Review & Outlook – 3Q 2018

Two big areas of uncertainty continue to hang over U.S. equity markets and are now joined by a third. While trade policy and Federal Reserve interest rate policy remain among the largest concerns for markets, the approaching midterm elections and associated political uncertainty have started to gain investors' attention. Despite this unsettled backdrop, the S&P 500 posted another solid quarter reaching a new record high in August and has now advanced 10.6% in 2018 and 18.3% over the past year.

Worst Case Scenario Avoided With Trade But China Still Under Pressure

Progress has been made on the trade front as a new trade agreement with Mexico and Canada, the United States-Mexico-Canada Agreement (USMCA), was signed on the last day of September. China remains the largest trade issue as three rounds of announced tariffs and retaliations account for most of the $133 billion estimated tariff related costs to the economy. The risk of trade policy mistakes remains, particularly given the Trump Administration's unusual approach to negotiations. It's important to note that while tariffs are rising, it is from a very low base. The average U.S. tariff rate in 2017 was 3.4%, lower than the EU, Canada, Mexico and nearly one-third the average Chinese tariff. U.S. equity markets have vastly outperformed Chinese equity markets since the announcement of the first new tariffs in the first quarter. The fiscal policy stimulus from tax cuts, federal government spending increases and repatriation has dwarfed the negative economic drag so far, giving some cushion as these issues are negotiated, most likely after the midterm elections.

Source: Strategas Research Partners

Fed Continues To Hike – From Very Low Levels

That same fiscal stimulus combined with low unemployment, accelerating GDP growth, wage growth and slightly higher inflation is giving the Federal Reserve justification to slowly normalize interest rates. After raising the fed funds rate 0.25% in September to 2.25%, one more increase to 2.5% in December seems all but assured. Markets seem to be anticipating somewhere between one and three additional raises in 2019 while the Federal Reserve's "dot plot" of where policymakers think rates will be suggests three raises next year. As short-term rates have risen, long-term rates have not kept pace, resulting in a flat yield curve. The concern of a policy mistake is if the Fed raises rates too quickly and the yield curve inverts (long-term rates are lower than short-term rates) which is usually a precursor to a recession. However, a flat curve can persist for several years as in the late 1990s, and the real fed funds rate is barely positive suggesting Fed policy is not restrictive but rather monetary policy is returning to normal following the last recession.

Midterm Elections Could Provide a 2nd Half Tailwind

The old adage is that "markets hate uncertainty" and that would appear to be true as it relates to politics as well. During midterm election years since 1994, the S&P 500 has been mostly flat in the year leading up to the election before rallying through the end of the year and into the following year as well. The S&P 500 has also not declined in the 12 months following a midterm election since 1948. Of course, these trends could change at any time, but at least historically markets perform well as the political uncertainty recedes post-election.

Political Conditions Remain Uncertain In Europe

While the midterm elections may assuage political uncertainty domestically, it is still very present internationally. The March deadline for the U.K. to leave the EU is quickly approaching and while negotiations are ongoing there is currently no deal. A populist threat remains in Europe and economic data remains a bit weaker than 2017. Emerging markets have been squeezed by tighter monetary conditions due to rising U.S. interest rates and higher oil prices. Consequently, emerging equity markets are down 7.4% year-to-date.

Still No Storm Clouds On The Horizon

There are is no shortage of concerns for equity markets, both domestically and internationally, and yet U.S. markets have performed well. Quarterly earnings for companies in the S&P 500 grew 26% year-over-year in the second quarter. While that growth is expected to be slower in the second half of 2018 and comparisons in 2019 will be difficult, earnings growth remains strong. Consumer confidence is also high, the personal savings rate has remained solid, and household debt service ratios are low, suggesting consumers are not stretched and the holiday retail season should be stronger than average. Equity valuations are not cheap but don't look excessive in historical context either at only about 6% above the 20-year average on a trailing price/earnings basis. There will undoubtedly be volatility and challenges ahead as the risks associated with changing trade policy, monetary policy and political uncertainty are navigated by investors and new risks appear. We remain committed to our principles, staying broadly diversified across global markets and market capitalizations with a patient long-term strategy.