Hughes Investment Advisory Service LLC

July 5, 2018

Dear Clients and Investors,

Happy 4th of July. The last two weeks of the second quarter were disappointing as escalating trade tensions continued to weigh on investors minds however the second quarter actually turned out to be fairly good, all things considered. The S&P 500 turned in a positive return of +2.88% during Q2 and is now up +1.7% for the year. The Dow Jones Industrials are negative -1.8% for 2018. Small cap US equities and the very largest Nasdaq stocks, i.e.: FANG have both outperformed while all other categories of US equities were lower. So, what we have here is a classic mixed/flat market so far in 2018.

Without any doubt, equity markets around the world faced stiff headwinds from the tit-for-tat tariff announcements from the US, China, The European Union, Canada and Mexico. Tensions related to the US-North Korea Summit in Singapore continued to keep traders on edge as well. Investors were also faced with rising inflation numbers, another .25% hike in the Federal Funds rate and a flattening yield curve, which often presages a recession. I would call this a market that has been climbing a wall of worry!

Clearly, there can be no guarantee that stocks will not soon suffer another -10% correction or larger -20% Bear market if trade tensions escalate to the point that our economy and our trade partners begin to deteriorate at a meaningful rate. To date, none of the players in this trade disagreement have shown any clear sign of backing down, with the Trump Administration even stating that a market downturn will not deter it's current tough stance on these trade issues. I have been listening and reading the press releases surrounding the trade dispute with keen interest. Where are we heading? I can only guess at this point but the German Government has indicated a willingness to eliminate tariffs on US auto imports, currently 10% versus US tariffs of 2.5% on German car imports. Canadian business leaders are pushing hard for a compromise with the US and Mexico has a new President this week so there are many moving parts to this trade situation. I believe that the markets are telling us one of two things: 1. That a resolution will appear soon or: 2. That any trade war will not derail, in any meaningful way, the current economic expansion here in the U.S.

So where are we now as we head into the 3rd quarter of 2018? For the Quarter ahead I believe that slow summer trading, trade concerns, higher short-term interest rates and the November mid-term elections will keep a ceiling on any significant market appreciation. Following the November elections and assuming progress on the trade front occurs, I am expecting a very positive year-end rally followed by solid returns in 2019. For now I'm sticking with my +12% return estimate for the S&P 500 for 2018 although clearly it will be mostly back-end loaded as indicated above.

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A little known historical market fact is that the S&P 500 has been positive in 87% of the fourth quarters of all midterm election years. It has also been positive in 87% of the quarters that follow – in this case Q1 2019. Historically, the average return for these 6 months has been a rise of 14%! Again, this is no guarantee but from an historical perspective it gives me added confidence when I add it to the other traditional methods that I use for judging the relative attractiveness of the markets that I follow.

Importantly, corporate profits, aided by tax cuts, less regulation and the Jobs Act are on track to remain strong for the foreseeable future. Standard and Poor's estimates, which I agree with, are that bottom-up operating earnings per share for the S&P 500 will jump to $158.00 this year and $175.00 next year, compared with $124.51 in 2017, even as US and global economies are on pace to grow at a modest pace – in other words global economies are balanced and not showing signs of excessive or booming growth. In fact the business backdrop appears strong enough to withstand trade difficulties as US economic statistics continue to be solid with healthy data on consumer confidence, housing and manufacturing. Current Q2 GDP growth estimates are in the +3.4% range as we move into the second half of 2018.

A few words on President Trump: Love him or loathe him, President Trump is so out of the ordinary that his presidency deserves special attention. President Trump is a complete outlier, on a different axis than any other leader. He is different. On balance, President Trump is likely to continue to be a very bullish factor on equity prices in the long run. This, not because he engenders confidence in a sunny future in fact with his Twitter habit I could argue the contrary. It is simply that he is an inflationist and stocks are an inflation hedge, while cash and bonds are the victims of inflation.

At this time I continue to favor large-cap, industry dominant, dividend paying, international corporations with strong balance sheets and special situation growth orientated equities. Risk/reward continues to favor equities over fixed income. For the first time in many years I like short term Government bills and notes with the 2-year yielding 2.50% Select MLP's, REIT's and specialized bond funds continue to look good as income producers.

Sincerely,
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