Making Sense of Finance

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Third Quarter 2018 Review

STOCK MARKET

If you had followed the old Wall Street adage “Sell in May and go away”, you would have missed out on the best quarterly gain in the stock market since the fourth quarter of 2013 as measured by the S & P 500 index. The index rose 10 of the 13 weeks in the quarter with a total gain over that time of 7.2%. Other major stock indexes had similar gains, the Dow Jones Industrial Average increased 9% and the Nasdaq Composite rose 7% in the third quarter and leads the way year to date with a significant increase of over 16%. Overall, the market moved upward in a steady fashion as no trading days last quarter closed with a gain or loss of more than 1%. Stock market advances reflected the growth in reported second quarter earnings (up 26.7% year over year) aided by lower tax rates and higher revenues (up 11.2% from last year). Also, investors were enthusiastic about operating margins which in the aggregate of S & P 500 companies were at a record in the second quarter, 11.55% (20-year average is 8.08%) and the continuation of enormous stock buybacks. All favorable news yet looming is the potential ramifications of tariffs, with another $200 billion on Chinese imports taking effect in September, which then caused China to retaliate with additional tariffs on $60 billion of US exports into China also taking place in September.

Healthcare and industrial stocks were the winners last quarter, as these sectors gained 14% and 9.5% respectively, in the third quarter which is when most or all of their year-to-date gains occurred. (On a year to date basis, healthcare sector up 15.2% and industrials up 3.3%). Other top sectors for the quarter and also performing well so far this year are consumer discretionary and technology stocks. Stocks that were flat in the quarter were primarily in the energy group, as oil prices were basically unchanged in the last few months, and the real estate sector, held down by rising interest rates. On a year to date basis, there is a wide variance among sectors in their performance. As of the end of September, among S & P 500 companies, the information technology group had a gain of 19.5% and at the other end of the spectrum the consumer staple category had a loss of 5.5%.

The U.S. stock market outperformed most foreign markets last quarter, as it has done most of the year, especially in US dollar terms. The MSCI EAFE Index of markets in developed countries increased approximately only 1% in the third quarter measured in US dollars. The recent strength in the US dollar tends to hurt emerging market economies more as higher oil prices (dollar denominated) hurt those countries that are net oil importers and countries that have

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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large dollar denominated debt must pay more. Stock markets in Turkey, Greece, Italy and Spain were among the worst performing last quarter. Sweden and Switzerland were among the better performing foreign stock markets as well as Mexico, aided by the settlement of NAFTA (North American Free Trade Agreement).

BOND MARKET

Bonds did not experience the same hefty returns of the U.S. stock market in the third quarter. Bloomberg Barclays Aggregate Bond index, which is a measure of a variety of quality U.S. bonds, had a zero return for the three-month period. In general, corporate bonds did better than Treasuries, as investment grade and junk bond (high yield) spreads tightened. Municipal bonds were slightly lower. The longer the term of the bond, the worse it did; when yields increase, prices come down.

Within a backdrop of continued economic growth (second quarter GDP up 4.2%) and increasing, yet low, inflation, the Federal Reserve increased rates for a third time this year in September. Most likely they will raise rates again in December. The effect has not only been a rise in short term Treasury rates but also long term. In the third quarter, a six-month Treasury bill rose from a yield of 2.11% at the end of June to close out September at 2.36%. During that same time period, the yield on a 10 Year Treasury rose from 2.85% to 3.05%, and as of the first week in October was 3.23%. In turn, mortgage rates have climbed as well as bank deposit rates, although still closer to historic lows than highs.

OUTLOOK

If you're speaking strictly about tariffs, the USA cannot lose the trade war with China. We import 3x what they do of U.S. products. A rise from cheap merchandise to a little less cheap may not have a great total effect on consumers, but we do think industrial companies will be hit harder. The U.S., for once, seems to be in the driver's seat. China has in fact lowered tariffs for imports since July, to stimulate its economy as its GDP growth rate slows. Conversely, US GDP seems to be accelerating or holding steady. At some point we should reach a level of equilibrium which should ease these trade tensions.

Rising interest rates have become de rigueur (regular). Indeed, there has been an anticipation of rising rates for over five years, and investors seem to have gotten used to the notion. Historically, interest rates remain near historic lows and it is our opinion that the psychological benefit for investors and the economy has already waned. We see this gradual reset of interest rates to more historical norms to be healthy. Should another economic slowdown occur, the government would have one less lever to pull if interest rates remained near zero.

The general economy continues to hum along. We still do not see any significant bubbles. Moderately higher stock valuations are reasonable given that we are still near a multi-decades low in interest rates. Real estate has had a good run in the past 10 years since the financial crises, but the frothy prices in hot markets has slowly been deflating in places like New York City, the bay area, and South Florida, etc. Much of it has been financed by foreign investors as the US is considered a safe haven. As long as building development slows, as it has been, then prices should settle. Property prices in mid-western states and in the heartland seem to be gaining ground, due to broader economic gains; another positive observation. Inflation remains a factor to watch. The most recent unemployment number was at a 48 year low. However, we suspect this number, while good, is a bit exaggerated due to a large able working population that is less motivated to find a job. Low unemployment does raise the specter of wage inflation. Recently Amazon.com said they would raise their minimum wage to $15 an hour and many other retailers have suggested they will follow suit.

Balance is always the key to sustained growth. Trying to grow too fast overheats the economy and leads to excess, which can lead to ugly corrections. I think most people would agree that as long as things continue to improve, then people will be happy. The Trump tax cuts have had a positive short-term benefit in the last 9 months. We think this could stretch to another year or more. It all depends on what actions the tax savings are used for. We had previously said that hoarding the money would lead to slow economic growth. Repatriation of foreign-held funds could help sustain this stock bull market with hundreds of billions of inflows into the U.S. over several years.

Like Warren Buffet, we are bullish on stocks over the long-term. Over the short term they seem to be attractive compared to other assets, although bargains remain limited. This plays into our strengths even more as stock pickers focusing on fundamentals and valuation. REITs have not performed well due to higher interest rates, but we think we are near a turning point, perhaps in 18 months when the FED signals it will slow down its rate hikes. Finally, bonds, which have mostly had negative returns in 2018 remain unappealing to us. We still utilize them for short-term stability buying shorter maturity bonds or bond funds. Consider that a 5-year treasury yields 3.05% but a 30-year bond yields a mere 3.27%. So for an extra 25 years of potential risk, investors are only rewarded by an extra 0.22%. No Thanks!

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