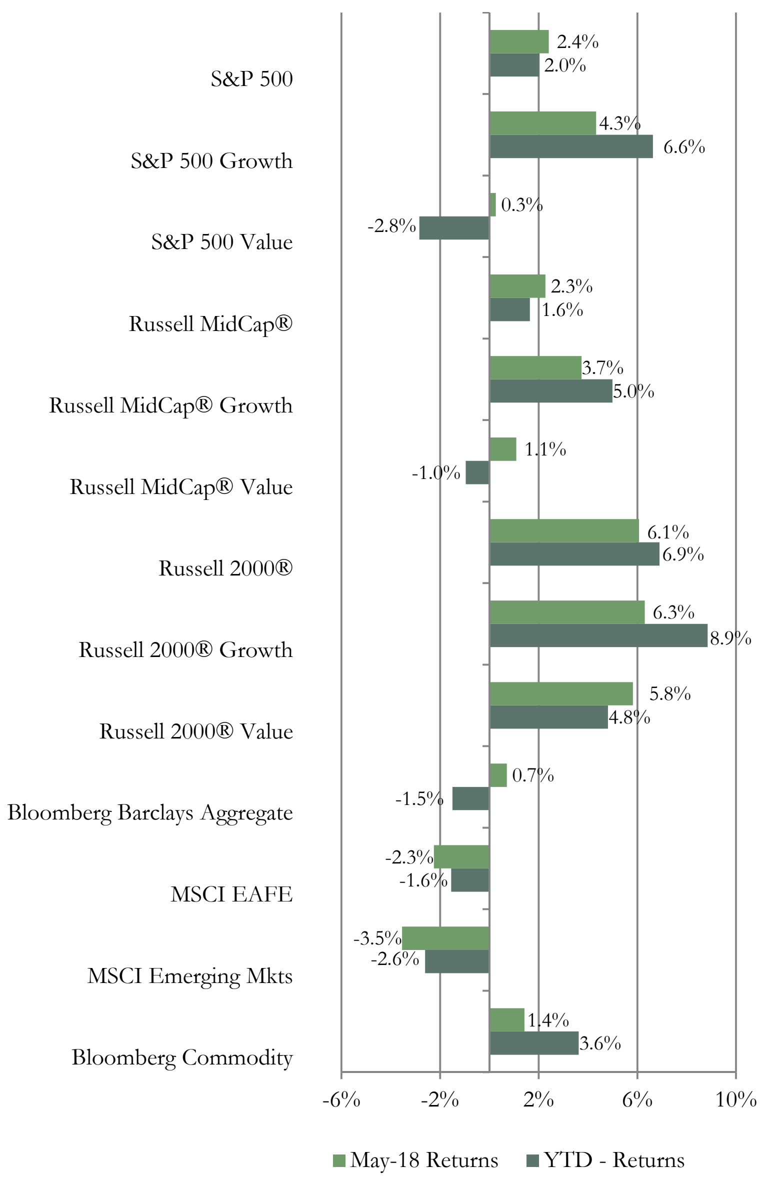
Monthly Market Summary – May 2018

A steady stream of geopolitical issues were a main focus for market participants during May and had a major influence on global financial market activity during the month. One such issue was the withdrawal by President Trump from the 2015 Iran nuclear deal which re-imposed sanctions against Iran. This action pushed up the price of oil due to the resulting supply reduction, and will force the negating of recently signed contracts for U.S. companies to sell goods to Iran. The loss of Iranian oil on the world market was one reason that Saudi Arabia and Russia held talks on lifting the oil production limits. One issue that created a sharp but brief shock to global currency, bond, and equity markets was the effort by anti-European Union (EU) parties to form a government in Italy. Markets reacted to fears that the Italian economy could be in disarray if a new euroskeptic alliance was formed and moves were made to exit the EU. This led to a sharp rise in yields for Italian and other European bonds, a drop in the value of the euro, and a drop in global stock prices. Safe haven assets such as U.S. Treasury bonds had large gains on "risk-off" trading. However, the initial shock was short-lived since a more moderate coalition was formed. Trade policy news was reported throughout the month which led to both positive and negative market reactions that varied day to day as events unfolded. For example, markets calmed in reaction to the U.S. extending the negotiation deadline with China, but reacted negatively when the U.S. moved ahead with tariffs on $50 billion of Chinese goods and after the announcement that the U.S. tariffs on imports of EU, Canadian, and Mexican steel and aluminum would become effective June 1.

Market Indices – May 2018



Returns for the major U.S. equity indices we track were positive for May. The Russell 2000 index of small-capitalization (cap) stocks hit several new record highs during the month boosted by investor's expectations that small-cap stocks are hurt less than large multi-national companies by the rising dollar and benefited more from the tax cuts. May was the third consecutive month that the Russell 2000 index outperformed the S&P 500 and Russell MidCap indices. Growth stocks outperformed value stocks with the performance gap particularly wide in the S&P 500 and Russell MidCap indices. Relative sector returns were similar in the large-cap and mid-cap indices with information technology and energy having the best performance and telecommunications and consumer staples having the poorest performance with negative returns. In the small-cap index, all sectors had a positive return with the healthcare and information technology sectors having the top returns and the utilities sector having the lowest return. The dispersion in sector returns continues to grow. For example, year-to-date, in each market cap range, the information technology sector had a double-digit gain compared to a negative return for the materials sector. In another example, the healthcare sector in the small-cap index had a 17% return compared to a 1% return for the utilities and industrials sectors.

Developed international and emerging market equities underperformed U.S. equities for the month of May. The MSCI EAFE index of developed international stocks had a return for the period of -2.3% on a U.S. dollar basis. The MSCI Emerging Markets (EM) index had a return of -3.5%. Currency movements had a negative impact for U.S. investors since the U.S. dollar rose, however the local currency returns for the EAFE and EM indices underperformed major U.S. equity indices also. The local currency return was -0.7% for the EAFE index and -2.2% for the EM index. Among developed international equity markets, the Pacific ex Japan region had the best return with Australia and New Zealand posting positive returns. The euro area was the weakest region hurt by political issues in Italy and Spain, some slowing in economic data in Germany and France, and concerns about the potential impact of new trade tariffs. Italy was particularly weak with the MSCI Italy index posting a return of -12% for May. In emerging markets, Latin America was the poorest performing region with the MSCI Latin America index down 14% for the month. Several Latin American country indices were down double-digits, such as Brazil and Mexico, due to negative currency impacts, political issues, and weakening economic data. China and Russia were among the best performing countries. Chinese markets received a boost from a better than expected report on manufacturing and service sector activity. Just as in the U.S., growth stocks outperformed value stocks in both the EAFE and EM indices. The healthcare and information technology sectors had strong gains while the more interest sensitive sectors, such as financials, telecommunications, and utilities had sizeable negative returns.

U.S. bond market returns were generally positive in May leading the Bloomberg Barclays U.S. Aggregate Bond index to end the month with a return of 0.7%. Solid economic data reports pushed the yield on the 10-year Treasury bond to 3.12% on May 18. This was the highest level for the 10-year yield since July 2011. However, the yield was down to 2.75% by the last week of the month due to a lower than expected inflation report and investors flocking to the safety of U.S. Treasury bonds due to a flare-up in geopolitical risks. The 10-year Treasury bond yield was 2.83% at month-end. The weakest fixed income sector was U.S. corporate high yield which was essentially flat while the best performing sector was the longest maturity Treasury bond index with a return over 2%.

The Bloomberg Commodity index had a return of 1.4% for May driven by gains in the energy and industrial metals sectors. The price of West Texas Intermediate crude oil (WTI) rose during the month to over $72 per barrel, which was a four-year high, on supply concerns especially with the loss of Iranian oil due to re-imposed sanctions. The price of WTI fell late in the month to near $67 after Saudi Arabia and Russia held talks about ramping up oil production as soon as in June. The price of gold fell during the month as the U.S. dollar strengthened. The grains index was down for May due partly to reports of a halt in Chinese buying of U.S. soybeans in response to U.S. tariffs on various Chinese products.

Vogel Consulting, LLC (Vogel) Tactical Recommendations

Even though trade and political risks have increased, we continue to be cautiously optimistic. We expect that financial markets will continue to be volatile as investors react to news on trade talks and tariff actions, monetary policy, signs of inflationary pressures, political issues, and corporate earnings. However, economic growth remains healthy in many regions, corporate fundamentals are generally strong, and corporate earnings growth looks to continue, even though the rate of growth may be lower.

We continue to recommend an equal weight to U.S. large-cap, mid-cap, and small-cap stocks and to developed international equities. We recommend an overweight to emerging markets equities. We continue to favor equities over bonds and retain our underweight recommendation for fixed income investments. Our underweight recommendation is because the return expectation for bonds is low since yields are likely to move higher (and prices lower) as the Federal Reserve continues to hike its policy rate. Within fixed income we continue to recommend a focus on short to intermediate term bonds. We also continue to favor non-Treasury bonds for the yield advantage they provide. We continue to favor hedge fund strategies over fixed income for the lower expected volatility portion of portfolios but also recommend an underweight allocation to hedge funds. Since our expectation is for a moderate rate of inflation, we recommend an equal weight to real assets. We continue to recommend an overweight to cash reserves that includes adequate cash to support spending needs over the coming 12-24 months.