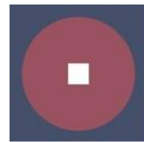

2018 Third Quarter Review and Outlook

Our quarterly letters have lately reflected the tug of war between politics and the economy. Positive economic trends and rising corporate profits have largely dominated the tussle, but ongoing trade conflicts are a reminder that geo-political forces cannot be dismissed. Though the US stock market ended the third quarter at fresh highs, international stocks reflected more difficult conditions in Europe, Asia and developing countries for whom exports are critical. Additionally, a brewing debt crisis has Turkey, Argentina and South Africa in its grip, while other emerging markets have had to contend with a strong dollar in addition to the threat of tariffs. More recently, the sharp sell-off of the past week has raised fears about the sustainability of our ageing rally and rattled the complacency of investors who have grown unaccustomed to high levels of volatility.

Despite such concerns, zooming out to survey broad economic conditions reveals a familiar picture. The global economic expansion has continued and second quarter GDP growth of +4.2% in the US indicated both underlying strength and the temporary boost from tax cuts taking effect this year. Corporate earnings sky-rocketed in the first half of 2018, fueled by strong sales, lower taxes and record stock buybacks. Buoyant business confidence mirrors consumer confidence that has been fed by record low unemployment.

As expected, the Federal Reserve has continued to raise short-term interest rates by +0.25% every three months. The slow but steady process of bringing rates back to more normal levels has taken the key Fed Funds rate from zero to 2.25% over the past three years. Though the bond market has responded with a broad decline, rates remain low by historical standards.

Portfolio Notes

Compared to last year's strong returns, when developed equity markets notched double-digit gains, emerging markets soared 37%, and bonds returned +3.5%, this year has been challenging. US equities have been the only real bright spot, with the S&P 500 Index up +10.56% through the end of the third quarter. International equities have lagged by a wide margin. The MSCI EAFE Index of foreign blue-chip companies fell -1.43% and the divergence was even starker in emerging markets, which lost -7.68%. Bonds, meanwhile, ended the quarter down, reflecting the rise in interest rates.

Our equities have generally outperformed the MSCI All Country World Index, but with a third of our holdings diversified in foreign markets, overall gains were modest. Our fixed income holdings have continued to outperform the languishing investment grade bond market due largely to short maturity funds that limit sensitivity to rising interest rates. Our alternative strategy funds gave up a little ground in the third quarter but continue to outpace bond returns by a wide margin.

Outlook

The current economic expansion will soon be the longest in US history and the global outlook remains positive. Manufacturing, though not uniformly robust, continues to expand in every part of the world. Consumer and business confidence are well-supported by employment gains, tax cuts and moderate inflation. While interest rates have risen, they remain below what economists consider to be "normal" levels.

US corporate earnings are expected to keep growing at over 20% in the coming quarters due to a favorable mix of strong sales, low wages and tax cuts. Given forecasted earnings increases, US stock market valuations, while not cheap, do not look wildly excessive.

Though damage resulting from the imposition of trade tariffs remains a concern, the fact that China exports roughly 5 times more to the US than vice versa makes it likely that the Chinese will ultimately seek a compromise, following in the footsteps of Mexico, Canada, South Korea and other trading partners. Domestically, US business and political interests are pressing for positive resolution, and their demands will also push the administration to reach a positive conclusion in trade negotiations.

US elections on November 6th are being scrutinized for their potential impact on the economy, however historical data provides little indication that control of Congress by either party–whether full or partial—is likely to have a sustained economic effect. There is, however, a strong probability that markets will be more volatile leading up to the polling date.

On a more cautionary note, the economy's growth rate will eventually be constrained as workers become scarce, higher interest rates increase the cost of borrowing, and the sugar rush of tax cuts dissipates. The Federal Reserve is expected to keep raising rates through next summer while simultaneously shrinking its bond portfolio, which will lead to tightening financial conditions. These factors could be temporarily offset by another round of tax cuts as we approach the 2020 elections, but any such move would only exacerbate the long-term problem of ballooning budget deficits.
A global rise in populist, authoritarian regimes (historically, a bad omen for sound economic policies) is also cause for unease.

In this often-bewildering tug of war, our advice is to focus on concrete data points and on the fiscal and monetary policies that affect corporate earnings, growth and inflation. On that basis, the current expansion seems likely to continue well into 2019, if not longer. We have been expecting an increase in market volatility and over the past months we have taken steps to reduce the sensitivity of our portfolios, but overall, we remain positioned to benefit from continued economic gains.

We wish you a wonderful fall season. Please let us know if you have any questions or concerns that we can address.

David Cantor

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