Smith Group
ASSET MANAGEMENT

MARKET PERSPECTIVES

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Tit for Tat

The daily barrage of tweets, retweets, retaliation, recrimination, reflation, etc. sure can feel unsettling. At times it is difficult to even understand what an investor should pay attention to in making investment decisions. Is a trade war imminent? Will rising oil prices derail the global expansion? Is inflation about to take off? Will the Fed tighten too much or too fast? Is the flattening yield curve a harbinger of a recession? Are debt levels too high? Is earnings growth peaking? What will happen in the mid-term elections? The wall of worry seems to be getting taller by the day. Yes, there are many things that could go wrong or that the pundits would like you to believe could undo the economy and markets. But is there a disconnect between the outward portrayal of the current situation and the underlying reality? The headlines would lead you to believe that business and consumers are just beside themselves with worry and may be on the verge of a nervous

(Continued on page 2)

Total Return	2Q18	1 Year
Russell 1000	3.6%	14.5%
Russell 1000 Growth	5.8%	22.5%
Russell 1000 Value	1.2%	6.8%
Russell 1000 Cons Disc	7.9%	22.0%
Russell 1000 Cons Stap	-1.2%	-3.4%
Russell 1000 Energy	14.2%	22.3%
Russell 1000 Financial	-3.1%	9.8%
Russell 1000 HealthCare	3.6%	7.6%
Russell 1000 Industrial	-2.7%	6.6%
Russell 1000 Info Tech	6.8%	31.3%
Russell 1000 Materials	2.4%	9.5%
Russell 1000 Telecom	-1.0%	1.0%
Russell 1000 Utilities	4.2%	4.5%

Total Return	2Q18	1 Year
Russell 2000	7.8%	17.6%
Russell 2000 Growth	7.2%	21.9%
Russell 2000 Value	8.3%	13.1%
Russell 2000 Cons Disc	9.9%	19.5%
Russell 2000 Cons Stap	11.9%	16.5%
Russell 2000 Energy	19.9%	20.3%
Russell 2000 Financial	4.2%	12.6%
Russell 2000 HealthCare	10.2%	29.5%
Russell 2000 Industrial	3.2%	15.8%
Russell 2000 Info Tech	7.2%	21.4%
Russell 2000 Materials	3.6%	11.5%
Russell 2000 Telecom	11.4%	2.0%
Russell 2000 Utilities	8.2%	7.9%

Total Return	2Q18	1 Year
S&P 500	3.4%	14.4%
MSCI AC World*	2.7%	10.8%
MSCI AC World Ex U.S.*	1.9%	7.4%
MSCI World (Developed)*	3.6%	10.9%
MSCI Emerging*	-3.5%	10.5%
MSCI Dev. Europe*	4.1%	4.3%
MSCI Pacific Ex Japan*	4.5%	11.2%
MSCI Japan*	1.2%	8.9%
MSCI China*	-3.5%	21.7%
USD/EURO	-5.2%	2.5%
USD/U.K. £	-4.4%	2.5%
USD/MSCI EM FX	-4.4%	-2.2%

* in local currency, net of tax withholding

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(WWW.SMITHASSET.COM)

S&P Earnings Report Update (2Q 2018) by Chris Zogg, CFA
Market Perspectives (March 2018) by Rick Villars, CFA

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breakdown. But the reality is they have remained quite optimistic despite the naysayers. The optimism portrayed in exhibit #1 is quite striking. Survey readings for business leaders, both large and small, have now exceeded the peak of the previous expansion. In the case of small businesses the reading is the second highest of all time. Consumers are equally cheery and are also more upbeat than the last peak. The portion of respondents saying jobs are plentiful is 2.5 times those saying jobs are hard to get, which is a very big boost to consumer activity. Finally, despite the negative headlines a recent Gallup poll showed the highest percentage of people "satisfied with the way things are going in the U.S." since 2005. This reading is well off the late 1990's highs, but the fact it is rising stands in stark contrast to what you would expect from looking at the headlines or Facebook posts. While the wall of worry is full of things that could undo this exuberance, that is not an unusual condition. Like most investors the headlines keep us up at night, but our data driven nature tells us to look beyond the hype to the underlying reality.

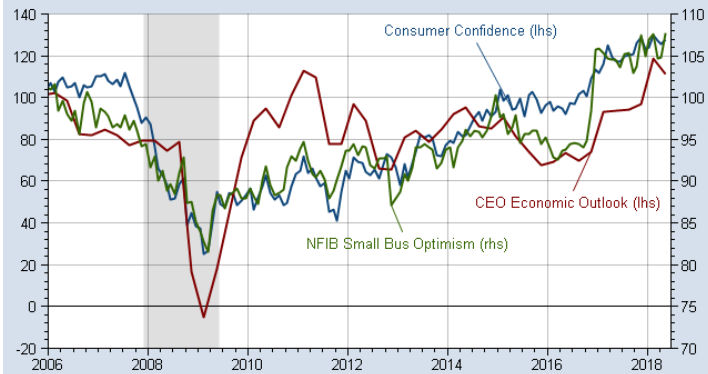
Tariff Tantrum

Clearly, a hot topic of the quarter was the escalating trade war undertaken by the current administration that has been met with considerable resistance. Some of the objectives have merits, but danger lurks in the methods and some of the emphasis seems misplaced. Yet, successful investors have to look beyond what should happen to what is likely to happen and what the data is telling us about the current situation. Being an earnings driven organization, we are looking to forward-looking earnings sentiment as our primary indication of what the investment community is seeing as the ultimate impact. From all the hand wringing of market pundits one would assume that earnings expectations were likely being hit hard, especially for some of our trading partners and export heavy industries. In reality, the movement since the first salvo of the trade war in earnings expectations for next year for some our largest trading partners is miniscule (see exhibit #2). Most of the countries have seen modest net earnings expectation increases. The only decrease is in Japan where expectations are a mere 0.5% lower than before the first tariffs were announced. Given the volatility in stock prices and daily onslaught of negative headlines, one would have thought equity analysts must be in a panic. Chinese stocks in the MSCI index in particular have fallen more than 6% in local terms, but earnings expectations are about 1% higher. Of the remaining trio, Canadian stock prices are actually up about 5% in local terms, while Japan and Europe are little changed (note that the strong dollar makes those returns worse). So far investor sentiment in the stock markets of our trading partners has seen only a muted response.

Industrials Get No Respect

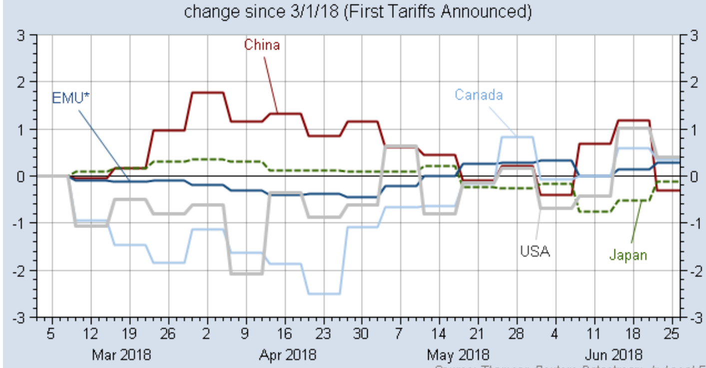
U.S. stocks have also seen an uptick in volatility as tariff talk ebbs and flows. Industrials have a rather high exposure to export markets so the

Exhibit #1: U.S. Confidence



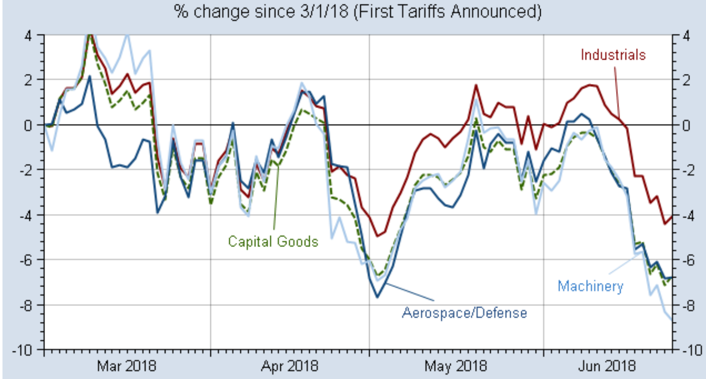
Source: Thomson Reuters Datastream, Conference Board, Business Roundtable

Exhibit #2: 2019 IBES Earnings Estimates MSCI Indices
change since 3/1/18 (First Tariffs Announced)



Source: Thomson Reuters Datastream, In Local FX
**EMU = Austria, Belgium, Finland, France, Germany, Ireland, Italy, the Netherlands, Portugal and Spain*

Exhibit #3: Price Change of S&P 500 Industrial Sector
% change since 3/1/18 (First Tariffs Announced)



Source: Thomson Reuters Datastream

peaks and valleys seen in exhibit #3 are not surprising. After all, companies like Boeing and Caterpillar have more than 50% of their sales outside of the U.S. and employ a lot of people, so they are easy targets for retaliation. Investors are obviously nervous. Tough talking world leaders create indigestion, then cooler heads step in to "clarify" their bosses' statements, creating the roller coaster we have seen in stock prices. So one would think stock analysts would be along for the same queasy ride in looking at earnings. They should at least be showing a bit of caution, right? But they have hardly blinked. In fact, exhibit #4 on the next page shows that not

(Continued on page 3)

only are earnings expectations holding up against fears of a trade war, they are actually rising for this export-heavy group. In the case of the machinery group, expectations for next year have risen more than 5% in the last few months. So what is going on here?

CAPEX Catch Up

It is likely that Industrial earnings expectations are still benefiting from a business investment renaissance. And there is plenty of reason to believe that will continue. The ingredients of confidence, intention, need, and cash available are all in place. The business optimism we noted on the previous page is the first building block needed for business investment and capital expenditure. At the small business level the feeling that this is a good time to expand is at all time highs, even better than in the hyper growth period in the late 1990's. With big business readings as high as they are we would guess CFO's are extra busy calculating ROI on a multitude of expansion plans. Which leads to the second building block, intent. Survey readings highlighting plans for capital expenditures are also quite high, showing that both large and small businesses are intending to invest in their future. Both exhibit #5 and #6 show plans for investment. But do businesses need to invest in new capacity? Capacity utilization is still below theoretical levels, based on the old rule of thumb, of where bottlenecks occur. But those peak levels have been steadily trending lower over the past few decades and the average age of fixed non-residential assets has risen to levels last seen in the early 1960's. This is illustrated in exhibit #7. Much of the excess capacity is in outdated equipment or old industrial plants. With recent innovation in production and distribution solutions, the need is for modernizing facilities, not just buying more of existing equipment. Finally, companies are awash in cash. For most of this expansion they have been using it to buy back their own stock. If they believe that expanding capacity is a profitable endeavor, they can easily redirect the flow in that direction. Of course, we would be remiss if we did not acknowledge the possibility that a trade war could mute or completely undo this investment. The moving target of tariffs and other trade restrictions creates uncertainty and new dynamics as to where and what investments make sense. For businesses to retain their current confidence the playing field will need to settle sooner rather than later. For the time being businesses are assuming that the volleys back and forth between trading partners are negotiating tactics. But if the fire does not abate soon with a longer term settlement, that confidence could be hurt and plans put on hold.

Is the Bark Bigger than the Bite

A bit of perspective is helpful at this juncture. With each retaliation the impact size of proposed tariffs is growing. The initial steel and aluminum tariffs are actually quite small in relation to the U.S. economy and to im-

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Exhibit #4: 2019 IBES Earnings Estimates S&P 500 Industrial Sector
% change since 3/1/18 (First Tariffs Announced)

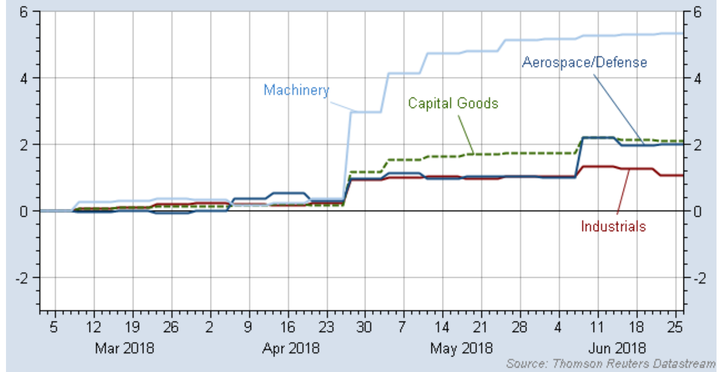


Exhibit #5: U.S. Small Business Confidence

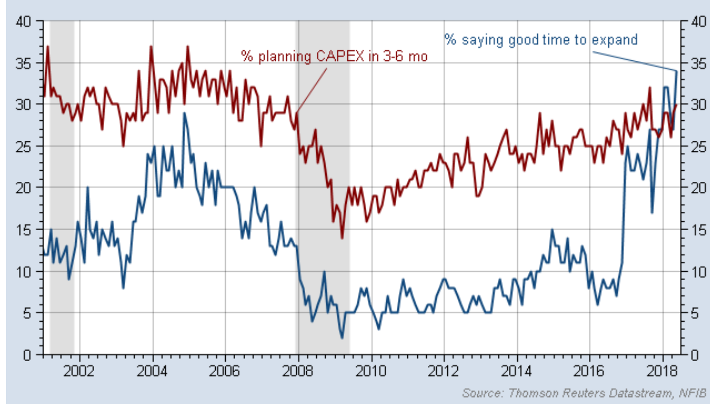


Exhibit #6: Capex Plans vs. Actual Capex

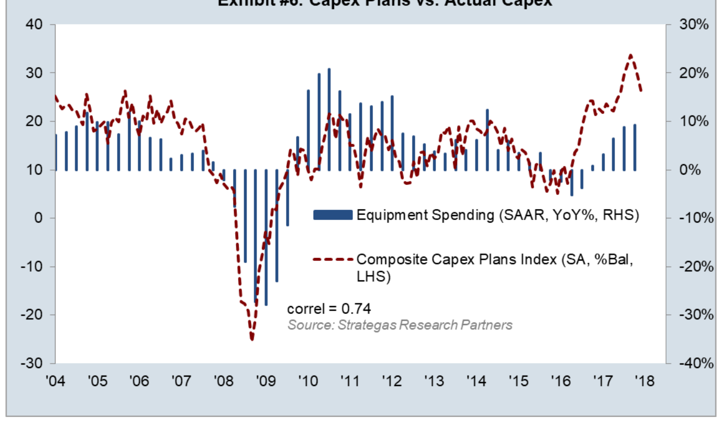
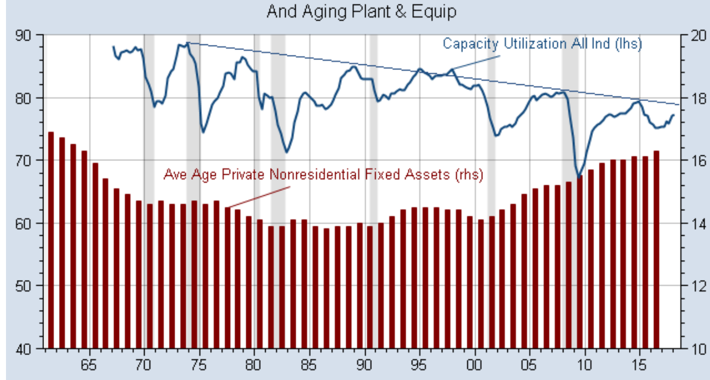


Exhibit #7: Tightening Capacity
And Aging Plant & Equip



ports. With the new rounds of tariff proposals the potential impact has grown to a not insignificant number. Strategas Research Partners estimates that if the current proposals are implemented the cost to the U.S. economy could approach $120 billion. Compared to the fiscal stimulus from the tax bill passed in December, which is estimated to be about $800 billion in total, that is still quite a small number (see exhibit #8 at right). Within a $19 trillion U.S. economy the actual direct hit of tariffs is small. The real impact could be disruptions to supply chains, damage to our export competitiveness from retaliatory measures, inflationary pressures on consumer prices, and delays in investment decisions by companies waiting to see how this all shakes out. If it is all a negotiating tactic that plays out quickly there will be minimal damage. But the longer the negotiating positioning goes on the more potential damage could eventuate. As the master negotiator will tell you, a threat has to be believed to be effective. So it is likely that we will not know how far this trade war goes until it is over.

FED is Feeling Frisky

The U.S. economy remains quite resilient despite tariff talk, so the Fed has stuck to its plan to gradually raise rates toward neutral and drain some liquidity out of the system. The speed at which they do that is a matter of some debate. Inflation is still moderate and wage growth has picked up but not to a worrying level. The economy is no longer in need of monetary stimulus, so a move toward neutral is appropriate. However, exiting this experiment from ultra low rates and quantitative easing was never going to be easy. At the current pace there are a few stresses in the system beginning to show up. One of them is that longer term rates are not moving up in lock step with short term rates as the Fed tightens. This leads to a flatter yield curve, as seen in Exhibit #9. An inverted curve is often a warning sign of an impending recession and a possible bear market. But a relatively flat yield curve can persist for some time without inverting and the lead time before a recession is generally over a year. Another side effect of a tighter monetary policy is showing up in currencies. The U.S. dollar is gaining against all our trading partners. Both the Euro and Yuan have fallen 5% this quarter, but some of the Emerging Market currencies have really been crushed. Exhibit #10 shows the Brazilian Real and Turkish Lira down about 15%, while the Argentine Peso has dropped more than 25%. For those countries depending on external funding, moves of that magnitude put considerable stress of their financial system.

Scratching Below the Surface

Being earnings focused investors means we try to look beyond the headlines or tweets of the day, to indicators of earnings direction. The recent

Exhibit #8: Est Tariff Impact vs. Est Incremental Fiscal Policy, CY 2018, $bil

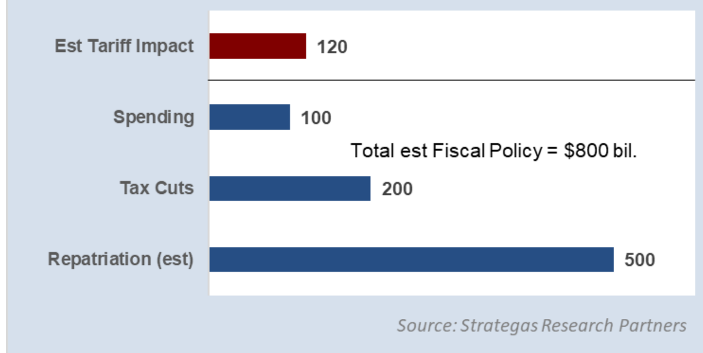


Exhibit #9: Fed Funds & Yield Curve

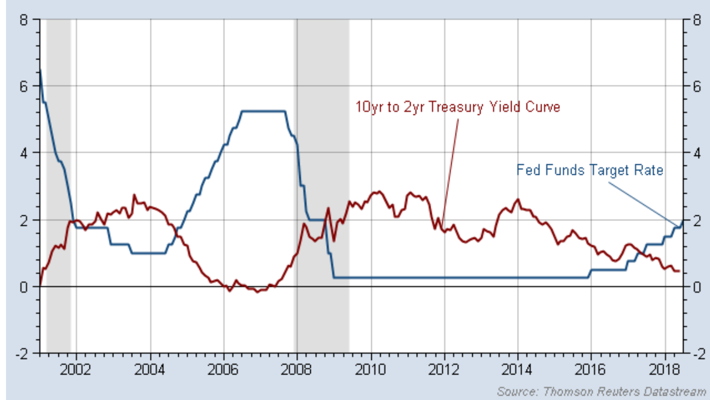
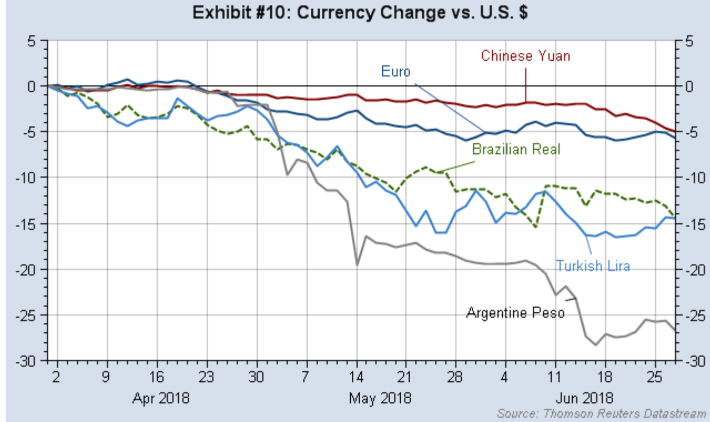


Exhibit #10: Currency Change vs. U.S. $



market volatility is apt to continue as the rhetoric ramps up in Washington and around the world. But earnings will still drive our investment decisions. In many respects, changing trade dynamics create opportunities to identify companies growing faster or slower than expectations. We will continue to focus on doing that well.

Disclosures

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