Northern Oak Wealth Management, Inc.
555 East Wells Street, Suite 1625
Milwaukee, WI 53202
414-278-0590 Fax 414-278-1294
Toll Free 888-283-1884

Market Commentary

Summer 2018

Out of Sync

The US economy is performing quite well, but apparently, the stock market doesn't know it. Many expect second quarter gross domestic product (GDP) to have reached above 4% growth and possibly near 5%. We will find out on Friday. In fact, the Atlanta Fed is forecasting the number to be 4.5%, more than double the 2.2% average growth we have experienced since this expansion began in mid-2009 and higher than the 2.7% average growth over the past 50 years. The factors behind this growth are a lessening regulatory environment and the continued impact of the tax bill. Just last week, President Trump's economic advisor, Larry Kudlow, stated that several more years of growth at a higher rate would not surprise him. We admit growth expectations are hard to believe as we continue on in one of the longest economic expansions we have ever experienced. When does it end? While we do not know the answer, we do find it unlikely it will end at a time when economic growth is accelerating.

The economy is creating jobs. Unemployment is at the lowest level since 2000. The unemployment rate in June actually ticked higher not because of people losing their jobs, but because of 600,000 more workers entering the work force as they became more upbeat on their employment prospects. In addition, a gradual increase in wages is keeping inflation in check. Theories abound on why wages have yet to see more increases, but some reasons cited have been productivity gains and, according to Barron's, younger, lower paid workers replacing higher paid retirees. Ultimately, we do see higher wages posing an inflation threat, but right now, this is not a concern for the market.

While global trade issues dominated the headlines in the second quarter, we believe corporate profits are slowly stealing the show. Growth in earnings were in excess of 20% in the quarter in large part due to the cuts in the US corporate tax rates and a cut in the repatriation tax. This opened the door for corporations to bring back money from overseas accounts and back into the US for investment and, in some cases, stock buybacks. Fewer shares outstanding obviously increases earnings per share. According to TrimTabs, US public companies announced a record $437 billion in stock buybacks in the second quarter, more than twice that of the previous record achieved in the first quarter. Apple led the way with a $100 billion buyback. Next time you buy a charger for your iPhone, which actually comes in two pieces and is sold separately, you will know why it has so much money!

Some argue that the earnings increase is a one-time event due to the tax cuts that took place. However, 2019 forecasts, where tax rates are the same when compared to 2018, are predicting 10% growth according to Factset. In addition, revenue growth, not directly impacted by tax cuts as earnings are, for the S&P 500 in the second quarter is expected to come in at around 8%. That is outstanding.

Despite the strong earnings growth the market has barely budged, rising just 2.6% in the first half of 2018. However, the news on performance actually gets worse. Performance has been very narrow and dominated by the technology space which represents one-quarter of the entire S&P 500. According to Bank of America Merrill Lynch, the technology sector accounted for 98% of the S&P's return. Furthermore, it suggested ***the S&P had a -0.7% return when you exclude the five FAANG stocks (Facebook, Amazon, Apple, Netflix and Google).*** When you expand the analysis to the top 10 stocks in the S&P 500, they account for 122% of the S&P's return! Amazon alone accounted for one-third of the market's return.

Northern Oak Wealth Management, Inc.
555 East Wells Street, Suite 1625
Milwaukee, WI 53202
414-278-0590 Fax 414-278-1294
Toll Free 888-283-1884

Performance concentration can also be seen at the sector level where just 3 of the 11 S&P sectors outperformed (Discretionary, Technology and Energy). In addition, dividend stocks, as represented by SDY, a dividend ETF, was down -0.65%. Finally, international markets, both developed and emerging, posted negative returns. Most would prefer a bull market to be supported by more than just a few stocks. The overall breadth of the market has been somewhat disappointing and is something to keep an eye on. One underperforming sector that concerns us is the financial sector. Historically, financials have led the way to higher markets as improving economic prospects raise interest rates that help increase profits for the sector. Financials have underperformed this year, but we expect that to change as rates ultimately climb higher, improving the outlook for earnings, and eventually stock performance in that sector.

Longer-term rates have not moved much this year, suggesting investors are not convinced of a sustainable expansion in the economy. In fact, the spread between the 2-year and 10-year US Treasuries narrowed to the smallest spread since 2007. Why is this a concern? If short-term rates exceed long-term rates, the curve is said to be "inverted." An inverted yield curve implies that investors believe future growth will be slower. In addition, while not a guarantee, it has often been a precursor to a recession. Recently, however, 10-year yields have ticked higher and now are once again approaching 3%.

As we cited in our last newsletter, we believed (and still believe) that trade wars are a key risk to the markets, and this risk was elevated in the second quarter and even more so in July. Any news on this front can have a major impact on the markets. A few weeks ago, the market quickly rose 300 points on rumors of an end to the trade war and tariffs. It is clear to us that the uncertainty in current trade negotiations are constraining this market. Except for the FAANG stocks, investors remain cautious for now as reflected in the negative year-to-date returns in most of the market.

Few believe, including us, that anyone wins in a trade war. How can everyone be better off with higher prices? But we also don't think this is the end game for the Trump Administration. The administration has made it clear that it believes our trade partners have more to lose than the US and ultimately is hoping for concessions from them. In the end, we see China and others stepping back. It is not right to steal our intellectual property and to impose higher tariffs than the US. Imagine the confluence of faster economic growth in the second half of the year, alongside a resolution to the trade dispute! While the market has been held back by these concerns, we believe the underlying positive fundamentals of this economy will drive it higher by year end. We would also expect more participation from the rest of the market narrowing the gap created by just a few large technology companies.

2018 has been a slow year so far for dividend investors, but that is simply a symptom of the aforementioned affinity for higher growth technology stocks. Ultimately, dividends comprise a significant amount of investor's returns. Sometimes, however, they get overlooked in the euphoria of growth. At the end of the day, however, there are few investments better than a growing stream of secure cash flows. Investors will once again be rewarded for holding quality companies as their core.