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Global equity markets entered 2018 con gusto in anticipation of a synchronous economic recovery. Indeed, all major world economies appeared to be accelerating. Just a few months later, however, the global economic picture seems to have changed. Equity markets responded by exhibiting a measure of anxiety. Stock prices process anxiety in the form of volatility, and to be sure, the second quarter was volatile. Throughout most of the quarter, markets churned as leadership rotated from one sector to another. By the end of the quarter, however, some markets were able to make some forward progress while others stumbled. The U.S. was a bright spot, returning 3.4% in the quarter and 2.7% YTD (as represented by the S&P 500). Europe, as a whole, fell slightly (MSCI Europe -0.9%) in the quarter, but Italy stumbled. Emerging markets stumbled badly, in general, with Brazil and Argentina down substantially. In Asia, Hong Kong (Hang Seng) declined by 2.5%, Japan (Nikkei 225) was up 1.4% and Korea (MSCI Korea) declined 9.0% during the second quarter.

As we expected coming into 2018, the U.S. economy is strong and likely accelerating. When we get the first report of economic growth for the second quarter in a just few weeks, the U.S. economy will likely have shown growth above 4%, which would represent a substantial rebound from the 2.0% rate of growth reported for the first quarter. If so, the average rate of growth for the first half of 2018 will have been above 3%, which we believe is sustainable for the rest of the year and, possibly, into 2019. We attribute this acceleration in economic activity to The Tax Act of 2017. While the tax cuts provided by The Act are likely to be stimulative for a year or two, longer term a substantial increase in capital spending will be necessary to keep the economic fire burning.

In contrast to an acceleration in growth in the U.S., many other economies around the globe showed signs of slowing growth in the second quarter. In particular, several economies in the Euro Zone, China and Japan all reported data that suggested slightly slower growth. More concerning than a slight economic pause in several economies, the currencies of Brazil, Argentina, Turkey, and South Africa declined sharply. The proximate cause for these currency troubles was likely an increase in interest rates in the U.S, which, of course, is a function of the Federal Reserve allowing interest rates to return to a more normal level than the ultra-low rates of the post-recession era. Importantly, we do not at present believe the currency weakness in the countries noted are likely to spread throughout the emerging economies more broadly. Nonetheless, as the Fed continues to foster higher interest rates at home, we will have to closely monitor the effect on emerging economies for signs of broader currency distress.

The currency distress in the economies noted above was one factor that likely contributed to stock market volatility during the quarter. Other factors were: the ebb and flow of tension between the U.S. and North Korea; a looming trade war between the U.S. and every other nation on the planet; signs of inflation evident in Q1 earnings reports; and, populism creeping into European politics. These issues are expressed in order of our concern, lowest to highest.

North Korea

Is it really possible that we are in the early stage of an easing of hostilities with North Korea? We all witnessed the historic summit between President Trump and Kim Jung Un in Singapore. While each of us has our opinion regarding the sincerity of the North Korean dictator and, indeed, a sustained alleviation of tensions between the U.S. and its Pacific allies and North Korea, for now there are no missiles flying over Japan nor is the ground shaking due to hydrogen bomb tests. A step in the right direction for sure, but only time will tell if detente is sustainable. In any event, the stock market doesn't seem to care about North Korea right now.

Trade

OK, we all know by now that Donald Trump fashions himself as the consummate deal maker. He takes an extreme position in negotiations, creates a cloud of dust that allows him to appear to be inclined to compromise and yet more aggressive at the same time. We would like to believe that when the dust settles the Donald will strike a trade deal with China, the European Union, Canada and Mexico. Nonetheless, the questions we must now ask ourselves are: Has President Trump over-played his hand? Have our trading partners figured out his schtick, and are they calling his bluff? More specifically, will our trading partners respond to Trump's trade tariffs by giving a little, or will they implement countervailing tariffs?

Again, as in the North Korean situation, we all have our opinions. Ours carry no greater insight than the opinions of others. In any event, global stock markets are concerned that we are headed for a full-blown trade war. Indeed, the perceived possibility of a trade war was very likely responsible for most of the stock market volatility in the second quarter. From an investment perspective, our current challenge is to determine the extent to which the mere prospect of a trade war will affect corporate decision-makers in the form of reduced investment spending. At a recent press conference, Jerome Powell, Chairman of the Federal Reserve, was asked about his thoughts regarding the potential for the trade situation to affect the U.S. economy. Chairman Powell said he was "beginning to hear reports of companies holding off on making investments and hiring people." He went on to clarify his comments by noting that "right now, we don't see that in the numbers at all. The economy is very strong. The labor market is strong. Growth is strong. We really don't see it in the numbers, it's just not there—so I would put it down as more of a risk." We concur, for now, but recognize that we may be approaching a slippery slope.

Inflation

First quarter corporate earnings revealed two drivers of inflation: raw material and transportation costs, that are currently impeding gross profit margins, and are likely to drive consumer price increases in the coming months. Although gross margins were broadly lower than expected in the first quarter, most companies were able to generate earnings above expectations because revenue growth was typically better than expected. Despite strong earnings growth, businesses are likely to attempt to restore gross margins by raising prices. Typically, price increases lag input cost increases by 3 to 6 months as producers need time to sensitize their customers to the need for price increases. Comments from the companies we monitor was consistent: Customers were aware that raw material and transportation costs were up sharply and there was a broad consensus that price increases would stick. This is a big change in the pricing environment from the experience of the past ten years!

In its May statement on monetary policy, The Federal Open Market Committee (FOMC) noted "Inflation on a twelve month basis is expected to run near the Committee's symmetric 2 percent objective over the medium term." The key word in their statement is "symmetric." This is Fed-speak acknowledging that inflation is likely to be higher than the FOMC's target rate of 2% along with a palliative for stock and bond markets. Essentially, the FOMC is saying that inflation was below their target for a very long period of time, therefore, they will tolerate inflation above their target for a while. The FOMC has left it up to markets to guess how high and for how long they will tolerate inflation above their target by characterizing their inflation objective as "symmetrical." For now, we will assume that the FOMC will keep monetary policy accommodative despite the near-term inflation that will likely appear as companies pass along raw material and transportation cost increases. If, on the other, hand, cost push inflation were to get out of control, the Fed may need to restrain the economy sooner than presently anticipated. Our current assumption is that monetary policy will remain accommodative to growth through the middle of 2019.

Populism in Europe

On June 23, 2016, Britain voted to leave the European Union. The historic decision referred to as Brexit roiled global stock markets briefly, but the decision quickly became a non-event for investors. Last year, the composition of parliament in both Austria and Germany took a few steps to the right. Markets were unimpressed. More recently, German Chancellor, Merkel, has been struggling to keep her ruling coalition in tact after a challenge by Germany's Interior Minister, Horst Seehofer, seeking tighter border control. Although the immigration showdown in Germany is on hold for a few weeks to find some common ground, it is clear that factions within Germany want tighter borders. If Merkel were to fail to keep her coalition government in place, Germany would need to dissolve parliament and hold a new election. The uncertainty surrounding the future leadership of Germany could result in an extra measure of volatility in global markets. The new government in Italy, however, is of greater concern than the shifting politics of Germany.

Italy recently formed a government around two fringe political parties, 5 Star and the League. Two issues that come into focus with this anti-establishment coalition are a universal basic income and a hard line on immigration. This coalition is, essentially, Italy's version of Trump's mantra of draining the swamp. However, unlike the U.S. populist movement which is driven by older Americans, Italy's populist movement is powered by an increasingly disenfranchised Millennial generation. According to The Wall Street Journal, "Almost 30% of Italians age 20 to 34 aren't working, studying or in a training program." Essentially, Italy's youth are not working and, therefore, the European Union is not working for Italy. We can only imagine the long-term problems that are likely to result from nearly one third of an entire generation failing to gain entry level work experience.

Before the Euro was created. Italy would have responded to this youth unemployment problem by de-valuing its currency. Of course, since the adoption of the Euro as its currency, a devaluation for Italy without de-valuing the euro is not possible. Stimulating the Italian economy through a currency devaluation would only be possible if Italy were to leave the European Monetary Union. This note is already too long so we will leave that discussion for another day. Suffice it to say, as Italy is the third largest economy in the European Monetary Union, leaving the Euro has the potential to cause massive dislocations in global stock, bond and currency markets. For what it's worth, we believe the Italian people know this as well. Therefore, we'll monitor events in Italy very closely, but see no need to take any action in our portfolios, at the present time.

For now, we are looking forward to a robust second quarter earnings reporting season. Hopefully, strong earnings will enable the stock market to break out of the quagmire that has stifled forward progress thus far in 2018. Our interest as investors continues to be the United States and Asia. We have very little interest or direct exposure to Europe or Latin America in our portfolios at present.

With best regards,

Your SeaBridge Team