OmniStar financial group

Market
A Glance at How the World Affects You
Perspectives

June 2018

The Bull Market is still persistent

Stocks spent much of Friday in recovery mode following weakness on global trade concerns as President Trump said he would impose tariffs up to $50 billion on goods from China. According to officials in Washington, China's theft of intellectual property and technology and other unfair trade practices reignited Trump's promise to inflict heavy tariffs. Markets opened deep in the red on Monday amid lingering trade tensions between the two largest economies in the world.

The long-term effect of tariffs is nebulous and full of speculation. On the other hand, Treasury bond yields are presenting a compelling case as they rose sharply in recent weeks on stronger-than-expected U.S. economic data. In contrast, corporate bond yields have not risen as fast -- so spreads between corporate and Treasury bond yields have narrowed. The spread between AAA-rated corporate bonds and 10-year government bonds in May was 102 basis points, well below the 35-year average of 123 bps. The gap between the government 10-year bond yield and a BAA-rated bond in May was 185 basis points, also below the historical average spread of 233 bps. These spreads help us gauge the bond market's view of corporate financial strength. Based on this premise, corporate balance sheets look solid, but corporate bonds are not as favorable to investors. From an investment standpoint, we are favoring inflation-protected securities and shorter-duration Treasuries.

If bonds are confirming strength in the economy, GDP is our next place to look for clues about the direction of equity markets. The consensus on 2Q18 GDP growth appears to be coalescing in the 3.5% range. Among the Federal Reserve regional banks, estimates range from 3.1% at the New York Fed to 4.6% from the Atlanta Fed. Assuming the economy grows at the high end of expectations, or by 4.6%, that would be the strongest quarterly growth since 4Q09, when GDP growth was 5.6%.

If the U.S. economy can follow solid 2.2% GDP growth in 1Q18 with 4%-plus growth in 2Q18, the implications would be felt in multiple areas. Moreover, an economy which has the ability to accelerate amid trade-wars might very well have the upper hand when it comes to negotiating.

The first reading on 2Q18 GDP will be issued in July, roughly four months before the mid-term elections. Why are we making reference to elections? Just as a weak economy or recession often precedes the prevailing party losing ground in the mid-term elections, unequivocal signs of economic growth would likely help GOP candidates in November. Elections notwithstanding, unambiguous evidence of accelerating growth in GDP, which captures much more than corporate profits, could be the catalyst to move investors back into the bull believers' column.

Before we get to overzealous, let's agree that an occasional spike in GDP does not mean much if the economy cannot sustain strong growth. We still have the second-half of 2018 and growth could be hampered with tariff implementation and rapidly rising interest rates. Still, we believe the U.S. economy has the strength and momentum to handle additional rate hikes.

The Bottom Line: Overall, we think equities still look attractive and believe the bull market can and should continue. Our investment strategies are positioned based on our expectations for stocks to continue outperforming bonds through 2019. By the time the Federal Reserve has raised rates into 2020, the Fed's balance sheet is expected to be in a much better position to deal with another financial crisis. Our supposition is based on the assumption that quantitative-easing programs are unwound without the addition of new debt. We also anticipate continued strong demand from international investors for longer-term Treasuries - helping keep bond yields on 10-year and greater maturities relatively low.

Best Regards,
Phillip L. Clark, RFC
President & CEO