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GCG's Market and Economic Update

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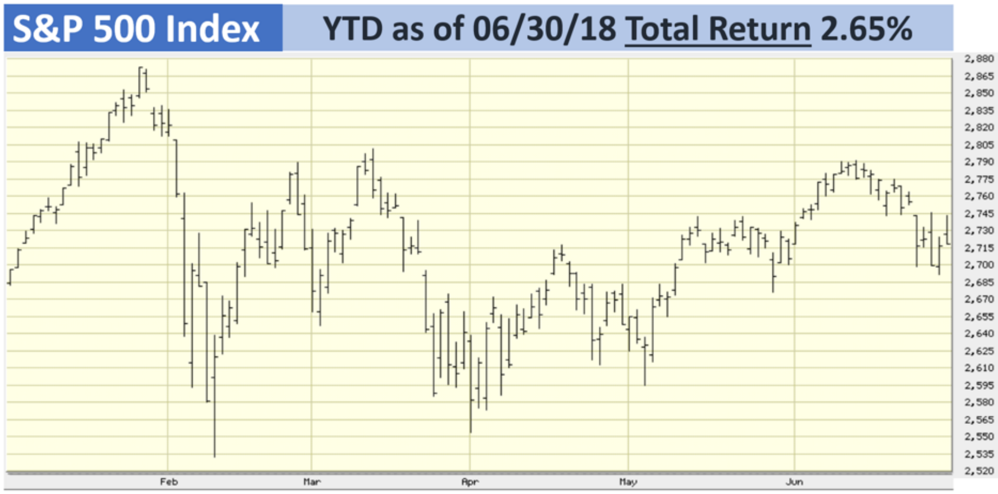
Market

The US stock market, as measured by the S&P 500 Index, started the year by making a new all-time high in January only to suffer its first official 10% "correction" in almost two years. The total return for the S&P 500 Index, year-to-date through June 30, 2018, including reinvested dividends, was 2.65%.



Source: bigcharts.marketwatch.com, Morningstar

The second quarter produced quite a reversal in fortune for several investment categories as emerging market stocks and international stocks, which had been leading after the first quarter, are now lagging. Categories like real estate and US small cap stocks are now in positive territory. The reversal was initially caused by rising US interest rates but now the markets are wading through the trade skirmishes. This is starting to take its toll on international stocks relative to the US markets. US small cap stocks, which conduct most of their business domestically, seem to be more immune to the trade rhetoric.

Given the rising interest rates during the first part of the year, the total return for most bond categories are still slightly negative, so far in 2018. The Bloomberg Barclays US Aggregate Bond Index total return is -1.62%, year-to-date, through June 30, 2018. As interest rates stabilize, the interest paid on the bonds should help to make up for the fall in prices.

The valuation metrics, like the price/earnings (P/E) ratio, for the US stock market had been rising steadily since the financial crisis. There was some concern that valuations were running ahead of earnings growth rates and becoming a little too high. Since the recent correction in January, stocks have generally been trading sideways, but, with earnings continuing to rise, valuation metrics have moderated. A market "correction" doesn't always have to be a severe downturn to bring valuations back to more reasonable levels. A sideways market can also serve that purpose, with much less pain and drama. Only bubbles produce markets that go higher from lofty levels – with disastrous results, as we saw with tech in 2000 and real estate in 2007.

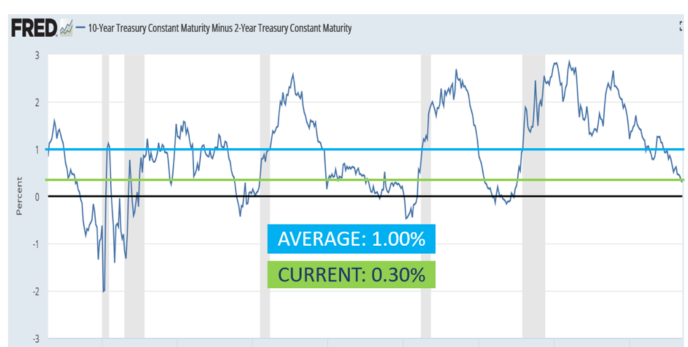
Source: FactSet, FRB,Robert Shiller, Standard & Poor's, Thomsan Reuters, J.P. Morgans Asset Management

2017 was one of the least volatile years on record with stock prices seemingly going up virtually every day. It stands to reason that the following year will probably be more volatile. 2018 has already had 24 days in which the US stock market has gone up or down by more than 1% in a single day. Last year only had 8 such days. The year following a low volatile year averages about 38 up or down 1% days. In other words, the volatility we have experienced this year is a return to normal.

Economy

The US economy has been slowly growing since the financial crisis ended in 2009. In terms of duration, this recovery is now the second longest on record for the US economy. It is also one of the slowest. Recently, the GDP growth rate has accelerated a little bit, with the preliminary reports for the 2nd quarter showing a quarter-over-quarter rate of change potentially above 4%. Global growth has also been improving since the European recession in 2012. Here in the US, tax policy has improved the financial fundamentals for US companies. Employees may also benefit from this improvement through faster wage growth. Unlike other economic recoveries where wages grew faster as the unemployment rate came down, this recovery has not produced the same acceleration in wage growth. As the employment picture continues to improve, wages may start to grow as companies fight for talent. The current unemployment rate is under 4% and, some observers project that it could drop below 3% if the economy continues to grow. Recent changes to trade policies have yet to show impact on global economic growth. It remains to be seen who the winners and losers will be. As with any change in policy, there can be unexpected consequences.

For the Federal Reserve, wage growth has been the single most concerning problem in this recovery. The fact that wage growth has not accelerated has kept the Fed from raising rates to normal levels faster. Short term interest rates at 0% is not normal. With anemic growth and low inflation, rates have been kept lower for longer. If wage growth does start to accelerate, it may cause inflation and the Federal Reserve may be forced to become even more aggressive in raising rates to slow down the economy. For now, the Fed has been able to slowly bring short term rates up off the historic lows without impacting growth. The bond market, on the other hand, does not feel that inflation is a long-term problem and has brought longer term rates down over the last several years. This convergence between higher short rates and lower long rates means that the yield curve is flattening. A flattening yield curve by itself is not an issue. In fact, the massive bull market of the late 1990's was built on a very flat yield curve. The tipping point comes when the yield curve gets inverted. That is, when short rates are higher than long rates. An inverted yield curve has been a very strong indicator that a recession may be looming.



Source: Federal Reserve Bank of St. Lewis

As the economic recovery continues, some are beginning to wonder when the next recession will happen. There are many factors that may cause the economy to stall. Some factors that have been in the mix during prior downturns are rapid spikes in commodity prices, overly aggressive Fed action, and extreme market valuations. Most times, it's a combination of all these factors. The Fed is certainly increasing interest rates and reducing the Fed balance sheet, in a reversal of the prior asset purchases (TARP). The Fed could slow the pace of interest rate increases if it was concerned the yield curve inverting. They could also slow the pace if they do not see an acceleration in wage growth and sustained inflation. The recent correction may have taken some of the steam out of the inflated market valuations. However, it remains to be seen if the tariffs enacted by the US and other countries increase consumer prices without the commensurate increase in wages. Higher prices without higher wages could trip up the US economy as well as stall global growth. For now, a strong economy might be enough to overcome artificially higher prices.

SUMMARY AND PORTFOLIO STRATEGIES

The recent market correction may be the pause that refreshes a stock market that has been building momentum based on strong corporate earnings and a strong labor market. The Federal Reserve is taking a steady approach to raising short term interest rates and has a focus on wage growth to make sure it is accelerating but not at pace to cause inflation to run away. The full effect of the tax and trade policies on the US and global economies are still not completely clear.

For the Strategic Growth (equity) strategy of our investment portfolios, we favor a neutral market capitalization weighting between US and international stocks, including exposure to international small/midcaps and emerging markets. This may result in a higher weighting to international stocks than some investors may expect. Global economic growth should continue which means stock markets should resume their upward trajectory. However, the relative valuations favor better opportunities in foreign stocks. For our Low Volatility (bond) strategy, we are currently positioned to guard against interest rate risk and credit risk. With the improving employment picture, the inflation pressures are increasing which may force interest rates higher. Our portfolio's average duration is lower than the market for that reason.