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Market and economic update

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Contributors from U.S. Bank Wealth Management:

Robert L. Haworth, CFA
Senior Investment Strategy Director

Terry D. Sandven
Chief Equity Strategist

William J. Merz, CFA
Senior Research Analyst,
Fixed Income

Current economic events

The U.S. economy continues to strengthen based on last week's reports showing rising inflation and improving retail sales, which allowed the Federal Reserve (Fed) to continue its path of higher interest rates. Tighter monetary policy may eventually slow the economy. However, the continued lift from tax cuts this year and the positive momentum in U.S. economic data indicate to us the economy is likely to remain on positive footing well into next year. A trade war presents the most significant near-term risk to the economy, but the current tariff skirmish is not enough to derail positive economic momentum. We could become concerned if tariffs expand to cover significantly more valuable products and lead to a spike in domestic inflation.

- Both the Consumer and Producer Price Indexes rose for the United States in May, with headline year-over-year inflation results the highest since 2011. Core prices, excluding food and energy, also continued to climb. While the trend for inflation remains higher, the recent pullback in commodity prices, including oil and grains, is likely to temper overall price growth.
- Retail sales continued to accelerate, growing 5.9 percent for the year ending in May. Coupled with low weekly jobless claims and robust consumer confidence, we believe consumer spending will continue to support economic acceleration in the United States for some time.

The economic story is not so positive outside the United States, where economic momentum continues to soften. In Europe, sentiment data, such as surveys from ZEW (a European economic research company), continue to weaken from strong readings in January. Inflation data has also been somewhat disappointing for investors. However, the overall pace of growth and inflation was sufficient for the European Central Bank (ECB) to indicate it plans to wind down its quantitative easing at the end of this year. We anticipate the story outside the United States will continue to soften for now, with an expanding trade war also a risk to international economic momentum.

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Equity markets

U.S. equities are muddling along while tariff-related discussions continue and second quarter reports approach. Our year-end 2018 price target for the S&P 500 remains 2,900, based on a multiple of 18 to 19 times the midpoint of estimated 2018 earnings in the range of $155 to $160 per share, roughly 4.5 percent above current levels. We continue to favor growth and cyclical stocks over defensives, absent ramping inflation and a looming recession.

- Broad-market performance improved in June, with the large-cap S&P 500 Index advancing 2.7 percent and the small-cap Russell 2000 Index up 3.1 percent. Additionally, nine of 11 S&P 500 sectors are up month-to-date, led by the 6.2 percent gain in the Consumer Discretionary sector. Favorable broad-market performance among the popular indices and S&P 500 sectors are typically indicative of a market that is poised to trend higher.
- Valuation remains elevated, with the S&P 500 closing June 15 trading at approximately 21 times trailing 12-month earnings estimates and 17.5 times 2018 estimates. Consensus estimates are for earnings to advance roughly 20 percent year over year in 2018 and a more modest 10 percent in 2019. Of looming concern is how investor sentiment may change as focus shifts to a slower rate of earnings growth in 2019.
- Earnings growth, on balance, continues to provide valuation support and the basis for stocks to trend higher. Consensus estimates for 2018 and 2019 are approximately $159 and $175 per share, according to Bloomberg, FactSet and S&P Global. Second quarter sales are projected to increase roughly 8 percent and earnings are estimated to rise 20 percent, according to Bloomberg, in line with first quarter results. The second quarter earnings reporting season unofficially begins on July 13.

Fixed income markets

The Fed announced a 25-basis-point increase to the target funds rate last week. Fed Chair Jerome Powell expressed optimism, noting the U.S. economy "is in great shape." The median committee member's estimate of the year-end rate rose to imply two additional rate hikes this year. Shorter-term Treasury yields offer increasing competition versus riskier assets. We continue to expect modestly higher rates based on our expectation for additional Fed rate hikes, rising inflation expectations, robust Treasury issuance and waning foreign demand for Treasuries. We recommend shortening maturity profiles within bond portfolios.

Central bank actions and inflation expectations should support modestly higher yields. Inflation expectations have trended higher over the past year, though they have stalled recently. Strong labor markets should support rising inflation in the near term. The ECB expects to end its asset purchase program in December and begin raising rates as early as summer 2019. A primary risk to our view is if inflation or inflation expectations fall, which could occur if investors discount a slower economy looking ahead.

We maintain a favorable view of investment-grade municipal debt. Municipal bond prices are fair-to-slightly elevated based on historical comparisons to other bonds, but limited supply continues to support prices. Municipals have outperformed Treasuries, investment-grade corporate bonds and the Bloomberg Barclays Aggregate Bond Index year to date, even before accounting for any tax benefits. Net issuance is expected to remain below 2017 levels and provide continued support for municipals. The steepness of the muni curve makes extending maturities particularly attractive for crossover buyers compared to investment-grade corporate debt.

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