SilverOak

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Second Quarter 2018 Market Summary

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Second Quarter 2018 Market Summary

Summer months in the market tend to be more docile and come with lower trading volume and volatility as investors chase sunshine rather than returns. However, just like mosquitos, macro headlines tend to emerge as unexpected guests. The recent narrative has been dominated by trade tariff rhetoric which has escalated into a global tit-for-tat. This ruckus has caused some market weakness particularly in certain regions and industries as investors demand higher risk premiums due to the limited visibility into the end game on trade policy. While it appears some of the risk regarding geopolitical events is priced in; the unknown risk is, at what point do consumers and businesses get rattled and halt spending or capital expenditures due to uncertainty. The broad range of possible outcomes makes it impossible to accurately predict the projected impact on the global economy. The public negotiating tactics of the global leaders will certainly test the emotions and confidence of investors. Trade will continue to be a key topic for the markets as the U.S. nears mid-term elections which will serve as a barometer for the country's support of the current administration and its direction. Historically, returns in mid-term election years tend to be subdued with more bumps in the road.

The outlook for the remainder of the year is largely unchanged. On balance, the global economy still shows signs of strength. This statement is made in acknowledgment that not all data points are rosy. Global economic growth has softened but remains solid. Corporations are reporting strong earnings growth despite investors' concerns that the rate of change is declining. Consumer and business surveys are currently optimistic and at all-time peaks; however, they often are prior to recessions. Trade protectionism, tightening financial conditions, and a flattening yield curve are headwinds that are casting a dark cloud over a generally positive macro picture.

After a volatile first quarter, U.S. stocks have relatively stabilized and are slowly regaining ground lost during the pullback. Somewhat concerning, the breadth in leadership is narrow with technology, energy and certain consumer industries leading the way. U.S. large company stocks, represented by the S&P 500 Index, were up 3.4% during the second quarter of 2018. U.S. small company stocks, represented by the Russell 2000 Index, had an even stronger quarter and were up 7.8%. Growth stocks continued their outperformance over value stocks in the U.S. and international markets. International stock markets, represented by the MSCI ACWI ex US Index, were down 2.6% for the quarter.

Emerging markets, represented by the MSCI Emerging Markets Index, were hit harder and were down 8% for the quarter. The U.S. dollar appreciation was a strong headwind for international markets. Elections in Italy and Mexico continued the global trend of populist leaders ascending to leadership causing consternation.

For the quarter, the Barclays U.S. Aggregate Index, which represents a broad basket of bonds, was down 0.2%. Bond returns were mixed with some sectors having positive returns, such as municipals, while other sectors, such as investment grade corporates, were down during the quarter. Interest rates moved higher, credit spreads generally widened and the yield curve flattened. In June, the Federal Reserve raised the Fed Funds rate 0.25%, for the second time this year, to a target range of 1.75% - 2.00%, which was widely expected. During the FOMC meeting in June, the Fed upgraded their view of the economy which led them to increase their forecasted rate hikes for this year and 2019 to a total of four and three rate hikes respectively. While rising interest rate environments can pose a challenge to fixed income portfolios, the reasons for investing in bonds does not change. Fixed income is the ballast of the portfolio, offering protection in periods of economic turmoil and equity drawdowns.

Second Quarter 2018 Market Summary (continued)

Meanwhile, if interest rates rise slowly, bond returns can be resilient and still provide income to portfolios while continuing to play the role they are meant to play – risk mitigation.

The market is searching for direction. While our crystal ball is currently out of commission, there does not appear to be major recession warnings flashing. That being said, there are plenty of themes to monitor the rest of the year. The reasons that tip the economy into recession are different each time (monetary policy, geopolitical, inflation, etc.); however, there are commonalities that we can observe to create a story which helps in setting expectations. As economic cycles age, the labor market tightens and inflation increases, causing pressure on corporate margins. Monetary policy becomes restrictive and the yield curve flattens or inverts. Leverage and debt in the system (corporate, government, consumer, etc.) rises and credit spreads increase reflecting potential defaults. Leading economic indicators and consumer spending will also trend lower. As we will show in SilverOak's Market Dashboard during our July webinar, many of these data points remain positive. While macro headlines may keep investors up at night, our process keeps us grounded, and allows us to make decisions objectively and in the best interests of our clients.

HIGHLIGHTS

MACROECONOMICS

- The Bureau of Economic Analysis released the advanced estimate of first quarter 2018 real GDP, an annual rate increase of 4.1% from the preceding quarter. The estimate was the highest growth recorded since 2014.
- The University of Michigan Consumer Sentiment Index final reading for June was 98.2, which was a slight decrease from the first quarter. Consumer sentiment remains very strong.
- The ISM Manufacturing Index remained high during the quarter, finishing at 60.2 in June. Typically, when the ISM Index is above 55 it is bullish and when it is below 45 it is bearish.
- In June, the Conference Board Leading Economic Index increased 0.5% month-over-month to 109.8. The Index has shown steady economic growth over the past year.
- The price of WTI Crude Oil was $74.13 at the end of June, which is 14.3% higher than $64.87 at the end of March. The price of Brent Crude Oil increased 12.2% in the quarter to $77.44. Strong demand, OPEC supply cuts and geopolitical events have caused the oil market to tighten faster than investors expected.
- In June, headline CPI increased 2.9% year-over-year, which is higher than the 2.4% realized in March. Core CPI, which does not include food and energy, had a 2.3% increase. Inflation is expected to remain contained but could drift higher as commodity prices increase.

HOUSING

- The housing sector has been solid the past few years with increasing sales and rising home prices. However, the past few months the housing sector has softened with declining sales and home prices month-over-month.
- Preliminary existing home sales decreased in the quarter with a monthly average annualized rate of 5.41 million units from 5.51 million units in the first quarter. The June annualized rate is 2.2% lower than the 5.5 million units in June 2017. Unsold home supply remains at very low levels.
- Median existing home sale prices increased during the quarter. The preliminary prices for June were 5.2% higher than the levels of one year ago and have been trending up since the beginning of 2012. Prices are now higher than the previous peak in 2007.
- New home sales were strong during the quarter, up 7.0%, and have been increasing since 2011. However, new home sales declined on a month-over-month basis in June.
- S&P Case-Shiller 20-City Home Price Index (seasonally adjusted) showed home prices rose over 6.5% year-over-year in April.

EMPLOYMENT

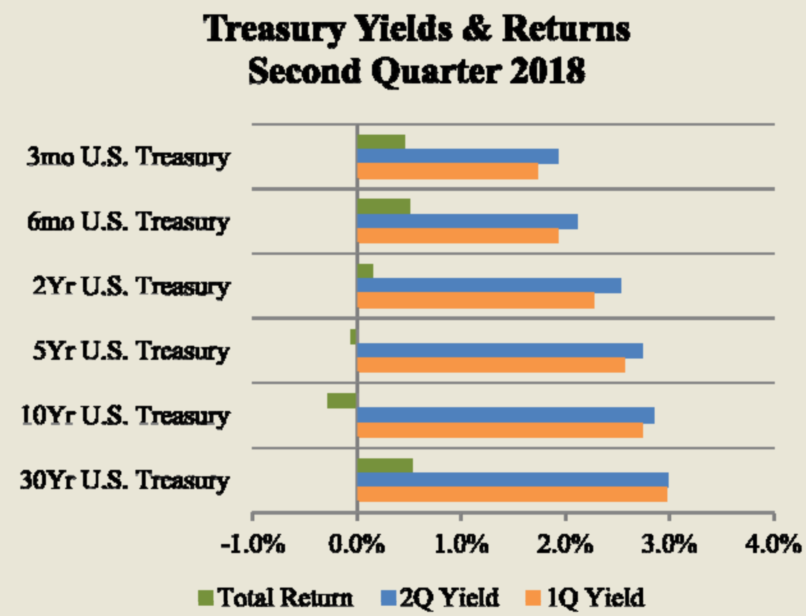
- The labor market has generally been healthy. The job growth rate has slowed slightly as employers are having difficulty finding workers with the required skills. Wages have moderately risen over the past few years.
- During the quarter, nonfarm payrolls averaged 210,000 jobs added per month, which is slightly higher than the average over the past two years.
- The unemployment rate decrease to 4.0% during the quarter.
- Initial Jobless Claims have been decreasing since 2009 and dipped to lows last seen in 1969, reflecting a tight labor market.

DOMESTIC CORPORATIONS

- Corporate operating earnings in the first quarter 2018 were much higher than the previous year. Estimates for the remainder of the year show very high levels of earnings growth.
- Operating profit margins have increased over the past year and remain well above historical averages. Margins have benefitted from lower taxes but have yet to be pressured by increased interest rates nor wages inflation.
- Forward P/E multiples have declined to historical average while trailing P/E multiples are above historical averages.
- The U.S. dollar reversed trend during the quarter and appreciated 5% vs. major currencies, which hurt non-U.S. securities. The U.S dollar had been in a depreciation trend for the previous five quarters. Many investment managers believe the U.S. dollar will resume its depreciation trend over the long-term.

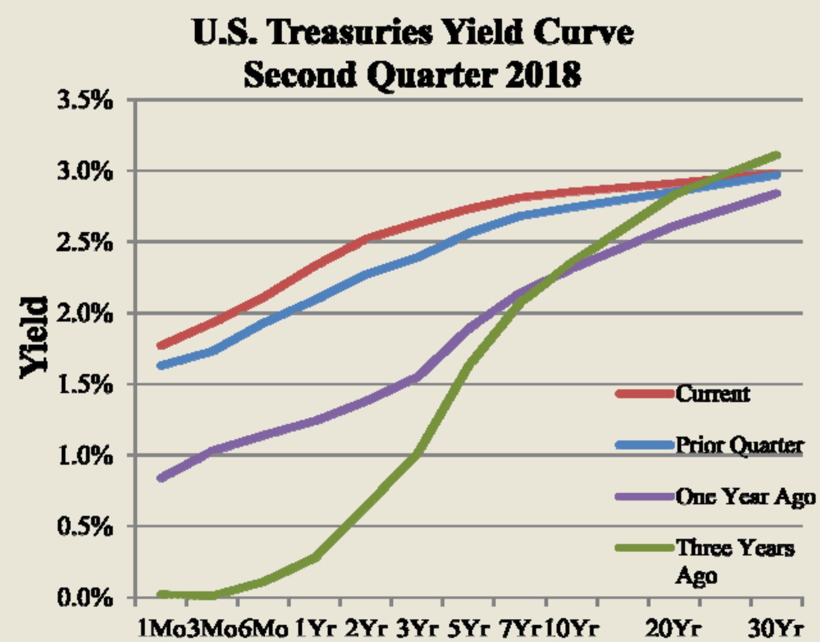
FED POLICY

- In June, the Federal Open Market Committee (FOMC) decided to raise the federal funds rate 0.25% to a target range of 1.75% - 2.00%, which was widely expected. The Fed's assessment of economic conditions was upgraded as the committee revised higher their growth estimates for 2018 and 2019. They noted U.S. economic growth is solid, the labor market continues to strengthen and inflation will reach their target by year end.
- The Fed is forecasting they expect to raise rates two more times in 2018 and increased their expected hikes in 2019 to three rate increases. Market expectations believe the Fed will increase rates through the end of the year but will not follow through on its rate hike projection in 2019-2020. Unless the economy shows signs of weakness the Fed will continue with their rate hikes.
- The unwinding of the Fed's balance sheet may put upward pressure on interest rates and financing costs for corporations and consumers.



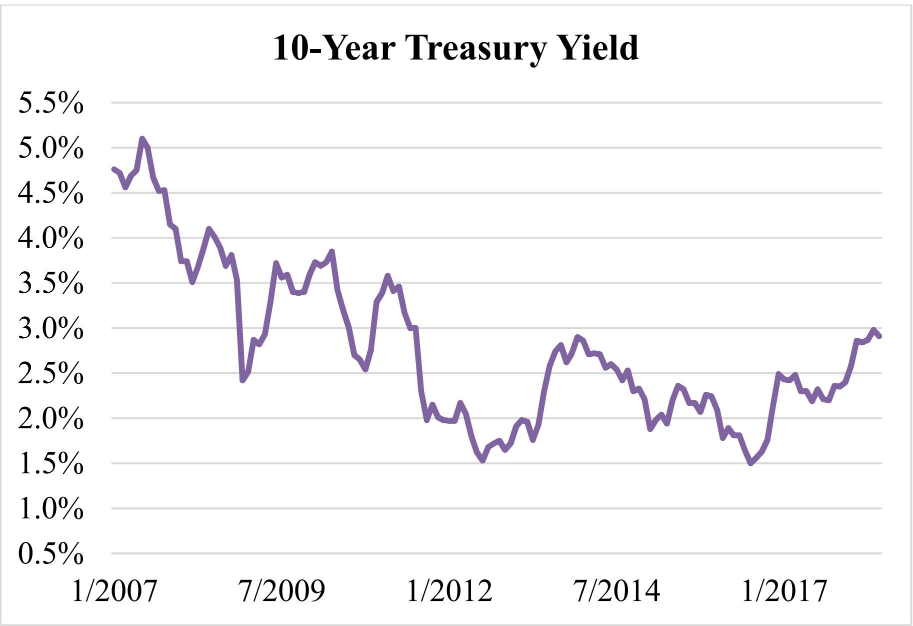
FIXED INCOME

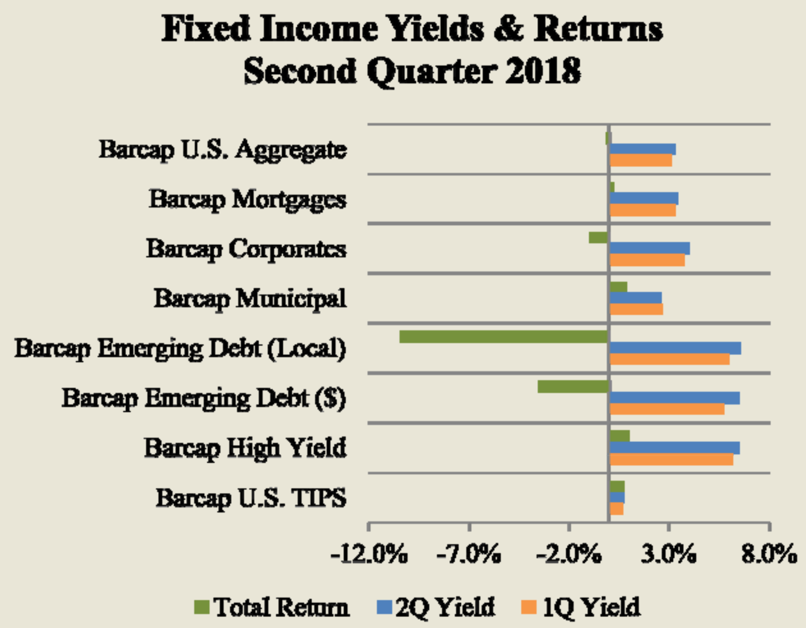
- Long-term yields remained relatively stable quarter-over-quarter; while, the short and intermediate end of the curve rose, causing the yield curve to flatten. Short-term interest rates are controlled or heavily influenced by central banks where as long term interest rates are controlled by market forces and economic growth.
- The U.S. Treasury yield curve continues to flatten. The 2-Yr. to 10-Yr. Treasury spread is the lowest it has been since prior to the financial crisis in 2007. Historically, the yield curve has flattened as the Fed raises interest rates and the business cycle matures. The yield curve is looked at as a recession indicator as it has inverted typically a year prior to the majority of the U.S. recessions over the past 50 years.

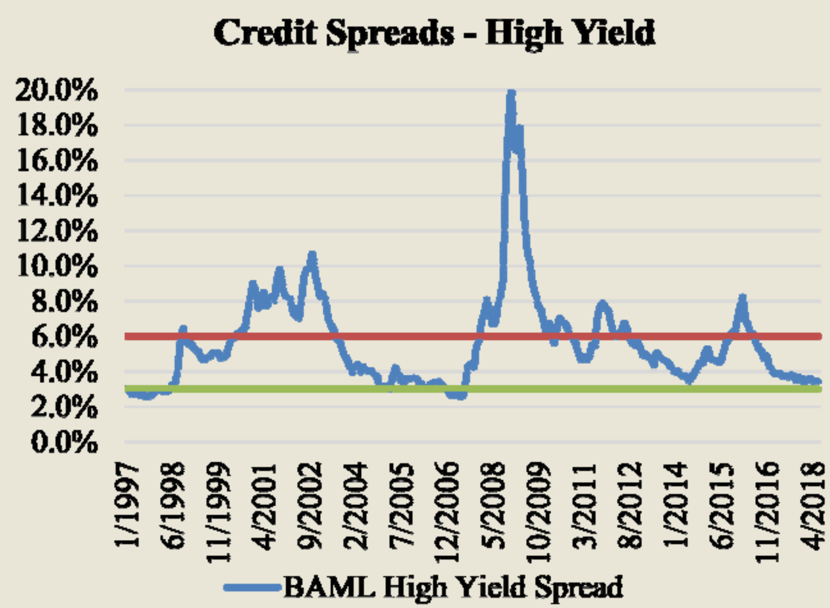


FIXED INCOME (continued)

- Returns across fixed income sectors were mixed, with the Barclays U.S. Aggregate down 0.2% during the quarter. Municipal returns generally outperformed taxable bonds. Corporates performed worse than the broad market. Emerging market debt was hit hard due to emerging market currency depreciation.
- Evidence of late cycle indicators are showing up such as poor valuations, weakening credit standards, and high leverage in corporate and consumer balance sheets. Rising interest rates and higher funding costs will create problems for companies with weak balance sheets. While these will be concerns going forward, credit spreads remain low.
- Fixed income returns, going forward, are expected to be lower than historical averages as interest rates are still at a low level. Historically, future ten year fixed income annualized returns have been about equal to the 10 year Treasury yield at the start of the period. Despite the low rates and muted expected returns of fixed income, it remains an important part of a diversified portfolio as it provides stability when equity markets decline.

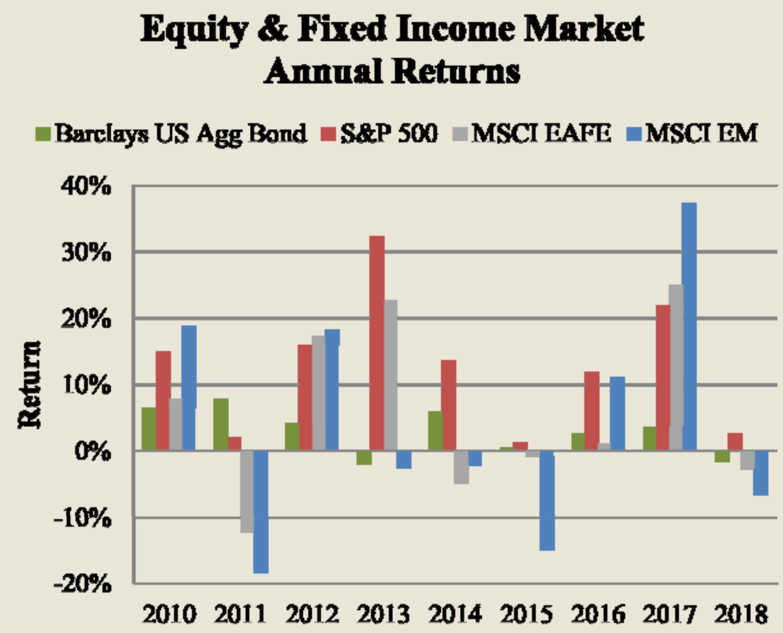


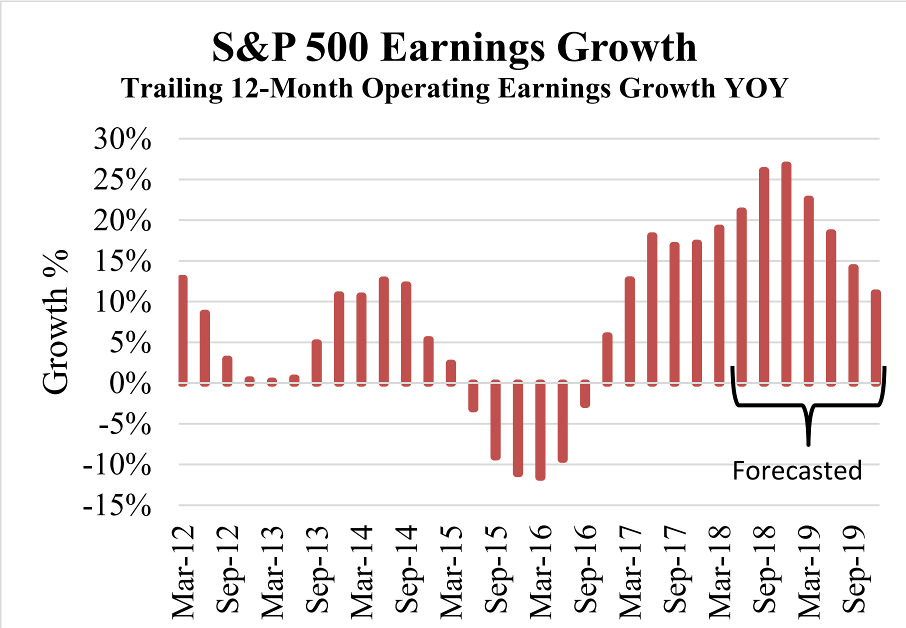


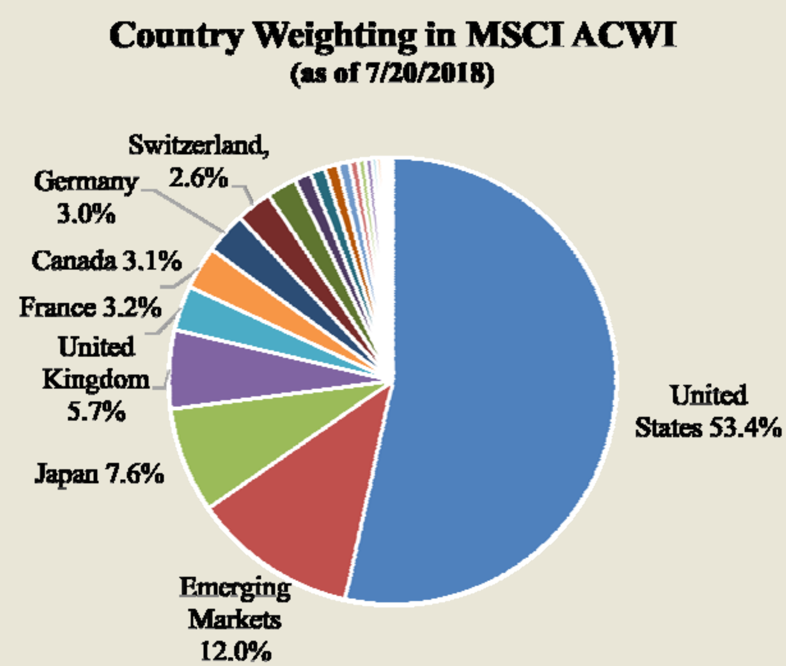


EQUITIES

- Investors have become more cautious as macro headlines battle corporate fundamentals. The synchronization of global growth seen over the past year has been challenged as certain markets have fared better than others. The U.S. continues to show strong corporate earnings growth while international market returns were hurt by the rising U.S. dollar.
- Global growth continues to support equities. Global economic indicators show growth is still solid even if the rate of growth has slowed. However, geopolitical events such as trade tensions continue to be a risk. Any decline of confidence among businesses and consumers leading to delays in capital expenditures or consumption due to trade rhetoric may be more impactful than the tariffs themselves. Rising earnings expectations and peak margins create a high hurdle for equities and may contain returns.





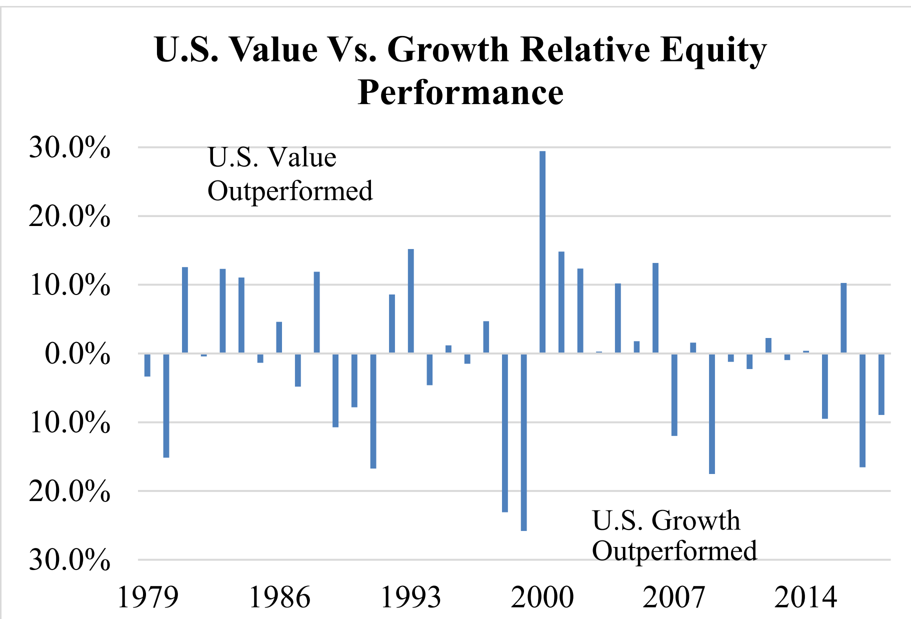


DOMESTIC EQUITIES (continued)

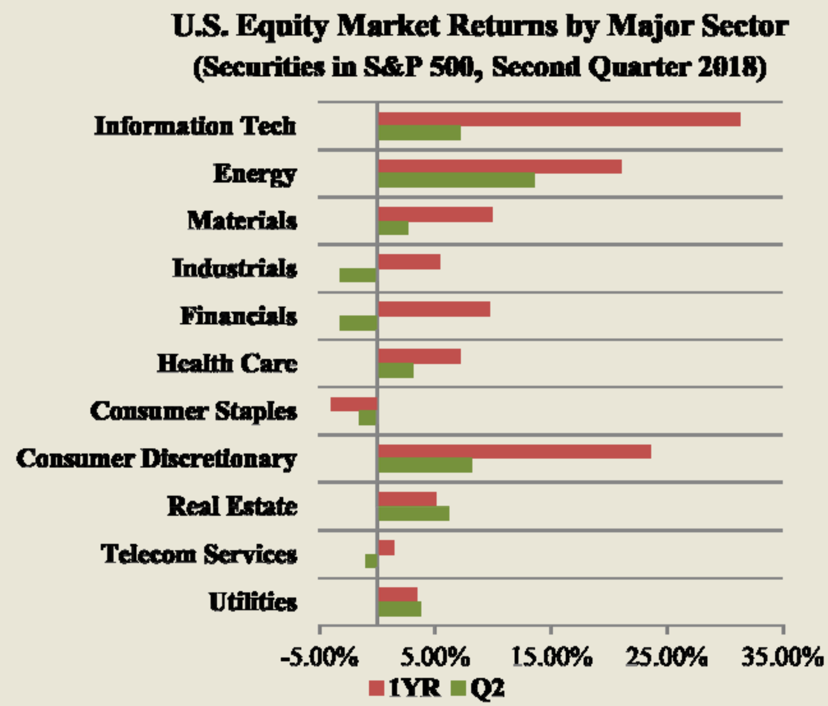
- The Russell 1000 Index, comprised of large and mid-capitalization stocks, posted a total return of 3.6% during the quarter. On a year-over-year basis, the Russell 1000 Index has increased 14.5%.
- Small capitalization stocks, as represented by the Russell 2000 Index, posted a total return of 7.8% during the quarter. On a year-over-year basis, the index has increased 17.6%. Small cap companies tend to be more domestic focused and thus investors felt they are less impacted by the global macro headlines.
- Growth companies continued to lead the market, specifically technology companies. A handful of tech companies are responsible for the entirety of the S&P 500's year-to-date return. The energy sector benefited from the continued rise in oil prices.
- The gap in returns between U.S. growth equities vs. U.S value equities is the widest it has been in 17 years as growth continues to outperform value.

Second Quarter 2018 Returns

	Value	Core	Growth
Mega Cap		4.2%	
Large Cap	1.2%	3.6%	5.8%
Mid Cap	2.4%	2.8%	3.2%
Small Cap	8.3%	7.8%	7.2%
Micro Cap	10.2%	10.0%	9.7%

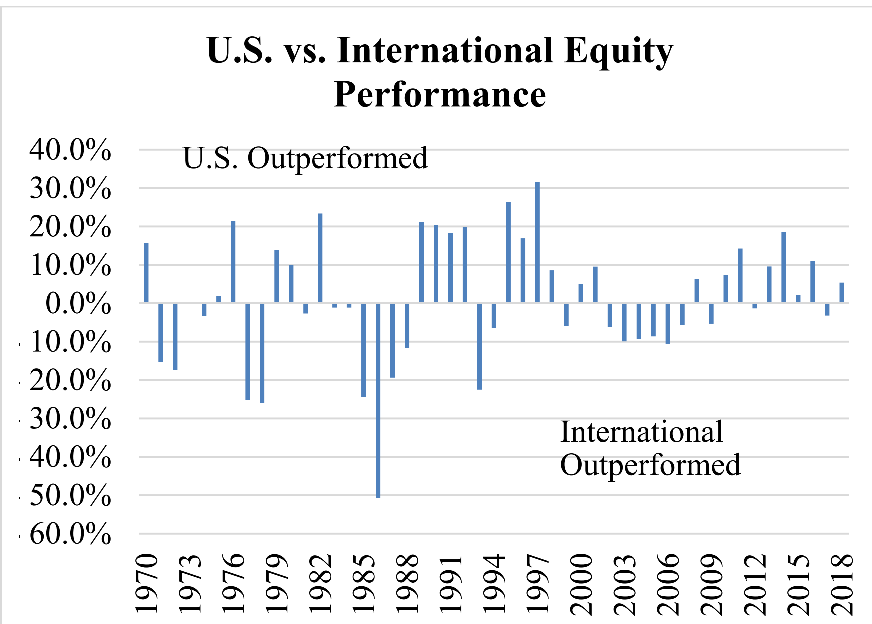


Russell 1000 Growth TR vs. Russell 1000 Value TR

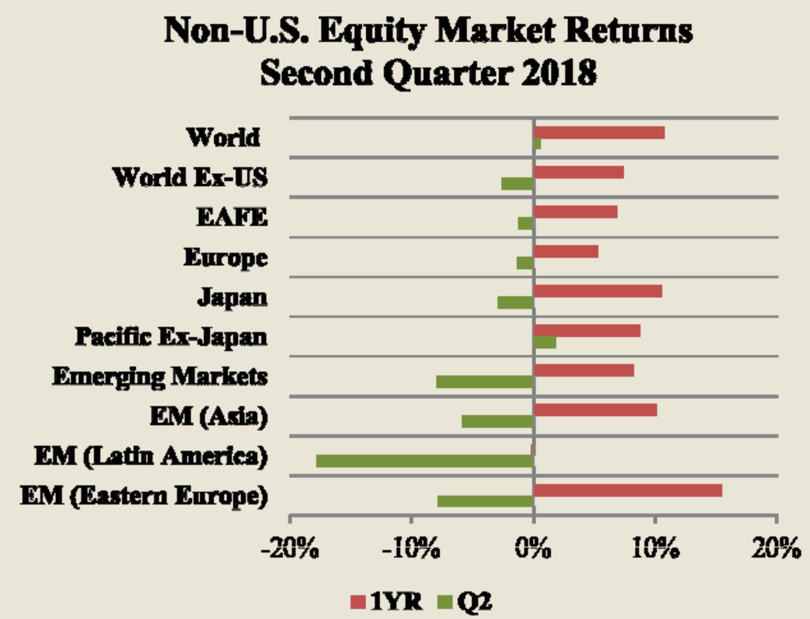


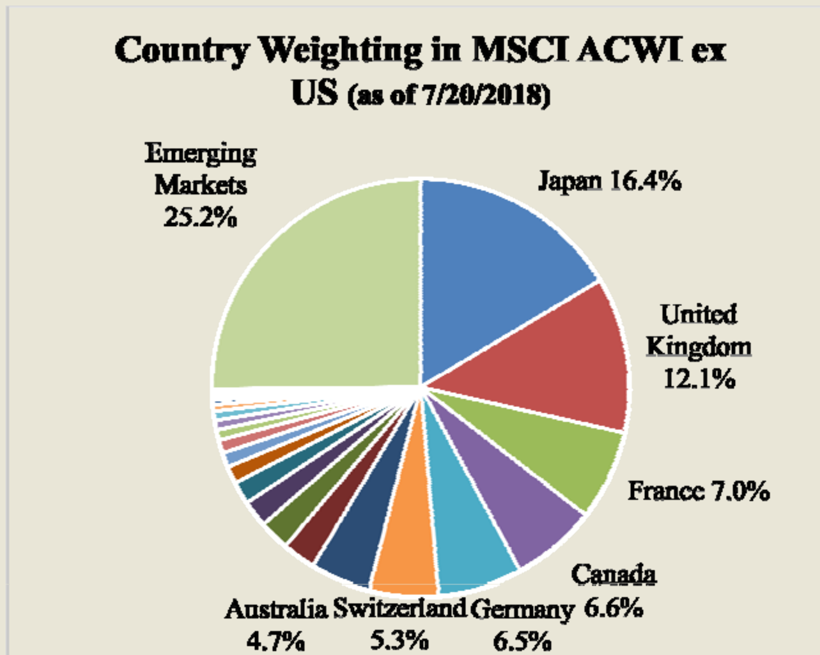
INTERNATIONAL EQUITIES (continued)

- Developed international stocks, as represented by the MSCI EAFE, were down 1.2% during the quarter. On a year-over-year basis, the EAFE is up 6.8%, performing worse than U.S. domestic equities. International equities modestly outperformed in 2017.
- Emerging market stocks underperformed developed markets during the quarter. The MSCI Emerging Markets Index decreased 8.0% in the quarter; however, they have increased 8.2% over the past year.
- The appreciation of the U.S. dollar, trade concerns and some idiosyncratic macro events weighed on international equities. Uncertainty with Brexit, recent turmoil in Italy and depreciation of certain emerging market currencies cloud sentiment.
- Internationally, earnings trends are still positive and valuations tend to be less demanding which should support for equities. The cyclicality of U.S. and international equities can be seen below.



S&P 500 TR vs. MSCI EAFE NR





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