SWM INVESTMENT REPORT MAY 2018

STEWART
WEALTH MANAGEMENT

Market Outlook

In our opinion, the stock market is taking a short term breather after a substantial run in 2017. Interest rates on the 10 year bond have moved a full point higher and the increase in debt service for corporations and consumers obviously raises some cause for concern. Income producing stocks are underperforming growth stocks, as rate increases have impacted certain sectors more than others. It takes time for the market to digest these changes and re-calibrate the valuations of individual companies, sectors, and the market as a whole. Since Fed Chair Jerome Powell has informed us about rising inflation, and the possibility of 2 or 3 rate hikes in 2018, the market has been in decline. We have already seen the Dow give up 3000 points since its peak on January 26th. Trump's administration has had more turnovers than a bakery and trade tariff threats have not helped the markets either.

2018 YTD DOW & S&P 500

Here is the good news. The economy is expanding, with GDP rising by 2.9% year-over-year. And the first-quarter annualized growth rate of 2.3% is one of the best first-quarter numbers in years. We have robust business investment in fixed assets and capital goods. We have consumers earning more and spending more and this is excellent news for the economy, which in turn will benefit US companies. Unemployment is close to 50 year lows. Yet, with all this good news, the Dow and S&P 500 are down modestly YTD and in the short term, investors seem cautious. We think this is temporary and the market will eventually turn back higher in the second half of the year.

10 Year Bond Yield Now at 3%

Looking back, it is without question the 10 year bond was in a bubble over the last several years. Loaning money to our government for 10 years with a 2% interest rate gave the economy all time low rates on mortgages and other debt instruments. The 10 year yield sits at 3% today which means that the intermediate term bond market is probably overvalued, but no longer in a bubble. Interest rates, home equity lines, and 30 year mortgages are still a great deal for consumers. Keep in mind the average 10 year government bond rate is over 5% since the 1940s. Our focus remains to invest in bond investments with shorter term maturities to mitigate interest rate risk.

Expect Two More Rate Hikes

Until the 10 year bond hits the 4% mark, which would be somewhat normal, I think the higher rates will have a moderately low impact to earnings on the S&P 500 companies. Our expectation is that the fed will raise short term rates a **quarter point in June** and a **quarter point again in September**. I do not think there will be a rate increase in December as Powell will need to see how the economy reacts to the rate increases. I do believe that we will see 5% on 30 year mortgages by year end. We continue to search for private real estate investment opportunities for accredited investors and see the rate increases reducing our return expectations for upcoming real estate investments. The cost of debt has been increasing while CAP rates have been moving down. For a more detailed analysis of future real estate opportunities, you can email Ben or set up a call.
(**Definition**: **Capitalization rate**, commonly known as **cap rate**, is a **rate** that helps in evaluating a real estate investment.)

Taking Advantage of Timeless Strategies

Our favorite strategy to build wealth (in liquid assets) is to buy core ETFs on a 10% pullback. The S&P 500, Dow Jones, Mid Cap, Small Cap, Dividend, International, Emerging markets, and REIT indices are all 10% from their Peak. The Nasdaq has held up fairly well, with an 8% pullback at the time of this newsletter. Momentum ETFs are still favoring high weighting and allocation to tech stocks. Market timing is difficult, but buying the dips when valuations are reasonable and the market has pulled back 10% off the peak is a prudent strategy. We continue to favor US equities over international, but our outlook for international moved from slightly bearish to neutral last year. The 12-18 month outlook is that there is little chance of a recession in the US. We also think US corporate stock buybacks should provide some support as well.

Potential Headwinds-Escalation of a Trade War:

While the likelihood of a full blown trade war coming to fruition still seems unlikely, the ongoing rhetoric from both China and the U.S. could prove to be a headwind for the market. At the end of the day, no one wins in a trade war. While the direct economic impact of tariffs is relatively small ($150 billion on a $20 trillion economy), the impact on financial markets and business sentiment could prove much more costly. Any resolution or compromise will turn into a tailwind for the markets.

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