ICR® 2nd Quarter Newsletter – July 2018

U.S. stocks bounced around during the second quarter, but ultimately the S&P 500 finished up 2.9%, bolstered by strong economic conditions. Small cap stocks (+7.4%) performed well as they are less exposed to the risks presented by the ongoing trade war. A surge in oil prices led energy (+13.5%) to be the best-performing sector in the quarter. A flattening yield curve and trade war tensions, respectively, caused financials (-3.2%) and industrials (-3.2%) to post second quarter losses.

After declining at the beginning of the year, the U.S. dollar staged a sharp comeback in the second quarter which held back the performance of foreign stocks. The MSCI EAFE foreign stock index posted a 2.3% gain in local currency terms, but once converted into U.S. dollars, actually declined by 2.3%. Similarly, over half of the 8.7% decline in the MSCI Emerging Markets index was attributable to currency fluctuations.

The ten-year treasury yield rose sharply during the first half of the quarter from 2.74% to 3.11%, but then moderated and finished at 2.86%. The most interesting story in the bond market is the yield curve, where we are seeing a rapidly narrowing difference between the yields on 2-year and 10-year treasury bonds. Normally, the interest rate is higher for longer-term bonds because investors demand more return for a longer-term investment. However, sometimes shorter-term bonds can yield more than longer-term bonds, resulting in an inverted yield curve. That hasn't quite happened yet, but it's getting close and the spread recently dipped as low as 0.24%.

Why does that matter? Historically, an inverted yield curve has been a fairly reliable leading indicator of recessions. It hasn't been completely accurate, and it doesn't tell us much about the depth or nature of a potential recession, but it's certainly worth watching. If the Federal Reserve continues to raise short-term rates, and longer-term rates don't follow suit, we may see an inverted yield curve in the coming months.

Whether the Fed should continue its planned rate hiking path is subject to debate. In recent days, President Trump has questioned the logic of raising rates, suggesting that it could hurt the economy, which has recovered slowly but surely since the Great Recession of 2007-2009. Indeed, one of the Fed's goals is to prevent the economy from being *too* strong and potentially overheating, which could lead to excessive inflation and a painful recession.

Following the Great Recession, in the absence of adequate fiscal stimulus, the Fed took unprecedented steps to help the struggling economy, lowering short-term rates to near zero and expanding its balance sheet from $900 billion to $4.5 trillion by purchasing bonds. All of the cheap money that flooded the system was a boon for financial assets (stocks, bonds, etc.), but didn't have nearly such a positive impact on the real economy (wages, GDP, etc.).

With the Fed and other central banks now reversing course and unwinding their monetary stimulus, governments around the world are taking action to replace that with fiscal stimulus, not only to stimulate growth, but also to appease the public which (perhaps rightly) believes that most of the benefits of monetary policy have gone to the wealthy. In the passing of the stimulus baton, governments are focusing on fiscal policy that can increase GDP, provide jobs, and grow wages for their citizens. This is a unique situation in that the U.S. is nine years deep into an economic expansion, albeit a modest one. Historically, fiscal stimulus has been enacted during recessions or very early in expansions to help a struggling economy. Now, we are seeing the government take on massive amounts of debt in an attempt to extend or perhaps increase the trajectory of this expansion.

The wrinkle in all of this is the ongoing trade tensions between the U.S. and the rest of the world – primarily China. So far, the amounts of the tariffs are small relative to the size of the countries' economies. President Trump has indicated a willingness to place tariffs on all $500 billion of Chinese imports to the U.S., which would still "only" amount to about 3.5% of China's total economy. Thus far, the markets have mostly shrugged off this trade war as a negotiating tactic by the President, but the lessons of the past should not be forgotten. A wave of protectionism in the 1930s shrank global trade and likely exacerbated the Great Depression. While we are nowhere near that type of threat yet, it is important to recognize the road we could be taking.

Investment Implications

A shift toward fiscal stimulus could favor assets with greater linkages to the real economy, rather than just the financial economy. If global governments are successful in growing their economies through fiscal policy, we would expect inflation to pick up around the world. Increased inflation could present new opportunities in certain asset classes that benefit from it. The ongoing trade war merits caution with respect to a number of potential investments. Notably, it gives any nation on the wrong end of tariffs every reason to continue weakening their currency. If this trend endures, the dollar may strengthen even more, reducing dollar-adjusted returns of foreign investments, as happened this past quarter. This could also have a negative impact on multinational U.S. companies whose products would become even more expensive to foreign customers.

As usual, the current environment presents a number of challenges, many of which haven't been seen in decades (rising interest rates, for example). As the investment environment changes, our goal and process remain the same. We seek to protect and prudently grow your hard-earned wealth by taking advantage of evolving opportunities that offer reasonable reward without undue risk. Thank you for your confidence and support, and we look forward to discussing any questions or concerns you may have.

Sincerely,

James A. Heine   James L. Cobb

Market Report (as of 6/30/18)

Index	**2018 YTD (%)**	**3-Year Annualized (%)**	**5-Year Annualized (%)**
S&P 500	1.67	9.63	11.10
Dow Jones Industrial Average	-1.81	11.27	10.24
U.S. Aggregate Bond Index	-1.62	1.72	2.27
MSCI EAFE (Foreign Index)	-4.49	2.06	3.63

Disclaimer: The views expressed herein are those of ICR as of July 15, 2018 and are subject to change at any time based on market and other conditions. This is not a recommendation or solicitation for the purchase or sale of any security and should not be construed as such.