

QUARTERLY ECONOMIC UPDATE

QUOTE OF THE QUARTER

“Politeness and consideration for others is like investing pennies and getting dollars back”
- Thomas Sowell

QUARTERLY TIP

Are you a freelancer? Here is a mid-year reminder to get ready for taxes. See if you can calculate how much you'll have to pay the I.R.S in April 2018. Start setting aside a little money per month, so that you can pay the bill with ease.

A review of Q2 2018

THE QUARTER IN BRIEF

At the end of 2018, economists and journalists may look back on the second quarter and see the moment when a global trade war began. Whether one is truly underway or not, the fact is that Q2 was a good quarter for equities. The S&P 500 gained 2.93% in three months, and while the blue chips had their struggles, tech shares ascended once again. Many foreign benchmarks also had a good quarter, even as the Trump administration's planned import taxes on U.S. trading partners drew tariffs in kind and bred pessimism overseas. Our labor market and manufacturing and service industries continued to look healthy, and consumer confidence and spending reports were largely encouraging. Existing home sales tailed off. Oil made quite a comeback, aided by supply concerns. It was a quarter in which relatively strong economic data was overshadowed by a shift in the playing field for global trade.¹

DOMESTIC ECONOMIC HEALTH

The Trump administration had begun imposing import taxes early in the year, but in the second quarter, the international tariff spat truly grew heated. U.S. duties against metals imported from Mexico, Canada, and European Union nations were met by 25% taxes levied by the E.U. on American jeans, bourbon, orange juice, and other products, and Canada, India, and Mexico announced duties on select imports from America as well. Then the U.S. supplemented its earlier tariffs with new 25% taxes on \$34 billion of Chinese imports (set to take effect July 6), and threatened to impose further 10% duties on another \$200 billion of Chinese products and a 20% tariff on autos coming out of the E.U. China replied to the new tariff on \$34 billion of its exports with an equal tariff on U.S. goods, to be implemented July 6.²

Interest rates moved north in Q2. The Federal Reserve made its second rate move of the year on June 13, taking the target range for the federal funds rate 0.25% higher to 1.75%-2.00%. A new wrinkle was found in the Federal Open Market Committee's latest dot-plot consensus projection: it suggested four quarter-point rate hikes would occur this year rather than three.³

April saw consumer spending jump 0.6%, but the May number was just a third of that. Consumer wages were up 0.3% in April, then advanced another 0.4% a month later. Retail purchases were up 0.4% in April; then, 0.8% for May.^{4,5}

Some of the data in the previous paragraph might seem a bit contradictory, but the takeaway was clear: consumers were playing a strong role in keeping the economy healthy. While consumer confidence indices fell during Q2, they were still at lofty levels. The University of Michigan's index came in at 98.8 in April, then 98.0 in May and 98.2 in June; its historical average is 86.4. The Conference Board announced successive readings of 128.7, 128.0, and 126.4 for its consumer confidence index in April, May, and June, respectively.^{6,7}

Inflation pressure also mounted during the quarter. The headline Consumer Price Index showed a 2.5% annualized gain through April, and that increased to 2.8% in May; core consumer prices were up 2.1% in a year through April; then, 2.2% as of

May. Yearly wholesale inflation jumped from 2.6% in April to 3.1% in May.⁵

Even with those production costs rising, the manufacturing and service sectors of the economy continued their fast growth. The Institute for Supply Management's factory purchasing manager index improved from 57.3 in April to 58.7 in May, and its service sector PMI also rose across those two months, ascending from 56.8 to 58.6. (At the top of July, more good news rolled in: the factory PMI had climbed to 60.2 in June.) Perhaps these readings would decline in summer, as the federal government reported hard goods orders declined 1.0% in April and 0.6% in May.^{4,5}

Unemployment declined even further in the second quarter. The headline rate was just 3.9% in April, and it ticked down to 3.8% a month later. In tandem, the U-6 rate, encompassing underemployed workers, fell to 7.6% in May from 7.8% in April. April brought 159,000 net new jobs to the economy, and the Department of Labor said that 223,000 more were created in May.⁵

In late June, the Bureau of Economic Analysis concluded that the economy grew at a middling 2.0% annual pace in Q1. That was still the best first-quarter number since 2015. As the third quarter started, the Federal Reserve Bank of Atlanta's GDPNow model estimated 3.8% GDP for Q2 (the estimate had been up at 4.8% as recently as June 14).^{4,8}

GLOBAL ECONOMIC HEALTH

China is coping with U.S. tariffs at an inopportune time. While its official growth target of 6.5% for 2018 may still be met, several signs point to its economy decelerating. Through May, its annualized retail sales pace was the slowest in 15 years, and its year-over-year export growth slipped from 3.7% in April to 3.2% in May. Fixed asset investment growth also tailed off to an 18-month low in the quarter. Given that consumer spending, capital investment, and exports are the pillars of the nation's economy, this news was troubling. Additionally, the yuan hit a 6-month low versus the dollar in May. China's central bank had been tightening in step with the Federal Reserve, but it broke ranks in Q2 and left its benchmark interest rate unchanged; it also cut its reserve requirement ratio for commercial banks by 1% in April and another 0.5% in June. Japan, meanwhile, warned the U.S. that it could impose import taxes of its own on U.S. products, especially if the Trump administration announced car tariffs in addition to the existing levies on steel and aluminum from Japan.^{9,10}

The European Union held its breath as power struggles played out in Italy and Spain: the ascension of the Five-Star Movement and League party in the former country, the replacement of one Prime Minister (Mariano Rajoy) with another (Pedro Sanchez) in the latter. So far, neither country has made noise about exiting the euro. Eurozone yearly inflation accelerated during the quarter, reaching 1.9% in May – the most in 13 months, just beneath the European Central Bank's 2.0% target. This was a factor contributing to the sunset of the ECB's longstanding asset-purchase campaign. The ECB announced it will gradually phase out this effort in the fourth quarter and stop buying bonds entirely in 2019. At their June 14 meeting, ECB policymakers also pledged to hold interest rates at current levels through the summer of 2019.¹¹

WORLD MARKETS

The MSCI Emerging Markets index took it on the chin during the quarter: it slipped 8.66% (and was down 7.68% after six months of 2018). The MSCI World index, on the other hand, gained 1.09% in three months.¹²

How did other major benchmarks do in the quarter? Results were mostly positive. The winners included the CAC 40 in France, +3.02%; the United Kingdom's FTSE 100, +8.22%; Japan's Nikkei 225, +3.96%; India's Sensex, +7.45%; Australia's All Ordinaries, +6.89%; Canada's TSX Composite, +5.92%. The losers included the German DAX index, -0.82%; Hong Kong's Hang Seng, -3.78%; China's Shanghai Composite, -10.14%.¹³

COMMODITIES MARKETS

WTI crude soared 18.42% in the second quarter, leading all commodities except for the international oil benchmark, Brent crude (up 18.92%). WTI crude ended the quarter at \$74.25, with supply concerns pushing up the NYMEX price by about \$10 during the second half of June alone. Other notable Q2 gains: orange juice, 12.72%; lumber, 12.64%; RBOB gasoline, 9.70%; wheat, 6.19%; the U.S. Dollar Index, 5.56%; cotton, 4.38%; natural gas, 3.85%; palladium, 3.02%.^{14,15}

Numerous commodities suffered Q2 setbacks. Some of the significant losses: silver, 1.53%; copper, 3.73%; cocoa, 4.18%; sugar, 4.82%; coffee, 7.24%; gold, 7.25%; platinum, 8.60%; corn, 11.61%; soybeans, 18.66%. Gold finished the quarter at \$1,254.20 on the COMEX; silver, at \$16.06.^{14,15}

REAL ESTATE

Once again, mortgage rates ascended. As a look at Freddie Mac's March 29 and June 28 Primary Mortgage Market Surveys shows, interest rates on adjustable-rate home loans made the biggest move. The mean rate on a 5/1-year ARM was 3.66% on March 29, but 3.87% on June 28. Rates on 30-year FRMs averaged 4.55% in the June 28 PMMS, up from 4.44% in late March. Regarding the refinancer's favorite, the 15-year FRM, the story was similar: a 3.90% mean interest rate on March 29, a 4.04% mean rate on June 28.¹⁶

With the housing market presenting buyers with gradually rising mortgage rates, thin inventory, and high prices, it is little wonder that the pace of home buying decelerated in Q2. The National Association of Realtors found sales slowing 2.7% in April, and then another 0.4% in May. NAR's pending home sales index, the nation's top measure of housing contract activity, also weakened. It retreated 1.3% in April and then 0.5% a month later.^{4,5}

As for new home sales, the story told by Census Bureau reports was slightly different. They were up 14.1% year-over-year through May; they fell 3.7% in April, but surged 6.7% a month later. The median sale price had declined \$10,600 in 12 months to \$313,000, and the inventory of new homes on the market actually grew 1% from April to May.¹⁷

Groundbreaking, as tracked by the Census Bureau, increased 5.0% for May after a 3.1% reversal during April. Building permits fell 1.8% for April and 4.6% a month

afterward.⁵

LOOKING BACK...LOOKING FORWARD

The small caps came in first in the second quarter: the Russell 2000 rose 7.43% to 1,643.07. After its sizable Q2 advance, the Nasdaq Composite stood at 7,510.30. The Dow ended the quarter at 24,271.41, the S&P 500 at 2,718.37. The CBOE VIX? The stock market's primary fear gauge settled at 16.09 on June 29, down 19.43% in three months.¹

% CHANGE	YTD	Q2 CHG	1-YR CHG	10-YR AVG
DJIA	-1.81	0.70	14.02	11.38
NASDAQ	8.79	6.33	22.23	22.75
S&P 500	1.67	2.93	12.34	11.24

REAL YIELD (%)	6/29 RATE	1 YR AGO	5 YRS AGO	10 YRS AGO
10 YR TIPS	0.74	0.55	0.53	1.48

Sources: wsj.com, bigcharts.com, treasury.gov - 6/29/18,19,20,21

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly. These returns do not include dividends. 10-year TIPS real yield = projected return at maturity given expected inflation.

So, what could this third quarter hold for equities? Can the market retain its upward bias, maybe even strengthen it as the summer proceeds? It is possible, but bulls will have to overcome some big factors: the major headwinds from the multinational tariffs fight, perceptions that growth may be slowing or moderating in China and the European Union, rising inflation, and the ongoing normalization of monetary policy by the Federal Reserve. Then again, the recent ISM PMIs, consumer confidence surveys, the labor market, and decent-to-good retail sales and consumer spending figures seemed to affirm the economy's health this spring; the first estimate of Q2 GDP may also impress investors. In addition, the Fed's monetary policy remains essentially supportive. If the trade battles continue to siphon enthusiasm from Wall Street, however, bulls may trot to the sidelines and stay there for much of the quarter.

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DEFINITIONS:

The Dow Jones Industrial Average is a price-weighted index of 30 actively traded blue-chip stocks. The NASDAQ Composite Index is a market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System. The Standard & Poor's 500 (S&P 500) is a market-cap weighted index composed of the common stocks of 500 leading companies in leading industries of the U.S. economy. NYSE Group, Inc. (NYSE:NYX) operates two securities exchanges: the New York Stock Exchange (the "NYSE") and NYSE Arca (formerly known as the Archipelago Exchange, or ArcaEx[®], and the Pacific Exchange). NYSE Group is a leading provider of securities listing, trading and market data products and services. The New York Mercantile Exchange, Inc. (NYMEX) is the world's largest physical commodity futures exchange and the preeminent trading forum for energy and precious metals, with trading conducted through two divisions – the NYMEX Division, home to the energy, platinum, and palladium markets, and the COMEX Division, on which all other metals trade. The MSCI Emerging Markets Index is a float-adjusted market capitalization index consisting of indices in more than 25 emerging economies. The MSCI World Index is a free-float weighted equity index that includes developed world markets, and does not include emerging markets. The CAC-40 Index is a narrow-based, modified capitalization-weighted index of 40 companies listed on the Paris Bourse. The FTSE 100 Index is a share index of the 100 most highly capitalized companies listed on the London Stock Exchange. Nikkei 225 (Ticker: ^N225) is a stock market index for the Tokyo Stock Exchange (TSE). The Nikkei average is the most watched index of Asian stocks. BSE Sensex or Bombay Stock Exchange Sensitivity Index is a value-weighted index composed of 30 stocks that started January 1, 1986. The All Ordinaries (XAO) is considered a total market barometer for the Australian stock market and contains the 500 largest ASX-listed companies by way of market capitalization. The S&P/TSX Composite Index is an index of the stock (equity) prices of the largest companies on the Toronto Stock Exchange (TSX) as measured by market capitalization. The DAX 30 is a Blue Chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange. The Hang Seng Index is a free float-adjusted market capitalization-weighted stock market index that is the main indicator of the overall market performance in Hong Kong. The SSE Composite Index is an index of all stocks (A shares and B shares) that are traded at the Shanghai Stock Exchange. The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index. The CBOE Volatility Index[®] is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Additional risks are associated with international investing, such as currency fluctuations, political and economic instability and differences in accounting standards. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. MarketingPro, Inc. is not affiliated with any person or firm that may be providing this information to you. The publisher is not engaged in rendering legal, accounting or other professional services. If assistance is needed, the reader is advised to engage the services of a competent professional.

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