Boston Trust Commentary

June 30, 2018

FINANCIAL MARKETS

After a brief respite in the first quarter, US stocks registered gains in the second quarter. Domestic indices were led by small cap companies which, on balance, stand to benefit more from the recently enacted tax cut and are less directly impacted by a potential trade war. International markets were down, however, with emerging markets equities declining most sharply. Oil prices continued their steady march higher, adding 13 percentage points this quarter. At $79 per barrel, oil is now 66% more expensive than it was a year ago.

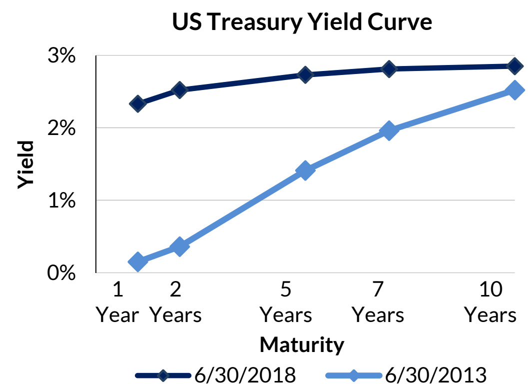
Total Returns through June 30, 2018		
US Stocks	**2nd Qtr**	**1 Year**
Standard & Poor's 500	3.4%	14.4%
Russell 2000®	7.8%	17.6%
International Stocks		
MSCI World Ex-USA	-0.6%	7.0%
MSCI Emerging Markets	-7.8%	8.2%
US Fixed Income		
Bloomberg Barclays Gov't/Credit	-0.3%	-0.6%
US Treasury Bill	0.4%	1.4%

Fixed income investments did not provide their expected stability to portfolios during the quarter. While the Bloomberg Barclays Government/Credit Index was almost unchanged for the second quarter, the path was not tranquil. In the span of just two weeks in late May, the yield on the 10-year US Treasury dropped from 3.11% to 2.78% (leading to a corresponding 3% increase in price) before nearly fully reversing. Market movements can typically be ascribed to a multitude of factors, but the quick round trip likely reflected shifting political developments, including the planned summit with North Korea. While we believe investment risks are increasing, low interest rates and still-reasonable equity valuations lead us to continue to prefer stocks over bonds in the context of widely diversified multi-asset portfolios. Below we highlight the foremost issues we are monitoring, including movement in interest rates, geopolitics, and trade policy.

INVESTMENT PERSPECTIVES

Interest Rates

The US economy sustained its firm footing during the second quarter, supporting further gains by stocks. The persistent economic strength has given the Fed confidence to raise rates twice already this year. Going further, the new Fed Chair, Jerome Powell, indicated a likelihood that rates will be increased twice more in the second half of 2018. Importantly, while the Fed controls short-term interest rates, investors, via buying and selling bonds, dictate longer-term rates. And at 2.86% (as of June 30), the yield on the 10-year Treasury is remarkably close to where it was five years ago. As seen in the chart, the combination of rising short-term rates and relatively stable longer bond yields



has led to a flattening of the yield curve. In past periods "flat" yield curves have served as a harbinger of recession as they are usually the result of an aggressive effort by the Fed to quash incipient inflation. We don't believe, however, that is the case in the current period. Despite the Fed's actions, both long- and short-term interest rates remain low relative to history, and a financially strong banking system is primed to fund further expansion of an already robust domestic economy.

Recent data, including consumer spending and capital investment, underpin consensus full-year GDP growth expectations of over 3% despite a first quarter reading of 2%. The unemployment rate hit an 18-year low at 3.8% in May as non-farm payrolls continued to expand at approximately 200,000 jobs per month; more significantly, wage growth further solidified. Taken together, the underlying economic durability and tightening labor market provide the Fed with some assurance that its actions won't derail the economy.

While fresh pricing data provides further support for the Fed's interest rate policy, inflation remains low by historical standards and near the Fed's stated target of 2%. Should rising inflation become more of a concern, higher longer-term rates are likely to follow. From a stock market perspective, prospects of higher interest rates can pressure shares of companies that have become overly reliant on the debt market in an era of historically low borrowing costs. For now, however, we believe that global forces are likely to prevent long-term rates from rising sharply.

Similar to actions taken by the Fed in the wake of the financial crisis, the European Central Bank (ECB) initiated its own bond buying program in 2015. By early 2018, the ECB had purchased more than €2.4 trillion of euro-area bonds, driving long-term rates to unprecedented lows. In a global financial system, Europe's low bond rates have served as a governor on their US counterparts. Other central banks have similarly aided their economies, helping to further limit rates around the globe. (As the table shows, US rates are far from the lowest). The ECB's efforts have largely worked, and they recently announced the program would end in December. Nonetheless, given extremely low rates of inflation and the still slow-growing economies in southern Europe, the ECB has committed to maintaining an accommodative stance with ultra-low short-term rates for some time.

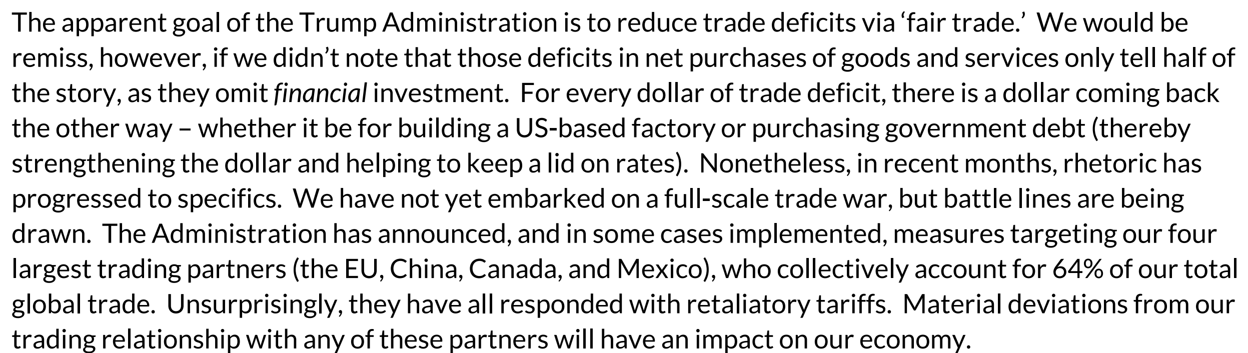
10-Year Government Bond Yields

United States	2.9%
Italy	2.6%
Canada	2.2%
United Kingdom	1.3%
France	0.7%
Germany	0.3%
Japan	0.0%

Data as of June 30, 2018.

Geopolitics and Trade Policy

As always, geopolitical developments have the potential to disrupt economic progress. The associated fear can quickly send investors flocking to the safety of US Treasurys – pushing interest rates lower. A recent split election in Italy has spurred new questions regarding the future of the euro, while also serving as a risk to the growing, but fragile European economy. In the Middle East, changing US stances on the Iran nuclear deal and the location of the Israeli embassy have provoked a new round of turbulence and are likely contributing to the rise in oil prices. Looking farther east, on-again, off-again tensions with North Korea have provided headlines, too. To be fair, both perilous issues have existed for decades. Contentious trade rhetoric, though, is relatively new; if threats become reality, the resulting trade war could set economic globalization back decades.



The apparent goal of the Trump Administration is to reduce trade deficits via 'fair trade.' We would be remiss, however, if we didn't note that those deficits in net purchases of goods and services only tell half of the story, as they omit *financial* investment. For every dollar of trade deficit, there is a dollar coming back the other way – whether it be for building a US-based factory or purchasing government debt (thereby strengthening the dollar and helping to keep a lid on rates). Nonetheless, in recent months, rhetoric has progressed to specifics. We have not yet embarked on a full-scale trade war, but battle lines are being drawn. The Administration has announced, and in some cases implemented, measures targeting our four largest trading partners (the EU, China, Canada, and Mexico), who collectively account for 64% of our total global trade. Unsurprisingly, they have all responded with retaliatory tariffs. Material deviations from our trading relationship with any of these partners will have an impact on our economy.

Tariffs often have unintended and perverse consequences. Consider this example: tariffs on foreign steel will encourage higher demand (and prices) for domestic steel, and, in turn, create more steelworker jobs; however, the benefits in employment in the comparatively small sector (the US steel industry employs 147,000 people) will be dwarfed by the impact higher steel prices will have on downstream industries using steel as an input. Manufacturers requiring steel employ 6.5 million people, while the construction industry employs another 6.3 million. Higher steel prices will likely hurt these industries' profit margins (and their payrolls) – more than offsetting benefits for the steel industry.

From a higher level, trade tensions present two substantive risks. Our largest trading partners also tend to be our closest political allies; fraying relationships can have derivative, but material consequences as it relates to global cooperation. More saliently, should escalating tensions evolve into a full-blown trade war, it will threaten the fabric of globalization. Notwithstanding rising income disparities, the free flow of goods, labor, and capital have been the foundation of widespread economic advancement over the past 35 years. Investors have disproportionately benefited as the resulting global growth and expanding profit margins have produced record corporate profits and impressive stock returns. A reversal of the multi-decade progression toward free trade will hinder access to supply chains, labor, and financing sources, not to mention important consumer markets. The result for companies, the economy, and the stock market could be devastating. We remain optimistic that the headline-grabbing rhetoric is posturing ahead of productive negotiation as the alternative would be economically, and likely politically, self-defeating.

Data Sources: Bloomberg, FactSet.

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