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***October 2018***

**Third Quarter 2018 Financial Market Update**

**Strong Economic Fundamentals Drive Shares to New Highs**

October has a ghoulish reputation. Maybe it’s the October 1929 market crash or the one-day decline in October 1987 that exceeded 20%. Using data from the St. Louis Federal Reserve that goes back nearly 50 years, September has historically been the worst month for stocks. There is not a plausible reason that might explain the typical weakness in September, but this year, September saw new highs.

The S&P 500 Index, which is comprised of 500 large companies, pushed past its prior peak in August, added to its advance in September, and registered its best quarter since 2013.

In the short term, risks never completely abate. In fact, you only know which risks were significant after the fact. So accept it, risk is part of life (including investing) and needs to be built into your thought process.

Problems in developing markets are simmering, and we have been treated to a steady drumbeat of discouraging headlines on trade with China. In addition, as reflected in recent actions by both countries, the discourse between the U.S. and China has eroded into a more confrontational tone.

Retailers have begun to loudly complain that tariffs will boost prices. At a late September press conference, Fed Chief Jerome Powell said he has “been hearing a rising chorus of concerns from businesses all over the country about disruption of supply chains, materials, cost increases, and loss of markets.”

But he was quick to point out that if you look at the data holistically, “It's hard to see much happening at this point (slowing the U.S. economy).” That is likely why investors have not been fretting over trade frictions (although that is starting to change).

Maybe investors are underestimating the longer-term negative impact of these policies. That said, historically when new risks have failed to materially dent the economic outlook, investors have tended to refocus on the fundamentals (which are currently pretty good). In addition, many stocks are reasonably priced which should help support the stock market.

**The Risk of Rapidly Rising Interest Rates**

Rates are no longer at rock-bottom levels as they were in the years that followed the 2008 financial crisis. Since the Federal Reserve began hiking interest rates in late 2015, the Fed has raised the fed funds rate eight times. Each hike has been in 0.25 percentage-point increments. Today, the target range for the fed funds rate is 2.00-2.25% – see Figure 2.

What is concerning to us (and some other investors), is the rapid increase in interest rates in the past few months. While no one knows what triggered this recent ascent, we are watching it very closely.

Why would increasing interest rates be of concern? Below are the primary reasons:

* At a certain point, rising interest rates will slow the economy and likely hurt corporate profits which in turn will make valuations more expensive.
* Interest rates are a discounting mechanism. In its simplest form, many investments (including stocks) often go down when interest rates go up (at least once they have crossed a certain level).
* With all the debt in both the U.S. and around the world, higher rates are not a good thing. With higher rates, the cost to repay debt will go up and may cause real stress for overburdened borrowers.
* The speed of the increase in rates can cause shocks to the markets since investors don’t have the necessary time to adjust. We suspect that we will learn if there are any problems in the not too distant future.

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| Stock Indices | Q3 return\* | 2018 YTD Return %\*\* |
| S&P 500 (large) | +7.71% | +10.56% |
| S&P 400 (midsize) | +3.86% | +7.49% |
| Russell 2000 (small) | +3.58% | +11.52% |
| MSCI EAFE (developed int’l) | +1.35% | -1.43% |
| MSCI Emerging Markets | -1.09% | -7.68% |
| Bond Yields | **Sept. 28 Yield & Qtr. Change** | **Dec 29, 2017 Yield** |
| 3-month T-bill | 2.19% (+0.26%) | 1.39%  |
| 2-year Treasury | 2.81% (+0.29%) | 1.89%  |
| 10-year Treasury | 3.05% (+0.20%) | 2.40%  |
| 30-year Treasury | 3.19% (+0.21%) | 2.74%  |
| Commodities | **Sep 28 Price & Qtr. Change** | **Year end 2017** |
| Oil per barrel |  $73.25 $-0.90 | $60.42 |
| Gold per ounce |  $1,187.25 $-63.20 | $1,296.50 |

*\*Q3 stock indices include reinvested dividends and are NOT annualized*

*\*\* Year-to date stock returns are through September 30, 2018, include reinvested dividends and are NOT annualized*

**What to Do Now**

We can not discount the possibility that unexpected headlines could sway sentiment and create volatility. So what is an investor to do?

It is crucial that your circumstances drive how you manage your portfolio. That is why we spend so much time trying to understand all aspects of your situation and what you are trying to achieve before we make recommendations and manage a portfolio. What is appropriate for one client may not be appropriate for another. We are of the belief that **most people don’t plan to fail, they fail to plan.**

One area that we would like to emphasize that allows us to take advantage of current circumstances is bonds (i.e. fixed income). This has been a very unpopular asset class for a number of years, but it has always been a very important part of our investment philosophy. Our philosophy has always been that equities should give higher returns over time while bonds give a steady income level and return of principal.

While increasing interest rates are concerning in some respects, they really help our clients’ portfolios since we primarily own **individual** bonds and hold them to maturity. So as our clients’ bonds mature, we can reinvest at higher and higher rates. As an aside, this is not the case with bond funds because while bonds in a bond fund mature, most bond funds do not mature so there can be real impairment to your money.

While equities have a place in most all portfolios, bonds also have a very important function. They act as a shock absorber when held to maturity. It is the safe part of a portfolio and should be balanced with the volatility of the stock market in order to achieve your desired results.

**Final Thoughts**

We had a very successful **15-Year Anniversary Party** at the end of September. Thank you to all who attended and for the many well wishes. What we found truly inspiring were several comments about how we had made a meaningful difference in people’s lives. This means the world to us and, frankly, is what drives us every day.

Please know that the feelings are very mutual. You have all had a very positive affect on our lives and we sincerely thank you for all your support through the years.

**Hopwood Financial Services, Inc.**