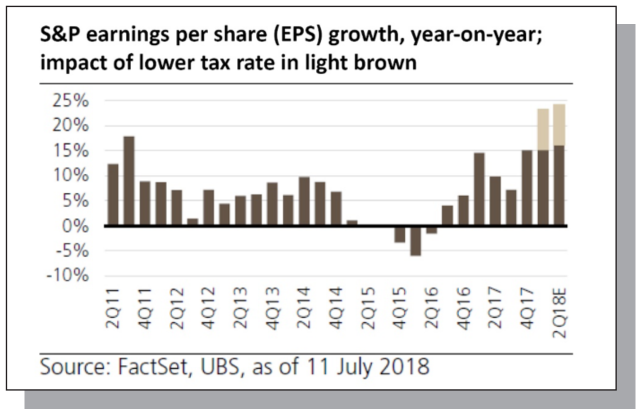
Hemenway Trust Company LLC

Summer 2018 Investment Report

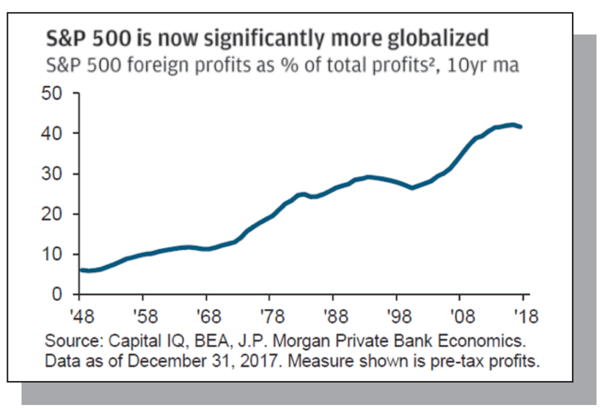
In the first six months of 2018, we have seen a sharp increase in market volatility, as compared to 2017. This volatility has developed as investors digested mixed global economic data, higher US interest rates and increasing concerns of a global trade war. At the end of the second quarter, the broad MSCI World Index was flat for the year, with US equities up 3% and international developed stocks down 3%. Emerging market stocks have seen greater volatility (down 8% for the quarter) due to increased sensitivity to global trade and a strong US dollar. Fortunately, US stock earnings have been less worrisome, with most companies benefitting from healthy sales growth and a lower corporate tax rate. That said, looking forward, we expect the companies we invest in to grow their earnings over 20% in 2018, with +/-10% growth in 2019. With these estimates, our portfolio of stocks trade at a reasonable 17x price-earnings ratio (P/E).

So, while much of the economic news is positive and earnings are generally strong, investors are now focused on a flattening yield curve and beginning to question when this long bull market will end - and if it will be with a bang or a whimper. However, this has not stopped investors' appetite for tech stocks, which have returned 10%, while non-tech stocks are collectively flat YTD.



Tariffs

For much of the last year, the protectionist rhetoric from Washington has been viewed as a means to start negotiating trade with countries bi-laterally, with China at the top of the list. What started off with placing tariffs on washing machines and solar panels, has now grown to include a larger portion of the $2.5 trillion worth of goods and services that the US imports each year. As expected, we've seen China and key European countries discuss retaliatory tariffs on targeted US exports. Although no one can say where trade negotiations will ultimately go, we should acknowledge that a protracted trade war would have a more significant impact on corporate earnings, than on US GDP. As long-time investors in companies with sales across the globe and with intricate global supply chains, we've seen the benefits of globalization and hope that we continue to see more free trade, as opposed to less.



Flat Yield Curve

In their June meeting, the Federal Reserve raised short term interest rates by 0.25% to 2.0%; this was the sixth time since 2016. At the meeting, the Federal Open Market Committee (FOMC) discussed at length the strength of the US economy and the need to continue moving towards a neutral interest rate of 3% (or higher). However, the impact to rates at the long end of the curve has been muted, with the spread between 2-year and 10-year treasuries down to only 35 basis points (0.35%). The fear is that additional rate hikes will invert the yield curve. It's important to note that, while every US recession in the post-war period has been preceded by an inverted yield curve, not every instance of curve inversion has led to a recession. Another factor playing a role in the flat yield curve is simple supply and demand. To the dismay of many, as the trade deficit grows and long-dated bonds mature, the US Treasury has been primarily issuing short (1-5 year) treasuries. With the Federal Reserve, and other central banks, continuing to hold a good deal of long-dated treasuries, this creates increased supply at the short end of the curve and artificial demand at the long end.

Technology Stocks

The gains seen within the technology sector have been impressive. Over the past five years, tech stocks have generated an annualized return of 20%, as compared to 12% for non-tech stocks. This outperformance is similar to what we saw in the late 90's, but unlike then, today most of the companies in the sector are highly profitable, have a diverse client base, and many trade at "reasonable" valuations. While most client portfolios are still heavily weighted to the sector, we are slowly rotating capital away from the technology sector and towards stocks that have attracted less attention, but also have proven business models, superior management and have generated strong free cash flows.

We are also watching the increased regulations the sector will likely face. We've all seen the issues Facebook has dealt with in the recent Cambridge Analytica scandal, but the European Union has been focused on this for years and has rolled out the new General Data Protection Regulation (GDPR), which aims primarily to give control to EU citizens and residents over their personal data. Data protection will continue to be an important issue for all companies. We expect there will be additional regulation affecting the largest tech companies, which may chip away at their future earnings.

Conclusion

As interest rates continue to rise and trade policies are negotiated, we expect the recent market volatility to linger. That said, we continue to have a constructive view on the global economy, and believe that a well-balanced portfolio of growth and defensive investments will provide both the income and growth that our clients seek from their portfolios.

We hope you enjoy the rest of the summer and please let us know if you have any questions about your investment accounts.