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Stocks were all over the map in a jittery second quarter. Investors seemed to ignore trade tensions, a Fed rate increase and rising inflation and focused on a more benign development: an increase in corporate profits resulting mainly from the reduction in corporate income tax rates late last year.

That helped the benchmark S&P 500-stock index rise 2.9 percent in the three months that ended on June 30. The average domestic stock index did even better, rising 3.8% in the second quarter, led by real estate, health care, technology and consumer cyclical issues. By contrast, the average international stock fund fell 4% with emerging markets faring the worst, down 7% for the period. The sharp rise in the dollar over the past few months have strained finances in emerging economies.

In the recently ended quarter, small stocks outpaced larger ones by a wide margin. The Russell 2000 small-company index returned nearly 8% compared with 1% for the Dow Jones Industrial Average, which contains big companies. The recent small-stock outperformance may derive from fears over the impact of a trade war with China. Small stocks tend to be more resistant to tariffs because they are usually domesticated.

In recent months, inflation has definitely ticked upward. The Consumer Price Index rose 2.9% over 12 months through June 30, its biggest increase in 6 years. That's still below the long-term historic average of 3%. Yet a year ago, inflation was running at just 1.6%. Inflation pressures hurt bonds, which pay out fixed income over time. Bond funds of all kinds lost value, with those of the highest quality dropping the most and high-yield issues down modestly. There has been a gradual "flattening of the yield curve", which describes the condition when short-term interest rates approach that of long-term rates. We think that rising inflation will push up long rates and normalize the yield curve.

Despite the headlines, the risk of a prolonged trade war is small, according to a report last month by Bank of America. But allies in Western Europe have stepped up their tough talk on trade lately, and President Trump is unhappy with NAFTA - North American Free Trade Agreement – and blames it for the loss of several manufacturing jobs to Canada and Mexico. We will continue to monitor these developments and their effect on our clients' portfolios.

In light of these economic trends, we continue to believe in constructing balanced portfolios that depend on combinations of asset classes rather than individual securities. We rely on top-down macroeconomic events like those highlighted in this commentary to formulate our strategies.

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Sources:
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