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Q3 2018 Market Review

Historically, the 3rd quarter has been a seasonally weak period for U.S. equities. Not so this year, as U.S. stocks saw strong returns in the quarter and handily outperformed both International equities and fixed income investments. The U.S Federal Reserve's gradual tightening of monetary policy along with investor concerns around global trade proved to be strong headwinds for both International equities and bonds in the quarter.

Economic Review

Q3 2018 By The Numbers[1]	Q3 2018	Q2 2018
GDP Est.	3.1%	4.2%
Inflation (CPI)	2.2%	1.8%
S&P 500	7.2%	3.4%
Bloomberg Barclays U.S Aggregate Bond Index	-0.8%	-0.2%
Bloomberg Commodity Index	-2.5%	0.0%

The U.S economy is in the midst of one of its strongest periods of growth this cycle thanks to the fiscal policy boost enacted late last year. GDP in Q2 came in at a robust 4.2%[1] and Q3 growth is estimated at 3.1%[2]. A number of economic data points like leading indicators, retail sales, and both manufacturing and non-manufacturing point to continued economic strength in the U.S. Inflation has ticked somewhat higher and is expected to move slowly higher in the near-term. However, it does seem relatively contained and we don't see a surprise move higher in the near-term. The Federal Reserve estimates 2018 GDP to be 3.1%[3] and that estimate has moved higher as we have moved throughout the year. We recognize that going forward this type of growth is probably not sustainable. We anticipate growth will slow somewhat next year and currently the Fed is pegging 2019 growth at 2.5% . As we move closer to the end of the year we will continue to monitor the prospects for growth in the U.S. and adjust our positioning accordingly.

Outside the U.S, the issues that existed in Q2 continued to weigh on foreign markets in Q3. Trade tensions and tightening monetary policy in the U.S. caused developed international equities and emerging market equities to significantly underperform U.S. equities. During the quarter developed international equities, as represented by the MSCI EAFE benchmark, trailed the S&P 500 by almost 600bps. Emerging markets, as represented by the MSCI Emerging Market Index, underperformed the S&P 500 by almost 900 basis points in the quarter. Year to date, both of these benchmarks are trailing the S&P 500 by considerable amounts. Developed international equites trail by over 1,100 basis points and emerging market equities are behind by over 1,700 basis points.

[1] Source: Factset
[2] Source: Factset
[3] Source: Federal Reserve Board meeting September 26, 2018
[4] Source: Federal Reserve Board meeting September 26, 2018

Economic activity has varied across countries also. A number of emerging markets are seeing a slowdown while more developed economies are seeing more stable growth patterns. We think emerging markets will still see some near-term headwinds as tensions continue. However, developed markets, while still seeing some headwinds, may represent a compelling opportunity. Please see our recent International Equity Market Commentary for a more detailed discussion of the current state of markets outside the U.S.

Equity Markets

US Sector Returns[5]	Q3 2018	Q2 2018
Health Care	14.0	2.5
Industrials	9.5	-3.6
Information Technology	8.4	6.2
Consumer Discretionary	7.2	7.9
Consumer Staples	4.7	-2.1
Financials	3.7	-3.6
Telecommunication Services	2.4	1.5
Utilities	1.3	2.8
Materials	-0.2	2.0
Energy	-0.3	12.7
Real Estate	-0.7	6.8

The equity markets in the U.S. were very strong in Q3 with S&P 500 up 7.2%, the Dow Jones Industrial Average up 9.0% and the NASDAQ Composite up 7.1%. Much like Q2, U.S. equity markets handily beat both developed international equity markets and emerging market equities. Developed international equities were up 1.8% in the quarter while emerging market stocks were down 0.9%.

Corporate earnings continue to be a tailwind for U.S. equities, as Q2 saw operating profits grow over 20% year over year and analysts expect Q3 to see close to 28%[6] growth . That would be the third quarter in a row of 20% or more growth in operating earnings. While this year's earnings strength has been stellar, we are focusing on what 2019 will look like, as earnings comps will definitely be more challenged.

The quarter's strong price performance in the U.S. resulted in a slight uptick in forward earnings multiples. The S&P 500 now sells at just over 18.0x[7] this year's earnings estimates. This compares with around 16.5x[8] at the end of the second quarter. While above long-term averages, we don't view the current valuation levels as prohibitive to stock prices in the near-term.

[5] Source: Factset
[6] Source: Factset
[7] Source: Ned Davis Research
[8] Source: Ned Davis Research

Country - Index Returns (USD)[9]	Q3 2018	Q2 2018
America - S&P 500	7.3	3.4
Brazil - Bovespa	5.8	-27.4
France - CAC 40	4.0	-0.7
Japan – MSCI Japan	3.7	-3.8
Europe - Stoxx 600	1.1	-3.0
Europe - Stoxx 50	1.0	-2.6
Germany - DAX	0.7	-4.1
Emerging Markets - MSCI EM	0.5	-9.7
India - Sensex	-0.3	-2.3
UK - FTSE 100	-1.1	2.5
Hong Kong - Hang Seng	-1.2	-2.8
China - Shanghai	-5.9	-5.3

Emerging market equities were the worst performing equity index for the second quarter in a row. The index return was 0.5% for the quarter which follows the 2nd quarter return of -9.7%. Trade tensions and the U.S. Federal Reserve's continued gradual tightening of monetary policy continued to provide headwinds. China's equity markets continued to bear the brunt of the trade headwinds. The inability of China and the U.S. to make any progress on the trade front caused the China Shanghai Composite to fall into bear market territory during the quarter. The composite has contracted over 20% since its peak in late January of this year. Developments throughout the quarter in Turkey, Argentina and South Africa all proved to limit the ability of emerging market indices to move higher. Economic activity in many emerging markets slowed throughout the summer and it looks like most emerging economies will struggle to return to growth mode in the near term.

Developed international equities performed much better than emerging market equities mostly thanks to a really strong move in the Japan Nikkei during the month of September. The Nikkei was up almost 6% in September and Japan ended up 8.1%[10] for the 3rd quarter. Developed international economies are performing better as they are less influenced by U.S. Federal Reserve monetary policy. Despite recent stock market strength, developed international equities trade at forward price to earnings valuations that are only on par with their 10-year averages[11] . A wide gap has developed in valuations between domestic U.S. equities and international developed markets. The U.S. trades at just below 17.0x while developed international equities trade at 13.0x[12]. Based on both absolute and relative valuation levels, developed international equity markets are starting to look compelling.

[9] Source: Factset
[10] Source: Factset
[11] Source: Ned Davis Research
[12] Source: Ned Davis Research

Fixed Income Markets

Bond Index Returns[13]	Q3'18	Q2'18
SPDR Bloomberg Barclays Convertible Securities ETF	1.7	3.3
iShares iBoxx High Yield Corporate Bond ETF	1.6	0.6
SPDR Blackstone/GSO Senior Loan ETF	0.8	0.2
iShares iBoxx Investment Grade Corporate Bond ETF	0.3	-1.5
iShares J.P. Morgan EM Corporate Bond ETF	0.0	-2.2
iShares 1-3 Year Treasury Bond ETF	-0.3	0.2
iShares Core U.S. Aggregate Bond ETF	-0.8	-0.2
iShares Mortgage Bond Securities ETF	-0.8	0.3
iShares U.S. Preferred Stock ETF	-1.5	1.8
iShares 20+ Year Treasury Bond ETF	-3.7	0.5

Much like Q2, the bond markets struggled in the face of higher interest rates. In the U.S., the Barclays Aggregate Index was down 0.8% in the quarter. The Federal Reserve raised the Federal Funds rate in September for the 8th time this cycle to a range of 2.00%-2.25%. Expectations are for one more 25 basis point hike this year and potentially four more next year.

Credit sensitive bond classes actually had decent performance this quarter relative to the Barclays Aggregate despite higher rates. High Yield continues to have a decent year with a positive 1.6% return in the quarter. Floating rate loans were also positive, up 0.8% during the year. Floating rate loans have very much been in favor during this rising interest rate cycle. Troubles within the credits markets have been non-existent and credit spreads continue to be very narrow. We don't see this changing in the near term but still, given the narrowness of the spread, we find taking bigger positions in the credit side of the bond market to be unattractive as the risk/reward going forward tilts more toward the risk side of the equation.

Given that the Federal Reserve will continue to raise rates for at least the next six to nine months, we favor being below the benchmark from a duration standpoint. We recognize that the Fed is closer to the end than the beginning of its interest rate cycle and as a result we are sensitive to the fact that we may need to adjust our positioning sometime soon. We are analyzing with great effort what the bond portfolio should look like in light of an interest rate cycle that, again, may be closer to the end than the beginning.

[13] Source: Factset

Summary: Our Focus for the Rest of the Year

In summary, we continue to favor an overweight position in equities versus fixed income and domestic equities versus international. We are keenly aware that the dynamics of the capital markets are presenting opportunities all the time. Maybe international equities are that opportunity today. Maybe it's something in fixed income. As we have mentioned many times before, we study these opportunities with an eye towards the right risk/reward balance. The return potential has to exceed the potential risk we are taking with our client's capital. If expected returns do not outweigh perceived risks, that investment will not make it into the portfolios. We are constantly striving for the right balance that will allow our clients to achieve the returns they are targeting. Please give us a call if you want to talk about anything mentioned in this update in more detail.

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* Forward Price to Earnings is price divided by consensus analyst estimates of earnings per share for the next 12-months
** A basis point is commonly used to express differences in expenses or interest rates. 1bp=0.01%

Bloomberg Barclays U.S. aggregate bond: The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. invest¬ment-grade fixed-rate bond market, including both government and corporate bonds.
S&P 500: The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg Commodity Index (BCOM) is a broadly diversified commodity price index.

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Stock investing involves risk including loss of principal.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.
Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. It is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. The bigger the duration number, the greater the interest-rate risk or reward for bond prices.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Floating-rate loans are often lower-quality debt securities and may involve greater risk of price changes and greater risk of default on interest and principal payments. The market for floating-rate loans is largely unregulated and these assets usually do not trade on an organized exchange. As a result, floating-rate loans can be relatively illiquid and hard to value.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

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