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Investment Commentary

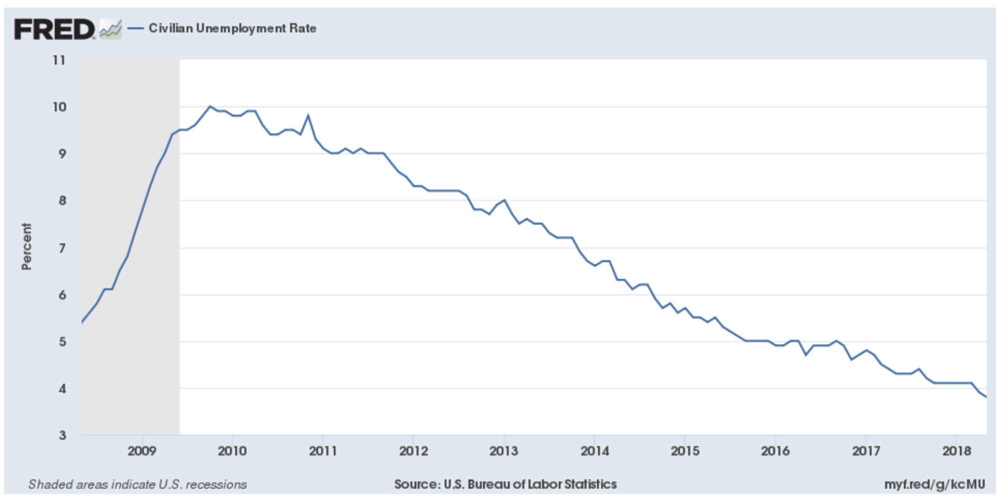
2nd Quarter, 2018

Below you will find our investment commentary for the most recent quarter. We hope you find it informative and will consider our investment services in the future. If you have any questions or concerns about the market or your investment portfolio, please call our office to schedule a meeting or conference call.

Economic Review & Outlook

According to the most recent Wall Street Journal Economic Forecasting Survey, GDP is predicted to grow 3.6% in the second quarter of 2018. This would mark the highest growth rate since the third quarter of 2014. Fiscal policy has clearly played a vital role in the recent jump in economic growth, but it also can't be denied confidence in America is growing. The University of Michigan Consumer Sentiment survey posted a reading in June of 99.3. This is only slightly off the multiyear high (101.4) it registered in March of this year. The last time this index breached the century mark was January of 2004 and it only lasted one month. You have to go all the way back to the year 2000 to find a period where the index was consistently above 100.

Further evidence of economic strength comes from the employment picture. The chart to the right shows the unemployment rate over the past ten years. As you can see it has been in a steady downtrend since the recession ended in 2009. It now sits at 3.8%, the lowest reading since April 2000. Politics aside, it's pretty difficult to argue the economy isn't doing fairly well at the moment.



Of course, the one concern economists always warn us of during periods of expansion are higher interest rates. The current economic prosperity is certainly not lost on the Federal Reserve who is charged with maintaining a maximum level of employment as well as price stability. As one would expect, with higher growth comes expectations for an acceleration of inflation. The Federal Reserve has been combating this risk by raising short term interest rates. They had held short term interest rates at nearly 0% for almost eight years before beginning a steady number of rate increases in 2017. They have now raised the "Fed Funds" rate to a range of between 1.75% and 2.00%. This is the highest level it has been since they were in the process of aggressively cutting rates in 2009.

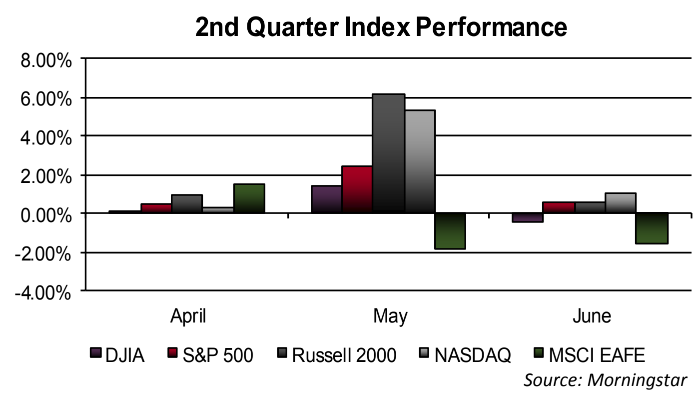
The Federal Reserve has signaled they intend to raise interest rates a couple more times before they pause on their current rate hiking campaign. This is an effort to slow down the rise in inflation expectations which currently stand at 2.6% in 2018, up from 2.1% in 2017. Keeping an eye on how the economy reacts to higher interest rates will be a key focus for investors over the next couple of quarters. As a country, our debt to GDP ratio is currently at its highest level in the postwar era. This suggests even a modest rise in interest rates could deal the economy a crippling blow since both private and public-sector debt is constantly being refinanced. If the Federal Reserve can engineer a "soft landing", a result that would combine positive economic growth with a slowdown in inflation expectations, the current expansion could continue for years to come. Only time will tell if they are ultimately successful on this endeavor.

Bond Market Review & Outlook

Bonds continue to deliver disappointing returns as higher interest rates are causing price declines that in most cases are greater than the income being generated. The only major bond market segment showing gains this year is the high yield sector, delivering just under a 1% total return. The broad market Barclays U.S. Aggregate Bond Index has generated a loss of 1.6% at the midway point of 2018. The losses in the bond market are causing some investors to consider shunning these securities as they watch stock prices continue to move higher. While the frustration over short term losses is understandable, we caution investors over making any adjustments to their bond allocation. It has been nearly ten years since the last bear market. The Q2 Financial Market Highlights on the next page has a table at the bottom illustrating the frequency of downturns in the Dow Jones Industrial Average. Notice losses of 10% or more are relatively common even though they have been rare as of late. Also take note of the frequency of a 20% or more decline, about once every 3.75 years. This table makes it clear the current bull market is very long in the tooth and while we don't believe bull markets die simply due to old age, we do believe the longer a bull market goes on, investors typically become less disciplined.

We are fully confident in predicting that eventually another recession will occur, and a corresponding bear market will ensue. Throughout history these tough economic periods have typically seen interest rates fall and bonds outperform stocks. While there are never any guarantees when it comes to the financial markets, we would expect this scenario to hold true again during the next bear market. Keep in mind, bonds are in your portfolio to diversify your assets from the higher level of volatility demonstrated by stocks. If you have little to no risk aversion and are comfortable watching your portfolio decline dollar for dollar with the S&P 500 the next time it drops 40% or more, then bonds are an unnecessary addition to your portfolio. However, if the thought of watching your investments decline by this much or more troubles you, bonds remain the best option to hedge your portfolio against future stock market losses.

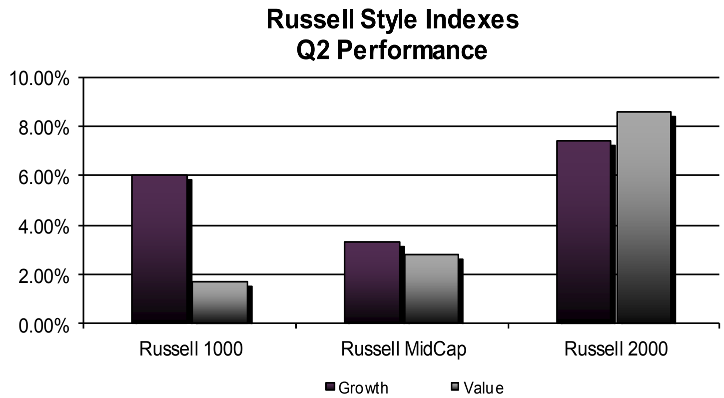
Stock Market Review & Outlook



Stocks got back to their winning ways in the second quarter with most indexes posting gains in all three months. The Dow Jones Industrial Average delivered a gain of 1%, while the broad based large cap S&P 500 index returned 3.6%. Small caps have taken over leadership, with the Russell 2000 leading the pack in the second quarter, up 7.8%. The technology laden NASDAQ Composite was right on the heels of the small cap index, returning 6.8%. If there was a blemish for stocks it came from the international markets. The MSCI EAFE index lost 2% during the quarter. We find these returns to be remarkable in the face of the constant barrage of concerning economic news such as the tariff war and higher interest rates. Many market pundits are dumbfounded by the resiliency of the stock market, which is proof that trying to time the market is futile.

The outperformance by small caps is something we want to highlight. Many investors believe these stocks are benefiting from the proposed tariff war since they tend to be less export driven. We think this is a keen observation and one that likely will continue to drive the relative performance of small caps versus large caps through the rest of 2018. Many are perplexed as to why a businessman like Trump would want to start a trade war. With the U.S. now energy independent due to the shale revolution over the past decade, the U.S. is in perhaps the best bargaining shape from a trade standpoint in history. Since we are not dependent upon any one country to keep our economy afloat, we can look to level the playing field for many of our industries that have been unfairly punished by foreign policies. If Trump is successful and ultimately creates a more favorable environment for U.S. exports, multinational large cap stocks will be the primary beneficiaries and likely resume their leadership. If not, small caps should continue to outperform. Either way, a compelling case can be made that the U.S. has tremendous bargaining power. Trump is fully aware of this, which is why we expect him to remain steadfast with his negotiating tactics. Many have criticized him on how he dealt with North Korea, yet look where we are. Could starting a trade war result in a similar outcome? We shall see.

The chart to the right illustrates the performance of each market segment by style. For the most part, growth stocks show no signs of letting up on their outperformance. Growth sectors are outperforming value sectors by nearly 9% year-to-date. It's really a case of the same story, different day. The market leaders remain the same "FAANG[1]" stocks we have mentioned in the past such as Facebook, Apple, Amazon, Netflix, and Google. All are up double digits percentage wise this year, with Netflix up triple digits!! The lack of any meaningful pullback in any of these stocks is truly amazing. We can't help but be reminded of the eerie similarities between investors' adoration of these names and the likes of Cisco, Microsoft, Intel and Oracle in the late 90s. These stocks were the darlings of their day and although they are still great companies, they all came crashing back to earth when the dot.com bubble burst. Predicting if, or perhaps when, this fate may occur with today's favorites is anyone's guess. The fact is, these are great companies and they may continue to lead their respective industry for years to come, but risk management is one of the pillars to a successful investment strategy. An acute focus on risk management has us constantly reviewing our accounts for positions that may have become significantly larger than originally intended. When appropriate, you will not see us hesitate to trim some of our best performing securities to keep the portfolio risk in line with the original desired asset allocation model.



Source: Morningstar

What the markets have in store for us in the second half of 2018 is anyone's guess. Morgan Stanley's chief U.S. equity strategist, Mike Wilson, thinks a bear market has already begun and will last through the end of 2019. He is calling it a "rolling bear market", highlighting the fact that every sector has already declined by at least 11 or 12 percent, with some down over 20%. He suggests this bear market may be different than the classical bear market defined as a 20% drop in the S&P 500. Instead he describes it as, "… a tougher environment, it's hard to make money." Of course, for every bear on Wall Street you can find a bull. Tom Lee, head of research at Fundstrat Global Advisors, is one of the most bullish analysts in the business. Lee was quoted by CNBC discussing the end of the current bull market being, "… I think it's more like 2029 is the peak of this equity market cycle and then, the S&P is 6,000 to 15,000." Both of these gentlemen are very well versed in their trade and have credentials most in the business would envy. The point of illustrating this divergence is to reiterate that no one in this business has a crystal ball. The next recession may be six weeks, months or years away. No one can proclaim to be sure what will happen tomorrow. Long term investors who realize the futility in trying to predict short term moves and instead remain focused on growing capital over periods measured in years will be the most successful. Thus, if a bear market is right around the corner, we challenge you to embrace it since it will create some excellent buying opportunities for new investments. If instead we are on the verge of reaching new highs in the second half of the year, continue to enjoy one of the longest bull markets in history. Either way, your long-term investment strategy shouldn't change.

Sincerely yours,

McGill Advisors

Wealth Management Team
McGill Advisors

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