Insights: June 2018

Market Overview and Performance

The month of May brought us an upward turn to the sideways churn we have witnessed since the beginning of 2018. The S&P 500 for example, rose 2.4 percent which pulled the year to date return from negative to positive. However, little has changed on the macro front. In fact, matters have deteriorated. Trade tariffs are due to be imposed on the US's closest allies – Canada, Mexico and the European Union- later this month and previously announced measures against China are scheduled to go into effect on June 15th. As we have stated in the past, tariffs (taxes) will unequivocally hurt global trade. No one wins. As all sides involved move closer to the precipice of the June deadlines without any indication of reconciliation, the momentum in global economy built up over the past 18 months looks to perhaps be in serious jeopardy. No one wants this course of action. Not law makers, not our "friends" or our "enemies (China)", and certainly not US companies or everyday consumers who will be hurt the worst. This is not a "national security" issue, it is simply a return to polices that have failed in the past. As Ronald Reagan stated in his address on November 26, 1988, "*Our peaceful trading partners are not our enemies; they are our allies. We should beware of the demagogues who are ready to declare a trade war against our friends—weakening our economy, our national security, and the entire free world—all while cynically waving the American flag. The expansion of the international economy is not a foreign invasion; it is an American triumph, one we worked hard to achieve, and something central to our vision of a peaceful and prosperous world of freedom.*"

As always, thank you for reading our latest Insights.

	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	2.41	2.02
Russell 2000 Index	**6.07**	**6.90**
MSCI EAFE Index	-2.25	-1.55
MSCI Emerging Markets Index	**-3.54**	**-2.61**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.71	-1.50
Barclay's U.S. Aggregate Credit Index	0.46	**-5.26**
Barclay's U.S. Aggregate Corporate High Yield Index	-0.03	-0.24
Barclay's Municipal Bond Index	**1.15**	-0.33
Macro Measures		
Gold	-1.11	-0.35
Crude Oil	-2.28	**9.87**
CBOE Volatility Index	-3.24	**28.45**
USD Dollar Index	2.29	1.99

Current Theme – Markets Continue to Search for Direction Amid the Escalation of Trade Wars

Global Growth May Have Already Peaked and Now Appears Particularly Vulnerable with Tariffs from Various Sides Due to Go Into Effect Shortly

After a decidedly negative period for stock returns in February and March followed by a flat month in April, May provided somewhat of a respite as US stocks turned positive for the month. With a gain of 2.4 percent for the S&P 500, May also dragged the index back into positive territory for 2018, although just barely. In fact, as one can see below, not much progress has been made over a very choppy first five months of 2018. With a positive start to June, there is also some optimism that stocks will be able to break out of the downward trend represented in blue below.

S&P Range Bound Since the Jan Peak and Feb Decline

Source: Thomson One

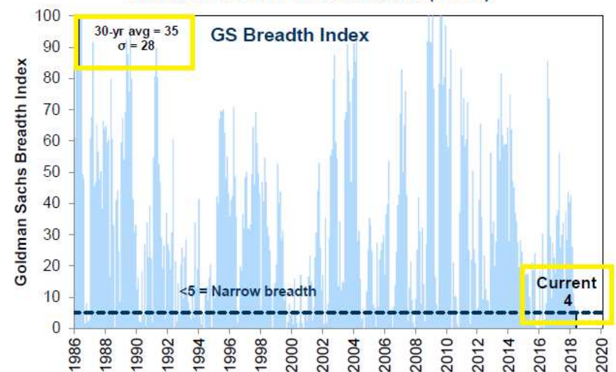
However, the small gains achieved have come amidst the most volatile period in quite some time with 34 one percent (or more) daily moves so far this year, the most since 2010. Further, we are starting to see some notable divergence in trading patterns.

Trade Wars Boost Small Caps While Average Stock Falls

Source: Leuthold Group

The previous chart highlights two themes that we are currently witnessing. First, as trade tariff look to become more of a reality than a threat, small cap US stocks, viewed as largely insulated from international tariffs, have outperformed. Second, despite what the headline indexes are doing, the "average" stock has not been faring nearly as well. An equally weighted measure (rather than the market cap weighted) shows a good deal of weakness. The interpretation of this factor would be that the market is very narrow with just a few stocks leading the way higher.

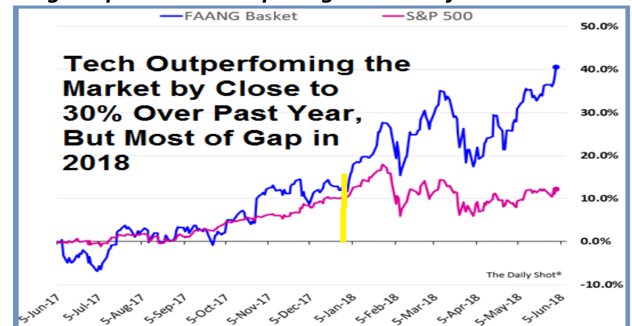
Market Breadth Very Poor - Only a Few Stocks Leading



Source: Goldman Sachs Investment Research

Goldman Sachs confirms this with their Breadth Index. They are seeing a reading of just 4 at the moment, well below the 30 year average of 35. And it is not hard to find who those leaders are because they have overwhelmingly come from the large cap technology sector. As the chart below illustrates, FAANG stocks have outpaced the S&P 500 by close to 30 percent over the past twelve months, with the large majority of the gains coming in just the 5 months of 2018 alone.

Large Cap Tech Far Outpacing the Rest of the Market



Source: The Daily Shot

To put a more emphatic point on the influence of tech this year, consider the table below from Larry McDonald, Head of Macro Strategy at Societe Generale. As of June 6th, the S&P was up 78 points for the year, but just eight stocks have provided more than the full amount of that gain. In fact, just two stocks alone, Amazon and Microsoft, have contributed 50 percent of the Index year to date gain.

Just 8 Stocks Account for 105% of S&P Year to Date Gain

S&P 500 is up 3% YTD or 78 points

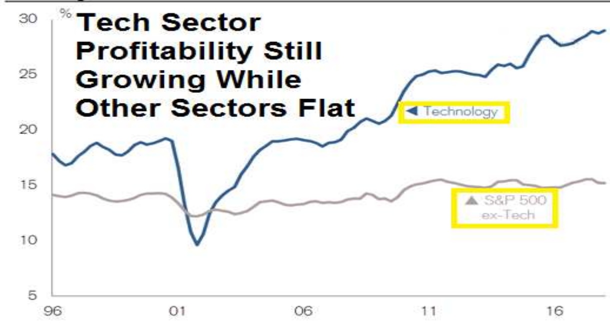
AMZN is contributing 24 points (+31%)
MSFT 15 pts (+20%)
AAPL 15 pts (+20%)
NFLX 9 pts (+11%)
INTC 6 pts (+8%)
MA 5 pts (+6.6%)
NVDA 5 pts (+6.5%)
FB 5 pts (+6.5%).

8 stocks are ~105% of the YTD SPX move (and AMZN and MSFT are 50% alone.

Source: Lawrence McDonald; Societe Generale

And there is good reason for those select names attracting capital – they are simply more profitable. As the chart below from Credit Suisse shows, the tech sector as a whole has been able to consistently increase profitability while the remainder of the market has largely been stuck at the same level for 20 years.

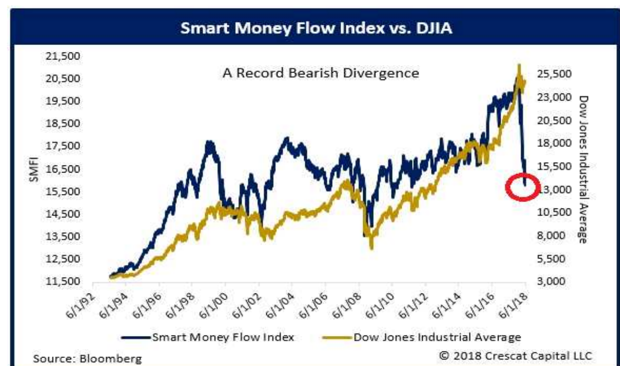
Tech Leading for a Reason- Profits Keep Growing



Source: Credit Suisse; Standard and Poor's; Thomson

While it might be tempting to look at these data points and ask, "Why don't I just buy passive exposure to tech?", remember the following: while Amazon is up an impressive 67 percent over the past twelve months, so-called "dead" retailers such as Kohl's, Dillard's and Macy's are up 120, 86 and 84 percent respectively over the same time period. So a blind following of momentum in the market can lead to missed opportunities. We have mentioned the Smart Money Index before. It measures the difference between trade flows early in the day (retail buying) with those at the end of the day (institutional investor activity). The Index continues to show a worrying divergence that suggests institutions are selling heavily at the end of the trading day, including those large, liquid tech names which have helped performance.

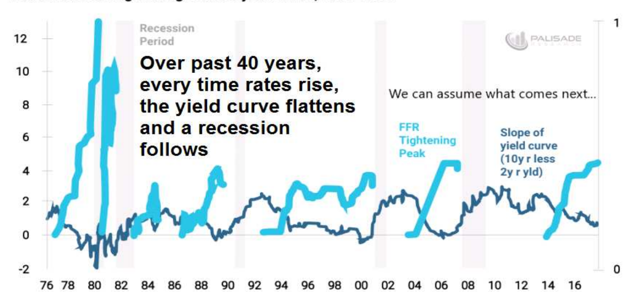
Smart Money Index Still Falling = Institutions Selling



Source: Bloomberg; Crescat Capital

Perhaps institutions realize that they cannot run away from history. We are unquestionably in a rising rate environment now, and the yield curve continues to flatten. The difference between the 2 year treasury and the 10 year treasury fell to just 41 basis points in early June. Every time this pattern has developed over the past 40 years, the US economy fell into recession. Whether justified or not, the Fed's rising rate agenda is coming at a very difficult time for the rest of the world.

40 Yrs of Rising Rate History Shows Reason for Concern



Source: Zero Hedge; Palisade Capital

Essentially, higher interest rates increase the costs of borrowing for many participants while a wind down of the Fed balance sheet removes liquidity from the system – the opposite of QE. This makes financial conditions more difficult for the system as a whole and of course, we are now on the precipice of an all out trade war, which would drastically slow global commerce.

Has Global Trade Peaked Before Tariffs Even Start?

Global trade

Export of goods, volumes

Import of goods, volumes

Note: Shaded areas mark US recessions

Source: Nordea Markets; CPB; Macrobond

As the chart above from Nordea shows, we have already witnessed a sharp decline in overall global trade from just the dialogue of tariffs and retaliatory measures among various regions. Punctuated by the negative tone of the recent G7 summit in Quebec, announced tariffs are set to begin at the end of June with the logical conclusion being that the chart above will rapidly dip into a contraction of trade. As we have stated previously in no uncertain terms, this course of action will benefit no one. And with Trump perplexingly confronting the US's closest trade allies, Americans themselves will suffer. Just look at how many states depend on Canada and Mexico as their main export market.

Canada and Mexico Are Integral for US Export Market

Top export partner by state

Source: US Census Bureau

And even China, which many would argue does actually take advantage of global trade practices and norms, would not be effectively hampered by US announced policies. Beyond the 1300 list of goods proposed by the US, the attempts to target the specific issues surrounding intellectual property violations by the Chinese are misguided. As the chart below from the Peterson Institute shows, the US tariffs would in fact harm the non-Chinese portion of the global supply chain rather than China itself. Clearly, this would be a tremendous negative impact on global trade as a whole.

Announced US Tariffs Against China Are Misdirected

Tariffs Against Chinese Imports to Protect US Intellectual Property Would Mostly Hit Non-Chinese Supply Chains

Share of targeted US imports from China from Chinese vs. non-Chinese firms, 2017

	Non-Chinese Multinational Corporations	Domestic Chinese firms
Computer and electronic products	86%	14%
Other manufacturing	68%	32%
Electrical equipment, appliances, and components	63%	37%
Machinery, except electrical	59%	41%
Chemicals	15%	85%

Source: Peterson Institute; Mary Lovely

Additionally, while Trump continues to agitate, the US desperately needs foreign partners to buy US treasuries in order to fund the huge amount of debt the US has brought upon itself with recently enacted tax cuts and spending initiatives. For example, the US treasury will issue $193 billion in treasuries this week alone! China and Japan have traditionally led the way in this regard, owning as much as 50 percent of the total US treasuries. However, the two counties have displayed a reduced appetite and now hold their lowest exposure (35.5%) since 2000.

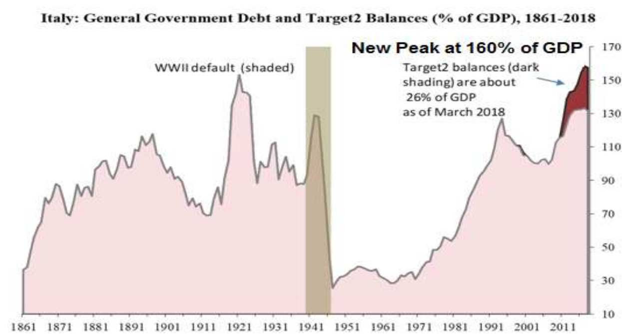
China and Japan: Lowest US Treasuries Exposure in 20 Yrs

China and Japan's Holdings of US Treasuries

Source: TIC Data; Nicholas Glinsman

The US is certainly not alone is having to deal with fiscal issues. As we are sure you are aware, Italy has been front and center of the news flow in May due to its tumultuous election process that resulted in members of the populist parties coming into power. Italy has had financial issues for quite some time, but this shift in regime is significant.

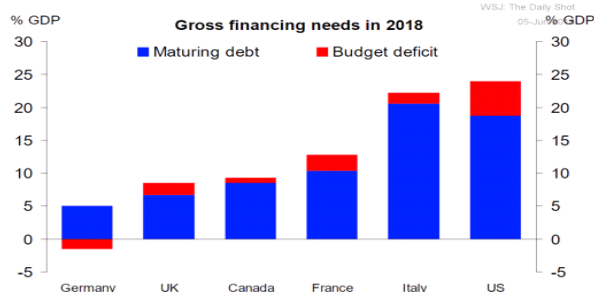
Italian Debt to GDP Now Past Previous Default Levels



Source: Bank of Italy; ECB; IMF; Reinhart and Rogoff

As the chart above highlights, Italy's liabilities when including those owed to the Eurosystem (Target 2) have now reached 160 percent of GDP. That is a big number and well beyond the level seen in WWI or WWII when they defaulted on their debt. To a certain extend however, the market was generally willing to put up with these debt levels due to the perceived "backstop" assurance of the ECB. The new populist regime on the other hand, represents a threat to push these debt levels significantly higher. The market took notice and pushed Italian bond yields from 0.3 percent to 2.73 percent in two days. That is a clear sign of distress. And before you place judgement, consider that the US has a more acute need for financing itself this year than Italy does – almost 25 percent of GDP.

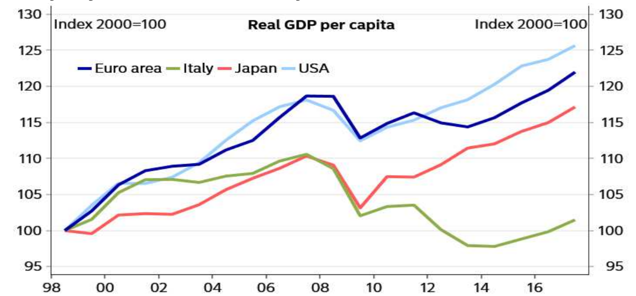
US Has More Pressing Financing Needs Than Italy



Source: Deutsche Bank

Now to be clear, we see very little chance that Italy would try to leave the EU – the costs would simply be too high – but the change in government is clearly the result of voter frustration with the trend below. Since the beginning of this century, most developed economies, and even Italy's neighbors, have grown their economies on a real per capital basis, but the Italian economy has remained stagnant.

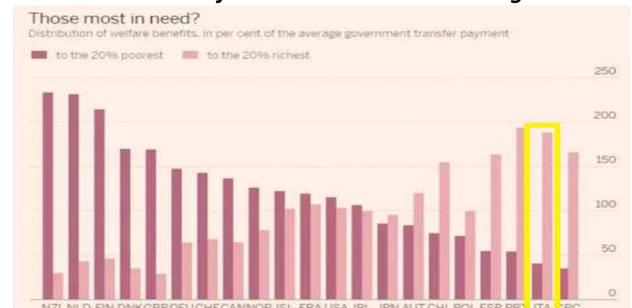
Italy Left Behind – Basically No Growth Over Last 20 Years



Source: Nordea Markets

As a result, Italy's new Prime Minister Giuseppe Conte has vowed "revolutionary measures" that would likely breach the European Union budget rules including a citizen's income, a flat tax, a boost in health spending and a reduction in austerity measures. Time will tell, but the larger worry for the market is that others will follow. Again, we see little to no chance of any further EU exits, but consider the chart below when you think about a voting populace. Most of welfare benefits in Italy go to the 20 percent richest at the cost of the bottom 20 percent. Greece, Portugal and Spain have similar anti-egalitarian dynamics. There is a clear need for change, and unfortunately, with change comes uncertainty. It's not really the change that the market fears, it's the uncertainty, and with the EU economy general in good shape, that will pass.

Italian Allocation of Resources Not Well Managed



Source: The Financial Time; OECD

Going Forward

The market continues to look for direction as the US stance on trade goals and policies seems to shift on an almost weekly basis. The resilience of a sideways equity market with a slight positive tilt is therefore encouraging in our view. However, it is difficult to not be concerned about the continuing evidence of slowing global growth, a relentlessly flattening yield curve and the very real impact that just the threat of trade tariffs is already having on global trade. And as we discussed, the Italian political situation adds to the overall level of instability. So this month will be important. Barring any "kick the can down the road" type delay tactics, we should get some clarity on what the nature and scope of the tariffs will be on all sides by the end of June. For the time being, the market seems to be suggesting that announced actions and retaliations are merely bluster, however we are not so sure and believe downside risk is being under estimated by most investors.

Assuming a benign environment for the time being, within US equities, we favor the information technology, financial and energy sectors in particular and added to these areas on a selective basis during the correction in February and March. The technology sector continues to display very strong sales growth and profitability. Financial names are still reasonably priced and will benefit from a raising rate environment and a reduction in their tax rates and regulations. The energy sector is riding a wave of strong momentum from its price bottom in 2016 which should help the bottom line of energy companies for the remainder of the year. We also prefer exposure to selected consumer discretionary names that have outperformed thus far in 2018 and look to continue their growth and profitability in the near term.

With the potential damage to global trade that tariffs represent, domestically focused small and mid-cap stocks have become more attractive in our view. Small cap stocks in the Russell 2000 Index experienced considerable multiple compression during the February sell-off making their valuation levels compelling versus their large-cap counterparts. Importantly, smaller non-global companies are generally less impacted by trade tariffs, making them a good counterbalance to internationally exposed companies. The Russell 2000 has outperformed the S&P 500 by 8.5 percent over the past three months.

As the protectionist stance of the U.S. becomes more entrenched, equity markets outside of the US are compelling in our view. Even with the political issues, Europe and Japan are seeing their past simulative policies now bearing fruit in terms of economic growth and inflation. This has directly translated into better earnings for companies located in these regions. This is particularly attractive since valuations are lower than the US and expectations are much more reasonable than the "priced for perfection" tone within the US market. Even in the face of recent US dollar strength, we also see long-term opportunity in emerging markets. As a group they are demonstrating strong profit growth, improved balance sheet stability, and very attractive valuation levels. Significantly however, emerging markets are perhaps most susceptible to interruptions in global trade so we remain vigilant.

Our biggest concern in the fixed income market is the flattening yield curve. With the yield curve at its flattest level since 2007, the bond market is suggesting that apprehensions about future growth are justified and that the Fed will continue to push short term rates higher. Additionally, the new supply of treasury bonds this year will be substantial, pushing yields even higher with an increasing dependence on foreign buyers. As a result, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We continue to focus our exposure on municipal bonds and short-term corporate bonds and believe that the opportunity in these segments provides a better relative value.

Given the continued unsettled environment thus far in 2018, we have maintained a position in gold in many of our portfolios as a non-correlated asset and continue to do so, adding when appropriate. Until there is more clarity on the global macro trajectory, we are likely to add opportunistically.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.

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