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2018
3rd QUARTER

Sarah Swan,
Vice President,
Client Experience

The Equity Market

Taking Heed, but in Stride

By Sarah Swan
sswan@howeandrusling.com

Despite some occasional faltering and vulnerability this quarter, major US stock indexes are still boasting decent gains for the year. But a quick look at the Federal Reserve, the bond market, and growth prospects across the globe tell us to at least take heed as we head into the last quarter of 2018 and look ahead to next year.

The Fed

At the end of September, the Fed raised its benchmark federal funds rate for the third time this year to a range of 2-2.25%, and economists generally agree that one more rate hike is in order for December. FOMC members' projections, which are reflected in the "Dot Plot" that we've discussed before, showed that most expect to lift rates by another whole percentage point through 2019 (through three gradual hikes). Many, ourselves included, are focusing on Fed Chairman Jerome Powell's belief that interest rates are "a long way from neutral," as well as his confidence in the current environment and the path forward. In other words, he believes we are still presumably several hikes away from interest rates being what in the Fed's mind is neutral—formerly 3%, but possibly higher now. His optimistic sentiment seems to envision a historically unusual environment in which the unemployment rate remains under 4% and yet core inflation never gets too far above its 2% target.

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John Trentacoste,
Director of Fixed Income

The Bond Market

3rd Quarter Overview

By John Trentacoste
jtrentacoste@howeandrusling.com

Finishing the third quarter, we can all look back and remember it has been ten years since the financial crisis and the beginning of the Great Recession. On September 15, 2008, Lehman Brothers, what was then the fourth largest investment bank, filed for bankruptcy. Much of that event was occurring over the previous weekend, but at shortly after midnight, the filing set in motion a dramatic sell-off in the stock market and credit markets that froze as investors learned quickly just how interconnected the financial markets were at the time. And Lehman Brothers was not the only news to rattle the markets and the global economy. Earlier in the month, Bank of America's purchase of Merrill Lynch, AIG, Washington Mutual, Fannie Mae and Freddie Mac (two government agencies), among others, were all in the headlines.

Through the U.S. Treasury, several backstops to the banking industry were put in place, and through the Federal Reserve, an era of zero percent short-term interest rates began. Most backstops have been lifted and the Fed is now raising rates again, but questions remain as to whether a financial crisis of that magnitude can reappear. The debate may never end, though the fact of the matter is that banks are much safer now than ten years ago. Capital requirements have been raised. Big banks no longer just freely get bigger. Funding sources are more stable coming from a growth in deposits.

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Some economists are seriously questioning these inflation forecasts, but Chairman Powell insists the Fed will "stand ready to act with authority if expectations drift materially up or down." He is confident that the central bank will be able to keep a handle on inflation by managing expectations so that any labor market surprises don't have as much of an ability to shock the system. This is possibly why in part, according to Chairman Powell and the rest of the bank, the past several years have seen a divergence from an economic model known as the Phillips Curve (which shows that when unemployment falls, inflation rises). In this prolonged period of economic recovery, we've yet to see the associated rise in prices. However, Chairman Powell did at least state the importance of remaining skeptical "when forecasts predict events seldom before observed in the economy." We have to say—we agree.

What's Up with Treasury Yields?

When the economy is booming, stocks tend to do well because investors look to this economic growth to allow companies to grow earnings, and all else being equal, stock prices. The bond market has had a different experience, which has seen its prices fall for most of this year, in part due to rates rising (and we know that bond yields rise as prices fall). For several years now, the bond market hasn't been seen as a great source of income by many (not by historical standards during other economic cycles). However, we're now seeing a reversal of this trend. As risk-free rates climb in the Treasury bond market, the typical appeal to take on additional risk in the stock market to drive higher returns might be beginning to fade. Treasuries may be offering some risk-adjusted alternatives to the volatile equity markets. The 10-year Treasury note yield has hit five new highs this year. For the first time in a long time, Treasuries are yielding more on average than the dividend payments of the S&P 500 stocks. For some time now, stocks have managed to defy the rise in yields and have continued to grow in value themselves (the yield on the 10-year Treasury has more than doubled and the Dow Jones Industrial Average has gained more than 8,000 points since the summer of 2016), but there is some skepticism over how long this can go on uninterrupted.

So Why Have Stocks Continued to Fare Well?

Stocks have continued to rise because the economy is still healthy (September saw the unemployment rate hit its lowest level since 1969 and beat expectations for new private sector jobs added), corporate profits are even healthier, and corporate tax payments (under President Trump's new stimulus tax deal) are down 40% from a year ago, driving corporate margins to historically high levels.

However, all of these factors come with important caveats to consider as we look ahead. We discussed above the potential risks to inflation with sustained low levels of joblessness, so let's focus on the other topics.

The notable earnings growth that has driven the stock market's prices this year is expected to slow next year, possibly by as much as half of the growth that is projected for 2018. Not every sector or every stock is currently expensive, but given the big picture scenario, the forward price to earnings multiple should probably be lower than it currently is, so as we've said the last couple of quarters, our expectations for mid-single digit returns next year suggests a rather unimpressive stock market. Also, it's important to note that while the general mantra has been true that US stocks are doing well, a closer look reveals that valuations are being skewed slightly by two sectors (technology and consumer discretionary) and, beyond that, a handful of large cap growth companies that are carrying much of the index on their backs.

And lastly, we believe the positive impacts of the corporate tax cuts are likely fully digested, not to mention that along with the 40% cut in corporate tax payments comes with a substantial increase in government spending. So while the impacts on corporations have been favorable thus far, it's important to remember that the stimulus didn't happen free of cost. Moreover, a more recent quarter-end look suggests that global indexes may be beginning to outperform the US. We'll discuss tariffs in the next section, but the US policy toward trade tariffs, especially toward China, could very likely make this scenario worse for US companies by raising companies' costs and ultimately weighing on profits.

Global Outlook

It's probably fair to say that global synchronized growth is no longer a theme that we're seeing. The number of countries in economic expansion has fallen, as has the number experiencing accelerating momentum, to the lowest levels since early 2016. We've also been witnessing a slowdown in global manufacturing PMI (a leading indicator of economic health for manufacturing sectors), evidence of a slowing in international trade flows, for some time now.

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And banks have turned back to more typical lending instead of trading risky assets. With the crisis behind us, the Fed has squarely returned its attention back to its dual mandate of maximum employment and stable prices.

The Federal Reserve did not disappoint as it used the September 25 FOMC meeting to raise short rates an additional ¼ percentage point. The fed funds rate, now 2.25%, has followed a rather predictable path this year of rising ¼ percentage point per quarter. Currently, and once again reflected by the markets, we expect the final ¼ percentage point increase for 2018 to occur at the FOMC meeting on December 19. Looking ahead, the Fed's projections show a probability of three rate increases in 2019 and a final increase in early 2020.

We have dedicated a fair amount of time in this year's commentaries to the flattening yield curve due to the Fed raising short-term rates while intermediate and longer yields have held steady. It is important in that an inverted yield curve has been a good predictor of recessions. Without going into a lot of detail, we saw the curve flattening continue in the third quarter. The spread between the 2-year Treasury Note and the 10-year Treasury Note finished the quarter at 24 basis points. At the end of the second quarter it was 33 basis points.

This spread is commonly used by traders and commentators, though it is not the only combination possible. Recently the Federal Reserve of San Francisco published an economic research paper on the predictability of using the 3-month Treasury Bill and 10-year Treasury Note. Its data show that combination as a better choice and while it is still almost 1% from being inverted, it would be a lessened predictor of a near-term recession. The Fed is going to great lengths to assure us a recession is probably not in the cards and while we are not necessarily agreeing upon which combination is the best, we do agree there is a low chance of recession.

Economic reports from the third quarter back up our expectations for continued growth. We are taking a little liberty here discussing second quarter growth, but we must wait until the third quarter for the data. First released in late July and later revised, GDP surged to an annualized 4.2% for the second quarter. That is up from 2.2% in the first quarter and the highest reading since late 2014. Retail sales are strong, and unemployment is near generational lows. Tax reform stimulus is waning but there is enough strength remaining in the economy to keep quarterly GDP above the past few years.

The reports also show contained inflation both in the economy and wages. At the Fed's target of 2%, annualized inflation gives it little wiggle room, but we believe inflation will not heat up to the point of causing a faster or greater tightening cycle. Some in the markets think it may be just the opposite.

For the third quarter, the broadest market index, the Bloomberg Barclays U.S. Aggregate Index, was slightly positive though year-to-date it is still down 1.6%. The Intermediate Government/Credit Index, our benchmark, returned a positive 21 basis points for the third quarter. A rough start to 2018 (Q1 was down .98%) still weighs on the Index but that has now been followed by two slightly positive quarters. The credit side of the Index, which was the main driver for the negative performance in the first quarter, was up 73 basis points in the third quarter as spreads tightened and new issue supply was met with strong demand. We expect spreads to continue to tighten as a robust economy keeps investors comfortable with owning corporate debt.

The Bloomberg Barclays U.S. Corporate High Yield Index had positive returns each month, leading to an impressive third quarter returning 2.40%, as quarterly new issuance was the lowest since 2015. A strong equity market and rising oil prices also helped the high yield market return the best performance of the sectors. The high coupon and short relative duration of the high yield market has it in a unique spot for outperformance, though we remain cautious as history has shown volatility can return quickly.

Switching to the tax-exempt market, the Bloomberg Barclays Municipal Bond Quality Intermediate Index returned a negative 11 basis points for the third quarter following a strong second quarter. For the year, the Index is now at negative 21 basis points. Heavy new issuance in September negated positive July and August returns. 10-year municipal bonds rated double-A ended the quarter at 2.81% (Bloomberg), above the 2.65% at the end of the second quarter. On a taxable equivalent basis (35% tax bracket), municipal bonds provide a good relative value to corporate securities past a five-year maturity and should remain attractive for investors as the last income tax shelter following the federal curb on SALT deductions. Along with a steepening yield curve out to a 15-year maturity, we still believe the best value for our clients is in the intermediate maturities. Looking ahead, fourth quarter supply will be dominated in October and November with full year 2018 issuance similar to lower historical levels seen in 2013/2014. The municipal bond market is a very high-quality asset class and whether on a taxable equivalent basis or through taxable municipal bonds, it remains a top choice for our clients' portfolios.

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It is of course difficult to say with certainty how the effects of a global trade war and ensuing tariffs will shake out exactly. Tariffs, though, almost by mere definition, interrupt global supply chains and naturally efficient systems of supply and demand. Trade wars are not to be viewed favorably—in fact, a recession is even a possible outcome of a fierce trade war between powerful players, albeit a worst-case scenario one. The tariff war of retaliation between the US and China in particular poses a great risk to our domestic and global economy. These taxes on imports could raise operational costs for US companies and therefore cut into profit margins. They could also further strengthen the US dollar which will hurt offshore revenues and lessen the impact of the tariff on the Chinese. Although the Fed has yet to see any real risk to inflation, this is another potentially impacted facet of the economy to keep an eye on. The risk, of course, is that all of this could ultimately strain US GDP and growth, as well as that of other countries, regardless of the desired impact on Chinese exports.

Perhaps one bright light on the global scene is oil, which saw marked strength in September, with Brent Crude (the trading classification for oil as a commodity) breaking above $80 per barrel at the end of the quarter and then above $85 in the first week of October. Of course, higher oil prices will take dollars out of consumer pockets, so while oil companies will certainly benefit from higher crude prices, higher energy costs will likely serve to dampen overall consumer spending activity.

Our Positioning

Our expectations are tempered and realistic for what the stock market is likely to bring in the months to come, and we feel we are postured appropriately for now. We do know that recessions and bear markets are part of the natural lifecycle of the market, albeit not always welcomed by investors, and certainly difficult and imprudent to try to time. We remain cautious and are therefore cushioned against a typical amount of market volatility, but if any additional risks become more substantiated, we'll be poised and ready to act.

End

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Based on the strong economic data and contained inflation in many ways cancelling each other out, volatility in the bond market was generally lower in the third quarter than in previous quarters. Lower volatility allows us to comfortably position our clients' portfolios across the intermediate maturities of the yield curve. We expect gently rising rates for the remainder of the year. We feel our current strategy of over-weighting credit and quality is still appropriate, and as such, we continue to seek out the optimal maturities to capture the most income without introducing undue risk to the portfolios.

End