

HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

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Last quarter the markets were stressed as investors absorbed the global uncertainties regarding trade tensions with our commerce partners. The mix of positive and worrisome news was confusing – and the tea leaves were murky. Our perspective is clearer as second quarter earnings start to roll out. The end of the long-running bull market is inevitable. However, we expect the market to still show modest gains for the rest of 2018 and most of 2019.

We are in agreement with a recent *Barron's* article: “Why the Bull Market Could End in 2020.” The basic argument is pretty straightforward. First, the current strength of the economy and corporate earnings is being boosted by the tax cut stimulus. But that stimulus was front-loaded and will lose impact by mid-2019. Second, the Federal Reserve has clear intent to raise the short-term interest rate from its current 1.75% to 3.5% by the end of 2019. At the same time, the Fed is shrinking its \$4 trillion balance sheet.

The result will be significant slowdown in 2020. The *Barron's* analysts are not predicting recession. However, the loss of economic momentum could be enough to put the brakes on the long-running bull market – and throw stocks into a period of bearish setback.

The good news is that we expect modest market expansion for the remainder of 2018 and most of 2019. GDP and earnings growth will be healthy for much of that period. But rich stock prices will keep the market in a narrow trading range. We are managing asset allocation and stock selections for clients accordingly. It is a defensive strategy for the upcoming period of modest growth and eventual downturn.

Equity Market: U.S. stock indexes in the second quarter moved into slightly positive territory after the declines incurred in the first quarter. Nonetheless, the booming market seen in 2017 is clearly over. Investors have many concerns. While the U.S. outlook is good, the global economy is slowing. The Eurozone is wracked with political uncertainty. But the biggest concern is the escalating trade tensions. The U.S. is now engaged in tariff actions against all of its major trading partners – and those partners are fighting back. This situation has unpredictable economic consequences.

The Dow Jones Industrial Average was ahead 0.52% for the quarter, but still down 0.91% for the year. The S&P 500 was ahead 2.9% for the quarter and 1.7% for the year. The strong performer was the Nasdaq Composite with a quarterly gain of 6.3% and a year-to-date gain of 8.8%. Despite some of the issues in technology, investors clearly favored the sector because it is less affected by the tariff battles. The same advantage existed in the Russell 2000 index of small stocks which was ahead 7.4% for the quarter and 7.0% for the year.

Fixed Income Market: The bond market was relatively stable in the quarter. The yield on the 10-year Treasury was 2.84% at the end of June – versus 2.74% at the end of March. (Yields move inversely to prices.) Some investors use it as a temporary haven from stocks.

MARKET TRENDS

The accompanying chart summarizes stock and bond market prices for the first half and second quarter of 2018. Stocks recovered some of the loss experienced in the first quarter – although much of that growth was concentrated in the technology sector. Bond prices were relatively stable in the second quarter after taking declines in the first quarter.

MAJOR MARKET INDEXES

	YTD Return
Dow Jones Industrials Composite PR	-0.91
S&P 500 Index PR	1.67
Russell 2000 Index PR	7.00
NASDAQ Composite PR	8.79
EAFE Index NR	-2.75
Barclays Aggregate Bond Index TR	-1.08

source: Morningstar®

THE OUTLOOK

The Economy: The U.S. economic performance is strong. The economy had a net gain of 213,000 jobs in June. Manufacturing, construction, and consumer activity are all vibrant. The forecast is that the GDP will have grown 4% in the second quarter and 3% for full-year 2018. As result, corporate profits are expected to increase 21% in 2018 – compared to 11% in 2017. As explained, the tax cut is working to stimulate this growth – especially with its encouragement of business investments.

All this positive news means that long-dormant inflation is heating up. The annualized rate of inflation is now over 2% for the first time in nearly six years. That 2% level is the benchmark that provokes the concern from the Federal Reserve that the economy needs tighter monetary policy. It explains their announced intent to raise interest rates in 25 basis point increments until reaching the 3.5% level by the end of 2019.

As stated, the economy is not expected to sustain this pace in 2019 and 2020. As the tax stimulus fades, and interest rates increase, the GDP is forecast to grow at about 2.5% in 2019 and slip back below 2% in 2020. Corporate earnings in 2020 should be back at about 10%. Also, once the tax stimulus fades, the economy will be left with the burden of an increased and massive federal deficit.

The Market: We expect the market to have modest growth this year of about 5%. It may also enjoy similar expansion in 2019. But we accept the *Barron's* view that a slowing economy finally will turn the market bearish by 2020.

A major wild card in this prognosis is the tensions over international trade. Should the current situation escalate into a more full-scale trade war, investors will be nervous

and spooked. Sustained conflict over trade would likely cause the market to go negative faster and sooner.

OUR STRATEGIES

Asset Allocation: For clients investing new money, we recommend 60% allocation to equities and the remaining portion to cash, bonds with maturities under two years, and alternative investments. We stagger the time period in which we reach that 60% level. For fully invested clients, we recommend to trim equities to 60-70% depending upon time horizon and objectives.

Preferred Equities: We remain focused on large cap companies with strong balance sheets, sustainable cash flows, and credible business models. Companies that pay attractive dividends are central to our strategy. Some of the sectors getting our attention:

TECHNOLOGY: We are cautious about this sector – especially given how rich the stocks have grown – but areas such as bio technology and semi- conductors have our interest.

FINANCIALS: Rising interest rates will make banks more attractive – and our focus is upon regional banks. Prices are reasonable for many of these bank stocks.

ENERGY: Productive capacity will be in high demand as increased energy supplies come to market.

HEALTH CARE: Medical devices are an interesting area of opportunity.

Other Investments: Our repeated aversion to bonds with long maturities remains firm. We still believe the risk of a sharp decline in prices is too great a risk for our clients. We prefer to find alternative investments such as real estate limited partnerships, demand notes, and municipal tax liens. We also note that interest rates of 2% make cash a more attractive asset class than in recent years.

Dow Jones U.S. Sectors Total Return (Percent Change for YTD, Ending June 30, 2018)

Source: Morningstar®

Oil & Gas	7.49	Consumer Services	8.72
Basic Materials	-2.15	Telecommunications	-9.12
Industrials	-1.67	Utilities	1.03
Consumer Goods	-5.29	Financials	-0.81
Health Care	3.08	Technology	10.39

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Top 25 Performing Stocks through YTD 6/30/18 - US Listed companies with a market cap above \$5 Billion.Source: Telemet ®

Issue	Name	Last	Mkt Cap	Net Pct YTD	Industry Group
DTSRF	Digital Shelf Space Corp	1.17	62,210	1,439.47	Commercial Services & Supplies
NAKD	Naked Brand Group, Inc.	6.34	38,500	337.24	Media
WWE	World Wrestling Entertainment	72.82	5,619	138.13	Media
SRPT	Sarepta Therapeutics Inc	132.18	8,662	137.56	Biotechnology
TWLO	Twilio Inc	56.02	5,365	137.37	Wireless Telecommunication Services
ABMD	Abiomed Inc.	409.05	18,194	118.26	Health Care Equipment & Supplies
ETSY	Etsy, Inc.	42.19	5,041	106.31	Catalog Retail
LOXO	Loxo Oncology, Inc.	173.48	5,217	106.08	Biotechnology
NFLX	Netflix Inc	391.43	170,138	103.91	Catalog Retail
FMI	Foundation Medicine, Inc.	136.7	5,063	100.44	Biotechnology
OKTA	Okta, Inc.	50.37	5,370	96.68	Internet Software & Services
GOOS	Canada Goose Holdings	58.85	6,569	86.47	Textiles & Apparel
TWTR	Twitter, Inc.	43.67	32,164	81.88	Internet Software & Services
GDS	GDS Holdings Limited ADS	40.09	38,877	77.94	Diversified Telecommunication Services
SQ	Square, Inc. Class A	61.64	23,667	77.79	Consumer Finance
MOMO	Momo Inc. ADS	43.5	8,746	77.7	Software
NEWR	New Relic, Inc.	100.59	5,631	74.12	Software
DXCM	DexCom, Inc.	94.98	8,366	65.5	Health Care Equipment & Supplies
SSDOY	Shiseido Co., Ltd.	79.53	32,238	64.11	Personal Products
SWTUY	Swedish Orphan Biovitrum ADR	21.55	5,801	63.63	Commercial Services & Supplies
TRIP	TripAdvisor, Inc.	55.71	7,744	61.67	Catalog Retail
XL	XL Group plc	55.95	14,451	59.13	Insurance
LULU	Lululemon Athletica Inc.	124.85	15,720	58.86	Textiles & Apparel
HLF	Herbalife Ltd.	53.72	9,477	58.65	Personal Products
BGNE	Beigene, Ltd.	153.73	7,929	57.32	Biotechnology

Bottom 25 Performing Stocks YTD 6/30/18 - US Listed companies with a market cap above \$5 Billion.Source: Telemet ®

Issue	Name	Last	Mkt Cap	Net Pct YTD	Industry Group
LOMA	Loma Negra Compania Industrial	10.26	5,819	-35.47	Construction Materials
FNMA	Fannie Mae	1.42	8,137	-46.42	Thrifits and Mortgage Finance
DB	Deutsche Bank AG	10.62	14,643	-44.19	Capital Markets
LPL	LG Display Co. Ltd.	8.24	5,897	-40.12	Electronic Equipment & Instruments
ACH	Aluminum Corp. of China Ltd.	10.91	5,902	-39.15	Metals & Mining
GOL	Gol Linhas Aereas Intelgentes	5.34	9,270	-39.04	Airlines
LB	L Brands, Inc.	36.88	10,223	-38.76	Specialty Retail
ARNC	Arconic Inc.	17.01	8,213	-37.58	Aerospace & Defense
FMCC	Freddie Mac	1.59	5,142	-36.9	Thrifits and Mortgage Finance
CRZBY	Commerzbank AG	9.5	6,241	-36.37	
TKC	Turkcell Iletisim ADS	6.54	14,281	-35.88	Wireless Telecommunication Services
THO	Thor Industries Inc.	97.39	5,132	-35.38	Automobiles
PPC	Pilgrims Pride Corp	20.13	5,012	-35.19	Food Products
DLAKY	Deutsche Lufthansa	23.98	11,140	-34.84	Airlines
XRAY	DENTSPLY SIRONA Inc.	43.77	9,955	-33.51	Health Care Equipment & Supplies
BGAOY	Proximus Group Unsp ADR	4.41	7,114	-33.18	Commercial Services & Supplies
UNM	Unum Group	36.99	8,182	-32.61	Insurance
MAN	ManpowerGroup	86.06	5,665	-31.76	Professional Services
AZUL	Azul SA	16.36	5,494	-31.35	Airlines
TLSYY	Telstra Corp Ltd ADS	9.74	24,239	-31.17	Diversified Telecommunication Services
OC	Owens Corning Inc.	63.37	7,015	-31.07	Building Products
DISH	DISH Network Corp cl A	33.61	17,654	-29.61	Media
ELUXY	AB Electrolux Class B	45.68	6,601	-29.34	Household Durables
INCY	Incyte Corp	67	14,202	-29.26	Biotechnology
EXEL	Exelixis Inc.	21.52	6,389	-29.21	Biotechnology