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MARKET OUTLOOK LETTER

July 30, 2018

Our growth and dividend stocks have been oscillating with the overall stock market recently, but we expect that one by one, as they post better than expected second- quarter sales and earnings that operational performance may translate in better price action. The following table from our friends at Bespoke shows what has been working for the first six months of 2018 in the S&P 500 when broken into deciles:

S&P 500 Decile Performance: First Half 2018

	Decile 1	2	3	4	5	6	7	8	9	Decile 10
Market Cap (Largest to Smallest)	-0.65%	2.69%	1.44%	2.18%	-4.08%	-1.74%	-0.24%	2.05%	0.03%	7.43%
P/E Ratio (Lowest to Highest)	-1.66%	-4.37%	-3.53%	0.33%	-0.90%	-1.06%	0.33%	5.67%	5.05%	9.48%
Dividend Yield (Highest to Lowest)*	0.28%	-1.85%	-4.98%	0.55%	-0.48%	-3.18%	0.63%	-1.67%	1.68%	9.88%
Short Interest (Lowest to Highest)	1.55%	0.20%	-3.75%	-1.71%	1.34%	-1.50%	-0.49%	2.92%	1.37%	9.28%
Price to Sales (Lowest to Highest)	5.06%	-1.73%	-3.73%	-4.26%	0.48%	1.90%	0.33%	0.46%	8.14%	2.51%
Analyst Ratings (Best to Worst)	3.80%	1.30%	-0.93%	2.39%	0.86%	-0.39%	-2.26%	1.10%	-0.67%	3.82%
% International Revenues (Most to Least)**	-1.33%	1.18%	1.49%	7.63%	3.19%	-1.28%	3.86%	0.65%	-7.18%	0.97%
% Chg in 2017 (Best to Worst)	8.26%	-1.83%	3.24%	-0.89%	0.68%	-2.66%	-0.87%	-1.54%	-0.67%	5.90%

*Decile 10 of dividend yield category is made up of all stocks that pay no dividend.

**Decile 10 of international revenues category is made up of all stocks that have no international revenues.

Source: The Bespoke Report 6/29/18

What's more intriguing, the best performing stocks in the S&P 500 in the first 6 months of 2018 were:

1. Bottom 10% of Market Cap, up 7.43%, which demonstrates the small to mid cap strength caused by a strong U.S. dollar;
2. Top 10% with highest P/E ratio, up 9.48%, which demonstrates FAANG strength & short covering;
3. Bottom 10% of dividend yield, up 9.88%, which also demonstrates FAANG strength & short covering;
4. Top 10% of Short Interest, up 9.28%, which demonstrates short covering.

Overall, the small-to-mid capitalization rally this year is real and should persist due to a strong U.S. dollar, since it diverts money away from multinationals that are now fighting a currency headwind. However, this year's short covering rally is hard to capitalize on and is unlikely to be sustained. If the trade friction with China is resolved this fall, money should flow towards companies with strong earnings growth and those that are moving on short squeeze tailwinds will fade.

The S&P 500's second-quarter earnings are supposed to be up 20%, down a bit from a torrid 24% annual pace in the first quarter, due to the strong U.S. dollar hindering multinationals and more difficult year-over-year comparisons. Since the S&P 500 is not going up as much as earnings, P/E ratios continue to be severely compressed. However, our growth stocks are still forecasted to post much stronger sales & earnings than the overall stock market and could continue to sustain strong sales & earnings momentum … see link:

https://navellier.com/advisors/portfolios/sales-and-earnings-projections/?t=7

Last year our international stocks performed especially well in August and helped us have the top performing mutual fund in the third quarter of 2017. However, that currency tail wind that propelled our international stocks higher in 2017 is now a currency head wind, so we are adding more domestic stocks to our respective portfolios.

We would like to discuss the biggest worry on Wall Street, namely the escalating trade war with China. First, an additional $200 billion in tariffs on Chinese imports amounts to a small percentage of U.S. GDP so these tariffs may not have a big impact. Second, China's merchandise trade deficit hit a record of $152.2 billion in the first five months of 2018, so China is winning the trade war so far, because they continue to set new export records almost every month. Third, there will not be any evidence of a true trade war with China until many of the shelves at Best Buy and Wal-Mart are bare, since the vast majority of their goods are made in China. Fourth, for every dollar of U.S. exports to China, the U.S. imports $3.87 of Chinese merchandise. Finally, China has a lot more to lose than the U.S., so in the end, I expect that China will cooperate as the Trump Administration continues to apply more pressure via tariffs.

Please note: Louis Navellier does not currently hold a position in Wal-Mart or Best Buy. Navellier & Associates does currently own a position in Best Buy and does not currently own a position in Wal-Mart for client portfolios).

China and the U.S. are dependent on each other economically. As a result, the relationship President Trump has with Chinese President Xi Jinping is very important. We suspect that the Trump Administration will not try to publicly humiliate President Xi Jinping like our Canadian and German allies, since that would be a cultural disaster. Instead, I expect that the tariff "tit for tat" between the U.S. and China will be resolved diplomatically with each country's respective trade representatives. In my opinion, every market dip on trade concerns represents a buying opportunity.

The danger here if this trade negotiation is not resolved quickly, it would impact the investment cycle in both the U.S. and China. The Chinese are at a disadvantage because they have tried to extend their economic cycle into perpetuity via forced lending quotas of state-owned banks, which is impossible to do based on hundreds of years of economic theory and hard data. The last evidence of a recession in China was in 1993, even though that recession was not officially admitted but it did show up in bank loan loss provisions. With a heavy debt load (due to forced lending quotas), the Chinese economy is headed for a hard landing if the investment cycle is interrupted due to lengthy trade friction so they have every incentive to make a deal with the Trump administration.

The other major process impacting the economy is the quantitative tightening being performed by the Federal Reserve. Fed Chairman Powell recently mentioned the trade war between the U.S. and its global competitors, saying only that it is “difficult to predict” what the ramifications will be on the economy. We suspect that if the trade friction drags on, the Fed will be on hold until there is a resolution.

If the Fed is looking for another excuse to postpone raising key interest rates, it may be a shocking Commerce Department announcement recently that housing starts plunged 12.3% in June to a seasonally adjusted annual rate of 1.173 million and building permits declined 2.2% to 1.273 million. Housing starts are now running at the lowest level in nine months and building permits have declined for three straight months, so clearly between higher home prices, higher mortgage rates, and a labor shortage, there is no doubt that the housing industry is cooling off.

Overall, a “Goldilocks” environment of moderate interest rates, strong GDP growth, and modest inflation persists. There is no doubt that inflationary pressures are moderating, so the Fed can use the trade spats and the housing slowdown to postpone key interest rate hikes. Speaking of interest rates, even though the short end of the Treasury yield curve has risen, the 10-year Treasury bond remains extremely well behaved. As a result, the Fed now has an excuse to postpone its next key interest rate hike.

SUMMARY

We are now in the midst of the strongest economic environment in over a decade, so if the trade situation is resolved without a big delay we suspect the stock market will respond favorably. Furthermore, the physical stock market continues to shrink due to relentless stock buy-back activity, which actually accelerates EPS growth (same earnings amount spread over a smaller number of shares).

You may have heard that August is not our favorite month, due to the “air pockets” that can materialize from time to time as both Europe and Wall Street tend to be on vacation. Still, we are off to a great start this earnings announcement season, so we expect wave after wave of positive sales, earnings, and surprises may propel our growth and dividend stocks higher in the upcoming weeks. We remain in a favorable investment environment contingent on the trade situation being resolved in a timely manner. The Chinese have more to lose in this fight so the Trump administration is operating from a position of power.

LOUIS G. NAVELLIER
CEO/Chief Investment Officer

MICHAEL J. BORGEN
Senior Portfolio Manager

MICHAEL GARAVENTA
Portfolio Manager

TIM HOPE
Portfolio Manager

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1 East Liberty Suite 504 Reno Nevada 89501

800-365-8471 • 775-785-2300 • www.navellier.com