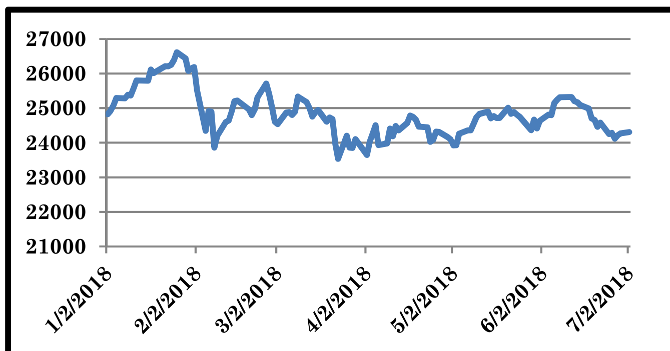
Quarterly Commentary

CHESAPEAKE WEALTH MANAGEMENT

U.S. Equity Markets

In spite of the elevated levels of volatility, the Dow Jones Industrial Average finished the second quarter on a high note versus the end of the 1st quarter. Concerns over trade tensions and the effect of tariffs were front and center. U.S. economic growth remained solid as corporate earnings were strong, and the tax cuts have encouraged consumer spending and business investment. The Federal Reserve raised short-term interest rates in June, commenting that the likely uptick in second quarter GDP will spur further rate hikes in 2018.

Dow Jones Industrial Average



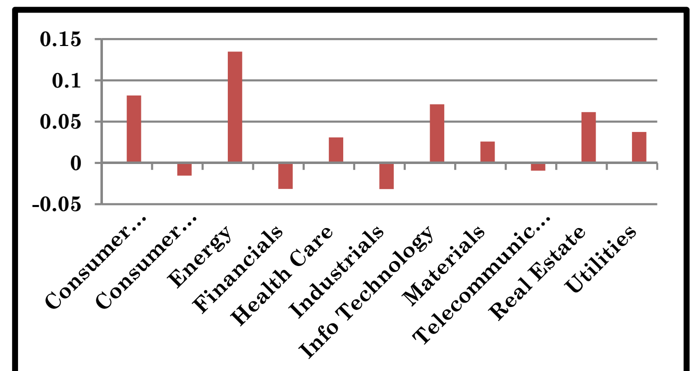
When looking at growth from a global perspective, expansion continues, but at a less synchronized and slower pace. Although China's economy remains in an expansionary phase, manufacturing has slowed, the risk of a recession in China is growing, and policymakers have begun easing monetary conditions. Other economies such as Germany and Japan are beginning to feel the impact of a slowing Chinese economy.

On a macroeconomic front, the effects from tariffs could lead to stagflation. The disruption of smooth-running supply chains has a tendency to stifle business investment, reducing economic growth. Higher prices for goods are passed on to consumers, and inflationary pressure rise. We have seen some of this with the recent rise in commodity prices. While accelerated levels of inflation are not ideal, stagnate or negative growth coupled with rising inflation is the worst scenario. On the surface, imposing tariffs on certain goods may appear contained within specific industries, but there are always overlaps which have a wider impact globally. Companies and sectors that are less reliant on limited supply sources and are more domestically oriented could come out ahead if a full-blown trade war materializes.

Sector Performance

Energy and Consumer Discretionary stocks were the top performers for the second quarter. The sharp rise in oil prices and resurgence in consumer spending were the driving factors. Financials and Industrials suffered and were the weakest sectors. A flattening yield curve weighed on the banks and talk of tariffs and trade tensions had a negative impact on the Industrials sector. Real Estate and Utilities fared well. Even though a variety of semiconductor companies suffered, the Info Technology sector ended the quarter on a positive note.

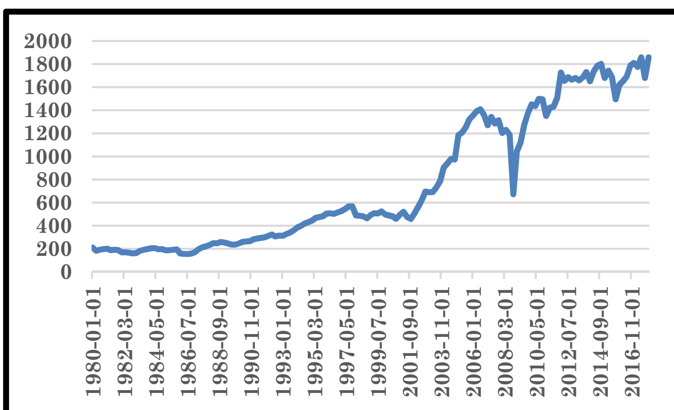
2nd QTR Sector Performance



Corporate Earnings

Corporate earnings growth rates continued to rise at a steady pace during the second quarter. Recent data from FactSet shows that analysts expect corporate earnings to surpass levels not seen since 2011. In spite of solid numbers, there are concerns that earnings could be peaking. Typically, earnings tend to peak at the mid-point of an economic cycle and trail off into the late period. The U.S. remains in a prolonged state between the mid-and-late phases of the expansion cycle. In addition, trade tensions have elevated volatility. Uncertainty surrounding trade and its impact on earnings has caused some large cap multi-national companies to reduce forward guidance. While an unlikely outcome, even a short-term trade war would make it hard for many sectors to continue to gain ground. Once the rhetoric fades and trade negotiations are finalized, the thought is that markets could break out of their current trading range to the upside. Investors will certainly be looking to July and August earnings releases, as well as corporate CEO comments on sentiment, going into the end of the year.

U.S. Corporate Profits

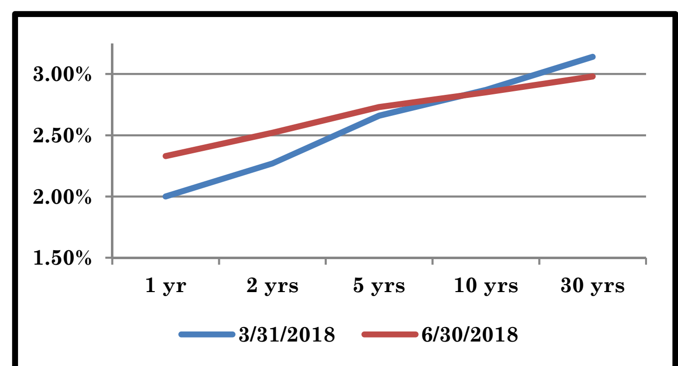


With so many moving parts, the equity market could experience more turbulence going into the second half of 2018. While there will always be headwinds causing short-term disruptions to the markets, focusing on longer term goals and objectives remains the prudent strategy. Proactive decisions are superior to reactive ones, and making changes to one's asset allocation should only be done when one's fundamental goals or objectives change. Market fluctuations are normal and with the fundamental strength of the U.S. economy, CWM is cautiously optimistic on the markets going forward. We are firm believers in diversifying across all S&P 500 sectors and weighting them according to economic and market outlooks. In addition, exposure across multiple asset classes reduces volatility and can protect on the downside.

Fixed Income Comments

Employment data remained quite strong during the 2nd quarter of 2018. Inflation indicators have met the Fed's target of 2.00%, consumers' spending habits are steady, and most economists agree that the U.S. economy is strong with second quarter GDP expected to approach or perhaps even exceed 4%. The bond market and the shape of the yield curve are indicating a less than robust outlook. The yield spread between the 2-year and the 10-year Treasury have narrowed considerably since the beginning of the year, and concerns have surfaced over the flattening of the curve. The Federal Reserve continues to raise the Fed Funds rate, confident that the strength of the U.S. economy can handle interest rates moving higher, but at a measured pace. Longer-term yields have risen only modestly, due in part to geopolitical uncertainty and lack of substantial inflationary pressures, causing the yield curve to flatten to levels not seen since 2007.

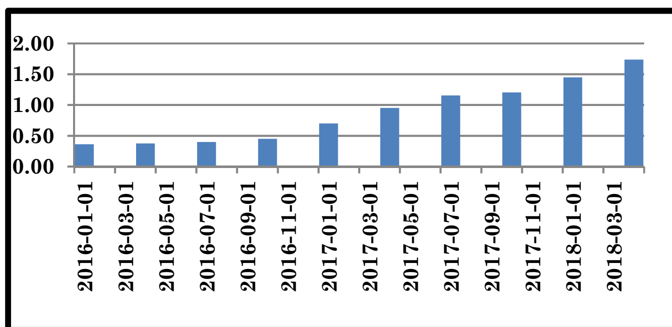
U.S. Treasury Yield Curve



Historically, when the yield curve flattens (i.e. short-term yields rising faster than long-term yields) it is a signal that economic growth is slowing. Some argue that this once reliable predictor is not as strong of a signal as in previous cycles. In response to the financial crisis of 2008, Central Banks kept longer-term interest rates artificially low by buying Treasuries and Mortgage Backed securities for their own balance sheet. In 2017, when the trimming of the balance sheet began, it was unclear as to how this would impact the movement in interest rates.

The short end of the yield curve, however, has seen substantial movement as the Fed continues its mission of returning short-term rates back to a neutral position. After the latest rate hike in June, the Federal Reserve signaled two more rate hikes planned for 2018. The argument can be made that the flattening of the curve is more of a byproduct of short term rates moving higher and Fed action, as longer term rates have remained mostly stable.

Fed Funds Rate



The minutes from the most recent Federal Reserve meeting show that they discussed tariffs and their effect on future investment confidence. The flatness of the yield curve was mentioned but currently, their opinion appears to be that markets are driven more by geopolitical events than the strength of the economy and inflationary pressures. It does beg the question: Is the flattening implying an economic slowdown, or just a function of the difference between where the Federal Reserve is on tightening, versus the bond market's views on inflation? Historically, the bond market usually gets it right.

An Inverted Yield Curve

So what happens when and **if** the yield curve inverts? Historically, an inverted yield curve signals that a recession is ahead. Although the last 7 recessions have been preceded by an inversion of the curve, there have been a few periods where a recession did not materialize. The timing of the onset of a recession is not consistent and has ranged anywhere from a few months to two years. Most analysis do not see recession possibilities for at least two more years. In the time between a yield curve inversion and the beginning of a recession, it is possible for the economy and equity markets to stay in positive territory. The S&P 500 has rallied 11% on average during these periods. Analysts expect the Federal Reserve to stick to their rate hike plans which could cause the curve to invert. They will have to see some hard core evidence of a slowing economy before backing off their goal, and they will be cautious in relying on the shape of the yield curve alone.

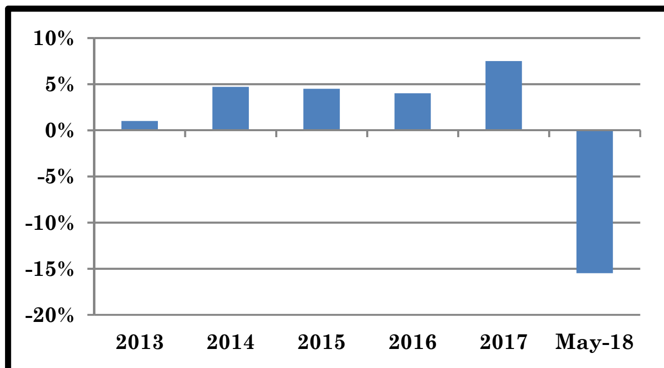
In spite of the reasons, a flat yield curve is not positive for the overall economy, specifically the financial sector as borrowing and lending are typically reduced. However, with the Fed's balance sheet unwinding and increased pressure on wage growth, a more 'normally sloped' yield curve may not be too far off. Additionally, in the third quarter the Treasury will announce its refunding needs. The expected amount of debt needed to finance recent budget increases should put upward pressure on longer term rates.

Corporate Debt Market

The recent tax cuts, especially the lowering of corporate tax rates, is having its intended effect on the earnings and bottom line for many corporations. It has elevated cash flows, which can be used to increase capital spending and hiring. It can also have a positive effect on a company's credit quality, which means a reduction in the interest rates on the debt that corporations issue. As companies issue less debt, it provides support levels, keeping bond prices

elevated and interest rates low. The markets have seen this effect more recently, but this tailwind of corporate liquidity could fade if the effects from tax reform diminish.

U.S. Corporate Debt Issuance



With interest rates still near historic lows, conventional wisdom says that rates have nowhere to go but higher. Predicting rate direction and timing, however, is extremely difficult if not impossible. Currently, our fixed income strategy is to ladder maturities and durations across the yield curve, as opposed to focusing maturities in the short end and long end of the curve. We continue to emphasize quality in our bond portfolios and do not take any unnecessary credit risk. As in our equity positions, we believe in diversifying fixed income securities across varying sectors, credit quality ratings and duration bands.

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www.chesapeakewealth.com

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2. Sector Performance
Morningstar: Sector performance of the 11 S&P 500 sectors on a quarterly basis.

3. U.S. Corporate Profits
Federal Reserve Economic Data.

4. U.S. Treasury Yield Curve
Federal Reserve Economic Data.

5. Fed Funds Rate
Federal Reserve Economic Data.

6. U.S. Corporate Debt Issuance
Sifma: Securities Industry and Financial Markets Association.

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