

Third Quarter 2018 Market Review

Key Takeaways

U.S. equity markets outperformed international equity markets in the third quarter of 2018, posting a 7.4% return against a 1.4% return for EAFE markets and a 1.1% loss for emerging markets. **Since April 30th, U.S. equity markets have outperformed ex-U.S. developed markets by 13.0% and emerging markets by a whopping 19.5%.**

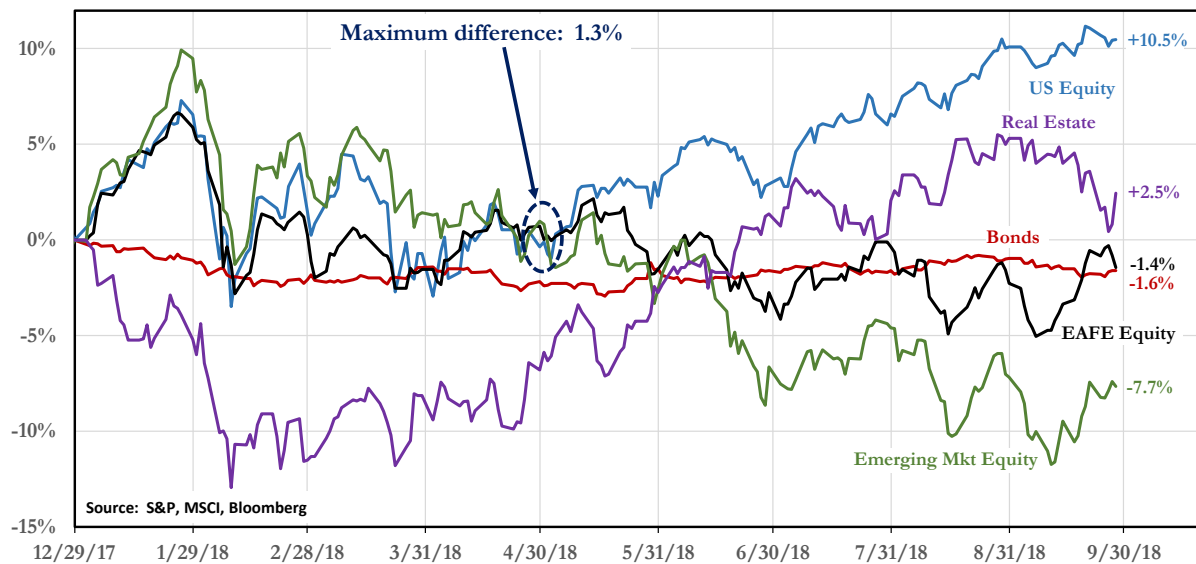
We believe international stocks are cheap vs. U.S. stocks and we are overweight international stocks vs. U.S. stocks in client portfolios.

U.S. fixed income markets were largely unchanged for the quarter and real estate picked up 1.1% after a difficult September. We are bearish on interest rates and prefer to be short duration in fixed income portfolios and market-weighted to under-weighted in real estate allocations.

Table 1: Benchmark Index Performance as of September 30, 2018

Benchmark Index	1 Mo	2018 Q3	YTD	2017
Domestic Equities (S&P 1500 Composite)	0.34%	7.35%	10.5%	21.1%
International Developed Equities (MSCI EAFE)	0.87%	1.35%	-1.4%	25.0%
Emerging Market Equities (MSCI EM)	-0.53%	-1.09%	-7.7%	37.3%
Fixed Income (Bloomberg Barclays US Aggregate)	-0.64%	0.02%	-1.6%	3.5%
US Real Estate (S&P US REIT Index)	-2.72%	1.06%	2.5%	4.3%
Global Equities (MSCI ACWI)	0.44%	4.28%	3.8%	24.0%

Chart 1: Market Index Performance through September 30, 2018



Overview

The momentum behind U.S. Equities slowed to a trickle in September and international equity markets were little changed as well. For the year, U.S. equities remain the darling of the market and international equities a clear laggard. Chart 1 shows the story of U.S stocks vs. international stocks. At the end of April, all three of the equity markets we track (U.S. domestic, ex-U.S. international developed or EAFE, and emerging markets) were in a close race with remarkably little change in year-to-date returns. Since April, however, the market has performed much differently as the U.S. market has outperformed EAFE by 13.0% and emerging markets by a whopping 19.5%. Chart 3 below outlines the ratio of EAFE and EM indices to the U.S. broad index, highlighting the large drop-off since April.

International markets suffered from a few different ailments but the main aggravator has been the increase in interest rates spurred by Federal Reserve monetary policy. That rate increase has led to a higher dollar exchange rate, especially compared to weaker currencies. Higher rates and a strong dollar then force other countries to prop up their own currencies by raising interest rates internally and by selling dollar reserves. Those actions have weakened markets in some countries, notably Argentina and Turkey but also China, South Africa, Indonesia, Brazil, and India. The main concern is, as always, a threat of contagion as the prospect of higher rates leads to defaults which starts a downward economic spiral. Add to that mix the turmoil of international tariffs and trade sanctions and you get a “risk-off” mindset for countries outside the U.S. and declining international stock markets.

From our vantage point, we don't see the downward economic spiral for emerging markets. International stocks largely traded sideways in September, indicating a break in the streak of weaker international performance. With international stocks substantially cheaper, we decided to move our clients to slight over weights in international stocks. We realize that U.S. stocks may run further against overseas markets but our goal is not to pick the bottom but to rotate out of more expensive assets and into cheaper assets.

U.S. Market Review

U.S. equities had an excellent third quarter 2018, advancing 7.4% overall. Most equity indices set new all-time highs throughout the quarter. Large cap stocks led the way with the S&P 500 outperforming the S&P SmallCap 600 by 3.0%. Large caps led despite the poor performance of foreign equity markets which usually drag down large cap stocks that derive substantial earnings in overseas markets. Factors leading U.S. markets in the third quarter include growth, quality, and momentum factors while sectors leading the market include health care and industrials.

Economic fundamentals remain strong. Employment fundamentals are very strong with the unemployment rate at 3.7%, the lowest official figure since 1969. Wage inflation was reported at 2.8% year-on-year for September, down from 2.9% in August. Overall inflation also remains tepid at 2.7%. The FOMC, as expected, raised rates ¼% on September 26th and telegraphed another ¼% increase for December 19th. The dollar, as measured by the Bloomberg Dollar Index, rallied 0.7% in the third quarter after a very strong second quarter increase of 5.0%. Tariffs that were threatened earlier in the year have now been implemented and new trade deals with both Mexico and Canada have been finalized, with the Canadian deal coming on the last day of the quarter.

The rally in the market outstripped earnings increases resulting in P/E ratios moving from 16.3x to 17.0x and E/P percentages moving from 6.14% to 5.89%.

We moved some asset allocations out of U.S. stocks into international stocks in September to take advantage of cheaper international valuations vs. the U.S. market. This is meant as a strict relative value play. We acknowledge that the market may go against us on this trade in the short term but our conviction is that international markets are relatively cheap to the U.S. market. We believe that much of the optimism in the U.S. market comes from the effect of corporate tax cuts, a one-time gift to the market whose effect has been measured and fully priced into the market. The U.S. economy can continue to move forward at a strong, steady pace but earnings growth will slow as growth gains from corporate tax cuts are eliminated. Furthermore, S&P has revised earnings estimates downward lately instead of upward. S&P is estimating year-over-year earnings growth at 12% in the Q2 2019 versus 28% for Q3 2018.

Chart 2: U.S. Equity Relative Value Metrics through September 30, 2018

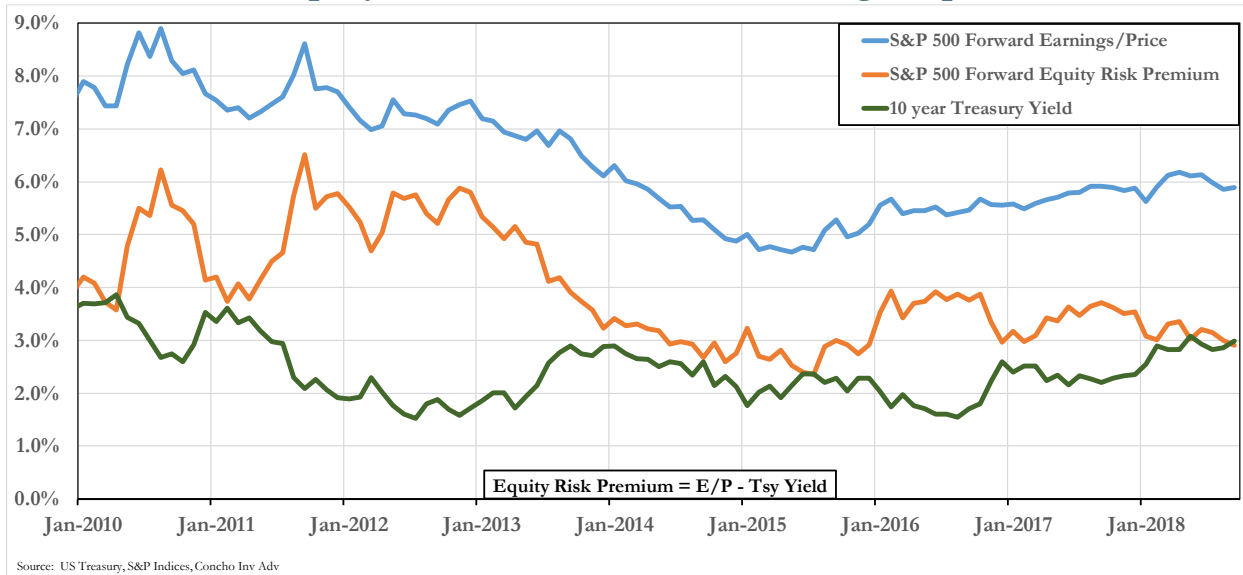
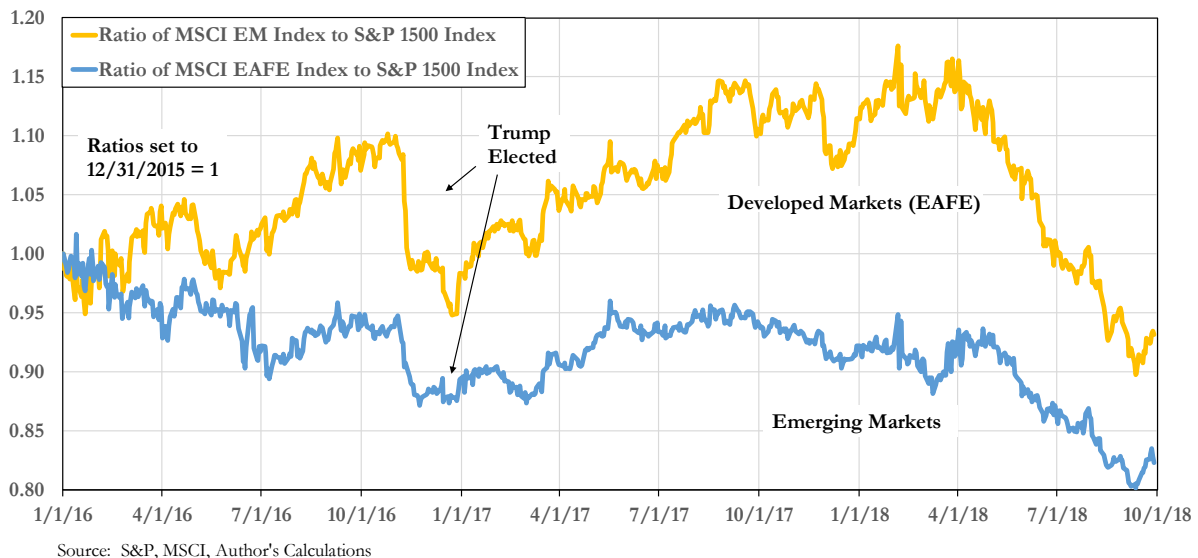


Chart 3: U.S. Equities Outperform Foreign Equities in the Second Quarter: Asset Exchange Rates through September 30, 2018



International Equity Markets

International developed equity markets as represented by the MSCI EAFE Index were up 0.9% for the September and 1.4% for the third quarter. European markets were little-changed with the small gains coming from Japan and other developed markets. The European economy is still growing but overall growth rates are down since the beginning of the year. The effect of the strong dollar and higher rates in the U.S. is having a small dampening effect on non-U.S. developed markets. The European Central Bank is still on track to end asset purchases or “quantitative easing” by the end of this year and they also communicated that short-term interest rates will not rise until 2019.

According to FactSet, the EAFE index is trading at a 20% discount to average forward P/E ratios based on data going back to 1995. Most of this discount is attributable to Japan, Europe is trading slightly above long-term averages. However, the U.S. market is trading significantly above long-term averages.

Emerging Markets

Emerging market equities lost 0.5% in September and 1.1% in the third quarter, much better than the 8.0% loss in the second quarter. Emerging markets also experienced significant volatility in the third quarter, especially when compared to the even progress in U.S. markets.

As stated above, emerging markets have been hit hard by higher interest rates, a stronger dollar, and a U.S. administration that is taking a hard line with emerging countries. While we remain cautious, we have decided to overweight EM in our portfolios in hopes that the cheap valuations will richen over time and EM returns will surpass developed markets in the future.

Bond Market Review and Outlook

Interest rates rose significantly in the third quarter with most of the action occurring in September. Rates increased 20 to 25 basis points across the yield curve with shorter maturities experiencing the higher rate increases. Ten-year Treasuries ended September at 3.05% and the Bloomberg/Barclays U.S. Aggregate Bond Index was largely unchanged at the end of the quarter as coupon income was offset by price decreases.

The Federal Reserve Open Market Committee raised short-term interest rates on September 26th by a quarter point and re-iterated their intention to increase rates another quarter-point at their meeting on December 19th. Furthermore, their median “dot-plot” forecast calls for 3 additional quarter-point increases next year which would put the range for Fed Funds at 3.0% to 3.25% by the end of next year.

We continue to be bearish on interest rates. If the Fed expects Fed Funds to exceed 3.0% by the end of 2019 then 10-year Treasuries at 3.0% seems rich to us. We also see too much supply looming in the wings as the pace of quantitative tightening increases and as the Federal Government issues debt to pay for 2018’s tax cuts. To exacerbate the issue, Asia has backed off from purchasing U.S. debt and one-time pension purchases for tax reasons ended in September. The bond market has a record volume of short sales in the market which means that most of the market believes rates will increase.

Real Estate Market Review and Outlook

U.S. Real Estate markets, as measured by the S&P U.S. REIT index, dislocated moderately from both equity and bond markets in September, dropping 2.7%. Real estate stocks are feeling pressure from higher interest rates as the cost of leverage increases and as higher interest rates reduce real estate affordability.

We believe higher interest rates are a concern for real estate markets and we are either market weighted or underweight in our real estate allocations.

Ed Yale, CFA

President and Chief Investment Advisor

October 2018