Peter Sorrentino, Chief Investment Officer, Comerica Asset Management Second Quarter 2018

Quarterly Commentary

Second Quarter 2018 Recap

If the hallmark for the first quarter of 2018 was rising interest rates, the second quarter can claim global politics as its theme. For as much of a concern as the course of interest rates was, it faded quickly, thanks to the escalating war of words on trade that took center stage. A closer look at the complexion of the stock market leadership coming out of the 2016 trough explains the threat. The narrow group of market leaders share a common characteristic – they enjoy about a 2% faster growth rate than the balance of the market, the bulk of that coming from offshore. Threats to that, real or simply perceived, are quickly being telegraphed back through to share prices. So, for those leading companies in the technology and consumer groups that managed to escape the self-inflicted wounds of the first quarter, covert data collection and privacy breaches, the prospect of diminished foreign opportunity is adversely impacting share prices. The dispersion of performance in the second quarter also stood in stark contrast to the homogeneity of the market in 2017. While the once laggard energy sector posted the strongest gains for the quarter, up 13.5%, both the industrial and finance sectors lost slightly over 3%. The revival of price volatility was again evident, not only in stock prices, but in commodity prices and interest rates as well. Copper fell 8%, while in the agricultural sector, corn and soybeans fell 14% and 19%, respectively. As expressed in Exhibit 1, interest rates in the U.S. did rise over the quarter, but ended the quarter off the May 17 highs, as political uncertainty in Europe following elections in Italy and continued Brexit confusion combined with trade anxieties to spark a migration to the comparative safety of U.S. Treasuries.

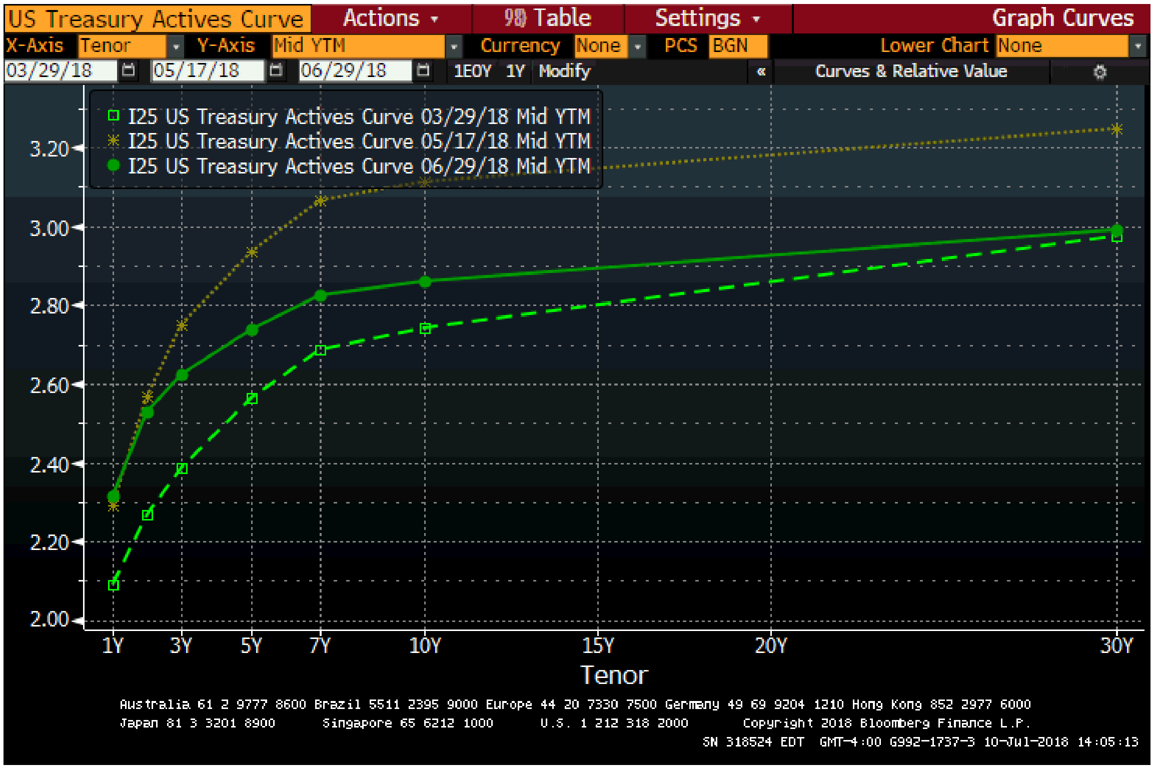

Exhibit 1 (Source: Bloomberg)

This easing back of interest rates took place across the term spectrum. The result for stock prices was a dramatic turnaround of investors' appetite for bond surrogates, such as REIT's and utilities, which after having suffered declines in the first quarter, posted gains of 6.13% and 3.74%, respectively, in the closing weeks of the second quarter. The move in interest rates had broad implications for the overall market, as it reversed the value bias witnessed in the first quarter firmly back in favor of growth, as the Russell 1000 Growth Index gained 5.8%, versus the Russell 1000 Value Index gain of only 1.2%. What the rise in rates did not affect is the performance advantage small capitalization stocks have been enjoying. Both the S&P 600 Index (+8.8%) and the Russell 2000® Index (+7.8%) bested the large cap S&P 500® Index (+3.4%) and Russell 1000 Index (+3.6%). This rotation is typically seen late in an economic cycle, as spending shifts from consumers to businesses, setting off a period of accelerating revenue and profit growth for smaller companies. Adding fuel to this episode are the recently-passed tax reform and the concerns over foreign trade and currency fluctuations – issues smaller companies are typically less exposed to relative to multinationals. Among the casualties of the second quarter were the foreign markets, particularly the emerging markets with both currency and investor sentiment quickly turning against them. In Exhibit 2, you can see that the developed markets of the MSCI EAFE® Index fell roughly in line with the change in currency valuation. The shares of the MSCI Emerging Market Index experienced absolute price declines as capital flight drove those markets downward.

Exhibit 2 (Source: Bloomberg)

Third Quarter 2018 Outlook

Threats to U.S. equities are rising input cost for labor and commodities (the impact of gasoline prices on consumer spending), an abrupt leadership rotation sending the overall market into a correction. But as was the case in 1987, solid economic fundaments should prevail. The wild card for the back half of 2018 will be how the market responds to the growing size of U.S. Treasury auctions, now slated to increase at a 15% rate in the back half of 2018. A ‘Buyers Strike’ by global central bankers, or simply a loss of appetite, could serve to push rates higher. Threats to U.S. corporate bonds are a cascade of defaults within the corporate bond market (think retailers and private equity refinancing).

Our outlook for both the economy and the market remains unchanged. We view this as a late cycle expansion characterized by increased business spending to improve efficiency and enhance profitability. The principal beneficiaries are smaller, domestically-focused enterprises with limited exposure to the global uncertainties of trade tariffs and currency fluctuations. The duration of this economic recovery has reached the point where it is likely to be reinforced by a modest replacement cycle for passenger and commercial vehicles of all types. Infrastructure replacement, beyond just bridges and roads, will experience increased spending for example as pipelines replace rail tankers for moving fuel and autonomous vehicles rescue us from a national driver shortage.

Topline revenue growth for the S&P 500® Index is 7.2% for 2018, and 3.1% for 2019, driven by accelerating growth abroad and increased domestic CAPEX. Profit margins should improve approximately 12% by the end of 2018, resulting in about $163.23 ep and about 174.70 for 2019 for the S&P 500 Index, a 7% year-over-year gain. The S&P 600 index is forecast to earn roughly $52.50 in eps for 2018, and roughly $58.90 for 2019, a 12% year-over-year gain. We anticipate mid-single digit returns for the large cap segment of the market, with the small cap segment generating mid-teen returns for the year. The bond market, and municipal bonds in particular, have been resilient in the face of shifting interest rate trends and rising concerns regarding demand in the face of rising supply. It bears pointing out that the municipal bond market not only absorbed a record new issuance, it has also navigated the Puerto Rico defaults without incident. And while clearly not out of the woods by any means, most state budgets have been approved, and the post-retirement funding gaps, while not closed, are at least now acknowledged. In our first quarter commentary, we pointed out the interest rate compression across the credit quality spectrum, warning that investors were not being adequately compensated for the inherent risk of lesser credits. We continue to recommend investors gravitate towards higher quality credits, as those interest rate differentials have begun the process of return to their historic levels. As evidenced in Exhibit 3, while the yield on U.S. Treasury debt did climb slightly during the quarter, the rise in rates at the bottom of the investment grade debt was notably larger.

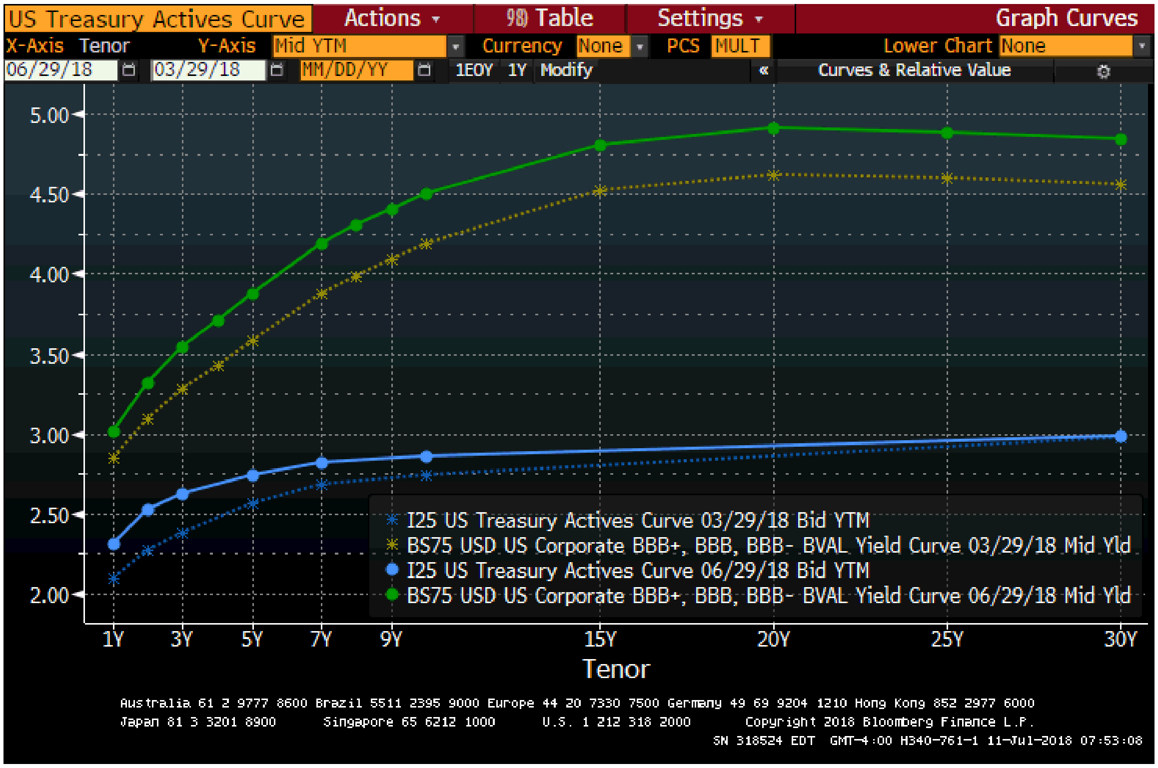

Exhibit 3 (Source: Bloomberg)

Our inward emphasis is not to imply that we eschew investment opportunities elsewhere around the globe, but quite the contrary. In the developed markets of Western Europe and Asia, we see accelerating economic growth as an opportunity for enhancing investment returns. Emerging markets, too, offer attractive risk and reward propositions for investors with valuations well below those found in the U.S. and those of the developed foreign markets. But as the past quarter has demonstrated, investing in this asset class is not without the perils of currency, capital flows and politics that serve to amplify volatility.

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