# Market Update

October 10, 2018

**Equities Pull Back After Making New All Time Highs**

U.S. equities markets hit new all-time highs late in September, bucking a trend that historically September is one of the worst months for the U.S. stock markets. The markets remained close to their all-time high through the close of October 3rd. Weakness started to show the next day and once the unemployment report came in, at near a 50-year low, the markets continued to pull back as inflation fears and higher interest rates started to weigh more heavily on investor sentiment.

A strong dollar and rising oil prices have added to concerns that inflationary pressures are here, and the U.S. economy and its corporations will need to prove they can continue to grow. October is the start of the 4th quarter and earnings season. It appears that this October is looking to be more like the historically difficult month of September for equities markets with a lot riding on what earnings reports and outlooks from corporations will look like.

Trade tensions with China are still an issue that the markets are trying to figure out. However, the recent deal between the U.S. and Canada has calmed some of the fears of a broader trade war. Since last month, we have seen an accelerated sell off in the fixed income/bond markets, as the price of bonds has dropped and interest rates have risen. The 10-year treasury note now sits above 3.2%. In our chart below, we can see TLT (orange line) has continued its decline. This is a proxy for longer term treasury bond prices. Gold has continued to remain lackluster even as oil rises in price. Often, there is some correlation in the prices of the two commodities, but they do diverge. GLD, our proxy for gold (red line), shows a continuation of the downward pricing pressure on gold. Gold trending downward is a potential sign that longer term fear for equities has not gripped investors yet, considering the current short-term equities market pull back. Lastly, the Dow Jones REIT Index (green line) has also pulled back as Real Estate tends to be sensitive to interest rate changes.

Another area that is starting to pop up in conversations is the strength of the dollar. Since the February to April period this year, where the dollar bottomed out, it has strengthened. This influences corporate earnings, particularly those earnings of US companies that do business overseas. The cost for U.S. goods and services priced in dollars becomes more expensive for foreign markets. This is due to the stronger dollar costing more money in the local currency. Currently, we see the pull back as something expected, after equities markets hit new highs. We anticipate equity indices will recover as the year nears end.

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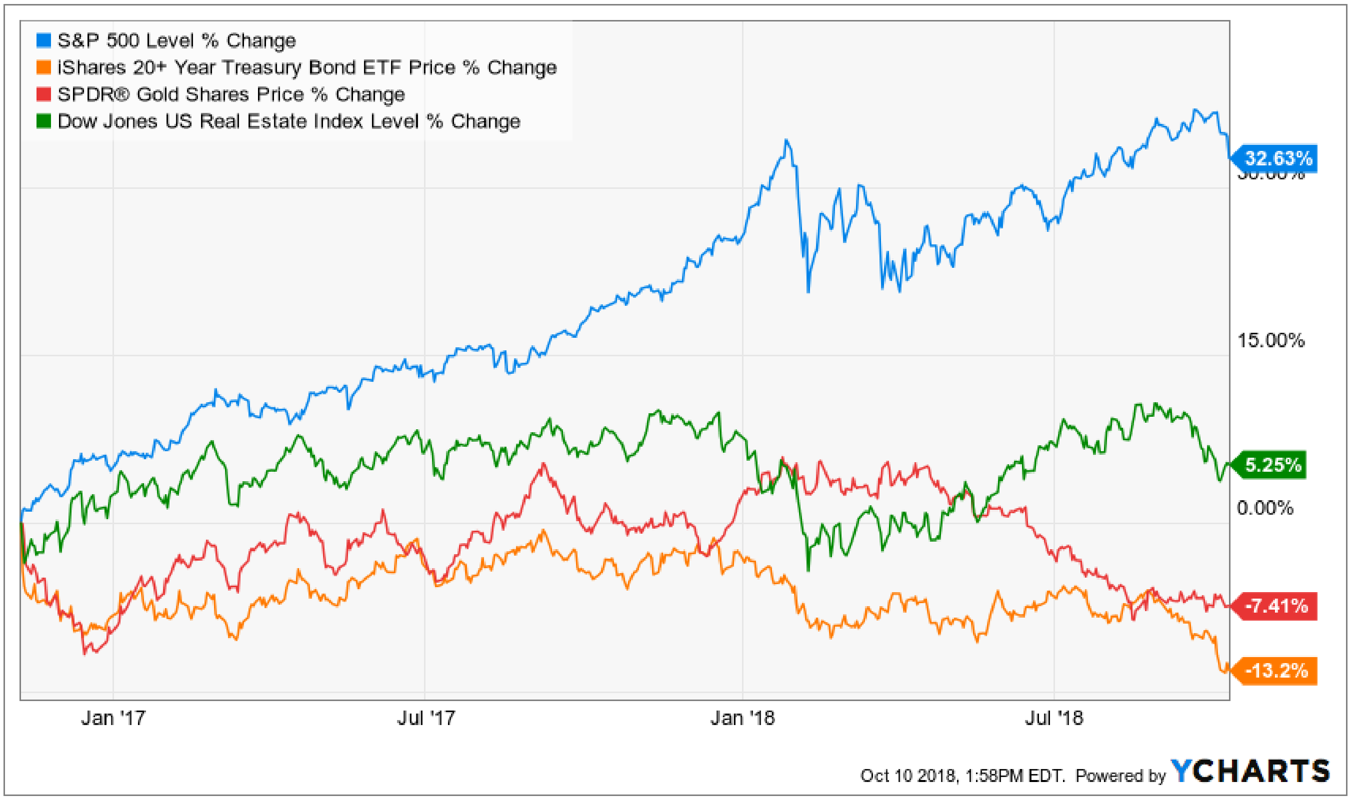


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The U.S. is still adding jobs and unemployment is continuing to go down. Ultimately, this does mean that there are more dollars in the market place looking to buy goods and services. This is a sign of a strong economy, but the current level of unemployment, higher inflation and interest rates are a concern. Economic conditions tend to be cyclical in nature but not identical in scope and breadth. The new tax reform bill has provided additional stimulus to the U.S. consumer and should be helpful for a longer period. Our position on the economy is that we are in the later stages of the economic cycle, but we can certainly remain here for an extended period. Our number one concern is what the Federal Reserve will continue to do regarding interest rate policy which is driven by economic data. Specifically, inflation data and unemployment data are where we see the Feds focus.

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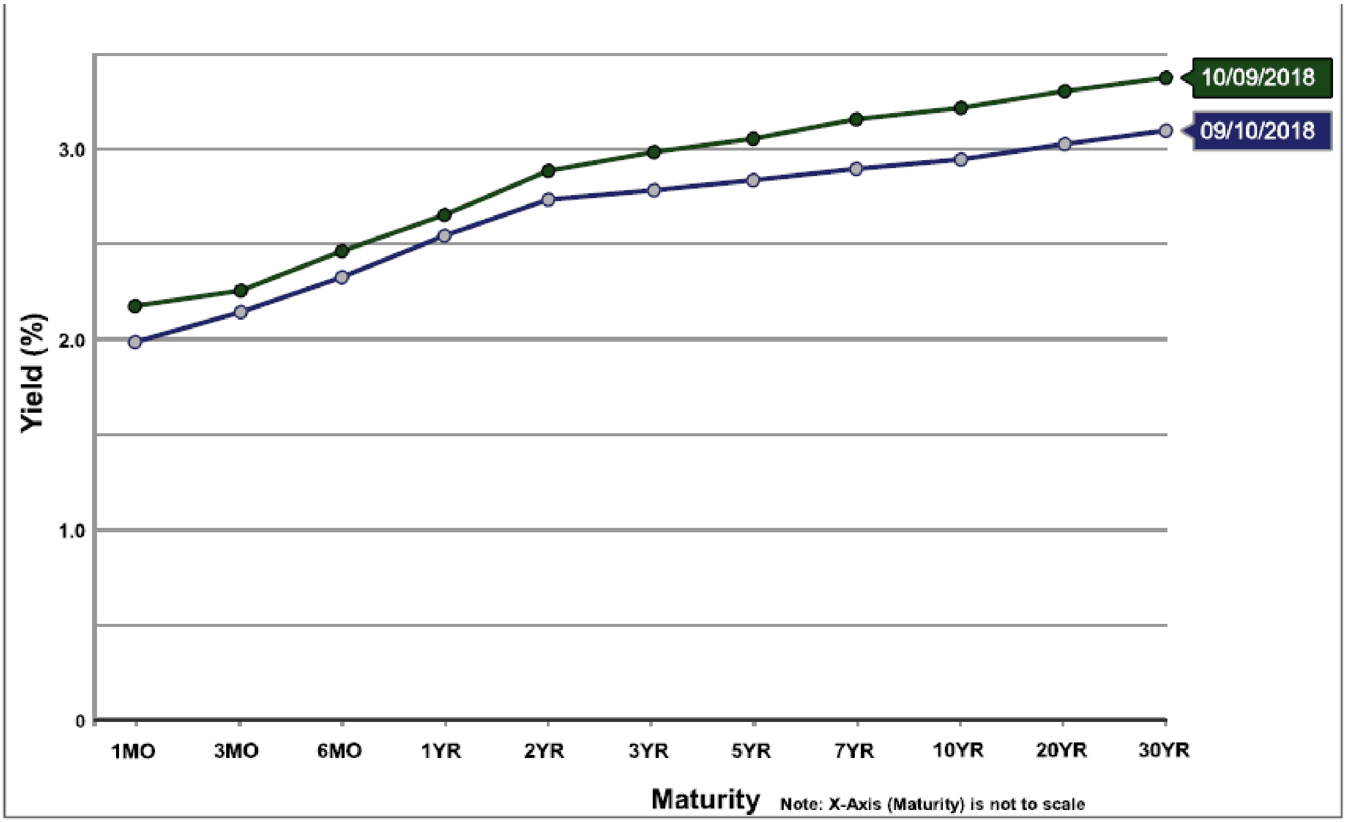


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https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/Historic-Yield-Data-Visualization.aspx

The chart above shows the US. Treasury yield curve has steepened since last month and shifted to the left, as higher rates continue to be a theme affecting the markets. A steeper yield curve tends to point to a healthy economy. At some point, higher rates will slow the economy down, as borrowing continues to become costlier. This is where Federal Reserve interest rate policy is important. They need to continue to walk the tight rope of raising rates to make sure the economy does not over heat. At the same time, they must be cautious not to raise them to quickly, which will hurt economic activity.

As mentioned previously, we still feel that there are signs of a later stage economic environment, as evidenced by wage increases, inflation and rising interest rates. The US could stay in this economic phase for an extended period. The biggest concern for the economy in the next 12 months is the Federal Reserve increasing rates too quickly to combat inflation. This can often stifle growth. Our outlook is more cautious for the remainder of this year, although we do feel there is more opportunity for growth.

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Overall, we prefer domestic equities over international equites, although some international markets may become more attractive, as the U.S. economic cycle continues to mature. We are starting to look at making some shifts in domestic equities between growth and value stocks. Value stocks tend to move more slowly in either direction when the markets react to stimulus. In later stage economic environments, a tactical shift to overweighting value type stocks will reduce portfolio risk. This is an area we are now looking at to make tactical changes over the course of the coming months and into next year. We are currently bearish on fixed income and interest rates and believe that the future will bring a higher rate environment. As mentioned in the past, we are looking at combating the decline in fixed income prices by shifting some of our fixed income holdings to floating rate securities. These tend to hold value better in rising rate environments. Also, we are looking at ways to directly combat inflation, such as investing in Treasury Inflation Protected Securities (TIPS). These securities have important tax ramifications. They are typically most appropriately used in retirement accounts, where the current tax effects are reduced and often eliminated. It is important to maintain discipline regarding strategic asset allocation. Tactically, the shift to holding some floating rate bonds or bond funds and TIPS should help reduce some of the pressure on the bond allocations in our portfolios.

If you have questions or would like to discuss this further with regard to your personal portfolio, please contact me at 310-433-5378.

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