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Market Overview | July6, 2018

Important work has been accomplished in the markets this year, even though it does not feel like it when you review your statements. The economy is doing well and earnings have been quite strong. Markets, on the other hand, have not done much. As I stated in the last letter, though, strong earnings and a flat market result in lower valuations (in place now). So here we stand with historically average valuations while earnings are expected to remain strong. Not a bad place to be.

Year to date, the S&P500 is up about 2.6%. International markets are down about 2.8%, and the bond market is down about 1.6%. For most diversified portfolios then, investments from two of the three main components were likely negative so far this year.

Earnings, on the other hand, tell quite a different story. First, a caveat on earnings estimates. There is always some level of uncertainty about estimates for earnings. The farther away the period of time being examined, the more uncertainty there is. For the period January '18 through June of this year, the current estimates should be fairly accurate (companies will announce earnings over the next month or so to confirm this). It is expected that the operating earnings for the S&P500 during the first half of this year will increase 20% from the same period last year. From December 31 to June 30, it is also expected that 12 month operating earnings will rise about 13%. To rephrase that a different way, even though the market did not appreciate much so far this year, earnings likely rose about 13%. This has resulted in a much lower valuation. Over the next 6 months, 12 month earnings are expected to rise another 12%.

At the beginning of the year, I stated that we thought the market valuation was a bit too high. During the first quarter, earnings grew and the market fell, largely correcting this problem. One could make the argument that after the market valuation returnedto a historically average level, perhaps it would then begin to grow or appreciate along with earnings. Makes sense to me. And that is what started to happen in May of this year. As earnings continued to rise, the market followed. So what happened in June? Concerns over trade and tariffs.

The market worry about trade disputes and trade wars has put the brakes on market appreciation while things get worked out. The tariffs put into place are still a small portion of what has been discussed as possible. And there are imbalances that need to be addressed. It's hard to discern what will actually happen, and what might be a negotiating position. The market has responded to the uncertainty by calling a 'time out' from continued appreciation. For now.

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The Federal Reserve is also removing fiscal stimulus from the system. This action tends to allow interest rates to rise, and can over time work against economic growth. For the rest of this year and into next year, however, the forces working against growth (contractionary stimulus, trade uncertainly, higher interest rates) are competing against pro-growth forces (higher earnings from a stronger economy buoyed by the various elements of tax reform and a more pro-growth regulatory environment).

To repeat some commentary from last quarter, if you look at the 10 bear markets from 1929 to the present, at least one of four elements are present during those times. None of those four elements are currently present. They are: recession, commodity spike, extreme valuations and an aggressive Fed. Sometimes recessions and commodity spikes can be caused by significant, devastating events that cannot be predicted. Outside of that, the tea leaves suggest that it will be quite unlikely to experience a recession this year. This could provide room for the markets to respond positively to growing earnings for the rest of the year.

Please call with any questions or concerns.

Regards,

Peter B. Harre, CFA