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**MARKET COMMENTARY** August 22, 2018

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| **Dow Jones Industrial Avg.** | **24,271.41** | **Standard and Poor's 500** | **2,718.37** |
| 2018(YTD) -1.8% | 2nd Qtr. 0.7% | 2018(YTD) 1.7% | 2nd Qtr. 2.9% |

**Uncertainty and Strife – "**It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair…."
- *Tale of Two Cities* – Charles Dickens

**Eye of the Beholder** – This country is as beset by uncertainty and division as was France in Charles Dickens' novel. In the current political environment it is virtually impossible to achieve agreement on any issue of consequence. The country is so divided politically it is difficult for the average person to determine what the truth is or even if it is possible to define truth. Political spin masters have determined they must communicate their truth to their political base. Since participation in the Democrat and Republican parties has continued to erode and independents now are believed to outnumber each, where are voters of any persuasion able to gather objective information on the issues of the day? Political advertising is slanted to portray each candidate in the most favorable light. Discernment of the truth has been passed by default to the media, yet across the board, media providers have abandoned their primary role as reporters of all the news that's fit to print. Truthful, factual news is what most readers would like to see, instead their secondary role as provider of editorial opinion has come to dominate media of all types. They have been compromised by the vast sums of money that flood into politics today. The end result is a political system incapable of addressing the most pressing problems of the day. There are issues looming which must be resolved or the future of our nation's growth will be seriously impaired. These include moral issues such as global warming; the future of medical care, and immigration as well as monetary issues, such as our nation's outstanding debt and the mushrooming annual budget deficits; the faltering sustainability of the nation's entitlement programs; the woefully underfunded state and local pension systems; and the huge college debt burden. In order to have any hope of solving this myriad of challenges, priorities must be established and sacrifices shared. It is difficult to imagine how the chasm separating the two opposing political camps can be bridged. More tax cuts will only exacerbate the challenges which lie ahead.

**Plus Side of the Ledger** - For the moment, the economy is providing a reason for continued optimism. The below-average growth which persisted for nearly a decade after the Great Recession of 2008-2009 has begun to exhibit positive momentum and it is evident in a number of government statistics. Growth in real gross domestic product (i.e., GDP) reached 4.1% in the first quarter. Based on U.S. Commerce Department statistics, there have been just four quarters in the last dozen years that reported a higher growth rate. This improved growth is reflected in a number of areas including soaring corporate profitability, wage growth, expanding employment, and capital investment. Minority unemployment has fallen to levels not seen in over 50 years.

Last year's tax law changes were a major factor behind the improvement as they helped generate a large increase in corporate profitability. Another benefit was many companies also experienced a dramatic increase in their free cash flows. This allowed them to increase their capital spending, increase hiring, increase wages, and boost dividends. Another change to the tax laws encouraged companies with significant foreign operations to repatriate foreign profits trapped overseas. With their accounts flush with cash, many of these larger companies with considerable international exposure have been buying back significant amounts of their own company's shares. Both of these tactics help support a company's stock price, and they have been equally helpful in fuelling the overall stock market advance.

**The Flip Side of the Ledger -** Although stock price levels remain near record highs and the economy continues to forge ahead, investors remain uneasy. Cash held on the sidelines remains at a surprisingly high level. One reason for the reticence is the fear of a repeat of the market crash in 2008-2009 when the stock market retreated more than thirty percent in a year's time. It should not be any surprise that deep wounds engender long memories. When coupled with the extended market advance since the slaughter, it is reasonable for investors take a more cautious approach. Another factor, which is not to be ignored, is the historic valuation metrics for equities. Recent positive earnings announcements have helped to allay this concern, yet valuations remain well above the historical mean. This raises the question of how next year's results will compare with this year's stellar numbers. As the beneficial effects of last year's tax cuts diminish, economic growth will be less robust and advances in corporate profits will be more subdued. The net result will be less support for continued gains in stock prices.

Interest rates and inflation are two other related concerns, which may already be impacting investor confidence. The long secular decline in interest rates, which began in the early 1980's has finally reversed itself over the past year or so. As the Federal Reserve (i.e., the FED) recognized that growth in the economy was beginning to accelerate, they became concerned the very low interest rates (near zero!) brought on by their "quantitative easing" strategy would result in more rapid growth of the economy. To lessen the possibility of accelerated growth, they announced their intention to institute a gradual series of incremental rate increases based on prevailing economic results. Since this approach began, the federal funds rate has increased by more than one percent and two more ¼ point increases are expected before the end of the year. These higher rates can be expected to create a drag on future economic growth as borrowing costs will increase across all sectors of the economy.

The final great imponderable looming over the stock, bond, and currency markets today is the influence of international interaction. Every week there is a new "hot spot" requiring attention. If it isn't China or North Korea, it is Russia or Iran. President Trump has broadened the discussion by insisting the United States has been victimized by a long list of is trading partners for a long period of time. What began as his initial focus on reducing the sizable trade imbalance with China has since expanded to include our neighbors, Canada and Mexico, and many other countries. There is widespread concern his aggressive approach to this issue will ultimately disrupt and suppress world trade. His efforts may prove self-defeating if it reduces the ability of our domestic companies to export while boosting prices for consumers because of the tariffs on imports. Any meaningful disruption of world trade is likely to have a negative impact on stock prices here as well as in any other countries involved in the disputes. In summary, our stock market is benefitting from the favorable economic growth trajectory aided by the recent tax law changes. This has helped fuel the current, near-record stock market rally, yet any of the potential black swans mentioned could cause an abrupt reversal.

Accordingly, it is wise for each investor to review their appetite for risk in light of the sizable advance over the past several years. With the market at its peak, it is suggested investors pay particular attention to the likelihood their equity allocation has move to the top of their comfort range if not above it. Consider rebalancing. With bonds, careful attention is required for bond positions with longer maturities. If interest rates continue to increase, a distinct possibility, principal values will be adversely impacted. Lower quality bonds are also at risk if the economy begins to slow down. Now is an ideal time to raise cash reserves in order to provide for any expected expenditures over the next year or two.

**A Change Worth Noting –** The note included with this mailing provides a description of a change in the treatment of cash flows by Schwab in accounts. In some cases it will be advantageous to add a separate money market account. The note provides more detail of what is involved. Your questions are welcomed. - JML