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Market Commentary

October 10, 2018

"October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February."

Mark Twain, Pudd'nhead Wilson

As fall begins, pumpkins arrive on doorsteps, and a welcome chill enters the air – even here in Texas. Perhaps it's simply the glowing ghosts on my front lawn, but the market can appear more fraught at this time of year. With the specter of trade wars, inflation and emerging market woes looming, markets largely treaded water in September. As Mark Twain suggests above, investing always entails taking some risk, no matter what month you are in.

	September Return	YTD Return
S&P 500	0.6%	10.6%
Russell 2000	-2.4%	11.5%
MSCI EAFE (Europe, Asia and Far East)	0.9%	-1.1%
MSCI EM (Emerging Markets)	-0.5%	-7.5%
Gold	-0.9%	-8.6%

Source: Bloomberg. Indexes are total return.

Equity Markets:

Equity markets hit the pause button in September, though the environment overall remains constructive. Large cap stocks posted a nominal gain for the month, but still posted a sizable increase for the year to date of almost 11%. After solid outperformance of small-cap stocks in August, the Russell 2000 retreated in September, down over 2%, though year-to-date gains are still impressive at almost 12%. Outside the US, equity gains were also muted, with the MSCI EAFE up marginally and the MSCI EM down marginally.

Despite concerns about equities being expensive, the S&P 500 is currently priced at 16.8x forward earnings estimates, just slightly above the 25-year average of 16.1x, and the index's dividend yield of 2% is right in line with its long-term average. For the first half of 2018, earnings growth reached a whopping 27%, boosted by the corporate tax cut. Next year, without the added bonus of a tax cut, corporate earnings are expected to increase by a more modest, though still impressive, 10.5% year-over-year.

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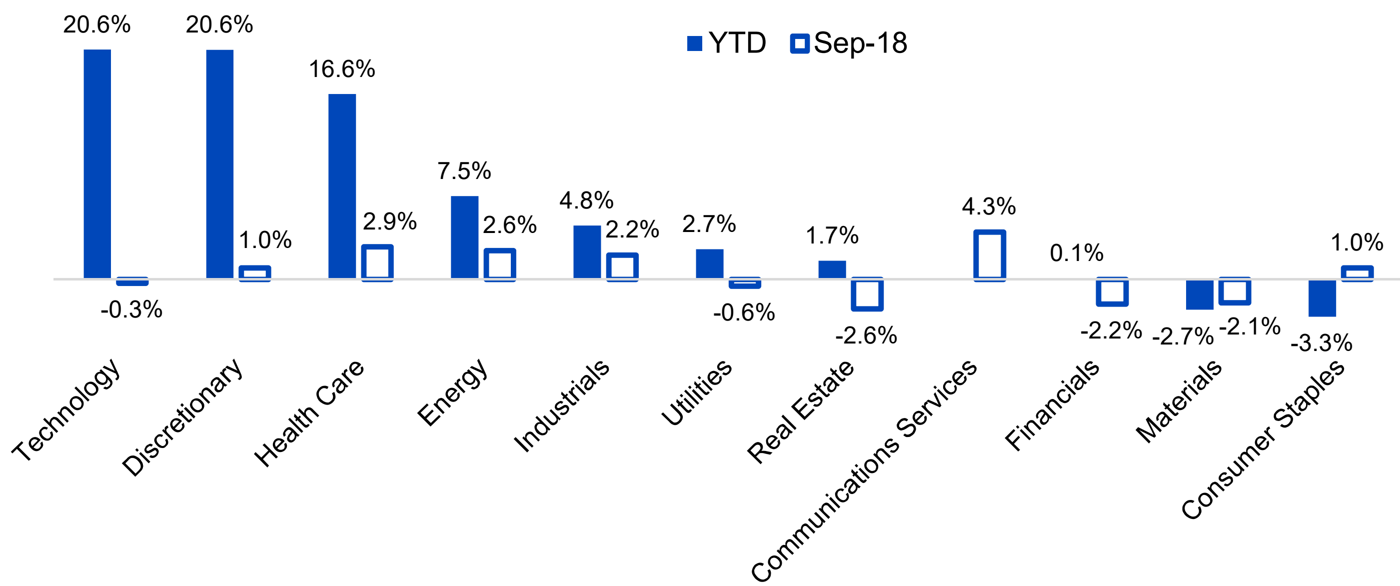
With more cash in their collective pockets, US companies continue to boost corporate spending in a number of ways. Companies are aggressively buying back their own stock, at a pace well above previous years. The full outlay is expected to hit $1 trillion this year. Not slowed by the pace of buybacks, companies are continuing to increase capital expenditures and acquisitions of other companies.

US Sector Scorecard:



Source: Bloomberg, S&P 500 GICS Sectors Level-1

The new Communications Services sector made its grand debut in September. As discussed in last month's note, the new sector culled some of the biggest and best known companies from the Technology, Consumer Discretionary and Telecom sectors, and went on to post the best returns of any sector, rising 4.3% for the month. Buoying returns, the new sector enjoyed more than $1.5 billion in inflows as investors rushed to get access to the new grouping.

The Energy sector rose 2.6% for the month in tandem with higher oil prices, helped by a new high in US oil exports of 2.2 million barrels a day, and the US government's impending re-imposition of sanctions on Iran. Despite the political gyrations, the Energy sector is the most loved among Wall Street analysts with a full 59% of all stock ratings a Buy. Analysts' admiration of the sector is no surprise given that Energy earnings are expected to increase by 24% in 2019 – higher than any other sector.

Real Estate, Financials and Utilities were three of the four worst performers in the month. Those high-dividend-paying sectors sold off as long-term rates marched higher. Despite Financials' lackluster performance in September, earnings are expected to jump by more than 25% over the next 12 months, helped by higher short-term interest rates. Relative to the broad market, valuations and dividends for the sector are attractive.

Fixed Income:

	September Return	YTD Return
US Fixed Income Aggregate	-0.6%	-1.6%
1-3 Year Treasury	-0.1%	0.2%
5-7 Year Treasury	-0.9%	-1.7%
10-20 Year Treasury	-1.9%	-4.1%
Municipal Bonds	-0.6%	-0.4%
High Yield Bonds	0.6%	2.6%
Corporate Bonds	-0.4%	-2.3%

Source: Bloomberg. Total returns based on Bloomberg Barclays indexes.

In the bond world, investors were rewarded for taking credit risk in September, but punished for taking duration risk. The pain was most notable within 10-20 year Treasurys which declined 1.9% for the month, more than retracing the 1.3% gain in August. The 10-year Treasury yield reached 3.1% at the end of September, its highest level since May 2018. Shorter duration Treasuries fared better, with 1-3 year issues essentially flat for both the month and year-to-date periods.

In contrast to duration bets, credit risk was rewarded in September as the high yield index rose 0.6%, versus high-quality corporate bonds which declined by 0.4%. With that outperformance, credit spreads – or the difference between high-yield bond yields and corporate bond yields – reached their lowest level since 2006. Supply and demand of high-yield bonds has remained carefully in balance. Investors pulled $34 billion from high-yield funds for the year to date, which would normally drive down bond prices. But this pressure was offset by a decline in the amount of new high-yield bond issuance of 30% year on year. Companies that are issuing high-yield debt are still well positioned to continue paying their debts, even this late in the cycle. With record levels of cash, high-yield companies' default rates are among the lowest of this cycle.

The Economy and the Fed:

The labor market continued to tighten with just 3.7% of the workforce looking for a job. The improvement in employment has been fairly widespread with college degree holders and those without a high school degree – and practically everyone in between – enjoying more jobs and higher wages. This solid jobs picture has buoyed consumer sentiment and spending alike. Folks are looking and feeling good.

The flipside of that positive picture is inflation. With wages marching higher, companies spend more to produce, and in turn have to raise prices for the end consumer. Broad price indices such as the Consumer Price Index (CPI) are reflecting this. CPI reached 2.2% year on year, well below its long-term average, but at the top end of its range since 2008. It is this cycle of price increases that the Federal Reserve is watching closely as it decides how much, and how fast, to raise interest rates. In September, the Fed raised the federal funds rate another 25 basis points to 2.00-2.25%, its third such raise this year. The markets are currently anticipating another rate increase in December.

Inflation represents an important risk to continued economic growth. Unlike, for instance, a trade war, which can be ended with an agreement, inflation is a difficult beast to tame because it is so broad based. At current levels, price increases are still at a very manageable level but the issue bears close evaluation.

Conclusion:

Markets do indeed climb a wall of worry and the present is no exception. Just as my kids will willingly walk past those glowing ghosts and scary skeletons for some candy, so must investors look past the markets' latest concerns and keep focused on the long-term plan. Interestingly, since 1926, the S&P 500 has only been up every month April through September five times – and one of those was in 2017. In each of those periods, the market was up for the following fourth quarter. Will the fourth quarter of 2018 follow suit? Only time will tell.

Regards,

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Chief Investment Officer

Definitions: S&P 500 Index: A broad based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. It is a capitalization-weighted, unmanaged index that is calculated on a total return basis with dividends reinvested. The S&P 500 represents about 75% of the NYSE market capitalizations.

Russell 2000 Index: This index measures the performance approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

MSCI Europe, Australasia, and Far East (EAFE) Index: This index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada.

MSCI Emerging Markets Index: This index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of June 2009 the MSCI Emerging Markets Index consisted of the following 22 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

Bloomberg Barclays U.S. Aggregate Bond Index: A market capitalization weighted bond index of investment grade U.S. dollar-denominated fixed-income securities.

Bloomberg Barclays Municipal Bond Index: The Bloomberg Barclays U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds. Gold (spot): Gold price per ounce in US Dollars.

S&P 500 GICS Sectors Level-1: In 1999, MSCI and S&P Global developed the Global Industry Classification Standard (GICS), seeking to offer an efficient investment tool to capture the breadth, depth and evolution of industry sectors. GICS is a four-tiered, hierarchical industry classification system. It consists of 11 sectors, 24 industry groups, 68 industries and 157 sub-industries. Companies are classified quantitatively and qualitatively. Each company is assigned a single GICS classification at the sub-industry level according to its principal business activity. MSCI and S&P Global use revenues as a key factor in determining a firm’s principal business activity. Earnings and market perception, however, are also recognized as important and relevant information for classification purposes, and are taken into account during the annual review process.