JULY 2018 | Woodmont Market Commentary

2Q 2018: Full of Surprises, Even After All of These Years

This week our nation celebrates 242 years since our Declaration of Independence. We've been rather radical from the start, establishing rule by elected officials versus the aristocratic and wealthy, and thinking that thirteen still disparate colonies could defeat the British army. Many years later, although our representative democracy experiment now stands as a model for the world, we are still a nation and people full of surprises. The first half of 2018 is proof yet again of this unconventionality. After all, who was expecting a Presidential summit with North Korea, many Republicans defending the economic utility of trade tariffs, some Democrats criticizing them for it, and a twenty-eight year-old Democratic Socialist spending under $200,000 to unseat a high-profile, ten-term Congressional incumbent?

The numerous policy and political curveballs of 2018 have awakened most investors from the atypical, albeit rewarding, low-volatility market slumber of 2017. While the increasingly tech-heavy S&P 500 and NASDAQ posted first-half gains of 3% and 9%, many dividend-centric, historically defensive, and global trade dependent stock sectors are down 5% to 10%. Seven of the thirty Dow Jones components are down 13% or more year-to-date. The count climbs to eight if we include recently dropped Dow component, GE, which was dismissed after 111 years in the index.

The performance picture is even worse looking outside the U.S. International stocks as measured by the MSCI Ex-U.S. stock index were down 4% in the first half of 2018. Emerging markets declined 7%. Following a big year of gains in 2017, threats of a trade war, governmental funding concerns, and weakening currencies have pushed emerging markets closer to bear-market territory, now off 15% from their January highs.

Higher interest rates in the U.S. didn't help international markets either. The increased yields drew money out of overseas markets, which contributed to a stronger dollar. Higher interest rates also meant that a long running bond portfolio tailwind turned into a headwind, evidenced by the Barclays Intermediate Aggregate Bond Index declining 2% in the first half. With a slightly longer duration profile, the investment grade corporate bond index was down 5%.

> **"I must study politics and war that my sons may have liberty to study mathematics and philosophy."** –*John Adams*

As part of this market commentary, we will provide an updated view on equity and fixed-income markets and address some of the topics investors are focused upon heading into the second half of 2018. We will also consider our increasing national debt. The issue could receive more attention from investors in future quarters, particularly as trade negotiations take place with some of the largest purchasers of U.S. debt. And, after all, it is the week of the 4th of July–a time when many reflect on the health of our nation, as well as celebrate our liberty and the wisdom of our Founders.

While not without their failings, our Founders' vision, desire for something bigger than themselves, and the bravery required to pursue freedom knowing failure meant death, are certainly worth celebrating. The fact that we continue to celebrate these ideals, regardless of which side of the political aisle we sit, is another reminder that we're still rather radical and have much for which to be thankful.

Tough Trade Negotiations, or a New Approach to Trade?

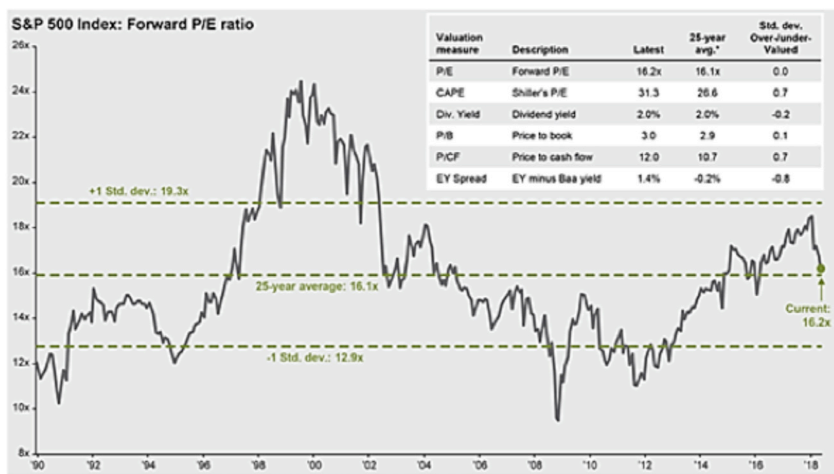
The markets' first concern upon President Trump's election was trade. Fears of an anti-trade agenda were calmed when President Trump's cabinet included a number of high-profile free-trade proponents. Cabinet members and senior advisors have since come and gone. As a result, the trade agenda, and some of the administration's actions such as the tariffs on steel and certain goods from China, have taken on a more protectionist tone. Heading into the second half of 2018, the range of outcomes for a number of high profile and ongoing trade negotiations is rather remarkable. For instance, on July 6th tariffs covering $34 billion of Chinese goods are set to take effect with additional threats looming for a combined $450 billion of goods.

Fair trade and protection of our nation's intellectual property are worthy pursuits. It is clear, however, that the market is concerned about new trade policies that would restrict the international flow of goods and services. We can see this in the markets' reactions depending upon the headlines and which Presidential advisor is viewed as having the upper hand influencing trade policy. We can also see this concern at the company-specific level. Approximately 40% of S&P 500 sales are to overseas buyers. And the $375 billion trade deficit with China? It certainly doesn't sound good, but many insist it is the wrong metric on which to focus. For instance, over half of the trade gap is related to computers, electronics, and apparel, in which American companies often outsource production of goods to China only to then "import" those same American products back to the U.S.

Trade policy is complicated, especially in a world economy that grows more intertwined every year. Needless to say, negotiating trade is also a high stakes issue with significant economic and employment ramifications. One only need to mention the Smoot-Hawley Tariff Act in support of that conclusion. As a result, we expect markets will remain focused on whether these initial tariffs are part of the negotiation or representative of a new and more restrictive vision for trade that could lead to an all-out trade war. If the latter, we would expect a negative market reaction.

U.S. Corporate Tax Savings and Accelerating Economic Growth = Increased Earnings and Cheaper Stocks

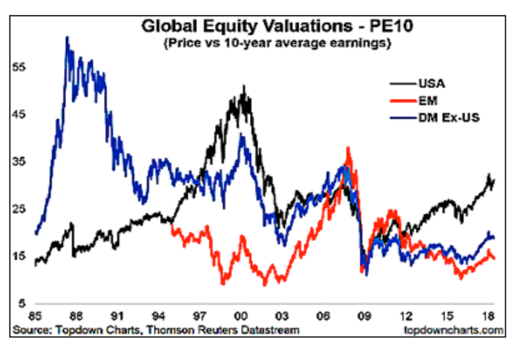
Beginning in 2017, markets rallied in response to the passage of legislation to lower the U.S. corporate tax rate from 35% to 21%. Now that companies are reporting 2018 results, we are seeing the tax rate change come through in the form of increased earnings. For the first half of 2018, S&P 500 earnings are expected to grow over 20%. While earnings growth is expected to moderate to 10% growth in 2019, the S&P now trades at 16X forward estimates, or approximately in-line with their 25-year averages.



Source: *FactSet & JP Morgan*

Economic growth has accelerated as well. Economists differ on whether this accelerating economic growth is a function of a long overdue cyclical bounce, tax cuts, increased business and consumer confidence, or other stimulus measures. Jamie Dimon, CEO of JPMorgan, who has an interesting perspective from his banking seat, calls the cuts "historic" and a key to driving higher wages and improving American companies' global competitiveness. Whatever the reasons, this improved forecast for earnings means stocks appear cheaper.

Shop for Stocks at Home or Abroad? Both!



After strong outperformance in 2017, international developed and emerging markets have trailed in 2018. Higher interest rates in the U.S., a stronger dollar, and legitimate concerns for the fiscal health of many developing and developed nations have weighed on these markets. We continue to think investors need international exposure as part of a diversified portfolio, given the relatively attractive valuations, and to gain exposure to some fast growing economies with multi-decade demographic tailwinds. The chart below highlights the unusually large geographic valuation spread. A review of the economic statistics in many far-flung places like India, Vietnam, and parts of South America and Africa will highlight the potential growth runway.

The Bond Market Remains Unconvinced

The bond market continues to be full of mixed signals. The spread, or the additional return investors require for owning economically sensitive high-yield bonds versus low-risk U.S. Treasuries, remains tight at just 3.6%. Whether this small spread is a function of retail investors still reaching for yield, inflows to passively managed bond funds, or increasing confidence in an elongated economic cycle, is tough to say. We do know that one recent Capital Research study indicated many retail advisors have as much as one-third of client fixed-income investments in junk bonds. And according to Blackrock, the value of passively managed fixed-income exchange traded funds (ETFs) has increased to $800 billion versus just $300 billion in 2015. If nothing else, these trends are a reminder why Woodmont generally prefers to own individual bonds versus a passively managed bond fund or bond ETF, particularly for issues with maturities of two years or greater.

Perhaps even more intriguing is the spread between five and ten-year U.S. Treasuries. In April, we characterized the small spread as reflected on the yield curve as “flat as a pancake.” At the time, the five and ten-year spread was 0.18%. Today’s spread is a mere 0.11%. What is this now even flatter than a pancake yield curve telling investors? For one thing, the market does not seem to believe the Federal Reserve can raise rates much more. Also, it means there are plenty of domestic and international investors seeking added safety in the event the economy slows, stocks sell off, and rates move lower. That is, if interest rates decline 1.0% a five year bond increases in price 4.5%. Whereas, a ten-year bond increases in price almost 9% under the same scenario. We can appreciate the desire for some enhanced performance offset in the event of a stock sell-off. The time may come when we want to extend bond portfolio duration. For now, however, we see little reason to pay such a significant premium for long bonds, especially knowing the risk to these bonds if interest rates move higher.

SPREADS BETWEEN 5-YEAR AND 10-YEAR U.S. TREASURY YIELDS ARE AT LEVELS LAST SEEN IN 2007

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Source: *Bloomberg*

Many Bank Investors Remain on the Sidelines

One sector intricately linked to the yield curve and economic activity is banks. Down 3%, banks have been an underperforming sector in 2018. The performance is especially bleak compared to the red hot S&P Tech sector and FANG (Facebook Amazon Netflix Google) stocks, which were up 10% and 42% in the first half. The threat of non-traditional lenders, and the fight for deposits in an increasingly efficient and digital deposit marketplace are obvious headwinds. Yet the regulatory burden confronting banks is declining, and the opportunity for improved earnings if the yield curve were to steepen is significant. With the underperformance of bank stocks, and given that many high-quality banks pay a decent and well-covered dividend, we think the sector is reasonably compelling. If, for instance, the yield curve stays flat, or interest rates decline, bank dividend yields look attractive relative to available fixed-income yields. Or, on the other hand, the curve steepens and long rates move higher, bank margins should expand leading to better earnings, further highlighting the sector’s below market valuation. In the meantime, bank investors must hope Amazon has enough on its plate with its recent healthcare industry initiative and thus will stay out of the banking business.

Mounting U.S. Debt: One Day It Could Matter

Current U.S. Budget & Debt Picture	U.S.A.	Household Translation
Income		
Taxes/Income	3.4 trillion	34,000
Spending	4.2 trillion	42,000
Annual Surplus (Deficit)	(.8 trillion)	(8,000)
Liabilities		
Debt/Credit Card Balance	21.2 trillion	212,000
Unfunded/Needed for Retirement	74.6 trillion	746,000

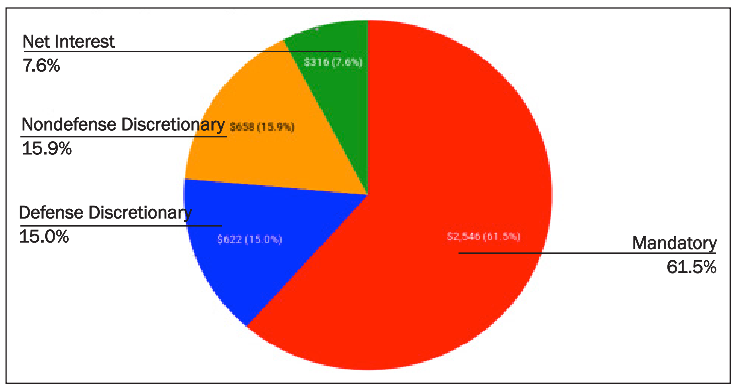
Source: U.S. Government Data & Vanderbilt Univ. Professor Larry Van Horn. Unfunded government liabilities include $9.2 tril. federal retirement plans, $30.8 trillion projected social security costs above revenues, and $34.6 trillion projected medicare obligations above projected revenues.

The U.S. debt balance has swelled to over $21 trillion. Adding the generally unreported $75 trillion of off balance sheet liabilities paints an even more ominous picture. The table below translates the current U.S. Government fiscal position into a single household's income and liabilities. While the U.S. remains arguably the most attractive credit on the globe, and we remain optimistic for our future, the individual household analogy is a reminder of the magnitude of the potential crisis.

China is our largest single creditor and currently owns $1.2 trillion of this debt. Foreign buyer demand and historically low interest rates have kept the debt service burden down, despite the debt balance more than doubling in the last ten years. If, however, the interest rate on U.S. government debt were to increase 1%, that would require redirection of more than $200 billion of our $4.2 trillion annual budget. A 2% increase in interest rates would mean an incremental $400 billion, or 10% of all planned federal expenditures, would be needed for debt service. It does not take much imagination to understand the crisis that could ensue from either a more normal interest rate environment, or reduced demand from foreign debt purchasers, especially since we are already running large annual budget deficits.

Many point to the opportunity to cut wasteful spending, the benefits of economic growth, and increased labor force participation (at just 63% of eligible workers) as solutions for our fiscal deficits. These would help, but currently 62% of the budget is tied to historically untouchable entitlement spending, which includes Social Security, Medicare, and the Federal portion of the state-administered Medicaid program. Add on the 8% of the budget that is currently spent on debt interest expense and that leaves just 30% of the budget pie for trimming waste. And unfortunately the entitlement spending tsunami is getting worse by the day. Recent government reports of higher than anticipated Social Security and Medicare spending have accelerated the dates at which both of these programs are expected to deplete their reserves.

FEDERAL SPENDING IN FY 2018 (DOLLARS IN BILLIONS)



More taxes? Even if we assumed wealthy taxpayers wouldn't make adjustments upon any higher tax levies, those who advocate for increasing taxes on the wealthy must acknowledge we can't address the spending issue via taxes alone. The top 1% paid approximately $550 billion of taxes in 2017. For context, the fiscal 2018 budget calls for $4.2 trillion of spending on an estimated $3.3 trillion of government revenues. No amount of tax increase on the wealthy realistically plugs this hole. Plus, estimates for growth of Social Security and Medicare's annual spending for the next ten years are 3.8% and 4.9%, respectively. Because these programs' spending rates will outpace discretionary spending growth, the amount of our budget tied to entitlements will continue to increase.

"The American Republic will endure until the day Congress discovers that it can bribe the public with the public's money." *–Alexis de Tocqueville*

What is the bottom line for any investors concerned about the United States' fiscal health? It is that entitlement reform is the only way to meaningful improvement. We understand tackling this issue will be a difficult task for our elected officials. Yet when viewed in contrasts to the risks our Founders took, and the generations of service men and women who paid the ultimate price to win and preserve our freedom, this political leap doesn't look so radical.

Wishing You a Wonderful Fourth of July Holiday

We appreciate your continued confidence and look forward to answering any questions that you may have regarding your current portfolio or our investment outlook. We also invite questions regarding your long-term financial plan, including from your tax or estate counsel. Having initiated or updated almost fifty financial plans for current and new clients in the first half of 2018, we have been regularly reminded of the investment, estate, philanthropic, and forecasting benefits of this endeavor. Best wishes for a wonderful Fourth of July and rest of the summer season.