Third Quarter 2018
Quarterly Letter to Clients
By Scott A. Wendt, CFA
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The third quarter of 2018 is in the record books, and the results put the current economic expansion one step closer to becoming the longest one in post-World War II history. Well into its 10th year of growth, the U.S. Economy continues to forge ahead despite the swirling headwinds of increased interest rates, tariff worries, natural disasters, and increased geopolitical uncertainty.

The focal point for the capital markets has been the extraordinary easy money policy of the Federal Reserve – almost to the exclusion of all else. Since 2015, the Fed has slowly been shifting from its super accommodative policy towards returning interest rates (and maybe more importantly, market participants' expectations) to more normal levels. The Fed Chair, Jerome (Jay) Powell, has continued his attempt to provide transparency around the Federal Open Market Committee (FOMC) decisions, while trying to balance the potential that the shift in policy might stifle, curtail, or outright stop an expansion that is just shy of claiming its spot in the record books.

Expectations are shifting, as the FOMC participants have telegraphed their forecast of higher rates, and Wall Street is beginning to take note and attempt to handicap what higher rates really mean to an economy, and more specifically, capital markets that have been addicted to the mantra "lower for longer". The crystal ball is not any clearer, and may even be cloudier, due to the now all too common frequency of natural disasters and geopolitical rifts that have put stresses on the melting pot of economic growth. The crux of the issue is whether the combined monetary and fiscal stimulus will create enough momentum for economic growth to be sustained as it is removed and battered about by the storms of life, whether they are natural or political in nature.

There are many bright spots in the most recent economic reports that provide hope that the economy can continue its positive trends. For instance, consumer confidence, as measured by the Conference Board's Consumer Confidence Index, was 138.4 in September, the highest level seen since 2000. This reading reinforces the belief that households remain optimistic about future economic and labor market conditions. Higher confidence most likely also contributed to the steady growth in consumer spending, which maintained its firm pace over the past quarter. While the consumer did spend on services and nondurable items, the combination of higher interest rates and higher housing prices are beginning to put a damper on sales of new and existing homes. In addition, auto and light truck sales, which peaked near 18 million units during the third quarter of last year, have fallen into a saw-toothed pattern, alternating between some replacement activity due to last year's hurricanes and reduced production to meet growing inventory levels. Both Hurricane Florence and Hurricane Michael are expected to have similar impacts on replacement demand, which could buoy near-term sales as folks in the affected areas try to rebuild and resupply.

The Labor reports continue to impress, with record low unemployment, currently at 3.7%, marking the lowest level reported since December 1969. The momentum in the job market has remained steady, despite the monthly variations in the reports. Throughout the year, the payroll stats have recorded between 150,000 and 200,000 new nonfarm job additions every month. The good news is that means more folks are earning a paycheck and spending more on goods and services. The bad news is that around the country both large and small businesses have an increasing number of unfilled jobs than are awaiting skilled workers to fill them. The mid-summer data reports showed that the available jobs increased to 6.94 million, above the last peak set in 2000, and far exceeding the number of reported unemployed at 6.28 million people. Other employment statistics show that "quitters" are quickly finding their next job and that the number of Americans unemployed 5 weeks or less is now at the lowest level since the 1970s. The acceleration in hiring is contingent on attracting many of those that aren't actively seeking employment back into the workforce, raising wages, and convincing current workers to stay on the job, rather than leave or retire.

Bonds

The 10-year U.S. Treasury yield saw a major increase between early September and the end of the quarter, rising 21 basis points. The reasons for the increase may be the result of a number of coinciding factors. For instance, a higher volume of U.S. Treasuries funding the annual Federal deficit is putting greater downward pressure on bond prices and increasing yields. In addition, the FOMC's dot plot calls for the expectation of higher rates in the short part of the maturity spectrum, as the Federal Reserve continues to slowly tighten monetary policy, also putting upward pressures on interest rates. In addition, the Fed's balance sheet restructuring, which is a part of their announced plan to restore some semblance of normalcy in the credit markets, will be overshadowing the demand side of the market for longer dated Treasuries - again putting additional downward pressure on prices and increasing yields. It has been estimated that the three major central banks, the Fed, ECB, and the BOJ, will be reducing their quantitative easing programs (read either as quantitative tightening or in plain terms – reducing their manipulation of the long-term market), which has the very real impact of reducing the demand side for sovereign credits by about $100 billion per month at the start of the 4th quarter of 2018.

The timing and speed of the policy reversal could have a direct impact on financial assets and the magnitude of the resulting rate increase. Remember that the imposition of the Quantitative Easing (QE) policy inflated financial assets. We can reasonably expect that the removal of the extraordinary measures could well have the opposite impact and deflate asset prices. The Fed's intervention put demand where there was no demand, aiding in the time of crisis back in 2009. However, the unintended consequence was a market that was lulled into a false sense of security. Poorer quality credits have been priced to perfection, or in some cases, outright mispriced for the risks associated with the underlying businesses. As the Fed kept rates lower for longer, more of corporate America leveraged their balance sheets, joining both the consumer and government sectors to push the Debt to GDP ratios past the levels seen in 2008. The result is a world awash in cheap capital, funded mainly by the promise to repay, which is, in many cases, based on the assumption of being able to refinance a large tranche of debt in the next few years. Despite the Fed raising rates 8 times since December 2015, monetary policy remains extremely accommodative – especially for this stage of the economic expansion.

The Fed faces another conundrum of its own making – its actions have had little impact on meeting the twin goals of containing inflation (price stability) and enhancing the labor market, which impact Main Street. However their actions have had a strikingly important impact on Wall Street's fortunes. New Fed Chair Powell has the most difficult task of balancing the path to replenishing the Fed's arsenal to combat the next recession, with the possibility of deflating financial assets and potentially contributing to the reversal of the economic expansion. When yield starved investors wake up to the realization that they hold bonds bought during the frenzy of the Zero Interest Rate Policy (ZIRP), and prices and yields that cannot be sustained, bonds across the spectrum will be re-priced and endowments, pension funds, and investors of all classes stand to lose the principal they agreed to lend to borrowers of marginal credit quality.

The increased volatility in interest rates and the performance of various credits are beginning to reflect the aforementioned changes. Yields on treasury bonds continue to oscillate within a trading range. During the past 91 days, the 10-year Treasury bond traded to yield between 2.82% and 3.10%, posting a yield of 3.05% at the end of June. As the table on the next page shows, lower quality bonds underperformed higher-quality credits, as spreads narrowed on corporate debt and risk-aversion decreased. Over the past quarter, interest rates traded in a wide range, with bond investors again seeing negative returns across most maturities.

Morningstar Bond Indexes			*As of 9-30-2018*	
	Quarter	1-Year	3-Year	5-Year
US Inter Core Bd TR Bond	0.0	(1.2)	1.1	2.1
US Lng Core Bd TR Bond	(0.3)	(2.7)	2.6	4.2
Corporate				
US Corp Bd TR Bond	**1.0**	**(1.1)**	**3.1**	**3.5**
US Inter Corp Bd TR Bond	0.9	(1.0)	2.5	2.9
US Lng Corp Bd TR Bond	1.3	(2.2)	4.5	5.0
Government				
US Gov Bd TR Bond	**(0.6)**	**(1.6)**	**0.3**	**1.4**
US Inter Gov Bd TR Bond	(0.3)	(1.9)	0.1	1.2
US Lng Gov Bd TR Bond	(2.0)	(3.3)	0.4	3.4
US Shrt Gov Bd TR Bond	0.1	(0.3)	0.3	0.6

Stocks

With the advance in equity prices this year, U.S. Stocks are sporting valuations and absolute performance that are stretched when compared to historical norms. Rising interest rates are a potential threat to this trend, as rates above 3% will begin to compete with the average stock's dividend yield. Corporate profits are still riding the wave of tax relief, with forecasts for third quarter of 2018 earnings growth expected to show above average year-over-year improvements. However, analysts' have lowered their forecasted growth rate of earnings estimates in 8 of the 11 S&P 500 sectors, reversing the upward revisions seen earlier in the year. Tariff uncertainty, weather and the strong dollar are all contributing to reduced expectation.

With U.S. stocks priced nearly for perfection, many investors are beginning the process of rebalancing their portfolios towards either less risky alternatives or those areas with better expected returns. Fund flows for both mutual funds and exchange-traded funds reflected the shift. "Investors sent a net $62.23 billion to bond-focused mutual funds and exchange-traded funds in the quarter, according to Investment Company Institute estimates. In contrast, U.S.-stock funds had a net outflow of $51.11 billion; international funds took in a modest $83 million."[1]

The Lipper Performance table on the next page displays the range of returns earned by mutual fund managers during both this past quarter and the 1-year, 3-year, and 5-year time periods. For the third quarter of 2018, the table illustrates that smaller capitalization stocks underperformed again when compared to larger capitalization stocks. In addition, for the seventh quarter in a row, lower-quality stocks outperformed their higher-quality counterparts. On a total return basis for the quarter, the Dow Jones

[1] https://www.wsj.com/articles/u-s-stock-funds-rose-5-2-in-the-third-quarter-1538964960?mod=searchresults&page=1&pos=1

Industrial Average (DJIA) increased +9.6%, while the S&P 500 was up 7.7%. The tech-heavy NASDAQ posted a gain of +7.1%, in line with most other major indices. The average mutual fund, represented as Equity Income Fund in the table, saw an increase of +5.3% for the quarter. International funds faired much worse, increasing +0.3% for the quarter, providing additional evidence of the wide dispersion of returns over this past quarter.

LIPPER MUTUAL FUND INVESTMENT

Performance Averages

Friday, October 5, 2018

Investment Objective	3rd qtr	1-year	3-year	5-year
S&P 500 Daily Reinv IX	7.7	17.9	17.3	14.0
DJ Ind Dly Reinv Avg IX	9.6	20.8	20.5	14.6
Multi-Cap Value Funds	4.5	9.5	12.9	9.6
Equity Income Funds	5.3	10.6	13.0	9.7
Large-Cap Core Funds	7.0	15.7	15.4	12.1
Large-Cap Growth Funds	7.6	25.0	18.6	15.0
Large-Cap Value Funds	5.9	10.6	13.4	10.1
Mid-Cap Core Funds	3.9	10.9	12.5	9.4
Mid-Cap Growth Funds	6.9	21.9	16.2	12.1
Mid-Cap Value Funds	2.5	7.8	11.7	9.0
International Stock Funds	0.3	1.5	8.8	4.3

Sources: Lipper; WSJ Market Data Group

For stocks to make further gains from here, company profit growth would need to top current, already high levels, and inflation expectations and interest rates would have to stay the same or rise slowly over an extended period of time. The odds that this would occur at the current time are slim.

As we move into the final quarter of the year, it has never been more important to keep a long-term investment perspective. If one believes that the capital market participants have been overly generous in their assessment of the risk factors that could agitate the market, the resilience that has heretofore kept the upward trajectory in motion could change rather quickly. An extra dose of caution is probably in order. Thus, while the average investor's investment time horizon has been reduced from years to weeks (or dare I say days?), our focus remains on meeting your long-term objectives and goals by custom-tailoring your portfolio to minimize the risks of sustaining a permanent capital loss.