Third Quarter 2018 Investment Outlook

Increasing Chance of Thunderstorms

"In the West you have the notion that if somebody hits you on the left cheek, you turn the other cheek. In our culture we punch back."

China President Xi Jinping

"EM-specific stories like Turkey can serve a psychological trigger for investors to reduce risk more broadly. Like birds in a tree, they fly off on any rustle."

Greg Venizelos - Senior Credit Strategist at AXA

"I don't normally speak in hyperbole, but we're entering some uncharted territory," "If there is a 10 percent increase in transportation costs, that gives you a 1 percent increase in inflation for the broader economy. That's real."

Donald Broughton – Cass Freight Index

Aaaah summer. Doesn't just about everyone look forward to it? Most vacation time gets saved up to be used during the summer. Memorial Day and Labor Day bookend the 4th of July holiday with most summer vacations falling in between. Companies institute casual Fridays in summer and sneaking out a bit early on Friday is not necessarily frowned upon since the boss is trying to do it too. Weekends carry a different level of excitement with so many options to consider. The grass isn't growing as fast so the yard work slows down and summer flowers are in full bloom. More backyard grilling, cornhole, beer, and hammock time. What's not to love about summer?

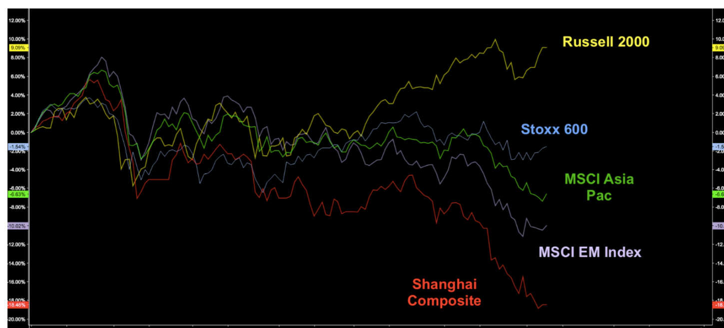
Like everything else in life, summer presents us with the yin and yang of life. Yes, we have more sun, surf, and suds but with more heat and humidity also comes increasing volatility of the weather and the chance for it to ruin the good vibrations (the Beach Boys hit that vibe spot-on) that summer offers. During summer there are tornadoes on the Plains, hurricanes out of the Caribbean, and Great White Sharks on the Cape. Bad weather during summer really gets to people more than the other three seasons. During summer, the collective mood is light, you're looking forward to the next weekend adventure and some R&R and there you see it on the 5-day forecast. Saturday and Sunday are forecast to be cloudy with a chance of thunderstorms. Your thoughts turn to hating the weatherman and killing the messenger. Dang it. Why? Why? Why? No other season elicits these thoughts. Winter-bring on the snow. I'll work from home and stoke the fireplace. Spring-the flowers and lawn need the water and I won't have to cut the grass. Fall – too bad on Saturday but Sunday is the NFL and I'll be inside in front of the HDTV anyway.

Pop-up thunderstorms in financial markets seem to hit more often during the summer too. As more investors and traders are on summer vacations, trading volumes decline. Most of Europe is on holiday during August. When an unexpected event hits, it seems to roil the markets more because volumes are lower, which leads to outsized price reactions as fewer players are on the other side of the trade.

2018 has the potential to experience more pop-up financial thunderstorms than most years. The situation on the trade front is at the center of the brewing summer storm. The fight is about trade fairness or lack thereof. Trump has strong views about how the U.S. has been used by other countries on the trade front for decades and he is determined to upend the status quo and reduce the U.S. trade deficit. The main bout now is the U.S. vs. China as tariffs went from threatened to actual tariff implementation on July 6th. The undercard is U.S. vs. Canada and the U.S. versus Europe. Most on Wall Street thought it would never get to this point but here we are.

We now determine who is winning or losing the trade wars based on financial markets outcomes. The chart below shows sizable outperformance of the U.S. small cap stocks over other regions since Trump went on the trade war offensive. China's Shanghai Composite is down 23% from its January peak, it's worst stretch in six years and is trading at a 12-year low relative to the U.S. The U.S. has a $375 billion annual trade deficit with China so any trade actions taken by the U.S. has a larger potential negative impact on China. At least in theory. However, we live in a globally interconnected world and it is naïve to think that the U.S. is somehow going to be much less affected should trade wars really become unhinged. Global economic growth will undoubtedly be negatively impacted should this war continue.

During the second quarter investors rotated massively into U.S. small cap stocks (+7.8%) as they have the least amount of foreign revenue exposure and presumably offer the most protection to U.S. investors if the trade war situation deteriorates further. This reasoning may be misguided. Wouldn't all U.S. companies be subject to higher prices on imported goods subject to U.S. tariffs? The recent outperformance of U.S. small caps doesn't mean small caps are all of a sudden attractive investments in their own right and are being bought for that reason. There are bigger geopolitical issues playing out in financial markets right now that don't have anything to do with fundamentals. For now, U.S. stocks have been the refuge from the trade war thunderstorm so far. The $64,000 question is will U.S. stock market continue to outperform? Will the U.S. be the greatest (only?) beneficiary in a global trade war?

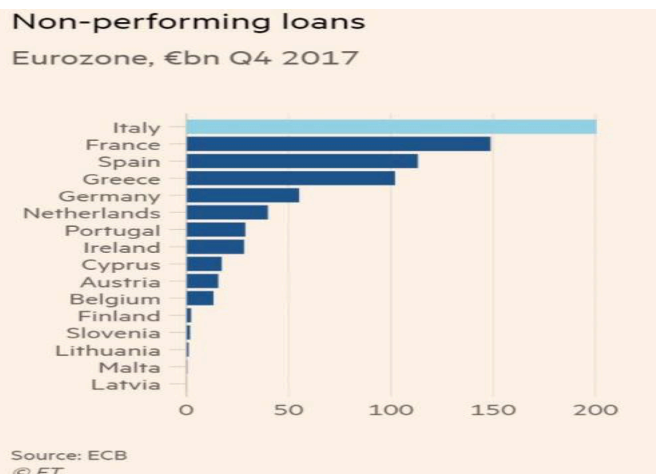


Source: Heisenberg Report

China's counter punches to date have been to go for Trump's political base as they focus their initial tariffs on pork, soybeans, steel, and autos. Europe and Canada are now joining the fray too on aluminum, steel, and other products. One can imagine that U.S. producers and manufacturers with large export revenues are increasingly nervous about taking a big hit. Unfortunately, like tornadoes, the next trade war volley (or tweet from Trump) can form rapidly and quickly unleash its fury. So far the rising trade war risk has meant U.S. financial markets are acting as the storm cellar for global investors. However, like weather forecasting during summer, the ability to pin down exactly where a thunderstorm may hit is challenging and so one needs to be prepared to quickly shelter in place as the storm fronts form.

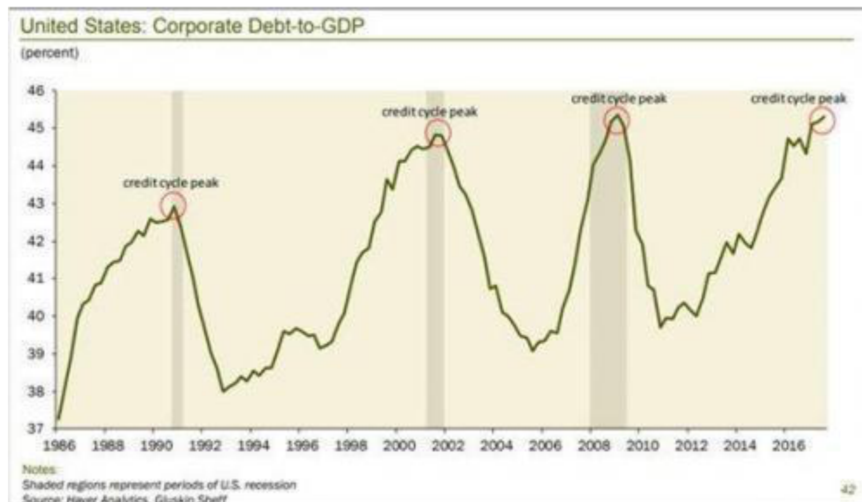
Italy Blows A Tire

Another situation during the second quarter that rattled investors with non-U.S. investment exposure involved Italy. Italy has excessive debt levels and Italy has been mired in an inept political structure for decades (65 prime ministers since 1946). More recently, nationalistic parties have gained ground and these parties are not big supporters of staying in the Euro. In May, the political situation quickly turned into a storm, which caused Italian bond yields to explode higher in rapid fashion (left hand chart below). Without the European Central Bank buying up billions of Italian sovereign debt, its bond yields would be significantly higher today instead of below comparable maturity U.S. Treasury yields. The right hand chart below shows Italy with the largest amount of non-performing loans compared to other European countries.

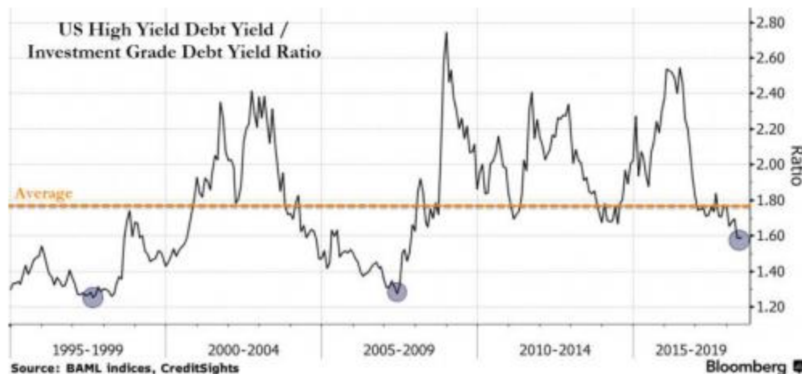


Italy is a member of the Euro currency bloc and so the knock-on effect from the unstable Italian political and debt situation caused the Euro to weaken during the second quarter along with European banks getting hit hard since they are large holders of European government debt including Italian debt. The next two charts below show how this situation played out for both the Euro and European financials in the first half of 2018. Trade war rhetoric, a weak Euro, and the Italian crisis were major factors on the weak performance of European stocks this year.

The precarious debt situation is not unique to Europe but is simply getting more attention now than our own debt problems in the U.S. The next chart below shows that U.S. corporate debt to GDP levels are once again at prior peaks. When debt to GDP hit these levels in the past, a recessionary period (red circle and grey shaded areas) eventually followed not far behind.



The chart below shows the ratio of yields of U.S. High Yield debt (aka junk bonds) compared to investment grade U.S. debt. When the line on this chart is moving up it means investors are receiving a higher yield premium for the risk of investing in lower quality high yield debt compared to higher quality investment grade debt. The chart today shows that high yield debt is offering one of the lowest yield premiums going back to the 2007 period right before the Global Financial Crisis hit. In the low yield world of the past nine years, many investors have increased risk in their portfolios to stretch for yield. Investors with high yield debt exposure should adopt a more cautious approach and consider rotating back towards higher quality investment grade debt as an economic slowdown or recession would cause the yield spread to revert higher. In other words, high yield bonds would substantially underperform.



Big U.S. Dollar Move

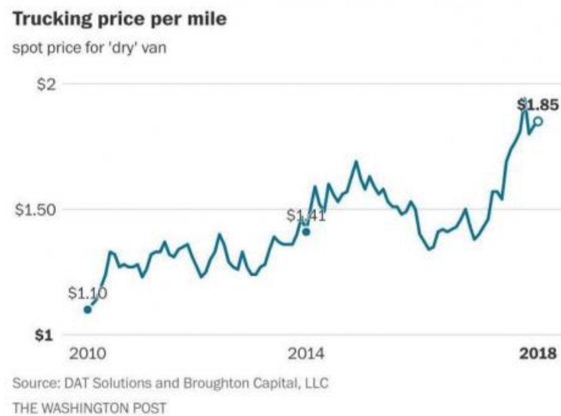
A big factor negatively impacting international stocks and bonds this year has been the rapidly rising U.S. dollar. The U.S. dollar is strengthening as the U.S. economy is currently outperforming the rest of the world. At the same time, the Fed is raising interest rates, putting additional upward pressure on the U.S. dollar. Second quarter U.S. GDP growth looks set to deliver a 3+% growth so this trend looks unlikely to change soon. Also, trade wars raise the prospects for foreign countries to experience weakening economic growth given the size of the U.S. economy and its trade position within the world. As the next chart below shows, from April through June the U.S. dollar increased 6.5% against a broad basket of foreign currencies. This size change is unusually large move for a major currency over three months. The biggest currency losers against the U.S. dollar were emerging markets such as Argentina (-30.4%), Brazil (-14.7%), Turkey (-13.7%), Mexico (-9.2%), China (-5.4%), and India (-5.3%), helping to explain why the MSCI EM Index was down nearly 8% in the second quarter.

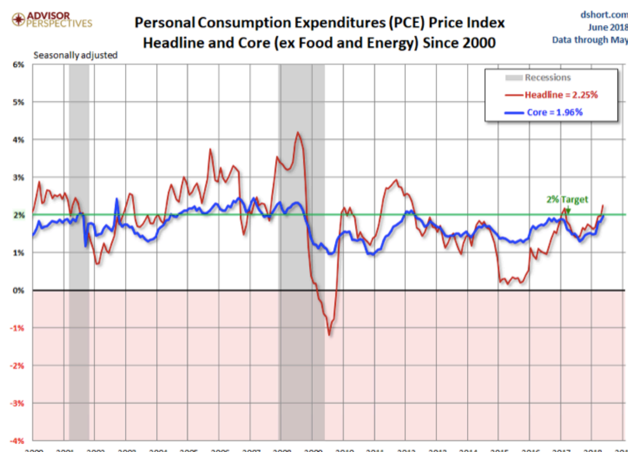
Emerging Markets Hit A Wall

Emerging markets, both stocks and bonds, suffered the worst quarterly return since the second quarter of 2015. It came on fast and accelerated to the downside quickly starting in late April when the U.S. dollar began its big rally. EM is coping with China jitters (both economic slowdown and yuan weakness), trade war concerns, and the Fed's intent to steadily raise interest rates, all of which drove the U.S. dollar higher. It is difficult enough to deal with any one of those issues at once but all three hit at the same time as the chart below shows. U.S. investors are selling EM ETFs and mutual funds at an accelerating pace. During the second quarter, the major beneficiaries of the rotation out of EM were riskier U.S. assets like high yield bonds and small cap stocks. So, it hasn't been a completely risk-off trade but more of a risk rotation trade. This does not mean that U.S. high yield bonds and U.S. small cap stocks are compelling investments in their own right.

Inflationary Pressures Coming?

One of the opening quotes on the first page was from a Cass Freight Index analyst. The Cass Freight Index captures national freight cost trends. Freight costs are driven by normal supply/demand trends but also from diesel prices and driver wage costs. Next time you drive on the highway, look at how many 18-wheelers have Drivers Wanted signs on the back of the trucks. Truck driver shortages are at all-time highs. Freight costs are often a reflection of the health of the U.S. economy and in recent months they have been accelerating upward as shown in the top chart below of the trucking per mile spot price. Freight shipping customers (retailers, etc.) will ultimately have to decide to eat all or some of the price increases or try to pass them on to consumers in the form of higher prices. The prices paid component of the ISM is near all-time highs as well. An already tight labor market as reflected in the unemployment rate at 4% combined with rising input costs puts inflationary pressures on an upward path. The monthly Personal Consumption Expenditures Index will be a closely watched inflationary gauge in the months ahead. As noted in the second chart below, the PCE has been creeping higher throughout 2018 and the Core PCE, an important variable monitored closely by the Fed, is now reaching the Fed's 2% inflationary target level. More inflationary pressure in the months ahead means more certainty of rate hikes by the Fed. Higher inflation will lead to higher bond yields and rising input costs could ultimately start to negatively impact corporate profit margins and earnings. Both of these outcomes would be bad for U.S. stock and bond returns.





The Impact of Rising Bond Yields

Related to potential inflationary pressures is the rising bond yield environment. During the first half of 2018 bond yields rose by a meaningful amount. On the short end, the Fed has raised the Fed Funds rate 0.50% already with two more 0.25% rate hikes expected in the back half of the year. The long end of the yield curve has also risen, although not by as much as the short end. Keep in mind that longer maturity bond yields are set by the marketplace and not the Fed.

The first six months of 2018 represents a great window to see how various types of bond funds and maturities have performed during a rising yield environment. The following table at the top shows the changes to the U.S. Treasury yield curve so far this year followed by current yields and year to date returns for various Vanguard bond funds from shortest to longest maturity.

Fund Name	7/5/18 Yield	YTD Yield Change or Total Return
2-Year Treasury Yield	2.53%	+0.60%
10-Year Treasury Yield	2.85%	+0.44%
30-Year Treasury Yield	2.98%	+0.24%
Vanguard Federal Money Market	1.84%	+0.77%
Vanguard Short Treasury	2.14%	-0.14%
Vanguard Short Investment Grade	3.06%	-0.33%
Vanguard Intermediate Treasury	2.63%	-1.33%
Vanguard Intermediate Invt. Grade	3.48%	-2.08%
Vanguard Long Term Treasury	2.94%	-2.40%
Vanguard Long Term Invt. Grade	4.07%	-5.79%
Vanguard Corporate High Yield	5.71%	-1.23%

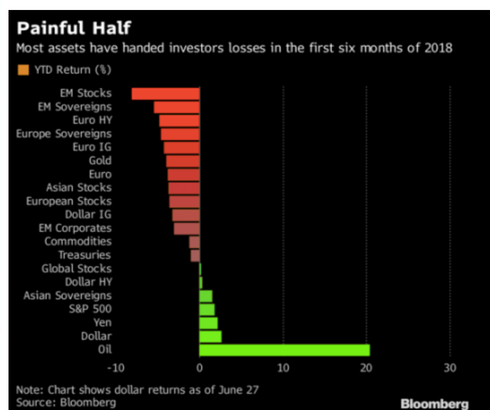
A rising bond yield environment is caused by falling bond prices, which negatively impacts total returns. The longer a bond's maturity, the more sensitive it is to changes in interest rates. This dynamic is in full display so far this year. The Federal Money Market fund has the shortest maturity and is most directly impacted by changes to short-term interest rate implemented by the Fed. The yield on the Federal Money Market fund has increased to 1.84% year to date while the fund itself has generated a +0.77% return. Conversely, while longer maturity bond yields have not risen as much as shorter maturity bond yields, the negative price impact of the rising bond yield environment is more evident in the Vanguard Long Term Treasury and Investment Grade bond funds which have total returns of -2.40% and -5.79%, respectively. If inflationary pressures rise, and the Fed maintains its path of increasing interest rates, the headwinds to bond fund returns will continue with negative returns for the year the most likely outcome. Should this occur, and the Fed continues to increase short-term interest rates as expected, money market funds are going to be a good place to hide for bond investors.

Slim Pickings for Returns

Broad market index returns are used to represent how a group of stocks have performed. The S&P 500 Index is the most popular stock benchmark in the U.S. However, index returns can be deceiving at times and this year is one of those times. The left side table below shows the Top 10 contributors to the S&P 500 Index return in the first half of this year, which returned +3.4%. Just these 10 stocks represented 122% of the S&P 500 Index year to date return and just four stocks (Amazon, Microsoft, Apple, Netflix) represented 84% of the S&P 500 Index return year to date. The chart on the right side shows a broad array of global indices and their performance during the first half of 2018. The positive performance of U.S. stocks was a clear outlier in a global context. The overriding message here is that it has been very slim pickings for investment returns and while U.S. stocks have positive returns, the underlying dynamic for U.S. stocks is much less positive than the index return would indicate.

Ticker	Company	Cons. 2019E sales growth	Total return	Mkt cap weight	% of SPX Return
AMZN	Amazon.com Inc.	23 %	45 %	2.1 %	36 %
MSFT	Microsoft Corp.	10	16	2.9	18
AAPL	Apple Inc.	4	10	3.8	15
NFLX	Netflix Inc.	24	106	0.4	15
FB	Facebook Inc.	27	11	1.9	8
GOOGL	Alphabet Inc.	18	7	2.8	7
MA	Mastercard Inc.	12	31	0.6	7
V	Visa Inc.	11	17	0.9	6
ADBE	Adobe Systems Inc.	19	37	0.4	5
NVDA	NVIDIA Corp.	14	25	0.5	5
Top 10 contributors		**16 %**	**20 %**	**16 %**	**122 %**
S&P 500		**5**	**3**	**100**	**100**

Source: FactSet, Goldman Sachs Global Investment Research

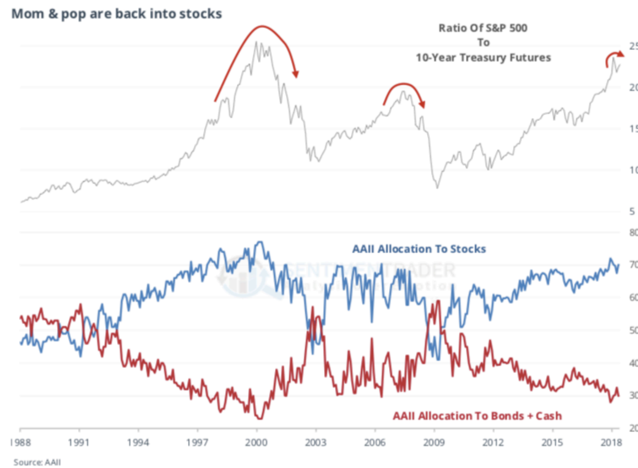


Mom & Pop Pick the Top

It is helpful to monitor the moves of retail investors and consider doing the opposite to increase your odds for investment success. It's the George Costanza investment strategy. Collectively, the average investor is nothing more than a performance chaser. They observe what had the best returns in the most recent past and then put their money into that option, often near the peak of the recent trend. It's a buy high, sell low setup. It probably wouldn't surprise you that retail flows today are overwhelmingly into tech funds. The left table above pretty much explains why.

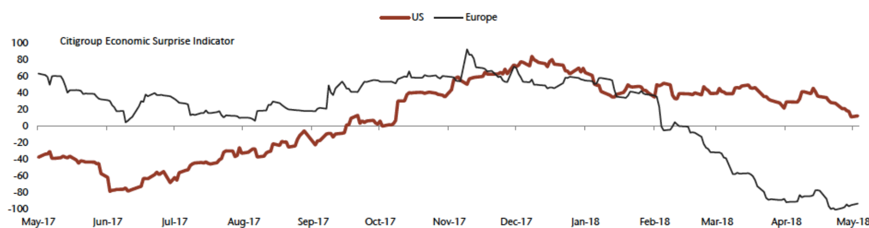
The chart on the next page highlights this phenomena going back in time. The top line in grey plots the ratio of the S&P 500 Index returns to the 10-Year U.S. Treasury returns. The line moving higher means stocks are outperforming bonds. Below it shows the asset allocation of the average investor as captured in the American Association of Individual Investors data. Note that when the stock market fell apart during the Great Financial Crisis of 2008/2009, retail investors bailed big time from stocks and moved heavily into bonds. Today, the allocation to stocks (70%) for the average investor is now back near all-time highs, exceeded only by the Tech Bubble of 1998-2000 when the allocation to stocks hit 75%.

While this data does not necessarily mean the end of the last 9+ year bull market rally is imminent, the retail investor data suggests that chasing risk at this stage of the game is a sure fire way to lower your net worth. Most investors chasing tech stocks returns today will learn a hard lesson.



Economic Surprise Indicators

During the second quarter international stock markets underperformed the U.S. by a nearly 5% return margin. The prior sections covered trade wars, rising U.S. dollar, and the Italian situation, all of which were important favors negatively impacting foreign markets. Another factor was the deceleration of economic surprises in Europe vs. the U.S. as captured in the following chart by the Citigroup Economic Surprise Index for both regions. From February into May the Europe ESI decelerated more quickly than the U.S., which also saw some deceleration as well. It is important to note that the U.S. does not live in a vacuum and trade wars are not going to be a one-way benefit to the U.S. It's highly unlikely that the U.S. will sustain positive economic surprises while regions like Europe are decelerating. As they say, it takes two to tango.



Source: FactSet; FTSE Russell; Jefferies

Summary

Summer always presents a challenging time for financial markets. Trading volumes are lower because more market players are on vacation and not as actively involved in trading/investing. Lower trading volumes and liquidity make financial markets more susceptible to unexpected events. This summer has a greater risk of pop-up financial thunderstorms given the elevated trade war friction and the knock-on effects related to them. More recently, global investors have hunkered down in U.S. stocks, which outperformed the rest of the world by a wide margin during the second quarter. But, it is questionable that this trend will continue and the U.S. will act as a port of refuge in the Sea of Uncertainty. U.S. stock valuations are significantly higher than the rest of the world and trading near all-time record valuations. The outperformance of U.S. stocks and significant decline in Chinese stocks has likely emboldened Trump to push the trade envelope. He may continue right into the mid-term election, as he knows it is critical for Republicans to retain the majority in order to push forward his MAGA agenda in the last two years of his term. The mid-term election itself is likely to cause increased volatility into September and October as well. The next four months could be a real doozy. Most major asset classes have had difficulty achieving positive returns so far this year and there is a high probability for this type of environment to continue in the months ahead.

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July 10, 2018

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