IN THIS REPORT

The Colony Group

MARKET PERSPECTIVES

QUARTER TWO 2018

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Financial markets experienced a calmer second quarter, with volatility retreating across major asset classes from the elevated levels exiting the first quarter. Despite an escalation of trade tensions, domestic equities rose during the period, but outside the US, stocks fell. The dollar rallied sharply, advancing +5.1% in the second quarter, which in turn pressured emerging-market securities. While the broad S&P 500 index managed a total return of +3.4%, the MSCI Emerging Market index plunged -8.0%. In general, the further from the epicenter of the trade tumult, the better the returns – small-cap US stocks, which are less exposed to transnational trends, registered the best returns among major asset classes (+7.8%), while Chinese stocks entered bear-market territory.

Although the Federal Reserve raised rates by another 0.25% in June, its seventh such move in this cycle, fixed-income markets were quiescent. The 10-year Treasury note yield rose 12 basis points during the quarter to 2.86%. The broad domestic bond market, as measured by the Barclays US Aggregate index, returned -0.2%.

The US economy was the only major economy to perform up to expectations during the quarter, and GDP growth estimates edged higher. Japan, the Eurozone, and China, on the other hand, all saw growth projections downgraded. Coupled with the Fed's executed and forecast interest-rate increases, the global economic outlook tilted the currency tables toward the dollar as noted above.

With the turn of the calendar to July, our minds began wandering to the quintessential summer experience of reading a good murder mystery on the beach. In that spirit, we wonder . . .

What Will Kill the Bull Market (and When)?

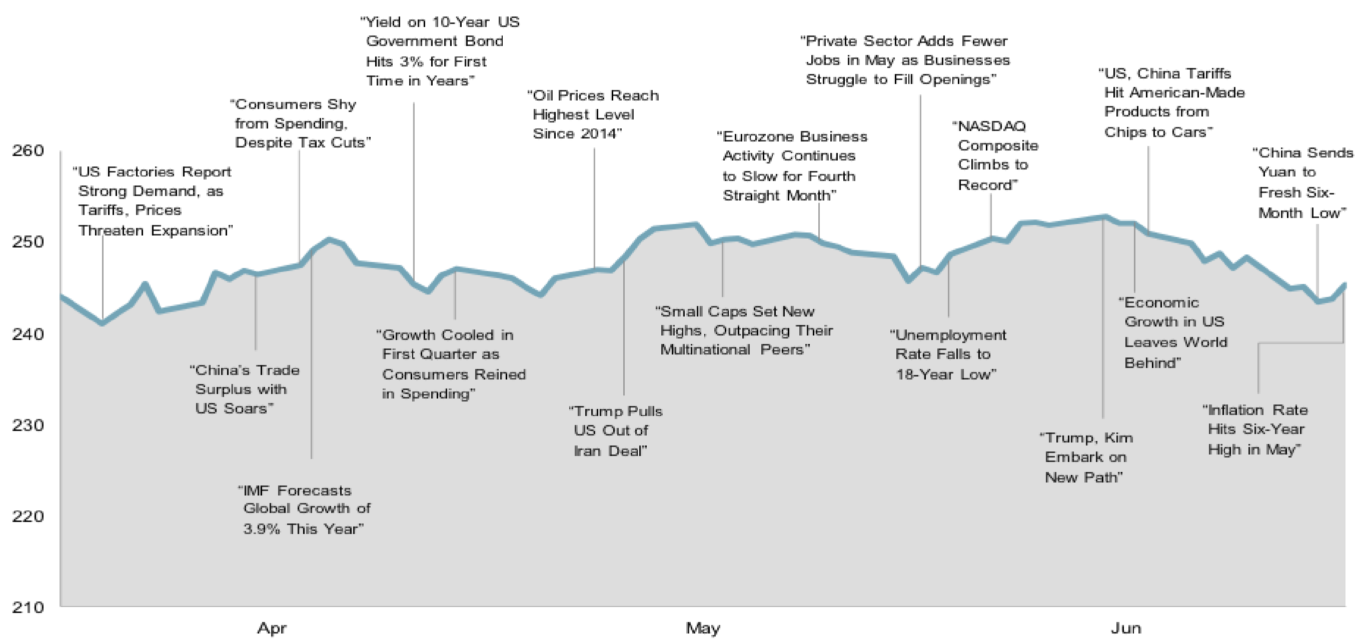
You may be familiar with the saying "bull markets don't die of old age." In other words, it is not the passage of time itself that dictates a downturn in stocks but some external constraint that becomes powerful enough to instill fear into markets and push returns deep into the red. The primary suspect in almost every case is a notorious recidivist: the Federal Reserve. In the current instance, there is a secondary player of interest as well: trade policy. On the side of law and order is fiscal policy, in the form of tax cuts and budget increases. The looming convergence of these forces will ultimately pinpoint the culprit, but the timeframe is as important as the identity. Leaving the scene of a bull market too soon can be a felony offense, as the biggest returns have very often come in the final stages.

Monetary policy has almost always played a large, if not the largest, role in bringing market cycles to a close. The unfortunate reality facing the Fed is that the setting of short-term interest rates and the use of its balance sheet to influence the flow of credit are crude tools at best. Monetary policy acts with a lag (estimates range from three months to two years, an eternity in a real-time world) and is unable to finely target specific trouble spots. Therefore, the Fed is usually either behind or ahead of the curve when it is actively changing rates, as it gathers feedback from the economy on the impact of its previous actions. Nor does the Fed operate in a vacuum. Other global central banks may or may not be acting in the same direction, which can counteract or compound the effects as capital flows around the globe.

The primary feedback mechanisms for the Fed are the rate of consumer price inflation and the level of employment, as the Fed's so-called "dual mandate" is to promote price stability and maximum employment, goals which are often in conflict (wages and prices tend to rise during periods of full employment and vice versa). With the unemployment rate running at a nearly 50-year low, the Fed is understandably nervous about inflation making a comeback. Nevertheless, the CPI has yet to meaningfully accelerate, leaving the Fed in an uncomfortable position: continue to raise rates regularly and risk crushing a benign recovery prematurely, or proceed more slowly and risk inflation expectations becoming unanchored, which might require a severe catchup phase of tightening that could result in a deeper recession.

Not only must the Fed weigh those choices, but it also must consider the actions of other influential central banks in a world where capital flows more freely than in the past.

MSCI ALL COUNTRY WORLD INDEX FOR Q2 2018



These headlines are not offered to explain marketplace returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: Dimensional Fund Advisors. MSCIACWI Index [net div.].
It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results.

The European Central Bank, for example, stated last month that it would not consider interest rate increases until the autumn of 2019. Troubles in Italy, the third largest economy in the Eurozone, could extend that horizon even further.

The shift in US trade policy (see our last Investment Perspectives) is yet another variable that could significantly alter the duration of the market cycle. There is a large school of thought on Wall Street that the administration's imposition of tariffs on a growing number of raw materials and finished goods is a negotiating tactic, and that the previous order will be restored once our trade partners compromise, but this is a narrative that becomes more tenuous with each new retaliatory proclamation. Although the total cost of the cumulative tariff announcements (thus far) is small in comparison with the impact of fiscal stimulus (investment research firm Strategas counts $120B of tariffs against $800B of tax cuts, increased government spending, and repatriation of overseas cash by US companies), there are hundreds of billions more invested in global supply chains that could become stranded costs in an all-out trade war. To the extent tariff costs cannot be passed through to customers, profit margins will suffer. Another, less tangible, cost is the impact of the uncertainty on business spending. Absent clarity on trade rules, some expansion plans are sure to be tabled.

In short, the risk of a policy mistake is higher now than it was at the turn of the year, but an imminent end to the cycle remains far from certain. The impact of the tax cuts is just beginning to flow through to the real economy. Second-quarter real GDP growth looks to have accelerated to over 3%. Core durable-goods orders grew 6.6% year-over-year in May. The Bipartisan Budget Act of 2018 authorized $1.3 trillion of federal spending, a double-digit percentage increase over 2017. Consumer balance sheets are in their best shape since the financial crisis, and the rise in employment has led to lower defaults on outstanding debt. The housing market is hampered by a shortage of inventory, but new household formation continues to drive demand. Inflation, as noted earlier, has yet to gain traction. The shallow nature of the recovery (cumulative GDP growth lags that of each of the past seven expansions), despite its length, also suggests that it can persist.

Stocks themselves do not look stretched from a valuation perspective. S&P 500 operating earnings are forecast to grow 27% in 2018 and another 11% in 2019. Shares trade for a reasonable 17.2x 2018 estimates. Free cash flow production too is healthy, with the market averaging about a 4% trailing yield. While cash yields are becoming more competitive with stocks, the latter's free cash flow yield still towers above the return on the former.

WHAT THIS MEANS TO US

There are a number of factors we monitor to gauge the proximity of the next bear market. Among the key economic yardsticks are the shape of the yield curve, the progression of monetary policy relative to market expectations, Treasury bond inflation break-even rates, and purchasing manager intentions. We also eye a number of indicators of stock market froth such as merger and acquisition activity, retail mutual fund and ETF flows, IPO activity, valuation levels, and credit spreads. None of these alone are reliable warning signals, but taken together we can assemble a kind of balance sheet, categorizing each as positive, neutral, or negative. When the preponderance tilts unfavorably, we can then act to increase portfolio defensiveness. At this writing, several of the above measures are flashing cautionary signs (the yield curve, monetary policy, and IPO activity) that suggest the cycle is indeed aging, but none are squarely in the downturn camp, and, as a group, they suggest that there may be more room to run. As of now, we would consider weakness a buying opportunity, but to paraphrase John Maynard Keynes, we will change our minds as the facts change.

Conclusion

There are no expiration dates on market cycles. Instead the accumulation of excesses is usually the precursor to restrictive monetary policy. Tighter financial conditions then throttle back growth, which historically most often results in a recession. The bluntness of monetary policy makes the ideal of a "soft landing" for the economy a near impossibility. No investor wants to overstay his or her welcome in a downturn, but exiting too early can carry a high opportunity cost, as can re-entering too late. We therefore prefer to work carefully with our clients to determine the proper strategic asset allocation and work on the margins to raise or lower defensiveness as appropriate. Investing is a probabilistic and dynamic endeavor, and mental flexibility is crucial.

While this may not be the page-turner you were hoping to tote to the seashore, there is something to be said for a calm, dispassionate assessment of current conditions. After all, summer should be for relaxation, not portfolio anxiety. Let us do the worrying for you!

COLONY SPOTLIGHT

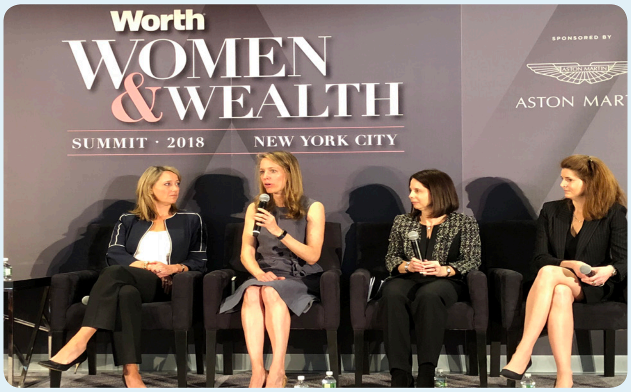
▶ Colony hosts After The Final Whistle: Your Inspired Life Journey Continues

Over 50 guests including our athlete clients and their families, influential professionals and sought-after speakers attended a 3-day retreat hosted by The Colony Group in beautiful Bachelor Gulch, CO. Together, we explored the best that life has to offer through all of life's transitions: career, health, wealth and family relationships.

Our guests came away refreshed and equipped with ideas and life-enhancing skills that bring more meaning and joy to their lives.

▶ Nadine Gordon Lee speaks at Worth's Women & Wealth conference

In our ongoing commitment to empower women and support diversity, Dina Lee, CPA/PFS, CFP®, Managing Director, Metro NY Offices & President, Colony Group Family Office, shared her expertise and insights as a panelist for *Disruption and Its Impact on Financial Markets* at Worth magazine's Women & Wealth conference in New York City on April 19. Other distinguished presenters included Laura Schwab, President of Aston Martin; Mercedes Abramo, President and CEO of Cartier; and Louise Blais, Canada's Ambassador to the UN.



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