HAVERFORD

2018 SUMMER OUTLOOK

After the rain cometh the fair weather. —AESOP

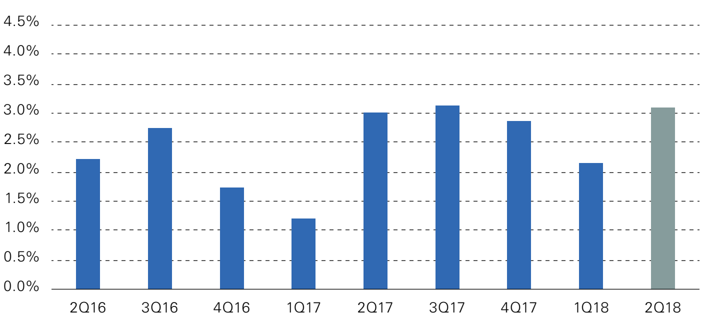
The spring of 2018 was unequivocally gloomy for those of us in Philadelphia. Not only did spring's warmth come a month late, but rainfall was 30% above average with four days of clouds for each day of sun. After a sunny 2017, it seems as though the clouds have also darkened the landscape of the financial markets. As of early June, the equity markets gained 3% year-to-date, while fixed income returned roughly 1%. These are relatively dreary returns given exceptionally strong corporate earnings growth and robust economic data.

This unusually long business cycle has now stretched into its ninth year. The Consumer Confidence Index recently hit a 15-year high of 128, and employment growth is stronger than anyone would have expected this far into an economic expansion. U.S. real gross domestic product (GDP) grew 2.2% in the first quarter, a relatively slow pace but consistent with the below-trend growth posted in the first quarter in each of the last several years. We expect economic growth to pick up considerably in the second quarter—the consensus forecast is 3.1% according to FactSet—with the Atlanta Fed GDPNow forecast above 4%. Earnings per share for S&P 500 companies are expected to be up 19% year-over-year in the second quarter (on top of 26% growth in the first quarter!), based on FactSet estimates. Jobless claims continue to come in below expectations, while consumer spending remains robust.

We believe this economic cycle will be further elongated by the 2017 tax law changes and continuing regulatory relief.

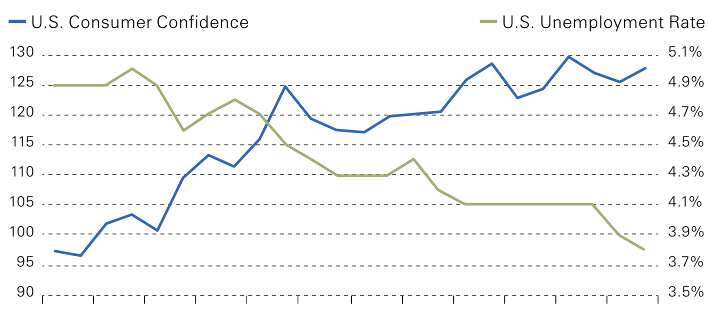
The arithmetic effects of the new tax law, easily calculated, resulted in an immediate positive step change to corporate earnings. Aside from this obvious benefit, the positive effects of the tax bill on corporate behavior and capital allocation will be felt for some time. Companies will be repatriating hundreds of millions of dollars back to the

U.S. Real GDP Growth



All Chart Data: FactSet Research Systems

U.S. Consumer Confidence vs. U.S. Unemployment Rate



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United States in the coming years—freeing up funds available for capital spending, dividends, share repurchases, and debt repayment—and the disincentive to invest domestically has now been removed from the tax code. The effects of regulatory relief will also have a positive impact on other areas, such as bank regulators' proposed softening of the Volcker Rule and the easing of capital requirements for smaller banks.

A recession has never occurred in tandem with rising consumer confidence, growing corporate earnings, and declining jobless claims.

Add the effects of fiscal stimulus to these traditional measures of economic health and we put very low odds on a recession within the next 18 months.

However, even the most optimistic investor must admit that there are some recent developments of concern. So as the sun shines on the economy and business environment, it is healthy to scan the sky for potential storm clouds on the horizon.

The flattening yield curve (i.e., the difference in yields between 10-year and 2-year Treasuries) is certainly one of the primary concerns. An inverted yield curve usually foreshadows a recession by 12 to 18 months. While the 10-year yield has risen over the last two years, the yield on the 2-year Treasury has risen even faster. There is now a very small gap in yields of 40 basis points between these two maturities. We do not believe the Federal Open Market Committee (FOMC) would intentionally invert the yield curve by raising short-term rates too quickly. In a recent interview, Atlanta Fed President and CEO Raphael Bostic acknowledged, "It's my job to make sure that doesn't happen." Nevertheless, the FOMC can only successfully control the short end of the curve; factors other than monetary policy could put downward pressure on 10-year yields, resulting in an inverted curve.

We can doubtless say that even supporters of President Trump's economic agenda would define the administration's trade rhetoric as capricious at best and incoherent at worst. On-again, off-again trade wars are fantastic for the 24-hour news networks, but they're not that great for the global economy. Until recently, we believed the use of tariffs as a negotiating tactic was more bark than bite, with the belief that "this too shall pass." The fiscal stimulus put into motion by the administration dwarfs relatively inconsequential tariffs. However, recent trade developments have given us pause. We believed Canada, our most important trading partner, would be spared from tariffs. We were wrong. Still, in a relatively closed economy where exports account for only 12% of GDP, things would have to get a lot worse to affect our outlook.

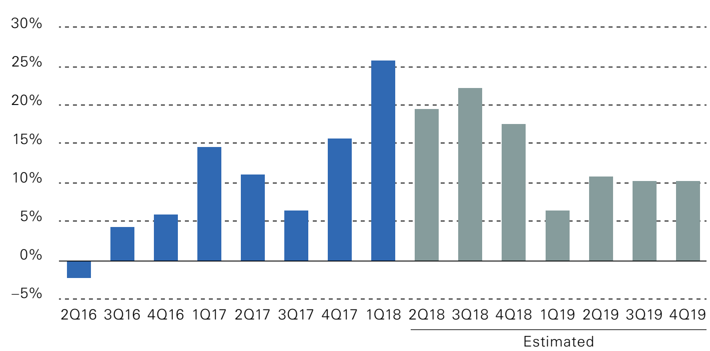
Caterpillar's CFO Brad Halverson made the biggest splash of the quarter when he stated the first quarter would be "a high-water mark" for the year. Although his comments were directly related to Caterpillar's 2018 fiscal year results, he nonetheless sparked a wave of concern over peak earnings for the entire market. We do not believe the earnings power of public companies has peaked, but we do believe we are experiencing peak earnings *growth*. Analysts expect earnings to increase 19% this quarter and close to 21% for the full year. This is probably as good as it gets, as far as *growth rates* go. The market has adjusted for this spike up by paying a lower multiple for those earnings.

Even the boy who cried wolf has stopped worrying about inflation.

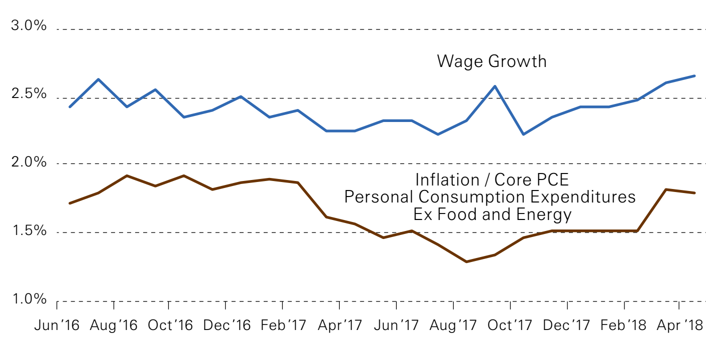
The U.S. economy has been a job-creating engine, and evidence suggests that the labor supply is shrinking.

Yield Spread—10-Year Treasury minus 2-Year Treasury

S&P 500 EPS Growth



Inflation and Wage Growth



All Chart Data: FactSet Research Systems

Yet neither one of these economic trends is driving sustained signs of rising wages or inflation. Tangential sightings of inflation, such as strong monthly wage data earlier this year, sent market participants diving for cover. We expect these same investors will slowly begin to adapt to higher levels of headline inflation—somewhere above, but not too far above, 2%. Of all the scenarios for a weak or falling market for the rest of the year, the higher inflation narrative appears most plausible to us. Inflationary pressures should pick up following a tax cut. That said, we do not anticipate pricing pressures will rise to a level that forces the FOMC to accelerate increases in the Fed Funds rate.

During the last week of May, markets were gripped by renewed fears of Euro instability. When Italian President Sergio Mattarella raised the prospect of new elections that could strengthen the hand of anti-Euro forces, it once again brought into focus Europe's fragility. As of now, the reports out of Europe are more noise than news, but if the European economy slows, it will affect us all. A turbulent Europe could further widen the gap in monetary policy between the FOMC and the European Central Bank. The United States and Europe are at very different places regarding monetary policy, fiscal policy, and financial regulation. As a result, this disconnect between U.S. and European yields will likely persist in the near term.

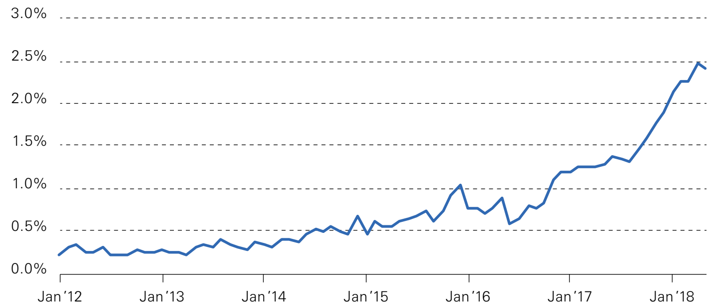
Our expectation of an elongated expansion has led us to reposition equity portfolios with the goal of adding exposure to companies we expect to benefit from increased capital expenditures and strong consumer spending.

Emerson Electric, Honeywell, Lowe's, and Johnson Controls all fit these criteria. It is important to point out that we have not neglected to execute more contrarian decisions. We increased our portfolios' exposure to beaten-down consumer companies like CVS Health, Pepsi, and Kimberly Clark—in these cases, the price we pay for a company's stock relative to our outlook of its business is the primary driver in our decisions.

We are now able to approach fixed-income purchases with more optimism than in the past.

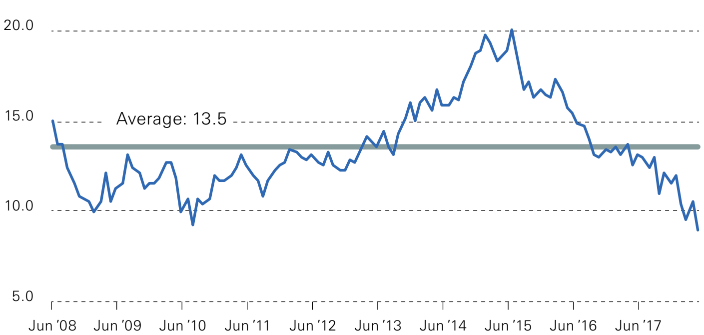
For the first time in close to a decade, short-term yields have risen to a level where they now provide a real return above inflation. The 2-year Treasury yield averaged only 0.50% from 2012 through 2016—it is now yielding 2.5%. This is a significant improvement for investors with spending needs. Whereas in the past it cost an investor more than $50 million in short-term investments to generate $100,000 in income, today it costs only $4 million.

2-Year Treasury Yield



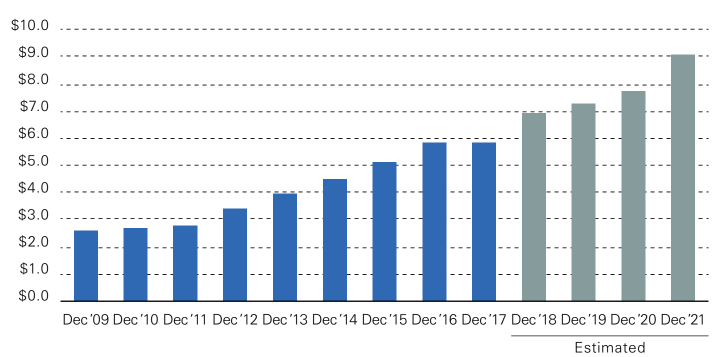
The yields on tax-free municipal securities have not risen as much as their taxable counterparts, but they still offer attractive returns for the taxable investor. Low unemployment rates and strong housing markets are beneficial for state finances. Munis also have exhibited little correlation to financial markets during the past year, making them a suitable investment for some individuals looking for both income and diversification. For non-taxable investors, we still favor corporate bonds. Corporate cash flow is strong, and one of the intrinsic effects of tax reform noted earlier has been the deleveraging of some corporate balance sheets. The degree of debt repayment as a use of repatriated funds has surprised some observers. It is very reasonable though, as many companies issued debt in lieu of cash stranded overseas to pay for share repurchases and dividend payments. Overall, we are not surprised that they would use the newly available cash to unwind those earlier borrowings.

CVS Price-to-Earnings Multiple



All Chart Data: FactSet Research Systems

CVS Earnings Per Share



We have no expectation that this summer will see a slowdown in consequential news for the markets, trade, and geopolitics. We believe economic data will continue to remain strong, but we would not be surprised to see financial markets trade in a range until the November mid-term elections.

This would be consistent with the experience of past years with mid-term elections. Encapsulating our view, we expect the results coming out of Main Street could outpace those of Wall Street for the first time in many years.

Thank you for your trust and partnership with Haverford. We hope you enjoy your summer and are optimistic that the bulk of the bad weather is behind us. For those who enjoy reading in their free time, below are three books that members of Haverford's Research Team have enjoyed reading recently and highly recommend.

Thinking in Bets: Making Smarter Decisions When You Don't Have All the Facts was written by Annie Duke, a former World Series of Poker champion turned business consultant. She highlights how the decision strategies used by top poker players can improve everyone's decision process. For most people, it is difficult to say, "I'm not sure." The world values and rewards the appearance of certainty. Shifting away from the need for certainty towards accurately assessing what you know and what you do not know will make you less vulnerable to reactive emotions, knee-jerk biases, and destructive habits in your decision-making.

The Alice Network, by Kate Quinn, is a fantastic piece of fiction inspired by the real-life work of Louise de Bettignies, a French secret agent who spied on Germans during World War I under the pseudonym of Alice Dubois. The story bridges the events taking place in the front-line city of Lille, France, circa 1915, with the search for a young girl in post-WWII France. It is a story of courage and redemption.

After reading *The Alice Network*, we were compelled to read the true story of America's greatest female spy (that we know of!). *The Wolves at the Door*, by Judith Pearson, chronicles the story of Virginia Hall. Hailing from Baltimore, Virginia dreamed of becoming a foreign service officer, but prejudice led her to have to accept less prestigious foreign deployments. Virginia happened to be travelling in France when Hitler's army raced through Western Europe. She stayed in France, working for the British Special Operations Executive before being exfiltrated through the Pyrenees. After a stint in a Spanish jail, she made her way back to England and was once again reinserted into France to help the Resistance prepare for D-Day and the eventual liberation of Europe. We encourage everyone to enjoy this moving story of courage and patriotism.

All data as of June 11, 2018, unless otherwise noted. Chart data from FactSet Research Systems.

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