TERRA NOVA
ASSET MANAGEMENT

U.S. Financial Markets
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Stock Market Development

The corrective phase in the stock market, which began in February, continues. In relative terms, however, U.S. stocks have held up well despite the nasty headlines. It is likely, in our opinion, that analogous to 1984 and 1994, the markets will trade sideways despite a strong economy, strong corporate earnings and low inflation. History has also shown that it is rare for the market to make much progress during the summer months of a mid-term election years. Despite earnings growth of nearly 25% in the first quarter, the S&P is only up about 2% YTD. There have been net outflows from domestic equity mutual funds and ETFs thus far in 2018, and common measures of sentiment indicate a broad-based caution on the part of investors. Trends in earnings and economic growth appear robust and inflation remains tame enough, in our view, that the Fed has room to raise interest rates very moderately. Therefore, the greatest risks to the market are, in our opinion, the fiscal health of the country and the prospects for free trade. While both are liabilities, they appear to be manageable. The President's style of communication can be disconcerting, but the headline risk is likely to be greater than any lasting risk to the economy in our view. Furthermore, the recent stability in long-term interest rates would suggest that the markets are not overly-concerned about the country's fiscal health.

Fixed-Income Market Developments

In corporate bonds we expect some volatility in the near term, but not a significant movement overall. In this scenario, we recommend to diversify credit risk and take a balanced approach in a mix of short term bonds, and for yield in fixed/floating rate investment grade bonds of undervalued sectors like banks, insurance companies and specialty finance firms which have increased their capital cushions and are more limited in their activities thanks to tighter regulation since the financial crisis, both of which are good developments for bond holders. Floating rate notes and laddered short term corporate bonds are also an option, as well as short-term municipal bonds for U.S. residents. The goal in this environment is to maintain capital and generate some interest income.

The Economy

The U.S. economy is operating at full throttle heading into the second half of 2018. Tightening labor conditions are supporting consumer spending, and business capacity constraints necessitate increased capital spending. Fiscal tailwinds, like tax cuts, could accelerate real GDP growth sufficiently and provide a buffer to offset some of the headwinds from escalating trade tensions. Tariff measures to date are likely to impact GDP growth by about one-tenth of a percentage point, which will hardly be noticeable as the economy approaches 3% growth. However, as trade partners attempt to maximize the impact of their counter measures, or if tariffs spread to a much broader spectrum of goods, as the latest rhetoric threatens, economic optimism would be dampened incurring more widespread consequences.

Federal Reserve Policy

The Fed is responding cautiously to accelerating growth and an unemployment rate of 3.8%. It increased interest rates by another 0.25% to 2% in June and projected two more rate increases for 2018 and three for 2019 in order to reach its neutral target rate of 2.9%, which would be consistent with full employment, trend in growth, and stable prices. Until this neutral rate is reached, monetary policy can be considered accommodative, a policy that should continue to support equity markets. The Fed wants to avoid a too restrictive monetary policy so that potential benefits from the tax reform will not be diluted. The yield curve is flattening instead of steepening, influenced by technical factors such as the increased issuance of treasury-bills covering short-term funding needs by the government. If the yield curve does not steepen by itself, or trade tensions become a threat to the economy, the Fed will need to slow down its pace of interest rate increases as an inversion of the yield curves historically indicates an impeding recession. With both monetary and fiscal policy supporting faster growth, the biggest risk remains increasing trade tensions.

TN-Outlook

In addition to robust earnings, talks of a second round of a U.S. tax reform, ahead of the midterm elections, could lend support to the equity markets this summer. Areas of focus are likely to include clarifications to capital expenses and lower capital gains and dividend tax rates, which is essentially a break for higher-income and wealthier individuals (60% of households with $ 500,000 in net worth own stocks and bonds). Two significant sets of changes to the accounting of depreciable assets in the tax code may lead to a further acceleration in capital spending and draw steadier investment in the U.S. if made permanent. Tax reform is likely to play a role in the turnaround of S&P 500 capital spending which is supposed to recover to double-digit growth after declining 1% through the end of 2017. Rising corporate earnings in the U.S. and slowing global growth explain the recent rotation out of other markets into the U.S. Furthermore, the U.S. interest rate premiums in comparison to other currencies, in particular the Euro, continue to grow as the ECB, for example, is not likely to raise interest rates until Q4 of 2019, whereas the Federal Reserve Bank is likely to have raised rates a few times by then. This will bode well for the Dollar as investments are likely to continue to be redirected into the dollar. Energy (1), Real estate (2), Consumer discretionary (3) took the lead in Q2 followed by Technology, Utilities and Healthcare. Since the beginning of the year, however, Technology and Consumer Discretionary still have the lead with +10% performance. We continue to believe that trade tensions will not get out of hand. Corporate earnings and the positive effects of the tax reform are likely to continue to support the stock market.

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We will continue to stay our course but we are acutely aware of developments and will act accordingly.

Your dedicated Terra Nova Team!

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