Investment Commentary

October 19, 2018

3rd Quarter Recap

Domestic stocks generated positive returns for the 3rd quarter with the Vanguard Total Stock Market Index providing a return of 7.07%. And after a strong performance earlier in the year small cap stocks underperformed large cap stocks. Mid-cap stocks have been relatively lackluster this year and have underperformed both large cap and small cap. International stocks did not fare well with the Vanguard Total International Stock Index barely breaking even with a 0.31% return.

Investment grade bond funds were essentially flat with a loss of -.08% for the Barclay's Aggregate Bond Index. The Federal Reserve raised short term rates .25% in September. Long term rates have moved up and the 10 U.S. Treasury Note is currently 3.20%.

Global Economy

The U.S. economy continues to perform well and the rate of unemployment is currently at a low of 3.9%. The corporate profit picture continues to look good and lower tax rates will provide a boost to profits in the near term. But concerns remain over the effect of rising interest rates and trade tensions on economic growth.

European economic growth picked up over the summer and Britain and the EU are closer to a deal on Brexit. However, continuing trade tensions could reduce growth as soon as next year. And Italy remains a question mark with concerns the government could potentially leave the Eurozone and default on their massive debt. If that happens the fallout will be much worse than the Greek credit crisis.

The economies of emerging markets continue to suffer due to a higher U.S. dollar. Trade tensions have had a negative effect on the Chinese economy and the International Monetary Fund just lowered their outlook for growth in 2019. An escalating trade war will significantly lower growth as soon as next year.

Review of Asset Classes

Domestic Stocks

Domestic stocks reflect positive returns this year and could continue to move modestly higher over the remainder of the year. We have just experienced a “correction” with the stock market down about 6% over a 2 day period. The yield on the 10 year U.S. Treasury Note reached a 7 year high which appeared to be a catalyst for the sell-off.

Growth stocks have continued to outperform value style stocks but it is possible that is about to change. Underlying the overall stock market there appears to be some rotation out of the “acronym” stocks (Facebook, Amazon, Apple, Alphabet, Netflix, Microsoft, etc.) into other sectors.

International Stocks

International stock markets have underperformed the U.S. stock market this year. They remain undervalued but a rising U.S. dollar and trade tensions will continue to exert downward pressure on those markets over coming months.

Emerging market stocks are the worst performing asset class this year after an extraordinary performance last year.

Investment Grade Bonds

Downward pressure continues on investment grade bonds with the recent sharp move up in intermediate term interest rates. Over coming months we are likely to see rates continue move up resulting in minimal performance from investment grade bond funds.

Floating rate investment grade bond funds and even higher yielding money market funds are good place to hold a portion of a portfolio’s bond allocation while the Fed continues to raise rates.

Non-Conventional Bonds

Returns for non-conventional bond funds including floating rate funds year to date are modestly positive. But the returns are higher than conventional investment grade bond funds. They will continue to outperform conventional investment grade bond funds over the next several months as interest rates move up.

However, I will likely recommend a reduction in the allocation to non-conventional bond funds in coming months. These funds do not perform well in a slowing economy or credit crisis type of environment (such as the Greek credit crisis).

REITs

The Vanguard REIT Index ETF is up only about a half a percent year to date. I am not currently recommending this sector due to rising interest rates.

Oil and Gas Sector

Oil prices are volatile and often affected by geopolitical concerns. Prices are likely to continue gradually moving up due to U.S. economic growth and supply issues with Iranian sanctions going into effect in November.

This sector began to perform well this year after years of dismal performance. And even if oil prices do not move up substantially oil companies are well positioned to reflect strong earing growth.

Going Forward

Overall investment returns could continue to be modestly positive over the next several months unless there is an escalation in trade tensions. And next year the Federal Reserve is likely to continue to raise interest rates potentially slowing economic growth.

The interest rate environment is currently in a transition after years of exceptionally low interest rates. I believe the remainder of this transition will occur over the next year. It is a good news/bad news situation. It is good that interest rates are moving back to a more normal level providing a better return from investment grade bonds. But the investment return on bond funds will continue to be minimal over the next year or so as interest rates move up.

Over the past few years the “new economy” stocks have been the engine pulling up the whole stock market. We are now starting to see profit taking in those stocks and rotation into other sectors of the stock market. So after years of underperformance the value style of stocks may start to outperform growth stocks.