Review & Outlook

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THIRD QUARTER 2018

Review and Outlook

Stimulus from tax cuts and deficit spending in the U.S. continued to push the economy forward in the third quarter of 2018. Firms worried about tariffs accelerated purchases, creating a buildup in inventories and giving GDP a temporary boost. As such, most economic indicators remained strong, giving investors the confidence to push the major stock indexes to new highs. But now people are starting to wonder if the bull market will continue and for how long.

Index Performance Data: Total Return as of 9/30/2018

Indices[1]	Q3 2018	Trailing 12 Months
CRSP US Total Stock Market Index (Total Return)	7.08%	17.62%
MSCI Global ex-US Total Stock Market Index	-0.27%	-0.74%
Bloomberg Barclays US Aggregate Bond Index Composite	0.02%	-1.22%

The Blue Chip consensus forecast calls for the U.S. GDP to grow at 2.9% in the coming year, with inflation at roughly 2%. This forecast is primarily driven by inertia. With a strong labor market and consumer confidence still high, most economic forecasters remain positive looking well into 2019, if not the whole year. While we understand the optimism, we also see potential pitfalls on the horizon, like problems with debt and Brexit turmoil, which make us think that a slowdown in 2019 is more and more likely.

Another concerning development is the fact that Apple, Amazon, and a few other firms now account for 16% of the S&P 500 index and almost as much of the broader CRSP index. Investors have bid up the prices of these companies more than any others, inviting questions about whether or when a market correction might occur.

Markets outside the U.S. did better in the third quarter, but continue to struggle. Investors around the world saw value in U.S. stocks and found yields on U.S. debt (specifically U.S. Treasury bonds) to be relatively attractive, which drove up the value of the U.S. dollar relative to other currencies, causing problems for many emerging markets that have debt denominated in U.S. dollars. Towards the end of the quarter, as the U.S. dollar weakened slightly, markets in other parts of the world improved. We expect stocks in foreign, developed countries to do slightly better than they have so far this year, and, in the long term, we think markets in developing countries will be a major source of growth, but for now, they will continue to struggle.

In Focus

There has been a lot of talk about the possibility of an inverted yield curve (the graphic representation of the relationship between the interest rates and maturity dates of bonds), and whether that indicates trouble ahead for the economy and the stock market. Historically, the yield curve of US Treasury bonds shows yields rising as maturities increase. The Federal Reserve controls interest rates for bonds with the very shortest maturities, while market forces control interest rates on bonds with longer maturities. Usually, if the Fed raises short-term rates, investors demand higher yields on longer term bonds. But that does not always happen. Sometimes longer-term yields do not rise when short-term rates do, causing the yield curve to flatten. And when long-term rates fall below short-term rates, the yield curve inverts. If the yield curve inverts in the near future, it will be because the Fed is pushing policies in the U.S. that increase rates for short-term U.S. bonds, while people in the rest of the world are buying longer-term U.S. bonds, keeping those rates low.

A lot of people think that an inverted yield curve means a recession is imminent, since an inverted yield curve has preceded all of the recessions in recent history. Moreover, the stock market often falls prior to a recession, so many investors are trying to guess when the yield curve will invert so they can get more defensive with their portfolios before a downturn. However, as the yield curve comes closer to inverting, we think there is good reason to believe this time may be a little different.

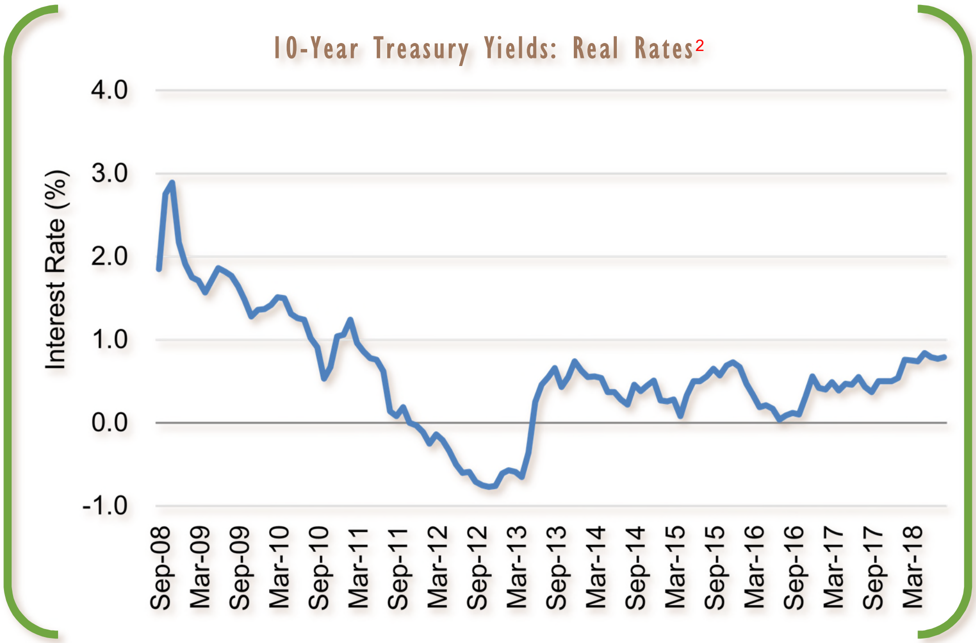
Right now, the interest rates offered by other central banks are much lower than U.S. government bond rates, so U.S. bonds are more attractive to investors in other countries. More buyers mean higher prices and lower yields for U.S. bonds. If long-term rates stay low because investors in the rest of the world view U.S. bonds positively, the yield curve could invert with the Fed raising short-term rates, but we do not think those conditions indicate that a recession is imminent.

Of greater concern to us is the possibility that longer-term interest rates, especially real rates (or inflation-adjusted rates), could rise noticeably in the near future. If the rest of the world were to decide that longer-term U.S. bonds were no longer attractive, the U.S. Treasury would be forced to raise rates to entice more buyers. Higher rates on longer-term bonds would push us back towards a normal yield curve, which would likely cause trouble for stocks and the rest of the economy. An increase in real interest rates would give investors a reason to move their money from stocks to bonds, which could cause a market downturn.

Low interest rates for much of the last ten years have made investors favor stocks over bonds, driving up stock prices. If interest rates rise, we could see the reverse, with stock prices falling as investors move money to bonds.

Even if inflation increases along with bond rates, some investors might still move their money to bonds, hurting stock prices, although the impact of that would not be as significant as if real interest rates rise.

The chart below shows real interest rates for 10-Year U.S. Treasury bonds. You can see that real interest rates have been increasing in 2018, pushing rates above where they have been since 2012. Those low interest rates are one reason that stock prices have been bid up so high recently, so if this trend of rising real rates continues, stocks could be in trouble. Without low bond interest rates to deter investors, stocks prices start to look too high.



In an ideal scenario, longer-term real interest rates would rise slowly, staying just ahead of short-term rates, and corporate earnings would remain strong enough to keep stocks attractive to investors. However, we are ready to respond if real long-term rates start to increase sharply. We currently invest in index funds that include a mix of growth and value stocks, but if long-term real interest rates start to rise faster than inflation, we plan to put a larger emphasis on value-oriented stocks and mutual funds. Growth stocks tend to have high price-to-earnings ratios, and become less attractive when earnings slow or when better investments that carry less risk become available, like bonds with higher yields. Value stocks tend to be less susceptible to earnings fluctuations and often perform better in market downturns.

1. Index price data is downloaded from ICE Data Services. Index performance data is calculated by Axys portfolio accounting software, a product of SS&C Advent.
2. Chart prepared by Waycross. Data provided by the Federal Reserve Bank of St. Louis.