2018 FALL INVESTMENT OUTLOOK

The domestic capital markets have diverged this year. Stocks have posted gains reflecting strong corporate profit growth, investor confidence in Washington's business friendly policies, and economic stimulus from tax cuts and increased government spending. Real GDP growth was a strong 4.1% in the second quarter, consumer confidence is at multi-year highs, and wage growth has recently picked up. While stocks have generally done well and may set a record this year by being up ten years in a row, the bond market has declined. The Federal Reserve under the leadership of Chairman Powell continues to take gradual steps to end the very accommodative and easy money policies of the last ten years. The benchmark 10-year US Treasury Note, for example, has risen some sixty basis points and yields slightly over 3.0% today which means investors in that security have lost 2.2% on a total return basis since year end. The corporate bond universe as measured by the Bloomberg Barclays Aggregate Index (average maturity of 8 ½ years) has also experienced a decline.

Foreign markets have posted declines in both stock and bond markets year to date. Developed foreign markets as measured by the EAFE index have declined 5% while other indices have experienced sharper falls. Three widely followed foreign indices, the Hong Kong Hang Seng, the MSCI Emerging Market Index, and the Shanghai Composite are all now 20% beneath their January highs and hence technically are in bear market territory. The strong dollar is exacerbating problems in emerging market economies where dollar denominated debt has doubled to over $3.7 trillion in the past decade. Debt payments and new financings are a major challenge.

The Dow 30 Industrial Index peaked in January and while again approaching that high and at nine and one half years old is the longest bull market run in the history of that index. The S&P 500, benefiting from large market capitalization stocks in social media and technology, reached new record levels in late August and is now the second longest bull market on record. In contrast, the MSCI All Country World Index ex-USA has declined 4.2% year to date.

Equity Markets – 9/18/18

	Index Price Level	2018 YTD Total Return
Dow 30 Industrials	26,247	+8.0%
S&P 500	2,904	+10.2%
NASDAQ Composite	7,956	+16.1%
MSCI All Country World Index ex-USA	286	-4.2%

Outlook

Near term economic growth in the United States appears solid and, while likely down a bit from the strong second quarter, remains in the 3% area. Very good employment growth has produced an unemployment rate of below 4% and there appear to be more job openings than job seekers. This has contributed to rising hourly wage rates of nearly 3% while the important and widely followed consumer price index (inflation proxy) remains reasonably subdued at under 3% on an annual basis. Wage growth has benefitted consumer confidence and ongoing spending which over the near term is positive for consumption of a broad variety of goods including automotive and durables. Indexes of business sentiment are up and capital spending which has been a laggard in this economic recovery period is expanding at a satisfactory pace. It is hence likely that the broad based US economy will continue to expand through year end and into 2019. Corporate profit growth, however, is slated to grow in the mid to high single digit range next year as the benefits from this year's tax reduction are not in the comparison while underlying costs are on the rise.

While the above is all good news and has driven the market to new highs this year, a number of factors lead this firm to conclude that investors should maintain appropriate reserves and not be swept up in the very bullish sentiment of the rising US stock market.

The two principle levers of government influence over the economy, fiscal and monetary policy, are now working in opposite directions. Fiscal policy is highly stimulative given this year's tax cuts, the omnibus spending bill, and ever growing mandatory spending (now accounting for some 62% of federal spending). This year's federal deficit is projected to reach $850 billion, up 28% from last year's $666 billion, and approach $1 trillion next year. Proponents of the current fiscal stimulus argue it will generate a greater revenue stream down the road and hence reduce the deficit. There is early evidence the economy is expanding at a faster rate than prior to the stimulus package, however, the level of incremental revenue and hence deficit reduction remains to be determined. Fiscal stimulus has historically been best applied during weak economic times to return the economy to a normal growth track and not in the later years of a lengthy and full employment expansion. This condition set last occurred fifty years ago at the height of the Vietnam War and ended with the recession of 1969 and more severe downturn of 1973-1974. While history may not repeat itself, it does seem to rhyme as Mark Twain once noted.

Monetary policy on the other hand is becoming less accommodative as the Fed periodically raises short term interest rates to curb excesses in the system while also seeking to reduce the size of its bloated $4.5 trillion balance sheet, up from roughly $800 billion ten years ago. The ten year Treasury at 3.0% plus yields only slightly more than the two year Treasury at 2.8% and given likely additional short term rate hikes could produce an "inverted yield curve". This condition while not necessarily a leading indicator has typically led to a weaker economy down the road. For one thing, bank earnings are squeezed given the narrow spread between their cost of funds and investment earnings, and for another, it suggests the bond market is telling the Fed that it is being too tight.

A decade of easy money across most of the globe following the recession and near financial collapse in 2008-2009 has been a burden on savers while encouraging borrowing, leverage, and risk taking across the economy. Corporate debt in the US today stands at some 45.2% of GDP, matching the highest level it reached during the financial crisis in those years. Emerging market debt in US dollars has also grown dramatically as noted above. Monetary policy of the last ten years has paid scant attention to the words of William McChesney Martin (Fed Chairman 1951 to 1970) who once opined that the Fed "is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up". In the present instance, the punch bowl has extended the party and efforts to remove it have put new political pressure on the Fed as evidenced by President Trump's recent tweet to Chairman Powell that he should keep interest rates low. Rising interest rates of whatever magnitude will add to the challenges of fiscal stimulus by raising the cost of carrying the growing federal deficit.

Likely excesses resulting from easy money can be found in certain real estate and private equity sectors where respective asset values have been driven notably higher. A growing number of private companies have also benefitted from new and higher valuation rounds of additional low cost capital producing capitalization levels above public company peers. This has effectively blocked them from going public and is a growing concern to their investors, a select few of which are large public mutual funds. In addition, leverage in companies financed by high yield (junk debt) has grown to record and unsustainable levels and will likely prove problematic in the next economic downturn. Leveraged loans in the $1.4 trillion below-investment grade market have also grown significantly and in many cases have weaker covenants and legal protection for lenders than in the last downturn.

Escalating tensions between this country and its trading partners within North America and overseas merits serious attention. Tariffs now being applied by the United States and China on one another could prove more than counterproductive if a diplomatic course to constructive conversations cannot be found. Consumers, businesses, and economies in these two largest global economies will be negatively impacted as will many other economies. One can look to the negative effects of the Smoot Hawley Tariff Act of 1930 on the global economic wellbeing as an example of ill crafted trade policy.

Regulatory oversight of the financial markets also bears mentioning. Some reforms coming out of the 2008 financial crisis have been eased while others remain in place. Efforts by the Labor Department and SEC to implement a uniform fiduciary rule across the investment management and broker dealer community requiring full disclosure and to always act in the best interests of clients have effectively been stymied. It was a lack of oversight on derivatives and many other poorly designed financial instruments of ten years ago that brought the country close to financial calamity. In regard to proper market oversight, it is a good thing that the Department of Justice and the SEC are opening a fraud investigation into the public statement of Elon Musk that Tesla was likely to go private with "funding secured." This statement produced a one day 11% rally in the share price and if incorrect or improperly stated appears to be a violation of existing securities laws.

Investment Conclusion

While a recession does not appear on the near term horizon, the inherent conflict between a highly stimulative fiscal policy and a more restrictive monetary policy could impede sustainable economic growth. Simultaneously, existing high borrowing and leverage in many parts of the US economy as well as high debt levels in many foreign economies will dampen the rate of global growth.

Record stock price levels in the US may very well come under pressure as investors reflect upon current high valuations and the various challenges facing the economy including the trade issue, geo-political tensions, and the partisan political gridlock in Washington. Investors are counseled to stay the course with stock holdings in well managed and financially sound companies but to hold adequate reserves, depending on individual circumstances, for known liabilities and purchase opportunities that are likely to develop as this bull market runs its course. Bond holdings are best protected by holding short term and investment quality issues which can be reinvested at higher rates under current Federal Reserve policy of raising short term rates.

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