CLIENT BRIEFING

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U.S. stocks wound up a strong third quarter, with the S&P 500 index climbing 7.2% and the Nasdaq composite rising 7.14%. Saavy investors looked past the dysfunction in Washington, D.C. and instead focused on the strong economic fundamentals that have propelled the stock market to record highs.

Though most agree the general economic outlook looks bright, stocks face a number of obstacles in the next three months: The Federal Reserve is expected to raise interest rates again in December; the U.S. has yet to resolve its trade disputes with China, Canada and other partners; and the coming midterm election cycle is anticipated to be controversial. Yet politics can actually be a plus for the stock market. While October typically is associated with crashes in investors' memories, the month is usually positive during mid-term elections, according to the Stock Trader's Almanac.

While domestic stocks continued to perform well this quarter, most foreign stock indexes, particularly those representing emerging countries like China, lost value. The benchmark Shanghai index is down 15% this year, while Hong Kong's Hang Seng has dropped 7.1%. European stocks are also down this year. To some degree, these are the result of interest rate hikes and a stronger dollar, which are somewhat related. In the case of China, the Trump administration's tariffs clearly shoulder some blame for the underperformance. In the simplest terms, investors have bid the price of the dollar to a point where the expectations are for continued solid growth and interest rate hikes by the Fed. At the same time, they believe the European economy will remain in the doldrums for a long time pressuring the European Central Bank to keep borrowing costs low. However, Europe's economy is improving and there is good reason to believe that the ECB will be more assertive in raising interest rates in the near future.

By the end of the third quarter, many bond investors were glad to see the 10-year Treasury note surpass 3%. While bond prices do fall when yields rise, the trend to a more normal historical average yield for this benchmark is a healthy one. It signifies that the underlying economy is robust and can withstand higher borrowing costs on such large ticket items as homes and cars. There continues to be an investor bias towards shorter duration bonds, which will likely continue until the Fed announces plans to stop raising rates. U.S. investment grade bonds in the aggregate managed just a .02% return for the quarter.

Some of our clients may question whether it pays to keep emerging market stocks, commodities and bonds in their portfolios. The short answer for most is yes. International and commodity stocks have noticeably cheaper valuations than domestic equities, which portends well for future return prospects. Bonds are an essential ballast that lessens market risk and volatility, which will inevitably resurface. Now, ten years from the Lehman Brother's collapse, the lesson of avoiding overconfidence should be etched in our memories. The risk factors noted above are just too great to ignore. We continue to support a diversified investment strategy for most clients, especially in such times of uncertainty and political divide.

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Sources:
Stocks Ignore the Hurricane, Barron's, October 1, 2018
Stocks Advance Despite Risks, Wall Street Journal, October 1, 2018

Past performance is not a guarantee of future results. It is also important to note that one cannot invest directly into an index. Diversification cannot assure a profit or guarantee against a loss of value.

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