VERITAS
INVESTMENT & WEALTH ADVISORY

Second Quarter Market Review and Comment
July 2018

Updated Market Performance

Returns	2nd Quarter 2018	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**3.43%**	**14.37%**	**11.93%**	**13.42%**	**10.17%**
DJIA	**1.26%**	**16.31%**	**14.07%**	**12.96%**	**10.78%**

Performance: Stocks rebounded after the first negative quarter in the last 10 quarters.

After negative returns in the first quarter 2018, the S&P 500 (SP500) posted a solid 3.43% return in the quarter that just ended on June 30, 2018. The Dow Jones Industrial Average (DJIA) trailed, posting 1.26% over the same period. For the previous twelve months the SP500 has returned 14.37%, underperforming the DJIA which returned 16.31% over the same period. The annualized three-year returns are still strong, with the SP500 posting 11.93%, while the DJIA is running at 14.07%. Over the last five years the annualized returns continue to run ahead of historical norms, with the SP500 returning 13.42% and the DJIA posting 12.96%. The ten-year annualized numbers are running a little above long-term averages (around 10.00%); the S&P500 posted 10.17% vs the DJIA which turned in 10.78%.

Breaking down the returns for the second quarter 2018, we note that there were four outperforming sectors and seven underperformers. ***The best sectors were Energy (12.69%), Consumer Discretionary (7.84%) and Information Technology (6.75%)***. ***The big losers during the quarter were Industrials (-3.66%), Financials (-3.58%) and Telecom Services (-2.33%).*** Over the past year the growth sectors except for energy have dominated their value counterparts. The clear winners the last twelve months were Technology (29.60%), Consumer Discretionary (21.87%) and Energy (17.50%). Bringing up the rear were Consumer Staples (-6.66%), Telecom Services (-3.84%) and Utilities (-0.18%). We note that only three sectors (Information Technology, Consumer Discretionary, and Energy) were above the SP500 average for the year, so the advance has been narrow with the majority of the returns for the SP500 coming from a handful of stocks.

The DJIA managed to eke out a meager gain in the second quarter. However, escalating trade tensions have punished the blue-chip index more than its peers and left it vulnerable to further volatility. More than half of the 30 Dow components get 50% or more of their revenue from outside the U.S., according to FactSet. The SP500 by comparison derives 38% of revenue from outside the U.S.

Economy: U.S. growth in the first quarter slowed more than estimated, weighed down by the lowest consumer spending in nearly 5 years, but is projected to recover in the second quarter.

The third estimate of first quarter Gross Domestic Product (GDP) is 2.0% according to the report released at the end of June by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the first quarter decelerated by ~1% compared to the fourth quarter 2017 when GDP was running at a rate of 2.9%. Overall, the economic recovery has continued into 2018

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following growth of 2.3% in 2017 and 1.5% in 2016. The long slow recovery which has been in place since mid-2009 should continue for the foreseeable future. By comparison, China says their GDP grew at 6.7% in the second quarter of 2018. China's economy has clung to the lower end of its growth range (6.7%-6.9%) over the last three years. Slowing to 6.7% for the second quarter as exporters braced for bruises as the government's efforts to tackle debt risks crimped economic activity and a trade war with the United States threatens exports. Growth rates for the European Union (EU) and the Euro area beat expectations in 2017 to reach a 10-year high of 2.4%. Growth is set to remain strong in 2018 and ease only slightly in 2019, with growth of 2.3% and 2.0% respectively in both the EU and the Euro area.

Unemployment continues to stay around historical lows. According to the Bureau of Labor Statistics, June unemployment rose 0.2% to 4.0% from 3.8% in May, the last time the unemployment rate maintained an average of 4.0% or lower was in the 1960s. Job growth occurred from professional and business services, manufacturing, and health care, while retail trade lost jobs.

Inflation increased in the second quarter. After averaging 2.2% in the first quarter, inflation as measured by the Consumer Price Index (CPI) increased to an average of 2.7% in the second quarter. The average rate of inflation for 2017 was 2.1% and continues to be subdued by historical standards (2.64% over last 30 years).

Consumer spending continues to be an important driver of the economy in June. The U.S. Census Bureau announced earlier this month that retail sales for June 2018 were up 0.3% compared to May but were up 6.4% above June of 2017. Gasoline stations were up 21.6% from June 2017, while Non-store Retailers were up 10.2% from last year.

Manufacturing economy had strong growth in manufacturing for the 22nd consecutive month. Economic activity in the **manufacturing sector** grew for the twenty second consecutive month in June, with the Purchasing Managers Index (PMI®) registering 60.2 compared with May's reading of 58.7. This was led by a continued expansion in new orders, production, and employment. However, inventories continue to struggle to maintain expansion levels as a result of supplier deliveries slowing further. Still, the **overall economy** grew for the 110th consecutive month, according to the nation's supply executives in the latest **Manufacturing ISM®** *Report on Business®*.

Home prices continue to rise. According to the S&P Case-Shiller Home Price Indices home prices continued their climb in April with the S&P CoreLogic Case-Shiller National Home Price Index rising 6.4% over the last 12 months. Cities west of the Rocky Mountains lead price increases with Seattle, Las Vegas, and San Francisco having the largest price increases. The favorable economy and moderate mortgage rates have supported recent gains in housing. There continues to be a low supply of homes for sale which is another factor that is leading to rising prices as demand continues to outweigh supply.

Markets: 1, 2, 3, 4, I declare a thumb (trade) war.

- ***Earnings are expected to come in strong for the second quarter.*** According to FACTSET, of the 23 SP500 companies that have reported earnings as of 12 July, 89% reported earnings above the mean estimate and 85% have reported sales above the mean estimate. The blended earnings growth rate for the fourth quarter is 19.9% so far, it will mark the second highest earnings growth since Q3 2010 (34.1) if the current momentum continues. ***Earnings guidance, however, has been negative, with 62 companies issuing negative EPS (Earnings per Share) guidance and 47 issuing positive EPS guidance***. Currently the negative guidance has been attributed more to negative currency translation (Stronger $) as opposed to the negative impact from tariffs.

- ***Stocks are fairly valued.*** The current 12-month forward Price Earnings (PE) multiple on stocks is 16.6. The long term (20 Year Average) PE for stocks is 16.2, so we still do not see much evidence of a bubble in stock prices, but we also do not see compelling values either. Bears will make much over the fact that current forward PE's are above the 10-year (14.4) average. However, the ten-year numbers include those years 2008-2012 when PE's were abnormally depressed after the Financial Crisis and during the Great Recession. With little room for PE expansion, we will need an increase in earnings to sustain the continued bull market.

- ***Global Trade Tensions.*** Trade tensions continue to increase, the thumb war like shots across the border have not only been between China, but have expanded to other trade partners, Canada, Mexico, and Europe just to name a few, which has led to a cloud of uncertainty in the market. With new tariffs in the news daily, the likelihood of real measurable impacts on U.S. businesses from domestic trade tariffs and retaliatory measures increase.
- ***Corporate Revenue and Earnings Growth are Surging.*** Second quarter earnings are expected to increase 22.0% from the same period in 2017. The second quarter 2018 revenue growth estimate is 8.3%. As of July 20th, 73.6% of companies have reported second quarter revenue above analyst expectations, which is above the long-term average of 60%.
- ***Rising Interest Rates.*** The Federal Reserve raised the target range for the federal funds rate by a quarter of a percentage point to a range of between 1.75% and 2% during its June meeting. The increase predicated by the continued strength of the labor market and economic activity. Policymakers projected two additional hikes by the end of this year, compared to the one estimated previously. Fed officials have committed to gradually raising rates but noted that uncertainty and risks associated with trade policy have intensified, which could eventually have negative effects on business sentiment and investment spending. Trump has begun expressing his opinion to the Federal Reserve by telling the fed he is "not thrilled" with them for raising interest rates.

Forecast: Subdued first half of 2018 followed by a more robust second half, made possible by a pickup in global growth, an increase in EPS growth mainly attributable to the administration's recent tax cuts only to be spoiled by protectionism, the Fed or both.

Pick up in global growth, low unemployment, and low inflation. Lower corporate tax rates are now starting to add to growth meaningfully as spending has picked up. This pick up in consumption should lead to a better than average 4.0% growth rate for the second quarter. However, as fiscal stimulus goes into the rearview mirror, interest rates continue to rise, and tariffs begin to make their impact, growth will begin to moderate. Unemployment has reached lows not seen since 2000. Inflation continues to run below average compared to the past.

Earnings Growth. This is what is needed to get the market out of its current trading range. Ever since the correction in late January early February the market has been rangebound. Strong second half earnings and revenue growth should be enough to propel the market through resistance and out of this range.

What risks are out there that might disrupt a robust second half of 2018?

- ***Downward earnings revisions and negative earnings surprises***. There is already an increase of downward earnings revisions from SP 500 companies for their next earnings report. If earnings come in worse than expected, stocks will be sent reeling. Valuations are already "feeling" high to many investors, weak earnings on top of that would likely give them the excuse to sell. The probability of this scenario is low but could increase if we continue to see an increase in negative earnings revisions.

- ***Continued Fed Tightening***. Given the recent increase in the dollar, low inflation, low unemployment and average economic growth, we think the risk of rate increases by the Fed are high. The fed has raised rates twice so far this year and unless we see some meaningful increase in inflation we should only have one more .25% increase the rest of 2018. Nine of the last eleven recessions have occurred during a rising interest rate environment when short term rates were higher than long term rates (Inverted Yield Curve), which leads to our ongoing concern of the Fed raising rates too fast.

- ***Global trade war.*** A trade war will hold back business and consumer animal spirits. (***Animal Spirits*** is a term used by the famous British economist, John Maynard Keynes, to explain financial and buying decisions in conditions of uncertainty. In Keynes' 1936 publication, The General Theory of Employment, Interest and Money animal spirits describe the human emotion that drives consumer confidence.)

We think the biggest threat to the stock market is the uncertainty presented by the current trade negotiations. This uncertainty will persist until there is clarity over what potential retaliatory tariffs might be and what the final resolution will be on the trade front. The market is fragile right now since volumes are light due to seasonality. It would not take much pessimism to break the market out of its trading range to the downside. We believe the third quarter will be flat to up 2.0% and rally in the fourth quarter to close the year. The SP500 ended the second quarter at 2,718 and is up 3.43% including dividends year to date. We think the SP500 will end the third quarter between 2,700 and 2,772. At this juncture, we venture a guess that stocks will end up somewhere between 8.0%-10.0% for the year.

For the next six months, the Federal Funds rate should remain near 2.0%-2.25%. ***The 10-year Treasury which is currently priced at 2.9% may see even 3.25 before the end of the third quarter.*** By year end we should see the rate between 3.25%-3.50% assuming the Fed raises short-term rates by year end.

We appreciate your continuing confidence in our firm. Please let us know if you have questions.

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