Monthly Market Commentary
July, 2018

US Economy

US GDP (Gross Domestic Product) increased 4.1% in the second quarter, the best pace in nearly four years. We had been anticipating a healthy increase due to reports on household spending, business investment, and labor market conditions that indicated favorable activity in the second quarter. Retail sales (a proxy for household consumption) through June grew at the fastest pace in three quarters. Solid reports on capital goods orders suggest that private sector investment activity also accelerated over the same period, while a persistent decline in initial jobless claims is consistent with an economy experiencing solid growth.

Looking to the second half of the year, we expect virtuous developments in consumption and investment activity to underpin the current economic expansion – but likely at a slower pace relative to the second quarter. While uncertainties surrounding trade continue to weigh on market sentiment, we are still maintaining our current forecast of 2.9% US GDP growth for 2018.

US Markets

Since February, we believe the S&P 500 has been in a classic technical correction, which could eventually resolve itself with the index breaking out and establishing a "higher high" than the 2873 level it reached in January. After bottoming at an intraday low of 2538 on February 9, the market has spent the past six months slowly climbing the proverbial "wall of worry" – and working its way through one resistance level after another. What is even more remarkable is that it has displayed this strength even as trade and global-growth concerns have intensified.

While we are firm believers that the trend remains higher and that US equity markets could eventually break out to new highs, from a timing standpoint, we believe that it is too soon for such a breakout. First, August, September, and October tend to be seasonally weak months, and markets have been tracking seasonality this year. Second, the US midterm elections will likely be an additional source of uncertainty as we get closer to November. Lastly, macro issues, especially trade and interest rates, seem like they will remain a concern for the foreseeable future. That being said, we believe that US equity markets are in the final phase of a technical correction and advise investors to remain vigilant while this correction finishes playing out.

Fixed Income

The bond market received a jolt on July 20, after President Trump challenged the Federal Reserve's (Fed) position of gradual interest-rate hikes in a media interview. The president stated that he was "not thrilled" with interest-rate hikes – and appeared (to some) to be trying to influence Fed policy. The bond market took notice, pushing yields higher, especially on the longer end of the yield curve. The comments crossed a red line for Fed watchers as the executive branch historically has left the Fed to its mandate (full employment and price stability) without interference.

Most market participants view an independent Fed as critical to a healthy economy in the long term – allowing the Fed to implement policy without the approval of the government's executive, legislative, or judicial branches. Once nominated by the president and approved by the Senate, Federal Open Market Committee (FOMC) members are free to implement their mandate without political influence or pressure. If pressure is brought to bear on the committee, members may be unwilling to make the hard choices, such as increasing interest rates to slow growth (which can stave off economic overheating and damaging inflation).

Despite the fact that President Trump has nominated 50% of the current Fed governors, we expect the Fed will remain independent and uninfluenced by presidential rhetoric. On several occasions, Chair Jerome Powell has commented on the importance of an independent Fed, and we anticipate that he will remain above the political fray.

International Markets

On July 1, Andrés Manuel López Obrador (better known as AMLO) was elected as Mexico's next president, and will be inaugurated on December 1. This historical election marked the first time (since 1929) that one of the country's two major political parties failed to win the presidency. Little is known about how the newly elected president's policies will differ from those of previous administrations. However, as mayor of Mexico City, AMLO did increase social spending programs for senior citizens (among others), but he also cut government jobs, top official's salaries, and debt growth. By most accounts, he led a fiscally responsible government and has pledged to do the same as president.

While president-elect AMLO has talked tough on the North American Free Trade Agreement (NAFTA), his tone has moderated recently. This suggests that he understands Mexico's meaningful dependence on its northern neighbors. US protectionism remains a risk to Mexico, as well as to Latin America and emerging markets in general, since they typically rely on trade to fuel economic growth. We expect NAFTA to be renegotiated and trade disputes to be resolved without escalating into a global trade war.

Commodities

Over the last month, commodities have struggled. In our view, much of this can be blamed on the amped-up rhetoric around global tariff wars. Until recently, one key commodity, oil, had largely avoided sinking with the tariff drama. Prices finally capitulated on the day that President Trump announced tariffs on an extra $200 billion of Chinese goods. West Texas Intermediate (WTI) and Brent prices declined -5% and -6%, respectively.

At risk, should more tariffs against the US come to pass, are US oil producers. This may sound like an obvious statement today, but prior to 2015, it was not. The reason is that the US government largely banned oil exports, except for trade with Canada, prior to 2015. Since 2015, the US has exported crude oil to 46 different countries. Interestingly enough, the biggest single buyer of US crude oil as of March 2018 was China, which is a likely reason for the recent pullback. Looking ahead, we continue to see lower oil prices in the back half of 2018. Our main driver behind this guidance is oversupply, but amped-up tariff talk could contribute as well.

What Does This Mean To Me?

Despite concerns surrounding tariffs and trade wars, the US economy continues to expand and consumer confidence continues to improve. As such, despite the potential for near-term market volatility, we anticipate that the US equity markets could improve as we move past the elections and into 2019. As always, we continue to recommend investors remain vigilant through periods of market volatility and maintain a focus on their long-term goals.

If you have any questions or concerns, please do not hesitate to reach out to us at any time.

Sincerely,

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