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SANDERSON WEALTH MANAGEMENT

2nd Quarter 2018

Financial Market Update

Risky asset returns were quite different in the second quarter of 2018. Emerging market stocks, which led the group with a 1.4% gain in the first quarter, fell 8.0% in the second. The interest rate sensitive asset classes of global real estate and global infrastructure were off to a difficult start in Q1 with a 5.1% and 6.5% loss, but their Q2 performance was quite different with gains of 6.7% and 5.2% respectively. Also noteworthy was the 8.8% appreciation of U.S. small companies that gained value as trade tensions heated up.

Major Asset Class Returns

		Q2 2018	2018
Core Bonds - Taxable	(BBGBARC U.S. Agg)	-0.2%	-1.6%
Core Bonds - Municipal	(BBGBARC 5Yr. Muni)	0.9%	0.3%
Global Stocks (as a whole)	(MSCI AC World)	0.5%	-0.4%
U.S. Large Stocks	(S&P 500)	3.4%	2.6%
U.S. Mid Stocks	(S&P MidCap)	4.3%	3.5%
U.S. Small Stocks	(S&P SmallCap)	8.8%	9.4%
Foreign Developed Stocks	(MSCI EAFE)	-1.2%	-2.7%
Emerging Market Stocks	(MSCI EM)	-8.0%	-6.7%
Commodities	(Bloomberg Comm)	0.4%	0.0%
Real Estate	(DJ Global Select REIT)	6.7%	1.2%

Currency Effect

During the first quarter of 2018 the U.S. dollar fell in value against other major currencies. This was beneficial for U.S. investors, as the currency effect enhanced returns of foreign developed stocks by 2.75% and emerging market stocks by 0.70%. The second quarter was quite different; the U.S. dollar appreciated and hurt U.S. investors who held assets overseas. By June 30, the currency effect had turned negative for the year and diminished returns of foreign developed stocks by 1.79% and emerging market stocks by 3.84%.

Business Cycle

Over the past 70 years, the U.S. has experienced many economic expansions and contractions. On average, expansions have lasted 58 months and resulted in increased annual production of 23% more goods and services than the prior peak. At 108 months, our current expansion is the second longest since World War II, yet economic growth has been quite muted compared to past expansions. In fact, the lack of robust growth may very well be what has kept inflation in check and allowed the expansion to continue for such a long period of time.

Central Bank Influence on the Current Expansion

As economies around the world struggled to recover from the great recession, major central banks resorted to extraordinary measures to help promote economic growth, reduce unemployment, and maintain price stability. One of those extraordinary measures was several rounds of asset purchases by major central banks. In fact, the U.S., European, and Japanese central banks alone increased their combined balance sheets by over $10 trillion, a process that many believe helped to increase the value of risky assets such as stocks and real estate. As this process starts to reverse, it will be interesting to see what effect shrinking central bank balance sheets will have on the economy and asset prices.

Rising Wages & Inflation

Over the past few years the United States has seen a dramatic improvement in the labor market. Today's 4% unemployment rate can be attributed to both the millions of jobs created since the end of the great recession as well as shifts in demographics (most notably the aging of the baby boomers). With over 80% of prime age workers currently participating in the labor force, competitive pressures have now started to force employers to offer higher wages to attract and retain workers. In fact, for the first half of 2018, wages have increased 2.7% when compared to the same period in 2017.

An additional expense to businesses has been higher raw material prices, which rose 4.3% in 2017 and are continuing to rise in 2018. In response, businesses are now starting to pass along their higher costs to consumers, where prices for goods and services have risen 2.8% from just one year ago.

Trade Dispute

In early 2018 the Trump administration began to disrupt the status quo with the implementation of tariffs on solar panels and washing machines. This move led to threats on U.S. agricultural feed products, foreign steel and aluminum, Kentucky bourbon, Levi's jeans, Harley-Davidson motorcycles, and European cars as the U.S. and foreign governments responded in a tit-for-tat manner.

In the second quarter, threats increased in number, became more defined, and reached dollar amounts in the billions. By quarter end many of the threats had been implemented and the skirmish had widened to include Argentina, Australia, Brazil, Canada, China, the European Union, India, Japan, Mexico, Russia, South Korea, and Turkey.