The Ten Themes of 3Q 2018

U.S. stocks had their best quarter in over five years in the 3Q 2018 period. Over the three months ended September 30, 2018, large cap U.S. stocks, as measured by the S&P 500, gained +7.20% and shares of smaller companies, as measured by the Russell 2000, rose +3.26%. Outside of the U.S., stock returns were not as good, and in some cases awful. The MSCI Developed International index, which represents mostly Europe and Japan, only rose +1.48% and Emerging Market stocks declined another -0.95% during the third quarter of 2018.

Given the poor returns outside of the U.S., our decision to overweight U.S. stocks over International has been the correct one in 2018. Our research indicates that the performance gap between U.S. stocks and International stocks is likely to grow even wider through year-end. There are several reasons why U.S. stocks are performing better this year. Perhaps the two biggest reasons are the lowered U.S. corporate tax rates, which have provided a short-term boost in cash flows for U.S. corporations and the potential for better trade deals for American companies and workers. We also are not overlooking the fact that stocks have had quite a run since their February 2018 lows. As such, beginning in September, our research has discovered that investors should become less greedy on stocks. A major reason why is because underlying expected corporate profit trends have become a little less positive.

As we enter the last quarter of the year, remember 2018 has been the year of increased fears. Thus far, most of those fears, such as trade wars, inflation, and rising interest rates, have been unjustified. Therefore, stock prices have climbed higher. As the fourth quarter of 2018 kicks off, there is renewed fear that rising U.S. interest rates will derail economic growth. Because of an escalating fear of additional tariffs adversely impacting global trade, investors have been getting very nervous. Some have even brought up the R word (i.e. recession.) Let us say, there is nothing in our current data that suggests a recession for 2019. At the earliest, it would come in 2010.

While fears could run higher than reality and drag down stock prices, the fact is during the first nine months of the year, we learned earnings among the companies in the S&P 500 index are growing at a rate close to +25%. This represents the best growth we have measured in over eight years. Yet, many are continuing to ignore the positive data points and are fixated on the negative factors. This creates both challenges and opportunities for patient, diligent investors.

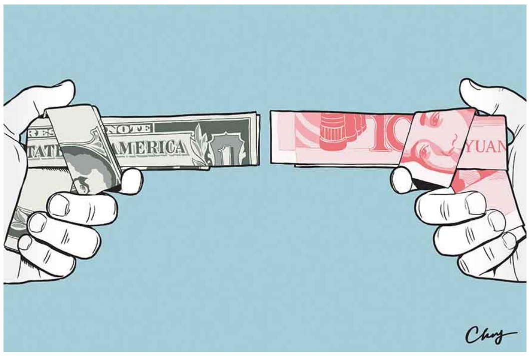
Stay tuned as we objectively measure and analyze the data for any changes that could alter our opinion(s). In the meantime, **here are the ten themes** that we believe **were the most relevant for financial markets over the past three months.**

1. Trade war fears easing?
2. U.S. stock outperformance
3. Emerging Market crash continues
4. More Fed rate hikes ahead
5. Less stimulus abroad
6. Flattening yield curve
7. Commodity prices still contained
8. Bricks in the Wall of Worry
9. Fear of trade wars on and off and back on again
10. Global stock market performance

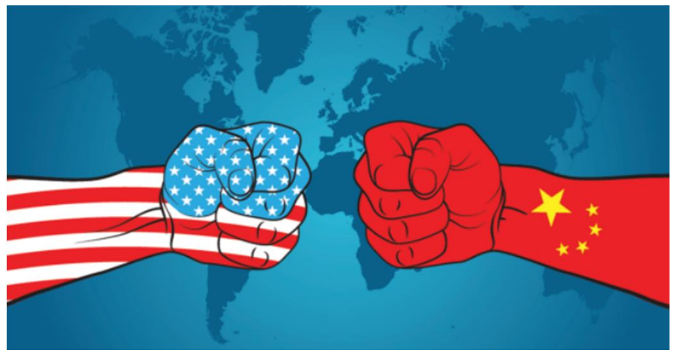
Trade War Fears Easing

The Trump administration proposed tariffs on Chinese goods earlier this year. It should have come as no surprise as President Trump has talked about America's unfair trade deals for the last thirty years. Still, the threat of a global trade war has caused investor anxiety to run high at times this year. Towards the end of the third quarter those fears eased somewhat after Canada agreed to join Mexico in a new trade deal to replace NAFTA. This gave investors hope that the U.S. and China can reach a similar agreement.

Our overall view on this topic has not changed. The threats of an escalating trade war make great headlines, but the fact remains both China and the U.S. still need each other. President Trump is trying to get better deals for U.S. companies and workers. As such, trade war fears have been overblown with regards to the overall impact on the economy. Of course, if the business you are in is in the cross hairs and facing tariffs, then it could easily have a material impact on your profits. But, we are talking about the larger economy and the effects of additional tariffs on our economy is immaterial and should remain that way.



Fear of a China / US trade war is a worry



A trade war is unlikely though because both sides needs each other

U.S. stock outperformance

After posting its first quarterly loss in three years during the 1Q of 2018, the S&P 500 index bounced back in the 2Q of 2018 by gaining +2.93%. And, during 3Q 2018 the index posted its best quarterly gain in over five years by rising +7.20%. In fact, the large cap index has now posted six straight months of gains. That may come as a surprise given the negative headlines in the press on global trade and the Fed set to become more restrictive with its policy.

As we have already noted, small cap U.S. companies fared well during the 3Q 2018 period, but not quite as well as large caps. The Russell 2000 index, a well-known small cap index, gained +3.26% and is now up +10.49% YTD.

We continue to favor smaller U.S. companies over larger ones as they will benefit more from last year's corporate tax rate cuts from 35% to 21%. The trade wars will also benefit smaller companies as fairer trade practices will impact their bottom lines disproportionately over large companies, which have more international operations. Interestingly, as trade war fears ease, as they did in September, the Russell 2000 index fell -2.54% during the last month of the 3Q 2018.

Emerging Market Crash continues

While U.S. stocks have posted gains this year, many of the major stock indices we track in the MSCI Emerging Market index remain in crash mode. We have been correctly underweight International stocks this year and we are sticking with that recommendation as we enter the last three months of the year. There are several reasons why Emerging Markets have underperformed and why we do not see those negative factors abating. Perhaps the two greatest factors that keep us cautious on overseas markets are the potential for less favorable trade conditions, and the negative impact the rising value of the U.S. dollar will have on developing economies. So, with investing choices of staying home or going global, we want to keep a greater than normal allocation to staying home and less than normal allocations abroad.

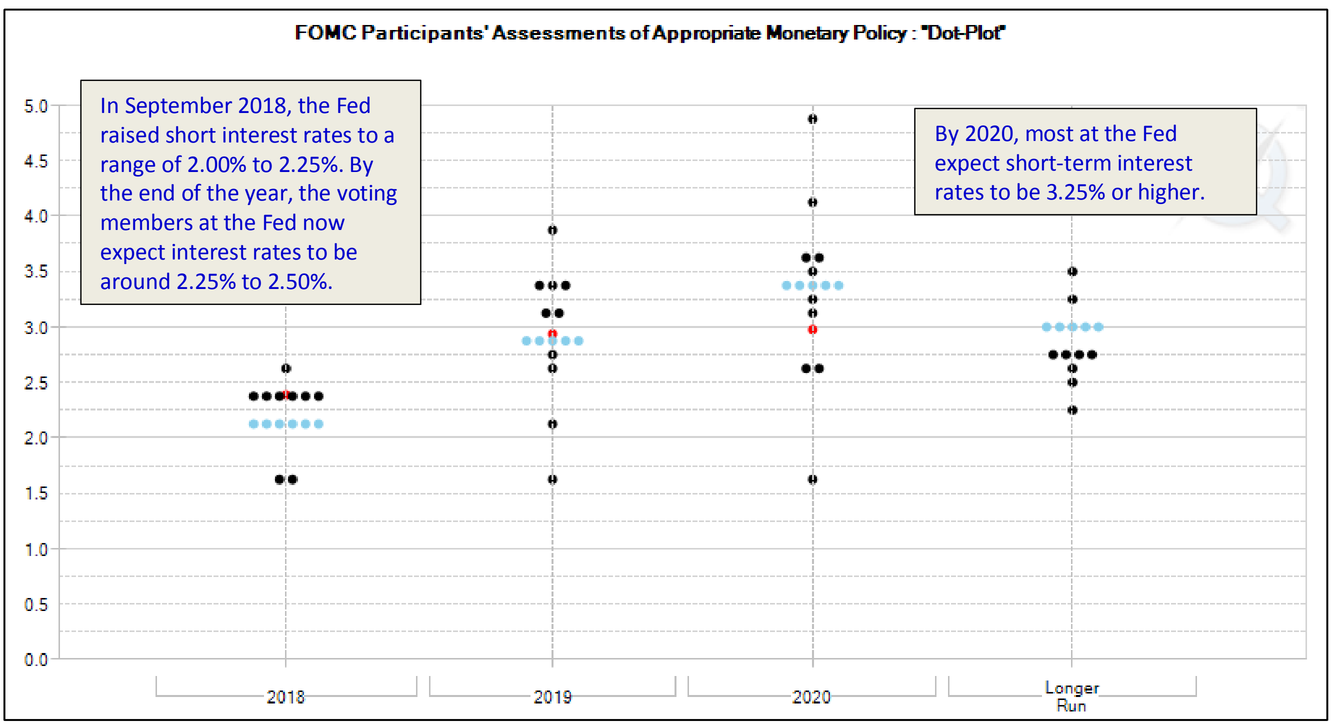
Country	Stock Index	*3Q 2018 Return	*YTD Return
U.S. Small Cap	Russell 2000	3.26%	10.49%
U.S. Large Cap	S&P 500	7.20%	8.99%
Portugal	PSI	-3.06%	-0.54%
Canada	TSX Composite	-1.26%	-0.84%
U.K.	FTSE	-1.66%	-2.31%
South Korea	KOSPI	0.73%	-5.04%
Germany	DAX	-0.48%	-5.19%
Italy	MIB	-4.23%	-5.22%
Indonesia	JSE Composite	3.06%	-5.96%
Spain	IBEX	-2.43%	-6.52%
Hong Kong	Hang Seng	-4.03%	-7.12%
Ireland	ISE	-6.59%	-7.33%
Greece	ASE	-8.70%	-13.79%
China	Shanghai Composite	-0.92%	-14.69%
Philippines	PSEi	1.16%	-14.97%

*As of September 28, 2018
Source: Bloomberg

More Fed rate hikes

On September 26, 2018, the Fed hiked its benchmark federal funds rate by another +0.25% to a range of 2.00% to 2.25%. The policy setting FOMC (Federal Open Market Committee) envisions one more rate hike this year. If that occurs, it would mean a total of four rate hikes in 2018. Back in March 2018, the FOMC was only expecting three rate hikes this year. The more aggressive Fed is causing some investors to get nervous.

By the end of this year, short-term interest rates should be around 2.25% to 2.50%. As the Fed raises rates, expect slightly more from your savings account, but also to pay more in interest on mortgages, auto loans, credit cards, etc. The key for the economy and stocks is how will higher interest rates impact future corporate profits?



Less stimulus abroad

While the U.S Federal Reserve ended its QE bond buying stimulus program three years ago, and has now embarked on normalizing interest rates by raising them to prior levels, central banks outside of the U.S. still have been pumping stimulus dollars into the economy. Most notably, the European Central Bank extended its QE bond buying program this year, when it was supposed to have ended it last year. However, the amount of stimulus has been cut in half. It was cut in half again in September with the goal of ending the program at the end of the year.

Our research on the impact global central bank stimulus has had on improving macroeconomic expectations over the past ten years suggests that less stimulus from the monetary policy makers is having an adverse impact on expected global economic growth. This is yet another reason we are more negative on international markets.

You may ask but what about the U.S.? The U.S. Fed is no longer doing QE and is raising interest rates. That should hurt growth and U.S. stocks should be underperforming even more than international stocks. We say do not overlook the help on the fiscal policy side in the U.S. in the form of the Tax Cuts and Jobs Act and less regulation. The easy fiscal policy initatives have helped carry the baton of stimulus in the U.S,, and our research indicates this will extend the current economic cycle longer than the consensus anticipates.

Flattening Yield Curve

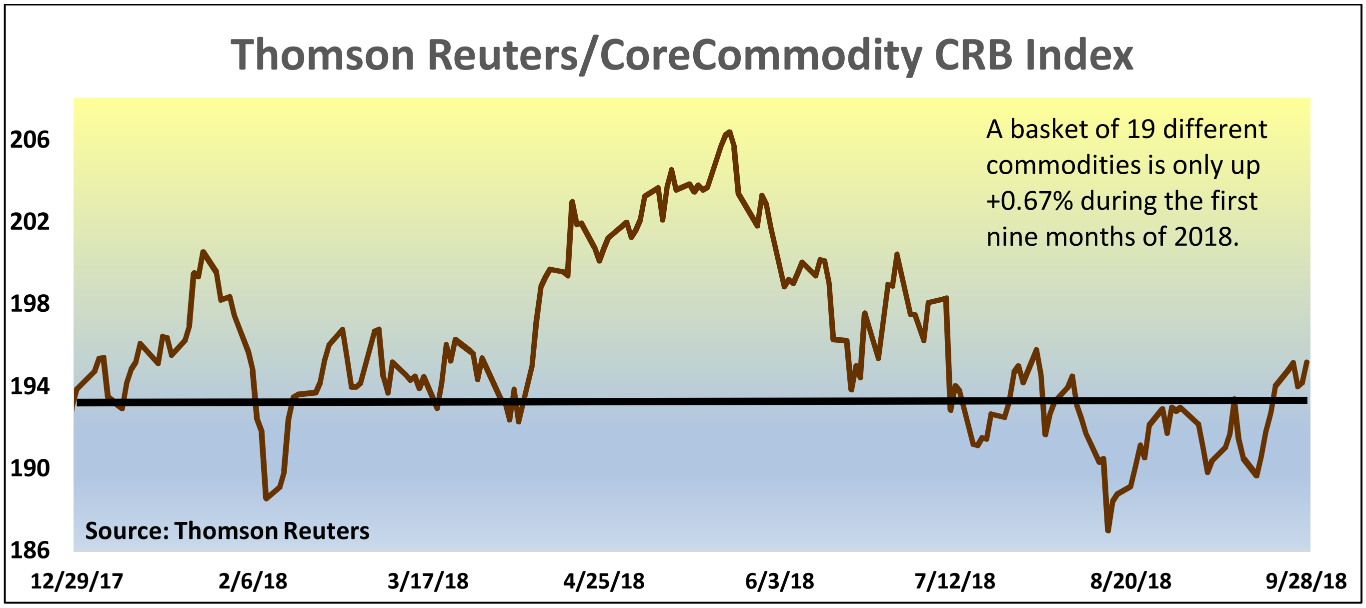
The U.S. yield curve is often referred to as the spread between the rate on a 2-year note and a 10-year U.S. treasury bond. When the spread widens (i.e. steepening yield curve) between the rates on 2 and 10-year notes, it usually indicates an expanding economy. When the spread narrows (i.e. flattening yield curve) it typically means less robust economic growth on the horizon. When it inverts (i.e. the rate on a 2-year note becomes higher than that on a 10-year bond), it indicates a pending recession. In the last 20 years, the yield curve has inverted twice. Once in 2000 before the dot.com collapse and again in 2007 before the financial crisis of 2008.

The rate on a 2-year note closed 2017 at 1.89% and the 10-year bond ended the year at 2.40%. Thus, the yield curve was +51 basis points. At the end of the first nine months of 2018, the rate on a 2-year note has risen to 2.81% while the 10-year rate jumped to 3.05%. If you take a closer look at those numbers, you will see the rates on the short end of the curve (i.e. the 2-year note) rose more than on the long end (i.e. the 10-year note). As such, the yield curve has narrowed 27 basis points in 2018 to just +24 bps. Ideally, we would like to see this yield curve steepen so it would reflect better economic growth ahead. However, the bond market remains cautious and market bears keep pointing to the flattening yield curve as a sign a recession looms on the horizion.

Commodity prices still contained

In addition to the U.S. bond market signaling caution, commodity markets have been cautious as well in 2018. However, from August 15, 2018 to the end of September, commodity prices, as measured by the Thomson Reuters Core Commodity CRB index, which tracks 19 different commodities from crude oil to orange juice, rose +4.39%. Still, commodity prices were only up +0.67% in the first nine months of the year. With investors worried about inflation rising too fast, we are unlikely to see it any time soon given commodity prices being held in check.

We want to also highlight that falling commodity prices are usually a sign of slowing economic activity, particularly in Emerging Markets. Therefore, with prices rising gradually, commodity markets are indicating a gradually improving economy. Our research on earnings trends paints a similar picture of the economy. We will explain more in detail shortly.



Bricks in the Wall of Worry

In 2017, markets were remarkably calm rising on the hopes of Trumpôs tax cuts even though uncertainty about its passage was very high. In our opinion, last year was when market volatility should have been excessive. Instead, 2018 has turned out to be a roller coaster ride for stock investors.

On Wall Street, there is an adage that ñstocks climb a Wall of Worry.ò This is actually very true since stock prices reflect future earnings expectations for each company. Therefore, if the market is expecting negative things for a company and those negative factors have been discounted into its stock price, if those negative things do not occur, the stock price will eventually rise ñclimbing a wall of worry.ò

In 2018, there have been many negative factors that have arisen that have caused the stock market to sell off. Some of which include rising interest rate fears, inflation fears, threat of global trade, etc. If any of these factors begin to impact corporate earnings expectations, then lower stock prices would be justified. For the time being, we acknowledge these threats as potential negatives; however, we are not yet measuring any deterioration in U.S. earnings expectations. Therefore, they are each bricks in the Wall of Worry that should allow stocks to climb higher when they are proven as unjustified fears.

Fear of trade wars on and off and back on again

Fears have come and gone and then re-arisen this year. This has depressed stock prices. However, the main long-term driver of stock prices, changes in earnings expectations, has been very stable. Whatôs more, this was the first time since Q1 2011 that we measured most companies in the S&P 500 raising their earnings expectations after reporting results. We attribute most of those rising earnings expectations to the Tax Cuts and Jobs Act. In fact, in nearly 25 years of compiling earnings data, we have never measured so much growth this late in an economic cycle. The key questions for markets is, ñIs this as good as it gets? And, can above trend growth persist longer than the market expects? With revenue growth running near +10% among S&P 500 companies during the 1H of 2018, it increases the chances for an extended rally. This is why we will be monitoring 3Q 2018 top-line sales growth as corporations report in late October 2018. If it stays strong, the market sell-off this month will be unjustified. If it weakens significantly, the end of the economic cycle may be near absent any additional monetary or fiscal stimulus.

How S&P 500 EPS growth estimates have changed? They are remarkably stable!

Date	3Q18E EPS Growth	4Q18E EPS Growth	1Q19E EPS Growth	2Q19E EPS Growth
6/1/2018	23.39%	15.18%	6.29%	7.58%
7/1/2018	23.82%	15.44%	7.11%	7.55%
8/1/2018	22.97%	15.51%	7.32%	7.01%
9/1/2018	22.25%	15.38%	8.45%	6.66%
10/1/2018	21.26%	15.37%	8.79%	6.47%
10/5/2018	21.25%	15.45%	8.61%	6.25%
10/11/2018	21.15%	15.29%	8.61%	6.22%
10/12/2018	21.21%	15.26%	8.57%	6.22%

Source: The Earnings Scout

Global Stock Market Performance Returns

Country	Stock Index	3Q 2018 Return	*YTD
U.S. Small Cap	Russell 2000	3.26%	10.49%
U.S. Large Cap	S&P 500	7.20%	8.99%
India	SENSEX	2.27%	6.37%
Japan	Nikkei 225	8.14%	5.95%
Brazil	Ibovespa	9.04%	3.85%
Taiwan	TSE	1.56%	3.42%
France	CAC	3.19%	3.41%
Australia	S&P/ASX 200	0.21%	2.28%
Mexico	Bolsa IPC	3.86%	0.30%
Thailand	SET Index	10.08%	0.15%
Portugal	PSI	-3.06%	-0.54%
Canada	TSX Composite	-1.26%	-0.84%
U.K.	FTSE	-1.66%	-2.31%
South Korea	KOSPI	0.73%	-5.04%
Germany	DAX	-0.48%	-5.19%
Italy	MIB	-4.23%	-5.22%
Indonesia	JSE Composite	3.06%	-5.96%
Spain	IBEX	-2.43%	-6.52%
Hong Kong	Hang Seng	-4.03%	-7.12%
Ireland	ISE	-6.59%	-7.33%
Turkey	BIST 30	4.95%	-12.78%
Greece	ASE	-8.70%	-13.79%
China	Shanghai Composite	-0.92%	-14.69%
Philippines	PSEi	1.16%	-14.97%

*As of September 28, 2018

Source: Bloomberg

Conclusion

Last year's global stock rally was built on hope and speculation that easy fiscal policy would lead to increased profits and higher stock prices. Because of the reality of lower U.S. taxes, we are now more optimistic that CEO's will go out and spend those savings on property, plant and equipment. This has already supported further revenue growth for S&P 500 companies in the 1H of 2018. This has been a huge positive for the Trump Administration. However, markets are having a difficult time with the prospects of a Trade War with China and the Fed wanting to raise interest rates even higher.

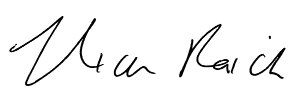
While fears may grow and create short-term turmoil in markets, we expect more U.S. stock outperformance over International markets. Our research also indicates more solid performance ahead for small cap U.S. based companies because they stand to benefit more from the tax cuts than large cap companies. Small caps should also benefit more from better trade deals for American companies and workers.

More so than ever, we will be paying close attention to U.S. monetary policy. The Fed has taken steps to raise interest rates and reduce the size of its balance sheet. These moves are the opposite of the stimulus the central bank has provided markets for almost a decade. Additionally, we must closely monitor the impact additional tariffs will have on global economic activity. Will all the bricks in the wall of worry derail the improving economic growth? Maybe, but our research indicates that it is still not likely at this point.

While we take great pride in our measurement and understanding of all the economic and earnings data, it is impossible for us to know every major market factor in advance. Because of this we continue to apply our fundamental beliefs that risk and return are related, markets are efficient over time, profitability matters and diversification is key. These fundamental beliefs continue to be the core of our short term and long-term investment approach.

We hope you found this information useful and encourage you to approach us with any questions you may have. We look forward to our next conversation.

Strategic Investment Advisors Investment Committee,

Mark Klopfenstein, AIF® **Nick Raich, CFA®**