Lowe, Brockenbrough & Company

Second Quarter 2018

Commentary

Tariffs/Trade War

First of all, our best guess is that Trump would prefer a second term to a recession. That's probably the only thing we can say for sure. The markets appear to be thinking this too—they haven't stroked-out… yet. But that doesn't mean there won't be further escalation in the ongoing trade war. In fact, escalation now seems likely. How might it end?

With just a little Googling and some quick skimming/reading, one quickly realizes there is no such thing as free trade. All countries impose tariffs to protect various domestic industries. The U.S. does too, but one can make the case that the U.S. is getting the short end of the stick. According to the Munich-based ifo Institute, the unweighted average EU customs duty is 5.2%, versus the U.S. rate of 3.5%. Take cars, for instance. The European Union imposes 10% tariffs on imported U.S. cars; the U.S. rate is 2.5%. Trump has specifically threatened German carmakers with higher tariffs. Car manufacturing is vitally important to Germany's economy, and Angela Merkel's government has been weakened by the EU's immigration dilemma. Viewed from this angle, it sure looks like Trump has the upper hand, at least on cars. We don't expect he'll back down. It might be political suicide to cave to Trump, but it's just as deadly to have your most important industry crippled. Suicide or sacrifice – it makes no difference to the worms how you end up in the ground. Germany will lower their tariffs, or Trump will raise ours – heads he wins, tails they lose. Either way, he'll loudly proclaim victory and then move on.

Actually, we don't have any idea how this will end. We haven't even touched on the China dilemma, which is orders of magnitude more difficult, given that they're our largest economic and soon-to-be military rival. As of this writing (11:30am 7/10/18), we still believe a real global trade war will be avoided, but it looks increasingly likely that there will be some casualties.

We're certain to have more commentary on trade, but we'll have to see how the play develops. We haven't changed our view that the economy remains strong and stocks are well supported by reasonable prices and robust earnings. As for the bond market, the long end still looks expensive to us. But rather than go through all that again, let's touch on another topic which we view as critically important in our musings about markets and the economy. Hope you enjoy.

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Commentary

All the Eggs in One Basket

The Cloud: that's the something/somewhere pestering you to send your photos, your data, your apps, and, perhaps, your business. Your digital treasure (secrets too) used to be on your phone, pc or server, right where they should be: at home or down the hall, under lock and key, so to speak. No more. Software advancements now make it possible to outsource and get lower cost, safer data management solutions. This is THE THING in tech and the stock market right now - helping the Nasdaq Composite to a 9.4% return so far this year (versus a more subdued broader market) and almost 24% over the last year. It has all the makings of a classic investment boom and potential bust. And it's got that brilliant name: The Cloud.

But first a bit of history, and Amazon is a good place to start. By the very nature of its business, Amazon had to build a scalable, robust system to handle its burgeoning online empire. Along the way, it realized it could use its expertise and capacity to host other businesses, and Amazon Web Services was born. Others followed, and what was once annoying background noise is now a thing. At this very minute, your teenagers are no doubt carpet bombing the Cloud with pointless selfies; and as I glance over at my other monitor, I've got 4127 emails in my inbox. Absurd. It appears they're intent on building a box big enough to save every last keystroke and pixel ever produced. And isn't there something just a little disturbing about all this? You kinda, sorta, used to know where your digital life was stored and who might have access to it—pictures on the PC, medical records at the doctor's office, and so on. Where is all that stuff now? Is it all going to end up on Amazon servers? And what do you think they are going to do with all that data? Sell it to the highest bidder, we guess. Did your grandma ever say: "Hey kid, it's cheaper and more efficient to put all your eggs in one basket."?

Paranoid ramblings aside, moving most everything to the Cloud is an enormous undertaking, and there's a powerful investment story ongoing. Getting this approximately right will be important, especially if there's a bust to follow.

The cloud story's principal actors include service providers - most notably Amazon, Microsoft, and Google; and semiconductors - Intel, NVIDIA, Broadcom, Micron, and a few others. Since the beginning of 2017, these stocks have returned an average of 75%, and they accounted for nearly 30% of the S&P 500's 22% price return over that period. That is an unusually concentrated contribution. It's not unprecedented, but it's certainly rare, and it echoes the astonishing growth in the Cloud. Not to get too far into the weeds, but just a few figures can help frame the boom in spending.

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Commentary

All the Eggs in One Basket *continued*

- Analysts at RBC, an investment bank, estimate that cloud service revenues (hosting, storage, etc.) were approximately $2.5 billion in 2012, and more than 10 times that amount last year. They forecast spending will top $100 billion in 2021. And that's in addition to the tens of billions being spent on Software as a Service (SaaS).
- As for investment spending to build the Cloud (hardware, semiconductors, facilities, etc.), Empirical Research Partners, a research resource, estimates that U.S. cloud spending grew from about $25 billion in 2012 to $70 billion in 2017, and they project near $90 billion for this year.

For the equity markets, there is no bigger story than...The Cloud. And this story has meaningful implications for the technology sector specifically, and therefore the broader market.

One important thing about tech cycles: there is a winner-take-all mentality. So, a spending boom is really a race: a race to stay ahead, to catch up, or not to be left too far behind. And when everyone finally realizes what's going on, it's more like a stampede. Microsoft, Google, and newer entrants like Oracle are terrified that Amazon could, one day, threaten their core businesses if it becomes the ubiquitous cloud provider. Hence, they are spending like mad on cloud infrastructure and marketing, and so is Amazon. For hardware and semiconductor manufacturers, the boom in spending is nirvana. They can't meet exploding demand, so they raise prices, repeatedly, and plow money into new manufacturing capacity and acquisitions.

There's a self-reinforcing quality to the whole thing, and it actually accelerates the cycle. Ironically though, it's destabilizing as it inevitably leads to excess. Service providers add too much capacity, eventually depressing pricing, margins, and stock prices. And for semiconductor manufacturers, the history of spending booms is even more troubling, as capacity increases have often led to prolonged pricing collapses and stock wipe-outs. We'll want to avoid that. Unfortunately, in our experience, there are no reliable barometers for figuring when to bail out. As traders like to say: no one rings a bell. And that goes for the insiders too. Do you really think Microsoft, for example, has any idea how much cloud infrastructure to build? Probably the only thing they really do know is that they're adding way more capacity than they can fill in the next couple of years. So is everyone else. This means that semiconductor manufacturers will likely feel the squeeze of slowing demand long before the service providers. Typically, the end of a semi cycle shocks like lightening from a clear sky. Our portfolios reflect this nervousness about the semiconductors, but we still own a fair helping of the service providers. We're not quite ready to come down off The Cloud!

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The Financial Markets

- For the second quarter of 2018, the S&P 500 Index finished up 3.4%. The Dow Jones Industrial Average climbed 1.3%, while the Nasdaq Index surged by 6.6%. The Russell Mid-Cap Index rose 2.8%. Small caps delivered the strongest returns in the quarter with a 7.8% gain in the Russell 2000 Index .
- Led by Amazon and Apple, ten equities were responsible for 2/3 of the S&P 500's return for the second quarter. These ten equities consisted mostly of the FAANG stocks and big energy.
- The Energy, Consumer Discretionary, and Information Technology sectors were the best performing sectors in the second quarter. Telecommunications, Consumer Staples, Financials, and Industrials each produced negative returns, which was a noted improvement over the nine S&P 500 sectors that performed negatively in the first quarter.
- International equities retreated, as the MSCI All Country World ex-US Index of developed and emerging markets finished with a -2.6% return, weighed down by a decline of -8.0% in the MSCI Emerging Markets Index.
- The Bloomberg Commodities Total Return Index rose slightly in the second quarter, up 0.4%. Crude Oil prices continued to strengthen, increasing 14.5%. Natural Gas rose 7%, while both Gold and Silver decreased, ending the quarter down -5.5% and -0.8%, respectively.
- The CBOE Volatility Index (VIX), a common measure of the stock market's expectation of volatility implied by S&P 500 Index options, saw significant fluctuations throughout the quarter before closing at 16.09. Although it ended the quarter down 20% since the beginning of April, the VIX is still 45% higher than the start of 2018.
- Following the Federal Reserve's increase in interest rates in March, expectations of another 0.25% hike were realized at its June meeting.
- After reaching 2.77% at the end of March, the 10-Year Treasury Note yield rose to just over 3.10% in May before ending the quarter at 2.85%.
- The U.S. Dollar Index rose 5.1% in the second quarter. This ended the weaker trend seen in the five quarters prior to this one.

The Economy

- The U.S. economy saw its strongest period of growth in the second quarter since 2014, according to several prominent economic models.

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The Economy *continued*

- According to the Atlanta Fed's GDPNow running estimate for GDP growth, the U.S. economy's seasonally-adjusted annual rate was 3.8% for the second quarter of 2018, a significantly stronger pace than in the first quarter. Non-farm payrolls rose 213,000 in June following an upwardly revised increase of 244,000 in May. The unemployment rate rose from an 18-year low of 3.8% to 4.0% as the labor force expanded. This increase may reflect that the improving job market is providing incentive for sidelined Americans to seek employment.
- According to the Institute for Supply Management (ISM), the non-manufacturing sector continued a 101-month streak of growth in June. This was marked by a 0.5% increase in the ISM Non-Manufacturing Index (NMI), which rose from 58.6 in May to 59.1 in June.
- In April, the Case-Shiller National Home Price Index rose 6.4% year-over-year, continuing the trend of home price appreciation.
- After a disappointing first quarter, retail sales picked up in the second quarter, jumping 0.8% in May. Although this increase reflects a strengthening economy, it is also partially an artifact of higher prices.
- On top of President Donald Trump's plans to implement tariffs on billions more of our trading partners' imports, the rising U.S. dollar is making matters tougher for U.S. exporters as this increases the price of their goods in foreign markets.
- With an estimated 60% of sales growth for S&P 500 companies coming from overseas, the specter of an escalating trade war may dampen investor sentiment, potentially creating headwinds for global equity prices.

Future Prospects and Portfolio Strategy

- Macro-Economic Indicators (+): Early readings on U.S. second quarter GDP growth confirm a still robust domestic economy, while overseas economies have slowed. Despite concerns over the uncertain impact from an escalating trade war with U.S. trading partners, global economic growth remains favorable.
- Interest Rates/Credit (+): Given a strong economic outlook, the Federal Reserve has telegraphed its intention to raise short term rates two more times this year. Still, a 10-year U.S Treasury hovering below 3% continues to support a positive credit environment. Attention remains focused on a flattening yield curve, with the 2yr/10yr spread falling to about 35 basis points from 50 basis points at the end of March. An inverted yield curve has at times been a precursor of recession.

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Future Prospects and Portfolio Strategy *continued*

- Valuation (N): Expectations for strong corporate earnings for the remainder of 2018 have improved the valuation outlook modestly, as the S&P 500's forward price/earnings ratio, at 16.5x, is close to its long-term average of 16x. Additionally, the S&P's free cash flow yield of approximately 4.3% continues to compare favorably with a 10-year Treasury yield of less than 3%.
- Sentiment (N): At quarter-end, U.S. Advisory Sentiment readings were well below the frothy levels of late January, signaling lower near-term market risk. However, investors have not yet reached levels of caution that would support broad accumulation. Growing concerns about the global trade war could be the catalyst for more favorable readings.
- Summary: Overall, the U.S. economy is continuing along a desirable path of expansion, supported by favorable economic data. A full-blown trade war is a risk we must consider, but to-date the economic fallout is less than clear. For now, we anticipate that sustained domestic economic strength should be able to withstand those forces. Given the above, our portfolio allocations remain unchanged from last quarter, with equity allocations in line with strategic targets, and fixed income portfolios maintaining shorter durations than benchmarks with allocations below their long-term targets.