STRATEGAS insight

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The Dog Days of Summer

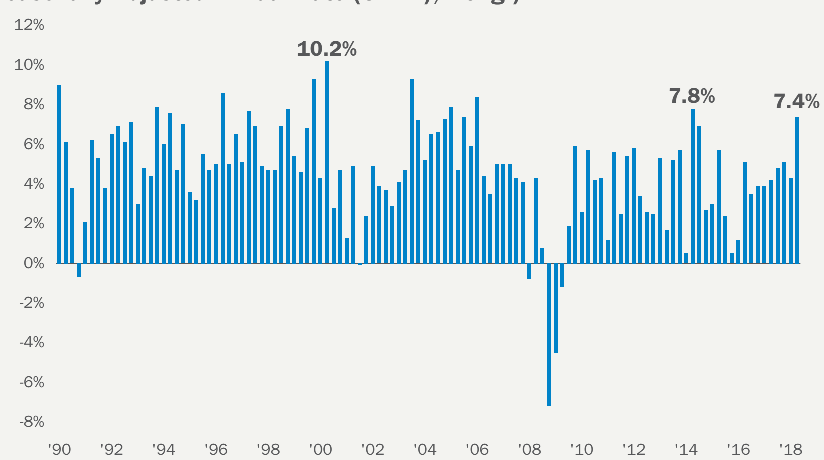
The undercurrent of the US economy remains strong. For data junkies, US real gross domestic product (GDP) grew 4.1% quarter over quarter at an annual rate ("Q/Q AR") in Q2 2018, and nominal GDP surged 7.4%—the highest readings since 2014. Corporate capital expenditure (capex) was an important contributor to the growth mix in Q2—signaling optimism from corporations through their preference for investment in productivity being at least on par with the other outlets for corporate spending (acquisitions, buybacks, debt reduction, dividends, increased wages, or savings). As our Economics team has highlighted, inflation (as measured by the core personal consumption expenditure or PCE) continues to trend upward at a moderate 1.9% pace, and wages too are rising, at a digestible 2.7% year over year with near full employment. This was a good report. With just a handful of companies left to report for the second quarter, corporate profits are trending up 23% year over year… and, in the face of a rising US dollar. Looking through this data, the case is strongly in favor of the US economy notching its longest expansion on record. And although we believe the backdrop is firming for active security selection to take share from passive allocation, the broader stock market is well positioned to continue on the generally upward trajectory it has enjoyed for the past year. **We remain bullish.** We believe investors should too.

However, there are just enough points of uncertainty to draw investors' attention away from these strong currents during these long dog days of summer.

1. Uncertainty around FAANG leadership.

The precipitous 19% drop in Facebook shares on July 26 bled $121 billion

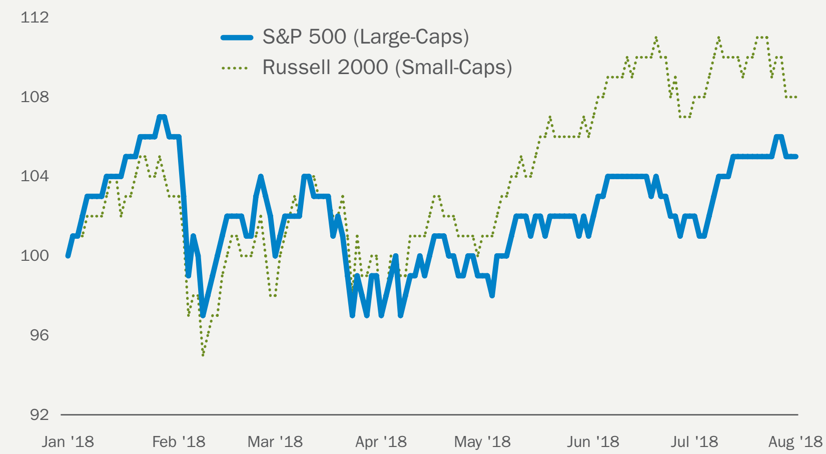
Nominal Gross Domestic Product (Seasonally Adjusted Annual Rate (SAAR), %Chg.)



Source: Bureau of Economic Analysis Data through 6/30/18.

from the social media leader's market valuation, the largest single-session notional decline in an S&P 500 constituent since Intel's 22% drop slashed $91 billion from its value in September 2000. The FAANG narrative is an important one for several reasons, not the least of which is the impact on investor sentiment from Amazon's and Apple's race toward respective trillion dollar valuations in a period of heightened government and regulatory scrutiny. The impact of social media, digital distribution platforms, and content for the consumer and for the economy is not in question, but in measuring strength in the real economy, we continue to take our cues from semiconductors. The semis have evidenced earnings (and more importantly, sales growth) at a pace exceeding FAANG and the S&P 500 Index overall.

S&P 500 Index vs. Russell 2000 Index (Indexed to 100, 1/1/2018 – 7/31/2018)



Source: S&P, Russell, Bloomberg.

2. Will the Fed go too far?

The Federal Reserve (the Fed) is set to continue to raise rates—twice this year and as many as three times next year. The market appears comfortable with this tightening roadmap—for now—but the potential for a policy mistake in late 2019 or 2020 could throw some shade on the market's advance. Aside from the Fed's guidance (and comments from Chairman Powell in particular), another yardstick to watch is the yield curve. The most popular construction is the 2s-10s (the spread between the 10-year and 2-year Treasury yields). The curve has been rolling over, flattening enough to suggest 2Q18 could be "peak GDP growth" in the US for a while. But whereas the Fed (and other global central banks) should watch the yield curve and other international developments, there's no immediate danger, in our view. **Advisor's Note:** The utility of the yield curve garners a fair amount of debate in the wake of aggressive fiscal stimulus, which effectively resulted in an "administered price" at the short end. Although we would not dismiss the importance of an inverted curve, we would view with skepticism overt concern about the integrity of the market rally to persist, so long as the curve remains positively sloped, however flat.

3. Will tariffs kill growth?

The overarching concern that the Administration's insistence on using the threat of tariffs as a negotiating tool in global trade negotiations will backfire remains overstated to us. Overstated, but worth bearing in mind as a notable headwind. (We would likely pay it more credence as a risk in the absence of substantial fiscal stimulus.) "Concessions" gained by President Trump from European Commission president Jean-Claude Junker, at a late-July trade summit in Washington, seemed to quell concern on an all-out trade war erupting with European allies. More importantly, they showed the Administration's ability to understand the limits of threatening rhetoric and take a victory, even if it's deemed to be face saving.

More progress has been made with Europe and on NAFTA than with China, but it looks like Chinese growth has slowed enough to generate the need for more stimulus. The central bank has injected additional liquidity, and Chinese banks are set to buy corporate bonds. We're watching the China producer price index (PPI) to see if this stimulus is enough, or whether more could be in store. So the synchronized global growth story, which had faded in 2018, now looks to have a second wind, courtesy of the People's Bank of China (PBOC) and the China state council. If the US is hitting a near-term peak, China could be hitting a near-term bottom.

4. Small vs. large?

There had been some insistence among investors and strategists (ourselves included) that a cocktail of US fiscal stimulus, protectionist rhetoric, a rising dollar, regulatory easing, and tax reform would lead to the broad outperformance of small cap shares (generally viewed as more domestically oriented) vs. large caps. Year to date this trade has worked—small caps have advanced 8.5%, and large caps have risen 5.5%—but we have some concerns it may be overdone in the near-to-intermediate-term. The equal-weighted FAANG Index has not tested its 200-day average in more than two years, whereas the market-cap-weighted S&P 500 moved to the 200-day just three months ago. The building blocks for small (and mid) caps to outpace large caps remain in place, particularly with weakness from the FAANG segment, but an increase in summer uncertainty may not be the time to chase this trade. We'd wait for the fundamentals to return to focus.

5. How important is weakness in housing?

Interestingly, the housing market has been less robust than would be generally expected with unemployment at 60-year lows. Home prices are elevated, but appear restrained from advancing further by the combination of rising interest rates and some supply shortages. Given the restrained price profile for housing during most of this nine-year-plus cycle, we do not see a bubble that has to pop. So the course remains elevated, but steady—an important building block for consumer optimism.

6. Election-year politics.

Nothing sucks the air out of a room faster than partisan punditry. In this era of heightened partisanship, we expect little more than worthless bluster from either side. Although we're certainly not suggesting abdicating from an informed view on the societal debates of the day, we are suggesting that our investor antennae remain trained on developments affecting the economy and the markets—more directly, profits, taxes, trade, and rates—and the rest of our attention on family, friends, or a good book. Unplug. Rest up. We've got a busy time ahead.

Advisor Takeaway:

Advisors and investors have reasons for optimism, although some concerns may be justified. The FAANG stocks have exhibited leadership, but recent turbulence in Facebook has given investors pause. So long as the yield curve remains positively sloped, the Fed's tightening should not adversely affect the market. The ability of tariffs to harm the market has been offset somewhat by recent concessions the Administration has garnered from European allies, and China's slowing growth is being met with government stimulus. Small caps have outperformed large caps this year, but going forward, fundamentals could reverse that trade. Housing is being constrained by rising interest rates and some supply shortages, but a bubble does not seem apparent. So, staying focused on economic developments rather than election-year politics may be a good approach going forward.

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Index Overview & Key Definitions

Fed, The Fed or FED refers to the Federal Reserve System, the central bank of the United States. **Fed Funds Rate**, the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **Gross Domestic Product (GDP)** rate is a measurement of the output of goods and services produced by labor and property located in the United States. **Real Gross Domestic Product (GDP)** is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year. **Nominal Gross Domestic Product** is gross domestic product (GDP) evaluated at current market prices. The **S&P 500 Index** is an unmanaged index comprised of 500 widely held securities considered to be representative of the stock market in general.The **Russell 2000 Index** is an unmanaged index considered representative of small-cap stocks. The **PCE (Personal Consumption Expenditure) Index** of Prices is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures; essentially a measure of goods and services targeted towards individuals and consumed by individuals. The **Producer Price Index (PPI)** program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services. **FAANG** is an acronym for the five of the market's most popular tech stocks, namely Facebook, Apple, Amazon, Netflix and Alphabet's Google. The **North American Free Trade Agreement (NAFTA)** is an agreement signed by Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The **Seasonally Adjusted Annual Rate (SAAR)** is a rate that is adjusted to take into account typical seasonal fluctuations in data and is expressed as an annual total. SAARs are used for data affected by seasonality, when it could be misleading to directly compare different times of the year.

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