HalpernFinancial
Maryland
11 N. Washington Street, # 720
Rockville, MD 20850
Virginia
20365 Exchange Street, # 200
Ashburn, VA 20147

2nd Quarter 2018 – Investment Commentary

Kirsty Peev CFP ®, Portfolio Manager

Market and Portfolio Performance:

Summary:

- **As investors struggled to balance good news versus bad, markets provided a strong quarter.** On the one hand fundamentals are incredibly strong, but fears of a trade war and higher rates are keeping optimism in check.
- **Continuing strong news from a fundamental standpoint –** In Q2, we saw great earnings, record M&A activity, and strong jobs numbers, coupled with the previous quarter's deregulation and tax cut. Inflation is at target levels and the Fed continues its rate increases in a measured and manageable manner, in response to a healthy economy.
- **Potential trade war dominated headlines and moved markets.** Markets moved up and down depending on sentiment related to tariffs and the potential trade war.
- **Second quarter had normal volatility and respectable returns.** This quarter was much less volatile than Q1, with healthy positive returns for portfolios despite a slight drag from international markets, and stable bonds.
- **The Federal Reserve raised rates and our bond prices stayed firm.** It wasn't long ago that Fed rate hikes could cause bond prices to drop (bond yields and prices often move inversely to each other). This is a good sign that our bonds are able to weather a rising rate environment.
- **Investors responding to natural market volatility.** Two years of very low volatility means that a return to normal volatility feels scarier since we are coming off such a smooth sailing period.

U.S. Equities:

- **Strong quarter for U.S. equities.** Coming off a stellar 2017, Q1 began with a rollercoaster ride, including a true correction, then ended the quarter about where it started. Q2 also provided ups and downs, and a mixed bag of positive and negative news – but the moves were not quite as wild, ending the quarter firmly in the positive. Despite continuing good news from an economic standpoint, markets moved mostly in response to tariff announcements by the U.S. and China.
- **Small caps had a stellar second quarter.** The current environment is favorable for small-caps. We have a rising U.S. dollar, and because small-cap companies have greater U.S. revenue exposure than large caps, their performance is often aligned with the U.S. dollar. Smaller companies are also more likely to benefit from recent tax cuts, and are less likely to be affected by international trade issues.
- **Great news is being overlooked**, lost in the tariff tit-for-tat between the U.S. and China. The U.S. jobs situation continues to be very strong, exceeding expectations. A study by the National Association of Business Economists forecasts rising sales, continued hiring, and pay increases. In fact, to start the 3rd quarter, a healthy U.S. labor report more than offset the trade concerns! We have seen 5 straight months of private payroll growth over 200,000. Inflation is at target levels, near 2%, and strong GDP growth is projected for Q2.

International Equities:

- **Emerging markets were the real story for the quarter**. EM is your highest risk-return asset class, so it is often the leader or laggard. After outperforming most other categories in Q1, EM equities (particularly China) stumbled, especially due to May and June trade war headlines. Rising U.S. Treasury yields and a stronger U.S. dollar also contributed to losses. However, emerging market countries continue to have strong corporate earnings momentum. According to American Century Investments, the direct effect of tariffs should be manageable (having a 0.1% effect on China's GDP), and the macro effect should be limited. We are monitoring these risks, as well as the impact of rising US rates and a rebounding USD, but we continue to see opportunity in EM.
- **Developed markets slightly negative for Q2.** A political crisis in Italy had the potential to create a Brexit-like election, which did not end up happening, but did cause a lot of concern. (Details on the U.K. Brexit itself remain up in the air, after Prime Minister Theresa May lost the Parliament majority, and a key Brexit official resigned.) Tariffs have also impacted developed markets. In response to U.S. tariffs on steel and aluminum, the EU applied theirs to bourbon, orange juice, peanut butter and motorcycles!
- **Promising developments on the horizon for developed markets.** ECB officials indicated conditions were right to start unwinding their bond-buying stimulus programs. The ECB is expected to hold interest rates steady at least through summer 2019. After nearly a decade of tough austerity measures to restore economic growth, the Eurozone ended the financial bailout of Greece. This is a positive outcome, and the EU and Greece agreed on a debt-relief plan for post-bailout.

Bonds:

- **Nearly all of your bond holdings delivered positive returns during the second quarter**, absorbing the second Fed rate hike of the year in fine fashion. The Federal Reserve increased rates in its June meeting by 0.25%, exactly in line with expectations. This was the second rate hike of 2018, and 1-2 more rate hikes are expected this year.
- **Your short duration/high quality strategy helped navigate a Treasury inflection point.** The U.S. 10-year Treasury yield bounced around the 3% mark – a level which has rattled markets in the past. Your bond holdings absorbed this in a measured way, due to the focus on shorter durations and high quality within the class.
- **Emerging market bonds followed their equity counterparts.** EM bonds led the way decisively during 2017 and delivered equity-like returns, but were affected by the trade and tariff discussions and lagged all other bond categories in Q2. However the healthy yield in this category means it still remains attractive.
- **Municipal bonds out-performed corporate bonds.** Muni performance was tempered during the first quarter as municipalities absorbed the tax reform changes. Muni bonds are back on strong footing.

Expectations and Perceptions for the Future:

Equities:

- **Global equity markets are likely to continue to bounce around based on trade news.** Once things settle, a focus on strong fundamentals should return. We believe investors will focus more on earnings results from the second quarter as July progresses. Companies will communicate how tariffs may impact them, and how they plan to respond. Investors will respond accordingly.

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- **Strength potential in small caps and tech stocks.** As noted, the current environment is very favorable for small caps. Technology stocks also stand to benefit, and should see limited impact from tax reform.
- **Strong incentive to mitigate tariff disputes.** Markets hate uncertainty, and right now, we have plenty of uncertainty related to tariffs. We also have the strongest level of global economic growth since the "Great Recession." While we cannot predict the outcome of the tariff issue, the incentive for world leaders to foster growth is enormous.
- **Several areas becoming more stable and better for investors.** Mexican elections are out of the way with a working majority in Congress and a commitment to fighting corruption, crime and inequality. Increasing stability in Greece has led the country to emerge from 'bailout' territory. An agreement was reached in Germany to continue with a coalition government, and given resistance to a hard-line Brexit, in all likelihood it will not be as extreme as initially thought.
- **The full impact from the U.S. tax package still not been felt.** This will provide a boost to many corporations and individuals. While corporations are reacting to the relief now, individuals see much of this impact until they file 2018 returns.
- **Strong long-term returns in EM.** EM is your highest risk-return asset class – so it nearly always will be the leader or laggard. Over any extended period of time, the class has and should continue to deliver stronger performance since it takes on higher levels of risk.

Bonds:

- **Your bond strategy will continue to benefit as rates increase.** Your bond strategy uses Institutional share class (lower cost) mutual funds with the ability to "float" as rates increase. These are baskets of bonds which can reshuffle to provide access to new and higher yielding bonds as they become available. Our continued focus on the shorter end of the yield curve should also serve your portfolio well. In the current environment, investors are not sufficiently rewarded for taking on longer-term risk.
- **Yields are up, and so are growth expectations.** Real interest rates, and inflation expectations have gone up. Nominal GDP growth has been rising – we should expect rates to go up. This is not like the 2013 taper tantrum (when we had negative real rates). This quarter, bonds just got cheaper and your yields increased, so your longer-term expected returns just went up!
- **Sufficient inflation (between 2% and 2.5%) is expected.** Global financial markets have received $2T recently through quantitative easing programs. Our current global inflation levels give monetary policy makers the confidence to unwind these stimulus programs and begin to normalize monetary policy.

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Tel 240-268-1000 Fax 240-449-8818 Toll Free 877-268-1200