

## Key Market/Economic Update

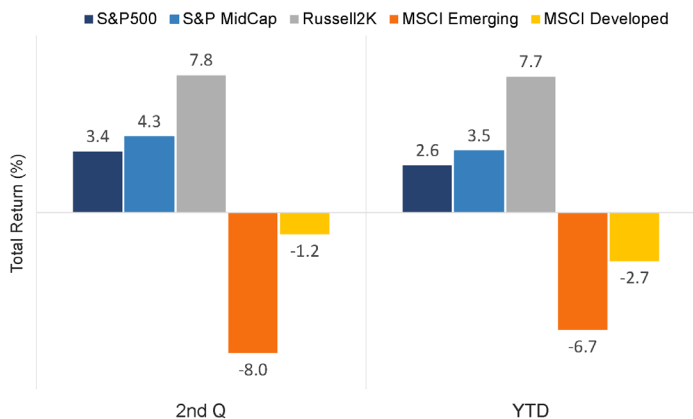
- U.S. macroeconomic data reflected continued robust growth amid rising potential of a full-scale trade war with major trading partners.
- The Federal Reserve again raised its benchmark short-term interest rate by 0.25% at the June meeting, the second time this year. Markets anticipate two more rate hikes in the 2nd half of the year.
- Domestic stock markets were the best performing markets among all major global exchanges.
- Riding on favorable fiscal and tax policies, S&P 500 quarterly profits are expected to grow around 20% annually in each of the next two quarters.

## Stock Market Review

U.S. stock markets exhibited remarkable resilience in the second quarter despite a barrage of negative news. Notwithstanding spiking yields, emerging market currency routs and the escalating rhetoric of trade wars, domestic stock indices recovered their losses from the first quarter and turned positive for the year.

Growth and technology stocks (Amazon, NFLX, for example) continued to capture the spotlight, but quietly small caps, as measured by the Russell 2000 index, produced a 7.8% total return over the last three months, which was more than double the 3.4% gain from the S&P 500 large-cap index. Small cap stock's outperformance might be attributable to the fact that smaller companies typically have less exposure to international markets, so are less vulnerable to trade conflicts. Also, the corporate tax cuts were more beneficial for small U.S. companies with higher effective tax rates than large multinationals. Finally, investors might start taking profits from past winners such as emerging markets in favor of small caps.

**Fig 1. Domestic stock returns outperformed both international developed and emerging market returns**



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

At a sector level, information technology and consumer discretionary, two of the best-performing sectors with double-digit returns in Q1, maintained their strong momentum. The energy sector rocketed up almost 14% and was the best performing sector in Q2, boosted by the rise of crude oil.

**Fig 2. The rally in crude oil price fueled 13.5% energy sector returns in Q2 while info tech and consumer discretionary stocks continued to lead YTD**



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

Two traditionally defensive sectors, telecom and consumer staples, and financial and industrial stocks, declined for the quarter as rising interest rates and the newly announced tariffs on imported steel and aluminum acted as a drag.

Developed international equity markets, as measured by the MSCI EAFE index, suffered a modest decline of 1.2%, its second consecutive quarterly loss. A potential trade war and rising interest rates sent some shockwaves through emerging market currencies. Major developing regions like Latin America experienced precipitous drops in both local currencies and equity markets. Both Brazil and Turkey's stock investors lost 26% of their market value for the quarter according to the MSCI country indices. The MSCI emerging market index also declined 8%, reversing course from the best performing regional market to the worst.

## Bond Market Review

U.S. Treasury prices fell as interest rates rose. The Federal Reserve continued to tap the brakes of monetary policy by raising short-term rates. As a result of the rising yields in short and intermediate-term issues, the differential between short and long-term bond yields has narrowed to a decade low. Investment grade corporate bonds fared much worse than Treasuries, while high yield bonds showed a slight positive return, benefiting from a revival of “risk-on” market sentiment.

International bond markets suffered a total reversal of fortune from Q1, as both developed and emerging market dollar-denominated bonds saw material losses. The main culprits were rising U.S. interest rates and a strengthening dollar as many EM countries relied on dollar-denominated borrowings.

**3.)** New corporate tax and fiscal policies are stimulating growth. According to some market research, U.S. companies have repatriated \$300 billion cash held abroad. JP Morgan estimated U.S. corporations would plan to return most of that cash to shareholders and spend \$800 billion on stock buybacks.

**4.)** S&P 500 companies are on track to repeat 20% plus earnings growth in the current Q2 and Q3 earnings season.

**5.)** An economy at full employment typically presages inflation. While inflation has ticked up, it remains at moderate levels.

### Headwinds:

**1.)** The Federal Reserve has hiked short term borrowing rate seven times since the end of 2015 and the Fed funds rate has risen 0.75% since June of 2017.

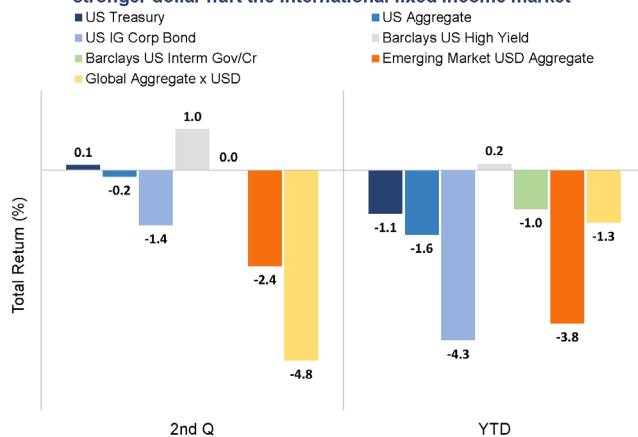
**2.)** The Federal Reserve reversed its quantitative easing program last year, beginning to reduce its \$4.5 trillion balance sheet. The pace of unwinding will increase to about \$50 billion a month in Q4 from \$30 billion now, which could translate into higher yields on the longer end of the curve. The European Central Bank is also likely to end its version of the same program and stop bond buying in the third quarter.

**3.)** Domestic stock market valuations are higher than long-term averages.

**4.)** High leverage among non-financial companies could dampen growth. With the Fed maintaining monetary policy at zero percent for many years, non-financial companies built up significant leverage on their balance sheet.

**5.)** Uncertainty surrounding tariffs is causing some industries to postpone capital investment. History indicates that there are no winners in a trade war. Even if only a threat, it introduces a great deal of uncertainty for trade that dampens the business decision making and investment process.

**Fig 3. Rising rates weakened domestic bond returns while a stronger dollar hurt the international fixed income market**



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

## Tailwinds vs Headwinds for the Second Half

After a reasonably strong first half of the year, we consider what could be major positive and negative forces for the rest of year.

### Tailwinds:

**1.)** The U.S. economy started to accelerate in 2016 and strong momentum is expected to continue through 2018. Preliminary Q2 GDP climbed to 4.1%, the highest since Q3 2014, while the growth rate likely moderated to near 3% in the second half of this year.

**2.)** Consumer and business confidence as well as employment statistics are all at record high levels.

For the near term, we believe economic strength and strong corporate profits will keep the secular bull market in stocks intact. However, corrections like we saw in the first quarter are not always a result of fundamental reasons. As such, long term investors should stay disciplined and diversified across asset classes and investment styles to achieve their goals. Don't hesitate to reach out to your Relationship Manager or Portfolio Manager if you have questions regarding your positioning.

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