

July 17, 2018

Key Points

- It's getting later in the cycle and time to weigh the rising risks, like trade, alongside the continued rewards, such as strong economic growth.
- Earnings growth has been stellar and remains a tailwind but be wary of a very high expectations bar heading into 2019.
- Trade concerns continue to dominate the headlines, but tighter monetary policy and financial conditions, alongside higher inflation, are also keeping stocks from making headway out of the range they've been in since February

Our key theme coming into this year was "it's getting late," in reference to the stage of the economic cycle. The key implications noted were the likelihood of rising inflation, tighter monetary policy and greater market volatility. Check. We have also been consistently highlighting protectionism and trade as a market and economic risk. Check.

Much like the fireworks that many enjoyed as you celebrated the Independence Day holiday, investors have been bombarded with lots of noise and smoke as of late. Stocks have pulled back from the top of the range, and volatility has increased. Risks of a damaging trade war have risen.

We are entering the second half of the year in the middle of the S&P 500's trading range, which has been in place since the correction that began in late-January. Until the index takes out its January high, it's considered to still be in correction mode. For what it's worth, only the 1994-1995 correction went longer without turning into a bear market (20% decline or more, using the standard definition). If this was a typical correction, it would have been at or near new highs by now; and the longer that takes, the higher the likelihood that this correction gets worse before it gets better.

Incredibly, almost all of the gains in the S&P index this year have been as a result of only a few companies. Amazon, Netflix, Microsoft, Apple, Facebook, and Google, have contributed to approximately 98% of the gains. It is remarkable to see so few companies responsible for almost the entire move of the index.

Looking Ahead

Many who are brushing off a possible trade war often cite the limited impact of the currently-proposed tariffs on gross domestic product (GDP) growth. The problem with that argument is that it only considers "first order" effects; while not considering "second order" effects which include, most importantly, the impact on business and consumer confidence. Pessimism by economists about sliding down the slippery slope toward a trade war is already getting reflected in surveys, including those conducted by the National Association for Business Economics (NABE), The Wall Street Journal, Reuters and CNBC.

Contentious trade negotiations have occurred in the past, but the fact that they're being played out so publicly is a new phenomenon resulting in rising trade-related market volatility.

Tax reform provided a huge jolt to earnings in the first quarter and to estimates for the remainder of this year. But comparisons will begin to get more difficult, so expect a slowing in the year-over-year growth rate in earnings. Aside from the simple math, there are also some high hurdles which earnings growth face in the near-to-medium term, including trade/tariff hits, rising labor and input costs, the strong dollar and rising interest rates.

Tighter monetary policy and financial conditions were pre-conditions for the increase in volatility this year; and that force is not likely dissipating any time soon. Please note that last year's lack of volatility was the exception, not the rule. This year is more in keeping with the rule, and consistent with late-cycle tendencies.

With central banks retreating from the extraordinary policies put in place after the financial crisis, the amount of excess global liquidity is likely to shrink. That extra liquidity was a key factor holding down volatility and risk premia. As the process unwinds, we see the potential for a much more volatile stretch ahead of us.

Fiscal stimulus, both tax and regulatory reform, has had a material impact on the trajectory of both the economy and corporate earnings, and that tailwind should persist at least in the near term. However, with that sugar high comes the side effect of deteriorating budget deficits over the next decade. Public and non-financial corporate sectors' debt has surged. This is both a risk, as rates continue to rise and interest payments balloon, and an impediment to economic growth due to the "crowding out" effect on other spending.

In summary

In early 2009, equities became extremely attractive from a risk/reward perspective, in spite of weak economic growth; because monetary policy was exceptionally easy, equity valuations were attractive and forward earnings expectations were bottoming at extreme lows. Fast-forward to today, and we see an economy that's late in its up-cycle amid a tight labor market and tighter monetary policy. Perhaps not all of the good news is priced into the stock market, but the risk/reward proposition has unquestionably deteriorated.

With competing headwinds and tailwinds, the U.S. stock market has been largely range-bound since the January-February correction. If a few things go right in the near-term, including an easing of trade tensions, stocks could break out on the upside. But there are the aforementioned catalysts for a break out on the downside as well.

One thing that will always present in the stock market is uncertainty. As the famous investor Shelby M.C. Davis was quoted as saying, "History provides a crucial insight regarding market crises: they are inevitable, painful and ultimately surmountable." So, with that said, we are not fearful of what lies ahead. Think long-term, maintain balance, and stay the course. We would welcome the opportunity to increase ownership of great companies, at more attractive prices, if a market downturn happens.

Respectfully,



Anthony L. Christensen, CPWA®
President, Managing Partner

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