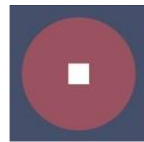

LongView
ASSET MANAGEMENT

2018 Second Quarter Review and Outlook

During the second quarter, the roller coaster ride of political events once again overshadowed steady economic and business conditions. Despite the roar of news—North Korea, immigration, trade, the Russia probe—financial markets remained fairly sanguine. The MSCI All-Country World Index fluctuated within a narrow trading range, ending -0.43% lower for the first half of the year. The Bloomberg US Aggregate Bond Index recouped some of its earlier losses, but was still down -1.62%.

Markets have absorbed political discordance and uncertainty in large part because underlying financial conditions have been good. Unemployment fell to 3.8% in May, a level not seen in almost two decades. US economic growth increased to 3%, well above the average during this long-lived recovery. First quarter earnings from S&P 500 companies¸ fueled by tax cuts, rose a whopping 27%.

At the same time, investors have understandable concerns. The President has escalated rhetoric with allies and trading partners, and the first tariffs have been implemented, raising fears that political theatre could lead to an economic crisis. It doesn't help that rising US interest rates support a strong dollar, which makes US exports less competitive.

Shrugging off these perturbations, the S&P 500 posted a +2.65% gain through June 30th. This may reflect the fact that the total value of US exports in 2017 was $1.55 trillion, a big number, but only 8% of US GDP. Moreover, despite all the handwringing, tariffs currently in place affect a mere 5% of US exports, and only 0.04% of US economic output.

Emerging markets by contrast fell -6.7%, reflecting the greater importance of exports to their economies. Countries like Mexico, for whom trade represents 36% of GDP, South Korea (37%) South Africa (48%) and Taiwan (53%) stand to lose far more from tariff wars. Some also have currencies tied to the US dollar, which makes their challenges even more daunting as the dollar rises. The Eurozone, where 16% of the economy is export-driven, got some relief from the recent decline in the euro, but not enough to avert a -2.75% drop in developed international stock markets.

Portfolio Notes

Contributors to Equity performance included US small companies, which have been part of the earnings boom and were more insulated from concerns about international exports than large companies. The Russell 2000 Index of smaller companies rose +7.66% during the first half of 2018, compared to the S&P 500's gain of +2.65%. The main detractors from performance were international equity funds that reversed first quarter gains to finish lower. Nevertheless, our equities remain well ahead of the global MSCI All Country World Index (ACWI) at mid-year.

Our fixed income holdings continue to outperform the languishing investment grade bond market, due largely to short maturity funds that limit sensitivity to rising interest rates. Our alternative

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strategy funds lost ground in the second quarter but continue to outpace bond returns by a considerable margin.

Outlook

The current economic expansion is now the second longest in history and it's natural for investors to contemplate the risks ahead. There's no shortage. Since the financial crisis, central banks in the US, Europe, and Japan have engaged in unprecedented monetary stimulus. Will this mountain of debt, and mounting budget deficits, become inflationary? Or, as the sugar high of tax cuts wanes, will economic growth and earnings growth lose momentum? These are familiar questions.

Trade remains top-of-mind today and the drumbeat of sanctions has quickened as Canada, China and the EU responded with reciprocal rounds of tariffs. Still, we are at the early stages of the trade conflict and a path to reconciliation—or at least back to the status quo—is still within view. The economic effects on the US thus far have been small and strategically targeted by our trading partners to affect supporters of the president.

Meanwhile, the Federal Reserve continues to raise short-term interest rates in 0.25% steps and we can expect up to four more hikes (totaling 1%) in the coming year. Even with recent increases however, both inflation and interest rates remain low by historic standards. In fact, longer-term rates have remained relatively stable despite rising short-term rates. Such a flattening of the yield curve is not without precedent, and though sometimes a precursor of recession, it is not necessarily a cause for concern. We continue to have a relatively conservative stance in fixed income, focusing on high-quality and short-term holdings.

With a tight job market and improvement in wages, consumer confidence is high. Corporate earnings have kept pace with stock market gains, leaving valuations at average levels. The US will not easily return to the pre-crisis era of 4% GDP growth, but improved capital reserves of global banks mean we are far less vulnerable to serious recession than before the 2008 credit crisis. And worldwide growth is on a long-term uptrend. Since 1993, China's middle class has swelled from 0% to 30% of the population; it's expected to reach 70% by 2030. Other developing countries like India are on similar trajectories, with profound and positive consequences for the global economy.

We are taking steps to decrease volatility in our portfolios at this time, though as usual we avoid attempting to predict future events or the timing of major market moves.

Please don't hesitate to contact us with any questions you may have. We wish you a happy Summer!

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