

3<sup>rd</sup> Quarter 2018 Update

A strong economy and rising earnings helped the S&P 500 post a very strong 7.71% return for the quarter, and the index is up over 10% for the year. The health care and industrial sectors were among the better performers for the quarter while the energy and materials sectors lagged. For the year, growth investing has significantly outperformed value, and domestic equities have outperformed international by over 11%. Emerging markets have been particularly weak and are down (-7.39%) for the year.

In September, the U.S. Federal Reserve raised interest rates .25% to a range of 2.00% - 2.25% with the expectation for another .25% increase in December. Rate increases should be taken as a good sign as they indicate that the overall economic environment is improving, but as interest rates have risen during the year, the fixed income space has been under pressure and generally produced weak returns (Barclays Aggregate is down -1.60% for the year). On the bright side, higher rates are providing more income for investors as yields have improved.

The employment situation continues to be strong, and overall, the U.S. economy is doing well, which should continue to produce strong corporate earnings. While we are currently in an economic sweet spot (good growth with moderate inflation), the strength in the economy is causing some concern regarding rising inflation and the Fed responding with faster rate increases. Since rising rates increase business and consumer costs and impact company earnings and ultimately the stock market, it's very important that the Fed gets the pace and magnitude of rate increases correct. If the Fed moves too quickly, they could derail the economy, but if they move too slowly, inflation could get out of hand. It is a fine line to walk. Inflation risk is one of the more important investment factors to watch for the remainder of the year and into 2019.

In addition, a trade dispute with China has injected a great deal of uncertainty in the markets. The tariff discussion seems to be more about politics than economics and should be resolved without an all-out trade war that raises prices (inflation) and damages the U.S. and global economies. The recent announcement of a trade resolution with Canada and Mexico (USMCA) is good news and will hopefully lead to something being worked out with China.

Domestic equity market valuations are trading at multiples that are on the higher end of their long-term averages, but valuations have improved as corporate earnings have been strong. Elevated equity valuations and a pricey fixed income market have created a very challenging investment environment as most asset classes are expensive. However, if global growth continues to produce strong earnings without too much inflation, equity markets could continue to grind higher, but investors should expect increased volatility and more modest returns going forward.

Please give me a call with any questions.

Source: Morningstar, federalreserve.gov

The performance data shown represents past performance, which is not a guarantee of future results.

Return data is as of 09/30/2018. Index returns are total returns except for MSCI EAFE which is a net return.