notes increased 26 basis points (0.26%) and 12 basis points (0.12%), respectively. The yield curve flattened by 14 basis points (0.14%) and ended the quarter at 33 basis points (0.33%), its tightest level since 2007.

The Fed contributed to the jump in short-term yields in the quarter by raising the federal funds target range 25 basis points (0.25%) at the June meeting of the FOMC.

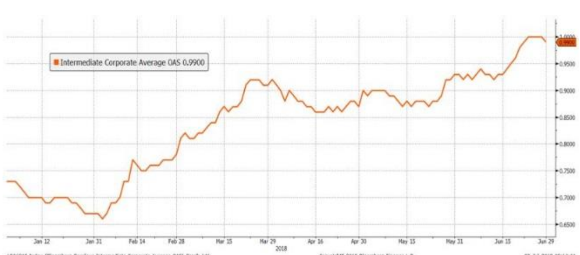
The Fed also indicated that, given robust U.S. economic growth, an additional two rate hikes, at 25 basis points (0.25%) each, may be needed this year to keep the U.S. economy from overheating.

Based on economic data received to date for the second quarter, annualized economic growth is expected to surpass the roughly 2.0% annualized growth rate the U.S. economy has experienced since June 2009. Company earnings and revenues have bene[redacted]d, whi[redacted]as le[redacted] healthier company fun[redacted]enta[redacted]

Despite the favorable envi[redacted]nt for corporate issuers, investors favor[redacted] government bonds over investment[redacted]de [redacted]orate issue[redacted] during the quarter, [redacted]ng to [redacted]ning cr[redacted] spreads, a common[redacted]urrence this[redacted]r.

This is illustrated in the graph below, which reflects that, through the first six months of the year, the Bloomberg Barclays Intermediate Corporate Average option-adjusted spread (OAS) increased 26 basis points.

Bloomberg Barclays Intermediate Corporate Average OAS: 1/2/2018 – 6/29/2018



Source: Bloomberg Finance L.P.

In the quarter, intermediate U.S. government bonds returned six basis points (0.06%), compared to intermediate U.S. corporate issuers, which were down 10 basis points (-0.10%). Overall, the Bloomberg Barclays U.S. Intermediate Government Credit Index finished the quarter mostly unchanged, up a very modest one basis point (0.01%).

Widening credit spreads were partly due to ongoing trade war rhetoric and rising tensions among U.S. trading partners. The potential negative impact to economic growth led to increased risk aversion and demand for U.S. government securities.

Also worth noting, given higher levels of corporate debt after many years of low borrowing costs, investors are looking closely for indications that corporate credit metrics are deteriorating.

[redacted]jump [redacted]nd yield[redacted]ar in 2018, coinciding [redacted]th a flat[redacted]yield[redacted]rve, has reduced the incentive to e[redacted]oo far out on the yield curve. We con[redacted] to believe the short to intermediate [redacted] yield curve provides the [redacted]st favora[redacted]isk/r[redacted]n trade-offs. Corporate [redacted]amen[redacted]remain s[redacted], and we continue to fav[redacted] high-grade issuers, given the additional yield pickup over U.S. government securities.

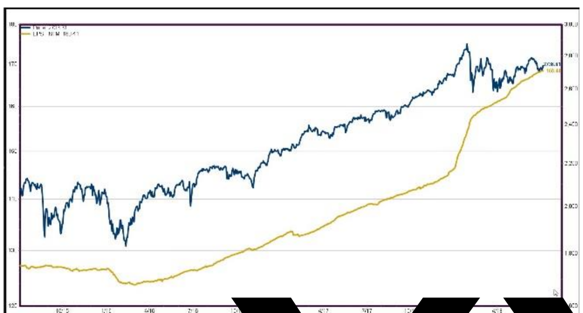
Looking Ahead

We remain optimistic about the trajectory of economic growth and corporate profitability over the near term. In the first calendar quarter of 2018, quarter-over-quarter earnings growth came in at a strong 25%, driven by solid top-line (sales) growth of 8.5%. Expectations are for a good second-quarter earnings reporting season.

The graph below tracks the price of the equity market, as measured by the S&P 500 Index (blue line), and the growth in projected earnings per share (gold line). We have been watchful of the "gap" between stock price growth and underlying earnings, and have held the view that further gains in stocks would need to be supported by earnings, not expansion of valuation.

Since the beginning of the year, earnings growth has accelerated faster than price. This confluence of events has caused the forward price/earnings ratio (P/E) of the S&P 500 to decline from over 18 times to a current 16.1 times forward earnings.

S&P 500 Price vs. Next-12-Month Earnings Per Share: Three Years Ending 6/30/2018



Source: FactSet, Inc.

At this juncture, we are in an extended period of economic expansion and positive equity market returns. The risks of policy errors (faster monetary tightening) or overheating demand (commodity and/or wage inflation) can more easily tip the scales at this stage of the cycle.

We affirm the importance of diversified equity and shorter-duration fixed income portfolios, and we see the potential for incremental returns in a more risk-sensitive environment.

Ernest E. Cecilia, CFA
Chief Investment Officer
610.254.2030 | ececilia@bmtc.com

Andrew G. Keefer, CFA, CFP®
Director of Equity Research
717.520.5684 | akeefer@bmtc.com

James T. Barnes, CFA, CIPM
Director of Fixed Income
610.254.2012 | jbarnes@bmtc.com

Anthony G. Natale, CFA
Director of Strategic Research
610.254.2005 | anatale@bmtc.com

BMT Wealth Management
bmtc.com/wealth