Daniel WILDERMUTH™
MARKET COMMENTARY

June, 2018

- *Presented by Wildermuth Asset Management*

Earnings are Spectacular, but Fears Keep Market in Check

By Daniel Wildermuth

> *"The economic expansion, now the second longest on record, seems likely to continue at least another year, which will make it the longest in U.S. history."*

After a 6% rise in January followed by losses nearing 15% from highs into early February, the market has returned to its more normal pattern of continuous ups and downs. The market is up on the year, but not by much. Yet, even though the market has not repeated its nearly perfect showing of 2017, the outlook for 2018 still appears positive.

First quarter earnings for U.S. companies were fantastic, up 24.9% year over year, which compares very favorably to average earnings per share growth of 7.5% since 2011. While some of the earnings growth results from the new tax regime, nearly all estimates project tax benefits well below 10%, leaving a healthy increase resulting from other factors. Companies in every sector reported better earnings results than expected.

Still, despite the fabulous numbers, the S&P 500 is down since the reporting period began. Numerous reasons are cited including fear over future earnings, inability to sustain current momentum, looming inflation, future Fed interest rate hikes, trade tariff threats, and more recently, softness in the European economies.

While all these concerns are valid, and there are certainly more as well, conditions still look good. New tax benefits should continue to positively ripple through the economy, and in many ways the impact has not yet been recognized. While the U.S. economy slowed a bit in the first quarter, partly because of sluggish consumer spending over the winter, forecasters at Macroeconomic Advisers projected a strong 3.0% GDP growth rate for the second quarter.

The number of Americans receiving unemployment benefits hit its lowest level since 1973 when the population was less than two-thirds of today's. Layoffs are growing increasingly rare and companies are working much harder to fill vacancies as the job market tightens further.

Economists also expect that U.S. productivity growth, stuck at a very low level since the 2008 recession, will increase in the next few years. Companies are making more investments in technology and equipment, and the Trump administration's war on regulation is gaining more traction. Numerous industries are just starting to experience a freer environment, and the innovation associated with less bureaucracy tends to take time to unfold.

The economic expansion, now the second longest on record, seems likely to continue at least another year, which will make it the longest in U.S. history. Growth may eventually slow, but the U.S. has become less sensitive to credit cycles, inventory changes and capital expenditures. The U.S. is also much less dependent on foreign oil reducing many traditional geopolitical risks. The Fed still has room to cut interest rates and inflation remains muted.

Outside of the U.S., earnings have also been strong. Europe, Japan, and emerging markets have all seen significant earnings per share jumps in the past year that are nearly as strong as in the bounce back following the 2008 meltdown.

Still, even though good news continues and in many cases is increasing, investors seem to be paying more attention to risk factors largely ignored last year.

We believe one of the greatest challenges to the ongoing expansion will likely come from some version of resource challenges. A jobless rate approaching 4% is creating wide-spread labor shortages and many U.S. labor markets are the tightest in a generation. Wages are only one of the many inputs that are growing more expensive. Costs for

Continued ...

fuel, freight hauling, steel, copper and many more inputs are rising. Companies have not been passing along much of their cost increases, but this pattern could change and start pushing up inflation. As cost and constraints grow, earnings tend to suffer.

Government actions also deserve mention in the risk category. Fed rate increases have caused around half of all past recessions. While most believe the Fed will tread lightly, history suggests this can be difficult. Recent rate increases have resulted in a much flatter yield curve and rising short-term rates are growing closer to long-term rates. When short-term rates surpass long-term rates, the resulting inverted yield curve has provided a reliable signal of a coming recession as it generally signals an overheating economy.

The current administration also creates unique circumstances. While tax and regulatory policy are unleashing growth and freeing up resources, ongoing threats of a trade-war and less predictable policy increase angst and uncertainty.

Outside the U.S., Europe entered the year having outpaced U.S. growth for the past two years and much optimism led to claims that Europe had moved past its many post-recession problems. Unfortunately, January's rosy forecasts have proved to be overly optimistic, and European growth no longer seems a certainty. After Italy's President blocked the formation of an antiestablishment government, Italy's bond market melted down while the country's credit rating went under siege. Doubts on the future of the euro-zone also resurfaced.

Still, even though most economists believe that growth will pick up again after an unusually cold and snowbound March in Northern Europe combined with strikes in Germany and France, Europe's troubles are gaining increasing attention. The euro is at its lowest since last July, and safe havens such as U.S Treasuries have enjoyed a rally as investors seek safe havens. Growth for the euro-zone is still projected at 2.4% for the year, but confidence has dropped, shaking markets.

Prospects for emerging markets have also grown a bit murkier. After a fabulous year which saw many emerging country indexes rise over 30%, returns in 2018 have been solidly negative in the aggregate. Concerns that rising interest rates will lessen foreign direct investment, increase debt service and increase commodity costs have resulted in strong sell-offs. A rising dollar has also hurt returns. Still, growth remains solid across emerging markets, and China continues to successfully manage a soft economic landing through its curtailment of credit driven investment spending.

Overall, U.S. and global economic conditions still appear quite positive. Yet, confidence has waned. News that would have driven markets up sharply last year have failed to impress investors seemingly more focused on potential problems. While we believe the expansion will continue at least through mid-2019, the benign conditions and heady expectations that took markets to new highs last year with almost no market volatility seem to have passed. We still expect the market to end in positive territory for the year, but double-digit returns seem unlikely, and we expect the market ride will get bumpier in the second half of the year.

Wildermuth
ASSET MANAGEMENT