PRESTIGE WEALTH MANAGEMENT GROUP

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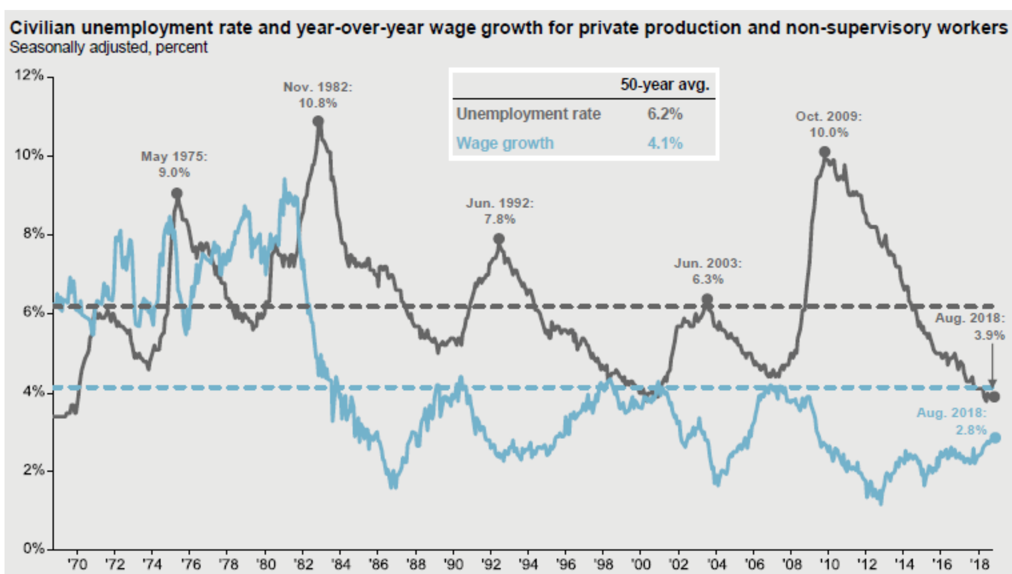
Recap of Q3 2018 Markets and Economy

For the third quarter of 2018, the U.S equity market showed much resilience in the face of some concerning short-term events. Investors managed to look beyond these risks and focused on the fundamentals of robust second quarter earnings and a positive economic backdrop for the U.S. economy. However, international equity markets did not manage to keep pace with U.S. as a combination of trade war fears and a strengthening dollar weighed on returns. Rising interest rates in the U.S. also pushed long-term bond prices downward.

U.S. Economy

Economic growth continued to advance from the prior quarter with real GDP posting a 4.2% increase putting its year over year change to 2.9%. With expectations of similar growth for the fourth quarter, the U.S. economy is expected to reach its 3.1% growth target for the year. The unemployment rate dropped to multi-decade low of 3.7% in September and hourly wage growth increased by 2.8%. We find this continued trend to be very promising as the convergence of these two data points in the past has shown to be supportive of a healthy labor market and consumer. The Conference Board Leading Economic Index which is an index comprised of ten of the most prominent leading economic indicators for the U.S. also managed to grow by 0.4% in August. “The leading indicators are consistent with a solid growth scenario in the second half of 2018 and at this stage of a maturing business cycle in the U.S., it doesn’t get much better than this,” according to Ataman Ozyildirim, Director of Business Cycles and Growth Research at The Conference Board. The housing market and new building permits were two of the few areas that came under pressure as a result of rising interest rates.



31 State Route 12, Flemington, NJ 08822 | 908-782-0001 | FAX 908-782-4168
Schoolhouse Plaza, 374 Millburn Avenue, Millburn, NJ 07041 | 973-532-6770 | FAX 973-218-1452
800-743-4768 | pwm@prestigewmg.com | www.prestigewmg.com

<u>Trade Fears Narrow</u>

As our Q2 Market Commentary noted, trade uncertainty continued to run high in the wake of strong economic growth. While we remain positive on the strength of the U.S. economy, we have confidence that overall trade policy uncertainties have lessened to some degree as we enter the final quarter of 2018. This notion was reinforced on the last day of the third quarter as the U.S., Mexico and Canada successfully negotiated a replacement for the North American Free Trade Agreement (NAFTA), the United States-Mexico-Canada Agreement or USMCA.

We view this development as being very significant to the future of global economic health and capital market risk. What was originally perceived to be a global trade war that involved many countries and trade partners has now dissipated to a tiff between the U.S. and China. Canada and Mexico are our second and third largest trading partners (China being the largest trading partner.) with combined total 2017 trade of over $1.1 trillion. Although very sizeable, China's total trade with the U.S. last year came in at just $635 billion which approximately $80 billion less than the trade conducted between the U.S. and the European Union. It is also important to note that the U.S managed to confirm a new trade deal with South Korea, its sixth largest trading partner. The U.S. has also established a framework for future negotiations with its fourth and fifth largest trading partners, the Eurozone and Japan.

In the short run we realize that current trade dispute with China will contribute to volatility. However, we feel that the tariffs currently levied and slated for 2019 by both nations are not large enough to derail economic growth as well as future negotiations. The 25% tariffs imposed by the U.S., have been shown to be manageable by China as they have been able to strategically devalue their currency to offset some of this tax burden on their exports. We would be more concerned if the tariff rate were to increase substantially from current levels and be applied to all Chinese goods. However, we have not seen any statements that indicate trade policy will take this direction.

<u>Federal Reserve Concerns Resurface</u>

The Federal Reserve continued its path of monetary tightening for the third time this year and for the eighth time since lifting the Fed Funds Rate from the 0% level in December of 2015. The current Fed Funds rate now stands at a 2.00% - 2.25% range. Although the current level of GDP growth and the unemployment rate have supported such action, the muted pace of inflation has stoked fears that the Fed may be tightening too quickly and could send the U.S. into a recession. Our opinion differs with this conclusion as there is plenty of evidence that our economy is healthy enough to justify a moderation of interest rates. One could argue that prior Fed policymakers attempted to preemptively raise rates purely based on economic theories. We still believe that the current Fed Chair, Jerome Powell, is being data dependent in his policy action. History has shown that the current slow, low and steady rising rate policy has never managed to derail an economy by itself. Rather it has been a combination of frequent and larger rate (greater than the existing 0.25% rate hikes) increases that have been detrimental to sustained economic growth.

The trend of rising rates will have different implications for bond and stock investments. For bonds with longer maturities, rising rates have typically suppressed total returns. However, stocks have tended to remain insulated from rising rates in the past provided that the yield on the U.S. 10-year treasury bond remains below 5%. Historically, stock returns have been positively correlated (moved in the same direction) with rising rates as the yield on the 10-year treasury approaches 5%. Based upon the current 3.1% yield of the 10-year and the rate hikes slated for 2019, we do not see this threshold being reached in the intermediate term.

Global Equity Markets

Volatility managed to subside in the U.S. equity market compared to the first half of the year. U.S. stock market returns were positive for Q3 as the steady wave of double digit earnings growth reports for the second quarter supported returns. The trend of large-cap stocks out performing small-cap stocks reverted for the quarter as investors assessed the modestly stretched valuations in the small-cap space. Value stocks also continued to underperform the momentum of growth stocks for the broad market. When compared to the prior quarter, the U.S. stock market return benefitted from wider contribution of returns across more sectors and companies.

International Developed and Emerging Markets were mixed for the quarter. The trade resolutions with some of our key trading partners allowed Developed Market stocks to recover most of their losses for the first half of the year. Continued tariff talks with China and a stronger U.S. dollar weighted on Emerging Market returns with most of pressure being placed on Chinese and peripheral Asian markets.

Fixed Income Markets

Bond yields moved higher in lockstep with the Fed's decision to raise rates again in September putting slight pressure on prices. The U.S. 10-year treasury breached the 3.00% mark for the second time this year managing to reverse the narrowing spread between long term and short-term Treasury rates. As noted in our previous Market Commentary investors had grown worried over last quarter's "yield curve flattening," and its implications for an economic slowdown. With signs of the yield curve now steepening (longer term rates being higher than shorter term rates) these fears have started to diminish.

The 3.00% yield for the U.S. 10-year treasury has been viewed as critical level for long-term bonds as a yield sustained above this level should eventually lead to declining prices for longer dated bonds. Therefore, we remain confident in our decision to further increase the defensive positioning in our bond allocation to shorter-term bonds earlier in the year.

Outlook for Q4 2018 and Beyond

The 20 % earnings and mid to high single digit revenue growth trends for the U.S. market should continue for the remainder of 2018. Although annualized earnings growth for 2019 is expected to return to 10% (a similar level to 2017), we do not believe this to be an impediment in achieving positive total returns for U.S. stocks over the next 12 months. U.S. midterm elections may add to pricing pressure in the near term. Although there is no guarantee, U.S. stocks have historically tended to produce positive returns in the aftermath of the election.

Both International and Emerging Market stocks continue to trade at noticeable discounts compared to the U.S. The price earnings multiple of the broad international stock market as represented by the MSCI ACWI ex-U.S. Index trades at just 77% of the S&P 500 multiple. Granted, geopolitical risks coupled with foreign trade and currency concerns are the reasons for this disparity. But we are still optimistic that valuations will begin to converge as matters resolve.

With some trade talks persisting and the U.S. economy being in the later stages of the business cycle, we expect volatility to continue which is a normal function of the equity markets. While the "noise" created by the financial media may drive stock and bond prices on a daily basis, our team remains committed to the continuous discipline of long-term investing, proper diversification across global markets and prudent risk management.

Investors should always put their primary focus on their own personal goals and objectives. When equity markets become volatile sometimes even the best investors become not just concerned, but unnerved. It's important to keep perspective when markets are volatile. It is important that you understand your situation and your financial plan. Letting your emotions drive your decisions can be costly.

Our focus is on helping you meet your personalized goals through customized financial planning and diversified professional investment management. We can discuss your situation at your next review meeting or you can call to schedule an appointment. As always, we appreciate the opportunity in addressing your financial matters.

Roy Williams, ChFC   John DeAngelo, CFP®   Alyssa McMahon, MBA, CFP®, CFA   Paul R. Esposito, CFP®, CFA

Sources for graphs: *JP Morgan Market Insights.*

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