Third Quarter 2018
Market Review & Outlook

FELTZ WEALTHPLAN
A REGISTERED INVESTMENT ADVISOR

Market Summary

Q3 2018 Highlights

- Growth vs. Value Disparity Accelerates
- Bond Yields Trend Higher
- Asset Allocation Struggles
- Equity Risk Premium Resets

During the most recent quarter, consumer and small business sentiment hit cycle highs while corporate earnings remained on track to grow at the fastest pace since 2010, north of 25% year-over-year. The economy, helped by recent fiscal stimulus, could be set for its best annual growth tally of this decade-long economic recovery, a remarkable feat at this stage of the cycle. And yet fading sentiment towards international stocks and the implications of rising rates/inflation has minimized the benefits to global equity prices as we enter the last quarter of 2018.

During the quarter, the S&P 500 rallied 7.7% while the MSCI All Country World (ACWI) ex-U.S. index advanced less than 1%. Emerging market stocks, as measured by the MSCI EM index declined 1%. For the year, the S&P 500 was ahead 10.6%, including dividends while the ACWI ex-U.S. and EM indices were down 3.1% and 7.7%, respectively. U.S. bonds, as measured by the Bloomberg/Barclays US Aggregate Bond index were down 1.6% YTD through quarter-end as interest rates continue to rise.

Growing trade disputes and the strong dollar have taken a serious toll on international markets over the past 6 months. While the U.S. has appeared insulated from these headwinds thanks to its unique fiscal stimulus measures and healthier economic momentum, investors were awakened from relative complacency during the first couple weeks of October with a swift correction in the S&P 500 highlighted by weakness in some of the tech and momentum leaders. Investors may be starting to reassess risk assets, including high growth stocks, in the wake of new interest rate levels and a perceived more “Hawkish” Fed, as well as the inflation ramifications of protectionist trade policies and other threats to successive earnings trajectory. Or this could be just another patch of noise, time will tell.

The spectacular earnings growth this year, that is partly but not entirely due to corporate tax reform, will create higher hurdles for next year in which we will be layering on the inflationary ramifications of a tighter employment market, in-effect trade tariffs, and higher commodity prices, along with rising debt financing costs. All factors that have the risk of pressuring record high profit margins, even with a strong revenue base like we have had so far this year.

Stocks are a forward-looking discount mechanism and sentiment, like what we have seen this year towards interest rates, inflation & geopolitical concerns, can and often does outweigh fundamentals. Even with the trend of global synchronized growth becoming desynchronized to U.S. expansion, global markets are still on pace to post strong underlying growth numbers this year. For instance, corporate earnings in emerging markets are on pace to grow 16% in 2018, yet EM stocks recently entered a bear market, down over 20% from January highs. Even the U.S., with all the enthusiasm of a strong economy and surging corporate earnings, has seen a sizeable haircut in valuations due to rising rates and other apparent risk factors. It is also possible that some of last year’s gains were pricing in some of this year’s good news.

Whether the market is accurately discounting more challenging times ahead is difficult to know at this point. Many transitory risk factors have come and gone during this long bull market. Regardless, the impact of sentiment and the unknown on market prices is another reminder of why overconfidence based on the current pulse of fundamentals should not dissuade investors from diversification and long-term investing.

Growth vs. Value Disparity Accelerates

Since October 2007, large cap value stocks have advanced 89.5% which includes the 2008-2009 bear market. That is impressive until you consider that large cap growth stocks over that same time are up a cumulative 193.4%. While this return spread has been persistent for the duration of this bull market, the disparity has really blown out over the last two years. Year-to-date through September, large cap growth stocks were up 17.1%, while large cap value stocks were up only 3.9%.

Source: FactSet as of Sept. 25, 2018

In a world of low growth and historically low interest rates, investors are happy to pay premiums for growth potential. A good portion of the relative performance differential has come from higher earnings growth, but the valuations investors are paying have also widened in recent years. In terms of relative P/E ratios, growth stocks have not been as expensive vs. value stocks in 17 years, the tail end of the dotcom bubble.

The sector makeup of growth vs. value stocks has a lot to do with the disparity. Financial companies comprise over 30% of the Russell 1000 (large cap) Value index and over 40% of the Russell 2000 (small cap) Value index. Technology stocks comprise less than 10% of both the Russell 1000 & 2000 Value indices, but comprise over 30% of the Russell 1000 Growth index and 20% of the Russell 2000 Growth index. Rising rates (a tailwind for banks) and compressing growth premiums could be the catalysts that toss the baton back to value in coming years.

Bond Yields Trend Higher

The nearly 40-year long bond bull market likely peaked in July 2016 when the 10-year yield hit a record low under 1.4%. Now with a healthy labor market and moderate inflation, the Fed feels comfortable accelerating its rate normalization path and interest rates have moved progressively higher. The 10-year yield breached the 3.25% level in recent weeks, a 7-year high.

For those who depend on low rates for financing or valuing risk assets, the proverbial ‘punch bowl’ is still technically flowing but the party is entering the late hours. Not only are short-term rates moving higher, driven by Fed policy, but the Fed’s $4.5 Trillion balance sheet is now in net redemptions to the tune of ~$40B/month. Other global central banks are also moving that direction, even if at a more glacial pace.

Long-term rates are driven more by supply and demand and with the largest bond buyer (central banks, including the Fed) now a net seller, along with a growing fiscal deficit, it seems highly likely that this excessive bond supply will continue pressuring rates higher. Not all bonds are created equal, however, as some fixed income sectors will do better than others in this environment. This is quite a change from the past few decades in which bonds were almost indiscriminately great levers for portfolio risk-return contributions. At some point we will be glad this reset occurred since savers will be rewarded, but for now the returns for bonds overall will remain challenged and the interest rate risk may surprise those that have passive exposures.

Asset Allocation Struggles

Nobel Prize-winning economist Harry Markowitz, the father of *Modern Portfolio Theory*, called diversification “the only ‘free lunch’ in finance.” The concept being that the lack of correlation, or different return paths of various asset classes, helps to create a more harmonious blended return profile for a portfolio over time, with less risk.

Unfortunately, a decade-long divergence in U.S. and ex-U.S. stock performance, along with a bond market being re-priced from higher rates has created an increasingly difficult stretch for portfolios that maintain diversification mandates. Comparing the return of the S&P 500 to various target-date funds or asset allocation strategies has rarely, if ever, had so much variance. Doing so with such positive momentum in the U.S. economy where home bias influences investor decisions also has the potential to bait investors out of diversified allocations.

Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.

As it relates to international stocks, the short-term will continue to be driven by sentiment, but we think over the next 3 to 5 years, investors will be rewarded for sticking with these allocations. Consensus rarely breeds opportunity and a near 3 to 1 return differential over the past decade has led to despondency towards the merits of international allocations. As for bonds, investors will continue to face short-term pain as rates trend higher, but proper active positioning can help retain portfolio risk benefits and minimize headwinds during this reset.

Equity Risk Premiums Resets

Without a major breakdown in leading indicators for the economy, which we have yet to see, we would not expect this bull market to come to an abrupt end. We see it as more likely that as rates rise, equity risk premiums will have to be adjusted, at times in a nonlinear fashion. Elevated valuations in certain pockets of the market, like technology stocks, could be more susceptible to these spells of volatility.

Although the stock market has become increasingly dominated by the major tech titans in recent years, we have actually seen a healthy level of sector breadth over the past few months. For example, health care stocks were the best performing sector last quarter, up 15%, while industrials and consumer staples were up 10% and 6%, respectively.

Midterm elections are sure to provide some fireworks in the remaining months of the year, but the big test for the market will be the follow-on earnings story in 2019/2020, which will have diminishing benefits from recent fiscal stimulus. If interest rates end up spiking quicker than expected, we would expect a challenging backdrop for risk assets. If not, the recent correction in valuations should be a welcome sight for those who are still putting money to work for the long-term.

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