Economic Commentary

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"And the cracks begin to show"

- The Freestylers

As we have noted in our last two letters, there is significant historic precedent to suggest financial markets will experience a year of low but positive returns and higher volatility in 2018. The second quarter played to the script perfectly, with several sharp drops and furious rebounds, but little net change. Domestic stocks were up 3.43% during the quarter, but just 2.65% for the year. International stocks have been even weaker, falling -1.06% for the quarter and are now posting a -2.75% return on a year-to-date basis. Emerging markets were particularly weak, with countries like China and Brazil in bear market corrections. Bond prices, pressured by the normalization of monetary policy, have also been weak, although not nearly to the degree forecast by some at the end of last year. The Bloomberg/Barclay's Intermediate Aggregate Index was +.09% in the second quarter and is down -0.97% through the end of June.

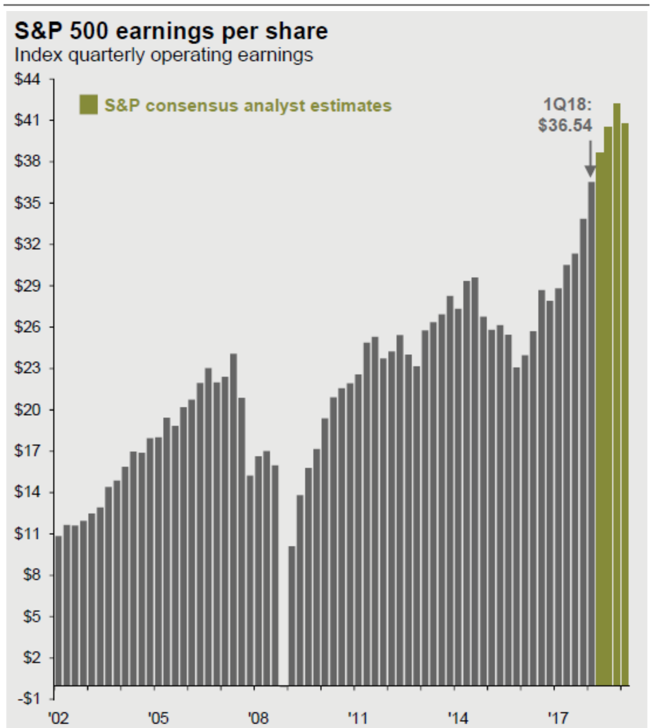
For now at least, this action reflects market valuations catching up with fundamentals and not a sign of things to come. Equity prices have assumed a low risk environment for some time. The volatility we have seen in recent months is nothing more that the recognition the world is not a perfect place. While valuation multiples may have been a bit high, the positive factors supporting the price moves of the past year remain intact. These include a vibrant domestic economy, surging corporate profits, and record high business and consumer confidence. The flat equity price moves relative to the strong increase in corporate earnings over the past six months simply reflects investors assigning lower multiples in a higher risk world.

This valuation adjustment may continue for a few more quarters, with two historically negative forces (for the stock market) likely to influence security prices in the months ahead. The first of these - trade policy changes – is well known and often discussed. The second – the upcoming mid-term elections – has received far less market attention, but has historically been a negative for valuations. Interest rate worries remain, but we believe these first two risks will allow the Fed to move slowly, despite official comments to the contrary.

The trade war risk is no longer theoretical. Risk became reality in the second quarter when talks failed to materialize and the U.S. implemented tariffs on friends and foes alike. As countries enact counter tariffs in response to U.S. actions, a slow-down in global growth, and therefore corporate profits, is becoming an increasing possibility. It is hoped cooler heads will prevail, but the Administration cannot give much ground on a key campaign promise and national pride will not allow foreign leaders to negotiate in the face of aggressive actions. Without a compromise, the situation may escalate quickly.

The focus on trade and geo-political concerns has taken some of the traditional focus off the mid-term election cycle. Historically, mid-term election years have made people nervous. Since 1980, stock indices have averaged declines of 1.6% in the months prior to elections. The lows have often set in October and post-election rebounds are often strong. We expect the polarization of the electorate to magnify these patterns.

EXHIBIT 1: S&P 500 Quarterly Earnings



Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management

We continue to believe 2018 will be a positive year, but one that should see fluctuation along the way.

Strategy and Market Outlook

Along with the aches, pains, and higher golf scores, being older does provide one the advantage of having seen things before. One of the more interesting "flashback" items is the increasing similarities between current market conditions and those of 1999. Back then, valuations were extended and market returns were highly concentrated in a handful of stocks. In 1999, for example, five stocks accounted for the bulk of S&P earnings. Currently, eight tech stocks account for virtually all of S&P returns for the year (offsetting losses in other names). We see a healthier market today, with small- and mid-cap stocks performing strongly. However, the concentration of returns in large cap indices is a red flag to watch. It also speaks to the vulnerabilities of this market. Any trade move against these large tech firms by foreign governments would shake the market. An aggressive tariff war would hurt too, as it did in the 1930's. The foundation of the recovery is still sound, but cracks are beginning to appear.

We continue to take some risk out of client portfolios, despite the positives we see for the market. We are modestly increasing our bond exposure and increasing diversification in stocks. However, we are also keeping a significant equity exposure in most accounts. We believe this late cycle phase still has room to run and stock fundamentals remain healthy. The chart provided by J.P. Morgan Asset Management found in **Exhibit 1**, shows corporate earnings are strong and should remain so for the visible future.

Most market corrections are the result of extended valuations colliding with economic reality. For now, valuations remain healthy as shown in **Exhibit 2** on the following page.

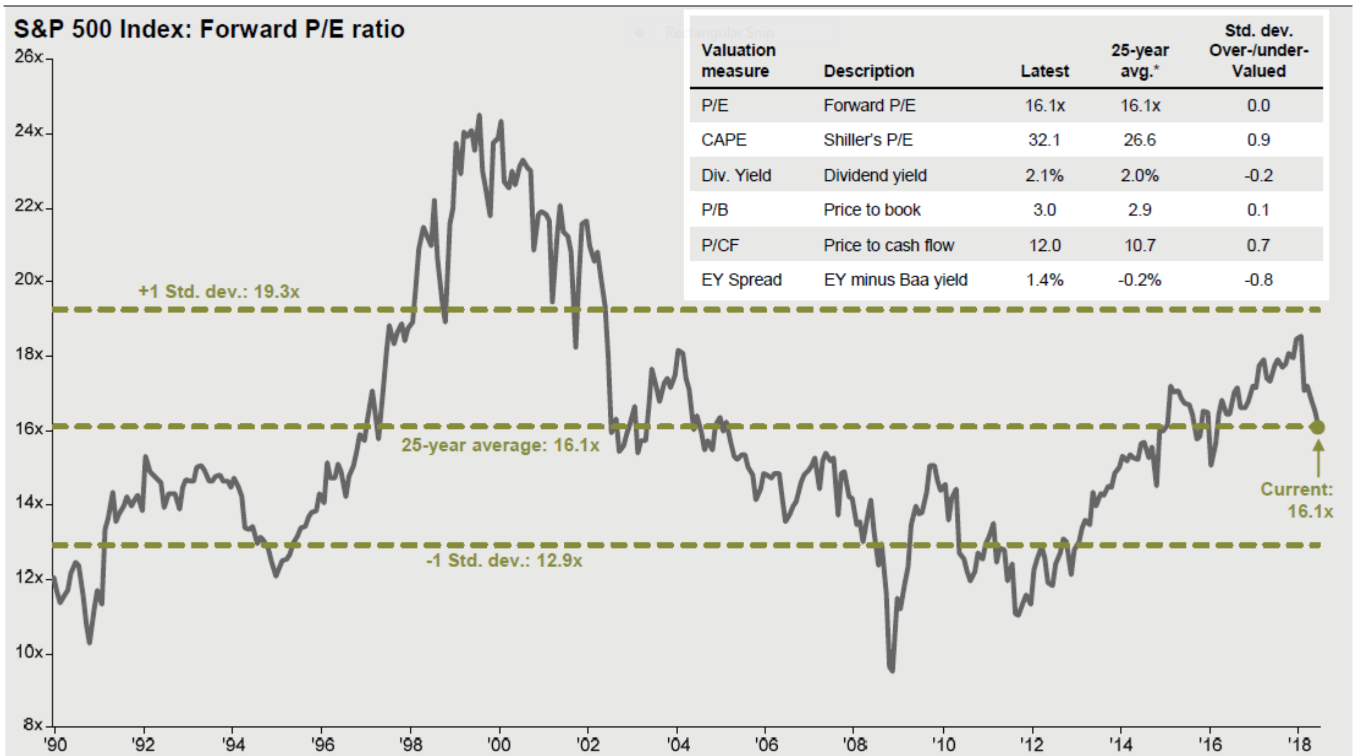
While technology stocks and small cap stocks have been driving returns this year, we see the current stage of the cycle favoring larger companies, especially if positive trade talks materialize. We will be watching how events unfold and will act on information as it develops. For now, however, we plan to view any pullback as a buying opportunity.

High-grade bonds act as an important hedge in the event of a severe stock market correction. We are growing increasingly concerned about the risks to the vibrancy of the U.S. economic expansion. Left unchanged, current U.S. trade policies will affect longer-term global growth trends. Slowing economic growth would lead the Federal Reserve to be more accommodative under normal conditions. However, higher inflation may prevent the Fed from acting. The U.S. is at or near full-employment, and wage pressures are mounting. Inhibiting low cost imports will lead to higher prices in the U.S. This potential combination of slower economic growth and higher inflation calls to mind a term not used since the 1970's: stagflation.

The interaction between stocks and bonds continues to be a dynamic to watch. For now, though, we maintain our positive outlook for the balance of the year.

As always, please contact us should you have questions.

EXHIBIT 2: S&P 500 Valuation Chart



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	16.1x	16.1x	0.0
CAPE	Shiller's P/E	32.1	26.6	0.9
Div. Yield	Dividend yield	2.1%	2.0%	-0.2
P/B	Price to book	3.0	2.9	0.1
P/CF	Price to cash flow	12.0	10.7	0.7
EY Spread	EY minus Baa yield	1.4%	-0.2%	-0.8

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management

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