# Market Commentary

September 30, 2018

After a tepid first half of the year, the S&P 500 surged 7.7% in the third quarter, its biggest quarterly gain since Q4 2013. Year-to-date, the S&P was up 10.6% through September 30. The US economy continues to power ahead, fueled by tax cuts, still-low interest rates, and a big rollback of government regulations. However, the dark side of this big rally is that, by some measures, US stocks are quite expensive. As of 9/30, U.S. equities were trading at a 12% premium (on a price/earnings basis) to an MSCI index of 46 world stock markets. That is the biggest gap since 2009.

In Q3, Large Cap beat Small Cap, Growth outperformed Value, and US Domestic stocks crushed International. The US Healthcare sector had a blowout quarter, returning 14.5%. On the downside, Energy was the worst performing sector in Q3 with a paltry 0.8% return. On a year-to-date basis, the Technology and Consumer Discretionary sectors still lead the way, each with a 20.6% return. While the S&P was up 7.7% in Q3, the Small-Cap Russell 2000 turned in a more modest 3.6% return. On the International side, the MSCI EAFE developed market index was up only 1.4%. The EAFE Emerging Markets index had a -1.0% return in Q3.

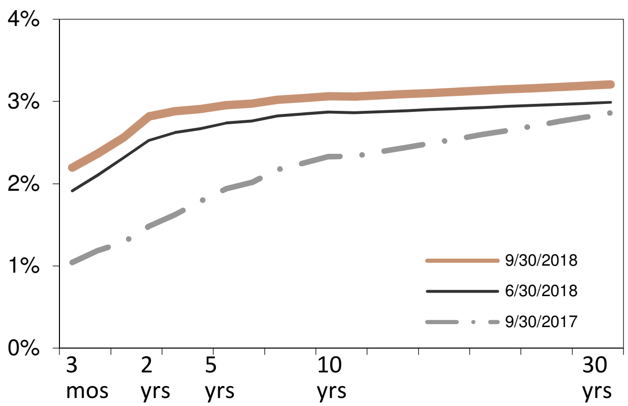
As stock prices rose during Q3, so too did interest rates. With the Fed in the midst of a tightening cycle and the economy apparently firing on all cylinders, the yield on the 10-year US Treasury rose 0.2% to 3.1%, its highest yield since 2011. In the face of rising rates, the Barclays Aggregate Index eked out a miniscule 0.02% return in Q3. YTD, the Barclays Aggregate return was -1.6%.

As expected, the US Federal Reserve raised the federal funds rate 25 bps in September, which was the third rate hike this year. Another increase is widely expected in December. Things are likely to get more interesting in 2019 as we anticipate a battle of wills shaping up between investors and the Fed. The Fed has indicated a desire to hike rates three times next year. However, markets are currently pricing in just a 50% chance of ONE hike. In other words, investors don't believe that inflation is a problem, and if the Fed remains on its current hawkish path, they risk triggering a recession.

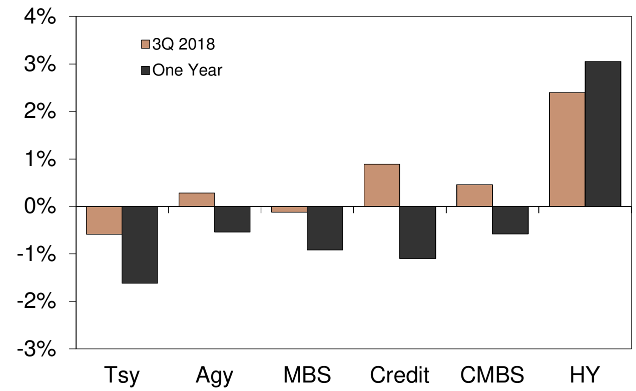
A well-known market analyst, Jim Bianco, puts it succinctly: "The Fed is the leading cause of recessions over the last 100 years. They tighten too much, fearing inflation, invert the yield curve and a recession ensues." Ouch! An inverted yield curve, when short-term yields rise above yields on longer-term bonds, is considered a reliable early warning signal of recession. An inverted curve has preceded every U.S. recession in the past 50 years. It's a sign that Fed policy is too tight, stifling economic growth. The yield curve has not yet inverted, but it has flattened significantly. In August, the 10-year US Treasury's yield premium over 2-year Treasury notes shrank to 0.19%, the narrowest since 2007.

The fear of a potential curve inversion is puzzling given the surging pace of economic growth. Second quarter GDP rose at a 4.2% clip, the highest quarterly rate of growth since 2014. The Atlanta Fed's GDPNow forecasting tool anticipates an identical 4.2% pace for the three months ended in September (final numbers aren't in yet). In addition, the US unemployment rate fell to 3.7% in September, its lowest level since 1969! One possible explanation for this impressive growth spurt is that the fear of future trade tariffs is causing panic buying by businesses. Corporations are building inventories to beat the tariffs, pumping up GDP growth in the short term, but in the process, stealing from future growth.

### US Treasury Yield Curves




### Sector Index Returns




As we go to press in mid-October, volatility in financial markets has increased significantly. Through October 11, the S&P 500 fell 6.3%, wiping out most of the Q3 return. Bonds also took it on the chin, as the yield on the 10-year US Treasury spiked to 3.23% on 10/5. In late September, former Dallas Fed official Danielle DiMartino had a very prescient call on the October stock market turbulence. She warned that world-wide financial market liquidity would soon be significantly curtailed due to a stepped-up level of "quantitative tightening" both in the US and internationally. The Fed has been gradually reducing the size of its balance sheet by not reinvesting the proceeds of maturing bonds. Effective October 1, the Fed has ramped up its "run-off" to its maximum level of $50 billion per month. Also, on October 1, the European Central Bank (ECB) reduced its bond purchase program to €15 billion per month and all purchases should conclude by year end. Likewise, the Bank of Japan has also cut in half its bond purchase program. So, for the first time since the financial crisis, world central banks will be net tightening monetary policy. Financial markets will swing from $2.1 trillion of global QE in 2017, to a net negative rate by year-end 2018. This is a huge swing that helps explain the underperformance of risky assets outside the US. This evaporation of worldwide liquidity is now impacting US financial markets.

Despite the recent market volatility, we remain bullish on US stocks, viewing this as an opportunity to put idle dollars to work and rebalance portfolios where warranted. History shows that in nearly every mid-term election in the last century, there was a sell-off preceding the election, yet U.S. markets were typically higher by the following March. Stay the course! In our fixed income portfolios, we continue to tactically adjust portfolio durations to take advantage of anticipated interest rate changes. For the past several weeks, in expectation of higher rates, our client portfolios have maintained average maturities that are shorter than their respective benchmarks. This defensive posture has benefitted our clients' portfolios. Our portfolios continue to be underweight government and mortgage-backed securities, while maintaining an overweight position in the investment grade credit sector.