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SEPTEMBER 30, 2018 INVESTMENT MARKET COMMENTARY

In the quarter just ended, US stocks rose smartly, interest rates moved higher, and many international markets faced mounting difficulties. More speculative growth stocks continue to lead the advance, quite typical for bullish cycles in their later innings. Bond returns were generally flat, as lower prices were mostly offset by increased interest received. While rising rates hinder near-term returns, it is encouraging that our clients are earning more income from their bond investments. As for the macro picture, **the continuing recent trend of strong US economic growth and weakening foreign prospects was magnified, and this divergence has been reflected worldwide in the performance of many asset classes including currencies and stocks. Most overseas indices suffered losses in the third quarter (and remain negative for the year), while the major averages in the US were higher.**

Conundrums Abound

Our second quarter review pointed to the many mixed signals challenging investors, yet also to an expectation for further investment gains before the next recession and market downturn. On that front, little changed over the past few months, other than that the signals are now even more mixed. Though caution lights continue to flash, stocks may well move higher for longer, as most major bull markets usually end with a final euphoric surge that has yet to occur. As for the challenges noted above, the points that follow illustrate just how many contradictory factors are currently at play:

1) **US economic conditions are far stronger than at any time in the last ten years**. The employment picture is healthy, and both consumer and small business sentiment are near record levels.

    - Despite mostly positive indicators, **the historically predictive US Treasury bond yield curve continues to flatten, not a sign of economic vitality**. In addition, there are several trouble spots internationally, including currency crises in Argentina and Turkey, and a potentially destabilizing budget impasse in Italy.

2) While likely not sustainable, **corporate earnings are currently growing at a strong double digit percentage rate.**

    - With the market near all-time high levels, **stock valuations would seem to reflect most of the good news** evident in strong company results.

3) **Interest rates remain low** relative to historical levels and to inflation.

- While still benign, **the Federal Reserve is raising short-term rates and, as importantly, unwinding the unprecedented stimulus instituted during the financial crisis of 2008-2009**. Additional rate increases are expected over the next two years.

4) **'The trend is our friend'** with regard to US equities; importantly, extended movements in both directions often last far longer than most expect.

   - While the stock averages have been strong of late, **market breadth (the number of advancing vs. declining issues) has weakened meaningfully, and stocks with little or no earnings have been a key component of the recent rally**. This narrowing of market leadership is not a positive sign.

5) After a shaky January, and a 10% correction, **volatility has become dormant once again**.

   - **The lack of volatility is curious considering the ubiquitous drama in Washington, the coming mid-term elections which may upset the status quo, mounting trade frictions with China, and the Fed raising interest rates, among other potentially consequential factors**. While draining liquidity from financial markets could have far reaching effects on market stability down the road, in the near term the budding trade war would be more damaging. Once thought to be simply a negotiating tactic, newly imposed tariffs will soon impact broad swaths of the global and US economies. The fact is that there are no winners in a trade war, rather everyone loses to some degree.

"What, Me Worry?"

Judging by stock returns in recent years, all appears to be calm, and the future bright. From an historic perspective the stock market is indeed entering the best time of year (the fourth quarter) and, as stated earlier, there is reason to believe that investor enthusiasm may reach higher highs. But, worrying is part of our job, and **this movie is familiar to those of us who have followed markets for a long time. Remarkably, the human condition makes the same mistakes repeatedly**, often choosing to focus on current conditions when making decisions tied to longer term developments. **This is why many buy stocks when they are up, and sell when prices are down**.

Since 1962 no major stock market top has occurred in the second half of an off-presidential election year – and it is almost equally unusual to experience one the following year. This fact, and **because stocks appear impervious to obvious risks, has resulted in considerable investor complacency. Indeed, the markets have been remarkably resilient in the face of many threats** including, as noted above, tightening monetary policy, currency instability in certain emerging markets, the threat of a global trade war, and burgeoning inflation.

For now though, no broad crisis seems imminent, and the timing of future turmoil is indeterminable**. Our overarching theme, therefore, is that prudence and balance are warranted.** Portfolios should be allocated to take advantage of future market strength, yet at the same time be able to withstand more difficult conditions, whenever they may turn up. **While more aggressive and risky alternatives are now in vogue, quality stocks and bonds provide the profitable balance we seek**, protecting and growing your capital through the ups and downs of market cycles.