Summer fades as domestic stocks gain

The S&P 500, Dow Jones Industrial Average and NASDAQ moved higher for the month of August, along with the Russell 2000. Technical momentum is strong and all major U.S. equity indices were at or near highs on the back of strong second-quarter earnings and good economic data.

However, investors showed signs of caution toward the end of the month, seemingly concerned about U.S. trade and foreign policy, as tariffs on $200 billion worth of Chinese goods could be imposed in early September. In addition, negotiations between U.S. and Mexico ended without a new trade deal, but will continue under deadline pressure as the Trump administration informed Congress that a deal is forthcoming. Negotiators now have 30 days to strike a deal among Canada, Mexico and the U.S. and submit the final details to Congress. As a result, domestic stocks slipped slightly on the news, even as the dollar strengthened. However, the momentary slip wasn’t enough to erase gains from earlier in the month, according to Bloomberg.

We believe that a North American trade deal can be worked out in the near future, which should create market support via positive market sentiment and alleviate some trade war fears.

The U.S. economy was expected to be pushed and pulled by three factors in 2018: fiscal policy, monetary policy and labor market constraints. Judging by the increase in the federal budget deficits, fiscal stimulus now appears to be larger than anticipated, adding to the economy’s momentum for the last few months of the year. The pace of job growth has remained strong, beyond a long-term sustainable pace, as there appears to have been more available slack than earlier thought. Data for early third quarter are consistent with moderately strong growth in the near term.

	12/29/17 Close	8/31/18 Close	Change Year to Date	% Gain/Loss Year to Date
DJIA	24,719.22	25,964.82	+1,245.60	+5.04%
NASDAQ	6,903.39	8,109.54	+1,206.15	+17.47%
S&P 500	2,673.61	2,901.52	+227.91	+8.52%
MSCI EAFE	2,050.79	1,962.05	-88.74	-4.33%
Russell 2000	1,535.51	1,740.75	+205.24	+13.37%
Bloomberg Barclays Aggregate Bond	2,046.37	2,026.72	-19.65	-0.96%

Performance reflects price returns as of 4:30 EDT on Aug. 31, 2018.

Here is a look at what's happening in the economy and capital markets, as well as key factors we are watching:

Economy

- Early data for the third quarter continued to show moderately strong growth in the overall economy, with consumer price inflation trending at the Federal Reserve's (the Fed) 2% goal.
- Consumer spending (68% of gross domestic product) appears to be trending at a 2.5% to 3.0% annual rate, following a 2.1% pace in the first half of the year.
- Fiscal stimulus (lower taxes and increased spending) has provided support for the economy in 2018, but has also added significantly to the federal budget deficit, worsening demographic strains ahead (i.e., paying for Social Security and Medicare as the baby-boom generation retires).
- The Fed is very likely to raise short-term interest rates following the September policy meeting, but officials are increasingly aware of the risks of raising rates too fast or too slow. Another rate hike in mid-December appears more likely than not, but that could change depending on the economic data.
- Increased tariffs and retaliatory measures have had a significant impact on some sectors, but little effect on the overall economy. That may change if trade conflicts escalate.

Equities

- S&P 500 second-quarter earnings season was very strong. The average stock traded 0.39% higher on its earnings report, with the best price reaction coming from the Telecom and Industrials sectors.
- Earnings continue to drive the market; however, there is widespread underinvestment, signaling room to move to the upside.
- A strong dollar generally favors the Consumer Discretionary sector and domestic companies with little foreign sales, since a stronger dollar tends to keep inflation in check, which puts more money in the hands of consumers.
- Technology, Healthcare, Financials, Consumer Discretionary and Industrials are all hitting their highest levels in at least three months, and Energy and Materials have been acting better recently too. The recent laggards have been the more defensive and rate-sensitive areas like Staples and Utilities, an indicator that investors are becoming more confident again.

Fixed income

- The spread between the two- and 10-year Treasuries has shrunk from 78 basis points (bp) a year ago to the current ~20 basis points. There has been a lot of discussion of a potential inverted curve. The long end of the Treasury curve remains low and may be explained by investors' poor/bearish long-term outlook and/or foreign investors creating huge demand for U.S. investments, largely due to interest rate disparity.

- Regardless of rationale or potential outcome, the effect on long-term fixed income planning should be minimal on Winthrop portfolios, as we have been favoring the short end of the yield curve, and generally inverted curves and/or recessions represent relatively short moments in business cycles.
- The yield curve (looking at the 10-year Treasury yield less federal funds rate) is not inverted (a common indicator of recession), but a flatter curve bears watching, noted Raymond James Chief Economist Scott Brown.
- Increased government borrowing, somewhat higher inflation, and an improving economy would normally be associated with rising bond yields. However, long-term interest rates remain very low outside of the United States, and there has been a global flight to safety into U.S. Treasuries.

International

- Headlines centered on high-profile troubles in emerging markets, including Turkey and Argentina, and issues arose including domestic economic challenges, the impact of a higher dollar on debt burdens and geopolitical tensions around potential application of new tariffs and trade restrictions.
- High levels of volatility in the early part of the month did, however, progressively calm down as some investors viewed this volatility as more of an opportunity than a threat.
- Challenges remain and the direction of both the value of the dollar as well as trade talks with China and the rest of the world will be highly influential.
- With valuations low and sentiment depressed, we continue to find some diversification potential by maintaining or even establishing emerging market allocations in Winthrop portfolios.
- There were some indications of modest progress in the Brexit talks between the United Kingdom and the European Union, although hopes for a final deal appear to have been pushed back.

Bottom line

- We remain cautiously optimistic, and encourage clients to measure the success of their financial plans based on steady progress toward their goals, not the short-term vagaries of the markets. We believe you should continue to make decisions based on your long-term goals. A well-diversified portfolio should allow you to participate in upside potential here and abroad, as well as serve as ballast against any short-term volatility.

Thank you for your continued trust in us. As always, feel free to reach out to us with any questions or if you would like to discuss.

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