Colorado Capital
MANAGEMENT

SUMMER NEWSLETTER / JULY 2018

Economic Review

This edition of our newsletter is all about the economy. We are pleased WRntroduce a new table which tracks a dozen of preferred economic indicators; we plan to update the table each quarter. The commentary that follows refers back to these metrics (and more) and also includes our market outlook.

12 Key Economic Indicators

Indicator	Current (6/30/2018)	3 Months Ago (3/31/2018)	1 Year Ago (6/30/2017)
US Economy			
Quarterly GDP Growth-Annualized	3.40*	2.00	3.10
Unemployment Rate	3.80**	4.10	4.30
Inflation (Core CPI)	2.20**	2.10	1.70
Interest Rates			
Fed Funds Rate	2.00	1.75	1.25
10-Year US Treasury Note	2.86	2.74	2.30
Currency & Commodities			
Trade Weighted Dollar	124.1	117.6	121.3
Crude Oil (WTI)	74.00	64.94	46.04
Gold Price	1,255	1,323	1,242
Confidence			
Consumer Confidence Index	126.4	127.0	117.3
Purchasing Managers Index	60.2	59.3	56.7
Stock Prices			
Dow Jones Industrial Average	24,271	24,103	21,350
S&P 500 Forward P/E Ratio	17.07	16.93	18.65

**Estimate **Prior Month*

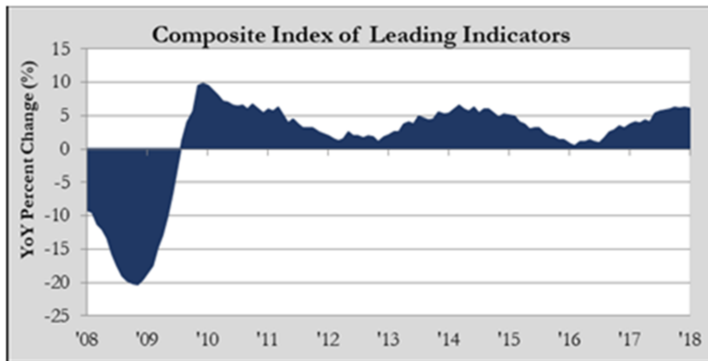
GDP Growth. The U.S. economy has been firing on all cylinders. Growth in the second quarter may come at a 3.5% or higher annualized pace, helped along by a strong rebound in household spending, business investment, a strong labor market, and surprising strength in net exports. Growth is expected to continue at a 3.0% annualized pace on average for the remainder of 2018, thanks in part to fiscal stimulus from the recent tax cuts that are estimated to contribute half a percentage point to overall growth.

Employment. Strong economic activity has been absorbing remaining spare capacity. The unemployment rate now stands at an eighteen year low, and as of June there were more job openings than there were job seekers. Wage growth has been healthy by historical standards but should move even higher as skilled labor becomes scarce.

Colorado Capital Management contributors and editors: Steven Ellis and Julia Wentworth.

Economic Review *(continued)*

Confidence. Both consumer and business confidence are up markedly from a year ago. In the U.S., unemployment continued to fall, wages rose, and home values and stocks remained relatively high. Those factors, along with the tax cuts, have lifted Americans' spirits. Lower taxes, better job prospects, increasing household net worth, and this overall sense of optimism have prompted many Americans to spend more. These factors have also contributed to an upswing in the index of leading economic indicators, a predictor of future economic growth. This index has been increasing since 2009, most recently at an accelerated pace.



Source: Conference Board

Inflation. Consumer price inflation finished Q2 above 2.0%, a sign that the U.S. economy is bumping up against capacity constraints. Add higher fuel prices, higher import prices due to increased tariffs, and stronger wage growth, and it's only a matter of time before profit margins are pinched enough for firms to pass on rising costs to consumers.

Interest Rates. The Federal Reserve, pointing to this momentum and firming inflation, raised its benchmark interest rates for the second time this year and penciled in two more increases by year end to keep the economy from overheating.

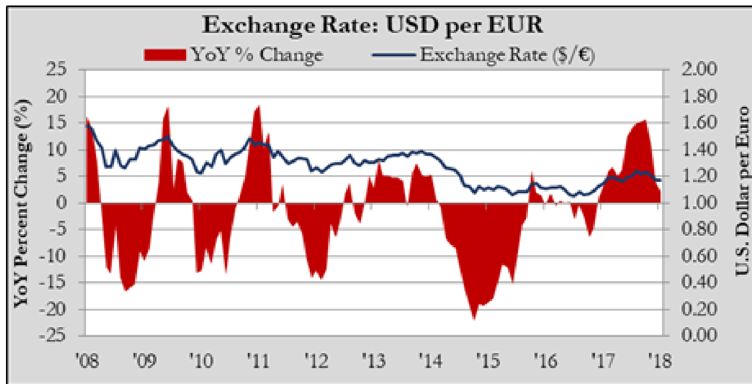
Oil prices: West Texas Intermediate (WTI) is up nearly 40% since last year, and prices at the pump have started to pinch consumers' wallets. The price increase has been fueled by a combination of tighter supply/demand and the U.S. administration's decision to pull out of the Iran nuclear deal and re-impose sanctions. Though oil prices have not reached levels that would seriously hinder spending, a significant reprieve is unlikely. Demand is expected to outpace supply over the next year, and with the potential for the geopolitical risk premium to oil to remain elevated, prices are likely to remain relatively high.

Housing: One place consumer confidence is showing up is the housing market: Americans are buying more homes, but the rate of growth in existing home sales has been slower than expected given the strong employment and economic numbers. Housing turnover has remained incredibly low as a growing proportion of homeowners are opting to remain in place rather than trade up or downsize. The lack of willing sellers has contributed to a prolonged slide in the inventory of existing homes for sale. Moreover, a significant proportion of homes have been taken off the market and shifted to rentals, either directly by institutional investors or indirectly by homeowners keeping their home and renting it out.

With existing home inventories tight, and likely to remain that way for quite some time, more buyers have shifted to the new home market. New home construction has increased in line with expectations, and the outlook appears promising, although new tariffs on steel and escalating trade tensions, along with rising interest rates, may create headwinds for homebuilding activity.

Tariffs: Trade spats with important trading partners affect more than just the housing market. They pose the risk of higher consumer prices, reduced exports, supply chain disruptions, and denting consumer and business confidence. Under the presumption that the tougher trade rhetoric is simply a negotiating tactic, there is still hope that cooler heads will prevail, and tensions will de-escalate. The risk, however, is that once the wheels have been set in motion, tensions could quickly escalate to a trade war. Canada, China, Mexico and the EU have already retaliated to some degree. The U.S. may up the ante, further reinforcing the negative feedback loop.

Currencies: The dollar has strengthened, particularly against the Euro. Recent political crises in Italy and Spain revived simmering concerns about the future of the Euro in an era of populist politicians and diverging economies.



Source: Board of Governors of the Federal Reserve System

The surging dollar has also pressured emerging market countries to support their currencies by halting interest rate cuts or even tightening monetary policy, adding to investor concerns about growing stresses on their economies. Argentina, Brazil, Indonesia, South Africa and Turkey have recently either increased rates or left rates unchanged, citing concerns about global economic turbulence, rising inflation and weakening local currency.

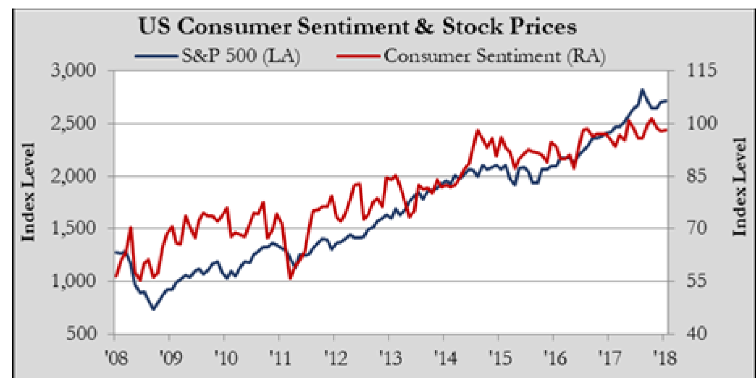
Market Commentary

Following a first quarter during which broad developed domestic and international equity indexes were generally negative, the second quarter produced mixed results. U.S. equity indexes posted positive returns while international indexes were negative. The S&P 500 generated a 3.4% return for the quarter while the MSCI EAFE index was down 1.2%. The S&P 600 small cap index reached all-time highs. Emerging markets suffered through a difficult quarter, falling nearly 8%. Fixed income markets were broadly negative as the Barclays U.S. Aggregate Bond index fell 0.2% and the Barclays Global Aggregate Ex-USD index slid 4.8%.

Macro factors provided a tailwind in the U.S. as the economic expansion became the second longest in history. Following June's FOMC policy meeting, Fed Chairman Jerome Powell noted, "the economy is doing very well…the overall outlook for growth remains favorable." This confidence led the Fed to raise interest rates 25 bps in June and signal the possibility of two additional hikes by year end. In contrast, and on the heels of some disappointing data, the European Central Bank (ECB) announced there would be no rate hikes until at least the fall of 2019. The ECB also announced a plan to halt its bond purchasing program by the close of 2018.

Domestic Equities: An important post-recession market theme has been the dominance of U.S. equities over international equities. Since 2010, the S&P 500 has generated a cumulative return of 183% while the MSCI All-Country World Index ex U.S. has only gained 83%. Last year, it appeared the tide was turning as international stocks generally outperformed their U.S. counterparts. Thus far in 2018, the old paradigm of U.S. relative outperformance has returned driven by strong corporate profits, solid economic growth, and business friendly policymaking.

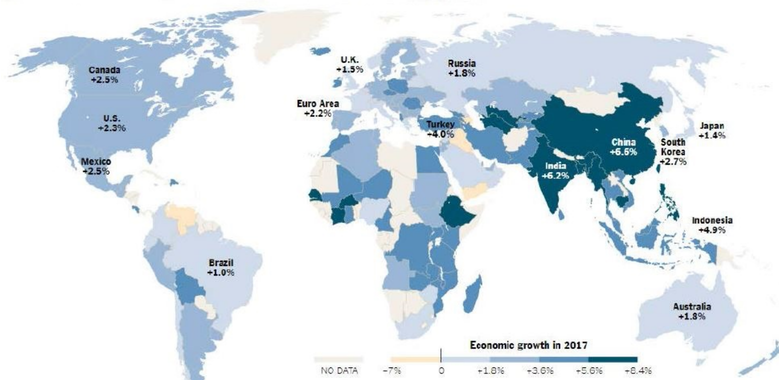
Leading the charge has been corporate earnings. Year-over-year, the S&P 500 earnings growth rate was 25% in the first quarter. This represents the highest earnings growth rate since the third quarter of 2010. Year-over-year sales growth exceeded 8%, and nearly 80% of S&P 500 companies reported a positive earnings surprise, the highest percentage since FactSet began tracking this metric in 2008. Earnings growth has been supported by solid economic growth as the labor market remains strong, consumers are confident and have been spending freely, while businesses have been investing more. Over the past decade, the growth of the US stock market has tracked fairly closely with increasing consumer confidence.



Source: University of Michigan, Standard & Poor's

Substantive new policies out of Washington, including regulatory reform and the Tax Cuts and Jobs Act, have contributed to U.S. equity market gains. Of course, commentary on Washington would be incomplete without noting the market volatility and potential risks driven by uncertainty surrounding the Trump Administration's trade policies, North Korea, and Iran.

International Equities: Trade concerns continue to weigh on international equity markets. Fears of a trade war, a strengthening dollar, and rising U.S. interest rates have had an especially negative impact on Chinese and other emerging market stocks. The Shanghai Composite index is officially in bear market territory, having fallen more than 20% since its January 24th high. Country-specific developments also played a role in some emerging markets. Labor unrest, anemic economic growth, and political uncertainties, for example, contributed to the MSCI Brazil index's quarterly slide of more than 26%.



Source: J.P. Morgan Asset Management, 1Q18 Guide to the Markets

In developed international markets, political uncertainty has produced volatility as European investors fear a stronger mandate for anti-establishment, skeptic politicians and face uncertainty about Italy's future in the Eurozone. And in Asia, the Japanese economy shrank in the first quarter at an annualized rate of 0.6%. This decline marked the end of eight straight quarters of economic expansion for the world's third largest economy, the longest streak since a 12-quarter run between 1986 and 1989. A rebound is expected when second quarter results are reported.

Fixed Income: The first half of 2018 was characterized by rising Treasury yields, a flattening yield curve (as short term rates rose more than long term rates) and widening credit spreads (the difference in yields between corporate bonds and government bonds). Volatility increased, particularly in emerging markets. Given this backdrop, money market, high yield, and short-term bonds have performed relatively well, while emerging market debt, investment grade corporates and U.S. Treasuries have lagged.

Market Outlook: Our economic and market outlook remains generally positive for the remainder of 2018 and into 2019. Strong earnings growth and improving capital investment should support the US stock market. At the same time, we remain sensitive to signs of late-cycle dynamics in the U.S., including higher inflation and interest rates which could put pressure on stock prices. As it stands now, wage growth appears manageable and slow moving, and shouldn't drive interest rates or inflation to the point where the equity bull market rides off the rails.

The clearest risks to equity returns include geopolitical concerns and potential trade issues. An escalation of current bickering into an actual trade war could hurt stock returns. A rising dollar would also continue to pressure emerging markets, despite their attractive fundamentals and valuations.

While continued tightening by the Fed is expected to continue to be a drag on fixed income results, municipal bonds appear relatively attractive for taxable accounts. Fundamentals are solid as state and local governments continue to benefit from an improving economy. Defaults remain low and credit upgrades exceed downgrades.

Sources: Capital Market Consultants, Dept. of Labor, Dept. of Commerce, the Conference Board, Federal Reserve, National Federation of Independent Business.

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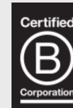

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