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THIRD QUARTER 2018 ECONOMIC AND FINANCIAL MARKETS REVIEW

The financial markets have been the subject of a tug-of-war this year between good news about the economy and corporate profits and the tumult of political and geopolitical developments. Positive news regarding job growth and consumer and business confidence have provided support for stocks, while international trade concerns, political conflicts in Washington, rising short-term interest rates, and potential inflationary pressures have provided reasons for investors to be anxious. Additional uncertainty regarding the upcoming mid-term elections could be preventing investors from taking on additional risk. Despite the mix of both positive and negative news, the S&P 500 Index still ended the third quarter up 9% year-to-date, while the Dow Jones Industrial Average gained 7%. Due to several interest rate increases by the Federal Reserve Board, bonds have not performed well this year. For example, the Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index lost 0.76% year-to-date as of September 30, 2018. *

The main reasons for positive economic and corporate earnings growth this year have been large corporate tax cuts and the deregulation of certain industries. When corporations feel more optimistic about their profits, they normally hire more workers, increase wages, and spend more money, which leads to an increase in economic activity. Stock prices generally reflect the underlying profits of corporations, so it is not surprising that stocks of the most profitable and fast-growing companies have been responsible for the majority of the stock market's gains this year. In fact, according to Bloomberg, approximately half of the overall stock market advance this year has come from just six large technology stocks.

While economic growth has been quite strong throughout the year, a concern for investors going forward is the potential for international trade conflicts to worsen. For example, China has already been targeting certain U.S. industries such as agriculture, metals, and energy to those sectors' detriment. Also, because tariffs increase the cost of products and raw materials, a full-blown trade war with China or other countries could lead to inflation.

Inflation can also occur if the U.S. economy grows too rapidly. If the economic growth brought upon by corporate tax cuts and deregulation continues at a rapid pace, the Federal Reserve Board may need to increase short-term interest rates even faster than it has been to combat these inflationary pressures. Longer-term interest rates in the bond market could rise because investors would demand higher yields to compensate for the rising cost of goods and services. Rising interest rates would lead to higher borrowing costs for individuals and corporations as well. For example, an increase in mortgage rates, credit card rates, auto loan rates, student loan rates, and other interest rates could make it more expensive for consumers to borrow and finance their existing debts. Corporations would also need to pay more to borrow when issuing bonds, which could harm corporate earnings. Also, when interest rates rise, the prices of previously-issued bonds generally decline because new, similar bonds that are being issued pay higher yields. Therefore, the best-case scenario going forward is moderate economic growth without significant inflation that could present problems for both stock and bond prices.

Finally, markets may become more volatile in the short term if it appears that the Democrats are going to take over the majority in one or both chambers of Congress. Investors may become concerned that they could attempt to reverse the economic growth policies that the Republicans have promoted since 2017. Investors do not like uncertainty and a contentious election and its aftermath could result in a market correction.

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However, as long as political and geopolitical uncertainties, trade wars, inflation, or rising interest rates do not result in declining corporate profits, stock market declines will likely be relatively limited in scope. Market corrections are typically based on bad news with declines limited to 10%-15% over days or weeks. By contrast, bear markets are usually caused by fundamental, structural economic problems. These declines can be much longer-lasting than corrections, with resulting declines of 20%-50% over months or years. Therefore, we will continue to watch leading economic indicators to determine when the next bear market may be on the horizon.

In the meantime, we still prefer large company stocks over small company stocks, despite the recent short-term rebound in the prices of small company stocks. We also believe that the U.S. economy is stronger than foreign economies and emerging markets are at an even greater risk if interest rates continue to rise and trade issues persist. We also prefer short-term bonds over long-term bonds as yields on short-term bonds are almost the same as they are on long-term bonds and short-term bonds carry less risk. If inflation or the rising U.S. debt begin to concern institutional bond investors, long-term interest rates could rise in the future, so it does not make sense to invest in longer-term bonds at this time.

As always, we will continue to monitor economic and financial market conditions and technical market indicators. In the meantime, please contact us if you have any questions or concerns regarding your investments or the financial markets in general.

** Index returns were obtained from the Wall St. Journal and Bloomberg Barclays on September 29, 2018.*

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