

ECONOMIC & MARKET REVIEW

Second Quarter 2018



The U.S. equity market ground higher in the second quarter, with the S&P 500 up 3.43%. U.S. small cap stocks had a terrific quarter, +7.75%, which put it near the very top of all equity markets around the globe. Also noteworthy in the second quarter was the bond market. Interest rates went up but did so in such a way as to flatten the yield curve dramatically (more on that later). Because of rising rates, the Bloomberg Barclays Aggregate bond index returned -0.16% in the quarter.

Second Quarter and Year-To-Date Investment Performance

	<u>Second Quarter</u>	<u>Year to Date</u>
S&P 500	3.43%	2.65%
Russell 2000	7.75%	7.66%
Barclays Agg.	- 0.16%	- 1.62%
MSCI EAFE	- 1.24%	- 2.75%
MSCI EM	- 7.96%	- 6.66%



Source: FactSet, Cavanal Hill Investment Management. As of 06/30/2018

The Federal Reserve moved ahead with the expected rate hike in June. This was the seventh hike since December 2015 when rates were moved from zero. The Fed cited improvement in the economy and a rise in inflation as the basic reasons:

"Information received since the Federal Open Market Committee met in May indicates that the labor market has continued to strengthen and that economic activity has been rising at a solid rate. Job gains have been strong, on average, in recent months, and the unemployment rate has declined. Recent data suggest that growth of household spending has picked up, while business fixed investment has continued to grow strongly. On a 12-month basis both overall inflation and inflation for items other than food and energy have moved close to 2 percent".

The Federal Reserve also raised the expected number of rate hikes for the rest of the year from one to two. Ok....now they have my full attention. The yield curve flattened in the first half of 2018. What's concerning is that an inverted curve, short term rates higher than long term rates, is a solid predictor of a recession. The spread between two-year Treasury notes and ten-year notes is now only 0.32%, down from 0.52% at the beginning of the year. Flatter is not negative, but the central bank's appetite for additional rate hikes increased in June. The Fed has a history of tightening until something breaks in the economy. Is the Fed on automatic pilot? If so, they run the risk of delivering a recession sooner than it would otherwise occur. The bond market is saying the Fed should reconsider its current rate hiking plan. I'm confident enough in current Fed Chairman Jerome Powell that he would back off the rate hike routine if necessary. But the odds of an error have gone up. I still expect incremental rate hikes, just not as many or at the same pace as the Fed sees them.

Inflation has moved higher, just not very rapidly. The Federal Reserve's preferred inflation gauge, core personal consumption expenditures, finally reached its 2.00% target in June, after ten years of effort. So, like the phys-ed weakling who finally was able to do a pull up (with the assistance of fellow classmates), the Fed can claim success.

In last quarter's review I said there would be no trade war, but no trade peace. I'm sticking to that opinion. We have obviously inched closer to a full-on trade war, but actions have not yet risen to an insurmountable problem. The tariffs announced so far equal -0.10% to -0.20% of U.S. GDP. The real risk to the economy from a trade war isn't the potential of retaliatory reactions from our trading partners (much more specific risk to individual companies and industries with high foreign sales), but that trade concerns lead to a reduction in capital spending projects. In addition, there is the potential negative impact on business and consumer confidence. On a more upbeat note, any deal to settle some of the trade issues would be a significant market positive.

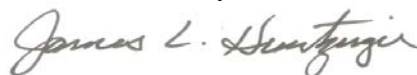
The U.S. economy is firing on all cylinders. The unemployment rate stands at 3.80%, the lowest rate in eighteen years, and it will continue to fall through 2018. The labor force results have improved...more people who could work are working. A combination of tax cuts, regulatory relief, incentives for capital spending and repatriation of foreign profits held abroad, has improved growth. GDP growth was 2.00% in the first quarter. Expect growth rates between 3%-4% for the remaining quarters of the year. Retail sales are up along with consumer and business confidence. Growth will probably slow some next year, but the outline of a recession is still not present.

Energy was the best performing sector of the equity market in the second quarter, +13.50%. Yes...energy not technology, which returned +7.10%. It is noteworthy that this is the ten-year anniversary of the apex of the idea that we were at peak oil. Peak oil is the point in time when the maximum rate of extraction of petroleum is reached, after which it is expected to enter terminal decline. We were going to run out of oil, and we were at the peak of production. Because

of that, the world's economies were headed to the same outcome as the dinosaurs. Not the Jurassic Park versions the real ones. Thankfully the experts were wrong... again.

Price to earnings multiples have come down for the overall market, and next twelve month multiples stand today at 16.4x. No doubt the decline has something to do with the headline risk that has jumped this year, and we are getting later in this cycle. But it does give the equity market some breathing room during a rocky period. One final point regarding equities: Amazon represented 36% of the return of the overall S&P 500 year-to-date. Add in Microsoft, Apple, and Netflix and you have 85% of the index return in just four stocks.

The idea of synchronized global growth has lost some of its pizzazz. It's not quite as unified as it has been over the past two years. The Chinese equity market is down over twenty percent peak to trough this year. European politics are beginning to make our political environment look normal in comparison. As we finish the first half of the year, I reiterate my point from January that this is a year when the economy does better than the market.



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