Investors Trust
Investment and Trust Services

Your Goals. Our Knowledge.

Third Quarter 2018

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Index	9/30/2018	6/30/2018	12/31/2017	Total Return 2018 YTD	Q3 2018
Dow Jones	26,458.31	24,271.41	24,719.22	7.0%	9.0%
S&P 500	2,913.98	2,718.37	2,673.61	10.6%	7.7%
Nasdaq	8,046.35	7,510.30	6,903.39	17.5%	7.4%
S&P 400 Midcap	2,019.55	1,951.67	1,900.57	7.5%	3.9%
Russell 2000	1,696.57	1,643.07	1,535.51	11.5%	3.6%
Yield on 10-Year Bond	3.06%	2.86%	2.41%		

Source :FactSet

Quarterly Summary

Trade remained the dominant theme in US equity markets in the third quarter. Indeed, trade agreements between the US and Mexico, and subsequently including Canada, combined with a calming of tensions between the US and Europe to ease concerns that President Trump's harsh trade rhetoric would actually lead to a full-scale trade war. As a result, **US equity markets hit fresh all-time highs in the quarter, posting their best quarter in almost five years with many indices up over 7% in the third quarter alone.** For the year, many indices are up double digits. Much work still must be done on trade between the US and China, but the Street increasingly believes that the rhetoric, and even the announced tariffs, is part of the Trump Administration's tactics to negotiate the best possible deal for the US. We do expect headlines on trade between the US and China to continue to impact markets for the balance of the year; however, at the risk of unintentionally sounding a bit flippant, the question in our minds is more when a deal will occur and what it will ultimately look like than whether some kind of deal gets done. We are not especially concerned about an all-out trade war with China. We'll see.

While we would expect some pullback following the strong returns in the third quarter, we continue to like the US equity markets for the balance of the year. As we have noted previously, stock prices are ultimately driven by corporate earnings growth, and the outlook for healthy earnings growth remains in place. Admittedly, things can change relatively quickly, but US corporate earnings growth should exceed 20% in 2018 and is currently forecast to come in around 10% in 2019. **The economic backdrop in the US remains quite good**, with the economy poised to grow roughly 3.0% in 2018 and around 2.5% in 2019. Such growth should bode well for US equities.

On the Road with Clients….

Recent meetings with numerous clients have revealed a genuine unease about the markets. While pleased at their returns, there is an underlying discomfort that the markets are setting up for significant declines. Our guess is that these feelings have more to do with the state of Washington, DC than the economy, and there have been plenty of headlines over the last three months along the lines of "Preparing for the Coming Market Downturn," often with politics playing a central role. In that context, let me remind you that history shows it is unwise to invest based on your politics. Dysfunction in Washington, DC is the norm, not the exception, and while dysfunction may appear to be higher than normal today, the market only focuses on Washington to the extent it could impact corporate earnings.

With that said, **we are mindful of what clients may be worried about,** so we wanted to share some of the key concerns we have heard from you and discuss our thoughts on them.

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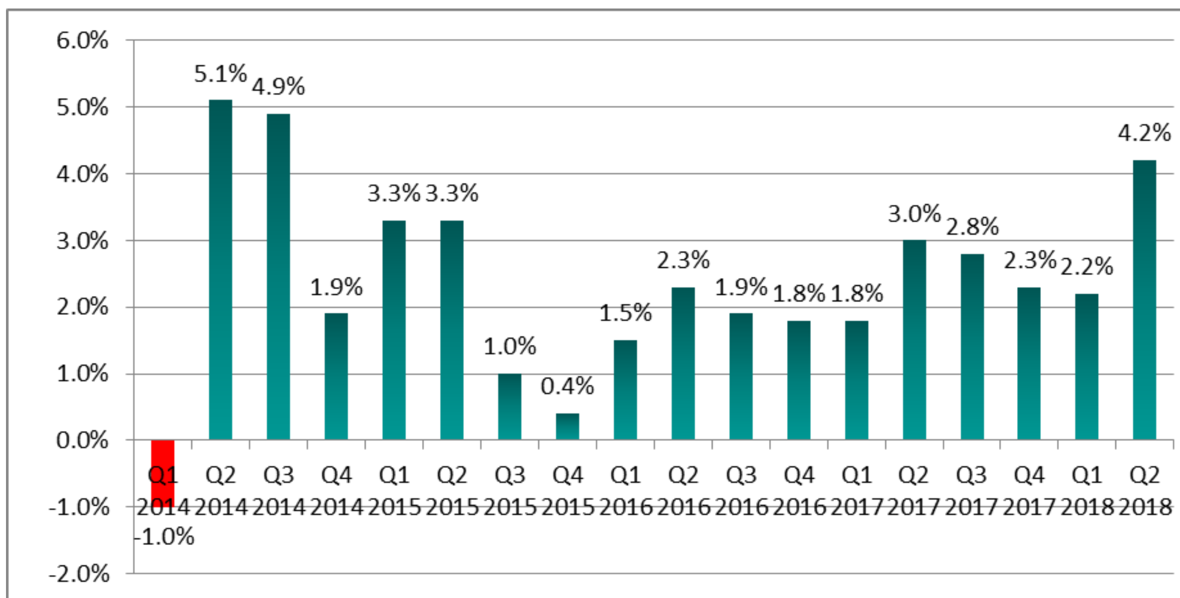
Concern #1: Risk of US Recession (not very concerned)

To any equity investor, the risk of an economic recession should be the single largest concern on anyone's mind, as the biggest declines in the equity markets have been the result of the US entering into a recession. In fact, many short-term pullbacks in the market have come about due to fears that a recession was around the corner, even if a recession never materialized. A recession is defined as two consecutive quarters of negative economic growth. Simply stated, **we are not worried about the US entering a recession in the near future**. As Chart 1 below shows, the US economy had its best quarterly growth rate (4.2%) in roughly four years in the second quarter of 2018. While a growth rate of over 4% is likely not sustainable, the US is a long way from having negative growth. The current momentum of the US economy is such that the earliest a recession could come is likely in 2020; importantly, we are not predicting that a recession is coming in 2020, just that 2020 is likely the earliest that one could come. So we are not especially concerned about a recession at the moment.

Chart 1: Quarterly US Economic Growth (GDP), 2014-2018



Source: Bureau of Economic Analysis

Concern #2: Trade (a little concerned)

Our view on the strongly-worded comments that President Trump has previously said about our trading partners was that it was indeed his negotiating tactic. Admittedly, some of the comments have been unsettling, and it has certainly been an unorthodox approach. But the recent trade agreements between the US, Mexico, and Canada, and the lessening of US trade demands from our European allies, give us confidence that President Trump will not let the current trade tensions descend into an all-out trade war. President Trump is a businessman, and this is his approach to try to extract a better deal for the US. We do think it is easier to negotiate trade deals with our friends than with China, so we fully expect it to take several more months, if not longer, for some type of deal to be worked out. As a result, we are a little concerned about the headlines that could be forthcoming out of both the US and China as each side tries to position itself well in the negotiation process. We are also aware that Chinese President Xi is the president of China for life, whereas President Trump will have to contend with an election in two years, so it is possible that President Trump's efforts with China will not succeed simply because President Xi can wait it out longer than President Trump can.

As things now stand, **if all announced tariffs were indeed implemented, then the negative impact to the US economy is estimated to be around $240 billion, or roughly 0.12% of what is a roughly $20 trillion economy**. While not positive, this pales in comparison to the fiscal stimulus that has already been enacted in the US through tax cuts and additional government spending, which totals roughly $1.0 trillion. So **trade issues bear watching, but we are not overly worried about them at present**.

Concern #3: US Mid-Term Elections (not very concerned)

Historically, in years with mid-term elections, the equity markets have not done much for the 10 months leading up to the election, then rallied sharply subsequently irrespective of who wins. As we have discussed in the past, the markets do not like uncertainty, so the post-election rally is usually based on the elimination of the uncertainty of the election outcome. **The current consensus on the Street is that the Democrats will win the House of Representatives, while the Republicans will keep the Senate**. Divided government has historically been good for the equity markets, as the extremes from either political party are unable to enact what could be disruptive legislation.

The business-friendly regulatory environment that President Trump has pushed will likely not be changed following this election, irrespective of the outcome. Accordingly, the current business-friendly environment should remain in place, at least until the next presidential election in two years. As a result, we do not think the mid-term elections this year should have a material impact on the markets. However, it is quite possible that the dysfunction in Washington, DC increases after the election. If the Democrats win the House, then we would expect the House to impeach President Trump, with all of the media coverage that an impeachment would entail. But that impeachment effort would likely be futile, as there will not be enough votes in the Senate for the impeachment to pass.

Our view about the election impact could change if either party won in a landslide. If the Republicans actually retain both the House and the Senate, then it is possible that additional tax legislation could proceed, which likely would further stimulate the economy. If, however, the Democrats won impressively, then it could signal a forthcoming shift in tone in which an anti-business candidate could emerge as a serious presidential contender. We will cross those bridges should we get there.

Concern #4: Policy Error by the Federal Reserve (somewhat concerned)

Of the issues expressed by our clients, **a policy error by the Fed is the one that we believe merits the most attention**. The Fed has been on a steady and gradual path of raising interest rates, having done so 8 times over the past 3 years. The yield on the US 10-Year Treasury bond has increased from 2.41% at the beginning of the year to around 3.20% in early October. The Street currently expects the Fed to raise the Fed Funds rate by another 0.25% at its meeting in December, then another 2-3 times in 2019. This is in an effort to “normalize” rates following the emergency measures that the Fed put in place following the 2008-2009 financial crisis.

We track closely interest rates, and the things that affect interest rates, as they have an impact on economic growth. The biggest impact on rates has historically been inflation levels, and for much of the year, inflation has largely been kept in check. However, recent data points suggest that inflation may be starting to pick up. For instance, recent year-over-year wage growth is approaching 3.0%, which is the highest level since 2009. Energy prices have risen over 20% in 2018, and the recent tariffs imposed by the Trump Administration serves as a tax to US consumers. Higher interest rates themselves also serve as a tax on consumers and businesses.

The Fed has a challenging balancing act regarding interest rates. On one hand, the Fed wants economic growth to be strong, which would support keeping rates low. On the other hand, the Fed does not want inflation to accelerate too rapidly and therefore could raise rates in order to try to slow the economy to keep inflation in check. If the Fed raises rates too quickly, then it actually could lead to a recession at some point in the future. Indeed, despite best efforts, the Fed’s rate policy has been a significant contributor to recessions in the past. Accordingly, this is something that we will continue to monitor closely.

Conclusion

At any given point in time, there are always things that investors could be worried about. Today is no exception. However, the conditions that have historically caused the biggest declines in the market (i.e. an economic recession) are not currently present. On the contrary, the backdrop for a continued rise in the equity markets is well in place. We still come to work every day and worry about issues that could hurt our clients’ portfolios. Indeed, we are continually monitoring and analyzing the market and the economy to determine if risks have increased that merit adjusting client portfolios. While the market will pull back from time to time as it responds to various short-term news items, we believe that the longer-term health of the market will continue to be based on corporate earnings growth. At present, the outlook for such growth remains strong.