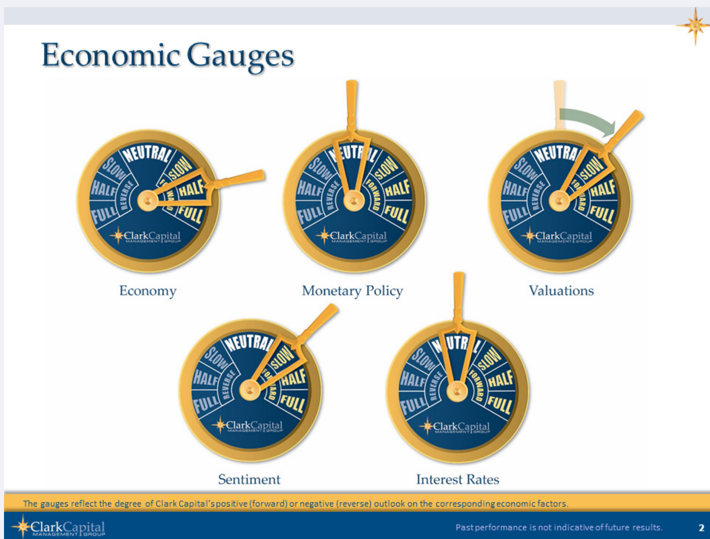
ClarkCapital MANAGEMENT GROUP

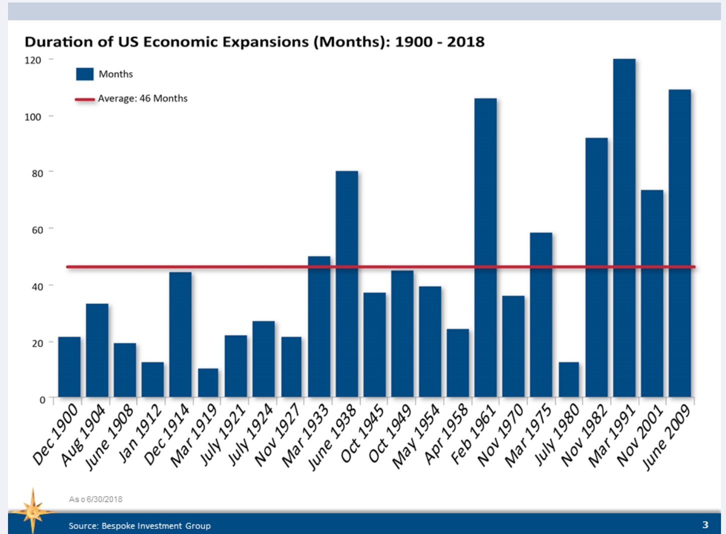
Economic Review & Outlook

Video Transcript | Second Quarter 2018

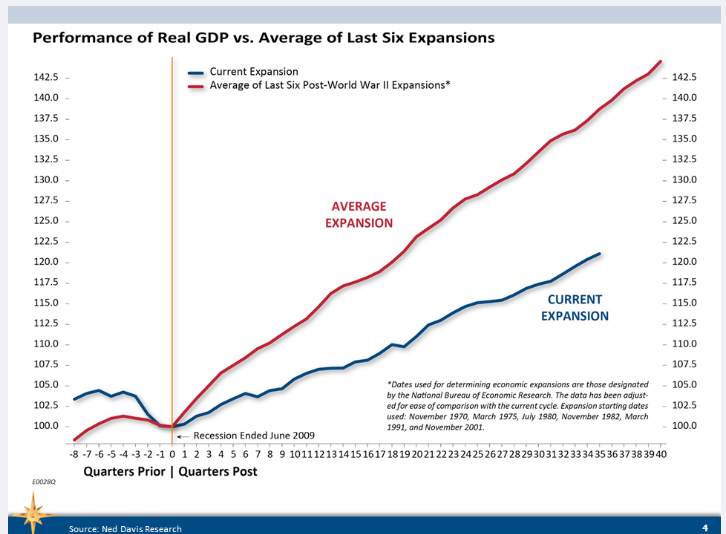
Thanks for joining me for a recap of the latest economic and capital market developments, as well as what we're seeing heading into the second half of 2018. So let's begin.



These gauges represent the five major areas that help shape our view for the overall economic environment, which in turn drives our expectations for the stock market. As a reminder, 12:00 is neutral. Anything to the right of 12:00 is positive for stocks, anything to the left of 12:00 is negative. We made one adjustment this quarter, improving the valuation gauge by one notch from Neutral to a slight Positive, so we currently have 3 gauges that are positive, and 2 that are neutral.

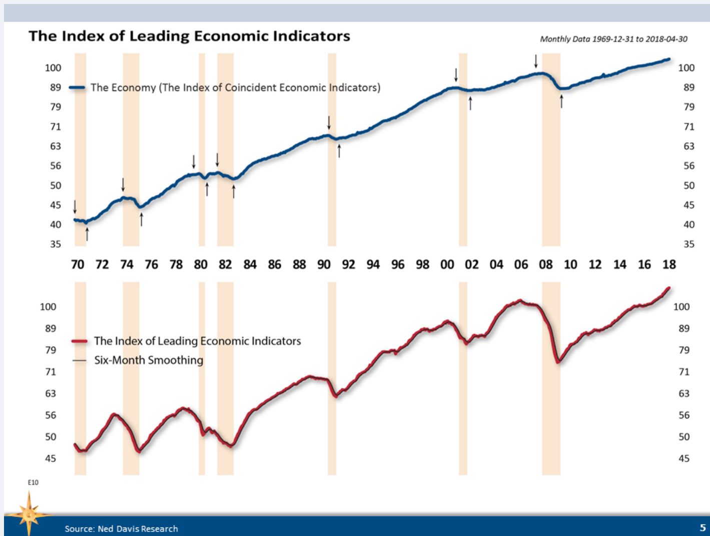


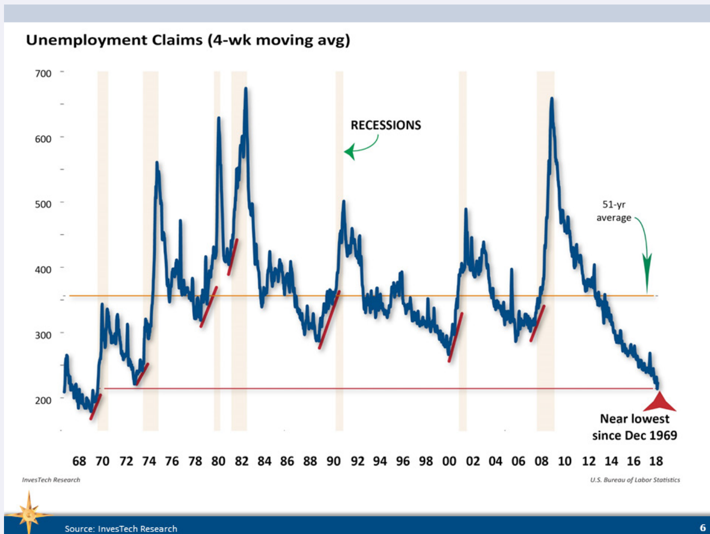
First let's discuss the U.S. economy. The current U.S. economic expansion has now lasted more than 9 years making it the second longest expansion since 1949, surpassed only by the expansion from 1991 to 2000.



However, while it has been long-lasting, it has also been one of the weakest economic expansions averaging only a 2.2% annualized growth rate. As the chart shows, the strength of this recovery has paled in comparison to the average of the last 6 recoveries, which helps explain why it has been longer lived.

We continually keep a keen eye on indicators that have historically started to weaken prior to an economic slowdown. At this point, those indicators are not signaling pending economic weakness.





The Conference Board's Leading Economic Indicators index (the red line on the bottom of this chart) recently hit an all-time high and shows no signs of rolling over, which it has historically done about 11 months prior to a recession; weekly initial jobless claims are at their lowest levels since the late 1960s reflecting strength in the job market, which is critical for our consumption led economy; and the yield curve, while flattening, remains positively sloped, as can be seen by the Current tally on the bottom line of this slide. The yield curve has become inverted prior to every recession since the late 1960s. At this point, we remain positive on the U.S. economy and we expect the economic expansion to continue into 2019 with the odds of a recession this year very low.

Yield Curve Leading Up to Recessions

	Yield Curve (bps)	
Start of Recession	At Start of Recession	52-Week Low
12/31/1969	-13	-45
11/30/1973	-61	-187
01/31/1980	-87	-208
07/31/1981	-20	-373
07/31/1990	61	-16
04/02/2001	72	-99
12/31/2007	79	-60
Current	94	89

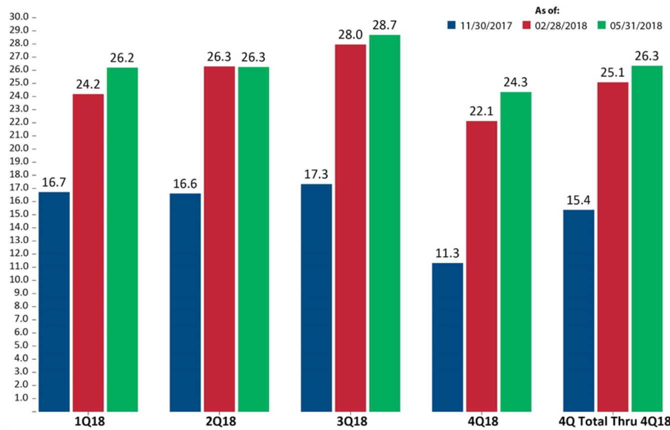
As of 6/30/2018

Source: InvesTech Research 7

The next gauge is Monetary Policy and we keep it in a Neutral position moving into the second half of 2018. The Federal

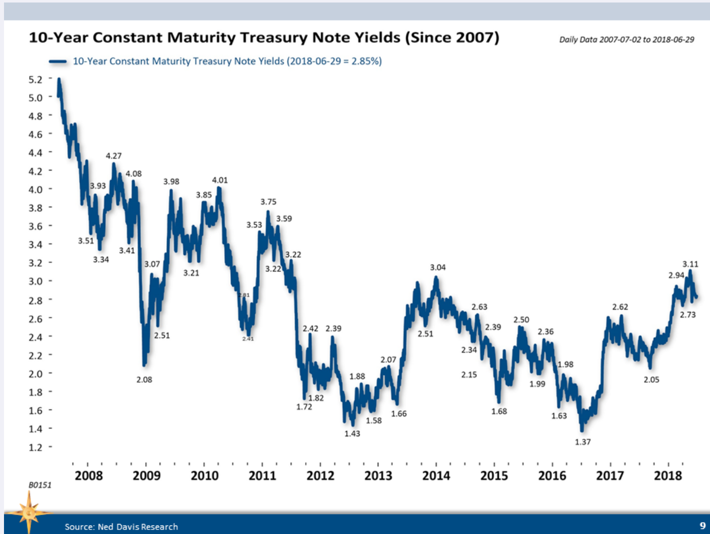
Reserve raised rates once in the first quarter and once again in June. This totals a mere 7 rate hikes since this tightening cycle began in December 2015. We believe this is the Fed trying to normalize policy rates from the near zero interest rate policy from the credit crisis period and acknowledge improved economic conditions, as opposed to a Fed that is trying to slow down an over-heating economy. We continue to expect a slow-paced and measured rate-hike cycle throughout the rest of 2018 and into 2019.

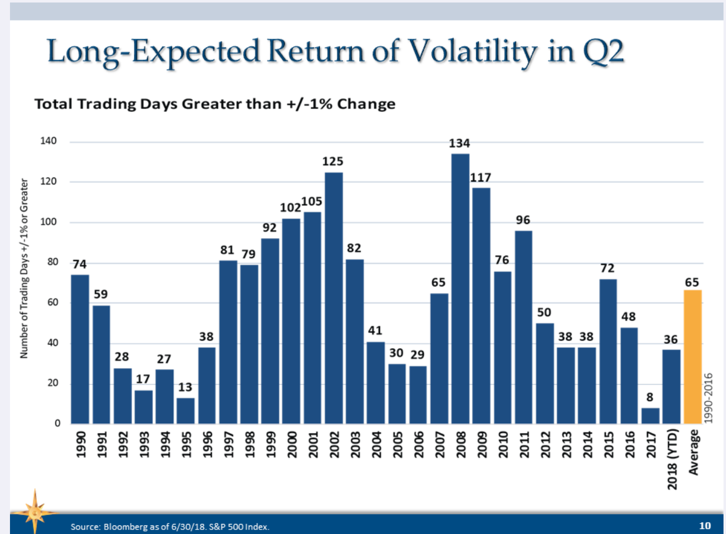
Valuations are next and after shifting this gauge from a negative to a neutral position last quarter, we have improved it one notch and put it into Positive territory this quarter. Valuations had been one of our key areas of concern in recent years as the Price to Earnings or P/E ratio moved well above historical averages. Fast forward to 2018, and the newly minted tax cuts, along with stock buybacks and a strong economy, caused expected corporate earnings to surge.



While U.S. stock prices or the "P" have increased modestly this year, actual and expected earnings or "E" have increased dramatically. This chart shows first quarter earnings growth was expected to exceed 25% on a year over year basis (which it did), and the expected earnings growth for the second and third quarters are at or above that mark as well based on estimates on May 31. This modestly increasing P coupled with a rapidly rising E has created a more favorable valuation environment, which led us to move this gauge forward. Corporations meeting or exceeding these lofty earnings goals will be key to maintaining this positive valuation environment, and we will be monitoring that closely.

The next gauge is Sentiment, which can be thought of as a measure of speculation. We moved this indicator to a slight positive last quarter and maintain that same position. The 15 straight months of gains for the S&P 500 from the presidential election through January of 2018 seemed to usher in some complacency, but that abruptly ended as elevated volatility and the first 10% correction in about 2 years brought back some healthy skepticism to investors and a reminder that corrections can and do occur. Furthermore, the cryptocurrency craze seems to be receding and some sentiment indicators have moved to more pessimistic levels. We think this has created a better overall market environment from a sentiment perspective.

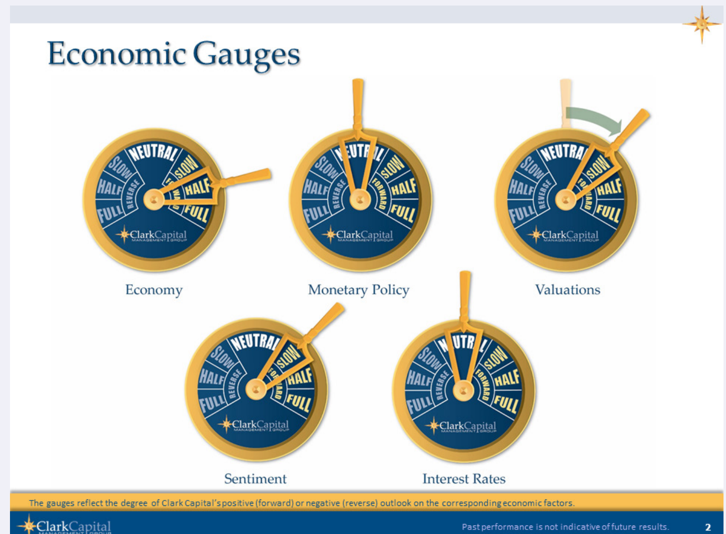




Our final gauge is interest rates, which we leave in a neutral position. We certainly acknowledge that rates have risen rather dramatically in 2018 with the yield on the 10-year U.S. Treasury breaking above 3.1% in May - its highest level since 2011.

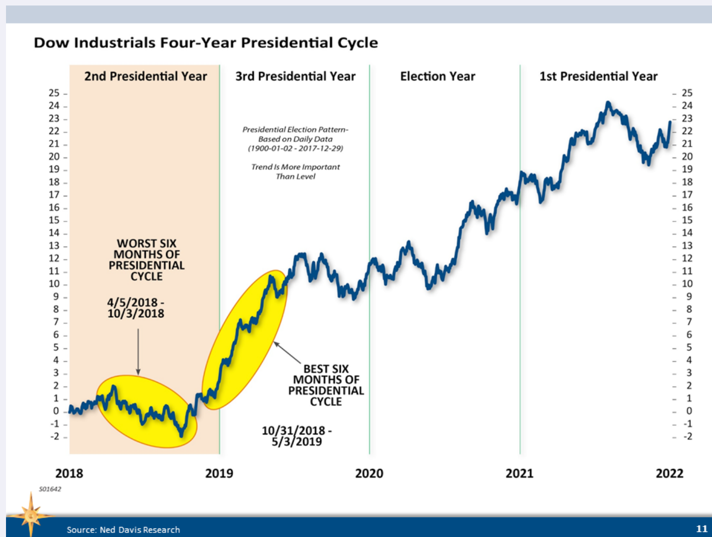
However, rates subsequently moved lower and settled around 2.85% by the end of June. We believe that interest rates will continue to move higher over the next several quarters, but at a measured pace. At this point, we believe the level of interest rates is having a neutral effect on the U.S. economy and the slope of the yield curve remains positive – a historically good omen.

Moving to the capital markets, gains in the second quarter helped push the S&P 500 into positive year-to-date territory and the NASDAQ Composite and Russell 2000 indices both put in new all-time highs in June. Equity markets remained volatile in the second quarter with sharp swings often precipitated by trade and tariff issues improving or deteriorating from one day to the next.



One of our key themes moving into 2018 was our expectation of a return to more normal levels of market volatility, meaning higher volatility compared to 2017. We have indeed experienced this so far in 2018. Last year, there were only 8 days that the S&P 500 either gained or lost 1%. As this chart shows, the historical average from 1990 to 2016 is closer to 65 of those such days….and in the second quarter of 2018, we had 13 such days coupled with the 23 - 1% days from the first quarter. While more volatile markets and corrections can be unsettling, we believe it is important to focus on business fundamentals

and the underlying economy. Earnings are expected to grow strongly in 2018 and the economy looks poised to continue to expand throughout the year.



Mid-term election years also tend to be more volatile historically and we are currently in the weakest 6-month period for stocks of the Presidential Cycle. However, that weakness has historically given way to the strongest 6-month period of the 4-year Presidential Cycle. Clearly, history does not need to repeat itself and we might have already experienced the normal mid-term correction earlier this year. However, elevated volatility and some more consolidation and market weakness would not surprise us ahead of mid-term elections in November.

Turning to bonds, results were more mixed in the second quarter, but most bond sectors were negative through the first half of 2018. Consistent with our belief that credit exposure is currently more desirable than interest rate exposure, high-yield bonds were the clear outperformer in the second quarter and stand as one of the few fixed income categories with positive year-to-date results.

We continue to expect interest rates to gradually move higher and for the yield curve to flatten. As a result, we continue to favor credit exposure in our bond portfolios over pure interest rate risk. Rising interest rates are usually associated with an improving economy and these conditions should support a stable or narrowing credit spread and help corporates outperform treasuries. We believe active bond management should also be able to add value over passive, laddered bond portfolios in this type of environment.

Putting this all together, we continue to favor stocks over bonds, and we believe the long-term secular bull market is intact. Our forecast this year for the S&P 500 continues to be 2,900, or about an 8.5% increase driven by strong earnings growth. We maintain our expectation of higher capital market volatility, especially as we get closer to mid-term elections.

There are always risks to an outlook and the direction of trade and tariff barriers might play an important role moving forward, but we still maintain this is more of a negotiating tactic at this point. But, this does continue to be a headline risk and a driver of volatility.

Ultimately, however, we think fundamentals are what matter in the long run and the current fundamentals are positive. During these periods of elevated volatility, we believe it is imperative for investors to stay focused on their long-term goals and not let short-term swings in the market derail them from their longer-term objectives.

Please contact your Investment Consultant to discuss how we can support your client reviews and how we can help you deliver successful outcomes to your clients.

Thanks for watching.

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