

ECONOMIC OUTLOOK

Summary

There are two issues we would like to discuss this month on the economic front that were included in the recent Fed minutes. The first is trade tariffs and the second is the Federal Reserve's "symmetric" approach to their 2% inflation target. On the trade/tariff front, much has been said about fair trade and how to reorient 30 years of laissez faire U.S. trade policy, with its attendant supply chain networks, into a more U.S. centered production point. Although the goals are laudable, it seems as if the law of unintended consequences is occurring in real time. For example, excerpts from the minutes detail the following; "However, in a number of Districts, contacts expressed concern about possible adverse effects of tariffs and trade restrictions, including the potential for postponing, or pulling back, on capital spending". So, clearly, the large uncertainty surrounding these discussions are making business leaders more cautious about their spending plans.

On the inflation front, a symmetric focus means that policy makers will tolerate 2.3% readings as well as 1.7%, when looking at their 2.0% target level, over a modest time frame. Therefore, instead of looking at the 2.0% inflation target as a ceiling, a symmetric orientation will accept cyclical readings above the Fed's preferred inflation level. When one puts these two factors together, it suggests that the Fed is concerned about growth headwinds due to tariff negotiation posturing, and a willingness to accept

temporary increases in official inflation statistics, before getting more concerned about a secular inflation problem. While one of the biggest threats to the risk markets is an aggressive Fed that overtightens and sends the economy into a recession, it seems as if the monetary gods are giving themselves some wiggle room in the months ahead.

Positives

Unemployment rate drops to an 18-year low of 3.8%

ISM manufacturing and service measures surprise to the upside last month

Continuing claims for unemployment insurance fall to lowest levels in 50 years

Negatives

Labor force participation rate falls for the third month in a row

ISM prices paid index hits highest level since 2012

Unit labor costs increase 2.9% in Q1, 2.8% was expected

EQUITY OUTLOOK

Summary

The S&P 500 rallied 2.4% in May as equity markets responded positively to the excellent first quarter corporate earnings results and other positive geopolitical developments. The results pushed stocks back into positive territory for the year. We anticipate that the increased volatility we have experienced will continue.

Heading into the year, broad U.S. equity indexes looked expensive based on price relative to earnings (P/E), one of the most commonly used valuation metrics. A 5.6% rally in January made this multiple even more lofty. However, after correcting early in February, stock indexes have essentially moved sideways to lower allowing the “P” to stay steady, while tax-cut fueled corporate earnings have created a massive boost in the “E”. Today valuations look more attractive with forward multiples based on even higher projected future earnings appearing even more attractive relative to historic norms.

Mid-term election years have historically coincided with equity markets that are choppy through the first three quarters of the year and then rally near the close of the year when the outcome of the election is less in doubt. We believe that pattern could very well be repeated this year

cycle. Given President Trump’s approval ratings have been improving in recent months, the blue wave of Democrat support that had previously been anticipated is no longer a foregone conclusion. This creates even more uncertainty surrounding the outcome of the elections. Uncertainty tends to add to volatility which we may not see subside until later in the year. We remain relatively bullish on equities over the intermediate and long term. Appreciable gains in the short term most likely won’t take place until closer to, or after, the conclusion of the election.

Positives

Upbeat corporate revenue, earnings and outlook

Consumer and business confidence remain elevated

Negatives

Unsettled trade negotiations

Rising wages and input costs

FIXED INCOME OUTLOOK

Summary

The upward trend in interest rates continued during the first half of May as the 10-year Treasury note hit its highest level in nearly seven years at 3.11%. The 2-year Treasury note yield reached the highest level since the summer of 2008 at 2.59%. Just to add a little salt into bond investors' wounds, credit spreads widened making investment-grade corporate bond returns even worse than comparable maturity government debt. At this point the broad based, investment-grade bond benchmarks were down about 3% on a total return basis and even the intermediate benchmark was down almost 2%. 2018 is setting up to possibly be the worst year for bond investors since 1994.

Then, over a period of seven trading days, we were once again reminded of the benefits of diversification and the role that fixed income securities play in a well-balanced investment strategy. Equity markets, particularly in Europe, were roiled by news that the newly elected Italian leadership was unlikely to be able to form a coalition government. That called into question Italy's ability, or even their desire, to remain in the European Union. Investors flocked to the safest markets in the world causing the yield on the 10-year German bund to drop 38 basis points to 0.26% and the 10-year U.S. Treasury note to drop 35 basis points to 2.78%.

We still believe the Fed will increase the overnight Fed Funds rate in June and possibly again in September, or more likely December, but it is unlikely to validate its 3.25-3.50% range that it forecasts for the end of 2020. We believe that the terminal rate for this hiking cycle will be around 2.50-2.75%, which should be achieved in 2019. We believe the 2-year Treasury

yield at about 2.50% adequately prices in our forecast so it should not have to rise much more over the next year. As the political uncertainty in Europe settles down and all-out trade wars are averted, longer yields should march steadily higher and retest the May highs before settling slightly above those levels later in the year.

Positives

Global synchronized growth story is eroding with European weakness

Political uncertainties continue to fuel a flight to safety

Inflationary pressures remain moderate

Negatives

The Fed's rate hiking cycle will continue

Negative returns could alarm retail investors who then sell holdings

Inflationary pressures could reemerge if trade wars flare

Unknowns

North Korean nuclear negotiations could be huge market positive or negative

Ability of Trump team to successfully negotiate new trade agreements
