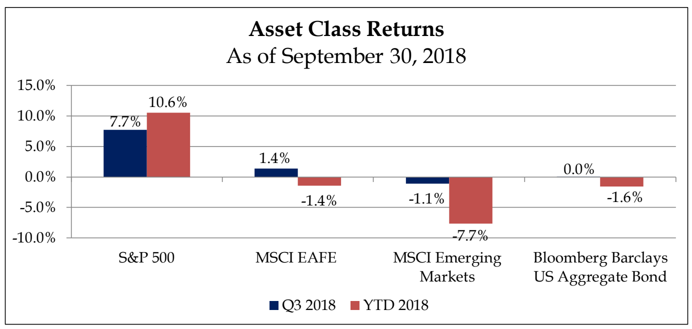
Market Update & Economic Outlook

October 2018

U.S. Continues to Shine as Overseas Markets Languish

The third quarter of 2018 saw a continuation of the desynchronization that has characterized the global economy and capital markets for most of the year. On one hand, U.S. economic growth continues to strengthen, and domestic equity market indices remain at or near record levels. On the other hand, overseas economies, both developed and emerging, have experienced a pronounced deceleration in economic growth, translating into declines in international equities and weakness in international currencies relative to the U.S. dollar. In many ways, the current environment is reminiscent of 2014-2016, when a similar global desynchronization occurred and eventually resulted in a slowdown in U.S. economic growth and a correction in domestic equity markets that ultimately proved short-lived.

One of the most important questions facing investors as we enter the final quarter of the year is how much longer U.S. economic and equity market strength can persist, especially if overseas markets remain under pressure. For context, the U.S. economy expanded by 4.2% in the second quarter (Bureau of Economic Analysis), as measured by real gross domestic product, and is expected to have grown in excess of 4% again in the third quarter according to the Federal Reserve Bank of Atlanta's GPDNow™ measure. These levels of economic growth are the strongest the U.S. has experienced in years. Further, U.S. corporate earnings growth has been exceptional in 2018, with the earnings of S&P 500 companies growing more than 25% on a year-over-year basis in both the first and second quarters (they are also expected to have expanded by more than 20% in the third quarter) (FactSet). Not only have U.S. corporate earnings been supported by the recent strength in economic growth but also by the sharp reduction in corporate tax rates due to the Tax Cuts and Jobs Act passed at the end of 2017. Based on current data points, the U.S. economy and capital markets appear to be firing on all cylinders entering the final quarter of the year.



Source: Morningstar

As U.S. equity markets have continued the multi-year trend of outperforming their international peers and fixed income markets in 2018 (see right), many investors have begun to question the merits of maintaining diversified portfolios. The recent period of U.S. equity market dominance has parallels to the late 1990s when investors increasingly eschewed diversification and increased allocations to top-performing U.S. growth stocks in the lead-up to the technology bubble. While we do not see a comparable valuation bubble in U.S. equities today, U.S. stocks have grown increasingly expensive relative to their international peers across most valuation measures. We continue to believe that patience and discipline remain critical to investors seeking to realize the long-term benefits of diversification. History has repeatedly demonstrated the pitfalls of attempting to chase returns and time markets, and we do not expect a "this time is different" mantra to play out any differently for investors this time around.

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Authored by the Freedom Capital Management Strategies® Investment Team

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Perspectives on Recent Market Volatility

After a decidedly calm and prosperous period for U.S. equity markets in the third quarter, as described earlier, volatility returned to markets in the early weeks of the fourth quarter, during which both U.S. and international equity markets experienced sharp declines.

The seeds of the recent volatility began in traditionally stable fixed income markets, where the yield on the benchmark 10-year U.S. Treasury bond rose sharply to multi-year highs and caused declines across global bond markets (bond prices are inversely related to interest rates). A similar sequence of events transpired in the first quarter of the year, when concerns over rising U.S. interest rates led to a pronounced drop in U.S. equity markets that ultimately proved short-lived. Our initial assessment is that the current bout of market volatility will also prove a healthy correction rather than the beginning of an extended bear market. The primary reason for our sanguine view of the current market volatility is our belief that the goldilocks conditions of robust U.S. economic growth and contained inflation appear likely to remain intact in the near term.

- U.S. economic fundamentals remain healthy, as discussed earlier, and the risk of recession, which has historically been a reliable predictor of bear markets, remains low according to several key measures, including: leading economic indicators, manufacturing new orders, unemployment claims, and durable goods orders (BCA Research).

- Despite the recent rise in interest rates, overall monetary policy is still accommodative, as interest rates remain at historically low levels (see right). The recent increase in rates has been driven by a rise in real rates rather than a rise in inflation expectations. This likely indicates that bond markets are repricing in response to stronger expectations for U.S. economic growth, which would be supportive of equity markets, rather than inflation concerns, which would catalyze the Federal Reserve to implement a more restrictive monetary policy and prove a headwind for stock prices.

Although our near-term outlook remains constructive, we continue to closely monitor several risk factors that have the potential to disrupt the favorable fundamental backdrop in the U.S. Domestically, we are closely monitoring Federal Reserve policy and its impact on fixed income markets, alongside the potential for rising inflation amid a tightening labor market. Overseas, we remain vigilant about the impact of the growing trade dispute between the U.S. and China, as well as the potential for a slowdown in Chinese economic growth to spill over to other emerging economies. We are also closely watching the political situation in Italy for signs of renewed strain in the Eurozone. In the near term, we expect the strong fundamental backdrop to continue to outweigh these risk factors. However, we will be monitoring the dynamic capital market environment closely for potential catalysts of change to our sanguine view.

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