Redhawk Quarterly Commentary

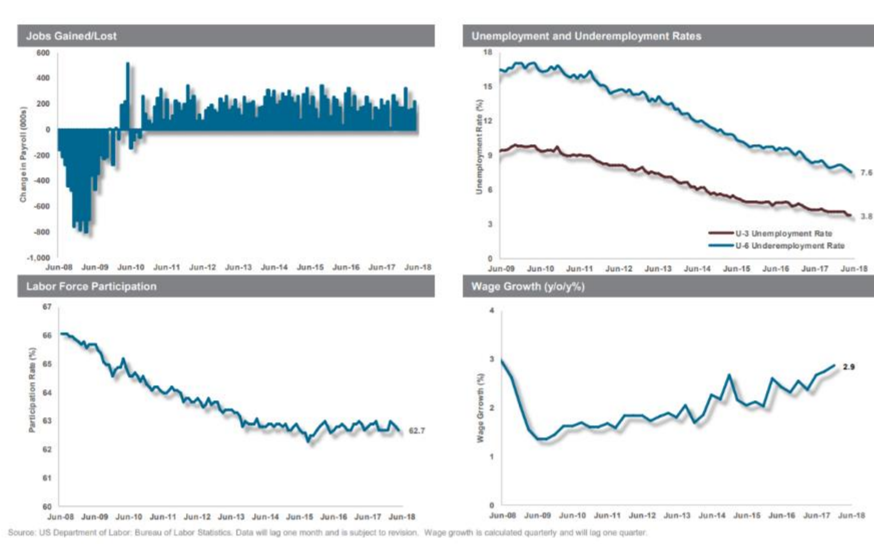
June 30, 2018

Each quarter, Redhawk's Investment Committee provides a Quarterly Commentary. We look at what's going on in the investment landscape and provide our perspective on a variety of topics. These aren't predictions and it represents our perspective on important market and economic topics designed to help make decisions affecting your long-term financial strategy.

Market Commentary

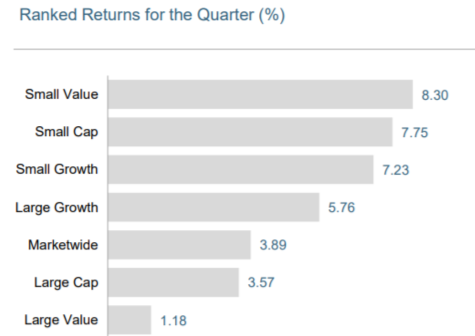
US Market

The US economy is performing well as we approach the middle of 2018. Consumer spending is strong, corporate earnings are outstanding, the unemployment rate is at a 49-year low and the Federal Reserve ("Fed") has taken tightening steps. We believe the fiscal stimulus package from President Trump should keep the economy humming along with above-trend growth through the middle of 2019. Against this positive narrative, the Fed is likely to continue hiking rates to prevent the economy from overheating.



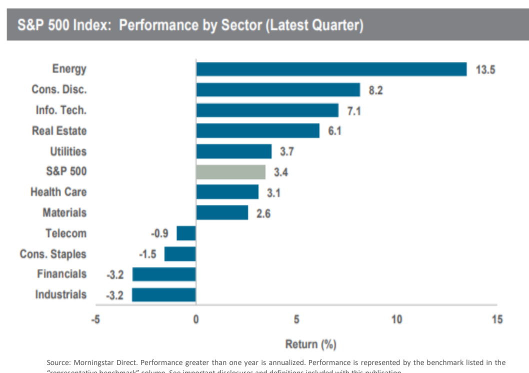
The US economy added an average of 215,000 jobs per month in the first half of 2018, surprisingly strong job growth in the 10th year of this expansion. Solid job growth has reduced the unemployment rate to nearly 17-year lows, and the underemployment rate has also declined sharply. But wages have continued to rise slowly, up an average of only 2.7% over the past year, suggesting the labor market may have more flexibility than previously thought and may not become a near-term limit to overall growth.

The US economic growth rate is expected to average about 3% in 2018. Solid job growth combined with individual tax cuts should continue to power rising consumer spending, which contributes to almost 70% of US economic growth. In addition, higher business confidence has helped bolster business investment, housing construction is increasing, and higher government spending for the next two years all point to somewhat better economic growth for the next year.



The US equity market bounced back from a weak start to the year with the S&P 500 posting a 3% increase in Q2, making its YTD return also 3%. Among market cap segments, small-cap equities again outperformed larger cap stocks. Domestic-oriented small caps benefited more because they are insulated from international trade and tariff concerns. The Russell 2000 returned 8% in Q2 and 8% in the first half. Growth continued to gain ground relative to value during the quarter.

Performance varied by sector as Energy gained 13%, Consumer Discretionary returned 8%, and Technology with a 7% return outperformed. On the downside, Financials had a -3% return, Industrials had a negative performance of -3%, and Consumer Staples with a -2% result added to YTD losses.



The chart below shows the returns for the second quarter.

	Trailing Returns (%)						5-Year Risk Stats		Other Metrics			Representative Benchmark
	Last Qtr	YTD	1-Year	3-Year	5-Year	10-Year	Std. Dev.	Max. Loss	P/E	EPS Gr.	Div. Yld.	
Bellwethers												
S&P 500	3.4	2.6	14.4	11.9	13.4	10.2	9.9	(8.4)	17.1	12.3	2.0	*S&P 500*
Russell 1000	3.6	2.9	14.5	11.6	13.4	10.2	9.8	(8.6)	17.2	12.2	1.9	*Russell 1000*
DJIA	1.3	(0.7)	16.3	14.1	13.0	10.8	10.6	(9.0)	16.1	13.4	2.3	*Dow Jones Industrial Avg.*
Market Cap												
Mega	4.2	2.2	14.9	12.7	13.3	10.0	10.2	(8.4)	17.2	12.0	2.2	*Russell Top 50*
Large	3.9	3.1	15.4	12.5	13.8	10.2	9.9	(8.6)	17.1	12.1	2.0	*Russell Top 200*
Mid	2.8	2.3	12.3	9.6	12.2	10.2	10.3	(12.8)	17.4	12.6	1.8	*Russell Midcap*
Small	7.8	7.7	17.6	11.0	12.5	10.6	13.9	(16.8)	17.8	12.9	1.3	*Russell 2000*
Micro	10.0	10.7	20.2	10.5	12.8	10.6	15.2	(21.0)	16.8	13.9	1.0	*Russell Micro Cap*
Style												
Value	1.7	(1.2)	7.3	8.5	10.4	8.6	10.1	(10.4)	14.4	11.1	2.5	*Russell 3000 Value*
Core	3.9	3.2	14.8	11.6	13.3	10.2	10.0	(8.8)	17.2	12.3	1.9	*Russell 3000*
Growth	5.9	7.4	22.5	14.6	16.1	11.8	10.5	(8.8)	20.9	13.7	1.3	*Russell 3000 Growth*
S&P 500 Sectors												
Consumer Discretionary	8.2	11.5	23.6	14.4	16.0	16.4	12.2	(8.0)	21.0	14.8	1.4	*S&P 500/Cons. Disc.*
Consumer Staples	(1.5)	(8.5)	(3.9)	5.5	8.2	9.9	10.7	(13.9)	15.6	9.9	3.2	*S&P 500/Cons. Staples*
Energy	13.5	6.8	21.0	3.7	2.2	1.0	17.1	(38.7)	19.5	28.2	2.6	*S&P 500/Energy*
Financials	(3.2)	(4.1)	9.6	12.5	13.1	7.1	13.9	(15.2)	13.0	10.9	1.9	*S&P 500/Financials*
Health Care	3.1	1.8	7.1	5.7	13.8	12.7	11.9	(13.1)	15.3	11.0	1.8	*S&P 500/Health Care*
Industrials	(3.2)	(4.7)	5.3	11.3	12.7	9.7	11.6	(11.3)	17.2	12.1	2.1	*S&P 500/Industrials*
Information Technology	7.1	10.9	31.3	22.6	21.9	14.7	13.1	(8.2)	19.7	12.7	1.2	*S&P 500/Info. Tech.*
Materials	2.6	(3.1)	9.9	8.5	10.9	5.7	14.7	(22.7)	16.4	12.1	2.1	*S&P 500/Materials*
Telecom	(0.9)	(8.4)	1.4	3.9	3.7	6.2	14.9	(13.8)	10.2	4.7	5.9	*S&P 500/Telecomm*

Source: Morningstar Direct. Performance greater than one year is annualized. Performance is represented by the benchmark listed in the "representative benchmark" column. See important disclosures and definitions included with this publication.

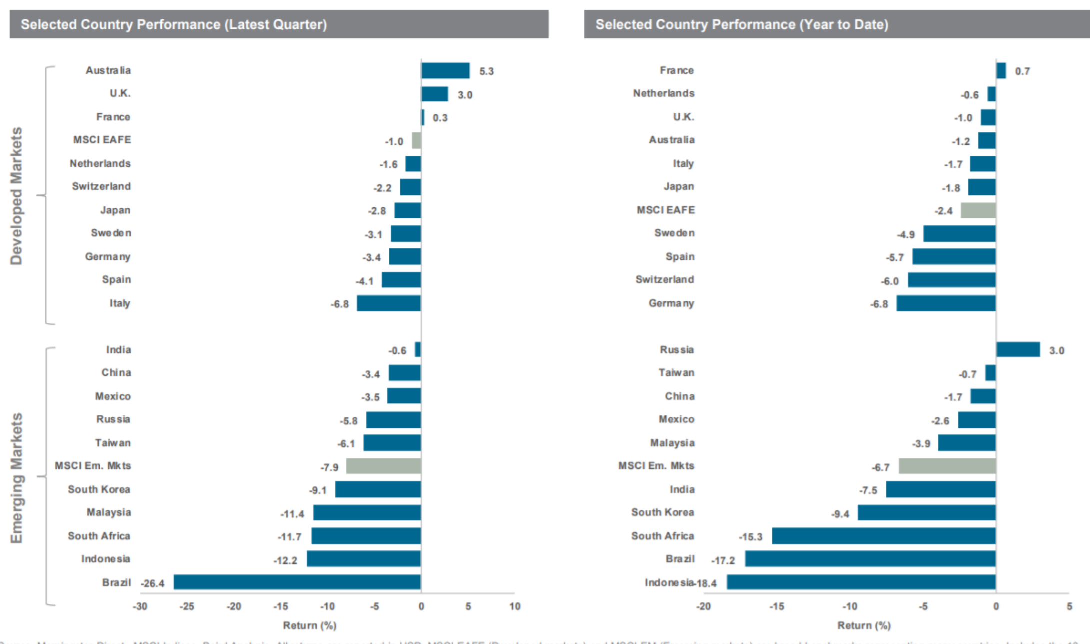
International Markets

After last year's acceleration, slightly slower global economic growth and rising tariffs have lowered expectations and triggered uncertainty in some emerging markets. However, the underlying fundamentals of global economic and earnings growth remain solid and the outlook remains positive.

A trade war hasn't started, but higher US tariffs and retaliations from other countries have raised the risks. At the end of the day, most tariff announcements won't be implemented, but trade is an important part of the US and global economies. So far, the impacts of higher tariffs have been small and uneven by hurting specific producers, consumers, and companies. However, further tariff increases and other moves that disrupt trade could trim US and global growth, lowering the outlook.

Despite the uncertainties created by higher tariffs, monetary policies in the rest of the world continue to provide stimulus and interest rates remain well below US levels. Thus, international markets and economic conditions appear to be further from the end of the cycle than the US, and equity valuations are more attractive.

International equities declined in Q2 with developed markets down -1% and emerging markets down a more staggering -8%. Within emerging markets, India -1% and China -3% fared best in Q2, while Brazil -26%, and Turkey -25% were the worst.

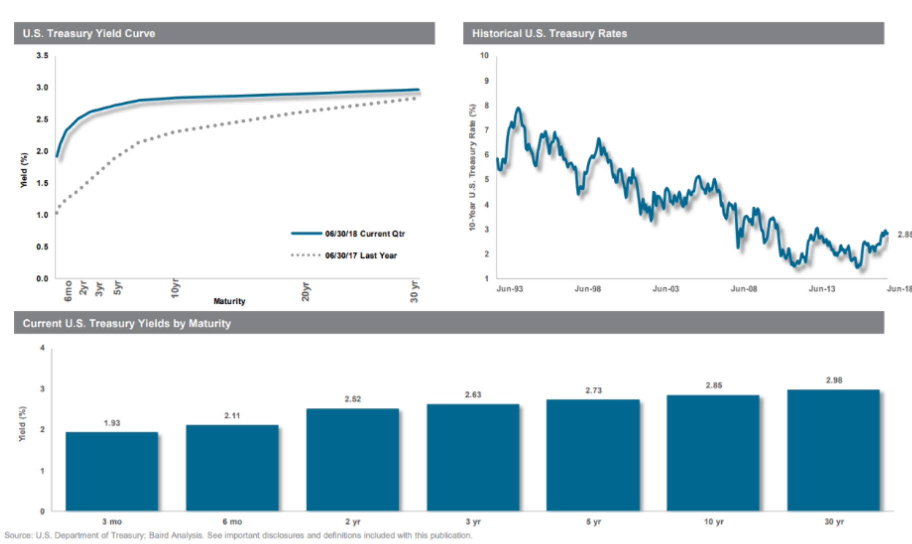


Fixed Income Markets

If the economy continues to grow moderately, and inflation remains near the Fed's 2% target, the Fed will continue increasing short-term interest rates quarterly. As the Fed reduces the size of its balance sheet and short-term rates rise modestly, higher long-term rates will continue as well. But low long-term interest rates in the rest of the world mean foreign buyers are attracted whenever US rates start to rise which will keep long-term US rates low. Higher short-term rates have made CDs and other short-term fixed-income investments more attractive.

The broad US bond market, measured by the Bloomberg Barclays US Aggregate Index, returned -0.2% in Q2. Markets were heavily impacted by trade tensions and political unrest. Yields drifted higher during the quarter and ended with a flatter yield curve as the difference between the 2-year and 10-year yields narrowed to 0.32% which was a level not seen since mid-2007.

US fixed income outperformed global bonds as concerns around the deterioration of global synchronized growth developed. Global fixed income investors suffered this quarter as European -5.5%, Asian -3.8%, and Emerging Market -2.4% debt declined. Within emerging markets, higher oil prices helped oil exporters but hampered large net importers including Turkey and India.



Relative performance for US fixed income markets prevailed in Q2 with positive performance coming from most sub-categories. The one clear underperformer was investment grade corporate credit, down -1.0% in Q2. High yield bonds gained 1.0% and US Treasuries which returned 0.8% led in Q2. Municipal bonds once again outperformed their taxable peers delivering 0.9% in Q2.

Economic Outlook

US Equity Markets

2018 has seen the US reassert its dominance over the rest of the world. This is due mostly to the extra push from the Tax Cuts and Jobs Act, as well as the 2018 budget deal, which includes a $300 billion increase in discretionary spending. With consumers already spending freely and businesses investing more, the US economy didn't require government assistance. Even so, the gross domestic product ("GDP") growth is likely to top 3% in the first half of the year.

US corporate earnings growth is expected to double that of the rest of the world this year because of the reduced tax rates and other changes in the corporate tax code. US companies managed to grow revenues by nearly 10% in the first quarter of 2018. Robust global demand for exports, including energy-related goods, and a better domestic investment environment provide multiple sources of stability if risks emerge. Although earnings are also improving in the rest of the world, relatively sluggish economic activity in Europe and a series of policy-related setbacks in emerging market countries ranging from Turkey to Brazil have prevented valuations from rising.

Source: Bloomberg, Markit, as of 31 May 2018.

Despite increasingly deteriorating economic relationships between the US and other exporting countries, most of the macroeconomic news has been good so far in 2018, particularly in the US. US stocks should continue to benefit from lower individual and corporate tax burdens, vigorous private-sector hiring and consumer spending, and more government spending. Additionally, US interest rates should keep rising gradually as evidence of strong growth becomes even more convincing, at least for this year.

International Markets

Global growth is becoming uneven and has a broader set of possible outcomes. The US is the growth engine, propelled by fiscal stimulus. Rising interest rates, a more restrictive monetary policy, and a strengthening US dollar are tightening financial conditions across international markets. Tighter funding conditions have played a role in this year's emerging markets hardships,

including Argentina and Turkey, countries with big external financing needs. Further gains in the US dollar could cause more pain, especially global banks that rely on dollar funding. Higher US short-term rates mean renewed competition for capital and less need to stretch for yield when investors can get above-inflation returns in short-term "risk-free" debt.

Heading into the second half, European stocks found new sources of strength after a weak start to the year, as earnings improved. The euro declined, and the European Central Bank announced it would roll back its quantitative easing program later in the year but leave rates on hold until 2019. That announcement was good news for China and emerging markets in general, whose stock markets have been supported by higher currency volatility and rising oil prices. Higher oil prices are good news for oil exporters but less so for emerging countries whose economies are more energy-intensive than developed markets.

Emerging markets have come under pressure in the second quarter due to problems in a few countries as well as global trade tensions, a strengthening US dollar, and higher US Treasury yields. Many of the tailwinds that caused emerging markets to outperform in 2017 such as accommodative monetary policy, a weakening US dollar, and the growth differential over developed markets have subsided or started to reverse. Across the emerging markets universe, economic fundamentals remain broadly supportive, inflation relatively under control, and currencies undervalued.

The growth differential between emerging markets and developed markets is expected to widen over the next few years; higher commodity prices should bolster emerging markets and yields should remain attractive. Emerging markets equities outperformed developed markets last year, but the earnings growth differential has since narrowed. According to consensus forecasts, emerging markets earnings should grow 15.9% in 2018 versus 15% in developed markets. This narrowing is principally due to the immediate impact of the US tax cuts and it's expected that the differential will start to widen again in 2019 as this effect plays out. Last year, earnings accounted for the largest proportion of emerging markets returns since 2010.

Fixed Income Markets

One of the stories of 2018 has been the lift in government bond yields. As of mid-March, the 10-year US Treasury yield had risen by 0.50% and the estimate for the 10-year US Treasury yield is around 2.8%. This is based on an expected path for the federal funds rate over the next few years. The estimate includes an expectation of the likelihood the US will experience a recession by 2020, which means the Fed will be lowering rates.

Long-term interest rates remain very low, especially compared to historical averages, despite a clearly improving global economy and Fed tightening. However, in 2018, some forces like further

hikes in the federal funds rate, stronger economic growth, and lessening accommodation by other central banks should push yields higher. This increase in rates should result in weak total returns on Treasuries and some high-quality corporate bonds. This suggests that other fixed income sectors, like high-yield debt or emerging markets will perform better relative to other asset classes.

Summary

While several trends that have supported global economic growth and financial asset prices in the first half of 2018 look set to continue, other factors have emerged that could affect the investment climate in the year's second half.

Forecasted gross domestic product (GDP) rates, as of July 2, 2018

	Forecasted GDP Growth (%)		
	Q2 2018	Q3 2018	Annualized (Q2)
United States	0.8	0.9	3.3
Euro Area	0.2	0.2	1.0
Germany	0.4	0.4	1.4
France	0.4	0.4	1.6
Italy	0.3	0.3	1.0
Spain	0.9	0.9	3.5
United Kingdom	0.3	0.4	1.2
Japan	0.7	0.1	2.8
China (Y-O-Y)	7.0	7.3	—

Forecasts for U.S. growth continue to outpace those for most developed nations.

Source: Now-Casting Economics. Y-O-Y=year-over-year. Note: Calculations for annualized GDP based on originally reported figures before rounding.

We've listed some of the major developments over the second half of the year that could influence markets:

1. US congressional negotiations around the debt ceiling.
2. A potential US government shutdown should those negotiations fail.
3. A possible conclusion to the investigation by US special counsel Robert Mueller into Russian interference in the 2016 US presidential election.
4. The scheduled wrap-up of Brexit negotiations by U.K. legislators.
5. Related U.K.-EU negotiations.
6. Continued friction between Italy and the rest of the European Union over budgetary rules.

It's not enough to own a portfolio personalized for your situation, based on your comfort with risk and long-term financial goals. You must be patient and disciplined, too. With our risk management process, our investment committee is reviewing the market conditions and underlying investments on a weekly basis. Please contact your Redhawk advisor to learn more.

Redhawk Wealth Advisors, Inc. is an SEC registered investment advisor (RIA) that provides comprehensive retirement plan and financial planning tools and critical back-office support for advisors nationwide. Redhawk's focus is to enable advisors create, grow and manage wealth through a broad range of financial products and services that promotes the economic well-being of our select group of clients and advisors.

For more information, please contact Redhawk at either research@redhawkwa.com or (952) 835-4295.