September 2018 Capital Markets Commentary

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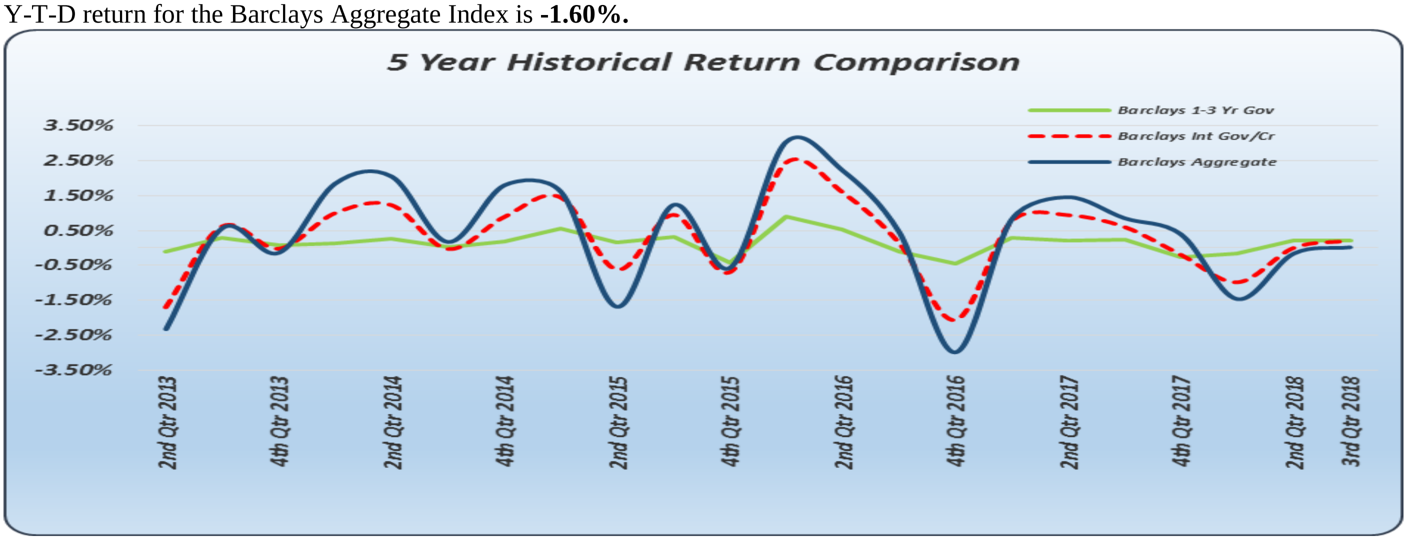
"Many people despise wealth, but few know how to give it away."

Francois De La Rochefoucauld

Fixed Income

Based on solid growth numbers and modest inflation, the FOMC raised interest rates another 25 basis points for the third time this year. This led to slightly positive returns on the short end of the curve and slightly negative returns on the longer end. During the quarter volatility slowed and the 10-year U.S. Treasury yield ended at 3.05%, the highest level since May. As anticipated, the FOMC increased the Fed funds rate in September for the third time this year. Although interest rates rose for the third consecutive quarter, bond yields remain below their historical averages. Credit spreads for US investment-grade and high-yield corporate bonds tightened significantly, while spreads for EM debt stabilized after 2 consecutive quarters of tightening and remain slightly below their historical averages.

Returns were flat to slightly positive across all maturity spectrums. The Barclays Aggregate posted a +0.02% return for the quarter; the Intermediate Index was at +0.21%; and 1-3 year Governments were at +0.20%. The 6 month U.S. T-bill index posted the biggest positive return for the quarter at +0.34%. As a whole, returns for the 3rd quarter were underwhelming. This was due to yields moving higher in all sectors during the quarter. The 10-year Treasury yield ended the quarter at 3.05% after starting the quarter at 2.85%. The 5 year Treasury yield ended at 2.94%; the 2 year Treasury yield ended at 2.81%; and even 1 year T-Bills moved to 2.59%. With the 3rd quarter's upward movement in yields, the 2 to 10 year spread narrowed to 24 basis points to end the quarter. As we continue to see from the chart below, bond market returns over the past five years have been in a low range, now averaging an annual return of approximately 2.10% annualized, as referenced by the Barclays Aggregate Index. The 2018 Y-T-D return for the Barclays Aggregate Index is **-1.60%.**



Fixed Income Markets - Looking Ahead

The Fed raised rates 25 basis points in September. However, recent statements from the Fed could point to slowing rate hikes over the next cycle. With short-end rates moving up and the yield curve flattening, will the Fed continue to raise rates? No one really knows when the Fed will stop hiking rates, but the Federal Open Market Committee gave a new clue in their most recent policy statement by removing the word "accommodative" to describe their approach. Since the Financial Crisis, the Fed has been holding rates artificially low in attempts to fuel the economy – which they term as accommodative policy. Thus, the Fed believes we're in a neutral rate environment where current rates neither help nor hamper economic and inflationary growth. The Fed will need to start defining future rate increases as restrictive soon, which might be a tall task. The Fed's preferred measure of inflation, Consumption Expenditures Price Index, just recently ticked above their 2% target for the first time in six years. A hiccup in inflation growth, which is all too common, won't leave the Fed much ground to stand on.

As mentioned last quarter, we continue to see the Fed targeting higher rates. And although yields in general have risen, the current low-yield environment will probably stay with us in the near future and through 2020.

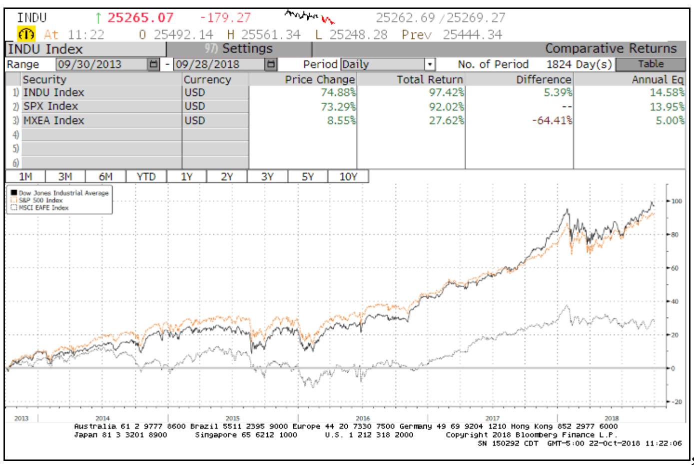
Equity

Domestic equities posted another quarter of positive gains with the S & P 500 hitting new all-time highs. The US stock market continued to grind upward during the third quarter, despite concerns about interest rates and trade wars. The third quarter began with very strong corporate earnings reports and the vast majority of public companies beating consensus earnings estimates. Operating earnings on S & P 500 companies were up 8% during the first quarter of 2018 and showed 6% growth during the second quarter. Economic data continued to be strong, including the largest increase in GDP in four years at 4.2%.

Growth stocks, particularly in the health care sector, spearheaded the risk-on for the quarter in US markets. Historically, the mid-cycle has tended to favor riskier asset classes, while the late cycle has had the most mixed performance of any business-cycle phase. The late cycle often has featured more limited overall upside and less confidence in equity performance, though stocks typically have outperformed bonds.

The foreign equity markets were another story. International stocks continued to underperform versus the U.S. markets in the quarter as the dollar remained strong. Both developed market equities and emerging market equities continued to show weak performance against U.S. markets. For the year, developed and emerging markets now trail the U.S. by 12% and 18%, respectively.

All of the indices below were positive for the 3rd quarter, including international markets. On the U.S. side, the Dow Jones Industrial Index was up the most with a quarterly return of +9.63%. The S & P 500 returned 7.71%, the Russell 1000 returned +7.42%, and the Russell 2000 returned +3.56%. Internationally, the markets struggled to be positive. The EAFE had a small positive return for the quarter, posting +1.42% for the quarter. It seems as though the foreign markets are more worried about a trade war than the U.S., and add to the fact a strong dollar versus other currencies.



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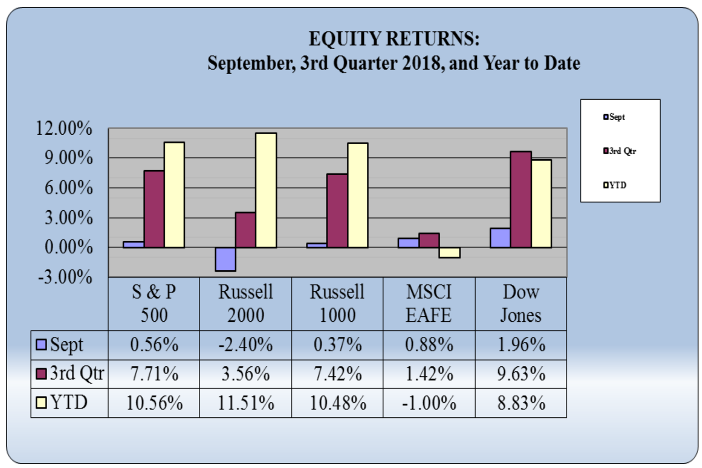

	S & P 500	Russell 2000	Russell 1000	MSCI EAFE	Dow Jones
Sept	0.56%	-2.40%	0.37%	0.88%	1.96%
3rd Qtr	7.71%	3.56%	7.42%	1.42%	9.63%
YTD	10.56%	11.51%	10.48%	-1.00%	8.83%

Equity Markets - Looking Ahead

How will 2018 end up? Wait and see!

Consensus now seems to be that the US economy is in the late stage of the economic cycle. It's not entirely surprising after a nine year bull market, making it one of the longest in history. It remains an unloved bull market as investors are skittishly trying to call a market top and every data point is dissected for potential cracks. It remains to be seen if the market sell-off in early-Q4 is a temporary reset or a material shift. When you dig in to the underlying economic data, there are a slew of conflicting indicators. For instance, GDP, corporate earnings growth, and employment/household income remain robust. Market valuation is still high but less extreme as the multiple contracted YTD. Fed policy remains neutral as they gradually tighten in response to modest inflation and full employment. While rates have risen materially in the last year, spreads still remain tight.

Recent equity market volatility, driven primarily on trade war rhetoric, could subside as long as cooler heads prevail. It seems that trade uncertainty and tariffs are not yet causing significant enough headwinds to offset strong underlying U.S. fundamentals. Market returns are usually expected to be driven by these fundamentals, along with a solid interest rate policy and economic growth. If this environment continues, expectations are that the equity markets will likely be positive through the rest of the year, but probably will not experience the above average returns we saw over the last few years.

Last month we mentioned that in 2017 the equity markets (both U.S. and foreign) had relative tranquility. Well, 2018 has been different. (We have had 2 different 10% down-side corrections). Expect volatility going forward, given the uncertain trade policy and the continued political tumult surrounding Washington.

The Economy

As markets expected, at the Federal Reserve's September Federal Open Market Committee (FOMC) meeting interest rates were increased by 0.25 percent. During the recession of 2008-09, the Federal Reserve decreased interest rates to stimulate lending and borrowing. The Federal Reserve started a rate hike cycle in December 2015 as the economy regained its strength and has raised rates seven times since then, once in 2016, three times in 2017, and three times in 2018.

With the September rate hike, interest rates now sit at 2 percent to 2.25 percent. Based on the "dot plot" of where Federal Reserve members see interest rates going, the consensus is one rate hike this year, three in 2019 and two in 2020. This expected reduction in the frequency of rate hikes is encouraging. It alleviates a concern of investors that the Fed might raise rates too quickly, which might cause reduced investment and slowing economic growth.

The U.S. economy continues to report above-trend data. GDP for the second quarter of 2018 was reported at 4.2 percent, the fastest growth rate since 2014. Looking through the first half of 2018, GDP has grown 3.2 percent.

Consumer confidence rose to its highest level since September 2000, while small business optimism rose to its highest level ever, crossing levels not reached since the 1980's.

For the quarter, although economic indicators continued to trend positively, there were continued worries that other factors could dampen the growth track of the U.S.

The Economy - Looking Ahead

The FOMC will raise the Fed Funds target at least one more time this year. (That is what I said last month)

Right now, the markets expect at least one more rate hike this year, probably in December. However, if the economy starts to weaken and puts more pressure on the lack of wage acceleration, the Fed might pause their rate hike track. Current data puts the probabilities of a December increase at above 80%.

It seems that global economies are slowing. However, macroeconomic indicators still point to a global growth story despite recent slowing indicators. Notwithstanding these trends, several factors show that the risks are still contained. Overall, monetary policy remains accommodative and both borrowing costs and bond spreads are lower than historical averages. In fact, a considerable share of speculative-grade debt expected to mature in 2018 and 2019 has already been refinanced.

With the unemployment rate below 4%, tightening labor markets continue to help boost consumer spending. At the same time, tighter labor markets have put upward pressure on prices, with various measures of wages and consumer inflation showing signs of modest acceleration. Over the past 6 tightening cycles, the Fed has responded to falling unemployment and rising wages by continuing to raise rates, even after the curve inverted. This suggests to us that if wages are rising and labor markets remain tight, the Fed is likely to continue raising rates even if the yield curve inverts.

While the economy and company fundamentals are strong, trade tensions and geopolitical risks could derail recent market gains. If this happens we could be in for a bumpy ride as the year ends.
