WESTLAKE
PRIVATE WEALTH MANAGEMENT

Quarterly Missive

July 2018

Over the last several quarters we've risked sounding like the proverbial broken record: the economic fundamentals are strong, yet geopolitical risks are elevated and the current expansion is getting a bit long in the tooth. We've cautioned that volatility – largely absent in recent years – would play a greater role in our investing psyche and might challenge some of us to rethink our tolerances. Yet we've remained constructive on the markets throughout and we've suggested our clients remain invested as well.

Very little changes our outlook as we move forward.

Fundamentally, we believe the macroeconomic backdrop is as sound as it's been in years. We are entering what should be the third consecutive quarter of double-digit S&P 500 earnings growth with anticipated year-over-year growth of 20%. Small company stocks (as measured by the Russell 2000 Index) may actually report earnings in excess 40% year-over-year. Share buybacks announced in the second quarter surpassed $440 billion, nearly double the previous record set in the first quarter. Companies paid a record $111 billion in dividends last quarter, a 7.8% year-over-year increase. The conversation surrounding overall economic growth is equally impressive, with second quarter real GDP of 4.1% - the best quarter for growth since the third quarter of 2014 and a far cry from the ~2% annual growth rates seen prior to 2017. Global central banks are tightening monetary policy, another reflection of accelerating global growth. And the labor market is similarly strong, with the number of job openings exceeding the number of available workers for the first time this century[1]. For these reasons, the fundamentals give us tremendous reason for optimism.

Nevertheless there are two broad areas of concern we're watching carefully.

We're keeping a sharp eye on continued "tariff talk" out of Washington. By now it is clear that the President's "smash mouth" negotiating tactics are just that, and given the opportunity to structure a compromise from a position of strength, we believe he will. As of this writing, the risk of a much-feared trade war with Europe has faded and we continue to believe that many of the current disputes will be resolved. However we've seen the President shift repeatedly on trade, with steel and aluminum tariffs on, then off, then on again. One thing we know – trade talks are incredibly complex and will require months of negotiations. During this time some headlines may appear ominous and investors may be spooked as a result, so continued volatility should be expected.

We're also watching relations with China. One must expect that as long as Trump is President, he'll aggressively go after them. China's theft of US technology and intellectual property costs our economy an estimated $225-$600 billion annually[2]. Furthermore, China's tariffs on imported goods dwarf those imposed by the US[3], creating an inequity the President loathes. Given this, and given that China is widely considered more adversary than ally, one can argue that an aggressive stance on China is justified, especially since the gentle diplomacy of the past hasn't worked. Assuming the possibility that China risks intensify in the coming weeks, one should anticipate volatility to intensify as well.

We're also watching the market itself for inflection points. It is well known that earnings are the mother's milk for equity prices, but we also need to remember that at elevated earnings growth rates, stock market returns can begin to suffer as investors begin anticipating the inevitability that those growth rates may soon slow. Liz Ann Sonders, Chief Investment Strategist with Schwab Capital Markets has often said that "better or worse tends to matter more than good or bad" so we're looking less at the absolute level of earnings growth and more at the rate of change. As a leading indicator, the stock market does a pretty good job identifying economic and earnings turning points well in advance. This is why the data typically looks terrific at market tops and awful at market bottoms. So the question becomes "are the current economic and earnings growth rates sustainable, or has the bar been set too high?". This is a question we'll repeatedly be asking in the coming weeks.

So as we head deeper into the third quarter, our conclusion – the macroeconomic and corporate earnings fundamentals are terrific and the uptrend in the S&P 500 remains intact, but deep into the recovery we naturally begin to ask about longevity, and with robust data we naturally begin to ask about sustainability. At this point we see no telltale signs of a recession on the horizon, so we remain invested and our glass remains half-full.

As always, we remain grateful for the continued trust and confidence you have placed in us, and we hope you enjoy the best of what the summer has to offer.

James H. Dryden
Director

[1] Wells Fargo Investment Institute – July 24, 2018

[2] Stanford Law School – April 10, 2018

[3] Pew Research Center – March 22, 2018