Third Quarter Market Review and Comment
October 2018

Updated Market Performance

Returns	3rd Quarter 2018	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**7.71%**	**17.91%**	**17.31%**	**13.95%**	**11.97%**
DJIA	**9.63%**	**20.76%**	**20.49%**	**14.57%**	**12.22%**

Performance: The S&P 500 soared in the 3rd Quarter posting the best quarter since the end of 2013.

After modest returns in the second quarter 2018, the S&P 500 (SP500) posted a solid 7.71% return in the quarter that just ended on September 30, 2018. The Dow Jones Industrial Average (DJIA) bested the SP500, posting 9.63% over the same period. For the previous twelve months the SP500 has returned 17.91%, underperforming the DJIA which returned 20.76% over the same period. The annualized three-year returns are strong, with the SP500 posting 17.31%, while the DJIA is running at 20.49%. Over the last five years the annualized returns continue to run ahead of historical norms, with the SP500 returning 13.95% and the DJIA posting 14.57%. The ten-year annualized numbers are running above long-term averages (around 10.00%); the S&P500 posted 11.97% vs the DJIA which turned in 12.22%.

Breaking down the returns for the third quarter 2018, we note that there were five outperforming sectors and six underperformers. **The best sectors were Healthcare (14.04%), Industrials (9.46%) and Information Technology (8.49%)**. **The losers during the quarter were Materials (-0.15%), Energy (-0.11%) and Real Estate (-0.02%).** Over the past year the growth sectors have continued to dominate their value counterparts. The clear winners the last twelve months were Consumer Discretionary (30.77%), Technology (29.85%) and Healthcare (16.38%). Bringing up the rear were Communication Services (-1.12%), Utilities (-0.63%) and Consumer Staples (-0.09%). We note that only three sectors (Information Technology, Consumer Discretionary, and Healthcare) were above the SP500 average for the year, so the advance has continued to be narrow.

The DJIA managed to rebound strong in the third quarter as some trade tensions relaxed. However, trade tensions continue to be visible and the blue-chip index is still vulnerable to further volatility. More than half of the 30 Dow components get 50% or more of their revenue from outside the U.S., according to FactSet. The SP500 by comparison derives 38% of revenue from outside the U.S.

Economy: As projected U.S. growth in the second quarter recovered, posting a 4.2% increase.

The third estimate of second quarter Gross Domestic Product (GDP) is 4.2% according to the report released at the end of September by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the first quarter accelerated by ~2.2% compared to the first quarter 2018 when GDP was running at a rate of 2.0%. Overall, the economic recovery has continued in 2018 following growth of 2.3% in 2017 and 1.5% in 2016. The long slow recovery which has been in place since mid-2009 should continue for the foreseeable future. By comparison, China says their GDP

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grew at 6.7% in the second quarter of 2018. China's economy has clung to the lower end of its growth range (6.7%-6.9%) over the last three years. Slowing to 6.7% for the second quarter as exporters continued to brace for bruises as the government's efforts to tackle debt risks crimped economic activity and a trade war with the United States threatens exports. Growth rates for the European Union (EU) and the Euro area beat expectations in 2017 to reach a 10-year high of 2.4%. Growth rates for the second quarter were 2.1% for both the EU and the Euro area.

Unemployment continues to stay historically low. According to the Bureau of Labor Statistics, September unemployment fell 0.2% to 3.7% from 3.9% in August, the last time the unemployment rate maintained an average of 4.0% or lower was in the 1960s. Job growth occurred from professional and business services, healthcare, transportation and warehousing.

Inflation decreased in the third quarter. After averaging 2.73% in the second quarter, inflation as measured by the Consumer Price Index (CPI) decreased to an average of 2.63% in the third quarter. The average rate of inflation for 2017 was 2.1% and continues to be subdued by historical standards (2.64% over last 30 years).

Consumer spending continues to be an important driver of the economy. The U.S. Census Bureau announced this month that retail sales for September 2018 were up 0.1% compared to August but were up 4.7% above September of 2017. Gasoline stations and Non-store Retailers were up 11.4% from June 2017.

Manufacturing economy had growth in manufacturing for the 25th consecutive month. Economic activity in the **manufacturing sector** grew for the twenty fifth consecutive month in September, with the Purchasing Managers Index (PMI®) registering 59.8, a slight decrease from August's reading of 61.3. This was led by a continued expansion in new orders, production, and employment. However, inventories continue to struggle to maintain expansion levels as a result of supplier deliveries slowing further. The **overall economy** grew for the 113th consecutive month, according to the nation's supply executives in the latest **Manufacturing ISM®** *Report on Business®*.

Home prices continue to rise, but at a decreasing rate. According to the S&P Case-Shiller Home Price Indices home prices rose in July with the S&P CoreLogic Case-Shiller National Home Price Index rising 6.0% over the last 12 months. Cities west of the Rocky Mountains lead price increases with Seattle, Las Vegas, and San Francisco having the largest price increases. The favorable economy has continued to support recent gains in housing. There continues to be a low supply of homes for sale which is another factor that is leading to rising prices as demand continues to outweigh supply.

Markets: Recent market volatility should calm as we continue through the holidays.

- **Earnings growth is expected to come in at double digits for the third & fourth quarter.** According to FACTSET, of the 24 SP500 companies that have reported earnings as of 16 October, 86% reported earnings above the mean estimate and 68% have reported sales above the mean estimate. The blended earnings growth rate for the third quarter is 19.1% so far, it will mark the third highest earnings growth since Q1 2011 (19.5%) if the current momentum continues. **Earnings guidance is too early to tell with only 4 companies issuing negative EPS (Earnings per Share) guidance and 3 issuing positive EPS guidance**. Currently companies are seeing more of a negative impact from FX (Foreign Exchange) than from tariffs.

- **Stocks are fairly valued.** The current 12-month forward Price Earnings (PE) multiple on stocks is 16.8. The long term (20 Year Average) PE for stocks is 15.9, so we still do not see much evidence of a bubble in stock prices, but we also do not see compelling values either. Bears will make much over the fact that current forward PE's are above the 10-year (14.5) average. However, the ten-year numbers still include those years 2008-2012 when PE's were abnormally depressed after the Financial Crisis and during the Great Recession. With little room for PE expansion, we will need an increase in earnings to sustain the continued bull market.

- **Global Trade Tensions still exist.** Trade tensions continue to be present, which has cast a cloud of uncertainty in the market. With new trade concerns in the news consistently, the likelihood of real measurable impacts on U.S. businesses from domestic trade tariffs and retaliatory measures increase.
- **Rising Interest Rates.** The Federal Reserve raised the target range for the federal funds rate by a quarter of a percentage point to a range of between 2.00% and 2.25% during its September meeting. The increase predicated by the continued strength of the labor market and strong economic activity. Policymakers projected one additional hike by the end of this year. Fed officials expect further gradual increases in the target range for the federal funds rate that will be consistent with sustained expansion of economic activity, strong labor conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term. Risk to the economy appear roughly balanced.

Forecast: A stellar 3rd Quarter has led to an October that has given back a lot of gains.

Continued global growth, low unemployment, and low inflation. Lower corporate tax rates are continuing to add to growth meaningfully as spending has picked up. However, tariffs and currency translation have begun to impact profit margins. Fiscal stimulus will soon be in the rearview mirror, interest rates continue to rise, and tariffs are beginning to make their impact, growth will begin to moderate. Unemployment has reached lows not seen since the 1960s. Inflation continues to run below average.

Earnings Growth & Maintained/Increasing Profit Margins. This is what is needed to get the market out of its current negative sentiment. Ever since hitting a market high in early October the market has struggled to maintain the gains achieved during the third quarter. Strong earnings and revenue growth should be enough to reverse our current negative momentum and head back to test the high reached in October.

What risks are out there that might disrupt a robust finish to the year?

- **Negative earnings guidance and negative earnings surprises**. There is already an anticipation of negative earnings guidance from SP 500 companies for their next earnings report due to tariffs impacting margins. If earnings come in worse than expected, stocks will continue to give back gains earned earlier this year. Valuations are already "feeling" elevated, weak earnings on top of that would likely give investors another excuse to sell. The probability of this scenario is medium but could increase if we continue to see an increase in negative earnings guidance.

- **Continued Fed Tightening**. Given the recent low inflation, low unemployment and strong economic growth, we think the risk of rate increases by the Fed are high. The fed has made three .25% increases so far this year and unless we see some meaningful increase in inflation we should only have one more .25% increase the rest of 2018. **Nine of the last eleven recessions have occurred during a rising interest rate environment when short term rates were higher than long term rates (Inverted Yield Curve), which leads to our ongoing concern of the Fed raising rates too fast.**

- **Global trade tensions.** A trade war will hold back business and consumer spending, leading to a slowdown in economic growth.

We think the biggest threat to the stock market is the uncertainty presented by the current trade negotiations as well as the impact of rising interest rates. This uncertainty will persist until there is clarity over what potential retaliatory tariffs might be and what the final resolution will be on the trade front. Rates on the long end of the yield curve have spiked recently, which has added to the near-term weakness in stocks. It has not taken much pessimism to break the market out of its trading range to the downside. I was wrong when I forecasted the third quarter would be flat to up 2.0%. We ended up having our best quarter since 2013. The SP500 ended the third quarter at 2,914 and is up 10.56% including dividends year to date. We think the SP500 will end the fourth quarter between 2,950 and 3,000. At this juncture, we venture a guess that stocks will end up somewhere between 12%-13.0% for the year.

For the next six months, the Federal Funds rate should remain near 2.25%-2.50%. **The 10-year Treasury which is currently priced at 3.16% may rise above 3.25% before the end of the fourth quarter.** By year end we should see the rate between 3.25%-3.50% assuming the FOMC (Federal Open Market Committee) raises short-term rates one more time by year end.

We appreciate your continuing confidence in our firm. Please let us know if you have questions.

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Chief Investment Officer

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