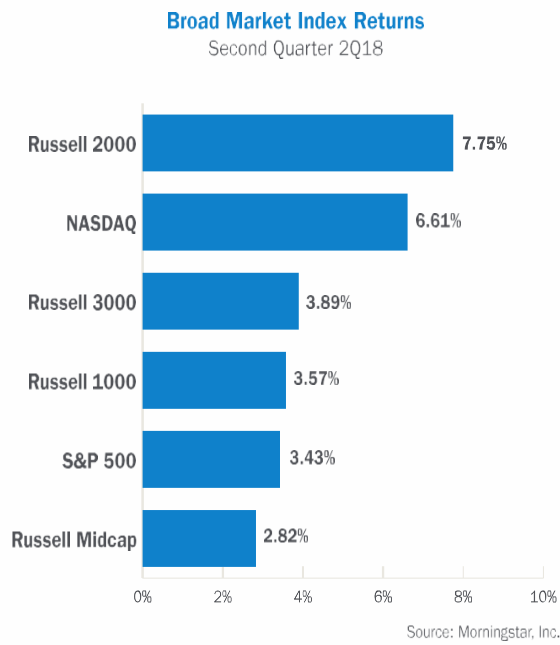
Ramsey & Associates, Inc.
(206) 324~1950
info@RamseyAssoc.com

In the second quarter, volatility continued, yet overall, we saw a rebound in the US equity markets from the first quarter. While most domestic markets were up for the quarter, international markets were largely down with emerging markets faring worse than developed markets. Bonds were a bit of a mixed bag. Domestic corporate bonds edged lower, but high yield bonds posted slightly positive returns. As with equities, international bonds (particularly in emerging markets) fared worse.

The Economy

The US economy remained on an uptrend, although growth in the first quarter was the lowest in a year. The Bureau of Economic Analysis reported its third estimate of first quarter 2018 gross domestic product (GDP) of 2.0%, down modestly from the prior estimate, and lower than the fourth quarter's 2.9% reading. The employment situation continued to post gains, with an average of approximately 179,000 jobs added each month. At the same time, the unemployment rate fell to 3.8%. The Federal Open Market Committee (FOMC) modified its interest rate policy by raising the federal funds rate target 0.25% to a range of 1.75% to 2.00%. Economists expect up to two additional increases in 2018, as economic growth accelerates, and inflation and wage pressures increase.



The global economic environment is expected to remain on an upward trajectory, benefiting from several drivers, including an expansionary fiscal policy in the US and improving trade and investment in many regions of the world. The Eurozone economy slowed somewhat in the first half, following a growth revival in 2017. A decline in exports due to a strong euro was the primary driver of this slowdown. Japan also hit a speedbump in the first part of the year, with GDP actually contracting modestly due to weaker private consumption and lackluster wage growth. Economists expect Japan's GDP growth to slip to 1% in 2018 from 1.7% the prior year. China bucked the trend, as its economy posted solid gains despite the back-and-forth trade and tariff tiff with the US. The country posted annualized GDP growth of 6.8%, which matched its 2017 rate. Most analysts believe that China's growth will moderate in the coming months as credit controls imposed to prevent overheating in certain economic segments kick in.

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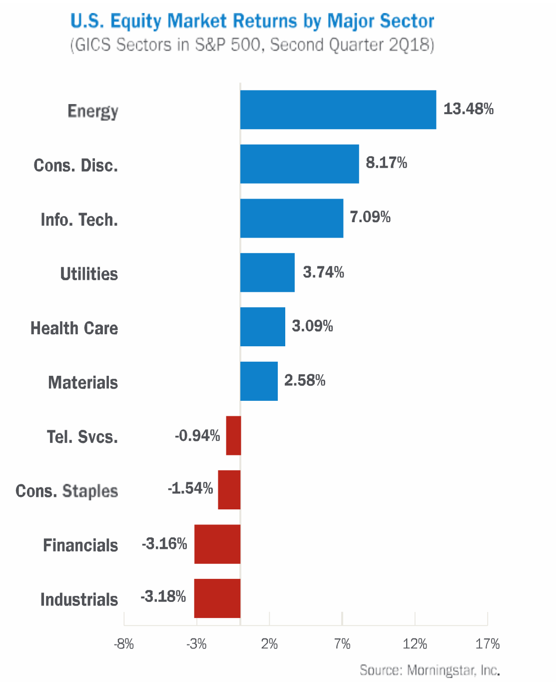
Highlights

GROSS DOMESTIC PRODUCT (GDP)

The Bureau of Economic Analysis released the third estimate of the first quarter 2018 real GDP, a seasonally adjusted annualized rate of 2.0%, down from the fourth quarter's 2.9% annualized growth, and also below the 2.3% prior estimate. Analysts and economists are encouraged by the sustained growth over the past several quarters and believe that it should continue as the full impact of tax cuts and government spending is now starting to flow through the economy. The slight slowdown in the quarter was attributed to measurement issues and poor weather. The current expansion recently tied for the second longest in history. Aggressive fiscal stimulus is the key catalyst for the economy's current growth trajectory. Inflation was relatively benign in the quarter, with the personal consumption expenditures (PCE) index of prices rising 2.5%, following a 2.7% advance in the prior quarter. Corporate profits rose by 1.8% (not annualized) during the quarter. Economists warn that with the economy at, or near, full employment, and with confidence high, policymakers often become conservative, which has the potential for constraining growth and triggering a recession.



HOUSING

The housing segment continues to be a positive for the economy, although housing analysts expect that the rise in mortgage rates will eventually put a damper on demand and price increases. Existing home sales for May (the latest monthly data available) grew at an annualized rate of 5.4 million units, a decline of about 0.4% from April, and down about 3% from year-ago levels. The inventory of existing homes was slightly more than four months of supply, up somewhat from the prior year. Existing home prices in May were up 2.6% from April and have increased 5.2% from May 2017. In the new-home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at 68, slightly lower than the previous month, but still at high levels. Homebuilders' confidence should continue to remain strong as the aggressive domestic fiscal stimulus begins to have a greater impact on the economy and wages.

EMPLOYMENT

The employment situation improved once again in May. Employers added 223,000 jobs during the month, obliterating the consensus expectations of 185,000 new jobs, and outpacing the prior month's gain of 159,000. Despite May's solid results, the three-month moving average slipped due to lackluster reports for the prior two months, coming in at 179,000. The unemployment rate in May declined to 3.8%, the lowest level in 18 years. Average hourly earnings increased by a greater-than-expected 0.3% in the month, with economists anticipating further increases as the economy gains steam.

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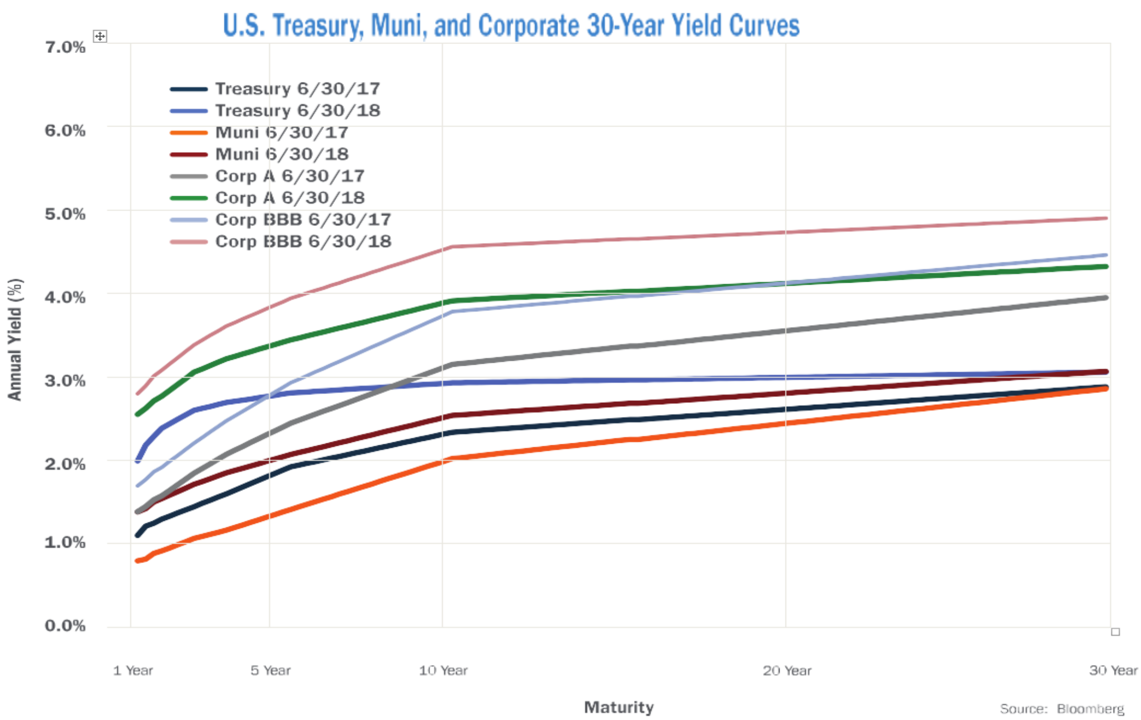
FED POLICY

The Federal Open Market Committee (FOMC) ended its recent June meeting by announcing an increase of 0.25% in the federal funds rate target from 1.75% to 2.00%. The rate increase was widely expected, but the big change came in the accompanying statement, in which the FOMC removed its forward guidance, which stated that the federal funds rate was likely to remain below levels expected over the long run. In addition, the FOMC removed language describing inflation expectations as being low.

Interest Rates

Several factors affected fixed income securities' prices and yields, including the FOMC's decision to raise short-term interest rates once again at its recent June meeting; the escalating rhetoric with China and other trading partners regarding trade and tariffs; and geopolitical events, such as President Trump's summit with North Korea leader, Kim Jong Un. The President's continued strong stance on trade has disrupted financial markets, but the fixed income market has largely moved to the tune of the economy's resilient growth. The benefits of an aggressive fiscal policy, including the tax cuts signed into law in the past six months, are now beginning to flow through the economy, and the FOMC is taking a measured approach to raising interest rates to mitigate any overheating. The FOMC expects to raise short-term rates at least two more times in 2018.

The shape of the Treasury yield curve again flattened somewhat during the quarter, with yields on short- to intermediate-term maturities climbing more than those for long-term issues. By the end of the quarter, the yield on the benchmark 10-year U.S. Treasury Note was higher, ending the quarter at 2.86%, compared with 2.74% on March 31.



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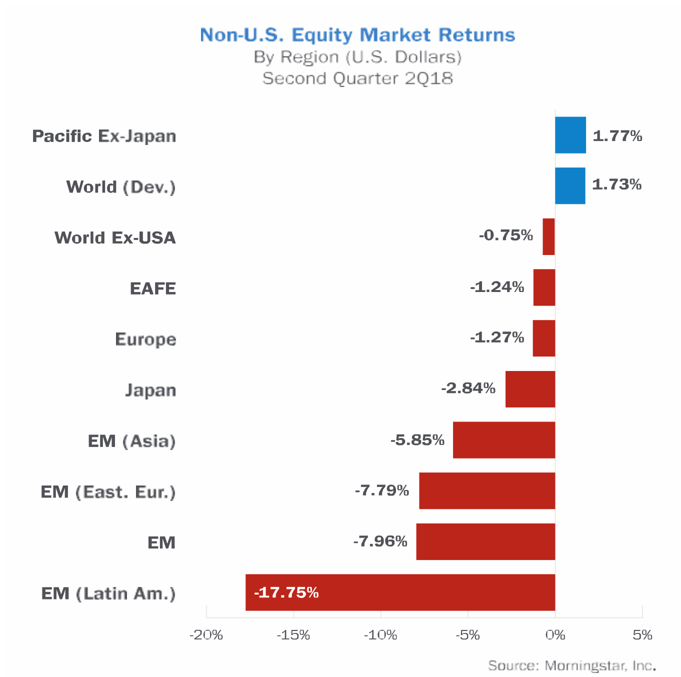
With the economy now in the second-longest expansion in history, investors are becoming acclimated to the FOMC's need to normalize interest rates from abnormally low levels. In addition, fixed income markets have been confronted with other issues, such as the imposition of tariffs and heightened rhetoric about trade that has irked China and other trade partners. The trend in yields was higher during the first half of the quarter and declined for the last several weeks. Inflation expectations rose modestly, with the Federal Reserve's gauge of five-year forward inflation expectations rising to 2.15% from 2.03% on March 31.

Total returns on fixed income securities were generally mixed across the various market segments. The Bloomberg Barclays Treasury 5-7 Yr. Index eased lower by 0.1% for the quarter. The Bloomberg Barclays U.S. Corporate 5-10 Yr. Index fell by 0.6% during the three months. High yield securities, which often follow the performance of equities, delivered a positive return of 1.0%. Municipals also were higher, as the Bloomberg Barclays Municipal Bond Index edged up by 0.9% during the quarter. Prices of non-US fixed income securities were sharply lower in the quarter, as the Bloomberg Barclays Global Aggregate ex-U.S. Index declined 4.8%. Emerging markets bonds also gave up ground, with the JPM EMBI Global Index declining by 3.5%.

Equity Markets

Equity markets lurched modestly higher during the quarter, seeming to take two steps forward and one step back. The volatility appeared to be a result of investor angst over the Trump Administration's trade policy and its insistence on imposing tariffs on certain imported goods. Markets generally do not like tariffs, considering them to be a tax. In addition, our trade partners have not shrunk from the fight, retaliating with their own tariffs on goods that we export. These escalating tensions create uncertainty in the minds of investors, who are beginning to wonder if the benefits of the tax cuts will be offset by the adverse effects of the trade war. Within this landscape, the S&P 500 Index finished the quarter with a modest gain of 3.4%.



The ten primary economic sectors produced mixed performance results during the quarter. Energy, Consumer Discretionary, and Information Technology were the strongest performers on a relative basis, generating returns of 13.5%, 8.2%, and 7.1%, respectively. The Financials, Industrials, and Consumer Staples sectors were the poorest relative performers, posting returns of -3.2%, -3.2%, and -1.5%, respectively.

The Russell 1000 Index of large capitalization stocks generated a 3.6% total return. Within the large cap segment, growth stocks once again outperformed value stocks. Small cap stocks, as represented by the Russell 2000 Index, outperformed large caps by a fairly wide margin, finishing the quarter with a total return of 7.8%. Small cap value outperformed small cap growth. The NASDAQ Composite Index, dominated by information technology stocks, finished the quarter with a gain of 6.6%.

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The Dow Jones Industrial Average of 30 large industrial companies inched higher by 1.3%.

Real Estate Investment Trusts (REITs) posted material gains during the quarter, with the DJ US Select REIT Index surging 10.0%. Commodities were little changed, with the Bloomberg Commodity Index gaining 0.4% for the quarter.

International stocks performed poorly on a relative basis, with almost all markets lagging US equities. Economic growth, although still positive in most regions, cooled in the second quarter. As a result, international stock indices had a difficult time. The MSCI ACWI Ex-USA Index, which measures performance of world markets outside the US, declined 2.6%. The MSCI EAFE Index of developed markets stocks fell by 1.2%. Regional performance was likewise poor for the quarter. The Pacific region ex-Japan was the strongest performer on a relative basis, with a return of 1.8%. No other region delivered positive gains for the three months. Latin America was the poorest performer, declining 17.8%. China also was a poor performer, falling 3.5%. Emerging markets performance was abysmal, as the MSCI Emerging Markets Index shed 8.0%.

Looking Forward

The US economy remains strong and, although the current expansion is now the second longest in history, the consensus among economists is that the prospects for further growth are solid. Aggressive fiscal stimulus in the form of deficit-financed tax cuts and increased government spending, according to many economists, has the potential to provide the fuel for continued expansion for at least the next several quarters. It is estimated that these factors will accelerate domestic economic growth to 3% over the next couple of years before slowing down somewhat at the beginning of the next decade.

Not all is bright on the horizon, however. The escalation in trade skirmishes poses a real threat to this growth, as investors view tariffs as tax increases, because consumers will spend more on imported goods. If the tariff retaliation were to end with what has already been imposed, leading economic consulting firm Moody’s Analytics projects that the overall effect would not be significant, amounting to a decline of only about 0.1% of GDP. However, if the additional tariffs that have been threatened—and their retaliatory responses—are imposed, Moody’s estimates the adverse impact on GDP would rise to about 0.4% and result in a loss of about 500,000 jobs. For that reason, if the brinksmanship doesn’t subside, there is a real possibility of a tariff-induced recession down the road. But the expectation is that if the equity market continues to have difficulties because of the back-and-forth tariff tiff, President Trump will relent, enabling the recent strong growth and employment gains to continue.

It will be interesting to see how the rest of the year plays out. Things could certainly get interesting particularly as we move towards the mid-term elections.