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THIRD QUARTER 2018 MARKET RECAP

Foreign Stocks And Investment Grade Bonds Suffer While U.S. Stocks Flourish. Is There A Cure?

Yes. Invest Abroad And Reduce Investment Portfolio Volatility!

The U.S. stock market has benefited from a period of strong growth since the end of the financial crisis in 2009. U.S. Investment returns have been above historical long-term averages for the past five years and since the financial crisis. This year, the growth differential between U.S. and foreign markets has attracted investment capital away from developed international and emerging markets stocks and into U.S. equities. Developed international stocks and emerging markets stocks have also suffered from the perceived risk of emerging markets "contagion" as a result of the U.S.-China trade dispute and other country-specific issues. Meanwhile, rising U.S. interest rates continued to pressure bond valuations.

As the benefits from fiscal stimulus (detailed below) enacted earlier this year wane, U.S. economic and corporate earnings growth will begin to converge with the rest of the world. At the same time, the increase in U.S. stock volatility experienced over the past 12 months will likely heat up as U.S. political uncertainty intensifies, anxiety over the U.S.-China "trade war" persists, and continued rising interest rates increase the eventual likelihood of another

U.S. recession. These factors will raise the appeal of owning more foreign stocks, which are cheaper relative to U.S. stocks, offer more appealing risk-adjusted returns, and provide the potential to reduce investment portfolio volatility.

Investment grade bonds provide an important ballast to portfolio returns due to their negative correlation (relationship) to stocks. This is especially true during periods of extreme stock market volatility. Owning a diversified mix of low interest-sensitive bonds and emphasizing categories and bond-like assets with positive underlying tailwinds reduces the negative impact rising U.S. interest rates have on bond investments.

U.S. Stock Market Recap

The S&P 500 Index ("S&P 500") was up 7.7% during third quarter 2018 and +10.6% for the first three quarters of 2018. Not only did the S&P 500 experience its strongest quarter of performance since the end of 2013, but also on August 24, the current "bull" market became the longest in history. (A bull market is the period of time for an index to rise 20% or more after dropping at least 20%.) Strong corporate results and solid economic data once again offset the negative sentiment associated with rising interest rates, mounting trade tensions, and political uncertainty. Within the S&P 500, Healthcare (+14.5%), Industrials (+10.0%), and Telecom Services (+9.9%) led all sectors over the third quarter while Materials (+0.4%), Energy (+0.6%), and Real Estate (+0.9%) delivered the worst results. Year-to-date (through September 30), Consumer Discretionary (+20.6%), Technology (+20.6%), and Healthcare (+16.6%) were the top sectors while Consumer Staples (-3.3%), Materials (-2.7%), and Financials (+0.1%) were the worst. Growth oriented stocks, which tend to represent shares of more economically-sensitive companies, continued to lead the market, posting gains of +9.3% for 3Q 2018 and +17.2% during the first three quarters of 2018 versus +5.9% and +3.5%, respectively for defensive-oriented, value stocks that tend to pay dividends.

Foreign Stocks Recap

The MSCI EAFE Index ("Europe, Australia-Asia, and Far East"), which measures the U.S. dollar-denominated return of large company stocks in developed, foreign markets outside of the U.S. and Canada, was up 1.4% during the third quarter but down 1.4% year-to-date. Investor sentiment towards developed international or stocks remains subdued due to a strong dollar and decelerating economic and corporate earnings growth trends. Populist-related, political events, particularly in Italy, continue to weigh on sentiment but not nearly the way these occurred in 2016/2017.

The MSCI Emerging Markets Index declined 1.1% on a U.S. dollar basis in the second quarter and was down 7.7% January through September of this year. Chinese stocks, which account for roughly 33% of the index, continued to weigh on results, declining 7.3% during the quarter and -17.4% year-to-date. Since exports represent 19% of China's gross domestic product ("GDP") versus 8% for the U.S., investors view the escalation in trade tariffs between both countries as more impactful to China. (GDP is the value of economic activity within a country or the sum of the market values of all goods and services produced in an economy.)

Rising oil prices (+4.0% in 3Q 2018 and +23.7% year-to-date), which impacts net exporters such as China and Korea, along with political and policy-related setbacks in other key emerging economies, namely Argentina, Brazil, and Turkey, fueled continued uncertainty during the quarter.

Expectation for Equities Going Forward

Positive U.S. economic fundamentals and accelerating corporate earnings growth have been the driving forces behind the strong results of U.S. stocks relative to foreign equities year-to-date. While “late-cycle” factors, such as low unemployment and robust capital spending, have provided positive tailwinds to U.S. economic growth and corporate financial results, the pronounced growth differentials relative to foreign markets can be largely attributed to $1.8 trillion worth of fiscal stimulus that was injected into the economy early this year ($1.5 trillion of corporate and personal tax cuts plus $300 billion of federal spending increases). The strategists we speak with expect the benefit from fiscal stimulus to be transitory with much of the impact fading by the end of this year. This is due to the timing of stimulus, which is occurring during the late phase of a business cycle when the U.S. labor market is already near full employment. This poorly timed fiscal policy package is expected to lead to firmer inflationary pressures, mainly in the form of higher wages, which will compel the Federal Reserve (“Fed”) to raise interest rates at a faster pace than it would have without fiscal stimulus. Higher interest rates will lead to a slowdown in economic activity and ultimately the next recession. (A recession is defined as two consecutive quarters of negative GDP growth).

The timing of the next U.S. economic recession is an important factor to monitor considering almost all bear markets since 1950 have started just prior to or during a recession. Most strategists we consult with anticipate the next recession to occur in 12 to 24 months if not sooner given the potential for an unanticipated rise of inflation expectations. While U.S. stocks are expected to generate positive returns over the next 6-12 months, the pace at which U.S. stocks outperform foreign stocks will abate as growth expectations for U.S. and foreign markets once again converge. The risk associated with U.S. equities will also continue to increase as interest rates rise and the market more meaningfully discounts the probability of a recession. (Market risk is the possibility of an investor experiencing a loss. The higher the volatility the greater the risk. Since volatility measures the frequency and magnitude of price movements, higher levels of volatility increase the likelihood of adverse price movements thus the potential for losses.) Rising political uncertainty, especially as we approach midterm elections in November, and the intensifying trade dispute with China will further fuel volatility, which has increased 9.8% year-to-date and +27.0% over the past 12 months according to the CBOE Market Volatility Index.

For these reasons, we continue to advocate generally reducing weightings to U.S. stocks in favor of foreign equities (both developed international and emerging markets) and alternative and tactical assets that offer the potential for better risk-adjusted returns over the mid-to-long term. Developed markets equities are not only cheaper relative to U.S. stocks but key economies, namely Japan and the European Union, are earlier in their business cycles as compared to the U.S. economy. This offers the opportunity to compound positive returns over a longer period of time as compared to owning just U.S. stocks. Monetary policy within these regions also remains "accommodative," which helps to contain market volatility due to the expectation that the European Central Bank ("ECB") and Bank of Japan ("BoJ") will maintain low interest rates for a longer period of time to induce economic and market stability.

Emerging markets stocks remain highly attractive as compared to U.S. stocks. Investor sentiment is overly pessimistic considering the positive underlying fundamentals for emerging markets stocks remain intact, namely favorable demographic trends and the broadening of "fiscally healthy" emerging market economies (as measured by the number of countries with a sustainably positive current account balance). As discussed above, China's trade issues with the U.S. are unlikely to bleed over into other emerging markets given China's substantial foreign currency reserves, which will be used to stimulate domestic consumption and prop up Chinese asset prices. This means China will not likely choose to aggressively devalue its currency as a means to bolster export activity thereby enabling other emerging markets economies to maintain their competitiveness. Rather, it is likely a number of emerging markets economies will be net beneficiaries of the China-U.S. trade dispute as more U.S. manufacturers diversify a portion of their manufacturing base out of China and among a number of other lower cost, manufacturing-based countries in Southeast Asia and Central Europe.

It is also important to note that the emerging markets "complex" is comprised of a diverse set of economies with their own unique sets of risks and opportunities. As such, the issues experienced in Argentina, Brazil, South Africa, and Turkey should be considered country-specific "fragilities" as opposed to linchpins to a broader emerging markets crisis. The managers we use to gain exposure to emerging markets stocks have strong records of delivering good results compared to their peers and have consistently demonstrated an ability to limit the impact from "problematic" country exposures over market cycles.

While we continue to favor Technology, Healthcare, and Financial sector stocks in the U.S., we regularly evaluate sector investments that may provide better risk-adjusted returns. It is particularly important now to assess the S&P 500 Index relative to specific equity sectors ahead of the U.S. economy's transition from the late phase of its business cycle to a period of sustained slowing (if not contracting) economic activity. We also expect "mid-stream" energy companies (i.e. companies that own pipelines and storage facilities) to more meaningfully outpace the broader U.S. stock market given the sustainable rise in energy prices and the industry's move towards "simplifying" business structures. The latter will broaden ownership, which predominately is comprised of individual retail investors, to include larger institutional investors given the improvement in operational transparency and enhanced corporate governance.

Alternative assets and strategies remain important portfolio components that cannot only dampen portfolio volatility through enhanced diversification but provide differentiated return streams compared to traditional stocks and bonds. This can help to stabilize returns during challenging market environments. We continue to view exposure to real estate and global infrastructure as important options to owning bonds as they provide relatively steady income streams and the potential for capital appreciation. These assets also provide a hedge to inflation, as their values tend to rise when bond prices decline (bond prices tend to decline in inflationary environments due central banks' efforts to raise interest rates to combat unanticipated rises in the general price levels for goods and services.) We will consider adding exposure to commodities should we see evidence of a rise in inflation above levels currently anticipated by the market.

Fixed Income Results

Fixed income or bond markets were essentially flat for the quarter, as price appreciation of credit-sensitive bonds offset the negative impact to U.S. government bonds from rising Treasury interest rates. U.S. government bonds, as measured by the Bloomberg Barclays U.S. Aggregate Treasury Bond Index, declined 0.6% in third quarter 2018, increasing the year-to-date loss for these bonds to -1.7%. The yield on the 10-year Treasury bond ended 3Q 2018 at 3.19%, or 79 “basis points” (100 basis points equals 1.00%) above the prevailing yield on 12/31/17, while the Federal Reserve's target for short-term interest rates has risen 75 basis points over the same period. The Bloomberg Barclays U.S. Aggregate Bond Index, a composite of investment grade bonds of all types, increased 0.2%, trimming its year-to-date loss to -1.60%. U.S. investment grade corporate bonds were up 1.0% during the quarter and drove aggregate investment grade bond returns as strong corporate financial results renewed interest in these bonds, which are down 2.2% over the first three quarters of 2018.

The Bloomberg Barclays Global Aggregate Bond Index, which measures the U.S. dollar denominated results of global investment grade bonds of all types, declined 0.9% during the quarter and is down 2.4% year-to-date. Rising U.S. interest rates have increased demand for U.S. bonds of all types at the expense of lower-yielding international government and corporate bonds, which are down 1.8% and 0.6% on a U.S. dollar basis respectively. Through September 2018, international government and corporate bonds are down 3.0% and 4.6% on a U.S. dollar basis respectively.

Emerging markets bond valuations recovered during 3Q 2018. The U.S. dollar denominated Bloomberg Barclays ex-US Emerging Markets Bond Index increased 1.8% in 3Q 2018, reducing the index's year-to-date loss to -3.7%. The recovery in emerging markets bond results corresponded with a slight weakening of the U.S. dollar compared to a basket of key emerging markets currencies. The strong results in the face of rising U.S. interest rates and China's trade issues signals moderating “contagion” fear or the perceived risk that specific challenges in a few emerging markets economies may turn into a broader emerging markets crisis.

How Do We Avoid Bond Losses with Rising Interest Rates?

U.S. interest rates are anticipated to continue rising as the Fed is expected to raise its target for short-term rates (otherwise known as the federal funds rate) by another 25 basis points this year and by an additional 50 basis points over the course of next year. Even though default rates remain near historical lows, we expect corporate credit spreads (i.e. the yield differential of corporate bonds compared to Treasury bonds of the same maturity) to continue to widen as investors increasingly demand higher returns for assuming default risk as the current business cycle winds down. For these reasons, we favor owning diversified exposure to shorter duration investment grade bonds of all types both domestically and abroad. Low duration bonds, which tend to have shorter maturities and/or higher coupon payments, have less price sensitivity to interest rate changes. Holding balanced exposure to a variety of investment grade bonds reduces the risk of concentrating assets in any one credit sector.

The primary goal for our clients' fixed income investments is to provide a "shock absorber" to portfolio results during severe market downturns. However, we do see opportunities to enhance the return potential of our client bond holdings while maintaining a relatively low volatility profile by emphasizing municipal bonds, structured notes, and emerging markets bonds where appropriate. The U.S. tax reform bill that took effect at the end of 2017 meaningfully impacted the demand and supply dynamics within the municipal bond market, which provides a unique opportunity for active municipal bond managers to take advantage of this dislocation to purchase mispriced national municipal bonds with attractive yields. Municipal bonds may also provide viable investment alternatives for clients in high tax brackets given the limit on state and local tax ("SALT") deductions. Structured notes, which are also known as mortgage backed securities ("MBS"), are one of the only investment grade bond categories that provides the opportunity to have relatively low correlation (i.e. relationship) of returns to other investment grade bonds. We expect MBS to enhance diversification, due to their "non-traditional" payoff structures and the underlying assets from which these returns are derived. As discussed above, the fundamental outlook for emerging markets economies remains intact, and the sell-off of these bonds during the first half of 2018 provided a unique opportunity for us to add direct exposure to these bonds where suitable.

What Do We Expect?

We continue to expect both U.S. and foreign stocks to deliver positive returns over the next 6-12 months. However, the declining growth disparity between U.S. and foreign markets, combined with even higher U.S. stock volatility, make foreign stocks a more appealing long-term investment opportunity. Investment grade bonds continue to provide an important means by which to lower overall portfolio risk. Owning a diversified mix of low duration bonds and bond-like assets combined with low correlated alternative assets reduces the sensitivity of portfolios to rising interest rates while stabilizing overall returns during periods of heightened stock market volatility.

As always, please contact us if you have any questions or concerns about your investment portfolio. We welcome the opportunity to discuss your goals and the most appropriate strategy to attain them. We are also honored to speak to any of your friends, associates, or relatives should they have an interest in our financial planning or investment management services.

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