bond yields remain stubbornly low. Wage growth is struggling to move higher even as unemployment falls to its lowest level in 50 years and the Fed continues to raise interest rates.

Nevertheless, one should consider a number of potential downside risks going forward. U.S. growth may have shifted to a higher gear, labor is in short supply and wages are rising. Tax cuts and fiscal stimulus are accelerating growth; and after remaining stubbornly low for years, inflation is finally starting to creep higher.

Perhaps the biggest concern is that the economy will overheat. A 3.8% unemployment rate suggests the labor market is as tight as it was in the late 1990s, which coincided with an unsustainable tech boom. This presents an environment for continued Fed rate increases, which could eventually act as a drag on equity prices. In our view, rates are relatively low and are still below a neutral level. As such, we think equity markets can withstand additional rate increases, especially if they remain slow and well telegraphed. Rising rates, however, are likely to put significant downward pressure on bond prices.

The dollar's surprising rally with strong U.S. growth is upending investments across the globe, punishing commodities and emerging markets, while attracting more overseas money to the U.S. in line with the Federal Reserve's move to a more aggressive stance on interest rates. Still, a rising dollar does not help all U.S. investments, especially the larger firms that are the major exporters. A strong currency makes U.S. products less competitive abroad and eats into the profits of multinationals when they convert foreign earnings into dollars.

From a political perspective, a most pressing risk is possibly further deterioration in trade. The prospect for an all-out, 1930's-style trade war remains low, but the G7 summit and new tariffs on China are not encouraging. We hope that heightening tensions are more about negotiating ploys and that trade issues decelerate, but they are a major risk to be watched.

Tax reform provided a huge jolt to earnings in the first quarter and to estimates for the remainder of this year. But comparisons will become more difficult, so it is possible that a slowing in the year-over-year growth rate in earnings could occur. There are also some high hurdles that earnings growth faces in the near-to-medium term, including foreseeable trade/tariff hits, increasing labor and import costs, the strong dollar and rising interest rates.

The yield curve, short-to-long rates, continues to flatten and continues to cause consternation. The spread between 10-year and 2-year Treasury yields flattened to 32 basis points at quarter end. Clearly, this is getting close to an inversion.

A flattening yield curve is normal at this stage in the economic cycle, with the Federal Reserve having begun a rate hike campaign in December 2015, followed by the shift from quantitative easing to quantitative tightening last fall. Other central banks, notably the European Central Bank, are also moving toward normalization, which means the tide of global liquidity, which has been a tailwind to the economies for some time, is receding.

Another reason to expect continued bouts of volatility in financial markets is that we are in a midterm election year. History has not been kind to midterm election years in terms of stock market weakness in the months prior to elections, but then strengthened in the periods after the elections.

With competing headwinds and tailwinds, the U.S. financial markets have been largely range-bound since the first-quarter correction. If a few things go right in the near term, including an easing of trade tensions, equities could break out on the upside, even as the headwinds are becoming somewhat stronger. Fixed income will, however, be negatively impacted by interest rates.

FINANCIAL MARKETS

EQUITIES

Global and U.S. equities peaked in late January. Apart from tech stocks, they are yet to regain that high, or even come particularly close to it, but have traded basically within a narrow range during the past six months. This is despite astonishing earnings in the U.S. for the first quarter. The S&P 500 companies managed to raise earnings per share by about 26% year over year, according to Thomson Reuters. Meanwhile, investors are braced for more good results in the quarter that just came to an end, with predicted earnings growth of about 20%.

Usually, companies cut guidance as the quarter end approaches and earnings decrease by about 2% or more. This time, they have actually risen slightly since the beginning of April. If they had merely stayed constant, such increase in optimism for corporate profits should have translated into a rallying stock market. It has not happened. At the turn of this year, the prospective earnings multiple for the S&P 500 was just over 20x, its highest since 2001. It is now trading at only 16 times prospective earnings—high, but back within normal range.

This suggests that the markets had been priced expecting just the burst of corporate profitability that we have seen, and that the year has seen a downward re-rating. Or, put differently, the so-so performance of stocks against such a strong corporate backdrop suggests grave concerns about monetary policy and quite possibly about the unknown conclusion of the trade policies.

Stocks were all over the map in a jittery second quarter as investors dumped industrial stalwarts on fears of a trade war stifling global growth and increased their bets on shares of large technology and domestic-related companies. Indexes finished the tumultuous three months mostly higher, even as investors were buffeted by the worries about trade and political uncertainty in the eurozone and signs of slowing global growth. Higher levels of geopolitical uncertainty have caused a rise in market volatility this year. It has also helped keep a lid on both stock prices and Treasury yields, despite the stellar corporate profits backdrop.

As reflected in the following table, all four major indexes were higher in the quarter: 3.43% for the S&P 500, 1.26% for the Dow, and 6.31% for the NASDAQ, as it was a solid quarter for technology, while small caps prospered with a strong return of 7.75%. Economic trends have favored smaller companies this year as the dollar rose 5.5% in the quarter against the euro, hurting larger companies in the Dow and S&P that export more of their goods. And smaller companies are less likely to be hurt by a trade war because they sell more of their products domestically.

	Equity Returns*		
Index	**2nd Qtr**	**1st Qtr**	**YTD**
S&P 500	3.43%	-0.76%	2.65%
Dow	1.26%	-1.96%	-0.73%
NASDAQ	6.31%	2.32%	8.79%
Russell 2000	7.75%	-0.08%	7.66%

*Total: price change + reinvested dividends

The first two indexes remained well below their January records, whereas the NASDAQ notched a series of all-time highs in June. The one-directional nature of the stock rally has left some investors worried that a market whose gains have been dependent on technology stocks could reverse sharply in the second half of the year.

Tech's growing dominance has skewed the broader S&P 500 away from so-called defensive sectors, such as Utilities, Consumer Staples and Health Care, that investors have traditionally gravitated towards in bouts of market volatility. Technology, in turn, has the highest share of overseas revenue of the 11 sectors, with a foreign exposure level of about 59%, according to FactSet, greater than the broader S&P 500, which gets about one-third of its revenue from overseas.

While volatility remained within the stock market during the quarter, there was some stability to the overall market, as measured by the returns within the 11 broad sectors of the S&P 500 stock index. As reflected in the following table, only four sectors had negative returns, compared to nine groups in the first quarter of the year. Industrials and Financials were the two sectors that experienced the major losses of three plus percent, a reflection of increasing concerns about trade negotiations and the fear of rising interest rates.

	S&P 500			
		Returns*		
Sector	**Weight**	**2nd Qtr**	**1st Qtr**	**YTD**
• Materials	2.6%	2.58%	-5.52%	-3.08%
• Industrials	9.5%	-3.18%	-1.56%	-4.69%
• Telecommunications	2.0%	-0.94%	-7.48%	-8.35%
• Cons. Discretionary	12.9%	8.17%	3.09%	11.52%
• Consumer Staples	7.0%	-1.54%	-7.12%	-8.55%
• Energy	6.3%	13.48%	-5.88%	6.81%
• Health Care	14.1%	3.09%	-1.22%	1.83%
• Info Technology	26.0%	7.09%	3.53%	10.87%
• Utilities	2.9%	3.74%	-3.30%	0.32%
• Financials	13.8%	-3.16%	-0.95%	-4.09%
• Real Estate	2.9%	6.13%	-5.02%	0.81%

06/30/18
*Price + income
Source: S&P Dow Jones

Of the seven groups that had positive returns for the period, Energy and Consumer Discretionary were the leaders at 13.48% and 8.17%, respectively, a reflection of higher energy prices plus increased consumer spending in light of full employment. Not following far behind was the 7.09% return for Information Technology, which makes up 26.0% of the full index.

For the past several months, as stated, the main geopolitical issue has been a rise in trade protectionism. Rising protectionism tends to be a lose-lose proposition for all parties. But the Trump Administration seems determined to stick with harsh trade rhetoric, both to call attention to the large and rising current budget deficit and to appease the President's base. The world has avoided a serious trade war so far, and economic sentiment is holding firm, although the situation could escalate quickly and change for the worse, as time will tell as we move through the second half of the year.

For now, we think global financial markets will continue in the present churning range, assuming the geopolitical backdrop does not worsen and derail the economic expansion. Within equities, we see few negative technical signs other than the ones cited previously. Small cap stocks have been outperforming this year and bond spreads remain relatively low. The reverse tends to be the case when markets are facing a pronounced risk-off phase. Stock prices are treading water during the longer bull market phase. This should bode well for equities over the long term. Interest rates are experiencing upward pressure in this environment but are unlikely to break out strongly to the upside since investors are focused on downside risks, giving limited support to interest rate-sensitive areas of the markets.

It is apparent that the stock market is currently undergoing a corrective phase that began the end of January. To a degree, equities have experienced several such corrections of varying degrees since the financial crisis ended. While frustrating to watch accounts lose value at times, corrections are a normal part of a functioning market. Corrections phases vary in duration but can last anywhere from a couple of months to over a year. Once a correction runs its course, the market typically resumes its upward trajectory unless the economy goes into a recession, a situation that does not seem evident at this time.

FIXED INCOME

Many fixed income investors have predicted a steady move up in interest rates, based on what they expected would be a stronger U.S. economy and higher inflation. The economy is doing fine, as indicated, if not superbly; and as we move into the second half of the year, inflation remains pretty tame, with the core Consumer Price Index increasing by 2.2% in the 12 months ended in May.

In many contexts, 3% is just a number and an arbitrary one at that. But during the second quarter, it had all kinds of meanings for the well-known 10-year U.S. Treasury note, one measurement of growth in the U.S. economy. For most of the quarter and year, the note's yield was unable to stay above 3% for very long. At quarter end, it was at 2.85%, down from 3.10% in mid-May, as the note's price had been bid up for a variety of reasons. (Prices and yields move in opposite directions.)

The note's lower yield also comes at a time when the yield curve is flattening. As stated, an inverted curve, in which short interest rates are higher than those at the longer end of the curve, can presage a recession. The Fed has increased short-term rates twice this year with two more moves expected in the year.

The gap between yields on short- and longer-term Treasuries has narrowed to nearly an 11-year low, a sign that investors remain cautious about the outlook for economic growth, even as they expect the Federal Reserve to continue raising interest rates. The increase in rates is reflected in the following table, which shows the rates along the full Treasury yield curve, with a gap of only 32 basis points between the yield on the two- and 10-year Treasury notes at quarter end.

Base Interest Rates

	U.S. Treasury Yields				
	---------- Maturity ----------				
Date	3 mo.	2 yr.	5 yr.	10 yr.	30 yr.
Dec 31, 2017	1.38%	1.88%	2.21%	2.41%	2.74%
Mar 31, 2018	1.70%	2.27%	2.56%	2.74%	2.97%
Jun 30, 2018	1.91%	2.53%	2.73%	2.85%	2.99%
Change:					
3/31-6/30/18	0.21%	0.26%	0.17%	0.11%	0.02%
12/31-6/30/18	0.53%	0.65%	0.52%	0.44%	0.25%

Two-year yields have climbed as policymakers have raised rates to normalize monetary policy following the extraordinary stimulus in the wake of the financial crisis. At the same time, the 10-year yield, at 2.85% at quarter end, had retreated from nearly a seven-year high in May of 3.10%, weighed down by trade war fears. The concern is that trade tensions will disrupt global growth, tempering expectations for an economic surge spurred by recent tax cuts. Investors, globally, have also bought Treasuries, a haven asset due to tariff fears and a source of yield and safety above that of other global economies.

As a result of the movement in rates, most, but not all, fixed income indexes continued to decline over the course of the second quarter, as reflected in the table below, which shows the returns, price change plus income earned, for taxable and tax-exempt market sectors. While there were slight positive returns in the government and municipal areas, the net effect was not as severe as what took place in the first quarter.

The Corporate/Government index, a measurement of taxable returns, was -0.30% for the quarter and -1.86% for the year to date. The overall decline was mainly driven by the increase in interest rates across the entire yield curve but was also under negative pressure from widening investment grade corporate credit spreads (difference in yield between corporates and comparable maturing Treasuries). An unusually heavy amount of new corporate debt came to market in the quarter due to the low rates and a fear of higher rates in the future. The supply was greater than the demand, resulting in higher yields. The demand for quality and safety is further reflected in the higher negative returns for longer-maturity and lower-yielding corporate bonds.

Fixed Income Returns

Index	2nd Qtr	1st Qtr	YTD
Corporate/Govt.	-0.30%	-1.56%	-1.86%
Int. Corporate/Govt.	-0.01%	-0.96%	-0.97%
Long Corporate/Govt.	-1.23%	-3.46%	-4.66%
U.S. Treasury	0.11%	-1.21%	-1.10%
- Intermediate	0.07%	-0.70%	-0.64%
- Long	0.28%	-3.18%	-2.91%
Corporate	-0.94%	-2.20%	-3.12%
- Intermediate	-0.15%	-1.46%	-1.61%
- Long	-2.78%	-3.89%	-6.57%
- Quality			
- AAA	-0.38%	-2.85%	-3.22%
- AA	-0.41%	-1.88%	-2.28%
- A	-0.77%	-2.37%	-3.13%
- BBB	-1.20%	-2.08%	-3.26%
Municipal	0.89%	-1.15%	-0.26%
- Intermediate	0.76%	-0.57%	0.18%
- Long	0.99%	-1.54%	-0.57%

Source: BofA Merrill Lynch

A bright spot for the period was the government sector. While experiencing higher yields, but less than corporates, there was strong demand, especially in the longer area, as global investors went for safety and liquidity in light of all market concerns and a growing sense, by some, that interest rates may not move a great deal higher, as previously expected.

On the other hand, the fundamental backdrop for municipals remains strong, as state and local governments are benefiting from the improving economy; therefore, upgrades exceeded downgrades during the quarter. Municipal interest rate tailwinds, including improving credit, narrowing interest rate spreads, higher investor demand and decreased new issue supply, continued to support their returns versus the taxable sectors.

What is in store for the second half of the year? We believe more of the same. U.S. Treasury yields will rise modestly as the Federal Reserve gradually boosts its benchmark rate range, potentially lifting yields of corporate and municipal investments as well. This could lead to modestly lower prices. We do not expect returns for investment grade corporate bonds to be as poor as they were in the first quarter due to lower anticipated supply, but the markets are still challenging.

The size of the corporate bond market has grown sharply over the past decade, related to low interest rates. Much of the increase has been concentrated in the investment grade markets. Since the end of the financial market meltdown, corporations have taken advantage of record-low borrowing costs, issuing more and more debt with low coupon rates. Since the end of 2008, it is estimated, by some, that the amount of debt has more than doubled and will need to be repaid or refinanced, potentially at higher rates. While this may pose a risk when the economic cycle takes a turn for the worse, for now, we think that corporate issuers should generally be able to handle this rising amount of debt.

Despite the headlines, investment grade corporate bonds are beginning to look a bit more attractive for income investors as well as for portfolio diversification. Given our outlook for modestly higher bond yields, price appreciation may be limited, and coupon payments will likely be a key driver of second-half returns. At these current levels, the average credit spread in the investment grade market is at its widest level this year and at its highest level since the beginning of 2017.

We believe that coupons and not price appreciation will drive returns for fixed income securities in the latter half of 2018; thus, we see better value in shorter-than-average maturities to control price risk. With the greater increase in short-term interest rates, one can now earn income returns above that of the existing inflation rate.

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