Quarterly Outlook

JUNE 2018

Second Quarter 2018

Markets remained volatile throughout the second quarter of 2018, reacting to mixed news on tariff announcements, trade tensions, and geopolitical strife along with strong corporate earnings and upbeat economic data. On balance, the good news held more sway, and US equities booked respectable quarterly returns. The S&P 500 posted a total return of 3.43% in the quarter, aided by strong performance from the energy, consumer discretionary, and information technology sectors (with returns of 13.48%, 8.17%, and 7.09% respectively). Oil's long-awaited comeback finally arrived in the quarter, advancing 10.6% (WTI) as long-running efforts by OPEC, anticipated increases in demand and supply disruptions pushed prices higher. Performance in the aforementioned sectors was checked by losses in industrials, financials, and consumer staples (with returns of -3.18%, -3.16%, -1.54% respectively).

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Trade concerns were perhaps the largest source of volatility in the quarter, as markets were continuously rattled by headlines regarding steel and aluminum tariff announcements, the escalating trade war with China, and tensions with European allies on trade questions. Canada responded to US steel and aluminum tariffs with billions of dollars' in countermeasures, Mexico slapped duties on food and steel, and the EU vowed its own retaliation.

On a more positive note, data points signaled strong continued economic expansion in the US, with first-quarter GDP growth coming in at 2.0% (third read) - the highest performance since the first quarter of 2013. Unemployment fell to an 18-year low of just 3.8% in May, while a robust 223,000 jobs were created in the same month. Average hourly wages improved by 0.3% - a year-over-year increase of 2.7%. Continuing claims sunk below 1.7 million for the first time since the early 1970s. Altogether, these data paint a decidedly optimistic picture from a labor market perspective.

The Fed raised interest rates once again in June and projected two additional increases for the year, expressing confidence in the US economy's ability to shoulder rising borrowing costs while maintaining upward momentum. US equity markets were unphased by the Fed's move, however, international stocks were less resilient. In response to rising inflation and interest rates, the US dollar promptly increased against a basket of foreign currencies. As a result, international equities became the worst performing asset class for the quarter, reversing last year's trend. The MSCI EAFE (Developed Markets) Index lost -1.24% in the quarter, while the MSCI Emerging Markets Index retreated -7.96%. Rising inflation expectations and increasing yields negatively affected bond prices as well (albeit less dramatically), with the US Aggregate Bond Index falling -0.16% in the quarter.

The US remained the sole rising-rate environment among developed economies, while investors continued to speculate about when the European Central Bank

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(ECB), Bank of Japan (BoJ) and Bank of England (BoE) will begin their own quantitative tightening measures. Despite keeping interest rates unchanged, the ECB decided to taper down its policy of buying back assets beginning in October and shut it down completely by yearend, signaling increased confidence in its comprehensive economy despite recent turmoil in Italy and Spain.

Going Forward: Tandem's Outlook

The two largest threats to market performance remain unchanged since last quarter: accelerated inflation and trade concerns. Higher anticipated inflation has already triggered support for an additional rate hike in 2018, while increased trade tensions have contributed to recent market volatility. Although Tandem does not anticipate 2018 market returns to match last year's figures, the later stages of the economic expansion cycle still present opportunities for performance. We continue to see solid economic growth, easy financial conditions, and a low probability of recession.

What began as a trade *dispute* with China appears to be evolving into an all-out trade *war*, though there is not consensus on the technical distinction between these terms. It is yet unclear how far the conflict will go, how long it will last, and to what extent it will impact domestic industries and consumers. Interestingly, much of the conflict's damage may be inflicted on the economies of uninvolved countries with deep connections to the global value chain. As such, a prolonged conflict has the potential to significantly impede the global economy.

Tandem continues to apply an informed, disciplined approach to managing clients' portfolios. As always, we suggest a long-term perspective in times of short-term uncertainty.

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