Market Update by *Kirk Hackbarth CFP®, CPA/PFS, MS*

Summary Points

- An improving global growth environment has supported the outlook for corporate profits and higher stock prices around the world.
- U.S. stock prices in particular reflect a lot of good news; therefore, valuations are a bit stretched.
- Inflation is still benign along with commodity prices, most notably oil and iron ore.
- The Federal Reserve raised the federal funds rate 0.25% in June as expected.
- U.S. economy is entering the late stages of the economic cycle, although probability of a recession is still low.

Global Outlook

As we transition into the second half of the year, the big question is how long can the eight-year plus bull market last? The current political turmoil in our nation's capital makes the second half of the year difficult to forecast. Will tax reform finally get passed? How about a new health care bill? Let's not forget about the geopolitical risk (North Korea clearly comes to mind).

In the short-term, global growth has improved and investor sentiment remains strong. However, the longer-term outlook for economic growth at this point looks a bit murky.

Stock Valuations

U.S. equites look expensive while European equites have moved to slightly expensive after their recent run. For the first time in years, emerging-market equites outperformed U.S. large-caps on a one-year basis.

The challenge for the remainder of 2017 is that we are in a later-cycle, momentum driven market where valuations are above longer-term averages. Momentum can drive markets beyond fundamentals for an extended period of time. However, no investment process can accurately pick the peak of the cycle. Since valuations are currently a bit stretched, we are at about 85% of our full allocation to stocks. Therefore, we may reduce equity allocations if the market becomes more overvalued and add on the dips.

Inflation

Fed chair Janet Yellen, in her June news conference, noted that core inflation edged lower. Core consumer price index (CPI) has been essentially flat over the last three months. Oil prices, have dropped about 17 percent since the beginning of the year. If inflation continues to remain soft, the Fed may be forced to slow down its interest rate hiking cycle.

Fed Watch

Why is monitoring U.S. Federal Reserve (the Fed) policy so important? There have been 13 interest rate tightening cycles since World War II. 10 have landed the economy in recession while the other 3 have caused slow growth. Fed actions definitely have a big impact on the economy and markets. However, it's not the first or second interest rate hikes that matter, it's the last few. The current economic environment is showing virtually no sign of an impending recession. However, looking down the road, every Fed rate hike is bringing the economy a little closer to recession.

The Treasury yield curve has flattened, and there is little sign of central bank tightening outside the U.S. If the curve flattens gradually, it generally means investors believe the Fed will keep future inflation in check with gradual rate hikes. This does appear to be the path were on. On a cautious note, the flattening long-term yield curve could be signaling weak real growth.

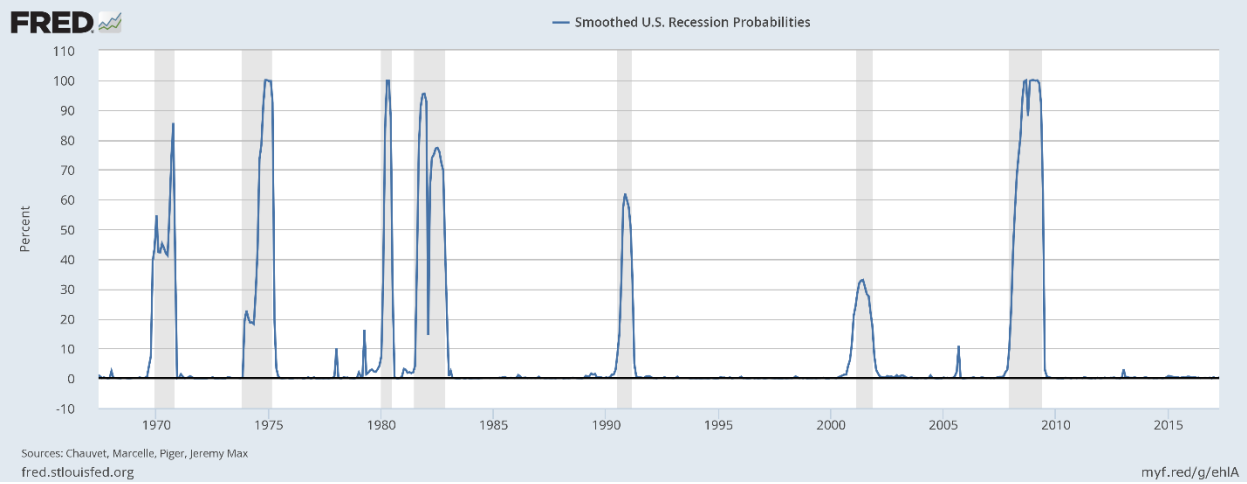

Chart #1 – Federal Reserve Economic Data

The Fed Chart above is predicting less than a 2% chance of a recession currently. Going out to June 2018, the probability increases to about 10%.

Strategy Outlook

Analyst expectations for Developed ex-US and Emerging Markets have been upbeat and improving all year. International growth prospects are improving and valuations are attractive in a world where investment opportunities are becoming scarcer. Emerging market equities are now the best performing asset class on a 12-month basis.

Despite risks, the overall economic evidence continues to support the current bull market. Stocks still look more attractive than bonds and cash at this point in the business cycle.