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SECOND QUARTER 2018 ECONOMIC AND FINANCIAL MARKETS REVIEW

After a correction in the first quarter, the stock market stabilized during the second quarter this year. Concerns about inflation, rising interest rates, and potential trade wars have been offset by growing corporate earnings and a broad-based economic expansion. Despite political and geopolitical worries, investors are pleased that corporate earnings continue to exceed expectations due to a robust economy and the recent corporate tax cuts. Furthermore, the first quarter stock market correction relieved excessive optimism among investors and created more reasonable stock valuations. Despite the second quarter recovery, the S&P 500 Index ended the first half of this year up only 1.7%, while the Dow Jones Industrial Average finished down 1.8%. Because of rising interest rates, most bonds declined during the first half of the year. For example, the Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index lost 0.97% during the first half of this year.*

It is not surprising that lately investors have focused on positive corporate earnings and economic data rather than the potential damage that growing inflation, which leads to rising interest rates, can inflict on the economy and the stock market. Historically, in the early stages of an increasing interest rate cycle, stocks appreciate because increasing inflation and interest rates are the result of a faster-growing economy. Mild inflation is also a positive for stock prices because inflation may result in greater pricing power and revenues for corporations. However, if inflation and interest rates eventually rise too rapidly or for too long, a recession could ensue. This is because rising interest rates increase the cost of borrowing for consumers, businesses, and governments. Increasing borrowing costs slow lending activity and leads to a decline in economic activity, which often leads to a declining stock market.

Although stock market gains may continue, it is very likely that inflation will increase in the future to the point where it becomes a negative for the economy and the financial markets rather than viewed as a positive result of economic growth. This could be caused by several factors, including a tightening labor market, increasing oil prices, a weakening U.S. dollar, or tariffs imposed by the Trump administration and foreign governments. Rising inflation may cause the Federal Reserve Board to raise short-term interest rates more rapidly in an attempt to tame inflationary pressures. As interest rates rise, fixed-income investments paying higher interest become more attractive to investors, resulting in the reallocation of funds out of stocks and into safer, higher-yielding fixed-income investments.

Because rising inflation and interest rates may eventually lead to the next recession and stock market decline, we are watching for signals that a recession is near. Recessions are typically preceded by an inverted yield curve where short-term interest rates rise faster than long-term interest rates. Also, leading economic indicators that gauge future economic growth tend to decline before the economy actually weakens. These leading indicators could include a slowdown in building permits, an increase in business inventories, a reduction in the number of goods being transported, a decrease in consumer confidence, or a decline in the price of raw materials used in manufacturing.

If it becomes apparent that inflation and rising interest rates are signaling a decline in leading economic indicators, we will likely take a more defensive position for most of our discretionary client portfolios in anticipation of a bear market. However, as long as stock market volatility is due to negative news events that do not necessarily have a negative impact on the overall economy, we will likely maintain our current equity allocations.

Finally, for the first time in several years, small company stocks have performed relatively well due primarily to threats of global trade wars that do not negatively impact small companies as much as large, multinational companies. However, it is possible that the recent small-company strength is just a short-term reflex rally and that large companies may resume their outperformance, particularly if global trade concerns abate. Until this trend is solidified, we continue to prefer large company stocks over smaller companies. Regarding fixed-income investments, we continue to favor short-term bonds over intermediate-term and long-term bonds. Short-term bonds are less sensitive to increasing inflation and rising interest rates, which have already negatively impacted longer-term bond prices. Finally, we may also become interested in gold as a hedge if inflation begins to rise significantly in the coming months.

As always, we will continue to monitor economic, interest rate, and financial market conditions in case the economic and corporate profit outlook changes. In the meantime, please contact us if you have any questions or concerns regarding the financial markets.

* *Index returns were obtained from the Wall St. Journal and Bloomberg Barclays on June 30, 2018.*