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INVESTMENT ADVISORS

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INVESTMENT REVIEW AND OUTLOOK

Change is in The Air

For much of the last three years the economic and investment narrative has been remarkably consistent: the global economy has operated in a pattern of synchronized growth, interest rates remained near historically low levels and inflation was largely subdued. Global stock markets reflected the favorable fundamental backdrop. Through September 30th the MSCI All Country World Index had a 3-year annualized return of 13.7%. U.S. equity markets fared even better with the S&P 500 turning in a 3-year annualized return of 17.9%.

Starting in late 2017 several developments emerged which had the potential to alter the economic and market backdrop. The most prominent of these was a shift towards tighter global central bank policies which were reflected in key lending rates as well as a reduction in open market purchases of debt securities. In short, borrowing has become more expensive over the last two years. A second trend that began late last year was a modest increase in the rate of inflation. Following almost a decade of sub-2% annual growth in the Consumer Price Index, the rate increased to 2% in late 2017 and 2.5% in the first half of 2018. Notable areas of strength include energy (+6.7%) and industrial commodities (+8%). Wage growth has also accelerated. With the U.S. unemployment rate is at its lowest level since 1969, shortages of workers have become widespread and the Wage Growth Tracker, reported by the Federal Reserve Bank of Atlanta, averaged 3.2% for the first half of 2018.

The U.S. economy continued to fire on all cylinders during the third quarter: real GDP is expected to exceed 3% for 2018, the economy is operating at essentially full employment and consumer confidence remains at multi-year highs. However, due in part to the developments described above, global economic trends have shifted from the synchronized growth discussed in recent letters. In Europe, China and parts of South America economic growth has slowed from the pace of 2017. The International Monetary Fund recently downgraded its estimate of global GDP growth for 2019 from 3.9% to 3.7% in response to slowing economic trends.

Additional factors weighed on global growth during the quarter. The deadline for the United Kingdom to reach an agreement on the terms of withdrawal from the European Union is March 2019 and progress has been halting. In Italy, the recently elected coalition government has proposed a budget which exceeds deficit guidelines established by the E.U. and Italian bond yields recently reached their highest levels since 2015. Emerging market economies in Turkey, Pakistan and Argentina were negatively impacted by the combination of higher energy prices, expanding deficits and currency declines.

Stock market performance in the third quarter reflected the diverging economic outlook. While the S&P 500 had a return of 7.7%, foreign markets were more mixed and the MSCI All Country World Index returned 4.4%. Several foreign markets had negative returns during the quarter including Germany (-0.5%) and Hong Kong (-4%). The Lipper Balanced Fund Index returned 3% in the quarter and 3.2% for the year to date. Bond returns were modestly positive during the quarter. The Barclays U.S. Aggregate Bond Index returned 0.02% for the quarter and -1.6% for the year to date.

An Unheralded Big Story

One of the most consequential developments of 2018 has been the steady increase in global interest rates. During the third quarter the yield on the benchmark 10-year U.S. Treasury bond rose above 3% and in early October the yield reached 3.25%, a level last seen in 2011. Similarly, short-term interest rates, as reflected by the 3-month Treasury Bill, rose to 2.25% in the quarter. The rise in short-term interest rates is even more dramatic than long term rates because short-term rates were essentially zero in the years following the financial crisis of 2008-2009. As a reference, the yield on the 3-month Treasury Bill was 0.08% as recently as October 2015.

Over the last year we have written about several of the forces that could cause a rise in interest rates. These include tightening central bank policies, modestly rising inflation, increasing Federal Government deficits (which precipitate increased borrowing by the Treasury) and expanding world economies. The recent increases in both short-term and long-term interest rates appear to indicate that, after a prolonged period of central bank intervention, market forces are again reasserting themselves in the credit markets. While we view this as a constructive development and a sign of the greatly improved health of the global economy, there are important consequences of higher interest rates. These include:

- Higher borrowing costs for businesses and consumers. Home mortgage rates have increased significantly. In early October the interest rate on a 30-year fixed rate mortgage averaged 4.8% which was a level last reached in 2011.

- The increase in interest rates is also likely to have an impact on borrowing costs for the federal government. The Congressional Budget Office (CBO) projects that a 2019 Federal budget deficit of $1 trillion and total federal debt outstanding in 2018 is estimated at $21 trillion. Interest payments on federal debt equaled 6.8% of the federal budget in fiscal 2017 and this figure is expected to exceed 10% of the federal budget by 2020, according to the CBO.

- For investors, higher interest rates are a mixed blessing. Higher rates are a boon to savers who invest in short-term money market instruments. The Federal Reserve estimates the total value of short-term money market funds at over $3 trillion; a 1% increase in short-term interest rates adds over $33 billion to holders of money market funds. On the other hand, higher rates act as a headwind for stock valuations, and bond prices have an inverse relationship with interest rates; when interest rates rise, bond prices decline.

In general, the trend towards higher interest rates can be viewed in a positive light which is reflective of a growing economy and reduced central bank intervention. However, following a prolonged period of abnormally low interest rates, such as we have experienced from 2010-2016, investors need to be mindful of both the challenges and the opportunities of higher rates.

Making Sense of the World

While interest rates are an important, if unheralded, development in 2018, there are a myriad of other concerns on investors' minds. In the U.S., the administration has proposed a significant broadening of tariffs on imports from China (in addition to existing tariffs which were implemented in fall of 2018). Mid-term elections are less than a month away and the U.S. electorate appears deeply divided; following several years of legislative success and regulatory reform, a significant shift in either the House or Senate may portend gridlock in the year ahead. Outside the U.S., the world remains an unsettled place: a strong undercurrent of populism is evident in Europe as demonstrated by the difficult Brexit negotiations and the recently proposed Italian budget. China and Russia are both continuing a pattern of more assertive behavior which has sometimes violated the norms of diplomacy. In short, geopolitical tensions remain elevated, as they have been for much of the last decade.

Taking into consideration the shifting economic picture, the potential for higher inflation and interest rates and the unsettled geopolitical climate, our portfolios are guided by the following:

- For the reasons cited above, we expect a modest deceleration in global GDP growth. While the rate of corporate profit growth will likely slow, we do not expect a recession in 2019.
- Our equity weightings continue to be at or below the benchmark for balanced portfolios. We are maintaining prudent cash reserves for clients with an all-equity allocation.
- Given the potential negative impact of higher interest rates on long-term bonds, our balanced portfolios continue to emphasize short and intermediate maturities for the fixed income allocation.
- In a period of rising interest rates, we are paying careful attention to company valuations for new purchase candidates and we are avoiding highly levered companies.
- Given signs of incipient inflation, we are seeking investments with above-average pricing power and/or attractive unit growth characteristics.
- There continues to be a wide valuation disparity between U.S. and foreign equity markets. Our search for opportunities outside U.S. markets is ongoing.

As always, we welcome your comments and questions.