

Third Quarter 2018 Market Commentary

MARKET PERFORMANCE AND ANALYSIS

We have highlighted in past quarterly market commentaries how the performances of indexes like the Dow Jones Industrial Average and S&P 500 do not reflect the performances of well-diversified portfolios. The Dow, for example, is a price-weighted index of only thirty companies, so the returns of stocks that have higher prices are given a higher weighting in the index. For example, the stock price of Boeing is in the mid-300s and therefore represents about 10% percent of the Dow Jones Industrial Average. The S&P 500 on the other hand, is a market capitalization weighted index so the largest companies have a disproportionately greater weighting within it. Therefore, the well-known FAANG stocks (Facebook, Amazon, Apple, Netflix, and Google) with very large market capitalizations will account for a disproportionate percentage of the S&P 500's gains.

To provide a benchmark that better represents sample portfolios with different risk tolerances, we will utilize all-in one asset allocation mutual funds as benchmarks for market performance. These funds, passively managed by Vanguard, maintain fixed allocations to domestic and international stocks and bonds, depending on desired risk levels. Because their compositions more accurately reflect diversified investment portfolios, these funds are better benchmarks than the commonly quoted headline stock indexes.

The most aggressive is the Vanguard LifeStrategy Growth fund, which at 80% equities was up 3.5% in the third quarter and bringing the year-to-date return to right around 3.0%. Vanguard's LifeStrategy Moderate Growth fund, at 60% equities, was up 2.6% in the third quarter and ended up 1.7% year-to-date through September 30, 2018. Lastly, the most conservative asset allocation fund is the LifeStrategy Income fund; it has 80% in bonds, was up 0.26% in the third quarter and finished the year-to-date in the red, down just over -1.0%. Large domestic technology and healthcare stocks rose steadily through the third quarter while international stocks and bonds detracted from overall portfolio performance.

Calm Markets Come to Terms with Trade War Uncertainty

The most notable aspect of markets in the third quarter was their calm ascent to new highs. The market's fall back mode since President Trump's election is a cautious realism. Investors have been disciplined in their buying and selling—reallocating as necessary upon consideration of changed market and economic circumstances—and not allowing uncertainties to induce panic or euphoria. The result of this caution is a mostly low volatility, steadily rising market. This is not to say that there hasn't been and won't be volatility because volatility is an entirely normal trait for the markets. It is just to recognize that investor reactions to external and internal market data have gone from emotionally-driven to deliberately levelheaded. How long this prudence on the part of investors will remain the dominant attitude is anyone's guess.

Nevertheless, this prudence held sway in the third quarter as the S&P 500 experienced exactly *zero* daily price moves of 1% or more in either direction. A common refrain last year was that nothing seemed to spook the markets. This observation applies just as fittingly to this past quarter. Oil has risen over 20%, emerging markets fell into a bear market, global growth is slowing and interest rates keep climbing. And yet none of these seemed to spook the markets. In fact, indexes rose consistently to new heights. The S&P 500 was finally able to surpass its January all-time high and set another record in September. And in late-August the S&P recorded its 3,453rd day since the bottom on March 9, 2009 thus making this the longest bull market on record. Investors seem to have come to terms with the trade war uncertainty and were unbothered by these developments in the third quarter. Going forward through the end of this year and into next year there remain plentiful uncertainties and unknowns, not least of which include the trade war and the prospect of an overheating economy. We explore these below.

For the third quarter at least, the Trump administration trade war uncertainty has transformed into an indifferent complacency for investors. While the \$250 billion of tariffs on Chinese imports and China's \$60 billion of retaliatory tariffs are beginning to have some real world effects, the markets remained oblivious. American farmers are suffering the brunt of the tariff impact: without China buying corn, soybeans and pork, farm income is set to contract 13% this year. The USDA has begun distributing \$5 billion in aid for these farmers, though critics see this as an untenable stop-gap measure for the self-inflicted wound of domestic agriculture losing one of its top consumers. Administration officials believe they have the upper hand, however, noting that China's economy is showing signs of slowing with the communist central government instituting somewhat desperate stimulus measures in order to maintain their "6%" growth rate. Also, China imports \$130 billion worth of goods from the U.S.—compared with the \$500 billion we import from China—thereby leaving them with less ammunition to retaliate again should additional tariffs take effect later this year. So, while the tangible effects of the China trade hostilities have been minimal for most Americans and for markets, they do appear to be exerting pressure on the Xi Jinping regime's ability to manipulate their domestic economy and to dictate detrimental trade terms to the rest of the world.

At the close of the third quarter President Trump's top trade negotiator Robert Lighthizer and his son-in-law Jared Kushner were able to secure an agreement for what is essentially NAFTA 2.0 (it's new name is the United States-Mexico-Canada Agreement, or USMCA). The agreement contains terms favorable to both labor and business interests and endorses the free flow of goods through North America while bolstering America's national economic interests. The President flirted with pulling the U.S. out of NAFTA on the campaign trail, a proposal that caused some minor consternation in the markets. But the USMCA puts these fears and uncertainties to rest as investors have come to tune out the bluster of Trump's negotiating and concentrate on the results. And the results so far show that, as *Wall Street Journal* analyst Greg Ip notes, the President's protectionism is ultimately constrained by the sheer amount of interconnectedness of our system of international trade.

Key Economic Indicators

Consumer Sentiments (Animal Spirits)

The outlook for American consumers has rarely been more positive than it is right now. Independent measures of consumer sentiment, confidence and comfort all stand near record levels and all tell the same story: consistent economic growth and ample employment opportunities have lifted Americans out of their post-recession malaise. Secular stagnation this assuredly is not. Such good readings through this past third quarter bode well for the fourth when growth should receive an additional boost from consumer's holiday spending.

Gross Domestic Product

Growth for the second quarter came in at an impressive 4.2%. Consumer spending remains elevated even considering recent data have shown that large purchases such as homes and vehicles have faltered of late owing to the effect of rising interest rates. That being said, retail spending is thriving and has revived moribund big box stores to say nothing of the behemoth Amazon whose market cap topped \$1 trillion in early September. Consumer spending accounts for 70% of the GDP reading so the elevated sentiments referred to above may continue to contribute to the better-than-average growth trend. What's more, domestic manufacturing climbed through 2017 through this year and stands near post-recession highs. The Federal Reserve Bank of Atlanta predicts 4.2% growth for the third quarter, a number which would put us on track for 3% annual growth. We haven't experienced such annual growth in over a decade.

Labor Market

We are sure you have seen the headlines, or the President's tweets: the unemployment rate of 3.7% is the lowest since 1969. It's hard to overstate how healthy the labor market is right now. Quite simply it is as strong as it ever has been. There were brief periods when the unemployment rate was lower—the early '50s and late '60s—but today's numbers are even more impressive considering the dire predictions accompanying our transition from a manufacturing/agriculture-based economy to our current knowledge/service-based economy. We have gone 96-straight months without an aggregate loss of jobs. Weekly applications for unemployment benefits have fallen to levels last recorded in the late 1960s, a positively extraordinary statistic when you consider that today's pool of claimants (the population of the U.S.) is fully 125 million more than it was in 1969. The roaring labor market is the foundation of the good health of our economy's fundamentals. Consumers have options for jobs and are being compensated as employers hunt for qualified applicants. There is still some slack in the labor market; both the wage growth rate and the labor force participation rate are running below average so there may yet be room for this solid jobs environment to improve even more.

Looking Forward

As we write this newsletter markets are already experiencing more turbulence than we've had since February's correction. And like the correction, this most recent sell-off is based on interest rates and inflation. This particular uncertainty for investors was always inevitable. The government's successful efforts to prevent the recession from becoming a depression ten years ago involved massive market manipulation. The Federal Reserve ate up billions of dollars in government bonds and kept interest rates at or near zero for almost eight years. It stands to reason and is not unexpected that markets would have a period of adjustment accompanied by volatility once rates and inflation started trending toward normalcy. Higher yields ripple through financial markets affecting all of its actors by making financing more expensive for governments, businesses and consumers. We can expect further disruptions such as interest on federal debt taking up a larger share of GDP

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and the related spending implications for the federal budget; overleveraged firms kept alive on the artificial life support of low-interest loans are likely to finally die off; and more expensive loans for consumers will lead to a slowdown in the housing and automobile markets.

The yield on the ten-year Treasury bond breached 3% for the first time since 2014 late in the quarter and the most recent volatility arrived when the ten-year rose over 3.1%, a number not seen in seven years. While we view the most recent volatility with understanding—investors had become accustomed to low yields and relatively easy money—we do not believe it portends the imminent end of this longest running bull market. First, yields are rising but they remain below historical averages. We note that from 1980 through 2017 the ten-year Treasury bond averaged an annual yield of 6%. Next, inflation also is rising but it's been at a gradual pace. The inflation gauge, the consumer price index, grew at 2.6% annually last quarter, within the Fed's desired normal range. And core inflation, which excludes volatile energy and food prices, was up 2.2% annually in September; both within the normal range and below its historic average. We expect an increase in volatility as financial markets become re-acclimated to a world of non-zero interest rates but we think talk of recession is premature.

In any event, our portfolio management software is able to disregard the noise and concentrate only on fund price movement. Our quantitative strategies are responsive to market trends and can effectively manage risk through tactical allocations to participate in growth opportunities or go on the defensive as the market trends may require. We believe these investment strategies can help us to maneuver through the volatility that is likely to persist through the end of the year.

Performance Disclaimer

No investment strategy or methodology can guarantee profits or protect against losses. Investment risk is inherent in every individual portfolio and no computer model or modeling program used or relied upon in making investment choices for a portfolio can eliminate risk.

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