Commentary

Trade Update

With time running out, Team Trump and Canada came to terms on NAFTA 2.0. While that's not the official name (try USMCA!), NAFTA 2.0 is likely to stick. It'll take time to fully digest the actual language in the document, but it appears to address several of Trump's grievances. Briefly, it seeks to strengthen auto manufacturing jobs in North America relative to Mexico by setting minimum wages and production targets. It also purports to weaken protections for Canadian farm products from U.S. competition, an often repeated Trump gripe. Of course, there's other stuff in there too, and we'll need some time to figure out what's really changed, if anything. The treaty will have to make it through the respective legislative bodies—much depends upon the November elections. There's no way to exaggerate the degree and depth of contempt that Democrats have for everything Trump, but the auto stuff is absolutely pro-labor. If you're a political cynic, it'll be interesting to watch the Dem's contortions on this. And free-trade Republicans won't want to support it either, but auto jobs are political dynamite - handle with care.

The equity markets took the resolution as a positive sign. Perhaps there's some read-through to China. Perhaps not. We in the financial services industry love auto workers and farmers as much as anyone, but there's just not much to gain (economically) from bullying tiny, friendly neighbors about auto and farm jobs. By the way, they make cars in Mexico because wages are $5.00 an hour. We can't recall any voting block bellyaching for more expensive cars. And we have no idea where Canadian bacon is made, but if it's in Canada, don't mess with it--lean and delicious. Try it.

As for China, that trade conflict - the real show - escalated during the third quarter. On September 24th Trump placed a 10% tariff on $200 billion of Chinese goods. That tariff is set to rise to 25% at the end of the year if no deal is reached. Trump further threatened to hit another $260 billion in Chinese exports if China retaliates. China responded with tariffs 5%-10% on another $60 billion tranche of U.S. exports, substantially all remaining. Ten percent of $200 billion isn't much to worry about relative to our $20 trillion economy, but critical manufacturing supply chains for U.S. technology and industrial companies reside in China. Many of these businesses have led the U.S. stock market's long ascent. Several have already warned that tensions will have earnings consequences. Jack Ma, one of China's business elites, says a trade war could last twenty years. We simply don't know where this is going. We don't know what's in Trump's heart - campaign slogan or dead seriousness? It's one thing to get rough with Canada - something akin to picking on your little sister - but China has cities bigger than all of Canada, population-wise. Stay tuned.

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Commentary

What Does the Market Know?

Millions of individual investment decisions made with no coherent view of the future push the markets this way and that every day. Out of something that from minute-to-minute mostly resembles chaos often comes a reasonable approximation of what is happening. Pundits say "the market knows." The third quarter produced strong equity returns while the 10-year Treasury yield finally climbed above the psychologically important 3.0% level and stayed there, although it's still close. A historical read of those two signals would suggest that the economy will remain strong in 2019, but not too strong. And yet the 2019 economic backdrop will be noticeably different. In no particular order, higher interest rates, slower housing, higher oil and gas, and tougher trade will conspire to slow the economy. The tax cut-induced earnings spike will be in the rearview mirror and federal spending, while high, won't accelerate. Our predictive powers are inexact so our guess is these forces are sufficient to slow growth. The degree by which it slows happens to be quite important. Seemingly modest changes (as measured on Main Street) in near-term economic growth can have significant consequences for market leadership. If growth falls back to around 2%, the market's infatuation with the mega-growth stocks could well continue, as exceptional growth will remain dear. Downshift further and investors might get spooked into the defensive, dividend payers, probably at the expense of mega-growth. But, if economic growth stays closer to 3%, participation could broaden considerably, lifting all boats - a welcome change. We're positioned for the 2-3% range. If that sounds like economist speak for 'hey, we don't really know, but we think growth will be ok', you'd be correct. In any case, somewhat slower growth would be healthy for this long bull market as the biggest danger today is economic overheating, causing the Fed to become more aggressive with rate hikes. To put it most plainly, you can jog a hell of a lot further than you can sprint.

The Financial Markets

- Equities surged to record highs in the third quarter of 2018, with the S&P 500 Index gaining 7.7%. The Dow Jones Industrial Average climbed 9.6%, while the Nasdaq Index rose 7.4%. The Russell Mid-Cap Index advanced 5.0%. Small cap stocks lagged with a 3.6% gain in the Russell 2000 Index.
- Health Care, Information Technology, and Industrials were the best performing sectors in Q3. Materials, Energy, and Real Estate were the laggards. All S&P sectors produced positive returns during Q3.
- International equities were mixed, as slight gains in developed markets were diminished by declines in emerging markets. The MSCI ACWI ex US Index was up 0.7%.

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The Financial Markets (continued)

- Commodities prices languished, with the Bloomberg Commodities Total Return Index falling -2.0%. Energy prices generally strengthened while industrial and agricultural commodities softened.
- Equity volatility was subdued as measured by the CBOE Volatility Index (VIX), an indicator of investors' expectation of volatility.
- As expected, the Federal Reserve raised the Fed Funds target rate another 0.25%, lifting short-term rates to 2.0%. This marked the third rate hike of 2018 and the eighth increase since Dec. 2015.
- Government bond yields continued to move higher, with the benchmark 10-Year Treasury Note yield ending the quarter at 3.06%, up 20 basis points from June 30.
- The exchange rate of the U.S. dollar continued to rise versus other major currencies, due to higher interest rates and stronger growth in the U.S.

The Economy

- The U.S. economy continued to grow at an above-trend pace in Q3, with GDP growth expected to exceed 3.0%. Q2 growth was a robust 4.2%.
- The U.S. labor market remains strong. Non-farm payrolls expanded by an average of 190,000 over the three months ending in September. The unemployment rate reached a 48-year low of 3.7% in September. Average hourly earnings rose 2.8% y/y.
- Retail sales indicated solid consumer spending in July followed by a softer reading in August. The strong labor market and rising wages are supportive of consumer spending.
- Inflation has edged up modestly this year, with the Consumer Price Index rising 2.3% year-over-year through September. The core rate (ex-food and energy) was up 2.2% year-over-year. Inflation expectations remain well anchored.
- Housing starts are up 6.6% year-to-date, but momentum slowed in Q3. Cost pressures on new homes, exacerbated by labor shortages, and higher mortgage rates are headwinds for this economically sensitive sector.
- According to the Institute for Supply Management (ISM), the ISM Non-Manufacturing Index (NMI) jumped to 61.6 in September from 58.5 in August, the highest reading in 21 years, signaling broad-based gains in the services sector at the end of Q3.
- On top of President Donald Trump's plans to implement additional tariffs on billions of imports, the rising exchange rate of the U.S. dollar is a headwind for U.S. exporters as it increases the price of their goods in foreign markets.

Commentary

Future Prospects and Portfolio Strategy

- Macro-Economic Indicators (+): The U.S. is experiencing robust economic growth, while overseas economies have slowed. Despite concerns over the uncertain impact from an escalating trade war with U.S. trading partners, particularly with China, global economic growth remains favorable.
- Interest Rates/Credit (-): Monetary policy is no longer accommodative. Given upbeat economic fundamentals and inflation slightly above its target of 2.0%, the Federal Reserve is more hawkish -- projecting one additional interest rate hike in 2018 and three more in 2019. With the 10-year Treasury Note moving above 3.0%, equity markets have become concerned that further Fed tightening may be the tipping point that ends this economic expansion. Attention remains focused on a flattening yield curve, with the 2yr/10yr spread falling to about 24 basis points from 85 basis points a year ago. An inverted yield curve has at times been a precursor of recession.
- Valuation (N): Robust earnings growth has underpinned the long equity advance, keeping valuation measures near long-term averages. Trade tensions have been mentioned in some corporate earnings pre-announcements, but we expect these to be the exceptions rather than the rule, at least for now.
- Sentiment (N): At quarter-end, U.S. Advisory Sentiment readings were nearing the frothy levels of late January, signaling the market could be at risk of a near-term correction. However, investor sentiment has subsided with the equity market decline in early October. Mounting concerns about the global trade war could be a catalyst for more favorable readings (reduced optimism).

Summary: This year's advance in equity markets coupled with the break above 3.0% on the 10-year Treasury Note suggest the economy is running at a brisk pace. Corporate tax cuts and unorthodox late-cycle deficit spending ramp have no doubt boosted the economy and stimulated the markets. Is the porridge too hot? Perhaps at this moment. Heading into next year, rising interest rates, higher oil prices and slower housing, in addition to the anniversarying of the tax cuts and federal spending increase, will most likely cool things off a bit--ideal for the health of this extended bull market.

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