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Third Quarter Investment Commentary
October 2018

Genius is eternal patience. - Michelangelo

The Quarter in Review

- The Federal Reserve increased short-term interest rates for the third time this year to a target range of 2 to 2 ¼ percent.
- The 10 year Treasury yield ended the quarter above 3%.
- President Trump imposed 25% tariffs on $50 billion in Chinese goods and announced a 10% tariff on an additional $200 billion in Chinese goods effective at the end of the quarter, which will rise to 25% at the beginning of 2019.
- 2018 was one of the hottest summers on record. Globally, 2018 is shaping up to be the fourth-hottest year on record.
- Croatia advanced to their first-ever World Cup final, but lost in the final to France.
- U.S. equity markets outperformed international markets.
- Facebook stocks dropped 20%, setting a record as the biggest single stock market loss in one day, and marking the first time that a stock lost over $100 billion in one day.
- Apple Inc. became the first public company to be worth $1 trillion.
- Mid-term election campaigning heats up.

Economic and Market Review and Update

Following a synchronized global expansion in 2017, economic growth has become more uneven across regions this year. The U.S. economy continues to be strong and has accelerated in the second and third quarters as tax cuts and reduced regulations stimulate the economy. But increasing trade concerns, a stronger dollar and higher debt has weighted on global growth.

Global trade growth slowed in the first half of 2018 with trade tensions adversely affecting confidence and investment plans. To date, these effects have been offset by fiscal stimulus in the U.S. boosting corporate earnings, confidence and spending.

This stronger growth has led to a robust labor market where there are more job openings than the number of hires, a sign employers continue to have difficulty filling open positions. Reflecting the difficulty in finding qualified workers, wages are increasing, up 2.9% annually. Wage and price inflation are surprisingly low but should continue to rise gradually. Wage growth of 4% has proven to be a warning signal for inflation and more Federal Reserve tightening (interest rate increases, shrinking balance sheet).

In addition to rising wages, increasing input prices due to higher tariffs are a risk to inflation as businesses raise prices to compensate for their higher costs. The Federal Reserve increased the federal funds rate by 25 basis points (0.25%) in September, gradually raising rates to try to maintain a level of growth without much higher inflation.

Global economic growth is expected to decelerate into 2019 as fiscal stimulus fades, monetary accommodation is removed, the dollar strengthens and there is a less favorable trade environment. A recession does not seem to be imminent, but we are likely in the late cycle of this recovery. The domestic imbalances that typically precede recessions have not yet developed. A trade war is a potential negative, as well as is restrictive economic policy.

As ugly as Washington politics has become and dominating all of the news channels, this is not what drives financial markets. Greg Valliere writes "we *understand the widespread frustration with Washington's dysfunction, which was so ugly yesterday. But an unmistakable trend is that the markets don't seem to care. A new budget in Italy, breaking an EU understanding on fiscal restraint, has had more of an impact on the markets than the Kavanaugh hearings. This week's FOMC meeting was more important for investors than the hearings. Savvy investors have looked past the dysfunction and instead have focused on the fabulous economic fundamentals that have propelled the stock market to record highs. Along the way, there have been partisan issues that investors do have to follow -- trade, deficits, tax policies, etc. But the Kavanaugh hearings, the Trump tweets, and the political ugliness have not moved the markets.*

So it's on to the next earnings reports, starting in a few days, which should be solid once again. Retail investors, bombarded by Fox and CNN, worry about Washington and the impact on their finances -- but they shouldn't worry, because the economic fundamentals are remarkably sound even if Washington is not."

Not a Stock Market, But a Market of a Few Stocks

We have written before about how just a handful of stocks have driven the returns of the S&P 500 this year. (This is not an unusual phenomenon, by the way.) The top five stocks, Apple, Amazon, Alphabet, Microsoft and Facebook currently make up slightly over 16% of the total market value of the S&P 500. The math is pretty simple; if the index was equally weighted among all 500 stocks in the index, the percentage these five stocks would represent would be 1%, not 16%.

Diversification Failed Us

Ben Hunt, Ph.D., was the chief investment officer at the investment firm Salient; he now posts his thoughts on the Epsilon Theory web site. His most recent work is entitled "Things Fall Apart (Part 2)". Below is an excerpt from that post.

"And here's the bottom line for how Things Fall Apart in the black hole of modern investing. In a multi-asset class market with high-peaked unimodal investor preferences:

There is no winning diversification advocate.
There are no outperforming diversified portfolios.

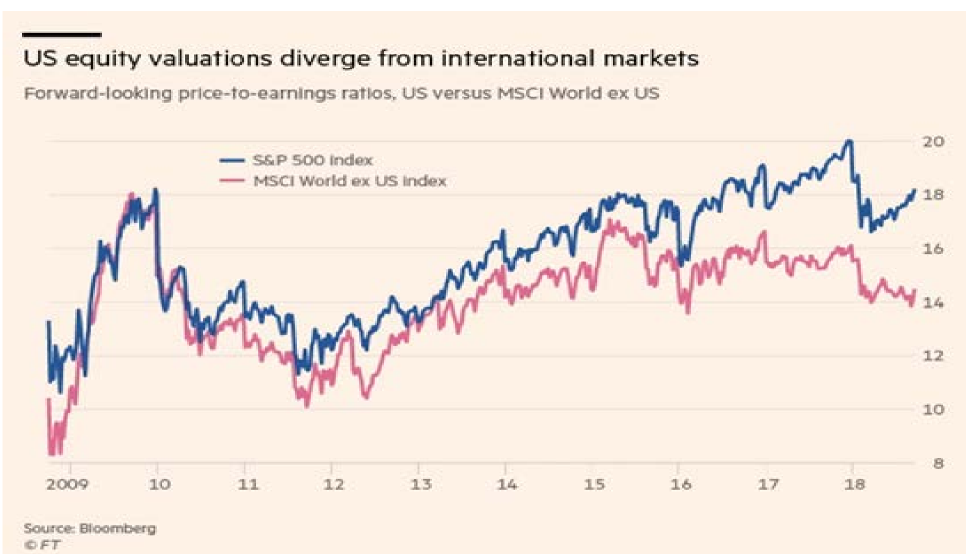
Sorry.

I can't overemphasize how damaging the failure of diversification is to both our portfolios and the stability of our financial advisory system. As both investors and advisors we have put our faith in the power of diversification, and when that Greater Power deserts us we are left open and exposed."

What Dr. Hunt is referring to is that over the last decade, since the Great Financial Crisis (GFC), Great Recession or whatever you want to call the period of 2008-09, the S&P 500 has outperformed virtually every asset category – Value, Quality, Emerging Markets, Real Assets (gold, oil, etc.), Developed International Markets and Hedge funds. U.S. large-cap growth has done even better (see the aforementioned five stocks). This contradicts Modern Portfolio Theory, which is built upon the idea that a portfolio of uncorrelated asset classes will, over time, outperform any one of its components, particularly on a risk-adjusted basis. That certainly has not been the case thus far in 2018. Part of the reason for the out-performance of the S&P 500 is the amount of money that has flowed into the funds that track the index. An example of this is illustrated by the exchange-traded fund (ETF) universe. The ETFs with the ticker symbols SPY, IVV and VOO all track the S&P 500 index; VTI is a total U.S. market index, but is still dominated by stocks in the S&P 500. Right now, these four ETFs total approximately 45% of the entire ETF universe. With that level of the dollars going into ETFs being directed into large-cap U.S. stocks, the basic principle of supply and demand would manifest itself in the pricing of those stocks.

Tough Times to Be a Global Investor

We believe that asset allocation and diversification is not dead, but rather is on hiatus. Since the GFC, the four major central banks of the world (U.S., China, the EU and Japan) have embarked upon an unprecedented policy of fiscal stimulus, originally to save the financial system, but as Dr. Hunt asserts, this policy has become "…permanent government policy to use the financial system for political gain." Financial assets are owned by the 1%, and those that are included in 1% are influential in government policy.



Mea culpa? Perhaps. There was no reason, in our minds, to believe that, post the GFC, the S&P 500 would embark on a ten-year domination of virtually every other asset class. Not every year, mind you, but in total over the period. The chart above illustrates the levels of valuation of the U.S. markets vs. the rest of the world. The divergence between these two markets has not been this wide since 1970. All things must come to an end, however, and we believe that diversification will return from its extended leave of absence.

If you look back at the history of S&P 500 returns vs. the rest of the world, U.S. stocks have dominated only because of their performance over the last few years.. With the valuations illustrated above, it shows us that non-U.S. stocks are overdue for a period of out-performance.

Closing Comments

I (Kevin) recently made a pilgrimage to Elkhart Lake, WI, with a stop in Iowa City, IA to see a client. My observations along the trip are as follows:

- Summer appeared to be losing its grip on us; when I checked into the motel in Iowa City it was 95 and when I checked out the next morning it was 61.
- The vehicles travelling well above the speed limit are those which would appear to be incapable of achieving that velocity.
- If truck traffic on I-80 is any indication, the American economy is alive and doing very well.
- Speaking of I-80, the Iowa rest areas along this Interstate are the best I have ever visited.
- The Wisconsin Department of Transportation needs to increase its budget for road maintenance. Immediately.
- Finally, people who say that the Plains are a flat wasteland do not understand the subtle beauty of manicured farmland, rolling hills and a sky that seemingly stretches beyond the horizon.

Here we are in the last three months of the year. Crisp mornings, leaves changing color, Halloween, Thanksgiving, Hanukkah, Christmas are all on their way. What a great time to enjoy family and friends.

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