**RDM CAPITAL ASSOCIATES**

*WEALTH MANAGEMENT*

# SECOND QUARTER 2018 MARKET COMMENTARY

***July 2018***

## STATE OF THE MARKETS

The second quarter saw equity markets rebound from a first quarter correction but dip again towards the end of the quarter amid ongoing concerns over trade wars with China and other trading partners. While the threat of a trade war has loomed over markets since the 2016 election, recently escalating dialogue between the U.S. and China has led to sentiment that a protracted trade war is more realistic. On the positive side of geopolitical developments, market fears over a potential armed conflict with North Korea have dissipated somewhat after the seemingly productive meeting between President Trump and Kim Jong Un in Singapore.

Looking forward, our optimistic view is that the White House will seek to reach a conclusion on the trade disagreements with China and other trading partners in the run up to the November congressional elections. President Trump wants to portray toughness with the likes of China to fulfill his campaign promises and extract economic benefit for American manufacturing, but ultimately, he wants to be regarded as a shrewd dealmaker and will want to point to the underlying strength of the economy to preserve the current Republican congressional majorities. If the trade negotiations progress in the coming months, we expect the equity markets to resume an upward trajectory in the third quarter as economic and corporate fundamentals reassert themselves, while election related uncertainty takes the forefront in the fourth quarter.

## Review of the Second Quarter

*Trade Concerns Dominate Investor Attention*

The second quarter was dominated by the continuing tit-for-tat threats between President Trump and trading partners over various trade deals. Trade-related announcements and leaks from the Trump administration have at times been somewhat mixed and dependent on the messenger, which has caused investor uncertainty. The most damaging economic effects of a trade war with China and other trading partners are twofold: 1) in a global economy where trading partners can, with the aid of increasingly advanced logistics and technology, capitalize on each partner's comparative advantage in production and services, long-term artificial trade barriers can hinder economic growth both domestically and for our allies, and 2) the constant uncertainty surrounding the extent of trade war escalation dampens business, consumer and investor sentiment, which ultimately chills business investment.

While the U.S. has threatened steel and aluminum tariffs around the world for several months, the most notable flare up in trade negotiations in the second quarter involved the escalating tariff retaliation between the U.S. and China. The U.S. currently has up to a $500 billion trade deficit with China and President Trump is looking to dent that trade deficit to fulfill campaign promises to protect U.S. manufacturing industries that have been harmed, such as steel and aluminum, as well as punish China for intellectual property theft. In June, Trump announced plans for a 25% tariff on $50 billion in Chinese imports, which China immediately responded to with an equivalent tariff on U.S. imports. This retaliation was met with retaliation of its own by the U.S. on up to $200 billion in Chinese imports with the threat of another $200 billion in tariffs if China were to retaliate in kind. As of the end of June, the

U.S. was exploring the possibility of restricting over-25% Chinese-owned firms from investing in U.S. businesses with industrially significant technology either under existing law or a harsher new proposal.

Our belief that we have reiterated in several market commentaries since the presidential election is that protracted trade disputes are counter-productive in that the benefit to protected industries is usually out-weighed by the harm to the overall economy from the loss of the economic benefits of freer trade, such as the harm caused to other non-protected industries that rely on tariff-restricted goods from our trade partners as an input of production. Additionally, tariffs have an inflationary impact on prices at a time when the Federal Reserve is trying to raise interest rates to, among other things, regulate inflation. Under some analyses, the direct impact of the proposed tariffs could reach 0.3% of GDP, which would counteract much of the benefit from corporate tax reform, and far outweigh any benefit to the select industries that are protected by tariffs. Last, trade uncertainty is negative for investor and business confidence because investors and businesses fear the long-term economic outlook under a protracted trade war, which hurts equity returns and increases market volatility. These indirect effects are harder to quantify, but no less real, than the direct impact on the economy.

As mentioned above, however, our base case scenario is that President Trump does not intend to wage a long-term trade war with China, the EU or our NAFTA partners, but rather is using tariffs to extract better trade deals through negotiation. If this ends up holding true, the long-term economic impact can be minimized. Yet, the longer the trade disputes continue, the harder it will be to negotiate out of them and risk appearing weak in the eyes of the international community, which could cause the negotiations to stall. From an investor perspective, we believe that cooler heads will ultimately prevail and the trade disputes will be negotiated to a conclusion that all parties can use to claim some degree of benefit. We do not believe that there is much political support for a protracted trade war with China, particularly when it begins to more significantly weigh on economic growth and investor portfolios. Thus, we are expecting that the Trump administration will look to show progress on the trade negotiations during the third quarter, well before the November congressional mid-term elections.

### *Despite Trade Noise, U.S. Economy Continues to Steam Ahead*

The U.S. economy has performed well year-to-date despite the geopolitical uncertainties created by the U.S.-North Korea tensions and the trade disagreements discussed above. Thanks to increased business and consumer confidence resulting from corporate tax reform, employment gains and reasonably low interest rates, the U.S. economy is expected to have grown approximately 4% in the second quarter, after growth of 2% in the first quarter and 2.7% for the prior three quarters of 2017. Corporate earnings are healthy as well. Earnings are expected to have grown approximately 20% in the second quarter from the same period last year. Given that the benefits of tax reform have not been felt for long by U.S. businesses, it is likely that businesses will increase investment in labor and capital going forward through 2018 as tax cuts continue to hit corporate profits, supporting further economic growth.

Despite this economic positivity, it is probable that the U.S. economy is in the second half of the economic cycle and growth is beginning to mature. We do not forecast an economic recession on the immediate horizon, however we are no longer in the early stages of an economic recovery either, as we were several years ago. During this late cycle phase, we believe it is important for investors to review their asset allocations to ensure that their risk profile is suitable given their financial life cycle. To this point, it is always important for retirement investors to maintain adequate liquidity to support retirement expenses if an economic recession were to occur sooner than expected while, at the same time, maintaining reasonable equity market exposure for long-term wealth accumulation of funds not needed for near-term liquidity. As a full-service wealth manager, we are happy to consult with clients to conduct a financial or retirement planning review, upon request, to assess the suitability of each client's overall household asset allocation given current market conditions.

For long-term investors, we continue to favor our large-cap value equity strategy for superior long-term wealth accumulation. Within this large-cap value equity strategy, we currently see attractive opportunities within, but not limited to, the financial and energy sectors. Energy stocks have performed particularly well of late, thanks to geo-political factors that have reduced supply, such as the Iranian sanctions and Venezuelan political upheaval, which have caused oil prices to rise significantly to the current approximately $75 per barrel WTI. Financials have under-performed recently, however stand to benefit from a steeper yield curve when some long-term economic uncertainties mentioned above subside (e.g. trade concerns) and the Fed gets closer to the point of short-term interest rate normalization, which could be as soon as 2019-2020. We also see opportunities within the industrial and consumer discretionary sectors, which despite the headwind of trade uncertainty for multinationals, stand to benefit from continued late-cycle economic growth and increased business and consumer confidence.

As usual, we welcome all comments and suggestions.