

MARKET AND ECONOMIC OUTLOOK



July 2018

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Broad Economy and Housing Stay Strong as Inflation and Trade Risks Emerge

As we reach the midway point of 2018, market volatility has returned to more normal levels after an eerily calm 2017. The president's approach to global trading policy has rattled the nerves of investors and trading partners. Bonds have languished while the Federal Reserve has continued to raise rates off of post-financial crisis lows.

The broad backdrop in the United States continues to be mostly positive, as the lengthy economic expansion continues and stocks have posted year-to-date gains — albeit somewhat modest ones. Meanwhile, some new risks took center stage this quarter, including rising oil and gasoline prices, and turmoil in Brazil, a key emerging market.

Positives	Negatives
Employment is strong	Future returns (for the next seven to 10 years) from stocks and bonds are expected to be lower than long-term historical averages
Housing market is firm	Escalating global trade tensions, which could derail economic growth and possibly lead to a trade war
Risk of a U.S. recession appears low, near term	Uncertainty on the effects of global central banks removing monetary stimulus measures
Consumer and small business confidence remains high	Very mature bull market with high valuations creating a “head wind” for the markets
U.S. corporate earnings are firm and expected to increase with tax reform	Increasing gas prices and other signs of emerging inflation

Total Returns (%) as of June 30, 2018				
Index Name	Capital Market Segment	Second Quarter 2018	Year to Date 2018	2017
Bloomberg Barclays U.S. Aggregate	U.S. Broad Market Bonds	-0.2	-1.6	3.5
S&P 500	U.S. Large Cap	3.4	2.7	21.8
Russell 2000	U.S. Small Cap	7.8	7.7	14.7
MSCI EAFE*	Non-U.S. Developed Markets	-1.2	-2.8	25.0
MSCI EM**	Emerging Markets	-8.0	-6.7	37.3
Hypothetical 60/40 Portfolio***	Diversified Mix of Indexes	1.0	0.0	15.3

* Europe, Australasia, and Far East

** Emerging Markets

*** 40% Barclays U.S. Aggregate, 32% S&P 500, 7% Russell 2000, 16% EAFE, and 5% EM

An investor cannot invest directly in an index, and the hypothetical portfolio is not intended to reflect any specific portfolio managed by CLA Wealth Advisors. An unmanaged index does not reflect any expenses that may be associated with an actual portfolio.

Source: Morningstar

Small cap stocks continue on upward trend

In U.S. stocks, small caps led the way in the second quarter. The Russell 2000 index, which tracks about 2,000 stocks with a median market capitalization of \$860 million (by comparison, the median market cap of the S&P 500 is \$21.2 billion), had a torrid quarter, finishing with a 10 percent gain.

Some analysts view outperformance in small caps as a positive sign for the market, demonstrating “market breadth” since there are more small companies than large companies. What is driving the relative strength of small caps? Smaller companies may be benefitting from the fact that, on average, they do most of their business domestically. This, in turn, may shelter them from geopolitical risks and concerns about tariffs and global trade (a topic to which we will return to) as compared to larger, multinational companies.

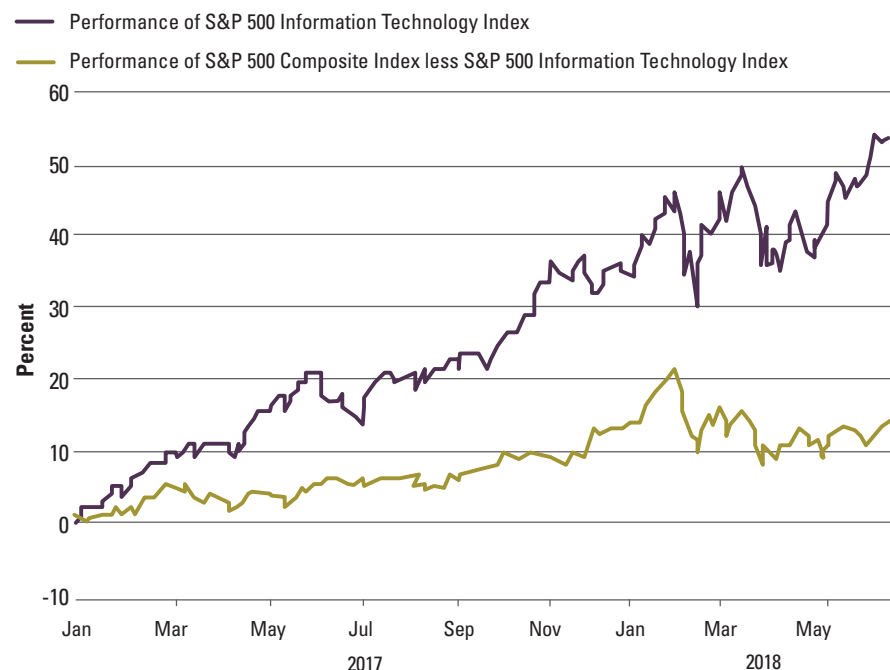
Technology stocks show remarkable staying power

One theme from last year has carried over to 2018 in U.S. stocks: strength in technology. S&P technology issues led all large company sector indices in the second quarter, with a 9.5 percent gain. The broad S&P 500 was up 5.5 percent for the quarter.

The run-up in tech shares has been remarkable. Technology now accounts for more than 25 percent of the total market capitalization of the S&P 500, which is approaching the 30 percent share it reached during the internet bubble of the late 1990s (Charles Schwab).

Are we now in a 2018 version of a tech bubble? Some would say yes, but there is compelling evidence that we are not (yet, at least) in bubble territory. One key reason is that earnings from the tech sector are stronger than in the internet bubble of 1999. Back then, tech reached a 30 percent share of the S&P 500 market cap and the earnings of technology companies accounted for only 13 percent of the S&P 500 total. In other words, investors, in their euphoria, bid the prices of shares extremely high relative to earnings. Today, tech earnings make up 24 percent of the S&P 500's total earnings, which is nearly in line with its 25 percent market cap share.

S&P 500 Information Technology Index



Sources: Charles Schwab, Macrobond, Standard & Poor's as of June 15, 2018

Consumer and business sentiment continues to be positive. The National Association of Manufacturers survey found that 95 percent of manufacturers have turned bullish about their future, which is a record high for the survey's 20-year history (*Manufacturers' Outlook Survey*, Second Quarter 2018). Respondents point to tax cuts as a key driver of their optimism. Consumer confidence, as measured by the Conference Board survey, dipped a slightly in June, but remained at a high level.

GE removal from Dow signals end of an era

On the subject of U.S. large cap stocks, there was one newsworthy event this quarter related to the Dow Jones Industrial Average (the Dow). The committee that selects the constituent companies of the 30-member index decided to remove General Electric Co. (GE) and replace it with drugstore chain Walgreens Boots Alliance. GE was the last remaining original member of the Dow, which was first published in 1896. This represents the end of an era for one of America's iconic brands and also signifies how our economy has and will continue to evolve.

"Consumer, finance, health care, and technology companies are more prominent today and the relative importance of industrial companies is less," explained David Blitzer, managing director and chairman of the index committee at S&P Dow Jones Indices.

Global markets finish down in second quarter

Non-U.S. stocks were negative in the second quarter, with emerging markets moving sharply. Developed-country stocks, as measured by the MSCI EAFE index, finished down 1 percent for the second quarter and are down 3 percent for the year. The fundamental backdrop for Euro-area markets remains sound, but risk factors, including slowing manufacturing output (Haver Analytics, May 2018), the negative effects of tariffs and trade tensions, and political uncertainty, have weighed on returns this year.

Italy made headlines in the financial press this quarter. Some analysts are concerned that populist parties there are gaining ground, which could lead to a break-up with the European Union (regrettably bringing us the term *QuitItaly*, an extension of Brexit for British exit and Grexit for Greek exit). This uncertainty led the prices of Italian government bonds to plunge, and the stocks listed in Milan fell more than 7 percent for the quarter. The effect of the MSCI EAFE index is not dramatic, as Italy comprises about 2 percent of the index (Morningstar).

Emerging markets (MSCI EM index) hit severe turbulence in the second quarter, falling 8 percent. Two countries — Brazil and South Africa — each comprising about 7 percent of the emerging market index, fell dramatically, in U.S. dollar terms, for the three-month period ending June 30. Brazil, which is Latin American's largest economy, seems to be in a constant state of political turmoil, and scandals involving elected officials continue to roil markets. Labor strife — including a truck drivers' strike in May — have also contributed to the sell-off in Brazil. South Africa's markets suffered this quarter due in part to a surprisingly negative GDP report that showed the economy contracting (more than 2 percent year-over-year) and because South Africa's currency, the rand, has plummeted versus the U.S. dollar. The largest emerging market, China, also sold off during the second quarter, with the index down 8 percent.

Turbulence in Emerging Markets

Selected emerging market, country-specific exchange-traded funds; total return percentage in U.S. dollars.

Country	Ticker Symbol	2nd Quarter Returns (%)
Brazil	EWZ	-27.4
South Africa	EZA	-14.9
South Korea	EWY	-10.3
China	FXI	-7.8

Source: Morningstar

Bonds down from last year, stay in positive territory for quarter

The broad investment-grade U.S. bond market, as measured by the Bloomberg Barclays Aggregate Index, churned out a slightly positive return for the quarter, but stands at -1.6 percent on a year-to-date basis. Bond market investors continue to closely monitor the interest rate policy of the Federal Reserve's open market committee. The Fed, led by a new chairman, Jerome Powell, has stated that it expects to raise rates two more times this year — in quarter-point increments — with more increases likely in 2019. The Fed is also in the process of [reducing the size of its \\$4.5 trillion balance sheet](#).

The specter of rising rates and falling bond prices has been looming for some time. Bond investors have felt some pain in the "front-end of the curve." The two-year U.S. Treasury bond yield began the year at 1.88 percent and closed the second quarter at 2.53 percent. The bellwether 10-year Treasury ended the

quarter with a yield of about 2.9 percent. Although the U.S. 10-year yield may not be exceptionally attractive on an absolute basis, it remains very attractive relative to other investment-grade government credits.

U.S. Government Bond Rates Compared to Other Sovereign Issuers	
Government	Yield of 10-Year Maturity Bond (%)
United States	2.90
United Kingdom	1.30
Germany	0.30
Japan	0.04

Source: Bloomberg (as of June 22, 2018)

Rising oil prices and inflation concerns

Oil prices have been on a general upward trend. In late June, west Texas intermediate (WTI) (a common grade of crude oil) spiked to more than \$72 per barrel — the highest mark in four years — as traders reacted to threats of U.S. trade sanctions against Iran. Demand has also outpaced supply. To improve the supply/demand picture, the president has been pressing OPEC (and specifically, Saudi Arabia) to increase output. The Saudis have agreed to increase output in the third quarter, which could ease upward price pressures (*Wall Street Journal*).

For the majority of U.S. consumers, the many global cross-currents that affect the price of WTI is less of a concern than the price of refined gasoline at the pump. With national average fuel prices up nearly 30 percent over a year ago (AAA.com), many Americans will be feeling some pain at the pump. There is concern that rising gas prices will dampen consumer spirits. For example, *Restaurant Business Magazine* states that 20 percent of consumer gas savings goes directly to restaurant spending, so when gas prices increase, restaurant spending decreases. The magazine cites four dollars per gallon as a critical level. In general, the burden of higher fuel prices can dampen consumer spirits.

One-Year Price of West Texas Intermediate (WTI) Crude

As of June 28, 2018



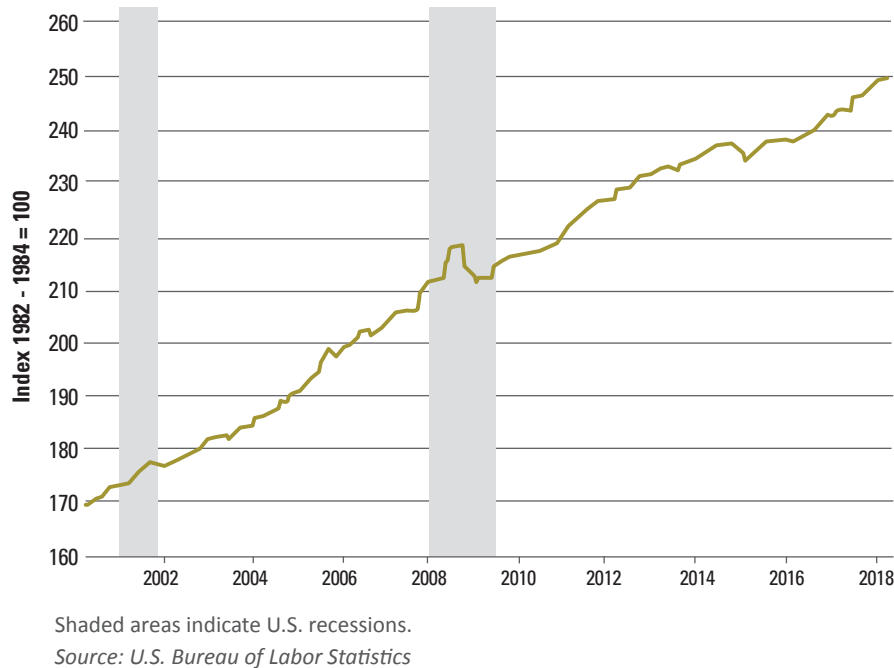
Source: MarketWatch

Other signs of inflation have been appearing. Regional Fed surveys released in late June indicated that input costs for U.S. manufacturers have been rising for months (Bloomberg and the Federal Reserve). The Dallas Fed report showed that materials costs for Texas factories are at a seven-year high. Labor costs are the biggest costs, and the data also showed pressure on wages due to a shortage of experience workers — a phenomenon not unique to Texas.

The Philadelphia Fed's report showed similar inflation-related red flags. The index that measures company input price expectations soared to multi-decade highs. The Richmond Fed's report, which accounts for manufacturers in the mid-Atlantic region, showed inflationary pressures, too, with several measures at multi-year

high. The question that remains from examining regional Fed surveys is: How much, if any, of these higher manufacturing input costs will be passed along to consumers? We will continue to monitor inflation expectations closely, as will policy makers and capital market participants.

Consumer Price Index, All Urban Consumers/All Items



Trade tensions and the danger of unintended consequences

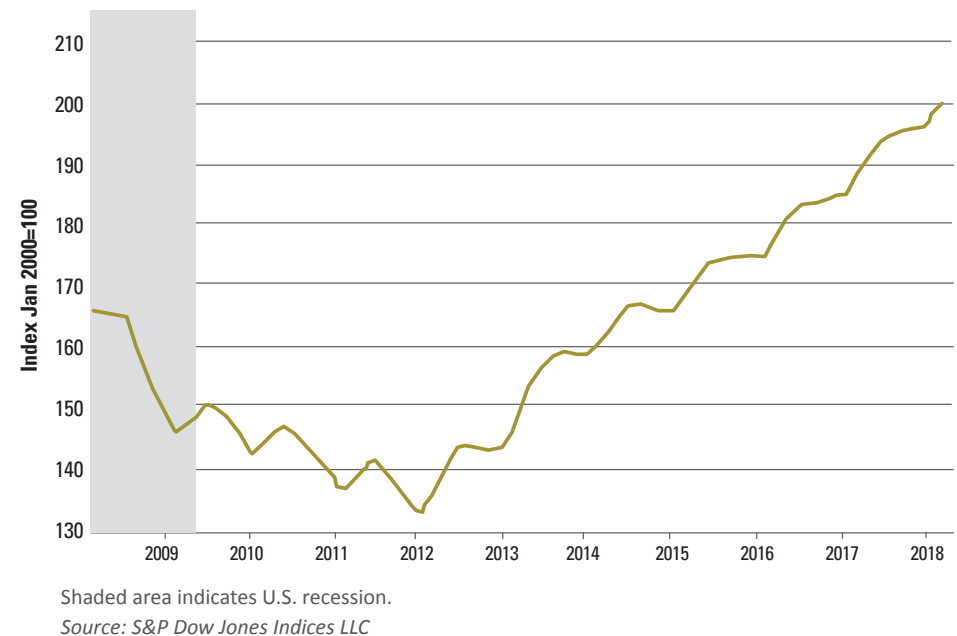
An the [April 2018 Market and Economic Outlook](#) we commented on the possibility of a trade war, brought on by a vicious cycle of tariffs, retaliatory tariffs, and still more tariffs. In our view, which is shared by many analysts, no one wins a trade war. U.S.-China trade relations appear to be entering a more heated and dangerous stage. The administration's targeting of about \$50 billion worth of Chinese goods is scheduled to take effect in July (*Bloomberg*). Considering the size of the United States and Chinese economies, \$50 billion may seem like a harmless amount, but China will certainly retaliate. Escalating tensions could then lead to policy mistakes, and that could seriously harm the global economy.

According to a study by Bloomberg Economics, if the U.S. were to raise import costs by 10 percent and the rest of world retaliates with tariffs on U.S. exports, it could trim half a percentage point off of annual GDP (or about \$500 billion). By comparison, that's roughly the size of Thailand's economy (*Bloomberg*). Investors would certainly react to this scenario, possibly causing a downturn in global equities prices.

U.S. housing is strong, but affordability concerns rise

Housing is a massive, complex market with many intriguing facets. It is also one of the bedrocks of our economy. According to data from *Forbes* (January 2018), the total value of all U.S. residential real estate is nearly \$32 trillion, a number that approaches 1.5 times the U.S. annual GDP. After bottoming out in 2012, housing has been in a strong uptrend. Low interest rates, low unemployment, and a generally robust economic backdrop have provided favorable conditions.

S&P/Case-Shiller U.S. National Home Price Index



30-Year Fixed-Rate Mortgage Average (U.S.)

Shaded area indicates U.S. Recession.

Source: Freddie Mac

The industry may be approaching a turning point in single-family housing. Data released near the end of this quarter show a softening market, with the number of sales decreasing (U.S. Existing Home Sales Unexpectedly Fall on Inventory Woes, *Bloomberg*, June 2018). The lack of homes available for sale pushed up prices, but according to the National Association of Realtors (NAR), those gains were mostly at the high end of the market. The decline in sales was most notable in single-family homes, and especially among lower cost properties. In addition to the inventory concerns, potential first-time home buyers may be feeling the pinch of higher mortgage rates and lackluster wage growth.

Growth in housing means the construction industry has also been on an upswing. Jill Bosco, CLA's managing principal for the construction industry, says construction spending is at record highs, with increased sales and profit margins.

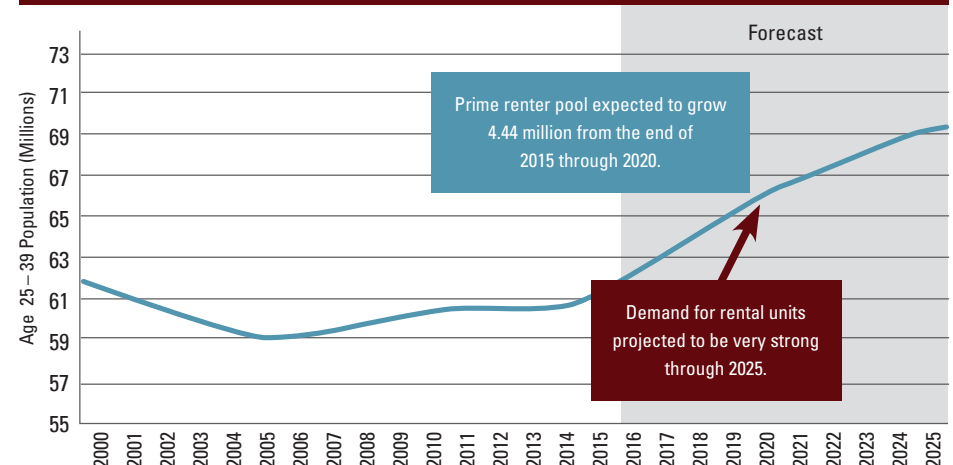
"There is a high level of confidence from contractors coming off strong results for the first half of the year," Bosco said.

But she said this optimism is tempered by concerns about the ongoing shortage of qualified labor to meet increased sales. "The demand for qualified labor, as well as project managers, has been increasing and a highly competitive job market continues to challenge contractors to keep a good team of employees for the long term," she said.

Trade tariffs have also entered the picture for construction. Bosco said volatility in materials (specifically, those made of steel and aluminum) can greatly impact the profitability of a job and can make it difficult to forecast into the future.

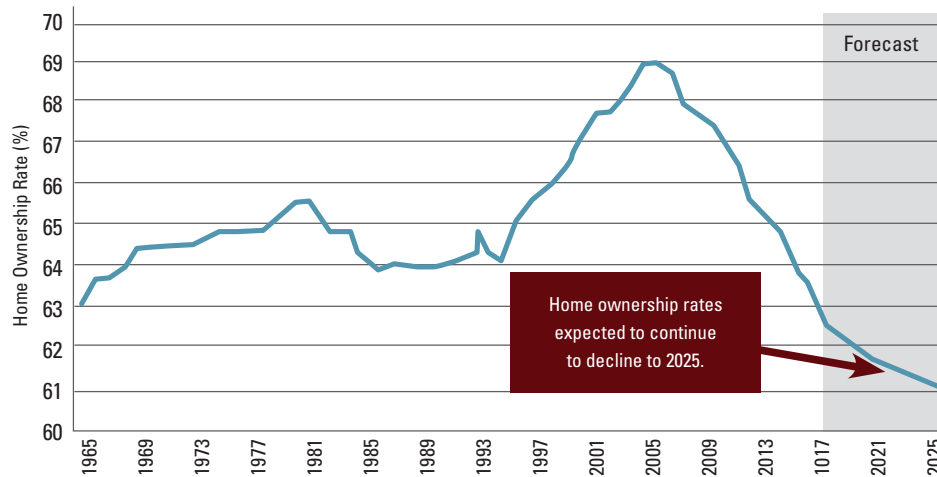
Demographics and lower home ownership will drive rental demand

Analysts are predicting that many more households will rent homes in the coming years. The move to rental will be driven in part by demographics. The U.S. population between the ages of 25 and 39 is growing at a rate of 888,000 per year. In addition, Millennials are expected to form 23 million households over the decade ending in 2025 (Harvard Joint Center for Housing Studies). Fewer in this younger demographic own homes than in previous generations, which will boost rental demand.

Prime Renter Pool (Age 25-39) Population Growth

Source: U.S. Census

Home Ownership Rate Forecasted to Continue Downward Trend



Sources: Source: U.S. Census, (through 3Q 2016)
Axiometrics, Federal Reserve, Green Street

Projections based on John Burns Real Estate Consulting

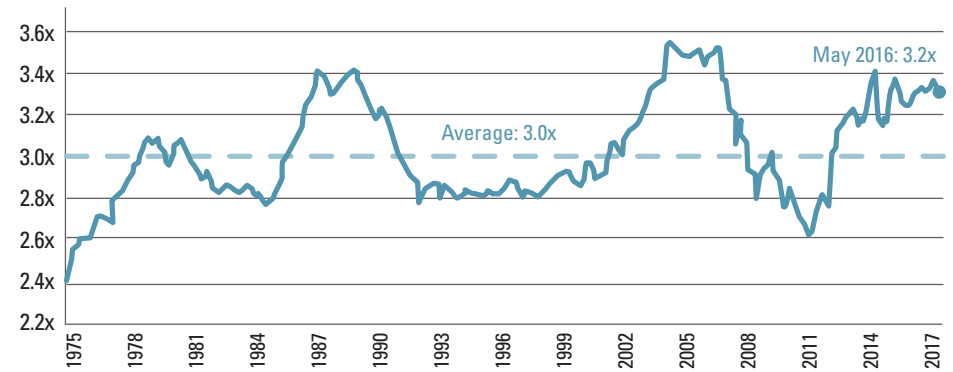
Home Ownership by Age

Age	2005	2016	Change
<35	43.4%	35.2%	-8.1%
35 - 44	70.1%	58.4%	-11.7%

Favorable supply/demand and demographics provide a tailwind to single-family rentals. We also believe that affordable housing rentals, including manufactured home communities, shows strong fundamentals. For lower income households, purchasing a home is becoming more difficult as prices climb and supply dwindles. In addition, underwriting standards for conventional mortgages are becoming stricter. These factors combine to provide support for [affordable housing](#) rentals.

Home Prices Relative to Income

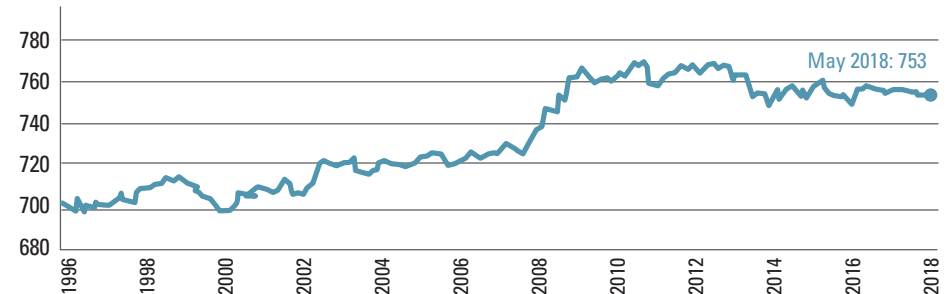
Six-month rolling average, new home prices as multiple of disposable family income



Source: JPMorgan and Bureau of Economics Analysis

Lending Standards for Approved Mortgage Loans

Average FICO, conventional purchase, score based on origination date



Source: Ellie Mae, JPMorgan

Look for volatility to continue

We expected to see volatility increase to “normal” levels after a weirdly calm 2017, and the first two quarters have definitely delivered in that regard. Having said that, it may be worth contemplating what is considered normal in the markets, and how reality often does not line up with short-term expectations. For example, what are normal (i.e., average) returns from stocks? The average calendar year return of the S&P 500 is about 10 percent. But out of the previous 92 years, the S&P’s return has only landed within an average return range of 8 percent to 12 percent range six times (Charles Schwab). This is another example of why, when creating financial plans and building investment portfolios, we focus on probabilities and long-term outcomes, and less so on short-term market swings.

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