July 2018

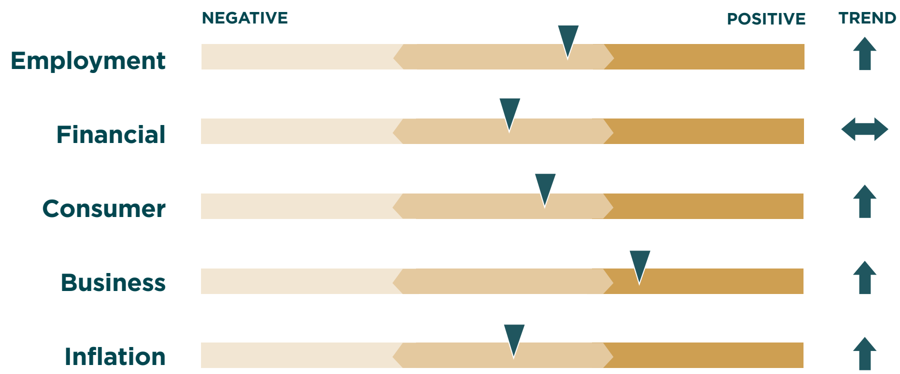
Midyear economic and market review

The news on the economic front continues to be largely positive: Employment is strong, consumers are shopping, earnings are robust and, perhaps most importantly, growth is expected to break out in the coming quarters. Investors seem to have other things on their mind, such as tariffs, inflation and a flattening yield curve. In our view, the certainty of the positives outweighs the uncertainty of the negatives, which should help sustain the late-cycle expansion and create opportunities for investment returns.

The economy: Ready for takeoff

Current overall economic scorecard

- **Employment:** Job gains in recent months remain strong for a late-stage expansion; the unemployment rate hit its lowest level (3.8%) since May 1969
- **Financial:** Short-term rates have outpaced long-term rates so far this year, flattening the yield curve to its lowest level since 2007
- **Consumer:** Retail sales have surged on the strength of employment and wage gains; home sales have risen as of late but are flat over the past year
- **Business:** Monthly business surveys suggest solid expansion for both manufacturing and service industries
- **Inflation:** Year-over-year inflation for the headline and core Consumer Price Index is climbing as the economy continues to grow — the headline rate reaching its highest level since 2012



Source for chart data: Nationwide Economics (June 2018).

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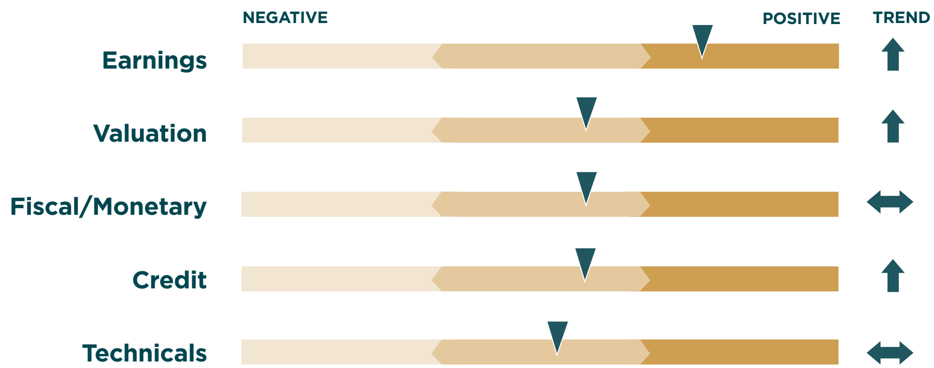
Financial markets:

Riding the stimulus tailwind

Current overall financial market scorecard

- **Earnings:** Corporate earnings have accelerated in 2018, with significant contributions from both revenue expansion and tax reform
- **Valuation:** Strong growth and sluggish markets have kept stock valuations close to historical averages
- **Fiscal/monetary policy:** Corporate earnings and stock prices continue to ride a tailwind from tax reform, government spending and low interest rates relative to historical averages; the Fed is expected to continue its modest pace of rate hikes for some time, while tariffs and likely trade wars present potential downside risks to the continuation of growth
- **Credit:** The corporate borrowing environment remains favorable for companies due to the low absolute level of interest rates and the availability of capital
- **Technical factors:** Market breadth has improved through the year with small-caps outpacing large-caps. There have been pockets of weakness in sectors exposed to rising rates and trade tensions (e.g., telecom, consumer staples and industrials), though a broad set of sectors have been strong (e.g., technology, consumer discretionary, energy and health care).



Source for chart data: Nationwide Investment Research, (June 2018).

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Investment opportunities and risks

OPPORTUNITIES

- **Small-caps:** Smaller companies are poised to see their recent run of outperformance continue; a stronger dollar and restrictions on trade would likely help small-caps as more U.S. firms would look to source domestically
- **Quality growth stocks:** Stocks with good fundamentals and solid balance sheets typically do well in a late expansion as stock selection becomes more important for capturing excess returns
- **International stocks:** Both developed and emerging economies are further behind the U.S. in their economic cycles and still have room to run
- **High-yield bonds:** Corporate debt should still present opportunities, thanks to a continuation of economic growth and the persistent demand for yield among investors

RISKS

- **Large-cap value stocks:** Growth stocks have historically performed better than value in the later phases of economic expansions
- **Defensive stocks:** Sectors that are typically proxies for bonds (utilities, telecom, real estate) are likely to suffer as rising bond yields make them unattractive as income investments
- **Long-term Treasuries:** While long bond yields have struggled to break above 3%, they are still expected to rise as the current growth cycle nears its end

Key takeaways

- Look for economic growth numbers to come in strong for Q2, driven by the fiscal stimulus of tax reform and government spending
- Inflation is likely to pick up in the coming months, and the Federal Reserve is expected to respond by raising its target rate two more times in the second half of 2018
- Potential tariffs and trade wars present a risk to the ongoing expansion and equity bull market, but be wary of emotional reactions to news headlines and President Trump's tweets

For more help or information, contact your financial advisor.

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