Mid-Year Market and Economic Outlook – June 2018

Economic Momentum Continues into 2019

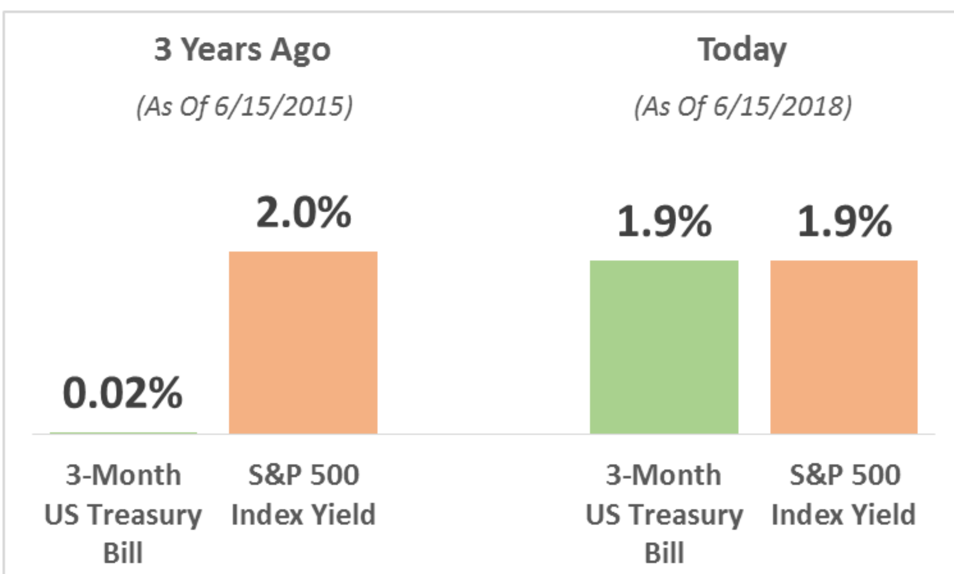
Given the tailwinds provided by solid corporate earnings and tax cuts, we expect economic momentum to continue through the start of 2019. Interest rates hold the key to how far the current economic expansion is allowed to proceed. It seems unlikely the current rate environment will cause much damage to corporate earnings. That will change when rates are 2% to 3% higher than today, however that is at least 2 years away in our estimation.

Inflation is the largest wild card in this equation. Tightness in the labor markets is leading to higher wage growth. Expect continued pressure on wages and heightened employee turnover, dampening the ability for companies to properly allocate resources to future growth plans and service existing business. This imbalance will eventually make its way to corporate earnings.

Rate Competition

Competition for investor dollars continues to heat up as rates increase as their relative yield looks less attractive. We believe the higher than average stock market valuations seen today can be tolerated in a low interest rate environment as has been the case since the 2007/2008 financial crisis. However as rates rise, the decision to buy overpriced stocks becomes harder to stomach.

As an example, last year investors had to go out 10 years on the interest rate curve for a U.S. Treasury bond with the same yield as the S&P 500 Index. Today the 3-month U.S. Treasury bill is yielding the same as the S&P 500 Index, taking away the incentive to allocate assets to stocks given the relatively low yield for bonds. The last time 3-month bills have been this attractive versus stock yields was back in 2007.



Source: Bloomberg

Focus on Growth over Value, Bond Market Risk Grows

In light of our positive economic momentum and rising rate forecast above, stock positioning for our clients will continue to favor growth stocks over value stocks through the balance of 2018. Given the grab for yield we have seen over the past 10 years some traditional value industry stocks have been pushed to unattractive levels. These higher prices have caused some stock dividend yields to look weak relative to the rising rates available from fixed income investments. We expect the selling pressure in value stocks which began early last year may continue into 2019.

On the bond side of the ledger we tend to believe the risks will only grow from here. Rising rates will result in capital losses for longer maturity bonds, leading to capital outflows. Investors must be diligent to hedge against the potential of significant risk in the bond market, employing active strategies which can take advantage of price opportunities, as well as a healthy allocation to floating rate bonds which adjust coupon payments upward as rates rise. Bond defaults are expected to stay low for the remainder of 2018, and creditworthiness does not become much of a factor until next year.

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