To Our Clients and Friends:

We are pleased to bring you our report for the second quarter of 2018.

Bond and equity markets improved slightly in the second quarter. The Bloomberg Barclays U.S. Aggregate Bond Index was essentially flat for the quarter but is still down 1.62% for the year. The S&P 500 Index gained 3.43% for the quarter, fully recouping (and then some) its 0.76% loss in the first quarter. Overseas, the MSCI World ex USA Index lost 0.48%, which was far less than the 1.92% it lost in the first quarter. Emerging (and particularly China) markets took the brunt of this, with the largest emerging markets stock fund (the Vanguard Emerging Markets Stock Index Fund) losing approximately 11% - its worst loss in 3 years.

The market has endured a lot over the last 5 months and has come out of it relatively unscathed, save perhaps a bit of investor confidence being lost (or at least severely tested). The S&P 500 Index peaked at 2,875 in late January only to fall precipitously to 2,532 at the height of the February correction. Twenty-nine percent of trading sessions in the first half of 2018 had moves - up or down - of greater than 1%, compared with just 3.2% (or ~8) of all trading days in all of 2017. The Dow Jones Industrial Average had two plunges of more than 1,000 points.

In our view, of all the things that affected the equity markets during the second quarter (and continuing to-date into the third quarter), trade troubles are potentially the most impactful. There are a couple of reasons for this. First, trade affects so many things that influence the markets. The global economy, company profits, inflation, interest rates (both short- and long-term), employment and recession fears are just a few of them. Secondly, the impact of the trade troubles is not yet known, adding another key market worry – uncertainty – to the mix.

It is difficult under the best of circumstances to predict the likely impact of the trade tariffs. Forecasting the impact is made even more difficult because there are so few (and none recent or as far-reaching) historical cases on which to base an opinion. Most believe that the aggressive stance the

---

1 Chinese stocks are firmly in bear market territory, having dropped ~20% from prior highs.
2 This is not a total surprise as the index had notched gains for five straight quarters during periods where the global economy was strengthening. Emerging markets often suffer the most when economic sentiments lessen, especially in times like this where trade worries and rising U.S. interest rates – both discussed below – are present.
3 Source: Reuters and Bespoke Investment Group.
4 While the threats and announcements related to tariffs are not new, the actual tariffs are. The tariffs on steel and aluminum imposed pursuant to Section 232 of Trade Expansion Act of 1962 are only a month old and the first round of Section 301 tariffs targeting China have only been in effect for a week or so. The economic effects of these actions (and the retaliation against them) is not yet reflected in any economic data.
5 In early 2002, then-President George W. Bush imposed tariffs of up to 30% on imported steel in an effort to shore up domestic producers against low-cost imports. These lasted until late 2003. The cost? The Consuming Industries Trade Action Coalition found that 200,000 U.S. manufacturing workers lost their jobs. Source: MarketWatch/Dow Jones & Co.
6 In 2009 then-President Obama imposed a 35% tariff on Chinese tires in an effort to help U.S. tire manufacturers. While that likely
Trump administration has taken is really just the President’s attempts to get the best trade deal he can (rather than pushing his ideology to absurd lengths that could result in an all-out trade war). Similarly, most believe that the leaders of the countries that are the targets of the most significant tariffs (all of whom have implemented or announced reciprocal measures), at least privately, are doing pretty much the same thing, almost like parties to a bitter lawsuit settling their differences just when they seem most entrenched in their positions. To date the markets (at least the U.S. markets) have generally discounted the impact of the tariffs but the longer they persist, the more likely it is that the market’s confidence will be shaken.

Recession is being bantered about more of late. Whether it is higher interest rates or U.S. companies being adversely affected by the Trump administration’s trade policies, both the cost of doing business (interest rates) and the ability to generate revenues (decreased demand for U.S. goods from foreign buyers) there is a lot of uncertainty in the air these days. Both of these factors can affect U.S. businesses and, if the impact is significant enough or goes on long enough, eventually U.S. businesses are going to potentially delay investment, hiring workers or raising wages until that uncertainty subsides. And, that can impact how much the American consumer (the primary driver of our economy) is willing to spend.

Earnings (actual and projected) in 2018 have been stellar. But, despite earnings being a key element of any sustained stock market health, not all (in fact a very small part) of the earning increases were saved at most 1,000 jobs in the tire industry, paying more for U.S. tires took over a billion dollars out of the retail sector, which equates to about 3,700 jobs lost in the retail sector. Source: CBS News.

The S&P 500 Index and the DJIA have both gone up all but one day since July 6, the day that the U.S. and China imposed tariffs of $34 billion on each other’s goods. Foreign markets have not been nearly as sanguine.

reflected in equity prices. Some of this can be attributable to the high valuations that preceded the crash in late January, but much is also due to trade fears and worries that the Fed will raise interest rates too much too quickly or that government borrowing will push up the federal deficit to a point where the government’s need to borrow will in turn push up interest rates. Earlier today Fed Chair Jerome Powell reiterated that “gradual increases” will continue to be the Fed’s strategy as it tries to delicately balance the significant forces (most notably low unemployment and the potential for accelerated inflation) that threaten to upset an economic expansion that is now the second longest on record.

Did you know that Midwest Capital Advisors has a presence on social media? Follow us on LinkedIn and Facebook for both informative and fun updates.

---

8 This is exactly what we predicted in our Q1 2018 letter.
9 In a speech in June, Chair Powell described the paradox of low unemployment and relatively slow wage gains in the U.S. as a “puzzle.”
10 Interestingly, the Fed has barely weighed in on the administration’s protectionist trade policies but has stated the obvious, that uncertainty around them is a concern to the financial markets.