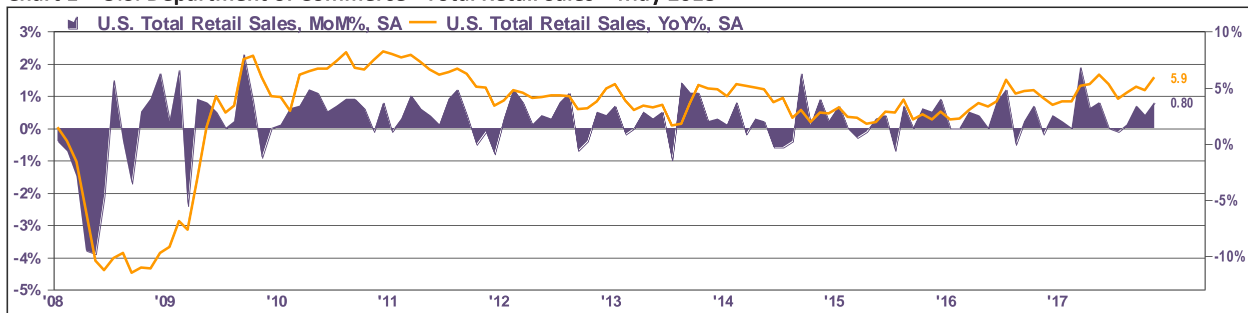
Overview

Economic growth likely strengthened in the second quarter bolstered by increased consumer and business spending, sustained high confidence levels, and low unemployment. Despite a strengthening economy and strong earnings growth, equity market returns during the quarter diverged as U.S. markets were tempered by trade tensions while dollar strength sent emerging markets sharply lower. Balancing the investment scale, more weight is given to the underlying strength in the economy and earnings growth, but the risks associated with trade tensions, Fed monetary policy, and curve flattening appear to be gradually gaining weight. We are maintaining our neutral asset allocation to stocks and bonds.

Economy

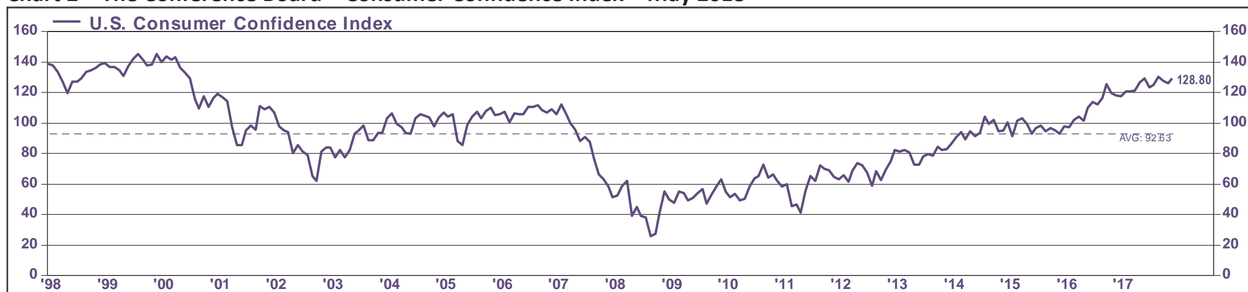
The American consumer appears to be in rather good shape and in a spending mode. In May, retail sales rose 0.8% crushing the consensus estimate of 0.4% and have risen 5.9% over the past year. Over the past 3-months thru May, retail sales are on an annualized sales pace of 7.6%. As a point of reference, over the past 20 years annual retail sales growth has averaged 3.8%. Driving this stellar retail sales growth is the household wealth effect of rising wages, a tight labor market, robust home price gains, strong market returns and sustained elevated confidence levels.

Chart 1 – U.S. Department of Commerce - Total Retail Sales – May 2018



Even with what seems to be ever increasing levels of contentious political rhetoric and policy distractions, consumers and businesses are still feeling good as sentiment survey levels remain near historic highs. According to the National Federation of Independent Business, the Small Business Optimism Index reading in May of 107.8 was the second highest level ever recorded in the 45-year history of the survey. As of May 2018, ISM Manufacturing and Service surveys have had consecutive expansionary readings for 21 and 100 months respectively. Consumer confidence has been on the rise since November 2016 and reached levels in February (130.0) and May (128.8) not seen since late 2000 and remains well above its 20-year average of 92.6.

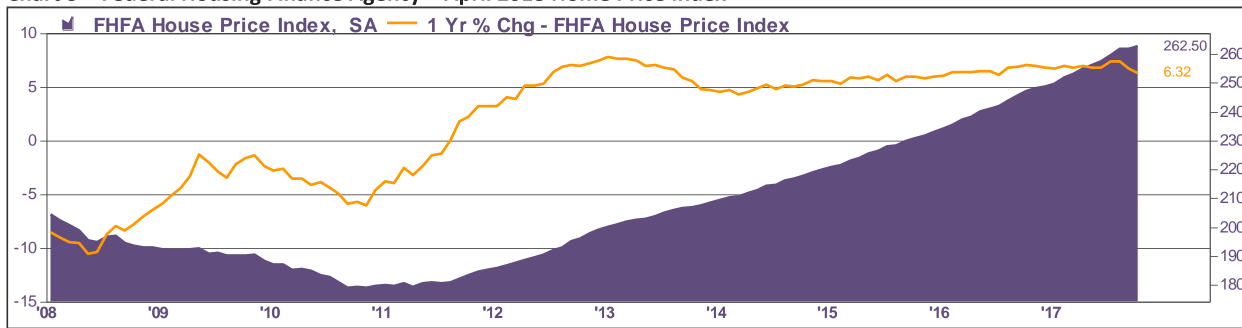
Chart 2 – The Conference Board – Consumer Confidence Index – May 2018



Home builder confidence, which remains elevated, is the only sentiment measure being hampered by concerns stemming mostly from economic growth.

Housing has seen slow and steady growth but is an area that has been unable to gain meaningful traction as the prolonged imbalance between high demand and low supply has put the housing market in a quagmire. Low unemployment, wage gains and a thriving economy is driving very strong housing demand. Conversely, housing supply is being impacted by very low inventory levels, increased regulations, higher mortgage rates, and a severe shortage of skilled and unskilled labor. Additionally, lumber prices have been going through the roof and according to the National Association of Home Builders, "Record high lumber prices have added nearly $9,000 to the price of a new home since January 2017." This housing imbalance has sent average home prices to numerous monthly record highs and is also impacting home affordability.

Chart 3 – Federal Housing Finance Agency – April 2018 Home Price Index



Housing isn't the only industry experiencing labor shortages. The labor market is the strongest it has been in almost 50 years and labor shortages are widespread. Listed below are some highlights taken recently from various U.S. Department of Labor reports:

- Monthly job gains have risen for 92 straight months – positive gains since October 2010.
- Last time the unemployment rate was at or below 3.8% was in April 2000 (3.8%) and December 1969 (3.5%) – the Federal Reserve projects a median unemployment rate of 3.6% for 2018.
- Initial weekly jobless claims on April 20, 2018 of 209,000 was the lowest seen since the December 5, 1969 reading of 202,000 and the 4-week moving average on May 11, 2018 of 213,500 was the lowest seen since the December 12, 1969 level of 210,750.
- For the first time in Job Openings and Labor Turnover (JOLT) report history, the number of jobs available in the U.S. (6.7 million) exceeds the number of unemployed (6.1 million).

Recently, the Federal Reserve slightly raised their full-year (FY) 2018 economic growth outlook to 2.8% from 2.7% as Fed Chairman Powell cited, "the outlook for growth remains favorable." The Federal Reserve Bank of Philadelphia's most recent Survey of Professional Forecasters estimates FY2018 U.S. GDP growth of 2.8% and the probability of contraction in the next four quarters at just 12.4%. Upward revisions to U.S. GDP growth have been on the rise since last October. At that time, the 2Q2018 estimate was 2.2% and the FY2018 estimate stood at 2.3%. Presently, consensus 2Q2018 & FY2018 GDP growth forecasts are 3.2% (+45%) and 2.8% (+22%) respectively. The bulk of these upward revisions occurred after the passage of pro-growth tax reform last December.

During the quarter, it was evident the economy was picking up steam as most macroeconomic measures pointed to continued expansion. The underlying fundamentals of the U.S. economy remain solid and should continue to be supportive of consumer spending, business capital investment, employment gains and earnings growth. While the risks associated with trade tensions are rising, most economists believe they will be limited in scope and are not expected to reach a level to be severe enough to derail the current expansion. However, the longer these trade tensions persist increases the likelihood tariffs may escalate, which in turn may lead to a larger negative impact than expected on the economy as well as on the confidence of consumers and businesses.

Capital Markets

Equity markets entered the second quarter with trade tensions being the primary concern, but these tensions slightly waned on the hope of trade talks and the widely held perception of tariffs as a bargaining tactic of this administration. As the quarter progressed, trade concerns were soon overshadowed by very strong first-quarter earnings. As the quarter closed, trade tensions were back in full focus as trade talks broke down, countries began to dig in their protectionist heels, and the ramification of tariffs became reality negatively affecting targeted industries and companies. Equity market returns during the quarter diverged as U.S. markets were bifurcated by trade tensions while dollar strength sent emerging markets sharply lower.

Small-cap stocks were the clear winner in the quarter advancing not only from recent tax-reform but also from being perceived as less exposed to global trade pressures. According to FactSet, S&P Small Cap 600 companies generate 20.3% of their revenue from overseas while S&P Mid-Cap 400 companies 24.5% and S&P 500 companies 38.1%. The total returns listed in Table 1 bear this out as the Dow Jones Industrial Average and S&P 500 lagged the S&P Mid-Cap 400 and S&P Small-Cap 600 indices last quarter as well as year-to-date.

Table 1 – Equity Index Total Returns - as of 6/29/2018

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
NASDAQ	0.98	6.61	9.37	23.60	15.96	18.54	13.87
Russell 2000	0.72	7.75	7.66	17.57	10.96	12.46	10.60
S&P 400	0.42	4.29	3.49	13.50	10.89	12.69	10.78
S&P 500	0.62	3.43	2.65	14.37	11.93	13.42	10.17
Dow Jones Industrial	-0.49	1.26	-0.73	16.31	14.07	12.96	10.78
MSCI Developed	-1.22	-1.24	-2.75	6.84	4.90	6.44	2.84
MSCI Emerging	-4.15	-7.96	-6.66	8.20	5.60	5.01	2.26

Recent U.S. dollar strength put pressure on emerging market debt and currency. Many emerging market countries issued dollar-denominated debt and a stronger dollar makes it more difficult for a country to service their debt and often leads to a rise in sovereign yields (risk premium). This, in turn, puts pressure on a country's currency and increases the overall level of uncertainty and volatility associated with the country. According to the International Monetary Fund, emerging market economic growth is forecasted to outpace developed nation growth, and this should help to alleviate these recent pressures.

Pro-growth tax reform passed in December 2017 propelled 2018 earning estimates. Listed below in Table 2 are FactSet consensus S&P Index annual earnings growth estimates. Although quarterly earnings likely peaked in 1Q2018, earnings are still expected to remain robust for FY2018 and then taper off to more normalized trend growth in 2019 & 2020.

Table 2 – FactSet Consensus S&P Annual Earnings Growth Estimates

Index	2018	2019	2020
S&P 500	21.3%	9.9%	9.2%
S&P 400	22.8%	12.4%	9.3%
S&P 600	23.4%	15.3%	12.5%

With S&P Index 12-month forward valuations currently trending modestly higher than expected near-term earnings growth and historical averages, it is easy to see why investors are so concerned about the possible negative impact tariffs may have on the economy and earnings. Trade tensions are expected to remain a near-term headline risk and the market will wax and wane with these headlines. An expanding economy is vital in supporting earnings growth and market valuations.

Bond market returns were mixed during the quarter with high yield and municipal bonds leading the way. During the quarter, investment grade and non-investment grade corporate credit spreads widened slightly, yields rose across the curve as the 2-yr Treasury rose 26 basis points to 2.52% and the 10-yr Treasury rose 11 basis points to 2.85%. The yield curve continued to flatten as the Federal Reserve raised the target rate to 2.00% and the spread between 2's and 10's narrowed to 33 basis points. The Federal Reserve projects two more rate hikes this year which would bring the target rate to 2.50%.

Table 3 - Fixed Income Index Total Returns – as of June 29, 2018

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Barclays Municipal 5-Year	0.27	0.87	0.30	0.27	1.62	2.07	3.46
Barclays High Yield	0.40	1.03	0.16	2.62	5.53	5.51	8.19
Barclays Michigan Muni	0.14	1.00	0.10	2.02	3.00	3.85	4.43
Barclays Municipal	0.09	0.87	-0.25	1.56	2.85	3.53	4.43
Barclays Inter Gov't/Credit	-0.07	0.01	-0.97	-0.58	1.16	1.60	3.08
Barclays Aggregate	-0.12	-0.16	-1.62	-0.40	1.72	2.27	3.72

In our Fourth Quarter 2017 Investment Commentary, we wrote a primary issue for 2018 was the possibility of the yield curve inverting. An inverted yield curve is when short-term rates exceed long-term rates. Yield curve inversions have preceded each of the last seven recessions and is considered a reliable predictor of business contraction. Although tariffs have presently dethroned yield inversion as the risk de jour, make no mistake, an inverted yield curve would still be a very important development and poses a real risk.

Asset Allocation

In December 2017, we moved our equity sub-class allocations back to neutral by lowering our overweight allocation to international stocks and raising our underweight to U.S. mid and large-cap stocks. U.S. company earnings were going to benefit from the passage of pro-growth tax reform and the U.S. economy was gaining momentum relative to other developed nations. We did not overweight equities or fixed income as an asset class for valuations were moderately stretched, credit spreads were

very rich, volatility levels were extremely low, the yield curve was flattening, and inflation was showing signs of trending higher.

We began to grow cautious on equities during the first quarter and remain cautious today. However, our prudence is mitigated by the strengthening fundamentals of the U.S. economy. Balancing the investment scale, more weight is given to the underlying strength in the economy and earnings growth, but the risks associated with trade tensions, Fed monetary policy, and curve flattening appear to be gradually gaining weight. We are maintaining our neutral asset allocation to stocks and bonds.

Prepared by Perry Adams – West Shore Bank

Sources: FactSet, U.S. Dept. of Labor, Federal Housing Finance Agency, U.S. Dept. of Commerce, National Federation of Independent Business, The Conference Board, National Association of Home Builders, International Monetary Fund, Institute for Supply Management, The Federal Reserve Bank, and The Federal Reserve Bank of Philadelphia

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