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Proactive Investment Management & Financial Planning

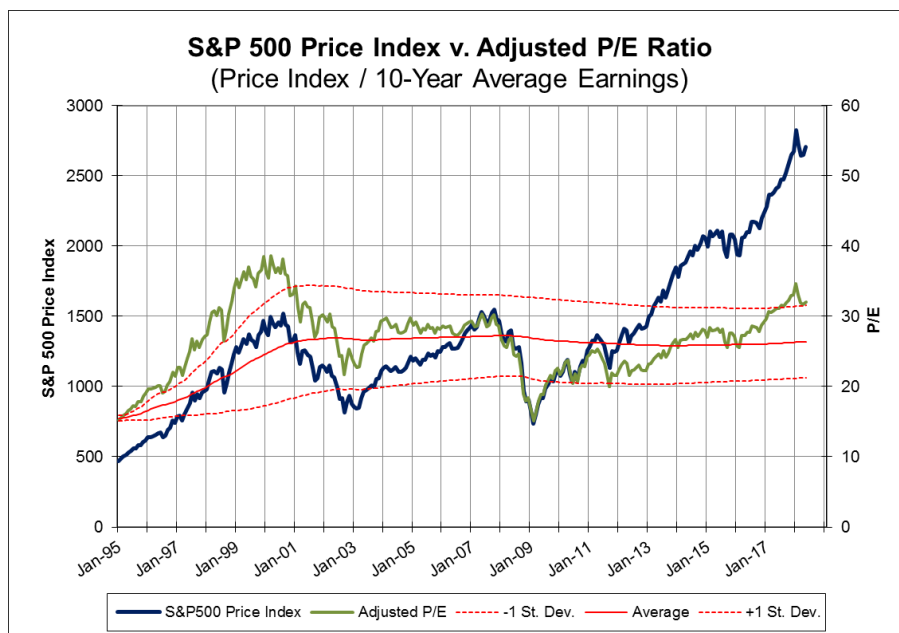
Monthly Market Comment June 1, 2018

Returns were positive, but relatively modest, across most U.S. financial markets during May. Stocks appreciated for a second straight month, in spite of a sharp sell-off at the end of the period. Bond returns were slightly positive, while real estate and commodities posted healthy gains.

Stocks

The U.S. stock market still seems to be stuck in a wide trading range, but prices drifted upward in May from near the bottom of that range toward the top of it. Stocks still seem caught in a tug-of-war pitting those investors focused on the continued good growth in the economy and strengthening corporate profits against those focused on increasing policy risks. The concerns about government policy came to a head at the end of May, when adverse political events in Italy sparked renewed worries about a European debt crisis. Still, we have the sense that people are now coming to terms with such risks and buying could be strengthening again. The S&P 500 stock price index ended the month up 2.2% from the end of April, and it was up a healthy 12.2% from the end of May 2017. Taking into account dividends, the total return on the S&P 500 was 2.4% in May and a 14.4% over the last year.

Looking forward, we think stocks are most likely to keep rising slowly toward the top of their current trading range, and perhaps beyond. We believe stocks will continue to receive support from the on-going economic expansion around the world and the impact of new tax cuts and government spending hikes in the United States. While inflation pressures are indeed increasing, we don't think they're worsening fast enough to prompt the Federal Reserve to hike interest rates much more aggressively than currently planned. Corporate profits should therefore be able to keep rising. On the other hand, it's important to remember that the continuing policy risks in international trade and national security could unexpectedly undermine sentiment at any time. Since the bull market has pushed stock valuations very high, stocks are now also more vulnerable to a correction.



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Technical indicators also seem to support the idea that stocks could keep drifting upward. For example, the S&P 500 price index is once again sitting above its key simple moving averages (SMAs). The index is now above its 20-day SMA, which in turn is above its 50-day SMA, which in turn is above its 200-day SMA. In our view, that pattern is a strong confirmation that stocks remain in a technical uptrend. In addition, the Dow Jones Transportation Index has recently been out-performing the overall market, which has traditionally been a positive indicator for stocks. Finally, a string of month-end record highs like the S&P 500 posted through January has historically been followed not by an abrupt, sustained downtrend, but by a continued uptrend where the record highs simply start to come less frequently. Of course, some technical indicators are less positive. For instance, market momentum is now much narrower than it had been previously, with only about 60% of the stocks in the S&P 500 trading above their 200-day SMA. In addition, the main short-term momentum indicators (such as the “moving average convergence/divergence,” or MACD) suggest stocks have become a bit over-bought. Most important, the top of the current trading range – 2,786 – will likely be a significant resistance level. If stocks can break above that level, we think they could continue to push higher to new records. If stocks fail to break through that level, we think they would likely remain in their current trading range for some time or even go into reverse. If stocks start to depreciate again, we think the next significant support level would be at about 2,690, with a secondary support level at 2,670.

S&P 500 Stock Price Index + “MACD” Momentum Indicator

Source: BigCharts.com



Bonds

Bonds remained under significant selling pressure throughout most of May, in large part because of continued concerns about strong economic growth, rising inflation, and the risk that the Fed could start hiking interest rates more aggressively. In contrast with equities, however, bonds rebounded strongly at the end of the month on the strength of safe-haven buying related to the situation in Italy. As strong buying pushed up prices, yields fell. The yield on the benchmark 10-Year Treasury Note had reached an 7-year high (intraday) of 3.115% on May 17, but strong bond buying then pushed the benchmark yield back down to 2.822% by month’s end, compared with 2.936% on the last day of April. As measured by the S&P U.S. Aggregate Bond Index, the total return on investment-grade bonds was a positive 0.5% in May, and a negative 0.3% over the last year.

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Looking forward, we think solidifying inflation pressure and increased government borrowing will be a headwind for bonds in the near term, but we are still not convinced that the selling will get too intense. As we have been arguing, we think the renewed volatility in riskier assets has started to remind investors of the relative stability and safe-haven characteristics of fixed-income investments. In addition, the run-up in yields since mid-2016 has made the potential income available from bonds much more attractive, prompting renewed buying pressure. Finally, the risk of policy mistakes has offset some of the concern about excess growth, inflation, and more aggressive interest-rate hikes. We think the strong bond buying at the end of May reflects all those ideas.

Real Estate and Commodities

Publicly-traded real estate investment trusts (REITs) are often challenged when bond yields rise, as has been the case over the last two years. However, as we noted last month, investors finally seem to have recognized that REITs are now a good bargain. REITs began to enjoy increased buying pressure even before the pullback in bond yields at the end of May. As a result, the FTSE NAREIT Price Index jumped 3.4% during the month, although it was still down 1.3% from May 2017. Because of their relatively high dividends, the total return on publicly-traded REITs was a positive 3.6% in May and 2.7% over the last year. Looking ahead, we believe the outlook for these REITs is modestly positive, so long as economic growth continues and bond yields don't rebound too much.

For commodities, the S&P GSCI Total Return Index rose 1.4% in May, marking its third straight monthly increase and bringing its gain over the last year to a strong 25.8%. Energy commodities have been the main source of the uptrend, with prices for crude oil and refined products surging as investors realized that virtually all excess supply around the world has now been eaten up by constantly increasing demand and constrained production. Coupled with the possibility of reduced exports from Venezuela and Iran, that helped push prices higher through most of May. In contrast, easing tensions with North Korea helped pull down gold prices. Values for industrial metals were flat to higher. Agricultural commodities were generally flat-to down, but lumber prices surged to nosebleed levels as a result of the administration's recent imposition of punitive tariffs on imports from Canada and bottlenecks in rail transport. Going forward, a big potential problem for the commodity complex is that Saudi Arabia and Russia have signaled they want to boost crude oil output and push prices lower. We still think rising demand and falling supply from some major producers will buoy crude prices and keep the overall commodity index on a modest upward path, but the downside risk has clearly increased.

Patrick Fearon, CFA
Chief Investment Officer

Asset Class	Index	Ending Reading, Latest Month	1-Month Change	3-Month Change	12-Month Change
U.S. Stocks	S&P 500 Price Index	2,705.27	2.2%	-0.3%	12.2%
Non-U.S. Stocks	MSCI All-Cap World Ex-U.S. Price Index	295.77	-2.8%	-3.6%	6.9%
REITs	FTSE NAREIT All-Equity Price Index	654.45	3.4%	6.9%	-1.3%
Commodities	S&P GSCI Total Return Index	2,783.92	1.4%	8.9%	25.8%
Bonds	S&P U.S. Aggregate Bond Index	190.90	0.5%	0.4%	-0.3%

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