Review & Outlook

Second Quarter 2018

July 10, 2018

Executive Summary

John Augustine, CFA, Chief Investment Officer

Year-to-Date Market Returns:

S&P 500	+1.67%
S&P 400	+2.69%
S&P 600	+8.66%
MSCI EAFE	-4.49%
MSCI EM	-7.68%

Barclays Intermediate Bond Index	-0.99%
Barclays High Yield Bond Index	+0.16%
Barclays TIPS Bond Index	-0.02%
Barclays Municipal Bond Index	-0.25%
Gold	-4.19%

Strong Economy, Flat Markets

As of this writing, the Federal Reserve's Nowcasting U.S. GDP Model shows the second quarter is on pace for over 4% growth. That's a strong number that we haven't seen since mid-2014.

Leading U.S. economic growth in the second quarter has been a mix of consumer spending, business investment, housing starts and exports….yes, exports, even with all the trade and tariff headlines. Exports have been over $200 billion a month from last November through this April. They currently stand at a record $211.2 billion.

With the better economic numbers, our nation's unemployment rate in May matched a 48-year low level of 3.8%. Also with the better economic numbers, the headline inflation rate rose to 2.8% year-over-year – returning to a level not seen since 2012.

Earnings per share for the S&P 500 grew 24.3% year-over-year in the first quarter when GDP growth was 2%. We will now be looking forward to what a stronger U.S. economy watch what it does in the second quarter. Currently, estimates are for 20.5% earnings per share growth in the quarter.

However, even with the good economic and earnings numbers, stocks had a lackluster second quarter. The major international stock indexes recorded price losses, while the domestic indexes only saw small single-digit gains, led by U.S. small cap stocks.

In the bond market, yields stayed mostly stable and range-bound in the second quarter, after rising in the first quarter. Overall total returns for bond indexes year-to-date are flat to slightly negative (see above). We suspect the path-of-least-resistance for bonds yields in second half of the year is to move slightly higher.

Arguably, the trade headlines took their toll on stocks and bonds in the second quarter. Hence, we look forward to some kind of trade negotiations commencing in the third quarter to level the playing field and allow financial markets to enjoy the economic and earnings successes of the first half of the year.

The Economy

George Mokrzan, Ph.D., Senior Vice President, Director of Economics

Spurred by strong labor markets, an expanding world economy, generally favorable financial conditions and the implementation of significant tax reforms, the U.S. economy accelerated during the second quarter. The highlights include:

- Retail Sales excluding motor vehicles and parts rose 6.4% year-over-year in May for the strongest annual leap in sales since February 2012. Fueled by strong labor markets, rising disposable personal incomes and sound average finances, consumer spending is projected to remain solid into 2019. Home investment should benefit from these same positive fundamentals even as mortgage rates edge higher.
- Labor Employment grew over 1 million jobs in the 5 months through May, bringing the official U.S. unemployment rate down to 3.8% -- the lowest since December 1969. Despite the strong job gains, wage growth has remained low, though on an upward trend. Labor force participation has also been rising, but has remained low by long-term historical standards.
- Business equipment spending has been rising, but annual growth of 6.1% year-over-year in non-defense capital goods orders excluding aircraft has not yet risen to its potential given the numerous investment incentives provided by recent tax reforms. However, improvements in capital spending are expected to pick up in the next year.
- Moving upwards with the 2.8% annual rise in the Consumer Price Index (CPI-U), inflation in Personal Consumption Expenditures Excluding Food and Energy (Core PCE) has risen to 2.0% in the last 12 months, which is in line with Federal Reserve objectives, but is also on a rising trend.
- The Federal Reserve has raised the Fed Funds rate target into the 1.75-2.0% range, and is forecasted to raise rates another quarter point in September. However, we anticipate the rate of policy rate increases to slow somewhat from the once-a-quarter pace. Monetary policy has begun to firm and policy uncertainty in trade has risen. Our Fed funds rate target projection is 2.25% at year-end 2018 and 3.00% at year-end 2019. The pace of increase in the 10-year Treasury yield is expected to ease by even more than in the Fed Funds rate target, with the 10-year peaking for the economic cycle around 3.50%.

- Exports of goods and services have risen 8.1% year-to-date in April as compared to the same period last year. Increased challenges to growth in Europe, China and some emerging market economies are expected to slow global growth somewhat from the strong pace in 2017 and early 2018. Export growth could also have been accelerated recently in anticipation of higher tariffs in the coming months. Nonetheless, exports continued impressive gains in the last half year.

The overall economy is expected to grow at a robust annual real GDP pace of 2.8% in 2018 and 2.7% in 2019. Inflation and interest rates are expected to remain historically low, but on rising trends that could eventually slow economic growth. We expect progress in trade negotiations to be made in the third quarter, but uncertainty over international trade policy is a potential risk to our forecast, especially if uncertainty restrains capital spending from reaching the high levels warranted by the incentives created in recent tax reform legislation.

Fixed Income Markets

Kirk Mentzer, Senior Vice President, Director of Fixed Income

The second quarter of 2018 was a challenging period for fixed income investors. Benchmark 10-year Treasury yields rose steadily in the first six weeks from 2.74% before peaking at 3.10% in mid-May. Concerns about trade negotiations and slower global growth provided a boost to the relative safety of U.S. government bonds. As a result, 10-year Treasury yields declined and ended the quarter at 2.85%.

Yield curves continued to flatten during the period as the gap between 2- and 10-year Treasury notes fell to 0.33%, the most narrow in over a decade. Two messages seem to be emanating from the yield curve;

1. Confidence in the Federal Reserve to follow through with their market commentary to continue tightening monetary policy; and
2. Fed Chair Jerome Powell commented in his first post-Fed meeting press conference in March that, "There is no sense in the data that we are on the cusp of an inflation surge."

Corporate bonds suffered another disappointing quarter and risk premiums moved wider by 0.3% or 30 basis points. Damage was most evident in lower grade issues, longer maturity bonds, and sectors experiencing significant merger activity such as telecom and media. At +130 basis points, the overall corporate credit spread is the widest in 6 quarters and stands at a 5-year average. Taken together, the Bloomberg Barclay's Intermediate index produced a total return that was essentially break-even at +0.01% for the quarter.

Looking ahead, we anticipate yields will rise modestly for the balance of 2018. The combination of Federal Reserve tightening, strong economic growth, and rising inflation pressures will keep the path of least resistance higher for bond yields. In terms of investor positioning, we offer these suggestions to best navigate the current macro environment;

- Expect the yield curve to continue flattening. The forces pressing the yield curve more narrow remain firmly entrenched.
- Seek ways to improve portfolio income steams: callable agency notes and quality corporate bonds are two simple ways to enhance returns with minimal risk.

Value in corporate bonds has been restored. The six-quarter widening spell benefits investors with incremental dollars to invest. Fundamentals remain supportive with strong earnings growth and low default rates. New issuance of corporate bonds in the first half of 2018 contributed significantly to the spread-widening of risk premiums and underperformance. However, we expect supply to diminish and foreign buying to improve thanks to better values even when currency hedging is factored into the equation. We find the best risk reward in large banks, REIT, utility and financial technology issuers.

Equity Markets

Randall Hare, Senior Vice President, Director of Equity Research

The second quarter was a positive environment for U.S. stocks, although international trade fears continued to weigh on risk-taking. The U.S. was the only major region to post positive returns for the quarter. U.S. Small Cap indexes outperformed the U.S. Large Cap benchmarks, as typically small cap stocks have less exposure to international trade.

- The biggest story of Q1 earnings (reported in Q2) was the concern that Q1 will represent the peak growth rate for U.S. earnings per share growth. Earnings per share for the S&P 500 grew 24.3% year-over-year in the first quarter, estimates are for 20.5% earnings per share growth in the second quarter.

Looking ahead to the third quarter of 2018 and the remainder of the year, some of the factors that we are keeping our focus on at Huntington include:

- U.S. economic growth, as noted above, is forecast to grow 2.8% for 2018. We forecast an acceleration in inflation, with a continual rise in Fed Funds rate.
- Amid the rally in oil prices, Energy staged the biggest comeback in Q2 to become the quarter's best-performing sector (+13.5%) after turning in among the worst returns in Q1. Meanwhile, Staples (-8.6%) and Telecom (-8.4%) were the worst performers in the first half of the year.

- S&P 500 EPS increased 24.3% in Q1-2018 from the year ago period. For Q2-2018, estimates are for a deceleration of growth to 20.5%. Overall, calendar year 2018 looks to continue with double-digit earnings growth. The earnings outlook has and should continue to provide a favorable environment for stock investors.
- Headlines for domestic equity markets have shifted from the tax cut incentives to the threat of tariffs being implemented. Depending on the outcomes of these efforts, we could see volatility in International markets as trade uncertainty creates a less favorable global investment backdrop.
- Given the uncertainty around the timing of higher rates and faster growth we believe this is not the time to be aggressively buying or selling portfolio holdings, only trimming or adding where portfolio excesses or deficits exist. We continue to focus on strong earnings growth where valuation presents attractive opportunities. Staying invested is likely to provide investors with the best opportunity to achieve their portfolio objectives.

Weighing the headwinds and tailwinds, we see a continuation of double-digit earnings growth, which should be beneficial for stocks. This will allow for U.S. investors to be patient, yet maintain a positive environment for U.S. equity investors.

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