CATAMETRICS®
MANAGEMENT, LLC

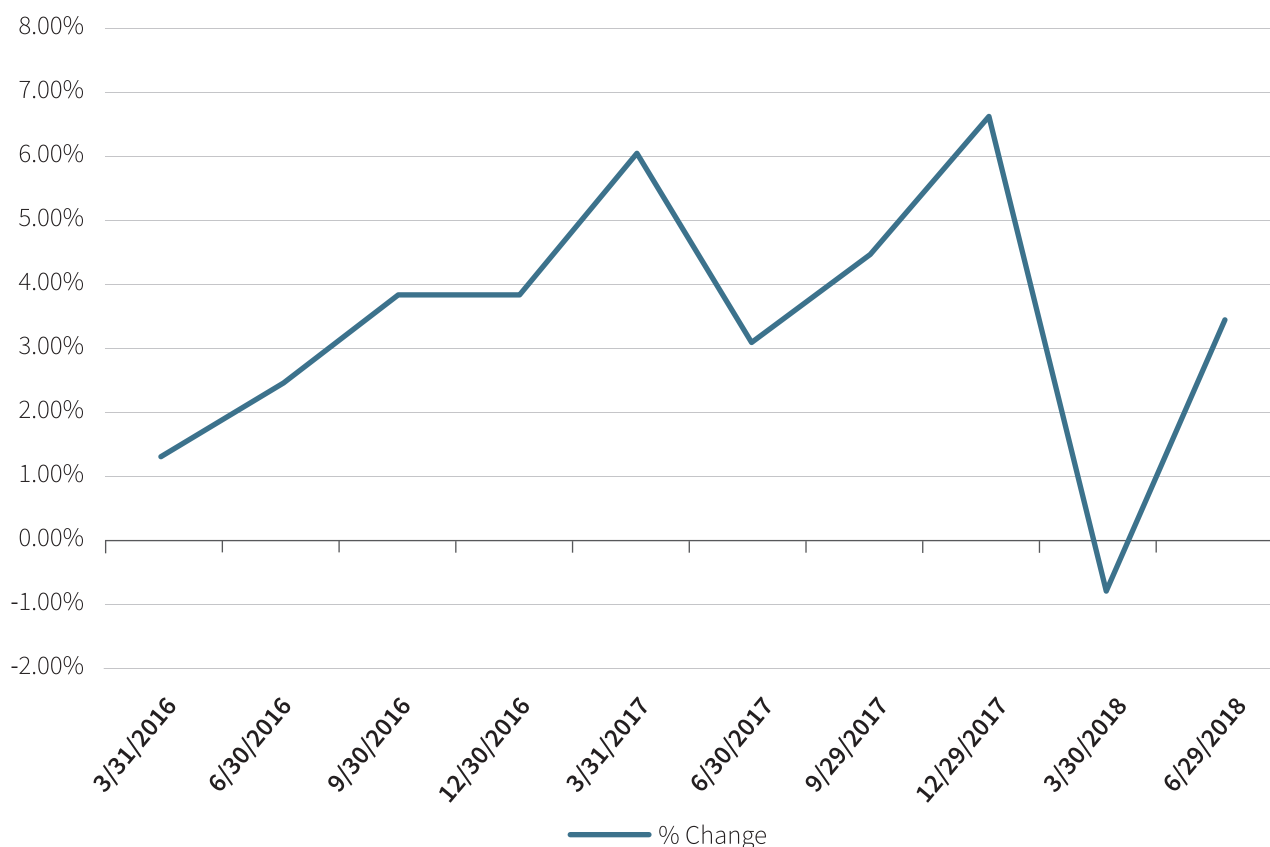
2018 Q2

Quarterly Review

We've clearly moved on from the post-recession era when the markets doled out steady and robust annual gains. A more tumultuous backdrop has set in, with a complex set of cross-currents that investors now must address.

Robust second-quarter GDP growth in the US, solid retail and corporate spending, and strong after-tax corporate profits are clear positives. Yet a slightly faster pace of interest rate hikes, surging trade tensions, and slowing growth in many other key economies could eventually blunt our domestic momentum. Against that backdrop, the S&P 500's 3.43% second-quarter gain is surely impressive. With 10-year Treasury yields holding firmly below the 3% mark, equities may continue to climb a "wall of worry" in the second half of 2018.

Exhibit 1. Source: Bloomberg, CataMetrics Management, LLC

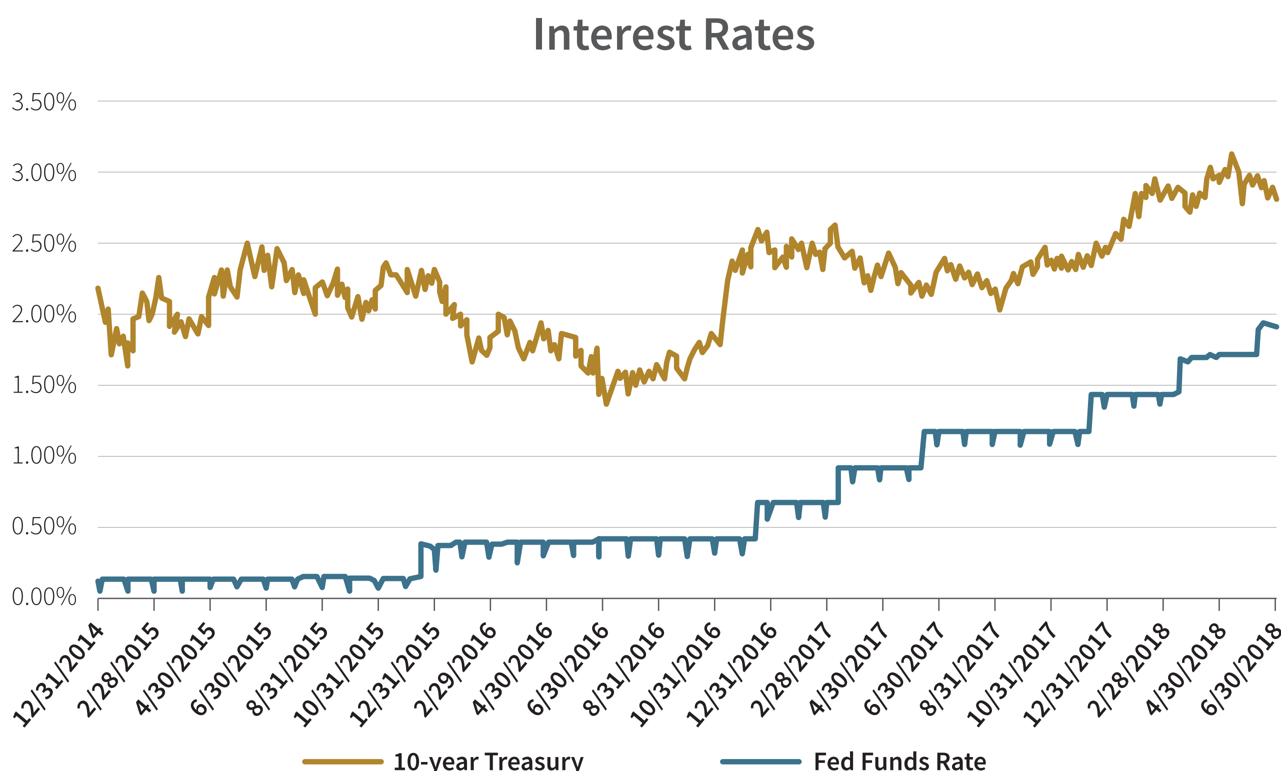


The Fed Threads the Needle

It's been five years since the Fed's "Taper Tantrum" first hit the headlines. In May 2013, the Fed signaled plans to begin to wind down its quantitative easing program and also eventually raise rates. A quick spike in bond yields at that time led to expectations that the markets were headed for a much rockier road.

But a rockier path failed to emerge, as long-term rates have not risen nearly as high as some had anticipated, and equity markets have posted another half-decade of solid gains. The Fed didn't actually begin to boost rates until December 2015 but has since raised the benchmark lending rate on six more occasions. While short-term rates have risen around 175 basis points since the Fed began to tighten, the yield on the 10-year Treasuries has risen around 60 basis points, from around 2.25% to a current 2.86%.

Exhibit 2. Source: Bloomberg, CataMetrics Management, LLC



There are multiple reasons for the muted response of longer-dated bonds (and the flattening of the yield curve), but the primary explanation resides with the European Central Bank (ECB) and the Bank of Japan (BOJ). Those two institutions have retained very loose monetary policies. ECB president Mario Draghi recently "provided an unexpectedly dovish addition to the bank's plans," noted the economist Mohamed A. El-Erian in a column in Bloomberg News.

At a news conference, Draghi said that QE-backed bond buying would continue in full effect this summer before a slow buying taper. And the ECB won't consider raising rates until the second half of 2019. With low global yields, US yields have remained in check as well.

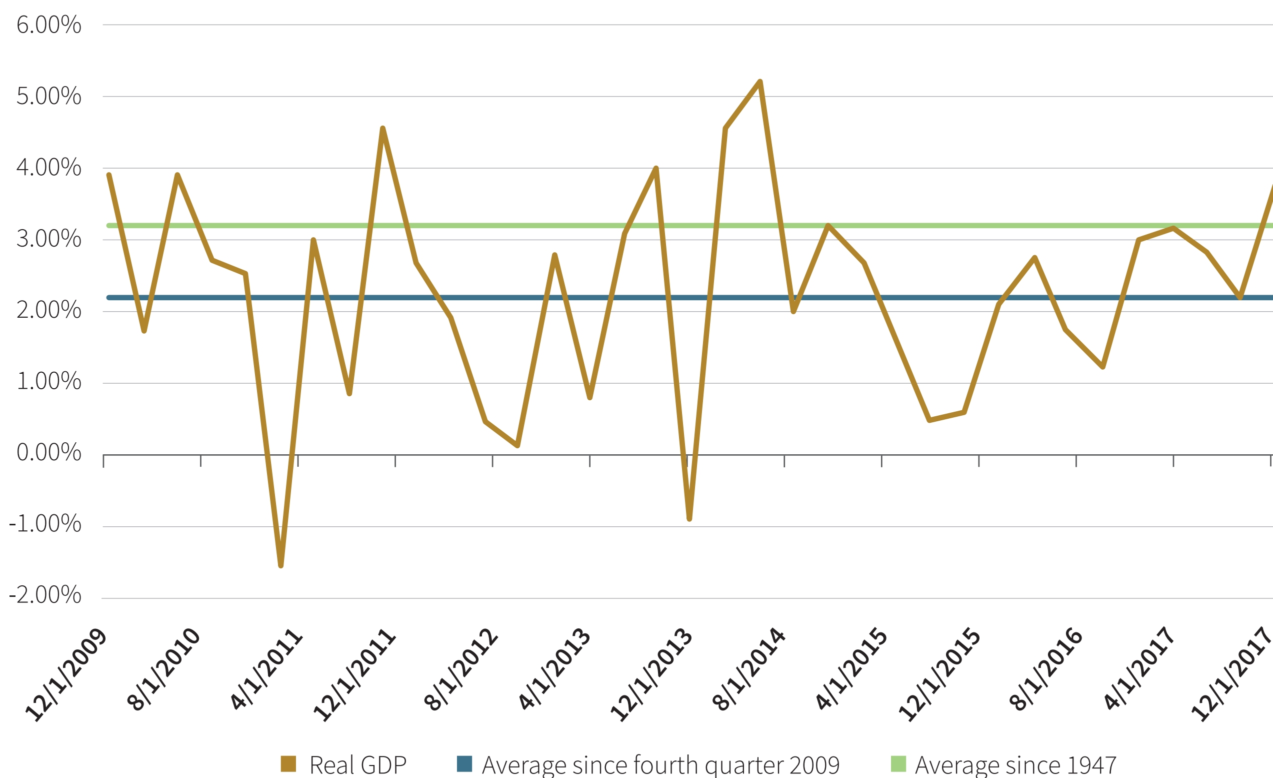
Draghi may be taking this more dovish stance in response to signs that European economies are cooling. European industrial production, for example, has fallen in four of the past five months, according to the European Union's statistics agency. In mid-June, the ECB lowered its 2018 eurozone GDP growth forecast from 2.5% to 2.1% and sees growth slowing further in 2019 and 2020.

Here in the US, the Fed is taking a pair of steps to shift its monetary policy stance. First, it is now shrinking its balance sheet, having sold more than $110 billion in bonds since the unwinding of QE started last September. That selling has become more rapid in the past few months (and has implications for emerging markets, as we'll note in a moment).

Impressive Resilience

The Commerce Department said that sales at US retailers surged 0.8% in May—double the consensus forecast, and the highest sequential gain in spending since November. That report is just one factor behind the Atlanta Fed's GDPNow forecasting tool's predicting that the US economy grew 3.8% in the second quarter.

Exhibit 3. Source: Bureau of Economic Analysis, Bloomberg, CataMetrics Management, LLC



Regarding consumers, an odd dynamic is playing out. Lower-income consumers are in a better mood these days, thanks in part to employment gains. In the University of Michigan's consumer sentiment index, confidence among households in the bottom third income tier has risen 11.4 points since February. Yet sentiment among Americans in the highest third of incomes has fallen more than eight points in that time.

Lower-income consumers may want to check their exuberance. According to the St. Louis Federal Reserve, the delinquency rate on credit cards rose to 2.54% in the first quarter of 2018, the highest level in five years. Fitch Investor Services says that subprime auto loan delinquencies now stand at 5.8%, above levels seen during the financial crisis and the highest rate since 1996.

And remember that the Fed plans to raise its key lending rate an expected four times over the course of 2018 and twice in 2019. Many forms of consumer debt are tied to short rates, and the cost of borrowing has been steadily rising. According to Bankrate.com, the average credit card interest rate now stands at 17%, the highest level in nearly a decade. Lower-income consumers are also more sensitive to rising gasoline pump prices.

Corporate spending trends are another reason the Atlanta Fed anticipates a very strong second quarter. A survey by Credit Suisse found that capital spending by firms in the S&P 500 increased by around 25% in the first quarter.

And there's no reason to assume that the current economic expansion, which is now the second longest in the nation's history, will slow in coming quarters. That's because smaller businesses are now also stepping up the pace of their investments. The National Federation of Independent Business noted that its Small Business Optimism Index increased in May to the second highest level in the survey's 45-year history.

The Fed now anticipates the US economy will grow 2.8% this year, before cooling to 2.4% in 2019 and 2.0% in 2020. The personal consumption expenditure (PCE) core deflator index, which is the Fed's preferred inflation gauge, was 2% on a year over year basis in May. This is the first time the index has reached the Fed's targeted rate since March 2012. The Fed's latest forecast predicts that the PCE deflator will remain flat at 2.1% over the next three years.

The Dollar's Sharp Reversal—and the Impact on Energy and Emerging Markets

The US dollar slid roughly 12% from the start of 2017 through mid-February 2018. The dollar began to rebound later in the first quarter, and in the second quarter of 2018, strengthened another 5% against a basket of currencies. That has had a clearly negative effect on emerging markets (EM). Not only do many of these markets face higher interest expense burdens on their dollar-denominated debt but they also feel the pinch of sharply higher energy prices, as oil is priced in dollars.

Exhibit 4. Source: Bloomberg, CataMetrics Management, LLC

In Brazil, for example, fuel costs are up nearly 30% from a year ago, which led the military to take action to end a crippling strike by protesting truck drivers. And the *Wall Street Journal* reports that Chinese truckers blocked roads and refused to move goods in a handful of cities, protesting higher fuel costs. Countries like Indonesia are being forced to sharply boost spending on fuel subsidies to avoid further political fallout.

Faced with an increasingly robust economic backdrop in the US and rising geopolitical risks abroad, investors have begun to unload EM equities and bonds. Since late January, for example, the Vanguard FTSE Emerging Markets ETF has slid roughly 17%. The yield on the JPMorgan index of local currency bonds has risen up to around 6.5%, which is roughly 3.5% higher than equivalent-duration US Treasuries.

The selling may be related to the Fed's balance sheet unwinding that we discussed earlier. Research from the IMF suggests that shrinking the Fed's balance sheet will reduce foreign purchases of emerging-market stocks and bonds by about $70 billion combined in 2018 and 2019. That is a contrast to average annual inflows of $240 billion since 2010.

Ironically, the selloff in EM stocks and bonds comes at a time when economic conditions are still quite robust in many EM nations. In its April outlook, the International Monetary Fund (IMF) predicted that EM economies would grow 4.9% this year (up from 4.8% in 2017) and an even more robust 5.1% pace in 2019.

Is China Slowing?

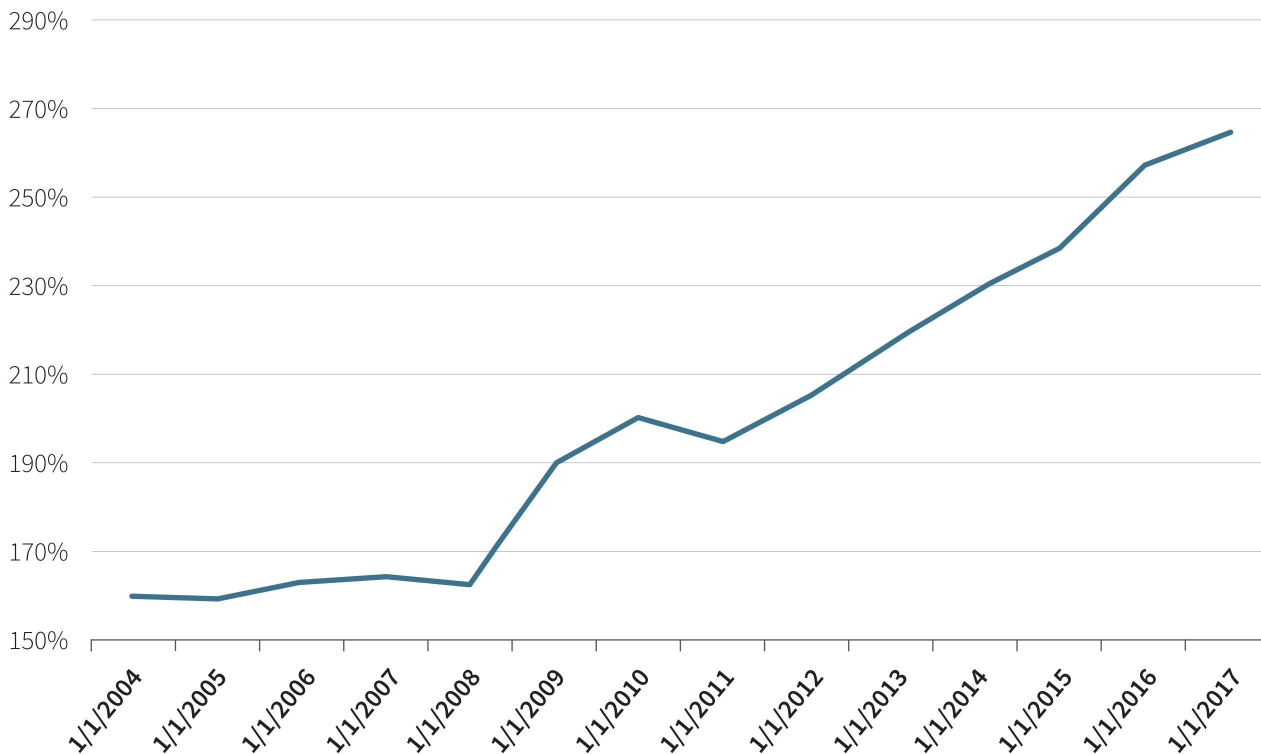
Whether rising trade tensions between the US and key trading partners will start to stunt global growth forecasts remains to be seen, but recent economic reports suggest that EM Asian economies are off to a strong start in the first half of 2018. However, a further increase in trade tensions with China could have region-wide implications.

In our first-quarter market outlook, we wrote that "in a best-case scenario, tough trade talk will translate into more open foreign markets (especially in China)." The best-case scenario has thus far not been realized. Instead, a tit-for-tat tariff war has broken out between the two nations. The market has slumped sharply on the days when trade war saber rattling has increased. And unless conditions de escalate from here, market sentiment is bound to be further impacted.

Weaker trade prospects might impact an economy that is already losing some momentum. Chinese economic strategist Long Chen recently told Barron's that loan growth is slowing as loan defaults rise. "If credit growth continues to slow, more and more companies will find it difficult to borrow, and more will default on their debts, in what could eventually become a self-reinforcing downward spiral," he said.

China can ill afford a debt crisis. Total debt could reach nearly 250% of GDP by the end of this year (according to S&P Global Ratings), up from 170% in 2012. Maintaining solid economic growth, even as the government starts to force banks to reduce lending, can be a tricky feat to accomplish.

Exhibit 5. Source: Bloomberg, CataMetrics Management, LLC



That backdrop, along with trade concerns, has already led the iShares China Large-Cap ETF to lose roughly 20% of its value since a late January peak. Further economic slowing would likely lead the Chinese government to pursue stimulus measures—as it has often done in the past. In light of China's key role in Asia and the global economy, this is just one more geopolitical risk that the markets will have to digest in the second half of 2018.

Incipient Price Pressures

Earlier, we noted that the Fed is now expected to raise rates four more times over the next 12-18 months before hitting a neutral target rate range of 2.75%-3.00%. That neutral target likely assumes continued muted inflation trends in the US economy.

For much of 2018, rising commodity prices have been a concern as lumber, cotton, copper, nickel, and other commodities moved up to multiyear highs. That has led to speculation that higher input costs would eventually lead firms to raise prices and maintain firm profit margins. However, after hitting a peak in early June, the CRB Commodity Index has slid roughly 5%, in large part due to concerns of slowing demand in China and elsewhere. Copper prices, for example, have slid more than 10% in the past month as this construction-related metal may see lower consumption in the quarters ahead.

Exhibit 6. Source: Bloomberg, CataMetrics Management, LLC

An Earnings Growth Peak?

Thanks to the 2018 tax reform, net profits have been surging. US firms saw a 25% increase in first-quarter earnings, the fastest pace since the second half of 2010, according to FactSet. And current consensus forecasts (which are always too conservative) suggest that aggregated profits for firms in the S&P 500 will rise by 20% in the second quarter. In fact, year-over-year comparisons should remain quite robust in the second half of 2018 as well, thanks to falling tax rates. The 12-month forward P/E ratio on the S&P 500 stands at a reasonable 16.1%.

However, recall the phrase “markets always look ahead.” And at the start of the third quarter, investors start to look out into growth prospects for the following year. That’s when profit growth rates will likely look far less robust. FactSet’s surveys suggest that earnings will only grow in the single- to low double-digit range next year. As we’ve discussed, multinational exporters are now seeing more challenging conditions in foreign markets, while here at home, rising interest rates will blunt momentum in certain sectors.

The changing interest rate backdrop, rising trade tensions, and robust domestic consumption are leading to divergent returns for various sectors. In the second quarter, the S&P 500 energy sector posted a robust 12.7% gain (though it’s up just 5.3% year-to-date). That move was aided by a 14% spike in crude oil prices in the second quarter.

S&P 600 small caps also fared quite well in the second quarter, rising 8.77%. Consumer discretionary and technology stocks also posted solid second-quarter gains. At the other end of the spectrum, financials and industrials slumped around 3.5% in the second quarter.

India and Australia were the top global performers in the second quarter as each rose more than 7%. But many other ex-US markets saw rising headwinds this past quarter. And much of that can be pinned on sharply eroding currencies. When measured against the dollar, the currencies of Argentina (-30%), Brazil (-15%), Turkey (-14%), South Africa (-14%), Hungary (-10%), Russia (-9%), and Mexico (-9%) all saw their currencies slide.

While many clear positives for US equities remain in place, they are operating against a much more dynamic and volatile global backdrop. How the markets digest further interest rate hikes, rising trade tariffs, a faster pace of US government borrowing, and a polarized domestic electorate will all be factors in how one of the longest economic expansions and bull markets plays out in the second half of 2018.

Exhibit 7. Recent Historical Returns – Source: Bloomberg, CataMetrics Management, LLC

Asset Class	Index	12M *Return*	YTD *Return*	2018Q2 *Return*
US large cap	S&P 500	+14.37%	+2.65%	+3.43%
US mid cap	S&P 400	+13.50%	+3.49%	+4.29%
US small cap	S&P 600	+20.50%	+9.39%	+8.77%
US broad equity market	S&P 1500	+14.50%	+2.91%	+3.65%
US broad equity market	Russell 3000	+14.78%	+3.22%	+3.89%
European equities	FTSE Developed Europe	+6.20%	-2.67%	-0.83%
Japanese equities	FTSE Japan	+11.13%	-1.88%	-2.14%
Emerging-market equities	FTSE Emerging	+7.65%	-6.77%	-8.00%
International equities	FTSE All World ex-US Net Tax	+7.28%	-3.83%	-2.51%
International equities	MSCI ACWI ex-US	+7.28%	-3.77%	-2.47%
US broad bond market	BBG Barclays US Aggregate	-0.40%	-1.62%	-0.16%
International bonds	BBG Barclays ex-USD Aggregate	+2.78%	-1.31%	-4.77%
Global bonds	BBG Barclays Global Aggregate	+1.36%	-1.46%	-2.79%

Exhibit 8. Recent Historical Price, Index, and Yield Levels – Source: Bloomberg, CataMetrics Management, LLC

Asset/Asset Class	Index/Instrument	6/30/2017 *Price/Level*	12/29/2017 *Price/Level*	3/29/2018 *Price/Level*	6/29/2018 *Price/Level*
Gold	Gold spot	$1,242.00	$1,303.00	$1,326.00	$1,253.00
Crude	WTI active futures	$48.21	$59.76	$64.54	$74.15
Industrial metals	GSCI Industrial Metals	1,505.40	1,576.99	1,581.82	1,502.17
Sterling ($/£)	GBP spot	1.30	1.35	1.40	1.32
Euro ($/€)	EUR spot	1.14	1.20	1.23	1.17
Yen (¥/$)	JPY spot	112.39	112.69	106.43	110.76
USD	BBG Dollar Spot	1,183.80	1,159.44	1,125.59	1,181.20

Yield Curve	Index	6/30/2017 *Yield/Yield diff*	12/29/2017 *Yield/Yield diff*	3/29/2018 *Yield/Yield diff*	6/29/2018 *Yield/Yield diff*
Fed funds	Fed funds	1.06%	1.33%	1.68%	1.91%
US 2-yr Treasury yield	BBG generic 2-yr Treasury yield	1.38%	1.88%	2.27%	2.53%
US 5-yr Treasury yield	BBG generic 5-yr Treasury yield	1.89%	2.21%	2.56%	2.74%
US 10-yr Treasury yield	BBG generic 10-yr Treasury yield	2.30%	2.41%	2.74%	2.86%
US 30-yr Treasury yield	BBG generic 30-yr Treasury yield	2.83%	2.74%	2.97%	2.99%
Steepness 5/2	5-yr less 2-yr	+0.51%	+0.32%	+0.30%	+0.21%
Steepness 10/Fed funds	10-yr less Fed funds	+1.24%	+1.08%	+1.06%	+0.95%
Steepness 10/2	10-yr less 2-yr	+0.92%	+0.52%	+0.47%	+0.33%
Steepness 10/5	10-yr less 5-yr	+0.42%	+0.20%	+0.18%	+0.12%
Steepness 30/2	30-yr less 2-yr	+1.45%	+0.86%	+0.71%	+0.46%
Steepness 30/10	30-yr less 10-yr	+0.53%	+0.33%	+0.23%	+0.13%
10-Yr Bund yield	BBG generic 10-yr Bund yield	0.47%	0.43%	0.50%	0.30%
10-Yr Gilt yield	BBG generic 10-yr Gilt yield	1.26%	1.19%	1.35%	1.28%
10-Yr JGB yield	BBG generic 10-yr JGB yield	0.09%	0.05%	0.04%	0.04%

Disclosures

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Before investing in an ETF, you should read both its summary prospectus and its full prospectus, which provide detailed information on the ETF's investment objective, principal investment strategies, risks, costs, and historical performance (if any). The SEC's EDGAR system, as well as Internet search engines, can help you locate a specific ETF prospectus. You can also find prospectuses on the websites of the financial firms that sponsor a particular ETF, as well as through your broker.

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