First Trust

Quarterly Market Overview

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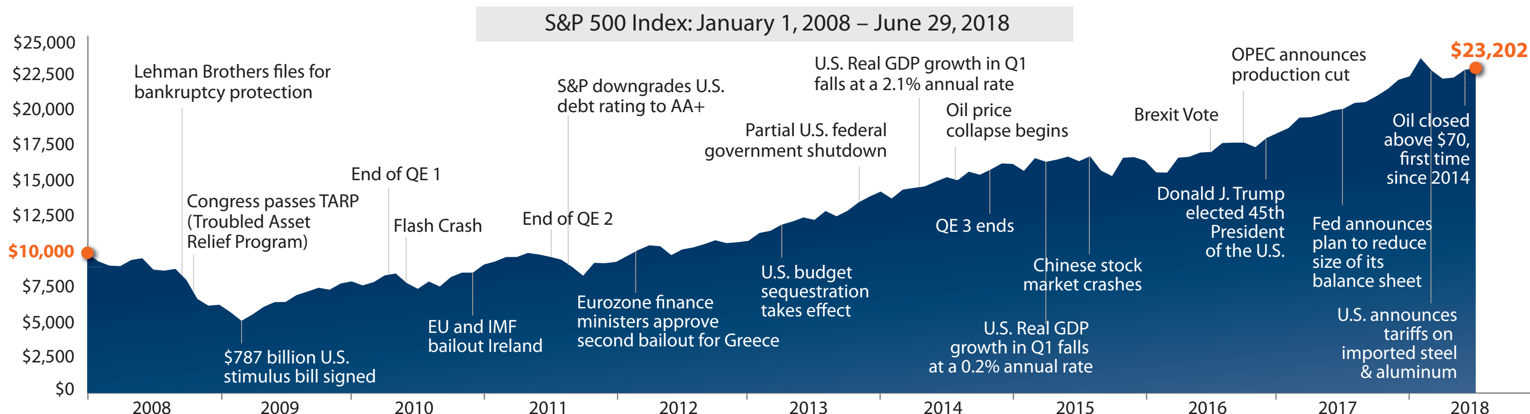
We invite you to visit Bob's Market Commentary Blog at www.ftportfolios.com for more insight.

2020 Foresight vs. 20/20 Hindsight

S&P 500 Index: January 1, 2008 – June 29, 2018



Source: First Trust Advisors L.P. *This chart is for illustrative purposes only and not indicative of any actual investment. The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges. Stocks are not guaranteed and have been more volatile than the other asset classes. These returns were the result of certain market factors and events which may not be repeated in the future. Past performance is no guarantee of future results.*

Let's begin with some foresight. Some pundits have recently stated that they believe the U.S. economy could slip, or even plunge, into recession by as early as 2020. One such individual is Ben Bernanke, former Chairman of the Federal Reserve (2006-2014). He seems to be leaning more towards the economy plunging into recession. Not to be outdone, the financial media tossed its hat into the ring by saying that 2020 could be the year in which the bull market in stocks comes to an end. That was the cover story for *Barron's* on 7/2/18. The current bull market and economic expansion both rank as the second-longest on record. To be forthright, the end of the bull market prediction actually wouldn't come as that big of a shock if a recession were to commence in 2020. The basic crux of the argument put forth by Bernanke is that the Trump administration has thrown a lot of fiscal stimulus at the economy, via last December's Tax Cuts and Jobs Act, valued at around $1.5 trillion, plus this year's $300 billion increase in federal spending, at a time when it really doesn't warrant it, according to Bloomberg. The low unemployment rate in the U.S. was cited as evidence the economy was already on solid ground. The U.S. unemployment rate stood at 4.0% in June 2018, down slightly from 4.1% in December 2017, according to data from the Bureau of Labor Statistics. Bernanke believes that the current level reflects full employment. By deploying it now, Bernanke's concern appears to be that the government could run out of stimulus options by 2020. Therein lies the rub.

Now for a little hindsight. In an attempt to navigate the fallout from the 2008-2009 financial crisis, the Federal Reserve (the "Fed") decided to significantly expand the size of its balance sheet in an effort to inject massive amounts of stimulus into the economy. This included three rounds of quantitative easing (bond-buying programs), which are acknowledged in the chart above. From 1/2/08-6/27/18, the Fed increased the assets on its balance sheet from $923 billion to as high as $4.52 trillion in January 2015, according to its own data. It stood at $4.31 trillion at the close of June 2018. While the Fed is in the early stages of shrinking its balance sheet, selling a combined $50 billion worth of Treasuries and mortgaged-backed securities each month at the top-end suggests that the drawdown isn't likely to influence or disrupt the markets for quite some time, in our opinion. In November 2010, one of the primary reasons cited for why the Fed was so aggressive in its response to the crisis was because Congress was not providing much in the way of fiscal support, according to *The New York Times*. Bernanke said at the time that the Fed cannot fix the problem with monetary policy alone. This loops us back to the present. Congress has finally stepped up with fiscal support, and it appears to be working. CEOs are definitely exploiting the cut in the federal corporate tax rate from 35% to 21%. Global mergers and acquisitions (M&A) activity totaled $2.5 trillion in the first half of 2018, up 64% from the same period a year ago, according to Thomson Reuters. The first half of 2018 was the strongest showing for announced M&A deals since records began in 1980. The rub we mentioned with respect to Bernanke's view has to do with the mindset that the U.S. government now has to play some massive ongoing role in determining the state of the economy. After everything the government has done to this point, perhaps it is time to step aside and let the private sector pull its weight.

The chart above features a collection of significant events since the start of 2008. It is actually just a sampling of the many challenges that confronted equity investors over that often turbulent period. As indicated in the chart, the S&P 500 Index more than doubled its value despite these events and others. 2020 is 18 months away. The Fed has said for several years that it is data-driven. Historically speaking, recessions in the U.S. have tended to occur when the Fed has tightened monetary policy too much. We have not even approached that scenario. So for now, we encourage investors to follow the data and ignore the bold predictions.

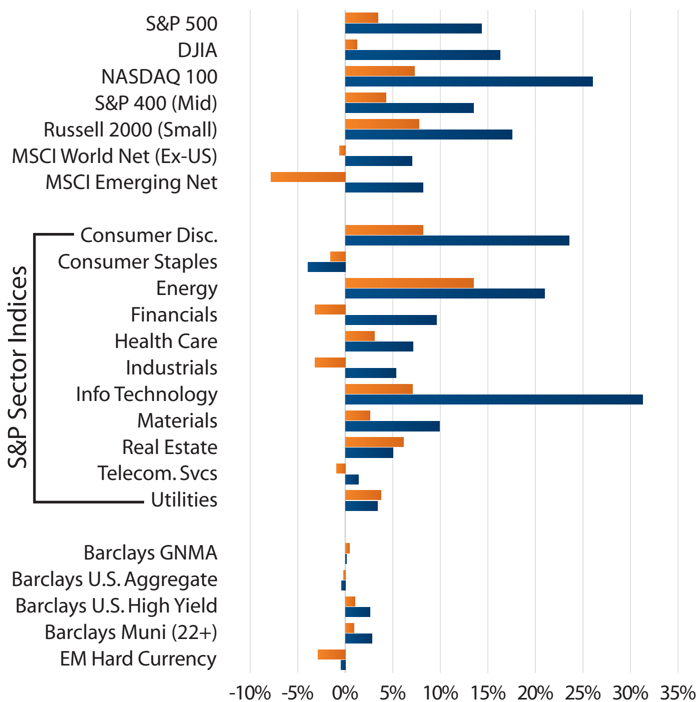
Continued

Data that reflects the current climate for U.S. stocks and bonds

- On 6/29/18, the S&P 500, S&P MidCap 400 and S&P SmallCap 600 Indices closed 5.38%, 2.61% and 3.33% below their respective all-time highs.
- The windfall from the cut in the U.S. federal corporate tax rate from 35% to 21% is expected to boost stock buybacks, dividend payouts and capital expenditures.
- TrimTabs reported that U.S. companies announced a record $436.6 billion worth of stock buybacks in Q2'18. The previous high was $242.1 billion in Q1'18.
- S&P Dow Jones Indices announced that total dividend distributions for U.S. common stocks rose a net $13.0 billion in Q2'18, up from $6.7 billion in Q2'17.
- Data from Morgan Stanley indicates that S&P 500 companies increased their capital expenditures by around 19% year-over-year in Q1'18. The most in years.
- Growth stocks have outperformed value stocks markedly both year-to-date and for the 12-month period ended 6/29/18.
- The top-performing S&P 500 Index sectors year-to-date through June were Consumer Discretionary, Information Technology and Energy. All cyclical in nature.
- In June 2018, U.S. banks passed this year's round of stress tests, paving the way for higher dividends and buybacks moving forward.
- As of 6/29/18, Bloomberg's Q2'18 consensus year-over-year earnings growth rate estimate for the S&P 500 Index was 20.45%. Its estimate for 2018 was 23.07%.
- As of 6/29/18, Bloomberg's Q2'18 consensus year-over-year revenue growth rate estimate for the S&P 500 Index was 7.96%. Its estimate for 2018 was 7.82%.
- Despite the ongoing bull market in stocks, retail investors have actually been liquidating capital from domestic equity mutual funds.
- The Investment Company Institute reported that domestic equity funds experienced net outflows totaling $84.6 billion year-to-date through 5/31/18.
- The Federal Reserve has raised the federal funds target rate (upper bound) 7 times, from 0.25% to 2.00%, since December 2015 (31 months).
- Brian Wesbury, Chief Economist at First Trust Advisors L.P., sees the Fed increasing rates another 6 times, from 2.00% to 3.50%, by the end of 2019 (18 months).
- For comparative purposes, the Fed raised rates 17 times (1.00% to 5.25%) from June 2004 through June 2006 (24 months). That was far more aggressive.
- One of the last things likely keeping U.S. intermediate and long maturity bond yields artificially low are the significantly lower yields on foreign bonds.
- U.S. bond yields bottomed in 2016. The yield on the benchmark 10-year Treasury-note (T-note) closed at an all-time low of 1.36% on 7/8/16.
- The 10-year T-note closed at a yield of 2.86% on 6/29/18, essentially matching the 2.9% rate on the Consumer Price Index (CPI). Not an attractive level vs. CPI.
- Since January 1962, the average yield on the 10-year T-note was 6.20%, more than double its 2.86% yield at the end of June 2018.
- In the $7.5 trillion corporate bond market, the demand for higher yields from investors has resulted in a big increase in BBB-rated bonds.
- BBB bonds are the bottom rung of the high-grade category and are now the largest corporate group outstanding at $2.56 trillion.
- The rest of the investment-grade category is valued at $2.55 trillion, followed by leveraged loans and high yield bonds at $1.22 trillion and $1.21 trillion, respectively.
- While bond yields and inflation (CPI) have been inching higher in 2018, retail investors have still been funneling capital into taxable bond mutual funds.
- The Investment Company Institute reported that taxable bond funds took in a net $63.2 billion year-to-date through 5/31/18.

Source: All data, except where noted, is provided by Bloomberg.

Total returns for Q2 and past 12 months (6/29/18)



Sources: Bloomberg and Barclays. Past performance is no guarantee of future results.

A Look Ahead:

A year-over-year earnings comparison in U.S. dollar terms. The S&P 500 Index dollar figures reflect the 11 major sectors on a weighted-adjusted basis.

Index (Weighting In S&P 500)	**Q3'18E**	Q3'17A	**Q4'18E**	Q4'17A	**2018E**	2017A
Consumer Disc. (12.9%)	**10.17**	8.86	**10.82**	9.62	**40.09**	35.23
Consumer Staples (7.0%)	**7.86**	7.17	**7.88**	7.43	**29.74**	27.32
Energy (6.3%)	**8.02**	3.73	**7.64**	2.93	**29.41**	13.28
Financials (13.8%)	**8.64**	6.14	**8.92**	6.64	**33.89**	26.59
Health Care (14.1%)	**15.45**	11.37	**15.47**	11.42	**58.42**	45.08
Industrials (9.5%)	**9.57**	8.05	**9.49**	7.85	**37.28**	30.29
Information Tech. (26.0%)	**15.58**	12.20	**18.98**	17.28	**64.55**	50.59
Materials (2.6%)	**5.68**	4.10	**5.63**	3.57	**23.07**	17.18
Real Estate (2.9%)	**1.24**	1.56	**1.32**	1.38	**5.25**	5.60
Telecom. Services (2.0%)	**3.81**	2.74	**3.48**	1.94	**14.45**	10.18
Utilities (2.9%)	**4.93**	4.66	**3.13**	3.06	**15.83**	14.53
S&P 500 Index	**40.47**	31.33	**42.16**	33.85	**157.82**	124.52
S&P 400 Index (Mid-Cap)	**28.02**	18.23	**29.31**	22.29	**105.32**	78.12
S&P 600 Index (Small-Cap)	**13.41**	7.85	**15.24**	8.45	**50.26**	31.19

Source: Standard & Poor's (6/28/18). Sector weightings as of 6/29/18.
There is no guarantee past trends will continue or projections will be realized.

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