The Cobblestone Advisor
Investment Brief
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CAPITAL ADVISORS

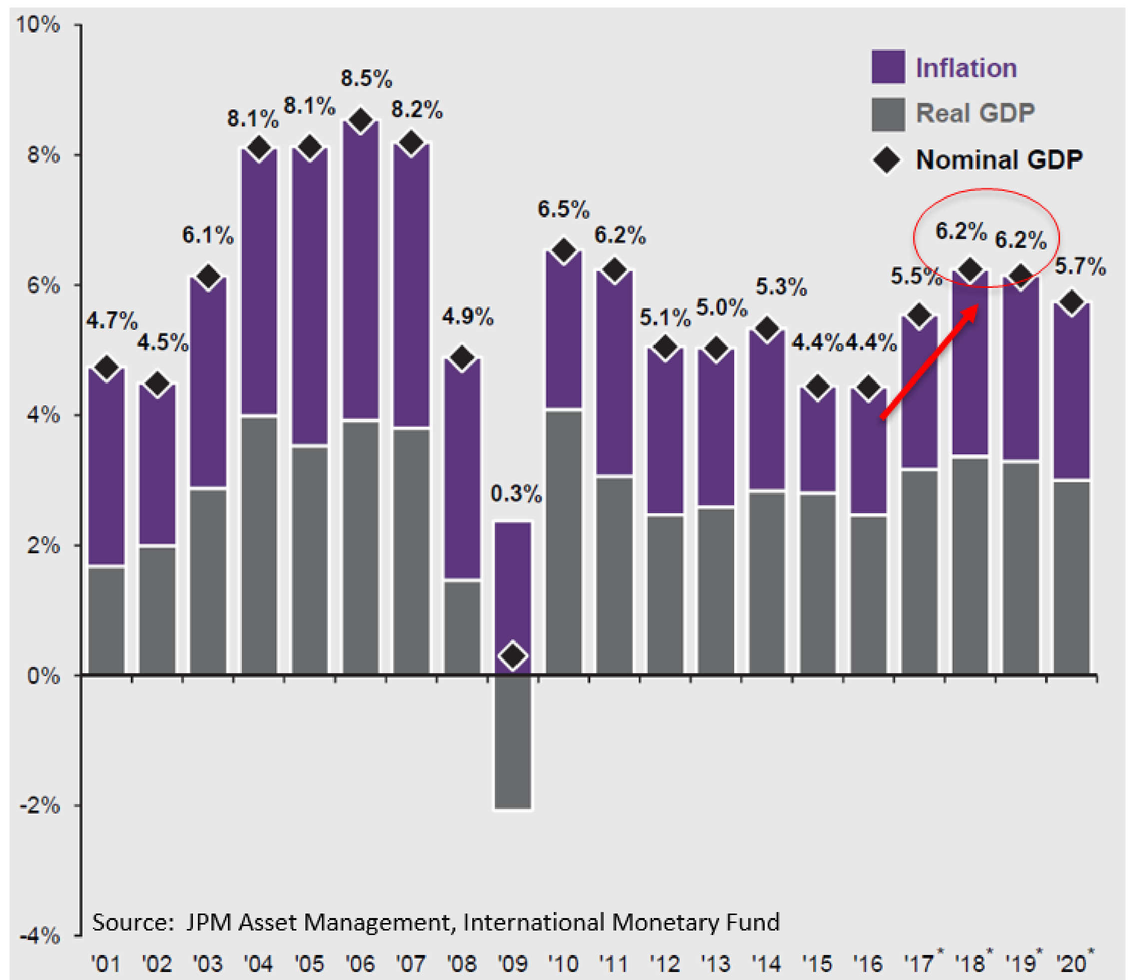
Economic Growth Calms Investors

After a jittery first quarter, U.S. financial markets settled back down in the second quarter. The large-cap S&P 500 index posted a gain of +3.4% for the quarter, while the small-cap Russell 2000 index rose +7.8%. After spiking during the first quarter sell off, implied volatility (as measured by the CBOE VIX index) fell back to historically low levels, suggesting a moderation of fear among investors.

Likewise, the sharp rise in interest rates that dominated the fixed income markets in the first quarter gave way to a much more muted change in yields during the second quarter. The Federal Reserve raised the target Fed Funds to 2% in June, the second 0.25% increase this year, and signaled further increases for the remainder of 2018 and 2019 as they continue steadily working to normalize monetary policy. Yields on short-term treasuries, which are the most influenced by the Fed Funds rates, continued to rise and finished the second quarter at 2.52% (up from 2.26% at the end of the first quarter). Longer duration treasuries rose a more modest amount with the 10-year bond yield increasing slightly to 2.85% and the 30-year bond yield staying basically flat at just under 3%. These yield increases, coupled with rising corporate bond spreads, kept the Barclay's U.S. Aggregate index just barely in negative territory (-0.2%) for the second quarter.

International stock markets, which were hampered by a rising dollar and increasing trade tensions, did not fair nearly as well in the second quarter. Despite local market returns that

The IMF Projects Global GDP Growth to Accelerate in 2018



Source: JPM Asset Management, International Monetary Fund

were in line with U.S. markets, developed international stocks were down -2.8% as the U.S Dollar index rose 5% during the quarter. Emerging markets—the portion of the global markets most impacted by the continued imposition of higher tariffs by the Trump administration—were down -8.0% in the second quarter. After a very strong 2017 and start to 2018, emerging markets are now the worst performing area of the markets for the year.

Despite the mixed returns, the backdrop for global equities remains quite strong. For the first time since the 2008-2009 financial crisis, global growth seems to be in a synchronized upswing. As shown in the chart on the front page, the International Monetary Fund (IMF) estimates that global nominal GDP growth will rise +6.2% in both 2018 and 2019 (up from +5.5% in 2017). This represents the strongest growth since 2011 and should continue to support domestic economic activity.

Additionally, the fiscal stimulus related to last year's tax reform continues to push economic output higher, with real GDP growth in the United States likely to top 3% in 2018 for the first time since 2015.

Further, this surge in growth is pushing corporate earnings to record levels. S&P 500 earnings, already at all-time highs, are expected to increase +22% in 2018 compared to 2017. These earnings are what allow companies to raise dividends, buy back stock, and invest in the capital expenditures or research and development that will drive future growth. These are all important drivers of stock market returns, both in the short term and the long term. Increases in corporate profitability also allow companies to employ more workers, as we are witnessing now. U.S. unemployment fell to 3.8% in May, the lowest level since the Vietnam War draft era.

While the conditions for continued expansion appear to be very strong, it is important to avoid complacency during times like this. The Federal Reserve rate hike cycle and the flattening of the yield curve, among other things, are starting to show up in the form of tighter financial conditions in the United States. This is not only normal at this point in the economic cycle, indeed it is a desired outcome for a central bank that is intent on making monetary policy more restrictive. Nonetheless, tighter financial conditions make growth harder to come by and will eventually play a prominent role in ending the economic cycle.

For now, though, we do not believe this inflection point is imminent. As such, we remain cautiously optimistic in the near term and are positioning portfolios accordingly.

Total Return Ending 6/30/2018				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
MSCI All Country World Index	0.53%	-0.43%	10.73%	8.15%	9.37%	5.78%
Russell 3000 Stock Index	3.89%	3.22%	14.78%	11.54%	13.24%	10.19%
S&P 500 Stock Index	3.43%	2.65%	14.37%	11.88%	13.37%	10.13%
Russell 2000 (Small Cap Stocks)	7.75%	7.66%	17.57%	10.92%	12.41%	10.56%
MSCI EAFE (International Stocks)	-1.24%	-2.75%	6.84%	4.88%	6.41%	2.83%
MSCI EMF (Emerging Markets)	-7.96%	-6.66%	8.20%	5.58%	4.99%	2.25%
Barclays US Aggregate Index	-0.16%	-1.62%	-0.40%	1.71%	2.26%	3.71%
FTSE NAREIT All Equity REITs	8.50%	1.27%	4.93%	9.10%	8.84%	8.27%
Consumer Price Index			2.5%	1.7%	1.5%	1.5%

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