Markets At Mid-Year: Still Bullish

Despite the noise of trade tariffs, Supreme Court nominations, and upcoming mid-term elections, so far so good for the U.S. economy, stock market, and corporate earnings. Second quarter real GDP could potentially top 4% on an annualized basis, and consumer confidence remains solid. Global growth appears to be holding strong despite a slight fade in Europe and China. In perhaps a more balanced world, long-dated Treasury rates would start reflecting the prospects of stronger nominal GDP growth. As it stands now, the yield on the U.S. 10-year Treasury is (still) below 3% and the yield curve is flattening. U.S. equity markets remain strong with small-cap stocks near all-time highs.

"TRADE WAR" WINNER VS. LOSER IS A CLEAR MESSAGE SO FAR

Source: Strategas Research. Reprinted with permission.

Two key questions waiting on answers over the next several months are whether the Fed will overtighten interest rates and how the "trade war" with China will be resolved. Fed tightening affects the economy with a lag, but capital markets move more quickly. The U.S. dollar has already strengthened substantially in the past several months while second quarter earnings growth for S&P 500® companies is forecast to be 23.7%. The U.S. continues to be one of the strongest developed economies globally, but the equity market may have to wait a bit longer to get compensated for these good growth numbers. As Strategas Research has observed, equity market performance tends to be back-end loaded in election years, as the first few quarters see actions that are more politically motivated than good economics.

For now, we remain bullish on the economy and markets. U.S. fiscal stimulus outweighs the trade tariff hit. Tariffs are like tax increases, and the tax cuts enacted last year are far greater in size than the tariffs. There could be second-round effects to the tariffs (a negative), and there could be second-round effects to the tax cuts (a positive). The Fed's planned tightening remains a key issue. The chances of a policy error increase the closer we get to an inverted yield curve. In the meantime, we have the support of solid U.S. economic growth.

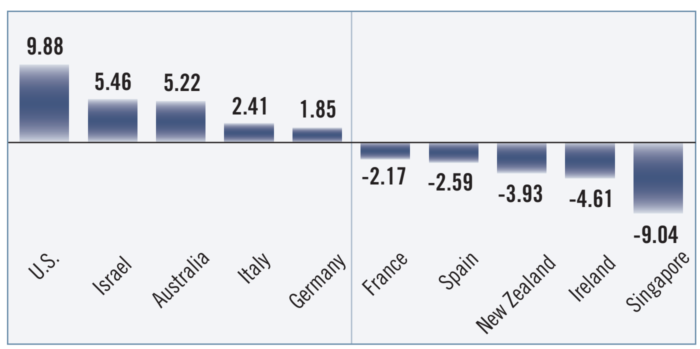
SECTOR HIGHLIGHTS

Global Real Estate – Picking up where they left off in the first quarter, global real estate equities continued to outperform broader equities into the second quarter. It was the first full quarter of relative outperformance in seven quarters, as trade issues simmered and European political noise escalated. For the second quarter, global real estate securities, as measured by the FTSE EPRA NAREIT Developed Index, returned 5.12%, while global equities, as measured by the MSCI World Index, returned 1.73%, expressed in U.S. dollars.

The U.S. dollar staged a healthy reversal in the quarter with a 5% return (U.S. Dollar Spot Index) that served as a headwind for international-over-U.S. real estate equity returns. The dollar demonstrated particular strength against a host of emerging market currencies, including the Brazilian real, South African rand, and Mexican peso.

The top-performing countries in the FTSE EPRA NAREIT Developed Index during the quarter were the U.S., Israel, Australia, Italy, and Germany, with all five countries posting positive returns on a total return basis and measured in U.S. dollars. Following a very weak start to the year, U.S. REITs came roaring back as long-term interest rates retreated from earlier highs and five M&A transactions were announced across four property sectors, highlighting the attractive public real estate values on offer.

FTSE EPRA NAREIT DEVELOPED INDEX (NET)
TOP 5 / BOTTOM 5 COUNTRIES (%) – 2Q18

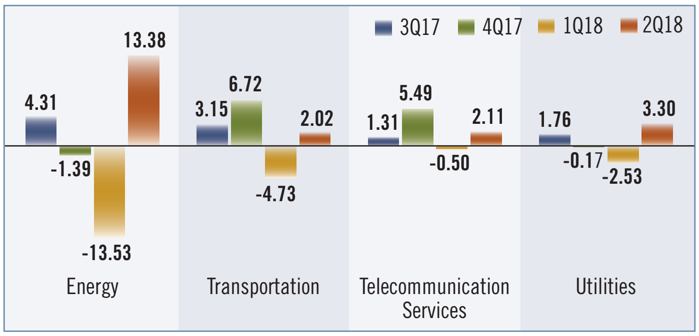


Sources: FTSE, Bloomberg, L.P.

Singapore, Ireland, New Zealand, Spain, and France were the bottom-performers within the Index. All had negative total returns in U.S. dollars, largely a result of the dollar's relative strength as all of these countries but Singapore had positive total returns on a local currency basis. Singapore's weakness was driven by concerns over interest rates, commercial property market health, and limited earnings accretion from recent large-scale acquisitions. Spain's weakness was influenced by its recent prime minister election, and France's by retail-focused REITs.

Global Listed Infrastructure – Global listed infrastructure stocks (FTSE Developed Core Infrastructure 50/50 Index, net) returned 3.86% in the second quarter, outpacing the broader global market (MSCI World Index, net), which returned 1.73%. All four global listed infrastructure sectors—transportation, utilities, energy, and communications—posted gains. Asia/Pacific and North America infrastructure stocks were strong while Continental Europe was a notable laggard.

FTSE DEVELOPED CORE INFRASTRUCTURE 50/50 INDEX SECTOR PERFORMANCE (%)



Sources: FTSE, Bloomberg, L.P.

> In **transportation**, Europe was hit by slowing growth, trade wars, and political upheaval in Italy and Spain. Many European airport and toll road stocks finished down, offset by good performance from Australian airport and toll road stocks. U.S. rails also had a strong quarter.

> Within **utilities**, European utility stocks were also hurt, especially Italian utilities. Anxiety about Europe and slowing global growth helped U.S. utilities, as these concerns seemed to put the brakes on the 10-year Treasury yield, which closed the quarter at 2.86% after hitting a high of 3.11% in May. U.S. utilities (Philadelphia Utility Index) rose 6.33% in the quarter.

> **Energy** infrastructure stocks rallied. Investors gained confidence that the March 2018 Federal Energy Regulatory Commission ruling, which hurt the sector initially, would impact a small number of master limited partnerships (MLPs). Meanwhile, fundamentals remained supportive. Oil, while volatile, jumped 14% in the quarter as global markets look to be increasingly short of supply driven in part by sanctions on Iran. Midstream companies also posted strong Q1 earnings. For additional perspective on the energy and MLP space, read Duff & Phelps' Mid-Year Market Review & Outlook: Energy & MLPs.

> In **communications**, much of the news was around two big mergers: AT&T/Time Warner, which closed in late June, and the proposed Sprint/T-Mobile tie-up announced in April, raising fears of slower cell tower growth. Even if this deal goes through, we think the long-term impact on tower stocks will be minimal.

A lot of noise is hanging over infrastructure sectors and global markets: trade wars, Europe's growth slowdown, rising oil, the strengthening U.S. dollar, and upcoming U.S. mid-term elections. We stand by our view that we are in a period of global growth, assuming Europe's slowdown will prove temporary and trade wars will not escalate.

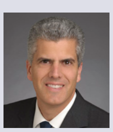
LOOKING AHEAD

The latest data on jobs, consumer confidence, and capital expenditure (capex) spending all point to the current strength of the U.S. economy. The labor market hit a milestone in June with the unemployment rate falling slightly below 4.0% and the underemployment rate to 7.8%. "Hidden slack" is dissipating and this matters because the unemployment rate can't get pushed down indefinitely without wage inflation accelerating. It's beginning to look like we are at that point. Consumer sentiment continues to hover near recent historical highs, undisturbed by the market volatility, political uncertainty, and warmer inflation. Capex also appears to be in a continued uptrend. A late-cycle reacceleration of the economy is possible now that corporate tax rates have been slashed and capex can be written off over the next five years. Furthermore, uncertainty over global trade is hardly impacting large and small business confidence so far. Even regional survey data appears robust.

Lastly, there are some changes coming to the S&P 500 Index in the third quarter that are worth noting. In late September, the telecommunication services sector will be renamed communications services and expanded to include companies that convey information and content through various media. The new communication services sector will constitute 10.4% of S&P 500 market cap versus 1.70% for the current telecom space, replacing a slower growing, high-dividend sector with an aggregation of more growth-oriented stocks. Current sector mappings for technology, consumer discretionary, and telecom will be recategorized, impacting 8.7% of the S&P 500's market cap. Technology will decline to 20.6% from 26.2%, with companies such as Alphabet, Facebook, Electronics Arts, and eBay leaving the group. Consumer discretionary will decline to 10.1% from 13.2%, with media and entertainment-related internet retail names, such as Netflix, departing. The transition of previously categorized tech stocks will add 5.6% to the new group, with 3.1% coming from the consumer discretionary space. These changes will force the purchase and sale of securities in many popular index funds, and impact the risk management process for many U.S. and global products across the style and market cap spectrum. As active managers, we will be assessing this situation carefully over the next few months to determine whether any action needs to be taken within our portfolios.

continued

Authored by:



John L. Creswell
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FTSE EPRA NAREIT Developed Index (net): A free-float market capitalization-weighted index measuring publicly traded equity REITs and listed property companies from developed markets, which meet minimum size and liquidity requirements. **FTSE Developed Core Infrastructure 50/50 Index**: A free float-adjusted market capitalization weighted index that gives participants an industry-defined interpretation of developed market infrastructure companies and adjusts the exposure to certain infrastructure subsectors. Constituent weights: 50% Utilities, 30% Transportation (including capping 7.5% for railroads/railways), and a 20% mix of other sectors including pipelines, satellites, and telecommunication towers. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.