Making Sense of Finance

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Second Quarter 2018 Review

STOCK MARKET

U.S. stocks in general fared better in the second quarter than the first three months of 2018. All three major stock indexes had positive returns led by the Nasdaq composite again, which gained 6.3% last quarter. The S & P 500 index and the Dow Jones Industrial Average managed to show lesser gains of 2.9% and 0.7% respectively. The impending implementation of some trade tariffs weighed on many sectors. The initial round of announced tariffs on Chinese goods took effect July 5th on approximately $34 billion worth of imports, and China as expected announced tariffs of their own on American exported goods to China. However recent large corporate stock buybacks encouraged by lower tax rates somewhat counteracted the negative effect of the announced tariffs on U.S. stocks this year. U. S. corporations set a record in the first quarter with $189.1 billion of stock purchased by companies in the S & P 500 index. A large portion of these buybacks has been in the technology sector. Dividends in the aggregate have also been on the rise, helping buoy stock prices amidst a bit of trade war anxiety.

The energy sector by far was the clear winner last quarter with a double-digit percentage gain of over 13%, not surprisingly as oil prices increased over 14% and have risen over 20% year to date. Consumer discretionary stocks in addition to technology stocks also performed better than the market as a whole. Real estate investment trust stocks rebounded in the second quarter as long-term interest rates stabilized. With short rates rising due to another Federal Reserve rate increase in June, and long-term rates not moving much, the yield curve is the flattest since 2007. This is making it more difficult for the banks to make money as the spread between long-term and short-term interest rates compresses squeezing their net interest income margins. This scenario is a large reason that financial stocks, and large bank stocks in particular, lagged the broader market in the second quarter.

Many foreign stock markets did not do as well as U.S. markets in the second quarter when measured in U.S. dollar terms. The MSCI EAFE index which is an index of developed country stock markets declined 2.3% when measured in U.S. dollar terms but registered a gain of 2.3% in local currency terms. This is

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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attributed to the recent strengthening of the U.S. dollar. The British stock market was an exception posting gains when measured in US dollar and the local currency. Emerging market stocks performed even worse with the MSCI Emerging Market Index losing 8.7% in U.S. dollar terms and 4.2% in local currency. Of special note is the Chinese stock market having entered what is considered bear market territory, down over 20% from its recent peak.

BOND MARKET

The majority of bond sectors declined last quarter; the Bloomberg Barclays Aggregate Bond index which measures various categories of investment grade bonds posted a decline of less than 1%. Quality corporate bonds did the worst in the second quarter as spreads widened amid large issuance of investment grade debt to finance huge mergers and potential trade tariffs hurt multinational companies. Bond sectors that gained ground last quarter were below investment grade bonds (high yield) given the continuation of U.S. economic growth and municipal bonds. Inflation-protected bonds rose slightly as the inflation rate crept up last quarter. The June CPI index increased 2.9% year over year.

As mentioned previously, the Federal Reserve raised rates for the second time this year last quarter. A recent statement issued by the Federal Reserve indicated that the median projections of the participants in the Federal Open Market Committee for the Fed Fund rate for 2018 is 2.4%, versus the prior projection of 2.1% in March. As a result, short-term rates moved up substantially last quarter. The one year Treasury was 2.09% at the end of March and finished the second quarter at 2.33%, and most recently was at 2.39%. In contrast, the ten year Treasury yield rose slightly from 2.74% at the end of the first quarter to 2.85% at the end of June and has remained there. The increase in the short term rates are welcome news to those looking to get a positive real (inflation adjusted) return on their savings.

OUTLOOK

It pays to be an optimist when investing in the stock market; after all, two-thirds of the time the market will be up in any calendar year. Last quarter, we illustrated how a generation (20-30 years) could go by without any major decline (greater than 15%) in the stock market. We already had a market correction (10% decline or more) in February yet we are still positive in calendar 2018. However, we are eyeing some indicators very closely, such as the yield curve, which actually deals with bonds not stocks, but has been a very good indicator in the past of the future for the stock market. A regular yield curve slopes up and an inverted yield curve slopes down. Currently, the yield curve is nearly flat. When there is an inversion, which means long-term rates yield less than short term rates; investors are indicating that investor sentiment is bleak for the future. Once this happens,often the stock market soon follows suit with selling. Currently, we don't see any large bubbles that we are waiting to burst. The yield curve is still slightly sloping up and this may be the case for the next one- to-two years. If this is the case, we may see continued growth in stocks. The most telling will be in the next six to 12 months. If corporations reinvest in growth with all the tax savings gained from the Trump tax cuts, we may see sustained growth for an additional year or two. But, if corporations simply hoard their newfound cash or only buy back stock, the economy may suffer. Other factors including the repatriation of hundreds of billions of dollars, if not over a trillion dollars, overseas could boost markets too. A decline, however, is inevitable, but we and Nobel Prize winners still have no magic crystal ball to determine the exact timing. The key to sustaining growth, in our opinion, is balance. We are confident that the Fed will continue raising rates, which bodes ill for the bond market, but if the economy continues to hum along, equities could still rise. The same goes for Trump's tariffs. At present, these "taxes" should have little impact on the economy, but an escalation of these tariffs could prove overpowering for the current strength of the U.S. economy. Too much of anything in one direction could spoil the party for everyone. Our outlook on real estate is slightly less bullish than corporate stocks as debt is a greater component for the asset class than stocks. Still, there does seem to be a tight supply of residential real estate and the carnage in retail real estate seems to have ebbed slightly. From most optimistic to least, we rank U.S. equities first, followed by U.S. REITs, U.S. Bonds; and don't even ask us about bitcoin.

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