MARKET UPDATE
AUGUST 10, 2018

As we head through the dog days of summer, we wanted to provide you with an update on the economy and the markets. After a significant run up to start the year, followed by a relatively brief but sharp correction of about 10% (that lasted from late January through early February), equity markets have largely rebounded. Like so many times before throughout the current expansion, the correct strategy has been to avoid panicking and stay the course. We realize that sometimes, this can be challenging for investors. As of this writing, the S & P 500 has moved back above the 2,800 level and is now just below its prior all-time highs reached this past January.

Our base case for now remains that solid economic growth over the next few quarters should help support somewhat further gains in equity markets. Looking further down the road, economic growth may slow down again as some of the tailwinds from recent tax cuts and fiscal stimulus start to fade. However, there is also the possibility that increased capital equipment spending (due to recent tax law changes) could lead to a rise in productivity levels and thus a period of above trend growth over the next several years.

While the S & P 500 and the Russell 2000 small cap indexes have rebounded over the past several months, not all stocks and sectors have participated in the rebound to the same extent. Foreign markets and many large cap blue chip U.S. stocks have so far failed to keep pace with the rebound in the overall S & P 500 over the past few months (although that is starting to change).

Over the near term, the biggest threat to the economy and equity markets is a full-scale trade war with China. President Trump is currently threatening to increase tariffs on an additional $200 billion in Chinese imports

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(note: this would likely go into effect this Fall). We are not sure exactly how China will retaliate but they have indicated that they will respond with their own counter measures.

Overall, we have been impressed with the resiliency of equity markets in recent quarters and their ability to overcome a number of obstacles that include the threat of global trade wars, additional rate hikes by the Fed, daily Tweets by the president and questions about the longevity of the current economic expansion. As far as the trade issues are concerned, we continue to believe that ultimately, calmer heads will likely prevail as it is in the best interest of all parties. Until these issues get resolved, we could see some bumps in the road as we head through the next several months.

In terms of the economy, consumer and business spending remain positive, liquidity conditions appear healthy, credit spreads remain fairly well-behaved, inflation and interest rates are rising but not too sharply and corporate profits are advancing at a solid rate. At least so far, we don't currently see the kind of major imbalances in the economy that have historically contributed to sharp economic downturns. Recent tax law changes and an increase in fiscal spending last year have provided an additional boost for the economy. Last quarter GDP rose to 4.1% versus an average growth rate of 2.2% through the current economic expansion. As of August 3, the Atlanta Federal Reserve Bank (which tracks GDP each quarter) is currently projecting third quarter GDP growth of 4.4% this quarter. We are not sure how long growth can be maintained at this robust level. For now, we believe the economy and equity markets should continue to receive the benefit of the doubt.

Where are we in the current cycle? We believe there is a big difference between the end of the cycle and the beginning of the end of the cycle. We are currently in the 9th year of the current economic expansion. If we make it through next summer, we will have established the longest economic expansion in the post WWII period. Importantly, when you evaluate a broad range of economic data, a majority of which currently remain positive, a recession looks unlikely looking out over the next few quarters.

Again, there are some areas of concern. The biggest is the potential threat from rising tariffs and possible trade/currency wars. On a positive note, it seems like talks between the U.S. and Europe may be taking a turn for the

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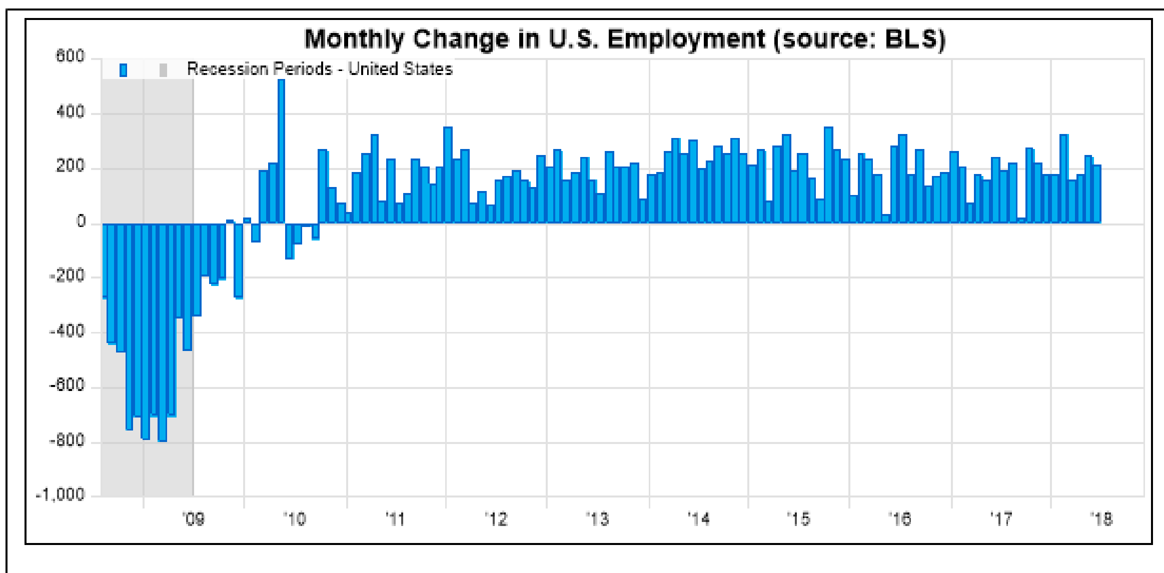
better. However, negotiations with China, Turkey, Japan and other countries remain a question mark. In addition, the U.S. Federal Reserve Bank continues to raise interest rates, Iran, North Korea and Syria represent areas of instability overseas and labor markets continue to tighten (causing a shortage of workers in some industries). Lastly, rising U.S. debt levels represent a longer-term threat to the United States. The administration's plan is for the economy to pick up speed over the next several years in order to help deal with our growing budget deficit and replace the revenues lost from recent tax cuts. It will take some time to see how this story plays out.

THE U.S. ECONOMY

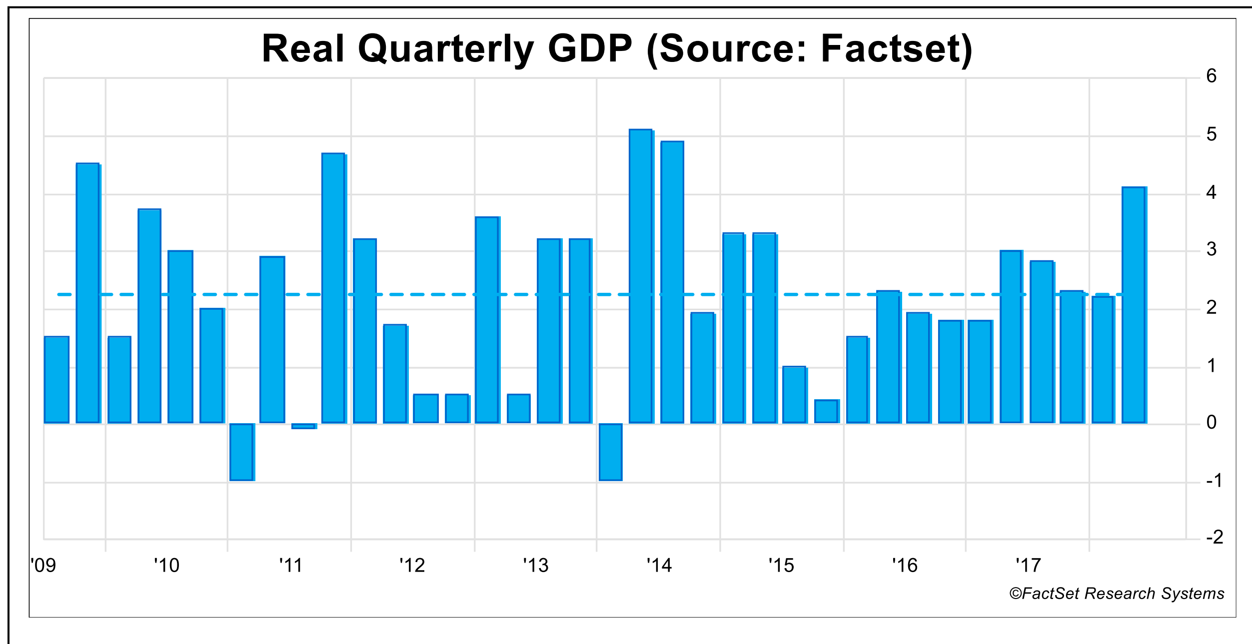
The U.S. consumer, which represents about two thirds of the U.S. economy currently appears to be on healthy footing. Over the past several years employment has continued to rise at a solid pace (see chart below), wages are rising at a moderate 2.7% rate and asset prices have continued to rise. One additional point is that when the Bureau of Economic Analysis (BEA) released its 5-year comprehensive economic update last month, adjusted data now shows that the consumer savings rate currently stands at almost 7% (6.7%) as opposed to the original reading of 4.2%. This indicates that U.S consumer balance sheets are on more solid footing than previously thought just a few months ago. In summary, the outlook for consumer related activity looks healthy heading into the second half of the year.



U.S. MANUFACTURING

Turning to the manufacturing sector, the latest ISM Manufacturing report indicates that manufacturing activity in the U.S. continues to expand at a healthy rate. The most recent reading came in at 58.1. While this is down somewhat from the prior month's reading of 60.2, it compares favorably with a 3-year average of 54.6. As a reminder, a reading above 50 indicates expansion while a reading below 50 indicates contraction. Taking a look at the two most important components within the report last month, new orders remained just above 60 (60.2) but fell to a more than one year low and current production edged down to 58.5 last month (compared with a three-year average of 57.2). The modest slowdown in the ISM Manufacturing Index last month could reflect worries about tariffs and this is something we will need to keep an eye on in the period ahead. At least for now, it looks like business spending plans, order activity and current production remain at pretty healthy levels.

Second quarter GDP was recently released and overall, it was a solid report that showed the economy grew at a rate of 4.1% last quarter (see chart below). This compares with a growth rate of 2.2% the prior quarter. Looking at various aspects of the report, the real star was consumer spending, which increased at a rate of 4% last quarter (compared with a gain of just 0.5% last quarter). Among other aspects of the GDP report, total capital spending rose a healthy 7.4% (likely reflecting a tailwind from tax law changes), government spending grew



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2.8% and real exports increased a sizable 9.3%. Food exports soared at a 110.9% annualized rate last quarter and reports indicate that some of this was due to soybeans and other products where farmers rushed to export these products ahead of Chinese tariffs on these goods. Therefore, some giveback in this large spike should be expected next quarter.

The only weak spots last quarter were a decline in residential housing activity and a dip in inventories. Housing activity seems to have turned a bit weaker over the past several months. While the multi-year trend in housing starts, new homes sales and existing homes sales remain largely positive, the housing market appears to have stalled a bit over the past few months. Housing activity has been restrained somewhat by a combination of rising interest rates, high prices and a shortage of homes for sale in a number of markets. For now, we continue to believe that the outlook for housing is likely to be two steps forward and one back.

The decline in inventories is a bit of a surprise (given the positive underlying health of the economy) and is something that could turn around and contribute positively to growth over the next quarter or two. Overall there was not a lot to dislike in the second quarter GDP report. It reflects an economy that demonstrated broad based growth last quarter without a lot of upward pressure on inflation. The more important question is can this level of economic growth be sustained for more than just one or two quarters at a time? This is a question that has been debated among economists in recent months. For growth to continue at levels above 3%, 1) Companies will need to spend more on capital equipment to help boost productivity and 2) The U.S. will need to find more workers to fill all the jobs companies are looking to fill.

Tariffs and Trade Wars

Over the past several decades, the trend in global trade has been towards lower tariffs and increased global trade. With President Trump in charge of the White House, this trend now appears to be on shaky footing. The impact of recent tariffs (along with the threat of additional tariffs on China) is already being felt in lost revenues for U.S. farmers, higher costs and weaker profits for U.S. auto manufacturers and a rise in uncertainty among U.S. corporate executives.

President Trump has threatened to increase tariffs sharply on China if they do not change their ways and provide a level playing field with

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the United States. In some ways the President is correct in that it is not fair for China to take advantage of U.S. companies that operate in China. It's the way the President has gone about things that has gotten lots of international attention. Given that the United States imports a lot more in goods than we export to China, you would think that the United States has some leverage here in trade negotiations. We still believe that comments from the Whitehouse in recent months represent Trump's version of hard-nosed negotiating. This past week, the business news channel CNBC reported that trade talks may now be taking place between the United States and China. We are not sure if this is fact or fiction. For now, we will continue to monitor news events and think about possible portfolio adjustments that may be necessary down the road.

THE FEDERAL RESERVE BANK

At its latest central bank meeting (which ended on August 1, 2018), Federal Reserve Bank Chairman Powell indicated that the central bank is likely to continue raising rates at a gradual pace over the next few quarters. When they released their policy statement, the central bank upgraded their assessment of the economy and stated that "the committee now sees that economic activity has been rising at a strong rate". *This compares with the Fed's* previous statement that "activity had risen at a solid rate". In addition, the central bank commented that "labor markets are strong, as shown by the low unemployment rate, and that household spending and business fixed investment have grown strongly."

The central bank is raising rates for two reasons. First because the economy continues to perform well and no longer needs the kind of emergency rates that it needed during the last recession. Second, by raising rates now when the economy is performing well, they will have some ammunition to lower rates and come to the economy's rescue when the time is needed in the future. Looking ahead, we believe that the Federal Reserve Bank is likely to raise rates two more times this year and likely three times in 2019 as it adjusts rates back to more normal levels. Historically (but not every time), when the central bank has raised rates too aggressively, they have caused a recession. With real (i.e. inflation adjusted rates) still negative, the central bank has more room to go before short-term rates become "tight." This will be something to keep an eye on over the next several quarters heading into 2019.

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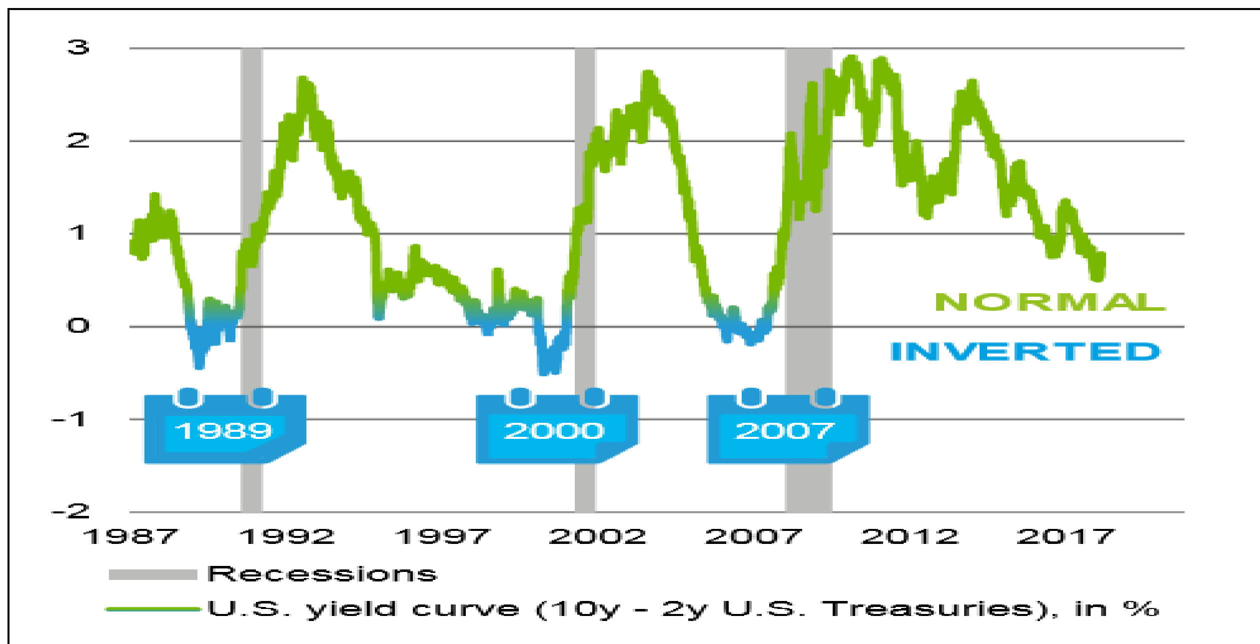
THE YIELD CURVE

One topic that gets a lot of attention is the shape of the yield curve (note: this is a topic I wrote a blog about several months ago on our team's website). The yield curve (i.e. the difference between long term rates minus short term rates) has been an accurate forecasting tool that can help predict upcoming recessions (see chart below – source: Deutsche Bank).

Looking at the chart above, you can observe that when the yield curve inverts (note: this represents the blue area where long term rates fall below short-term rates), a recession has typically followed. Based on its historical ability to forecast recessions, this is definitely an important indicator to follow. However, it's also important to point out that: 1) There is often a sizable lead time between when the yield curve inversion occurs and when a recession starts; 2) Other data should be monitored and evaluated as well and 3) The fact that short term rates are historically low this time around may distort the importance of the yield curve as an economic indicator. Lastly, although the yield curve has continued to narrow in recent months (which has historically occurred when the central bank raises short term rates), the yield curve continues to remain positive as of this writing.



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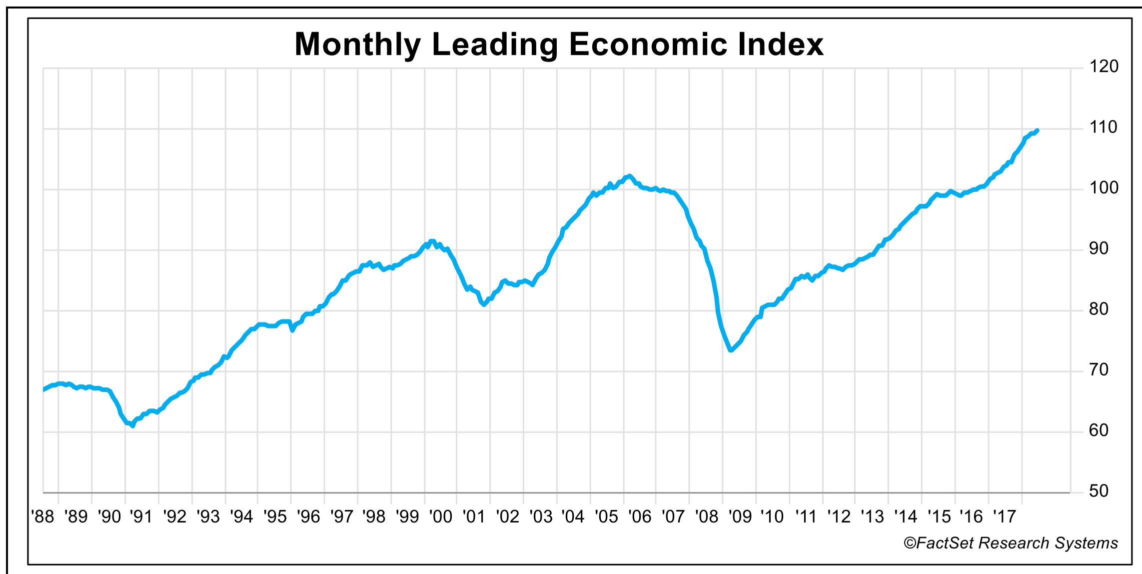
Leading Economic Indicators

At RDM we keep an eye on a number of different economic indicators to try and gauge the outlook for the economy over the next several months. One index that we watch each month is the Conference Board's monthly Leading Economic Index - LEI (see chart below – source: Factset). The LEI typically peaks several months ahead of an economic downturn and it has a long history dating back to 1952. Thus, we believe that it is a helpful indicator to follow.

Other indicators that we monitor on a regular basis include the level of corporate bond spreads, the Federal Reserve Bank's senior lending survey, consumer wage growth, the level of real short-term rates and the performance of the S & P 500 itself. We also wanted to highlight one more indicator called weekly jobless claims (which comes out each Thursday morning at 8:30 am). Looking at the four-week average (which smooths out big week to week changes), weekly claims recently declined to 214,000 which is close to the lowest level since December 1969. In summary, most of the forward-looking indicators that we keep an eye on continue to point to an economy on solid footing looking ahead over the next 2-3 quarters.

Second Quarter Earnings

Second quarter earnings season is currently in full swing and at least so far, earnings for the S & P 500 look quite positive. So far about two thirds of companies in the S & P 500 have reported second quarter results. Earnings per



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share (EPS) are currently on pace to rise about 25% on a year over year basis (note: this includes the fact that companies beat analyst estimates by a small amount on average each quarter). According to research from Credit Suisse, recent tax law changes have added about 7.7% to EPS. Excluding the recent one-time drop in corporate taxes, EPS would have increased closer to 16.0% last quarter on a year over year basis.

This past quarter, companies have been beating EPS estimates by 6.0%, with 78% of companies surpassing bottom-line estimates. This compares to an average earnings per share beat of 4.8% with 69% of companies beating estimates on average over the past 3 years. For next quarter (Q3, 2018), the current forecast is for 21.2% year over year EPS growth along with a 7.7% increase in revenues. Looking ahead, for all of 2018, EPS is currently forecast to rise 20.7% and for 2019, the current forecast is for a full year EPS increase of 10.2%. Revenues are currently forecast to rise 7.8% this year followed by an increase of 5.1% next year. For 2018, all 11 sectors of the market are currently forecast to generate positive year over year EPS growth with nine sectors posting double digit growth. For 2019, all 11 sectors of the market are once again currently forecasted to generate positive full year EPS growth but with just four sectors posting double digit growth.

OVERSEAS

Heading into 2018, global growth seemed to be hitting on all cylinders. However, outside the United States, growth has slowed somewhat over the past several months. Additional rate hikes by the U.S. central bank, a fear of trade wars and a rising dollar have all contributed somewhat to weaker economic growth overseas. However, it's important to point out that the global economy continues to grow and the slowdown we have witnessed overseas could prove temporary (time will tell but this is our base case). Based on our viewpoint that the U.S was likely to experience stronger economic growth than foreign markets this year, we froze our foreign equity allocation at about 15% in early 2018. At least so far, it looks like this turned out to be the right move.

According to a recent update from the International Monetary Fund (IMF), 79% of the world's economies are currently forecast to grow by 2% or more in 2018. In terms of countries, the IMF currently forecasts that the United States, Europe and China are likely to grow 2.8%, 2.4% and 6.6% respectively in 2018. While the U.S. is currently the engine pulling

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the rest of the world economy along with it, we believe it's still important to have some foreign exposure in your investment portfolio. For reference, a majority of the world's population, companies and market capitalization all reside outside the United States. Plus, valuation levels are more attractive overseas and monetary policy outside the United States is currently more accommodative.

FIXED INCOME

Looking at U.S. fixed income markets over the past several months, there have not been a lot of big changes. Credit spreads remain fairly healthy, short term rates continue to push higher while longer term rates (based on the U.S. 10 Year Treasury Bond Yield) remain largely range bound between about 2.85% and 3%. Looking at the widely followed Bloomberg Barclays Aggregate Bond Index (from 12/31/17 – 6/30/18), the index has generated a total return of -1.6% so far this year. As we have commented before, instead of simply focusing on the Bloomberg Barclays Aggregate Bond Index (which mainly owns U.S. government bonds and has a high level of interest rate sensitivity), we prefer to take a different approach that we believe is more prudent and sensible.

We don't believe that anyone can accurately forecast the direction of interest rates on a consistent basis. Therefore, with a majority of our fixed income assets, we create laddered corporate bond portfolios with a maturity range of approximately 3 to 8 years. While individual corporate bonds in your portfolio will experience some ups and downs over time, the yield to maturity and cash flow that these bonds generate are known at the time of purchase and this helps in the investment planning process. With the remainder of fixed income assets, we own a basket of multi-sector bond funds. Our expectation is that these bond fund managers will generate a moderate return and stay out of trouble if interest rates rise significantly. When the time is right, we can sell these bond funds and either add to our corporate bond ladders or invest in something more attractive that may come along over time. The single most important aspect of our laddered individual bond strategy is that we are not subject a loss of principal (if bonds are held to maturity) compared with many bond funds that will likely face principal loss if interest rates move higher.

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SUMMARY

In summary, as we look ahead, we remain moderately constructive in our outlook for the U.S. economy and financial markets. The U.S. consumer appears to be on solid footing, companies are starting to spend more on capital equipment, business and consumer sentiment remain healthy and corporate profits are rising. At this point we don't know how long the current expansion will last. However, we don't currently see the kind of rain clouds typically associated with a major economic downturn when we look ahead over the next few quarters. GDP growth of 4.1% last quarter was certainly encouraging and compares with average growth of 2.2% throughout the almost 10 year-long economic expansion. Looking ahead, our base case is that economic growth is likely to remain above trend for now (as a result of recent tax law changes and fiscal stimulus) before slowing down once again later this year or sometime in 2019.

While we don't currently see a big slowdown ahead right now, there are a few issues on our radar that could lead to a period of increased market instability during the second half of the year. For example, if the current trade skirmish between the United States and China becomes an all-out trade war, that would likely have a negative impact on financial markets. In addition, overly aggressive rate hikes by the central bank, excessive market valuation levels not supported by business fundamentals, or a geopolitical event overseas could also have a negative impact on financial markets. Lastly, as we look further down the road, we are growing more concerned about rising budget deficits and how that might ultimately impact financial markets and the economy in the years ahead.

As always, we welcome any comments you may have and hope you enjoy the rest of the summer.

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Bloomberg Barclays U.S. Aggregate Bond Index - The Bloomberg Barclays U.S. Aggregate Bond Index is a market capitalization weighted index that tracks the performance of the U.S. dollar denominated, fixed rate taxable income markets.

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