VAUGHAN NELSON

second quarter 2018

INVESTMENT *perspective*

During the second quarter of 2018, the S&P 500 and Russell 2000 Value rose approximately 3.4% and 8.3%, respectively.

Fiscal stimulus in the U.S. led to accelerating domestic growth, which combined with quantitative tightening by the Federal Reserve fueled a rally in the U.S. dollar that led to material weakness in overseas markets. Dollar strength and international weakness were further stimulated by increased trade war rhetoric from the United States and China **(Chart 1)**.

It is quite unusual to have material fiscal stimulus this late in a business cycle with little slack in labor markets. For the first time in several decades there are more job openings than people remaining in the labor pool. Accelerating economic growth is a welcome attribute; however, this late in the business cycle at a time when dollar liquidity is declining and margins are under pressure, the benefits will likely start to accrue more to main street than to Wall Street.

Global synchronized growth peaked earlier this year and it is imperative that U.S. economic growth pull the rest of the world forward if continued equity market appreciation is to be expected. Five-year S&P 500 annual earnings growth expectations are now in the mid-teens. The last time five-year earnings growth expectations were this high was in the late 1990's heading into the final years of the internet bubble. With declining dollar liquidity, rising margin pressures, and elevated earnings growth expectations, we expect market volatility to remain elevated until there is either a reacceleration in global growth or a pause in Federal Reserve interest rate increases or quantitative tightening.

Geopolitical concerns and trade war rhetoric overshadowed strong U.S. economic growth during the second quarter. First quarter GDP growth came in at 2% but second quarter GDP growth is tracking at around 4%. Both measures of core inflation followed by the Federal Reserve are now running at 2% or higher on a year-over-year basis, so we expect the Fed to maintain its current gradual pace of rate hikes. We expect one to two more quarter point increases in 2018, which will put the Federal Funds Rate at 2.25 to 2.50% at year-end.

The 10-year U.S. Treasury yield increased twelve basis points in the quarter to 2.86% and is now up 45 basis points in 2018. New issue supply in the investment grade credit sector weighed heavily on markets causing spreads to widen thirteen basis points to 129 over comparable Treasury yields. Large debt issuance (AT&T $31 billion, Bayer $15 billion, and Wal-Mart $16 billion) to fund mergers and acquisitions hit the market over six trading sessions in mid-June contributing to the $105 billion in new supply for the month. Municipal bonds have performed well as the lack of supply and increased investor demand have led to positive returns in the second quarter and year-to-date **(Chart 2)**.

Chart 1
U.S. Dollar Index
(3/31/18 to 6/30/18)

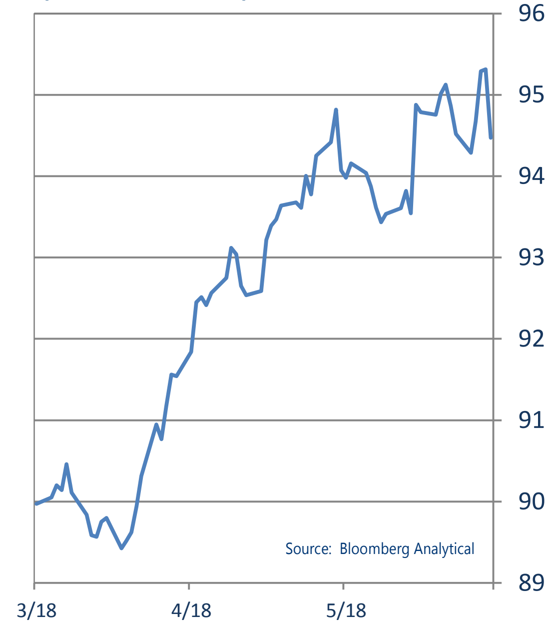
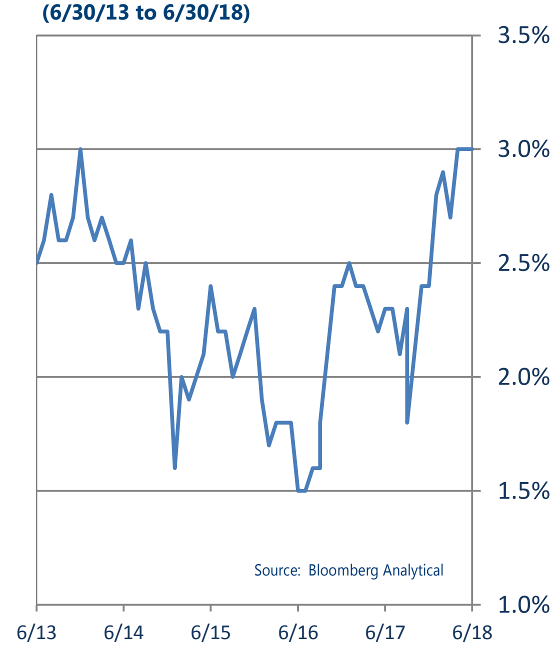


Chart 2
U.S. 10-Year Treasury Yield
(6/30/13 to 6/30/18)



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