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3rd Quarter 2018 – Investment Commentary

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Market and Portfolio Performance:

Summary:

- **All U.S. equity asset classes are positive this quarter and for the year-to-date.** Domestically, we are seeing many of the same themes from last quarter: strong corporate earnings, outsize impact of FAANG stocks, and strong fundamentals for equities and fixed income. Internationally, markets were impacted by trade and tariff concerns, Brexit uncertainty, and unsure governing outcomes in some European countries. Bond markets are poised for stronger returns, but current returns are muted somewhat due to 3 interest rate hikes.
- **Large-cap U.S. stocks reached new highs.** This is what we want to see! Note that these are not excessively high rates of return. Large caps are right in-line for their average historical annual return.
- **Diversification shows its worth again.** Other asset classes have been much more muted than stocks. Bonds mostly muted as bond investors absorb 3 interest rate hikes this year, and with the expectation of 1 more before year end. That is how asset class diversification works: one zigs, while the other zags.
- **Markets continue to "drink from the firehose" of data.** Trade war and tariff developments, interest rate changes and speculation, the upcoming midterm election, and wild headlines related to some individual stocks all caused volatility in several asset classes.

U.S. Equities:

- **Strong 3rd quarter and YTD for large-cap, U.S. stocks.** We saw strong returns for large-cap U.S. stocks in each month of the third quarter, supported by strong earnings and economic data. When headlines talk about "the market," this is the asset class they are typically referencing. But remember: large-cap U.S. stocks are just a single asset class among many.
- **Small and mid-cap company stocks delivered much more muted returns** for the quarter, coming off the back of a strong first half of the year where small caps soared and outperformed everything! A strong dollar helped small caps in an outsized way.
- **Growth and value duked it out for the top performing asset class spot! Growth won!** The growth category generally includes technology (strong future growth potential) and value includes mature companies with stable dividends and undervalued prices.
    - The tug of war between 'growth versus value' does not represent weakness in the value space—more so the exceptional growth of FAANG stocks. FAANG stocks have an outsize impact on the major indices (as noted in the Q2 commentary).
    - In July, Facebook plunged around 19% due to weaker-than-expected quarterly revenue and privacy concerns, the biggest-ever 1-day loss for an individual U.S. stock. Twitter (TWTR) also dropped around 15% pre-market in July based on a drop in users. Netflix dropped about 14% afterhours following disappointing quarterly results. In a quick August turnaround, Apple became

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the first EVER company to hit $1 TRILLION market cap (followed by Amazon weeks later), leading the growth category to highs, and outperforming value counterparts.

- **Unemployment down to the lowest level since 1969.** The U.S. unemployment rate is down to 3.7%. In a 'good news can be bad news' twist, these strong numbers fan the flames of inflation fears. Jumps in inflation can affect both stock and bond markets, so investors watch this data with a keen eye.
- **Market movements continued to follow the headlines related to tariffs.** The U.S. and China traded tariffs on imported goods. Markets abhor uncertainty, and have moved up and down based on the anticipated impact of these tariffs on global growth.
- **A new NAFTA!** Three nations reached an agreement in September to replace NAFTA with The United States-Mexico-Canada Agreement. Major changes relate to policies on labor, environmental standards, intellectual property and digital trade. USMCA must be fully ratified by all three governments.

International Equities:

- **Developed International markets delivered muted returns.** Despite a negative start to 2018, the asset class was flat for the YTD through July. Then things turned negative again in August on Brexit and tariff headlines. Developed international stocks were flat in Q3, but now lag the U.S. significantly on a YTD basis, down just over 1%.
    - **Italian budget crisis causes a dip in European stock markets, likely short-term.** The value of the Euro dropped, yields on Government debt jumped and European stock markets dropped in response to the Italian government's struggle to reach a budget agreement. Though Italy has a high relative debt level, we anticipate this Italian budget crisis may not be as severe as anticipated, and that the sides will come to an agreement. In fact, in the first few trading days of the 4th quarter, we received news that Italy aims to cut deficits and markets reacted with relief.
    - **Brexit negotiations continue between UK and EU commission leaders.** It is looking less likely to reach a Brexit deal before the UK 'crashes' out of the EU. There are even some calls for another referendum to determine whether British voters still want Brexit to occur!
    - **ECB monetary policy remains accommodative.** Policy is likely to remain accommodative well into next year, to provide stability to the region among the muddled Brexit negotiations.
- **Emerging markets were once again the story of the quarter.** Emerging countries stock markets had a terrible 2nd quarter, and compounded those losses with a slightly negative 3rd quarter. Turkey became embroiled in a political clash with the U.S. over steel and aluminum tariffs. There is a fear of contagion to other EM countries and even to European assets. We believe other countries in the EM space will hold up strength.

Bonds:

- **Another quarter….another rate hike!** Through 3 quarters of 2018, we experienced 3 Fed rate hikes. In fact, the 10 year Treasury note surged past the psychological 3% barrier and now sits around 3.2%.
- **Your managed bond funds fared much better than the broader bond market.** This is one of the reasons we use active management within your income portfolios. In a challenging rising rate environment, it is incredibly important for your bond holdings to be nimble and able to take advantage of increasing rates.

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- **Bond funds delivered flat or slightly positive returns for the quarter and YTD.** Your bond holdings have helped to support your portfolio returns, with mostly flat or muted returns YTD. This is typical of a rising rate environment. It takes time for the holdings within your bond funds to reshuffle and generate the higher levels of income that newly issued bonds produce. In the end, higher rates are a good thing for your income portfolio.

Expectations and Perceptions for the Future:

Equities:

- **Increased equity market volatility in response to inflation fears and rising rates.** We do believe the Fed has a handle on managing inflation, and a clear path for rising rates. However as the economy continues to grow, inflation fears may prompt the Fed to raise rates faster than originally planned.
- **Increased volatility around a mid-term election, trade, and tariffs.** Historically, the outcome of mid-term elections does not have a significant impact on stock market performance, but investors are watching this election closely due to the potential impact on fiscal policy. Trade and tariffs will continue to move headlines but may not have as large an impact as originally thought. Even the new USMCA agreement is not vastly different from its NAFTA predecessor….yet markets followed the development of the agreement with obsessive interest.
- **The overwhelming theme….increased volatility!** At a recent continuing education event, the speaker questioned, “How can we drink from the fire hose of data?” This abundance of data certainly makes us more educated, but it also provides markets with even more stimuli to move than ever before. The speed of data continues to increase, and so does the speed or market movements.
- **Likely continued good news from corporations in Q4.** The Fed Chairman, Jerome Powell, said that the outlook for the U.S. economy is ‘remarkably positive’ based on low unemployment AND low inflation contributing to the extended expansion.

Bonds:

- **Anticipate one more rate hike in December 2018.** This is already priced in to bond markets. Inflationary pressures should keep the Fed on track to gradually raise rates without significant spikes.
- **Potential for larger year-end income distributions and higher income.** Your bond funds have started to add in higher yielding bonds to generate more income. This ‘reshuffling’ is an essential part of managing a rising interest rate environment. Your year-end scheduled distributions may be larger than normal due to this reshuffling in the face of 3 rate hikes this year.

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