Investment Update

Second Quarter 2018

The S&P 500 generally trended upwards over the last three months and is back to having a modestly positive return for the year, while returns in other equity indices for the quarter were notably divergent. In the middle of the quarter the 10-year Treasury yielded over 3% for the first time since 2014, but ultimately it ended up roughly where it started, near 2.8%.

Equity Markets (Total Returns)	2Q18	1-Year
Dow Jones Industrials	1.3%	16.3%
S&P 500	3.4%	14.4%
S&P Mid-Cap	4.3%	13.5%
S&P Small-Cap	8.8%	20.5%
MSCI All-Country World	0.7%	11.2%
MSCI Foreign Developed Markets	-0.8%	7.0%
MSCI Foreign Emerging Markets	-8.0%	8.2%
US Bond Markets	**2Q18**	**1-Year**
Barclays US Gov't/Credit Intermediate	0.0%	-0.6%
Barclays US Gov't/Credit Long	-1.4%	-0.8%
BAML Municipal Intermediate	0.8%	0.5%

Meanwhile, the yield curve continues to flatten as the spread between the 2-year Treasury yield and 10-year narrowed to only about .3%. This is being carefully watched because recessions historically have been preceded by a yield curve "inversion" scenario in which short-term yields exceed longer-term yields. Some wonder whether this time might be different and that the signals from the bond market are being muddied by factors such as the Federal Reserve's dealings in US Treasuries related to past Quantitative Easing efforts, increased issuance by the Treasury itself, and unusually low interest rates globally. On the other hand, Ed Yardeni, an economist and strategist whose work we have followed for years, makes the point that implicit in all the concern about curve flattening is that it would somehow be better if long-term yields were higher, even though that would have negative connotations for equity valuations. If there is something positive to say of the flattening dynamic, it is that at least investors are now nominally paid a reasonable amount to seek the safety of cash or very short-term fixed income investments.

Trade talk dominated the headlines throughout the quarter and often drove stock market returns from one day to the next as investors' confidence in the global economy's ability to continue to grow in the face of a potential trade war waxed and waned. As this piece goes to press, some tariffs are in place, and others are somewhere between Twitter and implementation.

It is often said that no one wins in a trade war, but it might be more accurate to say that a very narrow group or groups derives a benefit from their industries being protected while everyone else loses because prices rise. It is ironic that while the latter group is considerably larger than the former, it is not able or likely to lobby and apply political pressure in the same way as the former for lack of anything else in common. We are reminded of the 19th century French economist Claude-Frédéric Bastiat who wrote a satirical petition to the French Parliament on

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behalf of candle makers to require that the populace end their use of natural light from the sun by closing all window shades and shutters. It is also ironic that most all of this is being instigated by a President from the party that historically has championed free trade. Presumably the tit-for-tat tariffs are a means to an end and the administration is not actually seeking a trade war as an outcome, but the lack of a publicly articulated strategy, even if the norm, has unnerved investors who are otherwise scanning the horizon for catalysts that could cause an end to the current long-running economic expansion.

If trade wars are so bad, then why has the potential for one not sent the stock market down? Remember, the S&P 500 did end the quarter about 5.5% below its all-time high from January, and earnings are up significantly this year, so holding a constant valuation we could have expected the market to be commensurately higher. It appears that investors are discriminating between stocks in areas that would be expected to fare the worst in the event of a trade war – like emerging markets or the industrial sector – and rotating into areas more immune such as small companies which are less likely to export in the first place. While the total dollar amount of goods threatened to be subject to tariffs might seem like a very large number, it is less so when contextualized within a nearly $20 trillion dollar US economy, and the vast majority of tariffs have yet to be implemented. Even if and when they go into effect, it will take some time for companies to be able to start quantifying the direct and indirect effects on their earnings.

Dow versus S&P

We wanted to take a moment to review an important difference between the Dow Jones Industrial Average and the S&P 500. The Dow is a relatively narrow index made up of 30 companies subjectively selected to generally reflect the US economy. Over the time since the index was first published in 1896, fewer and fewer of the constituents are actual industrials. So far so good, but where the Dow goes astray is that it is weighted by the price of each company's shares, which is essentially a random number, and can result in, say, the 15th largest company being the largest component. There are some subjective criteria for membership in the S&P 500 as well, so it is not necessarily simply the 500 largest companies as one might think. However, it is weighted by each company's total value, so it more accurately reflects the relative weight investors are assigning to the various sectors of the economy as well as the overall stocks market. All of this said, the Dow is far more prominent in the popular press and psyche of the public, but as you might imagine, the performance of these two indices can be divergent over any time period. As professional investors, we pay far more attention to the S&P 500 as we think about what is happening in the investing world and encourage you to do the same.

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