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Portfolio Comments
For the Quarter Ending June 30, 2018

At times when all the news coming out seems serious, and there's lots to digest, it can cast a shadow over the otherwise relaxed connotations of laid-back summer days, or, as Charles M. Schulz put it in a Peanuts volume back in the 1960's: "How can I play baseball when I'm worried about foreign policy?" The markets certainly acted as if there were a few things to worry about this quarter although, overall, they largely stood their ground.

The S&P 500 closed on June 29th at 2,718, representing a return of 3.44% for the second quarter, and 2.65% for the first six months of 2018. The Dow Jones Industrial Average (DJIA) ended June at 24,271 for a return of 1.26% in the past three months and -0.73% for the year to date. Following on from a strong start to 2018, with the S&P 500 and the DJIA climbing to record closing highs of 2,873 and 26,116 respectively in January, we experienced a rapid correction of close to 10% going into February. The subsequent charts through to the end of June tell the tale of a series of unsustained market bounces bringing volatility and an aggregate performance that is relatively flat for the first six months of the year. The latest dip, towards the end of the quarter, was steeper for the Dow as the industrial sector pulled back more sharply.

Economic and political news, mirroring and sometimes driving U.S. equity market levels, has been a series of ups and downs. The effect of the Trump administration's corporate tax cuts is translating into fatter bottom lines, with an analyst poll by FactSet suggesting that second quarter earnings for companies in the S&P 500 are expected to be up by close to 20% on average compared to last year. This is on the back of a 25% year-on-year gain for the first three months of 2018. Consumer spending is also on the rise against the backdrop of U.S. unemployment dropping to an 18-year low of 3.8 percent in May and the boost provided by personal income tax reductions.

A tighter job market and rising spending are both signals for the Federal Reserve to preemptively stave off the potential of rapidly rising inflation and continue on its controlled path of 'normalizing' monetary policy. It therefore came as no surprise in mid-June when Central Bank officials, under Chairman Jerome Powell, returned a unanimous vote to raise the federal-funds rate by a quarter of a percent to 1.75-2.00%. This marks the second rate rise of the year and also promoted the majority of Fed officials to forecast a total of four rate rises in 2018. Consensus opinion anticipates rates will be 3.25% and 3.5% by the end of 2020. The Central Bank's announcement coincided with the start of the latest U.S. equity market sell-off, partially amid concerns that higher borrowing costs will eventually depress earnings, as well as increased pressure on those debt-laden corporations that ramped-up leverage during the Fed's near-zero percent rate policy era. Interest rate policy was not the only market factor influence at this time though. Trade tariffs, domestic immigration policies, political turbulence in Europe, and volatile emerging markets have all played a role also. In aggregate, investors appear to have taken a pause to lower their expectations.

Factors that include the recent surge in Brent crude oil prices to $80 a barrel in May for the first time since 2014 may push inflation over the Fed's 2% goal later this summer, but shouldn't result in prolonged elevation over the target figure. U.S. 10-year Treasury yields briefly popped above the 3.1% mark in the middle of May, the highest level since 2011, but have fallen back down below 3% as a global flight-to-safety, stodgy growth outside the U.S, and the anticipation of a strengthening dollar pushed the benchmark's price higher.

Casting shade on any clear predictions for global economic outlook has been President Trump's escalating trade disputes with international partners; most notably, China. Ramping up the tit-for-tat back and forth, on June 15th, Mr. Trump published lists of Chinese imports totaling $50 billion that will be hit with 25% tariffs in 2018. Beijing retaliated in equal measure, prompting the U.S. administration to draw up a greatly expanded list to include new products with 10% tariffs, while threating yet more. China viewed the first round as violating global trading rules and lodged its complaint with the World Trade Organization (WTO). President Trump lays the blame with the Chinese for intellectual property theft and their industrial policies.

The United States Trade Representative (USTR) has taken measures to construct the import list to minimize the impact on American consumer prices, concentrating on capital and intermediate goods, as well as those that U.S. companies can readily source from elsewhere. Nevertheless, supply chain reconfiguration is never an easy task, and those U.S. companies affected by retaliatory sanctions are focused on agricultural exporters concentrated in states that staunchly favored President Trump's election. It now appears that America is prepared to further up the ante through a decision to restrict Chinese investments in certain sectors in the U.S., including robotics and aerospace in a move that would have greater long-term consequences. According to Treasury Secretary Steve Mnuchin, the restrictions would further extend to all countries "trying to steal our technology." In enacting the changes, the President may invoke The International Emergency Economic Powers Act (IEEPA), which dates back to the 1970's and has been used to impose sanctions such as those against North Korea and Iran. This administration's pattern of employing national security measures in its economic strategies marks a departure from historical protocol.

Relations with foreign nationals on our home turf is also causing a political storm for Donald Trump's camp following reports that thousands of children were being separated from parents as families are being detained for attempting to illegally cross the southern U.S. border. This is in the wake of Jeff Sessions, the Attorney General, announcing a "zero-tolerance policy" for non-authorized immigration into the U.S. The aim was to set up systems to prosecute all illegal immigrants on arrival through the criminal justice system, a more encompassing mandate than those offenders that have typically been classed as criminals. The significant demarcation between civil and criminal judicial procedure prompted the enforced separation of children. In the face of massive backlash to the policy, the President signed an executive order on June 20th reversing the separation practices. While no doubt intended to act as a harsh deterrent to those families entering the U.S. without the proper paperwork, the drop in numbers was not immediate and Border Patrol's widened mandate for arrests was not matched by increased processing power in the justice system.

In a separate immigration policy controversy that resulted in a win for Mr. Trump, on June 26th The Supreme Court in a 5-4 vote upheld the President's third version of an executive order that places specific bans on travel from mostly-Muslim nations. The nation's leader heralded the decision as a "tremendous victory" and pledged to continue to defend the U.S. against extremism and terrorism.

The government wasn't victorious in another court decision that saw a federal Judge reject the Department of Justice's (DOJ) anti-trust challenge to the acquisition of **Time Warner Inc.** by **AT&T Inc. (T-NYSE)**. Essentially, the court ruled that the DOJ failed to convincingly establish that the combination would substantially lessen competition. The closely-watched proceedings paved the way for the vertical merger – valued at $108 billion (including debt) and set forth in October 2016 – of a major entertainment company with one of the big communications providers. Aside from the impact for both companies and their stakeholders, the markets could now see a renewed interest in proposed mega-mergers potentially consolidating different branches of major industries.

The government's efforts have not entirely focused on trade, immigration and corporate America. In terms of international diplomacy, President Trump's Singapore summit with Kim Jong Un, the dictator leader of North Korea, marked a watershed moment in relations between the two erstwhile openly opposing powers. Aside from an outward show of the thawing of hostilities, Mr. Kim promised "complete denuclearization" (albeit with no concrete timeline or agreements on proof) in return for security guarantees. Such promises have been made numerous times before by North Korea only to be reneged on after extracting the benefits of a deal, but at least alarming threats from both sides have been replaced with dialogue for now.

A factor that continues to weigh on American market performance is political and economic unrest over in Europe given the global economic significance of the bloc. June marks two years since the U.K. voted by a narrow margin to leave the European Union and today the nation's leadership is still very much entangled in negotiations to determine what this means practically. Theresa May, the Conservative leader, became Prime Minister in the aftermath of the vote and seemed to unilaterally set course for a "hard" Brexit to free the country from European judicial, trade and migration controls. Such a break, however, is not without potentially negative implications for Britain's economy and security, and Ms. May is currently facing a mounting backlash at home as agreement terms need to penned.

The likely result is that, following eventual Parliamentary votes, the hard Brexit will have some soft edges, which is probably a good outcome for Europe, the U.K, and by extension, the world economy. A major sticking point, which may result in wider concessions in order to enact a workable settlement, has been how to get around imposing a trade border between Ireland and Northern Ireland. Given the historical tensions between the regions, the concept of checkpoints is undesirable. However, by keeping Northern Ireland in the EU customs union, it is difficult not to extend this to the whole of Britain since customs barriers between Northern Ireland and mainland U.K. would be a political disaster. On the other side of the negotiation, the EU may seek to insist on the free movement of people if the U.K. is to maintain access to the single market, further tilting the outcome towards a "soft" Brexit. Meanwhile, the nation's GDP growth has slowed and the country's central bank is holding interest rates at 0.5% to offset weak economic fundamentals.

Another European leader facing tough negotiation issues is the German Chancellor, Angela Merkel, who is struggling to resolve immigration policy disputes between her Christian Democrat party (CDU) and their Christian Social Union (CSU) coalition partners. At the heart of the matter is how to deal with the continued flood of asylum seekers registered in other EU countries arriving at the German border. Ms. Merkel sought a two-week time frame to work on a "European Solution". Sixteen EU leaders met in Brussels on June 24th for an impromptu summit on the issue.

A strong voice at the meetings was newly-appointed Italian Prime Minister, Guiseppe Conte, the head of a populist coalition with an anti-immigration stance. Mr. Conte favors designated centers where migrants can be congregated while the validity of their asylum-seeking claims are assessed. He also wants to decouple the location of a migrant's point of entry with the responsibility for processing. Following inconclusive Italian elections in March, the EU's third largest economy continues to struggle and default risk concerns have resurfaced around it $2.7 trillion in debt. And with Italy and Greece dealing with a disproportionate stream of displaced populations, the pressure to redistribute the burden is on in these countries.

In summary, there has been sufficient uncertainty, both home and abroad, to give the U.S. equity markets reason to pause after the end of January following what had been an extraordinary run-up since the last Presidential election. In addition, much of the good news surrounding tax cuts and a strong job market had already been priced in going into 2018. While we don't ignore macro factors, here at Stolper Asset Management our focus has never been to attempt market timing, and we remain optimistic and encouraged by the strong corporate fundamentals that we see in evidence. While patience isn't always an easy virtue, we subscribe to Mr. Buffett's assertion that "Over the long term, the stock market news will be good." In the meantime we wish you a good, hopefully excellent, summer and thank you for your continued confidence in us as your financial adviser.

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