STRONG DOLLAR AND ESCALATING TRADE TENSIONS HIT EMERGING MARKETS

Emerging market stocks and local currency bonds fell sharply in the second quarter due to significant headwinds from U.S. dollar strength and escalation in global trade tensions. A strong U.S. economy and a slightly hawkish Federal Reserve caused capital flows out of emerging market currencies and into dollar assets. Meanwhile the U.S. moved to extend steel and aluminum tariffs to the E.U., Canada, and Mexico, resulting in the announcement of retaliatory measures. Escalating trade tensions between the U.S. and China also contributed to risk aversion. Oil was the best performing asset in the second quarter due to strong global demand, supply constraints in U.S. shale, and geopolitical events which forced oil production from Venezuela, Iran, and Libya offline.

STOCKS: U.S. STOCKS STAND OUT

U.S. equity markets ended a volatile but positive second quarter with the Standard & Poor’s 500 Index up 3.4 percent and the Russell 2000 Index of small company stocks up 7.8 percent. For the third consecutive quarter, U.S. stocks outperformed their international counterparts as solid earnings, tax cuts, and the continued strength in the U.S. economy offset concerns about inflation, monetary tightening, and escalating trade tensions between the U.S. and its trading partners including China, E.U., Mexico, and Canada. The MSCI ACWI ex-U.S. IMI, an index of international stocks, declined -2.6 percent during the quarter. Emerging market stocks declined eight percent for the quarter, bearing the brunt of the anti-trade rhetoric and stronger dollar. A strengthening dollar primarily impacts emerging markets in two ways: capital outflows as some emerging markets are heavily reliant on foreign inflows to fund fiscal or current account deficits and higher borrowing costs for U.S. dollar denominated debt. There were also idiosyncratic reasons for weakness in specific countries. Brazil was the weakest market in the index, as a truck driver strike paralyzed the economy and amplified political uncertainty. Turkey, where currency weakness forced the central bank to implement an emergency rate hike in May, was exposed to ongoing global liquidity tightening. Subsequently, elections won by incumbent President Erdogan, who has been consolidating power, added to political uncertainty. Weak Eurozone growth and uncertainty stemming from Italian politics were negative for a number of emerging European markets, notably Hungary and Poland.
Within the U.S. market, secular growth companies in the technology sector and disrupters such as Amazon and Netflix in the consumer discretionary sector outperformed the broader market. Energy stocks benefited from gains in oil prices driven by strong demand and supply disruptions in U.S. shale and countries such as Venezuela and Libya. On the other hand, trade tensions hit industrial and material stocks and a flattening yield curve caused the financial sector to underperform. Small capitalization stocks outperformed their large cap counter parts by 440 bps (7.8 percent vs. 3.4 percent) in the second quarter. Small companies should disproportionately benefit from lowered corporate tax rates and face lower trade tensions related headwinds given they derive a higher portion of their revenue in the U.S.

**OUTLOOK 2018: GLOBAL GROWTH BUMPS UP AGAINST TIGHTENING POLICY AND TRADE**

The U.S. economy ended 2017 with positive momentum, and we expect it to further benefit from fiscal stimulus through tax cuts, regulation rollback, and a positive shift in business and consumer confidence in 2018. Over 200,000 jobs were created in the first half of 2018, and the unemployment rate fell to a low of four percent. Labor markets appear to be at or near “full employment” and inflation appears to be closer to the Federal Reserve’s target of two percent. The probability of a recession in 2018 is low.

Having achieved their dual mandate, we expect the Fed to hike two more times in 2018 and another three times in 2019. Currently the Fed is allowing $40 billion of its bond holding to mature every month without replacing them — called quantitative tightening. The European Central Bank announced it would end its bond purchase program by the end of 2018. A significant amount of liquidity is being withdrawn from financial markets. The declines in liquidity are likely to be a detriment to both stock and bond markets, increase market volatility, and strengthen the dollar. Emerging markets in particular are facing strains as investors worry about their ability to pay their debt.

**BONDS: STRONG DOLLAR HITS EMERGING MARKET BONDS**

Following the March rate increase, the Federal Reserve implemented a second 25 basis points rate hike at its June meeting bringing its target rate to a range between 1.75 - 2.00 percent. Bond prices continued to decline in the second quarter as interest rates rose and investment-grade corporate spreads widened. The Bloomberg Barclays Aggregate index returned -0.2 percent in the first quarter and -1.6 percent year-to-date. The 2-year Treasury yield increased 26 basis points, in addition to the 38 basis points it rose in the first quarter, finishing the second quarter at 2.5 percent, the highest level since August 2008. The 10-year Treasury yield rose 12 basis points to 2.9 percent. The 10-year yield briefly broke through the important level of 3 percent, but was driven back down as concerns over a possible global trade war drove a flight to safety. The yield curve continued to flatten, as short-term rates increased faster than long-term rates, with the 2-10 year spread ending at its narrowest level since 2007 at 33 basis points. As interest rates moved higher, shorter duration bonds continued to outperform longer duration bonds.

Investment grade corporates were the worst performing domestic sector for the quarter with the Bloomberg Barclays U.S. Credit index returning -0.9 percent. Investment-grade credit spreads are sensitive to debt-leveraged mergers and acquisitions that have recently become more possible after the U.S. Justice department lost its challenge to block the proposed merger between AT&T and Time Warner. Typically mergers are funded with significant amounts of new debt which increases supply and default risk. Investment grade credit spreads widened by 29 basis points for the quarter to 138 basis points. In contrast the Bloomberg Barclays High Yield index returned a positive one percent due to the higher yields and tightening of credit spreads. High yield companies are often bought by larger companies and are subsequently often upgraded to the acquirer’s higher rating. This outperformance was enough to lift the year-to-date return for the high yield sector to 0.2 percent.

Emerging-market debt significantly underperformed because of higher U.S. Treasury yields and a stronger U.S. dollar. The flattening yield curve and stronger U.S. dollar can be signs that liquidity is being taken out of the market. When liquidity tightens, the lesser liquid and lower quality assets are sold first, including emerging market debt. The JP Morgan EMBI Global index returned -3.5 percent for the quarter.

The Bloomberg Barclays Municipal index returned 0.9 percent for the quarter outperforming the broad taxable market. The YTD return is -0.3 percent. Municipals posted strong returns as they bounced back from seasonal weakness due to selling to pay taxes. Supply remains below average from historical norms.

*Source: Morningstar. Total return data.*
longer duration bonds. While we maintain an underweight to U.S. Treasury bonds in favor of sectors that offer spread and interest income, we are looking for an opportunity to add to U.S. Treasury bonds. We are late in the cycle and expect credit to deteriorate further as the Fed raises rates; thus, we are beginning to position our portfolios for the next recession.

We will maintain an underweight to government-backed pass-through mortgages. Reduced mortgage purchases by the Fed, as they reduce the size of their balance sheet, will force the market to buy more and may force spreads upward muting future returns. We will maintain our underweight position to high yield and emerging market bonds. High Yield credit spreads are at the low end of historical ranges and have a better chance of widening than tightening. Emerging market debt offers value to long-term investors but could continue to see outflows due to a strengthening dollar.

Equities remain wedged between a strong underlying U.S. economy and corporate earnings and the ramifications of a potential trade war with the rest of the developed world and China. While low interest rates, job market strength, and a pro-business administration continue to underpin corporate momentum, headwinds such as tariffs, supply-chain concerns, and foreign currency weakness could restrain overall market returns. We believe the third quarter will be volatile as these competing realities jockey for position. However, over the balance of the year, we anticipate favorable market returns from U.S. equities as trade concerns recede relative to underlying demand strength. Though macroeconomic concerns are valid, many companies are generating healthy results and remain optimistic — current issues will be a risk factor in upcoming corporate guidance.

At the corporate level, companies continue to see strong overall demand, but are cognizant of rising costs from inflationary pressures alongside tariff impacts on revenues. Notably, as China now oversees the global supply chain, manufacturing schedules can be used as retaliation toward U.S. tariffs and will likely cause a conservative stance by corporate management throughout the third quarter. Still, we expect corporate results to exceed forecasts as long-standing tailwinds continue to drive demand across certain economic sectors. For example, market leaders such as Amazon, Facebook, and Google derive very little revenue from China and can be expected to maintain strong results.

Overall, our favorable disposition to equities has been unaltered by current issues and we remain intrigued by opportunities in cyclical sectors given ongoing trends. In particular, earnings growth appears poised to continue its key role in driving equity outperformance. We continue to look for exposure to quality companies within sectors and geographies that would benefit from higher interest rates and sustained synchronized global growth such as financials, technology, and consumer. We believe there may be more value in international equities, particularly emerging market stocks, because they are playing catch-up to the strong performance of U.S. equites since the end of the financial crisis. Technology continues to play an ever-increasing role in daily life, we fully expect technology stocks to continue to imbue other industries. In summary, the trends that have driven equity outperformance over the last several months remain in effect. But, external political variables have hampered their effect. While fears that such variables could outright reverse global economic momentum are valid, we don’t believe they will be realized. Risks to our current outlook include political actions unfriendly to businesses, an unforeseen rise in interest rates, or an increasingly inflationary environment.

We expect oil prices to be supported by OPEC production deals, production outages, and geopolitical risks. We have no position in commodities, but maintain positions in material and energy stocks and energy pipelines.

**KEY RISKS:**

**Interest Rates** – inflationary pressures and Fed balance sheet unwind cause interest rates to move up faster than the market expects.

**Trade War** – escalation with China, NAFTA countries, and European allies.

**Geopolitical** – North Korea, Middle-East, cyber-attack, or increase in terrorism