Economic Commentary

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"I shake it off, I shake it off"

- Taylor Swift

Shaking off trade tensions, rising interest rates and political turmoil, stocks in the U.S. rose to new highs in the third quarter. This was the strongest quarterly gain in five years and the current bull market, which began in early 2009, is now the longest in the post-War era. The rally reflected the strong economic data released over the past three months, most of which were on the high side of estimates. Second quarter GDP came in at 4.2%, jobless claims fell to a level not seen since 1969, and inflation remained relatively subdued. The unemployment rate now stands at 3.7% and may fall lower, if some forecasts are correct. The U.S. is experiencing the strongest period of growth in many years.

This economic strength is creating a bit of a seesaw moment for investors. Domestic stocks were up 7.71% during the quarter and are now up 10.56% for the year. The economic strength also helped credit spreads tighten in the third quarter and the Bloomberg/Barclay's Intermediate Aggregate Index gained 0.11% in the quarter, despite a drop in Treasury prices. The index is still down -0.86% on a year to date basis. The third quarter reprieve has since been cut short, with the bond market broadly lower since the end of September. This rise in rates is a negative for stocks, since stable low interest rates have supported – both directly and indirectly – equity prices for nearly ten years.

U.S. interest rates are having an impact on international stocks, as well. As domestic rates rise relative to other countries, the dollar gains strength. Foreign capital is drawn to the U.S. by the interest rate differential and a stronger dollar only serves to increase the attractiveness of the "carry trade." These capital flows effectively act as monetary tightening in the affected regions, putting added pressure on already tepid economies. Furthermore, dollar strength makes foreign debt denominated in dollars more expensive to service. International stocks have continued to lag domestic stocks, as a result. Developed international markets, for example, ended the quarter up just 1.35% and the MSCI EAFE Index is still down 1.43% year-to-date. Emerging markets remain particularly weak, with the EM index losing 1.09% in the quarter and 7.67% on the year.

The relationship between growth and interest rates reflects a classic economic Yin-Yang struggle for balance. In this relationship, stronger growth pushes interest rates higher and higher interest rates, in turn, cause growth to slow. This is one of the clearest signs yet that the normalization of monetary policy is beginning to take hold. For much of this century, bad news has pushed interest rates lower, often allowing stocks and bonds to rally together. We are nearing the point where stock and bond prices may regularly move in opposite directions, with strong economic news being good for stock prices but bad for bond prices, and vice versa. This relationship should produce a natural increase in equity price volatility in the months ahead.

The bull market is now in its tenth year and any increase in volatility will worry investors who think prices have gone too far. While the data suggest growth will continue, it is important to remember the economy and the financial markets usually move together, but rarely in lockstep fashion. Equity values will fluctuate to incorporate the effect of higher interest rates and emerging risks, despite continued growth. It is quite possible the market has not yet found a fair equilibrium point. The volatility that may occur under such a scenario is simply the market establishing a new base. Simply put, investors should not view a five -percent or eight-percent drop in stock prices as the start of a new bear market.

The clearest risk now is the Fed being too aggressive in their efforts to keep prices in check. Jay Powell is a savvy and astute Fed Chairman, but he has been given a difficult hand to play. Fiscal policy and the paring of aggressive regulation have jumpstarted growth. Hindsight also suggests Janet Yellen was far too timid and accommodating with her policy decisions. These factors have forced Powell to react faster and more aggressively than many expected.

With events moving rapidly, the risk of an over-reach in monetary policy is real. The Fed will be challenged to shift policy quickly enough to avoid a slow-down caused by a trade decision or a crisis. With inflationary pressures building, they cannot risk proactively slowing policy changes to account for such an event, either. While we believe trade issues and/or geo-political concerns will allow the Fed room for a pause, the Fed governors have little choice but to maintain their hawkish public stance, even if they are considering slower moves behind closed doors.

Despite these risks, there is little to suggest we will hit a recession in the near term. We continue to believe 2018 will be a positive year for stocks and the fourth quarter should not affect this outcome. We expect the expansion to continue into 2019, but investors should be aware of the growing risks and increased volatility that may occur in the months ahead.

Strategy and Market Outlook

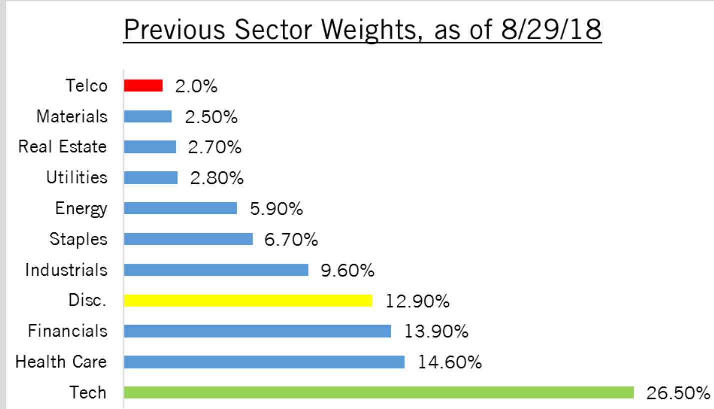
Barring a breakdown in the global trade fabric, the financial markets remain healthy. It would take a significant shock to move the economy off current trends. A trade war misstep or a Fed policy overreach would change this outlook, if either come to pass. For now, however, equity valuations remain reasonable in aggregate, even though some sectors are expensive.

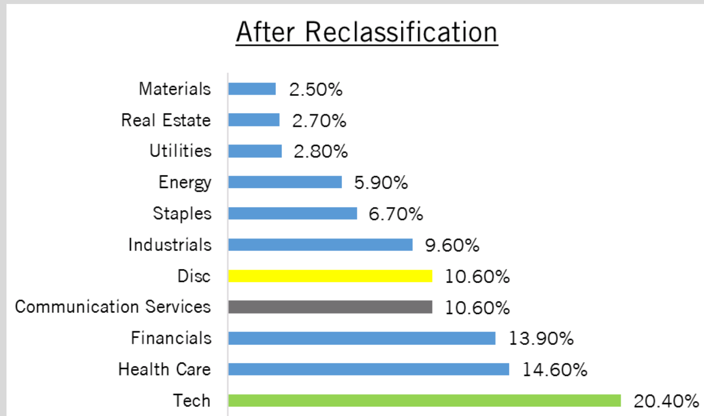
This outlook does not dismiss the risks outlined earlier in this letter. More than ever, it is important to adjust holdings to reflect changes in risk outlook and market conditions. We have been rebalancing portfolios throughout the year, and will continue to do so going forward. We will be moving portfolios toward the center of permitted asset allocation ranges and trimming risk where appropriate.

Within our equities, we have already made numerous changes to stock holdings this year to reduce company specific risk in client portfolios. We expect to trim holdings of U.S. stocks in general and will use the proceeds to finance further diversification of assets. Among the changes, we see a gradual shift toward more international equity holdings, which are increasingly attractive after the long underperformance of the asset class relative to domestic stocks. We are less enthusiastic about emerging markets, given the sensitivity of the asset class to any trade resolution, either positive or negative.

S&P SECTOR CHANGES

For the first time since 1999, the S&P 500 has made changes to how tech companies are categorized. The changes result in a newly created sector called Communications Services which includes telecom, media, and internet industries. This is only the second sector addition since 1999. Some examples of companies that are being shuffled around include Facebook and Alphabet moving from the Tech sector to the new Communication Services sector. In addition, Media companies have been displaced from the Consumer Discretionary sector to this new Communications classification. This list includes Netflix, Walt Disney, Comcast and several others. In general, not much changes from an investment standpoint, but the move certainly changes the optics when looking at drivers of performance for the index.





Source: Bloomberg; S&P Dow Jones Indices; Barron's calculations

On the fixed income side, we continue to move our bond exposures to the middle of permitted allocation ranges. We believe the consensus outlook is too bearish on Fed policy. However, we believe it still makes sense to limit duration exposure, as real interest rates will likely be pushed higher in the months ahead. We have focused recent purchases on shorter term assets, with this in mind. We are also seeking to increase the quality of the bonds we purchase to limit the impact of a future credit situation. Thanks to the FOMC interest rate hikes over the past two years, short term bonds now provide attractive returns with far less risk than longer dated alternatives and little yield needs to be sacrificed to reach this goal.

The interaction between stocks and bonds continues to be a dynamic one to watch. For now, though, we maintain our positive outlook for the balance of the year.

We conclude by observing the chance for an upside surprise remains high, especially on the trade front. The market reaction to the Canadian trade agreement illustrated just how much cash is waiting on the sidelines. We plan to view any sharp pullback as a buying opportunity.

As always, please contact us should you have questions.

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