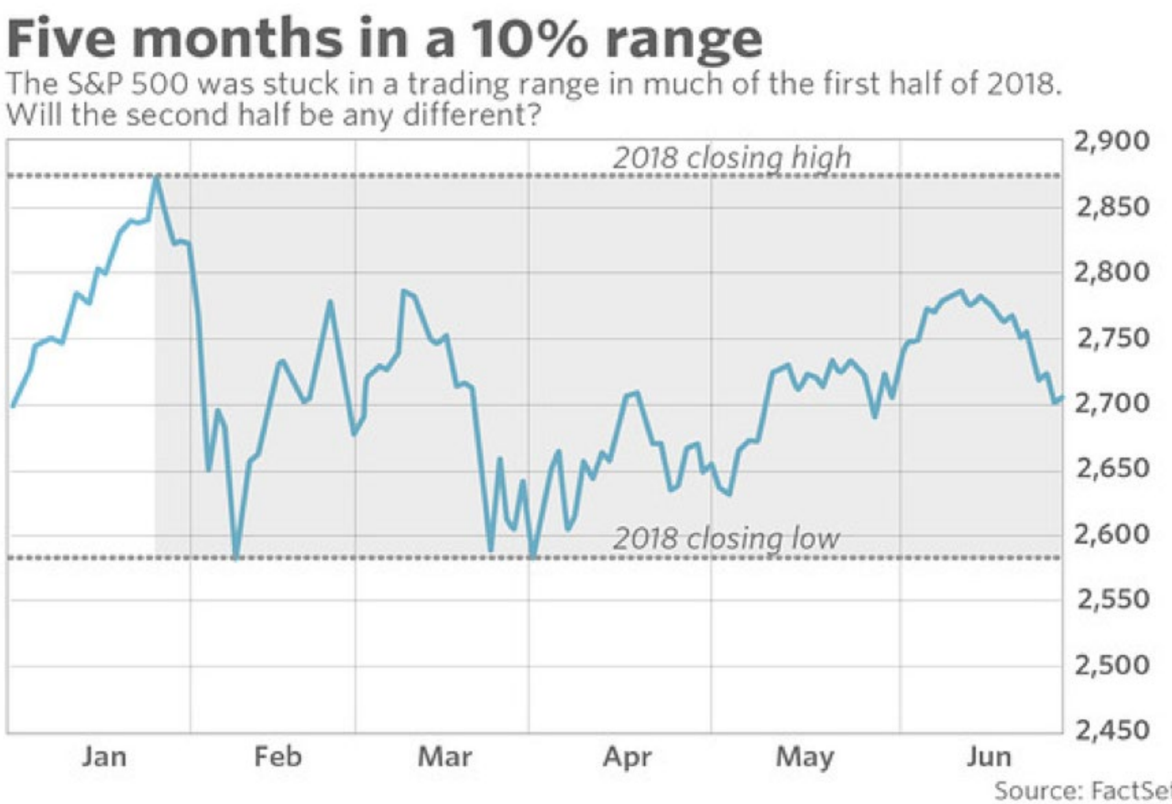
Q2 2018 Market Commentary

With the second quarter of 2018 now in the books, it is becoming more and more evident that increased market volatility has arrived and is here to stay for now. Though backing off the spikes of quarter one, the second quarter remained volatile with the CBOE Volatility Index up 40% since 2017.[2] In light of the volatility this year, the U.S. markets have remained somewhat resilient with the S&P 500 up +2.7%, the Dow Jones down slightly at -0.7% and the NASDAQ up +9.4%.[1] Though there have been many sporadic short-term movements, the S&P has been somewhat range bound thus far in 2018, not seeing a single close outside of a tight ten percent range (see chart below).



In the U.S equity markets, seven of the 11 sectors closed the quarter with gains, with losses taken in industrials, telecommunications, financials and consumer staples. The latter three were affected by the flattening yield curve, which made dividends less attractive and loans less profitable (see chart below).

Sector	Price move over the quarter	Price move year-to-date
Utilities	2.8%	-1.5%
Telecommunications	-2.3%	-10.8%
Materials	2.1%	-4%
Information technology	6.8%	10.2%
Industrials	-3.7%	-5.6%
Health care	2.7%	1%
Financials	-3.6%	-4.9%
Energy	12.7%	5.3%
Consumer staples	-2.3%	-9.9%
Real estate	5.1%	-1%
Consumer discretionary	7.8%	10.8%

Source: Market Watch[3]

Small cap stocks have led the way thus far in 2018 with the Russell 2000 up +7.7%.[1] After a few years of underperformance and the fact that they are more insulated from geo-political issues or tariffs, investors have been more active in the space. Growth stocks continue to outpace value, a multiyear trend that has investors asking, when will it revert to the mean?

As mentioned above, stock price volatility has increased in 2018, and equity valuations are high by historical standards. The market volatility, although heightened, has come back in line with historical norms as measured by the VIX Index. All the same, the U.S. equity outlook remains fundamentally sound with strong corporate profitability. As many as nine of the 11 sectors in the S&P 500 currently forecast to post double-digit earnings gains this year.[1] This is a robust U.S. economy that's now in its ninth year of expansion, one of the longest periods of growth on record. There has been significant tax reform in the U.S. that's benefiting both corporations and consumers. The second quarter GDP figure estimates are coming in at or above 4%! Several factors have combined to create a very favorable operating environment for many U.S. companies.

Having said that, investors have been unsettled by the increasingly protectionist stance from President Trump and the risk that a trade war breaks out between the U.S. and China. Trade tensions escalated greatly over the second quarter with tariffs and counter tariffs being imposed across the world, most namely between the U.S., China, the E.U. and Canada. Some of our key trading partners. More tariffs are currently being implemented by both the U.S. and China to the tune of $34 billion (although the markets seem to be shrugging them off due to a strong jobs report). The industries most affected by the new regulations include steel, technology, aluminum and potentially automobiles. There are estimates out there that the negative effect on U.S. GDP could be between -0.2 to -0.4% and will likely take some time for it to work itself through the economy. These trade disputes are becoming one of the drivers of financial markets currently and will remain closely watched by many investors. How large of an impact will they have on the economy? Will they be the tipping point towards a recession? Time will tell. The possibility of slower growth and higher prices is very likely and means investors must be diversified and prepared.

International markets were not immune to the headline risks we faced here domestically. The MSCI EAFE returned -1.1% and the MSCI All Country World x. U.S. returned -0.6% for the quarter.[1] We live in a very globally connected world and as a result, the decisions made by leading countries have consequences that reverberate across the globe.

Following the imposed tariffs and threats of more drastic measures, emerging markets were hit hard in the second quarter with the MSCI Emerging Markets Index closing with losses of -7.8% in the quarter and -6.7% year-to-date.[1] Chinese stocks took a nosedive in the quarter as well as their currency, the Yuan, which has been plummeting against the dollar, down -4.1% in the last month. [4] Some are questioning if this is tactical response to the imposed tariffs. Japan is seeing similar negative effects on their stock market, as the fall of their index, the Nikkei, started late in quarter two and is now nearing three-month lows. [1] While there is a large amount of short term volatility currently in the emerging markets sector, investors should know that long term trends generally prevail. Across the emerging world, middle classes are expanding, and with that, so is aggregate demand, purchasing power and investment. Over time the developing world should keep advancing at a faster rate relative to their developed market counterparts.

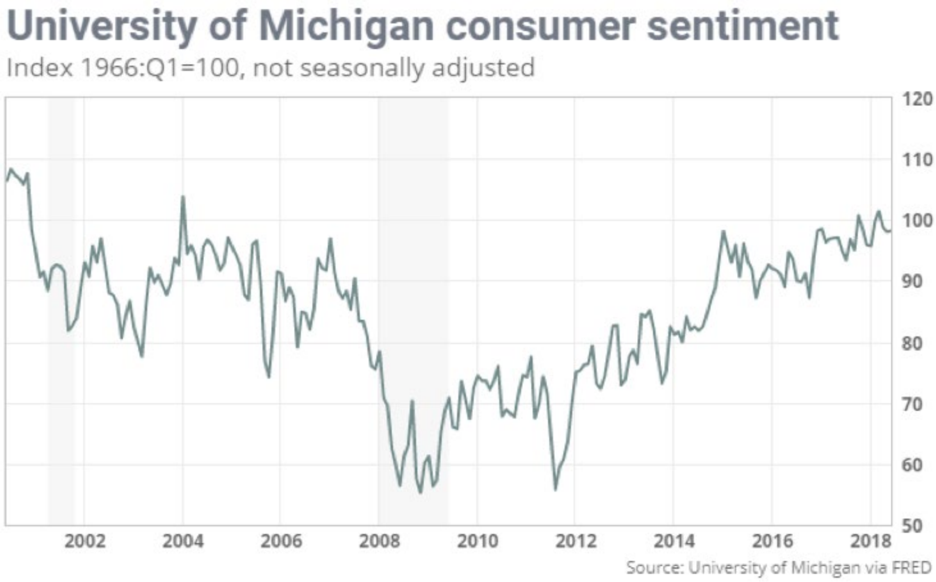
Fixed income has been disappointing this year, yet with rates rising and attractive yields on U.S. Treasury bonds, especially when compared to index dividends, such as the S&P 500, it is not so bad. The Bloomberg Barclays U.S. Aggregate Bond Index is down -1.6% year-to-date.[1] Bringing down the sector are corporate bonds, which were hit after threats of a trade war affected the corporate debt of multinational companies. Municipal bonds have held in well this year with municipal credit conditions remaining stable. Although there are some bad apples the Bloomberg Barclays Municipal Bond Index is basically flat down -0.25%.[1] The key ingredient for success in bond land has been to stay away from a traditional allocation and be more active in convertible bonds, high yield bonds and preferreds, something we at Hightower Westchester have been doing for the past 12-18 months.

In May the Federal Reserve hit its target for inflation of two percent for the first time since April 2012. With the Federal Reserve increasing their target interest rate range in mid-June to 1.75-2.00%, the bond market was affected, making yields less attractive. Further increases in rates are expected following the recent rate hike in June, but economists believe inflation would have to reach 2.5% before the expected timeline for additional rate hikes would accelerate.

The Organization of the Petroleum Exporting Countries ("OPEC") convened on June 22 and reached a decision to end its oil underproduction with relation to output levels decided upon last year. Effectively, this could boost oil production by about 600,000 to 800,000 barrels per day.[6] Such an increase is needed due to the supply-constrained nature of the market but was less than many had hoped for. This led to an increase in oil prices at the end of the quarter, and energy becoming the best performing sector over the quarter. Outside of energy, precious metals fell due to the rising dollar which gained 5.3% over the quarter.[1]

The housing market stayed in line with previous trends this quarter. Though the first quarter witnessed a slight dip in housing prices, they remain elevated going into the third quarter. Prices of homes between 2011 and 2017 grew 48%.[7] While some expect prices to keep rising due to a supply constrained market and the increased price of lumber, others are expecting a slowdown in the market as interest rates continue to rise.

Consumer sentiment has backed off its March highs but is still up more than 75% from its 2011 low. Much of this improvement is due to the vastly improved job market. U.S. hiring exceeded forecasts in June with unemployment rising from an 18-year low while wage gains unexpectedly slowed, indicating the labor market has room to keep expanding.



This quarter has us on track for a record year in mergers and acquisitions ("M&A") with $2.5 trillion in mergers announced through the end of the second quarter.[6] Much of this is due to pressure from technology giants to diversify. As many technology companies move into other areas such as healthcare and entertainment, leaders in those sectors will have to adapt and grow to stay competitive. Solutions to these burgeoning problems are being found around the world. Despite high concern regarding trade, more than 40% of U.S. M&A deals included companies based internationally.[5]

A key concern for investors is that the business cycle is moving into an increasingly mature phase. The U.S. economy is now in one of the longest periods of growth on record and at the same time, some of the world's most important central banks are shifting away from the extraordinarily accommodative monetary policies they have deployed over the last decade or so. Given these factors, risks are starting to rise, and are becoming more skewed to the downside, especially given asset price gains in recent years. As a result, volatility is likely to continue for the foreseeable future.

The U.S. financial markets have survived volatility before, have triumphed over rising rates, have beat inflation, and have excelled in the face of tariffs. But they have never had to do them all at the same time. Volatility and inflation can spike to new highs, trade wars can heat up, and markets can start to price in much higher risk premiums. Investors who diversify early and shift to low volatility, uncorrelated assets will be ready. We have been adjusting client portfolios to reflect much of the risk mentioned in this letter. As you have likely heard us say before, diversification is the only free lunch in town.

To discuss this commentary further, please contact us at 914-825-8630.
hightowerwestchester.com

1 *FactSet financial data and analytics. www.factset.com*

2 *https://www.marketwatch.com/story/investors-look-to-the-second-half-of-2018-expecting-growthamid-rising-uncertainties-2018-06-30?siteid=yhoof2&yptr=yahoo*

3 *https://www.marketwatch.com/story/stocks-see-broad-gains-in-the-second-quarter-but-not-without-turbulence-2018-06-29?siteid=yhoof2&yptr=yahoo*

4 *https://www.ft.com/content/04c29d0c-7df0-11e8-bc55-50daf11b720d*

5 *https://www.nytimes.com/2018/07/03/business/dealbook/mergers-record-levels.html?rref=collection%2Fsectioncollection%2Fbusiness-dealbook&action=click&contentCollection=dealbook&region=rank&module=package&version=highlights&contentPlacement=1&pgtype=sectionfront*

6 *https://www.cnbc.com/2018/06/22/opec-ministers-strike-deal-on-oil-production-levels.html*

7 *http://rismedia.com/2018/07/05/millennial-buyers-face-tough-housing-market/*