ECONOMIC & MARKET REVIEW

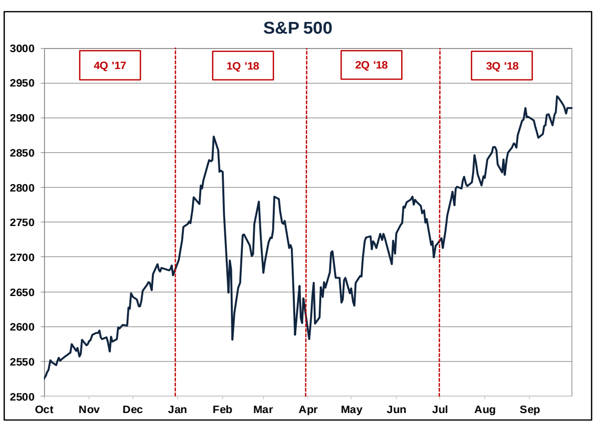
Third Quarter 2018

U.S. equity engine continues to hum; bond markets flat

The U.S. equity market had its best quarter in many years in Q3 with the S&P 500 up 7.71% and Small Cap stocks up 3.58%. While the U.S. economy and stocks are doing well, bonds have been a different story. The Bloomberg Barclays Index was flat for the quarter (+0.02%). International developed markets ticked up slightly to gain 1.35% while emerging markets continue to struggle with a 1.09% decline for the quarter.

Q3 and YTD Investment Performance

	Third Quarter	Year to Date
S&P 500	7.71%	10.56%
Russell 2000	3.58%	11.51%
Barclays Agg.	0.02%	- 1.60%
MSCI EAFE	1.35%	- 1.43%
MSCI EM	- 1.09%	- 7.68%



Source: Factset Research. As of 09/30/2018

Confidence remains high – at least at home

Consumer and business confidence have been very strong all year, reflecting a generally ebullient attitude regarding the U.S. economy. It's easy to understand why with the unemployment rate below 4%, continued increasing wages and corporate profits up 20% year over year. Individual and corporate income tax cuts from the beginning of 2018 are another reason for continued optimism. The tax package included an incentive for corporations to make capital expenditures sooner rather than later. Capex spending plans have jumped higher as a result, with actual spending for big ticket purchases such as buildings, equipment and machinery still to follow.

What to expect: Uptick in spending on buildings, equipment and machinery will continue to fuel the economy in 2019

Housing starts, typically a major contributor to growth post recessions, have improved but remain far from previous peaks. The housing market was at the epicenter of the 2008 meltdown and has been slow to recover. Housing has not been the piston that has driven the economic recovery this time. I doubt it will be the reason things fall apart, either, but it does matter at the margin. We've probably underbuilt new homes which put upward pressure on existing homes.

International scene puts a damper on the global economy with growth and interest rates lower than the U.S.

The picture is less rosy once you look outside the U.S. at YTD results for international equity markets. Developed markets were down 1.4% YTD and emerging markets posted a 7.68% decline. Well-publicized trade disputes with the U.S. have been an additional burden on top of already modest growth. Notably, China and Germany are export driven economies, and tariffs have an outsized negative impact on their economies. The U.K. is struggling with both themselves and the E.U. over Brexit while Italy's new government is arguing with the E.U. over just about everything. China is stimulating their economy in an attempt to overcome the drag of the tariff conflict with the U.S. And – if it's even imaginable – Venezuela has imploded with (among other problems) an annual inflation rate of…1.37 million percent. Imagine if something that used to cost $1 now costs $100,000. Something has to give there.

What to expect: Now that the U.S. trade deal with Canada and Mexico is done, expect President Trump to focus on a deal with Europe and Japan next. That leaves China, which will be the toughest deal to cut, but a united front by the U.S. and its trade partners will provide better leverage.

The two key objectives for a trade deal with China will include dealing with the theft of intellectual property followed closely by their policy of forcing U.S. companies to turn over technology so it can be replicated. Those business models are imbedded in the Chinese economy, and the Chinese won't give them up easily. We can expect friction during the process – which feels bad – but if you don't have friction you don't get the results you want. There's no way to get trade deals done if one side thinks the other one is bluffing.

With all of these international challenges, I don't see the global economy on the verge of overheating and bringing with it dramatically higher interest rates. In fact, leading economic indicators for developed economies have been flat for the last several years even with the U.S. doing well this year.

Gradual rise in interest rates is a sign of a healthy economy.

Bond and equity markets have diverged this year with stocks doing well and fixed income understandably down year to date as interest rates have edged up. Average hourly earnings have increased slowly for the last three years while inflation has moved up modestly, and, finally, cash returns are no longer stuck at zero. These are all good indicators for workers and for the economy overall. Interest rates at near zero is an aberration and not healthy for the economy. The Fed's three interest rate hikes this year (with a fourth forecast for December) are a sign that the markets are working their way back to normal. If we consider an alternative scenario where growth returns and rates continue to hover near zero…well, something would be very wrong. The rate rise this year has been a relief.

What to expect: Higher rates don't mean the end of the bull market in stocks – but don't look for 25% year over year earnings growth through 2019.

The most problematic impact on both the economy and equities market would be a shockingly sharp rate increase over a very small time frame – in essence, the Fed slamming on the brakes vs. the gentle taps that we've seen over the past few years. At this rate, earnings should still be good through next year, albeit likely at a slower pace.

And then – there's the election.

It's typical for the President's party to lose seats in midterm elections. The Republicans currently have control of both the Senate and the House. History suggests the Democrats probably will gain seats. Only twice in the last 21 midterm elections (that's 42 years) has the President's party gained seats in both the House and the Senate. Market volatility increases in election years, but I don't expect much movement regardless of which party "wins" the midterms.

What to expect: It's typical to see markets do better just before or after the election as the uncertainty dissipates. Politics can make everything seem abnormal. Look beyond the short term volatility to what will likely be a solid foundation for both the markets and economy over the next year.

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