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3rd Quarter 2018 Review

This year's contrast of winners and losers continued in the 3rd quarter. Losses in bonds, emerging markets stocks and most commodities were offset by gains in U.S. stocks. The S&P 500 Index rose +7.6% in the third quarter, posting its largest quarterly gain in nearly five years. The benchmark for large U.S. stocks has now returned +10.3% for the year. The record wide disparity between "growth" and "value" continued, with the Russell 1000 Value Index, dominated by cheaper, higher dividend yielding stocks, rising +5.6% in the quarter. It has gained +3.6% year-to-date. Smaller stocks fared worse than large, with the Russell 2000 Index rising +3.5% for the quarter. It still leads mainstream U.S. equity indices for the year, up +11.5%

International stocks continued to struggle, led by disconcerting headlines coming out of Turkey, Argentina, and at quarter's close, Italy. The MSCI EAFE Index of stocks domiciled in developed international economies increased +1.5% in the third quarter. It is still in the red for the year, down -1.4%. The strong U.S. dollar and trade war tensions further weighed on international emerging markets. The MSCI Emerging Markets Index fell -0.9% in the quarter, and has now lost -8.3% this year.

On September 25, the U.S. Federal Reserve increased the target short-term borrowing rate (Fed Funds Rate) by 0.25% to 2.00%. This makes three moves this year totaling +0.75%, to the current range of 2.00%-2.25%. Longer term rates also rose in the third quarter. The yield of the 10-year U.S. Treasury note rose by 20 bps to 3.05%. The yield of the 30-year U.S. Treasury bond increased in lockstep, rising 20 bps to finish at 3.19%. The Barclays Aggregate Bond Index slipped -0.1% for the quarter, and has lost -1.7% this year. High Yield bonds rebounded sharply from their selloff at the end of the second quarter. The Bloomberg Barclays High Yield Bond Index rose +3.0% in the quarter and is now up +1.8% for the year.

Crude oil strengthened further in the third quarter as global production failed to keep up with firm demand, leading to steep inventory draws. The U.S. Department of Energy estimates that the huge U.S. inventory surplus created by U.S. shale in 2013-2016 has now been removed. The ICE Futures Europe Brent Crude Oil continuous contract gained +4.1%, and has increased +23.7% this year. Copper and gold fell slightly in the quarter.

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VWG's Current Market Views

U.S. Economy and Corporate Earnings

Employment, manufacturing activity, and retail sales all remain firm. U.S. gross domestic product (GDP) grew 4.2% in the second quarter, its fastest rate of growth in almost four years. Economic leading indicators continue their positive assent. Predictions of an economic recession in 2020 have no firm substantiation and are premature, in our view. Thanks to the major tailwinds of corporate tax reform, 2018 U.S. corporate profits are expected to increase by over 21% from 2017. Most economists are predicting added earnings gains in 2019, but at a much slower mid-single digit rate. Corporate foreign profits are being repatriated – mostly to retire debt and to fund share repurchases.

Investor Sentiment and Stock Market Technicals

The U.S. stock market has been largely unphased by numerous potential perils – including U.S. trade turmoil, the mid-term election, Federal Reserve rate hikes, rising oil prices, and political dissention. Investor sentiment is by no means ebullient. The most recent AAII weekly survey showed only 36.2% bullish sentiment, slightly below the average reading taken over the past nine years. Contrary to widespread media conjecture, the breadth of trading in large U.S. stocks is not a cause for concern. Chris Verrone, head of technical strategy at Strategas Research, points out the capitalization-weighted (conventional) S&P 500 Index, the equal-weighted S&P 500, and even the reverse-weighted S&P 500, have all traded to all-time highs over the past month. Small stocks (Russell 200 Index) which weakened throughout the month of September, are on watch for signs of longer-term diversion.

Interest Rates and Inflation Expectations

Last weeks' rate increase by the Federal Reserve was widely anticipated. Markets now expect a fourth 2018 hike at year's end, and perhaps one or two more in 2019. Any whiffs of inflation, both in the U.S. and internationally, have been a function of energy prices. The absence of persistent growth and inflation fears has combined with international demand for yield, keeping longer term U.S. interest rates very stable. VWG does not currently see a case for sharply rising rates. We will take a 3.40%-3.50% 10-year U.S. Treasury yield as an opportunity to add to bond allocations in diversified portfolios, where we have been widely underweighted.

International Markets

This year's international economic and market results have starkly contrasted with 2017's strength. Brexit, Chinese deleveraging and slowing growth, Latin American instability, fears of trade wars, and now Italian fiscal projections – have all weighed heavily. Strategists we regularly consult do not see this underperformance as dark clouds portending future problems. Bespoke Investments recently stated that "the fundamental backdrop of (European) of re-expanding credit markets and general cyclical expansion look to be in place." Counterintuitively, we see international equities as having lower risk, as they are already pricing in a lot of negative news and dampened forward expectations. The recent strength in shares of global industrial bellwether provides anecdotal evidence supporting this stance.

What Could Go Wrong?

The most obvious current threats to asset prices are escalating tensions with China, which could escalate beyond trade, and political volatility centering on the November mid-term elections. We should also be reminded that short-term bouts of volatility and correction are always possible for any reason, real or imagined.

Beyond these, we see potential risks in corporate earnings and forward guidance. Placing the current market multiple of 17x on 2019's earnings estimates for the S&P 500 gives the index only another 3-5% upside. Unless economic growth further accelerates, the rising Federal Funds (discount) rate poses a headwind against multiple expansion. Therefore, it is possible that some lofty expectations have become priced into U.S. stocks and the market. Rising input costs, tight labor markets, and ramifications from trade sanctions and tariffs, could all be cited as reasons for companies to mute forward earnings guidance which would not be greeted positively by investors.

Portfolio Strategy and Asset Positioning

This summer we've witnessed a lot of pop media prediction and conjecture about when we'll see the next U.S. recession. "Is it 2020 or 2021?" "What inning are we in?" And VWG has fielded an increasing number of client calls and conversations, asking why they don't own more U.S. stocks, stock funds, and the individual high-flying FAANG names. These two behaviors bring to mind some valuable insights from legendary investor Howard Marks, co-chairman of Oaktree Capital Management.

The first that comes to mind is the title of his 2001 memo *"You Can't Predict. You Can Prepare."*

VWG Wealth Management does not spend much time attempting to predict the future path of the economy. In agreement with Mr. Marks, we don't find much value in this exercise. We do try to observe and understand "what is," and from our above commentary you see that our present take on the economy is quite positive. We do spend a lot of time observing (but not predicting) investor sentiment and behavior. Although the above statistics show investor sentiment to be currently contained, we have witnessed notable contrary investor actions this year. Increased risk-taking and pockets of froth have shown up in the cryptocurrency mania, the massive run-up of the cannabis stocks, the degradation of covenants in newly issued high yield bonds, and the raising of very large mezzanine debt funds.

Because there is a lot of good news and expectations already priced into U.S. stocks, and because we see increased risk-taking activities of investors, we want to prepare for the *possibility* that either expectations fall short, or that risk-taking contracts. Additionally, rising interest rates and rising energy prices have historically been accompanied by the expansion of asset price volatility. Howard Marks dives deeply into the topic of *preparation* and *possibility* in his 2014 memo "Risk Revisited." He states: "The key point number one in this memo is that the future should be viewed not as a fixed outcome that's destined to happen and capable of being predicted, but as a range of possibilities."

VWG Wealth Management passionately believes that the best way for us to prepare for the *possibility* of increased uncertainty and volatility is to attempt to diversify our portfolios. Diversify - in that we still have exposure to a positive economy, and to investments with exposure to growing companies and sectors. Diversify - in that we also have exposure to some quality assets that are less-in vogue, exposure to some strategies that we hope to be less correlated to the macro economy, and exposure to some partially-hedged or partially-protected strategies. Diversify – in that we have an adequate allocation to safe, stable short-term income instruments that can provide liquidity, ballast and "dry powder" should unexpected developments and volatility occur.

Best wishes for a delightful and engaging autumn!

Regards,

VWG Wealth Management
Suzanne, Ashley, Rashmi, Kay, Lynette, Michelle, Christina, Justin, Amanda, Sarah, Patricia, Elana, John, Rick and Jeff

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* Index Data Sourced from FactSet Research and Morningstar

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