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The major US stock averages rebounded in the second quarter, though to varying degrees. Technology issues continued to lead, while smaller stocks benefited from strength in the US dollar and the perception that their domestic businesses are protected from potential trade wars. Higher quality and value oriented stocks lagged, as consistent earnings and dividends have taken a back seat to 'growth' for the moment. **With regard to fixed income, investment grade bonds were virtually flat on a total return basis,** with tax-free securities slightly higher and taxable bonds down a bit.

Transitions Are Often Bumpy

After a long and generally steady multi-year move higher, **the stock market has been on a roller coaster ride thus far in 2018.** The broad headlines are mostly favorable, with the US economy strong, unemployment low, and second quarter earnings expected to rise 19%. **Yet, concerns are mounting, as volatility has increased due largely to 1) rising interest rates, 2) burgeoning trade conflict, and 3) worry that corporate earnings and economic activity may be peaking.** In addition, while the Fed has raised short-term interest rates, yields on longer maturities have fallen, causing the yield curve to narrow, a condition that often presages economic weakness.

The bouncy action in stocks is consistent with the transition now underway to a more 'normal' economic environment. Among other attributes, normal means interest rates being 2-3% above inflation, levels not seen in a decade. Normal also anticipates the potential for recession, as downturns are key elements of economic cycles. Finally, normal suggests higher volatility, and not the one-way road to riches that some have come to expect. With the equity bull market in its 10th year, historically quite extended, all investors should be prepared for setbacks that restore balance to the risk/reward equation, and set the stage for subsequent advances.

Though today's lofty valuations may result in modest intermediate-term returns, it is reasonable to expect further gains before the next economic downturn. First, strong corporate earnings growth and only gradual bumps in interest rates should provide a conducive backdrop for stocks to move higher, assuming the current tariff spats are resolved before morphing into a damaging global trade war. Second, due in part to cash being repatriated from overseas, 2018 will mark the first year that corporate America will return in excess of $1 trillion to shareholders through stock buybacks and dividends. Significantly, while this repatriation process has begun, only a relatively small amount of cash held outside the US has returned, suggesting that far more is on the way. Finally, history has shown that toward the end of the second year of presidential administrations, and into the third year, stock returns have been nicely positive. These several points support an optimistic perspective in the near-term.

All Is Not Perfect

Looking longer-term, there are several important crosscurrents now at work within the credit and equity markets. While yield spreads between corporate and treasury bonds have narrowed, suggesting that corporate balance

sheets are mostly solid, the flattening yield curve may be signaling that the economy is not as strong as advertised. In addition, 'money supply' is not growing, the 'velocity of money' (the rate at which funds move through an economy) is at its lowest reading since 1949, the year-over-year change in bank credit is down, and gross federal debt as a percentage of GDP is almost double the average since 1952. These indicators are not typically reflective of underlying strength, despite current economic reporting being mostly positive.

These mixed signals lend reasonable credence to the notion that the tumultuous first half of 2018 for equities resulted from investors having already discounted the good news on tax cuts, global growth, and generally positive financial conditions, and that more uncertainty may be on the horizon. **The market averages have been largely supported by a small group of technology stocks and, despite the slightly higher indices, every sector within the S&P 500 has declined at least 10% at some point this year. This choppy activity is consistent with a market advance that may have entered the late innings.**

A Familiar Picture

While the crystal ball is always a bit murky, we believe the current market cycle has much in common with the period 1998-2000. Of course, no two historical moments match identically but the parallels between now and then are instructive, including**:** 1) an unusually long economic expansion that began with tepid growth rates, and eventually reached full employment with high consumer and small business confidence readings, 2) a Federal Reserve that tightened policy, but not at a pace that noticeably restrained risk taking by companies or investors, 3) a rather flat yield curve but one not yet inverted, 4) wobbly emerging markets due to US dollar strength, and 5) huge 'growth' and technology stocks dominating the market amid talk of a new era, while the stocks of a bevy of industry leading companies struggle.

In fact, **the dominance of technology is probably the most glaring similarity to the late 1990's.** Back then, investors piled into the Four Horsemen (Microsoft, Intel, Cisco Systems, and Dell), despite their sky high valuations. Those names have been replaced today by Facebook, Amazon, Netflix and Alphabet (Google), along with a few others. As with the earlier group, each of these companies sports a riveting story to match valuation levels that are challenging to sustain. In keeping with historical precedent, the higher the stocks rise, the more interest they draw. With this as prelude, we believe that a scenario similar to the early 2000's could well unfold.

Unlike the bear market of 2008-2009, when virtually all stocks declined sharply, the 2000-2002 market decline was largely a tech bust phenomenon. However, many quality stocks held their own quite nicely during this period, and we would suggest that the same is possible in this cycle. As noted earlier, a large number of industry leaders are currently being ignored, just as they were in 1999. These companies generally share the same qualities: excellent businesses, reasonable valuations, above average dividend yields, and an ability to weather economic storms. A repeat of the scenario described above would be well suited to our investment philosophy, in harmony with the normalization process and, most importantly, consistent with the goal of growing your capital and income over time while controlling risk.

In sum, the financial markets appear to be moving toward an environment that better reflects fundamental underpinnings as opposed to government driven initiatives. We believe this represents a healthy development, though recognize there will be discomforting moments in the process. Having asset prices and valuations determined by the reality of key factors such as market driven interest rates and inflation, and the status of corporate earnings and balance sheets, will be a long-term positive for the markets and investors.