Second Quarter Recap:

As we pause to reflect at the midpoint of the year, it seems so far 2018 has served as yet another reminder to investors that over the short term, markets are driven by innumerable and often random factors that are impossible to consistently predict. In the first quarter, US stocks experienced their first “correction” since 2016 and a return to more “normal” market volatility. Many market prognosticators speculated that this could indeed be the end of the nearly decade-long US bull market.

Fast-forward through three more eventful months and this time around US stocks have been the net beneficiaries, gaining several percent while foreign stock returns for dollar-based investors were hurt by an appreciating US dollar. Developed international stocks fell slightly, with emerging-market stocks faring the worst among non-U.S. equities.

Investment-grade bonds declined, hurt by rising U.S. interest rates and signs of higher inflation. In April and May, the yield on the benchmark 10-year U.S. Treasury note rose above the psychologically important 3% threshold before settling slightly lower to end the quarter.

Asset Class	*2Q*	*1 Year*	*5 Years (Ann.)*
U.S. Large-Cap	*3.40%*	*14.22%*	*13.26%*
U.S. Large Growth	*5.67%*	*22.29%*	*16.18%*
U.S. Large Value	*1.18%*	*6.63%*	*10.15%*
U.S. Small Blend	*7.86%*	*17.72%*	*12.60%*
Developed Int'l Stocks	*-1.84%*	*6.97%*	*6.90%*
Emerging-Markets Stocks	*-9.60%*	*5.94%*	*4.34%*
REITs	*8.78%*	*2.13%*	*7.77%*
Investment-Grade Bonds	*-0.20%*	*-0.62%*	*2.09%*
Municipal Bonds	*0.87%*	*1.56%*	*3.33%*
High-Yield Bonds	*1.00%*	*2.53%*	*5.51%*
Global Bonds	*-3.35%*	*1.90%*	*1.10%*

Source: Morningstar Direct as of 6/30/2018

U.S. Markets:

US stocks rose to the top of asset class performance charts with solid returns in the second quarter. Larger-cap US stocks gained 3.4%, but were outdone by smaller-cap stocks, which jumped 7.9%. The smaller-cap outperformance was driven by the market narrative du jour that smaller companies are more domestically focused and therefore not as exposed to a strengthening US dollar or potential trade wars, both of which are assumed to be detrimental to larger-cap (multinational) company profits.

Foreign Markets:

Developed international stocks fell 1.8% and European stocks declined 1.6% for the period. Emerging-market stocks fared the worst, dropping 9.6% in dollar terms. The global stock index, which combines US, international, and emerging stock markets, gained just 0.3% for the quarter and is slightly negative for the year.

In addition to the currency effects, EM stocks were buffeted by on-again, off-again (and back on-again) trade tensions between the United States and Europe, Mexico, Canada, Japan, and China—in other words, all its major trading partners. Fears of a trade war with China and the European Union escalated into quarter-end, with the entities engaged in vigorous trading of threats and counter-threats.

Fixed Income Markets:

Moving on to the bond markets, in May, the benchmark 10-year Treasury yield pierced the 3% level, hitting a seven-year high. Yields then fell back, ending the quarter at 2.85%, an 11-basis-point increase from the prior quarter-end. As such, the core bond index had a slightly negative return (note that bond yields and bond prices move inversely to each other). For the year, the Barclays US Aggregate Core Bond Index is down roughly 2%, with returns modestly negative over 12 months. Three year returns remain in positive territory.

While many factors impact bond yields on a day-to-day basis, a primary underlying driver is Federal Reserve monetary policy (and the market’s expectations about such). Fed policy in turn is driven by the Fed’s assessment of the US economy, and specifically its twin objectives (“dual mandate”) of price stability and full employment. To this end, with the economy growing above trend and the labor market tight—the unemployment rate fell to an 18-year low in May—the Fed continued its gradual path of tightening monetary policy. In June, as expected, it hiked the federal funds policy rate another 25 basis points to a range of 1.75%–2%. It also forecasted a slightly accelerated path of hikes over the next two years, which, if it comes to pass, would bring the fed funds rate to a range of 3%–3.25% by the end of 2019. Whether the economy can withstand that degree of tightening remains to be seen.

Looking Forward:

Our clients know we don't invest based on three-month time horizons or short-term expected outcomes. To the contrary, we strongly believe that a critical element of our investment process and edge is our discipline to maintain a longer-term perspective while other market participants over-react to short-term performance swings, daily news flow, and other emotional/behavioral triggers. We try to minimize the harmful impact of "myopic loss aversion" on our investment decision-making that can come from paying too much attention to short-term results. That said, it is helpful to understand how macro trends impact portfolio performance in the shorter-term, so we'll highlight several pertinent themes in play.

It is understandable that fears of a global trade war are rattling financial markets. Any resolution of the current trade tensions is a meaningful uncertainty—our relationship with China being the most fraught—with the potential to seriously disrupt the global economy at least over the shorter to medium term. (The potential for a positive surprise seems more limited, but also exists). President Trump's unconventional negotiating approach adds an additional wildcard dimension. The process is likely prone to several more twists and turns before things become any clearer.

Our view on the matter, however, remains broadly the same. It is in the best interest of both the United States and China to negotiate a resolution and prevent trade skirmishes from becoming an all-out trade war. However, the potential for a severely negative shorter-term shock to the global economy and risk assets (not just emerging markets) can't be dismissed. Even absent an actual trade war, the negative impact on business and consumer confidence from the uncertainty and fear of a trade war is a risk to the remaining longevity and strength of the current economic cycle.

The recent dollar-strength trend may also continue for a while. But there are reasons to expect the dollar may weaken looking further out: the prospect of a ballooning US federal budget deficit in the coming years, a large trade deficit, and the eventual convergence of central bank monetary policies—as other central banks start to raise interest rates, thereby shrinking the yield gap versus the United States.

Big Picture Focus:

There are always risks and uncertainties associated with investing that have the potential to cause significant shorter-term price declines. Whether it is a trade war, a geopolitical event, an unexpected economic shock, a monetary policy mistake, or innumerable other factors, stocks can deliver big losses, at least over shorter-term periods. Market corrections and bear markets happen. An investor must be able to withstand these drops, stay the course, and stick to their long-term planning objectives. Should a bear market strike, our portfolios have "dry powder" in the form of lower-risk fixed-income and alternative investments that should hold up much better than equities. We'd then expect to put this capital to work more aggressively by, for example, reallocating to US equities at lower prices and higher expected returns sufficient to compensate us for their risks.

In sum, this quarter's equity returns felt fairly similar to the past few years. Domestic stocks led the way, international stocks lagged, but overall things generally ticked up. This is yet another example of a time when it feels hard to be well diversified, including owning international stocks. In the short-term, there may be an asset class in our portfolios that we wished we didn't own, which may seem easy to identify in hindsight. In real life we can't predict where markets will move next, so we'll stick to our boring, methodical approach of diversifying across asset classes knowing this process works in our favor over the long haul. We will continue to direct the majority of our energy and attention towards what truly matters, including aligning clients' portfolios with their most important long-term goals, risk tolerance, and cash flow situations.

As always, we appreciate your confidence and welcome questions about your individual portfolio or financial situation.

-We thank you for your continued support!