2018 Third Quarter Review of the Markets

Index	3rd Qtr Return	YTD Return
S&P 500	7.71%	10.56%
MSCI ACWI Ex USA	0.71%	-3.09%
Barclay's Bond Index	0.02%	-1.60%
Consumer Price Index	0.45%	1.65%

Investment Commentary

The third quarter of 2018 saw continued strong results for large cap U.S. stocks. The S&P 500 gained 7.7%. Smaller companies were positive as well, with the Russell 2000 returning 3.6%.

Overseas, the MSCI ACWI ex USA edged up 0.7%. As has been the case for much of 2018, emerging markets performed worse than their developed market counterparts, dropping 1.1%.

The interest rate on the 10-year U.S. Treasury note increased over the quarter from 2.87% to 3.05%. This hurt the Bloomberg Barclays Aggregate Bond index, which was flat for the quarter. On the shorter end of the yield curve, The Federal Reserve ("The Fed") continued to tighten monetary policy as expected, increasing the target Federal Funds rate for the third time this year to 2.25%. After years of near-zero short-term rates following the financial crisis, The Fed has now managed to hike interest rates eight times over the past three years. Data continue to show a strengthening economy. Absent any unforeseen shocks, the hikes will likely continue into 2019 and possibly beyond.

Economic Outlook

Progress was made with U.S. trade tensions as the United States-Mexico-Canada Agreement (USMCA) replaced NAFTA. While the particulars for the agreement are certain to help some companies and hurt others, reasonable assurance that the rules won't change in the near future should be positive for companies on both sides of the border. We are unsure if an agreement with China is on the horizon. It should not be assumed that the reduction in trade brought about by tariffs and other protectionism will go away quickly. Beyond the actual effects of the ongoing trade tension, global markets continue to struggle to absorb negative headlines surrounding global trade policy. Even before the impact of tariffs began to hit China, the Chinese economy began to slow which prompted another round of stimulus from the world's second largest economy. All indications are that a deal with China is unlikely to be reached prior to mid-term elections. Markets will be watching for indications that trade issues will extend into 2019.

Positive economic data in the U.S. continued. Unemployment dropped back below 4% during the quarter and has now been below 5% for over two years. The September reading of the Institute for Supply Management's (ISM) Non-Manufacturing Index reached its highest level since its inception in 2008. These data are consistent with an improving economy and the Fed tightening monetary policy.

Internationally, concerns about Turkey's central bank roiled emerging markets. Popular fiscal policy that had increased government spending after a failed coup attempt induced dramatic inflation. The central bank attempted to curtail rising inflation and a free-falling currency with a large increase in interest rates, sending the Turkish lira higher (although still well below the levels of only one year ago). This, along with other country-specific emerging market stresses, do not alter our outlook on emerging markets as a whole.

As the European Central Bank ("ECB") tapers its quantitative easing program it also bears watching how the European economy reacts to increasing interest rates. The European economy is already digesting an economic slowdown and concerns about the path of Brexit, as well as populist movements in other countries such as Italy. These are likely to continue to give investors concern. Central Bank stimulus has certainly helped to stabilize an economic zone that not long ago was staving off deflationary pressures. It is safe to say that the removal of said stimulus could reveal other problems in what is still quite a fragile European economy. We believe much of the uncertainty surrounding the economic path forward is reflected in equity markets which are priced at attractive relative valuations but volatility will accompany further negative headlines.

Investment Strategy

The third quarter saw no strategic shifts in asset allocation. With the dramatic underperformance of emerging market stocks during 2018, some have asked if it's time to increase client allocations. In our view, valuations have not yet reached levels that would suggest it is time to deploy more capital in these areas. It is possible, however, that valuations will continue to fall and an increased allocation would be warranted.

Interest rate sensitive fixed income has not been a profitable place to be in 2018. However, we still believe it is a critical part of all but the riskiest portfolios with significant equity exposure. If we look at the increase in nominal interest rates this year versus the increase in inflation expectations, we can reasonably assume that most of the move has come from increased growth expectations rather than increased inflation expectations. In such an environment, interest rate sensitive bonds should retain their diversification benefits in periods of stock market stress. We observed this to be the case during the equity market drawdown that began in the fourth quarter.

As always, we continue to believe that a client's risk profile should be determined by their long-term goals. We remain available to discuss the level of risk appropriate to meet each client's goals.