THIRD QUARTER REVIEW

The third quarter could be considered a case study in the power of economic fundamentals over the noise. There was no shortage of negative headlines about trade, North Korea, Russia, and in a country that seems evenly split politically, tensions and rhetoric from all sides seemed to reach new levels. Often lost in those headlines were the stories about stronger economic growth and increasing corporate profitability. Investors, however, remained focused on the positive leading to a strong quarter for the equity market. The S&P 500 increased by 7.7% in the third quarter, taking the year-to-date return to 10.6%. The market was led by more economically sensitive sectors such as Industrials and Consumer Discretionary, while more interest rate sensitive sectors like Utilities and Consumer Staples lagged the market. As expected, the Federal Reserve (Fed) raised its short-term interest rate by a quarter of a point to a range of 2.00% to 2.25% at its September 28th meeting. Expectations are for one more rate increase before the end of the year. Interest rates increased across the maturity spectrum on Fed action and the stronger economy. The yield of the 10-year U.S. Treasury ended the quarter at 3.06%, the highest level since 2011.

THE U.S. ECONOMY IS SHOWING BROAD-BASED STRENGTH.

U.S. economic growth has been accelerating recently driven by the healthy consumer, increased government spending and increased business investment. The economy grew at a 4.2% annual pace in the second quarter, and expectations are for a similar pace of growth in the third quarter. Since the end of the recession, consumer spending has been the consistent driver of economic growth, leading to overall GDP growth of around 1.5% to 2.0%. At times, we would see a positive contribution from business investment or government spending that would push the growth rate above 2.0% for a quarter, but it was not consistent. Today we are not only seeing broad-based contribution to economic growth, but the drivers of growth appear to be sustainable and should lead to solid growth over a longer time horizon.

Consumer Spending Provides the Foundation for Economic Growth

The consumer continues to be the foundation of economic growth, and near record levels of consumer confidence are driving even more consumer spending activity. The labor market remains healthy with more than 1.8 million new jobs created since the start of the year. The unemployment rate fell to 3.7% in September, the lowest level in more than 40 years. Not only are more people employed, but we continue to see wages increasing as employers need to increase pay to attract new workers. The consumer is also benefiting from the reduction in tax rates, which impacted take-home pay starting in February. Retail sales are up more than 6.5% versus this time last year, and the National Retail Federation is predicting a healthy holiday shopping season.

Increased Business Investment is Pushing GDP above Recent Trend

For much of the year, we have been highlighting the elevated levels of business confidence at both large and small companies, as a signal of future growth. As time has passed and the tax cuts begin to take hold, the data is now showing increased business activity. Non-residential fixed investment contributed more than 1 percentage point to 2nd quarter GDP. Despite headwinds from trade and weather disruptions, the manufacturing sector continues to expand. New orders and production remain near recent highs suggesting strong on-going demand. The services sector also showed solid expansion in the quarter, and strong demand continues to outpace supply, which is another signal of steady future activity. With the changes in the tax law, multi-national companies are now able to bring foreign profits back to the U.S. at a favorable tax rate (repatriation). Early estimates were that companies would repatriate around $500 billion of the $3.5 trillion held overseas. We have now surpassed that number and expectations are that $700 billion will be repatriated this year. Companies are using these funds for various activities that can support future growth. Some companies have made voluntary pension payments or are paying down corporate debt, which improve corporate balance sheets. Some companies have paid employee bonuses and increased wages which supports consumer spending. There has been an increase in capital spending on projects that will lead to future growth, as well as an increase in merger and acquisition activity. Finally, some companies have chosen to increase dividends and buy back shares. It can take time for business spending to ramp up given the long-term nature of some projects and we are in the initial stages of this process. We believe business spending can be a positive driver of the economy for some time.

Stronger Economic Growth Supports Corporate Profitability and Rising Equity Prices

Stronger economic activity and the effects of the tax rate reductions are impacting corporate sales and profits. Earnings for S&P 500 companies increased more than 20% in the first half of 2018 vs. the prior year and are expected to increase by double-digits in the second half as well. While some of the increase in earnings is a direct result of lower tax rates, a significant amount of the gains is coming from increased activity. Sales for S&P 500 companies, which are a direct result of increased activity, grew about 10% in the first half. Equity market valuation, as measured by the price-to-earnings ratio, shows that the market is fully valued, but with solid economic growth and double-digit earnings growth, there is still room for prices to continue to move higher. At this stage in the cycle, the correlation between individual stock price changes is declining. This means that investors are making a distinction and rewarding fundamentally strong companies, versus those that are not generating positive results. This makes security selection even more important and provides the opportunity to build portfolios that will benefit from solid fundamentals.

Interest Rates Should Trend Higher on Fed Actions and Stronger Economic Growth

While changes in interest rates have mostly impacted short-maturity bonds, we believe that rates on longer-maturity bonds will begin to increase as well due to stronger economic growth. The Fed has raised the Federal Funds rate 8 times since December of 2015, taking the funds rate from near zero to the current target range of 2.00% to 2.25%. The Fed is expected to increase rates one more time this year and two or three times next year. The actions taken by the Fed primarily impact short-maturity interest rates, such as the 2-year Treasury yield, which has increased to 2.82%. Longer-maturity bonds, which tend to react to faster economic growth and rising inflation expectations, have remained relatively steady. More recently with economic growth exceeding 4.0% and inflation moving above the Fed's 2.0% long-term target, we are starting to see higher long-term rates. We do not believe, at this point, that higher interest rates will impact economic growth or the equity market returns, however, we are concerned about the impact that higher rates can have on fixed income investment and other income-producing investments. As interest rates rise, prices on fixed income securities fall, and that impact is greater on longer-maturity bonds. In addition, as interest rates rise and yield in the fixed income market become more attractive, investors will look to shift from riskier income investments into the relative safety of fixed income. This tends to negatively impact sectors such as real estate, utility stocks or other high-income equity securities.

Headline Risk Could Lead to Increased Market Volatility

Equity market volatility was relatively low during the third quarter despite the daily news stories about a potential trade war, rising geo-political risks outside the U.S. and the political theatre in Washington D.C. As we move closer to the mid-term elections, we would expect to see market volatility increase. Investors do not like uncertainty and in this politically charged environment, we expect to see even more uncertainty leading into November 6th. But, once the election is over, when the make-up of the Congress is known, markets should return to a focus on the fundamentals. Trade and tariffs will also remain a cause of market uncertainty and volatility over the near term. Even with a new NAFTA agreement, trade deals with China and Europe remain to be worked out. While tariffs can impact individual companies and sectors, the broader fiscal impact of tariffs is more than offset by the positive fiscal stimulus from tax cuts, repatriation and increased government spending. Geo-political risks also remain regarding our relationships with China, Russia, Iran and North Korea, and any of these have the potential to provide near-term volatility in the financial markets. However, we still believe that fundamentals matter over the longer term and we remain optimistic on the long-term outlook for the economy and financial markets.

IMPACT ON YOUR INVESTMENTS

We remain optimistic about the outlook for the economy and believe your portfolio is well-positioned to benefit from stronger growth. For clients with an income equity allocation, we have reduced our exposure to traditional income equity sectors in favor of companies that pay a high and rising dividend but can also benefit more from healthy economic growth. During the quarter, for those with a fixed income allocation, we completed the transition from bond mutual funds into a corporate bond ladder. We believe that the mutual fund investments were a necessity during the years of near zero interest rates, but with higher rates we can return to a more traditional fixed income allocation. With the bond ladder, we can directly control the credit and interest rate risk, and we are not subject to the impact of changes in strategy or customer liquidations as can occur in mutual funds. We will continue to focus on the long-term fundamentals of the economy and the financial markets and seek to separate the short-term noise from the long-term benefits of the current environment.

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