Third Quarter 2018

Courtesy of Miles Capital

Economic Commentary

U.S. fundamentals continue to provide a tailwind, as evidenced by solid second quarter Gross Domestic Product (GDP) growth of 4.2 percent. While this number was inflated due to front loading of trade before tariff negotiations were finalized, the projections for third and fourth quarters remain over 3 percent. Leading economic indicators suggest solid growth over the coming quarters, including low unemployment at about 3.9 percent, strong housing prices and net worth trends, and record levels of consumer confidence. We are also starting to see the potential for wage growth. Consumer spending and consumption make up about two-thirds of the US Gross Domestic Product (GDP). Consequently, it is crucial to monitor the outlook for the consumer.

The financial markets continue to display only moderate signs of volatility due primarily to the strong underlying economic fundamentals. Strong earnings have also helped push the stock market higher after two quarters of 25 percent earnings growth among S&P 500 companies. Corporate earnings for both quarters are well above the 2010-2017 average which was about 6 percent.

The Federal Reserve (Fed) has now raised rates 8 times since December of 2015, and 3 increases occurred just in 2018. The Fed and Fed Funds Futures are indicating that the Federal Reserve will raise rates one more time this year and possibly three times next year, although it is more difficult to determine the validly of this longer forecast. The Fed is paying close attention to inflation as they want to stay ahead of any potential upticks. Inflation has been in the general range of 2 percent, generally in line with the Fed's targets.

The risks to the economy include tariff risks, geopolitical volatility, and inflation, which may lead the Federal Reserve to change its interest rate trajectory.

Fixed Income Commentary

A host of important events during the third quarter that pushed and pulled the U.S. bond markets in different directions. Trade and tariffs, a Federal Reserve (Fed) rate increase, moderately rising inflation, strong corporate earnings, and emerging market turmoil were just a few of the stories market participants deliberated on over the past few months. As in previous years, the markets mostly brushed off these potentially disruptive issues and drove riskier assets higher for the quarter. A key driver of absolute performance in the fixed income market was increasing interest rates across the curve.

Investors spent much of the quarter focused on the continued strength of the U.S. economy, as demonstrated by the robust GDP reports, unemployment and corporate earnings. In response, the Fed continued its gradual pace and increased interest rates ¼ of a percent in September. A December rate increase looks likely making it the fourth increase in 2018.

Interest rates, as measured by the 10 year U.S Treasury note, trended higher for the quarter and ended September near the highs of the year at 3.06 percent, 0.20 percent higher for the quarter and over 0.60 percent higher for the year. Shorter-term rates, as measured by the 2 year U.S Treasury note, continued their march higher over the quarter and ended at 2.82 percent, up nearly a full percent since the

beginning of the year. The difference between the 10 year and 2 year yields has shrunk to levels not seen since 2007, resulting in a very flat interest rate curve.

Within the fixed income markets, sector performance was largely positive on a relative basis to U.S Treasuries, generally considered the most liquid and safest asset. The Bloomberg Barclay's Aggregate index, a broad measure of the investment grade U.S. bond market, was essentially flat for the quarter but is still down 1.6 percent year to date. Most major spread sectors including corporate, municipal, mortgage, and agency bonds all outperformed similar duration U.S. Treasury securities for the quarter. Within the investment grade corporate sectors, lower quality assets outperformed higher quality and longer duration outperformed shorter duration securities.

As we look forward, we believe the solid economic footing should provide reason for the Fed to continue its gradual pace of rate increase into 2019. We also expect this growth to gradually drive longer term rates higher resulting in higher income opportunities but limited absolute return potential for most fixed income assets. Risks to our forecast include a more disruptive trade and tariff war, a global equity market correction, or more stress appearing in emerging markets.

Equity Commentary

Equity markets reached new highs in the third quarter on the continued strength of the U.S. economy. GDP growth, employment, and business and consumer confidence overrode concerns around the ongoing trade disputes with China, Canada, and Europe. By some measures, in August the current bull market became the longest in history.

Companies continue to perform well. Corporate earnings for the first quarter were up 24 percent and sales were up about 8 percent. Corporate earnings for the second quarter were up 25 percent, with revenues up 10 percent.

Despite political turmoil both at home and abroad, U.S. equities had a great quarter. The S&P 500 returned 7.7 percent, which marks the largest quarterly return since the fourth quarter of 2013 and a positive return in 11 of the past 12 quarters. Large cap stocks outperformed small cap stocks, with the Russell 2000 returning 3.6 percent in the quarter. However, on a year-to-date basis, large cap stocks have underperformed small cap stocks. Both indices have outperformed international equities. Both developed and emerging markets have suffered on political turmoil and tariff news.

Tensions have shown few signs of relief between the U.S. and its trading partners. The latest imposition of 10 percent tariffs on $200 billion worth of Chinese goods was implemented at the end of the quarter, and China struck back with levy on $60 billion of U.S. products. Meanwhile, the U.S. and Canada struggled to negotiate a resolution to a revised NAFTA, but finally came to terms on the last day of the quarter.

Given the strong economic and corporate fundamentals, we expect continued equity market strength, although we fully recognize that bull markets do not last forever.