PREDICTABLY UNPREDICTABLE

If one phrase can capture the first half of 2018, it could definitely be **predictably unpredictable**. There's a lot of it today. We see it in disruptive technology. We see it in global trade. We see it in politics and geopolitics. There is a great deal of tension and confusion around the world. The Market is most focused on the economic impact of said unpredictability. It has played a large role in the Market correction, which began in January.

The correction continues. While the first half of 2018 is now complete, the corrective price action of the US Stock Market is not. We do believe it is close, however. Volatility returned in size this year with fears of a growing Trade War. The Market was way overdue for a correction as we entered the year. It came, and it has been long lasting. It came in the form of both price and time.

TRADE WAR

The biggest risk and most important theme as we headed into the Summer was the growing threat of a global trade war. Tensions between China and the US are seemingly simmering. At least they are on the subject of trade. The 2 largest economies in the world have disagreements on trade and intellectual property. Trade deals and negotiation are not new. Deal-making on social media and in public is. The world isn't used to this. But it has been the modus operandi for the White House since President Trump took office day 1. The Market seems to be getting there.

The real issue as we see it is not tariffs on steel and aluminum. That was the opening act. The real issue, and it matters big time, is intellectual property and innovation. China has become an innovator. President Xi has a plan and it's called **"Made in China 2025**." The plan identified 10 industries that China wants to become globally competitive in by 2025, and dominant for the century. Intellectual property is the prize. The success will be tied to China's advancement in Artificial Intelligence and the industries range from Biotech and Aerospace to Software, Shipping and Renewable Energy. China thinks big. China thinks long. China is investing heavily. China is in it to win it. China perhaps underestimated the global response and realizes, it can't win a trade war with the US. **Nobody wins in a trade war. The Market is telling us that the US is best equipped.**

Companies in the S&P 500 rely on foreign markets for about a third of their revenue. For Tech companies, it's over 60%. Technology stocks, market darlings for years, have risen more than three times faster than the broader market in 2018. But that trend seems to have paused. Tech has felt some new pressure of late, much to do with the escalating trade tensions which threaten revenues and profits. We still really like Tech long-term. We just feel that Tech remains overbought and, in many cases, overvalued. Weakness is buyable.

EARNINGS AND ECONOMIC GROWTH

Earnings will be coming back into focus in July and August. The ability to study fundamentals and focus on facts which are reported 4 times per year is a refreshing time. The numbers are expected to be good. The problem is the threat of global trade breakdowns will absolutely factor into management forecasts. A tone of caution might be felt. The Market seems to be pricing it in already. We will learn a lot more over the Summer.

The rate of growth has accelerated this year, but chances are it will also peak. Earnings are expected to grow over 20% in 2018. Growth should continue in 2019, but it will come at a slower pace. The Market will be sniffing this out. Before the Dot.com bubble burst, S&P earnings growth peaked at 22% in Q3 of 1999. The S&P 500 peaked in Q2 of 2000 and fell 36% the ensuing 3 years. This year's correction has done its job, making this Market less expensive and in some cases, downright cheap. The Stock Market has proven its ability to keep increasing in value historically when the rate of growth declines. But Bull Markets don't last forever.

The US economy is growing. The pace is actually accelerating. 3%+ growth looks very doable for 2018. The economy appears to be gaining momentum on the back of a robust labor market and tax cuts. New home sales increased 14% year-over-year. Consumer spending remains solid, although rising gas prices are swiping Dollars from wallets. Some on the Street are modeling 5%+ growth in Q2. A trade war is not factored in those estimates. We will see the numbers soon.

INTEREST RATES AND CENTRAL BANKS

The Fed outlined a strong second half of the year ahead, with growth and inflation driving their thinking. Another interest rate hike was made. The problem is, the yield curve keeps flattening. The spread between 2-year Treasuries and 10-year Treasuries has shrunk to a decade-low 32 bps in June. This is the tightest spread since the Fall of 2007, which marked the highs for the S&P before the Financial Crisis. Things are quite different now, and much, much healthier, but a flat curve could lead to inversion which has almost always signaled a pending recession. The curve inverted in 2006, well in advance of the 2008 crisis. Today, the front end, controlled by the Fed, keeps rising. The back end, controlled by the Market has stopped. Importantly, the back end of the yield curve is influenced by international central banks, which have kept interest rates near historic lows.

The Fed is in a bit of a pickle, and they seem to know it. Engineering a soft landing is what they have in mind, which can very well extend this business cycle a few more years, but may cool the economy in the short run. The Economy in economic terms is overheating for the first time this cycle. In our view, the shorter term cooling off by the Fed outweighs inciting more bubble tendencies, which would make the inevitable recession and Bear Market worse.

Energy was the best performing sector in Q2 and had its best Quarter since 2011. The sector is known for its booms and busts. It's been booming in 2018. We've found great value being invested here. We see it continuing a bit further, but don't plan to overstay our welcome before the next bust.

BOTTOM LINE SUMMARY

The question in our work is whether we are close to the end of this 5-month Market correction. It has come in the form of both price and time. Earnings continue to grow while the Stock Market has ground sideways down. It's no longer as expensive as it was in January. And then there's this: The small-cap Russell 2000 index hit a fresh new high in June, while the rest of the Market sold off, proving investors still have demand for stocks. The S&P has taken things in stride. The US economy is in strong shape and investors still have an appetite for stocks. They are just being more selective. This is an important point.

Corrections are healthy. They are healing mechanisms. We've referred to them as Market Medicine. We believe we are close to the correction's end and the uptrend will resume into year-end. Demand for stocks is still high. The Bond Market is not compensating investors for the risk taken yet, but higher rates will get it there. We still think there is more to go for this Bull Market. **Remember the 5% gain in January? Historically that meant up for the year.** It has happened 12 other times. All 12 finished the year in the green. Can 13 be a lucky number? History is on our side.