2018 MID-YEAR MARKET REVIEW & OUTLOOK

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PUTTING VOLATILITY IN PERSPECTIVE

Volatility has returned from its hiatus in 2017. A strong February jobs report showing 313,000 new US jobs created[1], combined with another Federal Reserve rate hike, spooked investors into inflation fears and caused a rapid sell off. The Dow Jones Industrial Average closed down 1,175 points, or 4.6%, on February 5, giving back almost all of its gains for the year.

[1] https://www.whitehouse.gov/briefings-statements/februarys-strongjobs-report-another-sign-resurgent-economy/

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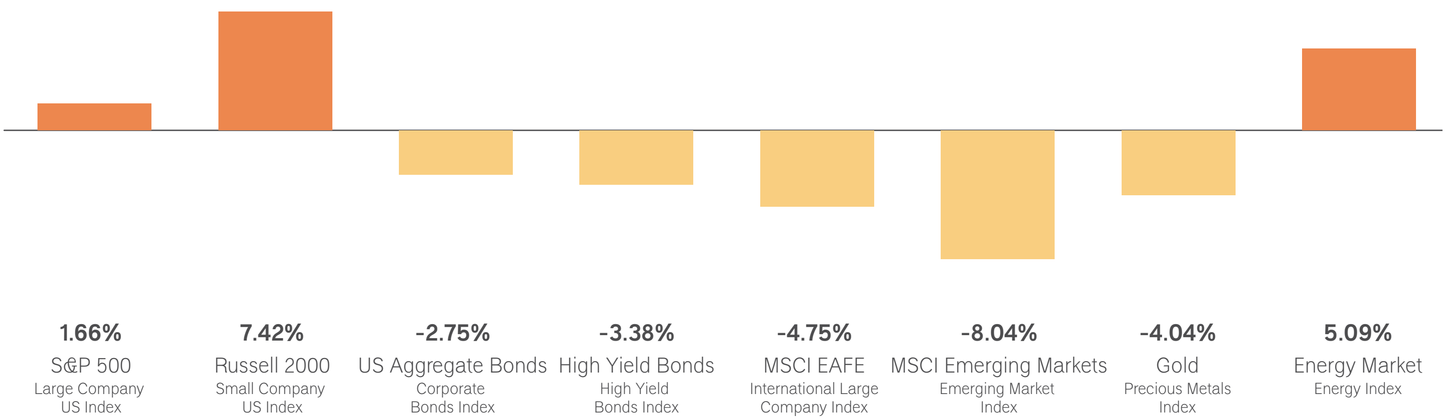
Market Performance

Volatility has persisted throughout the first half of 2018, causing some of the major indices to remain near flat (see Figure 1). Small-cap stocks (Russell 2000) significantly outperformed for two primary reasons. First, the positive impact of tax cuts on their earnings has been greater than expected. Second, because smaller companies generate most of their revenue from domestic operations, they are less affected by the recent trade war disputes that have contributed to increased volatility.

A rocky start for most asset classes

FIGURE 1. **BENCHMARK TOTAL RETURN PERFORMANCE (12/31/2017 – 6/30/2018)***



* The following indexes Year-to-Date total returns were found using the following tickers: SPY, IWM, AGG, JNK, EFA, EEM, GLD, and XLE respectively.

Source: Morningstar, data as of 6/30/2018.

Trade Policy

Trade wars have disrupted the stock market's momentum thus far in 2018. In March, President Trump announced $50 billion in tariffs on Chinese goods in response to their unfair trade practices over the years. China fired back a few weeks later by imposing tariffs on 120 US products.[2] The back-and-forth has continued between the two countries, creating concerns among economists who believe that trade war history is not on our side.

[2] http://money.cnn.com/2018/05/30/news/economy/trump-china-us-tariffs-trade-timeline/index.html

Interest Rates

The Federal Funds Rate currently sits at 1.75 – 2% after two hikes totaling 0.5% in the first half of 2018.[3] The Fed cited a strengthening economy, full employment, and a pickup in growth as reasons for the rate hikes.

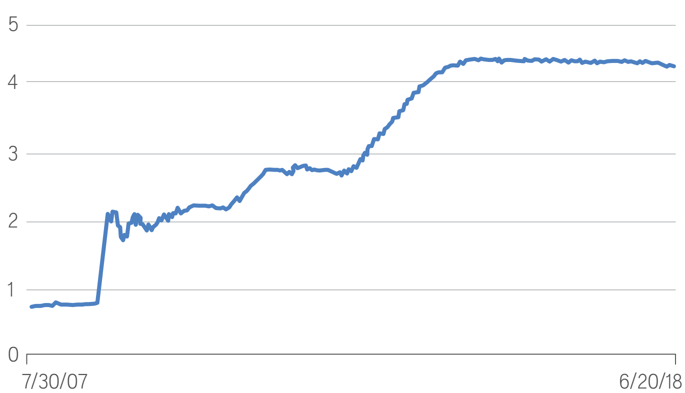
The Fed has signaled two additional hikes throughout 2018, which would push its target rate to a 10-year high of 2.25 – 2.5%.[4] Chairman Jerome Powell has stated that he expects inflation to continue to move toward the Fed's 2% goal.[5] Powell is much more hawkish than his predecessor Janet Yellen, favoring higher interest rates to manage inflation expectations. He notes that, "It remains the case that raising rates too slowly would make it necessary for monetary policy to tighten abruptly down the road, which could jeopardize the economic expansion."[6]

In an effort to "normalize" the economic landscape, monetary policy has undergone a role reversal from the last decade. Instead of quantitative easing (QE) to aid in driving down borrowing costs and boosting economic activity, the Fed has switched to a quantitative tightening (QT) strategy to reduce its balance sheet. In the wake of the recession, the Fed's balance sheet ballooned to more than $4 trillion (see Figure 2). It began tapering approximately $50 billion per month in October 2017 and has continued this trend throughout 2018 (see Figure 3).

As you can see, the Fed has a long way to go to get its balance sheet back down to pre-crisis levels. Simultaneously raising rates while reducing a $4 trillion balance sheet is proving to be quite difficult as market volatility rises.

Quantitative easing following the financial crisis

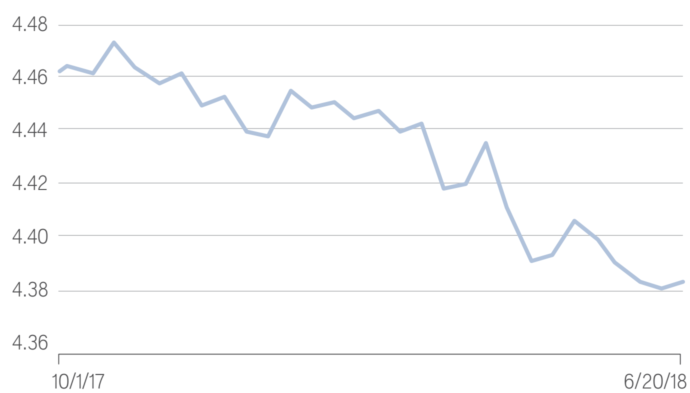
FIGURE 2. **GROWTH OF THE FEDERAL RESERVE'S BALANCE SHEET IN $ TRIL. (7/30/2007 – 6/20/2018)**



Source: Federal Reserve's Recent Balance Sheet Trends (https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm)

Quantitative tightening in a growing economy

FIGURE 3. **REDUCTION OF THE FEDERAL RESERVE'S BALANCE SHEET IN $ TRIL. (10/1/2017 – 6/20/2018)**



Source: Federal Reserve's Recent Balance Sheet Trends (https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm)

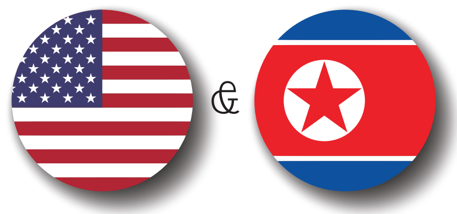
[3] https://www.federalreserve.gov/monetarypolicy/openmarket.htm
[4] https://www.nytimes.com/2018/06/13/us/politics/federal-reserve-raises-interest-rates.html
[5] https://www.cnbc.com/2018/02/23/fed-sees-economy-past-full-employment-but-with-only-moderate-wage-gains.html
[6] https://www.federalreserve.gov/newsevents/speech/powell20180406a.htm

US Economy

Consumer confidence has surged to a nearly 17-year high[7], as Americans have begun to see bigger paychecks following the recently enacted tax cuts. Unemployment stands at 3.8%, which the Fed considers "full employment." US GDP for the first quarter of 2018 grew at 2.0%[8], continuing the second-longest expansion in American history.

Geopolitics

For the first time since the Korean War, a North Korean leader stepped across the border with South Korea as part of an agreement to end the war after 65 years. "I would like to join hands together between the two sides so that we can open up a new chapter in our history," said North Korean leader Kim Jong-un.[9] This interaction between him and South Korean President Moon Jae-in has been a monumental development in history, as tensions have eased ever since the Winter Olympics in February.



President Trump and Kim Jong-un held a summit in Singapore in June, the first-ever meeting between US and North Korean leaders. The meeting was deemed a success. It resulted in a signed joint statement agreeing on security guarantees for North Korea, new peaceful relations, reaffirmation of the denuclearization of the Korean Peninsula, and recovery of soldiers' remains. There was also an agreement to hold follow-up meetings for further negotiations.

[7] https://www.whitehouse.gov/briefings-statements/februarys-strongjobs-report-another-sign-resurgent-economy/
[8] https://www.reuters.com/article/us-usa-economy-gdp/us-first-quarter-gdp-growth-revised-down-to-2-percent-idUSKBN1JO1QQ
[9] https://www.cnn.com/asia/live-news/north-korea-south-korea-summit-intl/

GOING FORWARD THROUGH 2018 AND BEYOND

Here at the halfway point of 2018, we continue, as always, to focus on risk management in guiding our investment selection process. During this newfound market volatility, active management has outpaced passive instruments.[10] As we continue through 2018, we'll pay close attention to how markets react to the amount of domestic and global debt as well as a rising interest rate environment.

Debt

The US debt problem has not been solved. Our national debt now exceeds $21 trillion[11] and continues to grow following recent tax cuts. We have identified three possible solutions:

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> **OUR NATIONAL DEBT NOW EXCEEDS $21 TRILLION AND CONTINUES TO GROW FOLLOWING RECENT TAX CUTS.**

1. GROWTH

It's been said that the US never actually repaid its debts from World War II, it just outgrew them. Back then, the economy was in full force, baby boomers were being born, and we were entering a historically peaceful era. Today, those same factors aren't in place to support 5 – 6% economic growth. For starters, we don't have the same population growth. US birthrates have declined nearly 50%[12] since then and are now nearing record lows. In addition, the method for calculating GDP has become quite antiquated and incapable of capturing true growth in today's technological environment.

2. DEFAULT

If the US government defaulted on its debt, it would be disastrous for the global economy. Because many foreign countries carry much of their reserves in US Treasuries, a default would decimate the value of those reserves. We believe the decline in equity prices would be similar to the stock market losses seen during the financial crisis in 2008, with the difference being treasury yields skyrocketing instead of contracting as they did in 2008.

[10] https://seekingalpha.com/article/4186482-2018-first-half-active-investment-wins-3x-capital-gains-passive-indexing
[11] https://fred.stlouisfed.org/series/GFDEBTN
[12] https://fred.stlouisfed.org/series/SPDYNCBRTINUSA

3. INFLATION

Of the three potential solutions to the debt problem, we believe inflation to be the most likely. By printing money and injecting it into the economy, the US can devalue its currency. Let's look at three possible scenarios:

01. GOOD

IT'S ALL UP TO THE FED!

The Federal Reserve has a dual mandate that boils down to achieving: 1) maximum employment, 2) stable prices, and 3) moderate long-term interest rates. Following zero interest rates over much of the last decade, a modest rise in inflation would allow the Fed to continue its rate hikes and get back on track toward its mandate.

02. BAD

RAPID INFLATION LEADS TO RAPIDLY RISING RATES

Historically speaking, when the Fed raises rates too quickly, stock markets tend to experience a correction. We saw this in February of this year. A slight uptick in inflation provided an early indicator that the Fed would raise rates, prompting investors to take profits and causing stocks to decline dramatically over a short period.

03. UGLY

STAGFLATION

In the 1970s, we entered into an economic era known as stagflation — an unhealthy combination of stagnant growth and rising prices. Because commodity producers tend to trend with inflation, they performed well while the rest of the economy struggled with declining demand. A similar event now could potentially trigger a recession like the one we saw in the first half of the 1970s.

Rising Interest Rates

Mutual fund manager Jeffrey Gundlach, known as the "Bond King," has stated that the 35-year bull run for bonds would end once the yield on 10-year Treasuries surpasses 3%.[13] That barrier was broken in late April.

Duration is the enemy in today's rising interest rate environment. The US Corporate Aggregate Bond Index currently has a duration of more than six years, making it highly sensitive to interest rate spikes. This index and others with high duration suffered sharp declines during rate hikes earlier in the year. With the Fed projected to continue raising rates in 2018 and beyond, it is now crucial to manage duration risk.

[13] https://www.cnbc.com/2018/03/14/gundlach-3-percent-yield-on-the-10-year-treasury-will-end-bull-stock-market.htm

Medicare and Social Security: Summary of the 2018 Trustees Annual Report

Medicare and Social Security are projected to run out of reserves by 2026 and 2034, respectively. For Medicare, this projection has been moved up from 2029 in last year's report.[14]

Treasury Secretary Steven Mnuchin noted in a statement that the programs remain secure and are on track to meet their obligations well into the next decade.[15] He also stated that there is still time to fix these problems. Short-term projections are shown as stable in the Trustees report, but long-term projections become dicey with more and more beneficiaries collecting benefits over the coming decades. According to projections, total costs begin to level off around 2040 due to a stabilizing number of beneficiaries. As part of our debt scenario, we will continue to monitor the economic longevity and sustainability of these programs.

PROGRAMS REMAIN SECURE AND ARE ON TRACK TO MEET THEIR OBLIGATIONS WELL INTO THE NEXT DECADE.

Treasury Secretary
Steven Mnuchin

Conclusion

Investing in this current market cycle remains precarious, as fundamentals do not necessarily apply. Volatility has been the prevailing market theme over these first two quarters. Historically, during times of turmoil, value investing has outperformed.[16] We remain focused on risk management, portfolio diversification, and investment strategy selection because we believe that markets trade on fundamentals over the long term.

Visit our blog at sfginc.com to read more about our review of the market, plus other relevant, timely articles or give us a call to discuss your situation at (775) 850-5620.

[14] https://www.ssa.gov/OACT/TR/2018/tr2018.pdf and https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/Downloads/TR2018.pdf
[15] http://www.chicagotribune.com/news/nationworld/ct-medicare-money-20180605-story.html
[16] https://blogs.wsj.com/moneybeat/2018/02/15/it-might-finally-be-value-stocks-time-to-shine/

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