MARKET UPDATE
SEPTEMBER 19, 2018

Despite a number of headwinds over the summer months, equity markets have rebounded following a 10.2% correction earlier this year. After several months of progress (with some ups and downs along the way), on August 24th, the S & P 500 surpassed its previous peak and established a new all-time high. In the process, the current bull market, which dates back to March 9, 2009 has now surpassed the previous longest bull market that lasted from 1990 – 2000.

There have been plenty of reasons to get more defensive over the past several years. However, by keeping our eye on key indicators including job growth, business activity, consumer confidence, liquidity conditions, Fed policy and the direction of corporate profits, we have remained largely invested throughout the more than nine-year old economic expansion. For reference, a number of economic indicators including the ISM Manufacturing Index, the unemployment rate, the level of corporate profits, weekly jobless claims and the NFIB Small Business Index currently stand at multi-decade or all-time highs. Things can certainly change, but for now we believe the glass as half-full. The one area that has not been as strong in recent months is the housing market, which we are keeping an eye on.

After several years of significantly under weighting foreign equities, we raised our overseas holdings to about 15% last year (a little bit higher or lower depending on the specific RDM investment model). At the start of this year, we evaluated adding further to our overseas holdings. However, as a result of last year's tax cuts (and increased fiscal spending), we decided that the U.S. economy was likely to receive a boost which would help U.S. markets outperform overseas markets. With about four months left in the year, this has so far turned out to be a prudent decision. As diversified portfolio managers, we will always have some amount of overseas exposure in our investment portfolios. With foreign developed and emerging markets trailing the returns of U.S. equities so far this year, this has created somewhat of a headwind for investment performance. It's worth noting that if we had followed the widely watched MSCI All Country World Index more closely (which currently has about 48% foreign exposure), this would have created a much bigger drag on equity market performance this year.

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What keeps us up at night? Looking around the globe, there are a number of factors that we have on our radar. The Federal Reserve Bank continues to raise short term interest rates (which could lead to a yield curve inversion or slowdown in the economy at some point), there is the potential for a much larger trade war with China and other countries around the world, a growing number of companies are having trouble finding qualified workers, rising debt levels represent a growing longer-term concern and developments in emerging markets are a growing concern as well. Recent news that the United States and Mexico have agreed to a new trade deal (note: negotiations with Canada are ongoing) helped boost investor confidence somewhat recently. However, the fact that President Trump initiated another round of tariffs on September 18th is not good news. For now, we don't believe that the issues highlighted above are big enough to derail the current U.S. expansion. However, that doesn't mean there won't be a few bumps in the road as we get closer to mid-term elections and head through the last several months of the year.

GDP Growth

Last quarter the economy posted real (i.e. inflation adjusted) GDP growth of 4.2%. For reference, this compares with 2.2% real GDP growth last quarter and an average of just 2.3% real GDP growth throughout the current nine-year economic expansion. According to the Federal Reserve Bank of Atlanta, real GDP is currently forecast to grow 4.7% in the current quarter. This number may certainly change between now and the end of the third quarter, but if we do in fact generate another quarter of 4% plus real GDP growth, that would be positive news. For reference, it would be the first time since 2014 that the economy has generated two consecutive quarters of 4% plus real GDP growth.

One reason that strong real GDP is positive is because over time, corporate sales tend to track the level of nominal GDP (i.e. real GDP plus inflation). Therefore, stronger GDP growth over time should help translate into rising sales, higher corporate profits and rising stock prices. Ultimately for the economy to continue to grow at an above trend rate of greater than 3% for a sustained period, we will need to achieve higher productivity growth along with additional growth in the labor force. The Trump administration believes that recent tax cuts should help boost the long-term growth rate of the economy. We are not so sure about this claim but are willing to keep an open mind at this point.

Labor Markets

Recently, the monthly employment report was released, and the economy added 201,000 jobs last month compared with estimates of an increase of 190,000. For reference, job growth over the past three months has averaged 185,000 per month and job growth over the past three years has averaged 198,000 per month. The unemployment rate remained unchanged at 3.9% last month which is just above the May 2018 cycle low of 3.8%. For reference, the May 2018 rate of 3.8% tied the lowest rate of the past 20 years set back in April, 2000. Despite another overall solid employment report, one blemish is that manufacturing related jobs actually declined

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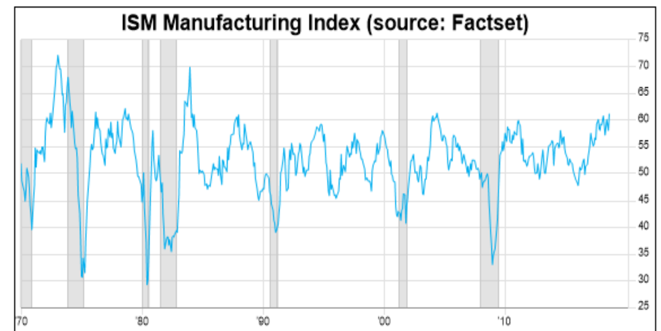
3,000 last month (despite strength in the monthly ISM Manufacturing report – see comments below).

Perhaps the most important observation from the most recent jobs report is that wage growth increased 0.4% month over month (double estimates) and wages have now increased 2.9% on a year over year basis. While this may not sound like a high number, the 2.9% rate represents a new cycle high for the current economic expansion. The strange thing is not that wage growth rose last month but that it has taken so long for wages to start moving higher. Numerous economic statistics point to the fact that labor markets are currently historically tight. For example, the "quits rate" (i.e. the number of people leaving their job for a new job) rose 0.5% last month, weekly jobless claims recently fell to the lowest level since 1969 and the JOLTS jobs report (from the Bureau of Labor Statistics) indicates that the number of job openings has increased to the highest since 2000 (as far back as this report goes).

According to the economist David Rosenberg from Gluskin Sheff, an increase in the "quits rate" (i.e. the percent of people who leave one job for another) has historically done a good job forecasting the direction of wages with a six-month lag. Therefore, if labor markets continue to tighten and the "quits rate" moves higher over the next several months, wage growth should continue to rise above the 3% level before too long. Right now, rising wages are a clear positive. They provide consumers with more money to spend and pay down debt, which represents a positive tailwind for the economy. However, if wages continue to rise over the next several quarters and move towards 3 ½ to 4%, this could make Federal Reserve Bank officials uneasy and could start to have a negative impact on the level of corporate profits. At least for now, we believe that this is a story for 2019 or later.

MANUFACTURING ACTIVITY LOOKS SOLID

Turning to the manufacturing side of the economy, the monthly ISM Manufacturing report was released on September 4th, 2018. Despite concerns about rising tariffs, the manufacturing sector currently appears to be on positive footing. The headline reading came in at a level of 61.3 (up 3.2 points month over month versus estimates of a reading of 57.6) and has now been positive for 112 consecutive months. Looking at key aspects within the report, new orders rose 4.9 points to 65.1 (this represents 16 straight months above 60), production rose 4.8 points to 63.3 (a 7-month high) and employment registered 58.5 (up 2 points and a 6-month high). Prices remain high at 72.1 but declined a modest 1.1 points month over month. Lastly, export orders came in at a reading of 55.2 versus 55.3 last month (a positive given recent news about the potential for trade wars).



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As a reminder, a reading above 50 indicates expansion while a reading below 50 indicates contraction. Overall this was a solid report and indicates the manufacturing sector remains on pretty solid footing as we head into the Fall.

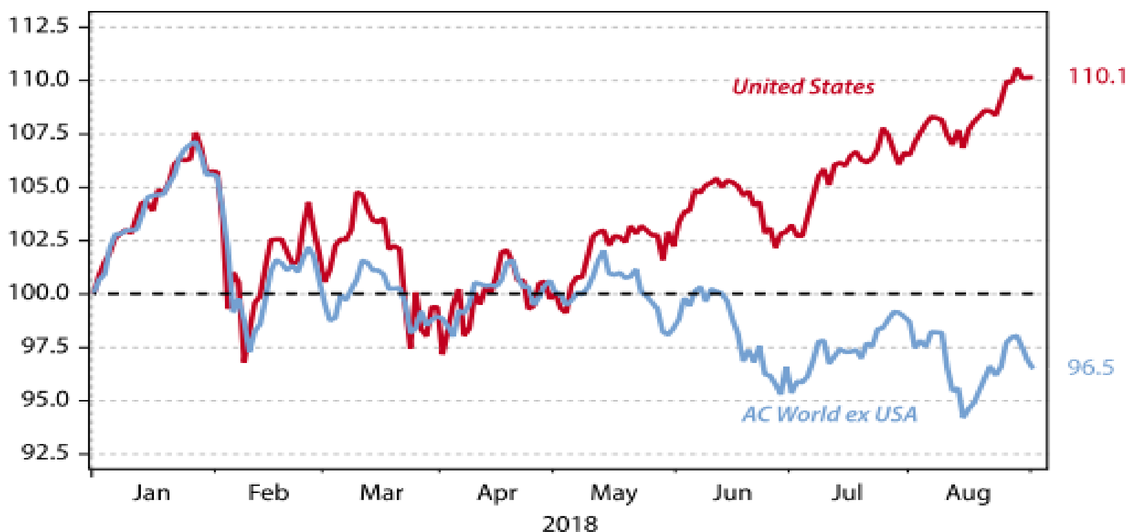
U.S. VERSUS OVERSEAS MARKETS

While the Nasdaq Composite, S & P 500 Index and Russell 2000 Index have been acting well in recent months, the widely watched Dow Jones Industrial Average has continued to lag and has not yet established a new all-time high yet. Looking around the world, one thing that is evident is that overseas markets are not keeping up with the U.S. In other words, the rise in stock prices this year has for the most part been a U.S. phenomenon. The chart below shows the growing divergence between U.S. and overseas markets so far this year (source: Gavekal Research).

Earlier this year we debated adding to our approximately 15% foreign market exposure. After all, market valuation levels are cheaper overseas, central bank policy is more accommodative outside the U.S. and a majority of the world's population and companies reside outside the U.S. As long-term investors, adding some additional exposure overseas seemed to make sense. However, after reviewing the outlook for economic and corporate profit growth in the year ahead, we decided that the U.S. was likely to outperform other countries around the world this year. So far this has turned out to be the right call, although we are aware that the outlook for foreign markets may change in the quarters ahead.

IT'S BEEN A WHILE SINCE THE LAST ALL-TIME HIGH

As mentioned on page 1 above, the S & P 500 recently posted a new all-time high this past August (following the last all-time high which took place back in January, 2018). We uncovered some interesting market research that we wanted to share with you. According to data from Strategas Research, when equity markets post a new all-time high after not having done so for at least six months, this has



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historically been a bullish sign for the markets looking forward. As you can see in the chart below, when the stock market (represented by the S & P 500 Index) posts a new 52 week high after having not done so for at least six months, it tends to perform reasonably well and generates higher returns than the markets average performance over historical 1, 3, 6 and 12 month periods. In addition, when the stock market posts a new all-time high after not having done so for at least six months, the odds of generating a positive overall market performance also increases (note: data goes back to 1950).

The Federal Reserve Bank and Interest Rates

Since its first rate increase this cycle back in December 2015, the central bank has raised rates 7 times by one quarter point at a time. The Federal Reserve Bank is likely to raise rates again at its upcoming September meeting from 2.00% to 2.25% as continued U.S. economic growth looks likely to continue. The central bank has historically had a dual mandate which is focused on healthy employment and moderate inflation. Both of those objectives appear to have been met and a number of economic indicators such as employment, manufacturing and consumer and business confidence are currently at all-time or multi-decade highs.

Looking ahead, an important question is how much further the Federal Reserve Bank raise short term rates over the next few quarters. Right now, the general opinion (although there are some differences among economists) is that the central bank is likely to raise rates two more times this year and around three times in 2019. That would bring short-term rates to a level of 3.25%. If the economy continues to grow, long term rates should follow short term rates and continue to drift higher, reflecting additional Fed rate hikes, rising wages and somewhat higher inflation. As central banks overseas also start to reduce policy

S&P 500 Forward Performance Following 1st New 52-Week High in 6+ Months (Data Since 1950)

	+20-Days	+65-Days	+125-Days	+250-Days
Average	1.2%	2.9%	7.2%	13.1%
# of Observations	24	24	24	24
% Positive	66.7%	70.8%	91.7%	95.8%

S&P 500 Historical Performance (Data Since 1950)

	+20-Days	+65-Days	+125-Days	+250-Days
Average	0.7%	2.2%	4.3%	8.8%
# of Observations	17256	17211	17151	17026
% Positive	61.1%	65.9%	70.2%	73.6%

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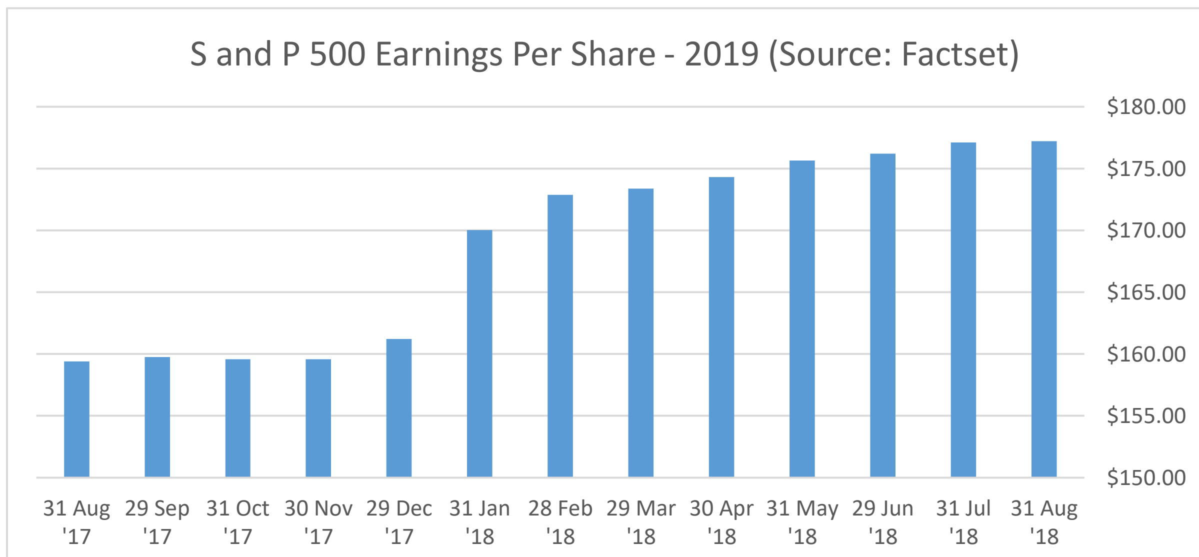
accommodation, (like the European Central Bank, for example) this should also allow U.S. Treasury Yields to move somewhat higher over the next few quarters. Rising interest rates reflect a healthy underlying economy and should not be feared as long as 1) rates do not move up too rapidly and 2) are justified by positive economic growth.

One growing concern is an inversion of the yield curve (i.e. when short term rates rise above long-term rates). At least historically, a yield curve inversion has had a strong track record of predicting economic down turns. However, it's important to point out two things. First U.S. long term rates are being kept abnormally low due to extremely low rates overseas (meaning an inversion of the yield curve might not provide the same signal that it has in the past). Second, even after the yield curve has inverted in the past, it has still been several quarters before an economic downturn takes place. All the same, further rate hikes by the central bank over the next year or two run the risk of causing a yield curve inversion which may lead to increased market volatility and uncertainty as we head through 2019. For now, short-term rates remain historically low and appear unlikely to threaten the current economic expansion. 2019 may be a pivotal year for monetary policy as central bankers debate the appropriate level of short term rates. This will be a story we will be following closely in the quarters ahead.

Corporate Profits

In terms of the profit picture, earnings per share (EPS) for companies in the S & P 500 have increased around 25% on a year over year basis in each of the past two quarters. Looking ahead, EPS growth is currently forecast to increase 20.9% this quarter followed by an increase of 17.2% in the fourth quarter of 2018. Full year 2018 EPS is currently forecast to grow 20.6% (note this estimate was 19.8% as of 6/30/18) followed by an increase of 10.1% for calendar year 2019 (note: the estimate for this was 9.2% as of 6/30/18). For 2018, all 11 sectors within the S & P 500 are currently forecast to generate positive EPS growth with 9 out of 11 sectors likely to post double digit growth. For 2019, all 11 sectors are once again currently forecast to generate positive EPS



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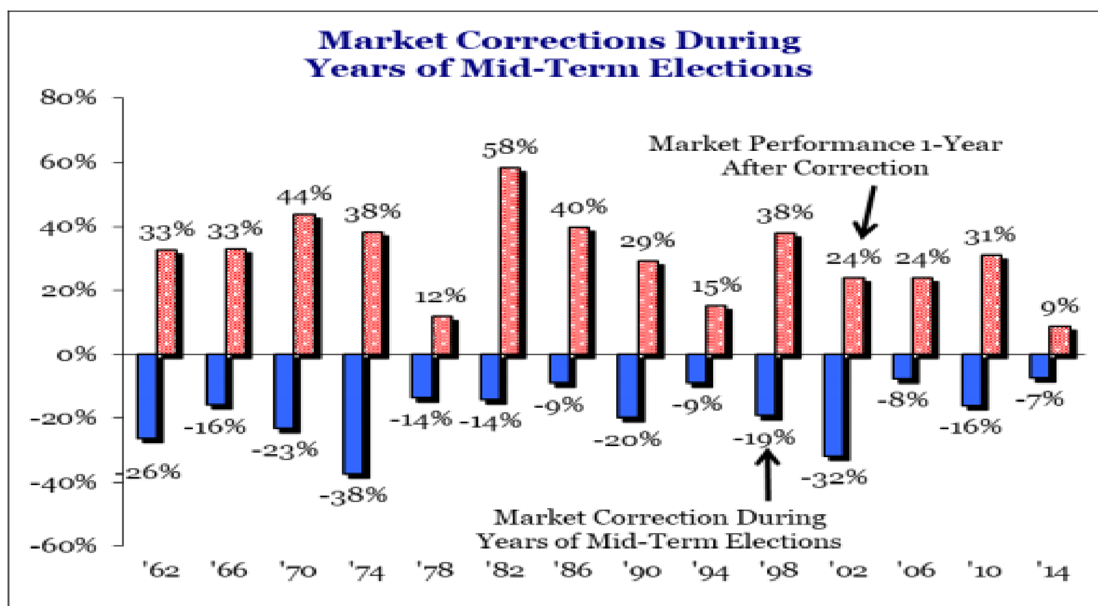
growth but just four out of 11 sectors are currently projected to post double digit EPS growth (source Factset).

On page 6 we have provided a chart which tracks the level of estimated EPS for 2019 (on a monthly basis). A big part of the increase in EPS growth over the past few quarters has been the result of changes in corporate taxes. According to the latest profit report from the Bureau of Economic Analysis (BEA) which tracks all corporations both large and small, corporate taxes declined 33% on a year over year basis last quarter. Without the Trump tax cuts, profits would still be rising but by a much less dramatic amount. Importantly company revenues are also rising and this should help sustain continued (but more moderate) EPS growth over the next several quarters. Revenues for companies in the S & P 500 are currently forecast to rise 8.2% in 2018 followed by an increase of 5.1% in 2019. All 11 sectors are currently forecast to generate positive sales growth in both 2018 and 2019.

MID-TERM ELECTIONS

Mid-term elections are now less than two months away. All 435 seats in the House of Representatives and 35 out of the 100 seats in the Senate are up for grabs. Based on currently available polling information (which can certainly change), the House of Representatives is likely to switch to the Democrats while the Senate is likely to remain in the hands of Republicans. With mid-term elections so close, it wouldn't be surprising to see a bit of choppiness in the markets over the next several weeks. On average, the markets have historically experienced moderate declines in the period leading up to mid-term elections but have then rallied solidly over the following 12 months. In the 14 election cycles dating back to the early 1960's, equity markets have generated gains 100% of the time in the one-year period following mid-term elections (see chart below – source: Strategas Research). This is certainly encouraging news, but we will continue to keep an eye on business



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fundamentals that we believe will ultimately help determine the direction of the economy, financial markets and stock prices in the period ahead.

Trade Wars with China

Over the past several months there has been a growing possibility of a trade war with China. On September 12, the Wall Street Journal (WSJ) released news that the Trump administration is reaching out to China for a new round of high-level talks. We do not know if the WSJ story is actually true (we assume it is) or whether anything will come from additional talks. More recently on September 17th, the Trump Administration followed through on recent threats and raised tariffs on another $200 billion in Chinese goods.

So far, it has been our opinion that the tariffs imposed on China are President Trump's way of negotiating and trying to extract better trade terms for U.S. companies that sell their goods overseas. The downside of tariffs is that they act like a tax on consumers and businesses and can undermine confidence levels. If President Trump follows through and raises tariffs even further on Chinese imports, this could lead to a period of increased financial market instability in the months ahead. Keep in mind that both China and the U.S. have a lot at stake. Ultimately, we believe that some kind of negotiated settlement is likely to occur as it is in the best interest of both countries. For reference, China exports more than $500 billion to the U.S. each year while the U.S. exports a little over $100 billion in goods to China. We will clearly continue to monitor this story as it unfolds in the months ahead.

Summary

As a result of continued growth in the U.S. economy along with positive corporate profit growth, relatively low interest rates and moderate inflation, we remain moderately constructive and believe that equity markets should be able to generate somewhat further gains heading into 2019. Importantly, based on a number of timely economic indicators that we follow (i.e. weekly jobless claims, the level of high yield bond spreads, the direction of the Monthly Leading Economic Index etc…) we don't currently see a recession looking out over the next few quarters. However, we would not be surprised if equity markets experienced some choppiness over the next several weeks as we digest recent gains and move closer to mid-term elections.

Our biggest concerns are that President Trump gets involved in an all-out trade war with China, the Federal Reserve Bank raises rates too aggressively (which could choke off economic growth) or that investors become overly concerned about rising U.S. debt levels. After generating 25% year over year corporate profit growth and 4.2% GDP growth last quarter, it's only natural to expect that growth will slow down somewhat over the next several quarters as we head through 2019. It's important to keep in mind that somewhat slower growth does not mean an outright decline or contraction in the economy. In short, despite 1) a number of concerns highlighted above along with 2) the age of the current expansion, we believe it's still premature to forecast an end to the current economic expansion and bull market.

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Due to the length of this report, we will be writing a separate update on the fixed income markets over the next few weeks. As always, if you have any questions please do not hesitate to reach out and give us a call.

Respectfully,

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