CLEARWATER CAPITAL

Thought · Leadership

THINK18

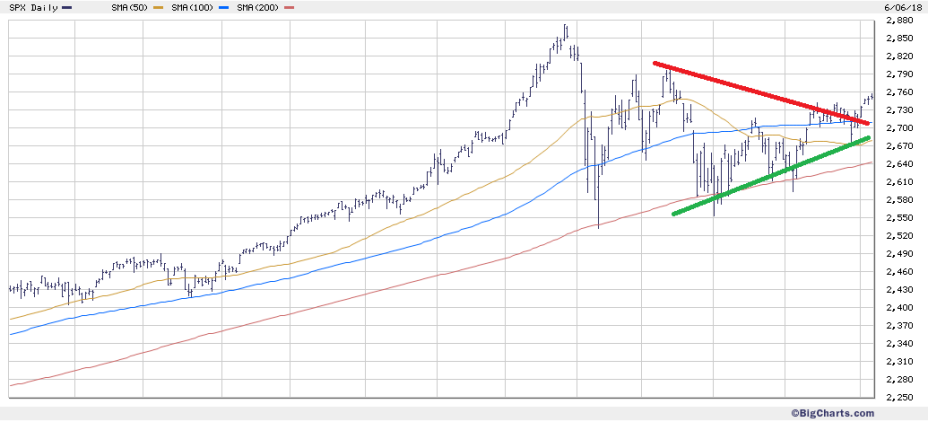
June 2018

Private Client Letter

Volatility Fading

Ever since the U.S. equity markets peaked last January, stocks have struggled to recover from the first legitimate correction seen in recent memory. For several months now, every attempted rally has quickly run out of steam with the markets failing to reach higher intermediate levels.

For much of this time stock prices moved modestly higher early after the market open, only to be pressured by consistent selling throughout the day. Worse, the last few minutes of the trading day often saw significant selling pressure with stocks typically finishing right at the lows of the day.



These bearish technical patterns now appear to have been broken. Instead of quickly reversing, the S&P 500 has recently traded in a sideways range indicating that sellers were more evenly matched with buyers. We are also now seeing reasonably consistent buying throughout the day which is generally a sign of steady underlying demand for equities.

The S&P 500 has now managed to make a new short-term high, trading to its highest level since mid-March. Marking higher intermediate levels is an encouraging sign. The downtrend that dominated equities for much of the current year looks to be giving way to a trend that could be turning higher.

May turned out to be a very strong month for U.S. equities. The S&P 500 gained 2.43% during the month. Yet, the real strength came in the Nasdaq 100 and in the Russell 2,000 (the small-cap space). Dollar strength and a continuation of the "domestic" trend continued to boost small cap stocks, which generally have much less international exposure than large-cap global companies. The Russell 2,000 (IWM) ended up gaining 6.16% in May, which was its best one-month gain since November 2016.

John E. Chapman

John is the Chief Executive Officer at Clearwater Capital Partners and serves as the firm's Managing Partner. With thirty four years of Wall Street experience, John directs all wealth management and advisory services for the firm. He also serves as the firm's Chief Investment Strategist and chairs the firm's Investment Policy Committee.

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Key Takeaways

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- For several months now, every attempted rally has quickly run out of steam with the markets failing to reach higher intermediate levels.
- The last few minutes of the trading day often saw significant selling pressure with stocks typically finishing right at the lows of the day.
- These bearish technical patterns now appear to have been broken.
- The S&P 500 has now managed to make a new short-term high, trading to its highest level since mid-March.
- The manufacturing sector is having its best year since 2004.
- The Philly Fed State Leading Index is now projecting an increase in in economic activity for all 50 states over the next six months and the U.S. Leading Index has edged up to its best levels since January 2017.
- We still believe a 4.0% growth rate in the second quarter is quite possible and we anticipate average growth of around 3% for 2018.
- We believe equities may be breaking out of the recent trading range and expect stock markets will enjoy another sustained advance over the balance of 2018.

Going forward we believe higher equity prices will be supported by favorable economic fundamentals. The ISM Non-Manufacturing Index (NMI) rebounded in May with its first increase in four months as services activity strengthened. The current reading, which is historically consistent with above-trend growth, shows that the economy has regained strength in the second quarter, following a soft first quarter.

The manufacturing sector is having its best year since 2004. Including May's reading of 58.7, the ISM manufacturing index has averaged a very impressive reading of 59.0 through the first five months of the year, and the healthy pace of expansion should continue in the months ahead.

The Philly Fed State Leading Index is now projecting an increase in in economic activity for all 50 states over the next six months and the U.S. Leading Index has edged up to its best levels since January 2017.

U.S. employment data is particularly strong with nonfarm payroll numbers up 223,000 in May and 2.4 million higher in the past year. The unemployment rate now stands at 3.8%, tying the lowest reading since 1969. Additionally, the number of job openings in the U.S. is currently at a record high with the number of job openings now exceeding the number of unemployed individuals for the first time since data started in 2000.

With all of the positive momentum in fundamental economic data, a rate hike is virtually certain for this month's Fed meeting. We expect the Fed will raise rates by 25 basis points, which would be consistent with the seventeen rate hikes between June 2004 and June 2006.

Importantly, a rate hike of this magnitude should not come as a surprise to the markets and we would not anticipate material weakness in equity prices resulting from this decision.

As usual, there are plenty of things to worry about in the midst of the many positive factors. Political turmoil across the globe, trade tensions, and the pending meeting between President Trump and North Korean dictator, Kim Jong-un, all hold the potential to drive mark volatility higher. Of these potential concerns, we are most focused on trade - however we are confident that a full blown trade war remains unlikely.

Financial markets and economic conditions appear to be quite healthy. With strong corporate revenue growth and sharply reduced corporate tax rates, we have the recipe for stronger economic activity and increased corporate investment. We still believe a 4.0% growth rate in the second quarter is quite possible and we anticipate average growth of around 3% for 2018.

The evidence is mounting that the economic fundamentals continue to run strong. While we can't say for sure, we think equity markets are still in the early stages of pricing in the many positives.

This said, we believe equities may be breaking out of the recent trading range and expect stock markets will enjoy another sustained advance over the balance of 2018.

Thank you for your continued trust and confidence.

John E. Chapman
June 2018

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