Quarterly Market Commentary

Perspective on the economy and trends in the marketplace.

The third quarter of 2018 was very positive for U.S. equities but very challenging for most other asset classes, creating a difficult environment for multi-asset class portfolios. Much of the gains in U.S. stocks can be attributed to a solid economic backdrop, which has translated into strong earnings for U.S companies. GDP increased 4.2% for the second quarter, which was the highest pace since the third quarter of 2014, while headline inflation was tame, up 2.7% year over year and the unemployment rate remained low at 3.9%. Another 0.25% rate hike by the Fed in September posed continued headwinds for fixed income, international developed and emerging market equities. Rising U.S. rates have supported a strong dollar at a time when trade rhetoric continues to dominate the headlines, causing a divergence in U.S. and foreign market performance. For the remainder of 2018, the U.S. economy should continue to strengthen due to year-end holiday spending but political uncertainty from upcoming mid-term elections and ongoing trade negotiations should warrant a diversified approach to investing with a focus on mitigating risk.

U.S. Equities

After a slow start to the year, U.S. equities rebounded to post their best quarter since the fourth quarter of 2013 with the S&P 500 up 7.71% and a greater 10.56% year-to-date. However, most of the performance within domestic equities was from large cap growth stocks (including companies such as Amazon and Apple) as the representative benchmark, the Russell 1000 Growth index, was up 17.09% year to date, trumping most other major asset classes. This has created a very challenging environment for global multi-asset class portfolios since such a specific segment of the market has appreciated so much. Domestic stocks shrugged off headline risks and advanced on the back of strong earnings and sales growth for the second quarter, up roughly 25% and 9%, respectively. Earnings continue to benefit from the most recent tax cuts and sales have been supported by a healthy consumer. Though U.S. equity valuations appear relatively expensive compared to stocks abroad, headline volatility has made it difficult to own anything else. While we expect volatility to pick up heading into midterm elections, we believe that equities should enjoy a year-end rally as certainty is regained post-election and holiday spending commences.

International Equities

International developed and emerging market equities continued to underperform domestic equities, with the MSCI EAFE returning 1.35% for the third quarter and -1.43% year to date and the MSCI Emerging Markets index (EM) returning -1.09% for the third quarter and -7.68% year to date. As global growth became less synchronized this year, international markets as well as emerging markets have been challenged by multiple headwinds, including weaker economic growth, political uncertainty, a rising dollar, and ongoing trade tension, all of which helped to exacerbate the differential between foreign and domestic equity performance. The recently announced tariff increase by the United States and the retaliatory actions taken by its trading partners have increased the likelihood of sustained international conflicts, which could derail near to mid-term growth prospects.

The International Monetary Fund (IMF) has revised down growth projections for the euro area from 2.4% to 2.2% and Japan from 1.2% to 1.0% due to negative surprises to activity in early 2018. Within emerging markets, not all economies are created equal. Emerging and developing Asia is expected to maintain its strong growth at 6.5% in 2018, whereas growth projections for emerging and developing Europe and Latin America have deteriorated.

While rising oil prices serve as a tailwind to oil producing countries such as Russia and Mexico, other emerging market countries are hindered by; escalating trade tensions, higher yields in the U.S., and rising geopolitical conflicts. We still believe foreign equities are beneficial to a diversified portfolio in the long term, but the risk-reward trade-off from this asset class has become less attractive in the near term.

Fixed Income

Year-to-date, the Bloomberg Barclays U.S. Aggregate Bond index returned -1.6% as of the end of the third quarter. The last time this index was down through the first three quarters of the year was in 2013. The 10-year Treasury yield broke 3% and short-term rates have also increased to around 2.8%, which has caused the difference between the two and ten-year yield to narrow to about 0.23% at the end of Q3. When the two-year yield surpasses the 10-year yield, it has historically been a leading indicator of a recession in the next 12 months, but we do not expect this to happen in the near term. The Federal Reserve raised the Fed Funds rate 0.25% for the third time this year in September and maintains their forecast of one additional hike in 2018 as they move away from the accommodative positioning that investors had grown accustomed to during the current economic expansion. Fixed income securities will continue to face headwinds with rising interest rates, but a diversified fixed income allocation remains the best way to diversify portfolios against equity market risk and an important piece of the portfolio.

Alternatives

Despite U.S. sanctions on Iran causing a potential supply crunch, members from OPEC and Russia have not agreed to an official increase in crude output. As a result, Brent crude is up 23.7% this year. During the third quarter, the global bench mark shot up 4.13% as it topped $81/bbl., the highest level since 2014. While global oil markets tighten, supply in the United States is abundant, thanks to rising output. US crude production hit a record 11.1 million bpd in the week ending Sept. 21, according to data from the Energy

Information Administration (EIA), an increase of almost a third since mid-2016. In the broader commodity space, commodities returned -2.02% for the quarter and -2.03% year-to-date as measured by the Bloomberg Commodity index. A stronger dollar should continue to be a headwind for commodities.

Real Estate

Residential real estate was volatile over the third quarter. Multi-family starts fell -3.7% in July following a sharp negative reading in the month prior, but rose 29.3% in August. Residential starts rose to a 1.28 million annualized rate in August, however with permits falling, a slowdown could be ahead. According to Bloomberg, the average US Home Mortgage 30-year fixed rate is 4.96% as of September 28th, 0.17% higher compared to the end of the second quarter, making it difficult for first time buyers to find a home at a reasonable rate. Rising interest rates and a potential slowdown in future supply could be an early signal of a tighter housing market.

Conclusion

In this extreme environment where we've seen U.S. stocks well outpacing other major asset classes globally, it is important to remember that our portfolios are designed to achieve long term investment objectives, not short term absolute returns and we employ a diversified approach even during times when one asset class is heavily favored over others. We remained disciplined in this approach earlier this year when some of our peers significantly increased allocations to foreign assets due to the euphoria surrounding the space. Because our portfolios were never over exposed to these underperforming asset classes, we've continued to generate positive returns and maintained reasonable levels of risk. Looking ahead, market performance is uncertain as the U.S. faces an important election in November to determine who will control the House and the Senate. Historically, however, the market hasn't posted a negative return in the 12 months following a midterm election since 1946. If history is used as a guide for the future, we would expect a similar outcome but acknowledge the current risks regarding tariffs and a later stage economy.

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