INFLATION IN THE WIND

Market Review JULY 2018

The US economic cycle is heating up and so is summer uncertainty. The Federal Reserve Bank (Fed) has been primarily focused on containing inflation, but now they may have to get ahead of it. Manufacturing and industrial data coming out of various Fed districts are all pointing to the same general theme. Manufacturers are facing increased costs for inputs and they are experiencing significant capacity constraints. The net effect will be higher prices for finished goods.

March's tariffs on primary metals are believed to be one reason for rising input prices. As a result, durable goods sales have been on a steady decline since peaking last March when the tariffs on steel and aluminum went into place. On the flip-side, imports are now steadily declining since the tariffs. That has helped lower the consumer trade gap, which is seen as a positive for second-quarter output growth. However, a lot still rides on consumer spending trends, since consumption represents over two-thirds of US growth.

Unfortunately, the latest consumer spending report turned up another soft consumption figure, contrary to what the Fed was inclined to believe at their last FOMC meeting in June where they raised the key interest rate another twenty-five basis points. Additionally, construction spending has cooled despite data supporting more new housing starts. Home builders are said to be challenged by labor and equipment shortages as they encounter their own capacity constraints.

Second-quarter economic growth was expected to be rosy, possibly coming in between 3% to 5%. However, based on the latest data and economic frictions, consumption and residential expenditure may actually drag second-quarter growth below the most optimistic scenario. In fact, first-quarter was recently notched back down to 2% in June.

Rising oil prices and tariffs as well as a tight labor market are perpetuating several economic complications. Prices should only continue to gain momentum. The price of West Texas Intermediate oil has already surged 23% this year. Price acceleration recently showed up in the personal consumption expenditure (PCE) index, which is the Fed's preferred inflation index.

The core PCE, which strips out food and energy prices, reached 2% in May's report after two gradual increases in the prior two months' reports. The 2% milestone is significant, because that is the Fed's preferred benchmark for inflation in a healthy economy. Anything above and beyond 2% may show that the Fed was actually behind the policy curve for containing inflation. Adding back in the effects for food and energy reveals that prices on personal consumption have risen 2.3% in one year's time.

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Inflationary data is certainly starting to catch up to annual wage growth trends. Currently, average hourly earnings are growing at about a 2.5% annual rate. Should inflation catch wages and pass them, households could see their net-worth diminish. That would force labor market participants to ask for raises, which would increase the cost of business and cause some businesses to scale back.

Today's US government bond rates certainly have something to say about the existing cycle. Two-year borrowing costs on government debt have risen steadily as one might expect in an environment of Fed tightening and rising prices. The two-year yield now trades around 2.5%. The ten-year yield on US debt, however, sunk back down from a mid-May high of 3.1% to about 2.85%. The difference between the ten-year and two-year yield has gotten narrower.

Government yields provide a window into short-term expectations versus long-term expectations. The short-yield communicates an expanding economy that may actually start to overutilize resources. Remember what the Fed manufacturing district reports are saying. Longer yields are indicating less robustness, hence, the flattening of the yield-curve.

Still, financial markets are hanging in there, especially the US stock market. US trade and international policy certainly appears to be helping US stocks at the detriment of international stocks. Tariffs may actually end up as a positive for US small business, which could be currently reflected in the existing performance of US small capitalization stocks.

Market Movers

The economic and financial market cycle is certainly becoming more dynamic. In prior years, investors had the luxury of rising asset prices across a wide array of asset classes brought on by quantitative easing. Now, things are changing and the call to active management is intensifying. Undoubtedly, US trade policy and a new interest rate environment is changing the ebb and flow of capital. So far, the beneficiaries are businesses operating inside domestic borders. This cannot be said of international business, possibly because of a stronger US dollar or trade concerns. The Core Allocation portfolios continue to show strength against their respective benchmarks: the Morningstar's World Allocation and Tactical Allocation category averages.

Asset Categories	*Monthly*	*YTD*
US STOCKS	0.52%	2.93%
FOREIGN STOCKS	-2.63%	-4.22%
US BONDS	0.03%	-0.54%
FOREIGN BONDS	-1.06%	-3.37%
HARD ASSETS	1.02%	2.68%
HYBRIDS	0.19%	1.55%

*DATA USED IS SOURCED FROM MORNINGSTAR®, DATE ENDING JUNE 30, 2018.

US STOCKS made it out of the month of June with positive gains. Technology stocks have held indexes up this year and are a dominant foe for competing categories of stocks. Small Cap stocks have lead US stock market performance this year. Our elevated allocations to smaller companies has strengthened the returns in our Core Allocation portfolios.

FOREIGN STOCK momentum is diminishing, especially emerging market stocks. Total returns of emerging market stocks are down nearly 7% this year and are teetering between a correction and outright bear market depending on the index. Developed foreign stocks are not as badly bruised but bruised nonetheless. The category's total returns have fallen over 3% for the year. International trade fears are most likely taking a bite out of international stock ownership.

US BONDS are a mixed bag this year. A few US bond markets bounced back last month narrowing earlier annual losses. The US bond market is sending some interesting signals. The US treasury category is down slightly this year on what was expected to be a year of bigger losses. US corporate bonds have pulled back further. Regardless, our bond allocation has been resilient due to the bond sector diversification that we employ.

FOREIGN BONDS are falling out of season just like their equity counterparts, although developed foreign bond markets have pulled back from deeper losses earlier in the year. The world bond category has only fallen roughly 1.5% this year. The emerging market bond category has suffered the greatest annual loss. We have minimized the foreign bond allocations in our Core Allocation portfolios which has benefited our investors.

HARD ASSETS are another mixed bag this year. The month of June was favorable for hard assets; except for precious metals. Energy has made its return in the cycle. After a few years of dormancy, it has broken out and become this year's best-performing asset class. The energy category has put up annual gains of approximately 14%. Precious metals have fallen to annual losses of over 4%. This evidences the powerful diversification benefits provided by hard assets, which is welcome in the current market environment.

HYBRIDS still remain one of most robust asset classes, neither too hot nor too cold. Most interesting is the consistent performance of convertible bonds. Total returns of convertible bonds are up over 4% this year. Total returns of preferred stock have fallen slightly. Still, the category of hybrids remains healthy and an important component of the Core Allocation portfolios.