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2018 Second Quarter Review
"From Sugar High to High Tariffs"

I have stolen this letter's title from Jeffrey Kleintop, market strategist at Charles Schwab& Co., because it aptly frames two major influences on stock prices so far this year: the corporate tax cuts and the rising risk of trade wars. It may be that the market's "sugar high" was reached in late January when investors felt more exuberant about increased corporate earnings due to the tax cuts. Soon after, however, the stock market indices fell 10% in short order and have been recovering ever since. Recent economic data have shown continued strength in the economy that has buoyed investor enthusiasm for stocks. The threat of trade wars, combined with rising interest rates and a still-expensive market, provide the main reasons for caution. As usual, it is a tug of war between the forces of greed and fear.

The Dow Jones Industrial Average was down almost 2% for the first six months of this year. The broader S&P 500 gained 1.7% while long term treasury bonds (as represented by the Barclay's 20 year Treasury Bond ETF) lost over 4% in value as long term rates have risen.

The important story may turn out to be the rapid and dramatic rise in short term rates from almost zero just a short while ago. The interest rate on 6 month treasury bills has risen from 0.08% (almost zero) in late 2015 to 2.1% today. To put that in perspective with stocks, the "dividend yield" of the S&P 500 is now 1.84%. Practically speaking, if stock prices stayed the same or went down from here, investors would make more money in 6 months by simply investing in treasury bills. Of course, stocks have a bias for growth and that's why we hold them long term. But attractive short-term interest rates can create headwind for stocks as they provide competition for investor dollars. At this point, stocks HAVE to go up at least some over the next year or so to net investors as much as they could get without risk by buying treasury bills and notes. As volatility increases, that alternative may look better to more and more investors.

The "yield curve," the graph of interest rates from short term to long term, usually has a rising slope as short term rates are lower than long term rates, sometimes dramatically so. The recent rapid rise in short term rates has not been matched by the rise in long term rates. Currently, the 2 year treasury note yields 2.57% while the 30 Year treasury bond yields 2.97%. Tying up your money for an additional 28 years will net you less than ½ a percent per year in increased income. This flattening of the yield curve, with short and long term rates not very different, is causing some concern. An inverted yield curve, with short term rates higher than long term rates, is often a forerunner of recession. Since the Federal Reserve Board still plans to raise short term rates a few more times this year, some investors are beginning to worry that an inverted yield curve is coming. It used to be said on Wall Street that the Federal Reserve tightens credit until something breaks. With the huge increase is debt levels since the recession, the burden of higher interest rates will likely place an added stress on the economy, particularly if rates continue to rise.

With the indices flat to only down slightly, it is surprising to note the number of stalwart major U.S. companies' stocks that have fallen significantly this year. For the first time in 110 years, the Dow Jones Industrial Average referred to above no longer counts General Electric as one of its stocks. Not that long ago, GE was considered the paragon of a well-managed American company. Now it is not only out of the Dow Jones Average but also down 22% for the year. AT&T stock has fallen 17%, Proctor and Gamble down 15%, Johnson & Johnson 13% and Corning 14%, to name a few. There are good reasons for these declines with the changes in retail, technology, and interest rates, but the weakness may portend more about the health of the stock market in general. The end of long advances in stocks often ends with a narrowing number of stocks that are "working." The short list of "FAANG" stocks (Facebook, Apple, Amazon, Netflix, and Google - aka Alphabet) seems to be representative of the soldiers holding the fort now while many of the other stocks retreat.

Although current economic data is strong, housing and other economically sensitive stocks have acted as though that strength may not last. Add to that the specter of trade wars set off by increasing tariffs among trading partners and the risks appear to be rising. It would be difficult to escape the extensive news coverage given this issue, so I won't bore you with any further explication. Suffice it to say that the range of possible outcomes has put investors on edge. It didn't go well with the Smoot-Hawley Act of 1930 and many fear a repeat of that scenario. Chinese stocks have already fallen 20% from their January highs, and further international weakness could have an impact on our own market.

Precious metals would appear to offer some value as disaster insurance, and that is the reason we have kept a small exposure to that market as volatility has increased. To that end we hold some shares in ETFs (exchange traded funds) and a smattering of individual precious metals mining companies. Recently, we threw in the towel on New Gold as they hired a new CEO who will possibly want to have a "kitchen sink" quarter where they write off everything in sight in order to give the new guy a fresh start. We may return to it later, but we felt it was best to avoid any further pain there.

Otherwise, we are looking for value in an expensive market with rising interest rates and perhaps rising risks as well. If S&P 500 rises above 2,800 again, you may hear a lot of jabber about how a rising market is inevitable. It never is, but we will continue to try to balance the risks and opportunities with an amount of caution appropriate for each portfolio.

As is our annual regulatory duty, we assure you that we share none of your personal information with anyone without your express consent. We also offer to send you a copy of our regulatory filing "ADV brochure" upon request should you find a need for further reading material guaranteed to induce sleep.

Your reports and statements are enclosed. As always, please give me a call to discuss any issues, change, or strategies you would like to consider as we navigate the second half of 2018.

Sincerely,

Claude Carmichael CFA