Market Review and Outlook—July 6, 2018

Moderation Returns — After a red-hot 2017, this year is shaping up to be a much more normal year. While the 3 month column, below, shows mixed results, the other four columns show fine trailing returns. The last line shows results for an average balanced portfolio, with annual returns from about 5½% to 6½%. Not bad.

Small (Cap) Shooting Star — We haven't seen US small cap stocks outperform all other major stock sectors for years. So it's newsworthy to see small cap returns for the last quarter leap. This could be due to the perception that smaller US companies are more insulated from global trade tensions. Small cap returns have been stronger for growth companies than for value companies, however this gap shrank during the quarter. Overall, US growth has outperformed US value for the past decade.

Bonds Continue to Bore — With the exception of municipal bonds, which did fine during the quarter, quality bond returns slid a little during the past quarter. This has been expected and should continue as the Fed keeps stair-step raising the overnight interest rate every few months. With a few exceptions, both quality and opportunity bonds posted uninspiring results. The worst results came from world bonds, which were hurt by the rising US dollar. While we prefer strong returns, we primarily hold bonds to stabilize the overall portfolio.

Foreign Follies — Foreign stock markets showed some weakness in the past quarter, posting losses while US stocks rose. Factors such as low unemployment, moderate earnings, and solid corporate profits abroad indicate that this past quarter's losses likely represent a short term drop during a longer cycle of growth. The positive side of foreign stocks posting a loss is that they are not moving in lock-step with US stocks, finally giving us the advantages of diversification after a year and a half of the markets moving together.

Dollar Drop — The US dollar jumped in value for the last quarter, which will naturally hurt international returns. Even with some momentary strengthening, in the medium term the dollar is still expected to weaken. So if you're an investor who has not already gotten exposure to foreign stocks, now could be a good opportunity to buy before the dollar weakens more.

	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Govt Cash Reserves	0.35%	1.00%	0.43%	0.26%	0.32%
Intermediate Term Bond	- 0.24%	- 0.36%	1.68%	2.20%	3.89%
Intermediate Muni Bond	0.78%	1.14%	2.30%	2.89%	3.67%
Large-Cap Stock	2.68%	12.58%	9.93%	11.73%	9.08%
Mid-Cap Stock	2.96%	11.31%	7.96%	10.61%	8.92%
Small-Cap Stock	6.31%	14.67%	9.41%	11.02%	9.73%
Foreign Large-Cap Stock	- 2.14%	6.08%	4.56%	5.92%	2.61%
Foreign Small/Mid Cap Stock	- 2.29%	9.29%	8.12%	8.81%	6.01%
Diversified Emerging Markets	- 8.90%	6.09%	4.76%	4.05%	2.09%
Financial	- 0.91%	9.57%	10.10%	11.47%	8.26%
Health	5.78%	12.38%	3.69%	14.50%	13.81%
Real Estate	7.98%	3.39%	7.22%	7.70%	7.27%
Technology	5.13%	27.11%	19.18%	19.54%	13.11%
Moderate Allocation (50-70% stocks)	**1.16%**	**6.58%**	**5.59%**	**6.85%**	**6.27%**

The data in this table comes from Morningstar and is as of June 30, 2018

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US Stocks — US stocks look good—not overpriced, in the midst of a year-long earnings surge, and with only modest impact from global trade tensions. The cautionary factors include the unwinding of economic stimulus from the Fed, boosting companies' borrowing costs, a rock-bottom unemployment rate, making it hard for companies to grow to meet demand, and the coming of an economic slowdown (not a recession, just a notable reduction in the growth rate). This leaves us liking US stocks, but curbs our enthusiasm.

European Peak — The Eurozone has been humming along with steadily increasing economic growth since 2013. Since that time, their stock markets have followed the slow-and-steady growth pattern set by the US. Since Europe stock markets started the upward run after the US, we expect that they will continue growing after the US slows. We bet on Europe early, leaning into the European markets to ride this upward growth. Now we are unwinding our Europe lean as its unique advantages are waning: Eurozone unemployment approaches historic norms, Eurozone economic growth approaches normal highs, and European central banks ending their stimulus. Our unwinding is designed to seal in the gains that resulted from this multi-year strategic move. The Eurozone, of course, will continue to be a significant portion of our foreign stock focus as it makes up approximately 20% of the global markets, it will just make up closer to that 20% mark rather than a higher amount.

Rising Rates Bring Back CDs — Investors who remember the late 70's and early 80's can remember interest rates on Bank Certificates of Deposit (CD) high enough to look like today's stock market returns (Although higher inflation at the time ate up most of the high CD yields). For the last decade it has been difficult to find CDs returning much more than a savings account. Fortunately, the upward climb of interest rates over the last two years has produced attractive yields for short term CDs.

What are Bank Loans? — We have been using **bank loan** funds as a key piece of our **opportunity bonds** since mid-2016. Bank loan funds invest in floating-rate loans made by banks to companies. This protects them somewhat from rising interest rates while providing a fine yield, making them optimal while rates are rising. We like bank loan funds as a complement to our other opportunity bond funds, providing a lower-risk version of high-yield bonds with a rising rate benefit.

Technology Takeover — Technology companies are growing, and fast. That becomes apparent when you look at the historical weight of the technology sector in the S&P 500 Index. The technology industry has grown from 18% in 2014 to 26% of the S&P today. We aren't overly alarmed by this steady tick upward because most tech companies have sales and earning to back up this growth, something they lacked during the tech bubble of the early 2000's. Furthermore, with worrisome demographic trends in the US, companies are increasingly using technology to help meet their labor/productivity needs. Nonetheless, we recommend a steady, unemotional approach to forecasting—fighting the natural tendency to get excited about the latest gadget and rather sticking to fundamental diversification principles.

What Goes Up Must Come Down — "So when is the next recession?" If we had a nickel every time we've heard this question or read a prediction in the last year, we would buy lunch for the whole office. 'When' is a question that can't be made with any precision, but it can be estimated. The important components missed by asking only 'when' is 'why' and 'how.' What causes the next economic slow down—is it a bubble popping or a 'normal' slowdown? How deep will the next recession be, and how long will it last? These are equally important questions, and, fortunately, history and leading economic indicators give us insight into the answers.

The U.S. has had eleven recessions since WWII. The two in most recent memory were precipitated by a housing and mortgage crisis (recession starting in Dec 2007) and the collapse of the speculative tech bubble (recession starting in March 2001). These two recessions averaged a pull back of around 50%, while the other nine of eleven recent recessions averaged a pull back of around 25%. Conventional wisdom and conventional estimates tell us the next recession won't start for at least another 12 months, and that the next recession will look more like a 'normal' recession, rather than like the last two, more severe, recessions. If the next recession is smaller than the last two, it will be good news for the second half of the baby boomer generation who are fast approaching their likely retirements.

As an investor, there are challenges and opportunities. The biggest challenge is making your plan and sticking to it. We're happy to help, don't hesitate to reach out.