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Third Quarter 2018 Newsletter

Fig. 1 – S&P 500

Fig. 2 – Russell 2000 U.S. Small Cap Index

U.S. stocks continued their rise in the third quarter of 2018, with most indexes recovering completely from the first quarter's sharp pullback and reaching record highs. The large cap S&P 500 index (**Figure 1**) posted a total return of +7.7% and is now +10.6% for the year. The Russell 2000 Small Cap index rose 3.6%. The Dow Jones 30 Industrials rallied after lagging in the first half, rising +9.6%. Foreign stocks continued to underperform. Emerging markets dropped again, losing -2.0%, while developed economies outside the U.S. eked out a modest gain of 1.4%.

Corporate earnings growth was strong again in the second quarter, helping to move stocks higher. S&P 500 second quarter earnings grew +25.4%, the largest increase since 2010. Revenue growth of +9.8% was also solid. According to research service Factset**,** 80% of companies topped analyst earnings projections, the highest percentage since Factset began recording this in 2008. While this does suggest a robust corporate profit picture, these results will be difficult to match going forward. Some of the profit growth is coming from a one-time boost from the recent corporate tax cuts. Third quarter earnings are expected to grow 17.7%. Continued earnings growth will be needed to keep stocks moving higher.

Most economic news was positive in the past quarter. Second quarter gross domestic product (GDP) grew at an annual rate of 4.2%, the highest reading since 2014. Growth in the third quarter is expected to be close to 3%, an improvement over last year. Business investment and consumer spending both grew strongly. Purchasing manager surveys were also robust, supportive of future growth. Employment remained tight with more job openings that losses, historically low initial unemployment claims, and relatively few layoffs. However, housing remained a mixed picture. Existing home sales were slow again, although home prices continued to rise. Affordability may be more of an issue, now that mortgage rates have risen. This sector bears watching, as housing is an important leading indicator for the economy.

The quarter provided investors with many headline worries, some of which weighed on markets, but only temporarily. Many of these were related to trade, trade wars, and tariffs. The U.S. and China implemented tariffs, which will raise prices on each other's imported goods. The Trump administration has also threatened other imports with tariffs, including European automobiles. In addition, the North American Free Trade Agreement (NAFTA) has been under contentious renegotiation. Yesterday, the U.S., Mexico and Canada announced a new trade pact to replace NAFTA. As of this writing, trade-related concerns appear to be quieting, at least for the U.S., and stock markets have responded. U.S. large cap

Index returns taken from Morningstar.com stocks, which rely more on exporting, have outperformed. By contrast, small companies, which are more domestic in nature, pulled back in September (**Figure 2**).

U.S. bonds continued to tread water in the third quarter. Yields rose in September (**Figure 3**), along with expectations for economic growth, as trade war headlines subsided, and the Federal Reserve raised short-term rates. However, August inflation readings from both the consumer and producer price indexes were lower than expected, indicating that future rate increases can proceed at a measured pace. In addition, bond rates in overseas developed countries, including Europe and Japan, remain relatively low. As a result, foreign bond buyers remain attracted to U.S. fixed income, helping to slow bond price declines. While fixed income returns have been disappointing this year, bonds continue to provide important diversification benefits, and are still likely to reduce portfolio volatility during future stock market pullbacks.

Foreign stocks remained weak in the third quarter. Growth has slowed in some emerging economies and investors have fled for the relative safety of U.S. stocks (**Figure 4**). Trade war fears have been a contributing factor. Emerging economies still offer solid growth and relatively low stock valuations. Historically, international stocks have provided some diversification benefits when included in a portfolio with U.S. equities. Patient investors may be rewarded as these economies recover and buyers return.

Investors are regularly bombarded with headlines insisting that the economic expansion is old or over-extended, that stocks are overvalued, and that the next recession is imminent. Some have called this expansion the most unloved bull market in history. There are certainly reasons for concern, including trade wars and slowing home sales, but it is extremely difficult to forecast the next bear market and recession. Investors are more likely to meet their long-term goals by staying invested, with an asset allocation that fits their objectives and risk tolerance.

Fig. 3 – U.S. 10-Year Treasury Yield

Fig. 4 – iShares Emerging Markets

We encourage you to contact us if you have questions about your own asset allocation. We look forward to speaking with you soon.

Sincerely,

Kenneth M. Bernard, CFA