Market Commentary

Third Quarter 2018

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During the Summer months, US equity markets had their best quarterly return since the fourth quarter of 2013. The third quarter of 2018 saw modest volatility and strong returns as investors focused on strong economic growth and solid corporate earnings to push stocks higher. The benchmark S&P 500 Index rose by 7.7% during the quarter bringing the year-to-date return to 10.5%. Again, we saw volatility concentrated in a few areas like technology and financial stocks. Fixed income yields continued to move slowly and steadily higher with the 10-year Treasury note yielding 3.05% at quarter end, modestly higher than the 2.85% yield at the end of June, and meaningfully above the 2.41% rate at year-end 2017. Thus far in 2018, most bonds are showing very modest returns as yields climb faster than many had expected.

Economic and Market Outlook

Economic data continues to show a very strong economy, with GDP showing the highest rate of growth in several years. Rapid GDP growth, continued low inflation, very low unemployment, and healthy consumer spending boosted by the 2017 tax cuts give us confidence the economic growth can continue for several more quarters at a minimum. As investors, we focus on the corporate earnings this economic growth generates. While acknowledging the current stock market advance has endured for more than nine years, we do not believe a meaningful market downturn is likely, provided earnings continue to grow. Earnings growth is forecast to continue into 2020, which supports our belief that equity markets can continue to move higher along with economic and earnings growth. At the September Federal Reserve meeting, the FOMC moved rates 25 basis points higher and gave indications that they would raise rates one additional time during 2018. For the first time in a decade, the FOMC removed the phrase "the stance of policy is accommodative." Additionally, this brought the Fed Funds rate above the rate of inflation for the first time since the financial crisis over a decade ago. This reinforces our belief we are nearing the end of the tightening cycle, noting that rates have already increased by 200 basis points since the tightening began in December 2015. Importantly, the FOMC raised its median 2018 GDP growth forecast for the fourth time in the past year. They now estimate full year GDP growth 0f 3.1% in 2018 which would be the most rapid growth since 2005.

Tariffs and trade frictions have been in the headlines for the past several months. To grossly oversimplify, we believe in totally free trade with zero tariffs for all. Obviously, this will never occur as most nations seek a competitive advantage for their own goods and services. Trade disputes can get messy and disruptive to economies as well as stock markets. Most world markets have seen declines thus far in 2018 while US markets have held up remarkably well despite the trade rhetoric. Markets abhor uncertainty and that is what the trade disputes are bringing. There is uncertainty regarding the reworking of NAFTA (although it appears a deal was reached in the final minutes of the third quarter), uncertainty about trade with China, and uncertainty that these tariff wars will bring higher inflation and lower economic growth. While these uncertainties may resolve in a negative manner, we believe that if they can lead to reworked trade agreements, the cloud of uncertainty will lift. This would be positive for not only US equities, but international stocks as well. Thus far, based on US GDP growth in 2018, the trade skirmishes are not affecting the US economy to any noticeable degree.

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Oil prices halted their two-year rise during the third quarter, declining to $66 a barrel in mid-August before rebounding to settle at $73.25 at quarter end (using West Texas Intermediate as the benchmark), nearly unchanged from $74.15 at the end of June, which marked the highest price in nearly four years. WTI is now approximately 45% higher than one year ago. A meaningful rise in oil prices from these levels would act as a constraint on consumer spending, reducing growth forecasts. As we wrote in our last commentary, based on current global GDP growth forecasts, oil prices are likely near the top end of their fair value range, barring any major geopolitical events that could cause a short-term supply disruption.

Portfolio Positioning

Client portfolios remain positioned for continued economic growth during the next several quarters. With interest rates continuing to move higher across most maturities, fixed income returns have been muted, although we continue to speak with clients about the need for a balanced asset allocation to weather unexpected downturns, like the one witnessed in February and March of this year. We are happy to earn the coupon on fixed income holdings, using the relative stability of bonds to offset the inherent volatility of equities. Strong earnings growth has ameliorated the valuation concerns that were beginning to surface earlier this year, putting US equities slightly below our estimated fair valuation in late September. As stated earlier, International equities have witnessed a very difficult time in 2018 with many developed markets declining 5%-15% and some emerging markets (Turkey, China, Brazil) falling 35% or more. We acknowledge foreign stocks are now much cheaper than US equities but note their higher current risk levels warrant this discount. We continue to favor US equities over international equities and all equities over fixed income. Additionally, higher yields on certain cash vehicles have made modest cash positions worth considering in portfolios for the first time in many years.

Conclusion

The US economy continues to grow at an above-average rate, with minimal signs of excess or stress. Thus, exogenous forces could be the key driver of financial markets in coming months. We believe the November US elections, the expected wind-down of the Mueller probe, and simmering geopolitical risks may all factor into moving the markets directionally, at least over the short-term. Earnings growth should remain strong into 2020 with current consensus estimates calling for growth in the high-single digits next year. The strong equity returns in the recent quarter has placed stocks just below fair value in our opinion, with future gains dependent on corporate profits. We do not see the catalyst for a sharp pullback in US equities.

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