FROM THE DESK OF BOB CENTRELLA, CFA: ***July 10, 2018***

2018 Q2 Summary & Outlook

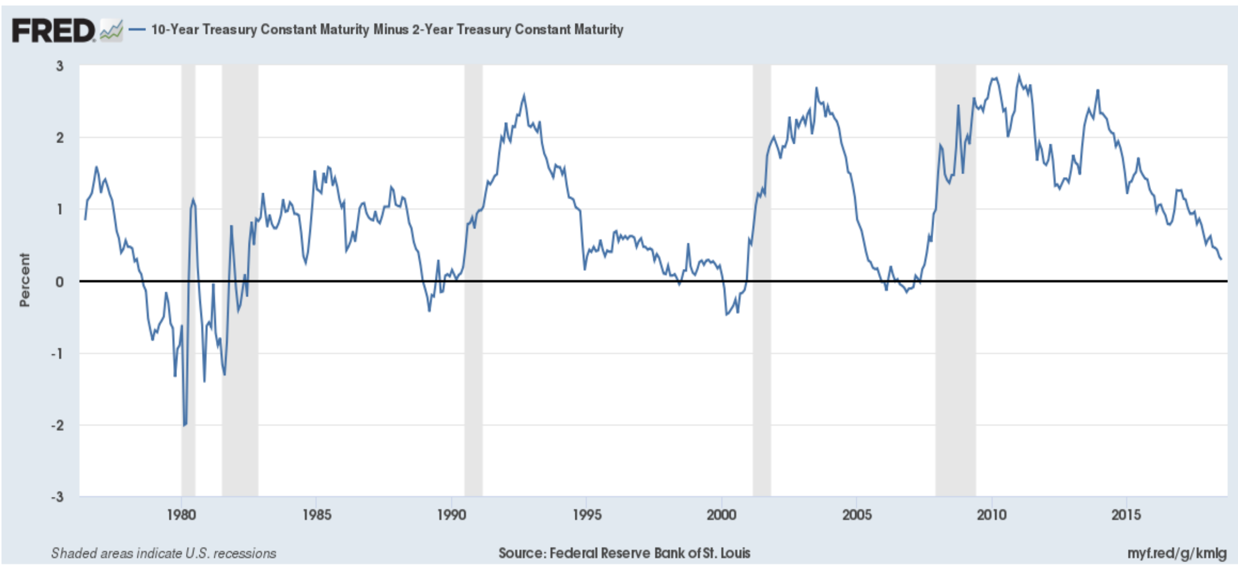
I hope you all had a great 4th of July holiday and a healthy first 6 months of the year. Baseball and Golf are in full swing, the World Cup is kicking up a storm and the weather has been brutally hot after a frigid and everlasting winter. In the meantime fears of a trade war have kept a lid on stocks despite a strong economy and excellent corporate earnings, but July is starting with an equity rally. For the 2nd quarter, stocks did manage to mostly rise in the US with the S&P 500 returning 3.55% and the Dow Industrials climbing 1.04%. However, outside the US MSCI World Index ex-US had a tougher time as it lost 3.47% in the quarter. For the first 6-months of the year, the S&P 500 returned 2.52% (including reinvested dividends) while the Dow Jones 30 declined .91% and the MSCI World dropped 3.96%. The bond market also struggled with the Barclays Aggregate Bond Index falling .19% in the quarter for a loss of 1.65% through June 30. Below is a list of major asset classes and their price change for Q2. Anybody own Lean Hogs? (They bounced back after a 20% decline last quarter… but are dropping again this month:)

Asset Class	Q2-18 %	Asset Class	Q2-18 %
Lean Hogs	44.8%	I-share 20+ UST Bd	-.15%
Nymex Crude	14.2	DJ Transports	-.50
S&P SmallCap 600	8.4	Silver	-.73
Russell 2000	7.4	Vang Tot Bond	-.93
Nat Gas	7	Invest Grade Corp Bd	-2.4
NASDAQ Comp	6.3	FTSE MIB (Italy)	-3.5
WSJ Dollar index	**5.1**	S&P Financials	-3.6
Nikkei 225	3.96	S&P Industrials	-3.7
S&P Midcap 400	3.9	Hang Sen China	-3.8
CAC-40 (France)	3.0	Yen	-4.0
S&P 500	**2.93**	Euro	-5.2
Stoxx Europe 600	2.4	Gold	-5.4
DAX (German)	1.7	Shanghai Composite	-10.3
Dow Jones Indust	.70	San Paulo Bovespa	-14.8
IBEX Spain	.23	Soybeans	-17.8

In the 2nd quarter, appreciation in the S&P 500 was largely driven by the FAANG stocks. For the quarter, Facebook rose 25%, Apple (+11%), Amazon (+23.9%) Netflix (+40%), Google (+11.5%), and Microsoft climbed 11.4%. If you didn't own all these stocks or a good combination of them, then likely underperformance occurred. Note how the Dow Industrial average has lagged the S&P 500 for the quarter and is negative for 6-months. The Dow only includes Microsoft and Apple. By asset class for the quarter Energy (+6.4%), Technology (+5.1%), Services (+4.9%), and Healthcare (+3.8%) outperformed while Industrials (-3.6%), Financials (-2.8%) and Consumer Goods (-.6%) underperformed. For the 6-mo period, the breakdown was similar in terms of asset classes. Financial stocks have produced record earnings, but the flattening yield curve has investors nervous that spreads and margins are being challenged. The Industrial stocks are being punished over the trade war fears, higher energy costs and a somewhat stronger dollar as all may potentially pressure margins looking forward. On the positive side, Energy stocks are rallying as the price of oil has moved solidly above $70. Tech stocks continue to ride a wave of investment due to the strong economy. Small Caps also turned in a solid quarter with the Russell 2000 rising 7.4%. Small caps are less likely to be hurt by a trade war or a stronger dollar.

BONDS

With the Fed raising rates a few times already this year Short Term T-Bills are now yielding more than the S&P 500 dividend yield with a yield of about 1.8% for 3-months. More concerning to some and causing debate among strategists is the declining spread between 2-yr and 10-Yr Treasury Bond yields. We touched on this last quarter and offer some more info here.



The shaded areas on the chart indicate where recessions occurred. As can be seen, the yield curve inverts prior to recessions – that is, the 2-yr yield surpasses the 10-yr and the spread goes negative. This has predicted the last 7 recessions. Presently, the (10 – 2) spread is only about .30% and seemingly approaching inversion and a point that would predict a recession about a year ahead if it inverts. However, it's tough to forecast a recession ahead given the strength of the economy, strong corporate profits, low unemployment and other encouraging economic figures. So, experts are looking at other factors why the 10-yr yield isn't higher such as a slowdown outside the US, artificially low long-term rates due to Central Bank buying, and a flight to safety with trade tensions in the background. Needless, this is something to continue to watch closely as the bond market has historically been an accurate predictor of recessions. Meanwhile, I remain cautious on owning any bonds beyond a few years maturity. With yields above 2% on 1-yr paper and rates still rising, I prefer these short-term bonds and would stay away from longer maturity bonds and from passively managed long-term bond funds.

STOCKS

The global economy seems to be slowing albeit growing while the US economy is accelerating. Trade tensions and tariffs could impede global growth. Can US companies grow while the rest of the world is starting to slow? Clearly US multinational companies would be affected negatively if the slowdown continues. Therefore, the Small Cap indexes have performed well recently as they are more exposed to the US economy. Corporate earnings season is upon us and EPS are expected to have climbed 20% in Q2 in the S&P 500. This would mark the 2nd consecutive quarter of above 20% growth. We look forward to earnings and corporate outlooks in the coming weeks. Because of the recent pullback in stocks and continued strong earnings, stocks are looking less expensive overall. The 12-month forward P/E for the S&P

is 16.2 which is equal to the 5-yr average and only slightly above the 10-yr average (14.4). This also compares very favorably to the end of 2017 when stocks were valued at 18.4x forward earnings.

What does concern me about the market valuation however is the breadth. Investors seem to be piling into the FAANG stocks and other big-name holdings. So, gains in the index are concentrated. But this has led to some opportunities in other areas such as Industrials, Financials and Consumer Staples which have lagged this year. Many stocks in these sectors look appealing but are lagging due to trade tensions, the flattening yield curve and other headwinds. So overall the market looks attractive, but there are pockets of overvaluation and undervaluation. For the market to move higher and deliver my beginning of the year prediction of 10%+ gains, these undervalued sectors need to participate in the second half of the year.

Although the strategy has underperformed somewhat in the first 6-months due to the previously discussed concentrated gains, I continue to like a diversified approach with exposure to financials, industrials, services, energy and technology stocks balanced out with more defensive sectors of Healthcare and select consumer stocks. On the oil front, the price of WTI has been above $70 for a while now and as expected energy stocks have mostly rallied. The stocks should continue to perform better with oil above $70 but may remain volatile if oil drops. Regarding foreign stocks, with Global GDP now slowing somewhat in 2018, I am a little cautious near-term but still recommend exposure to international stocks. I would limit emerging market exposure though as these stocks are sensitive to US interest rates and the dollar. Finally, I continue to like Mid and Small cap stocks which are less sensitive to trade concerns.

ECONOMY

The US economy slowed a bit to 2% in Q1 but is now expected to grow a robust 5% in Q2. That helps explain why the jobs market continues to be strong with 4% unemployment and employers having a hard time actually filling positions rather than creating them! More people are entering back into the labor force with the participation rate at 62.9%, near the higher end of its range the past 4 years. For the full year GDP growth is expected to be over 3% which would be the first time since 2005. Inflation is still low at around 2% which is the Fed target. Yeah, but what about a trade war you ask? Although an all-out trade war is not good for anybody, it's effect on economic growth is probably overstated. Personally, I still believe that some better trade agreements might still come out of this. Btw, according to the World Trade Organization, average tariffs in the US are 3.5% compared to 5.2% in the EU, 9.9% in China, 4.1% in Canada and 7.0% in Mexico. So maybe it is time for tariffs to be lowered around the world, and the US holds a lot of leverage.

The Fed raised rates for a 2nd time this year and could raise another 1-2 times in 2018. Expectations are for another 3-4 next year as well. If that happens, then we should see higher rates across the yield curve – or there will be a severe inversion. An inversion would certainly not be good for Financial stocks.

SUMMARY

In summary, Forza's recommendation remains consistent with how we started the year – we still like equities, are cautious on bonds but would maintain both in the overall allocation of assets for balanced portfolios. On a fundamental basis, we prefer equities to bonds and would have exposure to international stocks. I'm holding out hope for double digit equity gains in the US by year end barring an unforeseen geopolitical event or all-out trade war which I put at a low probability. If trade tensions ease look for better market breadth and the diversified approach to outperform in equities.

Enjoy the rest of the summer and I'll be back soon with some market comments as we work through earnings season.

Bob