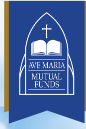

AVE MARIA MUTUAL FUNDS

MARKET COMMENTARY – Q2 2018

The Stock Market

For the six months ended June 30th, the S&P 500 Index rose to 2.65%. The Dow Jones Industrials, which is heavily weighted toward large-cap international companies, lost -0.72%. In contrast, the Russell 2000 Index of small cap stocks, which are less exposed to international sales and benefit disproportionately from lower taxes and less regulation, returned 7.75% in the first half (CHART 1).

As the old saying goes, "Stock markets dislike uncertainty," and the Trump Administration's tough stance on trade and tariffs has shaken market confidence. This stands in contrast to its steady climb following the 2016 elections. You can see the change in stock price volatility since early this year, as it seems that since then, every other headline mentions tariffs or trade wars. (CHART 2).

For the first half of 2018, stock market sectors with the strongest performance included Consumer Discretionary, Information Technology and Energy, while the weakest were Consumer Staples, Telecommunication Services and Industrials. Many of the Industries in these laggard sectors depend on international trade. So far, tariffs are limited, but if tit-for-tat retaliation grows, prices rise, and supply chains will be disrupted. One can only hope that cooler heads eventually prevail.

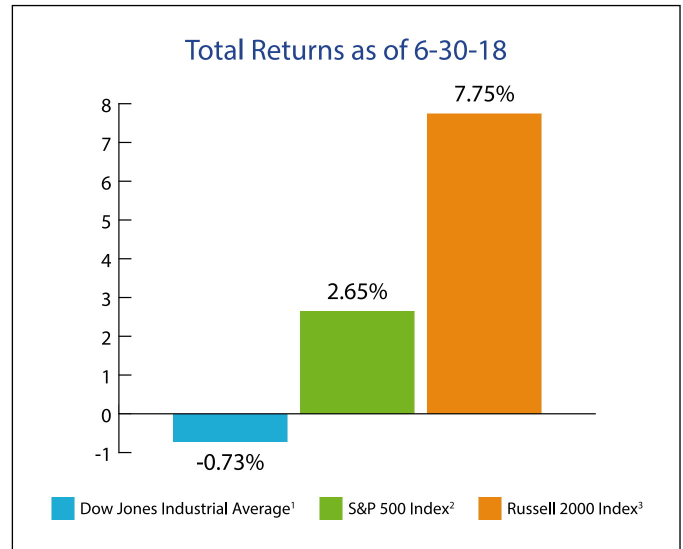

Chart 1

SOURCE: MORNINGSTAR DIRECT

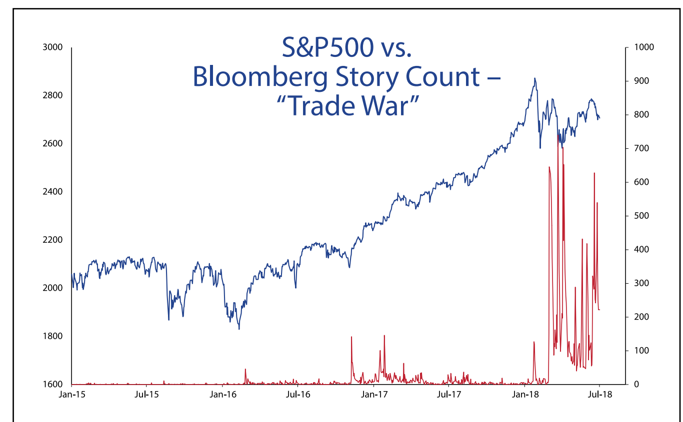

Chart 2

SOURCE: STRATEGAS RESEARCH PARTNERS, "TECHNICAL STRATEGY — DAILY REPORT" — JULY 3, 2018

Past performance does not guarantee future results. You cannot invest directly in an index.

[1] The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

[2] The S&P 500® Index is a capitalization weighted unmanaged index of 500 widely traded stocks, created by Standard & Poor's. The index is considered to represent the performance of the stock market in general.

[3] The Russell 2000® Index is an unmanaged index of the smallest 2,000 stocks in the Russell 3000® Index.

The Bond Market

During the second quarter, the Federal Reserve continued to "normalize" the Fed Funds target rate with a quarter percent raise to 2.0%. The Fed has signaled that two more rate hikes are likely this year with additional increases next year. In addition, the Fed started to shrink its bloated $4.5 billion balance sheet. How high might rates go? Over the previous three economic cycles, the real (AFTER INFLATION) Fed Funds rate rose to between 3% and 5.5% (CHART 3). Each round of tightening was followed by a recession (SHADED AREA). Currently, the real Fed Fund hovers near zero, so there is probably ample room for rates to rise before threatening the economy.

Since year end, the two-year U.S. Treasury note yield has risen by 1.14% points to 2.52%. The ten-year Note has risen by 0.55% points to 2.85% and the thirty-year yield has barely changed, ending the first half at 2.98%. A flattening of the yield curve is always a concern to investors. Historically, when the two-year yield exceeds the ten-year yield (AN INVERTED YIELD CURVE), recessions and stock market corrections become more likely. The Federal Reserve's objective is to normalize monetary policy, so it has flexibility to lower rates in the future if economic conditions deteriorate.

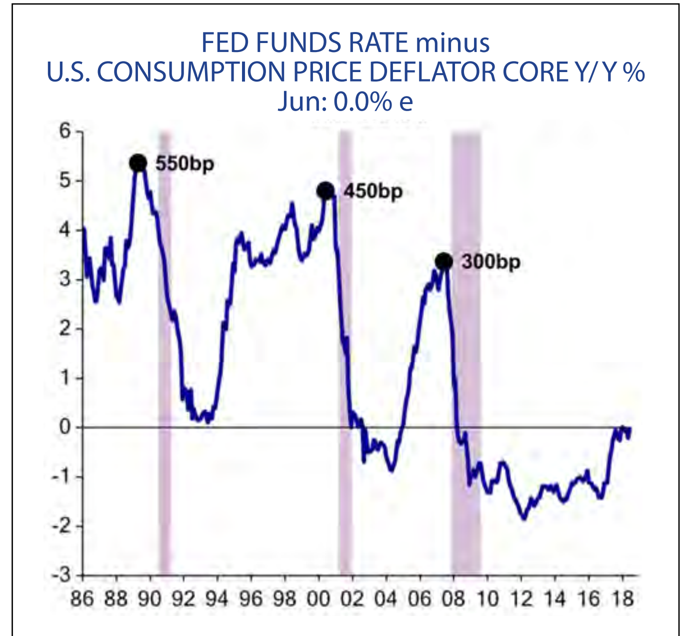

Chart 3

SOURCE: EVERCORE ISI
"MORNING ECONOMIC REPORT" – JULY 10, 2018

Past performance does not guarantee future results.

The Economy

The U.S. economy likely grew 3.5% to 4% in the second quarter. This compares very favorably to the 2.2% average annual GDP growth in the previous eight years of this recovery. This growth spurt was fueled by the continuing positive impacts of deregulation, tax cuts, government deficit spending, and surging exports and imports in anticipation of possible tariffs. While unemployment rose slightly in June to 4%, this was good news as it reflected a large increase in new entrants to the labor pool. Employment grew more than 200,000 in June alone and for the first time this recovery, there are more job openings than job seekers. The labor-participation rate rose to 62.9%, a post- recession high. Real wages rose 2.7%. Corporate profits rose an estimated 21% in the quarter compared to 26% in the first quarter. Earnings growth for corporate America looks to be very strong through at least 2019.

Both business and consumer optimism abounds. The NFIB Small Business Optimism Index May reading reached the highest level since July of 1983. The Bloomberg Consumer Comfort reached a new high dating back to 1997 when real GDP growth was 4.5%. (CHARTS 4 & 5) In stark contrast, the Misery Index, a combination of inflation and unemployment rates, remains near 50-year lows.

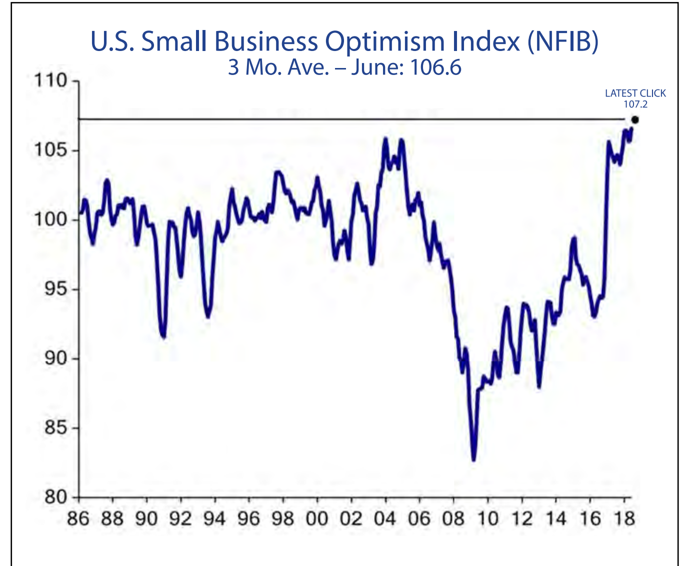

Chart 4

SOURCE: EVERCORE ISI

"MORNING ECONOMIC REPORT" — JULY 10, 2018

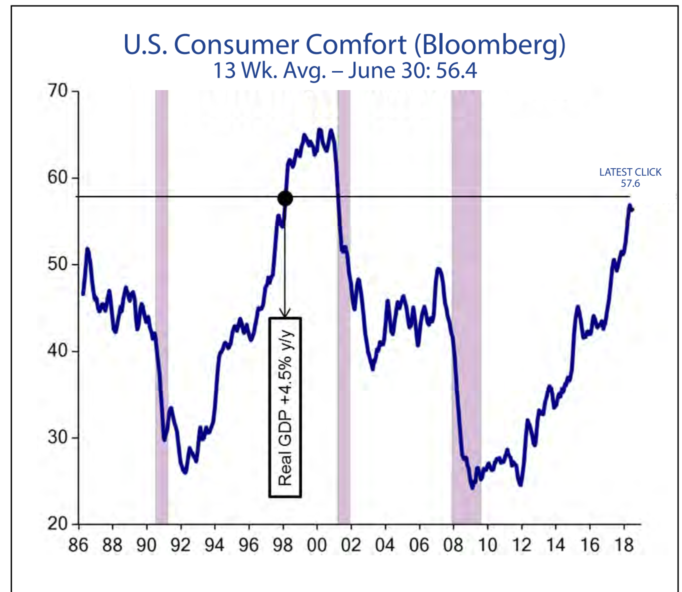

Chart 5

SOURCE: EVERCORE ISI

"WEEKLY ECONOMIC REPORT" — JULY 9, 2018

Past performance does not guarantee future results.

Politics

President Trump is following through on his campaign pledge to level the playing field in international trade which he considers tilted against the U.S. He is focusing on China's $376 billion bilateral trade surplus with us as evidence of unfair trade terms. China's policies that force U.S. companies into joint ventures and to share intellectual property as a condition of entry into their market are in violation of World Trade Organization rules which supposedly China agreed to as a condition of acceptance into the Organization in 2001. What started as a 25% tariff of $34 billion of Chinese exports has expanded and Trump is threatening to impose tariffs on an additional $200 billion of consumer goods. Each time the U.S. raises the ante, China retaliates. Trump has also placed tariffs on Canadian, European, and Mexican imports and wishes to renegotiate the NAFTA trade agreement.

In the short run, if the equity and currency markets are any indication, the U.S. seems to be winning the war as the China Shanghai market is down over 20% since January and the Yuan has declined 5.5% against the dollar. In the long run, trade wars are not won. They depress economic activity, raise costs and destroy business confidence and incentives to invest.

Beyond Trump's sincere if misguided motivation to punish misbehavior by our trading partners, he may have an eye toward this fall's mid-term elections. Tough trade rhetoric appeals to many in his populace base. What four months ago looked like a Democratic tsunami for control of the House seems to have lost some of its momentum (CHART 6). Trump's approval

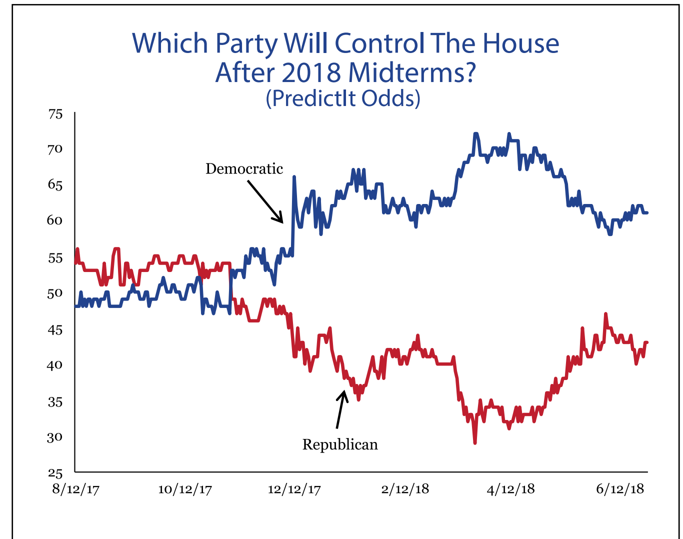

Chart 6

SOURCE: STRATEGAS RESEARCH PARTNERS
"QUARTERLY REVIEW IN CHARTS" – JULY 2, 2018

Past performance does not guarantee future results.

ratings have risen, at least from abysmally low levels last winter. The Senate still looks to be firmly in Republican hands. The opportunity to replace Justice Kennedy with the firmly conservative Judge Kavanaugh should also bolster the cause.

So, as we enter the ninth year of this market recovery and the eighth year of economic expansion, the wall of worry grows taller. Rising interest rates, trade tensions, Middle East chaos, cooling growth in Europe, and mid-term elections are just a few bricks in the wall. We, however, see as many or more offsetting positives such as rapid profit growth, reduced regulation, moderate inflation, growing employment, wage gains, pent up demand for productivity enhancing capital spending, U.S. energy independence, etc.

Both short and long-term interest rates are likely to rise further. So, in our opinion it's appropriate to avoid longer-dated maturities and emphasize high quality credits in bond portfolios. We still see attractive long-term investment opportunity in the stocks of growing companies with good managements, strong balance sheets and high profit margins.

Past performance does not guarantee future results.

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